LAW AND ECONOMICS YEARLY REVIEW

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

Editors

F. CAPRIGLIONE – R.M. LASTRA – R. MCCORMICK
C. PAULUS – L. REICHLIN – M. SAKURAMOTO

in association with
Mission

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

Address

Fondazione Gerardo Capriglione Onlus
c/o Centre for Commercial Law Studies
Queen Mary, University of London
67-69 Lincoln’s Inn Fields
London, WC2A 3JB
United Kingdom

Main Contact

Fondazione G. Capriglione Onlus - fondazionecapriglione@luiss.it
Editor-in-Chief
F. Capriglione

Editorial Board

Editorial Advisory Board
A. Migliorico - D. Siclari - I. Kokkoris - N. Casalino

ISSN 2050-9014

Review Process
1. Articles and case notes submitted to the Review will be reviewed by at least two reviewers (chosen among the Editorial Board members) and, where necessary, by an external advisor.
2. Any paper will be submitted by the Editorial Board – anonymously, together with an evaluation form – to the reviewers for an overall assessment.
3. In case of a single negative evaluation by one of the reviewers, the Editor-in-chief may assume the responsibility to publish the paper having regard to highlight this circumstance.
4. In any case, the submission of the paper or its positive evaluation does not provide any right to the author to ask for the publication of the paper. Fondazione Gerardo Capriglione Onlus may reproduce articles published in this Review in any form and in any other publications.
CONTENTS

Sovereign defaults to be solved by politicians or by a legal proceeding? .................. 203
Christoph G. Paulus

Financial crises. Where do we stand? ........................................................................ 234
Fabiano Colombini

Credit rating agencies, their regulation and civil liability in the European Union ...... 264
Mads Andenas

Parliamentary democracy and the Eurozone crisis ...................................................... 314
Elena Griglio - Nicola Lupo

Selected aspects of the European sovereign debt crisis ............................................. 375
Michael Hanke

The difficult journey towards European political union: Germany’s strategic role .... 392
Ulrike Haider - Valerio Lemma

Banking corporate governance and non-executive independent directors after the crisis: the case of Italy ................................................................. 447
Charles Mayo - Domenico Siclari

The impact of the global financial crisis on the Russian banking system............... 473
Galina Gospodarchuck - Sergey Gospodarchuck
SOVEREIGN DEFAULTS
TO BE SOLVED BY POLITICIANS
OR BY A LEGAL PROCEEDING?

Christoph G. Paulus*

ABSTRACT: Starting out from the overview of recent sovereign crisis, this paper sets out to examine the principal reforms and normative changes put in place through a new regulatory framework. In particular, the article considers whether, in the middle of the restructuring process, the proposed European Stability Mechanism (ESM) is such a good new solution or whether a different mechanism should be at place. However, the ESM is a highly political institution both with respect to its staffing and its mandate. So, the question at stake is: should politics be the driving force? It is argued that private sector is important only insofar that it has to waive part (or all) of its rights; but it has no rights whatsoever on its own against the debtor state or against the official sector represented by the ESM. The private sector, thus, is needed for relieving the sovereign’s debt burden but has no tools or remedies to demand anything from that sovereign in exchange for its own contribution to the restructuring; that power is exclusively given to the ESM. As a result, a closer examination of the new regulatory perspectives suggests that this brings to light a manifest normative development in the sovereign defaults issue.

1. At the present point of time, at the end of 2012, Europe is bound to look back to a period of almost five years in which one crisis replaced the other. The bad news is that, as of now, there is no safe prediction possible as to whether or not the pandemonium is over. What began as a financial crisis on a global scale due to the bursting real estate-bubble in the US and is inextricably associated with the name of the Lehman Bank, was followed by the Greek budget crisis in early 2010 that, due to the contagion effects on Ireland and Portugal (maybe also on Spain and Italy), almost caused a currency crisis of the Euro.

In sight of such a series of dramatic – previously in this intensity rather unknown – occurrences, one is tempted to raise more fundamental questions than just the usual ones as to which measures are necessary to overcome these crises, or – legally – who has to shoulder the responsibilities and liabilities. Suspicion grows that these crises are an expression of something deeper rooted than just individual failures; they might signal the dooming of the capitalistic system as did some decades ago the collapse of the Soviet Union indicate the decline of the socialistic system1.

Alternatively, and somewhat less fundamentally, one might think about whether or not there is a correlation between the crises particularly (but certainly not exclusively) in those Mediterranean countries and a failure of their democratic structures?

Isn’t it, one is inclined to deliberate, surprising or even indicative that the non-elected Premier Minister Monti has been quite successful in leading Italy out of the problem zone and that Greece started with an interregnum admin-

* Christoph G. Paulus is Full Professor of Civil Law, Procedural Law, Insolvency Law and ancient Legal History at Humboldt-Universität zu Berlin (Law Faculty), Director of the Institute for Interdisciplinary Restructuring (iir) and Dean of the Law Faculty of the Humboldt-Universität zu Berlin (2008-2010).

1 On this idea, see K. Schmidt, Finanzkrise und Wirtschaftsrecht – Überlegungen über die Aufgabe von Juristen in Anbetracht des aktuellen Krisengeschehens, FS Hellwig, 2010, 311, 312 f.
istration under Papademos to turn around? The former at least got reforms done which, under the previous, normal government regime, had proven to be politically impossible to realise.

However, being still in the middle of the restructuring process, it is quite impossible to give definite answers to those ground-shaking questions. What is possible, though, is to note that the present problems are of such magnitude that the traditional solution measures are more likely than not insufficient.

The need seems to be inescapable to come up with new solutions. The question examined on the following pages is whether the proposed European Stability Mechanism (ESM) is such a good new solution or whether a different mechanism should be at place.

For that purpose, a brief overview of the last two years of politicians’ handling of the crisis shall be given (2) before the ESM is briefly described (3). That portrait leads to a balancing of pros and cons (4) of having politicians “steering the crisis boat“, which finally is followed by an alternative proposal (5).

2. Even though commonly known, it might be appropriate to describe, at least briefly, the course of events, which lead to the situation as we face it towards the end of 2012.

2.1. Like Ireland and Spain, Greece enjoyed a period of economic boom before the outbreak of the global economic crisis in 2008/2009. The growth rate of the gross domestic product was 4% in the years 1997 to 2007 and had been,

---

2 It will hopefully be forgiven an ancient Roman law scholar like the present author that ancient Rome had an excellent constitutional instrument to overcome certain situations of political stalemate: the dictatorship (to be sure, it the name of this constitutional position which has spoiled it forever as a model for today’s politics).

thus, above average of the other European member states. This was owed primarily to gross domestic investments and to government spending. In contrast, private consumption was below average and the net export ratio was negative. Accordingly, the weak spot of this development had been quite from the beginning the constant high public deficits and the increasing deterioration of the Greek competitiveness.

In sight of these alarming factors, it proved to be an accumulating deficiency once the budgetary crisis had become public that the Greek governments had never used the period of relative prosperity to reduce Greece’s debt burden and that it failed to establish an efficient tax collection system. The need for money had, thus, always been satisfied by means of borrowing that, in turn, increased the budget deficit.4

Under these circumstances, it was a matter of logic that the onset of the crisis unveiled all those previous budgetary sins. They had been grave enough so that there was no additional need for a real estate bubble like, for instance, in Spain or Ireland. Promised saving programs of the newly elected Papandreou administration in early 2010 did not impress investors; they distrusted them.

2.2. The change of the governing party in fall 2009 lead to the openly admitted misinformation about the public debt situation in Greece; nevertheless, it took another couple of months until the correct number was ultimately made known. Within the period from 2008 to spring 2010, the true budget deficit increased, thus, in pursuit of what might be called a salami technique from 2 % to 15 %.5 It is to be assumed that this technique added reasons for the international investors to be sceptical about the Greek situation and makes it understandable why the interest rates skyrocketed. Accordingly, in early May 2010, Greece was practically cut off from the capital market and asked for sup-

4 This deficit spending has not been, in fact, a particular Greek phenomenon; see Di Fabio, Europa in der Krise, ZSE 2011, 459.
5 General observations regarding “Defizitkriterien des Europäischen Primärrechts” see Dittrich, ZSE 2011, 574 ff.
port. The member states of the Euro-zone and the International Monetary Fund (IMF) stepped in by means of bilateral agreements and provided the aggregate sum of € 110 bn – subject, however, to strict conditionality which was drafted by the EU Commission in close cooperation with the IMF.

As part of the crisis management, the European Council resolved on 8 and 9 May 2010, to establish the stabilisation mechanisms EFSF and EFSM with a lending capacity of up to € 750 bn. Both institutions were meant to be preliminary and to be replaced by the ESM in mid-2013. The latter was agreed upon by the European member states in July 2011; the deadline for ratification was end of 2012. The agreement comprises an amendment of art. 136 TFEU, which shall assure the compatibility of the new instrument with the no-bail-out- clause in art. 126 TFEU. In fall 2010 Ireland, and in spring 2011 Portugal tumbled into a position in which they were bound to ask the newly created provisional institutions for help.

In the course of early summer 2011, it became increasingly evident that the imposed conditions of structural reforms and austerity have set up a negative spiral of a deteriorating economy in practical all supported member states – with the exception of Ireland. The saving measures killed (and, as of today, still do so) any economic growth so that the estimated dates for a back-to-normal have to be adjusted again and again by the “Troika“. Every estimation was to be corrected shortly after its announcement– in late summer 2011 by eight years, from 2013 to 2021. In Spain, the austerity policy caused (and still does so) an unemployment rate of more than 20 %, among young people even 50 %!

The irritation on the capital market and the fear of contagion was addressed by the ECB, which bought enormous amounts of Spanish and Italian

---

6 The various attempts to declare this approach as scraping through legality, i.e the compliance with the “No-Bail-Out“-clause of art. 126 TFEU, sounds a notion of warning: my teacher and friend, Professor Steve Riesenfeld from the UC Berkeley, reported from one of his classes at the Friedrich-Wilhelms-Universität (i.e. present Humboldt-Universität zu Berlin) in which Professor Kohlrausch said: “Gentlemen, always do remember: We (i.e. the jurists) are placed on the coach box and we drive where our masters order us to drive to.”
In the meantime, not only in Greece but also in Portugal, Spain, and Italy, the population became more and more nervous and opposed increasingly aggressively the ever new impositions of decreasing salaries, increasing VAT, pension cuts, etc. Contrary to what was imagined with all those political measures, the situation in Greece deteriorates to a degree which puts all of a sudden in July 2011 the until then stigmatized haircut of the private sector on the agenda. However, here again, the same pattern can be observed: what started with 21% climbed up to 50% only a few months later and has now reached the record height of 70-80%. In that context, the tool box of EFSF and EFSM got widened by allowing preventive lending to potentially tumbling states, i.a. for their support of their banking and insurance sector.

As soon as the July 2011 summit was over, the crisis even worsened. The ECB had to intensify their purchase policy – primarily of Italian and Spanish bonds. This, in turn and in combination with the unsolved problems, lead to dramatic slumps on most global stock exchanges. A discussion started that the European banks had to become recapitalized, and the necessity to increase the lending capacity of the EFSF became obvious. The member states tumbled towards a recession, aggravated by the global economic slowdown but also by the austerity politics (due to its negative multiplication effects) in primarily the southern European states.

In October 2011, a new attempt for an ultimate solution is initiated. The heads of governments decided that the EFSF portfolio should be increased to more than €1 trn; that the European banks are to hold a core capital ration of 9

---

7 As to the role of the ECB in this context, see Sester, Die Rolle der EZB in der europäischen Staatsschuldenkrise, EWS 2012, 80 ff.
8 About some of the consequences see Sandrock, Ersatzansprüche geschädigter deutscher Inhaber von griechischen Staatsanleihen, RIW 2012, 429 ff.
9 An additional problem has been the fact that all attempts to come up with a package of measures did not take into consideration the peculiarities of the Greek economy and society but were rather strongly oriented after western economies. Interesting in this context Doxiadis, Kleinunternehmer, Rentiers, Oppurtunisten – Institutionen, Mentalitäten, 94 Lettre International (2011), 18; Chrysogonos/Koutnatzis, Die finanzielle Tragödie Griechenlands aus verfassungsrechtlicher und institutioneller Sicht: Feudalistische Grundstrukturen hinter demokratischer Oberfläche?, Jb.d.Öff.R.d.Gegenwart 2012, 401, 413 ff.
%; and that the abovementioned hair-cut shall be lifted to 50 %. However, all these measures proved again to be more or less in vain. It worked as an aggravating factor that Italy was closed to become insolvent due to its political and economic problems.

Only a few months later, in December 2011, a new meeting of the heads of government became inevitable in order to tranquilize the capital markets. As one tragic consequence, there of a split between the EU and the United Kingdom became apparent. Without her participation, steps were undertaken to establish a fiscal union (Fiscal Pact = Treaty on Stability, Coordination and Governance in the Economic and Monetary Union), which was supposed to enter into force in March 2012 (now postponed to January 2013)\textsuperscript{10}. One of its main features is what is called in German “Schuldenbremse” or debt break\textsuperscript{11} that was already agreed upon in September of that year as part of the so called “Six Pack.” At this point of time, it is hard to predict whether or not this step will prove to be an effective tranquilizer for the capital markets. Sceptics presume that this step, too, is made too late. In February 2012, a vast majority of private sector creditors agreed to participate in the submitted haircut, which relieves Athens from a debt burden of around € 110 bln.

In early April 2012, capital markets began to get nervous with respect to the Spanish and Italian economy. The borrowing costs are climbing dangerously. There is a constant up and down during the summer as if the capital market itself had become unsure which way to go. In fall 2012, the need for a further haircut for Greece becomes urging again but particularly Germany is reluctant


\textsuperscript{11} Aufschlussreich hierzu PÜNDER, Staatsverschuldung und Generationengerechtigkeit, in Bucerius Law School (Hg.), Begegnungen im Recht, Ringvorlesung der Bucerius Law School zu Ehren von Karsten Schmidt anlässlich seines 70. Geburtstages, 2011, S. 275 ff.
(likely because of election-strategic reasons\textsuperscript{12}). There is no real improvement of the situation in sight.\textsuperscript{13} 

3.1. Part of the pre-described reactive policy\textsuperscript{14} – in contrast to a pro-active one – was bringing forward the starting date of the ESM by some months. Even a brief look through the Treaty that establishes the ESM unveils that this institution is not much more than a shell. The real actors behind that institution remain more or less the same as those who had acted already in the preceding two years.

Pursuant to art. 3, the purpose of the ESM is “to mobilise funding and provide financial assistance, under strict economic policy conditionality, to the benefit of ESM Members which are experiencing or are threatened by severe financing problems, if indispensable to safeguard the financial stability of the euro area as a whole.” ESM members are all those sovereigns within the European Union that share the common currency euro; however, other member states of the Union are encouraged to act and participate in the meetings as observers.

Modelled quite closely after the IMF, the structure of the ESM is, pursuant to art. 4, a Board of Governors, a Board of Directors, a Managing Director plus staff. According to the specifications given in art. 5, decisions are to be made unanimously, by qualified or by simple majority\textsuperscript{15}. The same article rules that the finance ministers constitute the Board of Governors. Each Governor appoints the Director of his or her member state, art. 6. The appointment of both Governors and Directors is explicitly declared to be revocable at any time. The

\textsuperscript{12} Because of her specific form of federalism, Germany is practically constantly in times of pre-election.
\textsuperscript{13} See BUCHHEIT/GULATI, The Eurozone Debt Crisis – the Options Now, from October 8, 2012 (on file with the present author).
\textsuperscript{14} On this, see for instance H. HOFMANN/KONOW (as fn 10), p. 153 ff.
\textsuperscript{15} The fact that this institution brings with it a considerable devaluation of the budgetary powers of each member states’ parliament will not be further addressed here.
Managing Director is appointed by the Governors and must be a qualified individual with the nationality of one of the member states but must not be a Governor or Director, art. 7.

Artt. 18 through 25 deal with the ESM’s financial management and artt. 8 through 11 provide details about the institution’s capital; they are likely to be subject to frequent changes and adaptations. Accordingly, artt. 12 ff. are more interesting in the present context, as they regulate the ESM’s operations. In particular, art. 12 describes those operations’ guiding principles. Not only that Collective Action Clauses (CACs)16 shall be included in (practically) all euro denominated bond issuances; and not only that financial assistance is granted only under strict economic policy conditionality; this article also addresses the issue of private sector involvement (PSI), par. 2. Apparently meant to be a kind of last resort, i.e. when otherwise debt sustainability cannot be restored, it shall be linked with the requesting member state’s presentation of a “credible plan for restoring debt sustainability and demonstrating sufficient commitment to ensure adequate and proportionate private-sector involvement. Progress in the implementation of the plan will be monitored under the programme and will be taken into account in the decisions on disbursements”.

The other articles need not be referred to as they contain rather technical rules, which are beyond interest in the present context.

3.2. To summarize: The ESM is a highly political institution both with respect to its staffing and its mandate. Decisions and operations are initiated and executed by the ESM or other official institutions such as the European Commission or Council. Due to the ESM’s structure, the “real actors” in the support scenario are politicians – with the only difference to the last two years’ perfor-

mance that not individual politicians will be quoted but the institution as such. In contrast, the PSI plays a subordinated role if any at all. The duty might be imposed on the support seeking member state to get into “good faith” negotiations with its private investors for receiving a haircut. In other words, the private sector is important only insofar that it has to waive part (or all) of its rights; but it has no rights whatsoever on its own against the debtor state or against the official sector represented by the ESM. The private sector, thus, is needed for relieving the sovereign’s debt burden but has no tools or remedies to demand anything from that sovereign in exchange for its own contribution to the restructuring; that power is exclusively given to the ESM. In contrast, in a commercial insolvency context, creditors and debtor are the two stakeholders that form the two ends of the balance by negotiating for a tolerable result for both sides. They do so under the surveillance of a neutral instance, the court. We will come back to that under G.

4. What has been presented so far need not necessarily be understood as a clear negative vote against a politician driven proceeding. Accordingly, it is worthwhile to collect arguments in favour of this approach (I) and to contrast it with counter-arguments (II).

4.1. Even though it might appear to be a minor issue, one must not underestimate the power of negative connotations even in areas, which are believed to be entirely rationality-driven such as politics. In the Eurozone area, as in many other parts of this globe, the word – as well as the underlying phenomenon – ‘insolvency’ is one of those highly negatively occupied terms. There are strong forces active in almost every corner of those societies to making word and event a taboo. That has historical reasons\(^{17}\), and it would be naive to negate

\(^{17}\) On the history of the stigmatization of insolvency, see just PAULUS, Ein Kaleidoskop der Geschichte des Insolvenzrechts, JZ 2009, 1148.
the fact. Given this, it is certainly advantageous to have politicians dealing with
the situation of a troubled member state, as this guarantees to a certain degree
continuation of the same actors on still the same level playing field; it is like do-
ing ‘business as usual’ under slightly changed conditions. In contrast, if there
were a procedure explicitly declared as insolvency proceeding – it is to be as-
sumed that, here too, every effort was made to get around it – irrespective of
its potential helpfulness.

There are further – at least assumed – advantages related to the just men-
tioned one: when and if the actors in that scenario remain (more or less) the
same, they might have – or just believe to have – better control over some es-
sentials: There is not just the chaotic situation which is necessarily connected
with a failing sovereign and which shall be kept under control; suffice it to refer
to the above-given description of the last two and a half years. There is also the
(at least hoped for) control over how the rating agencies or the CDS market re-
act. And above all, when remaining in command of the situation, politicians gain
and keep control over the debtor state – most evidently by imposing conditions
in exchange for support and help. After all, a creditor-debtor relationship, gen-
erally, is always tainted with a power and control issue\(^{18}\); this is particularly
evident in the inter-sovereign-lending context: lending in this arena is some-
thing akin to buying influence over the borrower\(^{19}\). A final control issue for
politicians is that by remaining in command, they assume to be in a better posi-
tion to guarantee the trustworthiness of sovereign bonds. Even though it is well
known (more or less throughout) that the contrary is true, the pretence of the
complete risk-freeness of sovereign bonds\(^{20}\) is an eminent important factor in

\(^{18}\) See, very insightful, WESTBROOK, The Control of Wealth in Bankruptcy, Texas L. Rev. 82 (2004),
795.

\(^{19}\) The present day Chinese lending policy in Africa is a striking example, see PAULUS, Responsible
Bilateral Lending and Borrowing – an Approach to a Legally Binding Concept (forthcoming
in Festschrift für Rolf Knieper, to appear 2013); idem, What Constitutes a Debt in the Sovereign
Debt Restructuring Context?, in: LIGUSTRO/SACERDOTI (eds.), Liber amicorum in onore di Paolo

\(^{20}\) Pursuant art. 79 par. 1 lit. a EU Banking Directive (2006/48/EG as of June 14, 2006) in con-
nection with no. 1 Annex VI, the exposure to credit risks of claims on Central governments or
political and economic life. After all, it entices investors to provide their money, which is so urgently needed by sovereigns; and it alleviates banking as this pretence allows the imputation that bonds are the same as equity.

There is one more pro that is admittedly less obvious than those mentioned so far – namely that the economic costs of a sovereign default are not as awful as generally assumed. This is true, at least, with respect to earlier defaults\(^1\). To be sure, there are different types of costs – such as reputational costs, exclusion from the international market costs, costs to the domestic economy through the financial systems, or political costs – but Borensztein and Panizza have demonstrated that the economic costs are generally significant but short-lived; they contrast this result from the political consequences of a debt crisis which seem to be particularly dire for incumbent governments and finance ministers\(^2\).

Even though one might argue with some justification that this conclusion from past experiences disqualifies it from inclusion among the pros, it should be emphasized that the handling of such debt crises so far is obviously less damaging than generally assumed. A counter argument with respect to the European situation could be, however, that this historical evidence is possibly only of diminished relevance for the Greek default. Its uniqueness stems from Greece’s membership in the Eurozone and the consequential inability to depreciate her currency\(^3\).

---

Central Banks is calculated as 0 %.; for Germany, see also § 26 Nr. 2 SolVVO. Needless to point out that this assumption is based of hope rather than hard facts; it is, thus, the ideal starting point for all kinds of bubbles. One should recognize that this equation forms an “unholy alliance” of banks and sovereigns based on which they mutually provide each other with what they desire: money for the governments and business without protective equity for the banks.


\(^2\) For the latter, see also PANIZZA / STURZENEGGER / ZETTELMEYER, The Economics and Law of Sovereign Debt and Default, Journal of Economic Literature 2009, 47.3, p. 653, 694.

\(^3\) To be sure, the abovementioned “uniqueness” should not be overstated. After all, in the 19th century, numerous States of the United States defaulted and “revived” without depreciation of the Dollar. On this, just see Waibel, Sovereign Defaults before International Courts and Tribunals, 2011, p. 3 ff.
4.2. Seen from a legal angle, the first and foremost argument that comes to mind against a politicians-driven proceeding is a fundamental of any rule of law\textsuperscript{24}: these politicians are (representatives of) creditors and are, as such, antagonists of the debtor. If they have problems with each other, the mechanism that has been established to overcome them has been for centuries or even millennia the empowerment of a judge – or, more generally speaking, of a neutral instance that tries to solve those problems by means of clear and fixed rules.\textsuperscript{25} Moreover, only when and if there is such neutral instance in place, predictability and transparency can be ensured; both are quite essential constituents of the rule of law. They have the chance to evolve when there is a pre-determined procedure – as it is the general invaluable advantage of any legal procedure to establish a structure for a potentially chaotic situation. This is particularly true with respect to a commercial or consumer insolvency. Any insolvency practitioner can tell that the days, weeks and sometimes even months before the filing of the petition at the insolvency court is a period of chaos. The need to go to court and the guarantee that the court will thereupon initiate the subsequent steps is guidance and as such an enormous help to overcome the chaos. There is no reason whatsoever visible why this should not also be the case if there existed a comparable legal procedure for sovereigns.

Additionally, (active) politicians cannot act neutrally; they are inevitably caught in a conflict of interests. The situation of the last two years in Europe is paradigmatic: politicians acted not only as representatives of creditor states; they acted also as representatives of their constituency from whom they are dependent regarding the prolongation of their mandate. This combination puts them in the awkward position to strike a balance between the diverging interests of cheering those who shall re-elect them and their country as a creditor


\textsuperscript{25} It is noteworthy that a leading German politician once said to the present author in a private conversation: “the situation that we have right now (i.e. summer 2011) needs to be taken out of the hands of the politicians.”
plus the future co-habitation with the failing state. It is an inevitable consequence of this delicate mix that politicians are bound to destroy (or at least endanger) inter-state relationships. The latest developments provide ample evidence: suffice it to mention the pictures in various media showing Chancellor Merkel in a Nazi-uniform on the one side and on the other the public feeding of stereotypes about Mediterranean laziness. In sum, the politicians’ ambivalent role in this scenario forces them – to use a German phrase – to smash precious political China porcelain which has taken years if not decades before to build.

Closely connected with the aforementioned is a lesson that can be learned from the Argentinian experience some ten years ago\(^\text{26}\). Even though this paradigm of a debtor-driven proceeding turned out to be a solution far from ideal, it had the advantage of providing clear guidance. Instead of a sometimes cacophonous chorus of creditors with diverging interests, there was one voice which could not be missed and which determined the direction in which everybody was to go. To be sure, Argentina is but a striking and highly prominent example; others exist as well. They are less popular and, maybe for this very reason, more successful\(^\text{27}\).

The streamlining of the default resolution process, moreover, helps to reduce costs. Here, again, the last two years in Europe are indicative. What began in the first half of 2010 with a Greek need of around € 40 bln has grown to around € 350 bln in early 2012! That is a high price for indulging the politicians’ luxury of seeking for a fitting solution. It is to be assumed that the faster the proceeding the more reduced are the costs. In this context, the result of two economists’ research paper\(^\text{28}\) is interesting: in examining ‘the elusive costs of sovereign defaults’, the authors come to the conclusion that “defaults have no significant negative impact on successive output growth and, if anything, mark

\(^{26}\) See PAULUS, Gläubiger oder neutrale Instanz – wer soll das schlingernde Schiff steuern?, ZSE, 2012, 30 ff.
\(^{27}\) E.g. Poland in 1997.
the final stage of the crisis and the beginning of economic growth.“ The latter might (also) be related to a phenomenon that has been addressed supra (sub A), namely that a crisis allows for political and economic measures which seem to be undoable under ‘normal’ circumstances.

5. When balancing the aforementioned pros and cons for a politics- (and, accordingly politician) driven procedure, the scale goes down on the side of the cons; this is at least the jurist’s impression. But then the next question arises of how the alternative procedure should look like. What follows is a plea for a resolvency proceeding.29 The new term is used in order to overcome the abovementioned (sub D I) negative connotations usually connected with “insolvency” or “bankruptcy“. The resolvency proceeding is to be designed in a way that it fulfils the requirements of a fair, transparent, and predictable proceeding, i.e. complies with the rule of law that particularly the western world is proud of to call it one of its age-old pillars.

It takes not more than three steps to establish the resolvency proceeding: A contractual clause (I), a resolvency court (II), and procedural rules enacted by the resolvency court (III). It should be noted, however, that the subsequent deliberations do not address a highly important side effect of any resolvency proceeding: a cushioning system for the financial services sector. It is evident

and, under the given circumstances,\textsuperscript{30} inevitable that a restructuring of sovereign debts has a massive impact on all financial institutions. In the present context suffice it to mention that, on the one hand, the Lehman collapse in September 2008 has alerted both the European\textsuperscript{31} and the national legislators;\textsuperscript{32} on the other hand, historical experience unveils that all the hundreds of sovereign defaults muddled through without a banking breakdown. And finally, the control of capital flight might be one of the necessary measures to re-think in times of economic and political fragility like the present one.

5.1. In its simplest version, the resolvency clause could be phrased like: “In cases of default, the issuing sovereign is permitted, alternatively to activating the Collective Action Clauses, to activate a resolvency proceeding by filing a respective petition with the Resolvency Court.”

What is so special with such a clause and why a contractual clause? What would be its advantage? The answers have to do with how things around sovereign debt restructuring evolved over approximately the last decade: In the beginning of that time-span, there is the IMF’s proposal of a Sovereign Debt Restructuring Mechanism (SDRM) in the context of the Argentina crisis. The debate resulting from this proposition created two camps: there were those who advocated for a statutory approach and those who preferred a contractual one.\textsuperscript{33} A bit simplifying, this antagonism addresses the ground for the legally binding character of the respective approach. The IMF, for instance, had in mind to achieve such binding through an amendment of its Articles of Agreement;

\textsuperscript{30} See supra fn 19.
\textsuperscript{32} Particularly regarding the German Kreditinstitute-Reorganisationsgesetz see PAULUS, \textit{Brooklyn Journal of Corporate, Financial & Commercial Law} 2011, 171 m.w.N.; additionally KENADIJAN (ed.), \textit{Too Big To Fail – Brauchen wir ein Sonderinsolvenzrecht für Banken?}, 2012.
\textsuperscript{33} For what follows, see PAULUS, \textit{A Statutory Proceeding for Restructuring Debts of Sovereign States}, RIW 2003, 401 ff.
others preferred the implementation of a narrowly pre-defined model law into the national body of law\textsuperscript{34}. Both proposals fall into the category of a statutory approach, which, for several reasons, offers all-in-all preferable solutions. However, its decisive drawback is the big effort and time needed for its realization.

The contractual approach, most prominently represented by the Collective Actions Clauses leaves it to the respective sovereigns to contractually determine the procedure in all its details. Irrespective of some considerable deficiencies (these clauses do not provide fresh money, and they address just the debt structure and not the debtor’s economy and infrastructure), this approach seems to be – at least for the time being – the present day state of the art. Note that the ESM Treaty explicitly prescribing the future inclusion of such clauses in most Euro denominated bonds, art. 12 par. 3\textsuperscript{35}.

Given this state of affairs, the present proposal takes advantage of this approach. After all, it is less ambitious than the statutory approach and it allows for an easier realisation of the concept\textsuperscript{36}. There is no need to agree on an international treaty or to enact a statute; instead, it suffices to include the said contract clause into any borrowing agreements\textsuperscript{37}. Accordingly, the resolvency procedure can be established without being dependent on a supra-national legislative body.

5.2 It is part of the just described reduced ambition to refrain from developing elaborate substantive rules and to confine the proposal to the establishment of a Resolvency Court\textsuperscript{38}. It should be noted that such a self-

\textsuperscript{34} PAULUS, Rechtlich geordnetes Insolvenzverfahren für Staaten, ZRP 2002, 383 ff.
\textsuperscript{37} See sec. 4 BSchuWG.
\textsuperscript{38} There seems to evolve a trend of even bigger modesty in this field by confining rules just to the creation of creditors’ assemblies, see Expert Group Meeting on Sovereign Debt Restruc-
restraint is not without historical precedence: In the sixties of the 20th Century, when the decolonisation changed the globe’s political map tremendously, the details of an international investment protection system became subject of heated debates. The antagonistic interests of investors and the newly liberated sovereigns lead to an amalgam of highly complex and intricate problems which appeared unsolvable for quite some time. But yet, ultimately a solution was found – namely the creation of the International Centre for the Settlement of Investment Disputes (ICSID)\textsuperscript{39} at the World Bank. This is just an arbitration platform for disputes arising out of investment disputes, which offers only procedural rules and support but no substantive law. As a consequence, arbitral awards rendered under the auspices of this Centre add nowadays up to a considerable body of public international investment protection law\textsuperscript{40}. It is this model which gives rise for some optimism that a resolvency law will evolve in the long run under the auspices of a respective institution.

Moreover, it is not just this ICSID model for the overall concept; there are even further models for the details of a sovereign debt tribunal. Suffice it to refer to the Iran-US-claims Tribunal\textsuperscript{41} or its less prominent counter-part for Iraq.\textsuperscript{42} And finally, the IMF’s SDRM, too, provided for the establishment of a court-like institution\textsuperscript{43}. It is particularly this latter concept that should serve for the Resolvency Court: Accordingly, the Court would consist of a president and a pool of around 20 to 30 judges. The president and its office would be the only perma-
nent staff; the judges would not be. Instead, they would remain in their respective positions and would become actual judges only when and if they are appointed by the president for a particular case. Depending on the complexity of the case, those three or five appointed judges would then form the Resolvency Court Chamber. The advantage of this approach is that it reduces the tribunal’s current costs; they are to be paid only when acting as judges and then by the debtor sovereign.

Apart from the need of having outstanding reputation both as professionals and regarding their social competence, the judges should be in the position to develop rapidly expertise in all resolvency issues. Therefore, the pool of potential judges should be limited to the numbers mentioned above. The selection of the potential judges must be guided by various diversification criteria such as different nationality, professions, and backgrounds.

The experiences with the IMF proposal a decade ago teach us that the location of the Resolvency Court is an important issue. It is, accordingly, unacceptable to connect the tribunal with any of the existing credit institutions such as the European Central Bank in Frankfurt a.M.; the same is true also for any of the Brussels institutions as they are (or appear to be) guided by specific political interests. Given this, it would be possibly the optimal solution to have a special and independent chamber established at the European Court of Justice in Luxembourg. But since this would require a rather time-consuming legislative act, art. 257 TFEU, the second best solution under the present circumstances appears to be to have the Resolvency Court established at the Permanent Court of Arbitration (PCA) in The Hague. This would be an act of incidental consistency: Apparently, the idea of creating there a bankruptcy court for sovereigns was indeed circulated at the time of the PCA’s foundation – i.e. some 110 years ago.44

---

Alternatively, one could think also of Switzerland or Norway as places where to locate the Resolvency Court. These countries benefit from the nimbus of neutrality and would, thus, indirectly add to the Court’s trustworthiness.

5.3 The last step for the constitution of a resolvency regime is that the Resolvency Court lays down its rules of procedure.\textsuperscript{45} The comparison with the creation of ICSID (sub E II) suggests that these rules should be more or less restricted to providing a platform on which the stakeholders of a sovereign default are bound to find a solution under the auspices of the Resolvency Court Chamber. This is all the more advisable as the history of the last 100 years of sovereign defaults has shown that the prevalent solution of those situations has been negotiations. What is to be looked for, thus, is a platform, which offers sufficient space for such negotiations.\textsuperscript{46}

Given this point of departure, it is recommendable to draft the rules of procedure in cautious analogy to modern commercial insolvency law. This is so because this field of law has changed its appearance enormously in the last decade or so – away from the solely liquidating mechanism towards a highly sophisticated and effective tool for restructuring the debtor. Whereas liquidation is absolutely unbearable in the sovereign context, it is the latter all the more appropriate to serve as a kind of model. I.e. not the ‘moneyfication’ of the debtor’s estate is at stake, but just and exclusively the reconstitution of the debtor’s debt sustainability. For that purpose, the modern commercial insolvency

\textsuperscript{45} On the permissibility of such autonomous rule-setting, see for instance, art. 30 par. 1 of the ICJ Statute; art. 16 of the Statute of the International Tribunal for the Law of the Sea; or art. 3 par. 2 of the Claims Settlement Declaration of the Iran-US-Tribunal.

\textsuperscript{46} It might be noteworthy that it is particularly Germany which has benefitted tremendously from this type of crisis resolution. It was the London Agreement on German External Debts: Abkommen über deutsche Auslandsschulden, London, den 27.2.1953, BGBl. II, S. 333 (umgesetzt durch Gesetz betr. das Abkommen vom 27.2.1953 über deutsche Auslandsschulden vom 24.8. 1953, BGBl. II, S. 331); see Aas, Entscheidungen 1949 – 1953: Die Entstehung des “Londoner Schuldennaabkommens”, 1991. Additionally, Monatsbericht 02.2003 des Bundesministerium der Finanzen, S. 91 ff.: 27. Februar 2003 – 50 Jahre Londoner Schuldennaabkommen. Regarding alternatives to consensual solutions see HORNFISCHER/SKAURADSZUN, Von der Staateninsolvenz zur Insolvenzfähigkeit von Staaten, KTS 2012, 1, 6 ff.
cy law offers by now for roughly 40 years the option of the Chapter 11 proceeding (USA) or ‘Planverfahren’ (D) respectively\textsuperscript{47}. To be sure, the different context – commercial enterprises here, sovereigns there – makes numerous modifications and adaptations indispensable. Nevertheless, this new insolvency approach can and should be used as model for dealing with the situation of a defaulting sovereign as it has also proven to be workable with respect to defaulting municipalities, too\textsuperscript{48}; accordingly, issues of sovereignty can be dealt with in this type of proceeding.

For the present proposal’s better understanding it is certainly helpful to begin with a coherent description of how the envisaged Resolvency Procedure shall look like from the beginning to its end (1). Thereafter, a couple of selected issues shall be addressed in some more detail in order to demonstrate that the surely existing enormous legal problems can be mastered (2).

1.) The Resolvency Procedure as a whole

The procedure begins with the application by the debtor country. The application must be accompanied by the presentation of a restructuring plan which describes meticulously in every detail how the debtor imagines the restructuring of its country, i.e. the plan must explain in one part which concessions are requested by the creditors and, in a second part, which contributions the debtor itself is willing and ready to undertake. Note, that the plan is at this time of the procedure just a proposal that is, as a matter of fact, subject

\textsuperscript{47}It is of more than just academic interest that at this point of time when Europe is about to be acquainted with the idea of a resolvency proceeding for states, in the USA a heated debate has started about the need or nonsense of introducing a bankruptcy proceeding for their member states. See, e.g., Skeel, State Bankruptcy from the Ground Up, http://ssrn.com/abstract=1907359.

\textsuperscript{48}This refers to Chapter 9 of the U.S. Bankruptcy Code. For a transplant to Germany, see Naguschewski, Kommunale Insolvenz – Untersuchungen zu einem Insolvenzverfahren nach Vorbild des US-amerikanischen Chapter 9, 2011, p. 27 ff. For this context, see additionally Hornfischer, Die Insolvenzfähigkeit von Kommunen, 2010; Cranshaw, Insolvenz und finanzielle Perspektiven der Insolvenz von juristischen Personen des öffentlichen Rechts, insbesondere Kommunen, 2007; Frielingshaus, Die kommunale Insolvenz, 2007; Paulus, Überlegungen zur Insolvenzfähigkeit von Gemeinden, ZinsO 2003, 869; idem., Insolvenzfähigkeit von Gemeinden – pro, NordOR 2010, 338.
to manifold changes, adaptations, and amendments in subsequent negotiations with the creditors. Here at the commencement of the procedure, it serves as a kind of entry control: since it is the Resolvency Court Chamber’s (i.e. the freshly appointed three or five judges’) first task to examine the feasibility, fairness and reasonableness of this plan.

The creditors – and this means, generally speaking⁴⁹, all creditors⁵⁰ of that sovereign – are grouped together into classes that, of course, has to be done in accordance with rational and verifiable criteria. This is an essential feature of the proposed procedure since discussion about and final voting on the plan will be done through the groups. Even if the consent of each single group should be needed, such group formation implies that not every single creditor needs to concur; it rather suffices that the (however determined qualified) majority of, e.g., 66 %, 75 %, or 85 % of the creditors within one group do so. Thus, if there should be only a simple majority within a group be required, the consent of 50 % + 1 is sufficient.

However, before it comes to the voting debtor and her creditors have to sit on the same table and discuss the proposed plan. In order to reduce the mass of creditors and in order to enable meaningful discussions, one might think of having appointed special representatives – as they are foreseen, for instance, in many modern Debenture Bond Acts (see § 7 of the German Schuldverschreibungsgesetz). As a matter of fact, the parties involved in these discussions will negotiate toughly; it is to be assumed that every side will strongly argue for its own benefit. The Resolvency Court’s rules, however, should abstain from any substantive prescriptions; the result of the negotiations should

⁴⁹ As to the problem of who might qualify a creditor in a sovereign default, just see PAULUS, as in fn. 18.
⁵₀ This is in order to prevent segmentation as it is done by the Paris Club or its London equivalent. However, from a creditor’s stance, participation diminishes to the degree that ICSID panels declare themselves competent to deal with a sovereign’s bond creditors, as has recently be done in the case Abaciat and Others v. Argentine Republic, ICSID Case No. ARB/07/5, Award, 4.8.2011; see http://italaw.com/documents/AbaciatDecisionJurisdiction.pdf with Bischoff, Völkerrechtlicher Rechtsschutz bei Staatsbankrott?, WM 2012, 1371.
be left to the balance of powers. This is all the more advisable as one important
feature of the rules should be that different groups can be treated differently.
Given this peculiarity, it is possible to take full account of a widespread concern
among politicians: namely to bring together small creditors into a separate
group which could receive 100 % satisfaction whereas other groups with, e.g.,
institutionalized creditors accept a “haircut” of 50 %. The flexibility of potential
solutions in this context is as large as contractual freedom allows for adapta-
tions to the individual case.

It is not necessarily mandatory that these negotiations be connected with
those, which the debtor country is likely to conduct at the same time with po-
tential new lenders. After all, in a situation like the ones envisaged here, the
debtor would be in dire need of fresh money. Primary candidate for those ne-
gotiations will be the EMF or the IMF; however, there is even a slight chance
that, depending on the acceptability and the reaction of the capital market to
the commencement of the Resolvency Procedure, the debtor is able to get
money even from this very market (bonds) at tolerable interest rates. Whoever
the respective lender is, it might be interested to participate in the plan negotia-
tions. After all, the presence alone of this new creditor would increase the
disciplining effect on the debtor, which is certainly one of the most important
side effects of the Resolvency Procedure.

After a pre-fixed period of time, the voting must be done. As a matter of
fact, the debtor is dependent on the creditors’ majority’s consent and is, accord-
ingly, again under a certain disciplining pressure. Since without plan acceptance
the debtor’s debt situation does not change. This dependency on the creditors
is a kind of compensation for what will be described in more detail subsequent-
ly: namely the exclusive right of the debtor to pull the trigger for commencing
the procedure. However, this dependency could be mitigated by reducing the

---

51 This need brings with it the consequential question of which collateral securities the debtor
sovereign is able to offer for new credit? Standard models are either a super priority or the so
called tax-farming.
requirement of unanimity regarding the groups’ consent (attention! not the voting requirements within any one of the groups). If so wished one could think along the lines of the so called “cram down rule”, see 245 InsO, which allows under certain circumstances, a plan to be accepted when and if the (simple or qualified) majority of groups do concur.

If the plan is, thus, accepted the court must confirm the plan by examining the legal correctness of the proceeding so far. Given this requirement, it is advisable to have the judges be present all the time during the negotiations. They should probably function as moderators.

If, however, the necessary majority for the plan’s acceptance is not achieved a second chance should be granted for improving repair; i.e. renegotiations should be possible, although just for a rather limited period of time. When and if this second attempt also fails the European Monetary Union (unlike the situation of other overindebted sovereigns) could possibly provide for a whole range of sanctions up to the exclusion of that particular sovereign from the Union – which would likely be the most severe of such sanctions. However, the failure of the plan’s acceptance could likewise be in one (or more) of the creditors’ sphere of responsibility, who try to ‘hold out’. Due to the court’s moderation a situation like that could be sanctioned by withdrawing that creditor’s voting right or to interpret its vote as a ‘yes’ after special investigation of the result’s fairness and reasonableness. Thereby, both sides could be disciplined.

2.) Selected issue in detail

a.) A fundamental issue of any proceeding as the one presented here is, as a matter of course, under which conditions the resolvency proceeding shall become commenced. The commercial insolvency law of, e.g., the German Insolvency Ordinance, s. 17 to 19, provides three opening reasons: insolvency, imminent insolvency, over-indebtedness. For various reasons, none of them is
transferable to the realm of sovereign default and a resolvency proceeding. The IMF imposed in this context the requirement of ‘unsustainability of debts’, meaning that the debt burden has become too high to reduce the principal amount and to be captured, thus, in what is commonly called a ‘debt trap’. To be sure, this is just a very superficial description of what the IMF has in mind.

But one might ask if there is any need at all for pinning down a precise opening reason. It might suffice to have instead a subsequent abuse control.\textsuperscript{52} As will be discussed in more detail below (sub b), it is one of the Resolvency Court Chamber’s predominant tasks to examine the commencement prerequisites. If they are not fulfilled, the proceeding will not be commenced and the debtor country is obliged to look for alternative solutions – a purposeful unpleasant alternative to abusing the procedure.

b.) The IMF’s proposal of the SDRM, too, reserved the right to petition for the commencement of the proceeding exclusively to the debtor country.\textsuperscript{53} One might regret this from the perspective of disciplining the debtor; but the debtor’s sovereignty leave no alternative to this one-way approach. Since otherwise a creditor’s petition would urge the debtor into a straitjacket of actions which, in the worst case, are not needed at all. Moreover – and probably most importantly – the likelihood of such option’s general political acceptance is minimal at best. Germany, France, or any other country would hardly ever agree to submit themselves to such a right of others.\textsuperscript{54}

However, in sight of what has earlier been said about the advantage of any insolvency proceeding – namely its disciplining function for all stakeholders just by means of its mere existence – the present proposal might appear as a unilat-

\textsuperscript{52} See Paulus (as in fn. 33), p. 385. Another alternative would be, following an English model, to leave the definition of the opening reason to the parties, see Steffek, KTS 2009, 317, 348, 352.

\textsuperscript{53} See additionally Hornfischer/Skauradszun, Zeitschrift für Insolvenzrecht (KTS) 2012, 1, 16 f.

\textsuperscript{54} The same is true for many other countries such as the US – if the proposal were to become extended to a global model. However, for the Eurozone it appears to be imaginable to give the right to trigger the proceeding to a supranational institution such as the European Council.
eral favouring of the debtor’s position. Since if the debtor alone has the right to pull the trigger, it has therewith a bargain chip for its negotiations, for instance, at the Paris Club, London Club, or its negotiations with the private sector; the creditors have nothing to hold out against this. Nevertheless, this imbalance is for the reasons presented to be tolerated and must be compensated by other measures disciplining specifically the debtor – for instance the abovementioned (sub 3) need for the creditors’ consent to the plan.

c.) Given the mere procedural approach of the Resolvency Procedure, the attribution of competences to the Resolvency Court Chamber is quintessential for success or failure of the proposal. It should be noted, however, that at this point of the proposal’s evolution all what is intended is to present an overview over potential competences. Further refinement will certainly be needed in due time.

– It is possibly the Chamber’s single most important task to examine whether the application constitutes a potential abuse of the petitioning sovereign; if so, the application will be rejected. The Chamber has, accordingly, to review the debtor’s justification for the commencement of the procedure given in the proposed plan. It should be noted that conferring this task to the Chamber underscores the care and attention needed for the selection of the judges’ pool; intimate political, economical and legal knowledge is indispensable for such an examination. Since what is to be verified is the debtor’s claim that all existing sources of income and other means have been exhausted. The options here at stake are innumerable: (further) privatisations\(^{55}\) might be as possible and reasonable as increasing certain taxes, saving options might be available by cutting salaries in the public sector (for instance, cutting back the 13th month’s salary), certain commodities have not yet been (fully) exploited, or the gold re-

serves can – and be it partially – be sold, etc. To get an idea of the width of the possibilities of these resources, it could be helpful to study the conditionality catalogues of the IMF or World Bank which these institutions have previously set up for borrowing states.\textsuperscript{56}

- The claims’ verification might also be seen as one of the key tasks of the court. But, as a matter of fact, the devil here, as everywhere, is in the detail: Which claims are to be included in the resolvency proceeding? Just foreign ones or also domestic ones? Claims just against the state or also those against the national bank, the subdivisions such as Länder, provinces, regions, etc., or state owned enterprises? Only contractual claims or also those based on other grounds\textsuperscript{57}?

The preferable (but, of course, not only possible) answers to these selected questions are: Bearing in mind the need to overcome the selectivity of the Paris Club or London Club and to strive for an all-encompassing resolvency proceeding all claims should be included – be they foreign or domestic (possibly including the domestic tax- or wage claims); the debtor should include all those entities which have no separate legal existence (as for those which have such separate existence, the general insolvency law will be applicable); and there should be a restriction to contractually founded claims because for the time being the court’s competence can be founded only on a contract.

- It is by no means a marginal task of the SDT to moderate the negotiations and to check the legitimacy of the group formation, i.e. whether or not objective, coherent criteria have been applied. The goal of this latter task is to prevent the debtor state to strategically bind all creditors together in one group, which are likely to reject the plan. Accordingly, this task is one further piece of the puzzle to discipline the debtor state to not abuse the proceeding.

\textsuperscript{56} It is more than likely that cooperation of the judges is necessary at this point of the proceeding both with Eurostat and IMF; since these institutions have unique sources of information for the debtor’s economy.

\textsuperscript{57} For this, see just HAGAN, Designing a Legal Framework to Restructure Sovereign Debt, 36 Georgetown Journal of International Law (2005), 299 ff.
A final competence of the SDT could be the dispute resolution within the proceeding. The details should be elaborated by taking inspiration from existing commercial insolvency jurisdictions such as Austria or the US. They confer far-reaching competences upon their insolvency courts regarding the resolution of disputes between the parties. Such a concentration (in the commercial context labelled as “vis attractiva concursus”) serves the purpose of the proceeding’s acceleration and streamlining. In addition to the dispute resolution, one might also think about permitting the judges to serve as mediators or conciliators – thereby making references to the respective powers of ICSID tribunals.

d.) It has already been mentioned that the time factor is of eminent importance in any restructuring and, accordingly, in any Resolvency Procedure as well. Therefore, it is key to consider this facet and to provide for rather strict periods in order to prevent strategic abuse by either side in prolonging or abbreviating the procedure to one’s own benefit. However, it is to be assumed that, in most cases, it will be the debtor country which pushes for acceleration; since the earlier the plan is accepted the earlier the state can begin with the realization of the resolvency measures (see infra sub e). Based on this assumption the focus of timing rules should be in disciplining the creditors. Those rules could be, for instance, the right to ad hoc-interventions of the judges or fixed time frames after which the majority requirements could change.

e.) If the plan is accepted by the prescribed majority vote and if the court has ultimately certified the legality of the procedure, this court order will be the basis for all subsequent legal changes and obligations arising from the plan. The creditors’ “haircuts” are effective as of this time as are the debt deferral agree-

58 See just PAULUS, Insolvenzrecht, 2nd ed. 2012, par. 47.
59 When and if the debtor state should abuse such time frame the court could be allowed to prolong the deadlines.
ments, etc. But as of this time the debtor state, too, is obliged to begin with all those measures which, pursuant to the accepted plan, are to be done by the debtor – for instance, cutting back of salaries, privatization operations, exploring new (or increasing existing) taxing sources, etc.\textsuperscript{60}

However, it is possibly not an entirely unlikely scenario that the debtor, once the plan has been accepted and the debt burden is accordingly reduced, becomes somewhat hesitant or less enthusiastic to comply with the imposed obligations of the plan: all of a sudden, one might feel inclined to postpone the promised tax increase until after next year’s elections, or the sale of certain shares is ‘unfortunately’ presently not appropriate, etc. In such a case, the creditors would have recourse to the courts (which ever these might be in the given case), which, even if successful in the end, would take months if not years. Therefore, effective resolvency rules should provide for on-going supervision by the court in this plan-realization-period in order to discipline the debtor here, too. The sanction against such retarding of the debtor could be modelled pursuant s. 255 InsO\textsuperscript{61}: the court could be given the power to revoke the plan – with the consequence that the status quo ante is re-established and all claims do exist as they had been before the plan acceptance.

6.1 In summarizing the preceding arguments, the initial question can be answered in the positive – yes, a legal proceeding should replace politics when it comes to overcoming the challenges of defaulting sovereigns. Occasionally, it was mentioned that the Resolvency Procedure would unfold a disciplining function of either the debtor or the creditors, which is a consequence of the abovementioned (sub D I) stigmatization of insolven cy law. It is both to be assumed and to be hoped for that this causation serves as deterrence from

\textsuperscript{60} Some of these operations have already been mentioned supra (sub 2 c). This is not so surprising in sight of the possibility that the political chances for their realization might be greater when done in the context of the resolvency plan – i.e. after the creditors’ consent to do their part for the sovereign’s restructuring.

\textsuperscript{61} As an aside: The most recent Italian legislation on consumer insolvency, legge 212/2011, has in its art. 14 a respective clause.
excessive borrowing and lending.\textsuperscript{62} After all, history teaches us that default episodes accumulate after phases of lending booms.\textsuperscript{63} Since the accumulation of debts (both in Europe and worldwide) has reached before unknown heights,\textsuperscript{64} it appears to be a prudent strategy to develop and establish measures, which put a break on this evolution. One of those measures could be an effective Resolvency Procedure.

To fulfil this sort of meta-function, it needs to be said – particularly in sight of the previously existing but throughout ignored disciplining measures provided for in artt. 122 ff. AFEU – which the Resolvency Procedure, in order to effective, needs to constitute a credible threat. That is to say right at the outset that it displays its efficiency then and only then when everyone is ready to apply it. If this is the case, it is to be assumed that it will have the said disciplining, i.e. deterring effect. After all, which head of government would be willing to state in front of numerous cameras that his or her country has to file a petition at the Resolvency Court. Thus, if every actor on that stage is ready to comply with the legal proscription of not bailing out other member states, it follows that a Resolvency Procedure is most effective when and if it is never applied. The strategy is, thus, comparable to the earlier political motto ‘peace through deterrence’.

6.2 It should be noted that the comparison made supra (E II) with the evolution of ICSID to a public international investment protection law carries with it a further implication. Like there, a now and here created Resolvency Procedure could have the potential to expand from its original European application field

\textsuperscript{62} Regarding UNCTAD’s attempt to tame this lending and borrowing appetite, too, see PAULUS, Responsible Bilateral Lending and Borrowing – An Approach to a Legally Binding Concept, Fest-schrift für Rolf Knieper (to appear 2013).


\textsuperscript{64} It should not be forgotten that the increased spending of the state corresponds to a high degree with an increased claim of the “ordinary” citizen to be served by this very state. Reducing borrowing implies, thus, that the citizens reduce their attitude of asking their state for more and more.
to a global one. Even if this sounds banal: it should be remembered that the sovereign default trouble is not a European phenomenon. And it is also a seemingly banal conclusion that it is by no means true that for all other extra-European sovereigns fighting with the problem of default the Bretton Wood-institutions would offer sufficient help. Quite to the contrary, the need for a global resolvency proceeding is ubiquitous and urgent. 65

Accordingly, the preceding deliberations are meant (and should so be read) to include the option for such an expansion – irrespective of the then necessary modifications 66. It is, thus, the ambition of the proposal presented here that it could also be used as a blueprint for a global sovereign default restructuring mechanism.

65 It should be noted that the present German coalition had included in its agreement from 2009 the concern to promote the institutionalisation of a sovereign debt-restructuring tool. For Switzerland, note that in end September of 2011, the Bundesrat was requested to elaborate and come forward with a proposal for a fair and independent international insolvency proceeding for sovereigns that includes also private investors and which helps to prevent future debt crises and to guarantee stable currency and finance conditions. See http://www.parlament.ch/d/suche/seiten/geschaefte.aspx?gesch_id=20114033.
66 See KARGMAN/PAULUS (fn. 28).
FINANCIAL CRISSES.
WHERE DO WE STAND?

Fabiano Colombini*

ABSTRACT: This paper analyses the features, evolution and prospects of financial crises by examining the role of banks, states and central banks, also focusing on commercial and investment banking and the public real estate investment fund. Suggestions for improving bank risk management are described, together with an overview of the public real estate investment fund as an innovative instrument to cut down public debt and improve state risk management. In the framework of critical observations based on the recent experiences during the 2007-2012 period, some proposals for change are put forward.


1. This paper aims to analyse the features, evolution and prospects of financial crises by examining the role of banks, states and central banks, putting forward a number of critical observations in the light of the financial crises that emerged during the 2007-2012 period.

The paper also addresses the aspects involving commercial, investment banking, and the related banking models; additionally, it outlines the proposal to introduce the public real estate investment fund as an innovative instrument to cut down public debt, thus opening up a new route towards the solution of financial crises.

* Fabiano Colombini is Full Professor of Economics of Financial Institutions at the Department of Economics and Management of the University of Pisa, Italy.
Financial crises can be examined in the framework of crises involving financial markets, crises affecting financial intermediaries, sovereign debt crises and currency crises. Careful examination of the issues involved shows that financial crises are the result of interrelations among a number of circumstances: adverse trends on the financial markets, adverse situations affecting financial intermediaries, tensions focusing on public debts and turmoil in the exchange markets.

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

One aspect that clearly emerges is the importance of a scale of priorities concerning the volume of public resources required. Decisions on priorities must take into account the margins for public expenditure without causing excessive imbalance in the public budgets.

It likewise becomes clear that the irrational strategies based on innovative finance must be downsized or abandoned, in favour of restoring the concept of cultural and regulatory financial responsibility. Profits should be achieved by rational risk management, rather than arising from practices inspired by a separation between risk and return which ends up offloading the

---

negative impact of risk onto the state budgets, while the positive impact of returns is inserted into the balance sheets of individual banks.

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

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

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

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

Bailout plans to address the subprime mortgage financial crisis and expansionary policies designed to tackle the economic crisis have led to a marked deterioration in the public finances. However, the dramatic condition of the public finances should be ascribed not merely to the above described exceptional measures, but also to unbridled public expenditure that has risen to unsustainable levels. The most critical elements affecting the public finances involve the following aspects: rising pension and health care expenditure due to an aging population; fairly high expenditure on the national, regional and local level in matters pertaining to political affairs; intensity of tax evasion; amount of the public debt and its composition in terms of maturities and apportionment between residents and non residents; private debt levels and degree of solidity of the banking systems.

The elevated levels of public indebtedness create the premises for the sovereign debt crisis, leading to an increase in the returns that the markets demand on bonds issued by states perceived as being at risk and thereby bringing about an increase in spreads between the bonds of an individual state and those of the German state. This, in turn, exacerbates the fragility of the budgets of such states and makes it difficult, if not impossible, to intervene with measures aimed at economic recovery2.

---

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


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

In the light of the above observations, careful evaluations should be conducted in seeking to devise the best approach for overcoming financial crises and economic crises. More specifically, attention should be paid to identifying the specific problems, estimating the costs and formulating rational choices. Failure to assess these aspects results merely in wasteful use of public resources that provides no solution for the problems raised either by the subprime mortgage financial crisis or for the problems deriving from the sovereign debt crisis. In other words, the complex interactions are not addressed and definitive solutions are basically postponed to an indefinite future3.

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

---

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

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

2. The subprime mortgage financial crisis, together with the subsequent sovereign debt crisis, has had notable consequences in terms of transfer of monetary resources from subjects and sectors in surplus to subjects and sectors in deficit. This process comes about through two channels: on the one hand, by direct credit, which in turn presupposes the search for a counterparty in order to ensure preference satisfaction and an agreement on conditions, thereby giving rise to and fuelling the activity of the financial markets (direct circuit); on the other hand, by indirect credit, which presupposes a lengthier and mediated transfer of resources, giving rise to and fuelling the activity of the financial intermediaries (indirect circuit)\(^4\).

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

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

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

On closer examination, credit risk transfer onto financial markets, where the main figure both in the field of sales and also of purchasing is represented by financial intermediaries, assumes the extended meaning of an increase in the burden of risk weighing upon the financial system, due to the numerous inter-relations among financial intermediaries. Basically, the problem can be traced partly to unorthodox practices in granting loans to a very poor quality

---

customer base, and partly also to the subsequent experimental practices of risk transfer taken to excessive levels, as well as to failure of the supervisory authorities to exercise proper control.

In this regard, it is worth noting that the subprime mortgage financial crisis underscores the fact that systematic recourse to credit risk transfer can have adverse effects in a context characterised by marked integration between financial markets, financial intermediaries and financial instruments. The transferred risk aggravates the overall risk level, which becomes unsustainable and severely affects those who are driving the process and, consequently, the financial intermediaries that stand at the origin of the process.

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

It follows that the practice of experimenting with risk transfer and, consequently, of risk shifting from internal to external should not be taken to levels that could threaten the survival of financial systems. Precise rules should be laid down, together with the exercise of rigorous and systematic control by the supervisory authorities. There can be no doubt that if the regulatory setup is flawed or inadequate, or monitoring action is not performed at

---

6 Commercial banks likewise adopt speculative strategies on derivatives, increasing their range of risks and exposure and, at the same time, their leverage and hence their vulnerability to fairly substantial adverse fluctuations in their assets. A similar observation can be made with regard to the investment banks’ experiment with speculative operations on derivatives by increasing the level of risk. Speculation by means of derivatives is regarded as a solution for growth of profits, but careful attention should always be paid to the associated risks.
well defined and reasonably spaced temporal intervals, the problem of proper control will remain unsolved.

Exposure to subprime mortgages prior to the onset of the subprime mortgage financial crisis was a characteristic of a number of different types of financial intermediaries in the United States, testifying to interest in the market segment under consideration. This was an interest based essentially on purely commercial motives and on the aim of increasing the volumes, with the presumption of a growth of profits in the short run. However, the expansionary impact of risk on the systemic level was totally underestimated.

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

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

In the American context, the subprime mortgage financial crisis constitutes the most prominent component of the financial crises, whereas in

---

Europe it is the sovereign debt crisis that represents the main component, although interactions and signs of interdependency with the other component are not lacking.

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

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

Screening and monitoring activities, together with the information content of bank loans, the uncertainty of return and of the value of their assets, and the “certainty” of remuneration and of the value of their liabilities, as well as the specific nature and depth of financial transformation, underline the importance of banks and, at the same time, highlight their differences in comparison with other financial intermediaries\(^8\).

A considerable number of banks have undertaken the development of business areas which are parallel to the classical areas of raising and lending

\(^8\) See COLOMBINI F., Intermediari, mercati e strumenti finanziari. Economia e integrazione, supra note 4.
funds. Many of these developments frequently involve high leverage areas, as in the case of derivatives\(^9\). Restoring rational choices in the context of commercial banks constitutes a requirement for medium and long period financial stability, with less importance awarded to growth of their capital.

In this perspective, the Basle III regulation, based on prudential criteria, and the measures prescribed by the European Banking Authority (EBA), based on discrezional criteria, lead to overlapping rules\(^10\), underlining instability factors within financial markets, purely discrezional compensation mechanisms in comparison with Basle III, exacerbation and failed solution of the complex bank-state linkages and inadequacy of regulatory measures in Europe\(^11\).

The important role of commercial banks in financial systems must not be jeopardised by reckless commercial strategies aiming to increasing profits in the short term which, at the same time, induce some banks to embrace high levels of risk that could compromise management of banks. It is also necessary to re-examine the corporate governance models of banks, envisioning changes in the top management that would allow the entry of professionally competent figures capable of assessing the risk-return relation in the medium and long term\(^12\).


\(^10\) Basle III has introduced higher and better levels of capital, in the framework of risk-weighted assets, to be implemented progressively over time. It thus can be regarded as based on a prudential approach. In contrast, the EBA has introduced additional capital corrections, formulating estimates on the value of the sovereign bonds in bank portfolios and it can be regarded as adopting a discretionary approach. However, a number of problems can be pointed out and several critical aspects should be highlighted: overlapping regulations, timing, and the mistaken approach towards banks whereby banking intermediaries are viewed, via an analogical process, as similar to investment trusts which must, on a daily basis, satisfy the obligation to assess the value of their assets and disclose the information to the market.


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

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

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

Given the marked integration among financial intermediaries, financial markets and financial instruments as well as the interrelations among world economies, the credit risk level arising in a given financial system or a given financial sector provokes an impact on all the others, increasing the credit risk level on a global scale. Irrational criteria for creation transfer and multiplica-


tion of the credit risk which affect a given financial system or a given financial sector can lead to global financial and economic crises\textsuperscript{14}. It is essential to implement fair and rational risk management practices in order to avert the eventuality of risk escalating to unsustainable levels either for the individual financial system or on a global scale. Thus financial intermediaries, industrial firms and public agents should be characterised by rational criteria of risk management.

4. Banks pursue the objective of expansion of on and off the balance sheet instruments and volumes over time in order to create the premises for positive performance and profits. Banking balance sheets have grown rapidly in a low interest rate environment and in presence of a surge in innovative instruments\textsuperscript{15}.

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

Over time, the dealing and market making of securities and derivatives and proprietary trading have become increasingly important. There has also been a remarkable growth in derivatives, especially in the over the counter


(OTC) market\textsuperscript{16}. Since the beginning of the third millennium, securitisation markets have grown rapidly and created the shadow banking system, built up essentially by special purpose vehicles (SPVs) and structured investment vehicles (SIVs).

The growth of the banking business has underlined the shift from commercial banking to investment banking, and therefore an increase in the range of risks and in total risk. The process of identification, measurement and management of risks is of crucial importance in creating and maintaining conditions for profits and solvency. The above mentioned shift is evident when looking at the assets side, the liabilities side and income sources as the share of net interest income falls and non-interest income rises\textsuperscript{17}.

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

The universal model in Europe has been called into question and a number of helpful proposals have been put forward. The so-called Vickers Report makes the recommendation to build a robust ring fencing, separating investment banking from commercial banking, in order to reduce structural complexity and to ensure that banks are better equipped to resolve in crisis. Ring-fencing means that most of a bank’s investment banking and related risks will be separated from commercial banking and related risks\textsuperscript{18}. The main point is that since investment banking and the related risks traditionally involve a


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

\textsuperscript{18} See High-level expert group on reforming the structure of the EU banking sector (chaired by Erkki Liikanen), supra note 17; Banking reform: delivering stability and supporting a sustainable economy (chaired by John Vickers), HM Treasury, BIS, June 2012.
higher risk level than is the case with commercial banking, their separation insulates the ring-fenced bank and makes it more resolvable in the event of difficulties. Emphasis should be placed on the need to hold sufficient capacity so that any losses can be absorbed, and to increase levels of bank capital in order to build a more robust banking system. It is also important that there should be strong support for moves designed to increase competition in the UK banking system thereby stimulating new entrants to compete on a level playing field.\textsuperscript{19}

These reform proposals including ring-fencing, loss-absorbency and competition will be implemented in the UK. The government is committed to ensuring that the new industry-funded switching service is operational by September 2013.\textsuperscript{20}

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

The so-called Liikanen Report introduces a distinction between significant trading activities and commercial banking. According to this report, banks with significant trading in excess of a certain threshold should separate their investment banking activity from commercial banking. Banks in excess of the threshold would have to create a separate legal entity to transfer the trading assets. The trading entity would have to be economically independent and easily separable, meeting prudential regulatory requirements on a stand-alone basis.\textsuperscript{21}

\textsuperscript{19} See Banking reform: delivering stability and supporting a sustainable economy, supra note 18.
\textsuperscript{20} See Banking reform: delivering stability and supporting a sustainable economy, supra note 18.
\textsuperscript{21} See High-level Expert Group on reforming the structure of the EU banking sector (chaired by Erkki Liikanen), supra note 17.
Such reforms aim to curtail the impact of implicit guarantees of states towards the banking sector in the UK, the USA and the EU. It is difficult to quantify the value of implicit guarantees, which varies over time; a decrease in implicit guarantees can be explained by declining sovereign strength, by more effective bank failure resolution regimes and practices or by lower perception of the systemic risk\(^{22}\). It should be noted that implicit guarantees imply an undesirable close link between the value of banks and sovereign debt. They also imply a significant funding cost advantage for banks that benefit from them, giving rise to competitive distortions, excessive risk-taking, and misallocation of resources\(^{23}\).

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

5. Deterioration in the public finances, both in terms of deficit and in terms of increasing sovereign debt, affects many states and gives rise to measures for readjustments and sustainability. Financial support for the economy is of crucial importance, as a growing economy implies higher revenues and higher social welfare and thus easier ways of financing public expenditure.


\(^{23}\) See COMMITTEE ON THE GLOBAL FINANCIAL SYSTEM, *The impact of sovereign credit risk on bank funding conditions* (Study group chaired by Fabio Panetta of the Bank of Italy), “CGFS Papers”, 43, BIS, July 2011; High-level expert group on reforming the structure of the EU banking sector (chaired by Erkki Liikanen), supra note 17; SCHICH S., S. LINDH, *Implicit guarantees for bank debt: where do we stand?*, supra note 22.
The trade-off between reduction of public expenditure and intervention to support the economy implies an activity of planning and control and, at the same time, a rational management of public debt instruments in terms of amount, maturities and apportionment between residents and non residents. In seeking to improve management of the public debt, it is vital to set up budget policies for rationalising the maturities of public debt instruments, thereby avoiding a situation whereby reimbursement and refinancing schedules are concentrated within a single time frame and consequently give rise to liquidity tensions, which frequently have to be solved with issues of public debt at higher interest rates.

Rational management of expenditure and public debt instruments contributes to improving the credibility of individual countries on financial markets. It therefore exerts a considerable impact on the manner and instruments of financing, while at the same time also contributing to reduction in interest expenditure.

The globalisation of financial markets and economies imposes constraints, in that the problems afflicting individual countries rapidly develop into problems affecting all countries. In all countries, sustainable public budgets are a fundamental postulate for financial stability and economic growth. Expansionary budget policies enacted in the course of financial crises and economic crises can raise doubts concerning the management of public finances. Moreover, during the positive business cycle prior to financial crises and economic crises, the majority of developed countries fail to set in place strategies for the consolidation of public finances and tended, instead, to favour an increase in public expenditure, sparking a sharp rise in the deficit and public debt in the context of financial crises.

Those irrational criteria of public expenditure were rife in periods before the onset of financial and economic crises is undeniable. Equally clear is that government interventions on a world scale to overcome the subprime mort-
gage financial crisis and the resulting economic recession succeeded in avoiding the collapse of the financial and economic system. At the same time, however, they acted as the background for the advent and upsurge of the sovereign debt crisis.

The sovereign debt crisis implies the need for government intervention to restore balance in the public finances by planning rational expenditure policies which take into account structural reforms. Furthermore, it is essential that revenues and expenditure are planned through a precise and prudential analysis of future economic scenarios, as a means of ensuring that levels of expenditure are consistent with economic growth scenarios. The establishment of independent and supranational agencies entrusted with the task of monitoring the trend of public finances and the projections devised by each country could be interpreted as a positive aspect.

The most critical element concerns the margin for implementation of consistent choices in the context of the fiscal compact, to be carried out by reducing expenditure and/or increasing revenues. The shaky conditions of the public finances together with fears of contagion imply that government choices both at the European and the international level can no longer be deferred. Only through coordination of ideas and action on the European and international level can the conditions of financial and economic systems be improved, thus reducing the global imbalances between credit-rich and debt-ridden countries which can become a worrying source of geopolitical tensions.

The sovereign debt crisis increases the volatility of sovereign securities markets in the euro area, leading to problems in the management of public debt instruments. Therefore, the total amount, the apportionment between residents and non residents, the market interest rates and maturities constitute an important element in evaluating the solvency of a given country.

Raising funds on financial markets implies the need to consider a number of aspects which in the past were neglected, when attention was directed
mainly towards increases in the issuing and placing of public securities seen as a means for supporting unrestrained public expenditure. In the light of a more recent shift in the attitudes and preferences of investors with regard to sovereign securities, no longer conceived as a risk free asset, it has become important to create public financial instruments to be placed on financial markets in order to meet investor preferences without impairing sustainability in terms of total volume and of the timing of the individual fund raising operation. By staggering the maturities of public securities over a chosen time range, thus ensuring that reimbursement and refinancing schedules are not concentrated within a single time frame, it becomes feasible to avert the danger of future liquidity crises and the associated problems of increased refinancing costs, which otherwise culminate in a virtually insurmountable vicious circle.

The financial markets are nevertheless prompted to focus on the fragility of public finances as a consequence of the redefinition of the risk-return relation at a global level.

The sovereign debt crisis is essentially a distinctive feature of the European context, and it is embodied by a tendency towards the rise and persistence of adverse conditions for states and banks in the weaker part of the euro area. Not only do states characterised by low ratings encounter difficulty in raising funds, but they also face higher costs when placing securities on financial markets due to the growing spreads between the securities of an individual state and those of the German state. Not only do banks encounter more difficult conditions in raising funds on financial markets, but they also meet higher costs when placing bonds, leading to an interest rate increase, as there is an increase in the returns required by financial markets on public securities of peripheral states due to the rising spreads.
The resulting increase in returns required by financial markets on public securities of peripheral states worsens still further the fragility of their public budgets, intensifying the vicious circle\textsuperscript{24}. Implicit or explicit state guarantees for "too important to fail" banks and other financial institutions constitute liability items in the public budget. They can be regarded as put options in the context of contingent claims analysis (CCA), showing value fluctuations in connection with value changes in the assets of banks and financial intermediaries. It follows that financial crises intensify the intricate interconnections between states, banks and financial in-

\textsuperscript{24} Among the peripheral countries, for example, Spain and Ireland are characterised by the bursting of a real estate bubble and by the crisis affecting a number of banks, which requires government bailout intervention and, consequently, an increase in public expenditure and debt. Greece is affected by an expansion of public indebtedness and a situation of falsified public accounts, which becomes extremely severe if one considers the real value of the accounts revealed by the new government in 2009. This situation requires external aid from the International Monetary Fund (IMF) to refinance the Greek debts coming to maturity, taking the country out of the market where the spreads would be truly astronomical. Italy presents a fairly high incidence of public indebtedness and, at the same time, of debt compared to GDP, which is above 120%. The problem is linked essentially to the elevated levels of public expenditure and debt in conditions of low economic growth. The measures enacted for correction of the public accounts seek to rebalance the public finances and to reach a balanced budget by 2013. Reduction of the spreads is moving in the right direction, as the government has taken action in favour of liberalisations, simplifications and various structural reforms.

While the factors lying at the root of the problems are different, and although the situation of Greece is fairly complex and indicates a partial default for restructuring the debt and the application of a haircut, the common element is represented by an increase in the public debt and the onset of a sovereign debt crisis. Consequently, all of these situations call for solutions that must be based on concrete action undertaken and continued over time in the individual countries together with action on the European level by measures designed to reinforce instruments capable of defending the given economies.

In this framework, the progressive adoption of instruments for solving financial crises in individual countries mitigates the tension on the financial markets. This is promptly confirmed by reductions in the spreads between the sovereign bonds of an individual country and the German bonds, calculated by using ten-year maturity and other shorter-term maturities as the main parameter.

The various measures undertaken by the ECB to provide liquidity aim to consolidate the results achieved by the peripheral countries with regard to the slow and gradual reduction of the spreads. This also helps to abate the vicious cycle of increasing costs of public refinancing and of public expenditure arising from the interest rates, because it goes in the opposite direction, that is to say towards a reduction in the costs and public expenditure on interest payments.
intermediaries, leading to the application of implicit or explicit guarantees in the different countries\textsuperscript{25}.

The critical aspects have emerged clearly in states distinguished by high credit risks on their debts, above all on account of the negative repercussions on value fluctuations of sovereign securities portfolios on the asset side of banks and financial intermediaries. This problem raises the issue of a sustainable level of the credit risk, which necessarily implies the need to improve the control functions carried out by supervisory authorities with regard to financial systems, economic systems, the private sector and the public sector. However, the establishment of a greater number of rules is unlikely to be able to prevent new crises on a global scale: as shown by the subprime mortgage financial crisis and the sovereign debt crisis, the crux of the problem resides, respectively, within the banks and states, that is to say precisely in the two main subjects whose activity is most intensively constrained by defined rules.

Quality and quantity of controls, both internal in the context of increasingly defined risk management and external through specialised risk exposure monitoring bodies designed to exercise supervision over the various different agents, constitute key elements for crisis prevention. Taking into account the reduction of boundaries between financial sectors and economic sectors, it is vital to ensure coordination of supervisory activity on an EU scale and on a global scale for the identification, measurement and management of risks.

6. The sovereign debt crisis lays bare a major issue: namely the high levels of debt of many EU states. Cuts of public debt can be implemented in different countries by setting up public real estate investment funds which essentially indicate public real estate on the assets side and at the same time bonds on the liabilities side. Raising funds by placing bonds on financial mar-

Kets leads to investments in public real estate and consequent reductions in the total public debt, thereby reducing interest expenditure.

The establishment of a public real estate investment fund implies decisions concerning the identification, quantity and value of public property to divest on the real estate market in the future. These decisions must be made by each state prior to the establishment of the public real estate fund.

The shareholders in the capital thereby created will essentially be represented by the state, but the ratio of assets to capital, as is generally the case in the financial sector, will be very high. It implies the measurement of the leverage.

Such a strategy can be brought into action in many countries, allowing a drop in the total level of public debt and, at the same time, in the level of interest expenditure. This will make a structural and positive contribution that can address the sovereign debt crisis. It should be noted, however, that implementation depends on the choices made by each country.

The public real estate investment fund can be set up by different states and is characterised by the placing of bonds on financial markets with high rating, on the basis of the “guarantee” consisting of real estate assets and, additionally, by a very low level of public capital. The standard conditions of financial markets can be examined and monitored in order to define the appropriate time frames and individual amounts for the placing of bonds. It is important to emphasise that the bonds are issued without the state guarantee.

Such a measure can be implemented within a relatively short period of time and implies a substantial reduction in public debt; accordingly, it offers an exit strategy from the sovereign debt crisis as it allows a decrease in debt and at the same time a cutback in interest expenditure. Improving the financial situation of different countries would provide a stimulus to recreate
balance in the public finances which, in combination with other measures applied in the past, can offer a route to the solution of European problems.

It should be pointed out, however, that much depends on the value of real estate divested and the related amount of bonds placed, and thus on the consequent cut of public debt in the euro area. This is left to individual government choices, the effects of which can be extensive in the event of wide-ranging application in the different countries, above all countries of the peripheral euro area.

This innovative instrument can be used in order to fulfill the requirements of the fiscal compact while at the same time giving the benefit of fewer fiscal restrictions. The balance of the public debt can thus be restored, and with a less negative impact on the economy. This innovative instrument offers the potential for a solution to sovereign debt problems in the future.

7. A considerable number of measures have been implemented by national governments, the European Central Bank (ECB), the International Monetary Fund (IMF) for the reduction of financial crises.26

In this context, the framework to identify the three main areas of intervention is as follows: economic policies for balancing the public finances through reduction in expenditure and/or increase in fiscal taxation, the establishment, by European states, of the European Financial Stability Facility (EFSF), namely the so called “European state bailout fund”, which will be of a temporary nature, and its replacement by the European Stability Mechanism (ESM), in other words a permanent "European state bailout fund" which should bring a degree of stability into the euro area.

26 The ECB has undertaken different measures with the use of unconventional instruments forming part of a longer term refinancing operation (LTRO), through financing granted to banks with a three-year maturity period and also by means of the security market programme (SMP), which involves the purchasing of sovereign bonds of countries facing difficulties. See, in this regard, CAPRIGLIONE F., G. SEMERARO, Financial crisis and sovereign debt. The European Union between risks and opportunities, “Law and Economics Yearly Review”, 1, 2012.
Countries characterised by a ratio between public debt and gross domestic product (GDP) higher than 60 per cent should reduce at least 1/20 of the excess every year, thereby moving towards fiscal convergence together with the monetary convergence already set in place in the EU. These adjustments are in line with the recent measures of the fiscal compact applying to different countries, aiming to create conditions for the sustainability of public debts in the medium and long run.

The ECB pursues the priority aim of price stability using a number of different monetary policy instruments, both of a conventional and unconventional type. Recently the ECB has introduced an unconventional measure, termed Outright Monetary Transactions (OMT), through which the ECB can engage in potentially unlimited purchase of sovereign securities with maturities from 1 to 3 years, upon the request of an individual state and upon the given state's acceptance of the conditions imposed by the OMT measure\(^{27}\). This has helped to restore conditions for an increase in prices on bond markets and stock markets and a reduction in the cost of financing for states, banks and firms; additionally, it has contributed to reducing the spread between the yield on bonds of the weaker countries and those of the German country. Moreover, the ECB will support individual countries that submit a request for financial assistance to ESM-EFSF. The ECB will involve the IMF in adjustment plans and, at the same time, will not set ceilings on interest rates on sovereign securities issued in the financial markets of the euro zone.

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

---

The FED pursues several objectives, such as: control of inflation, economic growth, employment, financial stability, interest rates and exchange rates control. The quantitative easing (QE3) set up by the FED in the USA for the purchase of public securities implies an expansionary monetary policy, in pursuit of a monetary stimulus to the economy and, at the same time, to public financing. Therefore, the objectives and instruments adopted by the FED in the American context are wider than those favoured by the ECB in the European context. During the onset and evolution of financial crises, the FED tends to use a wider range of instruments and thus demonstrates greater capacity to cope with and overcome financial crises in comparison with the ECB.

Financial markets, in the components involving money markets, bond markets, stock markets and derivatives markets, reflect the initiatives, behaviour and choices of central banks. A central bank's approach can contribute to increasing trends in these various sectors through concrete action and/or intention of buying sovereign securities. However, conventional and unconventional instruments employed by central banks have the effect of rapidly increasing the volumes in their balance sheets and, consequently, the risk level as well, especially, the credit risk, as clearly emerges from observation of the 2007-2012 period.

8. The analysis carried out here underlines the importance and centrality of credit risk management. This was a major aspect involving the subprime mortgage financial crisis in the framework of financial instruments (loans, asset-backed securities, derivatives) created by banks, but it also plays a crucial role in the sovereign debt crisis in the context of financial instruments created by states (sovereign debt).

Financial crises have been a feature of financial systems for roughly the last five years (2007-2012) and have been addressed through a number of fiscal restriction measures, mainly in Europe, and expansionary monetary
measures especially in the USA. The presence of spreads discriminating between the yield on public securities of some countries (such as Spain and Italy) and those of Germany has negative repercussions not only on the cost of public refinancing but also on the cost of credit to private and public firms, thus creating an obstacle to investments and economic growth.

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

So where do we stand in the evolution of financial crises in Europe? In addition to the significant steps already taken, the way forward in the line of restoring standard financial conditions in Europe must include credible economic strategies, steadier interventions of the ECB and structural reform plans in the medium and long run28.

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

ECB can be regarded as instruments capable of lowering the spreads among yields; at the same time, however, they impose restrictions precisely on the countries that seek financial assistance. Such a circumstance tends to create difficulty in endeavouring to recover substantial economic growth margins. A structural reform plan should be pursued by those countries that are particularly affected by financial crises, with the aim of strengthening their position in the medium and long term.

Therefore, in the evolution of financial crises some progress towards financial stability has indeed been achieved, but a number of steps still remain to be taken.
9. The evolution of financial crises indicates great progress during the year 2012 in the field of financial stability. The analysis carried out in this paper allows the basic elements to be singled out and summarised:

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

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

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

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

5) the fiscal compact aims to restore ratios between total debt and GDP to 60 per cent, which is taken as the ceiling for the progressive recovery of countries in excess of this ratio; the fiscal compact thus seeks to rebalance the public finances and decrease the spreads in the different EU countries over the medium and long term;

6) the establishment of the public real estate investment fund represents an innovative instrument designed to decrease the public debt and at the same time to reduce interest expenditure;

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

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

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

10) the prevention of new financial crises is linked to restoring and maintaining rational criteria both in state finances and in the related risk management practices and, at the same time, to restoring and maintaining rational criteria in financial intermediary lending and investment and in the related risk management practices.
CREDIT RATING AGENCIES,
THEIR REGULATION AND CIVIL LIABILITY
IN THE EUROPEAN UNION

Mads Andenas*

ABSTRACT: This paper addresses some of the pressing issues of credit rating agencies, their regulation and civil liability in the European Union. The regulatory and supervisory arrangements for rating agencies represent a new model where the European level has taken over responsibility for the previously unregulated industry. New measures to enhance market discipline, including an investor tort liability action against the rating agencies are proposed. Fundamental issues remain open about the aims of the regulatory regime and the effects of the proposals.

SUMMARY: 1. Credit rating agencies and regulatory reform of the financial markets. - 2. Credit rating agencies in the financial markets. - 3. The European regulatory and supervisory regime for CRAs. - 3.1. ‘Self-regulation’ and the first EU measures. - 3.2. Examining the EU regime. - 3.3. The nature of...
and purpose of the governance. - 4. Governance, Market Discipline and Civil Liability.

1. Credit rating agencies are created for modern financial markets and have no direct functions outside them. What started as private sector advice and classification of issuers and issues of bonds, developed both in terms of the service provided and the reliance put upon it. Credit rating agencies have certain similarities with auditors in that they have a role as private sector gatekeepers to the financial markets. Their role as such has developed in an interaction between the demands of the private participants and the regulatory requirements. The latter may be requirements on other participants than the gatekeepers themselves: the issuer of bonds or equities has to subject itself to certification or classification in order to gain or keep access to the market for its securities. The role of the gatekeeper is at the core of the architectural design of financial markets. It becomes subject to renewed discussion when the search for remedies take place after a financial market scandal or larger crisis. In the United States the bankruptcy of Enron at the end of 2001 triggered such a discussion in relation to auditors¹. A wider debate about gatekeepers also including rating agencies took place in 2005 after other corporate scandals in the US and Japan². It gained further momentum against the backdrop of the financial crises

with the bankruptcy of Lehman Brothers in autumn 2008 and the subsequent eurozone debt crisis.

There are different ways of defining gatekeepers as a category. One is as reputational intermediaries providing verification and certification services to investors\(^3\). Credit rating agencies (CRAs) would qualify as gatekeepers under most definitions. CRAs have also been described as information intermediaries,\(^4\) contributing to reduce information asymmetry in financial markets.\(^5\)

The main criticism against CRAs is that they have done the opposite, and increased or created new information asymmetries that played an important part in the causation of the recent crises. Inflated credit ratings introduced or increased risks in the financial markets by disguising the actual risks of many mortgage related securities.\(^6\) Conflicts of interest jeopardized the objectivity and quality of credit ratings. The structural objections go beyond this kind of issues that traditional regulation could reduce or minimise. The structural objections are linked to the pro-cyclical effect of credit ratings, more than the transparency and quality concerns mentioned, including that of sovereign debt ratings.

---


The redesign of financial market regulation reflects the different regulatory and constitutional structures. In the United States the pressing issues would be the relationship between the federal regulators, and whether they covered the relevant tasks in an adequate manner. In the European Union the division of tasks between the national and the EU authorities, and the separation of monetary policy and financial supervision in the Euro states with the European Central Bank responsible for the first and national authorities in different configurations for the latter, added further challenges.

The European Union has in response to the crisis fundamentally redesigned its architecture of supervision of the European financial market. Building on the findings of the de Larosière report from the high-level expert group on financial supervision of 2009,7 a new European System of Financial Supervision (ESFS) was introduced as a first step. ESFS was part of a fundamental reshaping of financial supervision in the European Union. Introducing a new regulatory and supervisory regime for CRAs was an important part of this process. This paper will critically analyse the recently reformed regulatory, supervisory and liability regime for CRAs in the Union, with a focus on whether and how far it might be capable of minimising the distortive effects of the credit rating sector.

The legislative aims, the provisions of and the rationale behind the legal acts designing the regulatory and supervisory regime for CRAs in the Union might only be comprehended adequately against the backdrop of the structure and functioning of the credit rating market. Its key features which are highly in-

7 Recommendations of the High-Level Group on Financial Supervision in the EU as of 25 February 2009.
terdependent will be discussed in this order: (1) the role of credit ratings and CRAs in the financial market, (2) the ‘reputational capital’ of CRAs, (3) the oligopoly of the credit rating market, (4) the issuer-pays model including its ramifications on the quality and objectivity of credit ratings, and (5) lock-in effects.

2. Credit ratings is a new function in financial markets and have gained significant importance in the course of a short period of time, and across the world. There is no settled or agreed meaning of the term ‘credit rating agency’. For the purposes of this paper we rely upon the definition of credit rating under Art. 3 (1) (a) of the Regulation (EC) No. 1060/2009 on credit rating agencies (CRA Regulation). The definition addresses material and formal aspects of a credit rating. As to the material aspects, the provision defines a credit rating as an opinion regarding the creditworthiness of an entity, a debt or financial obligation, debt security, preferred share or other financial instrument, or of an issuer of such a debt or financial obligation, debt security, preferred share or other financial instrument. As to the formal aspects, the definition adds that a credit rating is issued using an established and defined ranking system of credit rating categories. A credit rating’s meaning is limited to an opinion on the probability of default or loss of entities or a debt or the other listed instruments; its form is standardised and the information condensed in a symbol. The pivotal role of credit ratings in global securities and banking markets is evidenced by the fact that investors, borrowers, issuers and governments use credit ratings when

making investment and financing decisions, and that amongst others - credit institutions, investment firms, insurance undertakings and institutions for occupational retirement provision may use credit ratings as the reference for the calculation of their capital requirements for solvency purposes or for calculating risks in their investment activity. The limited meaning and standardised form of credit ratings are in stark contrast to the reliance by market participants. Reliance on credit ratings is not only by market participants but in standards, laws and regulations. This ‘hard wiring’ of credit ratings lead to mechanistic responses by market participants and, in turn, contributed significantly to market reliance on credit ratings. Market (over-) reliance might cause a cascade of negative effects including ‘cliff effects’ such as the amplification of procyclicality by credit rating downgrades which in turn can lead to systemic disruptions. Herding in market behaviour might be triggered, too, and market participants reduced their own risk management capability instead of employing and enhancing it.

The self-regulatory regime for CRAs in Europe before the enactment of the CRA Regulation had been justified with the market regulating effects of the reputation of CRAs. It has been argued that CRAs act as reputational

---

9 See e.g. JOHANSSON, T. (2010) Regulating credit rating agencies: The issue of conflicts of interest in the rating of structured finance products, Journal of Banking Regulation 12 (1), 17.


11 See FSB,10 p. 1.

12 See FSB,10 p. 1.
intermediaries\textsuperscript{13} depending on accurate credit ratings as the acknowledgment of their credit ratings’ quality by the market was their most important asset.\textsuperscript{14} The core element of the reputational mechanism is the building up of a track record of many years’ standing, constituting a ‘reputational capital’.\textsuperscript{15} The financial crises after the Enron bankruptcy\textsuperscript{16} demonstrated that the reputational capital failed as a market regulating factor and cemented the oligopolistic structure of the credit rating market.

The credit rating market remains dominated by three CRAs primarily based in the US capital markets. One important factor that contributed to the building up and deepening of the oligopolistic structure of the credit rating sector was the reputational mechanism. The importance of a track record of many years restricted the access of new CRAs to the market. There were no smaller or European based CRAs. High start up costs of new CRAs exacerbated the high barriers to market entry. The registration regime for CRAs in the Union under the CRA Regulation might facilitate the entry of new players in the credit rating market. It will take some time before the registration regime for CRAs in the Union unfolds and fully takes effect. Several scenarios have been considered,

\begin{itemize}
  \item \textsuperscript{13} For more information on the ‘reputational capital’ of CRAs with further references, see STEMPER, M. (2010) \textit{Rechtliche Rahmenbedingungen des Ratings}, Baden-Baden: Nomos, p. 98.
  \item \textsuperscript{14} See RICHTER, M. (2008) \textit{Die Verwendung von Ratings zur Regulierung des Kapitalmarkts}. Frankfurt aM: Peter Lang, pp. 72 et seq.
  \item \textsuperscript{15} See DEIPENBROCK, G. (2007) \textit{Der US-amerikanische Rechtsrahmen für das Ratingwesen - ein Modell für die europäische Regulierungsdebatte?}. Wertpapier-Mitteilungen 61 (48), 2220 et seq.
  \item \textsuperscript{16} The bankruptcy of Enron has been considered as the crossroads at which the focus of debates on rating-based regulation shifted to rating- directed regulation. See HORSCHE, A.,4 pp. 265 and 334 et seq.
\end{itemize}
ranging from entrusting the European Central Bank (ECB) or National Central Banks with the task of issuing credit ratings to setting up a new independent European Credit Rating Agency\textsuperscript{17} and the establishment of a European Network of small and medium-sized CRAs.\textsuperscript{18}

The prevailing model in the credit rating market is the issuer-pays model: Issuers solicit and pay for the ratings of their own debt instruments. In this model, not the investor, but the issuer or debtor of the financial instrument selects the CRA. Conflicts of interest are inherent in this model. CRAs are driven to generate and increase their revenues from the issuer and might assign an inflated - higher than justified - credit rating.

Lock-in effects in the credit rating sector are closely linked to the issuer-pays model, the oligopolistic structure of the credit rating market and the reputational mechanism. In the prevailing issuer-pays model the issuer or debtor of a financial instrument selects a CRA to rate it. The issuer or debtor in this model appears not mainly to be incentivized to solicit a CRA with the highest reputation based on a long track record. It might be considered instead that the issuer or debtor is driven more by the prospect of being assigned the highest credit


rating available. The incentive of CRAs in the issuer-pays model to promote the quality of credit ratings to avoid damage to their reputation is less significant than the incentive to gain market shares and develop lucrative new market segments. Apart from these conflicts of interest of rating analysts, lock-in effects reduce the probability of loosing clients in case of a loss of reputation of a CRA. A credit rating client considering to replace the current CRA with a less known CRA may be deterred from doing so by damage to the credit rating client’s reputation from allegations of credit rating shopping. In addition, the oligopolistic structure of the credit rating market offers only limited choice of change.

Based on the issuer-pays model, the oligopolistic market structure and the lock-in effects, the reputational mechanism could not provide any effective market regulating impact on the credit rating sector.

This leaves the pressing question of whether or not the imposition of a regulatory regime could make a difference to the quality of ratings. Forster ar-

---

20 For more information on the developments of the credit rating market, see US Senate, Permanent Subcommittee on Investigations, p. 7.
22 For more information on that with further references, see Stemper, M., pp. 106 et seq.
gues that the chief difficulty in discerning the reliability of credit ratings lies in the opacity of the standards and methodologies used to produce the ratings. By using economic analysis, Forster shows that if rating agencies were subject to regulatory demand to make transparent their standards and methodologies, this would offer significant improvements in regulatory efficacy and user reliance, leading to increases in social good. However, do regulators have the technical expertise and capacity to evaluate and examine rating methodologies and assumptions? Ford argues that regulators generally need to increase staff and expertise in order to be able to critically evaluate industry developments. If so, the ability to critically examine credit rating quality and agencies’ procedures and methodology may come down to more robust recruitment by the regulatory sector. Nevertheless, Stolper argues that it is inherently difficult for regulators to detect whether optimal and accurate credit ratings have been delivered by agencies, as these are often ex ante technical judgements, leaving the accuracy of regulatory supervision potentially subject to as much doubt as the accuracy of the ratings themselves.

A more important concern is the implications of regulatory supervision for the perception of the quality of credit ratings. Would the existence of a regula-

tory regime and supervision lead the investment market to trust credit ratings as being somewhat endorsed by regulators? Would this introduce new moral hazards in investment decisions? Although this is a different point from that of regulatory coupling with credit ratings mentioned earlier, the existence of an overall regulatory regime could give rise to the same perception. Regulatory retreat from coupling with credit ratings may then be rendered meaningless if the existence of a regulatory regime continues to give the same impression of regulatory endorsement to the investment sector. It may be that the investment sector’s well-established reliance on credit ratings is unlikely to diminish, whether or not regulators remove regulatory licences for ratings in legislation.

Under all circumstances, utilising regulatory resources to support moral hazard on the part of the wholesale investment sector is unsound.

Another approach would follow from these starting points. The level of investor protection that regulators provide in the regulation of credit rating agencies should minimise the level of moral hazard by (a) focusing on the systemic risk elements of monitoring credit rating agencies; and (b) making the wholesale investment sector play a more active governance role in relation credit rating agencies’ role in mediating information.

3.1 The first approach to CRAs is set out in the European Commission’s 2006 Communication. In line with the advice received from the Committee of

30 Communication from the Commission on Credit Rating Agencies. (2006/C 59/02).
European Securities Regulators (CESR), the Commission did not present new legislative proposals in the area of CRAs. It stated its confidence ‘that the existing financial services Directives applicable to CRAs – combined with self-regulation by the CRAs on the basis of the newly adopted International Organisation of Securities Commissions (IOSCO) Code – will provide an answer to all the major issues of concern raised by the European Parliament’. The Commission added that it would ‘monitor developments in this area very carefully. It may consider introducing new proposals if it becomes clear that compliance with EU rules or the IOSCO Code is unsatisfactory or if new circumstances arise – including serious problems of market failure or fresh developments in other parts of the world’. The international discussions on adequate regulatory tools for CRAs and the efforts resulting from that\(^{31}\) had an important impact on the Union’s regulatory and supervisory approach to the credit rating sector.\(^{32}\) A landmark in the legislative approach to CRAs in the realm of securities regulation was the proposal of a self-regulatory regime for CRAs made by the International Organisation of Securities Commissions (IOSCO)\(^{33}\). The ‘IOSCO Statement of principles regarding the activities of credit rating agencies’ (IOSCO Principles) as of September 2003 has been the starting point. As the IOSCO Principles left open the implementation of its high-level objectives\(^{34}\) IOSCO developed the

\(^{31}\) See Recital 2 of the CRA Regulation.

\(^{32}\) For more information, see DEIPENBROCK, G. (2009) “Mehr Licht!”? - Der Vorschlag einer europäischen Verordnung über Ratingagenturen. Wertpapier-Mitteilungen 63 (25), 1166 and 1173.

\(^{33}\) For more information on IOSCO, see http://www.iosco.org.

\(^{34}\) IOSCO. IOSCO Statement of principles regarding the activities of credit rating agencies, September 2003, at introduction.
more specific ‘Code of conduct fundamentals’\textsuperscript{35} (IOSCO Code Fundamentals) already by the end of 2004, which were amended later.\textsuperscript{36} However, the IOSCO Code Fundamentals are (only) recommendations without legal binding force and lack sharpness regarding their contents.\textsuperscript{37} The European Union introduced a self-regulatory regime after the first release of the IOSCO Code Fundamentals. The Committee of European Securities Regulators (CESR) was entrusted with the task to oversee the voluntary compliance of CRAs with the IOSCO Code Fundamentals. The implementation by a self-regulatory regime failed dramatically. The financial crisis and the collapse of Lehman Brothers in autumn 2008 functioned as a catalyst for the paradigm shift for the regulatory regime for CRAs at European level.

The EU Regulation on Credit Rating Agencies is one of the earlier pieces of reform legislation passed in September 2009 pursuant to the de Larosière Report. When the European Securities and Markets Authority (ESMA) was formally established at the end of 2010, amendments were made to the Regulation in order to designate ESMA as the European regulator for credit rating agencies. Its role was to take over registration and approval, standard-setting, ongoing supervision and enforcement, so replacing a fragmentary coordinated approach to registration, supervision and enforcement undertaken by a college of nation-

\textsuperscript{35} IOSCO. \textit{Code of conduct fundamentals for credit rating agencies}, December 2004.


al supervisors. However, by late 2011, the Commission had proposed another round of amendments to this young Regulation.

3.2 The following part of the section will critically examine the regulatory regime for credit rating agencies in the EU, in particular whether the EU regulatory regime is likely to be able to exert influence over rating quality and address the market failures discussed above in order to improve investor protection. Article 1 states that the Regulation is intended to improve the ‘reliability of credit rating activities, contributing to the quality of credit ratings issued in the Community’. The Regulation states clearly that submitting to credit ratings is voluntary. EU legislation that has hitherto given ratings ‘regulatory licences’, by incorporating them into the legislative framework (such as the incorporation of Basel II and its reference to credit ratings in the Capital Requirements Directive 2006), is also to phase out such references to ratings in due course. However, this may not necessarily change the investment and financial sectors’ well-established practice of relying on credit ratings.

EU legislation that has hitherto given ratings ‘regulatory licences’, by incorporating them into the legislative framework (such as the incorporation of

---

Basel II and its reference to credit ratings in the Capital Requirements Directive 2006), is also to phase out such references to ratings in due course.\textsuperscript{42} However, this may not necessarily change the investment and financial sectors’ well-established practice of relying on credit ratings.

The Regulation applies to all credit rating institutions that intend to issue credit ratings for distribution by subscription or public disclosure in the European Community, excluding private credit ratings that are tailor-made and not intended for public disclosure or distribution, consumer and commercial credit scores, and ratings produced for export credit agencies and central banks.\textsuperscript{43} Credit rating agencies who wish to disseminate ratings information in the EU or be engaged by subscribers in the EU must be registered with ESMA.\textsuperscript{44} The Regulation also provides timeframes of between 30 and 40 days from the time a completed application is received by ESMA to ESMA’s decision, such timeframes being extendable by a further 15 days should the applicant agency be involved in outsourcing or endorsement of third country agency ratings. ESMA’s decisions are communicated to the European Commission and national regulators, as a measure of accountability.\textsuperscript{45}


There are three types of credit ratings allowed by the Regulation to be disseminated or distributed by subscription in the EU, namely: the registered credit rating agency’s rating, endorsed credit ratings issued by a third country credit rating agency, and credit ratings issued by a third country credit rating agency certified by ESMA.

A credit rating agency may only be registered with ESMA if it has a registered office in the Community and is a fully functional outfit with staff and a compliance function. Hence it is not likely that a credit rating agency that operates largely outside of the EU would be able to obtain an EU registration based on a minimal or shell registered office. A registered credit rating agency may endorse ratings issued by a third country credit rating agency in the EU, if all of the conditions below are met:

- the registered rating agency and third country agency belong to the same group;
- the third country rating agency is registered under and subject to a regulatory regime in the third country that imposes rules on the avoidance and management of certain conflicts of interest, disclosures of rating methodologies and assumptions, periodic and ongoing transparency and supervision concerning outsourced functions that are equally as stringent as those imposed by the Regulation, and the registered credit rating agency is able to demonstrate that

---

ongoing compliance by the third country agency with these rules has been verified;

- ESMA’s ability to assess and monitor the compliance of the third country rating agency with its applicable third country rules is not limited and that ESMA has cooperation arrangements in place with the relevant third country regulator; and

- the endorsing credit rating agency is able to provide all necessary information requested by ESMA; there is an objective reason for the third country rating agency to be located in that third country; and the regulatory regime of the third country does not interfere with the content and methodologies of the ratings.49

Credit ratings issued by third country credit rating agencies in relation to financial instruments established in third countries may be disseminated in the EU, if the relevant third country credit rating agency is certified by ESMA.50 The relevant third country credit rating agency must apply for certification and certification is based on fulfilment of all the following conditions:

- submission of the credit rating agency to an existing authorisation and regulatory regime in the third country, held to be equivalent to that imposed by the EU Regulation;

- the existence of operational cooperation arrangements and mechanisms between ESMA and the third country regulator; and

- the credit ratings issued by the credit rating agency and its credit rating activities are not of systemic importance to the financial stability or integrity of the financial market(s) of one or more Member States.

Although it was feared\textsuperscript{51} the Regulation would lock out all third country credit ratings if key differences existed between the Regulation and regimes elsewhere, ESMA’s practice has been tolerant of key jurisdictions such as the US and Japan. The then Committee of European Securities Regulators (CESR), now ESMA, issued equivalency decisions in favour of the US and Japan while acknowledging key differences.\textsuperscript{52} Where relevant, applicants for certification may also apply for exemptions from specific provisions relating to management of conflicts of interest and from having a physical presence in the EU where either or both are burdensome and disproportionate given the nature, scale and complexity of the business.\textsuperscript{53}

The two key American incumbents – Standard and Poor’s and Moody’s (who between them provide ratings for at least 70 per cent of the corporate debt market) – are already authorised by ESMA. Fitch, the UK-based ratings provider, has also been registered, covering about 90 per cent of the existing


ratings sector. Other registered raters generally operate at a domestic level in individual Member States.

3.3 We will now turn to the features of the EU regulatory regime in order to discern the nature and purpose of the governance provided by the regulation. The EU Regulation addresses a number of issues relating to ratings quality, which will be detailed below.

The Regulation targets the problem of conflicts of interest, as a proxy for improving ratings quality. The Regulation provides a mixture of prescriptive detail and meta-regulatory approaches in respect of management of conflicts of interest by credit rating agencies.

On a personal level, the Regulation provides for various measures to prevent credit rating analysts and other employees from being affected by conflicts of interest. These avoidance measures include a prohibition on persons directly involved in the rating process engaging in negotiations for fees;\(^\text{54}\) the mandatory rotation of lead analysts, analysts and approvers of credit ratings;\(^\text{55}\) the decoupling of analysts’ and approvers’ compensation from the rating agency’s revenues;\(^\text{56}\) and prohibitions imposed on persons directly involved in the credit


rating activities from having some form of personal, business or financial interest or relationship to rated entities and their associated entities.\textsuperscript{57}

In terms of mandatory rotation of analysts, lead analysts must not be exposed to the same rated entity for a period exceeding 4 years, other analysts must be rotated after 5 years, and approvers of credit ratings for the same rated entity need to be rotated after 7 years.\textsuperscript{58} In late 2011, the Commission proposed that even if analysts leave an agency for another agency, the prohibition in exposure to the same client after 4 years must also be applied.\textsuperscript{59} It is queried whether the mandatory rotation of approvers is necessary. Approvers are likely to be in senior executive positions in the rating agency and are likely to have overall charge of a number of client accounts. The mandatory rotation exercise could give rise to the transfer of client accounts from one senior executive to another among a small coterie of persons. It is queried whether mandatory rotation will necessarily achieve a significant amount of independence in the rating process, beyond the mandatory rotation of analysts who are involved in the complete mechanics of the process.

All persons directly involved in credit rating activities are also prohibited from having financial investments directly, or that would give rise to conflicts of


interest, in the rated entities and its associates.\textsuperscript{60} Nor may they have any personal or business relationship with the rated entity or its associates, including a previous employment relationship.\textsuperscript{61} If a rating analyst terminates employment with the rating agency and joins the rated entity or its associates, the Regulation requires the credit rating agency to review the work of the analyst over the preceding two years to determine if any conflicts of interest may have affected the quality of ratings.\textsuperscript{62} Further, any person directly involved in credit rating activities is prohibited from taking a key management position with the rated entity or its associates within 6 months of the issue of the rating.\textsuperscript{63}

All persons directly involved in credit rating activities are also prohibited from soliciting or receiving gifts or favours from anyone ‘with whom the credit rating agency does business’,\textsuperscript{64} making the prohibition against any form of inducements very wide.

The independence requirements imposed on credit rating agency employees far exceed those that apply to natural persons acting as investment advisers or brokers in the intermediation business and who may have direct customer-
facing roles. In particular, the lack of a complete prohibition on inducements\textsuperscript{65} for investment firms makes the blanket prohibition against gifts in Section C of Annex I of the EU Regulation appear rather harsh. It is questionable whether or not rated entities may buy a meal for a team of analysts after a meeting or whether minor hospitality gestures are caught by the blanket prohibition. The provisions in Section C of Annex I do not just cover management of conflicts of interest but also avoidance of such conflicts in most cases.

Although the Regulation believes in the control of conflicts of interest as a proxy for improving rating quality, we must still question whether the avoidance of conflicts of interest promotes more reliable or accurate ratings. To what extent can we strive for ‘accurate rating quality’ when ratings are basically opinions\textsuperscript{66} and not scientific evaluations? Even if the avoidance of conflicts of interest provides an environment for ‘more accurate’ ratings to be developed, how far along the spectrum of accuracy have we moved? Hill\textsuperscript{67} and White\textsuperscript{68} argue that regulatory governance of contextual matters, such as avoidance of conflicts of interest, is not likely to materially affect rating quality. Should regulators place more emphasis on the factors that could materially affect rating

\begin{footnotesize}
\begin{itemize}
\item[\textsuperscript{68}] LAWRENCE J WHITE, ‘Credit-rating Agencies and the Financial Crisis: Less Regulation of CRAs is a Better Response’ (2010) 25 Journal of International Banking Law and Regulation 170.
\end{itemize}
\end{footnotesize}
quality, such as rating competence and methodology,\textsuperscript{69} rather than regulating conflicts of interest?

At the agency level, some prescriptive detail may be found in terms of corporate governance arrangements for credit rating agencies of 50 employees or more, but which may also apply to credit rating agencies with less than 50 employees if ESMA is of the view that the structure of the agency is designed to avoid compliance with the corporate governance provisions.\textsuperscript{70} Such credit rating agencies must have at least a third, but no less than two, independent directors on the Board, to monitor the development of credit rating policies and methodologies, the internal quality control systems, the measures and procedures to manage any conflicts of interest and the effectiveness of compliance, governance and review procedures.\textsuperscript{71} Further, these credit rating agencies must also establish a permanent and independent compliance function, with the necessary resources, expertise and independence to monitor compliance with the Regulation.\textsuperscript{72} For all other credit rating agencies, an exemption needs to be sought from ESMA to avoid having to comply with the above if compliance is disproportionate with the size, scale, nature and complexity of the business.\textsuperscript{73}


All rating agencies must also establish an independent review function for the ongoing monitoring of its issued ratings.\textsuperscript{74}

In terms of corporate governance, it is uncertain whether the presence of independent directors necessarily improves rating independence and the management of conflicts of interest, or indeed improves rating quality. General empirical research has provided mixed evidence regarding the impact on conflicts of interest where investment funds or firms have recruited independent directors. Blanchard and Dionne,\textsuperscript{75} in relation to banks and insurance companies, conclude that the independent directors assist in mitigating situations of conflicts of interest that affect risk management. Kim,\textsuperscript{76} however, surveying the US, is of the view that independent directors in mutual funds have not played a significant part in addressing conflicts of interest that undermine shareholder protection. In terms of the relationship between independent directors and improved rating quality, dedicated empirical research needs to be undertaken in this area to discern whether corporate governance bears a relation to rating accuracy.

There are also certain blanket prohibitions in place, applicable to the agencies themselves, to control conflicts of interest. Credit rating agencies are


prohibited from issuing ratings for entities (or their associates) in whom agencies have made a financial investment, where the rated entity or its associates is related to the rating agency by ownership or control, where any person directly involved in rating activities under the agency’s control is a member of the Board of the rated entity or its associates, and where any rating analyst involved in the rating activity has had a relationship with the rated entity or its associates that causes a conflict of interests. Where an analyst is subject to avoidance of conflicts of interest as defined in Section C of Annex I, the agency has a corresponding obligation not to issue or to withdraw relevant credit ratings. However, Section C of Annex I applies to a range of persons wider than analysts (e.g. no person having a direct role in the rating process should have had a previous employment relationship with the rated entity or its associates). It would appear that only where analysts are implicated in the situations identified in Section B would a rating agency be mandated to withdraw or refrain from issuing a rating. However, in relation to other persons mentioned in Section C, it is unclear whether the obligation not to issue or to withdraw a rating applies. Given the stringent nature of the regulatory regime, the broader regulatory interpretation may be favoured such that where any person employed by the agency and directly participating in the credit rating process is compromised; the credit rating should not be issued or should be withdrawn. In late 2011, the

Commission proposed to subject credit rating agencies to rotation every 6 years.\textsuperscript{78}

Credit rating agencies are also prohibited from providing advisory or consultancy services, although ancillary services (such as market trends or price forecasts) are permitted provided they do not present conflicts of interest.\textsuperscript{79} In 2011, the Commission also proposed that any person holding at least 5 per cent voting capital in a credit rating agency be subject to the prohibition on offering non-rating services to clients who are rated entities.\textsuperscript{80} Agencies also have to ensure that rating analysts or persons who approve ratings do not make formal or informal proposals or recommendations to assist issuers in the design of structured finance instruments.\textsuperscript{81} The latter is a direct response to what is perceived as having contributed to severely inflated ratings in respect of collaterised debt obligations that crashed in the global financial crisis after obtaining the highest ratings. However, the Commission’s 2011 proposal to oblige rating agencies to issue ‘rating outlook opinions’ may undermine the provisions above. The Commission proposed that if rating agencies intended to amend ratings for any issuer, they should first issue a ‘rating outlook’ opinion\textsuperscript{82} to warn the issuer and


the market. This is possibly intended to prevent market panic and systemic crises triggered by rating downgrades. This problem is felt acutely by the Commission who has an interest in managing rating downgrade threats to sovereign debt in the euro area. Moreover, the Commission proposes that the issue of a ‘rating outlook opinion’ should be followed by dialogue with the rated entity. This would give rated entities the opportunity to influence any rating amendment. Although this measure may be in the interests of preserving the stability of the euro area, would this measure, applied to corporate issuers, undermine the controls on conflicts of interest discussed above?

Much of the organisational and operational requirements imposed on credit rating agencies under Article 6, and elaborated in Sections A and B of Annex I, are ‘meta-regulatory’ in nature. This means that the Regulation only provides a framework for systems, procedures or controls but is not able to prescribe excessively, since this would amount to a form of micro-management.

The key framework principles for credit rating agencies are: senior management responsibility; ‘adequate policies and procedures to ensure compliance’; sound administrative, accounting, internal control and risk management systems and procedures; clearly documented and communicated decision-making procedures and reporting lines; appropriate and effective organisational arrangements and procedures to identify, eliminate or manage and

---

disclose conflicts of interest;\textsuperscript{86} appropriate systems and resources to ensure regularity and continuity in the pursuit of rating activities;\textsuperscript{87} a review function for the adequacy and effectiveness of the systems, procedures or arrangements mentioned above;\textsuperscript{88} and appropriate and adequate record keeping.\textsuperscript{89}

The provisions mentioned above are not dissimilar to those found in the regime for regulating investment firms, such as under the Markets in Financial Instruments Directive 2004. These meta-regulatory provisions – that make reference to adequate, effective, appropriate or sound systems, arrangements, procedures and policies – have become a template applicable for the supervisory oversight of most financial institutions, from investment firms, to UCITS, to alternative investment fund managers. The open-textured terms of ‘adequate’, ‘effective’, ‘appropriate’ or ‘sound’ provide an opportunity for the regulated entities themselves to engage with the spirit and purpose of the regulatory regime, in designing structures and procedures that meet the needs of the firm and the regulator. A key challenge of meta-regulatory regimes is how to motivate regulated entities to engage meaningfully in the design process and not merely opt for minimal or lowest cost possibilities. Another challenge concerns


how regulatory supervision and enforcement may be carried out in view of evaluating procedures, policies and systems.

Further, how can meta-regulatory regimes co-exist coherently with the prescriptive regulatory regime that is concurrently in place? Bright line rules and prohibitions often entail a compliance mindset that is focused on the boundary between what is compliant and not compliant. But a meta-regulatory regime requires the application of a different mindset, that of understanding and willingness to achieve the spirit and purpose of regulatory regimes. Will senior management be able to embrace the requirements of both types of regulatory regimes?

Further, ESMA’s supervision of rating agencies’ meta-regulatory frameworks may be limited if there is no perceived link between organisational frameworks and rating quality. The provisions on organisational frameworks are similar and largely borrowed from the provisions in EU legislation governing investment firms and fund managers. Hence, these provisions have a legal integration and convergence character, but it is uncertain whether they relate directly to rating quality.

Finally, the question may be raised as to how a registered credit rating agency in the EU can endorse a third country rating agency’s ratings on the basis of compliance with meta-regulatory organisational and operational requirements, especially when such verification is likely to be based on subjective judgement? Further, the subjective judgement must be made on an ongoing basis to support continued endorsement.
Conflicts of interest and the familiar agency paradigm may *per se* give rise to concerns that investor protection is compromised and that regulation can play a role in addressing market failures. However, the verdict is not out on whether regulatory controls concerning conflicts of interest bear a clear relationship with rating accuracy. Next, we turn to the regulatory regime for regulating rating competence, more directly related to rating accuracy.

The Regulation does not interfere with the content of credit ratings or methodologies used in credit ratings, but it seeks to implement a regime to support the accuracy and quality of credit ratings by prescribing specific guidelines on how ratings may be carried out and on the development of rating methodologies, as well as mandatory public disclosure of standards and methodologies used by credit rating agencies. Specific rules also apply to structured finance products as a direct response to the diagnosis of the global financial crisis.

Article 8 of the Regulation requires credit rating agencies to undertake a thorough analysis of all information available to them and relevant to the rating process. It however stops short of an express duty of diligence. Nevertheless, it is arguable that a duty of diligence may be inferred. First, credit rating agencies need to make mandatory disclosure of ‘all information about loss and cash flow’

---

92 Discussed in the next Section.
pertaining to structured finance products\textsuperscript{93} and so there could be an implicit duty of diligence to discover and appreciate sufficiently such information in order to make disclosure. Further, credit rating agencies have to disclose ‘whether it considers satisfactory the quality of information available on the rated entity and to what extent it has verified information provided’.\textsuperscript{94} This could mean that there is at least a duty to consider the quality of information being worked on. However it could be argued that there is no such duty if further diligence is required. There also seems to be no duty as such to verify issuer provided information. Credit rating agencies issuing ratings for structured finance products are also allowed to rely on third party assessments as long as they disclose the extent of their own diligence and reliance on third party assessments.\textsuperscript{95} It could be argued that stopping short of an express duty of diligence is a weakness in the Regulation as regulators will not be able to enforce against negligence. Surely diligence could be regarded as directly affecting rating quality?

Next, credit rating agencies must use rating methodologies that are rigorous, systematic, continuous and subject to validation based on historical experience, including back-testing.\textsuperscript{96} It is not entirely clear what ‘systematic and


continuous’ means and whether discretionary deviations in methodology between rating procedures may render the methodologies impeachable.\textsuperscript{97} The Commission Regulation that supplements the parent Regulation defines ‘systematic’ as being associated with analytical models, key rating assumptions, the capacity to promptly incorporate new findings, and application across the same asset without idiosyncratic divergence.\textsuperscript{98} Although ESMA may be better able to judge consistency in application, it is queried how ESMA will judge the quality of models or assumptions. ‘Continuous’\textsuperscript{99} is defined as being capable of persistent application, unless there is an objective reason to modify, and being capable of incorporating new findings. There is a clear overlap between ‘systematic’ and ‘continuous’ in terms of rating responsiveness to new findings, so perhaps responsiveness is a key quality indicator. However, this may simply go to show that the criteria framing ESMA’s judgement are not altogether clear. Further, there may be an inherent contradiction between being capable of persistent application and being responsive to change. ‘Rigorous’\textsuperscript{100} means robustly devel-

\textsuperscript{97} 

\textsuperscript{98} 

\textsuperscript{99} 

\textsuperscript{100} 
oped, incorporating all driving factors affecting creditworthiness, taking into account all asset classes featuring the same risk factors, and having analytical models and key rating assumptions that are reliable and relevant. Again, there is duplication in the assessment of rigour and being systematic in referring to the quality of analytical models and rating assumptions. ‘Subject to validation’ means the use of appropriate assessments for historic credit ratings, in order to justify the predictive power and historical robustness of rating methodology.

In sum, rating quality seems to be equated with rating consistency, the comprehensiveness of considerations in the development of methodologies and procedures, rating responsiveness and historical robustness. These proxies may produce unintended consequences. With regard to the comprehensiveness of considerations in the development of methodologies and procedures, rating agencies may produce policies that show that their templates encompass comprehensive categories of information. However, the comprehensiveness need not feed into the process of application by analysts who are responsible for finalising the rating. Further, the matrix of information relevant to a rating may encompass comprehensive but conflicting informational signals. How will a regulator be able to judge the soundness of an analyst’s application of discretion in using the informational matrix?


Next, rating responsiveness may not be an altogether sound proxy for rating quality. One of the criticisms many commentators make of credit rating agencies is that the informational value of a rating has become poor as ratings are not responsive and hence reliance on them has become a hazard.\footnote{FRANK PARTNOY, ‘Rethinking Regulation of Credit-Rating Agencies: An Institutional Investor Perspective’ (2010) 25 Journal of International Banking Law and Regulation 188; TIMOTHY E LYNCH, ‘Deeply and Persistently Conflicted: Credit Rating Agencies in the Current Regulatory Environment’ (2009) 59 Case Western Reserve Law Review 227; ERIN M WESSENDORF, ‘Regulating the Credit Rating Agencies’ (2008) 3 Entrepreneurial Business Law Journal 155.} However, rating changes may themselves become triggers for significant developments in the issuer and investment community even if the rating is, at its core, an ‘opinion’.\footnote{AMADOU NR SY, ‘The Systemic Regulation of Credit Rating Agencies and Rated Markets’ (June 2009) IMF Working Paper No 09/129 http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1426448 accessed 14 December 2012.} This may explain rating agencies’ slowness in revising ratings. Further, Justensen\footnote{PAUL J JUSTENSEN, ‘Ratings Recall: Will New Reform Proposals Make Lasting Impact?’ (2009) 35 Journal of Corporation Law 193.} argues that it would be very difficult to design a regulatory regime to encourage or compel rating responsiveness in providing leading information to the market on the likely prospects of an investment product. Proactive ratings could be as wrong as unrevised ratings and any enforcement based on a duty to review will necessarily focus on procedural compliance rather than substantive judgement on the quality of a rating. Credit rating agencies now have a duty to review ratings at least annually or when material changes occur.\footnote{European Parliament and Council Regulation (EC) 1060/2009 of 16 September 2009 on credit rating agencies [2009] OJ L302/1, art 8(5).} This duty does not arguably differ significantly from what credit rating agencies practice at the moment, as rating change can be reactive
to changes that have occurred rather than providing insight to the trajectory of a particular debt or investment product. In late 2011, the Commission proposed a ‘middle way’ between mitigating the systemic impact of rating amendments and encouraging responsive and accurate ratings: rating agencies should be required to issue a ‘rating outlook’ opinion if a rating amendment is contemplated. Rating responsiveness may not be an unequivocal good and it remains to be seen if a more nuanced approach to assessing ‘responsiveness’ will be taken in light of the potential systemic risks involved.

Where a credit rating agency revises its methodologies for rating, it must disclose which previously issued ratings will be affected by the change and such ratings must be reviewed and re-rated using the revised methodologies. Credit rating agencies are now compelled to develop review models that take into account macro-economic conditions and general financial market conditions. It is queried how far this may help rating review models and outcomes, as such observations are often more tentative and speculative. If rating changes are made in response to a well-established economic or market trend, then they may have no further informational value. But if a rating change is in an informationally leading position, it could be mistaken, speculative and precipitate unintended consequences. It is feared that the regulatory regime is trying too

---


hard to define the proxy indicators for robust and accurate ratings, and the direction adopted in the Regulation may be a double-edged sword.

There may be reasons to be rather sceptical as to ESMA’s ability to make *ex ante* judgements regarding rating quality. Judgements may be made much more easily *ex post*, rather than *ex ante*, when events have proved the historical inaccuracy of the credit ratings. This begs the question of whether regulatory supervision over rating competence will really improve credit rating agencies’ role in information mediation. In order to facilitate ESMA’s supervision, reporting by credit rating agencies (see ‘Mandatory Disclosures’ below) is standardised and monitored via the Central Repository (CRep) system which ESMA has established, so that ESMA can monitor the reported rating assumptions and methodologies. However, it is anticipated that any enforcement is likely to be based on *ex post* developments rather than *ex ante* information. But if *ex ante* information does not raise alarms, then can *ex post* enforcement be justifiably taken? ESMA has also commenced hands-on supervisory monitoring of credit rating agencies’ procedures and methodology. The maiden round of on-site inspections was carried out by ESMA between 2-21 December 2011 and ESMA produced a report, as well as individual confidential responses to the inspected

---

agencies, on aspects of unsatisfactory procedures or methodologies that would need to be improved.\textsuperscript{110} Many of ESMA’s first-round concerns relate to organisational or procedural matters, such as the effectiveness of independent directors, the transparency and documentation of policies and meetings, the turnover of staff, and the reliance on automated IT systems. This report gives a flavour of the difficulties in being critical from an \textit{ex ante} supervisory position: supervisors are not likely to be able to make frontal judgements about rating quality, or about the models and assumptions supporting the ratings as such. The limitations of \textit{ex ante} pre-emptive judgements raise the question of how regulatory supervision improves the role of credit rating agencies. Further, the supervisory process is essentially a dialogic one and rating agencies are likely to be given an opportunity to improve upon dissatisfactory findings rather than suffer enforcement.\textsuperscript{111}

Credit rating agencies are also required to operate on a non-selective basis in the issuing or discontinuation of a rating.\textsuperscript{112} Where unsolicited ratings are concerned, credit rating agencies have to label them as such and make disclo-

\textsuperscript{110} ESMA, ‘ESMA’S Report on the Supervision of Credit Rating Agencies’ (22 March 2012) ESMA/2012/207 http://www.esma.europa.eu/system/files/2012-207.pdf accessed 3 January 2013. For example, ESMA found less than satisfactory the records kept of internal meetings that are crucial in the lead-up to the issuing of the rating (para 17), the decision-making procedures in internal committees finalising a rating (paras 20, 23), the time pressures under which analysts may be working (para 24), and high staff turnover that may affect rating competence and consistency (para 29).


sures of their policies, procedures and the information relied upon in issuing the rating.  

Where structured finance products are concerned, credit rating agencies have to use different rating categories and symbols to clearly distinguish them from other investment products. This has been criticised as being meaningless, as the differentiation of structured finance product ratings is not likely to assist investors in making an informed judgement about them. There is a rational basis for treating structured finance products distinctly, as the rating methodologies and assumptions, as well as information upon which the rating should be based, are likely to be different. However, due to the opacity of some structured finance products, it may be more useful for rating agencies to develop a ‘limited or qualified rating’, clearly labelled as such, and it may also perhaps be useful for regulatory guidance to provide that credit rating agencies should err on the side of caution for structured finance products, providing a more conservative rating in cases of any possible doubt.

Besides imposing direct regulatory standards in relation to rating competence in order to boost rating accuracy, the regulatory regime is also considering using other means of governance to boost rating accuracy. Regulators are considering including competing credit rating agencies and investors in


the wholesale sector as possible actors in governance to contribute to improving rating quality.

In the Commission’s 2010 proposal to amend the Regulation, credit rating agencies were to be compelled to provide a password-protected website listing all of the structured finance products rated and the names of issuers. Further, issuers of structured finance products were mandated under the draft Regulation to maintain password-protected websites containing all the information provided to the rating agency it appoints and access to the website must be granted by the appointed rating agency to any other rating agency that requests such access. Concern over the accuracy of ratings for structured finance products is a direct result of the diagnosis of the global financial crisis. Thus, these provisions seek to encourage credit rating agencies not appointed by the issuer to play a check-and-balance role in the information mediation process. This is a form of ‘smart regulation’, opening up space for these other actors to contribute a form of governance towards achieving the difficult objective of ensuring rating accuracy. In the final 2011 amendment Regulation, the provisions on sharing information to enable rival ratings have been dropped. However, the preamble to the 2011 amendment Regulation indicates ESMA’s commitment

---


to promote rival ratings, although more consultation is deemed desirable. There is potential in these forms of reflexive governance, as the matrix of information could be enriched by other rating agencies’ involvement. However, the incentives for a rating agency to engage in unsolicited structured product ratings remain nebulous. Could an aggressive young rating agency undertake such unsolicited ratings in order to boost its market presence and attract more business? Might not this ‘smart regulatory’ process turn into a competitive process with a tendency to adopt race to the bottom strategies as discussed earlier?

The Regulation has adopted the strategy of specifying certain proxies for rating quality as a means of checking the power of rating agencies and maintaining their useful function. However, it is difficult to supervise ex ante for rating quality. If ESMA penalises rating agencies for suboptimal rating quality via administrative penalties, this could chill the industry. If ESMA does not enforce but merely supervises and admonishes, how much will this improve rating quality? Or is this an expensive investor protection regime for the wholesale sector that may not even meet its aims? If ESMA leaves it to investor discipline, the consequences for enforcement are uncertain. Investor litigation may also be seen as an opportunistic measure to demand loss-sharing with credit rating agencies after the fact. ESMA needs to be able to keep the industry under check and to deflect any risks of ESMA itself taking on a role in information signalling, whilst nevertheless preserving the utility of the industry. Is the Regulation trying to achieve an inherently impossible balance? In fact, now that ESMA is considering involving investors in the regulatory space, would legislative acceptance of in-
vestor civil actions, perhaps accompanied by mandatory disclosures that would facilitate such investor discipline, restore market discipline for rating agencies, thus rendering regulatory intervention unnecessary?

4. The regulatory regime for credit rating agencies has placed ESMA at the centre of wholesale sector investor protection, as the accuracy of credit ratings is now subject to regulatory supervision and monitoring. In 2011, the Commission proposed to engage a wider group of governance actors in monitoring and enforcing market discipline for credit rating agencies.

First, the Commission suggested making stakeholder consultation mandatory when rating agencies develop new methodologies and subjecting new methodologies to ESMA approval.119 These measures show that the regulator ESMA intends to enrol the help of investors and other stakeholders so that the dominant role in information mediation undertaken by credit rating agencies can be checked by other actors in the regulatory space. Although ex ante scrutiny of rating competence remains an inherently difficult issue, reliance on a variety of governance forces may provide insight and add value, as well as forcing wholesale sector investors to consider what information would assist them or they would like to see. Gerding120 for example suggests that opening up the platform of proprietary information in various areas to encourage ‘open source’ work could improve the quality of systems and information in general. The rein-

statement of investor interest in the purpose of credit ratings could incentivise a form of governance from the investor quarter.

Second, the Commission also proposed an action for investors against credit rating agencies. The latter could be made responsible to investors, in order to ensure compliance with the Regulation. This proposed Regulation, which will be directly effective, will provide a civil action for investors who have relied on a credit rating where the infringement in question affects the quality of the rating.\textsuperscript{121} Ordinary negligence does not suffice; the Commission has proposed that investors may take civil actions against credit rating agencies only if the non-compliance with or infringement of the Regulation constitutes an intentional or grossly negligent breach.\textsuperscript{122} Under these proposals, an obvious lack of diligence or rating methodologies that are not well-developed or back-tested could provide evidence of intentional or grossly negligent breaches. This would be a form of \textit{ex post} action, perhaps flanked by regulatory enforcement. The regulatory strategy here continues with the theme of mobilising wholesale sector investors to contribute to governance in the issue areas where they play a significant part. However, this strategy also involves national courts in enforcing governance and developing jurisprudence, which could foster divergent tenden-

\begin{footnotesize}
\end{footnotesize}
cies in EU financial regulation.\textsuperscript{123} Perhaps, in the post-crisis era, the EU is striking a balance between the various objectives in financial regulation and not doggedly shaping its governance according to market and legal integration alone.

A number of commentators support the introduction of investor actions for civil liability to discipline credit rating agencies.\textsuperscript{124} However, there is a need to address some of the problems highlighted by US experience in private securities litigation.\textsuperscript{125} An oft-cited concern is the fear of floodgates of litigation\textsuperscript{126} and

\begin{itemize}
\item \textsuperscript{123} At the same time, an emerging liability for breach of EU rights could lead to core common rules. The primary forum would remain national courts, and procedures too would be national, but there would be references from national courts to the ECJ for preliminary rulings under Article 267 (ex Article 234) of the Treaty on the Functioning of the European Union and investors would also be supported by the principle of effectiveness of EU law.
\end{itemize}
perverse incentives on the part of investors looking for credit rating agencies to share in their losses after the fact.

Assumptions about ‘floodgates’ and American style litigiousness have resulted in civil liability regimes in the UK and Europe being subjected to such restrictions that they have not had any practical role in investor protection.\textsuperscript{127} There is, as already discussed, controversy over the net positive effects of wider civil liability in the United States compared with the UK and the rest of Europe. This kind of analysis does not take account of the very limited role of civil liability in Europe and the very many different mechanisms in the US that facilitate liability there, not the least in civil procedure with juries and mass actions of different kinds, many of which were developed in legislation to create effective remedies. There is strong industry pressure on the law-making process and as discussed above a proposal to beef up investor litigation against investment funds in the UK Financial Services Bill 2010 was dropped in the final version of the Act. This is a similar trajectory to the United Kingdom Financial Services Act 1986 (FSA 1986). Section 62 introduced rights of action to the regime for financial services, while section 62A of the FSA 1986 was later inserted by section 193 of the Companies Act 1989 so that, except in specified circumstances, only private investors could bring actions under section 62. The entry into force of the FSA 1986 was postponed until the adoption of section 62A after strong industry

\textsuperscript{126} Although the Davies Report 2007 was quick to refer to floodgates of litigation as a reason for providing a limited cause of civil action against issuers for breaches on ongoing transparency regulations.

pressure. This has been maintained at all the intermediate stages, as for instance with section 150 of Financial Services and Markets Act 2000 and the Financial Services and Markets Act 2000 (Rights of Action) Regulations 2001, the successors to sections 62 and 62A of the FSA 1986. The arguments are the same now as then, and no lessons seem to have been learnt from the experiences with the existing regimes where there has been no effective remedy for private investors in civil liability. The UK statute will not prevent liability under EU law.

Investor civil litigation against credit rating agencies is likely to face two uphill hurdles under tort law. First, credit ratings are likely to be regarded as opinions and it is difficult for opinions to be actionable as misrepresentations.\(^\text{128}\) Misrepresentations are misrepresentations of facts,\(^\text{129}\) or opinions that are not actually held or patently unwarranted due to the supporting context of facts.\(^\text{130}\) Credit rating agencies have constantly asserted\(^\text{131}\) that they are entitled to the freedom to publish opinions on creditworthiness and should not be taken to task. In the US, courts have now increasingly ruled that rating agencies are not entitled to First Amendment protection on the basis that the circulation of ratings concerns a limited audience of financial sector participants.\(^\text{132}\)

\(^{128}\) \textit{Bisset v Wilkinson} [1927] AC 177.

\(^{129}\) E.g. \textit{With v O’Flanagan} [1936] Ch 575.

\(^{130}\) \textit{Smith v Land and House Property Corporation} (1884) 28 Ch D 7.

\(^{131}\) Known as the ‘First Amendment’ right in the US. Although in an earlier case where CalPERS, the pension fund, sued Moody’s Corp, the judge in the California court ruled that Moody’s ratings were protected under the First Amendment. \textit{California Public Employees' Retirement System (‘CalPERS’) v Moody’s Corp.}, CGC-09-490241 (Super. Ct. Cal., SF County).

\(^{132}\) See for example, Thornburg Mortgage Inc., at http://securities.stanford.edu/1044/THM RQ09_01/.
The proposed Regulation attempts to address these issues. Article 35a (1) on ‘Civil liability’ states that the infringement must have ‘an impact on a credit rating on which an investor has relied when purchasing a rated instrument, such an investor may bring an action against that credit rating agency for any damage caused to that investor’. The proposed Regulation complements this with a legal presumption of an impact from infringements and adds a reverse burden of proof, against the credit rating agency, when a prima facie case has been made by the investor. In Article 35a(2), it provides that ‘an infringement shall be considered to have an impact on a credit rating if the credit rating that has been issued by the credit rating agency is different from the rating that would have been issued had the credit rating agency not committed that infringement’. In Article 35a (4), it further provides that:

Where an investor establishes facts from which it may be inferred that a credit rating agency has committed any of the infringements listed in Annex III, it will be for the credit rating agency to prove that it has not committed that infringement or that that infringement did not have an impact on the issued credit rating.

However, even if rating agencies are not able to sustain the shield of ‘right to opinion’ against civil litigants, the next issue is whether civil law would frame a duty of care owed to investors. In the classic English case of Caparo Industries v Dickman,133 a potential takeover bidder, who had built up a shareholding large enough to launch a takeover bid in Fidelity Plc, sued the auditors Dickman when it was subsequently discovered that a negligent audit had allowed the financial

statements to paint a rosier picture of Fidelity’s financial health than thought. The House of Lords dismissed the action on the basis that the auditors did not owe a duty of care to the shareholders at large and that the duty would only be owed in a situation of sufficient proximity between the auditors and the shareholder, whose purpose for consulting the financial statements had been made known to the auditors in advance.\textsuperscript{134} As credit rating agencies are no longer commissioned by investors but by issuers, any proximate relationship with investors may be difficult to establish, as ratings are generally available to investors at large.

This duty of care hurdle is overcome in the Regulation as it purports to explicitly confer a right to sue for breaches of duties in Article 35a (1). This would mean that, in the UK, the right to sue for civil litigants would be based on a breach of EU law.\textsuperscript{135} In such an action, the civil litigants must prove that their

\textsuperscript{134} The House of Lords overturned the Court of Appeal. Sir Thomas Bingham, in the majority with Taylor LJ, held that it followed from the general rule that the auditors should be liable. There was sufficient proximity or ‘closeness’. BINGHAM LJ cited CARDozo CJ (in the famous US case Ultramares Corporation v Touche, 174 N.E. 441 (1931)) who did not meet the same approval in the House of Lords. Lord Bingham returned to the case on several occasions, see for instance Lord Bingham of Cornhill, ‘The Uses of Tort’ (2010) Journal of European Tort Law, and referred less formally to the House of Lords’ decision as ‘judicial activism’, here to limit liability.

\textsuperscript{135} See concerning the development of liability under EU law and such cases in English courts, MADS ANDENAS AND RENATO NAZZINI, ‘Awarding Damages for Breach of Competition Law in English Courts – Crehan in the Court of Appeal’, 2006, European Business Law Review 1191. The case also illustrates the relationship to regulatory enforcement and the very high threshold courts set for private individuals or small businesses. The claimants lost in the House of Lords, Inntrepreneur Pub Company (CPC) and others (Original Appellants and Cross-respondents) v Crehan [2006] UKHL 38, [2007] 1 AC 333.
loss has been caused by the statutory breach.\textsuperscript{136} For example, if a credit rating agency breaches a bright line duty by failing to rotate its analysts and its rating quality has also been inaccurate resulting in misplaced reliance by investors, investors have to prove that the rating inaccuracy that has caused the loss is correlated with the failure to rotate the agency’s analysts. Unless the analyst who was not rotated produced the inaccurate rating which resulted in investor loss, investors are unlikely to be successfully in alleging that a statutory breach should be actionable. The causal link to loss must be established. In relation to more open-textured statutory duties, such as ensuring the rigour, continuity or historic validity of rating methodologies, a breach may be difficult for investors to prove and the Regulation does not appear to impose a duty of diligence, as discussed earlier. One question is whether the presumptions and reverse burden of proof in Article 35a (2) and (4) apply only when the first matter of impact is determined or also at the stage of causation. The latter is most likely and will further strengthen the position of the litigant investor.

Article 35a (1) of the proposed Regulation requires that the credit rating agency has committed the infringements ‘intentionally or with gross negligence’. This raises serious doubts about the possible efficacy of liability. Negligence liability for professionals in the UK and different civil law countries requires a higher standard than negligence in general. The Commission has in this instance gone the other way. With the very few cases of investors succeeding in actions against issuers, intermediaries and advisors under the general rules, there is every reason to query a decision that requires more than negli-

\textsuperscript{136} McWilliams v Sir William Arrol & Co [1962] 1 WLR 295.
gence. However, in Article 35a (3) the proposed Regulation provides another presumption: ‘A credit rating agency acts with gross negligence if it seriously neglects duties imposed upon it by this Regulation’. It is not obvious how these provisions will interact.

Liability is traditionally limited, or an attempt made to completely exclude it, by contract. Article 35a (5) bars this: ‘The civil liability referred to in paragraph 1 shall not be excluded or limited in advance by agreement. Any clause in such agreements excluding or limiting the civil liability in advance shall be deemed null and void’.

ESMA’s endeavour to situate investor litigation in the governance landscape demonstrates the general post-crisis trajectory towards the expansion of regulatory control through the involvement of alternative actors in the regulatory space. But there are issues in the application of the proposed breach of statutory action and it remains to be seen if investors will be willing to sue.

Investors may be inhibited from suing if they wish to continue to rely heavily on credit ratings and do not wish to chill the industry. After the onset of the global financial crisis, credit rating agencies seem to have declined to rate a number of structured finance products. It could be the case that rating agencies’ fear of liability is manifested in more conservative behaviour and they may decline to act as intermediaries of information where there is doubt. However, investors, who are used to relying on credit ratings, may not be motivated to undertake extensive and costly due diligence themselves. This could be a factor influencing investors in considering whether or not they will bring civil litigation against credit rating agencies.
The regulatory regime in the EU seems to be pulling out all the stops to deal with rating accuracy in response to the recognised market failures in the credit rating industry. However, this remains an inherently difficult issue and mobilising wholesale sector investors to contribute to governance in this area may either introduce perverse incentives or be elusive. In other words, the Regulation has not set itself out to overcome the market failure issue of lack of investor discipline, and it remains uncertain if any measure intended to enable investor litigation will achieve that effect.
PARLIAMENTARY DEMOCRACY AND
THE EUROZONE CRISIS

Elena Griglio - Nicola Lupo*

ABSTRACT: This paper concerns the channels of democracy, focusing on the questions related to the evaluation of the new economic governance, how it impacted the role of national Parliaments and, in particular, if it increased or reduced (and/or if it will increase or reduce in the near future) the capacity of Parliaments of getting involved in the governance process, influencing its results. It is clear that the answer to those questions is not a unique one. It depends largely on the features of the “form of government” of each MemberiState and on how the new constitutional provisions on budget limits have been drafted. Moreover, it also depends on the recognition of the Executive as the ‘master’ of legislative decision-making ... and the rediscovery of a new role for Parliaments. According to the idea that stricter financial budget limits would imply a closer control over the respect of budgetary provisions, the present analysis is meant to verify what has changed in the budgetary scrutiny role of national Parliaments with the coming out of the economic crisis and consequently with the launch of the new European economic governance.

* Elena Griglio is Senior Parliamentary Official at the Italian Senate of the Republic; Nicola Lupo is Full Professor of Parliamentary Law at Luiss Guido Carli of Rome. The essay derives from a joint work of the authors. However, Nicola Lupo has written the introduction and §3 and §4; Elena Griglio has written §2, §5 and the conclusions. Some of the ideas have been illustrated in two papers presented by the authors at the EUDO Workshop on “The Constitutional Architecture of the Economic Governance in the EU”, held at the European University Institute (Fiesole, 23 March 2012); in a paper on “Parliamentary oversight of national budgets. Recent trends in EU Member States” presented by Elena Griglio at the Tenth Workshop of Parliamentary Scholars and Parliamentarians - Wroxton College - Oxfordshire, UK, 28-29 July 2012; and in a lecture given by Nicola Lupo on “Parliamentary Democracy and the Eurozone Crisis” at the School of Law of the University of Connecticut (Hartford, 6 September 2012).
In conclusion, the essay will verify the thesis of the decline of parliamentary democracy in the European context, by highlighting how the crisis is actually offering to national legislators a real opportunity to gain new chances to intervene in the multilevel economic and financial governance.

1. There is a widespread perception that a problem of democratic legitimacy and accountability is affecting the architecture of the EU institutions. If according to part of the literature a democratic legitimacy of the EU decisions is either not possible or not necessary, most of the scholars rather tend to detect in parliamentary democracy the authentic foundation of the EU democratic legitimacy. This latter idea comes from the fact that the EU democracy relies not only on the legitimacy provided by the directly elected European Parliament, but also on roots deriving from the national level. Therefore, in order to understand the tangles of EU democracy, it is necessary to devote specific attention to the mechanisms of this double channel of EU parliamentary democracy. A legal basis for the democratic legitimacy of the EU built on a double channel of parliamentary representation can be found in Article 10 TUE.


2 According to SCHMITTER, How to Democratise the European Union... and Why Bother?, Oxford, Rowman and Littlefield Publishers, 2000, spec. 115 ff., the lack of a demos precludes a real democratic legitimacy for the EU, but some partial forms of legitimacy (through Parliaments and other channels of participation) are however possible.

3 Commenting the failure of the draft European Constitution’s attempt to legitimate the EU by inducing more popular deliberation about Europe’s future, MORAVCSIK, What Can We Learn from the Collapse of the European Constitutional Project? A Symposium, in Politische Vierteljahresschrift, 2006, vol. 47 (2), 219 ff. evidenced the success and stability of the existing “European constitutional settlement”, which is «both popular and broadly consistent with what European citizens say they want the EU to do» (221).

latter, mentions at the same time the direct representation provided by the European Parliament and the role of national Parliaments in holding accountable their governments”\(^5\). These two channels of parliamentary democracy give the idea that the compound constitution characterising the EU experience is based on a “multi-level parliamentary field”\(^6\).

The longstanding tension towards the recognition of a legitimacy criterion for the EU architecture has recently grown in importance as the Eurozone crisis started questioning the “output legitimacy” of the EU institutional system and its policies\(^7\). The need to counterbalance the effects of the financial and economic crisis has led the European institutions to urge the adoption of quick and intrusive measures, investing some of the core competences of Member States, in particular those relating the budgetary and financial decision-making. This situation boosts the need of democratic legitimacy of the EU institutions, due to the fact that the increased risk of a possible divergence between European


\(^{7}\) As observed by SCHMIDT, Dealing with Europe’s other deficit, in Public Policy Research, vol. 19 (2), 2012, 108, «The question for the EU, then, is not only whether it can get the economics right – thereby ensuring more ‘output’ legitimacy – but also whether it can get the politics right, through greater ‘input’ legitimacy» and greater ‘throughput’ legitimacy.
budgetary and financial policies and voters' preference makes it more difficult to justify the autonomy of the EU legal order.

The legitimacy problem of the EU in the Eurozone crisis is moreover exacerbated by the fact that one of the two channels of parliamentary democracy – the one relying upon the European Parliament – does not seem anymore capable of fully complying with the expectations concerning its contribution to the "democratic deficit" cause.

From the Single European Act of 1986 to the Lisbon Treaty of 2007, the European Parliament has in fact experienced a constant trend towards the enlargement of its functions, which has been very important, but has revealed itself not sufficient to solve the democratic legitimacy of the EU (as shown by the decrease of the citizens' participation to European elections).

However, this constant trend has stopped after the entry into force of the Lisbon Treaty. The weakening of the European Parliament, in particular, can be considered as a consequence both of the crisis of the “community method” (and the trend towards more intergovernmentalism in the EU and in the European Economic and Monetary Union); and of the coming into force of new legal

---

8 On the answers given by the Treaty of Lisbon to the problem of the democratic deficit, see PINELLI, Il deficit democratico europeo e le risposte del Trattato di Lisbona, in Rassegna parlamentare, 2008, 925 ff. and MANZELLA, Sui principi democratici nell’Unione europea, Napoli, Editoriale Scientifica, 2013, forthcoming.

9 The return to intergovernmental forms of cooperation is in fact traced back by part of the literature (MICOSI, Democracy in the European Union, cit., 1) to the institutional crisis of 2005, which followed the rejection of the Constitutional Treaty in the French and Dutch referendums.
constructions (as the Fiscal Compact), separated from the EU and not involving all Member States (all equally represented in the EP, by definition)\textsuperscript{10}.

The insufficiency of the European Parliament as a channel of democratic legitimacy for the European Union justifies the need to reinforce the other channel, the one based on the role of national Parliaments. As correctly observed, «When push comes to shove, European integration still needs democratic legitimation coming from the national level, both in a formal and substantive sense»\textsuperscript{11}.

This explains why the new European legal construction built after the Eurozone crisis opens up a new challenge for national Parliaments which, after the new opportunities offered by the Lisbon Treaty\textsuperscript{12}, could probably gain from the

\textsuperscript{10} In the six-pack and in the Fiscal Compact, in fact, the European Parliament: is involved too late; does not receive directly the NRP (national reform programmes), the SCP (stability/convergence programmes) nor the draft budgetary plans; is devoid of decision-making power, as it can not concur in fixing the strategic priorities of the fiscal year and the European Semester nor review the country-specific recommendations once adopted by the Council (see FASONE, The Struggle of the European Parliament to Participate in the New Economic Governance, EUDO working paper, Firenze, August 2012, available at: http://cadmus.eui.eu). So, the strategic priorities are defined by the European Council and the European Parliament has to be informed on specific occasions and can be consulted on others. However, it can activate the “Economic Dialogue” (with other EU Institution and with the institutions of the Member States involved). For a debate on the possible adaptation of the EP structure in order to be able to act only with MPs elected in some of the EU Member States, see the Workshop, organised by the AFCO Committee, on “Challenges of multi-tier governance in the EU”, European Parliament, 4 October 2012, and, among others, the contributions of Renaud DEHOUSSE and Andrea MANZELLA.


\textsuperscript{12} Ad evidenced by BARÓN CRESPO, Parliamentary democracy and the Treaty of Lisbon, OPAL Online Paper n. 1/2012, available at: www.opal-europe.org, the entry into force of the Treaty
economic governance some leeway at the expense of their Executives\textsuperscript{13}. The idea leads to reconsidering the traditional assumption according to which the European integration process has caused a strengthening of the Executives at the expenses of the Parliaments\textsuperscript{14} and according to which national Parliaments of Lisbon significantly strengthens parliamenty democracy in the EU. For an overview of the tools/procedures disciplined by the Treaty of Lisbon, which, in particular, promote the role of National Parliaments in the EU decision-making process, see KIVER, The Early Warning System for the Principle of Subsidiarity. Constitutional theory and empirical reality, Oxon, Routledge, 2012, and OLIVETTI, Parlamenti nazionali nell’Unione europea, in Digesto discipline pubblicistiche. Aggiornamento V, Utet, Torino, 2012, 485 ff. According to RAUNIO, The Gatekeepers of European Integration? The Functions of National Parliaments in the EU Political System, in Journal of European Integration, vol. 33 (3), 315, the new role acquired by national Parliaments in the subsidiarity monitoring »can also be seen as belonging to the ‘government oversight’ and ‘law making’«.

\textsuperscript{13} On the processes of adjustments in national Parliaments in response to emerging multilevel governance, see BENZ, Multilevel Parliaments in Canada and Europe, in International Journal, 2010-11, 109 ff. Obviously, as underlined by AUEL, Missing the point: the decision of the German Constitutional Court on the Lisbon Treaty and the Democratic Deficit of the EU, in AUEL and BAQUERO CRUZ, Karlsruhe’s Europe, Notre Europe. Studies and Research, n. 78, 2010, 23 ff., available at: http://www.eng.notre-europe.eu/media/Etud78-Karlsruhe_sEurope-en_01.pdf, national Parliaments’ contribution to improving EU democratic legitimation must be concretely assessed “case by case” and not generally taken for granted.

have been the losers of the institutional transformation determined, at national level, by this process.\textsuperscript{15}

National Parliaments, in fact, have been challenged in different ways by the variable geometry tendencies characterising the involvement of Member States in the European measures adopted in order to prevent future economic and financial disasters; and, at the same time, they seem to have gained new potential functions from the management of the Eurozone crisis. If at supranational level a new, and potentially extremely interesting, opportunity is given to national legislatures by the development of interparliamentary cooperation, as


provided by art. 13 of the Fiscal compact\textsuperscript{17}, in the present essay the attention is focused on the emerging spaces offered to representative assemblies in the national circuit of accountability related to the budgetary and financial decision-making processes.

In particular, the essay aims at reflecting on the possible effects that the new European economic governance could determine on the forms of government of the Member States\textsuperscript{18}, especially of the Eurozone Members, looking at the equilibrium between Parliaments and Executive in the legislative decision-making and in the budgetary and financial scrutiny. It tries to understand whether the constitutional architecture of the new economic governance has determined and could determine in the future a further acceleration of the increased role of the Executives or, on the contrary, a strengthening of national Parliaments\textsuperscript{19}.


\textsuperscript{18} For an historical overview on the possibility that «the economic consequences associated with a government’s inability to manage excessive debt may not only change a government’s personnel» but «may even contribute to a government’s constitutional transformation», see LOUBERT, Sovereign Debt Threatens the Union: The Genesis of a Federation, in European Constitutional Law Review, vol. 8 (3), 2012, 442 ff. (454).

\textsuperscript{19} The aim of the essay is therefore to focus on the implications of the European economic governance from the perspective of Member States' internal institutional balance. For a critical
In such a perspective, § 2 gives an overview of the political and legal framework in which to assess the role of Parliaments by introducing and defining the concept of “new European economic governance”. § 3 illustrates how the essay’s main question is assessed by approaching the issue of the Euro crisis as an independent variable, which could influence the Europeanisation of national legislatures. The role acquired by national Parliaments in the new European economic governance is discussed in § 4 and § 5, focusing respectively on the decision-making process (and therefore on the legislative function of Parliaments) and on the ex ante and ex post stages (the stages respectively anticipating and following the budgetary decision, here analysed mainly under the lens of the budgetary and financial scrutiny). Finally, § 6 draws some general remarks aiming at assessing if and how national Parliaments can (and will) take advantage from the new European economic governance in order to empower their role both at Member States’ level (having regard in particular to the interaction with national governments) and at European level (acquiring a new position in the multilevel and interinstitutional decision-making process).

2. In the last few years, the European economic governance\textsuperscript{20} has experienced a deep transformation, characterised by the endorsement of a

\textsuperscript{20}The expression “European governance” is here proposed as to define the complex and multi-level set of rules and measures adopted within the context of the European Union, usually approved by the EU institutions themselves (in particular by the European Council), but most often external to the EU legal order, and therefore characterised by an intergovernmental nature.
strengthened cooperation between Member States and EU institutions, mostly based on the coordination of economic policies and on the implementation of related objectives through the integration of national rules, procedures and structures within the European legal order.

Probably one of the main features of the “new” European economic governance can be found in its asymmetric nature, which, due to the differentiated degree of involvement of EU Member States in the regulatory mechanisms, seems to realise the model of the “multi speed” European integration21 theorised long before the coming out of the economic and financial crisis (and lastly rediscovered by the Lisbon Treaty22). Some of the new mechanisms of the European economic governance, in fact, involve all 27 Member States; others, on the contrary, are addressed only to Eurozone countries; a third potential level of differentiated integration is represented by those mechanisms (as the Fiscal compact) agreed on intergovernmental basis and voluntarily signed only by which attributes them to the category of international norms. Due to these reasons, the concept can’t be mistaken for the notion of EU economic constitution, which has been widely debated by literature (among others, see HATIE, The Economic Constitution within the Internal Market, in BOGDANDY and BAST (eds.), Principles of European Constitutional Law, London, Hart Publishing, 2010, 589 ff.).


some EU Member States. Also from the perspective of the addressees, there are measures specifically directed to some specific European States (as the rescue mechanisms and the rules on bailouts).

On the one hand, in fact, especially those countries belonging to the Eurozone have agreed upon the adoption of strengthened procedures aiming at preventing and promptly managing bailouts on the basis of reinforced fiscal and macroeconomic surveillance and correction mechanisms. On the other hand, some of the new rules adopted at European level delegate Member States to complete and integrate the set of European standards with reforms, to be adopted at national level, sometimes investing the constitutional discipline and in most cases impacting the role of governing institutions.

This ongoing institutional process seems to be characterised by two main features: its more or less direct connection to the management of the economic and financial crisis, which, also due to the original economic matrix of the European integration process, is likely to have a direct impact on the institutional arrangements of both the EU and of its Members States\footnote{On the institutional impact that the ongoing crisis is exercising both on the EU framework (the atypical procedures followed by the EU institutions tend to question the same identity of the European Union as a legal community) and on the national level (where the imposition from outside of emergency measures often comprises constitutional pluralism), see BALAGUER CALLEJÓN, El final de una época dorada. Una reflexión sobre la crisis económica y el declive del Derecho constitucional nacional, in Estudos en Homenagem ao Professor Doutor José Joaquim Gomes Canotilho, Coimbra, Coimbra Editora, vol. II, 2012.}; and its disposition to give place to a network of relationships well represented by the image of the "economic governance", stemming from the interconnection and mutual integration of EU and national actors and rules.
Such new economic governance is made up of rules adopted at various territorial levels and characterised by a different legal nature24. In particular, three rules can be inscribed within the category of international norms, adopted through intergovernmental agreements in between Members States25: i) the European Financial Stability Facility, established by the Eurozone Member States following the decisions taken on 9 May 2010 within the framework of the Ecofin Council, created as a temporary rescue mechanism whose mandate is to safeguard financial stability in Europe by providing financial assistance to Eurozone Member States within the framework of a macro-economic adjustment programme; ii) the Treaty to establish the European Stability Mechanism – originally signed on 11 July 2011 and then, after being modified to make it more effective, signed a second time on 2 February 2012 by Eurozone countries –, whose aim is to introduce a permanent resolution mechanism able to provide

24 Even before the beginning of the economic and financial crisis, Euro area countries had converged on fiscal and stability rules stemming from two main sources: the Maastricht Treaty signed in 1991 (which defined the convergence criteria) and the Stability and Growth Pact, negotiated together with the Amsterdam Treaty in 1997 (for further details, see FIUTOSSI and SARACENO, Fiscal Discipline as a Social Norm: the European Stability Pact, Collection OFCE/ANR, n. 22, July 2007, available at: www.ofce.sciences-po.fr).

In the present paragraph, however, we refer mainly to the rules and mechanisms specifically created in order to manage the financial and economic crisis; within this category, RUOTOLO, La Costituzione economica dell’Unione europea al tempo della crisi globale, in Studi sull’integrazione europea, vol. 2-3, 2012, 436 distinguishes between those measures which represent an adaptation of pre-existing rules (such as the Euro Plus Pact, the six-pack and the European semester) and the newly introduced mechanisms (such as the ESM, the EFSF and the TSCG).

25 An intergovernmental nature is shared also by the Euro Plus Pact, signed on 24-25 March 2011 by 17 Euro area countries and by other 6 countries in order to strengthen the coordination of national economic policies; the Pact, however, represents a political agreement deprive of the mandatory nature characterising legal rules.
financial stability support to States facing difficulties that could threaten the
stability of the EU as a whole; iii) the Treaty on Stability, Coordination and
Governance in the European Monetary Union (TSCG), signed on 2nd March 2012
by 25 (out of 27) Member States of the European Union, which includes a “Fiscal
compact” (Title III, but this terminology is often used to indicate the whole Trea-
ty) and whose aim is to enshrine commitments into EU law within five years of
its entry into force.

The three Acts are only apparently external to the EU legal order. This is
shown at least by two elements: firstly, by the fact that, in order to introduce
the European Stability Mechanism, the European Council of 25th March 2011,
acting by unanimity, adopted the Decision 2011/119/EU which amended Arti-

26 The ESM entered into force on 8 October 2012, upon completion of the ratification process
by the participating euro area Member States. Part of the literature (ARMSTRONG, Responding
to the Economic Crisis: Public Law in a Post-Lisbon Age, in Eutopia Law, 21 February 2012, avai-
able at http://eutopialaw.com/2012/02/21/responding-to-the-economic-crisis-public-law-in-
a-post-lisbon-age/) deeply criticised the process followed in order to establish the ESM, affirm-
ing that the adoption of an international treaty not only «circumvents the procedures both
for the adoption of revisions to the EU treaties as well as the EU’s own legislative processes», 
but at the same time - paradoxically - makes it more difficult to bring the ESM on-stream quick-
ly.

27 For a general overview of the legal implications of the Treaty, see BONVICINI and BRUGNOLI
(eds.), Il Fiscal compact., cit., and F. FABBRI, Il Fiscal compact: un primo commento, in Quad-

28 The ESM and the TSCG, in particular, are closely link from the point of view of their legal
form (they are formally placed outside the EU framework, but they essentially govern Union
matters) and from the point of view of their internal discipline (their purpose is to combat the
sovereign debt crisis). On this point, see JHR/WTE, Watching Karlsruhe/Karlsruhe Watchers, in

29 The decision was adopted following the procedure of Article 48(6), after consultation of the
European Parliament, the Commission and the European Central Bank.
Article 136 (3) of the TFEU recognising to Member States whose currency is the euro the possibility to establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole; secondly, by the fact that art. 16 of the TSCG formally foresees its inclusion in the EU legal order within five years from the entry into force of the Treaty, and that, in the meantime, some of the new rules lean on the EU institutions for their implementation.

30 On the legal reasons which lead the European Council to consider it necessary to amend the TFEU - making use of one of the two ‘simplified’ Treaty revision procedures introduced by the Lisbon Treaty - in order to sustain the good functioning of the EMU: DE WITTE, The European Treaty Amendment for the Creation of a Financial Stability Mechanism, in Swedish Institute for European Policy Studies (Sieps), European Policy Analysis, vol. 6, 2011, 1 ff. (available at: http://cadmus.eui.eu/bitstream/handle/1814/18338/SIEPS%202011_6_DE_WITTE.pdf?sequence=1).


32 The problematic legal form of the TSCG has been widely discussed by literature; as observed by CRAIG, The Stability, Coordination and Governance Treaty: Principle, Politics and Pragma-
Aside these intergovernmental rules, also some more or less typical EU secondary norms contributed to the creation of the new European economic governance.

It is the case, in particular, of the so called Six-pack, one of the main "building blocks" of the new EU economic governance, made up of five Regulations and one Directive which entered into force on 13 December 2011 and now apply to 27 Member States (with some specific rules for Eurozone Member States, especially regarding financial sanctions and some exceptions for the UK). Even though the main aim of the Six-pack is to strengthen the Stability and Growth Pact, the new set of regulations does not only cover fiscal surveillance, but it also includes macroeconomic surveillance under the new Macroeconomic Imbalance Procedure.

Finally, on 23 November 2011 the Commission submitted two proposals whose aim is to strengthen the surveillance mechanisms in the euro area; these two draft regulations, known as Two-pack, which are still under negotiation in between the EU Parliament and Council, are meant, respectively, to introduce "common provisions for monitoring and assessing draft budgetary plans and en-

---

suring the correction of excessive deficit of the Member States in the euro area" (COM (2011) 821) and to strengthen the "economic and budgetary surveillance of Member States experiencing or threatened with serious difficulties with re-

spect to their financial stability in the euro area" (COM (2011) 819).

Most of such new rules seem to reinforce the idea of a close interaction between Member States and EU institutions in the definition and implementation of effective rules capable of preventing future budgetary disasters. This transformation is fostered also by the awareness that if the criteria for national budgets were provided only by EU sources of law (Treaties and regulations), such discipline would reveal itself clearly not sufficient to bring Member States' finances closer to European standards; and, in any case, the same criteria could be eluded quite easily, as the Greek case showed to everyone.

The new idea, more coherent with a conception of EU Constitution as a “compound Constitution”, of which national Constitutions are a foundational element\(^{33}\), is clearly shown by the TSCG, which requires the introduction of the principle of balanced budgets, as specified in Article 3, para 2, “preferably” in national Constitutions; or, at least, in another provision “of binding force and permanent character […] guaranteed to be fully respected and adhered to throughout the national budgetary process”.

The integration of national decision-making within the European economic governance is moreover clearly shown by one of the Six-pack EU Regulations (Regulation (EU) No. 1175/2011 of the European Parliament and of the Council of 16 November 2011). The latter introduced the “European semester for strengthened coordination of economic and budgetary policies” (European Semester), the new architecture legally based on Art. 121 TFEU and designed to develop a new working method to ensure that collective discussion on key priorities about public policies takes place at EU level, before and not after national decisions are adopted.

The European Semester, in fact, is entirely based on the ex ante coordination of EU Members’ economic policies.34

3. The question faced in the present essay aims at evaluating if and how the new economic governance impacted the role of national Parliaments and, in particular, if it increased or reduced (and/or if it will increase or reduce in the near future) the capacity of Parliaments of getting involved in the governance process, influencing its results.

Consequently, the ongoing economic crisis is considered as a feature, which can impact the role played by legislatures at national level. As correctly observed, in fact, the need to increase the performances and rationalise the use

---

of public resources always involves a transformation of the role of Parliaments in the financial and budgetary decision-making process\textsuperscript{35}. This implies that the issue, usually considered by legal literature in a “static” perspective, should now be dynamically framed in the current trend, in order to assess what has changed after the inversion of the macroeconomic cycle. In particular, one main challenge is trying to assess if and how the call for well-timed decisions and the increased need for technical information and analytical data – two factors deriving from the crisis, which clearly tend to justify the intervention of Governments – have impacted the role assigned to Parliaments in the European economic governance.

To do so, a parameter for evaluating changes occurred before and after the definition of the new European economic governance would be desirable. However, it is necessary to clarify that there is no one single measure able to capture the amount of power attributed to national Parliament within a complex and multilevel governance procedure such as the one related to the EU economic policies coordination\textsuperscript{36}. Such difficulty, which appear unquestionable even adopting a static perspective, can help explaining why it is so hard to establish if something has changed after the coming out of the economic crisis in 2008.


In addition to this methodological complexity, it is important to clarify that the answer to the essay’s main question is not a unique one. It depends largely on the features of the “form of government” of each Member State and on how the new rules of the economic policies coordination have been or will be adopted by each of them. These choices are not insignificant for the health of European democracy. As already observed – and as it is now also legally recognised by art. 10 TUE, which has somehow internalised, in the framework of the European democracy, the “forms of government” of the Member States – the EU has a double channel of parliamentary (and therefore popular) legitimacy: a good functioning of political representation both through the national Parliaments and through the European Parliament constitutes, in fact, an indispensable element of the EU’s democracy.

As a first approach to the problem, therefore, the basic question of the essay is assessed by considering separately some of the most significant functions exercised by national Parliaments in the financial and budgetary process, and in particular the legislative decision-making and the budgetary and financial scrutiny.

4.1 In compliance with the Treaty on Stability, Coordination and Governance in the European Monetary Union (TSCG), signed on 2 March 2012 and entered into force on 1 January 2013, 25 Member States are now required to introduce – preferably in their national Constitutions – the rule of balanced budget. This reform will undoubtedly impact the budgetary and financial policy-making, urging the review or the introduction of new procedures able to orien-
tate the decision-making process towards the fulfilment of the budgetary balance. At the same time, the new rule will probably influence also the role played by the legislative and by the executive branches in the legislative decision-making; the present paragraph will therefore try to evaluate whether the reform will determine a further acceleration of the increased role of the Executives or, on the contrary, a strengthening of national Parliaments, focusing on the impact of budget limits only on legislative decision-making.

As already noted in § 3, it is clear that the answer is not a unique one. It depends largely on the features of the “form of government” of each Member State and on how the new constitutional provisions on budget limits have been drafted.

Given this general premise, it is quite obvious that the easiest and most probable answer to our fundamental question should be that of a confirmation of the Executives’ domain on the legislative design of fiscal policies. In other words, a further strengthening of the Executives is likely to happen and is actually happening, at least at a first stage: most of the national anti-crisis measures – either resulting from a spontaneous political decision of the national level, or to be considered as a due adaptation to European obligations – seem to find in the Government (rather than in the Parliament) their institutional point of reference. A confirmation of this trend can be found in the intense recourse to the decree-laws in Italy37, and now also in Spain38, as a means which, due to its im-

37 Starting from the period 2009-2011, the Italian budgetary cycle has experienced a deep transformation based on the anticipation of the budgetary decision with decree-laws to be adopted in the summer, before the beginning of the budgetary session (ALFANO, L’art. 81 della Costituzione e la "legge finanziaria": sistematica disapplicazione della norma da parte dei suoi
naturali destinatari, 2008, in www.forumcostituzionale.it); this trend was continued afterwards, due to the deepening of the economic and financial crisis (LUPO-RIVOSECCHI, Finanza pubblica: principi ordinatori e tendenze evolutive, in PELLEGRINI (ed.), Elementi di diritto pubblico dell'economia, Padova, Cedam, 2012, 133 ff.). In the XVI legislature, whose beginning coincides with the coming out of the crisis (April 2008), it is possible to count thirteen crisis-related decree-laws: the legislature is inaugurated by the adoption of decree law 112/2008 (introducing a triennial plan of public finances’ stabilisation) and decree-law 185/2008 (first anti-crisis decree, introducing some economic support measures), followed by the decree-laws 5/2009 and 78/2009 (directed at supporting specific sectors of the national economy); after decree-law 169/2009 (regulating internal fiscal dealines), the objective of financial stabilisation is continued through the adoption of decree-law 78/2010 (which anticipated the budgetary decision for the period 2011-2013); after the launch of the new European economic governance, the anti-crisis strategy goes on with decree-law n. 70/2011 (whose main purpose is to promote competitiveness and economic development), decree-law n. 98/2011 (related to the excessive deficits’ European procedure) and decree-law n. 138/2011 (whose main aim is to provide for the achievement of the budgetary balance objective already in 2013); after the assignment of the Government chaired by Mario Monti, new correction manouvers are approved through decree-law n. 201/2011 (aiming at reduce national debt load) and other three decree-law adopted between May and June 2012, the first two – decree-laws n. 52 and 95/2012 – intervening of the reduction of public expenses – and the third – decree law n. 83/2013 – aiming at increasing the competitiveness of the national economy in key sectors (data provided by CAMERA DEI DEPUTATI, Temi dell’attività parlamentare – Politica economica e manovre finanziarie, last updated 16 November 2012, available at: http://www.camera.it/292?area=27&Politica+economica+e+manovre+finanziarie).

These data are not surprising, as even before the crisis a trend to use the decree-laws as an ordinary means of economic and financial regulation had started, experiencing an intense increase in the passage from the XV to the XVI Italian legislature (for further details and data, see CAMERA DEI DEPUTATI, Tendenze e problemi della decretazione d’urgenza, Relazione presentata al Comitato della legislazione dal Presidente, on. Duilio, XVI legislatura, available at www.camera.it).

38 In 2011, among 50 laws approved by the Spanish Parliament, 20 were related to the transposition of decree-laws. As in 2010, most of these decree laws dealt with the management of the economic and financial crisis. (see CAMERA DEI DEPUTATI – Osservatorio sulla legislazione, Rapporto 2012 sulla legislazione tra Stato, Regioni e Unione europea, vol. 2, spec. 639 f., avail-
mediate entry into force and to its accelerated parliamentary procedure, is considered as capable of giving prompt relief to financial markets.

With regard to these trends, the fact that legislative decision-making is subject to a stricter budget limit implies in itself more hurdles for the approval of a legislation that could be drafted by Parliaments and in Parliament. Suffice to say that it is very difficult that MPs could approve amendments drafted and submitted by themselves, without the (formal or substantial) assent of the Executive.

Coherent with this expectation it seems to be the fact that during the last two years there has been an acceleration of such an effect: the EU Institutions, in order to face the crisis, have acted essentially following an intergovernmental method, clearly funded upon the national Executives (also exercising pressures for their substitution, in the case of Greece and Italy, as it is well known).

However, it should not be excluded that the constitutional reforms envisaged by the new economic governance would cause also some effects going in the opposite direction.

That is, on the one hand, a limitation of the powers of the national Executives, especially in the fiscal policy, which will be more constrained by the quite rigid quantitative limits to deficit and debt fixed in TSGC and in the “six-pack”, by the procedures and checks of the “European Semester” and by the more de-
tailed rules of “Economic Constitutions” which will be provided by the amended national fundamental Charters.

On the other hand, national Parliaments will be able to participate, although not from a leading position, to the process of budget and reform programming (through the stability or convergence programmes and through the national reform programmes); and, most of all, they will be put into condition to exercise their scrutiny and oversight function on the choices of the Executives, both on their national and their EU sides, invoking a clearer parameter for their assessment (see § 5).

In the new EMU scenario, in fact, Executives dispose of less margins for playing as free riders, while national Parliaments can count on the traditional and new instruments of inter-parliamentary cooperation. As mentioned in the Introduction, this cooperation is now explicitly recalled by art. 13 TSCG, according to which “the European Parliament and the national Parliaments of the Contracting Parties will together determine the organisation and promotion of a conference of representatives of the relevant committees of the European Parliament and representatives of the relevant committees of national Parliaments in order to discuss budgetary policies and other issues covered by this Treaty”. In this Article there is a generic reference to title II of the protocol n. 1 on the role of national Parliaments in the EU: clearly, there was no agreement regarding art. 9 (which covers the forms of interparliamentary cooperation co-promoted by the European Parliaments and national Parliaments) or art. 10
(which recalls the COSAC, a model in which the role of the European Parliament is less significant)\textsuperscript{40}.

Using these arguments, some have seen a “parliamentarisation” trend in the EU, which is not passing only through the European Parliament - as already observed, weakened by this process, especially because of the asymmetries among Member States that the new European economic governance determines- but it involves deeply the national Parliaments, in threefold: as co-promoters of policies; as co-constraint to common limits (as that of the budget balance); as parts of conferences and conventions\textsuperscript{41}.

More generally, national Parliaments are now considered, after the Treaty of Lisbon, also as autonomous actors in EU decision-making process, able to make their voice heard even without the intermediation of their Executive. Furthermore, their role has been strongly protected by the Bundesverfassungsgericht (BVG), both under a theoretical point of view and, more concretely, on the big options of European economic and monetary policy.

With a first ruling, adopted on the 30 June 2009\textsuperscript{42}, in fact, the German Constitutional Court judged unconstitutional the “accompanying law” of 2008 regulating the participation of the Bundestag and the Bundesrat to the newly ratified Lisbon Treaty institutional architecture. According to the constitutional


\textsuperscript{41} On the importance of interparliamentary cooperation see MANZELLA, La cooperazione interparlamentare nel “Trattato internazionale” europeo, in ASTRID Rassegna, February 2012.

\textsuperscript{42} Judgment of the Federal Constitutional Court of 30 June 2009 – 2 BvE 2/08.
judge, the new discipline did not grant the Bundestag and Bundesrat sufficient rights of participation in the EU’s lawmaking and treaty amendment procedures.

A second ruling was released by the Constitutional Court in September 2011\(^{43}\) and invested the euro rescue package for Greece and other highly indebted Eurozone countries. In rejecting three lawsuits against euro bailout measures, the Bundesverfassungsgericht partially approved some of the claims of the claimants, stating that the Bundestag should have a greater say and participation in future bailouts\(^{44}\).

With a third ruling, adopted on the 28 February 2012\(^{45}\), the Bundesverfassungsgericht evaluated the constitutionality of the new committee of lawmakers set up by StabMechG (Act on the Assumption of Guarantees in Connection with a European Stabilisation Mechanism – Euro Stabilisation Mechanism Act) and enabled, in case of particular urgency and confidentiality, to exercise some of the competences provided by the new Act and concerning the release of rescue funds from the EFSF. The Second Senate of the Federal Constitutional Court judged the panel to be “in large part” unconstitutional, since it violates the rights recognised to all Members of Parliament under art. 38.1. of the Basic Law, concerning the freedom of mandate.


Finally, the decision of 12 September 2012 on the ESM and on the TSCG\textsuperscript{46} recognised the mandatory overall budgetary responsibility of the Bundestag in the regards of German electors, which implies the independence of the German Assembly from directives coming from the EU institutions.

Reasons alleged by the Court in order to justify these judgments are clearly based on the exclusive role assigned to the Bundestag, in its role of representative of popular will as well as in the execution of budget law and fiscal responsibility.

This role, in particular, is restricted not only to budgetary approval, but also to the successive scrutiny stage, as Bundestag members have the right and the duty to exercise their scrutiny power over the fundamental fiscal decisions\textsuperscript{47}.

Such a remark constitutes a clear confirmation of the intrinsic political value of the parliamentary functions involved in the economic governance, which therefore could only be attributed to the Bundestag as a whole, thus excluding any technocratic alternative.


\textsuperscript{47} 2 BVE 8/11 <113>.
In protecting the Bundestag, even from itself, with the (unsaid) aim of not renouncing to its role of verifying the future steps of the European integration process, therefore, the BVG is probably and indirectly protecting the fundamental features of parliamentary democracy in the whole Europe\textsuperscript{48}.

In other words, in a context of diminishing national powers of political and financial choices, the loss of autonomy and of weight of the national Executives will probably be much more evident than the loss of autonomy and weight of the national Parliaments.

The latter, indeed, could keep most of their roles and gain some new functions: so that, considering only the national “form of government”, the result could be that of a (relative) reinforcement of the Parliaments at the expenses of the Executives.

4.2 The counter-intuitive hypothesis presented in § 4.1. can be illustrated with reference to the Italian case, focusing on the role of the Executive and of the Parliament in legislative decision-making with financial effects (excluding, therefore, budgetary procedures in a strict sense).

According to the Italian Constitution and to the experience of the first 40 years of the Italian Republic, the Italian Executive is usually qualified, in compar-

ative perspective, as a “weak” Executive. However, looking now to the real situation in the last 20 years, after the Treaty of Maastricht and after a mainly majoritarian electoral law, it should be recognised that the picture has profoundly changed, even in exactly the same constitutional framework: the Executive has acquired many de facto (and almost unlimited) powers, acting through decree-laws, using budgetary procedures and vetoing parliamentary legislation with effects on budget.

This trend has even been accelerated during the Monti Government: since the beginning, it has issued a series of financial decree-laws, the first of which transposed by Parliament in less than 30 days and all of them converted through confidence votes (“en bloc”, with all amendments approved under the menace of dismissal of the Executive) in both Chambers. In order to do so, the Executive has invoked the markets emergency, but most of all the necessity to hold together its heterogeneous majority, as recognised and explicitly requested by the leaders of the parties which supported the new Executive. So, a wide and powerful set of instruments is in the hands of the Executive and of its majority.

However, the Constitutional reform approved with the Constitutional law n. 1/2012, which introduced the principle of the balanced budget in the Italian

---


50 See FABBRINI, Governare l’Italia: il rafforzamento dell’esecutivo tra pressioni e resistenze, ivi, 33 ss.
Constitution, has broken the substantial “constitutional immobility” about the discipline of the form of government – still the same since 1948, notwithstanding many reforms have been attempted, in the last 30 years – and could represent an important step in recognising more clearly the role of the Executive in the use of public expenditures and increasing the level of transparency (also in the interest of future generations) of the financial policies.

In the meantime, there have been some (failed) attempts to codify – with regards to the budget, but not only – this new role of the Executive in the Constitution or in the parliamentary rules of procedure, introducing some limits and some checks and balances. And also the Constitutional Court has recently put itself, for the first time, in condition of verifying the homogeneity of decree-laws and of their converting laws (till now, as already observed, the main normative instrument used by the Executive and its majority).

The general idea is that it is better to have a power recognised and limited by the compound Euro-Italian Constitution than a power not provided at all by


52 Corte costituzionale, Decision n. 22/2012.

the Constitution but exercised widely, without any effective limitation or counter-balance\textsuperscript{54}.

4.3 In the final part of the section, abandoning the Italian point of view, the reflection is brought again on a general basis, leading to some more general, although provisional, observations, regarding the respective role of the Executives and of the Parliaments, in the “forms of government” of EU member states.

For what concerns the role of the Executive, maybe it is time to recognise (in some Member States it is happening already) that the Executive is the “master” of legislative decision-making in Member States’ parliamentary forms of government and that it should have the possibility to enact rapidly the fiscal reforms, especially after they have been presented and discussed at the European level. In the light of the role of the Executive in fiscal decisions and in the adoption of tax and spending laws, it is therefore necessary to redefine, in current multi-level constitutional dimension, traditional principles like the myth of fiscal control or of “no taxation without representation”\textsuperscript{55}.

In this context, for what concerns the role of the Parliament, some important steps have been made, in the Italian Constitutional reform but also

\textsuperscript{54} As observed by SCACCIA, La giustiziabilità della regola del pareggio di bilancio, in Costituzione e pareggio di bilancio. Il Filangieri. Quaderno 2011, cit., 211 ff., the new constitutional budget balance rule will probably depend for its implementation more on political decisions than on the intervention of the judges; that’s why the democratic participation and the parliamentary control will reveal themselves crucial in this field.

\textsuperscript{55} WEHNER, Legislatures and the budget process: the myth of fiscal control, Basingstoke, Palgrave Macmillan, 2010.
elsewhere, towards a reinforced and independent parliamentary oversight on public finance (see § 5), as well on the action of the Executive in the EU.

This has happened also thanks to an increased interparliamentary co-operation: important, on fiscal policy and on other intergovernmental policies, but not easy to achieve and to bring to concrete results. The opposition parties in each Member State and the public opinion are now able, at least potentially, to monitor the respect of the new constitutional limits.

Finally, it has to be considered that a new family of actors is rapidly – and controversially, but this is not the place to address such a topic – emerging in fiscal policy: in the architecture of the economic governance there has been a steep increase of the role of the Courts in ensuring the respect of the limits posed by the EU law (Court of Justice) and, in perspective, by the Constitutions of the Member States (Constitutional Courts)\textsuperscript{56}.

What democracies in the EU are desperately seeking is the effectiveness of political responsibility and accountability. Indeed, there is a search for political responsibility, which is dissolving in multi-level systems of government.

Executives should not be tempted to elude or modify the budget limits fixed in EU law and now recognised by national Constitutions.

National Parliaments (and citizens) need to dispose of a clear picture of the budget limits and of the possible fiscal policy options for each level of government, in order to be able to scrutinise the action of the Executive and to evaluate budgetary and legislative decisions.

And stricter constitutional budget criteria could ease this task, by offering an objective parameter ready to be used by parliamentary bodies (and, eventually, by the Courts) willing to avoid any escape from responsibility.

5.1 Basing on the idea that stricter financial budget limits would imply a closer control over the respect of budgetary provisions, the present paragraph is meant to verify what has changed in the budgetary scrutiny role of national Parliaments with the coming out of the economic crisis and consequently with the launch of the new European economic governance.

The theoretical premise of this analysis is related to the idea that, probably due to the influence exercised by the principle of the “no taxation without representation” in designing the role of Parliaments, the involvement of legislatures in the budgetary process has mainly been associated with the power wielded in the approval of the budget, and consequently in the determination of spending priorities. Such a perspective is, however, to overcome as, either adopting a synchronic or embracing a diachronic approach, the institutional dynamics reveals itself much more complex and multifaceted.

From the synchronic point of view, comparative research shows that the role of Parliaments in the budget process tends to vary consistently in the nature and intensity of powers attributed to the legislative assembly. This implies
that some countries promote the intervention of Parliament not so much in the
decisional stage, consisting of the amending-approval of the budget, but rather
in the successive stage of the scrutiny of budget execution.\footnote{Krafchik and
docs/2005/050404oversight.pdf; Johnson and Stapenhurst, \textit{Legislative Budget
Offices: International Experience}, in Stapenhurst, Pelizzo, Olson and Von Trapp (eds.), \textit{Legislative Oversight and

From the diachronic perspective, moreover, it is unequivocal that the type
and degree of parliamentary involvement have evolved over time and will con-
tinue to evolve in the future. Broadly speaking, the participation of Parliaments
to the budget process has showed cyclical changes over the last 70 years: the
original exclusion of legislatures from budgetary decision in the post-war period
was slowly replaced by the emerging awareness of Parliaments’ indefeasible
role in the governance of the budget. In the last decades, however, the need to
find a form of reconciliation between technicality (embodied by the govern-
ment) and democracy (represented by legislatures) has led to a compromise,
consisting in the limitation of the capacity of Parliament to condition budget de-
cision and in a correspondent strengthening of its scrutiny power over budget
execution.\footnote{Krafchik and Wehner, \textit{The role of Parliament in the budget process}, in South African Journal
of Economics, vol. 66-3, 1998, 243.} This confirms that not only the budgetary decision in itself, but ra-
ther the entire budgetary process (including the scrutiny of budget execution)
represents a 'testing ground' for evaluating the evolution of the balance of
powers between constitutional bodies\textsuperscript{59}. In particular, attention is focused on the scrutiny function, defined as the activity carried out by the Parliament in order to assess governmental responsibilities on the basis of a given parameter\textsuperscript{60}. Such restrictive notion could be defined as a form of ex post scrutiny\textsuperscript{61}, expressing the ‘supervision’ or ‘watchfulness’ of Parliaments over delegated authority\textsuperscript{62}.

Defined in these terms, the parliamentary oversight of budgets is mainly carried out at committee level and we can distinguish between two different types of committee expertise.

The first type is that of specialised budget committees operating during ex ante scrutiny, whose task is mainly that of analysing and/or approving the governmental draft budget. The second type is that of ex post scrutiny committees, which finds in the Public Accounts Committees (PAC) of the Commonwealth system its most relevant example. The modern PACs represent specialised audit committees operating in close interaction with the supreme auditor and entitled to scrutinise governmental accounts.


\textsuperscript{61} STAPENHURST, *The Legislature and the Budget*, in STAPENHURST, PELIZZO, OLSON and VON TRAPP (eds.), *Legislative Oversight and Government Accountability*, cit., 57

These two types of committee expertise do not always come together: as evidenced by comparative studies\textsuperscript{63}, the so called “Westminster system”, characterising Commonwealth Parliaments, represents a combination of low ex ante capacity (mainly due to the absence of ex ante committees’ involvement) and highly developed ex post capacity (thanks to the presence of PACs).

The opposite happens in Parliaments outside Commonwealth, such as the French Parliament. That’s why in these latter assemblies oversight of budget is usually carried out by standing committees charged, at the same time, both with the legislative power over the approval of budget and with the scrutiny of its execution\textsuperscript{64}.

Basing on this theoretical premise, in order to give an answer to the essay’s basic question, attention is focused on some relevant European ‘models’ of budget scrutiny, which clearly show how different, at national level, are the nature of the several parliamentary procedures and subjects dedicated to parliamentary scrutiny and the intensity of this kind of function\textsuperscript{65}.


\textsuperscript{64} For an overview of the main features of the parliamentary oversight of budget in the French experience, as significantly reinforced by most recent reforms, see BAUDU, L’incertaine renais-sance parlementaire en matière budgétaire et financière, in Revue du droit public et de la science politique en France et à l’étranger, n. 5, 2010, 1423 ff.; LE SEUIL, La dégradation des fi-nances publiques : la loi en échec, le contrôle et l’évaluation en recours, in Pouvoirs, n.3/2010, 83 ff.; LAMBERT, Vers un modèle français de contrôle budgétaire, ivi, 47-48.

\textsuperscript{65} For further details on the basic features of such parliamentary scrutiny models, see GRIGLIO, Parliamentary oversight of national budgets. Recent trends in EU Member States, Paper presented at the Tenth Workshop of Parliamentary Scholars and Parliamentarians, Wroxton College - Oxfordshire, UK, 28-29 July 2012.
<table>
<thead>
<tr>
<th>Parliamentary body in charge of the budgetary scrutiny</th>
<th>UK</th>
<th>France</th>
<th>Germany</th>
<th>Belgium</th>
<th>Italy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Permanent committees entirely dedicated to the ex post scrutiny function (Public Account Committees)</td>
<td>Standing committees, dedicated both to the ex ante and to the ex post scrutiny function (Finance Committees)</td>
<td>Standing committee of the Bundestag, dedicated both to the ex ante and to the ex post scrutiny function (Budget committee), with a specialised subcommittee entirely dedicated to the oversight of budget (Auditing committee)</td>
<td>Budget and Finance Committee of the Chambres des représentants, dedicated both to the ex ante and to the ex post scrutiny function</td>
<td>Standing committees dedicated both to the ex ante and to the ex post scrutiny function (Budget committees) – Participation of the floor (in the approval of the rendiconto)</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Level of involvement in the budgetary decision</th>
<th>Low</th>
<th>Medium</th>
<th>High</th>
<th>High</th>
<th>High</th>
</tr>
</thead>
<tbody>
<tr>
<td>Level of development of the budgetary oversight (Ex post stage)</td>
<td>High</td>
<td>High</td>
<td>Medium</td>
<td>Low</td>
<td>Low</td>
</tr>
<tr>
<td>Type of budgetary oversight tools applied (compared to other ‘general’ oversight tools)</td>
<td>Budget specific (typical)</td>
<td>Budget specific (typical)</td>
<td>Generic</td>
<td>Generic</td>
<td>Generic</td>
</tr>
<tr>
<td>Main source of budgetary information</td>
<td>External, mainly coming from the National Audit Office</td>
<td>Mainly internal (autonomously collected by the Finance committees). Other information are provided by the Cour des comptes</td>
<td>Mainly external (mostly coming from the Audit office)</td>
<td>Mainly external (mostly coming from the Government and from the National Auditing Office)</td>
<td>Mainly external (large dependence on governmental information)</td>
</tr>
</tbody>
</table>

Figure 1 – A comparison among different national models of parliamentary budgetary oversight

The figure clearly reveals that the intensity of the parliamentary oversight of budget depends not so much on the scrutiny model adopted (either based on
a specialised scrutiny parliamentary committee, as in the case of UK's Public Account Committee, or on an hybrid committee, dedicated both to the legislative and to the oversight function, as in the French experience), but rather on the chance given to Parliaments to count on independent (if not autonomous) sources of information and on dedicated scrutiny procedures.

5.2 Giving the substantial differences characterising parliamentary oversight of budget exercised at national level, comparative analysis seems to reveal that Member States have lately experienced some more or less structural changes directed, at various degrees and levels, to impact the scrutiny function. It is difficult to assess whether these reforms should be interpreted as a consequence of the economic crisis or as a spontaneous adaptation to long-term institutional needs. This latter solution is probably supported by the fact that the crisis doesn’t seem to have hybridised original models, which have rather experienced different forms of rationalisation of the already existing scrutiny procedures and organisational patterns.

In any case, in order to verify if and how national scrutiny systems have been impacted by the economic crisis, two parameters can be taken into consideration: i) the structural reforms approved in the last years at national level in order to adapt the parliamentary scrutiny of budget to the requirements of the new economic and institutional governance; ii) the changes occurred in the concrete behaviour of parliamentary scrutiny bodies.

Generally speaking, the empirical analysis based on these two parameters reveals that at national level some not insignificant reforms and changes im-
pacting the parliamentary oversight of budget have recently occurred. Such reforms and changes do not seem to have substantially altered the fundamental features of the reference scrutiny model. The Westminster model\textsuperscript{66} has kept its main focus on the ex post scrutiny stage, but the extension of the NAO-PAC interaction to the Whole of Governments Accounts has opened up new opportunities to invest in the ex ante evaluation stage\textsuperscript{67}. The French and the German Parliaments have confirmed their belonging to the category of the mixed models and in both cases the most recent reforms affecting the parlia-


\textsuperscript{67} Apart from the novelty of the Office for Budget Responsibility (which will be discussed in the following §), the institutional arrangement of the so called "Westminster model" has not encountered major changes in the very last period, probably due to the fact that in 2000 and 2006 NAO-PAC audit activity already experienced some relevant reform which determined the extension of their activity to the so called Whole of Government Accounts (WGA) and to public bodies established as companies. It’s difficult to assess whether this evolutionary perspectives are more or less directly related to the ongoing economic trend. Most probably, they represent an institutional ‘natural’ adaptation, in line with the UK parliamentary oversight tradition and consistent with the auspice of overcoming existing weaknesses in the working of accountability circuit (HANSARD SOCIETY, The Challenge for Parliament: Making Government Accountable, Report of the Hansard Society Commission on Parliamentary Scrutiny, Hansard Society Publications, 2011).
mentary oversight of budget have renewed the preference accorded respectively to the ex post (France) and to the ex ante (Germany) scrutiny. The Belgian and the Italian legislatures\(^6\) have not been able in the last few years to evolve from their original focus on the budgetary legislative decision-making, rather than on the subsequent ex post scrutiny stage, even though in both countries some significant novelties are going to be introduced after the implementation of the new budget balance rule.

What has just been noted on the substantial confirmation of the already existing characteristics of scrutiny models doesn’t imply that the oversight role

\(^6\) In Italy the coming out of the economic crisis promoted a number of changes, both formal and informal, affecting the budgetary oversight function of the Parliament, starting from the 2009 reform of the National Accounting Act, approved with Law n. 196/2009. Such reforms launched three main tendencies impacting the parliamentary oversight of budget: the rationalisation of budgetary documents (and data) in order to facilitate parliamentary (ex ante, but possibly also ex post) control; the harmonisation of bicameral procedures and tools through autonomous internal initiatives of the two Chambers; the enhancement of informative prerogatives for Parliament, promoted by the Title II of the National Accounting Reform Act (DICKMANN, La riforma della legislazione di finanza pubblica e del sistema di bilancio dello stato e degli enti pubblici, in Federalismi.it, n. 2, 2010, 17 ff.). The aim of these reforms was to reduce legislative powers of Parliament in the budgetary area and correspondingly to increase oversight attributions of Parliament (strengthening informative duties of Government). However, the reinforcement of governmental power over budget execution (BRANCASI, Le «Misure urgenti per il controllo, la trasparenza ed il contenimento della spesa pubblica», in Diritto pubblico, 2003, 962; DEGNI, La decisione di bilancio nel sistema maggioritario, Roma, Ediesse, 2004, 244 ff.) has not been accompanied by a corresponding empowerment of parliamentary oversight function (ARCONZO, Le scelte di finanza pubblica in una «democrazia decidente»: alla ricerca di un nuovo ruolo per Governo e Parlamento, in Quaderni costituzionali, n. 4, 2008, 829-830; PERN, Le procedure di bilancio, fra Governo e Parlamento, in una democrazia maggioritaria, in Il Parlamento del bipolarismo. Un decennio di riforme dei regolamenti delle Camere. Il Filangieri – Quaderno 2007, Napoli, Jovene, 2008, 150 ff.).
of Parliaments has not experienced a development in the last few years and that it will not experience in the near future an even more significant expansion.

One major trend is represented by the increasing interest of Parliaments for the ex ante evaluation of the fiscal frameworks and budgetary scenarios, which anticipates the drafting of the budget. A common feature characterising most national trends can be indeed identified in the fact that latest reforms and changes tend to extend Parliament’s intervention working at the same time on the ex ante and ex post stage: their purpose is to strengthen the capacity of the Parliament to fully evaluate the budgetary provisions in the decision-making process and to influence the long-term planning; and to consider this transformation, in the medium-long term, as the first step towards the enforcement of the parliamentary scrutiny over budget execution.

In some cases, moreover, the strengthening of the ex ante stage ended not only into a reinforced capacity of the Parliament to interact with budgetary documents, but rather into a newly established ability of the legislature to understand and evaluate the overall macro-economic and financial scenario. It's the case, in particular, of the UK experience, which has significantly invested in the last decades in the ex ante information concerning the fiscal framework to be acquired before the tabling of the budget⁶⁹ and which has recently provided for the foundation of an independent Budget Responsibility Office. Also the 2009 French modification of the National Assembly Rules of procedure (which created the Comité d’evaluation et de contrôle), as well as the Petit loi ap-

---

⁶⁹ WEHNTER, Committee structures for budget approval and oversight, Presentation prepared for the Meeting of OECD Parliamentary Budget Officials — Stockholm, Sweden, 28-29 April 2011, available at www.oecd.org/document/8/0,3746,en,2649_34119_47720893_1_1_1_1,00.html.
proved by the French Parliament on 13 July 2011 (which introduced the "Lois cadre" on the balance of public finances), can be interpreted as an attempt to favour a more structural control of the Parliament on the budgetary and financial assets, anticipating the budget bill\textsuperscript{70}.


A successive step in the progressive rethinking of parliamentary oversight of budget was fostered by the Constitutional reform of 2008, which impacted the relationship between the executive and legislative branches and found in the strengthening of parliamentary control one of its most significant novelties. See LUPO, Un Parlamento da rafforzare, non da indebolire. La revisione costituzionale francese del luglio 2008 a confronto con le prospettate riforme dei regolamenti parlamentari, in Italia, in La riforma dei regolamenti parlamentari al banco di prova della XVI legislatura, in GIANFRANCESCO and LUPO (eds.), Roma, Luiss University Press, 2009, pp. 252-267; CALAMO SPECCHIA, Il Parlamento francese. Profili strutturali e funzionali, in CAVINO, DI GIOVINE and GROSSO (eds.), La quinta Repubblica francese dopo la riforma costituzionale del 2008, Torino, Giappichelli, 2010; TÜRK, Le contrôle parlementaire en France, Paris, LGDJ, 2011, spec. 176 ff.; and DECARO, La limitazione costituzionale del debito in prospettiva comparata: Francia e Spagna, in Costituzione e pareggio di bilancio. Il Filangieri. Quaderno 2011, cit., 267 ff. The Constitutional reform created the premises for the 2009 modification of the National Assembly Standing Orders n. 146, which ended up in the creation of a new dedicated parliamentary body, the Comité d’évaluation et de contrôle (CEC). The last step of this progressive transformation is to be found in the constitutional reform on the balance of public finance, definitively approved on 13 July 2011 by the two Assemblies in the same text, which,
Finally, the 2012 Italian constitutional reform on the budget balance, approved with the Constitutional Law no 1/2012 in April 2012, could be inscribed within those measures also aiming to invest the Parliament with the ex ante evaluation of public finance.

In particular, Article 5, section 4 of the new Law clearly states that the two Chambers, in compliance with their own Rules of procedure, exercise the oversight function on the public finance, with specific regard to the balance between expenditures and revenues and to the quality and effectiveness of the public administrations' spending. If this provision apparently seems to encourage the two Chambers to operate independently in the exercise of the oversight function, Article 5. Section 1, f) of the Constitutional Law offers a bicameral solution to the problem. According to this norm, furthermore, an independent body shall be created by the Chambers, with due respect of their constitutional autonomy; it shall be entitled to analyse and assess the public finance trends and to monitor the respect of budgetary rules (see infra)\(^7\).

broadly speaking, is meant to strengthen the governance of French public finances and to adapt it to the requirements of the new “budgetary era” (ASSEMBLÉE NATIONALE, Avis présenté au nom de la Commission des finances, de l’économie générale et du contrôle budgétaire sur le projet de loi constitutionnel (n. 3253), relatif à l’équilibre des finances publiques, enregistré à la présidence de l’Assemblée nationale le 13 avril 2011, available at http://www.assemblee-nationale.fr/13/rapports/r3330.asp, 9), introducing a multi-year management of public finances thanks to the creation of a new type of «Lois cadre» on the balance of public finances. For further details, see BAGHESTANI, A propos de la loi tendant à renforcer les moyens du Parlement en matière de contrôle de l’action du Gouvernement et d’évaluation des politiques publique, in Les Petites affiches, La Loi, Le Quotidien juridique, n. 78, April 2011, 3-4.

\(^7\) According to DE IOANNA (La nuova cornice costituzionale apre nuove dinamiche tra le forze politiche e nella cornice delle interpretazioni, economiche e giuridiche, dei fenomeni di finanza pubblica, Presentation held at the Conference "La nuova governance fiscale europea. Fiscal
From a more general (and normative) perspective, there are a variety of reasons which would encourage the tendency to support the ex ante financial and budgetary evaluative function of Parliaments: i) legislatures’ raising awareness that the economic and financial governance requires a medium-long term perspective, which in turn commits representative assemblies to strengthen their analytical and evaluative capacity; ii) the conviction that the new European economic governance is based on a combination of budgetary and fiscal rules, which therefore binds Parliaments to extend the traditional accounting audit to a control over the evolution of fundamental fiscal trends; iii) the belief that investing in the debate and consultation on medium term fiscal and budget trends might diminish the need for amendment activity in the budgetary legislative process.

If, therefore, most recent trends reveal a growing interest of Parliaments for the ex ante evaluation of financial and budgetary trends, as far as the exercise of the ex post scrutiny is concerned, one could not detect at national level a one-sided shift towards the reinforcement of parliamentary scrutiny tools and procedures. Apart from the Westminster model, which was already enjoying a well-structured ex post scrutiny apparatus, only in France is it possible to register the introduction of substantial innovations which will concretely support the role of the legislature in the ex post stage. No significant effort, on the contrary,
has been recently made in this direction by Germany and Belgium, while also
the latest reforms approved in Italy, influencing the parliamentary scrutiny func-
tion, do not seem to have introduced radical changes, except for the
constitutional reform lastly approved in April 2012, which nevertheless still
needs to be concretely applied.

This acknowledgement does not exclude that, in the medium term, also
the ex post parliamentary scrutiny - taking advantage of the experience, data
and analytical capacity developed in the ex ante stage - will probably
acknowledge a further expansion.

5.3 The role played by national legislatures in the ex ante as well as in the
ex post scrutiny function will be deeply influenced by the emerging, at Member
States' level, of new advisory and oversight patterns affecting the budgetary and
financial area, based on the intervention of Fiscal councils. In the last two years,
in fact, the European Union has provided for the establishment, at national lev-
el, of fiscal agencies, better known as "Fiscal councils"72, independent
institutions, composed mainly of economic experts and academics, whose main
task is to enhance the transparency of the decision-making process on budget-
ary and financial matters73.

72 For further details, see FASONE and GRIGLIO, The setting up of the Fiscal Councils and the Per-
spectives for the National Parliaments. Comparing Belgium, Germany and the UK, Paper
presented at the European University Institute Dissemination Conference "The Euro Crisis and
the State of European Democracy", Florence - 22, 23 November 2012, available at
73 Among others, see DEBRUN, KUMAR, The Discipline-Enhancing Role of Fiscal Institutions: Theo-
ry and Empirical Evidence, in AYUSO-I-CASALS, DEROOSE, FLORES, MOULIN, European Economy -
The set of EU norms regulating the criteria for the establishment and the functioning of Fiscal councils is to be found mainly in the Directive 2011/85 EU, in the TSCG, in the Proposal for a Regulation on common provisions for monitoring and assessing draft budgetary plans (COM (2011) 821) and in the Communication from the Commission defining the Common principles on national fiscal correction mechanisms (COM (2012) 342). Such regulations,

---


74 According to Article 6 of the Council Directive 2011/85/UE of 8 November 2011, in fact, country-specific numerical fiscal rules shall contain specifications as to «the effective and timely monitoring of compliance with the rules, based on reliable and independent analysis carried out by independent bodies or bodies endowed with functional autonomy vis-à-vis the fiscal authorities of the Member States».

75 According to the TSCG (Article 3.2), the correction mechanisms (to be triggered automatically in the event of significant observed deviations from the medium-term fiscal objective) shall be put in place "on the basis of common principles to be proposed by the European Commission, concerning in particular the nature, the size, and the time-frame of the corrective action to be undertaken also in the case of exceptional circumstances, and the role and independence of the institutions responsible at national level for monitoring the observance of the rules".

76 The proposal for a Regulation of the European Parliament and of the Council on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area (COM (2011) 821) – which is still under the negotiation of the Council and of the EU Parliament – offers (Article 2.1.(1)) a formal definition of "independent fiscal council" as «a body endowed with functional autonomy vis-à-vis the fiscal authorities of the Member State in charge of monitoring the implementation of national fiscal rules».

77 The Communication “Common principles on national fiscal correction mechanisms” (COM (2012) 342) was adopted in June 2012 by the EU Commission as part of the implementation of
characterised by a different legal nature and status, contribute to create a range of requirements concerning both the structural and the functional features of Fiscal councils to be completed at national level.

Some Member States have experienced the creation of fiscal agencies long before the coming out of the current economic and financial crisis\textsuperscript{78}: it is the case, in particular, of Germany\textsuperscript{79}, Belgium\textsuperscript{80}, Sweden and Denmark.

Somehow peculiar is the experience of the United Kingdom, which has not signed the TSCG but has autonomously provided for the creation, in 2010, of the Office for Budget Responsibility; the Office, disciplined by the Budget Responsi-
ability and National Audit Act 2011 and entitled to provide authoritative analysis of UK’s public finance, could be undoubtedly inscribed within the category of independent budget authorities.

Irrespective of these pre-existing experiences, in the new European economic governance the presence of a Fiscal Council has become mandatory for Member States; that's why also those countries lacking similar institutions have recently started up some reforms directed at bridging the gap. It's the case, in particular, of Italy, which with the constitutional reform on the budget balance, approved with the Constitutional Law no 1/2012 in April 2012, has foreseen the creation, within the two Chambers, of an independent body entitled to analyse and assess the public finance trends and to monitor the respect of budgetary rules; the provision has recently been implemented by the reinforced law no 243/2012 of 24 December 2012, which establishes the Parliamentary Budget Office whose Council is made up of three members appointed on the basis of common agreements by the Chairs of the two Houses. The Italian upcoming Fiscal Institution could be therefore classified within the fiscal agencies with a solid, constitutional basis and a defined area of interven-

---

81 Article 5, Section 1, f).
82 See CABRAS, Un Fiscal Council in Parlamento, in Federalismi.it, 17 October 2012 (available at: www.federalismi.it).
tion, due to the fact that, at the same time, it enjoys a constitutional status and it operates with a fiscal rule set on a constitutional basis.84

Also France has recently provided for the implementation of the Fiscal compact through the loi organique of 17 December 2012 on the planning and governance of public finances85, which (art. 11), among other things, provides for the establishment of the High Council of Public Finances, an independent body set by the Cour des comptes86, chaired by the President of the accounts authority and composed by ten members, of which four judges of the Cour des comptes and four members appointed by relevant representatives of the two Houses87.

---

84 FRANCO, Comments on “The Role of Fiscal Policy Councils in Theory”, cit., 31 January 2011. On the importance that fiscal rules have in order to make the model based on the advisory role of Fiscal Councils really work, see also GORETTI, Preggio di bilancio e credibilità della politica fiscale: il ruolo del fiscal council nella riforma costituzionale italiana, 20 gennaio 2012 (available at: www.astrid.eu).

85 Following the Decision of the Conseil constitutionnel n. 2012-653 DC of the 9 August 2012 (on which see CASELLA, Il Consiglio costituzionale francese e il trattato sul Fiscal compact, 26 October 2012, available at www.forumcostituzionale.it), the French strategy can be defined as an example of a "minimal" adaptation to the TSCG (on this point, see STERDYNIK, Gouvernance des finances publiques: du Pacte budgétaire à la loi organique, 15 October 2012, available at http://www.ofce.sciences-po.fr/blog/?p=2637), based on the recourse not to a constitutional law, but rather on a reinforced law, as the loi organique.

86 On the origins of this interinstitutional cooperation, see CARCASSONNE, Les relations de la Cour et du Parlement: ambiguïtés et difficultés, in Revue français de finances publiques, n. 59, 1997, 131 ff. On the effects of the most recent reforms on the interaction between the Parliament and the Cour des Comptes, see PRAT and JANVIER, La Cour des comptes, auxiliaire de la démocratie, in Pouvoirs, no. 134, 3/2013, pp. 97 ff., which defines the French Supreme Audit Authority an «auxiliaire de la démocratie».

87 Before being formally approved, the French loi organique was submitted – in compliance with the procedure of art. 46 (5) and 61 (1) of the French Constitution – to the Conseil constitu-
Notwithstanding the large variety of national experiences concerning both the political, economic, legal context, which has determined the creation of fiscal authorities and the structural and functional features characterising such bodies, a general reflection on the possible interaction of such bodies with national parliaments reveals itself desirable.

From the legal point of view, in fact, the EU requirements concerning the establishment of Fiscal councils seem to advocate the development of a stable relationship with the legislative branch. The EU legislation, in fact, tries to protect the independence of Fiscal councils from existing fiscal authorities, but at the same time it requests Member States to introduce the most suitable tools for making Fiscal Councils accountable to Parliaments. This implies that Member States are free to choose the institutional arrangement of the fiscal independent body (detecting in the legislative branch or in the executive branch and eventually also in the existing advisory authorities, such as the French Cour des Comptes).

For further details, see Perrotta, Il rafforzamento della vigilanza sui conti pubblici e l’evoluzione della fisionomia delle istituzioni fiscali indipendenti, in Di Gaspare, Lupò, Meloni and Morana (eds.), Le autonomie in cammino. Scritti dedicati a Gian Candido De Martin, Padova, Cedam, 2012, 527 ff.
comptes, its privileged interlocutor), but having clearly in mind that the interaction with Parliaments is considered somehow necessary by the European regulations\textsuperscript{89}.

Also adopting a theoretical perspective, the establishment of Fiscal councils seems to widen the capacity of national legislatures to exercise their budgetary and financial oversight rather than representing a threat for the full development of such function. This statement is supported by different arguments.

In particular, it is important to distinguish between the analytical and advisory activity carried out by Fiscal Councils, mostly based on technical capabilities, and the political oversight exercised by Parliaments, which, given the representative nature of the body, ensures a real democratic control over the executive.

This remark confirms that the role assigned to Fiscal councils and to national legislatures in the budgetary and financial monitoring is potentially complementary and does not determine an overlapping of institutional duties.

The evaluation of public expenses, even though based on technical evidence, always includes a political judgement over the appropriateness of governmental performances, which explains the intervention of parliamentary bodies\textsuperscript{90}. The budgetary control is in fact physiologically bound to the budgetary decisional power, in its turn strictly dependent on the form of government.

\textsuperscript{89} This point has been pointed out by FASONE and GRIGLIO, \textit{The setting up of the Fiscal Councils and the Perspectives for the National Parliaments}, cit.

which therefore explains the cyclical ups and down of the parliamentary oversight function (referring to public finances). We can hardly imagine that a similar flexibility in the implementation of budgetary oversight could be provided by entirely delegating the budgetary and financial scrutiny to independent authorities. According to economic literature, moreover, the parliamentary oversight can give real credibility to executive budget performances, due to the fact that the bipartisan style, which usually characterises the scrutiny function, guarantees an evaluation capable of being impartial and unbiased, but not uninvolved and merely technical.

If therefore the scrutiny role of national Parliaments does not seem to be threatened, but rather potentially emphasized by the new European economic governance, the presence of a fiscal independent agency could help legislature to interpret in a more effective way this emerging task. As evidenced by the

91 A budgetary oversight based on the intervention of independent budgetary authorities, in fact, could be considered compatible with a presidential system, but probably not with a semi-presidential or parliamentary form of government. In such systems, we can get rid of the prejudice according to which the relationship between the legislative and executive branches in the budgetary process represents a ‘zero sum game’ (PERNA, Le procedure di bilancio, fra Governo e Parlamento, cit., 176), and therefore try to invest more on the formula ‘more accountability for Government in the budgetary decisions’ – ‘more ex post oversight of budget for Parliament’.

92 ANDERSON, The Value of a Nonpartisan, Independent, Objective Analytic Unit to the Legislative Role in Budget Preparation, in STAPENHURST PELIZZO, OLSON and VON TRAPP (eds.), Legislative Oversight and Government Accountability: A World Perspective, cit., 131 ff.

93 Such a perspective of ‘mature’ parliamentarism in the development of the budgetary oversight finds in the EU institutional architecture its most significant example. We refer, in particular, to the so called ‘discharge procedure’, which constitutes a clear model of political control exercised by the European Parliament on the budget execution made by the EU Commission (RIVOSECCI, Bilancio della Comunità europea, in CASSESE (ed.), Dizionario di diritto
Hansard Society Commission on Parliamentary Scrutiny94, the modern state is so vast and complex that it is “no longer possible for Parliament alone to ensure accountability across the wide range of activities of central departments, let alone the myriad of other public sector bodies”.

As a consequence, part of the literature recommended that Parliaments should be placed at the “apex of the pyramid of accountability”, drawing on the investigations of outside regulators and commissions, thereby on the one hand providing a framework for their activities, and on the other hand drawing on their expertise and resources to perform more effectively their scrutiny functions95.

Once assumed this thesis, one could wonder what are the most relevant factors influencing an effective interaction in between Fiscal councils and Parliaments in the development the economic and financial surveillance. If the answer to the question will probably need to be assessed on the basis of empirical evidence, one factor reveals itself striking.

Such factor is related to the capacity of Parliaments to autonomously develop a scrutiny function in the budgetary and financial area; in other terms, having regard to the different parliamentary scrutiny models presented in Fig-

---


ure 1, one could expect those legislatures sharing a well-suited institutional and procedural architecture in the scrutiny field to be more willing and more able to effectively interact with the fiscal agency by sharing data and combining analytical activities\textsuperscript{96}.

\textsuperscript{96} In its turn, the intensity of the parliamentary scrutiny function in the budgetary and financial area seems to depend not only by techniques and procedures - which are able to produce virtuous effects only if the political context is favourably oriented in this sense (PERNA, \textit{Le procedure di bilancio, fra Governo e Parlamento}, cit., 162) -, but also by the political commitment, whose importance in shaping the effectiveness of scrutiny activity is justified by the political and evolutionary nature of the parliamentary oversight of budget (GORETTI and RIZZUTO, \textit{Il ruolo del Parlamento italiano nella decisione di bilancio: evoluzione recente e confronto con gli altri paesi}, in \textit{Rivista di politica economica}, no 1-3, 2011, 51-52). The importance of this factor is confirmed by the fact that opponents of parliamentary oversight of budget justify their position by arguing that Parliaments usually do not have enough information or technical capacity to play an effective role in the budget process (KRAFCHIK and WEHNER, \textit{Legislatures and Budget Oversight: Best Practices}, cit., 2).
6. Starting from the debate on the destiny of parliamentary democracy at supranational level, stemmed from the so called “deparlamentarisation” thesis, arguments carried out in the essay have come to reconsider the thesis of the decline of parliamentary democracy in the European context by highlighting how the crisis is actually offering to national legislators a real opportunity to gain new chances to intervene in the multilevel economic and financial governance.

It can be objected that the effects that the crisis is exercising on national Parliaments are not homogeneous and univocal in all Member States. In particular, the national Parliaments of the Eurozone countries running high deficits do not seem to have the power to exercise a real scrutiny over their governments (due to the fact that the economic instability hinders any internal critique), while a different condition tends to characterise national Parliaments belonging to “rich” Eurozone countries (which, for instance, are actually gaining the opportunity to get involved in those decisions concerning the implementation of financial rescue mechanisms). Other differences in the role played by national Parliaments derive from the variable geometry perspective, which is character-

97 The thesis is based on the idea of the "crisis" of national Parliaments determined by the overriding role assumed, at national level, by the executive branch in EU-related decision-making processes. See RAUNIO, The Gatekeepers of European Integration? The Functions of National Parliaments in the EU Political System, cit., 304 ff.

98 This disomogeneity of conditions and opportunities in between national Parliaments has been highlighted by CARETTI, Introduzione generale, Presentation held at the Fifth Italian-Brasilian Meeting of Constitutional Law, held in Lecce, 14-15 September 2012 (available at: www.gruppodipisa.it).
ising the settlement of the economic governance within the European Union, determining a plurality of memberships for Member States (represented in particular by the Eurozone membership and by the adherence to multi-speed integration, as in the case of the Fiscal compact). Such a variety of national positions tends to influence the institutional role assigned to national Parliaments at European level (in particular in the dimension of the interparliamentary cooperation disciplined by art. 13 of the Fiscal compact) and possibly also at Member States’ level.

Notwithstanding these national specificities, the overview of parliamentary functions carried out in the paper has offered some common preliminary results investing the overall position of national representative assemblies in the new economic governance.

In particular, from the perspective of the exercise of the legislative function in a framework characterised by stricter budget limits, a new role seems to emerge for Parliaments as masters of the political budgetary scrutiny. If the political responsibility is dissolving in multi-level systems of government, in fact, national Parliaments are gaining a strategic role in granting to citizens a clearer picture of the budget limits and of the possible fiscal options for each level government. In this perspective, therefore, stricter constitutional budget limits seem to ease the task, by offering an objective parameter ready to be used by parliamentary bodies.

On the basis of such premises, it is therefore possible to argue that, paradoxically, the increased budgetary constraints imposed by most recent European reforms, and in particular by the Fiscal compact, could favour the role
of Parliaments, possibly at the expense of Governments. The budget balance rules adopted in compliance to the Fiscal compact will probably confirm the domain of Governments on fiscal policy; but they will also introduce more limits on their concrete activity, due to the fact that most of the political measures to be adopted will be more or less imposed by the need to comply with EU constraints. Such hurdles, of course, will limit also the decision-making function of Parliaments, extremely restricting their amending choices; but, at the same time, the new EU derived fiscal and budgetary rules will serve as strong parameters for legislatures in the exercise of their scrutiny of governmental actions\textsuperscript{99}.

Also from the perspective of the exercise of the budgetary oversight function in times of economic crisis, the analysis offered some clear arguments in support for a reinforced intervention of Parliaments\textsuperscript{100}. In particular, some national Parliaments have recently shown a growing interest for the ex ante evaluation of the fiscal frameworks and budgetary scenarios, which anticipates


\textsuperscript{100} BOUHADANA, Les commissions des finances des assemblées parlementaires en France, cit., 272. An optimistic judgement on the capacity of national parliaments to develop scrutiny mechanisms at the current stage of the European integration has been formulated by AUEL and RAUNIO, Introduction: National Parliaments, Electorated and EU affairs, in AUEL and RAUNIO, National Parliaments, Electorates and EU affairs, cit., 7. Some doubts have instead been expressed by NEYER, What Role for national Parliaments? European Integration and the Prospects of Parliamentary Democracy, ivi, 30, who in particular observed how «most often national parliaments shy away from publicly scrutinising their government in European politics and are content to support them».

370
the drafting of the budget. In other terms, there's an increasing willingness of national legislatures to strengthen their role working at the same time on the ex ante and ex post scrutiny stage, therefore getting involved in the monitoring of macro-economic conditions, in the evaluation of economic forecasting and in the examination of governmental economic planning (and considering this functions as propaedeutic to the enforcement of the parliamentary scrutiny over budget execution).

This transformation, which the new procedure of the European Semester seems to encourage\textsuperscript{101}, will be deeply influenced by the creation of Fiscal councils - for those countries lacking such an institution - or by the adaptation to EU requirements of already existing fiscal agencies. If, generally speaking, those Parliaments capable of autonomously exercising an intense budgetary and financial scrutiny over their governments are more likely to develop a positive and constructive interaction with such independent institutions, the establishment of these bodies can be considered an opportunity for all national representative assemblies\textsuperscript{102}. In particular, the cooperation with Fiscal Councils can give legislatures the chance to gather autonomous budgetary data and in-

\textsuperscript{101} As evidenced by the HOUSE OF LORDS - European Union Committee, \textit{The future of economic governance in the EU}, 12\textsuperscript{th} Report of Session 2010-2011, vol. I, 24 March 2011, par. 169-170, «We believe that Member States will benefit greatly from the introduction of a European Semester»; in particular, «rather than downgrading the role of national parliaments we believe that a European perspective can only strengthen national parliament’s scrutiny of their national executives by providing more information».

\textsuperscript{102} If, as evidenced by NORTON, \textit{La nature du contrôle parlementaire}, in \textit{Pouvoirs}, no. 134, 3/2010, 6, the perception of a possible ‘decline’ of Parliaments conceals the multifunctional nature of legislative assemblies, then such multitasking parliamentary identity can take great advantage from the cooperation with the Fiscal Councils.
formation and to develop independent analytical capacities, which - as evidenced in § 5 - represents the real turning point for the implementation of an effective parliamentary oversight of budget.

Mainly due to these reasons, the new European economic governance seems to offer national Parliaments the opportunity to rethink their role and lead it to undiscovered boundaries. Of course, the novelty of such perspective requires a high capacity of innovation and, most probably, a renegotiation of the Parliament-Government relationship within each national policy.

The provisional results presented in the essay seem to find on the normative ground clear arguments in support. In the new European economic governance, in fact, the increased role of Courts (the ECJ and the Constitutional Courts, not anymore quoted in the final version of TSCG, but implicitly inserted in the game) in ensuring the respect of the limits posed by the EU law (legal scrutiny) as well as the strengthened position of the EU Commission and of the Fiscal councils in the exercise of the technical scrutiny of economic and budgetary standards advocate revised mechanisms capable of granting more effective political responsibility and accountability, which find in national Parliaments a privileged point of reference.

This approach finds its main justification first of all in the democratic principle, or more specifically in the need to coordinate parliamentary functions with the overall functioning of the form of government, considered in a multi-level perspective. Only the parliamentary involvement in the governance procedures, in fact, is able to guarantee that the implementation of the new European economic governance at national level keeps up with the general
evolution of the executive-legislative confidence circuit. The second reason for supporting the intervention of legislative assemblies in the coordination of economic policies can be found on the ‘good governance’ ground: as evidenced by part of the literature, in fact, the role of Parliaments in such highly technical circuits can improve the overall governance of the mechanism, enhancing greater transparency and accountability\textsuperscript{103}. Parliamentary oversight, in fact, tends to give real credibility to executive budget performances\textsuperscript{104}, due to the fact that the bipartisan style which usually characterises the scrutiny function guarantees an evaluation capable of being impartial, but not aseptic, unbiased, but not merely technical.

Of course, some preconditions could influence the ability of national Parliaments to fully exploit these new perspectives of intervention. In particular, two factors reveal themselves striking. The first of such factors is based on the attitude and orientation of political actors and manifests itself in the political commitment of the main parliamentary actors. The second factor is instead dependent on the role played by parliamentary bureaucracies in creating the necessary conditions for the implementation of the emerging parliamentary functions. The importance of these two factors is confirmed by the fact that opponents of the parliamentary involvement justify their position by arguing that Parliaments usually don’t have enough information or technical capacity to play


\textsuperscript{104} ANDERSON, The Value of a Nonpartisan, Independent, Objective Analytic Unit to the Legislative Role in Budget Preparation, cit., 131 ff.
an effective role in the economic governance\textsuperscript{105}. But the claim clearly does not constitute a good reason for excluding a priori that Parliaments are capable and willing to fill in these gaps in search of more accountability and responsibility in the overall functioning of the new economic governance.

\textsuperscript{105} KRAFCHIK and WEHNER, \textit{Legislatures and Budget Oversight: Best Practices}, cit.
SELECTED ASPECTS OF THE EUROPEAN

SOVEREIGN DEBT CRISIS

Michael Hanke*

ABSTRACT: The European sovereign debt crisis is diverse and complex in many respects. Selection of topics, analyses and recommendations often reflect the scientific background (in the sense of discipline) of authors, and a complete picture can only be gained from a synthesis of papers from multiple disciplines. This paper contributes to this discussion by providing thoughts on some important aspects of the crisis, including roots, symptoms, and proposed solutions, from a (financial) economics point of view, considering in particular adverse economic incentives caused by bad regulation together with socio-economic and political aspects arising from a widespread perception of “overly flexible” interpretation of the EU’s legal basis.


* M. Hanke is Professor of Finance at the Institute for Financial Services, University of Liechtenstein, Vaduz. The author is grateful to Martina Herberstein for helpful comments and suggestions.
1. In the first issue of this journal, Capriglione and Semeraro\(^1\) analyze a range of issues in the context of the current sovereign debt crisis. They describe the historical development of the single currency, discuss some aspects of the crisis in more detail (e.g., speculative attacks and the role of rating agencies), and before analyzing current attempts to solve the crisis, their consequences and associated legal aspects. Additional aspects at the intersection of law and economics, which are not the primary focus of their paper, are the major roots of the European sovereign debt crisis, among others, the fundamental flaws in the design of the monetary union and adverse incentives provided by financial regulation. Moreover, the feasibility of economic measures against the crisis rests on the extent to which people in Europe back these measures. Any increase in EU-scepticism puts this public backing at risk. These economic and political aspects of the European sovereign debt crisis will be the main topic of this paper.

2. The long history and the political aspects of the idea of European unity have been discussed extensively, both in scientific literature and in the economic press.\(^2\) The question which direction the future development of the EU should take remains hotly debated: Whereas some envision as the final result of the integration process the “United Stated of Europe” with a lot of power transferred

---


to the European Parliament and the Commission, this would be a nightmare for others who have a clear preference for preserving (or restoring) a strong role of the individual member states.³

An important factor in this regard is the ongoing debate regarding the degree of democracy within the EU.⁴ Political representation in proportionality to the population (“one vote per European voter”) applies only to the European Parliament, which shares the legislative power with the Council of the European Union. The latter follows the principle “one vote per member state”, leading to an over-representation of small member states with respect to their population. This reflects the reluctance on the part of many Europeans to transfer “too much” competences from national to European institutions. Put differently, it can be viewed as an indication of many people in Europe still feeling (primarily) as citizens of their respective member state, much more so rather than as Europeans.⁵ This lack of identification with some important aspects of the idea of European unity (at least of the variant leaning towards the “United States of Europe”) is an important aspect of the current sovereign debt crisis in Europe. Many EU-sceptics also sense attempts at further integration to be a project of a (political) elite without broad support from European voters. This view is sup-

⁴ This has been a topic since the early days of the EU, see, inter alia, ANDERSEN and ELIASSEN, The European Union: How Democratic Is It?, SAGE Publications, 1996.
⁵ This question has also been addressed by the EU itself, see EUROPEAN COMMUNITIES, How Europeans see themselves, European Commission Press and Communication Service, 2001.
ported by inconsiderate but unmasking quotations by politicians, like the following (all by Jean-Claude Juncker):⁶

“Of course there will be transfers of sovereignty. But would I be intelligent to draw the attention of public opinion to this fact?” (on the Lisbon Treaty)

“If it’s a Yes, we will say ‘on we go’, and if it’s a No we will say ‘we continue’.” (on the French referendum on the Lisbon Treaty)

“When it becomes serious, you have to lie.”

“We decide on something, float the idea and wait a while to see if anything happens. If there is no public outcry and no uprisings (because most people do not even understand what has been decided), then we continue - step by step, until there is no turning back.”

These quotes unveil an unpleasant attitude towards voters and a lack of respect for democratic processes. It is this wedge between people and their (supposed) representatives that adds to EU-scepticism⁷, in particular in those countries who are net payers within the EU. It is myopic in that it might have speeded up political integration and extension of the EU for some years, but seems to backfire now through decreasing identification with the EU and the single currency. The lack of support of measures against the crisis, in particular


⁷ See MORRIS, European leaders must be wary of rising Eurosceptic populism from both the right and the left, in LSE EUROPP blog, March 26, 2012, http://blogs.lse.ac.uk/europppblog/2012/03/26/eurosceptic-populis/
those that are viewed as transferring more power from the member states to
the EU, is at least partly rooted in this myopic policy.

3. History has shown time and again that politicians trying to ignore eco-

nomic realities are asking for trouble. It was clear from the outset that the
Monetary Union was a major real-life experiment,8 regardless of its exact shape
and structure. The economic theory of optimal currency areas9 clearly states
that excessive heterogeneity (in economic conditions) is incompatible with a
single currency unless the countries sharing the common currency harmonize
their fiscal policy and/or agree on transfer payments from richer to poorer re-

gions.10 The size of these transfer payments is then a function of the degree of
heterogeneity.

Accepting Greece into the Monetary Union was a prime example for poli-

tics trying to “force” economics: Greece was accepted even though it did not
meet the criteria for entry at any point in time, let alone over an extended time
period.11 The acceptance decision was purely politically motivated, and the rules

8 See, inter alia, the description of JONES, The Politics of Economic and Monetary Union, Row-

man and Littlefield, 2002, which contains the sentence, “The formation of an economic and
monetary union among twelve of Europe’s leading economies is the most exciting experiment
in modern political economics.”

9 For a classical treatment, see MUNDELL, A Theory of Optimum Currency Areas, American
Economic Association, 1961. Revisiting this classical treatment and adding a modern perspec-
tive: BLEJER et al. (eds.), Optimum Currency Areas – New Analytical and Policy Developments,
International Monetary Fund, 1997.

10 This point will be taken up again later in 8.

11 See, inter alia, LYNN, Bust: Greece, the Euro and the Sovereign Debt Crisis, Bloomberg (UK),
2010, in particular Chapter 2, which is entitled, “How to Blag Your Way Into a Single Currency”.

379
were bent to accommodate this political will (or will of politicians). This was not the first time treaties or decisions were “interpreted liberally” in the EU when this was in the interest of influential parties, and many more instances of that followed both before and during the financial crisis. We will not discuss in any detail here the legal questions surrounding the role of the ECB. In fact, it is comparatively unimportant whether sophisticated interpretation methods lead to the conclusion that ECB measures like open market purchases of member states’ bonds do not violate articles 123 and/or 125 of the EU Treaty when this reasoning is only understood by European Law experts: In many countries that held referendums on the Maastricht Treaty, politicians had emphasized that transfer payments from richer countries to poorer countries as well as direct access to central bank funding for indebted member states were completely out of the question. For many voters in these countries (particularly in net contributor states), these promises were decisive for their approval. Legal or not, the massive aid packages are viewed by many as clear breaches of these promises. This leads to a loss in trust by voters, which in turn results in increased EU-scepticism, linking back to the discussion above in 2.

4. A number of adverse incentives provided by financial regulation contributed to the sovereign debt crisis. First, in the standardized approach of the Basel II framework, banks were allowed to treat sovereign debt of OECD member countries as risk-free, even if rating agencies and the markets clearly

---

signalled that they carried a high amount of risk. This is an example of politically motivated regulation, which is at odds with economic realities: from a political point of view, treating sovereign debt of member states differently due to differences in credit risk would have raised many questions and triggered unpleasant discussions. In the first years of the euro, this did not create any problems: Although financial markets did factor differences in credit risk into prices of sovereign bonds, no member state was viewed by financial markets as being of a high-risk nature.

This meant that yield spreads between member states’ bonds were comparatively small. This changed during the crisis, when markets viewed some member states as representing a significantly higher credit risk than others, resulting in widening spreads. For banks with a sufficiently high risk appetite, this biased their incentives from lending to, e.g., local businesses towards lending to governments, even when the latter business was riskier: Corporate loans required (depending on credit quality, sometimes substantial) equity to support the associated risk, but sovereign bonds did not. Hence, after accounting for the cost of equity capital, Basel II resulted in distorted risk-return ratios between corporate and sovereign debt, favouring the latter.

This artificially kept up demand for sovereign debt relative to corporate debt and thus effectively delayed the outbreak of the crisis. Moreover, this crowding-out effect contributed to the credit crunch observed in the real economies of many member states.
Second, for a long time into the crisis, the ECB accepted bonds of EMU member states as collateral.\textsuperscript{13}

Again, this implicit subsidy of sovereign debt of riskier borrowing states within the EU was purely politically motivated: In 2010, no private institution would have accepted Greek bonds at roughly the same conditions as German bonds, which is exactly what the ECB did.\textsuperscript{14} For banks, this created incentives, which were clearly undesirable: At a time when the ECB flooded the markets with cheap money at historically low interest rates, banks could use the funds to buy Greek bonds with double-digit expected returns, which were then accepted by the ECB as collateral.

Again, this artificially kept up demand for bonds of troubled member states and thus delayed the reflection of existing information in market prices of these securities. Is is reasonable to assume that the earlier the full extent of the problems had become visible, the better the losses and the crisis itself could have been contained.

5. Monetary policy is an important part of most countries’ economic policy toolbox: Control over the inflation rate as well as the external value of the currency provide important steering opportunities for an economy. Exceptions include three groups of countries: (i) countries that peg their currency voluntari-


\textsuperscript{14} Before 2011, the haircut for BBB securities was 5 percentage points higher than for better-rated securities. The ECB introduced graduated valuation haircuts effective from January 1, 2011. http://www.ecb.int/press/pr/date/2010/html/pr100408_1.en.html
ly to some other currency, (ii) countries that make another country’s currency their own official currency, and (iii) countries within a monetary union, which agreed to share a common currency.

Countries in the first group at least retain discretion over occasional de- or revaluations: If economic fundamentals get out of line with the exchange rate peg, the exchange rate can be revised. Countries in the second group have no control whatsoever on the money supply or interest rates, they simply have to live with the respective decisions made in the country whose currency they share.

This model is only viable for countries with very similar economic conditions. An example where this model works well is Liechtenstein, whose currency is the Swiss franc. The difference to a monetary union is that countries in the second group have no say with respect to the monetary policy of the country whose currency they adopted. Within a monetary union like the Eurozone, member countries can use the political mechanisms to influence decisions affecting inflation and exchange rate, although their influence is typically much smaller than if they were in full control.

Significant economic disparities between member states of a monetary union present a problem for monetary policy: When some economies would need a hard currency (low inflation, stable to strong external value) while others would do better with a soft currency (moderate inflation, continuous devaluation against major reference currencies), monetary policy cannot accommodate all member states’ needs to the same extent. In such a situation, there are basically two alternatives: Either lay down a particular monetary policy in the
constitutional treaty of the monetary union, or leave the decisions to the political process and the voting behaviour of the member states.

The Eurozone opted for the first alternative, implemented through the ECB’s clear focus on inflation, with a target just below two percent. Here, again, the trustworthiness of the EU itself is at stake: while, e.g., Germany would never have agreed to anything but a hard euro, it was clear from the outset that many Mediterranean countries would find it difficult to cope with this monetary policy.

Now, in times of the crisis, many member states favour an increase in inflation.15 While understandable from their viewpoint, this is exactly the opposite of what had been agreed upon, which has the potential to alienate people in traditional hard-currency member states, again linking back to the discussion above in 2.

Pressure is mounting on Germany, because the “inflation solution” to sovereign debt (i.e., devaluing existing debt by higher inflation targets) seems to be a viable alternative for many member states.16

The problem itself will persist as long as the economies in the member states (in particular competitiveness on the world market) remain different: You simply cannot have one currency with two different monetary policies.

15 See TILFORD, Eurozone crisis: Higher inflation is part of the answer, Centre for European Reform, October 3, 2011, http://centreforeuropeanreform.blogspot.com/2011/10/eurozone‐crisis‐higher‐inflation‐is.html
16 See TILFORD, Germany’s choice: Higher inflation or sovereign defaults, Centre for European Reform, May 9, 2012, http://centreforeuropeanreform.blogspot.com/2012/05/germanys‐choice‐higher‐inflation‐or.html
One possible solution to this could be to invent a second currency with a monetary policy tailored to the needs of the southern European countries. This “two-tier euro” has been proposed by a number of economists\(^\text{17}\) and is regarded as one possible future path for the Eurozone.

A major disadvantage of this suggestion is that it would mean a step back in the common European market. When implemented wisely, however, its positive effects on these member states’ economies might well outweigh this drawback. Moreover, it could be seen as the logical consequence if plans for a “two-tier Europe” materialize.\(^\text{18}\)

6. An aspect of the crisis that went unnoticed for quite some time is the dramatic increase in TARGET2 balances. The TARGET2 system is the real-time gross settlement system of the Eurozone.

Put simply, when funds are transferred across member states’ borders, the receiving country’s central bank books a claim on the ECB, while the central bank of the payers’ country books a liability.

During the financial crisis, balances massively increased: Germany’s total claims from this system now amount to more than 750 billion euros.\(^\text{19}\) While


\(^{19}\) See inter alia ABAD et al., Fiscal Divergence, Current Account and TARGET2 Imbalances in the EMU, University of Leipzig Working Paper No. 105, March 26, 2012,
these numbers do not mean a whole lot while the euro system is up and running, some observers started a discussion on what would happen to these claims in case of a breakup of the Eurozone.\textsuperscript{20}

If, in this case, recovery of these claims cannot be taken for granted, this mechanism serves to “lock” Germany into the Eurozone.

In fact, Germany’s economic strength and competitiveness, leading to (in expectation) even further increases in its TARGET2 claims in the future, make it increasingly difficult for the country to leave the monetary union, even if other countries manage to effectively alter the ECB policy towards higher inflation. In the worst case, Germany would be left with the debts incurred by importers in other countries paying for German exports: Paradoxically, Germany would then end up paying for the goods and services that went to companies and consumers in countries with negative TARGET2 balances.

In the US, the Federal Reserve System also consists of multiple central banks, potentially leading to the same problems. The Fed’s analogue to the European TARGET2 system, however, prevents the amassing of huge balances through periodic settling of balances between individual central banks.\textsuperscript{21}


7. One important aspect of the Greek situation is the connection between joining the Eurozone (with its “hard euro” policy) and the increase in Greek debt: Whereas in pre-euro times, gradual devaluations of the drachma cushioned the Greek productivity gap, this flexibility was given up when adopting the euro.

Given that sudden increases in productivity are not feasible, the alternatives were to either consume less or finance consumption via increased public debt. History has shown that the latter path was chosen.

Given the current massive problems in Greece, ranging from recession to social unrest, and recognizing that most of the problems are structural rather than temporary; one possible solution that has been put forward in the public debate is Greece voluntarily leaving the Eurozone, coupled with debt repudiation (sovereign default). 22

Optimality of sovereign default has been studied in the literature, and the criteria to weigh against each other to judge when the time is right for this step are (in principle) well understood, although not always easy to quantify exactly. Sovereign defaults occurred time and again in history, and the consequences are quite clear: loss in reputation, lost access to (international) capital markets for quite some time after the default, to name just a few.

On the upside, the debt burden is removed from the country, and in the case of leaving the euro, there is the additional benefit of regained (full) control over monetary policy.

The (occasionally heard) argument against a Grexit is that leaving the monetary union is simply not an option according to the treaties. In the light of all the breaches of treaties and “creative interpretations” mentioned above that happened in recent years, this cannot be taken too seriously: if Greece really wants to leave, we can trust the other member states to find a way.

8. One alternative to Greece leaving the Eurozone would be massive transfer payments from the other countries to the Peloponnese, presumably for decades. “Why not?”, some observers ask, “Given that we all are Europeans, why shouldn’t we help our family members who are in trouble?” Given that the current structure of the EU is quite different from that of the USA, this would be a dangerous strategy in many regards. First of all, it would put into question any incentives for other financially troubled member states to get their budgets in order, as the clear signal would be provided that funds come if needed. Second, it is hard to believe that people in net contributor member states would accept quasi-permanent transfer payments. The German reunion can be taken as a prime example for that: Even now, more than twenty years later, the “East” still requires transfer payments, funded by a special tax called “solidarity surcharge”. This surcharge is (and always has been) hotly debated, and many people in the “West” are fundamentally opposed to it. However, let us not for-

get that after German reunification, it was about Germans helping Germans, and even in this case of “close family in trouble” coupled with the historical moment of reunification and the end of communist oppression, many of those who have to foot the bill would like to stop their payments today rather than tomorrow, and took the matter to court. Add to this common prejudices regarding work and tax morale, fuelled by politicians on election campaigns, and any hopes for a majority of German voters supporting permanent and significant transfer payments to Greece (or, for that matter, to any other member state) might well turn out to be unjustified.

9. One major argument put forward by those who support keeping Greece in the monetary union “at all costs” is the risk of contagion: If one member state leaves, speculation could be spurred against other financially troubled member states, and this speculative activity could actually cause an escalation of their debt problems to a point where they face themselves in a situation similar to that of Greece in 2012. Although these fears do not appear unjustified in light of the speculative attacks seen during the financial crisis, Greece is a very special case in many respects. No other member state was so far away from the

---

24 Similar to US citizens helping US citizens when funds are transferred from Minnesota to Mississippi.
convergence criteria when entering the Eurozone, and no other member state has structural problems that are anywhere close to those of Greece. Widespread corruption, an inefficient tax system, a massive brain drain, and a huge gap in productivity compared to the EU render any hope for a short- to medium-term recovery of Greece as fatuous. The other countries named as potential speculative targets after a Grexit, like Portugal or Spain, only share a few of the Greek problems, and to a lesser extent. It should be possible to convey (with sufficient credibility) the message to financial markets that those member states would be supported, in particular if Greece leaves voluntarily (and a forced Grexit seems to be out of the question).

10. At the time of writing this paper (in late 2012), the European sovereign debt crisis is still there, and the focus still seems to be on temporary measures rather than any attempts at long-term solution. From our discussion above, we conclude that any viable long-term political solution has to fulfil the following criteria: First, it must be compatible with economic realities, which can be ignored for some time, but not in the long run. Second, it needs the backing of a majority of Europeans, also from net contributor member states. Third, financial

---

30 Although Greeks work longer hours than most other Europeans, the resulting GDP lags behind, see OECD statistics found at http://stats.oecd.org/Index.aspx?DatasetCode=LEVEL.
regulation should be incentive compatible, i.e., it should not lead to undesirable behaviour, which may saw the seeds for further crises. Fourth, any viable solution has to provide financially troubled member states with a realistic perspective to get their problems solved in the long term, not just provide short-term patches. Last, but not least, it has to deal with the risk of contagion to member states that might serve as new targets of speculation once attention shifts away from Greece.
THE DIFFICULT JOURNEY TOWARDS EUROPEAN
POLITICAL UNION: GERMANY'S STRATEGIC ROLE

Ulrike Haider - Valerio Lemma*

ABSTRACT: This paper analyzes the remedial actions adopted in Europe, focusing on Germany’s strategic role and its nationalistic resistances. In this context, common economic governance and mutual financial assistance realize an organization that provides direct advantages only to some of the Member States (i.e. the ones that have safe balances). This condition is possible because there are different needs - of legal reforms and financial aids - in the Euro countries. Clearly, this scenario is different from how in the beginning has been ascertained the need of a common space of peace and economic integration by the six states that founded the EU’s predecessor. This analysis shows that institutional answers given by new Treaties (on the Fiscal compact and on the European mechanism of stability) seem to be not adequate to deal with the systemic crisis, also because of the lack of a path for reforms of the (national, European or global) democratic public organization. We reach the same conclusion by investigating Germany’s legal framework. Moreover, the situation of impasse of the European Stability Mechanism – or, said in another terms, the reluctance to ask for its action

* Ulrike Haider is researcher of Constitutional Law at Università degli Studi Guglielmo Marconi, Rome, Italy; Valerio Lemma is full researcher of Economic Regulation at Università degli Studi Guglielmo Marconi, Rome, Italy. Although this paper is the result of a joint reflection of the Authors, which wrote together the preamble and the conclusions, Ulrike Haider wrote the paragraphs 3, 6 e 7 and Valerio Lemma wrote the paragraphs 2, 4, 5, 8 e 9.
by the countries that are in difficulties (as they are intimidated by the conditionality that the German Federal Republic could impose while using its whole predominant weight that has been recognized by the Treaties) – complicates the task of the European Central Bank, that is the only supranational institution able to disturb speculators’ plan through a decision making process that – how it happens on 6th September 2012 – can disregard the approval of Germany. In conclusion, it remains the necessity to define new development trends of the European legal system, which currently is hard-fought between the methodological austerity of the public finance (as framed since the Maastricht Treaty) and the auspices of a subsidiarian solidarism of the EU institutions (promoted by Mediterranean instances).

«Germany is an open and integrated economy, so it is not surprising that a slowdown in the rest of the euro area has an impact here ... it is less often noted how problems in the wider euro area affect the financial situation in Germany ... Financial developments in Germany are the mirror-image of financial developments in the rest of the euro area ... the stability of the euro area as a whole will also be to the benefit of Germany».

Mario Draghi, November 7th, 2012

1. In Europe, the German Federal Republic has until now been spared the financial woes that have befallen the Economic and Monetary Union. However, the latest figures suggest that the crisis is beginning to spread to Germany too, given the fact that it is an open and integrated economy, which cannot avoid the overall slowdown within the Eurozone.

The President of the ECB said as much in a recent speech, specifying that the weakness of the Euro results in very low interest rates, which in turn fall even lower in Germany due to incoming safe-haven flows of capital.¹

Current financial flows exploit the interconnectedness that comes with freedom of movement (of capital), highlighting certain effects of Europeaniza-

¹ See Speech by Mario Draghi, President of the ECB, at Wirtschaftstag 2012 «Kapitalismus in der Krise? Die Zukunft der Marktwirtschaft» der Volksbanken Raiffeisenbanken organised by Genossenschaftsverband e.V., Frankfurt am Main, November 7 2012.
tion on financial markets and affecting Germany’s ability to guarantee employment stability and allocate EU investments.

In wider terms, it is also worth considering the shortcomings of “mature capitalism”, characterised by global trade, financial wealth, the proliferation of public and private decision-making bodies, and the lack of any adequate forms of government able to guarantee the economic and financial balance of the European area. As a result, the implementation of development programmes depends on conquering the hegemony of the markets, (whose speculative bubbles are exacerbating the current crisis), and on interrupting the recession triggered by economic and financial instability, in order to invert the economic cycle and restore conditions for sustainable, intelligent and inclusive growth.

Clearly, any appropriate solutions to the aforementioned issues need to take on board market design and experimental economics. These analytical models, as indicated in the latest studies in international economic law, allow for a methodological approach, which identifies aspects that were not adequately controlled and free market failings not duly regulated, with particular regard to the subsequent negative «domino effect» that characterizes any systemic crisis.\(^2\)

\(^2\) See the work of prof. Alvin E. Roth, which said «banks’ increased exposure to the securities markets would make them less able to serve as a source of credit in a crisis», highlighting that «markets aren’t either free or non-existent. A better description is that markets have rules, and some rules work better than others, and the goal of regulators and others who shape the rules should be to find rules that enable markets to work better»; see The credit crisis and market design, January 3, 2009. See also Financial market design: the view from the Fed, March 10, 2009; Design of financial clearinghouses: Over the counter derivatives markets, May
In order to provide a complete picture of the financial turbulence’s outcomes that first struck Europe at the end of 2007, it is of paramount importance to also understand Germany’s involvement. An EU leader in terms of the strength of its productive economy and its social and political clout as enshrined in the European Treaties, Germany cooperated at an international level to reduce the negative effects of a crisis which, until now, it had seemingly managed to avoid.

An attentive assessment of Germany’s stance not only allows us to grasp the strength and scope of its neo-liberal policies (espoused by Germany in the period immediately preceding the crisis). It also provides answers to questions raised in terms of its quasi-neutral monetary choices, particularly regarding the raft of vetoes and bans Germany imposed in response to measures seeking greater solidarity rather than mere economic opportunism. Undeniably, this lack of openness towards struggling EU member states, an approach often noted over the past two years, has been damaging to Germany’s overall image. After all, this was a country that had played a guiding role in bringing together the populations of Europe in ways even more advanced than those we see today.

2. Given the scenario previously described, there emerges a situation whereby the socio-economic reasons for the difficulties faced by the worst-

---

28, 2010; Bernanke on economic engineering, September 26, 2010, all published in marketdesigner.blogspot.it

The abovementioned papers reflect the general theory of stable allocation and the practice of market design, see ROTH, The Shapey Value, Cambridge, 1988, p. 31 seq.
affected countries are tied to their recent history. More specifically, other shortcomings in the political leadership of these countries can be identified, because these have limited the development potential of their internal markets. ³

As for the particular difficulties affecting Mediterranean countries, these seem to be connected to an inherent inability to combine strict public finance measures (such as spending review and welfare system restructuring) with efficient institutions. ⁴ Greece, Spain and Portugal – all democracies that emerged after the dissolution of authoritarian regimes⁵ – found themselves involved in a

⁴ See European Economic Forecast - autumn 2009, by DG ECFIN on behalf of the European Commission, where it is stated that «Once the underlying recovery has gained sufficient traction, i.e. in 2011, a period of fiscal consolidation will have to follow to put public debt back on a sustainable footing» (p. ix).
⁵ In 1981, Greece becomes the 10th member of the EU, Spain and Portugal follow five years later; see CHILCOTE - HADJIYANNIS - NATAF, Transitions from Dictatorship to Democracy: Comparative Studies of Spain, Portugal, and Greece, London, 1990, passim; DEL Pero - GUIRAO - VARSORI, Democrazie. L’Europa meridionale e la fine delle dittature, Milano, 2010, passim.
European integration process that exceeded their effective merits and capacities. This process was driven by the political aims of other European partners, who undoubtedly did not dwell on whether it was economically sustainable for these countries to join the single currency.

The public administration in these countries was not always organised in line with principles of cost-effectiveness and efficiency. Rather, it aimed to use the welfare state to overcome internal rifts, reduce the risk of a civil war and thus to avoid the dissolution of the state itself. Hence, the costly nature of state apparatus and the high levels of public debt (supported by international resources which flowed into Mediterranean countries through various means). ⁶

The result was a lack of competitiveness compared to the more developed economies of Central Europe, such as that of Germany. ⁷

This situation did not improve with the introduction of the single currency, which put an end to the practice of intervention tools such as competitive devaluation, used in the past to manage the negative repercussions deriving from the different production capacity of various systems and their diverse degrees

---

See also DIAMOND, Developing Democracy: Toward Consolidation, Baltimore, 1999, p. 174 seq. where it is written that «Spain, Greece and Portugal were not only the first third-wave democracy but also the first to become consolidat». ⁶


of business development. There ensued regrettable cases of poor management (suffice it to think of Greece) and of capital being drained toward countries

8 There are noteworthy studies on competitive differences in Europe; see BERGS, *EU Regional and Cohesion Policy and Economic Integration of the Accession Countries*, speech given at Regional Transitions: European Regions and the Challenges of Development, Integration and Enlargement, convened by the Regional Studies Association at the Faculty of Economics, University of Gdansk, 15-18 September 2001, in *Policy Research & Consultancy Discussion Paper*, Bad Soden/Taunus, 2001, p. 8


9 This is the assessment of recent events in Greece according to CAPRIGLIONE - SEMERARO, *Crisi finanziaria e dei debiti sovrani*, Turin, 2012, p. 33 seq.
considered safer in terms of investment remuneration (which inevitably wors-
ened the situation at national level). 10

Furthermore, the default of certain member states meant that the EU had
to reassess its own choice of market design, introducing new equalization tools
to ensure a fair distribution of resources. It was also in this vein that a «Europe-
an Stability Mechanism» was established, with its own resources to inject in the
public finances of countries unable to access market financing.

In this context, the different historical and economic characteristics of
Member States that are in the Economic and Monetary Union (EMU) - and the
difficulties in policy coordination and intergovernmental cooperation that they
entail - take on particular importance.

There is a shared desire - at European regional level - to launch a process
of intelligent, sustainable and inclusive growth, but it slows because of a context
in which existing tensions between countries that have borne the brunt of the
crisis and those that have emerged relatively unscathed.

It is clear that the economic differences among these countries can be
measured. 11 It is equally clear that, from a legal standpoint, the countries cur-

10 See JANK - WEDOW, Sturm und Drang in Money Market Funds: When Money Market Funds
Cease to Be Narrow, in Deutsche Bundesbank Discussion Paper, 1999, p. 15 seq. on the «re-
turns and flows of German money market funds before and during the liquidity crisis of
2007/2008»; see also KAUL - SAPP, Y2K Fears and Safe Haven Trading of the U.S. Dollar, in Jour-
nal of International Money and Finance, 2005, p. 10 seq. on the «the impact of safe haven
flows on market liquidity by examining the bid-ask spread in the Euro-U.S. dollar spot and for-
ward markets around Y2K».

11 See BLOMMESTEIN - EIFFINGER - QIAN, Animal Spirits in the Euro Area Sovereign CDS Market, in
CEPR Discussion Paper No. DP9092, London, 2012, for a study of «determinants for the sover-
rently most afflicted had not put in place the necessary safeguards to protect themselves against the harmful effects of the crisis in the eventuality that their flawed political systems were unable to address the shortcomings and difficulties previously identified.

This explains why such countries were not able to seize the positive economic opportunities offered by various forms of international cooperation, both through informal summits (G7, G8 and G20 at a global level, bilateral meetings and the Euro Summit at regional level), and through independent initiatives launched by financial institutions (ECB and IMF).

The continuation of the crisis has shown the need for European member states to formally undertake (i.e. through binding agreements) to pursue common economic and financial recovery policies to complement the ECB’s adoption of non-standard measures. Naturally, such intervention imposed a behavioural change on countries undergoing difficulties. They were obliged to operate in line with principles of austerity, the only way to guarantee the sustainability of their public finance and domestic policy.

For this reason, European and international institutions chose to fully adhere to the principle of conditionality, whereby financial assistance depends on the adoption of specific economic austerity policies (as the necessary means to complete the economic integration).12

---

12 Aside from the gains resulting from the coordination of policies to combat the crisis, it is clear that the main benefits are connected to the shift from “inadequate national policies” to “optimal non cooperative policies”, as adopted in a stable international market; see FOREMAN-
Austerity and sustainability have become the pillars underpinning EU policy in the promotion of its values, the principle of peace, and the creation of “an ever closer union among the peoples of Europe” (Preamble of the Treaty of Lisbon).

From a political standpoint, the two new treaties adopted modify certain aspects of the European market. The contracting parties undertake to pursue financial stability, coordinate economic policy and improve Eurozone governance (Treaty on Stability, Coordination and Governance, signed 2 March 2012), as well as to provide mutual assistance through an international financial institution entitled the European Stability Mechanism (ESM Treaty, signed 11 July 2011).13

From an implementation standpoint, the strategic management and establishment of the relevant operational structures can be handed over to highly skilled technical bodies, whose mandate is to strengthen the economic pillar of the Economic and Monetary Union (Article 1 of SCG Treaty), and to support the rescue and recovery of countries experiencing severe financing problems (Articles 1 and 3 of ESM Treaty).


However, it is apparent that for the moment the new Millennium has not yet been able to guarantee adequate conditions of stability. These conditions can only be guaranteed through the convergence of interests in finding a solution to the systemic crisis affecting the global economy; see DRAGHI, Rationale and principles for Financial Union, speech at the 22nd Frankfurt European Banking Congress, Frankfurt am Main, 23 November 2012.

Consequently, national economic policy ties in more closely with the integration and development processes of the Eurozone as a whole.

The tools and structures established should ensure the stability of diverse national systems, thanks also to the introduction of specific rules to promote economic growth (such as the balanced budget rule and the automatic mechanism to take corrective action).  

3. Due to the extreme heterogeneity of the economic conditions in the single European countries it is possible to speak of a Europe of two “speeds”.

In this structural condition, the legal mechanism that allows the participation of Germany in the EMU is of particular interest, as we will see there is mechanism that the Federal Republic was able to keep its particular virtuous fiscal capacity that protects this country from “contagion” risks of the financial crisis of the European Union.

Analyzing the legal correlations of the participation of Germany to the Eurozone there can be asserted that the German legal system can be defined - compared to other countries that attend the European legal and economic space - as an “opened” system; this definition is possible even if the doctrine generally describes the correlations between the German and the European le-

---

14 See Preamble to Treaty on stability, coordination and governance in the economic and monetary union.

gal systems as a multilevel system within which the responsibility for the European integration is distributed between several national and European institutions.

The fundamental principle that characterizes the attitude of Germany vis-à-vis the legal system and the economic policies of the Eurozone arises from the preamble of the Grundgesetz (GG) that states that purpose of the German people is to maintain unity and liberty and to contribute as an equal partner to the perpetuation of the peace within the united Europe.

To this objective expressed in the preamble applies since 1992 the “article for Europe” (art. 23 GG) that provides explicitly for the constitutional limits to the European integration, as well as for some prescriptions in order to make compatible the German constitutional law with the participation in the EU (that since the Maastricht Treaty expanded further on more and more extensive sectors of European economic politics and administration). For this reason, the


17 See KIRCHHOF, Festschrift Herzog, 2009, p. 155 seq.

18 Inserted by the law modifying the GG from 21 December 1992 (BGBl. I S. 2086).

19 The constitutional objective to participate under the condition of liberty and unity to the EU originally has been implemented by the art. 24 GG that provides the possibility to confer – without amendment to the Constitution - sovereign rights – to supranational entities, including the European economic Communities.
purpose of art. 23 GG is to guarantee the integrity of the German legal and constitutional system, as well as the effective disposal of the State on the social and economic developments\textsuperscript{20}.

In this perspective can be explained the competence to consign for the reason of integration sovereign power to the EU institutions; this competence is subject to precise constitutional limits, that is the origin of the idea of the intrinsic and national limits of the supranational powers and of their creation ex novo. Indeed, pursuant to paragraph 1, second phrase of Art. 23 GG, the German Federation is authorized to consign (in the form of a legal act) sovereign powers to supranational institutions only with a previous approbation on the part of the Bundesrat\textsuperscript{21}. In the case that the constitution or an amendment of

\begin{footnotesize}
\begin{itemize}
  \item Indeed, for a long period there prevailed the conviction that the European Comunities constitute the most concrete ad constitutionally significant case of application of the present article. See the ruling BVerfGE 58, 1 e 59, 63 – Eurocontrol. Art. 24, 1° para. GG recognizes a broad margin to the ordinary legislator, that is limited only by the basic constitutional principles, that are detracted form amendments in virtue of art. 79, 3° para. GG as there is no definition of “interstate entity” and the volume of the “consignment of sovereign powers”. With the Maastricht Treaty there have been coming up doubts in the doctrine and on the level of jurisprudence if the law of ratification of the Treaty on the European Union comply with the limits provided for the power for the integration in virtue of art. 24, 1 para. GG.
  \item These limits now are provided by art. 23 GG. See DIETER DEISEROTH, Art. 24 GG, in Grundgesetz Mitarbeiterkommentar, Art. 1 – 37, vol. 1, Heidelberg, 2002, p. 1459; SCHOLZ, Grundgesetz und Europäische Einigung, in Neue Juristische Wochenschrift, 1992, p. 2593.
  \item In Germany, anyway, there is still a discussion on the quorum – simple or qualified majority - for the adoption of a law that provides for the consignment of competences on the EU institutions. See SCHWEITZER, Staatsrecht III, Staatsrecht, Völkerrecht, Europarecht, Heidelberg, 2010,
\end{itemize}
\end{footnotesize}
one of the EU Treaties implicates an amendment of the GG, art. 23, paragraph 3 
GG relegates to art. 79, that provides for a voting of the Parliament with a quali-
fied majority.

Furthermore, a specific competence to consign powers is provided by art. 
88 second paragraph GG that legitimates the constitution and participation of 
Germany within the European Central Bank (ECB) that is considered to consti-
tute the central element of the monetary Union. The condition for the 
consignment of competencies of the federal bank to the ECB is that the ECB 
pursuing among its principle objectives the price stability. Nevertheless there 
are no specific form requirements foreseen for the consignment of powers to 
the ECB. The provision of art. 88 GG has been the legal basis for the accession 
of the German Federal Republic to the European monetary Union and for the 
launching of the “single currency”, introduced by several ordinary legal acts.

22 Anyway, the article seems to be of little importance as the accession to the economic and monetary Union that has been created with the Maastricht Treaty was baes of art. 23 1° para in conjunction with art. 50 2° para HH. See SCHWEITZER, Staatsrecht III: Staatsrecht, Völkerrecht, Europarecht, Heidelberg, 2010, p. 28.

23 See BVerfGE 89, p. 155 seq., 201 seq.

24 "Gesetze zur Einführung des Euro". Le prime due leggi per l’introduzione dell’Euro sono en-
trate in vigore già all’avvio dell’Unione monetaria il 1° gennaio 1999: La "Gesetz zur Einführung des Euro" del 9 giugno 1998 è la prima legge per l’introduzione dell’Euro e disciplina le modifi-
che delle disposizioni societarie, sostituisce il tasso Diskont- durch den Basiszinssatz e contiene norme per la protezione delle monete dell’Euro (BGBl. 1998, I, p. 1242 seq.). La "Gesetz zur Öffnung der Sozial- und Steuerverwaltung für den Euro" del 24 marzo 1999 costituisce ist la seconda legge per l’introduzione dell’Euro. Tale legge crea un quadro giuridico sicuro per le imprese e per gli enti della prevvidenza sociale. (BGBl. 1999, I, p. 385 ff.). L’introduzione effett-
tiva della moneta unica è stata realizzata dalla terza legge sull’introduzione dell’Euro, la
4. After this review of the German legal framework there come up several questions related to the correlation of the legal system and the economic policies of these countries that retrieved strength and lustiness from the financial turbulences. For this reason the German and the Central European experiences seem of particular interest and they should be analyzed in this article with an interdisciplinary method and without of any form of separation between public action (on the part of the State) and private behaviour (of the market), in order to get to an unitary vision of the implications of the systemic crisis on the perspective to get to a common system of government of the whole European legal space.

As it has been observed, in the UE there has been realized a combination of liberalization (of the trade), globalization (of the markets) and financialization (of the economy) that was followed by a substantial limitation to the sovereign powers of the national States. From this standpoint, the creation of a common legal space - that is able to cover all the fields of the financial and economic operations - and consequently the possibility to reach to an union of general interests - as it had been reached, in an informal way and limited to the executive powers by G20 and the Euro Summit - seem to be still far away.25


25 See DUSSELBLOEM, Policy Priorities Eurogroup Presidency, 20 January 2013, where it is stated that «The Eurogroup will play an important role in this process as the main political decision making body» and that «Our economic and monetary union has been continuously evolving
If we pass, in particular, to reflect on the perspective of an involvement of Germany in the construction of a political Union, there must be stated that this seems to be not dissimilar from what is written in the preamble of the «Grundgesetz». Indeed, in the mentioned basic law of 1949, the German people declared himself as «inspired by the determination to promote world peace as an equal partner in a united Europe (vereinten Europa)» (Präambel). But it seems that the objective construction of German legal framework has not been recognized to European populations an analogous centrality those awarded by its Grundgesetz to the German people (see articles 20 and 23).

On the configuration of this problem, the jurisprudential interpretation – made by the German Constitutional Tribunal - exerts a dominant influence. Distinguishing between Europäische Union (realized by the European Treaties) and vereinten Europa (figured by the German basic law), it inclines to define the European construction in a reductive manner, just as a simple «legal community» (Rechtsgemeinschaft), whose power derives form the original sovereignty from the member States.\(^2^6\) This assumption - together with the lack of common posi-

\(^{26}\) See, in general, German Federal Constitutional Court, judgment of October 12, 1993, in Giurisprudenza Costituzionale, 1994, p. 667. See also the decision of the Second Senate of the German Federal Constitutional Court has decided today which stated that the Act Approving the Treaty of Lisbon (Zustimmungsgesetz zum Vertrag von Lissabon) is compatible with the Basic Law (judgement of June 30, 2009), examined by DICKMANN, Integrazione europea e democrazia parlamentare secondo il tribunale costituzionale federale tedesco and CASSETTI, Il "Sì, ma" del Tribunale costituzionale federale tedesco sulla ratifica del Trattato di Lisbona tra passato e futuro dell'integrazione europea, both in www.federalismi.it
tion on the need of a constituent process that aspires to create a State based on
the European people - points out a thesis that influences the modalities on how
Germany intends to participate in the continental association. 27

Especially the remedial action of the Federal Republic of Germany dealing
with the crisis of the own European partners is influenced by this jurisprudential
interpretation that casts doubts on the European constitutional identity, as it re-
fuses the realization of a federal structure by the provisions of the Treaty of
Lisbon and as it accepts only an association of sovereign States that commit
themselves to adapt their own legal systems to the decisions taken at European
level. 28

Nevertheless, there still remains the doubt if this interpretation is coher-
ent with the option - chosen by the European states - to counter jointly the
attacks of the international speculation. From a more general viewpoint arises
the question if such behaviour can be the adequate condition for the overcom-
ing of national identities and for the realization of a common platform of
sovereignty. A close look reveals that the need, felt by Germany, to verify the
compatibility of the new ESM Treaty with the principles of its own legal order
marks the limit of the European reply to the crisis of the sovereign debts. Indeed

27 See CAPRIGLIONE, Eurosclerosi e globalizzazione: (Contro un possibile ritorno
all’ euroscetticismo), in Scritti in onore di Marcello Faschini, Padova, 2011, p. 437 and RESCIGNO
G.U., Il tribunale costituzionale federale tedesco e i nodi costituzionali del processo di unifica-
zione europea, in Giurisprudenza Costituzionale, 1994, p. 3115 ss and EVERLING, Zur stellung der
Mitgliedstaaten der Europaischen Union als “Herren der Vertrage”, in AA.VV., Rechts zwischen
Umbruch und Bewahrung-Volkrecht- Europarecht-Staatrecht. Festschrift fur R. Bernhardt, Ber-
lin, 1995, p. 1161 seq.
28 See German Federal Constitutional Court, Judgement of June, 30 2009 - BverfG 2 BvE 2/08
the German Federal Constitutional Court reinforces that there has not been completed the transition from a common market – with a high «economic identity»\(^{29}\) - to a unified space in which an extensive «legal identity» of fundamental rights will be the paradigm of the sovereignty and therefore realizes a system of government that is exercised currently by institutions with a high technical qualification (ECB, Euro Summit, Board of Governors and a Board of Directors of the ESM) and, in future, by new political-representative organizations referred to the whole continent.

To this effect the ruling from 12\(^{th}\) September 2012 of the Bundesverfassungsgericht has to be considered as meaningful, as it affirms the centrality of the parliamentarism in the democratic systems (as a fundamental element in the European constitutional traditions). In this manner there has been revealed the breach of the democratic legitimation of the European political process, in the belief that vis à vis the still unresolved deficit the resources offered on the state level by the parliamentary democracy constitutes an essential protective barrier.\(^{30}\)

In other words, the German Federal Constitutional Court doesn’t recognize: (i) the existence of a European people, (ii) its democratic representation in the European institutions and therefore (iii) a legitimate form of self-government that refers to the whole continent. This interpretation brings about

\(^{29}\) See the Joint Press Conference of Monti and Barroso, september 6, 2012, in www.governo.it

\(^{30}\) See RIDOLA, Karlsruhe locuta causa finita? “ Il Bundesverfassungsgericht, il fondo salva-stati e gli incerti destini della democrazia federalista in Europa, in federalismi.it, n. 18/2012, p. 5
a clear limit of the supranational sphere and - at the same time – it defends the prerogatives of the Bundestag.\textsuperscript{31}

The democratic legitimation of the European Union and the protection of the fundamental rights (that are common to the constitutional traditions of the European states) should be, therefore, the criteria for an evaluation that does not exhaust its validity only referred to the solution of the problems individually brought up to the German Constitutional Court (on to the legitimacy of the ESM), but it conditions also the architecture of the future legal system referred to a unified Europe. Indeed, within this legal system it’s necessary to find the role that should be reserved in favour of the elected-representative body (in order to create new and stable balances between people, territory and governments of the old continent).

In this way, as there has not been recognized the existence of a European people, the German legal order appoints itself in some sort of apartheid – not just form a political and institutional standpoint, but also cultural and social – that can be attributed to the stage of a romantic individualism that has been idealized by the movements of the German philosophy of the end of the 18\textsuperscript{th} century. This refers in particular to the well known statement «The more alone,

\textsuperscript{31} Referring to Bundesverfassungsgericht judgement of september 12, 2012, see DE PETRIS, La sentenza del Bundesverfassungsgericht sul Meccanismo Europeo di Stabilità e sul Fiscal Compact. Una guida alla lettura; DI MARTINO, La sentenza del Bundesverfassungsgericht sul Meccanismo Europeo di Stabilità e sul Fiscal Compact. Una lettura alla luce della giurisprudenza precedente, both published in federalismi.it, n. 18/2012.
See also GUARRACINO, Brevi note sulla sentenza della Corte costituzionale tedesca in merito al Trattato istitutivo del Meccanismo europeo di stabilità e sulla collateralisation degli interventi dell’ESM finalizzati alla ricapitalizzazione degli istituti bancari, in Rivista trimestrale di Diritto dell’Economia, 2012, II, p. 61 seq.
the stronger you are» of the German writer, poet and philosopher Novalis (named, Friedrich Leopold von Hardenberg, 1772 – 1801), that shows the representation of an opinion that supports and justifies the German economic policies of the new millennium.32

It looks like there is a political ideology in which the accentuation of the leadership of Germany is the assumption of the decisions taken at European level. In this perspective, it appears that the goal of German participation in the UE seems to be to illuminate the other member States, in order to clear the way to the adoption of policies characterized by austerity, that seem to be the only instrument to guarantee the stability of the social wellness of the citizens.

On this basis, the strategy that the German Federal Republic has adopted after the introduction of the euro can be fully understood; indeed it refers to selective forms of industrial development and to public spending review.

In a German perspective, there is no doubt that – even if we agree on the reasonability of this position – it is reasonable to avoid that the distinctive use of austerity drifts to imbalances that are able to act against Germany itself. Furthermore it should be borne in mind that every time the constancy brings about a lack of (or just a weak) comprehension of other populations’ needs, there gets less every respect of the solidarity.

32 Prima facie, Grundgesetz looks like oriented to a vereinten Europa, but this sentence and other aspects of German romanticism – and in particular the ones of Edmund Burke (1729 - 1797) and Friedrich Karl Savigny (1779 - 1861) - doesn’t appear unrelated to German legal order. From this standpoint, the German approach to European unification is influenced by individualistic tendencies, which slow down this process.
In order to fully understand the above described situation, there has to be ascertained that – beginning from the years of the reunification – «German economic identity» has been characterized by a program of reforms able to put into safety the federal state (by acting sometimes also in violation of the conditions and limits imposed by the Treaty of Maastricht). Different, low commitments can be find in the rest of Europe, where there have not been implemented organizational and functional innovations able to improve the economic and social progress or the welfare of the citizens.

In particular, there have to be taken into account the automatic mechanisms enacted to balance public finance, that in some respects are similar to those that now are indicated by the German government to use in the States affected by the crisis of their sovereign debts. These mechanisms were the basis of the program of reforms that in Germany has accompanied the accession to the EMU and they have implied a revision of the system of social security (set off in 2001 and constantly improved during the following years). Therefore, this reform has brought out the premises for a stabilization of the social contributions and the related rules for the provisions of related benefits. In fact, the intervention of the «Commission Rürup» (2003) identified the measures neces-

---

33 See La rottura in sede UE sul Patto di Stabilità e Crescita: le reazioni in Germania, 27.11.2003, in www.lavoce.info

sary to make benefits - provided by the welfare state - more sustainable,\textsuperscript{35} having therefore introduced the so named «sustainability factor» (that is aimed to reduce the yearly adaptation of the individual pensions in consideration of the relation of the number of pensioners and jobholders).\textsuperscript{36}

In this scenario obviously emerges the German capacity to adopt a long term programming that is oriented to put the institutional conditions in order to promote the evolution of economic processes towards new balances between production and commerce. From this standpoint, it is important to highlight the program of government adopted in Germany since 2005 (thus before the release of the crisis), which made a reorganization of the fiscal system, a reduction of the number of unemployed people (as a result of the Hartz’s laws) and a stabilization of the public finances (that seemed to be precarious because of the overcoming of Maastricht criteria).\textsuperscript{37}


From what has been laid out above, it has been concluded that the way to adapt the German system to the EMU has defined a model that is able to stimulate the economy in this country without sacrificing excessively the objectives of the welfare state;³⁸ therefore it can be gathered that the German legal order prove the capacity to assume a leading role for the other member States.

5. The European legal system has to deal not only with the difficulty to coordinate economic policies but also with the voting weight of Germany within the governance of European institutions. Indeed, the current construction – deriving from the Treaty of Lisbon and from the other Treaties that have been adopted recently in order to deal with the crisis of the sovereign debts (i.e. SCG Treaty and ESM Treaty) – distinguishes by a decisional process based on veto and qualified majorities, that brings out the diversity in the «commanding» sphere during the summits of Eurolandia. In this situation, equal participation conditions are not satisfied: this is the reason that conducts the governments of some member States to show themselves less disposed to transfer part of their sovereignty on the European level, because of the fear to be subjected under the will of economically more relevant countries.

Furthermore, this caused a stagnancy of the constructing process of the European political union, which is influenced by the expectations of the coun-

tries in difficulties to ask, to other member States, to resolve the problems of their own public finances. In this circumstances, the action of the Deutsche Bundesbank seems to be particular significant as it assumes - very often - a behaviour oppositional to every form of solidarity and as just recently it starts to consider that the crisis of the Mediterranean sovereign debts can provoke a menace for the financial stability of the German economy. 39

Consequently, the drafters of the new treaties had to deal with serious difficulties in order to find a balance between stability, coordination and governance of the Eurozone (SCG Treaty) and institutional interventions of mutual financial assistance (ESM Treaty), without being able to have an influence on the current organization of the European institutions (as provided by the Treaty of Lisbon). The reasons of these difficulties are the obvious risk of a negative result of a ballot question on decisions characterized by austerity (that distinguish the current phase of the European construction).

Actually, the problem (that comes up today in the analysis of European legal order) is related to the possibility to introduce some sort of economic supervision on the budgets of the member States that are - or that risk to get - into serious difficulties. This explains why – in the Treaty on Stability, Coordination and Governance – to the coordination of the economic policies corresponds a «fiscal compact» (art. 3, SCG Treaty), as well as a « budgetary and economic

39 See The Deutsche Bundesbank’s Financial Stability Review of November 14, 2012 where it is outlined, «The Bundesbank considers that a substantial worsening of the situation would have a significant adverse impact on German banks and insurers. In addition, low interest rates, high liquidity and potential exaggerations in the German real estate market could pose a future threat to financial stability». 
partnership programme » (art. 5, SCG Treaty) and a procedure for bringing the matter to the Court of Justice if a Member State – or the Commission – considers that another one has failed to comply with Article 3 (art. 8, SCG Treaty).

It is important to highlight the interpretation of the Bundesverfassungsgericht according to which «the Treaty contains no essential changes of the present state of law». A crucial facto has been the positive evaluation on the compatibility of SCG Treaty with the legal system of the German Constitution.40

While trying to get to new forms of governance of the EMU, on 9 December 2011, the Member States agreed on a reinforced architecture that promotes the conditions for an overcoming of the «measures specific to those Member States whose currency is the euro» (pursuant to article 136 of Treaty on the functioning of the European Union) and of the enhanced cooperation (pursuant to articles 20 of Treaty on European Union e 326 ss. of Treaty on the functioning of the European Union) that till nowadays had characterized the construction of legal-economic relations that converged inside the European Union.41 Furthermore, limits to national sovereignty arise from the consignment of political-economic decisions in favour of new supranational institutions (and therefore to subjects that are out of to the democratic system of representation ideated in the last centuries).

41 The new regime of coordination and governance delineated by art. 11, SCG Treaty, needs new organizational structures able «to discuss questions relating to the specific responsibilities ... with regard to the single currency, other issues concerning the governance of the euro area and the rules that apply to it, and strategic orientations for the conduct of economic policies to increase convergence in the euro area» (art. 12, SCG Treaty).
This refers to the «European Summit» (informal meeting of the head of state and government of the Euro-countries, technically supported by the Eurogroup, art. 12, SCG Treaty) and to the «Conference of Representatives» (composed by deputies that participate at the relevant committees of the European Parliament and national Parliaments, in order to discuss budgetary policies and other issues covered by SCG Treaty, art. 13). The Bundesverfassungsgericht was aware of this fact when it has been called to rule the erosion of the budgetary autonomy provided by art. 5 of SCG Treaty, referring non only to the powers of interventions of the European Commission but also to the length of the partnership programs (that can take longer than a legislative period and that therefore seem to be able to reduce the decision powers of the national Parliaments) and to the irreversibility of the conditioning on the economical policies of each of the countries.42

Furthermore, it has to be burden in mind that – in addition to the powers recognized to the above mentioned organisms (i.e. «Euro Summit» e «Conference of Representatives») – the control procedure related to the «balanced budget rule» introduces new forms of corrections. It is provided, for example, the consignment to each member State of the aforementioned competence to appeal to the Court of Justice of the European Union if they consider (independently from the report of the Commission) that a member State has has failed to comply with the «fiscal compact» or did not undertake the measures

42 See Paragraph 165 – 166 of the Decision of the German Federal Constitutional Court of 12 September 2012 and the following statement of the Bundestag «the conditions ... do not constitute a curtailment of budgetary sovereignty, but serve to restrict the German liability risk» (para 183).
that are necessary to overcome any violation of the Treaty itself (art. 8, SCG Treaty).

These powers highlight the will of Germany to have the possibility to act on behalf of the European institutions if they will not intervene (especially if there will be a general financial instability inside the EMU). This explains also the position of the Bundesverfassungsgericht that – while affirming the existence of the right of the Bundestag to receive information on any question that refers to the ESM and to the «Euro Plus Pack»\(^\text{43}\) (pursuant to art. 23 of the Grundgesetz) – states the duty of the German government - and of representatives that participate on behalf of Germany in the mentioned institutions - to refer on this issues.\(^\text{44}\)

Moreover, the Treaty introducing the European Stability Mechanism goes to the above mentioned direction, as the provision of financial assistance is subjected to the compliance with specific conditions that are decided by the «Board of Governors» (composed by one representative for every Member State who is a member of the government who has responsibility for finance ex art. 5, ESM Treaty) and by the «Board of Directors» (in which participate the representatives that are appointed by the each governor, pursuant to art. 6, ESM Treaty): these are the decision-making institutions that are competent to concede assistance for the stability or not (pursuant to art. 13, ESM Treaty). In nuce, there is a

\(^{43}\) See Conclusions of the European Council, 24/25 March 2011, p. 5 seq.

\(^{44}\) See Press release no. 42/2012 of 19 June 2012 – referred to Judgment of 19 June 2012, 2 BvE 4/11 - with regard to the establishment of the European Stability Mechanism, according to the fact that the Federal Government has infringed the Bundestag’s rights to be informed under Article 23.2 sentence 2 GG.
new phase of the integration, characterized by the experimentation of a government-governance model that, while seeks for a balance between solidarity and conditionality, refers to integrated forms of intergovernmental cooperation, instead of introducing a direct connection between the European people and the new institutions that are competent for the recovery of the Member States in difficulties.45

There has to be observed, in particular, that the action of the European Stability Mechanism is subject to the capacity to share a systemic decision, differently if this is assumed by mutual agreement (that means by unanimity of all participants in the deliberation) or by a qualified majority (that requests 80% of the votes, art. 4 ESM Treaty). This capacity needs to function in a context in which only the German Federal Republic and the French Republic have individually a significant weight (as they have more than 20%) and therefore are able to block the operation of this decisional mechanism.

Probably, it is principally because of its dominant position in the government of this new financial institution that Germany has conceded to the EMU to adopt a permanent stability assistance mechanism. This interpretation arise also by the afore mentioned decision of the Bundesverfassungsgericht of 12 September 2012 that ascertains that further determinations of the ESM are bounded to the approval of the German representative «since the Federal Republic of Germany has a share of somewhat more than 27% of the capital in the

45 From a general standpoint, Greece Spain and Portugal show a practical dependence from international aids, see – referred to Greece - PADOA SCHIOPPA, La sovranità in movimento, in Corriere della Sera, February 15, 2010.
European Stability Mechanism, the latter cannot enter into effect without the deposit of the German instrument of ratification» (para 176).

In this way, we arrive at a first conclusion. Common economic governance and mutual financial assistance – while dealing with different problems originating by the diversity of the European countries as well as by different resilience (and capacity to absorb shock because of heterogeneous reaction policies) – realize an organization that provides direct advantages only to some of the Member States. This condition is possible because there are – and there have been felt - different needs of legal reforms and financial aids in the countries that have adopted the Euro (and this condition is different from how in the beginning has been ascertained the need of a common space of peace and economic integration by the « Inner Six», i.e. the six core states that founded the EU’s predecessor).

If there are structural limits inherent to the new Treaties, they are those that avoid resolving the internal financial problems in an equal manner for every European partner. This emerges even more clearly considering the circumstance that some States are able to condition the applicability of the Treaties (by linking their functionality to the interest of this State). It is obvious how the bailout of the countries in difficulties could be act even if it is not compliant with the economic conditions that legitimate its configurability (and so the action of the ESM). From our point of view, this is another negative aspect of the position that has recently assumed Germany (because of the own economic strength), although if it qualifies itself as the saviour of the countries in difficulties (and,
probably, Germany is convinced that itself will never stand in a situation of need).

Pre-drawing other conclusions (see paragraphs 8 and 9), we can say that the situation of *impasse* of the ESM – or, said in another terms, the reluctance to ask for its action by the countries that are in difficulties (as they are intimidated by the conditionality that the German Federal Republic could impose while using its whole predominant weight that has been recognized by the Trea- ties) – complicates the task of the European Central Bank, that is the only supranational institution able to frustrates speculators’ plan through a decision making process that – how it happens on 6th September 2012 – can disregard the approval of Germany.46

6. Subsequent to the recent evolutions of the EU legal and policy system, it seems that there can be asserted the phenomenon on which basis the European legal unity is put into question by the diverging interpretations given by the tribunals and courts of the single member states; a topic that seems to be particularly controversial is the application and implementation of the European law into the different national legal systems. This phenomenon emerged very clearly with the «Lisbon ruling» given by the German Constitutional Tribunal in

46 See DRAGHI - CONSTÃNCIO, *Introductory statement to the press conference (with Q&A)*, Frankfurt am Main, September 6, 2012, where – referring to the vote procedure – the President of ECB said «it was not unanimous. There was one dissenting view. We do not disclose the details of our work. It is up to you to guess». 422
June 2009\textsuperscript{47} that – by means of jurisprudence – endorsed a series of legal and cultural limits towards the European political integration.\textsuperscript{48}

Nevertheless, there can be also observed that the aforementioned different way of behaving of the German legal system is not so far apart from the behaviour of other countries that have an broader capacity to open the national system towards Europe; so that on constitutional level the European integration process is not significantly different in this countries compared to what has been said above on the legal situation in Germany.\textsuperscript{49}

On the contrary, the other German speaking legal system of Central Europe - \textit{i.e.} the Austrian system – distinguishes by a major «opening» (than the German system) towards the law originated from the European level\textsuperscript{50}.

\begin{footnotesize}
\textsuperscript{47} See 2BvE 2/08 e.a.
\textsuperscript{48} For a complete overview on the problems that come from the complex ruling of the judges of Karlsruhe see for example the volume n. 4/2009 of the journal \textit{Zeitschrift für Europarechtliche Studien}, Zum Urteil des Bundesverfassungsgerichts zum Vertrag von Lissabon vom 30. Juni.
\textsuperscript{49} The differences in dealing with the complex questions related to the relations between legal orders are still very marked and the current European constitutionalism distinguishes a strog asymmetry. See PITRUZZELLA, \textit{Chi governa la finanza pubblica in Europa?}, in \textit{Quaderni costituzionali}, 2012, p. 12. On the asymmetrics related to the European constitutionalism see also AA.VV., \textit{Il costituzionalismo asimmetrico dell’Unione europea}, a cura di Cantaro Torino, 2010, passim.
\textsuperscript{50} The general trend of the Austrian legal order to implement in a direct and much opened manner the norms of international law is proven since a long time within the field of the protection of the fundamental rights and freedoms. The European Convention on the protection of the human rights (ECHR), and in particular its 1\textsuperscript{st} part, has been recognized by the national legal system as federal constitutional law and is today one of the constituent elements of the Austrian human rights protection system.
\end{footnotesize}
It is well known that Austria belongs to the group of countries that incorporate the EU primary and secondary law following to the application principles inherent of the European law and without explicit integration limits (Integrationsschranken), that – and this is the case of Germany – have the ability to restrict the adaptability of European law within the national legal system\textsuperscript{51}.

The general incorporation without reserve of the European law into the Austrian legal system necessitated a total constitutional amendment and of the fundamental principles, confirmed by a popular referendum in 1994; consequently to this referendum there had been inserted into the Bundesverfassungsgesetz (B-VG) a new title B consecrated to the European Union (artt. 23 a – k). Due to the intensification of the European integration process the named title B has been amplified and complemented\textsuperscript{52}, so that it currently provides in a detailed manner a series of concrete aspects of the European constitutional law; among the provisions there are the rules for the election of the European Parliament (art. 23 a e b), the European cooperation

\textsuperscript{51} See ÖHLINGER - POTACS, EU-Recht und staatliches Recht, Die Anwendung des Europarechts im innerstaatlichen Bereich, Wien, 2011, p. 53 seq.

\textsuperscript{52} There seems to be a general consensus on the circumstance that the Austrian legal system implements the European law without limits to the integration or better (as confirmed by the doctrine) within the limits of the fundamental rights as asserted in occasion of the accession to the EU confirmed by referendum. From this statepoint the different amendments of the primary law provided by the Treaty of Amsterdam, by the Treaty of Nizza and by the Treaties of the accession of new countries and finally by the Treaty of Lisbon, even if they constitute amendments of the Constitution, are legitimated by the Austrian legal order as they are expression of the “immanent development of the system” ("systemimmanente Fortentwicklung").
(artt. 23 c e 23 j) and the participation of the national institutions in the political and legislative decisional process on European level (artt. 23 d – j).

This tendency to implement in a direct manner the European legislation emerges also from the jurisdiction of the Austrian constitutional Court (*Verfassungsgerichtshof* -VfGH), that – from the beginning of the accession of Austria to the EU in 1995 – leads a dialog with the European Court of Justice and presents regularly la demands for preliminary rulings.53

In general, the opening of the Austrian legal system to the supranational system has been recently confirmed by a ruling of the VfGH from spring 2012, that asserted that, on the basis of the principle of equivalence, the guarantees and freedoms provided by the European Chart of Rights can be invoked also vis à vis the VfGH within the proceedings of administrative appeals as constitutionally guaranteed rights and can, furthermore, constitute a parameter for the evaluation of compliance with the Constitution of the Austrian legal norms54.

7. Coming back to the problems related to the German legal order, as described above, in the jurisprudence, there can be ascertained a general aperture of the German Constitution towards Europe: from the preamble and from art. 23 GG, it emerges the constitutional objective of the realization of an unified Europe. The preamble stresses that the German people is inspired by the de-

53 See. EuGH causa C-143/99 (Adria-Wien Pipeline GmbH and Wietersdorfer & Peggauer Zementwerke GmbH versus Finanzlandesdirektion für Kärnten), Slg. 2001, I-08365; other rulings of the ECJ on the basis of in basis of prejudicial questions risen by the VfGH have been given in the case C-171/01 (Wählergruppe Gemeinsam), Slg. 2003, I-4301 and in the cases C-465/00, C-138/00 e 139/01 (Österreichischer Rundfunk), Slg 2003, I-4989.

54 See ruling of the VfGH from 14th march 2012, U 466/11-18.
termination “to promote world peace as an equal partner in a united Europe». Thus the voluntas legis to realize international peace and European integration is obvious.

Nevertheless, even if the German Constitution provides such an aperture vis à vis the European legal system, from the rulings of the Constitutional Court of this country emerges the tendency to abnegate an implicit aperture - without reserve - to the Treaties that constitute the framework for the promotion of the European integration, as compassed from the Maastricht Treaty on till the recent Treaty of Lisbon.

There is no doubt that the German constitutional Court – as the doctrine pointed since time⁵⁵ - and in particular in his recent rulings highlights the limits of the integration. Some of the rulings become important from a political point of view that have an impact further than the mere internal German national sphere, as they have become in some sort the indicators of a control mechanism (given by Germany) on the evolution of the European integration. At the same time, the tendencies adopted in the jurisprudence of the Tribunal of Karlsruhe are on the basis of some of the doubts risen by the doctrine relating to the role of the constitutional court and especially if he pursues the objective of the participation or if he constitutes a “brake” for the integration⁵⁶.

---

⁵⁵ See CAPRIGLIONE, Eurosclerosi e globalizzazione: (Contro un possibile ritorno all’euroscetticismo), in Rivista Trimestrale di Diritto dell’Economia, 2010, I, p. 32, nt. 60.

It has been asserted several times that in the jurisprudence of the judges of Karlsruhe can be observed two major trend lines: the German constitutional identity and the democratic conjunction of the integration process.

From the first point of view, the judges – beginning from the Lisbon ruling in 2009⁵⁷ - have emphasized that the GG does not allow the accession to a European federal state. In that case a complete amendment of the constitution would be necessary as the German Federal Republic would have to resign from its sovereignty.⁵⁸ The ruling highlights that the Treaty of Lisbon dose not entail an implicit accession to a European federal state, but cleaves to the design of the UE as a supranational organization and as a union of sovereign states.⁵⁹

Furthermore, it ascertains that the interpretation of German Constitution - made by the Bundesverfassungsgericht - points out a core identity that resistance to Europeanization; this can be revealed in the legislative power to consign competencies to the UE pursuant to art. 23 GG and finds a further limit in art. 79, paragraph 3 GG (that provides that the fundamental rights that protect the human dignity and the structural principles of the legal system as the democratic principle, the principle of the social state and the federal principle cannot be subject to a constitutional amendment). This core identity of the

---

⁵⁸ See BVerfGE 123, 267, p. 364.
⁵⁹ See BVerfGE 123, 267, p. 348.
German Constitution therefore cannot be modified by the European integration process\(^60\).

The other trend line in the jurisprudence of the constitutional Tribunal highlights the responsibility of the\emph{ Bundestag}\ within the European integration process; this responsibility is entailed by the principle of a parliamentarian democracy\(^61\) and prevails especially for the measures that have an impact on the public budget\(^62\). For example, the actions of huge financial supports in favour of member States, that are able to affect significantly on the federal budget, have to be approved by the\emph{ Bundestag}, that should be able to take autonomously its fundamental decisions within the frame of its powers related to the public budget\(^63\). The evaluation of the capacity of the federal budget to bear the guarantee that has been granted to the advantage of some member States is assigned to a broad discretion of the legislative body and this evaluation can be censured because of unconstitutionality only if it can be subject to an obvious confutation.

This specification allowed the rescue of Greece by the UE, but at the same time it affirmed that the\emph{ Bundestag} can assume some sort of veto power on the

\(^{60}\) See BVerfGE 123, 267, p. 348
\(^{61}\) See BVerfG, ruling 28\textsuperscript{th} February 2012 – 2 BvE 8/11. Referred to the information of the parliament by the side of the government see the ruling BVerfG 19 June 2012 – 2 BvE 4/11.
\(^{62}\) See BVerfG, ruling 7\textsuperscript{th} September 2011 – 2 BvR 987/10 e.a. For a detailed comment, see RIDOLA, “Karlsruhe locuta causa finita?” Il Bundesverfassungsgericht, il fondo salva–stati e gli incerti destini della democrazia federalista in Europa, in:\emph{ federalismi.it}, n. 18/2012, p. 2 seq.
\(^{63}\) See BVerfG, ruling of 28 February 2012 – 2 BvE 8/11.
European financial salvation plans. In this way it sticks that there cannot be blank authorizations for future salvation plans and every single rescue action by the federation within the UE necessitates a special authorization by the Bundestag. Indeed, in the ruling is clearly said that the German government cannot accept permanent financial solidarity mechanisms if they implicate an enduring debt obverse other countries, if this passivity is very high or indeterminate or if foreign governments can define by their own actions responsibilities towards third that also Germany has to assume.

In this manner, the Bundestag and the German constitutional Tribunal become some sort of guardians of the modalities of the European financial stabilization; this guardian-role assumed by Germany attests the theory related

64See LO BUE, Il “guinzaglio di Karlsruhe” e la sentenza del Bundesverfassungsgericht sul piano di aiuti alla Grecia, in Nuove autonomie, 2011.

65The economic crisis and the European state debts constitute are a general “challenge” for the Constitutional courts of the European countries. Till now not only the German constitutional Tribunal pronounced itself on the ESM Treaty but also the Constitutional Court of Estonia. In the Estonian Constitutional Court dealed in his ruling from 12th July 2012 in particular with art. 4, 4° para of the ESM Treaty providing that in the cases of emergency there can be taken decisions on financial assistance directly by the ESM institutions with a majority of 85%. In this manner, the decisions can be taken also without the effective participation of the Estonian parliament. The Court of Riga anyway has ruled that the mechanism complies with the Estonian Constitution ad the objective of the ESM is to guaranty the economic and financial stability of the Eurozone and therefore also in Estonia. Only in an economically and financially stable and constant situation there can be realized the fundamental values of the Estonian Constitution; therefore, the Estonian Constitutional Court considers that the intervention of the ESM on the mechanism on the internal budget is legitimate. See ruling of the Estonian constitutional Court of 12th July 2012, Az: 3-4-1-6-12, can be downloaded on www.riigikhouse.ee
to the «European constitutional network»\textsuperscript{66}. Indeed, in the last ruling of the Bundesverfassungsgericht emerges clearly how the functioning of the European law has been strongly determined by the evaluations of its compliance with national law given by the national Constitutional Courts; their rulings are significant in the horizontal dimension as well as in the vertical dimension.

The tension between the perpetuation of the national identity and the participation of the European integration have been treated by the German constitutional Tribunal on the basis of the criteria of the “responsibility for the integration” (Integrationsverantwortung), that has been developed in 2009 in the Lisbon ruling\textsuperscript{67}.

This criterion takes into account the circumstance that the international treaties can initiate a dynamic system of regulations, in which the institutions created for the creation of norms can promote also an evolitional interpretation of these norms. The permanent inclusion of the Parliament in this process should compensate, on one hand, the circumstance that at the time of the ratification there were not foreseeable the developments of the treaty law and on the other hand this should grant the respect for the democratic principles in favour of the European citizens.

The Integrationsverantwortung means, therefore, the assumption of responsibilities in the field of the European integration, that implies the consignment of powers and competences in favour of the elaboration of com-


\textsuperscript{67} See BVerfG 123, 267
mon decisional mechanisms in the evolution of the treaty law first and in its implementation secondly.\textsuperscript{68} This principle therefore has to be interpreted with a view in two directions that allows integrating the supporting approval on the side of the national system towards the integration process with the democratic element and the perpetuation with the national identity\textsuperscript{69}.

8. At this stage of the analysis it seems to be necessary to examine the role of the German national bank in the resolution of the problems brought up by the financial crisis and the one of the sovereign debts; this refers to the relations between the German State and the ECB (in the light of some dyscrasias that can be met within the positions given by the German representative within

\textsuperscript{68} BVerfG 123, 267, p. 435


It is interesting to indicate that also within the rulings of some other Constitutional Courts, ed in particular of those of Poland and the Czech Republic, emerge continuously the two contrasting elements of the preservation of the constitutional identity on one hand and of the promotion of the European integration process on the other hand. See for example the ruling of the polish constitutional Court of 11\textsuperscript{th} March 2005, K 18/04 can be downloaded on http://www.trybunal.gov.pl. On the evolution of the polish jurisprudence on the topic of the European integration see BIERNAT, Handbuch Ius Publicum Europaeum, vol. II, 2008, § 21 note 41 ss.

See also the more recent ruling of the Polish Constitutional Court of 18\textsuperscript{th} December 2009, K 32/09, in: Europäische Grundrechtezeitschrift, 2012, pp. 185 ss. In the jurisprudence on the integration of the Czech Republic, we mark the ruling of 26 November 2008 (Treaty of Lisbon I), Pl. ÚS 19/08 and the ruling of 3\textsuperscript{rd} November 2009 (Treaty of Lisbon II), can be downloaded on http://wwwconcourt.cz.
the ‘Executive Board of the European Central Bank and, on the contrary, by the President of the Deutsche Bundesbank).

Even if pursuant to article 112, paragraph 1, of the Treaty (and art. 10 of the Statute) all members of the Executive Board are appointed by the European Council (that decides by qualified majority), this procedure does not allow to ascribe tout court to the European Union the political responsibility of the actions made by the components of this organism, as there can be expected that the Council expresses a clear predominance of the national interests (which, at this level find, merge into mere shared decisions).

It is necessary to analyze the competencies of the above mentioned Board: this organism prepares the meetings of the Governing Council of the ECB, carries out some legislative competencies conferred by the ECB and is competent to implement the monetary policy (in accordance with the instructions and decisions of the Governing Council itself). Therefore the Executive Board is competent to give instructions and directives to the national central banks of the Euro area. In such a way, while exercising of these tasks, any member of the Executive Board can get also into a contradiction with the position of the single States where he belongs to.

There has to be taken into account the organizational criteria that has been adopted by the ECB for the distribution of the own functions of the named executive organism between its members; pursuant to this system the German representative is competent for the subject of «International and European Relations- Legal Services - New ECB Premises Project- Permanent Representation in
Washington, DC», while the «Financial Stability» is assigned to the Vice President of the ECB and the «Market operations» to the French representative.

Pursuant to art. 130 of the European union Treaty the requested independence of the different categories of subjects that are involved in the structure of the European Central Bank is guaranteed by the provision that there should not be any national influence. Probably it is virtue of this principle that there can be establish different orientations between the Deutsche Bundesbank and the ECB; as a consequence there will be a strong conditioning of the monetary powers, as well as of the financial activities that are oriented to defend the sovereign debts from speculation attacks (that could cause the disintegration of the Euro system).

In this perspective, seems significant the position of the German representative that – while drawing upon famous studies (Münchau, Roubini, Bowles, Mayer) – specifies how the extent of the mandate of the ECB comprises also actions in order to defend the EMU from speculations (on monetary level as well as on the level of supervision). Précising this position emerges a German approach that differs from the one of the other member States (and the European institutions): while Germany casts doubts on the exceeding of the limits given by the Treaties by the side of the ECB, the rest of Europe asks themselves

---

70 See Masera, Scienza economica, Moneta, Finanza e Metodologie quantitative, in AA.VV., Saggi sulla metodologia della ricerca in economia, Roma, 2010, p. 29 seq.
about the reasons that still continue to delay the amplification of the functions that are conferred to the ECB. In this context becomes significant the consideration of the German representative referred to the difficulties of some European people to accelerate the process of political unification (by the means of a new «europäische Wirtschaftsverfassung»).

In contrast with this position, there is the above-mentioned jurisprudence of the Bundesverfassungsgericht, which several times has pointed out the character of a mere association of the EMU. From this standpoint, more then the fears originated from the difficulties of a conciliation between the different tendencies of interpretation of the Treaties that can be observed in Germany, we can focus on the divergences of the French-German relationships (due to the results of the French elections as well as to the intransigence demonstrated by Germany in the face of the first softening of the transalpine economy). There have been ambivalent evaluations given on one hand by the Ministry of Finance Wolfgang Schäuble (when he tried to reduce the meaning of the downgrading assessment done by the rating agencies as a «kleine mahnende Beurteilung») and on the other hand by numerous German commentators on the French public organization (that not by case have been penalized because of the rigour of


74 See ASMUSSEN, Die europäische Wirtschaftsverfassung: Wettbewerbsfähigkeit, solide Staatsfinanzen und Fairness, Rede beim Versicherungstag 2012 des GDV, Berlin, 15.11.12

75 See Starrsinn, Reformstau, fehlende Wettbewerbsfähigkeit, in Die Welt of November 20, 2012. See also the reply made by french economist Patrick Artus in Frankfurter Allgemeine Zeitung of the same day «Die Herabstufung wird keinen Effekt haben». On the question of rating agencies’ role in the financial crisis, see CAPRIGLIONE - SEMERARO, Crisi finanziaria e dei debiti sovrani, Turin, 2012, p. 53 seq.
the labour and services market, low levels of innovations and the weakening of the industry oriented to the exportation).76

In this scenario it is useful to evaluate to what extent the position of the Bundesbank had an impact on the action of the European Central Bank aimed to counteract the negative effects of the crisis (and in particular of those that have determined the illiquidity of the markets and the refinancing difficulties of the sovereign States).

Therefore, the «Non-standard measures», the «Securities market programme» and the «Outright Monetary Transactions» are taken into account. These actions can be evaluated in the same way as financial restructuring plans that – while implementing the concept of Mario Draghi (who declared to be available to «whatever it takes to save the Euro»)77 – have introduced a debate on the necessity to put the European Central Bank in the centre of the construction of a hypothetic Banking Union in the future (by doing this it would be given up the leadership that in the soft law system the ECB has already achieved). 78

On this point, the interrogations brought up by the president of the Deutsche Bundesbank related to the adequacy of the “European Banking Union” as remedy instrument for the crisis (including the possibility that is can guard on the «dangers to the stability of the banking system that emanate from public fi-

77 See DRAGHI, Introductory statement to the press conference (with Q&A), Frankfurt am Main, August 2, 2012.
78 See art. 127 of the Treaty on the Functioning of the European Union.
**nances or the economy as a whole**) seem to be of particular relevance. 79 A valid deterrent of the crisis is the recognition by Germany of a common supervision system that is able to regulate equally the European bank intermediaries (in order to assure the stability of the States that are members of the UEM). Nevertheless this has been criticized because of the introduction of a «common restructuring and resolution mechanism» that is able to avoid the default of the States that are in troubles (these critics are based on the possibility, in this way enabled, to avoid that the subjects that are responsible for the crisis – and in particular the countries that did not managed the supervision over the financial situation - suffer from the negative consequences of their behaviours).

On the other hand the German orientation to safeguard the «close interconnectedness between the banking system and public finances» is meaningful; this is the reason why Germany has proposed to initiate – together with the constitution of a Banking Union – a conferment on the European level of the «powers of fiscal policy intervention to be used if a member state persistently violates the European rules or the conditions tied to the financial assistance programmes». Therefore, it is an ambitious goal and its achievement – involving objectives that are different from the institutional goals of the Banking Union - is even more complex and laborious.

In other words, it is supposed an extension of the role of the Banking Union towards spheres of the economic policy and of the public finances. This extension is linked to the proposal of a new model of governance that should

---

79 See WEIDMANN, The concurrence of crisis management and regulatory policy, Frankfurt am Main, 19.11.2012
have a deep impact on the order created by the European Treaties, complicating and delaying the reform of the ECB and of the European financial supervision.

It has to be highlighted the different institutional structure that has been supposed by the German member of the executive committee of the ECB. Indeed, the German member has proposed a Banking Union to be considered as a first step to deal with the crisis, accepting by this way the indications of the European Commission in the famous document that has been presented on 6th September 2012. In this way also other models (i.e.: Finanzmarkunion, Fiskalunion e Wirtschaftsunion) can be seen as part of a long term strategy that is necessary for the realization of a «Politische Union», that naturally has to match with consolidation of the relevant democratic institutions.

Of course, both of the above-mentioned hypothesis of the Banking Union have to take into account the diagram of the new summit power organization of the European financial supervision system: it has to be integrated into a «Single Supervisory Mechanism» that is necessary to comply with new policies of public finance that increase the competitive ability, while reforming the financial market and accomplishing in this way the economic and monetary union for Europe.

---

80 See CAPRIGLIONE, Mercato regole democrazia, Turin, 2012, p 189
However, this configuration is still far away from the proposal of the Commission and the Euro Summit that consider the ECB to be the European institution that is the best eligible to exercise the function of financial supervision and so the key element of a pure «financial market union». This has to be seen also in the prospective of an approach of the supervision to the monetary policy (and not to other economic policies), pursuant to a model that has been experienced within the national systems before the introduction of the Euro.

Lastly, on the basis of the difficult conjunction between Bundesbank and ECB (as mentioned above), there can be ascertained a situation in which the monetary sovereignty and the financial and banking supervision are in the centre of a transformations process because «a lot of governments have yet to realise that they lost their national sovereignty a long time ago ... because, in the past, they have allowed their debt to pile up, they now need the goodwill of the financial markets»; this motivation is completed in the reference to unfounded speculations which «put the effectiveness of our monetary policy at risk».

Therefore, it will be the technical forms of implementation of the Banking Union that will show the further extent of the conferment of sovereignty; this is connected with the possibility to construct a banking and financial system that founds its own stability and balance on the conscientious control activity exercised by the authorized supranational institutions (the ECB and the authorities

---

83 See Draghi, *Interview with Der Spiegel* conducted by Michael Sauga and Anne Seith on 22 October, published 29 October 2012 in www.ecb.int where it also said «That sounds like a paradox, but it is nonetheless true: it is only once the euro area countries are willing to share sovereignty at the European level that they will gain sovereignty». 
of the European System of Financial Supervision (ESFS) as well as on the mechanisms that are directed to resolve the crisis (the SSM and, in some regard, also the ESM).

From what has been said emerges very clearly how within the European dimension is afresh proposed one of the most significant organization principles achieved in the 20\textsuperscript{th} century: the relationship between ‘monetary policy’ and the ‘protection of the savings’, to which can be ascribed the identification of transmission mechanisms of the public economic policies that are directed to retain the integrity of the economic resources that are committed by the citizens to the banking industry.\textsuperscript{84}

From a juridical perspective, there is no doubt on the necessity to review the limits that the European Treaties put towards the actions of the ECB, especially the ones related to the exercising of new regulation and control powers \textit{vis à vis} the member States that did not adopt the Euro (and to the possibility to recognize them specific rights to participate to the decisional process - referred to the financial supervision activity - of the European Central Bank). These are the problems that – in default of some forms of democratic conjunction that connects the action of the ECB with the specific political advices of the Parliament (or at least to the ones of the European Council) – reflect themselves on the \textit{accountability} of the SSM, with obvious impacts also on the level of the political responsibility and the democratic guarantees.

9. Lastly, in order to find valuable solutions to overcome the difficulties of the current Europe (thus, the problems of the journey towards a political unification), it seems to be useful to consider the evidences related to a similar situation - on the level of the law and economics - that occurred in the beginning of the nineties of the 20th century, the time of the German reunification.

In this perspective, it is important to highlight that the legal conditions of the German economic and monetary policies were constrained by the context of the European Monetary System (EMS). Under this constrain, Germany had to deal with the challenge of the *reunification* of BRD and DDR in a way that was not completely free - at least in managing the *Deutsche Mark* - to assure the consistency of the social-economic conditions of the people of the two ex-Germanys.

When the Berlin Wall came down, the action of the *Deutsche Bundesbank* where inserted within a «pact of solidarity» - valid within Germany - that allowed to the *Länder* of the ex DDR to be assisted by substantial funding from the central government, as well as to participate in the distribution of the fiscal incomes (coming for the main part by the *Länder* of the ex BRD) and to receive subsidies for the financing of the welfare state (also though reduction of the public spending in Western Germany).

This operation has been evaluated positively as the unification with equal exchange rate of the two Deutschemark realized in June 1990 has been a triumph of the political will instead of economic considerations, that rationally would have recommended a differed way of integration (that probably
would have been less expensive).\textsuperscript{85} It has been a success of the German central bank which managed the effects of the economic policy on public finance through appropriate monetary choices.\textsuperscript{86}

Currently, there has to be observed that, in Europe, there are economic conditions that are similar to those that existed in the period of the German reunification. Consequently, the past German experience can become a model for the exercising (by European populations) of a conjunct sovereignty. In this way, all citizens of the Community could take part to the constitutive process of a new common administration. Political will, innovation of public organisation and economic investments have been, in the past, the key elements of the German reunification: this is where a new paradigm arises. The later should be borne in mind in order to get to a political European union. Furthermore, there can be ascertained the possibility to assign to the European Central Bank an integrative power, in the view of a future meeting of interests towards a sovereign Union, as it happened – at the beginning of the Nineties and at German national level – through the Deutsche Bundesbank.

As the economic policy of Germany – after the unification – has been decisive to assure the stability of this country and as this experience allows Germany to take a leading role in the process of European political integration, today a similar ‘call to action’ should deliver a new organization of the European development goals (where the price stability should be just one of the objective-instruments of the Union, in order to overcome an ancient vision of the Treaties

\textsuperscript{85} See FOREMAN-PECK, Storia dell’economia internazionale, Bologna, 1995, pp. 574, 573 and 591.

\textsuperscript{86} See Institut der deutschen Wirtschaft, Der Soli hat bald ausgedient, of November 5, 2009 and Die Gießkanne hat ausgedient October 4, 2012; both in www.iwkoeln.de
that is oriented just in this single direction). Therefore, the extension of the organizational and implementing functions of the ECB becomes a precondition for the constitutional frame of a future political European union.

At European level, the existence of a central bank with specific powers (currently extended also on the bank supervision) can support a positive trend on the journey to the creation of a new European Union, with stability effects on the Euro and the financial system of the countries of the EMU. In the perspective of a European Union based on the uniformity of the monetary and financial control systems, the EMU and the Banking Union – considered jointly – identify the embryo of the concept of «economic Constitution». Both these institutions - and their development – can be considered as the first constitutive event of a unitary system (eligible to outline social-economic elements and legal aspects that are necessary to regulate the integration between administrations and territories and, therefore, the creation of a single European country system).

Coherent to what has been said in reference to art. 23 of the Grundgesetz, it seems therefore possible to consider that the conferment of sovereignty from the Member States to the Euro system – and the consequent transmission of functions from the national central banks to the ESCB and the ECB – does not only represent a necessary decision in order to help European market integration, but it could be also a Unitarian mechanism of government, that is a valuable precondition for the unification of European people.
10. Some negative evaluations on the future of German economy - together with the critical review of other Member States’ conditions - confer a specific direction to the results of this work. The questions that have been risen - relating the effectiveness and the efficiency of the levels of integration that have been reached (by the new European Treaties, the *conditionality* of the remedial actions and the *neutrality* of the monetary policy) - try to identify the problematic elements in the centre of the current debate on *Europeanism* and on its legal order.

The approach followed in this paper – pointing out that European institutional organization are inefficient (or at least ineffective on social economic level) and insufficient (in the legal system: institution, rules for functioning, control system) – highlights numerous degenerative factors that exist in the European context. In this perspective, it is possible to understand that policies of austerity - by its own - cannot rise up again the economy (on the contrary, they worse the situation of the countries in difficulties).

The precise statistic data – that has been elaborated by Eurostat and that indicate negative trends in economic for Greece, Spain, France and (to some limited extent) also for Germany – confirms the above-mentioned assumptions. These have had evident repercussions on the whole euro zone, where it has been registered a decrease of 0,1% of the economic GDP.87 It is also clear that these results do not constitute a measure of the efficiency of the economic and regulatory policies enacted in the last years; but anyway they are able to indi-

---

87 See «GDP down by 0.1% in the euro area and up by 0.1% in the EU27», issued by Eurostat Press Office on December 6, 2012.
cate the current limits of the level of *solidarity* granted by Central Europe Countries (and to conclude that this level is not sufficient to get out of the crisis).

Furthermore, it has been outlined the interaction between the welfare of the European citizen and the negative consequences of a political union that delays in showing up. Governments, territories and populations of the member States - even if they seem to be part of the *European cultural climate* - look like as they were not able to overcome local policies of state support and laxity. In this context, the decisions taken with an excessive austerity – jointly with the imposition of impossible conditions (or an extra-long timetable for implementing) – lead to doubt the existence of a common spirit to change the European legal order; and Germany’s behaviour feeds these doubts. Moreover, German policies - that are not always fully shared by other European countries – arise the question if there is a will outstretched to the preservation of the advantages connected to the perpetuation of the market situation created because of the crisis of the sovereign debts.

Coming to the conclusions, it can be said that there remains the necessity to define the development trends of the European legal system, that currently is hard-fought between the methodological austerity of the public finance (as framed since the Maastricht Treaty) and the auspices of a *subsidarian solidarism* of the EU institutions (promoted by variegated demands of the Mediterranean countries).

The institutional answers given by new Treaties (on the *Fiscal compact* and on the *European mechanism of stability*) seem to be not adequate to deal with

---

the systemic crisis, also because of the lack of a path for reforms of the (national, European or global) democratic public organization. In this scenario arises the question if the identity paradigm of the European Union can continue to be based on the economic integration, as it results after the Treaty of Lisbon.

Indeed, there remain a series of doubts on the possibility that the European legal system is able to support new challenges, different from those of the 20th century. More than the peace, the diffusion of the common values and the welfare of the European people (art. 3 Treaty on European Union), the fundamental problems of the current period are related to the organization of the social State (and of its financing). From these problems emerges the necessity of a common choice on the model of sustainable welfare economics for the European citizens within the «economic and monetary union whose currency is the euro » (art. 3, para 4, Treaty on European Union).

These are the reasons for the petition of a new way of representation of the general interests; this petition that has to be changed when the will to create some supreme centres for mutual decisions will be real, in order to «déterritorialiser l’économie et construire un espace fluide et homogène, structuré par la seule géographie des prix».89 Subsequently, there is the auspice that the national governments – while ratifying the globalization of the essential principle of «ubi societas, ibi jus» - could change their role in order to become - instead of sovereign institutions of national norms - intermediaries of a commonly shared financial system on the European level. If, in general, austerity can

---

be positive, then it is also advisable an effective will to achieve a unified or federal structure, to raise the levels of government in order to create a participated political union in the *old continent*.
ABSTRACT: The 2007-2008 great financial crisis showed close relationship between corporate governance and financial stability. For this reason, new corporate governance rules try to stop crises from developing into systemic, by regulating also composition of the banks and financial intermediaries’ boards, appointing, in particular, non-executive independent directors. The appointment of non-executive independent directors aims at finding appropriate rules that define and solve the problem of board loyalty, especially in cases of conflicts of interest, promoting, as a consequence, the overall stability of the financial intermediaries. In Italy, the Law No. 262 of 2005 on a general reform of the legal framework of the banking and financial sector introduced, among other things, the figure of the independent directors of companies with shares listed on regulated markets, in order to achieve a more efficient system of governance and to protect more effectively the interests of the minority shareholders. The paper considers particularly the matter of the assessment and compliance with independence requirements.
and the specific role attributed to non-executive independent directors in the company’s transactions with related parties.


1. After the 2007-2008 great financial crisis, banking regulation can operate in various forms and affect different aspects of the organization of intermediaries: by providing for minimum capital requirements, by regulating corporate governance of financial intermediaries (*i.e.*, regulating bankers’ compensation\(^1\)), by providing a separation between retail and investment activities, by reforming the structure of public supervision\(^2\).

---


Scholars argue that there has been an increasing politicisation of governance and control mechanisms while dealing with the current financial and economic crisis\(^3\), and that the latter was indeed a catalyst rather than the cause for regulatory initiatives\(^4\).

Given the close relationship between corporate governance and financial stability\(^5\), new corporate governance rules should try to stop crises from developing into systemic, by regulating management remuneration, the role of the CEO and the composition of the boards.

As to this profile, in particular, appointing non-executive independent directors aims at finding appropriate rules that define and solve the problem of board loyalty, especially in cases of conflicts of interest\(^6\). Rules for an efficient,


\(^6\) See in these terms HOPT, Modern Company and Capital Market Problems: Improving European Corporate Governance After Enron, in ARMOUR - McCahery (eds.), After Enron, Improving Corporate Law and Modernising Securities Regulation in Europe and the US, Oxford, Hart, 2006, 458-459, according to which “one way out may be to have persons on the board who are not subject—or are less subject—to such conflicts, i.e., independent non executive directors. Indeed, in the last decades, in particular in the United States and in Great Britain but also in other countries, there has been a marked movement toward having non-executive directors on the board and especially on its key committees, though the initial enthusiasm for outside directors has been somewhat dampened, since no clear correlation has yet been found between having independent directors and firm welfare. This tendency toward independent non-executive directors is less marked in countries with a two-tier board system such as Germany, because this system as such provides for mutual exclusivity of membership of the two boards. In Germany, therefore, some argue that the supervisory board members are per se outside or
loyal, and competent board may in fact enhance corporate governance and promote, as a consequence, the overall stability of the financial intermediaries.

The well-known particularities of banking corporate governance, highlighted for some time by scholars\(^7\), led the Basel Committee on Banking Supervision to publish two editions of a guideline entitled “Enhancing corporate governance for banking organisations”\(^8\). The High-Level Group on Financial Supervision in the EU, chaired by Jacques de Larosière, stated in its Final Report that banks corporate governance “is one of the most important failures in the present crisis”\(^9\) and numerous reforms of national law have improved banking corporate governance in EU Member States, in United Kingdom and in USA\(^10\). Guidelines developed by the European Banking Authority\(^11\) on the internal governance of non-executive directors. Of course, this is only true insofar as there is a mandatory separation between the management board and the supervisory or control board, which both have to be comprised of different persons. But this neither precludes, as often happens, the movement of a former chairman of the management board into the supervisory board after retirement—typically assuming the role of chairman—not nor does it touch upon the question of financial relations between the supervisory board members and the company”.

\(^7\) FAMA, What’s Different About Banks?, in Journal of Monetary Economics, 1985, 15, 1, 29.
\(^8\) See at http://www.bis.org/publ/bcbs122.pdf.
banks provide some criteria to ensure the presence of efficient boards and internal control functions.

Recently, corporate governance codes were drafted and implemented in national laws and regulations, also with regard to the role of non-executive independent directors, often operating on the basis of their own unwritten rules, that are likely to be very different from those followed by their colleagues\(^\text{12}\).

2. In Italy, the corporate scandals at the beginning of the new millennium, such as those relating to cases “Cirio” and “Parmalat” have done serious harm to investors, so that the need was felt for a new legislative framework for the protection of saving in order to put in effect the provisions of Article 47 of the Constitution, which require precisely the protection of saving in all its forms\(^\text{13}\). It is up to the State the exclusive jurisdiction to protect the constitutional value, pursuant to Article 117, par. 2, letter e), of the Constitution, also providing for its active promotion\(^\text{14}\).

Following an in-depth inquiry aimed at analyzing the phenomenon in its many and varied problems, related both to the protection of investors and the efficiency of companies and financial institutions and to the functioning of financial markets, the Parliament then approved the Law No. 262 of 2005 on a


general reform of the legal framework of the sector. Among other things, this Law introduced into the Italian legal system the figure of the independent directors of companies with shares listed on regulated markets, in order to achieve a more efficient system of governance and to protect more effectively the interests of the minority shareholders.

By the phrase “independent directors” it is referred, pursuant to Article 147-ter, par. 4, of the Consolidated Law on Financial Intermediation (henceforth, Consolidated Law)\textsuperscript{15}, to those members of the Board of directors of the company - at least one member of the Board of directors, or two if this is composed of more than seven members - who meet the independence requirements for auditors set in Article 148, par. 3, of the Consolidated Law. If the statute so provides, independent directors must also fulfill the additional requirements of the codes of conduct drawn up by the management companies of regulated markets or by associations representing the sector. In essence, it is considered an independent administrator the person who does not maintain or has not maintained recently, even indirectly, such relations with the issuer or persons linked to the issuer as to influence their autonomous judgment. This would bring about the forfeiture of office due to the loss of the independence requirements provided by law\textsuperscript{16}. Therefore, whatever the origin of the applica-

\textsuperscript{15} Legislative Decree no. 58 of 24 February 1998 (Consolidated Law on Financial Intermediation, pursuant to Articles 8 and 21 of Law 52 of 6 February 1996, as amended by Italian Decree Law no. 179 of 2012, coordinated with conversion law no. 221 of 2012, and Italian Legislative Decree no. 184 of 2012.

\textsuperscript{16} About non-executive directors see, among Italian scholars, \textit{ex multis}, P. AGOSTONI, \textit{Alcune osservazioni in tema di amministratori esecutivi, non esecutivi e indipendenti}, in Le Società, 2000, 1, 37 ss.; R. LENER, \textit{Gli amministratori indipendenti}, in AA.VV. \textit{Profili e problemi...}
tion, what matters is the absence of ties with the company, the controlling shareholder and its group\textsuperscript{17}.

A non-executive independent director is now considered in the financial markets as a key to ensure good governance of listed companies\textsuperscript{18}, in order to protect minority shareholders within a system where directors are appointed mainly by the principal control\textsuperscript{19}. The activities of the independent director should then apply to prevent conflicts of interest, typical of the law of commercial companies, including majority shareholders, minority shareholders and directors of the company\textsuperscript{20}, helping to mitigate, if not to prevent, rent extraction at the expense of the minority shareholders\textsuperscript{21}. The independent director

\begin{flushright}
\end{flushright}

\begin{flushleft}\textsuperscript{17}See, on this point, R. Rordorf, Gli amministratori indipendenti, supra note 16, 154.
\textsuperscript{19}See the Review of the role and effectiveness of non-executive directors (Higgs Review), London, 2003, the enquiry led by Derek Higgs, experienced City investment banker, appointed by the UK government to look into the role and effectiveness of non-executive directors (NEDs) reported on 20 January 2003 (http://www.bis.gov.uk/files/file23012.pdf).
\textsuperscript{20}Compare, on this, G. Rossi, Il conflitto epidemiaco, Milano, Adelphi, 2003.
\textsuperscript{21}On the negative effects of the split between ownership and management in the company see the classic study of A. Berle Jr. – G.C. Means, The Modern Corporation and Private Property, New York, 1932 as well as, more recently, L.A. Bebchuk, A rent-protection theory of corporate ownership and control, Harvard Law School, Discussion paper John M. Olin Center for Law, Economics, and Business no. 260, Cambridge MA, 1999; A. Tucci, Gestione dell’impresa sociale e “supervisione” degli azionisti. L’esperienza italiana a confronto con la disciplina delle public
arises, then, as a tool to solve the problems of agency and information asymmetry between ownership and management, including the generality of shareholders, on the one hand, and the executive directors in charge of managing the company, on the other. Thereby independent directors play a role to ensure legality, fairness and adequacy for the organizational structure of the company.

Under Italian law, the figure of the non-executive independent directors was first introduced in the Code of Conduct for listed companies in 1999, as in the majority of these companies most shareholders usually do not belong to the control group. Their interests can be better protected by directors who are independent from the control group.

Subsequently, the European Commission has called on Member States, with Recommendation 2005/162/EC, to take steps to increase the presence and the role of non-executive directors and to enhance their independence. The European Commission took into account the provisions of the Anglo-Saxon legal systems, which recommend or require the presence of independent directors in companies.

---

22 See M. Baglioni – G. Grasso, *Nuovo Codice di autodisciplina delle società quotate*, in *Le società*, 2006, 1061 ss. Please note that after the first edition of the Code which contains the principles of corporate governance, drawn up by the Committee for the Corporate Governance of Listed Companies, chaired by Stefano Preda (hence the name “Preda Code”), dating back to 1999, there have been a second edition in 2002, and a third, following the reform of company law in 2006.

23 N. Salanitro, *Nozione e disciplina degli amministratori indipendenti*, in *Banca, borsa, tit. cred.*, 2008, I, points out that the figure of the independent directors does not have a tradition in the Italian legislation, inspired by the award of the management of the company to the directors appointed by the majority of shareholders.
the board of the company and the establishment of committees consisting wholly or mainly by them (for example, the Committee for audit and financial management, the Audit committee)\textsuperscript{24}, and the similar provisions of continental Europe\textsuperscript{25}.

Therefore, Article 1 of Law No. 262 of 2005 has introduced in the Consolidated Law the new Section IV-\textit{bis}, which includes Articles 147-\textit{ter}, 147-\textit{quater} and 147-\textit{quinquies}\textsuperscript{26}. In detail, Article 147-\textit{ter} regulates the election and composition of the board of directors of listed companies. After the most recent changes\textsuperscript{27}, it is set that the Statute provides for members of the Board of directors to be elected on the basis of the list of candidates and defines the minimum participation share required for their presentation, at an extent not above a fortieth of the share capital or at a different extent established by Consob with the regulation taking into account capitalization, floating funds and ownership structures of listed companies. The lists indicate which are the directors holding independent requisites established by law and by the statute. The Statute may also provide that with regard to the sector for directors to be elected, what is

\begin{itemize}
\item \textsuperscript{24} See in this regard F.M. Maccabruni – G. Presti, \textit{Gli amministratori indipendenti: mito e realtà nelle esperienze anglosassoni}, in Analisi Giuridica dell’Economia, 2003, 1, 100.
\item \textsuperscript{25} Compare A. Pericu, \textit{Il ruolo degli amministratori indipendenti nei paesi dell’Europa continentale}, in Analisi Giuridica dell’Economia, 2003, 1, 115 ss.
\item \textsuperscript{27} Above referred changes have been made in par. 19 of Article 3 of Legislative Decree no. 18 June 2012, n. 91 and par. 1 of Article 1 of the Law of 12 July 2011, n. 120.
\end{itemize}
not to be taken into account are the lists which have not reached a percentage of votes at least equal to half of the one required by the Statute for the presentation of same; for cooperative companies the percentage is established by the statutes also in derogation from Article 135 of the Consolidated Law.

Article 147-ter, par. 1-bis, states that lists are deposited with the issuer, also by means of remote communication, in compliance with any requirements strictly necessary to identify the applicants indicated by the company, by the twenty-fifth day prior to the date of the meeting called to resolve on the appointment of the members of the board of directors and made available to the public at the company's headquarters, on the company's website and in the other ways envisaged by Consob by regulation, at least twenty-one days prior to the date of the shareholders' meeting. Ownership of the minimum investment envisaged by par. 1 is determined concerning the shares recorded in favour of the shareholder on the day on which the lists are deposited with the issuer. Par. 1-ter adds that the Statute also lays down that the division of directors to be elected be made on the basis of a criterion that ensures a balance between genders. The less-represented gender must obtain at least one third of the directors elected. This division criterion applies for three consecutive mandates. If the composition of the board of directors resulting from the election does not comply with the division criterion provided for in the present section, Consob warns the company involved to comply with this criterion within the maximum
term of four months from the warning\textsuperscript{28}. The rules apply also to companies organised according to the monistic system.

Except as provided for in Article 2409-\textit{septiesdecies} of the Civil Code, Par. 3 enacts that at least one member shall be elected from the minority slate that obtained the largest number of votes and is not linked in any way, even indirectly, with the shareholders who presented or voted the list which resulted first by the number of votes. In companies organised under the one-tier system, the member elected from the minority slate must satisfy the integrity, experience and independence requirements established for auditors pursuant to Articles 148, par. 3, and 148, par. 4\textsuperscript{29}. Failure to satisfy the requirements shall result in disqualification from the position.

\textsuperscript{28} In the event of non-compliance with the warning, Consob applies a fine of from euro 100,000 to euro 1,000,000, according to criteria and methods laid down in its own regulations and sets a new term of three months for compliance. In the event of further non-compliance with respect to the new warning, the members elected lose their position. The statute regulates the methods of formation of the lists and the cases of replacement during a mandate in order to guarantee compliance with the division criterion provided for in the present section. Consob lays down regulations on the subject of infringement, application and observance of the rules on gender quotas, also with reference to the preliminary phase and the procedures to be adopted, on the basis of its own regulations to be adopted within six months from the date of entry into force of the rules.

\textsuperscript{29} Article 148, par. 3, of Consolidated Law stated that the following persons may not be elected as auditors and, where elected, they shall be disqualified from office: a) persons who are in the conditions referred to in Article 2382 of the Civil Code; b) spouses, relatives and the like up to the fourth degree of kinship of the directors of the company, spouses, relatives and the like up to the fourth degree of kinship of the directors of the companies it controls, the companies it is controlled by and those subject to common control; c) persons who are linked to the company, the companies it controls, the companies it is controlled by and those subject to common control or to directors of the company or persons referred to in paragraph b) by self-employment or employee relationships or by other relationships of an economic or profes-
Finally, in addition to what is provided for in par. 3, par. 4 states that at least one of the members of the Board of directors, or two if the Board of Directors is composed of more than seven members, should satisfy the independence requirements established for members of the board of auditors in Article 148, par. 3, and, if provided for, the additional requirements established in codes of conduct drawn up by regulated stock exchange companies or by trade associations.

Article 147-quater of the Consolidated Law, which regulates the composition of the Board of management of listed companies, provides in par. 1 that, if such a body is composed of more than four members, at least one of them must satisfy the independence requirements established for statutory auditors by Article 148, par. 3, of the Consolidated Law and, if the statute so provides, the additional requirements of the codes of conduct drawn up by the management companies of regulated markets or by trade associations. Par. 1-bis states that if the management board is made up of not less than three members, the provisions of Article 147-ter, par. 1-ter shall apply.

---

sional nature that might compromise their independence. Article 148, par. 4, of Consolidated Law, stated that in a regulation, in agreement with the Minister of the Economy and Finance, after consulting Consob, the Bank of Italy and Siva, the Minister of Justice shall lay down the integrity and experience requirements for the members of the board of auditors, the supervisory board or the management control committee. Failure to satisfy the requirements shall result in disqualification from the position.

30 This paragraph shall not apply to the Boards of directors of companies organised under the one-tier system, which shall continue to be subject to the second paragraph of Article 2409-septiesdecies of the Civil Code. The independent director who, following his or her nomination, loses those requisites of independence should immediately inform the Board of directors about this and, in any case falls from his/her office.
3. About compliance with independence requirements\textsuperscript{31}, the most recent judicial cases\textsuperscript{32} were able to clarify the criteria to assess the actual existence of any connection between the shareholder and the shareholder list presenter who expressed the independent director and the auditors of the minority, and the importance of the relationship between the independent director and the shareholder presenter of its list\textsuperscript{33}.

First, in terms of procedure, the Court has made it clear that it is not permissible to challenge only partially the appointment decision, or to obliterate the position of only a few of the members elected. Specifically, in the case of violation of the rules on personal qualifications of the independent members of minority or administrative body or supervisory body, it is precluded to the judge to replace the chairman of the company in the proclamation of the elect, considering inadmissible an appeal directed only to the appointment of certain directors or auditors. In this case, in fact, it is not deemed applicable the general

\textsuperscript{31} On this point see P. SANTELLA – C. DRAGO – G. PAONE, Who Cares About Director Independence?, March 2007, available at SSRN: http://ssrn.com/abstract=971189, that find here a general low level of compliance with independence requirements for both financial and non-financial companies, particularly with regard to the two key independence criteria of not having too many concurring commitments and not having business relationships with the company or an associated company. They also find that financial companies show a lower level of compliance than non-financial ones and are connected with each other and with a few non-financial companies through networks of cross-directorships.

\textsuperscript{32} For that decision see Tribunale Trieste, ord. 8 ottobre 2011, G.U. Sansone.

\textsuperscript{33} See, on this point, F. NIEDDU ARRICA, Un caso di impugnazione della nomina dell’amministratore indipendente e del sindaco di minoranza (con un appunto sulla portata della sospensione del voto conseguente alla violazione degli obblighi di comunicazione ex art. 120 t.u.f.), in Banca, borsa, tit. cred., 2012, 3.
remedy of partial nullity of the contract based on an atomistic conception of the resolution for the appointment of directors and auditors, though, in the minutes of the shareholders’ meeting, there may be an articulation of separate votes for each elected member.

On the other hand, with regard to the identification of situations incompatible with the status of independence that would result from links between the shareholder presenting the list and the controlling shareholder, the courts have ruled out the existence of such a connection that is based on a so-called "guarantee agreement" concluded between the issuer and the shareholder presenting the list, which has as its object the unsold shares after the share capital increase, based on an obligation to buy new shares\textsuperscript{34}.

The Court has also ruled out that the role of an independent director is incompatible with the office of director or former director of the company belonging to the shareholder presenting the list, because these relationships are not mentioned in Article 147-ter of the Consolidated Law nor in the Code of Conduct for listed companies. To this regard, it was already pointed out that the main function of the rules relating to the independence requirements is, in fact, to ensure the necessary presence of directors unrelated to the issuer with such relationships that are incompatible with the independent judgment as to decisions to be taken. It is important to note that, however, there is no rule

\textsuperscript{34} See, in this sense, F. NIEDDU ARRICA, \textit{supra} note 33.

4. Market self-regulation can then establish additional requirements for independent directors.\footnote{With reference to this eventuality, N. Salanitro, Nozione e disciplina degli amministratori indipendenti, supra note 23, wonders “if the reference to the statutory codes of conduct is to be considered limited, as required by the provisions of Civil Code, to the independence requirements requested in it, or whether it is extending to limits on the powers imposed on independent directors”.} For example, the Corporate Governance Committee of the representative Association of the Italian investment management industry (Assogestioni) has determined that the candidates presented by the asset management companies (società di gestione del risparmio, SGR) for the election bodies in listed companies, in their function as directors or auditors of minority, must be in possession of specific independence requirements beyond those required by law.\footnote{With this regard, M. Menchini, L'attività di corporate governance, in Assogestioni, 2008 Factbook. Guida italiana al risparmio gestito, supra note 16, 123, remembers that “the activities in the sector of the corporate governance by Assogestioni can be divided into three periods: an initial period characterized by a use of a voluntary activism (1984-1994) which was followed by an organized activity characterized by the creation of a formal committee (1994 - 2005), which was further developed with the establishment of rules and procedures established for the selection of candidates for the office of member of the administrative and control of major Italian companies (2005-present)".}
In Assogestioni document on "Principles and rules for the selection of candidates for office", adopted in 2008, it is in fact maintained that the candidates at the time of appointment, must not entertain, even indirectly, such relations with the company or persons linked to the company for which they are proposed, as to influence their independent judgment and perspective\textsuperscript{38}. The assessment of the existence of these requirements is made by referring to the criteria contained in the most recent version of the Corporate Governance Code of the Italian Stock Exchange (Borsa Italiana s.p.a.), integrated with a specific list of incompatibilities\textsuperscript{39}.

The composition of the lists will be based on a diversification of skills, welcoming personalities with experience in law, economics, business and technical fields; the competence of the candidates should be relevant to the business for which they are proposed. This is to ensure that directors and auditors elected by the SGR exercise complete control over the activities of the company and actively contribute to administrative or control decisions.

To be appointed, the successful candidates must sign a declaration stating, among other things, that they meet the requirements of professionalism, integrity and independence and confirming that they are not in any situation of incompatibility; they also accept to resign from office in the event that the requirements are not fulfilled anymore during their term of office, pledging, if elected, not to accept for at least one year officer or management positions in

\textsuperscript{38} COMITATO PER LA CORPORATE GOVERNANCE, Principi e regole per la scelta dei candidati alle cariche sociali, Assogestioni, Rome, 2008, 1.

\textsuperscript{39} For the requirements for the selection of candidates see COMITATO PER LA CORPORATE GOVERNANCE, \textit{supra} note 38, 3.
the same company or holding companies after the end of their mandate, except in the case of a candidacy by the Committee for Corporate governance\textsuperscript{40}.

Even the most recent amendments to the Code of Conduct for Listed Companies, taken on September 5, 2011, focused on the role of independent directors, whose number in the companies in the FTSE-MIB is now proportioned to a third of the members, while in other companies it amounts to two (3.C.3); the Code also promotes the appointment of a lead independent director, being due even when it is required by the same majority of independent directors (2.C.3)\textsuperscript{41}.

5. A key role is reserved for non-executive independent directors in the legislative framework of corporate transactions with related parties, where a clear risk can be seen of a conflict of interest between controlling shareholders and minority\textsuperscript{42}. Such transactions are, for this reason, subject by law to special rules of transparency and fairness\textsuperscript{43}.

\textsuperscript{40} COMITATO PER LA CORPORATE GOVERNANCE, supra note 38, 7.

\textsuperscript{41} With this regard see P.G. MARCHETTI, Il nuovo Codice di autodisciplina delle società quotate, in Riv. soc., 2012, 1, 37.

\textsuperscript{42} International Accounting Standard 24 about “Related Party Disclosures” stated that his objective is to ensure that an entity’s financial statements contain the disclosures necessary to draw attention to the possibility that its financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances, including commitments, with such parties.

\textsuperscript{43} About corporate transactions with related parties in Italian law see L. BONZANINI – A. MARTELLONI, Le operazioni con “parti correlate” di società “aperte”, in Le Società, 2005, 8, 950 ss.; M. STELLA RICHTER JR., Brevi osservazioni sulla proposta di disciplina regolamentare in materia di operazioni con parti correlate, in Riv. dir. soc., 2008, 4, III, 846 ss.; D.U. SANTOSUSSO, Sulla disciplina regolamentare di attuazione dell’art. 2391-bis c.c. in materia di operazioni con parti
The risk that the company enters such transactions on less favorable terms than those which would have occurred in the absence of the condition of correlation means that this phenomenon has become, especially in the last decade, absolutely crucial for the protection of investors, in order to avoid the expropriation of minority shareholders.\(^{44}\)

According to the recent Consob Regulation containing provisions relating to transactions with related parties\(^ {45}\), to strengthen the role of non-executive independent directors in all stages of the process of approving the transaction, giving adequate information to the public, an entity is a related party to a company if: (a) directly or indirectly related, through subsidiaries, trustees or an intermediary: (i) controls the company, is controlled by, or is under common control; (ii) holds a stake in the company to exert significant influence over the

\(^{44}\) C. AMATUCCI, Amministrazione e controllo delle società per azioni, in Enc. dir., Annali IV, 2011.

\(^{45}\) The Regulation was adopted by Consob with resolution no. 17221 of March 12, 2010 and subsequently amended by resolution no. 17389 of 23 June 2010. For a comment to this Regulation see M. BAGLIONI – G. GRASSO, Operazioni con parti correlate: il Regolamento Consob. Commento a delib. CONSOB 12 marzo 2010, n. 17221, in Le Società, 2010, 6, 727 ss.; V. SALAFIA, Le operazioni con parti correlate. Commento a delib. CONSOB 12 marzo 2010, n. 17221, in Le Società, 2010, 6, 735 ss.
entity; (iii) exercises control over the company jointly with others; (b) is an associate of the company; (c) is a joint venture in which the company is a participant; (d) is one of the key management personnel of the company or its parent; (e) is a close relative of a person referred to in paragraphs (a) or (d); (f) is an entity in which a person referred to in paragraphs (d) or (e) exercises control, joint control or significant influence or owns, directly or indirectly, a significant portion, but not less than 20% of voting rights; (g) is a supplementary pension fund, collective or individual, Italian or foreign, established for the employees of the company, or any other entity associated with it.

Transaction with a related party must be understood in the same Consob Regulation, any transfer of resources, services or obligations between related parties, regardless of whether for valuable consideration, considering, however, including merger transactions, spin-off by incorporation or strictly non-proportional spin-off, if carried out with related parties, and any decision on the allocation of wages and economic benefits, in whatever form, for members of the administrative and control bodies and management personnel with strategic responsibilities.

With regard to the regulation of transactions with related parties and the role it played in the independent directors, Article 4 of Consob Regulation requires first of all the Boards of directors or management board of the company shall adopt, as specified in this regulation, the necessary procedures to ensure transparency and substantial and procedural fairness of related party transactions, establish the manner and timing with which they are provided, to independent directors or board members advising on transactions with related
parties as well as to the management and supervisory bodies, information on transactions, and related materials, before deliberations, during and after the execution thereof\textsuperscript{46}. Resolutions on the procedures and any amendments shall be adopted following the favourable opinion of a committee, even specially formed, composed entirely of independent directors or, for companies that adopt the dual management and supervision system, of independent management and supervisory board members. Should no more than three independent directors remain in office, the resolutions shall be adopted following the favourable opinion of the existing independent directors or, failing that, after the non-binding opinion of an independent expert. The procedures provided for in par. 1, shall ensure coordination with the administrative and accounting procedures pursuant to Article 154-\textit{bis} of the Consolidated Law\textsuperscript{47}. In the interests of transparency, companies must make available to the public any opinions of directors or independent directors and independent experts\textsuperscript{48}.

In the event that a related party transaction is also subject to the reporting requirements set out in Article 114, par. 1, of the Consolidated Law\textsuperscript{49}, the com-

\textsuperscript{46} Consob Regulation, Article 4, par. 1, lett. e).

\textsuperscript{47} Should no more than three independent directors remain in office, the resolutions shall be adopted following the favourable opinion of the existing independent directors or, failing that, after the non-binding opinion of an independent expert: Consob Regulation, Article 4, par. 3.

\textsuperscript{48} Consob Regulation, Article 5, par. 5.

\textsuperscript{49} Article 114, par. 1, of Consolidated Law states that, without prejudice to the information requirements established by specific provisions of law, listed issuers shall make available to the public, without delay, the inside information referred to in Article 181 that directly concerns such issuers and their subsidiaries. By regulation, Consob shall establish the terms and conditions for the disclosure of information, without prejudice to the need to arrange for media publication through national daily newspapers, dictate measures to coordinate duties attribut-
munication to be disclosed to the public must be contained among other things, in addition to other information to be published pursuant to that rule, an indication that the counterparty to the transaction is a related party and description of the nature of the relationship as well as the possible approval of the transaction despite the contrary opinion of the directors or independent\(^{50}\).

With regard to the procedures for the approval of the resolutions relating to transactions with related parties, the Consob Regulation poses different disciplines depending on whether the transactions are of lesser or greater importance, according to the criteria laid down therein, and depending on the type of company governance (companies adopting traditional management and control systems or single-tier, companies adopting dualistic management and control systems, certain other types of companies). For example, for transactions of greater importance for companies that adopt the traditional management and control systems or single-tier, Article 8 of the Consob Regulations\(^{51}\) states that the procedures shall at least foresee: a) the reserved right to resolve of the Board of Directors; b) a committee, including specially formed, composed entirely of independent directors unrelated or one or more components of the same delegates are involved in the negotiation phase and the initial inquiry through receiving a complete and timely information and the possibility of request information and to comment to the managing bodies and entities re-

---

50 Consob Regulation, Article 6.

51 Without prejudice to the application of Article 11 with respect to transactions of greater importance, in addition to the provisions of Article 7, subsection 1, paragraphs b), c), e) and f).
sponsible for the conduct of negotiations or investigation; c) that the Board of directors approves the transaction after the reasoned opinion of the Committee indicated in b) on the interest of the company upon completion of the transac-
tion and on the convenience and the substantial correctness of the underlying 
terms, or, alternatively, whether other methods transaction approval are ap-
plied to ensure a decisive role by a majority of independent and unrelated 
directors; d) if at least three independent directors unrelated are not available, 
specific internal controls equivalent to those provided by the paragraphs b) and 
c) to protect the substantial correctness of the operation. Procedures may fore-
see, subject to the statutory provisions required by law, that the Board of 
directors approves transactions of greater importance despite the contrary 
opinion of independent directors, provided that the completion of these trans-
actions is authorized, pursuant to Article 2364, par. 1, No. 5), of the Civil Code, 
by the shareholders’ meeting acting in accordance with Article 11, par. 3, of 
Consob Regulation.

6. As a part of the legislative reforms to ensure greater protection to inves-
tors, the role assigned to the independent directors by Law No. 262 of 2005 is 
strategic to achieve greater transparency in the management of listed commer-
cial companies which make use of risk capital, in particular by protecting 
minority shareholders. It is well known, in fact, that political and legislative fac-
tors that promote shareholders’ rights greatly influence the development of the financial system, as well as political factors that promote investor protection\textsuperscript{52}.

New paradigms of corporate controls\textsuperscript{53} provide that, in addition to the control functions directly exerted by the CEO, to the control as evaluation decision by the Board of directors, to the supervisory control by auditors, the “new” supervisory function informing about the compliance to fairness rules by the audit committee composed of non-executive independent directors\textsuperscript{54}.


\textsuperscript{53} About this see the systematization made recently by P. Montaleenti, I controlli societari: recenti riforme, antichi problemi, in Banca, borsa, tit. cred., 2011, 5.

\textsuperscript{54} Some scholars, however, argue that the policy implications of the existence of a “dual role” of non-executive directors, that are supposed to serve both a management function and a monitoring function, are not well understood: J.R. Macey, Corporate Governance. Promises Kept, Promises Broken, Princeton and Oxford, Princeton University Press, 2008, 53-54, observes that “in particular, the issue of whether it is possible for board members to serve in both of these roles has not been thoroughly explored. As part of their core responsibilities to shareholders, corporate directors also have several discrete obligations. Perhaps chief among these is the requirement that directors become significantly involved in management when the corporation is experiencing a crisis, such as the loss of the CEO or the emergence of a corporate scandal that threatens the corporation’s survival. Directors clearly “earn their pay” during these sorts of crises and generally appear to perform well. Another traditional chore for independent directors in American corporate governance has been to approve transactions between the corporation and interested directors or officers. The job of the independent directors in this context is to ensure that the corporation is not disadvantaged by the directors or officers on both sides of the transaction. Directors also have generally succeeded in performing this limited, straightforward function. However, in recent years, directors’ roles have expanded from these more traditional, episodic responsibilities to being responsible for both monitoring management and participating in management decisions in the ordinary course of
Such a role attributed to the independent directors met with the appreciation of the doctrine, which only calls for greater effectiveness in exercising their prerogatives now recognized by law\textsuperscript{55}. It is acknowledged, however, that the efficiency in the application of various systems of corporate governance also depends on the cultural and ethical awareness of stakeholders\textsuperscript{56}.

This, in the larger frame of the European and Italian legal systems, as a result of the scandals and the financial crisis that began in 2007 in order to increase the powers of the shareholders against directors\textsuperscript{57}, seeking an appropriate balance between shareholders, directors and managers. This through the reform brought by Law No. 262 of 2005 which introduced into the legal system rules on the appointment of non-executive independent directors and of members of the supervisory board representing the minority shareholders\textsuperscript{58}.

---

\textsuperscript{55} C. AMATUCCI, Amministrazione e controllo delle società per azioni, in Enc. dir., Annali IV, 2011.


\textsuperscript{58} M. VENTORUZZO, La composizione del consiglio di amministrazione delle società mutate dopo il d. lgs. n. 303 del 2006: prime osservazioni, in Riv. soc., 2007, 205 ss.
The attention of the Italian law to the corporate governance of banks and financial intermediaries is most recently confirmed by the introduction of the ban on cross directorship for the banking, finance or insurance intermediaries, in order to combat anti-competitive practices related to the so-called interlocking directorates, in which the presence of individuals with leadership positions in companies operating in the same markets may develop anti-competitive practices\(^59\). In fact, Article 36 of Decree Law 6 December 2011, No. 201\(^60\) has planned a ban on “the office holders in the company management, monitoring and control and the top officials of companies or groups of companies operating in the credit markets, insurance and financial services to assume or exercise similar positions in companies or groups of competitors”.


THE IMPACT OF THE GLOBAL FINANCIAL CRISIS ON THE RUSSIAN BANKING SYSTEM

Galina Gospodarchuck - Sergey Gospodarchuck

ABSTRACT: In this paper we intend to analyze the causes of the world financial crisis triggered in 2008 and its impact on the Russian banking system, including changes in indicators of the banking system during and after the crisis as well as governmental measures adopted in order to stabilize the financial system. Our research showed that the Government’s anti-crisis policy was quite efficient. The crisis had a limited negative effect on banks and stopped all high-risk banking activities at the same time. This latter phenomenon enhanced the financial stability of banks, so the overall effect of the crisis looks positive.


The 2008 global financial crisis has provoked a huge impact on the world’s economy. The crisis had many causes and effects. It affected not only the economical but also the political sphere. Although it was global, the crisis revealed

* Galina Gospodarchuck is Professor of Finance at Lobachevsky State University of Nizhni Novgorod; Sergey Gospodarchuck is Head of the Laboratory of Modern Banking Technologies at Lobachevsky State University of Nizhni Novgorod.
itself in specific ways among different countries. Measures taken by governments to overcome the crisis also differed.

At the beginning of the crisis, risks and uncertainties of financial markets caused liquidity problems for several financial institutions, primarily banks. Through the banks, the crisis infected all sectors of economy. In addition, the financial component of the crisis showed itself most clearly. It offers more scope for investigating the causes and effects of the crisis.

After the crisis had begun, financial markets took short time to stabilize. Acceptable stability was observed by summer 2009, which let to consider the financial part of the crisis ended.

The economic recovery took longer time. By now, 4 years after the crisis all the long-term changes caused by the crisis can be considered complete. This allows us to analyze them without taking into consideration uncertainty related to changes in economic situation in future.

We begin to investigate the global financial crisis causes from a more general question, that is from the analysis of its determinants.

1. Among numerous processes taking place during the crisis, it is easy to highlight the most important one consisting in a sharp reduction in the money supply. This reduction made most assets prices decrease. Almost all other observed effects were due to this drop in prices. Among these, we can enumerate financial market fall, some investment funds and banks crash, the impairment of collateral, etc.

This implies two key questions to be taken into account:
What determines a sharp fall in money supply?

What determines assets devaluation if money supply decreases?

Let us answer the first question.

Modern fractional-reserve banking systems create the greater part of money by loan issues. The small remaining part is a stock of money issued by the Central Bank of the country. Except this money, there is also cash. It may be ignored as cash serves for a minor part of settlements, and some countries do not use it at all. For example, in Russia by October 1, 2012 cash in circulation amounted to 5.969 trillion rub.\(^1\) while the whole money supply (M2) was equal to 24.657 trillion rub. At the same time our previous research\(^2\) showed that a noncash turnover period in Russia is 4 to 5 days in average that is much lesser than a cash turnover period.

A money multiplier if calculated for noncash money represents a ratio of the Central Bank money and commercial banks money. In Russia, noncash money supply is equal to the total amount of bank deposits. According to the information given above, by October 1, 2012, noncash money in M2 amounts to 18.688 trillion rubles and in M0 – to 1.256 trillion rubles. Thus, we have a monetary multiplier of 14.88.

It is quite an important value meaning that commercial banks create the greater part of money without the Central Bank participation. We may observe


the same situation in many other countries. Any disturbance in money creation mechanism is likely to reduce the multiplier and thus the money supply.

The multiplier is strongly influenced by the demand for money from the economy (or, in other words, the availability of solvent companies) and risk expectations of banks. Failing companies eligible for a loan, credit money supply is likely to stop growing. If the risk in the economy is high, banks will increase the reserve that will also lead to the monetary multiplier reduction.

To prevent this, the Central Bank has the following main tools:

- the limitation of the monetary multiplier by changing the required reserve ratio and others;
- the development of a mechanism to provide a quick liquidity to commercial banks in a crisis.

Now let us answer the second question and explain how asset prices depend on money supply.

First, notice that this dependence is not proportional. If the quantity of money decreases, there is a decrease in average prices but the velocity of circulation rises and this partially compensates the lack of money. It is also true for average prices. Prices on different assets have a different velocity. Assets can have two prices: ask price (from a valuation report or any other official sources) and a real price used in selling transactions. If someone has to tell an asset price and there is no need to sell it urgently, then its official price can be used, which could be times higher than its selling price. This discrepancy became especially noticeable in times of crisis on the real estate market including residential property in Russia and on numerous assets markets in the USA. The USA had even to
suspend FAS Statement 157 emphasizing that a fair asset value is market-based. After it had become inactive, banks could value assets basing on mathematical models, which meant a certain freedom of action. It points out the seriousness of the problem.

Also, note that the assets devaluation as collateral for loans raises loan risks and hence makes the monetary multiplier further decrease.

It follows from the foregoing that the need to sell assets at falling prices is the main reason for that fall in prices and leads to a crisis.

The causes of fast assets selling in case of their devaluation are well known. The obvious reason is the use of assets as collateral for loans. The use of assets for production or investments is a less obvious reason. In the first case, production activity generates income, in the second one it is due to increase in market value of the asset. A special term asset-based economy is used to describe an economy where the greater part of income is generated by increase in market value of assets but not by production activity.

Production income is relatively stable. It could be threatened by competition, by increase in cost of resources, by drop in demand.

Income generated by increase in market value could disappear in a moment. An asset has to be sold to draw income but it is not profitable while the asset price is growing. When the market grows, there is sales deficiency. It leads to too optimistic assets valuation, which is true for low sales markets. If sales grow due to any reason, buyers do not have enough money to buy all assets at previous prices. The prices drop.

---

3 See the website http://en.wikipedia.org/wiki/Mark-to-market_accounting.
The possibility of financial markets long-term growth is a prerequisite of asset-based economy. In its turn, it requires a possibility of long-term money supply increase.

The asset-based economy began to shape in the USA from the beginning of 1980s after the definite cancellation of the gold backing of the United States dollar in 1971.

A series of financial crisis in 1987 in the USA, in 1990s in Asia interrupted the market growth. The asset-based economy started to grow significantly after 1996. This process was further advanced in 2000s by the started decrease in interest rates with its official aim to stimulate the economy. The real task was to ease money and credit emission. The development of asset-based economy led to the discussed crisis in 2008.

The financial system of Russia has some specific features of the described above asset-based economy, so we can make a list of indicators to assess the global crisis effect on the Russian banking system in line with its causes.

They are as follows:

1. Money and credit indicators;
2. Governmental measures to support bank in times of crisis;
3. Commercial banks activity indicators;
4. Structure changes of the banking system.

2. Fig 1 shows changes in monetary supply and monetary base in times of crisis and after it. As the crisis began, the money supply started to decline.Dia-
gram (fig.1) shows that the local peak was reached on September 1, 2008 (14.2 trillion rub.) and it fell to the lowest on February 1, 2009 (11.4 trillion rub).

The monetary supply decreased by 1.24 times, and so did the prices. However, prices on some goods (exchange goods, real estate, etc) decreased sharply. For example, prices on oil products fell twice, on real estate by two to three times. It seems that short-term money deficiency was more significant while M2 aggregate changes were smoothed by long-term loans in its structure. Noncash part of M2 underwent less severe changes: it went down by 1.27 times. It meant that cash money did not have any vital influence on M2 dynamics.

To respond to the liquidity deficiency, the Bank of Russia took measures that aimed to increase monetary multiplier by reducing reserve requirements (fig. 2). At the same time, the refinancing rate was increased rather than be reduced (fig. 3). This can be explained by the total growth of interest rates and by the limitation of inflation rate on basic goods. This step generates the difference between the Bank of Russia and the European Central Bank and other central banks that brought down interest rates. They were in position to do it with no fear of inflation, as deflation was stronger in developed economies.

Monetary base did not change significantly in times of crisis (fig. 1). It would have grown providing the Bank of Russia decreased the interest rates but the Bank’s decision was negative.

The Bank of Russia and the Russian Government exercised caution because banks, investors and the majority of population expected the same ruble devaluation as during the crisis of 1998. That was why extra money would have been
invested in dollar assets. In times of crisis, the ruble was moderately devalued, by 25% approximately. The gold reserve reduction from 600 to 300 billion dollars compensated the capital outflow.

For the rest, the crisis was deflationary. Russia replenished the spent reserves and now they amount to 526 billion dollars⁴.

Fig. 1 Monetary supply and monetary base, bill. rub.

Fig 4 shows a noncash M2 and noncash M0 adjusted monetary multiplier. We can see its moderate growth at the beginning of the crisis. The growth started while required reserve ratio was significantly decreasing to 0.5% on October

⁴ http://www.cbr.ru/eng/hd_base/mrrf/
15, 2008. These dynamics show that required reserve ratio is useless in monetary management, especially during crisis. The required reserve ratio decrease resulted in release of about 100 billion rubles.

![Fig. 2 Required Reserve Normative Ratios](image)

Before 1 Nov 2009: Ratio 1 for liabilities to non-resident credit institutions; Ratio 2 for liabilities to individuals in rubles; Ratio 3 for other liabilities.
Since 1 Feb 2011: Ratio 1 for liabilities to non-resident entities; Ratio 2 for liabilities to individuals; Ratio 3 for liabilities to credit institutions.

Fig. 3 Refinancing Interest Rate of the Bank of Russia
From spring 2009 we might observe low values of monetary multiplier. They were due to very high interest rates. From spring 2009 the Bank of Russia started to ease refinancing rate that brought an increase in loan demand. The multiplier grew. By autumn 2012 the monetary multiplier pierced the top values it had during the crisis. At the same time, no signs of a crisis were observed. That proved that 4 years were enough for banks to get used to the strain on liquidity.

Fig. 5 shows monetary base structure. It has the following peculiarities:

Required reserves fell almost to zero during crisis and then they started to grow smoothly.
Redundant liquidity reached its peak over the autumn 2009 through autumn 2011 period.

Redundant liquidity disappeared by autumn 2011.

The refinancing rate was reduced to 7.75%, which is very low for Russia and could have caused the inflation growth. At the end of 2011, inflation was artificially brought down by limiting the energy prices increase. The prices jumped in the second half of 2012. This postponed inflation and deteriorating global economic environment required additional anti-inflationary measures to be undertaken.

---

Fig. 5 Non-cash monetary base components, billion. Rub.
3. During the crisis, Russia took measures to support bank liquidity. The Bank of Russia introduced a compact procedure of crediting via repos and expanded the list of securities that may be used in repos.

Lowering of the required reserve ratio also aimed at rising bank liquidity. The Bank of Russia gave targeted loans to large banks to stabilize their financial condition.

Table 1 displays the most important steps made by the Bank of Russia:
Measures to Support Russian Banks Liquidity in October-December 2008

<table>
<thead>
<tr>
<th>Date</th>
<th>Measure</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>From October 15</td>
<td>All required reserve ratios reduced to 0.5%</td>
<td>About 100 billion rub.</td>
</tr>
<tr>
<td>October - December</td>
<td>Measures within the framework of the Federal Law #173-FZ &quot;On additional measures aimed at supporting financial system of the Russian Federation&quot;: in line with agreements concluded with credit organizations the Bank of Russia has to make up part of their losses due to transaction with banks which licenses were revoked; Vneshekonombank gave JSC VTB 24 bank a subordinated loan. Vneshekonombank gave JSC Alpha Bank 24 bank a subordinated loan</td>
<td>200 billion rub. 10.2 billion rub</td>
</tr>
<tr>
<td>November</td>
<td>Regulations #323-P was adopted, which gave the Bank of Russia the right to provide unsecured loans.</td>
<td>The total amount of given loans is 3 trillion rub (from 10.19.08 to 12.26.08)</td>
</tr>
<tr>
<td>From October</td>
<td>The limit to the deposit of temporarily idle budget funds was raised</td>
<td>Deposited funds amounted to 636 billion rub (from October 1 to November 06)</td>
</tr>
<tr>
<td>October - December</td>
<td>Requirements were reduced to assets quality accepted as collateral for loans</td>
<td>The total loans secured by “non market assets” amounted to 369 billion rub</td>
</tr>
<tr>
<td>From November</td>
<td>Deposit Insurance Agency turned around 15 banks in accordance with the Federal Law #175-FZ “On additional measures aimed at stabilizing the banking system until 12.31.2011”</td>
<td>n/a</td>
</tr>
</tbody>
</table>

The Government helped to make deposits in large banks. These measures were targeted. The total amount of money deposited in state banks on the contrary diminished (fig. 6) as tax revenues decreased. Thus, this money mattered only at the beginning of the crisis and by the end of 2008 was substituted for other tools of support.

---

5 Essence and mechanism of the lender of last resort function implementation by the Bank of Russia in the modern context (abstracts), Banking Supervision and Regulation in financial crisis. The 6th Scientific and Practical Conference. Nizhny Novgorod. The Bank of Russia Head Department in Nizhny Novgorod Region, 2009, pp. 55-60.
The Government took measures to stabilize stock-exchange market. 175 billion rub. were allocated in order to buy stocks that in the end entered the banking system. Purchases were made at the end of 2008 and the beginning of 2009 via Vnesheconombank.

Therefore, the Bank of Russia and the Government took very logical actions during the crisis.

Let us assess possible steps that the Bank of Russia could make to resist future crisis. As the Bank of Russia can affect only the financial sphere, its anti-recessionary policy should aim at resisting liquidity crisis in the banking system. These crises are very dangerous because their development can be fast and uncontrollable. To reduce monetary multiplier is one of the measures taken to avert liquidity crisis. The multiplier could be maintained at 6-8 in calm times, which will correspond to a 15% share of required reserves in bank loan portfolio. When the crisis begins, required reserve ratio could be lowered to free a large amount of bank resources comparable to the amount of their equity. This measure is similar to loans granted by the Bank of Russia. However, compared to the loans, it works much faster for it does not require a loan agreement and affects all the commercial banks.
Fig. 6. State authorities’ deposits in banks, billion rub.

Fig. 6, 7, 8, 9 are based on the bank accounting published by the Bank of Russia: http://www.cbr.ru/credit/forms.asp.
Monetary multiplier could be reduced by lowering required reserve ratio or other ratios limiting loans. Fig. 4 shows that the opportunity was not exploited and the multiplier is still high nowadays. The above said limitations were not introduced because of political considerations, and because they could disaffect banks and business.

To provide banks with fast financing is another way to resist liquidity crisis. In autumn 2012, the Bank of Russia declared that it had developed a mechanism, which included measures for stabilizing stock exchange market.

The Russian Government anti-recessionary policy for the most part is aimed at real economy. Various programs are implemented to develop Russian
industry. During the crisis final consumers, i.e. real economy companies, could not get money. Non-repayable financial aid was not planned. It was necessary to lend support on a repayable basis, i.e. by giving loans. However, credit risk rose and made it impossible to credit many companies.

The analysis shows that this was neither bank’s nor Government’s fault but companies’ one. Before the crisis, they secured loans using reliable collateral but did not pay attention to the current activity. After the crisis, collaterals became useless, banks started to analyze production related indicators, market positions of companies. However, those indicators appeared to be so bad that banks refused to give loans. Cost of production was too high (while prices on resources fell in times of crisis) and the demand was insufficient. The demand was poor because household income dropped and many service-oriented companies offered services people could easily do without.

Technical re-equipment of enterprises and primary branches development increase their share in economy and thus, make it crisis – resistant.

4. Bank performance indicators changed the following way. When the crisis began, there was liquidity deficiency, which made credit and deposit rates grow.

Deposit rates achieved the top of 18% by the end of 2008. After that, they started to fall smoothly following the decrease of refinancing rate. Credit rates changed in the same way. It is difficult to estimate maximum credit rates because they depended much on credit worthiness. Many companies were not granted any loans at all. Deterioration of loan quality impaired borrower catego-
ry quality\textsuperscript{7} and made it necessary to increase reserves against possible losses. As reserves are created from profit, many banks showed losses at the end of the year.

Fig. 7 shows a net increase in overdue loans. Because of a large amount of overdue loans, banks tried to conceal late payments. Generally, loan agreements were re-executed and repayment schedule was changed.

Low interest rates on loans given before the crisis contributed to increase in losses. Not all the agreements stipulated for raising credit rates. Banks tried to raise credit rates by legal means referring to force majeure.

During the crisis, many banks had difficulties in managing property seized as collateral for loans. Many loans were secured on real estate, even on unfinished construction. As real estate market shrank much during the crisis, seized property could not be quickly resold. As a rule, unfinished constructions had to be completed. To solve the issue large banks created special investment funds managing seized assets. The bank in its turn possessed 100\% of equity. Thus, the bank avoided placing real estate on the balance sheet.

In other situations, banks took possession of a part of shares used as collateral for loans. Fig. 8 shows changes in bank investment in other companies’ equity made either directly or through a trust. During the crisis, no significant growth was registered. This is because many assets were purchased at understated prices as they were encumbered.

\textsuperscript{7} Russian banks use five categories of loan quality, reserve level from 0 to 100\%
In spite of overdue debts and losses during the crisis, net assets of the banking system grew smoothly (fig. 9). It is explained by new loans taken to solve liquidity issues of bank clients. Old assets lost value but were reported at previous prices in books as bank assets where loans dominated are rarely revalued officially. Banks often revalue financial assets circulating on security market and currency assets.
Therefore, changes in assets of the banking system are a bad indicator of the crisis as well as changes in investments. Overdue debts growth reflected the best the crisis effects on banks.

5. Only few banks failed (fig. 10), as the Government did not drive banks to bankruptcy but saved them by selling to larger banks or to non-financial organizations. The greater part of acquired banks had a negative inmost value so their purchase price was not high and buyers were granted loans to support the purchased banks. For example, KIT-Finance Bank was sold for 100 rubles to Alrosa.

Fig. 9. Net assets value of the banking system, billion rub.
Company and to Russian Railways. Vneshekonom Bank purchased Svyazbank and Globex Bank for 5000 rubles each. The Bank of Russia gave Vneshekonom Bank loans of 2.5 and 2 billion rubles respectively for their financial recovery.8

Thus, the banking system consolidation became one of the crisis effects. Small banks appeared to be bad managed. In times of crisis, violations even serious were discovered more often in small banks than in large ones. That is why the Government and the Central Bank policy that they are now implementing has been destined to aim at the banking system consolidation. Large banks under state control on the contrary turned out to be efficient in carrying out anti-recessionary measures.

6. This study of the global financial crisis effect on the Russian banking system enabled us to make the following conclusions:

In spite of losses, the state of banking system improved because of the crisis. Due to the crisis, banks reduced loans to high-risk sectors inclined to create financial bubbles, i.e. real estate and stock exchange markets.

The crisis effect on banks was typical for deflationary situations. The Russian peculiarity was a possible inflation risk due to the started capital outflow.

The analysis shows that state authorities’ actions to overcome the crisis were careful. They took into consideration both deflation and inflation scenarios.

The banking system soundness during similar crisis depends greatly on the state of the real sector of the economy. Therefore, anti-recessionary measures

designed only to banks, are inadequate. An efficient anti-recessionary policy has to contain measures to improve the structure of the real sector of the economy.