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# A POSSIBLE RECONSTRUCTION OF RISK REGULATION IN FINANCIAL MARKETS

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**Prof.ssa Michela PASSALACQUA**

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## 1. RISK REGULATION IN ADMINISTRATIVE LAW

### *1.1 Society and risk economy*

The most recent studies in sociology identify risk as one of the typical elements of post-modern societies, which is the outcome of decisions taken in the name of scientific, economic and technological progress. In order to reduce the occurrence of future harmful events associated with it, a probabilistic assessment of such risks is needed so as to discipline it within public regulations and regain some sort of security through preventive and sometimes even precautionary actions.

However, globalization, essentially concerning negative events (such as environmental accidents and financial crises), has nowadays increased those risks characterized by a difficult assessment. This has considerably reduced the security gained through risk management and enabled risk to spread worldwide in unexpected manners.

On the other hand, economics has shown an ever-increasing interest in risk.

The dominant approach, the so-called neoclassical approach, considers risks as always assessable, since information asymmetry, capable of generating insecurity, can be totally set to zero by the markets' full ability to reflect all the information available into the prices (referred to as *Efficient Market Hypothesis*).

Nevertheless, such approach has been recently opposed by a new trend that does not share the *Efficient Market Hypothesis,* inasmuch as it considers uncertainty as not eradicable, since markets are not always able to reflect the “cost” of the uncertainty inherent in information asymmetry into the prices. This is due to the fact that when individuals are called to take decisions in lack of complete information, they tend to perceive risk distortedly, compared to the result of a normal probabilistic calculation, and to rely on heuristic intuitive solutions which do not always lead to entirely optimal decisions.

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### *1.2 Law and risk regulation*

While sociology and economics have only recently begun considering risk more and more carefully, risk has always undergone an accurate analysis by jurists even in the past.

There are obviously institutes and branches in law, such as the law of obligations and the contract law, in which risk, identified as "probability of a prospective economic loss" and subject to capital assessment, becomes part of juridical cases.

On the contrary, a different phenomenon can be traced back to the so-called "risk law", which is more closely concerned with risk society and in which the law has to manage the risks caused by technological uncertainty deriving from the technological and scientific progress.

Besides the uncertain future occurrence of harmful events, these risks are characterized by the ability to produce positive effects to the risk-taker's advantage, in the event that the decision to avoid risk may generate in turn a different and possibly even worse risk by bringing technological development to a standstill.

Given that a potential advantage can only be achieved by taking risks, public authorities are required to identify the maximum tolerable risk. Should the risk of damage exceed that threshold and therefore be considered not acceptable by the society, he shall renounce the advantage and apply the precautionary principle.

Notably, the administrative law has always dealt with the protection against risks, in particular concerning citizens, consumers and users' interests, who may be reached and damaged by risky decisions.

Risk acquires legal relevance as a "regulatory" parameter for the ensuing adoption of precautionary and preventive measures intended to avoid future damages.

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On the other hand, precaution rises to a general principle of administrative law and allows public intervention in its “moderate” version, only if the risk is at least likely to occur and it is based on objective scientific verifications.

In more detail, risk management is realized firstly through a phase of proper regulation, by means of which risk-oriented rules are developed, and secondly through their subsequent application.

Once the risk “technical” assessment has been carried out (through scientific parameters and procedures), the regulating task shall involve identifying the uncertainty level of that specific risk as accepted by the juridical system on the basis of the aforementioned assessment, as well as guaranteeing the normal activity of risk management, which may entail establishing prohibitions or permissions to operate depending on the specific nature of the risk, subject to particular standards of risk sustainability.

The specificity of risk regulation finally emerges from the rules whereby it is thoroughly applied. Indeed, these give legal recognition to the outcomes of a scientific indicator (i.e. the probability index), which – despite being often uncertain – enables the identification of the risk itself, while determining the progressive grading of the rules, according to the probabilistic index of the potentially occurring event.

Thus risk regulation must necessarily face both the inability of science to identify risk with certainty and the causal relationship between risk factor and potential damage particularly, which seems to be therefore only likely to occur. This condition of substantial scientific uncertainty calls for the above-mentioned precaution as a supplementing interpretation principle to identify the rules to which risk needs to be subjected. On one side, ordinary prevention of certain risks is realized through protection rules addressed to the community potentially affected; on the other, the application of the precautionary principle, according to a moderate and sensible view, aims at avoiding an activity, when it is reasonably likely (rather than certain) to cause irreversible damages in the future. This

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enables to protect the interests involved in considerable advance. It is just in view of this hypothesis that dealing with risk can be referred to as risk management.

When risk becomes emergency, due to a high probability of a potential damage, exceptional and predetermined measures are needed over a limited time span, in order not to damage the interests protected by the regulations.

Finally, a new frontier in the use of emergency powers has emerged. It aims at an extraordinary management of significant risks by acting upon them as stable and ordinary instruments. This phenomenon can be traced back to the progressive establishing of a "risk society", in which the emergency is no longer an exception, but rather the consequence of a permanent state of risk, either certain or potential.

An instance of this second dimension of emergency power can be clearly identified in the fields of bank legislation, insurance and financial intermediation. Indeed, if the intermediation infringes the complex regulation on savings protection, the legislator may impose some restrictions and decide to activate some form of provisional public emergency management of the subject under surveillance. This can be performed through its provisional administration with appointment of an external commissioners, as well as through regulations now extended to an increasingly wider range of intermediaries. The goal is to remove the irregularities that could determine severe damage to the public and private interests involved. We can here notice the precautionary function inherent to this extraordinary procedure, which is functional to an early risk management and to reduce risk below the acceptability threshold.

## 2. **RISK REGULATION IN FINANCIAL MARKETS**

### ***2.1 Risk and financial markets***

The recent economic and financial crisis has even more emphasized how risk is inherent to banking and finance.

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Especially banking is subject not only to those risks typical of any other enterprise, but it is indeed "intrinsically" risky, given its close relationship with public saving.

Credit loan, performed exclusively by banks, in accordance with Art. 10 of t.u.l.b (Bank Law), is realized by means of two different operations. On the one hand, it is carried out through short-term gathering of deposits, recorded as debit budget and refundable to the savers at any time. On the other hand, thanks to these funds, it is possible to grant longer-term loans generating credit budget, which still cannot be quickly paid and disinvested .

Thus the inherent risk of the banking activity lies in the very close link between short-term deposit and long-term loans, where risks are connected with the binding relationship established.

However, the financial market is getting more and more integrated and less compartmentalized, which has allowed banks to start an increasing financial intermediation activity. As a result, they are inevitably exposed to the typical risks of financial intermediation.

Furthermore, the adoption of new techniques of financial engineering, such as securitization and derivatives, involves a clear-cut separation between risk taker and risk manager on one side and holder of securitized loans on the other. This has allowed an ever-increasing massive financing of risk credits (deriving from loan contracts) transformed into market risks, as a result of their conversion into securities. This has produced the over-structuring and pulverization of risks among a multiplicity of subjects and their consequent spread among investors.

Besides causing a loss of responsibility in the banks by partly relieving them of the risks taken, these new business models have made risk assessment and control more complex, as they have made market less transparent and increasingly risky. As a consequence, risks can now produce systemic effects that may lead to the crisis of an entire financial system in turn.

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### *2.2 Prudential supervision and risk regulation*

In the light of the scenario here presented, juridical systems must be aware of such risks and find new instruments of management and control. Referring to the financial markets in particular, we intend to assess the possibility of adopting new rules guided by the concepts of risk regulation and precautionary principle above all, in order to allow operators to take only credit and market risks estimated as tolerable and to prohibit their assumption in any other case.

The volume we summarize in this contribution pinpoints the guidelines that public intervention on the risks resulting from banking and financial markets has historically followed.

The original regulation following the Great Depression of 1929 had an exceptional nature with respect to the ordinary law that granted full freedom of risk allocation to the enterprises. Decisions on risk were taken away from the banking institutions through a state-controlled intervention; namely the well-known structural supervision.

Within our juridical system this kind of direct control over the operators, carried out by means of administrative authorizations and operational restrictions, was even more meaningful since banking institutions were state-owned.

However, these special regulations were progressively reduced. Being inconsistent with the new banking statute now competing with other European operators in the liberalized capital market, the structural supervision over operators was eventually abandoned. In this new context, the decisions on risk management and allocation have been left to the full entrepreneurial autonomy of the banks.

It was nonetheless necessary to provide some kind of public supervision and “control” over risks to prevent banks from taking excessive risks with the aim of making profit to the detriment of the major public interests, such as savings protection

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Consequently, a new kind of supervision - the so-called prudential supervision - started gaining ground during the '80s.

By adopting prudential rules affecting several aspects in the activity and organization of the operators supervised, the latter are bound to respect the capital requirements that can provide against the risks taken, if necessary.

It is therefore the intermediary's capital that becomes the main protection against risk, as it guarantees the intermediary itself, should the risks turn into concrete reality and cause capital losses or temporary liquidity shortage.

Although a free and competitive financial market requires to leave risk management and allocation to the intermediary, some form of ex-ante market-friendly public supervision can be identified. This aims at discouraging banks from taking excessive risks by increasing capital requirements.

This different approach to risk regulation was first and fully accepted worldwide under the Basel Capital Accord in 1988, also known as Basel Accord I, adopted by the Basel Committee on banking supervision, later renegotiated following the economic financial crisis of 2007.

Following this first Accord, the stable capital adequacy of the banks as regards risks is ensured by fixing a funding ratio, called “solvency ratio”, which consists in a capital amount (at least 8% of the banking activity), designed to cover possible liquidity shortages connected with credit risk. The capital requirements identified were consequently weighted according to credit risk through increasing and fixed differential parameters, depending on the counter-party (governments, banks, private companies).

Besides oversimplifying the calculation of risk, limited to the sole prediction of such parameters and lacking a close examination of creditworthiness, operability and capital features of each operator, the real drawback of the Accord was its taking into account only credit risk, although banks were getting more and more exposed to market risks, due to their new operability.

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After the revision of 1996, new financial provisions were introduced to face the above-mentioned market risks. In addition, risk assessment through models set by the banks was also granted in compliance with a range of precise parameters.

Further to this, the guidelines of the Accord were partially extended in Europe to financial intermediaries other than banks, even though the original framework of prudential supervision was intended for the sole banks.

This prudential supervision underwent a thorough revision under the new Accord of 2004, the so-called Basel II, which reframed it completely. It is worth noticing that the regulation on capital requirements was reviewed. In short, the original approach, which intended theses parameters as fixed and predetermined, was surpassed. They consequently started to be considered not only in terms of quantity but also quality and referred to the quality of the various components of the bank's capital, as well as related to the various risks taken.

The assessment of customers' solvency risk is mostly left to external rating agencies or occasionally to the banks' internal organization, which follows evaluation models adopted by the operator upon authorization of the supervisory authority.

On 6th December 2010 a new Capital Accord (better known as Basel III) was signed.

Despite reinforcing prudential regulations to compensate for the evident deficiencies, the accord does not reject the original approach, which aims at ensuring the stability of the banking system by imposing predefined capital requirements to face risks. A qualitative and quantitative improvement of the financial instruments to estimate the regulatory capital is certainly required; however, the conviction that capital adequacy is still the best deterrent to taking excessive risks remains essentially deeply rooted.

Therefore such prudential regulations, inspired by economic efficiency, attempt contrasting and preventing market failures, though risk assessment, decision and management are left to the operators.

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At this turning point in history, it seems necessary to "revise" the so-called light-touch public supervision and to inevitably, though implicitly, question public supervision in itself, as it is essentially limited to an "approval" of the choices made by others.

The idea is that of consenting an alternation with an intensive supervision that, in the author's opinion, can be already identified in the increase of the public injunctive powers appointed to the Supervisory Authority, as stated in paragraphs 4.1 and 5.2.

We need to "reconsider" whether public intervention is possible on this matter and whether some form of risk management can be applied to the financial markets too, even resorting to the prudential principle in case of particularly harmful or catastrophic events.

If an "early diagnosis", typical of prudential rules, eventually coincided with the prevention of certain risks and potential damages, risk regulations would enable the use of prudential instruments to anticipate public intervention. Hence, the protection and management of increasingly unpredictable risks would take place at a stage in which there is no certainty that the approach adopted might bring to future damages, although this may occur in probabilistic terms, on the basis of technical and scientific data.

## 3. RISK REGULATION IN CRISIS LAW

### *3.1 The failure of prudential regulation and the crisis of risk control*

The economic and financial crisis has revealed the numerous evident deficiencies of prudential regulation, which has not been able to curb risks, as it could only intervene through an external control. The ever more complex operations of financial engineering have enabled the operators to circumvent prudential regulation and to expose themselves to externalized risks out of public control. Furthermore, rules and regulators ignored the systemic nature of the risks.

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Considerable doubts have also been raised concerning the procedures leading to the approval of the Basel Accords, in which the instruments of active participation ensured to the advantage of the sole supervised subjects, have enabled them to start regulatory captures influencing the very subject-matter of prudential regulations, by modelling them on their needs. The committee could shape prudential standards following a pressing negotiation with the recipients. Such standards do not result from specific technical and scientific investigation, activated by independent subjects, but they rather acknowledge the demands of the operators involved.

Further to the outcome of the negotiations between supervisor and supervised, everything leads us to consider that the standards elaborated are ultimately comparable with hypotheses of private self-regulation.

Not to mention the fact that both the members of the scientific community and the savers are practically left out of the consultation; being the former without incentives and the latter without the required resources. We are therefore confronted with a questionable and partial "reappraisal" of the American *notice and comment* institution in a global perspective; hence, the investigation is exclusively open to the interests of the economic operators to which the rules are addressed. In conclusion, the standards of the Basel Accord seem to coincide with minimal security levels to contain risk, based on accounting standards and primarily "agreed upon" by supervisors and supervised by means of massive consultations, which are essentially accessible only to the intermediaries. The outcome is the creation of a set of regulations that apparently meet the supervisors' needs, since they seem to "curb" the supervised by the precautionary principle, but which actually turn out to be difficult to apply or easy to circumvent.

At the same time such regulations disregard a variety of risks that cannot be politically controlled (large banks, shadow banking system) or pointedly detected (credit concentration).

All this involves prudential risk regulation being very distant from risk regulation as conceived in the administrative law, since the role of the public authority is basically

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reduced and marginalized in the former. Hence, it is a phenomenon to be clearly distinguished from the so-called meta-regulation, confined to the externalization of risk management and control to privates, though risk assessment firmly remains competence of the public authority.

Indeed, when risk management has recourse to standards, these are adopted by balancing conflicting interests and aiming at prudentially identifying the minimum tolerable risk threshold, beneath which the uncertain event, being juridically irrelevant, can be disregarded.

On the contrary, the standards "negotiated" within the Basel Committee are not grounded on the primary need of managing the uncertain, but rather on the need of standardizing the rules of global finance. For this purpose, the risk level identified is considered acceptable not because parametrized on the results of technical-scientific investigations, but rather because it is shared by the addressees, standardized to their best practices and therefore compatible with competitiveness. In addition, exceeding such risk threshold is not prohibited, but only discouraged.

In short, the prudential regulation is elaborated in the absence of a constant direct dialogue with science, which is typical of risk regulation. The participation to the global processes responsible for the creation of rules is dangerously one-sided. The regulator does not seem to be able to play a third-party role with respect to the information acquired, with the aim of protecting the common interests involved. It is not clear what the values used to determine the level of tolerable risk consist in.

It is natural to wonder whether the methods used to establish the standards and their contents can guarantee savings protection, being the latter a value defended by the constitution, at least in our national juridical system.

In corroboration of what so far stated, it is not to be forgotten that many experts, mathematicians and economists in particular, are critical of the market regulation based on the above-mentioned prudential rules, as they are considered somehow onerous to the operators on the one hand and totally inadequate to pursue the set objectives on the other.

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At the same time, the well-known Goodhart's law challenges the public intervention that is merely based on incentives by empirically proving that, any time the regulator adopts statistical parameters and indicators to summarize a complex phenomenon, such measures lose their value if they are taken as targets to reach by the supervised, due to the unavoidable opportunistic behaviours emerging from both parts.

Severe criticism is raised against market risk assessment models adopted by financial operators, as provided by the Basel Accords themselves (the so-called VaR). They are actually patterns that underestimate the losses and the amount of actual losses in particular, which may be much larger than theorized (the so-called overhang), should the market collapse. Real losses may be catastrophic.

We point out that the drawback of such models emerged in each single international crisis over the last fifteen years; that is, since the Basel Committee adopted and standardized this debatable method of risk assessment, which was developed in the headquarters of a notorious American commercial bank by sheer chance.

In any case, it is to remember that the scientific viewpoints on such problems are rather diversified and often even conflicting. What is certain is the uncertainty of science.

In the light of all this, it does not come into question that the juridical backbone of the rules to be imposed on the markets should proceed from technical-scientific investigations. Let us take into consideration routes similar to those developed in the field of the so-called risk law.

The critical situations so far illustrated have contributed to the shrinking effectiveness of prudential regulation.

This does not seem to be indicative of a general failure of the public intervention on the market, but rather of a failure of the rules, namely a failure of that specific type of market-friendly public intervention. Such rules should have economic efficiency among their paradigms. Should such efficiency not be pursued, this will imply the failure of the rules inspired by the market.

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It must be admitted that we are facing a failure of the rules because their being "little public", so to speak, or rather affected by an unsound hybridism between public and private, between state and market.

As someone has emphasized, neither increasing the prudential rules nor simply getting rid of them and leaving risk control to the the operators can be a solution to the problems raised by the crisis. However, we cannot merely change the contents of the regulations by affecting capital requirements or accounting standards. We should begin considering the idea of arranging new instruments of public control, other than prudential regulation.

The alternative would be starting from an independent scientific and technical analysis of the risks, not in the least connected with the banks' economic interests but, on the contrary, more concerned with the protection of savings and, most of all, well-aware of the scarce solidity of the efficient market theory.

The results should not be used to outline a thick network of rules aiming at regulating risk to substitute the free conduct of the operators and thus the market, but rather to succeed in elaborating few simple prohibitions and some sort of public intervention with a prudential approach, in order to restrain or regulate those behaviours that are indicative of an unbearable risk for the juridical system, as it may threaten beyond an acceptable threshold the public interests involved.

Yet, following the Basel Accord III of 2010, it was decided on an international level to keep on imposing increasingly strict capital requirements and risk-weighting parameters in the wake of prudential regulation, which has however turned out to be ineffective or even grounded on unreliable scientific assumptions.

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### *3.2 The emergence of systemic risk (state aids, monetary policies and stability mechanisms)*

Macro-economic risk is considered systemic when it can significantly prejudice the functioning, integrity and stability of the entire financial market or part of it, and cause a strong domino effect as well as repercussions on the economic system, given the close interconnection between intermediaries and markets.

During the last crisis, the systemic risks were mostly produced by those financial and accounting techniques implemented by the operators to abide by prudential rules and reduce the risks taken by each single enterprise.

In order to face and reduce these specific risk profiles, it seems necessary to adopt ex-ante public interventions characterized by a precautionary function, since ex-post interventions are very costly for the public finances, besides having little effectiveness once the crisis is self-evident and they are generally carried out by applying the bail-out principle to the intermediaries through public aids, together with frequent considerable exemptions to the competition rules.

The situation gets more complex because systemic risk occurs when a strong domino effect has already taken place. It seems therefore necessary to anticipate public intervention before the appearance of damages or serious threats, in order to implement explicit prudential interventions, which cannot be activated later.

The need to put an end to the spread of systemic risk has led to the implementation of specific measures to “support” operators in Europe, as well as in North America. Later, the European Union has established new authorities for risk control.

However, the considerable amount of public aids fixed in favour of the financial market has remarkably increased Sovereign debts, so that the effects of the crisis have repercussions on the states too.

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On this respect, basically concerning the States' financial stability, the current European framework has shown all its weaknesses, since there is a persistence of a clear-cut distinction between financial policies implemented by the central institution and the management of public debt, which is left to each single state. Numerous deficiencies on the intervention powers of the Central Bank have also emerged.

When the liquidity crisis spread to the Sovereign States, the EBC has immediately adopted measures of monetary policy (which lie outside the competence of state aids as such), whereby it has started to purchase public debt securities and to grant long-term refinancing in favour of the banks.

As occurred for the financial support to the banks, the European intervention has taken the line of the emergency management in the first place .

Although such purchases are in accordance with the prohibition of monetary financing, as set out in Art 123 of the TFEU (which forbids both the European Central Bank and the national central banks to purchase debt instruments directly from the Member States), they can be ultimately traced back to a credit loan to the Member States, which is not attributed to the ECB by the Treaties.

Apparently, there emerged a clear contrast between the ECB's conduct and the Art 125 TFEU, which states that the European Union shall not be liable to or assume the commitments of central governments (the so-called no-bail-out clause).

Also due to the regulatory gaps illustrated, the ECB reckoned that a massive purchase of government bonds of the lower-rating Member States was not feasible and was obliged to find a politically-tenable mitigating measure, to contain the new risk of collapse of the European banking system, which is now too exposed towards the States considered unreliable by the markets.

The purpose was reached through another instrument of unconventional monetary policy, represented by a particular type of bank refinancing by the ECB. Its distinctive feature consists in granting the beneficiary banks the possibility of offering, as a side

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guarantee, bonds that are considered too risky and thus normally not accepted, such as some public debt securities. Furthermore, the Central Bank has decided to purchase also covered bonds mainly guaranteed by the State, as a guarantee of such refinancing operations. As so far illustrated, although the macro-credit distributed by the European Central Bank can be traced back to an operation of monetary policy within its competence, the concrete financing rules make its legitimacy controversial. Coming down to it, the European Central Bank holds the public debt securities and government guarantees of the Member State involved. Although they are acquired as securities, they are potentially credits in favour of the public sector that the market would not have granted under such conditions.

This is nearly in conflict with the prohibition to grant any type of credit facility to the Member States (*ex* art. 123, par 1, TFUE). Such prohibition is also to encompass any transaction with the public sector that entail or may entail some form of credit towards it.

The only way to break the *impasse* is to conclusively interpret the case under examination as a transaction occurred with the private sector, namely with banks, rather than with Guarantor States.

In any case, the European Central Bank has restricted the possibility to resort to covered bonds following a decision taken in July 2012.

By purchasing public debt securities and once again playing the role of guarantor of last resort at all intents and purposes, the ECB is once more exposed to the suspicion of acting in non-compliance with the no-bail-out clause.

Hence, a reform of the European monetary policy and the revision of the rules on this issue are needed even on an institutional level.

At present, the most practicable solutions are apparently the following; that is centralizing fiscal and monetary policy and allowing a direct intervention of the Central Bank as a lender of last resort with respect to public debt securities. The result would be an "implicit guarantee" from the ECB on the public debt. However, none of these solutions

has been seemingly taken into account. As a consequence, the sovereign debt crisis here illustrated has endangered the very existence of the single currency regime.

This has led the Member States to the adoption of emergency mechanisms inspired by mutual aid and aimed at sharing an individual potential damage to make it more bearable.

The council regulation (UE) No 407/2010 of 11 May 2010 set up the so-called European State-rescue fund (European Financial Stabilisation Mechanism – EFSM), followed by the establishment of a limited liability company, the European Financial Stability Facility (EFSF), with the purpose of supplying with funds the Euro-area countries in financial difficulties by issuing covered bonds guaranteed by the Member States.

With the deepening of the crisis, this first fund was substituted by a proper international financing institution, the European Stability Mechanism, which will be able to purchase public debt securities of the Member States in both primary and secondary markets.

Looking at this complex instrument of mutual aid, it is necessary to consider whether it corresponds or not to an implicit acceptance of the prudential principle.

By means of it, the Member States obviously commit themselves to provide coverage resources against external risks, dependent on the occurrence of potential and uncertain events, which mainly consist in the Sovereign States' default risk. However, the deriving mutualisation of risks appears to be aimed at guaranteeing some form of financial protection (and risk-sharing in economic terms), which is typical of any insurance model, rather than a real activity of damage prevention.

Thus the European Mechanism does not meet a prudential function, but rather a function of economic risk protection.

On the contrary, the prudential rationale is even more baffled, since the ESM is granted the possibility to issue covered bonds and to raise the funds needed to accomplish

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its function. As a consequence,  we witness the spread of the risk deriving from an alarmingly growing employment of financial activities for insurance coverage. It is therefore to be wished that such market mechanism incorporated into the institution shall not prevail over mutualisation, which is certainly implicit in the Member States' mutual support whose federalization is in progress.

## 4. RECONSTRUCTING RISK REGULATION IN THE FINANCIAL MARKETS

### *4.1 Prevention and injunctive powers*

Generally speaking, injunctive powers can be traced back to the control function. They are actually concerned with the compliance of a private activity with the regulations and consequently with the adoption of injunctive provisions in case of a negative outcome.

In particular, injunctive provisions enforce the permanent termination or temporary (and provisional if preventive) interdiction of an activity reckoned to be illegitimate, because in contract with the laws or regulations.

Moving from a functional analysis to an evaluation on the nature of this regulation, injunctive  provisions can be compared to an administrative sanction, insofar as it is intended as a consequence,  at the expense of the private, of infringing the law, although it lacks the typical element of the sanction; namely the punitive value of the measure aimed at causing a damage to the author of the violation. On the contrary, injunctive interventions seem to charge the private-recipient of any detrimental, or at least unfavourable, consequence resulting from his unlawful act. Such intervention can be encompassed within the sanctioning sphere only in these terms. Therefore, it can only be qualified as a sanction in broad terms.

At the same time, the exercise of these injunctive powers requires an evaluation of the past conducts, as well as an analysis of the prospective direction the activity shall take,

which may turn into a positive provision with the order of refraining from doing something or an obligation to do something, in case of omissive conducts.

Also in the specificity of financial markets, injunctive powers, which are appointed by the law to the Authorities in this field, can be traced back to restrictive preventive purposes and aim at protecting the underlying public interests by restoring the status quo prior to their infringement, endangerment or exposure to risks.

To this purpose, some specific injunctive powers have been introduced both in the t.u.l.b. (Consolidation Act on Banking and Credit Laws) and in the Single Code on financial intermediation since 2006 to implement the European legislation.

As regards regulating supervision in particular, the current articles 53, 67, 108 and 109 of the t.u.l.b. and article 7 of the t.u.i.f. – Securities Law – (with reference to single banks, banking groups, other non-bank financial intermediaries as in article 106, financing groups and other certified investment intermediaries respectively) identify some non-regulating provisions, whereby the Bank of Italy may ban part of the activity of the intermediary concerned.

These measures may be regarded as an initial embryonic stage of risk management in banking and financial markets.

In detail, the above-mentioned provisions may lead to restrictions on activities, territorial structure of the bank, intermediaries or groups, as well as to the prohibition to carry out certain operations, to distribute profits or other parts of the capital or to pay interests with reference to the financial instruments calculable among the banks' regulatory capital (legislative decree 239/2010).

To impose on the operator a restriction on certain activities is an attempt to reduce its risk exposure, to prevent it from potential crises and to lead it back to a sound and prudent management.

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Although regulations are not thoroughly clear, the provisions here described seem to involve an ex-post control, rather than the regulating power mentioned in the articles and intended to guide the conduct of the operators supervised, through the implementation of several prudential rules.

Indeed, these specific measures are the direct consequence of mishandling or disregarding such prudential rules.

However, resorting to these public interventions does not necessarily imply the infringement of rules. Actually, the application of injunctive powers is subordinate to the condition whereby the situation "must require it".

In short, the activity under restriction does not need to be prohibited in itself or in contrast with the regulations. We are therefore confronted with a very different case compared with the expunction of acts and activities in contrast with the juridical system, as mentioned in the introduction. Being the risks involved neither specified nor *a priori* prohibited, we deal here with the restriction of activities considered "risky" in terms of a better risk-control and which may be due to the supervised operators' conducts not totally in line with the purposes of the supervision. Thus in contrast with the principle of risk control, restrictions aim at pursuing illegal conducts, namely detrimental to legally protected interests, rather than illegitimate ones.

No wonder the injunctive provisions adopted to protect financial markets might be easily associated with a more "fluid" elusion of the rules, rather than to their "blatant" infringement. The result is an increasingly discretional administration by the Authority resorting to it.

Indeed, these provisions should be interpreted in close connection with the prudential rules whose compliance they are in charge of. As previously observed, such prudential rules can be summarized as a complex "mechanism" of incentives and disincentives to control risks, instead of rules and prohibitions targeted to risk containment.

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Since they have to face the “stances” of the supervised, it appears therefore natural that controls follow the same direction, merely focused on the line of conduct, while disregarding the clear violation of the rules, as a condition for their activation.

The effects are paradoxical because the external risk-control by the authority turns out to be a limitation of that entrepreneurial independence on which prudential regulation has only fictitiously placed a high value. Such mandatory restrictive provisions act as mere preventive remedies against prospective potential damages to the savers and investors' interests. One could therefore claim that such measures have a preventive function against potential risks, characterised by uncertainty margins, in application of regulatory supervision models.

Consequently, such measures tend to positively guide the operators' conduct towards risk-taking.

In other words, restrictions imply neither the temporary nor the definitive non-qualification of the subject to carry out a specific activity, but rather the increase of the risk-level beyond a tolerable threshold.

Just as in risk management inspired by the precautionary principle, the restriction of risky activities is traced back either to situations not entirely clear or to incomplete evaluations.

However, the experts in procedural law, having tried to combine protective measures with risk law, have underlined the difficulties deriving from the legal relevance given to uncertain risk, when the restriction is applied only on a precautionary level and not on an unlawful act committed.

Finally, it is worth mentioning that the spread of the injunctive administrative powers here described appears to trigger an increase in the protection potential of individuals before the judicial authority, with regard to those cases in which the former has been injured by the activity, or by omissions of the competent authority, as it more often occurs.

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Given the inactivity of the administrative authorities, which fail to act in conformity with their injunctive powers, private savers, investors or buyers of financial services, according to the situation, can act against such silence under certain conditions.

### 4.2 ***A possible extension of the precautionary principle to the financial markets***

According to the author of the present contribution, it is essential to question the very rationale of prudential regulation, to find more effective alternative instruments and to give value to what prudential rules have always disregarded; that is uncertainty, which is however a typical element of the current banking and financial markets.

It would be therefore possible from this viewpoint to identify rules inspired by the precautionary principle, which activate a ranking system of public intervention in relation to the level of uncertainty connected with the activity being regulated. If technical investigations carried out by the competent authorities through statistics, financial mathematics and quantum physics in the field of risk regulation reveal that certain conducts may be "exceedingly" risky for savings protection, as well as for intermediaries and market stability, authorities should be allowed, if necessary, to give privates some rules on risk management, even precautionary ones, by imposing temporary prohibitions, authorizations, standards etc.

In such way the answer, which science cannot give, is retrieved in law by balancing the interests involved, as explicitly allowed by a juridical source and fully abiding by the main principles of administrative law, first of all that of reasonableness. Thus precaution contributes to reduce uncertainty by enabling its management.

Now the point is whether and to which extent the precautionary principle can be extended to financial markets.

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The advisable approach is to investigate whether such extension can be applied Europe-wide, consequently overcoming potential impediments deriving from the national juridical systems of individual Member States.

In European Law, the precautionary principle is by now self-evident as a general principle of the administrative action. However if it was so, it would not be confined to Environmental Law, but it would rather be extended to those cases not explicitly provided for by the legislation.

The result is that this principle should be automatically in force in each single national juridical system (see art.1, paragraph 1 of the national law n.241/1990 further modified by the national law n.15/2005) irrespective of the field of application. As such, administrations dealing with high-risk sectors should adopt it as a criterion of their action.

In short, we claim that nothing prevents from opening the precautionary principle to contexts not contemplated in art. 191 of the TFEU.

Hence, the precautionary principle could be certainly extended to sectors other than public healthcare and environment in both the Member States and the European Union (see consumer protection policies); also in consideration of the fact that the latter has already extended it, for instance, to protect the Union's budget interests (see Commission Decision n. 2008/969/EC on Early Risk Management, the so-called EWS).

A second issue to be addressed concerns the interpretation of the principle. Advisably, it should not be too stern, as it would become paralysing and self-defeating in turn.

Given that markets are always risky in their own nature, even in ordinary conditions, it seems advisable to restrict the precautionary principle only in the hypothesis of catastrophic events.

This implies the existence of public authorities in charge of controlling the risks generated by financial innovation and qualified for technical investigations with the support

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of science, as it occurs with food, pharmaceutical or industrial products in Europe, for instance.

In any case, the solution to extend a precautionary action to the financial markets implies raising the precautionary principle to a global level, as difficult as it may be. Indeed, in the long run, it cannot be introduced only by national or regional authorities (European ones for instance), unless we want to generate serious competitive distortions.

## 5. PUBLIC AUTHORITIES AND EUROPEAN NETWORKS FOR SYSTEMIC RISK PREVENTION AND CONTROL

### *5.1 New cooperative networks for risk control and regulation*

Risk regulation can produce effects also on administrative organizations, as a consequence of the requirements of risk regulation itself. Actually, network administration appears particularly adequate to guarantee risk regulation both because it is inherently able to reach simultaneously the diversified and fragmentary nature of risks, and because the Public Administration have been trying in a long time to make the most of the net to manage emergencies; namely events occurring when risks reach the maximum probability index of occurrence.

Whereas transnational networks of financial markets regulators, which are currently harshly criticized, have developed over time on a global level, the opposite process has taken place in Europe and has reached its peak with the "consolidation" of pre-existing networks of national financial regulators into supranational authorities.

In the wake of what occurred in the United States, which have been inclined long since to leave risk management and regulation to specific administrative agencies, even Europe has established European Authorities partly dedicated to risk "regulation" in a wide range of sectors. However, the financial sector was not included until recently, but it has

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been at least conformed by now to the framework of administrative organization applied to the other markets.

The introduction of supranational Authorities does not entail renouncing the net, which is in fact enhanced, as it turns out to be the essential infrastructure combining macro-prudential supervision (under the *European Systemic Risk Board*) and microsupervison. The network creates a polycentric organizational structure, capable of operating a macro-prudential supervision on systemic risk, in that it can rapidly interconnect single microsupervision Authorities, both European and national. The network structure, divided into smoothly interconnected “monads”, appears to be an essential precondition to face the risks that can jeopardise the system.

The main feature of networks, including institutional ones, is the so-called nodality, which grants them high flexibility and quickness of relations. It is namely the constituents' ability to connect with each other through connection points, called nodes. This enables the regulators, organised according to such system, to circulate data and benefit from the circulating information at best.

In this case, the network model does not only meet the administrations' requirements in terms of collaboration, but it also becomes functional to risk supervision. In other words, the network does not only embody in cooperative terms the requisite of synthesis of the viewpoints and information coming from the Authorities involved, but it is also suited to identify the reflection of relevant risks onto the system, thanks to its fractal dimension.

In short, the network model enables to increase the information by increasing the ability to analyse it and consequently the immediate diffusion of the results. But, most of all, it allows to recognize the risks that can only be perceived at the node intersections.

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### *5.2 The European Systemic Risk Board*

Both in the United States and in Europe, the spread of the global and systemic crisis has emphasized the lack of an authority qualified for gathering information, analysing and monitoring the possible occurrence of financial disasters, in order to identify the existence of an impending economic risk and give an early warning to guarantee a ready emergency management at worst.

To find a remedy, the European Systemic Risk Board (Esrb) was established in 2010, whose organisation includes a Scientific Advisory Committee composed of fifteen independent members (chosen through public selection) and provided with regulating and technical-scientific counselling powers.

The regulation appoints the Ersb to the task of monitoring and evaluating systemic risks in regular times for the purpose of moderating the system's exposure to the risk of failure and increasing the financial market's shock resilience.

The new European regulation on macro-prudential supervision is definitely inspired by the risk regulation process that is comparable to risk management. Once risks have been pinpointed, the Board shall proceed to risk assessment, followed by a proper phase of risk management, which is nevertheless left to the European and national micro-prudential Authorities, so as to guarantee a separation between several phases of risk analysis in terms of organization.

Once the risk identification and assessment phase is completed, the new European Board must restrict itself to warn against significant risks, but it is not within its power to take binding decisions with juridical effectiveness.

The 1092/2010/UE regulation underlines the value of the warning phase, thus outlining an early system of progressive alert on a European scale.

Consequently, the European Supervising Authorities shall often adopt injunctive provisions concerning risk management in precautionary terms, which can also be applied

to emergency cases. This is the most distinctive feature of the European regulation, compared to the American one.

In particular, it may occur in the initial phase of the scale that risk management combines with precautionary supervision in accordance with the Esrb's prescriptions, which may urge injunctive provisions from the European Supervision Authorities. Under certain conditions, such authorities may provisionally ban or restrict some financial activities endangering the correct functioning and integrity of the financial markets, as well as the partial or overall stability of the Union's financial system.

Civil law teaches us that emergencies can be faced through the unravelling of the maximum alert in the network.

In such organization, the network turns towards nodal Authorities in emergency situations. Yet these authorities do not embody a hierarchical power, since they are composed of the highest offices of the internal authorities, summoned to manage extreme risk together, once more by means of injunctive or even precautionary provisions.

In conclusion, there are all the preconditions for the competent Authorities to elaborate an emergency plan, while a new set-up is emerging, in which the juridical structure is compatible with the arrangement of a preventive or even precautionary plan, able to face in advance the critical phenomena that are potentially disruptive of the system, at least in terms of systemic risk.

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