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Editor's Preface

Chiara OLDANI¹

This issue of Rivista Bankpedia - Bankpedia Review publishes contributions that focus on the broad concept of market; S. Fallocco focuses on the sociological approach toward it, and describes how the literature has evolved in its analysis. Financial markets equilibrium are described by various theories, the most famous of which is the Capital Asset Pricing Model, described by R. Ciciretti. "Regulation can solve social problems, but can also impose its own problems" (Di Donato); the IAB is a European market infrastructure that examines and issues opinions on all the European Commission's draft impact assessments for the European market to work properly. The financial crisis of 2008-09 underlined the perverse effects of improper market supervision and monitoring and the G-20 has become the place where markets' regulation is developed; although derivatives were not the source of the crisis they definitely contributed to its spread and the recent implementation in their regulation are review by Oldani. Money laundering represents a global financial phenomenon and the EU is issuing a directive and regulation to deal with it, and effectively fight against financial crimes; D. Siclari reviews the main feature of the EU Directive and Regulation, and its challenges.

Since April 2014 Assonebb that sponsors the Bankpedia project and this Review has new Board's members; since December 2014 Assonebb has a new Scientific Committee members and their precious contribution will undoubtedly improve the Association's scientific products.

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MARKET

Simona FALLOCCO¹

Abstract

The market is a complex network of (voluntary, peaceful and mutually beneficial) economic exchanges which, without being planned in advance, is the product of the social cooperation. In this respect, it is the social institution par excellence as a web of reciprocal dependence between actors who owe the possibility to pursue their own (economic) projects to the matching of the intentions and expectations that determine the actions of different individuals. The market system owes its origins to a series of circumstances occurred in late-Middle Age, a time characterized by the lack of a strong central power and by the birth of civil society, that society whose subjects benefit from a certain amount of liberty and rights while having the free use of their goods, their work, and their private life. There is, therefore, a historically inextricable link between the market, modernity and freedom: the "market economy" is thus equivalent, first and foremost, to an economic freedom and the economic freedom is the means to a higher end, i.e. freedom tout court.

1. *Market and Economic Rationality*

According to Max Weber the market is "the archetype of all rational social action" (Weber, 1978, vol. I, p. 635). In Weber's opinion "[a] market may be said to exist wherever there is competition, even if only unilateral, for opportunities of exchange among a plurality of potential parties. Their physical assemblage in one place, as in

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the local market square, the fair (the “long distance market”), or the exchange (the merchants’ market), only constitutes the most consistent kind of market formation. It is, however, only this physical assemblage which allows the full emergence of the market’s most distinctive feature, viz., dickering” (*ibid.*).

More to the point, the market is the combination of all voluntary and peaceful exchanges of goods which are property of those who exchange them. Such exchanges, which are based upon agreed prices, are both recurrent and mutually beneficial, having as their only purpose the satisfaction of a reciprocal demand. When the individuals decide to enter a temporary relation of exchange, they do it rationally, since they consider this very exchange, with its values and purposes, as the most proper way to acquire the possible quantity of resources. They could in principle achieve the same goods by adopting other courses: self-production, robbery, barter, gift, theft, distribution by the community, allocation by a central power, etc. And undoubtedly these are the methods that, for a long time, have been preferred by most of the world population. On the other hand, the choice of free exchange—characterized by its “purely economic and rational character” , (*ibid.*, p. 639)—is explained by its being “the most impersonal relationship of practical life into which humans can enter with one another. [...] The reason for the impersonality of the market is its matter-of-factness, its orientation to the commodity and only to that. [...] its participants do not look toward the persons of each other but only toward the commodity; there are no obligations of brotherliness or reverence, and none of those spontaneous human relations that are sustained by personal unions” (*ibid.*, p. 635). That is to say that the market’s order is a kind of cooperation which allows individuals to collaborate with each other regardless of their ends or personal attachments. As a matter of fact, the great value of the market lies precisely in this, that while it does not require the establishment of a shared hierarchy of goals, it nonetheless allows the collaboration of all members of a society to the fulfilment of other people’s goals, without requiring individuals to previously agree upon them—or even without any knowledge of what

they are—on the basis of the sole desire of each to pursue their own goals. At the same time, the choice of free exchange is explained by the fact that the relation of economic exchange—differently from, say, gift or robbery, in which the gain is entirely on one side and the loss entirely on the other—is beneficial for all participants, who advance from a condition of lesser gratification to one of higher gratification.² In fact, exchange “brings about an increase in the absolute number of values experienced”, since everybody “accepts in exchange what is relatively necessary [to them]” (Simmel, 2011, p. 315), while receiving an higher quantity of perceived utility—that very utility which every part is trying to achieve through the transaction, and which prevents cooperation from occurring against the interests of the counterpart. And this is precisely what preserves the continuity of social relations. Cooperation would indeed cease in the long run if exchange turned out to be a bad transaction for any of the counterparts. No social life would be possible unless the members of a society establish a mechanism of cooperation, each accepting to satisfy the conditions of those they need to cooperate with in order to accomplish their own goals. Conversely, cooperation would be extremely difficult, not to say impossible, if individuals, while trying to maximize their own utility, expected to attain other people’s collaboration without providing an adequate “compensation”.

The hypothesis of a “maximizing” individual is thus unrealistic, for it conceals the fact that man can exist and develop only within a society, being immersed from his birth in a reality which is populated by other people with whom he has to interact, mediate, compete, on the basis of his own purposes and dispositions, provided his interest in seeing his own life-projects fulfilled.³ This state of things is due to the condition of “anthropological ignorance”—defined as the “necessary and irremediable ig-

² In this regard, modern game theory draws a distinction between zero-sum games and positive-sum games. A zero-sum game is a game in which all that is lost by a participant in the exchange is gained by the other (or the others), while a positive-sum game is a game in which what is aggregately gained by all participants is more than what they have lost.

³ Accordingly, the theory of *homo oeconomicus*, i.e. the infallible calculator of the utilitarian tradition, who acts rationally by maximizing his own utility, cannot provide a plausible explanation of the formation of the social order. Cf. Fallocco (2012).

norance on everyone's part of most of the particular facts which determine the actions of all the several members of human society" (Hayek, 2013, p. 13)—and by that of "scarcity", i.e. the fact that "our physical existence and the satisfaction of our most ideal needs are everywhere confronted with the quantitative limits and the qualitative inadequacy of the necessary external means" (Weber, 1949, p. 64). These two conditions (gnoseological and economic, respectively) constitute the two fundamental logical premises of the modern conception of man as "a social being, not only as one whose material needs could not be supplied in isolation, but also as one who has achieved a development of reason and of the perceptive faculty that would have been impossible except within society" (Mises, 1951, p. 292). By the same token, if individuals were infallible and omniscient, and if they could count on unlimited resources (both material and symbolic), there would be no impediments to the fulfilment of their projects. Conversely, their fallibility and ignorance, not to mention the limited character of available resources, induce them to cooperate with each other and to satisfy the conditions imposed by the others in the very attempt to realize their own objectives.

In all economic relations the universal conditions of "scarcity" and "ignorance", far from being an impediment, are precisely what allows the establishment of that complex network of economic exchanges known as the market—which, without being planned in advance, is the product of that very cooperation which is essential to the pursuit of personal goals. The market, in this respect, is the social institution *par excellence*, organized as it is as a web of reciprocal dependence between actors who owe the possibility to pursue their own (economic) projects to the "matching of the intentions and expectations that determine the actions of different individuals" (Hayek, 2013, p. 35); this beneficial correspondence, in other words, is precisely what produces a collective utility through the pursuit of self-interest.

The "discovery that there exist orderly structures which are the product of the action of many men but are not the result of human design" (*ibid.*, p. 36), i.e. that most of

human institutions (not only the market but also society, the State, and the law as well) are the result of spontaneous development rather than design, is commonly ascribed to the tradition of methodological individualism. This tradition—inaugurated by Bernard de Mandeville and by eighteenth-century Scottish moralists (David Hume and Adam Smith), and further developed by political thinkers such as Benjamin Constant and Alexis de Tocqueville and sociologists such as Georg Simmel and Max Weber—found its most comprehensive expression in the work of the Austrian School of Economics (Carl Menger, Ludwig von Mises, Friedrich A. von Hayek) and of the philosopher of science Karl R. Popper.⁴ These thinkers were the first who argued that each individual acts in obedience to the need of pursuing his own ends; yet, since everyone is also in need of other's people cooperation, every individual is also supposed to provide them with the services they ask for in return. Hayek elaborated the notion of spontaneous "order" (*cosmos*)—which he conceived as a process of deployment of relevant dispersed knowledge, i.e. as the un-programmed outcome of a long process of aggregation of single actions, having as their purpose the solution to common and recurrent problems—as an explanation of the *invisible hand* of the market. This well-known metaphor was propounded in 1776 by Adam Smith (1811) to account for the spontaneous mechanism occurring in modern industrialized and secularized societies which results in public prosperity—that is, the generally advantageous adjustment among reciprocal exchanges conceived by Smith as the unplanned result of each one's attempt to accomplish his own ends by means of free cooperation.⁵

⁴ See Infantino (1998).

⁵ The saying "private vice, public virtue", formulated by Bernard de Mandeville (1988) in his well-known *Fable of the Bees* (1715), may be regarded as the first expression of the "mechanism" which Adam Smith later referred to as the "invisible hand". Mandeville, a Dutch scholar, had in mind the seventeenth-century mercantile society, which was held together and made prosperous neither by selfishness nor by individual benevolence, but rather by the reciprocal advantage of the individuals who took part in those interactions animating commercial activities. Cf. the Appendix in Moroni (2005, pp. 157-169).

2. Institutions and Modernization

Every existing society acknowledges the institution of the market as the place (both physical and symbolic) where all relations of exchange between buyers and sellers occur. Yet, not all the existing societies are also market systems. The customary relationship between buyers and sellers, in fact, does not suffice to the establishment of a “market system” or “market economy”. To make this possible, it is necessary that those relationships of exchange are left to the free interplay among parties and regulated solely by the promise of a future payment, rather than being coordinated by a central political authority.⁶ This, in turn, requires a political system which allows and protects from state-interference private property, free initiative, competition, and the free interplay of supply and demand—a system, in other words, in which the distinction between civil society and state as well as the boundary between private property and sovereignty are well defined. A system which is perfectly represented by Benjamin Constant’s “democracy of the moderns” since “[t]he aim of the moderns is the enjoyment of security in private pleasures; and they call liberty the guarantees accorded by institutions to these pleasures” (Constant, 1988, p. 317).

Accordingly, the “market”—considered as the mere place where exchanges occur—may be said to have existed since the beginnings of civilization: “since the introduction of agriculture, the most important actor of the economic life (beside the farmer) has been the merchant, i.e. that particular social actor that operates in the market” (Pellicani, 2007, p. 131).

On the other hand, the “market system” arose only at the beginning of the Modern Age with the birth of capitalistic society, soon becoming the engine of a liberal and democratic development of society itself. In fact, “it is only thanks to the capitalistic system of production that the market becomes the core of the economic life; that exchanges occurring in the market are regulated solely by the law of supply and de-

⁶ For an analysis of the difference between “market” and “market system” cf. Lindblom (2001).

mand; that the factors of production, including manpower, are paid in money, and that only money is accepted in return for both goods and services" (*ibid.*).

The key-role of money in a capitalist economy is explained by the fact that only through money the so-called "economic calculation", i.e. the calculation of costs and benefits, is conceivable. Money originated as an instrument to establish comparisons and to mediate the resulting exchanges: if scarcity is one of the conditions which favour exchange, it follows that things do not possess any value other than that they acquire when compared with each other.⁷

The market system owes its origins to a series of circumstances occurred in late-Middle Age, a time characterized by the lack of a strong central power. British noblemen easily took advantage of these circumstances, soon extorting from legislators concessions and exemptions which would become the institutional habitat of the civil society—that society whose subjects benefit from a certain amount of liberty and rights while having the free use of their goods, their work, and their private life. More specifically, "autochthonous towns—born after the communal revolution, which had been chiefly a class struggle between the bourgeoisie and the feudal lords—experienced the formation of a "protected free space" in which productive classes could employ their own resources in the most rational way, thanks to the establishment of the logic of catallactics" (Pellicani, 2011, p. 92).⁸

The politico-juridical sanction of private property and free initiative (whether economic or not) soon allowed the emerging entrepreneurial bourgeoisie to establish a self-regulated market system, based on the private property of the means of production,

⁷ Beside being "impersonal" in its freeing the relation of exchange from any specific object or person, money is "abstract" in its conveying the economic nature of things—that is, their exchangeability—being exclusively concerned with the quantitative aspects of reality rather than individual goals or specific contents. Money is intrinsically quantitative since it allows to express numerically the fungibility of things. Cf. Menger (2009) and Simmel (2011). For a synthesis see also Fallocco (2011).

⁸ Adam Smith (1811) was the first to call attention to the so-called "feudal anarchy", although in this regard he owed a certain debt to Montesquieu and Hume (see Infantino, 2008, p. 43 n.). The same thesis was later defended by other distinguished scholars who studied the origins of capitalism, e.g. Baechler (1975), Weber (1978), and more recently Pellicani (1988, 2011).

on free work, on competition, and on the dialectics between supply and demand. The consequences of this process went far beyond what could be expected: the change undergone by such “right-distributing society” (*société distributrice de droits*)⁹ was not limited to its unprecedented economic development, involving on the contrary a broad transformation of institutions, beliefs, and values which would eventually create a secularized society governed by individualism and scientific rationalism. As a matter of fact, the market—by allowing the encounter with the Other (if not the radically Different), the exploration of new worlds and cultures, and ultimately the rejection of all exclusive philosophical or religious worldviews imposed by an oligarchic power seeking for its own legitimization—was the chief instrument of this process of “modernization”.

There is, therefore, a historically inextricable link between the market, money, and modernity. In market society all payments are expressed in money, which due to its impersonal nature, its neutrality, and its abstract character “is free from any quality and exclusively determined by quantity” (Simmel, 2011, p. 301). Beside its economic value, money is thus what best exemplifies the rationality, calculability, and impersonality of modern times, as opposed to the old worldview, based on the primacy of traditions.

3. *Market Economy and Freedom*

The preconditions of such “modern and almost endless network of exchanges, i.e. the market” (Rothbard, 1993), made possible by the existence of money, are private property, individual autonomy, and the resulting web of interactions which unintentionally gives life to the price system. Prices—whose utility lay in disseminating information on the preferences of customers, and which thus constitute a reliable index of the abundance or insufficiency of goods—are neither imposed nor deliberately decided, being rather the spontaneous result of the demand of a certain commo-

⁹ The expression recurs in Maalouf (1983, p. 301) and is adopted by Pellicani (2011, p. 88).

ty. In Hayek's words: "The Marvel is that in a case like that of a scarcity of one raw material, without an order being issued, without more than perhaps a handful of people knowing the cause, tens of thousands of people whose identity could not be ascertained by months of investigation, are made to use the material or its products more sparingly" (Hayek, 1996, p. 87). In a money-based economy, therefore, each good has its own price, and this implies that those who sell a good can then put their gain at the service of whatever purpose they like. The same freedom is symmetrically achieved by the buyer, as soon as he is able to pay for that good the price demanded by the market. Accordingly, we generally provide to each other the means to pursue each one's goals—goals of which the others are not aware, and which they could in principle even disapprove. Since no acceptance of each other's goals is required, the system of exchanges is perfectly free to develop, increasing in turn the extent of social cooperation.¹⁰ The market is thus to be regarded as a mechanism for the dissemination of knowledge by means of the essential information provided by prices—a mechanism which has as one of its outcomes "that someone is induced to fill the gap that arises when someone else does not fulfil the expectations on the basis of which a third party has made plans" (Hayek, 2002, p. 18). The actors in the market, therefore, are constantly trying to capitalize on such "dispersed" knowledge in order to fill the positions which will best allow them to satisfy other people's needs (whether in terms of goods or services). Moreover, since the ability to explore and discover the unknown becomes effective precisely within such relationship of exchange and social cooperation, competition—and catallactic competition in particular—can be regarded as the best instrument to realize human projects in general; for only where decisions and projects—modes of production and products—are both comparable and testable, it is reasonable to expect the development of society and the advancement of civilization allowed by the ceaseless selection of

¹⁰ Cf. Hayek (2013, pp. 269-271).

what each time proves most satisfactory.¹¹ In other words, it is only through the market that numberless activities may concur to the achievement of certain goods.

It should also be emphasized that both exchange and social cooperation can work exclusively on the basis of the private property of the means of production. "When two goods are indeed exchanged, what is really exchanged is the property titles in those goods. When I buy a newspaper for fifty cents, the seller and I are exchanging property titles: I yield the ownership of the fifty cents and grant it to the news dealer, and he yields the ownership of the newspaper to me" (Rothbard, 1993, p. 638). Consequently, "the key to the existence and flourishing of the free market is a society in which the rights and titles of private property are respected, defended, and kept secure" (*ibid.*). As Hayek pointed out in his *The Road to Serfdom*: "Whoever controls all economic activities controls the means for all our ends and must therefore decide which are to be satisfied and which not" (Hayek, 1972, p.91).

The "market economy" is thus equivalent, first and foremost, to an "economic democracy"; and the latter is what provides the most solid foundation of the freedom of citizens. In other words, economic freedom is the means to a higher end, i.e. freedom *tout court*: "As soon as the economic freedom which the market economy grants to its members is removed, all political liberties and bills of rights become humbug. [...] Freedom of the press is a mere blind if the authority controls all printing offices and paper plants. And so are all the other rights of men" (Mises, 1963, p. 287).

After all, given both the condition of "anthropological ignorance" and the "dispersion of knowledge", any project of centralized planned economy would be substantially impracticable in the long run. Adam Smith was the first to advance the idea that hu-

¹¹ The competition between the actors of the market, conceived as a procedure of discovery of the unknown, is not dissimilar to the condition of the scientist who is trying to solve a scientific riddle: in both cases, since not all the relevant information is available, different solutions (e.g. products) are proposed and then submitted to critical judgment (e.g. that of customers). For an analysis of the analogy between the competitive logic of the market and the logic of scientific research, see Kirzner (1973), Popper (2002), and Hayek (2002).

man knowledge is necessarily partial, fallible, and “dispersed” among millions of individuals, and thus unlikely to be gathered by one or few people. And this amounts to an unassailable criticism against all forms of protectionism or interventionism by an administrative welfare-State, which presumes to know what “every individual [...] can in his local situation judge much better than any statesman or lawgiver can do for him” (Smith, 1811, vol. II, p. 243). It was on this very bases that in the early twentieth century Ludwig von Mises (1951) could diagnose the failure of socialist regimes.

In fact, at the core of socialism lays the public property of the means of production, namely land and capital goods. Here, a real market for either lands or capital goods is basically impossible. While in a money-based economy the information conveyed by the price system allows the calculation of costs and benefits, in a planned economy in which private property is abolished such calculation—and thus the very possibility of a rational economy—is impossible. To authoritatively impose prices, to shield them from the law of supply and demand, means to suppress both competition and the market, thus favouring the social conditions historically connected to the rise of totalitarian regimes. By necessity, as already mentioned, those who possess the means also control the ends, and they can arbitrarily decide which ones deserve to be realized and which ones do not. Therefore, any centralized planned economy, having the presumption of controlling all human activities, “removes all freedom and leaves to the individual merely the right to obey” (Mises, 1963, p. 287). Nevertheless, the presumption of assuming full control of the price system is inevitably doomed to failure. Such system would in fact require the most perfect knowledge of the information influencing the preferences and choices of the economic actors. As a matter of fact, such knowledge is just impossible. As human knowledge is necessarily partial, fallible, and dispersed among millions of individuals, no centralized planning will ever be able to foresee with absolute certainty the future developments of knowledge, let alone being effectively able to centralize an immense amount of in-

formation concerning specific circumstances of time and place. And this—as history teaches us—explains the recourse to widespread campaigns of propaganda, having as their purpose to instil into people the idea of a common prevailing goal as well as the conviction that the means chosen by those who are empowered are the most desirable. Not to mention the recourse, against the “enemy” who does not share the same “truth”, to the indiscriminate use of violence and coercion.

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CAPITAL ASSET PRICING MODEL (CAPM)

Rocco CICIRETTI¹

Abstract

The Capital Asset Pricing Model (CAPM) is a market equilibrium model used to define the existing trade off between risk and expected return in portfolio choices. The CAPM attempts to answer the questions that come from the Markowitz's mean-variance approach, and the paper describes the model and its measurement.

The CAPM is based on a theoretical scheme to concretely assess the risk connected to a certain level of return according to the individual utility function. The CAPM attempts to answer the questions that come from the Markowitz's mean-variance approach, where investors make an optimal portfolio in accordance with the rule of a greater return for an equal risk (variance), or a lower risk with an equal return.

The model hypotheses, already seen in the Markowitz model, concern the behaviour of the individual and that of the market:

- The investors want to maximise their final wealth and they are risk averse.
- The investment period is unique and forecasts are formulated at the beginning of the period.
- The expected return and the standard deviation are the only parameters that orientate the portfolio choice.

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- The assets are perfectly divisible and there are no transaction costs or taxes.
- The market is atomistic, there are no barriers with regard to investment possibilities, and all investors have the same opportunities even if the available amount of wealth differs between them.

Moreover, it is necessary to add further assumptions to these hypotheses that are essential in establishing the concave frontier:

- All securities are negotiable.
- The market is perfect; that is, the information is freely and immediately available for all investors.
- Investor expectations are homogeneous, therefore each of them has the same perception concerning the expected return, the variances and the co-variances: the efficient frontier is unique and the same for all investors.
- The possibility to grant or obtain unlimited loans at a unique free-risk interest rate.

The previous hypotheses allow investors, by knowing expected returns, standard deviation of securities and covariance among securities, to draw the same concave set (in virtue of the homogenous expectations) and to choose the efficient portfolios. Since the CAPM is an equilibrium market model, each investor will make the same choice.

This framework implies that the expected return connected to a specific security shows a linear relationship with the existing co-variance between this return and the market portfolio return.

In the Sharpe and Lintner version, the principal equation is:

$$E[R_i] = R_f + \beta_{im} (E[R_m] - R_f),$$

$$\text{where } \beta_{im} = (\text{Cov}[R_i, R_m]) / (\text{Var}[R_m])$$

In the previous formulation R_i is the asset return; R_m is the market return and R_f is the free-risk rate.

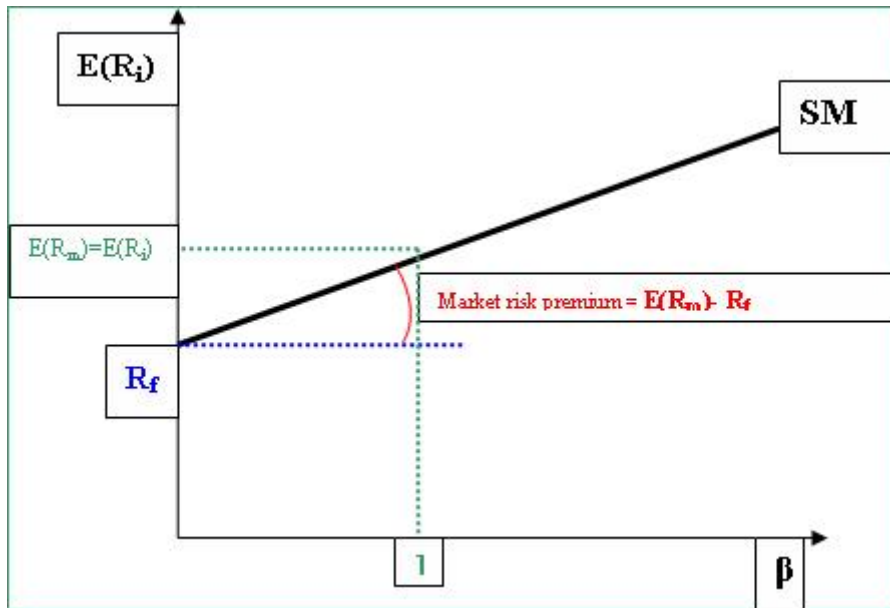


Figure: graphic representation of the CAPM

The same concept could be simply expressed in terms of excess return over free-risk rate. Calling Z_i the excess return (effectively realised) of the asset i over the free-risk rate, then inserting $Z_i = [R_i - R_f]$, and introducing the expected value of the variables Z_i and Z_m , the fundamental equations of the CAPM will become:

$$E[Z_i] = \beta_{im} E[Z_m], \text{ with } \beta_{im} = \frac{\text{Cov}[Z_i, Z_m]}{\text{Var}[Z_m]} .$$

In the previous equation, Z_m represents the excess return over the market portfolio of the various assets. Assuming that the risk-free rate is not stochastic (then its expected value is exactly equal to R_f), the two different equation versions coincide.

By using the CAPM, it is possible to define an asset value with respect to its non-diversifiable risk (β). The CAPM is based on the following insight: in a competitive market, the expected risk premium may vary proportionally in accordance with Beta. The expected risk premium of an investment with Beta equal to 0.5 is equal to half of the market's expected risk premium. Furthermore, the expected risk premium of an investment for which Beta is equal to 2.0 is double the market's expected risk premium. More specifically, CAPM is a one-factor model where the factor is coefficient β . In general, the portfolio risk premium is a linear function of β and of the market portfolio risk premium. Therefore, there will be a single asset risk premium equal to $\beta \cdot (R_m - R_f)$.

It is then possible to observe:

- A zero value β corresponds to a free-risk asset where the return is R_f .
- A β value of one corresponds to the market portfolio return. In this situation, the expected return will be R_m .

The line that links the asset expected return and its β has a positive inclination: it is easy to note a positive correlation between the sensitivity to systematic risk, measured by β , and the expected return (this is the so-called **Security Market Line (SML)** to which, in equilibrium, all the bought/sold stocks in the market belong). In other words, a progressive risk increase corresponds to a higher expected return. The CAPM is not the only reference model used for risk/return analysis. Other models are the *Arbitrage Pricing Model (APM)*, where the fundamental hypothesis is that all investors with the same risk exposure should be analysed by using the same price (no arbitrage), and where the measure of market risk Beta is given by various (non specified) market risk factors. Then, there is the *Multi-Factorial model*, which has the same hypothesis of the APM, and where Beta is measured with respect to various macroeconomic factors. There are different versions of the CAPM, such as the *intertemporal-CAPM*, the *Consumption-CAPM*, and the *Multi-CAPM* (the most

famous example is the one with the Fama-French factors), which are all evolutions of the basic model and where it is possible to add explicative variables in order to better capture market risk.

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IMPACT ASSESSMENT BOARD (IAB)

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Abstract

This essay explores the role of the Impact Assessment Board (IAB) in the context of the European Commission's impact assessment system. The first part describes the Regulatory Oversight Bodies (ROBs) that aims to correct the failures of regulation and the limits of regulation. The second part explains the European Union Regulatory Oversight Bodies model, e.g. the IAB, created in November 2006 and located in the Commission Secretariat-General under the direct authority of the Commission President. The IAB examines and issues opinions on all the Commission's draft impact assessments. The Board has been analysed focusing on its tasks, powers, composition and the effects of its opinions. The third part, finally, describes the IAB's findings.

The Impact Assessment Board (hereafter: IAB) was created in November 2006 and is located with in the Commission's Secretariat-General Department under the authority of the Commission President.

According to the **European Commission**, the IAB will: «provide widespread quality advice and control ensuring that the responsibility for preparing assessments and the relevant proposals remains with the relevant departments and Commissioners and contributes to ensuring that regulatory impact assessment approach is of high

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quality, that they examine different policy options and that they can be used throughout the legislative process» (COM 2006, 689).

The IAB is part of a wider Better Regulation of the European Commission, and it responding to repeat call for better quality assurance mechanisms and stronger coordination in the *ex-ante* assessment activities carried out by the various Directorate Generals (COM 2006, 689).

The IAB appears, at least *prima facie*, as the European version of the US Office of Information of Regulatory Affairs (OIRA) which is responsible for monitoring the regulatory proposals from federal agencies on the other side of the Atlantic (De Benedetto, Martelli, Rangone, 2011).

Context

Regulation can solve social problems, but can also impose its own problems. (Wiener 2008). Indeed, on the one hand, regulation is a basic function of government (the state) in every country. Its main objectives include correcting market failures such as externalities; e.g. health, safety and environmental risks; asymmetric information, e.g. in financial markets or in labour markets; market power, e.g. entry barriers, as well as correcting other problems such as unfairness. On the other hand, regulation can also impose its own problems, including compliance costs, inhibition of innovation, unaccountable decision-making, and ancillary risks. Thus, there are not only market failures but also government failures (Majone 1994, 1996, 2010).

These problems call for an oversight body to correct the limits and failures of regulation and the regulatory instrument, such as the better regulations tools.

The idea, already developed in some jurisdictions, starts from the assumption that decisions taken using regulatory impact assessment approach, in particular impact assessment tools, inevitably require a certain amount of discretion: the selection of measures to be submitted to impact assessments; exploring some aspects while ignoring others; impact assessments carried out at too advanced a stage in the pro-

cess – all these issues can influence the final decision (Bassanini, Paparo, Tiberi, 2006; Radaelli and Meuwese 2008).

The implementation of a 'bad' impact assessment, therefore, risks frustrating the objective it seeks to achieve, while also resulting in adding an administrative burden to the decision-making mechanism. Thus, to reduce this broad discretion, it seems necessary to verify the correct application of the tools they use (Radaelli and Meuwese 2008).

According to literature, these issues raise the following question: «*Quis Custodiet Custodes?*» or «Who oversees the overseers?» (Alemanno 2009).

The OECD has highlighted that «a key role of oversight bodies is to coordinate and supervise, [...] and that Regulatory Impact Analysis (RIA) is undertaken appropriately» (OECD 1997, 2002, 2007).

These structures, generically called Regulatory Oversight Bodies (ROBs) are a disomogenea category that have the common purpose of maximising the efficiency and the effectiveness of control via the use of the levers «transparency, accountability, and evidence-based analysis» (Cordova-Novion and Jacobzone 2011; Jakobi 2012).

From a structural point of view Regulatory Oversight Bodies can have a certain degree of differentiation: «in fact, they may be set up in different forms (units, boards, committees, departments), or placed inside one of several administrative structures, e.g. the executive or legislative» (De Benedetto, Martelli, Rangone, 2011). In Europe, regulatory review was not formally established until after 2000. Based on a White paper on Governance and Mandelkern Group report, both issued in 2001, the European commission under President Prodi launched its formal Impact Assessment procedure as way to improve policy design.

The European Commission, according to the Communication on "Impact Assessment" intends: «to launch impact assessment as a tool to improve the quality and coherence of the policy development process [...]» (COM(2002)276).

Since the launch of the impact assessment procedure in 2002, the European Commission has established an articulated evaluating system, with the task of supervising the quality of impact assessments performed by the Commission services.

However, notwithstanding the efforts put in place to establish mechanisms for quality control within the European system of impact assessments, a debate has started on how to create a new body that can better ensure regulatory control in the European Union (Meuwese 2007).

The participation of different levels has led to overlapping of controls (checks) and not procedures which are well-coordinated; in this way, the mechanism as above described has not contributed to the success of the existing system of regulatory control, and resulted in an «evaluation exercise poorly coordinated and supervised» (Renda 2006; Cecot *et al.* 2007).

At the European Parliament plenary discussion on Better Regulation on 4 April 2006, Commission President Barroso acknowledged the need to respond to the varying quality of Commission impact assessments after which the Commission committed itself to establishing a quality control body on 14 November 2006: the Impact Assessment Board (Lofstedt 2006).

The European Commission has adopted a system based on three distinct levels (Alemanno 2011; Benedetti 2012).

The first is represented by central units located within individual departments of the Commission itself: these are assigned the tasks of coordinating the operating units in preparing Impact Assessment drafts in their sectors (i.e. Inter-Service Consulting) (Alemanno 2011; Benedetti 2012).

The second level is represented by the General Secretariat to which, instead, is given the function of checking the quality of impact assessment drafts of the departments. In this way, the European Union has a hierarchical system, the apex of the pyramid is assigned to the highest office of the European Commission. The fundamental task is to guarantee that all European initiatives respond to subsidiarity and

proportionality requirements; applying systematic consultations towards stakeholders; and, including impact analysis on **Small and Medium Enterprises** (Alemanno 2011; Benedetti 2012).

Finally, the third level is based on the Inter-Service Steering Group (IASG): a inter-departmental committee that involves the Services of the Commission which concerned with the proposals under examination. The constitution of such committee is mandatory for regulatory proposals that have a transversal impact (Benedetti 2012).

The IAB is part of the third level: the Board intervenes after that regulation is evaluated by Directorate Generals and Secretariat General, but before of the IASG's control (Benedetti 2012).

The establishment of the IAB has not put an end to this heterogeneous oversight mechanism (Alemanno 2011).

Tasks and power

First of all, according to article 1 of the Mandate - The Mandate and Rule of procedure are IAB's document-base - the IAB mission's is that «to improve the quality of the Commission's impact assessment by strengthening quality control and providing advice and support». Its main task is therefore to provide advice and issue opinions on the quality of the impact assessment as prepared by the department.

There are limits to the power the IAB has when carrying out its functions: in fact, the IAB can only postpone a draft impact assessment that appears critical in some parts, but «it cannot force the Directorate Generals – authors of the initiative – to change it in the desired direction» (Allio 2007).

The IAB has no veto power over the Commission's impact assessment (Torriti and Löfstedt 2009; Wiener and Alemanno 2011).

This choice seems refers to the actual European institutional architecture, in fact, «the conferral to the IAB of a return letter power might breach the principle of colle-

giality, which governs the functioning and the operation of the Commission» (Meuwese 2008; Alemanno 2008).

However, the IAB was given the power, according to article 4 of the Mandate, to send *prompt letters* in order to encourage the writing of impact assessments on relevant legislative proposals that do not fall within the Commission's Legislative and Work Programme (Meuwese and Senden 2009).

The Commission's Legislative and Work Programme, as is known, does not necessarily cover the proposals that have the greatest impact; therefore, the existence of *prompt letters* can help fill this gap; in particular forwards Commission initiatives with significant impacts, also including proposals of delegated and implementing acts.

In this way, even if the opinions are not binding, the IAB has the possibility to exert a **moral suasion** on Directorate Generals - it is also called *fonction d'incitation réglementaire* (Alemanno 2008).

Moreover, impact assessments not only is required by relevant legislative and non-legislative proposals, but also covering both Commission's delegated acts which are likely to have significant impacts and implementing acts, which procedures are defined by articles 290 and 291 TFEU that followed the entry into force of the **Lisbon Treaty** (Alemanno and Meuwese 2013).

In particular, impact assessment also accompanied comitology issues in order to enhance the transparency of regulatory process in which such comitology procedures are adopted that, as known, these are out of parliamentary control (Alemanno and Meuwese 2013).

The IAB may also be asked to give their opinion on specific impact assessment. According to article 5(3) of the Rule of procedure: «on request of departments, and at the discretion of the Chair, the Board may provide advice on impact assessments during the course of their being drawn up. The Board can ask departments to report on the progress of the impact assessment work».

Although it is difficult to predict what role it could play in the development of impact assessment: «between the Secretariat General - which is essentially responsible for the quality control upstream and IAB itself - which is basically the task of quality control in the valley. The risk is that, with the involvement of the IAB, in counseling (for the preparation of impact assessment) becomes the same way both judge and party politics. It was expected that such a situation could compromise the independence and credibility of the Board» (Alemanno 2008).

Composition

The members of the IAB are: the Deputy Secretary-General responsible for Smart Regulation and eight permanent officials at Director level of the following areas: macroeconomic; microeconomic; environmental and social.

The Deputy Secretary-General is the chair and represents the Board. The Board's members are appointed by the Chair on the basis of their competence and independence. They are appointed by the Commission President for a 2-year term and are directly responsible to him.

According the article 3(1) of Rules of procedures, they shall act independently of their personal interests and the interests of their home departments.

In case of the conflict of interest, according to article 3(3), the Chair «shall decide on how to deal with cases where independence of a member is questioned».

The IAB's members can be influenced in their work - this is especially true when the IAB should consider a project of those Services that are not representatives of the Board. In these circumstances, «the risk could be that the quality control of the IAB is particularly heavy for delaying (boycott) the development of the proposal. Given the growing confrontation between the different branches of the Commission who compete to implement their respective programs, such a scenario boycott should not be overlooked in the context of the current criteria for the composition of the IAB».

According to doctrine, the only way to ensure complete independence from the services of the Committee is interpreted widely to article 3 of the Mandate, forbidding members to express their opinion on the draft impact assessment issued by their service (Alemanno 2008).

However, the IAB's independence seems to be formal, rather than substantial. In fact, the IAB is led by the Deputy Secretary-General, but it is subordinated to instructions of the Commission's President. This feature has raised questions from other European Union institutions (Benedetti 2011).

The European Parliament has called for the following measures to strengthen: «(i) the independence of members of the IAB, who must be scrutinized by the European Parliament and the Council prior to appointment and no longer be subject to the instructions of the Commission President; (ii) the involvement of experts from all policy areas as well as all stakeholder groups affected in the IAB's work [...]» (European Parliament 2011).

Apart from the composition and independence issues, the question of the criteria for membership on the Board, there is also a crucial question regarding the effectiveness of the organism (Alemanno 2008).

The article 1 of the Rules of procedure establish that members must have great competence in one of four areas that characterises the Regulatory Impact Assessment approach: macroeconomic, microeconomic, environmental and social. Therefore, on the one hand, in this way IAB has the necessary expertise to assess Regulatory Impact Assessment integrated (Benedetti 2011); on the other hand, this choice «seems surprising, especially in light of the mission of the Committee: to provide advice and contribute to the development of a culture of impact assessment of the Commission» (Alemanno 2008).

Functioning

All impact assessments of the Commission service are scrutinized by the Board which assesses the quality of their draft impact assessment report.

After a review of the draft impact assessment, the Board sends its detailed observations to the relative Directorate Generals in the form of a «checklist of the quality», through which the IAB will: (i) check the application of the Commission's guidelines as well as standards on impact assessments work - *Conformity Test*; (ii) deliver an opinion as to whether the degree of analysis in the impact assessment is proportional to the potential economic, social and environmental objectives of the proposed initiative - *principle of proportionate analysis* (iii) and assess whether the analysis is of sufficient quality with reference to the reliability of the data and the methods used - *suitability test* (Alemanno 2008).

When the Board concludes that substantial improvements are needed on a number of significant areas, it issues an opinion to the author service making recommendations on how the draft impact assessment should be improved; in this way, IAB can demand (request) a resubmission of a new impact assessment report.

In certain cases, the second opinion may again be negative, and a second resubmission called for. Albeit rare, a third negative opinion may be issued. When the opinions positive is the file can move forward once Board recommendations are taken into account.

In general, «the opinions of the Board are not binding and its evaluation on impact assessment quality is weak, and in this way, it cannot be considered the Commission's regulatory watchdog, but the IAB's functions can have some effects on the European Commission's impact assessment system» (Alemanno 2009, 2011).

This section explores the Board's activities: the IAB's first full year of operation was 2007, it examined 100 draft impact assessments.

In 2008, the Board examined and issued an opinion on 135 draft impact assessments. In 2009, the IAB examined all of the impact assessments produced by the Commission services. On 79 impact assessments evaluated in total, the IAB issued 106 opinions, 30 of which were on resubmitted impact assessment reports. As was the case in 2008, the IAB noted a continued shift in the nature of quality concerns from the basic elements of the impact assessments, which continue to improve, to more substantial analytical issues. However, there was still a slight increase in the resubmission rate from 33% to 37%, indicating that improvements in quality remain a challenge.

In 2010, the Board considered 66 impact assessments reports over 23 meetings. It issued 83 opinions, with 18 being on resubmitted reports. In particular, the impact assessment reports showed a heavy concentration on financial regulation as the Commission addressed problems that had become apparent in the financial crisis. Thus, the responsible service - Internal Market and Services - therefore produced the largest number of reports - 16 out of 66 or one quarter. In contrast, it had only produced 11% of reports on average in the three previous years (European Commission 2010).

In 2011, the IAB considered 104 impact assessments reports and issued 138 opinions, 35 of them are on resubmitted reports. It also examined 43 Multiannual Financial Framework (MFF) impact assessments reports being considered as standard upon first scrutiny.

Finally, in 2012, the IAB issued 144 opinions, 47 of them are on resubmitted reports. In particular, the opinions issued by the IAB were concerned 97 impact assessments – there is a slight decrease compared to 104 in 2011. Instead, it is further increased, compared to previous years (77% in 2011, 74% in 2010 and 68% in 2009), the percentage of impact assessments carried out on the legislative acts (78%) compared to those involving the so-called “Non-legislative proposals”.

As regards the type of initiative, the proportion of impact assessments reports concerning legislative proposals, as opposed to non-legislative proposals, was higher than previously, confirming the trend observed since 2007 for the Commission's impact assessment work to focus on initiatives likely to have significant impacts.

IAB's findings

Since its creation, there have been great expectations from the IAB's findings: in fact, a number of studies have argued that the IAB's activities seem to produce positive effects on impact assessment quality, but its powers are more limited and risk reducing its efficacy.

The European Court of Auditors (ECA) has analysed whether impact assessments have supported decision-making in European Union institutions. This analysis relied on: a comparison to other international impact assessment systems, an analysis of a sample of Commission impact assessment's, interviews and surveys with people involved in performing, reviewing and using the Commission's impact assessments, both within and outside the Commission (ECA 2010).

The European Court of Auditors has investigated whether the IAB has produced effects on impact assessment quality. According to the Commission staff interviewed in connection with the in-depth case studies, the creation of the IAB as an internal quality review body has put pressure on the Directorate Generals to present good quality draft reports. It has also added transparency to the system since all IAB opinions are published on the European Commission impact assessment website (ECA 2010).

In particular, the European Court of Auditors has recommended, firstly, that «considering that the Commission initiative has to go through interdepartmental consultation, decision-making by the members of the Commission and translation, the IAB opinion can only have a substantive effect on the final version of the underlying initi-

ative if the IAB review takes place early enough in the process»; secondly, the effectiveness of the quality review is subject to its timely availability (ECA 2010).

The Centre for European Policy Studies (CEPS) confirmed that the quality of the European Commission impact assessment system seems to have been positively affected by the creation of IAB (O. Fritsch *et al.* 2012).

According to this study, impact assessment tools within the European Commission and United Kingdom contexts – these are the two dimensions that are compared – can be understood examining their existing regulatory oversight bodies (O. Fritsch *et al.* 2012).

«It is interesting to look at the different work methodologies of the two models in order to underline some differences. The Regulatory Policy Committee (RPC) is the United Kingdom independent body with its own secretariat that does not take instructions from Cabinet Offices or other branches of the government. Then, the Regulatory Policy Committee, rather than publishing opinions on completed impact assessments, interacts with departments during the production phase and suggests modifications or types of analysis» (O. Fritsch *et al.* 2012).

Instead, the European Commission impact assessment system has a different structure. The IAB «publishes its opinions on the impact assessments produced by the different Directorate Generals - contrast this with the work 'behind the scenes' of the RPC, but in fairness, parts of the European Commission's work on impact assessments do take place behind 'closed doors'. The Commission only publishes the final version of impact assessments, together with IAB's opinion on previous drafts and the corresponding legislative proposal; earlier impact assessment drafts, in contrast, are not made public» (O. Fritsch *et al.* 2012).

In 2007, «when the IAB became operational, several indicators show a sharp increase in the order of magnitude of 20 to 30%, e.g. for the quantification of costs and benefits, the monetisation of costs and benefits, and the evaluation of the three main categories of impacts» (Fritsch *et al.* 2012).

Andrea Renda explores the development of impact assessment in the European Union and its study confirms that «the Commission impact assessment system is firmly nested into the Commission's policy cycle».

The European Commission has «certainly achieved important results in mainstreaming impact assessment in its policy-making process, though important margins for improvement remain» (Renda 2010).

This study observes that «at the end of 2009, the European Commission had completed 475 impact assessments. The number of impact assessments has been increasing significantly since 2006, although 2009 marked a slow-down due mostly to the transition towards a new European Commission and a new European Parliament.

In 2010, at least 140 impact assessments were expected according to the available 2010 roadmaps. In any event, available data show that the Commission impact assessments have become more complete and transparent over time» (Renda 2010).

Thus, the European Union experience with impact assessment is considered as being fairly successful, but margins for improvement certainly exist. In particular «expanded competence of the Commission calls for a stronger oversight on the quality of the Commission impact assessments. This can be achieved in several ways, including strengthening the IAB» (Renda 2010).

«Demand for quality assurance systems within the Commission led to the appointment of the IAB, which in turn generated significant pressure on Directorate Generals. Indeed, Directorate Generals such as Internal Market and Services and Enterprise and Industry are working on their own, expanded version of the impact assessment guidelines to make sure their officials produce better proposals and do not elicit negative comments by the IAB» (Renda 2010).

The Directorate General for Internal Policies examines tasks and procedures of impact assessments carried out in the European Commission and in eight member

states: Denmark, France, Germany, Hungary, Italy, Poland, the Netherlands and the United Kingdom (De Palo *et al.* 2011).

The comparative study focused on the European evaluation system and recognised that it has introduced both centralised and decentralised scrutiny mechanisms. The individual Inter-Service Steering Groups provide a decentralised form of scrutiny, since they are set up to support individual impact assessments, while the IAB acts as a central scrutinising body. In both cases, «it appears that the focus is on impact assessment quality control, rather than on formal or procedural checks» (De Palo *et al.* 2011).

Another issue explored by research is linked to independence: «although the IAB is formally an independent body, its members are director-level officials from Commission departments and they are appointed by the President of the Commission. This means that the IAB is, in practice, internal to the European Commission and thus only independent to a certain extent» (De Palo *et al.* 2011).

Even if the IAB's members act with their own professional expertise, in practice «there are situations where Directors of individual Directorate Generals scrutinise assessments produced by their Directorate Generals» (De Palo *et al.* 2011).

Such issues have raised some questions about the composition of the IAB as well as has the participation of other European institutions (in particular the European Parliament as mentioned above) in impact assessments scrutiny (De Palo *et al.* 2011).

This research has confirmed the general positive consensus that the IAB contributes to an improved quality of impact assessment, but the Court of Auditors has also confirmed that the IAB's opinions are often available quite late in the policy process and thus possibly limiting the effectiveness of the feedback mechanism.

The European Parliament Committee on Industry, Research and Energy (ITRE) has commissioned Copenhagen Economics to carry out a study on the implementation

of the so-called Small Medium Enterprises (SME) test in member state and European Commission services (Frelle-Petersen and Winther 2011).

Briefly, the SME test is a procedure – according to the Small Business Act - whereby the impacts of new legislative or other policy proposals on Small and Medium sized Enterprises are assessed.

The study was carried out in seven member state - Austria, Denmark, Germany, Italy, Latvia, Romania and United Kingdom and the European Commission.

The study's findings are that member states and the European Commission are facing different challenges and barriers in relation to the implementation of the SME test. In particular, the study shows that control mechanisms can play an important role both in the dissemination of better regulation, and in the applying of SME test (Frelle-Petersen and Winther 2011).

I focused on the European Commission that seems to have a well-institutionalised SME test procedure, in fact as noted the study: «the SME test is being used more and more consistently across European Union services» (Frelle-Petersen and Winther 2011).

Among the key factors that can explain the more consistent use of the SME test is the establishment of the IAB (Frelle-Petersen and Winther 2011).

The IAB's role as an external control mechanism has pushed the Directorate Generals to set higher internal standards to satisfy the SME test.

Interviews with European Commission services show that the IAB has a strong disciplinary effect: «the reason is that the IAB can publish critical opinions if a specific operational unit does not live up to the impact assessment guidelines. Individual European Commission officers describe the risk of receiving a critical opinion from the IAB as 'a big threat'» (Frelle-Petersen and Winther 2011).

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G-20 DERIVATIVES REGULATION

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Abstract

OTC derivatives had a clear role in spreading out volatility and risks in the recent crisis. While the broad approach to reform taken by G-20 countries to achieve financial stability is sound, what has been neglected so far, however, is the role played by non-financial operators and the low degree in international coordination on new financial regulation. Non-financial operators trading of OTC derivatives does not often take place under the new regulatory umbrella, either because of the relative size (i.e. below the minimum threshold) or because of the lack of capital requirements. This lowers the incentives to clear centrally, increases counterparty risks and reduces financial stability. The low degree in international coordination on new financial regulation further decreases the ability to deal with unexpected events.

Financial Derivatives

The global regulatory framework has not yet intervened on the trading of OTC derivatives by non-financial operators that constitutes a source of systemic risks. Global leaders of the G20 met in Pittsburgh (2009) and decided to revise the global financial architecture to better cope with evolving risks and to effectively promote growth. As most economists agree on, the financial crisis has been not only the product of excessive credit and assets' bubble, but also of "poorly designed liberalization, inef-

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fective regulation and supervision, and poor interventions" (IMF, 2014, p.3). Financial derivatives had a clear role in spreading out volatility and risks, but their economic role separates from the shortcomings in their trading infrastructures.

Under the auspices of the Financial Stability Board (FSB), the G-20 nations have moved to regulate the use of OTC derivatives by financial operators (i.e. banks and financial intermediaries), since they trade around 90% of the global derivatives markets. At the heart of the international regulatory effort is an attempt to build resilient, continuous, and transparent OTC derivatives markets.

Regardless of the reduced global economic performance, the derivatives' market continued to grow and reached \$710 trillion at end 2013 (BIS, 2014A), as measured with the notional amount outstanding; the corresponding gross market value declined to \$19 trillion, below its 2012 level (\$24 trillion), mostly because of interest rates contractions due to the lowering global path (Tabs. 1, 2, 3). The notional dimension of derivatives largely exceeds that of most financial products; as of December 2013, the global capitalization of the equity markets reached \$64 trillion, and the bond market reached \$22.4 trillion (WFE, 2014).

The BIS (2013) established a group to study the macroeconomic impact of the new regulatory framework for OTC derivatives; economic benefits and costs of planned reforms have been compared, and the long-run benefit is the reduced probability of economic and financial crisis which positively affects growth. The (short and long term) costs of planned reforms are relevant for the global financial system, but the lack of data on detailed bilateral trading exposure, together with the uncertainty over the final regulatory scenario limited the extent of the analysis. The probability of gaining higher benefits under the new regulatory system strongly depends on the level of coordination among financial systems and the ability to recognise and close those gaps left open in the past.

Generally speaking, the EU and the U.S. are well advanced in adopting the new rules, with respect to other G-20 countries, but that comes at the detriment of con-

sistency and coherence between the European and the American systems; in particular, divergent rules on capital, liquidity, derivatives and banking structure create regulatory misalignments that incentives the beggar-thy-neighbour, and the race to the bottom in terms of competition and price at the detriment of markets' stability (Deutsch, 2014). This has non-trivial effects on growth and development for all G-20 countries because of deep financial linkages.

Non-financial operators

The trading of OTC derivatives products by Governments, local administrations, and non-financial firms' accounts for 10% of the total global OTC market in 2013 and together with the model risk, i.e. the uncertainty over the pricing of derivatives, limit the possibility to effectively achieve financial stability under the new regulatory system. The relatively small dimension should not limit considering the potential risk involved, since domino effects might spread thanks the deep interconnections in the financial system. Before 2007 nobody would have ever imagined that a tiny market like that of subprime mortgages² would have created such a global disaster, not even the US Federal Reserve (Gramlich, 2004).

Governments and local administrations

After 1990 many sovereign states employed OTC financial derivatives to hedge their debt, and to smooth its costs (e.g. foreign-currency denominated bonds). The successful experience of U.S. states (e.g. California, Texas), Denmark, and Brazil confirm that OTC derivatives contracts are powerful risk management tools although the small disclosure of data on such contracts fuelled criticism (Oldani, 2008).

Local administration's experience with OTC derivatives strongly depends on their financial independence from the central state. Since the State is finally responsible

² In 2007 the subprime mortgage market accounted for around 12% of the entire mortgage market.

for all obligations underwritten by local administrations, the UK prohibited the use of derivatives by local administrations back in 1988; on the other side, Italian Regions have outstanding OTC derivatives worth €10,784 million in 2013 under no clear domestic regulatory framework³. In the recent past some public administrations bankrupted because of financial mismanagement involving derivatives contracts; the \$2 billion Orange County (California) default in 1994 and the \$4 billion default of the Jefferson County (Alabama) in 2011 in fact were caused by excessive financial risks (Howell-Moroney and Hall, 2011) and not by reduced resources available, like taxes or Government funding⁴.

The Governmental Accounting Standard Board (GASB) issued the Statement No. 53 in 2008 that “addresses the recognition, measurement and disclose of information regarding derivatives entered into by state and local governments”. The aim of the statement is to “improve financial reporting by requiring public administrations to measure derivatives at fair value in their economics resources measurement”.

The standard establishes disclosure requirements such as a derivative summary, information about hedge effectiveness, fair value, management’s objectives, significant terms, and risks. The standard is effective since fiscal year 2010, but not all countries decided to update the domestic accounting systems in order to provide meaningful and homogenous information on financial transactions (again Italy lies far behind). At present, small information is provided by administrations on their derivatives contracts, limiting the empirical analysis of risks and costs.

³ The outstanding debt of Italian local administrations is €115 trillion (7% of GDP, 2013); the Italian Republic has underwritten swaps to hedge the foreign denominate debt that is less than 3% of total debt in June 2014. The Italian public debt reached 132% of GDP in 2013.

⁴ The city of Detroit is an example of default due to over-financing with reduced resources, decreasing population and production. Unbalanced interest rate swaps produced further damage and the city paid large fees to banks to foreclose some of them

Non-financial firms

Non-financial firms trade OTC products to hedge and to speculate; the economic literature has highlighted that the lack of accounting data on OTC contracts separate from other hedging contracts (e.g. insurance) represents a barrier toward a comprehensive assessment of risks involved. While financial firms should comply also with capital and margin requirements, non-financial ones are free to engage in potentially risky contracts without any requirement and under small supervision. In July 2014 the International Financial Reporting Standards (IFRS) issued the standard n.9 that will replace the International Accounting Standard (IAS) statement n. 39 on the use of OTC derivatives by financial and non-financial firms after 2018; the fair value measures derivatives' exposure, and firms should provide information on the type of derivatives, scope and relations with the core business. The evolving financial system structure and increased complexity lead to this new comprehensive standard.

Model risk: the known unknown

Uncertainty over the pricing model of derivatives leads to the model risk. In 1997 the A. Nobel Prize in Economics has been assigned to Myron S. Scholes and Robert C. Merton for their contribution to the pricing of financial derivatives; in 1997-1998 the hedge fund they managed, the Long Term Capital Management (LTCM) was hit by the Asian and the Russian bonds crises, and finally crashed. The collapse of LTCM was due to the complex risk models employed and to the overreliance to such models. Many economists and markets players believe that derivatives' pricing models have been used wrongly prior to the subprime crisis and that they are still used wrongly today (Jarrow, 2010). Derman, back in 1996, introduced six simple rules of thumb to mitigate the model risk, but they can be further summarised in one: prefer simple models to complex ones since Devil is in the detail. This principle should be

taken into consideration by board's members of non-financial firms and managers of local public administrations.

Enron would be an easy example for the reader to figure out the potential risks involved in derivatives' trading, but instead we follow Warren Buffett's approach: he stated in his 2002 shareholder's letter that derivatives are financial weapons of mass destructions, but, by looking at Berkshire Hathaway balance sheet, it is clear that Mr. Buffett actively uses them, taken with a grain of salt. Nevertheless, which is exactly the size of the grain is not easy to say.

Conclusion

The trading of OTC products by non-financial operators (Governments, local administration and non-financial firms) often occurs in the absence of capitalization, proper financial accounting criteria and adequate monitoring or supervision. G-20 Governments trading should be under scrutiny by other member countries, and by credit rating agencies; however, the recent financial crisis already showed the limits of credit rating agencies, and the small degree of coordination among countries in case of unexpected financial shocks. Local administrations might have a certain degree of freedom to engage in sophisticated financial products, like OTC derivatives, and should be monitored by the central state. Non-financial firms either listed or not on a stock exchange, are monitored by domestic market authorities. However, their financial trading is not under intense monitoring and scrutiny.

The BIS (2014C) analyses the incentives to centrally clear OTC derivatives contracts under the new regulatory system, and, with respect to non-financial operators, states that:

if an end user of OTC derivatives is not subject to capital requirements for counterparty credit risk, its incentive for central clearing is reduced; if the end user is not subject to the margin requirement on non-centrally cleared derivatives, or that fall

below the margin required thresholds, the impact on incentives to clear centrally is not straightforward (p.19)

The regulatory frameworks in the EU and in the U.S. are not fully consistent with each other, and the lack of transatlantic consistency can be reduced by means of greater regulatory coordination by the G-20 over principles, rather than rules.

The G-20 should strengthen the international financial system structure and explicitly consider the role of non-financial operators trading of OTC products, since some of them fall entirely out of the new regulatory umbrella. Non-financial operators should be compelled to adhere to the centralised counterparty system, and the collateralised systems of trading, and to enhance their accounting and risk management procedures in order to properly deal with financial risks. The focus has to be out on the derivative, and not on the type of counter-part that enter the trading.

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THE FORTHCOMING EU 4th ANTI MONEY LANDERING DIRECTIVE AND THE SUPERVISION OF PAYMENT INSTITUTIONS

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Abstract

The EU 4th Money Laundering Directive will come into place in 2015 to improve transparency, information and effectively fight against financial crimes; the legal instruments employed to achieve greater financial stability are the Directive on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing, and the Regulation on information accompanying transfers of funds to secure 'due traceability' of these transfers. In this new regulatory framework, supervision of payment institutions represents one of the most important issues.

1. *The forthcoming EU 4th Money Laundering Directive (AMLD): the regulatory framework and the new fundamental rules.*

With the forthcoming EU 4th Money Laundering Directive (AMLD) the European Union is now putting in place a framework which focuses on greater effectiveness and improved transparency in order to make it harder for criminals to abuse the financial system, for example enhancing beneficial ownership transparency introducing new investigative tools.

Significant progress has been achieved on the review package which, as know, consists of two legal instruments: a new Directive on the prevention of the use of the

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financial system for the purpose of money laundering and terrorist financing and a Regulation on information accompanying transfers of funds to secure 'due traceability' of these transfers.

These proposals take into account the 2012 Recommendations of the Financial Action Task Force (**FATF**), and go further to promote the highest standards for anti-money laundering and counter terrorism financing.

The proposal for a Fourth Directive implementing the FATF Recommendations has been the subject of intense negotiations in the Council and the European Parliament for nearly two years. The Italian Presidency of the EU Council reached December 16, 2014 an agreement with the European Parliament on the Fourth Money Laundering Directive and the Regulation on funds transfers. At the moment, at the request from France, in light of the recent events, it needs more time to scrutinise the text on terrorist financing. However this does not affect the agreed texts and it does not have any consequences for the procedural steps to follow.

The new regulatory framework welcomes the risk-based approach: it acknowledges that the levels and types of action required to be taken by member States, supervisors and firms will differ according to the nature and severity of risks in particular jurisdictions and sectors, clarifying the types of situations in which simplified customer due diligence will be appropriate, as well as those situations where it is necessary for firms to conduct enhanced checks.

We have new rules concerning the extended definition of politically exposed persons – PEPs (here is clarified that enhanced due diligence will always be appropriate where transactions involve politically exposed persons), inclusion of tax crimes as predicate offences, national and Europe-wide risk assessments, reinforcement of sanctioning powers and requirements to co-ordinate cross-border action, lower exemptions for one-off transactions and expansion of the perimeter, new requirements on beneficial ownership information, to increase transparency by requiring companies and trusts to hold information on their beneficial ownership, and to make this

information available to supervisors and parties conducting due diligence on them.

2. The problem of supervision of payment institutions that operate across borders by agents.

In this new regulatory framework, we have the problem of supervision of payment institutions that operate across borders by agents. In fact most Member States result host some agents operating on a European passport under the EU Payment System Directive (PSD); a large number of Member States act as the home regulator for cross border Payment Institutions.

Risks associated with the Money Transfer sector, especially operating through agents, are considered very high.

For example, in Italy money laundering and financing terrorism risks associated with the Money Transfer sector are considered very high, due also to the size of the Italian money remittance market: amongst the EU countries, the Italian market is the second biggest one in terms of money remittance flows directed abroad (eur 7,39 mld in the 2011). In 2011 the market share of the Money remitters based in another EU country operating in Italy through very extensive networks of agents was equal to 55%.

In this framework, various criminal investigations found out that the money transfer networks are misused for money laundering purposes or for terrorist financing purposes by criminal organizations. Italy is conducting a specific **risk** assessment of the payment services sector in the broader works undertaken to draft the Italian National Risk Assessment.

In Portugal, PS agents, whenever they are not financial institutions, are considered as presenting an inherent ML/FT high-risk. This is the case due to their absence of control mechanisms in terms of the prevention of AML/CFT on the overwhelming number of agents operating in these conditions (gas stations, subway stations, su-

permarkets).

According to FATF's new Recommendation 14 on money or value transfer services providers, MVTS providers should be required to be licensed or registered. MVTS providers should be subject to monitoring for AML/CFT compliance. Agents for MVTS providers should be required to be licensed or registered by a competent authority, or the MVTS provider should be required to maintain a current list of its agents accessible by competent authorities in the countries in which the MVTS provider and its agents operate. According to para. 14.5, MVTS providers that use agents should be required to include them in their AML/CFT programmes and monitor them for compliance with these programmes.

Agents pursuing their activities on the basis of PSD Article 25, regarding the exercise of the right of establishment and freedom to provide services. According to this rule, any authorised payment institution wishing to provide payment services for the first time in a Member State other than its home Member State, in exercise of the right of establishment or the freedom to provide services, shall so inform the competent authorities in its home Member State. Within one month of receiving that information, the competent authorities of the home Member State shall inform the competent authorities of the host Member State of the name and address of the payment institution, the names of those responsible for the management of the branch, its organisational structure and of the kind of payment services it intends to provide in the territory of the host Member State. In order to carry out the controls in respect of the agent, branch or entity to which activities are outsourced of a payment institution located in the territory of another Member State, the competent authorities of the home Member State shall cooperate with the competent authorities of the host Member State. The competent authorities of the home Member State shall notify the competent authorities of the host Member State whenever they intend to carry out an on-site inspection in the territory of the latter. However, if they so wish, the competent authorities of the home Member State may delegate to the competent au-

thorities of the host Member State the task of carrying out on-site inspections of the institution concerned. The competent authorities shall provide each other with all essential and/or relevant information, in particular in the case of infringements or suspected infringements by an agent, a branch or an entity to which activities are outsourced. In this regard, the competent authorities shall communicate, upon request, all relevant information and, on their own initiative, all essential information.

3. The requirement of Central Contact Points in some European national legislations.

In EU Member States, there have been reported some cases of countries where the requirement of a central contact point has been set up by their national legislation.

In Italy, the reference to CCPs has been included in Article 42 of the Legislative Decree 231/2007 (Italian AML law) after its recent amendment by the Legislative Decree 164/2012. According to para. 3, the STR (suspicious transaction report) shall be submitted to the Financial Intelligence Unit by the agents of the PIs directly or through the CCP created in Italy by the EU EMI or PI. The creation of the Contact Point is mandatory in case of plurality of agents.

Payment institutions agents operating in Italy are subject to the Italian AML regulations; so they are obliged to comply also with the Italian Customer Due Diligence and record keeping requirements. At the moment, the Italian law provides a role for the central contact point (CCP) only in relation with the STRs. But, in their understanding, payment institutions are very likely to assign to the central contact point also coordination and supervisory role with regard to the other pieces of the AML obligations applicable to the agents operating in Italy.

In Belgium, Belgian AML law applies to payment institutions/electronic money institutions "providing payment services in Belgium through a person established there and representing the institution to this end". PIs/EMIs with such an establishment in

Belgium are subject to all the provisions of the Belgian AML law, including article 18 which provides that the obliged entities “shall assign responsibility for the implementation of this Law to one or more persons within their institution or profession. These persons shall primarily be responsible for implementing the policies and procedures referred to in Articles 16 and 17, as well as for examining the written reports drawn up in accordance with Article 14, § 2, second subparagraph, in order that appropriate action may be taken, where necessary, in accordance with Articles 23 to 28. [...] In the cases referred to in Article 2, § 1, 4ter, c) and 4quater, e) [*i.e.* in the case of PIs /EMIs providing payment services in Belgium through a person established there and representing the institution to this end] a person responsible for the implementation of this Law should be established in Belgium”. This person responsible for the implementation by the EEA PIs/EMIs of the Belgian AML law is the Belgian CCP, even if the Belgian Legislation doesn’t make use of that expression. Belgian AML law applies to all PIs/EMIs providing payment services in Belgium “through a person established there and representing the institution to this end”. The wording “through a person established there and representing the institution to this end” is meant to capture any form of establishment in Belgium (other than branches, already mentioned in another subparagraph), provided the establishment has the power to represent the PI/EMI.

Functions of the CCP result from Article 18 of the Belgian AML law. The main functions of an officer responsible for preventing money-laundering and the financing of terrorism –and hence of a Belgian CCP– consist in: examining the written reports relating to atypical transactions which are communicated to it and drawn up in accordance with Article 14, § 2, second subparagraph of the Law; deciding if such atypical transactions are suspicious and in filing, if this is the case, a suspicious transaction report to the Belgian FIU (CTIF-CFI) in accordance with Articles 23 to 28 of the Law; implementing the policies and procedures referred to in Articles 16 and 17. This includes the implementation of the internal measures and control proce-

dures set out by the PI/EME in order to ensure compliance with Belgian AML law, the implementation of the group AML policy and the implementation of the measures taken by the EME/PI to train their representatives in terms of AML obligations.

In Spain, according to the Spanish legislation, if an EU payment/e-money institution designates more than one agent in Spain for the provision of payment services, the agents would constitute a network of agents. In accordance with Articles 4.2 and 10.4 of Royal Decree 712/2010, Banco de Espana shall hold a register of persons responsible for the network of agents, and its establishment will be subject to the same procedure established in regard to branches of EU payment institutions. That means it is necessary for the PIs/EMIs to designate and communicate to Banco de Espana both a person in charge of the agents' network and contact address in Spain. The provisions above are included in the template of communication that Bank of Spain sends to the PI, once it has received notice from the Home Supervisor.

The legislation does not explicitly mention a "central contact point", but since the agents' network are considered similar to a branch, a central contact point is therefore a mandatory requirement. Furthermore, according to the regulation, agents of foreign PI must, in the exercise of their activity in Spain, observe the same rules of law that the agents of any Spanish PI must observe.

In Portugal, the draft rule through which the Portuguese Supervisory Authority intend to implement the requirement of the Central Contact Point for payment institutions is an Aviso do Banco de Portugal. A preliminary version was published in March 2013. In a more up-to-date version of the Article 7 of the draft Aviso do Banco de Portugal, which regulates the agents of foreign Payment Institutions or e-money institutions, according to its third paragraph, in order to facilitate the exercise of AML/CFT supervision and improve compliance with the related regulation, EU payment or e-money institutions must promote the creation in Portugal of a Central Contact Point, when-

ever they operate in Portugal through one or more agent or third party with operational functions.

The appointment must be done before providing such activities in Portugal through one or more agent/third party with operational functions. This central contact point must also be ensured by a natural or legal person who has a physical structure permanently adequate to meet the functions and who must be any of the financial institutions identified in Article 3 (among them, credit institutions or payment institutions, including branches of foreign ones) or act as an agent on a local or foreign PI or EMI.

4. The new 4th AMLD and PSD 2 rules.

In this context, now we are facing the new 4th AML Directive and PSD 2 rules. According to Recital (37a) of the new 4th AML Directive, where Member States decide to require issuers of electronic money and payment service providers established on their territory in forms other than a branch, and whose head office is situated in another Member State, to appoint a central contact point in their territory, they may require that such a central contact point, acting on behalf of the appointing institution, ensures the establishments' compliance with AML/CFT rules. They should also ensure that this requirement is proportionate and does not go beyond what is necessary to achieve the aim of ensuring the compliance with AML/CFT rules, including by facilitating the respective supervision.

According to Recital (38b) of the new 4th AML Directive, where an obliged entity operates establishments in another Member State, including through a network of agents or persons distributing electronic money according to Article 3 (4) of Directive 2009/110/EC, the host country's competent authority retains responsibility for enforcing the establishment's compliance with AML/CTF requirements, including, where appropriate, by carrying out onsite inspections and offsite monitoring and by

taking appropriate and proportional measures to address serious infringements of these requirements. The host country's competent authority should cooperate closely with the home country's competent authority and inform the home country's competent authority of any issues that could affect their assessment of the obliged entity's application of group AML/CTF policies and processes. In order to remove serious infringements of AML/CFT rules that require immediate remedies, the host country's competent authority may be empowered to apply appropriate and proportionate temporary remedial measures, applicable under similar circumstances to obliged entities under their competence, to address such serious failings, where appropriate, with the assistance of, or in cooperation with the home country's competent authority.

According to Article 42, para. 8, of the new 4th AML Directive Member States may require issuers of electronic money as defined by Directive 2009/110/EC and payment service providers as defined by Directive 2007/64/EC established on their territory in forms other than a branch, and whose head office is situated in another Member State, to appoint a central contact point in their territory to ensure on behalf of the appointing institution compliance with AML/CFT rules and to facilitate supervision by competent authorities, including by providing competent authorities with documents and information on request.

According to Article 42, para. 9, of the new 4th AML Directive the ESAs shall develop draft regulatory technical standards on the criteria for determining the circumstances when the appointment of a central contact point pursuant to paragraph 8 is appropriate, and what the functions of the central contact points should be. The ESAs shall submit those draft regulatory technical standards to the Commission two years after the date of entry into force of the Directive. According to Article 42, para. 10, power is delegated to the Commission to adopt the regulatory technical standards referred to in paragraph 9 in accordance with Articles 10 to 14 of Regulation (EU) No 1093/2010, of Regulation (EU) No 1094/2010 and of Regulation (EU) No 1095/2010.

According to Article 45, para. 4, of the new 4th AML Directive Member States shall ensure that competent authorities of the Member State in which the obliged entity operates establishments supervise that these establishments respect the national provisions of that Member State pertaining to this Directive. In the case of the establishments referred to in Article 42(8), such supervision may include the taking of appropriate and proportionate measures to address serious failings that require immediate remedies. These measures shall be temporary and be terminated when the failings identified are addressed, including, with the assistance of or in cooperation with the home country's competent authorities, in accordance with Article 42(1a) of this Directive.

According to Article 45, para 5, of the new 4th AML Directive Member States shall ensure that the competent authorities of the Member State in which the obliged entity operates establishments shall cooperate with the competent authorities of the Member State in which the obliged entity has its head office, to ensure effective supervision of the requirements of this Directive.

Also according new PDS 2, at Recital (31a), member States may decide to require that payment institutions operating on their territory under the right of establishment, and whose head office is situated in another Member State, appoint a central contact point in their territory, in order to facilitate the supervision of networks of agents and compliance with Title III and Title IV of this Directive. The EBA will develop draft regulatory standards setting out the criteria to determine when the appointment of a central contact point is appropriate and what its functions should be.

In this sense, Article 26a, para. 5, 6 and 7, of new PSD 2, regarding supervision of payment institutions exercising the right of establishment and freedom to provide services, Member States may require payment institutions operating on their territory through agents under the right of establishment, and whose head office is situated in another Member State, to appoint a central contact point in their territory to ensure adequate communication and information reporting on compliance with Titles III and

IV, without prejudice to any provisions on anti-money laundering and countering terrorist financing provisions and to facilitate supervision by home and host competent authorities, including by providing competent authorities with documents and information on request. EBA shall develop draft regulatory technical standards setting out criteria for determining the circumstances when the appointment of a central contact point pursuant to paragraph 5 above is appropriate, and what the functions of central contact points should be. EBA shall submit these draft regulatory technical standards to the Commission within one year of the date of entry into force of this Directive. Power is delegated to the Commission to adopt the regulatory technical standards referred to in paragraph 6 in accordance with the procedure laid down in Articles 10 to 14 of Regulation (EU) No 1093/2010.

5. Some problems arising from the application of the new rules in EU Member States.

From this new system of rules derive various problems related to the supervision of the money services agents.

Now a first issue concerns how and whether Article 25, para. 3, of the PSD could be implemented in some uniform way so as to allow Home supervisors to delegate Anti Money Laundering/Countering Terrorist Financing (AML-CFT) inspections of PS agents work to Host supervisors.

A second, but not secondary issue concerns which jurisdiction's (home or host) AML-CFT law should apply when such delegated inspections took place.

When will enter a regime the opportunity to request payment service providers as defined by Directive 2007/64/EC established on their territory in forms other than a branch, and whose head office is situated in another Member State, to appoint a central contact point in their territory to ensure on behalf of the appointing institution compliance with AML/CFT rules and to facilitate supervision by competent authori-

ties, we will run the serious risk of an asymmetric supervision of agents.

In my opinion, instead we would need – just to avoid reduced competition between the laws of the Member States in the implementation of the new EU Directives – as fast as possible harmonization of procedures for the supervision of payment institutions by agents.

We need a common approach to the regulation of cross border PS agents within Europe at present, to counter the risk of violation domestic law and distortion of competition within a local market because of uncontrolled AML/CFT measures by using a huge network of agents. We need a 'standardised' and uniform approach, so as to consider the justified interests of the PS industry to get predictable regulatory conditions.

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