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Open Review of Management, Banking and Finance

«They say things are happening at the border, but nobody knows which border» (Mark Strand)

Italy introduces new measures for NPL disposal

by **Patrizio Messina**

Abtract: *The article analyses the framework of the SPV's functions within a securitization transaction and with specific regard to the stage of debt restructuring, to the management of loans and to the financing activities as well.*
The main focus is given to the provisions of the new Article 7.1 of Italian Law No. 130/99, recently introduced by Law No. 96/2017, in order to understand how it can further facilitate securitization transactions.

Summary: *1. Introduction. – 2. Legislative updates. 3. Scope. Granting loans for a better credit recovery. – 4. Acquisition or subscription of financial instruments by the SPV. – 5. Acquisition and management of assets.*

1. Non-Performing Loans (NPLs) are credit exposures that credit institutions have against borrowers who, due to a worsening of their economic and financial situation, are unable to fulfill all or part of their contractual obligations.
In Italy, the Bank of Italy is responsible for having defined and classified impaired loans into subcategories by means of Circular No. 272 of 30 July 2008, which has been subject to several updates over time. Currently, the definitions of impaired loans adopted by the Bank of Italy are those harmonised at Single Supervisory Mechanism ("SSM"[1]) level, which reflect the criteria published in 2013 by the European Banking Authority (EBA) [2]. The transposition of the EBA's harmonised definition has not led to discontinuity in the aggregate, as it has been substantially aligned with the concept used previously in Italy[3] The prolonged recession that hit the Italian economy following the 2008 financial crisis and the lengthy credit recovery procedures have contributed to the accumulations of an high level of impaired loans in the Italian banking system[4].

2. The Italian banking system is currently subject to some legislative reforms. These reforms concern mainly the issue of non-performing loans, which, on 23 June 2017, led the Italian legislator to the publication, in the Official Gazette Law No. 96/2017 containing urgent provisions, initiatives in favour of territorial authorities, further interventions for areas affected by seismic events and development measures (and converting decree Law No. 50 of April 24 2017), which will come into force as of June 24[5].

The newly introduced law has modified securitization Law No. 130 of 1999 inserting the new article 7.1. entitled "securitisation of impaired loans by banks and financial intermediaries", which eight paragraphs implement what has already happened in legal practice and aim at ensuring the securitisationof receivables[6] qualified as deteriorated (*deteriorati*)[7]. According to the Bank of Italy classification, the amendments enhance the securitisation of NPLs, likely default loans[8] or expired and/or overdue exposures, as well as their management and recovery[9].

The regulatory changes have widened the operating possibilities of securitization special purpose entities[10], which can now carry out certain important activities in order to be able to manage, with a view to recovery, and no longer just liquidation, loans granted to counterparties that are subject to temporary crisis situations due to negative trends in the economy or the sector in which they operate, with reasonable prospects of a return in bonis through the revision or expansion of financial lines or reduction of leverage through capital increases[11].

To facilitate the structuring and implementation of such transactions, it allows:

1. securitisation companies (special purpose vehicles or SPVs), who have received NPLs, to grant loans aimed at improving the perspective for recovering the same receivables to the relevant debtors;
2. an Italian SPV, in the context of debt restructuring or under composition or recovery procedures[12], and always with reference to NPLs[13], to acquire or subscribe shares, quotas and other equity securities and equity instruments deriving from the conversion of part of the receivables of the acquiring subject;
3. to set up, in the context of securitisation transactions[14], a vehicle company (different from the SPV), with the exclusive task of acquiring, managing and enhancing the assets securing the securitised receivables, including assets leased under financial leasing agreements[15];
4. if selling non-block receivables, the use of simplified tools for transferability, represented by the publication of the transfer notice on the Official Gazette and by filing with the companies register, together with the indication, in the transfer notice, of the website where all relevant data will be available.

The regime introduced by the new article 7.1 of the securitization law is a significant improvement for the disposal of Italian NPLs[16].

3. The provisions of the new legislation apply only to securitisation transactions involving the sale of receivables that can be qualified as deteriorated. These will need to be transferrable to banks and financial intermediaries[17] subject to article 106 of the Banking Act and that have their registered office in Italy[18].

It's worth noting that the SPV which received deteriorated loans, in compliance with the conditions laid down by the securitisation law on financing by SPVs, may grant funding aimed at improving the chances of recovering such loans and supporting the debtor's recovery. In such cases, the management of the loans and of the financing granted by the SPV must be entrusted to a bank or a financial intermediary.

As such, the new version of the securitisation law expressly allows an SPV to grant loans and receive financing within the same transaction.

4. In the context of restructuring agreements or under a composition or recovery procedure, or other analogous procedures agreed with the assigning entity or agreements entered into under the bankruptcy law (Articles 124, 160 and 182-*bis* of the Bankruptcy Act), the SPV may acquire or subscribe shares, quotas and other equity securities and equity instruments deriving from the conversion of part of the creditor's receivables, grant financing to improve the recovery of such loans and favour the debtor's
The new provisions, therefore, have made plans for an SPV that, aside from the recovery of credit, can be actively involved in debt management.
In such a case, the sums deriving from the shares, quotas and other equity securities and instruments, for the purposes of the securitation law, are considered as payments made by the debtors. In addition, the same sums are intended solely for the satisfaction of the rights incorporated in the securitisation of the securities issued and for the payment of the costs of the transaction.
Accordingly, when this provision is applied:

- The SPV must identify a person of high competence and who has the necessary qualifications or authorisations to be responsible for management or administrative tasks in the interest of the holders of the securities, and to represent them.
- If the person above mentioned is a bank, a financial intermediary as per article 106 of the Banking Act, a securities brokerage company or a savings management company, the same person is also invested *ex lege* with the task of verifying the compliance of the activity and operations of the SPV with the securitisation law and with its prospectus.
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5. In order to acquire, purchase, manage and enhance – in the sole interest of the securitisation transaction – the value of immovable and movable registered property and other assets and rights granted or constituted in any form to guarantee a securitisation, including assets which are subject to leases, even if terminated, possibly together with the relationships resulting from such agreements, an *ad hoc* SPV may be created in the form of a corporation. This company will have the sole purpose of carrying out the aforesaid activities (the vehicle company)[19].
Therefore, this provision would be aimed at:

- enhancing the value of the assets which secure the NPLs[20], since these are generally subject to important write-downs during the execution procedures; and
- allowing the SPV – through the vehicle company – to purchase the leased assets, thus avoiding that these may remain within the originator properties and that the credits part of the securitisation transaction can be sold at a lower price as they are considered unsecured.

Remarkably, sums in any way deriving from the detention, management or disposal of such assets and rights, owed by the vehicle company to the SPV, are considered, for the purposes of the securitisation law, as payments made by the debtors. The same sums benefit of the segregation regime, thus are intended solely for the satisfaction of the rights incorporated in the securities issued and for the payment of the costs of the transaction.
With specific reference to leasing agreements, it is also envisaged that, if the trade of receivables, together with the assets leased, includes also the related leasing contracts or the legal relationships resulting from the termination of such contracts, the vehicle company:

- must be included in the bank's balance sheet;
- must be set up for specific securitisation transactions; and
- must be wound up when the transaction is completed.

In addition, with regard to the obligations related to contracts and financial lease agreements, such obligations must be performed by the servicer or by a person authorised to carry out a leasing business to be identified pursuant to article 7.1 of the securitisation law.

References

[1] For a complete overview of the creation, functions and composition of the SSM please see https://www.bankingsupervision.europa.eu/about/thessm/html/index.en.html.

[2] In October 2013 EBA, in view of the different notions of NPLs adopted by each of the Member States, has provided for the definition of NPLs to be harmonized. Instead, the harmonised definition of NPE can be found in the "Final Techincal Standards on NPLs and forbearance reporting requirements", published by EBA on 21 October 2013.

[3] Bank of Italy's, *Financial Stability Report,* No. 2 – 2014, p. 28.

[4] Bank of Italy's, "I crediti deteriorati (Non-Performing Loans – NPLs) del sistema bancario Italiano", 2017, available at https://www.bancaditalia.it/media/views/2017/npl/index.html.

[5] Law No. 96/2017 (Disposizioni sulla cartolarizzazione dei crediti) (as amended of Law No. 96 /2017) available at https://www.normattiva.it/uri-res/N2Ls?urn:nir:stato:legge:2017-06-21;96!vig= and Articles 7 .1. "securitisation of impaired loans by banks and financial intermediaries" (Cartolarizzazione di crediti deteriorati da parte di banche e intermediari finanziari).

[6] Association for Financial Markets in Europe, *High-Quality Securitisation for Europe*: https://www.afme.eu/globalassets/downloads/publications/afme-high-quality-securitisation-for-europe-the-market-at-a-crossroads.pdf.

[7] European Banking Authority, "*Eba report on the dynamics and drivers of non-performing exposures in the UE banking sector*", 22 July 2016, 8. M. Minenna, "*Il problema dei crediti deteriorati italiani e l'Europa*", in Social Europe, 30 September 2016, 1. B. Bruno, I. Marino, Milano, Giugno 2016, 2. L. G. Ciavoliello, F. Ciocchetta, F. M. Conti, I. Guida, A. Rendina, G. Santini, "*Quanto valgono i crediti deteriorati?*", in Note di Stabilità Finanziaria e Vigilanza, Banca d'Italia, April 2016. I. Ferraro, "*Sui crediti deteriorati vanno superate le penalizzazioni: a colloquio con Pier Carlo Padoan*", in Bancaria, 2015, No. 4, 91.

[8] Default loans are credit exposures for which a bank considers it unlikely, without the initiation of enforcement proceedings, that the debtor will fully meet its contractual obligations (in principal and/or interest) (such as, for example, and without claiming exhaustiveness, loans, mortgages and loans). Likely default loans are, therefore, all those loans that are formally intact but which inherently present a high degree of risk because their fulfilment is unlikely.

[9] For the notions of loans classified as Non-performing, Restructured, Substandard and Expired Exposures, please refer to the Bank of Italy, "Impaired loans of the Italian banking system", cited above, or consult the Bank of Italy's "Financial Stability Report" No. 2/2014, 28.

[10] Special Purpose Vehicle (SPV), is a company specialising in securitisation transactions. It is the assignee of a portfolio of homogeneous loans but also the company that issues the debt securities to finance the operation, offering them on the market. In Italy, SPVs are governed by Law No. 130 of 30 April 1999 on the securitization of loans, regulating every aspect of the securitization: from the requirements they must meet for the securitization to the corporate form to be adopted. For a more

exhaustive discussion of the subject, please refer to Law No. 130 of 30 April 1999 on the securitization of loans.

[11] A. Pilati, Deputy Head of the Banking and Financial Supervision Department of the Bank of Italy, in his speech at the conference AIAF, "*Le cartolarizzazioni: problemi ed opportunità*", 2017, 7-9. Moreover, the Author, in his speech at the AIFA Conference, states that "in order to encourage investment in the new finance, the securitization tranches, which represent the credit granted by the vehicle company, may be senior to the mezzanine and junior tranches issued against the previous debt transferred to the vehicle company. In addition, the vehicle company may participate in debt-to-equity swaps by subscribing capital or other equity instruments issued by the debtor and deriving from the conversion of the loans".

[12] The Debt Restructuring Agreement is an instrument that allows the recovery of a company in crisis. Its purpose is to reduce debts and to attempt, if possible, corporate restructuring. It takes the form of an agreement with many creditors representing at least 60% of the claims. Likewise, the composition with creditors is an instrument that allows the commercial entrepreneur who is in a state of crisis or insolvency to avoid judicial liquidation through the proposal of a plan that allows creditors to be satisfied through going concern or liquidation of assets. Both procedures are provided for and governed by the Bankruptcy Law (Royal Decree No. 267 of 16 March 1942 and subsequent amendments), presenting numerous aspects in common.

[13] Capriglione, F., "*Incidenza degli NPLs sulla stabilità del Sistema bancario. I possibili rimedi, in Giurisprudenza e autorità indipendenti nell'epoca del diritto liquido*", in Studi in onore di Roberto Pardolesi, F. Di Ciommo e O. Troiano, 635 ss.

[14] The securitization transaction involves the sale without recourse of a portfolio of loans without recourse by a bank ("Originator") to SPV, in which the latter buys the portfolio of impaired loans from the former at an agreed price and at the same time issues bonds in which the loans are incorporated, so-called "Asset-Backed-Securities" ("ABS") to finance itself. The ABS are then placed with investors (so-called "Noteholders") while the debt collection activity is entrusted to a Servicer, which is independent from the Originator.

Since its introduction, this structured finance technique represents an important leverage available to banks to meet their liquidity needs and, therefore, allow them to concentrate on their core business of financing businesses. In addition, financial practice has developed several securitisation models..

[15] Leasing is a financial transaction of Anglo-Saxon derivation, whereby the availability of a movable or immovable asset can be obtained by avoiding its purchase. By entering into a leasing contract, companies can acquire the availability of an instrumental asset without paying the necessary capital to buy it, without exposing themselves to the risk of the loss of value of the asset due to rapid obsolescence, and reserving the right, at the expiry of the established term, to purchase the property definitively or to return it.

[16] E. Norden, L., Buston, C. S. & Wagner, W., 2014, "*Financial Innovation and Bank Behavior: Evidence from Credit Markets*", in 'Journal of Economic Dynamics and Control', 43(C), 130–145.

[17] The regulation of financial intermediaries is contained in Article 106 TUB. According to this provision, the financial intermediary may carry out activities of granting loans to the public or collecting the assigned receivables and cash and payment services in accordance with Article 2, paragraphs 3, 6 and 6-bis of Law No. 130 of 30 April 1999 on credit securitization (so-called "Servicing")".

[18] F. Panetta e F. M. Signoretti, "*Domanda e offerta di credito in Italia durante la crisi finanziaria*", Questioni di economia e finanza, 63, Banca d'Italia, April 2014, 1-2.
[19] E. Brodi, S. Giacomelli, I. Giuda, M. Marcucci, A. Pischedda, V. Profeta, G. Santini, "*Nuove misure per velocizzare il recupero dei crediti: una prima analisi del d.l. 59/2016*", in Banca d'Italia, Note di stabilità finanziaria e vigilanza, no. 4, 2016.
[20] F.Cesarini,"*I crediti deteriorati nelle banche italiane*", in Giappichelli Editore, 2017, 53.

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Open Review of Management, Banking and Finance

«They say things are happening at the border, but nobody knows which border» (Mark Strand)

Assessment of financial stability of banking systems

by **Galina Gospodarchuk and Sergey Gospodarchuk**

Abstract: *The article studies the problems related to the assessment of the level of financial stability in the banking sector of the economy. It makes a strong case for the necessity and feasibility of using the Profit/Risk indicator (PR) for the assessment of the financial stability of commercial banks and the banking system.*

The study is based on the analysis of methodological approaches to assessing financial stability in the banking sector, methods for assessing and aggregating banking risks used by international financial organizations and central banks. The study includes analysis of financial statements of commercial banks, provides time series with information on the level of financial stability and the magnitude of aggregated banking risks.

We propose a methodology for calculating the PR indicator, which allows quantifying the financial stability of both individual banks and banking systems. In this article, we propose a simplified method for estimating aggregate banking risks based on published financial statements of banks. We have also developed an assessment scale that allows producing a qualitative characteristic of the financial stability of both individual banks and the entire banking system. Based on the calculation of the profit/risk indicator (PR), we have analyzed the financial stability of the banking system of the Russian Federation for the 2016 – 2017 period. The article also features quantitative and qualitative assessment of financial stability, provides a comparative analysis of the financial stability of banks, grouped according to the institutional principle, and identifies and quantifies the dependence of the level of financial stability of the Russian banking system on its aggregate risks.

Using the methodology for assessing financial stability in the banking sector on the basis of the profit/risk ratio should enhance the quality of the created strategies for the development of banking systems, improve financial monitoring of the implementation of strategies, and focus the attention of banking supervisors on the detection of problems in the actions of banks at an early stage. The assessment of financial stability based on the PR indicator will be useful for minority shareholders and external users such as rating agencies, think tanks, and potential investors of banks.

Summary: *1. Introduction. – 2. The concept of financial stability. – 3. The different methodological approaches for the assessment of financial stability both from a quantitative and qualitative perspective. – 4. Conclusion.*

1. The problem of ensuring the financial stability of banking systems has been gaining relevance recently. This is due to the fact that a weak banking system of any country can threaten the overall financial stability, both within the country and at the international level. In this regard, in the current circumstances, the most important task of central banks is to assess and monitor the financial stability of not only individual banks, but also national banking systems.

Shaping modern requirements to ensure financial stability in the banking sector of the economy, international financial organizations focus on improving the quality of banking risk management. In fact, according to the "Fundamental Principles of Effective Banking Supervision" [1] in order to maintain stability and confidence in the financial system, supervisors are encouraged to promote good corporate governance and maintain the proper level of the management of banking risks. At the same time, the effective banking supervision is aimed at individual banks, particularly at the individual and aggregated risks of these banks.

Today, central banks have accumulated extensive experience in assessing financial sustainability at the micro level, which relies on an analysis of the main banking risks. As for the assessment of financial stability at the level of banking systems in general, even its measurement poses certain challenges. This means that the assessment of financial stability of banking systems and measures to ensure it re-quire further improvement.

2. Analysis of scientific and specialized publications on this topic shows that the use of certain indicators of financial stability in studies of different levels is largely determined by the existing conceptual apparatus.

According to the classification proposed by G. Bårdsen, K. Lindquist and D. Tsomocos [2], there are two large groups of definitions of financial stability. The first group includes definitions based primarily on information characteristics. The second group includes institutionally-oriented definitions.

The authors believe that the first group includes the definitions of H. Minsky [3], F. Mishkin [4], O. Issing [5] and M. Foot [6]. The second group includes the works of A. Schwartz [7], E. Crockett [8], D. Tsomocos [9], A. Haldane [10], W. Allen and D. Wood (11), C. Gurhart and others. [12-16].

The first interpretation of the term "financial stability" is applied mainly to financial markets. Their increased volatility, as a rule, leads to the formation of so-called "bubbles" and thus negatively affects the economy. This opinion, in particular, is supported by Chant J. [17], Crockett A. [18], Ferguson R. [19,] Rosengren E.S. [20,], Kovalev M.M., Paseko S.I. [21], Stanik N.A. [22], Korolkov V.E., Yakushin A.P. [23].

In its second interpretation, the term "financial stability" is used as an analog of "financial sustainability". On the one hand, this interpretation implies the ability of the financial system to withstand shocks that deteriorate the transformation of savings into investments and transfer of payments in the economy. This approach to financial stability is reflected in the work of Padoa-Schioppa T. [24], On the other hand, it implies a low level of systemic and individual risks within an object, the stability of which is investigated. This view is supported by Shinasi G. [25], Moiseev S.R., Lobanova M.A. [26], Lunyakov O.V. [27], Kadomtsev S.V., Israelyan M.A. [28]. In this case, the term “financial stability” applies to organizations, regions, financial (including banking) systems.

This approach is the basis for the analysis of financial stability conducted by the International Financial Institutions and Central Banks. For instance, the International Monetary Fund [29] in order to assess the financial stability, recommends using a list of indicators, including indicators of the sustainability of financial and non-financial corporations, household sector, financial market and real estate market. The Bank of Russia in the analysis of financial stability also uses indicators of the sustainability of financial and non-financial corporations, as well as financial markets [30, 31]. At the same time, state and supranational bodies regulating the banking system rely on the assessment of banking risks assumed by credit institutions in assessment of the financial stability of both individual banks and entire national banking system.

3. Methodological approaches to the assessment of financial stability on the basis of risks are explained in the works of a number of scholars. In fact, Bhattacharya S., Goodhart C.A.E., Tsomocos D.P., Vardoulakis A.P. [32] propose to conduct the assessment of the financial stability using an indicator defined as the difference between a safer and more risky asset portfolio per unit of borrowed funds. In the opinion of these authors, a shift in the structure of assets towards positions with a higher risk ratio against the increased borrowing will help trace the tendencies of decreasing financial stability.

Goodhart C. and Tsomocos D. [15, 16, 33] propose to assess the capacity of banks to assume risks on the basis of a combination of the probability of default of banks and their profitability. In this case, it is the combination of these two indicators that is important, since the increase in the probability of default itself can be a sign of an excessive risk taking, but will not necessarily cause a rise of the tension in the financial sector. A decline in the profitability of the banking sector itself could be a sign of a recession in the real economy, and not the increase in financial vulnerability. The existence of financial instability based on the principle of combining the probability of default and profitability, according to the authors of this approach, will be characterized by a simultaneous high probability of default and low profitability. In this case, the probability of default is associated with excessive risks. As the authors themselves believe, the advantage of this approach is that it can be applied both at the individual and at the aggregate level.

Other important concepts, associated with risk assessment, are the concepts of regulatory and economic capital. In accordance with Basel II [34], the regulatory capital is the amount of capital required by a credit institution to absorb its risks in accordance with the regulations established by the country’s regulatory authorities. Economic capital is notion similar to a regulative capital, but it is calculated not according to the regulator’s standards, but using some other methods. Essentially, these two indicators are quite close to each other. They show the value of own funds required by the credit institution to cover possible losses on risky assets and transactions. The ratio of equity capital to economic (or regulative) capital shows the level of reliability of a given organization. The higher this ratio, the higher the sustainability, i.e. the lower the risk.

The disadvantage of indicators in the concepts of regulatory and economic capital is the lack of a clear methodology for assessing the initial risks generated by banks. The indicator of regulatory capital is based on the methods used by regulators, and they are very simplistic and do not take into account many important factors. The indicator of economic capital implies the use of non-standard methods and renders incomparable results. The need for a significant amount of calculations creates difficulties when we try to apply these indicators to the banking system as a whole, rather than to an individual bank.

Another, much less obvious disadvantage of measuring risks through the minimum required capital is as follows. When determining these capitals, the event against which it is necessary to insure is the bankruptcy of the organization. The risk of bankruptcy consists of risks for individual assets and transactions in non-additive manner. First, the dependence here is more complicated; second, there is a strong influence of the correlation of risky events. For example, issued loans generate not only credit risk, but also the liquidity risk. Credit risk is important for the long-term sustainability of a bank. Liquidity risk is more important than credit in the short term. In the Russian banking system, most of the banking license revocations were triggered by liquidity problems, which were manifested in the depletion of money on correspondent accounts, delays in carrying out non-cash payments and return of deposits to customers. At the same time, banks with problems with loan portfolios, but with acceptable liquidity, continued to operate.

Another well-known idea is the calculation of the ratio of the bank's profit to economic (or regulative) capital. It allows evaluating the performance of the credit organization in terms of possible investments in it. Taking into account that the number in the denominator is proportional to the magnitude of the risk, this ratio is, essentially, analogous to the profit/ risk ratio (PR). The ratio of profitability to risk shows the availability of sources of funds to cover risks, not only for banks, but also for the whole banking system. This allows using this indicator to assess its sustainability.

Thus, in many cases, the ratio of a certain value indicator to the size of the risks taken is used to assess the bank's reliability. At the same time, the most difficult task is the assessment of risks. Assessment of the indicator in the numerator, whether it is the accounting capital, income, or something else, is very simple. Of all the options, the most favorable is the profit/risk ratio. This is a very common indicator used in investment analysis. However, it is not applied to banks because of the complexity of calculating the magnitude of bank risks. Thus, the practical use of the indicator (PR) for banks is reduced to solving the problem of assessing the risks of the bank.

Solving the problems of determining and identifying risks, the international financial organizations in their recommendations propose to assess the following main types of banking risks: credit risk, market risk, liquidity risk, operational risk, legal and reputational risks. At the same time, international financial organizations pay special attention to risk aggregation and reporting on risks [35].

Central banks develop their own methods for assessing the risks of credit institutions. Such methods, on the one hand, comply with the recommendations of international financial organizations, and, on the other hand, take into account the national peculiarities of banking systems. For example, the Bank of Russia uses its own methodology for assessing the financial stability of credit institutions, which includes the assessment of the following risks: credit, market and operational, strategic, and liquidity risk. To calculate individual risks, the Central Bank of the Russian Federation applies its own very simplified methods, which are available in public domain. To aggregate risks for assessing the sustainability of banks, the Bank of Russia uses the Scorecard approach [on methods for assessing the financial sustainability of a bank in order to recognize it as adequate to participate in the deposit insurance system see the Instruction of the Bank of Russia of June 11, 2014 N 3277-U; on assessing the economic situation of banks see the instruction of the Bank of Russia of April 30, 2008 N 2005-U]. For the calculation of mandatory standards, the additive method described in instruction 139-I is used [on the mandatory standards of banks see the instruction of the Bank of Russia N 139-I of December 3, 2012]. The application of the Scorecard approach is difficult due to the fact that the raw data are not available in the public domain. Risk assessment according to the instruction 139-I does not require access to data. The results of the 139-I risk assessment are published in their final form, because they are used in the calculation of the capital adequacy ratio H1.0. This most important standard of the bank is published monthly in the form of Report No. 135 “Information on mandatory standards and other performance indicators of the credit institution.”

In accordance with the instruction 139-I, the standard H1.0 should be calculated using the formula:

$H1.0 = C / (CR+MR+OR)$, (1)

where:

C is the amount of the bank’s equity funds (capital)

CR is the amount of credit risk,

MR is the amount of market risk,

OR is the amount of operational risk.

In a more general form, formula (1) can be represented as follows:

$H1.0 = C / R$, (2)

where:

R is the amount of the total risk assumed by the bank.

R can be found using formula (2):

$R = C / H1.0$, (3)

The amount of capital (C) can be found in the Report No. 123 “Calculation of equity funds (capital) (“Basel III”).” This indicator is updated once a month. Value of the standard H1.0. can be found in the Report No. 135, which is also updated monthly. It should be noted that the correctness of the calculation of all indicators of Report No. 123 and Report No. 135 is under the close supervision of the Bank of Russia, since the capital adequacy ratio is the most important standard for banks. Sometimes, the Report No. 135 can feature the risk value R itself, so that it can be used directly. In Reports No. 123 and

No. 135, all data are given as of a certain date. In this regard, in order to calculate the index for a period, for example, for 1 month, it is necessary to average these data.

The aggregate amount of risks (R) obtained as a result of calculations according to formulas (1-3) can be used to determine the PR indicator using the formula:

$PR = 12\ P\ /\ R$, (4)

where:

P is the profitability of the bank;

R is the amount of the total risk assumed by the bank.

We suggest using the amount of the current profit of the bank before tax as an indicator of the profitability of the bank. Profit data is available in Report No. 102 “Statement of financial results”, which is updated quarterly. Monthly profit in the simplest case can be found by dividing the quarter profit by 3. This will be sufficient for retrospective analysis, plotting, etc.

Multiplication by 12 is necessary to scale the indicator to yearly value, since the monthly profit is very small compared to the value of the total risk (R).

The PR ratio for the banking system can be calculated as the weighted average of the PR indicators for banks in the banking system. In this case, depending on the indicator used to weigh individual indices, two options are possible.

For the first option, we suggest using the value of bank assets as weights. In this case, the formula for calculating the index of financial stability of the banking system will look as follows:

$$PR = \left(\sum_{N} PR_i \cdot A_i \right) / A$$

, (5)

where:

PR_i is the individual financial stability index of the i-th bank,

A_i is the assets of the i-th bank,

A is the total assets of the banking system,

N is the number of banks.

For the second option, we can use the size of risks assumed by banks as weights. In this case, the formula for calculating the index of financial stability of the banking system will look as follows:

$$PR = \left(\sum_{N} PR_i \cdot R_i \right) / R$$

, (6)

where:

PR_i is the individual financial stability index of the i-th bank,

R_i is the value of the cumulative risk of the i-th bank,

R is the amount of cumulative risk of the banking system,

N is the number of banks.

In the second option, essentially, the formula (6) will be identical to the equation:

$$PR = 12 P_{BS} / R_{BS}$$

, (7)

where:

P_{BS} is the profit of the banking system;

R_{BS} is the total risk of the banking system.

The choice of the calculation option is not essential for assessing the level of financial stability. The calculation results for both options will differ insignificantly. When using formula (6) for calculating the PR ratio, the PR values will be somewhat smaller than when using formula (5). This is due to the fact that the size of the risk assets of commercial banks is always less than the value of their total assets. However, this distinction must be taken into account in qualitative characteristics of the level of financial stability.

The values of the PR obtained from the formulas (1-6) do not allow giving a qualitative characteristic of the financial stability of the banking system. In order to solve this problem, we propose to use an evaluation scale that allows determining the level of financial stability by the actual values of the indicators. The scale has five options of qualitative characteristics of financial stability (table. 1).

As can be seen from Table.1, the levels of financial stability depend on the criteria corresponding to the values n1-n5. The proposed criteria should be formed based on the analysis of the financial stability of the banking system over a number of years, performed using the PR indicator. Naturally, for each national banking system the criteria for the formation of ranges will be different. So for the banking system of the Russian Federation based on the results of our analysis, we have formed ranges of financial stability with a step equal to 1.2% (Table.2). For calculating the PR indicator, we used the formula for weighing individual indices by asset level (5). In this case, the spread of data between their minimum and maximum values was taken into account. In the case of using in the calculation of PR formula (6), the boundaries of all ranges, with the exception of the lowest one, should be reduced by 3 points.

The step size 1.2% was chosen based on the following considerations. According to the banks' financial reports, average term of loans in the banking system is approximately 3 years. The average amount of provisions for possible losses on loans is 9.4% average (including 10.3% for individuals) [Aggregated accounts for all Russian banks http://www.kuap.ru/banks/9999/balances/%5D. Assuming that future loan losses are approximately equal to the amount of reserves created, we find that banks will lose about 9.4% / 3 = 3.13% per year of the amount of loans issued. The profit of banks, used to calculate the PR indicator, has already been adjusted for this amount of created reserves. Therefore, if PR = 0, then it means that the bank's revenues are barely enough to create reserves. If PR = 3.2%, then the bank can create reserves in double size. If PR = 6.4% in three times, etc. Since the possibility of double renewal alone greatly reduces the risk of bank failure, we took a value of 3.6% (with a small margin) as a criterion for high stability and divided the interval from 0% to 3.6% into three equal intervals.

Table 1

Rating Scale

Assessment of financial stability	Index of Financial Stability (IFS)
High	n3< PR
Good	n3³ PR >n2
Satisfactory	n2³ PR >n1
Questionable	n1³ PR >0%
Low	PR £ 0%

Table 2

Rating Scale for Russia

Assessment of financial stability	Index of Financial Stability (IFS)
High	3.6%< PR

Good	3.6%³ PR >2.4%
Satisfactory	2.4%³ PR >1.2%
Questionable	1.2%³ PR >0%
Low	PR £ 0%

Based on the proposed formulas (1-6) using the evaluation scale (Table 2) we performed the analysis of the financial stability of the Russian Federation for the period from January 2016 to June 2017. We have analyzed the largest banks of the Russian Federation, which were selected from the list of Top-30 as of July 1, 2017. The selection was made taking into account the availability of official financial statements of banks for the analyzed period on the Bank of Russia website [information on credit organizations is available at the Bank of Russia website. URL: http://www.cbr.ru/credit/%5D. As a result of the selection, 26 commercial banks were included in the sample, including 10 banks with state participation in the equity capital, 4 banks with foreign capital participation, and 11 banks from “other” category of banks. The share of assets of all analyzed banks in the total assets of the banking system as of April 01, 2017 was 76% of the assets of the entire banking system. General information on the analyzed banks is shown in Table.3.

Table 3

List of analyzed banks, ranked by the assets as of April 01, 2017

		Share in banking system assets	Type of ownership
1.	SBERBANK OF RUSSIA	0.270	with state participation
2.	BM-BANK	0.117	with state participation
3.	VTB 24	0.066	with state participation
4.	VTB	0.038	with state participation

5.	CREDIT BANK OF MOSCOW	0.034	other
6.	ROSBANK	0.034	with foreign capital
7.	BANK “OTKRITIE”	0.033	other
8.	ALFA-BANK	0.027	other
9.	GAZPROMBANK	0.016	with state participation
10.	NATIONAL CLEARING CENTRE BANK	0.015	with state participation
11.	UNICREDIT BANK	0.015	with state participation
12.	BINBANK	0.014	other
13.	PROMSVYAZBANK	0.010	other
14.	ROSSEKLHOZBANK	0.010	with state participation
15.	RAIFFEISEN BANK	0.009	with foreign capital
16.	ROSSIYA BANK	0.007	other
17.	SOVCOMBANK	0.007	other
18.	SAINT-PETERSBURG BANK	0.007	other
19.	CITIBANK	0.006	with foreign capital

20.	AK BARS	0.005	with state participation
21.	URAL BANK FOR RECONSTRUCTION AND DEVELOPMENT	0.005	other
22	JSCB “RUSSIAN CAPITAL”	0.004	with state participation
23	RUSSIAN REGIONAL DEVELOPMENT BANK (VBRR)	0.004	with state participation
24.	NORTHERN SEA ROUTE (SMP-BANK)	0.004	other
25.	YUGRA BANK	0.003	other
26.	ORIENT EXPRESS BANK	0.003	other
	Total	0.763	

Table 4 features the results of a quantitative and qualitative assessment of the financial stability of the banking system of the Russian Federation for the period from January 2016 to June 2017, obtained using the formula (5).

Analysis of the data in the Table 4 shows that in 2016 there was a gradual improvement in the financial stability of the banking system. PR at the end of 2016 increased 3 times compared with the beginning of 2016. This allowed the banking system in the Q4 2016 to improve its score from “questionable” to “good”. In Q1 2017, financial stability indicators deteriorated and financial stability once again returned to the “questionable” rating. However, compared with Q1 2016, financial stability proved to be almost 2.25 times higher, which indicates the stability of the trend of increasing financial stability.

Table 4

Assessment of financial stability of the banking system of Russia

For the period from 01.2016 to 06.2017

Period	PR	Financial stability
January 2016	1.101	Questionable
February 2016	1.102	Questionable
March 2016	1.144	Questionable
April 2016	1.895	Satisfactory
May 2016	1.841	Satisfactory
June 2016	1.801	Satisfactory
July 2016	1.700	Satisfactory
August 2016	1.691	Satisfactory
September 2016	1.737	Satisfactory
October 2016	3.016	Good
November 2016	2.879	Good
December 2016	2.876	Good
January 2017	2.200	Satisfactory
February 2017	2.177	Satisfactory

March 2017	2.190	Satisfactory
April 2017	2.433	Good
May 2017	2.416	Good
June 2017	2.415	Good

Fig. 1 shows the graphs describing the dynamics of the PR indicator of banks grouped by the type of ownership: banks with state participation (state banks), banks with foreign capital participation (foreign banks), and “other” banks.

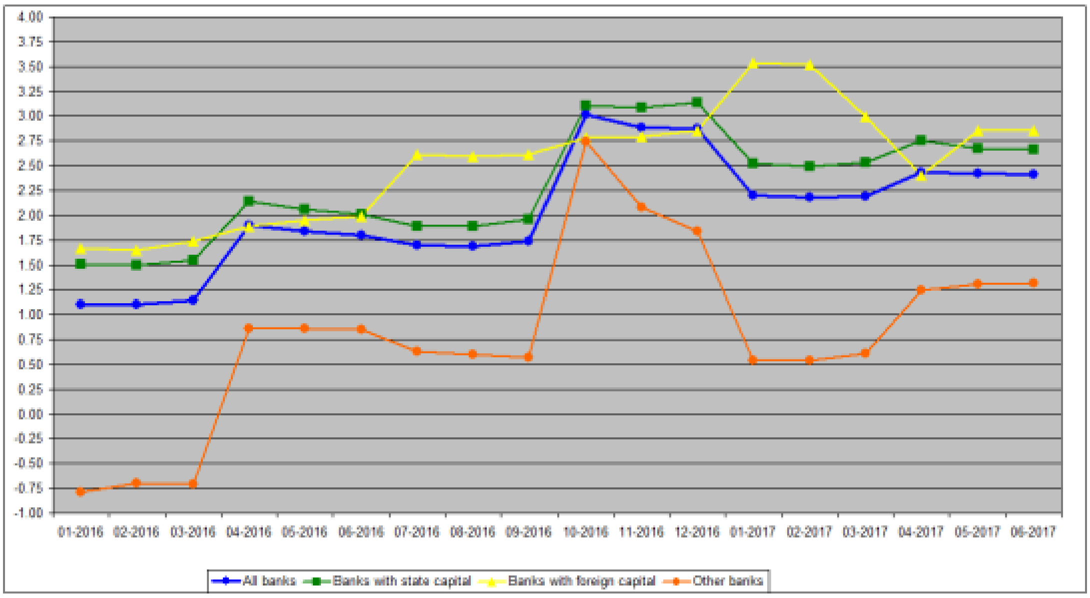

Fig. 1. Dynamics of PR indicators of banks,

Grouped by the type of ownership

Fig. 1 shows that throughout the analyzed period only the financial stability of banks with state participation has changed in the same ranges as the overall indicator across the entire banking system. This is explained by the high proportion of banks with state participation in the assets of all banks analyzed (in January 2016 – 81%, in June 2017 – 79%). The financial stability of banks with foreign participation was characterized by low volatility, but in this regard, the stability level of these banks for the entire 15-month period was characterized by a “questionable” financial stability rating. The peculiarity of PR dynamics of “other” banks was in its high volatility relative to the general level and stability level of other banks. High volatility of financial stability of “other” banks was caused by the following reasons:

- The presence of losses in these banks in Q1 2016,

- Sharp improvement in financial results in Q4 2016.

The improved financial results in Q4 2016 were significantly influenced by such banks as:

1. BINBANK (the monthly profit in Q4 was more than 4 bln. rubles against the losses in Q3 2016. The main factor of profit growth was the merger with MDM Bank);
2. PROMSVYAZBANK (the monthly profit in Q4 was more than 3.5 bln. rubles against the losses in Q3 2016);
3. ALFABANK (the monthly profit in Q4 was more than 7.8 bln. rubles against the losses in Q3 2016);
4. AK BARS almost doubled its profits.

Due to a sharp improvement in financial results, "other" banks in October 2016 managed to enter a new, higher level of financial stability with a "good" financial stability rating. However, the month after, this stability rating returned to the level of "satisfactory", and then (in Q4 2016) – to the "questionable".

Fig. 2 presents graphs of financial stability indicators of the Russian banking system (PR_1) and (PR_2) and growth rates of risk assets (R) [the growth rate against the previous month, multiplied by 100] of the banking system for the 2016 – 2017 period. The index (PR_1) was calculated using the formula (5), and PR_2 – using the formula (6).

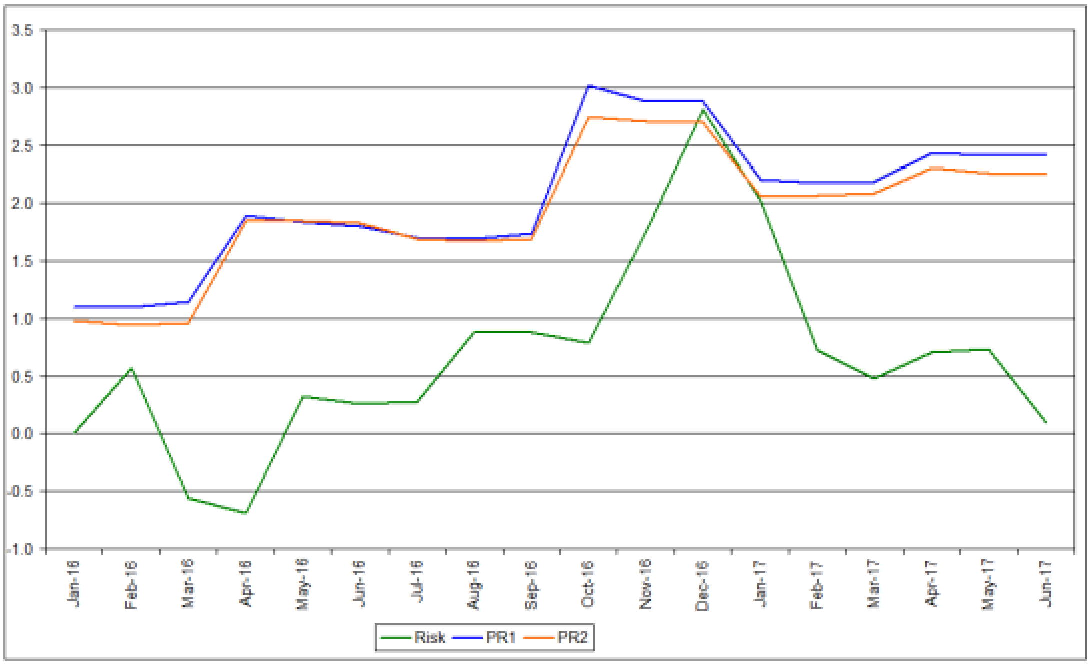

Fig. 2. The dynamics of the values of PR_1 and PR_2 and monthly increase

of the total risk (R, % per month) of the banking system of Russia

It can be seen from the graph that PR1 and PR_2 change in a similar way. Therefore, it does not matter for the investigation of the dynamics, which of the indices to use. However, it is important for the ratings on the criteria scale. In future studies, we are going to use PR_1.

Comparison of the dynamics of PR_1, PR_2 with the dynamics of growth in the total risk of the banking system of the Russian Federation allows to see the presence of a positive trend in all three indicators. Consequently, the correlation between the indicators is likely to be positive. At the same time, it follows from formula (4) that the correlation between PR and the level of risk (R) should be negative. Let us analyze this contradiction in more detail.

Fig. 3 and 4 show the dependence of PR1 on the magnitude of the risk (Fig. 3) and on the rate of risk growth (Fig. 4).

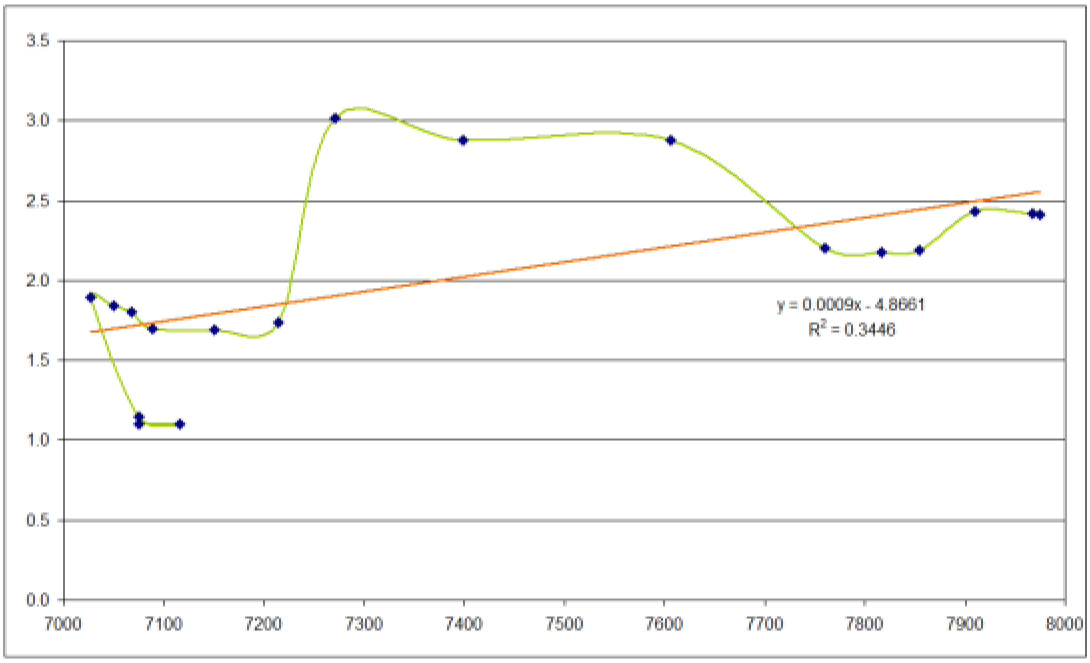

Fig. 3. Correlation of PR_1

and the total risk (R, in bln. roubles) in the banking system of Russia

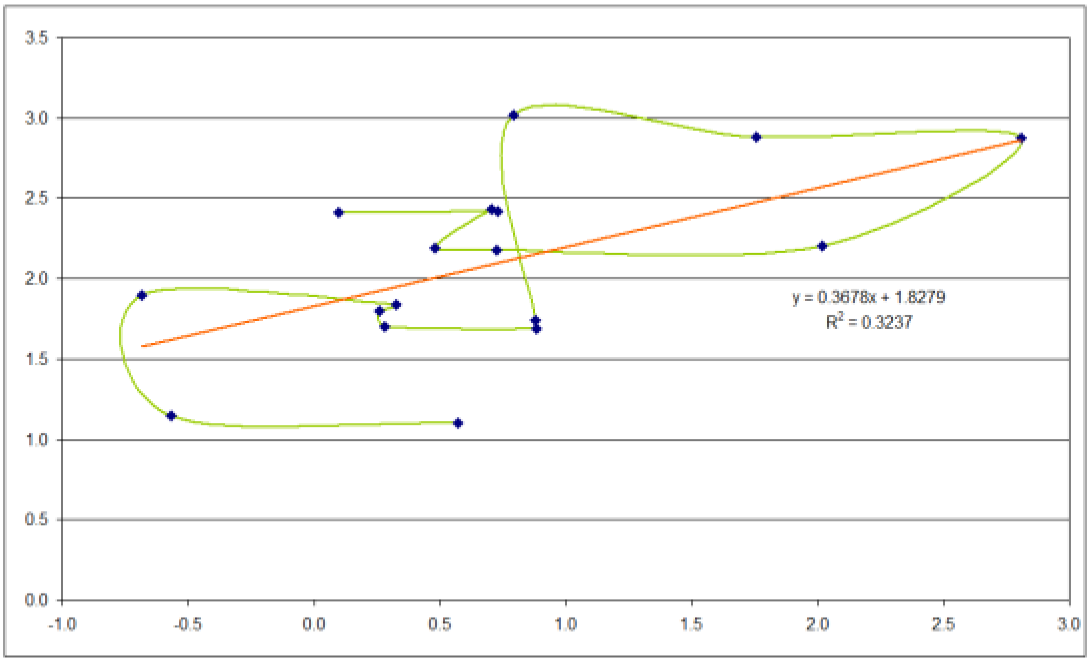

Fig. 4. Correlation of PR1 and

the growth rate of the total risk (R) in the banking system of Russia

As can be seen from the regression equations shown in Fig. 3 and Fig. 4, the correlation in both cases is positive: 0.587 for Fig. 3 and 0.569 for Fig. 4 respectively. There is a moderate positive correlation. It is explained by the fact that the profits of banks increased slightly more than risks. This is most likely due to the sampling of data, as the increase in the size of risk assets should not necessarily be accompanied by a faster growth in profits.

4. In general, the results of the analysis show that the proposed methodology for assessing financial stability on the basis of the ratio of profitability to risk has the following advantages:

1. It allows giving both quantitative and qualitative assessment of financial stability in the banking sector of the economy, both at the micro- and macroeconomic level.
2. The methodology is based on official reports that are publicly available and can be used for external evaluation of the level of financial stability by any interested party.
3. In view of the regular publication of the initial statistical data, the proposed methodology ensures monitoring of financial stability with the same frequency and regularity.
4. If the methodology is adapted to the financial statements of commercial banks of different countries, it can be successfully used to assess the financial stability of their banking systems and conduct cross-country comparative analysis.
5. Using the proposed methodology, as well as the correlation dependence of the ratio of PR on the amount of accounted risks, the central banks will be able to quantify the strategic goal for the financial stability of the banking system, and to exercise timely control over its achievement.
6. The assessment of financial stability based on the PR indicator can be used by banking supervisors to detect problems in the activity of banks at an early stage.
7. The results of the financial stability assessment based on the PR ratio will be useful to minority shareholders and external users in the form of rating agencies, analytical centers, as well as frequent investors planning to place their savings in commercial banks.

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«They say things are happening at the border, but nobody knows which border» (Mark Strand)

The New Italian Regime on Blockholders Disclosure and its Effects on Creeping Acquisitions: Preliminary Thoughts

by **Andrea Sacco Ginevri**

Abtract: *This Article analyzes the main issues arising from the new Italian regime on Blockholders disclosure recently introduced by a new paragraph of Article 120 of the Italian Securities Act. The analysis moves from a preliminary recognition of the new rules governing the transparency obligations on the acquisition of relevant shareholdings in Italian listed companies.*

Then, this paper compares the Italian provisions with those set forth, in the same field, by the applicable laws and regulation in the U.S. and in France. Such a comparison gives useful tools to deal with certain issues connected to the initial application of the new Italian regime scrutinized hereinunder.

In conclusion, this preliminary analysis shows how the new rule introduced by par. 4-bis of Article 120 of the Italian Securities Act falls into a grey area between disclosure and conduct rules, probably due to the fact that it has been enacted mainly for the purpose of reducing hidden creeping acquisition in the Italian financial markets.

1. On 16 October 2017, the Italian Law Decree No. 148 – setting forth "*urgent provisions on financial matters and for undeferrable matters*" (so-called "Tax Decree") – has entered into force. In particular, Article 13 of the Tax Decree has introduced a new paragraph 4-*bis* in the body of Article 120 of the Italian Securities Act (*i.e.* Legislative Decree No. 58 of 24 February 1998) which requires the purchaser of highly material shareholdings in the voting share capital of any Italian listed company (*i.e.* above 10, 20 and 25%) to file a statement on the goals pursued by the purchaser with the acquisition.
In the view of the Italian legislator, such provision aims at improving transparency and safeguarding the proper functioning of the market, increasing the level of information of the stakeholders in corporate M&A transactions (see the Press release of the Italian Government No. 50 of 13 October 2017).

The Tax Decree has been recently converted, with amendments, by the Law 4 December 2017, No. 172, entered into force on December 6, 2017.

Art. 13 of the Tax Decree has directly amended the Italian Securities Act by revising the provisions on mandatory disclosure of material shareholdings in Italian listed companies set forth by Art. 120 mentioned above.

Such latter provision – which, as known, is included in Section I (“*Ownership Structures*”), of Chapter II (“*Listed companies*”) of Title III (“*Issuers*”) of Part IV of the Italian Securities Act – sets forth, in paragraph 2, that any person holding a stake in “*a listed issuer having Italy as home Member State*” which exceeds 3% (or 5% for a SME) – or the other thresholds set forth by the Italian Stock Market Supervisory Authority (*i.e.* Consob) – shall communicate such shareholding both to the relevant issuer and Consob.

The relevant implementing provisions issued by Consob, and set forth in Articles 117 and following of the Consob Regulation in issuers No. 11971 of 1999, indicate, in addition to the other thresholds of material shareholdings for the purposes of the aforementioned disclosure notice (5%, 10%, 15%, 20%, 25%, 30%, 50%, 66.6% e 90%), also the criteria for the calculation of such holdings as well as the terms and conditions of the notice.

As well known, with the notice provided under Art. 120 of the Italian Securities Act, market participants acquire knowledge of the size of the shareholding acquired, of the direct owner of such shareholding and of the ultimate beneficial owner of the shareholding itself.

2. More in details, Article 13 of the Tax Decree has introduced in the body of Article 120 a new paragraph 4-*bis*, which requires that, upon acquisition of a shareholding in a listed company equal or exceeding 10%, 20% and 25% of its share capital, the purchaser giving the notice under Article 120 represents and states (also) the goals that the same intends to pursue in the six months after the investment.

For companies other than SME, the provisions of the new paragraph 4-bis are, in any case, without prejudice to art. 106, paragraph 1-*bis*, of the Italian Securities Act, pursuant to which – in the event that, after a purchase, the 25% threshold is exceeded and there is no other shareholder with a higher stake – the relevant purchaser is required to launch a mandatory tender offer, with the consequent disclosure and fulfillment duties.

The statement provided under the new paragraph 4-*bis* shall indicate, under the declarant’s own responsibility: a) the terms of financing of the acquisition; b) whether the purchaser is acting alone or in concert; c) whether the same intends to desist from other purchases or to carry on with additional purchases, as well as if the purchaser intends to acquire control of the issuer or, in any case, exercise an influence on the management of the company and, in such cases, the strategy that the same intends to follow and the terms for its implementation; d) the intentions regarding any shareholders’ agreements and arrangements to which the purchaser is a party; e) whether the purchaser intends to propose the amendment or removal of the administrative or supervisory bodies of the issuer.

Without prejudice to the above, in the event that, within six months from the delivery of the notice, there is a change in the intentions of the declarant “*on the basis of supervening objective circumstances*”, the declarant shall deliver, without delay, a new reasoned notice to the issuer and Consob, from which the above-mentioned six month-term shall run again.

The latter provision allocates the new rule introduced by par. 4-*bis* into a grey area between disclosure and conduct rules, notwithstanding the circumstance that it has been enacted mainly for the purpose of improving the transparency of creeping acquisition (*i.e.* of acquisition below the mandatory tender offer threshold but potentially aimed at triggering a change of de-facto control over the issuer).
All the above is without prejudice to the provisions on market manipulation under Article 185 of the Italian Securities Act, which punishes with criminal sanctions anyone who disseminates false information or sets up sham transactions or employs other devices likely to produce a significant alteration in the price of financial instruments.
In addition, pursuant to paragraph 4-*bis* – as amended following the conversion process – both the initial statement and its subsequent amendment shall be transmitted to the issuer whose shares are subject to the acquisition and to Consob, as well as to the market according to the terms and conditions set forth by the Consob regulation, issued for the implementation of Article 120, paragraph 4, lett. c) and d), of the Italian Securities Act [1]. Consob was granted with the faculty to identify, through its own regulation, the cases in which the aforementioned statement is not due, taking into consideration the features of the entity required to make the communication or the company whose shares have been purchased [2].
Pursuant to paragraph 5 of Article 120 of the Italian Securities Act, as amended by Article 13 of the Tax Decree, in case of failure to file the statement required by the aforementioned paragraph 4-*bis*, the voting rights attached to the listed shares or (when applicable) the other financial instruments purchased cannot be exercised. In the event of failure to comply with the above, Article 14, paragraph 5, of the Italian Securities Act shall apply and the resolution or act adopted with the decisive vote or intervention of such securities can be challenged also by Consob pursuant to paragraphs 6 and 7 of the same Article 14.
Moreover, according to Article 193, paragraph 2, of the TUF – as amended by art. 13 of the Tax Decree – and save that the fact constitutes a crime, in the event of failure to file the statement required by paragraph 4-*bis* of the art. 120 the following administrative measures and sanctions shall apply: a) a public statement indicating the responsible of the breach and the nature of the same; b) an order to remove the alleged breach, which may indicate the measures to adopt and the term for their implementation, as well as to refrain from any repetition of such conduct, when the same is deemed scarcely offensive and dangerousness; c) a monetary administrative sanction from Euro ten thousand up to Euro ten million, or, if higher, up to five percent of the aggregate annual revenues.

3. Blockholders disclosure provisions comparable to those introduced by the Tax Decree in Italy have since long been adopted in other foreign countries' corporate legislations, and in particular in the United States and in France.
The eldest experience of the so called blockholders disclosure system dates back to the United States' late sixties [3].
To date, the relevant provisions are set forth in Section 13(d) of the Securities Exchange Act, pursuant to which any person, after acquiring, directly or indirectly, equity securities of a listed company (also through a security-based swap) comes to hold, directly or indirectly, more than 5 per centum of the relevant class, shall file with the Securities and Exchange Commission (SEC), within ten days from the

acquisition (or the shorter term which may be set forth by the SEC), a statement containing, *inter alia*, the following information:

- the source and amount of the funds or other consideration used or to be used in making the purchases, and if any part of the purchase price is represented or is to be represented by funds or other consideration borrowed or otherwise obtained for the purpose of acquiring, holding, or trading such security, a description of the transaction and the names of the parties thereto, except that where a source of funds is a loan made in the ordinary course of business by a bank, if the person filing such statement so requests, the name of the bank shall not be made available to the public;
- if the purpose of the purchases or prospective purchases is to acquire control of the business of the issuer, any plans or proposals which such persons may have to liquidate such issuer, to sell its assets to or merge it with any other persons, or to make any other major change in its business or corporate structure;
- information as to any contracts, arrangements, or understandings with any person with respect to any securities of the issuer.

Similarly to Italian law, the Securities Exchange Act requires that if any material change occurs in the facts set forth in the statement filed with the SEC, an amendment shall be filed with the SEC.

Even more similar to the newly-introduced Italian blockholders disclosure legislation are the provisions adopted and implemented, since 1998, in the French legal system [4]. To date, the relevant regulation is set forth in art. L233-7 of the *Code de Commerce*, which – similarly to art. 120 of the Italian Securities Act – governs the transparency of the ownership structure of listed companies.

In particular, paragraph 7 of the above article provides that the persons required to file the statement on "material shareholdings" pursuant to the previous paragraphs of the same art. L233-7 are also required to disclose and represent, upon exceeding the thresholds of 10%, 15%, 20% and 25% of the share capital or voting rights, the goals that the same intend to pursue in the following six months.

Such statement, which must be filed with the issuer and the *Autorité des Marchés Financiers* ("AMF") within the end of the fifth open-market day after the relevant threshold has been exceeded (deadline set forth by the relevant implementing regulation and provided in the Statement Form prepared by the AMF), must include, amongst others, the following information:

- the sources and funds used for the acquisition, indicating in particular – as required in the Statement Form prepared by the AMF – (i) whether the acquisition has been funded through own funds or debt, specifying, in such latter case, the main terms of the relevant financing and the relevant securities, if any; as well as (ii) any quota acquired through securities lending transactions;
- whether the purchaser is acting alone or in concert;
- whether the same intends to desist from other purchases or to carry on with additional purchases, as well as if the same intends to acquire control of the issuer;
- the strategy that the purchaser intends to follow in respect to the issuer and the terms for its implementation and in particular – as requested in the Statement Form prepared by the AMF – all the plans regarding (i) merger, reorganization, winding-up or transfer of material assets of the issuer or its subsidiaries; (ii) amendments to the business and/or the by-laws of the issuer; (iii) issuance of new securities of the issuer or delisting of issued securities; as well as (iv) any other action or activity which may have an impact on the strategies of the issuer;

- its intentions regarding the "*dénouement*" of any agreement or instrument (such as options/derivatives), to which it is a party;
- any agreement of temporary transfer regarding the shares and the voting rights;
- whether the same intends to become or propose candidates to the office as director, member of the *directoire or of the conseil de surveillance*.

Also, the French provision governs the event of possible changes in the statements filed; however, the current provision of the Code de Commerce appears broader than the correspondent provisions of the Italian and U.S. legal systems, as it provides that, in case of changes in the intentions within six months, the declarant must file a new statement to the issuer and the AMF, from which the six-month term starts running again. In the original text of art. L233-7 – which was in force until January 2009 and, in such part, more similar to the provision of the new paragraph 4-*bis* of art. 120 TUF – a change in the intentions was allowed only in the event of "*modifications importantes dans l'environnement, la situation ou l'actionnariat des personnes concernées*".

4. The decision to introduce also in the Italian legal framework a set of provisions on "early warning" disclosure has the main goal of increasing the transparency of the so-called takeovers below Mandatory Tender Offer threshold (*i.e.* creeping acquisitions) [5], to protect and safeguard the proper functioning of the market and the equal treatment of all stakeholders.

Unlike the golden powers provisions– which are also supplemented and partially strengthen by the Tax Decree – the provisions on blockholders disclosure protect the interests of the entire market and the related stakeholders and not (only) those of specific sectors deemed of strategic and national interest.

However, a first remark concerns the scope of the new paragraph 4-*bis* of Article 120. As anticipated above, such provision expressly refers to the acquisition of securities in "*listed companies*". A first issue regards therefore what type of listed companies the provision intends to refer to. Considering the systematic inclusion of the new provision within the text of Article 120 and, more in general, within the Chapter on "*Listed companies*", it seems reasonable to conclude that, although not expressly specified, reference is to be made to the acquisition of securities in "*listed companies having Italy as home Member State*", just as provided by paragraph 2 of the same Article 120. Such conclusion seems further supported by the circumstance that paragraph 4-*bis* is included in a system of notices and statements already provided by Article 120, further requiring that the person who files the statement required by the said paragraph 2, when the conditions and requisites set forth under paragraph 4-*bis* are met, must also disclose and state its goals. The statement required by paragraph 4-*bis* is therefore an additional statement that supplements the statements already required by the other paragraphs of Article 120 (in the French system the same form of the notice on the holding of material shareholdings – the same form which, in Italy, is enclosed under Annex 4 to the Consob regulation on issuers – includes also the section on the reasons and goals of the acquisition).

A second issue of particular interest, given that the Tax Decree has been enacted quite recently, concerned the practical enforceability of the new paragraph 4-*bis* pending the adoption of the relevant implementing regulations by Consob. According to the original wording of the provision, as already mentioned, the "early-warning" statement had to be transmitted to the issuer and to Consob within ten days starting from the date of the purchase of the shareholdings, and Consob was granted with the power to determine, through regulation, the terms and conditions of the disclosure to the market. On the basis of the wording of the provision, it seemed reasonable to conclude for a “staggered” effectiveness of the new provisions: (i) immediate, with reference to the statement to the issuer and to the market; (ii) deferred (after issuance of the Consob regulation), with reference to the communication to the market.

On a practical level, prudence has, however, led to a full implementation of the new regulatory provision, even for the part of the same provision concerning the communication to the market [6].

Analogous principle of prudence seems to be applicable also with the entrance into force of the new provisions, as amended by the conversion law, which provides that the statements shall be transmitted to the issuer and to Consob, as well as to the market according to the terms and conditions set forth under Consob regulation issued for the implementation of Article 120, paragraph 4, lett. c) and d).

Pending any possible regulatory intervention by Consob, today it seems that, also for the statements provided under paragraph 4-*bis*, reference should be made to the terms and conditions of the communication and disclosure to the market already provided under Articles 121 and 122 of the Consob regulation on issuers concerning the disclosure of material shareholdings.

As for the content of such statement, reference must be directly made to the list provided under paragraph 4-*bis*, which – despite the doubts that may arise in its interpretation (for example as regards the notions of “*concert*” and “*influence on the management*”) – appears, in any case, sufficiently “self-explanatory”. Indeed, following the conversion procedure, the previous provision according to which Consob was granted with the power to specify the content of the items of the statement has been eliminated.

Further areas of attention, which will need specific analysis refer, as an example, to the calculation criteria of the significant holdings and the conditions that legitimate a change in the intentions of the purchaser, as already communicated.

As for the first aspect, that is the holdings calculation criteria, it appears reasonable to apply, in general, the criteria under Articles 118 and following of the Consob regulation on issuers implementing the other paragraphs of art. 120 of the Italian Securities Act, pursuant to which the following must be computed in the relevant calculation: (i) the shares owned by a party, even if the relevant voting rights belong or are granted to third parties or are suspended; (ii) the shares in relation to which a party has or is granted the relevant voting rights under one of the circumstances set forth by paragraph 1 of the mentioned Article 118 of the Consob regulation; as well as (iii) the shares owned by nominees, trustees or subsidiaries and the shares in relation to which the above persons have or exercise the voting rights.

Other than as provided under paragraph 3-*bis* of art. 118 of the Consob regulation in relation to the other disclosures provided by art. 120, pursuant to paragraph 4-bis it should not be considered relevant the so called “passive exceeding” of the thresholds, as it may occur in the presence of multiple votes shares. The purpose of the “early warning” provision, as noted, is to increase the transparency of information “upon acquisition” of shareholdings exceeding specific qualified thresholds. So, where the exceeding of such thresholds is independent from a voluntary act of the shareholder, paragraph 4-*bis*should not apply. Such conclusion seems to be confirmed also by the circumstance that paragraph 4-*bis*, for the purpose of defining the object of the disclosure, identifies elements which refer to an intentional increase of the shareholding held.

As regards the second aspect, a relevant issue arises as to whether there is any limit, and – if so – which ones, to the possibility to change the intentions already disclosed before the expiry of the six month-term. As reminded above, the provision indeed sets forth that “*without prejudice to what provided*

under art. 185, if, within the next six months from the delivery of the statement, there is a change in the intentions on the basis of supervening objective circumstances" a new statement must be filed, from which the above-mentioned six month-term shall run again. The possibility to change the intentions already communicated would seem therefore limited by, and subject to, the occurrence of supervening objective circumstances that justify the change. The purpose of such limitation should probably be brought back to the intention to avoid that the information transparency and the disclosure value descending from the first statement may be "nullified" *ad nutum* by the shareholder.
Other considerations refer to the set of sanctions, broadly intended.
First of all, the provisions of paragraph 4-*bis* on the change in the declarant's intentions expressly refer and save the application of the provisions of (the sole) Article 185 of the Italian Securities Act which sanctions the offense of market manipulation. To the contrary, no reference is made to the other provisions of the Italian Securities Act on the subject of market abuses (Articles 181 and following), which, to date, punish with both criminal and administrative sanctions the cases of insider trading and market manipulation, nor to the new European directive on market abuse. In this regard, the above provisions, even if not expressly referred to, should be in any case taken into account.
As specifically regards the sanctions introduced by Article 13 of the Tax Decree by way of amendment to Article 193 of the Italian Securities Act (as confirmed following the conversion), please note how the reference to paragraph 4-bis has been introduced only in paragraph 2 of such Article 193, which imposes sanctions over companies, entities and associations for the case of failure to make the required communication. To the contrary, Article 13 of the Tax Decree does not expressly mention the following paragraphs 2.1 and 2.2 of the same Article 193, which regulate the different hypothesis where the sanctions are respectively imposed on individuals or persons holding managerial, direction or control positions, or on the personnel of legal entities, whether and when the behavior of such persons has contributed to cause the breach committed by the latter. It is also not mentioned paragraph 2.3, which sanctions the different specific case of delay in the communications provided under Article 120, paragraphs 2, 2-*bis* and 4; indeed, differently from paragraph 2, such provision does not include any reference to the new paragraph 4-*bis*.
In a nutshell, the above preliminary thoughts show how the new rule introduced by par. 4-*bis* of Article 120 of the Italian Securities Act falls into a grey area between disclosure and conduct rules, maybe due to the fact that it has been enacted mainly for the purpose of reducing hidden creeping acquisition in the Italian financial markets.

References

[1] According to the provision originally introduced by the Tax Decree, the statement had to be transmitted to the issuer and to Consob within ten days starting from the date of the acquisition of the shareholdings, while Consob was entrusted with the power to determine, through regulation. the terms and conditions of the disclosure to the market.

[2] Before the conversion, Consob had been delegated to adopt, through its own regulation, implementing provisions aimed at clarifying: (i) the content of the items of the statement; (ii) the cases in which the latter was not due by the holders of the financial instruments provided with the rights set forth by art. 2351, paragraph 5, of the Italian Civil Code, taking into consideration, as appropriate, the

size of the shareholding and the characteristics of the declarant; and (iii) the provisions relating to the controls to be carried out by Consob itself on the content of the statements and the relevant terms.

[3] See, among others, L.A.Bebchuck and R.J.Jackson Jr., *The Law and Economics of Blockholders Disclosure*, in *Harvard Business Law Review*, 2012, 39 foll.

[4] In this respect see C.Maison Blanche and A.Barat, *La nouvelle obligation de transparence sur les operations de detentions temporaire avant tenue des assembles: Réflexions préliminaires*, in *Revue trimestrielle de Droit Financier*, 2011, 80 foll.

[5] See L.Enriques and M.Gatti, *Creeping Acquisitions in Europe: Enabling Companies to Be Better Safe than Sorry*, 2014, available at http://www.ssrn.com.

[6] In particular, please note: (i) the statement of Mark N. Lampert (BFV Partner L.P.) in relation to CTI Biopharma S.p.A. (cfr. Notice of *Borsa Italiana* no. 21958 of November 22, 2017); (ii) the statement of Elliot International in relation to Ansaldo STS S.p.A. (cfr. Notice of *Borsa Italiana* no. 21959 of November 22, 2017); and (iii) the statement of Aruba in relation to Dada S.p.A. (cfr. Notice of *Borsa Italiana* no. 22009 of November 23, 2017).

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«They say things are happening at the border, but nobody knows which border» (Mark Strand)

EBA launches harmonisation of European covered bonds rules

by **Patrizio Messina**

Abtract: *The article analyses the framework of Covered Bonds legislation, focusing on the European regulatory fragmentation with regards to this tool. Indeed, together with its utility within the structured finance environment and its challenging enhancement of potential interested investors entourage, the paper aims at highlighting how a lack of uniformity can lead to investments barriers within the European Union market.*

1. Covered Bonds are debt obligations of long-term finance issued by credit institutions which provide a double-recourse protection to bondholders: if the issuer defaults, the bondholder – usually institutional investors such as banks, pension funds, insurance companies or asset managers who prefer a low-risk and long-term investment – can exercise a direct and preferred claim against some specific assets (usually are high-quality assets) and an ordinary claim against the issuer's remaining assets. Such mechanism theoretically allows banks to perform more lending activities under safer conditions. It made them particularly useful during the crisis years of 2008.
Covered Bonds issuance is thus based on a general scheme involving:
(1) the transfer by a bank – which does not need to be the same bank as the issuer of the bonds – to a special-purpose vehicle of assets of high credit quality;
(2) the granting to the special-purpose vehicle, by the transferor or another bank, of a subordinated loan aimed at providing the vehicle with the resources required to purchase the assets; and
(3) the provision by the vehicle of a guarantee to the bondholders, within the limits of the separate assets.
The main characteristics of Covered Bonds may be said to be the high quality of the assets transferred and the dual guarantee provided, i.e., on the one hand, the segregation of the loans transferred to the SPV and their designation for the satisfaction of the bondholders, and, on the other, the guarantee

provided by the issuer pursuant to the civil regulation, in addition to the separate undertaking by the special-purpose vehicle in the event of a default by the issuer.

2. Notwithstanding their importance as a financing source for European banks, since they facilitate mortgages lending and public loans, the EU framework still provides for a fragmented legislation among different Member States, which creates obstacles for a common level playing field of access to different markets. Indeed, the European Regulation does not define in an exhaustive manner what constitutes a Covered Bond, but intervenes essentially to give Covered Bonds a preferential treatment from a prudential and regulatory point of view, provided that certain characteristics are respected.
The first European regulation on Covered Bonds, even if poor, can be found in the Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), which within Art. 52, provides a generic definition of Covered Bonds in order to identify the financial instruments in which UCITS may invest, and in Regulation No. 575/2013 ("CRR"), which, in Art. 129, on the other hand, identifies further conditions for obtaining preferential prudential treatment with reference to the capital requirements of credit institutions investing in Covered Bonds. These additional requirements, which set out the conditions under which investors in covered bonds can obtain such preferential treatment, while increasing the level of European harmonisation in the field of covered bonds, are not applicable outside of banking regulation. Therefore, in view of the fragmentation of covered bonds regulation between the different Member States on the one hand and the importance of covered bonds as a source of funding for national and European banks on the other hand, the need has arisen in the European context to regulate covered bonds as harmonised and comprehensive as possible.

3. To this end, in the context of the Capital Markets Union ("CMU") project, the European Commission launched a public consultation in September 2015[1], inviting stakeholders to provide elements that could be representative of the fragmentation of the European Covered Bonds market and some feedback on the following potential solutions:
1) a voluntary approach, with the use of non-binding tools in order to foster voluntary convergence by Member States on the regulation of Covered Bonds, such as the Commission's recommendations to States on the implementation of best practices defined by the EBA within the national regulatory framework;
2) a European legislative framework on Covered Bonds (through a Directive or a Regulation of Community law that functions as the "29th Regime"[2]).
The contributions sent by stakeholders in response to the consultation suggested that:
– the increased divergence in securities yields between Member States after 2007-2008 was not necessarily a consequence of legislative fragmentation or a disabling feature of the market, but probably a normal adaptation to the post-crisis environment;
– Covered bonds prices are directly related to the sovereign issuer risk, the credit risk of the issuer and the specific characteristics of each covered bond issuance programme (mainly in terms of structure and coverage);
– the rating of issuers and countries after 2007 led to the downgrading of many covered bonds issuance transactions, causing a loss of homogeneity of "AAA" ratings, from which almost all European covered bonds benefited and, as a result, a widening of the divergence between countries;

– demand on the investor side was not driven by the difference between the various legal frameworks, but rather by risk appetite, the search for an adequate return, investment strategies, regulatory regime, market liquidity;
– the prediction of the "29th regime" could lead to greater regulatory fragmentation in the short term. At the same time, the hypothesis of a European legislative framework on covered bonds, albeit with caution, has been more successful.
That said, on 20 December 2016, the European Banking Authority ("**EBA**") published the final version of a report entitled "*EBA Report on Covered Bonds – Recommendations on Harmonisation of Covered Bond Frameworks in the EU*" (the "**Report**"). The Report builds on previous work and provides additional recommendations on how to further harmonise the national legislative frameworks on the covered bond instrument.
In response to Recommendations of the European Systemic Risk Board (ESRB) and following the publication by the EBA of their Report on EU Covered Bond Framework and Capital Treatment[3], EBA began an extensive analysis of the regulatory and legal framework for covered bonds in individual Member States, with a specific focus on alignment with EBA's best practices.

4. The aim of the Report is to:
1) summarise the activity of regulatory investigation which was carried out following publication of the Report on EU Covered Bond Framework and Capital Treatment (in July 2014);
2) develop four key recommendations (the "**Recommendations**") to implement a common regulatory framework for covered bonds; and
3) set out three key steps for the implementation process of the Recommendations and define the necessary activities for each of them.
The Recommendations issued by the EBA are as follows:
Recommendation No. 1: Three-step approach to the harmonisation of the European regulatory framework for covered bonds.
Recommendation No. 2: Development of a covered bonds directive (the "**CB Directive**"). Recommendation No. 3: Amendment of EU Regulation 575/2013 (the "**CRR**"). Recommendation No. 4: Voluntary convergence of national rules governing covered bonds. The Report suggests implementation of the above four Recommendations in three key steps which are summarised below.

5. The proposed three-step approach builds on the strengths of the existing national frameworks, but allows better regulation of covered bonds in order to achieve a broad harmonisation throughout the EU. The adopted model provides for the development and implementation of framework legislation ensuring a more consistent approach, particularly with to regards prudential standards, generally applicable in all Member States, and which replaces the discipline currently contained in Article 52, paragraph 4, of Directive 2009/65/EU (Undertakings for Collective Investment in Transferable Securities–UCITS)[4].
In particular, European legislation should define structural requirements for covered bonds with specific reference to:
– requirements on the dual recourse of a covered bond, segregation of cover assets and bankruptcy remoteness;

– requirements on the coverage principle, liquidity risk mitigation and cover pool derivatives;
– requirements on a system of special public supervision and administration related to covered bonds, including requirements for a cover pool monitor, supervision of the issuer on an ongoing basis, supervision in the event of the issuer's insolvency/resolution, and administration of the covered bond programme following the issuer's insolvency/resolution;
– transparency requirements — i.e. scope, format and frequency of disclosure of information;
– conditions for soft bullets and conditional "pass through covered bonds".

EBA, also, recommends developing a new covered bonds framework, which primarily deals with providing a single and organic definition of the instrument. In particular, the definition, obtained in light of the experience of market players as well as the work of the competent authorities, should:
– define both minimum requirements and characteristics that covered bonds must have in all Member States;
– facilitate the achievement of a good level of harmonisation;
– differentiate covered bonds from other financial instruments with similar characteristics;
– replace and supercede all previous definitions, including for example those contained in the UCITS Directive.

The CB Directive would become the new European regulatory framework, ensuring a uniform development of the same legislation in all Member States, granting each Member State sufficient flexibility to safeguard its specific needs.

6. The second step of the process provides for amendments to the sections of the CCR dealing with covered bonds. Currently, the CRR deals with the regulation of covered bonds with reference to the three main aspects: 1) Criteria for investors (credit institutions and investment firms) in covered bonds for preferential risk weight treatment of their covered bond investments, being the eligibility requirements for collateral and the disclosure requirements for an issuer (Article 129); 2) Risk weight treatment under the standardised approach (Article 129), preferential LGD (loss-given default) treatment of exposures in the form of covered bonds under the (foundation) IRB approach (Article 161(1)(d)), as well as preferential specific risk treatment (Article 336(3)); and 3) Criteria for the valuation of immovable property collateralising mortgages in cover pools (Article 208 and Article 229(1) via Article 129(3)).

With reference to the risk weight treatment of covered bonds, the EBA recommends that the CRR is amended to be aligned with the provisions of the newly introduced CB Directive. In particular, with reference to Art. 129 of the CRR:
– eligible assets: EBA believes that the current level of eligible assets for Cover Bonds should not be extended. Funding for small and medium-sized enterprises (SMEs) and infrastructure financing should not be included among eligible assets; furthermore, they recommend further analysis on ship loans guarantees which are currently included in Art. 129 of the CRR as eligible assets) would be needed. In addition, the EBA recommends not extending the exemption for the inclusion of RMBS and CMBS beyond December 2017;
– limit on substitution assets: EBA recommends to amend the CRR in order to provide for the rules on composition of both replacement assets and limits within which replacement may be expected (this limit should be set at 15% of the minimum required coverage);

– LTV limits: EBA considers that the current LTV (loan to value) limits set out in the CRR are appropriate, however, the CRR should specify that they are “soft coverage” LTV limits and should be applied on an ongoing basis throughout the life of the programme;
– overcollateralisation: EBA suggests setting the minimum effective overcollateralisation at 5%; the percentage limits on exposures as currently set out in Art. 129 of the CRR should continue to be applied, but they should not be relevant to the voluntary overcollateralisation; and
– improving the disclosure policy for the issuer, so that the dissemination of transparent information can become a standard requirement for all regulated covered bonds, rather than a specific condition for obtaining a preferential prudential weighting factor.

7. The third and final phase seems to be less binding than the others; in any case, it will depend on the actions taken by individual Member States. In this respect, EBA recommends and encourages voluntary convergence between national frameworks also for other aspects (i.e. portfolios of assets constituted by underlying homogeneous activities or debtors located in jurisdictions not belonging to the European Economic Area).
Taking a long-term view, EBA believes that such spontaneous and non-binding approach to legislative reform could lead to extended homogeneity across Member States.

8. In March 2017 the European Covered Bond Council (ECBC) announced that it supported the Report’s recommendations and offered its collaboration to implement the harmonisation of covered bonds across the EU in the most effective way.
More recently, on 17 May 2017, the European Commission published the study “Covered Bonds in the European Union: harmonisation of legal frameworks and market behaviours” (“Impact Study”)[5]. The report includes an overview of the European Covered Bonds market and, in particular, a cost/benefit analysis of the proposals submitted at the end of 2016 by the European Banking Autorithy on harmonisation.

9. The Impact Study examines the current state of the European Covered Bonds market and the possible costs/benefits resulting from a specific EU legal framework, including:
1) an harmonised definition of Covered Bonds specifying its standard structural aspects (by amending Article 52(4) of the UCITS Directive);
2) the conditions for the specific prudential treatment of Covered Bonds (by introducing targeted amendments to Article 129 of the Capital Requirements Regulation).
Following EBA Recommendations published in December 2016, which set out the specific elements of a possible European legislative framework, the Impact Study focuses on: functioning and performance of European covered bond markets to identify improvements that can be achieved through EU intervention without damaging them, and the implications of possible EU actions and their potential added value also in view of autonomous market developments (such as the Covered Bond Label[6]).

10 The EBA and the results of the Impact Study suggest that there is no need to regulate at European level the assets backing Covered Bonds. The Impact Study assigns EBA the task of determining the principles for the structuring of the guarantee, but states that the precise definition of the guarantee should be left to the supervisory authorities of the individual Member States.

EBA's proposals provide for the introduction of a liquidity buffer in Europe to cover all interest and repayment maturities over the next 180 days. In the case of covered bonds with the possibility of maturity extension ("soft bullet" or "Conditional Pass Trough" ("CPT")), imminent redemption maturities should not be taken into account in the calculation of the liquidity buffer, as a kind of favouritism in favour of these solutions could be outlined.
On the basis of the EBA proposals, Covered Bonds of the soft bullet or CPT type should continue to be recognised as Covered Bonds and benefit from preferential regulatory treatment, provided that certain conditions that may be specified by the authority are met. In terms of Covered Bonds CPTs, the Impact Study proposes an initiative by private market participants to ensure the standardisation of the CPT mechanism and a new review by EBA within 2 years.

11. The available data – market statistics and feedback from stakeholders – suggest that the European covered bonds market is "well functioning".
Despite the presence of valid arguments for the superfluity of a European legislative intervention, first of all the resilience shown by the covered bonds market following the economic crisis of 2007 – 2008 and, then, the fear about the change of the "one size fits all" approach, the Impact Study suggests some reasons to support the EU legislative action, namely:
– the existence of significant risks and vulnerabilities in the market, which could suggest that previous positive performance is not necessarily a guarantee of future soundness. Appropriate EU action could reduce future risks to the extent that it would improve covered bond frameworks, in particular following an issuer's insolvency.
– the current lack of harmonisation between Member States and the relative weakness of certain aspects of covered bonds, while not necessarily considered serious by investors under current market conditions, could undermine the basis for the prudential treatment of the asset class of covered bonds.
In this context, it has been noted that the debate on the best prudential treatment for covered bonds and securitisations[7], given the developments in both markets, may represent a step forward in terms of regulatory convergence. EU legislative action could better align the prudential treatment of covered bonds between Member States and provide for a better justification for the current specific treatment of covered bonds.
The success of the covered bonds instrument as a funding instrument for existing activities could contribute to broadening the macroeconomic financing needs of the Union and to achieving the objectives of the Capital Markets Union. This potential benefit could prove to be the solution to the risk of disruption in the traditional covered bonds market, a key argument in the justification of actions to be taken at EU level.
All in all, the above reasons lead of the Impact Study to conclude that the intervention of the European authorities is justified and the results that could result from it would raise the level of quality of the covered bonds market.
Market participants are waiting for the possible announcement of a Covered Bonds Directive by the Commission as part of the Mid-Term review of the Capital Markets Union by June 2017 and the publication of a first draft of the Directive in the first quarter of 2018.

References

[1] European Commission (2015) Consultation Document: Covered bonds in the European Union. Available at: http://ec.europa.eu/finance/consultations/2015/covered-bonds/docs/consultation-document_en.pdf.

[2] The 29th Regime an alternative approach to EU integration allowing less law-making. Was provided for by the European Insurance and Occupational Pensions Authority (EIOPA) in a document entitled "Towards an EU-Single Market for Personal Pensions" which sets out a logic of harmonization of the sector by introducing a common regulatory framework for all existing private personal pensions (PPPs). Under this, individuals could adopt third pillar pension schemes throughout the EU, but national systems would continue to exist.The report follows on from the European Commission's February 2012 White Paper on policy, which sought to find a solution to tackle the ageing population without adequate pensions. See please https://www.ipe.com/towards-a-29th-regime/10001409.article.

[3] This consultation also dealt with the issue related to the development of a harmonised European framework for covered bonds, admitting that legislative divergences between countries may pose a major obstacle in terms of liquidity and investment opportunities and highlighting the importance of several recommendations on best practices suggested by EBA.

EBA report on Covered Bonds: recommendations on harmonization of Covered Bond frameworks in the EU, available at https://www.eba.europa.eu/documents/10180/1699643/EBA%20Report%20on%20Covered%20Bonds%20(EBA-Op-2016-23).pdf.

[4] In accordance with paragraph 1, first subparagraph, Member States may raise the limit of 5% up to a maximum of 25% if the obligations are issued by credit institutions having their registered office in a Member State and subject to a special public supervision for protection of bonds' holders. In particular, sums deriving from issue of such bonds are invested, conforming to the law, in assets able to cover receivables linked to the bonds for the entire duration and that, in case of insolvency of the issuer, would be used on a priority basis for both repayment of capital and payment of accrued interest. Where a UCITS invests more than 5% of its assets in bonds referred to in the first paragraph, issued by a single issuer, the value of such investments will not exceed 80% of the value of UCITS' assets. Member States shall communicate to the Commission the list of bonds categories referred to in the first subparagraph, as well as the categories of issuers authorised under the law and supervisory arrangements to issue obligations complying with criteria set out in the Report. These lists shall be accompanied by a description of the offered guarantees. The Commission shall immediately submit this information to the other Member States, along with appropriate comments, and make it accessible to the public. Such information may be exchanged with the European Securities Committee referred to in Art. 112.

[5] The text of the Impact Study is available at http://publications.europa.eu/resource/cellar/8df6d9cd-8c65-11e7-b5c6-01aa75ed71a1.0001.01/DOC_1.

[6] The Covered Bonds Label was created by the European Mortgage Federation ("EMF") and the European Covered Bond Council (ECBC) in 2012. Developed by the European issuing community, in close cooperation with investors and regulators and in consultation with all key stakeholders, the Label is a quality label that responds to a shared demand from market participants for high quality standards and increased transparency. For more information please see: https://coveredbondlabel.com/.

[7] The securitization transaction involves the sale without recourse of a portfolio of loans without recourse by a bank ("Originator") to a special purpose vehicle ("SPV"), in which the latter buys the

portfolio of impaired loans from the former at an agreed price and at the same time issues bonds in which the loans are incorporated, so-called “Asset-Backed-Securities” (“ABS”) to finance itself. The ABS are then placed with investors (so-called “Noteholders”) while the debt collection activity is entrusted to a Servicer, which is independent from the Originator.

Since its introduction, this structured finance technique represents an important leverage available to banks to meet their liquidity needs and, therefore, allow them to concentrate on their core business of financing businesses. In addition, financial practice has developed several securitisation models. On this subject, see Troiano, “Securitisation transactions”, p. 29; see also Granieri and Renda, “La securitization tra diritto e economia, tra normativa nazionale e modelli stranieri”, in aa.vv.. The securitization of loans in Italy, p. 8. For further information and literature on this form of securitization, please refer to the references identified by Troiano, “Le operazioni di cartolarizzazione”, p.35 ff.

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«They say things are happening at the border, but nobody knows which border» (Mark Strand)

Overview of property protection in Brazil (in the light of the World Bank's Doing Business Report)

by **Guilherme Calmon Nogueira da Gama and Patrícia Silva Cardoso**

Abstract: *The present article has the purpose to delineate a brief overview of the property right in Brazil and descant on the level of protection granted to such right, as well as the possibility of access thereto. Doing Business Report (2018) of the World Bank I hereby reviewed with the purpose of mapping the weaknesses and strengths of the protection granted to the property right in the Brazilian law in the light of the perception of the international community. This review is essentially descriptive of the results submitted by the report, with no propositional intention. This relevant issue causes direct repercussion in the foreign investments in the country and in the Brazilian people's welfare, once the level of legal certainty ensured by the institutions is considered one of the main standards of the Democratic Rule-of Law State.*

1. The definition of Rule-of-Law State encompasses the recognition of property rights for individuals and requires that property owners be given effective protection mechanisms both *vis-à-vis* the State and individuals that harm or threaten the free exercise of such rights. Respect for property rights is required minimally from all countries that are under a democratic regime. For this reason, it is considered that the existence of a democratic regime in a given State is an issue that concerns not only its citizens, but also the entire international community.

Democracy is an international cause that goes beyond the events and internal situations of a particular state and has a decisive impact on the global order (LIPSET, 1994, p.16). On the other hand, if democracy is an international issue, respect to property is the law of democracy, that is, one of the main rules of the game to be guaranteed in a democratic state, because it represents a fundamental problem of a constitutional and private order. It is a matter related to human interaction, which essentially concerns the choices made in the distribution and coordination of individuals by the State (SINGER, 2014, p.1289).

Although property is correctly considered a natural right, the level of effectiveness that is guaranteed to it is necessarily linked to the form of recognition and the mechanisms of protection that the State itself offers to the owners. Thus, if a given State only abstractly recognizes the right to private property without assuring the holder the legal means and instruments necessary to assert the right and protect it from the interventions of others, it can be said that democratic values are not fully realized. There is a structural deficit in the protection of a fundamental right (PEÑALVER, 2012, p. 20).

The issue becomes even more relevant before the emergence of new democracies in contexts characterized by political and economic fragility and often marked by institutional instability and fundamental rights violations. The third wave of democracy, represented by democratic transitions from the 1970s onwards[1], reinforced the concern to establish and ensure a minimum international standard of respect for democratic values in the international context (HUNTINGTON, 1991, p. 12).

It should also be noted that a number of international bodies, including the European Union, NATO, IMF and the World Bank, have regarded democracy as a precondition for States wishing to be members of such bodies or receiving financial assistance (LIPSET, 1994, p. .16). The so-called “Global Minimum Standard” or “International Minimum Standard of Treatment” can be applied to the most varied spheres of law, covering several institutes, including constitutional guarantees, democratic elections, foreign investment protection, among others (SPRANKLING, 2014, p.355).

In this regard, the Venice Commission for Democracy through Law, an advisory body to the Council of Europe[2] on constitutional issues, has the task of promoting studies and research on democracy and its articulation with the Rule-of-Law State. Based on the European constitutional tradition, expressed in documents such as the European Convention on Human Rights and the Statute of the Council of Europe, three pillars of European democracies are defined: the Rule of Law, the democracy and the human rights (VENICE COMMISSION, 2011, page 06). From such premises, the Commission intends to consolidate the establishment of democratic minimum standards in various thematic areas.

Within this perspective, the recognition and protection of property rights by States is considered a requirement for the full realization of democracy. Such a position is based on international principles and international declarations that recognize ownership as a fundamental right, including the Universal Declaration of Human Rights and the European Convention on Human Rights.

Property protection covers the legal and bureaucratic aspects of protection, among them, the material and procedural norms, the administration of justice and its effectiveness, as well as the costs related to access (PEÑALVER, 2012, p.23). Still in Europe, within the perspective of relevance of the protection of property in the international context, a Draft Common Frame of Reference (DCFR) is conceived, in order to define principles, definitions and model rules of the European Private Law, and covers issues relating to the protection of property and the possession of movable property.

Regarding the right of private property, the objective is to standardize the protection of property that must be minimally guaranteed in democracies, which includes protection against arbitrariness and against expropriation. Such standard obliges each State to ensure a uniform minimum level of protection for the core aspects of property rights – applicable to both nationals and foreigners -, which encompasses the recognition of private property and the guarantee against expropriation (PAPARINSKIS. 2013, p. 217).

In Latin America, this is a sensitive issue. The democratic expansion that took place on the continent in the 1980s gave rise to new democracies, still under construction, which are taking the first steps towards a real democracy. On the continent, the political process of democratization often took place at a time when countries were suffering a long and severe economic crisis, which resulted in the reinforcement of social exclusion and poverty. This is the case of the Federative Republic of Brazil, described in its Constitution as "*a Democratic Rule-of-Law State, aimed at ensuring the exercise of social and individual rights, freedom, security, well-being, development, equality and justice as supreme values*"[3].

It is important to consider that Brazil became a democracy in 1988, when a new Constitution was enacted after an authoritarian regime that began in 1964. The new text sought to reconcile various ideological tendencies and ensure broad protection of fundamental rights. The right of property was recognized as a fundamental right by art. 5 of the Constitution and, shortly thereafter, it was granted a social function (item XXIII of article 5), a concept endowed with open content and no precise doctrinal definition (FOSTER; WALSH; BONILLA, 2011, p. 112). In addition, the Constitution of the Federative Republic of Brazil treats urban property[4] and rural property differently, each assigning various functions and objectives[5].

Considering that the present Constitution was enacted after a long dictatorial period and in a context of economic crisis, and considering that Brazil is a recent democracy and, as such, presents the great majority of the problems regarding democracies that are under construction, the analysis of the international documents describing the systematic treatment of property law in the country is of utmost importance for the improvement of democratic institutions, with the consequent strengthening of an environment of transparency and stability for citizens and foreign investors.

2. The "Doing Business" (Comparing Business Regulation for Domestic Firms) is a World Bank report that looks at the business environment and legislation on business activity in one hundred and ninety (190) economies of the world. Each year, laws and regulations that facilitate or hinder business activity in each economy are examined to map economic outcomes and identify the necessary reforms in regulating business activity to promote a competitive and transparent environment for conducting business.

This is one of the most important international reports on the protection of property and investments in general, which maps the regulation of economic activity in the various countries, through 11 quantitative indicators: 1) start a business; 2) permission to build; 3) installation of electricity; 4) registration of property; 5) granting credit; 6) protection of minority investors; 7) taxes; 8) cross-border trade; 9) compliance with contracts; 10) resolution of insolvency; 11) labor legislation.

Continuous analysis of economic data and its cataloging in a systematic way through desirable standards of economic freedom fosters competition and the diagnosis of problems that prevent better performance and foster entrepreneurship in economies. It also encourages debate between researchers in the private sector and civil society on overcoming barriers to economic development and the business-promoting environment in each economy.

The outcome is the work of several scholars and experts who collaborate with the World Bank in the analysis of data and in the creation of valuation methods within their respective areas of activity. The indicators seek to analyze the several aspects of the regulation of countries that discourage investment or prevent private economic initiative, from the creation of new companies, their operation and expansion, regulation of business activities and protection of property rights.

It should be noted that each chapter is prepared through a detailed methodology that bases the final annual conclusions of each report. These methodologies have remained constant over the years, with some changes being made, which also occurs in the event of changes in the available economic data. The indicators of each country are calculated based on the city scenario that is the largest commercial center of each of the economies analyzed. Data on the second largest business center of these economies were also collected in countries with more than 100 million people (Bangladesh, Brazil, India, Indonesia, Japan, Mexico, Nigeria, Pakistan, Russia and the United States of America).

It is important to note that in 2003, when the first edition of the report was published, there were not yet any compilations on the regulation of business activity in the world. The 2018 edition, which marks the 15^{th} edition of the report, presents the data collected until June 1, 2017. In relation to the 2017 edition, it presents a new chapter on labor legislation in the countries (DOING BUSINESS, 2018, p.11). In addition, there was a clear expansion of the content and comprehensiveness of the report: the first version of the document had five indicators and covered 133 (one hundred and thirty-three) Economies; the 2018 version, as already pointed out, presents 11 chapters and analyzes 190 (one hundred and ninety) Economies.

Over the years, the report has become a source of secure consultation for policymakers in shaping public and economic policies throughout the world. In the last decade, more than 60 (sixty) Economies reported that Doing Business indicators were used as sources by committees to promote reforms in the regulation of economic activity in the States, which resulted in more than 3,180 regulatory reforms, of which 920 inspired directly by it (DOING BUSINESS, 2018, V).

In addition to the yearly report, which includes a comparison of all countries, specific country-specific reports are also produced in which indicators are treated and examined on a case-by-case basis. In this sense, it is presented the general position of each Economy in the global ranking, as well as the classification related to each of the 11 chapters covered by the regulation, besides its placement in the continent to which it belongs. The different economies of the world are divided by regions, classified by geographical proximity or by factors that approximate the economies: i) Europe and Central Asia; (ii) the Middle East and North Africa; (iii) Latin America and the Caribbean; iv) High-income Economies of the OECD (Organization for Economic Cooperation and Development); (v) South Asia; (vi) Sub-Saharan Africa; (vii) East Asia and the Pacific.

In addition to the overall report, national sub-reports are issued jointly to analyze each country's specific performance across all indicators, allowing for local perspective to be deepened, which is adequate for the concrete verification of the deficient aspects in the business environment of realized economies. These reports cover in detail various aspects of regulating the business environment in different cities and regions within a state and provide data on the ease of doing business, classify each location and recommend reforms to improve performance in each of the indicated areas[6].

In this way, a broad panorama of the performance of each Economy is set up, which allows comparative insertion at the global level and within the specific continental context of each country. Following this logic, the Latin American general report will be analyzed briefly in order to provide a broader picture of the region's performance, and then to detail the particular aspects of the Brazilian report, especially the regulation and registration of property in the country.

2.1. Initially, it should be established that the report analyzes the Economies from the so-called "distance measure to the border", which represents the best performance observed in each of the Doing Business sample indicators since 2005. The distance of an economy to the border is evaluated on a scale of 0 to 100, where 0 represents the lowest performance and 100 represents the boundary, i.e., the highest possible performance within the elaborated scale.

The ranking of 190 (one hundred and ninety) economies is determined by the classification of the distance added to the border scores, rounded to two decimals. The final score of each Economy corresponds to the weighted average of the scores attributed to each of the assessed items, from 0 to 100. The economies are evaluated globally and in each of the indexes presented; in addition, the report elaborates a ranking of the economies by continent, being possible to evaluate them in the global plan as in the continental plan. In the current report, the first twenty classified economies were as follows[7]:

Economy	Ease of Doing Business Rank
New Zealand	1
Singapore	2
Denmark	3
Korea, Rep.	4
Hong Kong SAR, China	5
United States	6
United Kingdom	7

Norway	8
Georgia	9
Sweden	10
Macedonia, FYR	11
Estonia	12
Finland	13
Australia	14
Taiwan, China	15
Lithuania	16
Ireland	17
Canada	18
Latvia	19

In the Latin America and Caribbean region, 32 economies have been examined.[8]. Mexico is the best-ranked economy, ranking 49th overall, followed by Peru (in 58thplace), Colombia (59th) and Costa Rica (61st). The economies with the worst ratings were Venezuela (188th), Haiti (181st) and Suriname (165th). Brazil is ranked 125th in the global ranking and in the 22nd in the continental ranking, with a score of 56.45 on a scale of 0 to 100, as shown in the table:

Economy	Ease of Doing Business Rank	Filtered Rank
Mexico	49	1
Peru	58	2
Colombia	59	3
Costa Rica	61	4
Puerto Rico (U.S.)	64	5
Jamaica	70	6
El Salvador	73	7
Panama	79	8
St. Lucia	91	9
Uruguay	94	10
Guatemala	97	11
Dominica	98	12
Dominican Republic	99	13
Trinidad and Tobago	102	14

Antigua and Barbuda	107	15
Paraguay	108	16
Honduras	115	17
Argentina	117	18
Ecuador	118	19
Bahamas, The	119	20
Belize	121	21
Brazil	**125**	**22**
Guyana	126	23
St. Vincent and the Grenadines	129	24
Nicaragua	131	25
Barbados	132	26
St. Kitts and Nevis	134	27
Grenada	142	28
Bolivia	152	29

Suriname	165	30
Haiti	181	31
Venezuela, RB	188	32

On the property register, the best overall position is occupied by Peru (44th position), followed by Costa Rica (49th position) and Colombia (60th position). In this regard, Brazil occupies the 131st position in the overall ranking (placement below that relative to all the questions, in which it occupies 125th position):

Economy	Ease of Doing Business Rank	Registering Property
Mexico	49	99
Peru	58	44
Colombia	59	60
Costa Rica	61	49
Puerto Rico (U.S.)	64	153
Jamaica	70	128
El Salvador	73	69
Panama	79	83
St. Lucia	91	105

Uruguay	94	112
Guatemala	97	85
Dominica	98	164
Dominican Republic	99	79
Trinidad and Tobago	102	151
Antigua and Barbuda	107	118
Paraguay	108	75
Honduras	115	91
Argentina	117	117
Ecuador	118	74
Bahamas, The	119	167
Belize	121	132
Brazil	**125**	**131**
Guyana	126	110
St. Vincent and the Grenadines	129	166

Nicaragua	131	133
Barbados	132	102
St. Kitts and Nevis	134	184
Grenada	142	141
Bolivia	152	144
Suriname	165	156
Haiti	181	180
Venezuela, RB	188	135

In the continental ranking, Brazil takes the 18th position:

Economy	Registering Property
Mexico	11
Peru	1
Colombia	3
Costa Rica	2

Puerto Rico (U.S.)	26
Jamaica	17
El Salvador	4
Panama	8
St. Lucia	12
Uruguay	14
Guatemala	9
Dominica	28
Dominican Republic	7
Trinidad and Tobago	25
Antigua and Barbuda	16
Paraguay	6
Honduras	10
Argentina	15
Ecuador	5

Bahamas, The	30
Belize	19
Brazil	**18**
Guyana	13
St. Vincent and the Grenadines	29
Nicaragua	24
Barbados	20
St. Kitts and Nevis	32
Grenada	22
Bolivia	23
Suriname	27
Haiti	31
Venezuela, RB	21

Latin America's performance, whose best globally ranked Economy ranks 49th, reveals the serious problems and structural obstacles that prevent continued economic growth in the region, which has been continually interrupted by political crises, fueled by the conflicts arising from the distribution of resources (FUKUYAMA, 2008, p. 70).

Equally worrisome is Brazil's placing within the continent: 22nd among the 32 economies analyzed, ranking lower than smaller economies like Guatemala, Uruguay and San Salvador. The classification reveals the chronic and historical difficulty that the country presents in the regulation and control of real estate. This is an important fact, which should provoke reflection on the institutional mechanisms that prevent an adequate classification of the economy of the country as to the ease of conducting business.

The existing bureaucratic apparatus often makes registration and recognition of private property costly in many areas of the national territory and makes it difficult to “formalize” the legal business executed. In fact, the parameters used to evaluate the registration of property in the Economies will be examined, with the subsequent examination of the results specifically presented in the report produced on the Brazilian economy.

2.2. As noted above, the Doing Business 2018 report covers eleven areas of business regulation.**[9]** This item evaluates a number of aspects related to property rights, including the costs and time of procedures for land registration and control, as well as the quality of information available and the ease of access to thereto. Indicators are prepared taking as basis the transparency required for the conduct of operations for the acquisition, transfer and registration of property.

The evaluation methodology analyzes the necessary steps, time and cost involved in the registration of property, from the pre-registration to the post-registration phase, the indicator traces the path that an interested company[10] to acquire real estate [11] from another must continue until the intended transaction is effected, with the consequent alteration of the registration and the definitive transfer of the asset in question from the assets of the seller/assignor to the assets of the buyer/assignee.

The topic emphasizes the importance of this *iter* so that the new owner has agility in its businesses, either through the possibility of expanding them through the production and the expansion of the offer of services, of the possibility of offering the good as guarantee for new loans or, if necessary, sell it to others.

Within the framework of the systematic proposal, the report establishes four categories to be analyzed: i) procedures necessary to transfer real estate; ii) time required to complete each step; iii) cost required for each procedure; iv) quality of land administration. The outcome is the weighted average of the scores of each of the subcategories, shown in the table below:

Table 1 – What do the indicators on the efficiency of transferring property measure[12]?

Procedures to legally transfer title on immovable property (number)
Preregistration procedures (for example, checking for liens, notarizing sales agreement, paying property transfer taxes)
Registration procedures in the economy's largest business city[a]
Postregistration procedures (for example, filling title with municipality)
Time required to complete each procedure
Does not include time spent gathering information
Each procedure starts on a separate day—though procedures that can be fully completed online are an exception to this rule
Procedure is considered completed once final document is received
No prior contact with officials
Cost required to complete each procedure (% of property value)
Official costs only (such as administrative fees, duties and taxes)
Value Added Tax, Capital Gains Tax and illicit payments are excluded

a. For 11 economies the data are also collected for the second largest business city.

The procedures are defined as the necessary interactions – between the buyer or seller (or its agents) with third parties outside the contract, government agencies, tax authorities, lawyers and notaries – to legally transfer the property. Within the aforementioned category are evaluated: a) pre-registration procedures, such as obtaining documents and payment of notary fees and charges; b) the registration procedures in the city that carries out the largest number of businesses in the country; c) post-registration procedures (for example, completion of subsequent registrations together with the municipalities). In short, all legal or customary procedures for registration of property are counted, although they may be avoided in special situations.

The assessment of the time required to comply with the necessary steps for registration is determined by the following guidelines, which do not include the time required to obtain information: a) each procedure is presumed to start on a separate day, therefore, the rule does not apply to procedures performed at once online; (b) each procedure is deemed accomplished when a final document is received, without prior contact with registration officials (DOING BUSINESS, 2018, p. 44).

The cost required to finalize each procedure is calculated based on the percentage of property value involved and includes only the official costs of ownership transfer (excluding value-added tax, capital gains and illicit payments). Finally, the quality of land management, the most complex of parameters, seeks to evaluate a series of vectors linked to the reliability and transparency of regulation.

Table 2 – What do the indicators on the quality of land administration measure[13]?

Reliability of infrastructure index (0–8)
Type of system for archiving information on land ownership
Availability of electronic database to check for encumbrances
Type of system for archiving maps
Availability of geographic information system
Link between property ownership registry and mapping system
Transparency of information index (0–6)
Accessibility of information on land ownership
Accessibility of maps of land plots
Publication of fee schedules, lists of registration documents, service standards
Availability of a specific and separate mechanism for complaints
Publication of statistics about the number of property transactions
Geographic coverage index (0–8)
Coverage of land registry at the level of the largest business city and the economy[a]
Coverage of mapping agency at the level of the largest business city and the economy[a]
Land dispute resolution index (0–8)
Legal framework for immovable property registration
Mechanisms to prevent and resolve land disputes
Equal access to property rights (-2–0)
Unequal ownership rights to property between unmarried men and women
Unequal ownership rights to property between married men and women
Quality of land administration index (0–30)
Sum of the reliability of infrastructure, transparency of information, geographic coverage, land dispute resolution indices and equal access to property rights

a. For 11 economies the data are also collected for the second largest business city.

The quality index of land administration comprises five vectors, each of them is given a score which makes up the total amount of the final index (ranging from 0 to 30), calculated by summing the same: i) infrastructure reliability index; (ii) transparency of information; (iii) geographical coverage; iv) resolution of land conflicts; v) equality in access to property. Each vector is analyzed by summing other vectors that integrate it, in a detailed check of all the factors that impact on the transparency of transactions (Doing Business, 2018, p. 44).

Note that the aforementioned evaluation criteria was not included in earlier versions of the report, and has only been included in the year 2016. The expansion of the indicator, which initially only evaluated the procedures, time and cost thereof was motivated by the data published in the Corruption Perceptions Index (CPI) by Transparency International[14], whose data showed that one amongst five users of property registration services in the world made the payment of bribes for obtaining services such as registration and up-to-date information on property rights. There have also been reports of fraud in the property registry, including duplicity of land registration.

In view of the data, it was necessary to improve the evaluation mechanisms of the registry of property to include other factors not previously analyzed and that are linked to the transparency in the management and the access to the information, since the corruption hinders the formalization of the property, stimulates informality and increases costs for doing business, as well as undermining private sector confidence in the economy[15].

A transparent land management system considerably reduces opportunities for corrupt practices. There is therefore a need to evaluate items such as: (i) the disclosure of information on property rights, including statistics on the transfer of property rights in the largest city of the country; ii) the accessibility of the property transfer process; iii) the existence of independent and specific instruments to respond to complaints from users of property registration services.

Regarding the property registry, Doing Business 2018 points out that of the one hundred and ninety (190) Economies analyzed, one hundred and fifty eight (158) publish tables with the amounts to be paid for the effective registration of property (DOING BUSINESS, 2018, pp. 51-55). On the other hand, in fifty-one (51) Economies analyzed, the only way to obtain information about the documentation required for the registration of property is through personal interaction with the public official responsible for registration.

In one hundred and thirty-one (131) economies, such information may be consulted from an electronic site specially designed for such advertising. Another important fact is that the availability of online platforms is more common in high-income economies than in low-income economies: 80% of the former publish the tables with transfer costs, while only one third of the latter do so (DOING BUSINESS, 2018, p.52).

The report points out that ownership tends to be transferred more efficiently in Economies where both the necessary documentation and the cost tables of the services are easily accessible and reinforces the need for online availability of such information, with the provision of registration information on the Internet and the preparation of electronic database for encumbrances. It also recommends the establishment of fixed deadlines for each stage of registration, in order to streamline procedures and promote greater legal certainty and transparency in operations (DOING BUSINESS, 2018, page 53).

The absence of strict deadlines for the provision of services encourages the payment of bribes with the purpose of promoting certain facilitation or advances of deadlines and results. In general, the results indicate that service standards in registries and registered ones are a rare practice around the globe: in one hundred and twenty-two (122) economies, there are no specific deadlines or limits established by law for the provision of registration services (DOING BUSINESS, 2018, p. 52). As it will be mentioned, in Brazil, Law No. 6015/73 establishes a maximum period for the registration of the title in the Registry of Real Estate, but it is an inappropriate term.

In addition, the evaluation demonstrates that another globally deficient aspect of real estate registration refers to the lack of further control mechanisms for services that are specific and independent, leaving the Judiciary to control only the most complex issues. According to the report, only twenty-four (24) economies have such mechanisms, which would provide a threefold improvement in the quality of services provided: (i) to protect citizens from “sub-service”, i.e. services are properly provided; ii) increased trust through a system of governance, in which registry officers are held accountable for their acts; iii) improvement of existing structures as a result of the mapping of failures (DOING BUSINESS, 2018, p. 54).

2.3. The sub-report on the Brazilian Economy covers the cities of São Paulo and Rio de Janeiro, which are separately evaluated in each of the criteria brought by the chapter *registering property*.

The city of São Paulo received a score of 52.84/100 and the city of Rio de Janeiro totaled a score of 52.23/100, which demonstrates a uniformity in the regulation of property in both cities, as shown in the tables below:

The proximity of the city classifications is linked to the Brazilian federal structure [16], in which it is incumbent upon the central body (Federal Government) to legislate on public records [17]. Law No. 6.015/73, known as the Public Registration Law, provides the general rules for registration, which includes the General Registry of Real Estate. It should also be noted that the notary and registration services are exercised on a private basis, by delegation of the Public Power and supervised by the Judiciary of the federal states, through its General Justice Internal Affairs[18].

Despite the uniformity of the general rules on public registers, local aspects are the responsibility of each of the aforementioned General Justice Internal Affairs; therefore, there may be differences in the costs of the services and the fees to be paid for carrying out registration and registration procedures, since the tables with the costs of the services are annually published by the aforementioned General Justice Internal Affairs.

Another important aspect is the tax on the transmission of real estate (ITBI), incumbent on the Municipalities[19]; therefore, their rates may vary according to the locality in which the property to be acquired is situated. In fact, it is possible that there are differences between the costs of paying the transmission tax in the cities examined in the Brazilian report.

The report lists the necessary procedures for the transfer of ownership in the aforementioned city and analyzes the costs and time required to implement each one of them; also analyzes the quality of land administration services. In the city of São Paulo, 14 procedures were listed; in Rio de Janeiro were listed 13 procedures required for registration. These procedures will be analyzed in their general aspects, trying to establish the common points and the differences presented (DOING BUSINESS BRAZIL, 2018, pp. 44-66).

For purposes of synthesis, the procedures will be divided into groups in order to facilitate the understanding of the discipline of the subject in Brazil: i) the first group refers to the certificates to be obtained; ii) the second group deals with tax matters; iii) the third group deals with the costs of the actual transfer of ownership. In order for the transfer of ownership to take place, the buyer must submit numerous certificates, including those relating to the seller, labor debts and those related to the property.

As for the certificates, the first procedure listed refers to the obtaining of the certificates of the notary's office for protested notes. Such certificate is not required by law for the transfer of ownership, but in transactions carried out by more conservative companies, they are required as evidence of the assets and solvency of sellers. There are 10 notary's office for protested notes in São Paulo and certificates are required from each of them, which can be requested online, at a cost of R$ 12.24 each, totaling R$ 1,224.00 (one thousand two hundred and twenty-four *Reais*) (DOING BUSINESS BRAZIL, 2018, pp. 47). In Rio de Janeiro, there are 4 notary's office for protested notes, integrated in an online platform called "Rio Rápido", in which the certificates may be requested, totaling R$ 385.32 (three hundred and eighty-five *Reais* and thirty-two cents). Although there is the possibility of a virtual application, the certificates cannot be issued by such means; the interested party must take them personally, within three to five business days, counting from the application (DOING BUSINESS BRAZIL, 2018, pp. 58).

State certificates should also be issued stating that the seller has no debts related to civil actions (Civil Distributor Certificates), commercial (Bankruptcy and Financial Restructuring Certificates) and tax (Certificate of Tax Enforcement) in progress. Such certificates must be requested from the state Judicial Branch. In São Paulo, each one costs R$ 19.40 (nineteen *Reais* and forty cents). They can be requested online – in which case they are delivered in one day, if the result is negative – or in person, in which case they are issued immediately. In Rio de Janeiro, they can be requested online by "Rio Rápido" platform, with a term of three to five days, with no possibility of virtual issuance. It should be stressed that equivalent certificates must also be issued by the Federal Court of first degree. The Certificate of Lawsuits Distribution, Civil, Tax, Criminal and Special Courts Enforcement can be requested and issued free of charge through the Internet in both São Paulo and Rio de Janeiro (DOING BUSINESS BRAZIL, 2018, p.50).

Another important aspect is the issuance of the certificate related to tax debts to tax credits and to the active debt of the Union, issued at no cost through the Ministry of Finance website. The contents of the certificate include the information on the existence of fiscal debts and delinquent debts of the Federal Government, as well as the debts related to social security contributions. The certificate is free and issued online through the Federal Revenue Service website, an agency of the Brazilian Ministry of Finance. As it is a federal certificate, the procedure is the same in both cities analyzed (DOING BUSINESS BRAZIL, 2018, pp. 49 and 60).

Regarding labor certifications, it should be pointed out that Brazilian legislation provides for two types of procedures: i) the Labor Lawsuits Certificate (Regional Labor Courts), which has the purpose of verifying whether the person or company investigated has labor lawsuits in progress; ii) the Negative Certificate of Labor Debt (CNDT), obtained from the Superior Labor Court, which indicates the existence of labor debts. There is also the FGTS' Regularity of Status Certificate, which certifies that the company is current with the monthly deposits, corresponding to a percentage of 8% of the employees' salary, which is an obligation of the employer to deposit into a bank account in the name of the employee, which must be opened at Caixa Econômica Federal Bank, a financial institution in the form of a federal public company. Such certificates are not legally required for the transfer of ownership, but are commonly requested in the negotiating practice (DOING BUSINESS BRAZIL, 2018, pp. 49-60).

The first certificate can be requested and obtained online in the city of São Paulo, free of charge. In Rio de Janeiro, the issuance term is three days and each sheet costs R$ 5.53 (five *Reais* and fifty-three cents). The CNDT, created by Law 12.440/11, which came into force in January 2012[20], can be requested and issued online and free of charge, through the National Bank of Labor Debtors. Finally, the FGTS certificate can be obtained free of charge from the Caixa Econômica Federal website (DOING BUSINESS BRASIL, 2018, pp. 47-60).

There are also certificates and taxes which refer to the property in question and which, in general, are mandatory for the transfer, as provided for in Decree No. 93,240 of September 9, 1986[21]. The certificate of registration data of the real estate is obtained from the municipalities, it informs the calculation basis of the IPTU (urban territorial property tax) of the property (real value) and determines if there are debts that are due on the property. Its submission may be waived by the acquirer who, in this case, will be liable, under the terms of the law, for the payment of existing tax debts. In São Paulo, the issue is online and free of charge (DOING BUSINESS BRASIL, 2018, pp. 48); in Rio de Janeiro, the online certificate is free and the one issued in person costs R$ 11.85 (eleven *Reais* and eighty-five cents) (DOING BUSINESS BRASIL, 2018, pp. 59).

The second necessary procedure refers to the obtaining of a twenty-year certificate obtained before the Real Estate Registry Office according to the location thereof. Such certificate is mandatory for attesting the chain of acquisition of the property, as well as proprietary ownership, allowing to verify if the seller is the real owner of the property registration, in addition to describing the real burden pending on the property. In São Paulo, the certificate can be applied and issued online, through a digital certificate that produces the same legal effects of a printed certificate (DOING BUSINESS BRASIL, 2018, page 48). The procedure lasts less than one day and costs R$ 49.94 (forty-nine *Reais* and ninety-four cents). In Rio de Janeiro, only a few registry offices allow the online application for the certificate, but there is no possibility of online issuance (DOING BUSINESS BRASIL, 2018, page 58).

With regard to expenses with the actual transfer of ownership, costs must be included with the drafting of the public deed and with its registration in the Real Estate Registry Office, in addition to the payment of real estate transfer tax (ITBI). It is important to clarify that in the Brazilian legal system the contract of purchase and sale produces only binding effects. This means that the contract does not automatically transfer the property, only creates the obligation to transfer it through another act, which is the title registration in the Real Estate General Registry (RGI)[22]. In addition, proof of payment of taxes is essential for the notary to draw up the public instrument.

It should also be noted that the public form is essential to the validity of legal transactions aimed at the constitution, transfer, modification or waiver of security interests over real estate worth more than thirty times the highest minimum wage in force in the country[23]. In addition, a procedure must be carried out for the drafting of the deed by the notary of each State of the Federation, in which it analyzes all documents submitted and verifies their regularity and then prepares the public instrument for the accomplishment of said transaction.

The value of the procedure is provided by the Notary Colleges of the respective States and varies according to the value of the property. The report shows a weighted average of R$ 3,110.93 (three thousand, one hundred and ten *Reais* and ninety-three cents) in Rio de Janeiro (DOING BUSINESS BRASIL, 2018, page 62) and R$ 4,757.00 (four thousand seven hundred and fifty-seven *Reais*) in São Paulo, with an average time of 3 days for completion (DOING BUSINESS BRASIL, 2018, page 50). As for the registration of the public deed, the value is also provided and variable according to the value of the property. Law No. 6.015/73 establishes that the maximum term for the registration is 30 days;

however in São Paulo, the procedure lasts 15 days. In São Paulo, for real estate with a value between R$ 250,700.01 (two hundred and fifty thousand, seven hundred *Reais* and one cent) up to R$ 501,400.00 (five hundred and one thousand, four hundred *Reais*), the cost is R$ 2,080.58 (two thousand, eighty *Reais* and fifty-eight cents) (DOING BUSINESS BRASIL, 2018, page 50). In Rio de Janeiro, for real estate with values above R$ 200,000.01 (two hundred thousand *Reais* and one cent), up to R$ 400,000.00 (four hundred thousand *Reais*) is charged the value of R$ 1,600.95 (one thousand six hundred *Reais* and ninety-five cents) (DOING BUSINESS BRASIL, 2018, page 62).

In order for the public deed to be drawn up, it is imperative that proof be presented of payment of the property transfer tax, due to the Municipality. The buyer must make the payment of the tax before the writing of the public deed; however, such incumbency can be ascribed to the notary, who can pay the tax in the name of the buyer, because he is responsible for the control of said payment. In Rio de Janeiro, the rate corresponds to 2% of the value of the property (DOING BUSINESS BRASIL, 2018, page 61) and in São Paulo 3% of the registered value of the property within the city hall (DB BRASIL, 2018, page 50).

When dealing with a legal business entered into between companies, the notary must also verify the Trade Board's certificate, which provides the basic information about the company, such as corporate name, national corporate taxpayers' registry (CNPJ), date of commencement of activity , economic activities, capital stock, shareholders and their respective interests in the capital stock and subsidiaries thereof. The procedure is free of charge and can be made through the electronic websites of the São Paulo Trade Board (JUCESP) and the Rio de Janeiro Trade Board (JUCERJA) (DOING BUSINESS BRASIL, 2018, pages 50 and 61).

Once the transfer of the property has been effected with the registration of the title, it is the responsibility of the buyer and new owner to update the ownership of the property with the City Hall, which can be done at no cost in both cities. In São Paulo, the update is after registration; in Rio de Janeiro, before the title is taken to registration, the Change of Ownership Communication Form must be completed and submitted to the Municipal Secretary of Finance (SMF). At the time of presentation of the title to the notary the number of the protocol generated at the completion of the submission must be informed. (DOING BUSINESS BRASIL, 2018, page 62).

Having seen the procedures, the evaluations regarding the quality of the land administration carried out by the Public Administration shall be briefly analyzed. The two Brazilian cities evaluated received similar scores in the general framework of the Doing Business 2018 "*registering property*" chapter, according to the following tables:

It should also be noted that the aforementioned score is slightly above the average of the region of Latin America and the Caribbean, in whose sample Brazil is inserted. Considering the country occupies the 131st overall position in the aforementioned item, position below its overall ranking, it is appropriate to examine the evaluation of the quality of the services rendered and to map the items that were negatively evaluated.

It should be emphasized that the quality of the land administration receives a score that varies from 0 to 30, formed by the weighted average of several other questions. The city of São Paulo scored 14.0 points on a scale of 30, while Rio de Janeiro scored 13.5 points. In both cases, the score fell short of half the total score set for the chapter. (DOING BUSINESS BRASIL, 2018, pp. 45-46). As mentioned above, the sub-chapter "*quality of land administration*" consists of the sum of several parameters, which are detailed and composed of other sub-items.

In spite of this, in the present study, a detailed analysis of all sub-items evaluated will not be done, which in fact would require another specific study. It was decided to present the score obtained by each of the cities in each of the five analyzed items and, within each question, emphasizes in a special way the topics considered problematic by the report. That said, it is not insignificant to recall the vectors in question: i) infrastructure trust (0-8 points), ii) information transparency (0-6 points); (iii) geographical coverage (0-8 points); iv) resolution of land conflicts (0-8 points); v) equality in access to property (-2 to 0 points). (DOING BUSINESS BRASIL, 2018, page 44).

The index of reliability of the infrastructure is assigned a score ranging from zero to eight. The item evaluates the existence of public agencies in charge of the registration of real estate, as well as the existence of databases and electronic registers to carry out the procedures, as well as the integration of the information between the supposed databases available. The city of São Paulo received 5.0 points (DOING BUSINESS BRASIL, 2018, p.52) and Rio de Janeiro 4.0 points (DOING BUSINESS BRASIL, 2018, p.64).

In São Paulo, two sub-vectors were negatively evaluated (with a score of 0.0). The first of these was the separation and lack of communication between the various databases, that is, the lack of a single platform in which all registered procedures could be carried out in a single and unified manner. The lack of integration between public agencies is evident in the absence of automatic updating of the registry of the property with the City Hall after the registration of the title in the Real Estate General Registry, which imposes on the new owner the burden of communicating with the city hall. Another point negatively evaluated (0.0 points) was the lack of a unique identification number of the property for all public agencies that participate in the acquisition chain (DOING BUSINESS BRASIL, 2018, p.52).

In Rio de Janeiro, in addition to the items discussed above, a score of 0.0 was attributed to the fact that there is no electronic database that allows the online obtainment of a certificate of real property liens. In a different way, the city of São Paulo allows the online version of such service through the electronic portal "Cartório 24 horas" (DOING BUSINESS BRASIL, 2018, page 64).

The second item – the transparency of the information – is the one in which the publicity of the information related to the documents necessary to carry out real estate deals, the easiness of access and the existence of mechanisms of improvement and receipt of complaints regarding the services rendered are evaluated. In this regard, Rio de Janeiro scored slightly higher (4.0/6.0) (DOING BUSINESS BRASIL, 2018, pp. 64-65) than that obtained by São Paulo (3.5/6.0) (DOING BUSINESS BRASIL, 2018, 54).

On the other hand, the two cities had their performance evaluated with the minimum score (0.0) in the same areas: i) the lack of a specific mechanism to allow complaints to be made as a result of the services rendered by the registrars (non-judicial); ii) the absence of official public statistics on the number of real estate transactions taken to register in the city; iii) the absence of a mapping or registration agency that publishes updated maps with the deadlines specifically required for each stage of the transaction; iv) lack of external and specific control mechanisms against such agencies (non-judicial).

The third item provides for the geographic coverage index, in which the mapping of the property registry and the verification of the formalization index of the transfer operations of the property are evaluated. The following items are evaluated: i) formal registration of privately owned land in the Economy; ii) formal registration of privately owned land in the largest city for business purposes; iii) the mapping of privately owned land (DOING BUSINESS BRASIL, 2018, page 54).

Both cities received very low scores, totaling 2.0/8.0 points, and in three of the four items evaluated they were assigned the minimum score (0.0). Note that in such a case both cities presented their worst evaluations among all the items evaluated in the "*registering property*" chapter (DOING BUSINESS BRASIL, 2018, page 64).

This is an important fact, revealing the informality of real estate transactions in Brazil, due to the high costs and disinformation of the population in general regarding the procedures for the transfer of real estate. As a result of the costs, private purchase and sale agreements are executed, which cannot be registered, since the public form is required by law. In addition, it is common for companies to enter into the transaction by public deed and postpone registration for lack of sufficient resources to complete the transaction stages.

In the fourth question – index of resolution of land conflicts or land disputes – cities also performed poorly, having obtained similar scores: 3.5/8.0. The item evaluates the management of conflicts arising from transactions related to the transfer of ownership and includes the extrajudicial and judicial mechanisms for the settlement of disputes (DOING BUSINESS BRASIL, 2018, p. 54).

In this index, the following questions were asked: i) is the real estate registration system subject to some public or private guarantee, such as insurance?; (ii) is there any specific compensation mechanism covering losses suffered by the acquirer in good faith who carried out a real estate transaction on the basis of erroneous information certified by the real estate registry?; (iii) is there a national database to verify the authenticity of the documents?; (iv) are there statistics on the number of cases in the first instance of jurisdiction?; and, finally, (v) how long does it take to obtain a first-degree judicial decision in the cities? (02 to 03 years, not including the appeals).

Regarding the fifth item, regarding equal access in property rights, the item assesses whether there are legal restrictions that impede equal access between men and women, including those bound by marriage. The item includes the possibility of acquiring, controlling, administering and transferring the real estate property. Unlike other items, here the score ranges from -2 to 0 points, in which each constraint is punctuated with -1. Both cities obtained the maximum score, which in the mentioned item is 0.0 points, which means non-occurrence of restrictions.

3. Based on the analytical presentation on the private property overview in the light of the World Bank's Doing Business Report, it is important to reaffirm that in the overall ranking Brazil ranked 125th, showing that it is necessary an urgently review of the treatment of this matter in the light of the national reality. Even more serious is the raking in chapter "*registering property*" according to which Brazil ranked 131st, below the country's overall score, which reinforces the urgent need for legislative, administrative and judicial reforms to facilitate the transfer of real estate.

There are some sensitive issues pointed out by the Brazilian sub-report, regarding the sub-themes of the lack of integration of the databases – notably in the public offices and Real Estate Registry Offices – of the low formalization of the property, as well as the duration of the demands, which generates an unreasonable length of the proceedings relating to ownership and possession.

The sub-items in which Brazil presented the worst performance were the geographic coverage and the dispute resolution chapters, which demonstrate two chronic Brazilian problems: the lack of registration of the purchase and sale contracts in most cases and the low effectiveness of the judicial protection and dispute prevention mechanisms.

The World Bank Report does not specifically determine what reforms should be implemented in Brazil regarding the private property landscape, but only points the data, which must be analyzed by each of the world's economies to carry out the reforms needed. It is symptomatic the commentary presented at the previous Doing Business Report (in 2013):

"*Whatever the motivation for reforms, the social problem they address is clear: without the possibility of owning land, some people are denied opportunities given to others. This is not grounded on their ability or willingness to work, but on outdated and often perverse government policies. Reforms in property laws and registration requirements can do much to reduce inequality before economic opportunities. This is what many poor people in town and in the countryside need. Governments should take on the obligation to serve them.*"

This critical observation confirms the high level of informality of property in countries with the highest rates of poverty and utter misery in the population. The absence of formal recognition of the property of the most deprived people under the social and economic standpoint prevents such assets from becoming capital.

From this perspective, especially in the search for the reduction of social and economic inequalities, one must retake the idea of the association between property and democracy to establish that there is not a full democratic nation without reducing or abolishing the barriers that prevent the plot access to real estate. Most likely, the question of informality arising from the legalization costs of the operations related to the acquisition and transfer of real estate is placed as a central matter to exactly prevent the effectiveness of democratic values with respect to private property.

It is true that, in relation to the formation and development of public policies, its planning requires the prior realization of diagnoses without which it is not feasible to consider any use of instruments, including legal instruments. Obviously, the World Bank's Doing Business Report points to issues that are bound to require confirmation, but at least points to aspects that public authorities and Brazilian civil society cannot ignore.

Thus, it is fundamental that the Federative Republic of Brazil abandons the immobility and accommodation that still today mark the system of recognition and protection of real estate properties, and it is incumbent upon the three branches of the Republic to carry out their activities and missions in order to seek to render effectiveness to the legal protection of real estate property in the territory and in the Brazilian Law. Thus, it will be possible to move towards the realization of democratic values in Brazil with equal opportunity for Brazilians, regardless of their access to private real estate.

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[1]Samuel Huntington defends the existence of three waves of democratization. The first wave of democratization began in the United States in the 1920s, extending the suffrage to most men in the United States of America and continuing until 1926, with the creation of 29 democracies. With the taking of power by Mussolini in Italy in 1922, the first reverse wave began, which reduced the number of democracies to 12 in 1942. The triumph of the Allies in World War II marks the beginning of the second wave of democratization, followed by a second wave of reversals (1960-1975) that reduced the number of democracies to 30. Between 1974 and 1990, at least 30 countries made democratic transitions, increasing the number of democracies in the world, characterizing the third democratic wave. The noted movement began in southern Europe and expanded to Latin America and some African countries in the later decade and in the late 1980s and early 1990s reached Eastern Europe, the Soviet Union and parts of sub-Saharan Africa.

[2]The Council of Europe, an international body created in 1949, shortly after the end of World War II, emerges as a body promoting harmonization of individual guarantees in the European context.

[3] Preamble to the Constitution of the Federative Republic of Brazil: "*We, representatives of the Brazilian people, gathered in a National Constituent Assembly to establish a Democratic State, designed to ensure the exercise of social and individual rights, freedom, security, development, equality and justice as the supreme values of a fraternal, pluralist and unprejudiced society founded on social and committed harmony, in the internal and international order, with the peaceful solution of controversies, we enact, under the protection of God, the next CONSTITUTION OF THE FEDERATIVE REPUBLIC OF BRAZIL*".

[4]Art. 182 of the CRFB: The urban development policy, implemented by the municipal government, according to general guidelines established by law, aims to order the full development of the social functions of the city and ensure the well-being of its inhabitants.
Paragraph 1. The master plan, approved by the City Council, mandatory for cities with more than twenty thousand inhabitants, is the basic instrument of the policy of development and urban expansion.
Paragraph 2. Urban property fulfills its social function when it meets the fundamental requirements of city ordinance expressed in the master plan.

[5] Art. 186 of the CRFB: The social function is fulfilled when rural property meets, simultaneously, according to criteria and degrees of exigency established by law, to the following requirements:
I – rational and adequate use;
II – adequate use of available natural resources and preservation of the environment;
III – compliance with the provisions governing labor relations;
IV – exploitation that favors the well-being of owners and workers.

[6] The report's indicators are used to analyze the results of the reforms carried out and to identify which reforms worked, where and why. With regard to the reforms implemented from the report, in the period between June 2, 2016 and June 1, 2017, 264 reforms were registered in the world economies, of which 119 (one hundred and nineteen) economies implemented at least one reform in the different

areas measured by Doing Business, providing an improvement in the ease of doing business throughout the world. The region with the largest number of reforms in the period was sub-Saharan Africa, which recorded 83 reforms in all areas measured by Doing Business. The highest percentage of economies implementing at least one regulatory reform is in the Europe and Asia region (79%) maintaining a trend that began more than a decade ago. The report on the reforms carried out is available at: http://english.doingbusiness.org/reforms. Access on Dec. 1, 2017.

[7] The ranking is available at the following address: http://www.doingbusiness.org/rankings. Access on Dec. 1, 2017.

[8]Chile is excluded from the sample because it has been included in the list of the most developed economies by the OECD, a group that is analyzed separately by Doing Business.

[9]The methodology for the registration property index is available on the report's website: http://www. doingbusiness.org/Methodology/Registering-Property. Access on Dec. 1, 2017.

[10] On the parties (buyer and seller), the methodology is based on the following assumptions:
– They are limited liability companies (or equivalent in the local legal system).
– They are located in the working-class suburbs area of the largest commercial city in the economy. In 11 Economies the data is also obtained for the second largest trading city.
– They are 100% owned nationally and privately.
– They have 50 employees each, all of whom are nationals.
– Perform general commercial activities.
(Registering Property Methodology, Available at: http: //portugues.doingbusiness.org/ Methodology/ Registering-Property.Access on Dec. 1, 2017).

[11]The report uses some assumptions regarding the property used as a standard for the indicator:
– It has a value equal to 50 times the *per capita* income of the economy. The sale price is equal to this value.
– It is entirely owned by the seller.
– It has no mortgages and it has been owned by same owner for 10 years.
– It is registered in the property registry or real estate register, or in both, and is not subject to litigation related to the ownership title.
– It is located in a working-class suburbs commercial zone and it is not necessary to provide a zoning of the area.
– It consists of the land and a building. The area of land is 557.4 square meters (6,000 square feet). On the ground there is a two story warehouse (or warehouse), covering an area of 929 square meters (10,000 square feet). The deposit was built 10 years ago, has no heating system, is in good condition and meets all safety standards, building codes and other legal requirements. The property, which consists of the land and building, will be fully transferred.
– It will not undergo renovations or additional construction after purchase.
– There are no trees, water sources, nature reserves or historical monuments of any kind.

– It will not be used for specific purposes and will not require special permits, such as for residential use, industrial facilities, garbage storage or certain types of agricultural activities.
– It has no occupants (legal or illegal) and no other party has legal interest in the property. (*Registering Property Methodology*. Available at:http://portugues.doingbusiness.org/Methodology/Registering-Property. Access on Dec. 1, 2017).

[12]*Registering Property Methodology*. Available at: http://www.doingbusiness.org/ Methodology/ Registering-Property. Access on Dec. 1, 2017.

[13]*Registering Property Methodology*. Available at: http://www.doingbusiness.org/Methodology/ Registering-Property. Access on Dec. 1, 2017.

[14]*Corruption Perception Index 2013*. Available at: https://www.transparency.org/cpi2013/results. Access on Dec. 1, 2017.

[15]In April 201, a survey conducted by Transparency International warned of the risk of money laundering in São Paulo through the purchase of real estate. The survey points out that about 3,452 high-quality properties in the city, whose value totals around R$ 8.6 billion, are linked to offshore companies or companies registered in jurisdictions that are not transparent. Available at: https://www.transparency.org/news/pressrelease/saeo_paulo_r_8.6_bilhoes_em_imoveis_estaeo _ligados_a_empresas_offshore. Access on Dec. 1, 2017.

[16] BRAZIL, Federal Constitution, Art. 1 The Federative Republic of Brazil, formed by the indissoluble union of States and Municipalities and the Federal District, is a Democratic Rule of Law State and is based on:
I – sovereignty;
II – citizenship;
III – the dignity of the human person;
IV – the social values of work and free enterprise;
V – political pluralism.

[17] BRASIL, Federal Constitution, Art. 22. The Union is exclusively responsible for legislating on:
XXV – public records http://www.planalto.gov.br/ccivil_03/constituicao/constituicao.htm;

[18] Article. 236 of the Brazilian Constitution provides:
“The notary and registration services are exercised in private, by delegation of the Public Power.
Paragraph 1 – Law shall regulate the activities, discipline the civil and criminal responsibility of notaries, registry officers and their representatives, and define the supervision of their acts by the Judiciary.
Paragraph 2 – Federal law shall establish general rules for the determination of emoluments related to the acts practiced by the notary and registration services.

Paragraph 3 – Admission to the notary and registration activity depends on the public competition for evidence and titles, and no service is allowed to remain vacant, without opening a competition for hiring or dismissal, for more than six months.

[19] Art. 156. It is incumbent upon the Municipalities to institute taxes on:
I – urban property and territorial property;
II – real estate "*inter vivos*" transfer tax, on any account, by an onerous act, of immovable property, by nature or physical access, and security interests over real estate, except for guarantee, as well as assignment of rights to their acquisition.

[20] The Doing Business 2013 report (DB 2013) points out that such legal change made it more difficult to conduct business in the country because it included more diligence within procedures. The DB 2016 report warns that the increase in the tax rate on the transmission of real estate in the city of São Paulo has made transferring of real estate more expensive. It is important to note that, during the period between DB 2008 and DB 2018, the two reforms mentioned were the only ones related to the registration property index, both making it more difficult to do business in Brazil. (*DOING BUSINESS BRAZIL*, 2018, p. 125).

[21] Decree n. 93,240, September 9, 1986.
Article 1. The following documents and certificates will be presented for the recording of notarial acts related to real estate:
I – the documents identifying the parties and other persons who appear in the public deed, when deemed necessary by the Notary;
II – proof of the payment of the Tax on the Transfer of Real Estate Property and Rights related thereto, when incident on the act, except for the cases in which the law authorizes the payment to take effect after it has been drawn up;
III – the tax certificates, understood as follows:

1. a) in relation to urban real estate, the certificates related to taxes on the property, subject to the provisions of paragraph 2 of this article;
2. b) in relation to rural properties, the Certificate of Enrollment issued by the National Institute of Colonization and Agrarian Reform – INCRA, with proof of discharge of the last Rural Territorial Tax issued or, when the deadline for payment has not yet expired, the slip of the Rural Territorial Tax corresponding to the previous year;

IV – the certificate of real and personal reipersecutory actions, relative to the real estate, and of real liens, issued by the competent Real Estate Registry, whose validity period, for this purpose, will be 30 (thirty) days;
V – other documents and certificates, whose presentation is required by law.
Paragraph 1 – The Notary shall consign in the public deed the presentation of the documents and certificates mentioned in items II, III, IV and V of this article.
Paragraph 2. The certificates referred to in letter a, item III, of this article, will only be required for the drafting of the public deeds that imply the transfer of ownership and their presentation may be waived by the acquirer who, in this case, will respond, in accordance with law, for the payment of existing tax debts.

[22] BRAZIL, Civil Code, art. 1.227: The security interest in real estate constituted, or transferred by acts between living people, are acquired only with the registration in the Registry of Real Estate of said titles (articles 1,245 to 1,247), except in the cases expressed in this Code.

[23] BRAZIL, Civil Code, Art. 108: In the absence of a law to the contrary, public deed is essential to the validity of legal transactions that aim at the constitution, transfer, modification or waiver of rights in real estate over thirty times the highest minimum wage in force in the country.

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Open Review of Management, Banking and Finance

«They say things are happening at the border, but nobody knows which border» (Mark Strand)

BverfG vs ECB: the 2nd Round

by **Diego Rossano**

Abstract: *This paper analyses the recent decision of 18 July 2017, published on 15 August 2017, with which the German Federal Constitutional Court (BVerfG) decided to suspend the proceeding aimed at ascertaining the validity of Quantitative easing (Qe), submitting a reference for a preliminary ruling at the CJEU.*

The investigation thus proposes to identify the differences and similarities between the "OMT" program (set out by the European Central Bank (ECB) in September 2012) and the program called Quantitative easing (Qe), carried out in March 2015, to ascertain whether the decision of the Court of Justice of the European Union (CJEU) of 16 June 2015 regarding the legitimacy of the "OMT" program, could provide a significant contribution to verify the validity of Qe.

1. At just over two years from the decision of the Court of Justice of the European Union (CJEU) on the legitimacy of the OMT program (Outright Monetary Transactions)[1], the German Federal Constitutional Court (BVerfG), with the ruling of 18 July 2017, published on the 15 August 2017, decided to stay the proceedings aimed at ascertaining the validity of the so called Quantitative easing (Qe) and submitted a reference for a preliminary ruling to the above mentioned judicial authority.

Preliminarily, it is noteworthy that the instruments of monetary policies present substantial differences even if they are attributable to the unconventional measures that the ECB, in accordance with EU rules[2], has the power to adopt.

As a general rule, it has to be said that the adoption of such measures is justified by the extraordinary contingent situations and pursue different aims. In particular, the "OMT" program consisted in the indefinite acquisition, by the ECB, of sovereign bonds Member State on the secondary market; acquired, moreover, subordinate to some conditions, among which was the necessary inclusion of the issuing Member State in specific economic assistance programs (EFSF or ESM). A further characteristic of the program consists in the sterilization of the liquidity created with the aim of realizing an anti-spread shield without increasing the money in circulation. It should also be added that the acquisitions should have focused on short or medium term securities (with a maturity of between one and three years); these circumstances are symptomatic of the ECB controlling inflation rates[3]. It should also be noted that the "OMT" program has never been concretely implemented as such, as the announcement of its essential characteristics, produced beneficial effects for the whole financial system [4].

On the other hand, the program called *Quantitative easing* (Qe) was launched at the beginning of 2015 and, even having some characteristics in common with the OMT program (in as much as this also specifies the acquisition of public debt securities on the secondary market of Eurozone countries), it differentiates itself on numerous aspects. In particular, the Qe is aimed at assuring greater liquidity for the system, increasing, therefore, the quantity of money in circulation, and returning the inflation rate to about 2%. It is aimed at all the Eurozone countries (and, therefore, not only at those who adhere to a specific procedure of financial assistance) and, however, its implementation is subordinate to strong elements of conditionality; we refer to the evidence that the securities of this acquisition can only be *investment grade* government bonds, asset-backed securities (ABS) and covered bonds. It can be deduced that the program regards specific categories of securities with certain *rating* restrictions that do not include, therefore, State bonds without these characteristics (such as Greek ones), and this is to favor the concession of loans to companies and individuals from credit institutions assuring a significant "injection" of liquidity into the banking system.

2. As mentioned above, the CJEU, with the provision of June 2015, considered the "OMT" program, announced by the ECB in a brief press release of 6 September 2012, compatible with European law. The BVerfG doubted that the ECB could adopt, legitimately, a similar program of intervention having regard for the rules stated in Articles 119, 123 and 127 of theTreaty on the Functioning of the European Union (TFEU) as well as those of Articles from 17 to 24 of the Protocol on European System of Central Banks (ESCB) and the ECB.

In particular, on the advice of the BVerfG, if the ECB had adopted this measure, it would have inevitably invaded the field of competence of the Member States regarding economic policies. From another viewpoint, it was seen that such an intervention would violate the prohibition of monetary financing of Member States in the Eurozone provided for by Article 123 of the TFEU.

For these reasons, the BVerfG wanted to submit an alternative program to the CJEU, with characteristics, instead, compatible with the rules of the TFEU; the *modus operandi* of the latter appears to confirm a behavior that in the literature has been attributed to "primacy" and will "of command" by the German Authorities regarding EU countries and European institutions[5].

With the aim of determining if the decision of the CJEU on the legitimacy of the "OMT" program could provide a significant contribution as regards the verification of the compatibility of the Qe with the rules of the TFEU, some conclusions have to be remembered that come from the above mentioned judicial Authority in that case. More specifically, the BVerfG clarified that, within the TFEU, there was no mention of the expected notion of “monetary policies”, including only indications about the finality and the instruments to carry it out. It followed that the aim of maintaining price stability, mentioned in Articles 127 and 282 of the TFEU, constitutes, also, the criterion that delimits, at the same time, the scope of the ESCB. Therefore, as already stated by the CJEU in other circumstances[6], it is necessary to consider the finality following the adoption of the interventions in it, stability is given to the respective areas on which it will act.

Leading on from such assumed logic, the CJEU considered that the aim of the “OMT” program, that is to assure “‘an appropriate monetary policy transmission and the singleness of the monetary policies” (pt. 47) should be considered compatible with the finality laid out in Article 127 of the TFEU: although such measures can influence the stability of the Eurozone and, in this way, produce indirect effects on economic policies of the member countries, this circumstance, according to the CJEU, is not enough to change its function.

With specific reference to the presumed violation of Article 123 of the TFEU, the CJEU underlines the necessity that the ECB builds into the “OMT” program with sufficient safeguards, being understood that acquisition of public bonds, such as those we have spoken of here, could lead a Member State to not follow a sound budgetary policy. To avoid this risk, according to the orientation of the CJEU, the date has to be established when the OMT program would finish as soon as its finality has been reached of guaranteeing “an appropriate monetary policy transmission and the singleness of the monetary policy” (pt. 4). Such an opportune delimitation of the operational area of the program in question would not have allowed, therefore, the beneficiary States to predetermine their own budget policies based on the certainty of the future reacquisition of the public debt bonds by the ESCB.

On this point, it was significant the prevision, already mentioned above, according to which the purchase would have concerned bonds of countries adhering to programs of structural adjustment (EFSF or ESM); therefore, the member states would not have been encouraged to renounce projects of financial recovery already undertaken, and that for the obvious observation for which adhesion is the prerequisite for the activation of the program.

And, finally, it should be noted that an eventual violation of Article 123 of the TFEU, could have taken place in the hypothesis in which “the potential purchasers of government bonds on the primary market knew for certain that the ESCB was going to purchase those bonds within a certain period and under conditions allowing those market operators to act, de facto, as intermediaries for the ESCB” (pt. 104). This danger, however, according to the CJEU, appeared averted in as much as the ECB, in the proceedings (!), assured that the ESCB would have foreseen the need to wait until the government bonds issued on the primary market were purchased by the ESCB on the secondary market.

3. The lack of predefined instruments able to handle the recent crisis events that also struck the countries belonging to the Eurozone and, in particular, those of the Mediterranean area, made the ECB make decisions justified by the state of emergency and suitable to overcome the contingent situation of difficulty.

It is true that, as has been authoritatively supported, the measures taken by the ECB to mitigate some negative effects of the problems that currently afflict Europe, do not seem, however, to constitute an effective remedy[7]; nevertheless, they contributed to playing an important role towards the realization of a European identity. It is necessary, in fact, to note that the ECB appears to be the only authority able to resist the German center forces, applying, everywhere, its own autonomy. The arguments put forward by the CJEU in its recent sentence on the legitimacy of the “OMT” program seem to divert the CJEU from starting a new preliminary procedure concerning the Qe.

This did not take place. The BVerfG, with a decision of 18 July 2017, published 15 August 2017, asked the CJEU of verify the compatibility of the Qe with the relevant regulatory framework.

It must first be said that the CJEU, on that occasion, seems to have adopted more subdued tones with respect to the recent past; such a change in behavior by the CJEU was underlined by the doctrine according to which <<virtually every conclusion it reaches on the 63 pages of its decision is relativized and framed as a possibility, a probability, a prospect, not as an assertive truth claim>>[8].

More specifically, the CJEU contested the legitimacy of the measures adopted by the ECB, namely: *Public Sector Assets Purchase Program*; *Asset Backed Securities Purchase Program*; *Third Covered Bonds Purchase Program*; *Corporate Sector Purchase Programme*. Such interventions would violate the Articles 123 and 127 of the TFEU, as well as the provisions contained in the *Protocol on the Statute of the European System of Central Banks and of the European Central Bank*. However, the BVerfG recognizes that the *Bundesbank* and the autonomous German government is responsible, this derives from the circumstances of not having applied all the instruments in their possession to prevent the measures in discussion.

The German judges’ observation is decisive, in par. 49 of the decision of 18 July 2017, it says: <<Aus der Integrationsverantwortung erwächst für den Deutschen Bundestag und die Bundesregierung die Pflicht, über die Einhaltung des Integrationsprogramms zu wachen und aktiv auf diese hinzuwirken>>; hence, the consideration that <<dabei sind sie grundsätzlich verpflichtet, sich im Rahmen ihrer jeweiligen Kompetenzen mit rechtlichen oder politischen Mitteln für die Aufhebung von Maßnahmen einzusetzen, die vom Integrationsprogramm nicht gedeckt sind, sowie – solange die Maßnahmen fortwirken – geeignete Vorkehrungen dafür zu treffen, dass die innerstaatlichen Auswirkungen der Maßnahmen so weit wie möglich begrenzt bleiben>>. It can be deduced that the violation of the principle of responsibility for integration (*integrationsverantwortung*), could affect the interests of the German electors who could safeguard their own purposes through legal proceedings; from which their power to directly condition the process of European integration.

On the other hand, the federal German government should have acted, in the appropriate forums, to contrast the decisions adopted by the ECB; in particular, the opportunity of proceeding with an appeal to the Court of Justice (Article 263 Abs. 1 AEUV) namely <<die Beanstandung der fraglichen Maßnahme gegenüber den handelnden und den sie kontrollierenden Stellen>> or, alternatively, <<das Stimmverhalten in den Entscheidungsgremien der Europäischen Union einschließlich der Ausübung von Vetorechten, Vorstöße zu Vertragsänderungen (vgl. Art. 48 Abs. 2, Art. 50 EUV) sowie Weisungen an nachgeordnete Stellen, die in Rede stehende Maßnahme nicht anzuwenden>>. Moreover, it should be underlined how <<Der Deutsche Bundestag kann sich insbeson dere seines Frage-, Debatten- und

Entschließungsrechts bedienen, das ihm zur Kontrolle des Handelns der Bundesregierung in Angelegenheiten der Europäischen Union zusteht (vgl. Art. 23 Abs. 2 GG, BVerfGE 131, 152 <196>), sowie – je nach Angelegenheit – auch der Subsidiaritätsklage (Art. 23 Abs. 1a GG the.V.m. Art. 12 Buchstabe b EUV und Art. 8 Subsidiaritätsprotokoll), des Enquêterechts (Art. 44 GG) oder des Misstrauensvotums (Art. 67 GG; vgl. BVerfGE 142, 123 <211 f. Rn. 171>)>> (par. 73 of the decision of 18 July 2017). In other words, the German government, in good time, should have carried out its right of veto, as well as proposing modifications to the TFEU or, alternatively, stimulated debates on the subject; because the intervention program proposed by the ECB could have been a concrete risk for the federal budget.

That said, the BVerfG showed how the Qe violate the disposition of Article 123 of the TFEU by not having the necessary guarantees to assure, concretely, the respect of the prohibition of financial assistance to the Member States. In fact, according to the BVerfG, the Qe would give the operators if not a juridical certainty, at least a certainty for the possible purchase by the ESCB of the public bonds/securities on the secondary market, as well as the respect for the minimum time, provided for in this program, between emission of the bonds/securities on the primary market and their purchase on the secondary market.

From another perspective, the BVerfG noted that the Qe exceed the mandate of the ECB. In particular, the judges do not doubt that the purchase program is a measure of monetary policies, and as such, adoptable by the ECB; however, the possibility that interventions of this type can produce indirect effects on economic politics of a Member State was not contested (without them losing their original sense). The BVerfG, instead, suspects that the impact of the Qe produces consequences on the economic politics of a Member State equal to those generated by monetary policies; such outcomes, however, were foreseen and evaluated during the planning of the program [9].

On the other hand, in the literature, it has been shown how <<there can be monetary financing of Member States if the ECB and the national central banks have to face considerable losses from a waiver of rights (a so-called “haircut”) or from the default of a sovereign. Such losses can, however, only be considered as monetary financing if the ECB had an influence on the waiver or the default. Otherwise, both cases relate only to a future and hypothetical situation entailing the restructuring of the State’s debt and are not an intrinsic component of QE. Any purchase of financial assets entails the risk of default>>, although <<such a situation, however, may never occur so long as the Eurozone exists>>. [10]

4. It was possible to state during the present discussions that the ECB has had (and still has) a decisive role in overcoming the critical situation in which the Eurozone countries find themselves. In such a climate of emergency, it was not possible to wait for the normal periods provided for by the traditional decisional procedures laid down by the TFEU; in this context, it was necessary to quickly identify the best risk strategies, however, to adopt not well-thought-out measures, in conditions of ” democratic deficit “.

These are measures adopted by the ECB that appeared to conform to the relevant regulatory framework (which, as is known, does not recognize in this Authority the role of last-resort lender) [11]. To this end, the CJEU has stated that these interventions have to be necessarily covered by suitable guarantees and, however, in our opinion, the reference to such a conditioning element, being rather generic, carries a wide discretional power of evaluation by the ECB.

On this point, the considerations expressed by the Court of Justice regarding the OMT program seem significant; in particular it refers to those, according to which (par. 68), since the ESCB is required, when it prepares and implements an open market operations program (...) to make choices of a technical nature and to undertake forecasts and complex assessments, it must be allowed, in that context, a broad discretion (see, by analogy, judgments in *Afton Chemical*, C-343/09, EU:C:2010:419, paragraph 28, and *Billerud Karlsborg and Billerud Skärblacka*, C-203/12, EU:C:2013:664, paragraph 35).

That said, the Court (par. 69 of the same decision) does not deny that where an EU institution enjoys broad discretion, a review of compliance with certain procedural guarantees is of fundamental importance; in particular, those guarantees include the obligation for the ESCB to examine carefully and impartially all the relevant elements of the situation in question and to give an adequate statement of the reasons for its decisions. However, it is underlined that the question whether the obligation to provide a statement of reasons has been satisfied must be assessed with reference not only to the wording of the measure but also to its context and the whole body of legal rules governing the matter in question (see, to that effect, judgment in *Commission* v *Council*, C-63/12, EU:C:2013:752, paragraphs 98 and 99). It can be deduced that the verification of the existence of adequate reasons able to justify the adoption of specific measures by the ECB in extraordinary contingent situations, cannot exclude the analysis of further circumstances with respect to those explicitly called by the act itself (relative to the complex economic context and the general legal framework).

From here, the further and decisive observation according to which (par. 75), given that questions of monetary policy are usually of a controversial nature and in view of the ESCB's broad discretion, nothing more can be required of the ESCB apart from that it use its economic expertise and the necessary technical means at its disposal to carry out that analysis with all care and accuracy.

This is, therefore, the recognition by the CJEU concerning the difficulty of carrying out an efficacious judicial review in sectors in which the estimates concerning convenient adoption of some interventional programs are particularly complex. There follows, thus, that in certain operational specialist contexts the Court of Justice does not have the necessary expertise to evaluate the relevance of measures of high technical profile.

From another point of view, as concerns the circumstances according to which the orientation of the CJEU expressed on this subject, could assume some relevance, also concerning the evaluation of the legitimacy of every decision of non-conventional monetary policies and, therefore, in our opinion, the validity of the Qe program.

In particular, the acknowledgement of an ample discretional power of the ECB in the identification of the best possible strategy to use in emergency situations should be a decisive factor to challenge the arguments of the BVerfG that, recently, in the decision of 18 July 2017, cast doubts on the legitimacy of the Qe program in as much as it does not present references and there are no references present regarding the necessity, and the amount and the duration of the economic effects; notwithstanding the further problems raised by the German judges regarding the uncertain determination of the moment in which it should be considered concluded [12].

It is well to consider, that the argumentation used by the Court of Justice in the “OMT” case should be used by the same Authority to demonstrate that the ECB, by means of adopting the Qe program, acted in accordance with the provisions of Articles 119, 123 and 127 of the TFEU. However, aspects of specific important problems are identified by the German Court regarding the eventuality that the federal Republic of Germany should intervene to assure the functioning of the Deutsche Bundesbank (in as much as it is a federal institution of public law) if possible adverse circumstances, deriving from the implementation of the Qe program, should require; these perplexities are justified by the fact that <<Der Ankauf von Staatsanleihen durch das Eurosystem ist grundsätzlich geeignet, zu haushaltsbedeutsamen Ausgaben oder Einnahmeausfällen zu führen. Offenmarktgeschäften wohnt stets ein Verlustrisiko inne>> (par. 125 of the measure of 18 July 2017); a loss that obviously cannot be foreseen a priori (par. 128).

On this point it should be stated that the program provides for a massive purchase of State bonds and securities for a total of €60 billion every month; a sum that was increased in December 2015 and March 2016 up to €80 billion, and then reduced to €60 billion from April 2017. In the presence of loss, the program provides for a different distribution of the risk by the ECB and national central banks (ECB, press release of 10 March 2016). In particular, only for 20% of the purchases is there a sharing of the risk between the national central banks, while the remaining 80% is taken by the single national bank[13].

On this point, once again, interesting insights come from what was set forth in the sentence of the Court of Justice concerning the OMT case in which (par. 125) it is specified that <<a central bank, such as the ECB, is obliged to take decisions which, like open market operations, inevitably expose it to a risk of losses>>; it being understood <<that Article 33 of the Protocol on the ESCB and the ECB duly provides for the way in which the losses of the ECB must be allocated, without specifically delimiting the risks which the Bank may take in order to achieve the objectives of monetary policy>>. It can be deduced that when even an interventional program such as that described here can produce a loss borne by the ECB and the national central banks, nonetheless, if it is accompanied by suitable guarantees, has to conform to the rules of the TFEU when they are aimed at principally following objectives of monetary policies and observes the ban of financial assistance to the member states.

References

[1] See, Court of Justice of the European Union, Grand Session, 16 June 2015, in *Riv. Trim. Dir. Econ.*, 2, 2015, with note by D. ROSSANO, *Legittimo il piano OMT: la Corte di Giustizia dà ragione alla BCE*

[2] Article 18 of the *Protocol on the statute of the European system of central banks and of the European Central Bank.*

[3] See, MESSORI, Laudatio. Mario Draghi, innovatore istituzionale, in DRAGHI, L'euro, la politica monetaria, le riforme, series of Lectures, University Press Luiss, 2013, 21.

[4] See, ALTAVILLA, GIANNONE, LENZA, The Financial and Macroeconomic Effects of OMT Announcements, in ECB Working Paper No. 1707, 2014.

[5] See, CAPRIGLIONE, Mercato Regole Democrazia. L'UEM tra euroscetticismo e identità nazionali, Torino, 2013, 189; HAIDER – LEMMA, The difficult Journey Towards European Political Union: Germany's Strategic Role, in Law and Economics Yearly Review, 2, 2012, 390 foll.
It also has to be underlined how this historical decision of the German Federal Constitutional Court, shows how this historical decision of the German Federal Constitutional Court was not fully shared within itself; we refer to the specific fact that the ruling was made with the unfavourable vote of two high court judges. See MAYER, Rebels Without a Cause? A Critical Analysis of the German Constitutional Court's OMT Reference, in the German Law Journal, 2, 2014, p. 144 ss.

[6] See, for this point, the sentence: Pringle, C-370/12.

[7] See CAPRIGLIONE – SEMERARO, Crisi finanziaria e dei debiti sovrani. L'Unione europea tra rischi ed opportunità, Torino, 2012, 108.

[8] See GOLDMANN, Karlsruhe refers the QE case to Luxembourg: Summer of love, in SAFE Policy Letter, No. 58, 2017, 2.

[9] See ZEI, , La politica monetaria della BCE di nuovo al vaglio del Tribunale Costituzionale Federale, in Nomos, 2, 2017. Cfr., also, par. 119 of the decision of 18 July 2017 of the German Federal Constitutional Court: Zweifelhaft ist indes nach Auffassung des Senats, ob mit der Berücksichtigung der Zielsetzung einer Maßnahme und der gewählten Mittel allein allerdings eine Abgrenzung zwischen der Währungs- und Wirtschaftspolitik und eine Bestimmung der Grenzen des Mandats des Eurosystems möglich ist. Zwar sind nur mittelbare wirtschaftspolitische Auswirkungen währungspolitischer Maßnahmen nicht per se geeignet, die in Rede stehende Maßnahme insgesamt dem Bereich der Wirtschaftspolitik zuzuordnen (vgl. EuGH, a.a.O., Rn. 52, 59). Vom Vorliegen „mittelbarer Auswirkungen "kann indes nur dann gesprochen werden, wenn diese lediglich eine durch weitere Zwischenschritte verbundene, nicht sicher vorhersehbare Konsequenz der angegriffenen Maßnahme sind. Von einer „mittelbaren" wirtschaftspolitischen Wirkung kann jedoch möglicherweise dann nicht mehr gesprochen werden, wenn wirtschaftspolitische Effekte einer Maßnahme intendiert oder zumindest bewusst in Kauf genommen werden und ihnen ein mit der währungspolitischen Zielsetzung jedenfalls vergleichbares Gewicht zukommt. Die Akzeptanz der von den zuständigen EU-Organen oder -Einrichtungen angegebenen Zielsetzungen, verbunden mit der Anerkennung weiter Beurteilungsspielräume dieser Stellen und einer Zurücknahme der gerichtlichen Kontrolldichte erscheint geeignet, den Organen, Einrichtungen und sonstigen Stellen der Europäischen Union eine eigenständige Disposition über die Reichweite der ihnen von den Mitgliedstaaten zur Ausübung überlassenen Kompetenzen zu ermöglichen (vgl. BVerfGE 123, 267 <349 ff.>). Ein solches Kompetenzverständnis trägt dem Prinzip der begrenzten Einzelermächtigung und der Notwendigkeit

restriktiver Auslegung des Mandats der EZB nicht hinreichend Rechnung. Es bedarf vielmehr einer wertenden Gesamtbetrachtung, die auch gegen die erklärte Zielsetzung sprechende Gesichtspunkte einbezieht (vgl. BVerfGE 142, 123 <218 f. Rn. 183 f.>).

[10] See PACCES, REPASI, Quantitative Easing in Europe. What it is, why it is legal and how it works, in EUROCEFG Commentary, viewable on the internet site: http://www.euro-cefg.eu.

[11] See, BENIGNO, Poteri straordinari della banca centrale in un sistema di moneta fiduciaria, in AA.VV., La gestione della crisi. Il mercato, le imprese, la società, Padova, 2013, 102.

[12] See, par. 123 of the decision of 18 July 2017 according to which: Im Übrigen fehlt es auch an einer spezifischen Begründung in den Beschlüssen, die die Grundlage des Programms und seines Vollzugs bilden (vgl. Rn. 110 a.E.). Zwar hat die EZB fortlaufend die Relevanz des PSPP für die Erreichung des von ihr angestrebten Inflationsziels betont. Eine nähere Begründung für Erforderlichkeit, Ausmaß und Dauer der wirtschaftspolitischen Effekte des Programms hat sie jedoch nicht gegeben; insbesondere fehlt es an einer Abwägung der beabsichtigten währungspolitischen Wirkungen des PSPP mit den zu erwartenden zusätzlichen wirtschaftspolitischen Effekten. Dies hat auch zur Folge, dass die Bestimmung des Zeitpunkts, zu dem eine Beendigung des Programms zu erwarten ist, zumindest erschwert, wenn nicht unmöglich gemacht wird.

[13] See, CAPRIGLIONE, SACCO GINEVRI, Politics and Finance in the European Union: The Reasons for a Difficult Encounter, Milano, 2015, 162, according to which we have certainly a compromise, as the intent did not want to impose on the construction of the “purchase plan” the logic of a “full risk sharing”, systemic criterion believed by the Governor of the Bank of Italy «more coherent with the unity of monetary policy».

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Open Review of Management, Banking and Finance

«They say things are happening at the border, but nobody knows which border» (Mark Strand)

The normative framework of non-performing loans: regulatory and accounting issues

by **Andrea Miglionico**

Abstract: *This article examines divergences in the definition of non-performing loans (NPLs) across countries, accounting regimes and firms. Currently no common definition of NPLs exists. From the point of view of setting standards, the divergence is manifested in several ways, not just across jurisdictions, across time and across entities, but also in the different priorities that accountants and regulators have. This article aims to shed light to the accounting and regulatory aspects of loan classification and NPLs, topics that are multifaceted but have not been exhaustively addressed in the literature. Since the 2007-09 global financial crisis, accounting bodies and prudential regulators have focussed on early recognition of credit losses and enhanced disclosure. In this view, a harmonized normative framework for loan classification is needed to address a regulatory gap since there is no consensus how to resolve NPLs across countries, firms or even within firms.*

1. One of the most important achievements of global financial regulation in the last few decades is that the definition of bank capital has been subject to a substantial degree of harmonization because of work promoted by the Basel Committee on Banking Supervision starting with the Basel I agreement in 1988 [1]. There also has been progress towards a common international understanding of liabilities as a by-product of resolvability assessments, recovery planning and 'bail in' regulation because it has been necessary to establish a hierarchy of debt instruments [2]. But while claims on banks are increasingly comparable internationally, much less traction has been made on standardising the asset side of the balance sheet [3]. Yet, for resolution tools to work in practice, there needs to be a better understanding of what assets are worth in a crisis situation, and therefore of asset quality more generally [4].

This article examines the lack of a common financial language for bank assets, loan classification in general and the definition of non-performing loans (NPLs) in particular. There is divergence in the definition of NPLs across jurisdictions, firms and within firms across time. This matters because it makes meaningful comparison of banks' assets difficult for investors and regulators. The incommensurability of banks' asset portfolios also has wider socio-economic implications. Bad lending is the root of many banking crises, which in turn are often the source of economic downturns and depressions [5]. In these situations, uncertainty with respect to the quality, and therefore ultimately the value, of banks' assets can prove to be a major stumbling block to bank recapitalisation and economic recovery.

The structure of article proceeds as follows. The first section sets out the reasons why non-performing loans often feature prominently in banking and economic crises. In this section the link between ex-ante loan loss provisioning (LLPs) and bank capitalisation is discussed along with the literature debate. The conventional view—and the rationale for imposing capital requirements on banks—is that LLPs and related capital deductions are meant to help banks deal with *expected losses* from their lending business, while bank capital is meant to provide buffers for *unexpected losses* [6].

While higher ex-ante provisioning against expected loan losses lowers bank profitability in the short term, over the long term the progressive constitution of LLPs in good times reduces the chances of having a situation in crisis times where ex-post NPL losses force a bank to raise capital. Following Borio, Furfine and Lowe [7] and Laeven and Majnoni [8], who have argued that loan loss provisioning needs to be an integral component of banking regulation, these issues are raised because forward-looking provisioning and timely recognition of loss are discussed less often in the academic literature on financial stability than bank capitalisation. The key economic consequence of insufficient loan loss provisioning and the persistence of NPLs on bank balance sheets is the combined threat of a 'capital crunch' and a 'credit crunch'. The Japanese 'lost decades' and the recent global financial crisis (GFC) provide cases in point [9]. The first section of this article reviews some of the challenges that a persistence of NPLs on bank balance sheets has posed post-GFC.

Section two analyses the resolution regime for NPLs. In many jurisdictions and for many firms, an NPL is defined as a sum of borrowed money upon which the debtor has not made his or her scheduled payments for at least 90 days. Generally, at some point after the debtor starts making payments again on a NPL, it becomes a re-performing loan, even if the debtor has not caught up on all the missed payments. In a sense, an NPL is either in default or close to being in default [10]. However, this definition is not universal. Section two also examines the heterogeneity of resolving tools for NPLs across jurisdictions. The focus is on current differences between prudential supervisory authorities. But there are also likely differences within jurisdictions across time, and again between jurisdictions in terms of the intensity of prudential enforcement of NPL standards.

Section three discusses the divergences in the definition of NPLs, particularly in the disclosures of NPLs by global systemically important banks (G-SIBs) in their annual reports and accounts, and in widely used commercial data sets. One possible explanation for this divergence is that detailed accounting standards are a relatively recent phenomenon and until recent decades there were no international accounting standards governing comprehensively either how to calculate LLPs or how to classify loans according to credit quality. Even at a national level, there were few standards. In the US, the issue of FAS 5 *Accounting for Contingencies* in 1975 was likely the first formalised accounting standard in this area. Before then, while banks did make provisions against bad loans, these often took the nature of 'hidden reserves' monitored by banks in private but often not disclosed publicly: in some cases, neither the extent of bad loans nor the level of provisions was public information. In the UK, for example, banks were, through custom and law, exempt from reporting the true nature of their provisions, profits, capital and NPLs until 1970 [11].

Section four deals with the accounting issues for NPLs. The need for accounting standards and enhanced disclosures has increased because the nature of lending has become longer term. For example, in the UK, until the second half of the twentieth century, short-term loans constituted the vast majority of UK bank lending, fewer than 10 percent of banks' loans to businesses between 1910 and 1914 had a contractual term greater than a year [12]. The development of longer-term lending, where the bank assumes more credit risk, increases the importance of having accurate and timely data to monitor asset quality through a loan's long life.

Sections five and six of the article examine the regulatory responses to create new standards for loans. Following the 2007 financial crisis, a number of actors at the Bank for International Settlements (BIS), the Financial Stability Board (FSB), the European Banking Authority (EBA) and the International Monetary Fund (IMF) have in various ways expressed concern with the lack of international comparability and inappropriately late recognition of loss when it comes to the asset side of banks' balance sheets. One specific criticism raised about pre-crisis accounting standards for provisions is that they operated on an incurred loss model [13]. This meant that impairment was only recognised when a loss event occurred. Such a model is inherently reactive and backward-looking. Indeed some critics have argued that it fuelled pro-cyclical lending and asset price bubbles ahead of the GFC because it meant loans were under-provisioned at the onset of the crisis. In its aftermath, there has been a growing chorus calling for a more forward-looking, 'expected loss' model.

The current debate revisits an older difference of opinions between securities and banking regulators about the appropriate allowance for managerial judgement and discretion in the estimation of future losses [14]. Traditionally, banking regulators often have been of the view that early provisioning provides a buffer against potential future losses. On the other hand, securities regulators have been wary of banks raising high provisions and then releasing them as a means of artificially smoothing profits in order to reduce the volatility of their stock market valuations. In fact, the latter concern contributed to the adoption of the 'incurred loss' model that dominated until the GFC. It can be argued that the steps being taken post GFC, to bring in greater forward looking loan loss provisioning, will increasingly integrate the accounting standards on provisioning with information useful to prudential regulators in assessing capital adequacy requirements.

Last section concludes by pointing that even if NPL definitions are standardized internationally, there are likely to remain instances in the future when discretion will be encouraged, and that this has implications for asset quality data. Indeed in the past regulators have sanctioned loan forbearance at a firm or system-wide level during financial crises as a means to stave off their worst depths [15]. While forbearance may be inappropriate if the obligor has no real chance of recovery, as this can hamper the reallocation of resources to other sectors of the economy and weigh down long-term productivity, it may be appropriate if an obligor is suffering just from a temporary cash flow problem, or restructuring or strategically reclassifying the loan gives them time to recover and become economically viable [16].

Given that some regulatory and management discretion is likely in crisis situations, standardising a definition of NPLs using only a hard-and-fast threshold based on arrears may be an objective that misses the ultimate mark. When forecasting future losses and loan performance, judgment inevitably plays a role. The implication of this observation is that, in addition to initiatives to harmonise NPL definition and asset classification for purposes of loan loss provisioning, considerable vigilance is required of the prudential regulator to enhance the quality of the data for the purpose of assessing asset quality to aid that judgment.

2. The problems NPLs create for economic recovery are evident in the period since the start of the global financial crisis in 2007, with the persistence of NPLs being a reason for the delay in the recovery from the GFC [17]. The fundamental problem is that the balance sheet counterpart of NPLs on the assets side is an eventual hit to bank capital on the claims side. Thus one key ratio to track is the proportion of LLPs to NPLs (coverage ratio), constructed and commonly used by credit rating agencies, among others [18].

In general, the goal should be having a level of provisioning commensurate with the initial expectations of recovery on loans (and therefore the pricing of credit) [19]. If this is not so, then the scale of losses may be so large that they cannot be covered by income, bringing a bank's capital below or close to the minima required. At that point, banks might have to recapitalise when they and the wider system may be facing a crisis. Crises, of course, are the worst possible moment for a bank to raise capital, as profits are falling, investors are wary of purchasing new shares, and general economic conditions are poor. So as a general rule, bank recapitalisation during a crisis is a second best solution to higher LLPs before they occur.

However, adequate provisioning for NPLs requires overcoming complex strategic incentives that banks have in either wanting to keep LLPs low, or for not writing NPLs off from their balance sheets. The timing of losses taken as a result of provisions or write offs, and the level of loan loss provisions set aside for future NPLs on the balance sheet, are often part of a bank's strategy to smooth reported earnings and reported capitalisation [20]. For example, current regulatory capital requirements give banks strategic reasons for wanting to keep LLPs low. Specifically, the BIS Common Equity Tier 1 and Tier 1 capital adequacy ratio numerators include common stock and retained earnings. However, since higher LLPs are taken as losses and so reduce retained earnings, this implies a trade-off between reporting higher Common Equity Tier 1 and Tier 1 capital ratios and maintaining adequate LLPs. This trade-off is further complicated by a Basel III Common Equity Tier 1 (CET1) capital requirement of 7% (comprising the minimum CET1 requirement of 4.5% plus a mandatory capital conservation buffer of 2.5%) of risk-weighted assets, with further buffers added to the CET1 requirement in specific cases. LLPs have the effect, generally speaking, of reducing CET1 and therefore the numerator of those ratios [21].

In addition to the above strategic reasons for potential under-provisioning to maintain regulatory capital, provisions may be mis-calibrated simply because the path of future NPLs may differ considerably from historical experience. For example, mortgage delinquencies from the 2007 house price fall in the US far exceeded any previous market downturns, so there was considerable under-provisioning for these losses [22]. In 2005, the US Federal Deposit Insurance Corporation (FDIC) stated that "while historical loss experience provides a reasonable starting point, historical losses, or even recent trends in losses, are not by themselves, a sufficient basis to determine an adequate level. Management should also consider any factors that are likely to cause estimated losses to differ from historical loss experience".

Since write offs mean that some loans and the provisions against them disappear from the balance sheet, and as some loans tend to have higher provisions raised against them as a proportion of the gross amount of the loan, it follows that a bank that elected to write off relatively more of its highly provisioned problem loans would show lower provisions as a percentage of overall loans. Thus full information about write offs, and further data on when a bank deems that such write offs take place, are critical for users of financial statements to compare overall provision numbers from bank to bank. For example, in their detailed study on why Italian banks have been slow in dealing with NPLs in the recent crisis, Jassaud and Kang note that these banks have delayed writing off highly provisioned loans as this would lower their overall provisioning ratio and possibly their credit rating [23].

Jassaud and Kang also observe a lack of tax rebates on losses in Italy, and also that the current accounting standard in Europe (IAS 39) is not explicit on exactly when and how to write off uncollectible loans. In this case, and in all situations, the more LLPs and related accounting policy decisions such as write-offs are left to management discretion, the more difficult it becomes to compare cross-firm and cross-border NPL and LLP figures.

3. While the negative economic consequences of NPLs are well understood, the actual meaning of non-performing loans is less so. In fact, there are divergences in NPL definitions across jurisdictions. Barisitz provides an overview of the general drivers behind these differences [24] finding that a majority of countries in his study classify loans as non-performing when principal or interest is 90 days or more past due and there is "well-defined weakness of loan or borrower" [25]. But two issues complicate matters. First, the definition of "well-defined weakness" remains unspecified within and across jurisdictions. In other words, different firms and regulators have different data and different interpretations of data they use to estimate obligors' ability to repay and whether it has deteriorated.

Second, there are other dimensions besides time (since last repayment) that matter in certain jurisdictions. These include whether collateral, guarantees or other forms of security are factored into the credit classification process; whether the full outstanding value or only part of a loan is reported as non-performing; and how to treat restructured loans.

Convergence around the global statistical definition of NPLs is established by the UN System of National Accounts and followed by all countries adhering to IMF or European reporting standards: "a loan is non-performing when payments of interest or principal are past due by 90 days or more, or interest payments equal to 90 days or more have been capitalized, refinanced, or delayed by agreement, or payments are less than 90 days overdue, but there are other good reasons (such as a debtor filing for bankruptcy) to doubt that payments will be made in full" [26]. Loan quality classification schemes range from three to nine categories in some jurisdictions. Furthermore, like the UN statistical definition, which comes with the proviso that the UN "definition of a non-performing loan is to be interpreted flexibly", the drafting of these definitions leaves scope for firm discretion because the meaning of phrases like "objective evidence of impairment" are not precisely defined. In the past, there have been efforts by some international bodies to establish firmer guidelines in assessing credit risk for regulatory purposes. For example, under the Basel II capital framework first published by Basel Committee on Banking Supervision (BCBS) in 2004, a system of credit risk calibration based on banks' own internal risk models was introduced. For those portfolios where banks elected to develop systems to follow this approach, the IRB methodology required firms to provide own estimates of probability of default, loss given default and exposure at default [27].

In particular, default is defined as where an obligor is 90 days past due, or is unlikely to pay its credit obligations to the banking group in full, without recourse by the bank to actions such as realising security. Indicators of unlikeliness to pay include the following: (1) the bank puts the credit obligation on non-accrued status; (2) the bank makes a charge-off or account-specific provision resulting from a significant perceived decline in credit quality subsequent to the bank taking on the exposure; (3) the bank sells the credit obligation at a material credit-related economic loss; (4) the bank consents to a distressed restructuring of the credit obligation where this is likely to result in a diminished financial obligation caused by the material forgiveness, or postponement, of principal, interest or (where relevant) fees; (5) the bank has filed for the obligor's bankruptcy or a similar order in respect of the obligor's credit obligation to the banking group; and (6) the obligor has sought or has been placed in bankruptcy or similar protection where this would avoid or delay repayment of the credit obligation to the banking group [28]. In 2006 BCBS issued guidance that specifically mentioned loan classification [29]. It recommended banks to have a credit classification system on the basis of credit risk but stopped short of spelling out the classification scheme [30]. While some bodies, such as the Institute of International Finance have established such systems, these lack the force of international law.

4. One area where one might expect the meaning of non-performing loans to be reasonably well defined is in accounting. However, neither International Financial Reporting Standards (IFRS) nor US Generally Accepted Accounting Principles (GAAP), treat the topic of non-performing loans as such. Rather, the focus is on impaired loans and note disclosures on credit risk. On the eve of the financial crisis, both the IFRS and the US GAAP accounting standards that governed impairment of financial assets (also known as 'provisioning') operated under a model known as 'incurred loss'. This meant that impairment was only recognised when a loss event had occurred. Within IFRS, the standard IAS 39 is specific that "losses expected as a result of future events, no matter how likely, are not recognised". Nevertheless, additional information on asset quality could be discerned through further analysis of the accounts prepared by banks reporting under IFRS.

US accounting rules in this area differ from IFRS, and the absence of common, cross-border accounting standards for judging when loans are impaired makes like-for-like comparisons between banks difficult for users of their financial statements [31]. In the lead up to the GFC, banks often did not disclose the level of write-offs: situations where both a loan and the related provision are derecognised from the balance sheet because there is no realistic prospect of recovery. The assessment of whether a write-off is required inevitably involves judgement on the part of the bank, and so it follows that one bank might elect to write off an asset where another bank would not, even when the underlying economics are broadly similar. In sum, in terms of asset quality, provisions, and write-offs, bank reporting practice is diverse and divergent. While there is convergence towards the definition of an NPL as being loans 90 days or more past due, there are also differences along quantitative and qualitative dimensions.

5. The period that immediately followed the GFC saw intense criticism of the 'incurred loss' model, and multiple initiatives in the area of loan loss provisioning and related disclosures, both from accounting standard-setters and from prudential regulators. Starting in 2009, the G20 called for accounting standard setters to "strengthen accounting recognition of loan-loss provisions by incorporating a broader range of credit information" [32]. In the same year, the Financial Stability Board (FSB) encouraged accounting standard-setters to agree standards that "will incorporate a broader range of available credit information than existing provisioning requirements, so as to recognise credit losses in loan portfolios at an earlier stage" [33]. The IASB and FASB models require provisions to be based on forward-looking expectations and so mark a clean conceptual break from the methodology of incurred loss. The IASB has also jettisoned the classifications based on past due status that previously formed part of the disclosure framework around it. Unlike the 2009 draft, the term 'non-performing' does not appear in the accounting standard. One reason for this may be that a definition of a set number of days past due is arguably of less relevance in a standard where provisions are calculated on a forward-looking basis [34].

Under the IASB approach, the forward-looking provision is set at 12 months of expected loss for all loans, and full expected loss over the lifetime of a loan where 'significant increase in credit risk' has occurred. When determining whether such credit deterioration has taken place, the accounting guidance makes reference to an internal credit downgrade as an indicator, thus assuming that an internal credit classification might exist. Although firms are required to disclose how they determine whether a significant increase in credit risk has occurred, the criteria used in internal classifications more generally are often opaque so users of financial statements may not be able to understand the full context in which a loan is reclassified, or to what extent loans have not been determined to have undergone a significant increase in credit risk even where some deterioration has occurred. A more comprehensive classification of asset quality, showing how credit quality changes from one period to the next, arguably provides further colour in understanding how the bank goes about applying the three-stage classification in practice.

The FASB intends to issue a standard that requires provisioning based on expected credit loss over the lifetime of a loan for all loans. Discretion over bank loan loss provisioning can have beneficial or negative consequences depending specifically on how managers exploit their discretion to shape loan loss provisions [35]. While management discretion to use loan loss provisions as a means to smooth profits is objectionable, better provisioning in anticipation of future deterioration is not [36]. Meanwhile, the European Securities and Markets Authority (ESMA) has noted that disclosures about forbearance practices in the financial statements diverged significantly and were often limited in the amount of information provided and vague as to content [37]. The European Banking Authority in 2014 published technical standards for the reporting of non-performing loans and forbearance. The EBA document provides the definition of "exposure", "non-performing exposures" and "forborne exposures" [38]. The EBA standard centres the definition of non-performing on the notion of either 90 days past due, or where the debtor is assessed as unlikely to pay its credit obligations in full without realisation of collateral. Further disaggregated reporting is required for forborne assets, and those defined as performing but nonetheless past due by 30 or 60 days.

6. In the wake of the GFC, one area where the lack of an internationally harmonized accounting concept of impairment was suspected of giving an especially incomplete picture of the health of the financial system was with respect to forbearance, that is, the restructuring of troubled loans. While IAS 39 is clear that restructuring is a credit event that might lead to impairment, and impairments have to be calculated based on the difference between the original and modified conditions, the standard does not rule out cases of restructuring where there is no impairment and there is ambiguity about whether once restructured, an exposure needs to continue being identified as impaired. Consequently, lenders choose to extend or otherwise modify the terms of loans that show evidence of financial stress, these loans might avoid arrears and as such might not be identified as impaired (or non-performing), despite underlying credit deterioration of the borrower [39].

In 2011 the UK Financial Services Authority (FSA) issued a guidance document on loan forbearance, noting that “we have concerns that certain accounting practices can have the effect of concealing the full effect of impairment and forbearance and thus may not present the true nature of credit risk within retail portfolios” [40]. Similar concerns were raised the same year in the US when the accounting standard-setter clarified its guidance around the definition of troubled debt restructurings (incidentally a term used only in US accounting), with the aim of developing more consistent standards in determining whether a modification of a loan receivable constitutes a concession to a borrower that is experiencing financial difficulty.

In this light, the Central Bank of Ireland in 2013 produced comprehensive guidance on accounting practice for loans and related disclosure. This document included standardised definitions of terms such as ‘performing loan’, ‘non-performing loan’, ‘cured loan’, ‘foreclosed loan’ and ‘forbearance’ [41]. Meanwhile, in the south of the European Continent, the European Bank Coordination ‘Vienna Initiative’— a private-public sector platform which brings together key international financial institutions, international organisations, public authorities and private banks— has called for an action plan to address NPLs in CESEE countries.

The main purpose is to establish a central forum for dialogue to create the right conditions for Western banks to remain engaged in emerging Europe. This means enhancing enforcement measures, improving consistency in the definition of NPLs and removing legal obstacles and execution issues in distressed transactions. In particular, the ‘Vienna Initiative’ is trying to establish an effective coordination mechanism for dealing with distressed assets. NPLs are considered a serious impediment to recovery from the financial crisis in certain CESEE countries because they impair banks’ ability to resume lending and weigh down overextended borrowers [42]. This can have macroeconomic consequences, as the burden of debt felt by some results in their decreasing spending, with reduced income down the line for others, including even those not indebted [43]. As a result, it has been claimed that “NPL resolution has moved to the top of policy makers’ agenda in central and eastern Europe” [44].

Looking across all of these post-crisis developments in the regulatory and accounting treatment of NPLs, a wide variety of approaches continue to be employed [45]. Within accounting standards, differences between US and IFRS approaches, as well as discretion allowed to banks in determining many credit quality metrics, means that banks still can diverge significantly from each other in their approach to asset quality classification. Within the regulatory sphere, forward-looking judgment can give rise to quite different estimates. Arguably more than ever, users of financial information are in need of meaningful and comparable information indicators against which to assess the asset quality of banks.

7. The current Eurozone crisis is a stark reminder of the dangers posed to economic and financial stability by over-indebtedness, under-provisioning and NPLs [46]. Besides being precursors to the current crisis, however, earlier episodes also evidence that 'creative accounting' has played a role in previous crises' resolutions. Consider the Latin American debt crisis in the 1980s. In August 1982 "the total risk to the nine money-centre banks in New York was estimated at more than three times the capital of those banks. The regulators did not force the banks to value those loans at the fire-sale prices of the moment, helping to avert a disaster in the banking system [47]. In other words, the nine biggest banks were all insolvent in the 1980s" [48]. The accounting treatment of non-performing loans encouraged regulators to effectively delay the recognition of any losses until banks had had the time to build up loan loss reserves [49].

If there is a place for forbearance as a resolution or macro-prudential tool in certain circumstances to prevent the worst of economic catastrophes, then this suggests that the search for a single, deterministic definition of non-performing loans is misconstrued. If so, then the focus of regulators should not be on establishing a global standard NPL definition because context often matters. Instead the focus perhaps should be on getting banks, regulators, investors and other stakeholders the right data to monitor asset quality in a more timely and transparent way. *Ex ante*, at origination, lenders collect lots of information about obligors. *Ex post*, in liquidation procedures, courts collect lots of information about defaulted obligors. But in the interval in between, in the absence of market prices for non-traded loans, there is a need for continual monitoring of asset quality by looking at the overall solvency of obligors, the progress of projects the loans are financing, and any other key risks that are evolving that are obligor-specific and macro-economic.

As regulatory and accounting standards shift from incurred to expected loss models, it is desirable that the debate will focus on harmonizing NPL definitions internationally and on global co-ordination to better collect and disclose asset quality data [50].

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[33] Note 3.

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[35] Basel Committee on Banking Supervision. "Basel 3: A global regulatory framework for more resilient banks and banking systems", Basel Committee on Banking Supervision Paper (2011).

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[37] ESMA, "Treatment of Forbearance Practices in IFRS Financial Statements of Financial Institutions", ESMA no. /2012/853 (2012).

[38] The focus of the EBA document is on non performing exposures (NPEs) broader than NPLs. Paragraph 149 of the EBA document states that for the purpose of template 18, "exposures" include all debt instruments (loans, advances and debt securities) and off-balance sheet exposures (loan commitments, financial guarantees and other revocable and irrevocable commitments) excluding trading exposures and off balance sheet exposures except held for trading exposures. European Banking Authority, "Final implementing technical standards (ITS) on supervisory reporting on forbearance and non performing exposures under Article 99(4) of Regulation (EU)". Official Journal of the European Union Volume 58, 2015.

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[40] Financial Services Authority, "Forbearance and Impairment Provisions – Mortgages", *FSA Finalised guidance* (2011).

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[47] In a crisis situation, such 'fire sale' prices may reflect much higher expectations of credit loss, or a further discount due to the illiquidity of the loan market.

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