EDITORIAL

CHRONICLE OF A REGULATORY FAILURE FORETOLD: DERIVATIVES AND LOCAL AUTHORITIES

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1. Despite the anachronism of those who seek to find the roots of capitalism in the Middle Ages, the evidence gathered by the most accurate studies of history show that in that period commerce was not regarded as being a value in itself: a recent and perspicuous analysis can be found in one of the last essays written by Jacques Le Goff, *Le Moyen Âge et l'argent: Essai d'anthropologie historique* (2012). Rather, it was one element in a world of meanings and values, at the apex of which was a fundamental virtue, *caritas*. Studies carried out by historians of law have confirmed the importance of non-economic values in the regulation of trade and industry. A particular emphasis was placed in the concepts of good faith and loyalty (*homini hominem insidiari nefas*), as well as the prohibition of *iniuria* (injury). These values and principles were not at all unknown to the founder of economics, Adam Smith. As a professor of jurisprudence and *belles lettres*, he devoted considerable attention to the non-material values of a civilized and commercial society. The importance of such values seems to have become completely lost, however, in the ideas and thoughts about the law put forward by a part of the legal community which not only comprises judges and academics, but also lawyers and experts. A prime example is that of the transactions entered into by local authorities with regard to derivatives.

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2. In modern capitalist economies, contracts relating to derivative financial instruments (in short, derivative transactions) *per se* are neither illicit nor a source of injury. They can provide market operators with financial liquidity when this is scarce. They can support entrepreneurs who propose innovative solutions and are thus well aware of the risks intrinsic to this type of transaction. But in a society that places some mild limits to the goals permissible to individuals, in order to protect non-economic values, and such values as good faith and correctness, transactions of this kind set some limits, underlining the importance of transparency. As for private parties, all risks must be made clear to those who ask for money and undertake the obligation to pay interest for its use. Regarding public bodies, in particular local authorities, it is not simply a question of a more accute need of transparency nor a more evident need of technical expertise. The issue that arises is whether they can legally enter into transactions that entail high risks or are of a purely speculative nature.

3. Until 2001, there was no question that the Italian legal system did not allow local administrators to enter into transactions of this kind. Since then, the Italian Constitution has been amended in order to allow regions and local authorities to "resort to indebtedness only as a means of funding investments" (Article 119, last paragraph), and it should have been even more evident that no debts could lawfully derive from other kinds of transactions. To use a concept from the common law countries, entering into a derivative transaction was *ultra vires*, as the House of Lords in its judicial capacity has held in its rulings concerning English local authorities. However, in 2002 the Italian legislation was amended in order to allow local authorities to enter into at least some transactions of this type, though not all. It is by no means an oversimplification to say that the consequences of this legislative choice, tolerated if not promoted by the Minister of the Treasury, have been extremely negative not only for non-economic values, but also for the soundness of public finances; a collective interest which is protected by both national constitutions and the "economic constitution" of the European Union. Several regions, provinces and municipalities have entered into contracts relating to derivative financial instruments, including some of a speculative character. Only initially, and not

in every case, did those contracts provide local administrators with financial resources. Subsequently, they had to pay out increasing sums of money and, when seeking to renegotiate those contracts, which additionally provided the jurisdiction of English courts, they faced high costs. According to the Court of Auditors' last hearing before a parliamentary committee (November 2014), several regions have lost dozens of millions of Euros, sometimes without even receiving an upfront, and in some cases have even signed contracts with hidden or opaque costs. The financial burden for local collectivities has risen and the risk that sooner or later Italian taxpayers will have to pay for this has also risen.

4. After a decade of financial disorder, lawmakers and judges have sought remedies. Parliament has established a temporary prohibition, for local authorities, to enter into derivative contracts. Subsequently, the temporary prohibition was transformed into a permanent one. New limits have been placed on local authorities' use of debt. Meanwhile, the highest administrative court (*Consiglio di Stato*) has clarified that public bodies, including local authorities, can revoke or withdraw the administrative measures which preceded and determined their contractual choices. The Court of Auditors has repeatedly affirmed that administrators must exercise their powers in this way, whenever possible. However, there has been an unprecedented waste of public money and there is little chance of recovering even a part of it. Moreover, the actions taken by the local administrators who are increasingly aware of the dysfunctions of their predecessors find themselves subject to legal action by the national and multinational banks before Italian and English courts, with uncertain chances of success. Furthermore, the steps taken by financial and criminal prosecutors (those of the Court of Auditors and public prosecutors respectively) against the managers of those banks have slim chances of success.

5. The developments summarised above are very important not only for public finances, but also for the functioning of financial markets. Not surprisingly, there are a variety of opinions about them. One of the lawyers who works for a multinational law firm, which is particularly active in supporting national and multinational banks, has argued that once local authorities have

entered into contracts relating to derivative financial instruments, the courts must simply impose compliance with the law: in other words, *dura lex, sed lex*. However, this is only apparently acceptable in law. If, for example, a pool of banks, initially selected as advisors by a local municipality, subsequently proposes to the latter to estinguish a loan with a development bank, replacing it with derivatives and negotiating them with the former, is this conduct compliant with the rules governing conflict of interest? And if the real risks of such derivatives have been constructed in so complex a way that neither an administrator nor a legal advisor can understand the magnitude of those risks without hiring an expert working within the City, is the banks' conduct *really* respectful of the principles of good faith and transparency laid down by the EU directives?

6. While it is a task for the judges to guard this troubled boundary between financial operators and the State and to assess individual responsibilities, there are two important lessons to be learnt for all lawyers who do not wish to be mere commentators either of the latest piece of legislation published in the official journal or the latest judicial decree. First, there is a case for arguing that the disordered decade that is behind us has been characterized by a regulatory failure. Several factors contributed to this failure: opacities, to say the least, in the offer of financial derivatives; weak external checks, or no checks at all, on the administrative procedures that preceded transactions; low perception of systemic risk. Both the guardians of the treasury and the guardians of the market failed to meet expectations, especially when local government should have used public expenditure to build infrastructures, instead of entering into highly sophisticated and risky transactions. Our regulatory architecture is in great need of repair, with a focus on *whether* public bodies can enter into certain contracts and, if so, *how* they can do so and with which consequences for those who take decisions that can curtail the financial capacity of a local community. Clearly, no regulatory change can ever be sufficient to deal with the rapidly evolving instruments used by financial institutions, without a more adequate and modern culture of public management. This brings us to the second lesson to be learnt, particularly important for those lawyers who still think that the market, if it is properly

regulated (as opposed to steered), can achieve outcomes precluded to other types of economy – for others, blaming the intrinsic defects of capitalism is an easy option. Precisely because legal rules can barely follow the rapidly changing financial instruments, it is of fundamental importance to think about market actors and regulators in a new way. This requires us to use the general principles of law more systematically and to be more aware of their non-economic rationales, i.e., to rediscover the genuine foundations of our legal tradition, including the relationship between law and justice. This relationship has been obfuscated, if not perverted, by the supporters of the market that self-regulates itself.