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

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

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FOCUS ON GLOBAL PERSPECTIVES

GOVERNOR CIAMPI AND THE "AMBROSIANO CASE": INTERNATIONAL BANKING SUPERVISION AND MONETARY POLICY *

Rainer S. Masera **

ABSTRACT: *Following bank failures in 1974, notably in Germany (Bankhaus Herstatt of Cologne on June 16) and the US (Franklin National Bank of New York on October 8), the Central Bank Governors of the G10 countries decided to set up a Committee at the BIS in Basel to improve quality and enhance the effectiveness of banking supervision. The Eurodollar market and the rise of offshore financial centers had concurred to create an increasingly interlinked web of international banking transactions. The system of national supervision of domestic banking system had to be completed by incisive and coordinated action at international level, also to cope with the vulnerability to frauds and interactions with organized crime. The Basel Committee issued in December 1975 the Concordat, which provided a framework for international banking supervision and made a distinction between solvency and liquidity.*

It was within this emerging frame of reference that the Bank of Italy and the

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G10 Governors dealt with the crisis of the Banco Ambrosiano Group: the crisis had started in 1977 and was concluded with the formal liquidation on August 6, 1982. The measures taken by Governor Ciampi and Treasury Minister Andreatta, the dialectical interactions with the Basel Committee, the G10 Governors (banking supervision and monetary policy) and the IOR in the Vatican City are analized and discussed in this article. In preparing the paper the author could benefit from the extremely competent support of the Historical Archives of the Bank of Italy and the access to documents only recently accessible for public consultation. As is shown, the action undertaken by Governor Ciampi and by the Bank of Italy in the Ambrosiano case contributed to the evolution of banking supervision as regards both the revision of the Concordat and, thereafter, the development of a system of mandatory risk-weighted capital ratios. A parallel lasting lesson is that capital adequacy requirements must be complemented by targeted effective supervisory guidance and oversight of corporate governance for banking firms to prevent, insofar as possible, inappropriate and illegal practices, while ensuring accountability of shareholders and top managers for their wrongdoings.

1. 1.1. On June 16, 1974 the Herstatt Bankhaus of Cologne went into liquidation as per decision of the Supervisory Authority of the Federal Republic of Germany following speculative foreign exchange transactions resulting in huge

losses. In addition to serious national repercussions, the bank failure caused problems in international settlements also because of the difference in time zones between Frankfurt and New York (the bank was closed down at 4:30 p.m. in Germany while it was 10:30 a.m. in New York). Therefore, its insolvency gave rise to supervisory issues in respect of gross settlements at the international level, which were not real time back then (BCBS, 2004). In the aftermath of such events, the Banking Supervisory Authorities of the Group of Ten (G10) at the BIS in Basel decided to set up the *Basel Committee on Banking Regulations and Supervisory Practices* (thereafter re-named *Basel Committee on Banking Supervision*). Back then, the Committee was often referred to as the Cooke Committee, after Peter Cooke, Director of the Bank of England who chaired the Committee for many years[1].

In December 1975, the Committee issued the Basel Concordat, a paper that set out a few international supervisory rules making a distinction, from the point of view of supervision, between solvency and liquidity. In addition, it provided guidelines as regards the choices aimed at supporting liquidity made by the central banks in favor of international banks, setting out the difference between *home country* and *host country*.

It was within this reference framework that the Bank of Italy had to deal with the crisis of Banco Ambrosiano Group (BAG) from the point of view of international supervision. (see also Walker, 2001).

Following the solution of the Banco Ambrosiano crisis, the Concordat was reviewed in May 1983 (BCBS, *Principles for the Supervision of Banks' Foreign Establishments*) with the aim of dealing with issues related to banking groups, parental responsibility and capital requirements. The papers issued by the Governors of the G10, by the Cooke Committee and by the Eurocurrency Standing Committee in 1982-1983 show that the decisions made by the Bank of Italy and shared – as we shall see – with some disagreement by the G10 (a few meetings

[1]For a History of the early years and the evolution of the Basel Committee see Goodhart (2011) and Ingves (2013).

were attended by the Managing Director of the International Monetary Fund, Jacques de Larosière) drove the reform of capital adequacy rules, shifting from leverage to risk-weighted capital requirements.

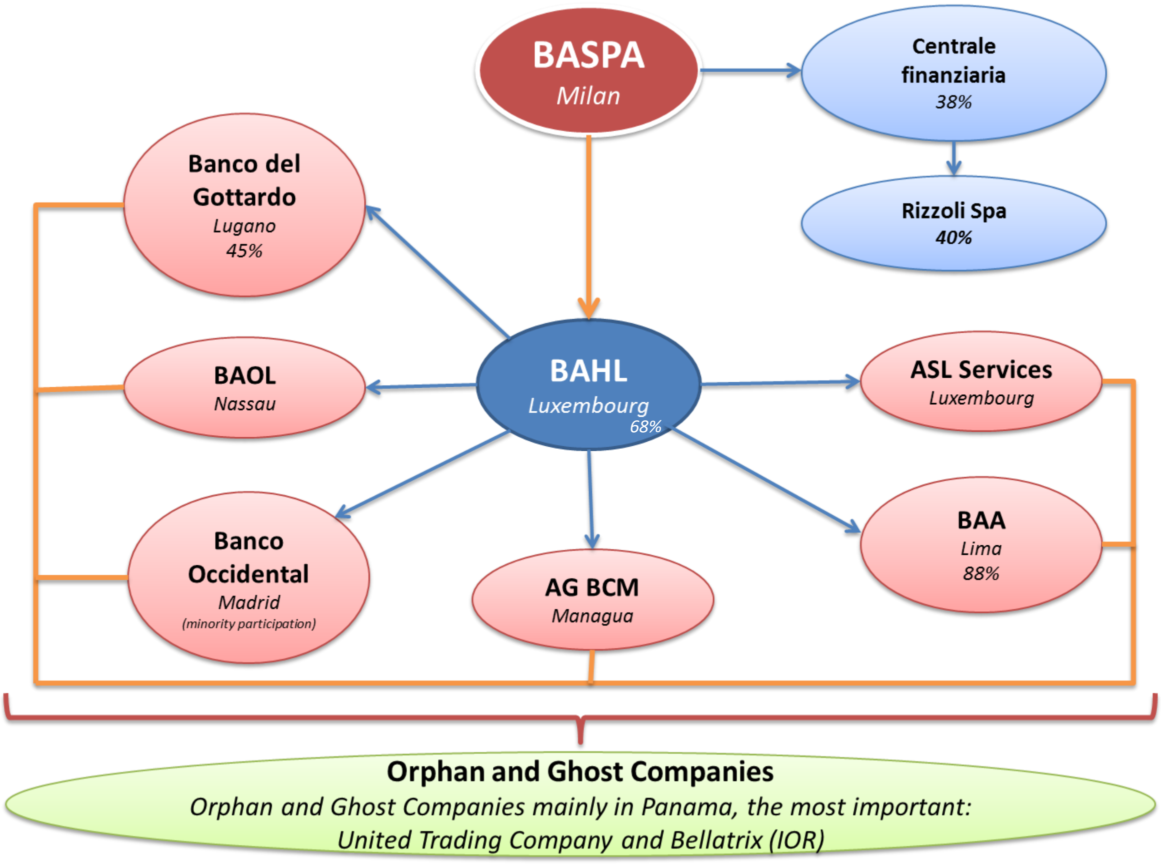
1.2. As evidenced above, the internationalization of the banking sector and the development of the Euromarkets took place in a context characterized by both lack of transparency and incomplete rules that had allowed some banks to implement models that were unscrupulous, highly risky and deliberately permeable to criminal activities. Banco Ambrosiano has been a case study on such topic.

It is not possible to review here the long history of BA and the gradual shift from a sound catholic social bank, operating mostly in Lombardia, to a large privately-owned banking group which, under the leadership of Roberto Calvi, operated widely abroad, mostly in Switzerland and in Latin America, while establishing close ties with *Istituto per le Opere di Religione* (Institute for Religious Works, commonly referred to as IOR) in the Vatican (from the point of view of supervision, IOR was an uncontrolled international bank).

Roberto Calvi (1920-1982) built his career within Banco Ambrosiano, which he joined in 1947 as a clerk. In 1971 he was appointed Managing Director and was President of the bank from October 15, 1975 until June 1982. In 1974 he was appointed *Cavaliere del Lavoro* and became one of the most important Italian bankers. Marcinkus, Sindona, Ortolani, Gelli, Tassan Din were Calvi's cronies in the mismanagement of Banco Ambrosiano.

Figure 1 summarizes the structure of BAG as developed by Calvi at the end of 1981.

Figure 1 - Banco Ambrosiano Group at the end of 1981



Source: Author

The elements of what may look like a puzzle are as follows: at the center there was **BASPA**[2], which owned 38% of Centrale Finanziaria, of which Calvi had been President since 1976, and Banco del Gottardo (BG) in Switzerland, established in 1957 in Lugano. At the beginning, BG was the main vehicle used by Calvi to transfer money abroad illegally and to set up foreign companies in close cooperation with IOR. International transactions were carried out mainly through Banco Ambrosiano Holding in Luxembourg (**BAHL,**) of which Calvi was President from June 1977 to June 1982.

BAHL <u>was not a bank</u> and was not subject to Italian laws. Since it was not a bank, it was not subject to supervision by Luxembourg banking authorities either. Moreover, BAHL could receive loans and other funds from BASPA; such funds

[2]Banco Ambrosiano Spa Milan, at the end of 1981, ranked 19th among Italian banks, with total assets amounting to Lit. 7,800 billion ($ 6.5 billion) (ASBI, Bank of Italy, Direttorio Oteri, n. 31).

could be invested in companies abroad, but also in Italy. As a matter of fact, it was used to set up many offshore banks and, above all, offshore non-banking companies. Shell companies were widely used for back-to-back loans and deposits, for money laundering and for tax evasion. The group operated also through a finance company incorporated in New York, Ultrafin International Corporation. Calvi had developed a sound operational knowledge of Latin America as well as of countries said to be non-cooperative in the field of taxation, supervision and anti-money laundering (such issue has been addressed at the international level, but it is far from being solved; see, for instance, Gara and De Franceschis, 2015).

BAHL was sided by **ASL Services** in Luxembourg from 1978 to March 1983.

The banks in which BAHL had shareholdings were the following:

1. Banca del Gottardo (**BG**) (45%)
2. Banco Ambrosiano Overseas Limited (**BAOL**), set up in Nassau in 1971 as Cisalpine Overseas Bank. Calvi was its President from 1971 to June 1982. BAOL had a representative office in Montecarlo (formally not authorized to undertake transactions).
3. Banco Occidental: **BAHL** gradually bought substantial minority shareholdings in Banco Occidental of Madrid.
4. Ambrosiano Group Banco Comercial Managua (**AGBCM**), established in 1977 in Nicaragua, was an offshore bank managed by BAHL.
5. Banco Ambrosiano Andino (**BAA**), established in Lima in October 1978 under the authorization of the Central Bank of Peru, was initially owned by BAHL (88%) and by BAOL (12%).

Through the above-mentioned companies, a large number of orphan/ghost companies were established for purposes of undertaking complex financial transactions that were difficult, if not impossible, to trace. Such companies were incorporated in offshore centers with minimal or non-existing transparency requirements. A major role was played by Intermarket Trading Company (ITC) (Smoutha, 1984) which had significant links with IOR. An important role was played also by Bellatrix which, at least in specific periods, appeared to be under IOR's direct control. Bellatrix was established in Panama in August 1979: its directors were BAOL's employees and secretaries.

IOR played an important role not only in ITC and Bellatrix, but also in the jumble of BA companies. Among other things, it issued comfort letters against which counter letters of indemnity were signed by Calvi himself through various companies. More specifically, IOR had a direct shareholding in BAOL, based in Nassau. Monsignor Marcinkus, President of IOR and previously one of the Pope's bodyguards and Chief of the Vatican security services, was for a few years a member of BAOL's Board of Directors. There was evidence that he attended some meetings of the Board of Directors in Nassau.

1.3. In 1977, Banco Ambrosiano faced its first crisis, also as a result of public denunciations of alleged irregularities in its transactions. Starting from April 17, 1978, BIT carried out a thorough inspection based on Deputy General Manager Mario Sarcinelli's decisions, obviously agreed to by Governor Paolo Baffi (see Bank of Italy, 1984). Dr. Giulio Padalino and the inspection team found some irregularities and it was uncovered that liquidity had been illegally transferred abroad (in Milan "*there was a counter, dedicated to and reserved for IOR, where several persons brought cash that was to be transferred abroad*", Tescaroli, 2011). Such irregularities were reported to Judge Emilio Alessandrini, who was killed on January 29, 1979 by a commando of Prima Linea terrorists. However, the bank still appeared to be relatively sound and even foreign transactions did not seem to foreshadow a point of no return. BA faced and overcame two liquidity crises in 1978 e in 1980, which were solved mainly thanks to financing provided by Banca Nazionale del Lavoro (BNL - London and Curaçao branches) and by Ente Nazionale Idrocarburi's (ENI) finance companies (operating in Nassau and in the Cayman Islands). Calvi continued to carry out important transactions: through Centrale Finanziaria (CF), on April 21, 1981 he bought 40% of Rizzoli, the company that controlled *Corriere della Sera,* the main Italian newspaper.

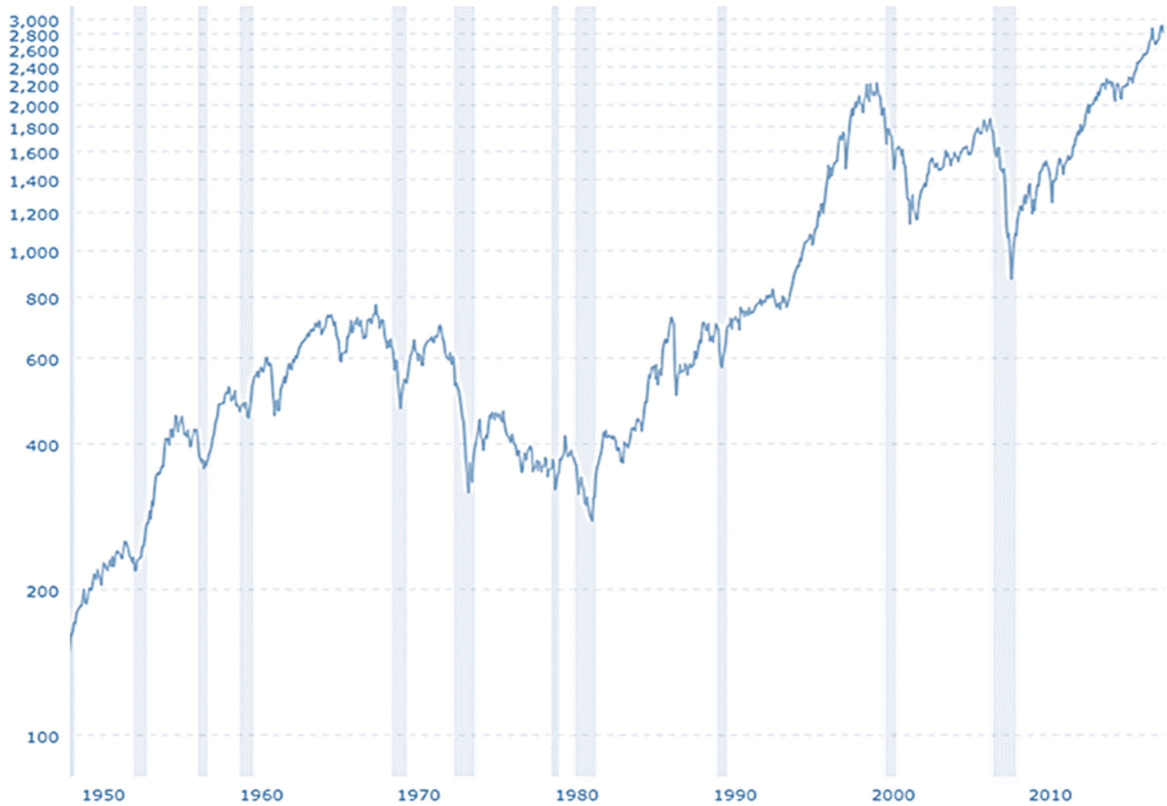
2. 2.1. Banco Ambrosiano's situation changed rapidly and drastically between 1981 and 1982. First, the incarceration of Roberto Calvi on May 20, 1981, following investigations about illegal exports of currency - triggered by the above-mentioned inspection which ended in December 1978 - caused a crisis of confidence, although Calvi was released from prison pending further proceedings. Moreover, the BAG model – which was not at all sustainable – was jeopardized by macro-economic circumstances, which do not seem to have been identified in many analyses of the crisis. On one hand, the monetary policy decisions made by Paul Volcker, the Chairman of the Federal Reserve Bank (figure 2.1) - which aimed at breaking the inflationary spiral - and, on the other, the continuing recession in the United States (July 1981 – November 1982) contributed to BAHL's collapsing from a liquidity crisis to insolvency.

Figure 2.1 – Inflation and Interest Rates in the USA:

The peak of 1981-82 triggered by FED Chairman Volcker to curb inflation

Source: FRED, Federal Reserve Bank of St. Louis (2019)

Figure 2.2 – Stock Exchange Trends in the United States: the bottom of 1981-82



Source: Macrotrends.com, S&P 500 Index - Historical Chart (2019)

Short-term interest rates in the United States rose above 20%, dollar rates on the Euromarkets were even higher. Under such circumstances, the cost of funds for BAG's offshore banks skyrocketed. BAHL itself entered into a crisis from which there would be no way out. Not only the loans to the Group's banks became irrecoverable, but also deposits made at BAHL by large international banks operating on the Euromarkets became subject to pressure: banks demanded higher and higher rates for not withdrawing their deposits. This compounded the difficulties. As shown in Table 1, the relative size of loans made to BAHL in 1981-1982 by third parties and by other Group's companies became very large and, as a whole, such amount doubled from the end of 1979 to mid-1982

Table 1 – BAHL's Main Lenders: Balance at the End of the Period (Swiss Francs/millions)

Year	1978*	1979*	1980	h1981*	1982**
Banco Ambrosiano S.p.A.					
- Direct Transfers	21,9	19,4	1,8	2,0	==
- Back-to-Back Loans	==	==	==	==	34,8
Total B. Ambrosiano (a)	***21,9***	***19,4***	***1,8***	***2,0***	***34,8***
Other Group Companies (b)	***15,7***	***41,0***	***9,5***	***3,7***	***317,9***
Third Parties (c)	***390,8***	***560,5***	***780,5***	***915,5***	***893,5***
TOTAL [(a) + (b) + (c)]	**428,4**	**620,9**	**791,8**	**921,2**	**1.246,2**

** 31 December ** 30 June*

Source: Fraud Auditing & Forensic Accounting, 2012

The two years under review were years of recession. Therefore, stock exchange and economic trends did not allow BASPA to make capital gains from its shareholdings not only in Italy, but also at the international level. (Figure 2.2). BASPA's shares experienced a very serious crisis. BASPA had been quoted on the stock exchange on May 5, 1982 (the stock price plummeted by 20% on the first day of trading and the stock was cancelled in the same year). Under such circumstances, the true value of IOR's comfort letters was impaired.

2.2. The courageous choices made by Governor Ciampi (and by Minister Andreatta) can be fully evaluated only by taking into consideration three concurrent adverse macroeconomic factors: international economic trends and the developments of the Italian balance of payments; the concern of key central bankers that some banks may end in trouble because of excessive leverage; the drastic change in the US monetary policy.

International growth continued to slow down in 1982 leading to stagnation and to the collapse of international trade (-2% for the year). It was the longest recession recorded since the post-war period. Trends were affected by the monetary policies pursued in many countries, notably the United States, in order to curb inflation. The increase in interest rates – with peaks of more than 20% - affected the Euromarkets raising fears of liquidity crises or even insolvencies.

In Italy, international recession and, above all, tensions in the financial markets heavily affected the balance of payments. Despite a slight decrease in the current account deficit, the total balance plummeted from a +1,533 billion in 1981 to -2,521 billion in 1982. The resulting huge capital outflows required that the Euromarkets be maintained open to "compensatory finance". The coexistence of inflation and recession made the situation even worse.

As regards international supervision, in 1981 the United States and Canada, concerned about the excessive leverage of their banks, decided to implement regulation policies based on leverage capital requirements (BCBS 1982a). Papers issued by the BCBS (1982b) showed the concerns of central bankers, as specifically pointed out in Richardson's (Governor of the Bank of England) and Volcker's reports to the G10. Richardson (1982) and Lamfalussy (BIS Assistant General Manager, 1982b and c) explicitly mentioned such concerns to Governor Ciampi, underlining the need for extreme caution.

Governor Ciampi (1983) had to make his decisions within such a delicate, complex context. He could not ignore the above-mentioned observations. Notwithstanding, he decided to maintain his position on one key respect: keeping BA's fate separate from BAHL's (Box 1).

Box 1	**Historical Outline of Banco Ambrosiano's crisis: May-August 1982**[3]
May 28	The Bank of Italy sends an allegation letter to BA's Board of Directors: "*despite numerous requests*", disregarded by the bank's management, the "overall risk", at the end of 1981, is estimated at more than $1,400 m.
June 11	Roberto Calvi (RC) disappears during the night.

[3]Drawn mainly from ASBI, Bank of Italy, Oteri Directorate, n. 30. For a detailed review, see also Carbonetti (2019).

June 17	BA's Board of Directors meets, votes down President RC, agrees to cooperate with the Bank of Italy and asks for administrative dissolution. RC's secretary Graziella Corrocher is found dead on the pavement in front of her office in the Milan headquarters of BA in via Clerici. As a matter of urgency, the Bank of Italy sends supervisory inspector Vincenzo Desario as interim Commissioner.
June 18	RC is found hanged beneath London's Blackfriars Bridge. He has a few stones in his pockets together with a fake passport registered in the name of Gian Roberto Calvini.
June 19	The Bank of Italy entrusts the management of BA to three Commissioners (Antonino Occhiuto, Giovanni Battista Arduino, Alberto Bertoni) under an order issued by the Treasury Minister on proposal by Governor Carlo Azeglio Ciampi.
July 2	BA's Commissioners meet President Marcinkus in IOR offices in Rome to ascertain IOR's responsibilities in respect of the international activities of Banco Ambrosiano Group. IOR maintains that the "letters of comfort" are just statements of favor and shows a "counter letter" addressed to IOR and signed by RC.
July 5	Serious irregularities come to light in BA's operations; all loans in favor of Group's foreign subsidiaries are suspended.
July 9	Governor Ciampi calls a meeting of qualified Italian credit institutions at the presence of the Treasury Minister in order to explore the possibility of Banco Ambrosiano continuing its operations with the required changes in its Statute and share ownership.
July 29	BAHL goes into temporary receivership under a provision confirmed by magistrates in Luxembourg.
August 3	The banks in the rescue consortium are willing to pay Lit. 350 bn for BA's goodwill (Draghi, 2007). As per Bank of Italy's instructions,

	they buy BA's assets and liabilities with the exception of shareholdings owned by Banco Ambrosiano Holding in Luxembourg, thus breaking any ties with BA's foreign affiliates.
August 4	In their reports dated August 4, the Commissioners asseverate BA's financial troubles, considering losses on the exposure of its foreign affiliates (amounting to Lit. 900 bn), with a negative balance sheet in the amount of 220 bn (Andreatta, 1982). The idea of turning to the market for recapitalizing BA through the provision of third-party funds in the amount of 1,000 bn had been taken into consideration. This option turned out to be unfeasible and even prejudicial.
August 6	The Bank of Italy autonomously decides that the circumstances require the compulsory liquidation of BASPA, a procedure under which old shareholders are kept separate from both the company and its new shareholders. The decision is validated by the Treasury Minister as well as by the Inter-ministerial Committee for Credit and Savings.
August 10	Compulsory liquidation procedures start on the following Monday when the Board of Nuovo Banco Ambrosiano (NBA) meets. The participating banks are as follows: Banca popolare di Milano (20%); Bnl (16,70%); Imi (16,65%); Istituto Bancario San Paolo di Torino (16,65%); Banca agricola commerciale di Reggio Emilia (Credem: 10%); Banca San Paolo di Brescia (10%); Credito Romagnolo 10%. Giovanni Bazoli becomes the President of the new bank.
August 25	Ruling of the Court in Milan that establishes BA's insolvency at the time when liquidation procedures were started.

The historical outline shows how the rules in force at the time and the decisions shared by the Italian Monetary Authorities contributed to solve an extremely serious bank crisis rapidly and efficiently. The results thus achieved should be measured also against the cost estimate in terms of public money used, which amounted to less than Lit. 200 bn (Draghi, 2007)[4].

2.3. On the basis of the evidence gathered by the Commissioners, the action undertaken by Governor Ciampi at the international level in the second half of 1982 aimed at explaining, confirming and implementing the above-mentioned guidelines.

The decision to start the compulsory liquidation of BA and to establish NBA – which took upon itself the responsibility for direct foreign assets and liabilities – was countered by the decision to place into receivership BAHL and group's foreign subsidiaries controlled by the Holding. In the same manner, the transfer of assets and liabilities to NBA did not include BAHL's shares or any relationship with the Holding company and with other parties linked to it in whatever manner, including the shell companies. This actually meant giving up BA's credits - which were in any event for the most part unrecoverable - according to the Commissioners.[5]

Strong pressure had been exerted even by key central banks of the G-10 asking that the Bank of Italy and ultimately the Treasury take over BAHL's losses and repay the existing loans. A confrontation occurred involving the Director in charge of banking supervision in Luxembourg, P. Jaans (see the exchange of letters with Ciampi: Jaans, 1982 and Ciampi, 1982) and some German banks (see Gekeler's and Lieven's letters, 1982, to Dini and Ciampi's reply, 1982, to Pöhl).

[4] In retrospect, one can understand Governor Visco's (2018) cogent criticism in respect of the BRRD (2014) resolution mechanism.

[5] According to the reconstruction provided by Minister Andreatta to the Chamber of Deputies at the meeting held on October 8, 1982, BAHL's situation in July 1982 – taking into account the fact that IOR was unavailable to pay back the debts of the companies for which it had issued letters of comfort – was as follows: "*BAG's affiliates owed $743 m to Ambrosiano spa; $788 m to the Euromarkets banks; $102 m to other subsidiaries (Banca del Gottardo, Credito varesino, Banca Cattolica del Veneto), totaling $ 1,633 m. In turn, IOR and its sponsored companies owed the subsidiaries $1,159 m. There was a difference – which could not be explained – of about $470 m spent outside IOR and its sponsored companies.*" Many representatives of the Christian Democratic Party and the Vatican did not appreciate such unambiguous stance. After the fall of the government headed by Spadolini, Fanfani's fifth government took over on December 1, 1982. Andreatta was not a member of that government.

Ciampi's letters had been preceded/accompanied by confidential meetings with the Governors, which I had the opportunity to attend.

Questionable references were made to the Basel Concordat of 1975. The agreement, whose main topic was international bank supervision, envisaged the possibility – not the commitment – for the central banks, as *lenders of last resort*, to provide support in case of temporary liquidity shortage. If anything, the Concordat's guidelines had prompted the decision to repay BA's foreign liabilities. As Ciampi pointed out in his letter to Richardson, BA's foreign debt was about double the debt of the Luxembourg Holding. BAHL was a non-banking company and, therefore, not subject to supervision by the Luxembourg banking authorities. Its main activity was to raise funds on the Euromarkets to finance its banking and non-banking subsidiaries. Beyond the letters of comfort issued by IOR, there was evidence that BAHL's financial troubles were the result of both mismanagement and economic crimes. As pointed out above, international financial tensions and US monetary policy decisions contributed to worsen BAHL's financial situation.

In short, the stance taken by the Bank of Italy also vis-a-vis the large international banks were explained as follows:

On a more general level, the stance taken by the Italian authorities was dictated by the conviction that the basic rule underlying the functioning of a market economy should not be undermined. Such rule, which international finance abides by, is that creditors should take the risk involved in allocation choices. This means that they should make a preliminary assessment of borrowers' creditworthiness.

In such a context, from the very beginning the Bank of Italy suggested that the banks to which money was owed by the foreign subsidiaries should cooperate actively in order to achieve the best possible realization of assets. Such goal was shared by foreign creditors and BA's liquidators who were trying to recover the large loans extended by BA to its subsidiaries.

Source: Banca d'Italia (1984)/author's translation

3. In addition to such firm non-negotiable transparent stance – which was fully supported by the Treasury Minister – there was genuine willingness – as mentioned above – to actively cooperate in order to achieve the best possible realization of assets as well as to try to find some form of agreement with IOR. Similar ideas had already been voiced by Minister Andreatta in his hearing at the Chamber on October 8[6]. A number of formal and informal meetings with the international banks, in which the London representatives of the Bank of Italy played a very important role, helped to establish a very different relation as compared with the initial threat of hindering the raising of funds on the Euromarkets to finance the Italian balance of payments[7].

The foreign subsidiaries' creditor banks – after initiating litigation with both the liquidators and NBA as transferee – acknowledged the Bank of Italy's auspice that the parties involved try to find a way to cooperate for the common good. Towards the end of 1982, liquidators' lawyers and the creditors of both the Holding and its subsidiaries met in order to negotiate a solution. At the same time, since arrangements with subsidiaries' creditors went pari passu with arrangements with IOR, towards which the subsidiaries themselves were either directly or indirectly exposed, the first steps were taken on the way leading to an agreement with said institution.

Source: Banca d'Italia (1984)/author's translation

A similar change in attitude involved the relations with the central banks in

[6]Thereafter, under pressure from the Italian Government and the Bank of Italy, on May 25, 1984, in Geneva, IOR signed an agreement with the creditor banks undertaking to pay approximately Lit. 250 bn as voluntary contribution (see the text of the agreement, Scottoni 1989). In 2015 Cardinal George Pell, Prefect of the Secretariat for the Economy of the Holy Sea, in an article about Vatican's finances (Pell, 2015) reported that total repayments amounted to more than $400 m.
[7]See *Promemoria* by V. Desario (1982) warning the Directorate of the Bank of Italy about problems in respect of medium- and long-term loans with some banks that threatened to terminate their contracts. The banks were Banque Scandinave & Suisse, Midland Bank, Banca del Gottardo, Kredietbank, Crédit Suisse, Landesbank Stuttgart, Schroeder Bank & Trust for a total amount of $400-500 m (Desario, 1982).

Basel. After a stage of critical remarks for denying support to BAHL, the firm stance taken by Ciampi, the authority and the import of the arguments presented – notably in respect of bank's required credit assessment of all borrowers, and the need to safeguard public finances - prompted a change in attitude.

The Bank of Italy gradually took over an important role not only for the 1983 revision of the Concordat (stating the principle of the international consolidation of all banks' activities), but also for the liquidity support provided to the Euromarkets, as evidenced by the speeches delivered by Ciampi on July 12 1982 (1982a) and by Lamfalussy on December 2 1982 (summarized in Lamfalussy 1982b).

In more general terms, based on the decisions taken in 1981 by Canada and the United States aimed at introducing mandatory minimum leverage ratio requirements (see Masera, 2019) and in view of the discussions triggered also by the Bank of Italy about the capital adequacy of banks operating internationally, in July 1982 the Cooke Committee (*Committee on Banking Regulations and Supervisory Practices*) addressed the issue of banks' capital. Although the assumption underlying the Report ("*the adequacy of banks' capital is essentially a matter of judgement*") appeared to be subjective, the Report stressed the fact that capital adequacy criteria had to be standardized internationally and underlined the need for weighting assets against asset-specific risk. In other words, it was the beginning of the revolution that would result in the regulation of international banking as detailed in the Basel I Capital Accord (BCBS 1988).

In closing, we can assert that the action undertaken by Governor Ciampi and by the Bank of Italy to solve the Ambrosiano case contributed to the evolution of banking supervision as regards both the revision of the Concordat and, thereafter, the development of a system of rules based on risk-weighted capital ratios.

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SHARPENING THE TEETH OF EU SOCIAL FUNDAMENTAL RIGHTS? THE CASE OF STATE PENSION AGE

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ABSTRACT: *This article analyzes current EU pension law and policy in light of the case "State Pension Age" (SPA) and considers the implications of this analysis for EU social rights. In examining the applicability of EU pension law, it provides two critical entry point of analysis into the SPA cases: i) Article 21 Charter Fundamental Rights of the European Union, and ii) The Internal Market scenario.*

1 Sarmiento wrote in 2018 a blog named: '*Sharpening the Teeth of EU Social Fundamental Rights: A Comment on Bauer*'.[1] This interesting analysis can be put into practice on the basis of a recent judgement by the Court in the United Kingdom (still bound by EU Law regarding pensions).[2]

This article examines an important and very topical EU Law element of the judgments (first instance[3] and appeal[4]) regarding two claimants (*Delve and Glynn*),

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[1]SARMIENTO, 'Sharpening the Teeth of EU Social Fundamental Rights: A Comment on Bauer', available at: https://despiteourdifferencesblog.wordpress.com/2018/11/08/sharpening-the-teeth-of-eu-social-fundamental-rights-a-comment-on-bauer/.

[2]SANDEEP, H. VAN MEERTEN, 'UK Collective Defined Contribution: Is it 'Dutch-Style' Collective Defined Contribution?', in: S. Andrew (et.al, eds.), *Pensions Law, Policy and Practice*. Oxford: Hart Publishing, 2020.

[3]https://www.judiciary.uk/wp-content/uploads/2019/10/Delve-and-Glynn-v-SSWP-CO-3174-2018-Final.pdf.

[4]DELVE & ANOR, R (On the Application Of) v The Secretary of State for Work And Pensions [2020] EWCA Civ 1199 (15 September 2020), available at https://www.bailii.org/ew/cases/EWCA/Civ/2020/1199.html.

backed by BackTo60, versus the UK Department of Work and Pensions (hereafter: *Delve and Glynn*). The claimants argued that the UK State Pension Age (SPA) was discriminatory and contrary, *inter alia*, to EU Law.

In this article the focus is *not* if SPA is discriminatory, but rather whether the SPA falls in the ambit of EU law. The Courts in the UK stated that SPA falls outside the scope of EU Law. Didn't the UK Courts in *Delve and Glynn* conclude too easily that SPA falls outside the scope of EU Law? In other words, as Sarmiento would have put it, how can we further sharpen the teeth of EU social protection?

2. The facts of the case are derived from the two judgements.[5] In Delve and Glynn it can be read that in successive statutes between 1995 and 2014 Parliament has legislated to equalise SPA between men and women. Legislation has contained a timetable for the adjustment of SPA, structured for successive cohorts of women defined by age, initially to age 65 and subsequently to age 66, rising to age 68. The Claimants Delve and Glynn are women born in the 1950s affected by these changes. 1950s-born women argue that the pace of change has been too quick and penalises them as a cohort. The Claimants "seek judicial review" of the mechanisms chosen to "Implement the Government's policy" of raising and equalizing the SPA. They also seek judicial review of "the failure to inform women of the changes".

3. The UK Court in first instance rightly admits that non-discrimination is a general EU principle. The Court also states that the principle applies only where the relevant national rule falls within the scope of EU law.

Firstly, the Court held that the receipt of state pension is not "pay" as defined by the TFEU, because it is not a wage or salary, and is not paid in respect of employment. The "equal pay" obligation contained in Article 157(1) has thus no

[5] Ibidem.

application. [6]

Secondly, the Court concludes that the claimants' claim to have been directly or indirectly discriminated against on grounds of sex contrary to EU law cannot progress in the face of Article 7 [of Directive 79/7/EEC (the Social Security Directive)]. The derogation contained in that provision extends to all aspects of the determination of pension age, whether equal or unequal.

Thirdly, the Court states that a regime for the payment of state pensions to those above a certain age is a paradigm example of a social protection scheme. Directive 2000/78 (the Equality Directive) does not apply, according to the Court.

The Court thus concludes:

*"The Claimants' EU law arguments must fail, because this legislation [*SPA, HvM*] is not within the scope of EU law".*

In appeal, the Court upheld the decision in first instance and stated[7]:

'The first claim was that the legislation unlawfully discriminated against the Appellants on grounds of age, contrary to EU law. The Appellants relied on both a general EU principle of non-discrimination and on the Equality Directive, Council Directive 2000/78/EC of 27 November 2000. The Court dismissed this claim on the grounds that the general principle did not apply because the payment of state pension did not come within the ambit of EU law concerning age discrimination and further that state pensions were excluded from the scope of the Equality Directive by Article 3(3) of that Directive: [37] and [41]. The Appellants do not appeal against that decision'.

4. To our mind, the UK Courts jumped too quick to conclusions, reaching decisions which open up venues for discussion on the applicability of EU law.

Prima facie the UK Court in first instance seems right. Regulating state

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[6]Article 157(1) TFEU reads: *'Each Member State shall ensure that the principle of equal pay for male and female workers for equal work or work of equal value is applied.'*

[7]Delve & Anor, R (On the Application Of) v The Secretary of State for Work And Pensions [2020] EWCA Civ 1199 (15 September 2020) at [17], available at https://www.bailii.org/ew/cases/EWCA/Civ/2020/1199.html.

pensions is not a competence of the EU. Also can be agreed with the conclusion of the UK Court in first instance that state pension is not "pay" as defined by the TFEU. The same goes for the reasoning of the UK Court in first instance regarding sex discrimination.

Nonetheless, the 'scope' argument by the UK Court in first instance – which was then upheld in appeal – can be contested.

There are at least two arguments that the 'scope argument' is too narrowly interpreted by the UK Courts: *i)* Article 21 Charter Fundamental Rights of the European Union, and *ii)* The Internal Market scenario.

First, concerning i) the dispute between *Delve and Glynn* versus the Secretary of State for Work and Pensions is a vertical relation: individuals against the State. ECJ Case law concerning direct horizontal relations (individuals vs individuals and/or pension funds) however seems to apply *mutatis mutandis* and *a fortiori*.

Moreover, the ECJ stated in *Milkova*:[8]

"66 In that regard it must be recalled that, according to settled case-law, where discrimination contrary to EU law has been established, as long as measures reinstating equal treatment have not been adopted, observance of the principle of equality can be ensured only by granting to persons within the disadvantaged category the same advantages as those enjoyed by persons within the favoured category (judgments of 26 January 1999, Terhoeve, C-18/95, EU:C:1999:22, paragraph 57; of 22 June 2011, Landtová, C-399/09, EU:C:2011:415, paragraph 51; and of 28 January 2015, ÖBB Personenverkehr, C-417/13, EU:C:2015:38, paragraph 46). Disadvantaged persons must therefore be placed in the same position as persons enjoying the advantage concerned (judgment of 11 April 2013, Soukupová, C-401/11, EU:C:2013:223, paragraph 35)."

The ECJ goes on by stating that a national court must set aside any discriminatory provision of national law, without having to request or await its

[8] C-406/15, Milkova.

prior removal by the legislature.

At first glance, this seems a 'Catch 22' situation: whether the SPA is discriminatory cannot be judged on the basis of EU law, because the SPA falls outside the scope of EU law. This issue will be elaborated upon further below.

Primarily, it is essential to make some remarks concerning the scope of Directive 2000/78.[9] This Directive establishes a general framework for equal treatment in employment and occupation. The UK Equality Act 2010 is the current legislation which covers the implementation of Directive 2000/78 (Equality Directive).

The Court states that the Equality Directive does not apply. The Court points at Recital 13 of the Equality Directive, which is relevant to the ambit of the Directive. It excludes social security and social protection schemes:

"(13) This Directive does not apply to social security and social protection schemes whose benefits are not treated as income within the meaning given to that term for the purpose of applying Article 141 of the EC Treaty, nor to any kind of payment by the State aimed at providing access to employment or maintaining employment."

In the ECJ case of *Dansk Industri*[10] in 2016 the European Court of Justice (ECJ) held:

"Lastly, it should be added that, in order for it to be possible for the general principle prohibiting discrimination on grounds of age to be applicable to a situation such as that before the referring court, that situation must also fall within the scope of the prohibition of discrimination laid down by Directive 2000/78."

But is the description of the scope in the Directive still the decisive criterion to decide whether EU Law applies, even when an applicable Directive excludes certain fields from its scope? In Bauer[11] the ECJ stated:

"53 Since the national legislation at issue in the main proceedings is an

[9]Council Directive 2000/78/EC of 27 November 2000 establishing a general framework for equal treatment in employment and occupation, OJ L 303, 2.12.2000, p. 16–22.
[10]C-441/14, Dansk Industri.
[11]C-570/16, Bauer.

implementation of Directive 2003/88, it follows that Article 31(2) of the Charter is intended to apply to the cases in the main proceedings (see, by analogy, judgment of 15 January 2014, Association de médiation sociale, C-176/12, EU:C:2014:2, paragraph 43).”

In other words, implementing an EU Directive triggers automatically the Charter of Fundamental Rights of the European Union[12] (the Charter). One might say then that, because of recital 13 of the Directive, the SPA is not implementation of Equality Directive. Hereby we must adhere a broader understanding of what it means to ‘implement a Directive’. The scope of Article 21 of the EU Charter comes into play. In *Delve and Glynn* Article 21 of the Charter was not invoked. It must be observed that a national court is obliged to apply the Charter *ex officio*.

Article 21 Charter is the codification of the general anti-discrimination principle. Article 21 (1) Charter reads:

“Any discrimination based on any ground such as sex, race, colour, ethnic or social origin, genetic features, language, religion or belief, political or any other opinion, membership of a national minority, property, birth, disability, age or sexual orientation shall be prohibited.”

Paragraph 2 provides:

“Within the scope of application of the Treaty establishing the European Community and of the Treaty on European Union, and without prejudice to the special provisions of those Treaties, any discrimination on grounds of nationality shall be prohibited.”

Again here, we face a ‘Catch 22’ situation. How can be judged if the SPA is EU discriminatory if it falls outside the scope EU Law and/or Article 21 which prevents any form discrimination? Or must we reason the other way around: whether a national measure is EU discriminatory is *per se* a matter of EU law, since the founding principle of EU law is to forbid any form of discrimination.[13] As the

[12]Charter of Fundamental Rights of the European Union, OJ C 326, 26.10.2012, p. 391–407.
[13]P. BORSJÉ, H. VAN MEERTEN, ‘A EU Pensions Union’, in: F. Pennings et al. (Eds), Research Handbook on European Social Security Law. Cheltenham: Edward Elgar publishing Limited, 2015, p. 385-412.

Court rightly stated, non-discrimination is a general principle of EU law and also of UK law and the law in many other EU Member States. Thus (potential) anti-discrimination falls via Article 6 (3) TEU in the ambit of EU law.[14]

'Fundamental rights, as guaranteed by the European Convention for the Protection of Human Rights and Fundamental Freedoms and as they result from the constitutional traditions common to the Member States, shall constitute general principles of the Union's law'.

As AG Trstenjak noted,[15] it can be argued that also in the case of *Delve and Glynn* it seems consistent to use the relevant provisions of the Charter as the starting point for interpretation of all other rules of EU law, including general legal principles and secondary legislation, "(*i)t is particularly worth avoiding any interpretation of rules that might conflict with sentiments expressed in the Charter*".

In the ECJ case of *IR*[16], the ECJ stated:

"69 Before the entry into force of the Treaty of Lisbon, which conferred on the Charter the same legal status as the treaties, that principle derived from the common constitutional traditions of the Member States. The prohibition of all discrimination on grounds of religion or belief, now enshrined in Article 21 of the Charter, is therefore a mandatory general principle of EU law and is sufficient in itself to confer on individuals a right that they may actually rely on in disputes between them in a field covered by EU law."

To conclude the first point, in the judgement of *IR* it seems that the ECJ is stating that the dispute in that case is covered by EU law because the Directive is applicable. This is the 'classic' reading. However, one might also reason that a 'field covered by EU Law' seems determined by the Charter, and thus by a fundamental principle that, via Article 6 TEU, automatically becomes EU law.

It can be inferred from several judgments that the conditions of Article

[14]Ibidem.
[15]C-282/10, Maribel Dominguez.
[16]C-68/17), IR.

51(1) of the Charter are satisfied if the national regulation constitutes a (i) measure implementing EU law or that it is (ii) connected in any other way with EU law. In particular the second criterion following from Article 51(1) of the Charter mentioned above ('connected in any other way') may lead to a broad scope of application for the Charter, precisely because it seems unclear what 'connected in any other way' means.[17]

The applicability of EU law to actions of Member States would result in a situation in which there are, in principle, no cases in which EU law applies without those fundamental rights of the Charter being applied.[18]

Second, as for ii) the EU Internal Market scenario.

As said, the dispute between *Delve and Glynn* versus the DWP is a vertical relation. As was already stated,[19] from the case law of the ECJ that refers to Article 51(1) Charter in vertical situations, a wide range of situations can qualify as the implementation of EU Law. Furthermore, national acts that might impede free movement fall within the meaning of Article 51(1) Charter.

In ING/Pensii[20] the ECJ held:

"50 In the present case, it is apparent from the documents submitted to the Court that the services in question could be cross-border in nature as the persons under an obligation to affiliate themselves to one of the approved funds and their employers might be established in other Member States and the pension funds established in Romania might belong to companies situated in other Member States."

This shows great similarities of the classic Dassonville[21] case, in which the ECJ took the view that all trading rules enacted by Member States which are capable of hindering, directly or indirectly, actually or potentially, intra-Community trade are to be considered as measures having an effect equivalent to

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[17]H. VAN MEERTEN, *EU Pension Law*. Amsterdam: Amsterdam University Press, 2019.
[18]Ibidem.
[19]M. DE MOL, 'Het leerstuk van de horizontale directe werking van Unie-grondrechten op de voet gevolgd', *Ars Aequi*, 2019, 5.
[20]C-172/14, ING/Pensii.
[21]Case 8/74, Dassonville.

quantitative restrictions.

To conclude the second point, one could argue that – if the SPA (even potentially) hinders the intra-Community trade, the SPA is a matter of EU Law. It seems not too hard to argue that it actually does.

5. This article analyzed current EU pension law and policy in light of the SPA case-law and considers the implications of this analysis for EU social fundamental rights. The article begins by addressing the major points of the. The article then examines the central challenge to bring the SPA under EU Law. A challenge, but not that far from being impossible.

This article puts forward the following arguments.

The SPA falls within the scope of EU Law. Individuals can directly invoke Article 21 Charter, and if they did not, a national Court *ex officio* must apply Article 21 of the Charter. National legislation that discriminates must directly be tested against the Charter. However, there might be an objective justification for age discrimination. The ECJ sometimes relatively is 'quick' – seen the budgetary consequences for the State – to assume that there is.[22] This is however a different topic.

In the conclusion AG Bobek[23] makes a very interesting case for individuals to grant them the most effective end enforceable rights. Not via horizontal direct effect but via the full effect of EU Law, an approach that the ECJ seems to follow. Bobek writes:

"146. The absence of horizontal direct effect of Article 21(1) (and, for that matter, other provisions) of the Charter does not mean they have no horizontal effects. Quite on the contrary. But those are of a different nature. With regard to national law, the Charter serves: (i) as an interpretative tool for conform interpretation of national law; (ii) as a yardstick for the compatibility of EU and

[22]See (in Dutch): A.J. VAN DE GRIEND, H. VAN MEERTEN, 'Hervorming pensioenstelsel: degressieve opbouw in uitkeringsovereenkomsten en vlakke premies in premieovereenkomsten', *Sociaal Economische Wetenschappen*, 2017/ 5, p. 189-198.
[23]C-193/17, Cresco.

national rules, with the possible consequence that where national rules (applied in the context in which the Member State acts within the scope of EU law) are incompatible with the Charter, they must be set aside by the national judge, even in disputes between private individuals."

A LOOK AT EU-UK TRADE RELATIONS IN LIGHT OF BREXIT, PANDEMIC AND THE TRADE AND COOPERATION AGREEMENT

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ABSTRACT: *A few months after the UK definitive departure from the EU, this work offers a comprehensive analysis of the trade relations between the two Parties and of their future perspectives in light of the scenario disclosed by the Covid-19 pandemic and by the Trade and Cooperation Agreement (TCA). The analysis highlights the deep commercial links between the two areas, characterized by the juxtaposition between the EU's large surplus in goods trade and the UK's dominance in the exchange of services. The outcome of the 2016 referendum had a modest impact on trade between the two blocs, although on both sides of the Channel a process of adaptation to the new setting is ongoing since several years also through the research for new trading partners. The TCA represents a good result compared to the dreaded alternative of a no deal, but a reduction in business at the EU-UK border seems still inevitable. On the one hand, goods producers and traders now have to comply with product-specific rules of origin to be exempted from duties: additional costs and efforts will be therefore needed to deal with customs red tape and to re-arrange production systems and supply chains. On the other hand, the vagueness of the TCA provisions on trade in services leaves crucial issues unsettled, as in the case of equivalence determinations. The overall picture looks more favorable to the EU than the UK, but the medium-to-long term effects on both Parties will mostly depend on their willingness and ability to restore a climate of mutual confidence and cooperation.*

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SUMMARY: 1. Introduction. – 2. EU-UK trade: a first snapshot. – 3. Trade in goods. – 3.1. Main UK partners within EU countries. – 3.2. Main goods traded between EU and UK. – 3.3 What changes with the TCA. – 4. Trade in services. – 4.1. Main UK partners within EU countries. – 4.2. Main services traded between UK and EU. – 4.3. Trade in services under the TCA. – 5. Conclusions.

1. After a long negotiation, at the end of December 2020 the European Union and the United Kingdom finally reached an agreement that will govern their bilateral relations starting from 2021.

Over 1200 pages long, the Trade and Cooperation Agreement (TCA) addresses a vast number of issues ranging from trade in goods and services, to digital commerce, to guarantees for a leveled playing field, to cooperation in law enforcement, health, science and dispute management.

Despite its limitations (on many topics there are only general provisions, which will have to be completed following further negotiations between the two Parties), the TCA represents an almost unexpected result, given the difficulties encountered up to the last weeks of negotiations, which led to fears of a no deal.

The most important result of the Agreement is that of having avoided the application of quotas and tariffs in the exchange of goods between the two sides of the Channel, which could have been entailed by the UK's exit from the single European market. Taking into account the deep economic and commercial integration between the two Parties, the transition to the basic structure envisaged by the WTO standards would have hit hardly the respective economies already battered by the Covid-19 pandemic. To access the exemption from duties and quotas, the TCA requires goods traded at the EU-UK border to comply with a detailed set of rules of origin, which are aimed at granting the preferential treatment only to goods that are (mainly) originating from the country of the exporter, be it either Britain or a EU country. The Agreement allows for bilateral cumulation on preferential rules of origin; yet it is inevitable that the new UK status as third-country with respect to the EU will engender trade frictions that so far were unknown between the two blocs. In fact, trade operators will have to comply with a previously inexistent customs red tape and producers will need to modify their supply chains if they want to benefit from preferential rules of origin. Furthermore, the problem of the Irish border is still far from being settled: UK domestic policy issues overlap with economic and trade ones, resulting in a continuing source of with the European Union.

With regard to the exchange of services, the provisions of the TCA are rather sparse and, from the United Kingdom's standpoint, far from the objectives it had tried to achieve during the long negotiations with the European Union.

In the field of financial services, the Agreement is practically negligible, especially if one considers that they are the most important component of the UK trade in services with the EU, with an annual surplus on average over 20 billion euros. Fundamental issues – such as the equivalence determination between the regulations in force in the EU and those in force in the UK – remain unsolved as relations between the two Parties continue to be undermined by mutual mistrust.

The EU has made it clear that it is in no hurry to settle the issue, considering instead it is appropriate to carefully evaluate the extent to which the United Kingdom will make use of the newly found regulatory autonomy to move away from the European discipline.

For its part, Britain is unlikely to accept a role of rule-taker, given that the recovery of regulatory sovereignty was one of the workhorses of the pro-Brexit campaign. Not coincidentally, in fact, it has already started a profound revision of its financial regulations, in order to strengthen the attractiveness of the City as an international financial centre and minimize the loss of capital and human resources resulting from the definitive departure from the EU.

The present work explores the evolution of trade relations between the EU and the UK over the past two decades, with the aim of gaining greater awareness of the degree of interdependence between the two economic areas, assessing the impact of the 2016 Brexit referendum and commenting on possible future developments in the light of the TCA.

The work is organized as follows. Section 2 offers an overview of the trade in goods and services between the EU and the UK, which highlights how the two Parties are extremely important to each other as business partners. Section 3 provides a focus on bilateral trade in goods, analyzing the main UK partners within the EU, the most relevant product categories and the innovations introduced by the TCA. Section 4 focuses on the exchange of services between the European Union and Britain; also, in this case the paper provides an in-depth analysis on the main UK partners within the EU bloc, on the most important types of services in the trade between the two Parties and on the most relevant attention profiles for the future developments of the trade in services in light of the TCA and the open issues it has left on the table. Section 5 concludes.

2. The European Union and the United Kingdom share a strong trade interdependence. Clearly the intensity of these trade links must be assessed taking into account the different order of magnitude of the two economic areas, given that the EU is an aggregate that includes 27 different nations.

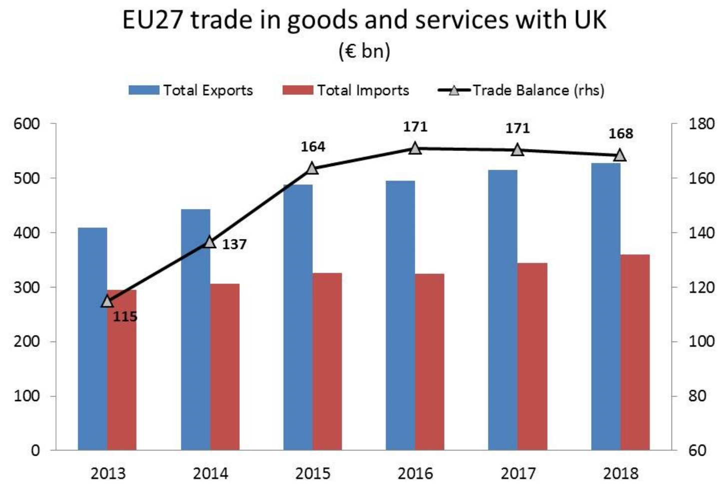
For the EU, the UK is one of the main trading partners on a global scale along with the US and China, while for the UK the EU ranks first as a trading partner.

In aggregate terms, the net balance of trade in goods and services between the two sides of the Channel is in favor of the European Union and over the last years (apart from 2020) hovered around to 100 billion euros per year.

The precise quantification of these balances depends, as it is often the case, on the subject reporting the bilateral trade data. In fact, due to trade asymmetries, especially with regard to services, the overall EU surplus (goods and services) with Britain varies depending on the use of data communicated by the 27 countries of the European Union or, instead, those reported by the United Kingdom.

Using only data collected by the EU (Fig. 1), the overall trade surplus against the UK averaged € 154 billion per year between 2013 and 2018.

Figure 1



Source: Eurostat

With regard to international trade in services, official data of the 27 EU countries only cover the period from 2013 to 2018 with annual frequency. On the other hand, those of the UK Office for National Statistics (ONS) are available quarterly from 2000 to the third quarter of 2020.

Using ONS data on trade in services and EU data on trade in goods, it is therefore possible to obtain the annual time series of the main trade variables since the beginning of the century (Fig. 2).

Figure 2

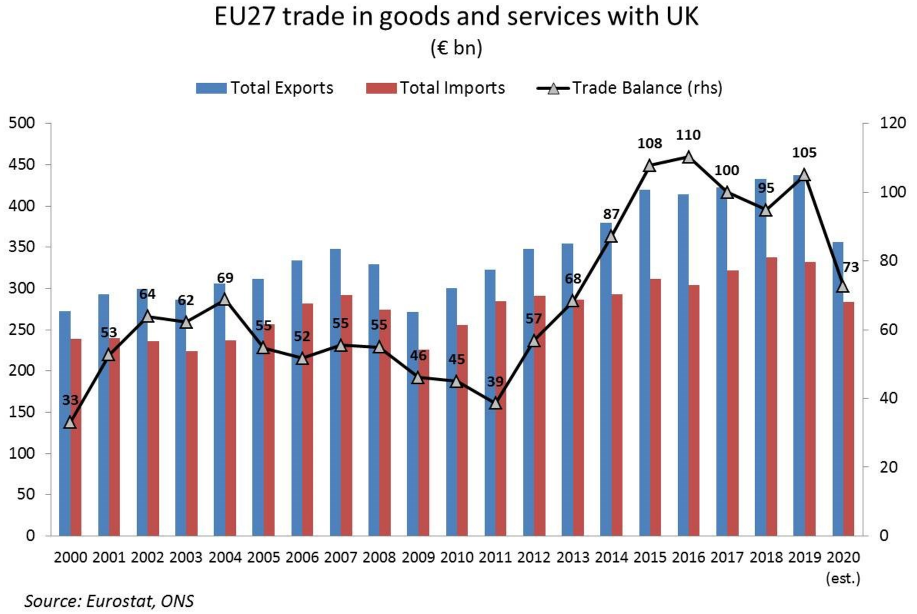


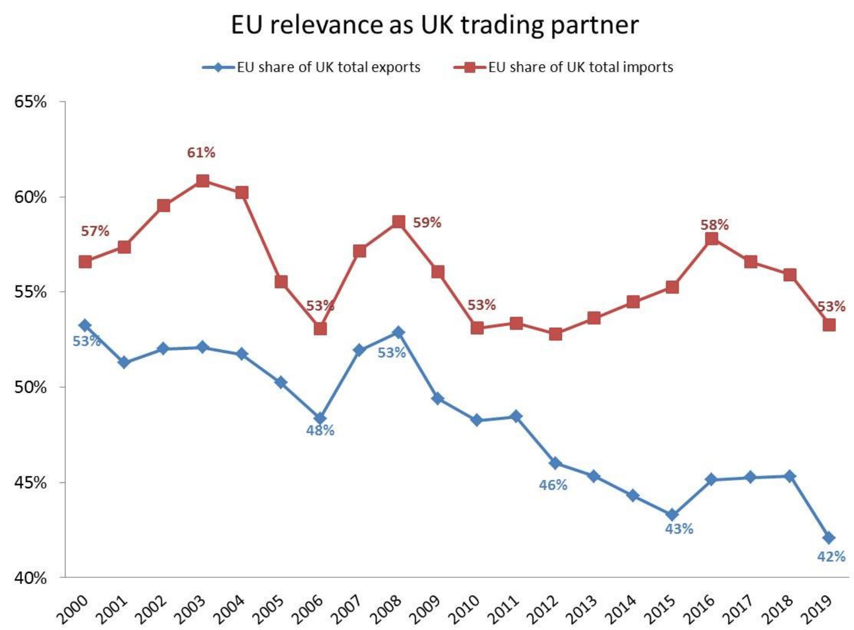
Fig. 2 shows a steady growth of the EU trade surplus towards the United Kingdom from 2012 to 2016, followed by a slowdown in the three-year period 2017-2019, and then by a collapse in 2020 (with an estimated value of 73 billion euros) mainly due to the heavy consequences of the Covid-19 pandemic on global trade.

Overall, therefore, these data support the thesis that following the 2016 referendum trade relations between the European Union and the United Kingdom have cooled down, causing a halt in the growth of the surplus of EU countries without, however, substantially compromising the trade volumes reached up to that moment. Something similar had happened between 2005 and 2011 for various reasons, including the pound devaluation against the euro between 2007 and 2008 and the recessionary effects of the global financial crisis of 2008-2009.

With specific regard to the period 2013-2018, the comparison between Fig. 1 and Fig. 2 shows that using ONS data on trade in services between the two sides of the Channel, the EU's annual trade surplus against the UK amounts on average to € 95 billion, quite below that resulting from EU data. This discrepancy indicates a considerable difference in statistics on trade in services between the two blocs.

Leaving aside the issue of bilateral discrepancies, it is interesting to relate the EU-UK bilateral trade data to those that each Party has with a wider reference universe. Exports of goods and services to the UK account for more than 17% of total EU exports to non-EU countries, while minor but still significant (over 13%) is the share of imports from across the Channel on the total EU imports from non-EU countries. In turn, the European market is the outlet market for more than 40% of British exports to the rest of the world and the market of origin for over 50% of UK imports (Fig. 3).

Figure 3



Source: Eurostat, ONS

Both shares are lower than they were at the beginning of the century, as a result of repeated phases of contraction in bilateral trade relations, the last of which began after 2016. Of particular evidence is the drop of about 10 percentage points in the EU share of British exports to the rest of the world, a phenomenon that has been taking place since 2009 and that, after a break between 2015 and 2016, has resumed following the Brexit referendum.

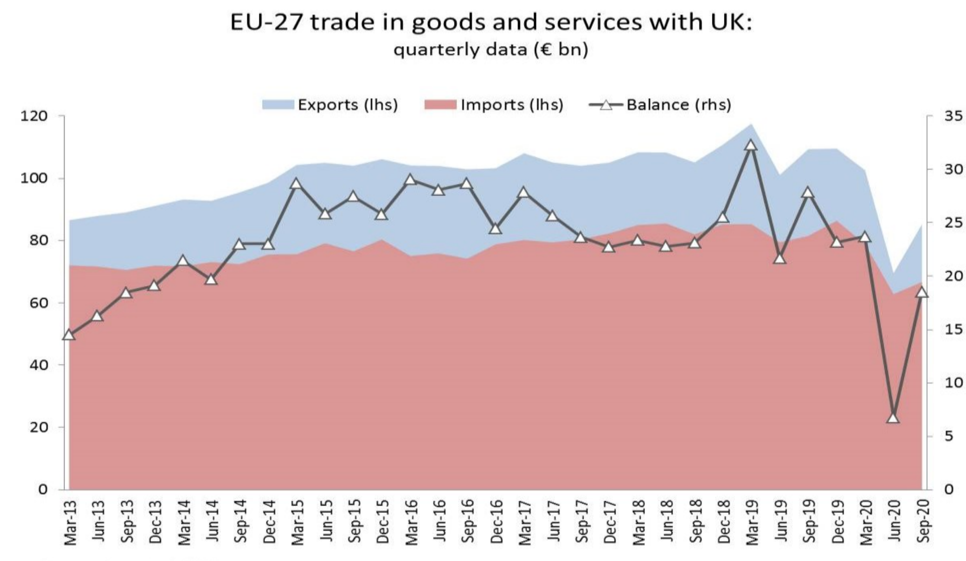
Using monthly Eurostat data of the EU member States on trade in goods and quarterly ONS data on trade in services, it is possible to build the quarterly time series for the import-export of goods and services between the EU and the UK in the recent years (Fig. 4).

Between 2013 and 2019, EU exports to the UK averaged € 102 billion on a quarterly basis, and imports € 78 billion. The EU trade surplus exhibits only a slight decline in the quarters following the 2016 referendum, which had begun to show signs of recovery between 2018 and 2019.

The real shock occurred, rather, in 2020 with a collapse in bilateral trade flows (particularly pronounced for EU exports to Britain) characterized by a rock bottom in the second quarter and a moderate rebound in the third. Although 2020 was the UK's last year within the European Union and the uncertainties over the negotiations continued until the end of the year, the observed dynamics suggest that the main drivers of trade between the two blocs during the year were the pandemic and the related contagion containment measures.

This makes reasonable to assume that the sharp decline in trade that occurred in 2020 due to Covid-19 has made a significant contribution to reaching the agreement at the end of December, at least to avoid further losses to economic operators already battered by the pandemic.

Figure 4



Source: Eurostat, ONS

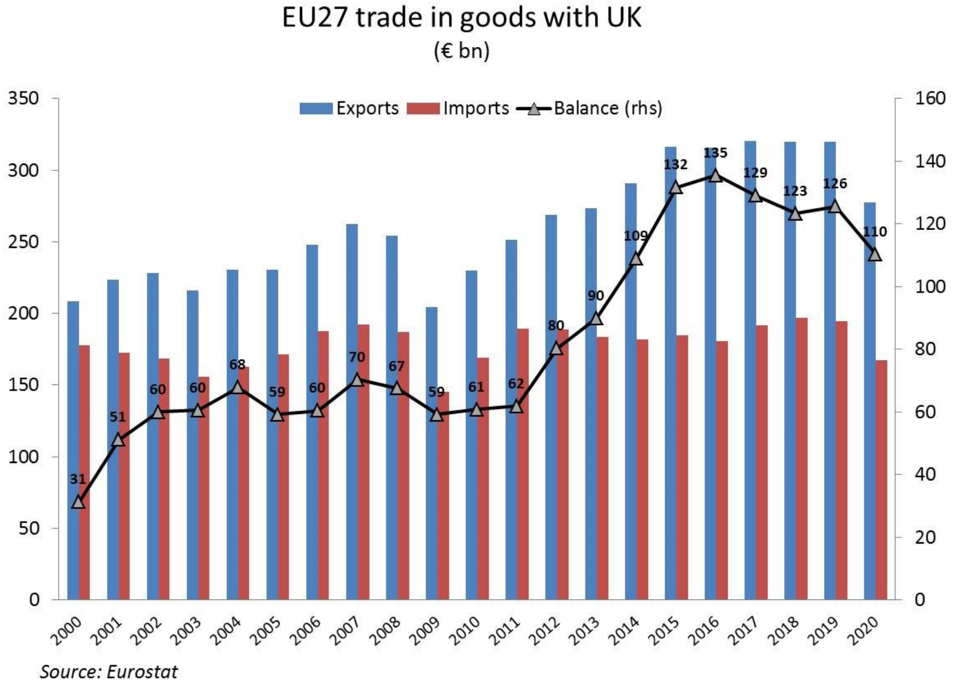
3. Trade in goods between the EU and the UK is the most important component of trade exchanges between the two economic areas, with total volumes amounting to around 500 billion euros per year.

Between 2010 and 2019, thanks to the progressive appreciation of the pound against the euro (the most widespread currency within the EU), the net balance of these trade exchanges almost doubled compared to the 2000-2009 period, reaching an average value of 105 billion euros per year in favor of the European Union. Currently the United Kingdom ranks second after the United States in terms of largest deficit in goods trade with the EU bloc.

Following the Brexit referendum, the EU surplus has left the growth path posted in the previous years, experiencing a decline of 7.3% between 2016 and 2019 (Fig. 5) also because of a new phase of weakness for the UK currency. A much more significant decline occurred in 2020 due to the pandemic and the approaching UK's final departure from the EU: compared to 2019, the EU's surplus towards Britain fell by more than € 15 billion, corresponding to a 12% reduction on an annual basis.

As a first approximation, therefore, Brexit seems to have had a relatively limited impact on the trade in goods between the two economic areas, also taken into account that, during the period considered, the escalation of tensions on global trade and the uncertainties related to the protectionist attitude of the US foreign policy under the Trump administration may have impacted on trade relations between the EU and the UK. After all, over the same period, the EU's goods trade surplus with non-EU countries other than the UK also experienced a downsizing, falling from € 129 billion in 2016 to € 66 billion in 2019.

Figure 5



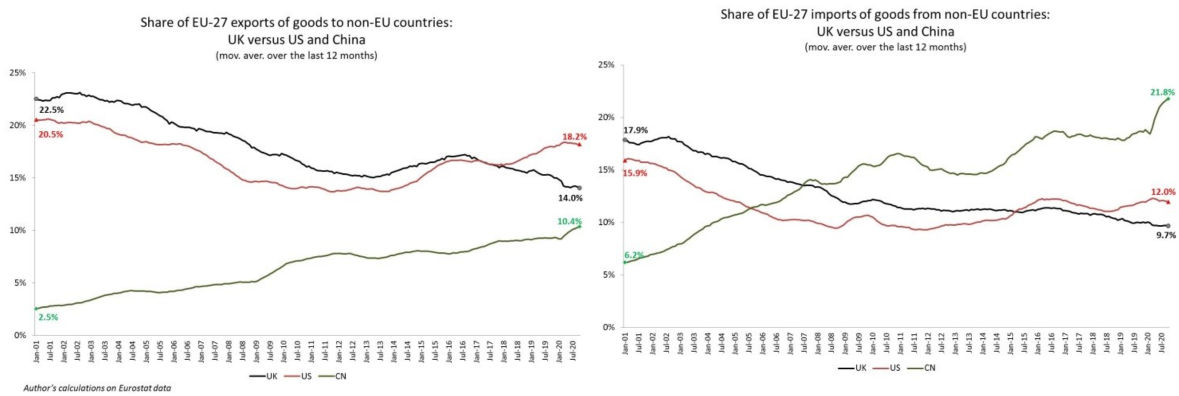
The analysis of monthly data confirms that after the referendum the bilateral balance of the trade in goods stabilized at around € 125 billion per year. However, monthly data also suggest that as of 2016 both the European Union and (to a lesser extent) Britain have scaled down their bilateral trade in goods and tried to intensify exchanges with other partners such as the United States and China.

With regard to the EU, data highlight a long-term trend towards a reduction in the UK's share on the bloc's total exports and imports of goods from non-EU countries. After a break between 2012 and 2016, this trend has regained strength following the Brexit vote result.

In detail, over the past 4 years the UK's relevance as an outlet market for European goods has fallen from 17% to 14% (Fig. 6), while its share of EU goods imports has fallen less (from 11.5% to 9.7%) as a result of the exchange rate dynamics, which have favored British exports to the EU. At the same time, the importance of the US and China as trading partners of the European Union has increased. Until 2015 the behavior of the UK and the US trade exchanges with the

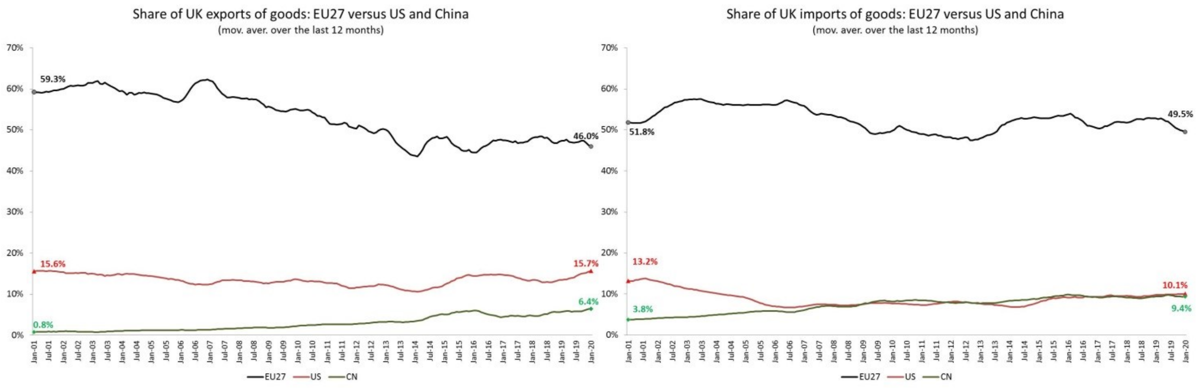
EU had been very similar; instead, starting from 2015-2016, it took place a decoupling, which led to a diverging trend in the relevance of the two countries as EU's trading partners. A sort of substitution effect has emerged, which helps to understand why, since 2018, the United States have overtaken the United Kingdom in terms of largest deficit in the trade in goods with the EU. Conversely, the growing importance of China as a trading partner of the European Union appears only weakly related to Brexit; in fact, this phenomenon was clearly underway before 2016, and its speed up during 2020 reflects the enormous competitive advantage that the Chinese economy was able to enjoy compared to the rest of the world for having brought timely the pandemic under control.

Figure 6



From the UK's standpoint, data need to be examined taking into account the EU's manifest dominance over any other foreign partner in the exchange of goods. Nevertheless, the British economy has also been showing a reorientation towards extra-EU markets for several years, especially as regards goods exports. After peaking at the end of 2006, the EU has absorbed a gradually smaller share of the total British exports of goods (Fig. 7) with a 16% decrease (from 62.3% of 2006 to 46.3% of 2019). Conversely, the US share has remained overall stable and it has even experienced a positive drift in recent years, and China's share has grown almost continuously over the last two decades. However, it should be remarked that the diminishing relevance of the EU as an outlet market for British goods is essentially a long-term phenomenon, to which Brexit seems to have contributed marginally.

Figure 7



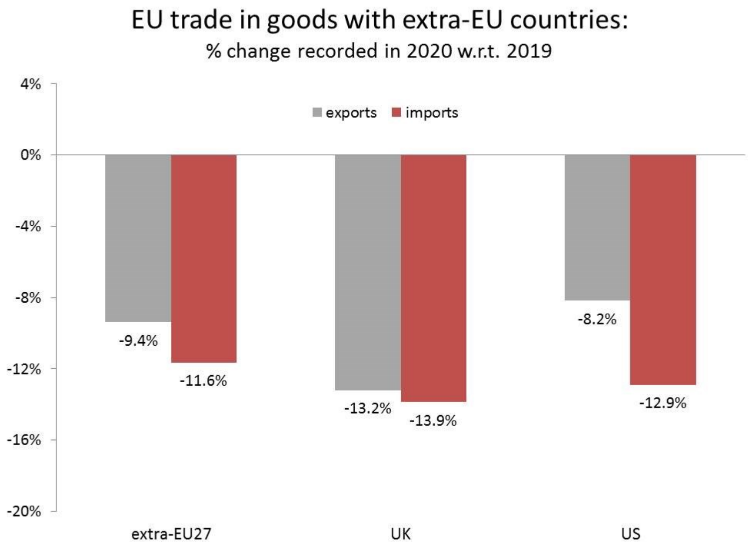
Author's calculations on Eurostat data

Also with regard to UK imports of goods, data highlight a long term trend of reduction in the reliance on EU countries, although less pronounced than the one regarding exports. At the end of 2019, the EU's share of total UK imports was around 50%, a large value but still 7 percentage points lower than the peak reached in 2003 (Fig. 7). Again, this phenomenon is only marginally related to Brexit, and it rather needs to be interpreted in the light of the broader picture of the recent developments in global trade with China's growing influence as a supplier of goods to the rest of the world. It should be noted, however, that as of 2019 the UK appears to have intensified its efforts to cut imports from the EU, with a substitution effect to the benefit of other foreign markets such as the US and especially the Chinese one.

A further in depth-analysis deserves what happened in 2020, the year in which – as mentioned above – the huge shock to international trade caused by the Covid-19 pandemic and related containment measures added to the imminence of the UK withdrawal from the EU. In 2020, exports of EU goods to the UK fell by € 42 billion (-13.2%) and imports by € 27 billion (-13.9%) compared to the previous year (Fig. 8).

As a result, the surplus in goods trade with Britain fell by 12.2% (€ 15 billion), a very high value, especially considering that EU net exports to non-EU countries increased by 13.5% over the same period compared to 2019. The data, therefore, suggest that the persisting uncertainties about the outcome of Brexit negotiations have made the negative effect of the pandemic shock on bilateral trade with the UK particularly tough for the EU.

Figure 8



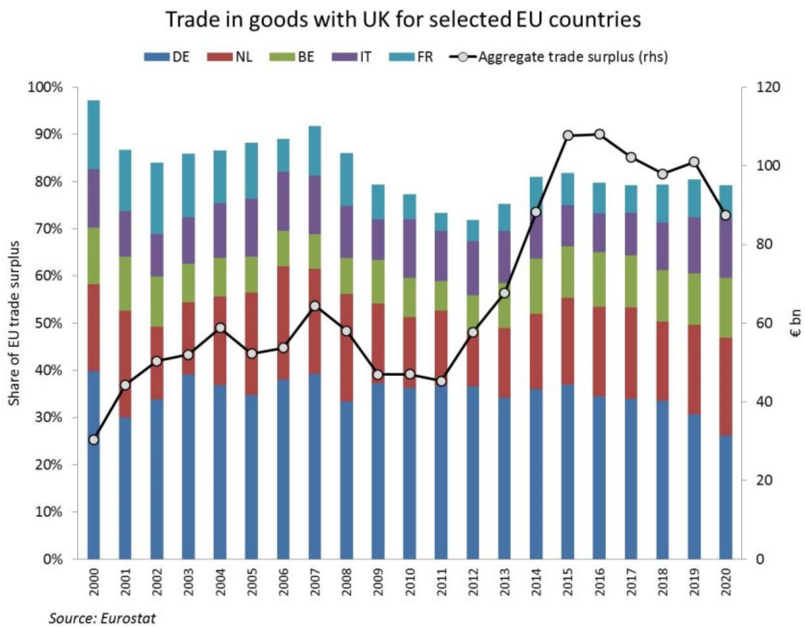
Source: Eurostat

From the UK's standpoint, ONS data on trade in goods show that the decline occurred in 2020 was more or less similar, in percentage terms, both with respect to the EU bloc and with respect to non-EU countries. The main difference is that, in absolute terms, imports of goods from the EU fell more than exports (resulting in an improvement in the deficit with the EU), whereas the opposite happened in trade with non-EU countries, leading to a slight worsening of the UK deficit towards this group of countries compared to 2019. It is worth stressing the significant surge (+22.3 billion euros) of the UK deficit towards China, a sign that the aggressiveness of Chinese mercantilism and the pandemic are affecting bilateral trade between the two sides of the Channel much more than Brexit.

3.1. Most of the trade in goods between the EU and the UK concerns a limited number of European countries: Germany, the Netherlands, Belgium, Italy, France and Ireland. Excluding the latter, all the countries just mentioned record a surplus in the import-export of goods across the Channel, which in aggregate terms accounts for the 80% of the entire EU surplus towards Britain.

The aggregate surplus of this group of countries to the UK increased significantly between 2011 and 2016 rising from 45 to 108 billion euros (+138%). It stabilized at an average annual value of around € 100 billion in the 3-year period following the vote on Brexit, and then experienced a 13% decline in 2020 (Fig. 9).

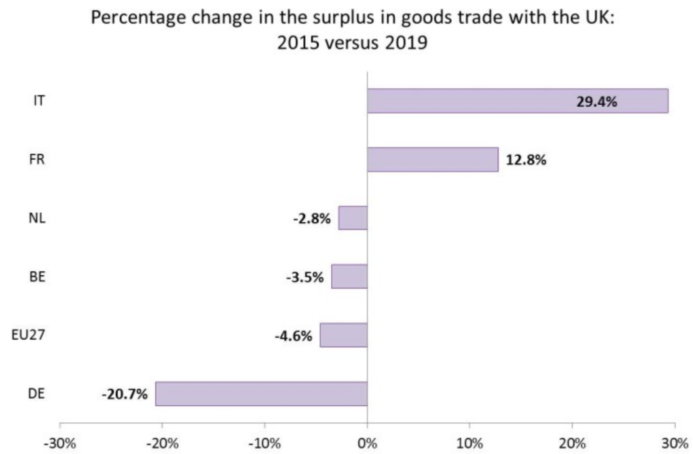
Figure 9



Germany is by far UK's largest partner in the EU: its surplus in goods trade with Britons accounts for 26.2% of the overall EU surplus. The Netherlands rank second (20.7%), followed by Italy and Belgium (both with a 12.7% share) and, in the end, by France (7%).

Among the countries considered, Germany is also the most affected by the downsizing in trade with the UK following the Brexit. By the end of 2019, its surplus to the Kingdom had fallen by 20.7%, compared with an overall decline in the EU surplus of 4.7%. The surpluses of the Netherlands and Belgium fell as well – although much less – while France and, especially, Italy increased their net exports across the Channel by 12.8% and 29.4% respectively (Fig. 10).

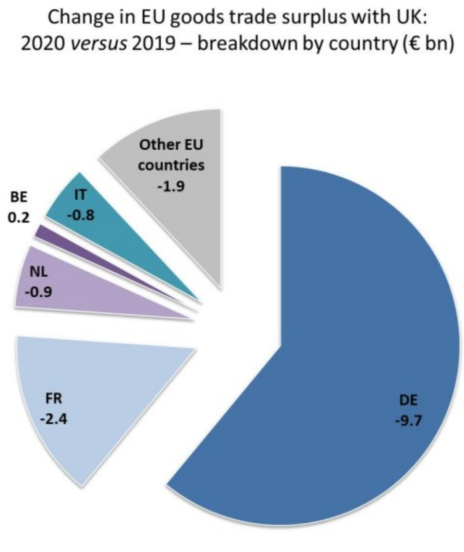
Figure 10



Author's calculations on Eurostat data

In 2020, all countries considered except Belgium suffered a decline in the goods surplus with the UK (Fig. 11).

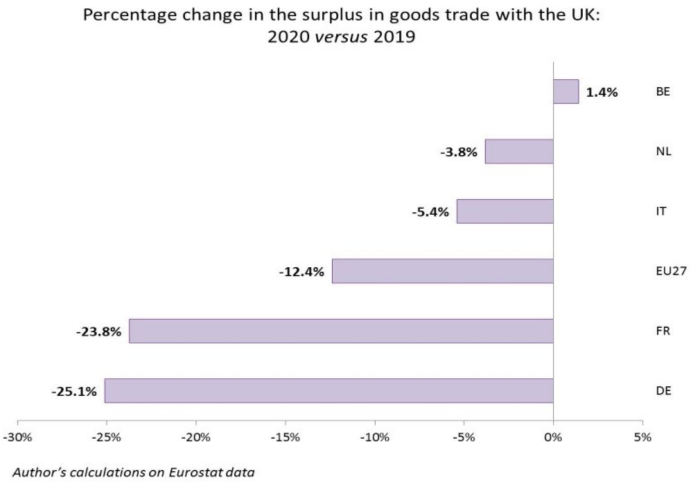
Figure 11



Author's calculations on Eurostat data

Germany was the most affected: its surplus in goods trade with Britain fell by almost € 10 billion compared to 2019, accounting for about 2/3 of the total decline in EU net exports to Britain. In percentage terms, this is a 25% decrease, well above the reduction (-13.3%) of the German trade surplus towards all non-EU countries in the 2020 compared to the previous year. France scored second worse after Germany, with net exports to UK shrinking by € 2.4 billion, equivalent to a variation of -23.8% in percentage terms. The Netherlands and Italy kept below 10% the decrease in their surplus with the United Kingdom (Fig. 12), with values of -3.8% and -5.4% respectively, and Belgium even managed to achieve a small increase of 1.4%.

Figure 12



Another major partner of Britain within the European Union is the Republic of Ireland, which – unlike the other EU countries considered so far – has a permanent deficit in goods trade with the UK[1], with a value of € 9-10 billion per year. Ireland represents a strategic partner for the UK: it is the third largest export market for British goods globally (after the United States and Germany), and ranks ninth as the country of origin for UK goods imports. Until 2020, trade relations between the two countries had not been affected by Britain's decision to leave the European Union; in the future much will depend on their ability to find a new equilibrium in the post-Brexit framework and on the solution that will be implemented on the Irish border.

The relations between the United Kingdom and the Republic of Ireland represented one of the most controversial points of the negotiations on Brexit, as economic issues are intertwined with a delicate balance on the political and social

[1]Other EU countries that have modest deficits in goods trade with the United Kingdom are: Malta, Cyprus, Greece, Croatia and Estonia [Ward, 2020].

level. The Withdrawal Agreement signed between the EU and the UK government in 2019 includes a specific Protocol on Ireland and Northern Ireland that, in order to avoid a hard border on the island of Ireland and to protect the Good Friday Agreement (also Belfast Agreement), places the border for trade in goods on the Irish sea. Therefore, goods entering Northern Ireland from mainland Britain will be considered imports and will need to comply with EU products rules and be subject to controls for safety, health and other public policy purposes. After the ratification of the Withdrawal Agreement, the EU and the UK have agreed to certain flexibilities that will help limit disruptions caused by the implementation of the Protocol on trade between Great Britain and Northern Ireland [EU Commission, 2020], including specific provisions for grace periods on customs checks at the Irish sea border.

However, the developments that took place during 2020 made it clear that the Irish border issue was far from being settled, essentially because of the discontent among Northern Ireland's unionists. In an attempt to manage the issue, in September 2020 the UK government published a Bill (so-called Internal Market Bill) with the aim of preventing internal barriers between the constituent countries of the Kingdom. As promptly challenged by the EU Commission, some provisions of the Bill were in contrast with the commitments made by the UK in the 2019 Withdrawal Agreement, and in particular with those provided for by the Protocol. In the end, the UK government had to withdraw some of the contested provisions in order to get the approval of the Parliament, but the core issue remained unsolved.

Northern Ireland's unionist politicians claim that the 2019 Protocol needs a judicial review because its current version introduces an unwarranted difference in treatment between Northern Ireland and the other countries of the Kingdom. In the umpteenth attempt to manage the internal political tensions arising from these positions, in early March 2021 the UK government extended the grace period on customs checks for agricultural and food products at the Irish sea border from end-March 2021 to October 2021. The European Union promptly reacted by denouncing yet another non-compliance by the United Kingdom with its commitments and postponing the ratification of the Trade and Cooperation Agreement by the national Parliaments of the 27 member countries, originally due by 30 April 2021. Although it is unlikely that the Agreement is torn apart, what happened in the first months of 2021 opened a new phase of tension and mutual distrust between the EU and the UK, which will require a lot of work and endeavors by both Parties to re-establish a climate of authentic cooperation in post-Brexit bilateral relations.

3.2. The most traded goods between the European Union and the United Kingdom are vehicles other than railway or tramway rolling stock, machinery and mechanical appliances, pharmaceutical products and mineral fuels and oils[2].

For both economic areas, these are strategic commodities in international trade, representing a total between 35% and 40% of their import-export of goods, even if with a different relevance for the EU and the UK.

Figure 13 shows the EU’s net exports to Britain for the four goods considered in the period 2000-2020.

Figure 13

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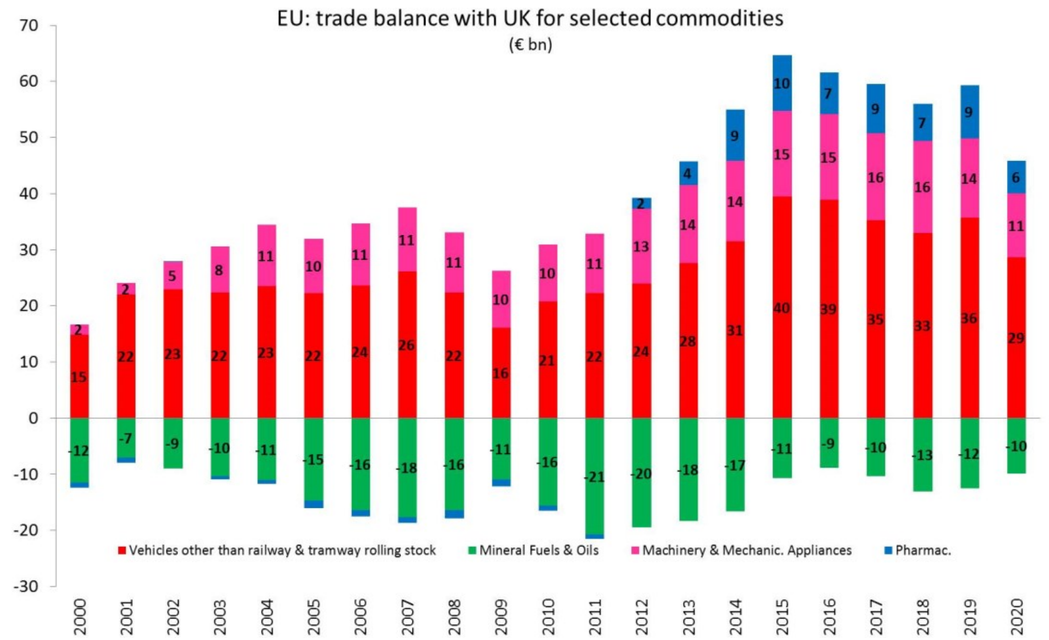
[2]The four types of goods were selected using the *Harmonized System* (HS) for tariff codes. In detail:

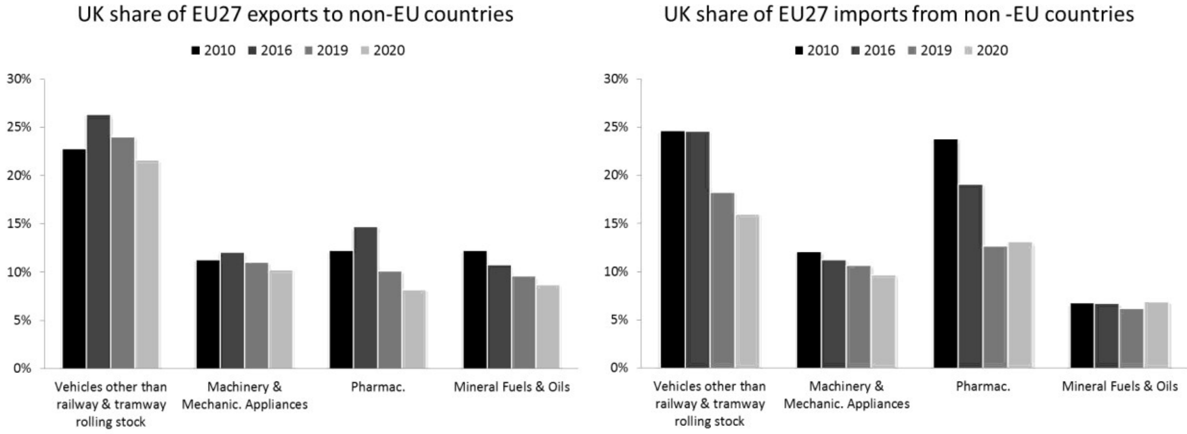
- *vehicles other than railway or tramway rolling stock* correspond to Chapter 87 in the HS codification, and their full description is: vehicles other than railway or tramway rolling stock, and parts and accessories thereof;
- *machinery and mechanical appliances* correspond to Chapter 84 in the HS codification, and their full description is: nuclear reactors, boilers, machinery and mechanical appliances and parts thereof;
- *pharmaceutical products* correspond to Chapter 30 in the HS codification;
- *mineral fuels and oils* correspond to Chapter 27 in the HS codification, and their full description is: mineral fuels, mineral oils and products of their distillation; bituminous substances; mineral waxes.



The European Union enjoys a high and consolidated surplus in the trade of road vehicles and mechanical appliances, to which, from 2012 onwards, pharmaceutical products have been added. Together, these three macro-categories contribute about € 60 billion per year to the European surplus towards the United Kingdom (apart from 2020). For its part, Britain boasts a stable surplus with the EU in the trading of mineral fuels and oils, with annual net exports of between 10 and 15 billion euros over the last years.

Road vehicles are undoubtedly the most important commodity for the EU trade with the UK, with an annual surplus between € 35 and € 40 billion up to 2019. Sales to Britain account for almost 25% of the EU's exports of road vehicles to non-EU countries (Fig. 14) and 18% of the bloc's total exports of goods to the UK. Britain is also a large exporter of vehicles to the EU: cars and other road vehicles sold to the continent absorb the 17% of the EU demand of this commodity to non-EU countries (Fig. 14) and in 2019 represented over 10% of all UK goods exports to the EU.

Figure 14



Author's calculations on Eurostat data

After the 2016 referendum, trade in vehicles between EU and UK embarked on a path of moderate decline, which affected mainly European sales across the Channel resulting in a drop of a few billion euros in EU net exports (Fig. 13).

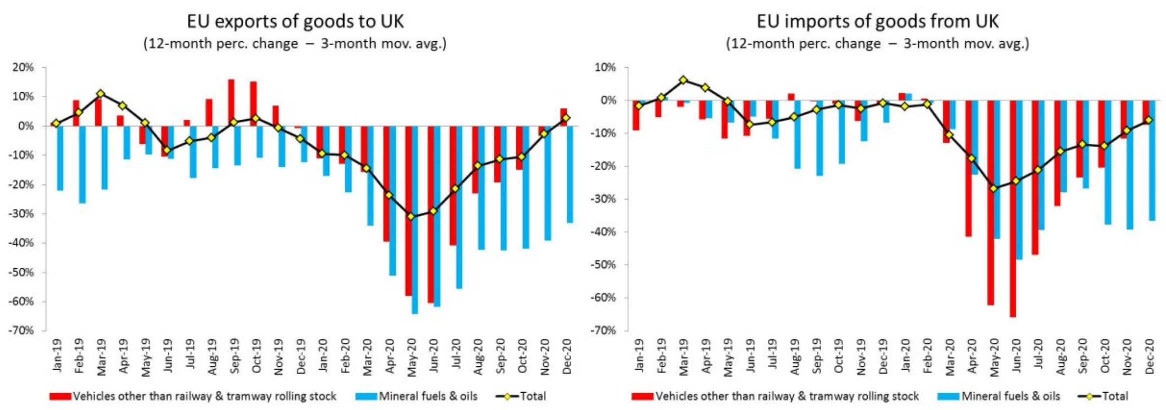
Machinery and mechanical appliances are another commodity that contributes significantly to the EU's goods surplus to the UK, with net exports of about € 15 billion per year until 2019. Britain absorbs about 10% of the total trade of this merchandise between the EU and non-EU countries (Fig. 14), a share that remained fairly stable over the past decade and was little affected by the outcome of the Brexit vote.

Pharmaceutical products are another key item in bilateral EU-UK trade: exports from the European Union to Britain take up to 8%-10% of EU drug exports to non-EU countries (Fig. 14) and to around 6% of EU total goods exports to the UK. Pharmaceuticals were among the protagonists of the boom in the EU's goods trade surplus with UK occurred from 2012 to 2015, with net exports reaching a peak of 10 billion euros in 2015. Since then, EU net exports recorded a small decline until 2019; a bigger fall occurred in 2020, which shrank their value to 6 billion euros.

Mineral fuels and oils are the flagship of British trade in goods with the EU, with a surplus of more than € 10 billion per year in favor of the UK. Until 2016, exports directed to the other side of Channel accounted for about 70% of the global UK exports of these type of commodities. Since the referendum, this share has shrunk to around 60% until 2019. As a percentage of the entire British export of goods to the European Union, mineral fuels and oils contribute 12% (equal to 22 billion euros per year).

As seen in § 3., in 2020 the shock to international trade caused by the Covid-19 pandemic has severely affected trade between the EU and the UK. Above all, stand out road vehicles and mineral fuels and oils: the collapse in the import-export of these goods from March to June was much more severe than the one occurred at the level of the aggregate trade in goods, resulting in an over 60% contraction compared to the same period in 2019 (Fig. 15). In the following months there were some signs of recovery (especially in EU exports to UK) in sync with the developments in the health emergency and the related containment measures.

Figure 15



Author's calculations on Eurostat data

For the EU, the greatest criticality arising from the pandemic was the almost complete freeze on sales of road vehicles to Britain in the second quarter of 2020; in the whole year gross revenues fell by € 12.6 billion and net exports by € 7 billion (-19.6%) compared to 2019, that is almost half of the reduction in the overall EU surplus towards the UK recorded in 2020.

Most of these losses hit Germany, whose net exports of road vehicles to the UK shrank by € 5.6 billion, over 50% of the drop recorded in 2020 by the

German trade balance in goods with Britain (see § 3.1.).

For its part, the United Kingdom was heavily affected by the decline in trade in mineral fuels and oils with the European Union: gross exports fell by 31% and net exports by 21%, resulting in a € 2.6 billion reduction in the surplus on this product category.

Trade in machinery and mechanical appliances also contracted significantly (-17%) in 2020, although less than the one in vehicles and fuels. To be most affected was the European Union – traditionally a net exporter of such goods versus Britain – whose surplus fell by over € 3 billion compared to 2019.

As for pharmaceuticals, 2020 led an improvement in the UK's position: EU exports dropped by 14.6% compared to 2019, whilst its imports from the UK rose by 5.7%. The net effect was a thinning of the EU surplus towards Britain estimated at around € 3.5 billion for the whole of 2020 compared to the previous year.

3.3. With the withdrawal from the European Union, the United Kingdom lost access to the single market and the status of a member of the customs union. Therefore, starting from 1 January 2021, it is considered a third country by the European Union and vice versa, with consequent restrictions on access to the respective domestic markets.

However, with regard to trade in goods, the Trade and Cooperation Agreement (TCA) represents a good starting point for redesigning trade relations between the two sides of the Channel in light of the new legal framework.

In fact, the TCA is first and foremost a free trade agreement that governs the import-export of goods between the European Union and the United Kingdom, with the sole exception of Northern Ireland which – based on the Protocol on Ireland and Northern Ireland – remains in the EU's single market for goods.

Unlike what would have happened in the event of a no deal and consequent application of the WTO standards, the TCA has made it possible to avoid the application of quotas and tariffs on goods that comply with a set of product-specific preferential rules of origin, which are stated in the Annex ORIG-2 of the Agreement.

Basically, a product qualifies for preferential treatment (and it is thus exempted from duties) if it complies with its specific rules of origin, which – depending on its HS code – are defined according to one of the following types or a combination of them:

1. *wholly obtained*: the product must be made only from materials from the country of the exporter;
2. *change in tariff code*: non-originating components used to assemble the product must be classified in a chapter, heading or subheading other than that of the final product;
3. *value added*: the exporter has carried out substantial processing in the production of the considered good;
4. *valued or weight percentage*: non-originating materials cannot exceed a maximum percentage either of the total weight or of the ex-works price of the product;
5. *specified processes*: only applies to specific products or industries – such as chemical, tyres and textiles – and requires that some well-identified processes participating in the production of the considered good take place in the country of the exporter.

The Agreement allows for bilateral cumulation, meaning that the intermediate components of a UK good that come from the European Union can be considered as originating components and vice versa for the purposes of qualification for preferential treatment. On the other hand, the so-called diagonal cumulation (desired by the United Kingdom) is not allowed, which would have made it possible to consider as local components also those from third countries provided that they were assembled in the exporter's country.

To access the preferential treatment, in addition to the customs declaration, a proof of origin is required, alternatively constituted either by the exporter's statement of origin or by the importer's knowledge. In some cases, the exporter's statement of origin must be accompanied by a supplier's declaration, whereas if the proof of origin is based on the importer's knowledge, the latter must have documentation that substantiates his declaration and must keep it for four years.

In order to mitigate the impact of the new rules, self-certification on the origin of the goods will be allowed. Furthermore, in the first half of 2021, the United Kingdom will not ask EU exporters to display the customs declaration at the point of import; and for the whole 2021 it will not ask for the supplier's declaration, which, however, can be requested retrospectively from 2022.

Obviously, the new set-up based on the rules of origin will entail additional costs for producers and traders on both sides of the Channel. Yet, as remarked by both parties, goods that meet the criteria for accessing preferential treatment will be exempted from tariffs, which represent a major hurdle to trade. For instance, without the TCA, cars would have been hit by tariffs of 10%, while textiles and footwear would have been subject to tariff peaks of 12% and 17%, respectively [EU Commission, 2020].

Moreover, it should be observed that the thresholds provided by the TCA's rules of origin are more favorable to UK exporters than those provided in other free trade agreements the EU has with other countries and, certainly, than those provided by WTO standards. Indeed, under the TCA the share of originating materials is typically set equal to the 55%-60% of the ex-works price, against the 80% set in the EU-Canada free trade agreement and the 90% usually required by WTO standards.

A special system of rules of origin is envisaged for the automotive sector and for the (related) sector of electric accumulators. The importance of vehicles in import-exports between the EU and the UK and the politically recognized priority given by both Parties to the issue of energy transition have led to the agreement of a six-year transitional period on the rules of origin for these product categories. Until 2026, therefore, less stringent rules of origin will be applied than those that will enter into force later. In particular, for road vehicles the maximum permitted percentage of non-originating materials will be equal to 60% of the ex-work price in the period 2021-2023 and to 55% in the period 2024-2026, and then it will definitively decrease to 45%. This phasing-in is particularly favorable to the EU car industry – especially the German one – whose supply chains are much less dependent on components manufactured abroad than that of the United Kingdom.

This disparity could, however, increase in the coming years due to the growing diffusion of electric or hybrid vehicles, in which batteries alone account for around 50% of the ex-work price. In order to secure exemption from duties in the exchange of vehicles at the EU-UK border, it will thus be essential to be able to rely locally on power accumulator production plants, and possibly located near the car factories. In this context European dominance is clear, with Germany in the lead [Hancké and Mathei, 2021].

Numerous batteries giga-factories are already in operation within the EU (many of them in Germany such as the one of the Chinese giant CATL) and many others are in the pipeline (such as the one that Tesla is completing in Berlin-Brandenburg and the half a dozen recently announced by Volkswagen). Compared to the EU, the UK lags far behind, with little ability to attract EV business-related investment. Nissan is currently considering opening a battery production plant to support its production of electric vehicles in Sunderland, and in late 2020 Britishvolt announced the intention to open the UK's first giga-factory, a project that, however, is unlikely to be completed before 2023.

The future of the UK car industry in trade with the EU (and beyond) therefore appears linked to the ability to quickly and efficiently make the transition to electric vehicles, in terms of on-site production of accumulators and, also, of adaptation of the plants and production-assembly chains of vehicles to the characteristics of the EV supply chains.

At the moment there is a competitive disadvantage compared to the EU; however, the country that was the protagonist of the industrial revolution could recover the gap with the EU in the coming years. Some important signals are already there. For example, in November 2020 the UK Government announced the decision to ban internal combustion vehicles by 2030 and to launch a green revolution with public investments in hydrogen, nuclear energy and carbon capture and storage technology. These decisions represent a further incentive for the UK car industry to convert its production systems relatively quickly and look for new solutions for the low-cost supply of electric accumulators.

The green revolution could also impact the EU-UK trade in mineral fuels and oils. As seen in § 3.2., goods comprised in this category represent the 1st UK export to EU countries and generate an annual surplus of about € 10 billion for Britain. But with the strong EU commitment to a more environment-friendly and sustainable growth model, a large part of this UK business could be at risk.

Beyond rules of origin, many other non-tariff barriers, such as customs paperwork and technical barriers to trade (TBT), will apply. According to some estimates[3], the annual cost of completing customs declarations alone should be in the range between £ 7.5 and £ 15 billion for the UK economy as a whole (not including the much higher costs of complying with rules of origin), and the number of declarations made in the country is expected to climb from 55-60 million to over 250 million per year[4]. The administrative burden could drastically rise for EU

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[3] See: https://ukandeu.ac.uk/the-brexit-deal-and-uk-automotive/

[4] See:https://www.independent.co.uk/news/uk/politics/hmrc-brexit-transition-business-paperwork-customs-b1767557.html

countries as well: an increase of 40% in customs declarations has been estimated for Dutch companies, and of 800% for French ones according to the respective customs offices, whereas additional customs declarations for German businesses are estimated in 15 million per year corresponding to an annual cost of 500 million euros [Business Europe, 2018].

Also technical barriers, represented by requirements related products standards in the fields of safety, conformity assessment, market surveillance, marking, labeling, etc., could prove harmful for trade at the EU-UK border. Indeed, under the TCA both Parties are free to regulate goods in the most suitable way for the respective domestic markets, whereas – as a general principle – it is not envisaged the mutual recognition of product conformity assessments certified by accredited bodies of the other Party (the UK has tried in vain for an agreement on this issue). As a consequence, products intended for export must have double certification, which clearly increases the administrative burden for both European and British exporters.

Further damages to bilateral trade could arise in case of an excessive regulatory divergence, should the internal regulatory choices taken by a Party be considered as harmful to fair competition and leveled-playing field principles. In particular, the Agreement includes the possibility of retaliatory measures to be adopted by a Party in reaction to unfair regulatory measures of the other. Such measures – to be submitted to the prior assessment of an independent panel composed by EU and UK representatives – should operate as a rebalancing mechanism to be activated unilaterally by a Party with the aim of remove trade distortions created by the other.

The whole set of the non-tariff barriers arising from the UK withdrawal from the EU and from TCA provisions will necessarily result in a significant trade loss for both the blocs. In a recent simulation on the short-term impact of the TCA on the EU-UK trade flows, the EU Commission has assumed that non-tariff barriers can be translated into an average tariff equivalent of 10.9% and 8.5% for EU and UK imports, respectively [EU Commission, 2021]. Under this assumption, the Commission estimates that by 2022 Brexit will generate an output loss of around 0.5% of GDP for the EU, and of around 2.25% of GDP for the UK. In monetary terms, these estimates correspond to a loss of over 120 billion euros for the EU bloc by the next two years, and of over 100 billion euros for the UK by the same maturity.

While it is difficult to assess the likelihood of these estimates, it is uncontroversial that huge trade disruptions are already occurring on both sides of the Channel. Limits to traffic and mobility caused by the pandemic have added to the new regulatory framework of the post-Brexit era, causing delays or even suspensions in goods shipment and delivery. On the UK side, the UK Road Haulage Association has reported that in the first months of 2021 one in five trucks has failed to cross the border; but also on the UE side, traders report a lot of inconveniences.

Still, many of these problems could prove to be a temporary phenomenon: operators need some months to get acquainted with the new rules and – to make matters worse – the pandemic has not yet been defeated. On the medium to long term, many unpredictable factors can affect EU-UK trade relations, including the dynamics of the EUR-GBP exchange rate, which, for instance, in the first months of 2021 is experiencing an unexpected trend of pound appreciation, with the British currency trading at higher values against the euro than in early 2020.

The effective additional costs of the post-Brexit border for UK and EU companies will be deeply affected by the ability of both Parties to fit their production systems and supply chains to the new rules and to implement suitable solutions of simplification in the customs red tape. Hopefully, there will be a positive learning-by-doing effect, than can deliver significant improvements with respect to the initial phase of the TCA implementation. Furthermore, to mitigate the multitude of frictions to trade deriving from the new regime, the two Parties have provided for customs cooperation mechanisms and for specific areas of mutual recognition, as in the case of Authorized Economic Operators (AEO) schemes. As a consequence, trusted traders will be given access to simpler customs procedures, waivers of certain obligations and faster clearance of goods.

In the next months the UK government is expected to make huge infrastructure investments at the border, and it has already announced bespoke measures to help domestic firms[5]. Other important interventions could soon arrive in terms of tax cuts (on VAT and excises) for UK importers (especially in case of significant pound depreciation against the euro). Meanwhile, businesses are likely to recalibrate their supply chains in order to reduce delivery delays and manage inventories in a more efficient manner [Boata and Poulou, 2021]. A higher reliance on the domestic supply of intermediate components and materials required to assemble products is expected, which – with the aim of by-passing the missed achievement of diagonal cumulation – could also lead to incentives for foreign companies to open production plants within the UK borders. It would be a kind of reverse relocation that could also have positive externalities on the competitiveness of the British manufacturing industry.

For its part, the EU is taking steps to safeguard its trade relations with the United Kingdom: facilitation arrangements have already been provided for specific products (wine, automotive[6], pharmaceutical, chemical and organic goods [TCA, 2020 and EU Commission, 2020]), most of which are among EU most traded goods with Britain and were severely hit by the pandemic (see § 3.2.).

Several EU countries are also adopting initiatives at the national level with

[5] The UK has also decided to maintain its membership in the Common Transit Convention (CTC) after Brexit. The CTC is an EU customs procedure that allows the free movement of goods between participating countries; in addition, goods from an EU member country don't lose their "unional" status even when they transit for a CTC country outside the EU. Currently, CTC members are: EU countries, UK, Turkey, EFTA countries (i.e. Switzerland, Norway, Iceland and Liechtenstein), Macedonia and Serbia.

[6] Under the TCA, the Parties have agreed the mutual recognition of approvals based on UN regulations with regard to products of the automotive sector.

the aim of favoring a smooth trade in goods with the United Kingdom, supporting logistics and easing customs formalities. France has implemented the so-called "smart border", whose pillars are the anticipation of the customs formalities before loading the means of transport and largely automated processes and checks, made possible by a dedicated information system.

French smart border also includes the "logistic envelop", a tool that groups multiple customs declarations under a single barcode, hence allowing to speed up the pairing process between documents and goods at the customs checkpoint.

Another example is given by Italy's "zero kilometer customs", a streamlined administrative procedure that allows the exporter to obtain the authorization of approved places other than the customs areas at which to carry out the formalities relating to export.

Thereby, those who have to ship goods to the United Kingdom can obtain an authorization that makes their production site an approved place for carrying out customs checks.

The authorization can be requested through a standard form that certifies the requirements of the place itself; once obtained the authorization, the exporter will simply have to submit electronically the customs declaration to the competent customs office and make the goods available for any physical inspection at the site approved for the export checks, saving the costs associated with the transport of the goods in the customs premises.

The above-mentioned measures adopted by both Parties will help to reduce the negative effects of Brexit on EU-UK bilateral trade. Nevertheless, many stakeholders maintain a pessimistic outlook on the impact of the new legal and regulatory framework. In a report of January 2021, Allianz research team concludes that Brexit could entail an average reduction of 4% in the long-term level of UK GDP.

Always in January 2021, a report from the think-tank "*UK in a changing*

Europe" estimates that over the next ten years UK exports to EU will fall by 36% with respect to EU membership, and imports by 30% [Sampson, 2021].

Expectations are not rosy even on the other side of the Channel: on February 2021, the President of the Kiel Institute for the World Economy (IfW) declared that the institute expects that in the long-term German exports to the UK will be 10% lower than the level expected without Brexit.

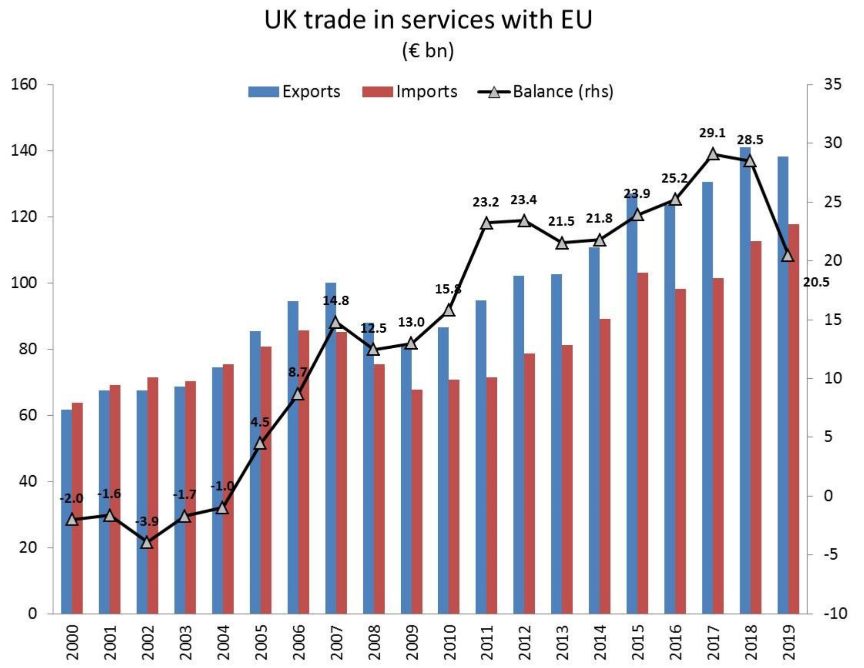
Time will say whether these forecasts are too pessimistic. Of course, both the EU and the UK are aware of the respective strategic relevance as trading partners. But nobody knows whether this awareness will be sufficient to curb the UK's hunger for regulatory independence and the EU's commitment to protecting fair competition, even with the use of protectionist measures.

4. Trade relations between EU and UK are very intense also in the exchange of services, with total volumes ranging between 250 and 300 billion euros per year. Unlike what seen for goods (see § 3.), in the case of services, Britain is a net exporter to the EU, with a surplus of about 20 billion euros in 2019 according to ONS data[7].

The 2019 figure is 29.5% lower than the peak of 29.1 billion euros reached in 2017, after over ten years of almost uninterrupted growth (Fig. 16).

[7]Data on trade in services with the United Kingdom reported by individual EU countries and available on Eurostat show an aggregate EU surplus of 43 billion euros for 2019. The huge discrepancy with ONS data suggests the presence of relevant trade asymmetries between the various reporting countries and confirms the importance of a greater shared commitment at the international level for the maximum harmonization of data collection and classification standards. In this work, ONS data were privileged as they are more complete in terms of depth and frequency of the time series.

Figure 16



Source: ONS

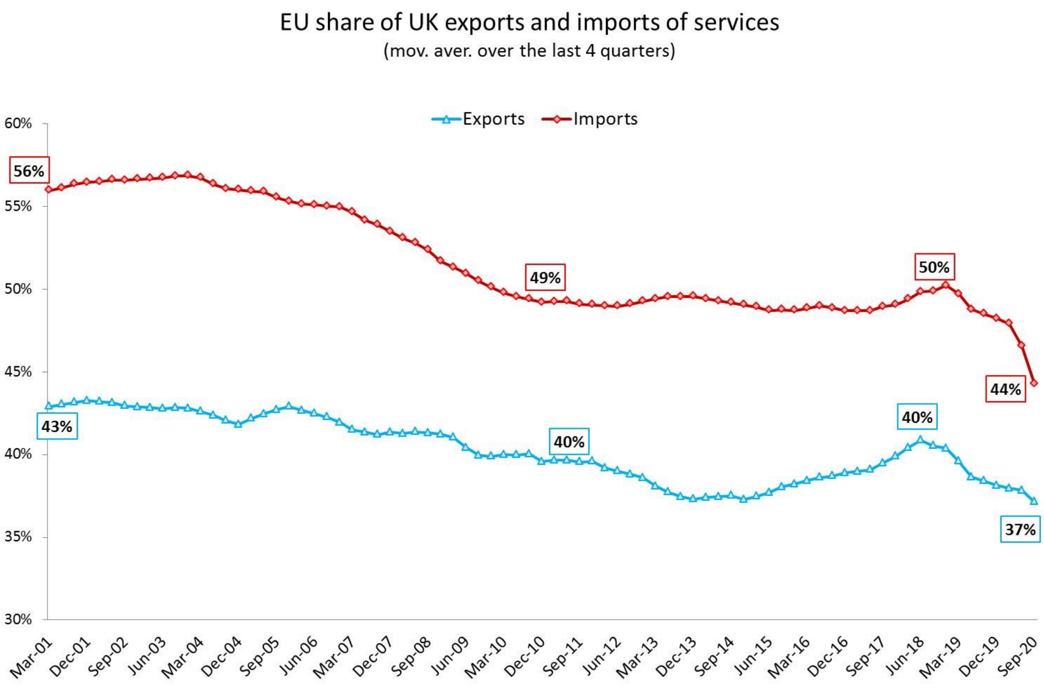
This pattern is in line with the excellent performance in the UK trade in services with the rest of the world and reflects its characterization as a service-intensive economy (equal to 81% of the country economic output), especially in the financial, insurance and real estate sectors (so-called "*fire economy*").

The 2016 referendum does not appear to have had a negative impact on the exchange of services with EU countries, while the reduction in the British surplus occurred in 2019 could be related to that year general decline in the UK's net exports of services to the rest of the world (133 billion euros compared to 146 in 2018).

In the first three quarters of 2020, the cumulated UK service surplus with the EU was over € 28 billion; therefore (barring surprises in the last quarter), 2020 may mark a rebound compared to the disappointing figure of 2019, despite the shock due to the pandemic.

Using ONS quarterly data, it is possible to analyze the time evolution of the EU share of the UK trade in services with the rest of the world (Fig. 17). In general terms, it is confirmed the primary role of the EU as Britain's partner in the exchange of services. However, while exports to the EU represent a fairly stable share (around 40%) of all UK service exports, in the long term a trend seems to be taking shape towards the progressive downsizing of EU countries as service providers to Britain. More in detail, between 2001 and 2020, the EU share of UK service imports from the rest of the world fell from 56% to 44%, with an acceleration in the last two years. A possible explanation is that, in view of the impending departure from the EU bloc, Britain has progressively redirected its demand for services towards non-EU countries.

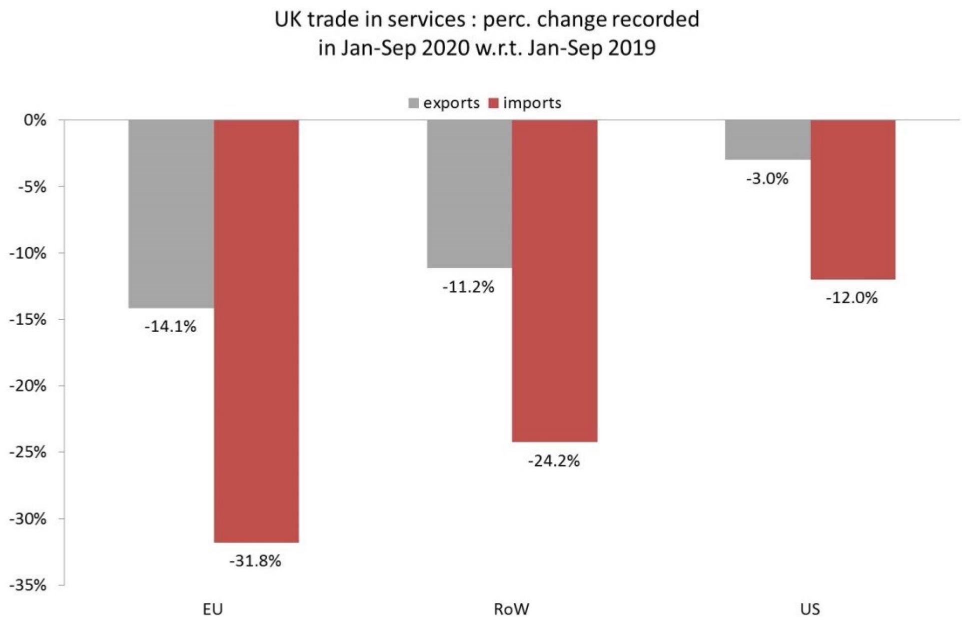
Figure 17



Author's calculations on ONS data

In 2020, the decline in the exchange of services with the EU was exacerbated by the overlapping of the economic emergency caused by the pandemic with the difficult negotiations on the free trade agreement. In the first three quarters of the year, imports of services from the EU fell by 27.5 billion euros (-31.8%) compared to the same period one year earlier, while exports of British services to EU countries shrank by 4.4 billion euros (-14.1%). The joint effect of these changes was an improvement of 13.1 billion euros in Britain's surplus towards the EU. The decrease in the UK's import-export of services with the EU was far superior to that overall experienced in the same period with the rest of the world (Fig. 18). In particular, numbers on bilateral trade with the United States highlight a modest contraction in UK service exports (-3%) and a more marked contraction (-12%) in its services imports from the US, but in any case, much lower compared to that recorded with the EU.

Figure 18

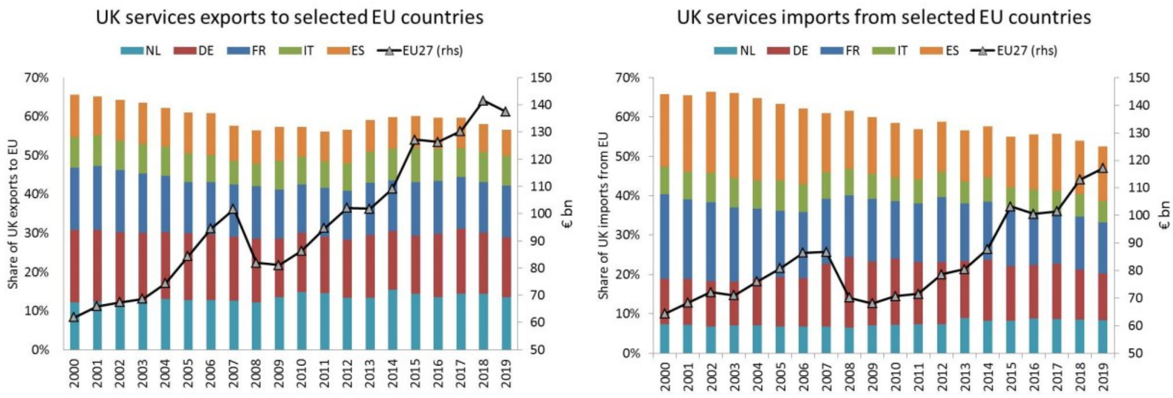


Author's calculations on ONS data

As for the EU, it is more controversial to understand and quantify the importance of the UK as a partner in trade in services, because Eurostat data are available only on an annual basis and only for the period 2010-2019 (and they significantly differ from those released by the ONS). Based on these data, the United Kingdom steadily absorbs over 20% of the all EU service exports to non-EU countries, while its share of total EU service imports is slightly lower (19%).

4.1. Within the EU, the UK's main partners in trade in services are Germany, the Netherlands, France, Italy and Spain. According to ONS data on international trade, these five countries absorb over 57% of the UK services exports to the EU and about 52% of its imports (Fig. 19). Germany and France play a significant role in both the purchase and sale of services to Britain, each of them with a contribution of more than 10% of the EU total. The position of the other countries considered is more heterogeneous: the Netherlands are an important outlet market for services provided by the United Kingdom, while Spain over time has retained a key position as an exporter of services to the other side of the Channel, surpassing even France and Germany in recent years. Finally, Italy from 2009-2010 has experienced a reduction in its share of the EU service exports to the UK, while maintaining stable (between 7% and 8%) its share of the EU service imports from Britain.

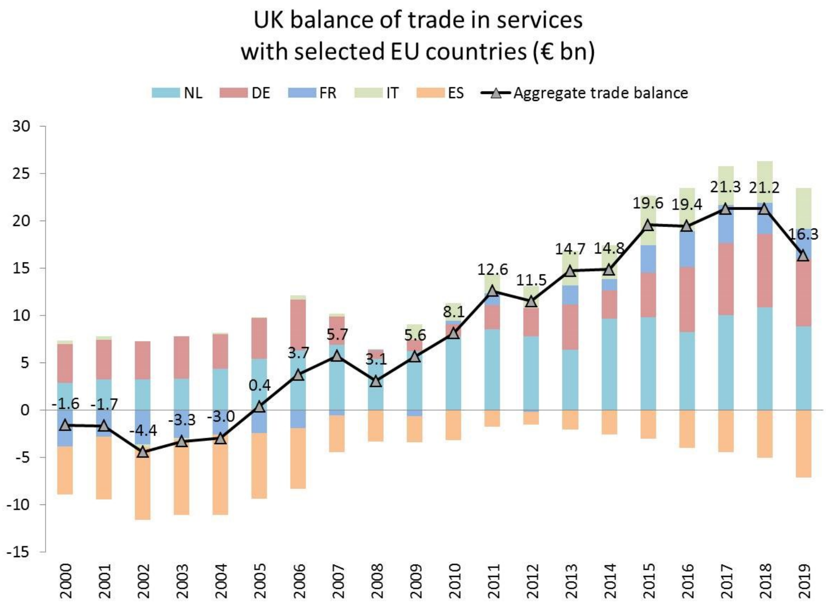
Figure 19



Author's calculations on ONS data

In net terms, over the last decade the United Kingdom has progressively increased its aggregate surplus towards the countries considered (Fig. 20), rising from 5.6 billion euros in 2009 to over 21 billion euros in the two-year period following the Brexit referendum. A decrease of 5 billion euros occurred in 2019 in line with what observed in § 4. The Netherlands are the EU partner to which Britain boasts the highest value of net service exports (€ 8.8 billion), followed by Germany (€ 7.2 billion) and Italy (€ 4.3 billion). Among the countries considered, only Spain has maintained a stable surplus towards the UK (€ 7.1 billion in 2019), which mainly stems from the fact that it attracts almost 33% of the entire UK imports of travel services from the EU.

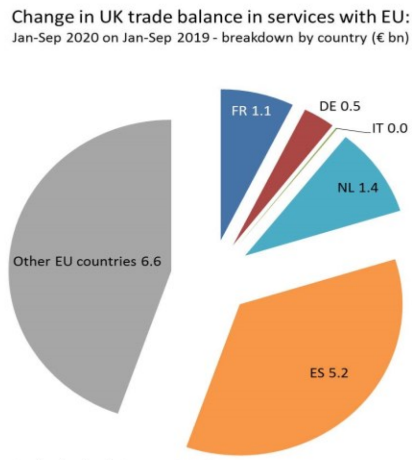
Figure 20



Source: ONS

With regard to the first three quarters of 2020, ONS data show that the UK's net exports to its main EU partners surged by € 8.2 billion (Fig. 21). The most affected country was Spain, which between January and September 2020 suffered a drop of over € 5 billion (-89%) in its services surplus to Britain.

Figure 21



Author's calculations on ONS data

The limitations on the free movement of people required by the pandemic have in fact precipitated UK imports of travel services of which – as mentioned –

Spain is the first source within the EU. In the period considered, net exports of UK services to the Netherlands and France also increased compared to the same period in 2019, while those to Germany and Italy were substantially unchanged.

4.2. The most important services traded between the UK and the EU are financial services, other business services, services related to telecommunications and information technology (hereinafter also ICT services) and travel services.

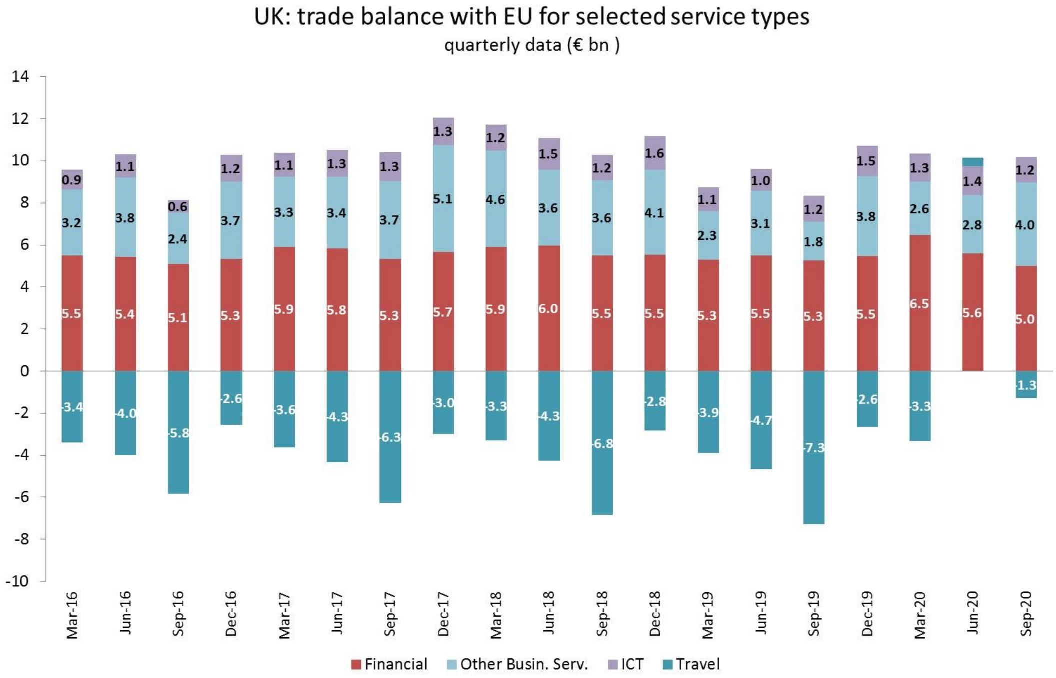
For both Parties, these types of services are of paramount importance in international trade, accounting for 70%-75% of the global import-export of British services and for 60%-65% of the EU trade in services with non-EU countries.

Fig. 22 illustrates UK quarterly net exports to the EU for the four types of services considered in the 2016-2020 period using ONS data.

Over the period considered, the EU posted a constant in surplus as regards travel services with net exports across the Channel averaging € 4 billion per quarter.

On the other hand, the United Kingdom recorded a systematic surplus towards the EU countries on the other types of services (financial, ICT and other business services), for an average total value of € 10 billion on a quarterly basis. All these three types of services fall into the macro-category of «*knowledge intensive business services*» (KIBS). In this category of services, the Kingdom holds a leading position on a global level, which was consolidated over time also thanks to the deregulation of financial and ICT services started under the premiership of Margaret Thatcher. The reforms introduced since the 1980s have in fact accompanied the transition of the British economy from an economy based on traditional industrial sectors to a service economy.

Figure 22

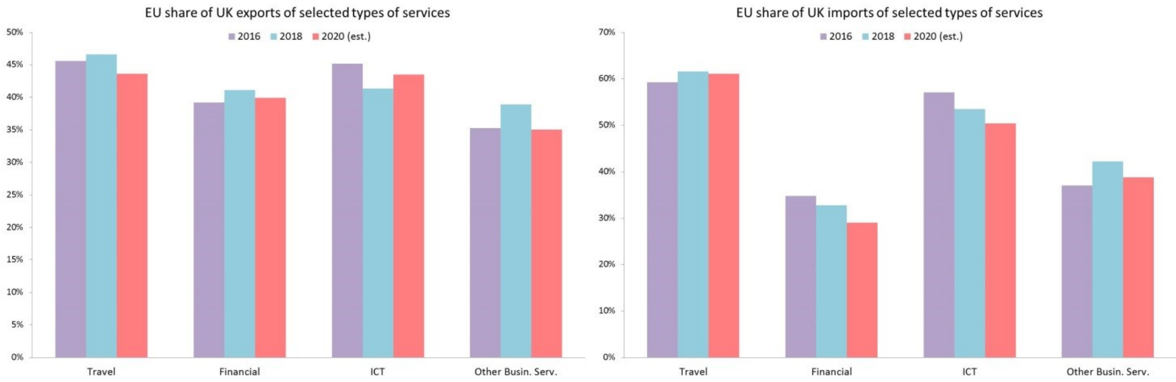


Source: ONS

Financial services are the most important component of the UK trade in services with the EU: on average, they earn the country an annual surplus of 22 billion euros, that is, between 40% and 45% of the entire British surplus in financial services. EU countries account for 40% of all UK exports of this type of services, a share that has remained pretty stable over the last years. On the other hand, since 2016 their share of UK imports of financial services has declined from 35% to 29%, hinting that the outcome of the Brexit referendum may have narrowed UK demand for EU services in this category.

Other business services represent another key item in UK-EU trade in services. They rank first among UK service exports to EU countries, with an over 30% share that was not visibly affected by the 2016 referendum. This category gathers various types of services, including those relating to professional and management consultancy and those of technical and commercial nature. In the 2016-2020 period, their annual contribution to the UK services surplus with the EU averaged € 13.5 billion. EU countries absorb between 35% and 40% of the entire British import-export of this type of services (Fig. 23).

Figure 23



Author's calculations on ONS data

Also ICT services make an important contribution to the UK services surplus with EU countries, with annual net exports averaging € 5 billion. EU accounts for the 45% of all UK exports of this type of services (Fig. 23), and for an even larger share of UK imports (50%, albeit on a declining trend over the last few years, as shown in Fig. 23).

Travel services are UK's largest service import from the EU: in the period 2016-2019 they made up 33% of the full value of the services Britain bought from EU countries. The European Union is in fact the preferred destination of the British, stably absorbing 60% of their spending on travel abroad (Fig. 23). EU is also a large importer of UK travel services, covering the 45% of the Kingdom's exports of this service category to the rest of the world (Fig. 23). In net terms, the UK' trade deficit towards the EU on this type of services is around 17 billion euros per year (except for 2020). Within the EU, the preferred travel destination for UK citizens is Spain whose net exports of travel services to the UK averaged € 10 billion a year between 2016 and 2019, corresponding to 60% of the entire EU surplus towards the United Kingdom on this service category.

Travel services were the most affected by the restrictions imposed in 2020 by many governments on the movement of people to contain the pandemic. These restrictions included in fact prolonged periods of closure of the borders between the EU bloc and the United Kingdom, which caused a slump in UK imports of travel services from the EU, down 67% in the first three quarters of 2020 compared to the same period in 2019.

In monetary terms, this reduction exceeds 20 billion euros and represents the 75% of the entire downsizing in British imports from the EU between January and September 2020 compared to the same period one year earlier. Although in the same months of 2020 travels by European citizens to the UK also dropped dramatically, the net effect was a thinning in the British deficit with the EU in this service category.

The other most relevant types of services exchanged between the UK and the EU (financial, ICT and other business services) have been substantially spared from the negative consequences of the pandemic, probably because they can be easily provided also remotely. Consequently, the above described performance of travel services explains much of the improvement in the UK service surplus with the EU recorded in the first three quarters of 2020.

4.3. Following the definitive exit from the EU, UK service suppliers have lost the automatic right to offer services in EU countries. As a consequence, starting from 2021, their exports will need to comply with the regulations in force in the host-country which are subject to a certain variability among the different member States.

Despite the great importance of services for the British economy, TCA provisions on trade in services are extremely sparse and, broadly speaking, very far from the objectives that the United Kingdom has tried to achieve during the long negotiations with Europe.

In essence, the TCA re-proposes the basic structure envisaged by the WTO's

General Agreement on Trade in Services (GATS) introducing some new features. GATS framework relies on a few core principles aimed at guaranteeing the liberalization of the trade in services [Jozepa *et al.*, 2019], namely those of non-discrimination among one's trading partners and of transparency and reasonableness of all applicable rules and regulations. Non-discrimination, in particular, requires that foreign service providers cannot be treated worse than domestic ones (*national treatment*) and that all one's trading partners are treated equally (*Most-Favoured-Nation* or MFN).

A first failure for UK negotiators regards the missed achievement of the mutual recognition of professional qualifications. Accordingly, as of 1 January 2021, British professionals such as doctors, nurses, pharmacists, lawyers, architects or engineers will have to obtain the qualification from the competent institutions of the relevant EU member State before being able to exercise their profession in that country. The same obviously applies to professionals from EU countries wishing to offer their services in the UK. As a (minimal) mitigation of the new set-up, the TCA foresees that in the future the two Parties may agree, on a case-by-case basis and for specific professions, on additional arrangements for the mutual recognition of certain professional qualifications [EU Commission, 2020].

Another novelty that is likely to impact on the exchange of services between the UK and the EU is that people will no longer be able to move freely from one side of the Channel to the other. Indeed, whilst the Parties have agreed not to require visas for travel, yet their citizens will be subject to checks prior crossing the border and they will no longer be allowed to use biometric passports to pass checks more quickly. Albeit also in this case the Agreement provides for some (temporary) mitigation especially for short-term business travelers, the introduction of border screenings could lead to a decline in the import-export of travel services between the UK and the EU. This would reasonably hit EU countries more than the UK, resulting in a worsening of their surplus with Britain on this service category.

From the UK's standpoint the main criticality of the TCA concerns financial services. As seen in § 4.2., financial services are the most significant component of the UK services surplus with the EU. And this still gives only a limited idea of the deep degree of integration between UK and EU in the financial field: prior to Brexit 37% of assets under management in the EU were managed in the UK and 46% of equity funding raised in the EU was raised in the UK [Moloney, 2021].

These numbers explain why the UK had already set to work in the aftermath of the 2016 referendum to try to obtain a bespoke treatment that would continue to guarantee its financial services firms an easy and streamlined access to the EU market. For its part, the European Commission had instead clarified from the beginning of the negotiations its unwillingness to grant the United Kingdom easier access conditions to the single market than those existing with other third-countries.

And so it was. As recognized by the European Commission, the TCA «*covers financial services in the same way as they are generally covered in EU's other FTAs with third countries*» [EU Commission, 2020].

Like for the other types of services, there is a reciprocal commitment to not discriminate operators from the other Party and to grant them continued market access. The Parties also committed to implement and apply internationally agreed standards in the financial services sector within their territories. However, all these commitments are subject to the *Prudential Carve-Out* (PCO), which gives each Party the right to maintain or adopt measures for prudential reasons, including the protection of domestic consumers of financial services and the preservation of financial stability and of the integrity of domestic financial markets. Officially the PCO is only intended to pursue prudential purposes, but in practice it could be used also as a protectionist weapon, because it can be very difficult to clearly distinguish whether a given measure is required to protect domestic investors rather than the domestic financial industry.

Financial services are also explicitly excluded by the MFN clause generally envisaged by the Agreement with regard to trade in services. Thus, neither Party will be entitled to claim any more favored treatment granted by the other Party in its future agreements on trade in financial services with other third countries.

Most importantly, the TCA does not address the new scenario for the exchange of financial services arising from the UK's departure from the EU. Until 2020 the UK was able to easily export its finance to the continent thanks to the passport system in force between EU member States. Indeed, under the passport system, once authorized by the competent authorities of a given Member State, a financial services firm can operate in all other Member States without the need for further authorizations. To get an idea of the relevance of the passport in the exchange of financial services between the EU and the UK, it is useful to consider that according to the Financial Conduct Authority (FCA) in 2016 the total number of passports inbound and outbound the UK was 359,000, of which 23,532 inbound and 336,421 outbound [EURO-CEFG, 2017][8].

Following the loss of the passport (from January 1, 2021), the access of British financial firms to the EU market becomes much more complex. Basically there are two alternatives available: the repatriation of operations to the EU or the achievement of an equivalence determination by the EU Commission. Both options, however, will entail significant additional costs for the UK financial sector with respect to the frictionless passport regime.

Option 1 (repatriation) is inherited from WTO standards, which recognize the supplier of a third country the opportunity to open a subsidiary in the host-country to be able to offer its financial services. Unlike branches (which are a mere

[8] More in detail, «*inbound passports*» are meant as passports into the UK from the European Economic Area, whereas «*outbound passports*» are meant as passports of UK firms into the European Economic Area. The European Economic Area, abbreviated as EEA, consists of the EU member States and three countries of the European Free Trade Association (Iceland, Norway and Liechtenstein, excluding Switzerland).

extension of the main office), subsidiaries are in fact legal entities distinct from the main office and subject to the regulation and supervision in force in the host-country in which they are established. Many financial services firms have opted for repatriation, as it is often perceived as less uncertain than the complex and still largely opaque framework surrounding the equivalence decision. According to the Ernst & Young (EY) Financial Services Brexit Tracker, 43% of Financial Services firms have moved or are planning to move some UK operation and/or staff to Europe, taking the total number of Brexit-related job moves to almost 7,600 as of early March 2021[9].

However, repatriation is not without costs for the UK financial industry and for the strength of the City of London as international financial centre. These Brexit-management moves, in fact, could lead to a greater fragmentation of the European financial markets, with consequences that could undermine the attractiveness of the Square Mile (the other name for the City of London).

As an example, consider that the establishment of a subsidiary implies that the new entity needs to fulfill specific capital requirements: therefore, a more or less large part of the capital envelope that prior to Brexit was concentrated in the London headquarters would have to be split across subsidiaries scattered among various EU countries. Part of this capital re-allocation is already in progress (if not actually happened). The above mentioned EY tracker reveals that since the 2016 referendum, 24 financial services firms have declared they will transfer almost £ 1.3 trillion of UK assets to the EU by the early months of 2021.

The ability to pool together a huge amount of capital is one of the strength points of a global financial hub. Should this comparative advantage fade, it would be a huge loss for the City. Not surprisingly many UK-based financial firms have thought of getting around the problem by resorting to back-to-back trading, that is

[9]See:https://www.ey.com/en_uk/news/2021/03/ey-financial-services-brexit-tracker--uk-financial-services-firms-continue-to-incrementally-move-assets-and-relocate-jobs-to-the-eu-but-changes-since-the-brexit-deal-are-small.

by duplicating transactions in order to maintain money and risk management activities in London. Here is the description of such a practice in an article appeared on the Financial Times (Jenkins, 2017):

«*So-called "back-to-back" trading allows an entity in one jurisdiction to carry out a duplicate transaction in a larger location. So a deal done on the ground for a client in Lisbon can actually be booked in London. Banks, which already use the mechanism routinely to book business from Asia, Africa and Latin America through London, will be able to do the same for transactions originated in the EU27. This is a big deal for banks, because it suggests they will be able to continue centralizing their European capital needs and risk management in London*».

Yet, as observed in the same article, this strategy is hard to implement due to the warnings issued by the EU competent financial authorities; in particular, the European Banking Authority (EBA) has stated that EU subsidiaries must not be empty shells units and that it will not be accepted the resort to back-to-back trading on an excessive scale [EBA, 2017].

Option 2 conditions the cross-border supply of financial services in the EU territory by third countries' operators upon the release of an equivalence determination by the European Commission, which decides after having assessed whether the regulatory and supervisory regime of a non-EU country is sufficiently aligned with the corresponding EU regime or not.

The decision on equivalence comes as a result of a complex process: one or more of the European Surveillance Authorities[10] (ESAs) issue a technical advice to the European Commission, which is responsible for the final decision. Often the Commission decides according to the indications of the ESAs, but it can also independently carry out an additional investigation before ruling.

Equivalence may be granted in full or partially, for an indefinite period or with a time limit and may apply to the entire supervisory framework of a non-EU

[10]European Banking Authority (EBA), European Securities and Markets Authority (ESMA) and European Insurance and Occupational Pensions Authority (EIOPA).

country or only to some of its authorities.

EU law on financial services contains around 40 provisions allowing the Commission to rule on equivalence [Deslandes *et al.*, 2019]. These provisions cover *only a small portion* of the core banking and financial activities ruled by the EU legislation, whereas most of them are excluded from the equivalence regime as an access route to the single market, as in the case of deposit-taking and lending, payment services and investment services to retail clients[11] [*ibidem*].

Furthermore, it has also to be recalled that, after having recognized the equivalence with respect to the relevant European sectorial provisions, the Commission retains the prerogative to monitor the ongoing status of the equivalence decisions and, with it, the power to suspend or even withdraw such decisions at any time and at short notice, including those issued for an indefinite period.

The described regime is clearly intended at safeguarding the interests of EU customers of financial services by preserving the right of the Commission to decide unilaterally and independently not only on the adoption but also on the suspension or withdrawal of equivalence[12]. These decisions cannot be appealed by the third country at stake. Thereby the Commission can promptly take corrective interventions when it detects excessive deviations of the relevant legal or regulatory framework of a third country compared to that in force in the EU.

From the standpoint of third-countries financial services firms, this set-up creates an unpleasant climate of operational uncertainty. For this reason, for a large part of the trade talks the UK government sought to obtain a permanent equivalence determination on its financial regulation from the EU. These attempts, however, were in vain, as the European Union clarified its unwillingness

[11]Activities for which the possibility of an equivalence decision is not contemplated can be carried out by third-countries financial firms through the establishment of subsidiaries within the EU borders (and, therefore, subject to European regulation and supervision) or in the hypothesis of reverse solicitation.

[12]In mid-2019 the EU has decided to not renew the equivalence status it had previously recognized to Switzerland's financial market rules.

to make similar concessions from the early stages of the negotiations[13].

The seeming intransigence of the EU needs to be contextualized in the broader scenario disclosed by the Brexit. One of the main workhorses of the pro-Brexit campaign in the United Kingdom was precisely the desire to regain legislative and regulatory independence from Europe. It makes therefore understandable the EU decision to manage this crucial aspect of the negotiations with an iron fist approach. EU institutions aim to prevent member countries from becoming easy prey to financial colonization by UK firms, which – should the requests of the UK government had been accepted – could have benefited from systematic regulatory arbitrage opportunities (given the concrete risk of a turn in an ultra-liberal sense of the UK regulatory framework).

In 2020 the UK government has had to take note of the firmness of the EU position and has updated its requests with the proposal of a regulatory cooperation for the purpose of establishing and maintaining, among other things, «*transparency and appropriate consultation in the process of adoption, suspension and withdrawal of equivalence decisions*»[14].

And actually this is what the UK more or less achieved. Attached to the TCA is a non-binding Joint Declaration by which the Parties commit to make their best endeavors to pursue regulatory cooperation and to carry on the discussion on how to move forward on specific equivalence determinations. The new framework for regulatory cooperation should be codified in a Memorandum of Understanding (MoU) to be signed by the end of March 2021, but it seems unlikely that the MoU can go much further than the umpteenth declaration of making any effort to carry on the dialogue on the possibility of future positive equivalence decisions on a case-by-case basis.

As aforementioned, the main obstacle to an actual agreement on

[13]See: https://www.consilium.europa.eu/media/37059/20181121-cover-political-declaration.pdf.
[14]See:https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachmentdata/file/886010/DRAFT_UK-EU_Comprehensive_Free_Trade_Agreement.pdf

equivalence are the EU strong perplexities about the UK ill-concealed ambitions of a second wave of financial deregulation. These perplexities are part of the broader EU concerns about the actual compliance by the UK with the TCA provisions aimed at ensuring open and fair competition through a leveled playing field on key topics such as environment and climate, labor and social standards, State aids and taxation.

In 2020, following the UK application for the EU equivalence determination on 28 distinct areas, the Commission has involved it in multiple rounds of clarifications, with particular regard to *«how the UK will diverge from EU frameworks after 31 December* [2020 and] *how it will use its supervisory discretion regarding EU firms*»[15]. The Commission also announced that it has taken note of the equivalence decisions taken by the UK on 17 areas relating to banking and financial activities, underlining that these decisions were taken in the UK's interest and that *«similarly, the EU will consider equivalence when they are in the EU's interest*»[16].

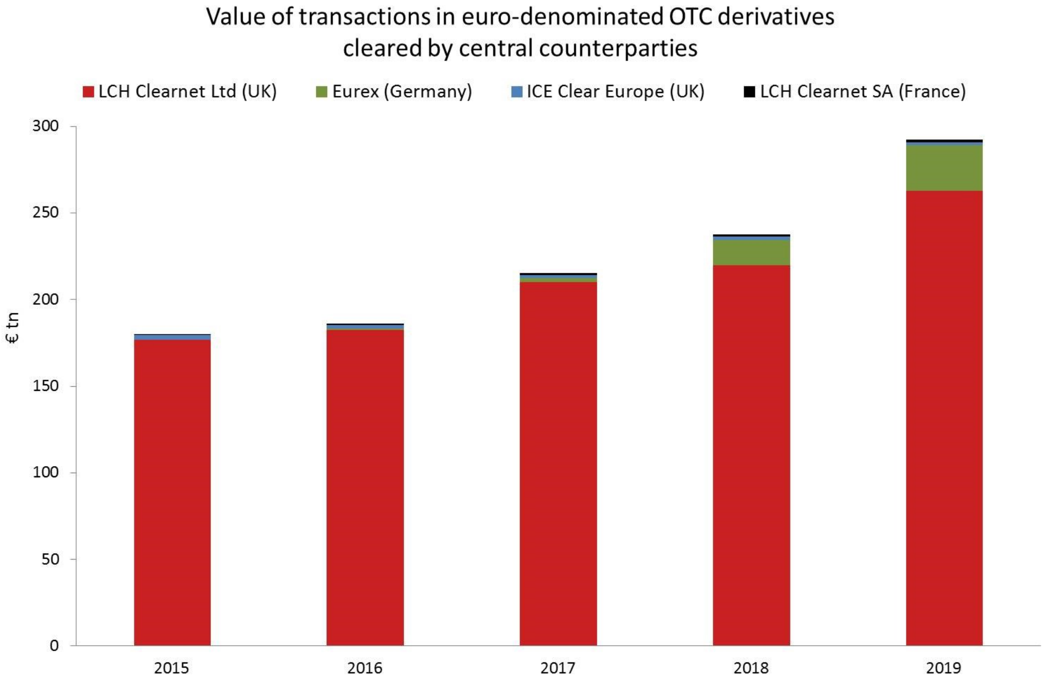
So far the EU Commission has taken a temporary equivalence determination on only two areas of the UK regulation: central securities depositories and central clearing counterparties (CCPs). Central securities depositories will be considered EU-equivalent until June 30, 2021, and CCPs until June 30, 2022. The Commission's favorable ruling on these two areas stems essentially from an assessment of convenience for the EU, whose financial industry is deeply reliant on the relevant UK market infrastructures.

This is especially true for London's clearinghouses such as LCH Clearnet Ltd and ICE Clear, which are among the major players worldwide and in practice monopolize the clearing of euro-denominated derivatives (Fig. 24) with market shares over 90% and annual revenues of around $ 400 billion. In 2019 they cleared euro-denominated derivatives for a value exceeding € 260 trillion, more than 10

[15]See: https://ec.europa.eu/commission/presscorner/detail/en/qanda_20_2532
[16]*Ibidem*.

times that of the main EU competitor, the Eurex (Minenna, 2021).

Figure 24



Source: European Central Bank

This explains why the Commission considered unaffordable the risk to the EU financial stability resulting from the sudden loss of access to the clearing services provided by UK-based counterparties. Probably its intention was to give the European financial sector the time necessary to prepare adequate market infrastructures on the continent and thus allow a smooth transition of market operators from London to financial centres established in the EU. For this reason, many observers are convinced that the equivalence determination on CCPs (and, actually, also that on central securities depositories) will not be renewed upon expiry, leading to the end of the monopoly of London's clearinghouses.

Something similar is already occurring for the trading of euro-denominated shares. Article 23 of EU Regulation on Markets in Financial Instruments (MiFIR) states the so-called share trading obligation (STO), which requires that the trading of shares that are admitted to trading on an EU regulated market or trading venue must take place on a regulated market, multilateral trading facility or systematic internalizer or on a third-country trading venue assessed as equivalent by the EU Commission[17]. With regard to the relevant UK regulation the Commission has decided not to grant – even temporarily – equivalence, with the only exception of stocks traded in pound sterling that, however, account for less than 1% of EU total trading activity. As a consequence, in January 2021, Amsterdam overtook London for the first time in history as the largest shares trading venue in Europe, posting an average daily share value of 9.2 billion euros versus 8.6 billion euros made by the City [Vaghela, 2021]. In the same month also other EU financial centres (Dublin, Frankfurt, Paris and Milan) recorded an increase in their average daily share values.

One could argue that the European Union is using equivalence as a political weapon to relegate Britain to the role of rule-taker. Yet, in this regard, it should be noticed that the issue of equivalence – however complex and controversial – embodies the irrepressible protection needs of European savers and investors who cannot be subordinated to the profit targets of UK finance. The whole thing must also be contextualized in light of the UK's questionable track record during the negotiations. On the British side, the negotiations were in fact repeatedly marked by unexpected moves such as the publication of the Internal Market Bill, which – as said in § 3.1. – included provisions in contrast with the commitments made by the UK in the 2019 Protocol on Ireland and Northern Ireland.

Of course, the Square Mile already initiated several counter-moves to minimize the impact of Brexit on its prestigious position among world's top financial centres. In February 2021 it resumed trading on Swiss shares, which the UK had lost in mid-2019 together with the rest of the EU[18]. Furthermore, the FCA is moving to a softer approach on dark trading for stocks than the one enshrined under the provisions of the relevant EU Directive (MiFID-II). Dark trading is the

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[17]There are some exceptions: trading on venues other than those provided by MiFIR is allowed when it is non-systematic, ad-hoc, irregular and infrequent, or when it is carried out between eligible and/or professional counterparties and does not contribute to the price discovery process.
[18]See footnote 12.

expression commonly used when financial instruments are traded on platforms that allow to execute transactions with a low pre-trade transparency. To safeguard market integrity and the effectiveness of the price discovery process, MiFID-II introduced a limit (so-called double volume cap or DVC), which basically limits the amount of dark trading in any share to a given percentage of total trading in that share. In December 2020 the UK regulator announced that it would no longer automatically apply the DVC to UK stocks, and in March 2021 the measure was extended to all other stocks. The move aims at recovering part of the business lost after the departure from the EU by attracting large international investors who are often interested in maintaining anonymity at least on part of their operations.

Recently the UK has also launched a review of the listing rules that is going to relax provisions on free float requirements and dual class shares structures. The review is mainly intended to promote the imagine of the City as the best place where to make the IPOs of tech companies that, as well known, often resort to dual class structures to preserve the powers of the founding shareholders. A particularly favorable regime will apply to the IPOs realized through Special Purpose Acquisition Companies (SPACs), the new US-born trend of shell companies established with the only purpose of raising public capitals to invest in the purchase of one or more operating businesses [Keown and Saigol, 2021].

The initiatives described above could hint that Britain is betting on a competition to the bottom with the EU, that is, on a softening of its financial regulation compared to that of the EU bloc. At the moment, however, it is too early to understand whether the UK will decide to press to the bottom of the accelerator of financial deregulation. A possible alternative could be, for example, that of a «*selective deregulation*», that is carving out the role of rule-maker in the new frontiers of banking and finance while adopting a more accommodating attitude with the EU on traditional finance.

Many of the regulatory novelties adopted or planned by the United Kingdom have to do with the latest developments in the financial sector. This is the case, for example, of the fintech sector in which Britain is one of the main players worldwide. In 2019 fintech generated revenues of 9.9 billion pounds, an increase of 7.5% compared to the previous year: a performance that attracts massive investments (38.3 billion pounds in 2019) both from "classic" finance and from players looking for profit opportunities such as venture capital and private equity. The particularly friendly regulatory framework represents one of the most important success factors of this thriving industry. Six years ago, the FCA was the first regulator in the world to launch a regulatory sandbox, that is, a space that allows digital finance start-ups to test innovative products and services according to an agreed and supervised plan by the competent authority (Minenna, 2020). The UK is also at the forefront of digital banking (home to prominent names such as Monzo, Revolut and Starling), open banking and use of artificial intelligence to process the data made available by banks through the opening of the application program interfaces. And the Kingdom has also signed numerous bilateral cooperation agreements (fintech bridges) with non-EU countries (especially in the promising Asean-Pacific region), which will ensure London a key influence in defining the international regulation of this sector.

Diversified know-how, top-level market infrastructures, regulatory flexibility and openness to innovation are all strategic assets for British finance. Nevertheless, a mismanagement of relations with the EU risks turning into a downgrade for the UK financial industry. An excessively confrontational attitude could push the EU to aggressive retaliatory measures, resulting in a large hemorrhage of human and capital resources for the City and the rest of Britain.

As a first approximation, there is the danger of a substantial downsizing of the trade in financial services with the EU bloc which, as seen in § 4.2., alone contributes 40%-45% to the overall UK surplus in this service category. In addition, there could also be consequences on the global competitiveness of the British financial sector as finance benefits from the so-called «*eco-system effect*», i.e. the added value arising from the specialization of activities and the geographical concentration of certain resources and operations. Financial intermediation in a broad sense is fueled by experience, expertise, concentration of monetary resources (think of the importance of liquidity for the proper functioning of markets) and human resources and the ability to do and offer networking, that is to exchange contacts, views, ideas and to share projects. For this reason, the loss of influence and acquaintance with the EU market could prove costly for the City in terms of its ability to attract investments, transactions and projects even from non-EU countries[19].

Other financial centres located within the EU (such as Dublin, Amsterdam and Frankfurt), but also non-European hubs (such as Wall Street, Hong Kong and Singapore) could benefit from this. In the first months of 2021 some of these hubs have experienced a surge in their activities, including shares trading, trading and clearing of euro-denominated swaps and trading of carbon allowances.

From the EU's standpoint, Brexit – especially if the United Kingdom will make excessive use of regulatory independence – represents an opportunity to bring onshore a large chunk of the banking and financial activities that so far have taken place mainly beyond the Channel. This opportunity is, however, also a challenge for the European financial industry that in some areas – such as the central clearing of derivatives – is strongly reliant on the UK market infrastructure and is not equipped with equally developed in-house infrastructure.

Furthermore, Brexit could strengthen the multi-centricity of the EU financial system. Even before the UK's departure from the EU, the ECB had found some degree of activity concentration among a small number of hubs in banks'

[19]According to estimates released on January 2021 by the Centre for Economic and Business Research, London's financial services and associated professional services firms will lose over 2 billion pounds of GDP per year [CEBR, 2021].

relocation plans [ECB, 2020]. The possible consolidation of these dynamics in the coming years would make it appropriate to improve the interaction between the various financial centres of the Union. To this end, efforts would be needed to remove the barriers to the cross-border provisions of financial services which – despite the good results achieved by the harmonization of the European regulatory framework – still present strong differences between national regulations on several issues, such as tax and insolvency regimes.

All-in-all, it seems that future developments in the EU and UK financial systems will be necessarily affected by the way in which the two blocs will manage their future interactions both on a strictly financial and on a political-economic level. On the one hand, Britain looks the Party that has the most to lose in the financial services business and, therefore, should carefully assess how much regulatory divergence the EU will be able to tolerate. On the other hand, it has to be recalled that EU's interests in the UK market are not limited to trade in services, and rather a huge part of these interests is in the form of trade in goods with Britain. Even if the EU bloc can count on a privileged position as a negotiating Party due to the higher-level size of its economy compared to the British one, a too rigid attitude on delicate issues such as that of equivalence could push the United Kingdom to hasten the search for new partners, such as China, willing to satisfy its excess domestic demand for goods.

5. After a negotiation that lasted almost 4 years, on the eve of Christmas 2020 the European Union and the United Kingdom finally reached an agreement – the Trade and Cooperation Agreement (or TCA) – which governs their bilateral relations since 1 January 2021, the date of the UK's definitive departure from the EU.

At the heart of the TCA are the provisions governing the trade in goods and services between the two Parties, historically linked by deep and important commercial relations.

In the post-Brexit context, these trade relations will inevitably encounter frictions due to the fact that the UK is no longer part of the customs union and the single market. Not surprisingly, already in the aftermath of the 2016 referendum, economic and financial operators on both sides of the Channel have embarked on a difficult path to adapt to the new scenario.

With regard to trade in goods, EU suppliers have tried to reduce the dependence of their exports on UK demand; and, in turn, Britain has initiated a re-orientation of its imports towards non-EU source markets. These dynamics have contributed to the UK's shift to second place (after the US) as a partner towards which the EU records the largest surplus in global goods trading and have also made easier the boom in British imports from China.

However, these developments cannot be attributed exclusively to the outcome of the 2016 referendum as they were also affected by the tensions that have characterized international trade in recent years, including the tariff war between the United States and China and, more in general, the protectionist attitude of the US foreign economic policy during the Trump presidency.

Furthermore, the data for the period 2016-2019 indicate that following the Brexit referendum there was a braking in the growth path that had characterized the EU goods surplus with the Britain from 2012 onwards, but the trade volumes reached until 2016 held up.

The UK's decision to leave the EU also had a modest impact on bilateral trade in services, in which even after the referendum Britain maintained its surplus towards the EU, thanks to the strength of its financial sector and, more in general, of its knowledge-intensive business services industry.

In 2020, the outbreak of the Covid-19 pandemic, adding to the impending exit of the UK from the EU in an extremely difficult negotiating climate, instead led to a significant reduction in trade between the two blocs. To be most affected was the EU, which recorded a decline in its goods surplus and a widening of its deficit in services trade with Britain. The joint effect was a worsening of the EU's overall trade balance towards the UK of about 30 billion euros compared to 2019.

These numbers probably had a key role in the EU's decision to reach a last-minute agreement with the UK government, despite the unconvincing attitude shown by the latter on several occasions, including the publication of the Internal Market Bill with some provisions in contrast with the commitments undertaken in the 2019 Protocol on Ireland and Northern Ireland.

This interpretation would help to understand why TCA provisions are carefully detailed in dealing with trade in goods (at the core of the EU' interests) and instead address in a vague and incomplete way trade in services on which is the UK to have the major interests at stake.

As for trade in goods, the TCA has made it possible to avoid the application of quotas and tariffs at the EU-UK border for products that meet specific requirements in terms of rules of origin. Nevertheless, the introduction of customs controls, bureaucratic formalities and detailed rules of origin engenders frictions on bilateral trade relations, as evidenced by the huge reduction in trading volumes occurred in the first months of 2021. In order to minimize friction costs borne by domestic traders, both the EU and the UK will have to adopt timely and efficient border control procedures. Important initiatives in this sense have already been taken, for example, in France and Italy.

On the exports side, UK looks more disadvantaged than the EU, as it still lacks strong and efficient customs infrastructures and British producers may need a deep rethinking of their supply chains to be compliant with the preferential rules of origin introduced by the Agreement. Yet, this disadvantage is somehow offset (at least partially) on the imports side, where the UK could be tempted to exploit its structural deficit position towards the EU by further accelerating the re-orientation of its imports to non-EU partners, starting from China. Such a move would create serious difficulties to the many EU countries (Germany in the lead), given that the UK has so far represented one of the most important outlet markets for European goods at the global level.

In the field of trade in services, the greatest risks are looming for the British economy, which owes the EU a substantial share of its services surplus with the rest of the world. In spite of this, the uncompromising stance held by the EU throughout the entire negotiation prevented the UK from reaping significant benefits from the agreement reached at the end of 2020.

The main concerns relate to the resilience of the British financial sector (the most important in trading services with the EU bloc) in the face of the loss of a streamlined access to the European market. As recognized by the European Commission, the TCA covers financial services in the same way as they are covered in EU's other free trade agreements with thirds countries. Mutual commitments to grant continued market access to operators from the other Party will be subject to the PCO, which gives each Party the right to maintain or adopt measures for prudential reasons.

The TCA also explicitly rules out financial services from the MFN treatment and – what matters most – does not address the issue of equivalence determinations due to the express decision of the EU to carry out further assessments on how the UK will diverge from EU frameworks after the definitive withdrawal from the Union. Consequently, the main alternative for UK financial firms that want to offer their services in the EU is the repatriation of operations to the European Union through the establishment of subsidiaries. However, this is not a cost-free alternative since it requires moving human and financial resources across the EU, thus fragmenting their business across multiple locations and losing the benefits associated with the so-called «*eco-system effect*».

A few months after the agreement was reached (the TCA has not yet been ratified by the national Parliaments of EU countries), it is not possible to understand whether or not Brexit has the potential to undermine London's strong position as an international financial centre. A reduction in business with the EU is obvious, but it is too early to estimate its extent and, even more so, to understand whether and to what extent it will also impact on relations between UK finance and non-EU countries.

In its favor, the British financial sector can count on numerous strengths: diversified know-how, top-level market infrastructures, regulatory flexibility and openness to financial innovation. On the other hand, a too bold approach in the review of post-Brexit financial regulation could fuel new tensions with the EU and a tightening of the European Commission on key dossiers such as that of equivalence determinations.

All in all, the TCA represents an important milestone in redesigning trade relationship between the two blocs, and a major achievement for the EU, which was able to chisel the text of the agreement in order to protect its interests and avoid excessive concessions to Britain.

Future developments will depend on the commitment that the Parties will make to base their bilateral relations on solid cooperation. In an economic setting weakened by the heavy consequences of the pandemic, a cooperative conduct looks the best strategy to safeguard the respective trade interests and avoid harmful retaliation. Tensions emerged in the first part of 2021 on the issue of the Irish sea border and on the exchange of anti-Covid vaccines unfortunately do not seem to go in the right direction. Time will tell if the EU and the UK will be able to reverse course and establish a climate of greater serenity and mutual confidence.

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IMPACTS, CHALLENGES AND TRENDS OF DIGITAL TRANSFORMATION IN THE BANKING SECTOR

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ABSTRACT: *Driven by the 2020 pandemic's work-at-home mandates, the future of work in banking and finance may be in the midst of disruptive change. The digital transformation process of banks sees the development and strengthening of digital channels as one of the first and most important stages, without prejudice to the importance of the physical channel for specific needs. On the one hand, this duality between digitization and the human factor is reflecting in the multichannel strategies of the banks, which are increasingly moving towards a synergy between digital channels and human touch. On the other hand, a thorough review of customer service logics leads banks to review the operation of internal processes, introducing elements of innovation through structured work paths that lead to the construction and management of an innovation strategy. Accordingly, society wide trust in the use of digital instruments and processes in finance has bounded forward. Artificial intelligence, machine learning, big data analytics, blockchain ledgers, digital money, and myriad digitally developed financial derivatives are losing their mystery both inside and outside institutions and companies operating in banking and finance. The 2020 year repre-*

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sented a major watershed between the world before and after the pandemic. The health emergency, in fact, has profoundly changed people way of living, relating, working, training and make financial operations. The year 2021 will be decisive for the integration of digital technologies in the banks, changing both the degree of centralisation / decentralisation of decisions and the management of information and knowledge. As a result of both the economic crisis and more restrictive regulation, the bank's top management has become very sensitive to having everything more directly under control. The organizational pyramid has consequently to be simplified and flattened. The disruptive growth of societal trust in digital banking and finance could accelerate to achieve higher levels of efficiency, requiring the bank to learn, develop new knowledge and innovate, in order to achieve the necessary condition for its vitality in a competitive environment.

1. The need to initiate a rapid and adequate recovery of the banking sector (which is currently experiencing some economic and financial imbalances subsequent the pandemic crisis) can be supported by the simplification of processes and the consequent savings that are achieved by using technology with different solutions, suited to the various needs that are to be satisfied. The transition from "analog to digital" is at the centre of this reality, allowing the streamlining of workflows which is achieved through the automation of activities; hence a profound innovation of procedures, linked to the production and distribution of products and services, which underlies a new method of managing administrative, accounting and tax document

flows[1].

Digitizing operational models means activating the possibility of adapting and optimizing processes[2] by making use of data that can be inferred from intelligent analyses and with limited margins of error. In particular, the prospect of an activity able to generate profiled databases, intercept potential customers and retain those already acquired is outlined. Added to this are the gains in terms of efficiency, speed, and full control of the data flow; and indeed, dematerializing the physical space, also intended as a digital archiving and storage system, means realizing a significant economic saving that takes the form of replacing paper and stand-alone computer systems, with advanced digital repositories to store, update and share documents and multimedia content.

This, considering a better management of company channels aimed at persistent market analysis, allows a complete and single administration - built in relation to the behaviours, preferences, and actions of users both online and offline - which creates value. data, as well as higher levels of transparency. It can be deduced from this that the introduction (and the affirmation) in the banking market of advanced information systems offers the opportunity for an assessment of credit risk in an aggregate form, which positively interacts with the verification of creditworthiness. The prerequisites for greater consumer protection are also identified and, therefore, for a strengthening of their role “as an agent (and no longer a ‘reactant’)” in determining one’s decision-making process[3]; it emerges an underlying rationale of rebalancing the position of the consumer as a structurally weak party.

Therefore, the specificity of the process in question translates into an efficiency of the sector which implies a transformation of the same, realized through systems governed by innovative technologies and artificial intelligence. Further, the in-

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[1]CAPRIGLIONE & CASALINO, *Improving Corporate Governance and Managerial Skills in Banking Organizations*, International Journal of Advanced Corporate Learning (iJAC), Austria, vol. 7, issue 4, pp. 17-27, 2014.

[2]ALPA, *Il mercato unico digitale - The digital single market DSM*, Debates, Contratto e Impresa / Europa Journal, 1/2021.

[3]DAVOLA, *Algoritmi decisionali e trasparenza bancaria*, UTET, Milan, p. 55, 2020.

credible amount of data and feedbacks, which are generated thanks to the presence of the latter, constitutes a complex of useful information that allows to improve the products and services to be rendered to customers; hence a first beneficial effect (which affects the reality of the market) represented by a strengthening of the fiduciary bond of the latter towards the qualified parties. In addition, the emergence of digital technologies involves a change of mentality that leads banks to a critical review of their current organizational structure and, therefore, to identify appropriate strategic lines aimed at achieving the essential objectives that they propose.

From another point of view, it highlights the fact that the change, induced by digitization, also involves the relational forms that characterize the production processes; it involves, in fact, the dematerialization of physical places, to which is added the sharing of information in real time, the possibility of working, even remotely, in a single connected and collaborative environment. Hence the new participatory methods that favour activities that can take place in spaces that are not limited and can be managed remotely (from online meetings to customer assistance via chat, to interactions on IT platforms), with the same level of effectiveness as those up to now delivered onsite.

Naturally, the delay that, at present, characterizes the digitization process of the Italian credit sector in some operational areas, gives a glimpse of certain difficulties for intermediaries in carrying out the transition in question, which - at least in the initial phase - will encounter obstacles of various kinds due to the lack of familiarity with the use of management tools and decision support even in the definition of development strategies. It will be the acquired awareness of the advantages of digital, obtained through experimented operational forms that make use of the latter, to give an adequate impulse to what we could define a “genetic mutation” of the sector, overcoming any attitudes of closure and the delays that may be found.

Companies can be helped in identifying the strategies to be followed by external professionals, capable of identifying the critical issues, establishing the urgencies and the objectives in progress on the basis of the various automated systems offered by the market; if necessary revisited in the light of the purposes pursued, for this purpose by identifying the most suitable software and solutions, researched by subjecting them to a convenience screening. The work of these external consultants can facilitate the understanding of the specific needs of the company and based on these, recommend customizable technologies.

In this renovation work, basic functionalities may be necessary, to solve certain inefficiencies that emerged during the analysis phase, or more complex and ad hoc applications, or even management systems to be integrated with the pre-existing ones.

Naturally, in the face of the activation of such a process in the banking sector, a similar digitization will have to correspond to the entrepreneurial system which avails itself of the financial support of credit institutions. This need is particularly felt regarding SMEs, manufacturing, and service supply companies, which, in a context marked by automation, if they do not adapt even by accepting the digital transformation, could cause delays and severe “deadlock” conditions, which certainly would benefit from their prompt recovery.

2. Elaborating the meaning of digital transformation in its many aspects, allows clarity on priorities and objectives, based on a preventive analysis of the most urgent problems to be solved and on new sustainable short and long-range goals. This, of course, by comparing data from other countries and questioning a wide range of important economic issues in order to arrive at a micro and macroeconomic verification of productivity.

Therefore, the structure and operational dynamics, the division of labour, the value chain and the appropriation of value will have to be assessed. The related data will have to identify the effects of technological change[4], the role of investment policies for innovation and the implications of competitiveness in techno-

[4]DAFT, Organization Theory & Design, Cengage Learning, 2020.

logical transformation. From a general point of view, the tools with which the policy intends to intervene should be explored to help banking companies in facing the challenges posed by technological change; similarly, the role played by the supervisory authorities assumes particular importance, as they, with the adoption of specific regulations, could favour or condition this transformation process.

It is evident that we are in the presence of a reality that is difficult to define, also because it is the same corporate digitalization that pushes the banking market in a direction characterized by a continuous development of innovative processes, which will require ever-changing skills and will expose companies in the sector to costs destined to grow over time. This introduces elements of uncertainty in the evaluations of the decision-making bodies of the latter, forced to identify complex programmatic lines to avoid the unknown factor of a sudden halt in their development plans[5]. Hence a complex problem that involves many aspects: from the protection of competition to the management of data in a to-be perspective, to the dimension of the choices made taking into account their opportune profitability.

Naturally, a differentiated framework is envisaged by territorial area and by type of digitization processes adopted, which are affected, on the one hand, by the availability of large investments, and on the other by the execution times that are prefigured. The traceability to the strength of the corporations involved in these significant system changes gives the measure of the difficulties that must be overcome in order to reach acceptable results in a short time. It is clear that the investigation must be centred on the critical areas to be "remediated", following a strategy focused on the essential objectives and on the technological tools to be used based on their functionality.

In this context, the analysis must then distinguish the corporate reality start-ups of the recently established from that of medium-sized enterprises of not recent origins; the former are immediately projected towards digital progress, in the face of

[5]The digital market is expected to be driven at least until 2020 by the ICT solutions (Assinform, 2018), which have an average annual growth ranging between 5% and 7%.

the latter which will have to overcome the complex phase of change by abandoning the use of traditional tools (client-server systems centralized onsite, fax, documentary archives of evidential value mainly on paper[6], of uncoordinated internal and external communication, unsecured registers and repositories, etc.) and, therefore, the use of manual data entry operations for which the risk of errors and incompleteness is considerable. It is evident how the process in question affects the workflows[7], avoiding a waste of energy or stalemate conditions in the same manner; hence the prospect of a review of the current structure of the banking sector which presumably should show more and more interest in the topic of smart working. This will result, as mentioned above, in an analysis of the critical areas and in the search for new strategies and technological tools which, at present, are not yet well configurable as they are linked to the affirmation of skills not yet defined. in their explanatory essence, being profoundly different from those currently practiced, focusing on classic IT products and services.

From the above it is clear that the new “modus agendi” is preordained a leave nothing to chance or approximation from which the priority needs to innovate business models, now linked, more than in the past, to the identification of parameters and IT infrastructures capable of providing the most appropriate solutions in terms of utility operational and economic convenience.

To this end, it will be necessary for intermediaries to follow an “integrated and systemic approach in the renovation work to be carried out internally that emphasizes not only what ... (we are called upon) ... to do ... but above all how to do it”[8]. It is true that economic science has for some time highlighted the connection of this

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[6]CASALINO, ZUCHOWSKI, LABRINOS, MUÑOZ NIETO & MARTÍN-JIMÉNEZ, *Digital strategies and organizational performances of SMEs in the age of Coronavirus: balancing digital transformation with an effective business resilience*, Law and Economics Yearly Review Journal – LEYR, Queen Mary University, London, UK, vol. 8, part 2, pp. 347-380, 2019.
[7]BULLINI ORLANDI, RICCIARDI, ROSSIGNOLI & DE MARCO, *Scholarly work in the Internet age: Co-evolving technologies, institutions and workflows,* Journal of Innovation and Knowledge, 4(1), pp. 55-61, 2019.
[8]SUPINO, *I modelli di business nei settori ad alta innovazione*, final dissertation, Luiss University, p. 24, 2011.

model to the innovation of processes and products, hence the reference to the efficiency guaranteed by the former and to the profitability allowed by the marketing methods of the latter[9]. There is also the need to release the new operating forms of banks from the limited areas of technological development in-house in order to derive from the comparison possible competitive advantages with skills developed in different locations.

Therefore, the possibility of establishing a very deep link between the product market and the market for strategic factors is taken into consideration[10]. And indeed, the model business chosen requires not only the analysis of reliable alternatives, but also the collection of the data necessary to support the managers' intuition regarding the positioning of competitors, the reactions of the latter and the needs of the buyers.

On this point, it can be said that a business model that takes advantage of the possibility of combining digital technologies with financial services is also able to avoid the dangerous competition that FinTech companies will be able to exercise in the future. These, as is well known, are increasingly present on the markets, carrying out functions that involve credit activities, payment services and technologies supporting banking and financial services, that is to say tasks that, up to now, have been normally typical of credit intermediaries[11]. Hence the unavoidable need of banks to be able to cope with the entry into the markets of start-ups technological, which - using modern IT tools and the uncertainty of the reference regulatory framework - could constitute a valid alternative to them[12].

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[9]GAMBARDELLA & MACGAHAN, *Business Model Innovation: General Purpose Technologies and their implications for Industry Structure*, Long Range Planning, 2009.

[10]SILVESTRELLI & BELLAGAMBA, *Creazione del vantaggio competitivo dell'impresa nella strategia a livello di business*, in Fattori di competitività dell'impresa industriale. Un'analisi economica e manageriale, Giappichelli, 2017.

[11]TROIANO*, Fintech tra innovazione e regolamentazione, national conference «Fintech: prime esperienze e prospettive di regolamentazione»,* Rome, Università La Sapienza, 2017.

[12]BANCA D'ITALIA, *Fintech in Italy.* Fact-finding survey on the adoption of technological innovations applied to financial services, 2017.

3. In the presence of a significant change in the contents of the banking business, a rethinking the systemic structure of credit supervision is also necessary, considering that the legal order of the market must comply with the innovative processes that have profoundly changed the operations of members of the sector[13].

The analysis must be oriented in the first place to the research of the modalities with which the Supervisory Body places itself in relation to the operational paradigms suitable for ensuring that the ganglia of the regulatory system include a series of phenomena that to date escape the attention of the legislator. This obviously requires a detailed survey of the economic and financial fabric on which action is taken, given the primary purpose of filling regulatory gaps that undermine competitiveness and expose the stability of the system to risks.

More specifically, the supervisory authority will have to carry out a qualitative / quantitative verification of the information acquired regarding the possible exposure to “credit risk” of the banks engaged in loan transactions. Hence the specificity of the role now ascribable to the Control Body, consisting in a renewed ability to synthesize the results emerging from the analysis of the data in its possession. Naturally, for this purpose it will be necessary that the structures of the authorities in question (European and national) comply with the canons of the digitization process, eliminating the use of traditional information tools (non-networked and interoperable systems, e-mail, paper documentation, absence of standardized procedures, etc.) which still occupy significant space in their operational processes.

Faced with the affirmation of the technological paradigm, the essential role of function supervision remains, aimed at preserving the safety and solidity of the financial system and, consequently, at ensuring the safeguarding of savings and the correctness of credit operations. What changes are the methods of carrying out this function, which - thanks to the use of decision-making algorithms - should tend towards greater objectification of the forms of intervention, hence a desirable resizing

[13]ALPA, *Il mercato unico digitale - The digital single market DSM*, Debates, Contratto e Impresa / Europa Journal, 1/2021.

of the discretion that often characterizes its essence and, therefore, the overcoming of particular constraints in the past imposed on members of the sector.

From another point of view, the simplification of the verification activity that characterizes the supervision is considered, which can be configured following the application of automatic credit risk assessment systems in aggregate form and, therefore, of the new tools based on the use of advanced specific algorithms for creditworthiness processing. The latter, in fact, make it possible to make use of "variables of analysis through the use of big data analysis and the use of techniques such as knowledge discovery in this way, making up for the shortcomings of the traditional system"[14]. The processing of such data facilitates the simplified reading of the information elements, so it is possible to obtain a risk profiling of credit applicants which helps in carrying out the activity that is the responsibility of the sector authorities.

There is, therefore, a sort of physiological mutation of the supervisory activity in which, without prejudice to the reference to the canon of "sound and prudent management", as the founding criterion of this function, the interventional paradigm changes on the level of concreteness, which will be increasingly oriented to the use of mechanisms that make it possible to objectify the evaluation processes. It resizes, therefore, the 'discretion' which, since ancient times, has characterized the strategy of the sector authorities such as the European Central Bank (ECB) and the Federal Reserve System (FED). There is less possibility of having recourse to informal persuasion techniques (moral suasion), intended to be replaced by a' more pervasive action which, in the face of the results of certain checks, directly interacts with intermediaries.

In this context, it will be possible to witness the adoption of disciplinary measures which, while responding to the aim of facilitating the digitization process, subvert certain ordering principles that have traditionally characterized the credit

[14]DAVOLA, based on LEXIS NEXIS, *Alternative Credit Decision Tools: Auto & Credit Lending. White Paper,* p. 136, 2013, available on *https://risk.lexisnexis.com/insights-resources/white-paper/alternative-credit-decision-tools.*

sector; this with an obvious negative impact on the national situations on which these measures impact. We refer, in particular, to the line followed by the ECB and FED to favour the large banking dimension.

In this regard and indeed, the president of the Supervisory Board of the ECB, Andrea Enria, recently argued that banking combinations in Europe serve to restore profitability to the sector, reduce excess production capacity, accelerate the revision of IT systems, develop new technologies, rationalize the branch network[15].

An orientation is envisaged that, in countries such as Italy, could determine a disconnect between the financial reality (represented mainly by large banks that are part of aggregations requested by the authorities) and the entrepreneurial system (consisting of a significant number of SMEs). The thesis supported by Governor Visco, according to which "for many intermediaries the limited size, together with their prevailing specialization, often does not allow to make the necessary investments in technology, innovate products and processes, exploit economies of scale and diversification"[16]; thus, reaching the denial of the principle pluralistic that has always characterized the Italian banking system.

4. The digital transformation process of banks sees the development and strengthening of digital channels as one of the first and most important stages, without prejudice to the importance of the physical channel for specific needs. On the one hand, this duality between digitization[17] and the human element[18] is reflected in the multichannel strategies of the banks, which are increasingly moving towards a synergy between digital channels and human touch. On the other hand, a thorough review of customer service logics leads banks to review the operation of internal pro-

[15]Editorial issue *Banche: Enria, aggregazioni servono sempre non solo in questa fase,* available on *www.ilsole24ore.com/radiocor/nRC_28.07.2020_10.27_20810208.*
[16]Public relation of ABI (Italian Banking Association), September 2020.
[17]BOCCARDELLI & IACOVONE, *L'impresa di diventare digitale. Come la rivoluzione tecnologica sta influenzando la gestione di impresa*, vol., Il Mulino, 2018.
[18]KEHOE & WRIGHT, *The impact of high-performance human resource practices on employees' attitudes and behaviours*, Cornell University, 2013.

cesses, introducing elements of innovation through structured work paths that lead to the construction and management of an innovation strategy. The 2020 year represented a major watershed between the world before and after the pandemic. The health emergency, in fact, has profoundly changed our way of living, relating, working, training and is also impacting shopping habits, increasingly aimed at the digital world. The year 2021 will be decisive, although full of unknowns: if the crisis were to be resolved, at least in part, we will begin to see which aspects of the new normal will influence the future, while if it continues, companies and other social actors will have to find further solutions to face it. One thing is certain: starting from the year 2020 the digitization process of companies has had unprecedented momentum. Growth involved all economic sectors in different ways. Even if the future is still uncertain, it is useful to take stock and understand what the consequences of the digital transformation have been, taking into account its peculiarities[19].

The banking and financial sector transformed during the pandemic, even acquiring a name that now circulates in newspapers and information sites: fintech, a union between technology and finance. Financial institutions have been able to continue to operate and offer innovative solutions thanks to digital. The banking sector is one of the most innovative of the moment and will evolve further in the future as well.

Emerging technologies, such as Artificial Intelligence, are further entering banking systems, allowing customers to meet their needs more quickly and effectively. For example, personalized home banking is now widespread, which thanks to the use of digital devices allows you to manage all the details of your account, financing, or other aspects of the contract remotely.

Customer service is already handled by bots, which strike up a conversation and help people, thus cutting waiting times. At the same time, banks have contribut-

[19] CASALINO, *Behavioural Additionality and Organizational Impact of European Policies to Promote Internationalisation of High-growth Innovative SMEs*, Journal of International Business and Economics, American Research Institute for Policy Development, USA, Vol. 2, No. 4, pp. 17-44, 2014.

ed to the spread of digital payments, such as contactless or payments via applications on mobile devices. Not to mention that, thanks to agreements with the public administration and other international bodies, they have made it possible to manage financing and loans in an increasingly effective way.

In the future, credit institutions will become “financial wellness partners”, which means that they will not limit themselves to using technologies to meet customer needs but will use more and more data and artificial intelligence to propose personalized banking experiences, offer financial solutions based on the single. Some institutes are also starting to offer companies participation in tenders for SMEs linked to subsidized loans and the like, based on sector, size and other requirements. They will therefore be increasingly proactive in the financial management of people.

Covid-19 has given a decisive acceleration to the digitization of the financial and insurance sector, both from the point of view of the demand and supply of services: if Fintech has always been considered an opportunity, now it has also become a great necessity that can only make the system more efficient. But beyond the emergency, in the world there is an ecosystem[20] that moves decisively, between agreements and collaborations, to guarantee the customer a quality user experience for consumers, increasingly demanding on speed of response, ease of interaction, integrated and personalized services. For banks and insurance companies, start-ups and new innovative players are not only competitors, but subjects with whom to create important synergies[21].

The banking sector in recent years has recovered a lot in terms of digitization: being one of the most conservative sectors, the great diffusion of digital has inevitably had innovative effects, with all the positive consequences of the case. There are numerous major changes affecting the banking sector.

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[20]PELLEGRINI, USKOV & CASALINO, *Reimagining and re-designing the post-Covid-19 higher education organizations to address new challenges and responses for safe and effective teaching activities*, Law and Economics Yearly Review Journal - LEYR, Queen Mary University, London, UK, vol. 9, part 1, pp. 219-248, 2020.

[21]COSTA, GUBITTA & PITTINO, *Organizzazione Aziendale – Mercati, gerarchie e convenzioni*, Mcgraw Hill, 2021.

5. The enormous success of digital banking represents the real turning point in the evolution of this sector: the progressive approach of customers to the banking world through digital tools such as smartphone apps and user-friendly platforms have in fact marked the end of traditional banks and the beginning of a new era. Furthermore, unlike what happened in the past, the typical customer does not have a single current account.

This happens because of the greater possibility of choice, different solutions are used according to one's specific needs: from liquidity to the management of one's savings, therefore, the answers are different from time to time.

Precisely with the aim of meeting more types of customers (young users in the first place), banking institutions are veering more and more in the direction of an innovation that makes simplification its strong point. For this reason, the products and services offered must also be accessible to those who have never used them: clear examples are the digital institutions that allow you to obtain loans in 24 hours, thus putting simplicity and speed in the procedures necessary for the first place. the request and, consequently, the customer experience. This simplification process is obviously bringing its advantages[22] to both sides: if banks manage to reach a greater share of customers, even those who use the services have a higher level of satisfaction, feeling this world less distant and cryptic, therefore closer to his daily needs.

Another fundamental factor in this perspective is the automation of a crucial aspect such as the relationship with the customer[23]. In fact, the application of artificial intelligence to customer care represents a way to support the customer at any time, thanks to the increasingly sophisticated and refined chatbots in terms of functionality.

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[22]PORTER, *Competitive Advantage: Creating and Sustaining Superior Performance*, The Free Press, New York, 1985.

[23]CASALINO, PIZZOLO, PINEIRO, ZIELINSKI, SMATER, VASSILEVA, SEYKOVA, HAJDUK, VAGAS & TULEJA, *Transfer of Technology and Innovation to Increase the Competitiveness of SMEs*, Scientific Letters of Academic Society of Michal Baludansky, vol. 7, n. 1, pp. 23-27, 2019.

Of course, this does not imply the disappearance of the human component: the watchword in this sector is omni-channel, that is the presence on different channels, for a more effective and integrated contact with the customers.

If, thanks to digitalization, banks have improved their efficiency[24] by streamlining, centralizing, and cutting costs, it is legitimate to ask whether the resulting impact on the organization, corporate culture and skills is also conducive to increasing their capacity for innovation. In fact, it is not enough to aim for efficiency, the bank must also be able to be innovative and create new business models to adapt to environmental change. Therefore, it is necessary for it to learn because learning is an essential precondition for innovating. As for the possibility that digital technology replaces decision makers, the question concerns not only artificial intelligence but above all the future of so-called social physics which studies, on the basis of digital traces, individual and group behaviours.

However, it is doubtful whether the strengthened organizational-digital model can produce new knowledge. According to experts, machines are unable to produce it; in fact, they do not tell us what the direct links between cause and effect are. Statistical correlations do not explain these links or account for the underlying phenomena.

Therefore, thinking that digital transformation can eliminate intellectual work in the bank means not understanding that the bank, like any other company, cannot be managed as a mere "input-output" system; to grow and innovate it must be managed as a cognitive system and therefore its intellectual capital must be enhanced and developed. Apart from the emergence of a demotivating organizational climate and the disengagement of the staff reduced to increasingly fewer professional roles, not counting on intermediate management is just a way to reduce the ability to learn.

A staff far from the market is not certain that, also thanks to sophisticated dig-

[24] PFEFFER, *Seven practices of successful organizations*, California Management, 1998.

ital and information supports, it will be able to perceive and understand promptly the changes in demand, new opportunities, and competitive threats, which the structures in direct contact have. with customers. Also, the creation of centralized units with the task of dealing with innovation has the same limits if they do not interact and compare with the rest of the structure. Middle management has always represented a point of accumulation of knowledge given its functions as a link between centre and periphery as well as personnel management, and above all its strategic role of mediating between top management inputs and market feedback. Organizational theory excludes that a top-down management structure is modelled only on efficiency and an effective executive staff can develop a culture of innovation[25] and producing new knowledge[26].

For example, consider the creditworthiness assessment process. The creditors are no longer called upon to express their judgment but are replaced by statistical-mathematical models and credit scoring systems. In this way, for the assessment of credit risk, operators who upload the digital system with a defined set of data are sufficient when these do not flow directly to this system electronically. It is argued that an automated valuation model, in addition to being less expensive, evaluates objectively; but in reality, the bank risks moving away from the true knowledge of the customer and his actual financial problems because not all information, even the relevant ones, can be quantified, codified and transferred with digital procedures.

Consequently, banks are not only not certain to reduce information asymmetries towards customers, but also suffer an impoverishment of the skills and knowledge of their employees. In fact, by not interacting with the customer, they do not learn from the customer. Thus, real cognitive asymmetries are consolidated between the bank and the companies when the latter innovate, and often the bank remains outside the circuits of new knowledge.

[25] CORALLO, PASSIANTE & PRENCIPE, *The digital business ecosystem*, Edward Elgar Pub, 2007.
[26] KEHOE & WRIGHT, *The impact of high-performance human resource practices on employees' attitudes and behaviours*, Cornell University, 2013.

6. Digital technology has been at the heart of the change in the bank's organization for years. Many observers consider it the solution to relaunch business models in crisis but also the key to the success of the bank of the future.

In recent years there has been a lot of debate about whether we have entered a phase of transition to a change of era with digitalisation that is changing the way we think, act and our lifestyles. The issues on the table concern important issues such as the relationship between digital technology and quality of life, between digital technology and freedom, but also the anthropological scope of technological transformation and the possibility that problems can be solved with computers.

It is increasingly important to focus studies on the new organisational-digital models of banks that will increasingly be the basis of new banking governance. The ECB and the FED now recognize the usefulness of machine learning. It is therefore likely that we are at the beginning of a transformative path of traditional banking models although digitalization has accelerated in banks because of the economic crisis.

The issue of human capital and knowledge is part of this debate. The competitive capacity of a bank depends not only on its technological development, but also on the development of its intellectual capital. It is the latter that often unfortunately decrease the innovation. With staff cuts, traditional banking skills are being reduced because new entrants are chosen with predominantly technological skills. Therefore, the organizational digital model requires corrections and measures that restore and supervise the learning function of the bank with a view not only to the optimization of the existing, but also to a continuous innovation and exploration of new businesses.

This means less top-down management style[27], engagement, delegation, motivation and enhancement of middle management, creation of learning infrastruc-

[27] CICCHETTI, *La progettazione organizzativa*, Franco Angeli, Milan, 2004.

tures, review of operational roles, sharing of knowledge.

If we look at the economic and social impact in EU and USA, the concentration in a few hands of large volumes of data collected through digital tools, which allow acquisition of knowledge about human behaviour, can be a serious danger. Apart from interference in privacy, it determines enormous power on the part of those who hold it.

So, there are similarities with the digital bank. This, if the control authorities do not take corrective action, feeds internal cognitive inequalities between top-level structures and operational structures that place staff in a position of strong subordination and that can impair the capacity for innovation[28]. The digital revolution undoubtedly brings great benefits, but it must be properly regulated at a social level, just as in companies and banks, management must manage digital transformation considering the right balance between technology and human capital.

Recent research on how banks' management structures are changing has shown a tendency to reduce the role of middle management and flatten organizational structures. But contrary to what the flatter organization theory says instead of a consequent empowerment towards staff, there is an increase in decision-making centralization, especially in large banking groups, and at the same time a reduction in the autonomy delegated to staff.

Banking work is now proceduralized in most business areas and controlled through digital reporting by the top management who no longer use intermediate management lines for this purpose. This is not only explained by the objective of reducing costs, in this period of economic crisis, by streamlining and flattening structures, but is also the result of increasingly invasive banking regulation that imposes greater internal controls on management[29]. In this way, the banks are pushed, we

[28]McKinsey&Company, *A future that works: automation, employment, and productivity*, McKinsey Global Institute, 2017.

[29]ARMENIA, CASALINO, GNAN & FLAMINI, *A systems approach to the Digital Transformation of Public Administration*, in *"The challenges of public management: new organizational models"*, Prospettive in Organizzazione journal, vol. 14, 2020.

might say back in time, towards the typical model of the mechanical bureaucracy that was widespread in the past when the bank was not yet computerized.

7. The digitization of processes instead of enhancing the bank's human capital tends to make it lose importance, requiring it to assume bureaucratic, essentially operational roles. Concerning a large part of the staff, this contrasts with the theory of business process reengineering and lean organization according to which ICT technologies should instead free work from routine, elementary and repetitive activities and increase the time to devote to intellectual activities. In addition, by assuming digital procedures a leading role of executive work, knowledge is centralized at the top of the company and above all the staff structures[30].

In the past, management, officials and generally bank staff were custodians of highly qualified knowledge, built with experience, and were able to interact with management on a strategic level, market developments and business valuation.

Knowledge was then distributed in the business context. Today this knowledge is very centralised. They are especially implicit in procedures, expert systems, and artificial intelligence. It is these intelligent systems that drive the behaviour of operational structures. There is no longer any need for staff to have a complex and interpretative knowledge of financial phenomena and decision-making skills. Staff are essentially required to be able to use the procedures correctly and to comply with the regulations. Thus, the relationship between digital technologies and employees has reversed: the ICT and the digital procedure are recognized as an intelligence while the user becomes an operational tool.

The diffusion of digital technology in the bank has therefore changed both the degree of centralisation/decentralisation of decisions and the management of information and knowledge. As a result of both the economic crisis and more restrictive regulation, the bank's top management has become very sensitive to having every-

[30]AHMAND & SCHROEDER, *The impact of human resource management practices on operational performance: recognizing country and industry differences*, Elsevier, 2013.

thing more directly under control. The organizational pyramid has thus been simplified and flattened. Efficiency has improved but management effectiveness is likely to have been reduced. In fact, the directional workload has increased, the internal dialectic has disappeared, the body spirit has faded, and the learning organization processes have weakened. Nonetheless, top management does not seem to care that much. In fact, he seems confident that he can govern the greatest complexity thanks to ICT technologies.

So, we are facing a challenge to Simon's limited rationality[31]? As the scholar observed, business decisions are never rational. They are conditioned by the information available, the cognitive limits of managers' minds and the time they need to be taken. As a result, they can only be relatively satisfactory. Today, however, the context has changed and is very different from when Simon elaborated on his important theory. Machine learning is thought to increase the rationality and objectivity of decisions through a higher predictive ability of behaviour made possible by the electronic processing of a wealth of information that was previously unimaginable.

In fact, the fact that banks are catching up on other operators and sectors and that a new bank model is being developed is becoming increasingly apparent. In fact, it is thanks to digital technology that top management is induced to shorten the hierarchical chain being able to directly control the operation. As far as the strategy is concerned, it believes that it can also be centralised with a good support staff. Thus, the strategies fell from above without comparison, internal dialectics, and involvement of operational structures[32].

Driven by the 2020 pandemic's work-at-home mandates, the future of work in banking and finance may be in the midst of disruptive change. Because this disruptive change is not just in banking and finance, but society wide, executives, support staff and customers (both institutional and private) have instantly developed ad-

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[31]SIMON, *A Formal Theory of the Employment Relationship*, Econometrica, vol. 19, no. 3, pp. 293-305, 1951.
[32]COSTA, GUBITTA & PITTINO, *Organizzazione Aziendale – Mercati, gerarchie e convenzioni*, Mc Graw Hill, 2021.

vanced capabilities in working digitally. Accordingly, society wide trust in the use of digital instruments and processes in finance has bounded forward. Artificial intelligence, machine learning, big data analytics, blockchain ledgers, digital money, and myriad digitally developed financial derivatives are losing their mystery both inside and outside institutions and companies operating in banking and finance.

Such a ubiquitous disruption means that formerly competitive organizations who seek relief in a return to old ways of working could be hopelessly outdated compared to competitors that capitalize on their own newfound digital skills, those of their trading partners, and those of their customers. But such a trust in a more digital society may quicken the pace of change. The disruptive growth of societal trust in digital banking and finance could accelerate to achieve higher levels of efficiency, requiring the bank to learn, develop new knowledge and innovate, in order to achieve the necessary condition for its vitality in a competitive environment. The bank runs the risk of suffering, without knowing or having noticed, but neglecting its effects, an impoverishment of its human capital. In this way, the company's top management risks losing control of the bank thinking instead of strengthening it.

Meanwhile, there is much to object to the effectiveness of centralised planning systems. The supportive technostructure, not being involved in the operation, from which it remains distant, can only reason according to deductive logics, macroeconomic analysis, scenarios, and simulation models. There are therefore serious doubts about the actual diagnostic and design superiority of these approaches over participatory systems, information flows and indications that can also come from below. Nor can it be considered that innovations of any kind proposed by the base, regardless of their relevance, are to be discarded because having to be digitized, creating integration[33] problems so that innovation can only be the responsibility of the centre that can manage it systemically.

All this could be further strengthened with a view to a fully virtual bank and a

[33]GHOLAMZADEHA & JALAIB, *Integrative approach in human resources strategy formulation*, Elsevier, 2012.

predominant use of big data and intelligent algorithms to be able to cover the needs of the several stakeholders[34]. It is believed that they are a fundamental support for decisions because they allow to identify recondite correlations between large masses of data with which to predict customer behaviour, risk trends, the probability of future scenarios.

[34]WU, *Towards a stakeholder perspective on competitive advantage,* International Journal of Business Management, vol. 8, 2013.

A STRATEGIC FRAMEWORK FOR THE CONSTITUTIONAL COURT

Bruno Chiarini * - Maria Carmela Aprile **

ABSTRACT: *The Constitutional Court should change its role and develop a cooperative context between the parties, rather than continue with a Manichean vision between the parties (especially in conflicts between lobbies and government). The current decision-making process of the Court, at least in the Italian experience, has shown an inadequacy: it does not have the necessary tools to sentence. In fact, the requests for the unconstitutionality of government policies, often advanced, through judges, by different lobbies fall into different contexts (juridical-political and economic) and in these contexts the judgments of the Court risk creating uncertainty in the economy. Rather a different role could be to generate a focal point on which the parties should converge.*

1. The "economy" is a complex interaction between economic agents with specific, possibly different, preferences, institutions and laws that regulate behavior and markets. Often the solutions found by a government (tax or expenditure policies, maneuvers, structural reforms) to improve social well-being (and also the probability

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of being re-elected), are opposed by lobbies and pressure groups that see their interests endangered or affected by these political interventions. A useful tool that the opponents can resort to, is the unconstitutionality of the maneuver in question. The appeal to the Constitutional Court takes place through a judge or a legal institution which challenges the non-constitutional nature of the reform or at least of some of its parts. The Court becomes a third party on a plethora of issues not only purely political but also economic.[35]

However, the question is not so simple. In this context, the institution of juridical review raises important questions concerning the separation of law and politics: when the judiciary declares government actions (policies, reforms) unconstitutional, it influences on the political objectives of the voters' representatives. Constitutional review thus invariably places the judiciary in the political fray (as the politicians) and triggers the debate about the correct role of judicial revision in a democracy in the face of government policies. On the contrary, limiting constitutional review allows the government a proper space to enact and implement policies and therefore to exercise its constitutionally assigned policy-making role (see Dragu and Simpson 2015).

In this paper we advance a new strategic framework for the decisions of the Constitutional Court, starting with some stylized facts concerning Italy. In the Italian case, we note that the Court sometimes takes the economic implications that the acceptance or rejection of the request produces into account, while, at other times, it does not take them into account.

The cases that we consider (but of course, they are not the only ones) are those that concern the constitutionality of the so-called "Robin Tax", a corporate income tax on the extra profits of oil and energy companies, and an electoral law approved by Parliament. Both court decisions rejected the constitutionality of the

[35]Some issues affecting the conflict between economic and legal implications in the context of the decisions of the US Supreme Court are passionately highlighted by Stephen Breyer, a member of Supreme Court in his lecture at the British Association for the Advancement Science. Breyer (2009).

proposed legal codes. However, while the supreme court took the possible effect of the former on the public budget into account, for the second (the electoral law), it did not take the possible implications of this rejection on budget constraints into account (a balanced budget is included in the Italian constitution). It seems that, for one case (Robin Tax) the Court is aware of the possibility of making contradictory decisions and, in this regard, has tried to avoid a contradiction, while for another case (electoral law), the Court appears to be unaware of this principle. This apparent oddity suggests that the Court does not have a framework for analysing the economic impact of its decisions. This lack of a framework, of course, can create uncertainty and inefficiency in the economy and suggests the need for a different decision-making model for the Constitutional Court.

Taking into account these constitutional sentences, in this paper we first, hypothesize the strategic consequences of a lack of interpretative framework of the Court. Precisely, when the Court is playing, unknowingly, on two different “spaces”, the legal space (where its decisions are unexceptionable and consistent) and the economic space, where the decisions show gaps in congruence. Secondly, aware that the recent literature on Law and Economics, considering the law as a third party capable of influencing society in selecting among multiple equilibria (McAdams 2000, 2015; Basu 2018), we advance some normative aspects of the Constitutional Court. Precisely, the Court should create for the contenders (judges and government) a wider space of action than that defined by a simple Nash equilibrium: a set valued equilibria where the players are not confined to a unique self-enforcing strategy. The recent literature on Law and Economics, points out how a sentence (of a judge or a court) can affect the society's selection of equilibria.

The strategic fremework that we will adopt to analyze these interactions hinges on the key concepts of Game of Life and Game of Morals. In Binmore (1994) setting, the former is a game where a full description of all the actions and strategies that individuals can choose. It is a dynamic concept and its rule are determined by a series of natural factors (demographics, geographical, biological etc.). We cannot alter the rule of Game of Life at will. The game of life is extremely complex, it is the game of all of the interaction of society. For instance, it is played in a much larger arena than a market game. The rule of markets games are interrelated and depend on social and legal institutions whose survival depends on how the individuals in a society are accustomed to play a much wider game (Binmore 1994). A social contract is an equilibrium of this complex game and this game generally presents multiple equilibria. Thus, a society or an economy can reform itself by moving from its current equilibrium to a new social contract. A Game of Morals serves to the individuals of an economy to select an equilibrium. The Game of Morals serves as an equilibrium selection mechanism (or a coordinating device) for the Game of Life.

This framework has been used by Basu (2018) to advance the theory of the “law as a focal Curb”: law cannot change the Game of Life, its strategies or the action open to the individuals, nor can it change the payoff functions of the individuals, but it can change their beliefs about what others will do without necessarily defining an area that is too narrow, such as the inefficient one typical of the "prisoner dilemma". For some contexts, the system of behavioral and strategic relationships is too complex to think that these should converge to a Nash solution like this. In this context, institutions must conduct beliefs in a set of possible stable solutions. Changing the individuals’ beliefs, and creating in this way a focal Curb, the law can lead the society to a new less inefficient and more realistic equilibrium. Only in this new strategic context, the Court as a third party, can plays a Game of Morals and removing the “veil of ignorance”.

Section 2, reports some decisions of the Italian Constitutional Court which have generated various economic implications, showing decisional ambiguity. Section 3 attempts to model the behavior of the Court in the face of instances of un-constitutionality in the government's economic policies. Section 4 advances a con-cept of focal curb as the Court's choice paradigm, requiring a more realistic game and referring to Binmore's theoretical specification of Game of Life. Section 5 concludes.

2. Below we briefly describe two decisions of the constitutional court that had significant economic and political implications.

2.1. The so-called Robin Tax is a corporate income tax (Ires) on the extra profits of oil and energy companies, which are linked to the rapid rise in international commodity prices but has been then extended to all operators' revenues. The Robin Tax (established with article 81 of the decree law n. 112 of 2008), introduced by the Berlusconi government, is a one-off tax (*una tantum*). Technically, the Robin Tax is an increase in Ires from 27% to 33%, and it would have resulted in an increase in the income tax for oil companies and an increase of the tax base for banks and insurance companies, a manoeuvre that should have led to an increase in revenue of approximately 2 billion euros, which would have balanced the cuts in the municipal property tax. Therefore, the Robin Tax sought to compensate for the budget gap generated by the reduction in property taxes of citizens by increasing the taxation on banks and oil companies (hence, the popular name of the tax, Robin Hood), but it would also block any speculation by energy and oil companies during a period marked by a sharp increase in raw material prices.

The question of the constitutional legitimacy of the Robin Tax was raised in 2011 by the Provincial Tax Commission of Reggio Emilia, with reference to some provisions of Law Decree n. 112 of 2008.

The sentence n. 10/2015 of the Constitutional Court judged the Robin Tax to be unconstitutional, but not retroactively so.[36] The Court, in fact, declared the cessation of the effects of the rules on the Robin Tax only from the day of publication of the sentence. Otherwise, the State would have had to proceed with refunds and reimbursements to the companies that had paid the IRES surcharge since 2008,

[36] According to the Court, the Robin Tax has led to an increase in the rate of an imposition that affects the entire income of the company and not "over-profits" only because it is missing a mechanism that allows it to separately and more severely only tax the part of the supplementary income connected to the privileged position of the activity exercised by the tax payer for the continuation of a given economic situation. The tax was created to cope with an exceptional economic situation but instead established as a structural tax to be applied starting from the 2008 tax period without time limits.

which would have totalled approximately 1 billion euros.

The choice of the Court to declare the unconstitutionality of the Robin Tax only for the future was dictated by the need to prevent the affirmation of a constitutional principle (Articles 3 and 53 of the Constitution, in terms of reasonableness and proportionality) from determining the sacrifice of another principle, as the retroactive application of the declaration of constitutional illegitimacy could have led to a serious imbalance in the budget.

2.2. With sentence no. 1 of 2014, a new course of constitutional justice concerning the constitutional control of electoral laws began in Italy. Before this sentence, the electoral law was part of a rather heterogeneous number of laws, which for different reasons are more difficult to control by the Court.

In 2005, a new electoral law known as the “Calderoli law” (n. 270 of 2005) introduced a fully proportional electoral system, with a majority bonus and thresholds for lists and coalitions.

The Constitutional Court (sentence n. 1/2014) declared the majority premium and the failure to provide preference voting to be unconstitutional. The electoral law was then transformed by the Constitutional Court into a purely proportional law, with preference voting and no majority prize. [37]

Proportional electoral systems favour an increase in public spending and, consequently, an increase in debt.[38] Empirical analyses performed by Kontopoulos and Perotti (1999), Ricciuti (2004) and many others show how public expenditure increases when the number of parties that form a ruling coalition increases and that this situation more likely occurs under proportional rule. If this assumption is more easily demonstrable from an economic perspective, it is less so from a legal point of

[37] With regard to the judgments that have taken place in recent years, the constitutional parameters that were deemed to be violated concerned the right to vote. In other words, the laws were considered unconstitutional because, in substance, they would not have made the right to vote, but not other parameters, much less those of an economic nature, fully effective.
[38]For a survey, see, Scartascini and Crain (2002); Persson and Tabellini (2003).

view. In other words, it is not easy to argue that, in view of the constitutional principle of a balanced budget, proportional electoral laws are, with regard to this specific profile, of doubtful constitutionality. The electoral models, abstractly considered, in fact, can be discussed for their characteristics and be evaluated on the basis of their positive and negative aspects but not in an abstract way that is more or less compliant or different from the principle of equilibrium.

3. Let us try to think of a strategic interaction where the judges (or the institutions that represent them) who turn to the Constitutional Court, are representatives of interests opposed to those of the government coalition. So when a government advances a reform or some economic policies, some legal institutions can challenge them by appealing to the Constitutional Court.

Thus, requests for verification of compliance with the constitution of some policy manoeuvers put forward by the government to improve the economic situation, are the expression of opposing interests. In other words, with the judge appealing to the Constitutional Court, we model, not only the relationship between the government and the Constitutional Court but, more importantly, the conflict between interest groups (judges) and government.

The game is composed of two players, the Court, who must accept (*A*) the judge's appeal and thus render the law in question unconstitutional or, on the contrary, reject (*R*) the claim of anti-constitutionalism put forward by the judge and let the law in question be put into effect. The second player is the judge, who puts forward a hypothesis of the unconstitutionality of the law in question (submit *S*) and compares the outcomes of the supporters of the law in question that instead motivate its constitutional legitimacy. For instance, in the case of the electoral law mentioned above, the judge either requests not to confirm the constitutionality of the law (*S*) approved by parliament or does not make constitutional revisions in this regard (*NS*). Obviously, the pair of strategies (*R, NS*) represents the status quo. If the *S* and *A* strategies, for judges and the Court, respectively, are understood to be dominant, the status quo loses the equilibrium connotation and causes players to deviate from this solution.

Table 1: Legal equilibrium and economic outcome

		Judge	
		NS	**S**
Constitutional Court	**R**	a_{11}, b_{11}	a_{12}, b_{12}
	A	a_{21}, b_{21}	x,y

In light of a strategic scheme such as the one presented, how can we analyse the consequences of the Italian cases listed above?

3.1. Suppose the Court does not have a clear outline of the repercussions that its decisions can have on the economy. This aspect highlights the role of information, which, in this case, is not perfect and is revealed in the game shown in Table 1 in the uncertain payoffs *x, y*. With appropriate restrictions, this game is a deadlock game, a sort of prisoner's dilemma, with dominant strategies and Pareto-optimal equilibrium: $a_{21} > x > a_{11} > a_{12}$ for the Court and $b_{12} > y > b_{11} > b_{21}$ for the Judge. The problem with imperfect information is that the Court can be convinced to play dominant strategies and to obtain the payoffs of a deadlock game while it is engaging, in fact, in a prisoner's dilemma, obtaining the Pareto solution that can be improved (inefficient) respectively for the Court $a_{21} > a_{11} > x > a_{12}$ and the Judge, $b_{12} > b_{11} > y > b_{21}$. Obviously, in both cases (Deadlock and PD)[39]:

$$A^* \in \arg\max_{A \in \sum_1} \pi_1(A, S^*)$$

$$S^* \in \arg\max_{S \in \sum_2} \pi_2(A^*, S)$$

[39] Obviously the equilibrium of the game, presented here as simultaneous, is supported by its sequential version.

(1)

This confusion can be represented by an inadequate economic scheme of reference or, in our cases, from a use by the Court of a partial equilibrium scheme instead of a general economic equilibrium model. Just think of the economic implications of the electoral law, not easy to analyse without taking into account the economic feedbacks and the relationships between the government structure and economic pathologies (for example, deficit and public debt).

The consequences can be significant, as shown in two simplified (the players are symmetrical and the payoffs certainly have no intrinsic value) cases pretend in Table 2:

Table 2: Confusion of the game

Constitutional Court \ Judge	NS	S
R	-3,-3	-5,0
A	0,-5	*-4,-4*

Constitutional Court \ Judge	NS	S
R	-3,-3	-5,0
A	0,-5	***-1,-1***

In other words, what causes confusion over the games the Court is facing is imperfect information regarding the two players' payoffs.

3.2. The lack of an analytical outline of the effects of the laws on the economy also leads to answering to a further question: Why does the Court sometimes seem worried about the implications of it rulings and sometimes not? The evaluation of judges who can present parameters to submit to the Court to better examine the unconstitutionality of a law also plays a crucial role in this aspect. In the case of the Robin Tax, the parameters, in fact, were mainly economic and of partial equilibrium. In the case of the proportional electoral law with a majority prize, it was not so simple, as the requests made by the judges were purely legal and political. The proportional electoral system is a system that has the advantage of guaranteeing greater political pluralism on the representation side. This aspect is positive, which, in itself, is an element that is fully consistent with the pluralist constitutional framework. We may hypothesize, for instance, that, in the purely legal aspect, the Court plays in the legal-political space. After all, as emphasized by Breyer (2009), the judges are "generalist" and their knowledge is limited. Moreover, we know that the economy reacts over time, it is often a matter of degree and, on some aspects, the economic theories are conflicting, while the law, at least in a final appeals court, often seeks clear administrable distinctions (rules). In this setting, the Court may well proceed with accepting the request to reject the electoral law based on the majority premium in favour of a purely proportional law. By contrast, in the Robin Tax case, the context space is the economic one. Thus, another aspect that emerges is that, instead of considering two games that are connected (or nested, see Tsebelis 1990), these are treated by the Court as separate games.

This scheme of analysis emphasises the lack of stability of Nash in different dimensions. First, at it is well known the problem is essentially that a Nash equilibrium only requires a deviation not to be profitable, rather than requiring that it actually involves a loss. The second related issue is that The concept of strict equilibrium may fail to exist. For instance, in our decision problem in the game of confusion, where the Court can choose between two distinct best responses (PD and Deadlock) or does not recognize the connection between two games, a strict equilibrium does not exist, although it exists in each single game.

4. The problem that emerges is therefore how to interpret the decisions of the Court and those of the Government in office on some issues that have purely economic and purely juridical-political implications. Those implications contribute to create ambiguity, affecting the conflict between government and pressure groups. The Court decision cannot be captured by a concept of equilibrium where each player is confined to a single optimal strategy. It is of Court interest to be able to identify a game's coordination-cooperation structure. The problem is that

economists and jurists need to keep in mind that the Game of Life is played in a much larger arena than a market game or a political game. Following Binmore, this game has multiple equilibria and, therefore, a Game of Morals is necessary.[40] If we think that the Court should play a prisoner dilemma or a deadlock game it means that we are specifying the model badly, with all that derives from it.

Basu (2018) argues that it may be futile to think of the law as unequivocally directing society to a focal point. In the context defined by the game reported above, the Court (the law) is unable to create an edifice of beliefs such that if everybody believes in it, everybody's belief is ratified. Since the Court cannot alter the game and the game has a unique equilibrium outcome defined by (1), the society would be destined to it. Basu shows the utility of set valued targets (equilibria). This type of reasoning is based on a crucial element that sees the law as necessarily ambiguous and requires two equally crucial changes in strategic behaviour: first, a different concept of equilibrium rather than the usual tight Nash, and second, letting the Court and judges (and government) not be confined to a single decision (strategy) but let them to choose a *set* of strategies. For reasons of realism, the logic is that nobody should be able to do better by choosing a strategy outside the set when others are very likely to use strategies in the set (or block as in Myerson and Weibull 2015).

First let's mention the ambiguity of the law. As Basu stresses, the ambiguity of the law is produced both by its interpretation and by the judges who must decide whether a particular action violates the law or not.

The ambiguity of the law is a rather broad and controversial topic. Here we stress that in spite of all good intentions, ambiguity of law does not denote a simple lack of clarity in language. Of course, the meanings of the words (and laws) are not always clear and unequivocal. They may be capable of being understood and interpreted in more ways by different people. When, on these interpretations, an unresolvable conflict is generated, as in the Constitutional cases, the Court is asked

[40] See also Sugden R. (2001) and Basu (2018).

to come up with its interpretation. This means that the law or in general, the legislative act (as far as we are concerned, the electoral law, or the law on the profits of some types of businesses or other economic manoeuvers of the government converted into laws) contains "ambiguity ". Paradoxically, ambiguity influences the Court itself, which interprets the Constitution and decides whether the manoeuver in question violates the Constitution or not (in our case, just think of the ambiguity of the Court in defining the Robin Tax reform unconstitutional).

Certainly, many might wonder if ambiguity could be appropriate for the decisions of the Constitutional Court, but if it is thought that it can be applied this would lead to enormous implications, especially if the Court has not clear the ambiguity that its decisions generate once inserted in a theoretical economic framework rather than in a juridical-theoretical one (and *vice versa*).

To be concrete, think of the Robin Tax's unconstitutionality sentence described in Section 2. What the Court has reported about the circumstances with which an economic measure can be considered unconstitutional and those for which its temporal applicability is justified, highlights three aspects:

i) First, it generates uncertainty as the non-retroactivity decision adopted for the Robin tax is completely arbitrary (it is related to contingent economic factors). Furthermore, the Court conjectures that the temporary factors that lead the government to limit the profits of some large companies will be considered permanent by the government itself, maintaining their taxation over time;
ii) second, it generates uncertainty because it does not represent a purely legal equilibrium;
iii) third, the decision on non-retroactivity is related to two other possible consequences concerning constitutional articles (violations of the articles of the Constitution relating to the budget constraint in balance and the needs of social solidarity) bringing out how, in fact, its decisions may be contradictory in themselves.

If the Court's decisions are ambiguous and generate uncertainty in society and in the economy, we can think of a non-Manichean role of the Court, which does not limit it to defining an optimal response to a conflict of interest between government in office and lobbies or pressure groups. Rather, it should be thought of as a coordination device rather than a simple third-party cheap talk focal point.[41]

The above PD game has not substantial realism. If this game (or the deadlock game) were played only once, by a pair of subjects in an experimental laboratory setting, then we would consider the equilibrium to be a reasonable characterization of how rational players might behave. One might plausibly argue that it would be the only reasonable characterization of rational behavior in such a situation, where the players have no history to guide them. But the Constitution compliance game is not played in such isolation. More commonly, Court's components, Judges, and government are aware of a history of similar games and its economic, legal and social consequences and this shared cultural history should influence the players' expectations about how the game will be played in the future.

We need to allow for the possibility that players may ignore some strategies that are feasible in the actual game. This leads us to take into account set valued games where the strategies of each player may be a subset of those actually feasible.

To simplify the set valued target concept by Basu and Weibull (1991), for a normal form game with a set of players *N*, we define with *X* a set of strategies closed under rational behaviour (CURB), that is a set composed of strategies that contains the best responses to any mixture over itself.[42] If players believe that no strategy outside of *X* will be played by their opponents, then such strategies will not be played by rational players. To get an idea of this solution, consider a game as a tuple $G = \{N, A_i, u_i, i \in N\}$ where set of players with a finite set of pure strategies A_i. The

[41]Many have proposed law and legal conventions as focal point to help people coordinate. See, amongst others, Myerson (2004); Hadfield and Weingast (2014); McAdams (2000), 2015; Basu (2018).

[42]Others definitions of set valued equilibrium (*rationalizability, preparation etc*.) is, amongst others, in Bernheim (1984), Voorneved (2004), Durieu et al (2003). See Myerson and Weibull (2015) for several definitions of *Block sets* and *Block game*.

utility function is a VNM $u_i : A \to \Re$, and $A = \times_{j \in N} A_j$. Now define a subgame of G obtaining by restricting the strategies set of each player to a subset $X_i \subseteq A_i$: $\{N, X_i, u_i, i \in N\}$. Finally, denote the set of mixed strategies of each player with support in the subset $X_i \subseteq A_i$ as $\sigma(X_i)$. We indicate con $\gamma_i \in A_i$ the profile of strategies for player *i* and his opponents mixed strategy profile $\varphi_{-i} = (\varphi_j) \in \times_{j \in N \setminus \{i\}} \sigma(A_j)$. So the profile of strategies are (γ_i, φ_{-i}). Thus, given a player *i* and the opponents mixed strategy profile φ_{-i}, the set of pure best responses of the player *i* to the opponents mixed strategy profile is:

$$\beta_i(\varphi_{-i}) = \arg\max_{\gamma_i \in A_i} u_i(\gamma_i, \varphi_{-i}) \tag{2}$$

If we denote the set of all games by Γ, a curb set of a game $G = \{N, A_i, u_i, i \in N\} \in \Gamma$ (a set of strategies closed under rational behaviour) is a (nonempty) product set $X = \times_{i \in N} X_i \subseteq A$ such that for each player *i* and each his belief $\varphi_{-i} \in \times_{j \in N \setminus \{i\}} \sigma(X_j)$, the set X_i contains all best responses of player *i* against his beliefs:

$$\forall i \in N, \quad \forall \varphi_{-i} \in \times_{j \in N \setminus \{i\}} \sigma(X_j): \quad \beta(\varphi_{-i}) \subseteq X_i$$

If no curb set is a proper subset of X, then the curb set is minimal. Thus, for a game $G \in \Gamma$, we have $\min icurb(G) = \{X \subseteq A\}$ where X here is a minimal curb set of G.

Thus, a minimal CURB set does not contain any CURB subset.[43] A set is CURB if the belief that strategies outside *X* will not be played and this implies that such strategies will not be played by players who are rational (because they never play strategies that are suboptimal). In other words, the set of pure strategy profiles *X* is CURB if in case all players believe that actions outside *X* are played with probability 0, then rational players will only play actions inside *X*. This indicates that the

[43] See Voorneveld et al (2005) for a comparison of the advantages of set-based solution concepts (such as the minimal CURB set) and point-valued concepts (such as Nash equilibria).

specification of the optimal strategy set being wider, for each player, is also more realistic than, for example, a prisoner's dilemma where the decision is dictated by the dominance of the strategies. The latter cannot be the strategic expression in which the Constitutional Court is involved. On the contrary, the Court should bring players to a mutually beneficial solution.

Let us now consider a new strategic form (Table 3), where the previous game between Court and judge (government) is embedded. Clearly the game maintains a Nash equilibrium (*A, S*). We can think of it as in the prisoner's dilemma version of Table 2. Given the awareness of both players (the Court and the judge) to affect the economy in an ambiguous or uncertain way, it seems very unlikely that any two rational agents will play (*A,S*), just as this game is unlikely to represent the Game of Life.

It is likely that each will play a different strategy in the belief that so will the other, and thereby they will both get large payoffs. In other words and paradoxically, it seems very rational about rejecting (*A,S*) and expecting your opponent to do the same, in search of a mutually beneficial solution.

In this context, the Court may not limit itself to rejecting or not rejecting the unconstitutionality of the governmental measure put forward by the judges. It could, for example, indicate a further decision, *M* which would lead to a better situation than that defined by the Nash equilibrium and the Status Quo solution, and would leave room for the judges to carry out a pre-play agreement with the government. In this case, the Court can direct agents to a more beneficial focal curb for all agents.

Table 3: the CURB strategic context for Court and Government (Judge)

		Judge M	NS	S
	M	z_{01}, h_{01}	z_{02}, h_{02}	z_{03}, h_{03}
Court	R	z_{11}, h_{11}	a_{11}, b_{11}	a_{12}, b_{12}
	A	z_{21}, h_{21}	a_{21}, b_{21}	x, y

To realize this, suppose now, for the game in Table 3, the following restrictions hold: for the strategies of player I:

M: $z_{01} > z_{02} > z_{03}$; *R*: $z_{11} > a_{11} > a_{12}$; *A*: $z_{21} < x < a_{21}$.

For player II we assume:

M: $h_{01} > h_{11} > h_{21}$; *NS*: $h_{02} > b_{11} > b_{21}$; *S*: $h_{03} < y < b_{12}$.

In other words, prisoner's dilemma version of Table 2 is now in Table 4:

Table 4: An example of the CURB strategic context for Court and Government

		Judge M	NS	S
	M	-1,-2	-2,-1	-5,-5
Court	R	-3,-3	-3, -3	-5, 0
	A	-5,-5	0, -5	*-4,-4*

Now all the cells in the upper left of the matrix and which correspond to strategies *M* and *R* for the first player (the Constitutional Court) and *M* and *NS* for the second player (the government) present better situations than the Nash equilibrium. A product set of pure strategies is closed under responses if all best responses against all possible mixtures of the strategies are contained in the set. Of course, this latter equilibrium $\{A\}\times\{S\}$ is a minimal CURB set, but $\{M,R\}\times\{M,NS\}$ is minimal closed under rational behaviour too. Thus $\{M,R\}\times\{M,NS\}$ is defined as minimal curb if $\{M,R\}$is the set of all best responses of player 1 to 2's strategies in $\{M,NS\}$, i = 1, 2. If participants have common interests in a block of conventional strategies, no player should prefer to deviate from this block when the others are likely to act conventionally and rationally inside the block. In other words, this "block" (the set of strategies closed under rational behaviour) is not "repelling" as in the cell (R, NS) of Table 2.

As the game in Table 3 shows well, the minimal curbs may seem an ineffective concept as it has a very low predictive power. In particular, in the above example they do not rule out any strategy of any player.[44] Moreover, the minimal curb set $\{M,R\}\times\{M,NS\}$contains even non-equilibrium strategies, although they are capable of providing mutually beneficial outcomes, and it is precisely this mutual benefit that an institution like the Constitutional Court should aim for. Consequently, the non-equilibrium outcomes (*M,M)*, (*M,NS)* and (*R,M)*, (*R,NS)* are not ruled out. In one way, the practical application of these sets as solution concept may entail some problems. There may be many of such sets and some of them may include non-equilibrium strategies. Above, we claim that, with the purpose of further narrowing down these sets, a concept of minimal curb (i.e. curb set that does not include any other curb as a proper subset of itself) was developed, but non-equilibrium strategies could appear even in the minimal curb sets, as this case demonstrates. On the other hand, for some games, the payoff in a curb set could Pareto-dominate the payoff obtained at some Nash equilibrium. In this context, it may be reasonable to expect players to

[44]See, for instance, Pruzhansky (2005).

play within a curb. Thus, we may expect players to choose pre-play communication as a process of negotiation strategies which are within a curb or a tight curb set (Basu, 1996).

As emphasized by Basu (2018), in many social contexts a "set-valued solution concept" is useful for defining a strategic space for a pre-play agreement that can be self-enforcing. Here, the Court may have a role to direct the society to a “focal curb” mediating between economic and juridical-political problems. Thus, Court should direct the economy and in general the society, not to a point but to a set of actions, creating a focal curb by influencing the belief of the agents. This, following Breyer (2009), may help to lessen the institutional obstacles that contrast cooperation between economic and juridical insights during the decision making process (judicial review).

5. The Constitutional Court may be aware of the economic repercussions of its decisions, but we may not dismiss the possibility that the Court is playing, un-knowingly, in two different spaces, the legal space and the economic space.

These aspects inevitably contribute to ambiguous solutions that generate uncertainty for economic agents and for the governance of the economy and at the same time do not clarify the solution in legal and political terms. In this paper we propose a less strong interpretation of the unconstitutionality findings, especially if they involve relevant aspects of the economy and of the society. The Constitutional Court and the governments in the advancement of some policies should take into account both the legal and economic aspects, avoiding thinking of an economy or society defined by a single equilibrium. This misspecification of the Game of Life does not leave room for possible collaborations that would bring a more efficient solution for both. A vision of the strategic relationships between the Court, judges and government as "Block Game" or the use of set valued targets (equilibria) seem more appropriate concepts to manage the complex reality between law and economy. In this paper we advance some normative aspects of the Constitutional Court. Precisely, the Court should create for the contenders (judges and government) a wider space of action than that defined by a simple Nash equilibrium: a set valued equilibria where the players are not confined to a unique strategy self-enforcing. Only in this new strategic context, the Court as a third party, can plays a Game of Morals and removing the “veil of ignorance”.

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