Early disclosure of business crisis in Italy

Giovanni Matteucci explains how and why such an early warning indicator does exist and does indeed work, but is not used

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When a company begins to show signs of crisis, all parties involved are trying to sweep the dust under the carpet.

Yet in Italy a warning system for financial crisis, especially conceived for small- and medium-sized companies, exists, it works, but it is not used. It is the RATING that banks give to all positions at risk with them that is particularly efficient, because it is influenced by:

- the structure of the company's financial statements, as in the bank's electronic archive;
- the negative elements drawn from databases (the Centrale dei Rischi at the Bank of Italy, the Register of Companies at the Chamber of Commerce, etc.).
- the day-to-day modus operandi of corporate customers at the bank itself, spot-tested.

"*Sero venientibus ossa*" or "*bones for those who come late*". When it comes to critical situations, whether they concern one's health or a raging fire, timeliness is key to increase the chances of achieving a positive result: this also applies to corporate crisis management.

Sweep the dust under the carpet

When a company begins to show signs of difficulty, all the parties involved try to sweep the dust under the carpet. An issue that is not a prerogative of Italy[1] only.

An entrepreneur who finds himself in financial trouble might think his difficulties are temporary. He recalls the times when he went through seemingly similar problems in the past. He resorts to do-it-yourself credit (issues post-dated checks, submits questionable receipts to the bank under reserve and calls them back just before the deadline, submits the same bill for the advances to several lender institutions and replaces it right before its expiry date, requests a mortgage loan for very different purposes than those stated; etc., etc.), when not to more fraudulent remedies. He waits for a "godsend" that never comes.

The banker who is in charge of the business relation will think

at first of temporary difficulties and will merely give the customer a call (which does not always come with a complete review of the credit risk), requesting a payment. Later he will feel uneasy in highlighting his own error of assessment in granting credit. The business relationship will enter then a blind spot because there are budget targets that must be achieved. The bank itself will seek to delay allocations to non-performing loans, which limit the possibility of granting credit (and thus generate income), or even make it difficult to comply with the regulations on the company's capital until the credit position is reclassified as impaired and its management is entrusted to the bank's Legal Department. For these "*blind falls*", in most cases, there are only two alternatives: a rigid repayment plan or a letter of formal notice with judicial recovery of credit.

The accountant who assists the company typically focuses on accounting and the relationship with the tax authorities, a task about which he often complains, as it is poorly remunerated and giving it any extra time would turn out to be considered "voluntary work". So, he adopts temporary-effect solutions. Later, when he turns to a colleague, who is a specialist in insolvency proceedings, the situation will be almost irreversible. The same is true when you ask a lawyer for intervention.

An early intervention, however, would be more than appropriate, because it gives more chances to save the ailing company.

For many years the financial doctrine (mainly Anglo-Saxon)[2] has developed some alert indexes based on the budgets (and therefore on historical data) which only proved to be effective in the 60-70% of cases and, especially, after two or three years since problems started. Then there are the impairment tests (based on the future), the calculation of the present values of the expected cash flows relating to the various balance-sheet items, to assess whether they will be able to meet the already existing liabilities – an analysis, that however, requires a proper corporate accounting structure and not low-level technical expertise.

International bodies as well are fully aware of the appropriateness of an early appreciation of the danger of the emergence of a business crisis.

- In 2005 "The Legislative Guide on Insolvency Law" (UNCITRAL)[3].
- In 2004 the European Commission issued a recommendation "*... to ensure that viable enterprises in financial difficulties, wherever they are located in the Union, have access to national insolvency frameworks which enable them to restructure at an early stage* … [4].
- In 2016 attention is given to the EWIs (*Early Warning Indicator*) by the European Central Bank[5].

With regard to the Italian legislation, a debate has been going on for several years: the topic of discussion is not the opportunity of such indexes, upon which everyone agrees, but rather on their configuration. Yet, in Italy, since the early 2000, an early warning index of corporate financial crisis does exist, it does work, but ... it is not used!

Forthcoming rules: will they prove effective?

In November 2015 the Rodorf Commission[6] presented a legislative proposal for a comprehensive reform of bankruptcy regulations: art.4 on "*alert procedures and mediation*", managed by The Body for the Resolution of the Crisis (*Organismi di Composizione della Crisi – OCC*[7]). Further, on March 11, 2016 the Government submitted to the Parliament a draft law[8].

In case there are clear indications of a crisis:

- a specialized section of the

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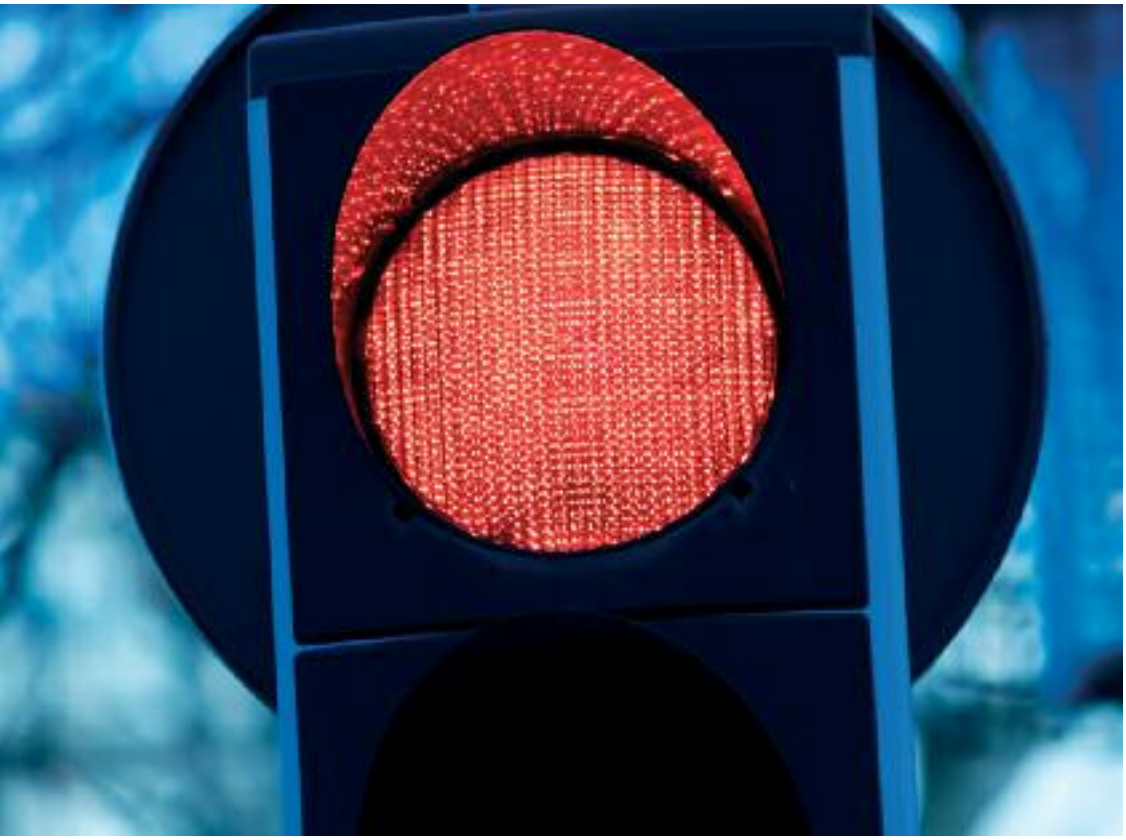

> **WHEN IT REACHES 7 AN ALARM SHOULD SOUND, A RED LIGHT SHOULD GO ON, A RED FLAG SHOULD BE WAVING**

body for the resolution of the crisis (OCC) will manage the proceeding;

- the proceedings can be started by the debtor, the corporate auditors, auditors and auditing firms (which should inform the company's board of directors or the OCC) or the Revenue Agency, IRS agents and social security institutions (which must report the persistence of a prominent breach to the supervisory bodies of the company or, in their absence, to the OCC);
- the professional entrusted by the OCC must convene the debtor and (if any) the company's supervisory boards (it is not made clear if creditors must / may also be convened) and within six months he must certify that the entrepreneur has put in place measures to overcome the crisis or that he has not, or that he did not even show up when he was summoned. In such a case the OCC must notify the President of the Commercial Court of the district where the company is established and the magistrate must immediately convene the entrepreneur, appoint a qualified professional to write a report, assign a deadline for the appropriate measures to remedy the crisis. If this deadline expires fruitlessly, the report is published in the register of companies; and
- the debtor can request the court to adopt, omitting any formalities not essential to the cross-examination, the protective measures needed in order to conduct the negotiations in progress, regulating their duration, effects, disclosure regime, competence to issue them and revocability.

The trouble is that companies which don't have any supervisory board are the overwhelming majority in Italy and the company's supervisory bodies have already company-related powers/duties towards their managers.

Delays in tax and social security payments are an appropriate index of financial difficulty, but it is possible to postpone them (other than applying for an instalment, which is a more and more often used trick) and, at the same time, it is also possible to delay payments to suppliers, create accounting tricks, resort excessively to bank credit, resort to "do-it-yourself credit" or fraudulent remedies. So, by the time the IRS agents and the social security institutions highlight any serious delay in paying the instalment plan, insolvency has already kicked in.

From the moment the OCC is informed, six months will pass, after which the judicial authority may be involved and, months later (after prior report), the crisis situation may be disclosed. It is therefore likely that from the beginning of the procedure, which is activated when the crisis is already evident, at least a year can go by!

What about the debtor? Once the procedure is activated, perhaps by himself/herself, he may request the court to suspend the proceedings against his/her assets, and perhaps the contractual obligations at his/her own expense as well. But the confidentiality of the procedure would be nonetheless weakened and, above all, all the contradictory effects experienced in the pre-filing insolvency proceeding "*concordato in bianco*"[9] could be revealed.

Last, but not least, there is no answer to the question: *What are the contents of the early warning indicator?* The definition of "*persistence of a prominent breach*" in relation to tax and social security obligations is too general.

The aspect that is more perplexing (at least for those who have an operative experience of the customer's bank relationship) is that in Italy, since 2000, there exists an early warning indicator, extensively tested, and effective in 70- 80% of the cases, which has a "lag time" of only about 12 months (if not less). It is the *rating*

that banks give to all positions at risk with them. A number, an alphanumeric scale, which can range from 1 (excellent economic situation, financial position and revenues of the client) to 10 (bankruptcy in progress). When it reaches 7 an alarm should sound, a red light should go on, a red flag should be waving.

What is the rating?

Faced with a capital of 100%, the banks expand their loans at significantly higher multiples. But how can they go without questioning their own solvency? What is an appropriate balance between capital and loans in a credit company?

In the Basel 1 agreement, 1988, a rate of 8% was agreed, giving the different activities in the bank's balance sheet a different "weight" according to the kind of customer (corporate, retail, government, etc.).

In the Basel 2 agreement, 2006[10], however, the activities were "weighted" according to credit-worthiness, with two different calculation methods: the easier standard method and the internal-ratings-based method (IRB, basic or advanced), both under the control of the credit authorities. Three categories of risk were considered: market, credit and operational.

The credit risk consists in the counterparty's ability to return the credit they obtained, in case of an unexpected event. The expected loss (*EL*) is calculated by the combination of the probability of default (*PD*) within 12 months (the customer's credit rating), the loss given default rate (*LGD*), influenced by the guarantees, the exposure at default (*EAD*), influenced by the type of operation, and the maturity, residual maturity of the exposure (*M*).

The rating of the customer (the PD) is an evaluation of the subject's ability to meet its obligations, referred to 12 subsequent months, on the basis of all available information of quantitative and qualitative nature, and expressed with an alphanumeric classification on an ordinal scale. It is determined on the basis of historical and prospective financial statement score, qualitative score and performance score.

Possible operating methods: mediation in bankruptcy

In a crisis situation, everybody sweeps the dust under the carpet. But the warning system exists, it works, it does not require further processing (and time), and is free (its cost has already been met!).

How could it be used? With communication and mediation in bankruptcy techniques[11].

In 1999, the ABI (Italian Bank Association) published the "*Code of behaviour for banks - enterprises in crisis*"[12] (modelled on the London approach), which provided for a concertation procedure, art. 4:

"In the event of activation of the conciliation procedure, (banks) members commit themselves:

- *to attend the meeting;*
- *to participate at the appropriate level;*
- *to provide immediately a proper written information with regards to every detail of the exposure, of collaterals and repayment sources;*
- *to manifest conflict situations (...);*
- *to maintain the confidentiality about the convening of the meeting;*
- *not to use the news of the meeting in order to change their situation in fact; and*
- *to send their decisions in terms foretold by each participant to the other participants at the meeting and in any case before the completion of any urgent acts against the company and the guarantors common .....".*

This procedure was practiced in Italy up to 20/25 years ago when the CEOs of the local banks met at the local branch of the Bank of Italy. A practice increasingly less suited to medium- and small-sized customers since the leading Italian (and international) banking groups have increasingly characterized their networks as points of sale and centralized decision-making and control all activities from a few locations, usually hundreds of kilometres away from the customers. The same procedure that may well be replicated by the OCC. ■

Summary

In summary, in Italy, the early warning index of financial crises for businesses, based on the rating (especially for small- and medium-sized) does exist, does work, is free, but... it is not used![13]

Footnotes:

1 http://www.accountancyage.com/aa/opinion/2196955/fds-must-smash-emergency-glass-and-call-for-help-sooner#ixzz23QBKTvlV
http://www.latribune.fr/opinions/tribunes/20121120trib000732105/-faillites-en-france-tout-ca-pour-ca-.html

2 Altman E., "*Financial ratios, discriminant analysis and the prediction of corporate bankruptcy*", in *Journal of Finance* sett. 1968, page. 589.

3 https://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf

4 http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014H0135&from=IT

5 https://www.bankingsupervision.europa.eu/legalframework/publiccons/html/index.en.html
https://www.bankingsupervision.europa.eu/legal framework/publiccons/pdf/npl/npl_guidance.en.pdf

6 http://www.dirittobancario.it/news/fallimento-e-procedure-concorsuali/riforma-procedure-concorsuali-testo-disegno-legge-delega-presentato-commissione-rordorf 4.12.2015.

7 Organismi di composizione della crisi, L. 3/2012, art. 15 e D.M. 202/2014
http://www.adrmaremma.it/norm65.pdf , Ministero della Giustizia
http://www.adrmaremma.it/norm67.pdf

8 http://www.osservatorio-oci.org/index.php?option=com_k2&view=item&id=413:riforma-delle-leggi-sull-insolvenza

9 To change a law is one thing, but how to change a culture? INSOL Europe, Inside Story, Italy https://www.insol-europe.org/download/inside_story/8075

10 http://www.bis.org/publ/bcbs128.pdf

11 Jacob A. Esher , "*Alternative dispute resolution in U.S. bankruptcy practice*", Boston 2009
http://www.mwi.org/images/publications/esher_adrbankruptcy.pdf
Matteucci G., "Come prevenire le sofferenza bancarie in Italia", in "Piazzetta Monte" III trim. 2012
http://piazzettamonte.dobank.com/III-Trimestre-2012/COME-PREVENIRE-LE-SOFFERENZE-BANCARIE-IN-ITALIA

12 http://www.promem.it/ris/documenti/risanamento/00RIS_ABI_CodiceComportamentoCrisi.pdf

13 For a more extended version of the article https://www.academia.edu/29734700/Early_diclosure_of_business_crisis_in_Italy_the_early_warning_indicator_exists_it_works_it_is_not_used_2016.10.30

> **THE EARLY WARNING INDEX OF FINANCIAL CRISES FOR BUSINESSES DOES EXIST, DOES WORK, IS FREE, BUT... IT IS NOT USED!**

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