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Early disclosure of business crisis in Italy: the early warning indicator exists, it works, it is not used

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 thought for small and medium enterprises, exists, it works, but it is not used. It is the RATING that banks give to all positions at risk with them, particularly efficient because it is influenced by:
- the structure of the company's financial statements, as in the bank's electronic archive;
- negative elements drawn from databases (the Centrale dei Rischi at the Bank of Italy, the Register of Companies at the Chamber of Commerce, etc.).
- 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 fire raging, timeliness is key to increase the chances of achieving a positive result; this also applies to corporate crisis management.

1 – 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 only a prerogative of Italy [1].

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 advanceå to several lender institutions and replaces it right before its expiry date, requests a mortgage loans 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, at first will think 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 unease in highlighting his own error of assessment in granting credit; the business relationship enters a blind spot because there are the budget targets that must be achieved. The bank itself seeks to delay allocations to non performing loans, which limit the possibility of granting credit (and

[1] "***Financial directors must smash emergency glass and call for help sooner***", Frank Tschentscher, partner at Schultze & Baun, UK.
http://www.accountancyage.com/aa/opinion/2196955/fds-must-smash-emergency-glass-and-call-for-help-sooner#ixzz23QBKTvlV
Faillites en France : tout ça pour ça ? - Stéphanie Chatelon e Arnaud Pédron, partner at Deloitte Touche Tohmatsu Limited, http://www.latribune.fr/opinions/tribunes/20121120trib000732105/-faillites-en-france-tout-ca-pour-ca-.html

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; "*blinds fall*" and, in most cases, there are only two alternatives: a rigid repayment plan or a letter of formal notice with judicial recovery of credit (mandatory mediation, as required by Italian legislation, is quite useless at this stage because relationships are totally deteriorated or because of a complete lack of liquidity on the customer company).

The accountant, who assists the company, typically focuses on accounting and relationships with the tax authorities (a work about which he often complains as it is poorly remunerated; giving any extra time would turn out to be "voluntary work") and, also, adopts temporary effects solutions; later, when he turns to a colleague, who is a specialist in insolvency proceedings, the situation is 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 firm.

For many years the financial doctrine (mainly Anglo-Saxon) 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 [2] . Then there are the impairment tests [3] (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; and even in the absence of duty avoidances at the agreed deadline or when the term is laid down by the law. An analysis, however, that 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 emergence of business crisis.

In 2005 "*The Legislative Guide on Insolvency Law was prepared by the United Nations Commission on International Trade Law (UNCITRAL). The project arose from a proposal made to the Commission in 1999 that UNCITRAL should undertake further work on insolvency law, specifically corporate insolvency, to foster and encourage the adoption of effective national corporate insolvency regimes. .... a mandate to prepare a comprehensive statement of key objectives and core features for a strong insolvency, debtor-creditor regime, including out-of-court restructuring, and a legislative guide containing flexible approaches to the implementation of such objectives and features, including a discussion of the alternative approaches possible and the perceived benefits and detriments of such approaches*" [4] .

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[2] Altman E., "*Financial ratios, discriminant analysis and the prediction of corporate bankruptcy*", in *Journal of Finance* sett. 1968, pag. 589; Beacer W.H., "*Financial ratios as predictors of failure*", in *Journal of accounting research*, 1966, pag. 71; Libby R., "*Accounting ratios and the prediction of failure: some empirical evidence*", in *Journal of accounting research*, 1975, pag. 97.

[3] Bauer Riccardo e Mezzabotta Claudia, "*Perdite di valore ed avviamento secondo i principi IFRS*", Quaderno 34, ODCEC Milano, SAF Scuola di Alta Formazione Luigi Martino, 2011 http://www.odcec.mi.it/docs/default-source/quaderni/N°_34_-_PERDITE_DI_VALORE_E_AVVIAMENTO_SECONDO_I_PRINCIPI_IFRS.pdf
Orzechowski BJ e Lyster Peter, "*Impairment testing: Effectively using the qualitative assessment*", December 1, 2012 http://www.journalofaccountancy.com/issues/2012/dec/20126497.html#sthash.Hf3Z7Jpl.dpuf

[4] United Nations Commission on International Trade Law-Uncitral, "*Legislative Guide on Insolvency Law*" (preface, pag.5), New York, 2005 https://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf

In 2004 the European Commission issued a reccommendation "*... 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 with a view to preventing their insolvency, and therefore maximise the total value to creditors, employees, owners and the economy as a whole. The Recommendation also aims at giving honest bankrupt entrepreneurs a second chance across the Union*" [5] .

The need for an early restructuring of the struggling company, the use of alternative extra-judicial out-of-court procedures and the possibility of a second chance are clearly present.

No mention of the early warning indicator yet, when the European Commission (2016) will not stop at a mere recommendation, but allocates EUR 3.8 million for a grant, aiming at the creation of a "*European network for **early warning** and for support to enterprises and second starters*" [6] .

In 2016 again, specific attention is given to the alert index, as pointed out by the European Central Bank in the guidelines for the management (and prevention) of doubtful loans by banks: "*In order to monitor performing loans and prevent the deterioration of credit quality, all banks should implement adequate internal procedures and reporting to identify and manage potential non-performing clients at a very early stage. ... Banks need to develop a suitable set of **EWIs (Early Warning Indicator)***" [7] .

With regard to the Italian legislation, especially on insolvency, 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 exists, it does works, but ... it is not used!

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[5] European Union, Commission Recommendation of 12 March 2014 on "*A new approach to business failure and insolvency*" (2014/135/EU) http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014H0135&from=IT

[6] Cosme Work Programme 2016, "*Cos-Early WarningEU-2016.4.01*" https://ec.europa.eu/easme/sites/easme-site/files/documents/call_text_eweu_2016.pdf

[7] European Central Bank – "*In order to monitor performing loans and prevent the deterioration of credit quality, all banks should implement adequate internal procedures and reporting to identify and manage potential non-performing clients at a very early stage. … Banks need to develop a suitable set of **EWIs (Early Warning Indicator)** in a dual perspective: portfolio and transaction/borrower level.*

"*At transaction/borrower level, ... EWIs should be set on the basis of internal or external input data/information ... . Examples of EWIs could be internal score systems (including behavioural) or external data issued by rating agencies, specialised sector research, or macroeconomic indicators for business focused on specific geographical areas.*

"... In addition to borrower-level EWIs, banks should also determine EWIs at the portfolio level. They should first segment the credit risk portfolio into different classes, e.g. by business lines/client segments, geographical area, products, concentration risks, level of collateralisation and type of collateral provided, or debt-service ability. For each subcategory the bank should then perform specific sensitivity analyses based on internal and external information (e.g. market overview released by external providers regarding specific sectors or area) in order to identify the portions of the portfolio which could be affected by potential shocks. This analysis should at least enable a sorting of the buckets in terms of riskiness. Policies should provide a set of measures with the level of depth increasing as a function of the expected risk.

"*Afterwards, banks should identify specific EWIs in relation of each class of risk to detect potential credit deterioration before negative events occurring at transaction level*".

European Central Bank, "*Draft guidance to banks on non-performing loans. Early warning mechanisms*" (page 34), 12.9.2016
https://www.bankingsupervision.europa.eu/legalframework/publiccons/html/index.en.html
https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/npl/npl_guidance.en.pdf

2 - The Italian legislation: a bit of history

The first warning index was most likely introduced into the Italian legislation by the Commercial Code of 1882, Art. 689: "*In the first seven days of each month notaries and bailiff must transmit to the President of the commercial court in whose jurisdiction they are resident or civil court that is its substitute ... a list of protests made in the previous month. / The list must indicate the date of each protest, the name, last name and addresses of the persons to whom it was made and the applicant and the protested bill, the amount due and the reasons the payment was declined./ Lists must be from month to month gathered in bundles and stored in the registry, so that everyone can take knowledge./...*" [8] .

The Bankruptcy Act of 1942 (art. 13) reduced the range of the reporting of protests from 30 to 15 days. The effectiveness was seemingly limited.

The problem was clearly present in 2004 to the Trevisanato Commission, whose proposal for a reform of the Bankruptcy Act (yet another!) started off with:

"*Article 1 - Purpose of the alert and prevention institutions, procedures for an agreed settlement of crisis and liquidation -*

"*The institutions for early warning and prevention are meant to bring out in a timely manner the company's crisis to seek the best solutions for overcoming it* ".

Institutions borrowed from the French experience, which proved uneffective. The bill was soon lost to sight.

Failing to pass a comprehensive reform of the legislation on business crisis, the Italian lawmaker in 2005 started working on singular institutions (often with questionable results), some of which were intended to compensate for the lack of indicators for the early emergence of the crisis.

3 - Forthcoming rules; will they prove effective ?

In November 2015, the Rodorf Commission [9] presented a legislative proposal for a comprehensive reform of bankruptcy regulations ; art. 4 provided "*alert procedures and mediation*":

"1. *Early warning procedures and mediation processes, non-judicial and confidential by nature must be introduced, must aim at encouraging an earlier emergence of the crisis, and facilitate the conduct of assisted negotiations between debtor and creditors:*

a) ...

b) requiring the corporate auditors, the auditor and the audit firm the obligation to immediately notify to the board of directors of the company the existence of reasonable evidence of the

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[8] "*Nei primi sette giorni di ogni mese i notari e gli usceri devono trasmettere al presidente del tribunale di commercio nella cui giurisdizione risiedono o del tribunale civile che ne fa le veci ... un elenco dei protesti fatto nel mese precedente. / L'elenco deve indicare la data di ciascun protesto, il nome, il cognome e il domicilio delle persone alle quali fu fatto e del richiedente, la scadenza dell'obbligazione protestata, la somma dovuta e i motivi del rifiuto del pagamento./ Gli elenchi devono essere di mese in mese riuniti in fascicoli e conservati nella cancelleria, affinché ognuno possa prenderne notizia./...*"

[9] Commission appointed by the Ministry of justice, decree 24.2.2015
http://www.dirittobancario.it/news/fallimento-e-procedure-concorsuali/riforma-procedure-concorsuali-testo-disegno-legge-delega-presentato-commissione-rordorf 4.12.2015 .

crisis and, in case of failure or inadequate response, to inform directly the competent ***Body for the resolution of the crisis*** **(Organismi di Composizione della Crisi – OCC** [10]);

c) by requiring qualified creditors, such as the Revenue Agency, IRS agents and the social security institutions, the obligation, under the managerial responsibility, to report immediately to the entrepreneur, or to the supervisory and administrative boards of the company, the persistence of a prominent breach, thus coordinating those obligations with those of information and supervision due to Consob; ....".

On March 11, 2016 the Government submitted to the Chamber of Deputies a draft law containing "*Delegation to the Government for a comprehensive reform of the disciplines of corporate crisis and insolvency*" [11] .

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[10] 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

[11] Camera dei deputati, n. 3671 – Disegno di legge presentato dal Ministro della giustizia di concerto con il Ministro dello sviluppo economico. Delega al Governo per la riforma organica delle discipline della crisi di impresa e dell' insolvenza,11.3.2016

Art. 4. - *(Procedure di allerta e di composizione assistita della crisi).*

1. … *il Governo disciplina l'introduzione di procedure di allerta e di composizione assistita della crisi, di natura non giudiziale e confidenziale, finalizzate a incentivare l'emersione anticipata della crisi e ad agevolare lo svolgimento di trattative tra debitore e creditori, attenendosi ai seguenti princìpi e criteri direttivi:*

a) attribuire la competenza a un'apposita sezione specializzata degli organismi di composizione della crisi, previsti dalla legge 27 gennaio 2012, n. 3, e dal regolamento di cui al decreto del Ministro della giustizia 24 settembre 2014, n. 202, con opportuni adattamenti;

b) porre a carico degli organi di controllo societari, del revisore contabile e delle società di revisione l'obbligo di avvisare immediatamente l'organo amministrativo della società dell' esistenza di fondati indizi della crisi e, in caso di omessa o inadeguata risposta, di informare direttamente il competente organismo di composizione della crisi;

c) imporre a creditori qualificati, come l'Agenzia delle entrate, gli agenti della riscossione delle imposte e gli enti previdenziali, l'obbligo, a pena di inefficacia dei privilegi accordati ai crediti di cui sono titolari, di segnalare immediatamente agli organi di controllo della società o, in mancanza, al competente organismo di composizione della crisi il perdurare di inadempimenti di importo rilevante, coordinando detti obblighi con quelli di informazione e di vigilanza spettanti alla CONSOB;

d) stabilire che l'organismo di composizione della crisi, a seguito delle segnalazioni ricevute o su istanza del debitore, convochi immediatamente, in via riservata e confidenziale, il debitore medesimo nonché, ove si tratti di società dotata di organi di controllo, anche i componenti di questi ultimi, al fine di individuare nel più breve tempo possibile, previa verifica della situazione patrimoniale, economica e finanziaria esistente, le misure idonee a porre rimedio allo stato di crisi;

e) prevedere che l'organismo di composizione della crisi, su istanza del debitore, anche all' esito dell' audizione di cui alla lettera d), affidi a un soggetto scelto tra soggetti forniti di adeguata professionalità nella gestione delle crisi d'impresa, iscritti presso l'organismo stesso, l'incarico di addivenire a una soluzione della crisi concordata tra il debitore e i creditori, entro un congruo termine, prorogabile solo a fronte di positivi riscontri delle trattative e, in ogni caso, non superiore complessivamente a sei mesi, precisando altresì le condizioni in base alle quali gli atti istruttori della procedura possono essere utilizzati nell'eventuale fase giudiziale;

f) consentire al debitore di chiedere al giudice l'adozione, omessa ogni formalità non essenziale al contraddittorio, delle misure protettive necessarie per condurre a termine le trattative in corso, disciplinandone durata, effetti, regime di pubblicità, competenza a emetterle e revocabilità, anche d'ufficio in caso di atti in frode ai creditori;

g) prevedere misure premiali per l'imprenditore che ricorra tempestivamente alla procedura e ne favorisca l' esito positivo e misure sanzionatorie per l'imprenditore che ingiustificatamente la ostacoli o non vi ricorra, pur in presenza dei relativi presupposti, ivi compresa l'introduzione di un'ulteriore fattispecie di bancarotta semplice ai sensi degli articoli 217 e 224 del regio decreto 16 marzo 1942, n. 267;

h) prevedere, in ogni caso, che, non oltre la scadenza del termine di cui alla lettera e), l'organismo di composizione della crisi attesti se l'imprenditore abbia messo in atto le misure idonee a porre rimedio alla crisi e, in caso negativo, ne dia comunicazione al presidente della sezione specializzata in materia di impresa del tribuna-

Art. 4. - *(Alert procedures and assisted resolution of the crisis).*

" *1. ... the Government regulates the introduction of alert procedures and systems for an assisted resolution of the crisis, both of non-judicial and confidential by nature, designed to encourage an earlier emergence of the crisis, and facilitate the conduct of negotiations between debtor and creditors, according to the following principles:*

a) responsibility is given to a special section for the body for the resolution of the crisis (OCC)*, as established by Law 27 January 2012, n. 3, and by the Regulation laid down by the Decree of the Minister of Justice no. 202 of 24 September 2014, n. 202, with appropriate adjustments;*

b) the supervisory boards, the auditor and the audit firm are required to immediately notify the board of directors of the company of the existence of any clear indication of reasonable evidence of the crisis and, in case of failure or inadequate response, to directly inform the competent body for the resolution of the crisis (OCC)*;*

c) qualified creditors, as the Revenue Agency, IRS agents and the social security institutions are required, under penalty of ineffectiveness of the privileges granted to the claims they hold, to immediately report to the control bodies of the company or, in their absence, to the competent body for the resolution of the crisis (OCC)*, the persistence of a prominent breach, thus coordinating those obligations with CONSOB's duties of information and supervision;*

d) the competent body for the resolution of the crisis (OCC), *as a result of reports received or at the request of the debtor, must convene immediately, on a confidential manner, the same debtor and, if companies with regulatory bodies are involved, the members, in order to identify as soon as possible, after verification of the financial and economic situation, the appropriate measures to remedy the state of crisis;*

e) the body for resolution of the crisis (OCC), *at the request of the debtor, even according to the outcome of the hearing referred to in subparagraph d), must entrusts a professional with appropriate experience in corporate crisis management, certified by the body itself , the task of*

. reaching a mutually agreed solution to the crisis between the debtor and creditors, within a reasonable period, which may be extended only in case the negotiations have a positive feedback and, in any case, not later than six months and

. identifing the conditions under which the procedure outcomes can be used in a possible judicial phase;

f) the debtor must be allowed to request the court the adoption, avoiding any unnecessary formalities to be heard, of every protective measures required in order to conduct the negotiations in progress, regulating their duration, effects, disclosure regime, competence to issue them and revocability, even ex officio, in case of acts in fraud of creditors;

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le competente per il luogo in cui l' imprenditore ha sede; stabilire che a tale comunicazione si provveda anche quando l'imprenditore non partecipi, senza giustificato motivo, al procedimento innanzi all'organismo;

i) prevedere che il presidente della sezione specializzata di cui alla lettera h) convochi immediatamente l' imprenditore e, quando occorra, affidi a un professionista in possesso dei requisiti di cui all'articolo 67, terzo comma, lettera d), del regio decreto 16 marzo1942, n. 267, l'incarico di verificare la situazione economica, patrimoniale e finanziaria dell'impresa; stabilire che, se dalla relazione depositata dal predetto professionista risulta che l'impresa versi in stato di crisi, il presidente assegni un termine per intraprendere le misure idonee a porvi rimedio, decorso inutilmente il quale disponga la pubblicazione della relazione medesima nel registro delle imprese "

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

g) a reward system for the entrepreneur who promptly initiates the procedure and fosters its success must be included; at the same time, punitive measures must be provided for the entrepreneur who unreasonably impedes the procedure or does not apply for it, despite the existence of adequate conditions, including the case of bankruptcy, in accordance with articles 217 and 224, Royal Decree no.267 of 16 March 1942;

h) in any case no later than the expiration date referred to under point e), the body for the resolution of the crisis (OCC) *must state whether the debtor has implemented every appropriate measures to remedy the crisis and, if not, the President of the Commercial Court of the district where the firm is established must be informed; such communication must be given even when the entrepreneur does not participate, without justification, to the procedure before the body;*

i) to provide that the President of the Commercial Court referred to under point h) must immediately convene the entrepreneur and, when necessary, entrust a professional, who meets the requirements of Article 67, third paragraph, letter d) of the Royal Decree 16 marzo1942, n. 267, with the task of verifying the economic situation and financial position of the company; to provide that if, according to the report filed by the above mentioned professional, the enterprise appears to be in a state of crisis, the President must assigns a deadline to take every appropriate measures to remedy it, passed fruitlessly which the report has to be published into the register of companies".

Therefore, in case there are clear indications of crisis:

- who manages the proceeding ?

. a specialized section of the body for the resolution of the crisis (OCC);

- who starts the proceeding ?

. the debtor

. the corporate auditors, auditors and auditing firms, which should inform the company's board of directors or the OCC;

. 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;

- how is the proceeding carried out?

. 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 certifies 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 the Commercial Court of the district where the firm is established; the magistrate must immediately convenes the entrepreneur, has a qualified professional write a report, assigns a deadline for the appropriate measures to remedy the crisis to be taken; this deadline expires fruitlessly, the report is pulished into the register of companies;

- can the debtor take any initiative?

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.

Nevertheless :

- companies which don't have any supervisory board are the overwhelming majority in Italy;

- 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 possibile 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 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, he may request the court to suspend the proceedings against his assets, and perhaps the contractual obligations at his 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 insolvecy proceeding "*concordato in bianco*" [12] 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 "*persistence of a prominent breach*" in relation to tax and social security obligations is too general.

Moreover, in most crisis situations, the main creditors are banks and tax authorities. It is hard to believe that the lawmaker has forgotten to include banks, among the qualified creditors, as they usually are well informed of the debtor's circumstances, even before the procedure starts.

The aspect that is more perplexing (at least for those who have an operative experience of the customer bank relationships) is that in Italy, since the beginning of the 2000s,

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[12] **To change a law is one thing, but how to change a culture?** "*Until 2005, Italian insolvency law was 'liquidation-oriented', in the sense that the main objective being pursued was the liquidation of the distressed company. Our old law focused on creditors' rights and disregarded the chances for the debtor company to be rescued as a going concern.*

" *Starting from 2005 ... we have a legal framework that is more "rescue- oriented".*

" *... Everything is fine, then? Yes, but...but it's easier and quicker to change a law than an attitude. The issue, here, is cultural.*

" *The cause of the scandal is a new proceeding* (concordato 'in bianco')*, introduced in Italy starting from 11 September 2012 (law decree n. 83/2012). According to this procedure the debtor company files the case and is granted by the Court an automatic stay period of maximum 180 days. If reorganization is not feasible, the company can be liquidated. But if the rescue is viable, the debtor will use the period of 180 days to try to reach agreements with its creditors, to prepare a plan to reorganize the business and to borrow the liquidity needed for restructuring. And, as usual, this is the hardest problem: the debtor in possession financing. Another hot issue is the payment of critical suppliers. Of course, we must divide pre-petition creditors from post-petition ones. Post-petition creditors (including lenders) are considered administrative creditors, which means that they have a super-priority in payments.*

" *If you really want to try to save the value of a going concern, if you really want to rescue companies, you should be happy to have provisions like those I shortly described above. Instead, an unexpected reaction happened. A very strong feeling of dislike arose, especially from the Italian Employers' Association.*

" *The competitors of distressed companies consider unfair competition the fact that the new law allows to have such a long period (180 days) to prepare a plan, during which all post-petition creditors will get the right of a super-priority in payments, while pre- petition (unsecured) creditors will receive only very low percentage of their credits*". Pusterla Giulia, "*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

there has been an early warning indicator, that has been extensively tested, is effective in 70 / 80% of cases and has a "lag time" of about (if not less than) twelve months. 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.

4 - What is the rating [13]

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 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 [14] , however, the activities were "weighted" according to creditworthiness, with two different calculation methods: the easier standard method and the internal-ratings-based (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 (*expected loss*) is given by the combination of PD (*probability of default* within 12 months, the customer's credit rating), LGD (*loss given default rate*, influenced by the guarantees), EAD (*exposure at default*, influenced by the type of operation) and M (*maturity*, residual maturity of the exposure).

The rating of the customer (the PD, probability of default) is an evaluation of the subject's ability of the party to meet its obligations, referred to 12 subsequents 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.

I.e. the rating is affected by

- financial ratios based on the financial statements of the corporate client listed in the electronic archive of the bank, related to several years and reclassified (but these data are, at best, four months old and their indexes, to be effective analysis, must refer at least to two years, preferably three);
- qualitative assessment by the credit relationship manager;

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[13] "***What's the Point of Credit Scoring?*** *- When one banker asks another 'What's the score?' shareholders needn't worry that these bankers are wasting time discussing the ball game. More likely they're doing their jobs and discussing the credit score of one of their loan applicants. Credit scoring is a statistical method used to predict the probability that a loan applicant or existing borrower will default or be come delinquent. The method, introduced in the 1950s, is now widely used for consumer lending, especially credit cards, and is becoming more commonly used in mortgage lending. It has not been widely applied in business lending, but this, too, is changing. One reason for the delay is that business loans typically differ substantially across borrowers, making it harder to develop an accurate method of scoring. But the advent of new methodologies, enhanced computer power, and increased data availability have helped to make such scoring possible, and many banks are beginning to use scoring to evaluate small-business loan applications* ".
Loretta J. Mester, Business Review (Federal Reserve Bank of Philadelphia); Sep / Oct 1997, page 3

[14] Bank for International Settlements, Basel Committee on Banking Supervision, "*International Convergence of Capital Measurement and Capital Standards – Compehensive Version*" June 2006 http://www.bis.org/publ/bcbs128.pdf

- external behavioral indicators; all the negative elements from databases, such as the Centrale dei Rischi (Bank of Italy), CRIF, Experian, Consorzio tutela del credito, Assilea, Centrale di Allarme interbancaria, register of companies at the Chamber of Commerce, real estate records (with two months delay in signaling);
- internal behavioral indicators; and this is perhaps the most interesting element, the way everyday business customer operate at the bank, spot-tested .

The rating proves effective in the 70/80% of cases because, among other things, it may be adversely affected by the bank's own internal bureaucracy: the non-renewal of the credit procedure within the deadline (usually 12 months, 6 months for problematic cases), the non-completion of the acquisition of guarantees required by the decision-making organ, the existence of a negative balance (even of low amount) in a secondary account for more than 90 days, improper reporting to the Centrale dei Rischi, etc. . The formal regularity control of the whole, then, is important.

The method of calculating the rating may differ (as it usually happens) from bank to bank. Also it is negatively affected by all internal bureaucratic shortcomings of the individual in the credit istitute. As a consequence if the same customer relies on several different banks, his own rating may differ from one banking institution to another. It should be the customer's concern (and a charge for of his business consultant) to be informed every six months, understand the reasons for the differences and, above all, for any deterioration. Particularly since the value of the rating influences the level of the borrowing rates paid by the customer (the worst the rating, the higher the credit risk, the more money the bank asks to keep in place the exposure) and the identification of the decision-making organ in the bank's hierarchy (the worst the rating, the higher the hierarchy of decision, the longer it takes for a resolution and, usually, a more sharp-eyed analysis).

The rating is the result of an internal processing in the bank, which is not required to inform the customer about it. Nonetheless, as far as one knows, the customer is very seldom kept unaware of the procedure.

5 - Possible operating methods: *mediation in bankruptcy*

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

Who should be interested in its use? First of all, banks.

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

If you have got a claim, it is more likely to be repaid (although partially) if the debtor is not in a state of financial asphyxiation. A prompt action, even -and especially- in the presence of negative economic conditions, will resulte in lower conventional charges on late payments and a reduced premium paid to IRS agents; i.e., there will be some more chances for the principal to be repaid. The banks are among the most informed creditors and are often those that have the most substantial claims; and since 2008 (explosion of the financial crisis on) it has been widely shown that the guarantees (collaterals as well) are useless. A greater attention is now given at European level to regulatory capital, and therefore the need for recapitalization; this new trend should push banks to a proactive behavior. But it seems that this is not the case [15] .

[15] A statistical indicator "proxy" shows how the extra-judicial settlement of disputes is not yet part of the "culture" of Italian banks. The success rate (achieved agreements / initiated procedures) of compulsory civil and com-

Once the rating turns on the red light, how to move ? Techniques of communication and negotiation activities: contacts, individual at first and collective later, with the various creditors, based on a shared perspective of the situation or, if you prefer, **mediation in bankruptcy** [16] .

In 1999, the ABI (Italian Bank Association) published the "*Code of behavior for banks - enterprises in crisis*" [17] (modelled on the London approach), which provided for a concertation procedure and art. 4 prescribed:

"*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;
· 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, whose director acted as the moderator of the meeting. A practice increasingly less suited to medium and small customers since the leading Italian (and international) banking groups have increasingly characterized their networks such as points of sale and centralized decision-making and control activities in a few locations, usually hundreds of kilometers away; since then the individual branches has been focused on marketing and more and more depersonalized with regard to the local "*area*".

The same procedure that may well be replicated by the OCC.

In summary, in Italy the early warning index of financial crises for businesses (especially small and medium) does exist, does work, is free, but ... is not used!

Giovanni Matteucci

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mercial mediation in Italy, net of bank procedures, in 2015 was an average of about 12%; one related to banking disputes 3%.

[16] Jacob A. Esher , "*Alternative dispute resolution in U.S. bankruptcy practice*", Boston 2009
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http://piazzettamonte.dobank.com/III-Trimestre-2012/COME-PREVENIRE-LE-SOFFERENZE-BANCARIE-IN-ITALIA

[17] http://www.promem.it/ris/documenti/risanamento/00RIS_ABI_CodiceComportamentoCrisi.pdf