ABI

Italian Bankers' Association

The code of conduct for banks and firms in crisis

The role of banks in corporate crises: the point of view of the Bank of Italy

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1. Introduction

The subject of corporate crises and the contribution that the banking system can make in the search for suitable instruments to manage them effectively is of continuing interest to the Bank of Italy, both for institutional reasons related to its supervisory duties and for the economic implications of crises for the enterprise system. It has been the object of statistical analysis and inquiry and the subject of joint discussion with representatives of the business community, academics and the judiciary.

The Bank of Italy has created scope for solving crises through its Supervisory Instructions: the rules governing bank shareholdings envisage a specific procedure for reorganization plans that include the acquisition of an equity stake in debtor firms in financial difficulty.

This issue takes on particular importance in times of recession, when the number and size of crises reveal the shortcomings of using bankruptcy proceedings to safeguard firm value, cause serious and widespread consequences, including social disruption, and prompt exceptional and often unsystematic regulatory interventions.

At a conference in Foggia in October 1995, I noted that timely intervention with troubled firms was in the interest of the intermediaries themselves in order to help restore stability, where possible.[1]

[1] See Banca d'Italia, "Il ruolo del sistema bancario nel risanamento finanziario delle imprese", in *Bollettino Economico*, no. 26, February 1996.

A number of characteristics of the bank-firm relationship discouraged this kind of initiative by creditor banks, nor did they facilitate their coordination. As a result, the role of the intermediary during a delicate phase in the life of the borrower firm was given a narrow interpretation.

The London approach was held up as an example of effective self-regulation aimed at by-passing the difficulties resulting from the lack of coordination among creditor banks.

I expressed my hope that the discussion under way in the banking world would lead to practical approaches to collaboration in the management of crises.

In my final considerations at the Bank of Italy seminar "Crises of firms, bankruptcy proceedings and the role of banks" in March 1996,[2] I reaffirmed the central role of the banking sector in assisting firms in difficulty. I noted that many of the problems in defining reorganization plans could be overcome by taking advantage of the strengths of the "bank-firm" relationship.

The "code" that the Italian Bankers' Association is introducing today is an important step in this direction. It demonstrates the heightened sensibility of banks in their relations with firms and makes a valuable contribution to managing crises in the best interests of all the parties involved.

[2] See Banca d'Italia, "Crisi d'impresa, procedure concorsuali e ruolo delle banche", *Quaderni di ricerca giuridica*, no. 44, March 1997.

The document enunciates a number of general principles that members undertake to respect; it outlines a procedure to coordinate creditor banks, with the participation of the firms, in order to facilitate corporate reorganization; and it provides for the aggregation of other creditors in the procedure.

The primary purpose of the code is to promote cooperation among those involved in the crisis. The procedure is based on criteria of simplicity and flexibility and recognizes the full responsibility and autonomy of the participants to initiate the reorganization process, evaluate the situation and search for possible solutions.

2. Self-regulation and the experience of extrajudicial solutions

The code is applied within the existing legal framework: the law establishes the fundamental principles and the measures enacted by the authorities complete the regulatory scheme, implementing the rules.

The Association's initiative takes its place in the roster of Italian experiences of self-regulation.

In the credit sector self-regulation has achieved much: the agreement on the transparency and disclosure of the conditions offered to customers; the anti-money laundering recommendations; the institution of deposit protection funds and the creation of the banking Ombudsman.

The latest legislative initiatives open new prospects. The Consolidated Law on Financial Intermediation, which regulates the management of markets and the centralized administration of financial instruments as business activities, assigns the task of dictating organizational and operational rules to the private companies engaging in these activities.

Self-regulation fills the gaps left by laws. It imposes constraints that members agree to abide by in their operations. It is borne of the free choice of a group of economic agents, but it can transcend their specific objectives when it affects the economic community in which they operate. Thus, it has the capacity to safeguard general interests.

Experience shows that self-regulation often anticipates the law which, when it does intervene, incorporates the concepts of the self-regulatory scheme and makes them obligatory, thereby confirming their general validity. For example, the interbank agreements on the transparency of customer conditions and on deposit protection subsequently became the object of specific legislation.

Self-regulation not only offers protection where the law is slow to act; it retains its importance even in the presence of compulsory rules. Operators are free to accept more stringent constraints, provide for more rapid and effective sanctions and establish more agile and efficient procedures.

The joint definition of rules heightens each participant's awareness of their usefulness: by definition, the rule reflects a shared value. For this reason, mutually-agreed regulation can be highly effective, regardless of the legal protection afforded to the agreement.

Compliance with codes of conduct enhances the reliability and professional credibility of operators. Its positive impact on reputation is generally a very effective incentive.

Self-regulation stands midway between the external compulsion of the law and the contractual autonomy of private parties. It too is part of the juridical experience, as law expressed by the community outside the framework of legislation. It fully expresses the social and economic pluralism recognized by the Italian Constitution.

In the credit sector self-regulation reflects the banks' awareness of the sound professional values they share and the essential role they play in the economic system.

Transparency, proper conduct, fairness and impartiality are among the norms that intermediaries accept when they agree to comply with the code. These principles, which are by no means exclusive to banking and are already provided for in law, serve as a reference framework for action where legal constraints are absent.

The rules governing corporate crises, which are set out in bankruptcy law and have been supplemented with new procedures over the years, have proven to be inadequate and ineffective. There is broad consensus that the system does not seek to help firms to reorganize and does not even ensure satisfactory protection of creditors, who are hurt by the length of proceedings and the low rates of recovery.

As a process of collective enforcement, bankruptcy proceedings do not aim to safeguard the productive function of the company nor the role of the entrepreneur. The mere continuation of a company's activity, often pursued for social reasons, does not guarantee

lasting recovery if no preliminary assessment is made of the real prospects for industrial and financial reorganization.

Those involved have developed an empirical response to these difficulties. The use of private agreements outside the procedures provided for by law has been affirmed. The practice has proven to be effective in protecting the multiple interests at stake.

The benefits of extrajudicial agreements, especially where reinforced by the broad participation of banks, have been confirmed by a Bank of Italy study showing more favourable recovery times and rates than under bankruptcy proceedings (19 months and 60 per cent for the former, compared with 72 months and 30 per cent for the latter).

The code reaps the positive results of past experience, offering a framework of conduct for banks, firms and third parties.

The cooperative approach is a major supplement to the legal framework. It corrects some of its inadequacies and provides a useful reference for legislators in any reform of bankruptcy law.

3. The code of the Italian Bankers' Association. Cooperation and competition in the management of crises

The code adopts the standard criteria of transparency; it ensures that information on the company's situation is widely disseminated, increasing the basic knowledge of each participant and permitting informed choice.

The Italian Bankers' Association's initiative is founded on the belief that in a crisis the benefits from sharing company information outweigh the advantage to individual parties deriving from privileged, but partial, information.

Once it is the shared property of all the parties involved, information allows for the early detection of difficulty; it facilitates prompter, more effective intervention. It reduces the risk that the imperfect perception of a company's situation may cause it to precipitate, setting off conflictual reactions which can lead to the break-up of the company even when there are reasonable prospects for reorganization.

In an irreversible crisis, a cooperative approach must foster the most expeditious disposal of the company's assets so as to avoid a deterioration in value, limit costs and maximize the liquidation value, for the common good. Selling the assets en bloc improves the possibility of satisfying creditors, avoids the dissolution of the productive organization and allows for the re-use of resources in the economy, while continuation of operations would only procrastinate the inevitable cessation of activity.

This approach is consistent with the rules of the market.

It is equally in keeping with the banking sector's principle of competition. The guideline provides for a procedure that adapts to the specifics of actual cases, binds participants to cooperation and imposes the suspension of unilateral initiatives until the situation has been collectively examined. However, the participants' power of decision remains intact, with regard both to the appraisal of the company's situation and the identification of a solution.

4. The code in the context of the bank-firm relationship

The conduct required of banks under the code fits into the evolving relationship between banks and firms. It corresponds to the model of intermediary as a broad interpreter of financial assistance to companies in every phase of their lives, in order to foster growth and, when appropriate, help to reallocate ownership.

Analyses by the Bank of Italy show that even though multi-borrowing is still common, there is now a tendency to form privileged relationships between the firm and a small number of financial institutions that provide most of its credit.

Given this trend, there is increasing reason for more incisive support from the intermediaries, utilizing their professional capacity to evaluate the financial needs, opportunities and risks related to the firm's activity.

In crisis situations, banks' decisions must be based on adequate information, dialectical analysis and negotiation. Action aimed to recover loans immediately, without consideration of the company's prospects, may preclude the possibility of reorganization and cause a loss in value.

The earlier a firm is perceived to be in difficulty and the more effectively the crisis is managed, the greater the probability of credit recovery, because the costs to intermediaries arising from lengthy bankruptcy proceedings and lower rates of recovery are reduced. This can have a positive effect on the banks' accounts, both the income statement and balance sheet, and free resources for profitable investment.

More effective crisis management procedures, by improving the ex ante prospects of loan recovery, permit the reduction of financing costs and an expansion in the supply of credit.

The firm, in turn, must not evade the banks' scrutiny. The transparency of information constitutes a fundamental element of the fiduciary relationship with intermediaries, and it is particularly valuable when the firm is in difficulty.

In the initial phase of a crisis, when there is still ample scope for action, the entrepreneur's choices are crucial. Open and constructive dialogue with the bank eliminates the possible infiltration of organized crime and provides incentives for rational conduct, as during the ordinary life of the firm. The different roles played by the bank and the firm and the physiological contraposition of interests are not impediments to a constructive approach.

These are the most important lessons from the experience of extrajudicial agreements and the bases of their effectiveness. They bear witness to the banks' efforts to safeguard firms' value and their propensity to search for every feasible initiative to salvage firms and, in the end, the productive wealth of the nation.

Under the present legal framework, however, this model faces obstacles.

When a firm enters bankruptcy after the agreement, the possible revocation of payments made under the reorganization plan, the insufficient protection of new financing granted during the plan and the possibility of criminal conduct are serious risks that banks and creditors face

owing to the lack of rules. The entrepreneur, whose bargaining power is reduced owing to his firm's troubled situation, also needs attention and protection, as do the other interested parties.

Dissent among parties to the agreement may also constitute a problem for the reorganization plan, even when this has been approved by large or qualified majorities.

A reform is necessary to provide a more suitable framework that recognizes the competence of private initiative while at the same time defining the sphere of choice and instituting appropriate safeguards.

5. The reform of bankruptcy law

Bankruptcy law is of recurrent interest in Italy. Its reform has become more urgent. It is an integral part of the modernization of business law that began with the Consolidated Law on Financial Intermediation. It also is connected to the general reform of company law.

Major innovations have recently been introduced: last year new legislation on the special administration of large insolvent firms was approved. Provision is now made for a preliminary assessment of the firm's true situation: if there are sound prospects for recovery, a reorganization plan is initiated, which may include either selling the firm or economic and financial restructuring. In the case of an irreversible crisis, the firm is declared bankrupt and liquidation is begun.

The legislator is called upon to undertake a systematic reform of bankruptcy proceedings based on uniform standards. The intervention must take account of Italy's specific productive

structure, which is distinguished by the large number of small firms, extensive family involvement and limited reallocation of ownership.

These characteristics add to the need for a crisis management procedure that encourages cooperation and acknowledges the role of the entrepreneur, who by virtue of having more complete information on the firm's real situation can propose more technically appropriate solutions to overcome the crisis, naturally subject to rigorous scrutiny.

The reform should delineate a flexible procedure that fosters dialogue between business representatives and other involved parties. If the economic function of these procedures is the pursuit of an acceptable organization of interests, the legislation that best reflects this function is surely one that respects the autonomy of the parties.

Bankruptcy law must be reformed because it penalizes firms under many aspects. It must be ensured that firms exit from the market only in the case of irreversible crisis, possibly by means of transferring the entire business, and not in the case of surmountable difficulties. The punitive effects of bankruptcy must be attenuated, re-establishing the distinction between entrepreneurs who are in difficulty owing to unfavourable market conditions, who need not be removed, and those guilty of serious violations of the law, who must be prosecuted. As long as a company retains productive value, it must be preserved.

The courts must intervene in order to guarantee that the procedure's prerequisites and rules are complied with; they must not restrict possible solutions or make decisions that are properly within the competence of those who bear the risks and costs.

6. Future developments

Looking towards a reform of bankruptcy law, it is to be hoped that the "code of conduct" being introduced today will help to strengthen and foster a culture and method of active crisis management that is more appropriate to preserving firm value and selective market mechanisms and more consistent with a modern interpretation of the role of banks.

The code must not be considered a point of arrival but rather a platform on which to build future developments; its application will permit further refinements so as to disseminate the best practices that emerge among operators.

We are embarking on a phase that could mark the effective renewal of business crisis management. A system of cooperation could be extended to firms with less than 30 billion lire of debt to the financial system. This would be an important step in aid of small and medium-sized firms, which are more vulnerable given their limited capital and the difficulty of undertaking reorganization with their own financial resources.

The British experience demonstrates how the central bank can play an active role in fostering coordination and dialogue among creditor banks.

The Bank of Italy will continue to follow the development of these issues closely. To support the search for appropriate solutions, the Bank could make available its wealth of information on local economic conditions acquired through its extensive network of branches.

Efficient crisis management is of utmost importance to banks, but it also is crucial to firms. It helps to create an environment that encourages the assumption of risk, entrepreneurship and economic growth. Broad and sincere adherence to the code and consistent conduct are expected from banks, while it is hoped that firms will concur with the principles that inspire the code.