New Financial Contracts for Italian SMEs. Liability of Credit Rating Agency

[Francesco Romano, Federico Maria Balletta, Roberto Balletta, Consiglia Botta]

Abstract— **The SME sector in Italy was hit hard by the global recession of 2008-09, as the whole Italian economy which hasn't yet recovered the 2008 level of GDP. Small enterprises, which constitute the vast majority of Italian companies, were more affected than medium and large-sized companies. For facing that situation Italian government issued some provisions to improve the general framework conditions for Italian SMEs (Small and Medium enterprises), making administration more responsive to the needs of businesses and improving policies for companies which want aggregate and internationalize theirs activities. Nevertheless, the country's overall performance of SMEs continues to be below the EU average in terms of exporting internationally and the single market, and access to finance. To cope with this problem Italian legislator has introduced amendments to the law on bonds and financing bills with the aim of facilitating access to direct financing for unlisted companies, especially for SMEs. Until now this new possibilities didn´t have a significant impact on the finances of Italian SMEs, in fact just twenty-six new instruments have been issued, for a total amount of just under €5 billion. So, the new measures have generated a substantial flow of capital. Last regulation on this topic was the "Destinazione Italia" Decree which contains in section 12 the legal framework for Italian corporate bonds, offering tax credit both for issuer and purchaser of mini-bond. Insurance companies and pension funds are now incentivized to purchase corporate bonds as those regulatory impediments that used to prevent them from investing have now been lifted. To purchase these bonds with competitive interest rate issuers should have a good credit rating. Only because of the availability of clear, internationally accepted indicators of the risk of default were investors willing to invest in such securities. This lead to the importance of credit rating, their fairness and about the liability of credit rating agency.**

Keywords— **SME, Italy, Mini-bond, Liability Law, Business Network Contract, Rating**

Francesco Romano, Ph-D Student in Business Law
University Federico II
Naples, Italy
francesco.romano2@unina.it

Federico Maria Balletta, Master- Student in Economy
University Federico II
Naples, Italy
federico_ball@hotmail.it

Roberto Balletta, Ph-D Student in Person´s, Business and Market Law
University Federico II
Naples, Italy

Consiglia Botta, Associate Professor of Private Law
Department of Economy, Management, Istitution, University Federico II
Naples, Italy

I. The Italian SME experience

The Italian market is dominated by Small and Medium enterprises. Indeed there are approximately 65 SMEs per 1000 inhabitants, which is above the EU-27 average. In line with this, the relative importance of SMEs for Italian economy exceeds by far the EU average; almost 39% Italians desire to be self-employed. That means Italy's SME sector has a higher proportion of small enterprises employing fewer than ten persons, compared to the EU average (Italy: 94%, EU: 92%). Therefore small firms contribute more to employment and value-added than elsewhere in the EU: nearly half of total employment and one-third of value added. On the whole, the crisis has had a very negative impact on the SME sector in Italy, both in terms of added value and employment, which is still recovering. As showed by 2013 SBA (Small Business Act) Fact Sheet, Italy is catching up with the EU average, as it has made major progress over the last 12 months in terms of policy and legislative reforms in most SBA aspects. No fewer than five decrees were converted into law in 2012, each containing important measures for SMEs. Access to finance is the most critical aspect for Italian small and medium enterprises, which is one of the most problematic area for Italian SME. Italy performs well below the EU average, with signs of increasing deterioration. Banks are less willing to provide loans to SMEs, and this, together with higher rejection and unacceptable loan rates, signals a drying up of private-sector financial support. Many policy measures have been brought in 2012 to facilitate the access of SMEs to credit and capital markets, improve the capital increase within firms and reinforce the guarantee system. However, despite the efforts made to launch the new instruments (aid to economic growth, project and mini-bonds, moratorium for debts), and reinforce existing instruments (the guarantee fund and renewal of credit for SMEs), and extensive use of traditional mechanisms (fiscal incentives, use of credits towards the public administration as leverage to obtain liquidity for companies), Italian SMEs still suffer from a chronic and structurally difficult access to finance.

II. New legislative measures

In order to help firms to cope with credit crunch, the Italian legislator has introduced some regulations for facilitating the access to finance for SME. Nowadays Italy has been strongly hit by recession. Therefore the Italian government is acting as first mover in SME´s financing sector. The most important policies which have been recently introduced are: Business Network Contract and mini-bond.

A. *The Business Network Contract*

Business Network Contract is the first policy introduced in 2009 and modified several times. This policy is becoming very common in the Italian productive system, which is largely made up of small and medium enterprises (SME). The Business Network Contract is a private agreement between two or more companies to jointly carry out projects to increase their potential for innovation and competitiveness. This contract enables parties to collaborate in projects, which would have been unfeasible without cooperation, thereby avoiding losing their ownership. This type of contract creates synergy between companies, in order to “exchange industrial, technical, and commercial information or services, or to jointly implement projects in their field, in order to boost their individual and collective competitiveness” law 33/2009.

The Italian «technical» government has considered this type of contract as an important tool for getting through the economic recession. For this reason the lawmaker has introduced some modifications to improve the discipline. The most important one is limited liability, which is connected to the relationship between networks and banks; it allows the network to obtain bank loans profiting by «Network’s rating». Business Network Contracts have become a very popular form of aggregation, positively welcomed by entrepreneurs. Since its creation, 1400 business networks involving 6000 enterprises have been created, covering all types of sectors, with the main objectives being internationalization, marketing, research & innovation, branding for high quality products and promoting local areas.

B. *Mini-bond: an easier access to finance*

Another instrument for solving credit access problem is: mini-bond. In Italy SMEs depend on bank loans while other alternative source of financing are not very developed. Indeed 81% of Italian SMEs’ debt is owed to banks and this percentage is noticeably lower in the other European countries as shown by BACH (Bank for the Accounts of Companies Harmonised) - the databank of accounts of non-financial European companies (66% in Portugal, 65% in Germany, 57% in both France and Spain). The incapability to access to alternative credit sources and at the same time the reduction of banks’ loan supplies has increased the financing problems of Italian SMEs.

To tackle this issue and facilitate direct access to capital markets among smaller businesses, the Technical Government overhauled the legislation on financial bills and bonds. In the Development Law (no. 83/2012), the Government introduced several new regulations to enable unlisted companies to issue debt instruments, commonly known as “mini-bonds” for the small amount issued.

The mini-bond legislation: broadens the possibilities to issue financial bills, introducing sponsorship to assist SME issuers; introduces “participating” subordinated bonds (i.e. with a clause entitling bondholders to a portion of the company´s profits); exempts investors from tax withholdings on interest earned, and allows issuers to deduct the interest paid for up to 30% of EBIT (Earnings before interests and taxes), and allowing bonds to be issued for amounts above the customary limit of two times equity plus reserves.

In 2012 the Development Law modified strongly the Italian corporate bonds law introducing a provision which permits SMEs to access the funding necessary to their survival and expansion of business.

The new legislation enables unlisted SMEs to issue Mini-Bonds in order to affirm SMEs’ independence from bank loans. The Italian Law Decree no. 145 of 23 December 2013 (the “Destinazione Italia” Decree) has now set a number of other restrictions on corporate bonds offering, particularly in terms of security and regulatory laws and has introduced additional tax and other incentives that are intended to create a new Italian corporate bonds regime especially for small and medium company.

The “Destinazione Italia” Decree has also broadened the possible purchasers of mini-bonds and other debt instruments. Thanks to this law, pension funds and insurance companies can invest in bonds which are not listed on any regulated market or any other multilateral trading facility and have not received an independent rating.

These provisions should implement the range of entities that can issue mini-bonds so that SME bond market could finally roll-out also by setting the more favourable tax regime including: the possibility for issuers to deduct from their tax bills all the expenses related to the bond issue; the opportunity for investors to benefit from the withholding tax exemption; the application of the more favourable 0.25 substitute tax. Investors will also welcome the opportunity for issuers to secure their offerings by granting a floating charge over their assets.

III. Rating as an essential element for benefiting from these new regulations

To benefit from these measures and to solve financial difficulties, a new phenomenon is spreading out deeply in the Italian market: SME´s rating. The Italian economy is struggling to survive one of the most severe recessions witnessed since the Second World War and the business environment has been deeply affected.

The bank loans have been strongly reduced by the recession. This credit crises has been aggravated by Basel capital regulations, which have imposed higher minimum capital requirements on banks to ensure that the broader financial system remains solid, and also accentuated the separation between creditworthy companies and more fragile ones; consequently, financing has dissolved especially for companies with low credit ratings. Regardless of this more selective approach to lending, there was a generalized decrease in lending to businesses, even to those meeting the necessary requirements. On the contrary banks are increasing their capital gain investing money in corporate or state bonds which still have enormous spread difference trough Europe. Furthermore the majority of enterprises are so small that they are not bankable. In a recent report of a credit agency based in Italy which is the sole focused on SME and recognized by European Commission it has been underlined that the quality of SME in Italy is very high. Over 24-thousand enterprises with more than a 5 million turnover would have a triple A rating, which would make them eligible mini-bond issuers. That means a very low default possibility. Almost the majority of SME is in a good situation while only 10 per cent is in a default situation.

Until now the rare use of new debt instruments by SMEs has not been due to a lack of companies solid enough to issue bonds or financing bills. The recession has triggered a Darwinian selection process in the Italian economy: the weakest companies have been ousted, while many others have had no choice but to strengthen their balance sheets in order to survive. As a crisis result, Italy's productive system has shrunk, but it is more solid than it was in 2007. Despite some balance sheet deteriorations in 2012, the companies' risk profile on the market today is still better than it was before the crisis began: about 46% of companies with over €2 million in revenue are "solvent", compared to 43% in 2007, and the percentage of "risky" companies has decreased from 21% to 17%. This market could boost SMEs and the Italian economy in general.

IV. Liability of Credit Rating Agency

"There are two superpowers in the world . . . the United States and Moody´s Bond Rating Service . . . and believe me, it is not clear sometimes who is more powerful". This sentence of an American senator underlines the importance of CRA (Credit rating agencies) judgments.

CRAs play an important role in our financial and capital markets. Their primary function is to value the quality of a company's credit and its´ debt obligations through credit ratings. As private suppliers of information, they can facilitate the raising of capital by providing information to investors at a lower cost than their own investigation, and as a result lower the cost of capital by companies who issue securities. Their opinions greatly influence the ability of these issuers to raise capital and the decisions of some fiduciaries to invest. CRAs act as intermediaries by evaluating issuers in order to protect outside investors. Their power can also lead to other abusive practices such as pressure on issuers to purchase more related services. CRAs may compromise their ratings in order to facilitate the selling of these services such as pre-rating advice and consultations. There are also potential conflicts of interest because the issuers pay for the credit ratings which are intended for use by investors. This could result in rating inflation to assist the issuers.

There is a strong opinion that CRAs contributed to the current financial crisis, which began in the United States (USA) in the summer of 2007 affecting the mortgage market and has then globally expanded. Indeed these companies underestimated the credit risk associated with structured credit products and failed to adjust their ratings to the fast deteriorating market conditions. The reliability of ratings was compromised in the crisis management because of CRAs methodological errors and unresolved conflicts of interests, with the result that these agencies lost market participants' confidence.

This lack of confidence has generated a lot of liability claims against CRAs because of their erroneous ratings especially by investors who relied on their opinions, investing all their patrimony in investment grade companies. The standards of care descends, in the contractual area, from contractually-agreed limitations of liability whereas outside contractual relationships, they are aimed to not only protect freedom of speech and of the press, but also to limit the risks of liability to a reasonable amount.

V. European CRA regulation

To recover the market confidence on CRAs a regulation should aim to make ratings more reliable and mitigate their conflicts of interests. Nevertheless CRAs' opinions have strongly increased the efficiency of the financial markets helping market participants by reducing information asymmetry. Securitization allows risk to be spread between parties and enables many categories of investors to diversify their investments more widely. It also facilitates improved risk management among issuers. This presupposes that risks have been accurately assessed.

A. *IOSCO code*

The Code of Conduct Fundamentals for Credit Rating Agencies was published by IOSCO (International Organization of Securities Commissions) in 2004 as a consequence to the CRAs' failings in the Enron and WorldCom affairs. They determine rules to value the quality and integrity of the rating process and the monitoring of ratings; on assuring adequate internal procedures and analyst independence to avoid conflicts of interests; on making sure that rating methods are transparent and that ratings can be adjusted if necessary rapidly; on handling confidential

information; and on disclosing the extent to which CRAs follow the Code. After the bankruptcy of Lehman Brothers, the international regulator decided to issue a new regulation, revising the previous one which was considered as inadequate. For this reason, the new Code entered into force in 2008.

Aims of this modification was to reinforce the quality and integrity of the rating process. As per this new provision, CRAs should: prohibit CRA analysts from making proposals or recommendations regarding the design of structured finance products that the CRA rates; ensure the quality of the information needed for ratings and inform users about the limitations of the rating; and finally periodically review the methodologies and models used.

B. *The European Regulation 1060/2009*

Before the irruption of the financial crisis, the regulatory setup in Europe was based mainly on self-regulation within certain supervisory “crash barriers” in the form of the IOSCO Code.

A CRA must meet the following requirements regarding its rating methodology in order to be recognized by supervisors:

• objective ratings. The methodology used must be systematic and subject to some form of validation;

• the process should not be influenced by political forces and economic pressure;

• ratings’ reviews should be done at least once a year;

• general information about the methodology should be publicized and documented.

Furthermore, ratings:

• should be judged credible and reliable by users, and

• should be available to all institutions with a legitimate interest in them on the same terms.

The Regulation on CRAs was implemented by the European Parliament in 2009, ratified by the Council and then applied in all member states.

The Regulation contains some provisions that are already contained in the IOSCO Code but are now legally binding. On the other hand, some important points of the Code have not been incorporated into the EU Regulation. This is unfortunate because it is unclear what role the IOSCO Code should now play in the EU.

C. *New EU-Regulation*

As a consequence of the financial crisis and in particular the euro debt crisis, the inadequacy of EU rules on credit ratings has emerged. In response to the financial crisis, CRAs failed to appreciate properly the risks inherent in more complicated financial instruments, issuing incorrect ratings that were far too high.

The first European Regulation on Credit Rating Agencies (CRA I Regulation) was approved by European Parliament and entered into force in December 2010. This provision constitutes the European response to the lack of rules about rating. The Regulation was amended in May 2011 to adapt it to the creation of the European Securities and Markets Authority (ESMA) by the so called CRA II Regulation.

The innovative regulatory package on credit rating agencies consists of both a Regulation and a Directive. The key elements of the new rules are: to make credit rating agencies more responsible for their actions and to reduce conflicts of interest due to the issuer-pays remuneration model and to encourage the access of more parties on to the credit rating market, reaffirming that ratings are not just simple opinions. Thanks to these new European Regulations, a rating agency can be held liable if it infringes intentionally or with gross negligence, the CRA Regulation, thereby causing damage to an investor. The new legislation is enriched rules for complex structured finance instruments and shareholders of rating agencies that improve the independence of credit rating agencies and eliminate conflicts of interests.

For improving the transparency of such judgments, The law has established the creation an European Rating Platform in which it will be possible to check all the available ratings. This with the aim of facilitating the comparability and visibility of the investment grade for any financial instrument rated by rating agencies registered and authorised in the EU. This should also push investors to make their own credit risk assessment and implement diversity.

Furthermore the Regulation introduces a mandatory rotation for certain complex structured financial instruments (re-securitisations) with the aim of removing conflicts of interest also guaranteeing the independence of credit rating agencies. The law determines also limitations as regards the shareholding of rating agencies.

On the other hand Investors will be in a better position to evaluate the credit risk of financial instruments themselves. Indeed the European Regulations provides them the access to the European Rating Platform where they can find, check and compare, for every firm they want, all ratings issued by CRAs registered and authorised in the EU.

To achieve all these ambitious aims, the EU-Commission will proceed with a two-step approach. First of all, the Commission will propose to reduce all references which trigger mechanistic reliance on ratings, and in a second step, the Commission will elaborate a report to the European Parliament on alternatives to external credit ratings with a view to removing all remaining references by 2020, without increasing the non-confidence on the market.

VI. Conclusion

Nowadays, ratings play a very important role in a globalised economy. CRAs opinions reduce information asymmetry and in this way permit an “informed” investment. Nevertheless their judgments are not only mere opinions but have important consequences. Therefore, CRAs should

operate consciously. Their responsibility for the financial crisis has been analyzed in depth by policymakers and various expert groups; indeed some legislative provisions have been introduced both by international organization as IOSCO and States as United States or European Union. By the way, the new EU-Legislation will ensure the responsibility of CRA. Furthermore it will increase liability for investors and issuers.

Regulation's primary objective is to solve the problem of conflicts of interests. Other key issues which remain unresolved until today – such as the lack of competition in the ratings market, liability and, above all, the pro-cyclical impact of credit ratings – need a new discipline. Furthermore SME will strongly benefit from the resolution of these difficulties SME's rating could spread out deeply in the European market helping small and medium companies to get financed by banks or by new financial tools – such as mini-bonds – to challenge global markets.

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About Authors:

Francesco Romano, Ph-D Student in Business Law at the Faculty of Economics, University "Federico II" of Naples, Italy. Daad-Scholarship holder at Freie Universität Berlin, Germany. Research focuses: Business Network contract and SME's rating.

Federico Maria Balletta, Master-Student in Economy. University "Federico II" of Naples, Italy. Master-thesis mainly oriented to financing problems of SMEs.

Roberto Balletta, Ph-D student in Person´s, Business and Market Law at the Faculty of Economics, University "Federico II" of Naples, Italy. Research focuses: law issues of financial tools for enterprises, and notary law.

Consiglia Botta, Associate Professor of Private Law
Department of Economy, Management, Istitution, University Federico II of Naples, Italy. Research focuses: Private Law, Private International Law and liability law.