

# International Similarities of Bank Lending Practices and Varieties of Insolvency Laws; a Comparative Analysis of France and Germany

Ingrid Größl

Nadine Levratto



Universität Hamburg

*Economix*

CNRS - Université de Paris Ouest Nanterre La Défense

# Motivation

- The VoC-approach seeks to explain varieties of capitalism by varieties in complementarities between institutional structures and their impact on firms as the major actors.
- Following this line of thought we examine complementarities between the insolvency law and prevalent lending practices towards firms:
  - Implications for the role of collateral?
  - Implications for the relative importance of arm's length and relational lending?
- In doing so we have a focus on France and Germany which exhibit pronounced differences in their insolvency laws.

# Economic Theory

- There exists a complementarity between the degree of priority of secured lenders in insolvency proceedings and the use of collateral in bank loans (**first complement hypothesis**)
- There exists a complementarity between a priority of inside collateral and relational lending (**second complement hypothesis**)

# Objectives of our Contribution

We seek to find out whether France and Germany represent examples for the empirical validity of both complement hypotheses

# Outline

1. The insolvency law in France and Germany: a very brief sketch
2. The two complement hypotheses in theory and practice (France and Germany)
3. Conclusions and future research

# The French and German Insolvency Laws: Commonalities and Differences


**Commonalities** exist with respect to

1. the maximization of the insolvent firm's estate as a primary objective
2. equal treatment for all creditors as a fundamental principle
3. exceptions to the „pari-passu-rule“

Differences exist with respect to (1) and (3)

# The French Case: a menu of possible solutions

- The actual framework is the result of a huge number of reforms enacted since the Commerce Code in 1807.
- 4 different laws since 1994 → 5 possible court-based ways :
  - Private agreements between debtors and creditors : mediation procedure + conciliation proceedings (kept confidential)
  - Procedures to reorganize the insolvent firm :  
Safeguard + Rehabilitation
  - Dissolution to close the business : Compulsory liquidation



Our main concern  
in this paper

# The French Case: a Propensity Towards Firm Reorganization

- Maximization of estate through reorganization : 3 procedures over 5 but less than 20% in practice
- Control rights are concentrated in the hands of the judges during formal proceedings
- Creditor boards have a right to negotiate
- Collateralization by itself does not determine the ranking of creditors : super-privilege for workers, state administration and court fees apply.
- Since 2005, later creditors (new money) benefit from favorable treatment



# The German Case: a Tradition for Liquidation Hard to Break

- Between 1878 and 1999 insolvency was regulated in the Konkursordnung (KO) with the Vergleichsordnung (VO) as a complement since 1935.
- The Konkursordnung had an exclusive focus on the **liquidation** of the insolvent firm.
  - The 1935 amendment sought to put emphasis on the reorganization of the firm
- Secured lenders had absolute priority concerning all types of collateral in the sense that the secured assets were excluded from the insolvent firm's estate (*exemption*) or that creditors retained control rights over the assets in formal insolvency proceedings (*separation*).

# The German Case: a Tradition for Liquidation

- Growing dissatisfaction with the KO and VO (Gessner et al. 1978, Bork 2005):
  - In the 1970s three fourths of petitions were turned down due to a lack of estate
  - Unsecured lenders did not recover more than 3-5%
  - Hardly ever was a firm reorganized (1% of all proceedings. (Bork 2005))

# The German Case: Towards Firm Reorganization

- In 1999 the Insolvenzordnung (IO) was enacted with basically the following objectives:
  1. Increase of the insolvent firm's estate
    - Impending insolvency as a reason for adjudication
    - deferment of procedural cost
    - partial cutback of secured lenders' rights to separation
  2. Promotion of firm reorganization through the insolvency plan procedure

# The German Case: Towards Firm Reorganization: Qualifications

## 1. Secured lenders:

- Their approval concerning the use of collateral is imperative.
- Compensation of secured lenders by the right to collateralize up to 110%

## 2. Promotion of Firm Reorganization:

- Secured creditors have to approve of a discharge of debt as well as of the inclusion of collateralized assets into the firm's estate.
- Creditors have to approve of an insolvency plan procedure and on a transfer of control rights to the debtor (Eigenverwaltung).

# **C1: Complementarity between the Seniority of Secured Lenders and the Collateralization of Bank Loans**

- The insolvency law decides on the extent to which secured lenders can assign an insurance function to the collateralization of their debt.
- However, this insurance has its costs. Costs are incurred in
  - the selection of collateral
  - monitoring of its value
  - enforcement
  - compensation of the borrower

# C1: Complementarity between the Seniority of Secured Lenders and the Collateralization of Bank Loans

- These costs have to be outweighed by the benefits of collateralization.
- According to economic theory these benefits go beyond ex post effects of insurance thus affecting the borrower's behaviour in favor of avoiding
  - adverse selection (Bester 1987)
  - moral hazard (Bester 1987)
  - and strategic insolvency (Bester 1994, Schäfer 2003)thus **making default less probable.**

# C1: Complementarity between the Seniority of Secured Lenders and the Collateralization of Bank Loans

- According to Welch (1997) banks are the principal secured lenders because they are capable of reducing the *cost* incurred in the pledging, monitoring and enforcing of collateral.
- Banks also enjoy particularly *high benefits* from collateral because they are the main lenders to SMEs as highly opaque borrowers (Harhoff,/Körting 1998, Rajan 1992, Petersen/Rajan 1994, Berger/Udell 1995).

# **C1: Complementarity between the Seniority of Secured Lenders and the Collateralization of Bank Loans**

- Note that the impact of collateral on the borrower's behaviour, rests on the degree to which the debtor has to count with a loss of the asset in case of opportunistic behavior.
- This leads us to conclude that the extensive use of collateral by banks should be typical for financial systems with an insolvency law which assigns a high priority to secured lenders.



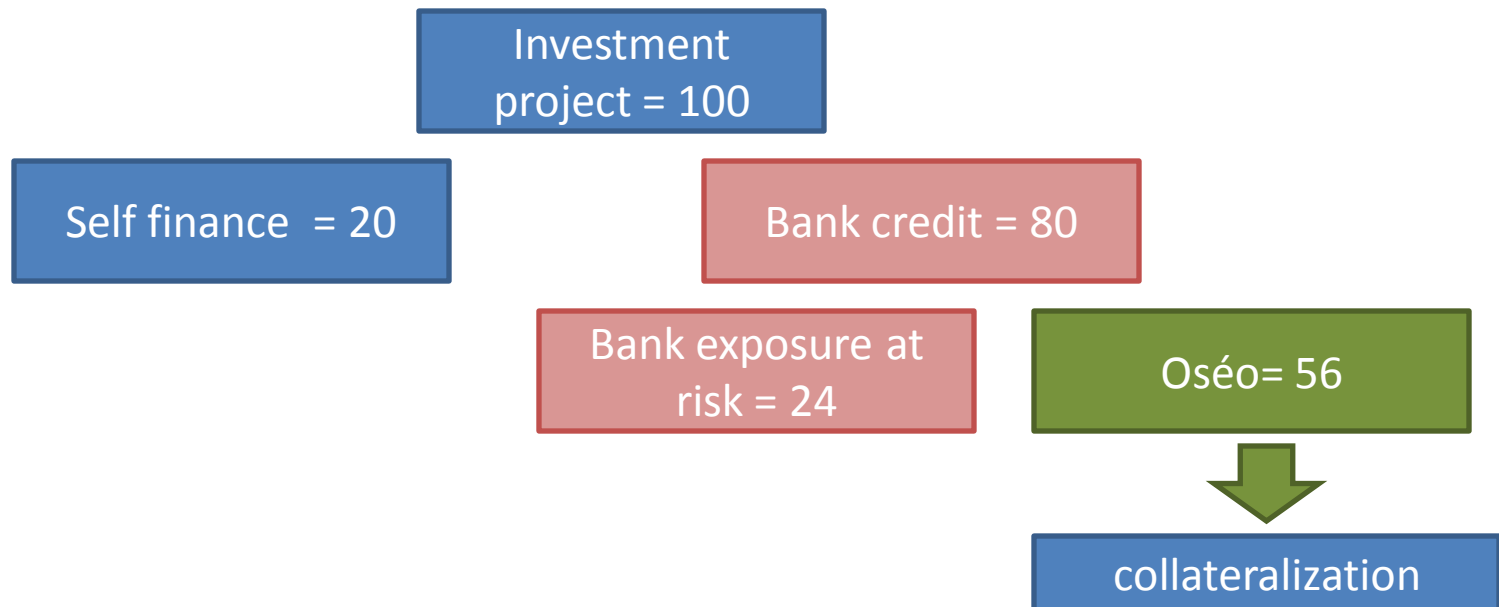
# C1: Complementarity between the Seniority of Secured Lenders and the Collateralization of Bank Loans

This can be confirmed for Germany:

- Under the KO three fifths of the insolvent firm's assets were secured with banks holding 70% of all rights of separation and exemption. 81 percent of their claims were collateralized (Gessner et al. 1978)
- So far comprehensive evidence for the Insolvenzordnung is missing. But:
  - Under the the new insolvency law unsecured creditors still appear to recover less than 5% on average (Kranzusch, 2009) thus indicating that not much has changed so far.

# C1: Complementarity between the Seniority of Secured Lenders and the Collateralization of Bank Loans

- In spite of low priority the level of collateralization in France is high, too!
- Specific role for the guarantee scheme offered by Oseo (state owned bank for SMEs) that is allowed to guarantee up to 70% of the borrowed amount



# **C1: Complementarity between the Seniority of Secured Lenders and the Collateralization of Bank Loans**

- A recent study (Blazy/Weil 2005) points out that over a sample of more than 300 insolvent firms about 74% of bank loans are collateralized.
- The guarantee scheme
  - circumvents the rule that disadvantages banks in the creditors hierarchy,
  - helps to increase the recovery rate of collateralized assets.

# Conclusion Regarding C1

- We confirm an extensive use of collateral by banks in **both** countries.
- This happens irrespective of how secured lenders rank in the insolvency law.
- In France possibly detrimental effects for lenders of the insolvency law are compensated by a public guarantee mechanism.

## C2: Complementarity between the Seniority of Banks and Relationship Lending?

- Whereas the previous arguments did not rely on the type of collateral but just on their priority in case of insolvency, now the **type** of collateral becomes important.
- Economic theory finds that priority for *inside* collateral has explanatory power for relational lending.
  - ❖ Inside collateral refers to assets whose value is correlated with the value of the firm (accounts receivable, the firm's premises, machinery)

## C2: Complementarity between Seniority of Banks and Relationship Lending?

- Theoretical arguments are based on four major properties of relational lending:
  1. intensive exchange of information which reduces information asymmetry.
  2. conclusion of incomplete loan contracts with respect to future states of the world.
  3. Renegotiations are used with a view to maximizing the mutual expected benefit.
  4. Relational lending is **not** identical with exclusive lending.

## C2: Complementarity between Seniority of Banks and Relationship Lending?

- Inside collateral serves to determine priority of the lender over future cash flows,
- thus setting the creditor incentives
  - to monitor the firms. (Rajan, Winton, 1995; Longhofer, Santos, 2000 )
  - to offer financial support in distress situations (Longhofer, Santos, 2000)
  - to invest in management knowhow and actively reorganize the firm in distress situations (informal workouts) (Schäfer, 2003)

## C2: Complementarity between Seniority of Banks and Relationship Lending?

- The German financial system is associated with relational lending.
- For Germany Elsas, Krahn (2002) state to have found evidence
  - for a positive correlation between inside collateral and informal workouts by banks
  - for a complementarity between inside collateral, priority for secured lenders, and the German housebank principle



## **C2: Complementarity between Seniority of Banks and Relationship Lending**

- Since the 1990s the French financial system can be characterized by a predominance of arm's length lending.
- The major reasons for this result can be found in a comprehensive withdrawal of the state from influencing lending relationships and the growing engagement of Anglo-Saxon investors.

## C2: Complementarity between Seniority of Banks and Relationship Lending

- Banks in France concentrate their collateralization policy on outside collateral with personal guarantees ranking first (44%), followed by mortgages (19%) long term assets (15%) and short term ones (14%).
- This weak use of inside collateral is confirmed by a report made by Auxiga, a bank guarantee expert which held € 1,434,666,100 of stocks on 31st December 2007.

# Relational Lending and the Insolvency

## Law: A More Critical Look

- A closer look at the descriptive statistics in Elsas/Krahnert (2002) reveals that arm's length and relational banks have about the same ratio of inside collateral to total debt (40% versus 41.6%) and both types of banks add outside collateral.
- Their distinction between inside and outside collateral remains questionable (real estate?).
- Also their finding of a positive correlation between relational lending and collateralization does not distinguish between inside and outside collateral.
- Concerning theory, it appears noteworthy that Longhofer/Santos do not consider outside collateral as an alternative in their model.

# Relational Lending and the Insolvency law: A More Critical Look

- The evidence for France may suggest the conclusion that French banks are reluctant to collateralize accounts receivables (inside collateral with priority) *because* they do not prefer relational lending.
- The evidence for both countries suggests that we are in need of further arguments supporting arm's length or relational lending which lie outside the insolvency law.

# Conclusions and Future Research

- The degree of priority appears to be less important for the role of collateral in bank debt than stated by economic theory.
- In particular we cannot confirm a dominant role of priority for inside collateral as an explanatory variable for relational lending.
- This moderates the role of the insolvency law for the shaping of lending practices.
- We are in need for alternative explanations. In doing so we plan to take history and different cultural value orientations (Tadesse/Kwok , 2006) into account.