

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

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# Motivation

- Following this line of thought we examine complementarities between the insolvency law and prevalent lending practices:
  - What is the role of collateral?
  - What is the relative importance of arm's length and relational lending?
- In doing so we have a focus on France and Germany.

# Motivation

- France and Germany differ both with respect to their insolvency laws as well as with respect to the prevalent financial systems.
  - The French IL is characterized as debtor-friendly and the French financial system is more market-oriented.
  - The German IL is characterized as creditor-friendly and the German financial system is bank-oriented with a focus on relationship banking.
- What role does the insolvency law play in this respect?

# 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
  - ❖ If priority is absolute collateral is extensively used in particular by banks (**first complement hypothesis**)
- There exists a complementarity between priority for inside collateral and relational lending (**second complement hypothesis**)

# Objectives of our Contribution

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

# Outline

1. The insolvency law in France and Germany
2. Differences and commonalities in ex post effects
3. The two complement hypotheses in theory and practice (France and Germany)
4. Conclusions and future developments

# The French and German Insolvency laws: Commonalities and Differences

Commonalities exist with respect to

1. attempts to maximize the insolvent's estate
2. the principle of equal treatment for all creditors
3. exceptions to the „pari-passu-rule“

Differences exist with respect to how the legislator seeks to achieve these objectives

# The French Case: a Propensity Towards Firm Reorganization

- Maximization of estate through reorganization
- Debtors have the right to choose the procedure according to their preferences
- Collateralization by itself does not determine the ranking of creditors
- Control rights are concentrated in the hands of the judges during formal proceedings
- Creditor boards have a right to negotiate

# 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 they retained control rights over the assets in formal insolvency proceedings.

# The German Case: a Tradition for Liquidation

- Growing dissatisfaction with the KO and VO (Gessner et al. 1978, Borg 2005):
  - In the 1970s three fourths of petitions were turned down due to a lack of estate
  - Banks as secured lenders claimed three fifths of the borrower's estate and realized a recovery rate of 84%.
  - Unsecured lenders did not recover more than 3-5%
  - Hardly ever was a firm reorganized (1% of all proceedings. (Borg 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
  2. Promotion of firm reorganization through the insolvency scheme

# The German Case: Towards Firm Reorganization: **Qualifications**

## 1. Secured lenders:

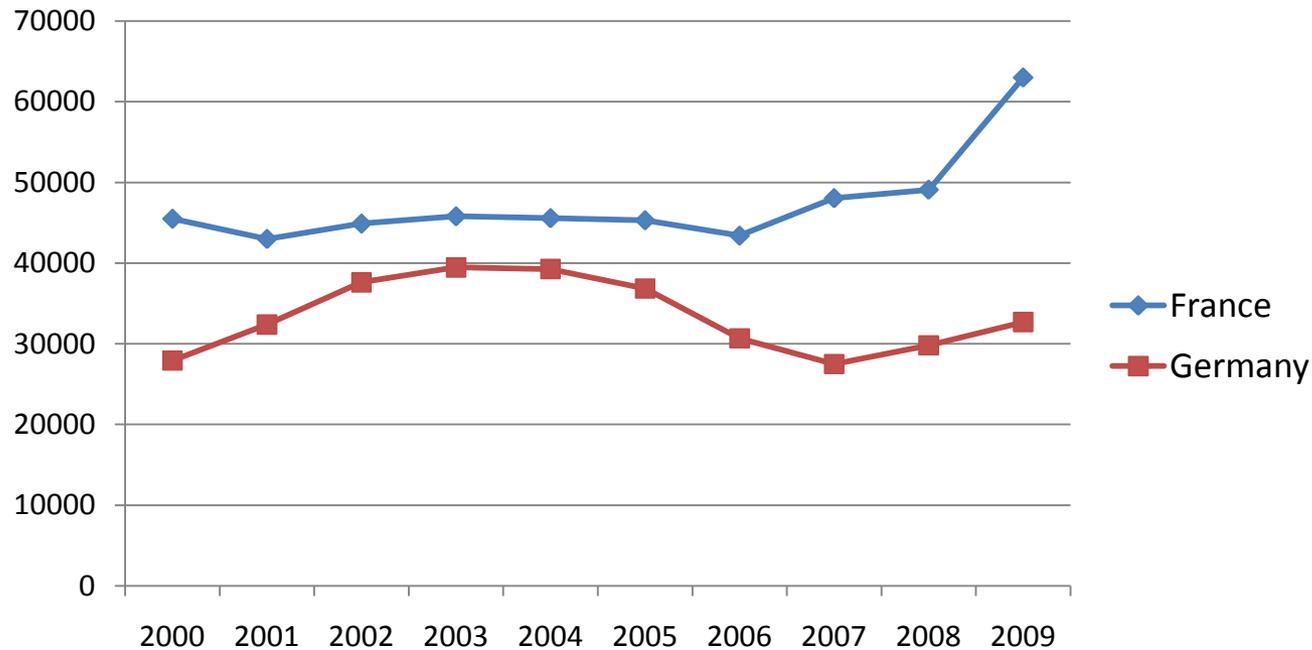
- Their approval concerning the use of collateral is imperative.
- Compensation for a higher participation in enforcement cost by the right to collateralize up to 110%

## 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 scheme and on a transfer of control rights to the debtor (Eigenverwaltung).

# Commonalities and Differences in Ex Post Effects

## 1. Number of insolvencies in both countries



In 2006 the insolvency rate in France was 1.8% and in Germany 1.7%

# Commonalities and Differences in Ex Post Effects

## 2. Recovery rates:

- Gross rates as a median in France 56% and Germany 67% (Davydenko/Franks 2008)
- Recovery rates for unsecured creditors are less than 10% in France and between 3 and 5% in Germany (Blazy/Weil 2005; Kranzusch 2009)

# Commonalities and Differences in Ex Post Effects

## 3. Firm Reorganizations:

- In 2009 in France about 1452 sauvegardes compared to 61595 insolvent firms (2.3%).
- In the empirical study by Kranzusch (2009) in only 1% of all cases did the participants of the formal proceedings opt for the insolvency plan.

# From Ex post to Ex ante Effects

- In spite of marked differences in the insolvency law we do not observe marked differences in ex post consequences between France and Germany.
- Does the same apply to ex ante effects?
  - Complementarity between priority of secured lenders and collateralization of (bank) loans (C 1)?
  - Complementarity between priority for inside collateral and relational lending (C2)?

# 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.
- Absolute priority guarantees perfect insurance, though at a cost. 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 avoiding
  - adverse selection (Bester 1987)
  - moral hazard (Bester 1987)
  - and strategic insolvency (Bester 1994, Schäfer 2003)

# 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 misbehaviour.
- 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 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'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 judging from in particular the continued low recovery rates for unsecured lenders, the new provisions should not have changed much.

# 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!
- About 74% of bank loans to SMEs are collateralized. (Blazy/Weil 2005)
- A guarantee scheme offered by Oseo helps to maximize the recovery rate of collateralized assets up to 70%.

# Conclusion Regarding C1

- We confirm an extensive use of collateral by banks in both countries.
- However, this happens irrespective of how secured lenders rank in the insolvency law.
- In France there exists a state-guided mechanism (Oseo) that ensures a high recovery rate for banks.
  - ❖ This only applies to SMEs thus helping to avoid credit rationing.

## 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?

Longhofer/Santos (2000)

- Adverse shocks require refunding that can be abused by the borrower to shift risks.
- Only a relational lender can avoid this.
- Relationship building is costly.
- Costs are outweighed by benefits only if the relational lender has seniority over other creditors.

Schäfer (2003)

- Seniority also motivates a relational lender to initiate informal workouts.

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

- For Germany Elsas/Krahn (2002) and Brunner/Krahn (2000) state to have found evidence
  - for a housebank's propensity to reorganize an insolvent client firm and
  - 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 ties.
- The major reasons for this result can both 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 ranging 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/Krahn (2002) reveals that arm's length and relational banks have about the same ratio of inside collateral to total debt and both types of banks add outside collateral.
- Their distinction between inside and outside collateral remains questionable.
- Also their finding of a positive correlation between relational lending and collateralization does not distinguish between inside and outside collateral.

# 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.
  - ❖ Following Tadesse/Kwok (2006) different cultural value orientations play a role.

# Conclusions

- 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.