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

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Abstract

Economic theory conjectures complementarities between the ranking of creditors in formal insolvency proceedings and the use of collateral in bank loan contracts as well as the existence of relational compared to arm's length lending. In this paper we seek evidence for these hypotheses taking France and Germany as examples which differ significantly concerning the ranking of in particular secured creditors. On closer scrutiny of empirical studies as well as statistical information we can neither confirm that a high priority for secured lenders explains an excessive use of collateral in bank loans nor that a priority for inside collateral promotes relational lending. Regarding relational lending we point to variables lying outside the insolvency law, like culture and history.

JEL classification: K12, K22, G21, G33

Keywords: Insolvency; France; Germany; bank-borrower-relationships; collateral; variety-of-capital-approach; law and finance

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1 Introduction

We observe a large variety of insolvency laws all over the world. Attempts to establish a correspondence between a particular type of the insolvency law and legal foundations have been made by the Law and Finance approach. Other attempts have tried to establish a correspondence between the financial system and the insolvency law in the sense that due to a high degree of creditor protection, market-based financial systems *optimally* establish a debtor-friendly insolvency law whereas the opposite should hold for bank-oriented financial systems because here creditor protection is low (Berkowich et al. 1999). Approaches with a close proximity to political sciences emphasize that insolvency law considers the interests of powerful groups, thus denying that insolvency laws adjust to the prevailing financial system and this in a consistent manner. Hence so far there exists considerable uncertainty with respect to possible impacts of the prevailing institutional background (legal tradition, financial system) on the insolvency law. We can observe, however, that scholars have increasingly come to acknowledge a specific insolvency law as a compromise of economic as well as a broader set of political and social arguments and that this compromise is not unaffected by powerful groups (Stiglitz 2001, Moss 2002, Gessner et al. 1978). In our paper we focus on the relationship between *lending practices* and the insolvency law. On the one hand, this implies that we take a more specific perspective. On the other hand, lending practices bear importance for the type of a financial system, since they determine typical patterns concerning the solution of information problems implied in the channeling of savings to investments. One important property of financial systems in this respect is the risk-sharing pattern between savers and investors and concerning the loan contract the risk-sharing pattern between multiple lenders. A further property of financial systems, but not unconnected to the first one, concerns the question whether loan contracts are predominantly arm's length or relational. Going back to Hirschman's distinction between exit and voice, arm's length and relational contracts pose different answers to the handling of contingencies yet unknown at the contracting date. With our focus on these questions our paper can be seen as a further contribution to the ongoing debate on relationships between a country's insolvency law and the prevalent financial system. We are in particular interested in the question whether the insolvency law and lending practices are complements in the sense that loan contracts reinforce provisions of the insolvency law. In this sense, our paper can be understood as a further contribution to the VoC-approach, in which complementarities between institutional structures shape varieties of capitalist systems (Hall and Soskice 2001). However, our paper can also be understood as a further contribution to the law and finance approach which proposes a complementarity between a country's legal tradition and the relevant institutional structures of its financial system (Djankov at al., 2008).

Concerning the links between the insolvency and lending practices, financial theory assigns a crucial role to the order in which the secured creditors of a bankrupt firm are satisfied in formal insolvency proceedings. In this respect, financial theory derives both a complementary relationship between the priority of collateralized debt and the extensive use of collateral in particular by banks as the principal secured lenders (Welch 1997) as well as a complementary relationship between priority for those types of collateralized assets, whose value correlates with the firm value (inside collateral) and relational lending (Longhofer and Santos 2000). The first complementarity bears importance for the properties of a financial system, since banks are the main lenders to small and medium sized firms. An extensive use of collateral by banks would thus signal a particular risk-sharing pattern between the borrowing of small and medium sized firms and their creditors. It would also signal the seniority of bank loans in insolvency compared to other lenders to this firm group, thus explaining a particular risk-sharing pattern between banks and the other lenders to SMEs. More generally, the seniority of bank debt might then offer another explanation for the high degree of bank-dependency of small and medium sized firms. The second complementarity is even more precise on this point, drawing a relation between a specific type of collateral and relational lending, saying that the type of collateral affects how the parties to a loan contract handle contingencies yet unforeseen at the contracting date.

In our paper we want to examine the existence of these two complement hypotheses for France and Germany. In doing so, we take the theoretical models as a point of departure and discuss existing empirical findings. France and Germany are interesting in this respect because their insolvency laws exhibit marked differences. Whereas the French insolvency law is strongly directed towards the reorganization of the insolvent firm, Germany has a tradition towards its liquidation. This in its turn has produced differences concerning the ranking of creditors. Whereas in at least the latest amendment of the French law, the degree of priority assigned to creditors depends above all on their contribution to attempts directed at reorganizing the insolvent firm, in Germany it is the group of secured lenders which hold the highest rank of priority. Against this background we confirm for Germany a complementarity between the degree of priority of secured lenders and a superior role of collateral in bank loan contracts. However, we also find that in spite of curtailed rights of secured lenders in France, there too, banks use collateral extensively and in doing so seek compensation for a cutback of their rights in formal insolvency proceedings by increasing the ratio of collateralization. Concerning the second complement hypothesis we cannot confirm the results proposed by empirical studies for Germany. Concerning France we find that in spite of a high degree of priority for accounts receivables and hence a particular type of inside collateral, in practice it obviously does not qualify as collateral for French banks. This leads us to conclude that the role of the insolvency law in determining the rights of secured lenders in explaining lending practices might have been exaggerated. In particular, we observe that financial theory is correct in emphasizing a high importance of collateral in decreasing expected default, but obviously this does not depend on the degree of priority in formal insolvency proceedings as long as the law does not impose severe upper bounds to the proportion of collateralization as such. In the same vein, we find that the role of inside collateral for the emergence of relational lending might have been exaggerated. Our skepticism assigns a higher importance to alternative explanations for the emergence of relational or arm's length lending which lie outside the insolvency law, an example being Tadesse and Kwok (2005), who emphasize the role of culture in this respect.

For the remainder of this paper we proceed as follows: In Section 2 we briefly sketch the French and German insolvency law. In Section 3 we describe commonalities and differences in ex post effects of the French and German insolvency law. Section 4 is dedicated to the relationship between priority rules for secured lenders and the excessive use of collateral by in particular banks. In Section 5 we examine the relationship between priority for secured lenders and relationship lending. Both in Section 4 and 5 we start with a brief summary of the theoretical literature and then move on to examining the empirical findings.

2 Insolvency laws in France and Germany

Formal insolvency procedures represent attempts to deal with a situation that arises when individuals or corporate entities no longer have the means to meet all their contractual or legal financial obligations. Losses are involved which concern not only the borrower and the group of lenders but also, and in particular in the case of firms, a much wider group of stakeholders. The insolvency law seeks to minimize these losses through regulations which do not only aim at maximizing the borrower's estate after he has become insolvent (ex post effects), but which furthermore aim at reducing expectations of losses through disciplining effects on borrowers' and lenders' behaviors (ex ante effects). As a basic commonality of all insolvency laws we find regulations which prevent a run of creditors on the borrower's estate, thus acknowledging that such a race almost never results in the maximization of the value of a debtor's assets whereas it is almost certain that it produces an inequitable distribution. Also basic to all insolvency regimes is the rule of '*pari passu*' (equal) distribution to creditors, a rule which, however, has come to be violated in most insolvency laws by specifying a class or classes of preferential creditors. Indeed, the ranking order of creditors constitutes one major reason for differences between national laws. Not unrelated to the question whether and how creditors should be ranked is the comparative role of liquidation and firm reorganization as a means to maximize the debtor's assets. It is therefore not astonishing that in this regard we observe differences between national insolvency laws, too. In the literature, it is this issue which has been discussed under the label “debtor- versus creditor-friendly insolvency law”. As will be shown below, the evolution of the French and German insolvency laws have indeed followed different routes in this regard.

2.1 The French System: Increasingly Favorable to Firm Reorganization

The French insolvency law has been subject to numerous amendments since the introduction of the French Commercial Law in 1807 with regulations for bankrupt firms as a crucial component. The Napoleonic law was extremely friendly towards creditors who held major decision rights during the formal proceedings with the court being restricted to supervising functions. By contrast, the debtor was harshly punished even losing his civil liberties. (Robbe-Grillet 2006: 20 and 21). In due consequence, the law was hardly ever applied, meaning that creditors and debtors sought out-of-court arrangements. With caution, this failure of the law can be considered as an important reason for subsequent amendments, which shifted the insolvency law more and more to the advantage of the debtor. A first milestone on this path can be seen in the 1889 amendment which supplemented the immediate liquidation (*faillite*) with a novel procedure that foresaw a debtor-in-possession regulation and intended composition (*liquidation judiciaire*) with the reorganization of the firm (*concordat simple*) as one option. Importantly, *liquidation judiciaire* was assigned priority over *faillite* (Robbe-Grillet: 21-23). A further reform of the law in 1935 extended the application of the insolvency law to corporations which so far had been excluded and strengthened the role of the court. The priority of the composition with reorganization as one option was confirmed by the amendments in the 1950s, which restricted the applicability of *faillite* to fraudulent bankruptcy and mismanagement of the insolvent firm. The *liquidation judiciaire* was renamed to become *règlement judiciaire*. Notably, until the late 1960s the application of the *règlement judiciaire* had been made dependent on personal characteristics of the debtor, namely his honesty and management capabilities. A new perspective was taken in 1967, when the option of a composition with reorganization as a possibility was made dependent on economic factors only. This change of perspective led to the introduction of a pre-emptive procedure (*procedure des suspension provisiore des poursuites*) for firms not yet insolvent but imminently so. Moreover, the insolvent debtor now was given the right to propose a reorganization plan which the creditors had to accept. The rights of the court compared to those of creditors were strengthened further. It was the responsible judge who decided on the acceptance of a reorganization plan, and it was the judge who determined the administrator. Secured lenders lost their right to segregate their collateral from the debtor's estate. This process of curtailing the rights of creditors and shifting the perspective towards the rescue of the insolvent firm culminated in the regulations of 1984, 1985. An out-of-court procedure was introduced offering debtors suffering from imminent insolvency (*règlement aimable*). Once a formal bankruptcy procedure was introduced, the liquidation of the insolvent firm (*liquidation judiciaire*) was possible only if reorganization was assessed to be absolutely without any prospect of success. Otherwise, the reorganization of the firm has to be started following the rules of the *redressement judiciaire*, which foresaw the conception of an insolvency plan and left the debtor in possession. Subsequent changes of the insolvency law commonly aimed at improving timely revelation of firms' difficulties in order to prevent that collective insolvency proceedings might be commenced too late, implying that the borrower's estate had become too small for a successful restructuring of the firm (Robbe-Grillet: 25-28). All subsequent reforms tended to soften the consequences of insolvency for debtors further, trying to ease the rescue of insolvent firms on the one hand and on the other hand promote a fresh start for the debtor. This was more or less confirmed in a report published in 2003 by an expert group appointed by the European Commission, which concluded that the French insolvency law was "not favorable to creditors" (EC 2003: 23). At the same time, several reports of the Parliament and of the ministry of justice showed that 89 per cent of the 44,699 insolvency proceedings in 2003 had ended up in liquidation. A further reform of the insolvency proceedings thus appeared overdue, and once again the French law makers were faced with the task to increase the number of firm reorganizations. In 2005 the French insolvency law was thus amended by the law regarding the Safeguarding of Businesses (the "Reform of 2005").The reform enacted in 2005 took effect on 1 January 2006. It has amended Book VI of the French Commercial Code, entitled “Businesses in Difficulty.” Its principal objectives were firstly, to improve the timeliness of reorganization and secondly, to honor creditors’ rights more than was the case hitherto, without impairing the prospect of reorganization. An important role in this regard was assigned to a novel out-of-court proceeding (*conciliation*), which replaced the *règlement aimable* and which under certain conditions and contrary to this old regulation could also be applied in the case that the firm had already declared insolvency. The condition said that this declaration of insolvency was not allowed to be older than 45 days. Providers of “fresh money” during the period of *conciliation* were given priority in the ranking order of creditors other than super-priority salary claims and court fees and expenses. Similar provisions were also foreseen to apply to suppliers of new services or assets for such purposes.

However, the most important legal innovation was the *procedure de sauvegarde* as a judicial proceeding meant to be opened in the case of imminent insolvency and which has come to be described as a French style of the American Chapter 11. In brief, the safeguard procedure is an insolvency procedure that enables the debtor to gain the time required to handle his financial difficulties. It shares with the *redressement judiciaire*, which was retained under the new law in order to allow for reorganization also after insolvency had been declared, the freezing of the debtor’s liabilities[1]. Importantly, like in the case of *conciliation* the ranking order of creditors was used as an instrument to promote the reorganization. In particular creditors’ control rights were made dependent on their role in the process of reorganizing the firm. As a further example of a higher degree of creditor-friendliness, the 2005 law foresaw provisions which acknowledge creditors’ claims having arisen prior to the insolvency judgment and for which creditors missed to file a petition in due time. Furthermore, according to the 2005 law, creditors

[1] Together with the alert procedures, introduced in 1984, it is now possible to discern seven types of procedures. From the most involved to the least invasive, they are court-supervised liquidation proceedings, reorganization proceedings, safeguard proceedings, conciliation, and compromise arrangement procedure specific to farming businesses, the ad hoc representative, and alert procedures.

may no longer be held liable for abusive support[2], that is to say, a creditor cannot be made liable for losses caused as a result of the credits extended[3].

Already in 2008 further amendments followed by the *Ordinance* n° 2008-1345, dated 18 December 2008, which came into force on 15th February 2009. The *Ordinance* introduces greater flexibility with respect to the payment of loans that were extended prior the opening of the reorganization proceedings. This includes the possibility of exercising purchase options, if it can be demonstrated that this is necessary on behalf of the continuation of the firm and if the exercise value is less than the market value of the underlying assets. Subject to certain thresholds for a company's turnover and its number of employees, the *Ordinance* has made significant changes regarding the rules and composition of the two creditor committees. The composition of the committees is now determined in accordance with the structure of loans extended before the reorganization proceedings have been opened, and the committees are established by the safeguard administrator. The *Ordinance* provides that a financial institutions creditors' committee will have to be composed of financial institutions (*établissements de credit*) and those creditors that are assimilated to credit financial institution (to be determined by decree).

A light but however abundantly commented innovation has been introduced and enacted in March 2011. The new procedure, called "accelerated financial preservation" (*sauvegarde financière accélérée*), is mainly a variation on the existing preservation (*sauvegarde*). It is designed for the use of debtors who have been undergoing a conciliation procedure under Article L. 611-4 of the Commercial Code. Under the new accelerated financial preservation procedure, under certain conditions[4], debtors will be able to petition for the opening of an accelerated

[2] Examples of abusive supports are given by Cavalier (2008), p. 2.

[3] Under art. L. 650-1 of the Commercial Code, "Creditors may not be held liable for harm in relation to credits granted, except in cases of fraud, indisputable interference in the management of the debtor or if the guarantees obtained for the loans or credits are disproportionate."

[4] The procedure applies for debtors who are in conciliation, who can demonstrate they are facing difficulties they cannot surmount and who are required to have creditors' committees formed for the purposes of approving a rescue plan.

financial preservation procedure. This is of great advantage to debtors, but it also considers the interests of at least the relevant creditors, as the court takes the likeliness of their approval into account. Notable this regulation benefits very large companies only and it introduces a difference between different classes of creditors in reaching an agreement.

In summary we may state that the French insolvency law has continued to give priority to the reorganization of the financially distressed firm. Creditors' rights are respected mainly in line with this goal.

2.2 The German System: A Tradition Towards Liquidation

Until 1999 insolvency proceedings in Germany had been regulated by the *Konkursordnung*, which was introduced in 1877. In accordance with the Prussian insolvency code the *Konkursordnung* was based on the idea that bankruptcies were an inevitable and necessary concomitant of market economies with welfare-increasing effects once the remaining assets of the insolvent firm were shifted to more efficient owners. In order to realize this objective, liquidation was thought to be superior to firm reorganization (Uhlenbruck 2007, Kohler 1891, Gessner et al. 1978). As a further mainstay the *Konkursordnung* did not foresee a discharge of residual debt.

The liquidation of the firm's assets was considered to maximize the insolvent borrower's estate, which then should be shared by its lenders on an equal par. Also in this vein the originators of the *Konkursordnung* aimed at assigning to the creditors of the insolvent firm a high degree of autonomy encompassing the absolute priority of creditors compared to all other stakeholders (Riedemann 2004).

However, both the principle of equal treatment as well as the principle of creditors' autonomy suffered significant cutbacks in the *Konkursordnung*. Regarding creditors' autonomy, the *Konkursordnung* realized a mixed system by assigning creditors the right to file for insolvency in the case that the debtor ceased to meet his financial obligations not only temporarily (insolvency) and on the other hand by foreseeing a court-appointed receiver with comprehensive rights. Creditors on the other hand were organized in the creditors' assembly and creditors' board, respectively, and as a group had a couple of selective rights only[5]. A violation of the principle of equal treatment was justified by taking the public good into account (priority of tax claims and wages). Gradually, however, secured lenders succeeded in reserving for themselves absolute priority (after wage earners and the state) (Gessner et al. 1978). Differences were made between those assets being factually possessed by the lender and those being possessed by the borrower. The first class of collateral could always be enforced outside the court, meaning that the underlying assets were *exempted* from the borrower's estate (*Aussonderung*). The second class remained part of the borrower's estate, but the lenders had the right to a *separate* satisfaction of the collateralized assets (*Absonderung*) and importantly, implied costs were borne by unsecured lenders (Sauvé et al. 1999). This strong role of secured lenders had not gone uncriticized at the time when the KO was enacted. However, it was accepted since then collateralized debt was rather rare (Kohler, 1891).

The almost complete ignorance of reorganizing an insolvent firm as an alternative to its liquidation proved to be untenable in the aftermath of World War I (Uhlenbruck 2007). It was not until the economic crisis of the early 1930s, however, that a composition code (*Vergleichsordnung*) was introduced as a supplement to the *Konkursordnung*. The composition code proposed a regulatory framework for the reorganization of an insolvent firm and in doing so placed both the right to apply for composition as well as control rights over the firm's asset during proceedings in the hands of the debtor (*Eigenverwaltung*). However, this did not touch the claims of secured lenders who maintained their right to seize or liquidate the collateralized asset (Sauvé et al. 1999). Furthermore, the composition proposal had to include a guarantee for the fulfillment of at least 35% of the creditors' claims.

[5] The creditors' assembly had the right to dismiss the court-appointed receiver. Once approved, however, creditors did not have the right to control the liquidator. Further rights concerned the decision on liquidation versus continuation of the firm, the assessment of the final report (Riedemann 2004).

Growing dissatisfaction with the *Konkursordnung* as well as with the composition code launched a debate about fundamental modifications of the existing law in the 1970s. The long and controversial debate led to the introduction of a new law (*Insolvenzordnung*) in 1999 with the purpose of overcoming basically four failures of the *Konkursordnung*, namely the lack of estate, the almost exclusive emphasis on liquidation, its lack of creditors' autonomy and finally the missing discharge of residual debt for natural persons and sole proprietors of firms.

A *lack of estate* was meant to be avoided by allowing the debtor to file for bankruptcy once insolvency is imminent but not factual, by granting a deferral for the costs of the proceedings[6], by curtailing the previously unrestricted rights of secured creditors with rights to separation, and by shifting the cost of enforcing collateral in some cases to the secured lenders (Bork 2005). By allowing the debtor to file for insolvency already in a situation when he still is able to meet his financial obligation but expects that this will not continue in the future, the law wants to overcome an essential weakness of the old *Konkursordnung* which obviously set both creditors as well as debtors incentives to file for insolvency at a stage when most of the debtor's assets were already "over-collateralized" or used up. The right to declare bankruptcy if insolvency is imminent but not a reality increases the so-called factual estate (*Ist-Masse*).

Concerning the ranking order of creditors, the new insolvency law retains the regulation of the *Konkursordnung* according to which secured lenders with the right to exemption are free to seize their assets thus reducing the factual estate. By contrast, secured lenders with a right to separation have lost the right to liquidate the collateralized assets by themselves, which is now in the hands of the court-determined receiver. The receiver is entitled to use the collateralized asset but has to compensate the creditor for possible losses. If the receiver wants to liquidate the asset, he has to inform the lender who in his turn is entitled to sell the asset by himself once he proves that he can realize a higher price (Bork 2005:139). Costs incurred by the liquidation of collateralized assets now have to be borne by the secured lender. However, secured

[6] This was introduced in the *Insolvenzordnung* as an amendment in 2001.

lenders are free to seek compensation by collateralizing their loans up to 110%. Furthermore, in the ranking of creditors, secured lenders with a right to separation rank second after secured lenders with a right to exemption.

A second mainstay of the *Insolvenzordnung* concerns attempts to promote the insolvent firm's reorganization. In order to achieve this objective, creditors and lenders can agree to put up an insolvency plan which serves as an alternative to the regular proceedings. The insolvency plan assigns to creditors a high degree of autonomy and flexibility allowing for regulations which also concern a right for secured lenders to give up their priority. It is also possible that the creditors agree on a debtor-in-possession rule ("Eigenverwaltung"). The *Insolvenzordnung* promotes firm restructurings by facilitating informal workouts and also by facilitating the sale of the bankrupt's firm as an entity ("übertragende Sanierung"). It is important to note that the debtor is assigned to file for reorganizations but it is the group of creditors which has the final say (Bork 2005: 189). In this respect it is important to note that there is an automatic stay as long as the prospects of reorganization are examined. This does also apply to secured lenders with a right to exemption.

A third mainstay concerns a higher degree of creditors' autonomy. In particular, it is the creditor assembly which is authorized to instruct the receiver to work out an insolvency plan together with the creditor committee. Furthermore, the insolvency plan has to be approved by all groups of creditors. Like in the *Konkursordnung* the creditor assembly has the right to dismiss the court-appointed receiver and decide on whether the firm should be liquidated or whether the chances of reorganization should be examined.

The fourth mainstay of the *Insolvenzordnung* concerns a possible discharge of the debtor's residual debt as long as the debtor is a natural person or sole proprietor (Bork 2005: 200), thus facilitating a fresh start for this group of borrowers. In order to promote this objective, it is not required that creditors have received a minimum ratio of their claims (Borg 2005: 201). However, conditions have to be met by the borrower concerning his "well behavior" during a period of

6 years. By this is meant that during this period, the borrower has to reveal every piece of information which affects his income or wealth situation. Furthermore, he has to announce a change in residence, and his distrainable income will be seized.

Disappointed by the meager outcome in terms of firm reorganizations to be discussed below in this paper, the law maker has once again undertaken a reform of the insolvency law. A corresponding draft law (*Entwurf eines Gesetzes zur weiteren Erleichterung der Sanierung von Unternehmen*, ESUG) was accepted by the German Parliament in October 2011 (Bundestagsdrucksache 17/511, October 26th, 2011). The ESUG represents the first step of a comprehensive reform of the insolvency law which in a second step will be amended by an out-of-court reorganization proceeding (Eidenmüller 2011). Like in France, the endeavors of the German law makers are directed at setting incentives for a timely beginning of reorganization processes, and at improving the governance process of the insolvency proceeding with an emphasis on increasing creditors' autonomy further. In this respect a previous creditor committee now obtains the right to propose the administrator, whereas previously this right had been assigned to the court. Furthermore, the law maker aims at strengthening the debtor-in-possession-alternative (*Eigenverwaltung*)[7]. The privileges of secured lenders have not been curtailed.

We may summarize our presentations of the French and German insolvency laws as follows: In spite of an observed convergence of both laws concerning the role of firm reorganizations, considerable differences remain with respect to the role of secured lenders, which in the German law continue to have a high degree of priority concerning all types of collateral but which remains to be restricted in the French law.

[7] The debtor has the right to work out an insolvency plan within three months. He has the right to determine a preliminary trustee which the court has to accept. The debtor is entitled to be granted a stay of execution (Eidenmüller 2011).

3 Commonalities and Differences in Ex Post Consequences

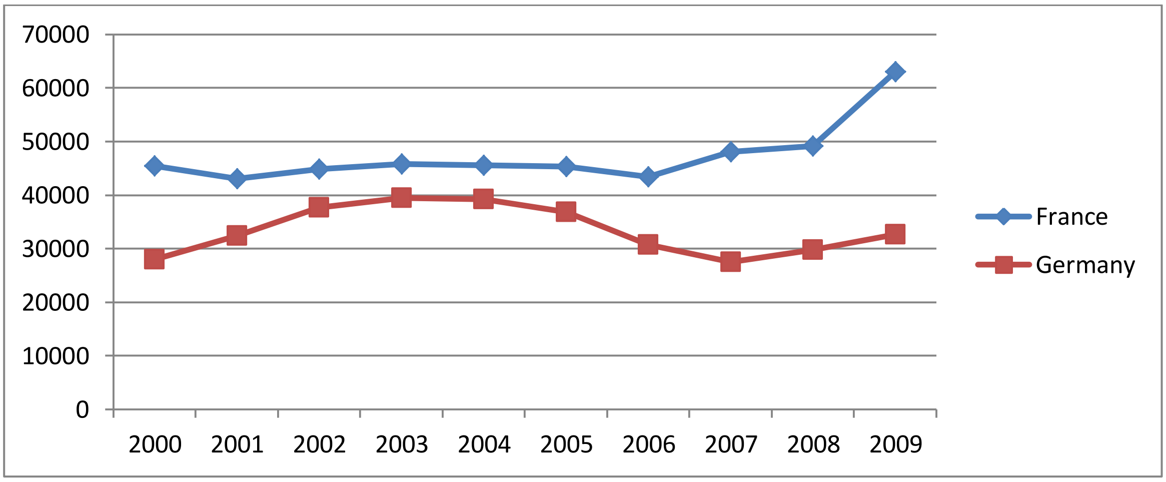
In the following, we will have a closer look at the number of insolvencies, recovery rates and the role of firm reorganizations in France and Germany. Many international programs seek to compare performances of legal frameworks. In this perspective, legal origins theory suggests that due to their differences in the structures, the institutions and the enforcement of legal rules, France and Germany should be characterized by drastically different results in the field of application of legal claims. Indeed, following “Doing Business”, the German system is more efficient with respect to the liquidation of firms than the French one.

Despite the tough and numerous criticisms addressed by French lawyers with respect to that evaluation (see for instance Haravon 2009 and Fauvarque-Cosson and Kerhuel 2009), the results are also confirmed by Davydenko and Franks (2008). Adopting a completely different method of the one used by the World Bank, they nevertheless confirm that banks’ recovery rates in default are significantly higher in Germany than in France when one controls for firm characteristics, collateral, and the state of the economy. According to their paper, collateral is the most important determinant of recovery rates.

3.1 An Increasing Number of Insolvencies in both Countries

Of course, when comparing insolvencies in different countries we are exposed to various complications, in particular regarding the definition of insolvency and the classification of corporate insolvencies. For example, in Germany very small firms with less than 20 creditors can file for personal insolvency proceedings and do thus not appear in the official statistics of corporate insolvencies. By contrast, this is not the case in France.

Graph 1 - Number of corporate insolvencies in France and Germany



Source: Graydon Belgium nv/sa

With these qualifications in mind the graph reveals that at least until 2006, differences in the number of insolvencies between France and Germany are not pronounced. Indeed, for 2006 the rate of bankruptcies defined as the number of decisions made by the commercial courts reported on the graph above related to the number of firms provided by the data base Eurostat – Newcronos is 1.7% in Germany and 1.8% in France[8].

From 2000 to 2009, the number of insolvent firms increased sharply in France (about 40%) but a major jump took place between 2007 and 2008, just after the new law produced its whole effect. One can also point out that construction and trade, which were the industries in which the rate of firm creation was the highest, are also the ones that exhibit the highest rate of insolvency. But a remark of caution appears in order at this point. Out of 62,000 insolvencies reported, 26,580[9] concern firms without employees[10]. Excluding them permits to compare in a more appropriate manner France to other European countries since then "only" 36,000 insol-

[8] In 2006, New Cronos database counts 1,779,785 firms in Germany and 2,336,416 in France.

[9] Source: Altares Report, available on Altares website: http://www.altares.fr/index.php/publications/etudes-altares/defaillances-d'entreprises.

[10] Such a bias is already mentioned for Sweden by Buttwill (2004). He explains the extraordinary high rate of insolvency in Sweden partly with the high share of insolvencies of "zero employee enterprises". Such "enterprises" when failed are most probably counted as "individual insolvency" in the statistics of other countries.

vent firms remain, which is very similar to the German situation. Another peculiarity is worth considering. It deals with the average size and age of firms getting into insolvency. The company Altares (2010) reports that in 2000, 23% of the bankrupt firms were small firms and less than 3 years old. This share reaches 30% in 2009 reflecting the turbulences of the national production system, in part due to the change in the business law concerning limited responsibility partnership voted in 2003[11]. The findings mirror a peculiarity of the French production system which is biased towards very small enterprises with a small amount of equity whose probability of default is high and resistance to shocks very low.

Regarding Germany we have to distinguish between the old and the new insolvency law. Under the old insolvency law (*Konkursordnung*) about 25% of all petitions were turned down due to lack of estate, 10% of all opened proceedings were abandoned for the same reasons. Between 1950 and 1972 the annual number of opened insolvency proceedings remained below 5000 and increased up to 10,000 during the years after the first oil crisis. During the 1980s the annual number of insolvency cases remained between 10 and 20,000 and increased to more than 30,000 until 1998 (Angele 2003: 295).

The observed increase in insolvencies in Germany, as shown in the graph above, is closely related to the enactment of the Insolvency Law in 1999, a major reason for this being the prospect of a final discharge of residual of debt for sole proprietors. A more detailed analysis can be found in the publications by the Statistische Bundesamt (*Wirtschaft und Statistik*). In Germany the courts convey information about insolvency proceedings to the regional statistical offices. In doing so, they proceed in three steps (Angele 2006): A first announcement becomes due if insolvency proceedings against an insolvent debtor have either been opened or if a petition in insolvency has been turned down due to a lack of estate. In the case of all accepted petitions, the courts are obliged to inform the statistical offices within two years about the financial re-

[11] The law said „Dutreil“ voted in August 2003 abolished the minimum level of equity for the limited liability companies. It resulted in a sharp increase of creation of firms from 2004.

sults of the proceedings. A third announcement concerns the decisions on a final discharge of residual debt. Between the introduction of the Insolvency Law in 1999 and 2003, the number of insolvencies of firms increased from 26,476 to 39,320 (Angele 2007: 352). Due to an amendment which now allows sole proprietors to have their expenses on procedural costs deferred, the contribution of this group of firms was particularly high. This is also confirmed by an increasing ratio of accepted petitions from 36% in 1998 to 49.5% in 2001, to 59.7% in 2007 (Angele 2008: 306). The continuous increase in insolvencies peaked in 2004. Favourable macroeconomic conditions then led to a fall in the number of insolvencies of firms between 2005 and 2007.

3.2 Recovery Rates

The recovery rate is one of the most debated ratios in the assessment of insolvency law performance. In international comparisons it is typically used as a proxy for the relative creditor-friendliness or debtor-friendliness, respectively. As pointed out by Davydenko and Franck (2008) recovery rates are supposed to be lower in debtor-friendly countries. Going one step further, Broggi and Santella (2003: 8) conclude that “whenever insolvency legislation cannot guarantee the possibility for creditors to recover their credits from insolvent debtors, the working of an economic system based on private property may be impaired”.

As demonstrated by different issues of “Doing Business” and as is intensively confirmed by the literature (Blazy et al. 2009), the recovery rates are differently measured in empirical studies. In this respect it appears important to distinguish between a gross concept including recovery rates for secured lenders and a net concept which focuses exclusively on unsecured lenders. Various studies have measured *gross* recovery rates in France and Germany with the main results being resumed in the table below.

Table 1 – Recovery rates in France and Germany: some attempts of comparison

	France	Germany
Assessed procedure in national language	Redressement judiciaire	Insolvenzordnung
Super-priority financing	Yes	Creditor's approval Required
Dilution of secured claims	Significant	Limited
Scores for creditor friendliness* LLSV (1 – 4): Wood (1 – 10):	 0 1	 3 8
Gross recovery rate D & F, mean: D & F, median: World Bank:	 54% 56% 48%	 61% 67% 53%
* Higher score means higher creditor friendliness.		

Source for the verbal information: D&F = Davydenko and Franks (2008).
Source for the scores: LLSV = La Porta, Lopez-de-Silanes, Shleifer and Vishny (1999)
Source for the recovery rate: Davydenko and Franks (2008)

The low level of French recovery rates has been repeatedly emphasized by the literature. However, the results depend strongly on the sample studied and on the proceedings assessed. Of course, secured lenders receive the most but this is not new. The recovery rate for unsecured creditors should be less than 10% according to the Conseil National du Crédit (1993) but many analysts emphasize that the effective result depends on the industry and the causes of insolvency.

In Germany it was in particular the disappointment about the recovery rate for *unsecured* lenders which fuelled the debate on a fundamental amendment of the insolvency law. Whereas under the *Konkursordung* secured lenders could recover an overall average of 84 percent, the average recovery rate for *unsecured* lenders was no more than 3-5% (Gessner et al. 1978: 514). The *Insolvenzordnung* had been enacted with a major objective to improve recovery rates in particular for *unsecured* lenders. As we have already observed, the number of insolvencies increased significantly in the years 1999-2004. Did the same occur for the recovery rates obtained by in particular unsecured lenders? Whereas information about the number of insolvencies as well as the ratio of accepted petitions is easy to obtain for the statistical offices, the same is not true for recovery rates. It appears to be unrealistic that the final amount of outstanding debt can be verified within a two years period. The *Statistische Bundesamt* therefore analyses the ratio of the bankrupt's estate to outstanding debt as estimated at the beginning of the legal proceedings. In 1998 this ratio was on average 36% and increased to 50% between 2001 and 2005 (Angele 2007: 355). Recalling that this data still contains the claims of lenders with rights to separation (*Absonderungsrechte*), we may conclude that one of the objectives of the Insolvency Law has not been reached, namely to increase the bankrupt's estate significantly. In particular, in only about 1% of all petitions which were registered in 2005 imminent insolvency was acknowledged as a reason for filing for insolvency. In 70% of all cases the firm had already been factually insolvent, thus leading to a considerably lower estate (Angele 2007: 355).

Factual recovery rates indicate what creditors receive on average after a final statement concerning the bankrupt's debt has been arrived at and *after* creditors with separation (*Aussonderungsrechte*) and exemption rights (*Absonderungsrechte*) have been satisfied. So far the Statistische Bundesamt has not been successful in delivering this information. In order to fill this gap the Institute for Research on SMEs (Institut für Mittelstandsforschung Bonn) has undertaken a research project based on data delivered by the Landesbetrieb "Information und Technik Nordrhein-Westfalen". The data set is based on 63,990 petitions in insolvency for firms (excluding self-employed and natural persons) between 2002 and 2007 in Nordrhein-Westfalen, with 44,115 having been accepted which yields an opening ratio of 68.9%. Contrary to the Statistische Bundesamt, the data also reveal information about final recovery rates for unsecured lenders. Nordrhein-Westfalen is the largest German federal state with 32% of all insolvencies taking place in this state which implies that the results exhibit a high degree of representativeness (Kranzusch 2009). At the end of 2008 the final results were reported for 15,140 proceedings with only 5,620 of these cases exceeding procedural cost, thus ending up with a positive value of the remaining estate to be distributed among the lenders. Hence only in 37% did unsecured lenders receive anything at all. On average, only 3.6% of unsecured claims could be satisfied by the remaining estate. In two thirds of all proceedings unsecured senders received nothing. For sole proprietors and very small firms the ratio was even significantly lower amounting to 1.7%. Recovery rates were found to be higher for shareholding companies (7.1%) than for private limited companies (4.7%) (Kranzusch 2009: 13). The recovery rates have also been found to be positively correlated with firm size (Kranzusch 2009: 13).

The evidence thus indicates that so far a considerable improvement in the recovery rates for unsecured lenders has not been reached, which also indicates that secured lenders continue to explain the main bulk of the recovery rates as presented in Table 1.

3.3 The Role of Firm Reorganizations

Looking at the French data (Table 2, below), it is evident that the rescue of firms is nothing but the least frequent solution implemented in practice. It represents less than 12% of the total number of firm closures, mainly because most of the insolvent debtors cannot be rescued due to the evident lack of equity. According to reports by Altares and Euler-Hermes the number of reorganization processes has remained low. On the whole, 68% of insolvent firms are directly closed after having been declared insolvent by the commerce court. This share differs however, when firm size is taken into account. Whereas very small firms are liquidated in 70% of all cases, only 30% of large firms share this fate. Obviously, the decision to reorganize a firm is significantly affected by its size and hence by negative externalities, and that is why most of the reorganization plans concern very large firms whose shut-down could give rise to politically unacceptable implications for employment and the local economy as such[12].

[12] One can nevertheless observe a real and growing tendency in the very large corporation to exploit the insolvency laws at their own advantage, since going directly towards a liquidation caused by "insuffisance d'actif" (inadequacy of the assets) allows them to conceal transactions between the different sister companies belonging to the same group and not to pay the layoff fees to employees, since, in that case, they are taken in charge by the system of insurance on wages managed by companies themselves.

Table 2 - **Nature and content of the decisions of the commercial courts**

	2001	2002	2003	2004	2005	Evolution 2005/2004 (Percentages)
Compulsory liquidations	**38,062**	**39,389**	**40,380**	**42,792**	**45,146**	**+5.5**
Nature of the liquidation						
Immediate compulsory liquidation	28,204	29,441	30,355	32,192	33,971	+5.5
Average length (in months)	2.0	2.0	1.7	1.6	1.7	
Liquidation after the safeguard observation period	9,858	9,948	10,025	10,600	11,175	+5.4
Average length (in months)	6.9	6.9	6.6	6.4	6.4	
Rehabilitation proceedings	**4,458**	**4,390**	**4,699**	**4,960**	**5,290**	**+6.7**
Nature of the rehabilitation proceeding						
Continuation plan	3,573	3,424	3,676	4,024	4,448	+10.5
Average length (in months)	13.3	12.8	12.4	12.1	12.4	
Cession plan	885	966	1,023	936	842	-10.0
Average length (in months)	7.9	7.6	8.0	8.0	8.0	
Judgments to end the liquidation proceeding	**42,742**	**40,360**	**39,842**	**44,059**	**41,710**	**-5.3**
Causes of the closing						
Inadequacy of the assets	41,979	39,614	39,047	43,096	40,511	-6.0
Average length (in months)	42.8	43.0	45.0	44.8	45.1	
Repayment of the debtors	783	746	795	963	1,051	+9.1
Average length (in months)	52.1	57.6	59.4	60.3	61.3	

Source: Ministry of Justice, SD SED – répertoire général civil (http://www.stats.justice.gouv.fr/dlactc1_web.htm)

The German case is different since reorganization does not appear to be the traditional solution to insolvency, neither in the law nor in the court practices. That is why, in order to increase the number of firm reorganizations, the *Konkursordnung* was amended by the Vergleichsordung in 1935. However, compositions with subsequent reorganizations fell from 30% in 1950 to 1.5% in 1978 (Flessner 1982: 24). Between the end of the 1970s and the enactment of the *Insolvenzordnung* only 1% of all insolvency procedures ended up with composition (Bork 2005: 5).

Under the new law, it is in particular the insolvency plan which is meant to promote reorganization. In this respect, deviations from the regular proceedings as well as discharges of secured debt are possible. Furthermore, creditors can agree to transfer the right to manage the firm's assets with the debtor (*Eigenverwaltung*). Following the Statistische Bundesamt, the principle of *Eigenverwaltung* amounted to 173 cases in 2004 out of 39,213 insolvencies and 159 cases out of 30,357 thus only playing a minor role (Angele 2007:356). Moreover, as Kranzusch (2009) has found, in only 1% of all cases the participants of an insolvency procedure did use the option of an insolvency plan (Kranzusch 2009: 33). This confirms findings by the Kreditanstalt für Wiederaufbau as well as by the Creditreform (KfW et al. 2009: 55). Factual reorganizations are expected to be even lower since an insolvency plan offers the possibility of reorganizations but does not guarantee it.

To summarize results, we may say that neither the number of insolvencies nor recovery rates and the frequency of firm reorganizations reveal pronounced differences between France and Germany. In France the politically intended debtor-friendliness of the insolvency law with a clear preference for firm restructurings has not brought the desired effects nor has the amendment of the German insolvency law towards a facilitation of firm reorganizations. Most importantly, gross recovery rates do not exhibit marked differences, though the treatment of secured lenders remains to differ between the two countries.

Though producing similar ex post effects we now turn to analyzing how the different treatment of secured lenders in the French and German insolvency law affects lending practices in either country, which directs our perspective from ex post to ex ante effects of the insolvency law. In doing so we start examining whether the seniority of secured lenders in formal insolvency proceedings and the extensive use of collateral in particular by banks (our first complement hypothesis), and then analyze whether a priority for inside collateral and relationship lending are complements (our second complement hypothesis).

4 Complementarities between the Degree of Priority of Secured Lenders and Banks as the Main Secured Lenders

The insolvency law decides on the extent to which secured lenders can have confidence in the *enforceability* of their collateral and hence whether lenders will assign an insurance function to the collateralization of debt. This concerns both the type of collateralized assets which receive preferential treatment as well as the creditors' control rights over the collateralized assets once the formal proceedings have been opened. Hence, the insolvency law decides on the degree of priority for secured lenders and – equivalently – on who is a *senior* lender. Absolute priority in this sense would then imply that the creditor continues to hold the right to use his collateral according to his preferences once the formal proceedings have begun.

If the insolvency law foresees absolute priority for secured lenders, this implies that the borrower has indeed to accept the loss of collateralized assets in case of insolvency as a *binding* constraint. This holds true not only for formal insolvency proceedings but also for informal workouts if lenders can always threaten to file for adjudication. It does, however, not necessarily imply that it is always profitable for a lender to collateralize debt. An important reason for this result is that collateral is not costless. Costs are incurred in the process of deciding on which assets to choose, in the process of monitoring its value over time and finally in realizing a maximum value in case the borrower defaults. Costs furthermore follow from the borrower's reluctance to pledge collateral. Mann (1997) undertook an empirical study interviewing representatives from both the lending and borrowing side. He found that borrowers typically have a strong preference for an *unsecured* loan, thus being willing to even pay a considerable premium to avoid having to grant collateral. According to Mann (1997) costs of collateral arise for the borrower in the course of closing a lending transaction as well as due to the fact that he might no longer be able to use his assets in the most profitable way, for given that lenders are risk-averse and not risk-neutral as is assumed in economic theory, the lender might be unduly conservative. This can deter value increasing risky transactions. If collateral has no net benefit for the borrower, then collateral will become a component of a loan contract only if he lacks bargaining power due to missing alternatives, which forces him to accept the contract or if he receives appropriate compensation for example by a lower rate of interest (Schäfer, 2003).

Hence, absolute priority of collateral in the insolvency law is not sufficient to explain why collateral should be widely used. For example, as an alternative to claiming collateral a loan contract could contain a right for the lender to claim repayment whenever the quality of the borrower deteriorates (Rajan and Winton 1995). Hence, in order for collateralization to be a superior strategy in the eyes of a lender, its net benefit must be positive and outperforming alternative insurance mechanisms. Taking outside collateral as an example which encompasses previously accumulated assets uncorrelated with the firm value, the lender will have to weigh its costs and benefits against a participation in income streams which are not yet known at the contracting date.

Going back to John Commons (1934) who proposed a unique framework of history and institutions, the significance that collateral in the sense of previously accumulated assets has in the economy, goes beyond the individual situation of lenders and borrowers. Rather, it decides how savers and investors cope with an uncertain future, which he considers as the core of the capitalist process. According to this approach the choice of the appropriate composition of existing and material assets on the one hand and expectations of income on the other as an element of a financial contract is highly favorable to investment and firms' development, thus also broadening the source out of which lenders are repaid. With respect to how such an optimal composition could look like, financial theory has found answers which emphasize that collateral does not only grant a safe income to lenders but that it helps significantly to mitigate information problems. In the following, we review important approaches which also show that this information-improving property of collateral has a net benefit in particular for banks. After resuming in brief the relevant theoretical literature we will have a view at the evidence in France and Germany.

4.1 The First Complement Hypothesis in Financial Theory

If collateral is costly, then it will only be used provided that benefits outweigh costs. In this respect it is important to note that collateral which enjoys priority in formal insolvency proceedings does not only provide the lender with insurance against a loss if the borrower defaults and that this insurance function is positively correlated with the degree of priority for the secured creditor. Economic theory assumes *absolute* priority in this respect and has generated manifold approaches showing that collateral may serve to reduce the probability that the borrower declares insolvency either due to a failure of his project or because he finds it convenient to do so if the project turns out to be a success, in which case we talk about strategic insolvency. The major reason for this result is the property of collateral to shift risks borne by the lender as a consequence of limited liability back to the borrower. For example, Bester (1987) proves that collateral may help the lender to better discriminate between different potential borrowers in the sense that borrowers with better projects propose higher collateral than borrowers with weaker projects. Collateral may thus help to avoid adverse selection. After a loan contract has been concluded, the probability that the borrower defaults due to a failure of the project also depends on his choice of project. Given that he may choose between two projects with the same expected gross return but with one project yielding a higher return in case of success though at a lower probability, then limited liability may set the borrower incentives to choose the riskier project even if this was not agreed upon in the initial contract. The reason for this result is that limited liability allows the borrower to reap the total of gross revenues in excess of the loan repayment and to shift the losses to the lender. If the lender is unable to monitor his borrower's decision, then risk-shifting provides an option at least if the borrower does not bother about his reputation. Pledging collateral improves the situation for the creditor, since this forces the debtor to participate in realized losses, thus shifting the risk back to the borrower (Bester 1994). Finally, if limited liability is paired with the inability of the creditor to verify the debtor's true profit situation, the debtor might have an incentive to declare insolvency even if the debt-financed project is successful. In order for this to be the case, net profits of strategic insolvency accruing to the firm have to be positive. As Bester (1994) and Schäfer (2003) derive within a formal model, collateral serves to render strategic insolvency to be the inferior strategy compared to truth-telling because it ensures that its net profit will always be negative.

Rajan and Winton (1995) examine the question why lenders do not exclusively accept loan contracts which give them the right to claim repayment whenever the information about the borrower suggests to doing so. They emphasize that the achievement of necessary information requires costly monitoring of the borrower. In particular in the face of multiple lenders monitoring of a single lender produces a positive externality since his actions turn originally private information about the borrower's true situation into a public good. In showing that collateral offers a possibility to internalize this externality, the authors prove that a loan contract which endows the lender with the right to claim repayment given relevant information poses no alternative to collateralized debt because such a contract, too, will contain collateral.

As a further benefit of collateral in the sense that it helps to reduce the probability of default, Mann (1997) quotes the lender's ability to limit subsequent borrowings justified by the belief that the borrower pays more attention to his business if debt is less dispersed.

A theoretical explanation for *banks* as the principal secured lenders has been provided by Welch (1997). His argument is based on the observation that the enforcement of creditors' rights is always costly. His definition of cost excludes creditors' attempts to gain protection against information asymmetry but includes "...the costs or organizing the creditor class, free-rider problems, reputation benefits in future restructuring negotiations (both positive and negative) and management and hassle" (Welch, 1997: 1204). Banks can minimize these costs due to their organization, as well as due to their higher ability to force the firm management to change the risk profile of investments, offer outright side payments or change loan terms in favor of the bank. Banks can afford to hire the best lawyers and sometimes even have their own legal staff (Welch 1997: 1208). Giving banks superior rights in insolvency bears advantages for all other creditors as well as for the borrower himself. Creditors profit from lower total deadweight and litigation costs. Since creditors include in their yield expected expenses associated with the enforcement of contractual agreements, lower total costs in this respect allow the firm to obtain capital at a lower interest rate.

We may conclude that it is the banking industry which has superior capabilities in collateralizing debt at low costs. We now turn to the question how banks evaluate the gross benefits of collateralizing debt. In this respect, the theoretical (as well as empirical) literature points to heterogeneity among creditors. Small and medium sized firms have been found to be a group of particularly information-problematic lenders due to a high degree of idiosyncratic risk and comparatively high volatility of their environment (Harhoff and Körting 1998). Furthermore, smaller firms' financial reporting systems suffer from incompleteness which is not only rooted in lack of time and competence. Smaller firms frequently specialize on the production of goods or services which exhibit only a low degree of standardization. Hence, in order to evaluate these firms qualitative data gain importance which are difficult to obtain and assess, and which above all are private and should remain since they determine importantly the firm's competitiveness (Levratto and Größl 2003; Reifner, Größl et al. 2003). Since small and medium sized firms have been evidenced to be bank-dependent all over the world, this also explains why banks are confronted with particularly serious information problems, thus considering collateral as highly beneficial in mitigating these problems.

4.2 Evidence in France and Germany

Financial theory shows that the pledging of collateral has a high net benefit above all for banks. Implied in these theoretical analyses is the assumption that secured lenders receive *absolute* priority in formal insolvency proceedings, because according to the theory only then the debtor will consider the loss of the collateralized asset in case of insolvency as a certain event and hence only then the bank will enjoy a significant mitigation of existing information problems through collateralizing its claim. This conjecture suggests that in a financial system with a higher protection of collateral in insolvency proceedings, banks should rely more on collateral than in a system with a lower protection. Since in Germany secured lenders receive a higher degree of protection in insolvency proceedings than in France, we should expect that banks take more collateral in Germany than in France.

In Germany the old KO hence regulated the claims of secured lenders as a right to be executed with absolute priority. The originators of the law were conscious of a violation of the principle of equal treatment. However, at the time when the KO was put into effect, the role of collateral was of minor importance (Gessner et al. 1978). This was supposed to change over the years. In 1976, Gessner et al. (1978) undertook an empirical investigation on the consequences of the KO for the various groups of stakeholders. The study was based on a questionnaires presented to representatives of the fields of law and the economic sphere as well as to insolvency practitioners. They found that about three-fifths of a bankrupt's assets were secured. By holding over 70 percent of all rights of separation and exemption, banks were found to be the major secured lenders. 81 percent of their claims were secured. "[T]hey participate in the distribution procedure as a general creditor in the last category of priority for a mere 19 percent of their demands" (Gessner et al. 1978: 514). Modifications of the new insolvency law exist which reduce lenders' autonomy in this respect. However, they receive compensation in their ability to collateralize up to 110% of the borrower's debt, and they continue to hold the control rights over their collaterals in the sense that decisions by the court-receiver require the approval of secured lenders. In particular, in order for the insolvent firm to be reorganized, secured lenders have to give their approval. Hence, a high degree of priority continues to prevail. Unfortunately, so far empirical studies concerning the collateralizing behavior of banks are missing yet. However, taking into account that secured lenders still hold considerable preferential rights and that they are duly compensated for retrenchments of these rights[13], the role of collateral should not have diminished. This view is supported by the evidence that under the new insolvency law the main bulk of the recovery rate continues to go to secured lenders (Kranzusch 2009).

Collateralization by banks has a long tradition in France too. Over the late C. 19th, the main target was the dower, which served to support the spouses who at the time did not typically earn their own living. Keeping this share of wealth non-seizable was a major challenge in an economic system resting upon land and real estate. However, exceptions started to happen in

[13] For example banks are now allowed to collateralize their loans up to 110% and collateral cannot be used without their approval.

order to permit the transformation of the goods and assets included in the dower and to allow their use in a production process aiming at creating value. At the end of the 1920s, the inalienability of assets belonging to the spouse under the control of her husband-entrepreneur was thus cancelled in France, as in most European legal systems permitting thus a phase of expansion in the concerned economies. From this time on, the role of bank lending could grow, giving credit a crucial role in the development of a capitalist economy.

Things remained quite stable until the end of the 1990s when lenders began to complain about the additional risks borne by them when rescuing of firms in difficulties. In exchange of the abandonment of the notion of the abusive granting of loan, bankers accepted to refund firms having difficulties in exchange of a revision of the priority order in such a case. The modifications introduced in the law of 2005 reveal the will of creditors to be given a priority rank that will allow them to anticipate a higher payout than that granted to ordinary unsecured creditors. The order of payment instituted by article L.622-17-II of the Commercial Code establishes the following ranking among earlier and later claims:

1. The highest privilege of employees.
2. The privilege of court fees prior to the decision to commence collective proceedings.
3. The privilege of conciliation (see article L.611-11 of the Commercial Code)[14].
4. Later claims eligible for preferential treatment.

[14] Carlson (1985) proposes an analysis of the nature of voluntary subordination of lien and insolvency priorities. It shows that all aspects of the agreement to subordinate debt derive from the junior simple creditor promise: after a certain point, the junior creditor promises not to receive payment from the debtor until the senior creditors are paid. The result of this pecking order is either in favor of secured and senior creditors only as in Baird and Jackson papers (see Jackson, 1996) or in a risk sharing output that advantages both secured and unsecured creditors as in Carlson (1985).

5. In the event of the sale of property subject to a special actual pledge (special privilege, pledge, mortgage) during the observation period or during the execution of a protection or rehabilitation plan, the holders of special pledges will be paid:
   - before later creditors not entitled to preferential treatment and earlier creditors,
   - but after later creditors entitled to preferential treatment.
6. Later claims not entitled to preferential treatment and later claims.

The law of 26 July 2005 introduced thus a distinction among the later claims[15] and provides that only those creditors whose claims are "useful" to collective proceedings shall benefit from favourable treatment. This modification corresponds to a new privilege in favour of later creditors, consisting of payment priority for later claims defined in articles L.622-17-I and L.641-13-I, in the event of failure to pay these claims by the debtor. This is a privilege insofar as the benefit of payment priority is maintained, even if further collective proceedings are subsequently initiated, regardless of whether they involve receivership or liquidation. This means that the 'useful' later claims of the first proceedings will retain their payment priority over the earlier claims of the second. They will, however, be ranked after the new "useful" later claims of the second collective proceedings.

Contrary to Germany, the rights of secured lenders in France are significantly curtailed during formal insolvency proceedings. Whereas in Germany it is the majority of secured lenders that decides over the liquidation or continuation of the bankrupt firm, in France this task has been placed in the hands of the courts, and the creditors have no right to turn the court decision down. Furthermore, and in contrast to Germany, it is the class of employees which ranks first among all creditors. A further distinction between the French and the German law concerns secured lenders' control rights once the official insolvency proceedings have been opened. In

[15] Traditionally, later creditors known as "article 40 creditors" (art. L. 631-32 of the Commercial Code) benefited from favourable treatment insofar as their so-called "later" claims had to be paid at due date by the debtors, as opposed to so-called "earlier" claims that were frozen until the end of the observation period and then settled, if possible, either within the scope of a continuation plan or a sale plan.

contrast to Germany secured lenders have to transfer their right to liquidate the collateralized assets to the court-appointed administrator with one exception being accounts receivables. Moreover, the court-appointed administrator is not obliged to sell for example real estate at the highest price possible as is the case in Germany. Does this imply that bank debt is less collateralized than in Germany?

The knowledge of the effective use of collateral in France is very low except for the guarantee scheme involving Oséo, a public bank specialized in SMEs financing[16]. For a more precise description of the way collateral is used by lenders, one has to refer to a study by Blazy and Weill (2005). Their analysis of the role of collateral in bank-borrowers relationships rests upon a sample of 735 credit lines attached to 386 French distressed firms. The sample is composed of a majority of small and medium sized enterprises whose managers are protected by limited liability. Loans were supplied by three French major banks from 1984 to 2001 and the default happened between 1993 and 2003. From the presentation of the sample done by the authors, one can see that the level of collateralization is rather high (74%) and what is most important, does not fall behind the ratio of collateralization of bank debt in Germany under the old insolvency law.

In fact we observe that the attempts made by French banks to circumvent the cutback in their rights as secured lenders in formal insolvency proceedings have given rise to new institutions which offer guarantees to banks, thus explaining why personal guarantees are by far the most frequently used type of collateral. Conditional on firms' eligibility, all applications for Oséo guarantees are made by banks, and not by the firms themselves. Once granted, a guarantee allows the bank to recover a pre-specified amount of the remaining loan principal in case the firm defaults. This fraction usually varies between 40% and 70%, and is not set case by case, but rather at the fund-year level, with the view to manage the aggregate risk faced by Oséo. The

[16] In 2008, billion Euros 6,861 of credit have been guaranteed by Oséo and the risk effectively borne by this institution reaches billion Euros 3,219. At the end of 2008, almost 60,000 firms benefited from this support, 25 % more compared to 2007.

counterpart of these guarantees is that the “benefiting” firm has to pay a fee, which is also set at the fund-year level, and which adds to the interest rate it has to pay to the bank. The effects of such a scheme are highly disputed (Lelarge et al. 2008), but most of the literature agrees that they result in an increase of the supply of credit.

This evidence leads us to the following conclusion: Collateral forms an important part of bank loans in particular to SMEs as long as the insolvency law does not undermine any kind of preferential treatment at all. It is in this respect that we observe a complementary relationship between the treatment of secured lenders in formal insolvency proceedings and lending practices. In particular the French evidence also tells us that priority does not necessarily have to be absolute as long as banks have the opportunity to get compensation by a higher ratio of collateralization. In Germany, a ratio of 110% is even guaranteed by the new insolvency law. Our results are confirmed by investigations for countries like the UK, where secured lenders enjoy absolute priority (Davydenko and Franks 2008 but also for the US, where Chapter 11 foresees an automatic stay also for secured lenders (Berger and Udell 1995).

5 Preferential Treatment of Inside Collateral and Relational Lending

5.1 The Second Complement Hypothesis in Financial Theory

Relational lending describes a contractual long-run relationship between a borrower and a lender marked by an intensive exchange of private information between the parties, thus allowing to circumventing problems due to information asymmetry (Elsas and Krahnen 2002). Notably, relationship lending does not mean that a borrower only has a single bank. Rather, as was found by Elsas and Krahnen (1998), multiple lending is present, however, with varying seniority regarding the loans. In particular the 1990s have spawned a large literature on various topics surrounding relational lending. This literature had a focus on the relative advantages or disadvantages for the lender and the borrower, compared to arm’s length lending. The models have generated a large variety of sometimes contrasting results – depending on the specific set of assumptions (Boot 2000 for a survey).

Of interest for our topic is a specific important aspect of relationship lending, namely that it regularly involves the financing of investment projects with a long maturity. In order to maintain the quality of a project over a long time horizon it is typically necessary for the relational lender to provide additional finance in the face of adverse shocks. In a successful relationship additional funds will increase the common surplus to be split among the borrower and the relational lender. Longhofer and Santos (2000) show that for such a situation to arise, priority rights of the refunding bank compared to other lenders in case of the project's failure play an important role, which in its turn explains a complementary relation between a seniority position and relationship lending. In their model a firm must borrow funds at time zero in order to finance an investment project with uncertain returns which matures at date 2. Prior to its maturity, at date 1, an adverse shock may occur. Whether and how this shock alters the probability distribution of the project returns and hence the quality of the project depends on the degree of effort which the firm has taken prior to the shock and on whether the firm receives an additional loan. If the firm has spent effort, then the additional loan will allow the firm to maintain the quality and hence the probability distribution of returns of the original project. In the absence of effort, however, the additional loan will motivate the firm to switch to a higher risk project.

The authors assume two types of lenders, a bank and a trader, where only the bank is able to provide additional financing. Since it is costly for the firm to spend effort at date 1 it may well happen that the firm does not spent effort and alternatively prefers a risk-shifting strategy once an adverse shock has occurred. The bank is only able to verify the firm's effort if it builds a relationship involving regular visits with the borrower to learn about his business, which, too, is costly, this time for the bank. The bank knows with certainty that whenever it does not build a relationship the refunding will lead to risk-shifting. On the other hand, building a relationship allows to maintaining the high quality of the original project, since in this case the firm spends effort. Whether this is a profitable strategy to both the bank and the firm will then depend on whether they can capture enough of the expected revenues from maintaining the original project. This gain must be sufficiently high to compensate for the cost of building a relationship and for the cost of spending effort. Taking these costs as exogenous, an important role is played by the relative share of project returns in case of failure accruing to the bank compared to what flows to the trade creditor, who has neither spent costs of building a relationship nor additional funds. Seniority of the bank in this regard lowers the impact of implied costs on the bank's decision to build a relationship, since it may expect a compensation for its additional funding activity. Since collateral constitutes an important way to enforce seniority, Longhofer and Santos (2000) can be interpreted to establish a causal relationship between collateral and relational lending.

It is important to note, however, that this argument is compatible only with *inside* collateral, which represents its holder's claims to the firm's assets in case of insolvency and which therefore is positively correlated with the firm value. Only in the case of *inside* collateral the bank will have an incentive to verify the firm's decisions, whereas outside collateral would assign to the bank independence of what the firm chooses as a project. The role of inside collateral as opposed to outside collateral for the emergence of relationship banking has also been examined by Schäfer (2003) who focuses on a further aspect of relational lending, namely a relationship bank's interest in restructuring a firm that has become insolvent. Schäfer (2003) assumes an entrepreneur who needs a loan for the financing of an investment project with uncertain returns. In order to get this loan, the entrepreneur approaches a single bank which has the market power to fix the lending terms, given of course the constraint that the borrower has to accept. In doing so the bank has to handle the problem that it is unable to verify the true outcome of the investment project and hence the entrepreneur might have an incentive to declare insolvency for strategic reasons. One way to circumvent this problem would be to engage in a (costly) monitoring process underpinned by inside collateral comparable to what was proposed in Longhofer and Santos (2000). In Schäfer's model multiple lending is absent and hence the single creditor can always be sure to take regress to the firm's assets by the virtue of the insolvency law. However, what this means factually, depends on what the firm will be worth once it has become insolvent. Schäfer assumes that through undertaking restructuring activities the bank can increase the value of the firm's assets. To be successful, however, requires from the bank to undertake costly upfront investments in acquiring sufficient restructuring capabilities. This upfront investment assigns credibility to the bank's announcement to take the firm over whenever the borrower declares insolvency. This, in turn, discourages the entrepreneur to declare insolvency for strategic reasons. Upfront investment poses a clear alternative to outside collateral as a means to prevent strategic insolvency for the following reason: As we have seen above, collateralization has costs and benefits. Costs occur for example because the borrower who now participates in losses will ask for some compensation in order to accept the contract. As a consequence the bank will have to claim lower interest rates in return which of course lowers the bank's net return from lending. Further costs are related to the posting as well as liquidation of the underlying assets. For a bank that has opted for upfront investment in restructuring, outside collateral will only incur costs without further benefits. Schäfer (2003) assumes a single creditor. This also implies that this single lender automatically sacks the total of the firm's assets once the borrower is insolvent, thus not requiring formal collateral. The model easily extends to the case of multiple lenders if we add the assumption that the bank is compensated for its upfront investment, which increases the total value of the firm by allowing this bank to take inside collateral.

5.2 The Evidence in France and Germany

Summarizing the theoretical articles presented above, there exists a complementary relationship between inside collateral and the building of a relational lending. This complementary relation includes a housebank's higher propensity to undertake informal workouts if the borrower is in financial distress. Gessner et al. (1978) have found that under the old KO the low number of formal compositions and liquidations can be explained with a high number of informal workouts undertaken by housebanks. Interesting evidence for Germany on this point has also been found by Elsas and Krahnen (2002). The data underlying their analysis was collected from credit files of five German large banks with business with SMEs. The data set was a 5 years-panel (1992-1996) encompassing a broad range of loan contract characteristics and a random sample of 125 small and medium-sized firms among which were 62 potentially distressed lending relationships with 21% involving a housebank. They find that collateralization is about the same for both housebank as well as arm's length relationships. In both cases inside as well as outside collateral has been pledged at about the same proportion, which they take as an indication that collateral primarily serves to determine the seniority structure among bank lenders. Estimating a panel regression between relationship, risk and collateral, they find that in their sample collateral does not vary with default risk. The authors interpret this result as an evidence of the role of collateral as a strategic instrument for renegotiations in case of multiple lending. By contrast, according to their regression collateral is positively correlated with relationship indicating that housebanks collateralize more frequently than arm's length banks, thus endowing them with a higher degree of seniority. Based on this result they estimate a panel regression between collateral, relationship and informal workouts. Their finding confirms that relationship lenders engage more often in workouts. It furthermore confirms a positive correlation between the degree of collateralization and informal workouts.[17] The significance of collateral decreases with the share of the housebank in the firms total debt, which again is considered to confirm the role of collateral as a device to ensure seniority.

France gives a good example of what Rajan and Zingales call "the changing character of European finance" (Rajan and Zingales 2003). In the literature on comparative institutions of capitalism, the French financial system of the 1970s was regarded as highly distinctive (see, for ex-

[17] Contrasting evidence is found by Davydenko and Franks (2008) who find more informal workouts in France than in Germany. However, their study encompasses the period between 1996 and 2003 and ignores the change in the insolvency law in 1999 which has produced an extraordinarily high number of formal bankruptcies in the first years after its enactment.

ample, Zysman 1983). In particular, the extensive involvement of the French state in the financing of economic activity is typically regarded as one of the defining features of French post-war capitalism. On the face of it, the French financial system came closest to its German counterparts at the time in terms of the economic importance of banks. However, and in contrast to Germany, the government dominated the allocation of bank credit in France through the framework or *encadrement* system that controlled the direction of credit allocation. During the nineties, the role of the French financial system in financing economic activity had been transformed along two crucial dimensions. First, there was a drastic contraction in the role of the state from a position of dominance over the allocation of funds to one of modest importance (Plihon 1995). Second, the role of financial markets in the funding of economic activity experienced a marked expansion what induced a dramatically decrease of the intermediation rate, whereas this ration used to be historically high (Banque de France 2002).

Explanations in terms of exogenous factors, notably developments in international financial markets, are favored by some scholars. The specifics of these arguments differ, but the basic contention is that France's financial liberalization was a policy response to the growing integration of global financial markets. Others insist upon inflationary pressures built up as the banking system made more and more money available to the economy on terms that did not reflect its real economic cost. It is worthwhile to notice that no major changes in the formal regulations could explain this concentrated expansion or the fact that it did not occur earlier; neither changes in insolvency law nor the evolution of banking regulation were voted at those time. Instead, Michel Goyer (2001) emphasizes the growing influence of foreign investors, "composed primarily of Anglo-American mutual and pension funds" on this renewal of financial relationships. This feature concerned financial institutions themselves too, so that in less than a decade, France shifted from an insider to an outsider model" (Goyer 2001). Departing from a relationship banking system under the control of government, France has developed a financial system that is suitable to the ideal type of a liberal market economy. The result is that even if banks remain the main institution involved in corporate financing (Cieply and Dejardin

2009), their relationships with borrowers have been transformed over the years, becoming closer to an arm's length relationship), in which the necessary trust does not prevent ex ante and ex post control and, more important, requires guarantees to persist.

On the whole, banks concentrate their collateralization policy on few types of collateral: individual guarantees (44%), mortgage (19%), long term assets (15%) and on short term ones (14%). This weak use of inside collateral is confirmed by a report made by Auxiga, a bank guaranteeing organization which held € 1,434,666,100 of stocks on 31st December 2007. The recovery rates in case of default differ according to the kind of collateral mobilized and for this sample, the strategy followed by banks is not the best one. Indeed, the lowest recovery rate concerns long term assets (11%) and the highest short term assets (21%). It is also worthwhile to mention that recovery rates on companies (39%) significantly exceed the ones for individuals (10%).

Does this evidence allow us to confirm the second complement hypothesis? We conclude that caution is in order here. Starting with Germany, we recall that in the Elsas-Krahnen-Study both relational banks as well as arm's length banks pledge inside as well as outside collateral and this at about the same proportion. Moreover, it is questionable whether the authors really succeeded in distinguishing clearly between these two types of collateral. For example they consider real estate as inside collateral, which is only true to the extent that it belongs to the firm and does not encompass personal real estate. The authors do in fact not make this distinction. Furthermore, their regression analysis does not distinguish between inside and outside collateral at all. Hence, the results of the Elsas-Krahnen-Study have to be handled with great care. Besides, since collateralized assets bear a large degree of privacy, it appears plausible that banks are rather reluctant to release the required information. The French evidence on the other hand just tells us that in spite of the guaranteed priority for accounts receivables, French banks are rather reluctant to collateralize them and instead prefer in particular personal guarantees (outside collateral). We also have learned that relational lending is largely missing in France. To interpret this as a confirmation of the second complement hypothesis would mean jumping to conclusions, however. The reason for this is that it might well be the case that French banks are reluctant to collateralizing accounts receivables because they are not interested in establishing a relationship at all. Our conclusion hence is that it appears difficult to find evidence for a complimentary relationship between absolute priority of inside collateral and the existence of relational lending. Rather, in particular the French evidence for both countries suggests that we are in need of additional arguments explaining arm's length or relational lending which lie outside the insolvency law. This is to what we turn in the final section.

6 Culture and History as Determinants of Relational as opposed to Arm's Length Lending

We now analyze more closely our conjecture that the significance of the insolvency law for the emergence and stability of relationship lending will have to be moderated if other explanations for relationship lending exist which have proven to be rather stable so far. Indeed, going back to financial theory, Longhofer and Santos (2000) find that *given* the cost of building a relationship, a relational debt contract has a higher probability if the bank is a senior lender. This argument can well be reversed saying that given seniority, relational lending has a higher probability if the cost of building a relationship is sufficiently low. Taking this as a point of departure we propose that in Germany the emergence of the housebank principle is closely related to low cost of building relationships, whereas this has not been the case in France.

In Germany, a low cost of building relationship banking can be explained by cultural value orientations which foster and facilitate the building of network complementarity which in its turn is a prominent feature of the housebank principle. This approach necessitates to extending the narrow economist's view to embedding economic relations into social relations as has been proposed by Granovetter (1985) and as has been applied to the financial system by Uzzi (1998). The German housebank principle may well be characterized by such a network complementarity. Of prominent importance in this respect is on the one hand the existence of stable bank-client relations and on the other hand the existence of competition between the group of large private banks, the sector of savings banks and the sector of cooperative banks. An interesting explanation for the emergence of the German financial system is proposed by Tadesse and Kwok (2006). Contrary to the finance and law literature, they offer a risk-reduction based explanation for the variety of financial systems. In doing so, they go beyond Allen and Gale (1997) by stating that the degree of risk tolerance prevalent in a country is rooted in that country's national culture. In accordance with Hofstede (1980, 1997, 2001) they argue that countries with a high degree of uncertainty avoidance favour collectivist over individualist organizations, thus preferring banks over markets. In their empirical study they find Germany as a prototype, whereas the US and the UK represent a case for a low uncertainty avoidance and France ranging in between. This view is supported by cultural scientists like Wildavsky (1987) who conjectures that individualistic cultures favour a social order marked by self-regulation achieved by exchange at eye level in competitive and largely anonymous markets. The price mechanism replaces the need for the building of long-standing personal relationships, thus making a significant contribution to individual autonomy. By contrast, collectivist cultures will prefer hierarchical forms of social interaction and hence personal relationships which typically are power relations. "[h]ierarchies are rationalized by a sacrificial ethic: the parts are supposed to sacrifice for the whole" (Wildavsky 1987, p.7). The following shows that bank-borrowers relationships in France and Germany are not only shaped by the importance and the kind of collateralized assets but that they are originated by political and social networks.

The origin of the German bank-based financial system is indeed rooted in imperial Germany when a set of formal as well as informal institutions developed, which allowed the integration of the ongoing process of industrialization into an upcoming new social order, which expressed the dominating cultural value orientations of the time and which is closely connected to the German bourgeoisie (Schulz 2005, Kocka 1995). It was not primarily material wealth which determined a person's social position in the bourgeois class but membership in social networks. Membership in social networks thus influenced the access to credit and fostered the building of business relations. Professional failure meant exclusion from the cultural and social life of the town, whereas it was expected that material success was to a considerable degree dedicated to the common good (Schulz 2005). These cultural value orientations generated a corporatist social order marked by hierarchies and strong-tie-networks expressing a pronounced sense of group identity as well as social harmony. Not surprisingly, such a social system fostered a financial system, which, too, rested on hierarchies and networks. The building of industrial cartels as well as cross-holdings of shares achieved political acceptance and were even welcomed in the late 19th century where banks played an important role in promoting this development (Guinnane 2002: 104).

These historical roots of the German financial system also explain why relationship lending emerged *prior* to the enactment of the *Konkursordnung*. Whereas Gerschenkron (1962) points to the role of universal banking as the solution of Germany's lack of capital, which at the same time allowed to develop close ties between the credit banks and large firms, Guinnane (2002) assigns a prominent role to private banks as the predecessors of credit banks as well as to co-operative banks. Since the private banks financed their lending business primarily through their own capital, they were not capable of directly lending large amounts. They lent to firms on a short-term basis using current accounts being a composition of demand deposits and overdrafts. Formally this meant a hands-off approach. Materially, however, repeated lending to one and the same borrower over decades was the rule. Both repeated lending as well as the combination of demand deposits and overdrafts allowed the bank to acquire information about the borrower's quality. Most notably, collateral was pledged only in cases where the debtor's private wealth was not considered as significantly high. Ongoing relations were used by the bank to provide its client with long-run capital (bonds) through the issue of bonds in security markets thus exploiting the then existing networks of private banks. Notably, the bank used to hold these bonds for some time on its own account to signal the borrower's quality. This, of course, required the existence of a stable relationship between bank and borrower often including the presence of a bank representative in the management of the firm (Guinnane

2002: 99). These practices were later on assumed by the evolving joint-stock banks (credit banks). Whereas credit banks developed relations with the large industrial firms, credit cooperatives concentrated on small firms as well as on farms. By the very construction of a credit cooperative, close ties between the members and hence between lenders and borrowers can be considered to be a predominating feature. In particular in the rural areas the risk involved by lending long and refinancing through short-term deposits was largely mitigated by the fact that the members knew each other's habits and character, and hardly ever did at least the rural banks pledge collateral at all (Guinnane 2002: 91). Hence, in sum, the beginnings of relationship lending in Germany were *not* closely connected to the development of a collateralizing culture. Rather, it was the building of networks with strong but also weak ties which were accepted as a pillar of social order and which contributed to low cost of relationship building.

Overall, this type of banking system survived the turmoil of the first half of the 20th century. In particular the social market economy with its specific legal framework which developed after World War II allowed and even promoted corporatist structures with close personal and financial linkages between firms and their housebanks. Competition between banks existed but was largely restricted to a so-called "group competition", representing competition between the group of savings banks and the group of cooperative banks and the group of large banks. Beginning with the 1980s this system started to crumble but mostly with respect to large corporations. As has been shown by Elsas and Krahnen (1998, 2002) small and medium sized firms have so far continued relationship banking. This also concerns their endeavours to broaden their equity position through mezzanine capital in the aftermath of Basel II. On a broader level Fohlin (2005) finds that networks between Germany's large firms have so far survived the challenges of globalization. Kogut and Walker (2001) confirm this result. Against this background the impact of the insolvency law on relationship lending indeed should at least be qualified.

French situation is less convincing than the German one concerning the relationship between collateralization, insolvency code and bank-borrower relationship, as it evolved over time. It is less the history and the roots of the banking system than the recent structural change, already mentioned in the previous section, that allow to contradict somehow the existence of a linkage between inside collateral and relationship banking. The history of the French financial system revealed that in Ancien Régime France, “credit assumed such importance that, as one historian suggest, an 18th-century person’s very reputation was bound up with his ability to obtain loans.” This private market of money consisting in matching borrowers and lenders, often on short notice rested upon trust inspired by notaries themselves through the deep knowledge they had of a person’s position. Looking at the demographic structure of this market, one can easily understand the crucial role played by reputation. The Paris credit market was very much Parisian (Hoffman, Postel-Vinay et al., 1992): Some 90% of the borrowers and 84% of the lenders were from the city. They also disproportionately came from the elite. From 1730 to 1788, 64% of the borrowers were nobles of officers, while they represented under 9% of the city’s population. Less than 10% of the borrowers were artisans or employees (p. 298), whereas they represented 78% of the population. Collateral was of minor interest, since a lender (even helped by a notary) had little chance to know whether the borrower’s collateral was overburdened (p. 304).

The French Revolution changed many things, public bonds were not sold through notaries but through banks, the prohibition to lend at interest was lifted and the national land registry allowed to verify collaterals. As a result, the embryonic banking sector grew rapidly, whereas investment holding companies started to play a central role. Notably, in the 19th century corporate finance came from investment groups rather than from the stock exchange. Those companies that sought to expand beyond the resources of their original family controllers were forced to align themselves with a bank or holding company that could guarantee them the capital they required. The banks did not, however, achieve the kind of dominance found in Germany, because of differences in the organization of the banking systems. An important role in this respect might have been played by a higher degree of direct state intervention in France than in Germany with respect to the allocation of savings to investors. Most importantly after

World War II the government took the control of a significant part of the financing system). The eighties intensified this model with the nationalization of the biggest banks. This decision confirmed in fact the historical proximity between industrial, financial and political networks as empowered spheres. The close relationships within and between these groups replaced, to some extent, collateral, what was obviously not the case at all for SMEs.

The mid-1990s marked the beginning of the last and most important phase in the importance of external finance for French companies. It was characterized by a steady increase in the issue of bonds and commercial paper and, more generally, by a clear dominance of market sources of finance. This applied particularly to large firms leaving banks with the primary task to provide finance for smaller firms whose probability of default is higher, thus inducing banks to intensify their demands of collateral. The focus on debt seniority on one hand and creditors ranking on the other may thus be explained by the decline in the state owned system of financing, the increasing role of foreign investors for listed companies and the change in credit portfolios of banks, since intermediation on credit market concerns SMEs mainly.

According to the relationship between inside collateral and relationship banking, it is thus clear that closeness between lenders and borrowers does not need such a linkage and can be strengthened by more sociological or political networks. In this perspective, the role of economic and political elites is at least as important as the formal rules organizing assets securitization in explaining the structure of debt relationships.

7 Conclusions

Examining complementarities between the bankruptcy laws and lending practices, we take up results of financial theory according to which the degree of priority for secured lenders is of crucial importance. Following this line of thought, absolute priority for secured lenders explains why above all banks use collateral extensively in their loan contracts as a disciplining device concerning the borrower (first complement hypothesis). In theoretical models it is furthermore derived that priority for inside collateral, i.e. assets which correlate with the firm value, qualify as an explanation for the emergence of relational lending (second complement hypothesis). After resuming these theoretical arguments, we turn to examining the evidence for France and Germany, and in doing so we draw on existing empirical studies as well as the official statistics in both countries. Since France has a bankruptcy law which has a more pronounced focus on the reorganization of the firm than is the case for Germany, resulting in a lower degree of priority for secured lenders, we should observe that German banks rely less on collateral as an insurance mechanism than in France. However, the empirical investigations do not confirm this conjecture. Depending on the data set, the proportion of collateralization is either found to be similar in both countries or even significantly higher for France. French banks seek compensation for their weak position in the bankruptcy law by demanding more collateral, and this strategy has been facilitated by the emergence of special institutions like OSEO. According to this result we cannot confirm the first complement hypothesis.

We have also not been able to confirm the second complement hypothesis. Arguably, there exists an empirical investigation for Germany that appears to establish a complementary relationship between the absolute priority of inside collateral in formal bankruptcy proceedings and relational lending. However, on closer scrutiny the results are less clear-cut than interpreted by the authors. Moreover, their distinction between inside and outside collateral is questionable. In France the bankruptcy law foresees priority of inside collateral. However, the evidence does not confirm their intensive use by banks which obviously have a preference for outside collateral even if it does not receive absolute priority, and banks are arm's length lenders. This evidence denies at least that absolute priority for inside collateral qualifies as an explanation for relational lending. Rather it indicates that other variables, which are not related to the bankruptcy law, have a higher explanatory power for the existence of arm's length and relational lending, respectively. In this respect we emphasize the role of culture and history. Our main conclusions from these findings are the following: First, the insolvency law plays a role for lending practices in the sense that collateralization would lose its benefit if secured lenders were not assigned any preferential rights at all. Second, apart from this extreme situation, the degree of priority for secured lenders appears to be less important than stated by economic theory. Third, the role of the bankruptcy law as an explanatory factor for the emergence of relationship banking has to be qualified in favor of explanatory variables which lie outside the insolvency law.

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