A comparative analysis of bank lending to small enterprises in Ireland and Germany.

Thesis submitted for the award of Masters of Business Studies to the Dublin City University Business School

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I hereby certify that this material, which I now submit for assessment on the programme of study leading to the award of Masters in Business Studies is entirely my own work and has not been taken from the work of others save to the extent that such work has been cited and acknowledged within the text of my work.

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To the memory of my grandparents
Mrs. Mary Flynn and Mr. Laurence Hanley

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Abstract

The issue of whether the Irish banking system compares favourably or more adversely with other banking systems in the provision of finance to small businesses and in particular enterprises with a riskier profile such as those with higher volumes of current or intellectual assets to fixed assets has been addressed by several authors to date. Foley and Griffith, 1993. Kinsella ,1992 (Culliton Report). Deloitte and Touche, 1994. Bannock and Albach, 1991 (Germany). Burns and Clements, 1992 (UK).

Bank specific studies such as the above are complemented by studies which examine the performance of entrepreneurs and where the issue of banking comprises an ancillary issue rather than main focal point. Carpenter, 1993. Kinsella, Clarke, Storey, Mulveanny and Coyne, 1994. Cosh and Hughes, 1994 (UK). SBRC, 1992 (UK). Hogan, 1995. Kenny, 1994. Aston Business School, 1991. (UK)

This survey seeks to contribute to the literature by focusing on the banking aspects of small business financing in an international context, building on the bank specific studies as its central thrust while incorporating some findings of firm specific studies where relevant.

Some practices of German banks were applied as a yardstick against which to assess the performance of Irish banks vis a vis lending to small businesses. This study endeavours to assess the validity of beliefs that German banks exercise influence on firms through relationship banking, proxy voting rights and membership on supervisory boards which supposedly permit the conferral of advantageous lending terms to business. Attempts will be made to establish if these widely held views about the superiority of the German banking system are valid in a small business context.

Through a series of in-depth interviews with German and Irish bankers who deal with small businesses from across the banking spectrum, additional insights emerge on how the German bankers perceive changes in the Irish system, the securing of loans, fallout rates in riskier small business groups and the orientation of lending.

A comparative analysis of bank lending to SMEs in Germany and Ireland

"The international convergence in the cost of capital ...applies in actual fact only to big firms. Where smaller firms are concerned, the impact on costs of the particular features of national financing systems continues to be an important determining factor in their international competitiveness".

OECD, 1994 National Systems for Financing Innovation

Introduction

A comparison between the German banks system of lending to small and medium sized enterprises and that of the Irish banks is useful for a number of reasons.

The most salient reason reflects the paucity of information which describes the experiences of banks who are involved in lending to smaller enterprises.

Bannock and Albach (1991) have conducted a survey which describes the experiences of the UK vis a vis the German banks while Foley and Griffith (1993) have explored the view that German banks take equity in SMEs.

Most studies however, conducted in Ireland or the UK are concerned with ascertaining which firms should be targeted by industrial policy. Such fast growth studies tend to focus on the performance of firms or the existence of financing gaps. UK examples include Storey (1994) and Binks and Coyne (1983). Corresponding studies in Ireland which have a large firm specific dimension include Hogan (1995), Carpenter (1993) and Kinsella, Clarke, Coyne, Mulveanny and Storey (1994).

Studies which concern the access of small firms to bank finance inter alia include the Chamber of Commerce of Ireland (1994) survey, the recent Forfas Innovation Survey (1995) and that of Deloitte and Touche, (1993).

There is a need for balance in the literature since the question as to whether there is a financing gap or whether Irish banks are risk adverse cannot be satisfactorily answered by reference to firm specific studies alone. Firm specific studies can be supplemented by studies which involve interviewing banks in lieu of entrepreneurs or industry representatives.

Since the UK banking system is similar to the Irish banking system (Rybcznski, 1984); (Frazer and Vittas, 1982), bank studies such as that of Binks, Ennew and Reed (1988) may permit comparisons to be drawn between Ireland and the UK. However, UK internal bank studies are not equivalent to studies which examine the bank based systems of mainland Europe. Similarly, the study in 1994 by the Irish Bankers' Information Service which investigates bank lending statistics in the US, UK and Ireland using material from the Small Firms' Associations' survey (1989), lacks a European dimension. (IBIS, 1994)

It is necessary to discuss the definition of a small business. This definition has been interpreted in numerous ways. The European Observatory for SMEs (Small and Medium Sized Enterprises) defines SMEs as being firms with fewer than 500 employees. Such a definition will not be applied in this discussion since it does not deal with smaller enterprises in an Irish context. The Government Task Force report on Small Business (1994) defined a small business as having less than 50 employees and a turnover of less than £3 million.

Caution should be exercised in interpreting the German definition of small and medium sized enterprises. The term "Mittelstand" the term categorising small and medium sized enterprises in Germany is misleading since it does not distinguish between industry and the professions. A partnership of accountants in Germany, for example, is referred to as an SME. (Kayser and Ibielski, 1986) A medium-sized enterprise in a German context can have approximately £40 million turnover (100 million DM) and employ 499 people. The word SME in the German context is therefore a misnomer and must be qualified by referring to small enterprises since their medium sized enterprises equate with large Irish enterprises.

The term "small enterprise" can also mean in certain instances start ups, young, innovative businesses, small firms dealing in intellectual (hi-tech) assets or small enterprises with low fixed asset to profit ratios. The term "small enterprise" has a multi-faceted and flexible application. The main criteria used to define a small enterprise refer to turnover and/or the number of employees. The author's discussions focused on bankers' reactions to small businesses engaged in manufacturing although bankers made occasional reference to the services sector by way of comparison.

No study which examines banking practices in Ireland and Germany, has yet recognised the significance of decentralised banking structures in Germany. These decentralised, autonomous banks at a local level in Germany, examples of which being savings banks and cooperative banks are responsible for most lending to smaller businesses. Several non-Irish studies testify to their importance. (Köhler, 1995); (Bannock and Albach, 1991); (Fischer and Edwards, 1993)

The Irish banks have been subjected to a "tooth extraction"[1] process since the Government Task Force Report on Small Business in 1994 to the effect that there are now a number of new loan schemes and services on offer to small business clients.[2]

There is as yet no evaluation as to how these recent changes made by Irish banks compare with existing bank lending practices elsewhere or with past Irish practice. As Foley and Griffith, (1994) express the need for an appraisal of these new schemes:

[1] Comments made by Mr. D. P. N. Tierney at the Forfas National Innovation Conference, December, 1995.
[2] Examples being the new Enterprise Loan Schemes some of which started as early as 1989 and the Access to Finance Scheme (introduced 1995) as well as loans subsidised by the European Investment Bank.

"Empirical assessment of many aspects of the bank/ SME interface is hindered by insufficient quantitative information. For example, there are no objective assessments of the role and performance of the single most innovative banking product in recent years, the Enterprise Loan Scheme, begun in 1989".[3]

It is beyond the scope of this survey to remedy this information deficit since this would necessitate comprehensive quantitative research. This survey envisages comparing the fallout rate of an Irish bank on its small business portfolio with that of German banks who divulged their fallout rates. Under the auspices of certain Irish small business loan schemes, the requirements for personal guarantees are relaxed. The appraisal by German bankers of the fallout rate sustained by an Irish bank under one such scheme is documented.

The survey captures aspects of regional bank policy in Germany by taking the following approach. Rather than concentrating solely on the regional clearing offices to savings banks (Landesbanken) or the head offices of main banks such as the Dresdner bank, the interviews were also carried out at local level in the region of Baden Württemberg. Baden Württemberg, which is the second largest German state and is situated in Southwest Germany, is referred to in the literature as having a particularly dynamic small enterprise base because it lacks the natural resources and mineral deposits typical of area in the Rhineland or Ruhr area. (Cooke, Morgan and Price, 1992); (Bannock and Albach, 1991)

[3] Foley and Griffith p.31 of the Irish Banking Review. Autumn, 1994.

It is an interesting time to undertake a comparative survey of this nature since Germany is experiencing its first recession in the period following the Second World War. Certain economists employed in Germany with the *Institut für Mittelstandsforschung*[4] are taking a revised look at bank lending to small enterprises in the wake of exacerbated credit conditions and trading difficulties encountered by small businesses. In particular, reservations are being expressed about the capacity of German banks to continue sustaining high gearing levels. (Kaufmann and Kokalj, 1995)

This study which neccessitated interviews on location in Germany, attempts to supplement previous studies by furnishing recent reports and statistics by the German guarantee banks and *Institut für Mittelstandsforschung* made accessible through the author's knowledge of German.

Also central to the discussion are the responses of German bankers inter alia to the loan fallout of an Irish bank on its loan book and the securitisation of lending. In other words, German banks are asked to comment on the threshold level towards unrecoverable loans exhibited by an Irish bank in lending to certain small businesses under the auspices of a small enterprise programme where the cash flow of the small business takes precedence over loan security. Other points investigated are the reactions of German bankers to new schemes

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[4] The German equivalent of the *Small Firms Association* or *Irish Business Employers Confereration.* The name literally means the "Institute for Research into SMEs".

which have been introduced by Irish bankers in recent years which provide for different arrangements concerning the use of personal assets as security on loans.

This discussion partially addresses the deficiency in the literature caused by an over emphasis on how firms perceive banks or experience difficulties in obtaining finance. It takes cognizance of changes made by Irish banks in recent years and tries to evaluate their innovativenss by comparing existing Irish bank lending practices with the experiences of their German counterparts.

Chapter One
An examination of the theory that German banks are better lenders

1.0 Introduction

This chapter examines the basis for claims that the German system of lending to small and medium sized firms is superior than that of its Irish counterpart. The views postulated by various industrial development theorists will be related to lending to small enterprises. This is because much of the literature is concerned with lending in general and does not cater for lending specifically to smaller enterprises. For this reason, there exist many erroneous perceptions of the German bank based banking system which suggest a greater involvement of German banks with small corporate borrowers than is actually the case.

This chapter examines the supposed merits of the German banking system and attempts to ascertain if widely held views that German banks are better lenders are valid with respect to German banks' small business clients. This review of perceptions about the German banking system draws on the contributions of British and German authors who have documented the role of banks in industrial development.

It is useful to examine the theory under the following headings.

1.1 The role of banks in industrial development

1.2 The German banks' historical and present day reputation as lenders to smaller enterprises.

1.3 The perceived advantages of the German banking system.

1.4 A description Irish and German banks which lend to small businesses.

1.5 Qualifications to the arguement that German banks are better lenders.

1.1 <u>The role of banks in industrial development</u>

Smaller, owner managed enterprises suffer from the well known problem of sourcing external finance with difficulty. OECD (1994), Cosh and Hughes (1994) and Hughes (1992) The reason for this so called market failure or "equity gap" emanates from the fact that outside investors cannot readily evaluate the performance of a small company due to the negative impact of high fixed monitoring costs and the problems relating to moral hazard. Moral hazard for instance implies the risk of opportunistic behaviour which can arise when a certain person or institution can mislead its contractual partner thereby creating gains for itself. This risk is inherent in corporate debt markets where firms can deceive banks and ultimately investors into believing that they are making satisfactory progress in order to obtain additional debt finance or avoid existing loans being recalled.

Writers such as Jenson and Meckling (1976) and Diamond (1984) have referred to agency theory as a way of explaining the role of financial intermediaries such as banks. They argue that the number of depositors who place their funds at the disposal of industry considerably outnumbers corporate borrowers. This fragmentation on the side of depositors does not permit any one depositor to gather sufficient information on the performance of the borrower. Collectively, depositors have a voice and can exercise influence through their financial representative over the manner in which the corporate borrower uses their funds. This representative of depositors' interests could be a bank or other financial intermediary. A bank or agency can convey more information through "noisy monitoring about a borrower than a single lender, even in the presence of informational asymmetries". Yanelle (1989a).

The second more general theoretical reason for needing a financial intermediary such as a bank emanates from the benefits accruing to the lender through shared risk. A banks portfolio should be diversified since it comprises, ideally, many different borrowers and borrower profiles. As a result of this negligible exposure of the bank or agency to any one company, the probability of a firm defaulting is reduced and by doing so the threat of a liquidity crisis occurring at the bank in averted. Gurley and Shaw (1960) examine the issue of risk portfolios and come to the conclusion that as an economy evolves, there is a greater necessity for this sharing of risk through diversified portfolios. They ascribe importance to banks and financial intermediaries in industrial development.

Now that the theoretical rationale has been presented as to how financial intermediaries assist industrial development through monitoring firms on behalf of depositors, the discussion turns to the role of enterprises in industrial development.

For countries embarking on growth policies, measures are taken to promote the growth of young firms with export and employment potential. It is envisaged that with the passage of time some of these seedling enterprises will become the growth engines of the future and create exponential employment. (Employment through Enterprise, 1994)

Just as individual investors can hope to gain from lower monitoring costs if a bank intercedes on their behalf, small firms pose problems to financial intermediaries due to the small scale of their operations and in the case of small incipient firms due to their lack of track record. If a large proportion of their borrowing is to cover non-tangible goods such as working capital or marketing expenditure, the problems of accessing finance are even more difficult. These problems are compounded by the fact that due to the small scale of their operations, they are precluded from selling securities on the capital markets. Holstrom and Tirole, 1990. Myers and Majluf, 1984. As the OECD Report (1994)[1] on innovation states the case;

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[1] The Financing of Innovation, 1994. P.60

"..the majority of SMEs, which have only limited access to the securities markets and inspire little enthusiasm among the providers of venture capital are the ones to suffer as they must bear the full brunt of credit rationing".

Stiglitz and Weiss (1981) in their frequently cited article elucidate the issue of credit rationing. They maintain that even incremental interest rates cannot continue to compensate for risk indefinitely. At some stage credit will be withheld from potential borrowers when the lender perceives the risk as being too great. There are therefore imperfections in the loan market because beyond certain threshold levels, an interest premium commensurate with the borrower's risk profile will not defray the risk incurred by the lender owing to the high variance of the returns.[2]

Even when credit is not withheld, the cost of obtaining a loan for a small enterprise can be prohibitive due to a higher interest differential or spread. Often, there is a several percentage points difference between the cost to larger corporations of credit and the cost charged their smaller counterparts. According to the same report mentioned above, the cost to the small firm of these incremental interest rates has not be ameliorated by converging international banking standards:

> "The international convergence of the cost of capital..applies in actual fact only to big firms. When smaller firms are concerned, the impact on costs of

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[2] In the event of borrower risk becoming too great yet with the possibility of high returns, debt could be converted to equity.

the particular features of national financing systems continues to be an important determining factor in their international competitiveness".[3]

The Government Task Force Report (1994) pointed to the fact that small enterprises in general have gained in importance internationally:

"Since the 1970s, the international trend has seen small business become a net creator of jobs, while large business has been a net shedder of jobs".[4]

Apart from smaller enterprises in non-traded sectors the financing of whom leads to substitution effects[5], there are many incipient and developing firms engaged in industrial activities which could create value for the economy through the production of goods in the form of export or import substitutes. In addition to established small enterprises engaged in the manufacturing sector, there are also others who have not yet realised their full potential and which constitute "deserving projects" from an industrial policy perspective. OECD Report (1994). The way in which a banking system functions has implications in particular for this category of fast growth enterprise, since inadequate financing of such firms could be detrimental to the welfare of the country as a whole;

"That is to say, selection by the market of innovation projects is not only incomplete, since it does not systematically choose deserving projects in terms of social need or growth, but is also partial, since the projects chosen are necessarily better than those rejected"[6].

[3] OECD. National Systems for Financing Innovation, 1991. P. 47
[4] Government Task Force on Small Business, 1994. P.II
[5] It depends on the defination of "non traded". The parameters as to what constitutes non traded are shifting and increasingly these enterprises could be categorised as exports as distribution improves
[6] OECD. National Systems for Financing Innovation, 1994. P60

The issue of market imperfections existing in the provision of finance to small enterprises particularly at the early and developing stages has its own extensive literature including Kinsella, Clarke, Storey, Mulveanny and Coyne (1994), Siobhan Kenny (1994), Cosh and Hughes (1994), Hughes (1992), Hughes and Storey (1994), Binks and Coyne (1983) and the Aston Business School (1991).

As can be seen from the above, the need for finance by small enterprises is a well documented fact. This discussion is less concerned however with fast growth and finance gaps such as those of the studies as with the relationship between banks and small enterprises in an economy. German banks were chosen by way of comparison with those in Ireland for several reasons.

Firstly, the German banking system is acknowledged to be a "bank based system". Gardener and Molyneux, 1990. The Irish banking system has been compared with that in the UK, Canada or the US. Bannock et alia (1991). SFA (1989) .

This tendency to compare Ireland with the market systems of the UK and the US could emanate from the proximity of the Irish banking system to such systems rather than the bank based systems witnessed in Germany or Japan. Rybcznski, 1984. Stanworth et al., 1992. It is useful to take the route of Foley and Griffith, (1992) Bannock and Albach (1991) or UK studies prompted by the

Macmillan Report[7] and look beyond the market based system in order to critically evaluate a bank based system which is allegedly more accommodating towards smaller enterprises.

Secondly, the German "Economic Miracle" brought about after the Second World War was largely ascribed to the burgeoning smaller firms which developed into viable, independent entities. Foley and Griffith refer to the need for "post-war reconstruction". The part played by the banks in this promotion of SME is well charted in the German literature although opinions differ as to the relative importance of the banks.

Thirdly, both Foley and Griffith (1993) and the Task Force Report on Small Business refer to the high prioritisation of small enterprises in German public policy:

"Ireland is behind, too, in the place it gives to small business in public policy making. The world's strongest economies, the US, Japan and Germany, have long recognised the importance of encouraging their small businesses side by side with their large ones"[8].

The following section describes the evolution of the German economy through the banks fostering of small industries before some of the opinions concerning the perceived advantages of the German system are discussed.

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[7] European Institute for SME Research (3i)

[8] Government Task Force Report on Small Business, 1994. P.II

1.2 The German banks' historical and present day reputation as lenders to smaller enterprises

Adjectives used to describe the German banking system are bank or credit based. Stanworth et. alia (1992) Rybcznsksi (1984) OECD (1994) Frazer and Vittas (1982) Gardner and Molyneux (1990).

Such a system is characterised by a large input from the banking community which manifests itself in high industrial gearing ratios, or "organic ties" between industry and the banks or in the incidence of banks taking equity in firms and influencing firms at corporate governance level through the exercising of proxy voting rights.

Bank based systems are also characterised by less developed equity markets since the financing needs of industry are met to a greater extent by the banks. (OECD, 1994)

The characteristics of the German based system in relation to its British market based counterpart can be summarised by drawing on the contributions of industrial economists. Mayer and Franks, 1990 on Germany and the UK. Von Thadden, 1990 on Germany. **Table 1.2.1**

Table 1.2.1 National Financing Systems; A simplified typology

Market based system United Kingdom	Credit based system Germany
Strongly mediated	Participatory governance
Relatively low debt/equity	Relatively high debt equity
Major financing instruments: comprise retained earnings and to a lesser extent, bonds and new equity issues	**Major financing instruments:** Loans and retained earnings
No of listed companies: Very large 1.84 per billion of GDP	**No. of listed companies:** Small 0.39 per billion of GDP
Type of monitoring: Dispersed among specialised institutions	**Type of monitoring:** Bank centred and participatory
How system copes with uncertainty: Venture capital and other financial instruments. Large to medium-scale Government support	**How system copes with uncertainty:** Banks consortia. Diversification of large banks towards support of SMEs' creation and development. Bank-supported entrepreneurship in large firms. Medium scale government support
Some critical issues: Short termism. Problematic financing of intangibles, especially human capital. Venture capital market shows signs of decline. Mixed record of mergers and acquisitions as a way to discipline use of capital especially when one considers their effect on R & D activities.	**Some critical issues:** The dominant corporate governence system is weakened by the tendency of large firms to drift away from bank financing and by the turbulances that the reunification creates on the labour market which makes co-determination more difficult. Diversification of large banks towards small firms calls for a problematic adaptation of their assessment and monitoring procedures

Source: Mayer C. and I. Alexander, 1990. Von Thadden, 1990

There is much similarity between the definitions that apply to the German banking system and descriptions of the Japanese system. (Hoshi, 1989b and c)

The historical evolution of the German system is well documented. Following the aftermath of the Second World War, Germany experienced a decline in personal savings needed to finance industry. At the same time, the Allies feared that if German industry were not restored, a repetition of the Weimar Republic could precipitate a reoccurrence of the Second World War.

The policy was to promote smaller enterprises referred to as the *Mittelstand* and nurture them into larger viable entities. (Cooke, Morgan and Price, 1992) In order to prioritise this objective, the importance of SMEs was codified into the legislation. This legislation which was implemented at regional level in Germany committed the Germany economy to support SMEs in order to secure economic recovery. Kayser and Ibielski, 1986. An example of this is the "Law to Promote Small and Medium Sized Firms, 1975" introduced into Baden-Württemberg. Sabel (1991) refers to the dynamic growth experienced in the Baden Württemberg region due to the promotion of small enterprises. Bannock and Albach, (1991). Cooke, Morgan and Price (1992) also testify to the importance ascribed the small enterprise sector in this region:

> "Nowhere is this (need for investment in R&D) more evident than in Baden-Württemberg, the first region in Europe to launch a SME oriented regional innovation strategy, and, arguably one of the best industrial success stories over the last 30 years".[9]

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[9] P Cooke, K Morgan and A Price. P. 163 The Future of the Mittelstand: Collaboration versus Competition in Globalisation, Networking and Small Firm Innovation , 1994 . Dermot O'Doherty (Ed)

In Germany, the role of the banks in financing the small and medium sized enterprises has been especially important since the Second World War. (Bannock and Albach, 1991) There is a conscious policy to promote SMEs in order to prevent a return of the major cartelisation of large corporations such as the chemical company BASF. (Fischer and Edwards, 1992) These were dismantled following the War to reduce their dominance. Competition via start ups was welcomed and supported by the German State. The historic and cultural reasons for establishing a healthy SME base are cited in the following extract which explains Chancellor Erhard's motives:

> "Competition is only possible if there are a sufficient number of firms in the market and Professor Erhard's first aim was to encourage as many people as possible to start up businesses. New business formation was therefore facilitated. Restrictions upon trade were abolished and a strict anti-trust policy followed. This meant ignoring demands for policies favouring the large scale industries in which pre-was Germany had excelled[10]".

In the industrial economic literature, writers have seen the importance of German banks predate the policies of the 50's.

Diamond, (1984), in his axioms on monitoring refers to information asymmetries between financial intermediaries and enterprises. Gerschenkron (1962) uses the function of banks as monitors to explain their importance at the inception of the German state. Young firms lacking a track record pose serious problems for financiers and so a bank is in a unique position to monitor a

[10] "Small Firms and the German Economic Miracle", Willibrord Sauer, in Small Business Theory and Policy, Cyril Levicki (Ed), Acton Society Trust, 1984

company since it is also in a position to monitor the firm's liquidity via its deposit account.

Hellwig, (1991) who discusses the ideas of Gerschenkron expresses the importance of banks in Germany during the early parts of this century as follows:

"We may therefore look at the imperfect information approach to financial intermediaries as the theoretical basis for Gerschenkron's view that banks and bank involvement (in Germany) were needed to provide outside finance when capital was "scarce and diffuse" and the "distrust of industrial activities...considerable""[11].

The risk associated with the financing of young or emerging industrial forms is present in many fast growth studies mentioned above. Gerschenkron thought that the German banks were best equipped to deal with this risk. Gerschenkron was of the opinion that banks in Germany had by 1962 fulfilled their function by filling the vacuum left by inadequate equity markets. As a country evolves and small firms lacking in track record develop, the role of the bank, in his opinion declines. Banks in his view were expedient in providing funds to industry but as firms become self sufficient the role of the banks should decline in importance. In fact, Gerschenkron argues that German banks are not as important now as they have been in supplying industrial SMEs with finance;

"..at the turn of the century, German industrial companies became rather less dependent on their banks than they had been during the start-up phase".[12]

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[11] Hellwig, 1991 referring to Gerschenkron's (1962) appraisal of the role of German banks

[12] Gerschenkron, 1962 cited P. 57 M. Hellwig in European Financial Integration. A. Giovannini and C. Mayer (Eds.)

This portrayal of the German banks as a useful transitionary tool in promoting industrial development is not shared by the author Mayer (1988). Mayer ascribes a more lasting role to the German banks in their support of industry. He examines the period 1970 - 1985 and concludes that banking systems such as those in Germany permit more long term lending. The presence or otherwise of long term lending is what differentiates one financial system from another. This presence of long term lending is facilitated through close, organic ties between the banks and industry.

Mayer contends that the German banks continue to be supportive of industry through their provision of long term finance while Gerschenkron insists that their role is becoming obsolete. Gerschenkron's views are shared by historians Feldenkirchen (1979) Pohl (1983) as well as industrial economists at the turn of the century, Jeidels (1905) and Riesser (1910).

Despite the disagreements of industrial economists as to the role of German banks in compensating for risk aversion in the financing of industrial firms with an inadequate track record, consensus remains on one issue; German banks provided finance to small businesses at a very crucial stage of industrial development in Germany. Whether inferences can be drawn from this to support present day support by banks in Ireland for SMEs remains to be investigated.

Such advocates of the German system are the industrial economists Cosh, Hughes and Singh (1990). They profess the superiority of the German system to its British counterpart as follows:

"The financial institutions would need to pool their resources together, set up specialised departments for promoting investment and innovations - in other words behave like German banks".

Another British advocate of the German system is Crafts (1992) in his dissertation examines the efficiency of the stock market in regulating the performance of managers as opposed to the strait jacket imposed on corporate borrowers by bankers who are takers of equity or providers of long term loans;

> "There are good reasons to choose the German rather than the British style of capital markets. Substantial bank involvement in long term lending and management of industrial companies....In practice the effectiveness of German banks as monitors of company performance (Cable, 1985) and the apparent ineffectiveness of the British takeover mechanism in eliminating poor performance and creating post merger efficiency gains (Meeks, 1977) makes the German system unambiguously superior"[13].

The final extract taken from a report which assesses various financial systems to support innovation testifies to German bankers being able to influence managers and accordingly the projects being undertaken through their possession of equity;

> "In continental Europe and Japan, the financial system's involvement in corporate management is much more direct and takes place within the framework of a complex network of bilateral relations between firms and financial institutions. Large-scale intermediaries holding substantial blocks of shares do not merely supply industry with savings, but share some of the

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[13] Fischer and Edwards citing from Crafts, 1992. Banks, Finance and Investment in Germany (1994) P. 4

corporate management's prerogatives with regard to investment project selection and management".[14]

Contrasted with this praise of the German banks based system, Irish and UK bank systems are infrequently referred to as being risk adverse or inadequate in some respects.

> "..This is a country (Ireland) where the environment for banks has always been good, with the Irish banks amongst the most successful, that they cannot ignore this. I see no reason, and I believe the shareholders (banks') would have no objection to more help being given to the indigenous sector by way of seed capital, since it is the success of the indigenous companies over the next 20 years which will guarantee the environment where the banks can continue to be to be successful .."[15]

He continues by exhorting them to become more involved with firms rather than consenting to help under outside pressure in a "tooth extraction" process.

Are these allegations as to the superiority of the German banking system substantiated by the literature? These perceived advantages of the German system can be examined in turn.

The first relates to the taking of equity by German banks in industry. This is both a weak and an invalid arguement where it refers to small businesses. It is a weak arguement since only listed companies with the legal title of AG are permitted to seek equity on the stock exchange. There are considerably more Public Liability Companies (their British and Irish equivalent) in the UK. At the

[14] OECD, 1994, P. 77

[15] Comments made by Mr. Dan Tierney speaking at Forfas National Innovation Conference. 08.12.1995

end of 1985 2,135 UK plcs were listed while 474 were listed in Germany. Partnerships are a far more popular legal form. (Edwards and Fischer, 1992)

There were 401,687 companies with Limited Liability status in 1989 and of those only companies with in excess of 500 employees were obliged to have a supervisory board according to Fischer and Edwards (1992). Since this discussion concerns itself with small businesses with less than 50 employees, it follows that it is totally misguided to say that smaller firms have profit in terms of favourable financing arrangements in Germany due to having banks participate on their supervisory boards. The event of a bank member presiding or being in a position to influence the company's direction in a firm with less than 50 employees never arises in Germany.

It is important to emphasise the fact that banks do not take equity in small firms in Germany. Only firms of the AG (Plc) legal form are permitted to issue equity if they have a listing. Since there were 2,508 Public Limited Companies in Germany in 1989 of whom 486 were listed, it follows that only these 486 of these with an average owners' capital of £19 million could possibly have been granted equity by a bank. Edwards and Fischer, (1994). A small business with less than 50 employees is not in a position to issue such stock. For this reason one has to dismiss the idea that banks take equity in small businesses.

This same fact that German banks do not take equity in small firms was evidenced in a 1993 Irish survey by Foley and Griffith where the German Regional Banks (Landesbanken) interviewed took equity only in certain circumstances. One stipulation of a Regional Bank in Northern Germany was that the firm be in a position to contribute at least £300,000 of its own funds. Another Regional Bank indicated that its provision of equity was to facilitate the firm in a floatation bid. Both these reports suggest that the firms in question may be SMEs according to the German definition as expressed by Kayser and Ibielski (1986) but large by Irish standards.[16] The other factor which reinforces the possibility that these were not small businesses concerns the orientation of the Regional banks. Regional banks focus their lending efforts on larger, established companies and not on young or riskier ventures. Such firms are catered for by the savings banks and cooperative banks as shall be seen at a later stage. **(See 1.4)** Foley and Griffith conclude that:

> "The German banks do not normally take equity in an SME as part of their financing packages, contrary to some comments made here in Ireland. The banks do hold a significant proportion of the economy's share, but this refers more to large firms".[17]

The next issue refers to the advisory role of German banks. One could reasonably hypothesize that even if bankers have no presence on supervisory boards dealing with SMEs, that perhaps being long term lenders, their commitment to the firm could be nonetheless important. If the banks had at their disposal technically qualified staff who could readily assess loan

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[16] Kayser and Ibielski postulated that the German defination of an SME includes firms with up to 500 employees and turnover of 100 million DM which is a large company by Irish standards.
[17] Foley and Griffith, 1994 in "The Irish Banking Review", Autumn, 1994. P. 44

applications on their ability to be commercially viable, this could permit a loan to be extended on the merits of the loan application rather than solely relying on the existing balance sheet assets of the firm. The ability of Irish bankers to possess such technological staff capable of ascertaining the potential of, for example, a computer component manufacturer has been raised in the past. (Government Task Force Report, 1994.) Although Kinsella, (1995) acknowledged the efforts made by financial institutions in recent years in terms of their knowledge base on the financing SMEs, he referred to the difficult task which could face financial institutions when technology has taken quantum leaps:

"The kind of companies that are coming on-stream now are quite different in their nature and in their financial needs to traditional companies....I would maintain that our financial institutions have not yet caught up with that[18]".

The question is whether German loan officers possess technological qualifications which would put them at an advantage in accessing loan applications of a technical nature.

Opinion differs in the literature as to the presence of technical banking gurus who could professionally assess an innovative loan application. There is evidence from the following quotations that German banks were formerly perceived to be particularly well informed about the loan applications

[18] Reply of Mr. Ray Kinsella to question at Forfas Annual Conference on Innovation, Dublin Castle, 1995

presented by industrial firms. The view that German bankers are endowed with technical qualifications which allows them advise entrepreneurs and appraise loan applications is challenged by more current evidence. The first abstract from William Olsson is cited by Hellwig (1991) and shows the degree of trust harboured by German bankers in their clients. It also suggests that there was a basis for the supposition that German banks, at least early this century, were familiar with technology.

> "The pioneer would take his proposal to one of the great banks with an industrial department, and the proposal would immediately be put before experts, scientific and technical, well known to the banks and thoroughly trusted, who, (on the assumption that the proposed business was really good) would report well on it, and would be believed"[19].

However, two other more recent writers would dispute Olsson's account. The first is Macrae (1966) who investigated the supposition that German banks have "those famous technical and technological departments". These transpired to be "myths". He goes on to say that:

"..even in the biggest banks, they seem to be merely bankers with some knowledge of present trends in particular industries, rather than great innovating boffins in their own right".

Corbett (1987) would agree with Macrae's conclusion, maintaining that the procedure in Germany for appraising loans is similar to that used in the UK and Japan.

[19] William Olsson (1919) cited by Hellwig (1991)

The final issue as to why the German banking system is perceived by some outsiders to be more advantageous than the UK banking system (to which the Irish system is closely allied) refers to the prevalence of long term lending in Germany. Even if has been established that banks do not take equity in German SMEs, the fact that there could be a greater amount of long term lending at fixed interest rates would be indicative of more lenient practices. If, for example, a young firm encountered high initial start up costs and exhibited a high ratio of trade debtors to creditors, a long term loan at fixed interest rates could demonstrate a bank's long term commitment to the firm.

Mayer (1988), as has been mentioned earlier, underlined the role of the German banks in the provision of long term finance. Although, it has been proven above that German banks do not exert any influence on firms via supervisory boards and so this issue should not affect the provision or otherwise of long term lending, this caveat does not detract from Mayer's claim that close links[20] between banks and industry is conductive to the provision of long term finance to industry by German banks.

The claim that German banks are good long term lenders to SMEs is evidenced in recent research. (Burns and Whitehouse, 1995) **Figure 1.3.1**

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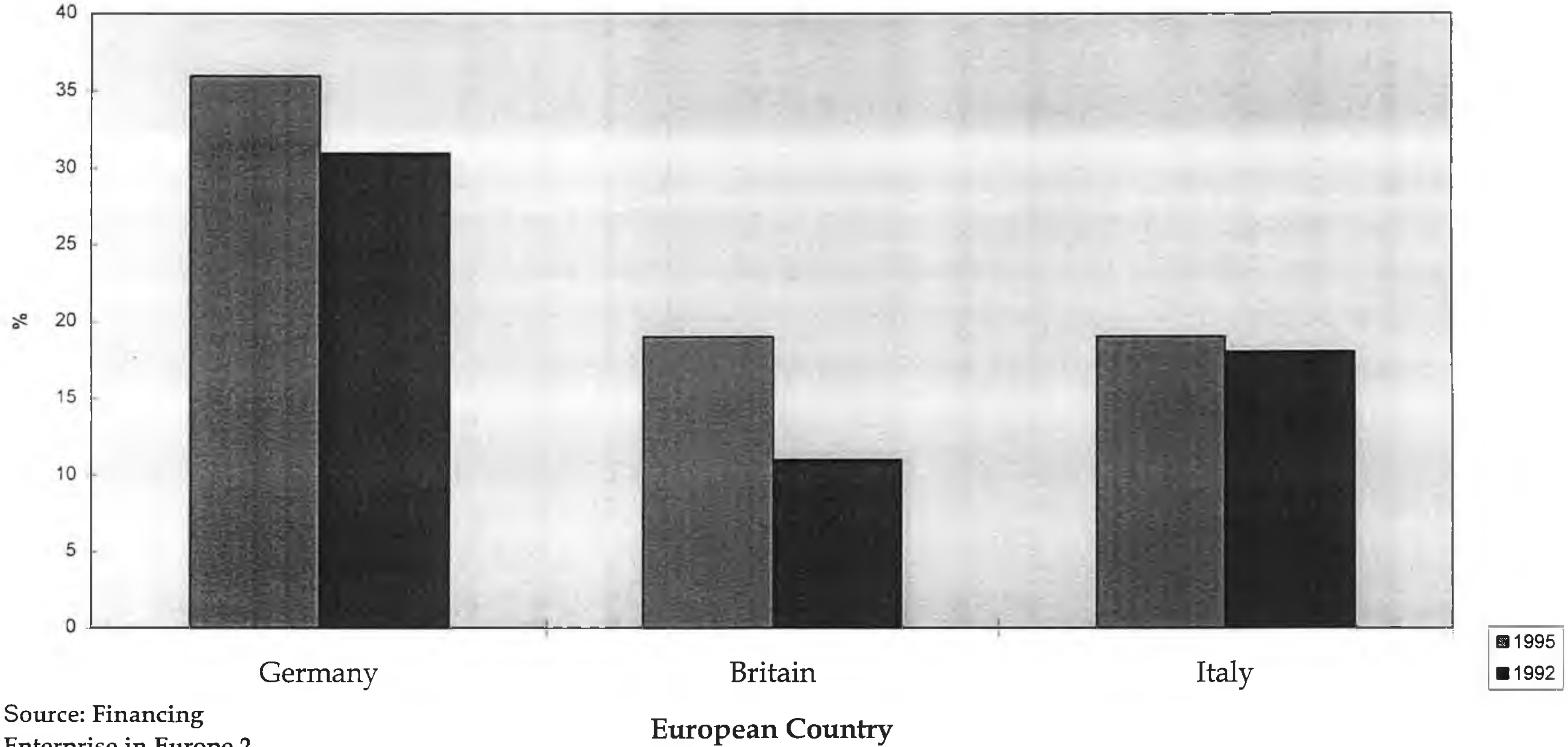
[20] Referred to in some industrial economic texts as "organic links

Figure 1.3.1 Long term loans (over 5 years) as a % of total debt



Source: Financing Enterprise in Europe 2, 1995

In Germany the proportion of long term lending as a percentage of total lending has increased over the 3 year period from 31 percent in 1992 to 36 percent in 1995. In Britain, the percentage has increased from 11 percent to 19 percent. This represents a percentage change of a 72 percent increase in the UK compared with a 16 percent decrease for Germany. However, it still does not detract from the arguement that there is more long term lending by German banks to SMEs.

It is not sufficient to infer the German banks have a long term view on the evidence of long term lending alone. One must look also take the nature of the lending into consideration. (Foley and Griffith, 1993).

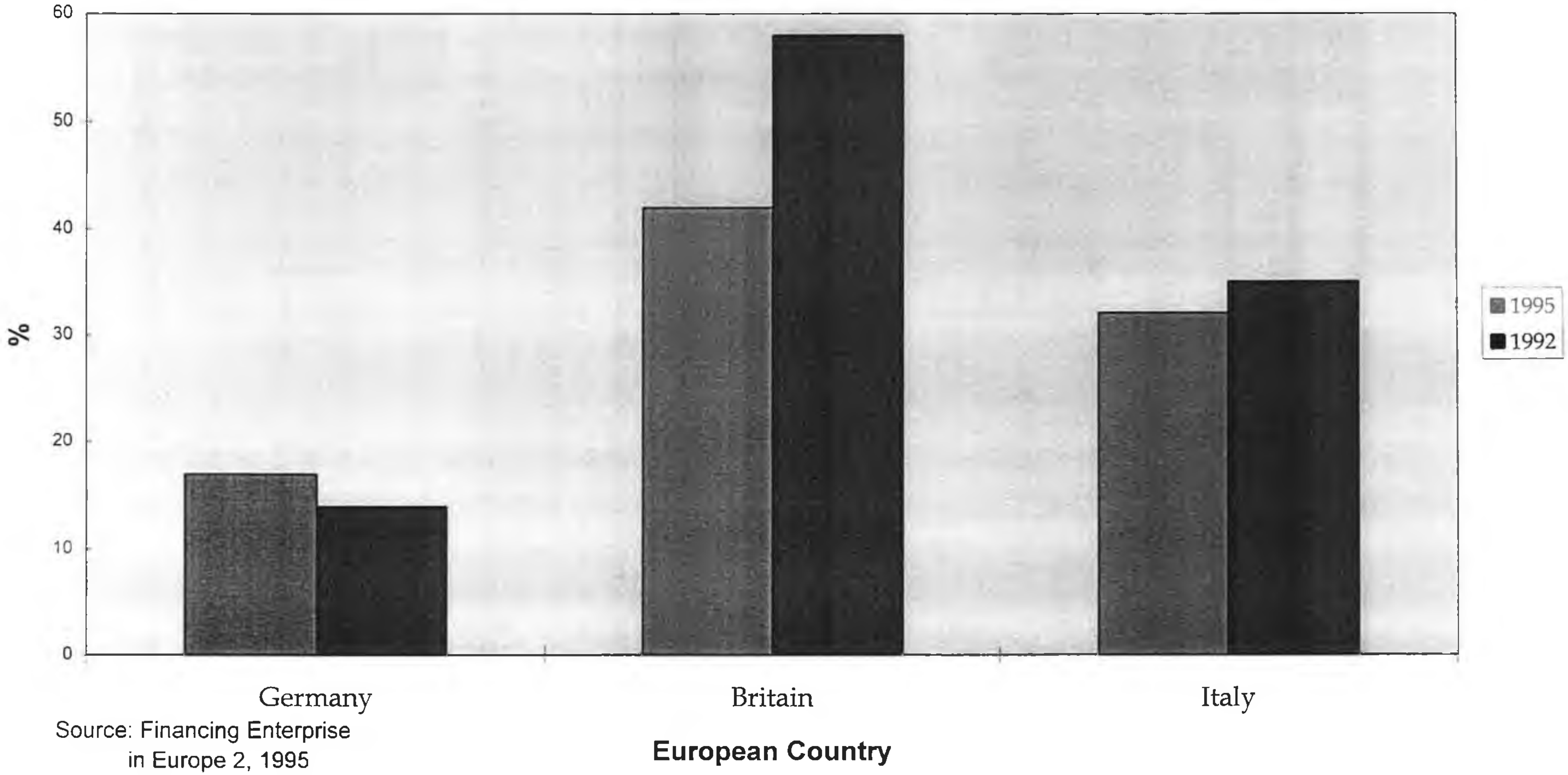
> "The type of funding is also significant. Mortgage-type funding is obviously very long term and one would expect such funding to be over 10 years or more. Long term funding of this nature would not be particularly innovative or risky in terms of long term availability of credit".[21]

Since different countries have different definitions of what constitutes "long term lending", it is useful to compare the percentage of total debt accounted for by overdraft finance. (Burns and Whitehouse, 1995) **Figure 1.3.2**

Here, it is evident that Britain exhibits a proportion of overdraft finance to SMEs of 42 percent in 1995 although this has diminished from 58 percent in 1992. Both these percentages are in stark contrast to a proportion of 17 percent of overdraft finance registered by Germany in 1995. Even though the figure

[21] Foley and Griffith, 1994 in "The Irish Banking Review". Autumn, P. 45

Figure 1.3.2 Overdraft as % of total debt



Source: Financing Enterprise in Europe 2, 1995 pertaining to 1995 overdraft finance to SMEs by banks has increased from 14 percent in 1993, it is still considerably below the average of 29 percent for 1995.

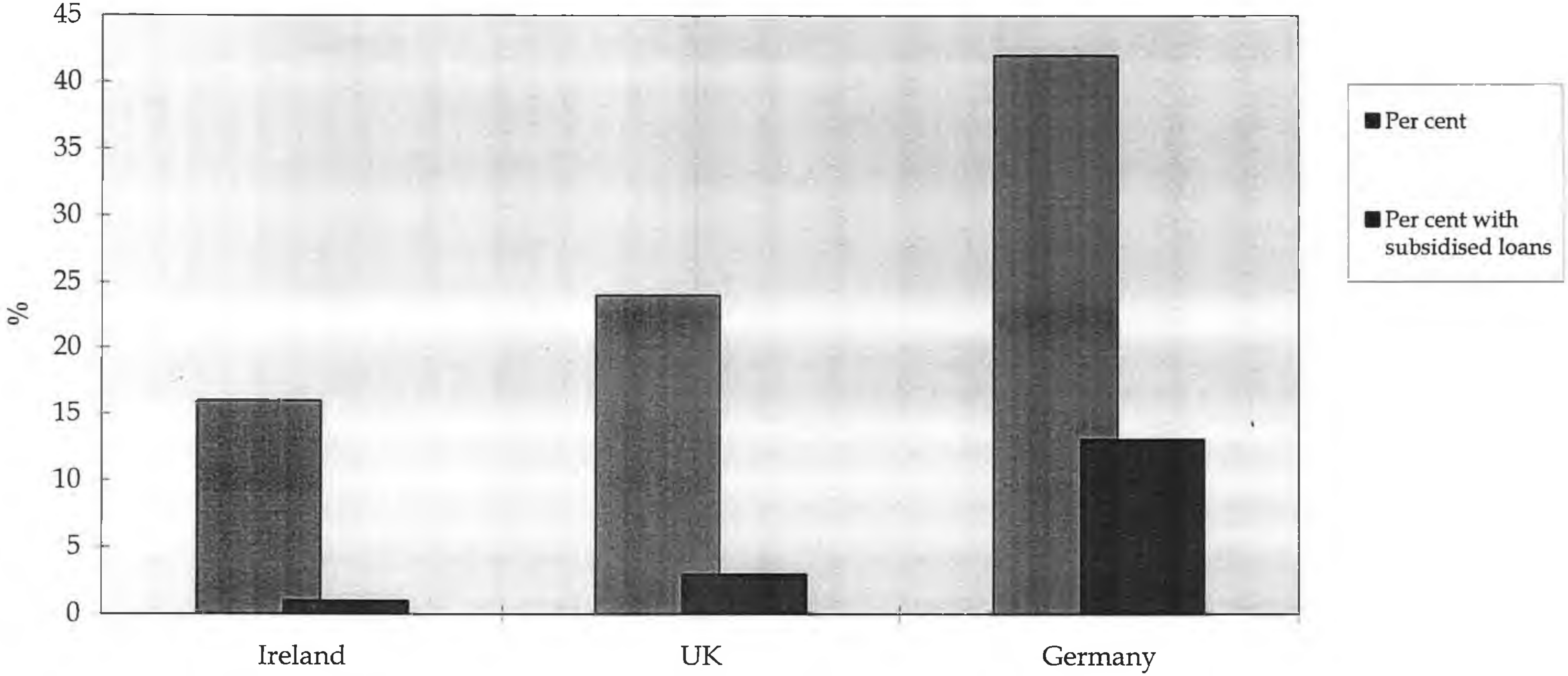
When the proportions of long term debt are related to the percentage of this debt accounted for by relatively riskless overdraft finance, the long term view of the German bankers is evidenced.

As Burns and Whitehouse (1995) assert:
"British SMEs have the shortest financing horizons in Europe whilst German SMEs have the longest".

Up to this point, Germany has been compared against the UK and Italy in the area of long term lending. Due to the fact that Ireland is a peripheral economy, international comparisons of long term lending which extend to Ireland are less prolific than comparisons which feature larger European countries. Nevertheless, the European Business Survey of SMEs (1994) rectifies this imbalance somewhat by supplying information on long-term lending which includes Ireland. **Figure 1.3.3**

In the context of the preceding statistics which include the UK, it is not suprising that fewer UK enterprises have long term bank loans compared with their German counterparts. The former amounts to 24 percent of all enterprises exhibiting long term loans while German enterprises exceed this proportion to

Figure 1.3.3 Companies with long term (exceeding five years) bank loans



Source: European Business Survey of SMEs, Spring, 1994 the extent that 42 percent of enterprises have loans above 5 years duration. Considerably more German enterprises display subsidised loans than UK firms: 13 percent vis a vis 3 percent.

The statistics manifest that a smaller proportion of Irish firms have long term loans than either UK or German firms. In 1994, according to this survey, 16 percent of Irish enterprises had long term loans. Again only 1 percent of all enterprises, at this period had subsidised loans. This shortage of long term lending in Ireland was indicative of an aversion on the part of lenders to channel funds into higher risk projects:

"There is reluctance to extend advances for periods longer than 5 to 7 years, particularly to firms lacking a sound track-record and thus, by comparison with other countries, Irish business is disadvantaged in this respect".[22]

Since 1994, the period investigated in the European Business Survey of SMEs (1994), there have been changes in the amount of subsidised loans made available by the banks. Writers such as Foley and Griffith (1993) have lamented the fact that until now the impact of these schemes has not as yet been ascertained:

> "Conclusive evaluation of the role of the banks is constrained by the limited availability of empirical data. Empirical assessment of many aspects of the bank/ SME interface is hindered by insufficient quantitative information. For example, there are no objective assessments of the role and performance of the single most innovative banking product in recent years, the Enterprise Loan Scheme, begun in 1989".[23]

[22] Section 6.4. Shaping our future: A strategy for enterprise in Ireland in the 21st century. Forfas
[23] Foley and Griffith, 1994. P. 31 "Irish Banks and the Development of Small and Medium Sized Enterprises" in The Irish Banking Review, Autumn 1994.

One may argue that the impact of the Enterprise Loan should be witnessed in the 1994 statistics. Under the auspices of this scheme a total of £58 million was extended in loans to start ups businesses and small developing companies while the requirement for personal guarantees was waived.

Although the Enterprise Loan Schemes should be registered in the 1994 statistics, the Access to Finance Scheme is not. This subsidised loan scheme envisages a fund of £208 million in the form of subsidised loans at a rate of 6.5 percent to established companies for 7 years. Since its inception in 1995, already £46 million had been drawn down by December, 1996 for these Section 114 loans. This scheme was funded to the extent of 50 percent by the participating banks themselves, the remainder being taken up by European Structural Funds and the Exchequer.

Subsidised lending of a more general nature is extended to SMEs by Irish banks in the guise of funds which emanate from the European Investment Bank. Irish banks have been at the receiving end of criticism from small firms representative groups for not drawing down their full allocation.[24] (Irish Independent, 09. February, 1994).

The 1994 statistics which testify to Irish banks being poor long term lenders predated much of these changes. Nevertheless, it cannot be denied that the

[24] Allegations were made by the ISME that at the end of 1993 only a proportion of the total EIB subsidised loans allocated to Ireland were drawn down by the banks. This proportion, it was claimed, amounted to 65 percent of the total amount allocated to Ireland by the EIB.

disparity between long term loans secured by UK and the Irish firms, on the one hand, and those of German firms on the other indicate that lending in Germany appears to be longer term. This does not impute that German banks are better lenders. In fact, the large proportions of subsidised loans suggests that banks are facilitated by government.

That the German banks are designated by the German government an important role in promoting SMEs is evident in a report by Bannock and alia (1991). **Table 1.3.1**

In Bannock's comparison of the UK and the German programmes for supporting SME, it emerged that 59.3 percent of the German budget allocated to SMEs in 1991 was administered in the form of loans, grants and guarantees. 43.3 percent of the total government spending budget in Germany on SMEs is assigned to guarantees and loan subsidies which are administered by guarantee banks and banks with special functions such as the *Lastenausgleichsbank*[25] in conjunction with the commercial banks. Bannock concluded that if German commercial banks are long term in their outlook it is as a consequence of the considerable proportions of Government resources which are channelled into direct financial assistance to firms via the banking system. This policy of facilitating the banking system is diametrically different to the British *laissez faire* or supply side policies whereby State funds are directed towards the

[25] Literally means the "Bank for compensating for burdens".

Table 1.3.1 **Support for SMEs by type of programme in 1991 (Britain and Germany)**

£ million	Britain	%	Germany	%
Special regional assistance	108.5	21.2	167.1	9.1
R & D and technology	10.0	2.0	375.2	20.3
Loans, grants and guarantees[1]	3.8	0.7	1093.4	59.3
Start-up assistance	199.0	39.0	61.7	3.3
Training	110.0	21.5	81.5	4.4
Information and consultancy	77.9	15.3	64.7	3.5
Other	1.6	0.3	0.3	-
Total	510.8	100.0	1843.9	100.0

Source: Graham Bannock and Partners, 1991

Table 1.4.1 **The Access to Finance Scheme as of 31 December, 1996 (£40 million)[2]**

Irish Bank	Quota (million)	Qualifying Applications (million)	Approved (million)	Drawn (million)
Bank 1	£79.0	£79.0	£6.633	£13.244
Bank 2	£89.0	£89.0	£22.529	£24.744
Bank 3	£30.0	£30.0	£21.453	£6.092
Bank 4	£10.0	£9.5	£4.424	£1.975
Total	£208.0	£207.5	£55.039	£46.055

[1] Loan support in Germany in the form of subsidised loans and guarantees amounted to an estimated £800 million. This corresponds to 43.3% of the total support administered by the German government in 1991.

[2] This Access to Finance Scheme provides subsidised loans at 6.5% over 7 years and is being delivered on the basis of a partnership between the Government, the EU and the participating banks.

education and training of entrepreneurs. It is evident that start up assistance is also a priority in Britain. A proportion of 39 percent was assigned to start ups compared with a mere 3.3 percent in the case of Germany. This data underestimates the considerable funds allocated to start ups in Germany via the Owners' Equity Assistance Programme[26] which is administered under the auspices of the Lastenausgleichsbank. Although only approximately 13 percent of guaranteed loans are allocated to start ups[27], guarantee banks represent nonetheless another source of funding to start ups which data supplied by Bannock does not categorise separately. It is logical to argue that Table 1.3.1 which supplies estimates by Bannock (1992) underestimates the contribution of finance available for start ups by not isolating out the element of subsidised finance which is administered via the banks to start ups.

A summarised profile of these two schemes supplies information pertaining to eligibility, interest rates, duration, the guaranteed amount, the processing fee involved, the administering bank or institution and the loan security required. **Table 1.3.4**

The reason why this information bears relevance to the high percentages of German enterprises who have long term loans witnessed in Figure 1.3.1, is that commercial banks extend loans and are joint partners in State guarantees. It follows that if 2 percent of the British State budget is assigned to SMEs in the

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[26] Eigenkapitalhilfeprogramm

[27] Annual Report of the Baden Württemberg Guarantee Bank and Venture Capital Company, 1994

Table 1.3.4 Two German state programmes which assist start ups

	Owner's equity assistance programme	Guarantee bank programme
Description	Eligible persons should be less than 55 years old and possess industrial as well as commercial qualifications. This programme is applicable when the owner's capital base in insufficient. It is imperative that the applicant be able to prove the viability of the project.	Bank loans and credits advanced under the auspices of State programmes must normally be secured. If a viable business proposition fais due to the lack of security, start ups can apply for a State/Regionally secured guarantee administered by a guarantee bank. All sectors including agriculture, fishery and the professions are eligible.
Interest rate and duration	A fixed market rate applies for the first 10 years of the loan after which a new fixed rate is established. Special conditions for start ups: A 2 year interest moratoria after which a 2% rate applies in year 3, a 3% rate in year 4 and a 5% rate in year 5. After this market rates apply.	In the case of loans comprising a mixture of working capital and fixed capital, the loan duration may be a long as 15 years. In the case of building premises, the duration may reach 23 years.
Processing fee	A once off fee of 2% the loan principle	-
Guarantee premium	0.5% p.a	1% p.a
Maximum amount	Approximately £270,000 or 700,000 DM	Approximately £385,000 or 1 million DM
Security	None	80% covered by guarantee
Method of applying	Administered by the Ausgleichsbank via every German bank	Administered by the house bank

Source: Translated from "Wirtschaftliche Förderung in den alten Bundesländern". February, 1995 form of loans, grants and guarantees, that the UK banks are less facilitated than the German banks. The policy of the British government may be to facilitate SMEs through supply side policies as mentioned earlier. This is evidenced in the high proportions of the UK budget allocated to training for and information to SMEs. The point being made here is that the absolute amounts of long term lending being advanced by banks in one country cannot permit inferences to be made as to how long term the view of these banks are. More significantly, these amounts are aggregates comprising the contribution made by both the private and public sector. It is only when the effects of government are detracted from the equation that the true relevance of the figures becomes apparent.

The fact that bank based systems are synonymous with high industrial gearing ratios was introduced above[28]. It is not suprising therefore, that German enterprises had in 1994, on average 82 percent bank debt as a proportion of total capital employed[29]. This proportion rose in the case of smaller enterprises to between 85 and 90 percent in the case of start ups. In one instance, the directors of a guarantee bank in Baden Württemberg indicated in their 1994 Annual Report that some of their clients had less than 10 percent equity. The fact that a German state programme administered by the Lastenausgleichsbank stipulates that every start up have 15 percent owners' equity as a prerequisite to obtaining the remainder in the form of a subsidised guarantee loan perpetuates the high gearing levels found in Germany.

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[28] See Section 1.2

[29] Bundesbank Monthly Report, November 1995.

This long term subsidised loan *Eigenkapitalhilfeprogramm* which literally means "Owners' equity assistance programme", accommodates ad priori low equity levels in start ups. This programme which involves loans of 20 years duration largely for capital acquisition purposes has been summarised separately. [30]

The fact that German economists such as Kaufmann and Kokalj (1989) and (1995) have cast aspersions on the ability of small enterprises with high gearing levels to remain viable through the recession, testifies to their frailty. In the words of the directors of the Stuttgart guarantee bank which are translated as follows:

> "Problems arising out of high gearing levels are onerous interest repayments which accumulate as debt rises, falling profits from turnover and declining margins prove that small enterprises are becoming increasingly vulnerable to crisis. An inadequate capital base in one of the most common causes of insolvency..........An adequate equity base is absolutely essential with regard to future investment, structural changes in our economy and the threat of cyclical downturns".[31]

On the other hand, Irish enterprises exhibit lower gearing ratios. To cite from a report on European gearing levels:

"Considering all sectors aggregates, gearing ratios for Belgian, Irish and French firms of all sizes appear similar, grouped around the 40 percent figure".[32]

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[30] See 1.3.4

[31] Geschäftsberichte der Bürgschaftsbank BW und der Mittelständische Beteiligungsgesellschaft BW, p.46

[32] European Observatory for SMEs. First Report.

Foley and Griffith (1993), in their comparison of inter alia the proportion of owner's equity in Ireland and the United Kingdom with other European countries, concluded that the low gearing ratios in Ireland could be symptomatic of more accommodating lending policies in countries with higher gearing ratios or could be indicative of an adequate equity base in Irish firms.

It is the author's opinion that where low gearing ratios are coupled with poor access to finance, the former scenario which was presented by Foley and Griffith (1993) could be the case. In this instance low gearing would be indicative of risk aversion on the part of banks. This could have implications for loan applicants where credit rationing policies would be pursued by the banks.

The fact that German economists such as Kaufmann and Kokalj (1995) have expressed their reservations about the high levels of gearing in Germany, indicates that high gearing levels may not always be advantageous, particularly in recessionary times.

Have German enterprises gained materially from what is perceived to be more accommodating lending policies by German banks? It is evident that Germany demonstrates an above average rate of start ups compared with its European counterparts. The European Observatory for SMEs (1993) cites a figure of 18.3 percent for start ups in Germany in 1989 as a proportion of existing enterprises. In Ireland this figure which relates only to manufacturing enterprises is 6.9

percent. The figures do permit comparisons to be drawn between Ireland and Germany. However, Germany exhibited higher natality rates for SMEs in 1989 than either Belgium, Denmark, France, Italy, the Netherlands or the UK whose SME natality rate as a proportion of the existing stock of enterprises amounted to 12.3 percent, 14.4 percent, 13.3 percent, 6.6 percent, 14.4 percent, and 5.9 percent respectively.

Perhaps the reunification of Germany in 1989 in responsible for some of this growth in enterprises at a time other European nations were experiencing recession. One could also interpret the low growth in Irish enterprises as being sector related. Start ups in certain services industries such as a guesthouse may require less capital and expertise. Since adequate figures relating to mortality rates are not furnished on Germany and Ireland, it is not possible to establish whether the low natality rate witnessed in Irish manufacturing could have been offset by a correspondingly low mortality rate. During the author's conversations with bankers which will be reported at a later stage, there were repeated accounts by German bankers of unemployed persons seeking to establish themselves in the services sector. Kinsella (1992) referred to this phenomenon of people being motivated by so called "unemployment push" factors rather than "employment pull". Suffice to conclude that figures relating to natality rates must be put in context with general economic conditions before opinions are ventured as to whether banks pursue more generous lending policies.

1.4 A description of Irish and German banks which lend to SMEs

It would be difficult to embark on a comparison of German and Irish banks' lending to smaller enterprises without first describing the raison d' etre of the different types of bank. Ireland has 5 main banks and an ICC bank as well as building societies, all of whom cater for smaller enterprises. The ICC bank in which the Minister for Finance has a 99 percent shareholding, covers 40 percent of its operating costs through its Investment bank wing. The ICC bank administers the £100 million Small Business Expansion Loan Scheme and a £30 million 20 year loan scheme. This bank is most closely allied to German guarantee banks which have the State as a majority shareholder and administer public funds such as that of the European Regional Programme. German guarantee banks also comprise a profit oriented wing which could be compared with the Investment bank wing of the ICC bank with a separate corporate identity. The profit oriented bank filiate subsidises the activities of its interventionist sister filiate.

In Germany, the range of banking type distinguishes itself from Ireland in that there are 3 categories of banks, all of whom have universal bank status and not all of whom serve smaller enterprises equally. In addition to this are the banks with special functions which have a State mandate to serve certain more disadvantaged corporate categories. Such banks are the Lastenausgleichsbank and the Bank für Wiederaufbau and the Regional guarantee banks described above .

In Ireland, the 3 banks with the largest domestic base are largely instrumental in extending advances to smaller enterprises. The largest bank in terms of total market capitalisation serves approximately 40 percent of smaller customers.[33] Its allocation under the Access to Finance Scheme amounted to £79 million which corresponds to 38 percent of the total amount administered. **Table 1.4.1**

The second largest bank in terms of domestic activities, serves the approximately the same number of smaller enterprises.[34] An estimate of 40 percent corresponding to its market share comes close to its allocation of funds under the Access to Finance Scheme. Its tranche which amounted to £89 million corresponds to 43 percent of the total quota. By 31 December, 1996, this bank exhibited the highest usage of the fund in providing subsidised finance to smaller enterprises.

The third large Irish bank in terms of lending to smaller enterprises, is also oriented towards larger, blue chip enterprises.

The smallest of the Irish commercial banks to serve smaller enterprises has a strong focus on this segment which was evidenced by its entering into an exclusive financing arrangement with the members of a small firm representative group.

[33] My own estimates based on the tranche of funds it received under the Access to Finance Scheme, 1995
[34] Estimate of a lending officer with responsibility for Small Business Development at this bank.

In Germany, the main banks such as the Dresdner bank, the Commerzbank and the Deutsche bank focus on larger SMEs.[35] Despite the fact that commercial banks in Germany traditionally have focused on larger SMEs in the same manner as regional savings banks (referred to as Landesbanken) have catered for SME at the higher end of the size and turnover range, there is evidence that this trend is changing. The OECD report (1994) has described this trend as a "diversification of large banks towards small firms". Other economists such as Cooke, Morgan and Price (1995) have witnessed the same phenomenon.

The important point to note is that in Germany, smaller enterprises are served predominantly by the local savings banks and cooperative banks. Edwards and Fischer (1994) articulate this same point as follows:

> "As far as lending to firms is concerned, the local savings banks in a particular region tend to concentrate on making loans to small firms, while the regional giro institutions lend more to medium- and large sized firms"[36].

The regional giro institutions operate as clearing banks at regional level to the autonomous cooperative banks and savings banks. Savings banks belong to their depositors whose interests are protected by the municipality or local area. The independence of the savings banks and cooperative banks is bounded by the interests of their depositors. In the case of the savings banks these depositors comprise members of the local community while in the case of cooperative banks local industry finances the bank by depositing funds.

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[35] According to the German defination of SME this could mean with 250 employees and 100 million DM (£400,000) turnover

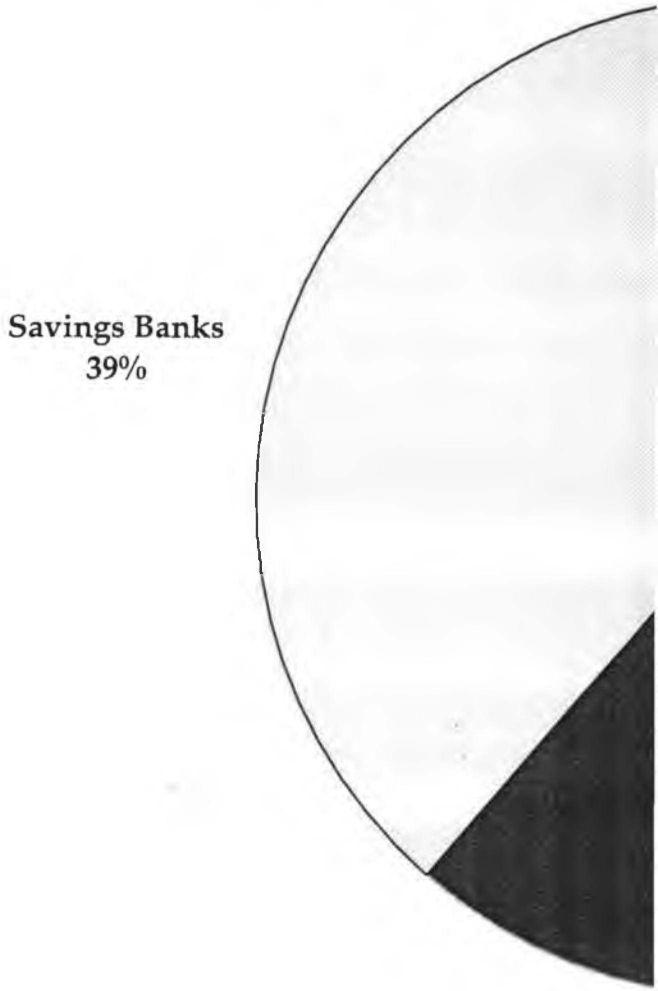
[36] Fischer and Edwards, "Banks, Finance and Investment in Germany", 1994. P.105

The contribution made by the local savings banks and cooperative banks in Germany towards financing smaller enterprises is further evident in the proportion of guaranteed loans administered by these banks. **Figure 1.4.1.**

Rather than rationing credit in the event of a small business applicant who cannot provide sufficient security, German banks have the option of recoursing to a guarantee bank. Since 23 percent of all State assistance to SMEs is in the form of guarantees and loan subsidies (Bannock and Albach, 1991), it follows that the administration of 71 percent of this assistance by a combination of savings banks and cooperative banks underpins their role as lenders to riskier, small businesses. Cognizance must be taken of the fact that all firms in receipt of such guarantees are small firms willing to become established or expand but who constitute credit risks from the banks perspective.

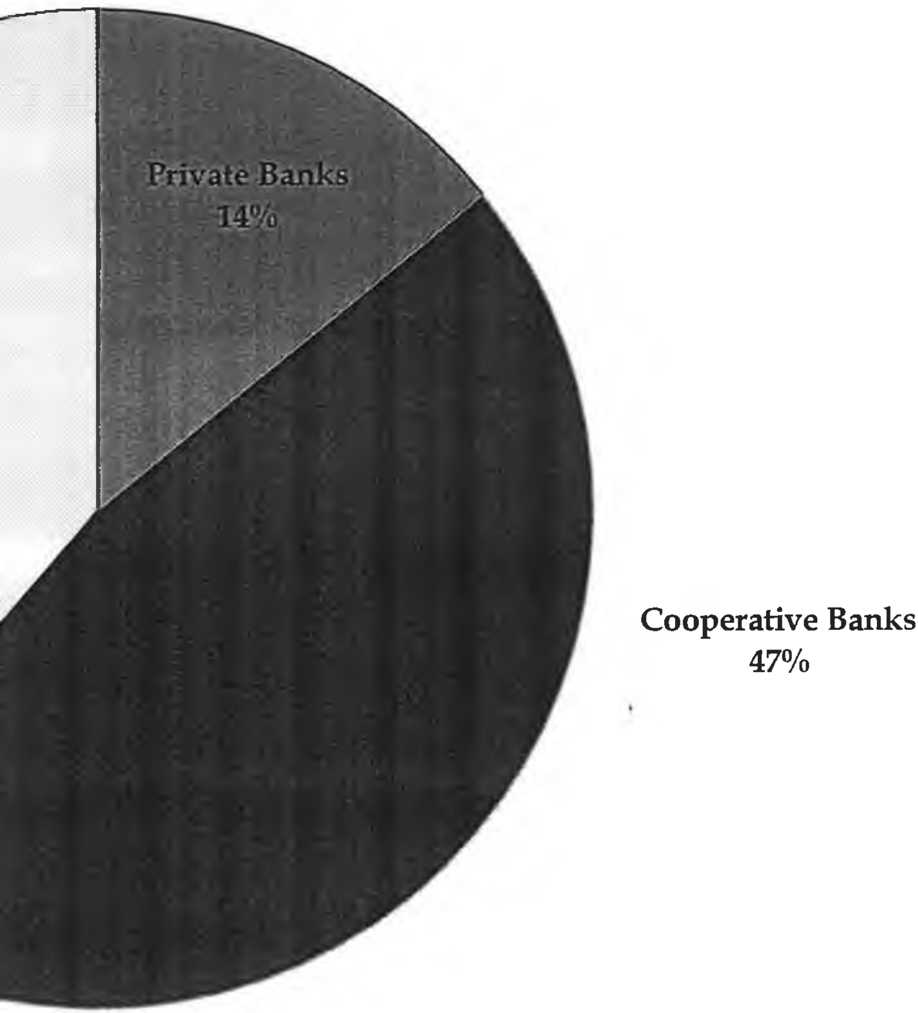
It is interesting, that despite the great variety of banking types in Germany, some of whom have a small enterprise focus, there are more bank branches per head of the population in Ireland. (Spanish Bankers' Federation, 1994) The European average of 3,894 members of population to every bank branch is more at variance with a figure in Germany of 10,790 per branch than the Irish figure of 3,564 per branch. It seems likely that the scale of operations of German banks can permit bank branches to operate as autonomous units since they have on average 3 times the potential customer base of Irish banks.

Figure 1.4.1



Source: Guarantee Bank Baden
Wuerttemburg Annual Report, 1995

Share of German Bank Lending to SMEs



1.5 Conclusion

The most important issue is not to confuse the perceived advantages of German bank lending in general, with lending to small enterprises. Since German banks do not take equity in small enterprises, it follows that if Irish banks are urged to participate in secondary securities, or Development Capital Markets (DCMs), or Unlisted Securities such as those described by Forfas (1996) and Kinsella (1995) and for higher risk smaller enterprises, that there is no established precedent in Germany for this[37]. In the event of Irish banks taking equity in smaller enterprises through such programmes, their participation should not be regarded as a catching up exercise.

Secondly, the perceived advantages of the German banking system with respect to bank representation on supervisory boards applies to a limited number of all German firms and does not apply at all in the case of enterprises with less than 50 employees.

Thirdly, with regard to long term lending to smaller enterprises, it is true that German banks are superior to UK banks in this regard. This is particularly true with reference to the greater amount of relatively riskless overdraft finance as a proportion of total finance extended by UK banks. There is a need for small enterprise specific data relating to Irish overdraft lending as a proportion of all lending.

[37] As of January 1996, banks and insurance have been permitted to participate in a Unlisted Securities Market although it is too early to evaluate the impact of this scheme according to a source at the *Institut fuer Mittelstandsforschung* in Bonn

The evidence suggests that German banks are more long term in their provision of finance to smaller German enterprises than Irish banks. Two facts however, suggest that German banks are also facilitated by the German government in this regard. The first is that a greater proportion of German firms are in receipt of long term loans but also in receipt of subsidised loans than is true of Irish enterprises. The fact that a considerable proportion of the German budget comprising support measures for SMEs in administered in the form of subsidised loans and loan guarantees which facilitate long term lending suggests that German banks are in receipt of comparatively more state support in their lending practices than is the case in the UK where more emphasis is placed on supply side government measures such as training for SMEs and advice. Since Ireland, similar to the UK has a market based rather than bank based system of industrial support measures, there is reason to believe that the situation in the UK with more supply side measures and less government support via banks is reminiscent of Irish situation.

The fact that small businesses in Germany have a tendency to manifest high gearing is a situation not regarded with equanimity by bankers and economists alike as recessionary conditions make the redemption of loans difficult for German SMEs. In this regard the lower gearing ratios exhibited by Irish enterprises are more prudential.

Despite the fact that German banks have indisputably a longer term view which is reflected in the longer loan durations and less emphasis on overdraft lending, the impact of the bank initiated Access to Finance Scheme introduced in 1995 has not yet been registered. There is reason to believe that the statistics comparing Ireland to Germany which relate to 1994 belie progress made by Irish banks in the intervening period between 1994 and 1996.

Chapter 2
The Problem: is there an Irish lending gap?

Introduction

This chapter seeks to address the issue of whether there are areas relating to bank lending in Ireland which are not sufficiently covered by the literature and thence need to be investigated.

Opinions differ as to what sort of a lending gap, if any, prevails in Ireland. Secondly, opinions differ among entrepreneurs themselves as to whether this lending gap presents a problem. For example, it will be shown that empirical evidence demonstrates certain types of small enterprises encounter difficulties in obtaining finance. Such firm specific studies which proceed to ask small businesses if accessing funds constitutes a problem, may discover that a shortage of finance is not first on the list of concerns voiced by such small businesses. In other instances, the difficulty is not judged by small firms to emanate from shortage of bank finance but of other types of funding.

It is imperative to consider the opinions of the entrepreneurs themselves as to how they would prioritise the issue of bank lending with respect to other issues.

There are ambiguities in the Irish literature as to the nature this funding should take. The existence of a funding gap is also either disputed or not qualified as being specifically a bank finance deficiency rather than one of venture capital.

This discussion takes the following format:

2.1 The issue of bank finance

2.2 Credit rationing in certain industrial sectors

2.3 Bank ratings by small firms which experience difficulties

2.4 The changing list of small firm concerns and how they compare with those of German firms.

2.5 Conclusions.

2.1 The issue of bank finance

The Government in 1993 in its response to the Moriarty Report articulated the view that:

> "It is a matter of some controversy as to whether there is indeed an increasing shortage in the supply of longer term finance for industrial projects, particularly for small and medium firms. While some assert that there is a shortage of finance, others claim that the problem is really one of a dearth of investment projects".[1]

One representative of an Irish bank interviewed[2], claimed that venture capital companies had approached the bank seeking clients and had lamented the scarcity of projects which merited investment. This is the reverse side to the argument that credit is being withheld or rationed by banks or financial institutions but of course there are other needs for finance apart from start-up equity.

[1] P.55 Employment Through Enterprise. The Government Response to the Moriarty Report.
[2] The name of the bank is not disclosed for purposes of confidentiality

The view of the Task Force on Small Business (1994) qualifies this further by arguing that there does not appear to be a shortage of finance but rather that the majority of projects being financed are classified as "low risk". This could be borne out in the citation above which specifies "industrial projects" as a category warranting most attention. Yet industrial projects in Ireland are in receipt of more grant aid than any other EU member state. (Task Force on Small Business, 1994)

Deloitte and Touche (1993) indicated a shortage of finance for the purposes of working capital in specific sectors. Their view if a financing gap refers to particular industrial sectors. In a later report (1995), they qualify this financing gap still further:

> "In our view, there are currently no material gaps in the provision of finance, long-term or short to good quality unquoted companies in Ireland; with an adequate track record and which are of such a size as to fall within the ambit of formal venture capital investors".[3]

The inference in the verdict by Deloitte and Touche (1996) as in the conclusion of the Moriarty report cited previously, is that the finance gap, if any, is prompted by a lack of good quality projects since all good quality projects automatically receive funding.

[3] The Scope for Increasing Investment Opportunities for Irish Pension Funds in the Economy of Ireland. July, 1996. P64.

The following section examines the case of loan rejection rates and individual industry specific success rates in obtaining finance to see if the rejections of a finance gap in bank funding by Moriarty and Deloitte and Touche too good quality projects is evidenced in the following reports.

2.2 Credit rationing in certain industrial sectors.

According to a recent report undertaken by Forfas (1995), certain small firms in advanced sectors exhibited a greater tendency than firms engaged in more traditional areas, to judge the lack of appropriate sources of finance as a significant concern. **Table 2.2.1**

In this survey which categorised businesses operating in Ireland according to size and country of origin, it emerged that 50 percent of advanced small businesses claimed to experience a finance gap vis v vis 35 percent of firms engaged in more traditional sectors. The interesting point is that this question does not refer to banks specifically but to sources of finance in general. Without a distinction drawn between venture capital finance and bank debt, a conclusion cannot be made as to the nature of the finance deficiency. The outcome is, in other words, ambiguous. The authors acknowledge however, that this survey predated changes which have been effected in the financial sector in the intervening period:

"It should be noted that the survey data was collected prior to the launch of a number of recent significant Government initiatives in the areas of venture

Table 2.2.1 Lack of appropriate sources of finance

Judged to be significant by 33% of firms				
	Irish		Foreign	
	Small	Large	Small	Large
Traditional	35%	29%	30%	21%
Advanced	50%	14%	27%	15%

Source: Forfas Innovation Survey, 1995

Table 2.2.4 Percentage of advances sanctioned to firms by banks

Small Firms Association 1989 Survey	%
Loan approved	70%
Of remaining, accepted by firm on revised terms	7%
Of remaining, rejected by firm on revised terms	3%
Rejected outright	15%
No final decision	2%
Rejected by firm on revised terms	3%

Source: SFA, 1989

Table 2.2.5 Percentage of advances sanctioned to firms by banks

Bank Internal Survey (1996)	%
Loan approved	69
Of remaining, accepted by firm on revised terms	14
Of remaining, rejected by firm on revised terms	NA
Rejected outright	17[1]
No final decision	NA
Rejected by firm on revised terms	NA

Source: Unpublished internal bank report

[1] Of these 17% declined outright, 89% were subsequently by another lending institution

capital and "soft" loans. It would be expected that the improved access to sources of finance, which these initiatives will provide, should impact on the perceptions of small firms in relation to the availability of finance for innovation projects."[4]

This development is analogous to the results of a survey by Deloitte and Touche (1993) which investigated, inter alia shortages of working capital. According to the results of their survey, 43.7 percent of small enterprises from the engineering and electronics sector sought an increase in working capital facilities compared with 28 percent from the services sector[5]. **Table 2.2.2**

This comparative difficulty in obtaining working capital encountered by the engineering and electronics sector in also evidenced by the fact that 57 percent of the applicants who sought an increase in their working capital facility obtained it in the last two years compared with 77 percent from the services sector. In essence, there were more applicants for an increased working capital provision from the engineering and electronics sector than from the more traditional services sector and also more rejections.

With regard to long term debt, firms from the engineering and electronics sector once again manifest a lower success rate in obtaining long term facilities

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[4] Comments made by Mr. John Travers at presentation hosted by Forfas, Dublin Castle. December, 1995.
[5] For the purposes of comparison with the Forfas survey described above, the engineering and electronics survey corresponds to the "advanced" sector while the services sector serves as an example of a "traditional" sector.

Table 2.2.2 Working capital issues by sector

Category	Number of firms		
	Sought increase in last 2 yrs	Obtained increase in last 2 years	Have difficulty operating within WC limits
Food and Drink	27.1	79	58.8
Electronics and Engineering	43.7	57	64.3
Chemicals and Pharmaceuticals	29.3	70	58.8
Textiles and Clothing	52.6	65	70
Paper and Packaging	25	75	37.5
Services and Distribution	28	77	55.5

Source: Deloitte and Touche, 1992

Table 2.2.3 Long term finance issues by sector

Category	Sought LT facilities	Obtained LT facilities
Food and Drink	29	76.1
Engineering and Electronics	34.2	60
Chemicals and Pharmaceuticals	28	57.1
Textiles and Clothing	33	44.4
Paper and Packaging	56.3	77.8
Services and Distribution	63.6	71.4

Source: Deloitte and Touche, 1992

than firms from either the services sector or food and drink sector. **Table 2.2.3** Both these latter sectors are reminiscent of more traditional industrial activities defined by Forfas (1995).

The consensus among three of the four Irish banks who ventured an opinion as to why the engineering and electronics sector exhibited higher than average rejection rates, was that according to their own lending experience there was not above average withholding of loans to applicants from the engineering and electronics sector.

The fourth bank representative suggested that according to his experience small firms in the electronics and engineering sector are overly reliant on large distributors who exert pressure on their operating profits. This in turn induces working capital difficulties.

The anecdotal explanations offered by bankers cannot be deemed as conclusive evidence which can be used to demonstrate that credit rationing does not take place. It is useful to refer to a survey carried out by the SFA (1989) and internal bank statistics cited by one bank representative.

Table 2.2.4 and Table 2.2.5

These two surveys both deliver information which relates to the average decline rate encountered by firms. According to the SFA Report 70 percent are sanctioned on application while the bankers' report puts this figure at 69 percent. The bankers' report cites a percentage of a further 14 percent being sanctioned on different terms[6] following a revision of the application while the SFA puts this percentage at 10 percent. A more recent survey which is cited in information released by IBIS (1995) cited a success rate of 70 percent among firms requesting new banking facilities.[7]

The two above mentioned reports which supply information pertaining to the rejection rates encountered by Irish firms can be related to a survey by Deloitte and Touche (1993) mentioned earlier. According to the survey by Deloitte and Touche the engineering and electronics sector exhibits a success rate of 57 percent for working capital loan applications and 60 percent for long term loan facilities. This does not compare not very favourably with an average acceptance rate of between 83 percent and 77 percent[8].

Does the fact that more advanced sectors experience a greater likelihood to have expansion plans thwarted by a lack of "appropriate finance" imply that there is a deficiency of bank debt on favourable terms? The authors of the report by Deloitte and Touche (1993) believe that there is a deficiency:

They proceed to voice their concerns as follows:

"The difficulties experienced by some firms with working capital and high banking costs is evidence of a need for some form of intervention by the

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[6] Presumably less favourable from the firms' perspective

[7] Market Research Bureau of Ireland; survey for the main retail banks, 1995

[8] The estimate of 77% which relates to the overall sanction rate of loans by banks according to the SFA report (1989) takes into account that of the 10% accepted after further negotiation with the bank, the firm only agrees to proceed with the new modified loan proposal in 7% of the cases.

State to enable these companies which are lacking in track record and security, but which nevertheless are viable profitable growth oriented operations, to access medium term debt finance at a reasonable cost[9]".

The less desirable companies from a banking and perhaps even venture capital perspective[10] warrant assistance. This report exonerates the banks and venture capital institutions for the deficiency by making it clear that it is incumbent on public policy makers and not the private sector to address this issue through suitable intervention.

As a corollary to the fact that an industrial sector such as engineering and electronics encounters a higher than average bank rejection rate, it is not suprising that a relatively higher proportion of equity finance in the engineering and electronics sector would be earmarked for refinancing purposes.

"The Engineering and Electronics sector indicated an above average equity requirement for refinancing purposes"[11].

This would infer that stretched working capital facilities could be financed by for example overuse of an overdraft. Could this be symptomatic of overtrading by some of the firms from this industrial category? It is interesting to note that the partially Government/ bank funded Access to Finance Scheme would therefore fail to address the issue of an debt financing gap in this sector since

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[9] P.8, Deloitte and Touche. Review of Irish SMEs. 1994

[10] The 1995 report by the same authors cited in 2.1, denies that there is a financing gap for firms with a track record either in the area of bank capital as well as venture capital.

[11] Deloitte and Touche, 1993. P. 35

one of the eligibility criteria stipulates that the loan not be used for the purposes of refinancing.

There is inadequate evidence to support the view that credit rationing or poor loan terms are adversely affecting those firms which exhibit high rejection rates. The reason for coming to this conclusion is presented in the following section. It can be demonstrated that rapidly expanding small firms in both studies by Carpenter (1993) and Kinsella (1992) which are most in need of funding to financing their expansion, rate their banks better than stable firms which do not exhibit such growth rates. Irish bankers interviewed by the author believed that the statistics presented in the Deloitte and Touche (1994) survey represented an anomaly. They denied that the expanding engineering and electronics sector exhibited higher loan rejection rates than a comparatively "safe" activity such as the food sector. In other words, higher rejection rates as a result of risk aversion on the part of bankers in high technology growth sectors did not accord with the experience of bankers.

It is to be expected that Irish bankers reject the inference made by the evidence of the Deloitte and Touche (1994) survey that a new, growing sector demonstrated a higher rejection rate on loan applications.

Banks could not supply a breakdown on the numbers of applicants from each industrial activity along with the corresponding rejection rate. In the absence of such information it is not possible to conclude that some sectors are more liable to be financed by banks. It is useful, however, to refer to the two firm specific studies mentioned above by Carpenter (1993) and Kinsella (1992) which investigate the attitude different categories of small business have towards their banks. The rationale behind including these two firm specific studies in the area of credit rationing is as follows. Irish bankers described the engineering and electronics sector as a growth sector. If it is a growth sector, it is in need of more finance to fund its expansion than firms from a stable, "safe" sector. It follows that if fast growth firms demonstrate a positive attitude towards their banks, it is unlikely that they have experienced above average rejection rates by banks on loan applications.

2.3 Bank ratings by firms which experience difficulties

It is interesting to compare ratings of the performance of Irish banks by small firms from diverse sectors. In order to do so, this discussion draws on surveys by Kinsella (1992) and Carpenter (1993)

Table 2.3.1

According to Kinsella, fast growth firms found their banks to be marginally more helpful than their match counterparts. On an average scale of helpfulness, banks were assigned a value of 3.5 for the former compared with a value of 3 for the latter.

Table 2.3.1 How small growing firms rate their banks.

		Fast Growth
Kinsella, 1992	Scale of helpfulness	3.5
Carpenter, 1993	I have a close relationship with my bank	[redacted]
	My bank manager does a good job	[redacted]

Sources: **Kinsella, 1992; Carpenter, 1993.**

Scales:

Kinsella:

1- *not helpful* 5- *very helpful*

Carpenter

1-*strongly disagree* 5- *strongly agree*

Match	Mean of companies who had employed more people in the last 12 months	Mean of companies who had not employed more people in the last 12 months
3.0		
	3.74	3.11
	3.82	3.15

In a survey of SMEs by Carpenter (1993) small firms were categorised into different classifications depending on several different indicators. These indicators comprised projected employment growth, historical employment growth or the selection of the company onto the Business Development Scheme under the auspices of the IDA., Carpenter (1993) sought to examine inter alia the issue of a financing gap.

In Carpenter's study, a higher proportion of firms who anticipated employing more workers in the following year, perceived finance to be a major obstacle to growth. This would correlate with the findings of the Forfas report and the outcome of the Deloitte and Touche report described above[12].

Carpenter however, did not sectorise according to the area of industrial activity but divided her sample along the parameters of those who proposed to increase their workforce within the next 12 months and those who had not envisaged such changes. She had decided on using this criteria following the discovery that by distinguishing between firms participating in the IDA's Business Development Programme and match firms from the Kompass Directory, one could not obtain significant differences in responses to the question,"What do you consider the most significant constraint to expansion"? However, the interesting point is that when the sample was divided between those firms intending to expand employment numbers in the coming year and those not, 53

[12] See Section 2.2

percent of the former perceived the shortage of finance to present difficulties in comparison to 47 percent of the latter.

An interesting point to emerge from Carpenter's survey and which bears relevance to this discussion as to how firms rate the performance of their banks, was that firms who anticipated increasing their employment levels within the next 12 months were more enthusiastic about their banks than other firms. This is despite that fact that these firms anticipated difficulties ahead in obtaining finance. This is suprising, since one would imagine that firms who anticipated difficulties ahead in obtaining finance would find their banks culpable or rate them more negatively than others. However, this phenomenon was not evidenced in Carpenter's survey.

"In this study, no significant differences were found between small businesses who had hired more employees in the last year and those who had not, in so far as they perceived individual aspects of the service they received from their bank. They still, however, tended to score more positively statements which gave approval to their bank's overall performance"[13].

It has been seen above in the survey by Deloitte and Touche (1993), that the engineering and electronics sector exhibited higher rejection rates for their loan applications than firms from the food and drink or services and distribution sectors[14].

[13] P. 59, Foley and Griffith, 1993

[14] See Tables 2.2.2 and 2.2.3

It would be expected, therefore, that such firms encountering above average rejection rates on their loan applications would be sufficiently piqued to mention access to finance as a salient concern. On the contrary, firms from the engineering and electronics sector displayed less concern with the access to working capital than firms from the services and distribution or food and drink sector. **Table 2.3.2**

Engineering and electronics assigned the concern a value of 4.7 compared with a value of 5.0 assigned this concern by the services and distribution category. Firms from the food and drink category gave even more precedence to this concern by denoting it by a value of 5.2. This tendency repeats itself with respect to the issue of long term lending. As seen previously, SMEs from the engineering and electronics sector demonstrated a lower success rate in obtaining a long term loan than firms in the food and drink or services and distribution sector[15].

It would therefore be expected that firms in this advanced sector would designate the access to long term lending as a more significant concern than either of the other two industrial categories. This is not the case. Firms from the engineering and electronics sector denoted this concern with a value of 4.5. This corresponds to their least significant concern. Both services and distribution

[15] See Table 2.3.3

Table 2.3.2 Concerns Irish SMEs have with their banks

Please rank the greatest difficulties you currently have with your banking arrangements								
	banks know business	margins	interest rates too high	lack of WC facilities	lack of flexible WC	bank charges & costs	lack of LT loan	guarantee
Food & Drink	4.4	6.9	7.3	5.2	5.5	6.4	4.8	5.4
Electronics & Engineering	4.9	6.6	7.3	4.7	4.7	6.0	4.5	4.8
Chemicals & Pharmaceuticals	4.0	6.6	6.9	4.9	5.0	6.3	4.2	5.7
Textiles & Clothing	6.0	7.7	8.1	5.7	6.2	7.2	5.9	6.8
Printing & Packaging	4.5	7.2	7.2	4.3	3.8	6.6	3.9	5.4
Services & Distribution	3.6	7.3	5.8	5.0	4.3	7.4	4.7	3.0

Source: Deloitte and Touche, 1993

and food and drink assigned this concern marginally more importance by assigning it values of 4.8 and 4.8 respectively.

2.4 The changing list of small firm concerns and how they compare with those of German firms

Another related issue which should be mentioned concerns the prioritisation of concerns firms encounter have with their bank. It is evident that the issue of bank security has ceased to be an important a concern as formerly has been the case.

This trend can be observed by taking two studies which investigated the securitisation of loans inter alia. According to the SFA report (1989) which is cited in Foley and Griffith (1993), the amount of collateral which firms had to submit as security qualified as being the second most urgent concern behind that of bank fees and service charges. **Table 2.4.1**

The taking of security was categorised by 22 percent of all firms in the 1989 report as being most important. 34 percent of respondents elected the issue of fees and service charges as being most deserving of attention. In other words, the taking of security is designated as being overall the second most significant concern. Interest rates occupy third place, being voted by 18 percent of the respondents as being most urgently in need of review.

Table 2.4.1 Most important concerns with the banks

Small business study		Bank margins too high	High interest rates	Bank charges/costs	Guarantees
Small Firms' Association, 1989		NA	18% of respondants rank 3	34% of respondants rank 1	22% of respondants rank 2
Deloitte and Touche, 1993	Less than 10 employees	7.7 weighting rank 1	7.4 weighting rank 2	6.5 weighting rank 4	6.8 weighting rank 3
	Between 10 and 50 employees	7.1 weighting rank 2	7.5 weighting rank 1	7.0 weighting rank 3	5.9 weighting rank 4

Comparing the SFA (1989) survey with that conducted by Deloitte and Touche (1993) 4 years later, the order of priorities most in need of attention have changed. **Table 2.4.1** In this instance, the issue of guarantees has been relegated to third place behind that of bank margins and interest rates. In the case of firms with between 11 and 50 employees, the issue of guarantees is demoted even further to fourth place by being placed behind that of bank charges. Deloitte and Touche (1993) disaggregate firms with less than 50 employees into those with less than 10 and those with less than 50 employees. The issue of bank margins is voted as the most important concern with a value of 7.7 by the smaller subgroup and as the second most important concern with a value of 7.1 by the larger subgroup. Similarly, there is no consensus among the subgroups as to the significance of interest rates as a concern. Although the smaller subgroup assigns interest rates a value of 7.4, their larger counterparts prioritise them as being a less important concern than bank margins by assigning them a value of 7.5. The concerns of the "11-50 employees" subgroup and those of the "less than 10 employees" subgroup do not always display unanimity as can be seen from the responses. There is no ambiguity however about the diminishing in the importance of collateral as a concern over the 4 year period since the SFA (1989) report and the survey by Deloitte and Touche in 1993.

For the purposes of comparison with small businesses in Germany, the concerns of German small enterprises as investigated by Clements and Burns (1992) are tabulated alongside those of their Irish counterparts. Unfortunately, the Irish and German surveys do not in every case use the same question format. It follows that the responses of the small businesses in Germany are not synchronised with those of the Irish survey. **Table 2.4.2**

The interesting observation to be made here is that the top two concerns with Irish small businesses, that of interest rates being high and the high cost of banking are either of little relevance in the case of the former or of diminished relevance in the case of the latter with respect to the area of lending to small businesses.

The claim about interest rates being too high is a macroeconomic issue or exogenous variable which is beyond the remit of the Irish banks. To cite from the IBIS Fact File (1995);

> "In the final analysis, the interest rates bank must pay to attract funds from both the wholesale market and retail customers are determined by forces outside their control - principally the interaction of supply and demand in the money markets".

The issue of high charges, as will be shown in the following chapter, has waned as a concern. A recent SFA Report (1995) conceded that a basket of banking services cost on average 25 percent less in the Republic of Ireland than in Northern Ireland and 137 percent less than in the UK.

This leaves the issue of government intervention in the form of guarantees and high bank margins as the remaining most important issues. There is evidence

Table 2.4.2 Criteria German bankers use to access loan applications according to small businesses

Indicator	Ranking in order of importance	
	Average	Owner managed
Value of the overall assets	1	1
Long term health of business	2	4
Interest cover	3	3
Personal guarantees	4	2
Charges on personal assets	5	5

Source: Clements, 1992

Table 2.4.3 Bank satisfaction ratings of Irish and German SMEs

	Irish SMEs	German SMEs
Relationship with bank	**All:** 59.4% very good **Less than 10 employees:** 54% very good	**All:** 90% excellent or good *of which* 29% excellent **Owner managed:** 92% excellent or good *of which* 38% excellent

Source: Irish Statistics from Deloitte and Touche (1993)
German Statistics from Clements (1992)

from interviews with the Irish banks that credit assessment has undergone changes which will allow the pricing of loans to be more contingent on objective criteria. This area of pricing will become in the future more obscure as loans will be tailored according to individual circumstances. As Mr. Thomas Mulcahy of the AIB stated in 1995:

"Ourselves and other banks have put a lot of investment into credit grading systems. We are beginning to get better quality grading"[16].

A positive result of this policy change on the part of Irish banks could be a greater percentage of more riskier loans constituting marginal cases being accorded better lending terms. If this were the case, the high ranking value assigned to this concern could be reduced. The reverse side to this argument would be that banks will perhaps not continue to defray the risk in lending to small businesses via a higher margin but rather that overall lending terms including a heightened demand for business assets as securities would deteriorate.

Kinsella (1992) suspected that the new credit grading systems would lead to more cautious lending on the part of the banks which in view of the more liberal lending policies of the early eighties;

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[16] Financial Times, 23 February, 1995

"The new effect is that banks, operating new credit assessment systems and with refocussed priorities are almost certainly more cautious in their approach to lending"[17].

Collateral does not feature highly as a concern either in Ireland or Germany according to small business owners. (Clements and Burns, 1992) (Deloitte and Touche, 1993) **Table 2.4.1 and Table 2.4.2**

In Ireland, as has been already witnessed, it ranks behind interest rates and charges whilst German entrepreneurs when asked which issues rank highest with bankers when extending a loan, personal guarantees and charges secured against personal assets come in fourth and fifth place respectively. However, Clements, in the same survey of small businesses in Germany does indicate that collateral ranked in second place for owner managed companies. This would suggest that smaller businesses in Germany are subject to more onerous collateral terms than their larger counterparts.

The survey by Clements asked firms to prioritise the criteria looked for by a German bank in assessing a loan application. Therefore, it can only be used as a proxy for a list of small business concerns. Clement's survey of small businesses in Germany, unlike the survey by Deloitte and Touche does not investigate the concerns of small businesses. It does demonstrate, however that owner

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[17] Kinsella, 1992. The medium term development of indigenous industry: the role of the financial sector. P. 18

managed businesses in Germany perceive the supplying of guarantees to be a more necessary prerequisite to having a loan sanctioned by the bank than other forms of business. Banks are therefore more cautious in lending to owner managed businesses in Germany since the procedure used is more transactions based than cash flow based.

How do the satisfaction ratings of Irish firms compare with the experience of German SMEs? Unfortunately, as in the case of many attitudinal surveys, the parameters used are not the same and caution must be exercised in interpreting such qualitative data. The responses of the Irish and German firms can be depicted in the following table. **Table 2.4.3**

It is difficult to make meaningful comparisons between the perceptions of Irish and German banks by small businesses in their respective countries. This is because "excellent", "very good" and "good" are subjective judgements. Also it is not possible to conclude that if a majority of firms in Germany describe the relationship they have with their bank as "good" or "excellent" that this is a more positive response than a smaller majority of Irish banks categorising their banking relationship as "very good". The comparability problem lies in the different adjectival indicators used in each study to describe the relationship between the small business and it's bank.

It follows that one cannot infer from the fact that if 90 percent of all SMEs regard their relationship as "excellent" or "good" that this is more enthusiastic than 54.4 percent of Irish firms judging their banks to be "very good". The frequency of the "good" responses registered by German firms in the study by Clements and Burns (1992) could outweigh the "excellent" responses. The net effect would be to bring the evaluation of German small businesses of their banking relationship closer to that of the Irish small businesses. Qualitative information such as this should serve as an indicator only. (Taylor and Bogdan, 1984)

What is interesting is that owner managed firms are more euphoric about their banks than non - owner managed firms which perhaps reflects aspects of the unique house bank relations prevailing in Germany which extends also to micro enterprises.

2.5 Conclusions

The most interesting conclusion is that the fast growth firms which are reputed to have most difficulty in accessing funds for expansion purposes are not shown in attitudinal surveys to perceive this shortage as emanating from the banking system. This phenomenon is evidenced in their above average ratings of their bank's performance.

Despite the fact that credit rationing appeared to prevail in a situation involving firms from the electronics and engineering sector, this did not register as a salient concern with the firms.

This evidence leads the author to believe that bank rationing is not prevalent and where it is exercised, the firms' affected deny it is a problem because they have or anticipate alternative sources of finance.

The other major inference which can be made on the basis of the evidence presented in this chapter, is that some concerns such as the securitisation of loans have cased to prompt the same anxiety among smaller enterprises. The precedence given this concern has changed and now bank margins remain the priority. This change in small firm priorities is evidenced in the SBA (1995) report whereby high bank charges are perceived as the saliant concern.[18]

It is true that small businesses pose present higher risks for banks. As Deloitte and Touche express the issue:

> "From a bank lending perspective, lending to SME's is fraught with difficulty... While banks in the past may have inadvertently lent money on a basis which left it carrying, effectively, an equity risk, it is clearly not a bank's function, in its capacity as a lender, to act as an equity risk taker in a project"[19].

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[18] This is in spite of the fact that bank charges in Ireland are on average lower than charges incurred by firms in the UK on a similiar basket of services. SBA (1995)

[19] P. 110, Deloitte and Touche, 1992. Review of Irish SMEs.

The solution therefore would be in some form of government intervention which would facilitate the banks in their task of lending to the small business sector, perhaps in the form of guarantees.

This solution is proposed by the President of the Institute of Chartered Accountants in Ireland (ICAI) on the presentation of their 1995 survey of small firms:

> "We recommend that some of the funds currently allocated by Government to capital grants would be better employed in providing some form of low interest subsidies coupled with partial guarantees for long term borrowings"[20].

It must be nevertheless acknowledged that banks have a role to play in matching medium term loan applications with medium term loans. In other words banks should be lending on terms conmeasurate with the time period and business risks rather than trying to revolve claims to the corporate sector in as short a time period as possible. The introduction of new credit grading systems might facilitate this development.

[20] Comments made by Mr. Joe Gannon on the presentation of a survey by the Institute of Chartered Accountants in Ireland entitled "Encouraging and supporting small business start ups". 09. March, 1995

Chapter 3
Gaps in the existing research

3.0 Introduction

In the previous chapter much information which relates to the funding by banks of small businesses in Ireland and Germany was presented. Why is there a need to examine this already well documented issue? There are a number of reasons.

Since the release of the Government Task Force on Small Business (1994), there has been no appraisal of Irish bank lending to small enterprises in an international context. No cognisance has yet been taken of recent developments such committments by the banks to refrain from taking a charge on an entrepreneur's residence as security on a loan. Discussions with German and Irish bankers will seek to address this knowledge gap.

Comparing two bank systems is hazardous in the case of Ireland vis a vis Germany due to the fact that most literature on this subject deals with German bank lending from a British perspective or vice versa. Ireland, being a relatively smaller player in a European context, has not prompted any external research to date in the manner in which the higher profile British equity based banking system has been the subject of research.

These deficiencies in the literature will be addressed under the following headings;

3.1 The secondary literature and its relevance to current bank lending practices

3.2 The need for a bank based survey.

3.3 Lack of comparisons in the literature between peripheral and larger banking systems.

3.4 Conclusions

3.1 <u>The secondary literature and its relevance to current bank lending practices</u>

As already mentioned in the preamble to this discussion, there is a time factor which must be taken into consideration when using information sources relating to a previous time period.

The traditional view of German banks being accommodating towards small firms has also been subject to review in the literature. This reappraisal of the "widely held view" as to German banks being better lenders is contained in a textbook type analysis of the German banks system undertaken by Klaus Fischer and Jeremy Edwards, 1992 of Cambridge University. They examined the close ties between industry and banks in order to ascertain if there were any substance in the belief that these ties made it possible for banks to place more trust in their small firm clients and thence enable long term lending. Clements and Burns (1992) in a critique of the above survey, expressed the following opinion:

"Recent research by Jeremy Edwards and Klaus Fischer challenges the conventional wisdom that German banks are more generous in their lending, more loyal and more involved with their business customers than UK banks, and suggests that the partnership is more loosely defined than is commonly supposed"[1].

Clements and Burns (1992) proceeded to establish how much formal contact German firms have with their banks. He revealed that 92 percent of owner managed firms in Germany did not regularly send a copy of their annual accounts to the bank. If one assumes that the owner managed firms corresponds to the smaller firms, this could be indicative of the informal relations between banks and firms borne out in Fischer.

Kinsella in his report to the Industrial Policy Review Group(1992) came to the same conclusion regarding the banks' distance from industry.

"...One major deficiency, which has been identified in other countries, is the lack of contact in the form of visits by senior branch executives to small, as compared with larger companies"[2].

There are two arguements one could use to challenge this notion that banks in Germany more are divorced from industry than thitherfore thought. The author's premise for making both of these points is from recent evidence collected in 1996.

[1] Clements and Burns, 1992. The relationship between German SMEs and their banks. P.4
[2] Kinsella, 1992. The medium term development of indigenous industry: the role of the financial sector. P.29

The first concerns the issue of guarantees. Small firms lacking collateral in the form of tangible assets who had been earmarked by their house bank for a guaranteed loan had to submit a comprehensive business plan. A representative of one of Germany's 4 main banks in Frankfurt complained about the amount of paperwork involved in assessing a loan of this nature. He maintained that this was the reason he solicited the assistance of the Institut für Wiederaufbau (a state development bank) rather than the Regional Guarantee Bank. All banks mentioned cash flow statements as being a prerequisite to giving a loan.

Perhaps Clements (1992) is correct in saying that contact is informal, in the case of ordinary, as opposed to government subsidised lending. However, all banks affirmed their role as universal banks. They alluded to the fact that all firms in a house bank relationship had personal and corporate deposit and current accounts with its respective bank. Lending bankers had licence to monitor these accounts and be aware of cash flow difficulties long before the firm defaulted on its loan.

Both Fischer (1994) and Clements (1992) testified to German banks facilitating their small firm clients when faced with a shortage in working capital. Respondents interviewed by the author 1996 were careful to distinguish between what constituted a short term crisis, i.e. one caused by a cyclical downturn in general economic activity and an industry specific crisis, i.e. a permanent and ongoing crisis encountered by an industrial branch. In the case of the former crisis, the bank would not hesitate to ease its clients financial distress whilst in the case of the latter (one banker cited the case of the local textile industry), a banker would be more reluctant to help.

The point being argued is that Clements has accused the German banking system of being uncompetitive, yet this very uncompetitive house bank relationship had enabled German banks to extend long term finance.
(Kaufmann and Kokaij, 1995) (OECD, 1995c, S107)

There is an element of inconsistency in Clement's arguments which, on the one hand condemns the monopoly of the German banks, whilst on the other hand revealing that German banks were accommodating in their lending behaviour, at least in the short run.

Currently, there is more competition witnessed among German banks at the point of writing than at the beginning of the decade. Although German banks demurred to answer a question relating to their margins, there is reason to suspect that savings banks and co-operatives are experiencing incursions made into their traditional small firm sector clientele by the 4 main banks. (Edwards and Fischer, 1994) This practice of "cherry picking" of their more profitable clients must have as a consequence a decline in savings bank margins. Analogously, the very fact that the 4 main banks are turning their attentions to the partnerships' sector, points to their declining turnover market share. The recession therefore, which was alluded to by many of the author's respondents, has not featured in either the study by Clements (1992) or Edwards and Fischer (1994) since both these predate the economic downturn in Germany with consequences for bank competition.

A more obvious example of events superseding the literature is in the case of Kinsella (1992). This interesting report anticipates the appraisal of loans on a case by case basis. This individual tailoring of interest rates by banks would be more commensurate with the risk exposure of the banks towards small businesses than the all - encompassing AA rate. This result is borne out in an analysis of deregulation on bank lending to riskier borrower categories. (T.P Quinn, 1992) According to Kinsella, (1992);

> "A more flexible approach to the pricing of risk would be to the benefit of both the company and the bank. This will require a change of culture centrally within banks and, also, an increased capacity at branch level to undertake the responsibility for this"[3].

Even writing in 1992, he has anticipated the evolution in credit grading systems expressed by Mr. Thomas Mulcahy of the AIB 3 years later.[4]

Kinsella anticipates change in the same report[5], where he emphasises the identification of fast growth firms as a precursor to targeting these for

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[3] Kinsella, 1992. The medium term development of indigenous industry: the role of the financial sector. P.31

[4] See 2.4

[5] The Medium Term Development of Indigenous Industry: The Role of the Financial Sector, 1992 P. 27

government assistance. This concept of using arbitrary indicators to define fast growth is inherent in the Section 84 loans which target industry, tourism and internationally traded services.

Section 84 lending was deemed necessary and useful in 1994 by a panel of entrepreneurs whilst at the same time the government was urged to expand the industrial categories eligible for support to include more categories from the service sector. (Government Task Force Report, 1994)

This move towards employment related indicators in assessing loan applications is anticipated in the Carpenter analysis presented in the last chapter. which indicates that it was more logical to segregate firms into classifications comprising those firms who had or had not employed more people in the last 12 months[6]. This method of distinguishing growth firms on the basis of employment indicators may be difficult to apply in an ad priori situation. Nevertheless it served as a better predictor of growth than a division of firms according to their participation in the standard Business Development Programme[7] vis a vis those not part of the scheme. This suggests that when one uses arbitrary methods of distinguishing fast growth firms, it may exclude other potentially good albeit "match" firms.

[6] See 2.1

[7] Selected by IDA

It is interesting to refer to the Task Force Report on Small Business (1994) as a final note when looking at the relevance of past studies relating to bank lending. The group had urged, while it was still in session for long term fixed interest loans. In response to their request, the ICC Bank placed £100 million in 1994 at the disposal of small businesses seeking long term loans at fixed interest rates. This was to become the Small Business Expansion Loan Scheme. The requirement for taking a charge on collateral was not waived. Different commercial banks received a tranche of this scheme and it has since been allocated. Since this scheme has been allocated, the banks themselves, under their own initiative, under pressure from the Government, introduced the Access to Finance Scheme[8]. Under this scheme, no charge was taken on the family home and there had been a reduction in the emphasis placed on security. Have both these schemes ameliorated the problem of a lending gap or have they been introduced as a temporary measure to appease pressure groups? In other words, is the introduction of these schemes an example of events overtaking the literature and has the crisis of a lending gap been permanently defused?

Evidence from the various interviews conducted with the main Irish banks suggests that these schemes have proven themselves popular. There is reason to believe that those who could have afforded finance albeit at higher interest rates or on more unfavourable terms, merely deferred applying for loans until the

[8] See 1.3

launch of these new measures. In other words, there has been a considerable displacement effect. The Irish banks do not reject the notion that the Access to Finance Scheme was to reward small firms who were already prospering. The banks can be commended for taking this initiative but from an industrial viewpoint, if one is looking at making finance more available for "deserving causes" these schemes may have to be supplemented or extended. It would also be interesting to establish what proportion of all lending to small businesses is accounted for by these schemes.

There was a need to ascertain if German banks also employed similar schemes. In order to establish if there were similar schemes on operation it was imperative to question German bankers personally in order to put the Irish schemes in a German context.

There is no current information apart from a not small firm specific German survey by Drukarcyk (1985) which deals adequately with the ratio of collateral used to secure a loan as a percentage of the loan. Drukarcyk's survey cannot be applied to the case of lending to smaller enterprises since his sample is weighted towards larger German firms. Its use is very limited due to this inherent bias. Due to the fact that the survey by Drukarcyk could not be extrapolated to small firms, as opposed to a biased sample representing all firms in Germany, it was necessary to compensate for this deficiency by undertaking interviews with German banks. These interviews would be supplemented by reference to the rules governing the evaluation of collateral in Germany contained in the *Kreditwesensgesetz*[9].

The SFA survey of 1989, was deemed more meaningful than that of Drukarcyk in that it examines specifically the ratios of collateral to loans of smaller enterprises. It could therefore be retained. The optimal situation however in any comparative research is a parallel approach and with this in view, the SFA survey relating to collateral needed to be supplemented by primary research.

The Government Task Force Report (1994) discussed above, suggested that the Business Expansion Loan Scheme which had been introduced at their suggestion, should have less onerous collateral requirements. They stated that most collateral is in the form of fixed, tangible assets. Their proposal was to alleviate the strain imposed on a young, firm with little to offer a bank as security but its book debts. In other words a charge should be taken by the bank of the book debtors of a company by repealing provision 115 of the 1994 Finance Act which gives precedence to the Revenue Commissioners to liquidate the assets of the company. This provision precludes the banks from using book debt as a security measure.

In view of the fact that banks have been ardently criticised by small firm representative bodies for their supposed unwillingness to have Section 115

[9] Literally means "Leglislation for financial institutions".

repealed. Invoice discounting was considered prohibitively expensive from the firms' perspective. On the other hand, it was alleged to be a very lucrative business from the banks' point of view. Mr. Eoghan Hynes of the ISME challenged the banks for;

"having devised a more lucrative buying and less risky approach to funding industry, have now a vested interest in the maïntainance of the Revenue's preferential status"[10].

In order to establish whether the German banks who are not precluded from taking a charge on company book debts have frequent recourse to this measure, it was decided to broach the issues in interviews conducted by the author. This is another example of a deficiency lack being remedied through primary research.

The final area which has not yet been examined in a comprehensive way by the literature is the extent of risk shouldered by the Irish banks in their Enterprise Development Units. The first of these "incubators" for promoting fragile yet potentially viable small firms was introduced by the bank of Ireland in 1994.

Preliminary interviews with the Irish banks suggest that these could represent an Irish version of a German house bank relationship. The basis for referring to the Units as such is the tacit understanding between the bank and the small

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[10] Comments made by ISME chairman Mr. Eoghan Hynes which were cited in Business and Finance. 17 November, 1994.

business that this is a long term relationship. There is evidence to support the view that a bank can only recoup its investment in this firm after a considerable number of years when the firm becomes profitable. (Hellwig, 1991)

There is a lack of information as to whether German banks which have reputably always maintained these house bank relations offer their small businesses lending terms equivalent to the Irish banks' Enterprise Development Units. As revealed in the Methodology, establishing what is meant by "better lending terms" can be difficult. Nevertheless, disguised statistics relating to inter alia the losses incurred by such a lending Unit were presented to German banks. It was therefore possible to relate the Irish banks' Units to the German main bank relationship under several parameters such as advice, risk and collateral.

It is useful to recapitulate that the banking system has progressed since previous studies were written. This time lag has led to information gaps arising in the following areas:

a. Change in small businesses' main priorities of concerns

b. Effects the upturn in economic activity has had on the relationship between small businesses and their banks

c. The extent of risk shouldered by Irish banks in their Units

d. Policy changes of the Irish banks induced by pressure from Government and SME representatives.

The first two points enumerated above will most likely be addressed in the future by a study examining the responses of Irish small businesses. In the opinion of the author, a study of this nature would most likely reveal a higher level of SME satisfaction than with the banks several years ago. This is not mere conjecture. During a recession, bank charges rise to defray the losses sustained by banks by higher firm default rates (Kinsella 1992) This is borne out in Carpenter's study (1993), where firms which were prospering assigned their banks higher ratings than firms who were not. Dissatisfaction with banks is to a large extent a cyclical phenomenon.

Since the research element of this discussion comprises interviews with banks and not small businesses, it follows it will relate some policy changes in Irish banks not covered by the literature to the banking German system.

3.2 The need for a bank based survey

The characteristics and financing of small businesses is a well documented issue in Ireland. Growth studies such as Carpenter, (1993), Kinsella, (1992) or financing studies by Foley and Griffith, (1993) and the Irish Chamber of Commerce, (1994) in addition to various Government Reports and SFA releases. Deloitte and Touche, (1993) asked a sample of 400 firms[11] with less than 50 employees to describe the relationship with their banker. This is essentially a

[11] Response rate of 64%

survey concerning firms and not banks. This is reminiscent of the study by Binks and Ennew, (1988) who posed similar questions to English firms. It was therefore interesting to regard the issues from another vantage point; that of the bankers.

The literature relating to banking relations in Germany is replete with studies in German which have not as yet been translated. Of the two landmark studies which are available in English, the first by Clements and Burns (1992) has been written under the auspices of 3i[12] which is a centre based in England. Its predecessor by Fischer and Edwards (1992) was written in conjunction with the University of Cambridge. Unfortunately, many studies, apart from those released at European level[13], have not been translated. In particular, reference can be made to publications by the German equivalent of 3i, the Institut für Mittelstandsforschung (literally "The institute for research into SMEs"). The annual accounts of many German banks, apart from the Bundesbank are also not translated. Fortunately, the author has been able to access some publications thitherfore not referred to in an Irish context.

An Irish study which examined the German banking system in relation to German banks taking participations in small businesses has been carried out. (Foley and Griffith, 1993) The aim of this discussion is to supplement this former analysis by interviewing, not merely the Regional Banks which act as

[12] Explain origins of 3i
[13] European Commission Publication "European Observatory for SMEs which contains extracts translated from various European contributors

clearing banks to the savings banks, but banks involved in lending to small businesses across the whole banking spectrum. This is borne out by the recent more stratified sample undertaken in 1996 which showed that the regional banks tended to cater for the larger SMEs seeking loans of £150,000 upwards[14]. As shown in Chapter One, the savings banks and co-operative banks between them account for 71 percent of lending to SMEs and therefore their inclusion would generate a more representative sample of German banks[15].

The telephone survey conducted by Foley and Griffith in 1993 did indicate that guarantees by guarantee banks are often used in the case of companies without sufficient collateral. This was substantiated by the 1996 interviews conducted by the author.

Foley and Griffith (1994) also exhorted the Irish banks to apply a more cash flow approach to lending;

"..there is a need to continue their (Irish bankers') efforts to better access risk, in particular, assessing businesses on a cash flow basis rather than on a balance sheet basis"[16].

Evidence relating to how German SMEs perceive how their banks assess lending demonstrates that German bankers look at total business assets before liquidity ratios. (Clements and Burns, 1992) This would put the behaviour of

[14] Volksbank, Reutlingen
[15] See Methodology in Chapter 5 for the composition of the sample
[16] Irish Banking Review, Autumn 1994. P.30

Irish banks into context[17]. In order of precedence, according to German SMEs, German banks place the value of the overall business assets first before the long term health of the business in the loan appraisal rankings. In fourth place comes interest and dividend cover before personal guarantees and finally collateral in fifth place. It is interesting that this observation is made by the firm owners themselves and not the bankers. If a banker asserted that collateral were of secondary importance and that the long term health of the business came first, he might be treated with more scepticism than if the observation were made by a small business owner.

The difference between the approach taken by this study and that of Clements (1992), is that while Clements interviewed German SMEs and elicited their responses in a number of areas including the criteria by which loans are evaluated by banks, this study proposes to interview the banks in and gain insights on the criteria they use. By interviewing banks in lieu of small businesses, one endeavours to gain information from the perspective of the bankers. Optimally, one would endeavour to relate the feedback from a firm specific survey to that of bank specific research in order to see if the two accounts deviate from one another. This optimal situation would necessitate a larger scale survey than the one being undertaken here.

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[17] See 2.4

Foley and Griffith alludes to the paucity of empirical information in the whole area of bank lending to small businesses.

> "Conclusive evaluation of the role of the banks is constrained by the limited availability of empirical data. Empirical assessment of many aspects of the bank/ SME interface is hindered by insufficient quantitative information"[18].

Despite the sensitivity of the information, banks proved to be co-operative in furnishing some vital statistics. The name of the Irish bank which provided the information relating to small firm default rates was not disclosed to German banks. The German banks were asked to comment on the figures in the context of their own experience of lending to small businesses. This may seem a very circumvent way of obtaining information regarding bank bad debt provisions or fallout rates with various risk categories of small business. As described in the Methodology, it is a way of eliciting responses to sensitive information.

As will be seen in Chapter 4, attempts were made to use data disclosed by Irish banks as an input into the German interviews. German bankers, due to the sensitivity of the information were asked to take a judicious look at the Irish information and put it in the context of their own lending experience. This indirect approach was applied in order to elicit responses in an area where information is scarce.

[18] Irish Banking Review. Autumn, 1994. P.31

There are considerable differences between the German and Irish banking systems which lead to information gaps and comparability problems. The following have been discussed in Chapter One.

The first difference between the two systems is inherent in the more interventionist approach of the German government via guarantee banks as discussed in the first chapter.

The second difference is that German banks are not precluded from taking a charge on the book debts of an enterprise as in Ireland.

The third is the autonomous nature of the savings banks and co-operative banks in extending loans.

The fourth major complication arises out of the importance assigned Chambers of Commerce and the Regional Governments in providing assistance to small businesses. (Bannock and Albach, 1992)

A very important comparability problem which had not been mentioned yet is the method of accounting for risk in both countries. A bank's specific bad debt provision is often an indicator of how much risk it is prepared to shoulder with firms. It often bears comparison with the historic default rate of borrowers. Another more direct measure is the actual default rate of firms. A representative of a German accounting firm in Düsseldorf[19] explained the fact that in Germany a general provision against bad debt in a bank can only amount to 4 percent of outstanding claims at maximum. This is subtracted from the asset side of the balance sheet. It is impossible to establish the level of a specific risk provision because it can be buried in the bank capital reserves on the liability side of the balance sheet. As will be seen in the Methodology, differences in accounting for risk in Germany and Ireland make it more difficult to establish the risk exposure of banks. This makes information furnished by Irish banks interviewed relating to default rates in two customer risk categories all the more useful since it helps overcome the lack of empirical data.

3.3 Lack of comparisons in the literature between peripheral and larger banking systems

This comprises the final issue in this Chapter which deals with reconciling imbalances and deficiencies in the literature through more up to date information sources or additional research. It is notable that in Ireland there are references to the UK banking system, the US or Canada. The prevalence of secondary literature which deals with the British banking system is fortuitous on the one hand, since this literature can be applied to the Irish banking system by virtue of similarities between the two systems. It can be argued that the Irish banking system resembles more the British system by virtue of well developed equity markets expressed in low gearing ratios. Recent evidence by Burns and Whitehouse (1995) finds the British short termism evident in short term

[19] Werth & Klein

financing horizons reprehensible[20]. It follows that it is not useful to compare Ireland against a country the whose banking system is acknowledged to be short term in its outlook.

Unfortunately, this most recent study by Burns and Whitehouse (1995) is representative of other landmark studies commissioned by another European country or transeuropean institution in that Ireland is rarely cited by way of comparison. This tendency of focusing on larger and more significant economies gives an imbalance to the literature. Binks, Ennew and Reid for instance (1988) also cite Japan and Germany as countries where banking practices differ. Similarly Irish authors use large economies as a reference point against which to measure the performance of the Irish banking system. Kinsella (1992) does not refer to a small banking system more comparable with that of Ireland such as Denmark when he states:

> "Firstly, the existence of an adversarial relationship between the banking industry and the authorities is not unique to Ireland. There are, however, numerous examples from other countries which confirm the benefits of a positive and open relationship. Germany is a case in point. So too, is Switzerland, and Japan"[21].

The point which should be made is that if one were to compare Germany with Britain, comparisons in the literature abound. Examples of such UK/ German studies include those by Mayer and Alexander (1990), the OECD Report (1994)

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[20] See 1.3

[21] Kinsella, 1992. The medium term development of indigenous industry: the role of the financial sector. P.24

and Mayer and Giovanni (1991). There is a reciprocity in studies undertaken in both countries.

Ireland, on the other hand, by virtue of its peripheral nature and the minor role it plays in a world or even European economic sense, has never surfaced much in the prolific internationally based British literature. This makes the task of retrieving comparative studies which mention both Germany and Ireland difficult. The solution is to use any information, however incomplete for the analysis. This information can then be supplemented by extensive interviews with both Irish and German bankers.

Given the prolific literature to date which contrasts the UK equity based system to the German bank based system, the task conducting a two nation study comprising Ireland in lieu of Britain is facilitated. Although the emphasis in much of this literature is on bank lending to larger corporations, it is useful in the provision of general background information.

The international literature pertaining to the subject of banking, focuses on larger, developed countries of comparable size and significance. Ireland and Irish banks are not well documented in external reports despite the existence of internal Government or public policy reports such as that of Kinsella (1992).

3.4 Conclusions

This survey endeavours to supplement deficiencies in the literature for the following reasons.

Firstly, since the publishing of the Government Task Force Report on Small Business (1994), the Access to Finance Scheme has been introduced. Foley and Griffith (1994) articulated the need for an international appraisal of the Enterprise Loan Scheme which they refer to as the "single most innovative banking product in recent years". One aspect of this scheme, namely a reduced reliance on the entrepreneur's personal collateral to secure a business loan, will be compared with the personal collateral policy pursued by German banks.

Notwithstanding, there is a need for a more comprehensive review of other improvements in the Irish system with respect to small business lending which are beyond of the scope of this survey. Such a study could entail ascertaining the proportions of the small business population eligible for preferential loans (i.e access) and whether the criteria employed by Irish banks in assessing loan applicants is comparable to that applied by other European banks such as Germany.

The second reason as to why it is necessary to undertake discussions with bankers, is due to the dearth of information on how the bankers view the situation of lending to small businesses. There has been a tendency to focus on the contributions of the entrepreneur or manager of a small business. In order to maintain some equilibrium, it is imperative to look at the testimonies of small business owners and also at those of their banking counterparts. Surveys which have collated information relating to small businesses are of vital use as an input to this discussion but must be supplemented by interviews with bankers if one is to obtain a balanced argument.

This survey aims to achieve more reciprocity and to rectify the imbalance in the literature which arises from an abundance of firm specific studies not paralleled by bank specific studies. This is not to detract from the value of firm specific studies such as those of Kinsella, Clarke, Coyne, Mulveanny and Storey (1994) or Deloitte and Touche (1994).

Another factor which prompted the need for primary research is one which can best be remedied by qualitative interviewing. This concerns the problem of obtaining empirical data which relate to certain banking practices such as the assessment of collateral. Such information can be categorised as highly sensitive in nature. For example, few bankers would discuss internal banking reports containing collateral to principle ratios experienced by their bank. Unfortunately, some of the most inaccessible information is also the most useful. This problem which arises in the event of comparing the ratios of collateral used as security by a bank and the corresponding value of the loan is compounded by the fact that the most comprehensive survey of this nature undertaken in Germany is redundant for the purposes of comparison with Ireland. This is due to the fact that Drukarcyk (1985) did not target small enterprises in isolation but rather an aggregate of industries in general. It follows that this study is not representative since a comparison between it and the SFA (1989) survey of collateral which does target small enterprises could be misleading. There was a need to remedy this gap in the literature by conducting discussions with German bankers themselves in order to establish the magnitude of collateral used to secure loans of different durations.

The final gap which occurs in the literature emanates from inter alia the geographical focus of past surveys on Germany to the exclusion of Ireland. It is obvious that on a European level, for example, Ireland is a minor player compared to Germany. Therefore, there is a proliferation of reports documenting German banking behaviour at a European level whilst at the same time a paucity of information relating to the Irish situation.

Chapter 4 Methodology

4.0 Introduction

The last chapter presented some of the gaps in the literature and questions unanswered which could be addressed by qualitative research in the form of structured interviews.

This research evolved in 3 stages. As described in the preceding chapters, it is possible to amass a considerable amount of secondary information in the form of reports which deal with the issues of bank lending to small businesses Ireland and Germany. Since these studies are not tailored to answer the particular questions this discussion seeks to address, there is a need to supplement this material by interviewing banks and State agencies in Ireland and Germany.

The manner in which interviews were conducted, the composition of questions asked and the sample frame are discussed under the following headings:

4.1 Research content: stage one

4.2 Research content : stage two

4.3 Research content : stage three

4.4 Limitations of the research

4.1 Research content: stage one

The research becomes progressively more refined with each stage. The first questions concern the broad "macro" issues. When one considers what makes one system of bank lending superior to another, the most salient and conspicuous differences are examined. The most sălient issues in this discussion comprise those most often discussed in the literature. During January a preliminary set of interviews was held with 6 German bank representatives and one representative of a Chamber of Industry and Commerce. This served to give direction to the research. The broad issues discussed with these bankers at this stage are described below. **Figure 4.1.1**

It was imperative to establish which banks in Germany lend to small businesses. The importance of the savings banks and co-operative banks was emphasised in some of the literature and so it was expedient to meet a cross section of banks. (Köhler, 1995) (Edwards and Fischer, 1994).

This representative sample section comprised in all 14 German banks. This included two savings banks, a state guarantee bank, a private bank, a regional bank, a local branch and head office of two main German banks and the head office of the organisation of savings banks[1]. It was also deemed important to meet the representative of a local branch of the Chambers of Industry and

[1] *Verein der Deutschen Sparkassen*, Frankfurt

Diagram 4.1.1 **Evolution of research**

Input into Stage 1: Cambridge Report, 1994 Köhler, 1995 Mayer and Alexander, 1990	**Input into Stage 2:** SBA failure rate on US guarantee loan scheme Information on working capital[1] Selected bank bad debt provisions Charge on Debtors[2]	**Input into Stage 3:** Irish bank fallout rate Irish risk provisioning Bundesbank gearing figures
↓	↓	↓
Preliminary interviews with: 5 German banks 1 regional guarantee bank Representative of Chamber of Commerce	**Semi structured interview with:** 5 main Irish banks 1 Irish accountant firm 1 Guarantee bank	**Semi structured interview with:** 14 German banks 1 German accountant Institut für Mittelstandsforschung
↓	↓	↓
Output from Stage 1: *Information on:* State funding administered by banks Relevance of different forms of German bank Current economic conditions affecting SMEs	**Output from Stage 2:** *Information on:* Irish bank fallout rate (normal borrowers) Irish bank fallout rate (Special Unit borrowers) Rejection rates of SME loan applications[3] Impact of New Policies Charge on house	**Output from Stage 3** *Information on:* German bank fallout rate relative to Irish Collateral weightings Use of Charge on Debtors Impact of Government Schemes and Guarantees

[1] Deloitte and Touche, 1993
[2] Government Task Force Report, 1994
[3] Also rejection rates following further negotiation with bank

Commerce at this preparatory stage since he liased with many small businesses and could supply information pertaining to different banking types.

The information obtained from these interviews was for the most part qualitative. These interviews endeavoured to establish the institutional differences between different types of banks. They also explored the autonomy of the savings banks in the area of lending. The bankers were asked to quantify if possible, the maximum loan amount extended prior to notifying a more senior colleague. The interviews explored the historic background to the German banking system and the need for different types of bank.

The effects of the recession of firm default rates and bank lending behaviour were also broached with the German banks. This is because I had reservations concerning the available literature on bank lending to Germany, which to a large extent predates the first major cooling of the German economy since the Second World War.

Also discussed with the bankers was the 20 year long term loan extended by the State via the banks, on which there is a two year interest moratorium[2]. The eligibility criteria were also discussed since the direction and scope of State intervention impinges on the type and number of small businesses being assisted through the banks.[3]

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[2] "Eigenkapitalhilfeprogramm" (literally assistance to self -finance)
[3] See 1.3

Table 4.2.1 Irish banks and institutions interviewed

Bank / institution	Representative	Description
Allied Irish Bank	Small Business Banking Executive	Irish bank
Bank of Ireland	Enterprise Support Unit Executive	" "
Ulster Bank	Retail Business Executive	" "
National Irish	Credit Assessment Executive	" "
Trustee Bank	Credit Assessment Executive	
ICC Bank	Lending executive	State Industrial Bank
Deloitte and Touche	Executive	Accountancy Firm
Forfas	Executive	State Agency
Irish Bankers' Information Service	Director General	Bankers' representative body
O' Riada Stockbrokers	Executive	Stockbrokers with bank clients inter alia

Table 4.2.2 The Interviews with Irish banks

SME by sector	Collateral	Risk	Long term or Short term finance	New Schemes
Evidence from 1993 that 43% firms in Engineering and Electronics Sector rejected for working capital loan than in Food and Drink Sector[1] In this their experience?	Collateral weightings	Fallout rate: 3.1% maximum[2] 1% minimum[3]	Would you prefer the repeal of Section 115 of 1986 Finance Act[4] or introduction of a government backed guarantee?[5]	Displacement effect of Access to Finance Scheme
	Use of charge on house	% of bad debts accruing from riskier SMEs (AA category)		Expertise of Special lending Units Outsourcing of loan officers

[1] Deloitte and Touche, 1993
[2] Small Business Association, 1989. Fallout rate of SMEs participating in loan guarantee scheme
[3] " " " " .Loss bank incurs on total claims outstanding with a 70% government guarantee.
[4] Charge on debtors would assist provision of short term working capital by allowing banks use company book debts
[5] Government guarantee facilitates provision of long term finance for SMEs who lack fixed sufficient assets

To begin with, one must establish upper parameter of small business fallout rate which an Irish bank can sustain. The Small Business Association in the US estimated that in 1989, for every $100 dollars of outstanding claims, $3.1 turned out to be unrecoverable debts. (Deloitte and Touche, 1994). In other words, the American banks involved in this scheme could not sustain a loss of 3.1 percent of claims but a proportion of 0.93 percent was conceivable.

Irish bankers were asked if they were offered a 70 percent guarantee could this fallout of 0.93 percent be entertained.

The Irish banks were presented with the scenario of "deserving firms" who could become viable but were risky from the viewpoint of a banker. According to the theory of banking, bankers prefer to ration credit rather than indefinitely increase the risk premium. (Stiglitz and Weiss, 1981). Assuming that this is true, these marginal cases will be declined as Kinsella has revealed. Kinsella et alia (1994) alluded to a certain percentage of fast growth firms in Northern Ireland and the Republic being denied bank loans.
"Out of the twelve sources of finance for which founders were turned down, five were loans from the banks; of these four were fast growth firms"[5].

Information supplied from newspaper cuttings which released risk provisions of several main Irish banks was also contained in the questionnaire. The

[5] Kinsella et alia. (1994) "Fast Growth Firms: An Irish Perspective." P.61

relationship between the bank's exposure to high risk small businesses and the magnitude of the general risk provision was discussed but not found to be very conclusive since risk provisions represent an aggregate of many other exogenous variables, many of which are macroeconomic e.g. general economic conditions.[6]

For this reason the actual fallout rate which a bank would entertain was deemed to be a more descriptive measure of a bank's lending behaviour.[7]

Sectoral lending was an issue raised by the Deloitte and Touche study of (1993), whereby SMEs in the engineering and electronics sector exhibited higher rejection rates compared with their counterparts in the food and drink sector. Irish banks were asked if these statistics conformed to their own lending experience and could they explain this sectoral variation.

Allied to this question was the issue of how they dealt with small firms who were in the start up or developing stage and had an innovative product. To cite an example of this, an entrepreneur, Mr. Ken Carroll[8] wrote to Seamus Brennan in 1993 because he had to start the company by getting an overdraft which he had to guarantee. This product which could belong to the engineering and electronics sector represented something innovative in that it was a new CAD

[6] See 4.4
[7] An exception to this general tendency was where one bank did disclose by how much his bank's general provision would rise in the event of an increase in riskier corporate borrowers.
[8] Government Task Force Report, 1994

software programme used in the making of injection moulds. How would an Irish bank deal with such a proposition? Would it outsource some technological guru who could explain the viability of the project to those not familiar with CAD software or would the bank use its own personnel?

The area of collateral had often been one of contention although not one rated as highly by entrepreneurs as a concern. (Deloitte and Touche, 1993) The importance attached collateral as a major concern has diminished since the SFA survey in 1989.[9]

This area has evolved in two ways. The first and most important policy change on the part of the banks is since the introduction of the Access to Finance Scheme, a reluctance to take the owner's house as security. Bankers were asked about the policy of their bank towards the house. The second issue was the proposition of the Government Task Force in 1994 to repeal section 115 of the 1986 Finance Act which gives the Revenue Commissioners precedence over the books debts on liquidation of the firm. The Task Force members suggested that the repeal of this provision should go in tandem with the long term loans administered by the ICC bank in 1994[10]. It is suprising that the Committee proposed this change in legislation in order to enhance long term lending since the book debts of a firm are looked upon as having an expiry date of at most 3 months. In accordance with normal banking principles, long term assets such as

[9] See 2.4
[10] Small Business Expansion Loan Scheme

fixed business assets or premises complement long term lending. Similarly assets whose value can be realised in a short time period, such as company debtors are used to securitise a short term lending facility.

A very sensitive question which relates to the issue of collateral is the ratio of collateral to principle. The moral hazard problem here is that while firms may be inclined to be forthcoming on how much collateral they have been requested to provide the banks, it is not in the bank's interest (unless the ratios appear equitable) to disclose this information. The methodology sought to make this question more acceptable by asking banks to assign weightings to different collateral types. It follows that one can make inferences about the policy of the bank as regards collateral going on the magnitude of the weighting. If, for example, a bank deducted 20 percent automatically from the market price of a house[11] to allow for the fact that a house being auctioned by a bank is regarded by the public as an asset which must be disposed of quickly, it follows that the bidding price may be therefore depressed. The bank also has a policy of lending a proportion of the remaining 80 percent of the adjusted house value. In the case of two hypothetical banks one may have a more conservative and consequently less generous (from the small business point of view) method of evaluating a house. The first bank and the second bank assign weightings of 100 percent the adjusted market price and 80 percent the adjusted market price respectively. This is assuming that both deduct 20 percent to compensate for

[11] Assuming it had the house valued by a professional

underbidding and disposal costs. The same procedure of applying weightings is used for the different categories of collateral which constitute the "basket of entrepreneur assets" which could be used as collateral. These weightings are then put in context with the frequency of use of each collateral type by the bank. One then has a clearer picture of the collateral policy of the bank by adding together each component in the collateral basket. This question can lead to better compliance from bankers than the more direct, "What is the average proportion of collateral to principle of your bank for 1996?"

The Irish banks were also asked to elaborate upon what exactly Mr. Thomas Mulcahy of the AIB bank had meant by stating that the Irish banks had introduced better grading systems. In other words would loan terms be negotiated on a case by case basis and therefore would the bulk of small businesses be extended loans at rates below the now discarded AA rate?

Banks were also asked whether the Access to Finance Scheme were a publicity exercise which cross- subsidised on loans to riskier small businesses in order to extend loans on more favourable terms to firms which had no problem obtaining finance at reasonable terms in the first place. This question sought to elicit from banks whether these new schemes have any real impact. The Access to Finance scheme, being initiated by the banks themselves represents one of their responses to pressure from government.

The other innovation in lending to small businesses is the Enterprise Development Units where firms with growth prospects are elected for special attention from bank personnel and conferred more favourable long term lending rates. Since this is reminiscent of the house bank relationship pursued by German banks, banks were asked about the profitability of such a venture. One bank supplied estimates of the percentage loss on funds lent to firms in this Unit which is considerably higher than the normal bank threshold level. This was used as a yardstick against which to measure the capacity of the German banks to support potentially viable but fragile enterprises.

A final area discussed with the banks was what support from the State would they most welcome which would assist in their lending to developing small enterprises. The two broad measures were the introduction of partial State guarantees and the repeal of section 115. The first measure would assist in the area of long term lending and the second would facilitate short term lending.

4.3 Research content : stage three

This stage involved more in-depth interviews with 8 German bankers, a representative from a German state funded institution which has a mandate to chart the performance of small German enterprises and lastly the representative of a German partnership of auditors.

The issues examined were as follows, portfolio composition, collateral, risk, duration of finance and service. **Table 4.3.1**

These issues varied in some aspects from those presented to the Irish bankers. This was to accommodate differences between the two systems particularly in relation to there being a more decentralised and varied banking system in Germany. Consideration must always be taken of differences which could lead to erroneous conclusions being drawn. An example of an erroneous conclusion alluded to in the first chapter would be to say that German banks were better lenders because on average the interest rate paid by small business owners were considerably lower than that paid in Ireland when in fact this could be a consequence of a lower Bundesbank discount rate or lower withholding taxes on deposit accounts which could cause banks to have lower cost funds for refinancing their lending transactions. The translated questionnaire can be seen in the appendix to this section. **(Appendix 4.3.1)**

A modified questionnaire was given to the two guarantee banks participating in this survey since their orientation and disclosure requirements would differ from those of the normal commercial banks.

Some of the German commercial banks unprompted cited figures relating to their small firm default rates but this was the exception and these findings had to be obtained in the more indirect way.

Table 4.3.1 The Interviews with German banks

Composition of portfolio	Collateral	Risk	Long term or Short term finance	Service
Artesian sector partnerships blue chip companies owner managed	Collateral weightings: Cash balances, bonds & Shares Business assets House Guarantee bank	Fallout rate of one Irish bank: 3 - 4% maximum[1] 1% minimum[2] Would you experience a similar fallout rate in both these risk categories?	% fixed asset vs. working capital loans in portfolio	Main bank relationship: SME better served in this arrangement?
Have you a State mandate to cater for a specific sector?[3]	Use of : charge on house book debts of firm guarantee by guarantee bank			Advice Financial advice Legal Industrial Expertise of advisor Financial Industrial

[1] Fallout rate experienced by Irish bank in a high risk category
[2] Aggregate fallout rate experienced by same Irish bank in AA and AAA categories
[3] establish differences (if any) in orientation of various German banks

The sample of banks with whom the author conducted the two hour interviews were located predominantly in the Baden Würtemburg region. This focus on the Baden Württemburg area was occasioned by the area's relatively large number of small businesses compared with the more stagnating, larger, and capital intensive enterprises located in the Ruhr area of Northrhine Westfalia which is renowned for its industry. (Cooke, Morgan and Price, 1995) It follows that it would be more logical to focus this survey on the local banks in an area replete with a growing small business base, yet not as under developed and subsidised as the former Eastern states. Bavaria would also have fulfilled the criteria but for ease of accessibility and its relative proximity to the commercial centres of Frankfurt, Düsseldorf, Cologne and Bonn, it was chosen.

The sample comprised banks at both local, regional and representative body level. The local banks were confined to the Baden Württemburg area as were the regional clearing banks or giro institutions. The *Verbände*[12] were located in the commercial centres. **Table 4.3.2**

A separate questionnaire was also compiled for a representative of the IfM.

A different question set was used in the case of the accountant of Warth & Klein who was familiar with the issue of allocating risk provisions.

[12] Since savings banks and co-operative banks are not governed by a central head office, their respective Association Headquarters were interviewed

Table 4.3.2 The German banks and institutions interviewed

Bank	Representative	Location/ type of bank
Dresdner Bank	Jürgen Huber Martin Buck	Head Office/ Frankfurt Local branch/ Baden Württemburg
State Guarantee Banks	Rupert Hukle Otto Züffle	Dealing with large corporates/ Stuttgart Dealing with SME's/ Stuttgart
Savings Bank Sector	Dr. R Landrock Kogel Roberto Nernosi Jens Heinert Walter Schmid	Head office/ Bonn Dealing with larger corporates Clearing banks to savings bank/ Baden Württemburg Dealing with SME's/ Freiburg Dealing with SME's / Reutlingen
Cooperative Bank Sector	Armin Horning Frank Unversagt	Regional head office/ Baden Württemburg Dealing with SME's/ Reutlingen
Bayerische Vereinsbank	Hösel	SMEs and large corporates/ Munich
Schwäbische bank	Maximilian Wölfle	All corporate types/ Stuttgart
Baden Württemburgische Bank	Peter Finkbeiner	Larger corporates/ Reutlingen
Warth & Klein	Dr. Gernod Hebestreit	Auditor and accountant/ Düsseldorf
Institut für Mittelstands- -forschung	Dennis Dee	Writes for European Commission on SME issues in Germany/ Bonn

It was necessary to interview some association which transcends the boundaries of Baden Württemburg in order to establish whether policies pursued for example in Stuttgart by local savings banks could be equated with those in Schleswig Holstein or Brandenburg. By interviewing the supra regional bodies and lobby groups attempts are made to eliminate bias which may otherwise result from focusing on banks in a particular area.[13] In the case of the two main banks interviewed, care was taken to interview in addition to branches at local level, the head offices in Frankfurt and Munich.

It is beyond the scope of this survey to interview the population of German banks since there are four main banks in Ireland catering to small businesses with growing competition from about 6 non - banks compared with 3,880 German banking institutions[14]. The autonomy of the community savings banks and co-operatives is reflected in the high number of reporting institutions.

As described in the introduction to this chapter, information arising from the interviews with Irish banks was used as an input into the later German interviews. German bank representatives were exhorted to judge the Irish figures in the light of their own experience.

[13] An example of this occurred in the case of a Regional co-operative bank located in Stuttgart. It provided the author with comprehensive information concerning guidelines and legislation which govern lending by co-operative banks. The "Handbuch der Volksbanken und Raiffeisenbanken" was used to evaluate how German co-operative banks collateralise loans.

[14] 1994 figures from Bundesbank Report. This is the number of credit institutions reporting to the German Bundesbank and not all of these lend to SMEs.

The first question, which presented the high gearing levels cited by the Bundesbank for 1995 was included in order to ascertain if German banks are satisfied with an average proportion of owners equity for small businesses amounting to 15 percent of bank gearing. This was also included as control question since the Bundesbank estimate relates to an average for all banks and may mask differences among different banking types. In other words, a local savings bank may not exhibit the same average equity as a proportion of gearing as a large commercial bank such as the Dresdner bank.

The second issue dealt with collateral. The procedure was the same as that used for the Irish banks whereby respondents assigned a particular weighting to different collateral types and also indicated which type of loan would normally be covered by such collateral. As a separate question and one which was not included in the questionnaire, bankers were asked about their preference for and the frequency with which their banks applied different types of collateral. The fact that there seems to be a more structured response given by German bankers to this question is discussed in the section dealing with the limitations of this research[15].

The third section concerned risk provisioning. It presented the general risk provisions of an Irish bank and German banks were asked if they thought this to be conservative (meaning they had lower provisions) or liberal (meaning

[15] See 4.4

they had higher provisions). The fact that many bankers were involved in lending and not compiling financial accounts detracted from the usefulness of this question. Another issue detracting from this question was the format of provisioning in Germany which will be discussed in the limitations to this research[16].

The second part of the third section in the questionnaire dealt with the issue of small business default rates. One Irish bank had disclosed the losses it sustains on normal consumer borrowing in addition to the losses accruing on loans to riskier, more cash flow based enterprises located in its Special Unit. Both categories of customer and the respective fallout rate were presented to the German banks. It was necessary to explain to them what is meant by a Special Unit since they had not encountered the concept before. The German respondents were asked whether their losses sustained were higher or lower than those experienced by the Irish bank in both categories.

The fourth extract was self explanatory in that it sought to establish whether German banks have assigned lending personnel to small businesses and the qualification of this personnel. This was parallel to the question posed to Irish banks which were asked if they had personnel familiar with technological aspects of a business proposition which could be useful in evaluating the viability of a loan.

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[16] See 4.4

The fifth question asked generally about how the recession in Germany had affected bank lending behaviour and margins. Again, there was a problem with this question which will be discussed later.

The sixth section was subsequently discarded further to receiving information from a guarantee bank that the question had been based on incorrect information.[17]

The seventh section concerned the composition of lending to small businesses. The objective of this question was to establish the percentage of lending which is for working capital as opposed to that for fixed assets.

The eighth section in the questionnaire comprised an unprompted question which asked German banks how they deal with small businesses lacking fixed assets which could be used to secure a loan. The reason this was unprompted was that the following extract which dealt with the contribution of guarantee banks might induce bankers to answer differently. It was therefore important to ask bankers about the procedure they use before mentioning one of the possibilities. This question preceded the final extract.

[17] This section asked banks to cite the number of proportion of loan applicants referred to them by guarantee banks. This event does not arise since the bank initiates the contact with the guarantee bank and not vice versa.

The final extract, as has been mentioned above, dealt with the raison d' etre of guarantee banks. Banks were asked if they perceived them to be purely a State intervention or a synthesis of commercial and State driven finance.

4.4 Limitations of the Research

The first and foremost limitation is the difficulty of obtaining truthful responses. There is the moral hazard problem alluded to in Kinsella (1994) when he was asking fast growth firms if they had had a loan application rejected by a bank in the past. Those which had had an application declined by the bank and subsequently went on to become successful despite having their business proposition rejected, mentioned with a certain "relish" this "apparent lack of foresight" by the banks. The converse was true for firms which had been rejected by banks. These might not have been so forthcoming about mentioning the reluctance of bankers to support them.

The veracity of responses can be undermined by respondents wanting to show themselves in a better light. The general theory on research techniques urges the interviewer to examine issues in advance of the interview which could prompt the respondent to embellish or withhold the truth. These distortions, the causes of which are recognised ad priori, permit aberrations from the truth to be put in the context of the respondent's individual circumstances. According to Taylor and Bogdan, (1984):

> "...the issue of "truth" in qualitative research is a complicated one. What the qualitative researcher is interested in is not truth per se, but rather

perspectives. Thus the interviewer tries to elicit a more or less honest rendering of how informants actually view themselves and their experiences"[18].

In the case of this survey, evidence supplied by and Irish bank concerning the losses accruing on its lending to riskier enterprises is considerably higher than those losses accruing on lending to normal customers. The moral hazard would be that these estimates are inflated in order to overestimate the willingness to take on risk in this Special Unit.

On the other hand, German banks have never been criticised to the same extent as their Irish counterparts. It follows that they may not have to employ defensive tactics. They may therefore underestimate the risk they are prepared to enter into. Others may wish to impress the interviewer with a show of largesse. This element of interviewer bias is difficult to prevent against.

Some of the questions were sensitive in nature. This was particularly true in the case of bank margins in Germany.[19] It had been hoped that the proceeding question which mentioned the growth of competition among banks in Germany and the recession would function palliate the question as to whether banks would now lend at more favourable rates to samll businesses. This question achieved a low compliance rate due to the sensitivity of this area.

[18] Taylor and Bogden, 1984. "Introduction to qualitative research methods: the search for meanings".P.98
[19] Section 5, Appendix, 4.3.2

In the area of collateral, Irish banks are reluctant to take an entrepreneur's home as security. In the German questionnaire, one had to be careful not to mention this fact in case it prompted German bankers to say likewise. In fact, the author was careful not to allude to the policy of Irish bankers in case it would colour the statements made by their German counterparts.

Again, in the area of collateral, it was thought expedient to present more sensitive small business assets such as the house and business assets together with other less contentious collateral types such as bank savings, bonds, gilts and shares. This presentation was used in order to appear less threatening to bankers and not put them on their defensive.

The second main problem concerns the issues being compared and investigated. Risk provisions are notorious for fluctuating from year to year and may not bear much relation to a bank's conservatism in lending. They are also aggregate figures which cannot be analysed separately to account for the component of risk exposure towards growing, capital deficient small businesses. For this reason it was thought more expedient to use the fallout rate on Special Unit loans which had been cited by an Irish bank. This bears a better relationship to riskier small businesses and the propensity of the banks to support risk than an aggregate figure which encompasses other borrower categories. Similarly, it was thought that the estimates supplied by the German guarantee bank which deals specifically with small and riskier borrower categories could be used as a German proxy of fallout rate. The guarantee bank has also an official mandate to disclose such information being in receipt of State funds. This can help to eliminate some of the moral hazard problems described above in addition to overcoming the problem presented by aggregate figures.

The final observation which can be made is that on the whole, German bankers preferred a structured questionnaire and tended not to deviate from the questions so much. This was very evident in the question concerning collateral which was presented to both German and Irish bankers. The Germans did not have a problem assigning weightings to different types of collateral. The Irish bankers, on the other hand, could not or would not comply with this question. Perhaps German culturally adhere to a mental yardstick and thus have no difficulty in supplying threshold levels and parameters. This issue will be discussed more fully in the chapter dealing with collateral.

Chapter 5 Comparison of bank lending in Ireland and Germany

5.0 Introduction

This chapter presents the results of the research. It also endeavours to compensate for information gaps which arise from non-response to particular questions by referring to the firm specific studies of the SFA (1989) for statistics relating to Ireland and a study by Drukarcyk (1985) which furnishes information relating to Germany.

It also investigates the allegedly better relationship small firms in Germany enjoy with their banks in the form of implicit, prominent banking relationships. Such close relationships referred to as "Hausbankverhältnisse" or house bank relationships, are reputed to be instrumental in permitting German businesses access to bank finance on more favourable terms than in the absence of such tacit agreements. The theory behind such relationship banking was presented in Chapter 1. The author's interviews with German banks from across the banking spectrum permitted to conclude if such close relationships between German banks and small businesses are witnessed in reality. If they do exist, this survey investigates whether close ties between German banks and small businesses have a positive impact on lending terms accorded German businesses on the premise that heightened trust between banker and entrepreneur results in relaxed security requirements on bank loans.

The results are categorised under the following extracts:

5.1 A comparison of uncollateralised lending

5.2 Comparing the ratio of collateral to loan for selected types of collateral

5.3 Comparing default rates of different type of small enterprises

5.4 How German bankers and economists evaluate high gearing and long term lending

5.5 Are German bankers more selective than than Irish bankers?

5.6 Comparison of branch discretion and bank monitoring

5.7 Relationship between small businesses and their banks

5.8 Implications of the results

5.1 A comparison of uncollateralised lending

Bannock and Doran (1991) in their conversations with bankers alluded to the difficulty in eliciting information from bankers concerning the amount of uncollateralised loans being advanced to firms;

> "Most respondents were unwilling to talk about the extent to which they were willing to lend without collateral, although there was widespread agreement that in some countries competition had lead to a higher proportion of lending being unsecured"[1].

[1] G. Bannock and A Doran, (1991) "Small business policy in Europe: a new era of competition". P.71

Due to the understandable reticence of banks in this area, it was deemed necessary to refer to two firm specific studies which examine the number of uncollateralised loans in Ireland and Germany. **Table 5.1.1**

Both studies categorise collateral differently. For example Drukarcyk (1985) uses the descriptions real estate and mobile assets while the SFA (1989) employ the classifications business collateral and personal collateral. The important point is that both studies take cognisance of the number of uncollateralised vis a vis collteralised loans in both countries. This amounts to 20.5 percent in the case of Germany. The corresponding figure pertaining to Ireland is 20 percent. The difference between the two figures is negligible. It is fortuitous that Drukarcyk's study confines to loans of between 1 and 7 years inclusive. This is due to the fact, as has been seen in the first chapter, German banks' propensity to lend long term exceed long term lending in Ireland considerably. In Germany the percentage of companies with long term loans of more than 4 years duration amounted to 42 percent vis a vis 16 percent in Ireland.[2]

Due to the bias inherent in German long term lending, it is likely that the number of uncollateralised loans in Ireland is higher than it appears. This is due to the fact that there are also long term loans present in the SFA (1989) sample which would tend to distort the result since long term loans are more likely to be secured.

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[2] See 1.3

Table 5.1.1 Comparison of uncollateralised loans by number in Ireland and Germany.

Research study	Total collateralised loans	Unsecured loans	Real estate	Mobile assets	Other	Business collateral	Personal collateral
Ireland *SFA (1989)*	80%	20%	NA	NA	24%	36%	19%
Germany *Drukarcyk*[1] *(1985)*	79.5%	20.5	26.9%	34.4%	3.8%	NA	NA

[1] In the case of Drukarcyk et al (1985), medium and short term loans are examined. Medium term is a loan of 7 years or less..

Despite the limitation imposed by the fact that Drukarcyk's (1985) sample refers to loans of between 1 and 7 years while the SFA survey (1989) does not distinguish among loans of different duration, the evidence suggests that a similar proportion of lending is unsecured in Germany and Ireland.

5.2 Comparing the ratio of collateral to loan for selected types of collateral

As was discussed in the last chapter, bankers were asked to supply information relating to the frequency of use of certain types of assets used to secure a loan weighting. They were also asked to assign a weighting which relates to the capacity of this asset to cover a loan. A high weighting of close to 100 percent such as in the case of cash balances held at the bank, could be indicative of the ability of the bank on disposal of the asset to realise the value of the loan principle. If many respondents gave a similar set of weightings to a certain asset this could suggest that this asset is one which could be readily liquidated and its value realised by the bank.

A high value could also suggest that the individual bank in question pursues a less conservative lending strategy and is prepared to extend the small business owner a loan on less onerous terms. This alternative interpretation of a high security value would arise if the same series of bankers interviewed followed different guidelines concerning the evaluation of an asset to be used as collateral.

Three of the four Irish bank representatives participating in this survey could not assign weightings to the different types of collateral used in securing a loan. One of the banks ventured an estimate as to what extent an entrepreneur's house could cover a loan. In other words, an entrepreneur's residence valued at £100,000[3] by a bank could be taken as security on a £50,000 long term loan for fixed capital purposes by one bank vis a vis another bank's policy of taking an equivalent asset as security on a loan of £40,000. In the former case, the bank pursues a more conservative lending strategy which is demonstrated by a collateral to loan ratio of 0.5 compared with a lower ratio of 0.4 in the case of the latter bank. This example is intended to illustrate how different bank assign collateral to loans.

The reticence of Irish bankers in providing estimates as to the ability of collateral to secure a loan differed from the responses of German bankers who cited parameters which indicated the ability of various classifications of collateral such as residential property and charge on debtors to secure a loan. The weightings relating to residential property can be translated into collateral to loan ratios. These in turn, as shall be seen at a later stage, will be employed in a comparison between ratios exhibited in Ireland and those evolved from the author's interviews with German bankers. **Tables 5.2.1a.**

[3] Net of a margin detracted to account for expenses incurred on the disposal of the entreprensur's home

Table 5.2.1a Weightings of selected assets used as collateral in Germany and Ireland

German Bank	Collateral cover of house	Duration of loans covered by house
Head Office of a main bank	45 - 64%	NA
Branch of a main bank	approx. 60%[1]	-
Regional guarantee bank	60%	-
Head office of savings bank	up to 60% 80% on good house?	Long term loans
Branch of savings bank	up to 80%	Long term and short term loans
Branch of savings bank	60%	Long term loan
Regional head office of cooperative bank		
Branch of cooperative bank	48% approx[2]	-
Regional bank head office	48 - 58%[3]	Long term
Regional bank head office	up to 80%?	-
Branch of regional bank	54% - 72%[4]	Short term and medium term

Irish Bank	Collateral cover of house[5]	Duration of loans covered by house
Headquarters of main Irish bank	50%	Long term but also for working capital loans

[1] 75% of the market value assuming a market value of 80%
[2] 60% of loanable value which is 80%
[3] 60% market value assuming market value of 80 - 90%
[4] 10% deducted for risk. 60 - 80% of the remainder.
[5] Irish bank does not favour taking house because of "adverse image"effects. It is bad policy to rely on an asset which is not frontline security

German bankers also indicated the nature and purpose of such a loan i.e. short term for working capital purposes.

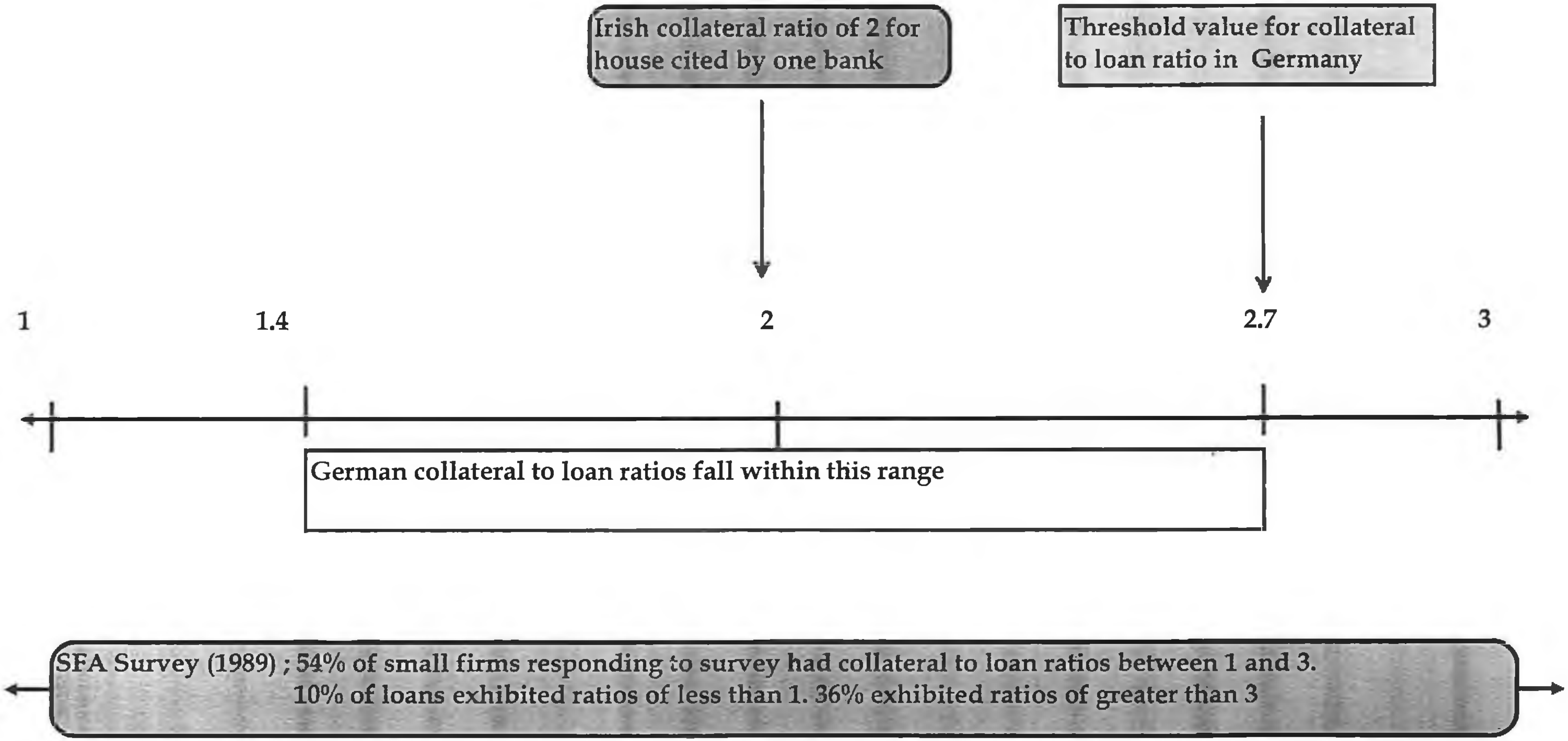
Despite the fact that only one bank of the four Irish banks provided a tentative estimate as to the capacity of an entrepreneur's residence to cover an advance from his bank, this setback could be overcome by referring to the same study mentioned earlier in which the SFA investigated inter alia the collateral to loan ratios of small, Irish businesses. This is another instance of a survey of small enterprises being sourced to supplement research on the banks.

The weightings supplied by the German banks were converted to ratios which permitted comparisons with ratios obtained by the SFA in 1989.

The weighting assigned by an Irish bank of 50 percent indicating the adjusted value of residential property to cover a loan translated into a ratio of 2. In other words, a house with a market value of £100,000 could be used to secure a long term loan of approximately £50,000. This was also included for purposes of comparison with the German ratios. **Figure 5.2.1**

It can be seen that the SFA ratios show a wider spread than the German values. The SFA ratios fall along the continuum from "less than 1" to "greater than 3". 51 percent of Irish firms exhibited ratios of between 1 and 3. According to the

Figure 5.2.1 Comparing the results of the collateral to loan ratios of German banks with Irish ratios from the SFA survey (1989)



SFA (1989) survey, a minority of Irish loans estimated at 10 percent were secured by a proportion of collateral equal to or less than the value of the loan.

None of the German banks interviewed secured loans in a 1:1 collateral to loan proportion. All spreads cited by German bankers fell within the comparatively narrow range of 1.4 and 2.7.

Similarly, the one Irish bank which complied by providing a weighting, cited a value which fell within the 1.4 to 2.7 parameter.

The guidelines governing the lending latitude of the co-operative bank sector, which in turn are dictated by the provisions of the Kreditwesengesetz[1], stipulate a maximum ratio of 2.7 times the amount of collateral to loan. This legal provision means that, in the case of real estate valuations, that the proportion of collateral to loan cannot exceed this collateral threshold level.

As will be discussed in the section dealing with the implications of this research, the fact that collateral has ceased to be ranked as the second most important concern by Irish small enterprises since the SBA survey in 1989, indicates that in the interim, Irish banks have become more accommodating in this respect.[4]

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[4] See 5.7

Before embarking on a description of the types of collateral used to secure loans in Germany which are not used in Ireland, a brief description of how German bankers assign collateral weightings follows.

The legal provisions which govern the amount of collateral a German loan officer can take on a loan are delineated under Article 18 of the Kreditwesengesetz. As mentioned earlier, these provide for a maximum collateral to loan ratio of 2.7.

The procedure for allocating collateral to loan is as follows.[5]

Firstly a market value for residential property is established by reference to a statistical price index which is circulated to all credit institutions.

Following this, a deduction is made from this market estimate to account for the processing costs and the event which could arise of a depressed auction price should the bank be compelled to liquidate the asset. No German banker cited a deduction exceeding 20 percent of the market value. The various deductions are made in accordance with the quality of the type of residential property in question. **Table 5.2.2**

[5] This procedure is one used by the co-operative banks and complies with the 2.7 threshold level. It is illustrated in the handbook circulated to their members entitled, "Handbuch der Genossenschafts- und Raiffeisenbanken", 1995

Table 5.2.2 Calculating value of assets for loans[1]

Property Description	Market Value Deductions	Loanable value deductions
Residential property		
New houses at most 20 years old of solid constructions and large proportions of contempory building style in middle to upper class districts	80% of the loanable value	0 - 10%
Buildings older than 20 years of age	"	5 - 15%
New buildings of less sophisticated construction, in less favourable locations	"	5 - 15%
Social welfare buildings	"	5 - 15%
Commercial Property		
Commercial and semi - commercial property	70% the loanable value	0 - 10%
New multipurpose buildings, at most 10 years of age in stable locations	70% of the loanable value	10 - 20%
Buildings over 10 years of age	60 - 70% of the loanable value	10 - 20%
New buildings with restricted functions in less favourable locations	60 - 70% of the loanable value	10 - 20%

Source: Extract translated from ",Handbuch der Volksbanken und Raiffeisenbanken", January 1993 edition.

[1] According to Article 20, Section 2 of the German Banking Regulations

With respect to the deductions made by co-operative banks in this example, it is clear that an entrepreneur possessing a well built house of less than 20 years old in a good location could leverage marginally more finance from the bank than an entrepreneur possessing a social welfare residence. In the case of the former the proportion of collateral to loan could be at most 1.38[6] and in the case of the latter 1.5[7]. The fact that the entrepreneur in possession of a social welfare residence has to place proportionately more collateral at the disposal of the bank reflects the higher disposal cost of such a residence.

It is also apparent that the value of residential property as an asset is easier to realise than that of commercial property. This is reflected in the fact that deductions of at least 30 percent are made on commercial property compared with 20 percent in the case of residential property. These deductions from the market value of the asset increase in the case of old premises or premises which require conversion before being reused.

German bankers cited a maximum deduction of 20 percent in the case of residential property. However, there was less unanimity in the value of cover each residential property could provide as security for borrowed funds.

Table 1.2.1a.

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[6] 100/100-10*0.8
[7] 100/100-15*0.8

To cite a case in point, the head office of a large German bank with its office in Frankfurt operates within a band of 45 percent to 64 percent of the loanable value for residential property. Converting this into a collateral to loan ratio following a 20 percent deduction from the market value evolves a ratio of at most 2.8.

On the other hand, a branch of a co-operative bank pursues a more lenient policy. This bank cited a value of 48 percent of the loanable amount. The loanable amount is again 80 percent of the market value. This bank cited a value of 48 percent of the adjusted market price or loanable value. This converts to a collateral to loan ratio of 2.6. This bank could legitimately request marginally more collateral because it has not yet reached the 2.7 collateral to loan ceiling.

There was consensus among all German bankers as regards the importance of residential property as collateral. This signalled, according to one German banker, the "commitment" of the entrepreneur to the project.

Low house ownership figures in Germany imply that, despite the desirability for German bankers of taking a charge on an owner's residence, from the perspective of German bankers, its availability as an asset was restricted. A representative from a savings bank in Baden Württemburg indicated that in the case of start ups, 90 percent of entrepreneurs live in rented accommodation.

One can conclude that, although the house is regarded as being an important asset in Germany which can be used to secure a loan, in reality most bankers are precluded from applying this measure due to low residential ownership figures. This is particularly true in the case of younger enterprises.

Both Irish and German bankers[1] alluded to the adverse image effects arising when a bank auctions a house[8]. For this reason it was thought more expedient to observe cash flows and the qualities of management than resort to using an owner's residence as security.

All German bankers expressed suprise at the decision of Irish bankers not to use the entrepreneur's residence as collateral under several schemes[9].

IBIS intimated in 1995, that Irish banks had agreed in principle not ask for the family home as collateral.[10] According to one Irish bank, a value of 50 percent was placed on the proprietor's home but that his bank did not favour taking a charge in practice due to averse image effects. Protracted legal disputes made using an entrepreneur's house as collateral more tedious.

The Enterprise Development Units which ensure close surveillance of fast growth firms with potential do not require guarantees either. A representative

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[8] Edwards and Fischer (1992) noted that this was especially true in the case of the savings bank and co-operative bank sector due to the presence of their close community ties.

[9] Examples of such schemes is the Access to Finance Scheme administered by the 4 main Irish banks and which is described in 1.4.1

[10] Management. "Angel or Devil?. 31. January, 1995

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of a German savings bank expressed an interest in such a venture. A communication from the German savings bank association announced the proposed introduction of such Units on a pilot scheme in September, 1996.

The views of Irish banks regarding taking a charge on residential property were at variance with those of German bankers. None of the German bankers interviewed hesitated to emphasise the usefulness of an entrepreneur's house as collateral since it signalled the owner's personal commitment.

The next item of collateral which German bankers rated was that of taking a charge on the book debts of the small firm. This was assigned a minimum weighting of 0 to 20 percent by a private bank in Stuttgart and a maximum weighting of 80 percent declared charges as opposed to undeclared charges by a local branch of the Dresdner bank. An average value seems to lie in the range of 25 to 30 percent. **Table 5.2.1b**

The taking of a charge on book debts of a company was proposed by the Government Task Force in 1994 as a way to supplement the Enterprise Loan Scheme. For this reason it was imperative to establish how German banks which are not precluded from using this facility rate this category of collateral. It was also deemed useful to establish the duration of loans for which a charge on book debts are most frequently used.

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Table 5.2.1b Weightings of selected assets used as collateral in Germany and Ireland

German Bank	Collateral cover of charge on debtors	Duration of loans covered by charge on debtors
Head Office of a main bank	100% of net value[1]	-
Branch of a main bank	60- 70%	Current account
Regional guarantee bank	20 - 50% average 30%	-
Head office of savings bank	up to 80%	Medium term to long term loans
Branch of savings bank	up to 80%	-
Branch of savings bank	up to 80% on open (declared?) accounts undeclared are worthless	-
Regional head office of cooperative bank		
Branch of cooperative bank	depends on creditworthiness of accounts	-
Regional bank head office	80% on an open (declared)[2] 50% on a still (undeclared) account	Short term loans
Regional bank head office	10 - 50% Sometimes 0%	
Branch of regional bank	0 - 40%	Short term

Irish bank	Collateral cover of charge on debtors	Duration of loans covered by charge on debtors
Headquarters of Irish bank	52.5% - 60%[3]	Short term lending

[1] This net value is unknown

[2] Evidence from another bank affiliate puts the value at 40%. This depreciation on the value of book debts has been prompted by poor payment by debtors and the recession

[3] This main bank with large operations in Ireland lends using charge on debtors in the UK. The weighting amounts to 75% of book debts but a charge can only be on average applied to 70 - 80% of a firm's portfolio

The representative of the four main banks in Ireland which conducts most of its operations overseas, mentioned that his bank already took a charge on book debts in Northern Ireland and the UK. He cited a weighting of 75 percent for this facility. This 75 percent weighting refers only to the accounts in the small business portfolio which are viable. This would mean that on average the weighting applies to 75 percent of between 70 and 80 percent of the small firm's portfolio. A small business could expect on average to secure a short term loan of £1000 having between £1604 and £1904 and worth of debtors. This average weighting of 56 percent on the portfolio of a business compares favourably with selected estimates from German banks which are delineated below.

There is evidence that databases which keep a current tabulation of a company's debts are extensively used in Ireland.

"Many small customers even with a wide customer base have a computer debtor system. These provide the bank with monthly statistics on the age profile of the debts[11]"

The values cited by German banks for a charge on debtors are low. It follows that with an average value of 25 percent [1], trading assets of a small business to the value of £1000 could expect to leverage an overdraft or short term loan to the value of £250. Evidence from the German bankers suggests that due to the fragmented and not so transparent nature of many small businesses trading

[11] Lending officer from international bank with large operations in Ireland.

accounts, the monitoring of individual debtors by banks is not cost effective. For this reason, book debts were never used alone as collateral but rather to supplement some other collateral item such business assets. As one German banker stated;

"It (a charge on debtors) is used as an indicator of the health of the firm to leverage short term debt. This is because of the immense portfolio risk in the case of a small firm which has only a few debtors. Daimer Benz, for example has a much wider spread of risk. The individual accounts are too time consuming and expensive to monitor[12]".

The evidence of several German bankers indicated that their relative importance as an asset has diminished in recent years. One large German bank in Munich discounted the value of book debts from 40 percent to 20 percent which represents a considerable decrease in their value as collateral. This is largely due to the impact of the recession, whereby payment periods have lengthened. The trend towards downward revisions of company book debts in the case of small companies in Germany has been precipitated by delayed payment periods which is most profoundly felt by smaller enterprises which have less bargaining power. **Table 5.2.3**

To conclude this section dealing with security on loans, reference is made to the criteria which German bankers employ in assessing loans. How weighted are they in a decision where a firm may have adequate cash flow but inadequate collateral with which the loan can be secured?

[12] Employee of a Stuttgart savings bank responsible for clearing operations

Table 5.2.3 **Average Payment Periods (all enterprise sizes)**

	Average Days		Days to Payment					
	1993	1992	7 - 14 %	15 - 29 %	30 - 59 %	60 - 89 %	90 - 119 %	120+ %
Germany	43>	34	15	37	40	6	1	1
Ireland	56	56	3	8	41	35	11	1
EU Average	66	65	6	11	30	30	17	7

Source: Grant Thornton, European Business Survey, 1993 and 1994. Distribution of average days for 1992 only

The importance attached to collateral lies in the weightings accorded collateral in the bank scoring system. According to the loan scoring system of a head co-operative bank, individual borrowing characteristics are evaluated. According to the scoring sheet, collateral was assigned a weighting of 8/90. A loan is approved if the applicant attains 65 out of 90 points so collateral really do not impinge upon a lending decision.

The minor role played by security in Germany is also evidenced by Bannock and Doran (1992) who also conducted interviews with German bankers. A German banker had the following to say:

> "SMEs generate more sight deposits which, when built into the customer's calculation, can allow some shading in loan pricing. We pay more attention to the quality of management and not so much to the security, which in general downturn becomes less valuable anyway"[13].

This was also evidenced by Clements and Burns (1992) whereby German entrepreneurs were asked to rank the criteria by which German banks access loans. German SMEs with no more than 250 employees ranked guarantees in fourth place behind the value of overall assets of the business, the long term health of the business and interest and dividend cover. Owner managed companies which are more closely related to Irish small businesses in terms of size, ranked guarantees in second place.[14]

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[13] Bannock and Doran, 1990. P. 76

[14] See Chapter 2

5.3 Comparing default and specific risk provision rates of different type of small enterprises

The final section of the three sections presenting the results of interviews conducted with bankers in Ireland and Germany concerns the default rates of small enterprises.

Two indicators were used to estimate how liberal or alternatively, how conservative banks were in lending to small enterprises.

Specific risk provisions operate to cover a bank in the contingency that a particular firm fails. It is discretionary on the part of bankers in Germany. This amount is subtracted from the liability side of the balance sheet according to regulation 340g of the Kreditwesengesetz. The advantage of using specific risk provisions rather than general provisions is that they are directly related to the confidence a bank has in a particular firm or type of firm. Specific risk provisions are values which give an indicator of how enterprises themselves perform and the likelihood of them being able to redeem their loan from the bank.

General risk provisions represent aggregates and so it is not possible for instance, to isolate the component of risk related to start ups or young manufacturing companies. On the other hand, the clearing bank to the German co-operative banks in Baden-Württemberg cited the specific risk relating to start ups which is based on the historical default rate of such risky investments.

The component of the risk provision which covers the exposure of banks towards younger, technologically innovative small businesses, as in this case, would ideally be shown in isolation as opposed to it being contained in an aggregate provision.

It might be expected ad priori, that banks which are in receipt of government funds such as guarantee banks would exhibit higher firm default rates and specific provisions if their customer profile represented young riskier firms than a bank which operated on a more commercial basis.

Closely allied to the concept of specific risks is the magnitude of the default rate demonstrated by various banks. The extent of firms defaulting on their loans is a useful piece of information since it reflects both on the health of firms (attrition rate) and on the willingness of banks to finance "deserving" firms which may result in a riskier bank portfolio.

As explained in the Methodology, an Irish bank provided default rates for "normal" business risks and small riskier businesses which were catered f or by its Enterprise Development Unit. Both these estimates were presented to German bankers. It was envisaged that these inputs into the discussions would prompt them into giving indicators as to how their exposure to riskier customer groups such as growing industrial companies would be reflected in their provisioning. **Table 5.3.1**

Table 5.3.1 Responses of German banks to selected Irish banks' risk provisions and default rates

German Banks using Irish provisioning and fallout as proxy	Irish Fallout rate of; "normal credit risks" 1% of claims	"Special enterprise department risks" 3 - 4% of claims	Do you have a Special enterprise department?
Association of savings banks	NA	Irish rate higher	From 1.09.1996, pilot project to spearhead similiar enterprise units
Regional head of cooperative banks		Specific provisions could amount from 3% to 10% for start ups	No
Savings bank branch	German fallout higher	Irish maximum loss rate equivalent for riskier groups	
Branch of main bank	German fallout higher	German loss rate exceeds this for riskier groups i.e 6 - 8% of claims	No Each loan officer has palette of clients
District savings bank	German fallout lower 0.7% = breakeven point	Specific risk = 3% max.	See entry of savings bank association
Head office of a main bank	Irish fallout higher 1995 fallout = 0.21%	Irish fallout higher	
Cooperative bank branch			Department which deals with small businesses in general
Headquarters of main bank	German fallout lower	German fallout lower	
Guarantee bank dealing with SMEs	No normal customers	German fallout is 3%	Clients correspond to clients of Irish banks' special enterprise departments

The results can be interpreted by aid of diagrams.

Figure 5.3.1

It can be seen that the Irish Enterprise Development Unit sustains a small firm loan default rate amounting to between three and four percent on loans.

According to the responses of German bankers, 37.5 percent of these banks incurred less loan fallout than these Units while 37.5 percent of German banks incurred a fallout equal to that sustained by the Unit[15]. A minority of German banks, corresponding to 25 percent of those responding to the question, sustained a firm default rate greater than that exhibited by the Enterprise Development Unit.

Comparisons could then be made between the fallout of riskier small business categories witnessed in the Enterprise Development Unit of one Irish bank and that corresponding to the default rate on "blanko riskio" small businesses in Germany. This description of a "know how-no capital" enterprise in Germany corresponds approximately to the definition of firms which have been enlisted into the Enterprise Development Unit. In other words, "blanko risiko" implies a firm with a high proportion of intangible assets but little to offer a bank in terms of tangible assets with which to secure a loan.

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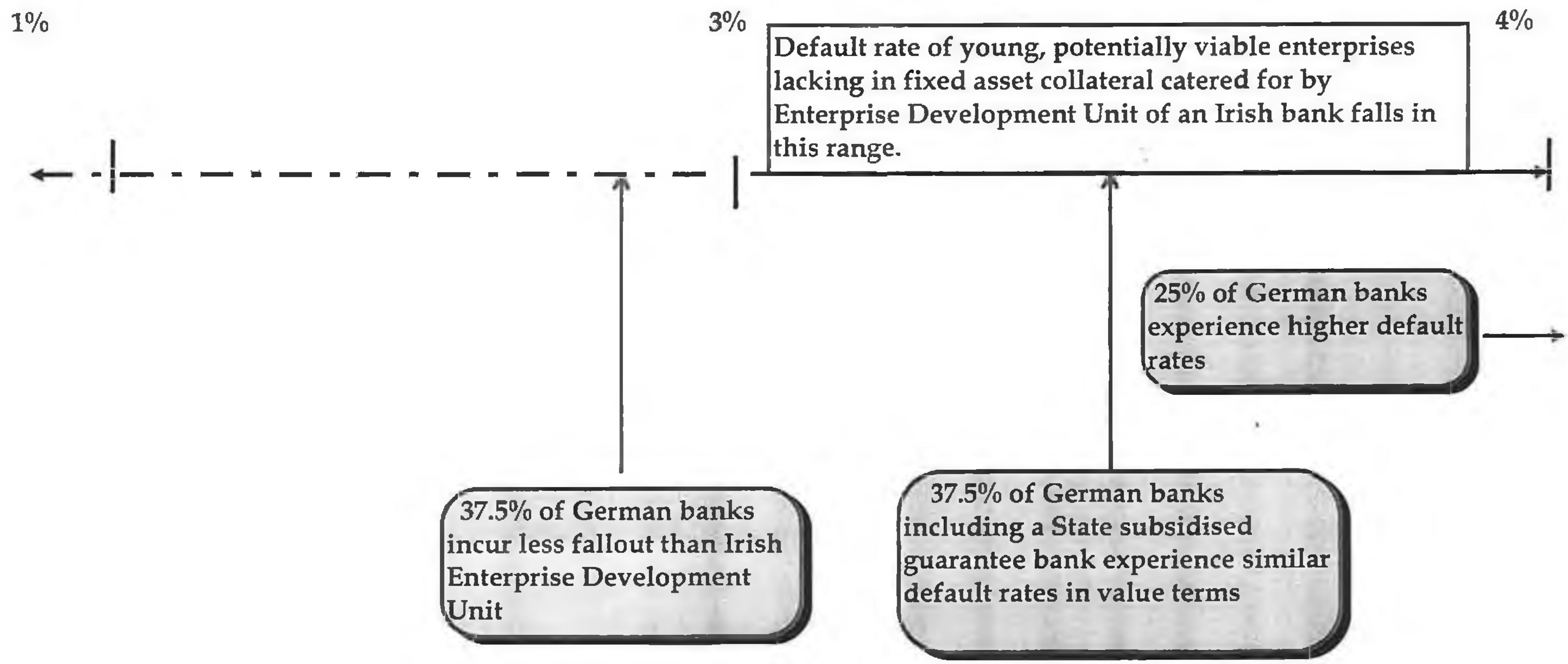
[15] Since German banks do not have Enterprise Development Units, German bankers were asked to refer to specific loan provisions or fallout rates covering their exposure towards riskier, small enterprises. Figures cited by German bankers invariably did not distinguish between fallout thresholds as in the case of Irish banks but rather referred to an aggregate threshold.

Figure 5.3.1 Default rates on riskier, small enterprises with growth potential



The majority of German banks, corresponding to 75 percent manifested loan fallout on their advances to riskier small businesses which was equal to, or less than that exhibited by the Enterprise Development Unit.

A suprising fact to emerge was the disparity in response rate between branches of big German banks and their subsidiaries. One branch of a big German bank experienced a fallout on its portfolio of advances to small, local companies of between 6 and 8 percent. The reason why this is suprising, is that big German banks such as the Dresdner, Deutche and Commerzbank are typically believed to be more conservative in their lending compared with savings bank and co-operative banks[16]. The two head offices of big banks which responded to the question concerning fallout did not incur fallout rates on loans to small businesses equal to that of the Irish bank in this example. Similarly, the local branch of one of these banks incurred a fallout rate far in excess of that exhibited by its Frankfurt head office.

This suggests that the branches of big banks in Germany may pursue lending policies divorced from their head offices. Less conservative landing practices among local banks, including savings banks and co-operative banks was corroborated by a representative of a Chamber of Commerce in the Baden-Württemberg area. He contended that in times of recession such local banks had taken more risks than big banks in supporting small enterprises.

[16] Edwards and Fischer, 1994

The fact that loan officers at German savings branches have discretion to sanction loans of up to 2.8 million DM (£1.75 million approximately) compared with a discretion of £50,000[17] in certain instances in Ireland facilitates this autonomy. Whether this is desirable or not, is a separate issue.

With respect to "normal business customers" or corporate borrowers posing "normal commercial risks", estimates of three Irish banks are available for comparison with German banks. The first Irish bank had an upper limit for loan fallout of 1.2 percent of loans by value, the second 1 percent while the third bank, which on its own admission had a high cost to income ratio demonstrated a value of 0.93 percent of advances which corresponded to its upper limit. **Table 5.3.2**

These values were elicited from Irish banks by asking them if they could sustain a fallout of 0.93 percent on a guaranteed loan. This loan would entail a 70 percent government subsidised guarantee similar to the guarantee administered by the Small Business Administration (SBA) in the US[18].

The Irish banks' fallout on normal credit risks corresponded to that of German banks. Of those German banks responding to the question; "Do you incur a

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[17] Estimate cited by Mr. Felix O'Regan from the Irish Bankers' Information Service. Management. "Angel or devil?". 01 January, 1995
[18] A description of this guarantee is given in Kinsella, 1995. Irish Banking Review. P.29

Table 5.3.2 Responses of Irish bankers to 70% US Small Business Association Guarantee

Bank	3.1% Special Unit Guarantees at 70% (loss 0.93% of claims)	Loss rate threshold	Reservations about guarantees	Suggested modifications to scheme
Bank 1	Yes	NA		
Bank 2	Yes. Would be happier with 85% cover = 0.46% loss instead of 0.93%	1% (in riskier cases 3 - 4%)	Suspects that administration costs not included in 3.1%	
Bank 3	Yes. Could sustain this guarantee	1.2% of claims	In use in the UK but underused due to excessive red tape. Problems with indivisibilities regarding collateral. Businesses tend to find 1.5% premium prohibitive	UK tiered system of 85% cover for start ups and 70% for development capital
Bank 4	Yes (Cost to income ratio high in this bank)			

higher or lower firm fallout rate on loans to corporate borrowers which constitute normal commercial risks than one percent of advances?", three sustained higher fallout while another 3 incurred lower fallout.

It is not suprising that one of the guarantee banks which supplied information which related to its provisioning against general risk, cited a percentage far in excess of the parameter cited in the questionnaire. With 5.3 percent of outstanding loans being set aside to defray against the risk of firms defaulting on their loans, this bank confirms with the notion of bank which have a state mandate supporting higher risk. According to a representative of this bank; "The guarantee bank has a level of loan defaults higher than the 1 percent breakeven point (breakeven point of Irish bank). This is because this bank does not have any "normal customers". Its customers are essentially those whom a normal commercial bank would refuse a loan because of a lack of security".

This would seem to substantiate the proponents of interventionist policies who argue for the nurturing of "deserving cases".

The head offices of two big German banks did not yield figures comparable to the Irish figures for fallout on loans. One cited a threshold level of 0.7 percent and another 0.21 percent although this can change on an annual basis[19]. In other

[19] Head office of a big German bank. Default rates for 1993 and 1994 were 0.3% and 0.29% respectively. These default rates refer to all businesses, including larger corporations and therefore the component relating to smaller, riskier enterprises would most likely be higher. However, smaller, riskier enterprises do not comprise a large proportion of their lending. (Edwards and Fischer, 1994)

words, a threshold level of 1 percent in Ireland was considered by head offices of two large German banks as comparable to liberal.

Again the response of the German branches of big and other banking types seems to differ on the maximum allowable loss rate on outstanding loans. A branch of a main bank and a savings bank claimed to experience higher fallout on loans.

5.4 How German bankers and economists evaluate high gearing levels and long term lending

Long term lending facilitated by house bank relationships is one of the most frequently cited reasons in the literature as to why German banks can overcome the risk of the firm moving off to another bank following heavy investment by the original housebank. Much of this debate has also revolved around the proximity of the savings bank and co-operative bank branches to the customer.[20]

The first comment to make on the issue of long term lending is that German bankers are indisputably long term lenders[21]. However there had not been unequivocal support for this practice of long term lending even from experts engaged in the area of research into SMEs. To cite from Kaufmann and Kokalj (1995)[22] who examine this issue of Government intervention;

"A weakening in the stipulation by the banks for owner's equity over the past few years can be the consequence of an efficient system of credit appraisal

[20] See 1.4
[21] See 1.2
[22] Report commissioned by the Institut für Mittelstandsforschung (Institute for SME research)

by the banks. One the other hand there is the hazard that certain types of enterprise due to the presence upper risk limits and the reliance on established bank firm relationships, may be precluded from obtaining sufficient external capital. Risky proposals (Start ups, marketing expenditure and product and process innovation) fall through the financial net in particular when with inadequate amounts of owners equity with which to demonstrate their commitment and reduce the risk encountered by the bank. The banking system is not especially geared at financing enterprises with particularly high risk profiles. This particularly affects growing firms or firms whose assets do not consist of the traditional, calculable assets or whose working capital is not of the type normally used by banks as security. It is to be expected that the importance of intangible investments is to grow in the future (OECD 1995,a, S.29). The suitability of the German financial system through the system of universal banking remains to be evaluated (OECD 1995a)"[23].

The banks have been facilitated in this long term lending by Government through several measures. The most important measure which puts together a package for start ups and developing companies is the so called Eigenkapitalhilfeprogramm. This literally means the Programme for Development of Owners Equity. It shall be referred to as the EKH programme for brevity. This scheme is administered by a State Bank known as the Ausgleichsbank. In effect the programme delays the repayments of both principle and interest in order that the firm consolidate its resources at the embryonic stage. This scheme is of 20 years duration, for the first 10 years of which no repayments of the loan principle are made. The first two years are interest free after which incremental interest rates are charged to a period of six years. At the sixth year the level of successive interest rates over the remaining 14 years is decided[24].

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[23] P. 58. Kaufmann and Kokalj, 1995. Schriften zur Mittelstandsforschung, N.68.
[24] See 1.3

This package has a 50 percent State input when the contribution of the Chamber of Industry and Commerce is added to that of the guarantee bank. This scheme assumes a minimum of 15 percent owners equity, a level which startled two Irish banks because it was very low. The remaining 18 percent of the package is supplied by the house bank normally in the form of an expensive overdraft.

It has been said by bank sources in Germany that the downside of this scheme is that once start ups have been extended this finance package, that they are at maximum gearing and so it is difficult to obtain additional borrowing for the purposes of working capital over the first few years of the scheme.

The existence of this very generous scheme may be one of the reasons why Germany boasts such a high proportion of start ups.[25] The low permissible owner equity levels have not only "startled" an Irish banker, however. Of the German bankers surveyed, the majority were not satisfied with levels of owner's equity in Germany. **Table 5.4.1**

It is interesting that of the two bankers who regarded a proportion of 15 percent owners with equanimity, one was the representative of a savings bank branch and another of a co-operative bank branch. In the former case, gearing was very flexible and contingent on the total balance sheet of the firm. If the balance sheet

[25] European Observatory for SMEs. First Report.

Table 5.4.1 Evaluation by German bankers of low equity levels

	Does a percentage of owners' equity of 15% for smaller enterprises in Germany cited by the Bundesbank reflect your experience?	Are you satisfied with the level of owners' equity?
Savings bank association	No	No
Regional cooperative bank	NA	Yes. 15% owners equity is alright.
Chamber of Commerce	No	No. Some start ups have 0 - 10% owners' equity. 50 - 60% would be more appropriate.
Local savings bank	Yes. Gearing is flexible. If firm has a good balance sheet there should be no anxiety.	Yes
Local big bank dealing with larger SMEs	No	No
Headquarters of a big bank	No	Yes
Local cooperative	Yes. It depends on the industrial sector. Ausgleichskapitalhilfeprogramm[6a] aims for 50% own capital over 20 years.	Yes. Bad cases are filtered out by the banks.
Guarantee bank dealing with smaller SMEs	Yes	No

[6a] This programme is administered by the State banks and aimed at start ups and young SMEs. It means literally, "Compensational Capital Assistance".

were in order, there was no reason to fear high gearing. In the latter case, gearing depended more on the industry concerned.

This could be interpreted to mean that in the case of partnerships of lawyers, doctors or accountants who may have a low amount of tangibles in the balance sheet but who otherwise have a prospering business, that higher gearing is tolerated. Concessions made by German banks towards partnerships who are also included in the definition of an SME must not create distortions.

This representative of a co-operative bank branch also pointed out that the EKH programme aimed at an entrepreneur attaining a level of 50 percent owners' equity within 20 years.

5.5 Are German banks more selective than Irish bankers?

There is reason to believe that German banks are just as selective as Irish banks in the event of advancing loans. A representative of a Chamber of Industry and Commerce maintained that in 1995, 50 to 70 percent of all start ups failed. In gastronomy which includes the hotel and restaurant industry failure peaked at 90 percent. This information can be put in context with the information supplied by a savings bank branch representative. This savings bank branch which is located in a predominantly tourism area, had an above average proportion of hotel and restaurants in his portfolio. Yet he maintained that only 40 to 50 percent of start ups fail. While this figure in itself is considerable, it does testify to the fact that being less than the industry average of 90 percent for the area of gastronomy, an intense filtering out of bad cases has been undertaken.

The issue of credit rationing can be investigated by referring to specific risk to default rates. The regional head office of a cooperative bank cited the case of a firm founded in 1990 having a provision for specific risk of 3 percent. According to this source, this provision which was arrived at by an external accountant at considerable expense[26] is unusually low. Most risk provisions in the case of start ups are in the region of 10 percent. Given that the average failure rate for start ups is 50 - 70 percent, specific risk provisions as low as 10 percent must indicate that quite a few bad cases have already been screened out. In other words, German banks must practice some form of credit rationing if one is to infer from the two cases above.

In Ireland there is more direct information which relates to screening by banks. Unfortunately this screening relates to all loans and does not isolate start ups as a separate classification. 69 percent of loan applications are accepted on first presentation and a further 14 percent are renegotiated.[27] It is to be assumed that many of the renegotiated loans are advanced albeit on less favourable terms on the part of the entrepreneur. One can also assume that the rejection rate for start

[26] Suggests that company has now achieved blue chip status if it can afford the cost of this report
[27] See 2.2. Internal report cited by an Irish bank.

ups is higher than for business loans as a whole since start ups represent one of the most risky transactions a bank could enter into. It can be said that more than 31 percent applications for start up finance in Ireland are screened out if the above assumptions hold true.

This discussion which relates to start ups has so far examined the result of bank decisions in issuing lending decisions. In other words it is necessary to change the causality and now examine the issue of whether German firms are perhaps more deserving of bank finance. It has frequently been said that the problem is not a dearth of finance but rather of good business projects.

Kinsella (1994) referred to the quality of business projects in relation to the reason behind the start up. Accordingly, entrepreneurs who have been made redundant or have never had a job may be compelled to start up their own business. This phenomenon which is known as unemployment push is less desirable from a banker's point of view. Alternatively, entrepreneurs who wish to exploit a business idea and who voluntarily leave a safe and pensionable employment in order to embark on a comparatively risk venture may find their business plans a subject of interest. Bankers therefore do try to ascertain if unemployment push or employment pull factors are present in an entrepreneur's proposal.

Some German bankers alluded to the fact that the present recession has prompted many start ups which have been motivated by employment push factors. Typically, start ups occur in easy to enter industries such as gastronomy why not suprisingly also exhibits the highest failure rate.

> "Because of the poor economic conditions, people with weaknesses are made redundant and try to set themselves up in business. They are not the best...Some services such as the hotel industry do not have this qualification (artesian "Meistertitel") and we have had bad experiences with them"[28].

Analogously, one Irish banker indicated that equity houses to whom his bank referred clients, signaled to him a lack of good projects in which to place their investment. These equity houses which or funds were not confined to larger enterprises but smaller companies in need of development capital.

> "Several venture capital companies have approached me looking for clients but there are no takers. These companies would also be dealing with small enterprises"[29].

A dearth of good projects does not appear to confined solely to Ireland but is on the increase in Germany as a result of the recession. This is true if one interprets a growth in unemployment push projects as being precipitated by factors other than the purely commercial.

It is true that in Germany great faith is placed by bankers in the artesian qualification. The artesian sector in Germany exhibits a very low attrition rate

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[28] Quote from German banker in district savings bank
[29] Quote from one of 5 Irish banks interviewed.

of 30 percent of start ups. Projects therefore, which are presented by entrepreneurs from this sector are given greater credibility than those without such a minimum qualification. The fact that German bankers fear the demise of this minimum qualification with the advent of converging EU standards, suggests that entrepreneurs may be screened by institutions other than the banks. For example the title of "artesian"[30] is only bestowed subject to the applicant meeting minimum standards set out by the Chamber of Industry and Commerce.

5.6 Comparison of branch discretion and bank monitoring

Loan officers at German savings banks have discretion to sanction loans of up to 2.8 million DM (£1.75 million approximately) compared with a branch discretion in Ireland of £50,000 in certain instances[31].

If it is true that German branches of main banks, cooperatives and savings banks are more autonomous than their Irish counterparts, it follows that they have more discretion to administer loans divorced from the decisions of a head office. As a corollary to this, it is possible for them to enter riskier transactions assuming that they can sink the costs involved in providing for risk through enhanced monitoring. This enhanced monitoring is facilitated via long term lending which ties the customer to the bank.

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[30] Handwerktitel

[31] Statement made by Mr. Felix O'Regan of the Irish Banking Information Service in response to criticisms made by Mr. Frank Mulcahy of the Small Firms' Association. "Angel or Devil?" Management. 31 January, 1995.

Clements and Burns (1992) made a valid point when they claimed that links in a German banking relationship are not as formalised or structured as one believed.
"Contact with the bank seemed informal with only 53 percent of firms sending them (banks) annual accounts (92 percent of owner managed firms) and only 26 percent sending them business plans or budgets"[32].

There is certainly greater control exercised by the loan officers of one main Irish bank who require firms accounts on a monthly or quarterly basis. Since this Department is only in its infancy and covers at most 2 percent of riskier (AA category) customers, one cannot argue that it is equivalent to house bank relationships in Germany which are a long standing part of German banking.

If this is the case, German savings banks and cooperatives will have to deploy all their informal information channels to survive the onslaught of the big main banks on their market share. On the other hand they may be anticipating the difficulties by initiating a pilot Special Enterprise Department along the lines of those operated by Irish banks.

Even though the Special Enterprise Departments operated by Irish banks cover in one case 2 percent of all riskier AA rated clients, the fact that firms are compelled to submit summarised accounts on a monthly or quarterly basis

[32] P.1. Clements and Burns, 1992. The relationship between German SMEs and their banks.

points to a formalised information channel which facilitates lending to riskier enterprises.

5.7 Relationship between small businesses and their banks

One of the reputed advantages of the German banking system which was presented in the first Chapter is the view that German banks nurture close links with industry in the form of dominant bank relationships called *Hausbankverhältnisse*. These dominant banking relations imply literally that a small business has a house bank which can command a premium interest rate in return for providing the firm with the security that if the firm is experiencing liquidity problems it can recourse to its house bank. The house bank relationship postulated by Fischer and Edwards (1994) and von Thadden (1990) represents a tacit understanding between the German firm and its bank.[33]

The imputed advantages of such relationships would imply heightened trust between the German firm and its bank in addition to lower monitoring costs. Enhanced trust would permit the firm more favourable conditions in securing a loan which could be reflected in lower collateral to loan principle ratios than would otherwise be the case.

The second advantage has economic implications. In a two period model, firms which can rely on the bank's continuing support will be more inclined to invest

[33] See 1.3

in their future in the knowledge that they can redeem the loan from returns accruing in the second period. Similarly a bank can afford to make the heavy initial investment involved when knowledge about the firm is scanty due to its security that the firm will not become opportunistic in subsequent periods and negotiate more favourable lending terms from competing banks. This two period analogy postulated by von Thadden (1990) can also be applied to the advantages associated with long term lending.

The costs of monitoring the performance of the small firm would be lessened due to heightened information about the activities of the firm occasioned by greater consultation between the firm and its bank. In return a small firm which had formed such an allegiance with its bank could be compensated for its loyalty by enhanced advice provided by German banks.

In order to recognise the existence of dominant banking relationships one would expect to witness lower collateral to loan ratios in Germany eased reporting requirements. A greater abundance of long term loans in Germany compared with the amount witnessed in Ireland would be expected to be a further testimony to the existence of close ties between German industry and their banks.

Finally, the intervention of banks at particularly precarious stages in the firms evolution typified by early stage investment and sustained investment when the firm slackened demand for its product in an economic downturn, are further indicators of such close ties. (Edwards and Fischer, 1994).

The existence of close ties in Germany appear in both the literature and interviews held with German bankers by the authors to prevail between small businesses and certain local German banks. These German banks belong to the savings bank and co-operative bank classification. From the banks' perspective, as shall be seen, opinion differs as to the desirability of these dominant bank relationships.

The existence of these relationships was substantiated by all the bankers interviewed by the author. Savings banks and co-operative banks which are, according to Fischer and Edwards (1994), the traditional lenders to small businesses, maintained dominant relationships with small businesses according to the testimonies of a representative of a Chamber of Industry and Commerce and a Government small firm research body. The former testified to their tenacity as lenders in the present economic crisis. Since bank commitment to a long term relationship is one of the tenets underpinning a dominant bank relationship, it follows that banks which consistently come to the assistance of small firms facing liquidity crisis come closest to the definition of house bank.

According to the representative of the small firm research body;

"It is true that savings banks are more committed on a local basis than their big bank counterparts. This is not suprising because savings banks belong to the community (depositors)."

Edwards and Fischer (1994) observed that banks reluctantly accepted the role of dominant financier since "good firms" or firms which presented good risks would prefer not lock themselves into such arrangements but seek bank finance in the firm of successive short term loans. In this manner, no bank could monopolise the credit extended to burgeoning small firm in successive periods but the firm could have the prerogative of bargaining down the price of future credits. As the authors observed,

> "Firms in the small size category which were performing well and were good risks from the banks point of view did not want to have dominant house banks because they desired competitive conditions for loans and wanted to prevent the influence of any one bank from becoming too large. The firms which were willing to commit themselves to a house bank relationship tend to be the financially weaker and less profitable small businesses...........Most banks interviewed were reluctant to seek a house bank position because such positions are sought after only by firms with lower creditworthiness and a need for shelter[34]".

The results of Fischer and Edwards (1994) survey do not unfortunately permit a cross section analysis according to the classification of bank. Evidence from the author's interviews suggested that savings and co-operative banks, were not averse to prominent bank relationships. Furthermore such close ties were presented by a representative of a local savings bank as its unique selling point

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[34] "Banks, finance and investment in Germany", Fischer and Edwards, 1994. P.137

to be deployed in stemming the incursions made by big banks into its small business territory;

"Deutsche Bank and other big banks are trying to get into the small business market. This is undermining the house bank relationship. Firms now have higher expectations from the banks. The advice offered by savings banks is superior. Savings banks have recognised the shift in the market and are trying to intensify relationships".

As stated in the preamble to this section, long term lending is facilitated by house bank relationships and in some cases may be a derivative of tacit links between industry and banks. As seen in the first Chapter, 42 per cent of all companies in Germany have long term loans exceeding 5 years while in Ireland the percentage was 13 per cent[35]. Although this data does not make distinctions between small businesses and larger corporations, it does suggest that time horizons are longer in Germany. This in term indicates higher commitment by German bankers in the long term welfare of their firms. Such long termism by German bankers was also exhibited by bankers interviewed by the author who stated that one of their primary concerns was the issue of company succession. In other words, with the demise of the owner, German banks wanted the firm to make provision for the continuity of the company through adopting a more permanent legal form. This concern was not mentioned by any of the Irish banks.

With regard to a bank's time horizons, evidence arising from interviews with German firms conducted by Clements and Burns (1992) reveals that 21 percent

[35] European Business Survey of SMEs, Spring 1994. See 1.3

of the firms believed that the banks operated with time horizons in excess of 5 years. In the absence of statistical significance and owing to the small sample number involved in the survey by Clements and Burns, it is more useful to regard the high percentages of long term lending revealed in the European Business Survey of SMEs, Spring 1994 survey as evidence of long term horizons in Germany. A derivative of long time horizons could be stable relationships prevailing between banks and firms.

A final indicator as to the role of savings banks and co-operative banks in catering for small businesses through dominant bank relationships is expressed in the testimony of a co-operative bank representative who justifies his bank's involvement with precarious young firms on the grounds that this customer may be induced to remain on in such an arrangement;

> "It is true that savings banks and co-operative banks are involved with start ups which are costlier and riskier. The justification for this is that, although we may not earn as much as the Deutsche Bank, one hopes that the costs can be recovered if the customer stays".

This contradicts a statement made by Fischer and Edwards (1994) to the contrary;

"Many banks clearly do not regard the somewhat higher rates they could charge if they were dominant house bank as sufficient to compensate for the greater risk involved in lending to these firms"

The authors refer to the theorem by J. Stiglitz and A. Weiss (1981) whereby investors prefer to ration credit than employ interest rate premia to defray the additional risk presented by riskier investments.

The dichotomy between what the author observed and the evidence of Fischer and Edwards (1994) could possibly arise out of the fact that certain banks such as savings banks and co-operative banks which cater for weaker small businesses cultivate close ties with small businesses. This would also corroborate with suggestions made by Fischer and Edwards that only weaker small businesses seek out banks which can afford them the security of a prominent bank relationship. The good risks have more leverage to bargain better conditions from across the banking spectrum and would be loathe to lock themselves into a house bank relationship.

What supposed advantage, if any, has the existence of prominent banking relationships in Germany over banking relationships in Ireland?

In the area of bank information, there is reason to believe that Irish banks are better informed than their German counterparts regarding some riskier small business segments. In the Bank of Ireland Enterprise Support Unit, participating firms are exhorted to present monthly cash flow statements.

On the other hand, the survey by Clements and Burns (1992) concluded that;

"Contact with the (German) bank seemed informal with only 53 per cent (of small firms) sending them annual accounts and only 26 per cent sending them business plans or budgets."

In the same survey, the authors stated that a higher proportion of owner managed firms in Germany corresponding to 92 per cent submitted annual accounts. In view of the fact that reporting requirements have been relaxed as of January 1996, whereby firms with up to 250,000 DM turnover[36] are required to submit such accounts compared with the previous threshold of 100,000 DM, the percentages supplied by Clements and Burns (1992) may overstate the proportion of small businesses reporting in Germany in 1996.

The same authors indicated that 65 per cent of German SMEs would only seek advice from the bank as necessary and a further 19 per cent would not seek it at all. One should not infer from this evidence that firms which are in a house bank relationship do not seek the advice of their bank. This is because the interviews conducted by Clements and Burns (1992) involved German businesses with up to 250 employees. Since Edwards and Fischer (1994) testify to the fact that larger, blue chip businesses in Germany tend to emancipate themselves from "close accounting relationships with principal bankers" and thence may supplant traditional bank advice with their own in house financial management techniques, it is likely that the independence of these larger

[36] Approximately £100,000

businesses is captured in the 19 per cent which do not seek a bank's advice. It is therefore plausible that small businesses which demonstrate close ties with their bank recourse to them for advice. In the absence of additional evidence, however, this conclusion remains tentative.

The presence of close ties between a bank and firm implies that collateral requirements can be relaxed than would otherwise be the case. The evidence of Burns and Clements (1992) does not testify to small businesses in Germany experiencing more lenient collateral conditions than their larger counterparts. In their 1992 survey, the smaller owner managed businesses believed that banks placed collateral in second place behind the value of the overall assets of the business. To cite from Clements and Burns;

"Firms were convinced that banks were concerned with the security of their investment and the long term health of the business was a secondary concern"[37].

This contrasts with the verdict of partnerships and businesses with limited liability in Germany which placed collateral in fourth place. Owner managed businesses in Germany were of the view that the banks demote the long term health of the business behind factors such as total balance sheet assets, collateral and interest and dividend cover.

[37] "The relationship between German SMEs and their banks" Clements and Burns, 1992. P. 3

Despite this reservation of owner managers in Germany concerning the lack of emphasis placed by banks on the long term health of the business, all businesses, including owner managed firms, believed that the banks would support them if they were in short term financial difficulties. Short term support does not necessarily translate into long term support in the manner of a prominent bank relationship.

In the absence of more substantial proof, it can be concluded that prominent bank relationships may be a characteristic of German bank practice. Such relationships may also be responsible or arise out of the prevalence of long term lending but the emphasis place by German bankers on collateral according to owner managed firms would tend to undermine this view. This emphasis on collateral by German banks challenges the house bank arguement which postulates that strong ties between firms and banks should partially dispense with the need for heavy monitoring of investments. A representative from a Government research body into the performance of small businesses in Germany confirmed the views of German owner managed firms that banks place emphasis on collateral in their lending transactions.

It cannot be concluded whether small businesses which are party to a house bank arrangement avail of a bank's advice or that this exclusive agreement would entitle them to consultancy by the bank. The author's own interviews indicate to the contrary. Banks interviewed confined themselves to advising their clients on financial issues but never on strategy. This reticence stems partially from the hazards of being held liable for extending bad advice and partially from not possessing any special qualifications in this area. This would support the view of Macrae (1966) who disputed that German bankers were "great innovating boffins" but had no particular expertise apart from their function as bankers.

As one banker from a savings bank articulated the view that it is incumbent on the small business to seek its advice from an institution other than a bank;
"Most firms from the artesian (Handwerk) sector do not avail of the services of an accountant. The bank cannot be expected to address this deficiency. The bank merely serves to give the business an impulse".

Clements and Burns (1992) summarise the investigation by Fischer and Edwards (1994) into the nature of the relationship between firms and banks in Germany as follows;

> "Recent research by Jeremy Edwards and Klaus Fischer challenges the conventional wisdom that German banks are more generous in their lending, more loyal and more involved with their business customers than UK banks, and suggests that the partnership between German banks and businesses is more loosely defined than is commonly supposed[38]".

[38] "The relationship between German SMEs and their banks", Clements and Burns, 1992. P. 4

5.8 Implications of the results

A comparison of uncollateralised lending in Ireland and Germany reveals that there is negligible disparity between the proportion of loans in both countries which are extended without guarantees. On the basis that the German survey by Drukarcyk (1985) does not take account of loans with a duration of more than 7 years, there is reason to believe that there is an even greater proportion of unsecured lending compared with Germany. This is because long term loans such as mortgages are generally secured by fixed assets and these are not included in the German estimates. Since the SFA survey in 1989, schemes such as the Access to Finance Scheme which waive the requirement for guarantees depending on the Irish bank in question which administers the fund, the value of uncollateralised loans in Ireland may be greater again.

It can be concluded that Irish banks are equally, if not more liberal than German banks as evidenced by the proportion of uncollateralised loans.

With respect to collateral to loan ratios in Ireland and Germany, Irish banks demonstrate wider variations than their German counterparts. This conclusion is made on the basis of comparing estimates from German bankers evolved from a series of asset weightings with the results of the SFA (1989) survey. The SFA (1989) survey indicated that 36 percent of Irish small businessess exhibited collateral to loan ratios in excess of 3. The highest German collateral to loan ratio corresponded to 2.7 since this represents a ceiling. This cap on collateral to loan ratios is imposed in Germany according to the provisions of the regulations governing credit institutions.

The only Irish bank which volunteered information on collateral to loan ratios cited a value which translated into a ratio of 2.2. This ratio fell within the spread of German collateral to loan ratios.

The relatively high collateral to loan ratios exhibited by Irish businesses should be put in context with two mitigating factors. The first relates to the time period in which the SFA (1989) survey took place. The late eighties represented a period of recession in Ireland which may have had a detrimental impact on loan security.

The second factor which should be acknowledged, is that personal guarantees have ceased to be accorded the same significance as a concern by smaller enterprises since 1989. The same SFA (1989) survey registered security as the second most important concern. In the intervening period since the SFA survey and that of Deloitte and Touche (1994), the issue of collateral has fallen in the list of priorities to occupy fourth place.

On the other hand, owner managed firms in Germany have ranked collateral as the second most important concern according to a survey by Clements and

Burns (1992). There is reason to believe therefore, that personal guarantees represent a more salient concern in Germany than in Ireland.

Another conclusion which can be drawn in the area of residential property and loan guarantees, is the issue of the owner's home. German bankers were suprised at the comparatively more lenient practice in Ireland of not taking a charge on the owner's home under the auspices of programmes such as the Enterprise Support Unit (Bank of Ireland) or the Enterprise Loan Scheme (Allied Irish Bank).

The comparative innovativness of the Special Loan Departments operated by the main Irish banks is reflected in the interest expressed by some German bankers in such schemes. The savings bank sector in Germany which has traditionally catered for the needs of small enterprises[39] demonstrated most interest. The Association of Savings Banks (Verband der Deutschen Sparkassen) has intimated that it envisages setting up similar Special Loan Departments on a pilot scheme at various locations throughout 1996.

In view of the fact that the Government Task Force on Small Business (1994) urged Government to repeal Section 115 of the 1986 Finance Act which gives the revenue Commissioners precedence over a company's debtors in the event of a liquidation, German banks were asked to express the value of such a security.

It is unusual that the Government Task Force suggested that the repeal of such a provision would alleviate a supposed dearth in long term bank funding in the context of the German bankers' experiences. A-charge on Debtor's was only used as supplementary collateral accompanied by additional collateral such as cash balances for overdrafts or short term loans. A charge on debtors was never used by German bankers to secure a long term loan.

The value of Charge on Debtors has diminished because of a disimprovement in debtors' days of payment registered by small firms in Germany. This has prompted one big German bank with its head office in Munich to diminish the value of such collateral by half.

The default rate of between three and four percent sustained by an Irish bank on riskier customer categories within its Special Loan Unit was greater than, or equal to the default rates of the majority of the German banks responding to this question. There is no reason to believe that Irish banks are any less capable of servicing younger or riskier small enterprises.

A German guarantee bank exhibited a fallout on loans similar to that of the Irish bank on borrowers in its Special Loan Unit. The Irish bank estimates that two to three percent of its riskier AA category borrowers are serviced by this Unit. In the case of the guarantee bank, one percent of all start ups in Baden Württemberg are allocated a guarantee from this bank[40].

It is interesting that a branch of a big German banks manifest higher firm fallout on its portfolio of advances. The head offices of two German big banks manifested a fallout on advances less than that of the Irish bank and considerably less than a local branch of one of these banks. This phenomenon whereby branches of big banks or banks at local level in Germany manifest more liberal lending policies is also evidenced in the literature.

German banks are indisputably better at long term lending than Irish banks. However, the traditional role of the banks in providing long term lending to the detriment of the owner's equity ratio has prompted anxiety in Germany regarding the ability of small businesses with low levels of owner's equity to withstand the recession in the light of potentially high interest rates.

A considerable proportion of German bankers interviewed corresponding to 50 percent were not satisfied with a percentage of owner's equity to market capitalisation in the case of small businesses amounting to 15 percent.

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[40] Calculation based on Annual Report of the "Bürgschaftbank Baden-Württemberg, 1994".

Similarly, none of the Irish banks interviewed perceived such high gearing to be advantageous from the point of view of bank or small businesses.

The responses of German bankers reveal them to be just as selective as Irish bankers in assessing loan applications. This selectivity has been intensified due to the incursions made by the recession in Germany. German bankers mentioned unemployment push factors as being the motivating forces behind amny start- ups in the services sector.

A comparison of a low specific risk provision pertaining to start ups in Germany in the context of relatively high failure rates indicates that better projects with a promising future are selected.

Figures referring to screening in Ireland indicate that approximately 14 percent of all loan applications are declined and are not renegotiated.

In the area of monitoring of loan applicants, there is evidence that Special Loan Departments operated by Irish banks practice more rigorous monitoring procedures than loan departments of German banks. Ongoing monitoring of applicants in Germany is not systematic based on the results of a survey by Clements and Burns, 1992. One cannot extrapolate from the practices which prevail in a particular department of an Irish bank however. This department only services the needs of 2 percent of risky AA category small borrowers. Due to the fact that German banks do not have Special Loan Departments which cater for riskier small businesses it is not possible to make inferences as to Irish banks being superior in this regard.

With respect to the relationship between small businesses and their banks, both the primary literature and the author's interviews with German banks indicate that close ties referred to as dominant bank relationships do exist in Germany particularly among local branches of savings banks and co-operative banks. Whether these ties are a derivative of or precursor to the large amount of long term lending witnessed in Germany is not clear. As seen in the first Chapter, 42 percent of all companies in Germany have long term loans exceeding 5 years while in Ireland the proportion was 13 percent. This data which does not make distinctions between small businesses and large corporations, nevertheless suggests that time horizons are longer in Germany. The long term view taken by Germany banks is also evidenced by the fact that several were concerned about the continuance of an unincorporated firm following the death or retiral of the owner. For this reason, some advice administered to small firms deals with making provision for the continuity of the company through adopting a more permanent legal form.

What is evident is that apart from the savings banks and co-operative banks who are involved in riskier small businesses, these close ties are not desirable from a banker's perspective since they are sought by weaker, less viable businesses.

There is no evidence to suggest that German house banks exercise influence over their clients or dispense strategic information. German banks justified this policy of withholding such advice for reasons of legal liability should the advice result in the firm taking a false decision and hold the bank accountable for the consequences.This policy of German banks not to advise firms on strategic and accounting issues is contrary to the widely held view that the relationship between German banks and their small business clients approximates a partnership arrangement.

There is similarly no evidence to support the view that close ties between German banks and their business clients culminate in relaxed collateral requirements. On the contrary, the survey by Burns and Clements (1992) indicated that owner managed firms in Germany believed that banks placed more importance in securing loans than on the long term health of the business. This undermines the widely held view that the long term health of a business in Germany takes precedence as a result of the long term horizons of German banks.

Irish banks have moved away from an emphasis on total balance sheet assets in the Special Loan Departments in lieu of assessing cash flow statements submitted on a monthly basis. German banks, according to the survey by Clements and Burns (1992) monitor their clients on an informal basis. 92 percent of owner managed firms submit annual accounts. Unfortunately the amount of ongoing assessment in the form of more regular cash flow statements was not quantified.

Finally the theory by Stiglitz and Weiss (1981) which postulates that banks would prefer to withold credit rather than extend loans covered by an augmented premium or additional interest charge to cover the risk involved in lending to a less creditworthy borrower undermines the desirability of prominent bank relationships from the banker's perspective. In reality, Fischer and Edwards (1994) observed that only weaker businesses willingly entered such exclusive arrangements where firms with greater potential preferred short term lending arrangements which presented an opportunity for improved lending terms on subsequent loans at later stages.

In general, the evidence suggests that Irish banks are more innovative regarding monitoring small firms under the auspices of Special Loan Units. They compare favourably with respect to their attitude towards not taking a charge on the owner's home in certain instances. This is at variance with the German banker's unanimous support for using an entrepreneur's residence as collateral. This reliance of the German banks on "frontline security" such as the entrepreneur's home further indicates that close ties between industry and business induce banks to treat firms more benignly than Irish banks with regard to loan security. However, there is reason to believe that in reality low house ownership figures in Germany limit serve to deny German banks the option of using an entrepreneur's residence as collateral.

Chapter 6 Conclusions

6.0 Introduction

The questions which were intended to be addressed by this study were set out in the abstract and introduction.

Each area with which this discussion dealt will be developed under the following headings:

6.1 The validity of commonly held beliefs about the superiority of the German banking system

6.2 A comparison of cash flow based lending of German bankers to smaller enterprises compared to that of Irish bankers

6.3 A conservative or liberal approach to lending

6.4 The relationship between small businesses and their banks

6.5 Implications of this survey

6.1 The validity of commonly held beliefs about the superiority of the German banking system

It has been seen that much of the literature which concerns the superiority of the German bank based system does not extend itself to the specific case of the German bank's dealings with smaller businesses. By smaller, one means SMEs with less than 50 employees and/or £3 million turnover. Some of the misconceptions which have implied the superiority of the German banking system have focused on the practice of such banks taking equity in industry.

Since an SME in German can have 499 employees and approximately £38.5 million turnover, the term SME in a German context is a misnomer. It follows that much of the literature dealing with banks and SMEs cannot be transferred to an Irish context where the scale of operations is much smaller. Approximately 33 percent of all SMEs in Germany according to the German definition of small enterprise have less than 50 employees[1]. In Ireland, 95 percent of non-farm enterprises are accounted for by small enterprises with less than 50 employees[2].

The assertion that German banks have an advantage over Irish banks in being able to monitor the performance of their small business borrowers through participation on supervisory boards cannot be substantiated. Only German Public Limited Companies (Aktion Gesellschaft) are required by law to have supervisory boards and companies with limited liability if their employee number exceeds 500.

The contention that the nature of German universal banks also confers them with benefits of monitoring can similarly be rejected. The advantage of being a universal bank implies that depositors entrust their shares in a company with a bank for safekeeping. This bank has the right to exercise proxy voting rights on behalf of the depositor and thus be in a position to influence the performance of the company. The fact that German banks are universal banks

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[1] Burns and Clements, 1992. Kayser and Ibielski, 1986
[2] Government Task Force on Small Business, 1994.

does not confer them with information or monitoring advantages in the case of SMEs since smaller German companies do not issue equity.

In the area of long term finance, it is my belief that assertions as to the long term view of German banks are not incorrect. German banks are indisputably better long term lenders. They also permit low level of owner's equity amounting to from 10 percent to 15 percent of a firm's capitalisation.

The survey revealed that half the German bankers were not satisfied with the levels of equity. None of the Irish banks interviewed perceived the high gearing levels cited for German banks by the Bundesbank[3] to be advantageous from the point of view of both the bank and the small business borrower.

Long term lending to small enterprises Germany is facilitated not so much by the commercial banks as by the Eigenkapitalhilfeprogramme which involves extending a 20 year loan. It is envisaged that the enterprise becomes sufficiently viable after this time to enable it attain a percentage of 40 percent owners equity to total capitalisation. In reality German banks interviewed are concerned with the fragile capitalisation of SMEs and their reliance on long term debt finance as a substitute for equity. A management of guarantee bank cited a proportions of owners equity amounting to less than 10 percent in the

[3] Deutsche Bundesbank, 1994.

case of start ups.[4] Other German economists have voiced concern about the ability of a bank based system which has accommodated high gearing levels in SMEs to withstand the recession.[5]

6.2 A comparison of cash flow based lending of German bankers to smaller enterprises compared to that of Irish bankers

Foley and Griffith (1993) urged the Irish bankers to practice the lending based on a cash flow rather than total asset basis. On the evidence of 20 interviews held with various German bankers at various locations in Germany there is reason to believe that they are no more oriented towards cash flow based lending than Irish banks.

It is the author's opinion that banks in Ireland have become better at cash flow lending and have already practiced such lending in Germany is based on the results of existing literature.

A comparison of uncollateralised lending in Ireland and Germany reveals that there is negligible disparity between the proportion of loans in both countries which are extended without guarantees. On the basis that the German survey by Drukarcyk (1985) does not take account of loans with a duration of more than 7 years, there is reason to believe that there is an even greater proportion of unsecured lending in Ireland indicated by an SFA survey (1989) compared

[4] See Note 7

[5] Kaufmann and Kokalj, 1995

with Germany. This is because long term loans such as mortgages are generally secured by fixed assets and these are not included in the German estimates.

It can be concluded that Irish banks are equally, if not more liberal than German banks as evidenced by the proportion of uncollateralised loans.

With respect to Ireland, two firm based studies in which the concerns of SMEs are ranked show a change in the prioritisation of collateral as a concern in the time period between 1989 when the SFA report was released and 1994, the period relating to the report by Deloitte and Touche. In the former report, collateral was placed in second place behind bank fees and charges as the second most important issue. In the latter study, collateral was assigned by firms to third place behind interest rates and bank margins.

Owner managed firms in Germany however, believed that guarantees were important to the bank in assessing loan applications. In contrast to larger German enterprises they were assigned to second place behind the overall assets of the business.[6] This implies that it is the belief of small, owner managed German firms that their banks attach more importance to securing loans than the long term health of the business. This is indicative of a transactions based rather than cash flow based attitude towards lending.

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[6] Clements and Burns, 1992

This firm survey in Germany carried out by Burns and Clements (1992) testifies to the cautious approach to lending exhibited by German bankers. This emphasis on security evidenced in the survey by Clements and Burns (1992) suggests that German bankers from the perspective of German firms take a conservative balance sheet approach to lending.

All banks interviewed in this survey professed to pay more attention to the cash balances of the firm. There is a marked dichotomy between what bankers say and what firms claim bankers actually do. For this reason, ratios such as collateral principle or gearing ratios can be more inferential about lending behaviour.

German bankers both in the savings bank and normal commercial bank sectors adhere to rigid guidelines[7] which govern the ratio of collateral to bank loans. There is reason to believe that Irish bankers observe less structured guidelines since only one of the five main Irish banks interviewed was in a position to provide an estimate on the ratio of collateral to loan. Irish bankers were reticent about providing estimates which indicated the valuation of collateral which was used to secure loans.

[7] Kreditwesengesetz

On the other hand German bankers had no difficulty assigning weightings to the following types of collateral; entrepreneur's house, charge on debtors' ledger, business assets, third party guarantees and various types of investments such as shares.

To compensate for the deficiency in data on Irish banks' weightings of different types of collateral, this analysis recoursed to collateral to principle ratios evolved from the SFA Survey (1989) and the evidence of one Irish bank which provided an estimate on the amount of principle which could be leveraged as a proportion of the market value of the business owner's house.

It seems likely that the issue of collateral is so regulated in Germany that collateral principal ratios in excess of 3 are never attained. The maximum collateral principal ratio is in the region of 2.7[8]. On the other hand, the SFA reported that 36 percent 1986 of small businesses exhibited ratios in excess of 3.

It would be imprudent to compare Irish figures pertaining to 1986 with German estimates one decade later. There is a need for more current quantitative estimates on collateral to principal ratios in Irish banks. However, the one Irish bank which cited a weighting of 50 percent which translates into a collateral principle ratio of 2 was not out of line with the

[8] Handbuch der Volksbanken und Raiffeisenbanken, January 1993

estimates of German bankers. Estimates varied between maximum of 2.7 and a minimum of 1.4 for collateral to principal ratios. The manner of deriving the value of the asset was very structured in Germany and involved the application of inflation adjusted property indices, discounting for risk and then the application of threshold levels of collateral to loan.

There is reason to believe that the Irish values for collateral to principle have improved since the 1989 survey conducted by the SFA. This is due to the fact that the 1989 survey predates the growth in impetus of the Enterprise Loan Schemes introduced in 1989 and the Access to Finance Scheme introduced in 1995. Several Irish banks have waived the collateral requirements under the auspices of Enterprise Development Units.

Furthermore, the fact that collateral as a concern of small business has fallen in priority in the time period between the SFA (1989) report and that of Deloitte and Touche (1994) further suggests that the securitisation of loans has ceased to be a primary concern of Irish industry and is in line with European trends. There is a need for further research in this area involving a larger sample size.

The one Irish bank which supplied an estimate of the valuation of collateral demonstrated that, at least in the case of his bank, the collateral to loan ratio was not out of line with the German estimates. The Irish value of 2.2 fell within the German parameter of 1.4 to 2.7.

One positive feature in favour of Irish banks is the innovativeness of their Enterprise Development Units. These were so innovative that the concept was unfamiliar to the German banks participating in the sūrvey. The Association of German Savings Banks (Sparkassenverband) in Bonn and a regional branch of a savings bank interviewed were aware of these incubator units. It was proposed to introduce such a pilot scheme in September, 1996.

The other positive feature of Irish banks lending practices is evidenced by the response of the German bankers to the Enterprise Loan Scheme introduced in 1989 which does not permit the taking of the entrepreneurs' house as collateral and the reduced use of personal guarantees. All German bankers without exception, were of the opinion that taking a charge on the house of a corporate borrower constituted a loss of "front-line" security. It was not unusual for German banks to take a charge on a house although the more local branches of savings banks were aware of the detrimental image effects the seizure of a house would entail by undermining their client base. However, the fact that only approximately 90 percent of entrepreneurs in start ups situations live in rented accommodation means that despite the importance attached this form of security by German banks, it essentially remains a security used in the area of bank finance for development capital in the case of more well established companies.

The Irish banks show themselves to be more progressive in relation to not taking a charge on the entrepreneur's house.

The Government Task Force Report (1994) urged for the repeal of Section 115 of the 1986 Finance Act which gives the Revenue Commissioners precedence on the book debts of a company in the event of a liquidation. In Germany, where book debts are used widely, they were not seen as being of much value. The fact that the book debts of a small enterprise comprise only several key accounts of larger companies some of whom may have placed a clause prohibiting the use of their debts as security means that sometimes the most valuable accounts have already been removed from the ledger and are not available as an asset on which could be placed a charge.

One Bavarian bank has recently diminished the percentage weighting on such book debts from 40 percent to 20 percent as a result of poor payment periods in industry in general. The use of book debts as security is only used to supplement existing collateral and applies only to overdrafts. The fact that the Government Task Force suggested that the repeal of Section 115 would facilitate the provision of long term finance is, in my opinion, misguided. It is to be envisaged that factoring in Ireland will continue to show the considerable growth exhibited in 1992 statistics[9].

6.3 A conservative or liberal approach to lending

The responses of German bankers reveal them to be just as selective as Irish bankers in assessing loan applications. This selectivity has been intensified due to the incursions made by the recession in Germany.

A comparison of a relatively low specific risk provision relating to start ups in Germany in the context of high failure rates indicates that better projects with a promising future are selected. This is because the risk provisions cited by German regional co-operative bank were lower than the small firm attrition rate.

Figures relating to screening in Ireland indicate that approximately 14 percent of all loan applications are declined and are not renegotiated[10].

In the area of monitoring loan applicants, there is evidence to suggest that Special Loan Departments of Irish banks practice at least, if not better monitoring procedures than loan departments of German banks. Ongoing

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[9] Associacion Espaniola de Factoring, 1992

[10] Internal bank survey, 1995.

monitoring of applicants in Germany is not systematic based on the results of a survey by Clements and Burns, 1992.

Guarantees from guarantee banks in Germany are not used very extensively in the case of start ups but confine themselves to development capital. 78 percent of guarantees in Germany are used for the purposes of development capital as opposed to 13 percent in the area of start ups[11]. However, all German banks found them a useful expedient in the case of riskier smaller enterprises which had good cash flow and good business plans but lacked tangible assets. These "know how - no capital" companies accounted for 9 percent of all guarantees.

It is my belief that such guarantees are facilitate banks in extending development capital. However, the German Laender system with each Land dispensing its own system of guarantees depending on the amount of private capital from industrial trade organisations invested in the guarantee banks cannot easily be transferred to Ireland unless there is a willingness by Government to accommodate a loss of 22 percent of the guaranteed amount[12]. In Germany funds from the European Restructuring Programme are used for this purpose. In my opinion, Ireland does not have a similar institutional

[11] Bürgschaftsbank Baden-Württemberg, Annual Report, 1994

[12] Buergschaftsbank Baden Wuerttemberg Gmbh. Mittelstaendische Beteiligungsgesellschaft Baden Wuerttemberg Gmbh; Geschaeftsbericht, 1994. SME Venture Capital and Guarantee Bank Annual Report, 1994.

framework comprising Chambers of Commerce and Guilds which would permit the adoption of the German system of mutual guarantees.

Of the 5 Irish banks interviewed by me, 4 signalled their willingness to enter into a scheme to the SBA system in the US. I do not see any aversion on the side of the Irish banks to supporting a 3.1 percent fallout rate on a loan which carries a 70 percent Government backed guarantee.

The second issue investigated was whether German banks incur more fallout on advances to small enterprises than their Irish counterparts. A higher fallout on the banks' portfolio could be indicative of the bank lending to riskier groups or being less likely to ration credit. Similarly, the level of provisioning for bad debts was explored, a high level being suggestive of a riskier lending strategy.

One Irish bank furnished a figure of 1 percent which related to its fallout on "normal"[13] borrower groups. It furnished a separate figure of 3 to 4 percent which relates to its fallout on riskier borrowers served by its Development Unit. Although many banks demurred to offer estimates on the level of their fallout simply because they did not know them or in observance of confidentiality requirements, of the 5 German banks offering estimates, 2 incurred a fallout higher than the Irish fallout for normal borrowers. One of

[13] All groups with exception of those in Enterprise Development Unit

these same 2 banks sustained a higher fallout for riskier borrower groups while the other sustained a fallout similar to the Enterprise Development Unit of the Irish bank. One of these 2 was the local branch of a savings bank and the other a local branch of the Dresdner bank. It is interesting that both of these banks operated at local as opposed to regional level. The branch of the Dresdner bank, which is a large German commercial bank incurred the highest fallout on its portfolio of advances to small customers amounting to 6 percent of all advances being unrecoverable. The interesting fact to emerge, a fact which deserves more empirical research in the form of a larger sample size, is that savings banks and co-operative banks are renowned in Germany for serving riskier elements of small business. If this hypothesis were to stand the acid test of reality, savings banks and co-operative banks would exhibit higher fallout on their advances than branches of normal, commercial banks[14] in Germany. This did not happen in this instance.

The other interesting comment which must be made regarding fallout on advances is that a guarantee bank sustained a fallout on its portfolio of advances of 3 percent. This fallout corresponds to the lower parameter of fallout on the portfolio of the Irish bank Enterprise Development Unit. It is my opinion that the Irish bank in question has served this riskier segment small enterprises better than its German counterpart. This Irish bank exhibits comparable fallout on its portfolio of "normal borrowers". It also serves a

[14] Such as the branch of the Dresdner Bank in this instance

segment catered for by a German guarantee bank. This German guarantee bank is in receipt of ERP funds which are used to compensate it for any losses it may incur. It is incumbent on the German guarantee banks to support riskier customers while the Irish commercial bank which serves the same palette of customers is not in receipt of government assistance on this scheme. It cannot be expected of Irish banks that they compete against German banks, given that German banks are facilitated by guarantee banks.

One may argue that the Enterprise Development Units set up by Irish banks cater for a minority of small enterprises corresponding to 2 to 3 percent of its total portfolio of advances to corporate borrowers. The loans in value terms guaranteed by German guarantee banks correspond to approximately 3 percent of all bank advances. Does this suggest that Enterprise Development Units in Ireland are fulfilling a function which is performed by guarantee banks in Germany? The author believes that they are, which if correct indicates that Irish banks have undertaken to enter into cash flow and relationship banking, since it was one of a limited number of options open to them when dealing with riskier small enterprises.

6.4 The relationship between small businesses and their banks

It would be reasonable to expect that close ties with a bank in the form of prominent banking relationships would give rise to lower monitoring costs and relaxed collateral requirements.

German banks are widely perceived to enjoy such advantageous terms which emanate from house bank relationships.

From the author's interviews, the local branches of savings banks and co-operative banks most closely approximated traditional house bank behaviour in that they proved more conciliatory when the firm was confronted with liquidity difficulties than their big bank counterparts. Their commitment to ailing firms extended only to firms with prospects of recovery. Firms which exhibited strategic, managerial or industry specific weaknesses were less certain of the continued support of their respective house banks.

The advice extended by Irish banks under the auspices of Special Lending Departments appears to be more clearly targeted than that of their German banking counterparts in that for example certain loan officers are designated as agricultural advisors. Although the merits of this system of demarcating information may have been disputed by Bannock and Albach (1991), the Irish system represents an effort to offer spectrally specific advice which is not evident in Germany.

Clements and Burns (1992) concluded that relationships between German businesses and their banks have a tendency to be informal although surveillance of owner managed firms which perhaps represent the smaller size categories is more intense. This is evidenced by the fact that 92 percent of these submit annual accounts compared with 53 percent on average.

In the Bank of Ireland Enterprise Support Unit, cash flow statements are submitted on a monthly basis by the firm. This close surveillance makes relaxed collateral requirements possible and most closely approximates "relationship banking" rather than "transactions cost" banking.

In view of the fact that German banks appear to have more relaxed reporting requirements than Irish banks, it follows that the emphasis on collateral or "frontline security" such as the entrepreneur's house could be used to safeguard the German banks against default by the firm. German bankers indicated that due to the fact that the accounts of a small business are not very transparent, such security is necessary particularly in the case of riskier enterprises such as start ups.

All German banks interviewed maintained that a healthy cash flow were the most important prerequisite to maintaining a loan, an assertion which is contradicted by German small firms who believed that German banks place collateral second on the list of priorities behind total balance sheet assets.

It can be concluded that perhaps local savings banks and co-operatives are most concerned about the long term health of small businesses in Germany since they are most instrumental in maintaining house bank relationships but that unlike in the case of Irish banks, there remains a heavy emphasis on personal collateral as a means to secure a loan.

6.5 Implications of this survey

The main conclusions of this survey could be enhumerated under the following three main points.

Firstly, assertions as to the extraordinary influence of banks in Germany over the performance of businesses via supervisory board representation which ensure equity participation by the banks in German firms apply to a limited number of German businesses. The legal requirement for supervisory boards assumes a minimum of 500 employees and is not invoked in the case of smaller businesses or partnerships of which there are many in Germany. Similarly, small firms in Germany, by virtue of their fragmented nature do not issue equity unless this takes the form of quasi equity in the guise of unlisted securities which are bought by Government guarantee banks in some instances.

Secondly, German banks have longer time horizons than Irish banks as witnessed in the proportion of firms with long term loans but this longer time horizons are argued by some industrial economists as not being desirable both from the perspective of banks as well as firms which present good credit risks.

In 1994, the percentage of long term loans amounted to 42 percent in Germany compared to 13 percent in Ireland. The similarly high proportion of State sponsored long term loan programmes amounting to 13 percent versus 1 percent suggests that the German Government facilitates commercial banks to a greater extent. An example of such a subsidised loan which is extended to start ups is *Eigenkapitalhilfeprogramme* or "Owners equity assistance programme". This entails a 20 year loan for fixed capital purposes with an interest moratoria and is largely State sponsored.

On the same issue of long term lending, evidence was presented by various other authors who argue that small businesses when analysed in a two period model would choose a short term loan and renegotiate successive short term loans in sequential periods at better terms. The theory postulates that businesses which present good risks would prefer not lock themselves into a long term credit contract with a house bank. This theory detracts from the much advocated value of long termism.

The final conclusion which can be made is the fact that contrary to expectations, even traditional house banks in Germany which are heavily involved with small businesses underlined the importance attached to collateral in securing loans. The Enterprise Development Units attached to Irish banks approximate most the idea of prominent bank relationships prevailing in Germany. These relationships are sustained based on enhanced information and cash flow as opposed to balance sheet or "transactions" based loan appraisal.

Due to competitive pressures in Germany between the traditional lenders to small enterprises represented by the savings bank and co-operative bank sector and banks which historically have focused on larger enterprises, an example of which being the Dresdner, Deutsche and Commerz banks, savings banks are anxious to adopt special units dealing with small, technological or enterprises with a high cash flow to tangible asset basis. These Units would perform the same function of the Irish Enterprise Development Units.

The fact that the German savings banks are now considering introducing such Enterprise Development Units suggests the progressive nature of Irish banks.

The unique advantage of the German banking system over the Irish system could lie in the assistance given the banks by guarantee banks, Chambers of Industry and Commerce and the Craft Chambers. The evidence from interviews held with these institutions and the banks themselves indicated a vast amount of co-operation from such industrial, self -help groups. The banks are not isolated players in Germany but one autonomous component in an organised, coherent whole.

It will be interesting to see if this structure will withstand the impact of the first deep seated recession to affect Germany since the beginning of the Second World War. The fact that the savings banks are already seeking to emulate the Enterprise Development Units indicates that the Irish banks whether consciously or not have set a precedent and are more innovative than has been acknowledged to date.

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Interviews were held with the following institutions in Ireland and Germany.
The names of respondants are not disclosed for reasons of confidentiality:

Allied Irish Bank	Executive from area of small business banking
Baden-Württembergische Bank At local level in BW	Loan officer
Bank of Ireland	Executive from Enterprise Support Unit
Bayerische Vereinsbank Münich head office	Loan officer
Cooperative bank At regional level in BW	Officer for industry and trade lending
Cooperative bank At local level in BW	Loan officer
Deloitte and Touche	Executive
Dresdner bank Local branch in BW	Corporate accounts officer
Dresdner bank Frankfurt head office	Loan officer in area of development finance
Forfas	Executive
Guarantee and Venture Capital Bank, BW	Loan officer
ICC Bank	Lending executive
Institut für Mittelstandsforschung	Representative of German institute for SME research in Bonn
Irish Bankers' Information Service	Director General
L-Bank Guarantee bank to BW	Development finance

Landesbank BW	Loan officer to larger SMEs
National Irish Bank	Executive from area of retail business
O' Riada Stockbrokers	Executive
Private German bank	Head of supervisory board and managing partner
Reutlingen Chamber of Industry and Commerce	Firm advisor
Savings bank At clearing bank level in BW	Corporate advisor and loan officer
Savings bank Bonn head office of association	Executive
Savings bank At local level in Hessen	Loan officer
Savings bank At local level in BW	Loan officer
Trustee Savings Bank	Executive from area of credit assessment
Ulster Bank	Executive from area of retail services
Warth & Klein Gmbh. Düsseldorf	Auditor

Appendix 4.2.1 Sample Irish Questionnaire

Draft Questionnaire

For Mr. X of the AIB bank.

- According to the Irish Bankers' Federation, in 1992 the main commercial banks have been losing 1 million per week on bad debts incurred by defaulting small enterprises. Has the attrition rate, in your opinion, diminished since then?

- What is the default rate of AA borrowers vis a vis AAA borrowers?

- Is there a link between the exposure to AA borrowers and the magnitude of the bad debt provision?

- In 1995, Allied Irish Bank decreased its bad debt provision to just 0.25% of total loan advances. Bank of Ireland had a less conservative bad debt provision of 0.11%. If, as your Chief Executive Thomas Mulcahy asserts, the reason for this decrease in bad debt provision is ascribed to you bank's investment in better credit grading systems will this mean in the future fewer small industrial SME's obtaining finance at AA rates but rather translating the better loan appraisal into higher handling charges?
  (Business and Finance, 23 February 1995)

- Does AIB's higher bad debt provision reflect in your opinion a greater exposure to AA customers than the Bank of Ireland?

- By what fraction does the bad debt provision increase as the exposure to AA borrowers increases?

In 1995 *(Business and Finance, 23 February)* Thomas Mulcahy of AIB ;
" A good portion of the bad debt will come from loans with a life of less than 2 years". Does this imply that most bad debts are incurred in start up situations whereby companies receive short term loans?

- Are they less securitized?

- With which collateral types would the majority of loans for working capital to small industrial enterprises be secured;

  Life assurance
  Proprieters' house
  Business assets
  Claim on company book debts

- Can you give a weighting to the differing ability of each collateral type to be cover the principal? E.g business assets to the value of £ 100,000 can cover a loan of £ 80,000. This gives the category business assets a weighting of 80%.

- Why have so many bad debts accrued on loans of less than two years if many of these, I imagine, are extended by the bank in the form of Credit Line finance?

- Deloitte and Touche in their 1992 Report entitled " *Review of Irish SME's*" interviewed 400 firms from the SME sector. They indicated in their conclusions that there was a need for medium term finance for the purpose of working capital to be supplied by the banks.

It has already been stated above that there seem to be many bad debts accruing to banks on loans of less than two years. In Germany, the State guarantee banks can securitise a loan to a maximum of 70%, the commercial bank taking the remaining 30%. The fee charged for this service is normally a 0.5 - 1% processing charge along with an interest premium of approx. 0.5 - 0.75% per annum.
Deloitte and Touche proposed a premium of 0.5 - 1.5% per annum but did not mention a processing charge.
In the opinion of your bank would the introduction of either of these guarantees defray the percentage loss accruing to Irish banks on loans to small industrial enterprises?

According to the US Small Business Administration (*reported in Deloitte and Touche, 1992)*, the loss rate on SBA loan guarantees was as low as 3.1% in 1989. "These projects would not meet the full lending criteria of the banks for lack of collateral reasons."

- Could your bank entertain such a loss rate?
- Do you feel that the loss rate of Irish industries would deviate from this American average?
- If so, in which way?

- Is profitability a good indicator of the ability of small industrial firms to repay loans?

How is an average SME profitability of 4.6% viewed by the AIB bank?

Working capital issues by Sector

Category	Number of firms Sought increase in last 2 yrs	Obtained increase in last 2 years	Have difficulty operating within WC limits	Need further WC within next year
Food and Drink	27.1	79	58.8	94.8
Electronics and Engineering	**43.7**	57	**64.3**	**73.8**
Chemicals and Pharmaceuticals	29.3	70	58.8	88.2
Textiles and Clothing	52.6	65	70	75
Paper and Packaging	25	75	37.5	75
Services and Distribution	28	77	55.5	66.7

Source; Own calculations from data extracted from Deloitte and Touche (P. 50 Review of Irish SME's, 1993)

- Why, in your opinion, have the Services Sector and Food and Drink sector such a low proportion of applicants for working capital and of these applicants such a high number of acceptances?

- With the introduction of a loan guarantee scheme which would guarantee commercial bank loans to the magnitude of 70% is it possible the relatively high rejection rate of 43% exhibited by the engineering sector could be brought into line with the lower rejection of 23% represented by the services sector?

- Does the AIB bank have any comments it may wish to make on the viability of such a scheme or propose modifications to it?

Appendix 4.2.2 Sample German Questionnaire in original format

Fragebogenentwurf

An Herrn X von der X Bank.

Abschnitt 1 **Fremdkapital/ Eigenkapital**

- Nach Angaben der Bundesbank Monatsstatistik beträgt das Durchschnittseigenkapitalmittelquote 18% und angesichts einiger Firmen mit weniger als 50 Angestellten beträgt kann das Prozzentsatz auf 15% sinken.

Unterscheidet sich Ihrer Erfahrung nach das F / E Verhältnis besonders bei jungen, innovativen Unternehmen von den obigen Angaben?

Ja ☐ Nein ☐

- Wie hoch ist die Rate, Ihrer Meinung nach? ....

- Halten Sie das in Deutschland bestehende Fremdkapital/ Eigenkapital Verhältnis, das junge, innovative Unternehmen aufweisen, für befriedigend?

Ja ☐ Nein ☐

Abschnitt 2 **Sicherheit**

Beigefügt finden Sie eine Liste von verschiedenen Sicherheiten **(Tabelle A2)** , die gegebenfalls bei der Sicherung eines Darlehens zum Einsatz kommen. Bitte weisen Sie den einzelnen Sicherheiten Ihr jeweiliges Gewicht sowie die Art des Kredites (Dauer, Umlaufvermögen vis à vis Anlagevermögen) und die Häufigkeit Ihres Einsatzes zu.

Abschnitt 3

Risikovorsorge & uneinbringliche Forderungen

Unten befinden sich zwei verschiedene Prozentzahlen. Die erste Prozentzahl entspricht den normalen Verlusten, die eine irische Bank bei Darlenensvergabe erleidet. Man sollte dabei in Erwägung ziehen, daβ 50% des Gesamtwertes ihres Kreditportfolios sich aus Krediten an Firmen mit weniger als 50 Angestellten besteht.

Die Vergabe von Krediten an "normale" Kunden weist eine Prozentzahl von höchstens 1% uneinbringliche Forderungen als Anteil von gesamten Forderungen auf. (1% entspricht dem Break - Even - Punkt)

Übertrifft diese Prozentzahl Ihre eigene Ausfallquote?

Ja ❑ Nein ❑

Die Vergabe von Krediten an ausgewählten Firmen, die von deren "Special Loan Department" betreut wird, weist eine Prozentzahl von höchstens 3 - 4% uneinbringlicher Forderungen als Anteil an gesamten Forderungen auf.

Ja ❑ Nein ❑

Wie charakterisieren Sie von einer Risikovorsorge im Rahmen von 0.11% bzw. 0.54% aller gegenüber Forderungen Unternehmen bestehender?

Konservativ ❑ Liberal ❑

Abschnitt 4 **Auswertung des Projekts eines jungen, innovativen Unternehmens**

Kommt es oftmals vor, daβ *Volksbanken bzw. Raiffeisenbanken* den Kreditantrag eines jungen, innovativen Unternehmens von einem mit Technologie vertrauten Experten auswerten lassen?

Ja ❑ Nein ❑

Verfügen Sie vielleicht über Angaben in bezug auf die Prozentzahl Ihrer Bankbranche, inwieweit sie mit folgendem Personal ausgestattet ist?

Ja ❑ Nein ❑

"Special loan departments ", die auf junge, innovative Unternehmen ausgerichtet sind.

Ja ❑ Nein ❑

"Special loan departments ", die auf den mittelständischen Sektor ausgerichtet sind.

Ja ❑ Nein ❑

Experten (die z. B mit Technologie vertraut sind), die im Fall der Auswertung des Antrags eines jungen, innovativen Unternehmens herangezogen werden.

Ja ❑ Nein ❑

Abstnitt 5 **Wettbewerb unter Banken**

- Hat die gegenwärtige, anfängliche Rezession, der sich Banken jetzt gegenüber sehen, zu geringeren Margen geführt?

Ja ❑ Nein ❑

- Hat es dazu geführt, daß einige Anträge von risikobehafteten Firmen zu günstigeren Kreditbedingungen akzeptiert wurden?

Ja ❑ Nein ❑

Tabelle 2

Art der Sicherheit	**Deckungsfähigkeit**	**Art der Kredit**
z.B		
Haus des Unternehmers	***60% "principle" + Bearbeitungskosten processing charge***	***Langfristiges Darlehen i.e 5 - 10 years***
Geldanlagens		
Aktien und Wertpapier		
Haus des Unternehmens		
Bürgschaften von Dritten		
Bürgschaften von Bürgschaftsbanken		
Abtretung von Kundenforderungen		
Andere		

Appendix 4.3.3 **Sample German Questionnaire (translated into English) from the German**

Questionnaire

To Mr. X from the X bank.

Section 1 **Debt/ Equity**

- According to the Bundesbank Monthly Stataistics of November, 1995, german SMEs in general exhibit levels of owners' equity amounting to 18% of the total capitalisation of the firm. In the case of enterprises with less than 50 employees, this can sink to 15%. Does this percentage accord with your lending experience?

Yes ❑ No ❑

- If the answer is no, how high is the proportion, in your opinion...................

- Do you find the prevailing debt/ equity ratio exhibited by young, fast growth enterprises satisfactory?

Yes ❑ No ❑

Section 2 **Security**

Enclosed please find a list of the different types of collateral which can be used to secure a loan. (Table A2). Please assign to each security type its respective weighting in addition to the type of the loan being covered by this security. (Duration, whether it is used for working capital purposes) and also the frequency with which you use this collateral.

Section 3

Bad debt provision and unrecoverable claims

Beneath you will find two different percentages. The first percentage corresponds to the normal default rate of a bank's portfolio of corporate customers. Please take note that 50% of the loanbook in value terms comprises firms with less than 50 employees.

The loan portfolio corresponding to "normal customers" exhibits a fallout of 1% of advances in value terms as a percentage of its total value. (1% is the break-even point)

Does this value excees your own fallout rate on such customers?

Yes ❑ No ❑

The extension of loans to firms belonging to an "Enterprise Development Unit" sustains a 3-4% fallout rate on total advances in value terms. Does this exceed your fallout rate to riskier customer groups, examples of which being firms which are lacking in tangible assets?

Yes ❑ No ❑

How would you characterise risk provisions against general risk amounting to 0.11% and 0.54% of total advances?

Conservative ❑ Liberal ❑

Section 4 **Appraisal of the loan application of a young, innovative enterprise**

Does the occasion often present itself that a savings bank (particular banking type mentioned here) appoints an expert familiar with technology to evaluate the viability of a loan application?

Yes ❑ No ❑

If the answer is affirmative, do you have statistics pertaining to branches of your bank which relate to the number of such persons evaluating loan applications?

Yes ❑ No ❑

Do you have "Enterprise Development Units" (Explain the term) which permit close surveillance of the small companies involved?

Yes ❑ No ❑

Do you have special bank divisions geared specifically towards dealing with smaller firms?

Yes ❑ No ❑

Section 5 **Competition among banks**

- Has the recession prevailing at the moment lead to narrower bank margins?

Yes ❑ No ❑

- Has it induced German bankers to extend riskier loan applicants more favourable credit terms?

Yes ❑ No ❑

Table A2

Type of Security	Weighting	Maturity of loan
i.e		
Owner's residence	*Covers the loan principle to 60% plus a processing charge*	*Long term loan i.e 5 - 10 years*
Cash deposits		
Gilts, bonds and shares		
Owner's residence		
Guarantees from third parties		
Guarantees from guarantee banks		
Charge on debtor's ledger		
Other		