How Banks Construct and Manage Risk
A Sociological Study of Small Firm Lending in Britain and Germany

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Abstract

This paper analyses the role of banks in financing SMEs in Britain and Germany. It applies a sociological institutionalist approach to understand how banks construct and manage risk, relating to SME business. The empirical analysis is based on the results of a comparative survey of a sample of British and German banks and also refers to statistical material produced by the banks themselves. The paper concludes that, even though bank-firm relations are still deeply embedded in national institutional frameworks, some tendencies towards convergence can also be observed, particularly among commercial banks from the two countries. These flow from both internationalisation and from the political influence of the EU.

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Key Words: Bank Lending, SMEs, Britain, Germany

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1. Introduction

Bank financing of small and medium-sized enterprises (SMEs) recently has received renewed interest as a result of the ongoing internationalisation of financial markets for corporate finance (for the latter see Vitols 2000; Deeg and Lütz 2000). Additionally, the enforcement of EU competition law is set to have a profound impact on the German banking system. (For further details, see Conclusion).

Large national and multinational companies in many industrialised countries are reported to be making increasing use of alternative sources of finance, such as stock market listing, international bond issues, and international markets for corporate lending which often involve transactions with financial actors other than just than banks. Small and medium-sized enterprises, which account for very significant parts of economic activity and employment in the two societies, have only limited access to such alternative sources of finance. They therefore still are, and in some countries even increasingly dependent on bank lending.

At the same time, the degree and the forms of financing of SMEs through banks vary significantly between countries as a reflection of different institutional environments in which banks and firms engage in financial transactions. In the literature on bank-firm relations, Germany and the UK often have been identified as contrasting cases. We will largely endorse this contrast but will also highlight a number of similarities between the two cases which are of recent provenance. It will be argued in this paper that a number of institutional features, such as company and insolvency law, the structure of the banking sector, as well as state policy towards the SME sector, in Germany have led to the emergence of rather close SME-bank relationships and a relative high reliance by SMEs on bank lending during the post-war period. During the 1990s, the propensity of German SMEs to use bank finance has increased even further, in contrast to the practices of large German companies which are reducing their dependency on bank lending (Deutsche Bundesbank 2000).

In Britain, the institutional environment has furthered a more arms-length relationship between SMEs and banks. A greater instability in the economic and institutional environment, a higher concentration in the banking sector, combined with a stronger orientation towards trade and international finance, as opposed to industrial and domestic finance, have historically hampered the development of a closer relationship between SMEs and banks. More recently, however, the relationship between banks and SMEs in Britain appears to have improved, due to a stabilisation of the economic environment, as well as to various initiatives from economic and political actors in favour of bank finance for SMEs. Even though British SMEs have diversified their financing during the 1990s traditional bank finance still remains by far the most important source of external finance (see references) (Centre for Business Research 1998).

In this article we analyse in more detail the role of banks in financing SMEs in Britain and Germany. We first present a sociological approach, developed in an earlier paper (Lane and Quack 1999), to how banks in different institutional contexts construct and manage risk relating to SME business. In sections three and four, this theoretical framework is then applied to an empirical analysis of bank lending, based on official statistics and a survey of a sample of German and British banks, conducted by an Anglo-German team of which the two authors are members. The results, as summarised in the conclusion, show that even though the relationship between banks and SMEs still is and probably will remain strongly embedded in national institutional frameworks it is nevertheless not completely sheltered from internationalisation. Nor is the relationship protected from the EU obligation to create a level playing field in all sectors of the economy. Ongoing restructuring processes of banks at the national and international level are likely to impact on their domestic SME financing, through shareholder pressures for high dividends across all segments of business (undermining possibilities for cross-subsidising). Shareholders' as well as bank managers' reassessment of the relative importance of different business areas will introduce further changes. Furthermore, decisions by the EU, undermining the special status and rights of savings banks within the European Union, are likely to have a huge and widely proliferating impact on corporatist, high-trust institutional settings such as the one historically evolved in Germany.

2. Analysing Risk Handling of Banks from a Sociological Perspective

Risk handling of banks, i. e. how they deal with and manage the risk involved in their decision-making, has been largely ignored by sociologists and left for a long time to be analysed by economists. Most economic theories, however, conceptualise decision-making of and within banks based on ‘rational actor’ models and mathematically inspired decision theory (for an application of these models to sociological theory see Coleman 1990). Economic theories assume not only that actors behave rationally (if not fully, then at least within the limits of ‘bounded’ rationality). They additionally assume that a clear distinction can be drawn, with the help of statistical probability models, between secure and risky decisions about payments which will be realised only in the future. Problems of risk handling in banks thus have been perceived predominantly in terms of ‘markets with imperfect information’, ‘bounded rationality of decision-makers’, ‘moral hazard’ and ‘adverse selection’ (Stiglitz and Weiss 1981). The individualist theoretical framework favoured by most economists, however, has difficulties in explaining the variation in approaches towards risk assessment which exists in different national environments, and within them between different types of organisations.

We argue that in order to understand cross-national (and to some extent also cross-organisational) divergence in bank managerial practice of risk assessment it is necessary to consider the institutional environment in which these relations are embedded. This entails the regulative effects of state policy, legislation and intermediary organisations on risk behaviour which have been highlighted in comparative studies of economic organisation in different societies (Whitley 1999, Lane 1995, Hamilton and Biggart 1988) as well as normative and cognitive effects of the institutional environment on risk behaviour of organisations emphasised by new institutionalists in organisational sociology (Meyer and Rowan 1977, Zucker 1987; Powell and DiMaggio 1991). In our view, managerial decision-making on risk in organisations (and more specifically, banks) will be shaped by all three types of institutional effects – regulatory, normative and cognitive. A combined consideration of these factors is useful in order to understand possible changes in the prevalent modes of risk

behaviour. Whereas in periods of stability, these three types of effects are likely to mutually support and reinforce each other, during periods of change, they might become dealigned and even contradictory.

In order to apply such a perspective to the analysis of risk behaviour in banks we suggest to integrate recent sociological writing on risk with institutional and neo-institutional sociological theory emphasising the social embeddedness of perception and handling of risks. Sociological authors such as Luhmann (1993) and Baecker (1991) have argued convincingly that perceptions and attitudes towards risk are socially constructed (see also Giddens 1990). According to this view, risk is not an 'objective' fact out in the business environment which can be assessed through probability calculus but is continually created by bankers themselves when they make decisions in relation to observed risk structures and risk behaviour of potential business partners in their environment. Since the future is unpredictable any decision involves risk: it might either lead to losses, or it might entail missing valuable opportunities. In order to deal with this uncertainty, banks have developed into 'specialised second order observers' which attempt to monitor how their potential business partners deal with risky decisions (Baecker 1991: 128).

We previously have suggested (Lane and Quack 1999) that insights from Luhmann's (1993) and Baecker's (1991) work - which itself remains at a rather abstract level of system theory – can be fruitfully combined with the work of Douglas and Wildavsky (1982) which provides conceptual tools for the analysis of social variations in risk handling of banks. These authors highlight the influence of organisational goals on risk perceptions and the ways in which distinct combinations of risk aversion and risk acceptance become prevalent in different societies. In their work, they introduce 'market' and 'hierarchy/bureaucracy' as two different broad institutional types which shape values, fears and attitudes towards risk. Each institutional type is associated with different styles of decision-making, varying manifest priorities and hidden assumptions and has distinct organisational limits. The defining characteristic of 'hierarchy/bureaucracy' is that all parts are orientated towards the whole, and collective attitudes towards responsibility, reward and decision-styles prevail. The attempt to preserve stability of the hierarchy may result in guarding against as many threats as possible

by controlled conditions. Hence, uncertainties tend to be considered more as a threat rather than as an opportunity. A pessimistic world view encourages risk sharing. The down-side of the bureaucratic institutional type is that certain risks may take organisations by surprise because they are unable to spot them in time.

The market-oriented institutional type supports individualistic behaviour and sustained profit-seeking of all kinds. The individual is acting as an entrepreneur, seeking to optimise at the margins of all his transactions. For this individuals need autonomy, particularly the rights freely to contract and freely to withdraw from contracts. Uncertainties tend to be regarded more as opportunities than as threat. An optimistic outlook favours a risk-narrowing strategy and discourages the sharing of gains and losses. The down-side of this system is the lack of concern for those who have been victims of the market.

Douglas and Wildavsky (1982) thus suggest that the values and fears of individuals and hence their attitudes to risk differ according to which type of institutions they have been persistently exposed to. Their emphasis on societal values is not incompatible with a focus on cognition, as suggested by neo-institutionalists (Powell and DiMaggio 1991). Values and associated decision-making styles are seen to differ according to long-term institutional affiliation within societies – a view which is not far removed from the perception of organisational routines and cognitive schemata as shaped by historical legacies (see e.g. Starbruck 1976; March 1988). We suggest that the typology of Douglas and Wildavsky (1982) can be fruitfully applied to both the cross-national comparison of attitudes towards risk and to the treatment of risk within societal sub-systems of different societies. Their distinction between a market-oriented and a hierarchical institutional type can be regarded as largely overlapping with typifications of British 'liberal market' and German 'coordinated' capitalism which have been identified by authors writing in the institutional tradition of economic sociology (Whitley 1994, 1999; Lane 1995; Soskice and Hancké 1996).

Furthermore, we believe that this typology will also be useful in analysing the potential impact of internationalisation on bank lending to SMEs in both countries. The contemporary internationalisation of

financial markets has been, as various authors have demonstrated in more detail (Held et al. 2000), predominantly driven by economic actors from Anglo-Saxon countries (particularly US and British banks and financial companies) to extend their economic space beyond their national borders. As a consequence, the institutional business environment of international financial markets can be considered to correspond to a large extent to the market-led, arms-length and short-term profit seeking approach inherent to Anglo-Saxon types of capitalism (Whitley 2001; Lane 2001; Braithwaite and Drahos 2000). Accordingly, banks originating from countries in which relationships between banks and companies have hitherto been embedded in an institutional framework of the 'coordinated market' type, such as Germany, will have to balance different and conflicting rule systems applied in international and national markets. For banks from Anglo-Saxon countries, in contrast, the rules of the international arena are likely to be identical or at least much closer to those shaped by the national institutional context. Nevertheless, the internationalisation of banks might impact on bank lending to SMEs in both countries due to increasing pressures for profit-maximisation exerted by banks' shareholders.

3. The Institutional Context of Small Firm Lending in Britain and Germany

Among the institutional features which shape bank lending to SMEs we can distinguish between overall societal institutions and more specific arrangements in the immediate environment of banks and SMEs. At the societal level, the role of the state in the economy, the financial system and certain aspects of the legal system shape economic actors' business goals, time horizons and attitudes towards the future. At the level of the more immediate business environment, banking regulation, the structure and role of the banking system and the nature of the small and medium-sized firm population are likely to influence banks' decision making on lending risks.

An examination of the institutional environment of British and German banks (Lane and Quack 1999) revealed how macro-level societal institutions affected the level of uncertainty and the kinds of risks which banks in both countries confront in lending to small and medium-sized companies. We found that a more consistent and

proactive policy of the German state towards the development of SMEs, the state's sponsorship of risk-sharing mechanisms in the context of pluri-lateral networks of various collective actors, together with the state's more stability-enhancing management of the economy, have made the economic environment more predictable and SMEs a less uncertain customer group for banks in Germany than is the case in Britain. These factors, together with more stringent banking regulation, have resulted in an *ex-ante* reduction of the risks involved in bank lending to SMEs in Germany whereas the British institutional context saddles banks to a larger extent with risks.

With regard to the questions addressed in this article, the more immediate institutional context of the bank-SME relationship deserves closer examination. This would help to understand which are the main banks involved in lending to SMEs in each country, how they are socially constructed in different ways and how their interactions with SMEs are shaped through regulations and institutionalised meaning systems.

3.1. The banking sector

The British banking system is highly concentrated, centralised and relatively homogenous. Retail banking as well as corporate banking are dominated by four big commercial banks whose operations are said to be strongly London centred. The German banking system, in contrast, has a more decentralised, less concentrated and more heterogenous structure. This is mainly due to the relatively strong position, vis-a-vis the commercial banks, of the savings and cooperative banks which combine a commercial orientation with some consideration of the common good for their locality or members respectively. These banks hold considerable market shares in both retail and corporate banking, and there exists semi-public development banks, specialising in long-term lending to the corporate
sector. German saving banks and co-operative banks, according to their statutes, have to take into account the economic needs of their locality and the welfare of their members (many of which are SMEs) and to balance these objectives with the pursuit of profitability (Stern 1984: 151; Viehoff 1979; Deeg 1992). To enable savings banks to serve the local community, the state has granted them various rights and privileges. (discussed below). Development banks, by definition,

have to pursue policy goals such as supporting the development of SMEs. Thus the German banking sector includes a considerable number of banks which, in their pursuit of business opportunities, are at least to some extent governed by goals serving the common good. The British banking sector, in contrast, is dominated by private commercial banks which, due to intensified competition and a fluid market for corporate control, have to put the interests of their shareholders above those of other potential stakeholders (Parkinson 1997: 143f).

The greater diversity within the German banking system, particularly the growing ascendancy within the sub-section devoted to SME lending of banks not exclusively ruled by considerations of profit, are reflected by data on bank lending to domestic firms during the period from 1990 to 1999. In Germany, throughout this period, the savings banks, together with their regional and federal bank institutions, increased their proportion of the total lending to companies from 30 to 37%, whereas the market share of commercial banks fell slightly from 36% in 1990 to 32% in 1999. The three largest commercial banks, which in 1990 accounted for 15% of lending to corporate customers, were able to increase their share to 20%. The picture of a more decentralised and less concentrated market for bank lending to companies in Germany is complemented by the figures for the cooperative banks group (organised along similar principles as the savings banks). This group provided about 10%, and specialised commercial and development banks provided about 20%, of lending to companies throughout the period (Deutsche Bundesbank 2000).

Even though no comprehensive data are available for lending to SMEs, figures concerning lending to craft businesses[1]) suggest that

savings and cooperative banks occupy an even more important role in lending to these companies than is indicated by the overall figures. In 1991, for example, savings banks provided 57% of the credit volume to craft business, followed by cooperative banks with 24% and commercial banks with only 11 per cent (Ellgering 1993). By 1999, savings banks had managed to increase their share of lending to craft businesses to 65%. They also provide a considerable proportion of loans to business start ups, financing every second start up in 1999

(Deutscher Sparkassen- und Giroverband (DSGV) 2000: 18).

In contrast, the market for lending to small and medium-sized companies in Britain is highly concentrated. According to figures in Bank of England (1994: 13), Natwest and Barclays held each 25% of the market for SME business in 1990, followed by Lloyds with 20% and Midland with 12%. Thus, Natwest and Barclays as the two largest providers of finance for SME held 50% and the Big Four about 80% of the market for financing SMEs. In contrast to Germany, TSB (originating from the British Savings Bank group) and regional banks like Royal Bank of Scotland (RBS), Bank of Scotland and Yorkshire Bank provided only small proportions of finance for SMEs. Market shares for finance to SME start ups are similarly concentrated. Several mergers which occurred during the late 1990s between the largest banks (e.g. Lloyds with TSB and Natwest with RBS) have increased market concentration further. When the merged NatWest/RBS began trading in 1999, the combined figure for the largest three suppliers rose to 73% (Cruickshank 2000).

A further important difference between the two banking systems is the differing propensity of banks to provide long-term credit to companies, and more specifically SMEs. As Table 1 illustrates, in Germany the proportion of long-term lending (referring to loans granted for four and more years) to domestic companies increased slightly from 58.1% in 1990 to 60.9% in 1999. Throughout the period long-term lending volume accounted for an above average proportion of the overall lending of savings banks and specialised credit institutions, whereas it remained below average among the commercial and cooperative banks. Overall, the comparison of the development of the term-structure of lending according to bank groups highlights the important role which German savings banks, together with co-operative and development banks, play in lending – and more specifically in long-term lending - to SMEs.

Historically, in Britain bank lending to small and medium-sized firms has often taken the form of overdraft lending which was used by the borrowers both for short-term liquidity and for more long-term investments. Since the beginning of the 1990s, however, the situation has changed considerably. Borrowing on overdraft has declined from 49.2% of total bank lending to SMEs in December 1992 to only

29.8% in June 1999, whereas term lending has increased from 50.8% to 70.2% during the same period (see Table 2). According to data in Bank of England (1995b), 42% of term lending was for five or more years. The British Bankers' Association reports that in 1997 about two thirds of the volume of term loans was for five or more years. Within Britain, thus, there has been a considerable change in banks' lending practices to SMEs which is attributed in the literature to both the increasing stability of the economic environment and to changing attitudes on the part of banks and SME customers alike. Compared to Germany, however, bank lending to SMEs in Britain still has a more short-term structure.

Concerning density of branch networks, statistical data support a lower density in Britain than in Germany. In 1995, in the UK there was, on average, one branch per 1,580 inhabitants, compared to one branch per 1,203 inhabitants in Germany. In both countries, the density of branch per inhabitants decreased during the following years but in 1999 it was still higher in Germany than it was in 1995 in Britain. As Hildebrandt (1999, 2000) has shown in a German-French comparison of banking, the higher density of branches in Germany is mainly due to the large branch network of a large number of savings and cooperative banks, whereas German commercial banks did not have a more dense branch network than their French counterpart's (ibid). A comparison of German and British commercial banks indicates that, in Britain, branches of commercial banks have to serve a much higher number of inhabitants than in Germany, which again reflects the much higher concentration in the British commercial banking sector. In recent years, however, there has occurred a tendency of German commercial banks to reduce their branch networks, which is reflected in a narrowing gap between the two national systems, as reflected in the data displayed in Figure 1.

3.2. Small and medium-sized firms

Differences in the institutional environment have generated significant variation in the nature of small and medium-sized enterprises (SMEs) between the two countries: German SMEs are on average larger than British firms (measured in number of employees; ENSR 1993; Storey 1994: 20-21); they have a lower level of failure and lesser degree of volatility (Mullineux 1994; Midland Bank 1994; Bank of England

1995a); their financing horizons are longer (Bank of England 1995b: 6), and they are more independent from larger firms (De Saint-Louvent 1991: 55); among them is a higher proportion of craft or artisan (*Handwerk*) firms (Doran 1984; Weimer 1992); and the level of certified skills among owners is higher than in Britain (Midland Bank 1994). As a consequence of these structural differences in the SME sector, banks in both countries are faced with very different customer demands and hence risk decisions in financing SMEs. Overall, it appears that institutional factors make German SMEs less problematic bank customers than their British counterparts.

The relationship between German banks and SMEs has been described as rather close and stable over time, reflecting among other factors a relatively symmetric power relationship between both partners (at least in comparison to other countries; De Saint-Louvent 1991). Most German SMEs traditionally have maintained a *Hausbank*-relationship with one dominant bank, although recently they have tended, to do business with more than one bank. German banks provide not only accounting services and bank lending to SMEs but have recently also set up special business units which offer consulting services to SMEs and support for medium-sized companies which aim to go public. Bank lending, however, still constitutes one of the core pillars of the bank-SME relationship in Germany, as is reflected by the increasing dependence of SMEs on bank lending during the 1990s. Bank borrowing which in 1987 represented between 28% and 32% of the total balance sheet of small companies (with an annual turnover up to 25 Mio. DM) had increased to between 33% and 40% by 1996 (Deutsche Bundesbank 2000), whereas the ratio of own capital had fallen among SMEs (Deutsche Bundesbank 1999).

In contrast, the relationship between British banks and SMEs has been more problematic. It has been characterised by a higher level of discontinuity and change in relationships, and a higher degree of dissatisfaction with and mistrust in banking policies (De Saint-Louvent 1991). More recently, however, the relationship seems to have improved as indicated by various customer surveys. Some of this progress is attributable to the more stable economic environment in the UK compared to the ruptures of the early 1990s, which has allowed SMEs to reduce their net bank indebtedness and to increase their long-term borrowing. Efforts made by banks, small businesses

and small business representative groups have also contributed to an improvement of the bank SME relationship (Bank of England 1997). The importance of traditional bank finance (overdrafts and term loans) for SMEs has declined in recent years as small businesses have increasingly sought to diversify their sources of finance, but bank finance nevertheless remains the most important type of external finance for small businesses. In the period 1995-1997 it accounted for 47% of external finance, against 61% in 1987-1990 (See note in References). Since the largest UK retail banks and their subsidiaries are also the largest suppliers of other forms of lending, such as leasing, factoring and asset financing, their central role in financing SMEs has been maintained (Cruickshank 2000).

4. Risk Handling and Risk Management in British and German Banks

From the theoretical perspective suggested in section two, risks are not something objective existing 'out there' in the business environment but are instead socially constructed by banks themselves. In the case of small firm lending, this means that risks are defined by bankers in the course of their decision-making during the lending process. The motivations, perceptions and implicit rationalities which enter into this decision-making process reflect the institutionalised organisational rule systems of the banks in which they work. These organisational rule systems are shaped by the institutional context of their society.
In order to gain a better understanding of the ways in which the societal context influences decision-making processes on small firm lending in banks we will discuss in this section results of our own empirical research based on interviews with bankers in British and German banks. The aim of this section is to analyse the impact of the institutional environment on risk handling strategies of banks. We assume that the institutional context will affect the risk handling strategies of banks in both countries, with respect to the degree and forms in which they will attempt to externalise part of the risk involved in lending to SMEs. Externalisation can occur through pooling it with other institutions or by displacing it onto individual customers. Furthermore, we expect the institutional environment to impact on the ways in which banks internalise the handling of the remaining risk involved in lending to SMEs in their decision-making processes on such lending, as reflected in their organisational

structures, informal routines and rule systems. The focus in this section is thus on how banks as organisations construct and manage the risk involved in lending to SMEs in different institutional contexts.

4.1 The survey data

As indicated above, the banking sector and the structure of the SME population differ considerably between Britain and Germany. That means that there is no ideal research strategy for comparing 'the incomparable'. Optimising the 'matching of cases' would exclude the savings and cooperative banks (which do not exist in Britain) and thus lead to a rather biased view of the German system of lending to SMEs. Emphasising the specificities of each national system, in contrast, makes case based comparisons nearly impossible. In order to find a viable compromise our survey includes the banking groups in each country which provide a significant volume of loans to SMEs. The presentation of results for Germany will provide breakdowns for commercial compared to other banks as far as there are significant differences. Furthermore, we have attempted to differentiate as far as possible between SMEs of different size in our interviews with bankers.

The following analysis is based on a sample of 12 banks (seven British and five German banks). In both countries, the sample includes large commercial banks operating nation-wide, as well as more regionally oriented banks. In Germany, where savings and cooperative banks provide more than half of the lending to SMEs, two larger savings banks and one larger cooperative bank operating in a region with a mixed economic structure were included in the sample. It is important to underline that the operations of local savings and cooperative banks, through close integration into their respective German-wide bank organization, go far beyond what an isolated regional bank could achieve. In Britain, the sample included five commercial banks – of which two subsequently merged – and two Scottish banks which, despite maintaining a network all over Britain, are considered to give more consideration to regional specificities.

In each bank interviews with higher-level managers, usually at headquarters, were conducted based on a questionnaire which consisted of three parts: a) organisational structure, b) customers and services, and c) risk assessment and lending portfolio. Interviews were conducted with several higher middle managers responsible for the respective area of business. Overall, interviews lasted between two and four hours in each bank. Additionally, banks were asked to provide standardised data on their lending portfolio and information gathered for lending decisions in an advance questionnaire which was posted to them before the interview. Advance questionnaires were returned by all German, but only by three British, banks. The interviews in British banks took place during the summer of 1995 and those in German banks were conducted in the early autumn of 1996[1].

4.2 Banks' organisation and perceptions of small firm business

The definition of SME customers and general perceptions which bank managers in our survey held of this customer group reflected the institutional environment and the structure of the SME population in the two countries outlined above. British and German banks in general distinguished between small, medium-sized and large corporate customers. With regard to the customer segment of small and medium-sized companies which is of interest here, it is significant that German banks on average operated with lower upper thresholds for

both the small and the medium-sized category of business customers (see table3)[2]. In both countries small business customers are referred by banks to the ordinary services provided by the retail branches. The size threshold after which they can expect more specialised bank services through customer advisors, often located in dedicated advisory centres, is slightly higher in Germany than in Britain. At the same time, the medium-sized category covers a wider spectrum of companies in Germany than in Britain. Differences in customer segmentation reflect the distinctive size distribution of firms in the two countries. They also indicate that, during the 1990s, British banks have been developing a stronger focus on, and have begun to invest more resources into, their activities for medium-sized companies, (see also Bank of England 1997).

It is not by chance that the two commercial banks and the large savings bank in Germany mentioned that in the future they wanted to focus more closely on medium-sized companies as the most profitable segment of SME business. For the two large commercial banks this implied the need for a world-wide or European-wide presence in this customer segment which they intended to achieve by reallocating resources from domestic to foreign markets, and from small to medium-sized business finance.

In both countries, small firms accounted for the large majority of corporate customers that banks were dealing with (70 to 90 per cent) though their relevance in terms of overall lending volume was clearly lower (between 10 and 55 per cent). In Britain and Germany, lending continued to constitute one of the core pillars of the relationship between banks and small firms. Survey banks generated most of their revenues in this customer category from interest (between 60 and 74 per cent). The revenue from commissions/fees was lower in their small business segment than that generated from medium–sized and larger corporate customers.

Asked about major changes in the relationship between banks and small business during the previous five years, banks in both countries underlined the necessity to establish a closer contact to small firms. In Britain, this seemed to be a reaction to the increased readiness of small businesses to switch banks and to terminate lending relationships, whereas in Germany it appeared to reflect a tendency of

small firms to deal with more than one bank (see Figure 2).

One important country difference that shaped bankers' perceptions of their relationship to small firms was the divergent overall development of the banking sector. The British banks interviewed had, as part of the overall banking crisis in the early 1990s, incurred considerable losses in corporate lending, and more specifically in small firm lending. German banks, in contrast, reported no or only minor losses in corporate and small business lending during the last five years (if there had been losses, these referred to specific sub-sectors and were regarded as normal). Banks in both countries stated that their current risk management aimed at improving monitoring and steering of the overall risk portfolio in this business area, but the means which they envisaged to do that varied considerably, as is analysed in more detail below.

4.3 Risk handling strategies

Our analysis of the institutional context and secondary literature (Lane and Quack 1999) has suggested that banks in Britain and Germany would focus on distinctive risk handling strategies. British banks, operating in what, following Douglas and Wildavsky, can be characterised as a 'market-type' institutional setting, should tend to externalise risks as far as possible by transferring them to customers. In contrast, German banks, situated in a more hierarchical bureaucratic and coordinated institutional setting which ensures them a greater amount of *ex ante* risk reduction, should focus more on the management and control of internalised risk. If externalisation of risk takes place in German banks, it should take collectivist forms of risk sharing with intermediary organisations such as public loan guarantee schemes which have been in existence for a longer time and have a more encompassing character in Germany than in Britain.

4.3.1 Externalising risk by transferring it to customers

Externalisation of risk by transferring it to customers can occur in different forms: British banks are said to make little effort to appraise individual loan applications, and to use instead the interest rate to price for risk differentials (Cosh and Hughes 1994: 32). The literature also suggests that British banks tend to lend more often short-term and at variable interest rates than their German counterparts, thereby displacing risks which they incur on the refinancing side to their customers (Deakins and Philpott 1993: 14; Kershaw 1996: 1; Midland Bank 1994: 9; Mullineux 1994: 2; Vitols 1997). Another form of transferring risk to customers is to ask for higher collateral for loans which are considered to involve above average risks. Whereas some studies report that British banks tend to take more collateral (Kaufmann and Kokalj 1989; Binks 1991: 153; Deakins and Philpott 1993: 16), other studies did not find any differences in volume (Bank of England 1995a: 9; Midland Bank 1994) but reported that different kinds of securities were being asked for. British banks are said to take private property more often, whereas German banks take mainly business assets (Kershaw 1996: 1).

In order to check the hypothesis that British banks are more likely than German banks to externalise risk by transferring it to customers, in our survey we followed a dual approach. We asked bankers to describe their approach towards handling loan applications from small businesses and the terms of lending applied to this customer group. In addition, they were asked to provide statistics on their lending portfolio which would allow us to compare the term-structure, variability of interest rates and taking of collateral between German and British banks in a more detailed manner than is possible on the basis of official statistics. In practice, however, the data provided was often not strictly comparable between banks and remained incomplete since many banks regarded this information as confidential. The average figures provided in the following section should thus be considered as rough estimates rather than exact measures. Together with the subjective assessment of the bankers, this data nevertheless offers some insights into the strategies of British and German banks with regard to risk handling.

Official statistics provided above (see Table 2) on the increase in recent years of granting term loans instead of overdrafts indicate a gradual shift in British banking practices (see also Young et al. 1993: 118; British Bankers Association (BBA) 1998; Bank of England 2000a). The trend towards more long-term lending in Britain is also supported by the slight rise of long-term lending in statistics referring to term-structure by residual maturity (BBA 1998). As stated above, the structure of lending of German banks is still much more oriented towards long-term lending than that of British banks, but the difference is now less stark than it has been in the past.

Regarding the use of fixed-term interest rates the results of the survey confirm persisting differences. British banks in our sample granted only slightly more than one-tenth of their loans to business customers using fixed-term interest rates. German banks, in contrast, provided more than half of their lending to this customer category based on fixed-term interest rates. The much lower proportion for Britain corresponds to in Bank of England data (2000: 17) which indicates that in December 1996 fixed rate loans accounted for 18% of total lending (28% of term lending) of British banks to small businesses. Since then, small businesses in Britain have gradually increased their usage of fixed rate loans, which according to the same source in September 1999 accounted for 24% of total lending (and 34 % of term lending).

With regard to collateral, the results suggest that British banks tend to take collateral on lending to business customers more often than German banks. In lending to small companies, however, they seem to take slightly less collateral, which might be related to the smaller average size of loans, as well as to the lower availability of collateral among small firms in Britain. As suggested in Bank of England (1997: 13), security is becoming less important for smaller loans because it is not considered as cost effective by British banks. The type of security taken did not differ significantly between countries, with British and German banks taking both tangible assets and private property. British and German bankers, however, referred to different criteria in determining whether collateral should be taken or not. Whereas German bankers reported that security was asked for as a result of the risk analysis of the loan application (e.g. after intensive internal

scanning of information), the answers of British banks suggested that they followed more a 'hit and miss' strategy of taking what is available.

Finally, bankers were asked how they dealt with loan applications with apparent above average levels of risk: whether they would attempt to charge higher interest rates, seek higher collateral, impose extra monitoring requirements or use combinations of these strategies. The answers tend to support the above described differences: British banks stated that they would use higher interest rates and higher security as well as more intensive monitoring (if the customer paid for it). German banks showed more reluctance towards pricing higher risks. The savings and cooperative banks included in our sample rejected completely the idea of asking higher interest rates, whereas the two commercial banks said that they would have recourse to this strategy under certain conditions. Overall, pricing of above average risks was not considered as a feasible strategy by German banks. They considered that firstly, it normally would not cover fully the higher risk the bank engaged in, and secondly, due to the fierce competition between banks, it was difficult to impose on customers. (Weak companies often even ask for lower interest rates in order to recover from their economic problems). As a consequence, German banks tended to be more selective in their loan decisions, and if granting loans with above average risk, tended to use a combination of asking for more security and engaging in more intensive monitoring.

Overall, the results provide support for the hypothesis that British banks tend to externalise risks more often and more extensively, and to pass them on to customers, than German banks do. They use variable interest rates significantly more often in order to protect themselves against fluctuations in financial markets. German banks, in contrast, grant a considerably higher proportion of loans with fixed-term interest rates. In individual lending decisions, British banks seem to be more ready than German Banks to grant loans involving above average risk if the customer is ready to pay for it in terms of higher interest rates (and to some extent also higher security).

4.3.2 Collective forms of risk sharing

An alternative strategy to externalise risk is to share it with other banks, with intermediary organisations or with the state. Risk sharing by intermediary organisations and the state has been, indeed, an accepted part of the post-war German social market economy, whereas it has not been so easily assimilated into the British liberal market approach (Zysman 1983; Albert 1993; Hutton 1995). We therefore expected collective forms of risk sharing to be more widely used by German than by British banks.

Empirical evidence confirms that this is the case with regard to two different forms of collective risk sharing. Firstly, savings and cooperative banks in Germany practice forms of collective risk pooling within the context of their banking groups. Through their regional and federal banking institutions, local savings and cooperative banks gain access to capital at lower interest rates and are shielded to some extent from the fluctuations of capital markets. Regional and federal savings and cooperative banks help to balance liquidity surplus and shortage within each of the banking groups, thus reducing liquidity risk. Local savings and cooperative banks can draw on their assistance in order to provide large loans for local customers which go beyond their individual financial capacity. Last but not least, local savings and cooperative banks can draw on a large and valuable body of information through their banking groups and central banking organisations (Vitols 1997). These forms of information pooling within banking groups do not exist in the highly competitive British banking system in which savings and cooperative banks have never played a significant role.

A second form of collective risk sharing in which banks can engage in order to deal with above average risk in lending to small firms are Loan Guarantee Schemes (LGS). Such schemes do exist in both countries. Their main task is to provide guarantees to banks which lend money to small businesses which wish to finance investments with longer-term prospects but are unable to provide the necessary collateral. Whereas German LGS have been in operation since the 1950s the British scheme was introduced in 1981 and has only recently gained momentum (Storey 1994: 226; Bannock and Partners 1995: 40, 67; Bank of England 1995b: 30). Since 1993, the scheme has differentiated the treatment of established and start-up firms, and

in 1996 the maximum loan term was increased to 10 years (Bank of England 2000: 20).

Hughes and Leube (1997) have undertaken a detailed analysis of the use made by British and German banks of Loan Guarantee Schemes. Their results confirm that the British scheme became more widely used during the first half of the 1990s. Nevertheless, in 1995 the overall number and the volume of guarantees, as well as the default rates of lending through these schemes, still differed considerably between the two countries. These variations reflect the different constitution of loan guarantee schemes in Britain and Germany, as well as differences in the use which banks in both countries make of these schemes.

The higher number of new guarantees issued by the German loan guarantee schemes in 1995 indicate that the use of these schemes is rather common in German banks. In Britain, loan guarantees have become also more wide-spread but the number of new guarantees issued in 1995 was still lower than in Germany. Information collected in our interviews with British and German bankers confirms this picture. Respondents from large commercial banks in Germany estimated that 10-20% of their overall lending to the corporate sector and 25% of their lending to *Mittelstand* firms (medium-sized enterprises) involved public guarantee schemes. The schemes were also reported to be widely used for larger business start-ups. In addition to the provision of guarantees, bankers regarded the external loan appraisal through public guarantee banks as one of the virtues of the loan guarantee scheme. In Britain, in contrast, bankers appeared to be more indifferent towards the operation of these schemes. This has to be seen against the background of the different way in which the British LGS has been set up. The German LGS were set up as 'help for self-help' organisations, with banks and insurance companies, as well as trade associations and Chambers of Industry and Craft as shareholders. The British LGS, in contrast, is a pure state scheme, administered by the Department of Trade and Industry (Kaufmann and Kokalj 1989: 7-8; Bannock and Partners 1995: 40).

Over the period from 1990 to 1995, the average volume of newly issued guarantees increased more strongly in Germany than in Britain, and thereby reinforced pre-existing differences. In 1995, the average

volume of new guarantees issued by German loan guarantee schemes was nearly three times as large as that of their British counterpart. More recent data indicate a drop of LGS loans in terms of numbers and volume in Britain compared to a continued rise in Germany, as well as continuing differences between the countries regarding the average size of LGS loans (Bank of England 2000: 20; Kreditanstalt für Wiederaufbau 2000). This is partly explained by the smaller average size of British SMEs and the smaller average amount of lending of British banks to SMEs. Another important factor, however, is the specific use that German banks make of loan guarantee schemes. Risk sharing in the context of these schemes is used predominantly for investment projects of medium-sized enterprises and larger business start-ups. Most of the German banks stated in the interviews that the amount of work necessary for the application and the duration of the decision-making procedure in order to obtain a public loan guarantee made them ineffective if applied to small firms and small business start-ups. This view was particularly pronounced among the savings and cooperative banks which deal more often with smaller firms. As a consequence, respondents of savings and cooperative banks reported much lower proportions of their lending to be supported by loan guarantee schemes than the large commercial banks (estimated as below 1 or 2 per cent of total lending to the corporate sector).

One explanation for the lower popularity of LGS among British banks is that default rates of lending secured through Loan Guarantee Schemes have been relatively high. Reforms of the scheme have been able to reduce the default rate in Britain during the first half of the 1990s whereas in Germany it increased slightly following the extension of the system to East Germany. In 1995, however, the default rate in Britain was still 13.7% compared to only 2.2% in Germany. This can be explained by the fact that in Germany, default risks are shared between the bank which grants the loan and the Loan Guarantee Scheme, and banks therefore have an interest in a rather intensive screening of such loan applications. In Britain, in contrast, the bank granting the loan does not carry default risks but displaces them to the state. An additional explanation, however, must be sought in the type of firm supported, with British LGSs being more likely than German ones to support high-risk start-up firms.

In sum, the evidence presented in this section confirms that German

banks do make more frequent use of collective risk sharing, both within certain banking groups (i.e. the savings and cooperative banks) and between banks and intermediary institutions such as the loan guarantee schemes. Recent attempts to establish schemes of collective risk sharing for lending to small firms in Britain have not been equally successful. This has been often attributed to the state-led character of the British schemes. Our results, however, suggest that another reason for the limited success of British LGS might be their focus on relatively small-scale lending to relatively small firms – a market segment in which the 'transaction costs' involved in collective risk sharing have made German banks equally reluctant to use such schemes.

4.3.3 Internalising risk: selecting risk in lending decisions

Sociological approaches towards risk in bank lending underline that risk is not on objective fact, but is actively selected and constructed by bankers in the course of their decision-making on lending applications. One important strategy of risk control refers to the use of information designed to reduce the unpredictability and variability of outcomes. Equally, the information searched for and the way in which it is processed within banks is not a matter of objective facts. Instead, each bank develops its own internal screening system, in which different categories are selected or similar categories prioritised to different degrees. Banks will then deploy the information thus obtained as a base for decision-making on lending (Baecker 1991).

Our previous analysis of the institutional environment in both countries (Lane and Quack 1999) led us to expect that the sources of information used and the processes applied to the selection of risk in lending decisions would display specific country patterns, beyond any variation between individual banks. In particular, we assumed that the existence of a pluri-lateral network of intermediary organisations, and the ensuing greater availability of information on SMEs, would enable German banks to assemble a larger and more varied amount of information, particularly from external sources, than their British counterparts. Existence of legal obligations to reveal existing debts in Germany provide banks with an additionaal source of information, not available in Britain. Furthermore, the existing literature suggested that British banks use the past financial performance of firms as a signal of

credit worthiness. German banks, in contrast, are reputed to consider in addition more qualitative and future-oriented aspects of the loan application (Deakins and Philpott 1993; Wood et al. 1992).

In our interviews we asked banks which sources of information, criteria for credit-worthiness and decision-rules they used in the assessment of loan applications from small business customers. The results indicate that banks in both countries used rather similar sources of information but made different use of them. Interesting differences appeared between different banking groups in Germany.

As Figure 3 indicates, the principal sources of information used by German and British banks and the relative importance accorded to them in terms of providing background information, were quite similar. Banks in both countries considered company reports and accounts, information provided by the loan applicant and internal data bases as very important or of highest importance. The higher importance accorded by British banks to commercial databases reflects the Anglo-Saxon market-led approach of externalising risk assessment to specialised private companies and professionals (e.g. rating agencies, accountants). Instead, German banks in our sample gave slightly more emphasis – even though at a low level – to intermediary organisations (chambers of commerce, industry and trade associations) as principal sources of information, which again reflects the specific institutional environment.

The influence of the institutional environment on banks' sources of information on small business, however, should not be overrated. Even though German banks can scan a wider range of information sources on small business customers than British banks, the key sources which they use in assessing loan applications are basically the same as in British banks. Banks in both countries reported reliance mainly on company reports and accounts, information provided by the applicant and internal data bases – in Britain complemented by external commercial data bases. There are, however, as Figure 4 indicates, significant differences between German savings- and cooperative banks and German commercial banks. Whereas the first included also information from other sources such as intermediate organisations, German commercial banks – like British banks – accorded no or only little importance to these additional sources of

information. In this respect, saving and cooperative banks seem to be more strongly inserted into pluri-lateral networks than their commercial competitors.

A further difference in the process of information procurement between the two national banking systems is the quality of information obtained from the main sources listed above. This is particularly the case with regard to the information which banks can obtain from loan applicants themselves. In Germany, enterprises exceeding a loan limit of DM 250,000 (around £ 83,000 at the exchange rate of September 2001) are required by law to reveal full information on their economic situation to the bank from which they aim to obtain the loan[3]. In Britain no equivalent regulation exists. Furthermore, the 'Hausbank' relationship in Germany also facilitates information gathering of German banks compared to the more transaction oriented business relationship between British banks and their customers. German bankers, for example, mentioned in the interviews that as part of the loan application they would require and obtain more up-to-date financial and planning data from applicants than contained in annual reports. This information was rated as highly important by German respondents whereas the use of such data was not particularly emphasised by British bankers.

Additionally, bankers were asked to give a detailed description of the decision-making rules applied in assessing loan applications. The answers tend to confirm the well-known contrast between the orientation of British banks to consider mainly the financial situation of the applicant or his/her business, with a strong bias towards historical data. This is in contrast to German banks' greater emphasis on managerial qualities and the future prospects of the applicant's project or business. Three of the four British banks which responded to this question listed predominantly financial indicators (such as account performance, cash position, personal credit references, forward orders, etc.). Only one bank explicitly included sector risk and management quality as a weighted factor in the assessment (the former being accorded 25-30 per cent, the latter about 30 percent, compared to financials with 25 and projected financials with 15 per cent). Two other banks stated – when asked for – that they would also look at the quality of management and make use of site visits. Overall, however, the assessment of the latter was considered as subjective and

unreliable.

Respondents in German banks stated that information relating to the financial situation of the applicant's business would carry a weight of between approximately 30 and 50 per cent, confirming the high importance given to company reports and balance sheets as sources of information. In addition, quality of management was listed by all German bankers as an important item to be included (with a weighting of between approximately 10 to 33 per cent, depending on the bank). In contrast to the British banks, the assessment of this factor was not regarded as particularly problematic by German interview partners. On the contrary, a certain subjective component was even considered necessary and desirable. Furthermore, most of the loan assessment schemes applied in the German banks included a future oriented component, either based on the prospects of the individual company investment project and/or on the projected development of the industry or economic sector (with a weighting between approximately 20 and 33 %).

In general, German bankers favoured case-based over class-based decision-making in lending to small business customers. This was reflected in their negative attitude towards the automation of lending decisions in this customer segment – an attitude which was found in only one of the British banks included in the survey. German bankers considered computer-based loan assessment as useful in order to steer and control the risk portfolio, and they also welcomed the standardising effect on the processing of loan application, but they did not consider computer-based decision-making as very useful when applied to individual cases. One of the German bankers even stated that their experience with different computer-based loan assessment schemes during the last ten years showed that the statistical methods used in these programs still produced more defaults than they had actually in their books. The preferences for case-based versus class-based approaches to risk assessment, as displayed in the answers of the German and British respondents respectively, might however, not do full justice to the actual situation found in banks of both countries. It has to be kept in mind that German commercial banks have separated out very small firms, to be dealt with in the retail branches. When the German interviewees rejected automation of lending decisions, they were likely to have in mind a more medium-sized firm

whereas for their British counterparts small firms would have been the main reference group.

In sum, commercial banks in the two countries are using similar information in assessing loan applications, whereas the numerically dominant German savings and cooperative banks differed somewhat from their commercial competitors in the type of information consulted. But German and British banks make different use of it. As far as scanning the environment for information is concerned, German savings and cooperative banks appear to be embedded more deeply into the institutional environment than German commercial banks. The indicators of credit worthiness which banks extract from their sources of information as well as the decision-making rules applied to loan applications, however, show greater homogeneity within than across countries. German banks tend to use a more case-based approach orientated towards the quality of management and the future potential of the firm compared to British banks which rely on a class-based approach with strong focus on the financial situation and past development of SMEs. Even if future prospects of small firms have recently been given more weight by British banks, as suggested by Bank of England (1997), the focus rests on financial indicators, such as business intentions and cash flow.

4.3.4 Managing the internalisation of risk

Following sociological approaches, managing lending risks basically means managing the decision-making process over lending, since that is where risks are constructed and selected by banks. Since the literature suggests that German banks tend to internalise more risks than British banks, we would expect them also to devote more organisational resources to bureaucratic methods of standardising procedures and creating uniformity in decision-making than do British banks. Following the market-based institutional type of Douglas and Wildavsky's typology, British banks should instead operate more on the basis of an internal market model, with lending managers acting as 'quasi-entrepreneurs' whose decision-making should not be hampered by too much bureaucracy. This should result in a greater variety in the mode and outcome of decision-making on risks in British than in German banks. In our survey, we included questions concerning the banks' organisational structure and processes relating to the small

business sector, as well as job descriptions and qualification profiles of the staff dealing with SME customers, in order to ascertain empirical evidence relating to the above mentioned issues.

The evidence collected for German banks suggests a gradual departure from what Baecker (1991: 151ff) described as the traditional 'niche strategy of risk management'. According to this strategy, banks attempt to absorb the insecurities involved in their decision-making through specialisation of their organisational structures and processes (see also Knight 1921). This implies a bureaucratisation of the decision-making process through a separation between customer acquisition and credit control, and standardised methods of assessment, double checking and a system of cascading discretion limits in decision-making on loan applications. Furthermore, a separation of customer acquisition from credit control leads to sequential decision-making. As a result of these two procedures, the overall risk involved in a decision is transformed into partial risks dealt with by different organisational units or different hierarchical levels. Bureaucratic methods of standardisation tend to take the consideration of risk out of day-to-day routines since decision-making is prescribed by rules which leave little discretion about risk taking to the individual staff.

In contrast to the findings of studies conducted before ours (Quack and Hildebrandt 1997; Hildebrandt 1999), a number of German banks in our sample reported that they had given up the strict division between customer acquisition and credit control in order to increase speed and efficiency of their decision-making. Two commercial banks and one savings bank had recently introduced teams consisting of relationship managers, credit officers and other specialised staff dealing with a group of specific SME customers. Two banks (one commercial and one savings bank) emphasised that, in order to increase efficiency and speed of decision-making, they were reducing the number of the hierarchical levels involved in the decision-making process. Applications would be immediately forwarded to the level of the hierarchy responsible for the respective size of lending, while intermediate levels of the hierarchy would be informed only after the decision had been taken. These banks, thus, were attempting to re-integrate decision-making on lending to SMEs, or at least to reduce the degree of sequential decision-making. The other savings bank and

the cooperative bank in our sample were still operating the classical division between customer acquisition and credit control, as well as hierarchical systems of discretion limits. They did not intend to change these.

Three of the German banks in our sample reported that the SME relationship manager (or the branch manager) would decide alone on lending applications up to a certain limit. This was specified as up to DM 250,000 – 500,000, depending on the seniority of the manager as well as the banks' decision-rules[4]. In general, commercial banks tended to grant higher discretion limits to individual managers than savings and cooperative banks. German commercial banks, thus, are more prepared to follow 'market principles' than savings and cooperative banks with their different constitution.

But even German banks which had reduced the incidence of sequential decision-making by introducing teams still kept a relatively strong focus on standardisation of decision-making. The main instrument to achieve this standardisation was computer-based expert systems for rating loan applications. These systems standardised the collection and weighting of the information relevant for the loan application and defined 'positive' and 'negative' areas of decision-making. The final decision, however, was still taken by the relationship manager. Standardisation of decision-making itself was, according to the German respondents, achieved through previous training and work experience (particularly as credit officer)[5]. Variations in assessment, if at all, would occur only with regard to the evaluation of the management of the company in question. Some bankers also referred to existing written guidelines on lending, but compared to the practical application of the rating systems they seemed to be of less importance.

Four of five German banks stated that they were satisfied with the degree of standardisation reached, and most of them explained that it was more a matter of steering the risk portfolio than achieving complete standardisation, which was considered as not possible. Surprisingly, when asked, only two banks reported that they had or were planning to introduce procedures which would control whether standardisation had been achieved or not[6].

In contrast to the German model, decision-making in British banks has been described in the literature as individualised and more idiosyncratic (Deakins and Hussain 1991; Hutchinson and McKillop 1992). The – relatively vague – answers of our British interview partners suggest that like in Germany, the relationship manager is responsible for decision-making on lending within the limits of his/her discretion[7]. Two commercial banks specified the discretion limits of business relationship managers / branch managers as up to approximately £ 40-50,000. Beyond these limits, applications would be referred either to managers at higher levels of the business unit, to the commercial/corporate lending unit, or to a regional credit control unit. Thus, in terms of discretion limits for relationship managers at the local level, British banks did not appear to differ significantly from German banks.

As far as standardisation is concerned, this seemed to be of less concern to British than to German banks[8]. One British bank states that standardisation was supposed to come from the training side (including internal and CIB training courses, as well as the 'apprenticeship' as relationship manager's assistant), and another bank used a computer-based scoring system to assess loan-applications above a certain size and assessed the lending of branches every second year. Three banks mentioned the aim to standardise decision-making as one of the reasons for their plans to install computer-based scoring and rating systems in the near future (other reasons given were to reduce costs; there were contrasting opinions as to whether these systems would increase the quality of risk analysis as such). As far as there were attempts to standardise decision-making in British banks, they referred to the introduction of computerised rating and scoring systems which assessed loan applications based on class-based probability calculations.

If not through bureaucratic standardisation, decision-making on lending in British banks might be managed and controlled through other mechanisms translating overall business goals into decision-making at the individual level. Performance related pay systems, for example, can be regarded as a method to steer the behaviour and decision-making of staff according to banks' business goals. Our results on performance related pay, however, do not support the claim

that British banks are more strongly oriented towards the introduction of market principles and German banks are more prone to preserve security. Nor do the results suggest that British bankers have more individual leeway and are more steered through profit-making than German bankers. In Britain, all banks had performance related pay systems for relationship managers which accounted for between five and 20 per cent of the overall income. In Germany, three out of five banks had performance related pay systems for relationship managers which accounted for between five and 25 per cent of the overall income. Due to limitations through the existing collective agreement, the two saving banks in our sample did not operate such systems but intended to introduce a performance related pay component in the near future. Among commercial banks, there were no clear differences in the criteria on which performance related pay was based. In both countries, banks listed volume and profits attained from lending most frequently, followed by the quality of the lending (e.g. risks involved) and listing organisational, staffing and community issues last.

Overall, banks in both countries still seem to operate rather bureaucratic systems of hierarchical decision-making on lending to SMEs within which performance related pay systems are only subordinate instruments to steer decision-making. Nevertheless, the survey revealed pronounced differences with regard to the degree of standardisation and of sequential decision-making. German banks tended to invest more resources in order to achieve standardisation, and they were still more prone to subdivide decision-making into different steps, or at least to involve people with different qualifications and backgrounds in the decision-making than their British counterparts. Recently, differences within the German system appear to have become more significant, with commercial banks being quicker to embrace the new ‘market’ principles than savings banks and, to a lesser extent, cooperative banks. These constrain managers to link pay to performance, and exert pressure on organisations to depart from sequential and bureaucratic to more integrated decision-making procedures.

5. Discussion and conclusion

Our analysis started from the assumption that in order to understand cross-societal differences in bank lending to SMEs we have to analyse

how the institutional environment shapes the way in which banks construct and manage risk. We suggested a theoretical framework combining institutional and neo-institutional approaches which would allow us to include regulatory, normative and cognitive effects in our analysis. Douglas and Wildavsky's (1982) 'market' and 'hierarchy' institutional types were chosen as appropriate typifications for a cross-national comparison of banks strategies and practices towards risk in lending to SMEs in Britain and Germany. Our interest, however, was not only to analyse similarities and differences between the two countries, but also to identify ongoing changes which could be related to the increasing internationalisation of banks in both countries.

Differences between a market-led, individualist approach and a hierarchical, collectivist approach towards risk taking and management are most clearly visible in British banks' greater propensity to externalise risk by transferring it to customers, compared to German banks' greater readiness to collective risk sharing. In both cases, banks' strategies remain closely related to the existing institutional environment in each country. But the empirical analysis indicates that, for each country, gradual changes in the institutional context and in banking practices occurred in parallel.

In Britain, the economic, social and political situation throughout the 1990s generated a climate that was more attentive to financing of SMEs, and within this context forms of collective risk sharing, such as the Loan Guarantee Scheme, could be established and consolidated on a limited scale. Since the overall institutional context is still characterised by market-led and arms' length relationships, collective risk sharing strategies cannot gain more than a niche status in the British context. Our results show that the reasons for their limited reach might not only lie in their state-led character and the indifference of commercial banks in Britain. The British scheme focuses mainly on smaller loans for which collective risk sharing is not regarded as an attractive or cost effective strategy by German banks either.

In Germany, increasing internationalisation has led commercial banks, and to a lesser extent savings and cooperative banks, to reassess their services to small firms in terms of cost effectiveness. It has, however, not undermined their willingness to use collective risk sharing for larger SMEs and business start-ups, nor does it seem to have led to an increasing externalisation of risks by passing them to customers so far. This partly is related to the fact that within the German market there is fierce competition between commercial, savings and cooperative banks for the custom of SMEs, which are considered to be a lucrative customer group. This is also highlighted by the fact that the aim of large German commercial banks is to achieve a leading position in the SME market throughout Europe.

Regarding banks’ strategies to select and manage risks in lending to SMEs, the results do not fully correspond to our original hypotheses of a market-led, individualistic approach in Britain versus a hierarchical-collectivist approach in Germany. In both countries, organizational structures and routines of the SME business (as that of retail banking in general) are still modelled along classical bureaucratic principles. Within this bureaucratic model, however, the results show clear country differences which appear to be reformed but not fundamentally changed under the pressures of internationalisation.

British banks follow a portfolio-led approach towards risk which favours class-based assessment of individual loan applications and uses mainly standardised, quantitative information such as company reports, account information and cash flow analysis. The downside of this approach is that qualitative indicators, relating to management skills and prospects of future projects, become regarded as subjective and unreliable, and are not systematically included in the risk assessment. Given the strong pressures for profit performance which financial markets exert on British banks, it is surprising, however, how little attention was given by the British bankers we interviewed to efforts to standardise risk assessment in their banks.
German banks, in contrast, tend to follow a case-based approach towards risk evaluation in lending to SMEs which encompassed quantitative and qualitative indicators of credit worthiness and
included also future-oriented variables. There are some indications that internationalisation of German commercial banks might drive them closer towards the portfolio approach of their British counterparts. Thus our results suggest that, as part of overall restructuring programmes, management hierarchies in lending to SMEs are becoming 'leaner' and 'slimmer', that the high degree of sequential decision-making is being reduced and that performance-related pay systems are being introduced. These developments become even more significant when seen in the context of the future changes which the top management of Deutsche Bank as the sectoral leader, envisage. Thus, German banks attempt to compensate for their more qualitative and subjective evaluation of individual borrowers with a highly standardised procedure to deal with risk. British bankers, in contrast, adopt a more quantitative approach to loan assessment while giving less attention to a standardised evaluation of risk.

The results of our analysis indicate an increasing differentiation among German banks in terms of business strategies and approaches towards lending to SMEs between commercial banks, on the one hand, and savings and cooperative banks,on the other hand. The commercial banks seem to have embraced more rapidly a market-driven approach which is reflected by a concentration on lucrative sub-segments of the SME market, a reduction of their branch networks, flatter organizational hierarchies and performance-related pay systems. Savings and cooperative banks, in contrast, continue to serve also the lower segments of the SME market, remain embedded in the

institutional networks of their locality, maintain most of their organizational and decision-making structures, and are more reluctant to adopt (or are institutionally limited in their use of) performance-related pay systems.

Whereas in the 1970s and 1980s competition for customers drove commercial banks to establish services for SMEs which resembled those of their competitors, the savings and cooperative banks, the internationalisation in the 1990s appears to have had the opposite effect. The gradual change in business strategies of commercial banks does not necessarily have to result in negative effects on the availability and conditions of SME finance in Germany. As we have seen in section 3, the specificities of the German banking sector are based to a large extent on the institutional framework under which savings and cooperative banks fulfil their task. These banks, because of their larger market share for SME financing, continue to shape outcomes for SMEs.

Threats to the German type of financing SMEs, thus, do not only or even mainly originate from market-led gradual realignments in the overall business strategies of large commercial banks. They also derive from the EU Commission's decision (taken in July 2001) to impose considerable changes in regulation and organisation of savings banks and their regional *Landesbanken.* According to this decision, the assumption of liability by the banks' (state) guarantor (Gewährträgerhaftung) - which prevents the occurrence of bankruptcy by public institutions - shall be abolished, and the provision ensuring the supply of sufficient capital by the state (*Anstaltslast*) will have to be adapted to EU competition standards within a transitional period of four years. An end of state liability would mean that banks no longer have access to credit below market rates. These changes in regulation signify a considerable transformation of institutional features which previously had allowed savings banks to play a central role in the financing of SMEs. Many savings banks are likely to change their status to that of limited liability company. Hence, mergers with/take-overs by commercial banks, heralding stronger concentration within the banking sector, are predicted, as is a radical reduction of the branch network (Financial Times Deutschland, 18.7.2001).

It remains to be seen how these changes will impact on the role , vis-a-vis SMEs, this important segment of the German banking sector will be able to play in future. Predictions of radical change (Financial Times Deutschland, 18. 7.2001) contrast with cautious optimism from within the savings banks system (Deutscher Sparkassen- und Giroverband 2001b). The latter promised not to change its philosophy of steering a course 'between competition and orientation to the common good' (ibid), and far-reaching organisational reforms and changes in business foci are envisaged to maintain the competitiveness of the savings banks group (Deutscher Sparkassen- und Giroverband 2001a).

Notes

1. During the mid 1990's, small and medium-sized firms provided 60 and 58 per cent of employment in Germany and the UK, respectively (DTI 1997).

2. In Germany, additional interviews were conducted with representatives of intermediary organisations which play an important role in risk sharing and risk assessment. This included two semi-public guarantee banks and the chamber of commerce in the region which the savings banks and the cooperative bank included in our sample were located. Data from these interviews have not been included in this paper but helped to cross-check information provided by the German Banks.

3. In general, savings and cooperative banks showed a lower degree of specialisation between different segments and tended to concentrate on smaller companies in each segment.

4. As one of our respondents indicated, fierce competition in the banking sector renders it sometimes difficult for banks to enforce these requirements on small business customers (see also Gude 1995).

5. The Mittelstand unit of the other large commercial bank represented an exception in the sense that loan applications were always decided upon collectively by the newly established team of relationship manager and credit officer, but it has to be taken into consideration that the upper limits for lending were much higher in this case (up to DM 500 million).

6. Outside the 'positive area identified by the expert system, the relationship managers' decision- making was again controlled through double checking and hierarchies: At least one bank stated that such a decision needed to be supported by another manager in order to be acceptable.

7. In one case, this was achieved through an analysis of default risk down to the level of the branch which then had to attempt to identify the source of ‘wrong’ decision-making. One other bank was planning to introduce such a system in the future in order to provide relationship managers with a better knowledge about their risk position and the diversification of risks. Three banks did not mention any method to control for standardisation, with one big commercial bank explicitly arguing that they did not need such a control.

8. Only one Scottish bank had just moved from this model to a centralisation of decision-making by sanctioners based in regional offices. This case resembled the ‘niche concept’ since the relationship manager would prepare the loan application and forward it with his or her recommendation to the sanctioner who would take the decision.

9. One British Bank even stated that they had no form for loan applications and used the business plan as basis for their assessment.

FIGURES AND TABLES

Table 1
Long-term lending as a proportion of total lending to domestic firms in Germany according to bank groups, 1990-1999

	Total lending to domestic firms (in bill. DM)			Long-term lending as proportion of total lending (in %)		
	1990	1995	1999	1990	1995	1999
Commercial banks	285,0	429,0	239,0	33,9	43,0	41,8
Saving banks	242,3	452,9	288,3	63,6	68,4	66,2
Cooperative banks	84,9	137,6	80,5	43,2	45,8	46,5
Others (including development banks)	187,0	242,5	151,9	94,8	91,1	88,8
Total banking sector	799,2	1262,0	759,7	58,1	61,7	60,9

Note: Long-term lending refers to loans which are granted for a duration of 4 or more years.
Source: Deutsche Bundesbank, Monatsberichte, various issues. End of the year data.

Table 2
Term loans as proportion of banks' total lending to SMEs in Britain, 1990-1999

	Dec. 1992	June 1995	June 1999
		In %	
Lending on overdraft	49,2	36,9	29,8
Term lending	50,8	63,1	70,2
Total lending	100,0	100,0	100,0
(bn £)	39,54	35,90	37,20

Source: Bank of England, Quarterly Report on Small Business Statistics, December 1995 and January 2000.

Table 3
Banks' definition of business customers

Category	Definition of size		Organizational unit assessing loan application
	Britain* (in Ecus)	Germany* (in Ecus)	
Small firms	<1.6 Mio	<0.65 mio	Retail branch
Medium-sized firms	1.6 mio – 99.2 mio (1/5 – 1/130)	O.65 mio – 70 mio (1/2 – 10/500)	Corporate advisory centres
Large firms	>99.2 mio (>5/130)	>70 mio (>10/500)	Corporate department in headquarters

*Calculated at exchange rates of £ and DM in Sept. 2001.
Source: Information provided to us by British and German banks.

Table 4
Lending portfolio of surveyed banks in Britain and Germany, 1995/6

	Britain		Germany	
	Small Business Customers	All Business Customers	Small Business Customers	All Business Customers
Proportion of lending on fixed-term interest rates in % of total lending (by volume)	12% (10-13%) (n= 2)	11% (n=1)	52% (52-56%) (n=4)	57% (40-70%) (n=4)
Proportion of lending backed by collateral in % of total lending (by volume)	59% (n=1)	68% (60-75%) (n=2)	66% (n=1)	54% (45-60%) (n=4)

Notes: Each square of the table provides first the average value, followed by the range of observed values (in brackets) and the number of observations (n).
Source: Lending statistics provided to us by British and German banks.

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