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Document Version
Final published version

Publication date:
2007

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Citation for published version (APA):
Gregoric, A., & Kosak, M. (2007). *SME Financing and Multiple Bank Relationships in Transition Economies*. Department of International Economics and Management, Copenhagen Business School. Working Paper / Department of International Economics and Management, Copenhagen Business School No. 8-2007

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Download date: 30. May. 2024



SME FINANCING AND MULTIPLE BANK RELATIONSHIPS IN TRANSITION ECONOMIES

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Abstract

This paper investigates bank-borrower relationships in an advanced transition country. The empirical analysis is based on a unique dataset of 121 privatized small and medium-sized Slovenian corporations in the first years following the end of the banking sector's reorganization (1998–2002). The results reveal the strong dominance of bank funding for small and medium-sized enterprises. Despite this, the firms included in the study are characterized by a small number of bank relationships. The specifics of the transition are moreover reflected in the substantial role of fixed assets that can be put up as collateral. However, the number of bank relationships relates to similar factors that have been proven to influence the number of firm-bank relationships in developed countries. We thus expect that the number of bank relationships in Slovenia will increase with the progress of restructuring and privatization of the enterprise sector and with the integration of financial markets following Slovenia's entry to the European Union.

JEL: G32, G21

1. Introduction

Several factors underpin the reasoning of the importance of banks in firm financing. The variety of services banks provide to enterprises enables them better access to information about firms. As a result, banks have a comparative advantage in screening projects and monitoring clients and in mitigating moral hazard and asymmetric information problems. In particular, banks might be better than markets in providing finance to *de novo* or smaller firms with no reputation. They may be more inclined to bargain and prevent inefficient liquidations and can rely on alternative mechanisms to boost the efficiency of investment allocations, such as credit rationing and collateral (Feldman and Wagner, 2002). For several reasons, all of these factors acquire further importance in transition economies. The transition to a market economy requires the extensive restructuring of the corporate sector and the constitution of *de novo* firms with the corresponding re-allocation of funds to more productive sectors. Given the limited development of capital markets and limited alternative sources of financing¹ firms in transition economies mostly depend on local banks. This provides the latter with relatively strong bargaining power and, consequently, the potential to extract rents through excessive

loan pricing (the hold-up problem). This could particularly be the case in highly concentrated banking sectors with a few dominant local banks, which is often the case in transition countries.² One way in which firms may avoid the hold-up problem is by building relationships with more than one bank (Rajan, 1992). We would thus expect firms in transition countries to have several bank relationships. However, the average number of bank relationships in the region is relatively small. Ongena and Smith (2000), for instance, report that Polish firms on average do business with 3.3 banks, while the number of bank relationships is only slightly higher in Hungary (4). This certainly raises doubts about the ability of firms in transition to rely on new banks and hence about firm capacity to avoid the hold-up problem and reduce their financing costs. Firms' access to bank financing in fact also depends on the institutional environment in which the firms and banks operate. In reality, despite firms' strong demand for financial funds the transition-related shocks to the economic environment and the financial system have largely hampered the financial inflows to these firms.³ It is thus the aim of the paper to explore whether the relative underdevelopment of the financial system, poor enforcement of both shareholder and creditor rights and other inefficiencies in the regulatory and legal environment somehow hinder firms from reaching the 'optimal' level of bank relationships. This, in turn, would normally reflect a firm's optimization of the costs and benefits of creating multiple bank relationships.

More precisely, our study focuses on the characteristics of bank financing for small and medium-sized firms in Slovenia, an advanced transition country. The sample and period of our analysis is interesting for various reasons. First, we focus on the initial years following the reorganization of the Slovenian banking sector.⁴ Although the banks began operating like normal corporations, they still shared some specifics in their behaviour and business environment that could have distorted their lending behaviour. They mostly lacked experience in 'traditional' lending activity and credit evaluation⁵. Moreover, at least initially the restructuring of the banking sector, limited entrance of foreign banks and domination of the two state-owned banks very likely introduced further distortions and obstacles to the banking sector's lending capacity. Second, our analysis studies the characteristics of firm-bank relationships on a sample of small and medium-sized enterprises (SMEs). Although these enterprises dominate the Slovenian economy⁶ they fit perfectly with the purpose of our study. In fact, SMEs may in particular be subject to the hold-up problem. They are most often too small to access the stock market and are characterized by greater opaqueness and information asymmetry than larger firms. Moreover, while the concentration of banking sectors and increasing integration of financial markets favour large companies, they make SMEs' access to bank loans more difficult.⁷ On the other hand, regulatory limitations of foreign investments have largely limited the inflow of foreign funds⁸ to the economy while the poor investor protection has mostly prevented the capital market from functioning, making bank financing almost the only source of financing available to Slovenian SMEs.

The results of our study show that the access to and costs of bank financing represented the main factors determining firm investments and growth in the period of our analysis. We further find that these firms valued their relationships with domestic banks highly, while on average less importance was attributed to outside equity investors and foreign banks. Notwithstanding the banks' importance, the number of firm-bank relationships was relatively small. The firms on average borrowed from two banks with the main bank providing them with more than one-half of their total loans. However, our

empirical findings show that, despite the peculiarities associated with a financial system in transition, the number of bank relationships relate to similar factors that determine multiple bank relationships in developed countries. On average, the number of bank relationships in the 1998-2002 period increased with firm size, the dependence of firms on bank financing and their influence on firm decision-making. Unlike other studies that proxy the importance of banks with selected financial ratios, we directly address firm management and measure their perception of the banks' role and importance of bank financing. Also consistent with the theoretical predictions is the negative impact of firm reputation (age) and bank board representation on the number of bank relationships. Again in line with expectations, poorly performing firms found it harder to build new links with banks. In addition, we find empirical confirmation of some weaknesses of transition banking: the significant positive impact of the size of the fixed assets on the number of bank relationships confirms the general observation about prudential bank lending and the relevance of guarantees in determining firms' access to credit in transition. Further, the limited role that the firms attributed to foreign bank financing reflects another feature of the transition, namely the monopoly power of the main local bank(s), inherited from the pre-transition period. We thus expect to observe more bank relationships in the future in relation to Slovenia's accession to the European Union (2004) and improvements made to corporate governance practice, the transparency and regulation of both the financial and non-financial sectors and the growing financial sector competition following Slovenian integration with European financial markets.

The paper is structured as follows. The second chapter provides a short description of the banking sector and the characteristics of small and medium-sized enterprises in Slovenia. The third chapter sets out the main theoretical and empirical findings explaining the emergence of firm-bank relationships. The empirical analysis of firms' access and decisions to create multiple bank relationships is presented in the fourth section. The last section concludes.

2. Aggregate data on banking sector exposure to the corporate sector in Slovenia

The analysis of the determinant of bank relationships in Slovenia relies on a sample of 121 small and medium-sized enterprises⁹ in the 1998-2002 period. As evidenced in Table 1 below, these firms financed most of their investments through internally generated funds (amortization and retained earnings), while bank loans represented a limited yet still the most important source of outside financing. In the period of our concern, we observe the growing importance of long-term financing, and nearly no reliance on equity or bond financing.

These data receive confirmation in the findings of Volz (2004) based on the 2002 Business Environment and Enterprise Performance Survey (BEEPS) implemented jointly by the EBRD and the World Bank. The survey covers 6,153 firms in 26 transition countries (including Slovenia). Volz (2004) reports similar observations to ours: internal funds constitute 39.20 (50.80) percent of new investments in medium (small) firms, while borrowing from banks provides 16.4 percent (10.5 percent). Equity issues and other sources of financing are negligible (below 1%), while foreign banks provide 2.8% of funding in medium firms and 0.97% in small firms. A similar picture emerges when

observing aggregate statistics at the country level. Bonds are mostly issued by banks (3% of GDP in 2004) and the government (17.8% of GDP). Corporate bonds, on the other hand, represent less than 1% of GDP in 2004 (Bank of Slovenia, 2005).

Table 1: Percentage of total additional firms' investments financed by different sources of financing for 121 small and medium-sized firms

	1998 Mean (Median)	1999 Mean (Median)	2000 Mean (Median)	2001 Mean (Median)	2002 Mean (Median)
New issued shares	0.46 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)
Retained earnings	13.63 (0.00)	14.86 (0.00)	15.67 (0.00)	15.91 (0.00)	16.63 (0.00)
New issued bonds	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)	0.00 (0.00)
Bank debt: long-term	5.52 (0.00)	10.16 (0.00)	10.49 (0.00)	11.41 (0.00)	12.83 (0.00)
Bank debt: short-term	3.31 (0.00)	4.14 (0.00)	6.86 (0.00)	5.75 (0.00)	5.47 (0.00)
Amortization	59.46 (70.00)	55.01 (59.00)	52.03 (50.00)	52.62 (50.00)	54.23 (51.50)
Other sources	5.73 (0.00)	6.20 (0.00)	5.42 (0.00)	8.62 (0.00)	6.71 (0.00)

Source: Authors' calculations.

The importance of bank financing is further explored on the basis of questionnaires. We asked the firms to evaluate the importance of different characteristics related to the financial sector for their investments and growth (1-not important; 5-very important). The descriptive statistics reflecting firms' perceptions of the importance of selected factors are presented in Table 2 below. As shown in the table, the costs of bank financing represent the most important factor influencing firm investments and growth. Also, half the firms attributed a high level of importance to their relationships with domestic banks. On the other hand, foreign bank loans and external investor capital mattered less. The required documentation and, in particular, potential lack of professionalism or corruption of bank employees when assigning loans also does not represent an important factor for SME financing in Slovenia.

Table 2: Importance of financial sector variables for firm operations and growth

	Mean (sd)	Median	Min	Max
High interest rates	4.14 (1.14)	5.00	1.00	5.00
Access to bank financing	3.43 (1.24)	4.00	1.00	5.00
Required loan documentation	2.97 (1.20)	3.00	1.00	5.00
Access to loan information	3.17 (1.30)	3.00	1.00	5.00
Relationships with banks	3.73 (1.19)	4.00	1.00	5.00
Lack of professionalism of bank employees	1.53 (0.99)	1.00	1.00	5.00
Access to foreign bank financing	2.67 (1.28)	3.00	1.00	5.00
External investor capital	2.67 (1.38)	3.00	1.00	5.00

Source: Authors' calculations.

Credit relationships were also the primary reasons for the existence of firm-bank relationships in Slovenia. For the period of our analysis, Gregoric (2003) reports that banks rarely held significant ownership blocks directly but, if present, participated in firm ownership indirectly through bank-founded investment funds. Consistent with the latter observation is the average percentage of shares owned by the banks in the firms in our sample, which amounted to just 1.06 (median share=0). The limited involvement of banks in firm equity also receives confirmation in the aggregate data. In the period of our analysis, the total equity holdings of banks did not exceed 0.5% (see Table 3). Slightly higher was bank participation in issues of other debt-like corporate securities (i.e. bonds). Loans, however, represented by far the most important bank claim on the corporate sector. Although they have been increasing over the last few years, in 2002 the share of bank loans in GDP was still substantially lower than in the Euro area countries.

Table 3: Banking sector claims on the corporate sector in Slovenia, as a % of GDP for the 2000 – 2004 period (GDP in million EUR)

As % of GDP and in mill. EUR	1998	1999	2000	2001	2002
GDP in million EUR	17,222	18,490	20,105	21,507	23,080
Corporate loans	20.7%	22.7%	23.5%	26.1%	25.7%
Corporate securities	1.4%	1.4%	1.4%	1.4%	1.9%
Equity holdings	0.5%	0.5%	0.4%	0.4%	0.3%
Total claims to corporate sector	22.6%	24.5%	25.4%	27.9%	27.9%

Source: Bank of Slovenia (2005)

Given the importance of bank financing for Slovenian small and medium-sized enterprises, the limited role of share capital, limitations on single bank exposures¹⁰ and inefficiencies in the institutional environment, we would expect multiple bank relationships to be quite common in Slovenia. However, as evidenced in Table 4 below the average number of bank relationships in 1998-2002 resembled that seen in the most developed European countries. This seems to be the case despite the fact that bank financing actually represented the main source of outside firm financing in Slovenia and despite the weaknesses in the institutional environment (i.e. insufficient creditor protection).¹¹ On average, firms borrowed from three banks, while half the firms did not borrow from more than two banks. A similar number have been reported for Norway (2.3), Sweden (2.5), the United Kingdom (2.9), namely all countries with functioning legal systems and a variety of alternative financing sources (i.e. large families in the Scandinavian countries, capital market and venture capital in the UK).¹²

Table 4: Frequency distribution of bank lending relationships for 121 small and medium-sized Slovenian firms

	Number of firms	Percentage of firms
One bank relationship	37	30.58
Two bank relationships	43	35.54
Three bank relationships	26	21.49
Four bank relationships	6	4.96
More than four bank relationships	9	7.44
Total	121	100.00

Source: Authors' calculations.

Most of the firms relied on one large bank; on average, the single largest bank provided 67.87 percent of the entire bank financing for the firms in our sample, while for half the firms this percentage exceeded 70 percent. We find that the percentage of loans provided by the main bank is negatively related to the number of firm-bank relationships (corr.=-0.55, sign=0.00). The observed dominance in loan provision by one main bank implies that relationship lending is an important lending technology¹³ in Slovenia. This privileged bank-borrower relationship may provide the banks with strong relative bargaining power and, consequently, the potential to extract rents at the cost of firms and their shareholders (or other stakeholders). This may particularly be the case in highly concentrated sectors where the ‘incumbent’ powerful banks may limit firms’ access to smaller banks and further aggravate the hold-up problem.

The Slovenian banking sector can be in fact considered a highly concentrated market. This is clearly illustrated in Table 5. Based on total assets, the data on concentration coefficients CC5 and CC3 show that in the period of our analysis the five largest banks in the country held more than a two-thirds market share. Even more indicative is the fact that the three largest banks controlled more than one-half of the market. Concentration rates in the loan market are somewhat different. The market share of the three largest banks in the country, measured by loans to non-banking firms, was lower (around 50%) than the market share measured by total assets in the entire period under observation. It is possible to observe a similar pattern of the market shares of the five largest banks in country, meaning that smaller banks managed to compete with their larger competitors as concerns credit operations.

Table 5: Market structure data for the Slovenian banking sector

	1998	1999	2000	2001	2002
Proportion of foreign owned banks	13.0%	20.0%	21.4%	20.8%	27.3%
Market share of foreign owned banks	4.9%	4.8%	15.3%	15.2%	16.9%
Market share of state owned banks	41.3%	41.7%	42.5%	48.9%	13.3%
Market concentration (CC5 - total assets)	63.2%	63.4%	59.5%	66.3%	67.2%
Market concentration (CC3 - total assets)	51.7%	51.4%	46.7%	53.6%	55.4%
Market concentration (CC5 - loans to non-banks)	---	---	60.0%	66.2%	67.1%
Market concentration (CC3 - loans to non-banks)	---	---	43.4%	51.1%	52.9%

Source: EBRD Transition Report (several issues), Bank of Slovenia (2005)

How then has all of this influenced the number of bank relationships in the first years of the ‘advanced’ Slovenian transition? To what extent were Slovenian banks capable of preserving their privileged relationship with SMEs and extract rents for their benefit? How much did the specifics of the transition and underdevelopment of the financial sector in general prevent firms from creating links with new banks and avoiding the potential hold-up problem? Several theoretical assumptions and empirical evidence discuss the influence of firm- and industry-specific factors on the costs and benefits of multiple bank relationships and, consequently, determine their ‘optimal’ value. Our aim is thus to explore whether the specifics of the banking sector in a transition country (e.g. court delays in enforcing contracts; high concentration of the banking sector; state-ownership; delays in firm restructuring and privatization) have somehow distorted the effects of any of the mentioned factors on the number of bank relationships.

3. Theoretical and empirical explanations of the number of bank relationships

By lending to enterprises banks acquire important information that is not available to others (firms' prior projects, liquidity, future intentions etc.). By gathering this information and monitoring the repayment of the debt, they ensure some control over the firms and resolve the private incentive problem related to monitoring by small individual lenders. As such, bank monitoring represents an important corporate governance mechanism and contributes to better access and lower financing costs. This is particularly the case with small and medium-sized enterprises, which have available fewer assets that can be put up as collateral (Gelauff et al., 1996). Banks can in fact gather information beyond the hard information available to other investors. Information is gathered through contacts with the firms, their owners, the local community, from the provision of earlier loans, from contacts with the borrowers' business partners etc. (Berger and Udell, 2002:37). Bank access to this 'detailed' information about the firm increases with the length and exclusivity of the bank-firm relationship, namely the establishment of 'informed' relations.¹⁴

The strength of the bank-borrower relationships normally results in a variety of positive effects for the firm such as lower loan interest rates, reduced collateral requirements, less dependence on trade debt, increased credit availability etc. (Berger and Udell, 2002). However, a fundamental consequence of this asymmetric information and the bank's 'preferential' access to it is that it yields an ex post monopoly power even when the banks are ex ante competitive. To put it differently, it provides the banks with some bargaining power over the firm's surplus, which can result in firms having less of an incentive to exert effort (Rajan, 1992). Competition among potential financiers reduces the bank's control over projects since uninformed lenders may continue unprofitable projects. Thus, firms may reduce this monopoly power by establishing links with more than one bank. The number of bank relationships should also increase with firm size since large firms' needs for financing might quickly exceed the financing capacities of one bank and with the limited firm access to alternative sources of finance such as a bond or equity market. Multiple bank relationships also decrease the risk of losing a single bank relationship and thus the firm's dependence on a single bank (Detraiche et al., 1997). We believe the former to be less likely when the single bank has alternative links with the firm such as participation in ownership or representation on the supervisory board. However, a firm's reliance on many banks potentially reduces the bargaining power and ability of the single (main) bank to exercise (exclusive) control over the firm's managers and, consequently, the availability of credit provided by the main bank (Ongena and Smith, 2000:27; Petersen and Rajan, 1994). The latter may be more important in poorly performing firms that, due to a poor performance history, find it more difficult to convey information about future prospects to other banks. Similarly, single banks are more likely to extract rents from firms with high financial burdens since the latter largely lose some of their bargaining power. We would also expect to observe a lower number of bank relationships in firms with a lower number of fixed assets that could be used as collateral. The financing requirement may also vary across industries since certain industries, such as manufacturing, may need more substantial outside financing than others. Thus, when choosing the number of banks to do business with firms somehow weigh up between the benefits and costs of multiple bank relationships. The decision depends on the relative bargaining power of the different sources and the revelation of information

(Rajan, 1992:1369). The latter, we believe, is largely influenced by the features of the financial sector and the institutional environment in which firms and banks operate. In fact, the highest number of firm-bank relationships is reported for countries with poor investor protection and a limited role of capital markets in firm financing such as Italy, Portugal, France, Belgium and Spain (Ongena and Smith, 2000).

4. Slovenian banks and corporate financing – analysis of survey data

The empirical analysis of the factors determining bank-borrower relationships in Slovenia is based on a sample of 121 small and medium-sized firms. The panel refers to the 1998-2002 period, namely the first four years following the conclusion of the banking sector's reorganization in Slovenia. Data on the ownership structure (aggregate ownership stakes by different investor groups), the composition of the supervisory board, the number of bank relationships and the other variables describing firm relations with banks were obtained from questionnaires sent to over 623 Slovenian firms with shares registered in the Shareholders Register of the Central Securities Clearing Corporation (161 responses were obtained, including 121 responses from small and medium-sized firms). Data on the firms' financial performance come from the Agency of the Republic of Slovenia for public legal records and related services.

The inclusion of the explanatory variables in part follows the theoretical predictions and existing empirical evidence from developed countries. In addition, we try to measure the firms' and banks' bargaining power by addressing the firms through the questionnaires. This is a novelty in comparison to existing empirical papers. First, we directly ask the firm managers to evaluate (using a Likert scale from 1-no influence; 5-important influence) the banks' influence on firm operations and decision-making (*BANK INFLUENCE*). Similarly, the banks' importance for firm financing is evaluated relative to managers' responses concerning the importance of the following factors for firm investments and growth: growth: i) the relationships with banks; ii) access to domestic bank loans; iii) the interest burden or, better, the costs of bank financing; iv) access to outside investors' financing; iv) and access to foreign bank loans. Using the responses we obtained we construct a composed variable which captures the importance of the costs of bank financing, access and relations with local banks (*ROLE OF BANK FINANCING*). The variables measuring the importance of foreign bank loans and outside investor financing enter into the regression separately. Similarly to other studies, we control for firm size, measured with the value of logarithm of total sales (*TOTAL SALES*). The possibility of a loss of the bank relationship is approximated by the presence of a banker on the supervisory board (*BANKER ON BOARD*). The existing financial leverage is measured alternatively by the percentage of interest payments in total sales (*INTEREST BURDEN*) and the percentage of firm long-term debt in total assets (*LDEBT TO ASSETS*; in logarithms). We further control for firm performance (*EBITDA/ASSETS*), age (*AGE*) and industry (*RETAIL, SERVICE and MANUFACTURING*). In order to capture the specifics of banking in transition, we control for the availability of assets for collateral, measured by the size of fixed assets (*FIXED ASSETS*, in logarithms) and the ownership structure (percentage of inside ownership¹⁵).

Since the dependent variable (see Table 4) is truncated at 1, ordinary least squares could produce biased estimates. Following Green (2003), we rely on the Tobit specification, which is effectively a hybrid between a standard regression model and a binary choice model. The selected¹⁶ results with the corresponding marginal effects at the mean values of the explanatory variables and OLS regressions are presented in Table 6 below. In all cases the dependent variable is the average number of bank relationships over the 1998-2002 period as reported by the firms.

Table 6: Firm-level Tobit Regression - dependent variable: number of bank relationships

	(1)	(1)Slope#	(1) OLS##	(2)	(2) Slope#	(2) OLS##
Constant	-14.489***	-11.207	-9.929***	-10.303***	-8.335	-8.058***
Banker on board	-0.788***	-0.564	-0.643***	-1.093***	-0.804	-0.865
Role of bank financing¹⁷	0.700***	0.541	0.442***			
Access to foreign bank financing	0.061	-0.036	0.058			
Access to investor capital	-0.047	0.047	-0.078			
Bank influence	0.337***	0.260	0.318***	0.307***	0.248	0.302
EBITDA/assets	-0.026**	-0.020	-0.146*	-0.026**	-0.185	0.126
LDEBT to assets				0.222***	0.178	
Burden	0.096*	0.074	0.044			
Total sales (ln)	0.457**	0.353	0.332**	0.405***	0.327	0.329*
Fixed assets (ln)	0.514***	0.398	0.422***	0.049***	0.397	0.426***
Age	-0.01**	-0.007	-0.01***	-0.015***	-0.011	-0.014***
Retail	0.096	0.075	0.075	-0.155	-0.123	-0.068
Services (4)	0.3	0.238	0.258	-0.04	-0.032	-0.014
Manufacturing (6)	0.283	0.222	0.074	0.035	0.029	-0.024
Number of observations	385		385	327		327
Pseudo – R²	0.14		Adj R ² =0.38	0.11		Adj R ² =0.35
LR test stat.	194.10***		F=16.83***	132.30***		F=13.43***

Note: significance levels are: 1% (***), 5% (**) and 10% (*)

Legend: # for dummy variables, the marginal change is for the discrete change of the X variable from 0 to 1
Pooled regression

The results of the empirical analysis suggest some efficiency in the firms' choices of the number of bank relationships: firms do seem to make a trade off between the benefits of 'informed' debt and bank bargaining power. There is in fact significant evidence that stronger reliance on domestic bank financing leads to a higher number of bank relationships (*ROLE OF BANK FINANCING*). Similarly, the banks' stronger influence on firm decision-making (*BANK INFLUENCE*), which also implies the banks' stronger bargaining power, significantly increases the likelihood of multiple relationships. Consistently with the limited importance of foreign bank financing, any eventual access to foreign bank financing does not effectively result in multiple bank relationships. Also in line with the expectations and the observations of other empirical studies is the impact of other firm-specific variables: larger and more indebted firms (see the variable *BURDEN* and *LDEBT TO ASSETS*) tend to have a higher number of bank relationships. Firms with a poor financial performance find it harder to make links with new banks. Older firms on average have a lower number of relationships; this may be due to the fact that firm age actually reflects a firm's reputation and, hence, greater potential to access alternative sources of financing as well as the presence of stronger bargaining power vis-à-vis the banks. The presence of a banker on board, on the other hand, results in a lower number of bank

relationships. As already argued, this might be because bank involvement on the board represents a long-term bank engagement and reduces the risk of the latter losing the existing bank relationships. This conclusion is further enforced by the positive and significant relationship between the size of the bank ownership share in the firm and their presence on the supervisory board (correl. coeff. = 0.41).

5. Conclusions

Despite the differences in the chosen privatization programs and methods of financial sector restructuring and development, financial sectors in advanced transition countries share some similar characteristics: the limited role of capital markets, concentrated ownership and control of the corporate sector, the (still) influential role of the state and pre-transition interest groups, a lack of transparency and poor enforcement of shareholder and creditor rights. While firms mostly rely on internal funds for financing their investments, banks provide the most important, although limited source of outside financing. The role of banks is particularly important with regard to the financing of small and medium-sized firms, which are likely to be the subject to bigger information asymmetries and, consequently, higher costs of financing. In order to mitigate the latter, these firms build an exclusive long-term relationship with a single bank (relationship banking) that provides a substantial part of outside financing and other services. Apart from the benefits of single bank relationships, an exclusive firm-bank relationship provides banks with the power to expropriate some 'private' benefits from future firm projects. This is particularly the case in countries where the high concentration of the banking sector and limited firm access to alternative financing sources largely increase banks' bargaining power when it comes to setting the terms of firm financing. In this regard, firms' access to multiple banks represents an important vehicle for reducing the potential hold-up problem.

For the sample of Slovenian SMEs we found that the number of bank relationships in the 1998-2002 period reflected similar factors that generally influence bank-borrower relationships in more developed countries. However, the relatively low number of bank relationships, the limited role of foreign banks and capital market financing and the relevance of fixed assets (as guarantees) for firms' access to banks most probably reflect the weaknesses of transition banking. Hence, we could expect that the number of firm bank relationships in Slovenia and other transition countries will grow along with the restructuring and privatization of the enterprise sector, with the adoption of good governance practices and improvements in the institutional environment in which banks and their clients operate.

Notes:

¹ The smallness of financial markets in transition countries can be attributed to the neglect of financial intermediation under communism, the low level of GDP per capita, the small size of the population of most countries and to the repeated cases of fraud and imprudent banking which led to significant financial losses by households and businesses (Fink et al., 1999:25).

² In fact, empirical evidence confirms that, although limited, bank financing for SMEs in Central and Eastern Europe (CEE) mainly comes from local banks and less from state-owned banks, while foreign bank financing is almost negligible (Volz, 2004).

³ As argued by Berger and Udell (2002:49), shocks to the economic environment can significantly affect the contracting hierarchy and the propensity of banks to make relationship loans and, consequently, significantly impact on the supply of credit to small businesses.

⁴ The restructuring of the two biggest state banks in Slovenia was officially concluded in June-July 1997.

⁵ In the pre-transition period banks were exclusively owned by non-bank corporations, which were at the same time also the most important borrowers. Consequently lending decisions in banking firms were not based on prudential screening and monitoring activities but rather influenced by the borrowers' interests, which eventually led to the unsound lending practices and to the accumulation of bad loans in banks' assets. Sound credit evaluation practices began to develop to full extent in the beginning of the 1990s when the transition was commenced, but it took several years for banks to develop best practice credit assessment procedures common in western European banking.

⁶ In 2003, small and medium-sized enterprises accounted for 99.7 percent of the total number of firms (entrepreneurs included) in Slovenia. SMEs employed 64 percent of all Slovenian employees; medium-sized firms (between 20-249 employees) provided employment to 21.4 percent of the employees (Slovenian Economic Outlook, 2006).

⁷ According to the large bank and foreign bank hypothesis, foreign bank ownership and concentration of the banking sector would reduce the credit available to small and medium-sized enterprises since large (and non-domestic) banks find it more difficult and have less incentive to gather information about opaque small business (Berger and Udell, 2002).

⁸ According to the Development Report (Slovenian Economic Outlook, 2006), the level of net foreign direct investments in Slovenia in the 2000-2005 period amounted to 14.8 percent of GDP and was, as such, among the lower levels in Europe. The level of foreign direct investment in Slovenia does not exceed the levels of any of the new EU member states.

⁹ This is firms employing less than 500 employees. The number of employees was selected as a classification criteria for separating SMEs from rest of the firms.

¹⁰ Limitations on bank credit exposure are part of bank prudential regulation and are incorporated in the Banking Act and subordinate decrees of the Bank of Slovenia as a banking sector regulatory body. In order to avoid excessive risk exposures to individual borrowers, banks need to closely follow so-called large exposures (i.e. total claims on individual borrowers exceeding 10% of bank capital). All large exposures need to be reported to the Bank of Slovenia and supervisory board of the banking firm needs to approve all the exposures that qualify as large exposures. The maximum allowed exposure to an individual customer must not exceed 25% of the bank capital (for customers related to the bank this proportion is set even lower at just 20% of bank capital). The total amount of all large exposures must not exceed 800% of the bank capital.

¹¹ In an environment with the poor protection of firm creditors, lending activity is riskier which should consequently result in a lower bank exposure to a single borrower (firm). The limited funding by a single (main) bank increases a firm's need to establish a relationship with new banks and should, under certain conditions, result in a higher number of firm-bank relationships. According to the EBRD survey on the quality of investor/creditor protection, Slovenia is ranked in the lowest position between Central Eastern Europe and the Baltic states, with a particular weakness relating to disclosure and transparency (Transition Report, 2005). Rather than the legislation on the books, the main reason for the inefficiencies in the Slovenian institutional environment lies in the poor functioning of Slovenian courts: in fact, in Slovenia it takes two years to recover debt, the same length of time as in Colombia, Mozambique and Lebanon (Gregoric et al., 2007).

¹² This is Ongena and Smith (2000).

¹³ With regard to small business lending, Berger and Udell (2002) stated the four main lending technologies: financial statement lending, asset-based lending, credit scoring, and relationship lending (p.36).

¹⁴ For more on the benefits of informed bank relationship, see Diamond (1991).

¹⁵ Inside ownership is the total percentage of shares owned by employees (managers), former employees and their relatives.

¹⁶ We replicated the analysis by including additional control variables such as the ownership structure, the percentage of bank loans in total investments etc. The inclusion of these control variables did not alter the impact of the variables presented in regression models 1 and 2. Since their impact was not significant, the 'extended' regression models are not reported.

¹⁷ Alternatively, the importance of bank financing was measured by the average percentage of bank loans in total firm investments during 1988-2002. The impact of the variable turned out to be positive but not significant.

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