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DURABILITY OF ACCESS TO ENTERPRISE FINANCING DURING THE THREAT OF BANKRUPTCY PERIOD

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Problems of forming the durable structure of company financing

In times of financial distress, access to financing options is usually limited due to little trust in the company by lenders. It is also a challenging task to develop a financing structure that will endure the whole duration of financial instability without breaking the various contracts relating to the financial support provided by various parties. The situation is also made worse by the existence of asymmetries in the relationships between the firm and the financial institutions which are normally characterized by over diversified cooperation between the two parties.

Such factors therefore makes it hard for a company to come up with a financing solution that will be able to solve the problem at hand and also sustain the firm through the entire period of working capital imbalance. For companies to overcome the risk of going bankrupt, it has to establish a strong combination of financing solution that will improve the liquidity of the firm and further help the company sustain itself. The time taken to achieve this depends on the nature of the bankruptcy risk. If the company is almost in the brink collapse, then a lot of capital will be needed to salvage the situation.

However, the bankruptcy risk will make such efforts very hard due to nature of various sources of capital that can be used to develop a longer term structure. These problems also stems from the agents in the market who own the rights to such sources. This includes

financial institutions, business partners, creditors, shareholders and potential investors among other owners of surplus funds.[1]

The firm also must consider diversifying its portfolio of capital in its capital structure during the bankruptcy periods. Having a capital structure full of equity and no debt can be detrimental in other ways such as tax impacts on profitability. Similarly, when the firm uses so much debt to finance itself out of the crisis can also mean the control, ownership and the going concern of the company is at risk. Therefore, the firm's optimal decision should be one that balances the major source of funds such that it reflects its objectives, wishes of the owners and the interest of other stakeholders.

The main problem in achieving a long term structure of financing for a firm facing risk of bankruptcy arises from the way the capital sources are combined in order to achieve an optimal mix between debt and non debt financing. Debt in most cases is a good source of financing for any firm whether facing bankruptcy or not. Debt has the ability of improving the performance of a company but it also comes at a heavy price to the firm. There are several problems that arise due to the relationship of the financing structure and the debt as a source of capital.

Firstly, debt is a good source of finance for the firm. But there is scarcity of capital arising due to the nature of financial markets imperfections. The supply of funds is lower than the demand for funds and therefore financial intermediaries often put restrictions when giving out such support. The element of risks and defaults that may occur when the funds are released also complicates access to funds.[2] This makes it hard for a firm to combine the various sources of financing options in order to solve the problem. The funds may be succeed to obtain various types of debt from the financial institutions but will not be available for a very long time. The banks knowing the type of borrower the firm is will not avail funds for a longer period due to the risk of insolvency the firm has exhibited. When releasing the funds, time of repayment will tend top be short than one given to stable firms. This is regardless of the interest rates charged by financial institutions.

Availability of debt to strengthen the capital structure and the working capital of a weak company is always limited to the extent to which the firm exhibits its willingness to cooperate with the lender. The commitment is further observed by the way the way the firm has been dealing with financial institutions in the market. In most countries, some information about the relationship between firms and lenders is usually available. The credit reference bureaus and credit rating agencies normally rate various firms and even countries and give indications about their credit worthiness.

Such information will be available to lenders whom the company has over-diversified relationship with. The diversification of cooperation in the financial markets makes

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[1] G. Ferri, T.S. Kang, I.J. Kim: *The Value of Relationship Banking During Financial Crises: Evidence from the Republic of Korea*, World Bank Publications 2001.

[2] S. Claessens, S. Djankov, A. Mody: *Resolution of Corporate Distress: Evidence from East Asia's Financial Crisis*, World Bank Publications 1999.

it impossible to develop close relationship, especially with lenders compared with a less diversified cooperation. The over diversified relationship will thus make it hard for lenders to give loan to a firm facing bankruptcy risk and which has had little cooperation with. This will create a problem to the firm since it cannot also obtain adequate funds from the many banks it usually deals with. This can contrasted to a firm which has had a steady relationship with only one lender over a long period of time. When face with bankruptcy problems, it can easily be bailed out because the firm is well understood by the bank. The relationship with financial institutions ultimately becomes a stumbling block to both obtaining a loan and also getting enough capital in order to form a strong financing structure that will endure the insolvency crisis. The availability of funds for longer term period is also not guaranteed further limiting the effort to have a long term financial structure of the firm.

Another problem is that financial institutions will monitor the way the firm will be using its borrowed capital. Since the bankrupt firm will find it prudent to use various sources of funds as a rescue package, the use of debt will be inevitable in balancing risks and profitability of the firm while using the combination of the finds from different sources. Although the firm will use some other sources to strengthen its capital portfolio, the debt provider still has an advantage of dictating most of the terms in the lending contract. For the purpose of safeguarding its funds, the lenders will be keen on how the firm will be using the funds.[3] For instance the lender may impose restrictive covenants that bar the firm from conducting certain business it deems very risky. This becomes a challenge to the firm since certain activities restricted might be able to generate quick cash flow that can further be sued to refinance the company.

The use of other sources of capital like sale of dormant assets, using creditors, sourcing new investors and other avenues to raise funds is limited. This is due to the existence of debt as a source of finance for the enterprise financing structure. When the firm uses a financing structure that has debt in it, the other source of capital is considered important only after the debt. This means that in case of liquidation those who provided debt must be repaid first, followed by the creditors and lastly shareholders. This arrangement that comes with most types of debt financing restricts the firm from using the combination of debt and equity to the fullest extent without restrictions.

The assets of the company also are tied and controlled with presence of debt from financial institutions. This makes the any long term plans in the financing of a company hard to achieve. The bottleneck is due to the nature of acquiring debt and also other source of financing like the creditors as a supporting source of finance which assets may be used to secure such agreements. Pegging assets to such agreements may be risky and restrictive to the firm which will have to make decisions that may compromise on the longer term strength of its financing structure during such critical times.

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[3] *Ibidem*.

Generally, using various source of capital, whether external or internal, long term perspective is important. However, faced with a combination of situations, the firm will find it hard to attain a truly stable structure that will help it out of the crisis. Most of the problems arise due to mismatch of the contractual needs and priorities attached to debt as a source of financing. Even without debt financing, the financing structure will not be able to sustain the company during bankruptcy problems. Stable companies can however survive without any debt but this is because their cash flow statements are highly impressive. This means that firms facing problems must borrow in order to finance their activities since other sources cannot adequately support a long term financing objective.

Over-diversified cooperation with financial institutions nevertheless makes it even harder to achieve desired degree of long term financing structure. Coupled with the risk of company failure, various agents who could provide much needed capital will not be willing invest or lend to a risky company. This further makes it hard for companies to form a long term structure of financing that can help solve the financial distress.

Excess of banks and financial instruments in cooperation with company

The efficiency and growth of financial markets is important for cooperation between agents existing and operating within the financial markets. Financial markets can only be efficient if there are many players, especially in the supply side. The number financial institutions highly determine variables like cost of capital, information asymmetry and banking relationships which are common in financial markets. Therefore, the high number of financial institutions in the market is good but has unique impacts on cooperation between firms and financial institutions in the market.[4]

Financial instrument is a proof of ownership of an interest in a company or an asset that can be traded in financial markets. A commercial paper for instance is a financial instrument. The financial instruments are largely traded financial markets and forms one of the basis which cooperation is established. The nature and type of cooperation between financial institutions and firms is also influenced by the number of financial instruments available in the market. A financial market with many securities being floated will tend to have unique and diverse relationship between firms and the institutions.

The number of financial institutions in a financial market affects the cooperation of firms due to the diversity the number creates. Many financial institutions will lead to a wider spread of relationships such that a firm will have different types of cooperation with financial institutions in the same market. For instance, the high number of banks in a single location/banking market means that firms in the area served by the banks will tend to try and have different relationship with more than one bank. This is because firms will be looking for the best offers from the many lenders in the market. Similarly, banks will be hunting

[4] G. Calcagnini, E. Saltari: *The Economics of Imperfect Markets: The Effects of Market Imperfections on Economic Decision-Making*, Springer 2010.

for new customers and will provide variety of products that are unique from other lenders such that not a single bank can provide all the best services alone.[5] The lesser the number of financial institution, the closer the relationship with the firms since there are fewer options for the firms and they have to cooperate with existing financial institutions.

The presence of many banks in the market makes financial intermediation much easier. Banking institutions attracts many other financial institutions like insurance firms, investments funds, pension funds and many other financial services. Such presence improves the confidence of participants in the financial markets and thus increasing business. The impact on financial instruments is that a lot of instruments will be introduced in the market because of the increased activity in the market. Strong companies will float their commercial papers and banks will be able to offer more financial instruments like mortgage loans, short term loans as well as support other sectors in issuing securities in the same market. The hyped activity in the financial market that is driven by many banks and availability of many financial instruments increases the interaction between banks and firms.

Availability of many types of securities or financial instruments also gives the firms an opportunity to grow and access funds. The access of funds however is determined by other factors that are strongly pegged on the information in the market. For companies to sell a financial security like a debenture or long term loan to the public, it has to do so through a bank. Again when a firm wishes to go public by joining the stock exchange market, it has to be guaranteed by an investment bank or another financial institution which will take the risk of purchasing any amount of shares not bought by the public.[6] Such arrangements mean the financial institutions will have to be close to the firms in order to cooperate successfully, this shows that high number of banks leads to stronger markets with many financial instruments that will strongly influence the relationships with companies.

The advantage of many banks and financial securities in a market accrued to cooperation is that banks will be very innovative in cooperating with firms. For banks to attract maintain close cooperation with firms in competitive market, it has to invest in cooperation and relationships that are focused on future growth and profitability for both the companies and banks.[7]

The desire for banks to remain influential and retain its existing market, a combination of financial instruments and use of information will be inevitable. Since there are many banks in the market, each bank will strive o satisfy its client and the companies with which it is doing business with. The bank will therefore dig for more information from companies so that it is able to build a strong and a longer lasting banking relationship. This will be possible by use of different types of instruments in order to watch the behavior of the firm. This makes information about firms and borrowers generally become available in the

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[5] P.T. Harker, S.A. Zenios: P*erformance of Financial Institutions: Efficiency, Innovation, Regulation*, Cambridge University Press, Cambridge 2000.

[6] *Ibidem.*

[7] E. Paulet: *The Role of Banks in Monitoring Firms: The Case of the Crédit Mobilier*, Routledge 1999.

market. Therefore, excess of banks and financial instruments in a market tend to boost the cooperation as every financial institutions works hard to bring their clients closer to them by offering a variety of services which includes financial instruments.

Collateral requirement in borrowing is a common thing in the business of lending. For a company to borrow large amounts of capital, it has to provide some kind of security so that the bank can be sure of its money in case of insolvency. In a scenario where the market is in excess of financial institutions and consequently financial instruments, collateral needs become different. First, cooperation between banks and companies affect collateral requirements depending on the extent of cooperation. A wider scope relationship between the bank and the firm will tend to reduce collateral requirements such that the firm which has cooperated with the bank in many different ways has the advantage to get a loan without committing many of its assets as security. This is because the bank has observed the firm using many ways compared with a firm whose relationship with a bank is only evident in overdraft5s and short term loans.

In a situation where many banks exist, the firms with wider scope relationship with banks will access loans with even minimal collateral requirements compared with a bank in a market with few banks. Many financial instruments in the market also make collateral requirements become less important as the many instruments compete for existing number of firms and customers. The overall impact therefore is that cooperation will even grow between individual banks and firms but not across banks. Each bank will demand lesser collateral in order to keep its clients due to competitive environment. Banks will also demand lesser collateral requirement from firms it has had wider scope of relationship than those firms it has had one/few types of cooperation.

The duration of relationship between banks and firms is not well supported by the excess number of banks in a market. In highly concentrated banking markets, there are challenges relating to hold up problem which tend to discourage long term relationships. It is also notable that the relationships in a highly concentrated banking market are not as close as in a less concentrated market. This is due to hold up problem and too much influence of the financial institutions that creates asymmetric relationships.

However, in less concentrated banking markets, the relationships are flexible and close due to little influence of banks which reduces asymmetrical relationships. This further has the impact of improving relationship positively through many ways. First, the cost of capital varies between concentrated and non-concentrated banking markets. In less concentrated markets, i.e. many banks in a market, cost of capital for a firm relating with many banks is higher than a firm cooperating with only one bank. The opposite is the same for highly concentrated markets. The difference in cost of getting capital in highly banked markets affects the relationship. Lower cost of capital encourages closer cooperation and higher cost of borrowing discourages cooperation.[8] This therefore shows a strong relationship between

[8] R.A. Brealey, S.C. Myers, S. Myers: *Financing and risk Management*, McGraw-Hill Professional 2003.

costs of capital, duration of relationship and the number of banks in a given market. Many banks tend to lower cost of capital, improve relationship with firms and further lead to a long term relationship.

The same is also seen in a case where there are many financial instruments offered in the market. It reduces cost of such financial instruments, encourages relationships and leads to long term cooperation between banks and firms. This is however the case when firms do not engage with many banks within the less concentrated banking market. Cooperation in such situation is also boosted by stiff competition for customers by the banks and each bank in the market will do everything to retain its customers who in this case are the firms.

The excess of banks and financial securities also have disadvantages with regards to cooperation between banks and firms. The high number of available opportunities tends to attract firms top the practice of engaging with many banks. This leads to multiple uses of financial instruments by companies to finance their businesses. This has the effect of increasing risks in the long run. This is because as firms seek to maximize the opportunities in the market, they end up not building strong relationship that is beneficial in the future.

Considering bankruptcy and related issues within such a market, it becomes even harder for firms to secure funds in a less concentrated market. High number of banks and financing instruments may mean less regulation and easy access of funds by firms. This further may increase risks in lending by banks to firms facing insolvency problems. The risk of defaults increases gradually and in the long run, banking relationships becomes weak as banks take stricter measures and tighten its control on the relationship. Firms facing liquidity crisis will also have fewer banks it can seek help since most of the banks it cooperated with are many, meaning it is not close relationship, therefore finding a bank with complete trust on the firm will be hard.

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Summary

In times of financial distress, The access to financing options is usually limited due to little trust in the company by lenders. It is also a challenging task to develop a financing structure that will endure the whole duration of financial instability without breaking the various contracts relating to the financial support provided by various parties. The situation is also made worse by the existence of asymmetries in the relationships between the firm and the financial institutions which are normally characterized by over diversified cooperation between the two parties. Over-diversified cooperation with financial institutions nevertheless makes it even harder to achieve desired degree of long term financing structure. Coupled with the risk of company failure, various agents who could provide much needed capital will not be willing invest or lend to a risky company. This further makes it hard for companies to form a long term structure of financing that can help solve the financial distress. Considering bankruptcy and related issues within such a market, it becomes even harder for firms to secure funds in a less concentrated market. High number of banks and financing instruments may mean less regulation and easy access of funds by firms. This further may increase risks in lending by banks to firms facing insolvency problems. The risk of defaults increases gradually and in the long run, banking relationships becomes weak as banks take stricter measures and tighten its control on the relationship. Companies facing liquidity crisis will also benefit from the support of fewer banks, therefore it will be difficult finding a bank with complete trust to the enterprise in financial distress.

TRWAŁOŚĆ DOSTĘPU FINANSOWANIA PRZEDSIĘBIORSTWA W OKRESIE ZAGROŻENIA UPADŁOŚCIĄ

Streszczenie

Nadmierne zdywersyfikowana współpraca z instytucjami finansowymi utrudnia osiągnięcie pożądanej, długoterminowej struktury finansowania. W połączeniu z ryzykiem upadku firmy, kapitałodawcy, nie będą skłonni finansować przedsiębiorstw w trudnej obarczonych ryzykiem niewypłacalności. To utrudnia tworzenie długoterminowej struktury finansowania, która mogłaby pomóc w rozwiązaniu problemów finansowych. W tym okresie dostęp do finansowania jest zwykle ograniczony ze względu na niewielkie zaufanie kredytodawców do przedsiębiorstwa. Wyzwaniem jest również zbudowanie struktury finansowania na okres niestabilności finansowej bez łamania dotychczasowych umów. Sytuację pogarsza również istnienie asymetrii w relacjach między przedsiębiorstwem a instytucjami finansowymi. Duża liczba banków i znaczna ilość instrumentów finansowych mogą oznaczać słabsze regulacje i łatwiejszy dostęp do funduszy dla przedsiębiorstw. To może zwiększyć ryzyko udzielania przez banki kredytu przedsiębiorstwom borykającym się z niewypłacalnością. Ryzyko upadłości zwiększa się stopniowo i w długim czasie, relacje bankowe słabną w miarę, jak banki podejmują surowsze środki wobec firmy i zacieśniają kontrolę nad relacją. Przedsiębiorstwa w kryzysie płynności będą mogły korzystać ze wsparcia mniejszej liczby banków, ponieważ współpraca z wieloma instytucjami oznacza, że nie są to ścisłe relacje i znalezienie banku, który w pełni zaufa przedsiębiorstwu będzie trudne.