



BANK LOCALISM AND INDUSTRIAL DISTRICTS

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1. Introduction

The aim of this chapter is to examine the link between firms and banks within industrial districts. At first glance the importance of the bank-firm relationship in industrial districts appears consolidated and easily identifiable on two grounds: first, since banks are the chief interlocutors of small and medium enterprises (SMEs) both in ordinary credit relationships and in selecting investment projects, industrial-district firms are largely bank-dependent; secondly, due to the distinctive characteristics of districts, known to be based on a close interweaving of relations among firms and with the local society, industrial-district banks require in-depth knowledge of the local context and the local economy. The common conclusion is that banks are called upon to establish close relationships with firms, and that this role is usually played by local banks which have operated in small geographical ambits, with long-lasting relationships and in-depth cultural affinity with local firms. It is on the basis of such premises that the district-stereotype of small-firms-small-banks has gained credence among scholars and observers.

A fresh view of the bank-firm relationships in industrial districts leads to a drastic revision of this stereotype, in line with the insights we have acquired by studying industrial districts with a systemic and dynamic approach to the analysis of local development. Such insights take on particular importance for economies which are characterised by the presence of many local systems of SMEs and marked territorial imbalances in levels of development. These features, found in several industrialised countries, are particularly important in the Italian economy, which represents a significant laboratory to which we shall chiefly refer in surveying the empirical evidence.

A systemic approach to local development takes account of the complexity of current development processes, in which many different actors interact and a variety of development engines are in motion. It takes seriously the matter of reconciling drives towards globalisation, which tends to level out and standardise, with the needs of localism, which recognizes diversity and promotes complementarity. In the presence of marked imbalances in the production structure of an economy, like that of Italy, the financial

system has the hard task of making the specific needs of the various local production systems compatible with the diffusion of the standardised innovations of global financial markets. To succeed in this task, banks play a key role: they represent the most flexible link in the chain between local and global markets, between traditional and innovative finance, and between bilateral and multilateral relations.

The dynamic approach leads to adopting an interpretative picture that leaves room for the evolution of organisations and agents' behaviour and calls for flexibility in operative strategies and intervention proposals. From this point of view, the basic issue is whether the recent transformations which have affected firms and banks have changed credit relationships in general and, as far as we are concerned, in district systems in particular.

The first profound transformation concerns technological, production and organisational changes of small and medium enterprises, which are now called to withstand growing international competition, decide strategically the location of different production phases, and invest in improving quality of products and production processes and consolidating size. When reported within the industrial districts these changes raise questions regarding their very distinctive features, which have to be reinterpreted dynamically, as maintained by Becattini (2000). The signs of change in district areas are evident. According to the Mediobanca-Unioncamere survey (2005), a quarter of Italian medium-size enterprises are headquartered in districts and are distinguished by a greater degree of internationalisation and a better financial structure. We are dealing with firms, selected by international competition, which are large enough to coordinate groups of small sub-suppliers not only within, but also outside the district. The increase in production size and market size, and the spread of the degree of internationalisation and innovation (Rabellotti et al., 2007) contribute to diversifying the demand of district firms for credit and financial services, according to a more complex framework which includes ordinary credit, the internal network of commercial credit, and finance for development.

A second major change has affected banking systems over the last two decades. The process of banking liberalisation that started early in the 1990s has opened for banks the possibility of making strategic choices in terms of mergers and acquisitions, of centralising decision-making structures, and expanding the network of branches, but at the same time it has constrained banks to assess and manage risk in relation to the value of capital. These changes have deeply transformed the structures of credit supply and financial services in and for local markets. Following many mergers and acquisitions the number of operating banks has declined and their average size has increased. However, bank presence in local systems has increased in terms of number of branches and innovative forms of contact. The very notion of bank localism has consequently expanded to include a heterogeneous group of banks, in size as well as in corporate and

organisational structures: from small cooperative banks to interregional banks, from independent banks to banks belonging to financial conglomerates.

These changes have intensified the debate on the practicability of a competitive coexistence in local credit markets of banks locally headquartered and banks headquartered outside the region. Following successive wave of aggregations, the formation of large bank groups has led to the progressive centralisation of decisional power in a smaller number of headquarters and the vanishing of banks' strategic functions from almost all local peripheral systems and from many industrial-district regions. This begs the first interesting question, as to whether local roots and "environmental familiarity" still count in banks' territorial competition strategies. Relatedly, one has to wonder whether the information advantages acquired over time by the renewed local banks substitute or complement the advantages coming from the broader range of financial services the major bank conglomerates can supply; how to obtain the right mix of transaction and relationship banking, product standardisation and flexibility, centralisation and decentralisation of decision-makings. Broadly speaking, we need to understand whether the evolution of banking supply is matched by the changing finance needs of SMEs in district systems.

The discussion in this chapter will be organised around two strictly interrelated themes: (a) the spatial organization of banks and credit allocation; (b) the banks' territorial strategies. To conclude, we will formulate some thoughts on what could be called a "desirable" local banking system.

2. Spatial organization of banks and credit allocation

There is now a broad consensus on the idea that local banking development facilitates access to credit for local firms, stimulates the propensity to innovate and boosts the growth of the local economy¹. The "development" of a local banking system has been measured in a great number of ways, including: the regulatory system, the competition/concentration of local credit markets, the observed or estimated credit availability to local firms, the presence of branches and their efficiency, and the type of bank branches working locally. The open yet crucial question is which indicator is most relevant to local banking development. The answer to this question is required in order to identify the spatial organization of the banking system which is most suitable to promote the growth of areas with different levels of development.

The effects that the consolidation of banking structures has on credit availability at a local level and on conditions under which such credit is supplied are ambiguous. They depend on the effects of mergers and acquisitions upon the efficiency of the banks involved and on market competitiveness. However, besides

¹ A review of this literature may be found in Alessandrini, Papi and Zazzaro (2003).

prices and quantities, the changes in the spatial organisation of banks also affect bank-firm relationships and credit allocation.

2.1. Large versus small local banks

A recurring theme in the banking literature is that large banks have a competitive disadvantage in small business lending, and other soft-information-based market segments, with respect to small local banks. Following this view, bank M&As would risk penalising systems of SMEs especially if located in peripheral areas. The reasons for this competitive disadvantage have been ascribed to the presence of organisational diseconomies which make it relatively more costly to collect soft information on borrowers and transmit it within the the higher layers of the bank organization. However, are bank size and local rootedness the key variables affecting organisational diseconomies and the capacity to support dynamic small local firms?

At first sight, empirical evidence suggests a positive answer to this question: small firms are more dependent on bank credit than large firms, while large banks tend to allocate a smaller share of their assets to small business lending than small banks (Berger *et al.* 1998, 2005; Craig and Hardee 2007). On closer scrutiny, however, the reality is much more complex. First of all, the effects of bank consolidation on small business lending seem to depend significantly on the type of institutions involved. For example, evidence for Italy and the US shows that while consolidations occurring between medium-large banks have brought about a reduction in loans to small firms, mergers and acquisitions involving small banks have led to a bigger share of loans to small firms (Peek and Rosengren, 1998; Strahan and Weston, 1998, Sapienza, 2002).

Second, to assess the effects of bank M&As on credit availability to small firms one cannot limit oneself to a static analysis, but should also take into account adjustment policies both of banks involved in aggregation processes and their competitors (Berger *et al.* 1998). Looking at the Italian experience, Focarelli, Panetta and Salleo (2002) found that M&As entail a significant and persistent reduction in the amount of credit supplied to small firms, especially in the case of acquired banks. By contrast, Bonaccorsi di Patti and Gobbi (2007) found that the reduction in credit available to small firms operating with banks involved in an M&A tends to disappear in the course of three years following the deal. Alessandrini, Calcagnini and Zazzaro (2008) found that acquisitions involving banks in the most developed area (central and northern Italy) were dominated by an asset cleaning strategy according to which the bidder bank makes a clean sweep of all the negative net present value activities in the portfolio of the target bank without permanently changing the asset allocation of the target bank. Differently, in the case of acquisitions of banks in the less advanced area (generally in Italy in the southern regions) by banks of the Centre-North, the asset restructuring strategy followed by the acquiring bank led to a structural change in the portfolio of

the acquired bank with a permanent reduction in loans to small firms and an increase in asset management activity.

Third, improvements in information technology and in credit scoring techniques have hugely facilitated the hardening of soft information. This has allowed a reduction in underwriting costs for small business loans and an enhancement in the failure prediction ability of banks, which has led to an increase in overall loans and easier credit access for marginal borrowers (Udell 2009).

If it is problematic to consider bank size a pure liability in small business lending, the idea that bank localism *per se* is able to ensure that credit is always allocated in a way which best suits local economic development does not appear fully convincing. Although the informational advantages of local banks, stemming from their historical roots and “cultural affinities” with the local community, permit a sounder assessment of local firms, their same close ties with the area may further separate, through various channels, local banks from funding more dynamic firms. Exclusive knowledge of a given economic situation may, for example, reduce local banks’ capacity to react to new ideas from the world of production. Alternatively, customer relations with local firms may drive local banks to limit the entry of new firms and the funding of strongly innovative activity which, if successful, could call into question the solvency of pre-existing firms. Or yet again, to reduce liquidity costs, local banks might prefer to finance firms that are not open to the outside - which distribute income locally and allow an expansion in their own deposit multiplier -, firms which, in peripheral areas, are often those that are less innovative and dynamic (Alessandrini and Zazzaro 1999; Zazzaro 1997).

The empirical evidence on Italy concerning the capacity of local banks to support local customers and stimulate the growth of local economies is somewhat ambiguous. Historically, local banks do not appear to have decisively performed the functions of a *Hausbank* for small firms. At the beginning of the last century, although local banks already had a strong presence in many areas in Italy, only rarely did bank-firm relations manage to evolve along the lines of the one-to-one bank-firm relationship model, as shown by the already widespread recourse to multiple lending (Conti 1997; Gigliobianco 1997; Chiapparino 2008). Moving onto the present day, available evidence is mixed. Several studies have shown that there is no significant relation between financial constraints and belonging to an industrial district (Guelpa and Tirri, 2006) or even that district firms are financially more constrained (Baffigi, Pagnini and Quintiliani 2000; Pagnini 2000). By contrast, others have shown that for district firms the probability of being rationed by banks is significantly lower than for non-district firms (Finaldi Russo and Rossi 2001; Rotondi 2005; Ughetto 2006; Alessandrini, Presbitero and Zazzaro 2008a). Either way, such positive effects chiefly appear due to a ‘district effect’ rather than any privileged relations the firms establish with the local banks (Finaldi Russo and Rossi 1999).

2.2. Does distance matter?

While the root of the importance of bank spatial organization for local development cannot be sought in the contrast of large banks *versus* small local banks, a more promising way to read the geography of a banking system can be found in the notion of distance. The combination of diffusion-centralisation, typical of bank globalisation processes, has resulted in two distance-contrasting effects. First, there has been a reduction in “operational distance”, that is the distance between banks and customers through the wide geographical spread of bank branches and the development of impersonal methods of communication – such as internet banking. Second, there has been a sharp increase in “functional distance”, that is the distance between bank decisional centres and local economies². Functional distance condenses *in se* different physical and cultural elements. For example, it is reasonable to believe that the costs of monitoring loan officers per visit increase with physical distance from the bank's headquarters where loan reviewers are employed. Similarly, reliability of communication and trust between managers at the parent bank and local loan officers decrease with the physical distance between the bank head office and the local branch, but also with the socio-cultural distance between the geographical areas where the staff of the bank's decisional centre and operational peripheries work and live.

In Italy, the consolidation process which began in the 1990s has radically changed the geography of bank organisation and decision-making powers. The number of independent banks has greatly decreased, especially in the South where almost all local banks have been absorbed by banks from the Centre-North of Italy. Consequently, the increase in functional distance in the last twenty years has been much greater in the South than in the Centre-North. The same geographical evolution in functional distances can be obtained either if we measure it in physical (kilometres) or cultural (social capital) terms. If we look at the industrial-district provinces³, bank proximity, whether operational or functional, is greater than elsewhere and such differences have increased in the past decade (Alessandrini, Presbitero, Zazzaro 2008a). This pattern suggests that district areas are more attractive for banks, that view proximity to industrial districts as a way to reduce information gaps and to obtain greater business opportunities than in other local productive systems.

The effects of banks' operational proximity to borrowers on lending decisions and contracts are controversial, as we have to balance the benefits of greater availability of soft local information with the costs deriving from the banks' greater market power⁴. On the contrary, functional distance between the bank headquarters and the local economy unambiguously make soft-information-based loans more costly.

² For the distinction between operational and functional distances see Alessandrini, Croci, Zazzaro (2005).

³ Becattini and Coltorti (2006) identify 28 district provinces.

⁴ Cerquero, Degryse and Ongena (2009).

Where information on credit valuation cannot be easily encoded and communicated within the bank, functional distance increases the cost of transmitting and processing *soft information* and reduces the reliability of communication and trust between local loan officers and central managers⁵. Economic, cultural and social disparities between centre and periphery broaden the liabilities of functional distance.

There is extensive evidence concerning different countries at different levels of financial and economic development that distance-related organisational frictions affect bank lending policies and credit allocation by local managers, limiting the amount of resources devoted to small business and relational lending⁶. As regards Italy, empirical evidence shows that small firms are more likely to be credit-rationed and are less inclined to introduce innovations if they are located in provinces where a greater percentage of branches belong to banks headquartered in physically distant provinces and in provinces with different social and economic environments⁷. Moreover, in Italian bank acquisitions, the greater the cultural distance between the provinces where the dealing partners are headquartered, the greater are the changes in acquired banks' asset allocation in favour of large borrowers and transaction-based financial activities, at the expense of small, opaque borrowers⁸. Consistent with the hypothesis that functionally distant banks specialize in lending to more transparent and safer borrowers, but by using loan-level data, the results show that functionally distant banks tend to operate with safer borrowers who they can charge low interest rates⁹. Finally, industrial district firms have a greater probability of establishing stable and exclusive relations with banks and less probability of being credit-rationed than non-district firms. However, this district effect tends to decline significantly for those firms that operate in provinces in which banks are functionally distant¹⁰.

3. Bank territorial strategies

Besides investigating the spatial distribution of bank “thinking heads”, it is also necessary to pose the question “What do they think?”, i.e. how much importance do they attach to the development of local production systems? To find this out we need to analyse banks' strategic objectives, their investments in organisational structures and their credit selection policies.

In terms of objectives, banking management has the difficult task of balancing two commitments: *profit efficiency* and *development efficiency* (Alessandrini, Papi, Zazzaro 2003). *Profit efficiency* focuses attention on banks as profit-oriented firms, operating in competitive markets. Under this rationale, banking management

⁵ Stein (2002); Alessandrini, Croci, Zazzaro (2005).

⁶ For a survey see Alessandrini, Presbitero, Zazzaro (2008b).

⁷ Alessandrini, Presbitero, Zazzaro (2008a; 2008b).

⁸ Alessandrini, Calcagnini, Zazzaro (2008).

⁹ Casolaro and Mistrulli (2008).

¹⁰ Alessandrini, Presbitero, Zazzaro (2008a).

should seek organizational solutions and operative choices that increase capital value and satisfy their shareholders. *Development efficiency* focuses on credit allocation, in which banks select investment projects, promote innovations, assess the potential of local firms, and assert the principles of transparency, reliance and professional merit. Inescapably, banks contribute to selecting the ruling class of a production system. From this standpoint, banks assume a fundamental role as local development agents: a role that is institutionally important in the presence of local systems operating in regions with different levels of development.

Profit and development efficiency are interdependent. In the more developed regions it is easier to obtain a virtuous bank-firm interaction that allows banks to achieve both targets. In peripheral regions, this successful combination of efficiencies is more difficult to obtain in the short run. Therein, the development efficiency of banks often contrasts with the goal of maximising profit in the short run. The support given to the riskier, but credit-worthy local firms could lead to an immediate decrease in profit. In this case, if local development efficiency has to assume priority, profit efficiency is a target to be postponed to the longer term.

Given the existence of regional disparities in development, the importance in bank strategies of being geographically rooted cannot be generalised and cannot be considered a bolstering factor for local development. Where it counts is in the forms of intermediation in which bank-customer operational proximity reduces information and transaction costs. It varies according to the level of socio-economic development of local contexts, according to risk factors, information and behavioural problems that assume particular importance in the case of industrial districts. In more advanced regions, bank branch density is greater, small firms are less penalised in credit conditions (rates, availability, collaterals) and the advantages of district agglomeration are enhanced. In peripheral regions, geographical rootedness can be more of a constraint than an opportunity, generating a local-local vicious circle which can be broken by opening up local banking markets to competition from out-of-market banks and the acquisition of local inefficient banks.

However, it is worth pointing out the importance of strategic proximity between the bank and the district firm, which maintains a high degree of information opacity due both to the small scale concerned and to the web of relations of cooperation and competition that need to be interpreted *in loco*. In addition to this, long-term bank-firm relations facilitate the acquisition of technological innovations and vertical re-specialisation from finished products to the production of equipment on the part of district firms, as reported by Ferri and Rotondi (2006).

Yet at the same time, we should not underestimate the risk of a systemic crisis which could have a negative chain effect among firms of a district suffering a competitive lag. Cases of insolvency could easily spread

through the complex network of inter-firm relationships that characterize industrial districts, including the extended use of inter-firm trade credit (Dei Ottati, 1994). There is greater exposure to such risks among local banks, which have a higher geographical and sectoral concentration in their loan portfolios.

For district SMEs it is essential to have banks that know how to play their own role as local development agents. The fact that distance from decisional centres reduces the credit supplied especially to firms operating in districts may be seen as further confirmation of this hypothesis. It is therefore important that the banking system can satisfy the renewed demand for credit and financial services by maintaining functional proximity with the area.

These local development needs must be met not only by local independent banks but also by large banking groups. It is no longer a question of large or small size, but rather of strategic sensitivity. Local independent banks and community banks, selected by banking competition, can renew their role of maintaining an active presence in local systems provided that they invest in human capital and in strategic alliances to exploit their advantages of contextual knowledge of the local environment. To survive competitively their aim is to compensate for smaller size and a strictly local sphere of operations by pursuing several routes: a) participating in joint agreements, exchange networks, circuits of shared services, which allow cost reductions; b) extending the range of financial products; and c) acquiring innovations and providing assistance to savers and firms that wish to link up with outside markets for more sophisticated operations. If this does not occur, local banks may become isolated and conservative, thus acting as a brake rather than a stimulus for development, as was seen above. In this case, the only practicable solution is to help them to be absorbed by larger banks or banking groups headquartered outside the area. This is the fastest route, albeit at the cost of increasing functional distances and at the risk of dispersing environmental knowledge and professional growth potential of local bank operators.

On the other hand, large bank groups may attenuate the adverse effects of greater functional distances with strategies of organisational decentralisation and flexible adaptation to the various environmental contexts. We must not forget that large banking conglomerates have higher potentiality to diversify their area strategies. Operating in regions with different levels of development, they could use the higher profit efficiency in the more developed local markets to subsidise in the short run the profit inefficiency in peripheral local markets where development efficiency is overriding.

4. Some concluding thoughts: desirable local banking structures

Our analysis in the previous sections leads to two major conclusions on appropriate bank structures for local banking systems, especially for industrial districts. The first concerns the importance of promoting a competitive equilibrium between several banks, differing both in size and in their management and

ownership structure (independent local, acquired local, independent outside banks). A diversified local banking structure tends to satisfy the combination of local and global tasks. The local task seeks to exploit the benefits of local knowledge supplied by geographical rootedness. The global task offers local operators the best solutions for allocating savings, financing investment and acquiring innovation. Resorting to several banking organizations is a sound practice: there is no single winning banking model *a priori* in achieving both objectives. Much depends on what one does, how one does it, with whom and where. Modern SME systems need a flexible approach with a mix of relationship activities, that offer bespoke products and services (specialised bank), and transactions activities, that offer standardised products and services (network bank).

As we saw in section 3, the problem must be tackled not in absolute terms, but in relation to the geographical area of reference. The needs of different local systems and the multitude of SMEs operating therein are complex and diverse: they range from size consolidation, technological and organisational innovations, to relocation investments and to problems of generational and professional turnover. Unlike in the past, such tasks can no longer be accomplished only by small local banks which grew in the same area where the firm operates. Relying only on their past local information advantages, may be a losing strategy for the local economy and for the same banks. At the same time, the variety of local development problems limits the contribution of efficiency made by large banking organisations which distribute standardised financial instruments.

In a local scenario of more banking competition, no operating bank, whether large or small, can afford to build up delays in acquiring innovations to deal with local development problems. Banks should grade financial innovations to the specific requirements of each system: the greater the development gaps to be filled and the endowment of small firms to assist, the more local-oriented such requirements should be. In this diversified field, the needs of local firms must be understood case by case, situation by situation. It is important to be able to exploit the advantages of relational and functional proximities. This holds not only for banks, but also for venture capital activities, which require an intensive long-term form of *relationship financing*. Hence it is pointless in many firms and regions to have only transaction banks; what is needed are banks that can interpret bank-firm relationships in a modern viewpoint.

To support the competitive development of industrial districts, the local banking system must be able to select and assist more dynamic small firms, which express higher potential in terms of entrepreneurial and organisational capacity, absorption of technological innovations, efficiency and profitability, penetration of markets both near and far. The qualitative consolidation of SMEs increases the demand for financial services at various levels: diversification and development investments, re-organisation of the ownership structure, partly in light of generational turnover, allocation of capital from institutional investors, as far as

providing assistance for stock market quotation. With respect to such needs, the advantage of direct knowledge and cultural and environmental affinities is reduced for local banks. What is required are specific financial competences which may easily be provided by larger and, above all, specialised intermediaries, such as investment banks, venture capital firms and investment trusts.

However, local banks are not *a priori* excluded from competition on innovative finance for development. Those that are more focused and far-sighted may remain a point of reference for emerging local firms, acquiring the most appropriate information and contacts for the requirements of the entrepreneur wishing to develop his/her firm. Thus the bank-firm relationship can be enriched by the assistance that the home bank can provide the innovative local entrepreneur in filtering the choices and contacting intermediaries specialised in the more complex financial operations. Working together with the experienced and competent local banker, with whom a consolidated relationship of trust has been established, may help small entrepreneurs overcome their fears, mistrust and lack of a financial culture. These limits are often the main obstacle to making the necessary leaps forward in quality and size, as shown by experience in Italy.

The second conclusion on the desirable local banking structure concerns the strategic importance of being able to count at least on a strong banking competitor with its “thinking head” in the region to which the district belongs. There are three good reasons to support this goal.

First, in addition to the positive effects on bank performance, functional proximity has important external effects. Specifically, it helps to maintain functional centrality, with important externalities for the accumulation of human, social and institutional capital. Usually, the most qualified and specialised human resources (managers, directors, professionals, financial analysts) reside in regions where banking decisional centres are located. Indeed, banks demand and produce their most qualified human capital in these regions. It is inevitable that, for example, local universities and other research and training centres strongly benefit from the presence of the headquarter of an independent bank in terms of job opportunities for students and research project financing. Externalities of this type affect entrepreneurship, as well as social and institutional capital. Indeed, the concentration of bank decisional centres through mergers and acquisitions leads to a change in the functional hierarchy between central and peripheral regions whose consequences need close scrutiny.

The second reason is that a significant presence of headquartered banks helps to maintain economic centrality in the region. In this case, outside banks have to consider the specific needs of the local area if they want to erode the advantages that headquartered banks have in terms of regional knowledge. This set of advantages is more relevant to less developed regions, as shown in the previous sections, where there is a stronger need to activate forces driving development not only from outside, but also from within the area. It is not a question of abandoning the selective process in the free market of property rights, which

should not be impeded. What is instead desirable is also to promote the entrepreneurial and managerial skills of local banks, selected by competitive pressures, as a vital agent of economic and social development in industrial districts and, in general, in any local production systems.

Last but not least, the more industrial districts can benefit from local banking structures that give strategic priority to the specific needs of local firms and local development, the less they should be open to standardized financial instruments, transferred through globalized circuits and subject to international destabilizing crises. In periods of greater worldwide financial instability, as experienced in the first decade of the new century, lower exposure to outside risks of financial contagion should not be undervalued in the picture of a desirable local banking structure.

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