

The banking sector and the capital markets: union creates strength

During the 1990s, the role played by banks and capital markets as mechanisms that channel savings towards investment opportunities gave rise to an intense and animated debate in academic circles, focused on the pros and cons associated with both alternatives. In the years following the outbreak of the Great Recession, this debate has once again raised its head, particularly in Europe where some consensus can be found regarding the advantages of encouraging the development of capital markets and reducing the euro area's excessive dependence on bank financing. The initiative promoted by the European Commission to create a capital market union in Europe is along these lines. However, we should not reduce this debate to merely a question of «banks versus capital markets» as these two spheres of the financial system are not so much opposing alternatives but rather complementary to each other.

Traditionally the euro area and Japan have provided clear examples of highly bank-oriented economies: between 70% and 80% of external financing for the corporate sector comes from banks and this percentage rises to 85% in the case of small and medium-sized firms on the European continent. In fact capital markets play a very modest role in the financing pattern of Europe's businesses, either by issuing bonds or by raising capital (equity). On the other hand obtaining funds from capital markets and particularly the corporate bond market is the predominant financing method in the US while bank financing only accounts for between 10% and 15% of all external financial resources for the US business sector. However, it should be noted that the role played by banks in the US in terms of providing funds to the private sector is rather underestimated due to the fact that the large amount of debt securitised by banks is not taken into account. Nonetheless there are considerable differences to the European situation given the little use of banks made by US small and medium-sized firms, accounting for just 35% compared with 85% in Europe's case. With these data in mind, many people from different spheres have suggested recently that the role played by the banking sector in the euro area should be considerably reduced, delegating to capital markets most of the responsibility for mobilising capital to meet companies' financing needs.

Nevertheless, such proposals do not always take into account the positive effects of bank financing in general and companies' ability to access capital markets. Firstly, bank lending is associated with an important process of checking and analysing companies' credit capacity and quality, both *ex ante* and also throughout the relationship between the bank and its customer. As a result of this, and of the long-term relationship established in many cases between both parties, information regarding debtor solvency is less asymmetric, consequently reducing financing costs.¹ Secondly, monitoring and selecting projects and the destination of the funds received fosters stronger corporate governance policies and this, in turn, tends to improve the credit capacity of the private sector as a whole and, as in the previous case, to push down its financing costs. At the same time, the indication and reduction of asymmetric information resulting from the granting of bank loans also have a favourable effect on those companies deciding to look to the capital market for their funds. Specifically, companies with some association with banks enjoy lower costs for debt and equity issuances compared with those firms with less degree of association.² So the effects of traditional bank activities go beyond the sphere of banking *per se* and even extend to the capital market.

For their part, the markets fundamentally have two strengths as a financing mechanism. On the one hand they help to share risk between players according to their preferences and especially their risk tolerance. On the other hand, when the markets in which debt securities or equity are traded are sufficiently liquid and the investor base is broad, corporate financing costs tend to fall. A minimal size of firm and issuance is normally required, however. The possibility of trading securities on the secondary market enhances price formation as prices reflect, approximately and in the absence of any significant distortions, the aggregate expectations of investors regarding the viability of the business project.

So banks and markets are far from being separate, sealed compartments as, in practice, both alternatives are closely related and complement each other.³ Even more so when we add securitisation into the mix, a natural link between banks and markets. Moreover, in the short or medium term capital markets are unlikely to replace bank financing because companies in the euro area currently have very limited access to corporate bond and equity markets (and particularly to the latter). This is due both to the

1. The literature on the role played by banks in reducing information asymmetry is very extensive but readers can find a particularly interesting reference in Song, F. and Thakor, A. (2010), «Financial System Architecture and the Co-evolution of Banks and Capital Markets», *Economic Journal*.

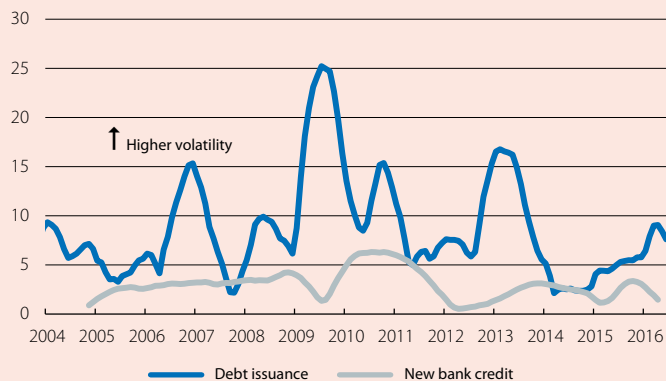
2. On this issue, see Drucker, S. and Puri, M. (2005), «On the benefits of concurrent lending and underwriting», *Journal of Finance*, and «Banks in capital markets», *Handbook of Corporate Finance*, Vol. I (2007).

3. In line with the theory supported by various studies, especially Levine, R. (2002), «Bank-Based or Market-Based Financial Systems: Which is better?», *Journal of Financial Intermediation*.

absence of a common operational, regulatory and insolvency framework and also to aspects related to the euro area's predominance of small firms. A recent study by the World Bank highlights this situation, revealing that those companies issuing debt or capital are much larger than those that do not.⁴ Specifically, the authors analysed a sample of 45,000 enterprises and 51 countries in the period 2003-2011 and found that the median company issuing capital is twice the size (in terms of total assets) of the median non-issuer. This contrast is even greater between firms that issue bonds and non-issuers as the vast majority of funds obtained by issuing debt are concentrated in just a few very large companies.

Euro area: volatility of financing flows in the non-financial corporate sector *

Coefficient of variation (%)



Note: * *New bank credit*: flows corresponding to new bank credit operations in the euro area in the non-financial corporate sector, cumulative over 12 months. *Debt issuance*: flows corresponding to bonds issued by the non-financial corporate sector in the euro area, cumulative over 12 months.

Source: CaixaBank Research, based on data from the ECB and Bloomberg.

On the other hand a larger role played by capital markets does not ensure the financing available to companies is more stable. Banks and capital markets have a disparate effect on the nature and volatility of the economic and financial cycle.⁵ The severity of the economic crisis in Europe after the outbreak of the financial crisis is put forward as the main argument by those claiming the advantages of a market-oriented system above the dangers of a bank-oriented system. However, unlike markets, if banks are well capitalised they have the capacity to withstand shocks, helping to stabilise the provision of credit and to soften the impact of such shocks on the economy as a whole. Moreover the costs and volumes of issuances of bonds and capital are often highly volatile and the liquidity of these markets tends to be drained off during episodes of financial instability. Such circumstances could end up having an opposite effect to the one desired: accentuating the procyclicality of the financial system and impinging upon financial and economic stability.

In fact, an analysis carried out by BIS economists shows that the depth of normal recessions (in terms of GDP lost) in bank-oriented economies is less than in economies more based on capital markets.⁶

In conclusion, far from being purely rival alternatives, banks and markets make up a duo in which the development of one has a positive effect on the other. Initiatives such as capital market union are beneficial insofar as they will complement the bank financing channel in the long term; even more so after all the efforts invested in making the euro area's banking system more robust.

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4. Didier, T., Levine, R. and Schmukler, S. (2015), «Capital Market Financing, Firm Growth and Firm Size Distribution», Policy Research Working Paper 7353, The World Bank.

5. On the procyclicality of the financial system, see Jódar-Rosell, S. and Gual, J. (2014), «La prociclicidad del sistema financiero tras las reformas», Documentos de Economía de CaixaBank.

6. Gambacorta, L., Yang, J. and Tsatsaronis, K. (2014), «Financial Structure and Growth» BIS Quarterly Review, March 2014.