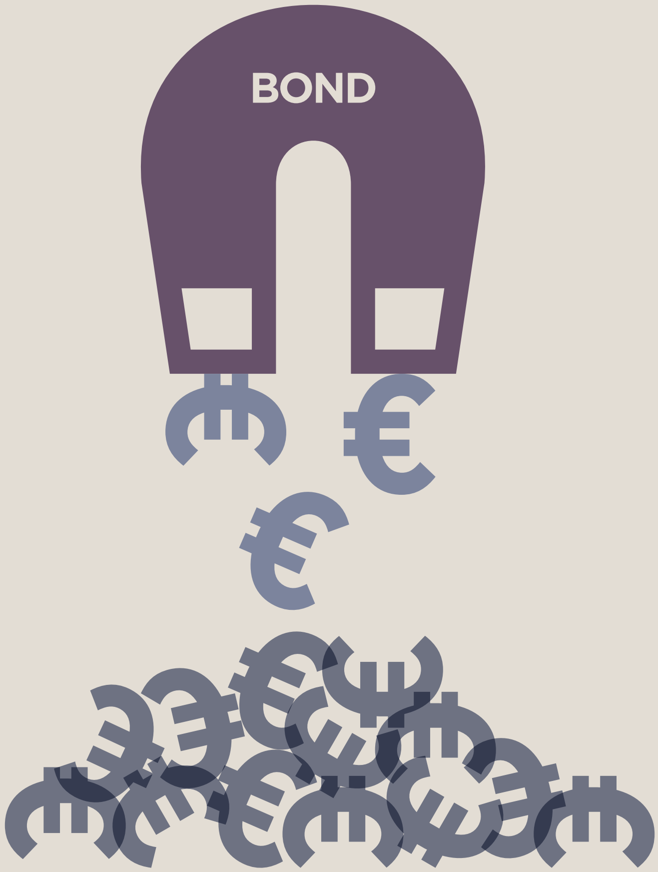
BANKING ON BONDS



EUROPEAN FIRMS ARE DRAWN TO THE CAPITAL MARKETS TO FULFIL THEIR FINANCING NEEDS, SAY AMRIT JUDGE AND ANNA KORZHENITSKAYA

A key function of the financial system is to intermediate funds between savers and borrowers. Up until 2008, banks in Europe played a dominant role in fulfilling this requirement. Although European banks remain important, the financial crisis and, more recently, the sovereign credit crisis, has dealt a severe blow to their dominance. A striking feature of the global financial crisis has been the extreme disruption to bank funding markets. In Europe, this has been fuelled by stress in sovereign credit markets and weak macroeconomic conditions in several EU countries – in part the result of government austerity programmes. During this period, European banks have faced funding difficulties, which has affected their capacity to provide credit to businesses and households.

In Europe there are serious concerns at present over banks' ability to service the credit needs of the economy. New regulation in the form of capital requirements could make it more difficult for banks to fulfil their primary role of providing the fuel for economic growth. European regulation based on the Basel III rules requires for a minimum equity-to-assets ratio of 3% to be achieved in five years' time. Recent research by the Royal Bank of Scotland (RBS) suggests that European banks need to substantially reduce the size of their balance sheets in order to meet this new target and, in the process, ensure that the eurozone could withstand another financial crisis.* RBS estimates that banks must remove around €3 trillion in assets from their balance sheets in the next three years. If this deleveraging takes the form of reduced lending, then there are potentially adverse consequences for the real economy.

In view of the heightened uncertainty in European credit markets and strains in the ability of European banks to provide long-term credit, there is a growing consensus among public policymakers that firms need to look at ways of diversifying their sources of debt financing and financing in general. The Bank of England suggests that since the start of the financial crisis in 2007, bond and equity issuance has allowed some large firms to dampen the impact of the contraction in bank lending and the worsening economic outlook on investment and hiring.

The implication of this is that there may be macroeconomic benefits to broadening access to public capital markets. In a similar vein, John McFall, the former chair of the Treasury Select Committee and David Davis, MP for Haltemprice and Howden, writing in the *Financial Times* in July, suggested that the failure of banks to lend threatens economic recovery and that the financial industry needs to come up with ways of financing businesses without having to rely on the banks. They argued that government efforts to encourage more lending to business have had a limited impact and that, unlike their US counterparts, UK firms are over-reliant on the banks for their financing. The greater diversity of funding sources in the US might, in part, explain why economic recovery there has been faster than in the UK.

In its *Financial Stability Review*, published in June 2012, the European Central

FIGURE 1. MEDIAN PERCENTAGE OF SENIOR BONDS IN TOTAL DEBT FOR EUROPEAN RATED FIRMS

Source: Authors' calculations using Capital IQ data

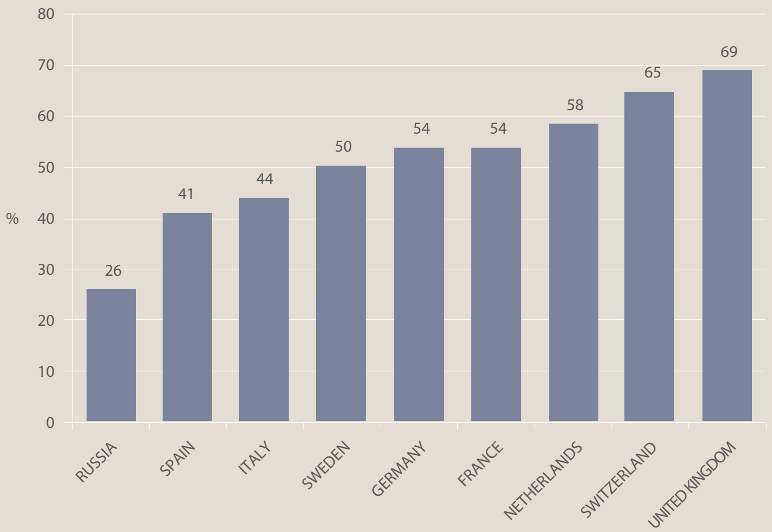


FIGURE 2. MEDIAN PERCENTAGE OF SENIOR BONDS IN TOTAL DEBT OF RATED FIRMS IN DEVELOPED EUROPEAN COUNTRIES DURING 2001-2011

Source: Authors' calculations using Capital IQ data

Bank (ECB) also pointed to the potential benefits of intermediation outside the banking sector. It suggested that greater access and availability of bond market debt and other non-bank finance may lead to more competition and efficiency within the banking system. This, in turn, will have a favourable impact on financial stability if it results in smoother provision of finance to the real economy from a more diversified range of finance suppliers.

Now we will examine how important the public debt markets are to European non-financial firms and the extent to which credit ratings have facilitated a substitution of capital market debt for bank loans during the period 2001-2011, which includes the credit crisis of 2002-2003 and the most recent financial and sovereign debt crisis.

In figure 1 we present the average (median) percentage of bond debt in a firm's total debt for rated firms across the largest economies in Europe. We find that the process of debt funding disintermediation is greatest for firms in the UK, followed by firms in Switzerland, where the median percentage of senior bonds is 69% and 65%, respectively.

For the two biggest economies in Europe – Germany and France – the median proportion of senior bonds in the debt mix is lower, at 54%. Firms in Spain and Italy possess relatively lower levels of bond debt funding in their debt structures, with median bond debt ratios of 41% and 44%, respectively. Our analysis shows that rated firms in emerging markets lag well behind in the level of debt funding disintermediation compared with their counterparts in developed markets. Our sample of emerging markets rated firms is dominated by Russian firms, with nearly three-quarters of rated firms originating from Russia. Russian rated firms have a median level of senior bond debt equal to 26% – a little below the median for all rated emerging market firms of 28%. For developed markets as a whole, rated firms possess double the level of senior bond debt in their debt mix relative to rated firms in emerging markets, 56% compared with 28%.

Figure 2 shows a time series profile of the median percentage of senior bond debt held by European rated firms in developed countries during the period 2001-2011. We find that senior bond debt usage peaked in 2003 at 58.7%, which coincides with a period of credit market tightening. This was then followed by five years of falling bond debt usage by rated firms as credit markets loosened, resulting in relatively cheap bank credit in abundant supply.

By 2008, median senior bond debt usage had dropped to 47.9%, its lowest since 2001. For three-quarters of 2007, the ECB loan officer survey shows that bank credit was readily available and, following the Lehman Brothers collapse in September 2008, bond funding markets froze temporarily. This combination of funding circumstances explains the significant dip in bond debt usage among rated firms in 2008. Our research shows that corporates substantially increased their use of bond market debt from 2008 as bank lending dried up. Since the peak of the financial crisis, bond market debt has become the dominant source of debt funding for European rated firms, making up 60% of total debt, a new high for these organisations.

We see a similar story when we look at the UK in isolation. Interestingly, our research shows that bond market debt consistently contributed more than 50% of total debt for UK rated firms during this period. This was not the case for EU corporates, such as those in Germany or France. There is much greater use of capital market debt in the UK than the rest of Europe after the peak of the crisis. By 2011, rated firms in the UK had close to 78% of their debt sourced from the capital markets compared with 62% for German rated firms and 58% for French firms. At the end of our sample period, the proportion of capital market debt sourced by rated firms in the UK is not too dissimilar to the figure of 80% reported for US firms.

We found that during loose credit market conditions bank loans replaced bond market debt. As credit conditions tightened during the crisis period, however, our analysis demonstrates that UK firms with access to the public debt markets replaced bank loans with bond debt in a significant way. As well as seasoned issuers tapping the public debt markets, Bank of England data indicates that the proportion of firms issuing bonds for the first time has been increasing since the second half of 2008.

These new issuers tended to be smaller and possessed lower ratings than existing bond issuers. Our research suggests that during the financial crisis, rated corporates were able to fill the financing gap by issuing bond market debt. It follows that tightening credit market conditions might not result in financing problems for those firms that can access the public debt markets. The key message of our research is that the rating agencies and policymakers should be looking at ways of improving access to capital market financing for UK firms.

A striking feature of the global financial crisis has been the extreme disruption to bank funding markets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