

Economic Research:

Eurozone Corporates' Move To Market-Based Financing Is Here To Stay

June 18, 2018

Nonfinancial corporations in the eurozone have long obtained most of their financing from the banking sector. That's unlike in the U.S., where firms make more use of the capital markets. However, since the financial crisis, nonfinancial corporations in the eurozone have been changing their ways. Financing through bonds increased to 16% in 2017 from 10% in 2006, while bank loan financing dropped to 46% from 56% over the period. Admittedly, this trend masks considerable variation across countries, with France accounting for the lion's share of the shift. French nonfinancial corporates raised 32% of their financing on the capital markets last year, compared with 14% in Germany and as little as 4% in Spain. What happened to provoke the change? Briefly put and which we explore below, banks put the brakes on lending to businesses in the wake of the financial crisis, and the European Central Bank (ECB) made capital market financing more affordable.

With the ECB set to tighten monetary policy by next year, here we take a closer look at possible lasting shifts in monetary policy transmission channels and the financing of nonfinancial corporates. Traditionally, the ECB's main policy rate has been its most effective tool in steering the cost of bank loan financing, and that has dropped. Meanwhile, quantitative easing (QE) has directly lowered the cost of financing through the capital markets. Therefore, if the aim of the central bank is to foster greater disintermediation in coming years, a very cautious tightening of its balance sheet will be needed to avoid sudden jumps in bond rates.

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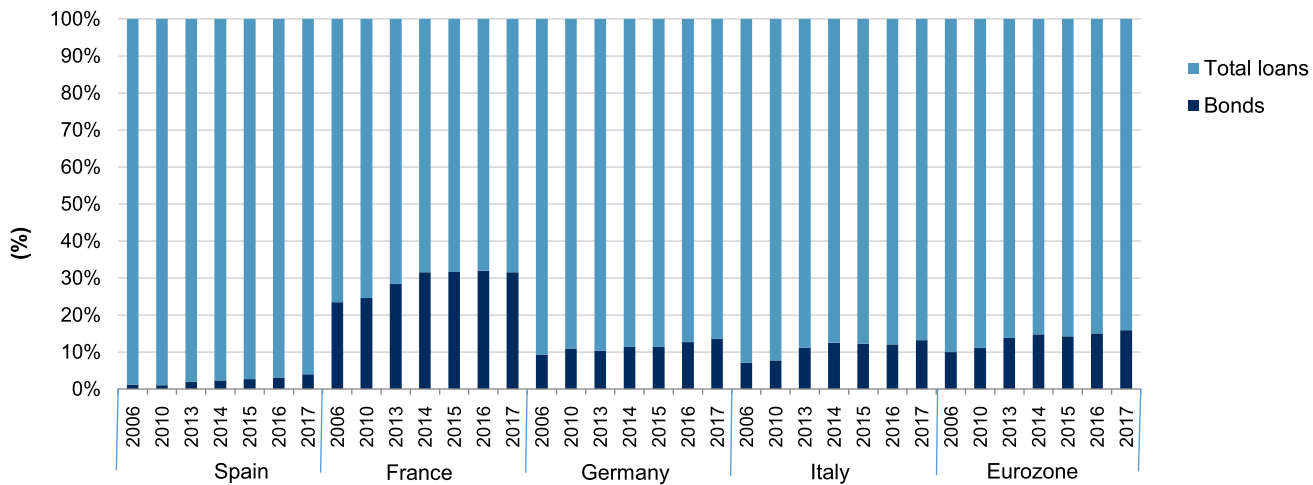
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Key Takeaways

- Nonfinancial corporates in the eurozone have made increasing recourse to the capital markets in the past decade and have decreased their use of bank finance—especially in France.
- The global financial and sovereign debt crises have been key catalysts in that change, as banks faced a liquidity crunch and reduced lending to corporates.
- The ECB's bond buying program has contributed to this disintermediation trend.
- We believe that disintermediation won't reverse in spite of monetary policy normalization, but continue to slowly gain hold as capital markets continue to develop across the eurozone.

Chart 1

Eurozone Disintermediation Has Been Rising Since The Financial Crisis, But Varies By Country



Sources: European Central Bank, S&P Global Ratings calculations.

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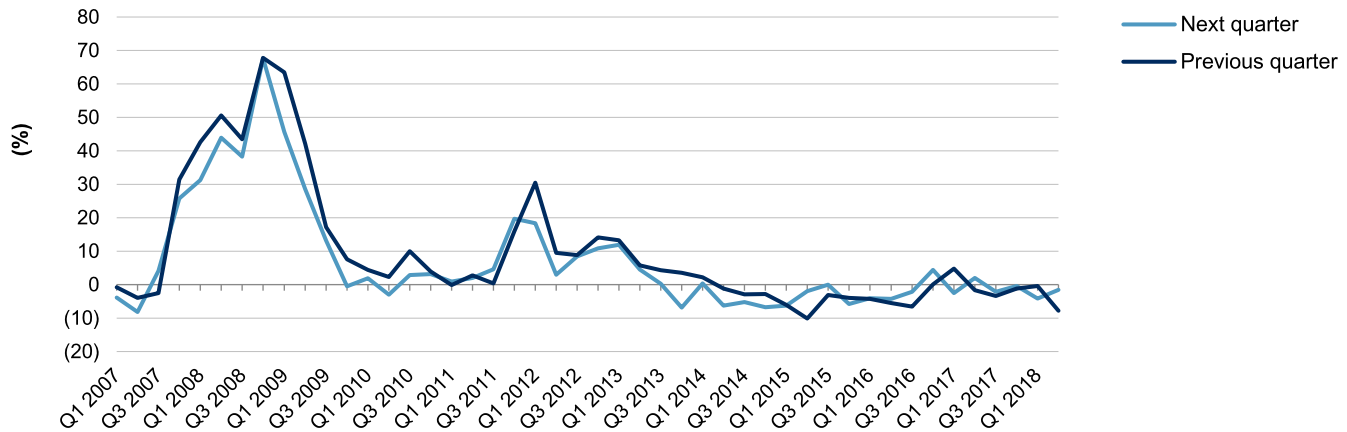
The financial crisis pushed corporates onto the capital markets

The global financial crisis appears to have been a catalyst prompting nonfinancial corporates to seek greater recourse to the capital markets in the eurozone (see chart 1). Facing a liquidity crisis in 2007, banks raised their credit standards and strongly restricted lending to nonfinancial corporations. As a result of this credit crunch, loans as a share of GDP decreased by 2.8 points between end-2009 and mid-2011. As banks became more reluctant to provide lending to the nonfinancial sector, large corporates started to issue more bonds. What's more, the sovereign debt crisis in the periphery of the eurozone and its spillover to banks led to another increase in the cost of bank financing and further contributed to the move toward the capital markets.

Chart 2

Banks In The Eurozone Have Reduced Lending Since The Financial And Sovereign Crises

Net percentage of banks reporting tightening credit standards or positive loan demand

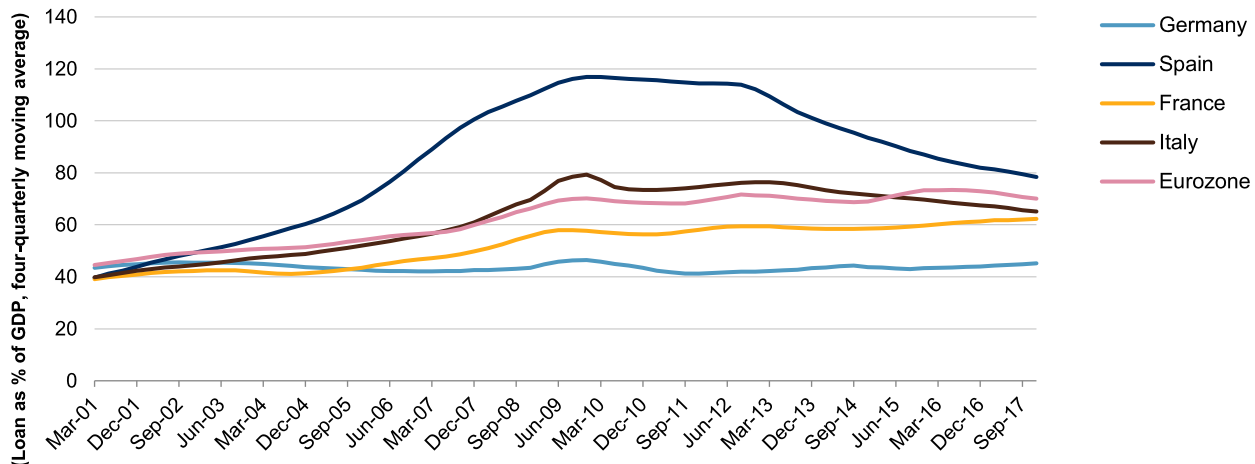


Source: Euro area bank lending surveys as of Q2 2018, European Central Bank.

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Chart 3

Eurozone Nonfinancial Corporates Have Moved Away From Financing Through Loans

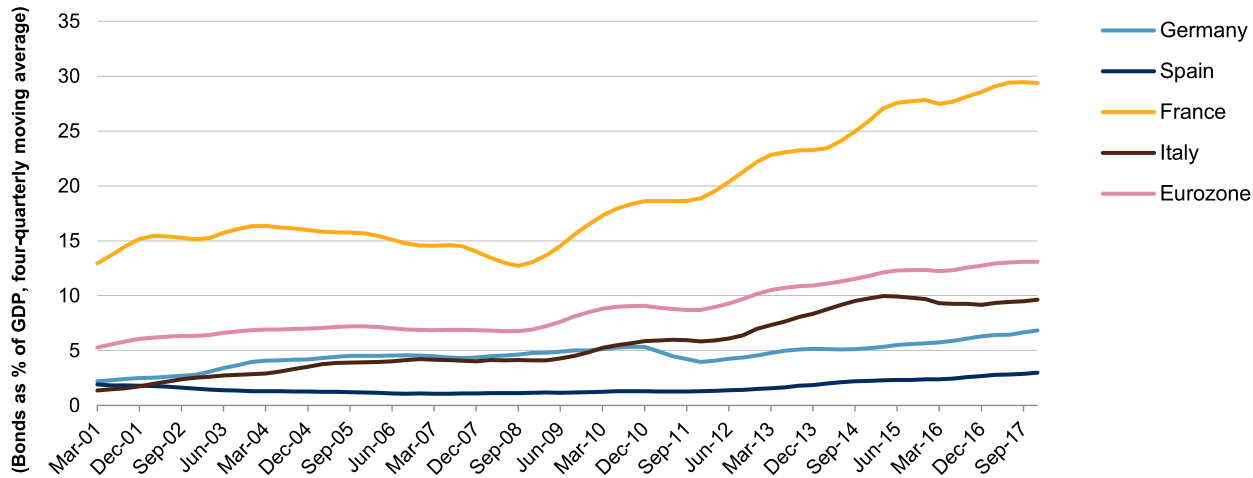


Sources: Deutsche Bundesbank, INE, INSEE, ISTAT, Eurostat, European Central Bank, S&P Global Ratings calculations.

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Chart 4

Bond Financing Has Been Easier For Nonfinancial Corporates



Sources: Deutsche Bundesbank, INE, INSEE, ISTAT, Eurostat, European Central Bank, S&P Global Ratings calculations.

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The ECB's accommodative policy contributed to disintermediation in three ways

More recently, the ECB's accommodative monetary policy measures seem to have furthered development of the capital markets in the eurozone. The ECB has influenced financing of nonfinancial corporations through three different channels:

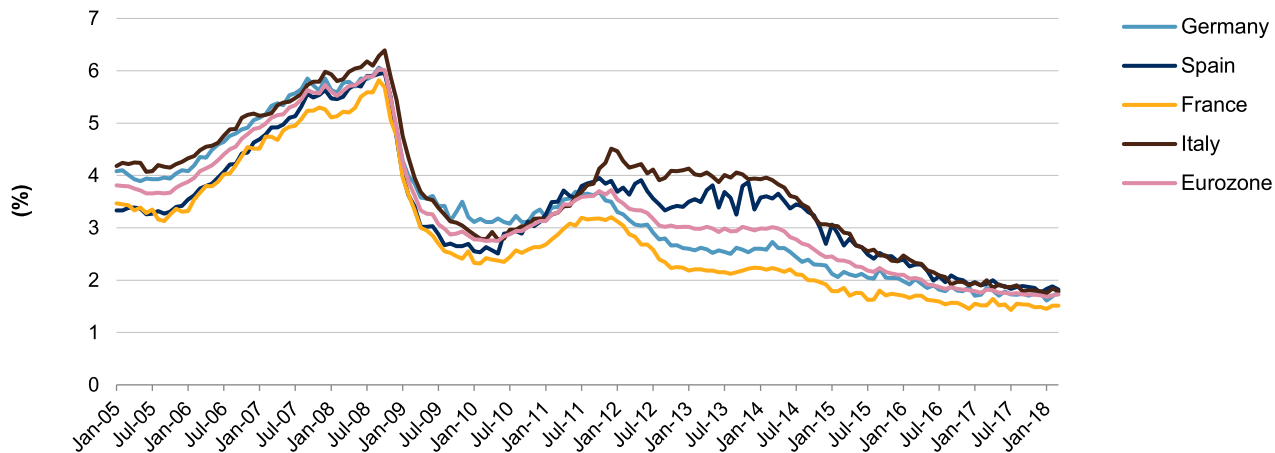
- Within the framework of the corporate sector purchase programme (CSPP; one element of QE), the ECB buys bonds issued by investment-grade nonfinancial corporates in the eurozone. The active presence of the central bank as an investor has boosted capital market liquidity, and therefore overall demand for bonds, lowering yields and the cost of this form of borrowing.
- Borrowing costs have also declined for speculative-grade nonfinancial corporates as investors rebalanced their portfolios with bonds not eligible for purchases under the CSPP. The portfolio rebalancing channel has facilitated the transmission of low yields to a broader spectrum of bonds and improved financing conditions throughout the capital market for a larger range of nonfinancial corporations.
- Finally, the ECB, like other central banks, drastically lowered its policy rate to avoid a more dramatic downturn during the financial crisis. Lower interest rates lowered the cost of bank financing and have helped boost economic activity in the eurozone. This has raised overall demand for external financing by nonfinancial corporates from both banks and the capital markets.

Yet we believe disintermediation is now likely to occur at a slower pace. That's because banks are in a better position to lend, except in periphery countries where nonperforming loans remain high.

Indeed, eurozone banks are still reporting that they are easing lending terms.

Chart 5

The Average Cost Of Bank Loans To Eurozone Nonfinancial Corporates Has Dropped As The ECB Lowered Its Policy Rate To An Historical Low

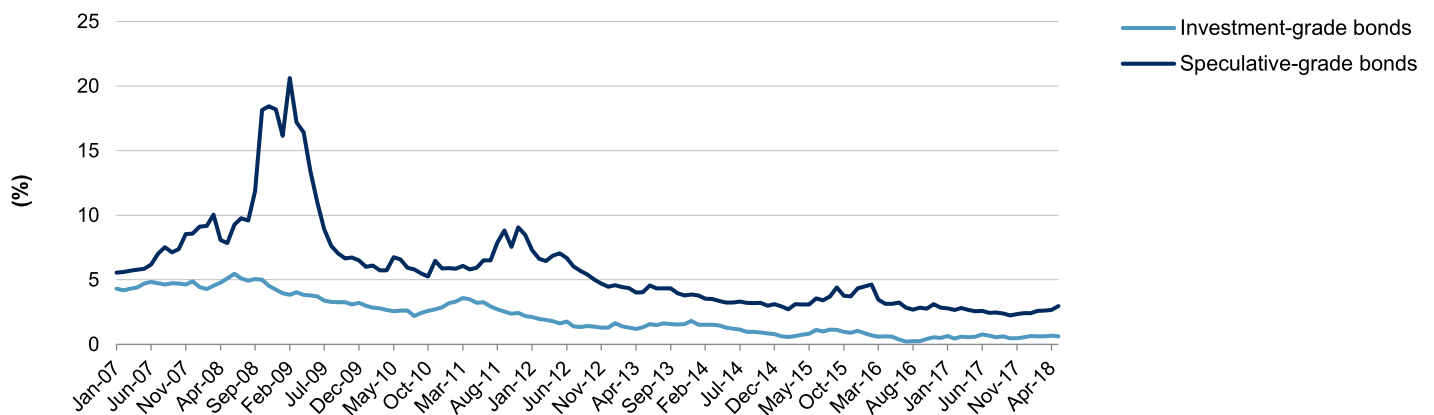


Source: European Central Bank.

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Chart 6

The Cost Of Financing On The Capital Markets For Eurozone Nonfinancial Corporates Plunged Thanks To The ECB's Bond Buying Program



Source: S&P Global Ratings.

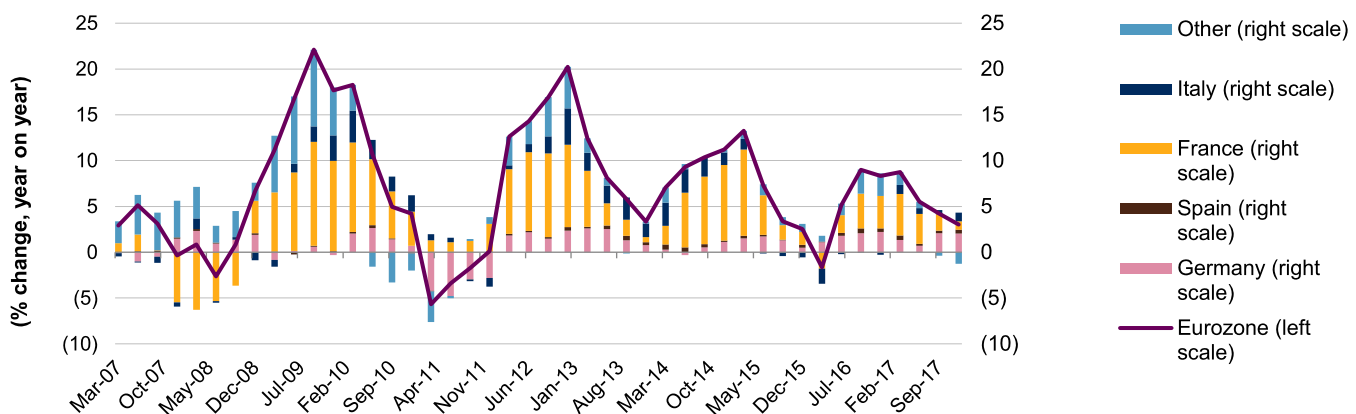
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The French are leaders in disintermediation, Spain and Italy lag, Germany barely budges

Despite being subject to the same monetary policies, eurozone economies aren't seeing the same speed and extent of disintermediation. These divergences reflect differences in the development of the capital markets in each country as well as their degree of exposure to the financial and sovereign crises.

Chart 7

Growth Of Disintermediation In The Eurozone Varies Greatly By Country



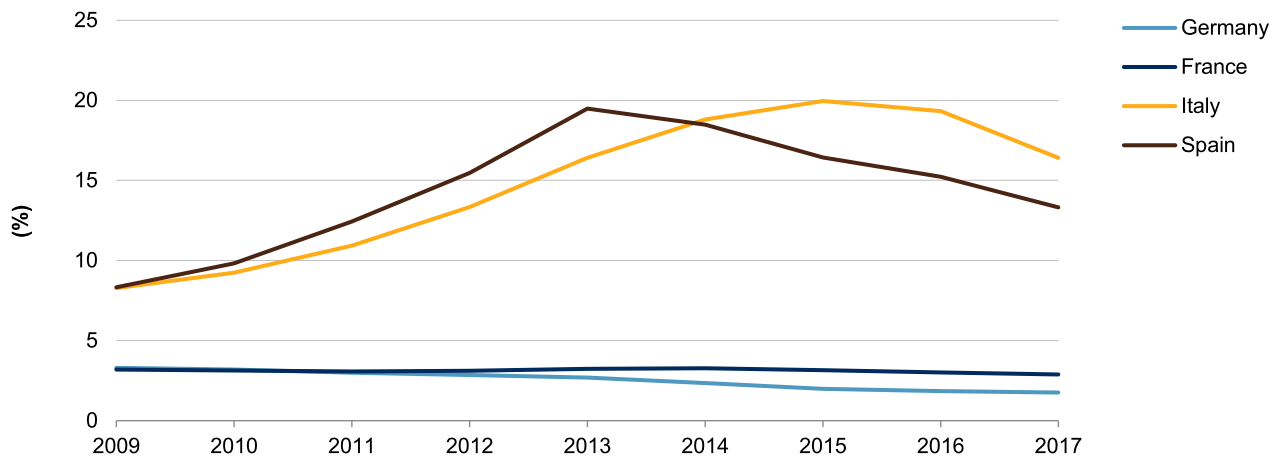
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The French are the main contributors to growth in debt securities issued by nonfinancial corporations in the eurozone. That's because France's capital markets have long been well developed, with a larger share of large firms, which have an easier access to the financial market and investors than in other eurozone countries. Bond issuance by nonfinancial corporates was already much higher before the crisis and could expand more easily as the situation of banks worsened during the crisis.

Although Spain and Italy experienced the biggest drop in the share of bank loans, they showed a very small increase in bond issuance compared to France. The sovereign debt crisis and the strong interconnectedness of sovereigns and banks damaged the health of the already weakened banking sector in these countries. The credit crunch that followed further decreased lending to nonfinancial corporations in 2012. However, the bond market was not able to fill this gap, because the capital market infrastructure in these countries was largely underdeveloped. That said, disintermediation has clearly increased since then. In Italy, nonfinancial corporate bonds to GDP doubled to 10% in the past decade. In Spain, while the stock of outstanding loans continues to shrink, bonds now comprise 4% of nonfinancial corporate debt--up from 1% in 2007. Another aspect that explains the slow development of the capital markets in these countries is the trend toward equity financing in Spain and Italy.

Chart 8

Nonperforming Loans Remain High In Countries On The Eurozone Periphery



Source: S&P Global Ratings.

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Germany stands out as the country where firms have barely moved toward disintermediation. A closer look suggests that German firms have substituted internal financing for bank lending. Thanks to a faster economic recovery, firms have been able to reinvest increasing profits, reducing the need for external financing by banks and the capital market.

Monetary normalization is unlikely to reverse disintermediation

In our view, disintermediation by nonfinancial corporates in the eurozone is a structural change that is unlikely to be reversed by a normalization of monetary policy.

Even if the ECB is likely to halt QE by the end of this year, we do not expect a reduction of its balance sheet before the end of 2020, and even then, a very gradual one. As a result, liquidity in the financial system will remain high over the next few years at least, limiting a rise in yields, as investors continue to search for returns in a world of low interest rates. Low rates will therefore continue working as an incentive for nonfinancial corporates to issue more bonds. Once the ECB starts to reduce its balance sheet, thus withdrawing one large source of market liquidity, we expect credit conditions to tighten, but only very gradually, though more meaningfully for speculative-grade bonds than for investment-grade bonds. That's because investors are likely to rebalance their portfolios again, this time in favor of safer assets.

What's more, we expect the ECB to start raising its interest rates in the third quarter of 2019, therefore increasing the cost of bank loans, in what might be another push for disintermediation.

Eurozone officials are also looking to boost disintermediation. Developing a capital markets union is high on the European Commission's agenda. It is seen as a key market tool to increase risk sharing across the eurozone and an alternative to the fiscal union for some. Outside of France, capital markets in the eurozone are still in a nascent stage of development. For that reason, we're likely to see more policy efforts in these countries.

Increased financial disintermediation already started to take place before the financial crisis. Now that more nonfinancial corporates have paid the upfront cost linked to entering the capital markets, they are more likely to arbitrage between bank loans and bond issuance—that is, shop for the cheaper option. If anything, the financial crisis has also shown that having different channels of financing available is an advantage, reducing a firm's vulnerability to financial crises.

That said, the expansion of the capital markets will remain slow chiefly because of the size of European corporates. Nonfinancial corporations that have access to the capital markets are generally the largest ones, as they can more easily afford to pay the entry costs. It is more difficult and costly for smaller corporates to tap the capital markets. Therefore, we believe they will contribute to a slower pace of disintermediation in the future.

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