II.3. Impact of the financial crisis on corporate finance: how big is the shift from bank financing to bonds?

The global financial crisis had detrimental consequences for banks' balance sheets, as well as for their funding costs and profitability, thus weighing negatively on their ability to supply new loans. As a result, banks tightened credit standards for all borrowers, including non-financial corporations. The restricted access to bank funding for the corporate sector induced the latter to seek other sources of external financing. The high level of euro-area corporate bond issuance in 2009 suggests that European corporations were able to partly replace bank financing with corporate bond market financing and, in addition, to do so at a relatively low average cost.

External financing of non-financial corporations has traditionally been more bank-based in the euro area than, for example, in the US, where the bulk of financing is done through the bond market. As a result of the financial crisis, euro-area firms — particularly large ones — seem to have moved towards this hitherto under-utilised form of external financing. Their success in doing so may suggest that corporate financial structures in the euro area are adaptable. If this change proved durable it would imply a more complete financial structure in the euro area with the possibility for large firms to obtain external financing from market sources and a relative concentration of bank lending towards small and medium-sized enterprises.

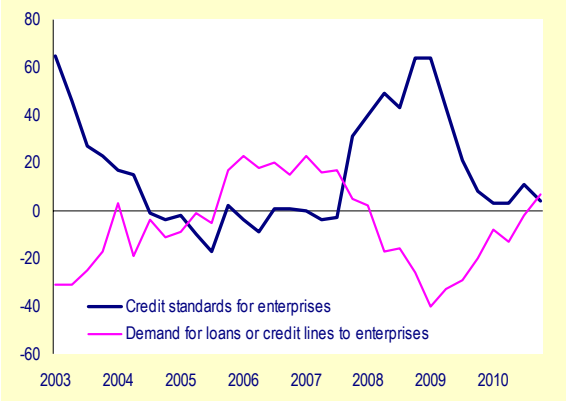
The financial crisis gave a boost to market financing

Bank lending has traditionally been the most important source of external financing for non-financial corporations in the euro area. From the start of the year 2000 to the second quarter of 2007, bank loans accounted on average for around 65% of the total external financing of non-financial corporations, while debt securities issued and net equity issued (netting equity issuance with the acquisition of equity) accounted for only 11% and 0.5% respectively.

In comparison with the US, the role of market funding is small in the euro area. In 2007, the capitalisations of the euro-area's equity and corporate bond markets stood at 85% and 81% of GDP respectively. At the same time, the respective US market capitalisations amounted to 144% and 168% of GDP.

In mid-2007, when the first signs of financial turbulence emerged, global credit conditions worsened substantially. The peak of the tightening of credit standards occurred in early 2009 and since then the rate of net tightening of credit standards has been on a declining trend, although banks have not yet started to ease their credit conditions (see Graph II.3.1). Whereas economic prospects have started to improve, net lending to non-financial corporations in the euro area remained in negative territory until the last quarter of 2010.

Graph II.3.1: **Credit standards and demand for loans by enterprises in the euro area (in %) (1)**



(1) net % of banks reporting a tightening of standards or an improvement in demand.
Source: ECB Bank Lending Survey.

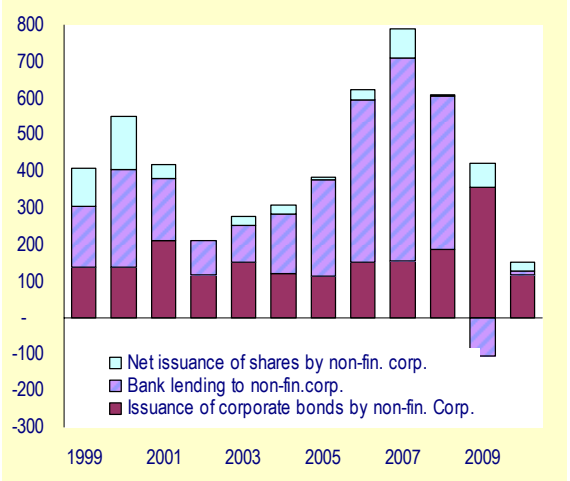
In this situation, several euro-area enterprises turned to the bond market in search of external financing. Graph II.3.2 shows that the issuance of bonds by the non-financial corporate sector in 2009 reached a record high, at nearly twice the amount registered in 2008 (EUR 354bn and EUR 183bn respectively). This suggests that non-financial corporations were able in 2009 to compensate partly for the loss of bank lending by increased bond issuance. Some research has also concluded that the substitution of debt securities for bank loans by non-financial corporations is indicative of binding bank loan supply constraints in the euro area. ([39])

In view of the fixed transaction costs involved when tapping market sources, the issuance of a bond requires a minimum amount to make economic sense. The possibility of seeking external financing is thus available mostly to large enterprises and does not apply to small and medium-sized enterprises (SMEs), whose financing remains mostly bank-based. The

([39]) See IMF (2010), 'Euro Area Policies: Selected Issues', *IMF Country Report*, No 10/222.

redirection of big firms towards debt securities nevertheless also helped SMEs as it freed up some of the banks' lending capacity, which may have been used to meet SMEs' funding needs. Conversely, SMEs were hurt when bond markets dried up during the critical phase of the financial crisis in late 2008 and corporate issuers sought external financing from banks, thereby curtailing the pool available to SMEs.

Graph II.3.2: **Bank, bond and share financing, euro-area non-financial corporate sector (EUR billion) (1)**

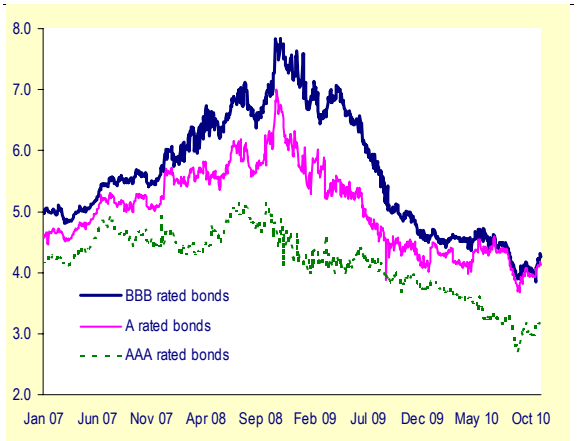


(1) 2010 covers data for the first 9 months.
Source: ECB, Commission services.

The increased issuance of corporate bonds did not have a discernible adverse impact on the costs of bond market financing. Firstly, corporate issuers benefited from the downward trend in government benchmark yields (typically the German Bund in the euro area) in 2009. Secondly, corporate spreads relative to the benchmark declined strongly, leading to a marked decline in yields, in particular for lower-rated bonds such as BBB. From above 400 bp at the peak of the financial crisis in late 2008, spreads on corporate BBB bonds fell to below 150 bp in late 2009. In all rating categories for which benchmark time series are available, yields on corporate bonds declined to a lower level in 2009 than recorded before the start of the subprime crisis in 2007 (Graph II.3.3). Thus, declining risk premia in the aftermath of the financial crisis clearly over-compensated the possible impact of higher bond supply on funding costs. ([40])

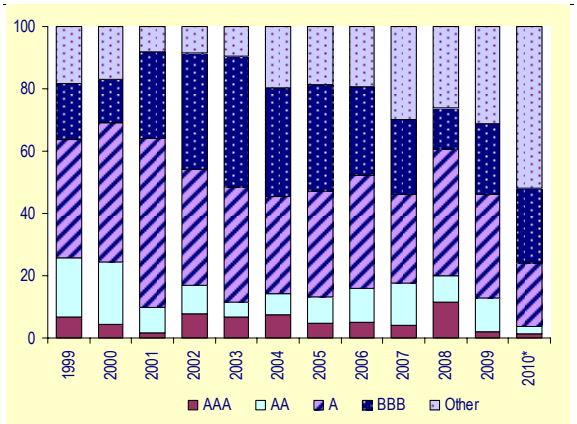
Some incentives for increased issuance activity are likely to persist. A number of non-financial corporations issued euro-denominated bonds for the first time in 2009. As issuance involves some entry costs (e.g. to build up an investor base), corporations that have issued once become more likely to issue in the future. Therefore, it is probable that the financial crisis has had a lasting favourable impact on corporate bond issuance by increasing the constituency of corporate issuers and thereby broadening the possible sources of financing for large companies.

Graph II.3.3: **Yields on corporate bonds (10 year maturity, in %)**



Source: Ecowin.

Graph II.3.4: **Rating structure of bond issuance, euro-area non-financial corporations (in % of total issuance) (1)**



(1) 2010 covers data for the first 9 months.
Source: Commission services.

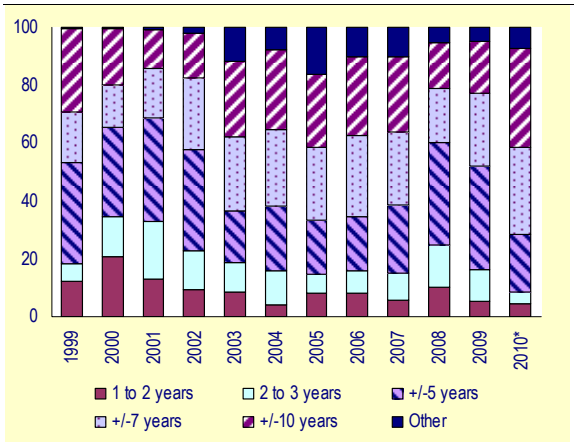
The surge in issuance did not adversely affect the average credit quality of corporate issuance. The share of issues with a rating of at least BBB remained broadly constant in 2009 (Graph II.3.4). Although the amount of non-rated issues rose significantly in 2010, most of them came from large firms with an established brand name. It was also reported that a few established corporate

([40]) Corporate spreads remain, however, higher than before the financial crisis.

issuers ceased to use credit ratings when issuing bonds. Some market observers therefore claim that credit quality was better than the average rating would suggest.

As regards the characteristics of the issuances, there has been a visible shift towards longer maturities over the last three years (see Graph II.3.5). Thus firms do not seem to have used bond issuances primarily to plug short-term funding gaps.

Graph II.3.5: **Maturity structure of bond issuance, euro-area non-financial corporations (in % of total issuance) (1)**



(1) 2010 covers data for the first 9 months.
Source: Commission services.

With respect to the geographic distribution of issuers, three Member States (FR, DE, NL) account for a combined share of 50% of euro-denominated long-term corporate bonds. ([41]) The share of German, French and Italian firms increased at the expense of Dutch and US corporations in 2009, and further in 2010. The market share of issuers from the 'peripheral' euro-area Member States (EL, ES, IE, PT) remained broadly constant until 2010.

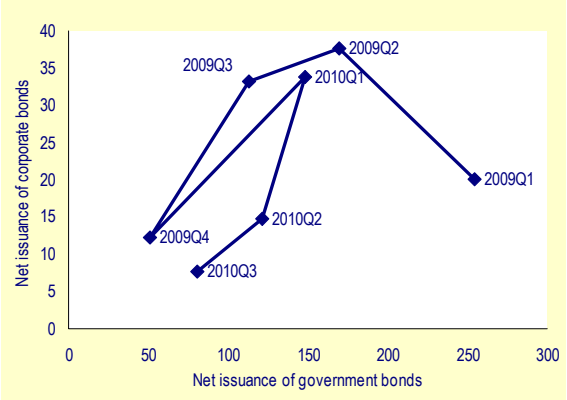
Share of corporate bond finance remains high in 2010 despite declining issuance

Issuance activity has slowed down on the euro corporate bond market in 2010. The amount issued over the first nine months is broadly comparable to the average level reached over the same period in 2006-08, suggesting that 2009 may have been a special year, driven by special factors such as an uncertain business cycle outlook and a high risk of credit constraints. Thus, developments in 2010 may represent a return to more normal conditions. However, despite the fall in absolute issuance levels, the share of corporate bonds in firms' external financing has remained high in 2010. The issuance of quoted shares has also weakened, while bank lending is still far below pre-crisis levels.

The cost of borrowing cannot be the reason for the decline in euro-area issuance of corporate bonds this year compared with 2009. Despite an increase in the spread of corporate bonds, further falls in the benchmark interest rate on government debt pushed the yield on corporate debt to very low levels, with the coupon paid by the average corporation coming close to the lowest level in 20 years.

The crowding-out of private sector issuance by the substantial increase in public sector issuance does not seem to be the main reason for the decline of corporate bond issuance either. Yields rose in response to increased issuance, mainly by central governments, but there were no indications of supply constraints. Between the second quarter of 2009 and the third quarter of 2010, there was a positive correlation between the net issuance of corporate and government bonds (Graph II.2.6), whereas crowding-out should result in a negative correlation. Notwithstanding the issue of crowding-out, the sovereign debt crisis may have weakened issuance activity on private and public bond markets alike as suggested by the fall in issuance on both sovereign and corporate markets visible in Graph II.2.6 in 2010Q2 and 2010Q3.

Graph II.3.6: **Net issuances of public and corporate bonds, euro area (in billion EUR)**



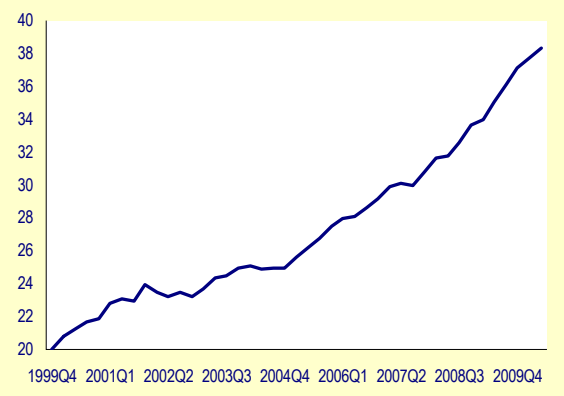
Source: ECB, Commission services.

The economic upswing could be a reason for lower issuance activity. A rebound in economic activity normally increases earnings and provides liquidity for firms in the form of internal funding. There may also be a lower need for external

([41]) Long-term means with a maturity of more than 1 year.

funding at the early phase of an economic upswing, when firms react to higher demand by increasing capacity utilisation, rather than by stepping up capacity through higher investment in physical capital. Such a hypothesis of lower external financing needs of the corporate sector is also supported by the belated recovery in investment growth ([42]) and by financial accounts data, which show that non-financial corporations have raised their holdings of liquid financial assets. In the second quarter of 2010, the combined holdings of deposits, short-term loans and short-term debt securities by non-financial corporations amounted to 38.3 % of GDP, up 3 pp over the same quarter a year earlier (Graph II.3.7). In particular, the share of loans extended by non-financial corporations increased, suggesting that intra-firm loans have become an increasingly important means of financing. Anecdotal evidence suggests that euro-area companies are endowed with relatively high cash reserves also due to the high corporate bond issuance last year. Finally, further support for the hypothesis of lower external funding needs comes from the spike of buy-back operations by European corporations. The number of buy-backs has risen from ten in the whole of 2009 to twenty-one in the current year to November 2010.

Graph II.3.7: **Liquid asset holdings of non-financial corporations (% of GDP)**



Source: Commission services.

Finally, there are widespread expectations that interest rates could remain low for some time. Overall, the slowdown of corporate bond issuance in 2010 probably reflects a range of factors, among which high liquid asset positions in European corporations — that funded aggressively last year — and expectations of low interest rates play an important role.

Conclusions

It is too early to conclude whether a durable structural shift from bank to bond financing has taken place in the euro-area corporate sector. Nevertheless, the surge in bond issuance by non-financial corporations in 2009 and the persistently high share of bonds in corporations' external funding in 2010 suggest that part of the euro-area corporate sector may have responded to tightened bank credit conditions by looking for other sources of external funding. If persistent, this diversification in the use of financing sources would make part of the euro-area corporate sector — mostly large companies — less reliant on banks and possibly less vulnerable to adverse developments in this sector.

([42]) Quarterly investment growth in the euro area was negative until early 2010 and only became positive in the second quarter this year.