ESBG

Financial systems in Europe and the United States: Structural differences where banks remain the main source of finance for companies

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Update of ESBG analysis: newly published United States Census Bureau shows even greater reliance on bank lending byy small and medium-sized businesses (SMEs)

The United States Census Bureau published on December 2015 results of its 2012 Survey of Business Owners. The longitudinal data provide a comparison with the 2007 results. ESBG has updated its analysis that was first published in September last year to reflect the updated data.

The side-by-side observation point to a drastic reduction of in the use of grants when starting a company in the U.S. market. Grants use fell by 2,2 percentage points to 0.31% from 2007 to 2012. When financing SME expansion, grant use tumbled from 24.91% to just 0.53%. This drop was only partially offset by government-guaranteed business loans from a bank or financial institution. As a result, the reliance on debt financing through banking institutions swelled when starting a company, climbing from 85.11% to 87.35% and from 47.36% to 64.09% when financing business expansion.

1. Background

The financial crisis in the US during the years 2007-2009 and the European financial crisis since 2007 have provided concrete examples of the existing relationship between financial systems and the real economy and highlighted how different financial structures may respond differently to shocks and policy measures. Interaction between financial systems and the real economy is largely dependent on regulatory aspects such as financial supervision and financial regulation, as well as on the way those financial systems are organised. The institutional composition of financial systems and the repartition in between banks and non-bank financial institutions may also have an impact on financial stability and on recovery processes. Additionally, financial systems are shaped by the use of different types of financial instruments and by how those instruments are used and in what proportion.

While capital market instruments such as equities or securities are widespread and represent a significant share of funding sources for borrowers in some financial systems, bank loans still remain dominant and provide the largest source of finance.

In the context of the Capital Markets Union, understanding the different characteristics of the EU and the US models, their similarities and differences, would provide a response to the widespread base assumption that the largest financial markets in the United States mean that SMEs are less dependent on bank lending and that their access to finance is significantly better.

2. EU vs. US model: Description of key differences

First, it is important to note that the EU financial landscape covers a wide diversity of domestic financial markets and that each country has its own specificities in regard to their financial systems and how they relate to the real economy. Yet, common trends exist which give the European Union a financial identity when compared to other financial systems. Those trends include:

- <u>Predominance of bank loans over capital market financing in the EU</u>

Although differences exist between European countries, bank loans generally represent the most important source of financing when compared with capital market financing in the European Union. While on average for the years 2000-2010, the ratio comparing capital market financing to the sum of capital market financing and of bank financing peaks at 69% in the US and at 66% in the UK, most European countries are below the 50% threshold; Germany with 43%, Italy with 33% and Spain with only 27% (Figure 1). In this context, France's ratio of 55% is an exception. The European Commission survey on the access to finance of enterprises (November 2014) also supports this evidence by establishing the list of preferences for financing sources for SMEs in the European Union. While bank loans are the preferred source of financing for SMEs with 60%, equity only comes 8th in the preference order with 17% and debt security 11th with 3%.

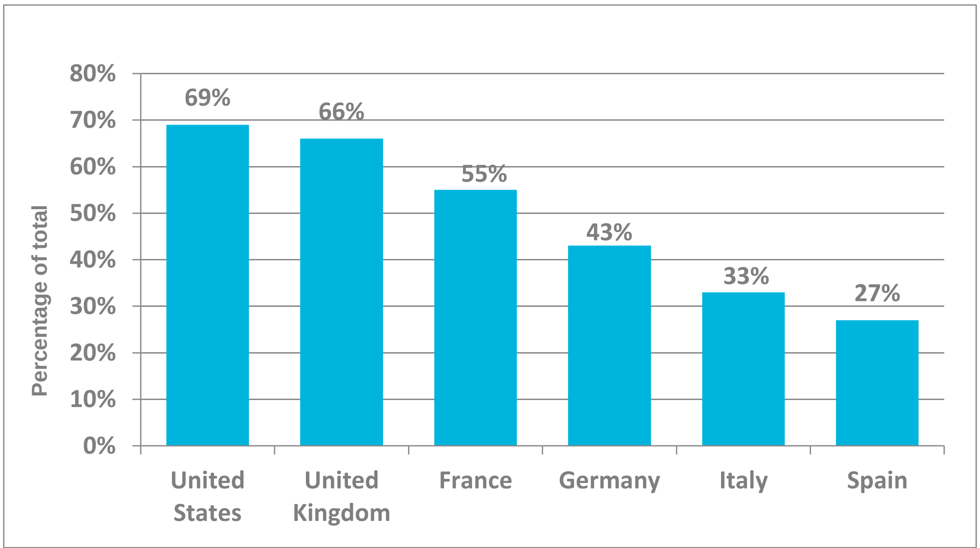

Figure 1: Capital market financing (M) versus Bank financing (B). Averages, 2000-2010. (M/[M+B]) %. Source: IEB (Instituto de estudios bursátiles)

- <u>A larger banking system size in the EU</u>

The European Systemic Risk Board's 2014 report of the Advisory Scientific Committee on the banking system in the EU has recently highlighted that the volume of credit intermediation by banks compared to national GDP is larger in the EU than in the US from both a historical and present point of view. While the trend for these bank loans to GDP ratio has been continuously upwards for both zones from the 1960's, the increase has been more significant in the EU and the gap has widened over time. The ECB Banking Structure report from November 2013 highlights this difference in recent years (**Figure 2**) where the total domestic banking sector to GDP ratio in 2012 amounted to 255% in the EU vs 60% in the US, around four times less. It should be noted however that the recent decrease in the EU banking system (by around 10% from 2013 according to the ESRB) would tend to decrease this gap. In addition, accounting differences between the EU and the US in regards to IFRS standards would tend to increase the size of the US banking system with regards to the US GDP by 30 percentage points[1]. By the same token, when including the assets held by the National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) would mechanically increase the US banking system's size by 32 percentage points[1]. Still, the EU banking system appears relatively larger than its US counterpart in regards to the size of the economy.

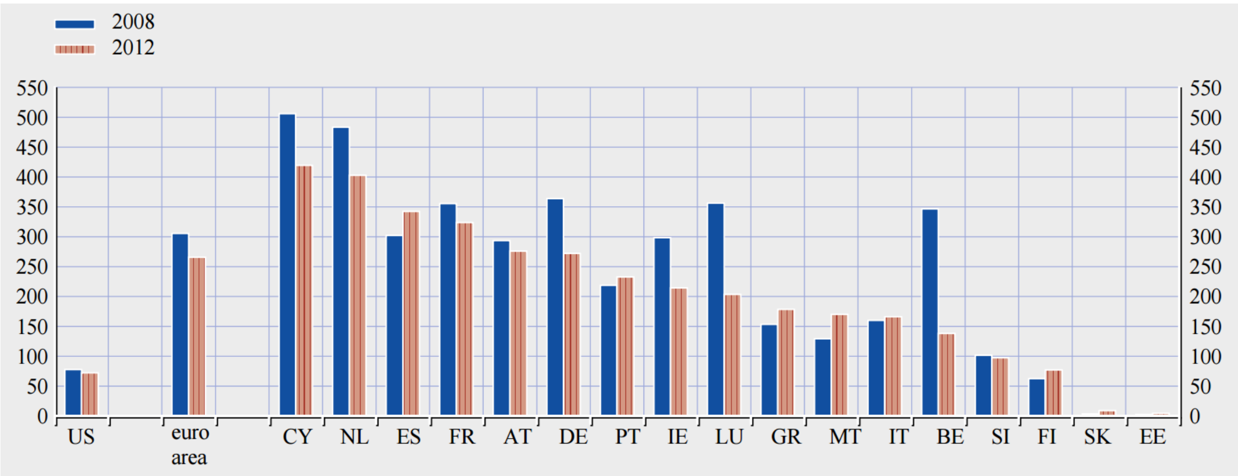

Figure 2: Total domestic banking sector assets (as % of GDP) excluding data for foreign subsidiaries and branches. Source: ECB

- <u>A common trend for the EU and the US financial structures in the 1990s and 2000s but a widening difference</u>

EU and US financial structures, despite their differences, have been following similar trends in the last two decades as regards the ratio of stock market capitalisation to bank credit. While financial systems became more market based in the 1990s, this pattern was reversed in the 2000s and financial structures became more bank-based. Due to the more profound shift towards markets in

[1] https://www.esrb.europa.eu/pub/pdf/asc/Reports_ASC_4_1406.pdf

the US in the 1990s and to the more pronounced growth of bank loans in the EU in the 2000s, the transatlantic difference in financial structure has widened over time[2]. As of 2011, the US had a ratio of stock market capitalisation to bank credit around 2 while the EU had a ratio below 1. This widening difference provides additional evidence on the preference for bank loans in the EU and of capital market instruments in the US.

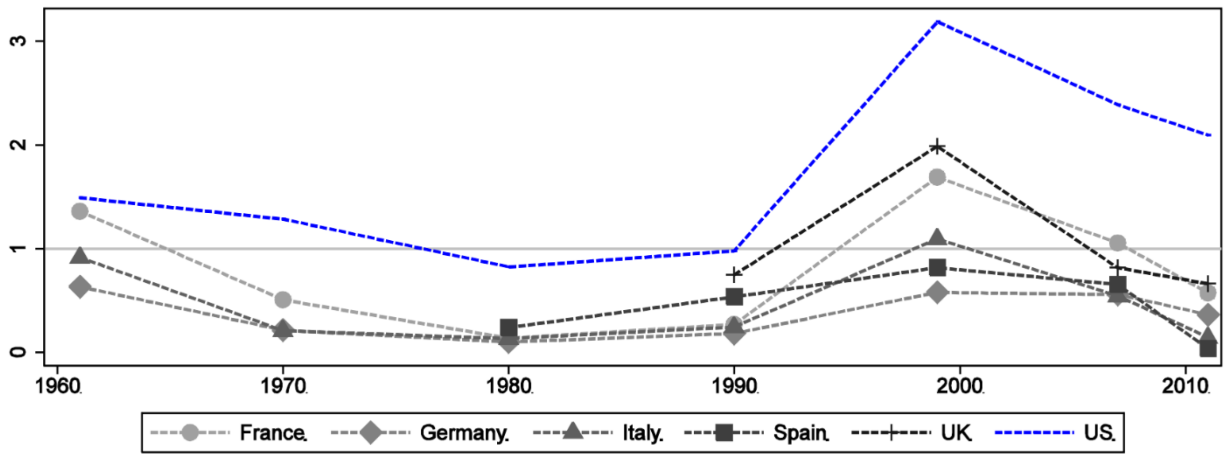

Figure 3: Financial structure (measured as the ratio of stock market capitalisation to bank credit to the private sector). Source: European Systemic Risk Board

3. EU and US models: Banks are SMEs' preferred source of finance everywhere

Despite the tremendous difference with regards to the size of capital markets in the US and in the EU, companies in both regions have comparable preferences when it comes to choosing their source of finance.

Surveys conducted in the EU and the US presents comparable information regarding the preferred source of finance for companies and in particular SMEs. As stated above, the European Commission's survey on the access to finance of enterprises (SAFE) of 2014 established that "SMEs prefer to use debt instruments such as bank overdraft and credit lines, bank loans and trade credit most often. Both equity and especially debt securities are needed by substantially fewer SMEs." Indeed, it appears that, when surveyed, SMEs responded that they got close to 70% of their financing from banks with only 3% coming from equity and 1% from debt securities, confirming that bank financing is indeed the preferred source of finance of SMEs in the European Union (**Figure 4**).

[2] In particular the shift towards markets was favoured by the collapse of the Bretton Woods system in 1971 and the imbalances created by the two subsequent Oil Crises which increased dramatically international capital movements, as well as an expansion of international trade. Later the decrease of the ratio stock market capitalisation to bank credit in the 2000s was caused by revelations of corporate scandals in the US and the bursting of the "internet bubble", reducing markets' credibility and strengthening "anti-market" forces.

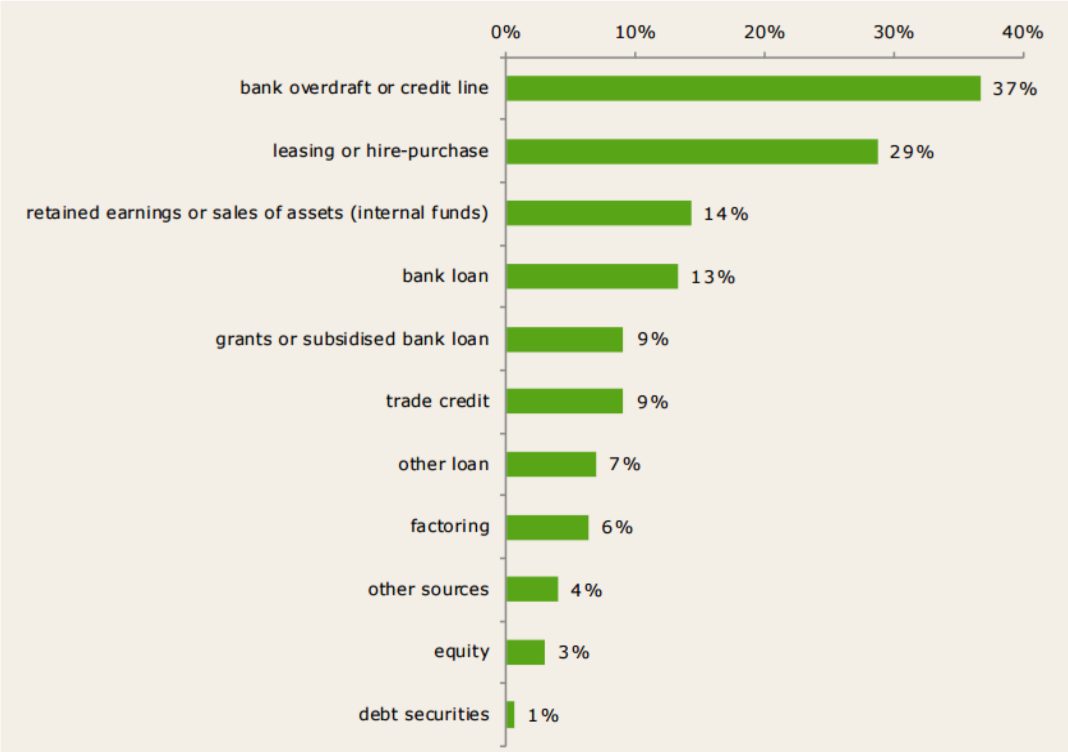

Figure 4: Sources of finance used by SMEs in the EU-28 between April and September 2014. Source: European Commission.

On the US side, a survey of business owners conducted in 2012 by the United States Census Bureau[3] provides comparable data:

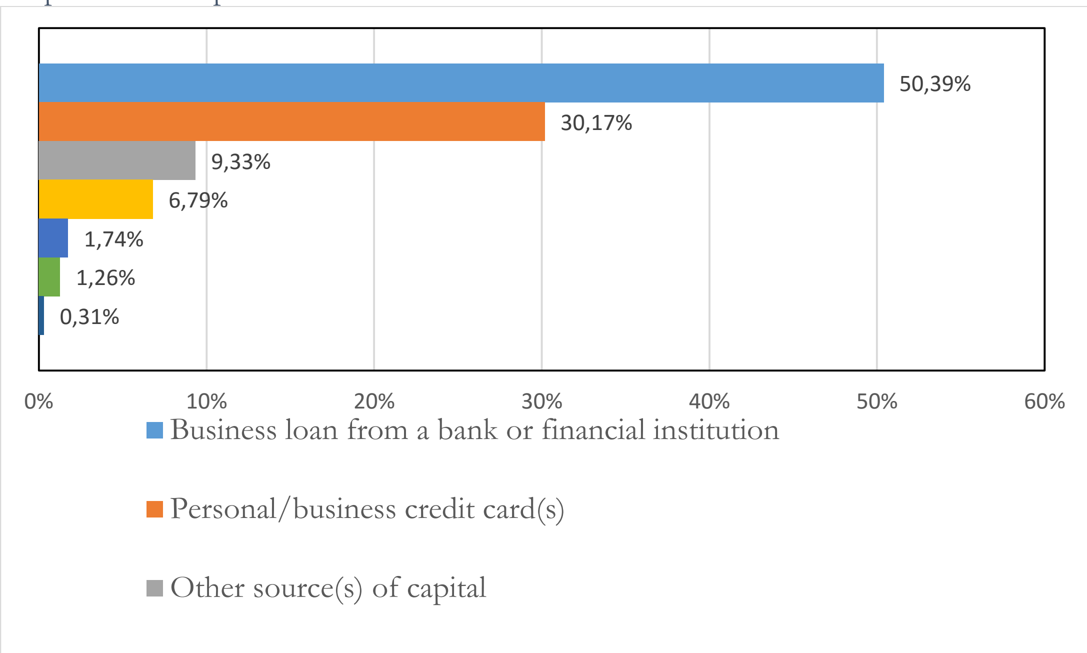

Figure 5: External source of financing for companies of less than 500 employees used to startor acquire the business (percent). Source: United States Census Bureau.

[3] http://www.census.gov/econ/sbo/getdata.html

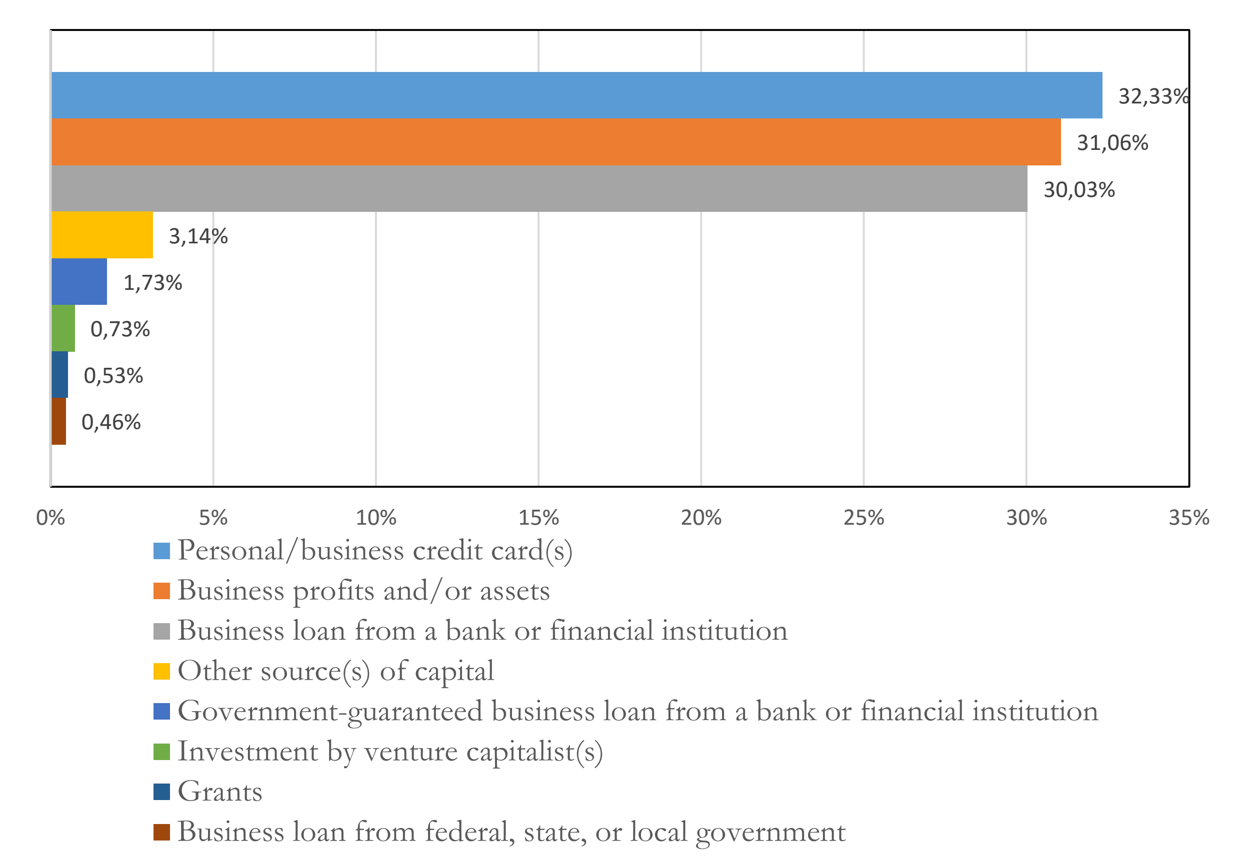

Figure 6: External source of financing and auto-financing for companies of less than 500 employees used to finance expansion or capital improvements (percent). Source: United States Census Bureau.

It appears that debt instruments, and in particular bank financing, are also the preferred source of finance for SMEs in the United States. More than 87% of businesses with less than 500 employees use bank financing to start or acquire a business. Already existing businesses turn to banking institutions in almost 65% of the cases for financing expansion or capital improvements. These figures are very similar and even stronger than the European ones above. It is also clear that capital markets financing in both the US and EU economies, and in particular venture capital, represents only a fraction of the sources of finance for these companies (around 1% venture capital in the United States and 3% equity in the European Union).

It is therefore wrong to affirm that European SMEs are more vulnerable to the tightening of bank lending than their US counterparts as they both equally need bank financing and do not seek non-traditional finance. There are therefore no fundamental differences between European and US SMEs in terms of source of finance.

It is safe to say that those figures can be taken as a generality both in the EU and the US markets as companies surveyed represent almost exclusively the companies present in both regions. Indeed, as the following table presents, companies with less than 250 employees account for more than 99% of the companies in both regions.

	Table 1: Number of enterprises by size class of employment (percentage, 2012)				
	0 - 9	10 - 19	20 - 49	50 - 249	≥ 250
US	79,47 %	10,27 %	6,63 %	3,05 %	0,58 %
EU	92,71 %	4,00 %	2,10 %	1 %	0,19 %

Sources: OECD (Entrepreneurship at a Glance 2015), Eurostat database

It is therefore clear that US businesses are also heavily reliant on banks for external funding and relatively less on capital markets, in contradiction with the generally accepted affirmation in the EU based on volumes and not actual access to non-traditional financing. The difference in size of the capital markets in both jurisdictions does not make it more accessible for smaller US companies than in Europe to the point that one can talk of opposite financing models.

Indeed, companies that are present on the US financial markets are much larger. A 2012 Market Segmentation Survey conducted by the World Federation of Exchanges[4] shows that on the American continent larger companies represent a significantly higher market segment than in EAME - Europe, Africa, and Middle East:

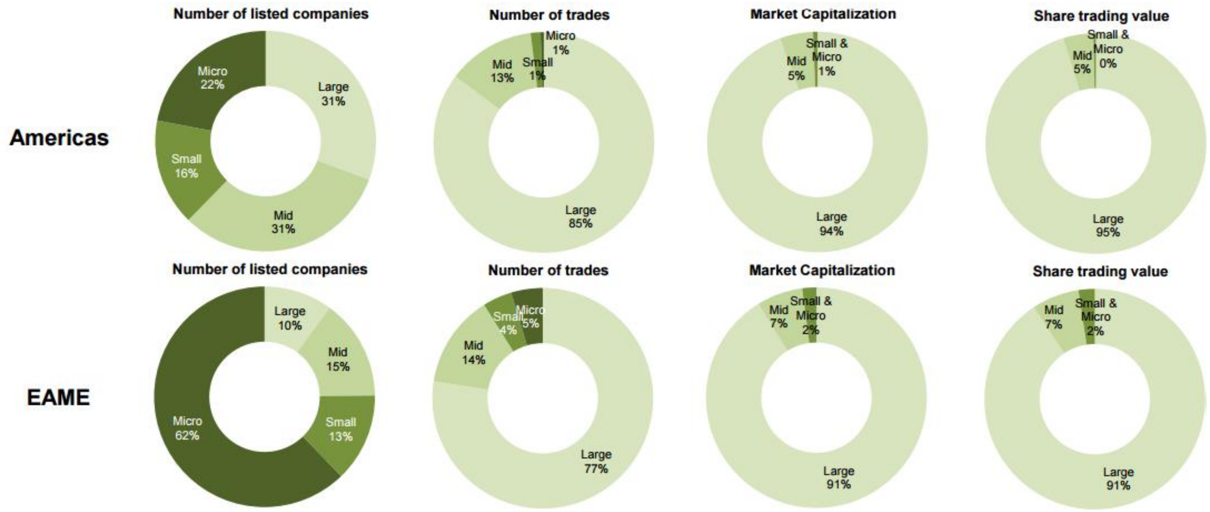

Figure 7: Weight of each market segment by region
(Large market cap segment : market cap > USD 1.3 bn, Mid market cap segment : USD 1.3 bn > market cap > USD 200 m
Small market cap segment : USD 200 m > market cap > USD 65 m, Micro market cap segment : market cap < USD 65 m)
Source: World Federation of Exchanges

Indeed using identical thresholds for the segments, 62% of listed companies in EAME can be considered micro-companies against 22% in the Americas, while large companies represent only 10% of EAME's listed companies against 31% in the Americas.

[4] http://www.world-exchanges.org/insight/reports/2012-wfe-domestic-market-segmentation-survey

Capital markets in the US system are, however, much better at financing very large companies that are not present elsewhere. A report made by PWC on the Global Top 100 Companies by market capitalisation[5] gives interesting figures in this regard as it shows that among the biggest 100 companies, 53 are based in the US market with a combined capitalisation of US$9,322bn while only 24 are based in the EU with a combined capitalisation of US$2,662bn. This gives a clear indication that US capital markets finance companies that are less present in Europe and are not the target of the current Capital Markets Union policy debate.

The belief that bigger and deeper financial markets allow companies to better resist in times of crises is also debatable, as a Natixis study entitled "Is the US model of corporate financing superior or inferior to the European model?" published on 27 September 2011[6], clearly illustrates in the chart below:

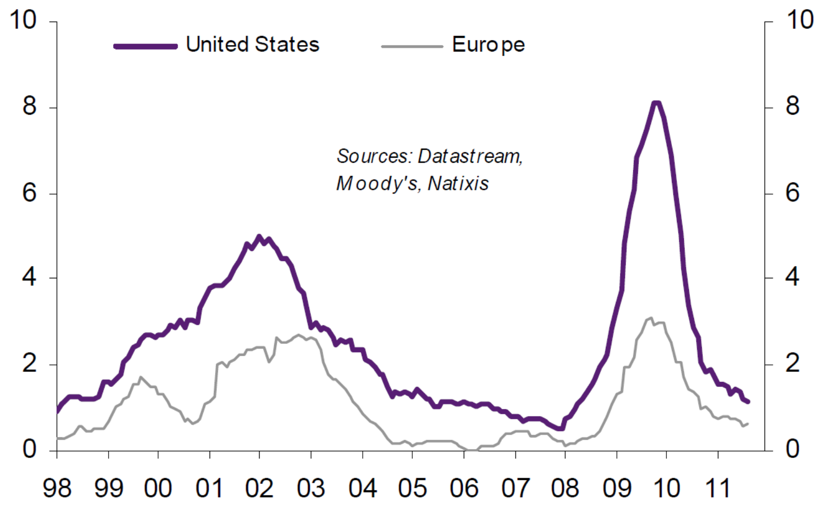

Figure 8: Corporate default rate (total corporates). Source: Natixis.

In particular, this study indicates: "*All in all, because of the behaviour of the two ways of financing, it seems preferable for companies to enter recessions with a European-type financing (by bank lending, with a smoothing of the recessions in terms of the cost and amount of credit, which is not the case in the United States even for credit).*"

The study also concludes that:
"The changes in the situation of banks and banking regulation in the euro zone (rise in the cost of medium-term fund-ing; Basel III stable funding ratio, rapid increase in capital requirements) will perhaps lead to disintermediation of corporate financing in the euro zone, i.e. a move towards the US model of corporate financing.
Would this be an improvement or deterioration?
We have seen:
- as regards the availability of financing for companies, the euro-zone system is better;
- as regards the behaviour of financing during recessions (availability, cost) and, as a result, the corporate default risk, the euro zone system is better provided that the banks behave like euro-zone banks and not like US banks."

[5] http://www.pwc.com/gx/en/audit-services/capital-market/publications/assets/document/pwc-global-top-100-march-update.pdf
[6] http://cib.natixis.com/flushdoc.aspx?id=60123

4. Conclusion: There is no US model to import to improve European SMEs' access to finance

We have seen that the European Union and the United States do have significant differences in terms of the size of their capital markets and of their banking system. To be simplistic, it is possible to say that the US has a very large capital market but smaller banking sector, whereas the EU has a very large banking sector but smaller capital market (even if we have seen that some subtleties tend to mitigate those affirmations).

However it is clear that companies in general, both in EU and US markets, 'rely heavily' on banks to finance them and are both vulnerable to the tightening of bank lending. The size of the capital markets or of the banking sector is irrelevant in this regard and might be more significative of the way the largest companies of both regions get their financing.

The 'US model' that is better at financing companies, and in particular SMEs, therefore does not exist. Companies in the US market are also not any less vulnerable than their EU counterparts to the tightening of bank lending, on the contrary American companies resist less in time of crisis. There is therefore no model to import and trying to do so can only damage access to finance in the European Union.

The most efficient policy response to the overall lack of funding should therefore be to increase the amount of bank lending available. Increasing access to capital markets financing will surely benefit companies that are not fit for bank lending, but will have no relevance for the other 99% of companies.

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