N°24 | MAY 2014

ECONOTE

Societe Generale
Department of economic and sector studies

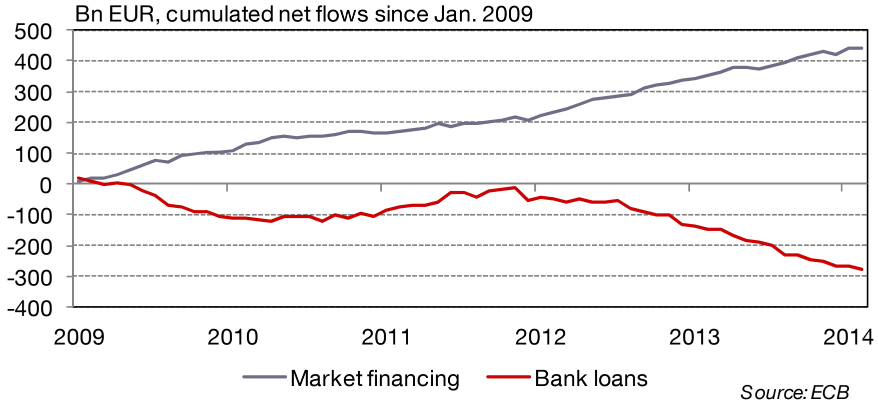
EUROZONE: CORPORATE FINANCING VIA MARKET: AN UNEVEN DEVELOPMENT WITHIN THE EUROZONE

— Non-financial companies in the eurozone are particularly dependent on bank lending. Consequently, specific challenges are posed to them by the reduced ability of banks to grant loans, due to tight constraints resulting from the crisis and tougher prudential rules.

— The alternative to bank lending – called “disintermediation” – can take principally two different forms: direct funding from investors (through debt public issuance or private placements) or mechanisms that enable banks to remove loans from their balance sheets (loan securitisation).

— Since 2009, market finance has more than offset the decline in bank loans to companies in the eurozone as a whole. However, this conceals substantial disparities between countries: disintermediation has been most extensive in France, whereas it has been virtually non-existent in Spain. There are also significant disparities according to the company size, with direct recourse to debt markets concerning mainly the largest firms. Securitisation has yet to be developed in the eurozone, particularly in the case of SMEs loans.

EUROZONE: DEBT OF THE NON-FINANCIAL CORPORATE SECTOR



Source: ECB

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Since the beginning of the financial crisis in 2007-2008, the banking sector has had to face major changes in its economic and regulatory environment. This note describes the already visible consequences on the financing of non-financial companies (NFC) within the eurozone.

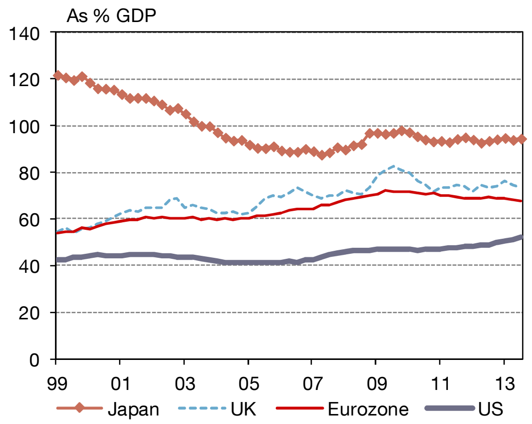
IN THE EUROZONE, BANK LENDING PREDOMINATES

THE INDEBTEDNESS OF THE NON-FINANCIAL CORPORATE SECTOR REMAINS CONTAINED…

The indebtedness[1] of eurozone NFCs increased by close to 20 points of GDP between the creation of the euro and its peak at the beginning of the financial crisis. It has since stabilised, at a level slightly below 70% of GDP in 2013 (chart 1).

Compared with other developed economies, this NFC debt ratio appears to be well below the figures observed in the United Kingdom and Japan. However, it remains higher than in the United States, even though the gap has been narrowing over the last two years.

GR1. DEBT OF THE NON-FINANCIAL CORPORATE SECTOR



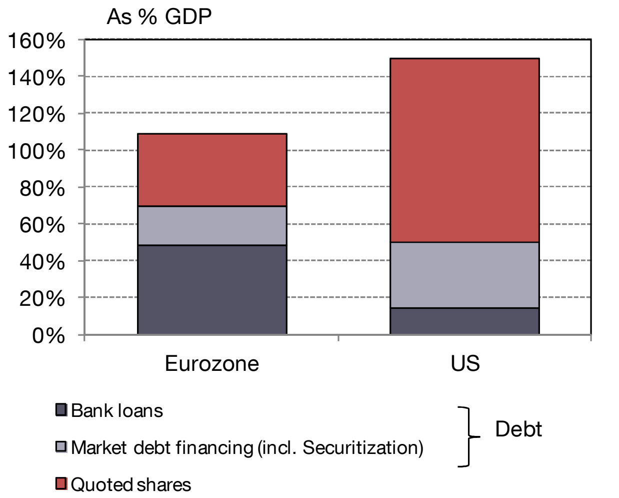
Source: Banque de France

…AND PRIMARILY MADE-UP OF BANK LOANS

If we break down the total consolidated liabilities of NFCs, it appears that eurozone companies obtain financing primarily via bank lending (chart 2). Bank loans to NFCs represent nearly 50% of GDP and close to 70% of their debt. By way of comparison, in the United States, bank loans to NFCs represent only 15% of GDP and close to 30% of their debt financing.

The eurozone financing model can be defined as "intermediated", since banks play a dominant role as financial intermediaries and retain the loan risk in their balance sheets. In contrast, the US financing model is "disintermediated", since market financing dominates.

GR2. LIABILITIES OF THE NONFINANCIAL CORPORATE SECTOR



Sources: Fed, BCE, BDF

ECONOMIC AND REGULATORY CHANGES FAVOUR DISINTERMEDIATION

Following the 2007-2008 financial crisis and its subsequent consequences within the eurozone, banks to face changes encouraging them to modify their role in the financing of economies. Eurozone NFCs are more directly affected given the importance of bank lending in their financing.

THE ECONOMIC ENVIRONMENT WEIGHS ON CREDIT DEMAND AND SUPPLY

The difficult macroeconomic environment has adversely affected both corporate loan demand and supply. The aggregate level of activity (measured by real GDP) in the eurozone currently remains lower than in 2008. At end-2013, real GDP was 7% below its pre-crisis level in Spain, and 8% below in Italy. This economic slump has been accompanied by a deterioration in companies' financial situation and a fall in investment spending (whose volume remains close to 20% lower in early 2008 for the eurozone as a whole), thus restraining their recourse to debt. Other consequences - the number of bankruptcies has increased, especially in peripheral countries, while non-performing loans are negatively impacting banks' balance sheets and thus limiting their ability to lend.

Against this backdrop, banks have also experienced specific difficulties. In many countries, the 2008-2009 crisis necessitated government intervention to support the banking sector. Moreover, the sovereign debt crisis within the eurozone increased banks' financing difficulties, particularly in peripheral countries. These tensions have forced banks to deleverage.

[1] *The indebtedness considered here (source Bank of France) refers to consolidated indebtedness, i.e. excluding inter-company indebtedness.*

A BANKING ENVIRONMENT IN THE PROCESS OF TRANSFORMATION

Apart from the direct effects on loan supply and demand, the 2008 crisis resulted in a set of regulatory reforms for the banking sector, in particular Basel 3. Banks must meet new tougher prudential requirements in terms of capital and liquidity. These changes limit banks' ability to carry and transform risks – credit and maturity – in their balance sheets. As a result, corporate financing in the eurozone is likely to shift from an "intermediated" model to a more "disintermediated" model.

TWO DISINTERMEDIATION CHANNELS

Disintermediation consists in moving from bank intermediation to a system where credit and liquidity risks are borne directly by investors.

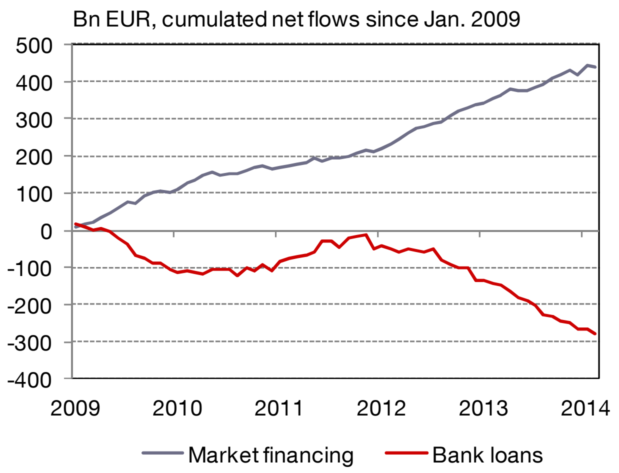
Disintermediation can take two forms:

- In the most standard case, market financing (through issuance of debt securities) replaces bank financing: investors and borrowers meet "directly" in financial markets. In this case, the role of banking is only to arrange the debt security issuance and to sell to investors. So-called "private" placements are another direct financing alternative where debt is sold to a small group of chosen investors through a private offering.
- Another form of disintermediation consists in banks continuing to originate loans but subsequently reselling all or some of their risks to other investors so as not to retain them in their balance sheets. This mechanism is commonly referred to as OTD (*originate to distribute*), in contrast with the acronym OTH (*originate to hold*) which refers to retaining loans within balance sheets. To do this, the bank may resort in particular to securitisation[2].

SOME DISINTERMEDIATION IS ALREADY UNDERWAY IN THE EUROZONE AS A WHOLE

The substitution of bank lending by market debt in the financing of NFCs is visible (chart 3). On a cumulative basis from Jan. 2009 to Feb. 2014, bank loans declined by more than EUR270bn, whereas issues (net of redemptions) of debt securities exceeded EUR430bn.

GR3. EUROZONE: DEBT OF THE NON-FINANCIAL CORPORATE SECTOR



Source: ECB

This substitution phenomenon is taking place principally among large companies: their ability to access markets enables them to borrow from markets rather than from banks. This trend has been helped by particularly attractive financing conditions in bond markets (chart 4), due to abundant liquidity global economy and historically low interest rates.

GR4. INTEREST RATE ON THE BOND MARKET FOR THE EURO ZONE CORPORATE SECTOR

Source: Datastream

That said, a more detailed analysis shows that this disintermediation process is developing very unevenly within the eurozone.

UNEVEN DEVELOPMENT OF MARKET FINANCING ACCROSS COUNTRIES

For NFCs in the eurozone as a whole, the increase in market financing has more than offset the decline in bank lending. However, an analysis of the four largest economies in the region shows substantial differences (charts 5).

[2] *In its simplest form, securitisation consists in issuing debt securities having as a counterpart in the assets a portfolio of bank loans.*

MARKET FINANCING IS INCREASING THE MOST IN FRANCE, WHERE BANK LENDING HAS NOT DECLINED

In France and Germany, bank lending has proved resilient (no "credit crunch"): since 2009, outstanding loans are virtually stable in Germany and continue to grow slightly in France (charts 5a and 5b). Surveys on bank lending conditions and SMEs' access to finance suggest that – apart from during the height of the financial crisis in 2008/beginning of 2009 – sluggish growth in bank lending stems more from weak demand than restricted supply[3].

However, with regard to NFCs market debt, there is a significant divergence between Germany and France. The cumulative increase since 2009 just above EUR40bn in Germany, compared with more than EUR190bn in France. The disintermediation trend therefore seems to be more important in France (where market financing now represents 36% of total NFCs' debt vs. 26% at the beginning of 2009[4]) than in Germany. Two factors may contribute to accentuating this divergence:

- a structural factor: the preponderance in France of major multinational groups, which are more likely to resort to market financing, whereas Germany is characterised by a substantial number of medium-sized companies, which continue to resist to resort to bank financing;
- a cyclical factor: because of the deterioration in their self-financing capacity, French companies have resorted to debt – in all its forms – to a greater extent than their German counterparts.

More detailed data on French NFCs[5] show that during the recent period, bank lending has been declining for large companies and intermediate-sized enterprises (ETI), whereas it has continued to increase for SMEs. Disintermediation therefore appears to operate for companies having a size that allows them easier access to markets, whereas SMEs continue to obtain financing via the banks.

Debt financing via private placements (which is statistically recorded in market financing) is an alternative to bank financing for mid-sized companies. However, in France, this financing channel remains in the start-up phase, with barely EUR 4 billion of new financing in 2013.

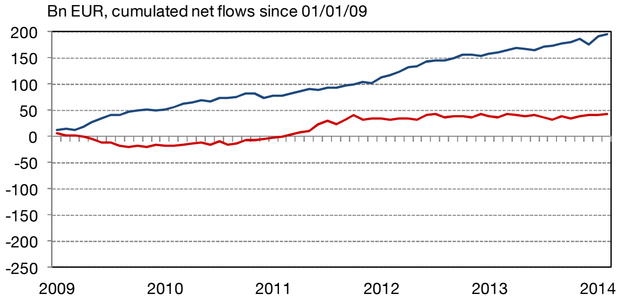
[3] *According to the latest survey by the ECB and European Commission carried out among SMEs (between April and September 2013), the percentage of SMEs having obtained the total loan they requested: 87% in Germany and 71% in France vs. 52% in Spain and Italy.*

[4] *Private placement are included in bonds statistics and represented 3.9 billions of euro in 2013, source AMAFI.*

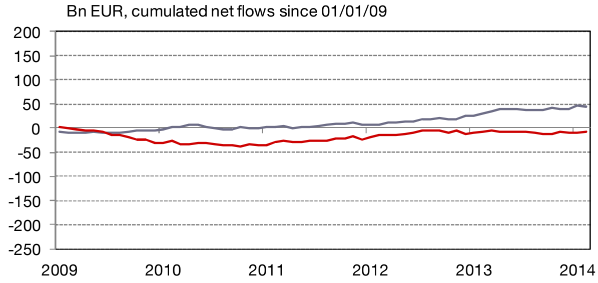
[5] *Source Bank of France*

GR5. INDEBTEDNESS OF THE NON-FINANCIAL CORPORATE SECTOR

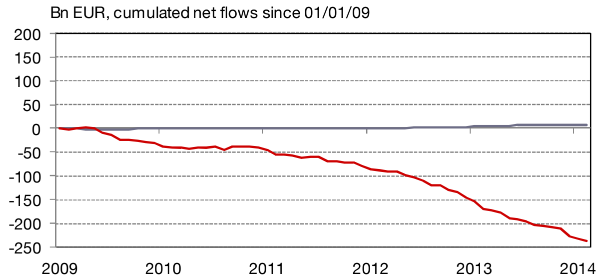
GR5A. FRANCE



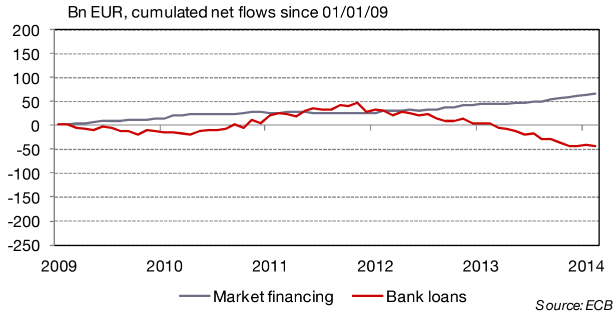
GR5B. GERMANY



GR5C. SPAIN



GR5D. ITALY



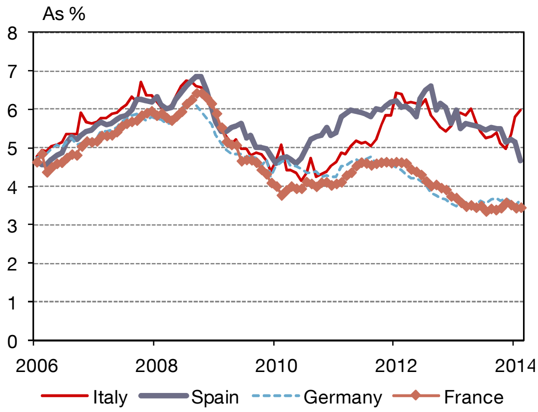
Source: ECB

MARKET FINANCING IS PARTIALLY SUBSTITUTING FOR BANKS FINANCING IN ITALY, BUT NOT IN SPAIN…

In Spain and Italy, bank lending has shrunk substantially. It has declined significantly since 2009 in Spain (by more than EUR200bn), whereas the decline is more recent in Italy (cumulative decline of more than EUR40bn since 2009, but nearly EUR80bn since 2012). These declines can be attributed to both weaker loan demand and supply constraints, in the wake of the difficulties encountered by banks in these two countries.

The differences in loan conditions between the four main eurozone economies appear clearly when we compare the interest rates on new loans to SMEs since 2010/11 (chart 6): they have been – and are still – much higher in Italy and Spain than in Germany and France[6].

GR6. SME INTEREST RATES
NEW LOANS
(<1mEUR, maturity 1-5Y)



Source: ECB

However, in the case of Italy, market financing has generally more or less substituted for bank loans (chart 5d). The observation of bank lending alone therefore gives an excessively negative picture of corporate borrowing. In fact, the debt ratio of Italian NFCs (as a % of GDP) has stabilised in recent years. That said, only the largest companies, and not SMEs, have been able to overcome the difficulties of accessing bank lending by turning to markets.

In Spain, however, market debt has not increased. This can probably be attributed to the fact that Spanish companies must first correct the excessive debt they accumulated prior to the crisis. In 2009, Spanish NFCs had a much higher debt ratio (at around 120% of GDP) than in other eurozone countries (chart 7). Since then, this ratio has fallen by around 20 points of GDP, but

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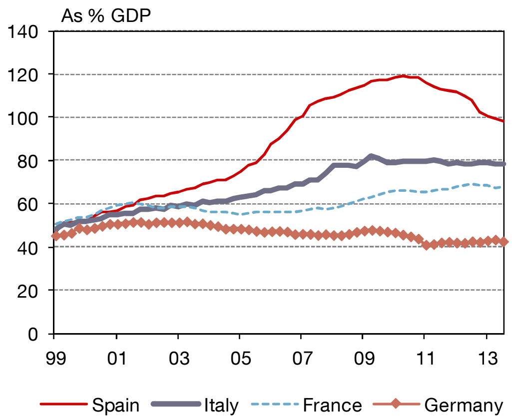
[6] *An ECB study (see August 2013 monthly bulletin) shows that these differences reflect not only the more deteriorated situation of borrowers in peripheral countries, but also the greater funding constraints of banks in these countries.*

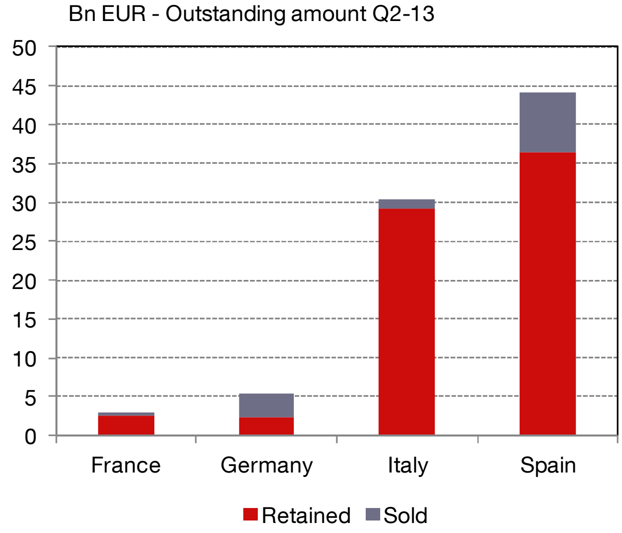
still remains much higher than in the other major eurozone countries.

GR7. DEBT OF THE NON-FINANCIAL CORPORATE SECTOR



Source Banque de France

GR8 . SME LOAN SECURITISATION



Source: AFME

SECURITISATION REMAINS MARGINAL FOR CORPORATE FINANCING

Disintermediation can also operate through the securitisation process, which enables banks to remove loans from their balance sheets. In particular, it might represent an appropriate alternative for the financing of SMEs, which have difficulty accessing markets. Securitisation would enable banks to continue to provide financing to SMEs, but without carrying the total risk in their balance sheets in order to comply with tighter prudential requirements.

For the eurozone as a whole, the amount of securitised SMEs loans totalled EUR145bn in Q2-13, which represents barely 10% of outstanding loans to SMEs. However, the country breakdown is very uneven (chart 8), with a preponderance in Spain[7] and Italy, where securitisations represent nearly 20% of total bank loans.

However, the majority of these securitisations are retained in banks' balance sheets and not held by non-bank investors: they have been put in place to serve as collateral for Eurosystem refinancing operations.

Against this backdrop, the relaunch of the loan securitisation market via ABS (Asset-backed securities) now seems to be desired by the European authorities. Firstly, the European Commission has recently recommended to restart securitization in its "roadmap to meet the long term financing of the economy". Secondly and more importantly, the ECB is clearly in favour of the development of such a securitisation market, advocating in particular a reduction in the regulatory capital requirements adversely affecting the simplest ABS. Moreover, the catalyst for such a development could be the launch of a purchase programme for this type of private assets by the ECB, should the central bank judge it necessary to resort to quantitative easing.

[7] The amounts "assigned" in the case of Spain appear to be substantial (7bn). However, it seems that they originate from amounts sold prior to the crisis. This is because these calculations originate from inventory data and the "sold" component represented 50% in 2008, vs. only 17% recently.

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