

Box 5

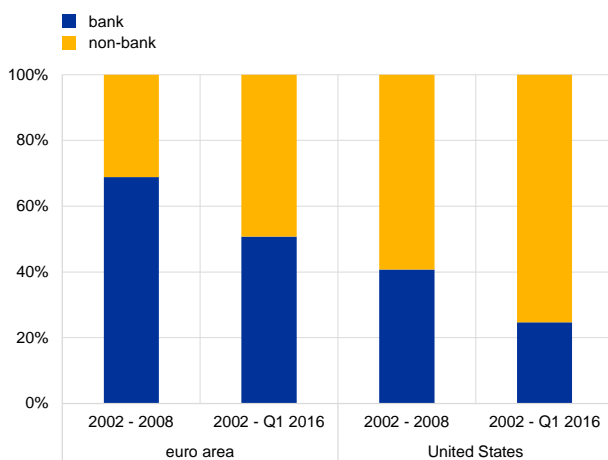
Trends in the external financing structure of euro area non-financial corporations

The funding structure of non-financial corporations (NFCs) plays a fundamental role in the transmission of monetary policy to the real economy and the resilience of the corporate sector to shocks. This box discusses the recent changes in the external financing structure of euro area NFCs, the possible factors behind them and potential implications for the transmission of monetary policy measures.

Chart A

Share of bank and non-bank financing in total non-financial corporation financing in the euro area and the United States

(cumulated transactions, percentages)



Sources: ECB, Federal Reserve System.

Note: The latest observation is for the first quarter of 2016.

Non-bank financing sources have become

significantly more important since the onset of the crisis. Traditionally, euro area firms have mostly relied on bank lending to finance their fixed investment and working capital needs. Looking at cumulated transactions between 2002 and 2008, the share of bank financing in total NFC financing stood at around 70% (see Chart A). However, this share dropped to 50% in the period from 2002 to early 2016, implying that alternative financing sources have gained in importance in the euro area. The decline in bank financing is primarily driven by developments in the financing structure of large enterprises. By contrast, small and medium-sized enterprises (SMEs), which are the backbone of the euro area economy, continue to be financed mainly via bank credit. It is worth noting that a move to an even more market-financed system can be observed in the United States, where the share of bank financing in total NFC external financing fell to 25% in the period from 2002 to early 2016, down from 40% in the pre-2009 period.²²

The increasing share of non-bank financing in total euro area NFC financing reflects both cyclical and structural factors. These are outlined below.

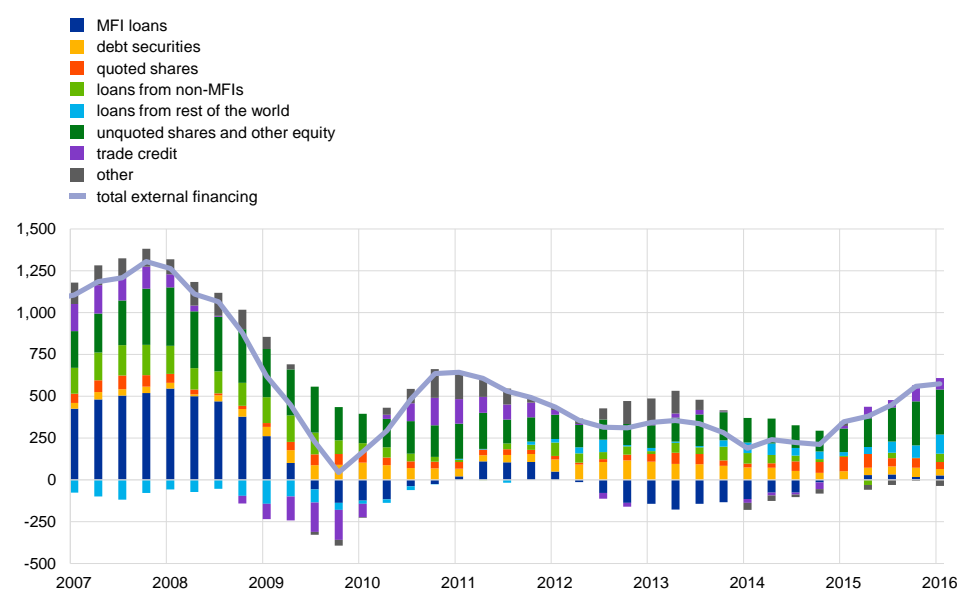
²² In terms of notional stocks, the shares of bank loans (not corrected for loan sales and securitisation) in NFC total external financing (net of intra-sectoral loans, unquoted shares and other equity issued, financial derivatives and other accounts payable) stood at 35.4% in the euro area in the first quarter of 2016 (down from 41.3% in the fourth quarter of 2008), while the respective share of debt securities issued stood at 10.1% (up from 6.5%) and that of quoted shares issued at 29.9% (broadly unchanged from 29.7%).

1. *A protracted period of weakness in bank lending.* The net flow of finance from banks to NFCs contracted in 2009 and 2010, and again between 2012 and 2014, reflecting both credit demand and supply factors, including stricter regulation and supervision (see Chart B). To the extent that credit supply restrictions were binding, NFCs were forced to find alternative sources of financing. Notwithstanding a recovery in bank lending to NFCs since late 2014, net credit flows remain rather low, implying an ongoing fall in the share of bank credit against the background of a strengthening in NFCs' overall external financing.

Chart B

External financing of euro area non-financial corporations by instrument

(annual flows, EUR billions)



Source: ECB.

Notes: The latest observation is for the first quarter of 2016. "Other" refers to the difference between the total and the instruments included in the chart and includes inter-company loans and the rebalancing between non-financial and financial accounts data.

2. *Relatively robust bond issuance activity of NFCs.* Partly to compensate for the decline in bank lending but also reflecting increasingly favourable market-financing conditions, NFCs substantially increased their net issuance of debt securities, especially between 2009 and mid-2014.²³ Though NFCs' bond issuance activity has been less vibrant since mid-2014, it remains above pre-crisis levels, as suggested by the most recent data on issuance activity for the second quarter of 2016, further supported by the ECB's new corporate sector purchase programme (CSPP) announced on 10 March 2016 (see Box 2 in this issue of the Economic Bulletin) and record-low corporate bond yields. The nominal cost of market-based debt stood at 1.45% in mid-July 2016, which is significantly below the current level of bank lending rates (see Chart C). The observed marked 650 basis point decline in the cost of market-based debt since

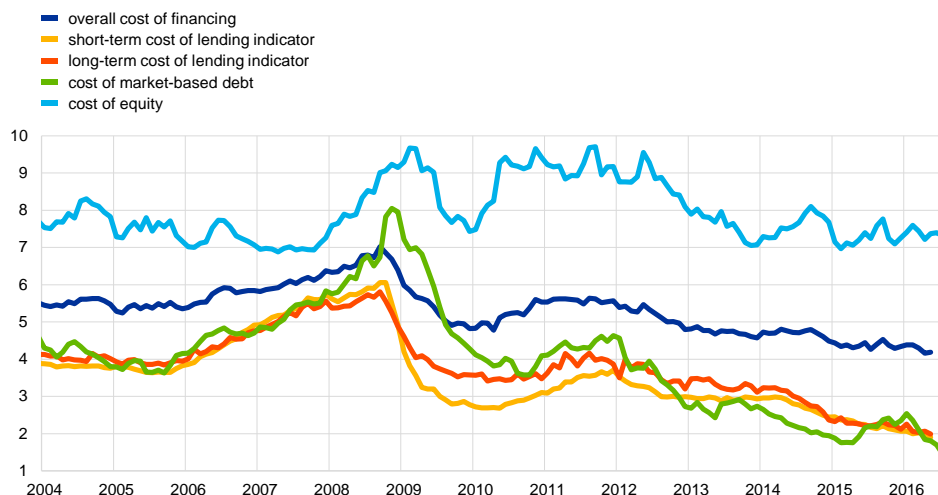
²³ See also the box entitled "Recent developments in debt securities issued by non-financial corporations in the euro area", *Monthly Bulletin*, ECB, April 2014.

the end of 2008 has been supported by both the ECB's monetary policy measures and globally declining bond yields.

Chart C

Nominal cost of external financing for euro area non-financial corporations

(percentages per annum)



Sources: Thomson Financial DataStream, Merrill Lynch, ECB, ECB calculations.

Notes: The overall cost of financing for NFCs is calculated as a weighted average of the cost of bank lending, the cost of market-based debt and the cost of equity, based on their respective amounts outstanding derived from the euro area accounts. The latest observation for overall cost and lending rates is for May 2016 and the latest observation for the cost of market-based debt and cost of quoted equity is 20 July 2016.

3. *Rising importance of non-MFIs in financial intermediation.* Lending from non-MFIs²⁴ to NFCs has increased since the crisis, which has also mitigated the effect of weak bank credit.²⁵ In recent years, the vigorous developments in non-MFI loans have mainly reflected an increase in loans granted by financing special purpose entities (SPEs) to their parent company, financed by the issuance of debt securities by these subsidiaries. Financing SPEs are typically resident in a different euro area country from the parent company or outside the euro area to benefit from a favourable tax regime and financial technology. Hence, the observed robust developments in loans from foreign entities in recent quarters most likely also mirror the increasing levels of bond issuance by firms through their subsidiaries located outside the euro area.
4. *Higher recourse to intra-sectoral financing.* NFCs also significantly increased their recourse to trade credit and intra-sectoral loans between mid-2010 and the end of 2012 to mitigate the negative impact of lower credit supply on the availability of external financing. At the same time, during the crisis firms financed a larger share of their activities with internally generated funds and

²⁴ Non-MFI loans consist of loans from other financial institutions (OFIs) and insurance corporations and pension funds (ICPFs). Loans from OFIs include loans from financial vehicle corporations established to be holders of securitised loans originated by banks, financing special purpose entities, financial leasing companies, venture capital corporations, development capital companies and holding companies. Loans from ICPFs cover, inter alia, loans granted directly to finance construction projects, purchases of securitised loans to investment portfolios and possibly participation in syndicated loans.

²⁵ See the article entitled "The role of euro area non-monetary financial institutions in financial intermediation", *Economic Bulletin*, Issue 4, ECB, June 2016.

higher retained earnings. This development has moderated debt financing growth and has helped to stabilise gross indebtedness. Moreover, NFCs have continued to park a significant part of their retained earnings in liquid assets. The current record-high liquidity buffers should improve firms' shock absorption capacity.

The observed shifts in the financing structure of NFCs may have implications for the transmission of monetary policy, but the overall effect is still difficult to identify. A more diversified funding structure of firms may render them more resilient to shocks hitting the banking system. It also diversifies the channel through which monetary policy is transmitted to the real economy. This has been reflected in the ECB's monetary policy, which has included a wide range of instruments to inject additional stimulus in recent years. A stronger role of non-MFIs in financial intermediation may accelerate monetary policy transmission as some non-MFIs may adjust their risk exposures more flexibly than banks in response to changes in the business and financial cycles. However, it remains to be seen whether the current trend towards a more market-based financing pattern for the real economy will continue once bank lending has fully recovered. In the past, a sustained growth in NFC external financing has always coincided with stronger bank loan dynamics. The EU has launched several initiatives to improve firms' access to risk capital and market-based financing. It is, however, too early to say to what extent these initiatives will be successful in reducing dependence, particularly of SMEs, on bank credit.