CAPITAL VS BANK-ORIENTED FINANCIAL SYSTEM - BENEFICIAL TRANSFORMATION TRENDS FOR FIRMS

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The financial systems provide economies with beneficial transformation services, which are the followings: mobilization, pooling and transfer of economic (liquidity transformation); risk diversification (risk transformation); reduction of information asymmetries between capital supply and demand (information transformation) and allocation of resources, corporate control. Transformation functions are ensured by both capital-market-oriented and bank-oriented financial systems but in different ways.

1. Introduction

In a financial system it is important to understand the entire network that serves the interactive process between capital demand and capital supply. First and foremost, this term covers the different money, capital and credit markets, but in a broader sense also insurance markets. These markets can complement one another but also compete with one another. They are all part of the overall financing system that serves the economic cycle.

When capital investment or procurement needs are to a greater or lesser extent met directly in the relevant markets and/or stock markets, there is a *capital-market oriented* financial system. In this case, the law of supply and demand is the main regulating factor. In contrast, when banks (or other financial institutions providing similar services, irrespective of whether or not they are closely related to banks) manage the process of capital transfer as so-called "financial intermediaries", there is a *bank-oriented financial system*. In this case, mechanisms can take effect that run counter to the pure principles of market law .
In general, it is considered that the predominantly bank-oriented financial system is found in Continental Europe and Japan and the typical examples of capital-market-oriented financial systems are US and UK. In reality, financial systems are neither purely capital-market-oriented in Anglo-American countries nor purely bank-oriented in Continental Europe or Japan and there are varying combinations of both these types of financial systems, with the relative significance of credit and capital markets as sources of external corporate financing differing from economy to economy.

Both the bank-oriented and capital-market oriented financial systems have to be seen as components of an economy's overall financing system. Moreover, the way in which any

individual financial system is shaped depends on country-specific and mostly complementary factors as: the regulatory framework, the economic and corporate structure, the pension system, and economic, and particularly banking, history. In this respect, the financial systems are not static, but rather they continually adjust to changing general frameworks.

2. Transformation services provided by the financial systems

The major players in the overall financial system are private households and companies as well as financial intermediaries such as banks, asset, management institutions, pension funds and investment funds, capital investment companies, insurance companies, and leasing companies. The services of different financial intermediaries may complement one another or compete with one another. This is the case, for example, with banks and insurance companies, and increasingly also with banks and companies that sell consumer goods.

The financial system encompasses further institutions such as legislative and supervisory authorities, stock exchanges, trading and payment systems, but also legal frameworks specifically relating to the transfer of capital.

The trading of resources, goods, and services involves "friction losses" that in turn act as cost drivers. These include the costs and time involved in searching, procuring information, negotiating, monitoring and where necessary implementing contractual agreements as well as overcoming the problem of distance. These transaction costs are an expression of market imperfections (asymmetrical distribution of information). The higher the transaction costs, the greater the friction or efficiency losses for the economy.

The liberalization of markets for goods, services and capital, together with advances in information and communication technology and logistics, all lead to lower transaction costs.
Transaction costs also affect the investment and procurement of capital, and in this sense legitimize the existence of financial systems. As well as providing an infrastructure for capital transfer, the financial systems provide economies with beneficial transformation services, which are the followings:

1. Mobilization, pooling and transfer of economic savings in the form, amount and security level dictated by supply and demand (liquidity transformation)
2. Risk diversification (risk transformation)
3. Reduction of information asymmetries between capital supply and demand (information transformation)
4. Allocation of resources, corporate control

Transformation functions are ensured by both capital-market-oriented and bank-oriented financial systems. The two sub-systems differ in the manner in which transformation services are effected. Both systems have their peculiarities, strengths, and weaknesses.

2.1. Mobilization, pooling and transfer of economic savings

In bank-oriented financial systems, client funds are recycled into the economy by financial institutions in the form of secured and unsecured loans. The terms and amounts of the individual loans granted are usually greater than those of the client funds deposited. The transformation of liquidity supply into liquidity demand is achieved by mobilizing and

pooling differently sized lots (amounts) and terms (repayment dates). Liquidity transformation is thus effected by the transformation of lots and terms.

In capital-market-oriented financial systems, economic savings flow directly via a range of different investment instruments (bonds, stocks, funds, derivatives) into the economic cycle. Here, banks act as fee-charging intermediaries between borrowers and investors rather than interest-charging creditors. Investors therefore have either a direct interest in the well-being of the company as equity capital providers (stockholders) or debt capital providers (corporate bondholders), or an indirect interest if they hold fund units. They can exercise an influence on companies through a number of security-specific options. In this case, banks do not act as intermediaries, but as advisors and suppliers of appropriate instruments to procure and invest capital. The huge advances in the development of financial products, coupled with the opportunities for cost reduction as a result of the opening up of markets, have led to a boom in capital markets.

2.2. Risk diversification (risk transformation)

Financial systems provide a platform for inter-temporal, inter-sectoral and inter-regional risk diversification. The allocation of risk – that is, which risks are assumed and who assumes them – works in different ways in the capital-market-oriented and bank-based financial systems.

In bank-oriented financial systems, the depositor bears *de facto* no risk, as banks grant loans on their own account and at their own risk. As a result, banks must offset risk themselves. This explains why banks set so much store by empirical, information-based credit risk management. Depositors essentially agree to forego higher potential returns on their savings in exchange for a higher level of security and liquidity.
In corporate credit financing, borrower default risk is spread among relatively few creditors (debt capital suppliers), most notably banks and suppliers. These creditors therefore have to try to factor possible corporate failures into the conditions and prices they offer. The frequency and extent of corporate failure is heavily dependent on the prevailing risk landscape and the rapidity with which this can change. The security of client funds, the financial health of the bank and the stability of the entire banking system are ensured by the statutory level of equity capital reserves held by the bank (capital adequacy requirement).

The fact that corporate lending is restricted to relatively few risk carriers can be economically inefficient. If the borrower proves either unwilling or unable to accept risk-adjusted interest rates, and if the risk is too high for the bank, a potentially attractive project will not be realized unless other financing alternatives can be found. In other words, the options for diversifying the risk are not fully explored.
In capital-market-oriented financial systems, investors (shareholders or partners, risk capital providers, bondholders) have to bear the degree of risk carried by their proportional holding. The risk is thus spread among many investors through capital markets – i.e. in the form of corporate equity or bond financing – in line with their investment objectives and horizons, as well as their readiness to take risks. This system is better than the bank-oriented financial system in exploiting ways of broadly diversifying risk among a large number of private and institutional investors with different investment objectives, investment horizons, and levels of readiness to take risks.

2.3. Reduction of information asymmetries between capital supply and demand (information transformation)

Information tends to be distributed unevenly or asymmetrically. The benefit of financial systems is that they reduce information asymmetries (information transformation). The parties involved collate data and information in a system-specific manner, evaluate this information and then make their plans and form their expectations of return, profitability and risk. Information therefore influences how investors form their expectations, and thus also the relative appeal of different financing and investment alternatives.

In bank-based financial intermediation, client and market information is internalized within the banks themselves. Because client information is made available to only a small circle of banks, borrowers can rest assured in the knowledge that their corporate data will not be disseminated far and wide. To a certain extent, this means they are dependent on one or a small number of capital lenders. However, both competition between banks themselves and the existence of supervisory authorities act as a counterbalance against the abuse of market power.

The internalization of information inevitably leads to a duplication of information gathering and processing, which is inefficient from an economic perspective. Multiple evaluations of the same data may produce the same information and same client profile, but may lead to different credit decisions if the evaluating banks have different business strategies. This reduces the danger of parallel credit approvals.

The information transparency plays a key role in capital-market-based financial intermediation. Factors that assist this transparency include accounting and disclosure standards, as well as regulations governing insider information. Companies publish investor-relevant information that is processed by the media and by suppliers of investment information, e.g. brokers, and is then made available to investors in the form of investment recommendations (externalization of information). The investment decisions of these investors cause stock exchange price movements in keeping with the law of supply and demand. The price changes send a signal to company management as to how satisfied investors are with the company's leadership, strategy and success.

The externalization of information reduces the information asymmetry between borrowers and investors, improves the tradability of the security in question (liquidity) and exercises disciplinary pressure on company management. In the capital-market-oriented financial system, a company's management will take into account market forces when making corporate decisions. Information externalization thus reduces the potential for conflict between a company's owners and its management (principal-agent problem), and also improves the company's prospects of finding interesting sources of financing. This explains why listed companies and those ready for the capital market attach such great importance to dealings with shareholders and bondholders (investor relations).

2.4. Allocation of Resources, Corporate Control

Equity capital provides cover for corporate risk. But it also boosts a company's ability to raise capital (capital stock increase, bonds, loans). Without equity capital and plausible future cash flows, company start-ups and investments that might have proved profitable will simply not get off the ground.

Suppliers of capital, employees, clients, unions and other organizations, the state, legislative authorities, and others all make demands on a company. These interest groups seek to exercise influence on company decisions and behavior because of the important repercussions that these entail for them. An important feature of differentiation between capital-market-oriented and bank-oriented financial systems is their different prioritization of controlling and liquidity interests, as well as the different instruments used to help channel and implement these interests.

A key characteristic of bank-oriented financial systems is their controlling orientation. Banks are interested in long-term client relationships that encompass more than just the business of lending. Through their credit approval criteria, and the regular monitoring of both borrower quality and collateral deposited, they exercise a certain disciplinary pressure on borrowers. The security of the client funds invested is of crucial importance. From a bank's perspective, what counts is not the highest absolute profit but the highest risk-adjusted return. The controlling orientation therefore tends to have a stabilizing influence on the price of a company's shares and on its ownership structure. Capital-market-oriented financial systems are distinguished by a particularly high level of liquidity orientation. Investors want to be able to adjust their portfolios quickly, in line with both their needs and the economic and corporate information available, and are therefore interested in liquid securities. Liquidity orientation thus exercises particular influence on a market-value-maximizing corporate policy. Accordingly, the market value of major public companies is often more volatile than that of other listed companies or companies with little diversification in their shareholder base Liquidity orientation contributes to the broad distribution of information and thus risk within the financial system. When a company has bad news to announce, liquidity orientation increases the probability that there will be change in the composition of capital suppliers, which in turn increases the danger of a hostile takeover.

3. Conclusions

Both ideal forms of corporate financing system thus bring transformation effects, which are beneficial for the economy and serve to reduce the transaction costs of resource allocation. It remains a controversial point as to whether the stability of the financial system is better preserved by the bank-oriented model (with its increasingly progressive risk management processes and cost degression possibilities) or by the capital-market-oriented model, which offers broad risk diversification, the disciplinary effect of information transparency, and market liquidity. The disciplinary effect of markets should be increased for the banking sector by the legislative requirement for disclosure of complete risk-management-relevant information under the third pillar of the new Basel capital adequacy guidelines (Basel II).

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