# Why we need more corporate bonds

#### 03 November 2016 Richard Kemmish

German corporate treasurers complain about Capital Markets Union. They claim that it is based on the false premise that capital markets must replace banks which, given their non-performing loans and regulatory constraints are no longer fit for the needs of the real economy. Maybe this is true in Italy or Spain, but corporate Germany’s funding needs are well served by its domestic banks and always will be. Right?

Do the same arguments apply for central and eastern European corporates? Seemingly yes. The banks are doing such a good job that we don’t need a bond market.  
   
According to data from the BIS, the bond markets provide funding for CEE corporates equal to a miniscule 12% of GDP. Take Russia out and the numbers are even lower, even in the fast growing countries in the region (take Poland for example where corporate bonds outstanding are just 3% of GDP). To put that into context, in the Eurozone the equivalent number is over 100% of GDP, in the US higher still. Even in Asia – where growth has traditionally been funded by banks and equities for cultural reasons – corporate bonds outstanding are over 60% of GDP.

So who needs the bond market?    
   
Given the extent of foreign ownership (and more importantly, funding) of the banking system in many CEE countries, the problems of western European banks that are driving CMU will inevitably be exported. Even for locally owned banks or healthy western European parent banks, the regulatory and monetary response to the problems of their western European peers will have the same effect: pressure to shrink balance sheets (via higher capital ratios, leverage ratios and floors to asset risk weights) and lower profitability from flat yield curves and less ability to undertake maturity transformation (for example due to the introduction of a net stable funding ratio).

The pressures on Europe’s banks to shrink their balance sheets may temporarily be ameliorated by the ECB’s extreme liquidity provisions. The key word there is ‘temporarily’.

And investors need CEE corporate bonds too.

The problems of euro area investors in a negative yield environment are well enough understood. But even so, we all underestimate the extent that those problems are compounded by the demographics of Western Europe. Bond yields can go negative, payments to pensioners can’t.  
   
Equally importantly, local currency investors badly need more bonds. The development of pillar 2 and pillar 3 pension schemes is essential to systemic and personal financial stability but it also requires something to invest in. Preferably something other than government issued bonds, far too scarce equities or securities with foreign currency risk.

Of course this is all a very simplistic, superficial analysis. And it would be wrong to underestimate the conditions that must be put in place for all of this to happen – from local capital market infrastructure to cheaper rating agencies. But it does seem inevitable that the 12% of GDP number will rise, and that will happen with or without Capital Market Union.