THE "FINANCING GAP": MYTHS AND REALITIES

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In recent years the debate on the "financing gap" has become increasingly contentious in numerous Member States of the European Union. The issue involved is nothing more or less than to know whether the world's financial system, both globally and through its national relays, allocates financial resources on the one hand efficiently and, on the other hand, equitably. To answer this question, each of these aspects has to be examined separately with regard to a different reference system. This paper is accordingly divided into two parts. As regards the system's efficiency, the question goes to the heart of modern economy, its principles of functioning and the dogma underlying such principles. As regards the equitable allocation of resources, that is more a question of social justice and the role of the institutions responsible for ensuring such justice.

Let us start by turning the question around: what could cause the financial sector to fail to allocate efficiently the resources with which it is entrusted? And, as a secondary question, what would be the consequences of such inefficiency? In a second stage, it is important to examine how the new approach to risk assessment adopted by the financial sector leads to part of the national economy being deprived of financing, with as a consequence certain sectors of the economy likely to suffer from chronic "under-financing" whilst other sectors are "over-financed".

1. Efficiency: myth and reality

The body of economic theory and the political arguments justifying the belief that the market economy is superior to any other economic system are based on the premise of the efficient allocation of resources. Literally, the premise of the efficient allocation of resources asserts that the market will ensure that the resources entrusted to it are allocated in such a way as to ensure that the productivity of the marginal unit of a given production factor is not inferior to the rest of the economy. That is the sine qua non condition to enable the market to accomplish its main function, namely that of setting prices. Consequently, it is possible to guess the consequences that would result from a dysfunction of the market which would moreover prevent it from allocating resources efficiently. Part of these resources would be wasted because they would have been allocated to sectors where the productivity of the last unit employed is inferior to those of the rest of the economy. The same economic theory is distinctly less forthcoming on how, in a system where, by definition, the actions of the economic operators are uncoordinated, the "invisible hand" can have a vision of the economy as a whole. The question that must be answered in this connection is whether the accepted characteristics of an economic model can a priori be considered as realistic given the concrete problems and contingencies to be faced in implementing a purified, idealised theory.

Adapting a theoretical blueprint to the actual functioning of the financial system is not easy, in particular on account of the extremely complex structure of the financial system itself. The growth of the financial system that we have witnessed over the last twenty-five years has been accompanied by two distinct developments which, on first analysis, would seem to be contradictory. On the one hand, the financial system has become even more complex, in particular due to the specialisation of individual institutions, while on the other hand there has been a standardisation of the public's expectations and requirements with regard to the remuneration of their deposits. We are only just beginning to measure the consequences of this twofold and paradoxical evolution.

Access to financing has become an area where companies from all over the world, all sizes and sectors taken together, are in fierce competition. Every company tries in its own way to attract investors and to convince them either to place their funds with the company directly, as in the case of a loan or share issue, or to "bet" on the company by acquiring its shares or bonds that have already been issued. In this race to attract financing, companies find themselves increasingly in competition with governments that are also looking to raise capital to finance their deficits.

At the other end of the market, among depositors of funds, there is a growing standardisation of the public's expectations and requirements with regard to the yield on the funds invested. In concrete terms, this means that depositors with funds placed on a savings account with a regional savings bank are amazed to see that the remuneration they receive is far less than the return that they hear or read about in respect of stock-market investments. Faced with such a situation, they will be tempted to switch their savings to unit trusts, for example. This reaction will be a warning for the savings banks and will in the future, in all likelihood, affect their investment strategy.

The essential function of the financial system is to act as an intermediary between the demand for financing and the supply of funds. In this respect, financial institutions play a leading role in matching supply and demand: they direct funds to one use rather than another. But, contrary to what is implied in the underlying economic theory, intermediaries are not neutral, since their actions introduce a new element into the process, which from the point of view of the recipients of the funds can seem to distort the process. This "distortion" is caused by the fact that each institution has its own cost structure. Thus, for customers of two different institutions, an identical investment will be more or less interesting, depending on the cost structure of each institution. Consequently, cost structure considerations, as well as existing methods of remunerating funds, will have an undeniable - and sometimes decisive – effect on the type of projects that the institution prefers to finance with its customer deposits. In a final analysis, taking an extreme scenario, an investment that is relatively unattractive in itself can appear more interesting to the customer and to the intermediary than another more profitable investment, but for which the intermediation costs are considerably higher.

The inescapable conclusion is therefore that - all other things being equal moreover - the intermediation cost structure of a specific financial institution influences the way in which it allocates the resources under its management. In fact, financial institutions endeavour to use their resources in such a way as to equalise the return on these resources. In doing this they pursue a policy of productive efficiency. However, productive efficiency at the level of a single financial institution is not enough to guarantee an efficient allocation at macro-economic level.

On the basis of current economic knowledge, it is difficult to assess the gap between an ideal and reality. On the other hand, it is possible to identify the characteristics of financial transactions which provide the intermediaries with a good return. These are either standardised large-volume transactions which generate commissions that are small in terms of percentage but produce large amounts in absolute terms, or very sophisticated transactions which involve interesting commission levels despite the relatively small amounts involved. In their determination to maximise profits from the two types of transactions, financial institutions are more and more clearly turning their back on certain types of operations, for reasons linked not to the profitability of the projects themselves, but on account of their insufficient "net profitability", that is to say profitability after deduction of the intermediation costs.

At the present time, there is a lack of empirical studies that explicitly take into consideration the effects of the cost structures of intermediaries on the pertinence of the allocation of resources. Such a lack of studies helps to perpetuate the premise of the efficient allocation of resources. However, it should not be forgotten that the intellectual appeal and formidable resistance to criticism of the premise of "efficient allocation" rely more on the fact that the premise is based on a syllogism rather than on empirical demonstrations that support it[1].

The conceptual analysis carried out here allows us to conclude that the structure of costs at financial intermediaries, their preference for such and such a type of transaction rather than for another, is effectively likely to introduce a bias in the allocation of financial resources. It is impossible to quantify the importance of this bias. However, it is not absurd to fear the worst and to assert that the world's largest companies - which directly do not produce more than 20% of the world's GDP - absorb a disproportionate share of world savings. If that were the case, the rest of the world's economy would - in relative terms - be under-financed. Thus, having regard to the growing role of the market in providing financing, the situation where 80% of savings is apparently allocated to the 20% of GDP produced by companies having direct access to the stock markets is perhaps not that far away. When these imbalances come out into the open, it will be too late to make adjustments. It will be time to take full stock of the wastage produced by "efficient allocation". The correction will come by way of a massive investment switch when confronted with the reality. Such a correction has a name: a major financial crisis.

2. The risk and the market's shortcomings

In the second part of this paper, the aim is to review the focus of the debate on the "Financing gap" and to look at different means of resolving the problem. The difficulty lies in the fact that the debate is being conducted on at least three very different levels: with regard to the role of financial

[1] See Paul Dembinski and Alain Schoenenberger, "A Safe Landing of the Financial Balloon is not impossible" in Finance & Common Good, Autumn 1998.

market operators, in terms of social considerations and, finally, from the point of view of whether a political intervention would be appropriate.

What price for what risk?

Among the professionals of the financial sector, the debate is a question of price and risk. To be more precise, the question is what price for what risk. To answer that question, increasingly sophisticated methods are being developed. At the root of these efforts, there is the barely concealed determination on the part of banks to make each customer pay the price that corresponds exactly to that customer's specific risk level. In reality, this determination to achieve transparency is the first step towards risk de-mutualisation.

However, the determination to put a price on the risk faces two major difficulties which stem from the very nature of financial risk. In fact, contrary to the risk of illness or death which can be quantified statistically for a given population, the same does not hold true for a specific investment project. The latter is calculated on the basis of a projected distribution of future earnings. Thus, assessing the financial risk is related more to forecasting than calculating probabilities. Contrary to an insurance company which seeks to increase the number of similar policies to cover itself against an homogeneous risk, finance institutions want to diversify risk. In other words, whereas in the case of insurance companies the increase in the number of contracts of the same type increases the financial soundness of the contracts as a whole, the opposite is true for a bank which by increasing the concentration of its exposure with regard to an homogenous population reduces its soundness. Thus, the risk of a given institution with regard to a specific credit comprises two potentially conflicting aspects: customer risk and portfolio risk.

By their ability to assess the two risk aspects described above, notably thanks to new evaluation methods, banks are able to manage rigorously their overall exposure. Thus, it is not unusual for banks to set quantitative ceilings on their exposure, or purely and simply to exclude certain sectors or certain types of credit from their portfolio. In such circumstances, the question "what price for what risk?" is meaningless. The bank simply rules out certain projects, irrespective of the economic viability of the project.

Empirical data confirm that the gap in terms of interest rates charged is widening between "AAA" borrowers that have access to the global market and self-employed persons who simply want to borrow a few thousand francs to provide their business with working capital. Nevertheless, the situation in Europe is very diversified. Globally, in the Northern European countries, even small firms do not complain over much about the problem of access to credit, whereas in the Southern European countries, the situation is considerably more divergent.

The strict application of these risk management principles to all potential customers can easily lead to the exclusion, purely and simply, of certain categories of "customers" from access to credit. The same is true for innovative and recently created businesses. These considerations highlight the relevance of the questions raised in the first part: are there any guarantees that this way of assessing credit risk contributes to the efficient allocation of resources at macro-economic level? Is it still a question of market forces, or rather a question of "market shortcomings" which can - even from a theoretical point of view - justify an intervention, for example by the public authorities? (see below).

Market shortcomings

This question on the existence or absence of the "financing gap" has an undeniable social dimension. According to an idea advanced with increasing force by part of the associative movement, access to financing is a social "right", derived from human rights principles. The question of credit to unemployed persons who are no longer entitled to receive unemployment benefits or to self-employed people, forced by the circumstances of life to build their own professional future, is becoming a question of fairness in the same way - or almost - as access to social security. To rectify such "market shortcomings", people are inevitably looking to the public sector or the para-public sector to provide a solution, and this in turn inevitably displeases the financial institutions which see "special" competitors gaining a foothold in their market.

Inevitably, at some point in time, the question becomes political. Is there a need to set up specialised institutions? Is there a need to regulate, subsidise, guarantee or give tax breaks to encourage the financial sector to adopt a more supportive approach to the parts of the society that they are increasingly neglecting? Is there a need to reverse the prism of the structure of their internal costs? Is there a need to correct the distortion referred to above? The replies vary according to the moment, and also depend on the economic and social context. There are three major challenges at the heart of this debate and the public and private sectors must meet these challenges in one way or another:

(1) The challenge of the conflict of interests: the globalisation of financial markets - whether one wants it or not - means that unemployed persons who borrow 20,000 francs to set up their own business are in direct competition with a company such as Nestlé when it floats a loan. Nowadays, for reasons of cost structure at financial intermediaries, the Nestlé transaction would be preferred. Is this choice in the interests of the depositor and the community to which the depositor perhaps belongs, or does it benefit only the intermediary? The conflict of interests that this example highlights can have an adverse effect on the financial sector's role in ensuring that resources are allocated in a pertinent way.

(2) The challenge of increasingly "contractualised" savings: the development of finance and financial products that are draining the traditional reservoir of informal finance. Consequently, one of the natural sources of financing for very small business is in the process of drying up. In time, the demography of these businesses could suffer. This is an aspect of the more general problem of the allocation of financial resources[2] that has not really been studied.

(3) We must not refuse to face up to the facts - the cost of processing a dossier is high - and small borrowers will not be able to bear such costs if there is no cost-sharing on a mutualist basis. Banks will find themselves facing a dilemma: on the one hand, some of them have to protect their "local" image which guarantees them a certain volume of savings, whilst on the other hand they are tempted to tarnish this image by excluding certain categories of customers.