Analysis of Substitution Relationship between Bank Loans and the Corporate Bond Market for External Fund-Raising

Businesses may finance business activities and investment either through internal funds including earned surplus or through external funding sources such as loans from financial institutions and corporate bond and stock issuance. In general, the existence of various fundraising channels increases the efficiency of financial markets and thereby reduces corporate financial expenses. Furthermore, it offers alternative fundraising channels when certain channels do not work well, consequently strengthening the stability of corporate fundraising and contributing to financial stability in the long term.

A look into Korean businesses' fundraising practices through external sources following financial crisis until early 2006 shows that bank loans increased dramatically whereas corporate bond issuance exhibited sluggish movements. In addition, there is marked polarization within the external fundraising market depending on firm size: large businesses make heavy use of direct financing through corporate bond issuance, while small- and medium-sized enterprises rely on indirect financing including bank loans. This polarization implies that firm size determines the degree to which corporate bond issuance substitutes for bank loans and vice versa in fund raising.

In this respect, an empirical analysis was conducted in this paper to find if bank loans and corporate bond market serve well as a route through which businesses can raise alternative external funds: the analysis was conducted on two groups including large businesses and SMEs, and the time period set for the analysis was between the first quarter of 1998 and the first quarter of 2006. With all the factors affecting fund demand and supply in bank loans and corporate bond market under control, a seemingly unrelated regression(SUR) model was used which estimates the equations of both bank loans and corporate bond issuance.

According to the results of the analysis, large businesses showed a strong substitution relationship between the corporate bond market and bank loans, while SMEs exhibited an asymmetrical substitute relationship where a decrease in bank loans was not followed by an increase in corporate bond issuance. This suggests that for SMEs the corporate bond market does not serve well as a source of alternative external funds in case of a decrease in bank loans, leading SMEs to enjoy much less stability in fundraising than large businesses.

Over and above the increase in corporate financial expenses, such potential instability in SME fundraising may lead to a higher risk of bankruptcy resulting from difficulties in fundraising, with a consequent negative impact on macrofinancial stability. In addition, given that the financial environment at home and abroad, including performance-oriented business practices in accordance with recent bank mega-mergers and universal banking as well as the new Basel Accord to be implemented in early 2008, may lead banks to reduce their lending to SMEs, it is a task of great importance to strengthen access to the corporate bond market for SMEs. In this respect, measures need to be worked out to expand the basis of demand for high-yield corporate bonds to improve the environment for corporate bond issuance and to develop various credit enhancement devices to strengthen SMEs' access to the corporate bond market.