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European financial market integration: the case of private sector bonds and syndicate loans

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Abstract

This paper uses individual transaction data on bonds and syndicate loans from European issuers to document market segmentation along national lines: banks manage bond issues because of ties to home institutional investors, and syndicate loans due to ties to home issuers. The evidence supports the hypothesis that historically grown reputational ties between financial institutions and their customers are in part responsible for the slow integration of the European financial market place. Traditionally, home currency investment restrictions for many of Europe's institutional investors were responsible for disproportionate market shares in the home currency markets of bond underwriters. The introduction of the Euro should greatly increase competition in bond underwriting. This, however, may benefit non-EU investment banks the most.

JEL classification: G15; G21; G24

Keywords: Bond underwriting; Loan syndication; Europe; Market segmentation

1. Introduction

This paper documents that European markets for debt issues of large private sector firms and banks are still largely segmented along national lines. Moreover, it establishes that the sources of market segmentation are different for syndicated loans, where upstream ties between issuers and banks are important, and bonds, where downstream ties between banks and institutional investors are the dominant source of market segmentation.

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Market integration — or its inverse, market segmentation — have been analyzed in the literature in a number of ways. Price effects of international securities activities have been examined for depositary receipt offerings[1], or foreign stock listings.[2] Chen and Knez (1995) define integration via the Law of One Price. Other studies have looked at the cointegration of markets[3] or interest rates.[4] The institutional dimension of European financial market integration has, for example, been addressed by Pont (1994). This paper represents a novel approach in that it uses individual transaction data to examine market structure considerations in the European wholesale banking markets for bond issues and syndicated loans.

I motivate market segmentation with reference to problems of informational asymmetries in financial markets as well as regulatory constraints on institutional investor portfolios in different European countries. I hypothesize that reputational equilibria are important to overcome rationing phenomena in markets with asymmetric information. Issuers can establish reputations for high quality claims with banks. Banks can establish reputations for their due diligence when marketing financial claims to institutional investors. Both types of reputation serve to reinforce customer–client relationships and represent an impediment to competition, which naturally produces concentrated market structure outcomes, since reputational equilibria gain stability in transaction frequency.

The currently integrating financial marketplace in Europe provides an ideal testing ground for such stickiness in competition[5], hence indirectly for the existence of reputational equilibria. Restrictions in cross-border capital flows, international expansion of financial institutions, and cross-border advertisements of financial services had left EU financial markets largely segmented along national lines. Today, EU Banking and Investment Services Directives are trying to create a level playing field for financial intermediaries, and many of the previously existing restrictions on international financial transactions are now removed, although notable exceptions are made with respect to prudential legislation.

I am going to make the case below that prudential legislation restricting institutional investors such as pension funds and insurance companies to invest in home currency have been the biggest impediment to financial market integration in the past. Currency restrictions on institutional investor portfolios reinforce previously developed reputational ties between financial intermediaries and institutional

[1] Errunza and Miller (1998).

[2] Forester and Karolyi (1999).

[3] Naranjo and Protopapadakis (1997).

[4] Alexakis et al. (1997).

[5] Dros (1998) attributes the stickiness in the regime shift solely to regulatory issues. This paper maintains — and the empirical evidence presented below supports the claim — that reputational customer ties are in part responsible for the slow transition to an integrated European financial marketplace.