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COMPARING FINANCIAL SYSTEMS AROUND THE WORLD: CAPITAL MARKETS, LEGAL SYSTEMS, AND GOVERNANCE REGIMES

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ABSTRACT. Financial systems are generally classified as being bank-based or market-based. This paper compares the characteristics of major financial systems on the basis of financing channels, legal system, governance models, cost of debt, and shareholding structure. It explains how the financial market is dominant in Anglo-Saxon countries like Canada, the United States or Great Britain, with a *common law* system, a *shareholder* governance model, lower cost of debt, and scattered ownership. On the other hand, the banking system is predominant in continental Europe countries like France and Germany, with a *code law* system, a *stakeholder* governance model, higher cost of debt, and concentrated ownership.
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1. Introduction

In recent years, the recovery of the capitalization of technology companies in the United States is reminiscent of the speculative bubble of the second half of the '90s, whose explosion during the year 2000 was more dramatic for the American firms than for the European firms, these latter having been less overvalued than their U.S. counterparts (Pilbeam & Nagle, 2009).

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Like Facebook, several emerging companies in the United States show a valuation of more than one billion dollars. Snapchat (2 billion), Uber (3.8 billion) and Dropbox (10 billion) are good examples. Yet very few technology companies across Europe are valued at more than $1 billion. In the top 100 of the highest-valued technology companies, only nine are European. A number that should rise to eight after the acquisition of the Finnish Nokia by the American Microsoft. This context suggests an investigation into the determinants that differentiate financial systems on both sides of the Atlantic.

After the Second World War, two models of financial systems gradually appeared around the world, influenced by countries' cultures and economic orientation (capitalism, socialism or communism). The money market was dominating in a number of countries while the financial market was praised in others. Some countries even managed to create a balance between the two types of capital markets. These two systems offered two different forms of external financing for countries' economic entities. The money market embodied by banking finance offers loans and the financial market represented by the stock exchange offers bonds and securities of capital as an alternative or a complement to self-financing. The difference between these two systems that will be presented throughout this article is the concentrated or diffuse position of the creditors. Following previous work which explains how the financial market is dominant in the United States and the United Kingdom, and that the money market is predominant in countries like France and Germany (Demirguc-Künt & Levine, 1999; Lee, 2012), this article compares the characteristics of the main financial systems on the basis of financing channels, governance models, the cost of debt and the shareholding structure. A financial system is defined by a set of institutions (markets, intermediaries and structures) within which households, businesses and governments get funding for their activities and invest their savings. It is the combination that each economy makes between the markets and the various financial institutions and the role and the relative weight of each of these institutions that determine the orientation and structure of the financial system. Regardless of its constitution, the essential economic function of a financial system is to channel funds from households, businesses and governments that saved excess funds by spending less than their income to those who lack funds because they spent beyond their income. Financial systems are generally classified as being bank-based or market-based. Usually, Anglo-Saxon countries like Canada, the United States or the United Kingdom are considered to be economies with a strong financial market dominance (i.e. market-based), while the economies of continental Europe countries and Japan are considered to have a strong banking dominance. This classification is based on a description of the institutional features of the financial system in each of these countries, in particular the extent to which stock exchanges and banks provide capital to non-financial economic agents. It also relies on differences

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in the roles played by the two types of financial institutions in each of these countries. This article thus presents the characteristics of each of the two systems by highlighting their differences and their specificities, particularly in regard to the actors involved.

2. The Financing Channels

In an economy, businesses generally use long-term external financing to support large-scale projects in addition to self-financing. The main source of these companies' long-term external financing is the first criterion to identify the financial system of a country (Wang & Ma, 2009). The financial market is a mechanism that allows economic agents to easily buy and sell financial securities (such as stocks and bonds), commodities (such as precious metals or agricultural products), and other replaceable items of value, at low transaction costs and at prices that reflect the efficiency of the markets. This type of market financing is also called "direct finance," the provision of funds for an investment being, for example, the result of a direct link between a lender and the final borrower by the issue of a bond.

The second financing channel, also called "indirect finance," describes the process by which entrepreneurs (borrowers of last resort) obtain funds via a financial intermediary who has previously accumulated funds from the original lenders. These intermediaries, who are institutional investors, are usually pension funds, mutual funds, insurance, and banks. Unlike bank loans, securities (including bonds) are easily negotiable and are held by investors who generally prefer to be independent from the issuer.

In a bank-based system, particularly the one based on relationships, a bank will have close links with companies that are potential candidates for a loan, due to frequent contacts in the past, risk-assessment records keeping, or ownership links. In assessing the company's borrowing needs and its ability to pay the interests and principal, the bank will take into account not only its current ability to service the debt, but also its long-term capacity to repay it, as well as the various levers the bank has to ensure a refund. Thus, banks can generally reduce the risk of adverse selection and moral hazard due to their long-time relationship with the companies to which they lend and their ability to collect information on the financial context of the firms in question. This reduces the risk they face.

In a market-based system, a company will be able to exploit a wider circle of potential lenders and benefit of a greater disclosure of financial information. This will lead to loans granted for a fixed period, and the interest rates will be competitive in order to reward the lender for the time and the risk linked to this particular loan.

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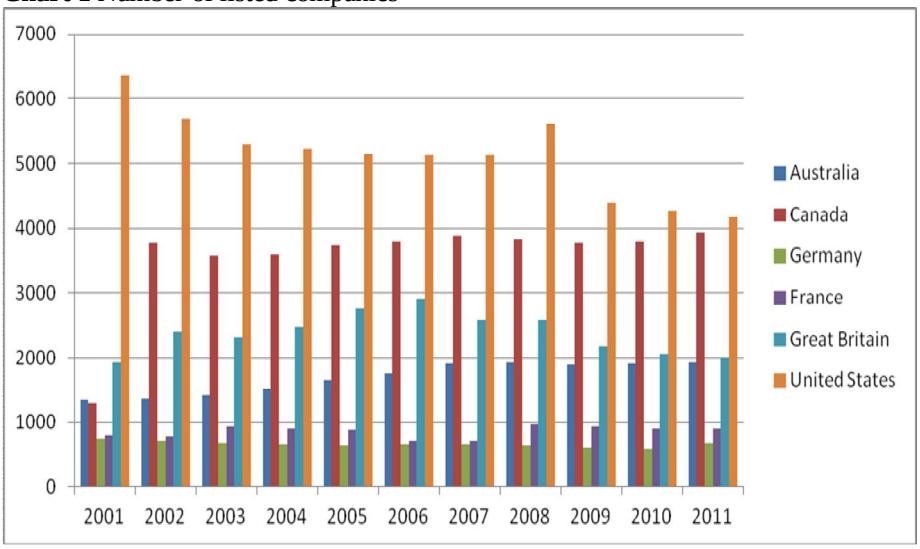
The mid-1990s United States and Germany are respectively two prototypes of the Anglo-Saxon and euro-continental models; only 16%[1] of corporate loans in the United States were from banks, while 49% of external financing was done through securities such as bonds and commercial paper. In Germany, 80% of corporate loans came from banks and only 10% came from securities. In the first half of the 1990s, American companies issued each year shares amounting to 1.2% of gross domestic product (GDP). Alternatively, German companies issued shares amounting to only 0.04% of GDP. Moreover, there was 3.11 IPOs (Initial public offerings) per million people in the United States in 1995, against 0.08 per million inhabitants in Germany (La Porta et al., 1997). These macroeconomic differences can also illustrate the culture of individual financing of large and small companies in each of these countries.

According to the criteria of differentiation used by Čihak et al. (2012), the figures below show the positioning of six developed countries compared to each of the modes of financing. They are the main Anglo-Saxon countries; Australia, Canada, the United States, and Great Britain, as well as the first two powers in continental Europe, Germany and France.

Chart 1 Number of listed companies



Source: World Development Indicators & Global Development Finance, World Bank.

Over the past decade, Canada and the United States have had the highest number of companies listed in the stock market, followed by Great Britain and Australia. Far behind, France and Germany close down the pack. These figures suggest that the stock market culture is more widespread in the first four countries than in the last two.

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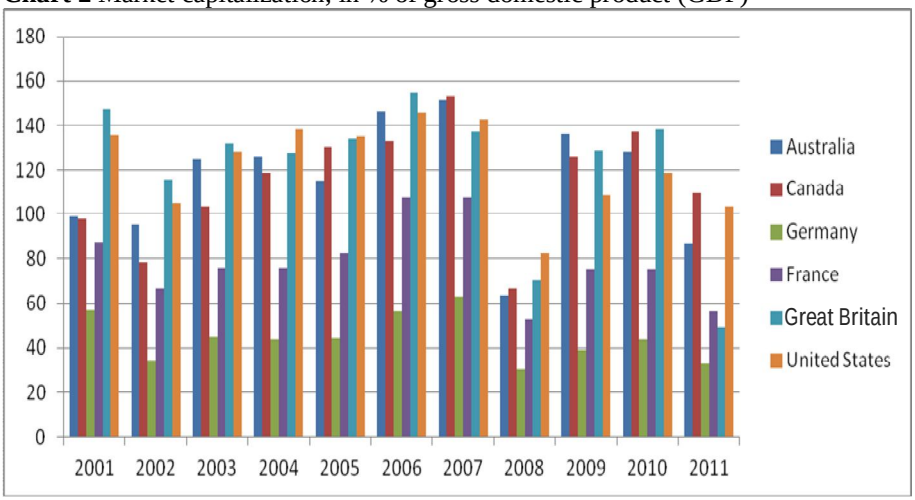
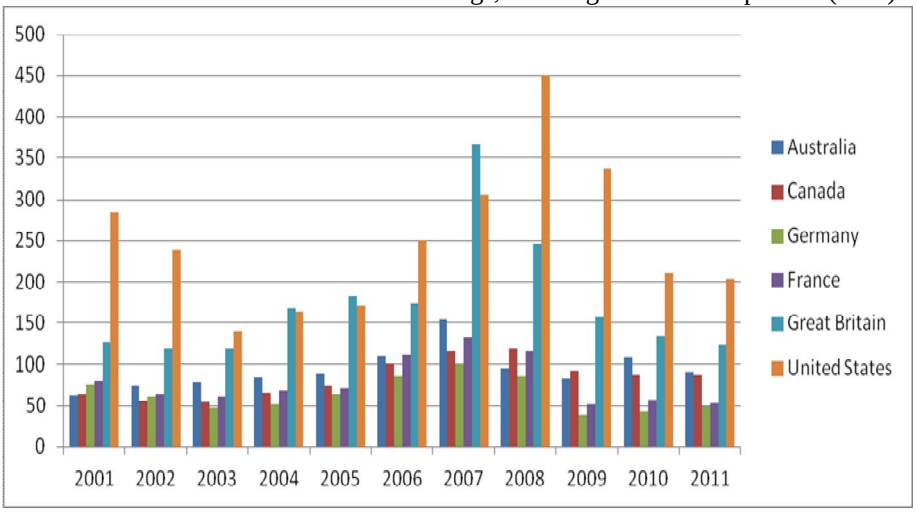
Chart 2 Market capitalization, in % of gross domestic product (GDP)



Source: World Development Indicators & Global Development Finance, World Bank.

Chart 2 shows the relative weight of all of the listed companies compared to each country's level of GDP. Here too, the trend is the same: Canada and the United States, followed by Australia and Great Britain, displayed the largest market capitalization in their respective economies, far ahead of France and Germany.

Chart 3 Securities traded on the stock exchange, in % of gross domestic product (GDP)



Source: World Development Indicators & Global Development Finance, World Bank.

Securities traded on the stock exchange are a good estimate of the level of funds raised in the markets. Chart 3 shows that the United States recorded the best performance in this regard, followed by Great Britain that was also right behind the United States between 2003 and 2006 before surpassing

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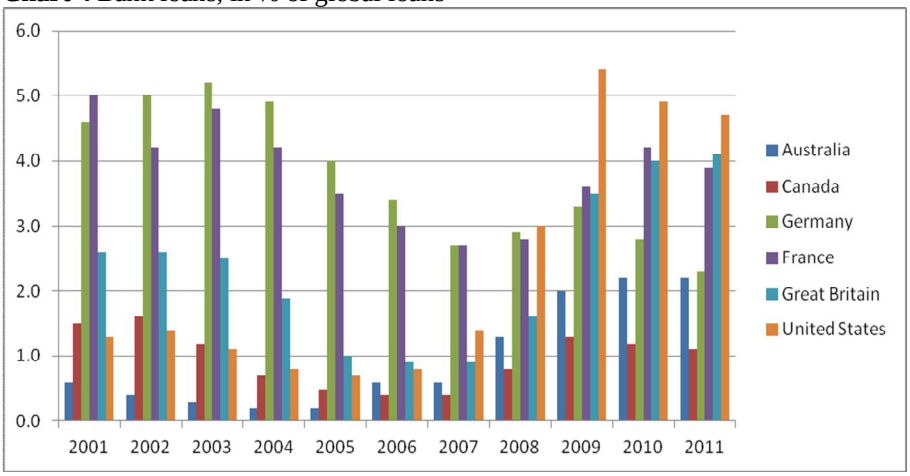
them in 2007. This was a period during which the Sarbanes-Oxley Act was applicable in its initial form and was considered devastating for the attractiveness of U.S. financial markets. In March and May 2007, various measures[2] were taken to ease the financial security law provisions. This probably explains the rise of the United States in 2008. Canada and Australia also present interesting fundraising levels while France and Germany's rates are the lowest.

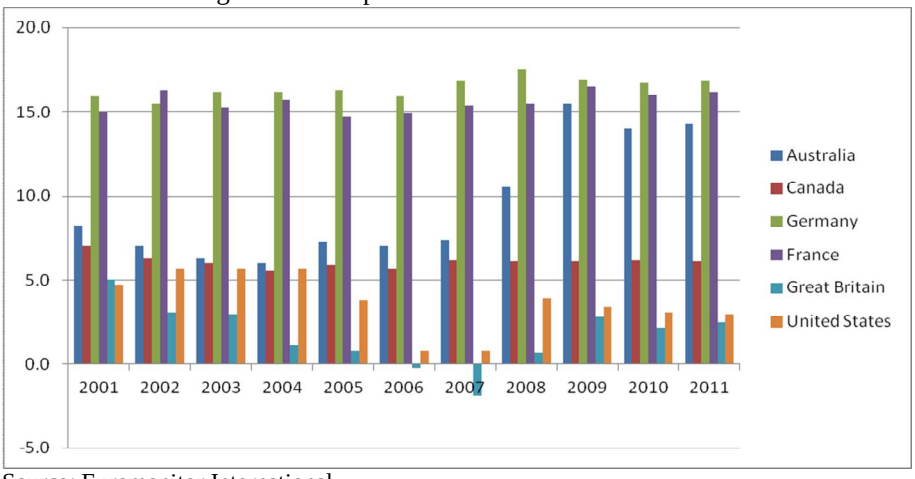
Chart 4 Bank loans, in % of global loans



Source: Euromonitor International.

Until 2007, France and Germany were the two countries where the level of bank financing was the highest. Starting in 2008, the United States and Great Britain began to present comparable bank borrowing rates, while Germany's score declined substantially.

Chart 5 Bank savings in % of disposable income



Source: Euromonitor International.

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France and Germany share the upper hand regarding the level of bank savings, as shown in Chart 5. The share of Great Britain remained low and even went down to a negative rate in 2006 and 2007. Curiously, Canada, whose economy is built on the strength of its banks, has bank saving rates significantly below the average. Lower rates of Canada, Great Britain and the United States shows a significant conversion of savings into investments on financial markets.

During the past two decades, the world's financial markets experienced a rapid development. While market-oriented countries like the United States consolidated their position by considerably increasing the number and the proportion of industrial projects financed by securities, market growth was even more pronounced in continental Europe. Since the '90s, market capitalization to GDP ratio has increased by over thirteen times, while the proportion of investments financed by issuing securities grew sixteen times bigger (Rajan & Zingales, 2003; Hardie et al., 2013). Although this development has not completely eliminated the gap between continental Europe and the Anglo-Saxon economies, it has clearly narrowed it down. In 1980, the market capitalization of the Anglo-American economies was five times greater than that of the countries of continental Europe. At the beginning of the 2000s, it was only 60% higher. Many countries of continental Europe now have a large number of listed companies. Moreover, the proportion of bank credit in the United Kingdom substantially increased and resembles that of continental Europe, while the United States still keep relatively small quantities of intermediation from commercial banks. Many countries of continental Europe have also introduced new stock markets, such as the Neuer Markt in Germany, where the disclosure requirements are substantially higher than in the past.

According to the five charts above, it is still possible to divide these six countries into two distinct groups, with Germany and France on one side and Australia, Canada, the United States, and Great Britain on the other. The first group presents a financial system where banks provide long-term financing to businesses, keep a close relationship with these companies and have means of monitoring their investments. Bank financing is therefore dominant. In the second group, banks provide more short-term loans, while long-term loans are generally sought on financial markets, with a greater possibility of risk diversification. The share of internal financing compared to the total financing also seems to be higher in the economies of the second group. Curiously, the slight differences between these two groups of countries in the importance of bank financing do not reflect what one would have expected on the basis of the traditional classification.

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3. The Governance Model

Beyond the level of financing that companies get on each of the capital markets, some qualitative criteria also allow to identify the financial system in effect in an economy. The governance model is, among others, one of these indicators.

Corporate governance systems have evolved differently around the world. The market-based system of governance is built upon the Anglo-American law. As financial markets are the main source of capital, investors hold a high power in the determination of companies' policies. It is therefore in line with market requirements that the governance system exerts control over the management of companies. Big modern enterprises effectively raise the issue of how control is used in a company in which the different groups with a share or an internet in the business, such as shareholders, managers, employees, creditors, and even the government, pursue different interests.

In the Anglo-Saxon countries, governance mechanism is based on the principle that managers are forced to serve in priority, and sometimes exclusively, shareholders' interests with the goal to maximize the market value of the shareholders' equity. The alignment of shareholders and managers' interests should therefore be guaranteed by a market that works for the control of the company and that ensures free trade and the free performance of property rights that are acquired through the purchase of shares. The financial market is therefore clearly at the heart of the corporate governance system. By purchasing shares and achieving significant influence or forming a majority, investors are able to put pressure on the management of the company and bring it to adopt a strategy that suits them. Control is very rigorous in this system as the Executive board mainly includes external members who are strongly influenced by the Chief Executive Officer. This model who joins the provisions of the agency theory is generally referred to as the *shareholder* governance model as shown by Aerts, Cormier, & Magnan (2007) because of the primacy granted to investors in terms of legitimacy within the company. This model is dominant in Australia, Canada, the United States, and Great Britain.

In Japan and in most countries of continental Europe, a different system of governance has evolved based on networks. This system is based on the assumption that a company is more prone to perform well and that the shareholders are more likely to benefit from this performance if opportunities are created by the different groups who have an interest in the company, according to their commitment and the relationships they build. There is therefore an implicit contract with these groups who have the right to expect a certain form of accountability from managers and to even see their interests taken into account in the activities of the company. This conception of the company, also known as a "nexus of contracts," is reflected in the way in which

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control is exercised on management. The principle of this governance model wants management to act in the best interest of the shareholders, while also taking into account the interests of other stakeholders, such as the government, employees and creditors, and aim to ultimately reconcile all these different interests. There are here two levels of administration: the direction and a form of supervisory board, with a less rigorous internal control system. This second governance model, closely linked with the theory of stakeholders and still dominant in France and Germany, is seen by Aerts, Cormier, & Magnan (2007) as the *stakeholder* governance model.

The agency problem arises differently in the two models of governance, just as the level of information asymmetry varies. Because managers accumulate immense power in a market-based system and funds providers (investors) do not have access to the same level of information as them – and even if they do, they do not necessarily have the same technical understanding on the activities of the company – monitoring or interest alignment mechanisms are usually offered to resolve the agency problems that arise, which are in general of a "manager-owner" nature. Information asymmetry is higher in a system that also requires transparency as an investor protection guarantee, which is usually made up of the general public. Investor protection laws are therefore more severe in countries aligned on this model of governance. The Sarbanes-Oxley (SOX) law and bill 198 are examples.

The Sarbanes-Oxley (SOX) law

The "Public Accounting Reform and Investor Protection Act of 2002" commonly referred to as "Sarbanes-Oxley Act" is the most important reform that U.S. financial markets have experienced since the promulgations of the "Securities Act" in 1933 and the "Securities Exchange Act" in 1934. This law follows the ENRON and WORLDCOM scandals that both called into question the firm Arthur Andersen (one of the five largest audit and consulting companies) and revealed significant financial and accounting manipulations that flew under the radar of specialized media and financial analysts, thereby harming the principle of supposed market efficiency (Zogning & Balata, 2014).

These cases have logically led to a loss of confidence among investors in the security of the financial markets, as they revealed problems of internal control, rule of conduct, independence and ethics, from the preparation of the of financial statements to the audit and other financial analyses.

The provisions of this act strengthen the independence of the auditor, increase the responsibility of companies and of their management on their financial statements and internal control system and impose greater disclosure on listed companies. The recommendations were considered drastic and costly to implement. Ayayi and Noël (2007) also write that managers convicted of financial crimes could incur a prison sentence of up to 25 years and fines of

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up to $5 million in the United States, and a maximum of 5 years and 375,000 EUR under French law.

Bill C-198

At the time of the adoption of the Sarbanes-Oxley Act, about 15% of the companies listed on the Toronto Stock Exchange also were on the United States Stock Exchange. Due to this, Canadian regulation authorities felt the pressure to also pass similar laws. This led to the drafting of Bill C-198.

The bill has the advantage of having been elaborated with a little perspective and covers almost all issues raised by the Sarbanes-Oxley Act, including the independence of the auditors, the responsibilities of the audit committee, of the Chief Executive Officer and of the head of finance, the internal controls, the faster disclosure, and the increase of penalties for illegal activities. Sanctions vary between $1 million fine and a one-year prison sentence to $5 million fine and 5 years.

Canada gave businesses until the end of 2006 to comply with Bill C-198 in order to observe the effects of the Sarbanes-Oxley Act first.

In a bank-based system, banks have, in contrast to investors in a market-based system, further financial expertise and know more about the financial health of the companies in which they fund the projects or the exploitation. They sometimes sit on these companies' Board of directors or Supervisory Board. This changes the nature of the principal-agent problem and significantly reduces information asymmetry. Additionally, banks are quite interested in businesses' financial performances, particularly in their profitability and solvency. Non-financial performance measures receive little attention. The disclosure on these measures can either be weaker or less relevant, given the fact that bankers' interests are primarily about financial performance. However, in the structure of disclosure, and independently of the fact that financing is done mainly by banks, it is possible that social and environmental disclosure is higher in those countries. Indeed, European Union countries generally have laws and regulations that encourage companies to integrate social and environmental concerns in their business activities, due to the diversity of stakeholders. The law on new economic regulations (NER) and the law of Grenelle 2 in France, as well as the sustainable development code in Germany, the Deutsche Nachhaltigkeitskodex (DNK), are well-known examples.

NER law & Grenelle 2 law in France

Promulgated in May 2001 and implemented in May 2002 in a country that introduced the social balance sheet in 1977, the NER law was aimed, through its article 116, to formalize and circumscribe the scope of disclosure of social and environmental matters, in particular for publicly traded companies. From an environmental perspective, it is a matter of companies communicating

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information on the environmental impact of its activity and indicate any remedial measures taken in this regard. The social aspect mostly regards labor and working conditions. Social and environmental information not linked to any of the eighteen points of this law is considered voluntary.

Passed in 2010 and made applicable as of 2012, the law of Grenelle 2, especially its article 225, extends and specifies the contours of corporate social responsibility (CSR) reporting. Now, any company with 500 employees and more is required to produce extrafinancial reports. Some innovations are: information about CSR must be included in reports intended for the Board of Directors and the General Assembly and must be audited by an independent third party. Finally, disclosure is extended to the scope of consolidation by integrating companies' subsidiaries. French companies, starting with the ones listed on the stock market, were given from 2012 to 2016 to comply to this law.

The Deutsche Nachhaltigkeitskodex (DNK) in Germany

Like France, Germany adopted very early a legislation to regulate social and environmental reporting, although the country mainly favored an exclusively voluntary approach integrating a wider range of indicators on international standards such as the Global Reporting Initiative (GRI). Very precise legislative texts go in this direction since 2001 and the most recent being the *Deutsche Nachhaltigkeitskodex*, the German sustainable development Code. Focused on twenty topics, this Code, brought about by discussions between various stakeholders, advocates an auto-declarative model where companies should voluntarily declare if they meet the Code and explain why they do not, if applicable (comply or explain). Despite its voluntary nature, the German Code seems to generate results, largely because of its international (and not local) perspective and its applicability to all companies. It is therefore be suggested that company that does not complete its social and environmental reporting may be at a significant disadvantage compared to similar size companies who do, even if they are in complete legality. It is therefore expected that most companies make efforts in this direction.

With a tradition of social balance and a legislative framework encouraging the accountability to different stakeholders, a focus on the social and environmental aspects, it is clear that the present model of governance in France and Germany contrast with those found in Canada and the United States which proclaim the pre-eminence of the investor.

4. The Cost of Debt

The cost of debt is particularly important for firms with limited opportunities for self-financing. Frankel et al. (1995) and Leuz & Wysocky (2016) showed

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that firms accessing external financing through financial markets tended to present a higher level of disclosure, and a lower cost of debt. Botosan & Plumlee (2002) confirm these results while arguing that it is in general the legal system and strict mechanisms of investor protection that encourage transparency and reduce the cost of debt. As bank financing can be done through the private exchange of information, the manager has limited incentives to provide information to the general public. This perceived lack of transparency as well as the costs of documentation for bankers towards companies seeking financing and of banking intermediation seem to predispose the money market at a cost of debt higher than the financial market.

Hail & Leuz (2005) have shown that the cost of debt is systematically related to various traditional risks. Risk is generally associated with a form of uncertainty related to absence or a lack of information. The high level of disclosure, prevailing in market-based financial systems due to the investor protection mechanisms that characterize them, gives them a lower capital cost.

According to the capital need theory (Choi, 1973; Baginski et al., 2016), companies will be motivated to improve the quality of information in order to obtain rare financing. This brings Whiting & Woodcock (2011) to suggest that companies that raise money in financial markets are likely to offer more information than others. Therefore, companies with significant growth opportunities in markets will prioritize external funding to support their operations, either by equity, or debt. In this situation, the mandatory disclosure of information is not sufficient to get the best deal on capital. This type of financing requires some sort of competition between companies in order to obtain capital in the most cost effective way in conditions of uncertainty, by revealing more information to external investors in order to inform them about the position of the company and to increase the security of their future cash flows (Choi, 1973). This suggests that, by its ability to provide better visibility on future performance to investors or providers of funds, voluntary disclosure helps reduce the cost of debt or capital.

In short, banking finance highlights the positive role banks play in obtaining an informational advantage over businesses for the allocation of capital, by ensuring better credit discipline. Alternatively, market finance highlights the role of fully functional financial markets in the strengthening of growth, the promotion of innovation, the application of market discipline and in corporate governance. It is also increasingly noticeable that, in fact, any system has a dynamic interaction between the banks and the financial markets.

5. The Shareholding Structure

The shareholding structure is different from one economy to another due to the type of external financing used and the type of control exerted by the

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model of governance in place, among others. In a bank-based system, ownership structures are quite complex and characterized by cross-holdings. The protection of the minority shareholders is relatively low because of the significant weight given to the majority shareholders (Berkovitch et al., 1998). Ownership in a market-based system seems less complex and more flexible. The protection of minority shareholders is very strong in this system, as despite their moderate capacity to influence, property rights protect individual and institutional shareholders. That's what concluded Lopez de Silanes et al. (1998), by showing that common law systems ensure better investor right protection, which largely helps shape the structures of shareholding. These results were confirmed by Nobes (2014) and McCahery et al. (2016).

The United Kingdom listing rules that actively discourage the acquisition of blocks of more than 30% of capital are a plausible explanation for the strong dissemination of share ownership. Investors seem convinced that the information provided by companies and governance mechanisms are sufficient to monitor and discipline management and think that they do not need to form a block to ensure this monitoring.

6. Conclusion

The question of which type of finance (by the banks or the financial market) is better has been debated for decades. In reality, everything largely depends on the economic orientation of the country (capitalism or socialism) and a number of social realities. In a market-based system, the majority of the financial power is held by the stock market and the economic mood of the region depends on the climate of the financial market. In such a system, banks' profitability depends less on loan interests since they earn a significant part of their income through services rendered outside of financial intermediation. In contrast, in bank-based financial system, the economy is strongly influenced by the state of the banking sector. Banks in this system focus their attention on loans and wield huge power in this area. The evolution of the stock market in this system has little power on economic trends.

A market-based financial system puts banks in competition with other sources of financing. In many programs put in place, the average borrower can always turn to non-bank sources for financial sponsorship. Investments made by private sector entities and the government are often in competition with those of the bank, forcing banks to adapt their practices and interest rates to the competition. In a bank-based economy, there is little or no government assistance and only a few private sector entities are able to compete with banks in terms of financing businesses. In this system, banks are therefore expected to help regulate the economy.

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The other significant difference between the two systems is of a legal nature. In a bank-based economy, laws and even financial standards are presented and carried out by the government. This is usually based on Code Law rather than Common Law. This is the case for Germany and France. Common Law is less well defined or circumscribed and may vary from one case to the other, jurisprudence being predominant. The judge has therefore greater power. Like the United States, market-based economies are most often in areas that have adopted a common law legal system.

The factors at the origin of a financial system are major and it can not really determine which system is better. Therefore, it is important to determine the relevance of one of the two systems in relation to the environment and economic positioning of each country. The table below shows the properties and characteristics of the two financial systems.

Table 1 Financial systems classification

Elements	**Market-based economies**	**Bank-based economies**
	Australia, Canada, United States, and Great Britain	Germany and France
Financial markets	Bigger size, more liquidity	Smaller size, small liquidity
Percentage of listed firms	High	Low
Capital & debt ownership	Scattered	Concentrated
Investor's orientation	Portfolio profitability	Control of the firm
Main agency problem	Shareholders vs managers	Majority shareholders vs minority shareholders
Role of the Board of Directors	Important	Limited
Internal control	Rigorous	Of low intensity
Legal framework	*Common Law*	*Code Law*
Accounting standards	Private (profession)	Public (government)
Investor protection	Very high	Low
Governance model	*Shareholders*	*Stakeholders*

Source: Elaborated by the author, inspired by Halpern (2000).

NOTES

1. Source: World Development Indicators & Global Development Finance, World Bank.

2. 21 March 2007 – La *Securities and Exchange Commission* (SEC) voted to soften the law in order to facilitate the listing and delisting of foreign companies. 23 May 2007 – Measures to soften Article 404 of the SOX law, concerning the implementation of an internal control system.

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