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Security Markets versus Bank Finance: Legal Enforcement and Investors' Protection

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Abstract

When minority investors' rights are poorly protected, the ability of firms to raise equity capital is impaired, leading to less finance for new ventures. Fewer firms will be financed with outside equity, resulting in a low market capitalization relative to GNP. External funding requires easily enforceable claims such as debt or requires long-term relationships with institutions. Provision of funding shifts from risk capital to debt, and to a predominance of intermediated over market finance. We report supporting evidence for a few countries. To measure investor protection, we use a price measure, the premium on voting stock, related to the control premium. In countries where the voting premium is large, corporate financing is dominated by bank lending and equity markets are much smaller.