

EXECUTIVE SUMMARY

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# THE FINANCIAL ECOSYSTEM OF THE BASQUE COUNTRY.

Diagnosis and opportunities

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## Executive summary

### The importance of an advanced regional financial ecosystem

Money is a fungible good, and while in recent years, access to it has been widespread, it is a good over which firms must compete. For firms, it is therefore **vital to attract the necessary financing for their growth, survival and solidity**. Thus, a resilient firm must have various sources of finance and avoid the risk of depending on a single financial provider.

The financial ecosystem of the Basque Country – defined as ‘the system made up of a community of agents in a physical space (Basque Country) where they interact to connect (or direct) surplus units (financial backers) with deficit units (firms) for financial resources’ – fits the profile of a **banking-dominated system**. This means there is a higher level of regulation, it is less market oriented, and brokering is largely concentrated with banks. However, it also has its own characteristic features – determined by its **history and the attributes of its business sector** – which differentiate it from other European ecosystems.

### Origins and trends of the Basque financial ecosystem

The Basque financial ecosystem was created and expanded in a context of strong **ties between financial agents and the business sector**. As it developed, especially in the late 20th and early 21st centuries, this bond weakened, and the importance of financial agents in the territory diminished. **Public administration, in collaboration with private initiative, has played an active role** in developing new initiatives aimed at energising the ecosystem. The goal of these actions has been to strengthen and promote the ecosystem (Bilbao Plaza Financiera), support business finance (Elkargi, Luzaro and the Basque Finance Institute), or more recently, reinforce business capital (Finkatuz and Ekarpen funds).

Despite these efforts, recent changes in the Basque financial ecosystem have been heavily influenced by **global trends**, which have determined the course of its development. These trends, external to the ecosystem itself, have evolved and will continue to transform its reality in upcoming years. Today, we can identify **four groups** of trends which will affect its future development and must be taken into consideration:

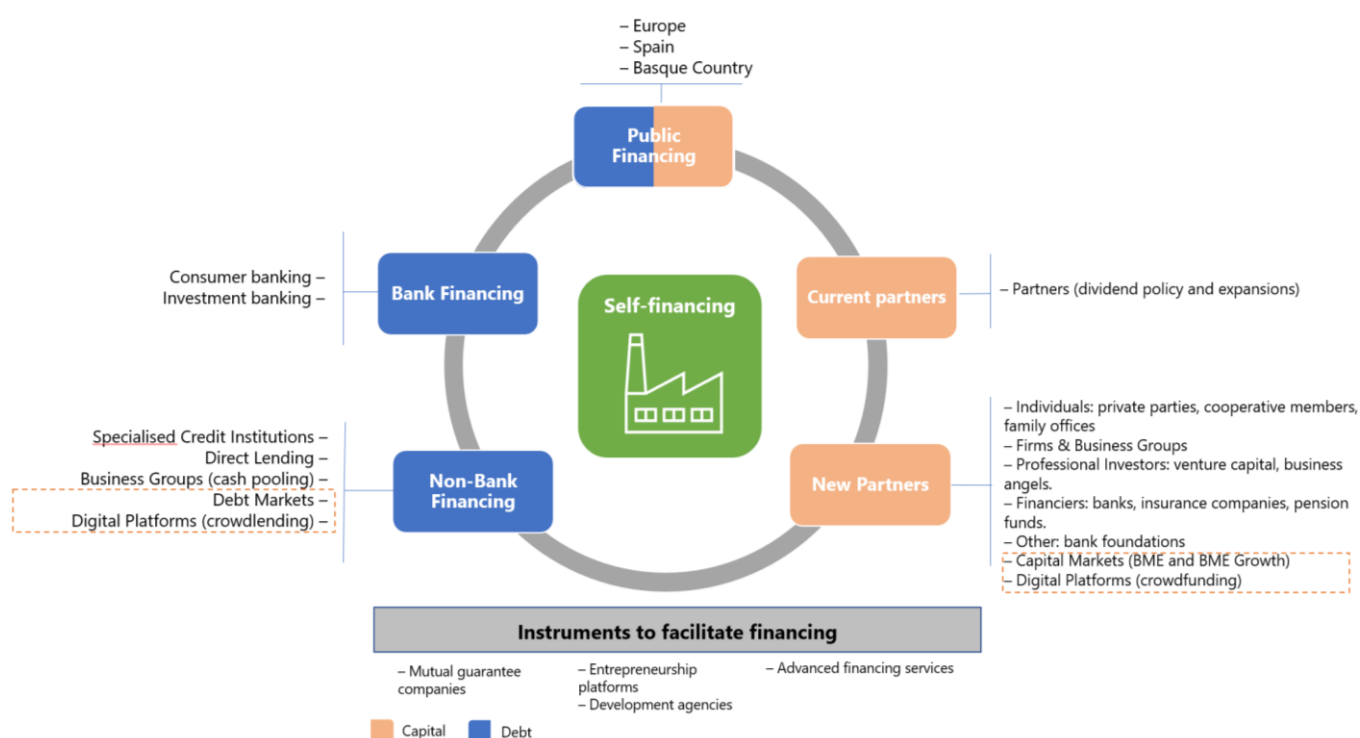
- **Globalisation and Concentration.** Globalisation is driving a process of concentration into a small number of financial ecosystems, weakening the presence of financial services in the Basque Country.
- **Digitalisation and DeFi.** Digitalisation is a trend which will continue to be a major driving force behind transformation. A related development known as DeFi, decentralised finance, has emerged from the use of digital technologies such as blockchain. It encourages the emergence of disruptive chains of financing, bringing traditional business models into question (for example, the Fintech portal initiatives backed by the Spanish Securities Exchange Commission – CMNV).
- **Regulation and Transitions.** The financial sector is subject to considerable regulation, which will continue to expand in upcoming decades, especially in Europe, and will affect the banks operating in the Basque Country. Some of these regulatory processes are related to economic transitions, such as for example, new investment criteria based on sustainable finance criteria or ESG (Environmental, Social and Governance), such as the Basque Government’s Sustainable Bonds.

- Financialisation.** This refers to the increased importance of finance, in all its dimensions, in non-financial firms, with the aim of generating new financialised business models (renting or pay-as-you-go solutions), making external acquisitions (investment in financial assets) or creating divisions to manage surplus (like General Electric via its subsidiary GE Capital).

A territory is unlikely to be able to change or influence the trends affecting it, as they are beyond its framework of action. Despite this, it is necessary to aspire to continue becoming stronger, aware of the implications for financing in the territory, and try to take advantage of the dynamics of opportunities that present themselves.

### Current snapshot of the Basque financial ecosystem

The Basque Country has a diverse financial ecosystem, with **six types** of financing sources.



Source: Own elaboration

**Not all firms have access to all types of financing.** Access and use are determined by various factors, including: i) size, ii) ownership conditions, iii) creditworthiness, iv) market position, and v) age.

There is evidence of a **growing presence**, especially over the past decade, of **non-bank actors** such as those linked to 'non-bank financing' (development of BME and BME Growth, asset financing credit institutions, direct lenders and debt funds) and the entry of 'new partners' in the firm (venture capital investors).

Despite the growing presence of non-bank actors, **bank financing continues to dominate** financing sources. This situation is also found in the rest of Spain and has not changed in recent years. In fact, the European Investment Bank estimates that in 2021, 77% of external financing for Spanish firms was linked to bank financing (the same level as in 2016).

In contrast, **public financing is becoming increasingly important** (for example, there are instruments backed by the Basque Government such as Capital Riesgo Euskadi and the Bideratu support line), with the aim of **supplementing/reinforcing other private sources of financing**. Also common are another type of public instruments related to **direct subsidies** (such as the Bateratu, Lortu and Bilakatu programmes) or **risk sharing** mechanisms (for example, public guarantees to cover some of the risk of the specific Elkargi credit lines).

### Failures identified in the Basque financial ecosystem

A 'market failure' occurs when in a market with **adequately developed supply and demand (type 1), the market does not produce an economically effective outcome on its own (type 2)**. The study identifies four main market failures in the current financial ecosystem:

- **Difficulties attaining sufficient critical mass** (type 1 failure): the ecosystem has a limited level of development and a low degree of sophistication. From the supply-side perspective, concentration in other financial markets has reduced the presence of actors in the territory. From the demand-side perspective, the Basque business sector is small in size and mass, limiting its ability to access/use some financing solutions.
- **Little connection between financial stakeholders and the local business fabric** (type 1 failure): the links between financial actors and the economic fabric have been weakened, making it difficult to align strategies among the agents present in the ecosystem (financiers, firms, and public administration) in driving territorial development strategies.
- **Challenges around access to financing for newly created, innovative and high-growth firms** (type 2 failure): these groups share challenges related to measuring risk associated with their business undertaking, which entails limits on access to financing. Additionally, the financing obtained is subject to higher financing costs and requires guarantees.
- **Over dependence on bank financing by SMEs, midcap firms and cooperatives** (type 2 failure): these types of firms have difficulty diversifying their financing sources and are overly dependent on bank financing. This dependence exposes them to changes within the banking sector – such as what happened in the 2008 crisis, when bank financing was limited – and determines their growth opportunities.

### Proposals for developing the Basque financial ecosystem

We believe an **advanced financial ecosystem with local ties makes it possible to better meet the needs of the territory's firms and ultimately drive economic development**. As other studies have shown, those European regions with advanced financial ecosystems have better levels of resilience in times of crisis and subsequent recovery periods.

While we are aware that trends and regulation limit the development of initiatives related to improving the Basque Country's financial ecosystem, we propose **six possible dynamics** which can help it evolve into a more advanced and diversified financial ecosystem.

- **Stimulate development of the financial ecosystem around missions:**<sup>1</sup> this would make it possible to gain in size, specialisation and sophistication, taking advantage of the country's major strategic aims (like the Basque Hydrogen Strategy).
- **Boost the private local investment industry:** to make it possible to diversify sources of capital finance and attract external capital in an organised way.
- **Align public investment tools with the more bank-dependent business sector:** to simplify and supplement financing instruments for firms based on their size and needs.
- **Promote a bank financing round table:** to identify/meet the unmet needs of smaller companies and forge a stronger connection between banking industry agents and the territory.
- **Generate and attract advanced financial capabilities to the territory:** with the aim of creating more sophisticated financing strategies for firms and increasing the importance of advanced financial services.
- **Create a research lab on DeFi:** to make it possible to understand future transformations of DeFi and their implications for the financial ecosystem.

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<sup>1</sup> According to Mazzucato & Dibb (2019), 'missions' are specific goals on which defined projects are focussed, constituting achievable milestones to overcome major challenges and acting as frameworks and drivers for overall innovation.



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