Otmar Issing: Relationship lending in the euro area

Dinner speech by Prof Otmar Issing, Member of the Executive Board of the European Central Bank, at the Second ECB Central Banking Conference "The transformation of the European Financial System", 24-25 October 2002, Frankfurt am Main, 24 October 2002.

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The conference is on "The transformation of the European financial system". This topic raises a wide range of fascinating issues.

The, first, and most immediate question is: have we chosen the right title for the conference? To what extent can we already speak of a *single* European financial system? To what extent are we still dealing with European financial system*s*, in the plural? I shall leave the answer to this question for the conference – and, most appropriately, for the future – to decide.

A second question could be: why should a central bank organise a conference on banking and financial issues? Here the answer is obvious. Central banks and the financial system are inextricably linked. Central banks rely on the financial system for the transmission of monetary policy. The financial system relies on the central bank as the ultimate source of liquidity, the monopoly supplier of central bank money to the economy and as the institution responsible for maintaining price stability and thus supplying a stable unit of account for all economic and financial transactions. A stable currency and a sound financial system are the foundation of a strong economy ... and if I may add: a stability-oriented monetary policy is a central bank's best contribution to a sound financial system, which in turn facilitates the conduct of monetary policy.

A further perennial theme running through the conference is the long-standing debate on the relative merits and drawbacks of bank versus market financing of economic activity. This – finally – brings me closer to the subject of tonight's speech. Here, again, I have no answer to offer, except to say that I trust in the forces of competition, evolution and adaptation in the economy. What matters in the end is that the financial system is robust, resilient and flexible in the face of shocks and new developments. In this context I would not rule out that a financial system based on two pillars of bank *and* market finance may well stand the test of time. While – as you may suspect – I personally have perhaps a natural inclination to associate *two pillars* with robustness, again, I would leave it to you (at the conference) and the course of history to come up with a verdict.

In any event, the papers presented today and tomorrow bring further evidence that the relative importance of banks and markets is a widely used summary indicator of the evolution of financial systems.

The changing nature of banking relationships in European finance today is the issue on which I would like to share a few thoughts with you this evening.

Banks deserve special attention as they are, in continental Europe, the main suppliers of credit and financial services to individuals and firms. My argument will develop around two simple questions:

- How important is relationship lending in the euro area?
- Given the current trends in bank structure and competition, is relationship lending on a declining trend, and if so, what could be the consequences?

1. Relationship lending in Europe

By relationship lending, I mean that banks and their customers build up agreements on terms of credit, implying for instance secured access to credit lines at pre-set prices. The bank acquires expertise about the credit-worthiness of its customer by keeping close contact with the management of the firm. For instance, the bankers who sit on the board of many European firms can gain insider information on these firms. The implication of this close link may be that the bank provides the firm with easier access to liquidity.

Relationship lending is particularly widespread in the euro area, in particular regarding small and medium enterprises (SME). Given that SME account for about 60% of private sector employment in the euro area, it is immediately apparent that a reduction in the availability of relationship lending could have an effect on the euro area's economy and on the working of monetary policy. This is particularly relevant to determine the importance of the often mentioned "credit channel of monetary policy".

At the micro-economic level, relationship lending implies that as a tendency the bank insulates its customers from liquidity or interest rate shocks. In case of a drop to its cash flow e.g., a firm can draw on a credit line that has been previously negotiated. Likewise, bank lending rates will not necessarily be adjusted in line with market interest rates. While firms that have access to these risk-sharing schemes can be expected to pay some form of an insurance premium to the bank, their decisions on investment, employment and production should be less sensitive to financial shocks.

Hence, at the macro-economic level, the more widespread relationship lending is, the smoother the business cycle should be. This may contribute to explain why business cycle fluctuations have traditionally been larger in the US and the UK, where relationship lending is limited, than in continental Europe, where relationship lending is thought to be prevalent. It may also imply that the role of banks in the transmission of monetary policy differs in continental Europe and in the US or the UK. In continental Europe, banks would insulate the firms from the effects of changes in the market interest rates to a larger extent than US or UK banks would, because of the larger proportion of loans granted through relationship lending.

But, as I will argue, current trends in bank structure and competition seem to be putting pressure on banks to limit the scale of their relationship lending activities.

2. What then are the main characteristics and trends of the European banking sector?

Let me briefly touch upon some aspects that have been addressed in the papers by Dermine and by Rajan and Zingales. These papers stress that competition, both among banks and from other financial intermediaries, has led to the consolidation of the European banking sector and to a diversification of the financial services proposed by banks.

First, there has been significant consolidation of the banking sector, including a sharp fall in the number of banks. Overall, the number of banks in the euro area decreased by about a third in the last fifteen years.

Second, financing through issuance of market instruments, which has historically played a minor role for euro area corporations, has become more important since the start of Stage Three of Economic and Monetary Union. Due to the monetary union, large issuers can more easily go abroad if their domestic financial markets are not sufficiently developed. And European Banks have been confronted with competition from non-European investment banks in the issuance-underwriting business.

Third, traditional deposit-taking activities have been challenged by the emergence of assets management companies and mutual and pension funds. These bank competitors have boomed in the last decades, accentuating the competitive pressure on the traditional banking business.

Fourth, retail lending, and especially lending to SMEs, remained untouched from the competition of either other financial intermediaries or foreign banks. However, given the over-capacity of most domestic banking sectors of euro area, retail lending is likely to undergo intensified competition among domestic banks.

Like any business that is confronted with new competitors, banks reassess their activities. For instance, we observe in most countries that banks have been able to generate income by entering into the business of their competitors. Banks actually have offered mutual funds and other portfolio management services to the customer network acquired via their traditional deposit taking and lending activities. Now, many economists have asked whether relationship lending can remain profitable in a more competitive environment.

3. Increased competition in banking seems to be reducing the availability of relationship lending in the euro area

Before further describing the effects of increased competition on the availability of relationship lending, let me stress that the phenomena we are talking about are not directly observable, and hence making it hard to evaluate the availability of relationship lending with certainty.

On the one hand, increased competition may deter banks from costly acquisition of information on borrowers if they fear that the latter can more easily switch to other banks in good times. On the other hand, the competition from non-banks in so many of banks' activities may push more banks towards relationship lending with SME, a segment on which they can not be challenged by non-banks.

Recent evidence seems to suggest that the availability of relationship lending is decreasing. We observe for instance that in Belgium and Germany, the growth rate of real loans to the private sector is lower than output growth, which is quite different from what was observed in previous episodes of economic slowdown. This decline coincides with large commercial banks reducing the scale of their retail banking because competition from local savings banks has intensified.

There is also evidence that the banks which have been involved in mergers tend to limit the scale of their lending relationship activities.

Finally, some observers expect that the introduction of the Basel II accord would increase the capital charges on loans supplied to Small and Medium Enterprises. This new regulation is likely to make the price of credit to Small and Medium Enterprises more responsive to market interest rates.

This would directly affect the role of banks in the monetary policy transmission; as the recent research in the Eurosystem has shown this role depends on the particular environment in which European banks have operated up to the recent past.

In conclusion, recent trends in the European financial markets seem to have put pressure on banks, leading some of them to reduce the scale of their relationship lending activities. If it continues, the recent reduction in the availability of relationship lending in Europe could affect the euro area business cycle and the transmission of monetary policy as the liquidity insurance provided by banks to SME decreases.

All in all increased competition will trigger substantial changes and cause difficulties. But in the end after a period of transition the financial industry of the euro area will have gained competitiveness and strengthened robustness.

Such developments are clearly of primary importance for central bankers and this is precisely why this conference is so useful.