

## **Yves Mersch: Credit developments in Luxembourg**

Speech by Mr Yves Mersch, Governor of the Central Bank of Luxembourg, at the Gala CFO World 2009, Luxembourg, 25 November 2009.

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### **Introduction**

Ladies and Gentlemen,

It is a great pleasure for me to be here today and I very much appreciate the opportunity to talk about credit developments in Luxembourg. In times like these the issue could not be more pertinent. Bank lending constitutes one of the most important sources of external financing. To many small- or medium-sized enterprises (SMEs) in particular, bank loans are the only means of external financing available; rather than raising funds directly, for instance through the issuance of bonds or shares, they have to go through a bank to obtain the necessary funds to finance their activities. The importance of credit intermediation cannot be overstated, and a healthy and well-functioning financial sector is therefore part and parcel of a healthy and well-functioning economy.

It goes without saying that a central bank, or a system of central banks, has a keen interest in credit developments. Indeed, credit growth is tightly interlinked with economic activity and inflation developments. Before I talk about actual credit developments in Luxembourg, let me say a few words about the main monetary policy transmission channels involving banks.

### **Monetary policy transmission channels involving banks**

While most monetary policy transmission channels go through the banking sector, either through the price of credit or through credit volumes, central banks can affect the supply of loans as well as the demand side.

Take the traditional interest rate channel. Cuts in the policy rate affect the investment and consumption decisions of businesses and households only to the extent that they are actually passed on through the banking sector. Banks determine the extent of the pass-through and their lending rates in turn impinge on the demand for loans from firms and households. Note that it is the real rather than the nominal interest rate which matters in this decision-making process. The underlying assumption is that some prices and wages are inflexible (or “sticky”) in the short run. This implies that the aggregate price level adjusts slowly over time, entailing that falls in the nominal interest rate also lead to falls in the real interest rate. This is an important distinction, as it provides a mechanism that enables monetary policy to stimulate the economy even if nominal interest rates hit their zero lower bound. Indeed, an expansion in the money supply can raise expected inflation, thus lowering the real interest rate and providing further stimulus to the economy through the interest rate channel.

Adjustments in short-term interest rates are also transmitted to long-term rates, which ultimately determine investment decisions and decisions about durable consumer expenditure. The expectations hypothesis of the term structure of interest rates is but one mechanism which explains how short-term interest rates may affect long-term rates, namely through an average of expected future short-term rates.

While the interest rate channel largely affects loan demand through the price of credit, monetary policy can also influence loan supply through the so-called credit channel. The credit channel proceeds from the assumption that there are frictions in financial markets, such as asymmetric information and moral hazard. A key function of banks is to overcome such information and incentive problems by screening and monitoring borrowers. The credit

channel is made up of two sub-channels. The first is the bank lending channel and works through the liability side of banks' balance sheets, which in turn triggers certain adjustments on the asset side. Thus, an expansionary monetary policy tends to increase loan supply by raising the availability of funds for banks. The empirical evidence on the existence of a bank lending channel in the euro area is rather mixed though.

However, the bank lending channel can also work through banks' capital positions. Cuts to the policy rate and a steepening yield curve can raise banks' net interest income, which in turn affects profitability and hence bank capital. The available evidence indicates that this only holds for countries where banks lend predominantly at fixed long-term rates, however. In fact, the opposite effect is found in countries where banks lend largely at floating or short-term rates. In this context, it should be mentioned that corporate loans in Luxembourg are by and large floating rate loans (or loans with an interest fixation period up to one year), as are mortgage loans; only consumer loans are primarily granted at fixed rates. However, asset price rises following a reduction in policy rates may also raise bank capital through positive valuation effects on banks' trading books.

The second sub-channel of the credit channel is called the balance sheet channel and works through changes in the quality of the borrower. Through its impact on cash flows and collateral values, monetary policy can affect borrowers' net worth, which is inversely related to their external finance premium. Owing to the pro-cyclicality of net worth, the external finance premium is thus counter-cyclical and therefore magnifies the impact of changes in short-term rates on credit availability. This spills over into consumption and investment, and finally into economic growth. This mechanism is also known as the "financial accelerator"

A final monetary policy transmission channel involving banks I wish to allude to is the risk-taking channel. Low interest rates and abundant liquidity may decrease risk aversion and encourage risky investments, as well as leading to laxer credit standards. This raises the supply of bank loans and can have a significant impact on credit growth.

### **The evolution of credit volumes**

So much for the theoretical background. Let me now move on to how corporate credit volumes have actually evolved in Luxembourg, and how those developments tie in with those at the euro area level. My intention is not to identify the workings of the different monetary policy transmission channels in Luxembourg – this would be a Herculean undertaking! However, it is helpful to keep the theoretical underpinnings in mind when looking at the actual credit developments and the potential underlying explanatory factors.

As you can see in the chart, the underlying trend developments in Luxembourg and at the euro area level coincide, despite the higher volatility in the Luxembourg data. Most notably, corporate credit dynamics rose continuously up until 2008, when they began to unwind rather rapidly, first in the euro area at large and shortly thereafter also in Luxembourg. The pace and magnitude of the decline in the loan dynamics are particularly worrying, with below or near zero growth rates in the third quarter 2009. It is worth emphasising that roughly one year ago, in September 2008, the annual progression of corporate loan volumes in Luxembourg peaked at 54%!

As for credit to households, the annual progression of mortgage lending has been on a downward trend since 2006, long before the crisis. However, this downward trend accelerated considerably and the annual growth rate recently stabilised just under 6%. Consumer credit has been progressing steadily since 2008, which represents a trend inversion compared to the preceding years. All in all, household loan dynamics have been much more benign than corporate credit developments.

This raises the question as to how and why the corporate credit cycle could take such a rapid U-turn. While the obvious answer is that banks refuse to grant loans in the wake of the financial crisis, this is but one side of the coin.

## Disentangling demand and supply

Indeed, the Bank Lending Survey or BLS – a euro area-wide bank survey on quarterly credit developments – strongly indicates that the sharp slowdown in corporate credit expansion is owing to both supply- and demand-side factors.

The graph plots the net unweighted responses provided by the participating banks from the Luxembourg BLS sample. A positive “net percentage” indicates that, relative to the preceding quarter, banks have tightened their credit standards or reported higher loan demand by firms. Conversely, if the respective line is below zero, this points to an easing of banks’ credit standards or a fall in loan demand.

As you can see in the chart, the survey results suggest that banks have been tightening credit standards since the onset of the financial crisis, making it more difficult for companies to finance their activities; lending standards have been tightened in particular for large enterprises. At the same time, however, the period of high loan demand ended shortly after the onset of the financial crisis, and net demand even turned negative on several occasions. The slowdown in loan dynamics is therefore owing to the combined impact of tighter credit standards on the one hand and a deceleration or fall in loan demand on the other.

You may have noticed that the slowdown in loan dynamics is lagging the tightening cycle: while the progression of loans to companies peaked in the third quarter 2008 before it slowed down rather rapidly, the BLS suggests that banks were already tightening credit standards since the early stage of the crisis in the second half of 2007. In other words, the information on credit standards from the BLS serves as a lead indicator. While the correlation between loan growth and credit standards is not perfect, the available evidence suggests that loan growth will stabilise shortly and subsequently pick up in the course of 2010.

This prediction is in line with an ad hoc survey we carried out very recently. The survey questionnaire was sent to four banks with a combined share of roughly 50% of the corporate credit market in Luxembourg. In one of the questions, the four participating banks were asked how they expect corporate lending volumes to evolve. For consistency, the BLS methodology has been used and the results are thus expressed as net percentages. However, the results of the ad hoc survey have been weighted according to the sample shares of the individual banks, while the BLS results are unweighted owing to methodological reasons.

As you can see in the chart, the survey results point to a moderate pickup in lending volumes, while lending to SMEs is even likely to accelerate considerably in the second half of 2010. New lending is expected to be the main driver behind the pickup in overall lending volumes, which also encompass loan repayments and write-downs. Banks do not expect a substantial change in loan redemptions over the forecast horizon. As for write-downs on loan portfolios, they do anticipate a rise in write-downs in Q4 2009 and H1 2010, but their mitigating impact on loan dynamics is expected to dissolve entirely in the second half of 2010. Of course, given that banks’ expectations pertain to lending volumes rather than credit standards per se, the expected rise in corporate lending should be seen as the interplay of demand and supply.

Some information on the demand side more specifically is also available from this ad hoc survey, though. It should be borne in mind that demand is rather difficult to predict, however; moreover, it is worth emphasising that the survey was addressed to loan officers and therefore naturally reflects the assessment of the lender rather than the borrower’s point of view. Be that as it may, as you can see in that same chart the four sample banks also expect the number of loan applications from new customers to rise, in particular as regards large enterprises. Loan applications from new SME customers, however, are not expected to rise significantly until the second half of 2010.

There is little doubt that the corporate credit outlook is improving. Nevertheless, it remains legitimate to ask why banks have tightened their credit standards in the first place. First of all,

not all banks have. In the BLS, the highest net percentages recorded in one single quarter have not exceeded 50%, the equivalent of 3 banks. Second, the results from the BLS are not weighted by bank size – in line with the methodology applied at the euro area level – otherwise you would see that the tightening is in fact not nearly as broad-based as it seems. But of course the question remains as to why some banks are tightening their lending standards, thereby reducing the supply of loans to enterprises. It is tempting to blame the tightening entirely on the financial crisis. In a way, this is also correct. However, the impact of “pure” supply-side constraints is not nearly as large as one would think. In other words, while it is true that a number of banks are more reluctant to grant loans to companies, this is not solely attributable to market access or to the cost of funds and balance sheet constraints. Indeed, as the next slide shows, the major reason banks have become more reluctant to grant loans to firms is that their risk perceptions have risen sharply.

Since the onset of the financial crisis in 2007, the various explanatory elements pertaining to the banks’ cost of funds and balance sheet constraints (represented by the red, orange and yellow bars in the chart) have indeed contributed to tighter lending standards. However, it is obvious from the chart that the role of these explanatory factors is secondary, while it is banks’ risk perceptions (represented by the blue and green bars) that have played a key role. Risk perceptions pertaining to the industry- or firm-specific outlook in particular have contributed to more stringent lending standards. If banks have chosen to restrict lending, it is therefore largely because of the economic downturn; admittedly, “pure” supply-side elements which constrain banks and thereby leave them no choice but to decrease lending volumes also played a role, but a much smaller one than is commonly believed. This evidence can easily be linked up to the theoretical background on monetary policy transmission channels expounded earlier: “pure” supply-side factors pertain to banks’ availability of funds, i.e. to the bank lending channel, whereas risk perceptions relate to the quality of the borrower, i.e. to the balance sheet channel.

How have banks implemented their tighter credit standards? The available evidence indicates that banks have strongly cut their lending rates, seemingly suggesting that tighter credit standards have been implemented through an adjustment of non-price rather than price conditions.

The chart plots the evolution of lending rates in Luxembourg, available through the Eurosystem reporting framework since 2003. The data indicate that loans to enterprises are usually floating rate loans (or loans with an interest fixation period up to one year); the chart therefore plots flexible (or short-term) lending rates on new business. Moreover, interest rates may differ substantially depending on the size of the underlying loan granted to the counterparty, which is why the reporting framework requires banks to distinguish between small and large loans. As you can see in the chart, there was a substantial reduction in corporate lending rates – for both small and large loans – in line with the monetary policy easing in the euro area. Peak-to-trough, lending rates on small loans have fallen from 6.24% to 2.42% in the twelve months up to September 2009; lending rates on large loans have fallen from 5.55% in September 2008 to 1.93% in September 2009.

However, the reporting framework provides no breakdown by geographical origin of the counterparty; this is unfortunate given that the lending rates are volume-weighted and that about three quarters of outstanding corporate loan amounts granted to companies in the euro area are actually granted to non-domestic enterprises.

The available information does suggest, however, that corporate lending rates have come down sharply, while banks have at the same time reported tighter credit standards. How can this information be reconciled? Were the stricter lending standards implemented through non-price factors, such as loan covenants or collateral requirements? Once again, the answer comes from the BLS. The survey does not point to a substantial tightening of non-price lending conditions, but rather to higher margins. Most notably, banks have signalled higher margins on riskier loans. This scores well with the rise in risk perceptions already

noted earlier in the context of explanatory factors underlying the tightening of lending standards. Moreover, it is consistent with non-survey data: margins, as given by the difference between lending rates and three-month EURIBOR rates, have risen since late-2008.

I have talked extensively about the supply of loans. This is because central banks collect a lot of information from the banking sector, either through statistical reporting requirements or in the framework of voluntary surveys banks participate in. Information on the demand side is sparse, which is why I have only mentioned it cursorily, in the context of the BLS and the ad hoc survey we carried out. The BLS does encompass further demand-side questions which are worth looking at in more detail though. Further to this, the next chart plots the key explanatory factors underlying the evolution of loan demand.

You will remember that loan demand began to slow down in 2008. The chart shows that there are various elements pulling loan demand in opposite directions. As shown by the orange and red bars, financing needs pertaining to fixed investment and, most notably, to mergers and acquisitions and corporate restructuring, have exerted strong downward pressure on loan demand. At the same time, financing needs pertaining to inventories and debt restructuring have pulled loan demand in the opposite direction, as shown by the yellow and green bars. Because there are countervailing factors, the evolution of loan demand is somewhat volatile; however, there is no questioning the fact that generally loan demand has come down since the onset of the financial crisis, in spite of some quarter-on-quarter fluctuations.

## **Conclusion**

To conclude, let me emphasise that the slowdown in corporate loan dynamics is at this stage not fully demystified. What we know for a fact is that loan volumes have ceased to expand at double-digit rates. Although the pace at which loan growth rates have come down is startling, the annual progression of corporate credit has mostly remained positive for now. Moreover, the available information suggests that corporate lending should recover soon and pick up pace in the course of 2010.

I have focused on the supply side because, as a matter of fact, central banks have much more information on lenders than on their counterparties. However, I also underscored that the tightening in credit standards is not as broad-based as the underlying data would suggest. This leaves the demand side, but comprehensive and reliable information on the borrower is notoriously difficult to come by. Perhaps this gap can to some extent be filled at today's conference.

Thank you for your attention.

Charts

Chart 1

The main monetary policy transmission channels involving banks

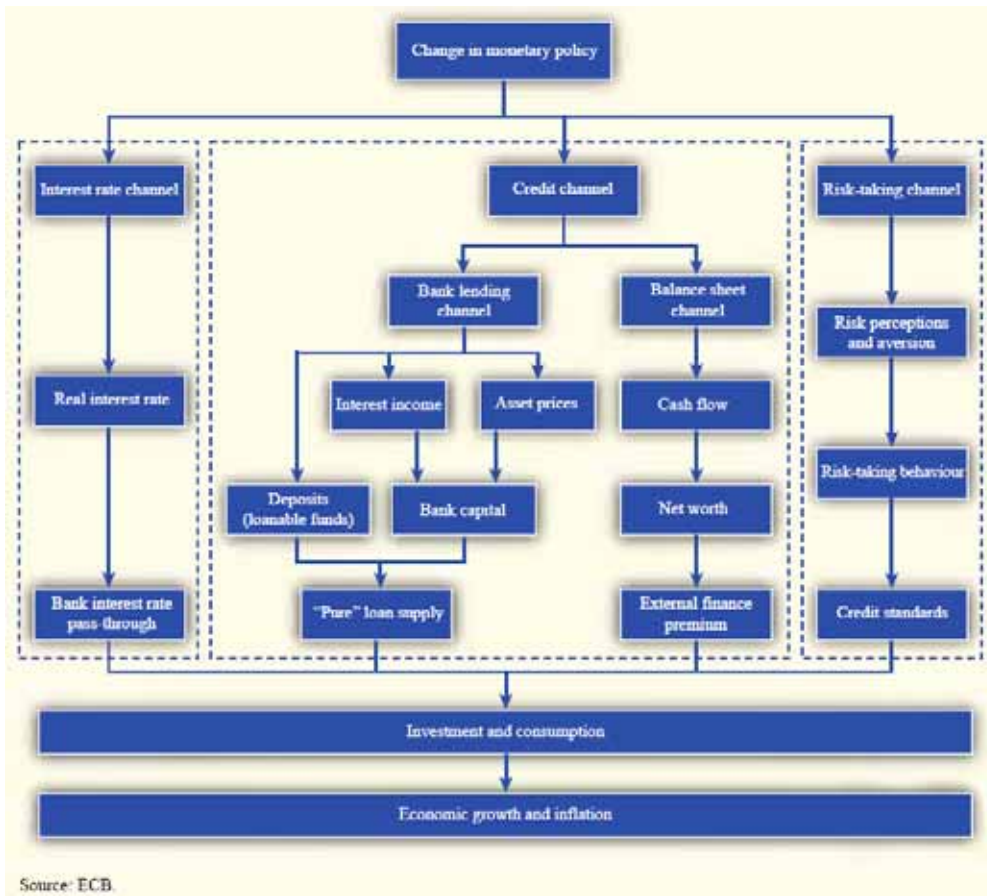


Chart 2

Corporate credit developments in Luxembourg and in the euro area, annual growth rate (in %)

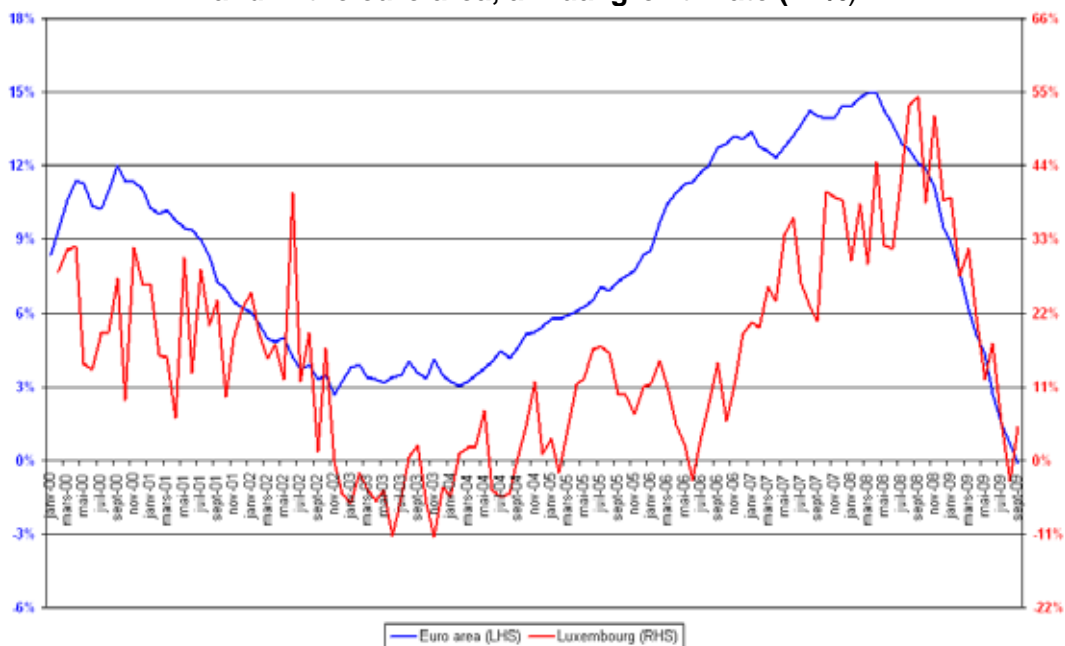


Chart 3

**Household credit developments in Luxembourg, annual growth rate (in %)**

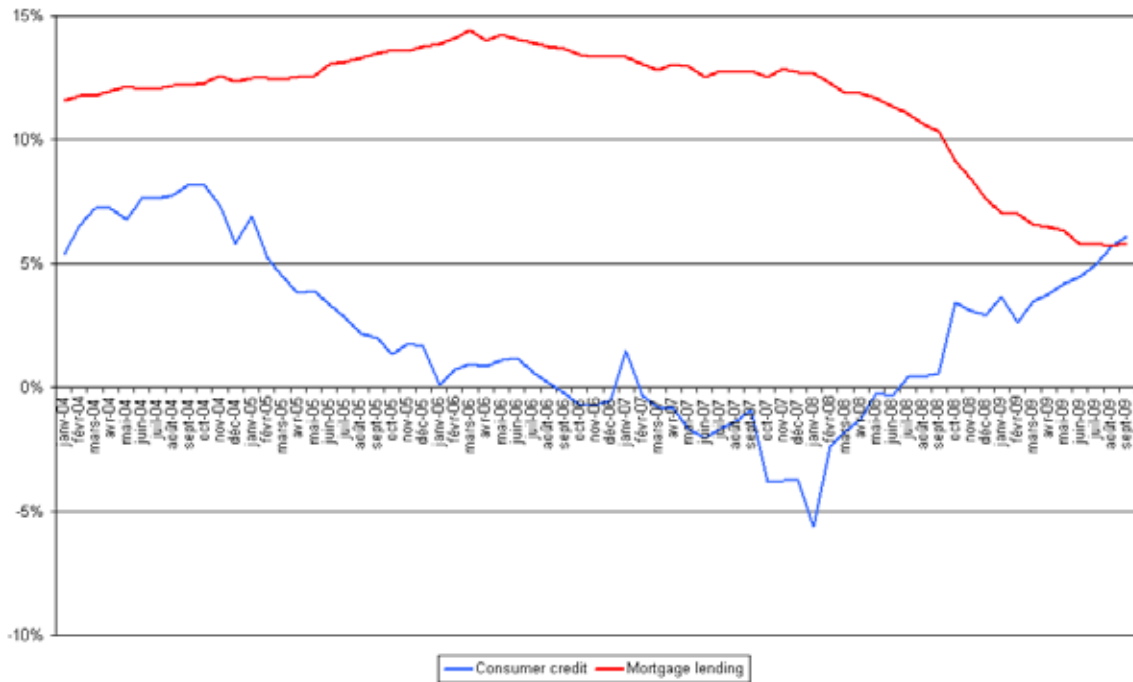


Chart 4

**The evolution of credit standards and loan demand in Luxembourg (net percentages)**

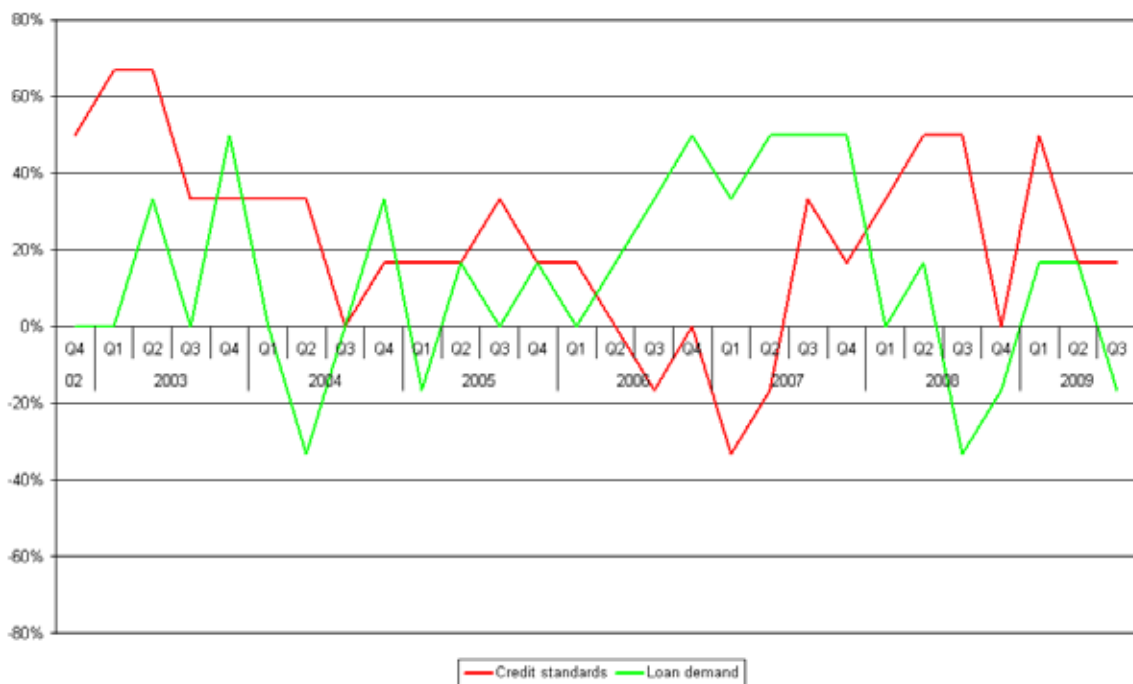


Chart 5

**Expectations regarding lending volumes and loan applications from new customers (weighted net percentages)**

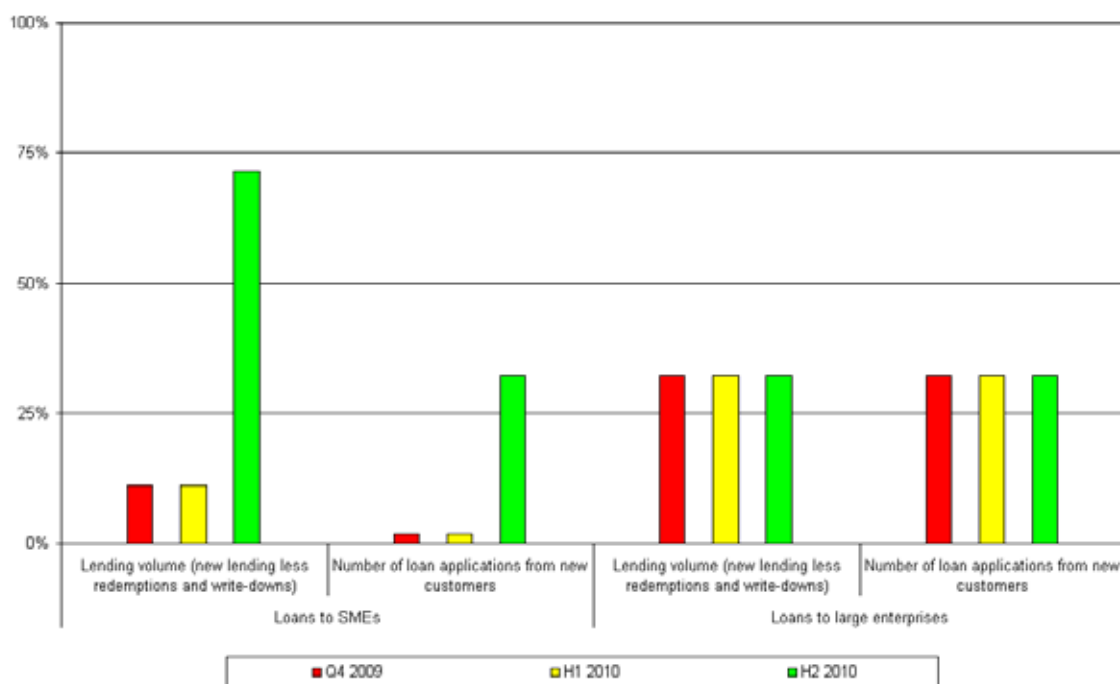


Chart 6

**Explanatory factors underlying the tightening of credit standards (net percentages)**

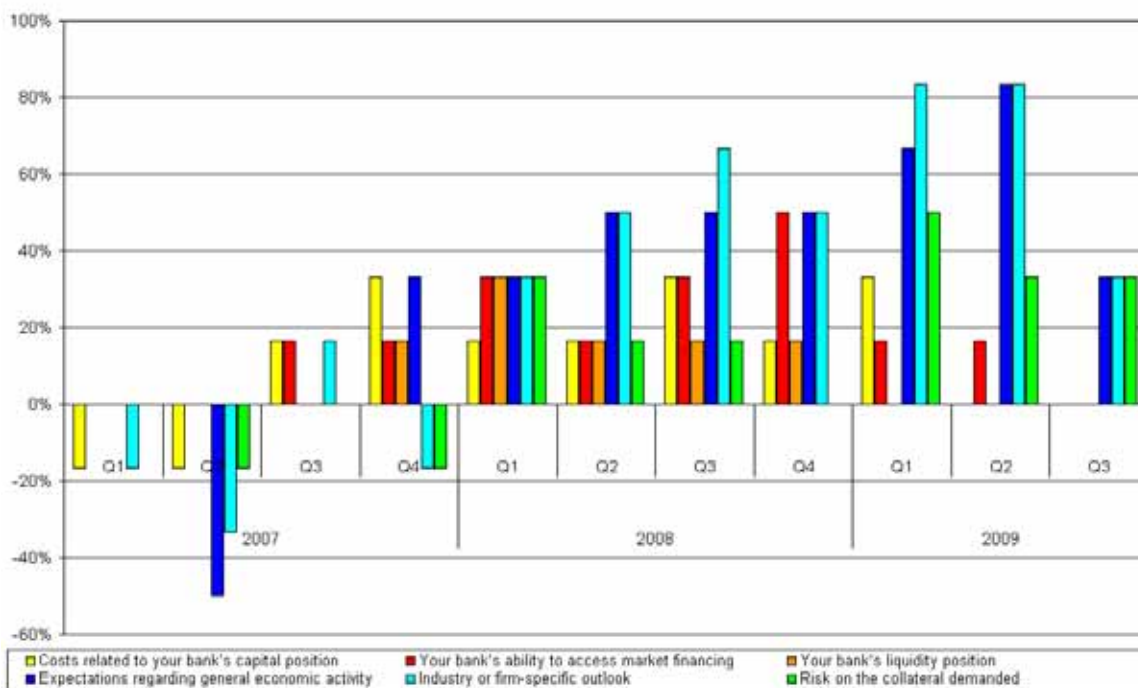




Chart 7

**Floating (or short-term) corporate lending rates on new business in Luxembourg**

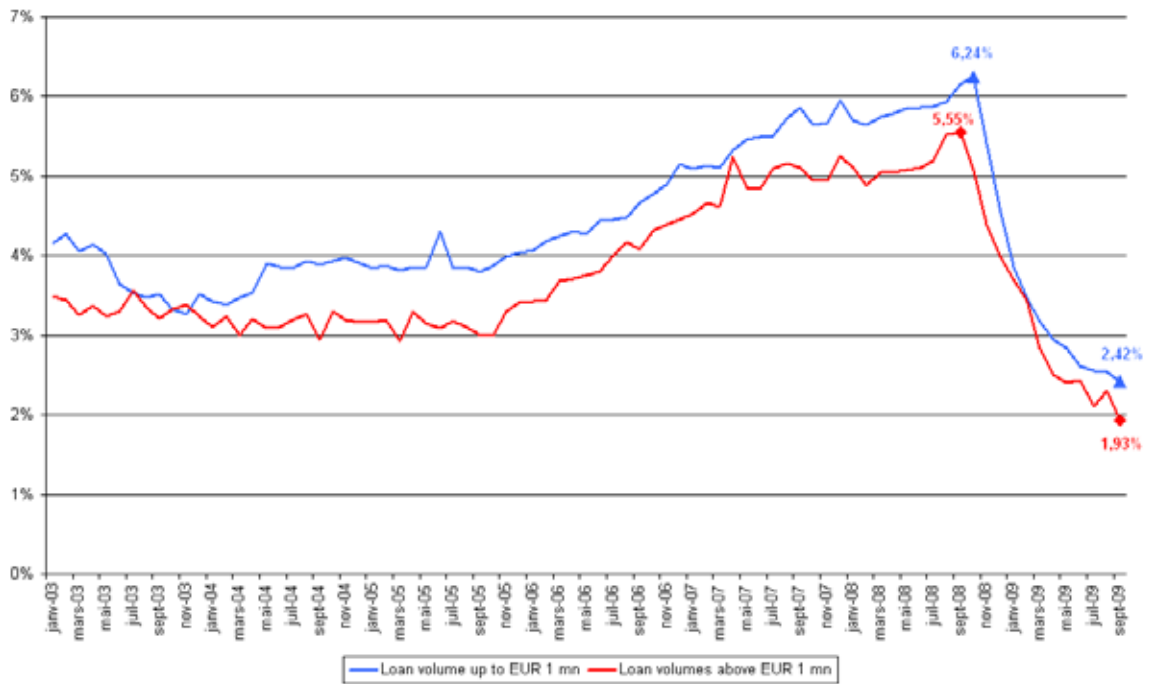


Chart 8

**Explanatory factors underlying the evolution of loan demand (net percentages)**

