Yannis Stournaras: Measures to revive credit markets: best practices and pitfalls

Speech by Mr Yannis Stournaras, Governor of the Bank of Greece, at the IMF/Bank of Slovenia high-level seminar on "Reinvigorating Credit Growth in Central, Eastern and Southern European Economies", Portoroz, 26 September 2014.

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The ***global financial crisis*** has impaired the ability of the financial system in the euro area to channel funds to the real economy, in particular for financing of long-term investment and SMEs. Banks in the euro area have been particularly affected as the financial crisis was followed by a sovereign-debt crisis, which has set in motion a negative feedback loop between banks and sovereigns. As a result, over the past six years, bank credit to the real economy and, in particular to SMEs, has fallen dramatically in the EU. Credit, which had been growing at double-digit growth rates before the global financial crisis, has contracted during the past few years.

The crisis also hit banks in the Central, Eastern and Southern European region as foreign bank engagement in the region declined and the over-indebtedness of households and businesses, a legacy of the earlier credit expansion, led to a large and rising volume of non-performing loans. In some cases, those have reached, or exceeded, 20 per cent of total loans. As a result, bank credit in the region declined from average growth rates above 30% in the period 2003–2008 to close to zero or even negative rates of growth in the recent years.

Bank credit is particularly important for economic growth in the EU. This situation is attributable to the fact that ***European economies are heavily dependent on bank financing***. This dependence on banks is in contrast to the US, where capital markets play a bigger role in financing the economy. Central, Eastern and Southern European economies are also bank-based financial systems in which capital markets remain relatively underdeveloped. Consequently, bank deleveraging, combined with increased risk aversion on the part of investors, has affected the ability to finance sustainable growth throughout the region.

A key characteristic of the economic recovery in the euro area at the present stage is the weakness of bank lending to the private sector in general and to companies in particular. This situation applies at both the aggregate level and for many individual countries.

The situation appears to be better in the Central, Eastern and Southern European region (perhaps with the exception of Turkey), as credit growth remains on average positive, but is nevertheless too weak to support satisfactory rates of sustainable growth. In particular, there are countries, like Bulgaria, Bosnia and Herzegovina and FYROM, where credit to the private sector is experiencing a moderate recovery but in other countries, such as Slovenia, Serbia and – to a lesser extent Croatia and Romania – bank credit growth to the private sector and in particular to enterprises is still negative.

As Fabrizio Coricelli discusses in his presentation, ***creditless recoveries*** are not uncommon in the aftermath of financial crises, in particular when financial crises were preceded by periods of credit booms to the private sector. Calvo et al (2006), in a seminal paper published in the American Economic Review, describe creditless recoveries as "Phoenix Miracles". The phenomenon of creditless recoveries has been documented mainly in Emerging Market and low-income economies but seems to also play a role in industrial countries. Empirical evidence suggests that creditless recoveries are more likely when the preceding recession was deep and when the recession coincided with a banking crisis. Several other factors also play a role: the openness of the economy to financial flows, the degree of export dependence, the degree of external adjustment during the recession and the stance and mix of fiscal and monetary policies.

Several explanations of this phenomenon have been proposed in the literature. One explanation is that economies can rebound without bank credit because capacity utilization is low during a recession allowing GDP to recover mainly through the absorption of unused capacity rather than through investment. A second explanation is that, in the absence of bank credit, firms increasingly use internal finance and trade credit. Furthermore, even if bank credit is declining, bank credit may be reallocated toward more-dynamic sectors, thus allowing an economic rebound.

Empirical research at the Bank of Greece suggests that the probability of a creditless recovery depends on two additional features of the economy: First, the saving – investment gap, in other words, the net financing needs of the private sector and, second, the degree of a country's fiscal and external adjustment during the recession. In particular, the lower are the net financing needs of the private sector at the bottom of the recession, the more likely it is that the economy can recover without bank credit. Since the gap between investment and saving can be financed through either capital inflows from abroad (in other words via current-account deficits) or through lower budget deficits (in other words by freeing private saving to finance investment), saving-investment imbalances naturally correspond to fiscal and external imbalances.

A second important implication of this research is that the degree of a country's fiscal and external adjustment during the recession plays a significant role during the recovery. In particular, the probability that a country may experience a creditless recovery is higher in countries that have followed economic adjustment policies during the recession to reduce their external and fiscal deficits. This result has important implications for both countries of the euro area periphery and countries of the Central, Eastern and Southern European region.

Nevertheless, creditless recoveries are suboptimal outcomes from an economic policy perspective since, as has been observed by several researchers, creditless recoveries are on average weaker than recoveries with credit. As Fabrizio Coricelli also points out, creditless recoveries may have negative effects on long-run potential growth by affecting investment and the stock of productive capital but also by increasing long-term unemployment.

A number of actions may be undertaken in order to address the problem. I will confine my remarks to three areas: ***monetary policy, confidence in the banking sector and initiatives that target the mobilisation of funds from capital markets*** thus broadening the sources of financing the economy. I will focus on our recent experience in the euro area, in general, and Greece, in particular, where the banking system has undergone a significant transformation over the past few years. Overall, my emphasis will be on measures which aim to revive bank credit and to mobilize funds from capital markets.

On ***monetary policy***, the ECB has taken important actions to improve confidence and to restore the smooth operation of the monetary transmission mechanism. Credit growth would have been significantly more negative had it not been for these actions.

The policy rate is now at an historical low of 5 basis points. Non-standard measures, including the Targeted Long-Term Refinancing Operations (TLTROs), the ABS Purchase Programme and the 3rd Covered Bond Purchase Programme will inject liquidity into both banks and markets.

The establishment of the Banking Union is restoring confidence in the banking sector. The supervisory authorities are assessing the resilience of banks and requesting injections of capital, so that confidence in the quality of bank balance sheets will be restored. In this respect, the ***Comprehensive Assessment and the EU-wide stress tests***, which are currently under way, will be key to improving confidence in the banking sector. Banking Union will also help reduce financial fragmentation.

The faster banks clean up their balance sheets, the easier it will be for them to regain confidence, to attract fresh capital from private investors and to provide credit to the economy.

At this point allow me to say a few words about Greek banks. Following the first recapitalization of our banks in 2012, we began to reform and consolidate the banking system. Banks sharply reduced reliance on central bank funding, while forming provisions for bad loans. As a result, they have been able to attract private investors.

Early this year, we concluded follow-up stress tests that were exceptionally well received by the markets. Following the release of the results of the stress tests in March, core banks completed much larger than requested capital increases to the tune of €8.3 billion with issues being significantly oversubscribed. Two systemic banks have repaid state aid that has been in the form of preference shares. All four systemic banks are now under private management.

These are the signs needed to restore confidence and lay the foundation for the healthy financing of the economy at a later stage.

Returning to the broader picture, it appears that bank credit will remain constrained at least until the European stress-test is completed and banks adjust to the results of the exercise. The burden of NPLs in economies which have gone through a deep recession – and Greece is a good example here – will be a major factor constraining the supply of bank credit in the medium term. Given the limited quantity of resources, it is important that banks use these limited resources in a way that improves allocative efficiency. In other words, they have to be channeled to the most productive uses.

Nevertheless, despite the important role that banks will continue to play, in the EU, particularly for SMEs, it has been clearly communicated by market participants that there is a pressing need to broaden the sources of long-term financing in Europe.

Broadening the sources of financing of the economy toward capital markets should be viewed as one of the key priorities of economic policy.

In this respect, the development of a deep, transparent and robust European securitization market for corporate loans would improve risk sharing and increase banks' lending capacity to corporates and, in particular, SMEs.

And this solution will probably serve its purpose better this time than previously, since the lessons of the inadequate regulation of some securitisation models in the past can be taken into account.

The ABS and the Covered Bond Purchase Programmes will provide an initial boost, especially for the European ABS market which has lain largely dormant since 2008.

However, in my view, if we are to move farther towards the development of a market for corporate loans, a concerted effort is needed in several directions. A ***list of key priorities in order to revive credit markets*** should include the following:

First, further measures to revive the market for securitizations, in particular for SME bank loans. Securitization is an important instrument to promote bank credit. Allowing banks to securitize and redistribute SME loans to a broader investor base can provide banks with capital relief and allow them to lend to the real economy. This is not an easy task given the stigma attached to securitization following the global financial crisis, when the "originate to distribute" model led to excessive leverage and financial fragility. Of course, lessons have been learned since then, and the regulatory framework has been adapted in a way that makes a repeat of past mistakes unlikely. For this securitization to work in a way that does not endanger the resilience of the financial system, we must ensure that only high quality assets that are simple and transparent are used in securitizations. In this respect, it is important to develop a set of rules that allow the definition of a pool of "high quality securitizations" at the EU level.

Second, changes to the prudential treatment of securitizations. It is essential, in my view, to adjust the *regulatory framework* for securitisations in a way that provides banks with incentives to engage in the market. Capital relief for banks' holdings of Asset Backed Securities which are simple, transparent and robust could provide an answer. The second aspect of regulation relates to potential investors, such as insurers, pension funds etc. The regulatory framework should allow for a fair treatment of high quality ABS relative to ABS products with higher risk profiles, in order to provide long-term institutional investors incentives to trade in the market.

Third, policies to promote better access of SMEs to capital markets. As is well known, corporate bond markets work well for large corporations while they are not attractive to SMEs, which remain largely dependent on bank loans for financing. Efforts should be undertaken to reverse this trend and promote the access of SMEs to capital markets. The development of "minibond" markets for SMEs in Italy and Germany could serve as examples to gain insights into best practices for the establishment of SME markets. The development of bond and equity markets for SMEs and mid-sized companies would also encourage more cross-border investment within the EU and from foreign investors.

Fourth, measures to develop alternative financial intermediaries for young companies and SMEs. In this context, efforts should be intensified toward the creation of a risk capital market for non-listed companies such as a market for venture capital funds and markets for infrastructure financing. MiFID II is an important step towards improving the functioning of EU trading venues and setting the stage for the development of SME capital markets. However, further steps are necessary, in particular to correct differences throughout the EU in the tax treatment of these products both at the issuer and investor level.

Fifth, measures to improve investors' access to business, credit and financial information on SMEs. It is well-known that most SMEs are not rated by rating agencies. The lack of adequate and readily available information on the credit quality of SMEs is a structural problem in the EU as a whole and in the Central, Eastern and Southern European region, in particular. This is one of the major reasons that SMEs in the EU have historically faced significant difficulties to access funding from capital markets.

There is, thus, the need of a harmonised EU approach to credit scoring comparability of SME data. Improving the availability of financial information is paramount in allowing investors to gauge the riskiness of securitized products. In this respect, it is important to develop national credit registers for SMEs, allowing for higher transparency, standardization and comparability of underlying assets.

A final word of caution is in order. Most of the measures I discussed above will likely have only medium- to long-term effects in reviving credit markets in the EU because most of these measures constitute fundamental changes in the structure of the financial system. Such structures naturally change only gradually over time. In the short term, monetary policy will continue to play the major role in determining liquidity provision to banks and the cost of funding for the private sector. Non-standard monetary policy measures and progress towards a banking union are, thus, of prime importance, in order to reduce market fragmentation and allow the normal transmission of monetary policy to the most vulnerable areas of the monetary union.