Peter Praet: Repairing the bank lending channel – the next steps

Speech by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the European Macro Conference, organised by Credit Suisse, London, 17 November 2014.

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Summary

The effectiveness of monetary policy in the euro area depends on a well-functioning banking sector as it operates through the bank lending channel. In recent years, efforts have been made to repair this channel. Policymakers agreed to establish Banking Union and the ECB assumed supervisory responsibilities within it. Against that background, we expect the monetary policy initiatives we adopted in June and September to gain pace in the coming months, thus incentivising lending to the real economy and ultimately bringing inflation closer to 2%. Indeed we have already observed a considerable easing of the effective monetary policy stance. We sustain that these measures will have a sizeable impact on the Eurosystem's balance sheet, which is expected to move towards the dimensions it had at the beginning of 2012. But as banks adjust to a new business environment, it is essential to ensure that they continue to have microeconomic incentives that coincide with our desired macroeconomic objectives, while we keep developing a banking landscape that is sufficiently efficient and diversified to sustain credit supply.

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The effectiveness of monetary policy in the euro area depends on a well-functioning banking sector. Different to other advanced economies, the transmission of our policy impulses operates predominantly through the bank lending channel. This means that, as monetary policymakers, we have to pay particular attention to developments in the banking system. Indeed, since 2008 many of our policy measures have been focused precisely on addressing blockages in bank intermediation, ranging from short-term liquidity to longer-term funding.

In recent years, other European policymakers have joined the ECB in this effort to repair the bank lending channel. In several vulnerable countries there has been a far-reaching restructuring and recapitalisation of the banking sector. And at the European level, policymakers agreed to establish Banking Union, the opening act of which was the ECB's Comprehensive Assessment of euro area banks' balance sheets. What I would like to focus on today is what these efforts have achieved so far – and what still needs to be done to fix the bank lending channel sustainably.

Credit at a turning point

There are several factors that indicate credit dynamics in the euro area have now reached a turning point. First, credit data have improved over recent months, albeit from low levels. The annual growth rate in bank loans to households again increased in September to 0.6% – twice the average growth rate recorded last year.[1] Bank lending to firms has continued to contract but the decline is bottoming out. And the latest bank lending survey saw banks report a further easing of overall credit standards.

Second, the Comprehensive Assessment, which we concluded just a few weeks ago, has encouraged banks to frontload their balance sheet repair and recapitalisation efforts. The

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1 The figures are adjusted for sales and securitisation.

exercise has also identified €25bn in capital shortfalls and imposed important prudential requirements on banks. Taken together, these actions increase transparency and confidence in the banking sector, which is a pre-condition for stronger recovery in credit.

Third, against that background, we expect the monetary policy initiatives we adopted in June and September to gain pace in the coming months, thus incentivising lending to the real economy and ultimately bringing inflation closer to 2%. As evident from the latest bank lending survey, participation in the Targeted Long-Term Refinancing Operations (TLTROs) is likely to pick up in December and beyond; the covered bond purchase programme has begun; and the operational preconditions to start asset-backed securities (ABS) purchases are now met.

Indeed, reflecting this progress in implementing the June and September packages, we have already observed a considerable easing of the effective monetary policy stance – although the liquidity injections via the TLTROs and purchase programmes are only starting to accumulate. These measures will have a sizeable impact on the Eurosystem’s balance sheet, which is expected to move towards the dimensions it had at the beginning of 2012. And the Governing Council underlined at its recent meeting that, should it become necessary to further address risks of too prolonged a period of low inflation, it is unanimous in its commitment to using additional unconventional instruments within its mandate.

Thus, many of the necessary conditions to restart credit growth are now in place. Yet, I think it would be short-sighted to claim that these alone will be sufficient. Coming out of a major financial crisis, it was always clear that repairing the bank lending channel would be a longer process, and the measures I have just described would only be the first steps in that process.

One of the most important issues now in the repair process is how banks adapt to the challenging business environment that has been bequeathed by the crisis.

The banking sector in transition

The euro area banking sector remains in transition. At present banks generally have low revenues and profitability arising from several factors, including legacy factors such as loan losses during the crisis; cyclical factors such as the weak macroeconomy; and in some cases regulatory factors such as the costs of adapting to new legislation. This is reflected in historically low returns on equity: the median return on equity for euro area significant banking groups is currently 5%.

It is unlikely, and indeed undesirable, that we will see a return to the high returns on equity we saw before the crisis, which were distorted in particular by excessive leverage and maturity mismatch.[2] Banks nonetheless face expectations from shareholders to raise profitability and returns on equity above their current levels – as reflected in a rather high cost of equity – which many will have to react to by adapting their business models.

This could involve a variety of measures, including repricing loans, reducing operating costs or streamlining business models – for instance, by shrinking credit provision in less profitable business lines, or exiting those business lines altogether. As policymakers we are in principle indifferent to how individual banks respond. But some of these strategies, when aggregated, may have system-wide effects that, as monetary policy operates mainly through banks, become relevant for our policy objectives.

[2] For example, Altunbas, Manganelli and Marques-Ibanez (2011) document that over-reliance on market funding was a major source of bank risk in the recent crisis. See Altunbas, Y., Manganelli, S. and Marques-Ibanez, D. (2011), “Bank risk and business models during the Great Recession”, ECB Working Paper No. 1394.

For example, repricing may counteract our monetary policy objective to ensure there is sufficient financing for a robust economic expansion. If banks lower costs in the short-term through underinvestment rather than efficiency gains, this may undermine their viability over the longer-term. And perhaps most importantly, if banks exit certain business lines due to the pressures of the difficult environement, this may imply cutting back on types of lending that are macroeconomically important, such as lending to SMEs or long-term infrastructure financing.

Part of solution to this is to create a more diversified and contestable financing mix, such that if banks finance becomes too expensive or scarce, non-bank finance can efficiently substitute for it. This is what the ongoing agenda to deepen and integrate capital markets in Europe aims to achieve – the so-called Capital Markets Union. Non-banks such a private equity investors or institutional investors can also play an important role in filling financing gaps, especially for the latter in long-dated lending such as infrastructure that matches their liability profile.

But we also know that for certain types of lending that are the preserve of banks, in particular SME financing, asymmetric information problems and high costs of monitoring means banks cannot easily be replaced by non-banks. And perhaps even more importantly, such lending cannot quickly be replaced by *other banks*, as exit from the market tends to destroy the relationship networks – or “soft information” – that is crucial for small business lending.[3] In this way, exit can in fact create a form of hysteresis in the banking sector.

What this shows is that, as policymakers, we cannot be agnostic as to how banks adapt to the current environment. We need to stay alert to the fact that actions by banks that are rational at the microeconomic level can create negative externalities at the macroeconomic level – analogous to the “fire sales” problem during financial crises.[4] And where those externalities risk becoming sufficiently large, there is a justification for policy actions.

In my view there are two main areas today where this applies: first, ensuring that banks retain the *incentives* to lend in markets where to all intents and purposes they are irreplaceable, namely for SMEs; and second, ensuring that they have *capacity* to do so.

Ensuring that banks’ retain incentives to lend

Ensuring that banks retain the incentives to provide an elastic supply of credit to SMEs involves a variety of issues, but the priority in the current environment is addressing the factors that could drive unwanted adjustment in the sector: in particular, the cyclical, legacy and regulatory factors I described above.

Cyclical factors matter for banks’ incentives because the longer weak demand conditions persist, the greater the risk that banks will shrink their balance sheets more than is necessary. Thus, a stronger recovery with stronger credit demand is a key part of repairing the bank lending channel. Achieving this means economic policies must do their utmost to bring the economy back to potential as quickly as possible, by strengthening both supply capacity and aggregate demand in the economy. As this is now high on the EU policy agenda, I will not dwell on it today.

In terms of legacy factors, the main issue today is dealing with non-performing loans (NPLs). The ECB’s Comprehensive Assessment has gone a long way towards ensuring adequate recognition and provisioning of NPLs, but there is still a legacy stock of NPLs on many

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3 For a discussion of the “switching costs” created by relationship lending see Kim, M., D. Kliger, and B. Vale (2003), “Estimating Switching Costs: The Case of Banking”, Journal of Financial Intermediation Vol. 12, Issue 1.

4 Brunnermeier, M. (2009), “Deciphering the Liquidity and Credit Crunch 2007–2008”, Journal of Economic Perspectives, Vol. 23, No. 1.

banks' balance sheets. This affects incentives to lend because, although some tolerance by banks towards NPLs can act as a shock-absorber, when NPL ratios exceed a critical level slow and inefficient resolution becomes a major impediment to both banks and the economy at large.

From the bank side, it undermines the payment culture, as it rewards strategic defaulters while discouraging performing debtors from continuing to repay their debt. The process of handling and supervising NPLs also often raises operating costs.[5] And in the wider economy, it prevents creative destruction in the form of resolving non-viable companies, as well as swift restructuring of viable but over-indebted firms. All this perpetuates the macroeconomic effects of the debt overhang and retards the economic recovery, which in turn slows down the recovery in credit demand.

Critical to addressing this problem is a legal and operating environment that encourages both banks and firms to accelerate NPL resolution. And this depends in turn on several factors at the national level including the efficiency of insolvency regimes, out-of-court restructuring frameworks and judicial systems.

For example, differences between countries in the speed of insolvency proceedings can affect the ability of banks to seize collateral, and hence influence their incentives and ability to resolve NPLs. To illustrate, according to the World Bank, to resolve insolvency in Italy takes 1.8 years, compared with just 0.4 years in Ireland.[6] Ineffective insolvency systems also render out-of-court restructuring frameworks less operable, as they fail to act as a credible threat, thereby dissuading creditors and debtors from agreeing on a restructuring.

This latter point may be particularly important because, in a debt overhang environment, the overall efficiency of NPL resolution and the cost for society hinges crucially on the ease with which debt can be restructured outside of the insolvency framework. For firms whose business models remain fundamentally viable, liquidation may be economically inefficient and some form of voluntary debt restructuring could be essential to restore their viability and allow them to borrow and invest again.

Several countries have already made progress in reforming their national legislation. To give just one example, in Portugal the government introduced new regimes for fast-track in-court and formalised out-of-court restructuring in 2011 and 2012. Experience has shown, however, that the effectiveness of an improved legal framework depends on various accompanying factors, such as improving debtor-creditor coordination and building sufficient administrative and judicial capacity to successfully mediate restructuring.

In short, improving the overall environment for NPL resolution would afford an opportunity not only to repair bank balance sheets, but also those of their *clients*. Both of these are ultimately necessary to achieve a sustainable recovery in bank lending, and in doing so to restore the effectiveness monetary policy transmission.

Finally, banks' incentives are necessarily affected by regulation. This is indeed its purpose. Regulation aims to internalise negative externalities, but it is the nature of regulating that policymakers must always be watchful that, in the process, they do not inadvertently create new forms of negative externalities.

Regulations passed so far have rightly aimed to make banks internalise systemic risks and markets to better price them. And there is in principle no long-run trade-off between higher

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5 For a discussion of how NPLs can affect cost efficiency see Berger A.N., and R. DeYoung (1997), "Problems Loans and Cost Efficiency in Commercial Banks", Journal of Banking and Finance, Vol. 21.

6 World Bank (2013), Doing Business 2014: Understanding Regulations for Small and Medium-Size Enterprises.

capital and higher lending.[7] But at the same time, much depends on the calibration of specific requirements, and here very careful macroeconomic impact assessments are required – for instance, to ensure that the transitional costs of implementing regulations do not have unwanted effects on credit.

Moreover, as such assessments necessarily contain a degree of uncertainty, policymakers need to continuously monitor how new regulations are actually affecting incentives in practice, and adapt them accordingly where unintended consequences appear. We have seen this, for example, with the Liquidity Coverage Ratio. Another example is securitisation.

It is now widely acknowledged that regulatory initiatives aimed at preventing a replay of the sub-prime crisis may have indiscriminately affected all ABS, including simple and transparent structures that can play an important role for SME financing. In line with on-going work at the international level, this is now in the process of being addressed through the amendments to the Solvency II (for insurers) and Capital Requirements Directives (for banks), recently published by the Commission.

As part of this agenda, we also need to ensure that regulations are mutually consistent. For example, a well-functioning SME ABS market requires banks that can market and trade securitised products. This depends in turn on their capacity and willingness to absorb temporary demand-supply imbalances. Thus, we should be careful to ensure that new regulations, for instance aimed at separating the banking and trading arms of universal banks, do not have negative consequences for market-making activities that are not justified by significant risks, in particular in less liquid markets.

In all these ways – cyclical, legacy, regulatory – setting the right microeconomic incentives for the banking sector can have significant macroeconomic consequences. They are therefore areas where, if we want to sustainably repair the banking lending channel, the attention of policymakers is warranted.

Ensuring that banks have the capacity to lend

If the first aim for policy is ensuring that banks have the *incentives* to remain engaged is economically important lending, the second is ensuring that they have the *capacity* to do so. A pre-condition for this is that banks are appropriately capitalised, as I have already discussed. But what also matters is the landscape of the banking sector – that is, whether the banking sector is sufficiently *efficient* and *diversified* to ensure a stable supply of credit.

According to some indicators the European banking sector is characterised by over-capacity relative to the size of the market. For example, the Herfindahl-Hirschman concentration index for the euro area currently stands at around 700; as a general rule, a figure below 1000 signals low concentration.[8] This suggests that one factor in difficulties facing the sector is that it is not operating at the efficient frontier – and consequently, that there would be macroeconomic benefits to some restructuring and consolidation.

We also saw during the crisis that the banking sector in the euro area was not well-diversified on either the asset or liability sides. Cross-border exposures mainly comprised of short-term debt, which meant that when bank assets were hit by an adverse shock, funding quickly dried up. The result was that risk-sharing through the banking system virtually collapsed

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7 See for example Buch, Claudia and Esteben Prieto (2014), "Do better capitalized banks lend less? Long-run panel evidence from Germany", International Finance 17:1.

8 The Herfindahl-Hirschman Index (HHI) is defined as the sum of the squares of the market shares of all firms within the industry, where the market shares are expressed as fractions. As a general rule, an HHI below 1,000 signals low concentration, while an index above 1,800 signals high concentration. For values between 1,000 and 1,800, an industry is considered to be moderately concentrated. See ECB Banking Structures Report, October 2014.

during the crisis, with negative spillovers to credit. Thus, there would be macroeconomic benefits not only to within-country consolidation, but also to cross-border consolidation.

In a single market, we would expect the private sector to drive such a rationalisation process, especially given the efficiency gains that can be reaped from cross-border M&A in terms of, among of things, information technology and corporate overhead costs.[9] There are several explanations for why this has not happened, but part of the reason seems to be the effect of a fragmented supervisory and resolution regime, which raises the costs of entry for cross-border banks and reduces the economic synergies of integration.

For example, industry surveys suggest that an important factor in low cross-border M&A before the crisis was opaque supervisory approval procedures. The high compliance costs created by different sets of national rules and interacting with several different authorities also affected the deal economics.[10] Moreover, the fact that European countries have tended in the past to merge failing banks, rather than resolve them, probably reduced space for new entrants: only a handful of new banks enter national markets each year.

Against that background, the establishment of Banking Union will be catalytic in triggering a change in the banking landscape. The balance sheets of cross-border banking groups will become progressively more fungible, allowing liquidity and capital to be more efficiently managed at the group level. And with the Single Supervisory Mechanism (SSM) and the new resolution framework barriers to entry and exit into national markets are expected to fall. All this should meaningfully lower the cost of doing business for cross-border banks and increase efficiency in the sector.

At the same time, a more integrated banking landscape implies greater risk-sharing within the sector, which should in turn support the stability of credit provision. Cross-border integration entails greater geographical diversification.[11] And the local affiliates of cross-border banks are also less likely to be exposed to the kind of market funding dry-ups we saw during the crisis, as intragroup funding acts as a shock-absorber.[12]

That said, we of course do not want to move from a situation of too low concentration towards a banking landscape dominated by large banks with excessive market power. Recent research looking at the pre-crisis period suggests that where banks face limited competition in their domestic markets, financing constraints for SMEs are higher. Moreover, the effect of bank market power on financing constraints increases in financial systems that are more bank dependent.[13]

This underscores the general need, as I mentioned earlier, to create a more balanced financing mix between banks and capital markets. But it also points again to the particular importance of securitisation. With well-functioning securitisation markets some of the benefits of cross-border banks – for instance risk-sharing – can be replicated by having small, local banks originate-to-distribute loans while larger, global banks securitise and market them. In

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[9] See for example Anna Kovner, James Vickery, and Lily Zhou, "Do Big Banks Have Lower Operating Costs?," Federal Reserve Bank of New York Economic Policy Review, Volume 20, No. 2, forthcoming.

[10] "Financial Integration in Europe", March 2007. In line with this, Carletti, E., Hartmann, P., and Ongena, S. (2007), "The economic impact of merger control: What is special about banking?", ECB Working Paper No 786, July, find empirical evidence that the opacity of national bank merger reviews entered elements of inefficiency in banking relative to non-financial corporate sectors.

[11] For a discussion on why retail bank integration may be a particularly attractive risk-sharing mechanism, see e.g. Fecht, F., Grüner, H.P. and Hartmann, P. (2007), "Welfare effects of financial integration," CEPR Discussion Paper No. 6311.

[12] See for instance Reinhardt, D. and Riddiough, S. (2014), "The two phases of cross-border banking flows", mimeo, Bank of England.

[13] Ryan, R., O'Toole, C. and McCann, F. (2014), "Does bank market power affect SME financing constraints?", Journal of Banking and Finance.

other words, it creates the conditions for diversity and competition within the sector so that an optimal market structure can evolve.

Conclusion

Let me conclude.

Repairing bank lending channel after a major financial crisis is inevitably a long and difficult process. Monetary policy has an important role to play, but the agenda is also broader: it involves supply and demand factors, and multiple aspects of national and European policy.

The steps we have taken so far to strengthen the banking sector are necessary conditions for a stronger recovery in credit, and I am confident that we will see increasingly positive effects. But as banks transition to a new business environment, ensuring that they continue to have microeconomic incentives that coincide with our desired macroeconomic objectives is essential, as is developing a banking landscape that is sufficiently efficient and diversified to sustain credit supply.