

Fernando Restoy: Bank credit developments in Spain

Speech by Mr Fernando Restoy, Deputy Governor of the Bank of Spain, at the European Association of Public Banks (EAPB) Annual Congress, Barcelona, 10 November 2015.

* * *

1. Introduction

Good morning everyone. It is a pleasure for me to be here today participating in the Annual Congress of the European Association of Public Banks, which is being held this year in Barcelona. Allow me to thank the organisers and, in particular, the *Institut Català de Finances* and its CEO, Josep-Ramon Sanromà, for his kind invitation.

I will focus my remarks on the developments in bank credit in Spain during the recent crisis and the current recovery. I really cannot think of a more qualified audience to share my reflections on these issues, given the active role played by national promotional banks in the recent crisis in facilitating the flow of credit.

As is well known, bank credit flows have contracted markedly in many advanced countries over much of the recent crisis. In Spain, the outstanding amount of bank lending to households and firms has been decreasing, in real terms, since 2009. The current process of deleveraging marks the sharpest contraction in bank credit in this country since the 1980s. The persistency of the adjustment of the stock of credit is likewise remarkable. In particular, even after emerging from the last recession in mid-2013, the outstanding stock of credit has continued contracting, albeit at a rate that has moderated significantly in recent times.

The weakness of bank lending over the recent past has motivated much discussion on the reasons behind this and on the best policies to deal with the situation. In order to define these best policy measures, it is important first to fully understand the behaviour of this phenomenon and to identify possible frictions in the credit market that may be hampering its recovery. With this in mind, I will next provide an overview of the main factors explaining recent credit developments in Spain: first, in the context of the crisis period, and then in the current recovery phase. I will conclude with some reflections on possible policy considerations.

2. The determinants of bank credit in Spain during the crisis

When analysing the factors behind the contraction of bank lending during the crisis it is useful to distinguish between demand and supply elements, even after discounting the practical difficulties in separating both components.

2.1. Demand-side factors

Starting with the demand side, several factors contributed to the sharp reduction in the demand for credit during the crisis. First, loan demand fell sharply as a result of the deterioration in economic conditions, which limited current and planned spending levels and, hence, the need for new credit.

Second, the need of households and non-financial corporations to deleverage and rebuild a sounder financial position is another factor behind the pronounced slowdown in credit demand. To give you some figures, non-financial corporation debt ratios grew rapidly during the last expansion up to close to 120% of GDP in mid-2010, clearly above the average values in the euro area, which stood at around 80% of GDP at that time. Similarly, the household debt-to-GDP ratio rose up to almost 85% in the same period, 20 pp above euro area levels.

2.2. Supply-side frictions

Turning now to the supply side, there exist some frictions that tend to exacerbate the negative pressure on credit exerted by the contractionary demand factors. One significant friction in this regard is the existence of asymmetric information between lenders and borrowers, a circumstance that limits the ability of the lenders to assess correctly the actual level of risk posed by a given borrower or a project. This friction normally intensifies during periods of crisis and, for reasons well known, is comparatively more relevant in the case of small and medium-sized firms as opposed to large companies.

The comparative disadvantage of small firms in accessing financing relative to their larger competitors has, in fact, been one of the most pervasive features of the recent crisis, despite the mitigating impact provided by the special facilities activated by many of the public institutions represented here today.

Another factor that significantly restrained credit supply conditions until recently was the financial fragmentation of the euro area that emerged as a result of the tensions in the European sovereign debt markets. In fact, one of the most visible consequences of financial fragmentation was the strong sensitivity of funding costs to the borrowing agents' nationality and not just to their creditworthiness.

Thus, drawing all the strands together, I think it is reasonable to conclude that the unsustainable accumulation of debt over the previous expansion paved the way for the subsequent credit contraction seen during the crisis. In my view, this contraction reflects primarily the sizable and unavoidable downward adjustment in the demand for credit. However, a number of frictions related to the supply of credit, such as those discussed earlier, have also played a relevant role.

3. Recent developments in bank credit and its determinants

Let me now turn to the recent developments in bank credit. The latest data show that the stock of credit to the private sector in Spain continues to fall, but the rate of decline has tended to slow gradually since the second half of 2013, in parallel with the recovery in GDP.

This slow pace of recovery of the credit cycle is consistent with historical regularities during previous similar episodes. In fact, there is a well-established branch in the economics literature that has coined this phenomenon "creditless recoveries", and there are abundant studies showing that these episodes are not exceptional either in emerging or in advanced economies, especially in the aftermath of a recession accompanied by a banking crisis.

The moderation in the contraction of the aggregate stock of credit points to an increase of new lending operations, which is consistent with the economic recovery. In fact, the information available on new credit transactions suggests that the segment of lending to SMEs has started to recover. And in the most recent period, this trend has gradually spread to the other credit categories, such as in the case of credit extended for house purchases.

What are the determinants behind these recent developments? In my view, demand-side factors are playing a relevant role in the incipient recovery in credit flows. The improvement in growth and employment prospects and the reduction in aggregate uncertainty have all resulted in an increase in current and expected income, expanding the willingness of agents to spend and their ability to take on new debts while reducing the risk perceived by lenders.

In parallel with the recovery in the demand for investment, we have witnessed an improvement in the financial position of borrowers. Specifically, from the peak observed in mid-2010, the gap between debt ratios in Spain and the euro area average has fallen from 37 pp to 9 pp in the case of corporates and from 20 pp to 9 pp in the case of households.

But credit flows are also being stimulated in the current juncture by several factors more directly connected with the supply side. First, the strengthening of the capital position of banks, following the conclusion of the cleaning-up, recapitalisation and restructuring of the

financial system, is contributing to enhancing their capacity to finance the economy. The Comprehensive Assessment carried out last year at the European level also contributed notably to restoring investors' confidence in the Spanish banking industry.

The increasing reintegration of European financial markets since 2013, stemming from various actions taken both at the national and European level, does also facilitate the normalisation of the economy's financial flows. These initiatives include the adoption by the Eurosystem of a number of bold, unconventional monetary policy measures, including the introduction of new long-term operations linked to new lending (the so called TLTROs) and the purchase of public and private sector securities.

The ongoing improvements to euro area governance arrangements are also operating in the right direction, helping stabilise European financial markets and reducing their fragmentation. One key development in this field is the Banking Union, which, though still incomplete, marks an unprecedented step towards a genuine European common mechanism of rules and procedures for supervising and resolving banks and protecting their depositors.

All in all, the recent normalisation in European financial markets has contributed to a significant easing in financing conditions in those jurisdictions that were previously under higher macrofinancial pressure, including Spain. As a result, the cost of lending in these countries has tended to converge gradually to the lower levels observed in the core euro area.

At the same time, some measures recently introduced at the national level have also supported the availability of bank financing to SMEs. Specifically, the regulatory definition of an SME has been significantly widened, bringing it in line with that predominating at the European level and so extending the benefits of the lower capital requirements associated with loans to such firms.

As a result of the conjunction of the previous developments, most quantitative and qualitative indicators point to a higher dynamism in credit flows in Spain which is linked both to supply and demand factors. For instance, data from the Central Credit Register show an upward trend in the number of credit transactions with non-financial corporations which has been driven by an increase in both loan applications and their approval rates. This evidence is moreover consistent with the results of the survey on the access to finance of firms conducted by the ECB on the basis of a sample of European companies. In particular, since the end of 2013, Spanish SMEs have reported an improvement in their perception of access to credit, a signal which is consistent with that from the Bank Lending Survey.

4. Policy considerations on SME's financing

Allow me to say now a few words on policy considerations regarding the specific case of small firms' financing. Undoubtedly, the crisis has been a painful reminder for us that the access of SMEs to finance may deteriorate suddenly and sharply in periods of high uncertainty.

Financial institutions, such as those represented here, with a mandate to promote access to financing for SMEs, can make an important contribution in this field. In any case, it is also necessary to study ways to tackle directly the asymmetric information problems faced by these firms. This in turn requires enhancing the quality and quantity of information available on both the credit track record and the financial situation of companies. In this regard, it is worth mentioning a new regulation recently approved in Spain that obliges banks, under certain conditions, to pre-announce three months in advance should they decide not to roll over existing credit lines or loans at maturity. Also, in those cases banks are obliged to provide relevant information on the credit profile of their customers whose loans are not rolled over. The Banco de España, in response to the mandate conferred to it under this new regulation, is currently working on a Circular, which will specify the relevant information to be

provided to the SMEs in these circumstances, together with a methodology to produce a standardised report on the SME credit assessment.

Other actions that could also help mitigate the possible frictions in the credit market during crisis periods include those facilitating debt restructuring by improving the bankruptcy legislation. These measures, if well-designed, could help to smooth the reallocation of resources from non-viable firms to viable and productive firms. Spain has recently introduced various reforms to improve the effectiveness of bankruptcy procedures, though it is still too early to appreciate in full what additional reforms are needed to further improve those procedures.

At the European level, I also welcome the Action Plan on Building a Capital Markets Union recently approved by the European Commission. This project envisages some measures to overcome information barriers that could inhibit SME lending. That includes, following the Spanish example, the strengthening of the feedback given by banks declining SME applications and the promotion of systems facilitating the availability for investors of comprehensive information on SMEs.

Moreover, the Action Plan also foresees actions to reactivate securitisations markets. Let me stress the importance of this specific set of measures.

For smaller firms, for which direct access to markets is not feasible due to problems of scale, bank credit will remain the predominant financing source. Therefore, an adequate availability of funds for SMEs requires banks to have sufficient means and capacity to properly conduct their intermediation activity. In that regard, the development of the securitisation markets seems a promising avenue to facilitate credit risk management by banks and, therefore, to support lending. Indeed, securitisation markets activity was seriously impaired after the subprime crisis due to the stigma attached to any kind of asset-backed securities, and the lack of recognition by investors and regulators of the specific quality of each product. To address some of these problems, the European Commission has recently published an interesting proposal for amending the European regulation on prudential requirements for credit institutions and investment firms that introduces a differentiated treatment for high quality securitisations that meet stringent standards in terms of simplicity, transparency and standardization.

5. Concluding remarks

Let me now conclude by highlighting what I think are the main lessons drawn from the recent crisis in connection with credit developments. First, it seems clear that given the large financial imbalances that emerged during the expansionary years, a protracted contraction in credit demand seems not only unavoidable but also positive to restore the ability of the economy to grow on a sustainable basis. Yet there is little doubt that frictions on the supply side amplified the contractionary effects of weak demand and that those frictions merit bold policy attention.

In any case, policy interventions aimed at revitalising credit during a crisis should be carefully designed and calibrated, duly taking into account that credit flows should not be expected to fully recover until lenders' and borrowers' balance sheets are on sufficiently firm ground.

In the case of Spain, some of the main constraints affecting credit developments for most of the recent crisis have abated considerably as a result of the improvement in the macroeconomic outlook, the bold banking sector reform and the introduction of various measures at both the national and European level.

These positive developments, however, should not be taken as conclusive evidence that the task is complete and that all relevant risks have been dispelled. Rather, the consolidation of the recent positive signals in the macroeconomic and financial spheres requires resolve to complete the reforms still pending on various relevant fronts. This should, in my opinion, be

the main priority in seeking to enhance economic growth prospects on a sustainable basis and to mitigate the volatility of the financial and economic cycles.

Thank you very much for your attention.