Euler Hermes Economic Research

Economic Insight

The eurozone needs a credit policy

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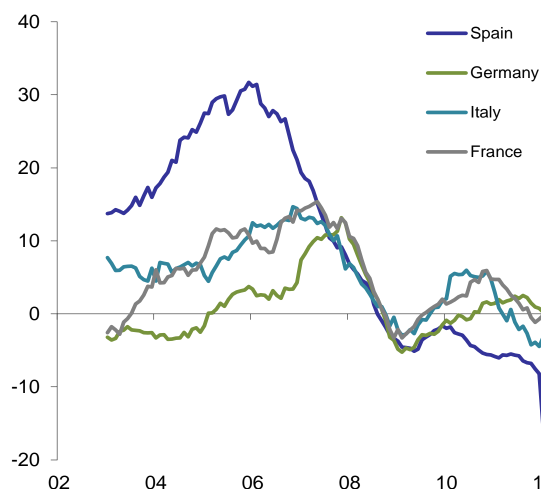
In summary

- The stock of credit to non-financial companies in the eurozone is at its lowest level since early 2008. Why? (i) anemic supply due to the rise in non-performing loans and banks' conservative strategy; (ii) flagging demand, undermined by the gloomy business climate; and (iii) cost of credit, reflecting dysfunctional monetary policy transmission.
- The risk of a credit crunch affects in particular SMEs, which form the heart of Europe's economic fabric. Bank credit is the source of funding for their investment spending. Restoring the credit channel would bring the recovery forward by several quarters.
- There is an increasing number of initiatives (EUR 180 billion EIB capital increase; easing of collateral requirements by the ECB, in particular on ABS). The European Commission and the EIB have even proposed contributing EUR 100 billion to 1 million SMEs via the securitization of loans to SMEs and risk pooling.
- Ultimately, the eurozone clearly needs a credit policy to make its monetary policy effective and draw up its industrial policy. It would add to the banking union, the fiscal union, and the political and institutional union, still under development.

The stock of credit to companies in the eurozone is at its lowest since early 2008

In June 2013, the contraction in lending to non-financial companies (NFC) gathered pace (-5.1% y/y), reducing the stock of credit in the eurozone to its lowest level since February 2008. With the exception of the Netherlands (+3.3%) and Belgium (+2.7%), this fall is widespread, and is more pronounced and has been longer-lasting in the Southern European countries. It has been ongoing for more than three years in Spain (-20% y/y) and Ireland (-5.6% y/y), for two years (or more) in Portugal (-5.3% y/y) and Greece (-6.7% y/y) and for a little over one year in Italy (-5.1% y/y) – see Chart 1. In addition, in the past few months, the core eurozone countries such as Germany (-0.9% y/y) and France (-1.1% y/y) have no longer been spared from this phenomenon.

Chart 1 : Credit to non-financial corporations (y/y, %)



Sources: ECB, Euler Hermes

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Moreover, borrowing conditions were more favorable for companies than households between 2007 and 2009, while this trend began to gradually reverse in 2009 (see Chart 2). It is now companies that are being offered the less favorable lending conditions.

Supply, demand, cost: factors blocking the credit channel

First, credit supply is limited for two reasons: (i) the impact of the crisis on banks' profitability; (ii) the rise in non-performing loans since 2008 in European banks' loan portfolios, in particular given the tightening of regulatory capital requirements for banks. Thus, the countries with record levels of non-performing loans, such as Portugal (15%), Spain (11%) and Italy (9%), are also those where lending has contracted the most.

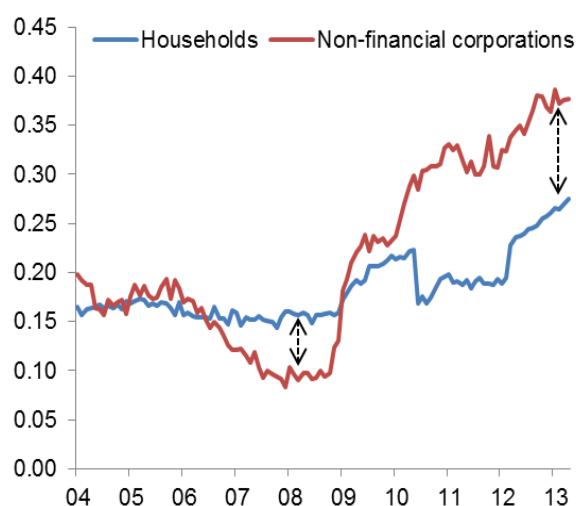
Second, weakened household spending (high unemployment, decline in purchasing power) and the gloomy business climate are weighing on companies' willingness to invest and therefore on demand for credit.

Third, lending conditions remain highly unfavorable in the eurozone (in particular in the Southern European countries) compared with the United States and the United Kingdom, with an ever-widening gap in borrowing conditions for companies, as interest rate spreads on loans are not only linked to borrower creditworthiness but also to geographical location (see Chart 3). In fact, in May 2013, bank financing was approximately 100bp more expensive (i.e. 3.5% on average) for Spanish and Italian NFCs than for their French or German counterparts. This is mainly due to Europe's dysfunctional monetary policy (see Chart 4): the spread between the interest rate on bank loans to eurozone NFCs and the ECB's key interest rate, for example, doubled between 2007 and 2013 (i.e. a spread of around 250bp in 2013).

SMEs are the most affected by the financing shortage

SMEs form the heart of Europe's economic fabric, accounting for 99.8% of all European companies (i.e. around 20 million companies), 67% of private-sector employment and 58% of value added (i.e. 40% in the manufacturing and trade sectors and more than 60% for the construction sector) – see Charts 5 and 6. At the European level, SMEs account for a higher proportion of all companies in the Southern Europe than elsewhere in the eurozone, while it is precisely in these countries that companies are having the most difficulty obtaining financing.

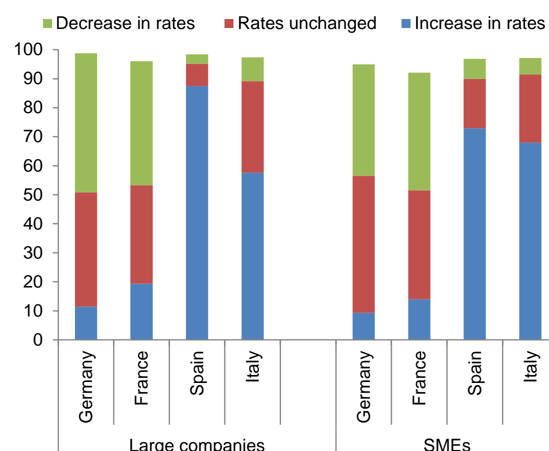
Chart 2: Divergence between interest rates on bank loans to households vs. NFCs



NB: The dispersion coefficient is calculated using the interest rates on bank loans to households/non-financial corporations in Germany, France, Italy, Spain, Portugal, Ireland and Greece.

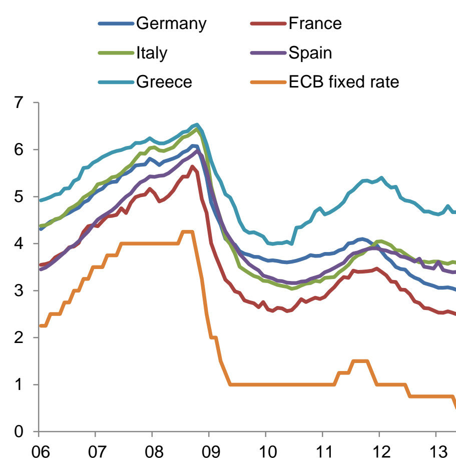
Sources: Eurostat, Euler Hermes

Chart 3: Diverging financing conditions across the eurozone



Sources: ECB, Survey on the access to finance of SMEs in the euro area (SAFE), October 2012 - March 2013

Chart 4 : Evolution of the average interest rate on bank loans to NFCs and ECB key rate (%)



Sources: ECB, Bloomberg, Euler Hermes

Since the crisis, financing problems have remained at the center of concerns for business leaders, in particular those of SMEs and, especially, in Southern Europe (see Chart 7). While the credit crunch affects all companies, large companies enjoy more favorable lending conditions. Between 2008 and 2012, the spread between the average interest rates paid by SMEs and large enterprises doubled, and is now at more than 150bp (see Chart 8). This divergence is more pronounced in Spain due to the banking crisis, as this spread has quadrupled since 2008 and exceeded 250bp in April 2013.

This is all the more worrying in that the investment cycle is mostly financed by bank credit. In the absence of any momentum in business investment, there will be no lasting recovery in eurozone growth.

The first measures to spur investment are taking shape

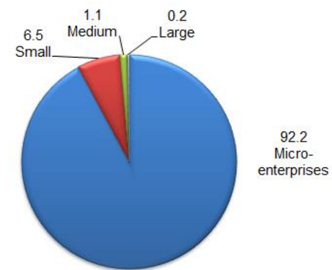
There is an increasing number of initiatives in European countries to kick-start the credit market, as illustrated by the number of public banks to support private market capacities such as the KfW in Germany or the Public Investment Bank (BPI) in France. Credit funds, in partnership with governments, which would guarantee SME bond issues, are among other alternative solutions put forward in Italy and France.

At the European level, the European Council has confirmed the EUR 10 billion capital increase of the European Investment Bank (EIB), which will strengthen its capital and therefore give an additional lending capacity of EUR 60 billion over the period 2013-2015. Added to the European Budget funds and the participation of Member States and national banks, this is expected to pave the way for around EUR 180 billion in additional investments in Europe (i.e. 1.4% of EU-27 GDP and nearly 8% of total investment), of which EUR 40 billion would be earmarked exclusively for financing SMEs.

The ECB, meanwhile, will ease its collateral rules on ABS in the coming months. This should help banks raise more funding from the ECB, in particular those in Southern Europe (see Chart 9). However, no measure is in place to encourage them to lend more to companies. A program like the Funding for Lending Scheme in the United Kingdom, which makes central bank funding conditional on an increase in loan portfolios (unlike the LTRO), would be desirable.

In late June, the European Commission and the EIB presented an initiative to encourage banks to grant loans to SMEs, but also to attract the private sector in large SME loan pools. The three tools aim to boost lending activity by securitizing new and existing loans to SMEs with an eye to

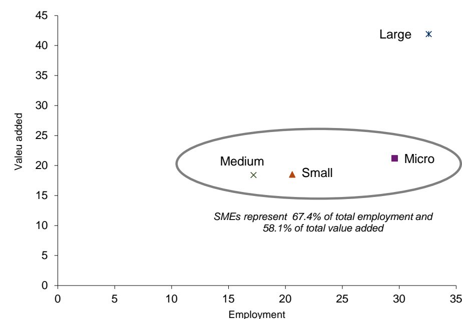
Chart 5: Breakdown of non-financial corporations by size (% of total)



NB: Micro-enterprises: less than 10 employees, small businesses: between 10 and 49 employees and medium-sized enterprises: between 50 and 249 employees.

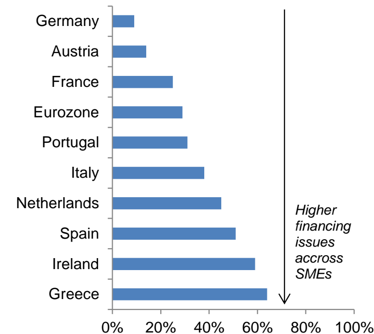
Source: Annual Report on small and medium-sized enterprises in the EU, 2011-12

Chart 6: Employment and value added



Source: Annual Report on small and medium-sized enterprises in the EU, 2011-12

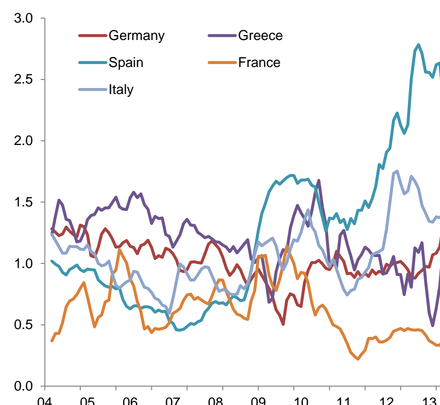
Chart 7: The obstacles to financing access*



*NB: *Indicator elaborated by the ECB as the sum of the (1) % of SMEs which have faced a loan application rejection; the (2) % of SMEs which have received less than their requested funding; the (3) % of SMEs which have abandoned the loan application process because of high costs and the (4) % of SMEs which have not applied because of the fear of a loan rejection.*

Sources: ECB, Survey on the access to finance of SMEs in the euro area (SAFE), October 2012 - March 2013

Chart 8: Spreads between bank lending rates to SMEs and larger NFCs (%, quarterly moving average)



Sources: Eurostat, Euler Hermes

helping banks' raise financing from the ECB (by pledging these securities as collateral or by selling them to the private sector).

More details on the terms governing the use of these new tools as well as their possible impacts will be specified during the European Summit in October 2013. They are expected to be implemented in 2014, once the ECB assumes its role as single eurozone banking supervisor (SSM) early in the fall.

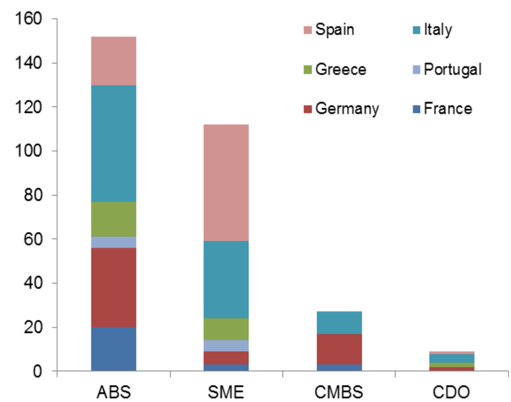
Focus: The three instruments of the European Commission and EIB joint initiative

- EIB and European Commission guarantees for (i) new bank loans to SMEs; (ii) portfolios of new loans to SMEs for securitisation in the two to three years following the creation of new portfolios. In exchange for loans granted to SMEs, banks will benefit from a partial easing of capital requirements. **Between EUR 55 and 58 billion (i.e. 2.4% of total investment in the EU-27) in loans could be granted to 580,000 SMEs (i.e. 2.8% of all SMEs in the EU).**

- EIB and European Commission guarantees allowing for the securitisation of new and existing portfolios of loans to SMEs. More specifically, this option would allow for guarantees for series of loans (new and/or existing) to SMEs and an easing of banks' capital requirements, while banks will not have to raise new capital to create new loans. **Around EUR 65 billion (i.e. 3.0% of total investment in the EU-27) in loans could be granted to 650,000 SMEs (i.e. 3% of all SMEs in the EU).**

- EIB and European Commission guarantees allowing for the securitisation of new and existing portfolios of loans to SMEs but also the pooling of risk between loan intermediaries (banks, Member States, private investors). This option will benefit banks by an immediate easing of capital requirements and additional liquidity. **Around EUR 100 billion (i.e. 4.4% of total investment in the EU-27) in loans could be granted to 1 million SMEs (i.e. 5% of all SMEs in the EU).**

Chart 9: Securitisation markets by country (Q1 2013, EURbn); Total securitisation market: EUR 1.6 tn in the eurozone vs. EUR 6.7 tn in the United States



NB: ABS = Asset Backed Securities; SME = Securities backed by Small and Medium Sized Enterprises; CMBS = Commercial Mortgage Backed Securities; CDO = Collateralized Debt Obligations

Sources: Bruegel, Euler Hermes

Chart 10: Joint European Commission-EIB initiatives aiming at increasing lending to the economy

1 — **Securitisation of new SME loan portofolios**

EUR 55-58 bn in SME lending supported (2.4% of EU-27 investment), benefiting 580,000 SMEs

2 — **Securitisation of both new and existing SME loan portfolios**

EUR 65 bn in SME lending supported (3.0% of total EU-27 investment), benefiting 650,000 SMEs

3 — **Securitisation of new and existing SME loan portfolios + risk pooling**

EUR 100 bn in SME lending supported (4.4% of EU-27 investment), benefiting 1 million SMEs

Sources: Joint Commission-EIB report (2013), Euler Hermes

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