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COVID-19: Bank credit conditions and monetary policy

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COVID-19: Bank credit conditions and monetary policy[1]

The Bank Lending Survey indicates that credit conditions remained relatively stable in the first quarter of 2020, but changes are coming. On the supply side, banks expect to tighten lending criteria in the second quarter of the year. Credit demand from households is expected to weaken substantially. Banks expect increased demand for short-term loans from firms, but less demand for long-term loans, reflecting liquidity needs of businesses and the downturn in investment prospects. Banks expect that monetary policy measures, that provide liquidity support and ease financing conditions, will support their balance sheets, which can help stabilise credit supply to the real economy.

Introduction

It is clear that the COVID-19 pandemic is having a significant impact on the economy, but hard data fully quantifying the effects are only available at a lag. In this context, surveys can be a useful and timely source of information on the effects of the shock and on what we can expect in the coming months. In this Letter, we examine the results of the Bank Lending Survey (BLS), which is carried out by the Central Bank of Ireland on a quarterly basis. The most recent BLS was carried out between March 19 and April 3 and banks were asked about changes in credit market conditions in the first quarter of the year and their expectations for the second quarter. As the pandemic only intensified towards the end of the first quarter, banks' expectations for the second quarter will more fully reflect the effects of the virus on the credit market. We use these results as a preliminary indication of the impact of this crisis on the banking sector and on credit conditions for both firms and households.

As a response to the pandemic, the Governing Council of the European Central Bank (ECB)[2] has taken a number of monetary policy decisions to safeguard liquidity and to protect financing conditions for all sectors in the economy. In March, liquidity support to banks was increased via targeted longer-term refinancing operations (TLTROs). These operations incentivise lending to firms and households as the interest rate paid by banks depends upon their lending activity.[3] In addition, a new Pandemic Emergency Purchase Programme (PEPP) was introduced, wherein €750 billion worth

[1] The authors are grateful for helpful comments from Gillian Phelan, Robert Kelly, Reamonn Lydon and Gerard O'Reilly on an earlier draft of this Letter.

[2] This comprises the governors of the euro area National Central Banks, including the Central Bank of Ireland, and the Executive Board of the ECB.

[3] The Governing Council decided to introduce additional longer-term refinancing operations, called pandemic emergency longer-term refinancing operations (PELTROs). Unlike the TLTROs, these operations are unconditional and their objective is to preserve the smooth functioning of money markets by providing an effective liquidity backstop. However, this was only announced on April 30, which falls outside the period of consideration for the most recent BLS.

of assets will be purchased until the end of the year to ease financing conditions and to prevent fragmentation across the euro area. This programme is in addition to €120 billion in additional purchases that were announced as part of the Asset Purchase Programme (APP) earlier in March.[4] The BLS reports how banks expect to be affected by these measures in the coming months.

The survey results for Ireland show that credit standards, i.e. banks' decision criteria for granting loans, tightened only marginally for loans to enterprises and remained unchanged for households in the first quarter of the year. Irish banks expect to tighten their credit standards for all categories of lending in the second quarter of the year, particularly for loans to households. Banks reported that changes in the economic outlook and concerns about borrowers' creditworthiness are contributing to a tightening in credit standards.

On the demand side, banks reported that credit demand from enterprises fell slightly in the first quarter, driven particularly by less demand for long-term borrowing. Banks expect firms' credit demand for short-term loans to increase in the second quarter of 2020 and they expect a further decrease in demand for long-term loans. For households, banks expect demand for loans to decrease dramatically in the next quarter. The Central Bank of Ireland's daily Central Credit Register data corroborate these findings.[5]

Finally, we show evidence that the APP and PEPP are expected to have positive effects on Irish banks' liquidity, market financing conditions and their profitability. An increasing share of Irish banks expects to take part in the Eurosystem's TLTRO programme over the next two quarters. It is likely that this reflects the Governing Council's decision to make the terms of the lending to banks more attractive. Irish banks expect the TLTRO to help their profitability, liquidity positions and ability to meet their regulatory requirements.[6]

In the remainder of this Letter, we provide an overview of the BLS and then explore how credit supply and demand conditions have reportedly changed, or are expected to change, in light of the pandemic. Finally, we report on how the monetary policy response to the crisis is expected to impact banks.

Overview of the Bank Lending Survey

The BLS has been conducted on a quarterly basis since 2003 by the Eurosystem (i.e., the euro area National Central Banks (NCBs) and the European Central Bank). Each NCB contacts a representative sample of

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[4] For full details on these announcements, see Holton et al (2020).

[5] See Behind the Data: Has demand for new loans changed during the COVID-19 crisis? By Rory McElligott, Martina Sherman and Maria Woods, May 2020.

[6] On April 30, after the conclusion of the survey, the Governing Council further lowered the interest rates on the TLTRO.

banks within its country for information on both credit supply and demand.[7] This supplements the information on credit market conditions available via banks' monthly balance sheet returns. The main part of the survey provides information on changes in credit standards, terms and conditions and loan demand for enterprises and households. The survey also contains ad-hoc questions on topical issues, such as the effect of monetary policy measures on banks.

The BLS is a leading indicator of euro area bank credit flows, particularly to businesses, and of real GDP growth (de Bondt et al., 2010). It explains credit flows even after controlling for the information included in financial variables, thereby providing qualitative information not available through other means. The survey facilitates disentangling supply effects from demand effects in credit flows. Kok and Hempell (2010) use the survey to capture how the negative impact of the financial crisis on banks' balance sheets affected lending via credit supply, controlling for credit demand. The survey is also useful for examining differences between banks. Altavilla et al. (2018) use the BLS to show that banks' credit supply increases, the greater their exposure to monetary policy measures (in this case to the APP and negative deposit facility rate).

The survey is a useful complement to actual data on loan flows as it is forward looking, timely and available before hard data on lending activity. Therefore, it can indicate changes in credit conditions before they manifest themselves in lending data. Pre-committed credit lines mean that credit flows may not accurately reflect credit standards and changes in supply at the margin. For instance, overall loan flows could increase even as banks try to decrease the supply of credit, as firms draw down pre-agreed credit lines in anticipation of tight credit conditions in the future.[8] Moreover, it not only captures whether there have been changes in credit standards and demand, but it also outlines the reasons given by banks for the changes in each. This is particularly useful for monetary policy makers as the source of a shock can determine the appropriate response. If there is a tightening in credit standards that is owing to problems with banks' liquidity, the necessary policy response will be very different than if the change is owing to concerns regarding borrowers' credit worthiness.

Credit supply and demand

Credit Supply

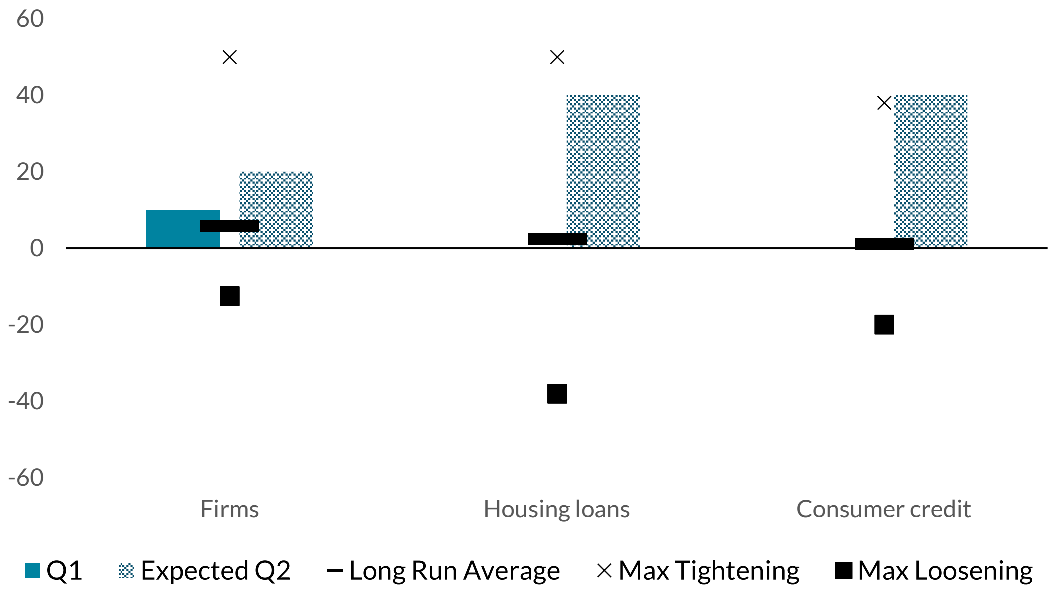
Banks tightened credit standards on loans to firms marginally in the first quarter of 2020, albeit at a rate not much in excess of the long run average for the series (Figure 1).[9] There was no reported change in credit standards

[7] For a detailed discussion of the survey, see Mottiar and Monks (2007).
[8] This phenomenon was observed in the US in the wake of the Lehman Brothers collapse where a spike in commercial and industrial loans was reported on banks' balance sheets (Ivashina and Scharfstein, 2010) and in the euro area (Carpenter, Demiralp, and Eisenschmidt. 2013).
[9] It is well documented that the BLS tends to show a tightening bias and this is common across jurisdictions (Scopel et al., 2016).

on loans to households for either mortgage or consumer credit. These relatively stable credit conditions reflect that the period under question also includes the time before the pandemic.

More notable are the changes in their credit standards that banks expect to implement in the second quarter of the year, the first quarter fully incorporating the outbreak in Ireland. Banks expect credit standards on loans to firms to tighten somewhat, though the expected changes are substantially less than the tightening observed during the height of the financial crisis over a decade ago.[10] For households, banks expect a more substantial tightening in credit standards, close to levels observed at the height of the financial crisis (see Figure 1).

Figure 1: Changes in credit standards on loans by Irish banks



Notes: Axis shows a diffusion index indicating responses to questions regarding the change in credit standards, where a positive value is a net tightening and a negative is a net loosening. In each case, the diffusion index takes on a value between -100 and 100, with -100 indicating that all banks reported a significant loosening, and 100 indicating all banks reported a significant tightening of credit conditions. Results are for the first quarter of 2020 and expectations for the second quarter of 2020.

The BLS examines four broad categories of factors that affect credit standards on loans to firms: banks' cost of funds and balance sheet situation, competition from other sources, their perceptions of credit risk and their tolerance for risk. So far, the only factor that has contributed to a change in credit standards is relating to banks' risk perceptions. Specifically, banks reported that concerns about the general economic situation and borrowers' creditworthiness are contributing to a tightening of credit standards. Thus far, there have been no changes in how banks'

[10] The maximum tightening of credit standards on lending to businesses (shown in the chart) occurred in the third quarter of 2008.

balance sheet situation, risk tolerance or competition are affecting credit standards.[11]

While issues with banks' balance sheets may arise over the coming quarters, the BLS supports other data sources that indicate that banks are in a better situation today than they were at the onset of the financial crisis more than a decade ago. During the previous crisis, banks reported that deteriorating liquidity, market financing and capital positions were strongly affecting their credit standards. So far, banks have reported no change in these factors, indicating also that swift monetary policy action has been so far successful in supporting banks. Overall, the results of the survey for Ireland are similar to those for the euro area, where concern about the economic situation is the most relevant factor affecting banks' credit standards.[12]

These results highlight the need for policies that help preserve the credit worthiness of borrowers and policies that support banks' liquidity and balance sheet quality, to ensure that banks do not engage in excessive pro-cyclical credit tightening.

Credit Demand

In the first quarter of 2020, banks reported a slight fall in demand for loans from firms (in line with the series average in the long run), a modest increase in demand for housing loans and no change in demand for consumer credit (Figure 2). The decline in loan demand from firms is driven by longer-term loans. The increase in demand reported for housing loans probably reflects the state of the housing market early in the first quarter of 2020. In response to a special auxiliary questionnaire on COVID-19, some banks noted a decrease in loan applications towards the end of the quarter.

Most noteworthy in the survey are the changes in demand expected by banks in the second quarter of 2020. Irish banks expect the biggest ever decrease in demand for loans for house purchase and for consumer credit, reflecting the major impact of the public health crisis on households and on consumer behaviour. This suggests that household credit demand will fall by even more in this crisis than it did at height of the financial crisis. Demand for credit from firms is expected to increase slightly in the second quarter of the year. This overall relatively small change masks larger offsetting movements, as demand for short-term credit is expected to increase and demand for longer-term credit is expected to decrease substantially.

The divergent pattern in short- and long-term demand reflects firms' increased needs for working capital or other short-term credit, rather than

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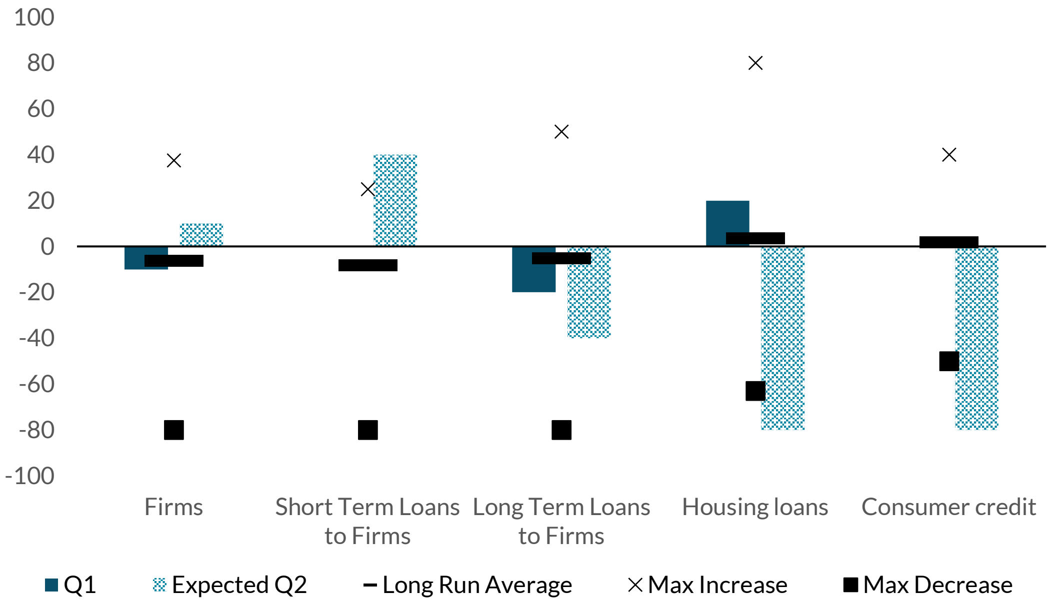
[11] The full results of the BLS for Ireland are available from the Central Bank of Ireland website.
[12] See "The euro area bank lending survey – First quarter of 2020" for further details.

funding for longer-term investment. The factors reported by banks that have driven changes in credit demand in the first quarter confirm this: an increased need for inventories and working capital and a decreased need for funding for mergers and acquisitions or fixed investment.

The responses in the BLS also correspond to other indicators of credit developments. Credit applications data show that demand from individuals decreased substantially since the middle of March, while demand for credit from firms has increased in particular for overdrafts.[13] In contrast to Ireland, euro area banks in total reported an increase in demand in the first quarter, though developments in the factors driving demand are similar in Ireland and the euro area (increased needs for inventories and working capital and decreased needs for fixed investment). Similar to the results for Ireland, euro area banks as a whole expect an increase in demand for credit from firms in the second quarter and a significant drop in demand from households.

Figure 2: Changes in demand for loans from Irish banks



Notes: Axis shows a diffusion index indicating responses to questions regarding the change in demand for loans, where a positive value is an increase in demand and a negative value is a fall in demand. In each case the diffusion index takes on a value between -100 and 100, with -100 indicating that all banks reported a significant fall in demand, and 100 indicating all banks reported a significant increase in demand. Results are for the first quarter of 2020 and expectations for the second quarter of 2020.

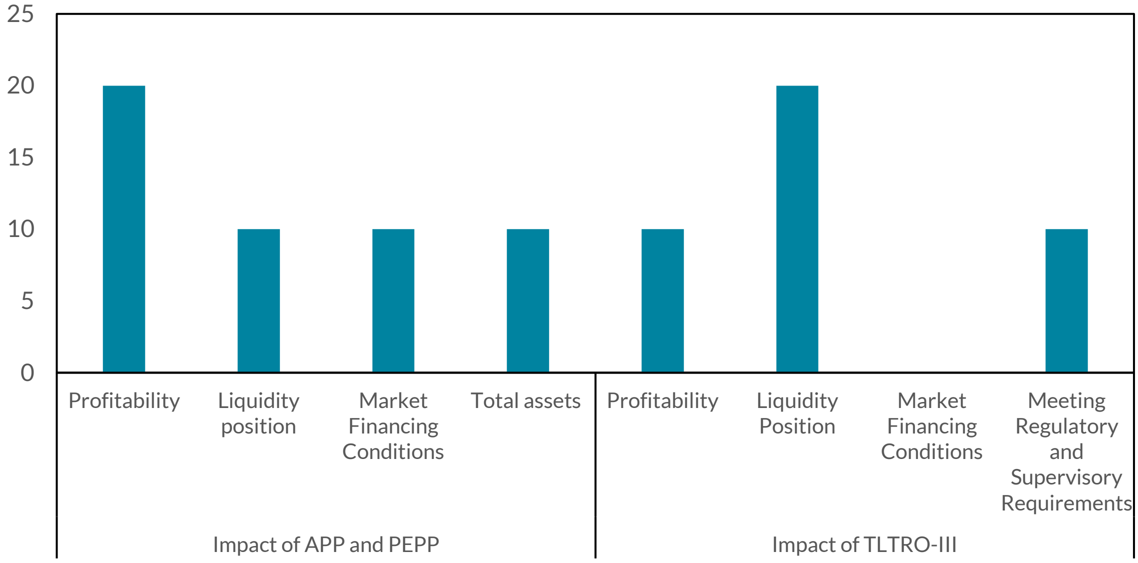
Effect of monetary policy measures

The Governing Council of the ECB has taken a number of monetary policy decisions to mitigate the effects of the pandemic by providing liquidity to

[13] See Behind the Data: Has demand for new loans changed during the COVID-19 crisis? By Rory McElligott, Martina Sherman and Maria Woods, May 2020.

banks and supporting financing conditions. As outlined in the introduction, these include making the terms of the TLTRO programme more favourable and expanding asset purchases. The BLS this quarter asked banks about the impact of these policies. In this section, we focus on banks' responses regarding the expected impact of these policies on their balance sheets over the next six months.[14]

Figure 3: Expected effect of APP, PEPP and TLTRO on Irish banks



Notes: Axis shows a diffusion index indicating responses to questions regarding the impact of APP and PEPP over the next six months (April to September 2020). Positive values indicate a positive impact, and negative values a negative impact. Scale is between -100 and 100.

Focusing first on the effects of the APP and PEPP, Figure 3 shows that banks expect the purchases to improve their liquidity and market financing conditions. The portfolio rebalancing channel of asset purchases compresses yields across a wide range of asset classes, thus improving market funding conditions (lowering yields) on bank bonds among other assets. The purchases are also expected to support banks' total assets and so will prevent deleveraging. In particular, banks expect that the programme will support their profitability. The ECB asked banks not to pay dividends or buy back shares during the pandemic and therefore such profits will instead be used to boost their capacity to absorb losses and support lending to households, small businesses and corporates.[15]

The Governing Council has lowered the interest rates on TLTRO funding at meetings in March and April 2020.[16] The BLS was conducted after the first

[14] These changes in monetary policy were made towards the end of the quarter and the first TLTRO operation that reflects the changes will only take place in June this year. Therefore, focusing on the effects in the previous six months is not relevant to the decisions.

[15] For more details, please see ECB Press Release "ECB asks banks not to pay dividends until at least October 2020".

[16] Following the April Governing Council meeting, the starting interest rate for TLTRO is now 0.5% below the average rate on main refinancing operations, which is currently 0%. If banks lend enough to firms and

meeting at which the terms were made more favourable. Irish banks can access substantial volumes of liquidity via this programme and in the most recent survey, 60% of banks in the Irish sample indicated that they would take up funding in upcoming rounds of the TLTRO programme, while 40% remained unsure. Figure 3 shows that Irish banks expect a large improvement in their liquidity positions due to the operation and they expect that it will improve their profitability and their ability to meet regulatory requirements.

Conclusion

Evidence from the BLS shows that COVID-19 had a limited impact on credit conditions during the first quarter of the year. Banks tightened their credit conditions somewhat due to a perceived increase in the riskiness of lending. In this context, credit guarantee schemes could play a role in offsetting the increase in banks' perceptions of credit risk among their borrowers, through loss sharing in the event of a default.[17] Importantly, however, banks have so far reported no changes in their credit standards due to a deterioration in their balance sheets or in their cost of funds.

Banks expect a record fall in demand for credit from households in the second quarter. Their expectations for credit demand from businesses are mixed. They expect demand for short-term loans to increase (reflecting higher working capital and inventory needs) and demand for longer-term credit to decrease (reflecting lower investment). These findings are corroborated by credit applications data that show sharp declines in individuals' credit demand since mid-March and increases in demand for overdraft facilities from firms.

Banks expect the recent monetary policy decisions by the Governing Council of the ECB to have positive effects on their balance sheets. These measures can support banks' liquidity, capital and financing conditions and therefore could help mitigate severe credit constraints on households and firms that can arise due to stress on banks' balance sheets, like those experienced in the last financial crisis in Ireland. The BLS will continue to be an important and timely indicator for credit conditions as the effects of the pandemic unfold.

consumers, the interest rate can be as low as 0.5% below the average DFR, which is currently -0.5%. Banks can borrow up to 50% of their stock of their loans to firms and consumers.

[17] See McGeever, McQuinn and Myers (2020) for a discussion of credit guarantee schemes.

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