Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Box B: QB 1 – March 2024

This Box content is extracted from the Quarterly Bulletin – Q1 2024

How have rising interest rates affected businesses' credit dynamics?

By Tom Keogan and Cormac O'Sullivan[1]

Summary

Rising interest rates have significantly increased the cost of credit, leading to a general decline in new lending to business. However, lending to SMEs has proven to be resilient to monetary policy changes, partially due to the substantial deleveraging that has occurred since the Global Financial Crisis which has reduced reliance on bank debt by SMEs. Nevertheless, certain sectors such as Construction and Real Estate have seen significant declines in the drawdown of new credit, possibly reflecting sector-specific factors. Increasingly, SMEs are utilising alternative forms of financing such as revolving credit and overdraft facilities. On the demand side, credit demand remains muted, with many SMEs preferring to rely on internal funding.

Cost of Credit

The cost of credit facing Irish firms has risen markedly in response to ECB monetary policy changes, with interest rates on new business loans having increased by 302 basis points to 5.69 per cent since the ECB began raising rates in July 2022. The pass-through of ECB rate increases to lending interest rates charged by banks has been more pronounced for businesses than for household mortgage or consumer lending

[1] Statistics Division

Table 1: Changes in interest rates, June 2022 – December 2023

	Rate June 2022	Cumulative change (bps)	Rate December 2023 (%)	Cumulative change since Q4 Quarterly Bulletin (bps)	Change in Volume of New Business (%)[2]
Deposit Facility	-0.5	450	4	-	-
Deposits					
Household overnight	0.02	10	0.12	8	2.62
Household term	0.02	271	2.73	14	506
NFC overnight	-0.11	21	0.1	-1	0.5
NFC new term	-0.22	391	3.69	-1	330
Lending					
New Mortgage	2.68	151	4.19	8	18.5
New Consumer	7.72	26	7.98	34	-15.38
New NFC	3.22	247	5.69	-15	-33.33

Source: Central Bank of Ireland Credit and Banking Statistics

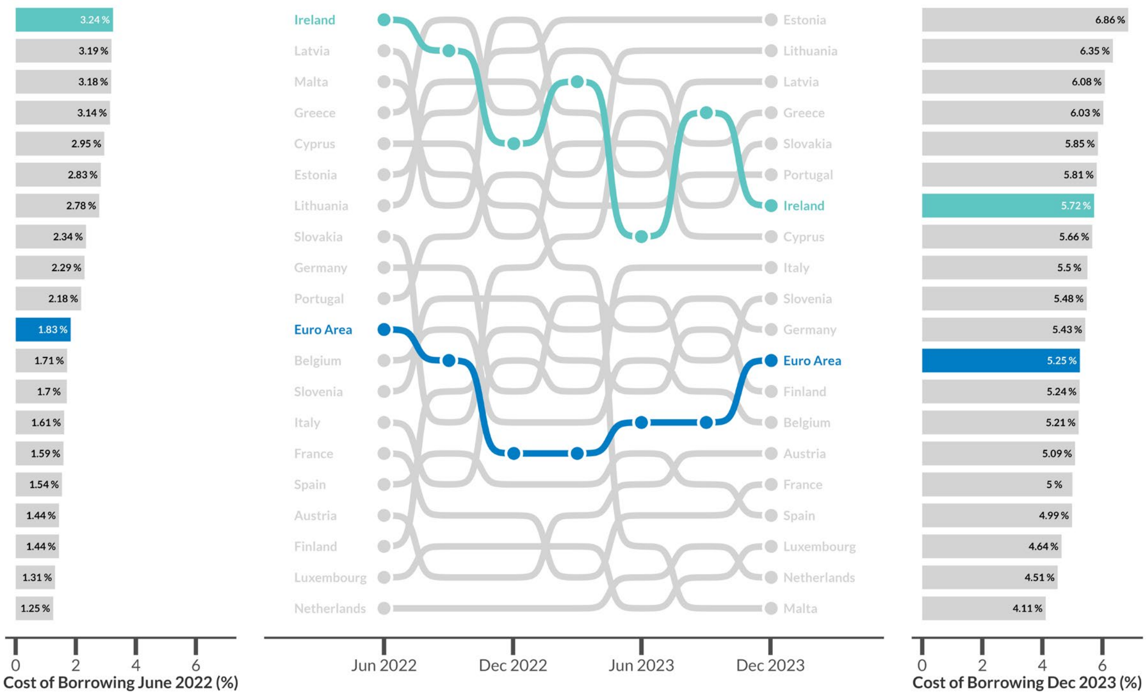
A higher cost of accessing bank credit dampens business activities such as investment and employment relative to what they otherwise might have been. However, there are factors that mitigate against the immediate impact of rate rises and increase the resilience of Irish businesses to monetary policy changes relative to the past. Notably, businesses have deleveraged substantially since the Global Financial Crisis, with lending by Irish banks to SMEs having decreased by over two-thirds since 2012. Even when lending to property-related sectors such as Construction and Real Estate is stripped out, outstanding business credit is less than half of what it was in 2012. Furthermore, the most recent Credit Demand Survey indicates that 40 per cent of Irish SMEs have no bank debt.

The cost of credit on new lending to businesses plateaued over the course of 2023, as the pace of ECB interest rate increases first slowed and then halted. In December, the weighted average interest rate on outstanding lending was 5.72 per cent, which compares with an average of 5.22 per cent for the euro area as a whole (Figure 1). While the cost of bank credit is higher for Irish businesses than the euro area average, that differential has decreased since ECB policy rates began to rise. This indicates that, on average, the rest of the euro area have seen a more pronounced pass-through of ECB monetary policy changes.

[2] Volume of new business in December 2023 compared to June 2022

Interest rates on lending to businesses are higher in Ireland, but have increased less than the euro area average

Figure 1: Ranking of the cost of borrowing for corporations across the euro area



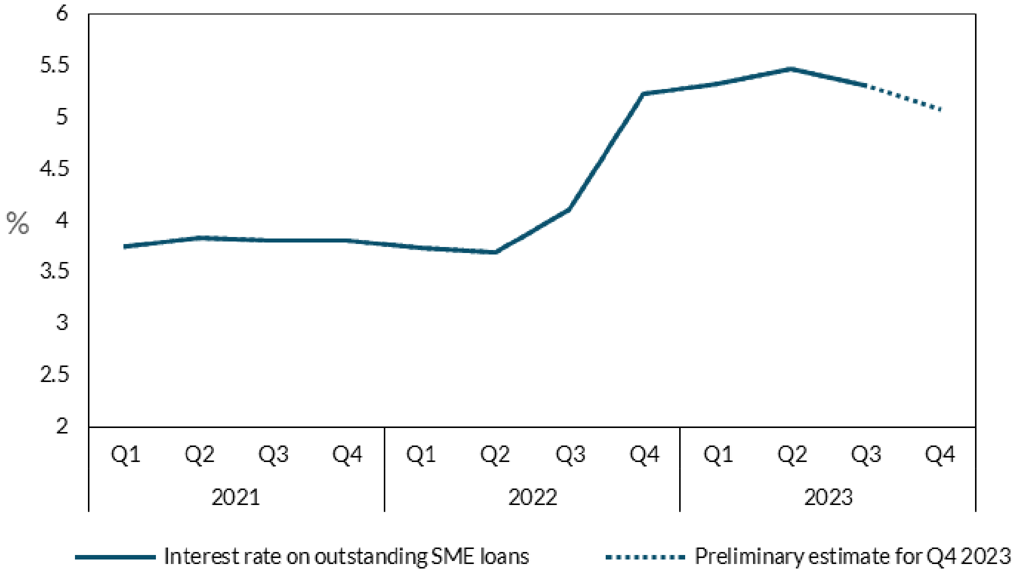
Source: European Central Bank MFI Interest Rate Statistics.

For SMEs, interest rates on outstanding lending rose by 161 basis between June 2022 and December 2023, and currently stand at an estimated 5.08 per cent (Figure 2). However, since June 2023, SME rates have also begun to level off.

The Bank Lending Survey suggests that there has been a tightening of credit standards generally, though credit standards on loans to SMEs specifically have not changed. Banks participating in the survey cited the general economic situation and outlook, as well as industry and firm specific factors, as being behind this tightening.

Interest rates on SME lending increased rapidly in the second half of last year, but have since plateaued

Figure 2: Interest rate on outstanding lending to SMEs



Source: Central Bank of Ireland Credit and Banking Statistics.
Notes: Preliminary estimate for Q4 2023 based on internal calculations using AnaCredit data.

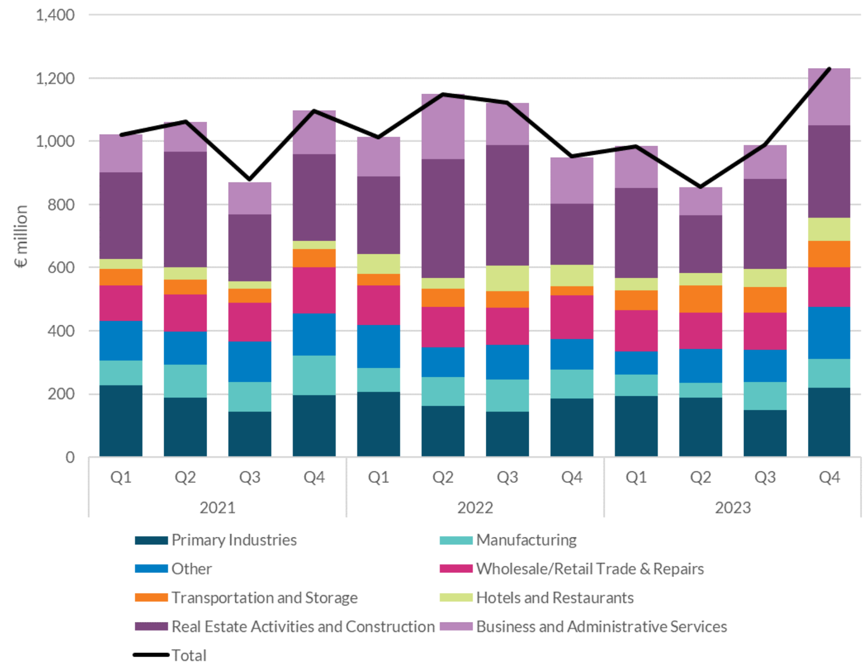
Flow of Credit

New lending to businesses, which had been trending upwards following the lifting of pandemic-related restrictions, moderated over the course of 2023 in the wake of rising interest rates (Figure 3). Cumulative new lending totalled €13.7 billion over the year, compared to €17.6 billion in 2022. Fewer loans over €1 million drove this decline, while new lending of loans of a value less than €1 million increased by 10 per cent relative to the previous year.

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Gross new lending to SMEs has proven to be resilient as interest rates have risen

Figure 3: Gross new lending by economic activity



Source: Central Bank of Ireland Credit and Banking Statistics.
Notes: Preliminary estimate for Q4 2023 based on most recent figures available at time of writing.

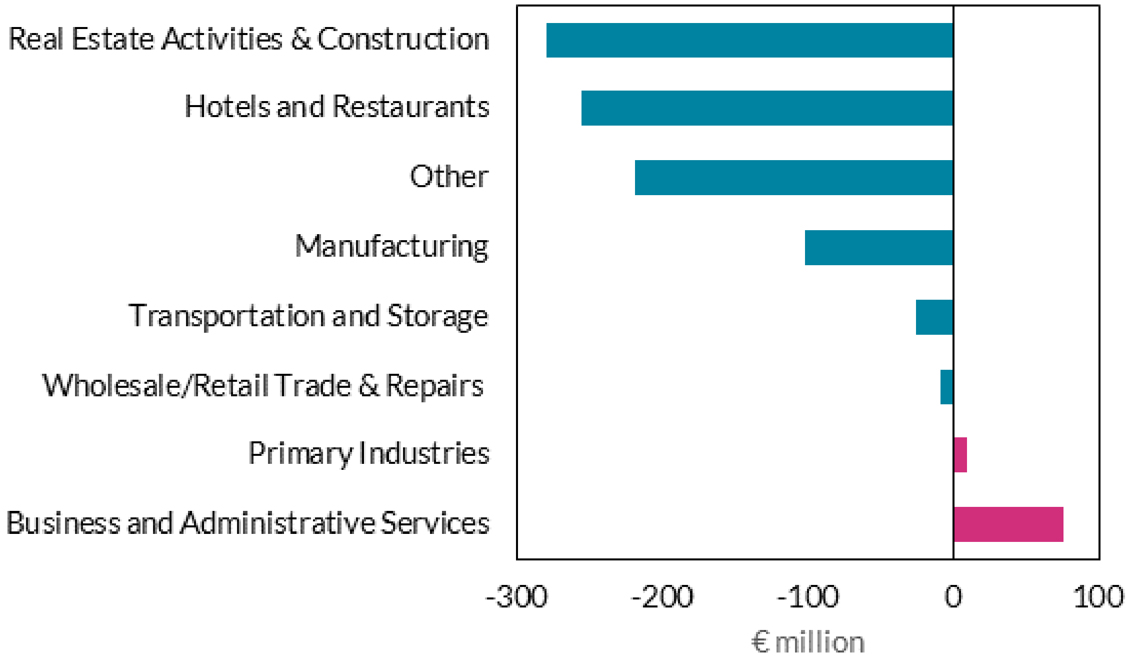
Looking at SMEs in particular, gross new lending has been less sensitive to interest rate increases. Cumulative new lending to SMEs in 2023 was €4.1 billion, compared to €4.2 billion in 2022. However, SME loan repayments exceeded drawdowns of new lending throughout 2023, such that total net lending for 2023 was -€804 million. Total outstanding lending to SMEs stood at €17.8 billion at the end of 2023 (Figure 4).

Real estate activities was the SME sector that saw the biggest decline in gross new lending in 2023. This reduction in lending is possibly related to the decrease in demand for commercial real estate space and construction following the pandemic and associated increase in home working for employees across various sectors. Combining real estate and construction activities, there was a decline of €152 million in gross new lending in 2023, relative to 2022. Net lending for real estate and construction was -€279 million for 2023.

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Net lending has decreased for most SME sectors

Figure 4: Net lending by economic activity



Source: Central Bank of Ireland Credit and Banking Statistics.
Notes: Preliminary estimate for Q4 2023 based on most recent figures available at time of writing.

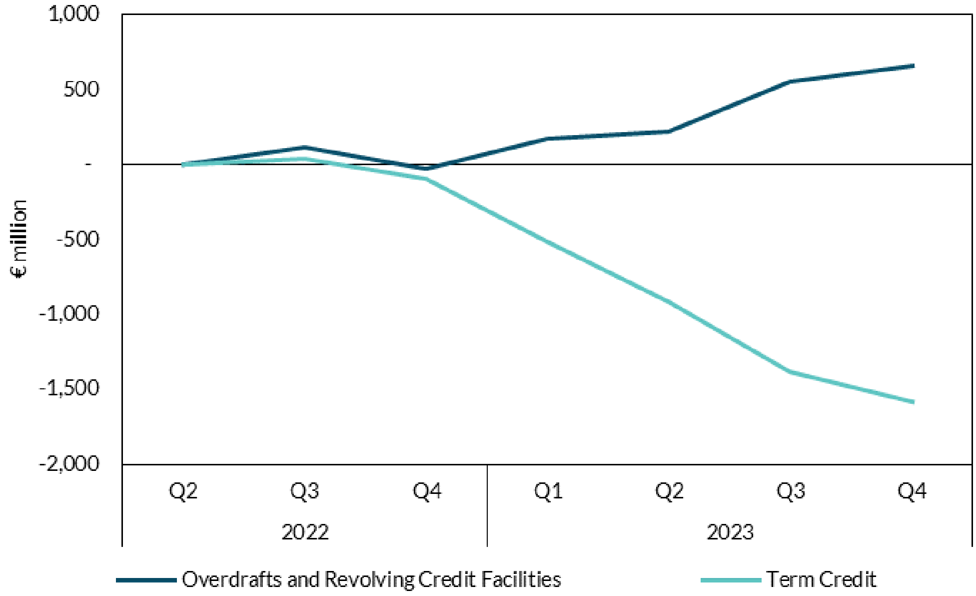
Revolving Credit Facilities and Deposits

Revolving credit and overdrafts are alternative forms of financing to traditional business loans and can be used as SME working capital. These forms of finance allow the borrower to withdraw and repay credit within a pre-approved limit during an agreed period of time. These credit facilities can be more flexible than a loan as they do not require a repayment schedule, allowing businesses to use available funds as they are needed during the agreed period. Lenders will usually charge a fixed amount for use of the facility as well as interest for funds used.

Although still a small portion of total SME lending, overdrafts and revolving loans have recently been an increasingly important source of SME funding. This funding type had declined during the pandemic, but has steadily risen in recent quarters. Total revolving credit and overdraft lending to SMEs fell from €1.4 billion in 2019 to €0.8 billion in 2020. Since Q4 2022, total lending of revolving credit and overdrafts has slowly increased back towards pre-pandemic levels, and stood at €1.5 billion at the end of 2023 (Figure 5).

Use of revolving credit and overdraft facilities by SMEs has increased as use of term credit has declined

Figure 5: Cumulative change in revolving credit facilities & overdrafts lending and transactions in term lending to SMEs since 2022 Q2



Source: Central Bank of Ireland Credit and Banking Statistics, Internal CBI calculations.
Notes: Preliminary estimate for Q4 2023 based on most recent figures available at time of writing.
Cumulative change in stocks does not account for changes due to reclassifications, revaluations or loan sales.

Accumulated deposits are another potential resource for SMEs. Between the beginning of 2021 and the end of 2022, deposits held by businesses with Irish banks increased by €17.6 billion to €73.8 billion. Over the course of 2023, deposits rose by only by €458 million, which was the smallest annual accumulation since 2012. Additionally, firms appear to have responded to increased interest rates on term deposits. Deposits with agreed maturities rose by €3.8 billion in 2023, while overnight deposits fell by €3.4 billion. Interest rates on deposits with agreed maturity of up to 2 years has increased from 0.07 per cent in July 2022 to 3.44 per cent in December 2023.

Credit Demand

In addition to the cost of credit, credit demand is also important for determining new lending. According to the Bank Lending Survey, demand for business credit increased slightly in Q4 2023, though demand from SMEs specifically has remained stable. Banks expect a further slight increase in demand for credit in Q1 2024, particularly for short term lending. Survey data from the firms' perspective, though less timely than the Bank Lending Survey, also show muted credit demand. The Credit Review found just 17 per cent of SMEs expected to borrow within the following six months, while the Department of Finance Credit Demand Survey cited a preference by the majority of SMEs for relying on internal funding rather than borrowing for investment.