II. Special topics on the euro area economy

II.1 Drivers of diverging financing conditions across Member States (15)

The dispersion both of bank lending rates to the non-financial private sector and of overall financing costs for the corporate sector has increased considerably across the euro area throughout the recent crisis period. Such divergence has occurred despite the existence of a single monetary policy implemented through the provision of liquidity to the euro area banking sector under the principle of equal treatment. It does not seem to have been significantly affected by the ECB’s new OMT programme. Available evidence suggests that greater cross-country variation in some structural characteristics of national banking systems, such as the quality of loan portfolios, profitability or the size of capital buffers, together with divergent financial positions of non-financial private sectors and sovereign funding costs, contributed to the increase in dispersion of bank lending rates at the country level.

This section analyses recent trends in the cross-country variation as regards bank lending rates for the non-financial private sector as well as in a broader composite financing cost indicator for the non-financial corporate (NFC) sector in the euro area. It also considers some potential underlying determinants of the increased cross-country divergence in financing costs, in particular possible sources of friction in monetary policy transmission.

Banking sector and monetary policy

The banking sector plays a central role in the financial system of the euro area as it channels the dominant share of funding from savers/lenders of capital to spenders/borrowers, in particular in the domestic non-financial private sector. The banking sector provides about 80% of total debt financing to the non-financial private sector in the euro area, compared to less than 50% in the US.

The importance of the banking sector is reflected in the operational framework of the Eurosystem, which satisfies the liquidity needs of the euro area credit institutions through its liquidity-providing refinancing operations. By setting the conditions at which banks borrow from the Eurosystem, the ECB directly affects short-term money-market interest rates. Moreover, market expectations about the future evolution of the policy rates should be reflected in medium and long-term interest rates. In addition, one of the guiding principles of the Eurosystem’s operational framework is equal treatment of all credit institutions irrespective of their size and location in the euro area, which implies identical conditions for all credit institutions in the euro area in their transactions with the Eurosystem. As a result, bank lending and deposit rates are normally also indirectly affected by changes in the ECB’s monetary policy stance.

The existence of a single monetary policy implemented through provision of liquidity to the euro area banking sector under the principle of equal treatment suggests that bank lending and deposit rates throughout the euro area should normally only diverge as much as required by variations in underlying fundamentals (e.g. financial health of the respective credit institutions, counterparty risk). Efficient markets eliminating evident arbitrage opportunities should ensure that costs of different forms of funding (loans, bonds and equity) should not exceed what is justified by differences in the idiosyncratic risk associated with each specific funding form. Hence, prolonged periods of diverging trends in the costs of funding within the euro area could, ceteris paribus, indicate the emergence of some friction in the transmission of monetary policy.

Cross-country divergence in financing costs

Since the euro area banking sector is the direct counterparty of the Eurosystem’s liquidity-providing refinancing operations and thus the first step in the monetary policy transmission process, this section starts by looking at the dispersion of bank lending rates for the non-financial private sector across euro area countries. (16) It continues with a discussion of cross-country variation in a composite financing cost indicator for the NFC sector which also reflects costs of capital-market-

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(16) Coefficient of variation (STDEV/AVG) and quartile dispersion coefficient (100*(Q3-Q1)/(Q3+Q1)) are used to assess dispersion, with only the former measure presented in the charts, as they display similar evolution over time.
The dispersion of bank lending rates initially surged for the whole non-financial private sector in late 2008/early 2009. While the variation in bank lending rates for the household sector more or less reversed throughout 2010, the variation in bank lending rates for the NFC sector remained broadly stable at an elevated level between mid-2009 and mid-2011. Bank lending rates then started to diverge again for the whole non-financial private sector in the second half of 2011 before some renewed stabilisation/marginal reversals occurred in the second half of 2012.

The divergence in bank lending rates was more pronounced in the corporate sector than for households. In January 2013, the highest corporate lending rates were recorded in Greece, Cyprus, Portugal and Slovenia, followed by Malta, Italy and Spain. This does not bode well for recovery and rebalancing prospects in these economies as it is obviously more difficult for domestic companies to expand their export market share without access to affordable funding. The highest bank lending rates to households (captured by a weighted average of lending rates for house purchase, consumption and other purposes) were registered in Slovakia, Cyprus and Italy in January 2013. However, statistics for this sector are somewhat blurred by varying shares of fixed-rate mortgages, which imply country-specific differences in the transmission from money market to lending rates.

In parallel to the increasing cross-country divergence in bank lending rates, spreads between interest rates on small and larger loans to NFCs have also increased since late 2008 (Graph II.1.3). Although these spreads have increased in most euro area countries, including Germany, the largest divergence can be observed in Spain and Ireland. As a result, costs of bank funding for smaller start-up companies in the peripheral economies are likely to be even more expensive than suggested by the dispersion in lending rates for the whole NFC sector. This intra-sectoral divergence is exacerbated by the fact that SMEs tend to have fewer alternative financing routes via debt and equity markets than large corporations.

Taking into account capital-market-based sources of financing (both debt and equity), a broader synthetic measure of the financing costs faced by the non-financial corporate sector can be
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computed (Composite Financing Cost Indicator, CFCI), at both euro area and Member State level. The CFCI for NFCs is based on the costs of three different financing instruments, namely bank credit, corporate bonds and quoted equity, which are weighted according to their outstanding amounts at the end of the period (stocks). Such country-specific CFCIs can be constructed for nine euro area countries for which data are available for all three types of financing.

Dispersion indicators based on country-specific CFCIs for NFCs broadly followed an upward trend from late 2008 up to mid-2012 but they started trending downwards during the second half of 2012. Compared to bank lending rates, the increase in cross-country variation seems to have been higher for corporate bond yields and lower for dividend yields. As a result, dividend yields currently exhibit the lowest and bond yields the highest cross-country variation, while the opposite was true until the onset of the global financial crisis in late 2008.

Pass-through of the key ECB policy rate to market and bank lending rates

While spreads between money market rates and the key ECB policy rate decreased and even turned negative during the crisis period, spreads between retail bank lending rates and money market rates increased. This suggests that apart from friction in money markets, developments within national

(1) In the CFCI calculation, the cost of bank credit is measured by the weighted average of Monetary and Financial Institutions’ (excluding Money Market Funds and central banks) interest rates for all maturities charged on new loans to NFCs (data provided by the ECB). The cost of corporate bonds is based, at the euro area level, on the composite yield for non-financial corporate benchmark bonds (calculated by Merrill Lynch). In the absence of similar data at country level, the cost of corporate bonds in a given country is proxied by euro area corporate bond yields plus the country-specific risk captured by the swap spread (government bond yield – euro swap rate). As a large part of the corporate bond issuance in the euro area concentrates around the 5Y tenor, the calculation is based on interest rates for this maturity. Finally, the cost of equity funding for NFCs is approximated by the dividend yield for main equity indices in every euro area country (calculated by Bloomberg). At the euro area level, the dividend yield for Eurostoxx50 is used.

(17) The CFCI for NFCs is based on the costs of three different financing instruments, namely bank credit, corporate bonds and equity, which are weighted according to their outstanding amounts at the end of the period (stocks). Such country-specific CFCIs can be constructed for nine euro area countries for which data are available for all three types of financing.

(18) It should, however, be noted that the precise level of dispersion is more uncertain for corporate bond yields, as in the calculation of the country-specific CFCIs these are just proxied by a formula including government bond yields (see previous footnote).
banking sectors may also have affected the transmission mechanism (see the next section for a discussion of possible underlying factors).

Spreads between overnight money market rates (EONIA) and the ECB’s main refinancing rate (MRR) have been negative since late 2008, reflecting non-standard measures implemented to safeguard monetary policy transmission, in particular injections of excess liquidity through fixed-rate full-allotment refinancing operations (Graph II.1.5). However, following a spike at the end of 2008, the spread between interest rates on unsecured (EURIBOR 3M) and secured (EUREPO 3M) money market transactions increased again during the second half of 2011, before declining gradually throughout 2012. Changes in risk premia thus seem to have influenced monetary policy transmission across different segments of money markets and possibly contributed to market fragmentation.

Graph II.1.5: Spreads between the main refinancing rate and money market rates, euro area

(in pps., Jan 2004-Jan 2013)

Source: Ecowin.

After an initial jump in late 2008 and early 2009, spreads between retail bank lending rates and money market rates stabilised at the short end and declined somewhat at the long end (Graph II.1.6). They started increasing again in the second half of 2011 before stabilising well above longer-term averages in late 2012. The easing of funding conditions on euro area sovereign debt markets in late 2012 thus was not simultaneously mirrored in bank lending rates to the non-financial private sector.

Graph II.1.6: Spreads between bank lending rates and money market rates, euro area

(based on EURIBOR 3M, Jan 2004-Jan 2013)

(1) MFI (excluding MMFs and CBs) lending rates on new loans to households for house purchase with interest rate fixation up to 1 year (2) Idem with interest rate fixation over 1 year (3) Lending rates on new loans to non-financial corporations with interest rate fixation up to 1 year (4) Idem with interest rate fixation over 1 year.

Source: ECB, Ecowin.

Possible structural determinants of bank lending rates in different euro area countries(19)

Bank lending rates in the euro area seem to diverge beyond what is justified purely by banks’ retail interest expenditure, as net interest income has in general been higher for those banking sectors which charge higher bank lending rates (Graph II.1.7).

In 2012H1 (the last period for which data are available), banking sectors(20) in Cyprus, Slovenia and Spain recorded the highest net interest income in the euro area compared to the size of their balance sheets (among the countries for which all data are available), and they were also among the five countries (together with Portugal and Italy) with the highest composite MFI lending rates to the non-financial private sector(21). At the same time, compared to 2008 the cross-country variation

(19) Charts in this sub-section include all euro area countries (based on 2008 composition) for which all relevant data are available.

(20) National banking sectors are in this section defined as including domestic banking groups and stand-alone banks as well as foreign-controlled subsidiaries and branches.

(21) Weighted average (by outstanding amounts) of MFI (excluding MMFs and CBs) interest rates on loans (total amount for new business in euro for all maturities) to HHs and NFCs; data available for 12 euro area countries.
in net interest income did not increase as much as the dispersion of bank lending rates, indicating that adjustments in lending rates reflected more than divergent interest expenditure.

Greater variation in loan portfolio quality appears to be one of the structural determinants of the recent divergence in bank lending rates. The four countries whose banking sectors exhibited the highest share of non-performing loans (NPLs) in 2012H1 (Cyprus, Italy, Portugal and Spain), were also among those with the highest composite MFI lending rate to the non-financial private sector (Graph II.1.8). At the same time, the cross-country variation in the share of NPLs has increased across the euro area since 2008. This might have contributed to the growing divergence in lending rates, as banks facing the prospect of relatively larger losses on their loan portfolios increased interest margins on new lending.

Larger differences in the availability of capital buffers also seem to account for some of the increase in the dispersion of bank lending rates. In 2012H1, the six banking sectors posting the lowest Tier 1 capital ratios included the five banking sectors with the highest composite lending rates to the non-financial private sector (Cypriot, Portuguese, Slovenian, Italian and Spanish) (Graph II.1.9). At the same time, the cross-country variation in Tier 1 ratios and thus loss absorption capacity has increased since 2008, allowing for a large divergence in bank lending rates.

Banking sectors charging higher lending rates displayed lower profitability in 2012H1, contrary to the trend observed in 2008 (Graph II.1.10). All six banking sectors charging the highest lending rates to the non-financial private sector in 2012H1 (Cypriot, Portuguese, Slovenian, Italian, Spanish and Irish) achieved lower returns on assets than banking sectors requiring lower lending rates. In contrast, at the outset of the global financial crisis in 2008, higher lending rates had in general gone hand in hand with higher profitability. This suggests that at the current juncture, higher lending rates may reflect the need to (at least partially) offset losses suffered on impaired assets.
Cross-country variation in the financial positions of non-financial private sectors, which has increased somewhat since 2008, is likely also to affect credit risks faced by national banking sectors and is thus reflected in bank lending rates (Graph II.1.11). In 2012H1, private sector indebtedness (relative to GDP) was the highest in Ireland, Cyprus and Portugal, which were also among the countries with higher-than-average composite MFI lending rates to the non-financial private sector.

Finally, banking sectors charging the highest lending rates to the non-financial private sector in 2012H1 were located in the countries where sovereign funding costs were also relatively elevated (Graph II.1.12). This suggests that the existence of feedback loops between the financing conditions of sovereigns and the respective private sectors was another factor which contributed to increased cross-country variation in bank lending rates.

Conclusions

The dispersion of bank lending rates charged to the non-financial private sector as well as that of overall financing costs for the NFC sector has increased considerably across the euro area throughout the recent crisis period. Such divergence has occurred despite the existence of a single monetary policy implemented through the provision of liquidity to the euro area banking sector under the principle of equal treatment.

The increase in cross-country variation in bank lending rates has been more pronounced in the corporate sector than for households. At the same time, spreads between interest rates on small and larger loans to NFCs have also increased since late 2008. Compared to bank lending rates, the increase in cross-country variation seems to have been higher for corporate bond yields and lower for dividend yields.

Although monthly data display considerable volatility, the most recent data suggest that the
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divergence in bank lending rates might have peaked in the second half of 2012. In addition, country-specific CFCIs for the NFC sector indicate a significant reduction in cross-country variation since mid-2012.

The re-pricing of risk premia in different money market segments appears to have influenced the spreads between the key ECB policy rate and money market rates. Moreover, while spreads between money market rates and the MRR decreased during the crisis period, spreads between retail bank lending rates and money market rates increased, suggesting that apart from friction in money markets, developments within national banking sectors may have also affected the transmission mechanism.

This seems to be confirmed by the fact that cross-country variations in some structural characteristics of national banking systems, such as the quality of loan portfolios, profitability or the size of capital buffers, have increased throughout the crisis period, partly reflecting diverging trends in the overall economic situation. These parameters, together with cross-country variation in financial positions of non-financial private sectors and in sovereign funding costs, are likely to account for much of the increase in dispersion of bank lending rates at the country level.