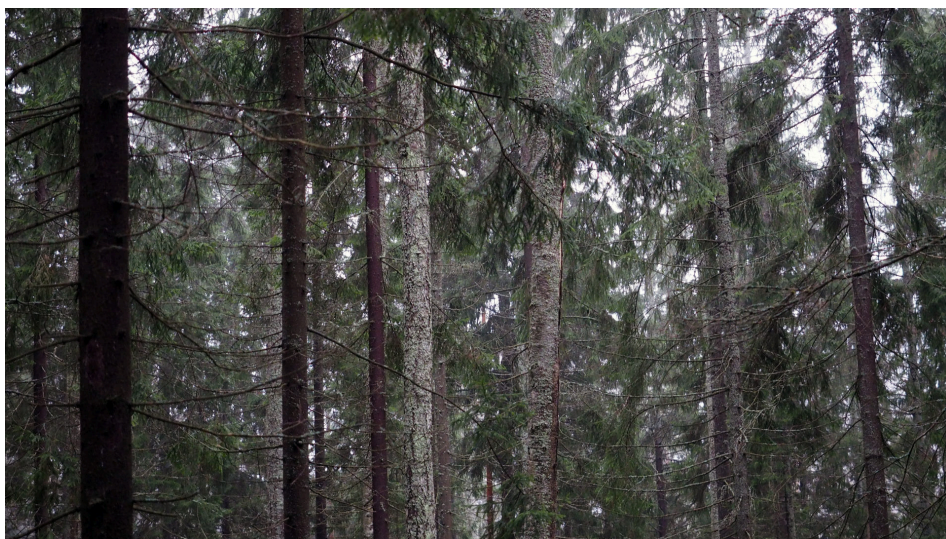




Why are euro area loans to non-financial corporations growing so slowly?

12 Oct 2016 – Analysis – International economy

In spite of an accommodative monetary policy and a general economic recovery, growth of loans to non-financial corporations has remained weak in the euro area. The consistently poor growth is largely due to extensive real estate market bubbles in a few countries, which then burst as a result of the financial crisis. The amount of non-performing loans on the balance sheets of banks significantly weakens banks' ability to offer new loans.

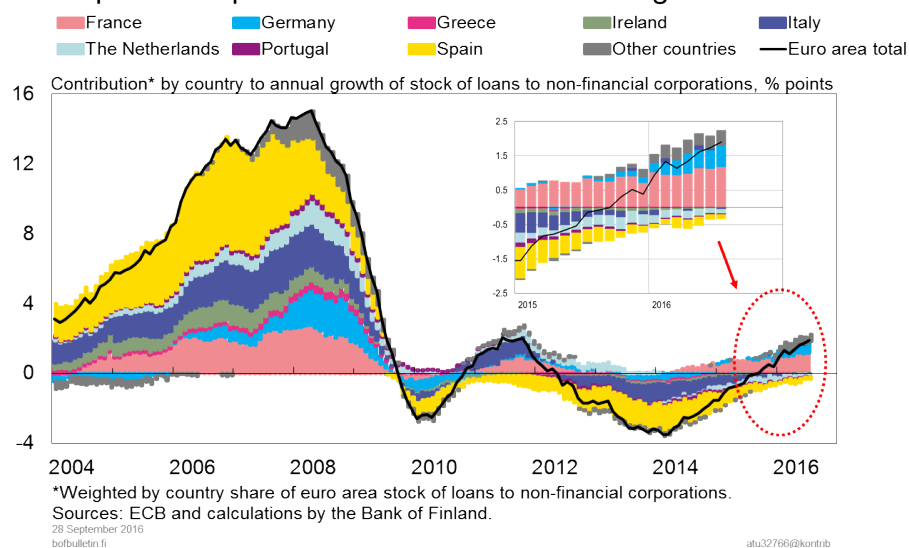


Average state of the euro area does not tell the whole story

From the beginning of 2012, the stock of euro area loans to non-financial corporations contracted for nearly three consecutive years. A closer look at developments country by country reveals that half of the negative growth originates from the declining stock of loans to non-financial corporations in the Spanish banking sector. One third of the decline is caused by the development of Italy's stock of loans to non-financial corporations.

Chart 1

Development of Spanish and Italian loans to non-financial corporations pushed down total euro area figures

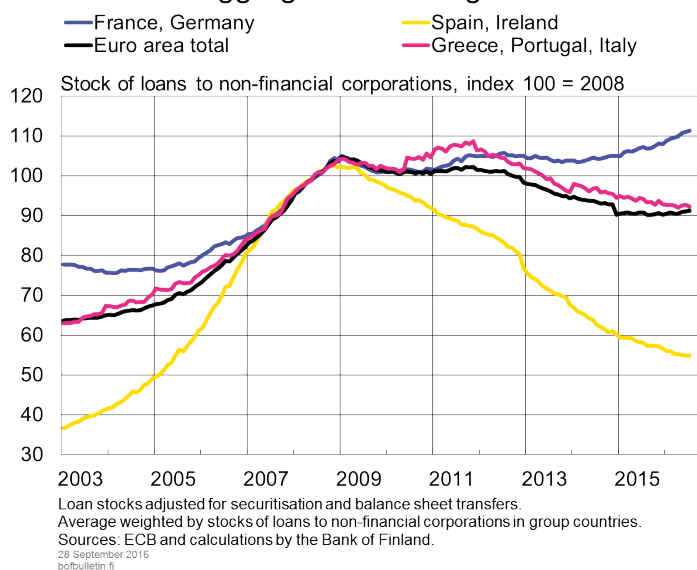


From the beginning of 2016, annual growth of the euro area stock of loans to non-financial corporations has suffered from a declining loan stock in the Netherlands and Spain. Growth of the euro area stock of loans to non-financial corporations has remained clearly positive, however, due to a strong growth particularly in France and Germany.

Since 2008, the volume of loans to non-financial corporations calculated on the basis of cumulative net flow has grown by about 10% in France and Germany. On the other hand, the average loan stock in Spain and Ireland has contracted to nearly half of the stock in 2008. The diverging development has kept growth of the stock of loans to non-financial corporations subdued at the euro area level.

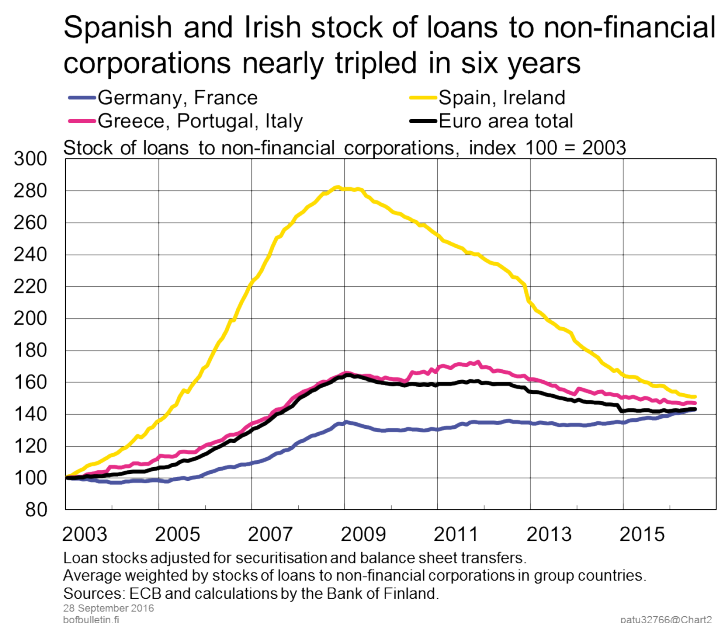
Chart 2

Euro area aggregate hides large national differences



The countries where recently the stock of loans has continued to contract can be divided roughly into two categories. The first includes the countries with deeper economic difficulties (Greece, Portugal and to a lesser extent Italy). In these countries, the contraction of the loan stock did not start until later, and it has largely affected all sectors. The generally weak economic conditions have also clearly weakened the banking sector in these countries, and companies have experienced limited availability of funding as one major business obstacle. However, the modest growth of the stock of loans to non-financial corporations is a result of problems on both the demand and supply side. Weak corporate sector profitability, high indebtedness and bleak prospects not only reduce the availability of funding but also the need for funding.

Chart 3



The second category includes countries where the construction sector grew substantially in the pre-crisis period and where the real estate market collapsed as a result of the crisis (particularly Spain and Ireland^[1]). Banks provided funding for the overheating real estate market, and loans to the construction sector and real estate activities rapidly accumulated on the balance sheets. Even though general economic conditions have already improved significantly in these countries, the large size of the construction sector and its close links with the banking sector will still dampen growth of the stock of loans to non-financial corporations for a long time to come.

Banking and construction sectors strongly connected

Loans to the construction sector and other real estate activities account for a good third of the total stock of loans to non-financial corporations on the balance sheets of euro area

1. The real estate market also collapsed in the Netherlands, and the Government bailed out the largest banks in the country. Due to better economic developments in the Netherlands, the difficulties of the banks were not reflected in financing conditions.

banks. When housing loans are added, real estate activities account for around 60% of the stock of lending to the private sector. This represents about 20% of the financial assets of the euro area banking sector, or 60% of the euro area's aggregate GDP.

Chart 4

Banks' loan receivables from construction, housing and real estate activities large in many countries

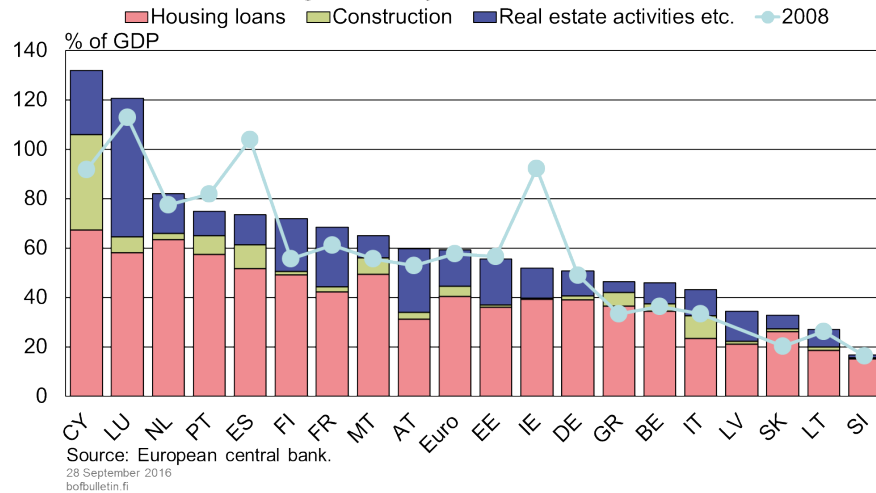
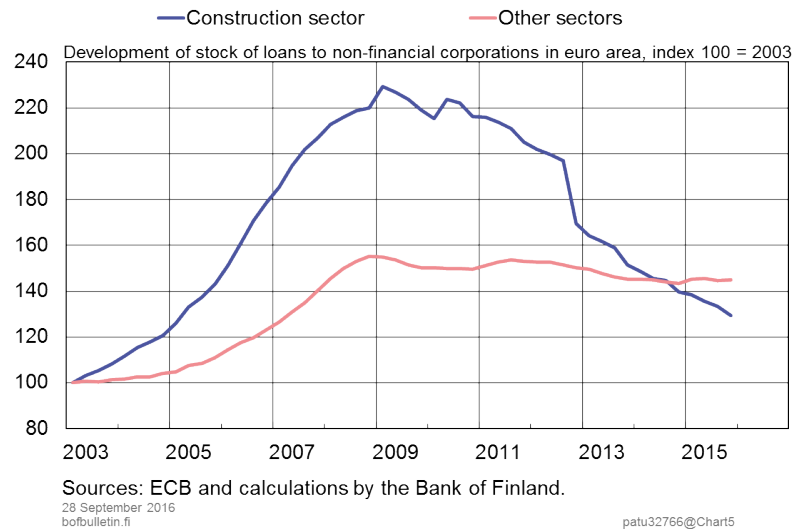


Chart 5

Construction sector's stock of loans to non-financial corporations more than doubled in six years



In the construction sector and other real estate activities, the portion of small and medium-sized enterprises (SME) is significant in the euro area (nearly 90% of the companies in question). Thus the victims of the burst real estate market bubble have mainly been SMEs, whose opportunities to obtain alternative funding from sources outside the banking sector are fewer to begin with.

Amount of non-performing loans exploded when

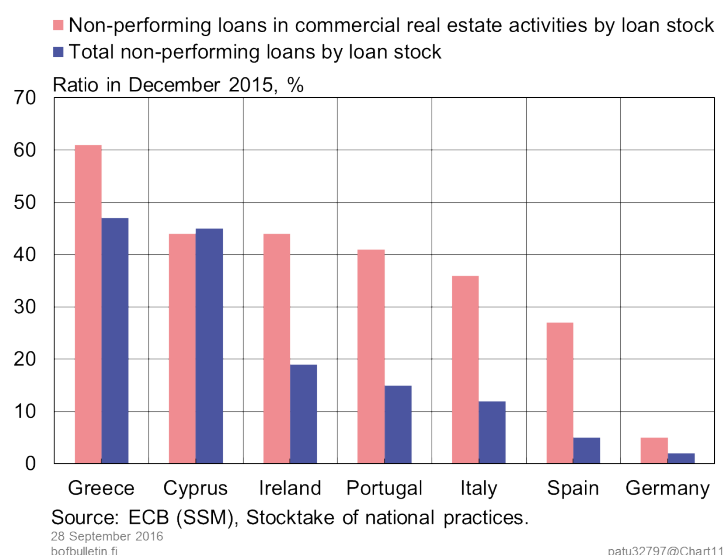
the bubble burst

The problems of the construction sector and in real estate activities have accumulated on the balance sheets of euro area banks. According to the US company Cushman & Wakefield, which provides real estate services, non-performing real estate loans and so-called non-core^[2] investments on the balance sheets of European banks amounted to no less than EUR 264 billion at the end of 2015. This was the case despite the fact that European banks have transferred investments representing more than EUR 360 billion of the original amount to different state-owned asset management companies.^[3]

According to the latest Financial Stability Review^[4] by the ECB, the average ratio of non-performing exposures in commercial real estate yields in relation to the sector's stock of loans was about 20% at the end of 2015. This problem is particularly due to the steep decline in commercial and residential real estate prices after the financial crisis. The steep fall in prices and weak economic development quickly infected construction and other real estate activities, which have been heavily bank-funded in several countries.

Chart 6

Non-performing loans in a few euro area countries



Recently, in little more than a year, real estate prices in the commercial real estate market have taken an upward turn in many countries. This is due to both the economic recovery and the search for yield by international institutional investors as well as banks' need to streamline their balance sheets.^[5]

2. High-risk objects. Normally the investment strategy involves use of leverage, real estate repairs, development etc., which not necessarily imply a buy-and-hold investment. The gains may be substantial.

3. A significant portion of these assets have either been sold or otherwise removed from the balance sheets of the asset management companies, as the amount was only EUR 173 billion at the end of 2015.

4. <https://www.ecb.europa.eu/pub/pdf/other/financialstabilityreview201605.en.pdf?e1a2bef79ed901d8ceae004f2fcecdd>

5. In the European Banking Authority's (EBA) latest Risk Assessment Report on the banking sector, banks recently declared commercial properties to be the most significant object of balance sheet cleaning.

The sharp rise in commercial real estate prices has led to increased loan portfolio and real estate sales in many European countries, which in turn has speeded up market recovery. Various real estate backed loans and real estate investments were sold for a record amount of EUR 85.9 billion in 2015. On the basis of the figures for the early part of the year, it seems that 2016 will be a good year in the loan market, despite market turbulence early in the year and the Brexit referendum^[6].

Although secondary markets for real estate backed loans have increased in Europe, traditionally the trade has mainly been concentrated to Ireland and the UK. Combined, these two countries accounted for 70% of sales in 2015. The third significant target country is Spain (11%), which also has Europe's largest amount of non-core loans. Undoubtedly the development of the loan market in these countries has been favoured by the vast size of the housing and real estate markets and the public sector's considerable significance in the capitalisation of banks and management of non-performing loans. The problem is that implementation of corresponding arrangements in other EU countries has changed with the entry into force of resolution procedure and Government subsidy regulations at EU level.

Nevertheless the secondary loan market is also opening up in other countries, such as Italy^[7]. The secondary loan market in Europe is continuing to grow; the amount of planned and settled transactions in 2016 has already exceeded the 2015 level. There are still EUR 300 billion of non-performing assets^[8] on the balance sheets of Italian banks, which makes the market attractive from the investors' point of view. Various reforms in recent years have supported the development of the Italian secondary market, although the measures have not been as comprehensive as in, for example, Spain and Ireland.^[9]

Ineffective resource allocation slows down recovery

During the dramatic rise of the construction sector, labour and other resources were excessively allocated to this sector in comparison with the national economy. In 2007, around every seventh Spanish and Irish employee worked directly in the construction sector or in real estate activities^[10]. In Ireland and Spain, the gross value added produced in the construction sector represented about 10% of the GDP of these countries prior to the collapse of the real estate market. In the first quarter of 2016, the gross value added produced in the construction sector was just 2.5% in Ireland and 5.1% in Spain.

6. There is reason to carefully monitor Brexit's impact on the commercial real estate market in Britain, but also in the rest of Europe.

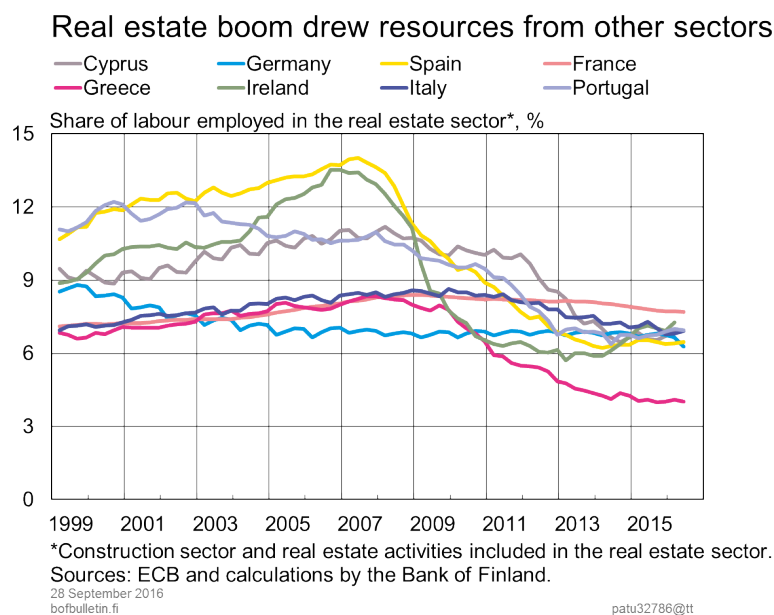
7. In 2015, Italian banks sold various loan portfolios for a record amount of EUR 20 billion.

8. The loan portfolios sold by Italy mainly comprise, however, corporate and household loans other than commercial real estate loans.

9. In recent years efforts have been made to advance the development of the Italian secondary market through, among other things, a new type of guarantee arrangements (GACS), a fund (Atlante) specialised in acquisitions of non-performing loans, and amendments to bankruptcy and execution legislation.

10. Real estate activities comprise real estate sales, acquisitions and rentals as well as other real estate services, such as assessment. Real estate management is also included in this main category.

Chart 7



Between 2008 and 2013, the turnover of the construction and real estate activities declined by more than 40% in Ireland, nearly 60% in Spain and Portugal and nearly 70% in Cyprus. In 2015, construction investment in these countries was more than 40% down from 2008.

According to a corporate information database maintained by the French Central Bank, the profitability of equity in construction companies operating particularly in the SME sector of the crisis countries clearly weakened after the crisis. In Portugal and Spain, nearly half of small construction companies were unprofitable during the height of the debt crisis.

As the oversized construction sector collapsed, a vast number of abandoned worthless properties and low-education workers remained. The movement of labour to other sectors has proved to be very difficult and rates of unemployment have stayed persistently high. Uncertain economic conditions and weak demand may slow down the rise of profitable companies and the winding up of unprofitable ones. Unemployment remains high and productivity suffers.

However, there are small positive signs in the air. Production in the Irish construction sector picked up after 2011 and housing prices started to rise in 2013, while the turnover of the Portuguese construction sector has grown since 2013. In Spain, the decline in the housing price index ended in 2015.

Solution to construction sector problems important

In a few euro countries, the construction sector has suffered from severe problems after the burst of the real estate market bubble. This is reflected not only in the collapse of companies' turnover but also as a decline in construction investments. After the burst of the bubble, the concentration of resources in real estate activities caused high

unemployment figures and left banks with worthless properties provided as collateral.

Non-performing loans still form a considerable burden for some euro area banks. In a number of cases, the difficulties are due to poor quality loans related to construction of residential and commercial real estate and other real estate activities. It has proved to be difficult to get rid of the bad loans, because there is no approach that would be clearly suitable for all countries. Application of resolution models in the private sector has been slowed down by differences in legislation from one country to another and an underdeveloped European secondary market for loans. The entry into force of resolution procedure and Government subsidy regulations at EU level also limit the range of measures available.

Due to a large amount of bad loans, the banking sector's ability in many crisis countries to provide funding for higher-risk customers has declined significantly. In the crisis countries, a considerable part of the cleaning of banks' balance sheets in order to fulfil the requirements of the capital adequacy regulation, has been achieved by reducing lending and higher-risk exposures, such as corporate loans to the SME sector. From the perspective of monetary policy transmission and financial stability, it is particularly important to solve the problem of non-performing assets in the real estate sector.

Tags

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