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THE FINANCING OF COMPANIES IN MALTA

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BOX 3: THE FINANCING OF COMPANIES IN MALTA[1]

This Box summarises a study on the financing of NFCs in Malta and the causes behind the observed decline in bank lending to companies.[2]

The financial crisis of 2009 had a detrimental impact on financing conditions in the euro area. From a peak of 14.9% in the first quarter of 2008, annual growth in bank lending to NFCs averaged just 0.2% between 2009 and 2010. Following a brief recovery, lending contracted by an average of 1.7% between 2012 and 2015 as a result of a more pessimistic economic outlook due to the European sovereign debt crises. This trend has only started being reversed recently, in 2016. On the other hand, although following a similar pattern between 2008 and 2015, bank lending to NFCs in Malta has as yet failed to recover, contracting by around 2.7% in 2016.

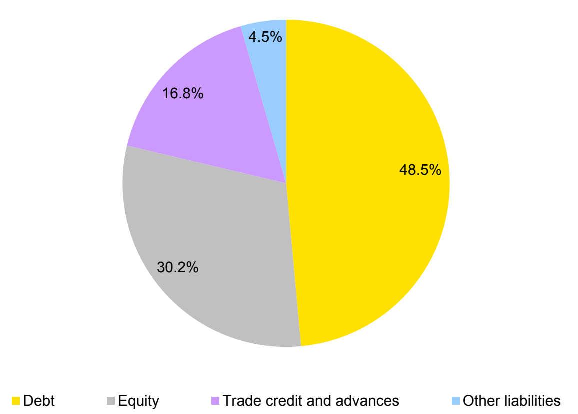
Overview of NFC financing

Chart 1 gives a snapshot of the financial liabilities of NFCs resident in Malta at the end of 2016. With a share of 48.5%, debt is the main source of financing for resident NFCs. Indeed, non-consolidated NFC debt stood at 136.0% of GDP in 2016, though this was lower than the peak of 161.3% registered in 2009. The rest of NFC financial liabilities are mainly composed of equity (mainly private equity) and trade credit and advances. When compared to their peers in the euro area, Maltese NFCs are more reliant on debt (mainly loans) and trade credit, while firms in the bloc are more reliant on equity as their main source of finance.

Domestically, loans make up around 94.9% of NFC debt. Given this high share, it is important from a policy perspective to understand the factors behind the sustained weakness in bank lending to NFCs in Malta.

Chart 2 gives an overview of the stock of loans granted to NFCs, based on Financial Accounts data.[3] During the years following EU membership

Chart 1
COMPOSITION OF NFC FINANCIAL LIABILITIES IN MALTA
(end-2016 stocks at market prices)



Source: Financial Accounts.

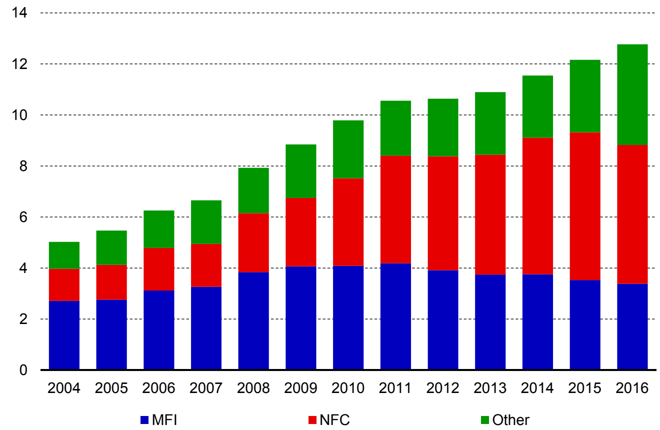
[1] Prepared by Jude Darmanin. The author would like to thank Mr Alexander Demarco, Dr Aaron G. Grech, Ms Rita Schembri, Mr Brian Micallef, and Ms Janica Muscat for their valuable help and comments. The views expressed in this note are those of the author and do not necessarily reflect those of the Central Bank of Malta. Any errors are the author's own.

[2] Darmanin, J. (2017), "The Financing of Companies in Malta", Policy Note July 2017, Central Bank of Malta.

[3] Annual Report 2016, "Sectoral Financial Linkages Using Malta's Financial Accounts", pp. 30-35, Central Bank of Malta.

in 2004, MFIs constituted the main share of NFC loan financing, averaging 49.8% of total NFC loans between 2005 and 2007. However, consistent with the decline in bank lending growth, this share began to drop following the financial crisis in Europe in 2008, reaching 26.5% in 2016. This is consistent with Micallef (2015), who concluded that a credit gap in bank funding to Maltese NFCs emerged in 2012 and widened substantially in 2013 and 2014 to around 15%-18%.[4]

Chart 2
LOANS TO NFCs BY SOURCE
(end-of-year stocks; EUR billions)



Source: Financial Accounts.

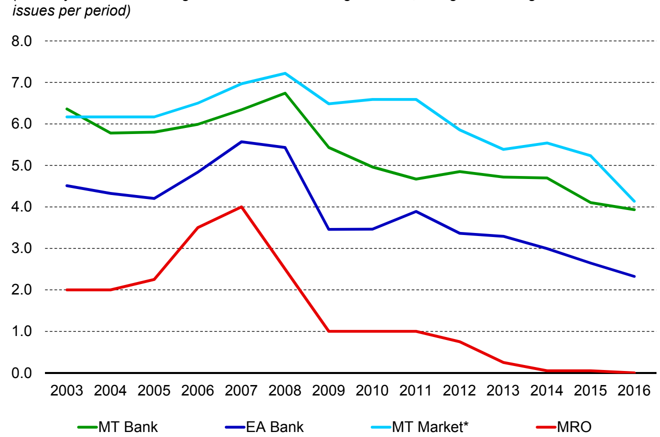
At the same time, the chart points to a sustained increase in the share of intra-sectoral lending between NFCs after the crisis, with the share of NFC-to-NFC loans increasing from 25.0% in 2005 to 42.6% in 2016.[5] Other loan sources are mainly comprised of loans from the rest of the world, namely foreign bank loans or trans-border NFC-to-NFC lending.

Factors behind financial disintermediation

These developments in the debt financing of NFCs can be attributed to a combination of loan supply restrictions on the part of banks and shifts in the demand needs of companies.

On the supply side, despite their recent downward trend, interest rates on bank lending to NFCs remain high when compared with those prevailing in most euro area countries (see Chart 3).

Chart 3
INTEREST RATES CHARGED TO NFCs
*(end-of-year annualised agreed rate on outstanding amounts; *weighted average based on new issues per period)*



Sources: ECB; MSE; Central Bank of Malta calculations.

[4] Micallef, B. (2015), "Estimating a Credit Gap for Non-Financial Corporations in Malta", Working Paper 04/2015, Central Bank of Malta.

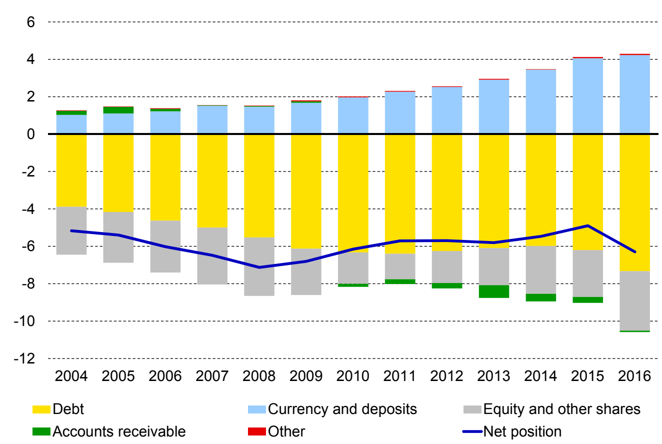
[5] The Financial Accounts statistics do not disaggregate intra-sectoral lending, thus preventing a more detailed sectoral analysis of NFC-to-NFC lending. Additionally, this prevents the deduction of whether lending between NFCs is related mainly to intra-group NFCs or between unrelated companies.

Since the end of 2007, prior to the ECBs first wave of key interest rate cuts, interest rates on NFC loans in Malta have fallen by 241 basis points, when compared with 325 basis points in the euro area, leading to a further widening of the spread between domestic and euro area rates to 161 basis points at end-2016. This corresponds with the conclusion of a Central Bank of Malta study that concluded that the interest rate pass-through from the ECB policy rates to the bank lending rates for firms in Malta is one of the lowest in the euro area.[6] This may be attributed to the funding structure of banks (since most banks in Malta rely on deposits as their main source of finance rather than the wholesale market) and also the higher debt/equity ratio of resident NFCs when compared with those in the euro area, as alluded to in Chart 1 above.

Survey data and other anecdotal evidence suggest that banks have upped their efforts to boost capital ratios in part through a tightening of lending to NFCs. In 2014 the European Commission reported that "lending standards were tightened significantly in response to the crisis, particularly for the construction sector, and have remained largely unchanged since then".[7] This is backed by results from past BLSs, which indicated a tightening of credit supply and terms and conditions around 2011 and 2012 that were not fully reversed in the following years. The higher perceived risks associated with the NFC sector, such as the lack of collateral and asymmetric information regarding newer economic sectors, as well as the need to diversify away from the construction sector, could be driving banks to shift their loan portfolios away from NFCs and toward households.

At the same time, evidence points to an increase in alternative sources available to companies in place of bank funding. Increased turnover on account of a robust economy has allowed companies to self-finance themselves internally or through their parent companies, while construction companies are able to sell properties on plan to finance building costs. Chart 4 shows how the net financial wealth of NFCs has generally improved over the past few years, with strong growth registered in companies' currency and deposits. Furthermore, company surveys such as the SAFE indicate a growing number of firms not applying for bank loans due to sufficient

Chart 4
NET FINANCIAL POSITION OF RESIDENT NFCs
(end-of-year net stocks; EUR billions)



Source: Financial Accounts.

[6] Micallef, B., Rapa, N., & Gauci, T. (2016), "The Role of Asymmetries and Banking Sector Indicators in the Interest Rate Pass-Through in Malta", Journal of Advanced Studies in Finance, Vol. 7, 1(13), p. 5. However, studies also suggest that the interest rate pass-through can also be influenced by the banks' funding structure.

[7] European Commission (2014), "Macroeconomic Imbalances Report - Malta", available at http://ec.europa.eu/economy_finance/publications/occasional_paper/2014/pdf/ocp184_en.pdf.

internal funds.[8] This could explain the observed shift in the share of NFC loans from bank to intra-sectoral lending, as given a sufficient amount of internal funds, a company would find it cheaper and less bureaucratic to borrow from within the company group rather than from an intermediary with tightened lending standards.[9]

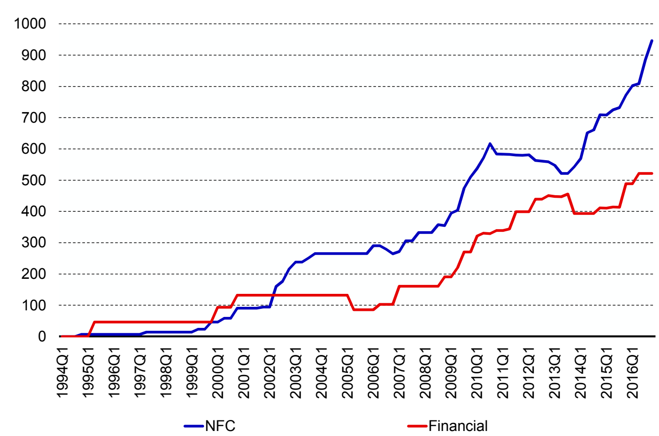
Financial accounts data suggests that the increase in intra-sectoral lending is especially evident within the short maturity loans category, which could indicate increased replacement of short-term bank loans such as overdraft facilities and credit lines with internal funding.[10]

Structural changes in the economy represent another factor that could be driving the drop in bank lending. In 2014 a European Commission report stated that "(the) structural shift in the (Maltese) economy to some extent lowers the capital intensity of the economy, resulting in lower need for investment, thus also lowering the demand for credit".[11] This refers to the gradual shift in Malta's economic structure towards more labour-intensive services industries. Indeed, Malta's private investment-to-GDP ratio has gradually declined over the years, from 15.9% in 2004 to 13.3% in 2014.[12]

Issuance on capital markets

Apart from increased use of internal funding, NFCs facing constraints in the loan market are expected to meet their demand for funds through increased issuance on capital markets. Chart 5 backs this argument, showing strong increases in the number of debt securities outstanding on the MSE, particularly since 2009. By the end of 2016, there was €946.4 million of NFC debt outstanding on the MSE in nominal terms, of which over three quarters was issued since 2009. The average maturity of debt has also risen in recent years, from 7.4 years between 2005 and 2008 to 9.2 years during the period 2013 to 2016. This all suggests that the decline in bank credit

Chart 5
CORPORATE SECURITIES LISTED ON MSE
(units outstanding as at end-period; EUR millions)



Sources: MSE; Central Bank of Malta estimates.

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8 Zerafa, S. (2016), "Survey on Access to Finance", *Quarterly Review* 2016:1, pp. 80-88, Central Bank of Malta.

9 Furthermore, one cannot exclude the inclusion of items such as movements in company funds for internal accounting purposes, estimation errors, and differences in the level of disaggregation of NFCs across countries, in the intra-sectoral lending figures. Further information on the statistical treatment of intra-sectoral lending is available in Hertkorn, A. (2015), "Consolidated and non-consolidated debt measures of non-financial corporations", IFC Bulletin No. 39.

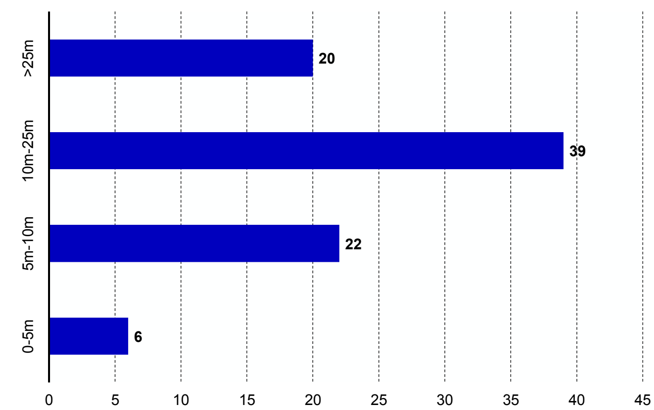
10 Short-term loans consist of loans with a maturity of less than one year.

11 European Commission (2014), "Macroeconomic Imbalances Report - Malta", available at http://ec.europa.eu/economy_finance/publications/occasional_paper/2014/pdf/ocp184_en.pdf.

12 Although the ratio rose in 2015 and 2016, this was due to government-induced projects.

has somewhat prompted increased debt issuance on the capital market, further encouraged by an increase in investment demand from households and a search for yield in a low interest rate environment.

Chart 6
NEW ISSUES OF NFC SECURITIES
(as at end-2016; number of issues per range, upper limit inclusive in EUR millions)



Sources: MSE; Central Bank of Malta estimates.

However, a closer look at the figures suggests that issuance of corporate securities remains limited to a few large companies. Since 1992, only 40 different companies have issued securities on the MSE, of which 34 were NFCs. Moreover, as shown in Chart 6, only six issues, out of a total of 87 new NFC bond issues, were for an amount of less than or equal to EUR5 million. Similarly, on the equity market, by the end of 2016 just 27 different companies had floated shares on the MSE since its founding, of which 22 were resident NFCs. Thus, although capital market issuance has increased since 2009, this is mainly limited to a few large companies. This could indicate that NFCs are still finding restrictions to issuing on capital markets, such as listing requirements and a relatively high market interest rate[13] (see Chart 3 above), which stands above the bank lending rate.

It is indeed telling that despite this relatively high market rate, large corporations are increasing their presence on the capital markets. This could be indicative to the presence of non-interest rate related lending restrictions from banks. Bond markets could offer certain advantages over bank finance, such as generally longer maturities and cash-flow considerations with the possibility of rollovers. At the same time, the large amounts borrowed by companies in the bond market could in part explain the unwillingness of banks to expose themselves to such transactions.

Policy implications and developments

The implication of the above analysis is that Malta's resilience to future economic shocks could be hampered if small enterprises, which comprise the large majority of resident businesses, are not in a position to obtain adequate funding. This is especially true in the eventuality of a drop in internal funds once the economy moves away from its current expansionary cycle. At the same time, a shift away from bank credit can reduce the effectiveness of the bank lending channel in the transmission mechanism of monetary policy. Lack of funding could make expansion more difficult for companies, with adverse consequences for Malta's potential growth in the future.

[13] The synthetic capital market interest rate presented in Chart 3 is based on Central Bank of Malta estimates. See Darmanin, J. (2017), "The Financing of Companies in Malta." Policy Note July 2017, Central Bank of Malta.

A number of initiatives are currently being undertaken to address the issues faced by firms in obtaining bank credit. The Malta Development Bank is intended to address the gaps in the domestic financial infrastructure, with particular attention given to SMEs and the financing of large-scale infrastructure projects. Meanwhile, in 2017, the MSE launched the National Capital Markets Strategic Plan, proposing a number of initiatives as part of its long-term strategy to develop a liquid and efficient securities market. The MSE has also recently launched Prospects, an exchange geared towards SMEs, giving them access to capital markets without need for collateral or minimum issue requirements.[14] These developments, along with other government and EU funding initiatives, constitute an important step towards increasing the funding mix available for small firms.

[14] See the MSE website dedicated to Prospects (www.smeprospects.com).