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NFC LOANS FROM OTHER CORPORATES – EVIDENCE FROM MALTA'S FINANCIAL ACCOUNTS STATISTICS

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BOX 2: NFC LOANS FROM OTHER CORPORATES – EVIDENCE FROM MALTA'S FINANCIAL ACCOUNTS STATISTICS

Introduction

A main pillar of the expansion in gross value added, apart from the financial institutions sector, remains the NFC sector.[1] Indeed, the assessment of the financing of NFCs has become a focus primarily because of the changing nature of its sources of finance.[2] Moreover, NFCs have strong linkages with other sectors in the economy, and account for the majority of private sector debt in Malta, which makes them systemically important.

The International Monetary Fund (IMF) has recently focused on the financing structure of NFCs in Malta, noting the current disintermediation taking place within the sector.[3] Using financial accounts statistics for Malta, their analysis highlighted the increased reliance on non-bank sources of funding, mainly intercompany lending, shifting away from traditional sources of debt financing such as bank loans. The IMF refers to intercompany lending as "lending between domestic NFCs, including unrelated NFCs and intra-group lending."[4] It also rightly noted that at the time of carrying out the exercise, data sources did not allow the disentangling of intercompany lending and loans from unrelated NFCs. The shift towards non-bank financial sources of funding was also observed among euro area countries following the financial crisis.[5]

Intercompany lending can be subdivided into two different categories. The first category is intra-group lending, that is, lending from corporates within the same group of companies. The second category is lending from other corporates, that is, lending that does not originate from within the same group of companies but from other corporates. This box focuses on the statistical subdivision between these two lending categories following further statistical research and analysis. Data on the corporates' group structure is used to differentiate between the two categories, and thus shed light on the quantification of lending within a group as against the other type of lending.

The IMF highlighted that the macro-financial implications of intercompany lending may be very different to traditional sources of funding. In turn, the macro-financial implications of corporates that source their funds within a group are very different to those that finance debt from unrelated corporates.[6]

This Box is divided into the following sections. The first section outlines the evolution of the NFC balance sheet over the years. The second section contains the disaggregation of the intercompany lending into intra-group and non-group lending. The final section presents some concluding remarks.

The aggregated balance sheet of the NFCs in Malta

A quarterly aggregated balance sheet of the NFC sector is published by the Bank as part of Malta's financial accounts statistics.[7] In turn, "from-whom-to-whom" data enable the analysis of the financial

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1 The NFC sector (S.11), as defined in the European System of Accounts 2010, consists of institutional units which are independent legal entities and market producers, and whose principal activity is the production of goods and non-financial services. The NFC sector also includes non-financial quasi-corporations.

2 Zerafa, S. (2017), "Access to finance for firms in Malta: Estimating the impact of reduced credit", Policy Note March 2017, Central Bank of Malta.

3 IMF, 2018. "Non-Bank sources of corporate financing in Malta". Malta Selected issues, Article IV 2018.

4 See footnote 3.

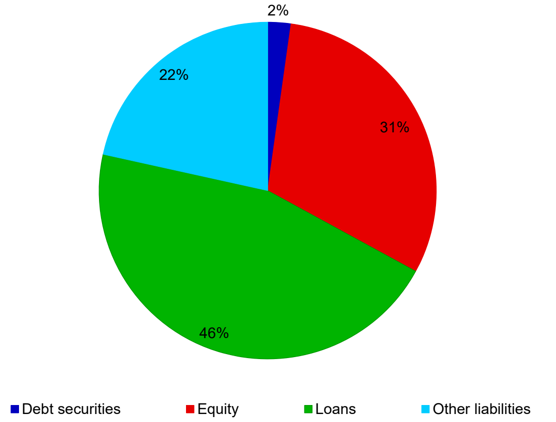
5 Constâncio, V. (2018) "Past and future of the ECB monetary policy, speech, at the Conference on "Central Banks in Historical Perspective: What Changed After the Financial Crisis?", organised by the Central Bank of Malta, Valletta, 4th May.

6 Hertkorn, A (2015), "Consolidated and non-consolidated debt measures of non-financial corporations." In IFC Bulletin No. 39.

7 The balance sheet of the NFC sector forms part of the aggregated balance sheet of all institutional sectors of the resident economy. For further details on financial accounts statistics see Muscat, J., Mamo, K. (2016), "Sectoral financial linkages using Malta's financial accounts", *Annual Report 2016*, pp.30-35, Central Bank of Malta.

inter-linkages between the sectors of the economy.[8] For example, such analysis sheds light on how a particular change in the composition of financial assets or liabilities of the NFC sector is transmitted to other sectors such as households, the financial sector, government, and the rest of the world sectors.[9]

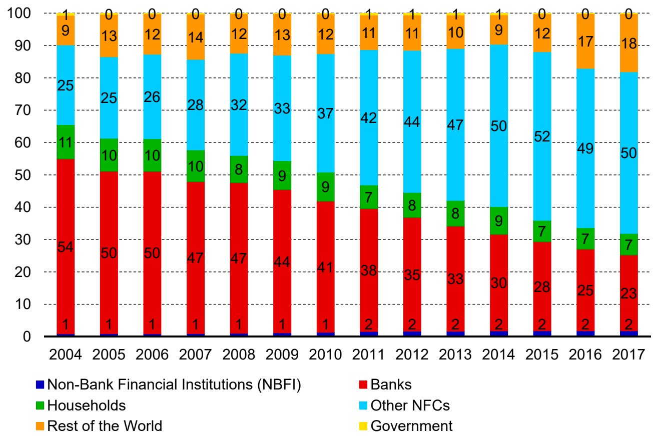
Chart 1
NON-FINANCIAL CORPORATIONS' LIABILITIES
(as at December 2017)



Source: Central Bank of Malta.

Chart 1 shows the liabilities side of the NFC balance sheet. As at December 2017, debt (defined as loans and debt securities) made up to 48% of the total balance sheet of NFCs and 46% of such debt constituted of loans.

Chart 2
NFC LOANS BY COUNTERPART SECTOR
(per cent)



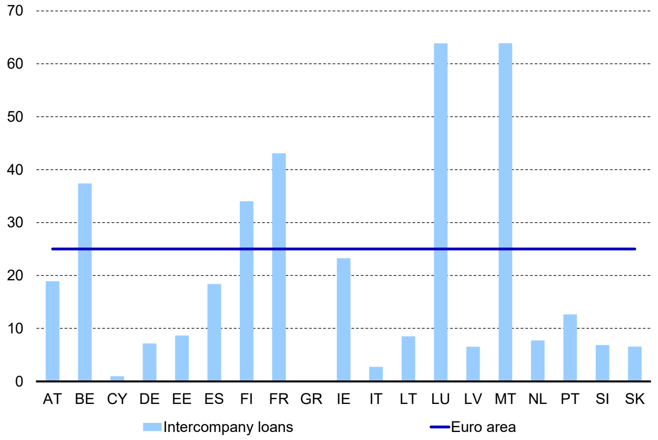
Source: Central Bank of Malta.

To better understand the development in the composition of loans to NFCs, Chart 2 shows the outstanding amounts of loans by the lending sector – that is, non-bank financial institutions, banks, households, NFCs, government and the rest of the world – over the period 2004-2017. In 2004, the primary source of loans to NFCs was the banking sector. However, the reliance on bank credit has steadily declined over the last few years, as non-bank financing became more prominent. Indeed, whereas lending from other corporates made up only a quarter in 2004, this has increased to half of total NFC loans as at 2017, amounting to €7.1 billion. This is consistent with the general observation that NFCs have shifted their sources of finance away from traditional bank credit towards alternative sources, primarily to lending from other corporates.[10]

[8] "From-whom-to-whom" data are published on the Bank's website at https://www.centralbankmalta.org/financial-accounts.
[9] The rest of the world sector as defined in the European System of Accounts 2010 consists of non-resident units engaged in transactions with resident units or have other economic links with resident units.
[10] See Darmanin, J. (2017), "The Financing of Companies in Malta", *Quarterly Review* 2017:4, pp. 53-58, Central Bank of Malta and Micallef, B. (2015), "Estimating a Credit Gap for Non-Financial Corporations in Malta", Working Paper 04/2015, Central Bank of Malta.

A comparison with other euro area countries also points to the above-average importance of intercompany loans for Maltese corporates.[11] Chart 3 shows that the average share for intercompany loans in the euro area amounts to around 25% of GDP, well below the 65% ratio for Malta.

Chart 3
INTERCOMPANY LOANS AS A PERCENTAGE OF GDP
(as at December 2017)

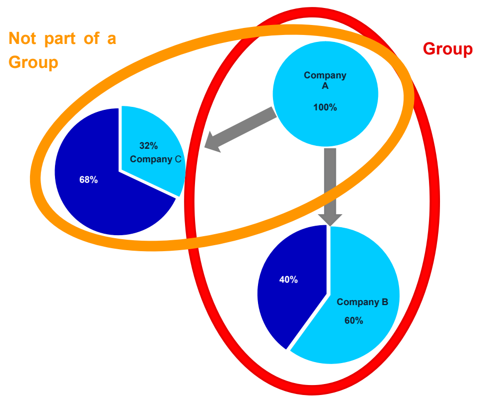


Source: Eurostat.

Disentangling intercompany lending

To distinguish between the two categories of intercompany and intra-group lending, data on corporates' group structure is used. In this data, companies are said to form part of a group when a company owns more than 50% of the shareholding in another company. Chart 4 illustrates two examples demonstrating the definition of a group used in the register data. Firstly, company A owns 60% shareholding of company B, hence companies A and B are said to form part of a group. On the other hand, if company A owns 32% of company C, according to the definition mentioned above, companies A and C do not form part of a group but are still related companies.

Chart 4
DEFINITION OF A GROUP



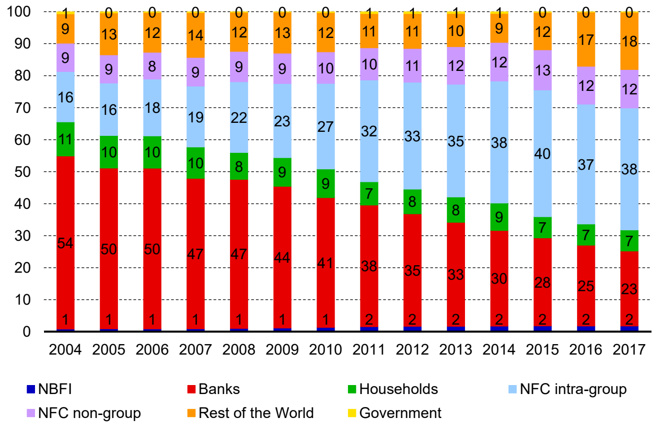
Source: Eurostat.

By combining the group structure data with NFC balance sheet data, intercompany lending can be split into two, namely intra-group loans and non-group lending. If the reporting company falls within the definition of a group, then any loans reported to be originating from related parties are assumed to be intra-group financing. Chart 5 shows that by end 2017, around 38% of total NFC loans were intra-group lending, while only around 12% of total NFC loans fall under the non-group NFC lending category.

[11] There is a degree of heterogeneity in estimating intercompany loans in the euro area. In particular, some countries use company-by-company accounts while others use group accounts to estimate intercompany loans. In our case, we use information from company-by-company accounts, which might lead to a larger estimate of intercompany loans when compared to countries that use group accounts (Hertkorn, 2015).

Over the period 2004-2017, on average, 72% of intercompany loans were reported by NFCs which are within a group and 28% by NFCs which are not part of a group. It is important to note that not all non-group lending can be said to be financed by unrelated companies. Indeed, an NFC which is not part of a group could be financed by other corporates which hold a minority shareholding in that particular company.[12] Although precise information regarding the size of lending of the non-group category is not available, initial estimates indicate that around half of non-intragroup lending involves lending with related parties.

Chart 5
NFC LOANS BY COUNTERPART SECTOR – FURTHER SPLITS
(per cent)



Source: Central Bank of Malta.

Concluding remarks

Malta's financial accounts statistics show that lending by NFCs has indeed increased but this is to a significant extent between companies of the same group (intra-group). This is consistent with the other findings in the literature which show that typically intercompany lending takes place within the same group, and only small amounts can be attributed to loans between companies that do not form part of a group.[13] This shift indicates that companies are preferring to use internal funds rather than resorting to bank lending. Indeed, the incentive for NFCs to decrease their reliance on bank lending could be varied and includes (i) practically no forgone interest on deposit funds owing to the low interest rate environment; (ii) use of internal resources instead of increasing capital; (iii) reduce costs of bank interest charges on loans; (iv) tax advantages associated with borrowing relative to equity financing and (v) easier access to funding without the rigorous process of obtaining bank financing. Furthermore, internal sources of finance may be less bureaucratic and it reduces borrowing costs other than interest rates.[14] Finally, the robust economic activity in Malta has led to strong improvement in profitability, which in turn increases the availability of internal sources of finance.[15] From a policy perspective, removing tax distortions between borrowing and equity financing could encourage NFCs to increase equity within the group rather than intra-group lending.

[12] As a robustness check, a sample of 172 NFCs, which cover 41% of total loans and 54% of intercompany loans, was used to investigate in more detail the results obtained from the population data. The audited accounts of such companies were used for comparison purposes which broadly confirmed the results obtained in the exercise explained above.

[13] Hertkorn, A (2015), "Consolidated and non-consolidated debt measures of non-financial corporations." In IFC Bulletin No. 39.

[14] Darmanin, J. (2017), "The Financing of Companies in Malta", *Quarterly Review* 2017:4, pp. 53-58, Central Bank of Malta.

[15] IMF, 2017. "Non-Bank sources of corporate financing in Malta". Malta Selected issues, Article IV 2017.