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CENTRAL BANK OF MALTA

UPDATE ON THE BANK LENDING SURVEY

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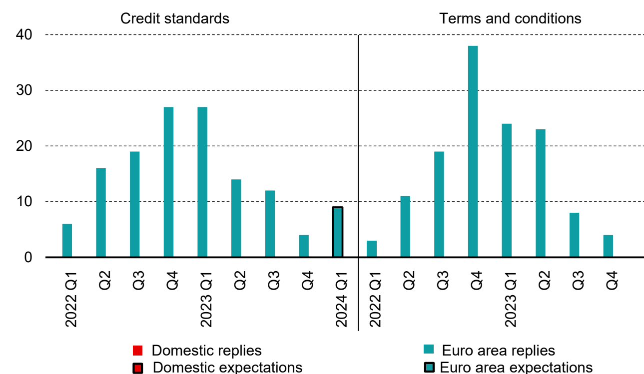
BOX 2: UPDATE ON THE BANK LENDING SURVEY[1]

The purpose of this article is to present an overview of the responses received in the 2023 BLS rounds.[2] Across the euro area, 150 banks were surveyed, four of which are Maltese banks. The latter, collectively account for over 87% of overall domestic bank credit. The BLS aims to track every quarter's recent and expected developments in lending policies and credit demand of enterprises and households.[3] Additionally, the survey includes ad hoc questions on specific topics such as funding conditions, the impact of new regulatory and supervisory measures, climate-related risks, as well as the effects of key ECB interest rates on bank profitability, amongst others.

Chart 1
CORPORATE CREDIT STANDARDS AND TERMS AND CONDITIONS
(+ indicates net tightening/- indicates net easing)

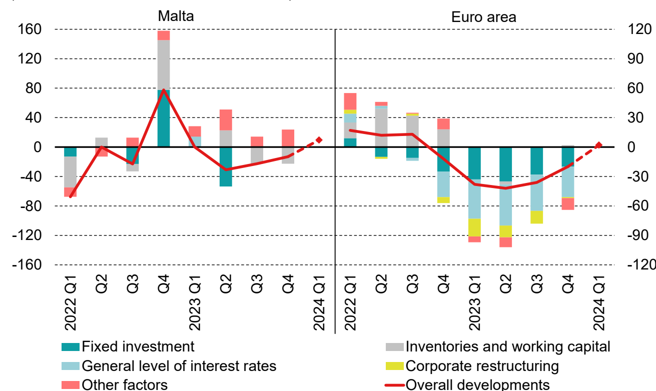


Sources: ECB; Central Bank of Malta calculations.
Note: Given domestic replies indicate no change in lending standards, no domestic developments are visible in the chart.

Loans to enterprises

As in previous years, Maltese banks reported no changes in their overall credit standards and terms and conditions for new loans to enterprises (see Chart 1). Notwithstanding, some signs of tightening were reported for loans linked to market rates, which however did not affect overall margins. Meanwhile, following the increase in the overall demand for corporate loans reported in the last quarter of 2022, no changes were reported in the first quarter of 2023 (see Chart 2). In subsequent quarters, weaker demand was reported owing to reduced fixed investment in the construction and real estate sectors as well as lower needs for inventories and

Chart 2
CORPORATE CREDIT DEMAND
(+ indicates increase/ - indicates decrease)



Sources: ECB; Central Bank of Malta calculations.
Note: Domestic and euro area developments are plotted on the left and right axis, respectively. Stacked columns show the factors impacting corporate credit demand. Markers plotted on 2024Q1 refer to expectations.

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[1] Prepared by Mr Shaun Zaffarese, Analyst within Financial Stability and Surveillance Office. The author would like to thank Mr Christian Mamo, Senior Economist and Mr Andrew Spiteri, Manager within the same office, Ms Wendy Zammit, Head, Financial Stability Surveillance and Research Department and Mr Alan Cassar, Chief Officer Financial Stability and Statistics Division, for their valuable suggestions.

[2] The BLS data for all euro area countries is published on the ECB Data Portal.

[3] Lending policies include credit standards and terms and conditions. Credit standards refer to the bank's internal guidelines or loan approval criteria, established prior to the actual loan negotiation. These specify the required borrower characteristics such as income levels, age, and employment status which banks consider in their credit scoring methods. Credit terms and conditions refer to the conditions of a loan that a bank is willing to grant, namely the interest rate, loan size, fees, collateral requirements, maturity terms and other conditions.

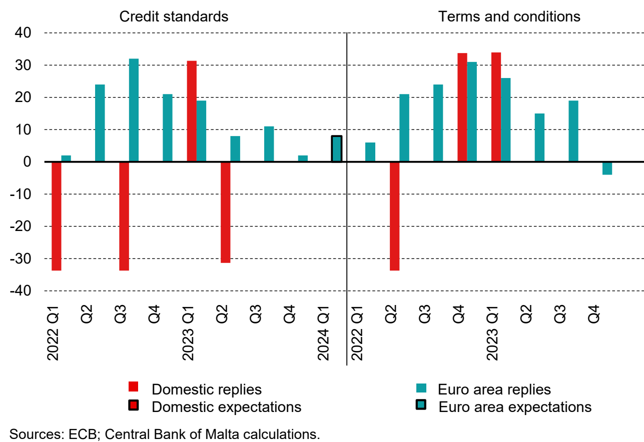
working capital. On the other hand, one bank reported higher demand by firms seeking to refinance existing bonds and loans linked to market rates. During the first quarter of 2024, on balance, banks expected an increase in demand for corporate loans, driven largely by one bank's improved capital position, which enabled it to focus more on expanding its corporate loan portfolio.

In contrast, in 2023, euro area banks reported further net tightening in corporate credit standards and terms and conditions, although gradually less as the year progressed. Such tightening was due to banks' risk perceptions and lower risk tolerance as rising interest rates and weak economic growth weighed on the creditworthiness of firms. This mainly led to wider margins on both average and riskier loans, coupled with higher collateral requirements. In line with this, net demand for euro area corporate loans declined in 2023, particularly in the first half of the year, amid higher interest rates and declining fixed investment.

Loans to households for house purchase

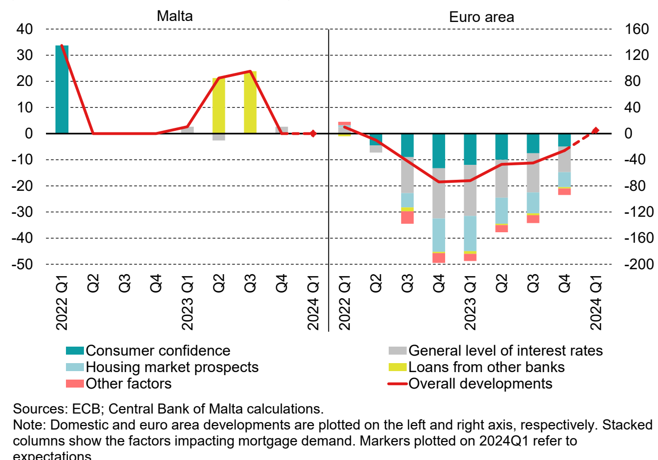
On balance, domestic banks tightened their lending policies for mortgages in the first quarter of 2023, driven by developments in both credit standards and terms and conditions (see Chart 3). This reflected lower risk tolerance, particularly towards high loan-to-value (LTV) lending, as well as increased funding costs which led to wider loan margins against market rates on both average and riskier loans. The tightening in credit standards was in part reversed in the second quarter following the adoption of a bank-specific measure. This allowed a higher LTV ratio but within the limits set by Directive 16, for borrowers having a low debt service-to-income (DSTI) ratio.[4] Meanwhile, net demand for mortgages remained strong, and increased during the second and third quarters of 2023 (see Chart 4).

Chart 3
MORTGAGE CREDIT STANDARDS AND TERMS AND CONDITIONS
(+ indicates net tightening/- indicates net easing)



Sources: ECB; Central Bank of Malta calculations.

Chart 4
MORTGAGE CREDIT DEMAND
(+ indicates increase/ - indicates decrease)



Sources: ECB; Central Bank of Malta calculations.
Note: Domestic and euro area developments are plotted on the left and right axis, respectively. Stacked columns show the factors impacting mortgage demand. Markers plotted on 2024Q1 refer to expectations.

Euro area participant banks reported a net tightening in mortgages' credit standards

[4] Central Bank of Malta Directive No.16 'Regulation on Borrower-Based Measures'.

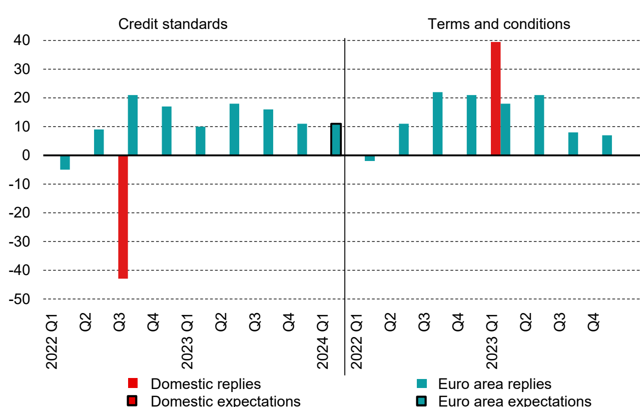
and terms and conditions throughout 2023. This was largely driven by higher risk perceptions and lower risk tolerance amid concerns on the general economic outlook, borrowers' creditworthiness and housing market prospects. Such tightening was also driven by increased funding costs propelled by the higher interest rate environment. This resulted in wider margins for both risky and average loans. Nonetheless, the extent of tightening decreased throughout the year, with a very marginal easing in terms and conditions reported in the last quarter of the year. Still, credit standards were expected to tighten in the first quarter of 2024 owing to tighter financing conditions, coupled with worsening consumer confidence. As a result, lower demand for mortgages was reported, with more muted developments expected in the first quarter of 2024.

Consumer credit and other lending to households

Domestic participants left credit standards for new consumer loans unchanged in 2023 but tightened terms and conditions in the first quarter, through wider margins on both average and riskier loans in response to higher cost of funding and balance sheet constraints (see Chart 5). Concurrently, demand was reported as stable in the first half of the year, with some increases reported in the latter half, particularly related to green financing for electric vehicles and other green loans under the Energy Efficiency and Renewable Energy (EERE) scheme (see Chart 6).[5]

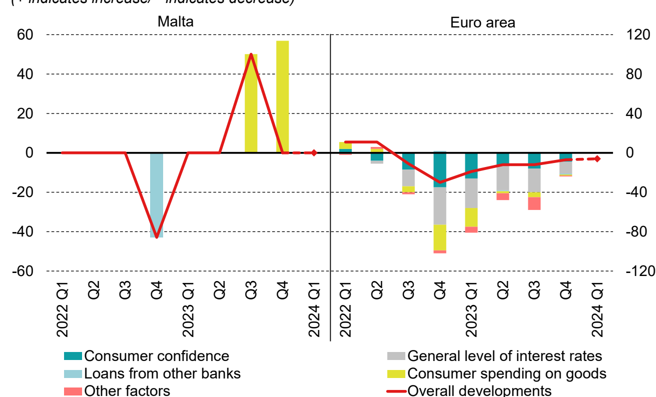
In the euro area, banks tightened further their lending policies during 2023. This reflected heightened risk perceptions and lower risk tolerance owing to the uncertain economic outlook and consumers' creditworthiness, along with higher cost of funding and increased balance sheet constraints. These factors led to wider loan margins which in turn, negatively impacted loan demand at a time of lower consumer confidence.

Chart 5
CONSUMER CREDIT STANDARDS AND TERMS AND CONDITIONS
(+ indicates net tightening/- indicates net easing)



Sources: ECB; Central Bank of Malta calculations.

Chart 6
CONSUMER CREDIT DEMAND
(+ indicates increase/ - indicates decrease)



Sources: ECB; Central Bank of Malta calculations.
Note: Domestic and euro area developments are plotted on the left and right axis, respectively. Stacked columns show the factors impacting consumer credit demand. Markers plotted on 2024Q1 refer to expectations.

[5] Two banks partnered with the European Investment Fund to deliver interest-free loans under the scheme of EERE during the first ten years.

Ad hoc questions

The first ad hoc question delves into detail regarding the wholesale and retail funding situation of BLS banks. Access to retail funding deteriorated slightly as some domestic BLS banks reported increased competitive pressures and more advantageous investment opportunities as bond yields rose. Otherwise, access to wholesale funding remained unaffected. Euro area banks reported deteriorating access for both retail and wholesale funding. Retail funding, particularly short-term, was impacted adversely in the first nine months of the year due to similar drivers reported domestically. A slight improvement was then reported in the last quarter of the year, driven by improved long-term funding. Access to money markets and debt securities also deteriorated, mostly in the first quarter of 2023, reflecting the short-lived market turmoil in March, and the lower surplus liquidity resulting from the voluntary early repayments in TLTRO III. Access to wholesale funding sources improved slightly in the last quarter of the year. Some tightening, albeit to a lower extent, was reported for access to securitisation and the ability to transfer credit risk off the balance sheet.

Another ad hoc question addressed the impact of new regulatory and supervisory actions on banks' assets, capital position, and lending policies in 2023. Some domestic banks reported continued expansion of their balance sheet, with some issuing MREL-eligible debt to meet their Pillar I and Pillar II capital requirements. Such developments are also expected to continue over the coming year. In the euro area, banks reported an increase in their capital, mainly through growth in retained earnings, as well as rising liquid and RWAs. This reflected the renewed attention towards liquidity levels following the March 2023 market turmoil and higher risk weights in anticipation of a potential increase in credit risk. Euro area banks also reported a net tightening in credit standards and margins across most loan categories.

Regarding lending conditions and demand across the main economic sectors, in 2023, local demand for commercial real estate (CRE) loans dropped mainly due to weaker demand for office space as the tendency for work-from-home practices rose. This was coupled with tighter credit standards, and terms and conditions for lending to the construction sector due to fears of a potential slowdown in the sector. This situation is expected to linger throughout the first half of 2024. Concurrently, following an increase in the first half of the year, demand for corporate loans in the manufacturing, and wholesale and retail trade sectors fell in the second half, while lending to the education sector look promising for the first half of 2024. In the euro area, lending conditions for firms tightened and demand dropped across all the main economic sectors, particularly for property-related loans in the context of falling real estate prices, rising lending rates, and higher construction costs. In addition, declines in collateral values and structural changes within the CRE segment affected the profitability of investment projects. As a result, banks reported higher risk perceptions and reduced risk tolerance to the CRE market across Europe in a bid to limit their adverse impact on their NPL ratio. These developments were expected to persist during the first half of 2024.

The survey also delved deeper on the effect of monetary policy and its tightening effect throughout the year. Responses indicated that the phase-out of the Eurosystem's TLTRO III had no impact on the domestic financial situation and lending policies. However, euro area banks noted the adverse impact on their liquidity positions, profitability, and funding conditions. Furthermore, in the first quarter of 2023, a tightening impact was reported on credit standards, particularly for loans to firms, while in the second and third quarters of the year, euro area participants reported a mild tightening effect on terms and conditions and downward pressures on loan volumes. Meanwhile, the impact of rising ECB key interest rates impacted positively the net interest margins of domestic BLS banks through wider margins and favourable yields on bond purchases. Some banks however reported adverse impact on their non-interest income due to lower valuations of fixed-income financial instruments. Looking ahead, one bank anticipated lower profits through tighter margins, due to its plan to increase remuneration rates on deposits in the six months ending March 2024 in a bid to remain competitive.

Similarly, euro area banks reported a markedly positive impact on their net interest margins, resulting in higher NII in the second and third quarters of 2023, although this was expected to slow down substantially in the subsequent six months. On the other hand, a negative impact was reported on loan and deposit volumes and a drop in non-interest income through capital losses and lower net fee and commission income, as well as higher provisioning needs and impairments.

In addition, because of the ECB's monetary policy asset portfolio, one domestic bank reported that during the six months ending March 2023 it utilised its excess reserves to purchase holdings of euro area sovereign bonds. Some respondents also reported an increase in their NII because of the ECB's portfolio rebalancing. Euro area banks also reported a positive impact on profitability from higher NII. However, they also reported a negative impact on their market financing conditions, liquidity positions and total assets. There was also a continued net tightening impact on terms and conditions accompanied by a negative impact on lending volumes.

Meanwhile, during the second half of 2023, domestic banks' excess liquidity held with the Eurosystem had no impact on their lending policies and volumes. However, euro area banks experienced a decline in excess liquidity which led to tighter credit standards, and terms and conditions. Such development was however limited and is expected to persist.

In the July 2023 survey round, respondents were asked about the impact of climate-related risks on their lending behaviour. Domestic respondents did not report any changes in their overall credit standards, and terms and conditions. However, it was highlighted that firms in transition and green firms benefit from advantageous terms and interest rates towards green initiatives, such as for investing in electric vehicles and renewable energy, reflecting products developed as part of the EERE scheme.[6] Meanwhile, some banks reported that demand increased for loans to all categories, whether brown, firms in transition, and green, and is expected to continue in 2024. This is more so for green firms due to higher fixed investment and corporate restructuring related to climate change. Such lending was supported by fiscal incentives through beneficial rates for customers qualifying for the banks' ESG products. In the euro area, banks tightened credit standards for brown firms but eased conditions for green firms and those in transition, with such changes expected to continue in the first half of 2024. Climate change awareness has raised demand for loans by transitioning and green firms, driven by corporate restructuring, investment needs for a sustainable economy and supported by fiscal measures and green bond issuance.

Conclusion

The 2023 BLS results shed light on the divergence in the interest rate pass-through between Malta and the euro area, as lending policies were largely stable for all loan categories in Malta. This contrasts with the tightening reported in the euro area because of higher risk perceptions and lower risk tolerance. This resulted in changes in domestic loan demand to be quite muted and mostly unrelated to the increasing ECB key interest rates. Conversely, lower demand for all loan categories was reported in the euro area. Meanwhile, rising ECB interest rates resulted in higher NII for banks across the euro area, including Malta, but capital deductions, as well as lower non-interest income and higher provisions were reported in the case of the euro area. Tighter monetary policy also resulted in higher funding costs, which negatively affected access to short-term retail funding, both in Malta and the euro area.

[6] "Green firms" – Firms that do not contribute or contribute little to climate risk; "Firms in transition" – Firms that contribute to climate change, which are making relevant progress in the transition; "Brown firms" – Firms that highly contribute to climate change, which have not yet started or have so far made only little progress in the transition.