

## Box 3

## HAVE EURO AREA BANKS BEEN MORE DISCRIMINATING AGAINST SMALLER FIRMS IN RECENT YEARS?

The combination of a general economic slowdown and the intensification of the financial crisis in late 2008 resulted in a marked reduction in lending to non-financial corporations in the euro area. Survey-based evidence suggests that the slowdown in credit to the euro area corporate sector reflects both lower borrower demand and more restrictive loan supply by banks faced with pressures on their balance sheets.<sup>1</sup> However, the economic impact on and hence potential feedback loops to the financial sector crucially hinge on the extent to which the borrowers facing a less abundant supply of bank credit are able to replace it with other sources of finance. Against this background, this box sheds some light on whether lending to smaller companies, which are typically more bank-dependent, has declined by more than credit to larger firms.<sup>2</sup>

There are several reasons why banks, when faced with pressures to deleverage and greater uncertainty about the economic outlook, may decide to restrain lending to smaller companies by more than that to larger ones. First of all, smaller firms usually suffer more from problems related to a lack of information on creditworthiness (e.g. owing to less rigorous requirements for their accounting statements) and hence in general face higher external financing costs. Second, this information problem is reinforced by smaller firms' typically lower amount of collateral (e.g. fixed assets) and less stable cash flows. Furthermore, smaller firms are generally in a weaker bargaining position vis-à-vis their banks, as they are less able (than larger firms) to tap debt markets and, due to their more information-intensive bank relationships, they face greater costs when trying to shift banks ("lock-in" costs). Overall, such problems are likely to be more pronounced during periods of heightened uncertainty about the value of collateral and banks' own situation.

Applying the ECB's MFI interest rate statistics, which contain information on MFI lending rates and new business volumes broken down by the size of loans to non-financial corporations, Chart A shows that since its peak in early 2008 the six-monthly flow of small-sized loans (i.e. below €1 million) started declining earlier and by more than for large-sized loans (i.e. above €1 million).<sup>3</sup> Moreover, by August 2010 the six-monthly flow of small-sized loans

1 See the Eurosystem's bank lending survey. See also ECB, "Monetary policy and loan supply in the euro area", *Monthly Bulletin*, October 2009.

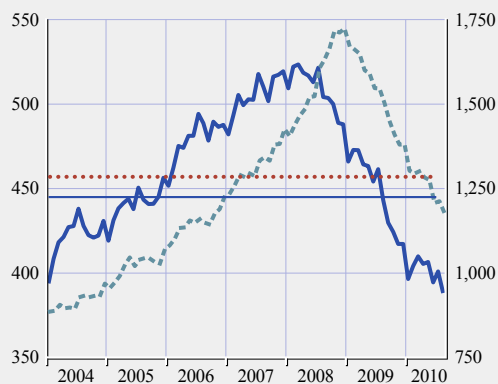
2 SMEs are of high importance in the euro area corporate sector. They account for 99% of the number of firms in the euro area, around 60% of turnover and almost 70% of employment; see also European Commission, "2007 SME Observatory Report", and the ECB survey on the access to finance of SMEs in the euro area.

3 Obviously, this distinction provides information about the size of the loans taken out, but not about the actual size of the firms taking out the loans. Nonetheless, it may serve as a rough proxy for the granting of loans to smaller and large firms, respectively. In particular, the large-sized loan category is likely to be dominated by larger companies.

**Chart A New business volumes of loans to euro area non-financial corporations broken down by size**

(Jan. 2004 – Aug. 2010; EUR billions; six-monthly flows)

- small-sized loans (left-hand scale)
- ..... small-sized loans (average 2003-10; left-hand scale)
- - - large-sized loans (right-hand scale)
- large-sized loans (average 2003-10; right-hand scale)

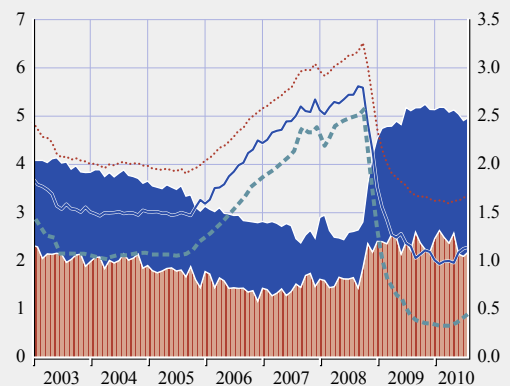


Source: ECB.

**Chart B Short-term MFI interest rates on new business loans to euro area non-financial corporations and the three-month EURIBOR**

(Jan. 2003 – Aug. 2010)

- spread between small-sized loan rate and three-month EURIBOR (percentage points; right-hand scale)
- ..... spread between small-sized and large-sized loan rate (percentage points; right-hand scale)
- - - three-month EURIBOR (percentage; left-hand scale)
- large-sized loan rate (percentage; left-hand scale)
- ..... small-sized loan rate (percentage; left-hand scale)



Source: ECB.

reached its lowest point since the beginning of the statistics in January 2003. In addition, it currently stands 15% below its 2003-10 average. In comparison, by August 2010 the six-monthly flow of large-sized corporate loans was close to its historical average and, while having declined rapidly in recent months, had only fallen back to the level last observed in early 2007.

A possible explanation for the stronger slowdown of small-sized lending might be that, in recent years, smaller firms have requested fewer loans from banks than larger firms did. However, it would normally be expected that such behaviour would put downward pressure on lending rates. But the opposite seems to have occurred since over the last two years, in parallel with the slowdown in lending, the rates on small-sized loans to non-financial corporations have failed to decline to the same degree as reference market rates (see Chart B). Notably, not only has the risk premium related to small-sized short-term corporate loan rates (i.e. the difference compared with the three-month EURIBOR) increased by more than 100 basis points since its low in mid-2008, but also their level compared with large-sized short-term corporate loan rates has increased and by mid-2010 reached its highest level since the inception of the statistics. This suggests that banks have become more discriminating in their pricing and granting of loans to smaller companies. This could contribute to the pressure such firms face amid weak profitability and significant financing needs, possibly aggravating the adverse economic feedback loop as small firms tend to be dependent on the banking sector to finance their investments and their ability to generate internal funding remains low (see Section 2.2).