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Economic Letter

Credit Conditions for Irish Households and SMEs

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Credit Conditions for Irish Households and SMEs [1]

The impact of COVID-19 could have caused pro-cyclical tightening in credit supply conditions. If this occurred, it would have had the potential to amplify the macroeconomic downturn and/or inhibit the economic recovery. Significant policy actions have been taken to reduce this risk. The biggest factor that shaped credit outcomes at the start of the pandemic appears to have been a fall in demand, given the impact of health restrictions on economic activity. Some tightening has also been observed in credit supply conditions due to heightened macroeconomic risk and borrower specific factors, but the latest data suggest credit standards are currently broadly unchanged. New lending has now started to recover, albeit with trends diverging across borrower segments. Some forward-looking risks to credit supply remain, including the possibility of an unexpected deterioration in credit quality on lender balance sheets.

1. Introduction

This Economic Letter examines the impact of COVID-19 on the Irish credit market including the relative roles of supply and demand. The Letter briefly discusses the role of policy interventions in supporting a sustainable supply of credit and maintaining the flow of credit as the economy re-opens. The analysis outlines that a disruption in credit supply may result in firms and individuals who would otherwise be able to sustainably borrow funds being unable to access credit. This can lead to businesses cutting back on employment or investment, and households cutting back on consumption or house purchase.

The key findings are as follows:

- Following an initial material contraction in new lending volumes, activity has started to recover, particularly in the mortgage market. Consumer lending remains subdued and is unlikely to recover before consumer spending. Aggregate SME lending started to recover in late-2020 albeit that trends vary widely across sectors, depending on the impact of COVID-19.
- The biggest factor shaping observed credit outcomes since the pandemic appears to be falling credit demand, due to the initial sharp drop in economic activity and rising economic uncertainty. Nonetheless, demand for credit may increase quickly as the economy re-opens and fiscal supports are unwound.

[1] The authors are grateful for the contributions of the many colleagues which have informed this Letter.

- Some tightening in credit supply conditions was reported by banks but to a much lower extent than during the financial crisis. This was driven by general economy and borrower specific factors as opposed to bank balance sheet constraints as was the case during the global financial crisis from 2008 onwards. No change in credit standards was noted in the first quarter of 2021, further suggestive of a more stable credit environment.
- Forward-looking risks to the supply of credit remain, including the possibility that supply will not facilitate firm demand for credit as the government liquidity supports are phased out and as the economy reopens, the possibility of an unexpected deterioration in credit quality, and individual lender decisions leading to a collectively sub-optimal outcome.[2]
- Despite significant policy actions having been taken, if a tightening of risk appetite by lenders were to crystallise, the provision of financing by the financial system may only partially meet demand from households and firms as the economy starts to recover. Firms without lender relationships may be particularly vulnerable in such a scenario.[3]

In summary, while the credit market has started to recover from the initial shock, and previously accumulated resilience as well as policy supports have enabled the financial system to absorb rather than amplify the shock to date, risks remain for credit supply as the economy reopens. This could have broader implications for the phasing out of policy supports and creating certainty around the timing of their removal, including fiscal supports such as government guaranteed loans but also direct fiscal supports such as tax warehousing given that many firms deferred payments during the pandemic (CSO 2021 Figure 13).

The remainder of this Letter proceeds as follows. Section 2 summarises policy developments during the pandemic in relation to credit. Section 3 provides an overview of household and SME credit. Section 4 looks at demand and supply drivers of these trends. Section 5 outlines some of the potential risks to credit supply that may emerge over the coming months and years.

2. Policy interventions to support credit supply

A wide range of policy interventions have been taken at a European and domestic level to reduce the risk of a pro-cyclical contraction in the supply of credit. The ECB enacted a number of monetary policy measures in the euro area, namely liquidity policies and asset purchases, aimed at creating

[2] See Chart 2 Box B Financial Stability Review 2020:II for discussion on how the macroeconomic downturn could be worse if the banking system were to restrict the supply of credit materially.
[3] See SME Market Report 2020 – Figure 18 and accompanying text.

favourable financing conditions to support the flow of credit across the euro area (Holton et al., 2020). The liquidity policies incentivise bank lending to the private sector, while asset purchase programmes have pass-through benefits to the broader credit environment and support the economic recovery.[4] Further measures by the ECB's SSM function were in the form of capital relief and capital conservation through various microprudential actions (Financial Stability Review 2020:II).

Additional to the euro-area wide measures, at a domestic level the Central Bank acted by reducing the Countercyclical Capital Buffer (CCyB) in order to support the continued provision of credit to households and businesses (De Nora et al., 2020). In addition, forward guidance was issued to reduce the uncertainty around capital planning, while public communication and engagement made clear that the expectation was to provide real economy support, rather than dividend distribution.[5] Fiscal supports for adversely affected households and businesses have also been extensive throughout the pandemic. They have helped to cushion the financial impact of pandemic-related restrictions (Cahill et al., 2020, Lambert et al., 2020), and likely acted as a substitute for overdrafts and short-term borrowing.

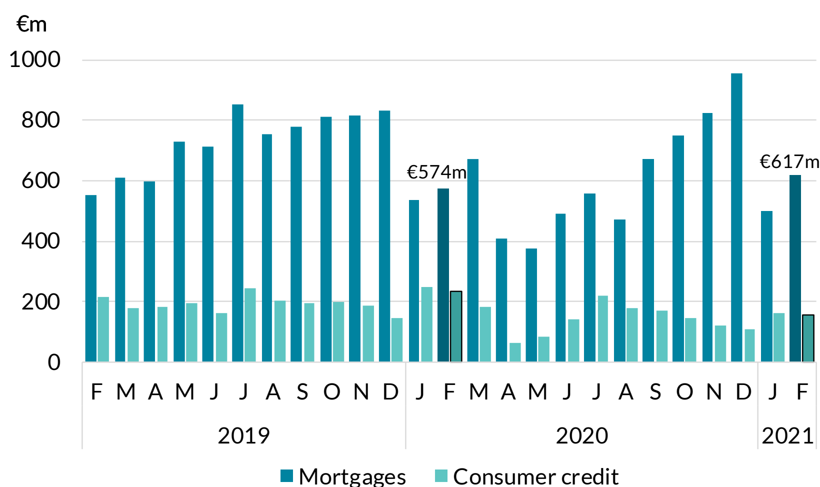
3. Developments in credit aggregates during the pandemic

Household Credit

Following a sharp fall in new lending at the onset of COVID-19, late 2020 saw a marked recovery in the level of mortgage activity (Chart 1). It is likely that the strong activity partly reflects pent-up demand, as transactions and activity from earlier in the year were postponed. Indications are that activity remains buoyant in early-2021, albeit new agreements in January were muted in comparison to 2020, whereas February new mortgages were 7 per cent above February 2020. Euro area mortgage developments showed a similar trend, albeit Ireland experienced a sharper decline in the early months of the pandemic. Forward-looking indicators such as the close-to-real-time monitoring of the number of new mortgage applications via the Central Credit Register remain elevated, with enquiries in recent weeks in excess of pre-pandemic levels (Chart 2).[6] Mortgage approvals data are also strong, with a noticeable increase in refinancing activity in recent months.

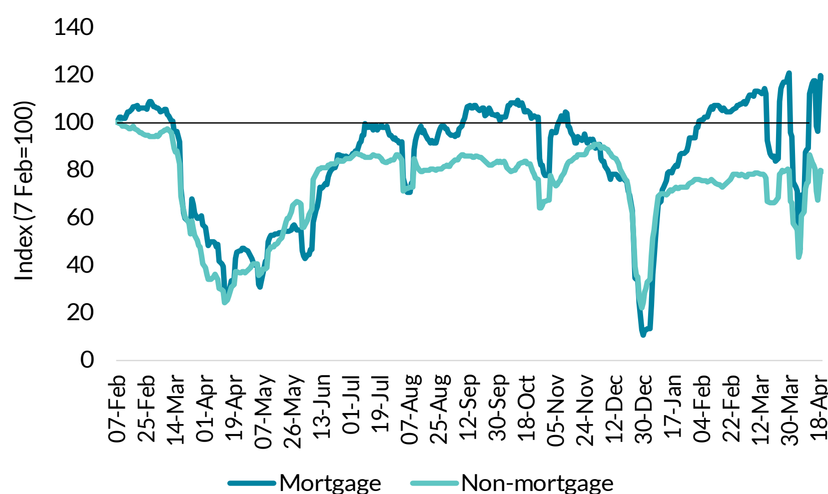
[4] Conefrey et al (2021) estimate that the purchase programmes boosted output by over 0.4 per cent and 1.4 per cent in 2020 and 2021 respectively relative to a counterfactual scenario excluding the policy supports.
[5] See Financial Stability Review 2020:II (p.11), and Central Bank of Ireland Statement.
[6] See McElligott et al. (2020) for background information on the high-frequency data on lender enquiries to the Central Credit Register related to new credit applications.

Chart 1: New mortgage and consumer credit agreements



Source: Central Bank of Ireland, Retail Interest Rate Statistics.

Chart 2: New loan enquiries to the Central Credit Register



Source: Central Bank of Ireland, Central Credit Register.
Notes: Data are 7-day rolling sum and refer to individuals only. Last observation is 20 April 2021.

New lending for consumption purposes is expected to remain subdued until consumer confidence and activity returns. New consumer lending for early-2021 remains 34 per cent below early-2020 levels (Chart 1). Consumer credit is largely driven by car purchases, holidays and credit cards, on which the opportunity to spend has been substantially curtailed due to the public health restrictions. The quick rebound in consumer lending seen in summer 2020 highlights that the flow of consumer credit can pick up quickly and sharply to support the recovery when health restrictions ease. There is some evidence that banks adjusted their underwriting approach to affordability assessments for consumer finance when the pandemic hit (e.g. including turning off automated approvals and higher scorecards for

approvals). Higher frequency forward-looking indicators for consumer lending show that personal loan applications remained well below pre-pandemic levels in April, albeit they have not reached the lows associated with the first set of restrictions in response to the onset of the pandemic last spring (Chart 2).

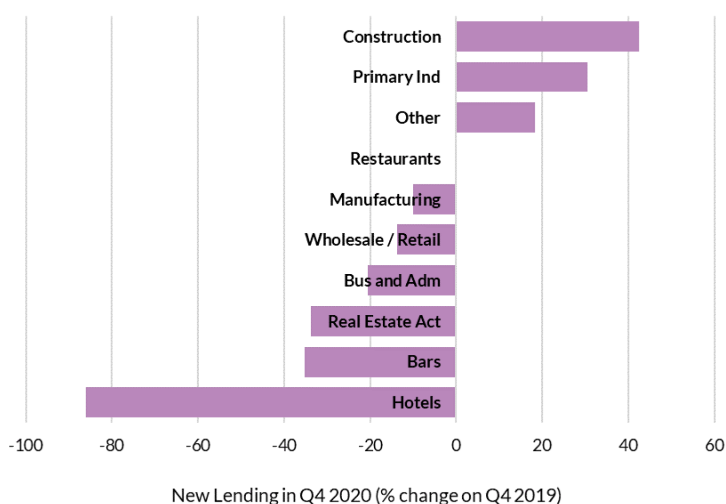
Credit to SMEs

The COVID-19 pandemic has had a huge impact on the domestic and global business environment. The scale and nature of the impact has differed from sector to sector with many firms seeing their revenue disappear overnight, and having to invest quickly to keep their business open, if permitted under health measures. The financing arrangements for a business can be more complex than a household with firms using a broader set of financing options including equity injections, inter-company credit, bank loans and non-bank financing.[7]

New lending to SMEs has recovered from the very low levels seen after the initial health restrictions in Q2 2020. New lending in Q4 2020 was 90 per cent above that of Q2, albeit still 15 per cent below Q4 2019, and remains above the levels of 2010 to 2016.[8] The recovery in lending activity varies across sectors, however, with strong growth in lending to the construction and primary industry (dominated by agriculture) sectors, reflecting their continued operational activity in late 2020 (Chart 3). The strong rebound in construction lending as construction sites reopened provides some tentative evidence that credit is flowing and available when demand returns. Nonetheless, construction lending can be volatile and makes up a relatively small part of total lending, so banks willingness and ability to grow lending will only be fully tested when a wider pick-up in economic activity occurs. On the other hand, credit drawdowns in heavily impacted service-orientated sectors are far below normal levels. This is most acute in the hotel sector where new drawdowns are 85 per cent down on Q4 2019.

[7] See Behind the Data, "The role of non-bank lenders in financing Irish SMEs".
[8] See SME Market Report 2021 Figure 12.

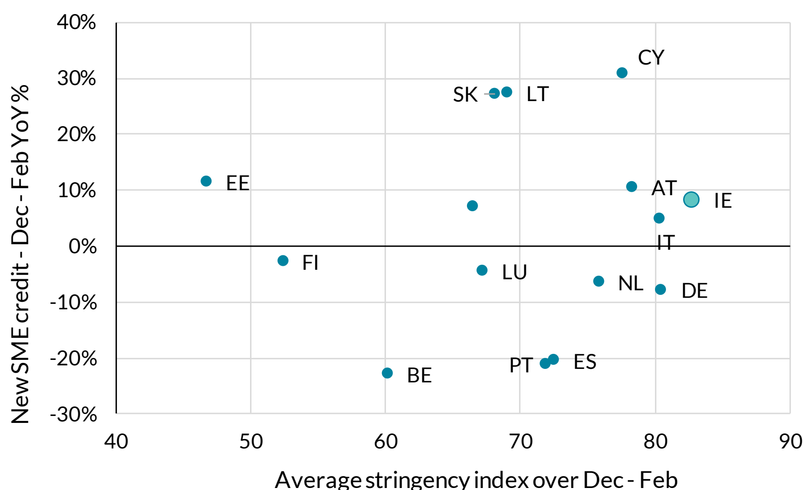
Chart 3: Annual change in new lending to SMEs by sector across SME sectors



Source: Central Bank of Ireland, SME and Large Enterprise Credit and Deposits Statistics.

More recent data, which acts as a SME loan proxy – lending to firms for amounts up to €1 million - highlight that Ireland is not an outlier over recent months (Chart 4). Indeed, lending grew over the three-months to February 2021, compared to a year previous, despite Ireland having the tightest public health restrictions in the euro area over this time.

Chart 4: Tight measures over last three months, and positive SME lending growth



Source: ECB MFI Interest Rate Statistics, and Oxford COVID-19 Government Response Tracker (OxCGRT).
Notes: The stringency index records the strictness of government responses, as well as support measures and health system policies. A higher index value indicates a more stringent response. Data refer to December 2020 to February 2021.

Policy has also supported the provision of credit. To date, €265 million has been lent under the COVID-19 Credit Guarantee Scheme (CGS) across 4,280 different loans[9]. Recent weeks have seen some signs of an increase

[9] For context, total bank new loans to SMEs in Q4 2020 (excluding financial intermediation) was €1.3 billion.

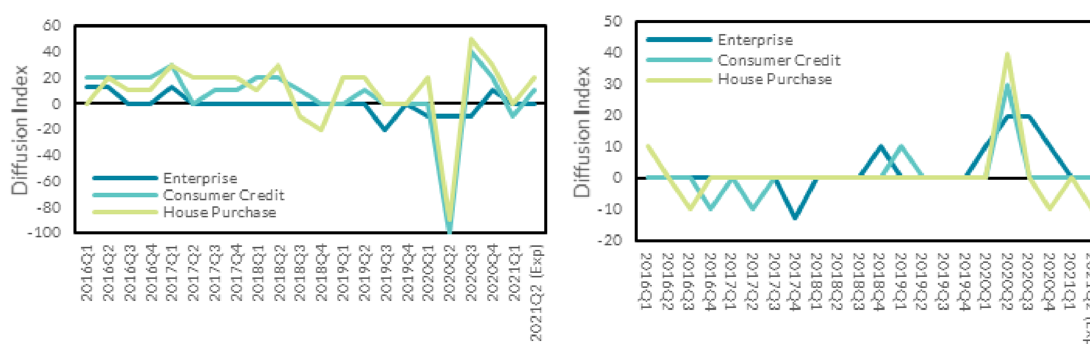
in the drawdown from the scheme but levels remain muted. The repurposed Future Loan Growth scheme has seen higher levels of activity with over €420 million in lending approved since July 2020 when the expansion was launched. This scheme offers longer-term loans, which may be more attractive to firms, with some banks now fully subscribed to the scheme. Although take-up of the CGS is relatively low to date, the availability of government supported lending schemes is important in the context of heightened uncertainty. In particular, the risk-sharing component may become more important to support the reopening of firms after a difficult period and bridging potential gaps between credit demand and lender risk appetite.

4. The role of demand and supply in credit

Observed trends in credit aggregates are reflective of underlying supply and demand conditions, and it is important to understand the relative dynamics of these to gain a full understanding of the current environment.

Latest data from the ECB/Central Bank of Ireland Bank Lending Survey show that there was a sharp decline in credit demand at the onset of the pandemic, particularly for mortgage borrowing and consumer credit, with a recovery in the latter half of the year (Chart 5).[10] This corresponds with the observed fall in new lending and the subsequent recovery.

Chart 5: Bank Lending Survey for Ireland – Demand (LHS) and Credit Standards (RHS)



Source: Central Bank of Ireland, Bank Lending Survey.
Note: Charts show a diffusion index on a scale from -100 to 100. -100 indicates the largest possible fall in demand or loosening of supply, +100 the largest possible increase in demand or fall in supply.

For businesses, the fall in demand reported by bank and firm surveys was much less pronounced and the recovery in the latter half of the year was also much more subdued than it was for households. This aligns to survey data, showing SME credit application rates were low compared to previous

[10] The Bank Lending Survey (BLS) is conducted quarterly by Eurosystem central banks in conjunction with the ECB, and asks a panel of commercial banks about changes in credit conditions over the previous quarter. For more details see here.

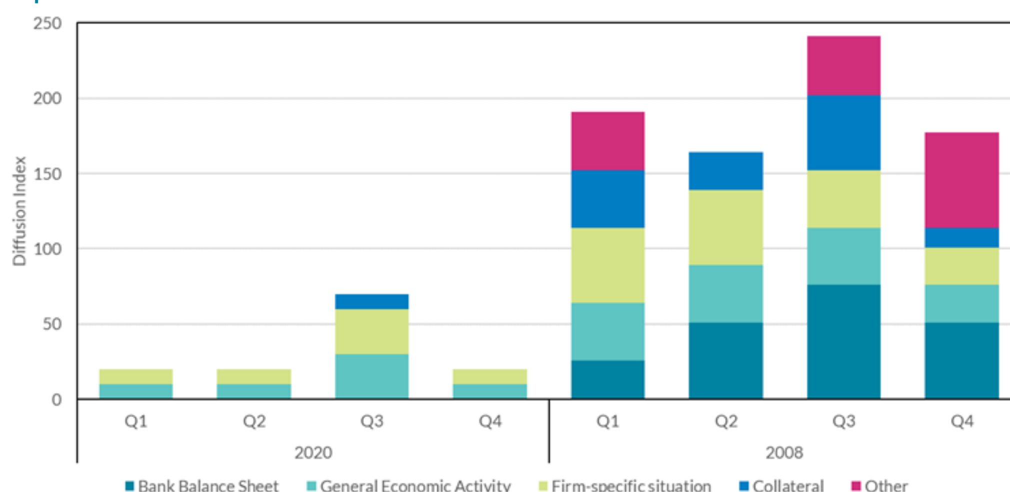
years, with SMEs mainly citing sufficient internal funds, some citing dislike of debt and only 3 per cent citing potential rejection.[11]

Large-scale government supports to firms may also be contributing to weaker credit demand. The State provided an estimated €13 billion through enterprise supports (SME Market Report 2021, Box 2), reducing the need for firms to seek external funding relative to what otherwise may have been the case.[12] However, as discussed above, it is likely that demand will increase as the economic and business environment recovers and where firms have used up internal funds to withstand the pandemic related shock.

On the supply side, survey evidence from the BLS shows that credit standards in Ireland also tightened somewhat over the course of the pandemic across all forms of lending (Chart 5, RHS). This tightening was, however, less than was seen during the Global Financial Crisis, and towards the latter half of 2020, evidence emerged of a slight loosening of credit conditions on loans for house purchase. No change in credit standards was seen across any form of lending in 2021 Q1, indicative of a more stable credit environment.

In addition, the factors driving the tightening of credit standards in 2020 were different to those that were seen during the Global Financial Crisis. Chart 6 shows that the factors driving changes in credit standards in 2008 were a combination of bank specific, firm and economic factors, while it appears to be purely firm (i.e. borrower) specific factors and economic concerns driving the tightening in 2020, consistent with a more resilient banking system.

Chart 6: Factors Influencing Credit Standards in Ireland on loans to enterprise a comparison between 2020 and 2008



Source: Central Bank of Ireland, Bank Lending Survey.
Note: The chart shows factors that influenced changes in credit standards on loans to enterprises over each quarter as implied by the BLS. Each individual section of the vertical bars can take on a value of

[11] See SME Market Report 2021 Figure 16 and 20.
[12] This excludes the €2 billion Pandemic Stabilisation Recovery Fund which is mainly for large corporates, as well as the Pandemic Unemployment Payment, heath expenditure etc. Overall fiscal supports are estimated at €24.6 billion or 12.2 per cent of GNI* in 2020 (Conefrey et al. 2020).

between -100 and +100, with positive values indicating a contribution towards a tightening and negative values a contribution towards a loosening.

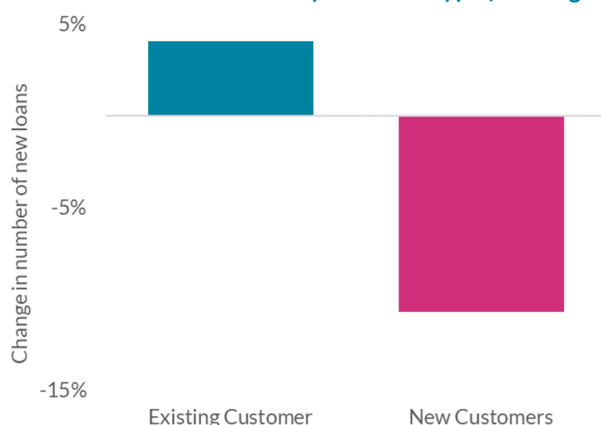
Government supports in the form of guarantees have also had a positive impact on supply by reducing the level of bank risk associated with lending. The BLS suggests that this effect is in operation, with banks reporting that such schemes had supported looser credit standards on eligible loans, relative to tighter conditions on unsupported loans. This highlights the role that fiscal policy can play alongside monetary and macro/micro-prudential policy in fostering positive credit conditions.

Access to credit by SMEs with no bank debt

The pace and scale of the recovery will be affected by the ability of SMEs to invest in the recovery and future of their business. It is possible that the risk appetite of banks may return in a gradual manner, as the economic and business outlook improves and uncertainty subsides. One area that may experience delays, given the information asymmetries, is lending to new-to-bank customers without an established relationship with the lender.

Firm survey data suggests some smaller SMEs, particularly Micro firms, lack bank relationships, which can help inform lenders credit assessments and support firm access to credit. Around four-out-of-ten SMEs do not carry bank debt.[13] Industry engagement has highlighted that lenders are actively supporting existing customers throughout the pandemic but are taking a cautious approach to new borrower proposals. In Q4 2020, banks increased the number of new loans to existing loan customers by 4 per cent over Q4 2019, but provided 11 per cent fewer loans to new-to-bank customers and existing customers[14] without debt in the same period (Chart 7). While disentangling the supply and demand factors is complex, continuing to monitor the availability and access to credit for all SMEs will be an important risk to monitor as we exit from the pandemic.

Chart 7: Number of new loans by customer type (% change on Q4 2019)



Source: Central Bank of Ireland AnaCredit, authors' calculations.

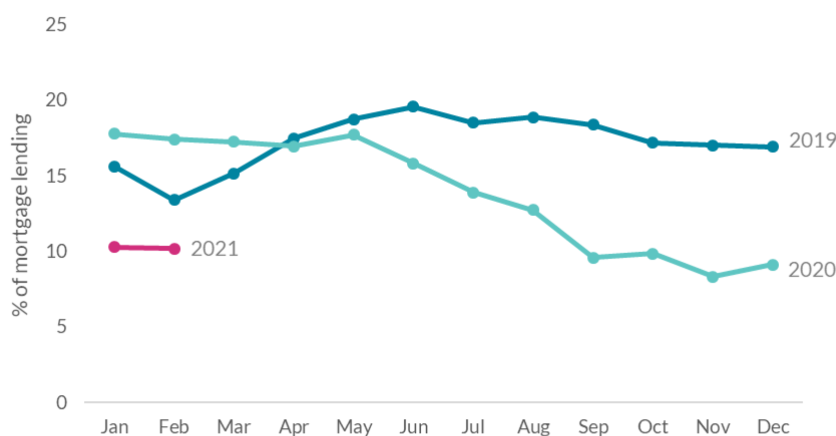
[13] See SME Market Report 2020, 'The Impact of Covid-19 on SMEs'.
[14] Existing loan customers are those with an existing loan at the Bank. New-to-bank and existing customers without debt are customers that have not had any loan with the bank over the previous 12-months.

Mortgage lending standards

While mortgage approvals and drawdowns have picked up significantly, there are some specific dimensions around the operation of the mortgage market during the pandemic that the Central Bank has monitored particularly closely.

The first is around changes in lenders' willingness to use the "allowances" framework of the mortgage measures.[15] At the onset of the pandemic, a number of lenders reduced their issuance of mortgages with an allowance. The share of lending with any allowance type fell from May onwards and hovered around 10 per cent of mortgage drawdowns by value towards the end of the year, which is about half the 2019 level (Chart 8). The share of lending with an allowance remains at about 10 per cent in early 2021. Previous analysis suggested that the restriction of issuance of new mortgages requiring an allowance reflected the interaction of the deterioration in the macroeconomic environment, banks' credit policies, and complexities in managing compliance with the proportionate limits in the mortgage measures (Financial Stability Review 2020:II). Supervisory engagement with banks suggests no further tightening of credit standards in recent months.

Chart 8: Share of mortgage lending with an allowance (drawdowns)



Source: Central Bank of Ireland data.

The second area is around the treatment of prospective borrowers who are in receipt of government supports. The Central Bank engaged with all large mortgage lenders to understand the approval process for applicants on government supports. Individual borrower financial assessments are undertaken to assess any new loan requests. No lenders reported outright rejection of loan requests if a prospective borrower is receiving PUP/TWSS or employed in a COVID-19 impacted employment sector. However, borrowers must be in a position to meet the bank's core affordability

[15] Banks and other lenders have the freedom to lend a certain amount above the LTV and LTI limits – see Explainer – What are the Mortgage Measures?

criteria. Tightening in credit underwriting standards during 2020 has been observed including, for example, no (historic) overtime/bonus payments included as guaranteed income sources/loan-to-income adjustments for borrowers in high-risk sectors. Given the volatile nature of the economic environment, lenders are also requesting updated documentation on employment, earnings, and savings prior to drawdown. Banks reiterate that they are conscious of their responsible lending obligations.

5. Key risks to credit supply conditions

While, so far, demand for credit appears to have been the main factor affecting observed credit developments, with little evidence to suggest that changes in credit supply have had broader macroeconomic implications, there remain forward-looking risks to the supply of credit, given the continued heightened uncertainty. These include:

- *Deterioration in asset quality:* An unexpected deterioration in bank balance sheets may change the current dynamics in relation to credit supply and cause lenders to alter credit standards and/or risk appetite causing tighter credit conditions than are currently in the market. There are a number of possible triggers for this risk, including latent borrower distress, that may materialise once government supports start to wind down, a prolonged period of pandemic-related disruption to economic activity or material 'scarring effects' on the economy. Any subsequent unexpected deterioration in bank asset quality could tie-up capital that would have otherwise supported new lending. The retail banking system has become more resilient over the past decade and has been supported by recent policy actions. A forward-looking assessment suggests that the system in aggregate has sufficient capital to absorb shocks that are materially worse than current baseline projections. Nonetheless, the degree of uncertainty associated with these projections is high and system-wide positions can mask significant dispersion across individual banks.

- *Selective risk appetite due to continued high uncertainty, even in the absence of bank balance sheet constraints*: A prolonged period of disruption due to the pandemic or increased uncertainty around the medium-term effects of the pandemic could potentially suppress lenders risk appetite, even if lenders have sufficient financial resources to absorb the shock. A collective contraction in the supply of credit by the banking system could amplify the downturn. The impact of tighter risk appetite may be felt across the full loan book or in specific sectors (e.g. those most exposed to the pandemic) meaning that the impact may be uneven across the economy and country.

- *Structural changes to the market:* Changes in the structure of the Irish banking market will reshape the dynamics within the market and, depending on the exit roadmap, could have implications for the supply of credit, especially in the SME sector. In addition, recent years have seen the emergence of new non-bank lenders globally. The product offerings, business and funding models of these lenders differ to traditional banks. Further work is required to develop a deeper understanding of the resilience and risk of these businesses and their funding models across the full economic cycle.

6. Summary

The combination of heightened economic uncertainty and the potential impact of the shock on banks' balance sheets caused by COVID-19 could have caused pro-cyclical tightening in credit supply conditions. If this occurred, it would have had the potential to amplify the macroeconomic downturn and/or inhibit the economic recovery.

Significant policy actions have been taken to reduce the likelihood of this risk materialising. As a result, while there was a material contraction in new lending volumes at the onset of pandemic, new lending has started to recover, with trends diverging across segments. Mortgage lending has recovered particularly strongly. In the SME segment, there has been a relatively strong headline recovery in bank lending activity, but trends vary widely across sectors, reflecting the sector-specific impact of COVID-19.

Overall, the available evidence suggests that the biggest factor shaping observed credit outcomes at the onset of the pandemic was a fall in the demand for credit, due to the initial sharp fall in economic activity related to the impact of COVID-19. There has also been some tightening in credit supply conditions. Importantly, the tightening in credit supply conditions observed so far does not appear to be driven by factors that relate to bank balance sheet constraints, such as capital, access to funding or liquidity.

While, at this stage, there is little evidence to suggest that changes in credit supply have had broader macroeconomic implications, there are forward-looking risks to the supply of credit. These include risks stemming from the phasing out of government supports as the economy reopens and the possibility of an unexpected deterioration in credit quality on lender balance sheets.

If a reduced risk appetite by lenders were to crystallise, the provision of financing by the banking system may only partially meet demand in some sectors as the economy starts to recover, or collateral and interest rates may otherwise tighten supply conditions in the market. This could be worsened by the decision of one of the main lenders to exit the Irish market. This could have implications for broader policy deliberations

around the phasing out of government supports, including government guaranteed loans.

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