THE CENTRAL BANK OF HUNGARY

What are the reasons behind the launch of FGS+?

INTRODUCTION

After the onset of the economic and financial crisis, the corporate lending declined as a result of tighter credit conditions and falling demand in Hungary. Narrowing credit supply dampens economic growth, leads to falling asset prices and the declining value of available collateral further reduces credit supply. The launch of the FGS, constituting a part of the monetary policy instruments, managed to hinder this negative spiral in Hungary, reduce interest costs to reasonable levels, stop the decline in lending and establish credit conditions that increased the willingness of companies to invest, hence improve monetary transmission. As a secondary effect of the FGS, investments generated additional demand for working capital loans, but enterprises not participating directly in the programme also benefited from a positive cyclical effect, which could improve their creditworthiness and increase their credit demand.

Notwithstanding the beneficial effects of the FGS, lending outside FGS has yet to recover, and excessive risk aversion by banks and tight credit conditions remained present in this segment. The loan stock continues to decrease just as it did in the previous years, even despite the MNB's significant cuts in the policy rate. Outside the FGS, enterprises either do not have access to funding or only with unreasonably high premium. This is particularly the case for long-term investment loans. All of these are symptoms of the abnormal operation of monetary transmission in this SME credit market segment.

THE EFFECT OF THE FGS ON THE CORPORATE CREDIT MARKET

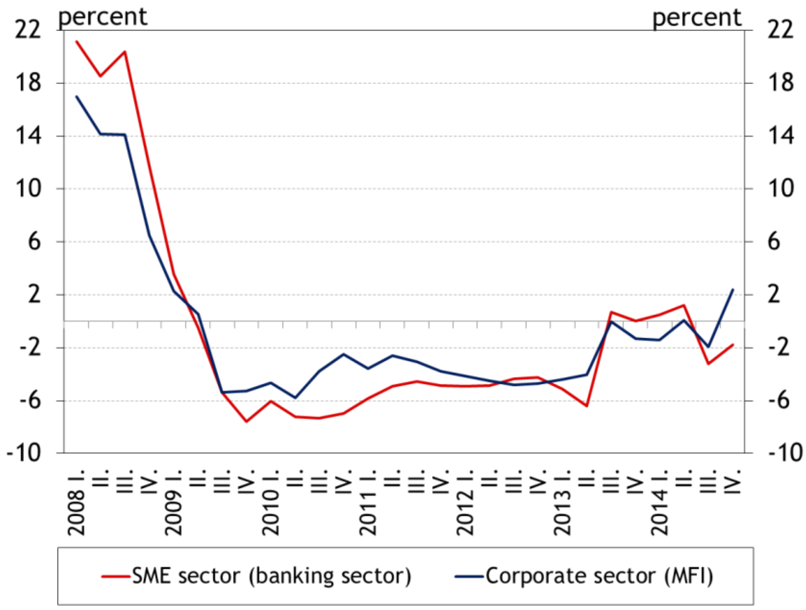
As a result of the central bank's easing cycle, the interest rate on market-based loans started to approach the maximum rate of 2.5 per cent available under the FGS; however, the difference is still substantial. In 2014, the average interest rate of contracts below a credit line of EUR 1 million fell to around 4 per cent, but spreads have not changed substantially. Naturally, this is only the interest burden of enterprises that are creditworthy and actually took out loans. The enterprises potentially using up loans that would be considered creditworthy, but have not borrowed due to high market interest rates are not represented in the statistics. The exclusion of these enterprises from the credit market lead to unrealised investments, which indirectly results is less lower-than-potential output and a lower rate of employment.

Despite the constant decline in interest rates, the FGS was needed to break the sharp decline of several years in corporate lending (Chart 1). Although a portion of transactions concluded in FGS would have realised on a market basis as well, the FGS still led to a significant increase in corporate lending, hence we observe the supplementation of market-based lending and rather than the substitution of that. Both the dynamics of the credit volume and the (non-representative) questionnaire survey[1] conducted by the MNB

[1] In a non-representative questionnaire survey, MNB asked 15,000 enterprises participating in FGS up to Q3 of 2014 on how the credit was used and if the programme contributed to the profitability, performance and growth opportunities of their business. The results are based on approx. 3,000 answers. The results of the survey can be read in detail in MNB publication *"FGS – the first 18 months"*.

among borrowers of the FGS imply that a significant part of disbursed loans would not have realised at all or only in a smaller amount without the FGS.

Chart 1 Annual growth rate of lending to SMEs and the entire corporate sector



In the above-mentioned survey 60 per cent of the enterprises taking out an investment loan, 79 per cent of the enterprises taking out a working capital loan and 85 per cent of the enterprises taking out a loan provided for the pre-financing of EU funds (according to the number of loans) would not have taken out a loan at all. Approximately 40 per cent of investment and working capital loans, while around 20 per cent of pre-financing loans of EU funds would have not been taken out without the FGS, while another 30-33 per cent would have been requested partially. The programme presumably made several enterprises take up loans for various purposes that would have not taken these loans or only to a lesser extent.

RECOVERING THE NORMAL FUNCTIONING OF THE ENTIRE SME CREDIT MARKET

The decline in corporate lending has stopped due to the FGS, but it is still far from an equilibrium level that is in line with the sustainable growth of real economy. Following the prevention of a credit crunch, it would also be needed that the lending activity increases, which could become a mutually reinforcing process (financial accelerator effect) through the revival of the real economy and its effect on corporate lending. This could be encouraged by the series of policy rate cuts by the MNB, but the transmission of monetary policy is impaired as a result of tight credit conditions particularly in case of non-FGS credit.

In normal circumstances a long-standing low interest rate environment encourages banks to increase their lending activity towards riskier enterprises. The low interest rate environment changes the perception of banks about risk through two channels: 1) the effect of low interest rates on the valuation of collateral, incomes and cash-flows may substantially influence the way banks perceive risks; 2) banks turn to investments with higher returns, particularly when they have to achieve ambitious profitability objectives. This is called the risk-taking channel of monetary transmission in the literature.[2]

[2] Gambacorta, Leonardo (2009): Monetary policy and the risk-taking channel, BIS Quarterly Review

When the risk-taking channel functions well, banks increase their lending activity more than what normal transmission channels would justify in a low interest rate environment, thus helping the recovery from the crisis.[3] In our case, this would mean that as a result of cuts in interest rates between 2012 and 2014, the willingness of the banking system to take risks should have increased. By contrast, the appetite of the banking system for risk remained extremely low, similar to that following the crisis, owing to the high ratio of non-performing loans and loan losses suffered during the crisis, which is manifested in tight credit conditions and prevents monetary easing from causing a stimulating effect in the corporate, particularly in SME credit market.

In its vision on the banking system,[4] the MNB formulated its intention to inspire a credit institution sector by urging loosening of credit constraints, to satisfy the current credit demand of the economy, including smaller economic agents. Based on the mutual relationship between credit volume and economic growth, the MNB estimates that a persistent annual 6-8 per cent growth rate of corporate lending is essential for the desired growth path of the real economy. Considering that according to the MNB's estimates corporate lending volume compared to GDP was around 6 per cent below the equilibrium level in the middle of 2014, a little higher, 8-9 per cent annual growth would be needed for the credit volume to catch up with its equilibrium level. Besides the corporate credit growth, its structure is also important to serve financial stability and economic growth, which is possible by the lengthening of maturities and the increase the share of forint loans.

The FGS has made a significant contribution to such a restructuring until now, but only in the range of SMEs, in case of which the expected losses (credit risk costs) enabled the participation in the programme. To achieve a steady growing credit volume the monetary transmission should be further strengthened in the case of credits currently excluded from the FGS, in order to ensure that the stimulating effects of the central bank's monetary policy easing impact a wider range of the SME credit market.

WHY ARE RISKIER, BUT STILL VIABLE ENTERPRISES EXCLUDED FROM THE CREDIT MARKET?

As a result of the FGS, a strong polarisation of the credit market can be observed both in terms of interest rates and maturities. Enterprises without access to the programme by banks typically have access to variable-rate loans of 3.5-7 per cent instead of FGS's maximum 2.5 per cent fixed-rate loans, according to available interest rate statistics (Figure 2). Moreover, it should also be taken into account that the interest rate statistics only show completed transactions, but does not present the figures of those that were not realised due to tight price and other conditions.

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[3] Several empirical studies support the functioning of the risk-taking channel: Altunbas, Y, L Gambacorta and D Marqués Ibañez (2009): An empirical assessment of the risk-taking channel", paper presented at the BIS/ECB conference on "Monetary policy and financial stability, 10–11 September, Jiménez, G, S Ongena, J Peydrò and J Saurina (2009): Hazardous times for monetary policy: what do twenty-three million bank loans say about the effects of monetary policy on credit risk-taking?, Bank of Spain, Working Papers, no 833.

[4] Fábián Gergely, Vonnák Balázs (ed.): "Átalakulóban a magyar bankrendszer – vitaindító a magyar bankrendszerre vonatkozó konszenzusos jövőkép kialakításához", special issue of MNB studies, 2014

Chart 2 Distribution of nominal interest rate of forint SME loans on the basis of volume (disbursements in 2014)

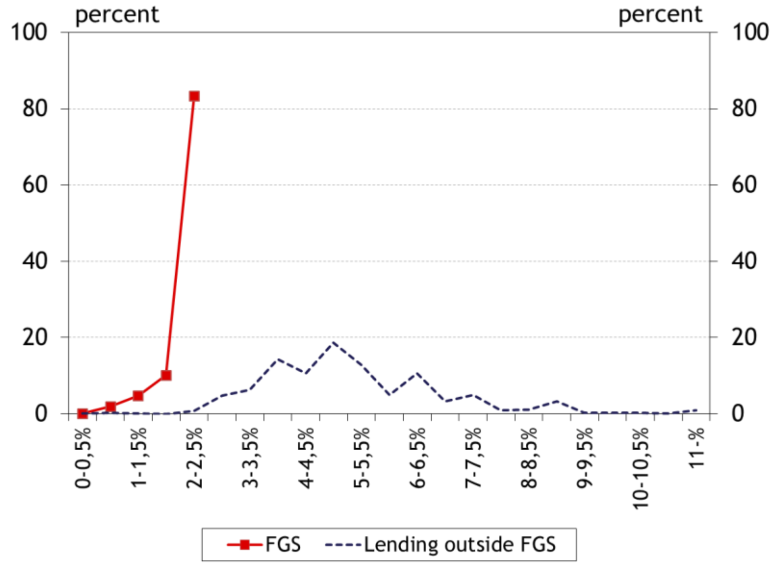
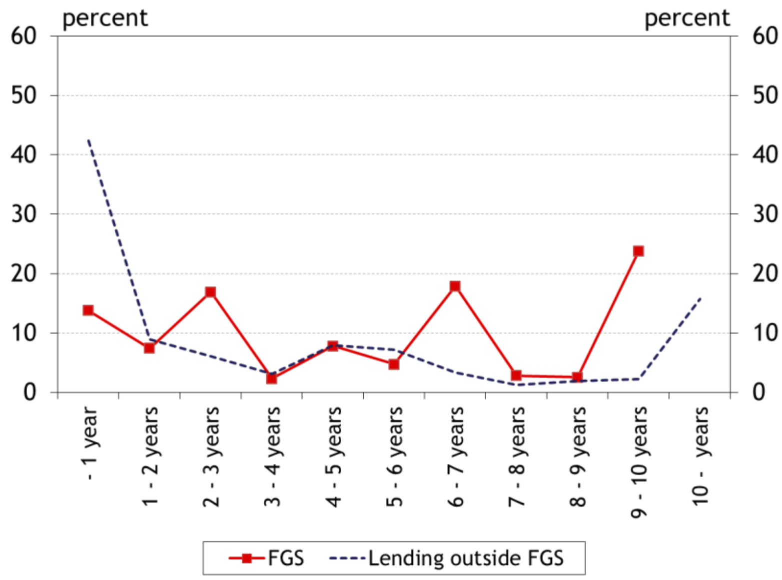
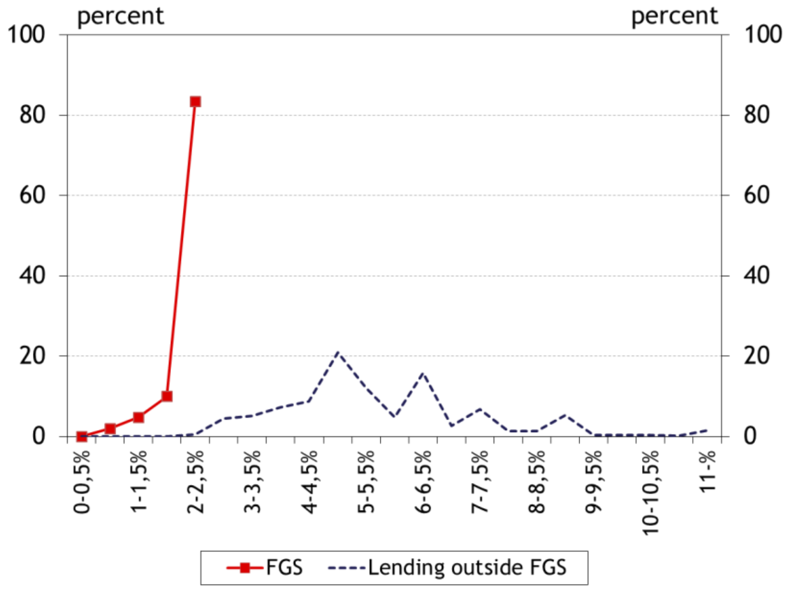


Chart 3 Distribution of the original maturities of forint SME loans on the basis of volume (disbursements in 2014)



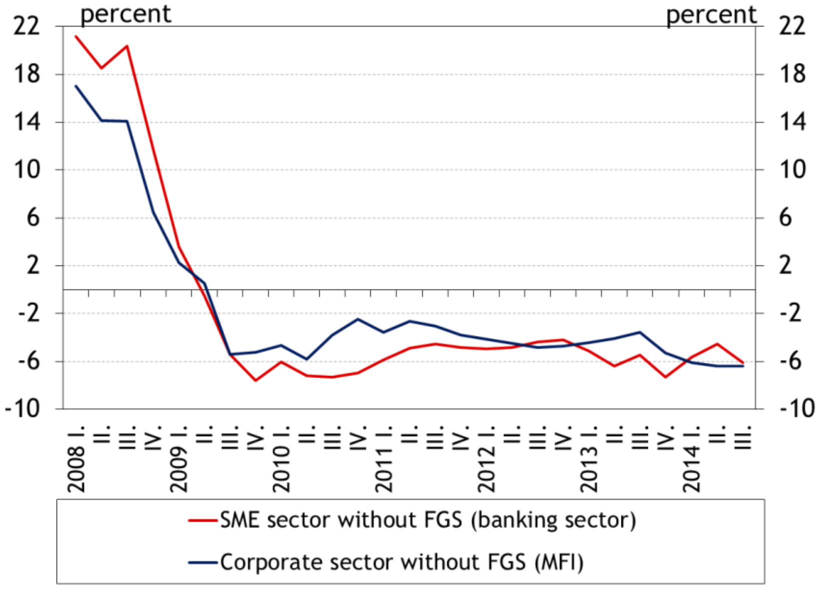
There is also sharp difference between the maturity distribution of enterprises taking part and those without access to the FGS. While mainly long-term (investment) loans are provided under the FGS, more than half of market-based loans granted in 2014 outside the programme had a term shorter than 2 years (presumably working capital loans and overdrafts) (Figure 3). This actually means that the enterprise that has no access to long-term financing in the FGS is unlikely to take up such a loan on a market basis with higher spreads. All these imply that there is a well-defined group of enterprises that is not present on the credit market.

Chart 4 Distribution of nominal interest rate on forint SME loans longer than one year on the basis of volume (disbursements in 2014)



The above-mentioned polarisation is even more obvious when the nominal interest rate on loans with maturity longer than one year is considered (Chart 4). Enterprises wishing to take out loans with terms longer than one year can only do this at a significantly higher interest rate outside the FGS. It is pertaining to these statistics that it only shows concluded transactions, but those potential ones that were not realised due to high interest rates or tight lending conditions are not included. Presumably this is more typical in the case of loans with terms over one year than those within one year.

Chart 5 Annual growth rate of lending to SMEs and the entire corporate sector outside the FGS



The Funding for Growth Scheme provided favourable credit conditions for a part of SMEs, and the fact that the previously declining trend of corporate lending was broken is mainly attributable to this segment.

There was no significant change in lending outside the FGS in terms of credit conditions, hence this volume is declining in line with the trend of recent years (Chart 5).

THE RANGE OF ELIGIBLE ENTERPRISES MAY INCREASE SIGNIFICANTLY AS A RESULT OF THE FGS+

As a part of its monetary policy instruments, the MNB will provide liquidity to credit institutions against eligible collateral under the FGS+. Counterparties shall use this refinancing to expand their lending to SMEs, while the MNB will assume SME credit risk from credit institutions for a limited time and to a limited extent and amount. Under the FGS+, the MNB will assume 50 per cent of credit losses from credit institutions, but only up to a five-year period and maximum annually 2.5 per cent of the loans outstanding of the individual credit institutions under the scheme.

The FGS+ will primarily reduce the interest rates of loans taken out by enterprises with medium risk. Lower interest burden due to the partial assumption of SME credit risk related to the collateralised central bank refinancing operation doesn’t only impact credit demand, but may also improve the rating of enterprises, which has a favourable effect on credit supply too. The FGS+ might also lead to loosening collateral requirements, hence credit institutions can satisfy the supplementary credit demand of enterprises with a good rating that have had leverage limits, since their outstanding loans have tied down their assets available for collateral at borrowing.