Box 10

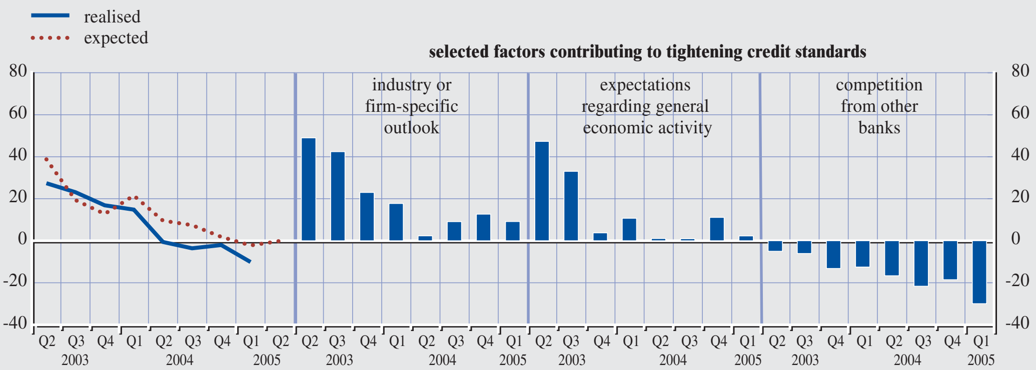
ASSESSING FINANCING CONDITIONS WITH THE ECB BANK LENDING SURVEY

The ECB's Bank Lending Survey provides important qualitative information on a timely and regular basis about banks' credit policies. By providing early indications of turning points in the credit cycle and potential credit crunches facing euro area households and firms, the survey constitutes a useful complementary source of information for assessing sources of risk and vulnerability to financial stability. With this perspective in mind, this Box examines recent developments – including the underlying driving factors – in banks' credit standards on the approval of loans to households and firms since late 2004, based on findings from the Bank Lending Survey.

According to the Bank Lending Survey, the pattern of net tightening of credit standards applied to the approval of loans to households and firms, which had been tapering off in earlier quarters, turned into a net easing over the past six months. In the first quarter of 2005, euro area banks reported a significant further relaxation of standards (i.e. the percentage of banks that reported an easing of credit standards compared with the previous period was larger than the percentage of banks reporting a tightening) for the approval of loans or credit lines to enterprises (see Chart B10.1). Competition from other banks was reported as being the most important factor in explaining this. By contrast, expectations regarding general economic activity as well as the industry and firm-specific outlook were seen by banks as factors for tightening credit standards. The principal way in which conditions and terms for the approval of loans or credit lines to enterprises were eased was through a decline in margins on average loans, more relaxed loan covenants and collateral requirements, as well as reductions in non-interest rate charges. By contrast, margins on riskier loans still contributed to a net tightening, suggesting that banks have recently become more discriminating in the pricing and treatment of risks.

Chart B10.1 Changes in credit standards applied to the approval of loans or credit lines to enterprises

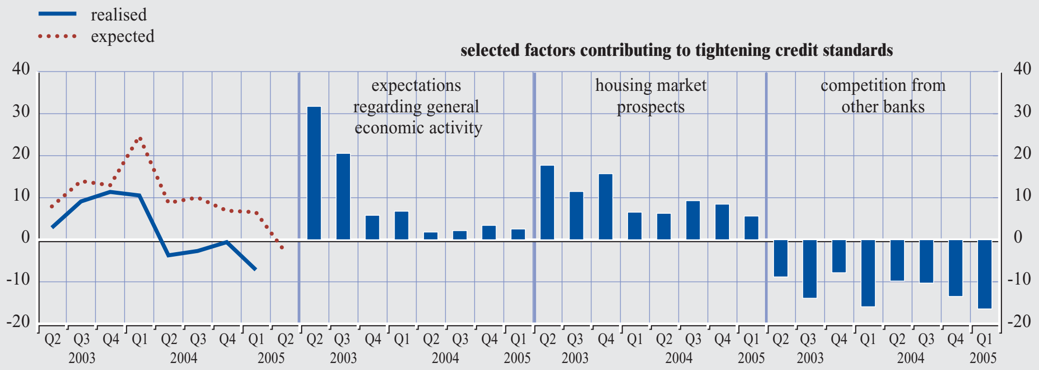
(net % of banks reporting a tightening of credit standards)



Source: ECB Bank Lending Survey.

Chart B10.2 Changes in credit standards applied to the approval of loans or credit lines to households for house purchase

(net % of banks reporting a tightening of credit standards)



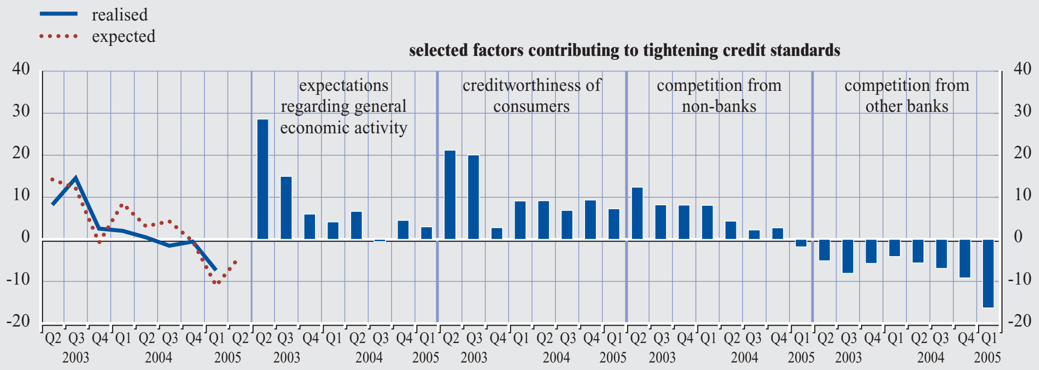
Source: ECB Bank Lending Survey.

A further net easing of credit standards was observed for the approval of loans to households for house purchase and for consumer credit in the first quarter of 2005 (see Charts B10.2 and B10.3). Competition from other banks was reported as being the most important factor behind the easier access of households to credit for house purchase. Expectations regarding general economic activity, housing market prospects (for loans for house purchase) and the perceived creditworthiness of borrowers (for consumer credit) were seen by banks as factors for tightening credit standards, as was the case throughout 2004. This too might indicate that banks have been persuaded to take on greater risk by supplying loans against a background of a deteriorating economic outlook. Whether or not lending institutions fully understand the risks involved and are pricing risks appropriately will only become evident in the event of, for example, a marked correction in the housing market (see Sub-section 2.2) or a slowdown in the pace of economic activity.

All in all, the Bank Lending Survey reveals that euro area banks have been gradually easing their credit standards over recent quarters. The offering of credit to households and firms with

Chart B10.3 Changes in credit standards applied to the approval of loans or credit lines on consumer credit and other loans to households

(net % of banks reporting a tightening of credit standards)



Source: ECB Bank Lending Survey.

easier terms against a background of intense competition from other banks on the one hand, and a somewhat deteriorating economic outlook on the other, suggests that banks have been adopting strategies of taking on greater risk in order to gain market share and boost profitability. Whether this is creating a basis for future difficulties – including a deterioration in the quality of banks' credit portfolios – will only become evident if the risk being built up actually materialises. This would call for close monitoring of these risks in the period ahead.