Box 2

FACTORS UNDERLYING THE STRONG ACCELERATION OF LOANS TO EURO AREA NON-FINANCIAL CORPORATIONS

Central banks have a key interest in understanding the factors driving corporate loan developments. For instance, MFI loans to non-financial corporations represent one of the main counterparts to the monetary aggregates and therefore play an important role in the monetary analysis. Moreover, firms' lending as part of overall corporate financing may provide important advance information about their fixed-capital investment behaviour, which, in turn, is relevant for the analysis of the economic situation. In recent quarters, the non-financial corporate sector in the euro area has increasingly had recourse to loan financing. By end-November 2006 MFI loans to non-financial corporations reached an annual nominal growth rate of 13.1%. This strong growth was particularly pronounced with regard to loans at medium and long-term maturities (more than one year), while a pick-up in short-term loans has also been witnessed more recently. This box examines the underlying forces behind this development, which seems to be driven by a confluence of economic and financial factors.

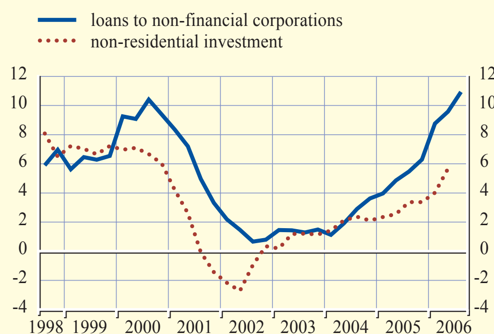
Corporate loan developments are typically driven by a combination of loan supply and demand factors. On the supply side, banks' credit conditions determine the availability of credit as a source of external financing for non-financial corporations. On the demand side, non-financial corporate borrowing is driven by financing needs in excess of firms' internal financing sources (the "financing gap"), as firms seek to finance items such as real fixed investment, the purchase of inventories, balance sheet restructuring and investment of a more financial nature, in particular mergers and acquisitions (M&As).

The increase in non-financial corporate loan growth observed in recent months appears to have been driven by several underlying factors. Turning first to the economic factors driving loan demand, the pick-up in firms' MFI lending has partly occurred in parallel with the recovery in fixed investment. The annual growth rate of non-residential investment reached 5.7% in the second quarter of 2006. This compares with 2.6% in the second quarter of 2005, but remains below the growth rates observed in 1998-2000 during the IT investment boom (see Chart A). The October 2006 bank lending survey also indicated that the strong rise in corporate loan demand was increasingly due to the need to finance fixed investment.[1] Likewise, data on syndicated lending to non-financial corporations suggest that a substantial share of recent loan growth has been driven by financing needs for capital expenditure and other general corporate

1 See Box 2, entitled "The results of the October 2006 bank lending survey for the euro area", in the November 2006 issue of the Monthly Bulletin.

Chart A Real annual growth rate of loans to non-financial corporations and non-residential investment

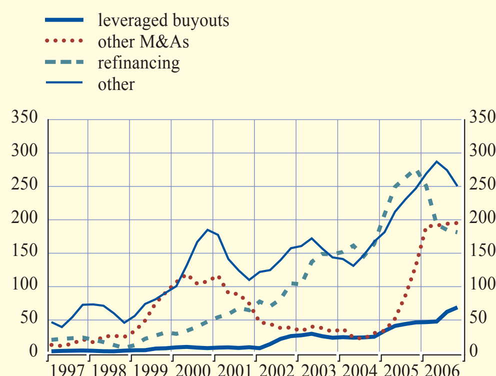
(annual percentage changes)



Sources: ECB and Eurostat.
Note: Deflated by the GDP deflator.

Chart B Syndicated lending to non-financial corporations in the euro area by purpose

(EUR billions)



Source: Thomson Deals.

purposes, as well as working capital needs (Chart B; category "other"). More recently, there has also been a rebound in expenditure on inventories.[2] This is likely to have contributed to the pick-up in the nominal growth rate of short-term loans, which reached 10.8% on an annual basis in November 2006.

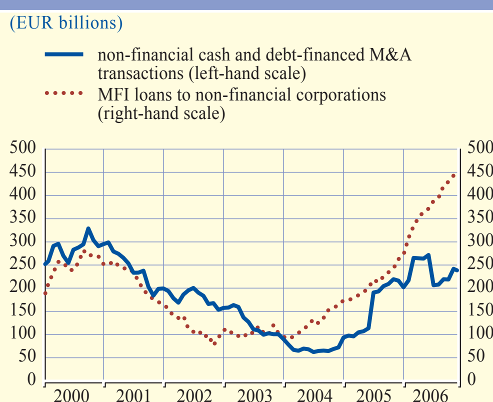
Financial factors also seem to have played a role in driving recent credit developments in the non-financial corporate sector. In particular, in recent years corporate loan growth has been fuelled by firms' reliance on banks (and cash holdings) to finance an increasing number of M&A transactions, including leveraged buyouts.[3] The value of cash and debt-financed M&A transactions with euro area non-financial corporations acting as acquirers reached around €270 billion on an annual basis in the second quarter of 2006, its highest level since early 2001 (see Chart C). Although M&A activity moderated somewhat in the second half of 2006, it remained strong in historical terms and is therefore likely to have continued to contribute significantly to the rise in loan growth (see Chart B). Moreover, this may also reflect the fact that syndicated lending seems, in recent years, to have replaced debt securities issuance as the primary debt-related financing source for M&A transactions. In addition to the significant rebound in M&A activity, corporate borrowing may also have increased in order to fund other financial investment. According to the balance sheet data of listed companies,[4] there has been a strong increase in euro area firms' financial assets since 2003. By contrast, whereas in previous years non-financial corporations largely had recourse to loan financing in order to restructure and refinance existing debt that had built up during the 1998-2000 period, this effect appears to have abated somewhat in recent years (see Chart B). Furthermore, it cannot be ruled out that funds raised by euro area non-financial corporations are also being used to finance foreign direct investment.

2 As indicated, for example, by the stock of purchased goods in the Purchasing Managers' Index for the euro area, for which expansion was observed during the third quarter of 2006, and as confirmed by the results of the October 2006 bank lending survey, in which "inventories and working capital" was reported as being one of the main factors driving corporate loan demand.
3 See also the box entitled "Recent trends in merger and acquisition activity in the euro area" in the July 2006 issue of the Monthly Bulletin and the box entitled "Recent trends in leveraged buyout transactions in the euro area" in the December 2006 issue of the Monthly Bulletin.
4 Based on data from Thomson Financial Datastream.

Some additional factors may have increased the capacity of euro area borrowers to acquire debt. First, not only have real interest rates been very low over the past few years, but the spread vis-à-vis some measures of the real cost of equity has also widened, as compared with the situation in 1998-2000. This may have caused a shift towards higher optimal leverage ratios, which has increased the demand for debt. Moreover, the low level of interest rates means that higher debt ratios have not resulted in higher interest payment burdens, which may have further increased firms' borrowing capacity. Furthermore, firms' loan demand may have been affected in regions with booming housing markets. Hence, in addition to corporations that regularly invest in residential property, other firms may also have intended to profit from the rising house prices, which may have contributed to corporate loan growth in some euro area countries in recent years. Notwithstanding the quantitative relevance of this demand impulse, increased property prices are also likely to have had a positive impact on firms' net or collateral value, thereby improving their access to bank financing.

Chart C Non-financial cash and debt-financed M&A transactions

(EUR billions)



Sources: ECB and Bureau van Dijk (Zephyr database).
Note: 12-month moving total of the flow of loans to non-financial corporations and the value of cash and debt-financed M&A transactions where euro area firms act as acquirer.

Finally, loan supply conditions have undergone remarkable changes in recent years owing to financial and technological innovations. In particular, the increasing importance of loan securitisation and the emergence of credit derivatives markets are likely to have improved banks' credit risk management and may thus have contributed to an outward shift in the banks' loan supply curve.[5] In this context, banks may have improved their ability to diversify their credit risk by selling loans or hedging in the derivatives market. This may have contributed to the observed gradual easing of credit standards applied to loans and credit lines, as reported in the ECB's October 2006 bank lending survey. At the same time, restructuring measures and efforts to increase cost-efficiency have improved banks' lending capacity over recent years.[6]

Overall, the surge in the growth of loans to non-financial corporations observed in recent quarters has been driven by a confluence of factors. As well as being supported by the low level of real interest rates, firms' demand for loans has been fuelled by the need to finance real fixed capital formation, inventories and financial investment, in particular M&A transactions. Moreover, non-financial corporations' access to credit may have improved, for example through an easing of bank credit conditions, partly as a result of improved credit risk management tools in the banking sector, including the emergence of credit derivatives markets.

5 According to the over-the-counter derivatives markets statistics published by the BIS for the first half of 2006, notional amounts outstanding for credit default swap contracts reached around USD 20 trillion by the end of June 2006 (up from USD 10 trillion one year earlier).
6 See "EU banking sector stability", ECB, November 2006.