ARTICLE – Banks' lending capacity in light of the coronavirus pandemic

Bankruptcies in the corporate sector and banks' credit losses have increased as a result of the coronavirus pandemic, but so far to a relatively minor extent. However, if the pandemic becomes more serious or more prolonged, it may impair banks' lending capacity. This article reviews the factors that affect banks' lending capacity, by focusing on lending to Swedish non-financial companies, and then describes developments in banks' lending during the year. Finally, we discuss the conditions needed for banks to be able to provide new loans going forward.

One important conclusion is that banks' lending capacity during the coronavirus pandemic has been good, but all companies have not had the same access to loans. There is also uncertainty about expected credit losses going forward, and about banks' use of capital buffers. The continuing ability of banks to supply credit to the system is a prerequisite for financial stability.

Several factors affect banks' lending capacity

The ability of banks to issue loans, and the interest rates they offer, are determined by several different factors. Banks need a certain level of capital and liquidity to be able to lend. These levels are affected by the bank's financial results, the size of dividends paid to shareholders and its access to funding, as well as by various regulatory requirements.

The aim of the requirements imposed by Finansinspektionen (FI), which are based on European regulations and concern the level of capital and liquidity a bank must hold, is to increase the bank's capacity to absorb any losses that may arise in the event of financial uncertainty, while they also encourage the bank to uphold its lending.[91] Among others, they relate to capital adequacy, leverage ratio, liquidity buffers (Liquidity Coverage Ratio, LCR) and degree of stable funding (Net Stable Funding Ratio, NSFR). In somewhat simplified terms, capital requirements are divided into minimum requirements that the bank must fulfil, and buffer requirements that the bank may contravene under certain circumstances. Furthermore, banks often hold more capital than is needed to fulfil the requirements, referred to as a management buffer.[92] A

[91] In the EU, the Capital Requirements Regulation and the Capital Adequacy Directive form the basis of the capital and liquidity requirements.

[92] The three major Swedish banks, Handelsbanken, SEB and Swedbank, have explicit internal financial targets for the size of the management buffer. The target can be expressed as a specific percentage or as a target interval and is normally between one and three percentage points above the requirement.

high management buffer implies that the bank could receive a higher credit rating and lower funding costs, and that investments can be made without the need to firstly seek external capital. This makes banks generally reluctant to reduce their management buffer and approach the limit for the set requirements.

If a bank's financial situation deteriorates so that it approaches the limit for the regulatory requirements, the bank's incentive to uphold and increase its lending may decrease, especially regarding loans with high credit risk that entails stricter requirements on capital adequacy and that increase the risk of credit losses[93]. However, FI has communicated that at this stage of the pandemic, the capital and liquidity buffers specified in the regulations may be used. There may, however, be stigma attached to the use of such buffers, based on market expectations of the bank's resilience.

Good capacity among banks to provide loans

Since the beginning of the coronavirus pandemic, the conditions for the major Swedish banks to provide loans on the Swedish market have been good, despite the financial turmoil in the spring. One important explanation is the various authority measures that have supported credit supply, such as the provision of large amounts of liquidity by the Riksbank and other central banks, in the form of both loans and asset purchases.[94] This section describes how bank lending has developed during the year.

Increased lending volumes to large companies

Banks in Sweden have increased their lending to companies during the pandemic.[95] In September, outstanding loans to non-financial companies were SEK 2,488 billion, which is 2.1 per cent more than in February.[96] In the spring, banks primarily increased lending to large companies. The outstanding loans to large companies continued to increase until the end of May and then started to decrease (see Chart 34). There may be several explanations for this.

Large companies normally have greater bank commitments and can often pledge better collateral for their loans, primarily in the form of property, than smaller companies. This reduces the credit risk for the bank. Furthermore, large state- or municipality-owned companies have more funding opportunities if the public sector can be seen as a guarantor of the loan. In addition, as a preventive measure, several large companies took the opportunity to use their unutilised credit facilities based on terms negotiated before the crisis. One of the explanations for the decrease in outstanding loans may be that companies have now begun repaying these loans. In addition, the corporate debt market is now working again, providing many large companies with an

[93] Here, credit losses refer to both direct credit losses and provisions for future credit losses.

[94] See, for example, *Financial Stability Report*, May 2020. Sveriges Riksbank.

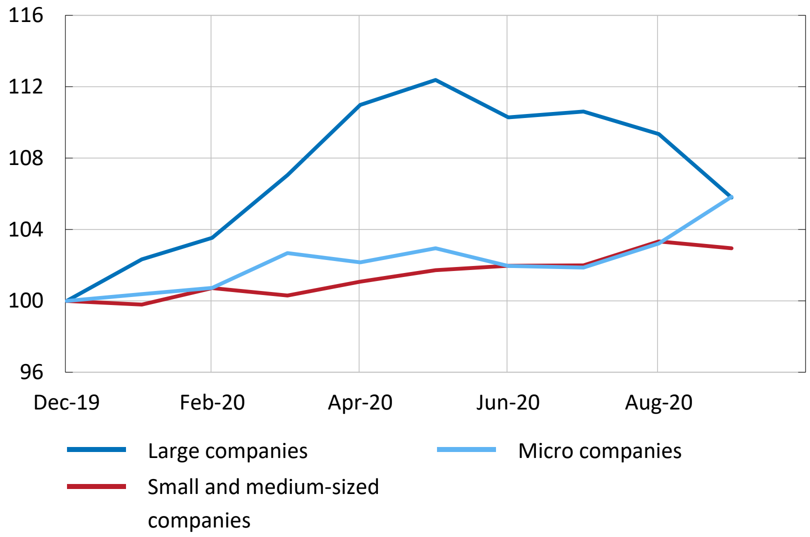
[95] This article focuses on Swedish non-financial companies in various company size categories in accordance with European Commission recommendation (2003/361/EC), in which the combination of employees, turnover and assets determine the size classification.

[96] Refers to total lending from Monetary Financial Institutions (MFI) to non-financial companies. Source: Statistics Sweden.

alternative to bank loans (see Section 2.2 “Some recovery in the Swedish corporate sector but uncertainty remains”).

Chart 34. Bank loans by company size

Index, December 2019 = 100



Note. Loans in all currencies. Outstanding loans (volume) to Swedish non-financial companies. Size breakdown in accordance with European Commission Recommendation (2003/361/EC). Loans to housing cooperatives have been excluded.

Sources: Statistics Sweden and the Riksbank.

Lending volumes to smaller companies have increased slightly

Many smaller companies encountered financial problems at the beginning of the pandemic and experienced difficulties funding their operations.[97] Lending by the banks to these companies was, however, relatively unchanged during the initial phase of the pandemic but has now increased slightly in recent months, primarily to micro companies (see Chart 34). It is difficult to know whether initially restrictive lending to smaller companies was mainly due to changes in supply or demand, but there are a few different hypotheses. One reason may be the decision by banks, when the number of loan applications increased, to prioritise lending to large and existing customers with lower credit risk and to restrict loans to smaller and new customers with higher credit risk or poorer collateral. Several of the companies that experienced problems may be companies that did not have loans previously and the incentive of banks to take on new corporate customers in times of turmoil can be limited. In various surveys, bank executives have also said that corporate lending has been stricter and that the proportion of rejected loan applications increased during the spring, from 13 per cent in March to 20 per cent in June, but then fell again to 15 per cent in September.[98]

[97] See, for example, *Economic Tendency Survey*, April 2020. National Institute of Economic Research.

[98] See, for example, *Låneindikatorn (Lending Indicator)*, June and September 2020. Almi.

To make it easier for smaller companies to access loans, the state can step in and guarantee some of the bank loans issued to these companies. Such credit guarantees have been launched by the Swedish National Debt Office and are an important complement to the Riksbank's measures aimed at keeping interest rates low in order to support credit supply in general.[99] The effect of such guarantee programmes depends, however, on their terms and conditions.[100] Many banks say that, as long as the state does not guarantee 100 per cent of the loan amount, they need to continue their credit risk assessment of companies, according to existing rules, as they are still taking on risk by granting the loan. This may imply that some companies are unable to borrow regardless of whether the loan has a state guarantee or not as long as the guarantee does not cover 100 per cent of the loan.

At the same time, smaller companies may have been unwilling to take bank loans during the coronavirus pandemic. One reason may be that companies in vulnerable industries have not considered increased borrowing as a way of saving the company, but rather as a greater burden associated with greater risk.[101] Smaller companies may also have chosen to make use of measures from authorities that do not require collateral, in order to alleviate their economic difficulties, such as forbearance on various tax payments, instead of taking bank loans.[102] The demand for credit may therefore increase when these measures end.

Banks' lending rates to companies rose at the start of the pandemic, but have now fallen back again

As Chart 35 illustrates, smaller companies normally pay a higher interest rate for bank loans than large companies. This is probably because lending to smaller companies generally involves a higher financial risk and because the bank's fixed costs are spread over loans that generally reach lower amounts. When market turmoil increased at the beginning of the spring, banks' borrowing costs rose, which increased lending rates to companies of all sizes. Once various action programmes to stimulate markets had been implemented and reduced market turmoil, lending rates fell again. In September, interest rates for companies of all sizes were slightly lower than in February.

Chart 36 illustrates the spread in interest rate levels for different sizes of company in the form of a box chart, where the length of the box shows the rate spread. Large companies are offered similar interest rate levels (short box) while the interest rates vary more among smaller companies (long box). The rate spread has been relatively constant in comparison to February, May and September, indicating that banks' pricing models have not changed significantly.

[99] See *Monetary Policy Report*, September 2020. Sveriges Riksbank.

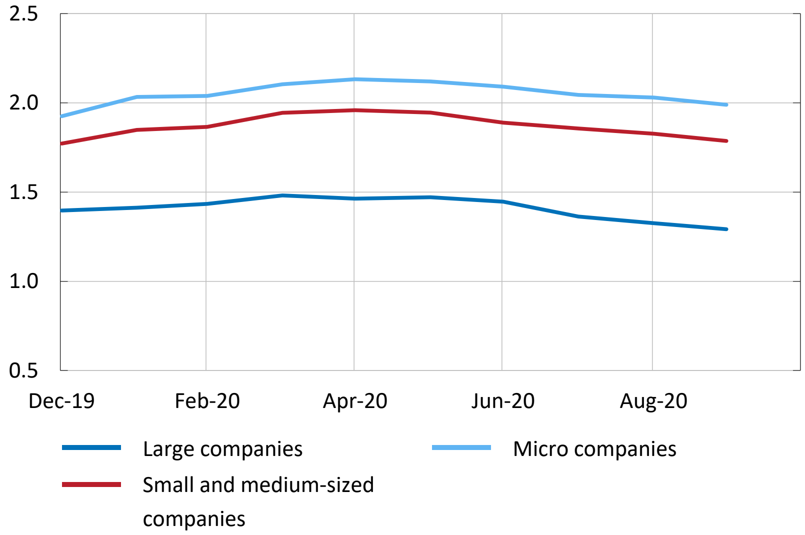
[100] See information on terms and conditions, as well as approved volumes, on the Swedish National Debt Office website (www.riksgalden.se).

[101] See also E. Frohm, J. Grip, D. Hansson and S. Wollert (2020), Two-tier credit developments during the corona pandemic, *Economic Commentaries* no. 6. Sveriges Riksbank.

[102] By 28 September 2020, according to information from the Swedish Tax Agency, 70 per cent of all tax forbearance applications had been made by small and micro companies. In total, the approved forbearance amount is about SEK 40 billion and small and micro companies make up almost a third of this amount. Tax forbearance is limited to 12 months from the decision date.

Chart 35. Interest rates on bank loans by company size

Per cent

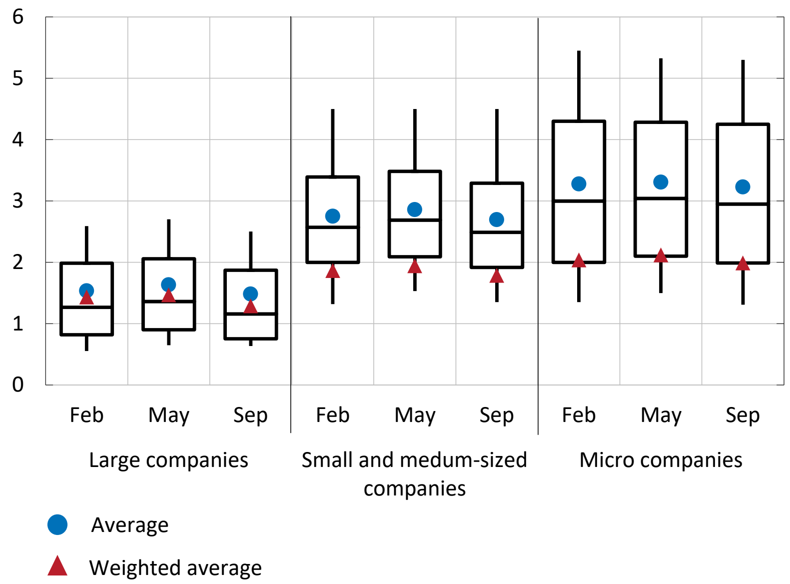


Note. Loans in all currencies. Outstanding loans to Swedish non-financial companies. The interest rate refers to the volume-weighted average. Size breakdown in accordance with European Commission Recommendation (2003/361/EC). Loans to housing cooperatives have been excluded.

Source: Statistics Sweden.

Chart 36. Interest rate spread by company size for bank loans of at least SEK 25,000

Per cent



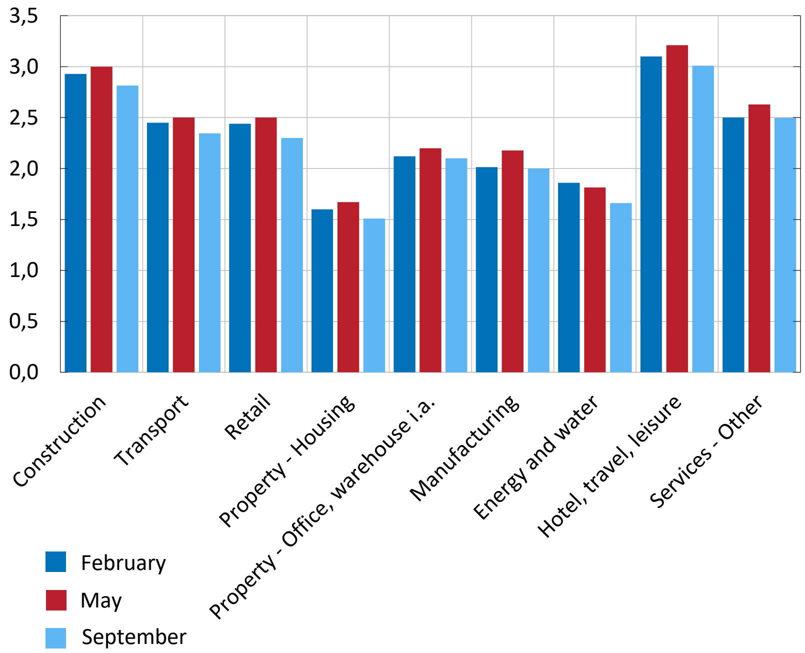
Note. Loans in all currencies. Outstanding loans of at least SEK 25,000 to Swedish non-financial companies. The line in the box represents the median, the upper part is the (75) quartile and the lower part is the (25) quartile. The vertical lines indicate the 10th and 90th percentiles respectively. The minimum loan amount limit of SEK 25,000 is set because many smaller loans are short-term loans, like overdraft facilities and credit card loans, which can have a zero interest rate for a period. Size breakdown in accordance with European Commission Recommendation (2003/361/EC). Loans to housing cooperatives have been excluded.

Source: Statistics Sweden.

The lending rates (median) for loans of at least SEK 25,000 to companies in different sectors in February, May and September are illustrated in Chart 37. The chart shows that, by September, the interest rate, after a general increase during the most turbulent months of the spring, was lower in all sectors than in February. In September, interest rates for *Property - Offices, warehouse, i.a*., *Manufacturing,* and *Services - Other* were on levels just below February's levels, while other sectors had fallen to a greater extent.[103] Companies in *Hotel, travel, leisure* have had to pay the highest interest rate during the period and *Property - Housing* the lowest interest rate. Companies in *Manufacturing, Hotel, travel, leisure* and *Services - Others* had the highest interest rate increases from February to May (between 0.11 and 0.17 percentage points).

Chart 37. Interest rates by sector on bank loans of at least SEK 25,000, median

Per cent



Note. Loans in all currencies. Outstanding loans to Swedish non-financial companies. The minimum median loan amount limit of SEK 25,000 is set because many smaller loans are short-term loans like overdraft facilities and credit card loans, which can have a zero interest rate for a period. Loans to housing cooperatives have been excluded.

Source: Statistics Sweden.

[103] The fact that interest rates for companies in the *Property - Office, warehouse i.a.* sector did not decrease to any great degree could be explained by FI communicating the intention to introduce a special risk weight floor for lending with collateral in the commercial property sector, which will increase the banks' capital requirements and thus also their capital costs for such lending. The aim of the risk weight floor is to ensure that banks with substantial exposure to commercial property have the resilience to manage a potentially large decline in property prices, which is of considerable significance for financial stability.

Increased credit losses could affect credit supply

Bank lending has increased since the outbreak of the pandemic, even though the loans initially mostly benefited large companies. Lending rates rose initially, as a result of the turbulence on the market, but they have now fallen back again. The lending capacity of banks has been good and there have not been any clear signs of a credit crunch. The next sections describe the liquidity and capital situation of banks and look at whether future credit losses may be significant for banks' lending capacity if the macroeconomic situation deteriorates.

Measures and recommendations from authorities support banks' lending capacity

Due to the coronavirus pandemic, Swedish authorities have introduced measures and recommendations to facilitate corporate lending by banks.[104] Certain regulatory requirements have been temporarily eased and support measures have been implemented to further stimulate credit supply. Alongside programmes from the Swedish National Debt Office and the Riksbank, FI has reduced the countercyclical capital buffer rate requirement from 2.5 to zero per cent. According to FI, the reduction will release capital for the eleven largest Swedish institutions corresponding to about SEK 900 billion in increased lending potential.[105]

Discussions have also been conducted, both in Sweden and internationally, on whether banks should refrain from paying dividends in light of the coronavirus pandemic as dividend capital could instead be used for lending.[106] The aim is to ensure that banks retain a continued high level of resilience to credit losses and the capacity to maintain credit supply. Several banks have announced that they are not planning to pay dividends generated in 2019 to shareholders in 2020.[107]

Regulatory requirements do not currently constitute a limitation for the major Swedish banks

Chapter 2 showed that the major Swedish banks have good access to liquidity and that they meet the levels in the regulatory requirements. Neither is it likely that, given the Riksbank's support measures, a shortage of liquidity will reduce banks' lending capacity in the near term. In addition, the Riksbank is ready to implement further measures should renewed market turbulence arise. This article will therefore continue to focus on the capital situation for banks based on their Common Equity Tier 1 (CET 1) capital ratios and leverage ratios. [108]

[104] See, for example, *Financial Stability Report*, May 2020. Sveriges Riksbank.

[105] See *Ändrade föreskrifter på grund av sänkning av kontracykliskt buffertvärde* (*Amended regulations due to reduction in countercyclical buffer rate)*, March 2020. Finansinspektionen.

[106] See, for instance, *Continued grounds for suspension of dividend payments for the rest of the year*, September 2020. Finansinspektionen, and the *ECB extends recommendation not to pay dividends until January 2021 and clarifies timeline to restore buffers*, July 2020. European Central Bank.

[107] The three major Swedish banks' planned dividends for 2019 totalled SEK 34 billion.

[108] *The Common Equity Tier 1 (CET 1)* ratio is the ratio between the bank's CET 1 capital and risk-weighted assets. *Leverage ratio* is the ratio between the bank's Tier 1 capital and total exposures, both on and off the

As illustrated by Table 2, the requirement for CET 1 capital for the three major Swedish banks amounts to SEK 290 billion for the second quarter of 2020, consisting of a minimum requirement of SEK 171 billion and a buffer requirement of SEK 119 billion. In addition to this, they also have a total management buffer of SEK 87 billion. Total CET 1 capital among the three major banks is therefore SEK 378 billion.

The Basel Committee recommends that banks' leverage ratios should be at least three per cent. As a result of the European Capital Requirements Regulation, this recommendation will become a requirement in Sweden as from next year, via the Banking Package.[109] The three major Swedish banks normally maintain a leverage ratio in the interval of four to five per cent. Table 2 shows that the banks' total Tier 1 capital needs to be at least SEK 289 billion to reach a leverage ratio of three per cent with regard to the second quarter of 2020. In addition to this, the banks have a management buffer of SEK 128 billion. Total Tier 1 capital for the three major banks is SEK 417 billion.

Table 2. Existing capital, requirement for capital and management buffers for the three major Swedish banks

SEK billion and per cent

CET 1 capital	Bn	%	Tier 1 capital	Bn	%
Capital to fulfil CET 1 ratio requirements	290	13.6%	Capital to fulfil a 3-per-cent leverage ratio	289	3.0%
Of which Minimum requirement and Pillar 2 requirement[110]	*171*	*8.0%*			
Of which Buffer requirement	*119*	*5.6%*			
Management buffer	87	4.1%	Management buffer	128	1.4%
Total CET 1 capital	**378**	**17.6%**	**Total Tier 1 capital**	**417**	**4.4%**

Note. Refers to total CET 1 capital and average percentage of risk-weighted assets and total Tier 1 capital and average percentage of the total exposure amount for the three major Swedish banks for quarter 2, 2020. Figures in the table have been rounded off.

Sources: Banks' quarterly reports, quarter 2, 2020, FI and the Riksbank.

Overall, the major Swedish banks have capital levels that exceed not just the regulatory requirements but also their own internal targets for management buffers. Even though the banks probably wish to keep a distance to the requirements, it is the Riksbank's assessment that the requirements do not currently limit banks' future lending capacity. Even if the new risk-weight floor for commercial properties communicated by FI is considered, this picture does not change.[111]

bank's balance sheet, without risk-weighting different assets. The concepts of *Common Equity Tier 1* and *Tier 1 capital* are explained in more detail in the glossary.

[109] This applies for Swedish banks as from 28 June 2021. See also *Financial Stability Report*, May 2019. Sveriges Riksbank.

[110] Pillar 2 is a requirement on individual banks and includes rules that guide banks' internal capital assessments and FI's oversight and assessment process.

[111] According to FI's calculations, the capital requirement for the three major Swedish banks will be raised by about SEK 5 billion per bank due to the communicated new risk-weight floor for commercial properties.

Banks should be ready to use the buffers to maintain credit supply

Lessons from previous economic crises have illustrated the importance of banks having capital and liquidity buffers. The buffers built up by banks over the last decade, due in part to higher regulatory requirements from authorities, have strengthened banks' position during the coronavirus pandemic. The pandemic shows how quickly and unexpectedly the economic situation can change, and how important it is for the financial system to have good resilience to shocks. Banks need to do what they can to maintain credit supply and contribute to an economic recovery in the society. They may thus need to use their capital and liquidity buffers. The Riksbank also considers that the banks should refrain from paying dividends to shareholders until further notice.

In light of the coronavirus pandemic, credit losses have increased but are still at relatively low levels. It is difficult, however, to know the extent to which the major Swedish banks wish to and can satisfy a future increase in demand for credit if credit losses rise and banks' capital and buffers decrease as a result. The Riksbank's stress tests illustrate that credit losses risk increasing if, for example, housing prices fall sharply in a worse future macroeconomic scenario. In addition, credit losses can arise with a significant delay among banks, as some measures and accounting rules (see fact box "IFRS 9 and measures in light of the coronavirus pandemic") can increase the amount of time it takes for a loan associated with payment difficulties to be classified as a non-performing loan. This means that certain risks associated with credit losses may be hidden before they materialise, which can lead to problems for banks in the longer term.

If the crisis now deepens and becomes more prolonged, further measures may be needed to support credit supply and safeguard financial stability. When the economic situation permits, the resilience of the financial system will need to be reinforced again. If banks have used parts of their capital and liquidity buffers, they will need to gradually build up sufficient capital and liquidity again after the crisis, in case they are needed in future crises.