FEEDING THE REAL ECONOMY

SEVERAL SCHEMES TO BOOST LENDING TO UK NON-FINANCIAL CORPORATES HAVE BEEN LAUNCHED BY THE UK GOVERNMENT. JOHANN KRUGER AND STANISLAV VARKALOV OUTLINE THE FEATURES OF EACH SCHEME

The greatest financial crisis since the Great Depression has led banks to significantly deleverage [see charts below right and on page 46]. Their bloated balance sheets, which harboured too many risky assets, battered by losses on US sub-prime mortgages, peripheral European government debt and highly leveraged loans naturally had to be trimmed. And while some governments have been supporting asset prices through ultra-loose monetary policy, including quantitative easing, the tightening fiscal and regulatory environments are accelerating the process of deleverage. Furthermore, in the context of austerity, which damages confidence, risky assets are even riskier, leading banks to be more cautious than they might otherwise have been.

Banks have been warning against the unintended consequences of regulatory overkill, but, until recently, this had largely been dismissed as scaremongering, with the hope of diluting the final effect of much tighter regulatory regimes. Since early 2012, politicians have started to take note, however. There is an increasing realisation that excessive restrictions on banks drains the blood from the body that is the 'real economy'. This, in turn, has a knock-on effect on one of the four key inputs required for economic activity – the availability of capital. Labour, technology and raw materials are the other inputs.

Deleveraging has different effects on different segments of borrowers. The largest borrowers have access to the capital markets. In the US, non-financial corporates (NFCs) typically source two-thirds of their funding from the capital markets and the balance from banks. In Europe (including the UK), it is vice versa. But the European funding model is likely to move towards the US model, and this is already evident in the issuance data for the past two years.

Basel capital requirements rank SMEs and households as the riskiest borrowers, which is why the cost of providing credit to them has increased the most. This is, no doubt, a factor as to why demand is relatively low. Clearly, if the price comes down demand will increase – it is a fundamental principle of economics. Therefore, the UK government's efforts to bring the price down are steps in the right direction.

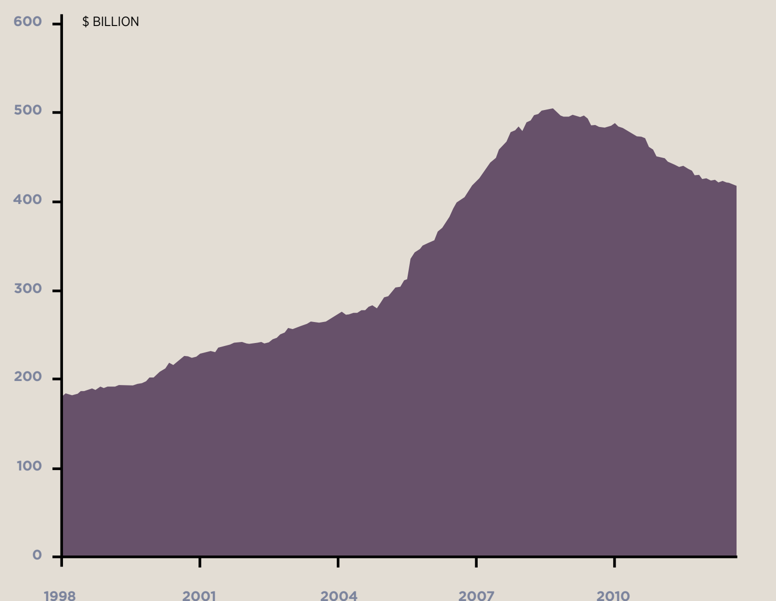
British Bankers' Association (BBA) data up to the first quarter of this year shows that out of £444bn total outstanding lending to the corporate sector as a whole, contributors to the BBA (mostly large commercial banks) report that SME borrowing accounted for £103.7bn, with around £39bn to what it describes as 'smaller businesses', and £66bn to 'medium businesses'. In the second quarter, this rose marginally to £112.1bn.

Business Finance Partnership (BFP)

Announced at the end of 2011, the BFP is operated by HM Treasury (HMT) and is aimed initially at co-investing with private sector investors (on fully commercial terms), in managed funds that lend directly to UK businesses.

In its *Business Finance Partnership: market engagement statement* in December 2011, HMT said: "HM Treasury will also consider the potential to invest through other non-bank lending channels... such as invoice financing and leasing... online platforms and other ways of directly accessing

TOTAL LENDING TO UK PRIVATE NON-FINANCIAL CORPORATES (NFCs)

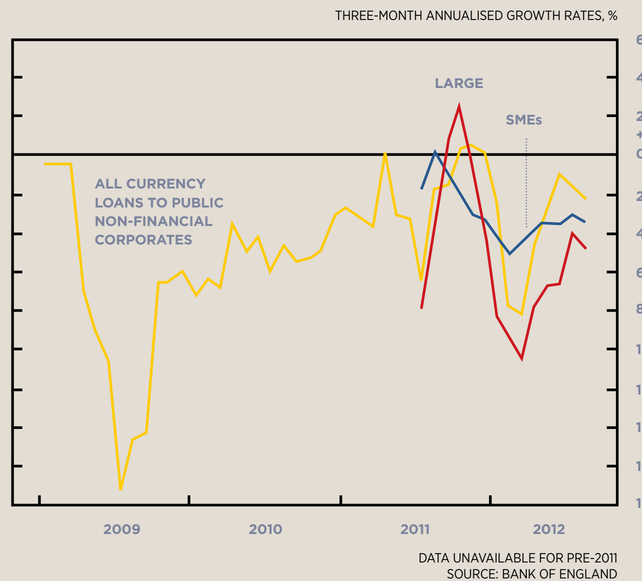


SOURCE: BANK OF ENGLAND

investors. This would be with the aim of increasing the supply of credit to SMEs, and helping to increase the diversity of finance options available to businesses in the UK in the longer term."

The Department for Business Innovation & Skills (BIS) is managing the £100m small-business tranche of the BFP (BFP B), which intends to co-invest into loans to businesses with up to £75m turnover, using alternative finance routes such as peer-to-peer platforms and mezzanine finance. Loans to any types of UK small businesses of any legal form and from any sector (subject only to the £75m limit on turnover) can qualify in accordance with the small-business tranche.

LENDING TO UK BUSINESSES



The National Loan Guarantee scheme (NLGS)

The scheme allows banks to raise up to £20bn of funding guaranteed by the government over two years, allowing the banks to lend directly to smaller businesses at a lower cost. The participating banks that are committed to pass through the lower cost of funding to business customers (most UK high street banks) would be delivering the scheme.

Small businesses currently have fewer alternatives to bank finance than larger

FUNDING SCHEMES

SCHEME**	SCHEME SIZE	TARGET	MAX TURNOVER*	NOTES**	CREDIT RISK
BFP A	£1.1BN	MID-SIZED BUSINESSES	≤£500M (OR A COMPARABLE ENTERPRISE VALUE METRIC)	◆ ADMINISTERED BY HMT AND BIS. CO-INVESTING THROUGH NON-TRADITIONAL CHANNELS ◆ NO MORE THAN 50% OF TOTAL INVESTMENT IN EACH FUND ◆ HMT HAS NO INVOLVEMENT IN INDIVIDUAL LENDING DECISIONS	STATE AS CO-INVESTOR, BUT WITH NO LESS FAVOURABLE A RISK AND RETURN POSITION THAN THAT OF OTHER INVESTORS
BFP B	£0.1BN	SMEs	≤£75M	ADMINISTERED BY BIS	SAME AS BFP A
NLGS	£20BN	ALL NFCs	≤£50M	DEBT MANAGEMENT OFFICE GUARANTEES BANK UNSECURED LENDING DIRECTLY LINKED TO THE LOANS TO CORPORATE CUSTOMERS	HMT
FUNDING FOR LENDING	THEORETICALLY UNLIMITED	DRAWN GBP LOANS BY UK NFCs	NONE	◆ BANKS CAN ACCESS BANK OF ENGLAND FUNDS (MAXIMUM MATURITY FOUR YEARS) PROVIDED THEIR GBP LOAN STOCK TO UK NFCs, AS AT 30 JUNE 2012, GROWS ACCORDING TO PRE-SPECIFIED MINIMUM REQUIREMENTS ◆ THE ACCESS PERIOD ENDS 31 DECEMBER 2013	BANKS***
SUPPLY CHAIN FINANCE SCHEME	NO MAXIMUM	SUPPLIERS OF MULTINATIONALS AND NATIONAL CHAMPIONS	NONE	COMPANIES WHO SIGNED UP INCLUDE ROLLS-ROYCE, BT, VODAFONE, TESCO, J SAINSBURY AND BAE SYSTEMS	BANKS
BRITISH STATE BANK FOR BUSINESS	◆ £1BN IN LOANS ◆ £10BN IN GUARANTEES	MANUFACTURERS, EXPORTERS, HIGH-GROWTH COMPANIES	TO BE PUBLISHED BY HMT	◆ TO FACE BUSINESS CLIENTS DIRECTLY THROUGH AN INTERNET PORTAL ◆ NO BRANCHES ◆ IT IS NOT CLEAR HOW CREDIT DECISIONS WILL BE MADE	HMT

*SIZE MEASURED AS AN AVERAGE OVER THE PRECEDING THREE YEARS **ACRONYMS EXPLAINED IN THE ARTICLE ***PRESS REPORTS THAT NO ADDITIONAL CAPITAL HAS TO BE SET ASIDE AGAINST UNEXPECTED LOSSES FROM FLS ELIGIBLE LENDING ARE INACCURATE. CERTAIN CAPITAL BUFFERS MAY BE IGNORED, BUT THE BASIC RISK WEIGHTS AND CAPITAL REQUIREMENTS ARE NO DIFFERENT FROM THE NORM

SOURCE: LGB RESEARCH

corporates, which can access the equity or debt markets, for example. The idea of NLGS is that by guaranteeing bank funding related to specific SME lending, the SMEs can borrow at a lower cost. The BIS claims that a reduction in the cost of business loans of up to 1% is achievable.

In August 2012, HMT said that "The [NLGS] scheme has been successful, with over £2.5bn in cheaper loans being offered to over 16,000 businesses so far." It went on to say that "Changes in market conditions since the introduction of the NLGS mean that it is now less economical for banks that raise unsecured funding. In practice, this means that banks that are currently offering NLGS loans are likely to opt to deliver credit easing to the whole economy through the FLS. [See below.] It is expected that banks currently offering loans through the NLGS will, over time, cease to offer NLGS branded products."

Funding for Lending scheme (FLS)

FLS was launched in July 2012 by the Bank of England and the purpose of this scheme was to counteract the forecast decrease in total bank lending to the UK 'real economy' caused by stricter bank capital adequacy, liquidity regulations, leverage ratios and sales of non-core assets/deleveraging. In the FLS webcast organised by the ACT in August 2012, the Bank of England's Paul Fisher, one of the architects of FLS, explained that FLS is a new and untested scheme with no directly comparable analogies in history.

FLS allows participating banks to use loans as collateral for borrowing from the Bank of England. The total amount of the initial borrowing is limited to 5% of the stock of existing loans to the UK non-financial corporate sector as at 30 June 2012. Any further expansion of the bank's lending during a 'reference period' from that date to the end of 2013 will also qualify. Note that the eligible loans include individual mortgages as well as loans to UK businesses. The Bank of England estimated that the initial 5% of existing stock of lending across all UK banks and building societies was equivalent to £80bn, and Lloyds Banking Group was the first bank to draw down from the Bank of England when it drew down an initial £1bn in mid-September.

Supply Chain Finance scheme (SCF)

SCF was announced by the prime minister on 24 October 2012 and requires the companies signed up to actively evaluate the implementation of, or continue to offer, supply chain finance. Many well-known FTSE 100 companies reported to have signed up for the scheme were listed on the Number 10 website.

Schemes such as SCF have been long established globally as a way to share the benefit of the higher credit rating of the buyer company with its smaller or less established suppliers. Under a typical SCF, a supplier uploads its invoices into a system shared between a bank and the buying company (typically a major corporate). After obtaining the buying company's approval, the bank pays the face amount of the invoice (less the fee for providing finance immediately) to the supplier. The interest charged by the SCF bank would be lower than if standalone funding was provided to the supplier since it shares the higher credit rating of the buying company.

The Number 10 website describes various benefits of the SCF, including provision of cheap funding to suppliers based on the credit quality of their customers. The significantly more capital-efficient manner of this method of financing SMEs could unlock capital for increased lending to the sector. SCF can play an important role in making finance available to small companies that have a limited choice of other funding alternatives.

Conclusion

It is too early to say whether government efforts to arrest the Great Deleverage will be successful. It is hoped that FLS will have the desired effect, in terms of stimulating demand for credit, increasing consumer confidence and helping to create a broader economic revival. At the time of writing, however, its impact is yet to be felt, so the jury remains out.

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