

3 – Bank lending and the recovery

Introduction

The role of banks as suppliers of credit to the economy has been highly scrutinised during the recession.

A key question has been whether constrained bank lending has contributed to the weakness in the economy, or whether the weakness in aggregate demand has contributed to the reduction in bank lending, or whether the former (during the initial stages of the credit crunch starting in mid-2007) turned into the latter (during the later full-blown UK recession). While anecdotal evidence has regularly pointed to difficulties in accessing credit, particularly for small and medium-sized enterprises (SMEs), banks have defended their behaviour, declaring themselves to be ‘open for business’.

In this article we revisit the role which credit provision has played during the recession (Section 3.1) and then move on to the more critical question of whether weak credit supply could hold back the recovery (Section 3.2). We then discuss the potential impact of regulatory reform in the banking industry on the wider economy (Section 3.3). Section 3.4 summarises the key conclusions from the analysis.

3.1 – Bank lending during the recession

The challenge of understanding the role of credit in the economy, and more specifically bank lending, is that we cannot separately observe supply and demand for credit. We observe the interaction of supply and demand and resultant lending, but it is difficult to tell whether supply factors or demand factors are dominant in driving trends.

Figure 3.1 shows how bank lending to non-financial companies continued to rise (but at a slowing rate) during the initial phase of the credit crunch from mid-2007 through to September 2008. But as the UK moved from a mild to a deep recession in the fourth quarter of 2008, bank lending

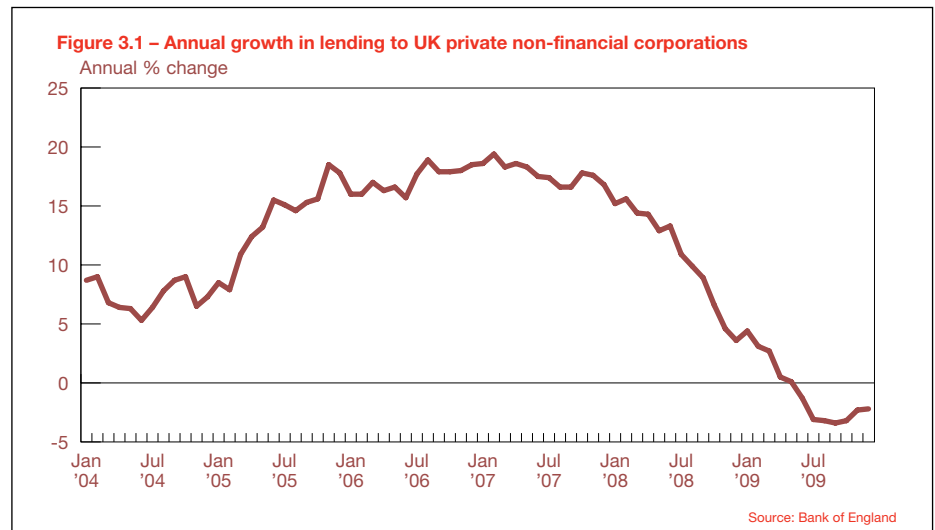


Table 3.1– Comparison of last three UK recessions

Recession	Real GDP change	Real bank lending change (consumer)	Real bank lending change (business)	Average interest rate	Average inflation rate
1979 - 1981	-4.7%	n/a	-0.3%	17.8%	17%
1990 - 1992	-2.5%	-6.1%	-5.5%	13.0%	8.0%
2008 - 2009	-6.2%	-12.9%	-4.2%	2.6%	1.5%

Source: ONS, Bank of England

started to slow and, from May 2009, net lending to private non-financial corporations actually started to fall. This downward trend had stabilised at the end of 2009, with a small positive monthly growth rate in December, but was still negative when measured on a quarterly or annual basis. Part of the explanation of why lending growth did not actually turn negative until some way into the recession could be due to the inherent inertia in bank lending – the time to process applications and draw down funds means that a slowdown in lending decisions (for either demand or supply reasons) can take some months to flow into the aggregate net lending figures.

It is possible to compare bank lending during this recession with the experience in previous recessions which were not associated with a banking crisis and hence may have been less constrained by the supply of credit. Table 3.1 below presents the peak to trough drop in real GDP, real bank lending, average interest rates and

inflation during the last three recessions. This shows that the overall drop in lending this time around is not too dissimilar to the drop in the 1990s recession, being larger for consumer lending but less sharp for business lending. This could suggest that demand has been the bigger driver of weak lending in the latest recession. However, the inflation and interest rate environment was considerably different in previous recessions – high nominal¹ interest rates in the early 1980s and 1990s recessions meant that companies had to use spare cash to meet interest payments, while current very low interest rates help companies and households to reduce debts by repaying principal rather than just debt interest. This difference makes it difficult to draw reliable conclusions from such historic comparisons of lending trends in recessions.

There is a range of other evidence that could be used to support either the supply side or demand side explanations for weak lending during the current recession.

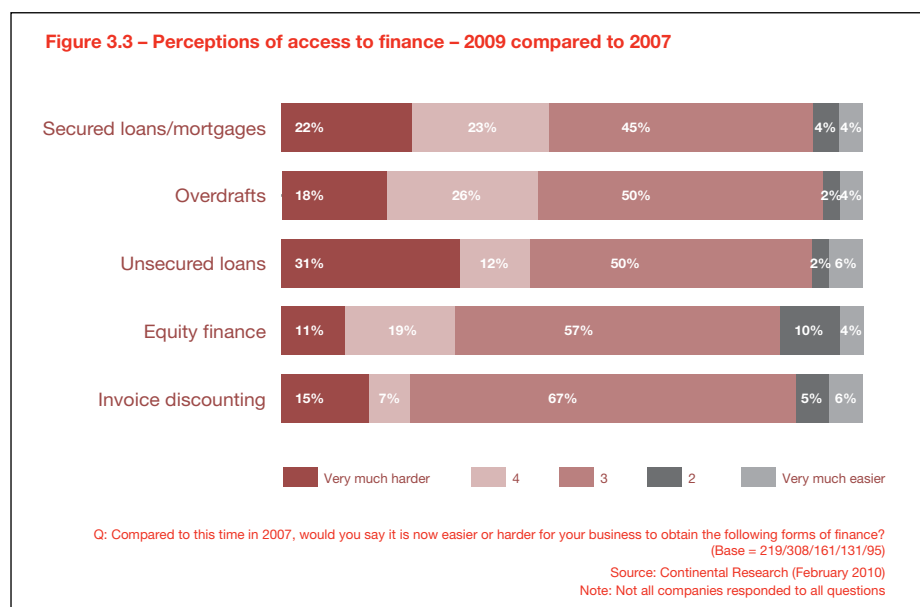
¹ Real interest rates are also low now, but nominal rates are more important for corporate cash flows and therefore short-term decisions on debt repayments.

Evidence supporting **weak demand for bank lending** being critical includes the following:

- Businesses and households have not been using all available credit facilities. RBS, for example, have publicly stated that British companies have unused overdrafts with it worth a total of £27bn and this figure has remained steady through the recession.
- In an environment of low confidence and high uncertainty, low interest rates mean that companies and consumers are more easily able to repay debt, thereby reducing net outstanding lending. Lending panel data shows that while gross business lending to SMEs fell by 22% in the 11 months to November 2009 compared to the previous year, repayments rose by 13% for the year to November compared to the previous year. This is in contrast to earlier recessions where high interest rates meant that more cash was used to pay debt interest charges, rather than debt repayment.
- Company insolvencies have not risen nearly as sharply as in the early 1990s recession (see Figure 3.2). Company liquidations rose by 154% from their mid-cycle trough to their 1992 peak, as compared to a 54% rise from their mid-cycle trough to the end of 2009. Although it is too early to be confident that insolvencies have peaked in the current cycle, the evidence to date suggests that many struggling companies have been able to access credit in 2008-9 due to banks taking a more supportive attitude than in the last recession.

- Larger companies have been able to access corporate bond markets and equity markets as an alternative to bank funding, thereby reducing demand for bank lending.

Evidence supporting **weak supply of credit** as the key factor includes the following:



- Surveys during the recession have typically found that businesses' views of credit availability have been weak².
- Investment was very weak during the recession as discussed in Section 2.1 above. Part of this was due to weak demand conditions for these companies and high levels of uncertainty, but part could be due to difficulty in accessing finance, particularly for SMEs³.
- Certain sectors, such as private equity and commercial real estate, whose business

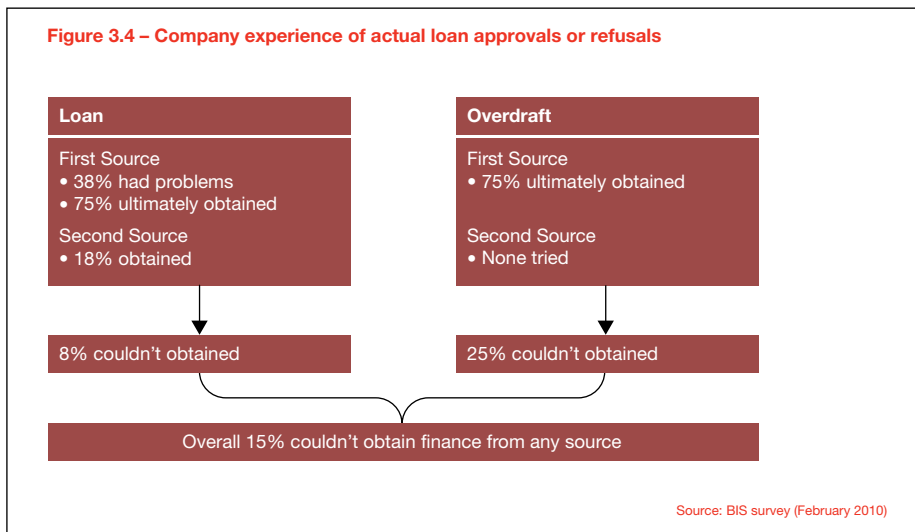
models are heavily dependent upon bank finance, have been significantly impacted by constraints on this funding over the past two years.

- Problems at certain banks clearly restricted credit supply during the recession. For example, HBOS's market share of mortgages and charges registered with Companies House dropped from above 15% in 2007 to below 5% during the course of 2009, while some foreign lenders have exited the UK market altogether.

² For example, in its November 2009 survey of UK businesses, the British Chambers of Commerce found that 33% of companies reported that accessing finance had been more difficult over the last three months (as compared to 20% in their June survey).

³ This point is supported by analysis in the Bank of England's February 2010 Inflation Report, which shows that employment and investment fell by significantly more in SMEs during the year to Q3 2009 than in the corporate sector as a whole (although output trends were less differentiated by company size).

On balance, we find the demand-side arguments more persuasive in explaining reduced bank lending in 2009, although it seems likely that supply constraint also played a supplementary role, particularly for SMEs. However, even for SMEs, it is important to recognise that many business surveys tend to pick up sentiment and perceptions rather than reality, a point well demonstrated by a recent BIS survey on access to finance. This found that, while 31% of mid-sized companies perceived that it was now very much harder to access unsecured loans than in 2007 (see Figure 3.3), only around 15% had not been able to access the finance they needed from any source (see Figure 3.4).

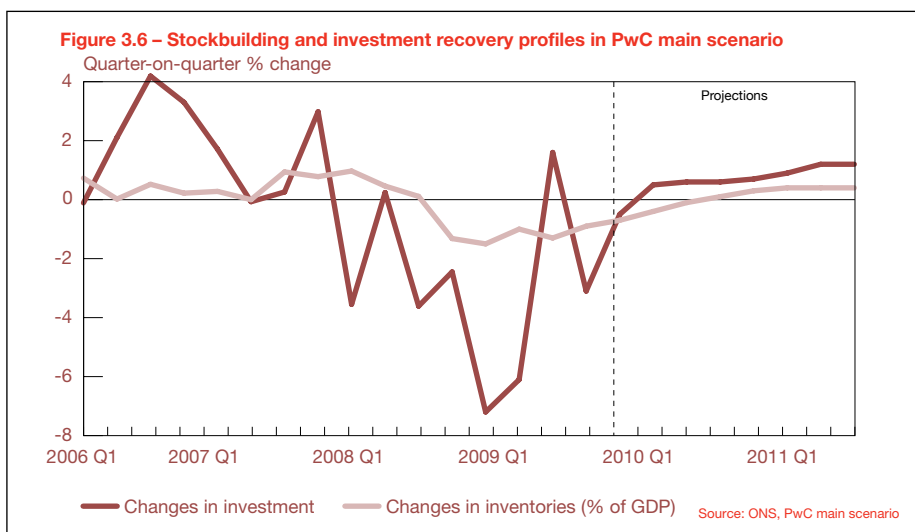
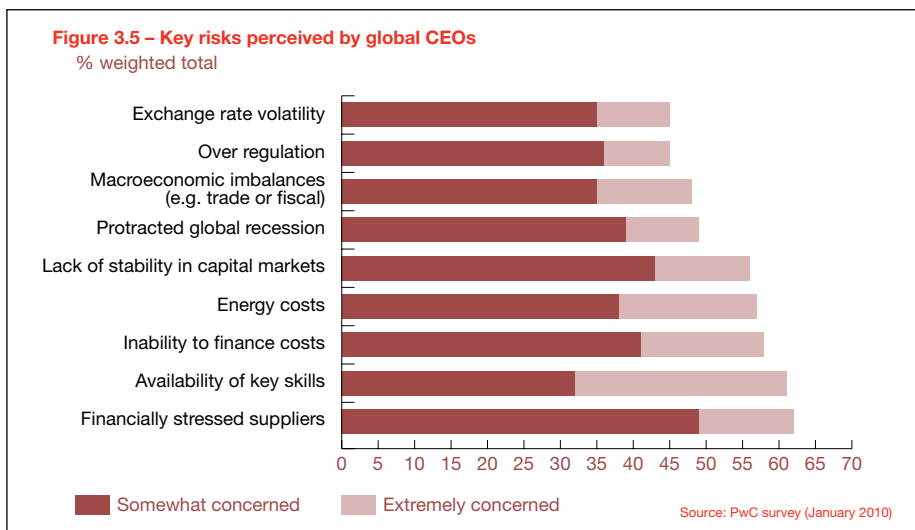


The undoubted supply shocks around the collapse of Lehmans and difficulties at HBOS clearly had serious short-term impacts, but the more recent stabilisation at HBOS and the bottoming out of the recession during the second half of 2009 has begun to restore the lending appetite of banks, albeit at a lower level than the over-exuberant levels prior to the crisis. This has been picked up in the Banks of England's Q4 2009 Credit Conditions Survey.

3.2 – Bank lending and the recovery

So if weak demand has probably been the most significant driver of weak bank lending during the recession, what happens when demand returns during the recovery? At some point credit constraints may become a problem as demand for lending picks up, even if credit supply has not been a serious constraint on growth during the recession itself.

The latest PricewaterhouseCoopers Global CEO survey, published in January 2010, throws some light on this issue. While some other concerns ranked even higher, 13% of CEOs were still extremely concerned about a potential inability to finance growth and 35% were somewhat concerned (see Figure 3.5).



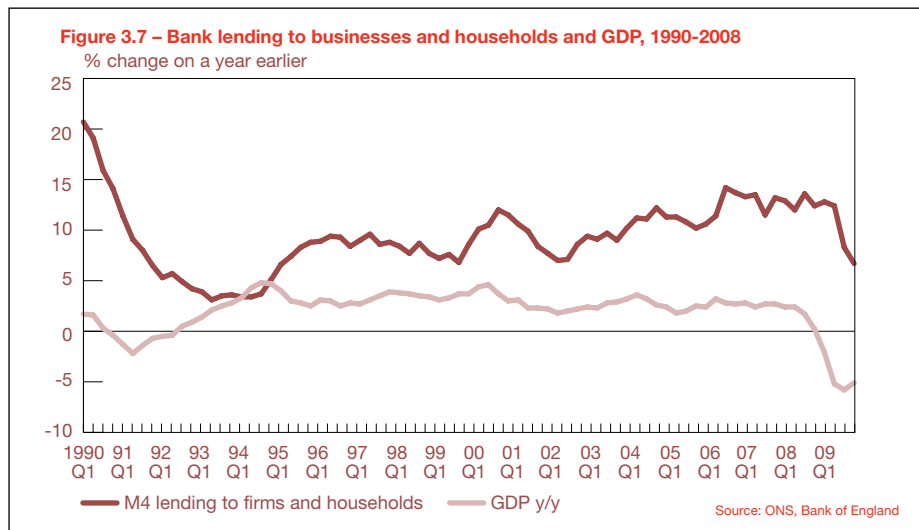
This concern is supported by evidence from insolvency statistics (as shown in Figure 3.2) that companies often find it harder to grow

out of recession than to survive the recession itself. This is because working capital needs shrink (so releasing funds)

during the recession, but expand as companies recover. So demand for working capital finance typically follows the stock

cycle and should increase markedly as stock levels bounce back from current low levels. We expect this process to be an important factor during the course of the current recovery. Demand for investment capital normally takes longer to recover, as surplus capacity reduces the need to invest, but could become a significant factor in 2011 in particular (see Figure 3.6).

The historical evidence suggests that as economies grow out of recession, bank lending takes some time to respond. For example, it was not until late 1994 when lending to firms and households picked up after the previous UK recession, as shown in Figure 3.7.



The requirement for bank funding will also depend on the nature of the recovery:

- An **export-led recovery** may not require additional credit if it involves switching domestic supply to international markets, but if the exporting manufacturing sectors are to expand (as our main scenario in Section 2 above assumes), then additional credit will be required.
- A **services-led recovery** would tend to involve lower lending requirements than a manufacturing-led recovery because a services-led upturn would depend less on re-stocking and capital investment. In practice, however, we assume both sectors will pick up gradually in 2010-11.
- A **consumer-led recovery** would require restored credit supply, as weak wage growth and continued relatively high levels of unemployment (compared to pre-recession levels) will tend to dampen down consumer expenditure growth. Given the stretched nature of household finances, we do not anticipate a substantial consumer-led recovery, as discussed further in Section 4 below. But demand for mortgage credit may pick up further and this could be somewhat constrained by supply for the next few years.
- A **public spending-led recovery** would not require private credit growth, but the size of the fiscal deficit rules this out as a credible option.

Overall, therefore, there may be some impact of credit constraints on the recovery as regards the working capital required to rebuild stock levels in 2010 and support export growth. In 2011, funding for capital investment could also face some credit constraints, although these should be easing somewhat by that time as the banking sector gradually returns to health. Generally, any such constraints will have their greatest impact on SMEs given their greater reliance on bank lending.

3.3 – Impact of bank regulation on the economy

A potentially distinctive feature of this recovery is the possibility of increased banking sector regulation, in contrast in particular to the financial deregulation of the 1980s recovery phase (the 1990s were more neutral in this respect). International banking regulators are currently busy proposing and evaluating a range of possible regulatory reforms. For example, the Basel committee has proposed a set of reforms to capital and liquidity requirements; the FSA is proposing 'living wills' to improve the robustness of banks' subsidiaries and the orderliness in the case of wind down; the Bank of England is proposing a range of new macro-prudential tools; the Obama administration has proposed a levy on bank liabilities; and the G20 is proposing a global resolution fund – to name just a selection. It is beyond the scope of this article to describe or evaluate these possible banking

reforms in detail, but we can try to sketch out the possible economic impacts at a high level.

On the positive side, such reforms should produce a more resilient banking sector, which should have economic benefits in terms of a more stable growth path and a reduced risk of the large permanent output losses associated with severe financial crises such as the recent one, which have been variously estimated at around 4-10% of GDP in recent studies by the OECD, the National Institute for Economic and Social Research (NIESR), HM Treasury and the IMF. At the same time, history shows that such financial crises will always happen from time to time however much effort goes into addressing the regulatory shortcomings that led to the most recent crisis. Furthermore, badly designed regulatory reforms could even sow the seeds of the next crisis as some financiers seek to circumvent the new regulations with adverse unintended consequences in the longer term.

In designing and implementing these reforms, a balance will therefore need to be struck between a desire to increase financial resilience and stability and the need to leave banks healthy enough to support future economic growth. We do not know yet where this balance will be struck, but it seems likely that banks will need to hold more capital and liquid assets and that bank profitability and equity returns will probably reduce as a result relative to pre-crisis levels. Because these reform

changes will be carried out at an industry-wide level, economic theory would suggest that they will raise the whole industry cost curve and that all or most of the cost of additional regulation is therefore ultimately likely to feed through into higher prices for businesses and consumers. For example, JP Morgan recently published a research note suggesting that current regulatory reform proposals could add a margin to loan pricing of around 1.2% across a selection of global banks.

Determining the exact mix of responses that banks will make is impossible at this stage and will no doubt vary across banks and over time, but Table 3.2 summarises some of the possible responses that banks might make. It is also worth noting that, if bank loan rate spreads are raised, one mitigating factor could be a reduction in the Bank of England base rate needed to achieve a given inflation target⁴. Nonetheless, there are clearly some potential adverse economic impacts from tougher bank regulation that need to be taken into account when designing and implementing this new regime.

3.4 – Conclusions

We would draw three main conclusions from the analysis:

- Weak bank lending during 2009 was probably driven more by weak demand for lending than by lending supply shortages (although the latter may have played some role for SMEs in particular).
- There remains a risk that credit shortages could restrict the pace of recovery in the medium term, which is one reason why we project a relatively modest rate of growth in 2011 in our main scenario.
- Bank regulatory reform could impose significant costs on loan rates. In a low interest rate environment pricing impacts will be concentrated in the medium term. These costs need to be balanced against the need to mitigate the risk of large permanent output losses from future financial crises.

Table 3.2 – Possible bank responses to increased regulatory costs

Possible response	Description	Potential economic impact
Increase loan pricing	Increases could be concentrated in areas where borrowers have fewer substitutes and areas where regulatory capital requirements are high (such as high LTV property loans and SME lending).	Increased loan pricing will tend to dampen lending demand and reduce corporate investment. It could also reduce mortgage demand and so dampen house prices. Large companies may shift to corporate bond and equity markets, but smaller companies could be squeezed by higher bank lending costs due to the lack of alternatives.
Reduce deposit pricing	In an environment of low interest rates and where banks are seeking to increase deposit funding in place of wholesale sources, reducing deposit rates may not be an attractive option at present. But it could be more of an option in a few years time when base rates have returned to more normal levels.	Reduced deposit pricing has an uncertain impact on the economy, because saving through banks may be discouraged, but this could shift savings into other asset classes, such as equities. Certain demographic groups would be more affected – e.g. pensioners, who tend to have a lot of their financial assets in bank and building society accounts.
Reduce operating costs	Reduced employment and other operating costs impacts the banking sector directly (e.g. employee wages) and the supply chains to the banking sector. Customers may have to adapt to a different way of consuming banking services (i.e. more use of online banking and less access to bank staff).	Any job losses in banking as a result would have some impact on the economy although this should not be over-exaggerated in macroeconomic terms. The banking sector is the biggest customer of the IT services sector and the communications sector, which could be boosted to the extent that computerised systems are replacements for bank staff.
Change business mix – moving out of low return or high capital requirement activities	Sectors that are particularly at risk might include high-LTV property loans and SME lending, particularly if pricing cannot provide an adequate return.	Reduced supply of lending to high-LTV mortgages could impact housing markets (as high-LTV mortgage first time buyers tend to enable a housing chain of 2-3 further transactions).
Reduce balance sheet and lending	If capital raising on the scale required is difficult, then lending could be constrained, or banks will seek other ways to reduce their balance sheets (e.g. sale of loan portfolios).	Reduced lending would have a direct impact on business activity levels and consumer spending. Of the potential banking sector responses, this would be most damaging to the economy.
Reduce maturity of loans	A key function of banks is maturity transformation – taking short term deposits and lending over longer terms. This naturally introduces risks, which are reflected in the regulatory regime. Shortening lending terms would reduce bank risk and regulatory capital requirements.	A reduction in longer maturity lending could impact certain sectors (e.g. infrastructure) which rely on longer term finance. This could be of concern at a time when public funding for major infrastructure projects looks set to be constrained for many years to come given the need to reduce the budget deficit.

Source: ONS, Bank of England

⁴ See, for example, the speech by MPC member David Miles on 'The Future Financial Landscape', 16 December 2009.