How is the patient?

Executive summary

- **With few of the fundamental issues that caused the credit crunch having been solved and governments unable to support the banks forever, the banks will ultimately have to deleverage or shrink their balance sheets. Investment funds can offer treasurers an alternative source of company finance.**

Over the last 12 months we have gone from a state of open panic about the very survival of some of the biggest high-street banking names to an uneasy calm. The financial markets have recovered some of their poise from the Q1 lows and there seems to be the beginning of a consensus that the UK may be starting to emerge from recession. In addition, the banks themselves seem to have significantly more lending capacity again. However, concerns remain significant. Are the markets just following a traditional bear market rally pattern? And does the recovery and apparent return to business as usual for the banks owe more to the ballooning government support for the financial system either direct or through quantitative easing (QE) than because of any fundamental improvements?

It is worth recapping on what are the key support structures in place which have led to the relative recovery we have seen in equity and credit markets and asking ourselves how sustainable they are. These are:

- close to zero risk-free interest rates of 0.5%, compared with an average over the last 35 years of almost 10% and the last 10 years of 4.5%;
- government guarantees for senior bank debt with maturities up to 2014 – £100bn+ has been issued to date;
- special liquidity scheme (SLS) – £185bn of collateralised funding for the banks by the Bank of England, which runs off in 2012;
- equity capital injections by the government into Lloyds/HBOS and RBS of over £35bn to date, with the potential to double if the asset protection scheme (APS) is implemented; and
- emergency support to Northern Rock and Bradford & Bingley.

Allied to these measures, the government is on course to run an unprecedented fiscal deficit in 2009 of at least £175bn and probably closer to £200bn (which represents around 15% of GDP). We have also seen around £140bn of QE, where the central bank essentially prints money to purchase gilts and corporate bonds. Finally, the APS itself, if implemented, will provide government insurance on over £500bn of assets currently on banks' balance sheets

Given the unprecedented levels of government support covering the banks' funding situation, the level of asset prices via QE, and the real economy via the fiscal deficit, it would be truly terrifying if the situation had not stabilised.

However, crucially, none of these measures and stimuli is remotely sustainable over the long term. The government cannot continue ad infinitum to add to the national debt without ultimately facing its own credit crunch and affecting the currency. Nor can the government fund the banks forever because of the enormous size

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MARK HUTCHINSON AND **JAMES KING** ASSESS THE LONG-TERM HEALTH OF THE UK CORPORATE LENDING MARKET.

of the banks' balance sheets and the perceived wisdom that retail and commercial banking needs to be a private endeavour.

Unfortunately, very few of the fundamental issues that created this financial crisis and ensuing recession have been solved. For instance, real money investors still have nowhere near the appetite or capacity to fund the banks in the amounts required for banks to continue to have their pre-crisis level of gross assets even if the parties could agree on the right price. In addition, it is hard to see how the securitisation market will return to anywhere near its pre-crunch level of importance as a funding source for the banks as the conduits that largely supported that market have gone for good.

The inescapable conclusion for most observers is that the banks ultimately have to deleverage or shrink their balance sheets to a size that can be funded via deposits and a much more modest amount of term debt, covered bonds, etc. The implications of a reduction in the size of the banks by hundreds of billions of pounds will have severe ramifications on the real economy but also on the banks' ability to lend to consumers and businesses in the future in our view.

Some commentators have pointed out that this situation creates short-term anomalies.

For example, José Viñals, lead author of an IMF report released on 30 September, said: "Either there is continuing support on the part of the authorities to underpin the credit process or there will be high lending interest rates and credit will be constrained."

There will also be a new climate within banking due to regulatory

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reform, all of which will increase the cost of funding for banks.

We believe that companies have to be aware of this pending change for banks, as well as the stopping of QE with its resulting effects on currencies and interest rates. While the day-to-day changes will be much less dramatic than the events of six to 12 months ago, it will change the behaviour of banks including their lending. We are still unfortunately a long way from a stable outlook for funding markets.

Given the lack of long-term resolution to the banks' future size, cost of funding and role, the questions we wish to pose to UK companies are essentially as follows:

- Do they think now is a good time to borrow or do they think market conditions will improve in the next, say, 12 months?
- How much would they value an alternative source of debt finance to bank facilities?
- Do companies wish to have a relationship with alternative providers of long-term capital or do they prefer the anonymity of bond markets?
- How important is longer-term debt and the avoidance of large concentrations of debt maturities? and
- How much do companies take into account the cost of ancillary services when deciding the cost of relationship banking loans?

We are keen for there to be a debate among those who are concerned about relying on a relatively small number of banks for debt finance and who recognise that while credit spreads are higher than during the bull years of the credit boom, all-in funding levels are very attractive on an historical basis.

M&G's UK Companies Financing Fund is now up and running and is ready to make private long-term investments in well-run companies that see value in the idea of diversifying funding sources away from banks and improving the security of funding for their balance sheets over the medium to long term. While this is only a small step in the direction of increasing non-bank lending in the UK, it is an important development.

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