The limits to lending

CAPITAL REQUIREMENTS AND BANKS' OWN CRITERIA ARE TIGHTENING THE CONSTRAINTS ON BANK LENDING, AND THE POINT AT WHICH THOSE TWO FACTORS MEET IS ALSO SHIFTING. **GRAHAM BUCK** REPORTS.

A cloud of uncertainty has started to lift on the exact nature of the regulatory costs and requirements that the forthcoming Basel II/III regime will impose on banks. In September, details on the future requirements for capital reserve levels were unveiled after central bankers and officials of the Basel Committee's oversight body concluded a deal.

The agreed Basel III package will more than double the core Tier 1 capital ratio from 2% to 4.5% when the new rules are phased in over a six-year period starting in January 2013, giving banks time to refinance their existing debt and raise new money by issuing bonds.

Basel III's requirements and its effect on the amount of capital held will combine with the other factors that govern a bank's lending policy – namely, the customers, sectors and geographies it wishes to lend to.

The question is whether the meeting point between these main influences will shift. "Will capital requirements be inversely related to sovereign ratings – that is, higher capital for lower ratings?" asks John Finn, managing director of consultancy firm Treasury Solutions. "If so, it will favour AAA-rated countries, which by definition are probably representative of a stronger banking industry."

The UK's major banks already need to refinance heavily over the next couple of years because of their reliance on short-term borrowing to finance their long-term investments. For 2011 the total refinancing figure is estimated at £204bn; that's around double this year's figure and also around twice the long-term borrowing average. It will result in their monthly borrowing more than doubling, from £12bn a month to £25bn.

The Bank of England has recently been stressing the need for banks to bolster their cash reserves. During the summer's European sovereign debt crisis, the Bank warned that the UK banking sector was particularly vulnerable due to its exposure to other European lenders, and that by the end of 2012 Britain's major banks would need to refinance or replace £750bn to £800bn of debt. This made devising a credible refinancing plan vital.

Finn suggests that the task involves several unknowns, one being whether the UK investment community is large enough to finance this requirement without any need to resort to euro zone investment sources. If not, as large euro-denominated funding will be needed for euro zone banks the question will be whether EU investors prefer to stay within the euro rather than face the FX risks of sterling investments. It may be that some will be ready to direct their money towards Britain's stronger banks.

In its most recent bi-annual Financial Stability Report, published in June, the Bank warns: "There's a risk banks alleviate their own funding pressures by further constraining credit conditions for customers. That would dent economic recovery and so raise credit risk for all banks."

The report confirms: "Banks need to reduce leverage further, extend the maturity of their funding and refinance substantial sums as official sector support is withdrawn. While their profitability is relatively buoyant and market conditions are broadly favourable, banks should take the opportunity to do so. That will reduce the risk of disruption to the flow of credit in the future."

SINCE SEPTEMBER 2008, UK FINANCIAL INSTITUTIONS HAVE CUT NET LENDING TO BRITISH COMPANIES BY £59.1BN WHILE CORPORATE BOND ISSUANCE BY UK BUSINESSES SIMULTANEOUSLY INCREASED BY £22.1BN.

This scenario offers little to reassure smaller businesses. Monthly data so far this year suggests that bank lending to British companies has been restricted since the downturn began and remains tight, whereas conditions in other major economies show signs of easing. Figures issued by the Bank of International Settlements showed a modest revival in cross-border lending by banks in the first quarter of 2010 for the first time since the demise of Lehman.

Here in the UK, lending to non-financial companies was negative in every month bar February in the year to August 2010. Firms repaid a net £1bn in bank debt during August and £2.4bn the previous month, according to the British Bankers' Association (BBA). Over the 12 months to July 2010, firms repaid to the banks £47bn more than they received in new loans, reducing their overall debt by 3.1%. The sequence of monthly declines marks the most persistent fall in company borrowing since records began back in 1997.

David Dooks, the BBA's director of statistics, says: "Bank of England research shows that there is around £25bn of new lending to business quarter on quarter, but this is being more than offset by businesses paying down debt as part of their balance sheet management and cost containment."

The Bank's own bank lending survey also confirms that the UK's 4.7 million small and medium-sized businesses have difficulty in securing bank lending, although the banks themselves maintain they are willing to lend to businesses able to demonstrate that they are viable.

Large companies generally find it easier to access capital and to do so on more favourable terms. "The general perception in both the US and the UK is that larger companies have deleveraged," says Finn, "partly because of boards' desire to do so and also because bank lending norms are driven off lower debt and EBITDA norms, whereas small companies continue to struggle."

DRIP-FEED FINANCE The Federation of Small Businesses reports that between 300 and 400 member firms go out of business each week. "Small businesses are the lifeblood of the economy, but are effectively being drip-fed by the banks," says FSB chief spokesman Stephen Alambritis. "Cutting off their credit poses a very real threat to the economic recovery."

However, Thomas Huertas, banking sector director at the Financial Services Authority, says that criticisms that the banks are reluctant to lend to small businesses are more perception than reality: "The discussion could be more fact-based as, contrary to some reports, evidence suggests there is quite a significant amount of lending by the banks to small businesses at the moment. The characterisation of banks as being unwilling to lend is at odds with the fact that there is currently a large volume of loans outstanding. The rate at which the banks are prepared to lend will be dependent on the degree of risk represented by the borrower.

"Any bank being operated prudently will want a rate that is commensurate, and it is often the case that the borrower's own view of the risk they represent is significantly more sanguine than the lender's."

But Finn points out: "Borrowers don't know their credit rating within the bank. Nor is there any communication between bank and borrower about what drives such ratings up or down and also how such actions impact either positively or negatively on margins and fees."

The banking sector has shown some sensitivity to accusations that too many SMEs are going under unnecessarily due to the lack of credit. In August the BBA announced that the UK's six biggest banks were commissioning research for pH, a subsidiary of Experian. The company is analysing the credit profiles of small businesses that have been denied funding and the data will be presented to the Treasury shortly.

POINTLESS EXERCISE Finn is dubious whether the exercise will achieve much, citing a recent similar exercise by the Irish government, which set up a credit review process. "The uptake has been extraordinarily low for a market that is clearly short of credit," he says, "even though the process has resulted in banks having to reverse their decision and lend in many cases. This is partly because many credit applications are informal – for example, phone calls or discussions. There is also the issue of timing delays, with delayed lending decisions exacerbating the situation as they cause the credit quality to deteriorate, and also a question mark as to whether the maximum loan size about which a refusal to lend can be appealed [€250,000] is simply too low.

"In addition, there has been an underhand credit reduction by some banks. In Ireland, overdraft limits were traditionally measured against uncleared balances. Some banks have changed to using cleared balances, thereby negating between one and four days' receipts, which effectively reduces the overdraft limit."

According to reports, the BBA's task force, headed by HSBC chairman Stephen Green, originally envisaged that the banks would undertake the work themselves. However, it was decided that the evidence would carry greater weight if presented by an independent analyst.

The banks believe that pH's findings will support their contention that the drop in lending is more a reflection of lack of demand and only riskier businesses are being refused loans. If correct, it will strengthen their case in arguing that the government should refrain from intervening and forcing them to lend more.

The FSA's Huertas contends that the banks' level of borrowing to smaller businesses over the next few years will be influenced principally by the general economic background, and both their willingness to lend and the amounts they offer are unlikely to be much affected by the requirements of Basel II and III.

Box: Banks to take action

The actions promised by the Business Finance Taskforce in October include:

■ **Publish lending principles** These will clearly set out the minimum standards that medium-sized and larger businesses can expect when asking banks for loans and other services.

■ **Establish transparent appeals processes** These will kick in when loan applications are declined. The processes will be independently monitored by a senior independent reviewer, who will publish the results of their review, to ensure that each bank has a fair and equitable appeals process.

■ **Initiate a pre-refinancing dialogue** This will take place 12 months ahead of any term loan coming to an end, and will include an assessment of what needs to be in place ahead of loan expiry to maximise the prospect of successful refinancing.

■ **Support the Enterprise Finance Guarantee Scheme** The aim is to seek continued government backing through to 2012, and accommodate any changes made by government.

■ **Improve SME access to trade finance** This will be achieved by targeted SME awareness-raising campaigns and by exploring possible regulatory adjustments with the Financial Services Authority.

"Past recessions were similarly marked by corporations conserving cash and paying down debt," Huertas says. "Small businesses cannot change the economic outlook, but they can respond – and are actively doing so – by strengthening their management and increasing the amount of equity capital they put into the business."

Specialist invoice financier Bibby Financial Services is using the opportunity of the BBA-sponsored report to promote its own alternative form of business funding. Its chief executive, Edward Rimmer, says: "They [the big banks] are by no means the only funding option for the UK's small business community and I would argue that they do not provide the best financial solution either. As we've seen over the last few years, banks can be large, inflexible organisations, ill suited to the unique financial needs of small and medium-sized businesses.

"For this reason, I would like to see the funding debate move beyond the actions of the big banks and look to explore the benefits offered by the wider finance market. Invoice financiers provide funding based on less complex lending criteria than the banks as the business's sales ledger is used to secure its access to funds."

BANK DEBT RETHINK Ratings agency Standard & Poor's believes that the financial turmoil of the past two years has prompted a rethink by companies "questioning whether their traditional reliance on bank debt finance could undermine their economic stability and growth". S&P suggests that tighter lending conditions could significantly change the balance between bank lending and capital market financing in the UK, where bank loans to corporates currently account for 76% of debt (as in non-equity) finance. It also anticipates a "more significant rebalancing" in the euro area, where about 90% of corporate debt financing is provided by the banks. This contrasts with the US market, where bank loans provided 63% of debt financing in 2007.

S&P's primary credit analyst Paul Watters and his team believe that the bond market is poised to take a larger share of UK corporate funding. Since September 2008, UK financial institutions have cut net lending to British companies by £59.1bn while corporate bond issuance by UK businesses simultaneously increased by £22.1bn. "This makes corporate bond issuance the main provider of new debt financing on a net basis since third-quarter 2008," observes a recent S&P report on the changing bank lending landscape.

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