Open for business

At the time of writing this article (the end of July), the business media continue to comment on the role UK banks should be playing in helping UK businesses through the recession – particularly those banks being supported by the UK government. As one of those banks, RBS is keen to ensure that the facts are well understood and even more determined that UK businesses recognise that we are very much open for business.

Let's start with a survey, Deloitte's Q2 CFO survey, entitled No Return to Business as Usual, which takes us right into the vexed question of supply and demand. The survey findings suggest that the UK's CFOs believe the UK economy may be at a turning point, although that upturn, when it comes, will be one marked by "sluggish growth, a strong focus on cost control and tight lending conditions". In other words, the survey respondents are pointing towards issues of underlying demand for banking products and services and to issues relating to the supply of credit, which they consider to be "scarce and expensive".

Executive summary

- **The banking sector has become a media scapegoat for the UK's continued economic woes. But, in truth, the demand for credit from UK companies has fallen, while the banks are willing to lend at a price that properly factors in risk and retain a partnering ethos.**

DEMAND The UK economy shrank by 2.4% in the first quarter of this year (that's as big a fall as the one recorded for the whole of the 1990s recession), and 0.8% in Q2. The slump has been felt across a range of industries, hitting construction and property early in the cycle as well as the service sector, which accounts for the bulk of the UK economy.

In the last six to nine months our corporate clients are discouragingly consistent in what they say to us. Our customers tell us they are focusing on cost cutting, curtailing capital investment, shelving investment plans and putting M&A activity firmly on the backburner. The latter used to be a major driver of lending activity but effectively dried up in the first half of this year, although there are signs that appetite is recovering.

Companies appear to be hunkering down, determined to reduce their debt levels and strengthen their balance sheets. The same is happening in the consumer segment. The whole economy has woken up to the fact that we all need to save more and borrow less. Companies in the quoted sector are getting these signals from their investors, who now favour conservative strategies. It's quite different mood music from earlier in the decade, when calls for purposeful balance sheets were very strong.

Banks are therefore facing a material downturn in demand for credit (although compared to previous downturns of this magnitude, business lending remains, in fact, relatively strong). The Bank of England's July Trends in Lending publication pointed to a steady downward march in lending to UK businesses by the major British banks, shrinking by an annualised 5.4% in the three months to May. It went on to say that its regional agents were reporting very weak business investment intentions, which in turn reflected the outlook for demand.

At RBS, we have attempted to get under the skin of the demand issue by speaking directly to our customers about their investment plans for the near future. When we asked our mid-corporate customers in May, we found that two-thirds of them were not expecting to borrow any more money in 2009. On a similar note, levels of applications for new credit were well down in the SME sector compared with a similar period in 2008.

So what will cause this picture to change? The first part of the answer is that we are (probably) coming towards the end of a long period of destocking in the UK. Inventories have been liquidated at the fastest rate in the last 25 years, which suggests the potential, at least, for some recovery, as companies rebuild stocks after the long cutback. But the extent to which that recovery is sustainable depends, of course, on the re-emergence of end-demand from consumers. And with consumers under pressure and industry still sitting on idle capacity, any such rebound remains uncertain.

SUPPLY Another way to address the question is to consider the business confidence factor, which takes us into the other half of the

IAN HENLEY DEFENDS THE BANKS FROM THE CHARGE OF HOARDING TAXPAYERS' MONEY AND STARVING BUSINESSES OF CREDIT.

demand/supply equation. The supply-side issue has a number of different dimensions:

Unwilling to play? The first is the perception that weak levels of credit demand arise from the banks being unwilling to supply it. UK banks all recognise their role and responsibility in stimulating growth. Indeed, the government-supported banks have entered into specific commitments to increase their lending to both the business and personal segments; RBS has agreed to make £16bn available to UK businesses while Lloyds Banking Group has pledged £11bn. Taken together, this amounts to more than total market net lending in 2008 and should, in theory, comfortably address the supply issue. The key is how to turn this availability into drawn borrowing in a responsible way, which serves the interests of both customers and shareholders of the banks.

We are making it clear to our customers that we are willing to lend more. This helps build confidence and encourages customers to bring forward business investment or corporate activity they might otherwise have held back from. We are openly advising our credit appetite to customers to stimulate this debate.

External signalling through advertising, conferences, literature and other publicity and community activity also plays an important role. For example, NatWest and RBS have made an additional £3bn funding available to SMEs in 2009. It appears to be having an impact: at the time of writing, we had written over 100,000 new loans since the beginning of the year and are continuing to write them at a rate of around 5,000 a week; and over £200m of loans had been agreed or are in the pipeline under the Enterprise Finance Guarantee scheme.

Too high a price? The second dimension of the supply debate is to what extent pricing chokes off demand. The Deloitte CFO survey pointed to a tendency among CFOs to prefer alternative markets in the belief that bank credit has become expensive. In particular, the public equity and debt capital markets have proven popular: they

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have been demonstrably open for business in the first half of 2009, with record issuance. It can be cheaper, depending on the type of issuer, to issue in the debt capital market than borrow from the banking system and the advantages of diversifying credit sources and stretching maturities are obvious. Equally clearly, not all companies can or want to use these markets and look instead to bank credit.

Risk had become underpriced in the boom years, driven in part by the strong supply of credit and the knowledge that bank debt was often refinanced into alternative markets, many of which have now closed to lenders. The retreat of a number of foreign lenders from the UK has played a role in the repricing of risk but our experience is that this component of credit supply has not vanished as quickly as some feared. We believe, in fact, that many foreign banks have been encouraged to continue lending now that risk is being priced at a level which creates value for their shareholders.

Beyond the cost of risk, the other elements of the price are the inputs, the cost of most of which has gone up. While banks can control operational and portfolio management costs, the costs of funding, liquidity and capital have all risen and must feed into pricing if banks are to operate profitably and deliver value to shareholders.

The good news is that the all-in cost to borrowers has gone down. Bank of England figures show that average all-in borrowing rates (margin and reference rate) on new loans to non-financial corporates in the UK fell from 6-7% in January 2007 (with the five-year rate peaking just above 9%) to the current 3-4%. Thus, the rates paid by customers have fallen by up to 70% over the last 18 to 24 months.

Moving the goalposts? The third dimension of the supply debate is whether or not banks have simply changed their lending criteria. The evidence for this leaves some unconvinced but perhaps of most relevance is the frequency of loan requests being declined.

In the corporate segment, this has not changed at RBS and the principle that we (and most other major British banks) work to is one of long-term partnership, seeking to provide consistent support based on a deep understanding of a company's business strategy and management. This is not to say that banks do not need to ensure their risk management disciplines are world-class. They do, and it is only right that lending decisions are made with all the thoroughness and diligence that the external risk environment demands.

We operate in febrile times, where soundbites dominate headlines and where it can be hard to discern what is really going on. Certainly, RBS is very much open for business and actively out hunting for it.

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