



# Perspectives by Ruth Lea

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## Continuing problems in the banking sector will curb recovery

### Introduction

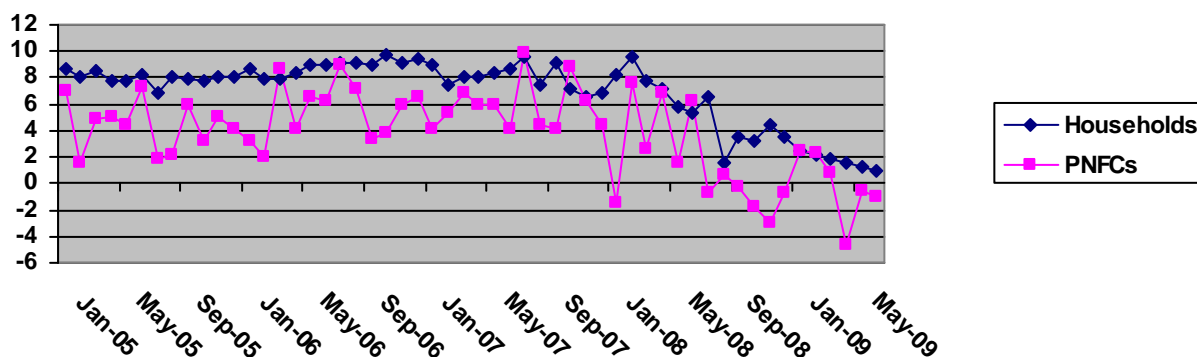
Britain's four biggest banks will release their results for the first 6 months of 2009 this week and it is expected that some will declare profits.<sup>1</sup> But this news should not be interpreted as a "business as usual all-clear" for the banking sector and a return to pre-credit crunch "normality". This clearly is not the situation as any inspection of the latest bank lending data and the, very significant, ongoing problems in the banking sector show.

### Bank lending remains very weak

Recent bank lending data are very weak. M4 lending to households, having averaged around £8-9bn a month from 2005 to mid-2007 was less than £1bn in June as households sought to rebalance their balance sheets.

Lending to private non-financial corporations, a volatile series at the best of times, was negative in April, May and June. This reflected three factors. Supply was restricted though credit availability had modestly improved, some UK businesses had repaid bank debt using funds raised on the capital markets and, crucially, demand remained weak.<sup>2,3</sup> Lenders have recently reported to the Bank that there has been little actual or expected increase in the demand for credit, except for balance sheet restructuring.

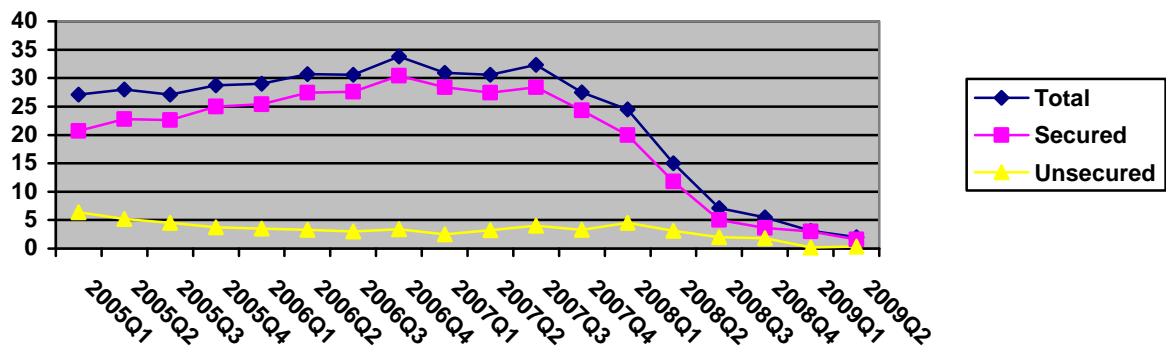
**Chart 1: M4 lending to households and private non-financial corporations, monthly seasonally adjusted data, £bn**



Bank of England, "Sectoral breakdown of aggregate M4 and M4 lending: June 2009", 29 July 2009 and Bank's database: on [www.bankofengland.co.uk](http://www.bankofengland.co.uk). Data exclude the effects of securitisations.

The breakdown in net lending to individuals is shown in chart 2 below. (Note these are quarterly, not monthly data.) Lending secured on dwellings was running at around £25-30bn a quarter at the height of the lending boom but plummeted to less than £2bn in 2009Q2. Consumer credit, unsecured credit, which averaged £3-4bn a quarter in boom times, was less than £½bn in 2009Q2. It was even weaker in 2009Q1.

**Chart 2: Net lending to individuals, quarterly seasonally adjusted data, £bn**



Source: Bank of England, "Lending to individuals: June 2009", 29 July 2009 and Bank's database: on [www.bankofengland.co.uk](http://www.bankofengland.co.uk).

The outlook does, however, look better for mortgage lending as the approvals secured on dwellings are picking up. Mortgage approvals in June were valued at nearly £11½bn compared with a previous 6-month average of £9½bn.<sup>4</sup>

#### *The banks' impaired balance sheets*

Even though the current weakness of bank lending can be attributed to weak demand as well as to restricted supply (albeit modestly improving), it is crucial not to lose sight of the fact that, even when demand picks up, the supply of credit is expected to be constrained by ongoing problems in the banking sector. This will act as a dampener on economic recovery.

The Bank of England's latest *Financial Stability Report* gives a masterly analysis of the state of the banks' balance sheets and acts as a timely reminder that bank lending will almost certainly be significantly restricted for a considerable time.<sup>5</sup> It seems inconceivable that the lending practices common in the run-up to credit crunch will ever be repeated. The practices were imprudent and damaging and the damage will have to be repaired.

The Bank report's main conclusions, which make for grim reading, are:

- "While pressures on the major global banks have stabilised over the past few months, their balance sheets remain impaired. Banks' leverage remains high, with the further impairment of assets placing continued pressure on profitability and capital ratios. Future revenue generation will need to balance the desire to deleverage with the need to generate new business at profitable spreads". It should be added that this emphasis on high leverage is especially pertinent as the over-leveraging in the lending boom, which contributed to the seemingly buoyant economy, was not restrained in any way by the Authorities.<sup>6</sup>

- The balance sheet pressures are weighing on banks' ability to lend to households and companies. Their willingness to lend maybe further affected by uncertainty about the economic outlook (and related risks attached to business bad debts, mortgage defaults etc), as well as concerns about future changes to liquidity and capital regulation.
- The major banks maintain a high and rising customer funding gap - the difference between customer loans and deposits. The gap amounted to a staggering £800bn in 2008. The Bank speculates that UK banks might conceivably need to shrink their balance sheets or find alternative sources of funding of around £500bn over the period to 2013, as various forms of public sector financing are progressively withdrawn.
- Finally, the withdrawal of overseas funding and competition for domestic deposits is adding to funding pressures.

### *Implications for the economy*

The continuing weakness of bank lending will inevitably act as a drag to recovery. Indeed tight credit availability could act as a major block on growth. The Bank has given some stark warnings:

- "The experience of past crises is that lending levels have typically fallen. Against this backdrop, there is a risk that – in the event of further adverse macro or financial sector developments – banks may not supply sufficient credit to support growth in the economy".<sup>7</sup>
- "But the evidence from prospective borrowers, and the terms on which lenders are willing to extend credit, suggest that banks' ability to finance a sustained recovery remains impaired by low levels of equity capital".<sup>8</sup>

The implications of restricted bank lending for the housing market is fairly clear as households tend to rely on banks (and building societies) for any loans they raise for house purchase. Restricted mortgage funds will inevitably restrain any recovery in the housing market.

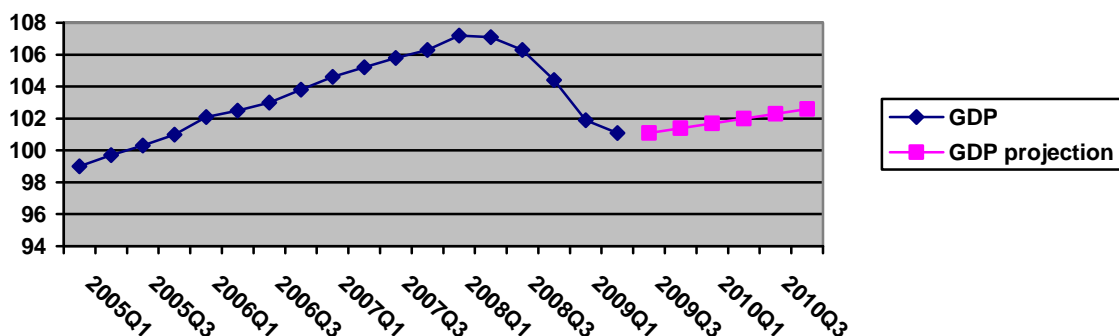
Concerning the corporate sector, the situation is less straightforward because larger firms can raise funding by equity and/or debt issuance as well as bank borrowing. The latest Deloitte survey of chief financial officers showed that credit availability for larger firms had improved for the second successive quarter, with equity the most popular form of finance and bank borrowing the least popular. This was exactly the opposite of the situation two years ago. Bank lending is, however, still important for business. In particular smaller firms tend to rely on their banks.<sup>9</sup>

### *Green shoots withering?*

Persistent problems in the banking sector are all the more dispiriting because much of the optimism of 6-7 weeks ago concerning the "green shoots" has faded recently.<sup>10</sup> Even though there remain signs of improvements in the housing market, the "recovery" in manufacturing industry appears to have faded and the ONS's preliminary estimate for 2009Q2 GDP was considerably worse than expected. NIESR, on the basis of survey material, had estimated that GDP fell about 0.4% in the quarter.<sup>11</sup> The ONS's estimate was twice that and showed a quarterly fall of 0.8%, to show GDP 5.6% lower than a year earlier. Granted this quarterly decline was not as precipitous as in 20089Q4 (1.8%) or, especially, 2009Q1 (2.4%). But it was still disappointing.

The latest GDP estimates almost guarantee that the Treasury's forecasts will be missed, with the inevitable negative implications for the public finances. At the time of the Budget the Treasury forecast a GDP fall of 3½% for 2009 and growth of 1¼% for 2010. Even on the relatively optimistic assumptions that GDP will stabilise in 2009Q3 and show some steady if modest growth in 2009Q4 and throughout 2010, GDP will fall by around 4½% this year and only grow by ¾% next. Chart 3 illustrates this growth trajectory. The detailed figures are shown in the annex table.

**Chart 3: GDP projection, index 2005=100**



Source of back data: ONS, "Gross Domestic Product preliminary estimate, 2009Q2", 24 July 2009, [www.statistics.gov.uk](http://www.statistics.gov.uk).

There are still some brave folk who suggest Britain will experience a sharp V-shaped recovery and the economy will be growing buoyantly next year. But this is not credible. This recession is unique in terms of post-war recessions because of the impairment of the banking system. As we have already discussed in this Perspective this will, as a very minimum, act as a drag on recovery.

It is hard to see where the drivers for buoyant growth would come from. Consumption will be restrained by rising unemployment, the need for the indebted household sector to rebalance its balance sheet, and higher taxes. Exports will be restrained by a sluggish world recovery. Business investment does not lead recoveries, it lags them. And government spending is likely to be severely curtailed.

## References

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3. Bank of England, *Trends in lending*, July 2009. Note that lending also turned negative in the final quarter of last year.
4. Bank of England, "Lending to individuals: June 2009", 29 July 2009.
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6. Ruth Lea, Big-bank bashing is pure political hypocrisy, *Times*, 29 July 2009.
7. Bank of England, *Financial Stability Report*, June 2009.
8. Mervyn King, Mansion House speech, 17 June 2009, available on [www.bankofengland.co.uk](http://www.bankofengland.co.uk).
9. David Smith, "Banks may be too weak to support the recovery", *Sunday Times*, 19 July 2009.
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11. The National Institute of Economic and Social Research, website: [www.ac.uk](http://www.ac.uk)

**Annex table: GDP projection, index 2005=100**

	GDP, 2005=100	QOQ (%)	YOY (%)
2008			
Q1	107.2	0.8	2.5
Q2	107.1	-0.1	1.8
Q3	106.3	-0.7	0.5
Q4	104.4	-1.8	-1.8
Total/average	106.3	Na	+0.8
2009			
Q1	101.9	-2.4	-4.9
Q2	101.1	-0.8	-5.6
Q3	101.1	0	-4.9
Q4	101.4	0.3	-2.9
Total/average	101.4	Na	-4.6
2010			
Q1	101.7	0.3	-0.2
Q2	102.0	0.3	0.9
Q3	102.3	0.3	1.2
Q4	102.6	0.3	1.2
Total/average	102.15	Na	0.7

Source of back data: ONS, "Gross Domestic Product preliminary estimate, 2009Q2", 24 July 2009.

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