



# Perspectives by Ruth Lea

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## Weak bank lending: constrained by demand factors not just supply

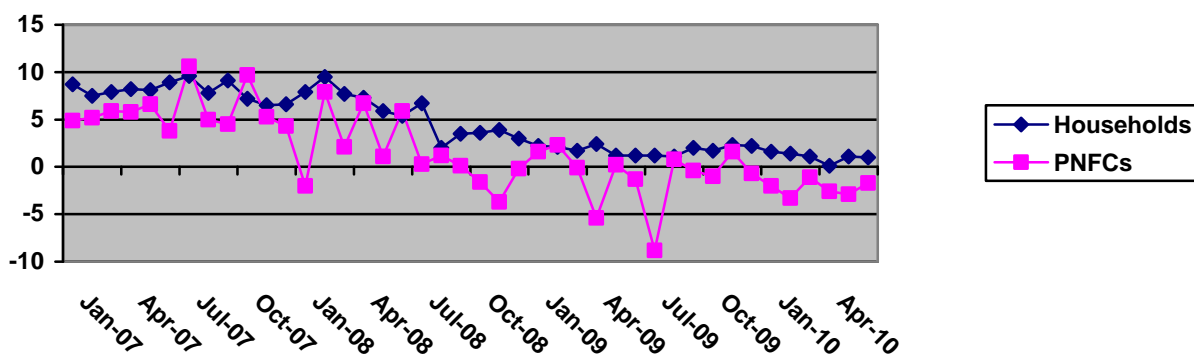
### Introduction

Weak bank lending is a hot topic, as is the widely-publicised implication that it is overwhelmingly due to supply constraints, with banks reluctant to lend, rather than deficient demand. This Perspective analyses recent developments in bank lending and concludes that, even though there are undoubtedly availability factors operating and credit availability remains tight, muted demand is also playing a significant role.

### Recent trends in bank lending

At face value bank lending certainly remains weak. Chart 1 below shows that M4 lending to households, having averaged around £8-9bn a month from 2005 to mid-2007 during the height of the credit boom, was around £1bn in May and June this year. Meanwhile lending to private non-financial corporations (PNFCs), a volatile series at the best of times, has been negative for many months.

**Chart 1: M4 lending to households and PNFCs, monthly changes, January 2007 to June 2010, seasonally adjusted data, £bn**

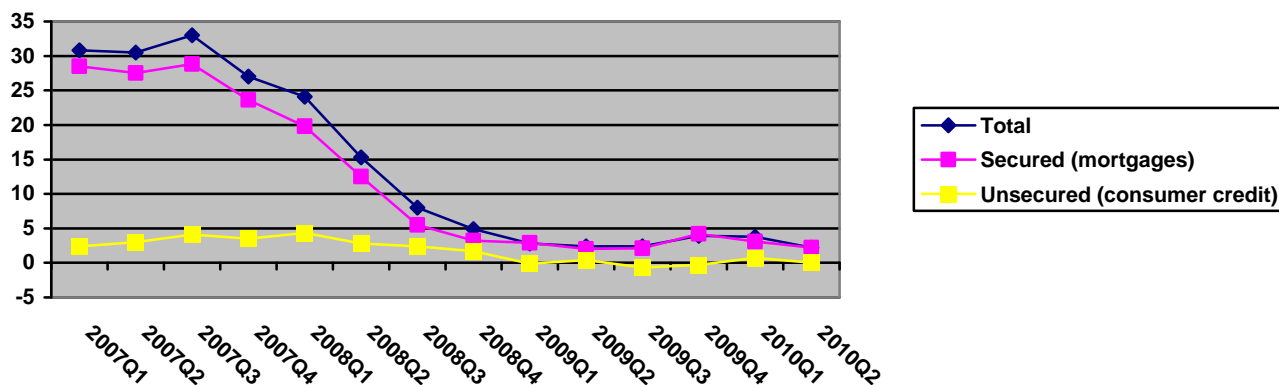


Source: Bank of England's database, on [www.bankofengland.co.uk](http://www.bankofengland.co.uk). Data exclude the effects of securitisations.

### Lending to households

Starting with households it is useful to split the series between secured (mortgages) and unsecured (consumer credit) lending (chart 2). Net lending secured on property collapsed during 2008, after the unsustainably high levels of the boom. And even though it picked up modestly in late 2009 and early 2010 it has recently weakened again. Unsecured lending, consumer credit, struggled into positive territory in early 2010 after having been negative for much of 2009, when households sought to rein back their indebtedness.

**Chart 2: Net lending to households (individuals), quarterly changes, 2007Q1 to 2010Q2, seasonally adjusted data, £bn**

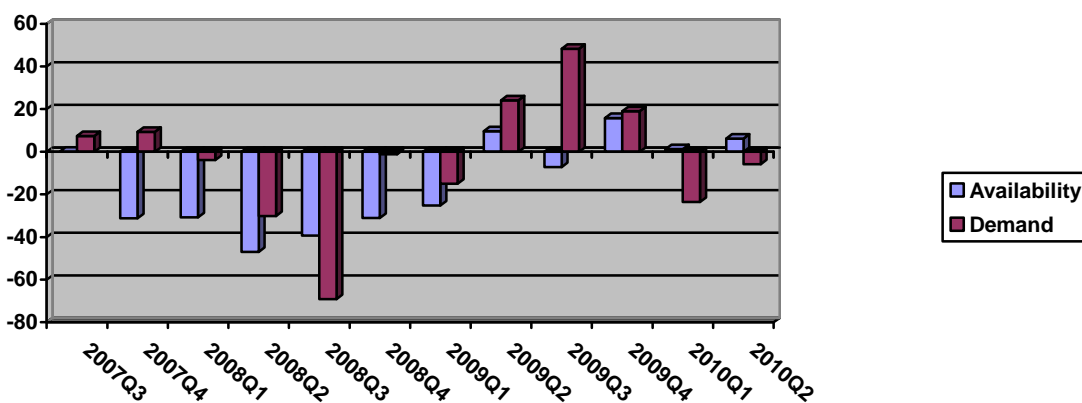


Source: Bank of England's database, on [www.bankofengland.co.uk](http://www.bankofengland.co.uk).

The continued weakness in mortgage lending reflects several factors but, as the Bank of England has pointed out, it is difficult to identify precisely the separate supply and demand influences.<sup>1</sup>

Supply is undoubtedly tight and lending criteria have been tightened, but availability has modestly improved in recent quarters according to the Bank's *Credit Conditions Surveys* (chart 3). The most recent survey specifically showed improvements for borrowers with high loan-to-value (LTV) ratios.<sup>2</sup> Demand continues to be constrained by the lenders' restrictions on mortgage finance, particularly for first time buyers. Moreover, demand has tended to fall away this year reflecting continued economic uncertainty despite signs of recovery.

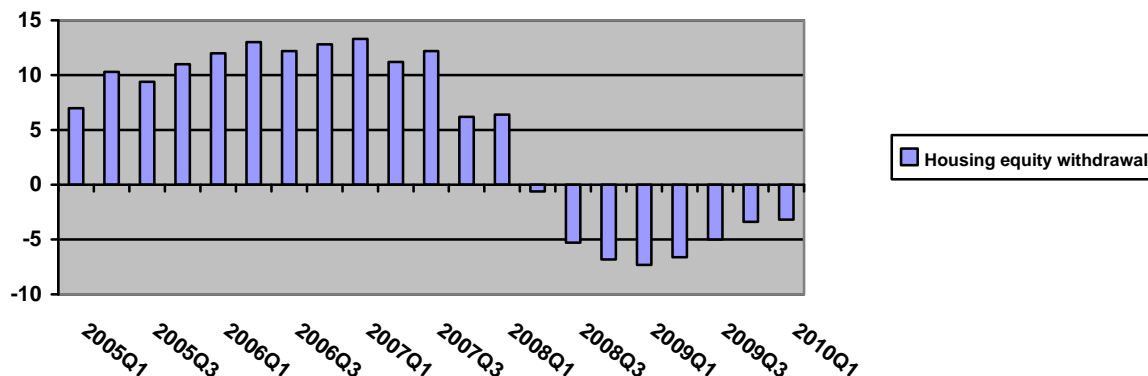
**Chart 3 Household sector secured credit (mortgages), net balances (%)**



Source: Bank of England, *Credit Conditions Survey*, 2010Q2, July 2010. Net % balances are calculated by weighting the responses of lenders who answered the question as to "how the availability of credit provided to the sector overall had changed in the past 3 months".

Another relevant factor is housing equity withdrawal (HEW). HEW continues to be negative as mortgage-holders cut back on their indebtedness, though note the rate of repayment has moderated since the first half of 2009 (chart 4). These holders are probably concerned about economic uncertainty but they are undoubtedly enabled to pay debt off because of low interest rates.

**Chart 4 Housing Equity Withdrawal, £bn, quarterly data, seasonally adjusted**

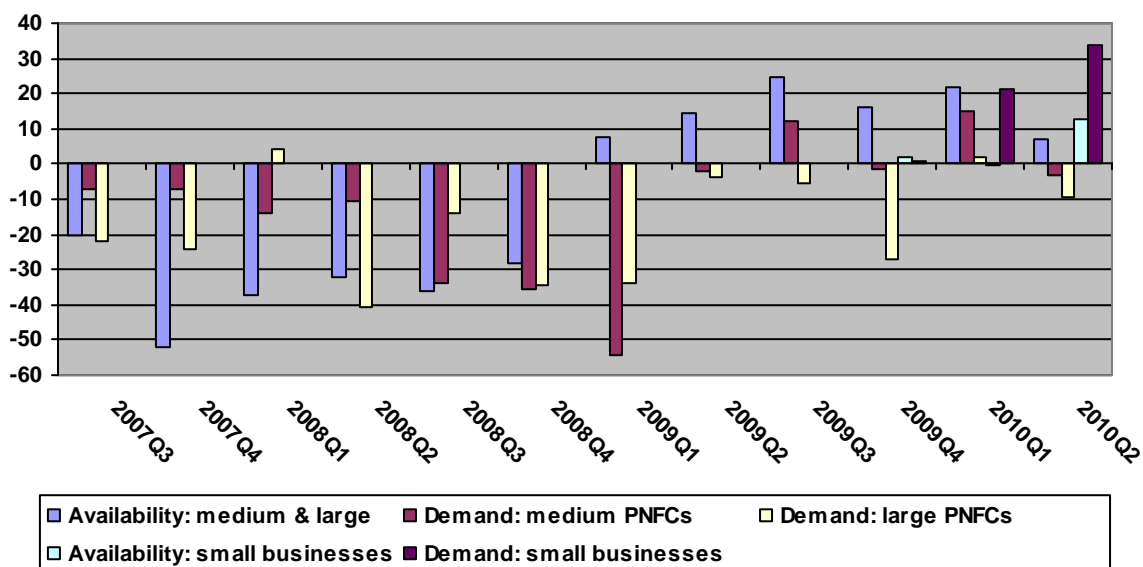


Source: Bank of England, statistical database.

### Business lending

Turning to the bank lending for businesses, the Bank's *Credit Conditions Surveys* suggest that, even though credit availability has improved this year, demand has tended to fall away (chart 5). Specifically demand by medium and, especially, large private non-financial corporations (PNFCs) has decreased. Small businesses' demand is however higher.

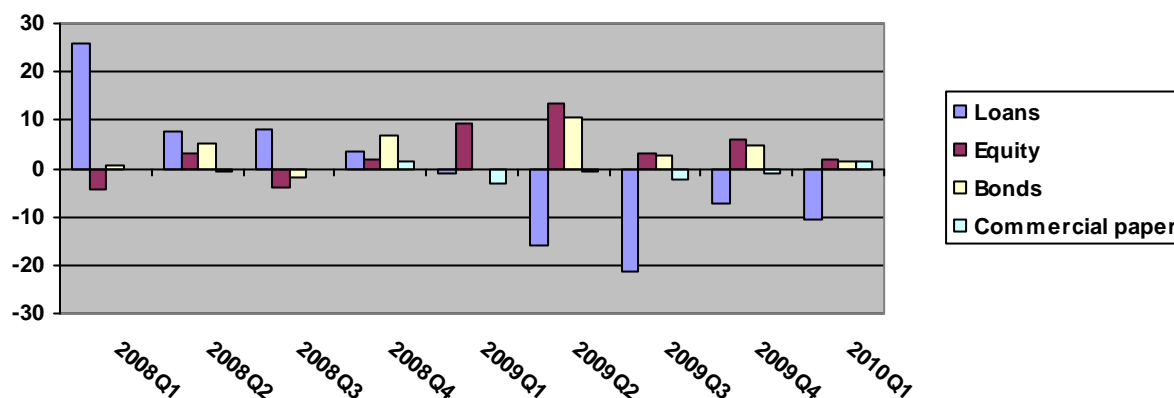
**Chart 5 Business credit, net balances (%)**



Source: Bank of England, *Credit Conditions Survey*, 2010Q2, July 2010; for explanation of the balances see chart 3. The small business results are only available from 2009Q4.

The Bank's network of Agents has reported that bank finance demand has remained muted because many businesses have been paying down bank debt and reducing their leverage. In addition, some larger businesses have used capital market issuance (bonds and equity) to fund their activities (chart 6). The negative lending figures for medium-large companies (see chart 1) can therefore be overwhelmingly explained by demand, not supply, factors. This situation may however reverse as there are currently signs of more difficult capital market conditions for larger companies.

**Chart 6 Net funds raised by UK businesses, quarterly, 2008Q1 to 2010Q1, non seasonally adjusted, £bn**



Bank of England, *Trends in Lending*, July 2010, [www.bankofengland.co.uk](http://www.bankofengland.co.uk). Monthly data are available up to May 2010.

#### *Bank lending to small businesses*

There is still the criticism that banks are starving small businesses of funds to answer. As a recent Green Paper from the Treasury and BIS points out, small firms are very dependent on bank lending for their external finance, having little recourse to the capital markets.<sup>3</sup>

The latest data from the British Banking Association (BBA) does indeed show that new bank lending to small businesses has been relatively subdued in recent months. Moreover substantial loan repayments from businesses “seeking to reduce financing costs and reliance on borrowing by operating out of cash flow” have more than offset the new lending.<sup>4</sup> But the fact that businesses are in a position to make these loan repayments out of cash flow, together with an increase in small business deposits from £54bn in June 2009 to £56bn in June 2010, does not suggest a sector in financial stress. The conclusion must be that the small business sector, as well as medium-large PNFCs, is seeking to cut back on borrowing and deleverage.<sup>5</sup> Of course there are small firms which are refused finance. But banks are under pressures which result in restrained lending (see below) and in uncertain economic times they take fewer risks.

Excessive credit, priced too low in easy pre-2007 credit crunch times, drove the bubble. Expectations of “normal” conditions must not be coloured by those years. They were exceptional and are unlikely to be repeated - one hopes.

### *Banks: the pressure to restrict credit*

There is no doubt that net bank lending is very, very subdued. Chart 1 shows this very clearly. But there are demand factors, as well as supply factors, operating. Both households and businesses have been paying off debt after the credit boom - and bust.

But there are of course supply factors operating too. The supply of credit has diminished as lenders have been exhorted to boost capital, shrink balance sheets and borrow less on the wholesale markets. They also face a major funding challenge and tighter capital and liquidity regulations.

The developments in, and pressures on, the banking system were eloquently explained by the Bank in its latest Financial Stability Report (FSR).<sup>6</sup> In particular, the FSR pointed out:

- The banks have already increased capital considerably. Tier 1 capital ratios are at their highest levels for more than a decade – up from nearly 9% in 2008 to nearly 12% in 2009. And the average leverage ratio continues to fall. Assets were around 19 times capital in 2009H2 compared with 30 times at the end of 2008. The Bank exhorts the banks to continue building capital through issuance and retention (with lower discretionary distributions to shareholders and staff).
- The banks' balance sheet is shrinking. Between 2008 and 2009H2 assets fell by £1.9trillion to £7.4trillion. UK bank lending to UK PNFCs and households fell by £34bn.
- The banks face a major refinancing challenge. The UK's largest banks will need to refinance or replace around £750-800bn of term loans and assets by the end of 2012. The expiration of the Bank's Special Liquidity Scheme (SLS) and the Treasury's Credit Guarantee Scheme (CGS) significantly contributes to the sheer enormity of this challenge.
- The banks have reduced their dependence on the wholesale markets, with the "customer funding gap" down to £475bn at end-2009 - over £350bn less than its peak in 2008H2. But the Bank exhorts them to further reduce their reliance on, while extending the maturity of, their wholesale funding. (Around 60% of funding falls due within one year.)
- On top of the funding challenges, the banks must plan their adjustment to future tighter regulatory requirements. The Basel Committee on Banking Supervision (BCBS) agreed in June 2009 that banks will have to hold more capital against trading activities. These were revisions to Basel II, to be implemented by end-2011. And the BCBS is currently developing a capital and liquidity reform package ("Basel III") that will require banks to hold larger buffers of resilient liquid assets and loss-absorbing capital.
- The banks continue to be exposed to domestic borrowers, some of whom over-extended their balance sheets in the build-up to the financial crisis, who would be very vulnerable to significant increases in the Bank Rate.
- And banks face considerable risks from adverse developments in the global financial markets, which have been dominated by sovereign risk concerns in recent months.

The tightness of credit can be explained by these developments, at least in part. And let us remember that banks, by their very purpose, are in business to lend!

But the FSR also exhorted the banks to lend more, in line with recent statements from the Treasury and the BIS. The Bank stated, quite logically, that banks would have more capacity to lend if they adopted more “conservative retention policies” (i.e. lower discretionary distributions to their shareholders and staff). And it calculated that if, for example, they constrained (staff) compensation ratios to pre-crisis levels while limiting dividend payments to 2009 levels they could generate around £10bn of additional capital over 2010. This additional capital could sustain around £50bn of new lending, which could help offset any lending reduction resulting from funding challenges and tighter regulations. Let us see where the exhortations lead.

### References

1. Bank of England, *Trends in Lending*, July 2010.
2. Bank of England, *Credit Conditions Survey, survey results, 2010Q2*. Survey conducted between 20 May and 9 June.
3. HM Treasury and BIS, *Financing a private sector recovery*, Cm 7923, July 2010.
4. BBA, “Statistics: small business support”, press release, 30 July 2010, [www.bba.org.uk](http://www.bba.org.uk).
5. There is some evidence of falling applications for loans from small businesses. Kamal Ahmed, “Banks not to blame for a lack of borrowers”, *Sunday Telegraph*, 1 August 2010, reported that applications to Barclays had “fallen significantly – from 18,000 in January 2008 to between 8,000 and 10,000 now”. The loan approval rate had increased.
6. Bank of England, *Financial Stability Report*, June 2010

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