

Paul Tucker: Credit conditions for firms – stability and monetary policy

Speech by Mr Paul Tucker, Deputy Governor for Financial Stability at the Bank of England, to the Association of Corporate Treasurers' Annual Conference, Liverpool, 18 April 2012.

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It is quite a few years since I last spoke to an ACT gathering and it is very good of you to ask me back.

Since then, many of you have been close to the front line of the financial crisis that overtook us nearly five years ago.

Bridging the financial economy to the real economy, you have had to navigate a demanding obstacle course while the real economy “rebalances”. That means that businesses – the productive part of the economy on which our prosperity depends – are having to adjust after years, preceding the crisis, when spending was loaded too much towards household and government consumption, the country's income from net trade was too weak, and investment was too heavily weighted towards commercial real-estate construction.

That rebalancing has some way to go. While many of the planned tax increases are already in place, government consumption will continue to be scaled back for the next few years. There is also a risk that households will spend less than expected in order to rebuild their balance sheets, holding higher liquid savings than previously as a precautionary buffer.

On the supply side, as the world economy recovers, the **balance** of production will continue gradually to shift towards exporters and towards firms which, given sterling's large depreciation since mid-2007, can now compete somewhat more readily against importers.

For sectors primarily serving domestic markets, the adjustment is more challenging. Some face both higher costs for imported inputs to production and weaker demand – not just temporarily but persistently – for their final output. On the ugly side of this rebalancing, there has already been an increase in vacant properties on the high street, which is also facing structural change due to on-line shopping. Some of those properties will no doubt be converted to other uses over time, but I know it will not be easy for the firms affected or for their employees. Company insolvencies have ticked up, and will likely continue to do so for a while.

Credit supply and the corporate sector

Recovery will come, and the necessary adjustments will occur, over time. But it is made harder for you by the problems in the financial system. You have faced first tightening, then in late 2008 frozen, and now a prolonged period of tight credit conditions. Many of you must have worried at times about the safety of your cash balances and other liquid investments. You will have wondered about the soundness of the counterparties you use in the capital markets. And, for the past couple of years, you and your representatives at the ACT have also had to grapple with the array of regulatory reforms reshaping the financial system, internationally and domestically.

It is clear that credit conditions prior to the crisis were unsustainably loose – reliant upon a financial system whose net worth was too low and which was overly dependent on flighty short-term wholesale funding. Banks of all kinds are themselves having to repair their balance sheets and adjust their business models. They face headwinds in doing so. First, legacy portfolios – bad and impaired loans – act as a drag on profitability. In the UK, that particularly affects the two big banks directly rescued by the government. That matters a lot because they were particularly significant in UK business banking before the crisis, holding just under half of the stock of such loans. Second, the lingering threat of some kind of

implosion in the euro area has led to elevated funding costs for banks. The longer that persists, the more it will be passed on to bank customers. In the UK, the government has introduced a scheme to reduce bank funding costs provided they are passed on to SME borrowers. And on the Continent, where the position is more precarious, the ECB's long-term repo operations have broadly similar effects, giving banks there time to restructure their liabilities and so leaning against the risk of a sharp contraction in the supply of credit.

This environment is affecting firms in very different ways. Some companies find themselves with little need for external funds, and so are relatively insulated from tight credit conditions. Indeed, the corporate sector as a whole is currently running an unusually large cash surplus, despite challenging demand conditions. A notable example is energy extraction. UK oil companies have run a large cash surplus – amounting to 1-2% of GDP – for much of the past decade. This accounts for around half of the overall corporate cash surplus over the period. But it's not just oil companies. The manufacturing sector as a whole is currently a net *lender* to the UK banking sector: it has more cash on deposit than funds borrowed. Other sectors look to have less healthy cashflow positions in aggregate – construction and real estate, hotels and restaurants amongst them.

For many companies, therefore, external finance remains important.

For *large* companies, the bond markets are an option. Some of you have switched the balance of your financing from the banking system to the bond markets. Over the past three years, the Chief Financial Officers of large companies have consistently rated bond finance more attractive than bank borrowing. Such firms seem, on the whole, to have made smaller cuts to investment and employment.

Large companies with good access to the capital markets and healthy cash-flow positions may, for the moment, be well placed to support the financing of smaller firms. Either via vendor financing, where a company allows a customer to purchase a product or service on credit. Or by extending credit directly to some of their suppliers. Or by supporting their supply chain indirectly by setting up programmes to allow suppliers to borrow against unpaid invoices. ACT data suggest that so-called “buyer driven receivable programmes” have been growing in recent years. And there is some anecdotal evidence from the Bank's network of Agents that larger firms are helping out smaller firms a bit.

But it is fanciful to entertain the notion that anyone other than the banking system can be the main *backstop* for working-capital finance – for small and large companies alike. Banks are unique in that their deposits comprise the money we all use for day-to-day purchases, so they and they alone can provide liquidity insurance (provided they are financially sound).

For much of our history, the Bank of England worked with the grain of that by lending against bankers' acceptances in our monetary operations: the famous Bill on London. The bill market atrophied in the mid-1990s, and withered away completely a few years later. But during the crisis I have wondered more than once whether a revival would be useful – although it was a market that relied upon guarantees from banks whose names were close to undoubted. That is for you, as corporate treasurers, and bankers to pursue if you wish to.

The Bank of England did try to help a couple of years ago via its Secured Commercial Paper Facility, on which my Markets colleagues engaged actively with the ACT. Suppliers were to be financed by banks, against a claim on their large-firm customers. By bundling together portfolios of such claims into securities, the lending bank was able to “discount” the resulting paper at the Bank, thereby obtaining off-market funding. In effect, the scheme offered banks providing invoice-financing a way to fund the lending involved. There has been an increase in invoice-based financing by banks, but take up of the Bank's facility has been very limited. It remains open should there be further interest.

However they are delivered, improvements in working-capital finance, while important, are insufficient. For longer-term finance, I hope that businesses and the City can work together to broaden access to the corporate bond markets. Since the onset of the crisis, there has been

a marked pick up in the number of UK companies successfully raising funds from the sterling bond markets for the first time. Here, I do think the Bank acting as a de facto market maker of last resort in corporate paper helped revive the market in 2009, by alleviating the inventory risk faced by cash- and capital-strapped dealers in those markets. And the Monetary Policy Committee's quantitative easing has helped, by encouraging longer-term investors out of gilts and into the bond market. But the number of smaller companies tapping the sterling markets remains low. More needs to be done by the industry.

A number of initiatives are underway. For some while now, the London Stock Exchange has been supporting the involvement of retail investors in the corporate bond market. The recent Breedon Review made a number of suggestions intended to help open the door to non-bank sources of finance for SMEs. And the Government is entering into a scheme to co-invest with the private sector in managed funds that will lend to SMEs.

Dare I say it, but securitisation might even play a role. Nearly £1bn of long-term financing was recently raised in the London markets by offering investors a first claim on a £1.5bn portfolio of loans to small businesses with a typical turnover of under £2 million per annum. The funds were raised at a lower cost than many bank issuers would face in their own name. A few other banks are thought to be exploring similar deals. It is important, though, that the lessons from badly designed securitisations in the past should be learnt. Almost the most important lesson is that to be healthy the securitization market, like any other capital market, needs a bedrock of real, unlevered investors. Holders and traders who have borrowed to make their purchases have a tendency to sell when the weather deteriorates. We have seen where that can lead.

If one thing is clear from that brief and incomplete survey, it is that, sadly, the repair of the credit system will take time.

Stopping this happening again: the Financial Policy Committee

So will the even broader task of putting in place better "rules of the game" for the financial system.

For all the measures in train internationally on banks' capital, resolution regimes, over-the-counter derivative markets, central counterparties, shadow banking and so on, they will I fear eventually be found wanting. Conditions change. One generation's reforms are eventually overtaken by the evolution of the structure of the financial system or by temporary bursts of misplaced exuberance.

At its simplest, that is why the government has established the Bank of England's new Financial Policy Committee – to ensure that the moment when the financial system's resilience is critically impaired does not get overlooked; that it is anticipated and appropriate action is taken. A standing body, meeting regularly, transparently, and backed by powers to take decisions on regulatory measures – the FPC is the body charged with being on the case. It won't be perfect, but it can be much better than the pre-crisis regulatory regime.

The initiative to create the FPC is necessary, because both macroeconomic policymakers and financial regulators have had to learn some tough lessons. On the one hand, we all need to be attentive to the effects that easy monetary policy globally can have on risk-taking behaviour. On the other hand, financial regulators cannot afford to focus exclusively on the health of *individual* banks and dealers as though they were isolated atoms. The financial sector is a *system* that hangs or falls together. Moreover, it is swings of exuberance and caution that drive excessive fluctuations in the supply of credit to firms and households. The FPC is about filling the space between monetary policy and microregulation – in an admittedly inelegant phrase, "macroprudential" policy: policy that is focused on the resilience of the *system as a whole*.

The FPC will not be a talking shop. It will have powers. At times, this will affect you directly. We have advised the government that, alongside controls over banks' leverage and risk-weighted capital requirements, the FPC should have the power to make the banking sector (and other financial intermediaries) hold more capital temporarily against exposures to sectors going through a dangerous boom. Sometimes that will be *within* the financial sector, as the run up to the latest crisis illustrates. On other occasions, it could be part of the real economy. History points to commercial real estate as an obvious example. Property-related borrowing booms have often driven financial stress. In those circumstances, simply increasing the *headline* capital requirement might prompt banks to cut lending to sectors of the economy that were not overly exuberant while maintaining lending into the booming sector that seemed to offer wonderful returns. That would be perverse. Better, sometimes, to try to address a bubble at its source. This could be unpopular, but such is the job of taking away the punchbowl. We will explain our decisions.

I cannot emphasise enough that the FPC will not indulge in attempts to micromanage the banking system or the allocation of credit. Nor will we be excessively activist, trying to *fine-tune* credit policy. This is about stability, which is an absolute precondition for steady improvements in economic activity and employment. The goal is to make the financial system resilient, to contain destructive "busts", and to do so without impairing the contribution that the financial sector makes to the economy's medium-term growth.

Can the FPC help right now?

The benefits of the new regime for stability will take time to come through. That might leave you asking what the FPC could do to help right now. Indeed, with credit conditions so tight, it has been asked whether the FPC should be easing regulatory constraints on banks. The aim would be to encourage them to loosen lending conditions, helping recovery. And, it is suggested, that would be consistent with the FPC's remit because it could reduce threats to stability from the risk of borrowers defaulting.

At its September 2011 meeting, the FPC concluded that such a step would in fact be counterproductive – endangering stability and jeopardising recovery. Given the precarious starting position of UK banks when the crisis broke, their capital adequacy is still being rebuilt. And banks are still operating in an extraordinarily risky international environment. It would not be sensible to relax capital requirements when the unusual hazards persist. Today, gradually strengthening capital adequacy, and so building resilience, is best not only for stability but also for sustaining the recovery through what might lie ahead.

Monetary policy

With government needing to set fiscal policy in order to repair the public finances, that means that the burden of stimulating our economic recovery falls mainly to monetary policy. Bank Rate is at, effectively, zero. And the Bank has provided further stimulus, via quantitative easing, in order to underpin demand, and so guard against inflation being persistently below our 2% target further down the road.

For the economy as a whole, that has bought time to smooth the adjustment. For firms, it has reduced the cost of capital and the weight of debt burdens. The equity prices of leveraged firms have generally risen more than the market as a whole. Easy monetary conditions no doubt go some way to explain why more firms haven't failed; and why the Bank has received few approaches, under what is still known as the London Approach, to help banks and firms keep talking when a co-operative solution is within reach.

In all this, the Monetary Policy Committee faces a delicate and unavoidable balancing act.

As I have said before, easily the Committee's biggest judgment in recent years has been that inflation will gradually fall back to the 2% target – initially as the effects of higher VAT, energy

and import prices diminish; and then as slack in the economy bears down on wages and prices. Though it has fallen significantly over the past six months, from over 5% to 3.5% on yesterday's reading, it remains uncomfortably above target. The MPC will guide inflation back to target in the medium term, but in the near term there is considerable uncertainty about the path that it will follow.

In its February forecasts on the outlook for growth and inflation, the MPC saw a gradual pick-up in activity as the headwinds from weakness in the world economy and tight credit conditions receded and as the squeeze on household incomes is ameliorated through lower inflation.

Big picture, that view on the growth outlook still looks broadly on track, but it is not always going to seem like that over the next few weeks and months as the ONS data for the first half of the year are published.

Two temporary factors look likely to muddy the waters, leaving the headline ONS figures for GDP growth well short of what has been suggested by surveys.

First, data for construction output over the turn of the year were extremely weak. That looks likely to be a substantial drag on recorded growth in the first quarter of the year, possibly leaving the headline figure for activity close to flat. But surveys point to much more modest falls in construction output. And growth in the sector is estimated by the ONS to have resumed in February. Also, construction was very weak in the first quarter of 2011, only to bounce back on the ONS measure in Q2. Mismeasurement, in what is still a fairly new monthly statistical series, can't be ruled out. Those straws in the wind suggest that the drag on growth may prove to be temporary, so long as the global environment does not deteriorate.

Second, the additional bank holiday for the Queen's Diamond Jubilee in June will reduce the number of days worked. Taken together, all this means that you will probably see weak headline ONS numbers for growth in the first two quarters.

The MPC will be focused mainly not on headline growth but rather on indicators of **underlying** activity. Surveys of UK companies' output have, in fact, continued to tick up, with the most recent CIPS readings, taken as a whole, at the highest level for over a year. Survey measures of private sector employment have begun to edge up too. Overall, surveys point to growth in underlying activity over the first half of 2012 – not stellar growth, indeed modest growth, but growth nonetheless.

But if the overall story of recovery in *underlying* growth still looks broadly intact, there has been bad news on the inflation front.

The recent inflation data, particularly for goods prices, has come in a little stronger than expected. Sterling oil prices and wholesale gas prices have risen by more than 5% since February. Together with duty changes announced in the March Budget, that seems likely to leave the short-term outlook for inflation on a path a little higher than incorporated into the central projection described in the MPC's February *Inflation Report*. I think inflation might remain above 3% throughout the second quarter of this year, and possibly into the second half of the year.

Already in February, there was a risk that inflation might fall back towards target less quickly than incorporated into our "most likely" central outlook. Not only was there a prospect of supply disruptions to oil production, there was also a possibility that firms might seek to rebuild margins faster than assumed as and when economic recovery becomes more secure.

So one possibility is that companies have begun to rebuild or protect their profit margins more quickly than expected. According to the latest ONS data, by the end of last year the profits of mainstream businesses (excluding oil and finance) had fallen to their lowest share of GDP for a couple of decades. Companies' willingness to tolerate a further squeeze, in the

face of rising import prices, might be limited. We need, therefore, to assess the extent to which spare capacity is dragging down on prices. In this particular context, we can take some comfort from the growth of earnings (wages and staff bonuses etc) being subdued, below 2%. But with productivity growth having been incredibly low for a while now, it is possible that the rate of earnings growth consistent with achieving the 2% inflation target has been below the 4–4.5% we typically used as a rough benchmark in more normal conditions before the financial crisis and subsequent recession. How and when businesses in aggregate will again generate productivity improvements will be at the heart of the Committee's deliberations.

To be clear, this is about the path inflation takes back to target, not whether it will return to target. The MPC will ensure that it does return to target and that medium-term inflation expectations are anchored to the target.

Conclusion

To conclude, UK companies are having to adjust to a different pattern of demand, to profound shifts in world trade and prices, and you are having to cope with this while the financial system both recovers itself and adapts to new "rules of the game". Given some threats to stability linger, the Financial Policy Committee's primary focus has to be on encouraging continued progress in building resilience in the banking sector. That will pay dividends in the longer run.

I hope that that time can also be used, by bankers working with your community of corporate treasurers, to richen the options for working-capital finance and longer-term funding available across the business community. Such has been the call during similar periods in the past, going back more than a century. But it also offers opportunities. Innovation, which we must not make a dirty word, might help.

Meanwhile, monetary policy will underpin the recovery so long as that remains consistent with anchoring inflation expectations in line with achieving the 2% target over the medium run. We shall not let that slip.