"RESTORING THE LENDING CHANNEL OF MONETARY TRANSMISSION"

Preliminary comments

- Bank lending has been falling across Europe, the US and also in Emerging Markets.

  In the UK growth of BL to all PNFCs was 10-15% p.a. pre crisis, now growth has been zero or negative (since 2010).

  While large and medium sized firms report greater availability of credit in BoE surveys, small firms do not report an improvement, and much smaller improvement in cost of finance (spreads) v large and medium firms..

  PNFC Investment spending between 2007-9 declined by 20%, employment and R&D spending also declined sharply.

- Fall in demand and fall in supply.

  Banks in the UK claim there is weak demand for loans. Maybe true – aggregate demand has fallen in the UK and in ROW.

  Not independent of the price of loans, spreads over LIBOR rose considerably. Cost of external finance lower for large v. small firms.

  Supply has been affected by new regulatory requirements, bad loans on the balance sheet, preference for safer borrowers e.g. mortgagees with high equity stakes, less so to SMEs (higher risk)

- Disparities between large firms and SMEs (restructuring of capital)

  Many large companies have been substituting bond and equity finance for bank lending; they have increased leverage, and reduced investment by less than non-issuers. Smoothing of finance over the cycle.

  For large companies the average maturity has risen and the cost of finance has fallen => cheaper longer term funding.

- Disparities between firms across Europe

  There is a large disparity between average loan rates offered to business in the northern countries v. southern countries (country risk?). DB study (3-4% difference in rates) over the same EURIBOR rates

  This is not at all surprising. Wholesale funding rates for Spanish and Italian banks are higher than for German, French and Dutch banks. Sen unsec bond rates over swap rates in last 12m range from 200-500bp for Italian and Spanish banks, 50-200 bp for N. European banks.

How can we restore the bank lending channel?

- Restore to what? Not the level before the crisis
    - Banks were over extended: v. high loan to deposit ratios and wholesale funding to deposit funding ratios
    - Too little due diligence on financial health, and not priced properly for credit risk.

  Ensure that there is no unsatisfied demand for creditworthy borrowers. Particularly important for SMEs with few alternative sources of finance.

- Much easier for policymakers to reduce bank lending in a monetary contraction than to increase bank lending in a monetary expanasion.
- Schemes to restore bank lending:
    - Subsidised lending by central bank. Both ECB and BoE have done this. UK FLS offers instits. conditional low-cost funding provided net lending increases. National Loan Guarantee Scheme did something similar (not really a guarantee scheme at all) lowered loan costs from banks by 1%.
    - Financial guarantees by govt or central bank. Enterprise Finance Guarantee Scheme. UK govt provides 75% guarantee on indiv loan, s.t. 20% limit on claims from a lender's portfolio. For SMEs up to £41m turnover seeking upto £1m.for as long as 10 years.
    - Govt bank. UK Govt Business Bank with £1bn funds due to be operational Sept 2014. Provides funds to finance providers (banks, direct lenders etc) to facilitate their lending to businesses.
- Do these schemes work?
    - FLS early days,
        - Majority of funds to mortgage lending, not SMEs. Net lending contracted in 2012Q4 by £2.4bn, lending to business fell £5bn
        - Diverse picture across different banks (govt owned banks worst performers on net lending)
        - Legacy issues due to bad loans on books
        - Regulatory issues about capital requirements
    - Guarantees help reduce risks for banks, but the case for borrowing at the loan rates offered may not be strong when output demand is weak.

- Regulation

    - need a balance between regulatory requirements on capital that safeguard banks, and levels of capital requirements that encourage prudent lending.

    - particularly adverse effect on cross-border lending, as regulators encouraged banks to lend within their own national borders, and reduce exposure to non-core areas due to risks of currency mismatches and liquidity shortages in FCY.

      BIS data show cross border lending growth fell from 15-20% in 2005-7 to -10% in 2008, and 0-5% 2009-2012. Much more volatile than domestic lending growth ranging between 5-7%.

- Growth – in a state of low demand growth, it is expected that we will see low lending growth. Answer to our question is to a large extent about how to create growth.