FINANCING IN THE US AND UK RECOVERIES

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Introduction

The importance of bank credit in the financing of the private sector in the main developed economies has been reduced as a consequence of the financial crisis. In the literature, there remain open questions regarding the role of credit over the business cycle. Even so, many authors conclude that, although the recovery of bank credit after a recession is not a necessary condition for recovery, the absence of credit may reduce its strength.[2] Indeed, the current crisis has shown that bank credit has important implications for the severity of recessions and the subsequent recovery.

The weakness of bank credit has had different consequences for different agents. In the case of firms it has coincided with a process of disintermediation, so that their access to the capital markets as an alternative source of financing has increased.[3] However, this channel is not easily accessible to households or small and medium-sized enterprises (SMEs), whose external financing continues to depend mainly on banks.

This paper analyses the growth of bank lending to households and businesses in the United States and in the United Kingdom, the economies that were first affected by the financial crisis. The weight of bank loans in the financing of business differs between these two countries and different measures have been taken in response to the decline in lending to the private sector. In both countries, lending to businesses fell, owing to the tightening of credit standards and the contraction in demand entailed by the slowdown in activity. The funding difficulties experienced by SMEs, in particular, led to the adoption of measures designed to facilitate their access to credit. In the United States a programme was approved in 2010 to support small financial institutions, which specialise in lending to small businesses, while in the United Kingdom there have been various initiatives, including the 2012 Funding for Lending Scheme.

The rest of this article briefly reviews the recent developments in bank lending in these two countries, before describing in detail the problems in each country and the main measures introduced. Finally, conclusions are drawn, with a particular focus on the challenges that remain.

Recent developments in bank lending

The financial crisis led to a general contraction of bank lending in the main advanced economies. At the end of 2007, the volume of loans extended by banks was growing at year-on-year rates of around 9% in the United States and over 13% in the United Kingdom. From mid-2008, lending in both countries slowed sharply, to negative growth rates, albeit at a different pace. In the United States, lending contracted by as much as 7.7% year-on-year in October 2009, although it subsequently recovered more rapidly and more vigorously. In the United Kingdom meanwhile, lending growth was in negative territory from mid-2009,

1 The author wishes to thank Emilio Muñoz de la Peña for his technical assistance.
2 In this respect, there are numerous papers regarding the determinants and implications of economic recoveries in the absence of growth in bank credit, known as “creditless recoveries”. See, for example, Abiad et al. (2011).
3 There are other alternative sources of financing, apart from banks and the capital markets, that have also been developed since the crisis, such as trade credit.

UNITED STATES: BANK LENDING (a) (b) **TABLE 1**
Year-on-year rates of change (%). Break-adjusted series.

	Annual average							2014								
	2007	2008	2009	2010	2011	2012	2013	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
Bank lending	8.6	5.6	-3.5	-5.3	-0.1	4.1	2.3	1.1	1.8	2.5	2.8	3.6	4.3	5.3	6.0	6.4
Securities holdings (b)	4.0	0.8	2.7	6.6	3.9	6.6	1.6	-1.7	-0.9	0.1	0.4	1.5	2.7	4.7	5.4	6.7
Loans (c)	10.0	6.9	-5.1	-8.8	-1.4	3.2	2.6	2.2	2.8	3.5	3.8	4.4	5.0	5.5	6.3	6.3
Commercial and industrial loans	14.7	17.4	-6.5	-16.0	3.3	11.2	9.0	6.9	8.9	9.4	10.0	10.5	10.4	10.9	11.8	12.1
House purchase loans (d)	8.6	-3.5	-8.8	-7.0	-1.4	2.0	-1.1	-4.0	-3.7	-3.4	-3.4	-2.8	-2.1	-1.4	-0.2	0.0
Non-residential mortgage loans	10.1	8.4	-0.4	-8.1	-7.8	-3.2	2.2	4.9	5.7	6.0	6.3	6.4	6.8	6.9	6.9	6.8
Consumer loans (e)	5.8	6.2	0.6	-6.9	-4.2	0.4	2.6	3.7	3.7	3.7	4.1	4.3	4.4	5.2	5.2	5.4

SOURCE: Banco de España, based on the Federal Reserve's "H8. Assets and Liabilities of Commercial Banks in the United States" statistics.

a The H.8 release provides an estimated weekly aggregate balance sheet for all commercial banks in the United States. It also includes aggregations for certain bank groups: US commercial banks, large US commercial banks, small US commercial banks and foreign banks in the United States. The H.8 release is primarily based on data that are reported weekly by a sample of approximately 875 banks and foreign institutions.
b In the United States lending figures include bank lending to the public sector both through loans extended and securities holdings.
c This heading also includes "revolving home equity loans", "Fed Funds and reverse repos with non-banks" and "other loans and leases".
d The rate of growth of the aggregate "residential mortgage loans, break-adjusted" is not available. The figures shown refer to the main component.
e Consumer credit includes credit cards, car loans and student loans.

standing at a rate of around –1% year-on-year, and remained sluggish until mid-2013. Since the beginning of 2014 lending has been more buoyant in both the United States and the United Kingdom, although again there were differences. While credit growth in the United States has reached year-on-year rates of 6%, in the United Kingdom it stands at 1.6% (see Table 1 and Table 2, respectively).

The different developments in bank lending in these two countries reflect different behaviour across its components. In late 2009 and early 2010, commercial and industrial loans in the United States and loans to non-financial corporations in the United Kingdom made negative contributions to total credit growth, while credit for house purchase behaved differently (for example, negative rates have not been recorded for this aggregate at any time in the United Kingdom). As a result the reduction in the debt of the non-financial private sector has occurred at a different rate and with a different composition in these two countries. While in the United States debt fell by 20 percentage points (pp) of GDP to end-2012, from a high of 180.3% of GDP, mainly due to the decline in household indebtedness (of 16.6 pp), in the United Kingdom the correction was similar for households and firms, and debt fell by 17 pp overall, from a high of 220.2% of GDP.[4]

In recent months, all the components have returned to positive growth rates in the *United States*. The total volume of loans has increased significantly since January 2014, the year-on-year growth rate reaching 6.4% in September. This improvement has been most marked in the case of commercial and industrial loans, which made the largest contribution, with year-on-year growth rates of over 10% (see Chart 1). At the same time, there has been a decline in the spreads applied to loans to firms, irrespective of their size (see left-hand panel of Chart 2). In the case of the United States, credit figures also include banks' fixed-income security holdings, and since 2008 part of the growth of this aggregate has stemmed from larger holdings of these securities.[5] At the same

4 See Garrote et al. (2013).
5 In the United States, credit figures include bank financing to the public sector, both through the granting of loans and the holding of securities.

UNITED KINGDOM: BANK LENDING

Year-on-year rates of change (%). Flow on stock

TABLE 2

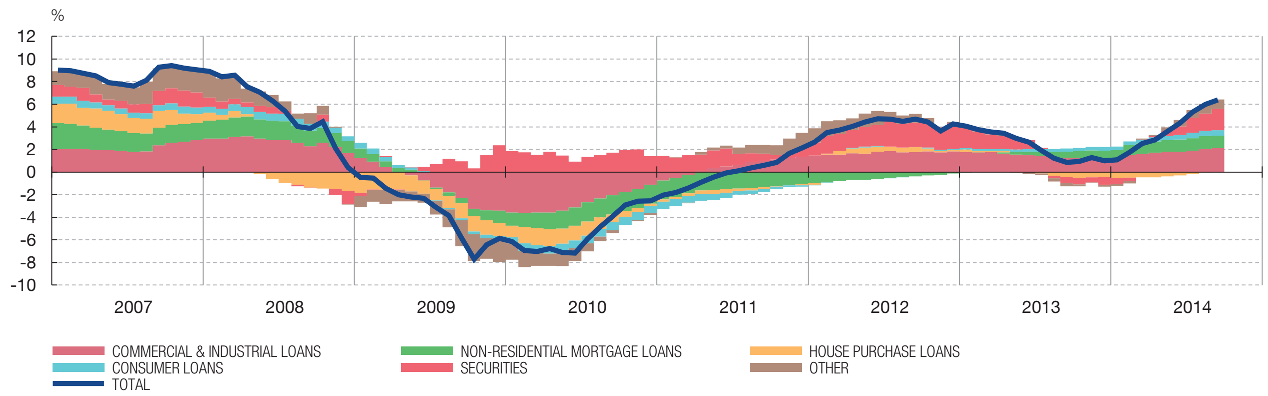
	Annual average							2014								
	2007	2008	2009	2010	2011	2012	2013	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
Lending to NFCs and to households and NPISHs (a)	12.0	7.7	0.8	-0.5	-0.2	-0.2	0.3	0.8	0.7	0.8	1.0	1.6	1.6	1.7	1.6	1.5
Households and NPISHs	10.1	6.6	1.3	0.5	0.5	0.7	1.0	1.4	1.5	1.6	1.7	1.9	2.0	2.1	2.2	2.2
House purchase loans (b)	11.1	6.9	1.4	0.9	0.7	0.9	0.7	1.0	1.1	1.2	1.3	1.4	1.5	1.6	1.7	1.8
Consumer and other loans (c)	4.9	5.1	0.8	-1.8	-0.8	-0.3	3.6	5.0	5.1	5.4	5.5	5.6	5.7	6.0	6.1	6.1
Non-financial corporations (NFCs) (d)	17.9	11.0	-0.6	-3.7	-2.2	-3.2	-2.1	-1.4	-2.2	-2.3	-1.6	0.5	0.0	0.0	-0.5	-1.2

SOURCE: Banco de España, based on the Bank of England's statistics "Lending to individuals" and "M4 Lending".

a Lending to the non-financial private sector excludes the public sector.
b Lending to households refers to loans extended by MFIs and other lenders, classified by kind of collateral (house purchase includes all mortgage loans, irrespective of purpose). Does not include securitisation.
c Does not include student loans from the government.
d Lending to NFCs includes loans and securities holdings. Does not include securitisation.

UNITED STATES: CONTRIBUTIONS TO GROWTH IN BANK LENDING

CHART 1



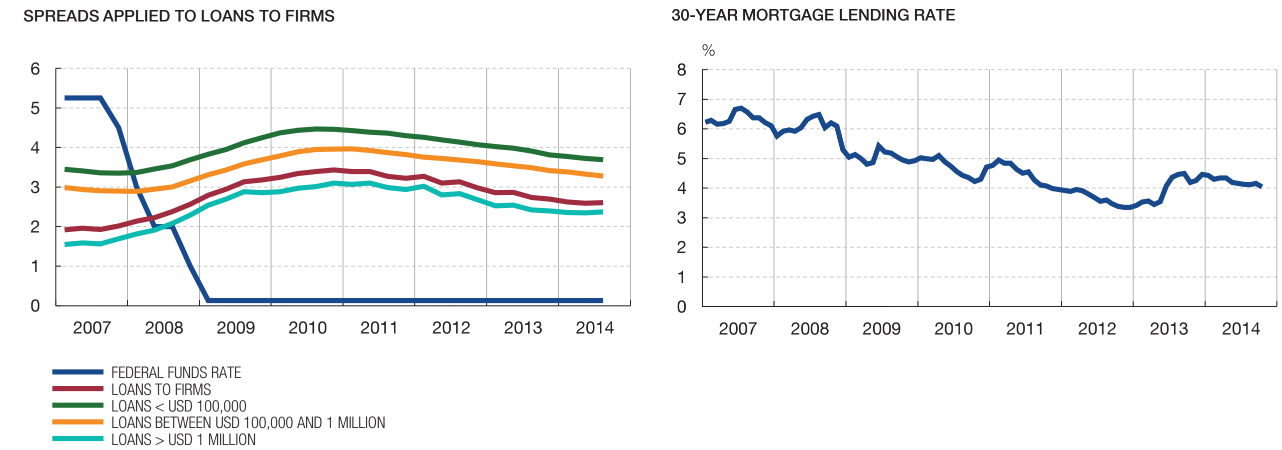
SOURCE: Banco de España, based on the Federal Reserve Statistics "H8. Assets and Liabilities of Commercial Banks in the United States".

time, loans to households have also contributed to the growth in financing to the private sector. In September, for the first time, falls in loans for house purchase ceased to be observed, while consumer credit grew at year-on-year rates of 5.4%. The 30-year mortgage lending rate has held steady in recent months (see the right-hand panel of Chart 2), having declined gradually from mid-2013, when it rose temporarily upon the Federal Reserve's announcement that it was beginning to consider commencing tapering, i.e. a gradual reduction in its purchases of bonds and mortgage-backed securities.

From a more qualitative perspective, banks have been continuously relaxing their credit standards for households and firms since mid-2012, according to the Senior Loan Officer Opinion Survey on Bank Lending Practices conducted by the Federal Reserve (see upper and lower left-hand panels of Chart 3). This relaxation is reflected in the conditions applied to large and small firms, after the considerable tightening recorded during the financial crisis. At the same time, demand has continued to increase in recent quarters, although with some variability in the case of firms.

UNITED STATES: INTEREST RATES FOR COMMERCIAL AND INDUSTRIAL LOANS, AND MORTGAGE LOANS

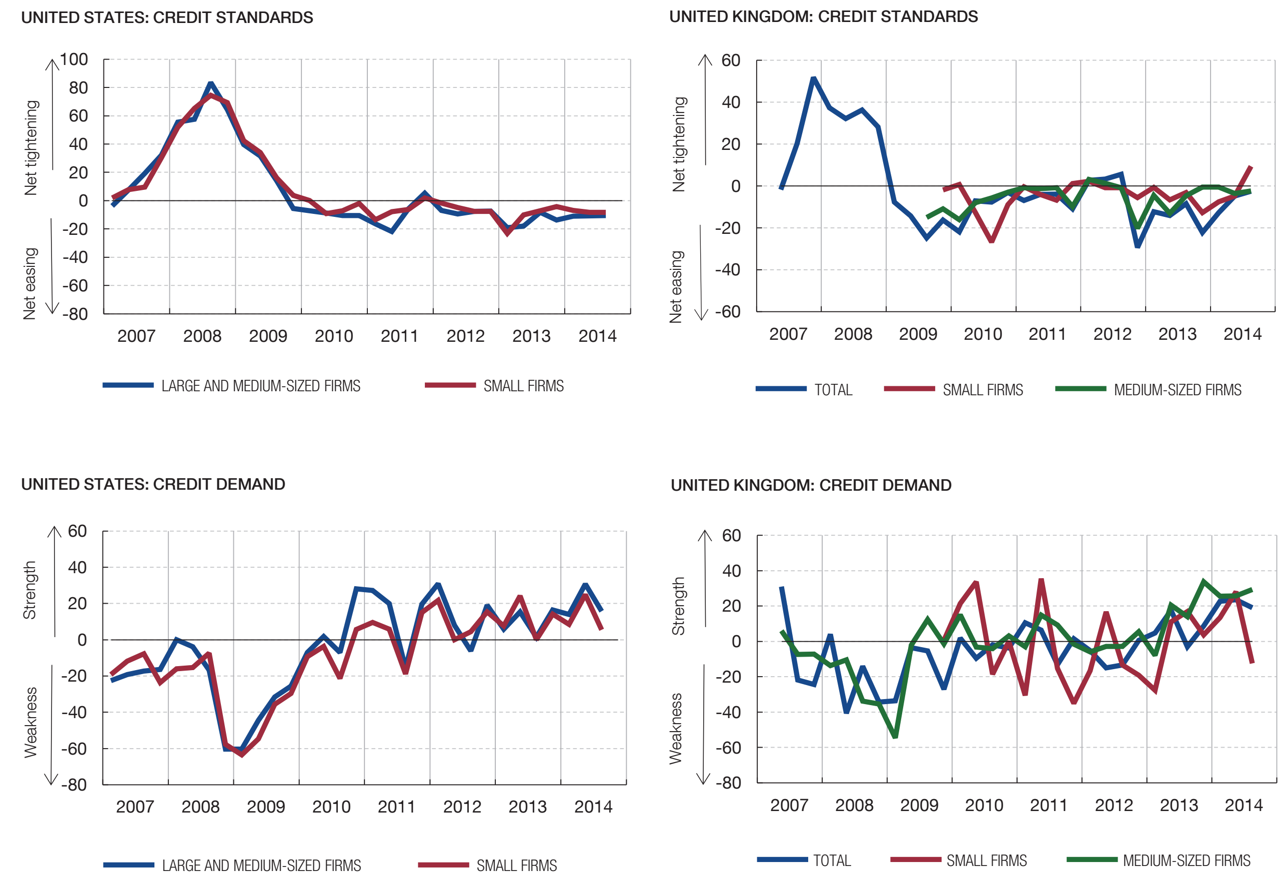
CHART 2



SOURCES: Federal Reserve, "E.2 Survey of Terms of Business Lending" (average for last four quarters), and Freddie Mac.

BUSINESS LENDING IN THE UNITED STATES AND IN THE UNITED KINGDOM: CREDIT STANDARDS AND DEMAND

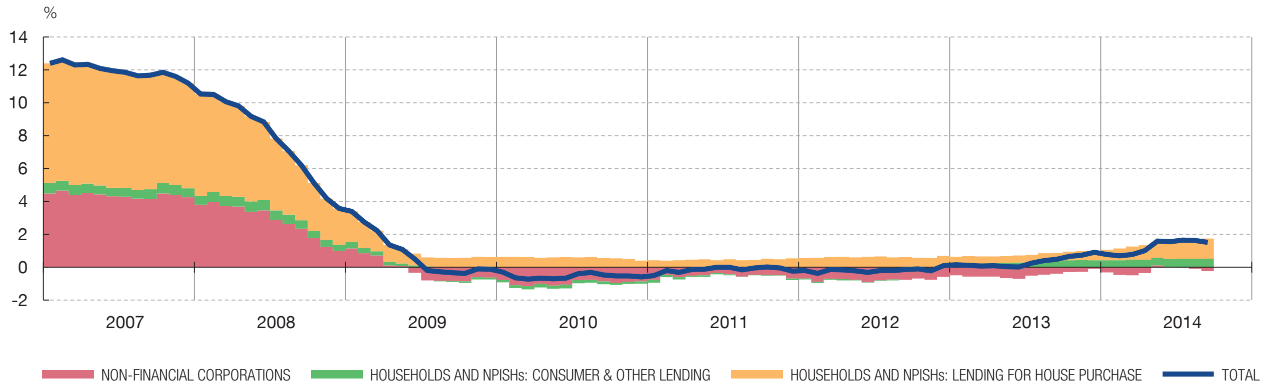
CHART 3



SOURCES: Federal Reserve and Bank of England (the UK series have been inverted as the opposite methodology is used).

UNITED KINGDOM: CONTRIBUTIONS TO GROWTH IN BANK LENDING TO THE NON-FINANCIAL PRIVATE SECTOR

CHART 4



SOURCE: Banco de España, based on the Bank of England's "Lending to individuals" and "M4 Lending" statistics.

In the *United Kingdom*, meanwhile, bank lending began to show some strength in mid-2013 after three years of small negative growth rates. According to the latest data available, credit grew by 1.5% year-on-year in September. The improvement over the last four months has coincided with an increase in lending for house purchase (1.8% year-on-year in September) and with a smaller negative contribution from lending to non-financial corporations. Chart 4 shows that during the period leading up to the crisis lending for house purchase was the component that contributed most to credit growth. In recent years, despite growing at lower rates, this component has always made significant positive contributions. The interest rates charged on new mortgage loans[6] declined from mid-2012, this being linked to the effects of the Funding for Lending Scheme (FLS).[7] However, coinciding with the exclusion of this type of loan from the FLS, these rates have been rising since the beginning of 2014, especially the fixed ones (see the right-hand panel of Chart 5).

Lending to businesses has still not recovered in the United Kingdom, although its rate of decline has slowed. The behaviour of such lending varies from sector to sector; financing to the real-estate sector, which accounts for one third of the total, continues to decline at rates of –7%, while positive rates of growth are being recorded for lending to other activities. As for the interest rates, the variable rates charged to firms differ, with those charged to SMEs being higher, especially those for small enterprises, which are above those charged at end-2009 (see left-hand panel of Chart 5).

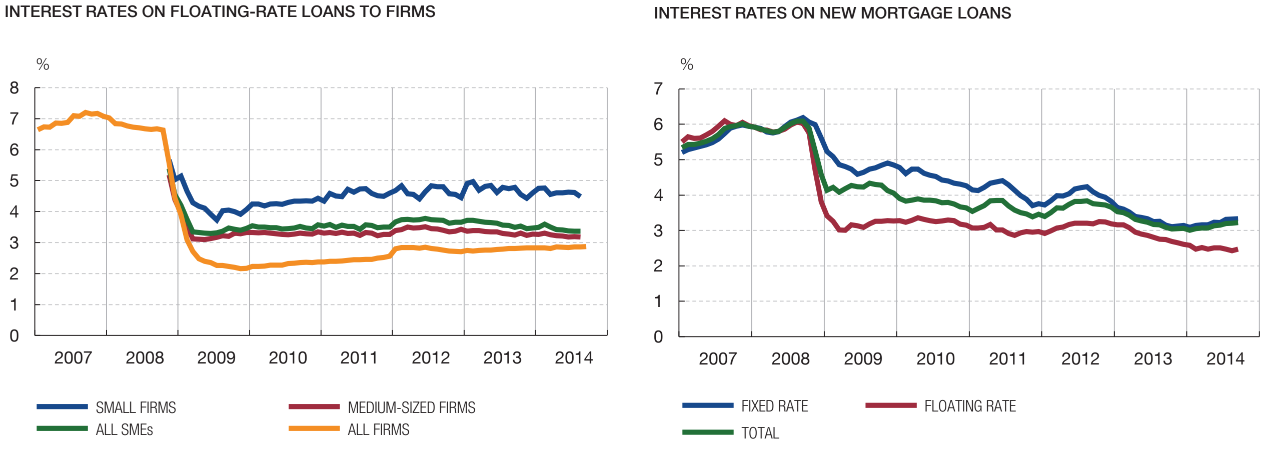
The Credit Conditions Survey conducted by the Bank of England among banks shows how in the last eight quarters the availability of credit to households has steadily improved, one of the factors responsible for this being the launch of the FLS programme. This trend seems to have been interrupted in the latest quarter, reflecting the change in the appetite for risk and the deterioration in house price expectations, as well as regulatory measures designed to protect the more vulnerable borrowers, such as implementation of the

6 In the United Kingdom, around 30% of the outstanding amount of mortgage loans accrues interest at a fixed rate. Although variable rate mortgages predominate, it is normal for mortgages to have an initial period of two years at a fixed rate, and then to switch to a variable rate. This rate is usually the lender's Standard Variable Rate, which may be subject to ceilings and floors depending, for example, on the differential with the Bank of England's policy rate. This is the most common type of mortgage in the United Kingdom.

7 See Box 1 for their main characteristics.

UNITED KINGDOM: INTEREST RATES FOR BUSINESSES AND MORTGAGE LOANS

CHART 5



SOURCE: Bank of England.

Mortgage Market Review[8] proposals and the Financial Policy Committee's recommendations announced before the summer.[9] In this latest quarter, there was also a notable decline in willingness to lend at high loan-to-value ratios, for the first time since this question was included in 2013, while the demand for credit for house purchase fell significantly, altering the trend that began in 2012. In the case of loans to firms, over the last two years banks have relaxed the standards applied and demand has increased across the board (see the right-hand panel of Chart 3), partly because of the improvement in the economic outlook.[10] However, in the latest quarter there was a decline in the demand of small enterprises for the first time since mid-2012.

As just mentioned, the tightening of credit conditions during the crisis, along with the contraction in the demand for credit, led to a reduction in bank lending, especially to firms, in the United States and in the United Kingdom. To counter this development, both countries have launched programmes to stimulate lending, with a special focus on SMEs.

United States

As a consequence of the financial crisis there was a considerable decline in bank lending in the United States between 2008 and 2010. Credit for house purchase and loans to commercial and industrial firms underwent significant adjustments. In both countries the authorities' attention was focused on the difficulties involved in gaining access to credit. Various assistance programmes were launched to support the housing industry (by facilitating access to mortgage credit and avoiding mortgage foreclosures) and to promote lending to SMEs by strengthening the capital of small financial institutions.

Within lending to *households*, loans for house purchase had grown considerably since the beginning of the 1980s, driven by favourable conditions of access and by the public

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8 The introduction of the Mortgage Market Review changes at the end of April entails a new regulatory framework requiring banks to apply stricter requirements to assess potential borrowers' ability to pay, through the performance of stress tests.

9 In June 2014, in order to limit the macroprudential risks associated with households' excessive indebtedness, the Financial Policy Committee recommended that banks limit mortgage loans with a loan-to-income ratio of 4.5 or over to no more than 15% of their new mortgages. It also recommended the use of stress tests to check that potential borrowers are able to afford rises in interest rates (of at least 3 pp) during the first five years of the loan. This requirement was already envisaged in the Mortgage Market Review [see Banco de España (2014)].

10 In the case of large firms, according to the survey of financial officers conducted by Deloitte, financing conditions are continuing to improve and show availability at its best level for seven years.

guarantee granted to a large portion of mortgage credit by the government sponsored enterprises Fannie Mae and Freddie Mac. The total outstanding amount of residential mortgage credit stood at 79.3% of GDP at the end of 2007, as against 45% fifteen years earlier.[11] From 2007, severe adjustment in the residential mortgage market and the correction to the valuation of instruments and assets linked to mortgage loans led to a weakening of financial institutions' balance sheets, a tightening of conditions of access to credit and an increase in the interest rates charged.[12] The rise in default rates and the deterioration in the government sponsored enterprises, and in the mortgage-backed securities they guaranteed, led to the launch in 2008 of a wide-ranging programme to support the housing industry, made up of two types of measures. First, there was a group of measures to facilitate access to mortgage credit and house purchases through: (i) an increase in the low-cost financing granted by Fannie Mae and Freddie Mac; (ii) the purchase of mortgage-backed securities by the Treasury and the Federal Reserve, and iii) the reactivation of tax credits for house purchase. The second group of measures was designed to prevent mortgage foreclosures, through a programme to modify troubled mortgages, a programme of mortgage refinancing and measures to stabilise especially hard-hit areas.

Consumer credit, which contracted sharply during the financial crisis, returned to positive growth rates in mid-2012. These rates have been rising continuously since, and currently stand at more than 5% year-on-year. Consumer credit has a number of sub-categories, such as credit cards, car loans and student loans, which have behaved differently. Credit card lending, which increased sharply in 2008, subsequently fell. The total outstanding amount is still below pre-crisis levels. Student loans, by contrast, have grown considerably, and up to three times faster than other more procyclical types of financing, such as car loans.[13] The rapid increase in the financing of tertiary education reflects both greater demand and an increase in the associated costs, and has occurred despite the fact that the percentage of loans more than 90 days past due is growing three times as fast as in the case of mortgages. During the crisis a large number of workers returned to education, to improve their qualifications and thus gain an advantage in the labour market. Although these loans do not amount to a large proportion of banks' portfolios, their recent evolution and their consequences for young people's spending capacity (potentially restricting their access to housing and ability to start up a business) are a cause for concern. The fact that this type of debt is increasing among older age groups[14] is also a cause for concern, because this is long-term financing that generally cannot be discharged by bankruptcy and may therefore lead to economic hardship during retirement.

Although lending to *businesses* plays a crucial role in the evolution of total lending, the weight of bank finance in corporate financing is very low: only 12%, as against 44% in the United Kingdom and 66% in the euro area (see Chart 6). Firms generally go to the capital markets to obtain financing, although small firms, which have fewer possibilities of gaining access to these markets, are usually more dependent on banks.

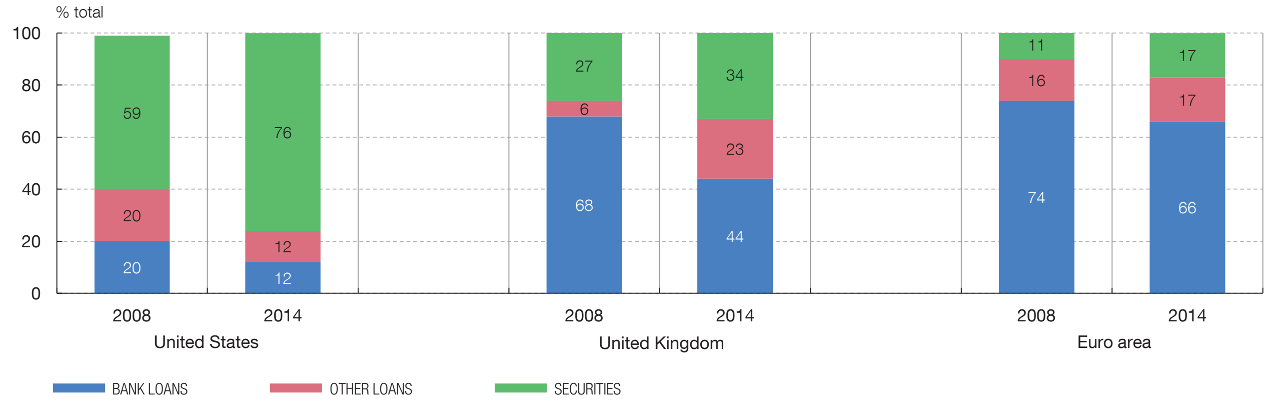
11 Cuadro et al. (2010) outline the developments in the residential mortgage market in the United States during the crisis.

12 The spread between the fixed rate on 30-year mortgages and the federal funds target rate rose by 4.3 pp between January and November 2008.

13 See Davis (2014).

14 The number of persons over the age of 50 with this type of debt increased by 130% – from 3 million to 6.9 million – between 2005 and 2012. See GAO (2014) for further details of the incidence of student loans among older persons.

SOURCES OF FUNDING FOR BUSINESSES. DIFFERENCES BY GEOGRAPHICAL AREA (2008-14) CHART 6
(Percentage of total corporate borrowing)



SOURCE: IMF Global Financial Stability Report, October 2014.

In the United States, small firms, defined as those with fewer than 500 employees,[15] account for 99% of all firms, and 50% of private-sector employment, and contribute around 50% of non-agricultural GDP.[16] Around three-quarters of the financing of the youngest firms comes from bank loans, credit cards and credit facilities.[17] After the sharp tightening of credit conditions between 2008 and 2009, the interest rates on loans to these firms have been gradually declining, although they are still higher than before the crisis (see left-hand panel of Chart 3). Also, banks' approval rates for loans to small businesses are increasing,[18] while bank lending to them, approximated by transactions for less than USD 1 million, is recovering, following the decline between 2008 and 2012, although it is still below pre-crisis levels. Surveys of banks highlight low business activity and the lack of demand for financing as one of the main determinants of these developments. However, surveys of firms point to supply restrictions as a factor of increasing importance (the percentage of firms that considered it would be difficult to obtain a loan in the following twelve months rose from 13% in 2007 Q2 to 36% in 2013 Q2, according to a survey conducted by Wells Fargo and its Gallup Small Business index). The increase in the percentage of collateralised loans and the decline in the value of commercial and industrial property further increase the difficulty of complying with the stricter requirements imposed by banks.

The evolution of bank lending to SMEs may also reflect a longer-term trend relating to banks' business model, reflected in the fact that the weight of loans to small businesses has fallen in the aggregate bank balance sheet. The proportion of non-agricultural and non-residential loans of less than USD 1 million has been falling continuously, from 49% in 1999 to 26% in mid-2014. During this period the banking industry underwent a process of consolidation, with a fall in the number of small banks, which are those most inclined to lend to small businesses. In addition, greater competition in the banking industry has led banks to shift their resources towards activities with larger economies of scale, which do not include lending to SMEs.

15 In Europe small enterprises are considered to have fewer than 50 employees and a turnover of less than €10 million, and medium-sized enterprises fewer than 250 employees and a turnover of less than €50 million.
16 See Grover and Suominen (2014) and Small Business Finance Office of Advocacy for more details of the specific features of small businesses in the United States.
17 SBA (2014).
18 See SBA (2014) for further details of the financing of small enterprises.

Nonetheless, despite the process of banking concentration, there are still many small banks in the United States with assets skewed towards loans to SMEs. Thus, in 2009, this type of loan accounted for 27% of the total portfolio of banks with less than USD 500 million in assets, as against 5% for the largest banks (those with assets of more than USD 50 billion).[19] A group of banks that are very important for the financing of small enterprises are the so-called "community banks", usually identified as those that have a volume of assets of less than USD 1 billion, according to the FDIC.[20] This group of banks has less than 11% of the assets of the banking industry, but provides around 40% of loans to small businesses. Their business model involves a specialisation in local business and long-term relationships, so it is more relevant for small firms with assets that are difficult to value for use as collateral and firms that do not have audited financial statements.

Given the difficulties SMEs have gaining access to financing, in 2010 the Small Business Jobs Act was approved, which, inter alia, created a fund of USD 30 billion,[21] known as the Small Business Lending Fund, to provide capital to financial institutions with assets of less than USD 10 billion, in order to encourage lending to small businesses. The amount of financing that could be applied for depended on the institution's risk-weighted assets[22] and the cost was established as 5%, subsidised in accordance with the increase in credit extended to small firms with respect to 2009. From its launch until March 2014, 94% of the participants in this fund increased their loans to this group of firms by more than the target, and 92% by the target plus 10% or more.[23]

At the same time, the decline in financing through traditional channels has forced SMEs to seek alternative sources. In the United States there is a greater variety of non-bank sources, including private placement markets (direct loans from an institutional investor to a company through a private transaction), venture capital and business angels or crowdfunding. To these should be added the recent development of online platforms that are beginning to provide a variety of instruments for financing between firms and, in particular, to SMEs.[24]

United Kingdom

In the United Kingdom bank lending first began to slow towards the end of 2007 and then declined sharply, posting negative growth rates in 2009. The subsequent recovery has been gradual, both for lending to households and to non-financial corporations. This weakness reflects a tightening of credit standards by financial institutions and feeble demand, against a backdrop of high indebtedness and economic uncertainty. In this setting, the British authorities adopted various programmes designed to make it easier for SMEs to access funding and to provide incentives for financial institutions to lend to households and firms, such as the Funding for Lending Scheme (FLS).

The rate of growth of mortgage loans to *households* dropped from more than 11% year-on-year in mid-2007 to less than 1% two years later, and has remained at that level since then. Until mid-2009, credit availability was considerably restricted and credit spreads widened. According to the Bank of England's Credit Conditions Survey, this was due to the

19 Corner and Bhaskar (2010).
20 See FDIC (2012) for further details of the characteristics of community banks.
21 This programme was established outside the framework of the TARP to avoid the stigmatising of banks that made use of it, and thus to promote its use.
22 The limit on financing that banks could request was 5% of their risk-weighted assets, if these did not exceed USD 1 billion, or 3% if their assets were between USD 1 billion and USD 10 billion.
23 Further details are available at: http://www.treasury.gov/resource-center/sb-programs/Pages/Small-Business-Lending-Fund.aspx.
24 See Grover and Suominen (2014) for further details on the development of new sources of online financing.

economic situation, the lower appetite for risk and the credit conditions offered by institutions. To a certain extent, the tightening of credit standards corrected the looser standards seen before the crisis. Indeed, since 2009 most mortgages have had loan-to-value (LTV) ratios below 85%.[25] Credit availability for mortgages with high LTV ratios began to rise again in 2012, thanks to the FLS (see Box 1) and the Help to Buy scheme[26] which both triggered softer financial terms for new mortgages and growth in mortgages with high LTV ratios. Recently, however, this picture has altered, as the FLS has been amended to exclude mortgages and the Mortgage Market Review[27] measures have been applied to new mortgage loans. In turn, consumer credit also declined considerably during the crisis, at some stages by more than 2%. Towards the end of 2012, however, it began to grow forcefully. In September the growth rate stood at 6% year-on-year, but this was still below the pre-crisis figures.

Lending to *businesses* has posted negative growth rates since the start of the crisis – after growing by 20% year-on-year in 2006 and 2007 – as British companies cut back their spending and investment decisions. Moreover, in recent years there has also been a disintermediation process, as a result of which bank loans account for 44% of all borrowing in 2014 (see Chart 6), in comparison with 68% in 2008, while bond issues have grown in volume (see the left-hand panel of Chart 7).

Evidence from business surveys and reports from the Bank of England's Agents show that both the tightening of credit standards and the fall in demand have played a part in the weakness of lending to firms.[28] In fact one of the reasons for weak bank lending is the change in the source of funding of large corporations, which is reflected in Deloitte's quarterly survey of chief financial officers (CFOs) that shows that bond issues have become a more attractive source of funding than bank lending. In this setting, the volume of issuance has risen in tandem with the contraction in bank lending. Moreover, the number of companies raising funds on the markets for the first time has also increased.[29]

However, it is not easy for small businesses[30] to raise funds on the capital markets as an alternative to bank lending. Just 35% of British SMEs borrowed funds in the first half of 2014[31] (a figure which has fallen in recent years), mostly in the form of loans, bank overdrafts and credit cards. Lending to SMEs in the United Kingdom is highly concentrated among the big four banks, which have a stable 80% market share [Bank of England (2014b)]. Indeed, the British banking system is highly concentrated,[32] with very few small specialist or co-operative banks or regional institutions, unlike the situation in the United

25 See Bell & Young (2010).

26 A programme launched in April 2013 providing two kinds of help to home buyers: i) Help to Buy equity loans, which are loans for buyers of new-build homes for up to 20% of the price, with no loan fees payable for the first five years; and ii) Help to Buy mortgage guarantees, which secure mortgage loans (both for new and non-new housing) with an LTV ratio of up to 95%, with a public guarantee for the tranche between 80% and 95%, so the lender retains a 5% risk in the portion of losses covered by the guarantee.

27 The Mortgage Market Review, which was launched by the Financial Conduct Authority (FCA) to improve the functioning of the mortgage market, requires that potential borrowers be subject to stress tests to ascertain whether they would be able to meet their mortgage payments if interest rates were to rise (by at least 3 pp) over the first five years of the loan. Also, no more than 15% of new mortgages should have loan-to-income ratios equal to or greater than 4.5.

28 See Bell & Young (2010).

29 See Farrant et al. (2013).

30 The Bank of England defines SMEs as those with annual turnover of up to £25 million.

31 Data from the BDRC Continental SME Finance Monitor. See Bank of England (2014e).

32 In 2011, the five major banks (Barclays, HSBC, Lloyds Banking Group, Santander UK and RBS) collectively managed 65% of assets and 79% of lending [Ares and Co. (2012)].

Over the last few years the United Kingdom has launched various measures designed to make it easier for firms — especially SMEs — to have access to financing. In 2010, the Treasury announced a raft of measures to support SMEs from two angles. First, by providing capital backing to new businesses in sectors with high-growth potential, through the Business Angel Co-Investment Fund, Enterprise Capital Funds and direct investment in private funds, and second through schemes for established companies that were finding it difficult to obtain capital and bank lending (the Business Growth Fund and the Capital for Enterprise Fund). Measures were also introduced aiming to directly encourage bank lending through loan guarantee schemes such as the Enterprise Finance Guarantee.

Since 2010 more substantial measures have been adopted, more keenly focused on SMEs. One such example is Project Merlin, launched in 2011, which was an agreement between the government and the big four British banks whereby they undertook to boost the flow of credit to households and businesses, to provide the Bank of England with information on lending and to disclose details of their executive compensation packages. The central bank was responsible for oversight of the scheme. The big four banks — Barclays, HSBC, Lloyds and RBS — all signed up, with Santander doing so only with regard to making credit available. Between them they undertook to provide new business lending amounting to £190 billion in 2011, of which £76 billion would be for SMEs (15% more than total lending in 2010).[1] As a result of Project Merlin,[2] total lending was ahead of target (at £214.9 billion in 2011), but SME lending was below target (at £74.9 billion) and SMEs continued to report difficulties obtaining lending.

In July 2012 a new scheme — the Funding for Lending Scheme (FLS) — was launched, designed to encourage banks to lend to households and non-financial corporations by lowering their funding costs. The scheme came into operation in August 2012, to be reviewed quarterly by a joint Treasury-Bank of England committee. For the first 18 months, banks were allowed to obtain low-cost funding, by swapping up to 5% of their loans to the non-financial sector (mortgages and corporations) at end-June 2012 — approximately £80 billion – for government debt (a collateral swap maturing in four years). Moreover, each new loan granted between end-June 2012 and end-2013 could be swapped for the total amount granted. In the event of default of the loans swapped, the originating bank would bear the loss. The cost would depend on the net volume of lending: if it is maintained or increased the cost would be 0.25% per year, but if it is reduced the cost would rise by an extra 0.25% for every 1% drop in the volume of lending, up to a ceiling of 1.5%.

According to the Bank of England's Credit Conditions Survey, the FLS was extensively cited by banks as an important factor in the decrease in wholesale funding costs and in rates applied to households, resulting in an overall improvement in credit availability.[3] The scheme did have an impact on interest rates on new lending, but not on rates on SME lending. In addition, it had an initial positive impact on the total volume of lending extended by the institutions involved, but this subsequently diminished, with differences from one bank to another. At end-2013 the FLS was extended, allowing banks to obtain additional funding under the scheme, but excluding mortgage lending, placing the focus exclusively on new business lending in 2014.[4] The flow of credit extended by the 36 institutions participating in the extension was still negative in 2014 Q2.

1 In addition, the banks would have to make available £1 billion in venture capital over a period of three years for small businesses in the regions hardest hit by the crisis.

2 http://www.bankofengland.co.uk/publications/Pages/other/monetary/additionaldata.aspx.

3 The FLS also included considerations relating to capital consumption by the loans granted under the scheme. Several analysts have cited these advantages among the factors behind the predominance of mortgage lending, rather than business lending, under the FLS.

4 Bank of England, "News Release – Bank of England and HM Treasury re-focus the Funding for Lending Scheme to support business lending in 2014", November 2013, http://www.bankofengland.co.uk/publications/Pages/news/2013/177.aspx.

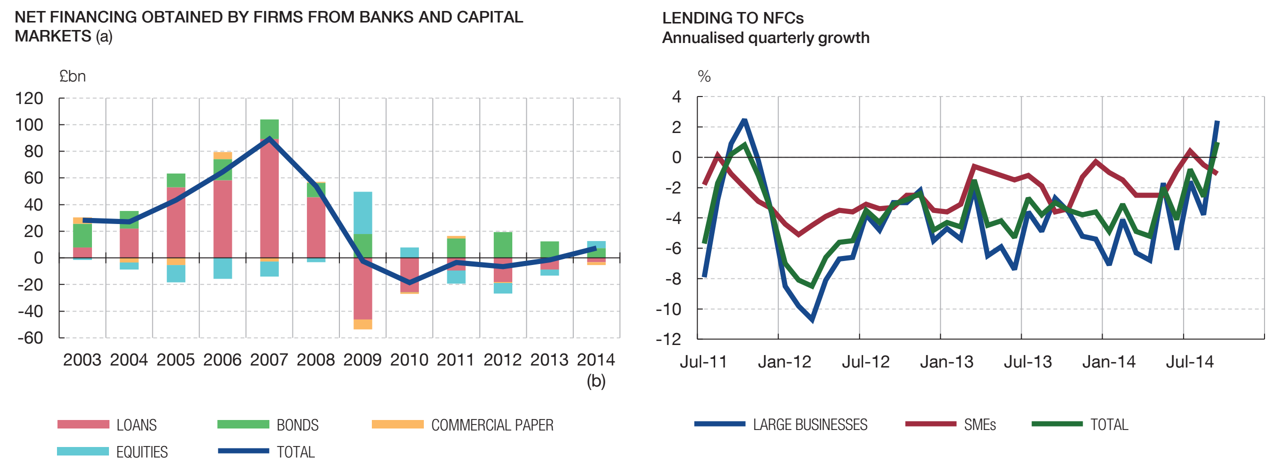
States and in other European countries. One exception was the sale of Northern Rock PLC,[33] which was state-controlled, to Virgin Money in 2011, within the British authorities' strategy to increase retail banking competition.

To understand the authorities' response it is important to know the situation they faced at the start of the crisis. Both the business surveys conducted and the Bank of England's Agents pointed to a decline in credit availability in 2007 and 2008 and to an increase in credit spreads.

33 Northern Rock was split into two in 2009: Northern Rock PLC, comprising the retail business, and Northern Rock (Asset Management) PLC, comprising the bad bank or asset management arm.

UNITED KINGDOM: BUSINESS FINANCING

CHART 7



SOURCE: Bank of England.

a Lending obtained by private non-financial corporations from monetary financial institutions and capital markets (not including retained earnings).
b Data to September 2014.

Rejection rates for loan applications by SMEs rose significantly in 2008-09, even controlled for the level of risk.[34] Moreover, rejection rates rose most at lower risk SMEs, suggesting greater relative tightening for the more solvent firms. In addition, high rejection rates discourage firms from applying for new lending. The surveys also reflect weak demand throughout the recession, with the economic situation a key factor.

It is, therefore, no surprise that lending to SMEs has been one of the main areas of concern for the authorities, especially in view of their weight in the British economy: in early 2013 they accounted for some 60% of employment, 50% of turnover and 40%[35] of total bank lending (see the right-hand panel of Chart 7). In this setting, since 2010 the British authorities have developed various initiatives, in all cases with the explicit aim of incentivising business lending, especially to small firms (see Box 1), with a seemingly limited impact.

Furthermore, a disintermediation process is under way which, although still confined in scope, could ultimately offset the lack of dynamism in bank lending to business. Thus there has been an upswing in lending by insurance companies and pension funds and in funding through financial leasing and invoice discounting. In the case of SMEs, the use of peer-to-peer lending, crowdfunding and venture capital funds is also increasing.[36] In 2010 the London Stock Exchange (LSE) launched the first retail bond market, the Order Book for Retail Bonds (ORB); this is a regulated market that has become a more flexible source of funding for certain medium-sized firms. In addition, the United Kingdom has introduced tax incentives for investors if, for example, they raise funds on the alternative investment market (AIM) or through venture capital trusts (VCTs),[37] with a view to broadening the investor base of SMEs.

Final considerations

Both the United States and the United Kingdom were affected by the financial crisis from the very beginning and its impact was soon seen as bank lending declined. As a result of the crisis, there has been bank disintermediation in both countries, with more funds being

34 Fraser (2012) and Armstrong et al. (2013).
35 Data at March 2014. See Bank of England (2014c).
36 See Bank of England (2014a).
37 Collective investment schemes listed on the LSE, 70% of whose assets must comprise shares of small companies, whether or not traded on regulated markets such as the AIM [CNMV (2011)].

raised by firms on the capital markets. In qualitative terms, this change has been most marked in the United Kingdom, where firms were previously more reliant on bank lending. Both countries have also taken various measures to incentivise bank lending, mainly targeting SMEs which find it more difficult to raise funds on the capital markets. However, the specific credit support measures taken differ from one country to the other, in view of the differences between their private sector credit financing and their banking industries.

In the case of lending to SMEs, the US authorities have focused on measures designed to support small financial institutions that specialise in SME bank lending, while in the United Kingdom broader measures have been introduced, aimed at lowering the cost of borrowing for banks. When it comes to mortgage loans there are also significant differences between the United States, where support has been channelled through state agencies, and the United Kingdom, where incentives have been offered to the industry overall, by cutting the cost of borrowing and providing guarantees or help to households applying for mortgages, at the same time as macroprudential and customer protection measures have been introduced to prevent over-borrowing among the more vulnerable sectors.

Lending patterns in the two economies are now quite different, even though they are both at a similar stage of the cycle. Bank lending to the private sector is recovering in both countries, but the pace and the make-up of the recovery is quite different: it is more dynamic in the United States, with a positive contribution from all areas, and quite sluggish in the United Kingdom, where the growth in household lending is mainly responsible for the latest improvement.

In any event, challenges remain in both countries. In the United States, rising indebtedness from student loans and the (protracted) reform of the mortgage guarantees provided by state agencies are the main concerns. In the United Kingdom, despite the numerous initiatives taken, credit availability remains constrained for SMEs, and in the case of mortgage lending, several macroprudential measures have been taken to prevent practices that might trigger over-borrowing by the more vulnerable groups.

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