Pointmaker

CREDIT WHERE IT'S DUE

EASING MARGINAL LENDING DECISIONS TO SMES

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SUMMARY

- There is a strong perception that many SMEs are struggling for credit; and that new mechanisms of financing SMEs have to be looked at. Hence the Chancellor's announcement of "credit easing".
- Lending to SMEs has contracted over the last two years with average monthly new terms lending to small businesses having fallen by 31% between 2009 and 2011.
- One reason for this may be a lack of confidence due to the current economic crisis. Many SMEs may be more interested in reducing debt than in taking out new loans.
- Indeed, survey evidence suggests that only 2% of SMEs have applied for a loan within the last 12 months and emerged with nothing.
- However, many SMEs may have been discouraged from applying to borrow because of a perception that the banks are not lending currently. Restoring SME confidence in the availability of financing for viable projects will be crucial to the growth of this sector.
- A quick, simple, low cost and effective way of achieving this would be for the government to set up an Ignition Capital Scheme. In this scheme, the government would provide mezzanine financing (of typically 20% of the total loan value) for those projects which would under normal economic conditions be considered a good risk but which in today's conditions do not quite meet the bank's lending criteria.
- The existing banking infrastructure would continue to be responsible for risk management and due diligence. The interests of the bank and of the government would be closely aligned.
- This approach would unlock a minimum of £25 billion of investment in SMEs for every £5 billion provided by the government. In addition, as a portfolio of the government's mezzanine loans would be an attractive investment opportunity for the private sector, it should be easily saleable. The original funding could thus be quickly repaid to the government; or a second phase of the Ignition Capital Scheme could be launched.

INTRODUCTION

"Everyone knows Britain's small firms are struggling to get credit and banks are weak. So as part of my determination to get the economy moving, I have set the Treasury to work on ways to inject money directly into parts of the economy that need it such as small businesses. It's known as credit easing."

Chancellor George Osborne, speech to Conservative Party Conference, 3 October 2011

Calls for better access to credit for small and medium-sized businesses (SMEs) abound. In response, in February 2011, the Coalition brokered the Project Merlin deal, which committed the four main high street banks, plus Santander, to providing £76 billion of credit for SMEs in 2011 (a £10 billion increase on the previous year).[1]

Figures for the first three quarters of this year suggest that the banks are roughly on course to meet this target – with £56.1 billion having been lent to SMEs already.[2]

Despite this apparent success, there is a strong perception that many SMEs are still struggling for credit; and that new mechanisms of financing SMEs have to be looked at. For example, Sir Mervyn King has said that: "Only the banks are in a position to assess credit risks for SMEs. What we have to do is to find ways of giving incentives to the existing banks in order to lend more."[3] While the Secretary of State at BIS has said that: "I think the Merlin agreement, contrary to some of the criticism, has been useful. But there is a deeper problem and that is why new mechanisms have to be looked at."[4]

Historic low interest rates and quantitative easing have done much to alleviate the financial crisis. Liquidity has been improved, and the cost of funding minimised, giving the banks capacity to continue lending at an aggregated level. However, the economic downturn, in conjunction with increased regulatory capital requirements, has caused the banks to apply more stringent criteria for loan applications. On top of that, reduced business confidence has limited the demand for borrowing.

The Coalition is now seeking a method of directing targeted finance to assist small businesses, which have been earmarked by many as the key driver in restoring strong economic growth.[5] According to the BBC's Robert Peston, sources in both the Treasury and the Bank of England are of the opinion that the semi-nationalised banks "are not stimulating the provision of credit to the businesses perceived to be intrinsically riskier, but whose prospects for long-term returns are also best."[6]

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1 Project Merlin – Banks' Statement http://www.hm-treasury.gov.uk/d/bank_agreement_090211.pdf

2 Additional data for lending to UK businesses, including 'Project Merlin' data http://www.bankofengland.co.uk/publications/other/monetary/additionaldata.htm

3 http://www.bbc.co.uk/news/business-15443610

4 www.guardian.co.uk/politics/2011/oct/10/project-merlin-not-enough-cable-admits

5 High growth SMEs key to UK employment growth says Experian http://www.experianplc.com/news/company-news/2010/02-12-2010.aspx

6 Sluggish UK economy means slower Lloyds revival http://www.bbc.co.uk/news/business-15634996

But do SMEs want more credit? Here the picture is not clear. It would be foolish to oblige banks to lend more to a sector that was more interested in reducing debt. On the other hand, it would also be foolish not to make sure that SMEs do have access to credit for sound business propositions as and when they seek to expand. The aim must be to find the least damaging means by which the government can encourage more business lending through credit easing while minimising taxpayer exposure and involvement, ensuring flexibility to economic conditions and utilising existing market structures.

LENDING TO SMEs IS FALLING

From the mid-1990s through to just before the onset of the financial crisis in 2008, lending from banks increased hugely. The financial crisis itself initially led to firms drawing down on existing loan facilities, enabling lending to continue to grow. But by the start of 2009, firms began to both deleverage and destock.[7] Since then net lending has declined significantly. Data from the British Bankers Association suggests that average monthly new term lending to small businesses for the first half of each year has fallen by 31% between 2009 and 2011.[8] The same data shows that net lending to small businesses has contracted by an average of £332m a month during 2011 compared to last year.

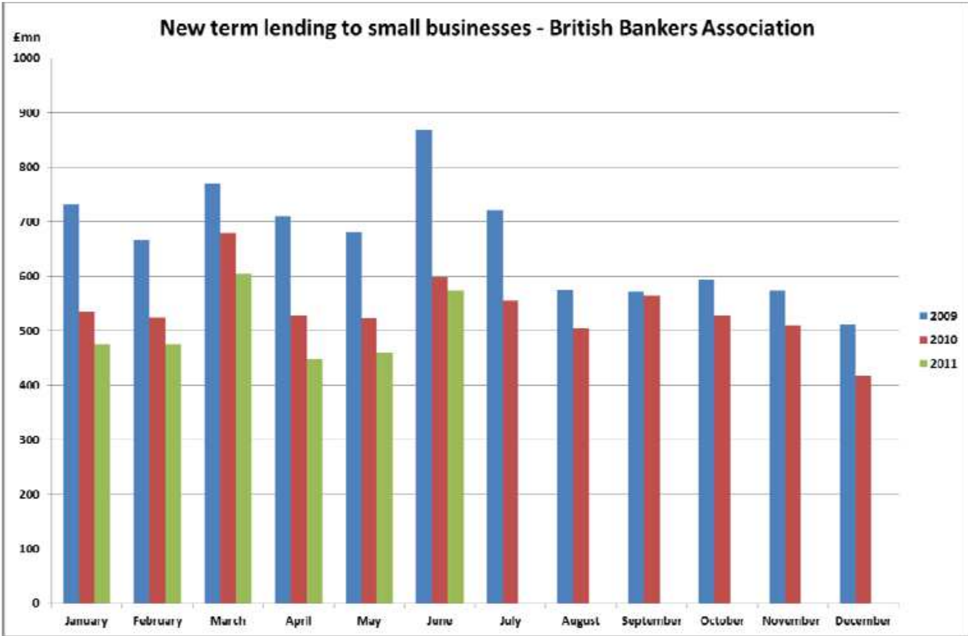
These trends are replicated in the Bank of England's *Trends in lending* reports. These show that net lending towards both small businesses and SMEs has been declining since 2010.[9]

SMEs are likely to be more heavily affected by a decline in lending than larger businesses: they tend to have fewer alternative funding

[7] Supporting UK business: The report of the business finance taskforce http://www.bba.org.uk/media/article/business-finance-taskforce

[8] Statistics – Small Business Support – British Bankers Association, September 2011 http://www.bba.org.uk/statistics/article/small-business-support-may-june-201111/small-business/

[9] Trends in lending – Bank of England – October 2011 http://www.bankofengland.co.uk/publications/other/monetary/TrendsOctober11.pdf



sources and in particular they do not have access to capital markets. This is problematic given that the cost of finance has been increasing for SMEs, who are now paying 3% over base rate, with the smallest SMEs paying as much as 4% over.[10]

What is unclear is whether this decline in lending is a supply or demand issue. On the one hand sits a large body of anecdotal evidence that viable businesses are unable to access funds. On the other, the BBA claims that credit is available but it is not being demanded as businesses are using the current economic climate to reduce debt and build up cash reserves.

NO HUGE UNMET DEMAND…

As part of the Project Merlin package, the market research organisation BDRC was commissioned to survey SMEs.[11] Its report tackled questions surrounding SME borrowing activity, reasons for applying/not applying to borrow, and the key challenges that SMEs envisaged for their businesses in the future. Their findings reveal both whether there is an unmet demand for credit, and the extent to which demand from SMEs for borrowing has fallen because of the current conditions.

Their findings indicate that only 30% of all SMEs are active borrowers; indeed, 47% never use external funding at all. Of these borrowers, only a relatively small proportion applied for credit and didn't get what they were looking for in the past 12 months. For example, 35% of those SMEs that had been through a 'loan event'[12] emerged with nothing – equating to around 2% of all SMEs overall.

There is evidence, however, that credit is more difficult to obtain than in the past. The proportion of SMEs successfully applying for or renewing a loan has declined from pre-financial crisis levels. In 2007, 85% of SMEs that applied for new or renewed loans got what they were looking for, while just 4% were rejected outright. These figures are now 58% and 27% respectively. The banks have predictably become more restrictive about lending – particularly to new, small businesses which tend to be more risky.

…BUT PERCEPTION THAT BANKS AREN'T LENDING

However, there is evidence that some SMEs are being discouraged from applying for credit. 15% of SMEs overall define themselves as 'unrequited'; they did not apply for some/more borrowing when they wanted to over the past 12 months. Significantly, for start-ups the figure is as high as 28%.

The current state of the economy seems to be the most important reason why these firms decided not to apply. But 6% of all SMEs (in particular smaller businesses) claim to be discouraged from borrowing because either they fear rejection or have been put off by initial conversations with their banks. This includes half of all would-be loan applicants.

10 http://www.bankofengland.co.uk/publications/other/monetary/TrendsJuly11.pdf. See Chart 2.4

11 BDRC Continental, *SME Finance Monitor: to what extent have SMEs had issues accessing bank finance?,* July 2011. All the data on SME attitudes come from this report.

12 A 'loan event' is defined as the renewal of or new application for a loan by an SME, the cancelation or renegotiation of a loan by a bank, or an SME choosing to reduce or pay off an existing loan.

Over the next 12 months, 44% of SMEs overall plan to grow, the main obstacle perceived as being the economic climate.[13] 12% of all SMEs see a need for more external finance in the next three months, but only 9% plan to apply. In fact, 18% anticipate that they will not borrow when they would like to. And amongst SMEs thinking they might apply for facilities, just 42% were confident the bank would agree to their request; a fall from 70% 12 months ago.

HUGE COMMITMENTS WOULD BE WRONG

The picture is mixed. Lending has contracted but this could be for various reasons:

- Economic conditions have depressed demand for finance from many SMEs. They may have decided to deleverage or build up their cash reserves instead. 11% of all SMEs plan to reduce the level of facilities they currently hold over the next 3 months.
- But there is some unrequited demand for finance: more SMEs are currently being rejected for loan applications than in 2007.
- Furthermore, many SMEs have been discouraged from applying to borrow because they feel that they would be rejected or perceive that banks just aren't lending at the present time. These tend to be firms that are new, small, and risky businesses with high growth potential.

Improving access to finance for these businesses could possibly have a positive effect on growth. But it must be recognised that there is a high degree of uncertainty about just how effective it would be. And it is this uncertainty which must drive the design of any credit easing mechanism.

[13] The accelerating uncertainty in the Eurozone will probably have reduced that figured.

PRINCIPLES IN DESIGNING A CREDIT EASING POLICY

As the economy recovers, it is vital for the health of our economy that appropriately priced credit is available for those SMEs with viable business propositions.

At the same time, banks will be required to build up higher capital requirements in the light of proposals from both the Vickers Commission and Basle III.

There is obviously considerable tension between these two factors.

The benefit of SMEs knowing that credit is available may not be easy to quantify. But surely it is better that the gun be loaded, even if it is never to be fired. It is therefore essential to restore both confidence and awareness among SMEs in the availability of finance, so that they are prepared to invest when they see that conditions are favourable.

A credit easing policy must therefore:

- improve access to finance if and when it is desired for companies which would, under normal conditions, have viable proposals;
- not become a vehicle through which the state further distorts economic activity;
- not commit taxpayers to expensive intervention and huge risks.

The policy should therefore:

- be widely publicised to maximise confidence in credit availability;
- be harnessed quickly via a simple, transparent and effective mechanism;
- be set up to allow the rapid exit of government from the scheme without any disruption to the private sector.

It should not:

- lead to lending at any cost to meet predefined targets;
- distort competition in the credit markets;
- prop up uneconomic ailing businesses;
- give preferential credit to favoured projects, industries or geographies

UTILISING EXISTING INFRASTRUCTURE

In order to make sure that such a system can be delivered quickly, it is essential to use the infrastructure and knowledge base of the existing banking system. The expertise in due diligence, procedural application issues and risk assessment on a wholesale level must continue to be the domain of the banks and not of government.

In terms of efficiency, the capacity already exists to cope with the fragmented SME market, which requires a multitude of small loans to be made and managed. The existing bank networks can be used to absorb some of the costs of establishing the approach.

It is also important that the roles of banks and government are kept separate. With regards to lending, there must be no confusion on the part of the SME as to who is the decision maker. The business should have no relationship with government.

Utilising existing institutions also helps to minimise the distorting effect of credit easing on competition.

Nor should loan decisions be directed by the state. UK banks are in the best position to evaluate which businesses are just missing out on loan criteria, and which projects would be most viable, were some limited support available.

A PROPOSAL

Today, at the end of any negotiations over a request for borrowing, loan managers face two choices: either to 'grant credit' or to 'reject application'.[14] But given the gravity of the current economic conditions, combined with the need for banks to rebuild balance sheets and increase capital, a third option could be considered: namely, for government to provide a small proportion of mezzanine finance for those companies which would otherwise be marginally rejected when applying for credit from a bank.

For example, in a case when a bank would normally have proceeded with an SME

[14] This is of course a simplification.

WHAT IS MEZZANINE CAPITAL?

Mezzanine capital spans the gap between debt and equity. Mezzanine finance looks like part of the bank loan to the equity holders in the business but looks like equity to the bank itself. Historically, it has been a vital part in the capital structure of growing business as it allows them to access credit when traditional debt markets may have felt there was too much risk. It has also exhibited some of the best risk/reward characteristics, as it is senior to every other part of a company's capital apart from the debt and loans, but enjoys a higher rate of return that both of these.

business loan but had to turn it down due to extraneous factors, it could apply to the "Ignition Capital Scheme". This would loan the first 20% of a sum on a first loss basis (the bank providing the remaining 80%).

In such marginal lending cases, this additional finance would mitigate enough of the risk of the bank to allow them to proceed with the loan.

This Ignition Capital Scheme would:

1) Inject finance as "ignition capital" by providing a vital cushion between the borrower and lender – thus unlocking the totality of the funds required. In essence, the government's mezzanine finance would mitigate the risk to the bank to allow them to proceed with the loan. As such, the risk that the government takes is a fraction of the credit it generates.[15]

2) Ensure that banks have enough "skin in the game", meaning only commercially viable companies will benefit from the credit easing policy. By aligning the risk the government would run with the commercial interests of the bank, only those projects with realistic long-term prospects would benefit from the program. The amortisation schedule for the government would be the same as that of the bank, ensuring that there is no risk of exposure to maturity mismatch.

3) Operate with eligibility criteria pre-defined by government. For example, the government could specify that this would apply only to UK businesses.

4) Command a commercial return commensurate with the risk it would run. This rate could vary depending upon factors such as sector, leverage ratio (possibly capped and floored), the interest rate on the loan provided by the bank, maturity and amortisation.

5) Use portfolio theory to both protect the government's overall investment, to ensure the rapid implementation of the policy and to provide an exit. Similar to the Loan Guarantee system, the Mezzanine approach would be achieved off-balance sheet and unfunded. The risk would still be transferred but without an upfront exchange of principal.[16]

The suitability, application and due diligence on all applications would continue to all be managed by the bank, which in the case of success would continue to provide the bulk of the loan.

Both the loan and mezzanine loan would be managed by the bank, and the customer would solely have a relationship with them, rather than government. As such, the government would be simply intermediating in the role that would normally be played by the private sector.

In order to avoid confusion or moral hazard as to which employees within the lending bank had the responsibility for these higher risk types of loans, they would be handled by a separate desk. This would limit any temptation for those in charge of regular lending to exploit the government's capital by absorbing any losses on regular lending into the large portfolio. A similar system of checks and balances is already in place under government's Enterprise Finance Guarantee programme.

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[15] See Appendices A and C.

[16] See Appendix C on using guarantees instead of direct investment and how a synthetic CDO works.

government would in effect have a 'second lien' over the assets of the company. That is to say, that if the company were to go under, government would have to wait for the bank loan to be repaid first, before it could look to recover its money. It would however, be able to recover all of its money ahead of all of the shareholders of the company.

SAFEGUARDS

It is essential that the credit generated is incremental and does not cannibalise loans that banks would have been made anyway. Even more importantly this process should not be used as a mechanism for banks to reduce the risk of their existing loan books.

As with all credit easing proposals, lending needs to be genuinely additional in order to be of wider benefit. The government needs to ensure that it prevents banks from using this facility to refinance existing "problem loans".

Cannibalisation can be prevented by a number of ways. For example, it could give access to the Ignition Capital Scheme only to those banks that have met their requirements under Project Merlin.

But the key protection for the government is that the banks interests are correctly aligned with those of the government. If the mezzanine tranche is capped at 20% of the loan and recovery is 40% of principal, then in default the bank's loss is twice that of the government. Indeed this shared risk would police the bank's behaviour more effectively than regulation.[17]

ENABLING GOVERNMENT EXIT

These proposals should be seen as short-term measures designed to ensure that viable SME propositions for loans can be approved at a time when such finance may not be readily available. It should be noted that, if SME finance is in fact readily available (as some claim), then this scheme would not be called upon.

Because of its short-term nature, it is essential that the risks borne by the government can be transferred quickly; and that the scheme can be shut down quickly once normal market conditions are re-established.

Exiting from the risk

Taken alone, any loan of small size is difficult to sell. There is no diversification and to sell the government's stake in each individual loan would be costly and time consuming, if possible at all. There is no natural investor base for this kind of asset.

However, when taken as a portfolio, the characteristics of the government's investment would be easily understood by financial markets. In time, this could represent an attractive investment opportunity.

The portfolio of loans with government involvement would tend to be of reasonable quality: each loan would have been originated and managed with high levels of due diligence, as a function of the strong alignment of interests with the banks. As government and banks would both lose money in each individual default, new investors can be confident that their interests are represented. Strong diversification and differing levels of commercial return would all contribute to its appeal as a financial product.

The government has several options to sell on part or all of that risk. One option would be the creation and sale of a fund, which holds the portfolio of investments. This could all be done outside of government. However, because the risk and return profile would be more defined,

[17] See Appendix C

the portfolio could be securitised into tranches to achieve even keener pricing.[18]

Once a part of the portfolio is sold, the government's investment could then be recycled if necessary, maximising the amount of credit released for the lowest risk taken. Clearly the easier that risk is to price and sell, the more efficient the use of the government's capital.

Winding the scheme up

Under this proposal, the government remains behind the scenes, providing invisible support to the SME sector. Companies would not make direct applications to the government; their relationship would remain with their banks. By preserving this relationship, banks would continue to be perceived as the primary source of lending, again helping to minimise distortion or any risk of anti-competitive behaviour. Government would be simply intermediating in the role that would normally be played by the private investment sector.

CONCLUSION

Economic conditions have depressed demand for finance from many SMEs, many of whom have decided to deleverage, or build up their cash reserves. But there is some unrequited demand for finance, and there is some evidence that credit conditions are tough for small, more risky businesses with high growth potential. The aim of a credit easing policy is to ensure that liquidity is available to appropriate SMEs if and when the demand for it is there.

The proposal made here would be quick and cheap to implement as it utilises the existing infrastructure. It leaves lending decisions in the hands of the experts. It has the appropriate checks and balances by aligning the risk of the government and the banks. It has the best potential for the government to exits its financial exposure by selling its investment on as a portfolio. It is complementary and supportive of Project Merlin.

Given that it is low cost and quick to establish on a functional level, it does not matter if it transpires that there is no immediate demand for credit – particularly important given the mixed picture outlined previously. The institution could remain in place to bolster the confidence of smaller companies, ensuring that a perceived lack of credit does not impede their ambitions.

Whilst it is difficult to be precise about how much credit would be generated for SMEs, it is reasonable to assume that, on the 20% mezzanine financing model, a minimum £25 billion would be available for every £5 billion contributed by the government.

In addition, as a portfolio of this size would definitely be able to be securitised, the scheme has the potential to become self-sustaining: once the first loans have been made, the government would be in a position to sell its portfolio on the private sector. The proceeds could be used again to finance a second phase of the Ignition Capital Scheme.

Ultimately, the success of such a proposal should be judged on whether confidence is established that credit is available if and when it is required, rather than whether it is actually drawn down in the short term.

This would ultimately represent an example of financial innovation being used to good effect for a positive cause. Given the changes to regulatory structures to the banks, and the Government's commitment to a credit easing policy, this represents the best hope of successful implementation.

[18] See Appendix B.

APPENDIX A: HOW IS MEZZANINE FINANCE STRUCTURED?

Mezzanine finance sits between equity (i.e. the share capital of a company) and the senior creditors of the company (bank debt and senior bonds). For larger companies this means that mezzanine finance would traditionally take the form of 'subordinated bonds', 'preferred equity' or 'payment-in-kind notes' normally with additional accompanying warrants over a significant portion of the equity of the business.

Mezzanine finance structured in this way would not be an appropriate tool for the government to use in credit easing. Smaller companies often have unusual and idiosyncratic capital structures: for example, equity investments can be structured as shareholder loans and 'friends and family' financing rounds are also often legally structured as debt, typically with restrictive covenants. The government's investment needs to rank ahead of all financings except the bank debt (i.e it needs to treat them all as 'equity'), regardless of whether they are legally structured as loans or not, simply to protect government's position. This will also help with the onward sale of risk.

In addition, in order to simplify the application process and minimise costs, the investment needs to take a form, which is universally applicable despite the wide range of capital structures seen in SMEs. Finally, it is undesirable and inappropriate for government to acquire meaningful equity positions in a portfolio of SMEs through warrants.

Consequently the 'mezzanine finance' suggested here would be structured in a different legal form from what is traditionally understood by the term. In reality, government's investment would be a senior (secured) loan ranking directly behind the bank's own loan, with second lien security over any assets pledged to the bank. In this way, the government can be relatively agnostic about the capital structure of the company, as all investors other than the bank will rank beneath the government. Despite this, we have used the term mezzanine finance as government is sitting between the external investors and the bank.

The company could simply be given a single loan with the government's support 'wrapped into' the bank loan. One way this could be achieved would be through a government guarantee of the first (20%) loss on any individual loan, or indeed through a credit default swap structure. The beneficial effect of either of these is to transfer the appropriate and equivalent risk to government, but without requiring any actual government funding. Obviously the coupons paid to government would be reduced by the bank's funding cost. Investors are quite used to seeing 'synthetic' portfolios of credit, and so structuring government's investment in this way will not prevent a future disposal as long as the other characteristics of the portfolio are recognisable and attractive.

One key question is how much of the finance raised should be through mezzanine and how much through the bank loan. Clearly this is a matter of debate and may vary by sector. However it should not be much higher than 20% of total borrowing, as if more than this is required by the bank, then, by definition, the business is simply unviable.

APPENDIX B: HOW CAN THE GOVERNMENT'S PORTFOLIO BE SECURITISED?

On an individual basis, the government's investments would be simply unsaleable as the loans are too small to justify the time for the required investor analysis. However on a portfolio basis, the investment gains sufficient scale, especially if there is enough diversification to reduce risk. As the banks would have 'skin in the game' on all of the loans issued, investors would have confidence that appropriate due diligence has been undertaken on each of the underlying companies. Correspondingly the investment analysis will focus on the actual construction of the portfolio.

Investors would use historical data to assess the distribution of defaults – i.e. how many defaults are likely to occur and when (how many coupons are received from each loan before default occurs). As this is a portfolio of loans which suffers the first loss, recovery on any defaulting loan is likely to be zero, but the historical data analysis will allow investors to assess how much income is received from coupons, against how much principal is lost through defaults. These cash flows can be "NPVed" (calculation to determine the Net Present Value) to give a present value of the portfolio. Re-running the analysis through varying economic scenarios would give investors a sense of the variance of this valuation. Portfolios of mortgages, credit cards and other consumer loans are already valued in this way, as well as portfolios of bonds and loans.

This type of analysis allows investors to assess how much of the portfolio will be paid back in all circumstances, how much will probably be paid back and what proportion is at risk of a probable element of default. By tranching the investment in this way, it might be possible to sell different elements of the portfolio to different specialist investors for a higher combined price. The individual tranches will command a higher price than package of the total portfolio. The anticipated high level of diversity within the proposed SME portfolio makes this a suitable approach to pursue.

Many of the portfolios that have been sold through this methodology have been 'synthetic' in nature – with the underlying economics of the loans rather than the actually loans themselves being placed into the portfolio. The government could sell an unfunded portfolio of guarantees in a similar manner as long as the underlying exposure was sufficiently diverse in risk profile.

APPENDIX C: WHAT IS THE DIFFERENCE BETWEEN THIS MEZZANINE FINANCE PROPOSAL AND GOVERNMENT'S EXISTING EFG PROGRAMME?

Under the EFG system, the government guarantees the first 75% of each individual loan. Indeed as the bank is able to take security from the creditors, it is hard to see that they have any substantial exposure. In reality, the government is taking all the risk. This is mitigated as the government guarantee only applies to a maximum of 13% of the total loans issued by the bank under the scheme, capping government's maximum loss to 9.75%. This gives a very different risk profile from the mezzanine finance proposal, where there is a far lower loss on each individual loan, but without the cap.[19]

[19] See http://www.bis.gov.uk/policies/enterprise-and-business-support/access-to-finance/enterprise-finance-guarantee/efg-guidance

For any given portfolio, the total losses from default would be equal, but clearly the split between bank and government would be very different. The graphs below illustrate how losses from defaults are divided between government and banks, assuming a 20% mezzanine tranche and 40% recovery. This has not been adjusted for income which should be broadly comparable in both cases.

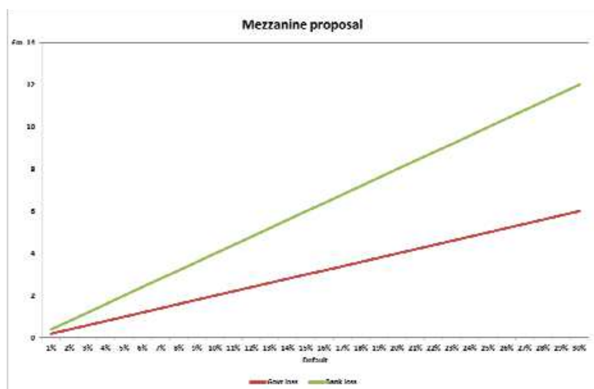
The main difference between the two schemes is that with the mezzanine proposal, both the government and banks suffer losses from the first default, more closely aligning interests. In order for the government's losses to reach the EFG cap under the mezzanine proposal, defaults would have to reach 39% of loans originated.

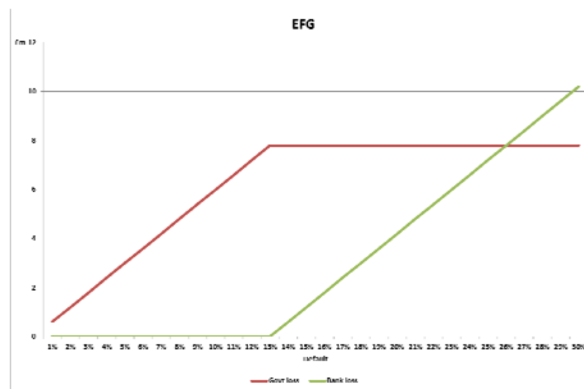
Indeed these graphs demonstrate that while the EFG scheme appears to be providing support to individual creditors, in reality it does this by providing first loss protection to the bank at a portfolio level. This means that for an individual loan, the bank does not know whether it is 'above' or 'below' the cap and so it is harder to assess how much benefit should be passed on to each individual company.

The implications for the government are that the scheme results in greater risk, as demonstrate by the higher losses in lower default scenarios. In addition there is far higher correlation risk – the government is effectively 'long' the worst 13% of loans which may lead to concentrations in specific sectors or geographies. This lack of diversification not only increases risk, but also makes it far harder for the government to sell the portfolio to investors, especially as this correlation will be difficult to analyse.

Indeed there is a greater problem in selling the portfolio in that the bank's and the government's interests are no longer aligned, at least from an economic perspective. The bank is agnostic to the quality of the worst 13% of loans, as long as defaults do not exceed this level, or at least as long as any further defaults have high recovery. It is therefore possible for the bank to construct the portfolio of loans to minimise their potential loss at the expense of the government (i.e through the blend of maturities, sectors and geographies). This simple mis-alignment of interests undoubtedly makes the government's portfolio harder to sell.

This is not a criticism of the EFG scheme itself. But it does indicate that it is not an optimal model for wider scale credit easing. Nevertheless the broad premise of using banks' infrastructure appears to be the right approach, and indeed much of the internal bank procedures used (such as having a dedicated separate team) would also seem to be the most efficient and quickest way to proceed.





APPENDIX D: WHY THIS IS BETTER THAN OTHER VERSIONS OF CREDIT EASING

Bond market

The London Stock Exchange's electronic order book for retail bonds has been suggested as a possible source of credit for SMEs. However, it seems extremely unlikely that this would be a plausible means of credit easing. It is not clear that non-amortising bullet repayment bonds are the appropriate form of capital for SMEs. Typically, their financing needs require more smoothed liabilities such as bank loans. In addition, an SME corporate bond market such as the ORB would likely take too long to mature. The regulatory and legal costs are fixed and would therefore be excessively high on a percentage basis for such small issues. The make-up of existing bonds listed on this exchange is constituted almost exclusively of large "blue chip" corporates, most of which have excellent credit ratings. The idea of asking SMEs to offer debt to retail investors seems a little chaotic and many difficult issues arise, such as due diligence on the company, and liquidity in the bonds in the secondary market place. However, the critical aspect is that there is no evidence that retail or indeed institutional investors have demand for this type of investment, and even if they did, that it would not prove transitory.

An In-House Bank

The Monetary Policy Committee's Adam Posen has suggested that the government should take an active role in extending credit through the creation of a new public bank.[20] There are international precedents for this, the most prominent of which is Fannie Mae and Freddie Mac in the US.

But the creation of a whole new bank would be deeply flawed. The government acting as a bank would have a huge distortion on the banking sector, with the taxpayer undertaking huge risk. It is unclear that the government has the infrastructure or personnel with the required skills to undertake such a bank of this scale, particularly with the requirement that it would distribute a very high volume of lower value loans. In addition, it would take years to establish at high cost, and would inevitably generate lending based on political considerations rather than rational assessments of the business cases.

Government Loan Guarantees

The system of pledging guarantees to lenders who make loans to SMEs for a given percentage of the loans and the portfolio also carries complications. Firstly this type of credit easing is difficult to scale. For instance, if 75% of the nominal value of the loan, it is difficult to build up a large and diversified portfolio without quickly running a great deal of correlation risk. It is also difficult to lever. Historically, some provisions have been made to ensure that the government knows its maximum loss exposure – such as they only have this 75% exposure to the first 13% of the loans which default, under any given scheme.[21]

However, such a system does not align the government's economic stake to that of the bank as, on a portfolio basis, the government would lose all of its capital guaranteed before the banks start to be significantly impaired. It can also be gamed by the banks as their exposure to the risk is not uniformly

[20] Adam Posen speech at Wotton-Under-Edge in September. See http://www.bankofengland.co.uk/publications/speeches/2011/speech517.pdf

[21] As noted in Appendix C.

distributed. Both the bank's and the government's exposures are also harder to predict. The maximum losses of both sides are knowable. However, the fluid dynamics within those parameters create obstacles in risk management which ultimately lead to higher pricing or less liquidity.

Loan Purchases

Buying portfolios of loans is also problematic. By offering to buy portfolios of loans, the government does get some benefits of diversification. However, it is much harder to see how there is any alignment of interest between the banks and the government. The implied lack of due diligence also makes such a portfolio more difficult if not impossible to sell on. This would seem likely to create another nationalised "bad bank".

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