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ABFA

Economic Report

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ABFA Economic Report September 2009

THE ABFA ECONOMIC REPORT

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EXECUTIVE SUMMARY

The global recession has been severe but there are some signs of improvement ... Both the Organisation for Economic Cooperation and Development and the International Monetary Fund were very pessimistic about global output growth at the end of 2009Q1, but their most recent projections have been more optimistic. Output growth in the United States, Japan, the euroarea and the United Kingdom are all expected to be positive in 2010, while strong growth is anticipated for the full year in 2009 and 2010 in emerging economies, especially China and India.

...although the recovery is expected to be slow and fragile. Positive signals of a return to growth could be tempered by the lasting effects of the financial crisis on banks and financial institutions, lack of confidence and greater uncertainty. The monetary and fiscal stimulus packages have assisted in improving the situation.

Financial stability is returning but monetary policy is expected to remain loose. Most of the advanced economies have acted to guarantee bank capital, raise deposit insurance limits and inject capital into the weakened banking system. Purchase of private sector assets in exchange for government securities and quantitative easing has further helped ease liquidity concerns. Interest rates are expected to remain low into 2010, but evidence of any sustained improvement in bank lending is yet to materialise.

Turnover in the asset based finance industry fell along with advances reflecting economic conditions... ABFA statistics report asset based finance figures for the half year to June 2009 for the United Kingdom and Ireland. In the UK, the industry advanced £14.3 billion at the end of June 2009, against invoices, stock, property and other trading assets worth £27.3 billion, while in Ireland, the advances were €1.4 billion against €3.4 billion of assets. These were down on the previous quarter and on figures from a year ago, reflecting the economic climate, but just as there are some encouraging signs in the wider economy, there are signs that the contraction in asset based lending is easing.

...and credit in general is still tightening. The downward trend in asset based finance parallels the reduction in the growth of total M4 lending (excluding the effects of securitisations etc) to private non-financial corporations (PNFCs) which has fallen from a rate of over 10% in 2007 to below 1% today, in spite of substantial injections of liquidity in the financial system. Surveys of lenders by central banks show credit conditions have improved in the United Kingdom and access to credit is easing, but this is an adjustment from extremely tight conditions. In the euroarea there is much less evidence of easing conditions compared to a year ago.

Evidence of financial distress is more apparent. Insolvencies have risen and the numbers of credit protection payments being made to ABFA members' clients in the UK has increased by 47% to £21.2 million in the year to June 2009 compared to £14.4 million at the end of June 2008.

GLOBAL ECONOMIC OVERVIEW

THE GLOBAL RECESSION IS SEVERE BUT THERE ARE SOME SIGNS OF IMPROVEMENT ...

In the six months since the publication of the previous economic report conditions in the world economy – already the worst for over sixty years – worsened, but there are signs that positive growth will return in 2010. Both the Organisation for Economic Cooperation and Development and the International Monetary Fund were very pessimistic about global output growth at the end of 2009Q1, but their most recent projections have been more optimistic. **Chart 1** reports projected year-on-year GDP growth figures from the International Monetary Fund. World output is expected to contract by 1.4% in 2009, which will then turns positive in 2010. Looking at the projections in **Table 1**, the advanced economies are expected to contract, with large negative adjustments to output growth in 2009. The United States is projected to contract by 2.6%, while Germany and Japan are forecast to contract by 6.2 and 6.0% respectively, and the United Kingdom will shrink by 4.2% in 2009. However, these projections are set to improve in 2010.

Looking at the comparison with projections made in November 2008 and April 2009 the outlook is more pessimistic than in the autumn of 2008 but better than in the spring of 2009. World output is now anticipated to grow 0.6% faster in 2010, and the United States, Japan, Germany and the United Kingdom are also expected to fare better than previously thought in April. The most recent official figures for France and Germany show a surprise exit from recession in 2009Q2, which runs counter to these predictions. These may yet be revised downwards.

The announcement of US data for 2009 were also more positive than many expected, but data showing sluggish consumer spending contributed further to uncertainty about the output path over the next eighteen months.

According to the same projections, emerging markets are expected to show signs of an earlier recovery, reflecting the considerable unevenness of the recovery across countries and regions. China posted growth of 9% in 2008 and 7.9% in the year to 2009Q2 (7.5% is expected for 2009 as a whole) while India saw 7.3% growth in 2008. Strong growth is anticipated for the full year in 2009 and 2010 in both economies, particularly China, as a result of powerful fiscal and monetary stimulus measures. But other BRIC economies have fared less well, partly due to their heavy dependence on exports of commodities such as oil, metals and agricultural products. The recent rebound in commodity prices will improve their prospects, but current prices are well below the peaks of 2008Q2.

...ALTHOUGH THE RECOVERY IS EXPECTED TO BE SLOW AND FRAGILE.

The Organisation for Economic Cooperation and Development has been cautiously optimistic about the approach of the bottom of the downturn, but it warned in its June 2009 Economic Outlook that 'The ensuing recovery is likely to be weak and fragile for some time. And the negative and social consequences of the crisis will be long lasting' (p.3). This view reflects the positive signals of a return to growth noted in the previous section, but also the lasting effects of the financial crisis on banks and financial institutions, the dent to confidence that this has brought with it, and the uncertainty surrounding future economic variables. Its latest statement ahead of the

TABLE 1 Annualised Nominal Growth Projections and Updates	Projections			Changes from Nov-08		Changes from April-09	
	2008	2009	2010	2009	2010	2009	2010
World output	3.1	-1.4	2.5	-1.9	-0.5	-0.1	0.6
United States	1.1	-2.6	0.8	-1.0	-0.8	0.2	0.8
Germany	1.3	-6.2	-0.6	-3.7	-0.7	-0.6	0.4
Japan	-0.7	-6.0	1.7	-3.4	1.1	0.2	1.2
United Kingdom	0.7	-4.2	0.2	-1.4	0.0	-0.1	0.6
Newly Industrialised Countries	2.1	-3.9	3.1			-3.9	3.1
Russia	5.6	-6.5	-0.5	-5.8	-1.8	1.0	1.5
China	9.0	7.5	8.5	0.8	0.5	1.0	1.0
India	7.3	5.4	6.5	0.3	0.0	0.9	0.9
Brazil	5.1	-1.3	2.5	-2.4	-0.5	0.0	0.3

Source IMF:WEO

G20 meeting in London anticipates an end to recession in the United States and the eurozone in 2009Q3, with Britain lagging behind.

Although it is impossible to say with any certainty what the counterfactual would have been, the positive impact of fiscal and monetary stimuli have been credited with making the recession less severe than it could have been, and possibly hastening the recovery. The likelihood of a deep recession, like that of the 1930s, and the threat of prolonged deflation have now receded. Fiscal packages have been used to raise nominal spending in the global economy, and low interest rates have helped to encourage private sector spending. Inevitably, with weak demand and greater uncertainty, investment spending has declined and precautionary saving has increased.

FINANCIAL SYSTEMS HAVE BEGUN TO STABILISE AND BANKS ARE RECAPITALISING...

The high priority attached to restoring financial sector confidence has seen initiatives by governments that have begun to stabilise their financial systems. Most of the advanced economies have acted to guarantee bank capital following the financial crisis, and deposit insurance limits have been increased. To stabilize the banks further, governments have injected capital, and in the United Kingdom, the United States, Germany, Ireland, Iceland and Switzerland, banks and mutual organizations have been taken into public ownership. The governments of the United States and the United Kingdom have isolated toxic assets and the US Treasury has purchased toxic debt through the Public-Private Investment Program. Besides these moves to stem problems in the banks, governments have purchased private sector commercial paper and high quality asset backed securities by changing the composition of central banks balance sheets. **Table 2** reports the extent of the asset purchase programmes in the United States, the euroarea and the United Kingdom.

Pressure in interbank markets appears to be easing as 3-month LIBOR-OIS spreads have narrowed. The peaks of 2008Q3 following the collapse of Lehman – when US spreads were over 350 basis points, and UK and Euroarea spreads were over 150 basis points – have steadily fallen to between 50-75 basis points. The cost of insurance for banks' debts, reflected in credit default swap premia, have fallen in the US to 200 basis points from highs of 400-800 basis points in October 2008, and in

CHART 1
Annualised nominal GDP growth predictions

Source IMF

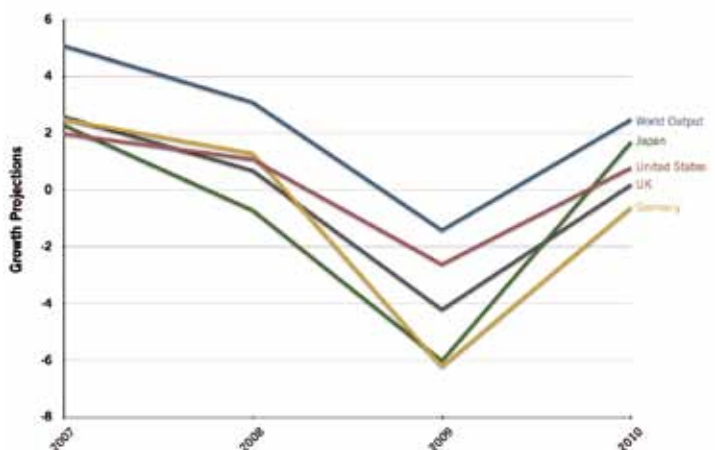


TABLE 2 Financial Support Measures	US \$tn	Euro Area €tr	UK £tr
Central Bank Actions			
Direct Lending	0.44	0.63	0.1
Asset Purchases	3.32	0.06	0.15
Asset Swaps	0.2	-	0.19
Currency Swaps	unlimited	unlimited	unlimited
Government Actions			
Loan Guarantees	2.08	>1.9	0.37
Insurance	3.74	-	0.46
Capital Injections	0.7	0.22	0.06
Total Support	10.44	1.64	1.26
Percent of GDP	73%	18%	88%

Source IMF

Europe to 100 basis points from highs of 200 basis points as late as February 2009. Share prices of banks have risen from mid-March relieving the pressure on banks as valuations of assets have improved.

Chart 2 shows that UK banks have begun to issue much more senior debt since 2008Q3 and much of this is under the auspices of the government credit guarantee scheme, although unguaranteed issuance has also increased, especially in the last two quarters. The fact that banks have been able and willing to issue senior debt reveals that wholesale funding markets are operating more normally. The European Central Bank's intervention in the covered bond market has similarly spurred an increase in issuance of covered bonds by European banks and large complex financial institutions which rose 40% on figures for 2008, and is higher than issues in 2007 and 2006 before the financial crisis.

...MONETARY POLICY IS PROVIDING ADDITIONAL LIQUIDITY THROUGH 'QUANTITATIVE EASING'.

Policy rates in the United States, the United Kingdom, Canada, and Japan have now reached their effective floor of near zero values. Any further reduction to zero would create a disincentive for the private sector to hold non-monetary assets. Without any means to stimulate economies by reducing short-term rates, the authorities in Canada have followed the commitment policy of Japan to maintain short-term rates for a specified period. Other countries, notably the United States, Canada and the United Kingdom, have significantly expanded the balance sheets of their central banks by purchasing assets using central bank reserves. In Canada the first auction took place on 21 July for C\$1bn funds with a one month maturity, although only C\$500m was actually transacted. In the euroarea, the European Central Bank agreed to purchase covered bonds – which have claims on the underlying assets and the bank that holds them – across the eurosystem in primary and secondary markets. Purchases began on 2 July and by September the ECB had bought €8.5bn of covered bonds, well short of the €60bn announced in June but still an effective amount to raise bond issuance. These represent significant innovations in monetary policy, and initially there were signs that aggregate deposits and bank lending had increased, bond yields had fallen and bond issuance had risen by €87bn since then, up significantly on previous years, reflecting greater confidence in the market. It is very difficult to determine whether this was a result of quantitative easing or other factors, and more recently the evidence seems to suggest that most of the effect is seen in capital markets rather than on bank lending growth. In the United States, while a broad measure of money has been growing faster since early 2009, data on credit shows commercial and industrial loans declining steadily since October 2008, down 9% from its peak, and total consumer credit has shown a similar pattern, down by 4.9% or \$10.3bn from May to June. More money has not translated to more credit.

INTEREST RATES WILL REMAIN LOW FOR SOME TIME, BUT THE EFFECT OF POLICY ON LENDING REMAINS TO BE SEEN.

Central banks are expected to keep interest rates at the very low levels reached in the first quarter. Canada is committed to do so, and the United States has signalled in recent testimony to Congress that it intends to keep rates on hold. While commodity prices have risen since the beginning of the year, with oil prices at \$73 per barrel, and metals such as copper, nickel and aluminium rising sharply, inflationary pressures are regarded as moderate. **Chart 3** shows measures consumer price inflation in the US and the euroarea have turned negative in recent quarters, while the UK CPI has remained positive but is currently below the official target of 2%. The UK retail price inflation, which differs in its measurement of inflation most notably by including mortgage interest payments, has also been in negative territory.

Although the cost of borrowing for banks has fallen since 2008 Q4, and quantitative easing has increased the balances banks hold at the central bank, there has been only limited evidence of greater lending activity. But lending figures are difficult to read for four reasons. First, we do not know what lending would have been in the absence of low interest rates and quantitative easing. Second, the demand for lending may have softened as the recession deepened in the first quarter, and investment activity has declined. Third, because lending grew quite fast in the corresponding quarter of 2008 as firms made use of existing facilities, any comparison of lending to the same period last year when lending was high will give an unfavourable impression of bank lending growth. Fourth, central banks are unclear over what horizon quantitative easing might be expected to influence bank lending, and what the expected increase in bank lending might be for an additional \$1bn of quantitative easing. We will have to wait to see whether the policy has any effect in subsequent quarters.

TRENDS IN THE UNITED KINGDOM AND IRELAND

THE UK AND IRELAND APPEARS TO HAVE SEEN THE WORST OF THE RECESSION, BUT RECOVERY WILL BE SLOW...

Revisions to the GDP data by the Office for National Statistics record that annual GDP growth in the United Kingdom fell by 5.6%, the worst four-quarter fall in output figures since 1956. These figures are shown in **Chart 4**. This means that the recession was deeper than previously thought, and sustained growth will be necessary for longer to bring output back to where it was in 2008. All parts of the economy are still contracting, but the rate of contraction has been smaller in the last quarter due to improving business confidence, the increase in production to meet demand, which is falling less sharply than the previous quarter, and the replenishing of inventories. According to the Bank of England's regional Agents, the degree of improvement is patchy across different industries: construction, manufacturing

of all types, haulage, distribution and hospitality industries continue to see little increase in demand, while professional services and print industries have seen an upturn. The Office for National Statistics recorded a decrease in industrial production figures for 2009Q2, as manufacturing output fell by 0.2%, extraction industries output decreased by 0.7% and output of the utilities decreased by 3.7%, compared with the previous quarter. But the Chartered Institute for Purchasing and Supply (CIPS) Purchasing Manager's Survey recorded the fastest growth in the service sector for 18 months suggesting that this sector is expanding once again. Forward-looking measures of activity point to greater confidence of recovery in the coming year, leading some analysts to think GDP growth could be positive in 2009Q3. According to its current projections the Bank of England's Monetary Policy Committee believes GDP growth will recover sharply in the remainder of 2009 and in the first half of 2010, returning to pre-recession growth rates of 3% by 2011. This is more optimistic than the IMF and the consensus of private sector forecasts, and appears to contradict the Governor's remarks that the recovery could be 'slow and protracted', but it does reflect the view that the recession has probably already reached the bottom.

The period of boom from through the late 1990s to 2007 in Ireland has given way to a steep fall in GDP as output fell by 2.8% according to CSO Ireland figures, given in **Chart 4**, and is expected to fall by a further 1.9% in 2009. In 2007 the Irish economy was growing at 5.8%, but the heavy reliance of the economy on property and construction industries which have seen a large fall in activity and the adjustment to weak demand have seen figures fall steeply. Given Ireland's openness, the relative strength of the euro against the pound sterling and the dollar has contributed to the decline in exports, although net trade has improved because imports have contracted even further.

...DOMESTIC DEMAND CONTINUES TO SHRINK, IN THE UNITED KINGDOM, WITH THE SOLE EXCEPTION OF THE PUBLIC SECTOR.

The Office for National Statistics and the Central Statistical Office Ireland report contributions to real GDP growth. In the United Kingdom household consumption in the first quarter of 2009 fell by 1.3%, which is the fourth consecutive decline in consumption. The decline reflects the deterioration in current income experienced by many households as unemployment has increased and many firms have reduced employee's hours. Net benefit payments have increased and VAT has been cut, but expectations of future income have been revised down in line with the deepening recession. Households are saving more of their income to offset falls in financial wealth and declining future income. The contraction in household spending is large compared to previous data, and it makes the largest contribution to GDP figures, but investment activity has fallen more steeply. Investment in total contracted 7.5% in real terms. Business investment fell 7.5% compared to falls of 0.6% and 0.7% in Q3 and Q4 of 2008. Inventory investment fell by

CHART 2
UK Banks' Senior Debt Issuance

Source Bank of England

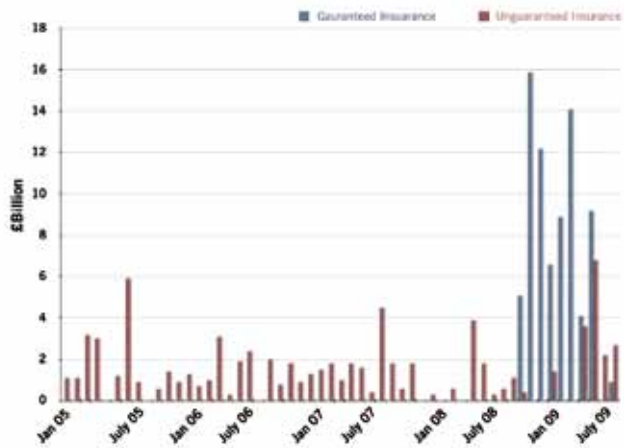


CHART 3
CPI Inflation Rate

Source ONS, BLS, ECB

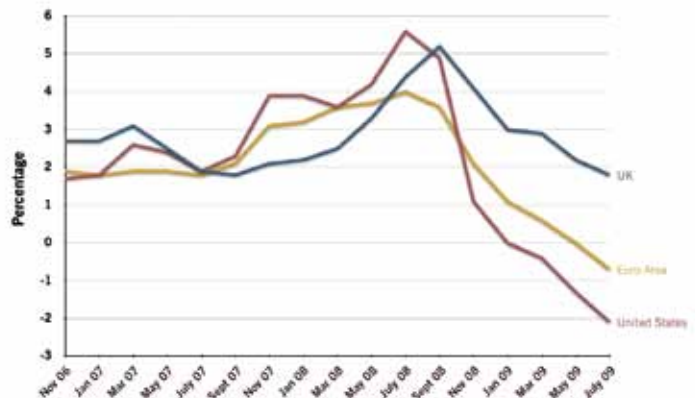
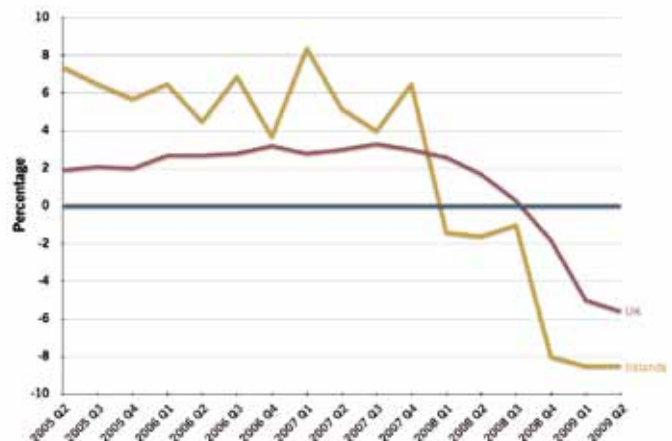


CHART 4
UK and Ireland Annual GDP Growth Figures

Source ONS and CSO Ireland



only 0.1%, because most destocking has already occurred in the UK economy, and net trade improved slightly by 0.1%. A similar experience has been observed in Ireland, with consumer spending projected to fall by 8%, investment demand to fall by 34.5% and exports to shrink by 4.5% in 2009 as a whole. Quarterly declines from 2008Q4 to 2009Q1 show consumption falling by 6.2%, investment by 28%, and only government spending increasing. As with the UK figures, the decline reflects a reduction in current and expected income due to concern about employment and credit availability. The fall in investment was due to reduced investment in construction and machinery. Investment in dwellings fell by a staggering 47.4% as asset values, which were widely regarded as the most overvalued in Europe in the mid-2000s, have been reassessed.

CONFIDENCE IS IMPROVING...

Indications from surveys are more positive about the outlook: confidence is expected to show positive growth and investment is forecast to contract less than it has done in 2009Q1. A British Chambers of Commerce (BCC) survey reported very negative results in 2009Q1, especially for the manufacturing sector, which saw declining domestic demand, and exports as well as confidence. Service industries were less badly affected, with some improvement evident in domestic sales and confidence leading to slightly higher employment and intentions to invest. All series were at historically low levels and remain very low, but the quarterly change in the survey responses between 2009Q2 and 2009Q1, reported given in **Chart 5**, demonstrates a marked improvement in confidence. Manufacturer's responses in the first column and service sector responses in the second column show confidence in turnover and profitability to have risen substantially. Home orders and sales and export orders and sales have also risen in the second quarter, more so for manufacturing than for services, because the service sector benefitted from improvements in the previous quarter. Measures of investment intentions lag behind sales and confidence, as expected, but are improving nonetheless for manufacturers and services. Employment has marginally declined for manufacturers in the last three months, but is expected to improve over the next three months. Together these figures tentatively point towards the beginning of a recovery, albeit slow and sluggish.

...BUT THE CONDITION OF THE FINANCIAL SECTOR IS A MAJOR CONCERN.

A major concern is the state of the banks in the United Kingdom and Ireland. Recent announcements of six-month pre-tax profits revealed that retail banking continues to suffer losses in the recession, but banks with investment arms were able to make profits from trading in rising equity markets. Among the larger banks in the UK the scale of bad debts remaining was £34.4bn, with the big four banks reporting different exposures: Lloyds Banking Group reporting £13.4bn, HSBC £8.3bn, RBS £7.5bn and Barclays £4.6bn. It is the scale of these bad debts and impaired assets that will drag on the recovery of the sector, and as Mervyn King explained in August we need to 'recognise that

the banking sector is still in a very bad way, and it will take several years for it to repair its balance sheets to get back to the point where it will ... lend normally'

CENTRAL BANKS HAVE OFFERED MORE LIQUIDITY THROUGH QUANTITATIVE EASING...

Quantitative easing involves the expansion of the central bank's balance sheet through the creation of reserves to purchase financial assets held by the private sector. The decision to begin quantitative easing in the United Kingdom was announced by the Chancellor of the Exchequer in January and the first purchases of private sector assets were funded by the issue of Treasury Bills by the UK Treasury's Debt Management Office initially and later by newly created central bank reserves. From February the Bank launched its commercial paper facility, with the aim of introducing liquidity in the commercial paper market. Unlike the United States, the sterling non-bank commercial paper market is relatively small at about £6-8bn. Participants in this scheme can issue commercial paper to the Bank or sell paper that they have purchased on the market. The Bank sets a price for the purchase of new issues as a spread over the risk free rate, which varies with the rating of the paper, and charges an additional fee for sellers of paper that was already on the market. Purchases of commercial paper have amounted to just under £1bn of the outstanding stock.

After the Bank's Monetary Policy Committee reduced Bank Rate to 0.5%, it eased monetary conditions further by undertaking quantitative easing of £75bn. To do so they financed asset purchases – commercial paper, and also commercial bonds and Gilts – with central bank reserves. Purchases amounted to £982bn of commercial paper, £12.9bn of Gilts, and £128m of commercial bonds in March through an auction mechanism in which sellers submit prices for sale, the cheapest bids being accepted by the Bank up to a maximum amount (subject to a maximum price, and in the case of commercial bonds a maximum value of each bond of £5m). The maturities of the government bonds range from 5-25 years, and are all rated AAA, while commercial bonds are investment grade (BBB or above). Gilts have become the main component of the asset purchase facility due to the limited availability of additional high quality commercial paper and commercial bonds. In May 2009 the Monetary Policy Committee raised the ceiling for purchases to £125bn, although it has only used £96bn of this amount, the majority of which has comprised further quantities of Gilts, with commercial paper and commercial bonds making up the residual. To the surprise of markets and economists, after neglecting to increase asset purchases or adjust their limit of £150bn in July the Bank then increased the limit to £175bn in August after forecasts of output suggested that the recession might be worse than the Bank had first previously thought. Currently the stock of Gilts purchases is £122.4bn, while commercial paper and commercial bonds purchases are £1.8bn and £0.92bn.

The Bank of England produces a quarterly report on the asset purchase facility. According to those reports the yields on medium and long dated government bonds initially fell, and

spreads of commercial paper and commercial bonds overnight index swap rates also dropped. Activity in commercial paper and commercial bond markets suggests that issuance has increased by around 10% (Bean, May 2009). But there is scant evidence to date that this has impacted positively on bank lending in a systematic way as this report will discuss in greater detail in the next section.

The euroarea announced a more limited programme to purchase commercial bonds than the United States or the United Kingdom in 2009Q2 comprising purchases of covered bonds – which have claims on the underlying assets and the bank that holds them - across the eurosystem in primary and secondary markets, of up to €60bn. The European Central Bank will purchase assets eligible as collateral in the eurosystem credit operations (in practice better quality asset pools comprising mostly mortgages on banks' balance sheets), and will not purchase bonds issued in volumes less than €100m, or with investment grade ratings of BBB or below. As in other countries with asset purchase schemes the objectives of the exercise are to promote the ongoing decline in money market rates, to ease funding conditions for banks, and through this means to spur banks to lend more to firms and households.

Purchases began in July and are scheduled to continue for a calendar year to June 2010. By 23 July the ECB had bought €2.6 bn of covered bonds, well short of the €60bn announced in June. €60bn is just 10% of the outstanding stock of euro-denominated covered bonds, and represents only 3% of the assets on eurosystem's banks' balance sheets. Nevertheless, the announcement effect raised the issuance of bonds by €9.6bn in May and saw the bond spreads over government debt of similar maturity fall to 85 basis points from 111 basis points.

...BUT THEY MUST BALANCE THE NEED TO STIMULATE GROWTH AGAINST THE OBJECTIVE OF KEEPING INFLATION TO TARGET.

In setting interest rates for the United Kingdom, the Bank of England's monetary policy committee must make an assessment of demand relative to capacity in order to ensure sustainable growth and to keep to the inflation target. On the demand side the impact of falling global demand, the net effects of the fiscal stimulus in the pipeline, the end of the destocking process and the effects of exchange rate movements all have a substantial effect. Many of these factors will continue to weigh on the economy for some time and unemployment, shown in **Chart 6**, is likely to continue to rise. The economy is some distance from full capacity – the range of survey indicators falls between one and two standard deviations from the mean measure of capacity utilisation over the last ten years. But the recession is likely to have reduced capacity as some employees that have lost jobs will not return to the labour force, some businesses that have failed will not restart after the recession, and the reduction in investment will lower the level of capital in the economy. Credit conditions are likely to continue to put downward pressure on demand until the banks' balance sheets have returned to normal.

CHART 5
Quarterly Change in Survey Responses to BCC

Source British Chambers of Commerce

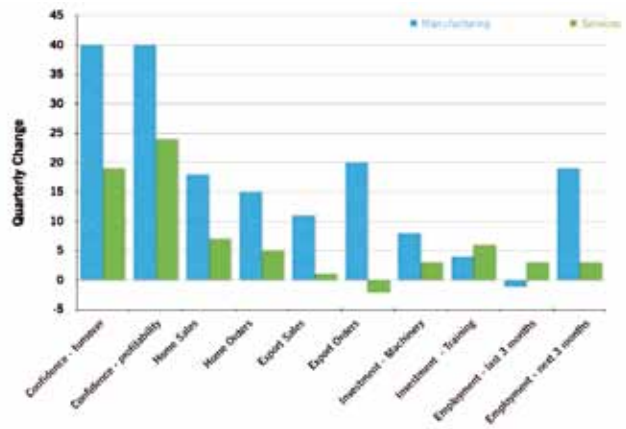


CHART 6
Unemployment Rate

Source ONS

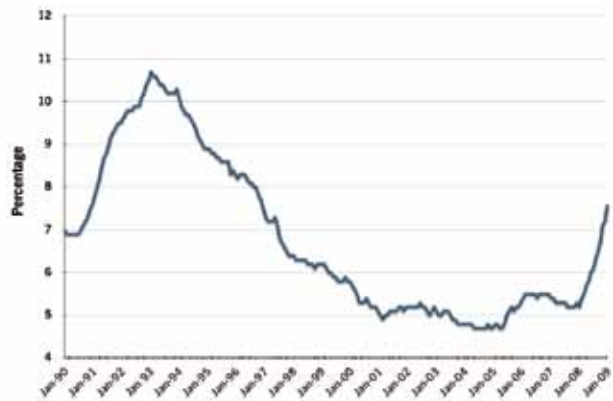
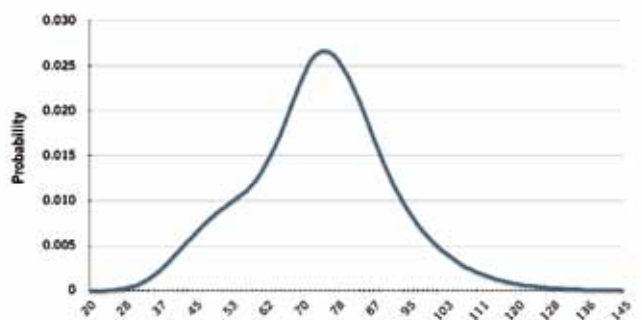


CHART 7
Dollar Price of Oil 3 Months Ahead (5 August)

Source Bank of England



The prospects for inflation is another concern. Although CPI inflation at 1.8% is currently below the Bank of England's target of 2%, and other measures of inflation are negative, showing prices are falling on average, there is still the need for vigilance about future inflation pressures. Inflation month by month is likely to be volatile, making projections more difficult, and the effect of quantitative easing depends on whether additional liquidity in the financial system is passed through to spending and at what rate. The intention of the government to reintroduce the 17.5% VAT rate will add to inflation. Factors that are less certain are future movements in the sterling exchange rate, with the knock-on effects on import prices, and the future path of commodity prices, in particular the oil price. **Chart 7** shows that the average perception about the oil price three months ahead in early August was \$78 per barrel, but perceptions show some variation around this average. The extent to which energy prices will impinge on inflation depends on whether suppliers of oil and gas have hedged against future price increases.

SUMMARY

The UK and Irish economies appear to have experienced the worst of the recession, and the prospect of a second dip is receding. Demand is weak and all categories of expenditure with the exception of government spending have declined further since 2009Q1, but there are indications that confidence is returning. Business surveys show that firms have greater confidence about turnover and profits and are seeing some improvement in sales and order books. The state of the financial system will continue to weigh on the economy, and credit will remain tight for some time, but liquidity is being provided by loose monetary policy through quantitative easing. Policymakers will need to remain vigilant about the prospects for inflation, but interest rates are likely to remain on hold so long as output remains well below capacity.

CREDIT CREDIT CONDITIONS AND ASSET BASED FINANCE

ABFA statistics report asset based finance figures for the half year to June 2009 for the United Kingdom and Ireland. In the UK, the industry advanced £14.3 billion at the end of June 2009, against invoices, stock, property and other trading assets worth £27.3 billion. This represents a reduction in advances compared to the high water mark of £17.5 billion in 2008Q3, and the same can be seen in Ireland, where the advances were €1.4 billion against €3.4 billion of assets down from the previous quarter. The downward trend in asset based finance parallels the reduction in the growth of total M4 lending (excluding the effects of securitisations etc) to private non-financial corporations (PNFCs) which has seen growth fall from over 10% in 2007 to below 1% today. Undoubtedly the figures reflect the prevailing economic conditions – weak demand, low investment spending, fewer acquisitions and tighter supply – discussed in this report. But just as there are some encouraging signs in the wider economy, there are signs that the contraction in asset based lending is easing.

THE MONETARY POLICY STANCE, DESIGNED TO INCREASE BANK DEPOSITS, INCREASE LENDING BY BANKS AND EASE CAPITAL MARKETS, HAS HAD MIXED EFFECTS SO FAR.

The combination of low interest rates and quantitative easing policy in the UK, discussed in the previous section, is designed to have a threefold influence on the economy. The first purpose is to increase nominal demand in order to reduce the depth and duration of the recession by reducing the cost of borrowing and by making liquidity available to the financial system. It is expected to drive up the price of the liquid assets that the Bank purchases, reducing their yield, and increasing the assets of the sellers. As a result deposits in the banking system are expected to rise, and banks will have incentives to expand their loans to the private sector. The extent that they are willing to lend depends on their own need to write off losses and restructure, and the expansion of the loan book also depends on the private sector's desire to borrow for investment and acquisition.

The most recent release of data on deposit and loan growth (the growth of M4 deposits at banks and building societies and the loans that they make) are given in **Table 3**. These show a mixed picture across sectors of the UK economy. Deposit growth for households and non-financial firms is 2.5% and 0.2%, respectively, compared to a year ago, while deposit growth for other financial corporations (OFCs) is 41.2%. If data for OFCs are included in the M4 growth figures then the aggregate figures show a 14.5% expansion, but when they are excluded this falls to 2.1%. A similar effect can be seen in the M4 lending figures. Lending growth for households and non-financial firms is 2.2% and -2.9%, respectively, compared to a year ago, while lending growth for other financial corporations (OFCs) is 32.0%. Annualised M4 lending growth is 8.2% but this falls to 0.7% if OFCs, securitisations and loan transfers are excluded. Excluding the OFCs, the reduction in the growth rate of bank deposits has continued unabated in almost every quarter since 2008Q3, while lending growth has fallen successively since 2007Q2. The effects of quantitative easing to date appear to have begun to limit the rate of decline in deposit growth but have had no noticeable effect on lending growth.

Quantitative easing has injected liquidity into the commercial bond and paper markets. As Deputy Governor, Charles Bean explained in a speech in May "By standing ready to buy commercial paper and corporate bonds, [the Bank] hope to improve their liquidity, lowering the spread above safe assets of equivalent maturity, and with it the cost of finance to business." There is some evidence that this has worked as net bond issuance has been buoyant in 2009Q2 as given in **Table 4**. Private sector non-financial companies raised £11.2bn in sterling capital markets in June 2009 and £2.7bn in foreign capital markets. The Bank of England argues that for companies with access to these markets refinancing using corporate bond issues has been preferred to bank borrowing, which is more costly and at shorter maturity than offered before the financial crisis. These firms are mostly large firms with investment grade ratings on their bond issues. It is possible that these large

net issues are responsible for some of the contraction in net lending. All the main sectors of the UK economy have experienced a contraction in the growth of net lending. The combined effect of greater capital market issues, additional bank loans and loan repayments in all currencies increased total funding to the private non-financial companies by £7.6bn at the end of 2009Q2, but this has subsequently been reversed with a £12.5bn reduction in July.

GROWTH IN ASSET BASED FINANCE HAS ALSO FALLEN, REFLECTING WIDER ECONOMIC TRENDS AND BANK LENDING FIGURES...

Asset based lending is closely tied to the economic cycle since lenders purchase invoices against sales, offering up to 90% of the value of the outstanding debts, or against the value of stock and fixed assets like machinery or plant. Turnover for asset based finance companies in the UK will necessarily reflect any reduction in sales volume or changes in asset valuation and will be affected by variation in client numbers as some firms fail.

The recorded ABFA figures in **Table 5** on client sales show sales of £46.6bn in 2009Q2, compared to £45.7bn in 2009Q1, representing a growth rate of 2% quarter-on-quarter. Asset based finance figures tend to grow through the year, with the first quarter often seeing a fall compared to the last quarter of the previous year, so these figures may reflect seasonal patterns in the data. Compared to a year ago the sales are down by 12%, and taking figures for the year to date with those in 2008 the sales are down by 9%. Many companies have reported a fall in sales, and these figures reflect that experience, the

CBI distributive trades survey for August reported a fourth consecutive fall in monthly figures for retail sales reported by its respondents.

The breakdown of sales figures into categories by the ABFA reveals the type of asset based finance used by clients of ABFA members. Annualised growth in turnover by product category is recorded in **Chart 8**, which shows clients' sales have fallen for domestic factoring and domestic invoice discounting since 2008Q2, and the total has declined since the financial crisis. With the exception of clients' sales for export factoring all categories saw a reduction in the figures year on year. Domestic factoring and invoice discounting, which represent over 90% of the total sales, saw falls of 18 and 11%, respectively, on an annualized basis. There were similar declines in balances drawn down by clients with advances falling by 17% in the same period. However, this fall in advances does not necessarily mean that money is not being offered by the financiers.

The declining average advance figure from 56% in 2008Q4 to 52% at the end of 2009Q2 supports anecdotal evidence that, although additional funding is available, many companies using invoice finance are showing prudence by only borrowing what they need to survive. This is not unusual during periods of recession and low confidence and as a result many companies have decided not to draw down all of the funds that are available to them. The lower levels of advances are therefore the result of reduced demand rather than reduced availability of supply. This is due to lower levels of organic growth within the existing client base and a more cautious approach to borrowing.

TABLE 3 12 Month Money and Lending Growth Figures	M4 Households	PNFCs	OFCs	M4 lending Households	PNFCs	OFCs
Apr 09	3.2	-1.2	51.7	3.4	0.5	38.2
May 09	2.9	-1.7	50.1	3	0.2	43.3
June 09	2.6	-0.3	38.9	2.6	-1.2	33.8
July 09	2.5	0.2	41.2	2.2	-2.9	32
	M4	M4 excl OFCs		M4 lending	M4 lending excl OFCs and securitisations	
Apr 09	17.2	2.3		10.2	2.5	
May 09	16.5	2		11.1	2.2	
June 09	13.7	2		8.3	1.5	
July 09	14.5	2.1		8.2	0.7	

TABLE 4 Capital Issues £bn Seasonally Adjusted	Sterling capital market issues	Foreign currency capital market issues	Total funds raised
April 2009	2.4	0.8	-1.6
May 2009	3.1	1.1	0
June 2009	11.2	2.7	7.6
July 2009	2.1	0.3	-12.5

Source for Tables 3&4 Bank of England

CHART 8
Annualised Growth in Turnover by Product Type

Source ABFA



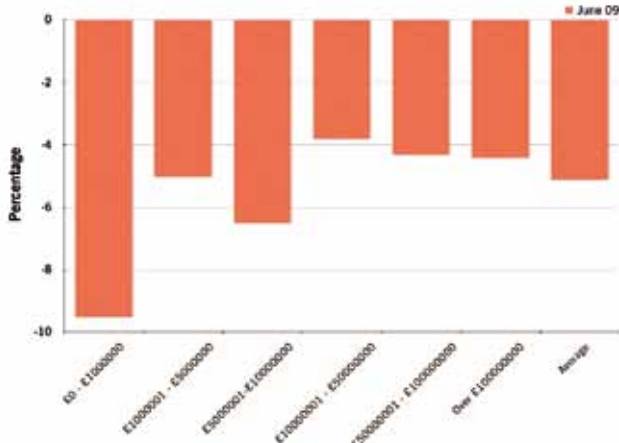
CHART 9
Annualised Growth in Total Advances

Source ABFA



CHART 10
Quarterly Change in Advances by Firm Size

Source ABFA



The growth of total advances has increased at an average rate of 16% from 2007Q1 to 2008Q3, and has declined only recently as shown in **Chart 9**. The majority of advances - over three quarters of the total - are pure invoice finance, representing £11.2bn out of the total of £14.3bn, raised against outstanding debts. The breakdown of client numbers using different types of finance reveals that 86% of clients engage in asset based financing of domestic activity, the remainder being import/export oriented. The majority use some form of factoring and invoice discounting, with domestic factoring used by 45.4% of clients and domestic invoice discounting used by 40% of clients, while export or mixed export and domestic factoring used by 8.6%. Just 1.4% of clients use asset based lending, but these clients obtain 16.8% or £2.4bn of the total advances.

ASSET BASED FINANCE FIGURES ILLUSTRATE THAT SMALL FIRMS FACE A HARSHER FINANCIAL ENVIRONMENT COMPARED WITH LARGER FIRMS ...

In the UK, the industry advanced £14.3bn at the end of June 2009, against invoices, stock, property and other trading assets worth £27.3bn. The total advances contracted by an annualized rate of 17%, and total security values fell by 13%.

A large number of these advances were made as factoring arrangements for small firms with turnover less than £500,000 per annum. The figures for December 2008 indicate 18,354 clients were advanced just under £0.6bn of the total advances, with an average advance to firms in this group of just over £35,000. But nearly a quarter of advances, £3.5bn, were made to large-sized firms with assets in excess of £100 million. It is noticeable that changes in the advances to firms of different sizes have not all been adjusted to the same degree. The quarterly change in advances by borrower size, reported in **Chart 10**, shows that smaller firms with turnover less than £10mn experienced a worse decline in advances in 2009Q2 compared to medium and large firms with turnover above £10mn. Their advances contracted by more than average, while for firms with turnover more than £10mn the advances fell less than average. This reinforces Bank of England findings in *Trends in Lending*, which argues that there has been an improvement in lending conditions for larger companies, partly because access to finance from capital markets has eased, but also because banks are showing greater willingness to lend. The August *Access to Finance* survey by the CBI also confirmed this finding, with large firms seeing some improvement in access to credit, while small firms found credit lines tightened, and they expect this to continue over the next quarter.

In Ireland, the advances were €1.4bn against €3.4bn billion of assets, a decline of 23% on a year ago. Once again a large proportion of the client numbers are small businesses receiving small advances - these firms received €23mn, which is about 1.5% of the total advances in 2009Q2 while firms with turnover in excess of €50mn received €416mn, or 30% of the total advances.

TABLE 5 Clients Sales June 2009	Quarter ended			Year to date		
	June 2009	June 2008	% change	June 2009	June 2008	% change
Clients Sales (£m)						
Domestic Factoring	3,957	4,803	-18%	7,826	9,603	-19%
Domestic Invoice Discounting	39,928	44,826	-11%	78,796	86,050	-8%
Export Factoring	384	380	1%	782	779	0%
Export Invoice Discounting	2,182	2,335	-7%	4,469	4,459	0%
Import Factoring	205	417	-51%	482	830	-42%
Total Client Sales	46,656	52,761	-12%	92,335	101,721	-9%
Non Recourse in total	4,813	5,830	-17%	9,577	11,408	-16%

Source ABFA

TABLE 6 Summary of UK and Ireland Credit Conditions Surveys (past 3 months)							
Net Percentage Balance	United Kingdom				Average Response	Ireland	
	Jun-08		Jun-09			Jun-08	Jun-09
Availability of credit	-32.1		14.3		Availability of credit	2.55	2.76
Factors affecting credit availability					Factors affecting credit availability		
Economic outlook	-44.3		-12.7		- Costs related to banks' capital position	2.77	2.85
Sector risk	-29.2		-2.3		- Banks' ability to access market financing	2.69	2.91
Pressure from capital markets	-19.9		2.2		- Banks' liquidity position	2.8	3.01
Risk appetite	-39.9		0		- Competition from other banks	2.94	2.94
Cost/availability of funds	-29.6		12.9		- Competition from non-banks	2.94	2.95
					- Competition from market financing	2.92	2.96
					- Expectations regarding general economic activity	2.4	2.42
					- Industry or firm-specific outlook	2.35	2.38
					- Risk on collateral demanded	2.8	2.67
	Jun-08	Jun-09	Jun-08	Jun-09			
Approved applications	-25.7	3.5	-24.2	5.4	Approved applications		
Changes to spreads	-63.4	-12.2	-72.5	-11.2	Changes to spreads	2.37	2.58
Changes to fees	-48.1	-11	-68.4	-6.8	Changes to fees	2.8	2.8
Changes to collateral required	-17.9	-7.3	-15.8	-3.5	Changes to collateral required	2.63	2.65
Maximum credit lines	-27.2	3.6	-44.2	7.4	Covenants	2.7	2.77
Covenants	-37.1	-27.1	-40.1	-24.2	Maturity	2.72	2.74
Bank of England: Negative Net balance indicates tighter credit availability/higher cost/terms compared to the previous 3 months Central Bank of Ireland: Positive number indicates tighter/more costly compared to previous 3 months							

Source Bank of England and the Central Bank of Ireland

Figures recorded as net percentage balance are the difference between the percentage of respondents with positive and negative experiences. Average responses are responses on a scale 1-5, where 1 is much worse and 5 is much better conditions.

...ACCESS TO CREDIT HAS BEGUN TO IMPROVE IN THE UNITED KINGDOM BUT NOT IN THE EUROAREA...

The Confederation of British Industry (CBI) *Access to Finance* survey reports that the availability of existing facilities and new credit improved for larger firms but remained tight for smaller firms as reported by borrowers. This has also been confirmed in surveys by the Bank of England and European Central Bank, who conduct their own surveys of lenders. **Table 6** reports the credit conditions assessed by UK and euroarea lenders. For the United Kingdom conditions appear to have improved considerably over the previous year, as many more lenders note that credit

availability has eased. The survey reports a positive net balance compared to a negative net balance in June 2008 demonstrating that lenders see an increase in the availability of credit to private non-financial corporations in 2009Q2 as resources have become more readily available and the cost of funds has fallen with the decline in LIBOR. When asked their reasons for changes to credit availability lenders cite an improvement in economic conditions, sector risk, capital market pressures, their own risk appetite and the cost of funds, all of which have smaller negative or positive net balances compared to negative net balances in June 2008. The terms and conditions attached

to loans for medium and large firms have eased, although they remain tight compared to conditions before the financial crisis. Although the demand for credit remains largely unchanged, lenders believe that demand for credit will increase in the next quarter. Consistent with the lagging nature of financial distress, lenders report increases in defaults, and losses given default over the previous quarter. It is important to note that these results refer to credit conditions for medium and large firms because small business results are combined with responses for households.

The euro area *Bank Lending Survey* conducted for July 2009 asked similar questions of 100 euroarea banks of which 5 were from Ireland, and these are also reported in **Table 6**. Comparing results from July 2009 with July 2008 it is clear that credit standards remain tight in the euroarea, and have not seen the same degree of easing as in the United Kingdom, although direct comparisons between surveys are difficult. Credit tightened very sharply for enterprises during the second quarter due mostly to expectations about future conditions and the sector specific outlook. Banks do not see substantial changes in their markets due to changing economic conditions, competition, or the industry outlook. Their own access to finance has improved slightly as the average responses are slightly higher, indicating an improvement in conditions. Banks all reported very similar responses on their spreads, fees, collateral requirements, covenant restrictions and maturity of loans compared to a year ago.

MORE FIRMS ARE SHOWING SIGNS OF FINANCIAL DISTRESS.

The amount of credit protection payments being made by the asset based finance industry to clients in the UK has increased to £21.2mn in the year to June 2009 compared with £14.4mn in June 2008 as shown in **Chart 11**. These payments are made by the ABF industry to their clients when their customers default on debt receivables where a non-recourse facility is in place. The payments rise as more businesses fail to settle debts and become insolvent. **Chart 11** also shows insolvency and liquidations for England and Wales. Seasonally adjusted figures show there were 5,055 company liquidations in 2009Q2, an increase of 2.9% on the previous quarter and an increase of 39.1% on the same period a year ago. Added to these figures were 1,529 other corporate insolvencies made up of companies going into receivership, administrations or voluntary arrangements. In total these represented an increase of 22.7% on the same period a year ago. Liquidations in Scotland and Northern Ireland rose by 10% and 14% respectively compared to a year ago. The number of insolvency cases reported grew by 39.1% in the last year, mirroring ABFA figures on credit protection payments, which have risen by 33% over the same period. These figures typically lag economic data as financial distress cumulates through a recession.

ABFA figures on the average number days debts remain outstanding are given in **Chart 12**. The figure for factoring clients has been pulled back to 62.4 for factoring clients from 70 days at the time of the previous economic report.

CHART 11
Protection Payments to Clients and Insolvencie

Source ABFA

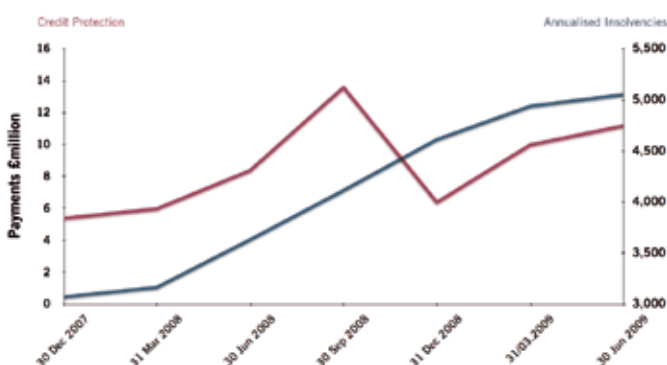


CHART 12
Debt Turn

Source ABFA



The figure for invoice discounting has also improved slightly at 60.7 compared with 61.0 in the previous report. Businesses are waiting fewer days to receive payment on debts and sales invoices as managers of accounts receivable have worked to chase outstanding debts more actively and bring them back towards their recent average values shown by dashed lines.

SUMMARY

ABFA statistics report asset based finance figures for June 2009 show the industry advanced £14.3 billion against assets worth £27.3 billion. While this represents a reduction in advances compared to the high water mark of £17.5 billion in 2008Q3, it reflects the general decline in economic conditions. A similar story emerges in Ireland where advances were €1.4 billion against €3.4 billion of assets down from the previous quarter. But just as there are some encouraging signs in the wider economy, there are signs that the contraction in asset based lending is easing.



The Asset Based Finance Association (ABFA) is the body that represents the interests of the asset based finance industry in the UK and Ireland. Members range from subsidiaries of major international banks to independent finance providers. The ABFA provides a variety of services to UK and Irish members, including on-line services, educational courses, lobbying, PR, and educational and networking events. The ABFA is a source of information and reference for those businesses looking to find out more about the products and services that this industry can offer.

For more information on the ABFA, or for more information on asset based finance in general, visit www.abfa.org.uk

This economic report was commissioned by the ABFA, and was written by Professor Paul Mizen, Director of the Centre for Finance and Credit Markets, University of Nottingham.

Disclaimer: The views are those of the author and not necessarily those of the Centre for Finance and Credit Markets or the University of Nottingham.



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Economic Report

