

The logo for ABFA, featuring the letters 'A', 'B', 'F', and 'A' in a stylized, serif font. The letters are white and set against a dark purple background. The 'B' and 'F' are connected, and the 'A's are also connected to the 'B' and 'F' respectively. The logo is positioned at the top left of the white rounded rectangle.

ABFA

Economic Report

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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.



EXECUTIVE SUMMARY

Economic growth will slow in the UK and Ireland, as it has done in the US and is beginning to do in other parts of the euroarea. This will curb demand, ease pressures in labour markets and reduce capacity utilization.

Credit growth will be constrained as banks face higher cost of funds in interbank markets, and attempt to rebuild capital following losses and write-downs on their assets. Uncertainty over the future direction of growth, inflation and interest rates will further reduce credit.

Surveys show lower expectations for sales, orders and profits in the coming quarters, reported by the British Chamber of Commerce, the Confederation of British Industry and the Bank of England Agents. They also expect a reduction in investment and employment.

Retail sales figures are volatile, and non-retail sales confirm this pattern. UK official figures appear to contradict survey evidence from the CBI and the BRC. Evidence from the non-retail sales figures collected by ABFA members shows domestic sales of non-retail sectors were down in the first quarter, but picked up in the second, in line with retail sales, which dipped in 2008Q1 but

rose in Q2. Exporters have been hit by currency movements, while importers were affected by the slowing UK economy. The major component of total sales - domestic sales by firms using invoice discounting - has increased in quarter two.

Credit conditions are also tightening, with central bank surveys showing that banks are raising rates and terms attached to loans. While demand and supply are falling, the official figures continue to grow as firms use prearranged credit lines. Evidence of distress is emerging in many sectors as firms take longer to pay outstanding debts, and more firms declare insolvency. It is anticipated that asset based finance will grow as bank lending declines.

Asset based finance increased by 15% in the year to June 2008. The asset based finance industry advanced £17.3 billion at the end of June 2008, against invoices, stock, property and other trading assets worth £31.2 billion. Growth in asset based finance exceeded the growth of total lending to firms, which grew by 13.2% over the same period. Asset based lending is expected to increase as credit from banks falls and the economic climate worsens.

GLOBAL ECONOMIC OVERVIEW

GLOBAL GROWTH IS SLOWING...

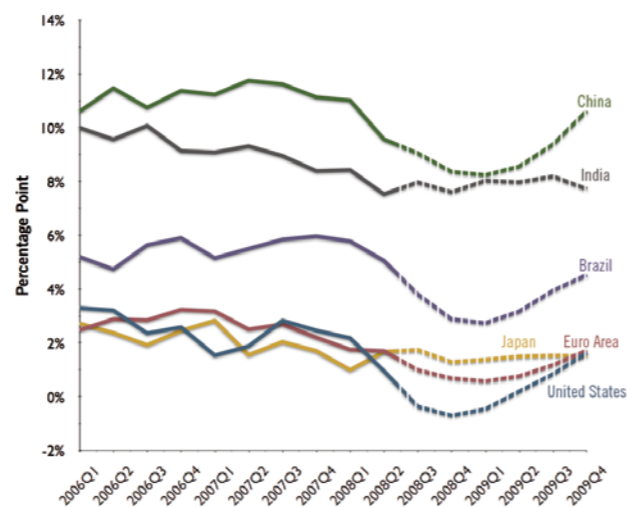
The half year to July 2008 has seen global growth weakening. This has been most noticeable in the United States where the economy began to shrink from the third quarter of 2007 and weak first quarter GDP growth in 2008 was followed by slowing in the second quarter. Recession in the US is now a distinct possibility - **Chart 1** reports actual and projected GDP growth figures to the fourth quarter of 2009 from the International Monetary Fund. Other advanced economies have also seen slow growth. The euroarea posted slightly higher GDP growth in the first quarter of 2008, but is also projected to experience a downturn in late 2008 and 2009 as its appreciating exchange rate hampers exports. Having avoided the worst of the financial market turmoil, euroarea economies have felt the effects of oil price increases and declining demand for exports. In general, however, countries with looser ties to the US business cycle have been more resilient, particularly Japan, although recent export weakness, as the yen has appreciated to the dollar, is expected to result in flat GDP growth over the next year. In the emerging industrialised countries, China, India and Brazil, there is evidence of slowing growth in 2008 as exports to the US fall off, but because the prospects of China and Brazil are closely connected to the US cycle an upturn is projected for late 2009.

...DUE TO FALL OUT FROM THE CREDIT CRUNCH AND FALLING HOUSE PRICES...

The immediate cause of the global slowdown has been the uncertainty in financial markets and weaker demand as house prices continue to fall in the US and the UK. The credit crunch, which was triggered by the increase in defaults in US subprime mortgages, spread to financial markets in August 2007. Despite significant action by central banks to inject liquidity into the markets, spreads of interbank rates particularly at rates of one

CHART 1
Economic Growth: Outcomes and Projections

Source: International Monetary Fund



Note: Solid lines show actual outcomes, dotted lines show projections

month or more, have risen sharply. Banks have incurred losses on holdings of mortgage based securities and collateralized debt obligations and have made efforts to rebuild capital and retain liquidity. As a result they have reduced lending among themselves and to non-banks. At the same time, the decline of house prices in the US continues, this has reduced the net wealth of consumers and has contributed to the downturn. Evidence suggests that tax rebates offered by the US government have not resulted in stronger consumer spending. Until house prices stabilize the negative pressures on consumer expenditure and financial institutions will continue.

...AND HIGHER COMMODITY PRICES.

Consumer spending and economic activity have also been negatively affected by the increase in commodity prices, particularly oil, but also agricultural commodities and metals. These commodity price increases have fed through to inflation which has edged upwards. Inflation in the United States, is currently 4.8% per annum, and for the eurozone it is 4.0%, the highest level since the inception of the euro. **Chart 2** shows that inflation has risen sharply in the US, euroarea and the US in recent months. China and India are also experiencing higher levels of inflation in recent months, in China the rate is 8.3% and in India 7.8%, and as they attempt to rein inflation in their economies will grow less fast than they have done in the recent past. As energy and raw materials bills have risen employment has declined and consumers have reduced expenditure on non-essential items. There is some doubt whether demand from emerging economies will be sufficient to pull advanced economies away from a recession. While China has attempted to control inflation with tighter monetary policy its managed exchange rate versus the dollar has limited its freedom to use monetary policy. Oil exporting countries in the Middle East have faced similar difficulties as their exchange rates are pegged to the dollar.

CURRENCY MOVEMENTS ARE CORRECTING GLOBAL IMBALANCES SLOWLY...

On currency markets the depreciation of the US dollar against other major currencies notably the euro and the yen has further raised dollar prices of imported goods and services. Consumers have also been affected by second round effects as more expensive raw materials prices have been passed through by manufacturers struggling to deal with rising costs and falling demand. For consumers in the euroarea the weak dollar has cushioned the direct effects of rising commodity prices but an appreciation against other countries has worsened second round effects by increasing the cost of imported manufactured goods and services. The net effect of dollar weakness has been to reduce the US current account deficit, but it has had little effect as yet on surplus countries such as the major oil exporters and large emerging Asian countries.

...BUT THE BALANCE OF RISKS AND THE DIRECTION OF MONETARY POLICY IS UNCERTAIN.

The combination of falling growth, rising prices and financial market uncertainty presents difficulties for policymakers. Central banks have generally faced what the International Monetary Fund refers to as 'a delicate balance between alleviating the downside risks to growth and guarding against a buildup of inflation'. Future policy decisions will be subject to greater uncertainty. Monetary authorities in different countries have adopted varying strategies. In the US the Fed has cut rates aggressively since mid 2007, which runs the risk of allowing inflation to increase but helps alleviate pressure on the financial system and borrowers facing higher costs. With rising inflation figures the danger of easing policy rates too much to avert a downturn or further financial market woes is that expectations about future inflation may also rise, increasing the costs of keeping inflation to target in the future. In the euroarea and the UK the rates have been raised or kept on hold because inflation fears have taken precedence over other concerns.

CHART 2
CPI inflation Rates

Source: Federal Reserve, European Central Bank, Bank of England

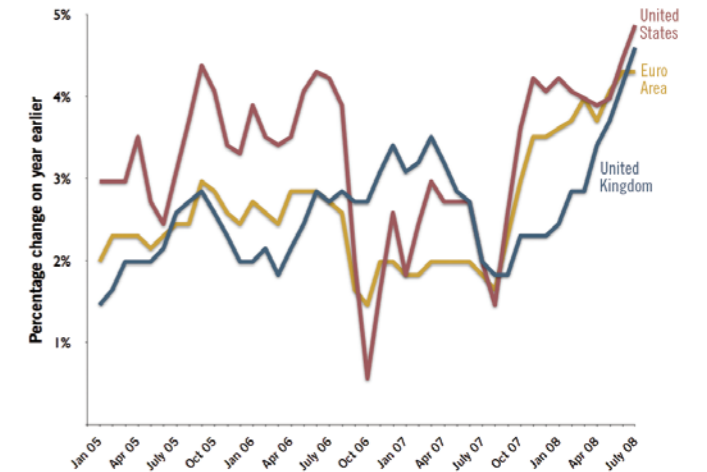
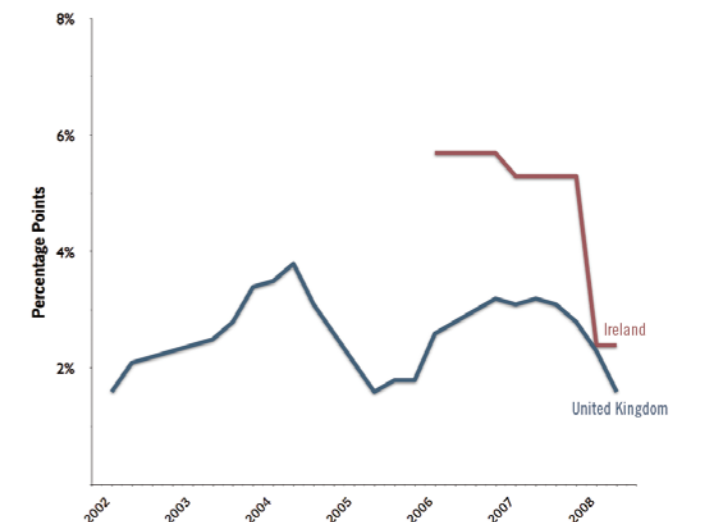


CHART 3
Economic Growth Paths: UK and Ireland

Source: UK Office for National Statistics; Ireland Central Statistical Office



TRENDS IN THE UNITED KINGDOM AND IRELAND

OUTPUT GROWTH IS EXPECTED TO FALL IN THE NEAR TERM, RISING AGAIN FURTHER OUT...

Chart 3 shows that according to the official statistics, output growth for the United Kingdom has fallen to an annualized rate of 1.4%, which lies below its lowest value at any previous time in the last decade. In 2008Q2 GDP growth was revised downwards to 0.0% the weakest data since 1992 and the end of 63 successive quarters of economic growth. According to projections the Bank of England's Monetary Policy Committee GDP growth will decline in the near term and continue to deteriorate into early 2009, before picking up sharply thereafter. The uncertainty surrounding their judgment is large, and surveys are more pessimistic. Output growth in quarter two shows that the largest deterioration for ten years, with construction falling 1.1%, manufacturing by 0.8%, only services showed modest growth of 0.2%. Businesses have lowered capacity utilization rates, suggesting activity is expected to continue to decline.

Irish real GDP growth dropped from an average of 5.3% in 2007 to 2.4% in 2008, and it is also expected to decline further.. The Irish central bank forecasts a downturn in early 2009 but its forecast picks up to 3.6% thereafter, if the world economy regains its momentum. They are somewhat cautious about these projections of Irish growth because of the high degree of uncertainty.

TABLE 1 Expenditure Components of Demand	United Kingdom				Ireland
	2007(a)	2007 Q3(b)	2007 Q4(b)	2008 Q1(b)	2007(a)
Household Consumption	3.13	0.9	0.4	1.1	6.32
Government Consumption	1.88	0.3	0.2	0.9	14.11
Investment	6.02	2.7	2.2	-1.5	1.20
Total Domestic Expenditure at market prices	3.77	0.8	1.5	0.7	
Exports	-5.08	1.3	-1.2	0.7	6.78
Final Expenditure	1.79				
Imports	-2.36	4.5	-0.8	-1.1	4.06
Gross Domestic Product at market prices	3.06	0.6	0.6	0.3	6.03

Chained volume measures,
 (a) percentage changes on a year earlier
 (b) percentage changes on a quarter earlier

Source UK Office for National Statistics, Irish Central Statistical Office

...DOMESTIC DEMAND IS DECLINING, ALTHOUGH NET EXPORTS HAVE IMPROVED...

The demand for goods and services by UK households has fallen considerably in the first half of 2008, which reflects higher costs of food and energy, lower real after-tax incomes and tightening consumer credit conditions for existing and new debt. This is likely to continue over the next half year as disposable incomes are squeezed by further price increases and lower pay settlements, but the extent of this effect depends on the future path of energy and food prices, and whether borrowing costs fall from their recent elevated levels. **Table 1** based on official data from the Office for National Statistics and the Irish Central Statistical Office shows that the contribution to real GDP growth from consumption is positive. Retail sales are up compared to a quarter ago, but monthly sales figures have been highly variable, and surveys by the Confederation of British Industry (CBI) and the British Retail Consortium (BRC) are more negative. We discuss these in more detail in the next section.

Other components of demand are unambiguously negative, including business and property investment. The fall in residential and commercial property prices has curtailed real estate investment (which amounts to about 40% of total investment). Firms have reported weak demand and uncertainty about future economic conditions to have been most influential over investment plans, while credit tightening as yet has had a relatively limited effect (we return to this issue later in the report). For producers in the United Kingdom the movement in the sterling exchange rate against the euro has boosted exports to the euroarea

(approximately 50% of UK exports by destination), but exports to another major market, the United States, have been adversely affected by appreciation against the dollar. Net trade has had a positive effect on demand, but the prospects for the future depend on future movements in exchange rates and the slowdown in export markets, which is uncertain.

In the Republic of Ireland consumer expenditure grew at a slower rate compared to 2007, and consumers reported that they were increasingly concerned about the prospects for the Irish economy. Consumption is expected to slow further in the last half of 2008 and early 2009. Investment expenditure has been the main drag on Irish economic growth. The flat investment figures for 2007 have given way to declining investment. While manufacturing grew strongly, it was offset by the sharp fall in residential construction, which fell by 8.8%. House prices declined by 8.8% in early 2008 compared to prices twelve months earlier and house completions fell to their lowest levels since March 2003. For producers in Ireland the appreciation of the euro against the pound and the dollar along with slower world growth put pressure on export growth.

... BUT CONFIDENCE IS WEAK AND BUSINESSES EXPECT TOUGH TIMES AHEAD.

Surveys of businesses across the UK present a bleak picture. Many firms are facing difficult conditions, with pressure to

increase prices due to rising costs on the one hand and falling demand undermining sales in domestic and export markets on the other. The balance of firms reported to be more pessimistic about conditions in the second quarter is greater now than it was in the first quarter of 2008, as indicated by **Table 2**. The British Chamber of Commerce (BCC) reports in 2008 Q2 the balance of firms in manufacturing reporting higher v. lower home sales fell by 15 points to -3% and home orders fell 13 points to -5%, both the lowest values since the end of 2001. The service sector is reported to have seen the worst sales and orders on balance since the early 1990s falling respectively by 19 and 21 points. Firms have been more pessimistic about employment in the last quarter and are inclined to be more negative about the future. The balance of firms in manufacturing planning to increase v. decrease investment fell 12 points to -2% while in services it fell 3 points to 5%, and for both manufacturing and services training is down by 10 points. Businesses in manufacturing and service sectors are gloomy about turnover and profitability, where on balance the number of firms anticipating greater weakness is higher than it was in the previous quarter. The Confederation of British Industry concludes the economy will probably stagnate in 2008, and that growth prospects for 2009 and into 2010 look no better than 'anaemic'. In a recent survey of 600 businesses expectations for output over the next quarter were at a seven-year low, the worst outlook since the end of 2001. To a large extent this depends on how the world economy fares in the next few years.

TABLE 2 British Chamber of Commerce Survey	Manufacturing		Services	
	2008Q1	2008Q2	2008Q1	2008Q2
Home Sales	12	-3	17	-2
Home Orders	8	-5	14	-7
Employment - last 3 months	9	3	16	7
Employment - next 3 months	9	-1	21	8
Investment - plant & machinery	12	2	8	5
Investment - training	21	11	24	14
Confidence - turnover	43	34	40	17
Confidence - profitability	27	5	17	1

Source British Chamber of Commerce

All figures are recorded as a percentage balance i.e. the percentage of firms surveyed reporting improvements minus the percentage of firms surveyed reporting worsening conditions. As numbers become smaller from one quarter to the next, it indicates a balance of opinion that conditions are worsening.

POLICYMAKERS AIM TO BALANCE DOWNSIDE RISKS TO ACTIVITY AND UPSIDE RISKS TO INFLATION...

Inflation prospects in the UK and Ireland are strongly influenced by two competing factors. There is the moderating pressure on inflation from the reduction in activity that needs to be set against the inflationary pressure from increases in prices of energy and food as can be seen in **Chart 4**. The effects of globalisation in previous years was beneficial because falling inflation or deflation in certain imported goods offset increases in prices of other goods and services in the CPI basket. But this benefit is no longer at work because inflation in China and India has raised prices of imported goods significantly. In addition rising energy prices have increased transportation, production and retailing costs. The prospects for inflation depends on policymakers assessments of future movements in oil and gas prices, exchange rate movements, global demand and inflation prospects in emerging export economies. In the United Kingdom inflation has exceeded 3.0% the trigger for the Governor of the Bank of England to write an open letter to the Chancellor, and in July 2008 reached 4.4%. The Bank of England's CPI inflation projection (assuming market expectations of interest rates hold) peaks at 5% in the second half of 2008, and then levels off until mid 2009 when it falls back towards the target. Markets have concluded that any prospect of interest rate cuts has been postponed by the peak of inflation in the near term, but there is considerable uncertainty in the Bank of England's outlook as indicated by the three-way split in the Monetary Policy Committee voting patterns two consecutive months in June and July. Official UK interest rates are expected to remain close to 5% for the foreseeable future. In the euroarea inflation has climbed to 4%, twice the upper level of the range 0-2% used by the ECB to maintain price stability over the medium term. The view of the Governing Council at its recent press conference was that inflation rates are likely to remain well above levels consistent with price stability for a protracted period of time and that risks to price stability over the medium term remain on the upside. The decision to raise interest rates in March and again in June and July reflect these concerns, but output growth is expected to slow in late 2008 and 2009.

... FINANCIAL CONDITIONS REMAIN TIGHT, AMID CONSIDERABLE UNCERTAINTY ABOUT FUTURE POLICY.

Globally we have seen the credit crunch work itself out in the financial markets over the second half of 2007 and 2008. Reappraisal of risks associated with structured financial products such as mortgage backed securities and collateralized debt obligations following increases in defaults in the US subprime mortgage market has continued to affect financial markets.

CHART 4
CPI Inflation and Energy Prices

Source UK Office for National Statistics

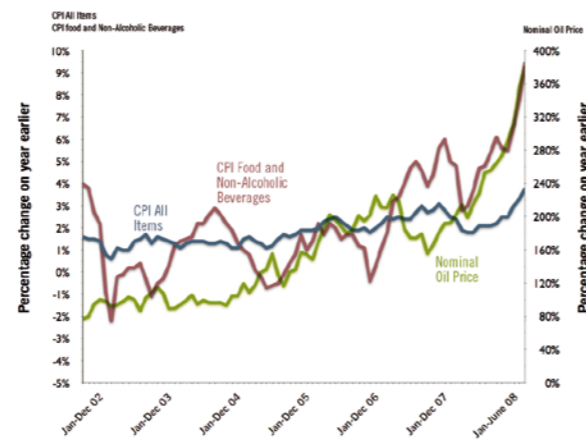
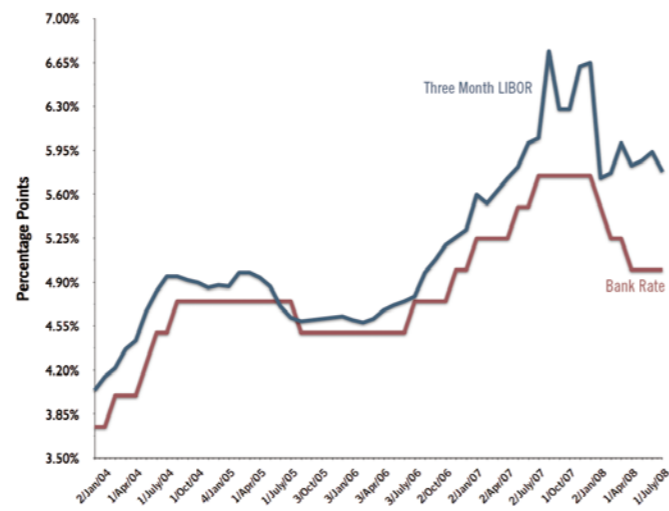


CHART 5
3-month Interbank Lending Rates and Official Rates

Source Bank of England



In the first half of 2008, interbank lending rates remained elevated compared to pre-August 2007 levels, and show noticeably higher spreads over the official rate, as illustrated in **Chart 5**. The cost of insurance through credit default swap markets peaked prior to the Bear Stearns rescue in March 2008, and banks have faced increased cost of funds in interbank markets at maturities of one month or more therefore central banks have provided additional liquidity through term lending. The Bank of England has done this through its Special Liquidity Scheme injecting more than £50 billion of liquidity into the financial system. The European Central Bank has extended term credit through similar means, against a range of collateral, for about 12 months, injecting €108.7 billion. Banks have attempted to rebuild their balance sheets after incurring heavy losses on investments in structured financial assets, by reducing lending to non-banks and by raising new capital. These effects have had repercussions on households and firms that report tighter lending conditions and higher rates on new loans. The rates on several forms of credit offered to firms are given in **Chart 6**. These mirror similar conditions in other economies including the United States and the euroarea. There is some evidence that while firms have continued to borrow from banks by drawing down pre-arranged credit, they face higher interest rates and stricter non-price terms e.g. covenants.

CHART 6
Cost of Borrowing for UK Firms

Source Bank of England



SUMMARY

The recent events in the macroeconomy and the financial markets give a clear signal about current and expected future economic conditions. Economic growth will slow in the UK and Ireland, as it has done in the US and is beginning to do in other parts of the euroarea. This will curb demand, ease pressures in labour markets and reduce capacity utilization. Banks and financial institutions have been adversely affected by the increased cost of funds in interbank markets, the need to rebuild capital following losses and write-downs on their assets, and by uncertainty over the future direction of policy. This will constrain credit growth on the supply side.

This message has been strongly reinforced by surveys of sentiment among private non-financial companies in the second quarter of 2008. The BCC, the CBI and the Bank of England Agents all report lower expectations for sales and orders in the coming quarters, a reduction in investment and employment, and a downturn in profits. Although manufacturing, transportation and construction are typically the first sectors to be affected by a downturn, conditions are reported to be as bad, if not worse, for the service sector.

CREDIT CONDITIONS AND ASSET BASED FINANCE

ABFA statistics report asset based finance figures for the half year to June 2008 for the United Kingdom and Ireland. In the UK, the industry advanced £17.3 billion at the end of June 2008, against invoices, stock, property and other trading assets worth £31.2 billion. This represents a growth rate of 15% from figures recorded in June 2007. By comparison growth of total M4 lending (excluding the effects of securitisations etc) to Private non-financial corporations (PNFCs) rose by £5.5 billion in June, or 13.2% over the same period. M4 lending is the total value of loans provided by banks and building societies, the growth of which provides a comparison to the growth of asset based finance. In Ireland, the advances were €1.7 billion against €4 billion of assets, a relatively small share of total private sector credit (PSC), which does not distinguish between lending to households and firms, but with a broadly comparable annualized growth rate of 12%.

We report on two themes that emerge from the ABFA quarterly statistics to June 2008 – indications of sales growth and credit conditions. Asset based finance companies routinely collect information on their clients' sales figures because factoring and invoice discounting provides finance against sales invoices. They also report uptake of asset based finance used by SMEs and larger firms either in place of or in addition to bank overdrafts and loans, venture capital, securitisations and other finance.

RETAIL SALES HAVE BEEN VOLATILE IN RECENT MONTHS, AND MORE OPTIMISTIC THAN SURVEYS...

The Office for National Statistics (ONS) provides official figures for retail sales, and other unofficial sources such as the CBI and the BRC provide surveys of business conditions. ONS figures have been extremely volatile in the last three months, with a monthly increase of 3.6% in May followed by a reduction of 3.9% in June and a surprise increase in sales in July of 0.8%. These recent official figures have been highly disputed. These figures are difficult to square with ONS figures for GDP growth, which show consumer expenditure fell by 0.1% over the second quarter. Both the CBI and the BRC report the balance of firms inclined to be more pessimistic about conditions in the second quarter is greater than it was in the first quarter of 2008.

...SALES PERFORMANCE FROM ASSET BASED FINANCE CONFIRMS VOLATILITY...

Asset based lending is closely tied to sales figures since borrowers seek to release liquidity tied up in sales invoices, obtaining up to 90% of the value. Asset based finance adjusts according to the variation in sales therefore the industry carefully records sales figures of its clients. The figures accord with a fall in retail sales in 2008Q1 and a subsequent increase in Q2.

ABFA figures on client sales are largely from sectors mostly other than retail, with the majority of the clients from manufacturing (31%), distribution (20%) and services (29%) sectors, and a further 23% from transport, construction and other industries. Firms in the retail sector amount to just 0.6% of the client base of 48,436 firms. In value terms the growth of sales over recent quarters has risen because of combined effects of growth in volumes of sales and inflation, which has increased their value. The annualized percentage changes in total sales in value terms have grown by 12%. These figures and a breakdown are given in the statistical appendix. ABFA separates firms' sales into the categories that indicate the type of asset based finance used by clients of ABFA members. Growth in the values of sales over the year show that sales of exporters have improved relative to sales in the year to date for the same period last year. Domestic sales of clients using invoice discounting also show an improvement over the year as a whole compared to 2007.

Quarterly sales growth figures adjusted for inflation are given in **Chart 7**. The figures provide sales figures for non-retail sectors in constant prices (2005=100) that help shed light on recent developments in the real economy. The figures show that while most firms were experiencing positive sales growth for 2007Q4, figures for 2008Q1 were negative, with a rebound in 2008Q2. This tallies with the ONS figures that show retail sales fell in the first quarter and rose in quarter two, with considerable monthly variation within the quarters. Taking all sales together 2008Q1 saw a reduction in sales of just under 5% and 2008Q2 saw a rebound with an increase of just over 5%. The rebound can be explained by the influence of positive sales growth for invoice discounting firms, which have the largest share of total sales. The picture for sales in other areas is downward.

Finance raised on domestic sales in non-retail sectors fell by 19% for firms using factoring and 3% for firms using invoice discounting. Firms that use factoring will typically be smaller firms, with fewer resources to control the sales ledger, while invoice discounting is usually used by medium-sized and larger firms that have good back-office arrangements. The large reduction in sales for firms using factoring compared to the smaller reduction in sales for firms using invoice discounting suggests that smaller, less established firms are facing more difficult conditions as the economy turns down compared to medium and larger firms. This confirms evidence reported by the ONS and the Bank of England that firms in transport, distribution and services (the sectors most strongly represented in the ABFA figures) have experienced slowdowns in recent months, as energy costs have increased and demand has declined. The figures for 2008Q2 show some improvement as sales for firms using factoring were falling at a slower rate of 2%, and for firms using invoice discounting sales rose by 7%. UK based exporters have experienced declining

sales in both 2008Q1 and 2008Q2. For firms using factoring the sales fell by 8% and 7% respectively, and for firms using invoice discounting in the latest quarter sales fell by 20%, reflecting the strength of the pound sterling against the dollar. Firms using import factoring did badly as UK economic growth slowed in 2008, seeing falling sales of 4% and 1% in each quarter. These are overseas firms that import to the domestic market, raising finance using their invoices to domestic purchasers.

On balance, while sales for many firms have a downward trend for 2008 – especially in export markets where the strong pound against the dollar has reduced sales, and import markets, where the weakness of the UK economy has dented sales – the total in the second quarter is up because invoice discounting, the major contributor to sales growth, has grown.

WHILE ASSET BASED FINANCE FIGURES SHOW HEALTHY GROWTH...

In the UK, the industry advanced £17.3 billion at the end of June 2008, against invoices, stock, property and other trading assets worth £31.2 billion. The total advances grew by an annualized rate of 15% over the year to June 2008. Total advances are given in **Table 3**. As economic conditions worsen, firms typically turn to asset based finance for funding to replace or supplement bank lending. By comparison growth of total M4 lending (excluding the effects of securitisations) to the corporate sector grew 13.2% over the same period. The vast majority of advances are made against debt (sales invoices) but advances are made against other assets, and these have grown at a faster rate. As firms have realized that asset based finance can release liquidity tied up in stock, plant and property, there has been an increase in the advances against these assets. Although still relatively small, the value of stock used to secure advances was £805 million at the end of June 2008, and the value of property was £567 million. Total advances against assets other than debt receivables amounted to £840 million at the end of the second quarter. **Chart 8** shows the total advances against debt, which is the majority component.

A large number of these advances are made as factoring arrangements for small firms with turnover less than £500,000 per annum, the figures for June 2008 indicate 39% of the clients were advanced just under 4% of the total advances, with an average advance to firms in this group of just under £35,000. But a large number of advances are made to medium to large-sized firms in the £1 million - £50 million turnover category. At the end of June 2008 44% of advances were made to these firms, with an average advance of £481,510. The small number of very large asset based lending arrangements to firms with £100 million turnover or more comprise some 32% of total advances and have an average advance size of £14.4 million. These large advances are likely to fall as merger and acquisition activity declines in the coming quarters.

CHART 7
Quarterly Growth in Sales Volume
Source ABFA

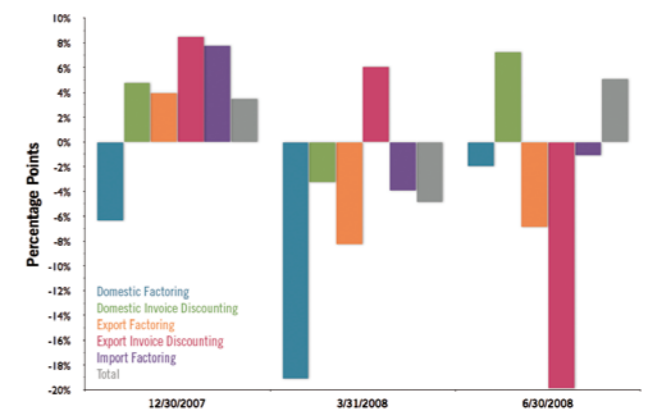
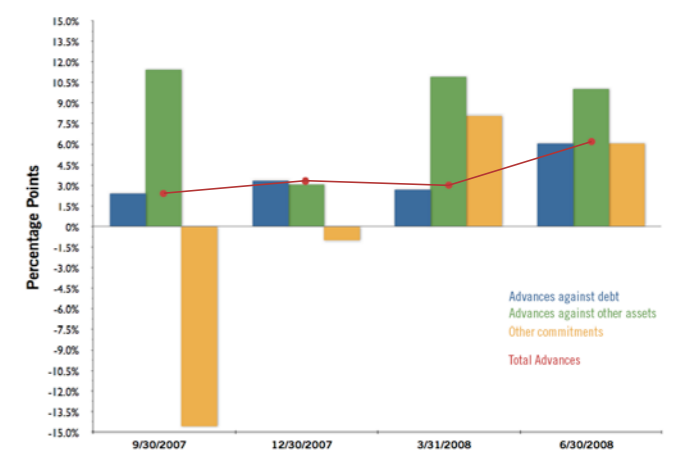


CHART 8
Quarterly Growth in Advances
Source ABFA



Source ABFA

TABLE 3 Advances by ABFA Members (£m)	Advances against debt	Advances against other assets	Other commitments	Total Advances
2007Q3	14300	441	233	14974
2007Q4	15074	503	197	15774
2008Q1	15479	558	213	16250
2008Q2	16421	614	226	17261

In Ireland, the advances were €1.7 billion against €4 billion of assets, a relatively small share of total private sector credit (PSC), but with a high rate of growth at 12%. Once again a large proportion of the client numbers are small businesses receiving small advances - these firms received €17 million or just under 1% of the total advances in 2008Q2 while firms with turnover in excess of €75 million received €596 million, or 33% of the total advances.

...THERE ARE SIGNS OF TIGHTER CREDIT CONDITIONS.

Credit conditions surveys indicate that there has been a tightening of credit markets over the past year as Table 4 demonstrates. Supply of credit has been tightening since the financial crisis began in 2007, and is increasingly affecting the volumes of new credit available to firms. The Bank of England's Credit Conditions Survey reports responses from lenders and the balance of respondents indicating lower overall unsecured credit availability to firms continued to fall – at a faster rate for commercial real estate borrowers and at a slower rate for other corporate borrowers compared to 2008Q1 and 2007Q4. The main reason given for the reduction are i) the macroeconomic outlook, ii) changing sector-specific risks, iii) a change in the risk appetite of the lender and iv) a change in the cost of funds. There seems to be little evidence that SMEs are affected more by these changes than large firms, since the balance of respondents reporting approvals of loans have fallen by similar amounts for SMEs and large firms. Lenders have increased interest rates, fees and collateral requirements on corporate borrowers, and anticipate doing so for the next quarter for all firms. Lenders indicate that demand for credit is also weaker because firms have lowered their investment intentions. There has been a reduction in demand for particular purposes, such as commercial real estate investment, capital investment and mergers and acquisitions. In general the weaker economic outlook and uncertainty about the direction of monetary policy has meant firms are more cautious about investment.

The euro area Bank Lending Survey July 2008 conducted for Irish banks found similar conclusions. Credit standards tightened for enterprises during the second quarter and were expected to continue to tighten in quarter three. The reasons for the tighter standards were cost of funds and balance sheet constraints, and the changing perception of risk. Demand also slackened as firms engage in less fixed capital investment and undertake fewer mergers and acquisitions.

THIS HAS NOT YET APPEARED IN THE OFFICIAL LENDING FIGURES...

Data from the Bank of England on M4 lending (excluding the effects of securitisations etc) to private non-financial corporations (PNFCs) rose by £5.5 billion in June, meaning annual growth increased to 13.2%. This represents a slight increase in the annual growth rate compared to a year ago when M4 lending to PNFCs grew by 11.8%. The figures for Irish private sector credit (including households and firms) have also grown, but less fast than a year ago. It is difficult to know how much of the reduction in growth is due to lower borrowing by households and how much is due to firms, but the annual growth rate for July 2008 is 14.3% and after removing mortgage lending is 20.2%, compared with figures of 20.3% and 25.9% a year earlier. The constriction of credit has not appeared in the UK and Irish official data because pre-negotiated credit lines have been used by firms to meet funding requirements, and this registers as an increase in lending by banks to firms. This pattern of behaviour is confirmed in surveys, but the same surveys of lenders report that they are now reducing maximum credit lines for all borrowers. It will take time to affect borrowing; meanwhile official data on lending by M4 deposit-taking institutions to private non-financial corporations continues to grow albeit at a slower rate.

Source ABFA

TABLE 4 Summary of UK and Ireland Credit Conditions Surveys				
Change in balance 2008Q1 to Q2	United Kingdom		Change in average rating 2008Q1 to Q2	Ireland
Availability of credit	5.2		Availability of credit	-0.2
Factors affecting credit availability			Factors affecting credit availability	
Economic outlook	-6.9		- Costs related to banks' capital position	-0.4
Sector risk	-39.8		- Banks' ability to access market financing	0
Pressure from capital markets	1.3		- Banks' liquidity position	0
Risk appetite	-50.4		- Competition from other banks	-0.2
Cost/availability of funds	-34.4		- Competition from non-banks	-0.2
			- Competition from market financing	-0.2
			- Expectations regarding general economic activity	-0.4
			- Industry or firm-specific outlook	-0.2
			- Risk on collateral demanded	0
	MEDIUM	LARGE		
Approved applications	-9.6	10.9	Approved applications	
Changes to spreads	-17.7	-4.9	Changes to spreads	-0.4
Changes to fees	-21.5	-18.8	Changes to fees	-0.2
Changes to collateral required	3.6	-14.1	Changes to collateral required	0
Maximum credit lines	3.4	4.8	Maximum credit lines	0
Covenants	-1.5	8	Covenants	-0.2
Bank of England: Positive change in the balance indicates higher credit availability/cost/terms compared to the previous quarter				
Central Bank of Ireland: Change to original ratings on a five point scale where positive number indicates looser, less costly compared to the previous quarter				

All figures are recorded as a percentage balance i.e. the percentage of firms surveyed reporting improvements minus the percentage of firms surveyed reporting worsening conditions. As numbers become smaller from one quarter to the next, it indicates a balance of opinion that conditions are worsening.

...WE ANTICIPATE A SLOWDOWN IN BANK LENDING, AND AN INCREASE IN ASSET BASED FINANCE...

While banks have been obliged to honour existing credit agreements the evidence suggests that they are reducing maximum credit lines, and are expected to reduce bank lending over the next year. We can anticipate some substitution will occur on the demand side as firms that cannot obtain funds from securitisation or bank loans will turn to asset based finance. Where cash stressed firms are unable to obtain bank loans to restructure, they may be able to obtain asset based finance. On the supply side, banks are more willing to offer asset based finance because it is generally less risky than finance through overdrafts and loans. Banks retain an element of control through the sales ledger, and

there is a lower loss given default because banks hold claim on the assets. Also capital requirements under Basel II are generally lower for asset based finance compared to bank loans. We can also anticipate some reduction in demand as sales figures fall, and fewer firms seek to expand or engage in M&A activity. On balance asset based finance has risen during downturns and we anticipate the same outcome in 2008-09.

...AS MORE FIRMS SHOW SIGNS OF FINANCIAL DISTRESS

Evidence that the economy is slowing can be seen from the average number days debts remain outstanding in **Chart 11**, also known as debt turn. The figure for factoring clients has risen to 64.8 days compared to an average of 61.1 days for 2007 and 60.3 days for 2006. The corresponding figure for invoice discounting clients is 62.6 days, which compares to an average of 56.8 days for 2007 and 58.8 days for 2006. This means businesses are waiting longer to receive payment on debts and sales invoices compared to earlier years. This is usually a sign that customers are facing tougher economic conditions, and are seeking to compensate for low cash flow by taking longer to pay invoices.

There are other signs of distress. The numbers of credit protection payments being made to clients in the UK has increased from £4.7 million in the year to June 2007 to £8.4 million in the year to June 2008, an increase of 79% over a single year, shown in **Chart 12**. These payments are made by the asset based finance industry to their clients when their customers default on debt receivables where a non-recourse facility is in place. When these numbers rise more businesses are failing to pay their debts as they declare insolvency. Experian, the business information services company reports an increase in insolvencies in the UK to 10,512 failures in the first half of 2008 and strong signs of distress with an above average risk of failure in retail, manufacturing, transport and services sectors for the year ahead.

SUMMARY

Retail sales figures have been highly volatile for the past few months, and UK official figures appear to contradict survey evidence from the CBI and the BRC. Evidence from the non-retail sales figures collected by ABFA members shows domestic sales of non-retail sectors were down in the first quarter, but picked up in the second. The pattern in non-retail sales appears to confirm the official evidence in retail sales in the last two quarters. Credit conditions are also tightening, with surveys showing that banks are raising rates and terms attached to loans. While demand and supply of bank lending are expected to fall in 2008 and 2009, the official figures continue to grow in the present as firms use prearranged credit lines to meet funding needs. Evidence of distress is emerging in many sectors, and firms are taking longer to pay outstanding debts, and more payments are being made to cover unpaid debts. As a larger number of firms becomes insolvent, we anticipate asset based finance will grow as bank lending declines.

CHART 11
Debt Turn
Source ABFA

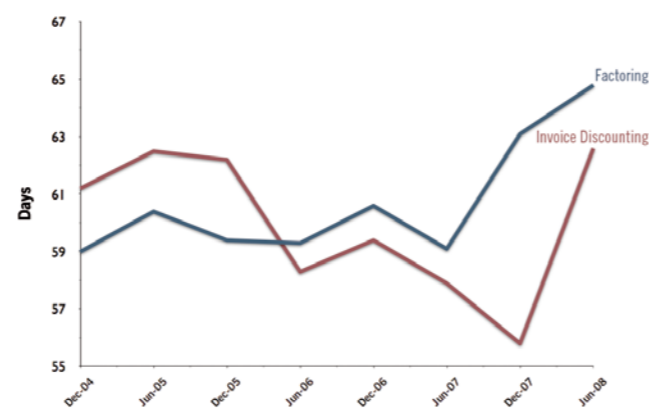
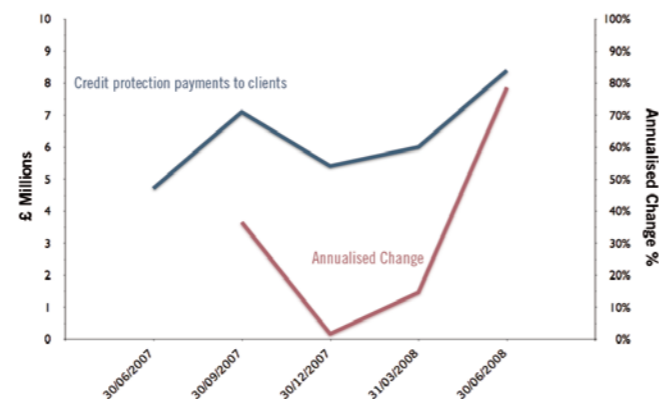


CHART 12
Credit Payment Protection to ABFA Clients
Source ABFA



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 small 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.

Economic Report

The logo for the Association of British Financial Analysts (ABFA), featuring the letters 'ABFA' in a stylized, serif font with a small graphic element above the 'A'.

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