ECO FLASH

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UNITED KINGDOM: MEASURES TO SUPPORT BANK FINANCING OF BUSINESSES

Laure Baquero

The BoE and UK government have responded to the Covid-19 crisis with a broad range of measures. These were announced swiftly, but some have taken quite a while to implement, particularly when it comes to financial support for private sector companies.

These measures share the feature of relying heavily on the country's banking sector, which is in solid shape despite facing the same challenges as banks in other European countries.

All this is taking place against the background of Brexit and the government's refusal to extend the transition period on the basis that this would increase uncertainty for businesses and could reduce the flexibility they will need to react to the health crisis.

EVOLUTION OF LOANS TO NON-FINANCIAL CORPORATIONS BY SIZE*

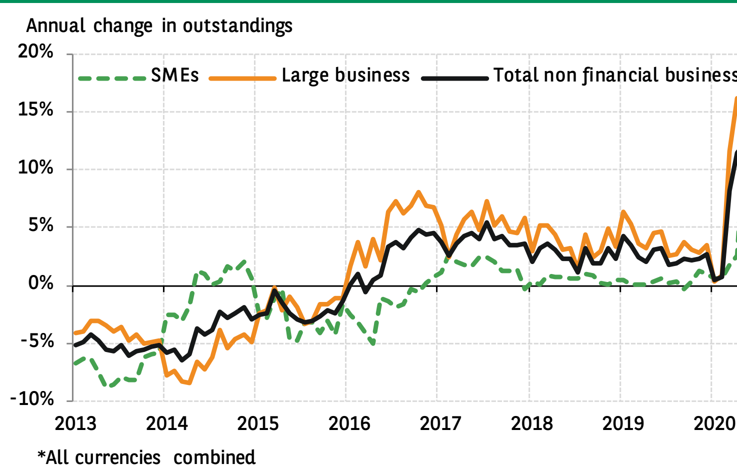

CHART 1 SOURCE: BANK OF ENGLAND

THE BANKING CHANNEL IS THE PREFERRED CHANNEL FOR SUPPORTING THE FINANCING OF SMES

TFSME designed to support lending to SMEs

Announced on 11 March, the Term Funding Scheme for Small and Medium-sized Enterprises (TFSME) has been operational since 15 April and is likely to remain open until 30 April 2021. It is designed to support the supply of lending to small and medium-sized enterprises (SMEs) through a four-year refinancing programme for banks and other lenders at preferential rates.

In practice, the BoE intends to meet demand for TFSME through daily refinancing lines charged at the discount rate plus a premium (see below). Interest will be calculated daily as a function of the discount rate and outstanding drawdowns. It will be split between participating Monetary Financial Institutions (MFIs) in proportion to their drawdowns. Fees will be determined at the end of the reference period (which runs from 31 December 2019 to 31 December 2020) on the basis of net lending (the sum of net lending to SMEs and net lending to non-SMEs over the reference period). The fee will be zero for MFIs whose net lending increases over the reference period. It will then increase linearly to 25bp for MFIs whose lending has fallen by a maximum of 5% over the reference period, but could exceed this 25bp level for those whose lending has fallen by more.

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Banks and other lenders qualifying for this scheme are the participants in the BoE's Sterling Monetary Framework (SMF) who have access to the Discount Window Facility (DWF[1]). Banks and other lenders who are not already signed up to the DWF may apply for access.

The TFSME includes an initial allocation, under which eligible participants may borrow up to 10% of their outstanding loans to the real economy. Above this amount, an additional allowance may be made available of a maximum sum equivalent to a participant's non-SME net lending and five times net lending to SMEs. On 1 July 2020, drawings under TFSME stood at GBP17.8 billion.

In practice, the borrowing rate of non-financial companies (NFCs) dropped from an average of 2.3% in March 2020 to 1.1% on average in May 2020, and from 2.8% to 0.8% over the same period for SMEs[2]. Although the resumption of growth in lending to NFCs was mainly focused on large corporations in April, SMEs benefited in May (see Chart 1), with their borrowing rate dropping from an average of 2.4% to 0.8%. Bounce Back Loans may also have contributed to this trend (see below).

The BoE's quarterly survey of credit conditions, published on 16 April[3], indicated a degree of optimism amongst lending establishments when it came to expected credit supply and demand for NFCs in the second quarter of 2020. However, this survey was taken between 2 and 20 March, that is to say before the UK went into lockdown on 23 March. Since then, the economic situation has worsened considerably as a consequence of the Covid-19 epidemic, as reflected in advance indicators such as the composite PMI, which hit a record low of 13.8 in April (from 36.0 in March), before climbing to 30.0 in May and 47.6 in June.

CBILS HAS HAD ONLY LIMITED SUCCESS COMPARED TO ITS MICRO-BUSINESS VERSION

The recently formed UK government has also announced a package of measures to support the country's economy. Some of these have involved the banks, such as government-guaranteed loans for a total of up to GBP330 billion. In its initial form, CBILS was available only to companies with revenue of less than GBP45 million, giving them access to six-year loans, with no interest charged during the first year and a government guarantee of up to 80% of the loan to a maximum of GBP5 million.

The scheme has required a number of adjustments since it was introduced on 23 March of this year.

Expanded scope of supply

Initially only about forty lending establishments were able to provide this financing by virtue of being accredited under the Enterprise Finance Guarantee Programme, launched in 2009. This programme has temporarily been replaced by CBILS, the operation of which has been entrusted to the British Business Bank (BBB). The BBB has invited lending establishments to apply to take part in the scheme.

Candidates must be able to demonstrate their experience in this area (or otherwise set out a clear strategy for penetrating this market), be in a position to make at least GBP 1 million in loans under CBILS, and demonstrate the solidity and viability of their business model. The fees and interest rates charged are also analysed, particularly with regard to the government guarantee, which they must reflect[4]. As a result, the number of banks allowed to provide these guaranteed loans has gradually been increased to nearly 100[5]. To date, most of them have participated in CBILS solely through making fixed-term loans, with asset financing, invoice finance and revolving credit being offered by only twenty or so establishments.

Expanded scope of demand

On 2 April, the BBB banned any requirement for personal guarantees on any CBILS financing of less than GBP 250,000. Above this amount personal guarantees may not include a private main residence and are capped at 20% of the balance due after the sale of the borrower's assets.

TFSME: A VARIATION OF TFS

The TFSME pursues the same line as the Term Funding Scheme (TFS) introduced by the BoE in 2016, after the referendum result in favour of Brexit. At that time, the BoE's intention was to amplify the transmission of the interest rate cut it had made (from 0.5% to 0.25%), given that it saw little room for manoeuvre in this area[1].

The TFS was organised along similar lines as the TFSME, save for the fact that it targeted all types of companies, with no size criterion[2].

The BoE viewed the scheme as a success. In line with its expectations, it considers that the TFS contributed to reducing the interest rates charged by the sixty-two participating lenders, thanks to the GBP127 billion they drew down. To have access to this lower-cost funding, banks and other lenders had to maintain or increase the volume of their lending to the real economy during the reference period (30 June 2016 to 31 December 2017). Fifty-four establishments achieved this, according to BoE calculations.

In the end, outstanding loans to NFCs held steady – or even increased slightly – during the reference period, which was the key condition for banks and lending establishments to receive funding at the lower rate. Although the rates available to NFCs did indeed fall after the launch of the TFS, irrespective of the size of company, the main benefit of the scheme seems to have been the volume of lending it produced[3].

However, the current economic crisis is of a greater order of magnitude and maintaining, or even increasing, loan books will be driven primarily by a need to cover cash requirements rather than the financing of investment. In any event, it will be challenging, when making the final judgement on the scheme, to separate out the effects of TFSME from those of other measures from the BoE and from the government, most notably the Coronavirus Business Interruption Loan Scheme (CBILS) which also sought to help finance SMEs.

1 BoE (2018 Q4) The Term Funding Scheme: design, operation and impact
2 The TFS should not be confused with the Funding for Lending Scheme (FLS) introduced by the BoE between 2012 and 2018 to make four-year funding available to NFCs and households through the intermediary of MFIs. MFIs could exchange eligible collateral for Treasury bills, which they could then use to obtain liquidity from the markets or register on their balance sheets against loans that they made.
3 Based on data for loans to NFCs in both sterling and other currencies. However, the same trends are found when looking only at sterling loans.

1 The DWF is a bilateral mechanism through which financial companies can borrow highly liquid assets from the BoE in return for collateral. It is available on demand to meet unexpected liquidity requirements.
2 Variable rates provided by the BoE, bearing in mind that the vast majority of SNFs borrow at variable rates in the UK, an observation that holds good for SMEs. See Chart oF The Week of 15 July 2020.
3 BoE (16.04.20) Credit Conditions Survey – 2020 Q1
4 BBB (11.05.20) CBILS, an opportunity for lending institutions to partner with the British Business Bank
5 Source: British Business Bank

The scheme was then expanded to include larger businesses in the form of the Coronavirus Large Business Interruptions Loan Scheme (CLBILS, see below), and then finally adjusted to create the Bounce Back Loans Scheme (BBL), for which the government guarantee was increased to 100% of the loan, but which were only available to the smallest companies and were capped at GBP 50,000. The government has ignored calls (including from Andrew Bailey, Governor of the BoE) to make these loans available to all companies in the country.

The fact remains that CBILS is now criticised for its slow implementation and has not proved popular, reflected in the fact that, according to the Treasury, by 28 June, only 52,275 loans had been made, for a total of GBP 11.07 billion, (see Chart 2). By comparison, the enthusiasm for the BBL scheme (967,321 loans made for a total of GBP29.5 billion by 28 June), even though it was launched later and is capped at a much lower level, has raised questions as to the suitability of CBILS relative to its potential target market.

Apart from anything else, some peculiarities of the UK economy may hinder the success of CBILS. First, bank lending faces significant competition from disintermediated financing in the UK[6]. Thus, although bank lending represented by far the biggest share of net financing raised by UK NFCs – of whatever size – in March[7], this appears to have been a short-lived phenomenon, with net financing shifting mainly to debt securities from April onwards.

Secondly, more than two months after launch, the approval rate of applications from UK SMEs for a CBILS loan was close to 50% (50% for CBILS and 80% for BBL).

Lastly, the number of company failures is already fairly high in the UK and tends to rise sharply during recessions, which may disincentivise lenders (see Chart 3).

CUMULATIVE AMOUNTS OF FUNDINGS ALLOCATED UNDER BBL, CBILS AND CLBILS FOR ALL NON-FINANCIAL BUSINESS

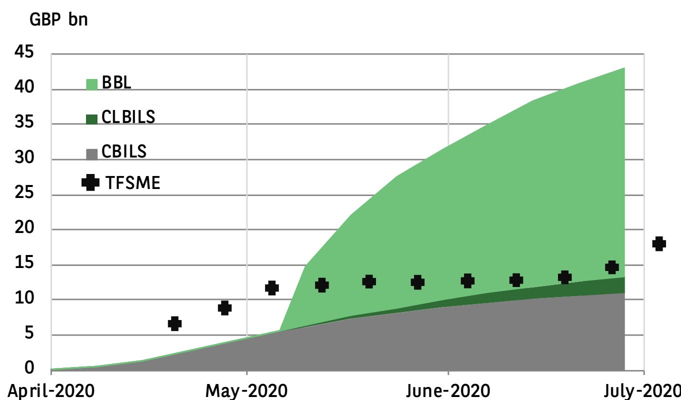
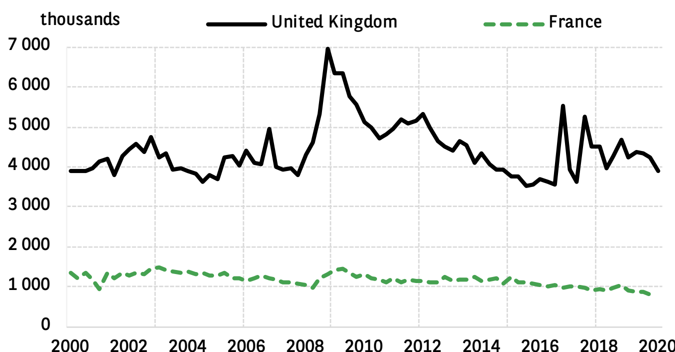


CHART 2 SOURCE: UK FINANCE, HM TREASURY, BOE

BUSINESS FAILURES*



*Last points: T4 2019 for France and T1 2020 for the United Kingdom

CHART 3 SOURCE: INSEE, ONS

MORE SELECTIVE SUPPORT TO BIG COMPANIES

Even before the introduction of dedicated support measures, major companies began to increase their bank borrowings from March onwards (see Chart 1).

CBILS extended to healthy large companies in the form of CLBILS

On 16 April, the government announced that the scheme would be extended to include large companies, with revenue above the previous limit of GBP45 million. Since 20 April, such companies have had access to government-guaranteed bank loans up to GBP50 million provided that they are in good financial health (investment grade rating). Unlike the scheme for SMEs, loans to major companies under CLBILS can have interest rates at the discretion of the lending banks. As of 28 June, only 745 applications had been made for CLBILS, with 345 approvals for a total of GBP2.3 billion (see Chart 2).

The Covid-19 Corporate Financing Facility

Some measures have been introduced as a direct partnership between the government and the BoE, demonstrating timely cooperation between the various authorities. This is particularly true of the Covid-19 Corporate Financing Facility (CCFF).

Designed for large companies, the CCFF consists of providing financing in the form of the purchasing of commercial paper (unsecured debt securities with maturities between one week and twelve months), issued by companies making a "material contribution to the UK economy"[8]. The scheme aims to offer similar financing conditions to those in force prior to the Covid-19 shock. The securities are purchased by the BoE on behalf of the Treasury.

The scheme is open to companies able to demonstrate their good financial health prior to the shock. The programme takes account of temporary impacts on companies' balance sheets and cash positions when assessing their financial positions and pre-Covid credit rating (minimum of A-3/P-3/F-3/R-3 from at least one of Standard & Poor's, Moody's, Fitch or DBR Morningstar on 1 March 2020). Banks, insurers and all other companies subject to financial regulations are excluded. The same is true of state-owned companies.

In practice, companies seeking to use the scheme must go through their bank; however, not all banks can organise the issue of commercial paper for their clients. The minimum size of an individual security that the Facility can purchase from an individual participant is GBP1 million.

6 The intermediation rate for UK NFCs was 61.8% in 2019.
7 BoE (02/06/20) Money and Credit – May 2020
8 Decision subject to BoE review on the basis of a number of criteria, including the number of employees, size of revenues generated in the UK and the number of clients supplied by applicants to the CCFF

SUMMARY OF THE CONDITIONS OF THE TFSME, THE CBILS, THE CLBILS AND THE BBL

	TFSME	CBILS	CLBILS	BBL
Recipient	Credit institutions	SMEs	Large businesses	Smallest businesses
Introduction	15/04/2020	23/03/2020	16/04/2020	04/05/2020
Rate	Key rate + 25bp max if the outstanding decreases	At the discretion of credit institutions		2.5%
Maximum maturity	4 years	6 years	3 years	6 years
Maximum overall envelope	Initial allocation of 10% of outstanding loans to the real economy+additional loans equivalent to 5 times the initial allocation for loans to NFCs, 1 time for other non-financial private agents	GBP 330 bn	GBP 330 bn	GBP 330 bn
Maximum envelope per company	-	GBP 5 mn	GBP 200 mn	25% of turnover within the limit of GBP 50 000
State Guarantee	-	Up to 80%	Up to 80%	Up to 100%
Interest free	-	Firts year	-	First year

TABLE 1

SOURCE: BRITISH BUSINESS BANK, HM TREASURY, BOE

The BoE can purchase securities in either the primary or secondary market. The scheme has been operational since 23 March and will remain in operation for at least twelve months and as long as necessary. On 1 July, the BoE reported GBP17.6 billion of CCFF assets on its balance sheet, lower than the GBP20.5 billion reported on 20 May.

EFFECT ON BANKS' REGULATORY RATIOS LIKELY TO BE LIMITED

CBILS, together with its versions for larger and smaller companies and the TFSME, were designed to maintain or increase lending to UK NFCs. As the old adage has it, 'loans make deposits'. An increase in lending should produce an increase in deposits with banks and lending establishments, reducing their Liquidity Coverage Ratios (LCR) accordingly[9]. This said, the five biggest UK banks[10] have LCRs well above the Basel minimum requirement of 100%[11], giving them significant room to manoeuvre on this front and in light of implicit market expectations, which are likely to exceed the minimum required. This effect is likely to be attenuated by the increase in banks' reserves with the BoE due to its accommodating monetary policy[12], and thus their HQLA[13]. This will only partly feed through given the amounts booked under TFSME on the one hand and CBILS, CLBILS and BBL on the other (see Chart 2).

For the banks, the government's guarantee of loans under CBILS, CLBILS and BBL also means a smaller reduction in solvency ratios, as the element of the loans guaranteed by the government does not consume capital.

The same is true of the leverage ratio for the BBL alone, as banks can exclude loans made under this scheme from the calculation of their leverage exposure[14]. Moreover, the UK Treasury is open to the possibility of temporarily excluding reserves at the central bank as allowed for under the Capital Requirements Regulation (CRR) under exceptional macroeconomic circumstances[15]. The CRR requires that these exclusions be counterbalanced by a recalibration of the ratio such that capital requirements for leverage remain unchanged. The UK Treasury recently rejected these provisions on the basis that the leverage ratio will only become a constraint from 28 June 2021, that is to say after the end of the Brexit transition period[16]. The UK would thus embark on a significant regulatory divergence from the EU. All these measures should help reduce pressure on banks with regards to their leverage ratios, provided that the market also relaxes its implicit expectations. Conversely, and still with reference to the end of the Brexit transition period, the UK will not apply the one-year deferral (to

9 LCR compares the High Quality Liquid Assets (HQLA) to total net cash outflows over the next 30 calendar days, which consist among other things of deposits. When a bank extends a loan, its assets increase and its liabilities to the same extent (the account of the borrower is credited). For given HQLA, the increase in deposits lowers the LCR because the bank has to assume that some of the newly-created deposits will flow to other banks when its customer who benefitted from the loan is paying invoices.
10 Ranked on the basis of Tier 1 capital.
11 At the end of 2019 LCRs were 137% at Lloyds, 141% at Standard Chartered, 150% at HSBC, 151% at RBS and 160% at Barclays.
12 A central bank influences the monetary expansion through its control of the monetary base. The latter consists of coins and banknotes in circulation, as well as banks deposits with the central bank (composed of mandatory reserves, excess reserves and deposit facilities). By pursuing an accommodative monetary policy, the BoE eases banks' refinancing conditions, which is reflected in particular in an increase in their reserves with it.
13 Banks' HQLA are made up, among other things, of reserves with the central bank.
14 BoE (04.05.20) Modification by consent of the exclusion of loans under the Bounce Back Loan scheme from the calculation of the total exposure measure of the leverage ratio
15 EU Regulation n°2019/876, Article 429
16 HM Treasury (25.06.20) HM Treasury letter on UK approach to CRR Amending Regulation

1 January 2023) under the banking reform package of the leverage ratio buffer for globally systemically important banks (G-SIB).

UK banks, in common with their European competitors, are, however, already facing a significant increase in the cost of risk[17] from loans granted prior to the crisis and made substantial provisions in the first quarter of 2020, in line with the new IFRS 9, reducing their net income accordingly. In the event that the credit risk associated with an asset increases, IFRS 9 requires that banks make provisions for impairment (stage 2) over and above the ex-ante provisions made when the asset was first recognised (stage 1) on their balance sheet, independent of any credit event[18]. By anticipating to a much greater degree the increase in the cost of risk than under the previous IAS 39 standard, IFRS 9 will limit its impact, but could prove to be pro-cyclical in the event of an abrupt economic downturn due to the additional provisions relating to the movement of assets from stage 1 to 2 or even 3 (i.e. significant credit risk increase to the point that the asset is considered non-performing). This is why the BoE has asked lending establishments to take account of the temporary nature of the shock and the economic support measures announced by the authorities. It remains to be seen to what extent banks will apply their existing approaches in the area of expected credit losses as set out in IFRS 9 in response to the repayment holidays granted on loans.

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It is likely that a large number of the projects identified in the BoE survey cited above will be called into question. Rather than pursuing their investment plans, NFCs see a growing need to borrow to cover cash needs, given the unprecedented fall in revenue. An attempt has been made to address these needs through the creation of TFSME and CBILS (including the latter's variants for large and small businesses). However, the reach of some of these programmes looks limited so far.

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17 In the first quarter of 2020, the cumulative cost of risk of the five major UK banks was multiplied by four relative to the fourth quarter of 2019.
18 BNPP (Nov. 2018) Conjoncture: "The impacts of IFRS 9 first-time adoption on southern European banks"

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