

## 2 The UK environment

### 2.1 The macroeconomic background

Growth in the UK has been more stable than in the USA or euro area in recent years and has picked up to around trend this year, broadly in line with the May central projection of the Bank's Monetary Policy Committee (MPC). Data on financial balances have been substantially revised, but the broad picture remains one of persistent current account deficits since 1999. The domestic counterpart was initially a private sector deficit, but more recently a widening public sector deficit has emerged (Chart 83). There has been a marked shift from deficit to surplus in the corporate sector since 2001, as companies have sought to strengthen balance sheets by reducing investment and dividend payments. This has more than offset a move into deficit by the household sector, reflecting buoyant household consumption and borrowing. But the latest data showed a narrowing of the private sector surplus in Q2, alongside some recovery in companies' spending and continued resilience in household spending and borrowing.

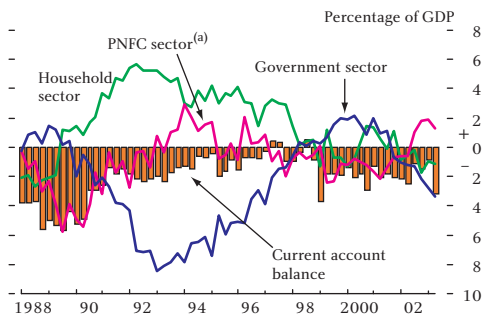
The November central projection of the MPC, on the assumption that the official interest rate remains at 3.75%, was for UK growth over the next two years to be marginally above trend (Chart 84). The MPC does not formulate projections for the financial positions of the UK corporate and household sectors. However, the outlook can be assessed using a method described in the December 2001 *Review*.<sup>38</sup> The MPC's November central projection was consistent with a continued recovery of corporate profitability, which would permit further reductions in capital gearing; income gearing and liquidations would be likely to remain low. On these assumptions, the household debt-to-income ratio would be likely to continue to rise, accompanied by broadly stable capital gearing and a moderate pickup in income gearing.

International imbalances continue to pose a risk to the outlook. The effect of any substantial change in global capital flows on the UK's external balance sheet would partly depend on the extent of any associated change in the sterling exchange rate. Despite persistent current account deficits, the UK had returned to a net external asset position of 2% of GDP by 2003 Q2, having had net external liabilities of more than 15% of GDP in early 1999 (Chart 85). The adverse effect on the UK's net external assets of persistent borrowing from abroad has been offset by revaluations of its stock of net external assets,<sup>39</sup> in the past few years due largely to the fall in sterling.

38: See Benito, A, Whitley, J D and Young, G (2001) 'Analysing Corporate and Household Sector Balance Sheets', December 2001 *Financial Stability Review*. The model has been developed further to incorporate adjustment by companies in response to changes in their balance sheets: see Bunn, P and Young, G (2003) 'Balance sheet adjustment by UK companies', Bank of England *Quarterly Bulletin* (Autumn).

39: See Westwood, R and Young, J (2002), 'The external balance sheet of the United Kingdom: recent developments', *Quarterly Bulletin* (Winter).

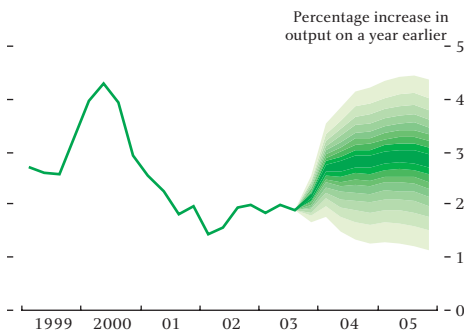
**Chart 83:**  
**Sectoral financial balances**



Source: ONS.

(a) Private non-financial companies.

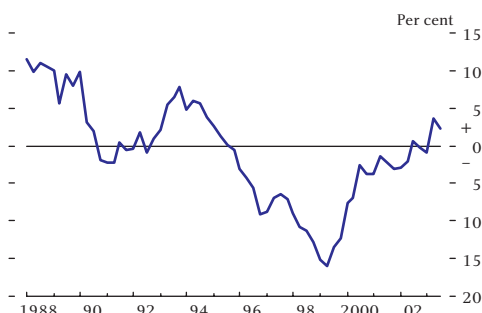
**Chart 84:**  
**November Inflation Report GDP projection based on constant nominal interest rates at 3.75%**



Source: Bank of England.

The fan chart depicts the probability of various outcomes for GDP growth in the future. The darkest band includes the central (single most likely) projection. See also the footnote to Chart 1 in the Nov. 2003 *Inflation Report*.

**Chart 85:**  
**UK net external assets as a percentage of GDP<sup>(a)</sup>**



Source: ONS.

(a) GDP is annualised.

## 2.2 The household sector

### Income, saving and the financial position

The broad picture for the household sector remains one of slackening growth in post-tax incomes, a declining saving ratio and a widening financial deficit (Chart 86), despite upward revisions to estimated household income and the saving ratio. Higher National Insurance contributions and increased Council Tax payments have tended to reduce post-tax incomes this year. But income growth remains positive, and unemployment has continued to be stable and low.

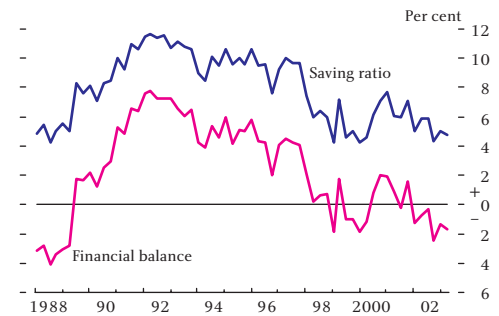
### Rising indebtedness

The shift in the household sector's financial position, from the surpluses of the 1990s to the more recent deficits, means borrowing has risen relative to financial asset accumulation. This mainly reflects the growth since 1996 in borrowing secured on property (Chart 87). The strength of mortgage borrowing has persisted despite the signs noted in the June *Review* of a weakening of housing market activity. Forward-looking indicators, such as loan approvals and net reservations, have since picked up. And although annual house price inflation has slowed since the June *Review*, three-monthly rates of house price increase have risen slightly.

Rapidly increasing house values may have priced some first-time buyers (FTBs) out of the market. Others have managed to remain in the market by taking out larger loans: the proportion of FTBs with loan-to-income ratios in excess of three has risen substantially in recent years, especially in Greater London and the South East (Chart 88). That may partly reflect the transition to a low interest rate environment, which has reduced the initial debt-servicing costs of a mortgage, and so raised demand – particularly from cash-constrained FTBs. Higher loan-to-income ratios will have increased their vulnerability to a rise in interest rates or a fall in their incomes. But the share of FTBs with loan-to-value ratios of over 90% has fallen back in recent years, suggesting that FTBs are in a better position to weather any fall in house prices.

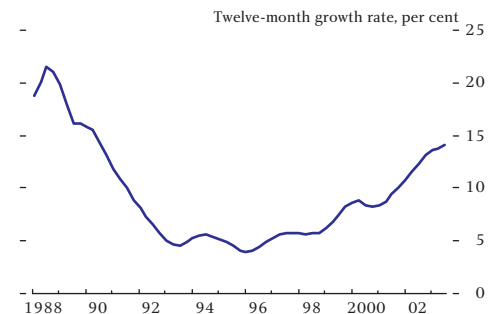
Some 40% of gross mortgage advances are still accounted for by remortgaging, probably reflecting in part the refinancing of existing mortgages at lower discounted rates. Remortgaging also provides one way in which households can extract housing equity.<sup>40</sup> Mortgage equity withdrawal has remained high and only a little below the peaks of the late 1980s as a share of post-tax income (Chart 89). It could well have risen further in 2003 Q3, given the recent robust lending data. But strong equity withdrawal has not raised the household sector's mortgage debt

**Chart 86:**  
Household financial balance and saving as a percentage of post-tax income<sup>(a)</sup>



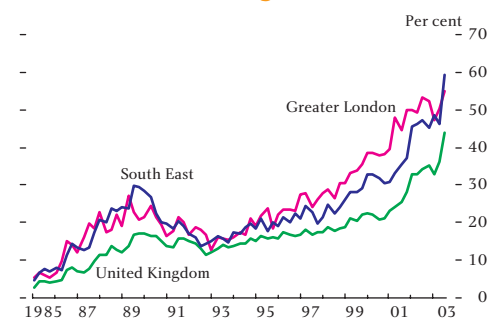
Sources: ONS and Bank of England.  
(a) Data are seasonally adjusted and quarterly.

**Chart 87:**  
Secured borrowing by individuals



Source: Bank of England.

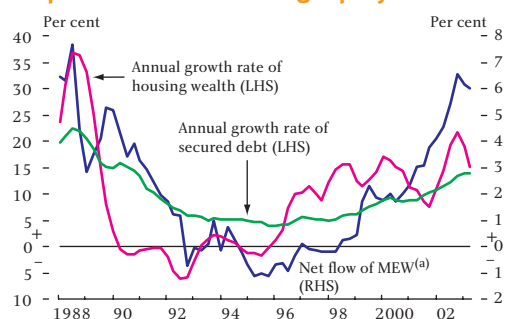
**Chart 88:**  
Percentage of first-time buyers with loan-to-income ratios greater than three<sup>(a)</sup>



Sources: Council of Mortgage Lenders and Bank calculations.  
(a) The Council of Mortgage Lenders changed the method used for validating loan-to-income ratios from June 2003 onwards. This has led to an increase in the estimated percentage of first-time buyers with loan-to-income ratios greater than three from that date.

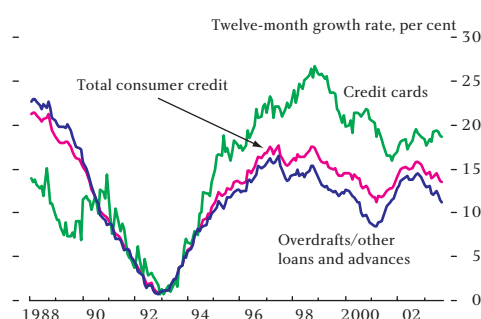
40: See the box on pages 8–9 of the November 2003 *Inflation Report* for the various ways of withdrawing and injecting housing equity.

**Chart 89:**  
**Mortgage equity withdrawal and components of net housing equity**



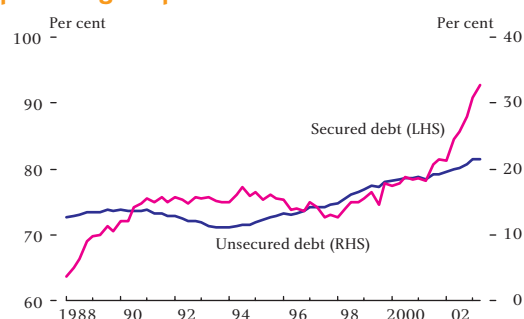
Sources: ONS and Bank of England.  
 (a) As a percentage of post-tax income.

**Chart 90:**  
**Borrowing by individuals: breakdown of consumer credit<sup>(a)</sup>**



Source: Bank of England.  
 (a) Data are seasonally adjusted.

**Chart 91:**  
**Consumer secured and unsecured debt as a percentage of post-tax income<sup>(a)(b)(c)(d)</sup>**



Sources: ONS and Bank of England.  
 (a) Data are quarterly.  
 (b) Debt data are not seasonally adjusted.  
 (c) Post-tax income is annualised.  
 (d) Consumers are defined as the household sector excluding sole proprietors, partnerships and non-profit making institutions serving households.

relative to its housing assets: since 1996, the rise in gross housing wealth has generally outpaced that of secured indebtedness (Chart 89), so net housing equity has grown substantially.

Unsecured borrowing growth has also remained buoyant over the past year, although it has eased back from the peak in autumn 2002 (Chart 90). Borrowing on credit cards has grown particularly rapidly and now accounts for around 30% of the total stock of unsecured consumer debt. Other unsecured borrowing, including overdrafts and personal loans, has also continued to increase strongly. But the British Household Panel Survey (BHPS)<sup>41</sup> suggests that a relatively large proportion of households do not have any debt at all<sup>42</sup> (43% in 2000, the last year for which these data are available). More recent information on the share of people holding unsecured debt (Box 6) suggests that participation in the unsecured debt market has not changed significantly since 2000. It also indicates that most of the increase in unsecured borrowing since 2000 reflects greater borrowing by those with higher incomes.

### Balance sheet indicators

Continued rapid debt accumulation, together with the slowdown in household income growth, has led to a further rise in the overall household sector debt-to-income ratio, which reached a record 129% of annualised post-tax income in 2003 Q2. The longer-term increase in the secured debt-to-income ratio partly reflects demographic factors such as the spread of home ownership, although these factors cannot explain all of the recent sharp rise in this ratio<sup>43</sup> (Chart 91). The unsecured debt-to-income ratio also rose to a new high in Q2, around double its level ten years ago. Again, longer-term factors, such as a widening of access to personal credit, help to explain the increase.

Despite the record debt-to-income ratio, overall household sector capital gearing fell a little in 2003 Q2, as did the ratio of unsecured debt to financial assets (Chart 92). This reflects the further rise in housing wealth and a modest increase in financial wealth as equity prices have risen. Neither measure of capital gearing is currently substantially above its long-term average.

The increase in aggregate debt raises households' vulnerability to any unexpected fall in incomes or rise in interest rates. In the event of any such shocks, households' ability to meet debt repayments readily from their pool of assets has fallen in recent

41: For more information on the BHPS, see Cox, P, Whitley, J D and Brierley, P G (2002) 'Financial pressures in the UK household sector: evidence from the British Household Panel Survey', Bank of England *Quarterly Bulletin* (Winter).

42: Surveys such as the BHPS generally exclude as debt the proportion of credit card balances paid off in full each month.

43: See Hamilton, R (2003) 'Trends in households' aggregate secured debt', Bank of England *Quarterly Bulletin* (Autumn).

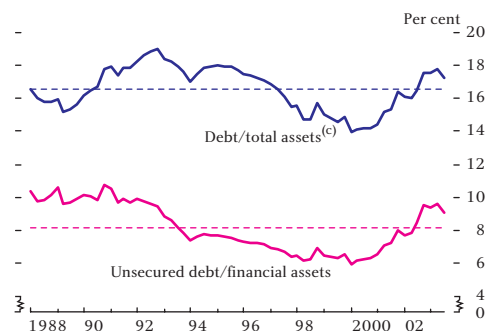
years, as household liabilities have risen in relation to liquid financial assets. The standard indicator of households' ability to service debt is their income gearing – the ratio of debt interest payments to income. This has remained stable since the end of 2001 (Chart 93). A broader measure of the total debt servicing cost that also includes regular repayments of mortgage principal has risen a little but remains below its long-term average. Other things being equal, the accumulation of debt in recent years will have increased the sensitivity of income gearing to interest rate rises, but the effect of any future change in interest rates will also depend on the shares of the mortgage stock accounted for by fixed and floating-rate borrowing. The latest data, for July, suggest that fixed-rate mortgages account for just under a third of the total mortgage stock<sup>44</sup>, although the share of new fixed-rate borrowing has fallen back in recent months, as rates charged on fixed-rate mortgages have risen alongside swap rates.

### Indicators of stress

Although the numbers remain small as a proportion of the population, personal insolvencies have risen by a further 18% over the past year (Chart 94). The rise in recent years reflects an increase in bankruptcies both of the employed and particularly the unemployed (bankruptcies of the self-employed have fallen). Over the same period, the proportion of credit card accounts in arrears has risen, although this has fallen back over the past year, as have arrears on other types of unsecured debt. And mortgage arrears as a share of the total mortgage stock have fallen to near-record lows (Chart Q in the Overview section). In the absence of a sharp pickup in income gearing or unemployment, or a marked fall in house prices, overall arrears are likely to remain low.

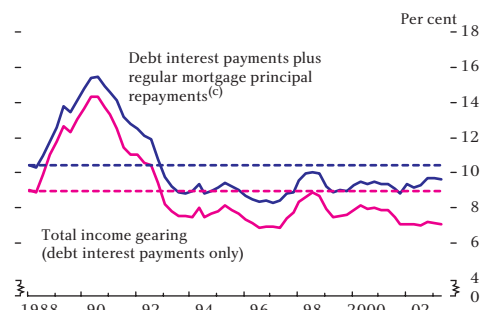
As noted in Box 6, a recent survey commissioned by the Bank suggests that the proportion of households that consider their unsecured debt repayments to be a burden has remained relatively flat in recent years. But earlier surveys also indicate a connection between problems in repaying unsecured and mortgage debt. Some 36% of households reporting in the 2000 BHPS that their unsecured debt repayment commitments were a heavy burden also reported problems in meeting mortgage commitments, compared with only 4% of those not reporting problems in meeting unsecured debt repayments. Those households facing difficulty in financing both their unsecured and secured debt are likely to be particularly vulnerable to adverse economic events or changes in individual financial circumstances.

**Chart 92:**  
Household sector capital gearing<sup>(a)(b)</sup>



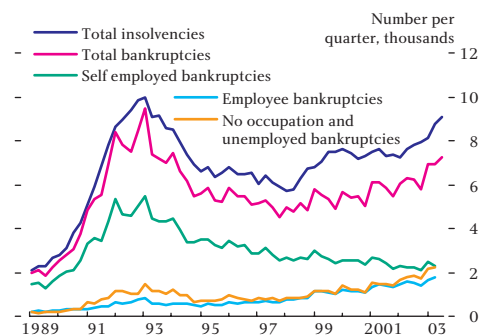
Sources: ONS and Bank of England.  
(a) Dashed lines indicate averages of series from 1988 Q1 to 2003 Q2.  
(b) Data are not seasonally adjusted.  
(c) Financial wealth plus housing wealth.

**Chart 93:**  
Household sector income gearing<sup>(a)(b)</sup>



Sources: ONS and Bank of England.  
(a) Payments as a percentage of post-tax income.  
(b) Dashed lines indicate averages for the series over the period from 1988 Q1 to 2003 Q2.  
(c) See page 82 of the Jun. 2002 *Review* for details of how this series is constructed.

**Chart 94:**  
Personal insolvencies and bankruptcies<sup>(a)(b)(c)</sup>



Source: DTI.  
(a) Data are for England and Wales. Total insolvencies are seasonally adjusted; bankruptcy data are not seasonally adjusted.  
(b) Total insolvencies include bankruptcy orders and individual voluntary arrangements.  
(c) Figures for 2003 Q3 are provisional.

44: Based on data from CACI Ltd.

## Box 6: Unsecured debt

Unsecured borrowing by households has risen rapidly in recent years. The risks arising from this build-up of debt are likely to be greater if debt is concentrated among more vulnerable households. There are no regular up-to-date surveys on the distribution of debt; the latest public information is from the 2000 wave of the British Household Panel Survey (BHPS).<sup>1</sup> To supplement this, the Bank commissioned a special survey from NMG Research, who in October asked a representative sample of 1,950 adults about their unsecured debt. Further details will be published in the Winter 2003 Bank of England *Quarterly Bulletin*.

Some 34% of the respondents have unsecured debt, similar to rates derived from the BHPS for 2000. The average debt reported for debtors was £3,516, a little higher than the 2000 BHPS figure of around £3,200.<sup>2</sup> Both surveys indicate that the likelihood of having debt and the level of debt are higher for 25–44 year olds than for other age groups, and are positively correlated with income. Comparing the two surveys, it seems that average debt has risen since 2000 only for debtors in the highest income group (defined here as income of £17,500 and above per annum).

The risks associated with unsecured debt depend on the type of lending. Table A shows that, taken together, average debt for the low and middle income groups is highest in personal loans and hire purchase agreements (excluding student loans). Lenders have better control over the supply of such loans than over credit card lending. However, average debt outstanding on credit cards is also relatively high for low income debtors, and differs only slightly across income groups. Yet only 6% of individuals in the lowest income group have debt outstanding on a credit card, whereas 22% of the middle and 32% of the highest income group do so.<sup>2</sup>

According to the NMG survey, 10% of debtors report their unsecured debts to be a heavy burden, 22% somewhat of a burden and the majority not a problem, consistent with the results of other recent surveys.<sup>3</sup> The

share of individuals reporting unsecured debt of £5,000 or more is relatively low, at 6%, and concentrated among individuals with higher incomes. However, of debtors of £5,000 or more, 17% reported their debt to be a heavy burden and an additional 25% somewhat of a burden.

The share of households reporting debt to be a burden seems little changed in recent years. In the BHPS surveys from 1995 to 2001, around 10% reported their debts to be a heavy burden and 29% somewhat of a burden, similar to the NMG survey. The rapid growth of unsecured debt in recent years has not, therefore, as yet led to any overall increase in the degree of financial distress reported by households. But the survey does point to a small group of heavily indebted individuals who continue to face substantial problems in servicing their debt.

**Table A:**  
**Average amount borrowed by individual debtors, and participation rates, by household income and credit instrument<sup>(a)(b)</sup>**

Instrument	Annual household income:			
	Less than £9,500	£9,500- £17,499	£17,500 and more	All <sup>(c)</sup>
<b>HP agreement</b>	1,525 (5)	1,978 (6)	2,743 (11)	2,468 (5)
<b>Personal loan</b>	1,959 (10)	3,479 (16)	5,231 (27)	4,388 (13)
<b>Overdraft</b>	359 (5)	715 (9)	855 (16)	718 (7)
<b>Credit card</b>	1,580 (6)	1,037 (22)	1,952 (32)	1,445 (15)
<b>Catalogue/mail order</b>	335 (9)	345 (13)	249 (9)	302 (8)
<b>Student loan</b>	5,967 (3)	4,044 (2)	5,196 (3)	6,343 (3)
<b>DSS social fund</b>	286 (7)	160 (4)	200 (0)	233 (2)
<b>Any other loans</b>	320 (2)	519 (4)	4,528 (2)	1,422 (2)
<b>Any unsecured debt</b>	1,936 (31)	2,398 (45)	4,991 (54)	3,516 (34)
<b>Per cent of respondents with debt of £5,000 or more:</b>	3	5	18	6

Sources: NMG and Bank calculations.

(a) Average amounts borrowed by those using each instrument are in £ and participation rates in percentages of debtors (in parentheses).

(b) 36% of respondents reporting their income are in the lowest income group, 28% in the middle and 36% in the highest. Those shares are more concentrated among low-income households than in the population as a whole. Income is before any deductions.

(c) Includes those who did not report their incomes.

1: See Cox, P, Whitley, J and Brierley, P (2002) 'Financial pressures in the UK household sector: evidence from the BHPS', Bank of England *Quarterly Bulletin*, Vol. 42, No. 4, pages 410–419.

2: There is a substantial gap between the aggregate amount of unsecured debt reported in survey responses and that published in official statistics. Some of the difference is due to the fact that household surveys exclude credit card and other bills fully paid off in the current month; these are included in the national accounts.

3: See, for example, Edwards, S (2003) 'In too deep. CAB clients' experience of debt', Citizens Advice Bureau.

## 2.3 The corporate sector

### Profitability

Corporate profitability has strengthened somewhat, alongside faster economic growth at home and abroad. Gross trading profits of non-oil private non-financial companies (PNFCs) rose by 4.6% in the year to 2003 Q2 (excluding the alignment adjustment<sup>45</sup>). The gross operating surplus of PNFCs has picked up a little in relation to GDP, after several years of falls (Chart 95). Company accounts data indicate that operating profit margins have stabilised for quoted companies that have reported results for financial years ending in 2003.<sup>46</sup> And Consensus forecasts for company earnings in 2004 have risen since the start of the year (Chart 96).

### Capital gearing and balance sheet adjustment

If sustained, higher profits and equity valuations may assist companies restructuring their balance sheets. The need for such adjustment arises from the substantial rise in corporate sector capital gearing since the mid-1990s (Chart 97), reflecting the financing of the earlier M&A boom and heavy borrowing by the telecoms and commercial property sectors. Recent Bank research suggests that capital gearing remains well above the level that would be expected in the long run given the tax advantages of debt relative to equity finance.<sup>47</sup>

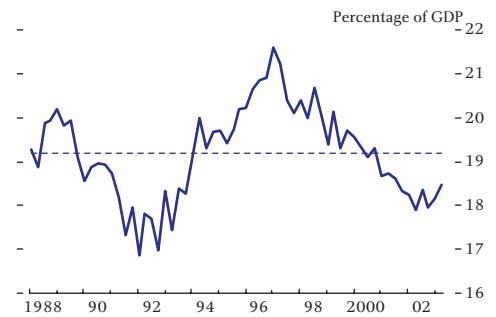
Previous *Reviews* have discussed how those companies with excessive gearing have sought to repair their balance sheets, for example through dividend cutbacks, reductions in capital expenditure and refinancing of debt. In aggregate this has helped stabilise – but not lower substantially – capital gearing (on the replacement cost definition) over the past two years. Gearing relative to the capital stock at current market values has remained at historically high levels. This evidence might suggest that the process of balance sheet adjustment has further to run. But data since the *June Review* suggest that there has been little further adjustment through dividend reductions and expenditure cutbacks. Indeed, PNFCs' total dividend payments rose sharply in 2003 H1, albeit from a low level in 2002 H2, and gross fixed capital formation rose by over 5% in 2003 Q2 (Chart 98), although business investment fell back again in Q3. But increased profitability has allowed the corporate sector to remain in financial surplus, consistent with continued but slower adjustment. The improvement in macroeconomic and market conditions this year may also have led some companies to believe that the risks associated with high gearing have fallen or

45: This alignment adjustment reconciles the income and output measures of GDP.

46: Some 469 quoted companies have so far reported results for financial years ending in 2003, just below 40% of the total sample.

47: See Bunn, P and Young, G (2003) 'Balance sheet adjustment by UK companies', Bank of England *Quarterly Bulletin* (Autumn).

**Chart 95:**  
PNFCs' gross operating surplus<sup>(a)(b)</sup>

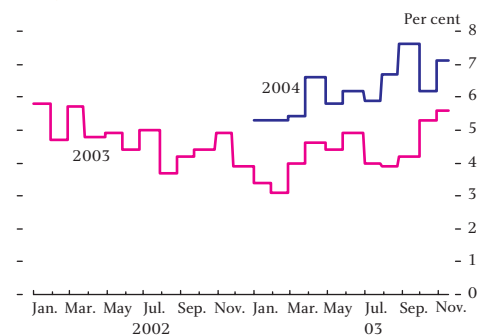


Source: ONS.

(a) Data are quarterly and seasonally adjusted.

(b) Dashed line indicates average of series from 1988.

**Chart 96:**  
Consensus profit expectations for 2003 and 2004<sup>(a)(b)(c)</sup>



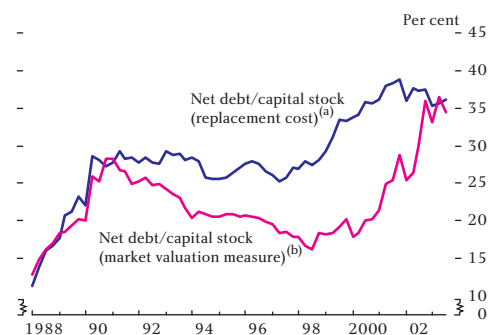
Source: Consensus Economics Inc.

(a) Defined as company trading profits.

(b) Average percentage changes for the year shown relative to a year earlier.

(c) Horizontal axis refers to the month in which the survey of forecasters is undertaken.

**Chart 97:**  
PNFCs' capital gearing

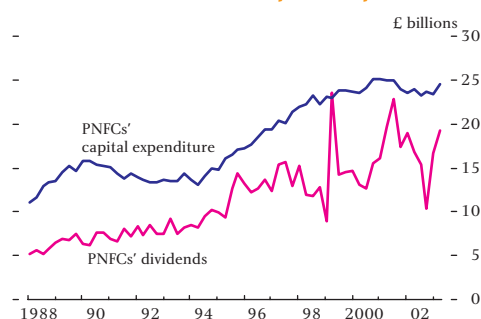


Sources: ONS and Bank of England.

(a) PNFCs' net debt divided by the total value of capital at replacement cost.

(b) PNFCs' net debt divided by the market value of UK-resident assets.

**Chart 98:**  
**PNFCs' dividends and capital expenditure<sup>(a)</sup>**



Source: ONS.

(a) Data are seasonally adjusted and quarterly.

**Table 7:**  
**Characteristics of firms in 2002 by dividend payer status<sup>(a)(b)</sup>**

	Dividend payers in 2002	Former dividend payers <sup>(c)</sup>
Number of firms	709	200
Median operating profit margin	7.4	-2.7
Percentage of firms making a loss	7.2	60.5
Median capital gearing at market value	16.1	33.3
Median capital gearing at replacement cost	14.6	15.5
Median number of employees	1,388	271

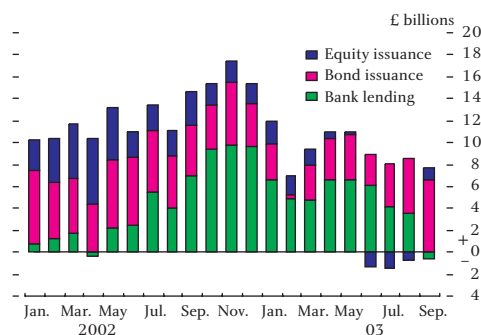
Source: Thomson Financial Datastream.

(a) Based on a sample of 1,253 quoted PNFCs. This includes 344 firms that have never paid dividends, which are not reported in the table.

(b) Data are percentages, except for number of firms and employees.

(c) Firms that did not pay a dividend in 2002 but had paid a dividend at some stage previously.

**Chart 99:**  
**Components of external finance for UK PNFCs<sup>(a)(b)(c)</sup>**



Source: Bank of England.

(a) Data are seasonally adjusted three-month rolling totals.

(b) Bank lending data exclude changes in MFIs' holdings of securities and also exclude the effects of securitisations.

(c) Figures exclude borrowing by PNFCs from foreign MFIs.

that gearing may in future be restrained through increased profitability or equity issuance.

Aggregate trends may conceal important variations across companies. The large increases in dividend payments and rise in capital spending in 2003 Q2 are likely to have been concentrated among stronger cash-rich large companies, the profitability of which may have benefited most from the pickup in GDP growth. Company accounts data indicate that companies that paid dividends in 2002 were much more profitable and less highly geared than companies that did not pay dividends in 2002, but had previously paid dividends (Table 7). But the latest data suggest that capital gearing (at replacement cost) of the most indebted decile of quoted companies that have published accounts for year-ends in 2003 has continued to rise. For these companies, at least, adjustment may be protracted.

The extent of corporate adjustment is also likely to depend on the size of deficits on companies' defined-benefit pension schemes, as they seek to reduce those deficits over time through increased employer contributions to those schemes. The aggregate deficit of FTSE-100 companies has fallen back somewhat to an estimated £57 billion (5.7% of their aggregate market capitalisation) at 31 October 2003<sup>48</sup>, compared with £83 billion (10% of market capitalisation) at 31 January 2003. This reduction reflects the recovery in equity prices and the rise in bond yields. Nonetheless, pensions deficits remain a source of financial pressure for some companies.

Adjustment may be assisted if improving profitability allows the corporate sector to reduce its dependence on debt finance. The flow of PNFCs' total external finance has been lower so far this year than in 2002 H2 (Chart 99). Bond issuance has picked up somewhat since the turn of the year. But the flow of PNFCs' borrowing from UK-resident banks has fallen considerably in recent months and companies in some sectors, notably manufacturing, have continued to repay bank debt. Discussions with companies suggest that access to finance has improved. But access to bond market finance has become easier relative to bank finance, with corporate bond spreads narrowing further (Section 1.1) and by rather more than bank loan spreads. That has led a number of companies to refinance their bank debt at longer maturities through increased bond issuance.

## Income gearing and debt sustainability

Despite the weak overall profitability and the debt accumulation of recent years, low and falling interest rates over this period have helped to keep corporate income gearing moderate

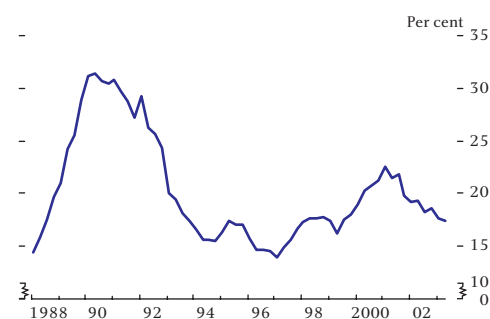
<sup>48</sup> For the sake of comparability, this estimate includes six companies who were no longer in the FTSE-100 as of 31 October 2003. It also does not include nine FTSE-100 companies who do not have significant defined-benefit pension schemes or for whom the relevant data were not available.

(Chart 100). The nascent recovery in profitability so far this year has reduced corporate income gearing further (Chart 101). Median income gearing has also fallen, according to the accounts of profit-making quoted companies that have published results for year-ends in 2003 (Chart 102). But income gearing has remained high for the most vulnerable firms – those in the highest income gearing decile – although it stands well below levels in the recessions of the early 1990s and early 1980s (Chart 102). The pickup in interest rates across the yield curve could signal upward pressure on the debt servicing burdens of these firms. And, other things being equal, the sensitivity of firms' income gearing to interest rate rises will have been raised by corporate debt accumulation over recent years. As with households, the effect of any future changes in interest rates will also depend on the shares of fixed and floating-rate debt.

In aggregate, however, corporate sector interest cover and liquidity remain strong, which helps to explain why the overall rate of insolvency for companies has been so low in recent years (Chart 103). Indeed, the rate fell below 1% in the first half of 2003, for the first time in 15 years, and fell further to a record low of 0.83% in Q3. Although balance sheet adjustment by larger firms in sectors such as telecoms may have put substantial pressure on smaller suppliers and customers, this does not yet appear to have led to any substantial rise in business failures. Bank research suggests that probabilities of failure (derived from company accounts data) are generally lower for larger companies<sup>49</sup>, partly reflecting their higher profitability and better liquidity on average, but also perhaps their more diversified income streams and sources of finance. But discussions with both corporate recovery bankers and major providers of small business finance suggest that small business failures have been lower than expected over the past year, perhaps partly because activity has held up better than envisaged.

The short-term outlook for company failures overall remains relatively benign. Although receiverships rose in Q3, in contrast to the trend over the past decade, they were still lower than a year earlier, as were administrations and company voluntary arrangements. Market indicators of corporate prospects have also moved favourably (Section 1.1): equity prices have risen by some 6% since the *June Review*, and corporate bond spreads have fallen across most sectors and ratings (Chart 104). This suggests that market participants have become more optimistic about the outlook for the corporate sector, although the greater reduction in spreads at lower ratings is also consistent with investors continuing the 'search for yield' discussed in the *June Review*.

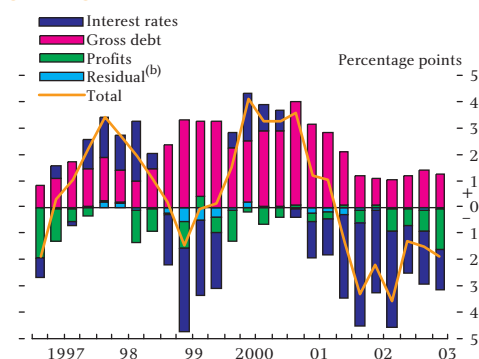
**Chart 100:**  
PNFCs' income gearing<sup>(a)</sup>



Sources: ONS and Bank calculations.

(a) As measured by interest payments as a share of gross operating surplus.

**Chart 101:**  
Contributions to annual changes in income gearing for UK PNFCs<sup>(a)</sup>

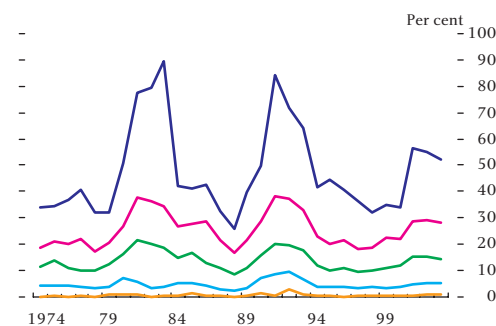


Sources: ONS and Bank calculations.

(a) Income gearing is defined as interest payments divided by pre-tax profits (gross operating surplus).

(b) A residual arising from the calculation of contributions.

**Chart 102:**  
Income gearing of profitable firms with 2003 accounts<sup>(a)(b)</sup>



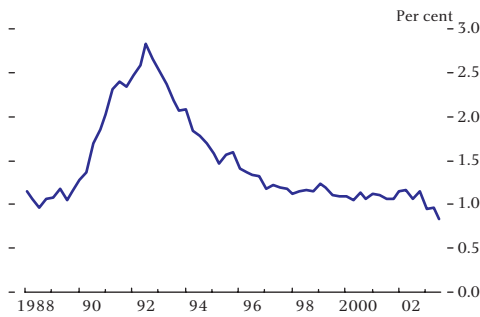
Sources: Thomson Financial Datastream and Bank calculations.

(a) Beginning at the highest line, the 90th, 75th, 50th, 25th and 10th percentiles of income gearing are shown.

(b) Based on a sample of 469 quoted PNFCs in 2003; the sample diminishes for earlier years depending on the existence of those companies at that time.

49: See Bunn, P (2003) 'Company accounts-based modelling of business failures', in the current *Review*. In this approach, size is measured by the number of employees.

**Chart 103:**  
**Rate of corporate insolvencies<sup>(a)(b)</sup>**

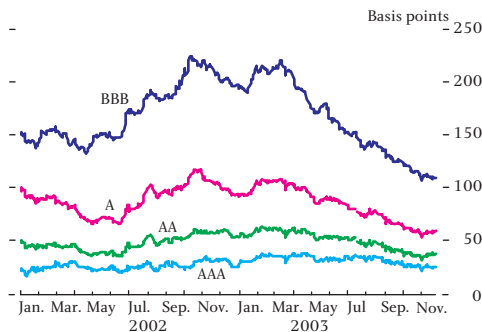


Sources: DTI and Bank calculations.

(a) In England and Wales.

(b) Calculated as the annualised number of insolvencies in the quarter divided by the number of active registered companies in the last month in that quarter.

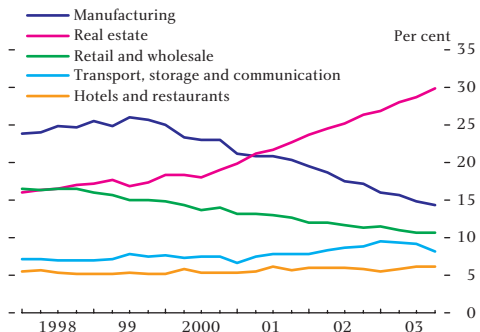
**Chart 104**  
**Sterling corporate asset swap spreads, by rating<sup>(a)</sup>**



Source: Merrill Lynch.

(a) Asset swap spread is defined as the option-adjusted spread over London Inter-Bank Offered Rate of a matched floating rate bond.

**Chart 105:**  
**UK-resident bank lending to non-financial corporations by sector<sup>(a)</sup>**



Source: Bank of England.

(a) Percentage share of total stock of non-financial corporate sector borrowing from UK-resident banks. Includes borrowings in all currencies.

Models of corporate default probability based on financial market prices have become more optimistic since the June Review. A Bank model of default probabilities, based on market valuations<sup>50</sup>, shows a sharp decline in expected default probabilities, reflecting the recovery in equity prices. In contrast, the accounts-based model suggests a small rise in default probabilities. Both models have over-predicted the actual liquidations rate in recent years, especially in the past 18 months. As noted in the June Review, lower-than-predicted liquidations may have reflected the greater incidence of successful restructurings of companies that have defaulted on their debt, most notably in the power and telecoms sectors.

## The commercial property sector

Borrowing by real estate companies has risen rapidly over the past five years, almost doubling as a share of the stock of non-financial corporate borrowing from UK-resident banks to close to 30% (Chart 105). But borrowing growth has eased since June, rising by 3.2% in Q3, compared with an average quarterly increase of over 5% during the previous year. The slowdown perhaps reflects the rise in the yield curve since mid-June, which will have raised the cost of new bank finance.

According to the latest De Montfort survey<sup>51</sup>, a significant share of bank lending in recent years has been directed into retail property, where rental and capital values have continued to rise (Chart 106). The office sector accounts for a similar share of the stock of lending – around 30%. Office rental and capital values have fallen in the past two years (Chart 106), with those falls largely affecting Central London offices. That can be attributed to a weakening in occupier demand in the City office market in particular.

In contrast to the 1980s, investment in this market has largely been in 'bond-type' assets let on long leases to tenants rather than in speculative development, although discussion at the Bank's Property Forum<sup>52</sup> suggests that investment in medium-term let property has risen recently. The profitability of these investments will hinge on the outlook for office markets in the next few years. But tenant default rates have remained low, reflecting low rates of corporate insolvency and benign debt servicing conditions.

Evidence from the De Montfort survey suggests an estimated 50% of property debt is due to be refinanced in the next five years (Chart 107). If the capital and rental values of a

50: See Tudela, M and Young, G (2003) 'Predicting default among UK companies: a Merton approach', *Financial Stability Review* (June).

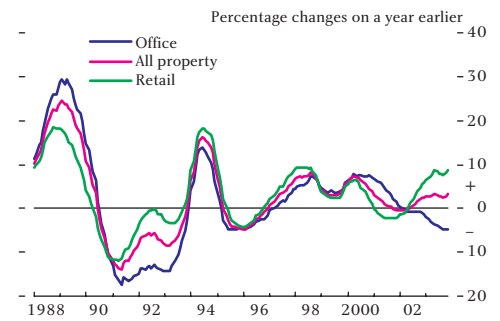
51: See Maxted, W and Porter, T (2003) 'The UK commercial property lending market', De Montfort University, May.

52: For background on the Property Forum, see the Box on page 72 of the November 1999 *Financial Stability Review*.

property due for refinancing have fallen markedly, the continuation of finance might require an additional injection of equity from the borrower. And if the borrower were unable or unwilling to meet that requirement, banks might make 'forced sales' of property to recover the value of their loans. There has been little evidence so far of distressed sales of properties whose capital values have fallen, in contrast to the early 1990s. And banks would have an incentive to renegotiate to avoid losses, particularly if forced sales risked lowering capital values further. Discussions with lenders suggest that they are prepared to wait and see whether capital values recover in the medium term, as long as interest payments remain secure.

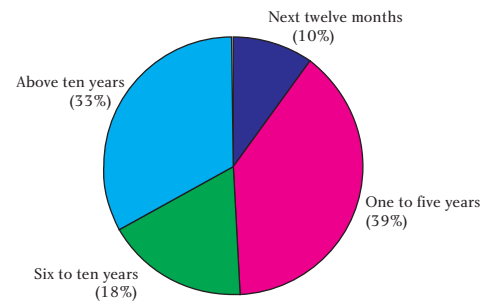
One risk is that the yield curve could move up further. That would increase the costs of refinancing loans and stretch interest cover, particularly for highly leveraged investors – such as some private companies and syndicates of private investors – who have accounted for much of City office investment in recent years. Another risk is a prolonged delay in rental and capital recovery for City offices, perhaps due to a rationalisation of the use of business space by occupiers and increased competition from alternative locations. In that situation, lenders might become more reluctant to maintain loans where loan-to-value covenants have been breached. But the outlook for the commercial property sector overall is also likely to reflect wider economic conditions, which have improved since the June *Review*.

**Chart 106:**  
**Commercial property capital values index**



Source: Investment Property Databank.

**Chart 107:**  
**Proportions of commercial property debt due for repayment as at end 2002**



Source: Maxted, W and Porter, T (May 2003) 'The UK commercial property lending market', De Montfort University.