Banks and industry

*The **Deputy Governor** notes[1] that—as a result of past inflation and recession and the consequent demise of alternative forms of financing—companies are heavily indebted to the banks, and indeed possibly over borrowed. Yet companies will have to continue to attract outside funds; and as the economy recovers, their financing requirement may be substantial. To resolve this dilemma, the Deputy Governor suggests various ways in which companies may diversify their sources of finance:*

- *with inflation down substantially, greater long-term fixed-interest borrowing may be possible;*
- *where debt is already high, greater equity funding by rights issues may be more suitable;*
- *where development expenditure is significant, new forms of off-balance-sheet financing might be appropriate.*

In addition, the beginning of a venture capital industry, in which new technology, entrepreneurial talent, and management resources may be combined to create new businesses, particularly in new 'sunrise' technologies, is a potentially important development.

Moreover, the establishment of these additional sources of finance would ease the task of monetary policy which the Deputy Governor also discusses.

My subject is banks and industry. First I will look briefly at developments in corporate financing over the past few years; then at the ways in which financing may develop in the future, and at some of the institutional innovations that are being designed so as to facilitate appropriate financing over the years ahead. Finally, I will touch on the Bank's role in this subject, and the interrelationship between corporate finance and monetary policy.

The legacy of inflation

A look back over the last ten years at the methods and problems of company financing shows how closely connected they have been with the extent of inflation in the economy. Indeed, problems of company financing provide a good example of the insidious and damaging effect of inflation and of why it has been so important to conquer it. An important effect of inflation is to cause uncertainty, and a natural response to such uncertainty is for individuals and companies to focus increasingly on the short term—especially in their borrowing, but also in their lending and spending decisions. Over the past few years this has certainly been the pattern in this country.

This makes my subject particularly timely, for it seems increasingly clear that we are at last succeeding in our battle against inflation. We are perhaps at something of a turning point and may hope that from now on plans can be based on more secure long-term expectations. The forms of financing may thus come to change from those that have characterised recent years. But at the same time, the residue of decisions taken under inflationary conditions will not suddenly disappear. There will remain a very substantial overhang of the effects of these past decisions made under different conditions and with different expectations. It is essential for companies and for banks to handle this overhang before they can fully take advantage of the opportunities for the future that the reduction in inflation may now increasingly bring about.

The inflationary pressures that have developed in the British economy over a long period have meant that inflation has only been reduced at very considerable cost. The battle against inflation has been responsible, in part, for the severity of the recession. We have had several years of very sluggish growth in total output, while in a number of sectors there have even been declines—some of them substantial.

There is no single unambiguous indicator of a company's financial position. But one frequently used is that of income gearing—the proportion of profits absorbed by interest charges. On this basis, the position of companies, both in the United Kingdom and overseas, has deteriorated sharply in recent years: partly because of declining profitability and partly because inflation has led to higher nominal interest rates. The Bank of England has studied a sample of 1,200 UK-listed industrial and commercial companies: for these, the average cover for interest has, over the past decade, been halved—from 9 times to $4\frac{1}{2}$ times. In respect of the smaller

(1) In a lecture to the Institute of Bankers in Bristol on 23 November 1982.

listed companies within the sample the decline in cover has been even greater, although from a higher level at the start of the period.

The changing structure of corporate debt

Lower profitability has reduced the capacity of firms to generate their own cash flow to provide for working capital, modernisation and expansion. Companies' fixed and working capital requirements have been met to a greater degree than was previously customary by recourse to borrowing. Moreover, from the early 1970s, the corporate debenture market, which had traditionally provided a ready source of fixed-interest long-term funding, ceased to be used; and dependence by companies on short and medium-term borrowing at variable interest rates increased markedly. This brought a dramatic increase in companies' dependence on banks. Between 1967 and 1973 the percentage of bank borrowings in companies' total new outside finance rose from 30% to 70%; between 1973 and 1982 it rose further, from 70% to 80%.

Within the total figures for corporate indebtedness, the Bank of England's work on the balance sheets of listed industrial and commercial companies suggests that there have been some significant developments in the maturity structure of corporate bank debt. There has been an increase in the proportion of bank debt raised by term lending rather than overdraft. Since overdraft facilities are—at least notionally—repayable on demand, this development should have improved companies' liquidity positions. However, this development has not prevented a significant shortening in the average maturity of company debt as a whole in that, since 1973, there has been a marked increase from about 30% to 37% in the proportion of companies' total debt repayable within a year.

Within the listed company sector, the gearing of smaller companies is lower than that of larger companies. This may partly reflect more cautious attitudes by the management of small companies, or by banks and other lenders with regard to small companies. But, it may be that smaller companies are having greater difficulties in obtaining the levels of borrowing that they require. The maturity structure of their debt also appears weaker than that of the larger firms. Around 60% of the borrowings of listed firms with a turnover of £25 million or less are at a maturity of one year or less. Again, this may reflect lower levels of sophistication on the part of small companies, or it could be a sign of a higher degree of caution by the banks in lending to these companies. All these developments have, as I have said, concerned smaller listed companies. The position of unlisted companies, who have benefitted from a number of special initiatives, is somewhat different. And I have also not considered the subject of leasing which has become an important new source of finance for many companies.

Thus we have seen the indebtedness of the corporate sector increase considerably over the last few years; banks have become the dominant—indeed virtually the exclusive—source of new outside finance. The average maturity of overall debt has become shorter, probably reflecting decisions by borrowers rather than by lenders. There has been an increased reluctance by companies to enter into long-term commitments at times of uncertainty associated with high inflation. This appears to have more than offset the fact that the banks have acted to move the maturity structure in the other direction, for instance by increased term lending in place of overdraft facilities.

A new relationship between companies and their bankers

So much for the situation we have reached to date. The combination of past high inflation and low growth has left financial problems that will persist, whatever the future may hold. And, despite these problems, companies will have to continue to attract outside funds. Indeed, as the economy recovers, the financing requirement may be substantial. Many companies will be starting from a position where profits are low; and where stocks, working capital and activity have been sharply cut back. Moreover companies will also need much new investment to face the intense competition that is bound to confront them. Investment now must compensate for the relative dearth of investment in manufacturing over the past few years of low demand and excess capacity. Economic upturn is likely therefore to give rise to financial difficulties, which in some cases may be severe. It is important that arrangements should be in place so that finance will not be an unnecessary impediment to recovery.

We start, unfortunately, from a position where, as a result of the length and severity of the recession, a number of companies are currently in difficulties and in need of active assistance from their banks. In these situations the Bank of England is occasionally able to play a role; and it may be worth saying a word or two about this. Our Industrial Finance Division at the Bank attempts to monitor the progress of many individual companies, keeping in close touch with both the companies themselves and their bankers. The aim is jointly to identify major problems as early as possible. If a difficulty arises it may sometimes help to bring together all the banks involved with the company, and encourage them to agree a mutually beneficial solution. In this way it may be possible to avoid the situation where one bank takes unilateral action at the expense of the other banks, without full knowledge of the overall situation, and in the fear that other banks may be contemplating similar action. If, on the other hand, the banks concerned can agree on a uniform approach, they—and the company—may well be able to devise an alternative outcome that could benefit them all more. We have, I believe, had considerable success, both in helping to bring about agreement on individual cases, and more generally, in making banks and companies aware of the need for frankness and completeness in exchanging information. Early resolution of problems in this way can often prevent them becoming more intractable later on.

The Bank of England's role can only be marginal; and it is satisfying to see how the banking system as a whole has also

been responding in a flexible and innovative way to the developing situation. Most banks have improved and tightened their own monitoring of their corporate customers, and there have in some cases been debt conversions and modest investments in equity by leading bankers. This has been materially helpful in mitigating the short-term cash constraints of some of their customers and restoring, to some extent, their balance sheet position, thereby permitting them a somewhat longer time horizon in which restructuring decisions can be put into effect. There are, nevertheless, severe limits, above all prudential, on how far banks can go in the direction of becoming shareholders: the stability of British banks—such a striking feature in the context of the world as a whole—would be much less evident now, if they had become shareholders on a large scale in the past. But judicious exercise of this option may, in suitable cases, both preserve a viable enterprise, and protect the bank's own investment in it.

New sources of finance for customers

Beyond the significant overall support that the banks are providing for companies in difficulties, there will be a fairly general need for new outside finance for companies—possibly on a substantial scale. This will come at a time when it is fairly generally held that companies are already fully borrowed. How can this dilemma be resolved? The answer I suggest must be through companies diversifying their sources of finance. I have already indicated the enormous increase over the last fifteen years in the proportion of companies' financing that has been provided by the banks, and have suggested that this was a reflection of the uncertainty surrounding the period of high inflation.

Now it seems that more options are open. Corporate treasurers have to balance the risks that achieving the greater security of fixed-interest commitments may seem burdensome if inflation falls significantly, against the risks that short-term borrowing facilities from the banks might not be renewed, or only renewed at higher cost. Recent developments in the economy have shifted the balance of these risks—with inflation down from over 20% to under 7% there is a much lower limit to the losses that companies could sustain in the event of further falls—and one would expect this to be associated with increasing amounts of long-term fixed-interest borrowing. Indeed, this has already begun to occur. I shall return to this in the final part of my talk.

A further readjustment may be considered between bond finance and equity finance. Equity finance has been unattractive to many investors because of the poor profitability outlook of many companies over the short term. But for companies there must be attractions in raising such finance, especially at a time when many are already worried at the extent of their debt service commitments. The difficulty is that, even at their present peaks, equity prices remain low in real terms, so that companies naturally remain cautious about issuing new equity. The volume of rights issues remains relatively small, with issues to date in 1982 running at only 60% of the level in the corresponding period last year, and less than half the number achieved in some years in the late 1970s. However, any further rises in the stock market are likely to increase the possibility for those listed companies whose debt is already uncomfortably high to undertake equity funding by way of rights issues.

The role of institutional shareholders, who now hold so high a proportion of the equity of listed companies, is of crucial importance here. Because of the nature of their obligations to their beneficiaries and policyholders, the institutions properly have an inbuilt degree of risk aversion. But there are a number of factors which justify them in taking a long-term view of their investments: their ability, because of their size, to spread risks; the long-term nature of their liabilities; and their underlying commitment and exposure to industry as a whole, since so high a proportion of their assets lie with British industry. Many of our institutional investors are very sensitive to these considerations, and much is being done by shareholders, by way not only of financial support but also of quiet stimulus to constructive changes in direction in the companies in which they hold shares. I believe that a good deal of progress in this respect has been made in the last couple of years, but there is more to be done.

I have outlined how conditions for company financing differ now from those of the last decade, and suggested that it is in their respective interests that companies, banks, and shareholders respond to these new conditions differently from the way they responded to the different conditions of the past. But this may not be enough. There may well be scope for other initiatives that will encourage companies to invest the sort of amounts that will be required over the next few years.

For instance, in the current environment, many projects which in easier times would be given the go-ahead must now be held back by the poor profitability outlook and inadequate internal sources of funds. In addition, if its balance sheet is already overgeared, a company may give preference to rationalisation and improving the quality of existing investment, rather than embarking on entirely new projects with relatively long, and possibly uncertain, pay-back periods. This cautious approach will be reinforced if a project involves large research and development expenditure which, under normal and prudent accounting conventions, may depress profits in its early years.

'Sunrise' technologies and venture capitalism

It may therefore be worth considering new approaches to financing, including, for example, the possibility that parts of development expenditure might be funded separately from the main balance sheet of a company; perhaps through an associate company, which would enjoy financial support from institutional investors. I do not belittle the difficulties of initiatives such as this, but the potential rewards must make them worth exploring.

Such possibilities relate primarily to the large companies, in established industries. But the regeneration of existing industries, even though in a very different form from that, say, of a decade ago, is unlikely to be the sole element of any significant recovery. The increases in productivity achieved over the past few years have released resources which, even when previous peaks of output are again exceeded, will still be available for use elsewhere. The industrial world of the future is bound to be very different from that of the 1970s, with new industries arriving to absorb these available resources or to make better use of those still in the traditional industries. Some parts of the world—particularly the United States—are enjoying considerable success in attracting and developing these new 'sunrise' technologies, in areas such as the computer related industries, other electronics, fibre optics, and medical and health care.

At present Britain is lagging here, just as in our traditional industries—but there are several reasons why these activities are likely to be important for our future. First, as I have said earlier, traditional industries are not likely to be able to absorb all the available resources; second, there is often thought to be a high income elasticity of demand for these new products, so that over time—as incomes rise—they will occupy an increasing share of world output; and third—since there is often a significant amount of product differentiation and patent protection in these industries—they can often generate relatively high profitability, thus providing further internal sources for growth. I understand that the owner of a silicon chip plant in California was asked why he looked so depressed, and answered that he had just heard that his plant's profits had only doubled that year! In any case, we must hope that, whatever our problems, impediments to financing should not stop us being able to compete here.

As a result of all this we need also to encourage the small firms who are attempting to develop in one of the new industries. Where small firms are concerned, individuals are the natural suppliers of equity capital. But for a long time now, and for a number of familiar reasons, the climate for such investment has not been propitious. So the initiative by the present Government in introducing the business start-up scheme was especially welcome. The tax incentives that it grants for individual investors can be viewed as an attempt to balance in some measure the very substantial tax inducements in favour of saving through pension funds and life assurance companies. That scheme is still in its infancy; and it would be optimistic to expect the change in attitudes to risk which it seeks to encourage to occur with dramatic speed. But we may perhaps reasonably hope that potential investors and their advisers are becoming increasingly aware of the new opportunities open to them.

A new, as yet very small but potentially important, development on the UK financial scene is the beginning of a venture capital industry. Both the term 'venture capital' and the activity it describes are imported from the United States, but derive from original English innovations. The merchant venturers in the eighteenth century were, of course, traders who frequently provided banking services to their customers as a lucrative sideline. It is interesting that it was the Bristol merchant venturers who, in 1774, sabotaged the first attempt by Parliament to control and reform banking, by petitioning against the bill on the grounds that it discriminated in favour of those whose sole activity was banking. With the demise of this bill, the serious reform of banking was delayed for over fifty years. Maybe it is not surprising then that bankers have been so wary of venturers!

Bristol, of course, is fast gaining a reputation as one of our leading growth areas for new industrial and commercial ventures, despite the city's location outside the assisted areas. A prime example was the opening earlier this year of the first phase of the 150 acre Aztec West science park between the M4 and M5 motorways on the city's outskirts. With the eventual prospect of up to 10,000 jobs located in this development alone (and in a range of sectors from high technology, electronics and aerospace to some of our more traditional industrial activities) this venture promises to be a fine example of the benefits and prosperity such well thought out projects can bring to an area, given positive attitudes from developers and local authority planners. One of the most pleasing aspects of this particular project, and no doubt many others like it, is the role played in planning and financing the development by one of our leading financial institutions who so often these days are criticised in some quarters for their apparent lack of support for UK industry.

There are therefore two separate, but related, objectives for the future. For companies in the traditional sectors, which have been through bad times but have reasonable long-term prospects, we must ensure both that the overhang of commitments incurred during the recent difficult years should not unnecessarily obstruct their prospects; and at the same time that there should be adequate ways for them to raise new finance. For companies in the newer industries, on the other hand, the main problems will be to ensure that arrangements are in place to facilitate sensible risk-taking; to encourage those who wish to become involved in this form of activity, and to remedy distortions that may in the past have tended to make such involvement unattractive.

Corporate finance and monetary policy

I should now like finally to say something about the close interrelationship between corporate financing and monetary policy—which of course is one of the Bank's principal concerns—and consider how our monetary policy achievements and objectives relate to the issues I have outlined.

As I have said, companies have turned in recent years to the banks for the major part of their finance. And contrary to past experience, and widespread expectations, bank lending to the corporate sector has continued to grow very fast indeed throughout the recession.

The other side of this development in bank lending has of course been that the banks have built up their deposit base rapidly. To put the same thing in other words, there has been strong expansionary pressure on the money supply, broadly defined. This has been a source of concern to the authorities, not only because of the threat posed to the achievement of our targets for money supply but also more basically because we have naturally been concerned about the possible future inflationary effects of a large overhang of liquidity in the economy. Any developments that would reduce the size of corporate borrowing from banks would—other things being equal—therefore help our monetary objectives.

Given the depth of the recession, it would not have been appropriate to have tried to choke off bank lending by higher interest rates. Much corporate borrowing has been involuntary, and raising interest rates could therefore even have perverse effects on the level of borrowing. In practice we have thought it right in general to reduce interest rates gradually as the rate of inflation has come down, thus maintaining rates at a reasonable but not excessive margin above the rate of inflation.

Restraining corporate borrowing would therefore have to come from encouraging the availability of an alternative source of finance for companies; and restraining the growth of the broad monetary aggregates would be achieved largely through controlling the sale of government debt. It has been suggested at times that these objectives have been mutually inconsistent.

Sales of government debt to the private sector have certainly offset some of the expansionary pressure on the money supply exerted by bank lending. This has put a heavy burden on the gilt-edged market. Indeed, we have been accused of issuing such enormous quantities of gilt-edged that we have crowded private sector borrowers out of the long-term debt markets. Our operations, it is sometimes said, have caused long-term interest rates to be higher than they need be, and this has discouraged companies from making their own debt issues.

In answer to this, I should first point out that it is not our debt management policy that affects the total quantity of savings available for borrowing by the private sector. That is determined essentially by the government's budget deficit, which must be financed somehow; if not by gilt-edged sales then in some other way.

The criticism might therefore be that we have done too much gilt-edged funding, and too little funding of other kinds. We have, in fact, done what we can to reduce our dependence on the gilt-edged market. That was the reason for the stepping up of national savings in 1980. And more recently we have increasingly concentrated our gilt-edged issues on short-dated stocks and index-linked stocks. Thus we have kept out of the conventional long-dated market, in the hope and expectation that private borrowers would come in. Since this summer, for instance, we have issued no stock—apart from indexed gilts—with a maturity longer than ten years.

We have, however, had to sell sufficient debt to the private sector to restrain the broad money aggregates. It would not have advanced the cause of the private capital markets if our gilt-edged funding had been too light and the money supply had grown so fast that inflationary expectations were reawakened. Long-term interest rates would have risen, and we would have been further away than ever from a revival of the long-term corporate debt market.

Progress so far and prospects ahead

As things have happened, the steady progress we have made in subduing inflation, and the prospect of further progress to come, have—until the recent hiccough—caused long-term interest rates to fall steadily. Indeed they have fallen to the point at which in September BOC made the first corporate loan stock issue for many years. Overall, in September and October, fixed-interest capital issues by UK listed companies totalled £460 million. Moreover, as people feel that the fall in the rate of inflation is likely to be a lasting one, there is every prospect that the revival of this market will continue. That is a development which we would greatly welcome, not only because of its significance for monetary policy but also because of what it would mean for the health of corporate finances. Ultimately, it might lead to what has been identified as a form of virtuous circle: companies might use their loan stock borrowings to repay bank debt; this could lead to a reduction in monetary growth, hence facilitating further falls in interest rates, and thus present further opportunities for corporate issues.

I will summarise my theme very briefly. Banks have played a major role in providing external finance to companies in recent years as the result of past inflation and recession and the consequent demise of alternative forms of company financing. For the future, companies will need new outside finance, quite probably on a substantial scale, and it seems that perhaps the banks may not play so dominant a role in this as they have played over the past few years. I believe that the financial health of the corporate sector is best assisted by the diversification of forms of corporate finance, including the generation of new sources of equity capital, and by a reversal of the trend of recent years towards shortening the maturity of company borrowing. The recent revival of the corporate bond market is perhaps an indicator of future developments, and it is—I believe—an indicator that we should all welcome.