Is there a 'credit crunch'?

This paper forms part of the written evidence submitted by the Bank to the Treasury and Civil Service Committee in March 1991 and was published by the Committee in its report on the 1991 Budget on 25 April.

What is a 'credit crunch'?

A 'credit crunch' is usually taken to mean a sharp reduction in the availability of credit. Such changes can arise in more ways than one. The existence of limits on the availability of credit is normal in market economies.

(i) To some extent borrowers are rationed by price; those appearing more likely to default are charged higher interest rates, with the premium over market rates covering expected risk.

(ii) But lenders cannot always match interest rates to risk and in practice choose to limit lending by amount rather than by, eg, varying the interest rate with the amount borrowed. (Charging higher interest rates may not adequately protect lenders against risk, if borrowers willing to pay higher rates tend to be worse risks.)

(iii) Credit rationing can also arise from the state of the lender's balance sheet in relation to regulation or other factors. Examples from the past include those in the United States arising from banks' inability to raise deposits, because their interest rates were limited by Regulation Q ceilings, and mortgage rationing in the United Kingdom which arose from building societies' unwillingness to charge market rates for mortgages. Liquidity concerns could have this effect, as could banks' minimum capital ratios, if coupled with inability to raise capital in the markets.

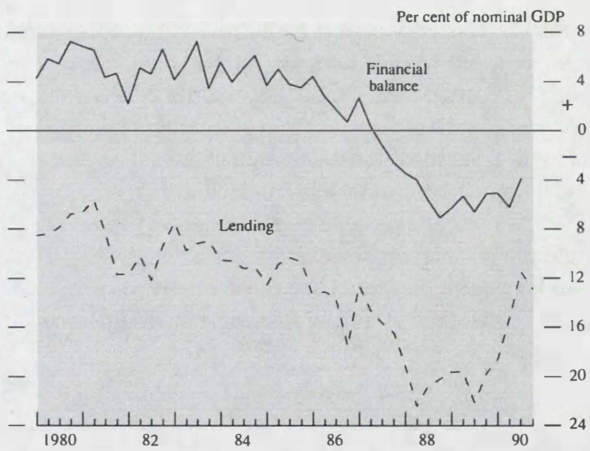
The most straightforward type of 'credit crunch' (and the main use of the term until recently) was of a sharp increase in credit rationing as described in (iii) above, with Regulation Q effects the classic example. But some changes in the cost and availability of credit, under (i) and (ii) above, are a normal feature of the trade cycle. The willingness of banks and others to lend clearly varies with the perceived creditworthiness of prospective borrowers, with their actual and expected cash flow, their interest commitments, the state of their balance sheets, and with asset prices (which affect the value of potential collateral). These factors change over the cycle, and are indeed altered by official action on interest rates. Changes in the availability of credit form part of the transmission mechanism of monetary policy.

A current issue in this country is whether the cyclical change in the availability of credit is so sharp as to justify the name of 'credit crunch'. If, for example, judgements made in the course of credit assessment were to swing by more than was justified by changes in the state of trade, reduced credit availability might indeed be regarded as an independent source of recession. Abrupt changes in credit standards have been observed in particular markets in the past. There is some evidence now of a general tightening in standards (discussed below) but it does not seem to be 'pathological' in the sense of being out of line with the underlying realities.

Recent developments in credit

The growth of credit was closely associated with the private sector's shift into deficit in 1987 and 1988 (see Chart 1) and with the excessive growth of domestic demand at that time. The growth of outstanding 'M4 lending' (sterling lending by banks and building societies to the UK private sector) reached a peak of around 30% at an annual rate in the middle months of 1988.

Chart 1
Private sector financial balance and M4 lending by banks and building societies[a]

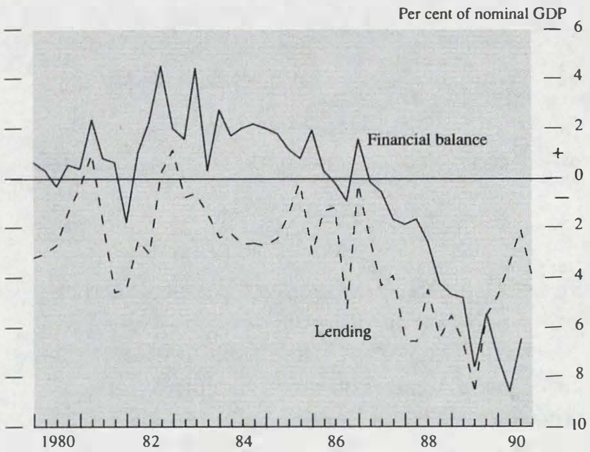


(a) Flow of lending is negative.

Adjustment in the economy has brought slower growth of credit: M4 lending grew at an annual rate of just under 10% in the three months to January this year. But this is likely to be faster than the growth of money GDP. In that sense the economy is still becoming *more* indebted.

In the early stages of adjustment it was personal (essentially mortgage) borrowing which slowed. More recently, outstanding borrowing by industrial and commercial companies has decelerated, from growth of nearly 20% at an annual rate in the first quarter of 1990 down to 7½% in the third quarter, but back up to 15% in the fourth. However, although full details are not available on a monthly basis, it seems that company borrowing was again low around the turn of the year. Company spending on fixed assets and stocks has slowed markedly since the middle of last year, and although figures are not available for the whole year, it is likely that companies' financial deficit has begun to fall. (See also Chart 2.)

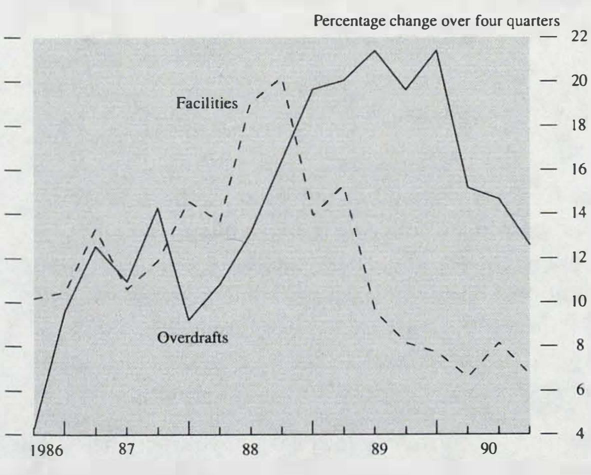
Chart 2
Industrial and commercial companies' financial balance and M4 lending[(a)]



(a) Flow of lending is negative.

It was bank lending which slowed most sharply last year, following an earlier slowdown in the growth of facilities. (See Chart 3.) We estimate that facilities have continued to grow in aggregate, and that their growth did not slacken much further last year. In itself, this tells against there being a severe 'credit crunch'.

Chart 3
Growth of UK banks' total sterling overdrafts and sterling overdraft facilities, estimates[(a)]



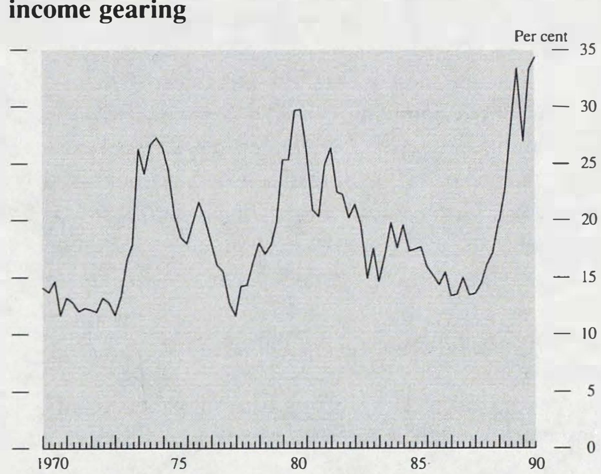
(a) When a facility may be drawn in either sterling or other currency at the option of the borrower, the unused portion is reported under 'other currencies'. Hence, actual sterling facilities may be understated.

Company finances

The slowdown and then fall in demand, coupled with recovery in the exchange rate, have reduced company profitability. The pre-tax real rate of return for industrial and commercial companies (outside the North Sea) is estimated to have fallen to 6% by the third quarter of last year, down from a peak of 10% in 1988. High spending on investment, which continued into 1990, brought with it a financial deficit unprecedented in size and duration.

Since the growing deficit was matched by increased borrowing, and interest rates remained high, income gearing (ratio of net interest payments to post-tax cash flow) reached unprecedented heights. (See Chart 4, which however runs to the third quarter of last year, since when base rates have been cut three times.)

Chart 4
Industrial and commercial companies' net income gearing



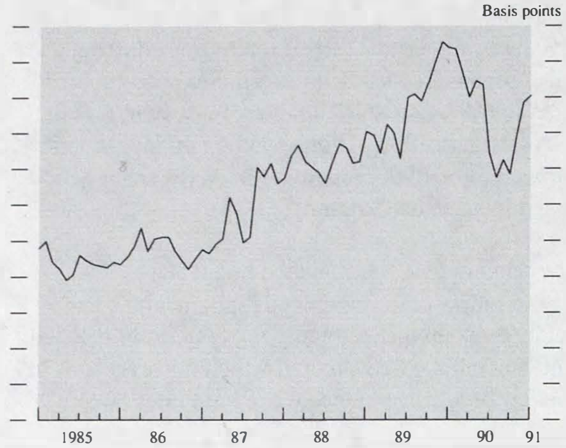
Companies have not yet succeeded in protecting their position by cutting costs. Only the most recent data suggest any fall in pay settlements, and with output falling faster than employment, unit labour costs have risen markedly. Nor is it clear that dividend payments have yet fallen on average. But fixed investment and stocks have both been cut, as has spending on takeover activity.

Company finances have manifestly become more fragile. Company liquidations in England and Wales rose by 43% last year, to a level which represented 1.4% of registered companies, compared to 1.5% in 1985 (the previous peak). The worsening business scene has also contributed to the increase in clearing banks' domestic provisions (see Table A). Companies are having to pay higher risk premia on their new borrowing, although quantifying the effect is not easy. In the sterling bond markets the spread of corporate bond

Table A
Domestic specific bad debt charge
£ millions

	1989	1990
Barclays	187	807
Lloyds	198	732
Midland	82	461
National Westminster	320	655

Chart 5
Corporate bond-gilt yield spread



yields over gilt-edged stocks has risen (see Chart 5) but is not as high as it was earlier: interpretation is difficult given the illiquidity of the corporate bond market.

Provisional evidence suggests that spreads (mostly over LIBOR) paid by UK companies on US$ denominated syndicated credits have risen from under ½% in 1989 to over 1% by the end of 1990. Spreads on US$ denominated bonds issued by UK companies (over US Treasury bonds) are very variable but seem to have been higher in 1990 than in 1989.

Spreads on borrowing not done through organised markets are harder to gauge. This is true not least of sterling borrowing from banks. The clearing banks' results do not reveal any increase in their spreads or margins for their

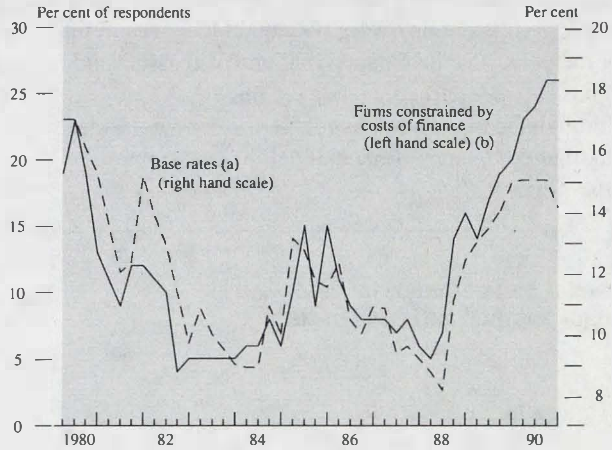
Table B
Domestic margins and spread
Percent

	Domestic margins [a]		Domestic spreads [b]	
	1989	1990	1989	1990
Barclays	4.3	3.9	2.2	2.0
Lloyds	5.2	5.1	3.0	2.9
Midland	4.1	3.5	2.0	2.0
National Westminster	5.2	4.6	2.3	2.1

(a) Net interest income divided by average income-earning assets.
(b) Difference between interest earned on average interest-earning assets and interest paid on average interest-bearing liabilities.

domestic balance sheets in 1990 as a whole. (See Table B.) However increased competition in the deposit market and non-performing loans will both have tended to reduce these overall spreads. The banks' results are not incompatible with increased spreads over base rate on loans. Certainly Lloyds Bank reported that 'margins are widening, largely because of reduced competition from US and Japanese banks who now fall under the same capital adequacy rules as the British banks.' The CBI's survey of manufacturers also offers indirect evidence tending to support the suggestion of higher margins on lending. In the past the proportion of firms quoting 'cost of finance' as a factor limiting investment has tended to match the path of base rates, but recently has continued to rise even after the first of the cuts in base rates. This may reflect in part the continued rise in the stock of borrowing and increases in spreads on other forms of debt, but it would certainly be compatible with a rise in margins on bank borrowing, the predominant form of

Chart 6
Cost of finance as a factor limiting capital expenditure, and lagged base rate



(a) The base rate lagged one quarter.
(b) Cost of finance as a factor limiting capital expenditure authorisations over the next 12 months.

debt.

It is worth noting that borrowing from the capital markets and in foreign currency have slowed down, as well as sterling borrowing from banks. (See Table C.) Also that the proportion of manufacturers quoting 'inability to raise external finance' as a factor limiting investment has risen from only 1% in April 1990 to 4% in January 1991. 4% is high by past standards, but is dwarfed by the 55% now quoting 'uncertainty about demand'.

Evidence from the banks and their customers

It is hard to judge, from statistics showing the economy and credit both slowing down, how far changes in the economy are reducing the demand for credit and how far changes in the availability of credit are causing adjustment in the economy. The Bank of England has a wide range of contacts not only with the banks but with their industrial and commercial customers. Qualitative evidence from these sources helps to throw light on this question.

Our contacts suggest that:

(i) the banks are certainly being more cautious in their lending and are adhering more rigidly to existing lending criteria. Typically banks are seeking to control additional borrowings, eg by reducing unused facilities. But there are some cases of banks reducing facilities which have been used.

(ii) demand for borrowing to finance investment has fallen back, and some companies which borrowed to finance takeovers are now aiming to return to earlier, lower levels of gearing.

Table C
Borrowing by industrial and commercial companies
£ millions: not seasonally adjusted unless otherwise stated

	Bank sterling borrowing (seasonally adjusted)	Building societies sterling borrowing (seasonally adjusted)	Bank and building societies foreign currency borrowing (seasonally adjusted)	Sterling commercial paper	Sterling capital issues: Ordinary and preference shares	Sterling capital issues: Other	Foreign currency issues	**Total**
1987	9,489	549	3,210	1,146	14,227	2,524	829	**31,974**
1988	23,014	950	8,304	1,343	4,916	2,890	1,584	**43,000**
1989	25,803	2,747	8,589	-20	2,651	4,680	1,573	**46,022**
1990	16,763	317	2,316	160	3,021	2,112	1,899	**26,587**
1990 Q1	5,387	84	768	418	1,301	333	559	
Q2	4,394	-236	694	521	607	330	39	
Q3	2,269	209	-412	157	553	1,059	728	
Q4	4,713	260	1,266	-936	560	390	573	

(iii) the standard of new proposals being put to the banks is generally low, and a greater proportion are failing to meet existing lending criteria.

(iv) there has been something of a return to 'relationship banking' with banks generally supportive of existing customers, but very wary of taking on new ones in current circumstances.

(v) companies are often unwilling to borrow at increased margins, not just because of the immediate cost but also because of the signal it might give about their status. (In such circumstances they may prefer to leave larger non-interest-bearing deposits with the banks.)

(vi) some companies have large deposits which they can use and are using to finance their activities. (In aggregate, company deposits fell by an unusually large amount in the fourth quarter of last year.)

(vii) UK banks by and large do not have a problem in meeting BIS capital adequacy guidelines (unlike some of their international rivals). But they are conscious of the need to husband their capital and of the need to improve their profitability.

(viii) UK banks have suffered cuts in their credit ratings, but they are not inhibited in their lending by any inability to raise deposits.

The Bank has also become involved in a increasing number of company support cases, involving increasingly large companies. Most of them reflect particular problems within individual companies, but debt servicing difficulties have been a frequent feature. The cases we have seen have not been precipitated by withdrawal of bank support.

The Bank supports the 'London Approach' towards providing financial support for companies with liquidity problems. The approach is not new, but with the rise in the number of support cases, we have taken steps to bring it to the attention of the many banks which may now be involved. The aim of the approach is to secure an orderly, collective and supportive attitude of banks towards companies experiencing financial difficulty. It highlights the need for a 'standstill' during which an independent assessment can be made of the company's position and prospects. In this way rational decisions can be taken on the basis of as full an understanding as possible.

Summary and conclusions

'Credit crunch' can mean different things. There is currently little or no evidence in this country of a 'credit crunch' in the original sense of lenders being unable to lend because they are unable to raise funds. There is evidence that the period of high interest rates has made borrowers less able and less willing to add to their debt, and that this has contributed, as was intended, to adjustment in the real economy. There is evidence that lenders have tightened their lending criteria, and more evidence that they have raised lending margins than that they have reduced lending facilities. There is little evidence that they have tightened standards beyond what is required, given the change in their customers' position and prospects.

7 March 1991