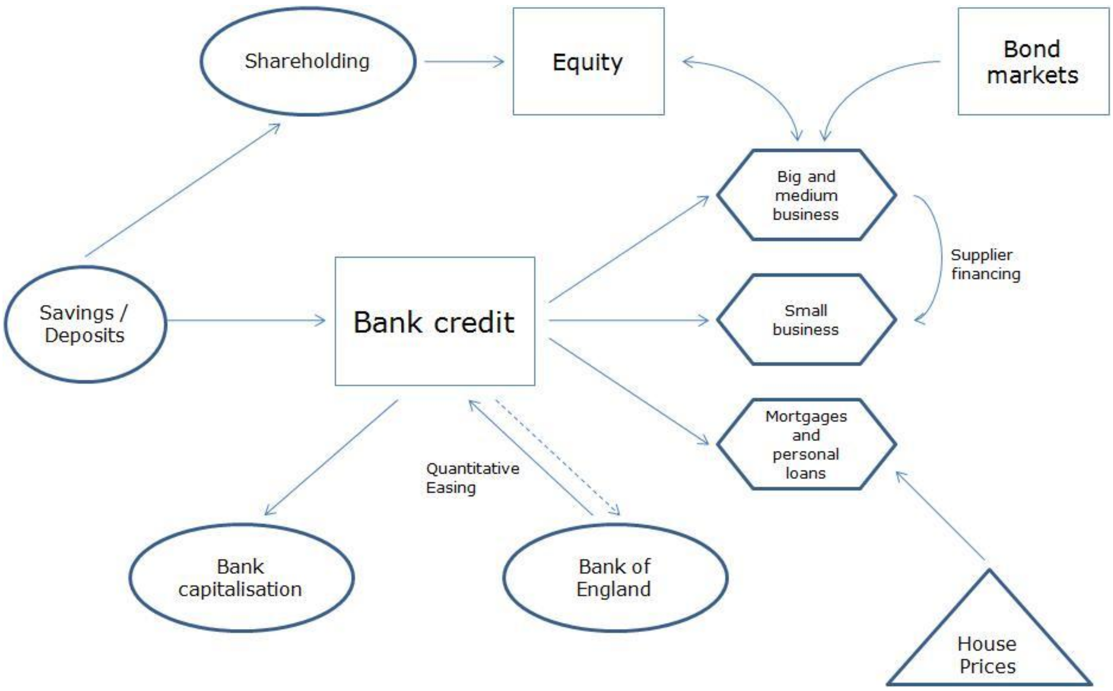
Credit after the Credit Crunch

> *Young men in the humblest walks of life may inspire their friends with confidence in their steadiness and judgment, and they become sureties for them on Cash Credit... Multitudes of men who have raised themselves to immense wealth began life with nothing but a Cash Credit* (Macleod, 1894, p.618)

Credit is vital in our modern global economy. This significance is not new: Adam Smith believed that the extension of credit allowed entrepreneurs to bring underutilised resources into production; the speedy development of the Scottish economy after Smith's death was attributed to a vibrant banking sector that monetised and extended the Highlands' economy.

Lack of credit, likewise, has a long history in political debate. In 1931, the Macmillan committee – formed to investigate the root causes of the 1929 stock market crash and the depression – identified a gap in the availability of credit that left small business underfunded. An attempt to rectify this market failure followed with the formation of the Industrial and Commercial Finance Corporation, an investment fund for small and medium businesses. This company – now known as 3i - was so successful that it is now publically listed and only invests in businesses with a value between €100m and €1bn.

Given the central place of credit in most people's lives (as outlined very briefly in the diagram below), it is no wonder that these issues are the subject of great ongoing public discussion. Access to credit can affect our ability to start and grow a business or to buy a home. Families and individuals also use credit for a variety of purposes beyond mortgages: credit cards, store cards, student loans, hire purchase and informal loans between family members make up a large volume of lending.



The recent 'credit crunch' has brought concerns on this subject to the fore. A tightening of the availability of credit means that compromises must be made between building safer banks (through recapitalisation and less risky lending) and increasing access to credit; between 'rebalancing' the economy away from debt and increasing access to credit.

The Credit Crunch

In the build-up to the financial crisis that began in 2007, lenders and borrowers took on risks that were excessive. The ratio of their liabilities to capital grew far too high - up to double normal levels - and poorly understood financial instruments were created to trade in this lending [see the video in the Further Resources section for a brilliant explanation of this]. This meant that when the housing bubble burst in the US, nobody knew how much any of these securities were worth. This led to the freezing up of credit markets and ultimately to the financial crisis, and bailouts to ensure that the banking system didn't fail.

The crisis inflicted huge costs upon the global economy: lost output, higher unemployment and weakened public finances. Though the crisis was global, the UK with its large financial sector was badly affected, as the Independent Commission on Banking describes:

> *National output in 2010 was 4.5% below its level in 2007 and 10% lower than if growth had continued on its pre-crisis trend. Unemployment has risen by more than 800,000 since 2007. The public finances have deteriorated sharply, and the 2010 deficit exceeded 10% of GDP. Despite recent de-leveraging, the total balance sheet of UK banks is more than four times annual GDP. More than 80% of RBS and more than 40% of Lloyds are in state ownership. Competition in UK banking has been seriously weakened as rivals to the largest retail banks have left the market or been absorbed into others* (Interim Report, April 2011, p.1)

In a standard recession, restoring credit flow to the economy at large is essential to combating the contraction of the market. In the wake of the credit crunch this has had to be balanced against the equally important need to recapitalise the banks and ensure a safe, stable and competitive future for the British banking industry.

Credit under the Coalition

The *Coalition Programme for Government* laid out an ambitious range of policies for dealing with the results of the credit crunch. These included:

- We will reform the banking system to avoid a repeat of the financial crisis, to promote a competitive economy, to sustain the recovery and to protect and sustain jobs.
- We will take steps to reduce systemic risk in the banking system and will establish an independent commission to investigate the complex issue of separating retail and

investment banking in a sustainable way; while recognising that this will take time to get right, the commission will be given an initial time frame of one year to report.

- We want the banking system to serve business, not the other way round. We will bring forward detailed proposals to foster diversity in financial services, promote mutuals and create a more competitive banking industry.

The Government established the Independent Commission on Banking to investigate these points. The Commission has already published an interim report and is due to conclude in the autumn of this year.

- We will develop effective proposals to ensure the flow of credit to viable SMEs. This will include consideration of both a major loan guarantee scheme and the use of net lending targets for the nationalised banks.

In February 2011, the Government announced that following the successful conclusion of 'Project Merlin' talks, the five largest UK banks had agreed to lend £190 billion of new credit to business (increased from £179 billion in 2010) of which £76 billion would be targeted at small and medium-sized enterprises (increased from £66 billion in 2010).

To enable lending to viable small businesses that lack collateral or a track record, the Enterprise Finance Guarantee scheme will provide up to £600 million of additional lending to around 6,000 businesses next year alone and, subject to demand, over £2 billion in total over the next 4 years.

To support small businesses with high growth potential, a new Enterprise Capital Fund is being launched. This new Fund will form part of the existing £237 million programme of Enterprise Capital Funds and will provide an extra £37.5 million in equity finance. It will be funded through a £25 million Government contribution and £12.5 million in private co-investment.

The Government will also provide much more, streamlined information (for example, about tax rates, how to register for business rates, how to register with Companies House) to businesses from a centrally run and managed website and call-centre. This will be supplemented by advice from a network of business mentors with business experience.

As well as these policies the Government aims, by 2015, to have handed back regulation of the banking sector to the Bank of England, laid out a future for the banks currently part-owned by the taxpayer, and ensured the economic stability that will get people both borrowing and lending again.

After 2015

1. What are the lessons for government from the credit crunch? Do you think these will remain relevant in the period 2015-2020?

2. Do mutuals, such as credit unions and building societies, have a different role to play than those of banks? If so, how would you describe that role and how can these be encouraged in 2015? If not, please explain.

3. Imagine you are in 2015, taking into account the expected recovery of the economy and the banks back to lending properly. What would you like the priorities for making available credit and loans to be?:
    - home mortgages
    - business loans
    - business loans to small and medium sized businesses
    - personal loans (for example, for holidays or for students)
    - car leases
    - credit card facilities and short term overdrafts
    - none of the above, it is up to the banks to decide for themselves
    - other (please specify)

4. Do you anticipate a shift in culture and attitude by 2015 towards lower levels of personal indebtedness? Should there be a national programme to tackle 'over-indebtedness' like that for obesity, drinking or smoking?

5. Comparing finance to energy security and food sustainability, from 2015 should there be a 'money security' policy for the nation?

6. Given the measures outlined above to help small businesses during this parliament, what could the government do after 2015 to help smaller businesses in your area to grow and attract investment?

7. A young person at secondary school now might be considering entering the financial services industry after 2015. What do you think can be done to encourage our able young people to enter into banking and other financial services professions? Should we be teaching better financial education to young people in the future?

8. What do you think will be the main credit-related challenges facing the country in 2015?

Further resources

A short animated video explaining how the credit crunch happened: http://vimeo.com/3261363

Independent Banking Commission website: http://bankingcommission.independent.gov.uk/

BIS consultation paper and response, 'Financing a Private Sector Recovery': http://bis.gov.uk/Consultations/financing-private-sector-recovery?cat=closedwithresponse

BIS consultation paper, 'Bigger, Better Business': https://online.businesslink.gov.uk/Horizontal_Services_files/bigger_better_business.pdf

Council of Mortgage Lenders, June 2011 Mortgage and Housing Market: http://www.cml.org.uk/cml/publications/newsandviews/90/332

People to seek out opinions from:

Business owners or aspiring entrepreneurs, house hunters, bank managers