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## **Credit Where It's Due**

How to revive bank lending to British Small and Medium  
Sized Enterprises

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## Introduction and Summary

*The short-run objective:* to increase the probability that funds released into the banking system by quantitative easing more directly influence both the risk appetite of banks for lending to small and medium sized enterprises (SMEs), along with their capability to lend rather than being hoarded, used to refinance investment banking activities, or simply disappearing out of the country into overseas lending.

*The longer-run opportunity:* to create an enduring mechanism that will encourage banks to increase lending to the kinds of innovative SMEs that are under-nourished by the current banking system but essential if the UK is to grow and rebalance its economy (Hutton and Nightingale, 2011).

*The proposal:* for the Treasury to create Special Purpose Vehicles (SPVs) that will purchase high-quality SME debt originated by individual banks, and for the SPV to issue tranches of debt in turn, in the form of asset-backed securities (ABSs) with decreasing orders of claim on its portfolio of assets. The originating banks will be required to retain the lowest-rated equity interest in order to ensure they have skin in the game, and the Treasury to provide credit enhancement to ensure the SPV remains bankruptcy-remote. Thus supported, the higher-rated paper issued by the SPV should meet the Bank of England's traditionally stringent tests to qualify for purchase in its quantitative easing initiatives. Banks will be able to use less capital than they otherwise would at this stage of the economic cycle to support new lending and would have access to funds at the cheapest rate. At a stroke SME lending will become potentially highly profitable.

This proposal achieves three aims simultaneously: it incentivises loan origination with the organisations that have the capacity to screen and monitor loans – banks, it gives them access to the cheapest finance and it provides a ready, controllable and easily adjustable means to stimulate economic activity in a targeted way. It creates the conduit for cash created by Quantitative Easing directly to flow in real business activity. These are advantages that other proposals, such as a special SME bond, do not possess. As a result the government could produce the public good of more contra-cyclical SME lending, so will be stimulating the economy and rebalancing it at the same time. We estimate the new lending could exceed £15 billion by 2013/14, equivalent to a fiscal stimulus of around 1% of GDP.

## The Problem

Recent downward revisions in forecasts mean the UK economy is now not expected to return to 2008 levels of output until 2014, representing a deeper fall in output and slower recovery than any since the nineteenth century. Estimates of the cumulative loss of output over the decades ahead compared to how it might have been expected to perform had it remained on trend range from £1.4 trillion upwards. Unemployment is above 8% and it is unlikely to fall appreciably until the middle of the decade. Most net new job generation outside London and the South-East came from the public sector in the run-up to the crisis in 2008. Given the high rate of public sector job losses there is a real concern that without a revival of private sector activity across the country, especially from SMEs, who play the biggest part in both promoting job growth and innovation, large parts of the UK will experience a severe crisis of joblessness.

There are many factors that will contribute to a revival of private sector activity and job hiring: a revival of business confidence, the prospect of rising demand, new technologies that offer new business models or customer propositions, and a potential resolution of the Euro-zone crisis. But one would be a greater willingness of banks to increase their risk appetite in business lending, especially to SMEs. Net new credit advanced to business has been plunging despite the so-called 'Project Merlin', and is even lower than should be expected given the slowness of recovery (Hutton and Nightingale, 2011). Given the condition of the underlying economy and the unwillingness of businesses to borrow, banks cannot be expected to unilaterally assume more risk without some change in the regulatory and financial architecture.

The SME funding problem can be summarised as follows:

1. Even in normal economic times SME lending is more costly, more risky and consumes more capital than other forms of lending. This is due to the widely acknowledged problem that borrowers know more about their circumstances and prospects than lenders, and banks necessarily protect themselves from their ignorance and risk of loan impairments by charging all borrowers a higher, one size fits all premium for loans, even if an individual borrower represents a good credit risk and should warrant a more keenly priced loan. This is known as 'information asymmetry' (Stiglitz and Weiss, 1981). On top of this, they simply reject applications they deem too risky or too costly to assess. High quality borrowers will then tend to scale back their investment plans. This might perhaps be an appropriate decision for an SME in these circumstances, but aggregated over the whole economy it is potentially a costly one for the country at large.

2. A key part of the problem is that high-growth SMEs cannot ameliorate the information asymmetry by the traditional route of either using their own or the business owners' real estate assets as collateral for the debt finance they are seeking. By definition, high-growth companies are ones where a major portion of the business's assets are intangible in nature. Indeed, it is that very characteristic that makes them valuable for a knowledge-based economy. Moreover, the kinds of SMEs that have the most potential for growth are often too large for the owners to have enough personal real estate assets to meet their collateral needs.
3. The textbook way for intangibles-rich medium-sized SMEs to finance their expansion needs is by raising equity finance, in the UK's alternative investment market (AIM). Outside investors can then get a stake in the upside potential of the firm to compensate them for the downside risks they face. Britain is fortunate in having an equity market that will cater for relatively small equity issues. However, this is not a universal solution to the problem of low collateral. The issue costs are proportionately large. The free-floats are small, the markets are thin and the shares consequently lack liquidity. Such shares are therefore unattractive to large institutional investors, which prefer to trade in large blocks, and to unit trusts that require liquid investments in order to be able to cover unexpected withdrawals. This means they do not attract analyst coverage and therefore are generally poorly monitored. For these and other reasons, many private companies are wary of going public and settle instead for a capital-constrained existence. The amount of new equity capital raised for SMEs from such sources as business angels, venture capital firms and public equity markets has been and will likely remain low compared to other sources. For example, only a very small proportion (2-4%) of SMEs seeks equity finance (IFF Research, 2010; Fraser, 2010). Money raised on AIM from initial public offerings by UK companies fell from a peak of £7 billion in 2005 to less than £1 billion in 2009 (URS, 2010).

As a result commercial banks will remain a key source of finance for SMEs in the foreseeable future, if only because they have an important informational advantage over other capital providers through their unique ability to monitor the cash flows of their customers. At the current time, however, the funding of SMEs has to compete with other bank investment opportunities for scarce equity capital – in particular with the proprietary trading activities of the banks. The fact that these are generally highly profitable (though very risky) suggests there must be a demand for the liquidity such activities create. But it is far from clear why taxpayers should implicitly insure such investment banking activities (Haldane, 2010). If capital were properly allocated to each activity such that these non-lending parts of banking received no implicit state subsidies other than funding for SMEs, which might reasonably qualify for such support, SME lending might be seen to be more

profitable than is currently the case. The Vickers proposals will have this effect when they are eventually implemented, but we need to go further and act sooner.

Our proposal can be viewed as a way of ring-fencing the funding by banks of SMEs such that taxpayer support is directed properly and does not simply go into one big banking pot.

## Our Proposal

We envisage the creation of a mechanism that will enable a bank to exploit its traditional monitoring advantage over other capital providers in the provision of finance for SMEs by ring-fencing those operations. It would have to expend resources to undertake the necessary due diligence work in distinguishing those SMEs that have high growth opportunities and low default risks from those that do not. This cannot be relegated to mechanical credit-scoring methods; it would have to be comparable to the analyses undertaken by the major credit-rating agencies and by investment analysts in the equity markets. The loan-originator banks would have to play a traditional monitoring role that would exploit their ongoing informational advantages. The contracts they write might have complex features – covenants to restrict the borrower's actions and to require compliance with specific loan conditions, interest rate terms that might depend on key performance metrics, etc. We envisage this business could be made highly profitable if the banks were able to devote relatively small amounts of equity capital to such activities.

This latter requirement would be met if the banks were able to sell such debt to a Treasury-sponsored SPV. They would be required to retain the lowest rated of the debt issued by the SPV, giving the banks a continuing interest in its performance and ensuring that the SME debt transferred to the SPV was of high quality, because they would bear first loss. They would be required to continue to monitor and service the SME loans and the fees they would get for this service would depend on how well they executed the task. For this due diligence role to be properly discharged it would be necessary for the Treasury to create at least one separate SPV for each participating bank – otherwise there would be a temptation for each bank to try to free-ride off the other banks.

Securitisation currently has a poor reputation, because of the role it played in the US subprime mortgage market that triggered the banking crisis. What we have in mind is different from past securitisation arrangements in several important ways. It is now widely accepted that the central problem with subprime securitisations was that the 'originate and distribute' model on which it was based led banks to lower their traditional mortgage lending standards – higher loan-to-value ratios, self-certification etc – in the belief that by selling the loans to SPVs the risks had been transferred to third parties. The expansion of mortgage credit had a feedback effect on the housing market that in turn led lenders to believe that the

risks from lowered originating standards would be covered by increases in the value of the collateral. Accounting considerations played a part as well: to get the mortgages off their balance sheets, in part to reduce the regulatory capital needed to support the business they were writing, banks had to follow the US rules that would determine whether the asset transfers to SPVs could be accounted for as sales or as secured borrowings.<sup>1</sup> This meant that a bank could not explicitly guarantee the holders of the mortgage-backed securities that they would make good any shortfalls in the SPVs' assets. Any support had to be a nod or a wink, creating subsequent uncertainty when the mortgage market faltered.

Our proposal differs from the previous securitisation model in important ways:

1. Banks will be required to maintain a significant continuing first-loss position in the SME loans they originate, but their exposure will be precise and bounded. Apart from the retained interest, they will be subject to normal commercial rules governing the sale of products that are fit for purpose. This will provide them with the incentive to carry out proper risk assessments when considering loan applications and to continue to monitor risks when servicing the loans.
2. The fact that the loans will be secured primarily on the growth potential of the borrowers rather than on their physical assets should rule out the possibility of a self-reinforcing spiral of loans and underlying asset values. The market cannot expand without limit as it will be dependent on Treasury guarantees needed to ensure the SPVs are bankruptcy-remote. Should the Treasury decide it either cannot afford to support more activity, or otherwise deem that the SME market is being over-funded, it can simply rein in the process.
3. This role of the Treasury in the process will guard against the problem that arose in the US concerning the role of Fannie Mae and Freddie Mac, the government-sponsored corporations that played a central role in the collateralisation of home mortgages. Though private business entities, the market believed their guarantees were backed by the federal government – a belief vindicated by subsequent events because their enormous size and reach had given them too-big-to-fail status. We can now see clearly that having mortgages backed by government-sponsored private shareholder-wealth-maximising entities opened the way for mortgage lending to expand almost without limit and with little regard to the risks involved. Our scheme provides a clear barrier between the guarantee function, which will be under the

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<sup>1</sup> The accounting rules in force at the time differed in America and Britain. In the US, most securitisations were structured to achieve off-balance treatment (ie the transfer of assets to the SPV would be treated for accounting purposes as a sale). Such treatment was rare in the UK – for example, Northern Rock's SPV assets and loans appeared on its balance sheet. A motivation for such off-balance sheet treatment not present in the UK can be traced to differences in the bankruptcy procedures in the two countries (Landsman, Peasnell and Shakespeare, 2008).

firm control of the Treasury, and SME loan origination, which will be down to the banks. This will prevent SME loan origination turning into a government backed boom.

4. The party originating the SME loans will not be the party sponsoring the SPV. The SPV will be the Treasury's creature, not the banks'. This means that third parties that purchase the SPV's paper will not be looking to the loan originators for assurances concerning the safety of their investments but rather to the SPV sponsor. Wholesale market participants seeking what Gorton (2010) usefully calls "information-insensitive" securities – eg ones that can be used as collateral in repo transactions – will have claims on instruments that are essentially government guaranteed. In addition, not being one and the same party, the sponsors and originator will negotiate genuine sales rather than disguised collateralised loans, making the issue of regulatory oversight of the participating banks' operations in this area more straightforward (capital requirements will be focused on the retained interests, not the uncertain commitments to all the SPV's paper).

Now let us consider more specifically what the proposed scheme offers for the various participants.

### **The Ultimate Funders**

It is envisaged that in the first instance the buyers of the highest-rated SPV ABSs will be the Bank of England, undertaken as part of its quantitative easing programme (QE). For the Bank, the debt will be high-grade medium-duration bonds of a quality essentially indistinguishable from conventional Government debt. The Bank has said the size of the corporate bond market makes it difficult for it to undertake QE via corporate bonds, and in any case it should not assume any risk. This proposal would solve both problems immediately. However it would make sense for part of each ABS issue to be sold publicly, in order to create a public market in the debt. This will have the added advantage for the Bank of enabling it subsequently to sell the debt if and when it decides to tighten its monetary stance.

Both the highest- and lowest-rated SPV debt should be attractive to the market because the SPV will have been made convincingly bankruptcy-remote through the Treasury guarantee. For securitisation to work properly it is essential that the SPV be legally and economically distinct from the banks that originate the underlying SME lending. The SPV capital suppliers must be convinced that, should the sponsoring bank itself get into financial difficulties, the bank's creditors would have no claim under bankruptcy against the assets that have been transferred to the SPV. In other words, the SPV capital suppliers' claim on the SPV's assets

must be rock solid. Even more important, there must be effectively no chance that the SPV itself could become bankrupt. This is where the Treasury guarantee is important, should the first-loss position of the originating bank prove insufficient to meet losses in the SPV's assets.

The Treasury guarantee is thus of central importance. The question might reasonably be asked as to why this insurance role might not be undertaken by the market. The first reason is that a Treasury guarantee is simply more credible, particularly in the current difficult conditions, than one provided by a private institution, where doubts about counterparty risk have to be taken into account by buyers of the ABSs. An arguably more important reason is to be found in the information asymmetry problem that faces any third-party guarantor. The fate of the monoline insurers of mortgage backed securities in the US is instructive in this regard. They were simply unable properly to monitor the risks they were underwriting. The Treasury would be in a much more powerful position. It could presumably coordinate its actions with those overseeing the banking system in a way not open to private insurers.

The Treasury habitually aims to charge a premium for the guarantees it provides – witness the Asset Protection Scheme or the Enterprise Finance Guarantee Scheme. We do not think that at the current stage of the economic cycle, with a depressed level of demand for credit, it would be appropriate to charge a premium. If lending to SMEs is judged to be sub-optimal even at current rates of interest, it will hardly create more demand if the interest cost is effectively raised by an insurance premium. Moreover, while the tools of contingent claims analysis could undoubtedly be brought to bear on the task, correctly pricing such a guarantee would be very difficult. Suggestions from the EU that not charging a premium is a state subsidy should be countered by arguing that it is a temporary, contra-cyclical and discretionary fiscal stimulus, and even when introduced should be very conservatively estimated so as not to deter banks from participating. Indeed a key benefit of the proposed securitisation programme would be to enable the Government to target more precisely the guarantee it is currently providing on a blanket basis free of charge to the banking system. By ring-fencing the lending that banks provide to at least part of the SME market, the regulators would have a much better line of sight on the risks they are underwriting. The Treasury would state how much SME lending it was willing to support in this way, thereby creating a mechanism to control the volume of lending that would qualify.

An alternative would simply be to provide government-backed self-funded insurance for SME lending, analogous to traditional export credits guarantees. The problem with such insurance is the information asymmetry that the securitisation model we propose is designed to address.

One risk remains: prepayment risk. A fixed-rate loan of, say, five years maturity might be paid back more quickly by the SME if things go well or interest rates fall (admittedly not a very plausible scenario in the long run). If such redemptions are correlated across SMEs, the holders of highest-rated SPV ABSs will be paid back more quickly than planned. This problem could easily be handled: the banks would simply be required to “re-load” the SPV with new SME debt to replace the debt already redeemed. Techniques for this are already well established for the securitisation of revolving credit instruments such as credit card receivables. Rules would need to be established to ensure that the banks did not try to game the situation by transferring lower quality SME loans than the ones they are replacing.

## The Banks

The main advantage for the banks of the proposed arrangement is that it would enable them to support lending by in effect reducing the capital requirements involved. SME lending lacks the collateral that is available for real estate loans, and it therefore requires more economic capital per pound lent. Current market conditions make it difficult to envisage how the private securitisation market could be revived without a powerful set of guarantees in place of the kind we envisage.

The effect of our proposal on the regulatory capital required of the originating bank to support its SME lending can be seen as follows. Every pound the bank lends in the traditional manner has a risk weight attached to it, depending on the credit rating accorded to the loan, which can vary from as low as 20% (ie 20 pence for every £1 lent) for top-rated loans to as high as 150% for the lowest rated loans. Under the revised Basel Accords, the sum of the bank’s risk-weighted assets must be backed by at least 6% of Tier 1 capital, which in Britain is to be lifted to 10% under the Vickers proposals (Independent Banking Commission, 2011). The first-loss retained by the bank under our proposed securitisation scheme would either qualify as a low rated securitisation that would require a 150% risk weighting or as unrated ABS that should be deducted directly from Tier 1 capital. The question of which method would require more regulatory capital, traditional or securitisation, depends on how big a slice has to be retained by the bank. If the bank’s first-loss position were to attract a 150% risk weighting, our proposed securitisation scheme will certainly require considerably less capital in any realistic setting.<sup>2</sup> The far more likely scenario, however, is that the retained interest would be required to be deducted from Tier 1 capital, and this effect is more complex to assess. The answer would also depend on whether the bank had a target Tier 1 ratio target in excess of the 6% or 10% minimum.

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<sup>2</sup> For example, consider a loan of £120. If the loan is kept on the bank’s balance sheet as per the traditional SME lending model, it will attract a weight of 1. With a Tier 1 capital requirement of 10%, the bank would have to support the £100 loan with £12 of its equity capital. If the loan were to be securitised with the bank retaining 67%, ie £80, on its balance sheet, the weighting applied would 1.5, ie £120. Again, it would need to invest £12 of equity capital. We do not envisage a bank retaining anything like such a large percentage. Suppose the bank retained only 20% of the loan (£24), which is still much larger than what we have in mind. With a 1.5 weighting applied, the bank would need only £3.6 of Tier 1 capital.

The following table shows the maximum percentage first loss the bank could retain. Beyond this the securitisation would be more costly in terms of regulatory capital than conventional SME lending, if the retained interest had to be deducted directly from Tier 1 capital. The columns cover three illustrative risk weights for the underlying SME loans: low risk (50%), conventional (100%) and high risk (150%). The rows are for three tier ratio targets – 8%, 10% and 12%.

	Risk Weighting		
	50%	100%	150%
Tier 1 = 8%	4%	8%	12%
Tier 1 = 10%	5%	10%	15%
Tier 1 = 12%	6%	12%	18%

Thus, the higher the risk weighting for the SME loan pool or the higher the target Tier 1 capital ratio, the greater the first-loss portion will have to be for the securitisation method to require higher capital. Given that our proposed securitisation scheme leaves the banks open to significantly less risk, by its design, than does conventional SME lending, it would be perverse if the regulatory requirements forced them to carry more regulatory capital, and we doubt that it would. In any case, the thrust of our model is that the bank would be required to carry less economic (as opposed to regulatory) capital, because the lending would be insured.

A key element of our proposal is that we deem it essential that banks change the ways they handle SME loan applications. As Hutton and Nightingale (2011) explain, credit-scoring models are inadequate tools for the proper assessment of SME loans. To do this, the benefits to the banks must exceed the costs. One key cost, the tying up of scarce capital, will be dealt with by our proposal. To do this, the scheme must allow the SME debt transferred to the SPV to be accounted for as a sale. To do this, risks must genuinely pass from the bank to the SPV investors. One of the legitimate complaints about past securitisations was that they were really little more than disguised collateralised loans. However, if risk does transfer then the temptation to skimp on risk assessment arises. We envisage dealing with this by forcing the banks to retain a first-loss position and have continuing loan servicing rights and responsibilities (for which they will earn a fee), and with strict oversight of the lending assessment methods by the regulators.

The banks will also be subject to conventional fitness-for-purpose sale standards when they transfer the assets to the SPV. This does not mean they must guarantee the SME will not default. It means that if the SPV can show that the SME loans were granted without proper

risk assessments being carried out then the originating bank would have to make good the SPV's loss. This risk would be determined at the portfolio level, not for individual SME loans. Such a standard should guard against the kinds of reckless lending that took place in the mortgage markets of various countries, where little or no risk assessments were made over and above reference to the outputs of credit scores.

Our proposal is designed to make it profitable for banks to provide loan capital for SMEs with good prospects. Securitisation designed around these principles allows means crucially that banks are able to exploit their comparative advantage in assessing and monitoring risks, but without simply sweeping the risks under the carpet – a huge advantage over other proposals such as a SME bond. We envisage it as being a means of avoiding the problems posed by the asset protection scheme launched in February 2009, under which banks paid the Treasury a premium in return for a default guarantee of 90% of the value of any loans they wanted to enter into the scheme. Such a scheme faced two problems. The first is that it was best suited to loans that take the form of straightforward corporate bonds that require no continuing servicing and monitoring by the lender, otherwise the lender has only a weak incentive to perform such tasks diligently. It is therefore less well suited to meet the borrowing needs of many SMEs. Second, because of the information asymmetry in the relationship the Treasury protected itself by charging premiums that were so expensive as to discourage banks from participating. Only Royal Bank of Scotland (RBS) is now in the scheme. The essence of a securitisation arrangement is to separate as much as possible the funding aspect of lending from the evaluation and monitoring processes that underpins it. Banks clearly have a comparative advantage in the latter if they deem it profitable to do so. But they face funding constraints. This proposal is designed to address both problems.

Much work remains to flesh out the details of such a plan. Banks would have to warehouse loan acceptances until they had a sufficient volume to ask the Treasury to create a new SPV. As the arrangement develops each participating bank would be associated with a growing number of distinct SPVs. This is a necessary step to provide the line of sight on loan origination quality essential to the safe working of the scheme. The Treasury might therefore find it convenient to create one or more master SPVs that would buy the top- and middle-rated SME-backed securities issued by each of its SPVs (recall the lowest rated would be retained by the originating banks) and tranche these claims in the same manner. The resultant instruments issued by the master SPV would be the ones guaranteed by the Treasury. The paper could be sold to the Bank of England and to other participants in the wholesale money markets. This would create sufficient value and volume to facilitate wholesale market transactions essential to the Bank of England as and when it wanted to tighten money market conditions by selling the claims. The paper created in this manner would be much like other government debt except that it would be backed firstly by direct

claims on the productive capacity of industry and commerce and only residually on the taxpayer.

## Conclusion

We have advanced reasons in this paper why we think our proposed scheme for promoting the flow of credit to the SME sector has advantages over the available alternatives. In economic terms it should have the same advantage of lowering capital requirements but with two important advantages: it will release new net money into a sector that desperately needs access to credit, and it does not give the politically contestable signal that the government and regulators are being “soft” on the banks by conceding demands on capital. Of course we understand that any case for using securitisation as the means to do this has to be convincing. There are two key differences with traditional securitisation arrangements. The first is that the scale of activity we have in mind is of a lower order of magnitude, and hence the risks are commensurately smaller. Bank of England statistics show that the amount of direct lending by UK banks to the corporate sector is dominated by commercial real estate; lending to other sectors (and to SMEs generally) is miniscule in comparison. However, the potential benefits in raising the animal spirits of entrepreneurs in uniquely troubled times, by making certain the flow of credit to the SME sector is at least maintained and at best increased, are enormous. Second, our proposal is focused on the question of the role that the government can play in dealing with the information asymmetry problem that is at the heart of the current economic malaise. If the banks respond as we expect this would represent a contra-cyclical, targeted credit stimulus whose macro-economic effects would be very similar to an orthodox fiscal stimulus but at a fraction of the cost, and would directly raise levels of investment, innovation and employment.

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Will's best-known book is probably *The State We're In* (1996), which was seen at the time as setting the scene for the Blair revolution, and his latest book, *Them and Us: Changing Britain – Why we need a fair society* was published in 2010.

Will is a governor of the London School of Economics. He is a member of the Scott Trust board and a fellow of the Sunningdale Institute. He is currently the Chair of the Commission on Ownership, which is examining to what extent and how ownership matters and is due to deliver its findings in autumn 2011. He also led the Public Sector Fair Pay Review, which published its final report in March 2011.

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His interest in banking pre-dates the financial crisis, being stimulated by the growth in asset securitisations in the USA. He is currently working on how equity prices responded to US banks' financial asset write-downs during the crisis and the interactions of newly-permitted accounting choices in 2008 by European banks with regulatory considerations and whether or not they are too big to fail. He is academic adviser to the Institute of Chartered Accountants of Scotland. He was the 1996 recipient of the British Accounting Association's Distinguished Academic of the Year Award and he was inducted into its Hall of Fame in 2004.

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