CHASM | Centre on Household Assets and Savings Management

Briefing Paper

The Credit Crunch after 'Project Merlin'

'Project Merlin'[1] was a twelve month agreement concluded in February 2011 between the government and the major high street banks intended to promote lending to small businesses *inter alia*. The banks largely met their targets in gross terms, but net lending fell in every quarter of 2011, and the UK economy fell into recession in 2012. The banks claimed that there were fewer firms applying for credit and there was a dearth of good quality applications. Small business associations claimed that applicants were being discouraged by rising interest rate margins on loans.

Rather than extend 'Project Merlin', the government launched the National Loan Guarantee Scheme (NLGS) in March 2012. This aimed to help businesses access cheaper finance by providing government guarantees to enable banks to borrow more cheaply. Participating banks are required to pass on the entire benefit through cheaper loans. The initial response of the big banks to the scheme, which aimed to subsidise up to £40bn in small business loans, was positive.

With the onset of the new recession, the scheme was scaled back and the Funding for Lending Scheme (FLS), was announced in June 2012 and brought rapidly into operation on 1st August 2012. It allows banks and building societies to borrow Treasury Bills, for a fee, from the Bank of England (Bank) for up to four years against the security of assets, such as

[1] Project Merlin in context http://www.birmingham.ac.uk/Documents/college-social-sciences/social-policy/CHASM/briefing-papers/project-merlin-2.pdf

business and home loans (mortgages). The Treasury Bills can be used to raise funds for both business and mortgage lending, in contrast to the previous schemes. The more a bank lends, the more it can borrow from the Bank, and banks that are increasing their lending will pay lower fees. The Bank will publish quarterly data on the usage of FLS and on the participating banks' lending performance.

The aim of the FLS is to tackle credit rationing faced by small businesses and to boost the housing market, in which average prices began to fall again in mid 2012, and ultimately to get the economy growing again. The launch of the FLS, which plans to inject £80bn into the economy met with scepticism from small businesses associations, which felt the participating banks would focus on mortgage, rather than small business, lending. Others felt that the net effect on mortgage lending would be limited and that banks would focus mainly on making larger loans to more wealthy households, which can afford to deposit at least 20% of the house value, rather than lend to first time buyers unable to raise such deposits. If small businesses suffer from the winding down of the NLGS in favour of the FLS, then an essential engine of job creation will be impaired and job losses may increase. The government may then need to re-orientate the FLS in favour of small business lending and also look to other initiatives to tackle the credit crunch.

Soon after the onset of the GFC, following the collapse of the Lehman Brothers bank in September 2008, the Small Firms Loan Guarantee Scheme (SLFGS) was replaced by the Enterprise Finance Guarantee. The EFG provides enhanced loan guarantees to a wider range of small businesses than its predecessor. The aim of such government backed schemes is to guarantee lending banks against losses on qualifying loans in order to increase bank lending to small businesses. Firms borrowing through banks under these schemes pay a premium (fee) on top of the bank lending rate and gain access to finance that would not otherwise be available to them, because they are unable to offer sufficient 'collateral' to secure a business loan in the normal way. The more collateral a bank takes, the smaller the guarantee it receives under the EFG scheme.

Loan guarantee schemes operate in many countries and function particularly well in the US, through the Small Business Administration (SBA, www.sba.gov) and Germany, through KfW (www.kfw.de). Not surprisingly, loan guarantees schemes are more attractive to banks, the higher the guarantee (currently 75% under the EFG) and more attractive to borrowers, the lower the premium fee (currently 2% per annum on the reducing loan balance under the EFG). By the end of 2011, it became evident that usage of EFG had declined by 63% compared with two years earlier.

The SFLG and the EFG have not proved popular with UK banks. Small business associations commonly claim that bank staff are confused about the details, and sometimes question their existence, of the schemes. Nevertheless, the EFG was broadened to include medium sized businesses in the 2011 Autumn Statement and the government claimed to be happy with its operation.

However, the RBS website (http://www.rbs.co.uk/business/borrowing/g1/government-lending-support/firms.ash) on 3/08/2012 stated at the top of its webpage on the GFG that: "The UK government could help secure your business loan". It then warned in bold letters that "Security may be required" and followed this with boxed text stating: "Your home or property may be repossessed if you do not keep up repayments on your mortgage". This suggests that RBS would prefer to take at least some collateral, in the form of a claim on the home of the potential borrower, and it would not be surprising if many potential borrowers are put off! Small business associations have long suspected that the banks find the UK schemes too costly, in terms of paperwork and staff training, to utilise.

Project Merlin set the banks small business lending targets, whilst the NLGS and the FLS adopted an incentive based approach to encouraging small business lending by banks, and the FLS extends it to mortgage lending. The underutilisation of UK small business loan guarantee schemes for more marginal lenders should be addressed, given their widespread usage in Germany, the US, and Japan. The extent of the subsidy could be enhanced by increasing the guarantee to banks, as Japan has done, and/or by reducing the fee charged to businesses; at least until the credit crunch abates. Further, the BIS should simplify the 'paperwork' and the banks should be required to train their staff appropriately.

If these government initiatives fail, then the option remains of creating a government owned small business investment bank to address the business 'funding gap' identified in the March 2012 Breedon Taskforce Report (www.bis.gov.uk) on boosting finance options for business. That report made various recommendations, but it should be noted that the government already owns over 80% of RBS!

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