INVESTMENT NEWS

GAD

01

MONTHLY NEWS BULLETIN
FROM THE INVESTMENT AND RISK TEAM

1 May 2013

MONTHLY UPDATE

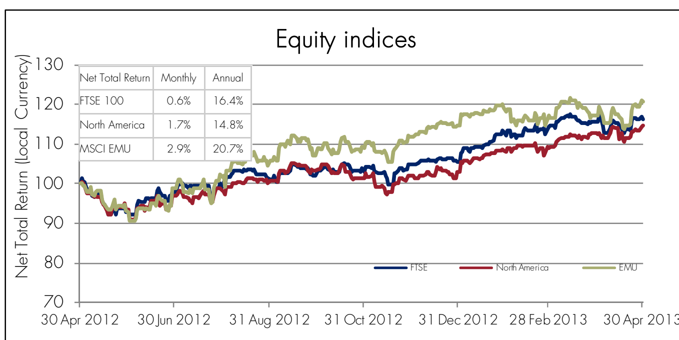
Overview

The UK has avoided falling back into recession, following an announcement by the Office for National Statistics that the economy grew by 0.3% in the first quarter of 2013. Growth was higher than was generally expected, and attributed to a strong service sector and a recovery in North Sea oil and gas output. Nevertheless, GDP per capita (adjusted for inflation) is 6.2% below the pre-financial crisis peak.

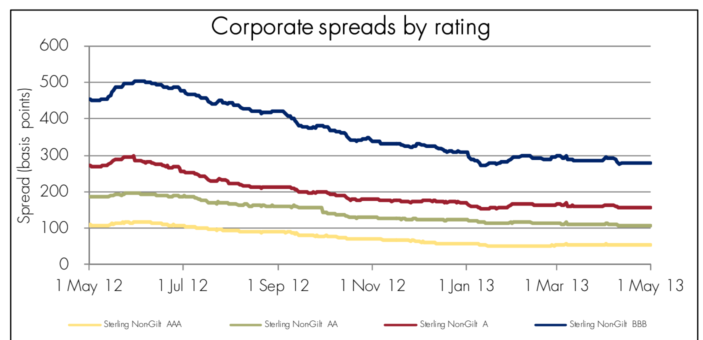
Despite avoiding a triple dip recession, Fitch joined Moody's in downgrading the UK's credit rating from AAA to AA+. It cited a weaker fiscal and economic outlook, although returned the new rating to "stable" which should reduce the threat of further downgrades in the short term. In light of the continuing weak performance of the economy the International Monetary Fund Chief Economist, Olivier Blanchard, has said it might be time for a reassessment of UK fiscal policy. The Government and Bank of England recently expanded the Funding for Lending scheme, which offers low-cost funding in return for lending to smaller firms.

Meanwhile there are more encouraging indications from Japan, where both economic growth and inflation forecasts have been revised upwards. According to the Bank of Japan, the world's third-largest economy has "stopped weakening and showed some signs of picking up". It follows the announcement of a massive stimulus package earlier in the month, aimed at ending two decades of stagnation.

Equity markets showed modest growth over the month



Credit spreads were broadly unchanged

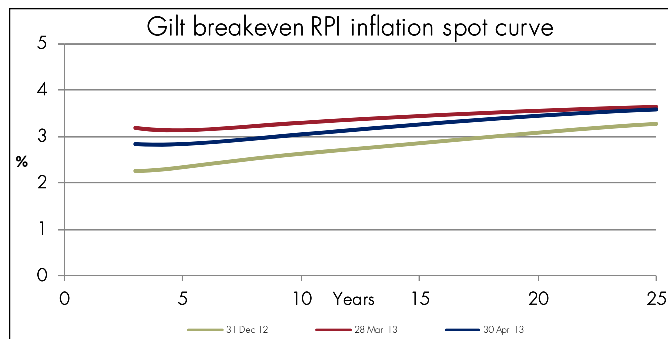


LATEST ECONOMIC NUMBERS

Current base rate	0.5%
Quantitative easing level	£375bn
CPI increase Mar (%y/y)	2.8%
Halifax house prices Mar (%m/m)	0.2%
IPD TR property index Mar (%m/m)	0.4%
PPF 7800 funding ratio	82.6%
VIX (volatility) index	13.5
$/£ exchange rate	1.52

Numbers as at the end of month unless stated

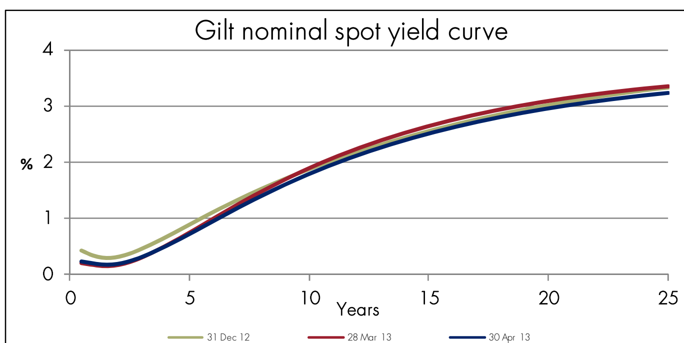
Breakeven inflation fell this month



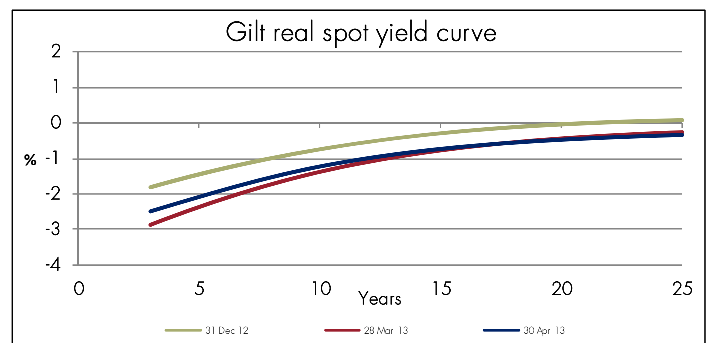
CALENDAR OF EVENTS AND DATA RELEASES

MPC interest rate announcement	9th May
UK Trade	10th May
Producer Price Index	21st May
RPI / CPI	21st May
Minutes of MPC meeting	22nd May
UK GDP (Q1 2nd estimate)	23rd May

Nominal yields fell slightly this month



Real yields rose slightly this month



All chart data sourced to Bank of England, Merrill Lynch, Financial Times, MSCI & Standard and Poor.

INVESTMENT NEWS

MONTHLY NEWS BULLETIN
FROM THE INVESTMENT AND RISK TEAM

GAD

1 May 2013

Non-bank lending revisited

Since the credit crunch, and the resulting deleveraging of banks' balance sheets, non-bank lending has grown in prominence as businesses searched for alternative sources of funding and investors moved into the gap left by contracting banks. In the UK, small and medium sized businesses have traditionally relied heavily on banks for financing - with a smaller proportion issuing bonds than compared to those in the US. However as banks tightened lending criteria, alternative funding sources have been seen as an appealing option, both to businesses and to investors who were attracted by the return characteristics that they might provide.

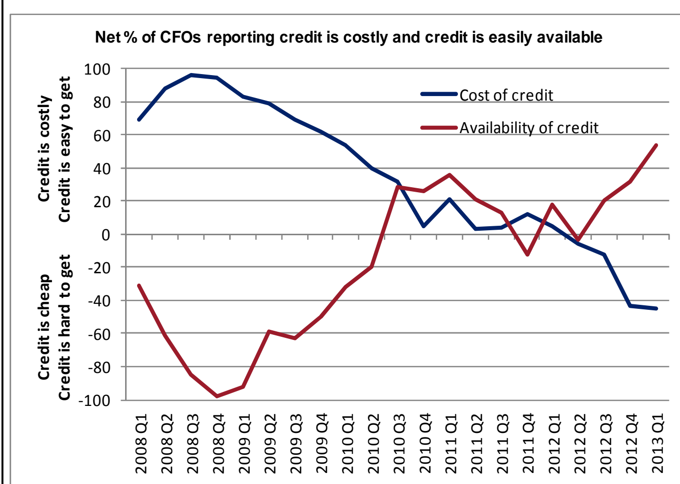
Background

Non-bank lending refers to a range of channels through which investors engage in direct lending to companies or individuals. For larger businesses there are opportunities to issue publicly listed bonds; however, for smaller businesses such issues can be prohibitively expensive and instead these businesses have generally relied on bank loans. During the credit crisis, businesses found the cost and difficulty of obtaining credit rose sharply and the risks of banks lending for long durations while relying on short term funding from deposits or wholesale markets were sharply brought to the world's attention. A variety of non-bank companies have since started or enlarged lending schemes with the resulting loans being potentially attractive investments for insurance companies or pensions funds who have long-term liabilities and less of a need for immediate liquidity.

Forms of non-bank lending

Non-bank lending now comes in a variety of forms, both in the type and purpose of the financing provided and in the way that investors access the asset. Since 2010, when we previously looked at this topic, a range of new investment funds have been launched targeted at institutional investors. These seek returns from managing a portfolio of private debt, in some cases focused on particular themes such as real estate, social housing or infrastructure. There has also been growth in schemes aimed at private investors, including a chocolate bond which pay coupons in chocolate, and a surge of interest in peer-to-peer lending websites offering opportunities to lend to individuals or invest in the development of the latest gadget. The government has aimed to boost lending to small and medium sized businesses by co-investing with the private sector through non-bank channels, originally through the Business Finance Partnership and now through the business bank launched in the 2012 Autumn Statement.

Box 1 - Cost and availability of credit



Source: Deloitte CFO Survey Q1 2013

Chief Financial Officers reported credit was particularly expensive and difficult to obtain in late 2008 but that recently it has become cheaper and more available than at any time in the past five years.

Considerations

One of the defining characteristics of this asset class is the potential illiquidity and lack of a secondary market. For insurance companies with annuity books or pension funds with long-term outlooks this may not be a significant problem. However, with loans being made for typically five years, investors should normally be prepared to tie up their money for at least this long and possibly for over ten years. For those that can do this, private debt markets may provide the opportunity for returns in excess of those available on publicly traded debt.

The traditional dominance of banks in this market means that the expertise required to assess the creditworthiness of companies is not always readily available. There is therefore concern that many investors could underestimate the level of default risk that these investments present. Several of the funds launched so far have seen the asset managers invest significant amounts of their own capital in the fund, providing reassurance that they have "skin in the game" and hence helping to ensure that lending standards will remain robust.

Banks have by no means been made obsolete by these developments. As well as continuing to carry out traditional lending, those with investment banking arms may help to advise on raising capital in these alternative markets. Existing bank networks may provide significant advantages when lending to smaller companies and partnerships with asset managers may allow banks to help arrange loans and continue relationships with clients, while passing some of the loans on to third parties. In the more than two years since we previously covered this topic, the market in alternative funding has become increasingly diverse. With surveys reporting that credit is now becoming cheaper and more easily available (see Box 1), it will be interesting to see how non-bank lending continues to develop.

Any material or information in this document is based on sources believed to be reliable; however, we can not warrant accuracy, completeness or otherwise, or accept responsibility for any error, omission or other inaccuracy, or for any consequences arising from any reliance upon such information. The facts and data contained are not intended to be a substitute for commercial judgement or professional or legal advice, and you should not act in reliance upon any of the facts and data contained, without first obtaining professional advice relevant to your circumstances. Expressions of opinion may be subject to change without notice.

Contact Information

Colin Wilson
Technical Director
T: +44 (0)20 7211 2672
E: colin.wilson@gad.gov.uk

Matt Gurden
Investment & Risk Actuary
T: +44 (0)20 7211 3498
E: matt.gurden@gad.gov.uk

Andrew Jinks
Investment & Risk Actuary
T: +44 (0)20 7211 2655
E: andrew.jinks@gad.gov.uk

Chris Bull
Investment & Risk Actuary
T: +44 (0)20 7211 2739
E: christopher.bull@gad.gov.uk