

Richard Lambert's speaking Note – 20 November 2009

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Today's reports suggest that we may be at the start of a new era for business, in which attitudes to finance and to corporate leadership are changed for a generation by the shock of the past two years.

The message for me is that financial engineering is yesterday's story. The new world will be less about complex financial transactions, more about collaboration, partnership, and longer-term relationships with a wide group of stakeholders.

In the twenty years up to the crash, a new and powerful form of global financial capitalism came to shape the business world. The international stock of financial assets multiplied at a dizzying pace; finance became much more oriented towards transactions of different kinds; and financial services contributed an ever rising share of corporate profits and corporate tax payments.

Bank balance sheets everywhere expanded rapidly, powered in good part by the huge growth in financial transactions of all kinds. And here in the UK, other types of lending became increasingly focussed on commercial real estate. Between 1986 and 2008, manufacturing's share of lending to non-financial companies fell from 29 per cent to just 5 per cent while the real estate share rose from 11 to 36 per cent.

Doing the sums in a different way, the Bank of England said yesterday that the real estate share is now close to 50 per cent.

The combination of a long period of low interest rates, low economic volatility, rising asset prices and steady growth led to a much increased appetite for risk. And that in turn changed the way that both bankers and their customers thought about their balance sheets.

The more you borrowed, it seemed, the richer you became. And in a world which was being shaped by a rising volume of financial transactions, the need to maximise short-term shareholder value took on ever more importance.

If chief executives in the industrial sector didn't deliver the results in a timely fashion, they either had to spend more time with their families – or face an aggressive takeover bid

Nowhere was all this more true than here in the UK. It was, and remains, the most open economy in the world, where almost everything is available for sale to almost everyone at the right price.

And the increasing focus on short-term shareholder value had a dramatic effect on the driving forces of British capitalism. Managers focused an increasing proportion of time and effort on their balance sheets, and were criticised if they weren't sufficiently aggressive. In the three years

to 2007, non-financial companies bought back around £40 billion more of their shares than they issued. Financial gearing increased; large numbers of companies passed into foreign ownership; unsuccessful financial engineering destroyed a number of household names, like GEC.

Then came the credit crunch, and what now looks like a very different world. The consequences for the way that credit is supplied to businesses have already been dramatic. And today's report shows how it is shaping the way that non-financial companies are thinking about their future.

The global nature of financial capitalism has been wound back, at least temporarily, as damaged banks everywhere have pulled in their horns and concentrated on their home markets. Foreign banks were responsible for over 40 per cent of new bank lending to British business in 2007: this year, they account for well over half the fall in business lending.

The domestic banks are doing a good job of rebuilding their balance sheets. Their average tier one capital ratios had climbed to nearly 7.5 per cent in the first half of this year, up from an average of around 6 per cent between 2003 and 2008. But it is likely to be quite some while before they have bolstered their capital base to the point where they and their regulators can feel entirely comfortable.

In the meantime, there is at least a question about whether they will have the firepower to finance a sustained period of economic recovery and growth. That's one reason why it is going to be so important to think about the impact of regulatory reform on the real economy, and strike the right balance between stability and growth.

I am especially concerned about the availability of finance for smaller companies. In contrast to a number of other big countries, small firms in the UK don't have much choice when it comes to raising money. They can't issue equity, bonds, or commercial paper at a sensible price, and for them there is no ready substitute for the small handful of very large bank lenders.

The good news is that the capital markets have reopened, and allowed large companies to raise big sums of money – much of which has been used to pay down bank debt.

And in this new and more cautious world, the attitude to equity finance has turned 180 degrees. In marked contrast to the past decade, net new issue of equities so far this year amounts to a remarkable £25bn. But for small companies, the cost of credit – 3.5 points over bank rate and sometimes much more – remains a big problem.

One important message from today's report is that companies will want to take lower risks with their balance sheets for some time to come. The cost of credit is expected to be higher, and banks will be more risk averse.

In addition, a less benign economic environment will make business conditions more volatile in the next decade than they were in the period that economists now describe as the "great moderation". Both these trends point to more conservative balance sheet structures, with a greater weight given to equity.

They also suggest a more collaborative business environment, with less emphasis on transactions and more on relationships.

This is not just about financial structures. For example, the recession has forced firms to recognise the vulnerabilities of a long, geographically stretched supply chain in which they are dependent on a small number of key suppliers.

Firms looking to reduce risk and acknowledge their interdependence are seeking more collaborative ways of working through partnerships and joint ventures.

We are already seeing changes in the way supply chains are financed. The credit shock has prompted companies with the largest, most solid balance sheets to help finance some of their key suppliers and customers, again enhancing the longer term relationships between the different parties.

This report is intended to stimulate debate, and it poses a lot of important questions for businesses, bankers and policymakers.

For example, given what's happened in the past couple of years, can it really make sense for bank balance sheets to be so heavily exposed to financial intermediation and to commercial real estate?

What would have to happen to secure more financial support for manufacturers? After a big devaluation and with massive infrastructure investments required in this country, we have the chance of a manufacturing revival here in the next decade. Do we have the financial structures to make this possible?

Would it be a good idea to have a wider range of shots in the financing locker? As a share of GDP, the private sector bond market in the UK is easily the smallest in the G7. It's great that the London Stock Exchange is to develop an electronic bond market for retail investors: more power to its elbow. But couldn't a country with such an enormous pool of pension and annuity assets also find other ways of developing new sources of corporate finance?

And might it be a good idea to encourage new forms of institutions to finance the growth of small and medium sized enterprises through equity and debt? That's what the old Industrial and Commercial Finance Corporation did successfully for fifty years after the war: why not reinvent it? Why not make it easier for companies to raise money locally, perhaps through new regional banking and investment institutions, rather than having to rely on a few very big players in London and Edinburgh?

Why not make it easier and less expensive for companies to issue new equity – perhaps by allowing smaller firms to charge the cost of equity issuance against tax?

And the implication of our report is that business managers have a lot of new thinking to do as well. In this more collaborative world, they are going to need closer and more lasting

relationships with other interest groups – their customers, suppliers, employees, and shareholders.

Would that require them to take a rather longer-term view of shareholder value – with managements' priority being more on innovation and wealth creation than immediate profit maximisation?

The era of financial capitalism brought real benefits as well as risks to the world. Emerging markets gained access to funds on a hitherto unimaginable scale, and world-class companies were created from scratch in a very short period of time.

But after the shock of the last two years, this report suggests that what we now need is a more balanced, less risky pathway to growth – one in which the short term returns may be lower, but the long term rewards for management success will be a lot more sustainable and secure.

Thank you.