The leasing market can survive despite being in flux

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Recent events in global markets have raised many questions about how the US sub-prime problem has led to concerns about world-wide financial stability. The speed and breadth of the crisis have taken many authorities and analysts by surprise.

As the turmoil spread, increased risk aversion, reduced liquidity, uncertainty about the soundness of major financial institutions, question marks over structured finance products and economic uncertainty have been feeding off one another and compounding the overall negative situation.

Mixed fortunes

The asset finance industry is going through a period of mixed fortunes, not all I may say of its own making. We continue to see the underperformers amongst the banking sector being exposed and, as a result, can expect to see more leasing and asset finance subsidiaries being sold or closed down. It is a tragedy that the sufferers may well not be the culprits.

On an upbeat note, others are successfully weathering the storm, achieving above-average industry growth and actively planning to expand, be this domestically or internationally.

Innovation should be high on the asset finance industry's agenda as it strives to rise to the challenge of creating value. Just under five years ago – when *Leasing Life* reviewed a decade of asset finance as part of the magazine's celebration of its first 10 years – I was quoted as saying the following: "There is a distinct lack of visibility of anything new from UK lessors. As a product leasing has been absorbed by the banks. There is a danger that creativity will be stifled and even that some banks will question the justification of leasing." Regrettably, I have similar concerns today.

Losses at major financial institutions have spread to a range of products, and credit discipline deficiencies are emerging in worsening economic conditions. Institutions with weakened balance sheets that need to raise more capital and to ensure their ability to fund are finding it more expensive to do so. Many have been exposed as insufficiently prepared for a period of intense liquidity strain. Normally well-functioning funding markets have dried up and the use of securitised products has slowed markedly.

Dramatic falls

Shares in banks have fallen dramatically and may well fall further. Moreover, the probability of multiple defaults has increased, meaning that if one bank fails it would not be surprising if others did too.

Off-balance sheet items are being transferred on to balance sheets and there is a preference for short-term assets. It may be the case that the scale of write-downs will be greater than expected; much depends on confidence levels.

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Banks will be weighing up the conservation of capital and liquidity to support legacy portfolios versus the use of capital and liquidity to write new business. If they opt to curb lending, this could be self-defeating should it result in a further tightening of credit conditions, contribute to adverse economic implications and cause further losses. If, however, as seems to be happening, lending does become tighter and, perhaps, more expensive, the switch in market conditions from abundant lending to caution will have been a swift turnaround. This has serious consequences for the customers; it is not just "I have to pay more", it is "Can I get my lease at any price"?

Fresh capital

As we have seen there is some reluctance amongst the banks to raise fresh capital except where it is clear that this is necessary. This may well be because institutions want to avoid being the subject of rumours that they are becoming illiquid. A collective strengthening of capital positions would engender confidence in balance sheets and in asset markets.

A further tightening of liquidity conditions could also lead to a long-term tightening of lending standards. A more careful approach to risk assessment and management is a prerequisite for an improvement in the quality of balance sheets and restoration of confidence. On the leasing front expect to see more attention paid to asset management and the setting of residuals.

Moreover, the authorities' reaction to the turmoil may result in more stringent controls and standards. Institutions also need to pay close attention to managing their capital and maintaining an appropriate mix to ensure that they meet regulatory capital requirements. It is unfortunate that it is often the leasing arms of the banks that suffer during this process.

Sub-prime

In recapitalising balance sheets of banks that have suffered from the sub-prime and other losses, other relatively healthier financial institutions may come to the rescue. The crisis may, therefore, provide opportunities for further M&A and a way to strengthen banks' balance sheets for the longer term. Conversely, funding problems and the nervousness of potential targets that they will be the losers in a deal that may only be achievable on give-away terms may be a reason for 'second thoughts'.

In the Bank of England Credit Conditions Survey Q2 2008, lenders reported that corporate credit availability had been tightened over the three months to mid-June, in line with their expectations in the Q1 survey. A small further reduction was anticipated over the next three months. Lenders reported that they had implemented the tightening in part through a reduction in maximum credit lines, stricter loan covenants and increased collateral requirements.

This had been driven by concerns about the economic outlook, changing sector-specific risks and a reduction in their appetite for risk.

Credit demand

While demand for credit by medium-sized businesses had fallen in line with lenders' expectations, there was a larger than expected decline in demand by large businesses. However, there was an increase in draw-downs on pre-arranged committed lines of credit.

Lenders reported unexpectedly large falls in demand for credit for M&A activity and capital investment. These factors were expected to contribute to a further weakening of demand.

This paints a gloomy picture so now is the time for the asset finance industry to hold on to its collective knowledge, expand its research into new products and maximise the opportunities that arise from adversity.

The author is chairman of The Alta Group, 'Advisors to the Asset Finance Industry'

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