DMH Stallard

# Banking and Finance Outlook: 2024-2025

Sharing an overview of the forthcoming year in the UK and international finance

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## General Banking and Finance Outlook

On the backdrop of the UK's economy entering a technical recession, interest rates remaining at 5.25% with an expected reduction to 4.5-5% by the end of this year (an expectation of two or three separate rate cuts of 25 bps subject to inflation falling in line with the Bank of England's expectations), reduced supply of cash, increased borrowing costs, geopolitical tensions, lack of investor appetite (despite there being sufficient dry powder being available amongst private equity firms and investment firms), and aggressive regulatory changes ("the Current Economic Factors"), both the appetite to lend and the ability to borrow will be negatively affected for the forthcoming year.

### Interest Rates, Inflation and the 2024 Spring Budget

Interest rates remaining high throughout 2024 will, as seen in 2023 already, continue to have an impact on borrowing costs both for consumers and lenders on the interbank and financial markets. Despite higher interest rates giving banks and lenders a boon in returns in recent years the effect of higher interest rates is one of a double-edged sword in that it has also in turn led to margins being squeezed due to higher funding costs.

Further to the spring budget announcement on the 6 March 2024, the chancellor has confirmed that there will not be any cut or changes made to income tax and instead the chancellor has opted to utilise his approximated £18bn[1] headroom (although this figure is disputed and is now subject to change bearing in mind the various new taxes and levys introduced in the spring 2024 budget which have increased the chancellor's projected headroom i.e. the introduction of vape duty, abolishment of non-dom status, revision to air passenger duty etc.) in be able to fund a further 2p cut to National Insurance. A cut to income tax at this stage was deemed to be more costly and inflationary in the long term than a cut to National Insurance.

It is argued that had the chancellor opted to cut income tax (depending on scope and scale) at this stage it would have resulted in the Bank of England having to wait until the beyond the summer before cutting the base rate[2] as opposed to reducing the rate in the next Monetary Policy Committee in June (it is anticipated that rates will remain at 5.25% in the hearing on 21 March 2024 subject to any unexpected deviation in the rate of inflation). This would primarily be a move to ensure that inflation remains to fall in a downward trajectory in order to fall in line with the Bank of England's target of 2%.

[1] https://think.ing.com/articles/uk-chancellor-has-limited-space-for-tax-cuts-as-market-rates-move-higher/

[2] Ibid.

Much of the Bank of England's decision to cut rates will also be dependent on the Federal Open Market Committee's (FOMC) meeting on the 20 March 2024 as well as their subsequent meeting the summer to decide on whether to cut rates from its current 5.25-5.50% range. In its previous meeting the FOMC indicated that until there is "greater confidence that inflation is moving sustainably toward 2 percent." This is a change from the tone used in their previous meeting in which three potential rate cuts this year were earmarked.[3]

As of writing US inflation has now fallen to 2.4% following data from the Bureau of Economic Analysis released on 29 February 2024 on Personal Consumption Expenditures (PCE) which notes that core rate for PCE (excluding energy and food price variation) is now 2.8%. PCE is the Federal Reserve's key metric for ascertaining price pressures and following confirmation of inflation now being at 2.4%, it will remain to be seen whether the Federal Reserve opt to cut rates in March or stick to waiting for inflation to come down sustainably to 2% before cutting rates.

### UK Gilts

In respect of the UK gilt market, using a fair value model which incorporates global factors and domestic macro drivers ING estimate there's a 40 basis point risk premium in 10-year gilt yields, which suggests that markets are not immune to UK fiscal risk.[4] For reference, the 2022 mini budget which caused market uproar due to the then incumbent government's decision to announce unfunded tax cuts with minimal Office of Budget Responsibility (OBR) oversight, led to a negative deviation in fair value at around 60 basis points. ING estimates that these early indications of a 40 basis point deviation suggest that markets are taking the uncertainty around the election into account in respect of pricing.

### Net Effect on lending

Due to the Current Economic Factors and subject to the potential rate cuts and variances within the UK gilt and US Treasury bond market, loan growth is expected to be modest.[5] Additionally, recent bank lending surveys conducted by the Federal Reserve and the European Central Bank (ECB) indicate that banks have already tightened credit standards across all product categories and anticipate further tightening of standards due to the Current Economic Factors and likely deterioration in security packages/collateral values and credit quality.[6][7]

However, the Current Economic Factors will not universally lead to a downturn in all loan product categories. For example, with consumer savings being depleted, demand for credit card and auto loans will remain strong.[8] Generally it is expected that bank loans to corporates may weaken in the short term but could pick up later in 2024 following base rate cuts and a further reduction in inflation.[9]

### Net Effect for Lenders

The Current Economic Factors will affect the ability of lenders to be able to generate income (both interest-based income and noninterest income) as well as manage expenses (both interest-based expenses and operational expenditure).

With rates expected to remain within the 4-5% range by the end of 2024, funding costs will remain elevated which in turn will squeeze margins and increase costs for lenders in relation to interest bearing deposits.[10]

Deposit costs are expected to affect larger banks and lenders more so than smaller banks and lenders. For example, in the US deposit costs for the largest banks stood at 2.2% in Q2 2023, compared to 2.5% for the smaller banks. There is a similar trend in countries that have seen rate hikes such as the UK and countries within the EU.[11] Lenders will seek to reduce these costs but may

[3] https://www.cnbc.com/2023/12/13/heres-what-changed-in-the-new-fed-statement.html
[4] https://think.ing.com/articles/uk-chancellor-has-limited-space-for-tax-cuts-as-market-rates-move-higher/
[5] https://www2.deloitte.com/us/en/insights/industry/financial-services/financial-services-industry-outlooks/banking-industry-outlook.html
[6] https://www.ecb.europa.eu/press/pr/date/2023/html/ecb.pr230725~8358d3939d.en.html
[7] https://www.federalreserve.gov/data/sloos/sloos-202307.htm#:~:text=Overall%2C%20responses%20to%20the%20July,the%20range%20in%20July%202023.
[8] https://www2.deloitte.com/us/en/insights/industry/financial-services/financial-services-industry-outlooks/banking-industry-outlook.html
[9] Ibid.
[10] Ibid.
[11] Ibid.

struggle to do so in the wake of customer expectations of higher rates and increased competition.

The amalgamation of higher deposit costs, lower policy/central bank rates, and somewhat constrained loan potential may adversely impact lenders' ability to generate a strong net interest margin (NIM) in 2024.[12] Currently, It is expected that US and European lenders will see a decline in NIM in 2024[13] which will require them to seek alternative channels to generate noninterest income for example via increased consumer fees. This will be easier for lenders with advisory, underwriting or corporate banking franchises who should have scope to increase their fee income via the backlog of deals and issuances and clearer valuations.[14]

In respect of the major UK banks, Fitch Ratings estimate that despite higher interest rates leading to the retraction of net interest margins coupled with asset-quality deterioration, higher funding costs and competitive pressure on lending margins the performance of the largest UK banks will only be affected slightly.[15] This is primarily due to the major UK banks' leading funding franchises, proven access to wholesale funding markets, and central bank facilities which should ensure that profitability remains strong.[16]

[12] Ibid.
[13] Ibid.
[14] Ibid.
[15] https://www.fitchratings.com/research/banks/major-uk-banks-performance-to-remain-robust-in-2024-07-02-2024#:~:text=The%20effects%20of%20higher%20interest,the%20largest%20banks%20only%20slightly.
[16] Ibid.

## Leveraged, Acquisition and Structured Finance Outlook

The past 12 months has been bumpy for the European leveraged finance market, the Current Economic Factors in particular consistently high interest rates leading to increased borrowing costs have in turn led to issuers being unable to afford new debt financings and refinancings (unless required due to a borrower being unable to pay the facility in full at maturity) becoming unappealing.

Debtwire figures note that there has been a 10% decline in floating rate European leveraged loan issuances from 2022 to 2023.[17] Holistically, there has been a 47% increase in European high yield bond issuances[18] with issuers opting for fixed rate high yield bonds over floating rate syndicated loans mainly due to the interest rate uncertainty and the Current Economic Factors.

### The Refinancing Trend

Deal progression over the last year in leveraged capital markets have been primarily driven by refinancings with high yield bond refinancings climbing 46 percent in 2023 to account for 58 percent of overall leveraged capital markets issuances.[19] The common theme here is that investors have been willing to refinance familiar and well-known bonds but at a higher coupon rate to set off against the current risk of market volatility and interest rate/geopolitical uncertainty.

With S&P estimating that global debt maturities will rise from nearly $2 trillion in 2024 to a peak of $2.78 trillion in 2026[20] and Fitch estimating that default rates in respect of European leveraged loans and high yield bond issuances is expected to rise to 4% in 2024[21], the global maturity wall will only be getting higher in 2024. In the face of the looming maturity wall, liability management transactions (i.e. amendment and restatements/extensions and debt buybacks) are likely to continue in 2024.

### New deals and dry powder

In respect of new deals, due to the Current Economic Factors, lenders are likely to remain cautious when assessing syndication risk and looking to underwrite new deals in 2024. This is reflected in the current figures which show a three-quarter decline in buyout/M&A activity as well as a 69% decline in syndicated loan and high yield bond issuances from 2022-2023.[22] Despite the lack of appetite to fund new deals, Bain & Co estimate that Buyout funds still have more than US$1 trillion of uninvested dry powder to deploy, with private debt dry powder sitting at approximately US$400 billion, according to Apollo figures.[23] We expect some of that dry powder to be utilised following market conditions becoming more favourable, namely a further reduction in inflation, rates being cut, a further narrowing of the valuation gap and following elections being decided in the UK and US.

### Rise in Private Debt

With traditional institutional lenders and banks being constrained in their ability to take on new deals, the private debt space has seen more deal activity with private debt deals being deals which traditionally would have been funded by syndicated loan facilities and/or high yield bond issuances.

As private debt funding offers a more flexible financial package for borrowers alongside increased leverage and the mitigation of syndication risk, the benefits for opting for private debt funding, in an economic environment in which the Current Economic Factors subsist, as opposed to the traditional syndicated loan and/or high yield bond routes, outweigh the traditional credit, liquidity, market and/or regulatory risks associated with private debt funding.

With Inflation and Interest Rate risks projected to now be on the decline, we expect private debt funding to remain attractive for alternate lenders and investors alike and further expect traditional investment banks and major UK banks to make further strides in the private credit/debt market.

The rise of collateralised loan obligations (CLO) which consist of portfolios of loans that have been funded via private debt being sold to investors demonstrates the rapid expansion of the private debt space and cementing its status a being a strong driver of liquidity and lending activity for the forthcoming year. It should be noted that the question of whether or not these CLO's are being correctly valued and if they are not could lead to a market crash akin to the collateralised debt

[17] https://www.whitecase.com/insight-our-thinking/european-leveraged-finance-2024#print-friendly-version
[18] Ibid.
[19] Ibid.
[20] Ibid.
[21] https://www.fitchratings.com/research/corporate-finance/emea-leveraged-finance-outlook-2024-04-12-2023
[22] Ibid.
[23] Ibid.

obligation market crash in 2008 is one that should be reviewed by prospective investors and lenders active in this market in 2024.

## Real Estate Finance Outlook

Due to the Current Economic Factors, commercial real estate (CRE) investment hit a decade low last year and residential real estate transactions slowed. The combination of persistently high interest rates as well as persistent inflation has led to increased borrowing costs and declining asset values which have in turn made residential and CRE investment unattractive for investors who are increasingly focusing on Distribution to Paid-In Capital as their key metric for assessing whether to invest in funds who further invest in residential and CRE investment alongside the traditional return on investment calculations being the cost method and out of pocket method.

### Residential Property

UK house prices rose 1.2% higher last month than in February 2023 and The Bank of England announced that mortgage approvals in January have risen to their highest level since October 2022.[24] The reasoning behind the increased demand in the housing market is attributed to the decrease in borrowing costs which started late last year and have rolled over to this year as well as increased competition between lenders to offer favourable mortgage rates to their customers.[25]

After a strong start to 2024, the increase in mortgage rates has led to trepidation within the market to take a deal from the origination stage to the formal offer stage and a slight downturn is expected until further clarity is gained on the expected interest rate and inflation positions later in the year.[26]

### First Time Buyers and the Reformation of the Mortgage Affordability and Repayment Rules

For first time buyers the situation is worse in that due to the cost-of-living crisis, first time buyers are struggling to find capital to fund the initial deposit amount for their proposed home purchase. The Building Society Association (BSA) has reported that the decline in first time buyers is due to the lack of flexibility afforded to mortgage lenders under the FCA's Mortgages and Home Finance: Conduct of Business (MCOB) and related rules. The BSA called for a revamp of MCOB 11 (the mortgage affordability and repayment rules) as well as an amendment to the 15% cap on the amount of home loans a lender can offer that are worth 4.5 times the borrower's income.[27]

The drive to change the affordability and repayment rules is driven by the desire to increase the amount of first-time buyers on the property market (and therefore allow for more products to be offered by mortgage lenders which afford flexibility in repayment i.e. interest only repayment at an initial high rate which declines over time or a rate increase closer to maturity) which has been declining since the mid-2000s[28] and even more so since the mortgage affordability and repayment rules were implemented after the 2008 financial crisis. It is anticipated that this relaxation of the rules which will aid in providing a further variety of mortgage products to first time buyers will also help to avail the increasing trend by first time buyers of opting for mortgages with a 35 year term.[29]

The potential risk for lenders and indeed the wider property market is that the relaxation of these rules may allow lenders to offer mortgages which are unlikely to be repaid hence leading to the same net effect of an eventual increase in default rates ultimately leading to a housing crisis akin to the subprime mortgage crash which eventually led to the 2008 financial crisis.

### Current Swap Rates

Swap rates which were declining late last year have started to increase again at the start of 2024. Swap rates, being the fixed rate, which is agreed by one party to pay to another under an interest rate swap, is directly affected by interest rate projections and fluctuations and with it increasing recently, one can discern that markets are reassessing how many rate cuts the Bank of England will actually approve this year.[30]

If the recent trend of swap rates increasing continues there is a danger that the housing market recovery could be delayed.[31] However, if the base rate is cut by June this year there should be a subsequent decline in mortgage rates and borrowing costs which should give the housing market a temporary boost by Q3 2024.

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[24] https://www.ft.com/content/045f773a-420d-45ac-8684-872748e1c1fd
[25] https://www.ft.com/content/dd1579f4-409d-4cba-bc61-4c9468158da4
[26] Ibid.
[27] https://www.theguardian.com/business/2024/mar/05/mortgage-reforms-have-excluded-first-time-buyers-say-uk-building-societies
[28] Ibid.
[29]
[30] https://www.ft.com/content/dd1579f4-409d-4cba-bc61-4c9468158da4
[31] Ibid.

## CRE

CBRE estimates that as the Current Economic Factors subside over the course of the year (particularly inflation falling and the base rate being cut), there should be an increase in the likelihood of positive real returns from property investments.[32] This should further lead to CRE investment becoming attractive to investors once more and an increase in CRE investment activity generally in comparison to the downturn seen during 2023 but investment volumes in cash terms will take more time to recover as investors trade at lower price levels in the wake of the CRE market downturn.[33]

In respect of sector specific investments in CRE, it is projected that the industrial and residential sectors are likely to benefit from better near-term prospects for rental growth and a greater investor appetite, while the office and retail sectors will continue to see polarisation based on the quality of assets.[34]

## Continuation of Refinancings

As further real estate and development loans reach maturity in 2024 and if interest rates remain high, lenders will be limited in their capacity to provide cost effective solutions to borrowers in need of refinancing. CBRE estimates that this will cause a distress to emerge where existing loans cannot be replaced and more equity from the borrower is not available.[35]

Bayes Business School UK Commercial Real Estate Lending Report indicates that between 2018-2021 £175bn+ worth of debt was made in relation to commercial real estate. CBRE estimates that much of this debt is due to mature across the next few years but that 2024 will be a "crunch year" for borrowers.[36]

## Challenges for Borrowers

The primary challenges for borrowers in this climate are twofold. Firstly, the decline in market value of CRE over the last few years has meant that upon revaluation, security held by lenders over the relevant CRE has synonymously decreased in value. This has led to covenant breaches which need to be remedied (often via an equity injection/cure) and/or the necessity to refinance with another lender, seek alternate ways to get capital, or sell assets to meet the shortfall if necessary.

Secondly, with interest rates remaining high there is will be an increase in lending at lower loan to value ratios as the rental income from the assets held by the borrower or its group companies must provide a lender with sufficient interest coverage upon refinancing.[37]

[32] https://www.cbre.co.uk/insights/books/uk-real-estate-market-outlook-2024/investment
[33] Ibid.
[34] Ibid.
[35] Ibid.
[36] Ibid.
[37] Ibid.

## Key Takeaways and Conclusion

### Key Takeaways

- **Pending any rate cut announcements as well as a gradual relaxation of the Current Economic Factors, it is anticipated that loan activity will increase after June 2023.**

- **As interest rates are cut throughout the year, lenders will need to find alternate avenues to make up any shortfall in their revenue due to a decrease in interest-based income.**

- **In the leveraged, acquisition and structured loans space, the refinancing and liability management transaction trend is likely to continue with the cost of borrowing still being too high for lenders to be optimistic enough to broker new deals.**

- **The private debt space is anticipated to continue its growth and is expected to take some of the market share from the declining leveraged loan space in 2024 due to the flexibility the financial package a private debt transaction affords borrowers.**

- **2024 will be a "crunch year" for borrowers who are exposed to the residential and CRE markets as many CRE facilities are expected to mature in 2024.**

- **Any growth in residential and CRE investment will be dependent on base rate cuts and further clarity being ascertained on the socio-economic position of the UK which is likely to occur at the back end of the year (as a general election is currently touted to be held in November 2024).**

- **The trend of shortfalls being met by borrowers via an equity injection either on refinancing/redemption will continue as the Current Economic Factors have rendered borrowers being unable to repay their loans in full on refinancing/redemption due to a decline in the value of the collateral/security package associated with the relevant loan.**

## Conclusion

Overall, the banking and finance landscape for the forthcoming year looks to be one of cautious optimism. The expectation is that once the Current Economic Factors subside (in particular inflation reduction and base rate cuts) and geo-political tensions are eased over the course of the year (likely by Q4 once election uncertainty is mitigated), investors, lenders and borrowers alike will be able to better gauge financial markets and should be able to access capital at a cheaper price in comparison to the previous year and the start of 2024. This should allow for a mitigation to some extent of credit and market risks associated with a particular transaction or deal which should then allow for loan activity to increase and allow for lenders and investors to be less risk averse when lending and/or investing in deals/transactions in the latter half of 2024.