

TFAC Corporate Credit Review: Background to Solutions for Limited Economic Growth

September 2017

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TRADE FINANCE ADVISORY COUNCIL

Agenda



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1. TFAC Background
2. Summary of Economic Challenges and Potential Solutions
3. Economic Growth
4. Corporate Role
5. SME Economic Importance
6. SME Credit Gap



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TFAC Mission Statement



TRADE FINANCE ADVISORY COUNCIL

- The U.S. Department of Commerce Trade Finance Advisory Council (TFAC) is established in accordance with the provisions of the Federal Advisory Committee Act, as amended, 5 U.S.C. App., to advise the Secretary on matters relating to private sector trade financing for U.S. exporters. The TFAC shall advise the Secretary in identifying effective ways to help expand access to finance for U.S. exporters, especially small- and medium-sized enterprises (SMEs), and their foreign buyers.
- The TFAC shall provide a necessary forum to facilitate the discussion between a diverse group of stakeholders such as banks, non-bank financial institutions, other trade finance related organizations, and exporters to gain a better understanding regarding current challenges facing U.S. exporters in accessing finance. The TFAC shall draw upon the experience of its members in order to obtain ideas and suggestions for innovative solutions to these challenges. The TFAC shall develop recommendations on programs or activities that the Department of Commerce could incorporate as part of its export promotion and trade finance education efforts.
- The TFAC shall report to the Secretary on its activities and recommendations. In creating its reports, the TFAC should: (1) Evaluate current credit conditions and specific financing challenges faced by U.S. exporters, especially SMEs, and their foreign buyers, (2) examine other noteworthy issues raised by stakeholders represented by the membership, (3) identify emerging financing sources that would address these gaps, and (4) recommend specific activities by which these recommendations could be incorporated and implemented.

Working Group Objectives



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- Size credit gap
- Evaluate whether credit gap can be categorized by credit use, size of corporation, and/or by type of credit
- Develop recommendations that can have direct and/or indirect impacts on credit gap
- Develop recommendations that may have future impacts



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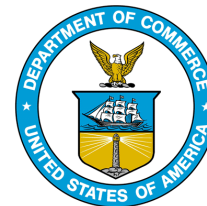
6. SME Credit Gap



Summary: SME Credit Access

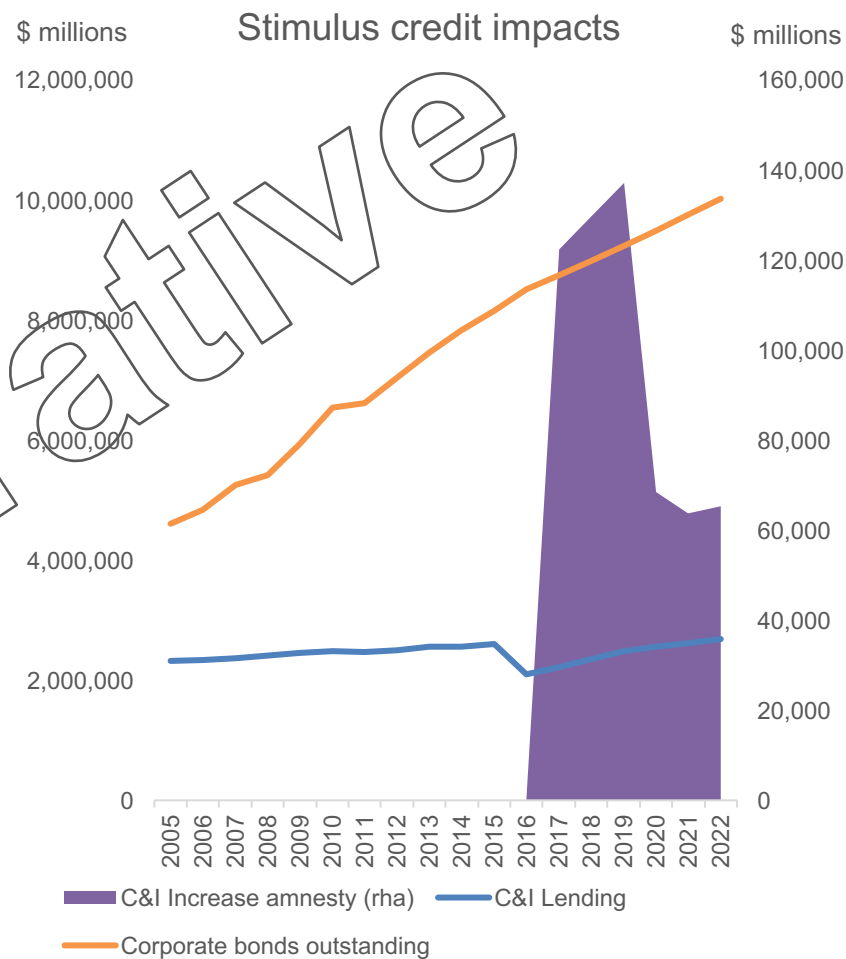
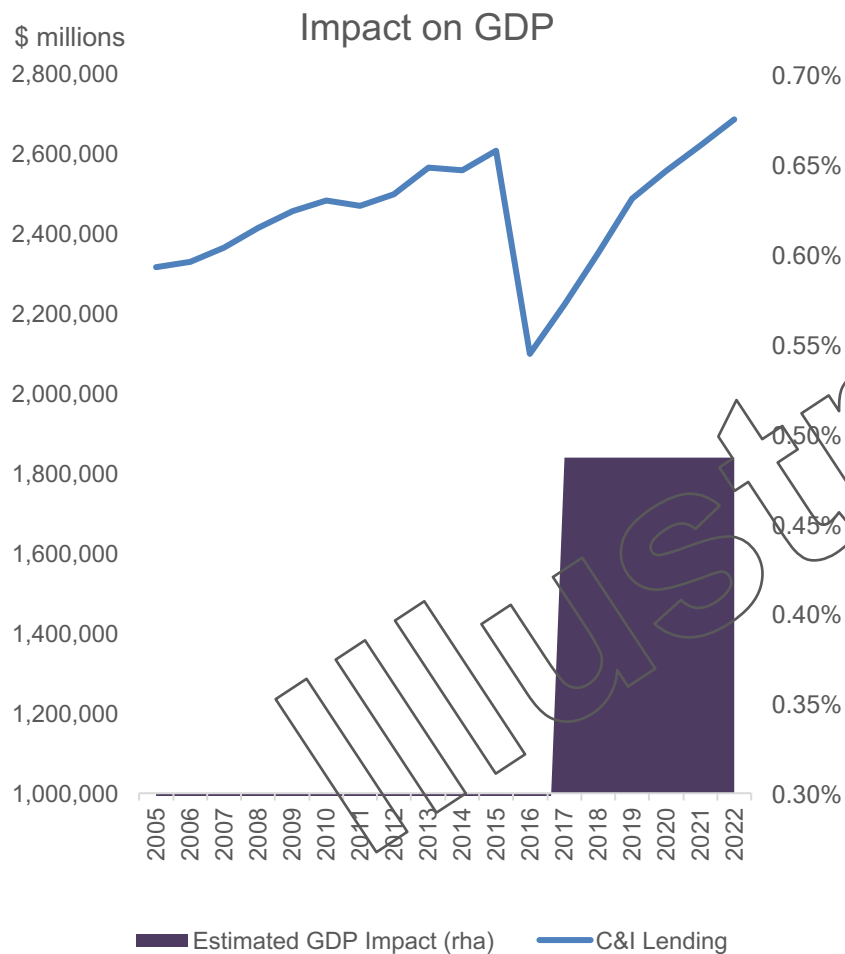
Key economic drivers are struggling to grow without necessary access to credit.

- Small and medium sized business (SME) have limited credit access, contributing to constrained economic growth
 1. Changes in bank and money market fund regulation has reduced bank financed credit access for those businesses without access to the bond market
 - a. Banks deleveraging and holding more cash and high quality securities as assets
 - b. Banks dissuaded from wholesale funding, increasing need for bank-to-bank lending, which further crowds out corporate borrowers
 2. Tax policy creates incentives, for those able to, to leave money offshore in lower taxed jurisdictions to increase earnings, issue debt, and buyback stock
 3. Significant cash build up has occurred
 - a. Corporations have trapped “tax” dollar based cash offshore
 - b. Banks needing to hold more liquid assets and cash
 - c. Low productive use of cash by banks left on Central bank balance sheet
- **Absent significant changes, the “new normal” will remain constrained.**
 - Increasing SME credit will drive growth and can be achieved through:
 - Modest changes to tax policy and bank regulation
 - Private sector incentives for credit provision
 - Consider policies that:
 - Incentivize creation of investors and investment managers to provide credit to small businesses



Impact of Increasing SME Lending

An illustrative model of the potential impact of increased SME lending.





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Broader Context of Specific Challenges in Greater Economy



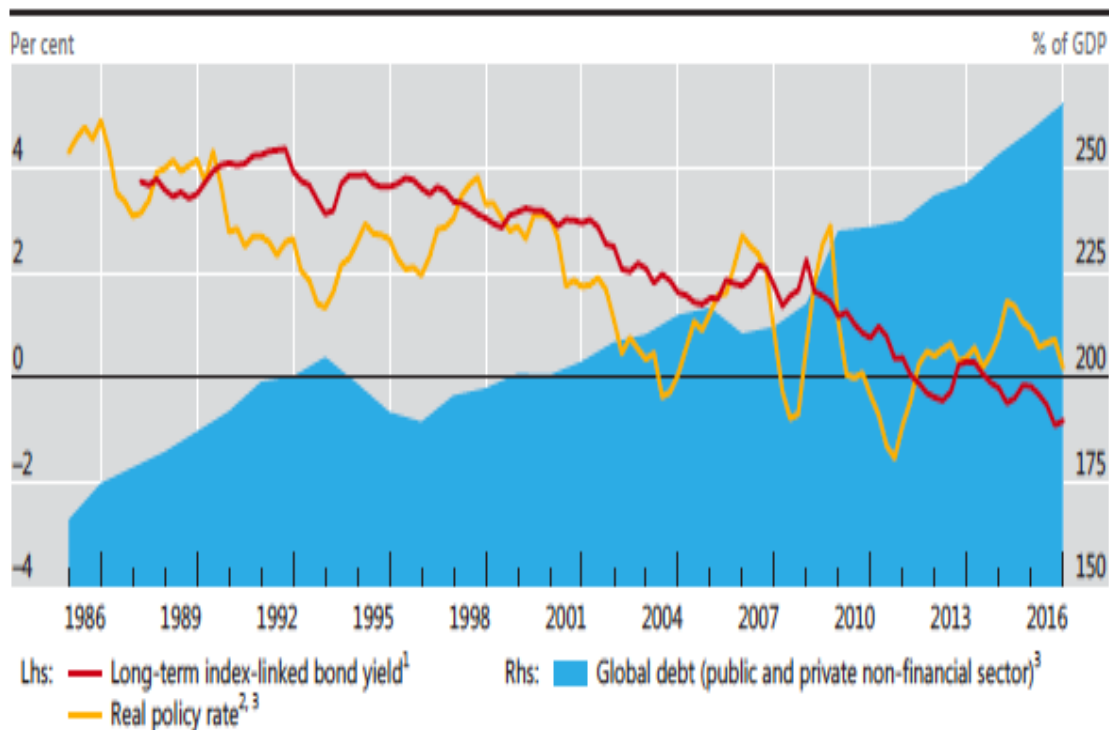
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- GDP growth is limited
 - Corporations are sitting on record levels of cash and profits and could do more to free up capital for other businesses
 - Meanwhile, key economic drivers, SMEs, are struggling to get access to credit necessary for growth
 - A combination of monetary policy, tax policy, and financial re-regulation limit access to credit
- 
- Increasing GDP growth is important to the recovery
 - Key to increasing economic growth is closing SME credit gap
 - Consider proposals that enable SME credit growth

SME's Left Out of Global Credit Expansion

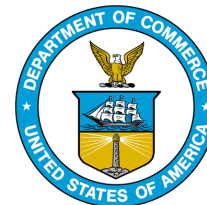
Interest rates sink as debt soars

Graph 1.6



¹ From 1998, simple average of FR, GB and US; otherwise only GB. ² Nominal policy rate less consumer price inflation. ³ Weighted average of G7 economies plus CN based on rolling GDP and PPP exchange rates.

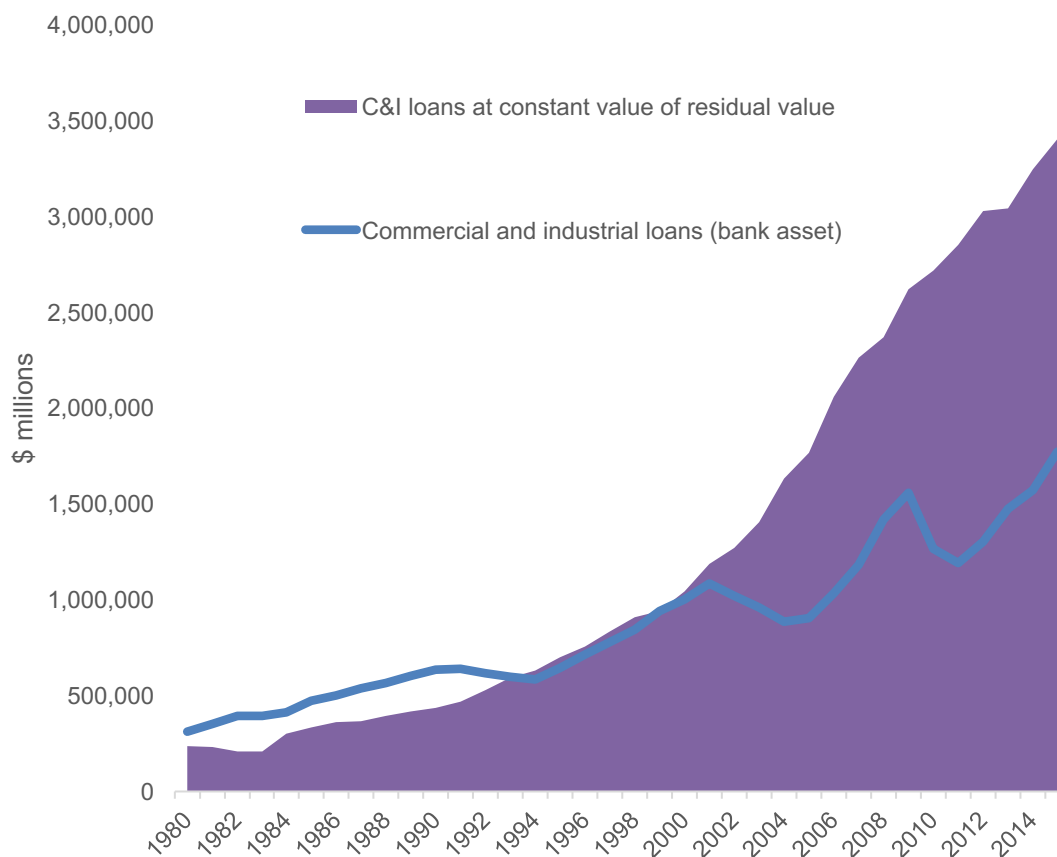
- Low interest rates make small business loans unattractive to lenders
- Easier for large corporations to issue debt (bond market)



Large Non Bond Credit Gap

SMEs are struggling to access credit.

H8 C&I lending assumed constant ratio to residual value



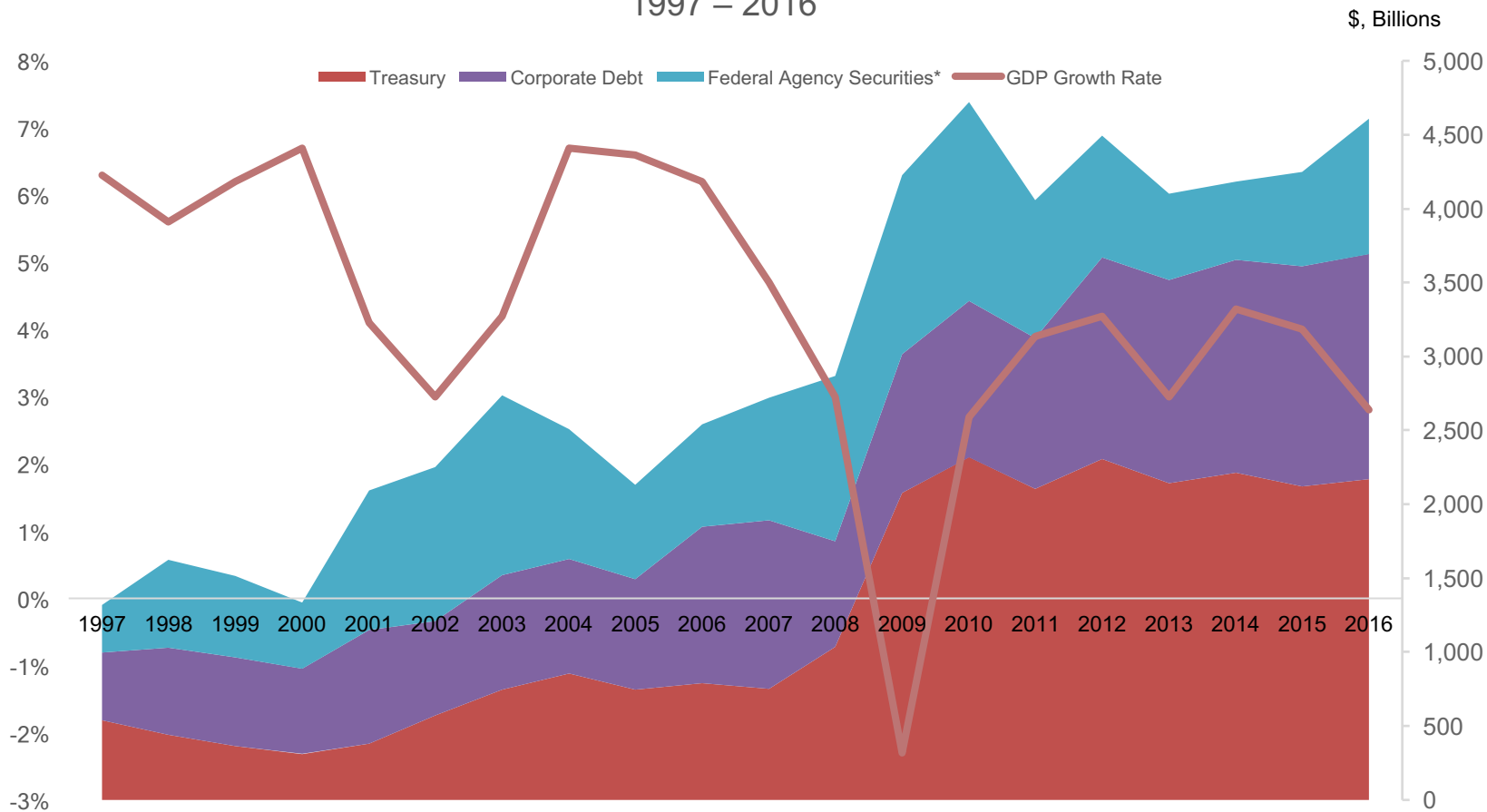
- SME credit gap is over \$1T, limiting the growth of important drivers of the economy
- Causes of credit gap pro-cyclically related to monetary policy, tax policy, and financial re-regulation



Limited Economic Growth

Debt has been increasing and GDP growth has been stagnant while rate declining.

GDP growth & Treasury, Federal Agency and corporate debt issuance 1997 – 2016



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Corporate Profit Growth

Despite limited economic growth, corporations' profits have not been stifled.

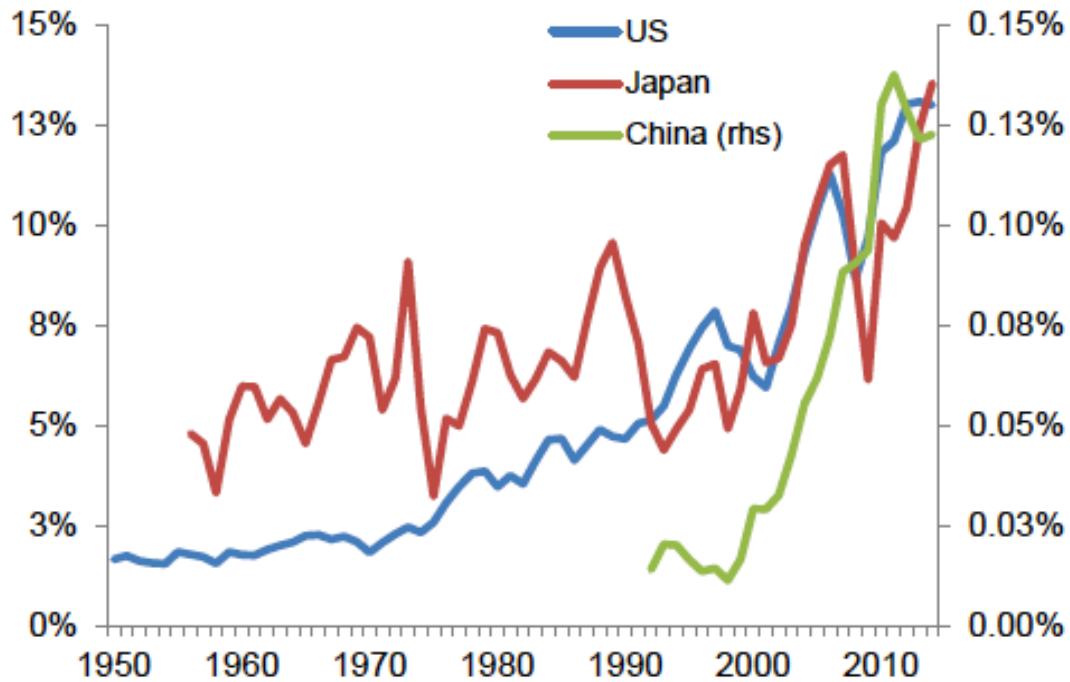


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Corporate profits at very high levels

As a percentage of GDP

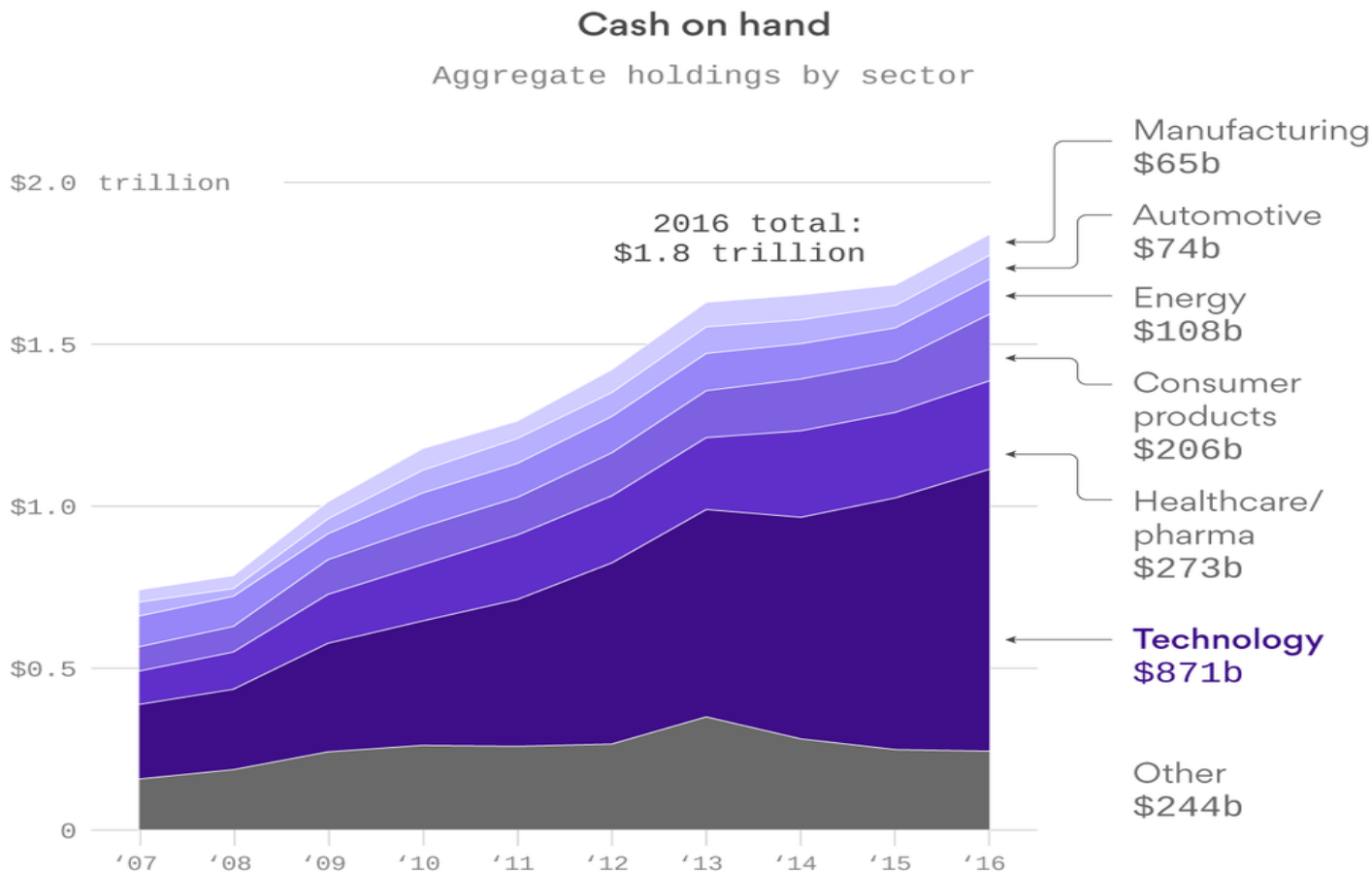
Graph 14

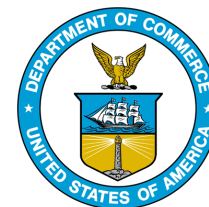




Record High Corporate Cash Holdings

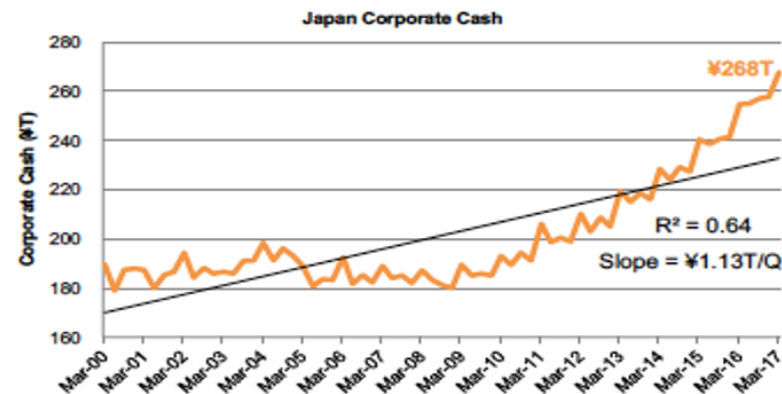
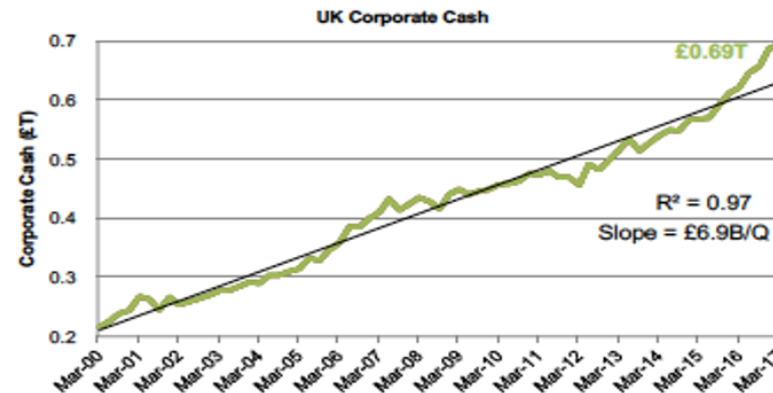
Breakdown by industry sector.

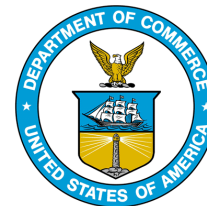




Corporate Cash Levels Steadily Increasing

Global cash growth is >\$60 Billion per quarter.

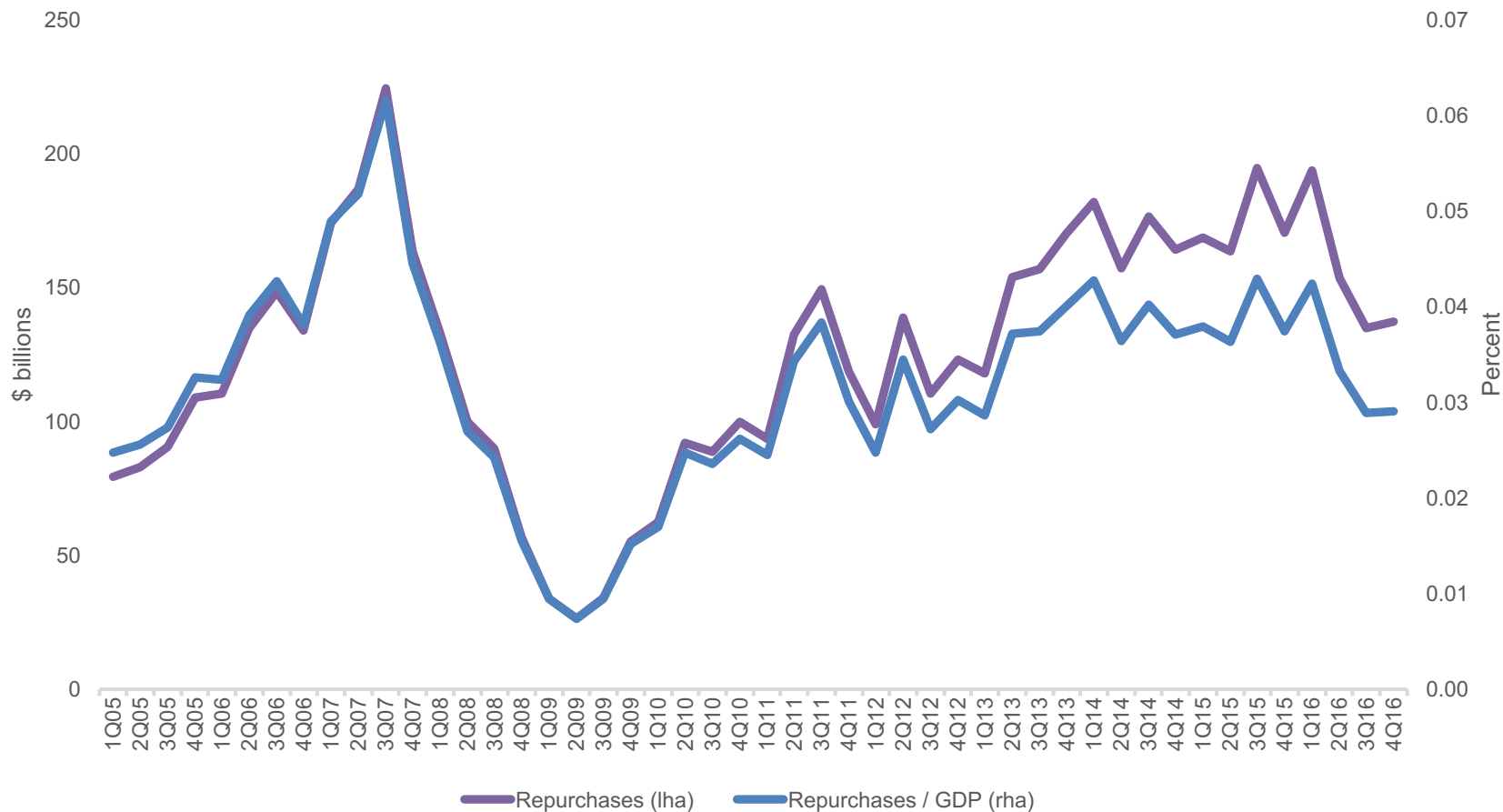




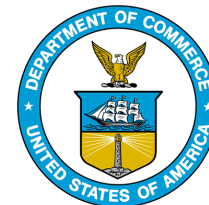
Stock Buybacks

Large public companies have stock buyback incentive particularly with low GDP growth.

Stock repurchases and GDP



Source: Goldman Sachs for stock repurchases analysis



Overseas Cash

Corporations also have an incentive to leave lower-taxed earnings as cash overseas.

Notes to Consolidated Financial Statements

Pfizer Inc. and Subsidiary Companies

C. Deferred Taxes

Deferred taxes arise as a result of basis differentials between financial statement accounting and tax amounts.

The components of our deferred tax assets and liabilities, shown before jurisdictional netting, follow:

(MILLIONS OF DOLLARS)	2016 Deferred Tax		2015 Deferred Tax	
	Assets	(Liabilities)	Assets	(Liabilities)
Prepaid/deferred items	\$ 2,180	\$ (68)	\$ 2,247	\$ (38)
Inventories	366	(47)	381	(190)
Intangible assets	1,139	(15,172)	1,063	(10,885)
Property, plant and equipment	92	(982)	65	(1,098)
Employee benefits	3,356	(74)	3,302	(167)
Restructurings and other charges	458	(2)	318	(20)
Legal and product liability reserves	650	—	730	—
Net operating loss/tax credit carryforwards ^(a)	2,957	—	3,808	—
Unremitted earnings ^(b)	—	(23,109)	—	(23,626)
State and local tax adjustments	301	—	328	—
All other	306	(503)	310	(846)
	11,806	(39,956)	12,552	(36,668)
Valuation allowances	(1,949)	—	(2,029)	—
Total deferred taxes	\$ 9,857	\$ (39,956)	\$ 10,523	\$ (36,668)
Net deferred tax liability ^(c)	\$	\$ (30,099)	\$	\$ (26,145)

As of December 31, 2016, we have not made a U.S. tax provision on approximately \$86.0 billion of unremitted earnings of our international subsidiaries. As these earnings are intended to be indefinitely reinvested overseas, the determination of a hypothetical unrecognized deferred tax liability as of December 31, 2016, is not practicable.

Selected Measures of Liquidity and Capital Resources

The following table provides certain relevant measures of our liquidity and capital resources:

(MILLIONS OF DOLLARS, EXCEPT RATIOS AND PER COMMON SHARE DATA)	As of December 31,	
	2016	2015
Selected financial assets:		
Cash and cash equivalents ^(a)	\$ 2,595	\$ 3,641
Short-term investments ^(a)	15,255	19,649
Long-term investments ^(a)	7,116	15,999
	24,967	39,290

- This is just **one** example of public information provided by public companies about overseas cash holdings
- “We have not made a US tax provision on approximately **\$86.0 billion** of unremitted earnings of our international subsidiaries”

Procyclical Impact of Cash Building in the Financial System

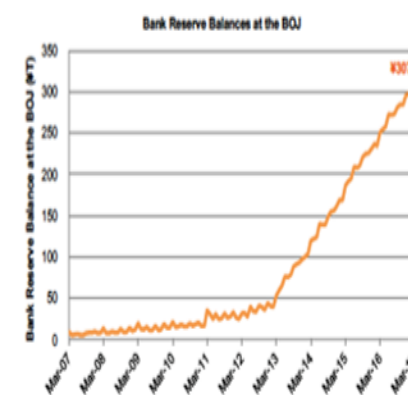
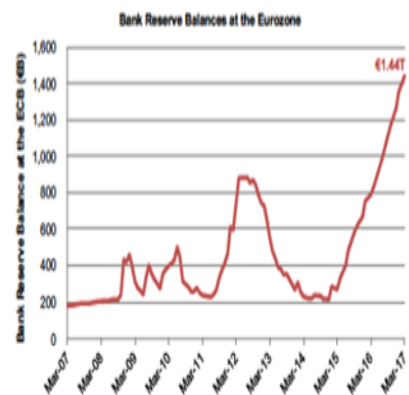
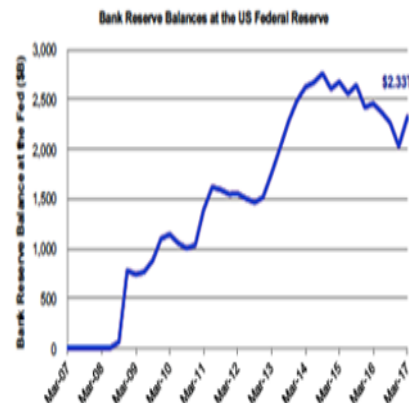
Cash relative to GDP is growing at record pace.

Corporate Cash as % GDP by Region



Country/Region	March 2000	March 2017
United States	9%	12%
Eurozone	13%	23%*
United Kingdom	21%	35%
Japan	36%	50%

*Eurozone corporate cash data lags other regions. Data reflects December 2016
Source: Treasury Strategies' estimate



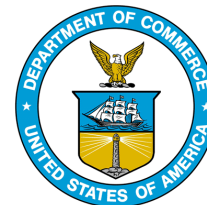


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5. SME Economic Importance

SMEs are key economic drivers but their growth has been limited.

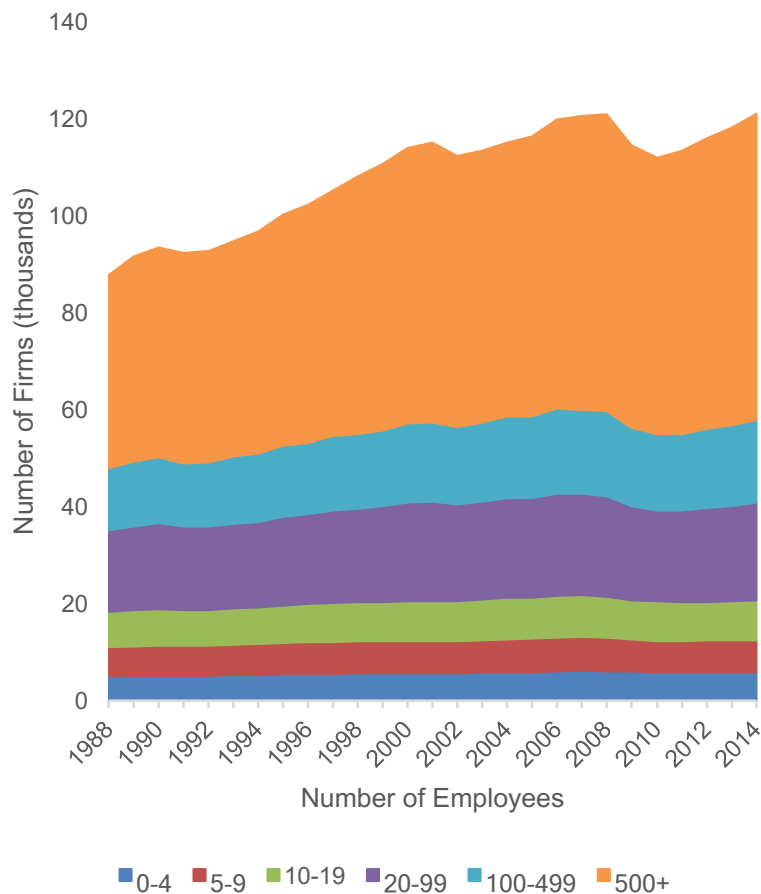
6. SME Credit Gap



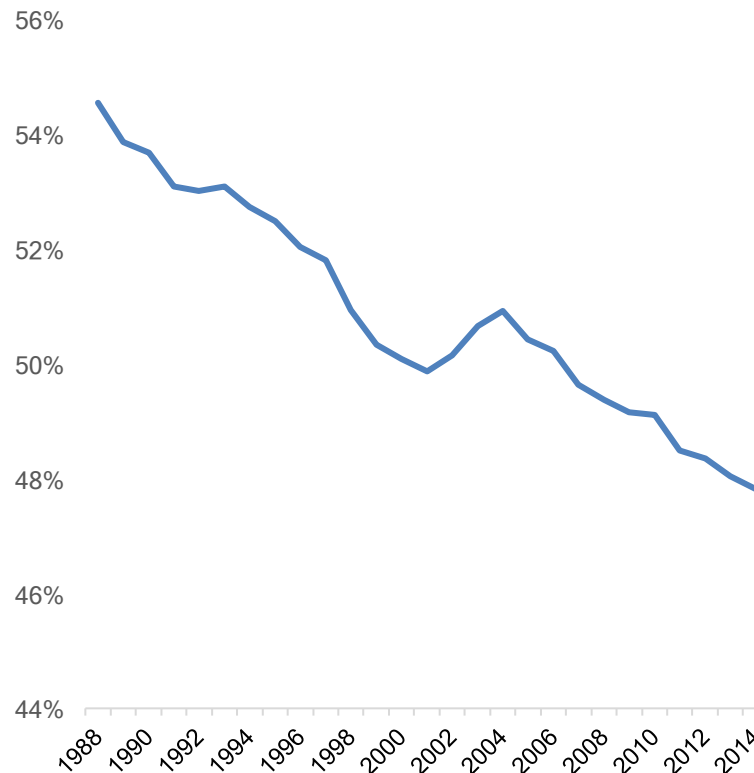
SME Employment

SMEs are large drivers of employment

Employment by firm size



% of private sector employees at firms with less than 500 employees

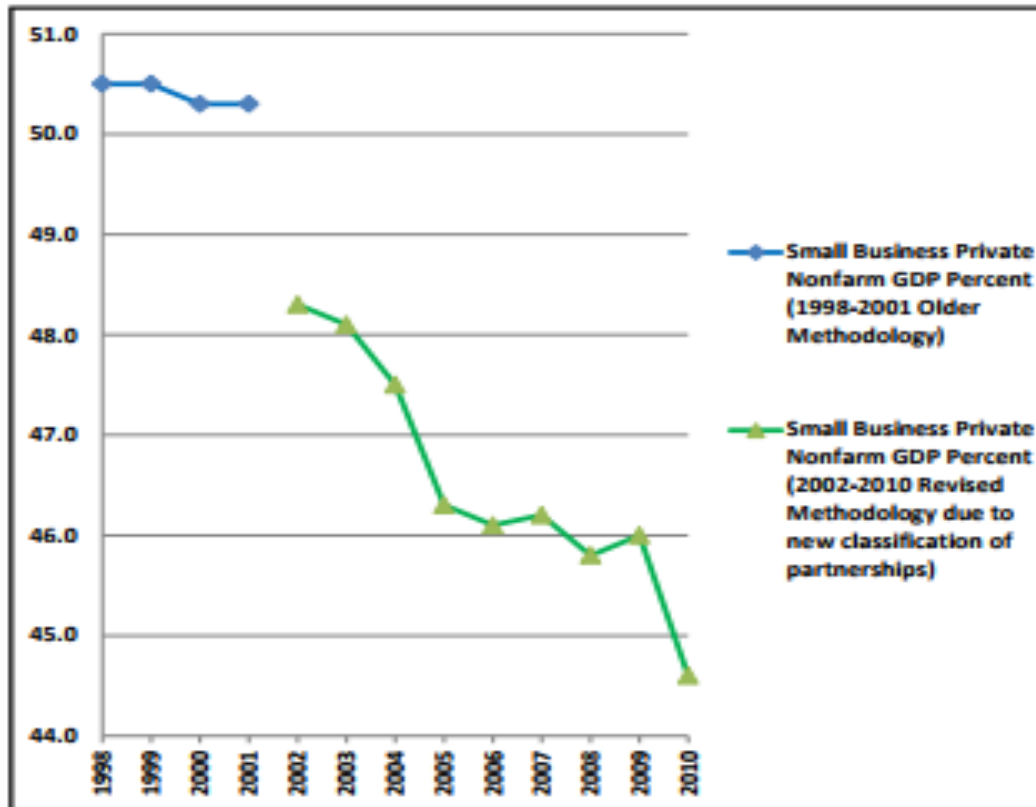


SMEs Drive GDP Growth



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Small Business GDP, 1998-2010



Note that y-axis is share of GDP

- The 1998-2001 trendline is slightly higher due to a change in methodology
- SMEs were hit particularly hard by the recession and did not have the same recovery resources as large corporations

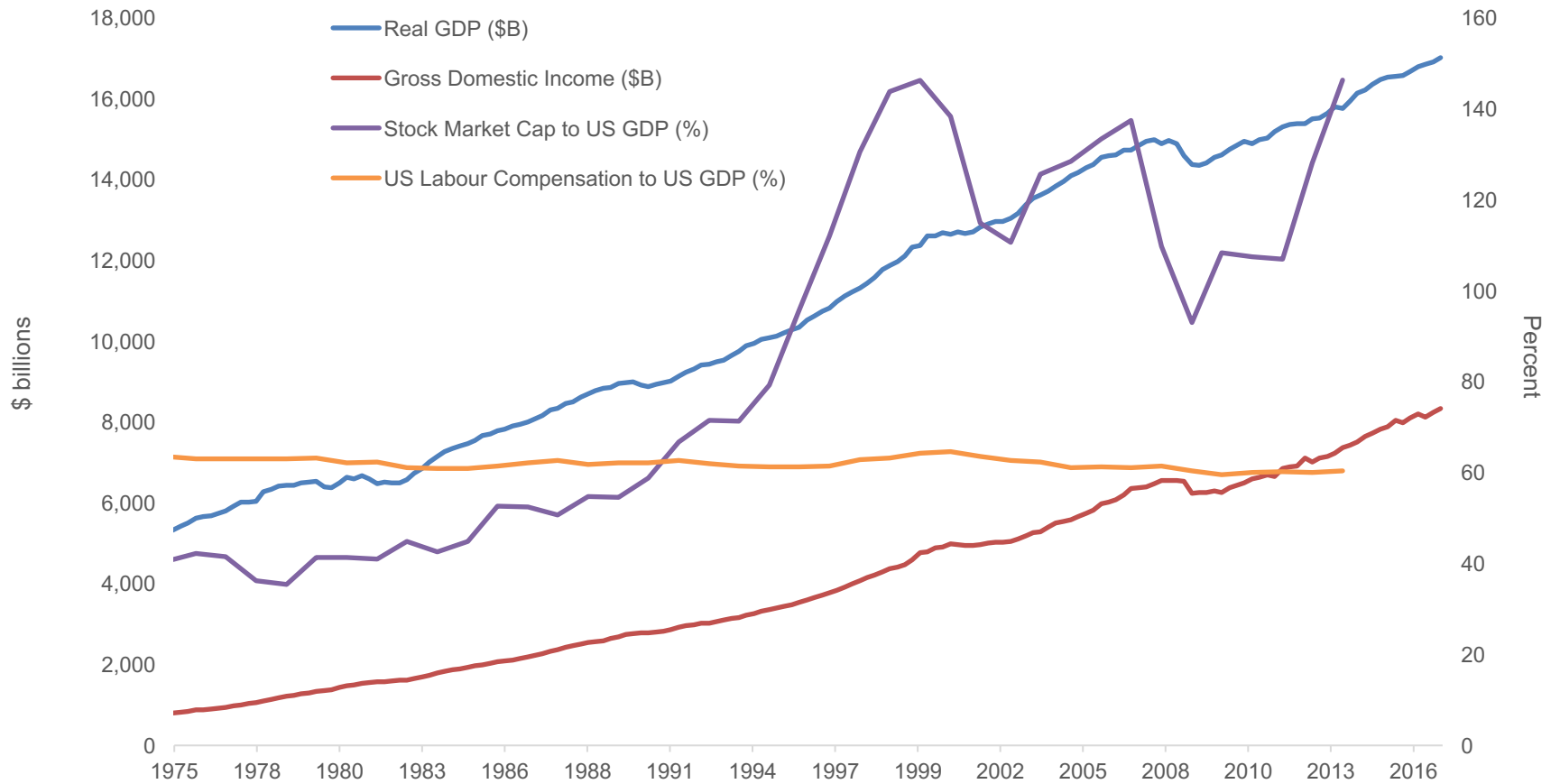
SME Growth is Limited

Low growth impacts labor and wage growth.

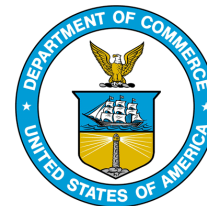


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Stock market and labor compensation growth relative to GDP



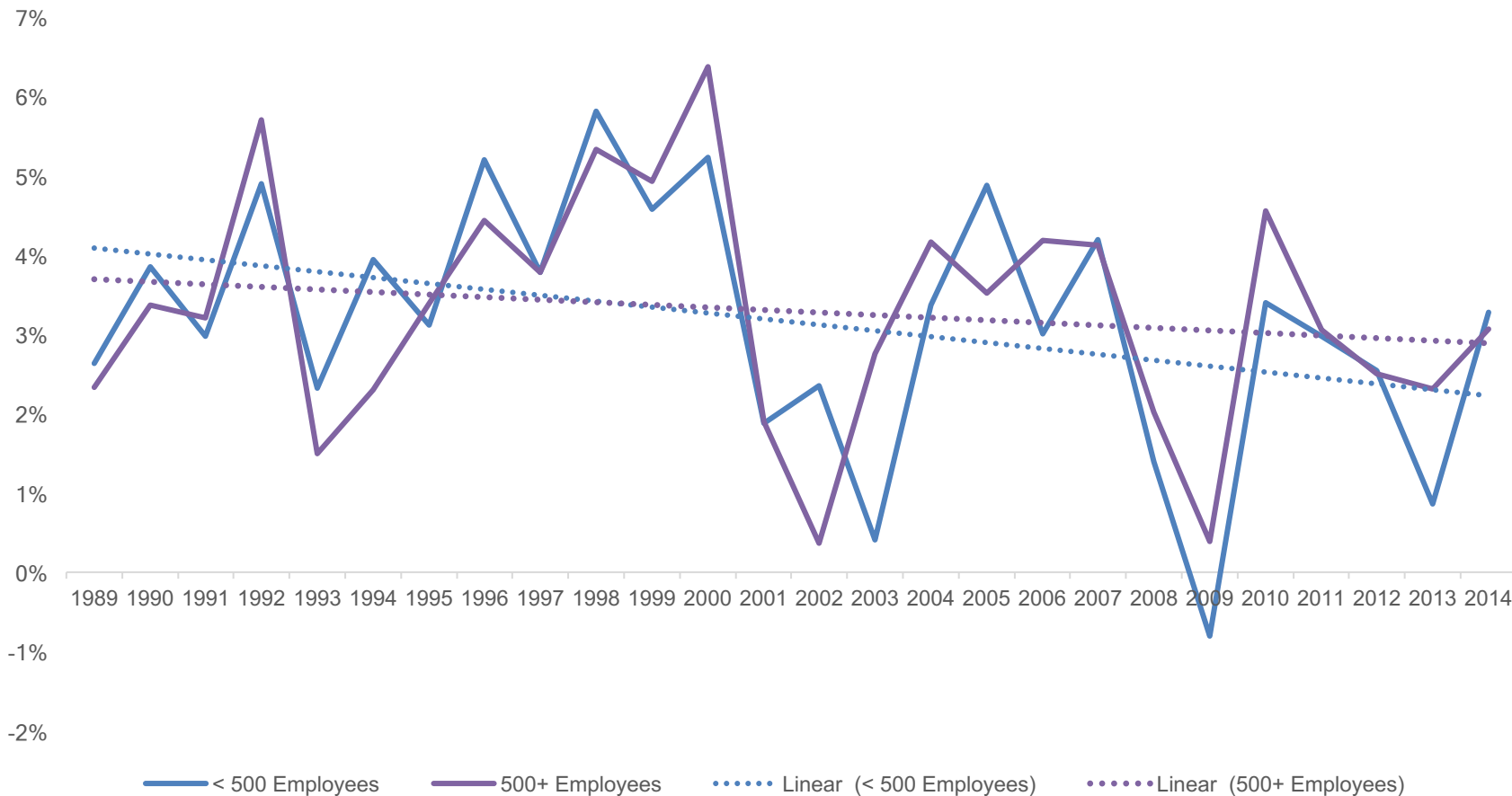
Source: Federal Reserve, analysis

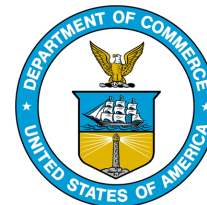


Payroll Growth Slowing

The trend holds especially true for SMEs.

Per capita annual payroll growth rate by firm size

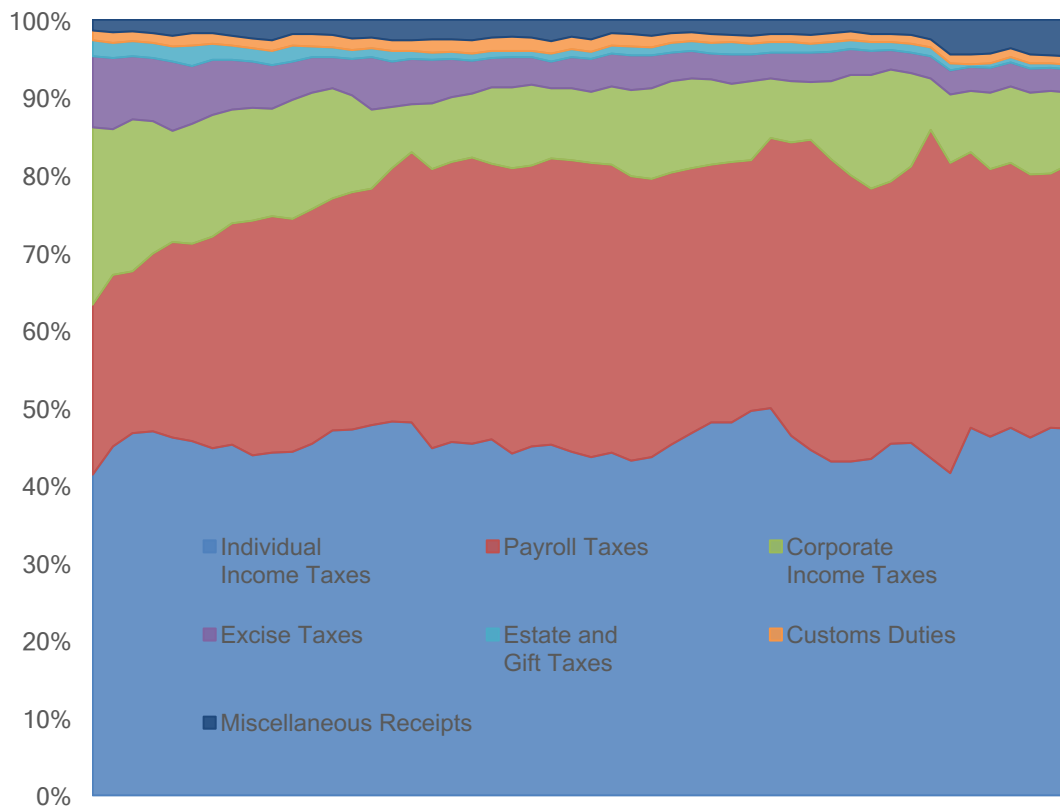




SMEs and the Tax Burden

SMEs are an important source of revenue.

Revenue source by type of tax
1967 - 2016



- Individuals and small businesses fund the bulk of Federal revenue
- Low wage and job growth limits tax revenue and tax revenue growth
- Thus, low growth is ultimately pro-cyclical
- Increasing SME growth will increase jobs, wages, and revenue, which will increase overall economic growth

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SMEs have limited access to credit.

Global Credit Expansion



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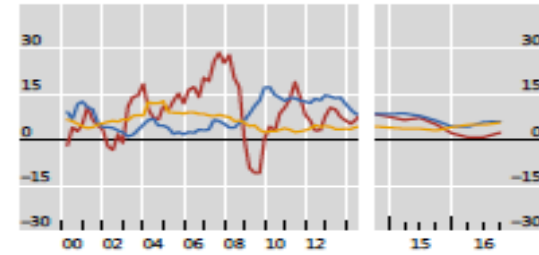
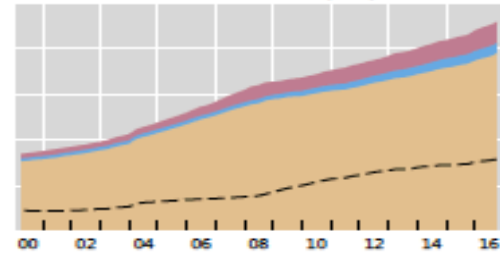
Global credit to the non-financial sector, by currency

Graph 2

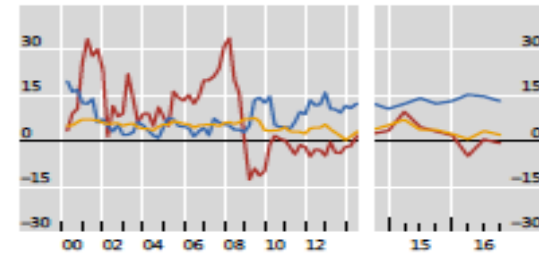
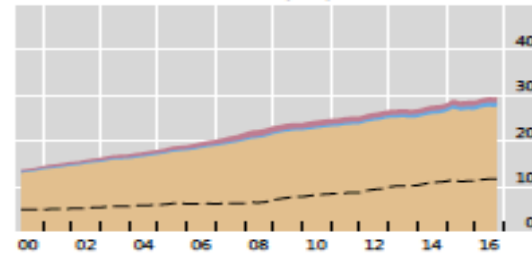
Amounts outstanding, in trillions of currency units¹

Annual change, in per cent⁵

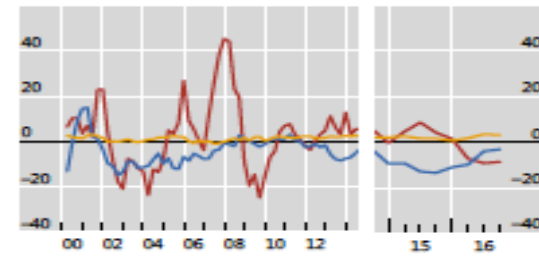
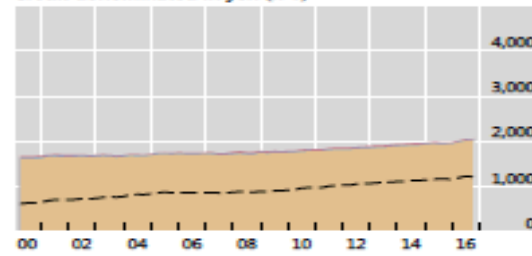
Credit denominated in US dollars (USD)



Credit denominated in euros (EUR)



Credit denominated in yen (JPY)



Credit to residents²
 Credit to non-residents³
 Loans⁴
 Of which:
 Credit to government

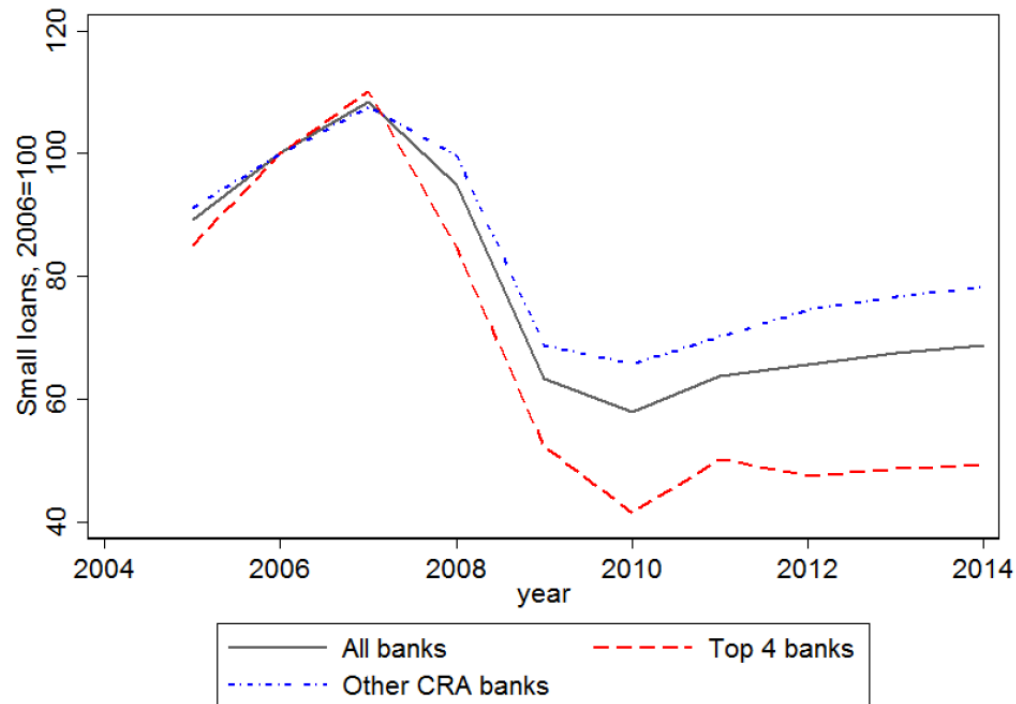
Declines in Small Business Loans

Loans declining as banks adjust balance sheet to regulation and monetary policy.



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Figure 1: Annual originations of small business loans by Top 4 U.S. banks vs. all other banks



Bank Re-Regulation Limiting SME Credit Growth

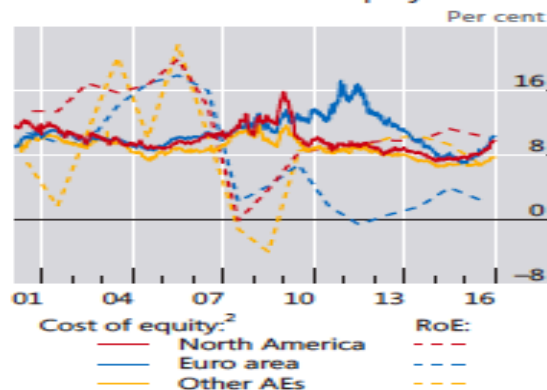
Despite improvements, many banks are still struggling to adjust¹

Graph V.4

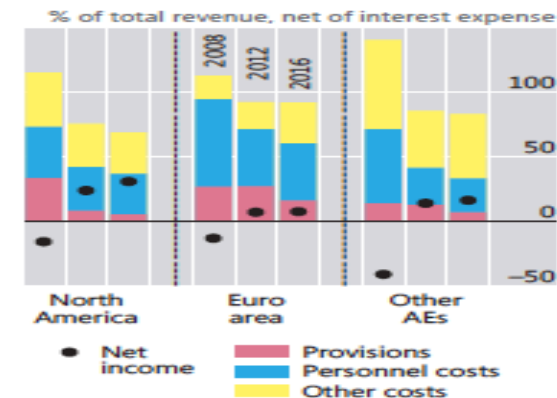
Price-to-book ratios remain low



Euro area return-on-equity (RoE) remains below cost of equity



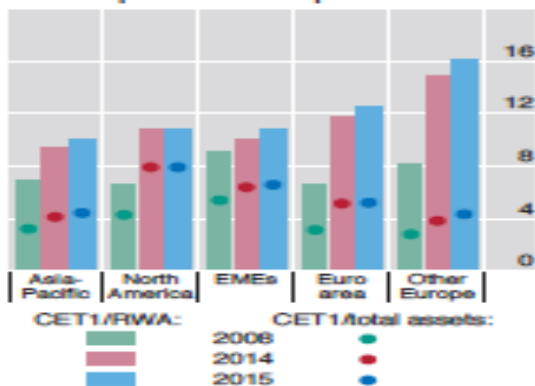
Lower provisions buffer net income



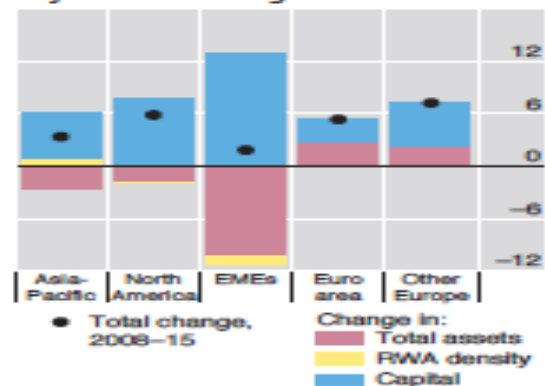
In per cent

Graph VI.1

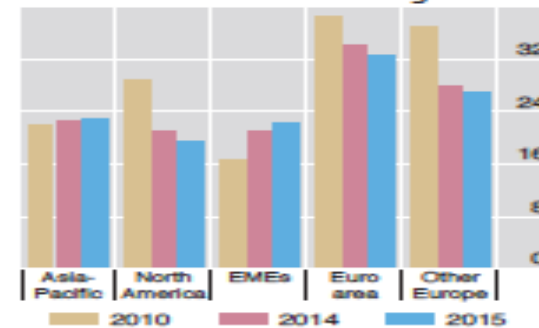
Bank capital ratios improve²



Adjustment strategies differ³



Decline in wholesale funding⁴

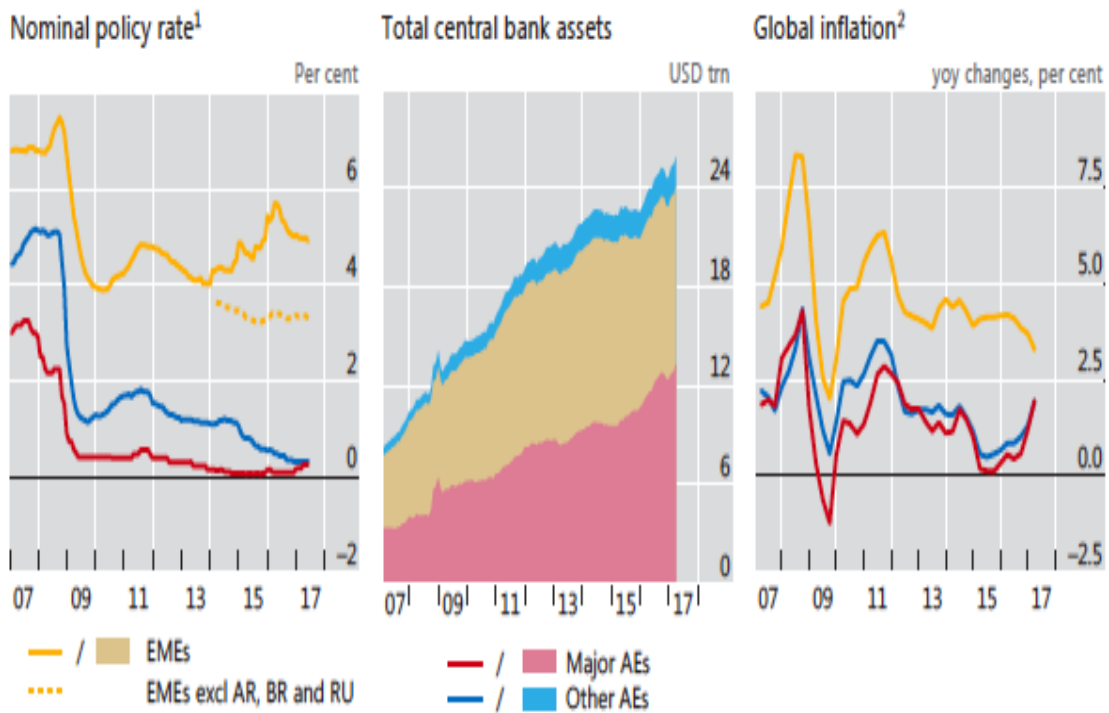


Central Bank Asset and Reserve Growth

Growth led by re-regulation and monetary policy.

Very accommodative global monetary policy persists, inflation outlook improves

Graph IV.1

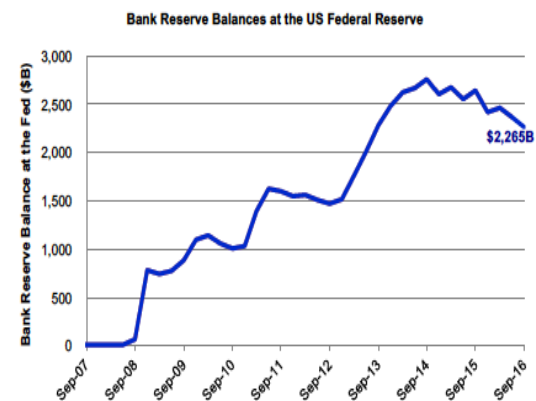


Major AEs = EA, JP and US; other AEs = AU, CA, CH, DK, GB, NO, NZ and SE.

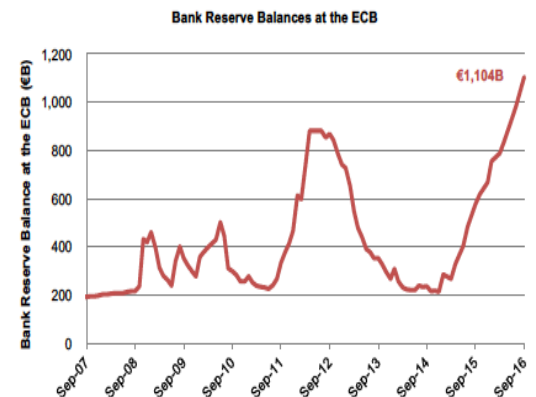
¹ Policy rate or closest alternative; simple averages. ² Consumer prices; weighted averages based on rolling GDP and PPP exchange rates.

Sources: IMF, *International Financial Statistics* and *World Economic Outlook*; Datastream; national data; BIS calculations.

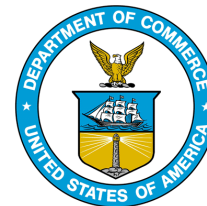
Reserve Balances



Source: Federal Reserve, Treasury Strategies



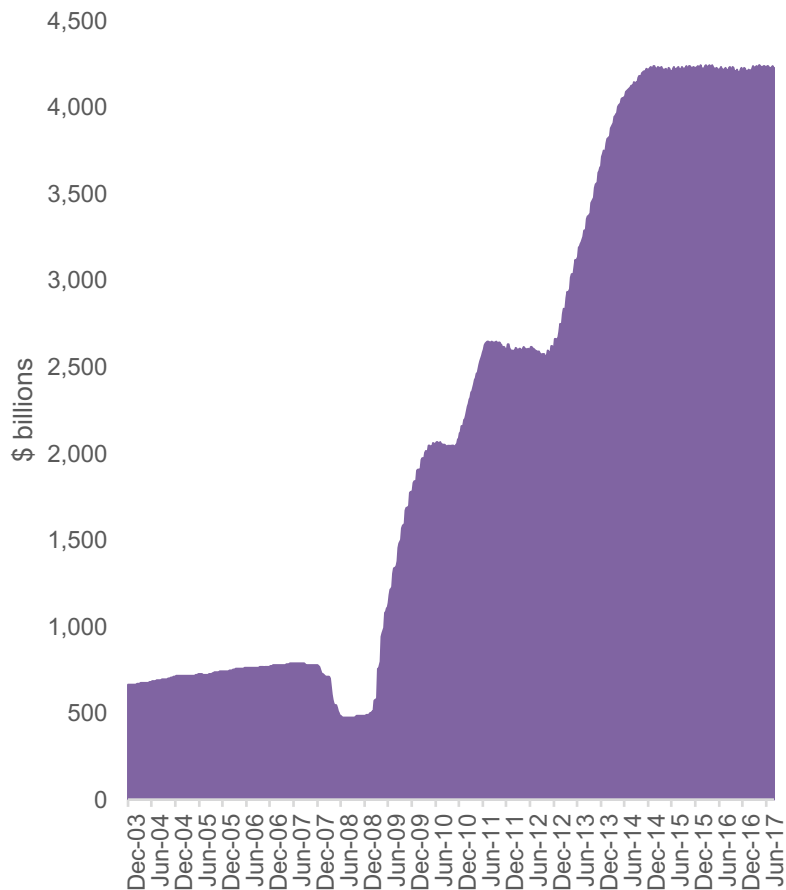
Source: European Central Bank, Treasury Strategies



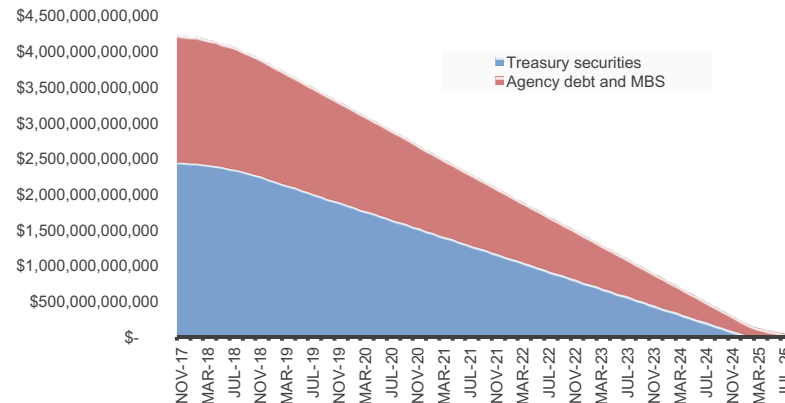
Crowding Out

Real money investors are being crowded out by Fed bond buying policies.

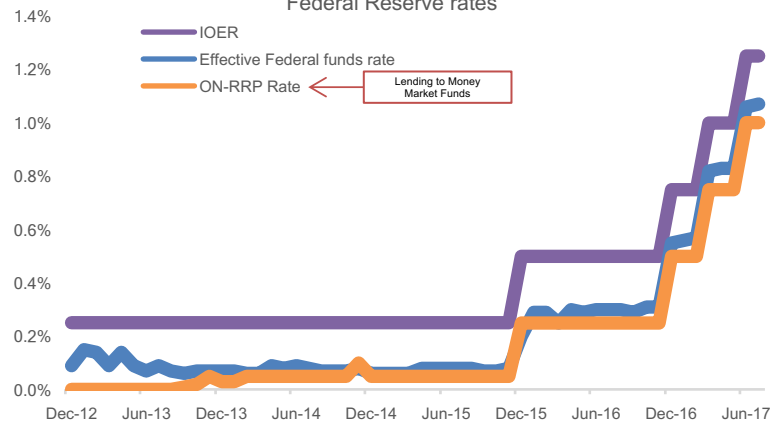
Federal Reserve SOMA total holdings



SOMA run-off schedule assuming 11/30/17 implementation



Federal Reserve rates



Conclusion



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- GDP growth is limited
- Corporations are sitting on record levels of cash and profits and could do more to free up capital for other businesses
- Meanwhile, key economic drivers, SMEs, are struggling to get access to credit necessary for growth
 - A combination of monetary policy, tax policy, and financial re-regulation limit access to credit
- Increasing GDP growth is important to the recovery
- Key to increasing economic growth is closing SME credit gap
 - Increasing SME growth will drive GDP growth
- Consider proposals that enable SME credit growth