

# The Credit-Crunch Explained

# Index

The Credit Crunch 1:	3
How it began	3
Where it all started	3
The sub-prime mortgage crisis	3
Taking the money out of debt	4
Bears, oil and interest rates	4
The outlook	5
The business effect	6
The Credit Crunch 2:	6
Household and personal finances	6
Mortgages	7
Credit Cards	7
Stock Market	7
Inflation	7
Managing your personal finances	7
Planning	8
Expenditure	8
Debt	8
Loans	8
Tax	8
Mortgages	8
Saving	9
Investing	9
The Credit Crunch 3:	9
Business Cash flow	9
Cash flow forecasting	9
Credit control	10
Customer credit checks	10
Problems with existing customers	11
Preventing late payments	11
Credit Terms	11
Invoices	11
<i>Payment</i> timetables	11
Payment collection	12
The Credit Crunch 4:	12
Business profitability	12
Sales	13
Overheads	13
Expenses	13
Wages	13
Marketing	14
Outsources	14
Suppliers	14
Energy efficiency	15
Waste management	15

# The Credit Crunch 1:

## How it began

We thought you might want to know how the credit crunch began, and then take look at how it affects businesses and individuals, and finally, how businesses and individuals can best weather the economic uncertainty.

## Where it all started

A sure sign that a new phenomenon has thoroughly permeated public consciousness is when the guardians of the English language feel that the term describing it has gained sufficient lexical weight and presence to warrant admission to the Concise Oxford English Dictionary. The latest edition of the Dictionary – along with ‘custard cream’, ‘drookit’ (Scots for wet) and ‘mocktail’ – has found space for ‘credit crunch’, which it defines as “an economic condition in which it suddenly becomes difficult and expensive to borrow money”. Unsurprisingly, given the frequency with which it too has been bandied about in newspapers and on television, ‘sub-prime’ has been similarly recognised for its recent disturbing ubiquity with an entry of its own.

The term ‘credit crunch’ has spread with all the relentless velocity of the events that it has ushered into our lives. One day in 2007 no credit crunch, just faraway rumours of something amiss in America; almost the next day in 2007 queues of worried savers outside branches of Northern Rock, anxious to empty the vaults of their savings lest the entire edifice collapse. Nor has there been any limit to its reach. Although its origins lie in the US housing market, the ‘credit crunch’ has echoed in households and businesses the world over, proving, if anyone doubted it, that we and our money inhabit a truly globalised economy.

## The sub-prime mortgage crisis

In recent years money has been cheap, low interest rates, easy-term borrowing. In America that cheapness encouraged competition among specialist lending companies; commission-driven sales staff offered mortgages to customers whose credit-worthiness often did not match the sums they were borrowing, risky, sub-prime borrowers. But elastic can only stretch so far, as more and more borrowers defaulted or failed to meet rises in interest payments, so more and more of those mortgages turned into bad debt as the sub-prime risks came home to roost.

The consequences for borrowers with \$200,000 loans they could ill-afford to service were catastrophic. But how did a family in Ohio, say, struggling to pay their mortgage – and many others like them – precipitate oceanic financial turmoil, the waves of which are still breaking on our shores? The lenders that provided sub-prime mortgages would package up the loans and sell them on as structured products – collateralised debt obligations (or CDOs to give them their innocuous, dusty acronym) – to financial institutions such as major banks and insurers.

Doing so allowed smaller lenders to clear their books of debt. The major banks were willing to take on the risk of sub-prime loans precisely because the risk appeared to be spread thinly, parcelled out in small amounts, bundled up with other, less precarious loans. From the banks, the loans, an

economic virus waiting to find another host, were sold on to private equity funds and investment companies. In a world of inextricably interwoven financial relationships, that home in Ohio represented collateral for a sliver of debt that could be held almost anywhere on the planet.

## Taking the money out of debt

Placed in the mighty scheme of things, the inability of an Ohio family to avoid defaulting on their mortgage repayments would not amount to a hill of beans (except, of course, for the family). The CDO in which their sub-prime mortgage was bundled would be able to continue to meet interest on the loans it contained. It's just that over the last two years, the number of American families unable to pay their mortgages has risen and risen and risen. In sufficient numbers, in fact, to create a critical mass of bad debt colossal enough to hammer many CDOs into valueless pulp.

In 2007, lashed by so many empty, broken mortgages, the international debt markets suffered a storm of mind-boggling losses. Where once trillions of dollars of debt could be traded cheaply, now billions upon billions of dollars were being wiped out in a tsunami of bad credit started by a small but gathering wave of over-sold and under-funded mortgages. Bear Stearns, a leading US investment bank, watched as two major hedge funds, which had bought up a lot of debt, disappeared into a heap, \$20 billion evaporating before investors' eyes.

The ramifications, of course, could not be absorbed by the more arcane and impenetrable regions of high finance. The storm hit the real world economy too. Cheap debt had helped to bolster company share prices. It had helped private equity firms to manage leveraged buy-outs. Now market activity, drained of the flow of affordable money, stalled. Buy-outs and mergers were called off. Risk became too risky. The value of the collateral on offer in return for institutional loans came under suspicion as house prices, against which sub-prime mortgages were set, began to tumble.

Banks, in Europe as well as America, sitting on debt packages that were now worth a lot less than they had paid for them and having to dig into reserves to write off their losses, grew reluctant to lend to other banks (Northern Rock faced its difficulties because it could not raise the liquidity needed to fund its loans). Hedge funds, that once invested in huge chunks of debt found themselves starved of cash, their appetite for funding corporate takeovers managed by private equity companies equally diminished.

Nor did the turning off of the money taps end there, banks grew reluctant to lend to smaller businesses and individual customers too. And where they did lend, they raised the cost of borrowing. Mortgages have become more expensive, business loans less easy to negotiate. Money is no longer cheap and no longer plentiful.

## Bears, oil and interest rates

The effects of the credit crunch are still reverberating. The equity markets are in turmoil. The FTSE 100's most recent high point was October 2007 when it reached 6730. By July it had fallen to 5260, the swingeing 20 per cent drop within the year qualifying it as a bear market. Banks are turning, cap in hand, to shareholders for injections of new funds in order to repair the damage done to their balance sheets.

As profit forecasts among listed companies have moved from disappointing to worrying, investors have deserted the market and sold shares. Only the performance of energy stocks, buoyed by

rocketing commodity prices, has prevented further steeping declines in the value of the equity market.

On the ground, consumers, the foot soldiers of the economy, have been reining in, their own, investments too, preferring, where possible, to snap shut purse strings rather than spend. High Street sales have, seasonal blips aside, been showing a series of falls that, month on month, is threatening to move from a short-term switch in spending habits into a medium-term trend.

New mortgage approvals are at a historic low, and, as the mortgage market shrinks, so house prices in the UK have seen thousands of pounds wiped from their value.

Making a bad situation worse, of course, has been the soaring cost of oil, energy, raw materials and food, pumping up inflationary pressures within the economy at precisely the time it requires a reduction in the cost of borrowing and an ease in the availability of money. This has been the Bank of England's Gordian knot: how to balance the imperative to keep the lid on prices, a move that would be compromised by making credit cheaper and easier through a cut in the base interest rate, with the equally urgent need to inject growth into the economy by encouraging consumer activity and enabling business borrowing.

In the US, the Federal Reserve went at interest rates with a sword, slashing from them percentage point after percentage point. Here, the Bank of England and the European Central Bank, caught on the horns of the inflationary/slowdown dilemma, have chosen to keep rates relatively high as a safeguard against rising prices.

Meanwhile, the CPI rate of inflation is offering signs that it will remain stubbornly above the Treasury target of 2 per cent for at least the rest of the year (it has reached as high as 4.4 per cent), just as growth predictions for the UK economy shrivel with each new forecast, dipping, some believe, to just 1.7 per cent for 2009. It is a tightrope walk for the Bank of England.

## The outlook

Things may appear gloomy, but just how gloomy? Is the worst of the credit crunch over? Is it now a case waiting for the money taps to be turned back on? For mortgage lenders, battered but unbowed, to start funding house moves again? For shoppers and businesses, reassured, to resume spending and trading?

Only in July Sir James Crosby, who was commissioned by the Treasury to report on the housing market, estimated that the credit crunch would make mortgages difficult to obtain until at least 2010. Sir James' report has prompted consideration by the government of a scheme that would allow the Treasury to underwrite mortgages by guaranteeing bonds issued by lenders. Even though it is now accepted that some form of government action may be needed to address the mortgage-funding gap, no decision is likely to be confirmed until the autumn pre-Budget report.

Hopes that ordinary savers can help bail out the banks and building societies, tempted by the generous savings account offers currently available into boosting the amounts they deposit, may be wishful thinking. Not only has the level of borrowing against mortgage-backed securities among banks and building societies, as opposed to the old habit of using customers' deposits to fund new mortgages, never been higher (a quarter of all the money raised last year for mortgages came from the money markets), ordinary savers, foraging deep into pockets to pay for petrol and food, are

having to cope with money issues of their own. How to save when disposable income is being eaten into by constant price hikes?

While the housing market labours in the doldrums, lenders unable to provide the huff and puff of finance borrowed from the money markets that would satisfy demand for new mortgages, so the rest of the economy, from major corporations to small businesses, will continue to feel the becalming effects of the lack of liquidity.

Last month, the IMF too poured more cold water on any optimism over an early end to the turbulence. “A bottom for the housing market is not visible,” its latest global financial stability report declared. Things, in other words, may get worse before they get better.

## The business effect

With people, including other businesses, spending less, firms in the UK have not been firewalled against the credit crunch. Sales have dipped in many sectors and, hit by the double whammy of rising commodity costs, profit margins have been squeezed.

In response, a new report suggested, businesses are storing up surplus cash against further downturns in the economy. As part of its six-month survey of business activity, Lloyds TSB recently reported that smaller firms are depositing record sums of money into their business accounts, preparing themselves for additional falls in sales and profits.

However, the report also suggested that many firms appeared to be in a better position to handle the current downturn than in previous periods when trading conditions became difficult. Balance sheets, it concluded, are in a relatively strong condition. And while cashflows have become more problematic, the percentage of firms suffering from late payments is still less than half of the 56 per cent that reported similar difficulties in the recession of the early 1990s.

It may not be possible to pencil in a date when newsreaders finally stop referring to the ‘credit crunch’, its destabilising consequences at last exhausted. It may not be possible to say exactly when the money markets rediscover that chimerical, totemic word ‘confidence’, a word upon which many powerful financial structures rely as much as they do upon more tangible things such as hard cash. Recovery will, eventually, happen.

It is, however, possible to take practical steps, whether as businesses or as individuals, to make sure that we are in the best position to deal with the current problems: steps we will be examining in the remainder of our series of articles on the credit crunch.

## The Credit Crunch 2:

### Household and personal finances

The credit crunch has seeped its way into the budgetary niches of almost every household in the country in one form or another. Here are some of the problems it has caused and some tips on how best to ensure its effects are manageable.

## **Mortgages**

In one respect, the credit crunch, whether or not its journey is yet over, has already travelled a full circle. Starting in the US sub-prime mortgage market, and taking a route via international structured debt products, it has now arrived Full Square in the UK's own mortgage market. Its most obvious impact has so far been to make mortgages both more difficult to find and more expensive. In fact, loans and credit of almost every description.

New mortgage agreements are at an all-time low. According to the Bank of England, new home loan approvals dropped by a massive 68 per cent in the year to June 2008. In June alone, approvals stood at just 36,000 compared with the 114,000 that were agreed by banks and building societies in June 2007. Where applicants are not being turned down, some first-time buyers and those with less than spotless credit histories are being offered deals that hover around the 11.5 per cent interest rate mark.

Rises in interest rates mean that some home owners are now finding that mortgages are swallowing ever greater proportions of their income, accounting, says the Council of Mortgage Lenders, for as much as 18.8 per cent of average earnings in certain cases. In the early 1990s that figure stood at about 10 per cent.

## **Credit cards**

All the while credit card companies have been busy reining in credit limits and declining new applications by the postbag full. As long ago as last December, Barclaycard was reported as refusing a half of all applicants and lowering the spending ceilings on some 500,000 existing cards.

## **Stock markets**

The credit crunch has taken a double bite out of the stock markets. Major investors have been selling shares or betting on falls in their value; smaller investors have been shying away from the turmoil of flip-flopping stocks altogether, preferring instead the calmer harbour of high interest savings accounts.

## **Inflation**

As if the credit crunch of itself were not applying enough pressure on personal finances, it has arrived riding on the back of rising commodity prices. You would need to have spent the last year living on a Himalayan outcrop not to have noticed that the cost of petrol at the pumps has galloped, while energy (gas bills are being threatened with a 30 per cent rise) and food, too, have become increasingly expensive.

# Managing your personal finances

While few individuals are in a position to escape the reach of the credit crunch, there are a series of practical steps that can be taken to limit its impact on household budgets.

## **Planning**

There is nothing quite like being forewarned to be forearmed. So, wherever possible, anticipate likely increases in household spending even before the statement or the bill lands on your mat. Allow for hikes in mortgage interest payments; allow for a rise in fuel and energy bills; allow for extra food budgets.

## **Expenditure**

To accommodate such allowances, take a microscope to your household spending. Examine every outgoing and decide whether it is really necessary. While delaying the purchase of a new plasma television looks like a saving (remember, its money you haven't yet actually spent), cutting back on some smaller daily outlays – is every car journey necessary? – can amount to a considerable reduction in costs when taken across a whole year. Interrogate each direct debit (they tend to get overlooked because they require no action on your part) and then review how essential it is. Utility bills may be rocketing, but it is possible to offset some of the extra cost paying by direct debit and making use of the discounts suppliers offer for this method of bill settlement.

## **Debt**

In times when money is in shorter supply it is also more expensive. So try to avoid any kind of debts. If you do have credit cards, pay off as much as you can afford each month and pay on time. Credit assessment is becoming ever tighter in its scrutiny, and late payments on even something as innocuous as a mobile phone can have an adverse effect on your rating.

## **Loans**

Should you find that you must take out a loan, settle down with a calculator first and do some maths. Never borrow more than you actually need to and always work out exactly how much a loan will cost you over the full span of its life (loans with the lowest total amount repayable are the most cost-efficient). And then budget for it.

## **Tax**

Tax, like a mortgage, is a priority payment. Always make sure you have set sufficient sums aside to meet any liabilities you will face. If you are unsure about your future tax bills, talk to us.

## **Mortgages**

The good news is that house prices are falling. The bad news is that mortgages come with more exacting loan conditions attached. Although the base rate has held steady at 5 per cent since April 2008, the costs of fixed-rate and tracker mortgages have been on the increase. First-time buyers without reasonable deposits and clean credit records may struggle to find a suitable loan; those with should brace themselves for some challenging interest rates. Home owners who are thinking of moving will not be treated quite so punitively.

One certain consequence of the credit crunch, however, has been the rise in mortgage arrangement fees, which have soared. Any decision to move will need to take these costs into account (though, with house values dipping more or less across the board, they may in part be offset by a reduction in the amount of stamp duty payable on the new property).

## **Savings**

While interest rates may be hurting some mortgage payments, they make it a good time to save. Competition among banks and building societies for customers has pushed savings rates to their highest level for several years. Some rates were as much as 1.3 per cent higher in July 2008 than they were in December 2006 when the Bank of England's base rate was also at 5 per cent. A recent study by Moneyfacts found that fixed-rate bonds could produce a return of 7.15 per cent on savings compared with a rate of 5.85 per cent in 2006. Even no-notice savings accounts have shown a 1.1 per cent rise to 6.4 per cent for the best rates available during the past 18 months.

## **Investing**

The stock market is a volatile place at the moment. The understandable instinct of many smaller, non-institutional investors has been to shun stormy equity markets and head for the tranquility of savings accounts. The Building Societies Association reported that cash deposits during 2007 reached £16 billion, almost double the 2006 total of £8.3 billion. Scattered across the City are the burned remains of once stable and lucrative investment sectors – banking, property, construction and retail.

However, amidst the tumble and slump of many prices, a number of well-structured, well-funded companies have taken hits that were not of their own making, their share values unfairly punished for the shortcomings of others, and are still worth investigating. Of course, now is not the occasion to plunge heedlessly into equities; but nor is it also necessarily the time to sell recklessly and crystallise losses. Over the longer term equities usually perform profitably, and periods of uncertainty may be the opportunity to review a portfolio and to realign investments. Taking professional, expert advice is, however, essential.

Guiding and husbanding personal finances through the credit crunch may not be easy, but, with careful management, it is possible to emerge intact. And the crunch, like all financial phenomena, will, one day, pass.

If you would like help in planning your personal finances or your tax, please don't hesitate to contact us.

# The Credit Crunch 3:

## Business Cash flow

At the best of times cashflow is vital to the wellbeing of a business. When cash is under pressure, as it is in the current credit crunch, ensuring that you are paid, and paid on time, is even more important. Key to this is maintaining a strict financial management policy.

### **Cashflow forecasting**

One way of making sure a business has as much control as possible over the money that moves in and out of its bank account is to put together a cashflow forecast.

A cashflow forecast works by charting how much money is to be paid in to a business over a fixed period of time and how much money the business will pay out during the same period.

The fixed period covered by a cashflow forecast can vary from a quarter to an entire year. It is usually divided into smaller sub-periods such as months or weeks or even days. The forecast will show: monies paid in; monies paid out; the difference between the two; the bank balance at the start of the period; and the bank balance at the close of the period. Forecasts usually include an estimate of the amounts of cash a business expects to receive and pay out as well as the actual amounts.

The advantage of a cashflow forecast is that it provides a business with a useful way of anticipating any downturns in its cash balance.

## **Credit control**

The principal cause of cashflow problems is late payment. In giving a customer credit, a business is effectively offering them a loan on which no interest is charged. Clearly, the sooner that invoices are settled, the sooner the business can use the money to re-invest in itself.

Matters are made worse if a business is having to borrow - say through an overdraft - in order to cover overdue payments; not only is the bad debt freezing much needed capital but it is actually costing the firm money.

The priority is to set up a credit control system; that is, a system of checks and procedures that optimises the chances of being paid and of being paid on time.

## **Customer credit checks**

While new customers are always welcome, it is important that a business is sure that they are capable of paying for the goods or services they have ordered. If a business has any doubts about a customer's ability to pay, then it is worthwhile carrying out a credit check first.

Most new, and viable, customers will be happy to complete a credit application preliminary to delivery of goods or services. This should include, among other things, the level of credit that is being given, references from other businesses that have had dealings with the customer, and permission for the business to ask for bank and credit references.

A business can make follow-up checks if their concerns run deeper, taking up bank references and requesting information from other suppliers about the customer's payment history. It might pay to commission a report from a credit reference agency. Two well respected credit agencies are:

Experian at <http://www.experian.co.uk/>

Equifax at <http://www.equifax.co.uk/>

They will check that customers are who they say they are and that they have the means to pay for the goods or service. The agency will also recommend a credit limit for individual customers. Other official agencies can help too. Companies House will keep records of the accounts of limited companies, and these are available for checking.

## **Problems with existing customers**

It is not always easy, at least at first, to tell if an existing customer is experiencing financial problems. There are, however, some early, telltale signs to look out for.

These include an unexpected change in payment timings. A good customer may always have settled their invoices on time; now they are delaying payment. Frequent errors on cheques – the wrong date, absence of signature – may be simple mistakes; but they may be a deliberate way of masking an inability to pay, constant querying of invoices or promises that the cheque is in the post or refusals to take phone calls may be other indications of problems.

If payment patterns deteriorate, you may want to run a credit check.

## **Preventing late payments**

Impossible though it is to get every customer or client to pay right on time, there are certain steps a business can take at least to minimise the accumulation of too many overdue invoices.

### ***Credit terms***

The first step is for a business to make sure that its credit terms are clear and easy to understand. If the time limit for payment is 30 days, then customers should be aware of this. Detailing and discussing terms and conditions before a sale is made will help avoid misunderstandings or difficulties later on.

Some businesses consider it worthwhile to operate a sliding scale of payment terms as an incentive to customers. For example, any bills that are settled within a week are entitled to a small discount, whereas those that exceed, say, the 30-day limit could forfeit their chance to cash in on the discount for the following three months.

Your terms may also offer customers alternative methods of payment, particularly electronic methods such as BACS. Electronic payment can stop the risk of cheques going missing in the post.

### ***Invoices***

The next step is to make sure that the invoices themselves don't become excuses for non-payment. For this reason they ought to be paragons of clarity. They should carry both the name and address of the business and the customer. They should be dated accurately and clearly. Just as prominent should be the date by which payment is due. Invoices should quote any purchase order raised and should describe the specific nature of the service, work or product. The amount charged should be for the correct and agreed price, and the VAT, if any, should tally.

As soon as the goods have been delivered or the project completed, an invoice should be raised and sent at once.

### ***Payment timetables***

Businesses should set customers, and themselves, a strict payment timetable and should keep to it. Reminder letters need to be sent and chase-up phone calls made according to the timetable.

Under the Late Payment of Commercial Debts (Interest) Act 1998, firms have the legal right to charge interest up to 8 per cent above the existing base rate, fixed for two six-month periods each year, on overdue invoices. Many businesses, not unnaturally, are wary of penalising customers and clients in this way for fear of jeopardising future contracts, so you may want to assess your relationship with the customer before applying the charge.

Lastly, when chasing late payments, it is always best to target the largest outstanding amounts as well as the oldest debts. If things get so bad that a business is forced to take remedial measures, then it is important to carry out the action of which the non-paying customer has been warned. Failure to do so will simply encourage the belief that the business is not serious about getting hold of its money.

### **Payment collection**

Regrettably, in some cases there will come a point when it is clear that no amount of polite coaxing or pleasant reminders will persuade the customer of the need to settle the invoice. Then it might become necessary to involve a debt collection agency (they will charge a fee as a percentage of the outstanding sum) to secure payment.

Other payment collection options open to a business include credit insurance, factoring and retention of title.

For a premium, credit insurers will cover the risk of incurring bad debts. Factoring companies provide finance against outstanding invoices and will assume responsibility for collecting the overdue amounts. In certain circumstances, retention of title allows a business to reclaim, as its own property, any goods that a customer has failed to pay for.

Running a business is demanding and time-consuming, no more so than in the difficult conditions the credit crunch has brought. If you would like professional help and guidance in managing your cashflow, please don't hesitate to contact us.

## The Credit Crunch 4:

### Business profitability

Survey after recent business survey has painted the same unfortunate picture of the UK economy.

For example, the latest CIPS index of trading conditions for the services sector, the driving force of the economy, eased up slightly in July to 47.4 from the seven-year low of 47.1 recorded in the previous month, an improvement if only in that the sector is contracting at a slightly slower rate. Also in July, the manufacturing sector saw 0.5 per cent shaved off its output, the fourth month on the trot it has fallen.

Businesses are beleaguered on the one side by the credit crunch – customer money in tight supply – and on the other by rising prices – supplier costs on the rise. Squeezed between them is that most vital of all business statistics: profit margins.

It may seem odd, when businesses are busy worrying about looming recession (the British Chambers of Commerce has warned of the possible imminence of two successive quarters of negative growth), spend-shy customers, evaporating credit, expensive borrowings and late

payments, to give priority to profitability. But it is profitability that keeps a balance sheet healthy; and profitability that means a business is best equipped to come through the buffeting winds of the credit crunch. In other words, make sure that your business has that most craved of commodities – surplus cash.

In two essential respects, maintaining profitability in a time of economic difficulty is no different to maintaining profitability under any other trading conditions. A business either looks to boost its sales income or to cut its direct costs.

## **Sales**

To fuel sales, a business, as ever, should keep an eagle eye on its market and its competitors. Products and services must meet the demands of one and stay ahead of the other. It is important not to let service standards slip (deliveries made on time and to the right specification): if customers are more reluctant to spend, don't give them the excuse to leave you because you are failing to live up to past quality of service. Remain flexible, agile and, wherever possible, innovative.

Confronted by a tightening market, it may be tempting to cut prices to attract more custom. Think long and hard about this. Will the consequent fall in profit be more than compensated for by an increase in sales volumes? Remember, too, that when the credit crunch has finally abated, you may find yourself having to push up prices by above-inflation amounts.

Your prices, of course, need to cover both the fixed costs (rent, wages) and the variable costs (energy, transport) incurred by your business. But also bear in mind that your customers may well see your product or service as adding a value to them. Even during tough trading conditions, the value of your service may be such that customers will still be willing – may be even more willing – to pay for the extra benefits you bring such as reliability and excellence of product.

## **Overheads**

Looking for ways to reduce your costs should always be an imperative. During the credit crunch, it has become a matter of greater importance.

## **Expenses**

Scrutinise all your expenses, including those of your staff, and look for ways to trim them without imperilling the efficiency or quality of your business.

## **Wages**

One of the worries of the Bank of England is that consumer price inflation will prompt wage inflation, adding oil to the flames of the rising cost of living. With inflation nosing up above the 4 per cent mark, driven by rocketing energy and food bills, it is understandable that employers are casting a concerned eye at wage demands.

The evidence so far suggests that wage inflation is holding within acceptable limits. But many employers will be asking themselves if their business can afford 4 per cent wage settlements.

Wages are often a firm's largest overhead. An employer must balance the need to keep labour costs manageable while also offering the sort of pay that attracts good, skilled recruits, and that motivates and encourages loyalty among existing employees.

While inflation and the chronic skills shortage the labour market is still experiencing may be pressurising pay, there are measures smaller firms can introduce to soften the impact of their wage bills without hampering their performance.

The first is to make sure that employees are working as efficiently as possible, which means you may not have to take on that extra recruit you have been advertising for. Review your working practices for duplication of tasks. Staff duties can be re-allocated to make better use of the skills and talents of the workforce.

Think about cutting down on overtime bills by employing a part-time worker (this can often be less costly and more productive). Where there is overtime, make sure it is approved beforehand.

It is also important to bear in mind that not all employees are going to be equally motivated or incentivised by financial rewards. Increasing numbers of employers are recognising that other rewards, such as training, regular consultations and flexible working patterns, are just as effective methods of encouraging staff loyalty as bonuses and pay offers.

### **Marketing**

Often the first cost to be cut in a downturn is the marketing budget. Consider, however, the possible positive effects on your sales if, while your competitors vanish from view because they believe that advertising their products and services is simply not worth the cost, you continue to invest in promoting your own business. Slashing marketing budgets can be counterproductive.

### **Outsourcing**

Equally compelling during periods of economic challenge is the urge of managers and owners to devote all of their time and energies to the day-to-day concerns of running the business. Time and energy that might more profitably be spent planning and considering longer term strategies.

A number of business functions can be outsourced. Outsourcing not only frees up resources within the business, it allows you to tap into the expertise of specialist firms and to save money too.

You may, for example, wish to talk to us about outsourcing your payroll and additional accounting tasks. Other areas where outsourcing could be a cost-saving solution include human resources (recruitment, training) and marketing.

Before handing certain operations over to an outside business, however, you will need to consider whether they can offer an appropriate service and have sufficient knowledge of your type of business. Just as importantly, you will need to calculate whether the fees they charge, along with the service they deliver, represent a measurable cost saving.

### **Suppliers**

Put your purchasing policy under the microscope. To investigate if supplier costs can be cut in any way, compile a list of all the businesses you buy from and work out how much is being spent on everything from paper clips to vehicles. Then contact your suppliers to find out if, say, bulk purchases or long-term custom entitle you to discounted rates (even a 5 per cent reduction on stationery can amount to a considerable saving across the year). If they don't, examine alternatives. The better your relationship with your suppliers, the more amenable they may be to discuss improved deals.

As valuable as price, of course, is the level of service and quality of product suppliers deliver. Opting for a cheaper competitor may not save you anything if the replacement product is not as good and impinges on the performance of your own business. So when reviewing your suppliers, it is vital to take service levels (are they reliable, are they responsive, do they mesh well with your own services, products and ambitions?) into account as well.

## **Energy efficiency**

One area where all businesses, large and small, can reduce costs is energy use.

Many energy efficiency measures are easy to implement. These include using energy-saving light bulbs; turning off radiators that are heating empty rooms or unused areas; placing thermostats in temperature constant positions; setting the hot water supply at 60 degrees (any higher is wasteful, any lower can encourage legionella); fitting draught excluders; improving insulation; making sure that delivery doors are opened and closed only when necessary during colder months; keeping office furniture away from radiators so that the heat distribution is not blocked; and maintaining equipment so that it runs efficiently.

Equipment that can be shut down, like photocopiers and air conditioning units, should be switched off when - overnight and at weekends - there is no one in the office. Some machines or equipment can be moved to a sleep or standby mode, which consumes less power, when not in use. It should be explained to members of staff which switches control which facilities, and they should be encouraged to turn off lights or equipment when rooms are no longer occupied.

Simplicity is the key to ensuring that everyone in a firm plays their part in preventing energy waste. The more straightforward the energy-saving policy that a business introduces, the more likely it is that employees will observe it.

More information and advice on saving energy is available from the Carbon Trust website at [www.thecarbontrust.co.uk](http://www.thecarbontrust.co.uk)

## **Waste management**

Managing waste efficiently can help save a business money too. Waste management covers everything from raw materials to technology, from water to sheets of paper.

While manufacturing firms are most obviously affected, all businesses can benefit from having a waste management policy in place. There are waste issues in most areas of business operation, whether it is something as simple as the invoicing system or something more complex like product design.

It is good to begin with the easiest areas in which to make changes. This could involve recycling more paper in the office, or ensuring that electronic filing does not lead to the printing of unnecessary hard copies of documents.

Then tackle the use of utilities, such as water, the way in which raw materials are managed, plant and equipment, working practices and waste disposal methods.

More details on better waste management are available at [www.envirowise.gov.uk](http://www.envirowise.gov.uk)

If you would like professional help and guidance in boosting your profitability, please don't hesitate to contact us.