BOOSTING FINANCE OPTIONS FOR BUSINESS

Report of industry-led working group on alternative debt markets, March 2012

"In light of the need to find new sources of capital to support the future financing needs for UK businesses, what are the barriers to the development and growth of sustainable non-bank lending channels in the UK?"

EXECUTIVE SUMMARY

1. The UK has one of the most sophisticated global financial centres, but UK finance does not fully serve the needs of smaller businesses. UK businesses that use external finance are currently heavily reliant on bank lending and, as we saw during the financial crisis, there is significant risk associated with reliance on one single source of finance. UK Plc is in good shape overall, with positive cash balances; however, this is not distributed evenly across all firms. We conclude there is a need for new mechanisms to support growth in the UK.

2. The economy is currently at a critical stage. As economic growth returns, UK businesses will need to take advantage of opportunities and expand production. The future availability of credit will be crucial to help support businesses to harness those opportunities and drive forward growth in the wider economy. Firms will need to borrow money for viable business plans at prices commensurate with their credit risk. As things stand, there is a risk that the supply of finance for investment and working capital will not match demand as firms seek to increase production. Banks remain essential in providing credit to the economy, but the stock of bank lending has reduced over the last three years, and there remains a significant funding challenge for banks as a result of regulation at national and international level which is likely to further restrict the availability of credit.

3. The arguments for alternative sources of finance are strong. More diverse financing gives businesses greater choice, promotes competition amongst finance providers, potentially reducing cost, and leads to greater resilience in the financial system. Some other countries, particularly the US, have a wider range of bank and non-bank finance options for businesses creating a more diverse and efficient market.

4. It is worth noting that external equity funding is significantly under-used by smaller UK businesses: only 3% of small businesses'[1] use equity finance, whereas 55 per cent use credit cards. Equity, along with alternative channels for debt capital, can potentially benefit these businesses in the early stages of their development. These smaller businesses often need significant capital injections to achieve their potential and may often be deemed inappropriate for bank finance alone due to their innovative nature. Whilst equity is not the subject of this review, it is important to create a framework to stimulate investor appetite for equity and lower the cost of raising such capital.

5. Along with supply side challenges, there are demand barriers: smaller businesses are quite rightly focused on building their customer base and lack the scale to be able to justify a dedicated finance professional. This has led to a general lack of

1 Small Firms in the Credit Crisis: Evidence from the UK Survey of SME Finances www2.warwick.ac.uk/fac/soc/wbs/research/csme/research/latest/small_firms_in_the_credit_crisis_v3-oct09.pdf /

awareness about alternatives to bank finance and hence improving support for this segment is a key element of our recommendations.

6. Given the anticipated growth in demand for finance and the expected constraint on availability from banks and other sources, on our assumptions the finance gap could be between c£84bn and c£191bn over the next five years. The Taskforce has examined options to increase the supply and take-up of alternative sources of finance in order to close this finance gap.

7. We believe that if Government and industry, working together, delivered the full package of our recommendations they could unlock significant additional finance for UK businesses, generating new funds from institutional and individual investors.

8. At the smaller end of the market, businesses themselves also need to be enabled to be better consumers of finance. Government can start by clearing up the "alphabet soup" of business support schemes, learning from countries that do it well. Professional advisers have a role to play, and the main accountancy bodies have agreed to work together to produce a kitemark scheme for business finance advisers. This will help businesses get the required advice and importantly access the type of funding that is right for the needs of their business.

9. There are also a number of innovations in the UK financing market that match up businesses and prospective investors, circumventing the conventional funding channels. Whilst there are risks associated with this and most providers are only in their infancy, it will be important to nurture innovations such as these in the coming years.

10. Our recommendations include proposals to create two new agencies and to unify existing Government interventions under a single brand. The combination of these agencies would create an entity which carries out many of the functions undertaken by state-owned business support agencies such as KfW in Germany. Whilst this is not one of our formal recommendations, combining our proposals into a KfW-type structure would provide a mechanism to address the market failures impacting the supply as well as the demand barriers preventing businesses from accessing non-bank finance. It would also provide a familiar channel for new initiatives, such as the Government's credit easing measures, to be delivered. This is something that the Government has to consider.

RECOMMENDATIONS

Increasing Awareness and Demand for Alternative Forms of Finance:

Recommendation 1: Introduce a Business Finance Advice scheme.

Recommendation 2:

a. Improve communication of Government support programmes through the creation of a single brand for its interventions.

b. Responsibility for delivery of Government Access to Finance programmes should be consolidated into a single delivery agency.

Improving Access to Capital Markets Financing for UK Companies:

Recommendation 3: Launch a feasibility study, led by the Association of Financial Markets in Europe, to explore the creation of an aggregation agency to lend directly to SMEs and/or to pool SME loans to facilitate SME access to the public corporate bond markets.

Recommendation 4: Increase the number of UK-based Private Placement investors through an industry initiative led by the Association of Corporate Treasurers.

Recommendation 5: Increase the UK retail investor appetite for corporate bonds through:

a. Launching electronic retail-dedicated gilt products available through registered stock exchanges; and

b. introducing additional tax incentives for investing in SMEs.

Stimulating Growth Through Supporting Smaller Companies:

Recommendation 6: Government should:

a. Require that benefits to large companies of its prompt payments are passed on to their suppliers; favourable payment terms should be withdrawn if those agreements are not met.

b. Explore practical ways to encourage faster payments by large companies.

c. Work with industry associations to promote invoicing best practices to enable more effective enforcement of the existing legislation on late payment.

Recommendation 7: Government should:

a. Explore how it can use its power as the biggest purchaser in the UK to encourage its own suppliers to adopt supply chain finance or similar schemes to support their suppliers; and

b. work with banks, industry associations and professional bodies (such as the ACCA, ICAEW), to accelerate adoption of Supply Chain Finance.

Developing New Financial Products:

Recommendation 8: Government should explore the potential for the Business Finance Partnership to make commercially attractive investments in the following:

- Online Receivables Exchanges;
- Mezzanine Loan funds; and
- P2P lending platforms;

The Evolving Regulatory Environment:

Recommendation 9: UK authorities and business representative bodies should provide an evidence-based perspective of the impact of international regulatory measures on the provision of bank and non-bank finance to UK SMEs and update their evidence on an annual basis.

Recommendation 10:

a. The BBA should explore greater credit data sharing with non-bank providers, and this should be considered by the FCA; and

b. Government should consider whether further data could be made available to support the development of new finance products and markets to benefit businesses.

Recommendation 11: An industry-led taskforce should be launched to make specific proposals on how to remove barriers on bank lending to support SME trade finance.

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1. FOREWORD

Most UK businesses, especially SMEs, have traditionally been reliant on banks to meet many of their financing needs.

We find ourselves now in a period of deleveraging and credit restriction, where businesses are frustrated by lack of access to capital of all kinds. Britain's recovery will depend on companies being able to access the finance they need to invest and grow.

A different and longer-term approach to this problem is needed: one that harnesses the positive qualities of our leading global financial sector to the benefit of ordinary businesses.

That is why I asked Tim Breedon, CEO of Legal and General and Chairman of the Association of British Insurers, to lead an industry Taskforce to examine this question: how do we re-shape the finance landscape to make it serve better the needs of British businesses?

Tim Breedon's approach has been very wide-ranging. His Taskforce brings together businesses, investors and advisers. They have mobilised many experts, across the UK, to provide evidence and ideas. I applaud this level of co-operation and believe it essential to deliver the changes needed. The problems are not intractable but they will take positive thinking and creativity to solve. I have encouraged them to be bold and I hope their work will represent a turning point in UK business finance.

BIS | Department for Business Innovation & Skills

Vince Cable, Secretary of State for Business, Innovation and Skills

2. INTRODUCTION

The remit of this Taskforce has been to examine a very large topic – the financing of UK SMEs – in a very short, three-month, timeframe. It has been something of a sprint, for the Taskforce members, our staff and those of BIS and HM Treasury who have helped, and for the many organisations and individuals who provided input through the Call for Evidence and the series of workshops we have arranged across the UK. I am very grateful to all for the range and quality of their contributions: this in itself tells us the subject is important and topical.

Good economic evidence exists for both supply and demand problems in bank lending. More importantly, there is compelling evidence that this is expected to become acute as business confidence and growth return and continuing bank deleveraging leaves a significant funding shortfall.

We have not identified a single “silver bullet” solution to deal with the issue. We have, however, explored a number of useful areas and come up with a series of recommendations which we believe will collectively help open alternative financing channels for UK SMEs. On the demand side, these include ideas to improve information about and access to finance for businesses. On the supply side, we have made recommendations which we consider would add to the quantity and variety of available finance, for example by opening up capital markets, asset-backed and trade finance to a broader range of users.

One strong theme that has emerged is the potential for businesses to work more effectively together through their supply chains: the UK corporate sector collectively runs a large surplus, which we believe can be deployed more effectively, particularly during a period of historically low interest rates. This aspect of our work, I believe, has been particularly important: it represents a significant, high-potential part of the financing landscape outside the banking arena, which remains underdeveloped.

Where possible, our approach has been to work with the grain of existing markets and institutions. This will continue to be important, given the time available and the technical complexity of the issues we have been examining. Taking forward our recommendations will require further detailed feasibility studies in a number of cases. This is an inevitable consequence of the short time the Taskforce was given to examine this complex issue. Industry has committed to lead several of these which we hope will inspire further Government and private sector work.

I know I speak for the Taskforce as a whole in hoping that this study is the beginning, rather than the end, of a process that will make a material positive change to the way our SMEs finance themselves.

Tim Breedon

3. ECONOMIC CONTEXT

"What needs to happen to make sure the British Banking System supports the real economy in the UK? My partial answer: diversify and deepen UK sources of funding for SMEs and new businesses"… Adam Posen February 2012[2].

3.1. Summary

1. Businesses require finance for working capital and to invest for future growth. Finance requirements will vary widely for different businesses of different sizes at different stages of expansion. Cashflow that is generated within the business is the primary source of finance[3]. For many businesses, however, the ability to raise additional finance from external sources, through debt or equity or a combination of both, can be critical to support their activities.

2. The impact of the financial crisis was severe for many businesses. For all businesses, the finance landscape has changed significantly. This section explores how businesses finance their activities and how recent developments have affected them. It aims to provide an insight into the future finance needs of businesses, and assess whether anticipated supply will be sufficient. The primary focus is on Small and Medium-Sized Enterprises (SMEs), but the analysis extends to larger businesses that may face similar challenges.

3. For the businesses studied, the main source of external finance is bank lending (loans and overdrafts). The scale and nature of bank lending is changing, with both cyclical and structural factors at play. This analysis sets out those factors, for businesses of different sizes, and explores the role of alternative sources of debt finance and their scope to support businesses alongside traditional bank lending.

3.2. Current finance conditions

4. Gross lending to the non-financial private sector peaked at £657bn in December 2008. Since then, the stock of lending to UK non-financial corporate businesses has shrunk by £151bn[4], reaching £506bn in December 2011. New lending has

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2 www.bankofengland.co.uk/publications/speeches/2012/presentation120202.pdf

3 Of those SME employers looking to grow in the next 2 to 3 years, the majority (66%) were planning on funding this growth entirely through internal funding sources (BIS Small Business Survey 2010).

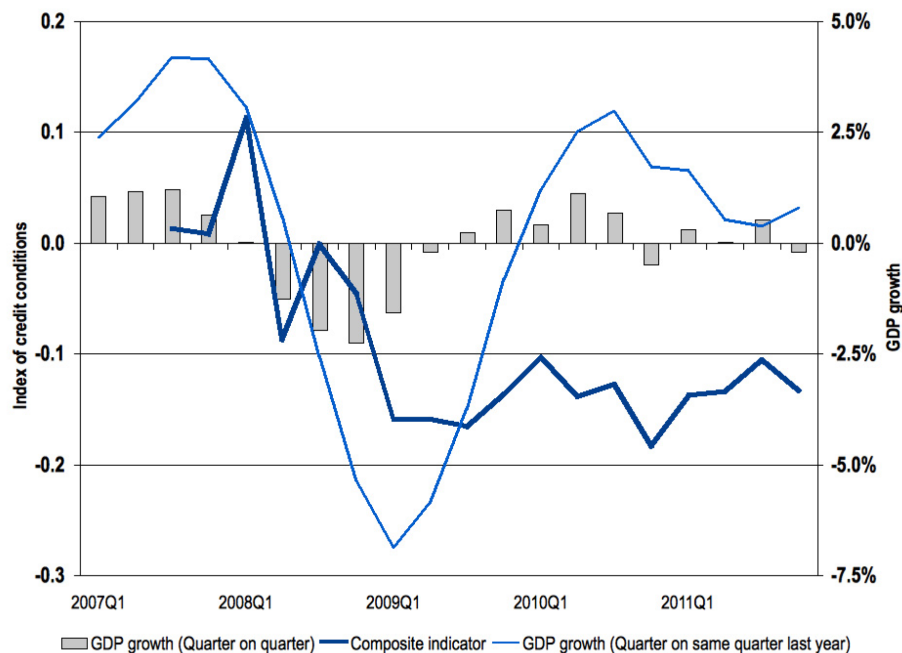
4 Bank of England Statistical Database, Table C, lending by industry 'lending to non-financial corporations' (Data extracted on 12/03/12, actual figures i.e. non-seasonally adjusted)

fallen at the same time as repayments of existing debt have risen. This deleveraging is to be expected to some degree, given the high levels of debt previously accumulated in some parts of the corporate sector.

5. A notable observation, however, is that excluding the commercial real estate/ construction sector (CRE), the total stock of lending to businesses did not increase markedly prior to the financial crisis. Indeed it increased broadly in line with GDP. The reduction in lending levels to businesses over recent years can therefore be seen as a complex interplay of demand and supply conditions.

6. The Credit Conditions Indicator (Figure 1) attempts to summarise changes in the ease of accessing finance over time, based on a range of data indicators. A rise in the Taskforce's indicator would suggest a loosening in credit conditions (more available and cheaper credit) whilst a fall in the indicator would suggests a tightening in credit conditions (less available and dearer credit). Note that the first point in the data series here, 2007 Q1, is close to the peak of the boom, when the economy was not in equilibrium.

Figure 1: Credit Conditions Indicator



Source: Taskforce estimates. Indicator comprises a range of data on the use of business finance including Bank of England, ONS and other survey data.

7. Various studies point to low levels of demand for finance among businesses, related to weak business confidence about future economic conditions. There is evidence that demand for bank credit is subdued. Applications for bank debt

remain very weak[5], with only 9% of SMEs seeking finance in the year to 2011 Q4[6]. Many businesses have reduced costs and scaled back investment[7], and this is seen in the increase in the amount of net cash balances on non-financial corporation balance sheets[8]. Applications for bank debt remain very weak[9] and utilisation of finance facilities including overdrafts has returned to pre-crisis levels[10].

8. However, low levels of demand do not appear to fully explain the reduction in lending. Banks have understandably become more risk averse in response to the crisis. Borrowers have reported that credit facilities are taking longer to approve; the maturity of loans has shortened, there are higher collateral requirements and in some cases additional fees for loans[11].

9. In part, this reflects a correction of the situation leading up to the financial crisis, where it is widely accepted that risk was wrongly priced and credit too available, and often provided where equity would have been more appropriate. There is now a return to more normal pricing for credit, but the difficult question is whether the provision of credit is constrained beyond the degree that would be expected by risk factors alone. There is some evidence that this has occurred: business insolvencies and loan losses have remained at modest levels[12]; and credit losses on non-CRE business portfolios appear to have remained modest by historical comparison.

10. Recent data showed that 33% of SMEs applying for a loan were rejected and had no credit facility by the end of the application process[13]. There could be a range of explanations for this, so the Taskforce has commissioned further analysis[14] to examine the pattern of rejection rates among businesses applying for finance over time. It suggests that, controlling for changes in risk and other factors, SMEs were more likely to be rejected for bank lending in 2008-09 than earlier in the decade[15],

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5 The value of applications by SMEs for new term loan and overdraft facilities in the six months to February 2011 was 19% lower than in the same period a year earlier.

6 www.sme-finance-monitor.co.uk

7 Bank of England (2011) “Agents’ summary of business conditions February 2011”.

8 SMEs’ deposits also exceeded borrowing by nearly £14bn in June 2011. www.bba.org.uk/statistics/article/small-business-support-may-june-201111/small-business/.

9 The value of applications by SMEs for new term loan and overdraft facilities in the six months to February 2011 was 19% lower than in the same period a year earlier.

10 Business Finance Taskforce (2010) Supporting UK Businesses.

11 The Bank of England Credit Conditions survey provides some empirical evidence supporting these trends over time.

12 In the 12 months ending Q4 2011, approximately 0.7% of all active registered companies went into liquidation compared to a peak of 2.6% in 1993, and the average of 1.2% over the last 25 years. Business loan write off rates which were on average 0.43% in the latest 4 quarters compared to an average of 0.62% in 1994. (Bank of England Trends in Lending January 2012).

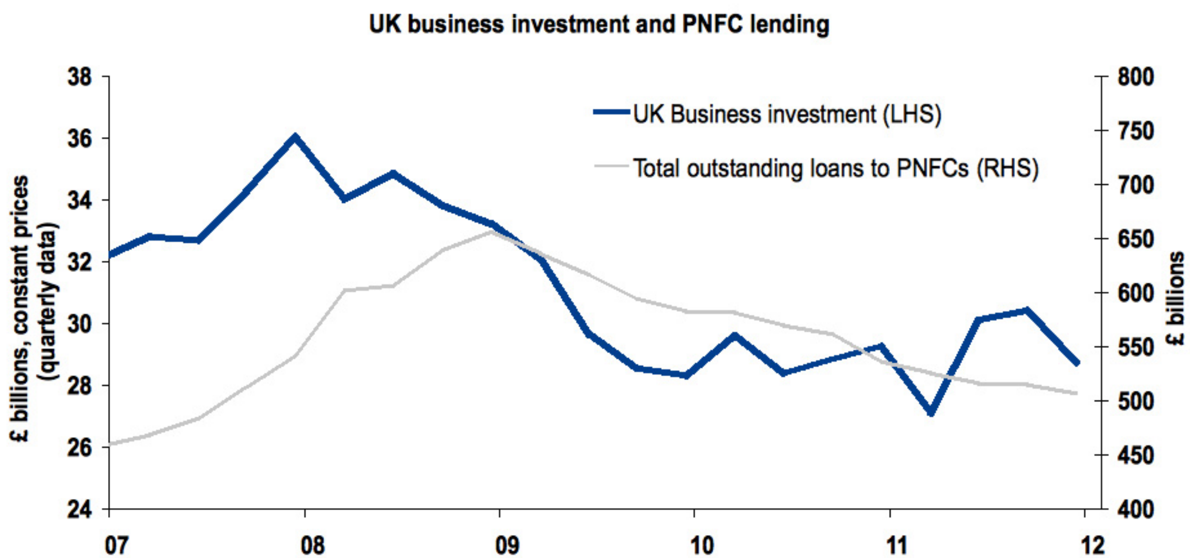
13 www.sme-finance-monitor.co.uk

14 Research by Stuart Fraser, Warwick Business School, specially commissioned by BIS for the Taskforce will be made available for scrutiny.

15 The research suggests that, controlling for risk and other factors, SMEs were more likely to be rejected for bank lending in 2008-9 compared to the period at the height of the boom but also earlier in the decade in the period 2001-4 when economic conditions were more subdued.

controlling for changes in risk and other factors. This is supported by international evidence[16], which shows that the UK had one of the highest SME loan rejection rates in the European area, and that the decrease in the supply of loans to SMEs in the UK has been much sharper than elsewhere. Evidence from the SME Finance Monitor[17] also shows rejection rates are higher than the historical norm. Figure 2 below shows that outstanding loans to the non-financial corporate sector increased throughout 2007/8, a consequence of a typical balance sheet recession where firms are unable to pay off loans due to weak demand. As can be seen, even after the worst of the economic contraction, the net flow of credit to the corporate sector continued to decline.

Figure 2: UK Business Investment and PNFC Lending



Source: ONS and Bank of England

11. On balance, the evidence would indicate some constraints in the supply of bank credit. This is not, however, evidence that the banks are acting irrationally. It is likely to be a function of the need to strengthen bank balance sheets, the 'overhang' of bad debt accumulated prior to the crisis, funding challenges, and current and impending higher capital requirements including for SME loans and overdrafts.

12. The critical question now is to what extent new and existing sources of finance can support businesses' funding requirements as the economy recovers.

16 Eurostat study of the rejection rate of SMEs raising loan finance before and after the credit crunch also supports this evidence. epp.eurostat.ec.europa.eu/statistics_explained/index.php/Access_to_finance_statistics

17 www.sme-finance-monitor.co.uk

3.3. Future outlook

13. Evidence from previous recessions[18] shows that the flow of credit is likely to track broadly the recovery in GDP[19]. As part of its GDP forecast, the OBR[20] projects an additional £127bn of business investment over the next 4 years. Although much of the additional investment will be financed from internal cashflow, many new and growing businesses will need to finance their expansion from external debt finance and firms will also need to fund their ongoing working capital needs. The Taskforce's analysis therefore supports the view that the corporate sector as a whole will require substantial external finance capacity in the coming years.

14. The Taskforce has attempted to quantify the level of finance that may be required to support sustained economic recovery. The analysis is based on the past trends in corporate lending and GDP growth, and the relationship between the two, and projects this forward over the next five years using OBR forecasts out to the end of 2016. The Taskforce has sought to estimate a level of finance that would be required by businesses. This requirement could be met with retained earnings or equity, but the analysis focuses on how much additional credit is likely to be needed.

15. The analysis seeks to project forward the anticipated growth in credit supply based on current and historical trends on a high and low scenario.

    - The low scenario is based on a projection of the growth in the net flow of credit to the corporate sector that would be consistent with a sustained recovery in GDP including a strong rise in business investment as expected by the OBR.

    - The high scenario takes an alternative approach. It looks at the underlying relationship between GDP and the flow of credit to the non-financial corporate sector (excluding the construction and real estate [CRE] sector) during the period before the financial crisis. This alternative approach then factors in that a good deal of the current corporate debt overhang was a consequence of the period of financial distress (shown by the blip in the red line in the chart below) and hence is now tied up in businesses that are only just able to meet their credit payments and therefore unlikely to grow. Because this element of the debt overhang cannot productively support the recovery, extra lending capacity is potentially required - to be made available to new and growing businesses that will drive the recovery in line with OBR forecasts.

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18 Business Finance Taskforce (2010) "Supporting UK Businesses", page 15
www.betterbusinessfinance.co.uk/images/uploads/Business_Finance_Taskforce_report.pdf
The 2010 taskforce noted the relationship between overall credit and GDP. This analysis focuses on the flow of business lending and GDP.

19 In the early 1990s, the relationship also held, albeit the recovery in credit lagged by around 18 months.

20 Office for Budget Responsibility, Economic and Fiscal Outlook November 2011, budgetresponsibility.independent.gov.uk/category/publications.

16. The results of this modelling suggest that, between now and the end of 2016, there is a risk that UK businesses are likely to need more credit than will be available. Figure 3, overleaf, shows that this finance gap could be in the range £84bn to £191bn – the amount potentially required to meet comfortably the working capital and growth needs of the UK non-financial business sector.

17. We would add three caveats to the model:

    - First, these estimates may overstate the need. This range includes the finance needs of the largest businesses, which would typically be able to raise finance through capital markets.

    - Second, as already pointed out, many businesses have generated significant positive net cash balances and will be able to fund growth through internal finance. However, there may be a mismatch between those firms that have positive cash balances and those that require finance; and

    - Third, this analysis is heavily driven by assumptions and the usual caution should apply as to any forecast modelling. However, it supports broader anecdotal evidence and reflects the discussions held with a broad range of stakeholders.

18. Growth in bank lending may meet some of this need. However, analysis of the impact of domestic and international regulation suggests that the ability and willingness of banks to lend to businesses will be constrained in future. Capital adequacy rules have tightened considerably including higher capital ratios and new specific rules on risk weightings on SME loans and overdrafts[21]. The impact of these rules is likely to fall disproportionately on smaller businesses which tend to be riskier and have higher risk weightings attached.

19. The Taskforce therefore considers the analysis useful in illustrating the scale of the challenge in developing additional sources of finance to support growth and recovery.

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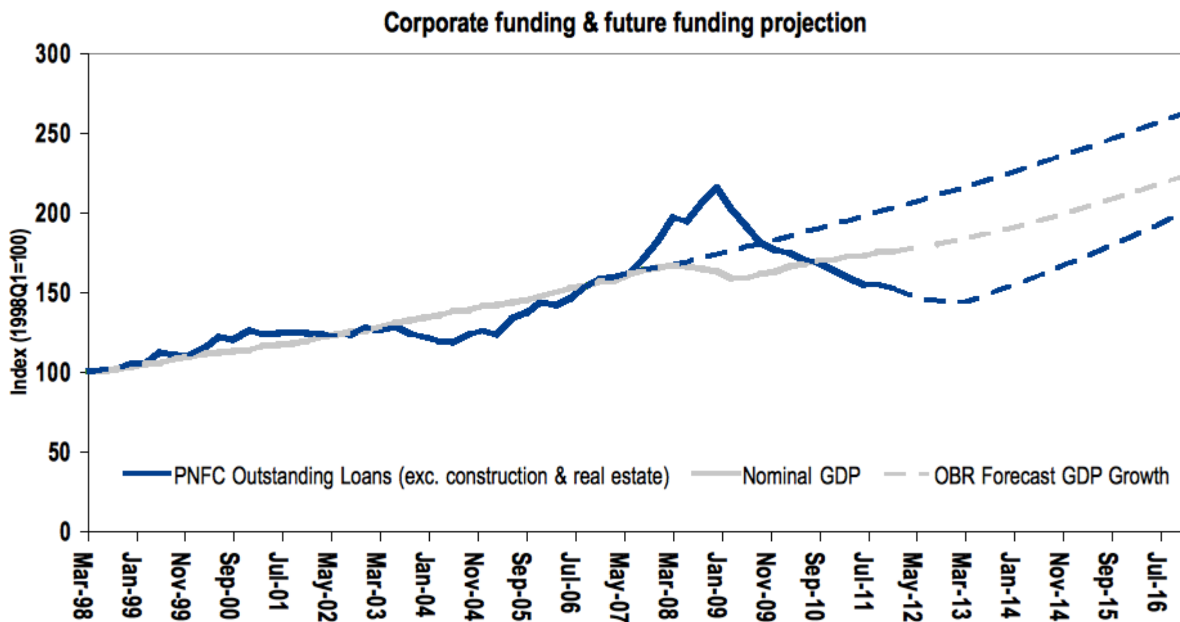
21 Slovik et al (2011) estimate Basel 3 will lead to higher bank margins, as banks pass on the rise in funding costs due to the higher capital requirements.

Figure 3: Illustrative credit requirements for businesses



Source: Taskforce estimates based on Bank of England, ONS, OBR data

3.4. Conclusion

20. Lending from banks to businesses has fallen sharply since the financial crisis. To some degree, this is a natural result of widespread deleveraging and reflects a fall in demand for external finance. However, most (non real estate) businesses were not highly leveraged prior to the recession and there is evidence that the reduction reflects some supply constraints.

21. Notwithstanding that these arguments are finely balanced, there is a consensus that credit availability needs to increase as the economy recovers, but analysis suggests that bank credit may not grow to the extent required to support sustainable economic recovery. The modelled estimates suggest a potential credit funding requirement over the next five years of between £84bn and £191bn for the business sector as a whole, of which between £26bn and £59bn is estimated to relate to smaller businesses. Bank lending may grow to meet some of this gap, but the ability of bank lending to increase may be constrained by the ability to raise capital and meet higher funding costs.

22. An increase in the provision of more diversified forms of debt finance to UK businesses would help address the structural issues and aid the business sector's performance during the recovery and better prepare them for future business cycles.

4. INCREASING AWARENESS AND DEMAND FOR ALTERNATIVE FORMS OF FINANCE

Only 23% of those responsible for making finance decisions in SMEs have a financial qualification; only 23% of SMEs are aware of the Enterprise Finance Guarantee and only 17% of SMEs were aware of the “Merlin agreement” despite widespread press coverage.

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1. Whilst many businesses say they are satisfied with their funding choices and do not intend to look to alternative sources of debt, for those businesses seeking finance and failing to secure it, the evidence suggests that they face three specific behavioural barriers. These are:

   - a lack of awareness amongst smaller companies of alternative sources of finance outside of the existing relationships with their banks;
   - a lack of the financial expertise required to assess the appropriateness of alternative sources for a borrower; and
   - a lack of confidence in their ability to secure these alternative forms of finance.

2. Only one in four (23%) of those responsible for making finance decisions in SMEs has a financial qualification or financial training; for SMEs as a whole, a minority have a financially trained person (see Annex 3). Alongside this lack of in-house expertise, there is also a failure to source external advice: only 9% of SMEs sought advice when seeking an overdraft and 16% of SMEs seeking a bank loan sought advice[22].

3. SMEs are also unaware of the many support schemes and initiatives that the Government has in place: only 23% of SMEs were aware of the Enterprise Finance Guarantee and only 17% of SMEs were aware of the “Merlin agreement” despite widespread press coverage. The following recommendations seek to address these behavioural demand-side barriers.

22 SME Finance Monitor Q4 2011

4.1. Ensuring expert help is at hand

4. There is currently no recognised source of business finance advice for SMEs to guide them through the complexities of bank and non-bank finance; to help them secure access to the most appropriate form of finance; and, where appropriate, the relevant Government support schemes.
5. For many smaller businesses, accountants are the main source of information. As a result of this review, the main accountancy bodies (ACCA, ICAEW and ICAS) have agreed to work together to create a shared scheme specifically for those accountants that offer advice on finance for smaller businesses.
6. The intention is to create a "kitemark" for the provision of business finance advice covering a full range of financing options. Businesses would then seek out those accountancy firms that provide that independent advice, incentivising those firms to offer a broader range of services to smaller business clients. As the practices would be overseen and monitored by the accountancy bodies, it will provide businesses with confidence in that advice. It should be possible to have the new scheme up and running by January 2013.

Recommendation 1: Introduce a Business Finance Advice scheme.

4.2. Improving communication of existing Government support schemes

7. Many businesses are confused by the large number of Government interventions supporting access to finance to SMEs. There are a bewildering number of acronyms (e.g. EFG / ExEFG / RGF / ECF / EIS / SEIS) to which Government is now adding NLGS and BFP. Frequent changes in programme names and branding, combined with occasional tweaking of the terms of each scheme, mean businesses do not have time to gain familiarity with the programmes or which Government department offers them. This also makes it harder for the banks who deliver many of these programmes to SMEs. Each change requires new processes and retraining across bank networks.
8. Government should improve the scale and effectiveness of its communications. There are many elements to an effective public communications programme, but one important component is a common brand across all the related activities.
9. Government should consider increasing awareness of alternative forms of finance by using all of its relevant communication channels with small businesses, including LEPs, *businesslink* and potentially HMRC (drawing on the detailed data that it retains about smaller businesses).

Recommendation 2a: Improve communication of Government support programmes through the creation of a single brand for its interventions.

4.3. Creating a Business Support Agency

10. Creating a single brand is only the first step: Government provides a range of business support activities through a number of different organisations such as HM Treasury, BIS, UK Export Finance, the Carbon Trust, and *businesslink*. During our workshops and in the submissions that we have received, businesses consistently report that they do not know where to turn if they are turned down for a loan from their bank; they have no “second port of call”. In many cases, they then decide not to proceed with their investment plan due to the time commitment required as well as the uncertainty of outcome in attempting to secure alternative finance.
11. A single entity could provide more effective delivery of the full range of existing Government programmes through the creation of a ‘one-stop shop’. Additionally, such an agency could ensure that the objectives of each intervention lead to coherent outcomes as a whole.
12. Finally, such an agency could expand current capabilities within businesses with the provision of training and management support particularly in the area of finance expertise.

Recommendation 2b: Responsibility for delivery of Government Access to Finance programmes should be consolidated into a single delivery agency

5. IMPROVING ACCESS TO CAPITAL MARKETS FINANCING FOR UK COMPANIES

Only 257 of 1.2 million UK companies have a financing mix that includes public bonds[23].

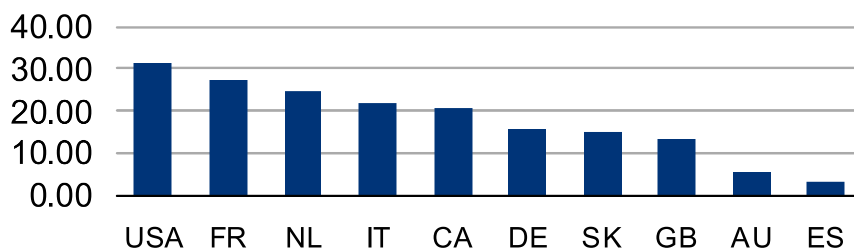
1. Despite the sophistication of the UK's capital markets and the concentration of international banking activities in London, the UK's domestic capital markets remain under-developed relative to those of other advanced economies. We believe that decisive action is required to bring the benefits of capital markets financing to a much broader set of UK small and mid-sized businesses.

5.1. Improving Access for SMEs through Aggregation

5.1.1. The UK Corporate Bond Market

2. Our review of the UK's domestic corporate bond market shows that it is under-developed compared with other major economies (see Figure 4 below) and that only 61% of FTSE 100 companies issue public bonds[24]. However, our analysis suggests that, for larger companies, there are no fundamental barriers to entry; their choice between bank debt or the public bond market is driven by the relative price and flexibility of the two types of finance.

Figure 4: Total non-financial corporate bonds outstanding, Q2 2011, % of GDP



Source: BIS, IMF

23 www.bankofengland.co.uk/publications/quarterlybulletin/qb110403.pdf
24 BIS analysis

3. The primary restriction on access to the public bond markets is the need for institutional investors to invest in liquid securities. This restricts the size of the majority of wholesale bond issuances to greater than c.£150m. The mark-to-market requirements of defined contribution pension schemes combined with the fact that investors are often benchmarked against indices (which often limit constituents to companies with an external credit rating), reinforces this bias towards large, highly traded, liquid issues. Upfront costs only limit the economic viability of bond issuances to c.£25m. Mid-sized and mid-sized+ businesses can therefore issue public bonds only if they can find investors who do not have concerns regarding liquidity, credit rating, or size of issue.

4. As we move down the spectrum of company sizes to SMEs, the cost of issuing public or private bonds becomes prohibitive and institutional investors, aside from the liquidity issue, lack the appetite and resources to analyse the credit risk of small companies. Therefore, **direct** access to the capital markets is not viable for SMEs and smaller companies.

5.1.2. An Aggregation Platform

5. An option which addresses the regulatory barriers and removes the requirement for investors to analyse the credit quality of many small issuances from individual SMEs would be to aggregate a large number of SME loans and finance them via the corporate bond markets.

6. One way to achieve this is to create a new agency or body to drive the development of this market (our working name is the Agency for Business Lending – “ABL”). As a single-entity issuer, ABL could aggregate and finance SME loans, for example by establishing a large-scale fund to buy SME loans and SME-loan backed securities from the originating banks. ABL could finance these activities by issuing securities on the public bond markets to institutional and retail investors. In addition to its SME lending activities, ABL could play an important role in accelerating the redevelopment of the SME loan securitisation market.

7. There is increasing support for such a lending agency: from early proponents such as Adam Posen and NESTA to many of the respondents to our Call for Evidence.

5.1.3. Design of ABL

8. Creating the ABL would require co-ordinated action across multiple market participants: banks, investors, rating agencies, infrastructure providers, pension fund consultants, industry associations and regulators. Hence the buy-in of each of these constituents would be required in order for it to be successful.

9. The precise form of the ABL needs further definition. One option would be that it focuses solely on the actions needed to kick-start the market. Then once the market is established, the need for ABL passes and it would wind down. The more

radical version would envisage establishing ABL as a rated, financial institution in its own right that could have a continuing existence.

10. ABL could be based within Government or formed through public/private sector co-investment. Government support may be required in the early stages, as traditional bank lending may remain cheaper for SMEs until the market is fully established. The primary challenge is less the higher cost of capital markets solutions than the lack of a scalable market and the need for a liquid secondary market to emerge. However, we would envisage that the need for this support would reduce after a transitional period as the ABL gained scale.

Recommendation 3: Launch a feasibility study, led by Association of Financial Markets in Europe [AFME], to explore the creation of an aggregation agency to lend directly to SMEs and/or to pool SME loans to facilitate SME access to the public corporate bond markets.

11. AFME's European focus will provide a vital perspective to the feasibility study; it will ensure that the study considers international best practice and that whatever aggregation mechanism is proposed it enables the agency to access the international financial markets.

5.2. Improving Access for Mid-Sized Companies to the Private Placement Market

> If UK institutional investors invested in Private Placements in the same proportion as US-based PP Investors, an additional £15bn of non-bank lending could be available for mid-sized business in the UK.

5.2.1. The Current State of the Market

12. Private Placements (PPs) are fixed coupon debt instruments issued directly to institutional investors. Due to the flexibility provided by the direct relationship between lender and borrower, PPs provide an effective route for mid-sized businesses to access the debt capital markets.

13. Whilst UK issuers account for nearly 21% of the global private placement market, the vast majority of these issues are placed with US based investors. The Private Placement market is an active source of financing for mid-sized and mid-sized+ companies in the US. The market in the UK functions well from a borrower perspective: 44% of the FTSE 350 and 40% of the FTSE 250[25] have Private Placements outstanding, and our research shows that the smallest issuance by a UK company is £20m.

25 Index constituents excluding 25 largest corporations, financial companies and international resource companies.

Table 1: PP issuances by FTSE companies

FTSE Index	% of companies issuing PP
FTSE 350	44
FTSE 100	40
FTSE 250	49

Source: BIS Analysis

14. However, ***the UK investor base is underdeveloped*** with the vast majority of PP investors in UK companies being US-based. In the US, approximately 0.2%[26] of institutional funds are invested in PP instruments. While some adjustment would need to be made reflecting differences between US and UK institutions, if a similar percentage of UK institutional funds invested in PPs, then as much as £15bn[27] could potentially be available in the UK PP market.

5.2.2. Barriers for Investors

15. The lack of ratings amongst mid-sized UK companies and the lack of in-house credit assessment capabilities of UK-based investors constitute a barrier, because the expertise to develop such a capability requires upfront and ongoing costs.

16. Maturity mismatch is a second barrier; due to the nature of their liabilities, many institutional investors prefer instruments with long maturities (for example 10 – 15 years or more). This is significantly longer than the borrowing requirements of most companies (normally 3 – 10 years).

17. A third barrier is regulation, in particular the emphasis placed on liquidity. The mark-to-market requirements of defined contribution pension schemes as well as the fact that investors are often benchmarked against indices, create an institutional bias against PPs. Solvency II is likely to create an additional barrier to investing in PPs.

18. A final barrier is price; in the US, investors are willing to trade liquidity in exchange for the early warning provided by covenants, whereas UK investors require an illiquidity premium.

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26 Total US life insurance and pension fund funds under management [FUM] amount to c. $20 trillion (NAIC) and c. $38bn was invested in PP in 2011 (WSJ).

27 On the basis of FUM analysis of the UK's insurance companies and pension funds.

5.2.3. Barriers for Issuers

19. The main barrier for issuers is the cost. Advisory and legal fees can be high, especially as there is no standardised PP documentation in the UK (unlike in the US). According to a prominent law firm, upfront legal fees can amount to over £120,000, as individual agreements need to be drafted for each transaction. Standardisation could lead to a reduction of these costs by as much as 75%.

20. Due to the high costs associated with cross-border transactions (such as multi-jurisdictional legal advice and currency swaps) smaller UK companies (with earnings before interest, taxes, depreciation, and amortisation [EBIDTA] below £25m) cannot access the US PP market. Significantly smaller US companies (with EBIDTA down to £15m) can by contrast access their domestic PP market.

21. We believe that industry working together to address and find solutions to overcome market and regulatory barriers could lead to an increase in investor competition and lead to a decrease in prices, allowing smaller companies (with EBIDTA of c. £15m) to issue PP debt.

Recommendation 4: Increase the number of UK-based Private Placement investors through an industry initiative led by the Association of Corporate Treasurers.

5.3. Increasing UK retail investor appetite for corporate bonds

22. The retail market for corporate bonds offers genuine growth potential: £1.4bn has been raised through 17 dedicated retail issues on the LSE's ORB, and APCIMS[28] estimates that the potential size of the untapped sterling retail bond market could be as much as £20bn. Each of the successful models for new bond markets launched in Europe in recent years has been retail-based (e.g. MOT in Italy, ORB in the UK, and BondM in Germany[29]) highlighting the growing importance of the private investor base as a means of diversifying sources of capital for companies.

23. Countries such as Italy and Belgium have more developed markets for retail distribution of corporate bonds, allowing this pool of capital to be regularly tapped and also facilitating smaller issuance sizes. The MOT in Italy is the most successful, liquid and heavily traded retail bond market in Europe with over 800 bonds listed. It is used as a significant pool of retail funding by all sizes of Italian companies as well as UK banks: RBS has raised €6.4 billion through 49 dedicated retail bond issues and Barclays has raised €1.3 billion via 29 issues.

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28 The Association of Private Client Investment Managers and Stockbrokers

29 MOT: Italian Retail Bond Market;

24. In Belgium, there is also a strong, well developed retail investor base for both Government and corporate bonds. In December 2011, the Belgian Government raised €5.7 billion via dedicated retail Government bonds.

25. Stimulating the retail investor base was a popular theme of the Call for Evidence responses. Many submissions highlighted that retail bond exchanges have the potential to offer smaller companies the possibility to issue publicly traded bonds, with MOT and ORB being commonly cited.

26. Developing easier access for retail investors to the more liquid Gilt market has the potential to increase confidence amongst retail investors in the retail bond market and improve their familiarity with bonds as a form of investment. Creating a product which is complementary to NS&I products, but with the additional benefits of secondary market trading and price transparency, has the potential to stimulate this market in the UK. As is the case with the MOT, this should be done by an instrument which can be traded via electronic order book so that it can be accessed by retail investors through several channels, e.g. a retail broker, or directly online through their online banking platforms.

27. Retail investment in smaller companies could be encouraged through the existing tax-incentivised ISA scheme. Alternatively the Government could introduce a separate allowance focused on small and medium-sized businesses. This could be structured like an ISA but with different branding to avoid confusion: an Enterprise Savings Account or ESA. Funds would be qualified as “ESA-able” if they met the criteria of providing debt or equity to mid and small companies. Such tax incentives should be neutral between debt, equity and mezzanine finance. By creating an additional layer, once the basic ISA allowance is full, this tranche of investment would be limited to more sophisticated investors, mitigating concerns around whether retail investors appreciate the risks posed by smaller companies.

Recommendation 5: Increase the UK retail investor appetite for corporate bonds through:

a. **Launching electronic retail-dedicated gilt products available through registered stock exchanges; and**

b. **Introducing additional tax incentives for investing in SMEs.**

6. LARGER BUSINESSES STIMULATING GROWTH THROUGH SUPPORTING SMALLER COMPANIES

Wider utilisation of Asset Based Finance could result in the UK economy growing by an additional 2% by the end of 2020, leading to more than 300,000 additional jobs[30].

1. Large businesses in the UK have an important role to play in aiding the recovery through supporting growth in the wider economy. The ability to support their supply chains, ensuring that suppliers are paid on time and have access to sufficient working capital is of particular importance: our research shows that UK non-financial companies' cash holdings stood at £731.4 billion in the third quarter of 2011[31], the highest level on record. At the same time, many small and medium sized suppliers to these companies are struggling with their working capital needs.

6.1. Encouraging prompt and certain payment

2. UK SMEs commonly complain that large buyers are slow in paying their suppliers. Data suggests that late payment has improved recently[32] and the implementation of electronic invoicing systems by many large buyers in the UK will have helped to support this. The Government's Prompt Payment Code encourages companies to pay their suppliers according to the terms agreed at the outset of the contract without attempting to change payment terms retrospectively as well as to avoid changing practice on length of payment for smaller companies. This has been a success, attracting 1,000+ signatories representing more than 60% of the total UK supply chain value[33].
3. There is also legislation providing for interest rates for overdue payments and establishing a 30 day payment period where terms are not contractually agreed. It is, however, the case that poor invoicing means that often the courts are unable to intervene meaningfully.

30 The "AR Factor, The Economic Value of Accounts Receivable Finance to Europe's leading economies" October 2011

31 Deloitte Monday Briefing (06 February 2012) "What to do with corporate cash?"

32 pH Group data for the third quarter of 2011 (July - September) suggests average number of days invoices were paid later than contract terms was 16.6 days, below the peak of 20.5 days in first quarter 2009.

33 www.promptpaymentcode.org.uk

4. Many late payment issues are caused by a lack of awareness of good invoicing practices by buyers and suppliers: improving these practices can materially speed up the approval process. It is now more important than ever for larger companies to recognise the importance of protecting their supply chains. One way to do this is by helping suppliers achieve greater standardisation of invoices. This would help to improve their invoicing systems as well as ensuring their own invoice processes are working effectively, enabling the entire process to run more smoothly.

5. Greater standardisation, and greater certainty, would also make invoices more easily assignable and hence tradeable, an important aspect of a more developed invoice discounting market. This would then facilitate the replacement of expensive overdraft financing with the sales of bills of exchange. Invoice discounting is discussed in more detail in the next section.

6. The priority for Government should be to promote a continuing improvement in payment practices amongst larger companies, entailing both quicker approval of invoices and faster and more certain payment terms. Government's laudable ambition to be an exemplar through paying its invoices on time, so giving certainty to its suppliers, is evidenced by the requirement that central departments pay 80% of invoices within five days.
7. However, whilst this has benefited Tier 1 suppliers in the Government's supply chain, this is not necessarily being passed further down to help Tier 2 and 3 suppliers. The Government should therefore take firm action to ensure that those companies benefiting from early payment terms are passing the benefits down to their suppliers.

Recommendation 6: Government should:

a. **Require that benefits to large companies of its prompt payments are passed on to their suppliers; favourable payment terms should be withdrawn if those agreements are not met.**

b. **Explore practical ways to encourage faster payments by larger companies.**

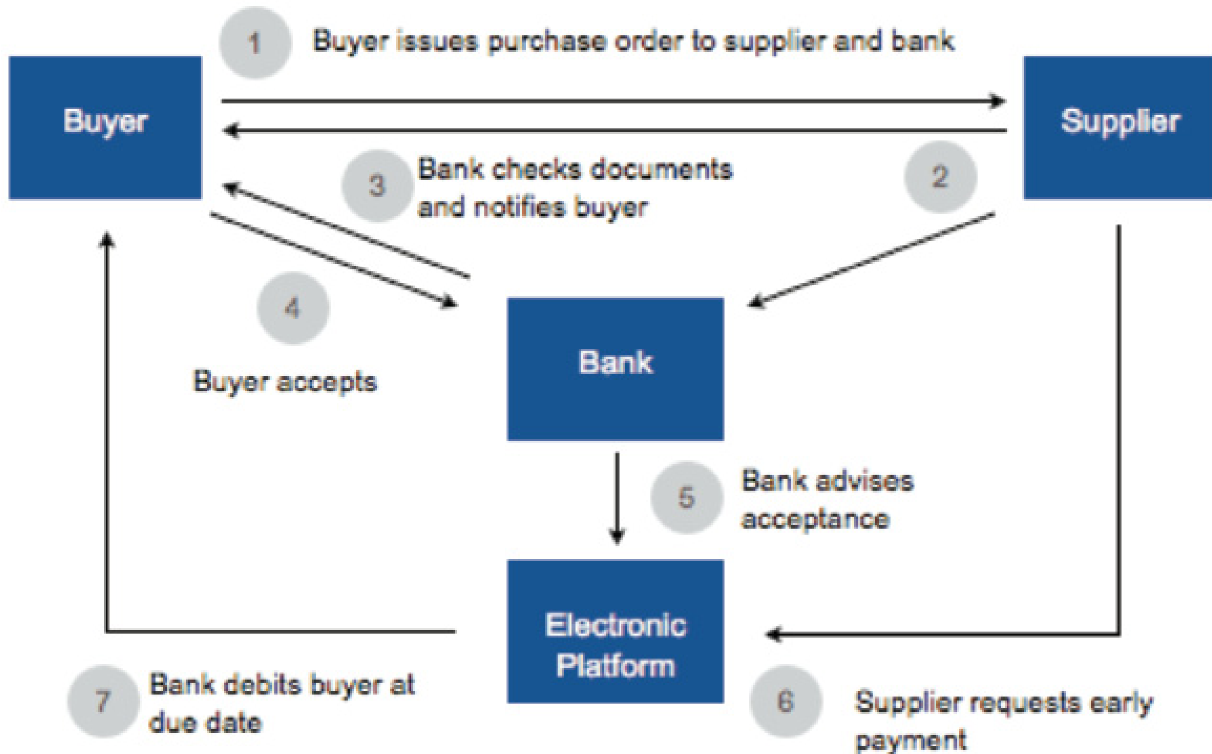
c. **Work with industry associations to promote invoicing best practices to enable more effective enforcement of the existing legislation on late payment.**

6.2. Increasing the Use of Supply Chain Finance

8. Many larger companies use payment terms to manage their cashflow. However, companies within their supply chains, typically SMEs, can struggle to raise working capital finance. For this reason, a suite of supply chain finance [SCF] products has evolved to help companies manage cashflow within their supply chain. These

products usually rely on larger companies using their credit strength to help their suppliers to access additional sources of credit. This would significantly improve the levels of liquidity within smaller companies in the UK. Only a handful of buyers currently use these products and we believe that this is an underutilised approach in the UK which has significant potential to improve the viability of SMEs.

Figure 5: An Overview of Supply Chain Finance



6.2.1. Barriers to increased uptake

9. The most significant barrier to increased use of SCF products is suspicion that the buyer is merely using it as a method of extending its payment terms. Other barriers include the requirement to set up electronic invoicing and the need to coordinate several different departments in order for SCF to work and therefore implementing a SCF product requires senior buy-in.

6.2.2. Benefits of Supply Chain Finance

10. The Taskforce believes that there is significant benefit to be gained from freeing up more of the cash currently tied up in supply chains across the UK economy. Reducing days-receivables would improve cash flow for small businesses and enable them to operate with lower overdraft facilities. Large companies would have correspondingly smaller positive cash balances, but given current low yields the impact on earnings would be less negative than the positive impact on SMEs. Banks would see reduced net interest income, but would require less capital to support overdraft lending and would face reduced funding constraints.

11. In total, the UK economy should be able to operate at a lower level of credit intensity which should, over time, result in a net benefit to economic growth and financial stability. Given the time constraints of this review and the complexity of the modelling required, we have been unable to quantify the economic benefit. However, we believe that given the high levels of gross lending to UK companies by UK banks (£625bn at the end of January 2012), the significant cash surpluses described above, and the current spread differentials between low-yielding deposits and expensive overdrafts, this benefit has the potential to be substantial. This appears to be the international experience, and the issue is worth further study by Government and/or the Bank of England given the implications on overall financial stability. Where these programmes have been successfully implemented there has been a notable improvement in the relationships between participating buyers and suppliers.

12. The objectives need be driven by a desire to secure stability for key members of a buyer's supply chain and to drive efficiency for both buyer and supplier in their payment processes (See Annex 5 for a worked example of the benefits of Supply Chain Finance).

Recommendation 7: Government should:

a. **Explore how it can use its power as the biggest purchaser in the UK to encourage its own suppliers to adopt supply chain finance or similar schemes to support their suppliers; and**

b. **Work with banks, industry associations and professional bodies (such as the ACCA, ICAEW), to accelerate adoption of Supply Chain Finance.**

3.2.3. Case study: Supply Chain Finance

Network Rail has recently developed iSupplier Portal, a tool that enables suppliers to see, on-line, their purchase orders, invoices, and when they are going to be paid. They have over 800 suppliers live on this Portal.

They have implemented an in-house Supply Chain Finance solution that enables suppliers to be paid earlier than their contracted terms. Suppliers have requested early payment on invoices equating to over £265m since it was initiated.

Specifically for the construction industry Network Rail has shortened terms on new contracts and encouraged Primary Contractors – who have committed to support to Network Rail's Fair Payment Charter – to cascade this liquidity through their supply chains. This reduces the Payment Terms from Application on all new Contracts from 1st October 2011 from 56 days to 21 days, for the delivery of Rail projects.

7. DEVELOPING NEW FINANCIAL PRODUCTS

1. More efficient and resilient business finance markets would see businesses regularly accessing a wider range of lending products. The Taskforce believes there is potential to expand the range of financial products currently used by businesses. To some extent, this is already happening as investors and businesses are finding new ways to extend credit and the Taskforce supports these market developments. This section focuses on financial products that have the potential to play a key role in financing businesses in future, and where concerted action by the finance community, businesses, Government or regulators could accelerate their development.

7.1. Asset-based finance

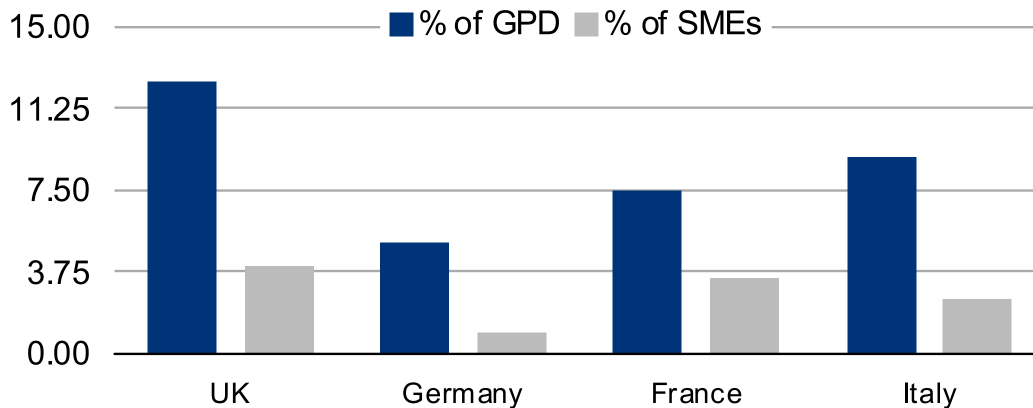
2. Asset-based finance (ABF) products play an important role by allowing businesses to raise finance against the value of their assets. Products such as factoring and invoice discounting involve lending secured against a variety of corporate assets such as invoices, stock, property, machinery and Intellectual Property. These products can improve the cash flow of companies and help support their growth. The Taskforce considers that there is significant potential for more companies to take advantage of asset-based finance to support their working capital needs and help them finance growth.

3. Asset-based finance can be beneficial for businesses at different stages of their growth. It can provide early-stage finance for start-up firms, or more structured finance for those with a good trading history or looking to restructure their finances. It also has the benefit of flexibility, where the finance available can expand as a firm's order book grows.

7.1.1. Current Landscape

4. The UK already leads other European countries in the levels of market penetration that these types of products have achieved. The Asset Based Finance Association (ABFA) estimates that around 42,000 of the UK's SMEs use accounts receivable finance. Whilst this represents a greater percentage of SMEs using this method of financing than countries such as Germany and France (see Figure 6 below), this is still well behind the levels of activity seen in the US where this is a very common source of finance. The US experience shows there is potential for much greater uptake.

Figure 6: Accounts Receivable Finance Penetration



Source: Appendix B of the Oct 10 BBA report

5. ABF products are attractive from a bank perspective, as they attract relatively lower capital requirements than unsecured lending. Capital requirements associated with ABF facilities can be 50% lower than overdrafts. The Taskforce notes that, were more businesses able to finance their working capital using ABF instead of overdraft finance, it would free up significant capital in banks for other lending. For every £1m converted, as much as £500,000 capital could be released into the economy. It would also contribute to the diversity and resilience of business finance.

7.1.2. Expanding the ABF Market

6. A number of respondents to the Call for Evidence highlighted barriers to the growth of ABF. The principal barriers to higher levels of adoption by UK SMEs appear to be behavioural: negative perceptions and a general lack of awareness. Companies have tended to see the use of these products as a sign that they are struggling and that these facilities represent a 'lender of last resort'. These behavioural barriers will take time to overcome, but could be addressed through education and information programmes provided by the banks, accredited business finance advisers and business associations and representative bodies. The recommendations set out above on information and accredited advice will also help to support the development of ABF markets.

7. Innovation and the application of new technology also present an opportunity to grow these markets significantly. The development of online receivables exchanges is encouraging in this respect. The launch of online trade receivables exchanges, where companies bid for invoices via platforms such as Market Invoice, Platform Black and Urica can allow greater access to receivables finance. The scale of this activity is relatively small, but is experiencing exponential growth. For

example, MarketInvoice has grown from facilitating £30k of loans in February 2011 to £1.1 m in December 2011. There are few companies in Europe currently offering a similar service but there is a more established operator in the US, the Receivables Exchange, which has facilitated over $1bn dollars to small and medium-sized businesses since its launch in late November 2008. The Taskforce welcomes the market-led development of these exchanges and considers that Government could support and accelerate their growth through co-investment by the Business Finance Partnership.

7.2. Mezzanine Finance

8. Mezzanine finance is a form of debt (see Figure 7 below) which shares characteristics of equity but ranks below senior debt. Mezzanine is a flexible product that can be tailored to the risk and repayment profile of the business or transaction. Whilst there is no single model, mezzanine debt usually contains three distinct features:
    - a cash coupon;
    - payment-in-kind or PIK, which increases the amount of principal outstanding and is only paid at the maturity of the loan; and
    - warrants or a share in the profits or growth of the company.
9. Mezzanine finance is used in product developments, penetration of new markets, infrastructure investments or strategic merger and acquisition plans. As it can be structured with low cash coupons, this form of finance is particularly suited for high-growth companies where senior debt may be less appropriate as it can reduce the cash burden in their early stages.

Figure 7: Capital structure grid

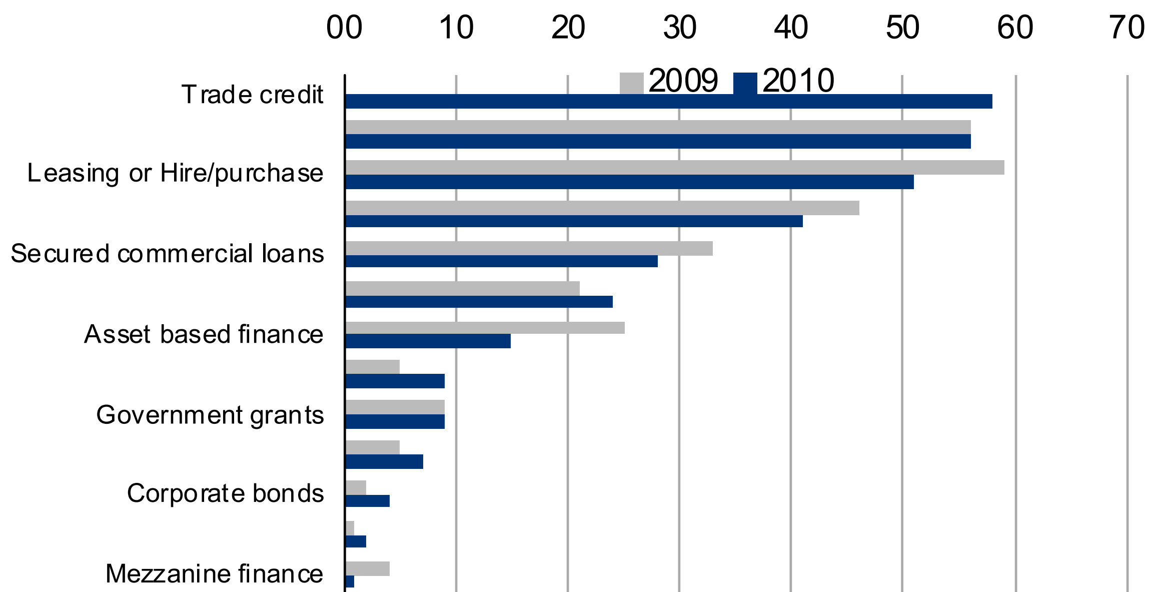
Positives		Negatives
Inexpensive Accessible	Senior debt	Restrictive covenants Asset oriented Amortising
Long-term capital Limited dilution of shareholders No amortisation Flexible coupon strucures Minority / non-control investors	Subordinated debt	Requires positive cashflow
Long-term capital No principal repayment	Equity	Dilutive/expensive Control systems Board seats

Source: Caltius Mezzanine

10. However, take-up of mezzanine finance in the UK is very low. Over a third of mid-sized businesses know how mezzanine finance works[34], but only 1% of businesses used mezzanine finance in 2010 (see Figure 8 below). The barriers are partly behavioural; businesses are aware of mezzanine finance but lack familiarity in actually using it as a source of finance. The Taskforce has also identified constraints in raising funds to support mezzanine finance. While several fund managers are seeking to provide mezzanine finance solutions, in some cases they are struggling to raise finance.

11. It is the view of the Taskforce that there is potential to grow the mezzanine finance market further in the UK. This will require greater interest from investors and fund managers to raise their familiarity; and increasing the size of individual funds to attract institutional investors. The Taskforce believes that the Government, through its Business Finance Partnership, could play a crucial role in driving the development of this market.

Figure 8: SMEs' current use of finance [%]



Source: 2010 BIS Survey of MidCap Businesses

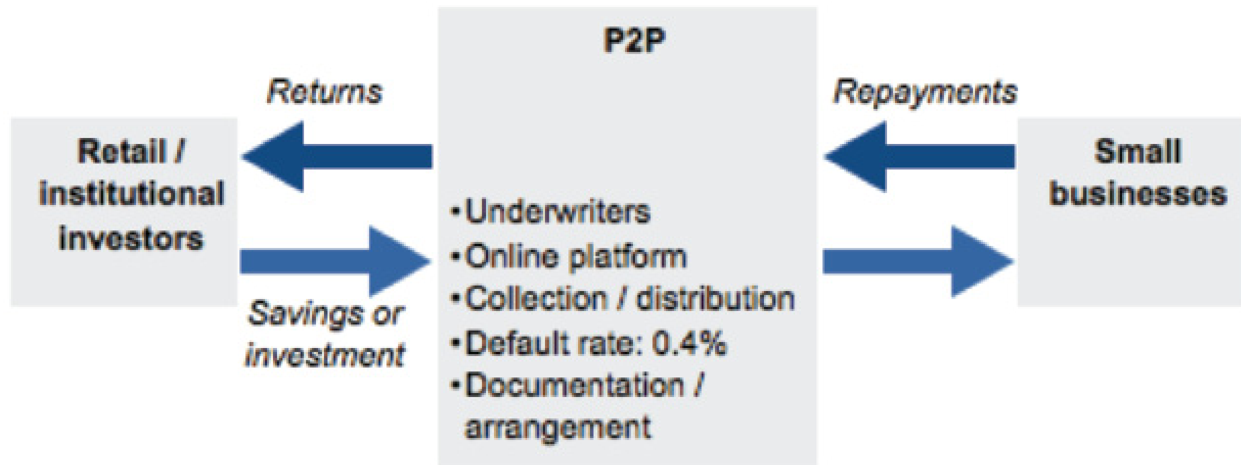
7.3. Peer to peer lending

12. Innovation in finance can disrupt existing models and result in new and efficient ways to provide businesses with credit. A current example is Peer to Peer (P2P)

34 www.bis.gov.uk/assets/biscore/enterprise/docs/r/10-p108-results-2010-finance-survey-mid-cap-businesses.pdf

lending, where new technologies are allowing individual investors and businesses to lend directly to borrowers without traditional financial intermediaries such as banks. These platforms match money from lenders, who are prepared to offer finance through a competitive bidding process, to potential borrowers.

Figure 9: P2P Business Model



Source: FSB ALT+ Finance,

13. Whilst these products are growing rapidly, they remain relatively small in terms of market share. The barriers tend to be behavioural, and greater awareness of P2P lending among both investors and businesses could see accelerated growth of the market. The Taskforce considers that direct support from Government, along commercial lines, could significantly boost the development of these markets in the short term. An investment by the Government's Business Finance Partnership could act as a cornerstone which could attract institutional funding, thereby allowing the Government's stake to be leveraged.

14. These markets have been allowed to grow in the UK, partly as a result of a permissive regulatory environment. However, some operators perceive the lack of regulatory underpinning as inhibiting potential investors and regulatory uncertainty may prove to be a barrier to other entrants joining and growing the market. The Taskforce has considered these arguments and sees some sense in proportionate regulation, to protect investors and provide confidence. However, there is a strong counter-argument that over-zealous regulation would add to costs, destroying this market before it has a chance to gain scale organically.

Case study: Peer to Peer lenders

Funding Circle was launched in August 2011 and had facilitated £18.5m of lending to c.480 UK businesses by 12 December 2011. It is currently facilitating around £3.4m per month to businesses and is forecasting to lend £35-40m in their first year (i.e. by August 2012) and c.£200m in the following year. Funding Circle assert that they can reach £1bn of lending within 3-5 years. The other specialist corporate lender in the UK is ThinCats.

The P2P lending platform is better established in the personal lending sector: Zopa and Ratesetter, for example, have around 2% market share of the unsecured personal loan market in the UK

Recommendation 8: Government should explore the potential for the Business Finance Partnership to make commercially attractive investments in the following:

- **Online Receivables Exchanges;**
- **Mezzanine Loan funds; and**
- **P2P lending platforms.**

8. THE EVOLVING REGULATORY ENVIRONMENT

8.1. Protecting Against Reckless Prudence

1. We recognise the critical importance of raising regulatory standards in the financial services industry and are supportive of the direction of change being implemented by the Government to ensure that there is no repetition of the financial crisis. We acknowledge the recent work of the Bank for International Settlements[35] and the European Commission[36] which suggests that the Basel 3 regulations will provide significant benefits to the global economy, including smoothing the economic cycle.

2. However, we are mindful of the risk of 'reckless prudence'. We are concerned that well-intentioned but excessively risk-averse regulation will make it harder for banks and non-banks to supply finance to SMEs. It is commonly accepted that Basel 3 is increasing the risk weights for many asset classes, and in some cases, e.g. Trade Finance, the charge may be disproportionate to the risk. Solvency 2 may make it harder for insurance companies to invest in instruments such as private placements or SME loan securitisations. UCITS[37] regulations limit holdings in unlisted loans to a maximum 10% of a portfolio, restricting the use of loans in retail targeted funds and hence inhibiting the creation of a non-bank senior loan fund market.

3. Equally, we should note that the expansion of finance provision by non-banks carries with it some additional risks. If non-bank provision of credit were to accelerate rapidly (e.g. with credit risk building up in the so-called 'shadow banking' system), that would be a cause for concern. P2P lending, although it provides a mechanism for providing finance to the smallest companies, brings with it new risks and carries the potential for misuse. At some point, these platforms will require regulation that provides appropriate consumer protection without stifling innovation.

4. The Government needs to recognise that its desire to expand the range of providers of finance to SMEs could be constrained by current and future regulation and that whilst there is considerable focus on individual elements of each of the new regulations, little work has been done on the impact of them as a whole.

   Recommendation 9: UK authorities and business representative bodies should provide an evidence-based perspective of the impact of international

35 www.bis.org/publ/bcbs173.pdf

36 www.ec.europa.eu/internal_market/bank/regcapital/index_en.htm

37 Undertakings for Collective Investment in Transferable Securities

regulatory measures on the provision of bank and non-bank finance to UK SMEs and to update their evidence on an annual basis.

8.2. Improving Information Sharing

5. The provision of credit by investors and intermediaries relies on good credit information on which to assess the risk and required return of lending to a business. The lack of easily available credit information can raise the costs of credit provision, as investors are required to undertake additional credit assessment. Further, credit information can present a barrier to entry for new providers if existing providers control access to credit information.

6. A number of finance providers who responded to the Call for Evidence raised the issue that a lack of access to credit information provides a higher barrier to entry for them in lending to SMEs. This was also raised by the Independent Commission on Banking in its report to Government. The Taskforce notes that other countries have pursued a regulatory solution to the sharing of information, such as in France where the Banque de France maintains two complementary databases with credit information: the FIBEN Companies Database and the French Central Credit Register. A range of summary information about companies is then provided to lenders.

7. The Taskforce is encouraged that the main UK banks already contribute credit information to the main credit reference agencies. This sharing of information will make risk assessment more efficient and improve overall outcomes for businesses. It also has the potential to foster greater competition between banks and other finance providers. The Taskforce therefore considers that the scope of data sharing could be broadened to include non-bank finance institutions. Whilst the Taskforce is not currently recommending a regulatory solution, it considers that the Financial Conduct Authority needs to work with the banks to see how the sharing of this data could be achieved to support a more diverse financing landscape.

8. Government also has a role to play through the disclosure of data that sits within public bodies. For example, financial information on registered companies is currently available publicly via Companies House[38]. This provides detailed information to assist with the credit assessment undertaken by investors and intermediaries. The Taskforce understands that Government is currently considering whether additional data could be made available to support growth, under its “open data” initiative. One example of how Government might support the development of new financial products and markets is the data currently held by HM Revenue and Customs. While much of this taxpayer information is commercially sensitive and should remain confidential, there is data that could be

38 www.bis.gov.uk/assets/biscore/statistics/docs/b/bpe_2011_stats_release.pdf

provided. The VAT register, for example, would allow basic assessments and cross-reference with other data sources on registered businesses.

Recommendation 10:

a. **The BBA should explore greater credit data sharing with non-bank providers, and this should be considered by the FCA; and**

b. **Government should consider whether further data could be made available to support the development of new finance products and markets to benefit businesses.**

8.3. Improving the UK's export performance

9. Improving the UK's export performance is a critical goal of Government economic policy. Specifically, the Government has launched the Exporting for Growth initiative to encourage more SMEs to become active in export markets. However, recent changes to bank regulation under Basel 3 place a disproportionately high capital charge on Trade Finance especially for SMEs. It is generally accepted that Trade Finance is a relatively low risk form of finance, but this is not properly reflected in the current regulatory proposals. Recent G20 summits have acknowledged the need to tackle this problem. The banking industry has been working with international bodies to develop specific revisions to the new regulations. A set of detailed proposals for changes to the new EU Capital Requirements Directive will address some of the problems but more needs to be done.

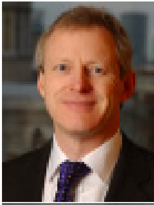
Recommendation 11: An industry-led Taskforce should be launched to make specific proposals on how to remove barriers on bank lending to support SME trade finance.

10. This recommendation builds on the proposal of the CBI/E&Y report 'Winning Overseas' and work already underway within the industry.

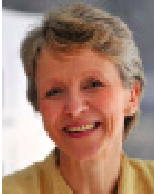
11. This Taskforce could be launched within a few weeks, with a mandate to deliver its first recommendations for implementation before July. This taskforce would build on the work of existing initiatives driven by the BBA, CBI, UK Exports and others.

ANNEXES

Annex 1: Taskforce Members



Tim Breedon, Chairman
Tim is the Group Chief Executive of Legal & General, which he joined in 1987. Tim is also the Chairman of the Association of British Insurers.



Dame Helen Alexander
Helen is deputy president of the CBI and senior adviser to Bain Capital. She is Chair of Incisive Media and also holds a number of senior positions with companies including Centrica and Rolls Royce.

James Douglas
James is a Partner and Head of Debt Advisory at Deloitte and the President of the Association of Corporate Treasurers. He previously worked for major investment banks in the City.

Professor Julian Franks
Julian is an economist and a professor of finance at the London Business School. He is also an Associate Editor of a number of prominent journals, including the Journal of Banking and Finance.

Brian Robertson
Brian Robertson is the Chief Executive of HSBC Bank UK. He has enjoyed a long and varied career within the bank before assuming his current position.

Xavier Rolet
Xavier is the Chief Executive of the London Stock Exchange. Previously he was a senior executive at Lehman Brothers and, most recently, CEO of Lehman in France.

Chris Rowlands
Chris is a director at Finance Wales and the chairman of the UK Government's 'Rowlands Review'. Before joining Finance Wales he was a director at 3i.

Charles Roxburgh
Charles is a director of the McKinsey Global Institute, McKinsey's business and economics research arm, and a director (senior partner) of McKinsey based in London

Annex 2: Contributors To Taskforce Consultation

- 3i
- ABFA
- ABI
- Absalon Project
- Access 2 Finance
- ACT
- Advantage Accountancy & Advisory
- AFME
- Aircraft Medical
- Aish Technologies
- Amor Group
- Andrew Baker Consultancy
- APCIMS
- Applied Professional Solutions
- Archangels
- Aston Reinvestment Trust
- Avebury Capital Partners
- Avingtrans
- Aviva
- AXA (UK)
- AXM Venture Capital
- Babson Capital
- Baird Capital Partners
- Bank of England
- BankToTheFuture
- Barclays Capital
- Barclays Corporate
- BBA
- BCC
- BCRS
- Beechbrook Capital
- Beer and Partners
- Benfield Motor Group
- Bepa
- BexA
- Bibby Financial Services
- Bilbus.com
- BIPA
- Border Biscuits
- Brace's Bread
- Bradford City Hall
- Brains SA Brewery
- British Land
- British Telecom
- BSA
- Business Finance Solutions
- Business Growth Fund
- Business Voice WM
- Capita Registrars
- Capital Enterprise
- Capital Law
- Caxton FX
- CBI
- CDFA
- Centrica
- Ceres Power
- CSFI
- Chamberlin
- Citibank
- City of London Corporation
- CLEC
- Clifton Asset Management
- CLS Holdings
- Collins Stewart
- Company Business
- Comtec
- Connectix
- Credit Asset Management
- Credit Safe
- Crowdcube
- Danny Fellows Associates
- Deloitte
- Dickinson Dees
- Dietchef
- DTS International
- East London Small Business Centre
- Eco2
- Eco-Xchange
- EEF
- Energy ventures
- Ernst & Young
- Euler Hermes
- Euro TRX
- Eversheds
- Evolution Securities
- Experian
- Factoring Advisory Service
- Fair Finance Consortium
- Fathom Consulting
- Fenchurch Advisory Partners
- Finance Options
- Finance South East
- Finance Wales
- First Flight NEDs
- FLA
- Flexible Commercial Funding
- Forum of Private Business
- FSB
- FTI Consulting
- Funding Circle
- Funding Options
- FW Capital
- G.D. Harries
- Gambit
- Gardiner Richardson
- GE Capital
- GE UK & Ireland
- Geldards
- Going for Grants
- Goldman Sachs
- Goodwood Homes
- Grainger
- Graydon
- Greater Birmingham & Solihull LEP
- Greenbelt Group
- Henderson Group
- Herefordshire Council
- HNWI Association
- HSBC
- ICAEW
- ICAS
- ICG

- IMA
- Incisive Media
- Institute of Credit Management
- Jaguar Land Rover
- JJ Churchill
- John Lewis
- Keystone Law
- KPMG
- Leeds University
- Legal & General
- Lloyds TSB
- London Chamber
- London Stock Exchange
- M&G
- Makin Movies
- Manufacturers Capital
- Marches LEP
- MarketInvoice
- Martineau
- Maven
- McKinsey
- Media Modo
- Metal Assemblies
- Millar Landscapes
- Miro House
- Mitchell Engineering
- MMS
- Morgan Cole
- Multichem
- Nationwide
- NCVO
- NESTA
- NIESR
- North East Access to Finance
- North West Fund
- NorthStar Equity Investors
- Northumbrian Water Group
- Orbian
- Oriel Securities
- P2P Finance Association
- Palio Capital
- Panoramic Growth Equity
- PD Ports
- Pentech
- PIMCO
- PIP Asset Management
- PKF
- PlatformBlack
- PMT Sales / Egame Media
- Policy Exchange
- PrefEquity
- Principality Building Society
- Prismtech
- Pritchard Englefield
- Pure Wafer
- PwC
- QCA
- Quick Hydraulics
- RBS
- Reed Group
- Reform
- RFF of the West Midlands
- Rockspring
- Roger Hannah & Co
- Rolls Royce
- Ryder Architecture
- Sage (UK)
- Salisbury & Co
- Sankaty Advisors
- Schechter & Co
- Scottish Government
- Scottish Investment Bank
- Seedrs
- SGH Martineau
- Shore Capital
- Sigma
- Silicon Valley Bank
- Skipton Business Finance
- Slaughter & May
- SMEi Group
- Smith Institute / SMMT
- Snowball Consulting
- Social Enterprise UK
- Soil Machine Dynamics
- Solstice Capital
- Southern Group
- Spaceright Europe
- Squire Sanders
- Standard & Poor's
- STJ Advisors
- Stockcube Research
- SWIG
- Tandem Financial Solutions
- Target Group
- Tata Group
- Tees Valley Ulimited
- Templestone Masonry
- The Alchemists (Northern)
- The Cashmere Centre
- The Social Investment Business
- TheCityUK
- ThinCats
- Third Horizon Consulting
- TIGA
- Tinopolis
- Total Business Finance
- Trade Finance Capital
- UKEF
- Unique Consulting
- Urica
- VCA
- Venture Beyond
- Verus Energy
- Watson Burton
- Welsh Entrepreneurs Group
- Welsh Government
- Westbeer
- WestInvest
- Wine Intelligence
- Winnock Hotel
- WRAP
- Zopa

Annex 3: Level of Expertise at Businesses

	Turnover	Level of in-house Finance Expertise	Broad characteristics	Use of regular finance	Use of specialist finance	Typical providers
Micro-businesses	Typically <£1m	Would rarely have a qualified accountant as finance directors [FDs] unless incorporated or growing rapidly.	Fewer than 10 employees; usually owner-managed	Many (c. one third) use no external finance. Otherwise limited to overdrafts, loans and credit cards. Personal finance also used.	Limited to vendor finance and trade finance. Some asset-backed lending.	Banks, credit-card providers, vendors. Also owners and family members.
SMEs	£1m to £25m	A minority have a financially trained person, especially if using external finance. £1-5m turnover [t/o]: unlikely £5m+ t/o: more likely.	Full-time employees; multi-regional and national activity; about 1 in 5 may import/export. Are relatively formalised and have reasonably well-defined business functions, such as Finance, HR.	Overdrafts and term loans. Faster growing firms may also be using personal finance in the form of directors' loans / equity.	Some use of: asset-backed lending export finance and venture capital. Those in major supply chains may access supply chain finance through customers.	Banks, specialist providers, business angels, venture capital funds.
Mid-sized businesses	£25m to £500m	Almost always would have a professionally qualified accountant.	Larger national and international firms; often with multi-national operations.	Overdraft or revolving credit facility, term loans, asset-based finance.	Export finance, invoice finance, asset finance, private equity or venture capital funding.	Banks, venture funds, private equity funds, stock markets.
Large businesses	> £500m	Have a professionally qualified accountant as FD.	Large number of employees; generally multinational operations.	Revolving credit facility, term loans, bonds, commercial paper.	Capital markets, private placements.	Stock markets, institutional investors, private equity funds.

Source: BBA. "Supporting UK business. The report of the Business Finance Taskforce". (October 2010), ACCA and ICAE

Annex 4: Calculation Methodology for Funding Gap

Methodology

The Taskforce has estimated the level of finance that will be required by businesses in the future. The analysis seeks to project forward the anticipated growth in credit supply based on current and historical trends in both a high and a low growth scenario.

The method is based on two stages:

1. Firstly, a relationship was established between the past trend in corporate lending and nominal GDP growth.
   a. This shows the gap between the current volume of credit available to businesses and where it might be in equilibrium; and
2. Secondly, the extra funding requirements of a growing economy were added in using OBR forecasts out to the end of 2016.

In (1), we establish a strong historic relationship between the growth of nominal GDP and the growth of outstanding loans to the private, non-financial corporate sector (excluding lending to the construction and commercial real estate sector “CRE”). As much of the bubble in lending prior to the credit crunch is attributed to CRE we exclude this sector from the calculation.

In (2), taking account of the forecast period, we have two **scenarios**:

1. **The low scenario** is based on a projection of the growth in the net flow of credit to the corporate sector that would be consistent with a sustained recovery in GDP (including a strong recovery in business investment) as is expected by the OBR.
   - Under this scenario, the future path for the stock of outstanding loans includes a continued fall in net lending during 2012. The fall we have estimated is consistent with the Ernst and Young Item Club’s estimate[39] of a 5.7% annual contraction in corporate lending in 2012.
   - Our forecast then assumes a strong, above-trend recovery in lending consistent with rates of growth seen during the period of recovery in both the business and credit cycles that occurred in the period 1994 Q4-1998 Q4. Such a recovery in lending will still require a significant loosening in financial conditions in the years ahead.
2. The **high scenario** takes an alternative approach. It looks at the underlying relationship between GDP and the flow of credit to the non-financial corporate sector (excluding CRE) during the period before the financial crisis.
   - This approach then factors in that a good deal of the current non-CRE corporate debt overhang was a consequence of the period of financial distress

39 www.ey.com/UK/en/Newsroom/News-releases/12-02-06---Bank-lending-to-contract-for-the-first-time-since-2009

(and not the boom) and hence some of this debt is now tied up in businesses that are only just able to meet their credit payments and therefore cannot grow.

- Because this element of the debt overhang cannot productively support the recovery, extra lending capacity is potentially required to be made available to new and growing businesses that will drive the recovery in line with OBR forecasts.

- The 'high' forecast can also be understood as returning productive non financial, non-CRE lending, to its historic relationship with GDP.

Table 2: summary of calculation of non-financial corporate funding requirement

	Low Scenario	High Scenario
Last data point prior to modelling	2011 Q4	2007 Q2
Total increase in loans between 2011Q4 and 2016Q4 (of which SMEs)	£83.8bn (£26.0bn)	£191.4bn (£59.3bn)
Implied quarterly growth in loans between 2011Q4 and 2016Q4	1.4%	2.8%
Modelling stage 1	Model 2012 by assuming a decline in total loans of 5.7% at a declining rate of change in each quarter (4/10 in Q1, 3/10 in Q2, 2/10 in Q3 and 1/10 in Q4)	Return total outstanding loans index to nominal GDP index in last period of economic growth (2008 Q2) Consistent with 66% growth in GDP and loans since 1998 Q1
Modelling Stage 2	Hold outstanding loans constant for one quarter then increase growth for 2013 Q2 - 2016 Q4 by the rate seen in the four years of sharp lending recovery after the 1990s' recession. Consistent with quarterly growth of 2.3% (the rate seen between 1994 Q4 and 1998 Q4 in PNFC loans as a whole – it is not possible to remove CRE for this period)	Apply historic growth rate in nominal GDP to outstanding loans projection until end of forecast period. Consistent with 1.3% quarterly growth (the average of nominal GDP between 1999 Q1 and 2007 Q2)

Data Sources:

Outstanding loans data is taken from Bank of England industrial analysis tables of monetary financial institutions' (MFIs) outstanding lending to UK residents. They are built from individual sector level data and exclude any financial sector corporates and those classified as 'construction' or 'buying, selling & renting of real estate'.

The Bank of England data start in 1998 Q1 which is indexed to 100 alongside nominal GDP in the chart. Growth rates are then applied until the latest data point available (2011 Q4).

Nominal GDP data is sourced from the Office for National Statistics (ONS).

Quarterly nominal GDP is forecast for 2012 Q1 onwards and is given by the OBR growth forecast joined on to the latest ONS data point.

Annex 5: Supply Chain Finance Worked Example

1. SCF is an innovative finance product that can benefit both the buyer (in the form of a secured supply chain and more streamlined payable management) and the suppliers (more certain cash flow and financing resources).

2. In addition, it is also a more attractive product from the banks' perspective as finance providers in SCF arrangements. Specifically, SCF is treated as an uncommitted facility rather than a committed one (such as overdraft) for capital allocation purposes. Therefore, the undrawn element of SCF incurs zero weighting for capital reporting purposes, whereas banks are required to allocate capital against undrawn overdraft limits. This frees up bank capital, which can be put to use more efficiently and also results in lower capital costs for the banks.

3. The cost efficiency of SCF for the supply chain as a whole can be demonstrated by the calculation below.

4. These figures show that prompt payment is the best way to lower costs within the supply chain, but that those costs are taken on disproportionately by the buyer as some form of discount is likely to be required in order to incentivise buyers to pay in advance of contractual payment terms. Supply chain finance provides a good medium between the different options as it creates a significant saving for the supply chain, but also has a number of supplementary benefits. If implemented properly, the setting up of a supply chain programme inevitably involves the streamlining of processes by the buyer and creates a more integrated relationship between buyer and supplier.

£	Case 1 Standard payment term	Case 2 Early payment	Case 3 SCF
Amount received by supplier on Day 10	-	98,000	99,660
Supplier financing costs	-	177	180
Amount received by supplier on Day 45	100,000	-	-
Supplier financing costs	814	0	0
Total supplier funding costs	**814**	**2,177**	**520**
Annualised supplier costs	**6,600**	**17,660**	**4,216**
Buyer financing costs	0	466	0
Total buyer financing costs/(saving)	**0**	**(1,711)**	**0**
Annualised buyer saving	**0**	**(13,880)**	**0**
Net annual costs to the supply chain (per £100k)	**6,600**	**3,779**	**4,216**

Annex 6: Industry Taskforce Terms of Reference

"Government will…establish an industry working group, to explore how to further develop access to non bank lending channels, including forms of bond issuance, for SME and mid sized businesses. The group will be led by the Department for Business, Innovation and Skills and will report by Budget 2012."
Autumn Statement, Nov 2011

Objective
To examine structural and behavioural barriers to the development of alternative debt markets in the UK, building on recent work on this subject, and to make evidence based recommendations to Government ahead of Budget 2012 on practical measures to facilitate the development of these markets.

Scope
The review will focus on alternatives to 'traditional' bank lending. The Group may consider availability of all forms of debt and credit to businesses that are not senior bank lending. The review should include direct debt issuance by firms in both public and private markets, but may cover other forms of debt such as asset finance, factoring, invoice discounting, or peer to peer lending and 'crowd funding'. The provision of equity finance is not in scope of this review, except to the extent that availability of equity finance impacts on the development of debt markets.
The Group should focus on those businesses that do not achieve the scale necessary to access UK and international public capital markets. Within this, the Group will want to prioritise those businesses that would benefit most from diversifying their external finance structure.

Activities

The working group should:
Assess the current role of non bank debt in UK businesses' current capital structures. Assess whether lack of diversity in their current capital structure impacts on their growth or risk.

Examine demand for raising external finance through non bank debt channels, for both working capital and investment, and the relative attractiveness of other finance products.

Assess the supply of funds for debt finance and the channels through which non bank debt is currently provided. This can include public and private debt markets.

Explore innovations in debt finance in the UK and other comparable countries. Examine the potential for new and innovative debt products for UK businesses and any potential barriers to take up.

The Government has separately announced that it will establish a Business Finance Partnership (BFP) to invest in mid sized businesses and SMEs in the UK. The BFP will make available an initial £1bn to develop non bank lending channels. The working group will focus on structural issues so will complement the BFP, but will not take investment decisions, which are a matter for the Chancellor.

The working group will be supported by officials in the Department for Business, Innovation and Skills and HM Treasury. Group members are expected to meet at least monthly leading up to Budget 2012. The Chair of the working group will be invited to report progress regularly to BIS Ministers.

Members

Members of the working group will be appointed at the invitation of the Secretary of State, Department for Business, Innovation and Skills. The roles will be non remunerated. Membership will be drawn from various market participants including businesses, the investor community and corporate finance practitioners. The Group may invite additional experts to attend meetings where their input would be helpful.

Contacts

This document and supporting data can be accessed via:

Website: http://www.bis.gov.uk/policies/enterprise-and-business-support/access-to-finance/taskforce

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