Business Bank Advisory Group

Overview paper

1. Introduction

The Advisory Group was asked by the Secretary of State for Business, Innovation and Skills to provide advice to determine the scope and working methods of the Business Bank. In light of this, the Advisory Group has prepared this paper, drawing together information on the SME finance market and areas of market failure, the range of current and potential interventions that Government could provide, and a set of key principles for organising Government's interventions most effectively.

It sets out the case for a publicly controlled but independent Business Bank, operating at arm's length from Government. The analysis we have conducted suggests that the £1bn of newly announced funding, together with existing commitments, could deliver an estimated impact of £6-10bn on the stock of SME lending and investment within five years.

1.1 Business Bank objectives

The Advisory Group has endorsed the following objectives, which have been proposed for the Business Bank, in line with the original intentions expressed by Ministers:

- support the development of diverse debt and equity finance markets for SME and mid-cap businesses, promoting competition and increased supply through new finance providers;
- increase the provision of finance to viable but underserved SME and mid-cap businesses;
- bring together the management of the Government's existing business finance schemes, creating a single portfolio and simplifying access for businesses;
- function on commercial terms to use taxpayers' funds most effectively.

2. Market analysis

It will be vital for the Business Bank to base its activity on a strong evidence base and the Advisory Group welcomes the fact that the team setting up the Business Bank team plan to carry out a number of additional assessments aimed at clearly identifying the main funding gaps in the market. This should allow interventions to be designed and targeted in such a way that most effectively addresses the existing problems in the market for SME finance.

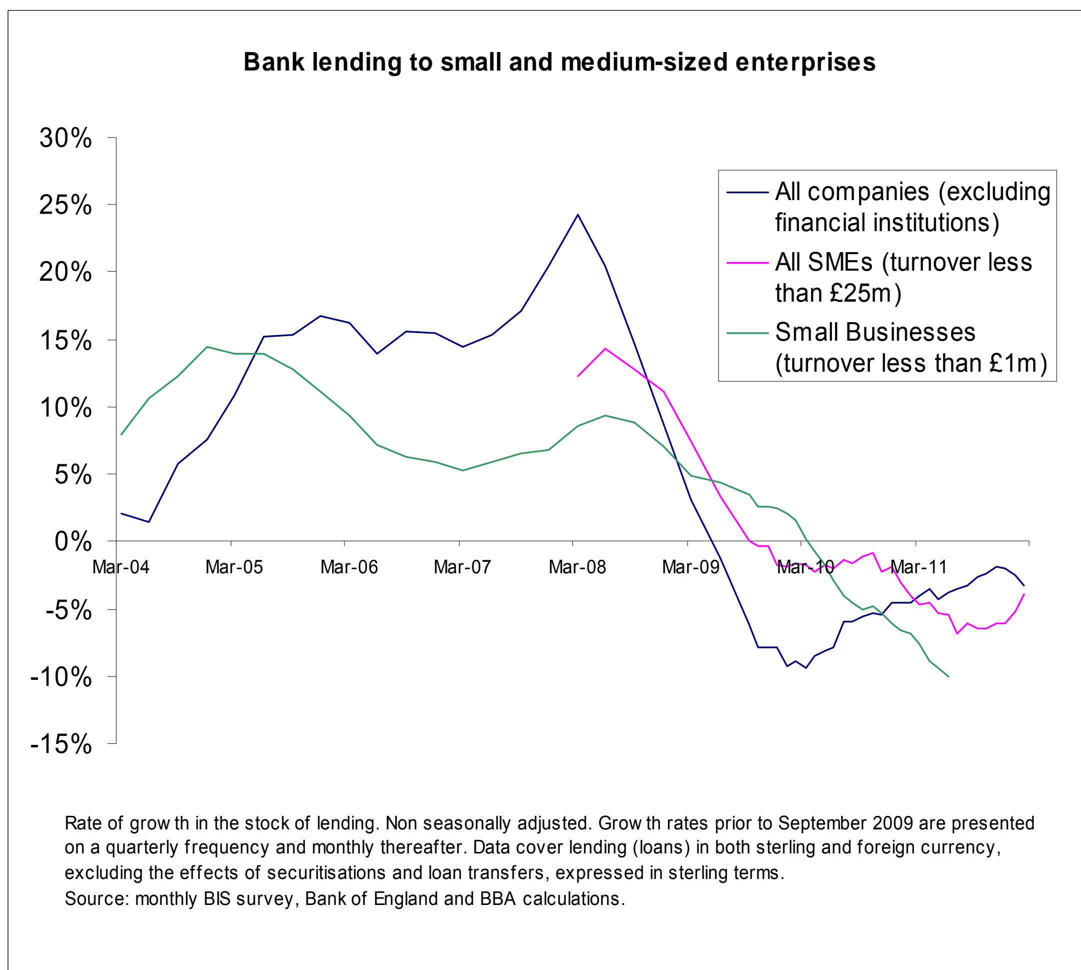
2.1. Size of the market for SME finance

The following table summaries data on the main forms of SME finance in the UK

	Finance provided in 2012 (or last year where data available)	**Change over time**	**Overall stock end 2012**	**Utilisation levels amongst SMEs**
Overdrafts	£5.3bn of new overdrafts	Overdrafts utilised by SMEs from the four major lenders fell 38% over the period 2009-2012	£21.1bn of facilities, £11.5 utilised	22%, (31% of micros, 31% small and 36% medium)
Credit cards	No reliable data on volumes	No reliable data on volumes	Of SMEs using credit card, 40% report they are using personal cards, whilst 60% are using business cards	18%
Bank loans	£17.1bn of secured lending to SMEs in 2012 (estimate).	Lending to SMEs has fallen every year from 2009 (see graph below)	£79.4bn	10%, but 16% of micro firms, 22% of small, 29% of medium
Trade credit	N/A	Fall of £4.7bn between 2008-11	£120bn facilities offered to SMEs	6.1% in 2011
Asset backed finance	Approximately £19bn of asset finance provided in 2011			6% all firms (11% micro, 24% small, and 33% medium)
Invoice discounting	£42bn funds advanced in 2012	No aggregate figures, but increasing utilisation widely reported	The outstanding balance at Q4 2012 was £17bn	3%
Peer to peer lending	Estimated flow of £240m per year	Rapid increases from low base	<£1bn	< 1%
Angel investment (including HMRC tax reliefs for SME investment)	£920m			<1%
Venture capital	£347m VC stage deals in UK businesses (based on returns from BVCA members)	Significant decline in European Venture Capital funding between 2007 and 2011		<1%

Sources: BBA, Experian, BVCA, HMRC, FLA, ABFA

Evidence indicates that supply of most forms of finance is declining. The graph below illustrates this point by setting out the rate of growth in the stock of bank lending to SMEs since 2004.



Rate of growth in the stock of lending. Non seasonally adjusted. Growth rates prior to September 2009 are presented on a quarterly frequency and monthly thereafter. Data cover lending (loans) in both sterling and foreign currency, excluding the effects of securitisations and loan transfers, expressed in sterling terms.
Source: monthly BIS survey, Bank of England and BBA calculations.

The reasons that SME finance is difficult to measure include:

- SMEs overcome problems in accessing finance through a broad range of available sources. SMEs and mid-caps flexibly source their finance between credit cards, bank debt, peer to peer lending, delayed payment, directors' loans and facilities taken out in a personal capacity, substituting working capital for investment needs and vice versa;
- Whilst statistics on the overall size and value of these individual markets is rarely available, these statistics do not disaggregate by the size of business demanding the finance- or their uses for it. For example, there are no estimates on the overall size of the mezzanine market and within this there is no data on the size of the market for SMEs and mid-caps.
- Even if this information is available, it is often not comparable between markets. Different time periods and customer definitions means that aggregating across markets can be difficult. Generally, Government splits SMEs

into the self-employed, micros at less than £1m turnover, small firms (£1m-10m turnover) and medium-sized firms at £10-£25m turnover. Businesses above £25m turnover are generally referred to as mid-caps (These are within scope of the Business Bank and we are conducting specific market research in this area).

- Finally, any estimates are likely to underestimate the total size of the SME finance market. This is because it does not take into account personal finance that is used to fund the business. Currently, the SME Finance Monitor survey[1] estimates around 38% of SMEs with an overdraft, loan or credit card uses a facility in a person's name (rather than the business). This is prevalent even for significant businesses (for 10-50 employee businesses the figure is 10%).

2.2. Market failures and gaps

A decline in the supply of finance does not automatically imply a gap in the market. However, evidence does point to a range of specific failures in the market.

2.2.1. Early stage equity investment:

There is a long recognised finance gap for firms seeking equity finance in the UK and due to the fixed costs of undertaking due diligence. This gap is more acute for those firms seeking smaller investments.

British Venture Capital Association data shows that in 2012 a total of 820 companies secured equity investment, of which 431 secured venture capital. There is not an accurate picture of how much unmet demand there is for equity finance although evidence of venture capital funding across Europe suggests that this financing source has declined significantly between 2007 and 2011. In parallel, public sector investment has become an increasingly important element of the European venture capital market growing from less than 15% in 2007 to 40% in 2012.

An alternative approach to estimate a financing gap is to compare the UK and US markets. The US is often seen as a model for a well-functioning and mature VC market, so it is possible to examine how many more deals could be done if the UK VC market operated at the same comparable level. This suggests there could potentially be around 185 companies/ start-up ideas that are not being funded per year. Assuming UK deal sizes remain the same as now, the finance gap could be in the region of £160m per year.

2.2.2. Restricted lending to smaller and less established firms:

Asymmetric information between finance provider and businesses on the creditworthiness and future performance of firms means finance providers are often reluctant to provide funds without evidence of track record and/or collateral to mitigate against the risk of default. This disproportionately affects smaller and newer

[1] BDRC Continental (2013) SME Finance Monitor Q4 2012

businesses as well as innovative high growth businesses that have business models that rely on intangible assets.

For example, the rejection rate for SMEs for bank loans is 38% for firms less than 5 years olds, compared with 19% for firms over 5 years old. Similarly firms with turnover of less than £1m are rejected in 27% of cases; firms with more than £1m turnover are rejected 16% of the time.

2.2.3. Constraints on supply of long term finance and unsecured lending:

Investments made by SMEs often need to be in long term and/or intangible investments. However finance solutions that reflect these needs are frequently not made available. This is due to the expense and capital requirements associated with longer term funding, and the risk associated with lending that is not secured on tangible assets. Preliminary analysis from BIS shows that there are 800-2500 firms in the UK with more than £1m turnover that could potentially be appropriate recipients for long-term debt product.[2]

2.2.4. Lack of diversity of supply:

In 2009, the largest five banking groups held approximately 80% of the SME banking market share in the UK. The primary consequence of this is that when large incumbent banks pull back from the market – like many have done in recent years – SME borrowers are left without alternative sources of finance. Survey data shows the vast majority of SMEs turn to their bank when they have a need for external finance and awareness of alternative forms of finance is low. For example, over half the SMEs that sought finance in the past 3 years went directly to their main bank. This was particularly the case for those that needed finance for working capital. 71% of those seeking finance contacted just one provider on the last occasion finance was sought, usually because they had a longstanding relationship with them. Less than a third were aware of alternative sources of finance such as business angels, export/import finance, or peer to peer lending.

Since the financial crisis there has been much debate about the UK Banking markets. Major initiatives have included the Independent Commission on Banking, leading to what was known as the Vickers report and the Parliamentary Commission on Banking Standards, often referred to as the Tyrie Commission. These initiatives have examined a range of possible structural and regulatory reforms for the Banking sector, which are now being implemented.

At the end of 2012 the Financial Services Act received Royal Assent and the new Regulatory structures for the industry are now in place. The Financial Services (Banking Reform) Bill was introduced to Parliament in February 2013. The Bill brings

[2] The is based on Experian analysis of Companies House data and matches existing firms to the profile of eligible recipients of long-term debt products e.g. positive cashflow, low risk rating, strong to moderate growth profiles, etc. This is then adjusts this to take account of variations in demand. The figures are broad estimates and should be interpreted with caution.

forward the most significant reforms to the banking sector in a generation, including the ring-fencing of retail deposits.

The Government is on track to have all legislation in place by the end of this Parliament (2015), and banks will be expected to have implemented reforms by 2019 at the latest.

Both Lloyds and RBS are mandated to divest a significant number of branches and debate continues about whether there should be further structural reform such as the creation of a “bad bank” or a further break-up of the major banks.

These regulatory and structural reforms are beyond the scope of the Business Bank project but it is worth bearing in mind the continuing debate and evolution of the policy context around the banking industry. The pro-competition aspects of the Business Bank, such as investing in new and growing lenders may be of significant benefit in creating a banking and finance market that serves the needs of UK SMEs.

2.2.5 Capital constraints in the banking sector:

Regulatory capital requirements constrain banks' willingness and ability to lend. The combined effect of realising losses, unexpected charges and costs with marked increases of capital requirements from international regulators has hit lending to SMEs particularly hard, as SME lending demands up to five times higher capital charges than other forms of lending such as household and corporate lending, reflecting the higher risk involved.

In March, the FSA examined UK banks and found that over the next three years, banks' expected losses could exceed existing provisions by around £30 billion; future conduct costs could exceed provisions by around £10 billion; and that a more prudent approach to risk weights would create a further £12 billion shortfall of capital. Taken together, the effect of these three adjustments would be equivalent to around a £50 billion reduction in the regulatory capital of the major UK banks and building societies. The UK Prudential Regulatory Authority responded by calling UK banks to raise another £25bn of capital by the end of 2013.

The impact of incoming prudential regulation on SME lending is a contributory factor. In a Deloitte report commissioned for the construction of the Business Bank, they described the issue of capital constraints in banks and how this issue was becoming more acute:

“The amounts of lending that banks can provide are primarily constrained by regulatory obligations on the minimum capital ratios that banks are required to maintain. Following the turmoil in the financial markets in the 2007-2009 crisis, banks have increased their capital ratios. Further tightening will be required in order for banks to comply with the Basel III or UK ICB requirements, to be implemented between 2013 and 2018. Furthermore, UK banks face certain obligations that are super-equivalent (i.e., more restrictive) than internationally agreed rules. For example, when

compared to Basel, UK super-equivalence requires that UK ring-fenced banks will need to maintain core Tier 1 capital above 10% and total primary loss absorbing capital above 17%...

…If capital ratios are currently below the Basel III or UK ICB requirements, in order to comply, banks must either reduce their Risk Weighted Assets (RWA) for any given level of capital held, by changing the product mix made available to SMEs, for example, or increase their holdings of the relevant capital components… …With the background in which banks can only grow RWAs at a slow rate (at best) capital allocation becomes an increasingly important tool. In particular banks will prioritise those activities with a higher risk adjusted return on capital. Thus low LTV mortgages with a risk weighting of, say, 15% (on an internal models basis) would be relatively more attractive to a bank required to risk weight SME loans at 100%."

Various studies suggest that the new rules could lead to a decline in the stock of SME lending of between 1.5% and 5% and an increase in lending spreads of between 15 basis points and over 500 basis points. All else being equal, capital constraints encourage banks to allocate capital to activities which are more capital efficient and thus profitable for the given capital consumed.

2.2.6. Information problems in the market

Lenders to SMEs have to make an assessment of the risk of lending to a particular SME, and decide the terms, collateral and pricing of the loan accordingly. Behavioural and quantitative factors are important as part of this assessment. Incumbent banks are uniquely placed, having access to large volumes of this data through providing current account facilities, which give the banks accurate behavioural data on potential borrowers with little cost. This gives current account providers, particularly large incumbent ones a strong advantage, as they possess both detail on the individual borrower, but also cohort data to enable them to place the risk of a borrower relative to her peers.

A cross-Government working group with members from BIS/Business Bank, the Treasury and the Bank of England is considering the issue of how lenders make credit assessments, what data they use for this process, where and by whom data is collected, and whether there are any potential improvements that could be made in this area, either by encouraging private sector entities to work together better, or by Government intervention.

2.2.7. Demand and awareness

For markets to work well, a diverse and competitive supply-side as well as an *active and informed* demand side is required. Through its website and, potentially, diagnostic tools, the business bank could certainly help shape this so that businesses understand the range of finance available to them and can identify the type that is right for their needs. There are a number of demand-side issues impacting SMEs' demand for finance:

- **Lack of investment readiness:** SMEs often lack the ability to effectively present themselves as investable opportunities, for instance due to inadequate management skills or poor business plans. For instance, only 25% of SMEs have a formally qualified financial manager, although this increases with the size of business to 66% of medium sized businesses. This may reflect why 41% of SME employers do not understand the way banks assess business credit risk, and why they do not feel confident in raising finance. A greater number of SME employers perceive they are poor (38%) at accessing finance compared to those reporting they are strong (25%).

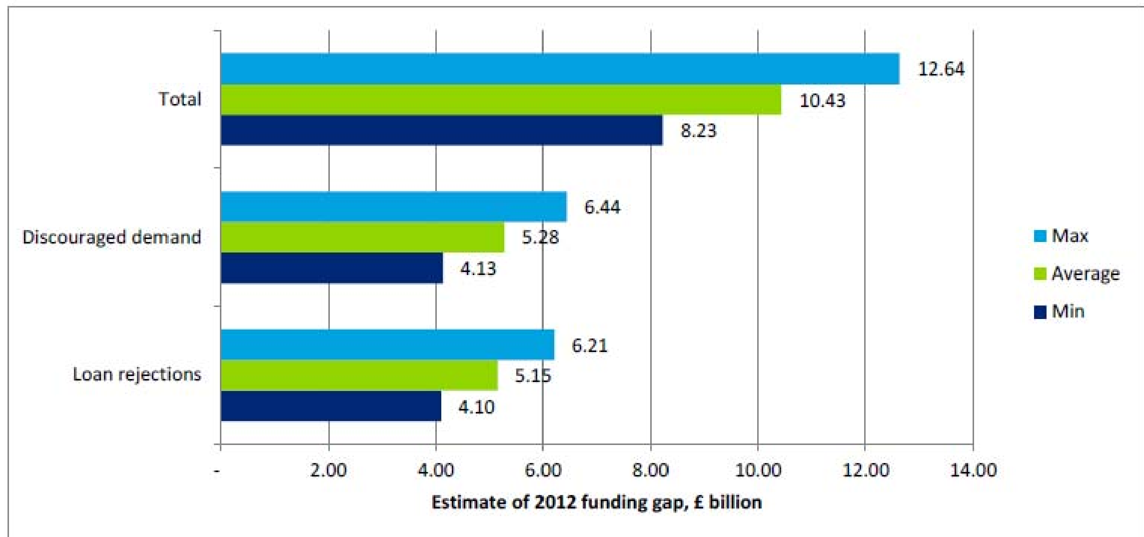
- **Uncertainty of demand:** Uncertainty created by the recent economic downturn has reduced businesses appetite to take on external finance. Many businesses have instead preferred to pay off their existing debts, rather than make new investments.

- **There are specific challenges to increasing the demand for equity finance:** A number of issues deter small businesses from seeking equity capital. Loss of control and restricted management freedom are the concerns most commonly cited by SMEs, but the costs of securing equity finance and a lack of knowledge are also common obstacles. For instance, survey evidence shows only 20% of SME Companies are aware of a local venture capital provider. Supply and demand side factors for SMEs raising external equity finance can interact leading to a 'thin market,' where a limited number of investors and high growth firms have difficulty finding and contacting each other at reasonable costs.

2.3. Quantifying the finance gap for SMEs

The concept of a "finance gap" is not necessarily straightforward. Clearly it is a function of demand as well as supply of finance. As part of the evidence gathering exercise for the Business Bank, Deloitte used BBA data to estimate an overall funding gap in 2012. They concluded this was between £8.2 and £12.6bn depending on demand – combining BBA figures for discouraged demand amongst borrower and loan rejection data. However, it should be noted that these figures are a point in time estimate and the funding gap will invariable change over the economic cycle. For example, demand for financing is likely to be lower today due to the state of the economy. But, as the economy grows and businesses require greater levels of working capital, demand for funds is likely to increase. This may create additional funding pressures.

Estimate of bank lending gap amongst UK SMEs in 2012



Source: Deloitte analysis

3. Existing interventions and policies to address the market problems

Government support for SME finance is not a blank sheet of paper – existing interventions are in place ranging from Bank of England schemes to support wider financial markets to local debt funds set up through European structural funds.

3.1. Macro economic interventions to address funding issues

Responding to the Credit Crunch, the Bank of England reduced its rate to 0.5%, lower than any point in its history. To further loosen monetary policy, Quantitative Easing (QE) was launched to further increase the money supply. These measures have been successful in increasing the money supply overall. But to further support banks and building societies and provide a strong incentive for them to extend their lending, The Bank of England and HM Treasury launched the Funding for Lending Scheme (FLS) on 13 July 2012. This scheme boosts lending to the real economy by offering banks and building societies funding at below market rates, with stronger price incentives for those institutions that increase lending to UK households and businesses.

Under the scheme, banks are able to swap illiquid assets for gilts at the Bank of England, paying a small fee to do so. Participants' net lending is measured to calculate the volume of funding they can access through the scheme (calculated on the basis of 5% of their lending stock at end June 2012, plus, pound for pound, any increase in net lending to the real economy); and also inform the pricing of the facility (which increases for banks whose net lending shrinks). Banks are able to use this benefit however they see fit.

Notwithstanding these actions, Bank of England figures showed that bank lending to businesses fell by £5 billion in the three months to February. At the same time, data from the Council of Mortgage lenders showed that mortgage lending increased by £11.6 billion in March, a 9% increase from February. Whilst the Funding for Lending Scheme has successfully supported lending, its positive impact was greater on corporate and mortgage lending than SME lending.

The Bank and HM Treasury announced an extension to the FLS in April. This extends the scheme by one year to allow participants to borrow from the FLS until January 2015, with incentives to boost lending skewed towards SMEs. Whereas access to funding was originality limited to 5% of lending stock at end June 2012 plus pound for pound any new net lending, this was increased to 5% of existing stock plus ten times any net SME lending this year, and five thereafter (for non SME lending, the allowance remains pound for pound new net lending). The FLS has also been expanded to count lending by banking groups to certain non-bank providers of credit, for example asset based lenders.

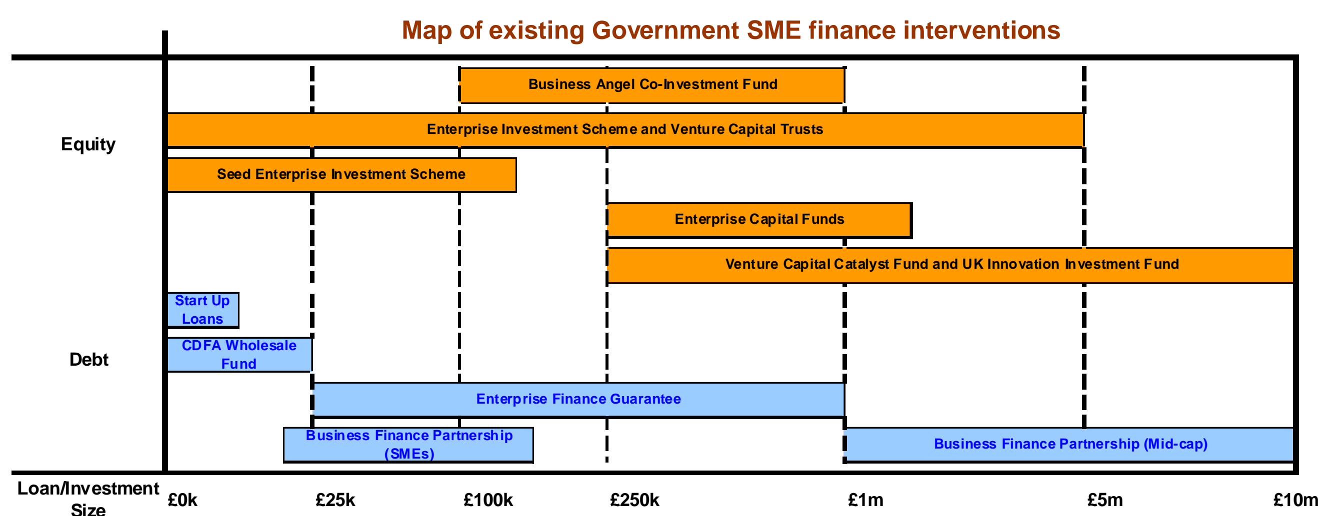
This extension of FLS and its increased emphasis on SME lending may help to incentivise SME lending through cheaper cost of funding. However, the intervention is not targeted at specific market failures in the SME landscape, by its nature the

measure is temporary and the degree of efficacy of the scheme will only be clear once the Bank of England begins to publish data disaggregating the lending to SMEs for institutions in early 2014.

3.2. Microeconomic schemes (funding and capital)

The alternative to macroeconomic schemes is targeted schemes which address funding or capital constraints for intermediaries so they can effectively fund certain types or sizes of firms.

The diagram below maps out the existing set of interventions which Government has in place to support SME finance.



3.2.1. Early stage equity investment

Tax based interventions

Tax based interventions target the equity gap problem by stimulating the supply of equity finance through reducing the cost, and therefore risk, to investors of investing in small high risk companies. The main tax based interventions are:

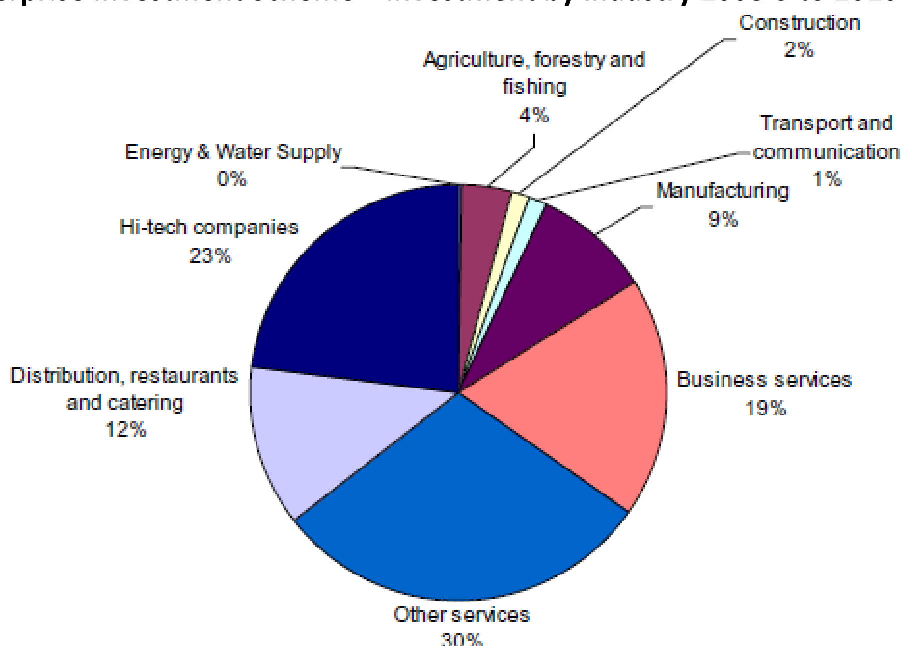
- *The Seed Enterprise Investment Scheme (SEIS)* is designed to help smaller early-stage companies raise finance by offering a range of tax reliefs to investors who subscribe for new shares in those companies. Investors get 50% income tax relief, and there is an annual investment limit for individuals of £100,000. Companies using the scheme will be able to raise a total amount of £150,000 via the scheme (lifetime, not annual limit). Eligible companies must have 25 or fewer employees and assets of no more than £200,000 at the point of investment. A campaign to promote the use of SEIS was launched in late 2012 and a dedicated website was established, www.seiswindow.org.uk, to raise awareness and understanding amongst investors and companies.

- *The Enterprise Investment Scheme (EIS)* is designed to help smaller higher risk trading companies raise finance by offering a range of tax reliefs to investors who subscribe for new shares in those companies. Investors receive 30% income tax relief, and there is an annual investment limit for individuals of £1m. Eligible companies must have 250 or fewer employees and assets of no more than £15m at the point of investment.
- *Venture Capital Trusts (VCTs)* encourage individuals to invest in small, unlisted higher-risk trading companies indirectly through the acquisition of shares in a VCT. VCTs are similar to investment trusts. The investor gets 30% income tax relief, and there is an annual investment limit for individuals of £200,000. Eligible companies must have 250 or fewer employees and assets of no more than £15m at the point of investment.
- Companies can raise a maximum of £5 million in any 12-month period from the government's three tax based venture capital schemes – SEIS, EIS and VCTs.

HMRC analysis indicates that these schemes do tend to channel investment into higher risk firms (although changes to the schemes are regularly introduced to prevent tax avoidance into companies specifically set up to benefit from the tax reliefs).

Whilst there is some bias in EIS companies to technology firms, broadly speaking the schemes support companies in all sectors in the economy. EIS currently supports around £500m of equity investment annually.

Enterprise Investment Scheme – investment by industry 2008-9 to 2010-11



Source: HMRC

HMRC publishes more detailed analysis of the EIS scheme on its website. [3]

[3] http://www.hmrc.gov.uk/statistics/enterprise/eis-commentary.pdf

Business Angel Co-investment Fund (Angel CoFund)

In addition to tax reliefs, there are also a number of other interventions focused on helping SMEs access early stage equity investment. The Angel CoFund is a £100m fund providing equity finance to high growth potential SMEs by investing alongside on a pari passu basis with business angel syndicates. Its aim is to build a long-term market for angel investing by catalysing business angel syndicate formation.

To date, £40.6m has been invested in high growth potential SMEs (29 investments; £9.7m from Angel CoFund; £30.9m from private sector investors); a further £16.7m of investment has been approved but not yet invested (8 investments; £2.2m from Angel CoFund; £16.5m from private sector investors).

Enterprise Capital Funds Programme

1) Enterprise Capital Funds (ECFs)
Enterprise Capital Funds tackle the equity gap by encouraging an increased flow of private early stage capital into SMEs, creating an effective and sustainable funding infrastructure and enabling the development of good quality investment managers.

ECFs are run by commercial fund managers, which are selected by Capital for Enterprise Limited (CfEL) on behalf of Government in a competitive, rolling process. They are 10-year funds, with an option to extend. In terms of capital split, up to two-thirds can come from Government to a maximum of £25m, and one-third has to be private investment at a minimum, i.e. £12.5m typically. The typical fund size is £37.5m, although there have been exceptions that are larger. Investors get significant leverage, where HM Government takes a 3% prioritised return on new funds and private sector investors get the majority of profit share. Since the programme only started in 2006 return expectations are difficult to forecast. The intention is for funds to be cost neutral to Government over the medium term.

The ECFs are state aid notified and can invest up to £2m in an initial funding round for an individual company, with the potential for limited follow-on investment. BIS is currently seeking state aid approval from the European Commission to allow for funding rounds of up to £5m and commensurately larger funds.

CfEL has launched 12 funds since 2006, with total investor commitment of £397m, of which £238m is from Government. To date, £203m has been drawn across all 12 funds. Over £180m is currently invested in over 150 SMEs (at 31 March 2013).

Table: Enterprise Capital Funds

Fund name	Fund Manager	Investment focus	Currently investing
Seraphim Capital	Seraphim Capital	Generalist technology	No
Sustainable Technology Partnership	Disruptive Capital	Cleantech	No
Amadeus and Angels	Amadeus Capital	Seed stage technology	No

Seed Fund			
IQ Capital Fund I	IQ Capital	Generalist technology	No
Catapult Growth Fund	Catapult Venture Managers	Generalist	No
Dawn Enterprise Capital Fund	Dawn Capital	Technology, media and telecoms sector, and technology enabled services	No
MMC Enterprise Capital Fund	MMC Ventures	Generalist technology	No
Oxford Technology Management	Longwall Ventures / Oxford Technology Management	Early stage science, engineering and technology	No
Panoramic ECF 1	Panoramic Growth Equity	Generalist growth equity	Yes
Passion Capital ECF	Passion Capital	Early stage digital media and technology start ups	Yes
Notion Capital Fund 2	Notion Capital	Internet-based services including cloud computing	Yes
Longwall Ventures ECF	Longwall Ventures	Early stage science, engineering and technology	Yes

The Spending Review (2011-15) committed £200m of Government funding to ECFs over 4 years: £50m was committed as at 31 March 2013, a further £150m is available for new funds to 31 March 2015 and the pipeline of new funds is strong.

Since the programme only started in 2006 return expectations are difficult to forecast. The intention is for the Government's contribution to funds to be cost neutral versus gilts over the medium term. ECFs focus more heavily on technology investments than the EIS programme.

2) Venture Capital Catalyst Fund

Since 2008 there has been a marked contraction in the investor base for early stage venture capital as investors, particularly institutions, seek more liquid assets. In response to this situation £25m funding to create a VC Catalyst Fund was announced at Budget 2013, as an extension to the ECF programme. This fund will support the UK's VC infrastructure through investing in commercially viable VC funds that might otherwise fail to reach a satisfactory first close. The VC Catalyst Fund will invest on a pari passu basis to unlock the private sector investment already committed to funds which may not otherwise be invested in growth companies. The guidance for prospective fund managers was published April 2013. The £25m will be committed to funds over two years to 31 March 2015, subject to strong proposals, with investment by funds over a longer timeframe.

Other funds managed by CfEL include Aspire, a co-investment fund investing in businesses led by women (£12.5m from Govt, est. 2008) and the Capital for Enterprise Fund (£75m fund of funds est. 2009).

3.2.2 Interventions to tackle restricted lending for smaller and less established firms

Enterprise Finance Guarantee (EFG)

The EFG scheme was introduced in January 2009, replacing the Small Firms Loan Guarantee scheme (SFLG) which dates back to 1981. EFG is designed to facilitate lending to viable businesses that can demonstrate ability to service loan repayments, but are lacking adequate collateral to obtain a standard commercial facility. EFG is primarily used for term loans, but also supports overdrafts and invoice finance. Facilities are available from £1,000 to £1m, with the average loan size being £100,000, and around half of all loans provided going to firms less than 5 years old, and 17% for start-ups.

The programme has supported over 21,500 businesses since January 2009, facilitating loan offers in excess of £2.2 billion. EFG lending peaked in 2009-2010, and has remained consistent at £350m during the last two years, during a period when net SME lending by banks continued to decline. EFG currently provides around 1% of total SME lending, which is within the 1% to 2% range it was designed for. EFG is more wide-ranging and comprehensive than SFLG scheme - resulting in higher lending volumes.

EFG provides a 75% guarantee to the lender on a portfolio of individual loans, with overall claims capped at 20% of their total annual EFG portfolio. In addition to the fees and changes applied by the lender, the borrower pays a 2% premium but also ensures a three way share of costs between the Government, lender and borrower. Income from premiums typically covers 40% of total costs.

£100m of EFG lending typically costs the Exchequer £4.5m (net after premiums). The main high street banks account for 95% of EFG lending, but 30+ other specialist lenders are accredited to provide EFG facilities including challenger banks, invoice finance providers and Community Development Finance Institutions.

All credit decisions are taken directly by the lender. The main uses of EFG-supported loans are:

- 30% working capital support
- 14% expand premises
- 13% start-up
- 13% new product or business expansion
- 12% purchase of assets

Whilst the core programme is creating £350m of additional loan offers per year, the budget is not currently fully utilised (equivalent to £500m of lending). Analysis indicates that certain banks are not making full use of the financial support available through EFG. The Advisory Group recommends that the Business Bank takes steps are in place to boost overall utilisation.

Start up loans

Start Up Loans is a new programme designed to deal with lenders' unwillingness to finance new start ups by young people. It is a facility designed to help people set up firms or become self-employed. The programme extends loans to people between 18-30 years old in England. Loans are on average £5000, charged at 6% with an initial 12 month capital repayment holiday. The programme also provides recipients with advice and support to increase their chances of successfully establishing their firms (and repaying the loans). The programme has been running less than a year and has already supported 5000 firms (the target being to support 30,000 by 2015-16).

The existing budget allocation for this programme is £117.5m (for the period 2012-15). Of this, 75% covers loans provision and 25% is to cover the costs of support.

3.2.3 Interventions to tackle lack of diversity of supply

The Chancellor announced the £1.2bn Business Finance Partnership (BFP) in November 2011. It was specifically designed to for non-bank debt providers, to help develop a market outside the large banks which are often the first port of call for businesses. Government provides up to 50% of funding, with the remainder from the private sector, all on a pari passu basis.

	Status
HMT Tranche 1: £700m **Open to debt funds** **Focused on t/o < £500m**	Announced in Autumn Statement 2012 £600m investment across four funds (with additional £650m from private sector): ▪ M&G (£200m) ▪ Pricoa (£200m) ▪ Alcentra (£100m) ▪ Haymarket Financial (£100m) ▪ Ares (£100m)
HMT Tranche 2 **£400m** **Open to debt funds** **Focused on t/o < £500m**	3 fund managers have been shortlisted to manage a further £400m of Government investment. Details of these investments will be confirmed later in 2013.
BIS Small Business Tranche **£100m** **Open to debt funds and other non-bank channels** **Focused on t/o < £100m**	Announced the first four successful bidders 12 December 2013: ▪ Funding Circle (£20m): peer to peer lender. First draw March 2013. ▪ Zopa (£10m): peer to peer lender. ▪ Boost&Co (£20m): direct lending fund. ▪ Credit Asset Management Limited (£5m): Legal completion expected shortly Announced three further successful bidders 22 March 2013 ▪ Market Invoice (£5m): invoice finance platform ▪ Urica (£10m): supply chain finance provider ▪ Beechbrook Capital (£17m): direct lending fund

It is too early to estimate the full impact of the Business Finance Partnership against its objectives. A monitoring and evaluation plan is in place and an early assessment of the scheme will take place 1 year – 18 months after commencement of lending, with a more comprehensive evaluation in the second year of lending.

In order to address the challenges arising from the lack of diversity of supply, in April 2013 a £300m Investment Programme was launched as the first new programme initiated under the Business Bank banner. The programme was designed in consultation with the Advisory Group to give the Department a wide range of investment powers. Whilst the Business Finance Partnership focused on non-bank lending channels, the Investment Programme has a wider remit, with opportunities to invest in equity and debt in financial institutions, debt funds, asset backed lenders and other non-bank channels such as supply chain finance, peer-to-peer lending and other platforms. Investments in capital of smaller financial institutions will need to be carefully considered with reference to risk and also the potential to increase SME lending. We advise that external due diligence is acquired for such investments.

Since launching the Programme, the Business Bank team has received an encouraging number of early stage applications from a wide range of lenders - as of early June more than 50 expressions of interest had been received from a wide variety of lenders. The Investment Programme continues to remain open to new proposals and we expect to receive further proposals in the coming weeks and months.

Governance arrangements for the assessment and approval of investments made by the £300m Investment Programme have been established to ensure that investments made are aligned to the Investment Programme's objectives and appropriate allocations are made. An Investment Committee will make investment recommendations and will comprise both non-remunerated external members with relevant business finance experience and Government officials with responsibility for the business bank initiative. HM Treasury will have observer status on the Investment Committee.

Consideration has been given to the external members of the Investment Committee to ensure that members have a balance of business and finance experience in areas where proposals are expected to come from, including lending funds, challenger banks and asset based finance.

We recommend that the Investment Committee for the new Investment Programme should include a representative of CfEL to ensure consistency with existing programmes.

4. Proposed enhancements to existing interventions

Existing interventions make up about £2.9bn of funds committed by Government, and in the autumn Government committed £1bn of new money. This new funding can either go into boosting or adjusting existing schemes, or can be used for new innovative schemes.

All existing schemes address one of the following market failures:

1 Early stage equity investment - caused by cost of assessing business proposals and risk aversion: Business Angel Co-Fund, Enterprise Capital Fund Programme (ECFs, VC Catalyst Fund)
2 Restricted lending to smaller and less established firms: core EFG and Start-Up loans
3 Lack of diversity of supply: BFP, Business Bank Investment Programme

4.1. Enhancements to equity schemes

The current equity programmes tend to address seed capital and early stage needs. For example, the funding rounds for developing tech companies are referred to as “seed” and series A”, “series B” and “series C”. The Business Angel Co-Fund and some of the ECFs do seed funding, while the significant majority of ECF money goes into Series A rounds of funding.

ECFs are unable to support Series B and C funding rounds, due to their limited capital and also State Aid restrictions, with the risk that businesses are sold early because the funds cannot take companies through to the optimal exit point (IPO or significant trade sale of a business with products, employees, customers and robust cash flows).

An oft-cited example of an optimal exit is Cambridge Silicon Radio (CSR), a great UK success, which was able to float, but only after about £50m of venture support through multiple rounds. Analysis conducted in early 2013 indicates that there may be a more systemic gap in the provision of Series B and C funding which means that success stories like CSR risk are becoming increasingly scarce.

Series B and C funds are increasingly struggling to raise money from institutional investors, because of historic poor aggregate performance (due to the dot.com bubble and recent economic environment), reinforced by prudential regulation and the illiquidity of the asset class. European Venture Capital Association (EVCA) data shows that in 2011 across Europe £1.9bn was raised for early stage venture capital, significantly below the £3.6 billion raised in 2007. For later stage VC the equivalent figures were £1bn in 2011 compared to £1.4bn in 2007. Only a small proportion of this translated into final closings for funds, with £0.8bn for early stage venture capital in 2011 compared to £2.4bn in 2007.[4]

[4] http://www.evca.eu/uploadedfiles/home/press_room/Yearbook_2012_Presentation_all.pdf

Without adequate availability of Series B and C investment, there are risks that businesses are under capitalised at each stage of their development, constraining the development of new technologies, products and services, or that they are sold too early meaning that technology could move abroad rather than contribute to long-term economic growth in the UK. This is particularly a risk as trade sales, rather than IPOs, are now the main exit route open to early stage companies.

Larger ECFs with higher investment limits will allow the Business Bank to do more Series A and, potentially, some Series B investments, but State Aid restrictions on follow-on investments would prevent them going any further. We are seeking State Aid approval for an increase from £2m to £5m for the initial investment funding round size limit per firm and an increase to the total Government contribution to an ECF fund from £25m to £50m to at least be able to do some follow-on investment and continue to support the Series A stage.

Many EU states, such as Finland, Norway, France, Denmark, Belgium, and Italy have investment programmes through which they invest pari passu with other investors in later stage venture funds because their Governments recognise the returns to their economies are enhanced by the adequate funding of the commercialisation of innovation. The only example in the UK is the UK Innovation Investment Fund, a £330m fund of funds investment in four strategically important sectors. However, this fund is largely committed at the underlying funding level and many other funds are struggling to raise funding or will do so when they come back to the fundraising market.

The VC Catalyst Fund will allow the Business Bank to help some of these, but could potentially be scaled up in order to make investment available for a greater number of companies. Intelligent investment of a discretionary pool of capital into Series B/C funds (i.e. avoiding the mistakes of the past and backing high-potential managers) could therefore have a significant return.

4.2. Enhancements to debt schemes capital for smaller and less established firms - EFG extensions

4.2.1. EFG Trade Credit variant

In April 2013, an EFG Trade Credit variant was launched, initially available to trade customers of Kingfisher plc through their network of B&Q and Screwfix stores. Other providers are coming on board. The Government guarantee provides confidence to the trade credit provider to extend credit to viable businesses outside their existing risk appetite, as well as increasing credit limits to existing customers. As with the core EFG scheme, the Government exposure is capped at 20% of a lender’s portfolio; however the fee is 1% per month on the value of outstanding EFG facilities, so higher than for the core EFG (which is 2% per year). Initial evidence from this pilot will be available in October 2013.

As of the end of May 2013, £0.5m worth of facilities were accepted, with a further £0.3m approved and awaiting acceptance from the customer. Over 20 trade credit providers from a range of business sectors were invited to express interest in participating in the scheme, with negotiations ongoing with a number of those.

4.2.2. Unsecured EFG

Banks generally provide loans of less than £25,000 on an unsecured basis with the majority relying on automated credit scores. Whilst the core EFG scheme can support lending under £25,000, it is principally designed to support higher value loans which are secured. Currently it is uneconomic for the banks to use EFG to provide high volume, low value facilities. The Business Bank team, alongside one of the major banks, are developing a pilot scheme aimed at facilitating lending to viable businesses currently being declined loans due to failed credit scores. The aim is to increase lending by £5-10m for each participating bank. The pilot is scheduled to start in the summer. The unsecured market is a much smaller part of the market (£2.1bn out of £19.2bn total gross lending in 2012), but could make a significant difference for smaller SMEs in terms of volume.

As is the case with the core EFG, a portfolio cap would apply for each bank. Unsecured debt by nature presents a larger loss given default than secured funding and therefore work would have to be done to price the risk accordingly. Based on monthly returns, we would expect to evaluate initial data within six months of launch. The pilot would cover capacity equivalent to around £10m of core EFG lending.

5 Potential new interventions

A number of the market problems which have been identified are not dealt with by either macroeconomic interventions such as FLS or the suite of microeconomics interventions run by BIS and HMT. Notably these include interventions to deal with capital constraints and interventions to increase the supply of long term finance and unsecured lending.

5.1 Solutions addressing bank capital constraints on lending

These solutions are designed to increase the effectiveness of capital backing SME lending, given the capital constraints discussed in section 2.2.5. The provision of guarantees on mezzanine tranches of SME securitisations reduces the risk retained by the originator and releases regulatory capital for the lender, increasing the rate of return on the SME portfolio. Without any further measures, the lenders would be free to recycle this capital relief as they wished. However, this benefit is offset through a premium charged for the guarantee, the level of which is set in such as way as to incentivise lenders to use the freed-up capital for additional SME lending, targeting segments of lending where current provision is less. Solutions of this nature may help improve diversity of supply, as it could help challenger banks and other non-bank lenders use their capital more efficiently.

This is the model used by the European Investment Fund, the sister company of the European Investment Bank. Distribution is through existing lenders. In order to carry out transactions of the nature described in this section detailed credit assessment on the SME portfolios would need to be carried out to judge the risk being taking on. This model requires similar skills to the provision of direct guarantees through the EFG, although the size of exposure is greater and risk analysis therefore becomes even more important.

There are a number of regulatory issues that would need to be addressed in relation to this intervention. The European Commission would require assurances that any benefit to the lenders under these schemes is minimised and the pass though of benefits to SMEs can be monitored clearly.

Another potential intervention which addresses funding rather than capital issues is a sponsored leasing vehicle, which purchases leases from smaller non-bank lenders and markets financial instruments to outside investors to fund the leases. Smaller non-bank lenders do not have the capacity to access securitisation markets themselves, and banks have been withdrawing their funding lines due to balance sheet clean-up post crisis. Whilst the recent FLS extension may temporarily help address this problem, a more permanent solution is required. The investor would keep the mezzanine tranche of the notes, and the senior notes would be marketed to private sector investors. The vehicle could fund up to around £400m of leases from multiple originators. The Business Development Bank of Canada runs a similar scheme.

5.2 Long term finance and unsecured lending

Market analysis has shown that companies wanting to expand, for example by offering new products, sometimes struggle to obtain finance. The finance they require is often longer term and therefore riskier or requiring more capital to be held by the lender.

The Business Bank team is assessing the potential to support high growth firms with additional products. Whilst there is no single model, mezzanine finance is a form of debt which shares some characteristics of equity to reflect the higher risk associated with this finance. The aim would be to address the perceived funding gap for growth companies that cannot access, or are unsuitable for, senior debt finance but do not have the higher growth potential necessary to attract venture capital funding. By its nature, such funding is likely to be longer-term as it will classically demonstrate some forbearance of capital and interest repayments.

There are some precedents in the markets which the Business Bank team is researching in more detail, set out in the table below. Other countries, for example Oseo in France and KfW in Germany and a number of other national development banks offer mezzanine products and we have analysed the structure of their mezzanine product. In principle, the product is debt, but is unsecured, is junior and features a generous repayment period.

ICFC (3i)	Until the early 90s, 3i had a regional infrastructure putting money to work in just this segment, constructed as loans but with upside, often in the form of minority shareholdings
Some banks and funds in the 90s	e.g. Uberior, Industrial Mezzanine Fund, CBGC, all put “loans with kickers” to work, some very successfully
Substitution with senior debt	A number of VC funds were losing out to banks for deals in the early and mid 2000s. Banks have admitted they were lending aggressively on the back of asset values, rather than underlying business dynamics. Post 2007, bank behaviour has needed to change and that, with developing regulation, will likely prevent a repeat of such lending
Business Growth Fund	Rowlands Review suggested the need for mezzanine-type finance and banks created BGF - but BGF takes minority equity stakes in (larger) growing businesses. It does not “lend” in order not to compete with its shareholders. The “Rowlands Gap” therefore continues to exist
Capital for Enterprise Fund “A”	A mezzanine fund (loans with kickers) launched in 2009 with serious constraints built a solid portfolio in 1 year and performance looks very positive – suggesting strong potential dealflow
Scottish Loan Fund	Appears to be performing well with a similar product to CfE Fund “A”
Signs of increasing market activity	Santander “Breakthrough” loans. Kreos and SVB back in the market for “venture debt”

Mezzanine finance can either be provided through guarantee programmes where Government takes the risk on some of the more junior components of a mezzanine product, or through direct funding of a more junior tranche in collaboration with lenders. A very different option would be on-lending not through intermediaries, but directly by the Business Bank, for example either in dedicated regional offices, or using existing intermediaries’ infrastructure to distribute Business Bank products.

6. How should Government organise its interventions?

Even if schemes provide good value for money for the taxpayer and encourage economic growth in theory, real benefits will only materialise if implementation is done properly. Credible decisions need to be made on how these schemes should be organised and delivered, both in terms of overall size and method of distribution of Government funds. Government also has to establish its own risk appetite, and the degree to which it is willing to take on risk/share risk with private sector investors. State aid considerations also need to be taken into account.

The sections below set out the different options.

6.1. Continuation of the status quo

One option would be to rely on existing macroeconomic schemes such as FLS and tax schemes such as EIS/VCT for a general stimulation of UK finance markets, combined with accommodating the management of schemes for the additional £1bn of capital in CfEL. The advantage of such an approach would be continuity and lower set up costs and efforts.

The creation of Capital for Enterprise Limited as a delivery organisation a few years ago has already made a very positive contribution to improve Government activity in the business finance markets. For example, it runs highly regarded equity schemes and is regarded as the centre of expertise in Government for those types of products; and CfEL also runs the key debt product, the Enterprise Finance Guarantee.

However, currently CfEL is an organisation which is more limited than the Business Bank is intended to be, where the major decisions on design of schemes and questions on the allocation of resources need to be referred to ministers. Its operating freedoms are narrowly prescribed and it does not have any of the Government's assets or liabilities on its own balance sheet. As a result, CfEL has not had to develop asset and liability management, treasury management or full blown risk management. Likewise it clearly has significant, but not comprehensive, market intelligence and product design capabilities. In its current state, CfEL provides a good foundation from which to build upon in the development of the Business Bank.

The disadvantage of relying on macroeconomic schemes is that they tend to be temporary when there is a need to boost large parts of the economy. Their impact is broad and they are seldom focused on specific enough customer or product segments to address particular market failures. The FLS is temporary and addresses issues of funding capacity and cost of funding for banks. Banks may still choose to direct their capital to other types of lending over SME lending due to the profit characteristics and capital requirements of SME loans.

6.2. Creation of an independent Business Bank working through intermediaries

The Business Bank should have a strong policy function to design and implement schemes across the lifecycle of SMEs and mid-caps, and change them as and when market gaps and the economic environment changes. It should be positioned at arm's length from Government but operate within a framework set by Ministers.

It should encompass <u>all</u> the capability in CfEL for managing existing equity schemes and debt guarantees and should consolidate a number of schemes currently managed elsewhere (including the Treasury BFP tranche, the £300m Investment Programme).

We recommend that the full delivery capability of CfEL should be retained within the new Business Bank and that therefore the Business Bank' headquarters should be in Sheffield, reflecting how critical it is that this be a regionally based organisation.

A number of new functions, for example an expanded market analysis team, a risk management team and a more extensive financial management team, as well as an enhanced governance framework, will be required to manage these schemes professionally. Private sector experts will need to be hired to staff the Business Bank. The Business Bank should have its own brand identity independent of Government, and work closely with the market, whilst still being governed by its overarching public policy objectives plus a financial return expectation.

The formation of the Business Bank should also present an opportunity to create a focal point for increasing confidence in the SME finance markets.

The Business Bank over time should build financial freedom, and be able to re-allocate resources between schemes as it sees fit. It should be able to recommend schemes, and stop operating schemes when they are not addressing proven market gaps. This provides a good balance between operating under public sector objectives, but in a way that is as commercial as possible. Whilst this institution will have the ability to create new schemes, it should have a strong focus on building and developing the schemes that are currently in place. The bank will require analytical functions that will be needed provide a strong rationale for any new interventions it creates if it decides they are necessary to plug gaps in the market.

Gaining state aid approval for the Business Bank will take 12 months or more. However, we believe that the broader capabilities of the Business Bank should be established now within Government before state aid approval.

6.3. Creation of an Independent Business Bank with direct lending and potentially direct distribution

All existing Government schemes are delivered through intermediaries and rely on creating either enhanced incentives for positive credit/investment decisions or additional funding capacity to catalyse new activity. Experience of schemes such as ECF and EFG suggests that this approach can be effective although it is possible that

there are natural limits to this strategy. For example, it is possible that the profitability of a specific type of SME lending activity is so poor that banks effectively withdraw from its provision or the distribution channels of the intermediary banks do not include the relevant credit assessment capabilities.

In these circumstances, a Business Bank could decide to lend directly to SMEs. It could do this through the distribution channels of existing banks (ensuring that appropriate incentives were in place to sell its products) or it could distribute these products directly through its own channels. Such a model would be the most ambitious in terms of reaching the target audience directly and would ensure that schemes can be very precisely targeted and marketed.

International models use this approach to different extents. For example, the French and Canadian national business development banks lend directly through their own regional offices. The Germans effectively lend directly but do so by providing attractively priced funding for specified products through partner banks. These banks focus on the provision of direct longer term finance to SMEs as well as start-up and early stage finance to entrepreneurs. Subordinated unsecured finance offered in partnership with senior secured finance from a partner bank is a central element of their offerings.

On the other hand, direct lending means that the Business Bank could be seen to be competing directly with private sector lenders, and therefore risk "crowding out" effects. The Business Bank would need to develop its own credit assessment capability if it did not rely on a partner for this function and implementation would be lengthy and potentially cost prohibitive if the distribution channels were set up from scratch. The Business Bank would take more risk onto its own balance sheet and leverage of private sector funds through direct lending would likely be more limited.

6.4 Conclusions

At this stage of development, we believe that the option set out in 6.2 above is the most pragmatic approach to developing the Business Bank, building on existing capabilities but augmented with additional and operating with greater impact.