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Department for Business Innovation & Skills

Financing a private sector recovery

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Financing a private sector recovery

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the Secretary of State for
Business, Innovation and Skills
by Command of Her Majesty

July 2010

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Foreword

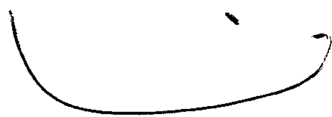
Making sure the financial system delivers for business is central to our ambition for growth. Unlike the flawed model of the past, we cannot again become over-reliant on unsustainable increases in household or government debt or base our prosperity on a housing bubble or under-priced debt. Instead we need a recovery led by sustained expansion in the private sector, and in particular through a growth in business investment, seizing the opportunities presented by a recovering global economy.

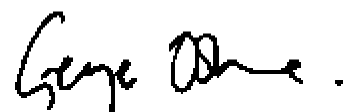
At the heart of this challenge is ensuring stable financial conditions for business. The Coalition Government has taken decisive action to tackle the fiscal deficit, which is the first priority for restoring business confidence. But businesses also need sustainable and secure sources of finance for investment.

Small and growing businesses are a vital part of the economic recovery. In the past they have been reliant on an over-leveraged banking sector, which has contributed to economic boom and bust. To address this matter the Government has set up an Independent Commission to investigate ways of improving stability and competition in the banking system. We are determined to work towards a more competitive and transparent banking system that serves better the interests of its customers.

We also want to ensure that, within a more stable financial system, businesses have access to a more diverse range of sources of finance that suits their needs. This paper therefore explores a broad range of options, including (among others) trade finance, the role of non-bank institutions, corporate debt markets, and securitisation.

This discussion document sets out lessons learnt from the past and some of the challenges ahead. We would like to encourage businesses, investors and lenders to participate in this consultation, as it will inform the Government's future response to the issues raised.





Vince Cable

Secretary of State for Business, Innovation and Skills

George Osborne

Chancellor of the Exchequer

1 Introduction

1.1 Access to sustainable finance is essential if businesses are to invest and grow. As the economy recovers, it is crucial to ensure that the supply of finance supports rather than constrains demand and business confidence.

1.2 Businesses need finance for both working capital and investment purposes. All firms make use of internal finance, such as retained earnings and cash-flow; many will also need to draw on external sources of finance such as bank lending, equity finance or corporate debt. This paper considers the range of finance options available to businesses of different sizes, and the extent to which market failures may constrain access to finance for some businesses.

1.3 If businesses are to play their part in promoting economic recovery, it is important that they are able to make optimal financial decisions in a stable macroeconomic environment. This paper explores the impact the financial crisis has had on the availability of finance for businesses, and the extent to which current challenges are transitional or structural. It also considers whether there are risks to the future provision of finance that should be addressed now, so that an appropriate range of business finance is available for viable businesses as the economy recovers. The Government stands ready to act if conditions require it, and this paper seeks views within a compressed consultation period to help inform the Government's assessment of, and response to, this important challenge.

2 Current context

Over the last decade, economic growth in the UK has been driven by rising private and public sector debt. Businesses, households and the financial sector have become increasingly indebted. By 2008:

- the household saving ratio had fallen to the lowest level since the 1950s, with household debt[1] reaching 100 per cent of GDP;
- despite the business sector continuing to be a net saver in the run up to the recession, corporate debt as a share of GDP had risen to over 110 per cent.
- easy credit access and rapidly increasing asset prices meant that UK banks entered the recession with loans to the UK commercial property sector accounting for almost half of all the outstanding loans to UK businesses; and
- the accumulation of debt within the financial sector was even greater. Between 2002 and 2007, there was a near tripling of UK bank balance sheets and the UK financial system had become one of the most leveraged in the world.

2.1 These imbalances were reflected elsewhere in the economy. The output of the financial sector relative to that of other sectors rose[2]. Government spending, partly financed through increased public debt, also generated a greater proportion of growth, while the non-financial business sector contributed less[3].

2.2 This reliance on public and private sector debt meant that the UK economy was hit hard by the financial crisis. The loss of confidence that accompanied a sharp tightening in credit conditions, combined with weak demand for exports as the credit crunch affected major trading partners, resulted in the UK's longest and deepest recession since WWII. The peak-to-trough fall in output (from the first quarter of 2008 to the third quarter of 2009) was more than 6 per cent, and 850,000 people became unemployed since the start of 2008. Business investment fell sharply by more than 25 per cent from its peak.

2.3 Financial institutions facilitated the build up of unsustainable levels of household and corporate debt in many countries. At the same time there was a huge growth in debt and risk within the financial system. Globally, low long-term interest rates encouraged a search for higher yielding assets, resulting in excessive risk-taking by financial institutions and a rapid growth in the use of complex and inadequately understood financial products.

2.4 In many cases, bank boards and their investors failed to understand the risks inherent in banks' business models. At the same time, regulation failed to keep pace with financial

[1] Specifically, gross interest-bearing liabilities – the sum of loans and securities other than shares.

[2] To note that there are major methodological difficulties in measuring the output of the financial sector; see, for example, http://www.bankofengland.co.uk/publications/speeches/2010/speech442.pdf. A European taskforce has been established to examine these issues and is due to report before end 2011.

[3] Between 1997 and 2007, government consumption increased from 18 per cent to 21 per cent of GDP, while business investment fell from 11¾ per cent to 10 per cent of GDP. Financial services output grew on average by 6 per cent and manufacturing output barely grew at all.

innovation and therefore failed to properly constrain bank risk-taking. Moreover, excessive rewards within the financial system blunted the incentives for banks to manage their risks.

2.5 Many banks increased their debts relative to their capital during the credit boom, leaving them with a limited buffer to cover losses. They also increased their reliance on short-term wholesale funding, making them vulnerable to any disruption in funding markets. This unsustainable increase in risk-taking by financial institutions, and the consequent growth in the size, complexity, and opacity of the financial network, increased the vulnerability of financial institutions to a change in market sentiment and the risk of markets freezing up in times of stress.

2.6 There are many international examples of previous financial crises. The US savings and loan crisis began in the early 1980s and reached a climax in 1989 with the failure of hundreds of small banks. Sweden experienced a financial crisis and subsequent recession in the 1990s. In Japan, the unwinding of an asset price bubble in the late 1980s ultimately led to the failure of several of its main banks in 1997. All these cases involved substantial state intervention and a subsequent re-shaping of financial sector regulation, as has been seen in the most recent crisis.

2.7 Banks across the world now face a significant refinancing challenge, but they have already made good progress in raising funding. The scale of the adjustment needed is substantial, however, and banks will need to maintain a steady flow of long-term issuance while, where appropriate, restructuring their balance sheets. Non-financial businesses and households have also begun the process of reducing their levels of debt. Both the household saving ratio and the net financial balance of the corporate sector rose sharply in the recession, and businesses are continuing to adapt to a changed environment and to greater uncertainty by cutting costs, reducing investment, building up cash reserves and reducing reliance on bank borrowing.

Fiscal Consolidation

2.8 It is important that, as the recovery strengthens, the mistakes of the past are not repeated. The right macroeconomic conditions are central to underpinning a recovery that is more balanced across industries and regions, and between the public and private sectors.

2.9 Unsustainable fiscal policy would derail the recovery by increasing uncertainty and raising the overall cost of investment. Recent developments in the euro area have shown the extent to which a lack of confidence in a country's ability to meet its debt obligations can destabilise financial markets. It can also lead to increased risk aversion on the part of investors. This can in turn weaken the ability of banks to restructure their balance sheets and support increased lending as demand picks up.

2.10 This adds to the strong case for accelerated fiscal consolidation, which has the potential for generating positive indirect effects. These include the retention of an expansionary monetary policy for longer and a positive reaction from the bond markets, which will keep long-term interest rates lower than they would have been otherwise. Fiscal consolidation can also boost private sector confidence and spending. Reassuring the private sector that concrete measures have been put in place to limit the rise in Government debt could prompt households and companies to increase consumption and investment.

2.11 At the June Budget, the Government set out a comprehensive set of policies to bring the UK public finances back to a sustainable position. This action has already helped to keep long-term interest rates close to record lows and will help to keep market interest rates lower for longer, supporting economic recovery. There has been renewed activity in UK corporate bond markets recently, aided by the UK's clear path of fiscal consolidation.

Lending and Economic Recovery

2.12 The independent forecasts provided by the Office for Budget Responsibility in June suggest that the recovery is currently underway. Its central scenario is one where strong growth in business investment and exports lead to a stronger and better balanced economy over the coming years.

2.13 There are risks to this outlook, including the extent to which regulatory change and bank balance sheet restructuring (both in the UK and globally) mean that the supply of finance fails to keep pace with reviving demand as the economy recovers.

2.14 The ready availability of cheap credit before the crisis in part reflected a mispricing of risk. This is not a situation the UK should return to, and the Government is addressing, domestically and with international partners, the inappropriate incentive structures and risk practices in the banking sector that contributed to the financial crisis. Households will need to reduce their reliance on debt at the same time as the public sector consolidates. Credit will cost more and it will be more carefully allocated.

2.15 However, it is important to ensure that this adjustment process does not overshoot. The ability of businesses to access finance will play a key part in determining the shape and sustainability of the recovery. The Government is determined that viable businesses should have access to affordable finance for working capital and profitable investment opportunities.

The UK Banking Sector

2.16 Recent months have seen significant stress in financial markets. In April, concerns over Greek sovereign risk spilled over to other European countries, developing into a generalised increase in risk aversion and strains in funding markets. The International Monetary Fund (IMF) and European authorities put in place a package of support measures in response. These have stabilised market conditions but confidence remains fragile.

2.17 UK banks have strengthened their resilience over the past year. Capital has increased significantly, and leverage has fallen. This has primarily taken place through improvements in banks' own financial position, partly as a result of liquidity injected into the system by the UK and other governments. However UK banks, like their peers in Europe, continue to face significant challenges. They need to remain resilient in a difficult environment, while refinancing significant amounts of funding in the coming years.

2.18 The Government strongly supports the work of central banks and regulators to strengthen the Basel international standards on capital, liquidity and leverage for banks. These reforms are vital to safeguard future financial stability and increase the resilience of the UK economy.

2.19 It will be important to ensure that these reforms strike the right balance between enhancing financial stability while supporting strong and sustainable economic growth. Recent work[4] drawing on pre-crisis evidence suggests a causal link between bank capital and lending. Constraints on bank capital have an adverse impact on lending to higher risk businesses, with banks favouring lower risk household loans instead.

2.20 The Bank of England's recent Financial Stability Report (FSR)[5] notes that there is scope for banks to build capital while sustaining lending to the real economy. The FSR estimates that if UK banks limited bonus and dividend payouts to pre-crisis and 2009 levels respectively, the major

[4] *Working paper No.387 Shocks to bank capital: evidence from UK banks at home and away*, March 2010, Bank of England
[5] *Financial Stability Report*, June 2010, Bank of England

banks could generate around £10 billion of additional capital over 2010, which could in turn sustain £50 billion new lending.

2.21 Implementation will also need to be phased-in carefully, particularly in light of ongoing market fragility and the bank refinancing challenge outlined elsewhere in this document. The Basel Committee, in conjunction with the Financial Stability Board, has been working to gather the views of stakeholders on the reform proposals, to assess the cumulative quantitative impact of the reforms and to design appropriate transitional arrangements. The UK authorities are fully engaged in these processes, as well as working with the industry to understand the impact on UK banks and their customers.

2.22 Emerging evidence suggests that the reforms, if appropriately calibrated, will bring net economic benefits in the long run by increasing financial stability, while the impact on lending in the transition can be managed if reform is appropriately phased. The Financial Services Authority (FSA), for example, found that even for quite significant increases in regulatory standards, the benefits for the economy in terms of greater financial stability and lower incidence and pervasiveness of financial crises will outweigh the costs[6]. Banks will also benefit from stronger regulatory standards, as financial markets will reward safer banks with lower funding costs.

2.23 UK banks have already taken steps to enhance their resilience and prepare for the stronger regulatory requirements that will apply in future by raising capital and retaining earnings. Banks earning large profits should, where appropriate, continue to treat the conservation and enhancement of capital as a higher priority than bonus or dividend payments.

2.24 The Government recognises the crucial importance of giving full clarity to markets on the design and implementation of the new standards as soon as possible. The Government therefore believes it is vital that the G20 meets its commitment to agree on a new prudential framework by the time of the Seoul Summit, and will work with international partners and with the Bank and the FSA to this end.

2.25 Uncertainty over changes in tax can also be damaging to market confidence. The corporation tax roadmap outlined in the June Budget was a good example of the Government providing certainty over change, allowing businesses and markets to plan and adjust rather than simply react to assumptions.

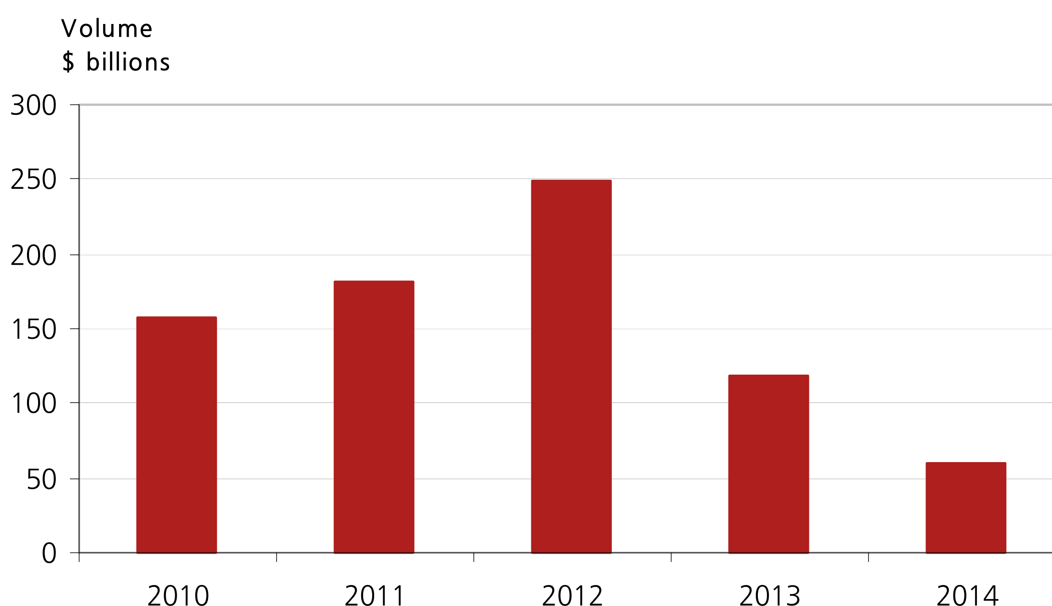
Challenges for Business

2.26 As the economy emerges from recession, UK businesses face a challenging environment. Many face uncertain demand prospects in both UK and overseas markets. Access to appropriate finance will be key to ensuring that businesses are able to survive and expand.

2.27 Many businesses face a significant refinancing challenge over the coming years, as older loan deals expire and new deals are negotiated to replace them. The level of refinancing by businesses is expected to peak in the next three years, which reflects the large amount of 5 year debt issued in 2007 and 3 year debt issued in 2009 (see Chart 2.1, which shows maturing loan volumes of European, Middle East and African investment-grade companies).

[6] For example, see *DP09/4: Turner Review Conference Discussion Paper*, April 2010, Financial Services Authority

Chart 2.1: EMEA maturing investment-grade loan volumes



Source: Thomson Reuters LPC / DealScan

2.28 The refinancing risk faced by businesses varies by size and sector. There are groups such as commercial property companies and leveraged buyouts that may face a greater challenge renewing their debt as pre-crisis bank loans expire. These companies are, on average, highly-leveraged.

2.29 The impact of refinancing risk on large corporates is likely to be mitigated due to their access to alternative sources of finance – many large corporates refinanced in 2009 in the capital markets and should not need to return for some time.

2.30 There are arguments on both sides as to whether the refinancing challenge faced by corporates will materialise as a serious problem at an aggregate level. Banks have an incentive to roll over facilities in the medium term rather than force repayment and bear immediate losses on their capital, and have shown forbearance in many cases since the start of the financial crisis. Businesses are generally aware of the risks and have looked to refinance early where possible, build up cash buffers and pay down debt.

2.31 Nonetheless, certain sectors appear vulnerable. Small and medium-sized enterprises (SMEs), in particular, may face more of a challenge given their reliance on bank lending, and the fact that they have historically faced greater challenges accessing external finance. The question of whether the existing set of Government schemes is sufficient to ensure that finance is available to SMEs as confidence recovers and demand revives, is of central importance.

3 Financing options

3.1 All firms rely on internal finance – cash flow and retained earnings – to provide working capital and support investment. Government support such as HM Revenue & Customs' Time to Pay scheme, which allows viable businesses experiencing temporary financial difficulties to spread their tax payments over an agreed timetable, can help firms manage their cash flow more effectively. Many firms also require external sources of finance. A firm's financing requirements can vary according to its size, growth intentions and wider economic conditions.

3.2 This chapter sets out the finance options open to different sized firms and evidence of current conditions in business finance markets. It also explains the Government schemes currently in place to help businesses access the finance they need.

Overview of Financing Options Open to Different Sized Businesses

3.3 The financing options open to businesses vary by firm size, although the investment quality of an individual business is also clearly a crucial factor. In general, larger firms experience fewer problems in accessing finance than smaller firms. SMEs, in particular, suffer from long-standing challenges in accessing bank and equity finance, and have therefore historically been the main target of government action.

3.4 Table 3.1 below summarises the external financing options open to SMEs, mid-sized companies and large companies.

Table 3.1: Financing options open to different sized firms

	Definition (turnover)	Bank lending	Equity markets	Private placements	Bond markets
SMEs	Under £25 million[1]	Yes	Limited	No	No
Mid-sized companies	£25 million to £500 million	Yes	Limited	Limited	No
Large companies	Above £500 million	Yes	Yes	Yes	Yes

[1] There is not a single definition for an SME. The European Commission, for example, defines SMEs based on a combination of turnover, employee headcount and total size of a firm's balance sheet. For simplicity, the definition used here is based purely on turnover.

Small Businesses (SMEs)

3.5 A dynamic, growing SME sector has the potential to make a significant contribution to economic growth. SMEs are a vital part of the UK economy. There are around 4.8 million businesses in this category (99.9 per cent of all UK businesses), accounting for over half of private sector employment and turnover.

3.6 SMEs have generally experienced greater difficulties than their larger counterparts in accessing finance primarily due to the higher risk they represent, especially those without a significant credit history or track record.

3.7 Around a third of SMEs do not use formal sources of external finance at all, relying instead on retained earnings or personal finance to fund investment and growth. Those SMEs that do seek external finance are almost entirely reliant on banks, in the form of bank loans, overdrafts or other working capital products such as invoice discounting or factoring. Only around 2 per cent of SMEs use external equity as a source of finance[2].

3.8 The barriers preventing some viable SMEs from accessing finance include the following:

- bank lending: lenders struggle to assess the viability of a loan to some SMEs lacking a sufficient track record or security. To assist these businesses, the Government has had in place since 1981debt guarantee schemes of varying shapes and sizes, first the Small Firms Loan Guarantee scheme and then from January 2009, the Enterprise Finance Guarantee (EFG). . To ensure that more businesses have access to credit as the economy recovers, the June Budget announced an extension of £200 million to the Enterprise Finance Guarantee scheme this year, enabling additional lending of £700 million for around 7000 small businesses to 31 March 2011;
- equity finance: the cost of due diligence for private equity investors is more or less a fixed cost irrespective of the size of the deal. As a result, the tendency is to favour larger investments in later stage businesses at the expense of some viable SMEs with high growth potential. Recent research[3] suggests there is an 'equity gap' for the majority of SMEs seeking equity finance in the range of £250,000 to £5 million, which is below the minimum investment level most private sector funds are willing to consider. In the case of sectors requiring complex research and development or large capital expenditure, the upper boundary of the gap may extend up to £15 million. This is likely to impact most on innovative businesses with high potential for growth. The June Budget announced the launch of a new Enterprise Capital Fund to provide an extra £37.5 million in equity finance to innovative small businesses with high growth potential, as part of a programme of similar funds. The Government has also invested in the UK Innovation Investment Fund, which is one of the largest technology Fund of Funds in Europe investing in growth areas such as life sciences, clean technologies, digital and advanced manufacturing. Finally, broader tax-based schemes like the Enterprise Investment Scheme and Venture Capital Trusts help to encourage equity investment in small companies; and
- growth capital: the Rowlands Review[4] identified a gap in the supply of finance of between £2 million and £10 million for established businesses looking to grow. The June Budget announced that the Government would create a Growth Capital Fund. This will address the Rowlands Review findings that, for some established SMEs, there

[2] *Finance Survey of SMEs,* February 2010, IFF Research (published by BIS)
[3] *The Supply of Equity Finance to SMEs: Revisiting the "Equity Gap"*, December 2009, SQW Consulting (published by BIS)
[4] *Rowlands Review: The provision of growth capital to UK SMEs*, November 2009, BIS

are gaps in market provision of growth capital, with this problem exacerbated by the recession.

3.9 There is evidence that smaller businesses undervalue the benefit of external advice, leading to an under-appreciation of the range of finance sources available to them. Findings from the Global Entrepreneurship Monitor survey[5] suggested that the inadequacy of investment propositions was the main reason why investors were unwilling to invest at the lower end of the equity market.

3.10 Despite these issues, the evidence suggests that the majority of SMEs seeking external finance can currently obtain some finance. Survey evidence from 2009 suggested that 78 per cent[6] of SMEs managed to obtain some finance from the first source approached. However, these companies may not have obtained all the finance they required and other survey evidence from 2009[7] suggests they may have funded themselves through sources such as credit cards or consumer overdrafts.

Mid-Sized Businesses

3.11 Mid-sized firms (sometimes referred to as 'mid-caps') are defined here as having a turnover of £25 million to £500 million. Although there are only around 10,000 companies in this category, they account for around a third of total private sector employment in the UK because of their greater individual size.

3.12 In the UK, mid-sized companies tend to be largely reliant on banks for external finance. Around 10 per cent use equity markets to raise capital and the largest 5 per cent are able to access debt capital markets as well[8]. The majority of firms are excluded from the wholesale corporate bond market, as the minimum issuance size is around £100 million to £200 million. Although smaller deals do occur occasionally, infrequent issuers are unlikely to be able to access the market at economic rates for small issues.

3.13 The private placement market for debt products such as bonds offers an alternative capital market channel. The Sterling market is currently small and confined to larger issuers. The US market is much more active, allowing firms to raise as little as $25 million. UK corporates regularly access the US market, but these tend to be large firms due to difficulties faced by mid-sized companies such as the fixed costs of issuance involved, a lack of familiarity with this form of finance and the difficulty in maintaining relationships with multiple investors. Firms with predominately UK businesses also face significant swap costs in converting dollar funding into sterling, making this market more attractive to corporates with US operations.

3.14 Although mid-sized firms have not been the target of explicit government support, this segment of the economy is significant in macroeconomic terms. Mid-sized firms tend to have reasonably long track records and comparatively sophisticated treasury functions, both of which help them to manage more complex financing arrangements and relationships. They also, however, typically lack the knowledge, scale and experience necessary to access debt capital markets. Feedback from market participants suggests that a lack of awareness among mid-sized firms has limited growth in these markets. HM Treasury and the Department for Business, Innovation and Skills (BIS) have been seeking to promote debt capital markets to diversify the sources of funding for mid-sized firms.

[5] *Global Entrepreneurship Monitor United Kingdom 2003*, January 2004, Rebecca Harding
[6] *Finance survey of SMEs*, February 2010, IFF Research (published by BIS)
[7] *Small firms in the Credit Crisis: Evidence from the UK Survey of SME Finances*, October 2009, Warwick Business School
[8] This is an HM Treasury estimate using data from the 2009 Finance survey of mid-cap businesses (published by BIS) and the Interdepartmental Business Register of all VAT-registered firms.

Large Companies

3.15 Large companies are defined here as having a turnover of over £500 million per annum. Although there are only around 760 firms of this size registered in the UK, they account for around a fifth of private sector employment. This category includes most FTSE 250 and FTSE 100 companies.

3.16 Large companies have direct access to the debt capital markets through private placements, commercial paper or corporate bonds. Most are also listed on the main equity exchanges and can easily access bank lending. They have had only limited problems accessing finance throughout the recession, compared with mid-sized companies and SMEs. When bank credit availability fell during the financial crisis, large UK corporates raised record amounts of debt and equity in the capital markets instead, using some of this to repay bank debt.

3.17 Large companies have, however, been affected to some extent by recent volatility in capital markets. The corporate bond markets closed temporarily in May this year as a result of sovereign risk fears in Europe, closing this source of finance for larger companies for a period. Market confidence in the sterling bond market has now returned, and there have been a number of issuances in July.

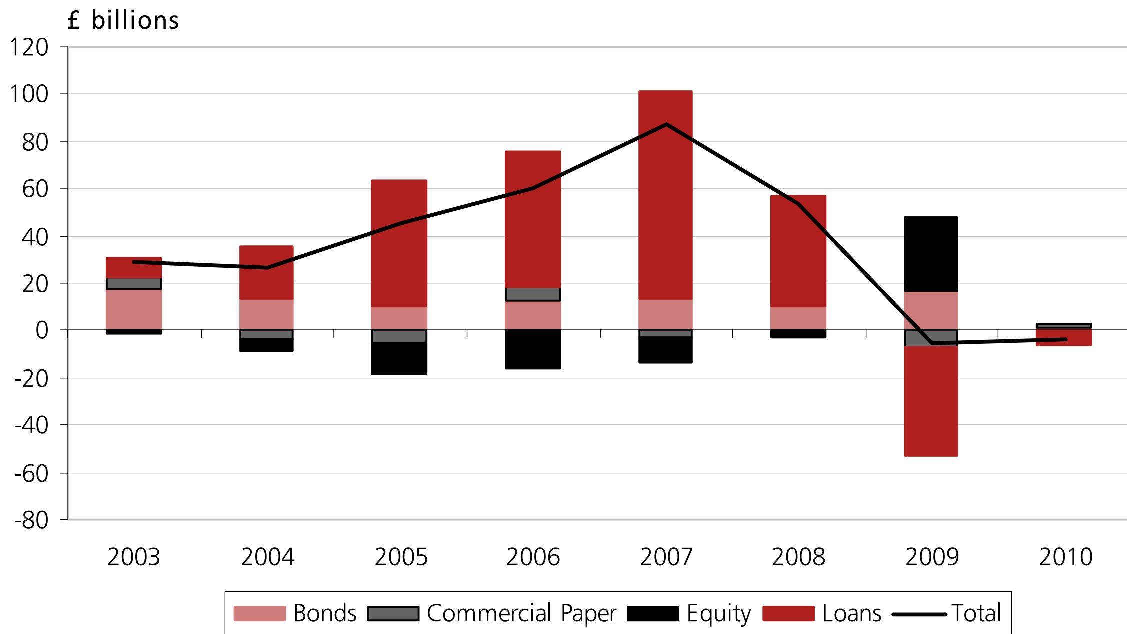
Overview of Different Types of Finance

Bank Lending

3.18 The extremely low price and easy availability of bank debt in the run up to the financial crisis contributed to the reliance of the corporate sector on this source of finance to the detriment of alternatives (that could not compete on pricing or ease of access). Bank debt is a relatively flexible source of finance and can be arranged much more quickly than bonds or equity. As a result, bank loans currently account for around half of the liabilities of non-financial corporates[9] and a much greater percentage for SMEs.

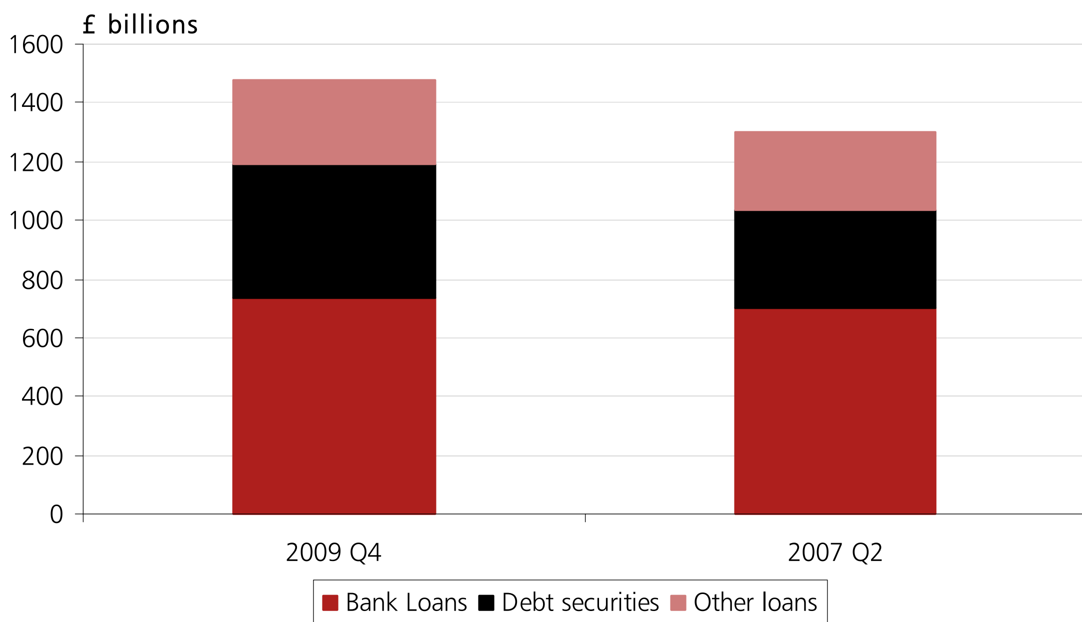
[9] Excluding equity and direct investment loans.

Chart 3.2: New financing for corporates



Source: Bank of England

Chart 3.3: Composition of corporate debt liabilities

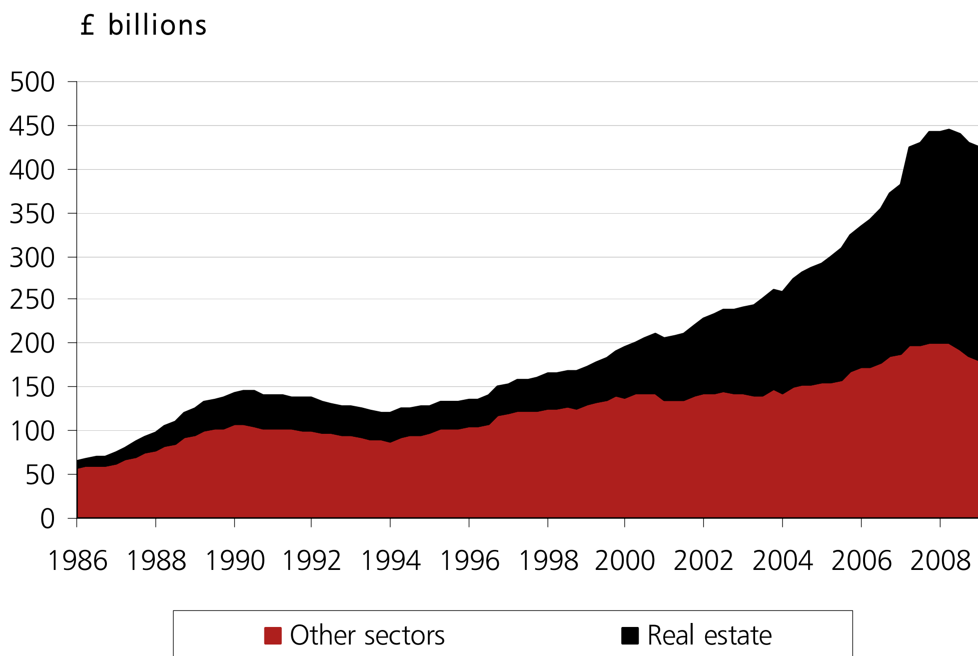


Source: National Accounts, ONS

3.19 Over the past decade the UK has seen an increase in lending to households and businesses, driven by a combination of forces. In particular, low global inflation meant that interest rates were consistently low and stable while advances in structured finance resulted in a lower price and increased quantity of private sector credit. Bank loans formed the bulk of the increase in business liabilities (see Chart 3.3), and the stock of loans to UK non-financial businesses more than doubled between 2002 and 2007. Much of this expansion in business

debt reflected activity in the real estate sector. UK banks entered the recession with loans to the UK commercial property accounting for almost half of all the outstanding loans to UK businesses, which in turn fuelled a rapid increase in asset prices in the UK (see Chart 3.4).

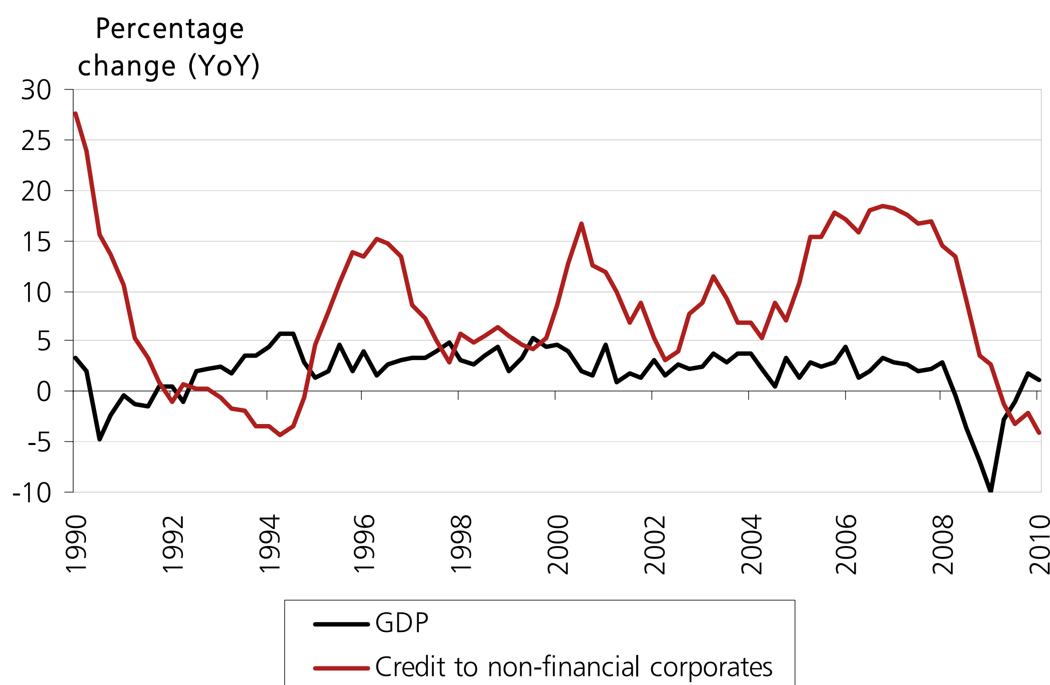
Chart 3.4: Growth in outstanding UK bank loans, split between real estate and other business lending



Source: Bank of England

3.20 Since 2008 net bank lending to UK companies has on average continued to fall, with debt repayments exceeding new lending. Demand for bank loans naturally declines during a recession as businesses cut back on inventories and capital investment, and build up cash reserves. In the 1990s recession for example, there was a swift decline in bank lending from its peak in 1990 until 1995, well after the revival in GDP growth in 1993. From 1995, as GDP growth continued, bank lending to businesses rose sharply.

Chart 3.5: Lending to non-financial businesses and nominal GDP



Source: Bank of England and ONS

3.21 The low interest rate environment has also allowed companies to make debt repayments, thereby reducing the volume of net loans outstanding. This is in contrast to the early 1990s recession when higher interest rates necessitated the payment of debt interest charges rather than allowed for actual debt repayment.

3.22 Although the absolute cost of bank lending has declined, the difference between the interest rate charged for new loans and Bank Rate or Libor[10] (the spread) has widened. The higher price of new bank lending as compared to Bank Rate may be explained by a combination of higher bank funding costs for banks and increased borrower credit risk. However, it may also reflect higher profit margins that could be used to repair bank balance sheets. This would be a cause for concern and a potential justification for Government action.

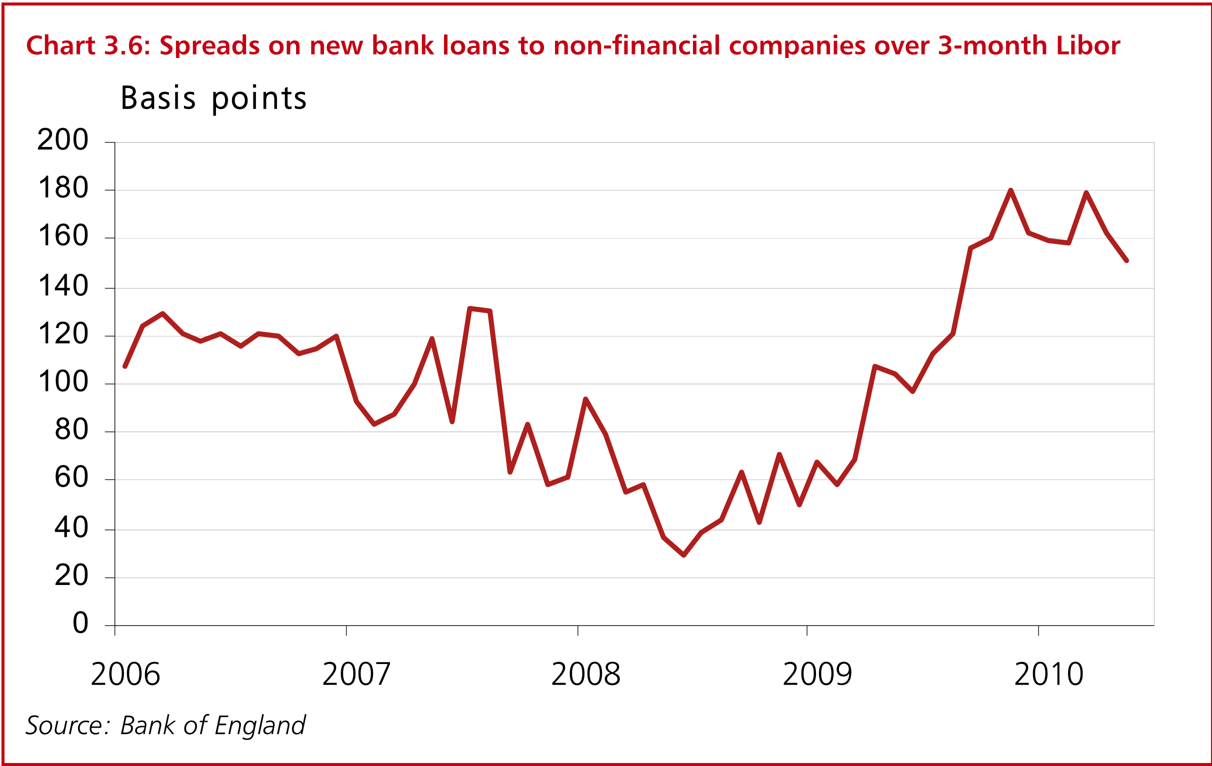
3.23 As banks must raise funds in order to extend loans, the cost of such funding will be a major component of the price at which loans are offered. Banks typically fund themselves through a combination of deposits and wholesale funding. The financial crisis has put upward pressure on bank funding costs relative to Bank Rate and this largely explains the widening of spreads.

3.24 The credit risk of the borrower is also a key element of loan pricing. Since the financial crisis there has been a reassessment of the creditworthiness of borrowers and the expected risk of business loan defaults, leading to higher spreads on loans. To some extent this is part of a necessary structural adjustment, following the under-pricing of risk on many business loans in previous years. SMEs' heavy reliance on bank credit means they are particularly vulnerable to such swings in risk appetite.

[10] Libor is the London Interbank Offered Rate, a measure of the interest rate at which banks borrow unsecured funds from other banks in the London market. It is a key reference rate for many financial contracts, including bank loans.

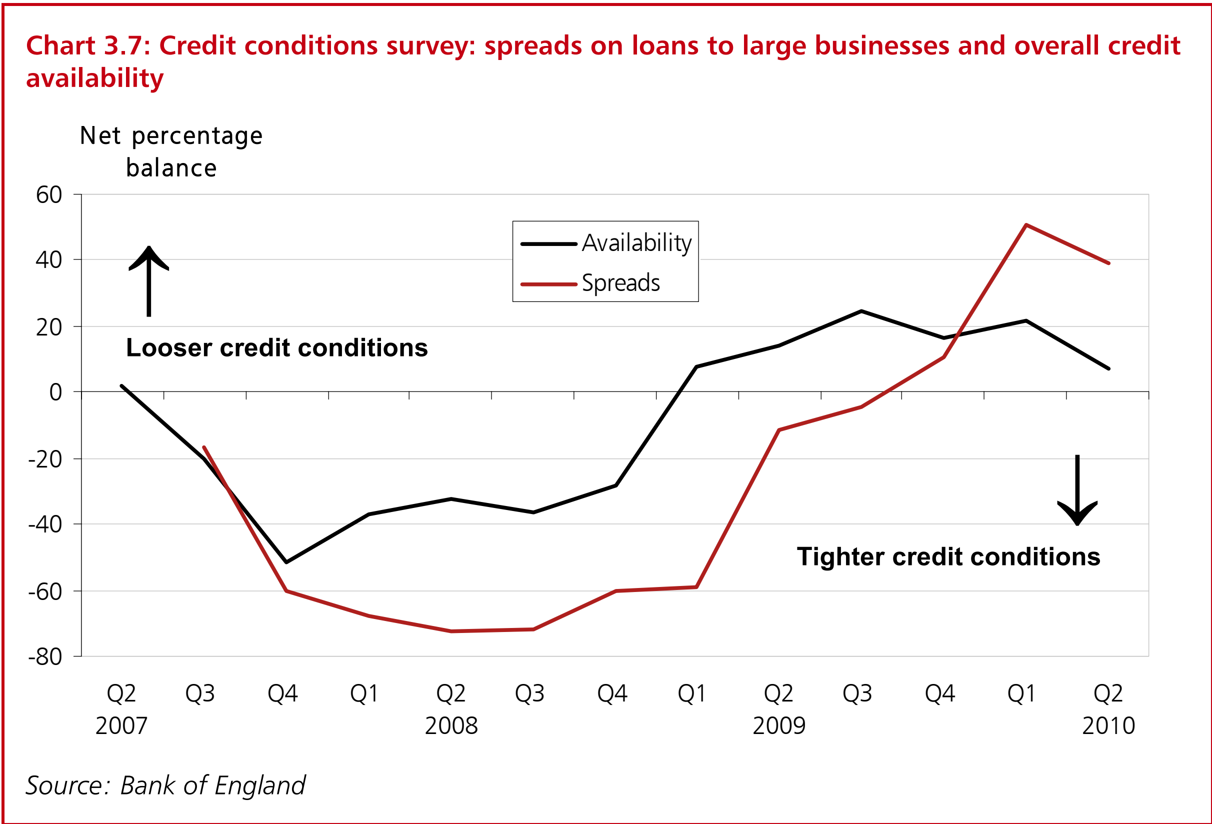
3.25 However, while recent reports suggest that default rates for small businesses are proving lower than expected, spreads are not yet narrowing for these businesses (see Chart 3.6, showing spreads on new bank loans to all non-financial companies). This may reflect banks' higher funding costs and, to a lesser extent, other changes in borrower credit risk. It may also, however, be the case that banks have increased the mark-up on new lending to make up for legacy commitments negotiated before the financial crisis and to try to repair their balance sheets.

Chart 3.6: Spreads on new bank loans to non-financial companies over 3-month Libor



Source: Bank of England

Chart 3.7: Credit conditions survey: spreads on loans to large businesses and overall credit availability



Source: Bank of England

3.26 The Bank of England's 2010 Q2 *Credit Conditions Survey* of lenders reported a further small increase in the availability of corporate credit in 2009 and up to 2010 Q2 following large declines in the second half of 2007 and 2008 (see Chart 3.7, note any point above the horizontal axis represents easing in credit conditions on average and any data point below represents tightening). The Bank of England's *Credit Conditions Survey* and reports from the Bank of England's network of Agents suggest that access to credit has eased more for larger businesses than for the more bank-dependent smaller businesses.

3.27 The challenge is to ensure that, as the economy picks up and as demand increases, the supply of finance supports rather than constrains the recovery. This concern is particularly marked with respect to SMEs and mid-sized businesses, given their historic reliance on bank lending.

3.28 As noted above, demand for bank lending reflects a number of factors including interest rates and available alternatives to bank finance. Demand for finance is not entirely separable from supply; the demand for bank lending will naturally reflect its price and associated terms and conditions. Business confidence and investment intentions are also clearly key influences on demand, as is confidence in the banks' willingness to lend. The banking industry has taken steps to rebuild trust and confidence through SME charters, statements of support, and most recently the six commitments made by the industry, as announced at the June Budget to improve service. In addition, Lloyds Banking Group (LBG) and Royal Bank of Scotland (RBS) agreed to legally binding lending commitments with the Government, in March 2010. These commitments will see both banks lend a total of £94 billion to businesses on commercial terms, over the 12 months to February 2011. The Government will keep these commitments under review.

Other Finance Products

3.29 There are also a number of alternatives to traditional bank lending or overdraft finance. Many of these are offered primarily by the retail banks, although there are other players in these markets. A selection includes:

- Asset-Backed Finance, also known as simply 'asset finance', such as leasing and hire purchase;
- Asset-Based Finance, includes invoice factoring, invoice discounting and stock financing;
- Supply Chain Finance, where a large company at the end of a supply chain provides finance for its suppliers; and
- international trade finance, providing those firms which export with finance to do so.

3.30 These products will be important during the recovery as firms look to use asset finance for financing investment, and Asset-Based Finance and Supply Chain Finance for working capital purposes. There do not currently appear to be constraints on these markets, but the Government is interested in hearing about the experience of businesses using such products.

3.31 For businesses that frequently update or replace equipment and want to use it without ownership, using Asset-Backed Finance can provide a useful way to fund investment. Indeed, in 2009, almost £30 billion of investment finance was provided to businesses and the public sector, representing around a quarter of all fixed capital investment last year. Asset-Backed Finance, such as hire purchase and leasing, provides finance to around 20 per cent of all SMEs,

and to around 33 per cent of those SMEs that seek external funding. This can be a longer-term option than some forms of bank credit, typically 3 to 5 years.[11]

3.32 For many firms, debtor balances are the largest asset on the balance sheet, often representing two or three months of sales. In order to turn these assets into cash, some firms use Asset-Based Finance, such as invoice discounting or factoring. Savings in administration can be substantial and faster customer payments mean less need to borrow and lower interest costs. This type of finance could play a crucial role in securing access to working capital finance during the recovery for many businesses.

3.33 Another alternative product to traditional bank lending is Supply Chain Finance, where larger companies at the end of a supply chain provide finance for their suppliers. This could offer a valuable source of funding to mid-sized firms and SMEs. In particular, Buyer Driven Receivables Programmes (BDRPs) seem to offer the biggest potential for growth given their relative simplicity for both the buyer and supplier, and the fact that the accounting treatment is favourable to buyers.

3.34 A recent report published by the Association of Corporate Treasurers (ACT) report on behalf of the Supply Chain Finance Working Group[12] asserts that there is not currently a shortage of finance available for BDRPs, with a number of non-UK banks keen to enter the market. This green paper seeks views on the appropriateness of this form of finance for businesses, whether there are constraints to the future development of BDRPs and whether Government should be using its power as a major purchaser to encourage supply chain finance techniques.

3.35 There is no precise definition of the term 'trade finance'. World trade needs reliable, adequate and cost effective sources of financing, both long term (for capital investments) and short term (to fill the time lag between the production of goods and the receipt of payments). 'trade finance' is sometimes, but not always, used to refer to the plugging of this short-term gap. It can cover both direct financing for business, to help with import and export, or 'commitments' such as letters of credit that can underpin deals between a supplier in one country and a customer in another, ensuring payment for the supplier.

3.36 Many firms that export rely on international trade finance in order to finance their ability to maintain a working capital cycle and provide cash flow to fulfil their order books. The financial crisis reduced the availability, and increased the price of, international trade finance, contributing to the dramatic decline in global trade. Since mid-2009, there has been some stabilisation of the trade finance markets, aided by domestic and international measures. However uncertainties remain and the global recovery in trade finance is uneven, with very limited and relatively expensive private sector finance in higher risk markets.

3.37 As a result of the increased aversion to risk by providers of trade credit, there has been a significant increase in the role played by international export credit agencies (ECAs), which continue to provide greater levels of support for global exports. In the UK the Export Credits Guarantee Department (ECGD) supported 51 per cent more business in 2009-10 compared with the previous year and this trend is continuing into 2010-11.

3.38 59 per cent of respondents to the International Chamber of Commerce (ICC) 2010 survey[13] indicated that the value of trade finance activity had decreased between 2008-09, mainly due to lower commodity prices, the weak US dollar and the debt restructuring process in 2009. Demand is still high for trade finance products, but costs are higher than they were pre-crisis and fees have increased for the services. About 30 per cent of respondents reported an increase

[11] *FLA annual review*, April 2010 , Finance Leasing Association
[12] See www.treasurers.org/scf for more details of this working group
[13] *Rethinking Trade Finance 2010*, April 2010, International Chambers of Commerce

in fees for trade finance products in 2009, and this was on top of significant increases reported in 2008.

Debt Capital Markets

3.39 Debt capital markets can be accessed through private placements, corporate bonds or commercial paper. As noted above, this is only an option for large and upper mid-sized businesses. These markets are an important alternative to bank term lending for these firms, and due to the large size of these firms, debt capital markets are significant at a macroeconomic level.

3.40 In 2009, the contraction in net bank lending flows was party offset by a significant increase in bond issuance. This was both as a reaction to the temporary closure of capital markets in 2008, and because falling corporate bond yields made this form of financing more attractive to many businesses.

3.41 In 2009, UK companies raised £10.2 billion through net corporate bond and commercial paper issuance, compared with £11.4 billion in 2008 and £12.0 billion in 2007. Since the beginning of 2010, debt capital market issuance has been a lot more restricted and the first six months from January to June show a small contraction of £397 million. The more muted capital market is due to a combination of reasons; many large corporates refinanced in 2009 and so have less demand for bond issuance this year, and more volatile market conditions have made capital market issuance relatively less attractive.

3.42 The dominant share of UK corporate debt liabilities is bank loans. Since the financial crisis, this share has fallen, as UK corporates have also raised finance using corporate bonds and commercial paper instead of relying on bank debt. During the financial crisis UK corporates sought to diversify their liabilities away from bank lending, both to reduce their exposure to one source of finance and because the relative price of bank loans to bond issuance was high. This shift in the composition of corporate debt liabilities is shown in Chart 3.3.

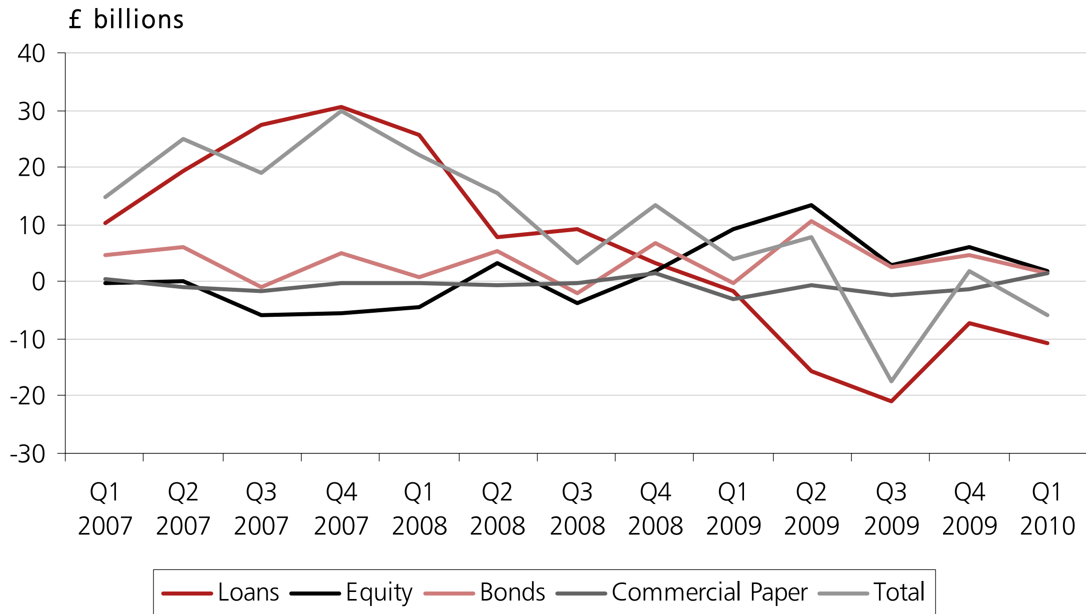
3.43 International comparison, particularly with the US, suggests that more firms could use debt capital markets. If prices continue to make these channels attractive relative to bank debt, then further market developments are likely to take place without Government intervention. This could potentially allow a greater proportion of mid-sized and large firms to access the market. There may, however, be a role for Government to facilitate this process through, for example, the work that BIS are doing to raise awareness of the private placement market among larger mid-sized corporates.

Equity Markets

3.44 During 2009 and the first half of 2010, the equity markets proved an important alternative to bank lending (see Chart 3.8). UK businesses raised over £78 billion of equity in 2009 and equity issuance remained more popular with FTSE 250 Chief Financial Officers (CFOs) than bank debt throughout the year, however bank borrowing has seen a resurgence in its relative attractiveness to CFOs more recently (see Chart 3.9)[14].

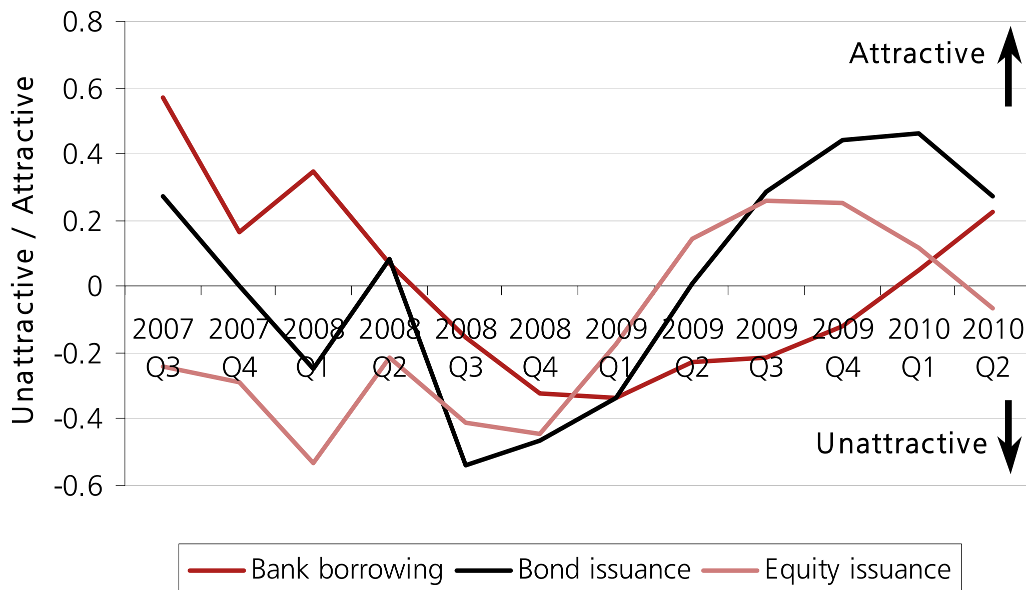
[14] Chief Financial Officer Survey Q2 2010, July 2010, Deloitte

Chart 3.8: New Capital Market Issuance



Source: Bank of England

Chart 3.9: Relative attractiveness of different forms of finance



Source: Deloitte, CFO Survey Q2 2010

3.45 Investment by Venture Capital and Private Equity funds has fallen dramatically since the start of the financial crisis. The value of UK Private Equity deals in 2009 was only 15 per cent of its pre-crisis peak. However, the market is recovering and internationally it is estimated that Private Equity funds have over $1 trillion in uninvested funds. Reports suggest that while private equity funds are keen to utilise this finance, there are reasons why they may have been held back. A reduced amount of debt finance may mean that deals cannot be as highly leveraged as pre-crisis and therefore cannot achieve the same level of returns. Tough competition for high quality assets has resulted prices being driven up to pre-credit crunch levels. As a result of the

huge sums that Private Equity funds currently hold, some may look to lengthen investment periods or gain support from investors to change their investment remit.

3.46 While equity finance is an important source of finance for businesses with high growth potential, only 4 per cent of mid-sized companies and only 2 per cent of SMEs have recently accessed equity finance[15]. Many SMEs are deterred from seeking equity finance because they may not want to cede ownership. In addition, many SMEs are unfamiliar with equity finance and may not be 'investment ready'. They may also be unable to attract investment because of their business model or corporate governance arrangements. Encouraging more small businesses to consider equity finance, improving their capability to access this source of finance and ensuring that there is a supply of equity finance for viable firms will support efforts to diversify the sources of finance used by businesses.

3.47 SMEs can access equity finance through private sources, such as venture capital funds or Business Angels, or through exchange-regulated markets such as AIM and PLUS-quoted markets. Since AIM's launch in 1995, over 3,000 companies have joined, raising over £68 billion at admission and through further fundraisings. As at June 2010, there were 1,235 companies (of which 1,005 were UK companies) quoted on AIM. £387 million of new funds have been raised year to date (as at June 2010) and over £2 billion has been raised through further fundraisings[16]. Over 200 SMEs are quoted on PLUS-quoted, which is similar to AIM and primarily a domestic market for companies typically capitalised at less than £50 million. A public listing on such growth markets can also provide a common exit route for private equity investors.

3.48 Business Angels are high net-worth individual investors that typically provide smaller amounts of equity finance to SMEs than venture capitalists. Business Angels typically invest less than £200,000 per deal, but may invest greater amounts when they group together in a syndicate. There is evidence to show that Business Angels have become more significant over the past decade as a source of early stage venture capital[17]. This type of investment bridges the gap between institutional investors that have moved to bigger value, less risk and higher return deals.

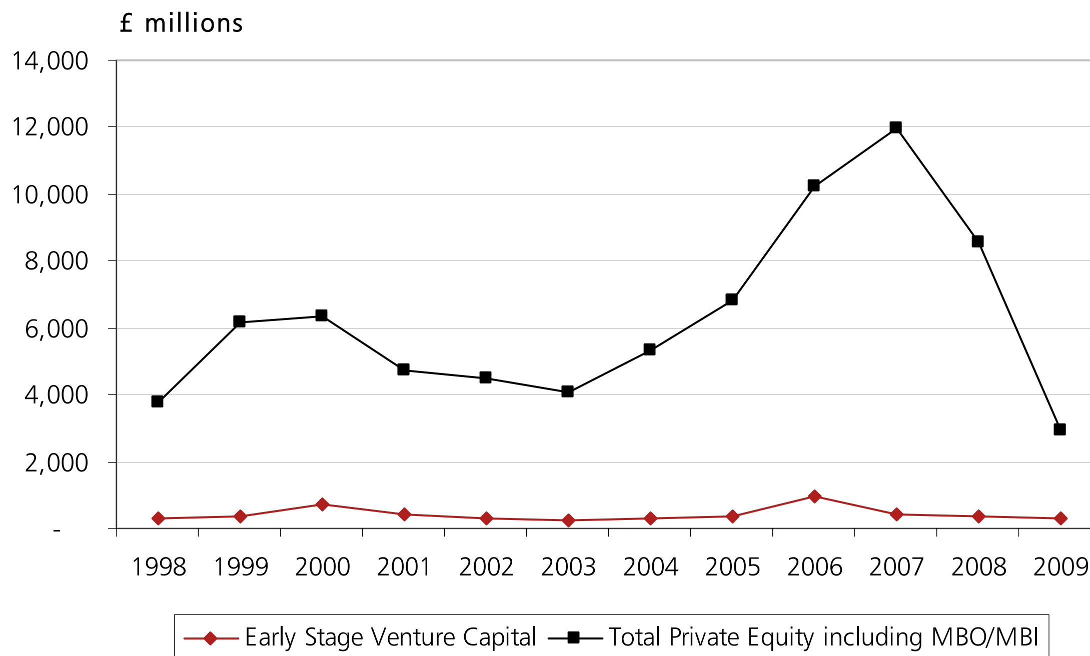
3.49 Over the decade up to the financial crisis, both the total amount of finance invested in Early Stage Venture Capital and the number of firms receiving this type of funding had remained relatively stable despite a significant increase in the overall value of private equity investments. However, since the crisis, there has been a significant decline in the supply of venture capital to SMEs. British Venture Capital Association (BVCA) data shows 388 companies obtained Early Stage venture capital funding in 2009 raising £296 million. This is a decrease of 18 per cent from 2008 (see Chart 3.10). Fund managers have concentrated on managing their existing portfolios rather than making new investments, and there have also been difficulties in raising new funds for investment.

[15] *2009 finance survey of mid-cap businesses*, February 2010, Continental Research (published by BIS) and *Finance survey of SMEs*, February 2010, IFF Research (published by BIS)

[16] *AIM Statistics June 2010*, June 2010, London Stock Exchange

[17] *Shifting Sands: The Changing Nature of Early Stage Venture Capital Market in the UK*, September 2008, NESTA

Chart 3.10: Amount invested by BVCA members



Source: BVCA

3.50 The regional investment pattern for private sector venture capital and private equity broadly reflects the geographic distribution of suitable businesses seeking equity finance. In the case of publicly backed venture capital funds targeting the 'equity gap', national funds aim to support the best small businesses in every part of the country to access the finance they need. This is because, although regional economic development is not a specific objective of these funds, it is recognised that any differences in the ease of accessing finance between regions can impede balanced economic growth.

Conclusion

3.51 Although access to finance conditions have improved since the financial crisis, and while the majority of businesses can now raise the finance they require, there are still areas of some concern. These include the recent decline in investment by private equity and the continuing challenge many viable SMEs face in raising debt and equity finance.

4 Future challenges

4.1 Evidence suggests that financing conditions have improved since the crisis, and that businesses generally are not experiencing severe financial constraints. This does not, however, mean that potential risks surrounding the future price or availability of finance can be ignored. Some of the challenges may be transitional, reflecting the aftermath of a global financial crisis and the economic cycle; others may be structural in nature, in particular with respect to financing options for SMEs and mid-sized companies.

4.2 Where problems are identified, industry and market-led solutions are generally to be preferred and the Government will support and promote these as appropriate. The Government also, however, stands ready to intervene to prevent downside risks to the economic recovery materialising. Any proposal for Government intervention must, however, satisfy a number of criteria including that it should:

- reflect a realistic expectation that it will successfully address a clearly identified market failure;
- represent value for money for the taxpayer, and be affordable within the Spending Review envelope set at the June Budget;
- be timely and time-limited, with appropriate sunset clauses and a clear exit strategy;
- be compliant with state aids rules;
- not crowd out private provision or market solutions; and
- avoid introducing distortions elsewhere in the economy.

4.3 The Government welcomes views from businesses, individuals and financial institutions on what they regard as the key challenges in facilitating business access to finance; the approaches they think would best address these; the roles for businesses, financial institutions and Government in this; and the extent to which such interventions should be temporary or permanent. This section sets out a range of approaches on which the Government would particularly welcome views, though comments relating to options not described here are also welcome.

4.4 There is, of course, much that Government can do to help markets work more effectively that does not involve fiscal incentives or direct intervention, for example, improving regulation, promoting competition and providing certainty over changes to tax and regulatory frameworks.

Macroeconomic Challenges

4.5 Following rapid expansion of bank balance sheets across the world in the last decade, banks now face significant challenges to restructure their balance sheets and refinance their liabilities. Many banks across the world are also still benefiting from extensive public support extended during the financial crisis. In the UK this includes some £125 billion of debt guaranteed under the Credit Guarantee Scheme, and £165 billion of Treasury bills accessed under the Special Liquidity Scheme. This is helping to ease the transition, but will expire in the medium-term. The overall adjustment process banks must go through has the potential to constrain the amount of

assets banks can fund. Depending on how they allocate available funds to their business activities, this could in turn affect banks' ability to lend.

4.6 The Government believes it is crucial that banks adapt to the changed economic and financial conditions and accept that they will have to rely less on short-term wholesale funding. Instead, retail deposits will grow in importance, while high-quality longer-term wholesale funding is likely to be less easily available than the short-term funding and securitisation banks relied on before the crisis. Banks will therefore need to make every effort to offer terms on new funding that are attractive to investors.

4.7 At this stage in the recovery it is difficult to judge the impact of this adjustment on access to credit. While net lending in the UK has fallen, corporate balance sheets are strong, and the corporate sector is well placed to meet rising demand as the economy strengthens. Yet the Government is alert to any risks to the recovery. These include the risk that continuing concerns about the ability of some Eurozone countries to service their public debts increases investors' risk aversion and disrupts their banks' access to funding, which could in turn affect the UK.

4.8 The Government is monitoring the macroeconomic situation closely, and is interested in views on what actions could be taken to underline banks' commitment to supporting economic recovery and mitigate these risks, should they materialise.

Securitisation

4.9 Securitisation can be an important source of funding for both banks and non-bank lenders. The financial crisis indicated significant underlying failings in these markets as previously constituted, and underlines the importance of reform to ensure that in the future the securitisation market is a more sustainable and robust market. Conditions in some countries' securitisation markets have improved, and activity in the UK such as the recent SME loan securitisation by Lloyds Banking Group is encouraging.

4.10 Recent changes to the Capital Requirements Directive will help align the incentives of issuers and investors in securitisations, while the requirements set out by the Bank of England for securitisations to be eligible for the Discount Window Facility should promote greater disclosure and transparency. The Government is also keen for industry to explore ways of standardising and simplifying securitisation products to make them more attractive to investors and sustainable in the long-term.

4.11 Other countries have intervened to encourage their securitisation markets. The US Term Asset Backed Securities Loan Facility (TALF) was a Federal Reserve programme that lent money to investors in asset-backed securities (ABS) as a way of stimulating demand for banks to originate business and other loans that could be packaged into ABS. The US securitisation market is, however, much more established and well understood by domestic investors than the market in the UK, and it is not clear that a programme such as the TALF would be as appropriate or effective in the UK. The Government is nonetheless interested in views on whether similar schemes could be helpful in supporting lending in the UK.

4.12 In the UK, the 2009 Asset Backed Securities Guarantee Scheme provided Government guarantees on the safest tranches of securitisations in return for a fee. This was designed as a temporary measure to restore and maintain financial stability and support the supply of credit. In fact, during the period the scheme was open, issuers were able to raise funds from a number of securitisations without the need for Government support. The Government is interested in views on whether there are other roles it could play in helping industry develop stable securitisation markets.

4.13 Some industry participants have suggested a covered bond guarantee scheme. This would offer a Government guarantee on the timely payment of eligible covered bonds backed by pools of new SME loans, with the aim of encouraging both banks to lend more to SMEs and investors to invest in a new asset class. Measuring the effectiveness of such a scheme in creating additional SME lending would be challenging, however, given the fungibility of bank funding and the difficulty in establishing how much SME lending banks are able to conduct unassisted. As with the Asset Backed Securities Guarantee Scheme, issuers would also be required to pay for the Government guarantee in accordance with EU state aids rules, which is likely to limit its appeal. The Government would welcome views on whether this or other schemes could be a viable and effective intervention if the need arose, taking into account the criteria set out at the start of this Chapter.

4.14 The major UK banks and the British Bankers' Association (BBA) have established a taskforce that will explore, among other issues, the problems currently affecting securitisations markets, and discuss what could be done from a UK banking perspective to create a stronger and more sustainable market.

Loan Guarantee Schemes

4.15 Historically, the majority of Government interventions to promote access to finance for business have been focused on SMEs. The Enterprise Finance Guarantee (EFG) was introduced as a temporary scheme designed to enable additional bank lending in response to concerns about the availability of bank credit for SMEs. It is due to expire in March 2011. However, the EFG also addresses challenges that are long-standing and structural (for example, the inability of viable businesses to gain debt finance without sufficient security or track record). This means that an extension of EFG, or a more permanent successor scheme, is likely to be required going into next year.

4.16 Any successor scheme will need to take into account restraints on public expenditure and the principle of sharing risk between Government, businesses and the banks. There are a number of options to explore, including:

- tying the Government guarantee rate more closely to different types of firms according to their credit rating. The Government would welcome views on how this could work.
- changing the way the premium is collected. Currently, it is collected quarterly on outstanding balances. An option would be to collect it annually or upfront. The Government would like to know which collection method businesses would prefer.
- increasing the premium to recover more of the costs to taxpayer of the scheme. The Government would welcome views on what impact this would have on SME take-up of the scheme.
- extending the coverage of the scheme to some mid-sized businesses in need of such support, which may have a lower credit risk than SMEs.

4.17 Early stage small businesses with the highest growth potential often have complex financing needs. Many venture capitalists and business angel groups support these businesses through mix of equity, debt and mezzanine. The EFG can already be used to guarantee the loan element of such a finance package, but banks, Business Angel groups and Venture Capital (VC) providers have to date only made limited use of the EFG to this end. The Government would be interested in views as to what more could be done to encourage debt providers to work with Business Angel groups and VC funds, so as to develop integrated finance packages that support business with the highest growth businesses potential.

4.18 In addition, the Government is interested in exploring the case for a National Loan Guarantee Scheme to improve lending to mid-sized businesses. If there were a clear case for

intervention, options might include partial guarantees of individual loans including possibly expanding the EFG, or payments of some part of the supply chain. As Government needs to consider affordability and state aids constraints, it would welcome views on the ability to design a scheme that is self-financing.

4.19 In his report 'Ingenious Britain - Making the UK the leading hi-tech exporter in Europe' Sir James Dyson recognised that it was important that bank lending flowed to innovative companies. He recommended that the Government should consider using the power of government guarantees to encourage lenders whether existing banks or new entrants to extend credit to innovative small businesses.

Promoting Access to Equity Markets

4.20 Equity finance is a potential alternative source of finance for businesses with high growth potential. Small businesses, however, often lack 'investment readiness' and face an 'equity gap' in the supply of modest amounts of equity finance. The Government has put in place a number of venture capital interventions to address the 'equity gap' faced by early stage small businesses with the highest growth potential. Business Angels are also becoming an increasing source of early stage equity finance.

4.21 Existing Government schemes include Enterprise Capital Funds that invest a combination of public and private funds, as well as tax-based schemes like the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCT). The Government would be interested in views on the impact of such interventions, in particular with respect to:

- specific issues impeding Business Angel activity that the Government should address, such as investor readiness or the structure of publicly-backed funds to encourage more syndication and enable larger deal sizes;
- the effectiveness of current tax incentives (such as the Enterprise Investment Scheme or Venture Capital Trusts) at encouraging private sector equity investment in small businesses;
- ways in which eligible businesses could be made more 'investment ready' for equity finance, and whether there is a role for Government to support the provision of advice and to focus support on businesses with high growth potential; and
- the effective targeting of the 'equity gap' by existing venture capital interventions. The European Commission is due to carry out a review of risk capital guidelines and the Government would welcome views on whether higher upper annual investment limits are needed.

4.22 In addition, the Government would welcome views on ways to reduce information asymmetries between firms seeking equity finance and investors. This could help ensure appropriate liquidity in growth markets, reducing the cost of capital for SMEs.

4.23 The Government is also interested in hearing views on any regulatory obligations that may disproportionately deter SMEs from listing on exchange-regulated markets such as AIM and Plus Quoted.

4.24 Some commentators have proposed regional stock exchanges to help develop regionally focused sources of business finance. Such an approach might, however, fragment liquidity and narrow the pool of investors available to each SME. The Government is interested in views on regional stock exchanges and how these could be made to work successfully, overcoming liquidity issues. It would also be interested in views on alternative ways of increasing local sources of finance through, for example, Business Angel finance or targeted promotion of local companies listed on national stock exchanges.

Promoting Access to Growth Capital

4.25 The Rowlands Review concluded that there was an identifiable undersupply of finance for growing, successful companies that required growth capital. Growth capital lies between high risk early stage funding and lower cost asset-backed bank finance, and is especially important for firms that cannot access public equity or bond markets. The undersupply is believed to be structural, resulting from investors moving up-market to deals with higher risk/ return profiles and greater deal size. In recent years the funding gap has been masked by the availability of cheap debt finance, but the recent financial crisis has revealed and compounded an underlying problem.

4.26 The practical consequences of this for SMEs are restricted growth, undercapitalisation and reliance on short-term debt. As announced in the June Budget, the Government is committed to developing a viable proposition with banks to overcome the barriers facing entrants to this market, and provide a credible channel for private capital to invest in growing businesses. In order to achieve these aims, it should have the following features:

- size: the fund should be of sufficient size to meet demand and diversify risk or meet follow-on requirements;
- reach: the fund should access multiple channels to achieve a blend of the best deals, and have UK wide reach;
- product: the product should be flexible, aimed at addressing the right risk/return profile for the investment;
- cost: the fund should represent an efficient channel to market for investors looking to access SME growth opportunities; and
- distribution: the fund should overcome the current fragmented provision and ad-hoc nature of growth capital deals.

4.27 The Government will be a minority investor in the Growth Capital Fund alongside several private sector investors. As a result, it will not be for Government alone to decide the structure of the Fund, which must be commercial credible. One approach to delivering this could be to offer equity or mezzanine debt finance of £2 million to £10 million to high quality, established firms with committed and successful management and a robust plan for growth.

4.28 A potential investment model is a fund product that is predominantly debt-based, offering investors ongoing yield, but with an equity element as well allowing investors to take a minority stake in the business, with warrants to expand the equity position if required. Under this model, the fund would have a 12-year life, with individual investments lasting typically 7 years and a target internal rate of return of 10 to 13 per cent. It would operate under the oversight of a Lead Fund Manager but would be disbursed through a number of sub-fund managers to provide full geographical and sectoral reach.

Promoting Access to Debt Capital Markets

4.29 Large firms were able to use debt capital markets to refinance bank debt during 2009. A shift in relative pricing and a desire to diversify funding sources encouraged firms to issue in these markets. Access to these markets is, however, generally limited to large firms. The Government's objective is to expand access to debt capital markets. As part of this, it is working with the support of parties such as the Association of Corporate Treasurers (ACT) and the Confederation of British Industry (CBI) to raise awareness of the different costs and risk associated with different sources of finance.

4.30 Reducing the cost of issuance by increasing market efficiency could also open bond markets up to more companies. Efficiency could be improved by supporting investors and brokers to standardise documentation and encourage adaptation of these standards. Improved information provision can also improve efficiency. The Government is supporting the Centre for Economic and Social Research (CESR) who will provide advice to the European Commission on measures to improve pre- and post-trade transparency in the corporate bond market. Finally, the development of a Sterling private placement market could contribute to increased participation from UK investors and companies. There is scope for the Government to support participants develop this market further, such as by supporting document standardisation.

Promoting Competition in Banking

4.31 A key priority should be to promote competitive banking markets, given that bank lending remains the largest and most important source of external finance for SMEs and mid-sized businesses in particular. A competitive banking market ensures that the wider economy benefits from the right quantity of products and services on offer at an economically efficient price. Competition is also a spur to innovation and economic growth.

4.32 The Coalition's 'Programme for Government' reiterated the importance of competition and diversity in financial services, including promotion of the mutuals sector. To this end the Government welcomes the interest demonstrated by new banks and other lenders looking to enter the UK market, along with those that have recently arrived. Businesses will benefit from a broader choice of financing options as lenders seek to win and retain customers.

4.33 The financial mutuals sector in the UK comprises building societies, friendly societies, mutual insurers, cooperatives and credit unions. Mutuals play a strong role in local communities, building long-term relationships with members and often operating in areas of economic and social deprivation. The range of services offered by building societies and other mutuals has expanded as the legal framework has been updated, and in response to changes in technology and customer demand. The Government is interested in views on the role that mutuals could play in facilitating access to finance for businesses and providing greater choice in financial services.

4.34 The Government also welcomes steps taken by the FSA to streamline and increase transparency in the licensing process for prospective deposit-taking institutions. Increased competition between banks, and between banks and other financial institutions can help foster a diverse range of business models and approaches to the lending relationship. Businesses will benefit from a broader choice of financing options as lenders seek to win, expand and retain customers.

4.35 The Government recognises the economic importance to SMEs of the Post Office's national network of 11,500 branches. Almost half of small businesses visit a post office twice a week, and nearly a fifth visit a post office every day[1]. The Coalition's 'Programme for Government' contained a pledge to look at the case for creating a Post Office Bank. This will include analysis of opportunities to expand banking services for SMEs at post offices.

4.36 More broadly, a new Independent Commission on Banking has been established to look at the overall structure of the banking sector and the issues it raises. The Commission will focus on ways to promote competition in both retail and investment banking, with a view to ensuring that the needs of banks' customers and clients are efficiently served. The Commission will, in particular, consider the extent to which large banks gain competitive advantage from being perceived as too big to fail. When drawing up its recommendations the Commission will be

[1] *Post Bank One Page Briefing*, January 2010, Federation of Small Business

mindful of a range of concerns including business lending and the recovery. The Commission held its first meeting in early July and will deliver a final report in September 2011.

Promoting Finance for Disadvantaged Communities

4.37 The Government wants to ensure that, no matter where they are based, viable businesses can access appropriate finance. Community Development Finance Institutions (CDFIs) can help to support this objective, by providing microfinance loans to both start-ups and established businesses in disadvantaged communities. The Government recognises the importance of community finance.

4.38 The Government will publish a White Paper on sub-national growth, which will set out plans to ensure new business and economic opportunities are more evenly shared across the country, including further details on local enterprise partnerships.

Promoting Better Informed Businesses

4.39 To get the most from a competitive market, businesses need to be able to exercise real choice between lenders. Many businesses can and do exercise this choice. It has been suggested, however, that doing so may be harder for new and smaller businesses. The Government therefore welcomes views on how material a concern this is and which businesses are most affected.

4.40 Ongoing work by the Office of Fair Trading (OFT) will shed light on competition issues. In particular, the OFT is reviewing barriers to entry, expansion and exit in retail banking and banking for SMEs and scoping a potential market study on equity underwriting and associated services. This work will improve general understanding of the market and the role of competition. The Government welcomes this contribution to the debate.

4.41 To increase transparency and promote competition in business lending, the Government would welcome views on ways to help businesses make better use of information and advice that is already available. This includes Government support services such as Business Link. The Government is also interested in ways of extending these support services and raising business capabilities, so that businesses make the right information available to facilitate credit assessments and strengthen their ability to negotiate with lenders.

4.42 The Government is interested in the steps that banks could take to make it easier for businesses to find a competitive deal by increasing transparency in the loan application process. This might include the development of tools such as checklists or basic loan templates agreed by all lenders and which could be pursued within the existing competition regime.

4.43 In addition, the Government welcomes proposals in any other areas not covered by the above that could stimulate competition in business lending.

4.44 Some businesses have expressed concern that banks have tightened the terms and conditions attached to loans (for example, by securing a loan on a SME-owner's home). Banks should be prepared to explain to individual businesses the reasons why terms and conditions have been tightened. The Government is interested in views on the extent to which loans terms and conditions have tightened in recent years and in how banks can be more transparent in explaining the reasons for these changes to businesses.

Reducing the Cost of Debt Restructuring

4.45 For some companies, the central challenge is to restructure existing debts. In order to help reduce the cost and risks involved in negotiating a restructuring, the Government is proposing that companies should have the option of applying for a statutory moratorium - a protected breathing space during which a restructuring deal could be negotiated and implemented. The

Insolvency Service will shortly publish a consultation document setting out the detail of this proposal and inviting views from interested parties[2].

Promoting Investment in the Low Carbon Economy and Infrastructure Sectors

4.46 The UK faces a significant investment challenge in transitioning to a low-carbon energy system. An estimated £120 billion of investment is needed in large-scale infrastructure and new electricity generating capacity in the period to 2020. The Government is determined to address the barriers facing the private sector in delivering this investment and has launched a project to consider possible reforms to the structure of the electricity market to enable it to support more low-carbon investment. This will include a consideration of the attractiveness of the sector to a range of investors, including insurance and pension funds. Proposals will be set out for consultation in the autumn, with a White Paper will be published in Spring 2011.

4.47 Alongside this project, the Government is considering a wide range of options for the scope and structure of a Green Investment Bank. Following the Spending Review, the Government will put forward detailed proposals on the creation of a Green Investment Bank to help the UK meet the low-carbon investment challenge.

Ensuring the Export Credit Guarantee Department (ECGD) Can Meet Increasing Demand

4.48 As noted in Chapter 3, ECGD has seen increased demand for its services as trade credit lenders have become more risk averse following the financial crisis. The Government will ensure that ECGD has the resources to meet even higher levels of demand should this trend continue, while maintaining ECGD's prudent risk management policies and pricing in order to protect the tax payer from underwriting losses. The Government will continue to seek innovative ways to improve the funding of medium and long term loans for trade, consistent with the general principles set out at the start of this chapter.

Conclusion

4.49 This chapter has summarised some of the risks that exist to the adequate provision of business finance in the coming years. As noted in Chapter 3, conditions in the markets have improved since the height of the credit crunch in 2008 and 2009, and the acute problems of credit availability and price have receded somewhat. Existing Government schemes, such as the Enterprise Finance Guarantee, have provided additional support to ease the supply of credit where there are the greatest pressures.

4.50 The Government recognises, however, that there are risks to the supply of finance to firms as the economy recovers and demand rises, and is seeking views on whether there are further actions that industry, financial institutions, or Government should take, and if so, what these should be.

[2] When published, a link to the consultation document and details of how to respond will be found at the Insolvency Service website, www.insolvency.gov.uk

5 Summary and questions

5.1 This Green Paper has set out the Government's understanding of current conditions in the key business finance markets, the funding options open to firms of different sizes and what it sees as the key challenges over the coming years in terms of access to business finance.

5.2 Conditions have improved greatly since the height of the financial crisis in late 2008 and 2009, and the economic recovery is now underway. Risks remain, however, and Government stands ready to act swiftly should conditions again deteriorate, in order to prevent finance problems endangering economic growth.

5.3 Any government intervention must of course be consistent with fiscal consolidation. It is therefore crucial that existing and future schemes are carefully targeted to benefit businesses with the most severe problems. Any future intervention must also meet a number of criteria, as noted in paragraph 4.2 and repeated here, i.e. that any proposal should:

- reflect a realistic expectation that it will successfully address a clearly identified market failure;
- represent value for money for the taxpayer, and be affordable within the Spending Review envelope set at the June Budget;
- be timely and time-limited, with appropriate sunset clauses and a clear exit strategy;
- be compliant with state aids rules;
- not crowd out private provision or market solutions; and
- avoid introducing distortions elsewhere in the economy.

5.4 Wherever possible, the Government's preferred option is always a market-led solution, designed and delivered by the participants. The Government recognises, however, that market solutions are not always effective and there may be a need to continue to intervene to address market failures in some areas, such as access to debt and equity for SMEs.

5.5 The key questions on which the Government would like to consult as part of this Green Paper are shown below. As responses may inform parts of the autumn Spending Review, the deadline for responses is 20th September 2010.

Questions

General Evidence Base

1. Do you agree with the evidence base as set out in this paper? Are there any additional issues that should be considered?

Certainty Over Frameworks

2. Do you think greater certainty over future tax and regulation would have a significant impact on current demand for or supply of business finance?

Equity Markets

3. Are there any regulatory obligations that may disproportionately deter SMEs from listing on exchange-regulated markets such as AIM and Plus Quoted? What can be done to address this?

4. Are there any additional barriers to corporates (of any size) accessing equity markets and how could these be addressed?

5. How can Government ensure that the best small businesses in all parts of the UK are visible to publicly backed venture capital funds? Should Government intervention to address the equity gap focus on the best firms regardless of geography, or seek explicitly to address regional economic disparities? The Government would be particularly interested in views on regional stock exchanges.

6. How can publicly-backed equity schemes and the Growth Capital Fund make more use of private capital in future? How could the scale and reach of publicly backed funds be improved? Are there any gaps within the portfolio? Does the potential model for the Growth Capital Fund meet the objective of filling a gap in the availability of funding for growth companies? Are there ways in which the potential model could be developed to improve its appeal to investors or its ability to make a material contribution to the funding of growth companies?

7. How could more high-net-worth individuals be encouraged to become Business Angels and participate in larger deals through syndicates? Are there specific issues impeding business angel activity that the Government should address, such as investor readiness or the structure of publicly-backed venture capital funds?

8. How can eligible businesses help themselves to become 'investment ready' for equity finance? Where should this be done by private sector, market-led solutions? What role is there for Government in supporting this, and should intensive Government support be focussed on businesses high growth potential?

9. How effective are current tax incentives for equity investment in small businesses, such as the Enterprise Investment Scheme or Venture Capital Trusts?

Debt Capital Markets

10. Are there any steps that industry, financial institutions or government could take to promote access to debt capital markets for a greater number of UK businesses?

Competition

11. What more could be done to promote greater competition in the provision of business finance?

12. What other actions could be taken to help businesses (of all sizes) access a wider range of different finance options?

Addressing Future Risks

13. Looking ahead, what are your views on future risks to the provision of business finance, in particular bank lending? If you have concerns, do these reflect transitional factors in the wake of the financial crisis, or structural factors? Are there steps that the banking sector, regulators or policy makers should be taking to mitigate these risks?

Banking Sector Environment

14. What steps can banks, industry or Government take to strengthen bank's relationships with their customers and ensure businesses are not discouraged from seeking finance? What steps can the banking sector and others take to improve the financial readiness of business?

15. What options might Government consider to support increased lending to business (including possible expansion of the EFG or of payments to part of the supply chain)? How effective is the EFG in increasing access to debt finance for small businesses? What could be done to improve it and can more cost be borne by users?

16. What steps would be beneficial in making securitisation more attractive to investors and a stable form of funding for lenders? Are there particular sectors or products that this should be focused on?

International Trade

17. Are there significant constraints on access to trade finance for UK exporters? What measures could banks, industry or the government take to increase the availability of trade finance?

Responding to the Consultation

5.6 This consultation began with the publication of this document and will last for a period of 8 weeks, closing on 20th September 2010. This consultation period is shorter than the usual minimum of 12 weeks, is to ensure that responses are available, where appropriate, to inform the Spending Review process in the autumn.

5.7 Comments on the specific questions raised in the consultation are welcome. Where possible, respondents are encouraged to provide evidence to support specific points. Respondents do not need to respond to all the questions in the consultation and, where they do not have an interest in all the issues considered in this consultation, should feel free to limit their response to those questions that are of interest to them.

Responses should be sent by email if possible to:

business.finance@bis.gsi.gov.uk

Or by post to:

Business Finance Green Paper
Fourth Floor
Department for Business, Innovation & Skills
1 Victoria Street
London
SW1H 0ET

5.8 Please note our preference is to receive responses in electronic format only (all email responses will be acknowledged).

5.9 This document can be found on the website of HM Treasury (www.hm-treasury.gov.uk) and the Department for Business, Innovation and Skills (www.bis.gov.uk/businessfinance)

5.10 When responding, please state whether you are responding as an individual or as part of an organisation. If responding on behalf of a larger organisation, please make it clear who the organisation represents and, where applicable, how the members' views were assembled.

Next Steps

5.11 After the consultation period has closed, the Government will consider the responses to the consultation.

5.12 In line with the Code of Practice for written consultation the Government will publish a summary of responses to the consultation, giving feedback regarding the responses received and how the consultation process influenced the policy.

Confidentiality Disclosure

5.13 You should be aware that information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004).

5.14 If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence. In view of this it would be helpful if you could explain to us why you view the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be

maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Department.

5.15 The Department will process your personal data in accordance with the DPA and in the majority of circumstances; this will mean that your personal data will not be disclosed to third parties.

About the Consultation Process

5.16 This Consultation has been conducted in accordance with the criteria in the Government's Code of Practice on Consultation. If you wish to have access to the full version of the Code, you can obtain it at: http://www.bis.gov.uk/policies/better-regulation/consultation-guidance

The Consultation Criteria

5.17 The Government's Code of Practice on Consultation sets out seven criteria for successful consultation:

1. When to consult - formal consultation should take place at a stage when there is scope to influence the policy outcome.
2. Duration of consultation exercises - consultations should normally last for at least 12 weeks with consideration given to longer timescales where feasible and sensible.
3. Clarity of scope and impact - consultation documents should be clear about the consultation process, what is being proposed, the scope to influence and the expected costs and benefits of the proposals.
4. Accessibility of consultation exercise - consultation exercises should be designed to be accessible to, and clearly targeted at, those people the exercise is intended to reach.
5. The burden of consultation - keeping the burden of consultation to a minimum is essential if consultations are to be effective and if consultees' buy-in to the process is to be obtained.
6. Responsiveness of consultation exercises - consultation responses should be analysed carefully and clear feedback should be provided to participants following the consultation.
7. Capacity to consult - officials running consultations should seek guidance in how to run an effective consultation exercise and share what they have learned from the experience.

5.18 If you feel that this consultation does not satisfy these criteria, or if you have any complaints or comments about the process, please contact:

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E-mail: enquiries@bis.gov.uk

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