NESTA Making Innovation Flourish

Beyond the Banks: lending for growth

Opening event, 19 July 2011

On July 19, Sam Gyimah MP, NESTA and the Daily Telegraph hosted a panel discussion to consider innovative ways to provide credit to small and medium-sized businesses. The panellists included Mr Gyimah, entrepreneur and investor William Reeve, Samir Desai, co-funder of Funding Circle, an online marketplace for lending to small businesses, Stian Westlake, NESTA's Executive Director of Research, and Malcolm Small, Director of Policy at the Tax incentivised Savings Association. The meeting took place at the Telegraph's offices and was moderated by James Hurley, Editor of the Daily Telegraph Business Club.

The discussion ranged widely but identified a number of central issues that require consideration during the consultation, which is intended to result in proposals for change that can be put to the Treasury during preparations for the 2012 Budget. *"The Treasury is very receptive to new ideas on the banking issue,"* Mr Gyimah told the meeting.

The first broad area of concern centred on the incumbent lenders. The big high street banks in the UK are under apparently irreconcilable pressures: on the one hand to shrink and strengthen their balance sheets as part of the general deleveraging process across the economy, and on the other hand to provide increasing quantities of finance to small business. However, given that the five major banks, including Santander, control more than 90 per cent of the market in small business lending, they are not necessarily keen to increase their exposure here. In fact, the Bank of England quotes figures showing that lending to small and medium-sized enterprises (SMEs, generally larger than the smallest businesses) started to contract in late 2009 and shrank at an annual rate of -3 per cent in February this year. Lending to smaller businesses, with turnover up to £1 million shrank at an annualised rate of -6 per cent in December 2010. This reflected both businesses' efforts to reduce their debts and banks' wariness about advancing fresh funds.

> *"In board meetings I attend,"* William Reeve said, *"if anyone were to propose getting money from banks they would just be laughed at."*

The issues that small businesses face in securing credit from the incumbent lenders arise mainly from the fact that most have only one banking and credit relationship and so have little choice when it comes to raising finance, be it for growth or working capital. Particular problems

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William Reeve, founder of LoveFilm

the panel touched on included sudden reductions in the facilities that lenders are willing to make available, limits on lending to individual customers that inhibited their ability to invest, inflexible fixed-term loans with early repayment penalties, a lack of transparency and certainty over arrangement fees, monitoring fees and borrowing costs, and long delays in deciding applications, typically 8-15 weeks.

A second broad area of concern might be termed market related. The costs of customer acquisition and subsequent due diligence were so high for the conventional lenders that they would frequently wipe out any profits on smaller sized loans, of the kind that small businesses typically seek. This tended to mean that banks could lend profitably only to existing small business customers about whom they had decent prior knowledge, and it therefore inhibited customer choice and mobility. A similar effect was observed in the market for corporate bonds. Mr Gyimah noted that the smallest bond issue on the London Stock Exchanges bond trading platform, which is open to retail investors, was in the range of £20-£25 million – a far bigger sum than most small businesses wish to borrow. This was because the costs associated with listing and distributing these bonds made issues much smaller than that unattractive for the borrowers. Both factors point to an apparent market failure at the lower end of the lending spectrum.

A third area for consideration concerned the borrowers themselves. Samir Desai from the peer to peer lender Funding Circle told the meeting that although the size of his company's lending book was doubling every two months, the biggest problem Funding Circle faced in making lending decisions was the quality and completeness of the management accounts that small business borrowers generally provided. Improvements here could help to expand the market for small business borrowing and bring down the cost.

The final ain issue was regulation across a broad spectrum. Several speakers and audience members criticised the Financial Services Authority over the weight of regulation that falls upon lending businesses and those who try to innovate in this area, in particular the money laundering rules. Similarly, there were barriers to direct equity investment in smaller companies, those who wanted to take this route needing to be Self-Certified Sophisticated Investors. *"Today we could characterise the FSA as part of the problem, rather than part of the solution,"* concluded Malcolm Small.

Panel members also criticised the seemingly constant stream of changes the tax system, particularly changes to Capital Gains Tax and Enterprise Investment Scheme rules, though changes in the 2011 Budget to increase the tax advantages available to EIS investors were generally welcomed. However, it was pointed out that only around 2 per cent of small businesses raise equity finance, while Samir Desai said that the Treasury had told Funding Circle that the number of people who used their full EIS allowance in the past tax year was *"a low double digit number"*. Malcolm Small noted that tax incentives tended to be targeted at equity investors but not debt providers.

A range of possible solutions to the funding difficulties of small businesses were suggested during the discussion, both by panel members and from the audience.

Among these was the need for much greater competition among the big lenders. The market would benefit from new bank entrants that can bring choice and diversity to the small business banking market. This may receive a boost thanks to the forthcoming sale of at least 600 bank branches by Lloyds to create a viable sixth big player, as part of its settlement with competition authorities. Similarly, overseas lenders operating in the UK such as Handelsbanken, which has a very relationship-based approach to its small banking offer, help to improve choice for borrowers.

> "When it comes to the regulation of finance start-ups, we could characterise the FSA as part of the problem, rather than part of the solution"
>
> **Malcolm Small, Director of Policy, Tax incentivised Savings Association**

The growth of non-bank sources of finance, such as peer-to-peer lending services including Funding Circle and Zopa, is also helping to bring much greater choice and responsiveness to the market. Similarly, the online invoice factoring market marketinvoice.com was opening up invoice finance and asset backed lending by bringing together small business borrowers and sources of finance from hedge funds, asset managers, family offices and wealthy individuals. These businesses use the cost and efficiency benefits of the internet to create a lending market where none previously existed, and offer a potentially important source of choice for small business borrowers. They provide swift decisions and flexibility over terms – two attributes borrowers greatly value and do not feel they receive from the high street banks.

However, the lack of a tax incentive for lenders to make funds available may mean the market doesn't grow as fast as it otherwise might, and the lack of a regulatory framework for them (P2P services such as Zopa are not regulated by the FSA) may ultimately inhibit their growth. Samir Desai also pointed out that the Enterprise Investment Scheme could not be used by investors in financial services businesses, which meant companies such as his were at a fundraising disadvantage.

Several panel members observed that larger companies had choice in sources of debt funding because they could issue bonds rather than simply borrowing from banks. This source of funding has become more popular recently, as bank lending has slowed. Could a similar market be created to benefit much smaller borrowers? A number of significant problems with this emerged, notably the high costs of listing and distributing such bonds, which made issues below perhaps £20 million uneconomic. Neither was it clear how such bonds could be rated to establish their credit score. It was generally felt that some form of securitisation would be necessary to make this market viable, under which bonds backed by large pools of small business loans would be sold to investors. However, the market for securitised loans of all sorts has contracted sharply since the financial crisis.

For a large proportion of small businesses, their most important business relationship is with their accountant. This makes accountants an important route through which to reach small business owners. Working closely with them could provide a low-cost way to reach small business borrowers, both to make them aware of alternative sources of funding and to help them to become better prepared to undertake the application process.

These and other potential solutions will be the subject of further research and discussion over the coming months, given what Sam Gyimah suggested could be *"the first economic recovery without a recovery in SME bank lending"*.

> *"There are really good businesses out there that are getting by on their existing cashflow,"* said Samir Desai. *"But if they want to grow they need finance."*

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Samir Desai, co-funder of Funding Circle

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