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NESTA Making Innovation Flourish

Beyond the Banks

The case for a British Industry and Enterprise Bond

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The case for a British Industry and Enterprise Bond

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Executive summary

Economic recovery and growth relies on investment by UK businesses. But levels of bank lending remain stubbornly low, and may fall further as the Eurozone crisis deepens. In October 2011, the Chancellor of the Exchequer announced that the Government would begin a policy of credit easing to improve small businesses' access to finance.

The issue of credit easing has been widely discussed by macroeconomists and large banks. This report offers a different perspective, drawing on the insights of the entrepreneurial businesses that rely on finance to grow and the new providers of credit who are attempting to improve the system.

Our central recommendation is that the right kind of credit easing measures can bring new sources of capital to invest in small businesses.

We propose that the government buy up banks' loan portfolios and finance these by issuing securities – a British Industry and Enterprise Bond – to investors. Our research among institutional and retail investors suggests there is considerable investor appetite for these bonds, with around 70 per cent of both groups saying they would be likely or fairly likely to invest.

This would address the immediate problem of a shortage of lending to small businesses, by freeing up banks' balance sheets for further lending. Just as importantly, it would help address a more structural problem of the UK financial system: its dependence on a relatively small number of banks and the relatively small size of non-bank lending options.

By accessing new pools of capital to invest in UK companies, the British Industry and Enterprise Bond would increase the diversity of the UK lending market, and would provide a basis for new providers to enter the market.

The development of this market could be stimulated by the Bank of England buying a portion of the highest-rated bonds as part of a future round of quantitative easing.

Any such investment of course has risks, However, there is good cause to believe that the risks associated with the British Industry and Enterprise Bond would be manageable and acceptable to investors. Good quality analysis exists of the risks of small business lending. And during the credit crisis, it was banks' larger corporate and real estate portfolios rather than their small business loans that caused embarrassment. This risk can be mitigated further by requiring banks to maintain a proportion of the securities sold to reduce moral hazard, and would retain responsibility for monitoring and managing the underlying loans.

At the same time as launching the bond, the government should also commit to concerted plans to increase the diversity of finance available to small business. The UK should level the playing field for start-ups that provide small business credit: these are currently unable to avail themselves of much of the government support open to other start-ups. Financial regulation should include an explicit aim of increasing diversity of business models (some specific proposals are included in this report), and swift resolution should be sought to the regulatory limbo that some innovative financial providers, such as peer-to-peer lenders, frequently face. And the government should set in motion a review of the taxation of debt finance, which artificially tips the scales in favour of debt rather than equity.

These proposals offer a way both to increase the amount of lending available to Britain's small and medium-sized businesses, and to increase the diversity, quality and resilience of the UK's business lending sector.

Part 1: Business credit: The nature of the problem

The quest for economic growth has become the defining challenge of the remainder of this Parliament. Having taken steps to stabilise the UK's deficit and protect its credit rating, the government is undertaking a range of policies to encourage economic growth, including a series of supply-side growth reviews on subjects ranging from infrastructure to university tech transfer and from corporate governance to intellectual property.

In October 2011, the Chancellor of the Exchequer announced that he had asked the Treasury *"to work on ways to inject money directly into parts of the economy that need it such as small businesses"* and to *"help solve [the] age old problem in Britain: not enough long-term investment in small business and enterprise"*.

The question of how to make credit easing a reality has attracted the attention of macroeconomists and the UK's leading banks. This report attempts to provide a different perspective: that of growing UK businesses, and of those seeking to provide business finance in new ways.

There have been widespread debates among macroeconomists and in the financial press on the technical merits of credit easing. So it is perhaps helpful to set out at the outside some broad principles that any policy in this area should seek to achieve.

1. **Availability of finance.** In order for the economy to recover, we need to see business growth. We know that high-growth businesses play a disproportionate role in economic growth.[1] As these businesses grow and others shrink, economic output increases as resources – capital, manpower, know-how – are shifted from less productive opportunities to more productive ones. One prerequisite for this is finance: the finance to back entrepreneurs, and the finance to allow successful businesses to grow. Increasing access to finance is the government's stated objective behind credit easing.

2. **Mix of finance.** The type of finance available matters too. Risky, early-stage ventures are best financed with equity. Our financial system discourages equity investment by providing tax deductions for debt interest payments, but not for the dividends paid to shareholders. Competition among providers of finance is beneficial for borrowers, encouraging innovation and better offers. Debt finance in the UK is dominated by a relatively small number of banks, with bonds being relevant only for the largest borrowers and non-bank, non-bond debt being rare. Mitigating these problems is a worthwhile objective for policy.

3. **Limiting government exposure.** At the same time, any policy that involves the government lending money or guaranteeing borrowing involves the risk that loans will go bad. Policies should keep to a minimum the risks that government takes on, and encourages that others are incentivised to reduce and manage them.

4. **Avoiding moral hazard.** The other danger of government loans or guarantees is that it will reduce the incentive on others to do their homework: why assess prospective borrowers carefully if the government will

1. NESTA (2009) 'The Vital 6 Per Cent.' London: NESTA.

pick up the tab if they default? Effective policy needs to minimise these perverse incentives.

The analysis that follows looks at the question of credit easing through these four filters.

The short-term problem: An ongoing lending malaise

The past three years have seen a dramatic fall in lending. During an economic recession, financial intermediaries and markets allocate credit less well with a bias against small firms who need to be carefully assessed and against new firms who have no track record.[2]

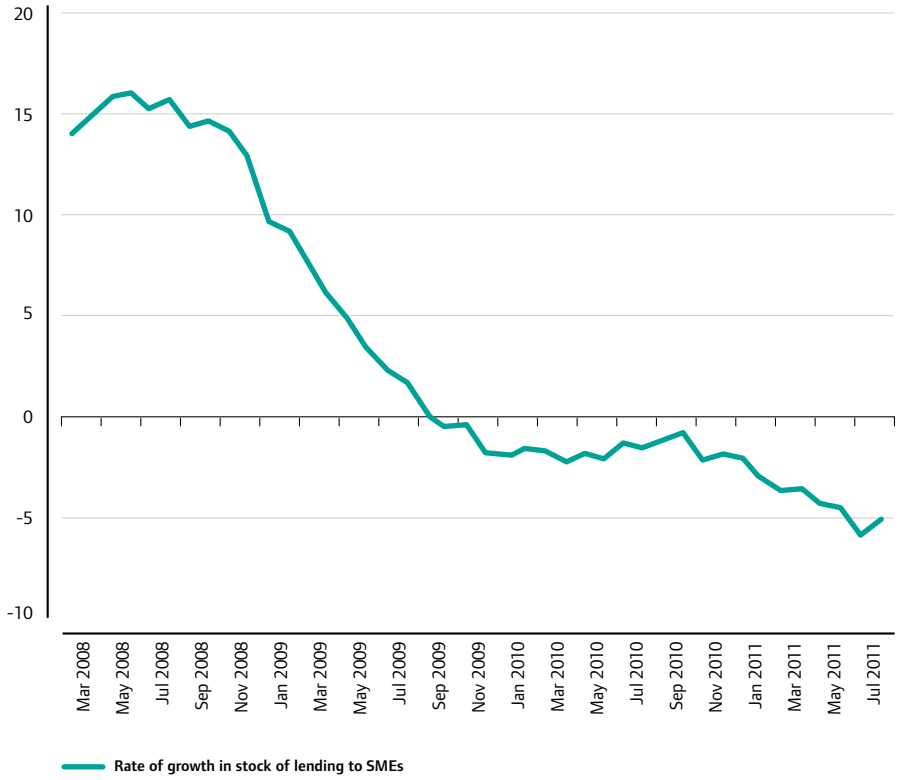
The BoE's Trends in Lending report, published in October 2011, shows that growth in the stock of lending to SMEs began to slow in early 2008 and turned negative in about July 2009.[3] The stock of lending to 'larger small businesses' (turnover of £1 million-£25 million) was contracting at about 4 per cent a year, according to the October 2011 report. The effect is more pronounced still among small businesses. British Bankers' Association figures show that at the end of April, banks' lending to small businesses stood at £39.9 billion, some £2.3 billion less than two months earlier, while overdraft borrowing had shrunk from £7.6 billion to £7.3 billion.

Behind these figures lies a story of frustration at banking relationships, inducing some SMEs to refrain from using bank finance. This withdrawal from loan finance is reflected in data from the Department for Business, Innovation and Skills (BIS) showing that the value of applications by SMEs for new term loan and overdraft facilities in the six months to February 2011 fell 19 per cent compared with the same period a year earlier.

The cost of debt is one explanation of this retreat. Corporate loans are priced in terms of a spread, or interest rate premium, added to a reference rate such as the Bank of England base rate. Recent data show that the average interest rate that the smallest businesses (up

2. 'How to do more.' Adam Posen, Bank of England, speech delivered 13 September 2011. Posen references a range of recent empirical research on this question.
3. Bank of England (2011) 'Trends in Lending.' October 2011. London: Bank of England.

Figure 1: Lending to UK small businesses



Source: Bank of England, British Bankers Association, UK Department for Business, Innovation and Skills in Lending to UK businesses and individuals, Bank of England, October 2011.

to £1 million turnover) have to pay has risen from less than 4 percentage points over base rate (0.5 per cent) in mid-2009 to about 4.7 percentage points by May 2011.

This claim has been disputed by banks, and it is difficult to show for sure to what extent a shortfall in finance is the result of lack of supply or lack of demand. However, research supports the idea that access to bank finance becomes more difficult in recessions, especially those following banking crises. In the words one economist,

> *"tighter credit conditions among fewer banks are not leading to better lending decisions... years of accumulated economic research are consistent with this... assessment of what happens in a credit crunch. Financial intermediaries and markets allocate credit less well under conditions of stress, with a bias against small firms who need to be carefully assessed and against new firms who have no track record."*[4]

Evidence continues to emerge supporting this finding. A recent paper by Becker and Ivashina provided evidence that those companies that could switched from bank loans to bonds when the economy was performing poorly and bank shares were low, implying that bank credit was harder to get or less attractive.[5] Looked at in the round, there has been both a general withdrawal from lending/borrowing by banks and small businesses, and a repricing of risk by lenders in the years since the credit crunch, with the smallest businesses the worst affected.

Two longer-term problems

The effects of the global financial crisis are significant and severe. But they are not the only issue that needs to be resolved when it comes to debt finance for UK businesses.

UK credit markets are curiously homogeneous. First of all, the UK's banking sector is relatively concentrated, as shown in Figure 2.[6] One senior regulator we spoke to observed that the UK was particularly lacking in medium-sized banks, which have a particular affinity for mid-sized business clients and unlike large banks are unlikely to retrench to large business customers following a crisis.

Moreover, the main debt alternative to bank loans, the corporate bond market, is unusually small in the UK, as demonstrated by Figures 3 and 4.[7] Part of the shortfall between the UK

4. 'How to do more.' Adam Posen, Bank of England, speech delivered 13 September 2011. Posen references a range of recent empirical research on this question.
5. Becker, B. and Ivashina, V. (2011) 'Cyclicality of credit supply: firm level evidence.' Harvard Business School Working Paper No. 10-107. Boston MA: Harvard Business School.
6. Posen, A. (2009) 'Getting credit flowing: a non-monetarist approach to quantitative easing.' Dean's Lecture Series, Cass Business School, London 26 October 2009.
7. Ibid.

Figure 2: Banking Sector Concentration

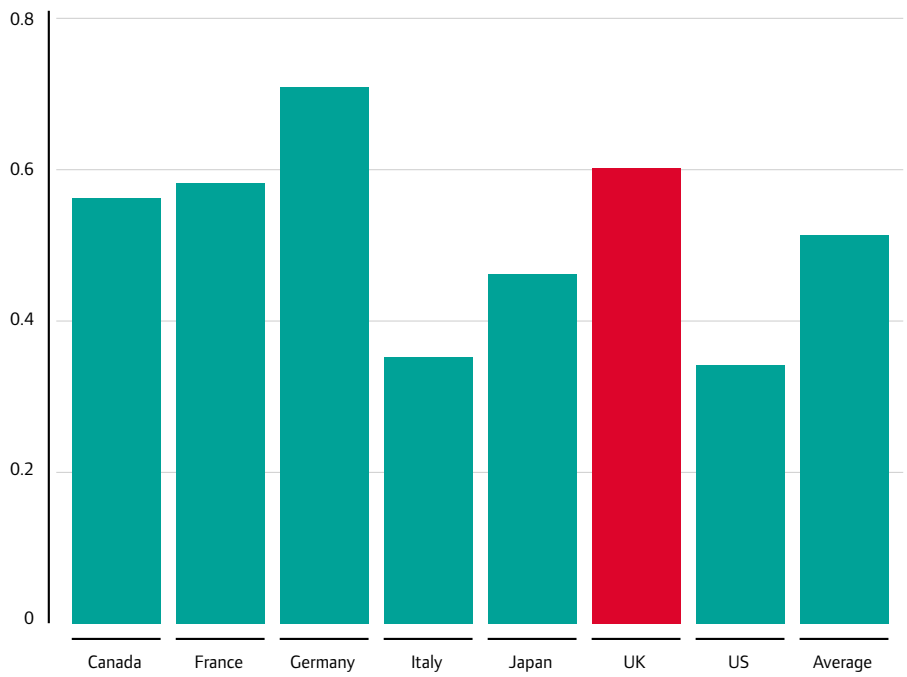


Figure 3: Private Sector Bond Market Capitalisation

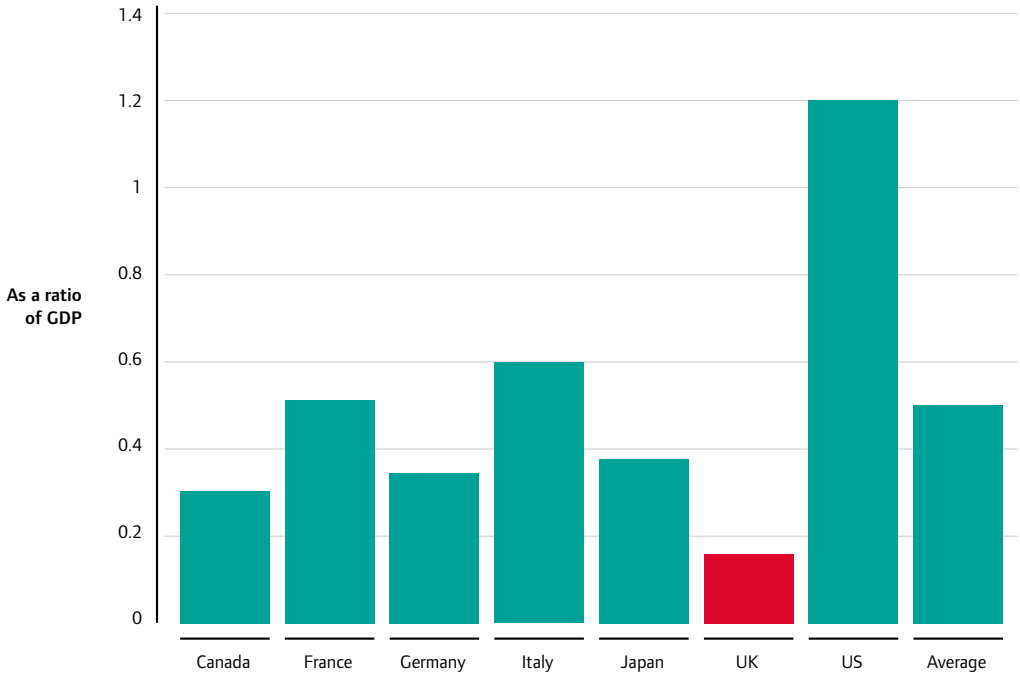
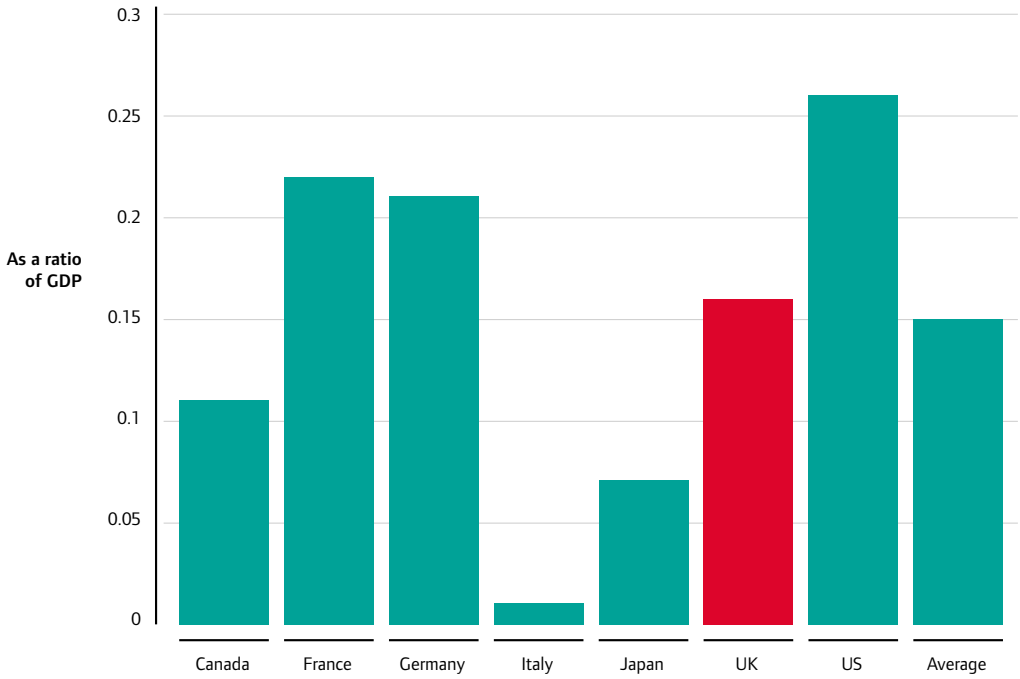


Figure 4: Short term Private Sector Securities



and other European countries may be explained by the greater ability of UK businesses to obtain equity finance; but the fact remains that when it comes to debt finance, UK banks are more dominant than their equivalents in most other countries.

It was not always like this. Private, illiquid debt used to be bought and held by a number of institutional sources: in particular, defined benefit pension schemes, insurance companies and with-profits funds. Demographic change and stock market performance has drastically reduced the number and size of defined-benefit pension schemes, and the defined-contribution schemes that have replaced them have less appetite for illiquid securities; while increasing regulation and transparency requirements are reducing the number and size of with-profits schemes and the appetite of insurance firms for untraded debt.

For some time, this shortfall was concealed by an inflow of bank lending, especially from the foreign banks that established themselves in London over the course of the 1990s and 2000s. But the financial crisis has caused this tide to retreat and the relative barrenness of UK debt markets becomes more apparent.

This lack of funding options can also be linked to the fragility of the financial system. The exposure of large UK banks to large commercial loans that in some cases performed disastrously poorly, created shocks that were felt by large and small business loan applicants alike. The concentration of the sector also saw balance sheet and management systems becoming increasingly homogeneous. As banks aimed to pursue diversification on an individual basis, diversity decreased across the system as a whole. Greater levels of homogeneity are understood to increase systemic fragility.[8]

A second issue is likely to compound the problem of slow lending. The need to deleverage, combined with the possible chilling effect of future capital adequacy regimes and the gathering storm of the Eurozone crisis (and in particular its chilling effect on the interbank lending market) will make it at least a little harder and maybe very much harder for banks to increase SME lending. Xavier Rolet, CEO of the London Stock Exchange argued that banks are being 'forced out' of financing small businesses because of regulatory pressure on them to improve their balance sheets following Basel III; even those who are less pessimistic appreciate that making up for the decreases in lending during the credit crunch will be difficult in this climate.

Towards a solution

In October 2011, the Chancellor of the Exchequer announced that he had asked the Treasury *"to work on ways to inject money directly into parts of the economy that need it, such as small businesses"* and to *"help solve [the] age old problem in Britain: not enough long-term investment in small business and enterprise"*.

The remainder of this paper considers how these kinds of measures can help address the twin problems of a lack of credit and relatively homogeneous debt markets. In doing so, we strive to avoid a number of possible unintended consequences, in particular increasing risk by encouraging moral hazard, incurring excessive costs or liabilities on the part of government and significantly increasing systemic risk.

8. Haldane, A. and May, R. M. (2011) Systemic risk in banking ecosystems. 'Nature.' 469, 351-355 (20 January 2011).

Part 2: Options to increase business lending

Although the UK banking sector is concentrated and its bond markets relatively immature, it is not short of innovative new ideas. This section surveys the landscape of early-stage proposals and ventures aimed at providing debt finance to small and medium businesses. It is based on a series of interviews with financial institutions, professional advisers, journalists, economists and central bankers conducted over the course of autumn 2011. These interviews were supplemented with quantitative research, in particular looking at demand for various types of SME bond among retail and institutional investors.

The proposals that follow are divided into two broad categories: a set of new regulatory and structural solutions, which involve using systemic change to increase the flow of credit to SMEs, and new or niche providers whose role could potentially both provide credit and increase market diversity.

In each case, we provide an overview of the proposal or venture in question, and brief outline of its advantages in addressing the two problems we have identified (the lack of finance for SMEs and the lack of diversity in the lending system), and the risks and costs associated with it.

A. New regulatory and structural solutions

The most immediate way to address the credit problems faced by SMEs involves working in one form or another with existing banks and with the regulations that govern the system.

Before we look at these proposals, it is worth considering how banks' business lending operations work. As is well known, retail banks are in a very general sense businesses that take deposits from savers that are short term (that is, the customer can ask for them back at will) and make loans that are *long term* (that is, the bank cannot ask for its money at will, and often does not expect it back for years or decades). Banks make money because they pay people less interest on their deposits than they charge on their loans. In a bank's balance sheet, loans are of course assets and deposits are liabilities. The time inconsistency between assets and liabilities is one reason why a bank run (when too many deposits want their money at once) is so damaging. Two factors protect against the risk that too many assets will turn out to be worthless or that too many liabilities will be called in at once by depositors. The first is the existence of the interbank lending market from which banks can meet short-term obligations. The second is the protective capital that banks are expected to hold by regulators. The amount of capital that must be held depends on the type of assets that are held (i.e., the types of loans the bank has made). Riskier assets require more capital. The more money the bank has to hold as regulatory capital, the less capital it can put to work as loans, to the detriment of its shareholders.

Most structural solutions look at ways of persuading banks to lend more, by relaxing some aspect of this model, generally by freeing up parts of the banks' balance sheets through the use of regulatory changes or public money (either in the form of money printed by the Bank of England as part of quantitative easing plans, or government guarantees).

Securitisation of existing bank business loans

A direct way to bring to bring new money into the business lending field is for the government to establish and organisation to buy, package up and securitise loans made by banks to small businesses,[9] resulting in bonds – that could be thought of as British Industry and Enterprise Bonds – which other investors could buy. By buying portfolios of loans, the proposal would free up banks' balance sheets to acquire more assets – that is, to make more loans. By taking banks' small business loans, which are essentially illiquid (banks rarely sell them, but rather wait for them to be repaid) and turning them into bonds, which are tradable, the proposal would allow other investors to invest in small business debt. These securities may well be attractive to investors at a time when interest rates and equity returns are low.

Another financing possibility, given the likelihood of further quantitative easing, is for the Bank of England to buy some of the higher-quality bonds generated by such a proposal, while others could be sold to institutional or even retail investors, who might very well be interested in assets offering a better return than many of the underwhelming investment opportunities currently available. Adam Posen, a member of the Bank of England's Monetary Policy Committee, has been a vocal supporter of this option.[10]

The proposal is an attractive way of bringing new capital into the SME loans space and freeing banks relatively quickly to loan more and bringing new private money into the business lending market. But there are a number of concerns that it has to overcome. The implication that the Bank of England would undertake to buy the bonds of a government-organised scheme could be seen compromising the Bank's hard-won independence. There is the question of how to measure the riskiness of the debt issued by the entity, and how to ensure that enough of it is of a high enough quality for the Bank of England to buy (the equivalent of AAA or AA rated) should this become an option. Would private investors really be interested in buying the new securities? And there are questions of moral hazard and asymmetric information: would banks provide the securitisation vehicle with a group of dodgy loans, or neglect their role in managing the loans once they had been parceled up and sold? There is also a question of diversity: by buying loans from banks, do we encourage rather than mitigate a monoculture of bank lending? Finally, there is the hygiene factor: securitisation has a bad name after the role that securitised mortgages played in the global financial crisis, and government-backed entities engaging in securitisation may remind the public of the ill-fated US agencies Fannie Mae and Freddie Mac.

These concerns are important ones, but all seem to have plausible answers.

Posen's speech itself makes a strong case that neither this proposal specifically nor the general idea of coordinated Bank-government action, compromise Bank independence and notes previous comments by Sir Mervyn King supporting the idea that in times of crisis, the Bank should *"play its role as an agent for government"*.[11]

The question of measuring the riskiness of securitised SME loans is a controversial one, not least because inaccurate measurement of the risk of securitised loans played a role in the financial crisis, and some distressed business loans were a cause of the travails of RBS. However, there is some cause for optimism. Firms like Experian, the UK's largest credit reference agency with an extensive corporate business, argue that they have the capability to measure SME lending risk that could be useful in assessing the portfolios, based on databases of company loan defaults that have very wide coverage (~80-90 per cent of UK firms). Defenders of the proposal argue that the default risk of large portfolios of small business loans is both less significant and easier to predict than that of the kind of large, often property-backed loans that caused so much trouble to RBS. The proposal in Box 1 gives one example of how similar schemes have been implemented in the past.

The question of how to ensure the debt of the new entity is of high enough quality to be purchased by the Bank of England is a more significant one. Posen's suggestion is that this would require a partial government guarantee in the event of widespread default of the loans. Providing such a guarantee would be in keeping with the Chancellor's remarks in the October 2011 speech in which he proposed credit easing, where he used a loan guarantee scheme as a model, and could allow a significant investment-grade tranche of bonds to be created without requiring the UK government to put its full faith and credit behind the entire bond – a costly and risky suggestion. For state aid reasons, any guarantee would most likely have to be paid for by the new entity.

9. 'How to do more.' Adam Posen, Bank of England, speech delivered 13 September 2011. Posen references a range of recent empirical research on this question.
10. Ibid.
11. Ibid.

Box 1: Deepening the pools of capital

In the early 2000s, one of the major UK clearing banks looked into the question of how to access new sources of capital to finance its small business loan book. Working with specialised data and risk advisors, the pH Group (now part of Experian) and InterRisk, bundled their business loan portfolio into a number of tranches of different risk levels, with a view to offering them to non-bank providers of finance. At the time, the reinsurance market provided a good value source of finance. By providing a clear view of the creditworthiness of the portfolio, the bank made the insurers comfortable with the risk they were undertaking; for their part, they freed up economic capital, improving the efficiency of their lending operations.

The insurance market is now considerably tighter than it was in the early part of the 2000s, but other attractive sources of capital exist, not least pension funds and other institutional investors, who are keen to identify new investment opportunities in a world of low interest rates and poor equity performance. These investors would find the opportunity to be exposed to generalised SME credit risk attractive. Firms like AgFe (whose members include some of the leaders of the bank reinsurance transactions in the early 2000s) have been developing this model and believe there is significant market interest.

Any government guarantee of course raises questions of moral hazard (e.g., will the entity care about how its loans are managed if a guarantee is in place?), alongside issues of asymmetric information that would exist even without a guarantee (e.g., how do we know banks will not unload bad loans on the new entity?). One way of mitigating the moral hazard is to require banks to retain a proportion of the securities issued by the new entity. Rather than making the banks retaining the most risky securities (which would require the banks to hold relatively large capital reserves, thus defeating the object of the proposal, and if some losses were sustained on the portfolio of loans might quickly wipe out the banks' incentives anyway, since the riskiest securities would take first loss), an alternative is to require banks to hold a small proportion of each type of securities, from the safest to the riskiest. Our interviews suggested that this structure was used in similar private sector structures undertaken by banks before the financial crisis, with the result that retail bank managers were on the whole not aware which loans of the loans they managed were owned by their bank and which by other investors. The issue of asymmetric information and the possible passing off of bad loans would be one of the main tasks of the managers of the new entity. However, proposals like the AgFe one discussed above suggest that at least some organisations currently believe they have the skills to do this, and were planning to do so even in the absence of government intervention.

The question of what other markets might exist for these securities other than the Bank of England is an interesting one. If it can be argued that these would genuinely be British Industry and Enterprise Bonds, with appeal to institutional investors and perhaps also to retail investors, the political argument for the intervention appears stronger. To this end, NESTA conducted two pieces of research: a quantitative survey of mass affluent investors conducted by Ipsos-MORI, and an interview-based evaluation of the views of a group of institutional investors, carried out by Evolution Securities. These results (which are also relevant to a number of other proposals set out here) are included in Box 2, and show widespread interest in investing in these products.

The issue of securitisation risking creating a monoculture is an important one, and has not been widely addressed in discussions of loan securitisation so far. It would certainly be unfortunate if non-bank investors were effectively left out of credit easing because the method used to deliver it did not factor them in. One solution for this would be to establish one securitisation vehicle that looked beyond the banks – to funds such as M&G's UK Companies Financing Fund and even to CDFIs and start-ups.

Box 2: Investor appetite for small business bonds

Two exercises were undertaken to assess investor interest in a British Industry and Enterprise Bond, a tradable fixed income product with some risk, a maturity date of five to ten years, and a return of around 7 per cent, that might be issued either as part of a securitisation of existing bank loans or by a new bank.

Ipsos-MORI undertook a survey of 200 investors with investment portfolios ranging from £100k to £1 million, asking about their interest in a proposed British Industry and Enterprise Bond.

The British Industry and Enterprise Bond as presented to interviewees was well-understood with 97 per cent finding it at least fairly easy to understand. Seventy-six per cent found it at least fairly appealing and 70 per cent are at least fairly likely to make an investment in it. Seventy-seven per cent of the investors who found the product appealing would be willing to allocate up to 10 per cent of their portfolio to this product.

Investors felt that the most credible providers of such a product would be either companies with a track record of investing in small businesses or new government-backed institutions created to support small businesses. (Over 70 per cent of investors identified each of these types of issuers as credible providers of the product.)

Qualitative interviews also suggest that there is significant interest from institutional investors in getting exposure to SME credit risk. Low interest rates and poor equity performance has increased investors' willingness to look at new asset classes. To the extent that these products can deliver relatively pure exposure to the credits of UK small businesses (rather than bank-specific exposure), our interviews suggested institutional investors would be keen to participate, either through private placements or by buying bonds.

The same survey has been carried out by Evolution Securities across 17 UK wealth managers. Seventy-six per cent of the interviewees are very likely or fairly likely to invest in the British Industry and Enterprise Bond.

Forty-four per cent of the wealth managers stated that the most credible providers of the product would be a new government-backed institution created to support small businesses; 30 per cent of them felt that the product should be issued directly by the SME who will benefit from the investment.

A government guarantee to cover 50 per cent of any loss in value of the initial investment is believed to make the product more appealing to 82 per cent of the wealth managers.

The final concern relates to what has been called 'Fannie/Freddie risk' – the worry that a securitised solution may fall prey to the excesses that finished off the US non-governmental mortgage securitisers. On this point, there is some cause to be confident. Adam Posen's original proposal notes that Fannie Mae and Freddie Mac ran into trouble not because securitising loans is a bad plan, but because they were explicitly allowed in recent years to keep mortgages on their own books, rather than quickly bundling and securitising them.

Assessment: Buying and then securitising bank business loan portfolios offers a way of bringing significant amounts of capital into the banking sector relatively quickly, and the major objections to it are remediable. Such a solution would of course require some government guarantees and the purchase of bonds by the Bank of England.

New lending entities

Since early in the financial crisis, a range of commentators have suggested that a new institution be established to make loans

to small businesses. Under the previous government, BIS spent some time looking at Germany's *Kreditanstalt fuer Wiederaufbau* to see if it offered a role model for a new government-backed institution in the UK. Anthony Hilton recently argued in the *Evening Standard*[12] that the Government should establish a new bank, perhaps carving it out from one of the nationalised banks, while Will Hutton has in the past been a vocal supporter of the establishment of several state banks. Indeed, it is occasionally remarked upon that while the US, Germany, France and Italy all have quasi-public banks or bank guarantor institutions (see Appendix A), the closest equivalent in the UK is the relatively recent, small-scale and non-institutional Enterprise Finance Guarantee scheme.

One suggestion is that a public bank be established to lend to SMEs, with a size-limit for loan applicants and a willingness to make loans and discount trade credits and invoices; because the bank does not have a legacy portfolio of (in some cases bad) loans, it is likely to be a more active lender, and will help address the issue of diversity of provision. Indeed, given the remit of the bank, it is possible that it will be able to develop a more SME-tailored offering, delivering extra value to its customers.

A few concerns have been expressed over the idea of a new, in-practice state-backed bank. One risk is that a state bank risks handing too much funding discretion to if not political appointees, then those who can be influenced by government. Although this could be mitigated by the way the bank is structured, while the bank remains in the public sector there will always be the accusation either that the bank is a distant unaccountable quango or that it is too politically controlled. On the other hand, it is worth noting that such institutions are not rare. As Appendix A shows, most rich countries, including the US, Germany, France and Italy, have their equivalent.

A more pragmatic concern is the time it would take to establish a new bank. The experience of Metro Bank and the Business Growth Fund are cautionary in this respect: both have taken months to set up and more months to bed in, and have both been criticised for it. Whether or not this criticism is fair, a state bank is not a short-term solution.

Assessment: An interesting solution both from a credit easing point of view and from the point of view of competition. The question of time to impact is important to resolve though.

12. See: http://www.thisislondon.co.uk/markets/article-24002556-smes-need-help-not-a-new-bond-market.do

Macroprudential easing

Championed by the Bank of England's Andy Haldane, macroprudential easing takes a different approach to the problem. Rather than buying bank assets so they can lend more without breaking capital adequacy rules, macroprudential easing involves changing the rules, at least temporarily while the economy is striving to recover.

By relaxing the capital reserves that need to be held against business loans, banks can be freed up to lend more to businesses. There is some precedent for this kind of policy: banks' (equity) investments in the Business Growth Fund were deemed by the FSA to be less risky for regulatory purposes than a normal private equity investment given the nature of its investments. It also has the advantage of being quick, requiring little more than a regulatory decision.

One important question to address when it comes to macroprudential easing is the political acceptability of the proposal, which conjoins two worlds that policymakers often seek to keep separate: capital adequacy and the promotion of growth, leading to nervousness about precendents.

Assessment: A fast-acting idea, if politically feasible. Probably does little to affect the diversity of the sector, but could be combined with other measures.

Competition regulation

Perhaps the most long-term proposal for encouraging new money into the SME lending market is to change the basis on which banks compete for customers. One issue that entrepreneurs report is the difficulty of seeking loan quotes from banks other than their main bank. This is unsurprising, as the credit scoring metrics used by banks to evaluate the bulk of loan requests rely on cashflow data that is easily accessible for a bank's own customers but not for others.

Businesses like Funding Options, a London-based start-up and winner of the TSB's Tech City Launchpad, argue that their IT-based systems can help improve companies' ability to seek out loans from a variety of banks. They have also argued that regulatory measures could be taken to assist this, such as increased standardisation of SME loan features (as is commonplace in retail financial services). (If implemented, this would also make it easier to securitise portfolios of SME loans). Another useful step would be if it were easier

for SMEs to access and use positive financial data held about them (such as their historic loan repayment track records, or evidence of their sound bank account management) to demonstrate their credit-worthiness (whilst also providing new structured and reliable data sources to support securitisation and/or underwriting); government may have a role to play here, for example in encouraging banks to open their programming interfaces to make it easier for third-party vendors to design software allowing this to happen.

B. Niche and emerging debt providers

The other set of options involves looking at existing but smaller players in the business debt market and looking at the potential role they can play. In the context of a market that could benefit from more diversity, this angle is important.

New banks
Although the financial crisis saw many foreign banks scale back their presence in London, across the UK we are seeing a range of growing start-up banks, the most famous of which are the UK operation of Sweden's Handelsbanken, the UK-owned Metro Bank, and Virgin Money, which recently acquired Northern Rock from the Government. Handelsbanken for one has a distinctive attitude to business banking, based on empowered branch managers, 'church spire lending' and a relatively high-touch service. This is a trend that many larger banks are trying to follow for their best medium-sized customers, but the inertia of large banks make this harder to achieve, especially while cutting costs. What is clear is that new banks are unlikely to scale quickly enough to offer a real challenge to the Big Four.

Assesssment: It would seem anticompetitive if any measure taken with relation to large banks, such as securitisation and bond purchase, was not also on offer to new providers. At the same time, growth of new providers is unlikely to be fast enough to address the credit needs of UK SMEs.

Investment funds
Although the UK's business lending market relies on banks heavily, a small number of funds either invest in business debt or have an appetite to. The UK Companies Financing Fund established in 2009 by M&G, one of the UK's leading fixed income fund management experts, is a prominent example: this is a £1.5 billion fund established to provide debt finance to medium-sized businesses, set up to fill the gap left by international banks going back to domestic lending. Similarly, organisations that currently invest equity, such as the Business Growth Fund (BGF) and the government-backed VC fund-of-funds operator Capital for Enterprise have also expressed interest in the question of how to expand debt finance. In the case of the BGF, it has argued that its existing due diligence network and the kind of businesses in which it invests would enable it to triple the sums it invests by being a debt provider (for example by raising bonds). These organisations also bring expertise with them – in M&G's case a track record of analyzing and valuing a wide range of private debt, and in the BGF's case the possibility of combining debt and equity products to offer a suite of finance potentially very relevant for the fast-growing companies on which the economy relies.

Peer-to-peer lending
Peer-to-peer lending involves can get funding directly from a community of lenders, generally through an online platform without reference to banks. The development of this market niche was boosted by the banking crisis when person-to-person lending platforms promised to provide credit at the time when banks and other traditional financial institutions are having fiscal difficulties. A pioneer in this area is Funding Circle. The company is an online marketplace where small businesses can borrow from a pool of individuals and organisations with money to lend, eliminating the high transaction cost and complexity of banks. Lenders can be private individuals, limited companies or public bodies. Funding Circle currently facilitates £2.2 million of business loans in the UK each month. Although loans may be more costly than other sources of finance, the speed of decision-making and flexible repayment terms are offsetting factors. Borrowers are usually companies that wish to borrow to finance their expansion or seeking working capital but they had been rejected by banks or they are frustrated with the length of time they had to wait for a loan decision from their bank.

CDFIs and mutuals
CDFIs lend money to businesses, social enterprises and individuals who struggle to get finance from high street banks and loan companies. CDFIs are funded in different ways. Many are part-funded by Government departments and agencies. For example, a number of business-lending CDFIs in England

have funding from the Regional Development Agencies, while many personal-lending CDFIs have funding from the Department for Work and Pensions Growth Fund. Other funding sources include European grants, donations from charitable trusts, social investments, and grants and loans from high street banks.

Direct bond issuance, including loan notes and 'shaving bonds'

Despite the relatively small size of the market for small and medium-sized corporate bonds in the UK, it does exist. The London Stock Exchange's ORB electronic market is increasingly dealing with smaller bond issues (a recent issue for the Places for People housing association raised £140 million). The CBI has recently argued that more medium-sized companies should consider issuing bonds, and the existence of a high-quality trading platform is an important prerequisite.

A number of companies too small to make the cost of issuing bonds worthwhile have taken advantage of loan notes, occasionally called 'shaving bonds' after an early bond designed and issued by King of Shaves in 2009. The buyer hands over cash for a fixed period while the company issuing the bond agrees to pay a set rate of interest for the duration. As the issuer asks investors to take a stake in the future growth of their businesses, they are particularly suitable for companies with existing brand loyalty or a 'following' by its customers or clients. Some UK businesses spurned by banks are increasingly turning to this source of cash to finance their expansion. The King of Shaves bond has a three-year term and carries an interest rate of 6 per cent per annum. Their fundraising raised £627,000, a sum that would be difficult to raise through any other sort of offering because of the high overheads. **Hotel Chocolat** offered to their 100,000 members of the testing club the possibility to choose between a bond of £2,000 with a gross annual return of 6.72 per cent or £4,000 at 7.29 per cent. They raised £3.7 million and they expanded their business taking on more staff and opening new stores.[13] **Caxton FX** is a £400 million-turnover foreign exchange business. The CEO, Rupert Lee Browne, after having been offered less than he required by a bank, decided to raise the working capital needed himself. Caxton is now issuing retail bonds, and so far they have raised £4 million of working capital with an investment of £60-100k in marketing and legal costs. Caxton FX allows investors to invest between £2,000 and £50,000 for a 7.25 per cent gross annual rate of return.[14] Other similar products have been offered by John Lewis Partnership and Ecotricity.

Assessment: the wealth of potential new providers in the UK is encouraging, given the lack of diversity among the big players. There are several options for using credit easing in a way that encourages their growth. One potential option is to establish a set of principles for quantitative easing funds to be applied to existing non-bank channels in the same way that the securitisation proposal gives banks access to it. This may be less relevant to the smallest new providers, but it could provide a valuable boost to new banks and other institutions like M&G and BGF, and could bring new expertise (such as the use of equity alongside debt for growth companies) to the market. Of course, the disadvantage of such an approach is that, to the extent that these are not deposit-taking organisations, there will be no money-multiplier effect from this.

Whether or not a formal credit easing policy is implemented, new providers have an important role to play in the UK's debt markets in the longer term. The proposals cited above to increase businesses' ability to shop around for their business loans will benefit new providers, by decreasing the advantage of incumbent banks. In addition, there is a wider question to be asked over the goals of financial regulation when it comes to new providers. Currently, financial regulators are rightly concerned to protect customers from risks arising from unproven new models. However, given the benefits of greater diversity of provision, it would make sense for regulation to have regard to the question of diversity of provision of debt finance. This would mean that in respect of new providers with new business models, such as peer-to-peer lenders, regulators would consider the development of more limited regulatory frameworks that could be quickly put in place to allow new ventures to go to market faster. Critics might argue that this is a foolish move in light of the deleterious effects of financial instability on the world's economy over the last three years. However, this view is mistaken: financial stability is not best served by a monocultural industry, and diversity brings a strength of its own. It is better to have a few small innovative financial services businesses fail than to encourage the persistence of a system overly dominated by large banks, which as we have seen are not immune to failure either, but who fail far more dramatically. The UK's willingness to allow peer-to-peer equity investment when the US did not gave it a lead in this useful and growing

13. See: http://www.thisismoney.co.uk/money/investing/article-1726430/How-invest-direct-retail-corporate-bonds.html
14. See: http://www.ft.com/cms/s/0/4babaa20-d8a6-11e0-9089-00144feabdc0.html#axzz1d6vx9CMU

sector – the opportunity exists to do the same for debt finance, and we should not be put off by a false dichotomy between safety and innovation.

Finally, there is a case for levelling the playing field between financial services start-ups and other start-ups. Currently, a number of incentives exist to encourage entrepreneurs to proceed with the risky business of starting innovation new firms. These include the availability of government risk capital through the Enterprise Capital Fund scheme, tax relief through the Enterprise Investment Scheme, the ability to pay share options at a reduced rate of tax through the Enterprise Management Initiative, and others. Financial services companies are for the most part explicitly excluded from these incentives. The intention behind this appears to be to exclude the likes of hedge funds or large leasing businesses, which arguably do not generate the same level of positive externalities as other start-ups, and which due to their ability to scale quickly might be able to take advantage of unduly large tax breaks. But it creates the odd situation that a company like Wonga, recently voted Europe's most successful tech company, was ineligible for any of the support generally available to tech start-ups in the UK. Drafting an exemption for financial services businesses of an appropriate scale that are providing new models of financing businesses, like Funding Circle, seems a fair step to take and one that would help encourage diversity of provision.

Part 3: Recommendations

Regardless of the final decision on formal credit easing, the long-term goals of government policy should be clear: to encourage a diverse and competitive market for debt finance that includes but extends beyond the banks.

There are some no-regrets moves that should form part of any plan: creating a level playing field for innovative start-ups involved in the financing of small and medium businesses, ensuring financial regulation has diversity of provision as one of its goals as well as simply stability, and encouraging banks to adopt standards that help business shop around for the best lending rates. The government should also encourage moves by individual businesses to seek independent debt finance, whether this is medium-sized businesses tapping bond markets like the London Stock Exchange's ORB, or smaller businesses raising loan notes from their customer base.

If the Treasury and the Bank of England seek to have more short-term influence on the flow of credit to small businesses, the most promising option is to set up a vehicle to buy business loans from banks and securitise them, supported by a partial government guarantee. Our research suggests that the 'UK Industry Investment Bonds' created by such a process would be of interest to institutional and retail investors. This would significantly increase the diversity of finance available to UK businesses. The securitisation process could also be carried out in such a way that the bonds can be purchased by the Bank of England, should it choose to buy corporate securities in a future round of quantitative easing. In order not to entrench the dominance of banks in the financial landscape, this scheme should also be available to non-bank institutions that issue and hold SME debt, such as M&G's UK Companies Financing Fund.

Finally, in the medium term, the combination of bond purchases through quantitative easing and a partial credit guarantee by the Treasury could also be used to support the growth of new or expanded entities to lend to businesses. A number of existing entities may be well placed to take up this challenge (including public entities such as Capital for Enterprise and private organisation such as the Business Growth Fund, demerged parts of currently nationalised banks, and investment managers) allowing new loans to be made rapidly.

Appendix: International examples of credit easing institutions

The report notes the relatively concentrated nature of the UK's credit markets. It is also worth noting that most other rich countries also have publicly-backed institutions whose role is to increase supplies of finance to small and medium businesses.

United States

Small Business Administration (SBA)
SBA is a US government agency that has been providing support to entrepreneurs and small businesses since its creation in 1953. SBA supports $27billion in loan guarantees for businesses.

SBA provides a number of financial assistance programmes for small businesses covering debt financing, bonds, and equity financing:[15]

- **Guaranteed Loan Programmes**[16]
  SBA does not lend directly to small businesses, but guarantees that banks' loans to SMEs are repaid, thus eliminating some of the risk to the lending partners. When a business applies for an SBA loan, it is actually applying for a commercial loan, structured according to SBA guidelines with an SBA guaranty.

- **Tax-exempt, industrial revenue bonds (IRB)**[17] are attractive financing options for small manufacturers looking to expand operations and upgrade facilities. These bonds are debt securities issued by a state or local government development agency on behalf of a private business. Once issued, tax-exempt bonds are sold in the open market or purchased by investors or financial institutions. Interest income earned by the bond purchaser is exempt from state and local taxes, which allows the lender to pass savings to the borrower in the form of a lower interest rate.

  Applicants have to demonstrate a strong business plan and project proposal, creditworthiness and strong financial statements. In addition, borrowers have to demonstrate how proposed projects will create jobs and positively impact the local economy.

- **SBA's Small Business Investment Companies (SBIC)**[18] are privately owned investment funds, regulated by SBA. With the private capital they raise with funds borrowed at favorable interest rates through SBA, SBIC provide financing in the form of debt or equity to small businesses.

15. See: http://www.sba.gov/content/what-sba-offers-help-small-businesses-grow
16. Ibid
17. See: http://www.sba.gov/content/tax-exempt-bonds
18. See: http://www.sba.gov/content/what-sba-offers-help-small-businesses-grow

Italy

Despite the critical economic situation of the country, in the past few years the Italian government has put in place numerous initiatives to increase the stock of lending to the four million plus Italian small businesses. Significant for this report are the two following intermediaries:

- **Cassa Depositi e Prestiti (CDP)**[19] is a joint-stock company under public control, with the Italian government holding 70 per cent and a broad group of bank foundations holding the remaining 30 per cent. The institution manages a major share of the postal savings of Italian citizens which it uses to contribute to the growth of the national economic system by supporting the wide variety of needs of Italian small businesses. In 2009 the CDP had been endowed with €8 billion for the support of small businesses. Since then, €6.5 billion has already been used to spur the expansion of ca. 36,000 companies.

  CDP funding to SMEs is not granted directly to the businesses but issued via the Italian banking system, provided that the banks are insured or guaranteed by SACE, the credit and investment insurance company. CDP can only directly fund a company if the transaction amount is more than €25 million, if the banking system is not willing to be involved to the same amount of credit. This process is, however, guaranteed by SACE.

- **Bank of the South – Banca del Mezzogiorno** is a new project that was launched in 2009 by the Italian Ministry of Finance with specific focus of providing long-term credit to small businesses in the South of Italy. The project aims to create new businesses, support young entrepreneurs, increase the internationalisation of southern companies, support innovation and reduce unemployment in the region. Banca del Mezzogiorno acts as a second level financial institution: it operates by networks of banks and institutions joining the initiative. Due to the fact that the bank has not started operating yet, the Italian government has not yet indicated how much money will be set aside for the project.

19. See: http://www.cassaddpp.it/cdp/Areagenerale/English/index.htm
20. See: http://www.KfW.de/KfW/en/Domestic_Promotion/Our_offers/Business_expansion_and_consolidation.jsp
21. See: http://www.KfW.de/KfW/en/KfW_Group/Press/Latest_News/News/2010/KfW_achieves_record_financing_volume_in_Germany.jsp

Germany

Kreditanstalt fuer Wiederaufbau (KfW)
KfW is a German government bank formed in 1948 as part of the Marshall Plan. The core activity of KfW has always been financing SMEs. Innovative instruments have been continuously developed to create a more conducive environment for SME financing. Examples of the new approaches pursued include the extension of global loans, promotion of the capital market and the securitisation of SME loans.

KfW Mittelstandsbank is the segment of the bank in charge of financing the expansion of small and medium-sized businesses. Financing is available for small and medium-sized businesses that have run into financial difficulties. The *KfW-Unternehmerkredit* is the specific programme for small and medium-sized companies from Germany that have been active in the market for more than three years, to finance their investments and working capital.

The loan has a term of up to 20 years and a maximum sum of €10 million. KfW's loans to SMEs are not granted directly to the SMEs but channeled via the German banking systems, therefore the SME can apply for a KfW loan with a bank of its choice. After a positive credit appraisal the application is forwarded to KfW by the bank. KfW checks whether the eligibility criteria for the promotional programme are met. The SME's bank bears only 50 per cent of the credit risk and KfW bears the other 50 per cent. Leaving 50 per cent of the risk with the bank, KfW ensures that the bank has an adequate incentive to conduct the credit appraisal as carefully as it would do if it was fully liable for the loan.[20]

In 2009 KfW Mittelstandsbank achieved a record volume of commitments of €23.8 billion.[21]

France

Caisse des Dépôts[22]
The Caisse des Dépôts (CD) is the French public institution responsible for the economic development of the country. Last year, CD spent €18 billion to finance SMEs through three main programmes:

- **CDC Enterprises** is a subsidiary of the CD Group. It is dedicated to financing SMEs with growth potential and not listed on the stock market, using equity capital.

  It invests in capital investment mechanisms which themselves invest in companies and directly in SMEs. On average, it accounts for 35 per cent of the seed capital funds in France and 20 per cent of venture capital funds. CDC Enterprises finances around 2,500 companies.

- The **Strategic Investment Fund (FSI)** is also a subsidiary of the CD Group, created in 2008. CD has a 51 per cent holding, while the State has a 49 per cent stake. FSI invests equity capital in French companies mainly in the manufacturing and service sectors with industrial projects which add value and competitiveness to the economy.

- CD approves funding to the **OSEO**. OSEO is a public institution whose mission is to finance and support SMEs, to ensure better continuity in the chain of financing for their projects, through three complement areas of work: innovation support, bank financing and guarantees. CD annual budget for OSEO is €6 billion. In addition CD and OSEO have created shared regional platforms to provide an even better support for companies seeking funds.

22. See: http://www.caissedesdepots.fr/

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