Business, Innovation, and Skills Select Committee
House of Commons
London
SW1A 0AA

10th February 2016

Dear Committee,

Institute of Directors' response to the Committee's inquiry into Access to Finance

The Institute of Directors welcomes this opportunity to respond to the Committee's call for evidence into the financing landscape for the UK's firms. This issue has been consistently high on the agenda for IoD members, who have struggled to achieve the levels of finance that they enjoyed before the 2007/08 financial crisis. While the last few years have seen many of the constraints around accessing finance ease somewhat, SMEs' access continues to lag that of their counterparts at the larger end of the size spectrum. Although the problem of small business financing is not new, there is now real opportunity to broaden the options available to these businesses. Policymakers should welcome this new landscape.

About the IoD:

Founded in 1903, and granted a Royal Charter in 1906, the IoD is an independent, non-party political organisation of around 35,000 individual members. Its aim is to serve, support, represent and set standards for directors to enable them to fulfil their leadership responsibilities in creating wealth for the benefit of business and society as a whole. The membership is drawn from right across the business spectrum. IoD members are well represented in the senior management of FTSE 100 and FTSE 350 companies, but the majority of members, some 70%, comprise directors of small and medium-sized enterprises, ranging from long-established businesses to start-up companies. In 2014, the IoD launched the IoD 99, a vibrant and active network of younger entrepreneurs which now counts nearly a 1,000 members.

How has the landscape for access to finance evolved since the end of the financial crisis?

Bank sourced corporate credit was undoubtedly the order of the day for UK firms in the run up to the financial crisis. However, the years following 2007/08 saw companies (in particular SMEs) struggle to access even relatively small levels of finance as banks looked to bolster their balance sheets against further shocks to the global economy and respond to a steady flow of new macroprudential regulation from policy-makers. At the same time, many firms were wary of taking on greater levels of debt in the face of ongoing economic uncertainty.

The ensuing situation was one of politicians lambasting banks for not making cash more readily available, a regulatory environment that discouraged doing just that, while lenders and borrowers passed blame back and forth for the sustained low levels of corporate investment.

In comparison to successful international competitors, the UK banking system was also poorly equipped to deal with the finance demands of small businesses during the crisis. Contrast the UK lending environment - centred on a handful of large banks - against the lending landscape in other successful western countries, and this becomes apparent. German mittelstand firms have access to (and often long-standing relationships with) around 1,500 small lenders across the country. Lending to German SMEs did not decline noticeably throughout the crisis. Over the same period, in the USA, small firms were able to access government funds (via the Small Business Administration) through a large network of intermediaries around the country. This does not necessarily mean that we would wish the UK to follow either of these paths, but is worth noting nonetheless. American firms, too, were significantly faster in taking up the new avenues for finance that have emerged over the past few years.

That being said, since the latter part of 2012 conditions in the UK have improved more or less across the board, albeit at differing rates. Currently the outlook for large corporates is particularly rosy, with a net percentage balance of CFOs reporting that new credit is 'cheap' in Deloitte's 2015 Q4 survey[1]. Many medium sized firms have also seen steady improvement in bank lending since 2012. However, the landscape is still more difficult to navigate for smaller firms who continue to face (relatively speaking) higher interest rates, despite the Bank of England's best efforts. The IoD has received anecdotal confirmation of reports that SMEs in supply chains linked to large corporate firms find it easier to secure loan finances from banks.

It is perhaps for this reason that IoD members (predominantly drawn from the SME community) are not necessarily looking to bank lending as their primary source of finance. Between 2011 and 2014, 55% IoD members did not apply for a bank loan and of those that did apply, 29% saw their applications rejected. At the beginning of 2016, 75% of IoD members cited retained earnings as an important source of credit for investment this year, against 35% who were looking to bank loans. There is an argument that the understandable reticence of the banks to loan in the immediate aftermath of the financial crisis has impacted the willingness of firms to even approach the banks.

Among the IoD 99, the IoD's network of younger entrepreneurs, there is a similar story to tell. While access to finance is an issue – some 39% say a lack of it is having a negative impact – it comes second to skills. When surveyed in November 2015, we asked IoD 99 members how important or unimportance certain types of finance had been in the past five years, and would be for their business over the next ten years. The results are below.

Over the past five years:

	Very important	Important	Did not use
Family	31%	22%	39%
Personal unsecured loans (credit cards)	16%	20%	44%
Private equity (venture capital)	16%	6%	62%
Government grants	15%	19%	52%
Non-Government grants	13%	16%	55%
Friends	12%	16%	55%
Government loans	10%	10%	60%
Bank loans	9%	10%	54%
Non-bank loans (eg peer to peer)	8%	11%	60%
Personal secured loans	2%	4%	72%
Equity crowdfunding	3%	5%	70%

[1] The survey also indicated continued concern over the levels of external financial and economic uncertainty facing their business.

Over the next ten years:

	Very important	Important	Will not use
Private Equity / Venture Capital	33%	18%	29%
Government grants	23%	30%	17%
Non-Government grants	23%	24%	26%
Equity crowdfunding	21%	17%	33%
Bank loans	18%	30%	27%
Government loans	14%	21%	36%
Family	13%	18%	38%
Non-bank loans (eg peer-to-peer)	12%	32%	31%
Personal unsecured loans (credit cards)	11%	18%	38%
Friends	10%	7%	45%
Personal secured loans	3%	10%	53%

What is clear is that many younger entrepreneurs see bank loans, in particular, as only *part* of the financing mix, rather than the be-all and end-all that it may have been decades ago. Further, while many businesses start off the back of family and credit cards, growth phases require capital beyond those capabilities.

One concern we do wish to flag is that the reliance on family for many start-up firms indicates that there needs to be a level of disposable – or perhaps 'riskable' – capital within those families in the first place. Ensuring that those entrepreneurs who might not have a financial family safety net are able to source finance in order that their potential businesses are not hindered from the off should be a big part of the Committee's work in this area

A timely palliative for the smallest firms – and especially start-ups – has been the proliferation of alternative finance providers in the UK over the past few years. The British Business Bank (BBB) places year on year growth of alternative finance lending to businesses in the UK at 75% in 2015, with equity crowdfunding putting in a particularly strong performance. The small business community has also seen a welcome boost in the amount of equity funding flowing towards it, with the BBB reporting a rise of 43% in equity finance investment in 2015.

At the other end of the scale, large corporates have also continued to successfully diversify away from bank lending; making greater use of capital markets (particularly the corporate bond markets). The new road-map set out by the UK's commissioner to the EU, Jonathan Hill, for a Capital Markets Union will hopefully lead to much greater movement towards capital markets – an area where European firms traditionally lag their US counterparts – and help bring smaller companies to the party by reducing access costs.

Despite these changes, many SMEs continue to feel as though a more diverse financing landscape is out of their reach. This is the case for a number of reasons:

- Most are still considered by banks to be relatively high-risk, low-return loan recipients;
- The costs of accessing capital markets are still too high for many, and;

- The majority still lack the appetite or understanding to risk approaching alternative lenders[2]

What these points boil down to is the fact that many SMEs are simply too small to consider expanding their horizons, and too large to risk heavy losses on a punt at finance platforms that have yet to face the test of heavy handed regulation, public scrutiny, or recession.

Survey data from the wider IoD membership corroborates this trend, with just 7% seeing non-bank options like peer-to-peer platforms as important to financing their business. This figure is at just 2% for equity crowdfunding and reward-based crowdfunding.

More attention should be given to how SMEs can be encouraged to diversify away from bank lending, whether it is through reducing the risk implicit in many new alternative finance platforms, or lowering the cost of accessing capital markets. Proposed changes to the EU's prospectus directive seem like a positive step in the direction of the latter.

On the start-up front, the IoD has been a firm champion for government schemes like the Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS)[3] that have widened the pool of potential investors for early stage businesses, which we will discuss in more detail later in this response. Other initiatives, such as the Patent Box initiative and the Angel Co-Fund have also been positively received, although poorly publicised.

Schemes like these have been helpful in sustaining the explosion in the number of UK start-ups over the past few years, and the Committee has correctly identified the issue of further and faster growth (scaling) as the next hurdle facing these firms. Statistics from the British Business Bank's Small Business Finance Markets Report 2015[4] also emphasise this need to focus on the UK's scale up businesses, suggesting that an increase in the number of these firms, alongside more impressive export performance, are needed to address the issue of lagging productivity.

What have been the most successful Government policies to assist growing companies access to private finance and where is there room for improvement?

Leading figures from across the political spectrum are effusive about the UK's potential to be a global start-up capital. This positive political noise, in addition to a favourable tax environment, flexible labour markets, an advanced internet economy, and the strength of London as a centre for global finance (and fintech), combine to create an attractive environment for investors and entrepreneurs alike. That being the case, the UK still undoubtedly lags the USA as a destination that many scale-ups approach for investment and with the possible exception of Skype we have yet to see a real global behemoth emerge from Europe, let alone this country.

Looking at specific government measures, tax incentives, available through Venture Capital Trusts, as well as the EIS and SEIS have been extremely useful in widening the pool of finance available to start-ups and small businesses. Additionally, funding options available to firms via the British Business Bank and the Government's Start-Up loans scheme have seen significant take-up by entrepreneurs. These developments are to be welcomed.

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[2] Although this trend does not quite hold true in London, where figures show that the capital's firms raised an estimated £350m last year through peer-to-peer platforms.

[3] McLoughlin, Jimmy (2015) 'Opening the Equity Economy', Available at: http://www.iod.com/influencing/press-office/press-releases/democratise-investment-to-create-equity-economy

[4] British Business Bank (2016) Available at: http://british-business-bank.co.uk/research/small-business-finance-markets-report-201516/

However, the real challenge now facing policymakers and the business community is how to increase the number of scale-up firms in the UK. OECD statistics put the UK near the bottom of the table in terms of the number of firms falling into the scale-up category.[5] Only 3% of UK start-ups become mid-sized, against 6% in the USA. At the same time, many of the obstacles identified in the Government's 2014 Scale-Up Report remain largely unchanged. The report indicated that successful leaders of fast growing firms face many more challenges than just access to a diverse range of financing opportunities. They also struggle in terms of:

- Finding employees to hire who have the skills they need
- Building their leadership capability
- Accessing customers in other markets / home markets
- Navigating infrastructure

On the first point, the UK continues to face a skills crisis. In January, UKCES Employer Skills Survey found that 23% of UK vacancies are hard to fill because of skills shortages, with demand for skills up 130% on five years ago.[6] Although this is a crisis that affects firms across the board, it is most acutely felt within firms looking to scale rapidly. Many potential scale-ups also sit right at the frontier of business and digital innovation, arenas where competition for labour is fierce and there is simply no time to waste waiting for new skills to ebb into the workforce. Skilled migration is vital in allowing UK companies to compete in these new industries and the bitter debate over immigration, stoked at times by political leaders, has drowned out this reality.

The Government has set an ambitious target of £1tn a year worth of exports by 2020 and a great many more UK firms will need to begin exporting to reach this target. However, global economic headwinds and sustained uncertainty around the UK's membership of the European Union are also making the leaders of small businesses more wary about the prospect of approaching new markets. Without the room or inclination for international expansion, the UK scale-up community is unlikely to grow at a satisfactory pace.

It's clear, then, that while this Government has done a great deal to support small and growing firms, there are still areas where more could be achieved. The IoD's 2015 report *Opening the Equity Economy* identified EIS and SEIS as particularly positive initiatives where more could be done to see their benefits realised. The report made a number of recommendations that we would also commend to the committee. It proposed:

- EIS and SEIS investments be included in a super-ISA
- Government to be more vocal in promoting EIS/SEIS as funding options to the business and investment community
- The introduction of an online-only system for claiming tax relief on investments of less than £2,000
- Industry and government to work together to create an EIS/SEIS 'aggregator fund' to give smaller investors the opportunity to take stakes in a number of companies with a much smaller investment

[5] Scale-ups are enterprises with average annualised growth in employees (or in turnover) greater than 20 per cent a year over a three-year period, and with 10 or more employees at the beginning of the observation period. (OECD

[6] UKCES Employer Skills Survey (2016) Available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/495447/UKCESS_2015_Report_-_for_web.pdf

- A pilot scheme to be launched in the North West which explores the impact of a higher regional rate of SEIS tax relief. If successful, this scheme could be extended to other area of the country as a way of encouraging start up growth across the UK, not just in the South East.

At a European Level:

At the other end of the size spectrum, the IoD has been encouraged by the roadmap set out by the European Commission for a Capital Markets Union. The CMU agenda could provide a real boost to the equity economy in the UK and open up a large pool of investment opportunities outside of this country. On a broader level, it also presents the UK with a chance to export its own, more market-based financing model to the rest of Europe and bring more capital through our financial markets.

To an extent, the simple recognition by the EU that companies should be encouraged to diversify away from bank finance is welcome. For too long the attitude in Brussels and many European capitals has been geared towards 'making the financial sector pay'. The result is that alternative finance has been caught up in the regulatory reaction to the crisis, with the Alternative Investment Fund Managers Directive a notable example. However, Jonathan Hill's tone on wanting the EU to focus on growth - with respect to its relationship to financial stability – reinforces an encouraging narrative. As he has stated, we do not want to see "the stability of a graveyard".

So far, the concrete steps taken by the European Commission on the CMU include a legislative revision to the Prospectus Directive, two new regulations to boost EU securitisation and the securities market, a green paper on retail financial services, and a cumulative review of the EU's regulatory framework for financial services. These are all firmly to be welcomed.

On the first of these, a prospectus directive that will be uniformly applicable across member states is a positive move. The uneven application of the directive as it currently stands has presented a big challenge for issuers (particularly cross border), investors, and national regulators. The altered directive will make it easier to 'passport' prospectuses from one EU country to another and will revise the exemption regime. There will now be no requirement for a firm to produce a prospectus if the security offering occurs in the 'home' state and is within the relatively low bracket of between €500,000 and €10 million.

The primary aim of this is to unencumber the free flow of capital across the internal market. The extreme variation in prospectuses across Europe, made possible by the scope for national legislation to go beyond the requirements laid out in the original directive, can make 'passporting' and approval a cumbersome process. It has been far too time consuming and expensive and an SME looking for finance can afford neither.

In another move to tackle this, the regulation calls for page limits (some prospectuses can run into the thousands of pages) and in effect would remove the existing wholesale disclosure regime. It would be replaced by a transaction summary requirement for all securities issuers. At present, transaction summaries are only required under the retail disclosure regime.

This has the potential to greatly reduce some of the costs (in terms of expensive legal and professional advice) that currently deter SMEs. However, we currently do not what will be required in the new minimum disclosure regimes until it publishes regulatory technical standards in 2016. There are positive signs, though, that SMEs will be able to adopt an optional Q&A format for prospectuses, which will hopefully lead to more small firms preparing their own disclosures in-house and avoiding the expenses mentioned above.

Overall, the aims of the Prospectus Directive revision are laudable and could get more SMEs involved in cross-border issuance, but we should always be aware of unintended consequences.

The two regulatory proposals by the Commission aimed at creating a safe, transparent framework for re-energising the European securities market may also help to increase the flow of capital and funding options to smaller firms. The "simple transparent and standardised" [STS] system being designed would consolidate all of the existing legislation relating to due diligence and risk retention into one framework covering all 'institutional investors'.

This would allow for a much needed differentiation between high quality and more risky, less transparent securitisations. It could help relieve the pressure of new capital requirements on banks and potentially knock on to an increase in loan applications from SMEs. It offers a way for banks to shift capital intensive assets off their balance sheets at a time when they are struggling to rebuild them, which should help assuage concerns by banks in some countries that CMU will be of no material benefit to them.

The Bank of England and European Central Bank have worked together to produce a joint paper helping to lay out proposals for the above uniform system. This is a positive sign of a coordinated approach to more market-based financing in an area where there is still considerable nervousness on both the supply and demand side.

The securities market in Europe is still recovering from a crisis of confidence from banks, investors, and SMEs themselves. This is partly due to its often misunderstood role in the wider global financial crisis. We encourage the committee and the Government to push for as much regulatory clarity in this area as possible. Clarity and uniformity will be vital in drawing SMEs to these markets.

Does the UK have globally competitive markets / suppliers for financing (and debt financing) at 1) seed 2) venture and 3) growth stages? What steps could Government take to strengthen these systems?

The UK has a solid base of pre-seed, seed, and across series A venture rounds. However, it does not have anything substantial beyond that series A round, of around £5-20 million. These are significant sums, of course, but compare and contrast to the fact that Uber has just undertaken a series E round, and it becomes clear just how much we lag our competitors on this front.

To give one example of what this means on the ground, it is worth looking at Mopp – a cleaning business. Set up in 2013, the firm expanded significantly before its founders sold to an almost identical American firm, Handy, in September 2014 in a deal worth 'several million pounds.' Handy raised £30 million from investors to expand, and used that capital to do just that. Mopp's founders, who couldn't raise £30 million in the UK, were left facing the realisation that they would not be able to compete with Handy, largely due to the latter's ability to raise significant venture capital in the US.

The problem is not an easy one for Government to solve. One of the key reasons the US has a far more mature venture capital ecosystem is that entrepreneurs who sell up reinvest their capital in growing and start-up firms; this is not necessarily the case in the UK.

At the exit stage, there is no question that the private equity industry is growing; over the past two decades, it has become second only to the US – it remains, unfortunately, a distant second.

Are alternative methods of raising finance (such as crowd-funding and peer-to-peer) sufficiently well-regulated and monitored for companies to be confident in utilising them?

The alternative finance sector in the UK has been largely self-regulating throughout its infancy. The indications are that bodies like the Peer to Peer Finance Association (P2PFA) and UK Crowdfunding Association (UKCFA) have held their members to high professional standards.

That being said, the FCA is also now responsible for regulating both loan-based and investment-based crowdfunding platforms, and they are planning to carry out a comprehensive post-implementation review of the crowdfunding market and regulatory framework in 2016. This review will no doubt indicate whether changes to the status quo need to be made.

However, the regulatory landscape for alternative finance providers is still young, and up to this point, the FCA has garnered significant praise for its 'light touch' approach. Arguably, this approach has contributed to the rapid expansion of the industry to the point where the UK is now at the forefront of the global alternative finance revolution.

One potential regulatory issue on the horizon for the industry, however, is that of embedding long-termism. As one of the buzzwords of the post-crisis regulatory bonanza, regulators have tried to ensure that long-termism is built into decision making processes throughout the financial sector. At the same time, UK start-ups are often run by serial entrepreneurs; individuals looking to start a firm, scale it quickly, and sell at significant profit. This attitude, deeply ingrained into the start-up sector, may well clash with the far sighted attitude that policy makers are trying to embed within the broader financial sector and may cause headaches for regulators further down the line.

All in all, the IoD acknowledges that the financial sector has a poor record on marking its own homework and, importantly, alternative finance platforms have yet to face the test of negative public scrutiny or economic recession. Therefore we believe that – as with the wider financial sector – they should be held to the highest standards on transparency and accountability by the independent regulator.

On a per capita basis, the UK has the largest alternative lending market in the world[7]. It follows that, in order to ensure its ongoing credibility and strong reputation, firms operating within the sector should be held to a gold standard of behaviour. We look forward to the results of the post-implementation review.

Conclusion

Access to finance is a significant barrier for many firms. We recognise the imperatives of lenders to ensure that they remain financially stable and, in turn, deliver profits to *their* investors, and also recognise that an urgent need to rebalance the books and respond to significant new capital requirements led to many financial institutions reining in lending. The partial retreat of banks and large financial institutions from the lending field, however, had a positive; numerous alternative financing mechanisms were given the opportunity to flourish, and many did. Our polling suggests that entrepreneurs are taking a much more holistic view of the business finance field than they may have done previously. As lenders become more interested in lending to SMEs again, we can anticipate even more options for finance developing and, hopefully, an increase in the amount of capital flowing around the system in the round.

[7] Business Insider (2015) Available at: http://uk.businessinsider.com/peer-to-peer-lending-in-the-uk-2015-8?r=US&IR=T%20

We would welcome the opportunity, of course, to discuss any of these issues at greater length with the Committee.

Yours sincerely,

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