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Agenda

Advancing economics in business

# 'Financing' outside the box: non-bank lending for businesses

**What alternatives to traditional bank lending do small and medium-sized businesses have? Tim Breedon, former chief executive of Legal & General plc, chaired a non-bank lending taskforce that examined this question. The taskforce's recommendations, which range from new forms of access to capital markets, to improvements in supply chain financing, were presented to the UK Department for Business, Innovation and Skills in March 2012, and are expected to be followed with government announcements later this year**

When the government asked me earlier this year to chair its taskforce on non-bank lending for businesses, it was clear that framing the right questions was just as important as working out the answers.[1] Hence the importance of the economic analysis part of the project, which constituted one of the major workstreams for the taskforce and underpinned many of our collective conclusions and policy recommendations.[2]

## Asking the right questions...

The economic analysis had three parts: a) to establish whether there is a current shortfall in bank lending to small and medium-sized enterprises (SMEs) in the UK; b) if so, to establish whether the constraints are on the demand or the supply side, or both; and c) to assess whether there is likely to be a future shortage of lending that would constrain growth.

Against a backdrop of evidence-based policy-making, these were the right questions to ask. However, our work was being conducted amid a highly charged political debate, where participants had taken entrenched positions supported by, at best, selective use of data or anecdotal evidence. Depending on who was speaking, either the banks were operating a blanket policy of starving small businesses of funds, or the SME sector lacked the confidence to expand and was not coming forward to borrow in order to invest and grow.

Inevitably, the real picture presented by the economic analysis was more complex.

## Supply, demand or both?

Gross lending to the non-financial corporate sector, at £506 billion in December 2011, is certainly relatively low: at its peak in December 2008 it was £657 billion.[3] For SMEs (broadly defined for our purposes as companies not large enough to access public bond markets), bank-lending volume is down, and the price of credit is higher. Conditions vary between sectors and regions. So, while any gathering—and we held workshops with businesses in different parts of the UK—provides anecdotal evidence of loans being unavailable, survey evidence does not highlight lack of credit availability as the top constraint for SME growth.

While the issue of credit shortages in no way eases the burden for individual businesses trying to raise debt finance for investment or working capital, the evidence therefore suggested that, *in aggregate*, it was not, at present, acute. Moreover, the UK corporate sector as a whole is running record cash balances of £731 billion despite record low interest rates, indicating a 'safety first' approach or, put another way, a lack of confidence to invest.[4]

In terms of supply versus demand, the conclusion was therefore that, while there were some structural and some specific issues, neither was uniquely responsible for the perception that there was *at present* a crisis of credit availability for our small and mid-sized businesses.

The author would like to thank the members of the taskforce for their contribution to the report: Dame Helen Alexander, James Douglas, Professor Julian Franks, Brian Robertson, Xavier Rolet, Chris Rowlands and Charles Roxburgh.

## Reversion to the old norm, or creation of a new norm?

While this was no doubt disappointing for the protagonists on either side of the supply–demand argument, note that I deliberately stress the words ‘at present’.

Taking a longer historical context, we looked at the availability of bank financing before, during and since the credit bubble of the mid-2000s, and offered some projections. One conclusion was that we may have simply reverted to more normal levels of credit availability, following a period when corporate UK allowed balance sheets to become over-geared, with debt financing that should, more properly, have been funded with equity. While equity was out of scope for our taskforce, it was certainly relevant, with SME proprietors often unwilling to expand if the result was a dilution of ownership or control. This, too, had a bearing on our recommendations.

Looking to the future, the economic modelling demonstrated that, while lending supply was currently adequate overall, any return to growth, combined with continued bank deleveraging, risked creating a lending shortfall, estimated at between £84 billion and £191 billion for the corporate sector as a whole (the wide variance depends on the assumptions underlying the model) as the economy recovers.[5]

This was, I think, one of our major contributions to the debate. We had provided an analysis that was as thorough as it could be in the limited time available to us, and free of any preconceptions, about the present state of lending, hopefully injecting some balance into the ongoing SME-lending debate. More importantly, we had identified a future problem that the policy-makers needed to address: in the absence of action, the ‘future normal’ looks problematic—and this should be a real focus, while there is still time remaining.

## Recommendations

We therefore made ten recommendations to the government, based on the issues we had identified as a result of the economic analysis, over 150 responses to our call for evidence, and a series of workshops and other meetings with companies, finance providers, intermediaries and trade bodies.

The taskforce members represented a balance between users and providers of finance—I was particularly determined that the banking sector should be represented alongside industry—and we attempted to find workable solutions (improvements to ‘the plumbing’) that could make a difference quickly.

We can group the recommendations under four headings.

## Information/access

A common theme from businesses was the difficulty in gaining sufficient insight into government support schemes and alternative sources of finance. A plethora of government schemes had resulted in an ‘alphabet soup’ of frequently changing schemes, and smaller businesses were confused and disheartened. For example, only 23% of SMEs were aware of the Enterprise Finance Guarantee, and only 17% were aware of the ‘Merlin Agreement’, despite widespread press coverage.[6] Only 16% of SMEs seeking a bank loan sought advice from their financial advisers.[7]

To address this, we looked at international examples and considered various restructuring options to create a single government delivery agency for small business, up to and including a UK version of the German KfW, which was discounted largely on grounds of political realism.[8] Nevertheless, we did recommend much better communication of all the various government initiatives by combining them under a single brand.

To address the issue of advice, our recommendation, which had the advantage of using existing structures and being capable of rapid implementation, was to use the existing network of accountancy professionals as ‘alternative finance advisers’, backed with appropriate certification. Often based in their communities, and with knowledge of local SMEs, they seemed ideally placed to develop the concept of a Business Finance Advice Scheme, as the proposed solution is known, and I am delighted that the accountancy profession is taking this forward.

## Capital markets

We deliberately defined SMEs broadly, as companies that are too small to access public bond markets. Our starting point was that, with constraints on bank credit, improved access to bond markets by large mid-cap companies could free up bank lending for smaller companies.[9]

The UK corporate bond market is underdeveloped, particularly compared with that of the USA: out of 1.2m UK companies, only 257 have a funding mix that includes public bonds.[10] One constraint is the requirement for institutions to invest in liquid securities, which effectively requires bond issues to be larger than £150m. There are the further problems of credit analysis and inclusion of bonds in indices, which again prevent institutional investment.

Our proposed solution here was the creation of an aggregation platform to lend directly to SMEs, or to buy and bundle SME loans, and issuing bonds to institutions, hence facilitating indirect access for smaller companies to capital markets. While others have proposed variants of this type of structure, we did not (in the short time available to us) attempt to flesh out the detail of such an agency. However, our proposal of a feasibility study, conducted by the Association of Financial Markets in Europe (AFME), has been accepted and we look forward to seeing the results of the Association's work later this year.

A second area under the heading of capital markets is private placements. Here, the UK market is again underdeveloped. Of the FTSE 250 companies, 40% have outstanding private placements, the smallest being £20m[11]—but investor appetite is lacking, especially compared with the USA. Regulation, in particular the requirement for liquidity, places a constraint on investment in private placements, as do the lack of credit ratings and the preference of institutions for long-dated securities. A further aspect for issuers is the high fixed cost of issuance, which, we believe, could be reduced by greater standardisation of documentation.

In total, we estimated that, by bringing UK private placement issuance up to US levels, as much as £15 billion of new funding could be available. Again, existing industry organisations, in this case the Association of Corporate Treasurers (ACT), will be taking this work forward.

The third area that could be classified under the capital markets heading is mezzanine finance. Mezzanine—debt that shares characteristics of equity but ranks below senior debt—has a variety of potential applications, but again UK take-up is low, with only 1% of UK firms using it in 2010.[12] We believe that this form of financing has the capacity to expand, but that this requires education and an increase in the size of funds to attract institutional investors. The government can take a role here through the Business Finance Partnership, the £1 billion fund established by the government in 2011 to facilitate investment through non-bank channels.

## The supply chain

The dilemma of record positive cash balances at some firms, and difficulties in financing working capital needs (eg, due to reductions in bank lending) affecting others, drove what I personally think is the most interesting part of our work. Where both of these factors are present in the same individual supply chains, it struck us as particularly counterproductive and wasteful of costly bank capital.

One recommendation, therefore, was to encourage prompt and certain payment, helping to reduce the requirement for (usually smaller) supplier companies to put in place and utilise expensive (and, for banks, capital-intensive) overdraft facilities through the period while they are waiting for invoices to be settled. This would lower the credit intensity of the corporate sector and deliver significant economic benefits, as well as enable banks to target lending where it is most needed.

Better invoicing practice can help, but the biggest boost can come through the government: it has a strong prompt-payment ethos (80% of invoices settled within five days), but we recommended that this should be passed down supply chains, to create a wider range and variety of beneficiaries beyond the primary supplier.

Supply chain finance was an area we felt had further potential. Greater standardisation and assignability would make invoices more easily tradeable, so that invoice financing and factoring could increasingly take the place of expensive overdraft finance.[13]

A supply chain finance market already exists, but greater uptake is desirable. At present, 42,000 SMEs are estimated to use accounts receivable financing—significantly lower than the corresponding figure in the USA.[14] One problem is perception: the widely held belief that invoice discounting (and, even more so, factoring) is a last resort for struggling companies. This perception needs to change: like other forms of asset-backed financing, invoice discounting is relatively capital-efficient when done by banks, while the use of technology should enable the nascent trading of invoices through exchanges to grow.

We are not alone in this view—other estimates have concluded that wider utilisation of asset-based finance could result in the UK economy growing by an additional 2% by the end of 2020, leading to more than 300,000 additional jobs.[15]

## Alternatives

Part of the background to our work was a growing level of political excitement around crowd-funding, peer-to-peer lending and other bank-disintermediation models. The current market is small and unregulated. We see merit in expansion, but in time it will require proportionate regulation. Protecting the consumer is clearly important, and, while we similarly supported measures to encourage greater retail investor engagement in the fixed income markets, we were concerned to avoid creating a yield-chasing retail investment or lending environment where consumers, acting without full information and with inadequate expertise, exposed themselves to undue risks.

This issue of regulation was indeed important as part of the background to our work. 'Reckless prudence' in response to the credit crisis clearly leads to negative effects in terms of economic growth, and we were concerned that the regulatory approach should not disproportionately reduce access to finance for SMEs.

## Next steps

The government welcomed our report in the March Budget statement, indicating support for the majority of its recommendations. Work is being taken forward, which we hope will lead to further announcements in the autumn.

## Tim Breedon

[1] The resulting study, 'Boosting Finance Options for Business', was published by the UK Department for Business, Innovation and Skills in March 2012.
[2] The economic analysis was provided by a team that included Oxera Director, Professor Julian Franks.
[3] Department for Business, Innovation and Skills (2012), op. cit., p. 10.
[4] Ibid., p. 26.
[5] Ibid., p. 3.
[6] This agreement between the UK government and banks, announced in 2011, sought to increase bank lending to SMEs by 15%. See HM Treasury (2011), 'Government Welcomes Banks' Statements on Lending 15% more to SMEs, and on Pay and Support for Regional Growth', press release, February 9th.
[7] Department for Business, Innovation and Skills (2012), op. cit., p. 17.
[8] The KfW is a development bank owned by the German government. Its financing options target specific markets, including housing, environment, SMEs, development and trade finance.
[9] A mid-cap company is defined as one with market capitalisation of up to £1 billion.
[10] Department for Business, Innovation and Skills (2012), op. cit., p. 20.
[11] Ibid., p. 22.
[12] Ibid., p. 30.
[13] Invoice financing, often referred to as invoice discounting, consists of borrowing that is secured against invoices (ie, these are used as a collateral). Factoring consists of the sale of invoices to a third party, normally at a discount.
[14] Department for Business, Innovation and Skills (2012), op. cit., p. 26.
[15] Ibid., p. 26.

**If you have any questions regarding the issues raised in this article, please contact the editor, Leonardo Mautino: tel +44 (0) 1865 253 000 or email l_mautino@oxera.com**

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