ICAEW

REPRESENTATION 41/18

TREASURY COMMITTEE – SME FINANCE INQUIRY

Issued 6 April 2018

ICAEW welcomes the opportunity to comment on the SME finance inquiry launched by the Treasury committee on 1 February 2018.

SMEs are an important part of the UK economy. It is therefore welcome that the Treasury committee is looking at how finance can better flow to them. There are some specific barriers to scale-up finance, and we outline in this response how they might be tackled. There are also demand side issues to investigate and address.

The senior managers and certification regime has now established clear conduct expectations for banks. We believe it is the right time to consider further regulatory extension of the perimeter to a wider range of firms but in a measured way; with the development of an industry code. This would help to support a sustainable SME finance market that is deep, liquid and plural in nature.

This response of 6 April 2018 has been prepared in consultation with the Corporate Finance and Financial Services faculties.

Recognised internationally as a source of expertise on corporate finance issues and for its monthly Corporate Financier magazine, the Corporate Finance Faculty is responsible for ICAEW policy on corporate finance issues including submissions to consultations. The Financial Services Faculty is recognised as a leading centre for thought leadership on financial services. It brings together different interests and is responsible for representations on behalf of ICAEW on governance, regulation, risk management, auditing and reporting issues facing the financial services sector.

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MAJOR POINTS

Background

1. SMEs are an important part of the UK economy and we strongly support this inquiry in seeking to consider how to better ensure that they can access appropriate finance when it is needed. The government has consulted on a range of policies and has responded with a number of measures that have been announced or implemented since the November 2017 Budget. The impact of these will need to be evaluated in due course.

2. There is more to do to improve conditions for growth, and demand for funding for growth. The British Business Bank's 2017/18 report *Small Business Finance Markets* suggests that the proportion of SMEs that expect trading conditions to improve in 2018 is falling. ICAEW's latest *Business Confidence Monitor* reveals that export growth is expected to continue, but at the same rate in 2018 as 2017.

Greater specificity would enable more targeted actions

3. There are more than five million SMEs in the UK; most of them very small. The sector (which by some measures is more than half the UK economy) comprises a wide range of businesses, with differing profitability, aspiration and financial capacity. Consequently, in considering Government action to improve the flow of finance to SMEs it is important to consider where action might have the greatest impact. HM Treasury's recent consultation *Financing Growth in Innovative Firms* looked at how finance might be improved for businesses with the potential and ambition to scale-up. In that response we highlighted a number of barriers to finance that government could tackle. These are set out in paragraphs 10 to 15 below.

Investigate why the demand for finance differs between entities and regions

4. Effective financing is not only a supply problem; there is a good deal of choice now in the market for SME finance. There is a demand issue too. Many SMEs that could benefit from an injection of external finance, and have the capacity to attract it, choose not to. Ambition varies between companies and the demand for finance is also stronger in some regions than others. ICAEW is working to help address this demand issue by providing better, easy to access information to the market through the *Business Finance Guide*, produced in partnership with the British Business Bank. Initiatives like this can help, but we believe that government should also have this demand issue in its cross-hairs. A first step might be academic research. ICAEW has experience in researching business sentiment through our *Business Confidence Monitor* and may be able to help in this regard.

The importance of conduct and culture

5. The inquiry explores dispute resolution and the regulation of SME lending. We think there is an opportunity to leverage the benefits of the new Senior Manager and Certification Regime (SMCR). This already operates with regulated firms but to avoid a two-tier system, or an uncompetitive market, the regulatory perimeter may need to expand to include a wider set of firms who may not be currently regulated. This would help to mitigate the risk of placing the onus solely on SMEs to take action against inappropriate treatment. We believe an effective conduct and culture regime can be more efficient and effective in helping to discourage and isolate bad behaviour where it does occur. Such a regime is now in place in the form of the SMCR, although it may be early to comment comprehensively on its effectiveness. To support the SMCR, thought might be given to encourage the development of an industry code for SME lending. In its development the code should take input from a number of stakeholders including but not limited to SMEs, lenders and regulators.

Promoting trust in SMEs

6. SME lending is predicated on trust. We cannot predict the future, but we can report transparently and reliably on the past. Company accounts are a succinct and standardised way of communicating a company's financial performance and position – and therefore its financial capacity. The process for producing company accounts enables owners and managers to better understand and assess their need for finance and capacity to service it. In this context it would be helpful to investigate the impact of the recent significant increase in the audit exemption threshold (2 of: turnover below £10.2m, assets below £5.1m, less than 50 employees) and the new simplified micro-entity reporting regime. It is important to ensure that the SME reporting and audit regime is effective in securing trust and confidence in SMEs. The near absence of publicly-filed financial information for most SMEs leads to an inability to bench-mark or make meaningful assessments of an SME's performance. While seeking to reduce the cost of compliance with regulation may appear to be a laudable aim, the unintended consequence is that many small companies no longer have financial information 'on the shelf', which is immediately unacceptable to external investors. Analysis of primary data will be required and even with modern techniques this can introduce further delays and uncertainty in finance raising.

ANSWERS TO QUESTIONS

Funding options available to SMEs

The availability and uptake of different sources of funding for SMEs, including banks, peer-to-peer lenders and crowdfunding.

7. Comprehensive details on the flow and stock of finance to SMEs can be found in the British Business Bank's 2017/18 report *Small Business Finance Markets*. This reveals an increased uptake in equity finance, asset finance and asset-based lending compared to 2016 whilst net bank lending is positive, though weaker compared to the previous two years.

8. As regards the uptake of funding, and the extent to which different businesses are motivated to seek external finance, we note that 'SME' is a very broad term. Of the 5.7 million private sector businesses in the UK, 99.9% are SMEs. They encompass businesses with a wide range of growth potential, profitability, liquidity and collateral. It is therefore difficult to generalise about their funding preferences. Moreover, for the present inquiry to produce targeted, effective actions that might be expected to boost economic growth and productivity we believe it has to be much more specific in identifying where government intervention or support can have the most impact.

9. One group that merits particular attention, are the high growth businesses seeking the finance to support scale-up; a form of finance long understood and known as growth capital. For this group, it is clear that they have the aspiration to obtain external funding, and with high growth potential are likely to have both the need for funds and the capacity to service finance. In September 2017, in our response REP 102/17 to HM Treasury's consultation *Financing Growth in Innovative Firms*, we identified five impediments, or weaknesses, to these firms accessing finance when it was most needed. These are set out in paragraphs 10 to 15 and we also refer, where applicable, to actions taken to date.

10. The first weakness: A comparison with the availability of later stage funding to US companies can be problematic, both due to the size of that market and its historical attitude towards risk and return. A more granular review of the differences might provide meaningful insights for remedial intervention, but would require time and cost.

11. The second weakness: There is evidence, from business and the business angel community, that a focus on key sectors and the development of geographical clusters with a density of principal participants, are vital components for financing, commercialising and generating positive returns from innovative businesses. The Government set out in its Industrial Strategy white paper (November 2017) that follow-on funding should be in emerging technologies and key sectors, which would include new ventures and technologies emerging from the Industrial Strategy Challenge Fund, the Catapult programme and from key industrial and advanced technology clusters. As part of the strategy, the government committed investment to digital and construction training (National Retraining Scheme).

12. The third weakness: Companies are generally staying private for longer and the effectiveness of the role of the UK's public capital markets in supplying finance to suitable companies is already being assessed by regulators such as the FCA (DP17/2 and CP17/4) and the London Stock Exchange (AIM Notice 46). Certain changes became effective on 1 January 2018, but it may be too early to assess the outcome. No clear need for government measures was identified.

13. The fourth weakness: The market in long-term and venture debt could be strengthened, this would contribute to a mix of more appropriate capital instruments for innovative businesses. The Government allocated in the Budget £2.5bn additional resources to the British Business Bank to incubate a Patient Capital Fund.

14. We believe that such a fund should offer a range of financing, on compatible terms, to help minimise the competing pressures businesses face from different capital sources. A report by BDO and the CBI, *Stepping Up*, highlighted that 'reduced availability of longer-term debt (loans with terms longer than five years)' is a barrier to businesses boosting their productive capacity. Moreover, research from ICAEW and the IET mentioned above also highlighted the growing role – and even greater potential – of 'venture debt' in UK capital-intensive, pre-profit but 'intellectual property-rich' companies. The experience of ICAEW members at a business roundtable arranged for the Exchequer Secretary in September 2017 confirmed the usefulness of venture debt received.

15. The fifth weakness. Certain government interventions could be fine-tuned so as to better support growth of innovative businesses in key sectors. We had identified that small adaptations could be considered to the criteria in tax-advantaged venture capital schemes, such as for Enterprise Investment Scheme (EIS), a lengthening of the holding period and an increase in the overall cap and annual limit, and for Venture Capital Trusts (VCT), an increase in the permitted age of the business and more flexibility in the nature of the transaction. An assessment of the continuing appropriateness for strategic sectors of the criteria for R&D credits, together with better promotion, could be transformational to the financing of those sectors. In the Budget the government announced it would double the annual allowance for people investing in knowledge-intensive companies through the EIS and the annual investment those companies can receive through EIS and the VCT scheme. Moreover, further to last year's consultation *Financing Growth in Innovative Firms*, the government is currently consulting on an EIS fund structure for investment in knowledge-intensive companies. However the consultation states that there are no plans to change the three-year holding period that applies to all EIS investment. This is a missed opportunity (see also paragraph 28).

The level of competition in the SME lending market and the impact of recent regulatory initiatives.

16. There has been a large amount of work done in recent years on increasing competition in the banking market for both retail and commercial customers. This has already had a major effect on the market: there have never been so many options for SME financing as there are today. From traditional, locally accessible branch based lending, albeit often now more efficiently consolidated, to new fintech products from both the high street banks and new challengers. ICAEW's annual SME conference will be considering access to finance as one of its topics, a key aim of which will be to help guide participants through the range of options available. At a 'debt for deals' roundtable we organised last month with leading market participants, again the conclusion was that there are no shortage of options for SME financing. However, the inquiry should note two significant impediments to SME accessing the finance that could help them to grow:

17. Firstly, unfortunately many SMEs do not have the appetite to seek or extend external funding – often despite having profitable investment opportunities to use it for. Fear of debt and reluctance to give up any control of the business are leading reasons in the British Business Bank's 2017/18 report *Small Business Finance Markets*. The negative publicity surrounding HBOS and RBS' GRG will not have helped with this. But equally, there is a cultural issue here that government might be able to start to address. We note that the appetite for finance also appears to vary regionally – with greater demand for finance, in line with higher levels of economic activity, around London and the enterprise hubs of Oxford and Cambridge. This is a regional imbalance that government can and should address, perhaps initially through academic research. ICAEW has experience of sampling business sentiment through our popular *Business Confidence Monitor* and we may be able to help here.

18. Secondly, SME lending is typically high risk. Many SMEs will not be in position to access the volume of finance that they desire or need. Some will fail as a result – and this is a natural part of the capitalist system. Given the rapid and ongoing changes to prudential regulation following the financial crisis, and the greater flexibility the UK should have after Brexit, it is right to review the effectiveness of the regulatory regime. It would also be right to have a particular focus on SMEs in that review. But this is notwithstanding that the prudential system has to reflect the underlying risk – and there are high risk weights on SME lending in some cases for good reasons.

19. It would also be productive for government to look again at how we can best maximise trust of SMEs in the economy, noting that much credit for these businesses comes from creditors other than banks – especially trade credit. We cannot predict the future, but we can report reliably and transparently on the past. Proportionate, reliable reporting by companies is the foundation of trust. Government might investigate whether the recent significant rise in the audit threshold or the new simplified micro-entity reporting regime have been effective in providing a proportionate but reliable basis for small businesses to report. Their financial position needs to be understood by potential creditors, as well as potential lenders and equity investors.

20. Beyond the competition that already exists in the SME finance market, greater innovation and disruption is now happening. For example, open banking, which opens up access to bank data is intended to address exactly this issue. Financial innovators are already designing products to utilise the new data – this has the potential to enable SMEs to much more easily compare alternative sources of finance. It is too early to say how much impact this will have – but the market now has the tools to innovate where there is demand. Many more businesses will now be regulated, rightly given the broader access open banking gives to payment initiation and account information. However, the FCA also needs to ensure that as the new regulatory regime introduced by the second payment services directive beds down, that the scope of regulation is set sensibly and does not extend to businesses that are making no, or only very low risk, use of the new powers under open banking.

21. A second area of innovation aimed at increasing competition has been the emergence in recent years of 'challenger banks'. A recent survey by KPMG called *Challenging Perspectives* provides insight on the sector. The business models of these banks vary, indeed one of the features of the sector is that different businesses often target a very specific niche, but a number of challengers target SME lending and have the ambition to disrupt the market in their chosen area. KPMG suggest that we may now be at a new 'inflection point' that changes the nature of the market. One of the reasons for suggesting this is because challengers typically have fintech at the heart of their business model and are using it to provide access to finance in more efficient ways. This of course does not only relate to the challengers – the high street banks, partly due to increased competition, are themselves rapidly innovating with fintech. Deloitte report other new operating models and how the market may be evolving in their report *Three types of SME lenders to watch*'.

22. We should note that some countries are already ahead of the UK in the adoption of fintech and there may be regulatory lessons that we can draw from their experience. The European Commission has published its *Fintech Action Plan*, including proposals for a fintech regulatory regime and pan European licensing regime. In our response REP 107/17 to the House of Lords inquiry into financial regulation following Brexit we suggested that after the UK's exit from the EU there may be greater flexibility to examine options that could reduce the costs for smaller banks and perhaps help to promote competition and growth in the UK. For example, more proportionate, differentiated capital rules might enable banks of different size and business model to compete on an equal footing, rather than the same rules being applied to all banks. *Fintech Sector Strategy: Securing the Future of UK Fintech* was published by the government in March; while referring to funding that has already been committed to Fintech firms and challenger banks through British Business Bank programmes and to measures for reducing the cost of complying with regulation, there are no commitments to working with the FCA and others on proportionate capital rules.

Trends in SME finance and how potential changes to regulation and redress may affect the market.

23. This question is largely covered in paragraphs 16 to 22, but we add some additional insights here.

24. Although this relates to equity rather than debt finance, the inquiry should be aware that the environment for foreign investment is changing, with a heightened focus on national security for investments in certain sectors. This is clearly a matter for government policy. However, in implementing policy it is important to carefully calibrate the impact of new regulation. In REP 04/18 to BEIS' *National Security and Infrastructure Investment Review*, we pointed out the risk that these proposals could disrupt business operations and/or discourage early stage investment.

25. At the larger end of the SME scale, we note that the London Stock Exchange has recently made changes to the AIM rules, specifically increasing the level of confidence that nominated advisers must have at an early stage. In REP 96/17 (para 3) we pointed out the risk that pharmaceutical and other companies requiring licences might not be brought to market due to the uncertainty around these factors.

26. We are also waiting to see the approach the FCA takes when it publishes its revised crowd-funding policy. Feedback was expected in 2017 but has not yet been published. Increased regulation might cause some platforms to exit the market or may create high barriers to entry.

27. We have not yet mentioned interest rates. This is clearly a major factor affecting SME finance given the continued abnormally low interest rate environment – albeit that this has persisted now for nearly a decade. Abnormally low rates have a number of implications:
i) Firstly, by lowering the cost of debt they should significantly increase the appetite for finance. If we still have a demand issue, as we suggest above, that must be caused by other factors than the cost of funding and merits further research.
ii) Secondly, as rates are so low, when they rise the relative impact on loan payments will be correspondingly higher. That will cause distress for some businesses.
iii) Thirdly, the lack of interest rate risk, as well as misselling concerns, has dampened the market for interest rate risk management products, meaning that more SMEs may be exposed to interest rate risk.
iv) Fourthly, low rates can be expected to depress bank profits, making SME lending less appealing. Higher rates might mean greater supply of finance.

28. Finally we note that current EIS rules mean that investors are forced to exit investments within a limited timeframe, which for hi tech and research based businesses may well be disproportionately short. We appreciate that this again relates to equity rather than debt investment. However, it may be possible to amend these rules post Brexit to benefit scale-up businesses, subject to state aid considerations that might still apply.

Any sources of finance which SMEs will not consider or approach and why.

29. We note above that demand for external finance is an issue and that further research on the reasons for this would be beneficial. We comment on some trends below.

30. Despite an increase in the uptake of certain funding sources (see paragraph 5) the British Business Bank's 2017/18 report *Small business finance markets* indicates that two in five SMEs do not use external finance. Among those who do, credit cards and overdrafts are most commonly used. The use of invoice or asset-based finance is not common, while only one in 20 business have considered equity finance.

31. Expectations of export growth are weak according to ICAEW's latest Business Confidence Monitor, despite a favourable exchange rate. Data from UK Export Finance (UKEF) reveal that in 2016 /2017, the amount of support provided for UK exporters increased by 60% to £3bn. This appears to correspond to 221 businesses, of which 175 were SMEs. It is worth noting that UKEF has a capacity to support exports of £50bn, according to the UKEF Business Plan 2017-20. The Budget announced that UKEF would introduce a new guarantee to banks designed to increase liquidity in the supply chain. This is expected to improve exporters' access to capital and enable their suppliers to fulfil new orders. The uptake will need to be monitored.

The ability of SMEs to resolve disputes and access fair and reasonable compensation when they borrow money

32. As one of the drivers for this inquiry is to address the issues raised by the mis-treatment of customers by RBS' GRG, we question whether dispute resolution and compensation is the most appropriate area on which to focus.

33. RBS has acknowledged that in some cases it 'could have done better for SME customers in GRG', and the bank has since made changes to its culture, structure and operations. Equally, since the financial crisis the FCA has put significant effort into improving culture and conduct in financial services, notably through the SMCR. The SMCR establishes a clear expectation and duty that senior managers will do the right thing, building on initiatives to instill appropriate culture that institutions had themselves already been developing internally. No regime can prevent all 'bad eggs', but the SMCR has the support and sanctions in place to expect to generally enhance standards of conduct while providing a benchmark to more easily call out outlying bad behavior.

34. With this in mind it is not immediately obvious why we should focus on solutions that shift the onus onto SMEs to themselves individually take action against the banks. Regulators are responsible for minimizing the risk of egregious behavior, and they have acted to do so through the SMCR and other measures in recent years. With this regime now in place, regulators should be able to take appropriate action should an outlying case such as the GRG occur again in the future. However, for individual SMEs that feel they have been subject to inappropriate behavior, particularly as they might be in difficult financial circumstances at the time, additional avenues for redress are likely to be welcome.

The effectiveness of existing arrangements for dispute arbitration and settlement.

35. Existing arrangements comprise the bank's own customer complaints process (where the lender is a bank), appeal to the Ombudsman (for micro entities) or legal action through the courts. Court action is naturally difficult for SMEs to pursue due to the inevitable imbalance of resources between the two sides, the risk involved and the time commitment required. Nevertheless, as noted in paragraph 34, it is not clear why SMEs should be expected to shoulder the burden of addressing inappropriate behaviour themselves – it is more efficient and equitable for the regulatory system to discourage such behaviour in the first place. An effective regulatory system can also make it easier for SMEs to demonstrate egregious behaviour where it does happen. The regulatory perimeter may need to expand to capture the range of firms that provide SME finance. Equally we recognise that entities that feel they have a case against their bank would be likely to welcome additional avenues for redress.

The merits of the Financial Conduct Authority's proposals for expanding SME access to the Financial Ombudsman Service.

36. More than 5.4 million businesses in the UK, which comprise over 95% of the country's enterprises, are micro-entities and can therefore already access the Financial Ombudsman Service. The FCA proposals would extend the ombudsman to a further 160 thousand SMEs, although larger small businesses would still be excluded. There is clearly a strong case for supporting small businesses that naturally lack the resources to pursue cases against their bank themselves through the courts, with the external assistance of the ombudsman. It may be that extending access to the Ombudsman is the most cost effective and proportionate way of providing greater opportunities for recourse for larger small businesses. However, there is also a balance to be struck here – in making complex financial decisions, businesses need to ensure that they have received appropriate, independent advice. There are a number of avenues available to receive this – for example: ICAEW's *Business Advice Service* provides a route for businesses to receive professional advice, benefiting from an initial free-of-charge consultation. In conjunction with the British Business Bank, ICAEW also provides the *Business Finance Guide*, a free-of-charge online tool to help businesses select appropriate finance. We would note that the current proposed thresholds focus on size (either by balance sheet size or number of employees). We think there may be other criteria that would help to determine where a SME may be particularly vulnerable to harm. The FCA's investigation into interest rate swap mis-selling set out a 'sophistication test' which might be leveraged to capture a more appropriate range of firms.

The case for establishing a new "tribunal" body for settling SME banking disputes and the means by which such a body could be created.

37. As noted in paragraphs 34 and 35 we believe the focus should be on effective regulation, as well as encouraging appropriate culture – a process the banks have already taken the lead with. If access to the Ombudsman is expanded as planned then this will also increase the opportunities for redress for many smaller businesses.

The design, governance and operation of such a tribunal body, and the potential relationship between it, the Financial Ombudsman Service, and the Financial Conduct Authority.

38. See paragraph 36.

The impact of additional avenues for redress on (i) the balance of power between SMEs and lenders; and (ii) the supply of, and demand for, credit.

39. The Ombudsman effectively addresses the 'balance of power' between the two parties by reducing the barriers to taking action. A tribunal system might reduce the costs and inconvenience of action, but it is likely to still suffer from an imbalance between the two sides.

40. If the focus of the inquiry is on egregious and unacceptable bad behaviour, then by definition this should be expected to be rare. Consequently it is not clear why it might be expected to have an impact on the supply and demand for credit.

The regulation of SME lending.

The level of protection currently afforded to SMEs when they borrow money.

41. The protection that SMEs have when they borrow money is limited to the law, the Ombudsman (if they qualify) and the parts of the regulatory regime, such as the SMCR, that are aimed at controlling bad behaviour.

The case for bringing lending to SMEs within the regulatory perimeter, including (i) the likely impact on the supply of, and demand for, credit; and (ii) lessons learned from past misconduct.

42. The regulatory premier has been fundamentally restructured and comprehensively enhanced over the decade since the financial crisis. In general we might hope that this period of evolution is now drawing to a close, with a focus instead on reviewing and ensuring the effectiveness of the package of new measures now in place. There is a balance to be struck to ensure that regulation is proportionate and reasonable, otherwise there is a danger that the case for deregulation can be made more forcefully, as we have seen in the US recently.

43. Lending activities, including business lending, have traditionally been outside the regulatory perimeter. However, it is clearly in everyone's interest that there are clear expectations and standards of conduct for those in positions of responsibility at financial institutions, such as SMCR has already introduced for some. With this regime now in place the bar should be correspondingly higher to considering incremental regulation such as any extension to a conduct of business sourcebook for SME lending. It is also worth noting that the largest conduct scandal – the mis-selling of PPI occurred despite the sale of insurance services being a regulated activity. It should also be noted that each layer of regulation carries a cost that is ultimately borne, at least in part, by SME customers. Nonetheless we think there is an opportunity to leverage the benefits of the new SMCR, to extend the perimeter and to develop an industry code. This would help to mitigate the risk of placing the onus solely on SMEs to take action against inappropriate treatment.

Other non-regulatory or quasi-regulatory options for policing SME lending, such as the establishment of industry codes and standards.

44. The SMCR already provides a much clearer basis for policing behaviour. To support this, thought might be given to encouraging the industry to develop a code for business with SMEs, any entity engaged in these activities could then be required to sign-up to the code. An industry led approach like this should be proportionate and cost effective while providing a clear mechanism to identify and call out egregious bad behaviour.