



ACCESS TO FINANCE INQUIRY

ICAEW welcomes the opportunity to submit evidence to the *Access to Finance* inquiry launched by the Business, Innovation and Skills Committee in December 2015, a copy of which is available from this [link](#).

This response of 10 February 2016 has been prepared on behalf of ICAEW by the Corporate Finance Faculty with contributions from the Tax Faculty, the Business Department and the Financial Services Faculty. Recognised internationally as a source of expertise on corporate finance issues, for its work on access to finance 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 Faculty's membership is drawn from professional services groups, advisory firms, companies, banks, private equity, law firms, consultants, academics and brokers.

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EXECUTIVE SUMMARY

1. Key messages and recommendations

- Access to finance and awareness among businesses of funding options have improved since the crisis, however more must be done.
 - Access to professional advice and information on sources of finance is essential: Advice gives businesses the tools to minimise the requirement for finance – through chasing debts, invoicing on time, negotiating contract terms and other general cash flow management techniques. It also helps businesses secure the most appropriate and cost-effective form of finance. The Small Business Enterprise and Employment Act 2015 requires banks to refer rejected applicants to other providers and including the provision of advice in this measure will increase its effectiveness.
 - Clarity is needed on the targeted outcome of government schemes and incentives (such as tax-advantaged schemes), as well as monitoring.
- Alternative forms of finance have been allowed to compete, but will benefit from:
 - a level playing field, eg for challenger banks; and
 - maintaining a pragmatic approach to financial services regulation, including of new services such as crowdfunding and peer-to-peer lending.
- The Government could review plans to reduce the supply of grant funding to capital-intensive, science-based businesses and consider alternative financial instruments to secured loans.

2. Very early stage companies with little security have traditionally struggled to raise finance and this situation worsened significantly in the aftermath of the 2008 financial crisis, which also affected established businesses in the same way. In 2009, ICAEW members reported that clients found their banks were effectively closed for new business and imposing tighter terms on existing business. By 2011, even as economic activity increased, many small and medium-sized enterprises (SMEs) were choosing to cut costs, managing cash flow and avoiding further indebtedness, thus dampening demand for credit.
3. The [Bank of England](#) reports that the supply of corporate credit, while increasing, remains low. Furthermore, other players have entered the market including challenger banks, other debt providers and providers of peer-to-peer finance and asset-based finance.
4. ICAEW's [Business Confidence Monitor](#) shows that access to finance is now a significantly less important factor impacting companies than at any time since the financial crisis. Moreover, the British Business Bank's [Small Business Finance Markets Report 2015/16](#) shows SME lending to be up for the first time since the crisis. This may be due to factors such as an increase in investment or due to companies paying dividends to shareholders in advance of the introduction of new higher rates in dividend taxation.
5. [Data](#) commissioned by the British Business Bank reveals that equity investment in early-stage businesses has been increasing since 2010, although the average amount invested fell from 2010 to 2013.

RESPONSES TO SPECIFIC QUESTIONS

Question 1: How has the landscape for access to finance evolved since the end of the financial crisis?

Then

6. ICAEW's research *SME Access to Finance*, conducted in [2009](#) and in [2011](#), provides a record of changes in terms of access, visibility, market competition and state support:

- In 2009, SMEs' difficulty in accessing finance ranged from 'fairly difficult' to experience of bank lending having 'come to a standstill'. By 2011, businesses chose to 'tread water' and demand for credit was muted.
 - In 2009, there was an expectation that the supply of credit would increase in the short-term. By 2011, bank credit was indeed available to well-managed businesses with track records, but...with far tougher conditions.
 - In 2009, the business: bank relationship had been damaged and by 2011, it had reached a low ebb, with transparency and consistency of banks' lending criteria and decisions not forthcoming.
 - In 2009, awareness of government schemes was low and access was hindered due to fragmentation of schemes. In 2011, alternative forms of finance were still not clear to businesses while state-backed funding schemes were perceived as too complex and insufficiently attractive. Even when used, they were considered less impactful than tax concessions.
7. Other established forms of finance were also hampered by the crisis. The private equity sector was forced to adapt its model to a low debt environment, described in the [2012 update](#) to ICAEW's publication, *Private Equity Demystified*, and investment in businesses slowed. Equity markets effectively closed for new admissions during and in the wake of the financial crisis. The London Stock Exchange launched the High Growth Segment to assist mid-sized, high-growth businesses to finance their growth through equity share capital raisings, but only one company took advantage of this scheme.
8. For early-stage and medium-sized companies seeking to achieve growth based on higher levels of external investment:
- equity investment increased after 2010, although the average amount invested fell from 2010-2013. This reflected a shift from venture capital to crowdfunding investments¹; and
 - debt markets improved significantly by 2012 with many US, UK and European Funds often competing to fund high growth UK companies².
9. For larger companies, ICAEW members report that institutional appetite for new listings in the period from 2010 to 2015, although selective, was sufficient to enable those companies best suited to listing to obtain equity finance via public markets. Generally low investment yields on conventional financial instruments increased the propensity for global institutions to enter the UK debt markets, resulting in strong market competition in provision of debt to larger companies and no shortage of supply.

Now

10. The variety and sources of both debt and equity funding available to many businesses in the UK have changed markedly since the financial crisis of 2008. Notwithstanding this, the Bank of England reports that corporate credit availability is still at low levels³. Moreover ICAEW member research⁴ suggests that both working capital and longer term funding for growth, previously supplied by overdraft and term loans from the big four high street banks, is now supplied via a combination of: directors' loans and equity investment (in particular during, and in the immediate aftermath of, the financial crisis); an increase in asset-based finance (debt factoring or similar); credit from suppliers; term loans from new entrants to the debt sector,

¹ [Small Business Investment Equity Tracker research report, March 2015, British Business Bank and DBIS](#)

² [ICAEW's 'Private Equity Demystified' by John Gilligan and Mike Wright, 3rd edition, 2014](#)

³ [Bank of England, Credit Conditions Survey, Q4 2015, Annex 3](#)

⁴ Business Omnibus December 2015

including peer to peer lenders and the ‘challenger’ banks; from retained profits and, to a lesser extent, equity investment from external parties.

11. Also an enduring legacy of the crisis, finance directors report retaining cash within their businesses as a precaution against another adverse macro-economic event. Many report that their businesses had been on the edge of failure when the banks had withdrawn support in 2008 and they did not wish to find themselves in that position again. [JP Morgan’s report](#) comments on this continuing trend, with global corporate cash balances high and, in larger cases, due to banks’ liquidity requirements, struggling to find a home.
12. Businesses surveyed for ICAEW⁵ continue to report access to finance as a challenge to their performance, but this is improving. Similarly, in the latest [SME Finance Monitor](#), only 6% of businesses rated access to finance as a major barrier. Those with any future appetite for finance were also still more likely to see it as a barrier (13%) but, again, this is declining. A less bright picture exists, however, for First-Time Applicants (FTAs), especially those with less than 5 years’ trading. Lack of financial discipline among younger businesses and inertia in seeking external advice are frequently cited as contributory factors.
13. So, while access and competition have improved, according to the [SME Finance Monitor](#), the main banks continue to provide approximately 80% of the small business lending. Corroborating ICAEW data reports that, for c.70% of businesses across the range, those intending to raise finance, the primary forms of external funding are expected to be bank loans and overdrafts⁶.

Question 2: What have been the most successful Government policies to assist growing companies access private finance and where is there room for improvement?

14. We highlight the following Government and public policies in terms of their effectiveness:
 - creation of the British Business Bank;
 - support from government departments for market-led information on finance options;
 - tax-advantaged venture capital schemes; and
 - pragmatic regulation of emerging forms of finance.
15. The report from the Breedon Review, launched at Chartered Accountants’ Hall in 2012, made a series of recommendations with the objective of increasing the variety and sources of funding available for UK businesses. One outcome was the [British Business Bank \(BBB\)](#), a publicly-funded, economic development bank. Notable successes include:
 - its initiatives to increase the market for access to finance through its investment in crowdfunding and peer-to-peer lending;
 - its support for a competitive landscape for challenger banks; and
 - together with ICAEW, the development of [The Business Finance Guide](#) – a journey from start-up to growth, which has been circulated to over 750,000 SMEs, and is a continuing initiative supported by 17 major professional, membership and representative organisations.
16. Post-crisis efforts to persuade the high street banks did not appear to result in marked changes in their lending policy. The Small Business, Enterprise and Employment Act 2015 obliges the

⁵ Business Omnibus December 2015

⁶ Business Omnibus, December 2015

major banks to refer all businesses refused credit to alternative finance institutions. This should provide SMEs with exposure to a wider pool of finance providers – although the measure will not guarantee that finance will be forthcoming. ICAEW believes that the referral scheme would be significantly improved if it also included access to information and good quality advice, both before the initial application for funding and again, before any referral and reapplication. Unless companies refused credit by one bank make an application to a funder with very different credit criteria scoring criteria, or the apply for a markedly different facility while offering some other form of security, for example by switching from an application for an overdraft to asset-based finance, then the companies' subsequent applications are also likely to be refused.

17. Transparent terms and conditions from providers together with expert financial advice can help ensure that companies secure the facilities that are most appropriate and suitable for future growth.
18. A level playing field is necessary to enable alternative forms of finance to establish themselves as effective market players. At present, the ability of challenger banks to offer alternative channels for business finance is being reduced, as described by the [British Bankers Association](#) and one such challenger bank, [Hampshire Trust Bank](#). We draw your attention to the [UK's Parliamentary Treasury Committee letter to the PRA](#) and its proposals for actions for financial services regulators.

Question 3: 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?

19. Yes, although more can be done.
20. The economics of investment management and monitoring mean that direct investment in smaller businesses is not a global operation. Therefore, for seed, venture and even growth stages a nationally competitive market is essential, as opposed to one which is truly global. Nonetheless, cost of capital in the UK compares favourably with other markets, due to a low central bank rate of just 0.5%, a competitive and highly developed banking and financial sector and lower geopolitical/economic risks.

1) Seed stage

21. Equity investing in early-stage companies is high risk. The majority of such businesses require both cash and business expertise. In the UK incentivising risky investments via tax reliefs has proven highly effective in ensuring that funds, which would otherwise have been collected by the state as taxation, flow into such companies. Such measures also ensure that entrepreneurs devote time and effort into advising the business. This means that they manage their own investment and the investment of tax-payers' money in early-stage companies as a quasi-agent of the state.
22. [HMRC](#) figures show that the Enterprise Investment Scheme (EIS) launched in 1993-94 had, by 2013/14, drawn a total of £12.3 billion equity funding for over 22,900 individual companies which are, by dint of EIS rules, at seed or venture stage. EIS rules also permitted investment in more established companies, and capital has flowed from the earliest start-ups to other early-stage companies.
23. The Seed Enterprise Investment Scheme (SEIS) helps small, early-stage companies raise equity finance by offering tax reliefs to individual investors who purchased new shares in those companies and complements the EIS. SEIS recognises the particular difficulties which very early-stage companies face in attracting investment, by offering tax relief at a higher rate. In 2013/14 2,030 (2012/13 1,160) companies received investment through SEIS and £166 million (2012/13 £86 million) of funds were raised.

24. While ICAEW members report that these tax reliefs have certainly encouraged investment in early stage companies, [data](#) produced for the British Business Bank suggested that in 2014 crowdfunding is competing with seed and venture stages for business angel investment⁷.

2) Venture stage

25. The [data](#) above suggested that venture-stage investment lagged behind seed and growth stages. Some of this can be put down to major changes to the tax-advantaged Venture Capital Trust scheme in the last few years, to comply with updated EU State Aid rules. Further changes in the Finance Act 2015 result from the UK's interpretation of the 'new product or market' condition and its retention of an annual limit for investment in individual companies. We believe that they are not well-thought through and risk reducing investment.

26. In 2014, ICAEW researched the UK's programme of government-backed Enterprise Capital Funds (ECFs), that were providing venture capital and equity capital to UK growth companies⁸. The research of the 16 extant ECFs found that the programme had been more effective than predecessor schemes, such as Regional Venture Capital Funds, because:

- despite the financial crisis, it had successfully seeded a variety of new venture capital firms and private investment networks across the UK, since the first ECF investment in a company in 2006;
- the 'matched-funding' structure of ECFs had attracted more private money into UK venture capital;
- it had encouraged an 'interplay between entrepreneurs, business angels and institutional investors';
- the funds generally managed investment capital patiently and with appropriate due diligence; and
- its conditions were likely to increase the flexibility of the ECFs' investment strategies and encourage a variety of investment styles.

3) Growth stage

27. ICAEW's *Corporate Financier* magazine reported on growth capital trends in the UK in November 2015, highlighting that:

- The availability of capital is not a major constraint to UK growth. While this decreases as the scale of demand decreases, schemes such as EIS and VCT, have succeeded in channelling substantial amounts into the smaller end.
- External debt is considered growth capital in some quarters, if it enables a company to pursue a growth strategy. In this context, banks (Santander) and peer-to-peer platforms, such as Funding Circle, offers Growth Capital loans.
- There is a lack of the skills typically deployed together with growth capital in order to pursue the growth strategy.

28. The launch of the Business Growth Fund (BGF) by the UK's major banks in 2011, earmarked £2.5bn of long-term capital funds for growing companies. By the start of 2016 it had made over 100 investments. The BGF is one provider of equity to early-stage companies. Our members report that certain of its investments have been made in businesses which otherwise would not have secured equity funding.

⁷ DBIS and BBB Small Business Investment: Equity Tracker research report, March 2015

⁸ 'Putting capital to work' and 'Cutting edge', by Shaun Beaney, *Corporate Financier*, May 2014; reproduced in the British Business Bank's *Strategic Plan* June 2014

Question 4: 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?

29. Research finds that companies do not lack confidence in using either peer-to-peer debt lending, or equity crowdfunding, if they believe it to be suitable for their purposes. NESTA [reported](#) that, the alternative finance market had more than doubled in size, year on year, from £267 million in 2012 and £666 million in 2013, to £1.74 billion in 2014.
30. There is also no lack of seasoned investor confidence in these business models; well-known investors have made early-stage investments in the platforms themselves (eg Jon Moulton in Finding Circle, Draper Esprit, Numis and Balderton Capital in Crowdcube and Nicola Horlick in Money&Co).
31. The collapse of Chinese peer-to-peer lender Ezubao, [reportedly](#) a 'Ponzi scheme' totalling over £5bn, reminds us that appropriate regulation and consumer protection are essential. We note that the FCA's own review of the regulatory requirement for P2P and equity crowdfunding is due to take place during 2016; policy makers may wish to look again at provisions for customer protection at that time. Crowdfunding is conducive to cross-border flows and, in order that UK businesses continue to benefit from this form of finance, we encourage the FCA to engage closely with the European Commission as the latter assesses practices and national regimes for crowdfunding as part of its [plan](#) for Capital Markets Union⁹.

Question 5: What are the main improvements or interventions, in terms of finance, that the Government should make to achieve the objective of increasing the number of successful and high-growth businesses in the private sector?

32. The Government could usefully
 - up its support for market-led information and education programmes on business finance;
 - reconsider its shift from grant funding to loans for certain businesses;
 - improve the clarity of outcome and monitoring of targeted schemes and the guidance provided on eligibility; and
 - reinstate a scheme that subsidises the cost of finance advice for smaller businesses.
33. Anecdotal evidence from our members suggests that lack of information on the variety and sources of funding available continues to be a barrier to firms taking external investment. Moreover, last December, ICAEW's Taskforce that produced the Business Finance Guide, met to exchange views on the effectiveness of the guide and the case for a second edition. That meeting of senior people from around 20 professional bodies concluded '...there is still a knowledge gap and [that] the guide has been and will continue to be a valuable tool.'
34. The move following the 2015 Autumn Statement from grant funding to loans for early-stage capital intensive, science-based companies supported by Innovate UK, is particularly concerning. [Recent academic evidence](#) finds evidence of 'an equity gap in the UK economy and particularly in the complex and fast-growing, knowledge-intensive sectors where informational asymmetries and market failure are perhaps more acute'. The technology developed at British universities and by UK companies continues to lead the world. It has the potential to continue to underpin new products in wide variety of sectors and yet product life cycles are shortening. A further threat is from breaches in cyber security and the compromise of intellectual property, so it ever more important for UK companies seeking early-stage investment to swiftly transition from university or business research project to production. Such

⁹ EC, Action Plan for Building a Capital Markets Union, September 2015, Page 7

transition requires up-front investment and is typically very high risk. Many ICAEW members believe that it is such initiatives and companies which require government support in the form of grant aid, rather than a system of loans.

35. We are also concerned by uncertainty and instability created by State Aid Rules, and the government's interpretation, in the context of VCT schemes, as detailed in our [submission](#) to the EC's call for evidence on the impact of financial regulatory reform.
36. The [SME Finance Monitor](#) measures the percentages of applicants who sought advice prior to applying for an overdraft or a loan. The figures are between 7% and 10% of those applying for an overdraft dependent on the amount required. For a loan the figures are 8% to 26%. ICAEW believes that more SMEs would be successful in raising finance if they took external financial advice, specifically on preparing a business plan and financial forecasts, as well as selecting the most appropriate finance for the stage of development of the business.
37. As ICAEW recommended in [Tomorrow's Enterprise: Building a public policy environment that reflects the changing state of enterprise](#), the government should consider viable alternatives to the Growth Voucher scheme, which subsidised businesses seeking strategic, including access to finance. That scheme was stopped in March 2015. Originally scheduled to cost £30 million, because of the short duration (15 months) it will have cost significantly less. The [Start Up Loans scheme](#) offers loans to FTAs up to £25,000 and some mentoring in making the application and for a year after the loan is received. We recommend that a voucher for finance advice be reinstated for applications in excess of £25,000; for example, £1,000 could be offered to be matched by £1,000 from the business.