House of Commons

Business, Energy and Industrial Strategy Committee

Access to finance

First Report of Session 2016–17

HC 84

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Report, together with formal minutes relating to the report

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Business, Energy and Industrial Strategy Committee

The Business, Energy and Industrial Strategy Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of the Department for Business, Energy and Industrial Strategy. The Committee's name was changed, from the Business, Innovation and Skills Committee, on 17 October 2016.

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1 Introduction

Our inquiry

1. In the aftermath of the 2008 financial crisis, bank lending to small and medium-sized enterprises (SMEs) came "to a standstill".[1] Between 2009 and 2012, new lending to SMEs fell 23%,[2] and it took till late November 2015 for it to return to positive annual growth.[3] Smaller businesses in the UK employ over half the total private sector jobs, are dynamic creators of new jobs, and account for almost half of private sector turnover.[4] It is in the interests of the UK economy to facilitate new businesses to start, grow and become large successful firms.

2. We wanted to hear from those providing finance and those seeking finance to see if the landscape had improved since 2008, what problems remained, and if the Government was taking appropriate action to ensure new businesses can flourish in the UK.

3. The marketplace has changed since 2008. Although the mainstream banks still dominate business lending—the four largest banks (Lloyds, HSBC, RBS and Barclays) account for 80% of business current accounts[5]—there have been important developments. The Government set up the British Business Bank (BBB) with the purpose of improving the market for SME finance. New banks have entered the market, some aimed specifically at business customers, and the UK has become one of the foremost countries for alternative finance. Both have introduced competition and innovation, particularly in embracing the possibilities of providing services online. We wanted to see what impact these developments were having on new start-ups and growing businesses, and if the industry felt the government was supporting and regulating it appropriately. We are grateful to all those who provided information and answered our questions. We wish to thank the National Audit Office and NESTA for providing guidance at the outset of our inquiry.

4. It is important to note that most of the evidence was gathered for this inquiry before 23 June 2016. Since our final oral evidence session, the Minister with responsibility for small businesses, and the Secretary of State for Business, Innovation and Skills, have changed. Indeed, the new Secretary of State is for a Department for Business, Energy and Industrial Strategy. **We acknowledge that the decision taken on the 23 June 2016 to leave the EU is likely to have repercussions for access to finance. We intend to monitor the data on access to finance, and the Government's response to any repercussions in light of the decision to leave the EU. If there are indications that the situation on access to finance has changed, then we will return to this subject.**

1 ICAEW ATF038
2 NAO report on improving access to finance for SMEs
3 Department for Business, Innovation and Skills ATF054
4 BBB, Small Business Finance Markets 2015–16, February 2016
5 Department for Business, Innovation and Skills ATF054, CMA Retail banking market investigation: Provisional findings report, 22 October 2015

2 The current landscape for finance

5. The financial crisis had a major impact on the UK business banking market.[6] The banks, while still the largest form of lending to SMEs, reduced the amount of risk they were willing to take in their lending decisions.[7] The manufacturers' organisation (EEF) said the access to finance landscape had improved "only marginally" since the financial crisis and credit conditions for smaller SMEs remain constrained.[8] Longstanding structural barriers remain which have a particular impact on SMEs, including the difficulty, and cost, of calculating the viability of SMEs with limited credit history.[9] Some sectors, such as construction, struggle to get finance irrespective of the size of the business because the banks consider there to be greater risk in those sectors.[10]

6. There are signs that the problem has been easing. SME Finance Monitor 2015 showed that 6% of the SMEs surveyed thought access to finance was a barrier—down from 11 per cent in 2012.[11] The supply side of the finance market is in much better shape than it was in 2008.[12] Net lending to SMEs has started to improve since late 2014.[13] Within this, lending has been more pronounced for medium SMEs, while net lending has remained negative for small SMEs.[14] The Octopus Investment High Growth Small Business Report in 2015 found nearly one in four found it difficult to secure the funding they needed on acceptable terms, and of those, 75% said this was a significant barrier to their growth.[15]

Reduced demand

7. The majority of lending to SMEs is still through the high street banks—80% to 90% of SMEs still go to their current account provider for a loan,[16] and banks provided two thirds of the increase in gross funding to SMEs between 2010 and 2015.[17] The evidence on SME attitudes to the banks is mixed. Many business people approach their existing bank to apply for a loan or overdraft because they are already familiar with the bank and the product.[18] Some SMEs were scarred by the financial crisis and there are signs that many businesses retain a negative view of the banks.[19] Older business people tend to go to the bank, but do so with low expectations. Younger business people, under 35 or 40, tend to be more willing to explore non-bank options from the start, yet younger and smaller businesses are more likely to have a loan application rejected.[20]

8. There are range of descriptions given to SMEs and their attitude to finance. 'Discouraged demand'—where businesses do want finance but do not approach the banks because they assume they will be rejected or have other credit facilities re-evaluated—was

6 HSBC ATF039, Community Investment Coalition ATF023
7 Q56
8 EEF ATF029
9 British Business Bank, Small Business Finance Markets 2015–16, February 2016
10 Qq20–21
11 SME Finance Monitor 2015, April 2016
12 Q189
13 Department for Business, Innovation and Skills ATF054
14 Department for Business, Innovation and Skills ATF054, Asset Based Finance Association ATF027
15 Octopus Investments ATF062
16 Q82
17 British Bankers Association ATF052
18 Q170
19 Institute of Directors ATF035, EZBob ATF022
20 NAO report on improving access to finance for SMEs

the main reason for would be loan seekers not applying for finance in Q3 2015, according to the SME Finance Monitor.[21] The proportion of businesses who would classify themselves as a 'permanent non-borrower' has increased from 34 per cent in 2011 to 46 per cent in Q3 2015.[22] And the majority of SMEs are 'happy non-seekers'—81% Q3 2015 have not sought any external finance and nothing is putting them off from applying.[23]

9. The financial attitude of the majority of SMEs (75%) is to pay down debt and remain debt free—the value of outstanding overdrafts has been decreasing since 2011[24]—and 80% of SMEs agree that their current plans for the business are based entirely on what they can afford to fund themselves.[25] Surveys indicate there has been a decline in SME confidence in 2015 and investment intentions had reduced to the same level as 2012. Keith Morgan, Chief Executive Officer of the British Business Bank, said his bank would be "looking very closely to see whether, on the demand side, there is any subdued confidence and demand for funding."[26]

Calculating a finance gap

10. In 2013, the NAO reported research that suggested there was an estimated 'funding gap'—the difference between the funding required by SMEs and the funding available—of between £10 billion and £11 billion. They said that by 2017 this figure may rise to about £22 billion but that uncertainty over future levels of GDP meant it could be as low as £6 billion or as high as £39 billion.[27] The British Bankers' Association said estimates of the gap range from a few hundred million a year to over £30 billion.[28] We did receive views that there is difficulty in meeting demand for venture capital of between £10 million and £25 million for firms looking to grow,[29] and for seed and early stage market equity in the £2 million 5 million range.[30] Rishi Khosla, Co-founder and Chief Executive, OakNorth Bank, said getting data on the size of the gap was difficult but his impression, from talking to business customers, was that he thought the gap was "very large".[31] Several witnesses said putting a value on any finance gap was difficult because of difficulties in measuring aspects such as discouraged demand.[32]

Interventions to improve access to finance

11. The Government, alongside the banks, has worked to introduce various initiatives to stimulate lending—and we received positive views on the Regional Growth Fund (RGF) and Funding for Lending.[33] Enterprise Finance Guarantee (EFG) encourages lending to viable businesses that would be turned down for a loan or other form of debt finance due

21 SME Finance Monitor 2015, April 2016. Institute of Directors ATF035
22 Bibby Financial Services ATF055
23 Permanent non-borrowers are those SMEs that are not using external finance and show no appetite to apply. Happy non-seekers are SMEs who have not tried to secure finance, and nothing had stopped them applying for funding in the previous 12 months.
24 Department for Business, Innovation and Skills ATF054
25 SME Finance Monitor 2015, April 2016
26 Q189
27 NAO Report, Improving access to finance for small and medium-sized enterprises, HC 734
28 British Bankers Association ATF052
29 Q23
30 SQW ATF017
31 Q82
32 Qq18–20, Q23, Q98
33 Finance and Leasing Association ATF008, HSBC ATF039, Greater Birmingham & Solihull LEP ATF028

to inadequate security. It does this by providing accredited lenders with a Government-backed guarantee for 75% of the loan value.[34] The EFG has stimulated over £2 billion of lending to SMEs.[35] Anna Soubry, the then Minister for SMEs, told us that the situation around access to finance had got "a lot better".[36] Part of its response to ongoing problems on access to finance for SMEs was the establishment of the British Business Bank in 2014, to bring together and coordinate better its SME finance schemes into one place.

The British Business Bank

12. The British Business Bank (BBB) is a publicly-funded, development bank described by the Government as its "centre of expertise for SME finance".[37] It is owned by the Department for Business, Energy and Industrial Strategy but has operational independence.[38] It does not operate as a direct competitor in the marketplace but delivers a range of products through third parties. The BBB has four objectives:

- To increase the supply of finance to SMEs where there is market failure
- To help create a diverse market for SME finance
- To promote better information on, and understanding of, finance options
- To manage taxpayer resources efficiently

13. It can operate at the Government's cost of capital rather than the private sector's cost of capital, and so offer products and solutions in full knowledge that financial return may not be always positive, but this will be offset elsewhere and the overall package will have a positive impact on the economy.[39] In 2015, the British Business Bank was supporting £2.5 billion of finance to over 40,000 smaller businesses, and participating in a further £3.6 billion of finance to small mid-cap businesses.[40]

14. The consensus view from our witnesses was to welcome the BBB and the contribution it had made for SME finance. The British Chamber of Commerce said it did good work but was underfunded.[41] Andrew Sandiford, Institute of Chartered Accountants in England and Wales (ICAEW), described it as an "unsung hero" and that many of his clients had benefited from its schemes, even when they had not heard of it.[42] Simon Littlewood, Grant Thornton, said the Business Bank was making an impact and that the Government should "be confident in the decisions we have made and let it grow. It is on the right track."[43]

15. **Calculating the gap between demand and supply for SME finance is complicated and there is a clear need for the British Business Bank to continue to gather intelligence on how the market operates. There is evidence of unmet demand for finance from SMEs, particularly at the scale-up and grow stages, where business are looking for finance of**

34 Royal Academy of Engineering ATF061
35 Community Investment Coalition ATF023
36 Q207
37 British Business Bank and Department for Business, Innovation and Skills ATF054
38 Q198
39 Q164, Q167
40 Department for Business, Innovation and Skills ATF054
41 British Chamber of Commerce ATF058
42 Q76
43 Q76

£10 to £25 million. We recommend that the Government targets its intervention at addressing this funding gap, working closely and flexibly with investors to respond to evolving demands.

16. **In the few years since it was created, the British Business Bank has filled an important space in the SME finance landscape. We agree with many of our witnesses who said it has had a positive impact and should be allowed time to establish itself. Its credibility with the business community is enhanced by its independence from Government and we do not recommend changes to existing arrangements.**

Assistance in accessing finance

17. The British Business Bank has identified three areas of market failure where there is scope for it to intervene: new business start-ups via the start-up loans company, scale-up/fast growth companies, and larger companies that want to stay ahead of the competition.[44] Different businesses have different ambitions: they do not necessarily wish to expand globally, and some might wish to expand quickly. Their finance needs will be different.[45]

Start-ups

18. The UK compares well against other OECD countries in terms of the number of start-up companies,[46] and there is currently a record number of small businesses in the UK.[47] New start-ups tend to find it difficult to demonstrate to credit-worthiness to the bank and over 50 per cent of loan applications for new start-ups are rejected.[48] Those wishing to commercialise scientific research can find it difficult to access finance to fund their development.[49] There is evidence of untapped demand, not least because of the number of start-ups which begin with seed funding from family and friends (and not everyone can raise funds that way).[50]

19. Responsible Finance, a campaigning organisation, said demand remains for SMEs seeking less than £150,000 for start-up or growth finance.[51] The Start-Up Loans Company—a partner of the British Business Bank that offers loans of up to £25,000 to entrepreneurs with a new business less than two years old—said Expressions of Interest for their loans had increased year on year since they started in 2012—in that time it has provided over 35,000 loans totalling £192 million of lending. Of those applying to the Start Up Loans Company, 86 per cent had been unsuccessful in applications elsewhere, and 48 per cent had used funds from family or friends. In addition to strong demand for their loans, the Start Up Loans Company said one in three applicants said the key reason

44 Q165. Start-ups are SMEs trading up to five years, Scale-up are SMEs trading more than five years with ambitions to grow, and stay ahead are SMEs trading for more than five years with no ambition to grow
45 Q144
46 Q165
47 BBB, Small Business Finance Markets 2015–16, February 2016. Grant Thornton ATF036
48 BBB, Small Business Finance Markets 2015–16, February 2016
49 Royal Society ATF041
50 Qq6–7. Funding Knight ATF047
51 ATF030

was the mentoring service and one in four said it was for the pre-loan support.[52] The default rate on Start-Up loans was near 30%. (The Start-Up Loan Company target is to keep defaults below 40 per cent.)[53]

20. We received positive views on the British Business Bank schemes for new start-ups.[54] EEF said the British Business Bank had "gone some way towards unlocking finance at the seed and growth stages" and the Alternative Business Funding Collaboration described the Start-Up Loans Scheme as "highly successful".[55] The Government said that an initial evaluation indicated that the programme was meeting its objectives and has had a "significant positive effect" on the business start-up rate.[56]

21. There is evidence of substantial demand for finance from the new businesses seeking loans from the Start-Up Loan Company.[57] A high proportion of those loan applications come from SMEs who have been refused a loan elsewhere. While a proportion of these new businesses default on their loan, it has helped thousands of people start their own business. A proportion of these loans will go to riskier ventures, but the role of the Start-Up Loan Company is to provide support where mainstream lenders may not, and where it sees the investment as providing a net positive gain to the economy. **We agree that the Start-Up Loans Company is a good and effective way to support entrepreneurs who want to create their own business. The Government should maintain its level of funding and assess if there is potential for Start Up Loans Company to be extended.**

Scale-up and growth

22. Research has shown that access to the right type of finance is a key reason why companies are unable to increase in scale in the UK, and there is an enduring problem securing finance for fast growth businesses wishing to scale-up.[58] The issue is especially acute among new, fast-growing companies that are too young to have a credit history (as opposed to those that have a history of bad credit).[59] OECD statistics put the UK near the bottom of the table in terms of the number of firms successfully scaling-up—only 3% of UK start-ups become mid-sized companies, compared to 6% in the USA.[60] Very few businesses end up employing more than 10 people in the UK.[61] The Royal Society said the UK "has a scale-up problem", partly because there was a mismatch between investor expectations and the time it takes to commercialise scientific ideas, leading to "businesses focus on selling out rather than scaling up". This leads to a reduction in R&D spend, which contributed to why the UK had few businesses to rival those in the US in terms of size.[62]

23. Keith Morgan, from the British Business Bank, described the UK's poor performance in growing start-ups to SMEs with more than nine employees in three years as "not

52 Start Up Loans Company ATF025
53 Express and Star, Start Up loans scheme sees almost third of money lent turn into bad debt, 6 September 2016
54 Q9
55 ATF029, ATF003
56 Department for Business, Innovation and Skills ATF054
57 Department for BEIS Press Notice, £250 million milestone for Start Up Loans, 31 August 2016
58 Scale-up report on UK economic growth, an independent report commissioned by the Information Economy Council, a joint industry and Government body. See also Q9 or Royal Society ATF041
59 Q2
60 Institute of Directors ATF035
61 Q141. Start-ups struggle to nurture rapid growth, report warns, FT, 25 April 2016
62 Royal Society ATF041

doing very well".[63] The BBB has directed extra resources to their scale-up work through venture capital initiatives and the Help to Grow scheme—a new scheme that will use a mix of guarantees and co-investment with the private sector to support fast growing and innovative UK SMEs with investment requirements between £0.5 million and £5 million.[64]

24. Fast growth can bring extra risk, and as such equity investment might be a more suitable form of finance than a bank loan,[65] and equity investors seeking high growth potential businesses may be able to take on a higher degree of risk.[66] The UK lags behind many of our global competitors, including other EU countries, in the proportion of SMEs using equity funding.[67] An internal poll of British Chamber of Commerce members found that while almost half (49%) of firms use banks or building societies for external finance, only 10% use equity.[68] We were told there were investors looking for good investments, but they found it a challenge to find good businesses to invest in,[69] and several witnesses commented on the need for SMEs to be 'investment ready' if they wished to attract potential equity investors.[70]

25. There are, however, signs that equity investments are growing in number and value.[71] There has been an increase in equity investment flowing to UK SMEs every year since 2010, reaching a total of £3.5 billion in 2015. Total angel and venture capital equity investment SMEs increased 58% between 2014 and 2015.[72] Yet several witnesses told us there was a finance gap for fast growth businesses seeking venture capital of between £10 million to £25 million.[73] Gaps that appear at an early stage in the funding pipeline can lead to knock-on effects later down the line, leading to a stop-start approach to growth. The UK Private Equity and Venture Capital Association told us:

> This process, by extension, often leads to innovative British companies being sold to larger American corporates when investors exit, sending intellectual property, jobs and economic growth overseas. Resolving this issue remains a priority if we are to bolster Britain's high-growth business community.[74]

At present, investment for growth is more often than not forthcoming from US or European backed funds.[75] The UK venture market is poor in comparison to the US.[76] There is scope for more investors to be encouraged into the UK business equity finance landscape, including institutional investors such as insurance firms, pension funds, and sovereign wealth funds.[77]

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63 Q165
64 BBB, Small Business Finance Markets 2015–16, February 2016. The Help to Grow Scheme
65 Equity investment is a payment by individuals or firms, in return for a share of the company stocks and where profits are in the form of capital gains or dividends
66 Q73
67 Q123
68 British Chamber of Commerce ATF058,
69 Qq66–67
70 SQW ATF017, Grant Thornton ATF036, UK Business Angels ATF032, Royal Academy of Engineering ATF040, Creative England ATF053
71 BBB, Small Business Finance Markets 2015–16, February 2016. British Bankers Association ATF052
72 Q226 [The BBB point out that the figures are distorted by a small number of pharma companies with deal sizes exceeding £10m, and including one pharma company receiving funding of £205m in 2015.]
73 Qq23–24, Q34, Q123
74 British Private Equity & Venture Capital Association ATF011
75 Q71
76 Alternative Business Funding ATF003
77 British Private Equity & Venture Capital Association ATF011

26. **Access to finance is one of the main barriers to scale-up for fast growth SMEs. There is a gap in securing finance at particular growth stages, and a lack of investors able to provide a pipeline of finance at all stages of development. It may be that the market for growth finance requires time to mature, but the Government must introduce targeted intervention to address the difficulties around businesses wishing to scale-up. The Government should set out what it is doing to incentivise further institutional investors into the private equity market.**

27. **Awareness of options for finance is growing. However, awareness in areas such as equity has not necessarily led to an increase in uptake of those options. Part of the reason for this is because SMEs are not taking the steps to become 'investment ready' and attract potential equity investors. The British Business Bank, alongside business groups and networks, needs to focus on identifying businesses with high potential for growth, and ensuring they have access to advice about what they need to do to secure the most appropriate form of funding for their next stage of development.**

The Alternative Investment Market (AIM) and encouraging investment

28. Several witnesses commented on the comparison between the investment market in the UK and the US, and the need to support fast growth businesses that can encourage a broader investment ecosystem in the UK.[78] AIM is the London Stock Exchange's international market for smaller growing companies. It is seen as important in creating an environment that encourages businesses to aspire to be listed and investors to invest in smaller companies.[79] London Stock Exchange Group runs the ELITE scheme which introduces investors to companies considering seeking venture capital in the near future.[80] **The Alternative Investment Market is an important part of the finance ecosystem in the UK. Whatever happens with the proposed merger of the London Stock Exchange and the Deutsche Borse, we urge the Government to support the retention of AIM as a forum for companies to raise capital and grow.**

Tax incentives

29. One of the ways the Government tries to encourage equity investors is to use the tax regime to incentivise private individuals to invest in growth companies. We received particular praise for the Enterprise Investment Scheme (EIS),[81] the Seed Enterprise Investment Scheme (SEIS),[82] Venture Capital Trusts (VCT)[83] and Research and Development tax credits.[84] These are managed by HMRC.

30. The SEIS helps small, early-stage companies (fewer than 25 employees and assets of less than £200,000) raise equity finance, supporting investments of £150,000 or less. Since its creation in 2012 it has helped more than 2,800 companies raise over £250m. The EIS helps unquoted companies with fewer than 250 employees raise equity finance by offering a range of tax reliefs to investors who purchase new shares in those companies. EIS

78 Qq118–119, Q121
79 Octopus Investments ATF062
80 Q82, Qq 108–109
81 Enterprise Investment Scheme (EIS)
82 Seed Enterprise Investment Scheme (SEIS)
83 Venture Capital Trusts (VCTs)
84 Qq26–28, Q33.Greater Birmingham & Solihull LEP ATF028, Institute of Directors ATF035, ADS Group ATF037, Funding Knight ATF047

underpins the majority of business angel finance in the UK and, in 2013–14, £1,529m was invested in 2,770 companies. The VCT scheme encourages individuals to invest in small, unlisted companies indirectly through the acquisition of shares in a VCT, which must be listed and approved by HMRC—the tax incentives include exemption from income tax on dividends and capital gains tax on disposals. In 2014–15, VCTs issued shares to the value of £435m and VCTs currently have investments in over 1,000 companies.[85]

31. We received suggestions for enhancing the range of incentives available to encourage investors, such as towards high innovation scientific companies, the creation of a VCT specifically targeted at scale-up SMEs, higher and further incentives for investors outside London and the South East, and initiatives to encourage a broader range of investors, such as developing an ISAs that can utilise EIS and SEIS investments.[86] The main criticism we received was that awareness among their intended market was low and the incentive schemes should be promoted more.[87] For example, Jimmy McLoughlin, from the Institute of Directors,[88] said only two in three of their members had heard of EIS and only one in three had heard of SEIS.[89] The other main concern was fear that the schemes would be changed or lost.[90]

32. **The SEIS, EIS and VCT schemes received praise from many of our witnesses for their role in cultivating a UK venture capital community. It is important that the Government does not tinker with how the schemes operate. The main barrier to greater take-up of the schemes appears to be low awareness among both businesses and investors. Promotion and take-up of the schemes would be helped by HMRC carrying out an assessment of the EIS, SEIS and VCT schemes, and demonstrated their value to both SMEs and the tax-payer.** ***We recommend that the Government directs resources towards promoting the SEIS, EIS and VCT schemes. This includes the British Business bank working with HMRC to consider how to improve promotion of the schemes.***

European Investment Fund

33. The European Investment Bank supports finance initiatives for SMEs in the UK. The European Investment Fund (EIF) aims to help SMEs across Europe secure finance through various banks, lenders and investors. In 2015, the EIF contributed €655 million in equity in the UK. EIF invested into two co-investments and in 16 funds.[91] One example was given to us by James Meekings, UK Managing Director and Co-founder, who said Funding Circle had a £100 million agreement with the European Investment Bank to support funding business in the UK but that such funding agreements would be at risk in the future.[92] The European Investment Fund has also backed European Venture Capital funds, "maybe to the tune of 25% or 45% of a fund". Chris Hulatt, Chief Financial Officer, Octopus Investments, said the Government needed to be ready to fill any gaps that may appear if the European Investment Fund retreats from backing aspiring British Venture

85 Department for Business, Innovation and Skills ATF054
86 Q139. Bio-industry Association ATF033, Funding Knight ATF047,
87 ATF035, Q161.
88 On 15 August, the Prime Minister appointed Jimmy McLoughlin to be her Head of Business Liaison.
89 Q29
90 Q49
91 The EIF in the UK
92 Qq160-Q161

Capital funds in the future.[93] The then Minister for Small Business, Anna Soubry, told us that European Investment Funds would not be withdrawn, although she admitted there was a problem not knowing when the UK will leave the EU.[94]

34. **The European Investment Bank has provided millions of euro into funds that underpin finance for businesses in the UK. Following the result of the referendum on the UK's membership of the European Union, there are concerns that this source of finance might not be available in the future. There is a risk that structures in place to assist SME finance will have considerable shortfalls in their resources without the value of these funds.** ***We recommend that the Government identifies the size of current European Investment Bank contribution in the UK economy, the timetable for current commitments, and make a clear statement on Government plans to ensure that the current level of funding will not be reduced.***

Angel CoFund

35. The Angel CoFund is a private company limited by guarantee, with a board and investment committee made up of people with industry expertise. It has about 60 investments providing £130 million, co-invested alongside a syndicate of angels to small, growing companies.[95] The Angel CoFund co-invests alongside individual angel investors to help businesses raise money early on in the development and give them more time to get up and running. An assessment of the CoFund in 2014 "showed the rationale for the Angel CoFund to be valid" and that it was providing finance to young, innovative businesses expecting rapid growth, and enabling firms to progress more quickly or on a larger scale.[96] Chris Hulatt, from Octopus Investments, described it as "part of what is now, to me, a strong functioning ecosystem for early stage companies".[97] If anything, demand for the Angel Cofund outstripped supply.[98]

36. **The Angel CoFund is a strong and positive part of the finance landscape for new businesses. It helps secure funding for new businesses through sharing risk, but also brings new businesses with potential and business angels, with their experience and networks.** ***We recommend that the Government and the British Business Bank build upon the success of the Angel CoFund, ensure it is funded adequately to meet demand, and consider how it could be expanded.***

Regional imbalances

37. There are regional disparities in several aspects of finance for SMEs.[99] The Royal Academy of Engineering said London ranks sixth out of 20 global start-up ecosystems, second only to Silicon Valley in the US, while the East of England, the South West, Wales and Northern Ireland all experienced a fall in the amount invested between 2014 and 2015.[100] The number of new business start-ups (25%) is over represented in London

93 Q128
94 Q223
95 Q185
96 Department for Business, Innovation and Skills ATF054
97 Q141
98 British Private Venture & Equity Capital Association ATF011
99 SQW ATF017, Responsible Finance ATF030, UK Business Angels ATF032, Cornwall Council ATF034, Grant Thornton ATF036 ,
100 Royal Academy of Engineering ATF061

compared to its proportion of the UK population (13%).[101] Research into start-ups and existing businesses by Local Enterprise Partnership between 2009 and 2012 found above average proportions of fast growing firms in London, the South East and Leicestershire. London came first or second in four out of the five metrics used to assess growth.[102]

38. The British Business Bank has recognised the regional imbalance in equity investments, and is using its own resources alongside those from the European Investment Bank to create two funds: a Northern Powerhouse Investment Fund and a Midlands Engine Investment Fund. The British Business Bank and LEPs in these two regions, are developing an investment strategy to deliver equity, debt and micro-finance to small businesses.[103] The British Business Bank was considering how further funding of the Angel CoFund could be used to address the regional imbalance in small business equity investments—most of which are in London and the south-east while the Midlands and the North were under-represented.[104] Similarly, 65% of SEIS and EIS transactions are happening in London and the South east.[105]

39. **The new Prime Minister has already spoken of her desire for opportunity and economic success to be more fairly distributed across the UK, and we look forward to learning how the Government intends to use the various levers at its disposal to make this happen. Enabling entrepreneurs to start their own business, and ensure they can access finance as they grow, can have an important role in rebalancing economic growth across the UK. The willingness of the Government to intervene where there are identifiable market failures in the business finance landscape across the whole UK, represents a test and an opportunity in the context of its new industrial strategy.**

40. **The British Business Bank, as the Government's centre of excellence on these matters, needs to be at the heart of proposals to address the regional discrepancies in SME finance. We welcome the intention of the British Business Bank to use the Angel CoFund to stimulate equity investment beyond London and the South East. The development of the Northern Powerhouse Investment Fund and a Midlands Engine Investment Fund will be important routes to focus investment away from the South East of England.** ***We recommend that the Government introduce a fifth performance indicator for the British Business Bank to assess its effectiveness in incentivising lending and investment activity in all parts of the UK.***

101 BBB, Small Business Finance Markets 2015–16, February 2016
102 Enterprise research Centre & Growth Accelerator, LEP Growth Dashboard, June 2014
103 Q186
104 Q75, Q185
105 Q32

3 Is there a finance information gap?

The importance of understanding there are choices

41. While the number of finance providers and the products available has increased since the financial crisis, a common theme in our evidence has been the barrier of SMEs not being aware of the finance options available or understanding which ones are most appropriate for their needs.[106] Over half of SMEs do not shop around but go straight to their bank to apply for finance.[107] And SMEs are, by definition, small and do not always have the time to research their options. As Mr Woolard, from the Financial Conduct Authority, said:

> We need to think about the opportunity costs that small firms face. We often want them to behave in a very economically rational way and spend lots of time shopping around, getting the right deal, but that is time that will not be spent on running their own firm, which is the core of what they do.[108]

42. Anna Soubry MP, the then Minister for Small Businesses, said the Government wanted business people to "shop around and to look at the alternatives" but that "not enough of them understand the full range of [finance] options".[109] Surveys of SMEs show that awareness of the alternatives has grown but awareness of a specific supplier of that alternative has not grown at the same pace. Similarly, greater awareness has not led to greater use of the alternative form of finance.[110]

43. The British Business Bank has recognised the need to improve the dissemination of information on finance options and to build confidence among SMEs in the options available.[111] The BBB used its "convening power"[112] to persuade the business groups, the British Bankers' Association, equity investors and venture capital bodies, and alternative finance providers, to collaborate on a Business Finance Guide for small business. The guide is available in hard copy, as a downloadable pdf and as an interactive online guide,[113] and its usefulness was highlighted by our witnesses.[114] Mr Morgan conceded the BBB could "do a better job" increasing awareness of the guide,[115] and that it would survey its intended audience for feedback.[116]

Information is not enough

44. Alongside making information available, it is important to enable the SMEs to seek advice on the options. Business that are prepared to take advice are more likely to be successful in raising finance as it increases the chance of them being matched with the

106 Q82. ATF008
107 BBB, Small Business Finance Markets 2015–16, February 2016
108 Q204
109 Q213, Q211
110 BBB, Small Business Finance Markets 2015–16, February 2016
111 BBB, Small Business Finance Markets 2015–16, February 2016
112 Q168
113 Downloadable pdf and interactive online
114 E.g. Q82
115 Q168
116 Q178

most appropriate source of funds.[117] This was a recurring point in our evidence, that education on options and the process of raising finance would help businesses be prepared to secure the most appropriate form of investment. To assist this, the alternative sources of finance needed to be promoted more.[118] The provision of information is not enough; as the Minister told us, "the British Business Bank can signpost you but it cannot give you advice about the best product for you".[119]

45. The marketplace for finance has improved since 2009, with more finance providers and a greater choice of products available. However, many SMEs are time poor and not experts in business finance. Their capacity and appetite for extensive research on finance options is small. **A recurring theme in our evidence is that access to information and advice on finance options is a more significant barrier to SMEs than the availability of funding. Furthermore, businesses that seek and receive advice greatly enhance their chance of securing finance.**

46. **The British Business Bank has been an important development in providing a single source of information for business finance. However, there remains a gap between demand and the availability of free business advice. Information provided by the British Business Bank, and others, must be user-friendly, consistent and accessible to non-specialists. It must be able to direct the customer onto the next step. The Government and the British Business Bank need to build on the work of the Business Finance Guide, and prioritise cooperation with business networks and business advisers, often local accountants, to encourage SMEs to seek advice at the earliest opportunity.**

47. **We welcome the fact that the British Business Bank has a performance indicator "to promote better information on, and understanding of, finance options". The publication of the Business Finance Guide is a positive step, but the British Business Bank has to rely upon other organisations to deliver the information.** ***We recommend that the British Business Bank explain to us, in the response to this Report, their strategy for promoting understanding of the Business Finance Guide, how it will identify and target hard to reach groups, how it will measure any increase in the awareness and take-up of alternative finance products, and its analysis of the feedback from SMEs on the Business Finance Guide. Furthermore, we recommend the Bank explain how they will analyse the volume of traffic to the online Business Finance Guide and how that will inform their strategy for increasing awareness of understanding finance options.***

Business networks and trusted sources of advice

48. Our witnesses were clear that SMEs place a strong emphasis on taking advice from trusted sources. Andrew Sandiford, an accountant who works with businesses in the South West on England, said it was "critically" important for businesses to "seek advice and have access to the networks and knowledge" in order to be successful.[120] Professional advisers, such as accountants—a point emphasised in the recent CMA Report into retail banking—and business networks, were popular.[121] Business networks also provided individuals to

117 Qq68–69. ATF017
118 Grant Thornton ATF036, Aldermore Bank ATF044
119 Q245
120 Q68
121 Q37, Q38, Competition and Markets Authority, Making banks work harder for you, 9 Aug 2016, p.11

act as mentors and coaches, experienced business people who can, formally or informally, provide ongoing guidance for less experienced business people. There were also initiatives, such as the ELITE programme operated by AIM, developed with the specific aim to nurture entrepreneurs.[122] HSBC ran workshops to help start-ups understand basic strategies and established businesses understand how to get to the next level of growth.[123]

49. There was scepticism about advice seen as being provided by the Government, and if the Government should be giving such advice at all.[124] HMRC was seen as a useful conduit to alert businesses to new developments simply because business people have to pay attention to HMRC.[125] We heard mixed views on Growth Hubs: Mr Sandford, ICAEW, said that their websites could be confusing so it was not easy to find out what service they provided, and it could appear inconsistent from region to region.[126] The British Business Bank was seen as addressing the needs of business and, importantly, was seen as suitably independent, a point made to us by the Minister for Small Business.[127]

50. **Our inquiry reinforced the importance of SMEs seeking advice from trusted sources. We were also struck by the initiatives providing mentoring and coaching for new business people, from bodies such as the Start-Up Loan Company to the AIM stock exchange. The Government should add value by working with the major business groups and finance providers to make sure they have mentoring schemes or events specifically aimed at passing on the experience of successful business people on how to secure finance to grow a business.**

122 Q239
123 HSBC ATF039
124 Q38, Q242
125 Q48
126 Q54. See Department for Business, Innovation and Skills ATF054
127 Q242

4 Choice and competition

51. The Government has tried to reduce the barriers to new banks entering the market, with the aim of improving the range of funding options available and reduce the high concentration of lending in the main banks. There is broad agreement that increasing the number of lenders will increase the diversity of choice and offer innovative products.[128] As part of this, the British Business Bank runs programmes to support the growth of challenger banks and non-bank lenders, and directs 90% of its funds through a wide range of banks, asset finance providers, equity and venture capital investors, to try and increase diversity of choice and competition.[129] It will take time for the new entrants and their products to become known among SMEs.

Challenger banks

52. In 2010, Metro Bank became the first institution in over a century to gain a full banking licence. A further six new banks have been authorised to operate in the UK since April 2013. Since then, the challenger banks have nearly doubled their share of the retail lending market,[130] including mortgages and unsecured loans, from 4 per cent in 2010 to 7 per cent in 2013.[131] In 2015–16, challenger banks increased their lending by 32 per cent, while lending from the big five banks fell by 5 per cent.[132] We heard different views on the extent to which the dominance of four main banks led to gaps in finance for businesses. There is a perception among some that the high street banks have become more formulaic in assessing finance applications and are not proactive in seeking to understand their business customers' needs.[133] Rishi Khosla, Co-founder and Chief Executive of OakNorth, one of the challenger banks, said a lot of high street banks have gone to automated decision making, that businesses get excluded for not fitting narrow criteria.[134] Gareth Oakley, Managing Director, SME Banking at Lloyds, said that Lloyds Bank does not operate a one-size-fits-all approach, and any perception that they did was anecdotal rather than borne out by the statistics. He said Lloyds enabled their local managers to have discretion to lend up to £1 million, and that Lloyds had increased its net lending by 25% over the last five years at the same time as the market has decreased by 13%.[135]

53. The new challenger banks appeared to be more willing than the high street banks to build a relationship with potential clients, and to understand their needs, before coming to a decision.[136] Jimmy McLoughlin, Head of Entrepreneurship Policy, Institute of Directors, said their members felt the challenger banks offered a more personalised service:

> When you go to the big high street banks it is that tick-box, "No", and very formulaic response. The challenger banks at least are seen to see people and go through the issues in that more traditional model that we have perhaps

128 ATF039
129 Q165, Q168
130 'Challenger banks' describes new, smaller banks, that are not the traditional High Street retail banks
131 Financial Times, Challenger banks try to shake up the big four, 4 January 2015
132 KPMG, A new landscape, challenger banks annual results, May 2016
133 Q5, Q11, Q16
134 Q82
135 Q95, Q79
136 Q16

> romanticised a little bit about from previous years gone by. It feels much more as though they are at least getting a hearing, even if the answer they get is not what they want to hear.[137]

54. Gareth Oakley, from Lloyds Bank, recognised that the new banks might have a different risk appetite which enabled them to offer a slightly different approach, and that they were driving competition.[138] The challenger banks were seen as providing a different service, with a focus on supporting business, emphasising customer service and longer opening hours.[139] Some witnesses suggested the new entrants to the market were complementary rather than in direct competition with the traditional high street banks.[140] Mr Khosla said that in the deals OakNorth had been involved in they had found it more likely to be in competition with private equity funds rather than other banks.[141]

55. The British Chamber of Commerce wanted the Government to reduce further the barriers for new banks entering the market.[142] Regulation is necessary to provide investors with confidence that their money is safe because there is robust protection.[143] We heard concerns that the requirement, since the financial crisis, for banks to retain a higher proportion of their capital in reserve can disproportionately impact upon new entrants,[144] not least because they had not had years to accumulate assets.[145]

56. **Bank lending remains the main source of finance for SMEs in the UK. Too many SMEs think that means the only source of lending is one of the established High Street banks. That is not the case. The new challenger banks have gained a reputation for being innovative, attentive to customer service, and proactive in reaching out to potential customers. We welcome the establishment of challenger banks and the fact they have started to increase their market share. The Government should set out how it plans to support the challenger banks that have entered the market for lending to SMEs, and what steps it is taking to further increase competition in the market place for SME finance. This includes consideration of how the regulatory regime, such as the rules on capital requirements held in reserve, can disproportionately affect the ability of new entrants to compete on a level playing field with the larger, more established banks.**

The importance of data

Sharing credit information

57. The Small Business, Enterprise and Employment Act 2015 (SBEE Act) includes measures to 'encourage' the banks to share credit information on their customers with credit agencies and other finance providers and to improve the quality of credit decisions

137 Q11
138 Q101
139 Q58, Q43, ATF044
140 Q42
141 Q98
142 Q47
143 Q114. Q156
144 Q117 ATF039 Funding for Lending Scheme
145 Competition and Markets Authority, Making banks work harder for you, 9 Aug 2016. Q117

across the market. The models that alternative finance sector use to assess credit is improved by having access to data, so more data leads to better decisions.[146] James Meekings of Funding Circle explained it as

> The better data we have, the better we can assess risk. […] We believe that by opening up more data, more of them [SMEs] will be able to pass our credit models. We will be able to get a better understanding of them. This will ultimately increase lending to small businesses.[147]

He also gave an example of where the banks fulfilled their obligations in sharing data with new entrants to the finance market, but they did so more slowly than they were required to.[148]

58. **The Government has stated that it wants to increase diversity and competition in the market for finance. The new banks are disadvantaged by asymmetry in access to customer data held by businesses they would like to work with.** ***We recommend the Government sets out in its response to this Report how they intend to monitor the implementation of the Small Business, Enterprise and Employment Act 2015 and, if need be, review the Act to ensure the banks are fulfilling their obligations to provide data when they are required to.***

VAT register

59. The SBEE Act introduced measures regarding disclosure of non-financial VAT registration data to help qualifying parties improve their models for credit scoring. HSBC suggested that Credit Reference Agencies (CRAs) should have access to VAT Register data so the CRAs could generate more accurate credit scores for unincorporated businesses.[149] Funding Circle also called for the release of VAT statements to CRAs—and then approved finance providers with the consent of the business—to improve the data they use in making credit assessments, particularly for sole traders.[150]

60. ***We recommend that the Government explore allowing the Credit Reference Agencies and authorised finance providers access to financial data in the VAT Register, subject to the appropriate safeguards.***

Referral scheme

61. The Small Business, Enterprise and Employment Act 2015 included proposals for banks to refer a business whose application for finance they have rejected to a designated platform, which will then match the SME with an alternative finance provider. Finance providers, from peer to peer lenders and banks, said they would refer a business on to another provider if they were unable to help, and that this was conventional in the venture capital community.[151] We heard widespread support for the Government's proposals to mandate designated banks to refer unsuccessful applicants to designated platforms. The British Business Bank has proposed three platforms to be designated, which have been

146 Q145
147 Q146
148 Qq132–137
149 HSBC ATF039
150 Funding Circle ATF021
151 Q158. Q159

confirmed by HM Treasury. The system for how it will work is being put in place "over the course of this year",[152] and the details of how it works in practice will obviously be important.[153] For example, the ICAEW believes that the referral scheme should come alongside access to information and advice, before and after an application. If an SME has an application refused then a subsequent application is unlikely to be more successful unless it is made to a funder with different credit scoring criteria or a different form of finance.[154]

62. **We found broad support for the scheme, introduced in the Small Business, Enterprise and Employment Act 2015, for banks to refer unsuccessful applicants on to an online platform that will link the business with an alternative finance provider. We also heard criticism that the implementation of the scheme was slow and there needed to be more information on how the scheme will work in practice.** ***We recommend that the Government set out, in its response to this Report, the timetable for implementation of the referral scheme and how it intends to assess its success.***

Switching

63. The Competition and Markets Authority's recent investigation into retail banking found that the established banks still dominated the market, they did not have to work hard to retain their customers; and that this made it difficult for new banks to attract customers. Their recommendations for small businesses related to:

- Competition to develop comparison tools
- Loan rate transparency
- Loan price and eligibility indicator
- Standard information requirements for Business Current Account opening
- Sharing of SME information
- 'soft' searches
- Role of professional advisers

Together, their aim is to give business customers more tools to exercise choice over their finances, and level the playing field for new banks to compete for customers.[155]

64. Central to this is improving the ability of business customers to switch banks. Half of start-up businesses open their business account at the same bank that the business owner has their personal account and only 4% of business customers switch to a different bank in any one year. Obviously, many business customers are satisfied with their bank and see no reason to switch. Some businesses will be aware that carrying out multiple searches for credit can negatively impact upon their credit score, which understandably discourages shopping around.[156]

152 Q171
153 Q61, Q62. Alternative Business Funding ATF003
154 ICAEW ATF038
155 Competition and Markets Authority, Making banks work harder for you, 9 August 2016
156 Competition and Markets Authority, Making banks work harder for you, 9 August 2016. HSBC ATF039

65. SME customers find it difficult to find comparative information on what the alternative offer might be. Disengaging from a bank is difficult and opening a new business account can be time-consuming. Small business people are often short of time and require quicker processes. The net benefits of moving from one bank to another do not appear to be sufficient to make the effort worthwhile. Customers understandably fear putting at risk a multi-faceted relationship built up over time.[157] From the banks' perspective, the Current Account Switching Service (CASS), introduced in 2013, had made progress. Gareth Oakley from Lloyds said the system worked "extremely well" and that more than 5,000 businesses switch accounts to or from Lloyds in a year.[158] FSB research suggests that loyalty to banks is diminishing, as new businesses created in 2010–15 are more likely to move their current accounts than those created pre-2000.[159]

66. The recent Competition and Markets Authority Report found that the traditional banks did not have to work hard to retain their customers. Several of their recommendations focussed on transparency and helping the customer compare products so they could switch bank accounts.

Comparison tool

67. The CMA Report supported the development of a one-stop-shop to provide customers with a way of easily comparing offers on lending criteria, quality of service and price, and backed the launch by NESTA of a 'challenge prize' for the development and delivery of comparison services.[160] The development of a comparison tool chimed with our evidence on the need for SMEs to see clear information online.[161] The BBB has tailored its Business Finance Guide to be accessible online.[162] Another initiative is the Business Banking Insight project, a website provided by the British Chamber of Commerce and the Federation of Small Businesses, and sponsored by HM Treasury, which carries online reviews of finance providers, products and services, posted by business people.[163] The number of bank branches where a customer could go in to talk to a business adviser has reduced since 2008,[164] and the rise of the alternative finance sector in the UK is testament to the appetite from business for providing this sort of information online. Banks and finance providers are more likely to rely upon an online presence and customers are becoming more likely to seek information online. The CMA want to encourage banks to develop online tools to help the SME customer find out their eligibility for that bank's lending products.

68. **We agree with the CMA that access to finance for SMEs would be improved by the banks providing comparable information, easily accessible online, in areas of interest to current and potential SME customers, such as lending criteria. We support the CMA's backing of the NESTA challenge prize to develop a comparison tool to provide this information for SMEs, and its requirement that the banks provide financial backing and technical support to the NESTA project. We will monitor its progress.**

157 Q10
158 Q96
159 ATF034
160 Nesta is a charitable foundation with the aim of promoting innovation
161 E.g. HSBC ATF039
162 Business Finance Guide
163 Business Banking Insight , HSBC ATF039
164 Banks close more than 600 branches over the past year, BBC Online, 13 May 2016

Alternative Finance

69. Technology has developed to enable businesses or individuals to come into contact with organisations which might wish to invest or lend to their business. Since the first online platform, Zopa in 2007, the alternative finance industry has continued to innovate and develop alternative ways of how to provide funding.[165] In 2014, the online alternative finance industry facilitated loans, investments and donations totalling £1.74 billion. In 2015, this had grown to £3.2 billion, a growth rate of 83 per cent in one year.[166] The sector is continuing to evolve. Local authorities use alternative finance to fund community projects and universities use alternative finance models to raise funds from their alumnae.[167] High Street banks are forming bilateral arrangements with online providers.[168] Institutional investors and high net worth individuals are increasing becoming involved in alternative finance.[169]

70. Two types of alternative finance, in particular, are growing in popularity. Peer-to-peer business lending involves investors lending money to businesses through an online platform. This has shown signs of growing strongly and accounted for £1.3 billion of lending in 2015—3 per cent of gross lending. Equity based crowdfunding enables individuals to contribute funds to a specific company or project via an online platform. The investor purchases a debt security or equity share in exchange for a product or reward. (It can also be a donation.)

71. Banks are seen as good providers of standardised loans but not so good at providing other, more bespoke products.[170] Where they have shown an unwillingness or inability to provide a service, others such as alternative finance have filled the gap.[171] A recent report from Deloitte said that alternative finance will not present an "existential threat to banks", and they should be considered complementary not as competitors.[172] The Institute of Directors did not see crowdfunding and challenger banks as replacing the traditional high street banks but rather were opening up entirely new avenues.[173] The alternative finance providers do not see the banks and investment funds as a high risk to alternative finance.[174]

72. Alternative finance has enabled SMEs to raise finance in a relatively simple way without going to the high street bank.[175] James Meekings, from Funding Circle, which started in 2010, said they specialised in helping the S in SMEs—the average number of employees of an SME borrowing from them is eight and the average loan is £50,000. It has since grown to be one of the top five lenders to SMEs in the UK.[176] He said Funding Circle was seen as easier and quicker than the bank, and attracted businesses that were struggling to get a meeting with their bank or do not approach their bank because they do not think they would get a loan.[177] It is noticeable that new business start-ups show

165 Q191, Q194
166 NESTA, Pushing boundaries: the 2015 UK Alternative finance industry report, 2016. See also NESTA, Business Insights, 2016
167 NESTA, Pushing boundaries: the 2015 UK Alternative finance industry report, 2016. The Royal Society ATF041
168 Alternative Business Funding ATF003
169 NESTA, Pushing boundaries: the 2015 UK Alternative finance industry report, 2016,
170 Q147
171 Q43, Greater Birmingham & Solihull LEP ATF028
172 Deloitte, 2016 Marketplace lending: A temporary phenomenon?
173 Q42
174 NESTA, Pushing boundaries: the 2015 UK Alternative finance industry report, 2015
175 Q65
176 Qq121–123
177 Qq122–123

average or lower awareness of traditional forms of debt finance compared to SMEs as a whole, but show higher than average awareness of new forms of finance such as peer-to-peer lending.[178]

73. The main barrier to the growth of alternative finance appears to be awareness among potential customers of what it is and how it might meet their business needs. An internal poll of British Chamber of Commerce members found "little understanding" of alternative finance options.[179] Surveys of Institute of Directors' members found 7% saw non-bank options like peer-to-peer platforms as important to financing their business, and only 2% for equity crowdfunding.[180] The SME Finance Monitor found only about 1% of SMEs used crowdfunding in 2015.[181] However, there are signs that this is changing—the Institute of Directors survey also found the number who thought equity crowd funding would be 'important' or 'very important' in the next ten years rose from 8% five years ago to 38%.[182]

74. The direction of travel is clearly towards finance being provided online, either through an alternative finance provider or an established bank, or a hybrid of both. The alternative finance sector in Britain is seen as user friendly, at the forefront of innovation, and filling a gap in SME finance for a raft of start-ups and entrepreneurs. **The main barrier to growth of alternative finance appears to be a lack of awareness of their existence among SMEs, and a lack of understanding of how they might meet the needs of a new or growing business. The barrier of access to information and advice, rather than access to finance, appears to be magnified with alternative finance.** ***We recommend that the British Business Bank's collection of feedback regarding the Business Finance Guide specifically seeks views on the range of alternative finance providers and the products available. We further recommend that they set out how that will inform their strategy for increasing awareness of understanding finance options, and how the alternative finance sector can be promoted among those in the accountancy, legal and banking sector involved in giving face to face advice to SMEs.***

The regulation of alternative finance

75. Surveys of alternative providers put the risk of an online lending platform failing as the biggest risk to the sector—57 per cent said the potential collapse of a well-known platforms due to malpractice was a "high, or very high" risk, followed by cyber security breach (51 per cent) and changes to tax incentives for investors, such as SEIS (37 per cent).[183] The FCA requires every authorised firm to have in place arrangements for what would happen if it were to collapse.[184] Mr Woolard saw the possibility of investments within a portfolio failing as a larger risk than failure of the platform.[185] The British Business Bank conducted detailed due diligence on the underwriting of the finance platforms when considering where it chooses to invest.[186]

178 British Business Bank, Small Business Finance Markets 2015–16, February 2016
179 British Chamber of Commerce ATF058
180 Institute of Directors ATF035.
181 Q181
182 Q3
183 NESTA, Pushing boundaries: the 2015 UK Alternative finance industry report, 2016
184 The Financial Conduct Association (FCA) was set up in April 2013 to act as the conduct regulator and prudential regulator for those financial firms in the UK not regulated by the Prudential Regulation Authority (PRA). The PRA is the prudential regulator and supervisor for around 1,700 banks, building societies, credit unions, insurers and major investment firms. The conduct of these firms is also regulated by the FCA
185 Q195
186 Q195

76. The FCA has three operational objectives: to secure an appropriate degree of protection for consumers, to protect and enhance the integrity of the UK financial system, and to promote effective competition in the interests of consumers. The FCA regulates two types of crowdfunding: investment-based crowdfunding, involving the purchase of unlisted equities and debt securities in start-up and young businesses; and peer-to-peer lending, which involves lending to individuals, businesses and projects.[187] The UK is the only country with a dedicated regulatory regime for peer-to-peer lending.[188]

77. In 2014, new rules came into force for the regulation of crowdfunding platforms operated by firms authorised by the FCA, with a commitment that the FCA to monitor and review in future the crowdfunding regulatory framework—an approach broadly supported by the alternative finance providers.[189] In July 2016, the FCA issued a Call for Input, inviting views on the review should cover,[190] with the intention of ensuring that the balance is right between supporting this evolving market and ensuring consumers are adequately protected.[191]

78. Evidence from the alternative finance sector supported the regulation of their industry, and supported the Government's current approach—90 per cent of online platforms in the 2015 UK Alternative Finance Industry Report thought current regulation was "adequate and appropriate" for their activities.[192] One Peer to Peer platform, Funding Knight, said that the regulatory framework in the UK had "created an investment climate which is the envy of the European Union and beyond".[193] The Institute of Directors said light touch regulation had contributed to the growth in the industry and put the UK at the forefront of the global alternative finance sector. Mr Woolard said the FCA placed the same requirements on both the existing crowd-funders as they stand today and banks are exactly the same.[194]

79. **The current regulatory framework was praised by those in the industry for being clear and relatively easy to understand, and seen as a standard for other countries to follow. We conclude that it has struck the right balance between safeguards and allowing space for the sector to innovate and expand. The sector is expanding and evolving. It is important that the regulatory framework is flexible, and if need be is revisited, to address the changing landscape. As such, we welcome the Financial Conduct Authority's willingness to engage with the alternative finance sector before making any change in the regulations. We urge that this approach is repeated in the future.**

187 More information on the types of product used in alternative finance, and which ones are regulated and unregulated are given in the FCA evidence ATF063 para 16
188 Q150
189 Q151
190 FCA launches call for input on crowdfunding rules, 8 July 2016
191 Financial Conduct Authority ATF063
192 NESTA, Pushing boundaries: the 2015 UK Alternative finance industry report, 2016
193 Funding Knight ATF047
194 Q184

Conclusions and recommendations

Our inquiry

1. We acknowledge that the decision taken on the 23 June 2016 to leave the EU is likely to have repercussions for access to finance. We intend to monitor the data on access to finance, and the Government's response to any repercussions in light of the decision to leave the EU. If there are indications that the situation on access to finance has changed, then we will return to this subject. (Paragraph 4)

The British Business Bank

2. Calculating the gap between demand and supply for SME finance is complicated and there is a clear need for the British Business Bank to continue to gather intelligence on how the market operates. There is evidence of unmet demand for finance from SMEs, particularly at the scale-up and grow stages, where business are looking for finance of £10 to £25 million. We recommend that the Government targets its intervention at addressing this funding gap, working closely and flexibly with investors to respond to evolving demands. (Paragraph 15)

3. In the few years since it was created, the British Business Bank has filled an important space in the SME finance landscape. We agree with many of our witnesses who said it has had a positive impact and should be allowed time to establish itself. Its credibility with the business community is enhanced by its independence from Government and we do not recommend changes to existing arrangements. (Paragraph 16)

Start-ups

4. We agree that the Start-Up Loans Company is a good and effective way to support entrepreneurs who want to create their own business. The Government should maintain its level of funding and assess if there is potential for Start Up Loans Company to be extended. (Paragraph 21)

Scale-up and growth

5. Access to finance is one of the main barriers to scale-up for fast growth SMEs. There is a gap in securing finance at particular growth stages, and a lack of investors able to provide a pipeline of finance at all stages of development. It may be that the market for growth finance requires time to mature, but the Government must introduce targeted intervention to address the difficulties around businesses wishing to scale-up. The Government should set out what it is doing to incentivise further institutional investors into the private equity market. (Paragraph 26)

6. Awareness of options for finance is growing. However, awareness in areas such as equity has not necessarily led to an increase in uptake of those options. Part of the reason for this is because SMEs are not taking the steps to become 'investment ready' and attract potential equity investors. The British Business Bank, alongside business groups and networks, needs to focus on identifying businesses with high potential

for growth, and ensuring they have access to advice about what they need to do to secure the most appropriate form of funding for their next stage of development. (Paragraph 27)

The Alternative Investment Market (AIM) and encouraging investment

7. The Alternative Investment Market is an important part of the finance ecosystem in the UK. Whatever happens with the proposed merger of the London Stock Exchange and the Deutsche Borse, we urge the Government to support the retention of AIM as a forum for companies to raise capital and grow. (Paragraph 28)

Tax incentives

8. The SEIS, EIS and VCT schemes received praise from many of our witnesses for their role in cultivating a UK venture capital community. It is important that the Government does not tinker with how the schemes operate. The main barrier to greater take-up of the schemes appears to be low awareness among both businesses and investors. Promotion and take-up of the schemes would be helped by HMRC carrying out an assessment of the EIS, SEIS and VCT schemes, and demonstrated their value to both SMEs and the tax-payer. *We recommend that the Government directs resources towards promoting the SEIS, EIS and VCT schemes. This includes the British Business bank working with HMRC to consider how to improve promotion of the schemes.* (Paragraph 32)

European Investment Fund

9. The European Investment Bank has provided millions of euro into funds that underpin finance for businesses in the UK. Following the result of the referendum on the UK's membership of the European Union, there are concerns that this source of finance might not be available in the future. There is a risk that structures in place to assist SME finance will have considerable shortfalls in their resources without the value of these funds. *We recommend that the Government identifies the size of current European Investment Bank contribution in the UK economy, the timetable for current commitments, and make a clear statement on Government plans to ensure that the current level of funding will not be reduced.* (Paragraph 34)

Angel CoFund

10. The Angel CoFund is a strong and positive part of the finance landscape for new businesses. It helps secure funding for new businesses through sharing risk, but also brings new businesses with potential and business angels, with their experience and networks. *We recommend that the Government and the British Business Bank build upon the success of the Angel CoFund, ensure it is funded adequately to meet demand, and consider how it could be expanded.* (Paragraph 36)

Regional imbalances

11. The new Prime Minister has already spoken of her desire for opportunity and economic success to be more fairly distributed across the UK, and we look forward to learning how the Government intends to use the various levers at its disposal to make this happen. Enabling entrepreneurs to start their own business, and ensure they can access finance as they grow, can have an important role in rebalancing economic growth across the UK. The willingness of the Government to intervene where there are identifiable market failures in the business finance landscape across the whole UK, represents a test and an opportunity in the context of its new industrial strategy. (Paragraph 39)

12. The British Business Bank, as the Government's centre of excellence on these matters, needs to be at the heart of proposals to address the regional discrepancies in SME finance. We welcome the intention of the British Business Bank to use the Angel CoFund to stimulate equity investment beyond London and the South East. The development of the Northern Powerhouse Investment Fund and a Midlands Engine Investment Fund will be important routes to focus investment away from the South East of England. *We recommend that the Government introduce a fifth performance indicator for the British Business Bank to assess its effectiveness in incentivising lending and investment activity in all parts of the UK.* (Paragraph 40)

13. A recurring theme in our evidence is that access to information and advice on finance options is a more significant barrier to SMEs than the availability of funding. Furthermore, businesses that seek and receive advice greatly enhance their chance of securing finance. (Paragraph 45)

Information is not enough

14. The British Business Bank has been an important development in providing a single source of information for business finance. However, there remains a gap between demand and the availability of free business advice. Information provided by the British Business Bank, and others, must be user-friendly, consistent and accessible to non-specialists. It must be able to direct the customer onto the next step. The Government and the British Business Bank need to build on the work of the Business Finance Guide, and prioritise cooperation with business networks and business advisers, often local accountants, to encourage SMEs to seek advice at the earliest opportunity. (Paragraph 46)

15. We welcome the fact that the British Business Bank has a performance indicator "to promote better information on, and understanding of, finance options". The publication of the Business Finance Guide is a positive step, but the British Business Bank has to rely upon other organisations to deliver the information. *We recommend that the British Business Bank explain to us, in the response to this Report, their strategy for promoting understanding of the Business Finance Guide, how it will identify and target hard to reach groups, how it will measure any increase in the awareness and take-up of alternative finance products, and its analysis of the feedback from SMEs on the Business Finance Guide. Furthermore, we recommend the Bank explain how they*

will analyse the volume of traffic to the online Business Finance Guide and how that will inform their strategy for increasing awareness of understanding finance options. (Paragraph 47)

Business networks and trusted sources of advice

16. Our inquiry reinforced the importance of SMEs seeking advice from trusted sources. We were also struck by the initiatives providing mentoring and coaching for new business people, from bodies such as the Start-Up Loan Company to the AIM stock exchange. The Government should add value by working with the major business groups and finance providers to make sure they have mentoring schemes or events specifically aimed at passing on the experience of successful business people on how to secure finance to grow a business. (Paragraph 50)

Challenger banks

17. Bank lending remains the main source of finance for SMEs in the UK. Too many SMEs think that means the only source of lending is one of the established High Street banks. That is not the case. The new challenger banks have gained a reputation for being innovative, attentive to customer service, and proactive in reaching out to potential customers. We welcome the establishment of challenger banks and the fact they have started to increase their market share. The Government should set out how it plans to support the challenger banks that have entered the market for lending to SMEs, and what steps it is taking to further increase competition in the market place for SME finance. This includes consideration of how the regulatory regime, such as the rules on capital requirements held in reserve, can disproportionately affect the ability of new entrants to compete on a level playing field with the larger, more established banks. (Paragraph 56)

Sharing credit information

18. The Government has stated that it wants to increase diversity and competition in the market for finance. The new banks are disadvantaged by asymmetry in access to customer data held by businesses they would like to work with. *We recommend the Government sets out in its response to this Report how they intend to monitor the implementation of the Small Business, Enterprise and Employment Act 2015 and, if need be, review the Act to ensure the banks are fulfilling their obligations to provide data when they are required to.* (Paragraph 58)

VAT register

19. *We recommend that the Government explore allowing the Credit Reference Agencies and authorised finance providers access to financial data in the VAT Register, subject to the appropriate safeguards.* (Paragraph 60)

Referral scheme

20. We found broad support for the scheme, introduced in the Small Business, Enterprise and Employment Act 2015, for banks to refer unsuccessful applicants on to an online platform that will link the business with an alternative finance provider. We also heard criticism that the implementation of the scheme was slow and there needed to be more information on how the scheme will work in practice. *We recommend that the Government set out, in its response to this Report, the timetable for implementation of the referral scheme and how it intends to assess its success.* (Paragraph 62)

Comparison tool

21. We agree with the CMA that access to finance for SMEs would be improved by the banks providing comparable information, easily accessible online, in areas of interest to current and potential SME customers, such as lending criteria. We support the CMA's backing of the NESTA challenge prize to develop a comparison tool to provide this information for SMEs, and its requirement that the banks provide financial backing and technical support to the NESTA project. We will monitor its progress. (Paragraph 68)

Alternative finance

22. The main barrier to growth of alternative finance appears to be a lack of awareness of their existence among SMEs, and a lack of understanding of how they might meet the needs of a new or growing business. The barrier of access to information and advice, rather than access to finance, appears to be magnified with alternative finance. *We recommend that the British Business Bank's collection of feedback regarding the Business Finance Guide specifically seeks views on the range of alternative finance providers and the products available. We further recommend that they set out how that will inform their strategy for increasing awareness of understanding finance options, and how the alternative finance sector can be promoted among those in the accountancy, legal and banking sector involved in giving face to face advice to SMEs.* (Paragraph 74)

The regulation of alternative finance

23. The current regulatory framework was praised by those in the industry for being clear and relatively easy to understand, and seen as a standard for other countries to follow. We conclude that it has struck the right balance between safeguards and allowing space for the sector to innovate and expand. The sector is expanding and evolving. It is important that the regulatory framework is flexible, and if need be is revisited, to address the changing landscape. As such, we welcome the Financial Conduct Authority's willingness to engage with the alternative finance sector before making any change in the regulations. We urge that this approach is repeated in the future. (Paragraph 79)

Formal Minutes

Tuesday 25 October 2016

Members present:

Mr Iain Wright, in the Chair

Peter Kyle	Michelle Thomson
Amanda Milling	Kelly Tolhurst
Amanda Solloway	Chris White

Draft Report (*Access to finance*), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 79 read and agreed to.

Summary agreed to.

Resolved, That the Report be the First Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

Written evidence was ordered to be reported to the House for publishing with the Report (in addition to that ordered to be reported for publishing on 23 February, 4 May and 12 July).

[Adjourned till Thursday 27 October at 10.15 am

Witnesses

The following witnesses gave evidence. Transcripts can be viewed on the inquiry publications page of the Committee's website.

Wednesday 4 May 2016

Question number

Suren Thiru, Head of Economics and Business Finance, British Chambers of Commerce, **Jimmy McLoughlin,** Head of Entrepreneurship Policy, Institute of Directors, and **Tom McMurtrie,** Managing Director, Hymid Two-Shot Ltd and EEF member — Q1–49

Andrew Sandiford, Partner, Bishop Fleming, and **Simon Littlewood,** Partner, Grant Thornton — Q50–77

Tuesday 28 June 2016

Gareth Oakley, Managing Director, SME Banking, Lloyds Banking Group, **Rishi Khosla,** CEO, Oaknorth Bank, and **Marcus Stuttard,** Head of UK Primary Markets & Head of AIM, London Stock Exchange — Q78–119

Chris Hulatt, CFO & founder, Octopus Investments, and **James Meekings,** UK MD & co-founder, Funding Circle — Q120–162

Tuesday 12 July 2016

Christopher Woolard, Executive Director of Strategy and Competition, Financial Conduct Authority and **Keith Morgan,** Chief Executive Officer, British Business Bank — Q163–205

Rt Hon. Anna Soubry MP, Minister for Small Business, Industry and Enterprise, Department for Business, Innovation and Skills — Q206–260

Published written evidence

The following written evidence was received and can be viewed on the inquiry publications page of the Committee's website.

ATF numbers are generated by the evidence processing system and so may not be complete.

1 Abundance Investment (ATF0019)

2 ADS Group (ATF0037)

3 Aldermore Bank (ATF0044)

4 Alternative Business Funding Ltd (ATF0003)

5 Asset Based Finance Association (ATF0027)

6 Association of British Healthcare Industries (ATF0018)

7 Association of Convenience Stores (ATF0057)

8 Association of Investment Companies (ATF0007)

9 Bibby Financial Services (ATF0055)

10 Bioindustry Association (ATF0033)

11 British Bankers Association (ATF0052)

12 British Chamber of Commerce (ATF0058)

13 British Private Equity & Venture Capital Association (ATF0011)

14 Business Enterprise Fund (ATF0002)

15 Community Investment Coalition (ATF0023)

16 Cornwall Council (ATF0034)

17 Creative England (ATF0053)

18 Crowdcube Limited (ATF0015)

19 CrowdShed (ATF0046)

20 Department for Business, Innovation and Skills (ATF0054)

21 EEF (ATF0029)

22 EZBob Ltd (ATF0022)

23 Fair Finance (ATF0051)

24 Federation of Small Businesses (ATF0010)

25 Financial Conduct Authority (ATF0063)

26 Finance & Leasing Association (ATF0008)

27 Funding Circle (ATF0021)

28 Funding Knight Limited (ATF0047)

29 Funding Options (ATF0048)

30 GLI Finance (ATF0059)

31 Grant Thornton UK LLP (ATF0036)

32 Greater Birmingham & Solihull Local Enterprise Partnership (ATF0028)

33 Greater Manchester Combined Authority (ATF0042)

34 Growth Street (ATF0050)

35 HSBC (ATF0039)

36 ICAEW (ATF0038)

37 ICAS (ATF0026)

38 Impetus (ATF0020)

39 Institute of Directors (ATF0035)

40 Intelligent Partnership (ATF0004)

41 Kickstarter (ATF0056)

42 Learning Enterprises Organisation (LEO) (ATF0014)

43 Leverhulme Visiting Professor Susanna Khavul (ATF0049)

44 Lloyds Banking Group (ATF0012)

45 London Stock Exchange (ATF0060)

46 Maxxia Limited (ATF0001)

47 OakNorth Bank Limited (ATF0009)

48 Octopus Investments (ATF0062)

49 Peer-to-Peer Finance Association (ATF0045)

50 Professional Standards Council for Asset Based Finance (ATF0005)

51 Professor Mike Wright (ATF0043)

52 rebuildingsociety.com ltd (ATF0006)

53 Responsible Finance (ATF0030)

54 Royal Academy of Engineering (ATF0061)

55 Royal Society (ATF0041)

56 SQW Ltd (ATF0017)

57 Start Up Loans Company (SULCo) (ATF0025)

58 Trillion Fund Ltd (ATF0016)

59 UK Business Angels Association (ATF0032)

60 UK Crowdfunding Association (ATF0013)

List of Reports from the Business, Innovation and Skills Committee during the current Parliament

All publications from the Committee are available on the publications page of the Committee's website.

The reference number of the Government's response to each Report is printed in brackets after the HC printing number.

Session 2015–16

First Report	The UK steel industry	HC 546 (HC 861)
Second Report	The Government's Productivity Plan	HC 466
Third Report	The Teaching Excellence Framework: Assessing quality in Higher Education	HC 572
First Special Report	Competition in the postal services sector and the Universal Service Obligation: Responses to the Committee's Ninth Report of Session 2014–15	HC 476
Second Special Report/First Joint Special Report	Education, skills and productivity: commissioned research	HC 565
Third Special Report	The UK steel industry: Government Response to the crisis: Response to the Committee's First Report of Session 2015–16	HC 861

Session 2016–17

First Report	Careers education, information, advice and guidance	HC 205 (HC 757)
Second Report	The Digital Economy	HC 87
Third Report	Employment practices at Sports Direct	HC 219
Fourth Report	BHS	HC 54
Fifth Report	The use of UK-manufactured arms in Yemen	HC 679
First Special Report	Careers education, information, advice and guidance: Government Response to the First Joint Report of the Business, Innovation and Skills and Education Committees of Session 2016–17	HC 757