ICAS comments on the EC Green Paper – Building a Capital Markets Union

The Institute of Chartered Accountants of Scotland (ICAS) welcomes the opportunity to comment on the Lending Code. The ICAS Charter requires it to act primarily in the public interest, and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members' views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which should be paramount.

Key messages

Approach and priorities

We support the objectives of the smart regulation agenda and welcome the intention to identify and facilitate non-regulatory and sector led initiatives in response to some of the problems identified, rather than just relying on a regulatory approach. We also welcome efforts to gather stakeholder views to develop a shared problem diagnostic and shape an action plan which considers both short and longer term proposals. Given the scale and complexity of the topic, and in order to maximise the opportunity for engaging stakeholders, we would recommend that a wider stakeholder engagement plan is arranged by the EC to generate wider understanding, interest and two-way dialogue on a face to face basis.

The remit of this Green Paper is wide ranging. We suggest that further prioritisation, which reflects the objectives of generating economic growth and jobs, would help focus efforts.

SMEs

In our view the range of businesses covered by the SME classification is too wide to identify the real problems in obtaining borrowing facilities[1]. Feedback from our members in the UK suggests that it is most difficult for businesses to obtain funding of between £100,000 and £1 million. This difficulty seems spread across a range of business activities with differing growth opportunities and historical track records. Policies should be targeted at specific sub-sections of the broad SME grouping to more effectively address the underlying problems. Provision of equity is a key issue for rejuvenating the economy and employment growth. In a UK context, bank lending is of secondary importance to developing and early stage companies as they usually sit outside the bank's risk appetite so bank loans are rarely offered to this group.

In our experience seekers and providers of funding to SMEs and early stage companies have a preference to operate locally (particularly for sums <£1m) whereas large companies and their investors operate across international boundaries. SMEs will never be in the same position as larger companies accessing finance – they are inherently riskier and any suggestion that the objective is for SMEs to be able to access finance as easily as larger companies is likely to miss the crux of the problem. Overall we would stress that the variability in the characteristics of businesses seeking funding and investors precludes a one size fits all approach.

Further research evidence is required to determine what demand exists for pan-European financial products for SMEs and what might encourage SMEs to look further afield i.e. more widely across Europe for funding so that actions to widen access to funding are tailored to the root cause before assuming that the larger project of harmonisation will address this.

There appears to be an assumption in the Green Paper that there is higher demand for finance than supply. Research in the UK has identified reluctance amongst SMEs to borrow[2]. Findings in the quarter 4 report state that "the proportion of 'would-be seekers' has declined from 7% in Q4 2012 to 3% in Q4 2014 and the proportion of 'happy non-seekers' has increased from 73% to 82% over the same period. Discouragement and the process of borrowing were the main reasons cited.

[1] ICAS submission to the UK Treasury Committee Lending Inquiry 2014
[2] http://bdrc-continental.com/products/sme-finance-monitor/

Separate ICAS research evidence also identifies on-going reluctance amongst high growth SMEs to externally fund growth plans[3]. We believe that further research to better understand demand and what could stimulate it would be productive. ICAS is currently undertaking further research to better understand the reasons for dampened demand[4]. We can provide a copy of our findings in due course. Given the scale of happy non seekers of finance and to provide a more holistic vision of the problem and potential solutions proposed, policy measures should also consider demand stimulation measures as well as looking at the supply side.

A common concern raised by our members is the complexity of the funding landscape for businesses. Improved awareness of alternative funding, as well as mainstream bank funding options, and more sharing good practice is needed. An independent one-stop shop could help businesses navigate the range of available bank and non-bank funding sources (including equity). This could help to consolidate and explain the different options for businesses seeking funding, when specialist professional advice is needed (for consumer protection reasons) and also to signpost seekers of finance to guidance/advice. The aim is to strengthen the capabilities of businesses for financial planning and improve the quality of a business's funding application.

We note the significant increase in the UK alternative finance market in a recent report published by Nesta and the University of Cambridge[5] which tracks growth from £267 million in 2012 to £1.7bn by the end of 2014 and forecast to nearly triple by 2015. The research finds that peer-to-peer business and consumer lending continues to dominate the market, worth £749m and £547m in 2014. However, equity crowdfunding is experiencing similar impressive expansion and grew by 410% to £84 million.

By the end of 2014, it is expected that the UK alternative finance market will provide over £1 billion worth of business finance to over 7,000 SMEs, equivalent to 2.4 per cent of national bank lending to SMEs based on Bank of England's 2013 baseline figures (Trends in Lending, October 2014).

This clearly indicates demand for new forms of non-bank funding yet the overall scale is still very marginal compared with banks. Capital markets cannot and should not, replace the banking sector but rather complement it as an additional alternative source for economic growth.

We would stress that retail investors need better quality advice and information to meet investment needs rather than training. Part of investor and consumer protection is knowing when to approach an adviser. From the perspective of investors we would add that high quality, proportionate and transparent information, which is targeted on specific needs, helps inform decision making however, care is needed that this is not rounded down to standardisation of information which could risk lowering standards.

Institutional investors

Direct lending by institutional investors to SMEs as part of taking up the slack provided by de-risking banks, gives concerns about (a) appropriateness as a fiduciary investment, and (b) expertise. This expertise was within the experience of banks who had the relationships with borrowers, but it is less clear who has it today given the demise of relationship based banking and more centralised lending models. The expertise of lending to smaller businesses is not within the experience of most institutional investors given the different investment focus and this understanding needs to be clear for policy makers.

In terms of infrastructure investment, this is already being funded by institutional investors. We note the research by Preqin[6] which looks at the increasingly important role of pension funds as investors in infrastructure. It identifies that public pension funds, private sector pension funds and superannuation schemes comprise 40% of the active global infrastructure investor universe. It confirms that Europe is one of the main hubs of infrastructure investment activity with 39% of all active pension plans in the

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[3] https://www.icas.com/technical-resources/publication-funding-issues-confronting-high-growth-smes-in-the-uk
[4] Reluctant borrowers? Examining the demand and supply of finance for high growth SMEs
[5] https://www.nesta.org.uk/sites/default/files/understanding-alternative-finance-2014.pdf
[6] Preqin – Investing in Europe July 2012 (based on their Preqin Infrastructure Online Database)

infrastructure space based in Europe of which 18% are located in the UK alone. Nonetheless the majority of these institutions only invest a small proportion of their total assets in infrastructure opportunities. We would welcome further clarification from the EC on root problems that it is seeking to address through this programme.

A suggestion to help increase access to funding is for a platform offering infrastructure investments to be diversified across a number of European member states rather than just using single country platforms. Alternatively sector-specific platforms e.g. telecoms, toll roads or rail infrastructure could be developed on a pan EU basis.

Other observations

As part of a comprehensive review of competitiveness and improving investor confidence, we suggest that priorities for the issues identified in the Green Paper include wider consideration of how to make the EU a more attractive destination for investment. For example, feedback from our members in business suggest that labour and social security laws can be a major disincentive to investment in some European countries which is not within the direct scope of a capital markets union. Further research to identify the range of 'push' factors would be valuable evidence to help articulate problems and design a targeted action plan. We note the findings in the EY European Attractiveness Survey 2014[7] which also identifies that around 40% of respondents said that cutting regulations is the first step for the EU to improve its future attractiveness followed by further economic integration.

We encourage the EC to prioritise growth over competition. In particular we advocate a simpler approach to SME exemptions from State Aid as they are not of a size to grossly distort competition. We suggest full exemption from state aid consideration for SMEs (at least starting with small companies) in the interests of generating high growth in employment. Although exemptions exist, this is quite a rules based approach which is more cumbersome to manage and navigate rather than a straight forward higher exemption level.

Finally identifying and sharing existing areas of national best practice is sensible. Further research to identify what is already working and which could be replicated elsewhere, without an additional layer of EU regulation, would be beneficial. For interest, ICAS participated in a joint working group with Scottish Financial Enterprise and the Royal Society of Edinburgh on the Supply of Growth Capital – a copy of the report is available online.

EU level accounting standard for small and medium-sized companies listed on MTFs

We support global harmonisation of accounting standards. This serves to improve the overall quality of financial reporting, enhances consistency and comparability, all of which would help to better position organisations to successfully apply for finance. We do not believe that the development of a new EU level accounting standard for small and medium-sized companies listed on MTFs is necessary. This would be a costly and time-consuming exercise which would ultimately add an unnecessary layer of complexity to the financial reporting landscape.

We firmly believe that the optimum solution would be for all listed companies to align with an international framework i.e. IFRS. This would either be EU adopted IFRS (currently required for the group accounts of companies listed on regulated markets in the EU) or IFRS for SMEs, a simplified version of full IFRS, the current version of which is under review by the IASB.

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[7] EY European Attractiveness Survey 2014 (page 40)