ICAS RESPONSE TO BIS

ACCESS TO FINANCE INQUIRY

10 February 2016

Introduction

1. ICAS welcomes the subject of this inquiry and the opportunity to comment. We are a leading professional body for chartered accountants with over 20,000 members working across the UK and internationally. Almost two thirds of our working membership work in business; others work in accountancy practices ranging from the Big Four in the City to the small practitioner in rural areas of the country.

2. ICAS's Charter requires its committees 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 must be paramount.

3. ICAS submitted a response to the Treasury Committee inquiry on SME lending 2014. Many of our observations still stand.

Our response to the inquiry questions

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

4. Our members report a more positive direction of travel with an impression that the banks are more open for business and companies have wider opportunities for alternative finance. We are seeing more evidence of banks building trust and greater flexibility with larger companies although this appears to be taking longer to filter down to smaller companies.

5. Over time, a shift in lending behaviour has been observed, reflecting a more cautious approach since 2008. Whereas in the past, a bank would have provided overdraft funding more often (in effect providing "soft equity"), the focus has moved to asset backed or structured finance deals. This trend has an adverse impact on businesses at an early stage or those which are growing and less able to afford loan repayments, and more generally those without assets to use as security.

6. We have also noted a lengthening in the period for loan decisions, particularly for smaller companies, greater attention being paid to cash flow (which we welcome), a more centralised approach to lending decisions and a greater tendency to lend a fixed amount for a fixed period.

7. A more cautious approach to bank lending was needed to strengthen financial stability. Our experience concurs with the Bank of England findings[1] that bank lending to UK businesses[2] has reduced and lending to SMEs has been much slower to recover both in terms of supply and demand. We also observe the dampened demand[3] and requirement for some companies to pay down debt and use private or alternative funding instead of bank funding.

8. The consequence of a more cautious approach and the restricted availability of bank overdrafts is a funding gap for working capital needs which will require to be met by private funding, equity or alternative finance. However we believe this pent up demand is not yet being met by supply. Although equity providers, angel investors and venture capitalists have picked up some of this demand, providing loans as well as equity, the result is that this enables fewer deals to be completed. The funding gap is most difficult for those trying to obtain funding of between £100,000 and £1 million. We note the findings of a recent Scottish Government report on The Market for SME Finance in Scotland (2015) which provides evidence estimating the funding gap to be in the range of £330 million to £750 million in Scotland. The report, "The Equity Gap and Knowledge-based Firms" from Leeds University and Imperial College Business Schools (July 2015), estimates the potential demand for finance in the UK is in excess of £10 billion.

9. The greater focus on asset backed finance tends to favour asset based over service related businesses. Many growing businesses may be asset light but nonetheless supported by a viable business model – these types of business should be able to access less structured forms of

[1] Communicated as part of the Financial Stability Report release December 2015
[2] http://www.bankofengland.co.uk/publications/Documents/other/monetary/trendsjanuary15.pdf Chart 1.1
[3] http://bdrc-continental.com/products/sme-finance-monitor/ (Half of SMEs were 'Permanent non borrowers' per Q3 2015)

finance. A flexible approach to working capital finance is important.

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

10. Overall tax incentivised schemes are effective. EIS has been very successful in unlocking additional sources of private finance.[4] As an example, one service sector business was funded almost entirely privately and has grown from 3 to 300 staff by raising over £13m from private business angels since 2006, of which at least 75% of the investors were supported by EIS. We believe the co-investment model is highly effective and note the positive contribution of VCT relief to raising this type of finance[5]and its contribution in turn to employment growth

11. EFG has been less successful, we believe, due to the interpretation of the banks generally that the Scheme requires them to take personal guarantees. We believe this dampens demand. Although a personal guarantee is most relevant in the first few years of a new lending relationship, as this is the riskiest period for the bank, such personal guarantees tend to remain in place indefinitely. We believe that there would be greater demand for lending generally if banks were encouraged to put fixed caps on personal guarantees in terms of monetary value and/or time. We believe this would remove a barrier to funding. ICAS contributed to the review of the EFG being conducted by the British Business Bank.

12. Many small businesses who have claimed R&D reliefs are quick to endorse how valuable these are. There is scope to raise the level of awareness to widen the pool of eligible businesses who can benefit[6].

13. In our view, Funding for Lending has helped to decrease the cost of lending and encouraged more bank lending however our concern is that the scheme may have been applied principally to mortgage lending and been too sector focused. We would welcome further information on the business categories this scheme has benefited to assess whether it has met the policy objective and its effectiveness in supporting business growth.

Does the UK have globally competitive markets / suppliers for financing (and debt financing) at 1) seed 2) venture and 3) growth stages? What steps could Government take to strengthen these systems?

14. We believe that the UK has a favourable environment for starting up a business and obtaining equity finance, largely due to good government initiatives employing tax incentives. There is however scope for alternative finance and equity finance to grow. Please refer to paragraph 17 for improvements.

Are alternative methods of raising finance (such as crowd-funding and peer-to-peer) sufficiently well-regulated and monitored for companies to be confident in utilising them?

15. We need more innovative sources of finance. Their comparatively fast decision making process which offers an interesting comparison with the increasingly impersonal and centralised lending decision-making frameworks used by banks.

16. With alternative finance there is an increasing variety of risk exposures, so greater education and explanation is needed so investors are fully informed of the risks as well as the opportunities. Some investors are better suited to certain types of investment product but there is a significant potential risk of mis-selling. The challenge for the FCA is to manage this process and further development without stifling innovation with too much regulation.

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

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[4]Amounts of funds raised through EIS approx. £1.5 bn per page 6 of [HMRC ONS Enterprise Investment Scheme and Seed Enterprise Investment Scheme October 2015]

[5] Venture Capital Trusts investors have claimed Income Tax relief on £408.4m of their investment in 2013-14. The majority of VCT investors tend to invest smaller amounts into VCT funds. See page 5 of [HMRC ONS Venture Capital Trusts Statistics Dec 2015]>, and its contribution in turn to employment growth

[6] https://www.icas.com/technical-resources/icas-response-improving-access-to-r-And-d-tax-credits-for-small-business

17. The vast majority of businesses are not in the high growth category yet they may be strong and reliable businesses which contribute to sustaining and growing employment in the UK economy. All growth is good for the economy even if this is slow growth. We would encourage government not to overly focus on high growth business. It is usually the tier below which struggles to obtain finance. In these circumstances, it is helpful for the government to underpin some of the risk (e.g. as it should be doing with EFG, and has done with EIS and VCT reliefs) to encourage wider take-up of available funding.

18. The selection process of investment ready businesses is highly competitive; as an example one enterprise capital fund may have over 800 applications but only invest in 10 of these. We support the growth of support structures e.g. entrepreneurial hubs and incubators which provide a holistic service, leadership development and, particularly, mentoring for start-ups which can help to improve the volume of investment ready businesses and encourage a growth/exporting mind-set.

19. We note that State Aid rules can, on occasion, present a barrier to government measures to support investment (a recent example being VCT relief). We suggest that the threshold for State Aid rules under the General Block Exemption Regulations should be raised to exempt SMEs, or at least small businesses. This would serve not only to simplify the rules but encourage targeted support across the EU.