Greater Manchester Chamber of Commerce
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BRITISH BUSINESS BANK

Since the onset of recession in 2008 many business owners have raised various concerns about the accessibility and affordability of business finance.

They have accused the banks of turning their backs on them at a time when they needed support the most and the counter argument has been that business demand for finance is declining.

The notion of a “Business Bank” has been around for some time without there ever being a strong sense of what it would actually do. The opposition has plans for a British Investment Bank with a regional focus whilst in September 2013 the government officially launched the British Business Bank.

In response to member concerns the Chamber has worked on this issue over the period of the downturn gathering member views and opinions as to what the role of a Business Bank should be.

This briefing paper contains the results of further research and investigation into the British Business Bank and current market conditions and the main conclusion it reaches is that the immediate primary role for the Business Bank should be to ensure that the multitude of existing schemes are effectively implemented and marketed to business. There are still too many similar sounding schemes that businesses have not heard of which are classed by government as examples of financial support which in reality have a take up rate that is, not surprisingly, negligible. The first priority should be to get current schemes working effectively and all efforts should be focused on this.

One issue that is beyond doubt is that this whole area is complex and whilst it is clear that the market is still far from perfect, conditions have and are changing, so it is important that whatever mechanism for support is set up, it is totally effective.

1. What will the British Business Bank do?

From www.british-business-bank.co.uk

“The British Business Bank is being set up as an economic development bank to create more effective and efficient finance markets for smaller businesses in the UK.

It is a key element of the Government’s Industrial Strategy, and we are already contributing to making the UK the best place in Europe to start, grow and finance a business. £1 billion of new funding will help to expand existing schemes, and create new ways to unlock finance for smaller businesses. We are also taking over the management of £2.9 billion of existing commitments which help smaller businesses. We are bringing together expertise and budgets to support economic growth by improving the UK’s business finance markets. We will do this by providing Government funding and targeted guarantees to encourage more private sector lending and investment. Our focus is on fixing imperfections in the market. The sort of problems we deal with include a lack of diversity and quantity of finance, and low awareness in the market of what is available.

Our approach is evidence-based, using a rolling programme of quality research, and focuses tightly on problem areas rather than distorting markets which function well. We maximise our impact and safeguard taxpayers’ money by applying our commercial expertise and applying robust corporate governance.”

2. That sounds welcome but just how realistic is this?

According to data from the Bank of England, lending to SMEs averaged £170 billion in 2013 down from an average £184 billion in 2012 and £195 billion in 2011. SME lending probably peaked in this cycle 2009 at around £225 billion according to our own estimates. The shortfall peak to trough is over £50 billion. It is unclear how a Business Bank capitalized at £3.9 billion can really address any long term structural gap in UK business finance, if indeed there is a long term structural gap at all.

On current projections, we estimate the level of lending to SMEs would need to increase by £50 billion over the next five years as the economy recovers.

3. Do we need a state-backed bank?

Some consider there is strong evidence of a serious market failure around access to finance, especially for fast-growing and newer businesses. Hence the call for a state-backed business bank, to support the aspirations of new and fast-growing companies.

4. But is this really the case?

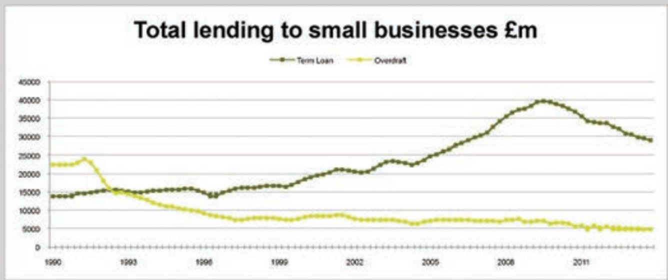
We need to be careful to differentiate between market failure and a market work out. The excessive credit boom in the years leading up to the recession led to an extraordinary increase in funding for SMEs and commercial real estate in particular. The subsequent work out, following the withdrawal of international sources of finance, increased regulatory control, capital restrictions, increased costs of credit, shorter period loans and higher risk horizons, was to be expected.

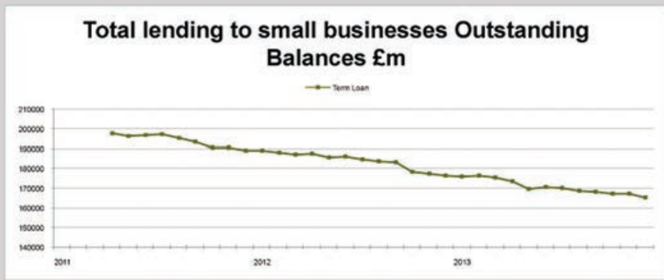
At the same time, demand for credit also fell, as a result of greater uncertainty, lower risk profiles, reduced working capital requirements, inhibited expansion and investment plans and the collapse in commercial real estate prices.

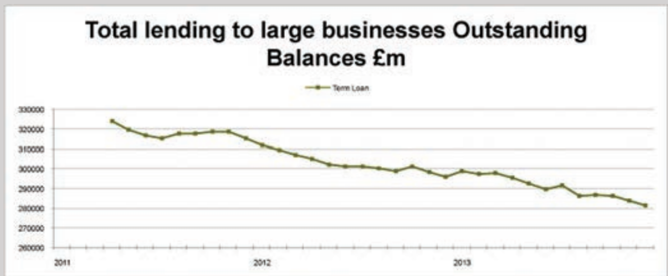
According to the broader SME lending data from the Bank of England (op cit) the total lending stock to SMEs including overdrafts and loans at the end of December 2013 had fallen to £165.3 billion from £176.3 billion at the end of 2012 and £189.1 billion at the end of 2011. Overdraft exposure had fallen as a percentage of total lending stock from 9.6% to 8.1% over the period.

Total lending to large businesses also fell over the period from 2011 to 2013. The total stock of term loan lending to large businesses was £262.2 billion down from £297.5 billion. Loan stock to large businesses had actually fallen faster down by 12% compared to 11% for SMEs.

There is little in the data to suggest term lending to SMEs has differed from the pattern of lending to large companies. Both sectors have witnessed a lower level of debt and leverage.







5. Are banks open for business?

Lending to SMEs and large businesses increased by just over 10% in 2013 compared to prior year. Lending to SMEs increased from £38.1 billion to £42.6 billion. Repayments increased from £44.4 billion to £45.1 billion. The level of overall indebtedness fell by £6.3 billion and £2.5 billion in both years respectively.

The pattern of debt reduction is also mirrored in large company lending. The level of lending to large firms increased by 10% over the period but the overall level of debt fell by £30 billion as a result of loan repayment.

According to the latest update from the Banking Task Force Appeals Process 2012/13 the suggestion is that the issue of net lending to SMEs is becoming more a lack of demand than a restriction of supply.

6. But does the UK really need another business bank at all?

There is no doubt access to credit has become more difficult and more expensive in the period of the recession compared to the “easy credit” in the years leading up to the recession, but as we have identified much of this can be considered as a cyclical adjustment returning indebtedness to a pre-recession norm.

7. BIS commissioned research

Research commissioned by BIS suggests access to credit has become much more difficult and will also become an “impediment to growth in the future” if the problems are not addressed.

Overall, we suggest that the research is indicative of a shortage of finance for SMEs, reflecting banks’ attitudes to risk and their own pressures to de lever combined with banks’ market power in the SME sector. Although demand is also probably subdued, there is a high level of discouragement from application for lending as well as high rejection rates and margins on credit after controlling for risk.

If the situation is not resolved, output, investment and employment will be lower than would otherwise be the case, with adverse effects on economic performance in the short and longer term.

8. Funding for Lending Scheme Update Bank of England Q3 2013

According to the Funding for Lending Scheme Update Bank of England Q3 2013, indicative median interest rates on new credit facilities to SMEs overall have fallen modestly since mid-2012.

Surveys of small businesses show more of an improvement in the cost of credit to SMEs: for example, businesses responding to the Federation of Small Businesses (FSB) survey reported that, on average, their cost of credit fell between mid-2012 and 2013 Q2 and continued to edge lower in Q3 . Those surveys also suggest that the availability of credit has been improving over the past year or so, albeit from a low base.

There has been increased SME lending activity consistent with this improvement in credit conditions and the economy overall. Gross lending in the three months to October was £1.5bn higher than the same period a year ago. But repayments have also risen, resulting in negative net lending.

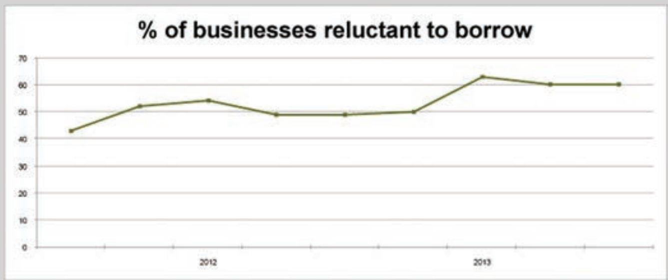
In addition to Funding for Lending, other government schemes such as the Enterprise Finance Guarantee scheme are having success at providing finance for SMEs.

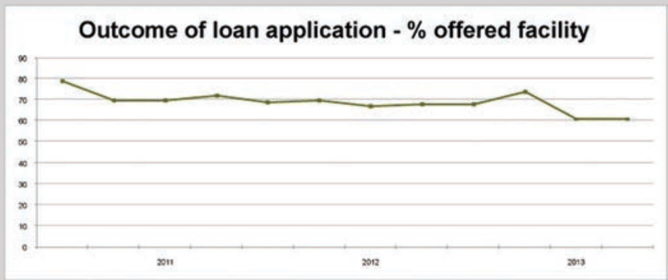
9. Is greater competition the answer?

Some consider, there is a fundamental lack of competition within the highly concentrated UK banking sector. This was discussed extensively by the Independent Commission on Banking, which noted that 85% of SME accounts sat with the ‘big four’ high street banks.

The recent expansion of SME lenders such as Handelsbanken and Aldermore is considered to be welcome news. As is the development of new peer-to-peer and alternative funding models, such as Funding Circle, Market Invoice, and Platform Black.

More competition, more funding types such as Peer to Peer Lending, CDFIs, Business Angels, Small Business Private Equity, Asset Backed Finance, SME Debt Bonds and even the introduction of Wonga business loans offer a plethora of alternative funding options. However it should be noted that the reluctance of business owners to sacrifice equity for greater financial security is a long standing challenge to the venture capital and business market.





10. Too many Government Schemes already - the real role for the Business Bank

In January this year the Public Accounts Committee (PAC) based on evidence from the Department of Business, Innovation and Skills (BIS), HM Treasury, the British Chambers of Commerce, the Federation of Small Businesses and Barclays Bank, released a quite damning report on current government attempts at intervention in the market.

"Small and medium-sized enterprises have a vital role to play in driving the UK's economic recovery, but despite government attempts to encourage lending to SMEs many still struggle to access the finance they need," Margaret Hodge, chair of the PAC, explained.

The problem stems from a failure to properly manage the issue. "Departments manage their various schemes not as a coherent programme but simply as a series of ad hoc initiatives," Ms Hodge explained.

Historically, schemes have been created ad hoc to address particular market weaknesses, meaning no department has a view of what success will look like for the programme as a whole.

"Government must use the establishment of the (British Business) Bank to start managing departmental schemes as a coherent programme, clearly setting out what it wants to achieve, and how each scheme and the programme as a whole will contribute towards the overall objective of making it easier for SMEs to access the finance they need," Ms Hodge said.

Thus far, BIS hasn't gone far enough to ensure businesses have access to the information they need on the potential range of financing options available to them.

Consequently, there must be a clear strategy to enable SMEs to become aware of the appropriate funding options for their needs.

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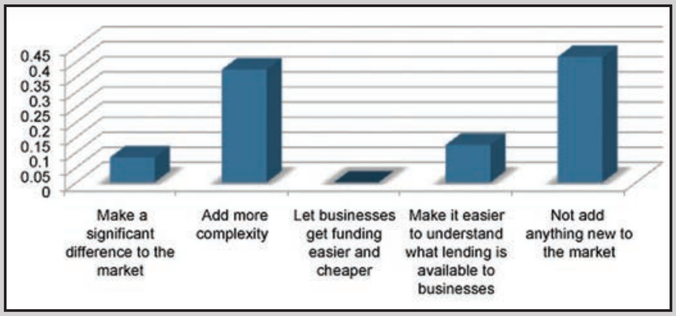
11. Summary and Conclusion

Whilst there is still some way to go on the journey back to "normal" market conditions we don't believe that the current positioning nor purpose of the British Business Bank will deliver the necessary help.

One of the main roles of the Bank must be to act as an umbrella body for the administration and promotion of all existing state-backed lending and equity schemes. The proliferation of similar sounding schemes is having the opposite intended effect on the market. Existing schemes need tidying up before new schemes are launched. This should be the primary role of the British Business Bank.

At February's Chamber Council over 40% of members voted that a British Business Bank would add nothing new and just over 30% said it would add extra complexity to the market if it started to operate as a "bank".



We see little or no role for the Business Bank in acting as a first point of contact nor lender of last resort for businesses seeking finance. However, the Business Bank can act as a sign post to channel leads and enquiries.

We do not perceive the role of the Business Bank to be to lend directly to viable, high-growth, new, or innovative businesses, including SMEs unable to obtain finance through the commercial banking system.

Given the outstanding level of SME debt currently (£165 billion) and the likely demands for additional SME finance (£50 billion) over the next five years, the capital adequacy of the Business Bank is a severe problem.

We do not consider there is a fundamental lack of competition within the highly concentrated UK banking sector.

As economic conditions continue to improve and market influences alter, the role of the Business Bank may become more defined. At present though the lack of understanding and awareness in the business community does not bode well for its immediate acceptance and success. With poor take up of funds through existing schemes the immediate focus should be on delivering these effectively to a wider business market.

Chris Fletcher
Director – Policy & Communications

Dr John Ashcroft
Chief Economist