

ACCESS TO FINANCE REVIEW

Stage 2 review

**Professor Dylan Jones-Evans
Bristol Business School
University of the West of England**

November 2013

TABLE OF CONTENTS

TABLE OF CONTENTS	2
EXECUTIVE SUMMARY	4
Bank funding	4
Alternative sources of funding	4
Finance Wales	5
The Development Bank for Wales	5
1. INTRODUCTION	7
2. RECOMMENDATIONS AND ACTION FROM STAGE 1 OF THE REVIEW	9
3. BANKS' LENDING PATTERNS TO SMES	13
UK trends in bank lending	13
Trends in bank lending in Wales	16
Cost of lending	19
Rejection rates	20
Summary	21
4. ALTERNATIVE SOURCES OF FUNDING	23
Trends in non-bank lending	23
Invoice discounting and factoring	23
Asset finance	24
Building Societies	24
Informal investment	25
Venture capital	27
Peer-to-peer lending and crowdfunding	28
Funding of social enterprises	30
Summary	31
5. FINANCE WALES	33
Cost of lending to SMEs	33

	The cost of borrowing and EU reference rates	36
	Finance Wales’s strategy	39
	GBER and De Minimis	41
	Summary	42
6.	THE WAY FORWARD	44
	The five principles of public funding for SMEs	45
7.	THE DEVELOPMENT BANK FOR WALES.....	50
	Mission and objectives	51
	Funding	51
	Organisation	52
	Summary	54
	GLOSSARY OF ABBREVIATIONS	55

EXECUTIVE SUMMARY

Bank funding

- Whilst the UK banking sector states that it remains ready to lend, the data shows that the value of borrowing approved facilities to SMEs in Wales is actually falling by 30 per cent since Q3 2011. Differentiating by size of firm, the data shows that the borrowing levels of small firms have fallen during the last two years whilst the number and value of lending approvals to medium-sized businesses have also flatlined during the last 12 months. Whereas there have been efforts by the UK Government to introduce cheaper lending, this has not been translated into increases in the number of loans from the banks.
- The report estimates a total funding 'gap' of around £500 million per annum for those businesses who want to get access to funding but have been refused support by the banks in Wales. This is clearly an upper limit as a proportion of those applying for funding may not be in a position to receive it from any source although it does exclude those that are reluctant to go to the bank for funding because of the current uncertain economic conditions or have been actively discouraged from doing so.
- A large part of this problem may be attributed to the way that banks are currently assessing risk, valuing collateral and whether to invest in certain sectors. Therefore, is a new challenger bank needed within Wales - either in the public or the private sector – especially as it will face many of the same issues that are affecting the current set of high street banks? Alternatively, is there a more effective way for the Welsh Government of working alongside current providers whilst, at the same time, encouraging access to other types of alternative finance?
- It is important that banks and the Welsh Government do not operate in isolation in terms of the provision of finance to SMEs and there have already been negotiations between the Welsh Government and the high street banks to develop a referral system for those businesses turned down for bank lending and to work more closely in developing the potential of growth businesses in Wales.

Alternative sources of funding

- During the last 12 months, there has been increased use of invoice discounting, leasing and other forms of non-bank finance, possibly as a result of decreased lending by the high street banks. Building societies, however, seem to be withdrawing from being a potential source of funding for SMEs in the immediate future.
- Overall demand for funding remains relatively low partially due to a lack of understanding and awareness of different alternative sources of funding amongst the business community. The Welsh Government could look at using its resources to provide more information on these alternative sources of funding whilst also considering whether they should form part of existing lending schemes.
- There is considerable scope to improve informal investment and venture capital as a source of funding to SMEs in Wales. To date, informal investors have not been used as effectively as they could have been in supporting start-ups in Wales, despite the relative success of xénos. More could also be done to ensure that there is greater focus on venture capital for growth firms at all stages of development within Wales. New support networks should be developed for growing firms, especially as financial support alone is not in itself sufficient to secure the success of early stage businesses.
- There have been positive discussions with peer-to-peer (P2P) lenders and crowdfunding firms and there is an opportunity for the Welsh Government, through working in partnership with such organisations, to stimulate greater use of these sources of finance in the future.

- Discussions with the banks suggest that one potential route for promoting P2P lending and crowdfunding would be via a direct referral system from Welsh High Street banks, Finance Wales and Welsh Government itself and this should be explored in further detail.
- The Welsh Government could consider investing in peer-to-peer funding as an alternative mechanism for financial support. This would be particularly attractive given the weaknesses in some of the current models in delivering finance to SMEs. The same could apply to crowdfunding through the development of a new co-fund, working with existing providers, which could help to stimulate the start-up market in Wales.
- The funding of social enterprises is an important area that was not the focus of this report although there may be synergies with some of the financial solutions being put forward for the SME sector.

Finance Wales

- According to data submitted to the review, Finance Wales is offering higher rates of interest on borrowing to SMEs within Wales than it needs to under European Commission (EC) State Aid guidelines.
- The evidence gathered also suggests that Finance Wales has not utilised the full range of financial instruments available under EC regulations. For example, with two thirds of Wales classified as qualifying for the highest level of aid, General Block Exemption Regulation (GBER) could have been used to subsidise the interest rates on loans to hundreds of SMEs and been a significant policy tool for Welsh Government. In addition, there is no state aid impediment to Finance Wales offering cheaper loans to the vast majority of micro-businesses under de minimis regulations if it so wished.
- It remains unclear as to whether Finance Wales is still essentially operating as a commercially oriented fund manager in all but name. Given this, the Minister may have a view as to whether Finance Wales is fit for purpose or whether the organisation needs to be taken in-house into the Welsh Government so that it can focus on its economic development role for the Welsh economy.

The Development Bank for Wales

- The evidence from the review indicates that public sector financial support in Wales seems to be fragmented and more relevantly, the organisation tasked with providing debt and equity finance to SMEs is not specifically focused on developing the Welsh economy.
- The Welsh Government needs to develop an approach where public funding for SMEs is affordable, focused on economic development, is supplemented by business support and is oriented towards the needs of the business customer. It is also critical that the public sector does not displace the private sector but works alongside the banks and other stakeholders to address a market failure in the provision of finance to SMEs.
- Therefore, the review recommends the establishment of a Development Bank for Wales that will be created by bringing together all the financial support schemes for SMEs within the Welsh Government, the funds managed by Finance Wales and elements of Business Wales, as well as UK Government schemes such as UK Export Finance and the Business Growth Fund. It will:
 - Act as a gateway for business and financial support to ensure access to the right type of support is provided to SMEs;
 - Work in partnership with the banks and other public and private sector partners to provide loans, guarantees, grants and other financial instruments, all of which will maximise the state aid exemptions available to provide affordable debt finance to Welsh business;

- Develop specific consultancy and business support services for Welsh SMEs as found in exemplar organisations around the World;
 - Gather, collate and provide detailed information on the SME sector in Wales to enable the Welsh Government and other partners to understand the dynamics of the Welsh economy;
 - Establish close relationships with Welsh Government economic bodies including the sector panels, the enterprise zone boards, city regions and Industry Wales;
 - Ensure a focused approach to the provision of financial and business services to microenterprises, regional SMEs and high growth firms.
- The Welsh Government is urged to examine the feasibility of this approach urgently to ensure that a viable and coherent approach to supporting SMEs in Wales is put into place as quickly as possible.

1. INTRODUCTION

In January 2013, the Minister for Economy, Science and Transport announced an independent review into access to finance for SMEs in Wales. Supported by a voluntary advisory panel from academia and business¹, the aim of the review has been to examine how effectively SMEs in Wales are served by existing sources of funding, identify areas of particular challenge and provide recommendations for action.

During the last ten months, an extensive and detailed consultation has been carried out through meetings with over 140 representatives of the banking sector, other financial institutions, the Welsh and UK Governments, intermediaries, academia and businesses. This has been supported by a substantial amount of data collated from various sources and interviews undertaken with a range of other publicly funded bodies in other countries, including Canada, Finland, Germany, Scotland, Sweden and the USA. In addition, the Welsh Conservatives and Plaid Cymru have submitted their own solutions to supporting funding for SMEs in Wales to the review, some elements of which have been considered by this review and integrated into the final conclusions.

The report for the first stage of the review, published in June 2013, analysed the situation regarding the access to finance of SMEs in Wales and focused specifically on the role of banks. It also presented information on other forms of alternative finance that are available to SMEs. As part of the review, a number of recommendations regarding access to finance in Wales were made and, as this report will show, the Welsh Government has already moved quickly to implement a number of these during the last five months. Given this, the second stage of this report will update the information on bank support and alternative sources of funding to SMEs in Wales. It will also, following a request by the EST Minister, examine the strategy undertaken by Finance Wales in terms of supporting SMEs in Wales, focusing specifically on the cost of borrowing. However, the main aim of this part of the review was to consider whether the current situation in Wales regarding access to funding was fit for purpose and, if not, what should the Welsh Government do about it.

So what does the review tell us? Very little seems to have changed in terms of lending by the banks to Welsh SMEs in the last six months. Despite the cost of borrowing being at historically low levels, the British Bankers' Association's (BBA) own statistics show that lending to SMEs remains stagnant. The report also estimates that there is a funding gap of around £500 million in Wales between the demand from SMEs and the current supply by the banking sector.

In terms of alternative finance, data from various organisations National Association of Commercial Finance Brokers (NACFB), Asset Based Finance Association (ABFA) and the Finance and Leasing Association (FLA) shows that there has been increased use of invoice discounting, leasing and other forms of non-bank finance during the last 12 months, although this has not been sufficient enough to alleviate the demand from the SME sector for funding. In terms of supporting growth businesses via sources such as informal investment and venture capital, there is a need to ensure that there is funding at all stages of the life cycle of such businesses and, more importantly, that every effort is made to leverage greater amounts of private sector funding into Wales. Finally, there have been positive discussion with peer-to-peer lenders and crowdfunding firms and there is an opportunity for the Welsh Government, through working in partnership with such organisations, to stimulate greater use of these sources of finance in the future.

¹ These advisory board members are: John Antoniazzi, former partner at Deloitte in Wales; Katy Chamberlain, Chief Executive of Business in Focus; Professor Robin Jarvis, Head of SME Affairs, The Association of Chartered Certified Accountants (ACCA) and Professor of Accounting, Brunel University; Professor Phil Molyneux, Dean of the College of Business, Law, Education and Social Sciences and Professor of Banking and Finance, Bangor University; Huw Morgan, former Head of Business Banking, HSBC Bank plc; Chris Nott, Chair of the Financial and Professional Services Sector Panel and Managing Partner of Capital Law LLP; Professor Stephen Thomas, Professor of Finance, CASS Business School, City University London; Mark Woolfenden, Managing Director, Afonwen Laundry.

As part of the second stage of the report, the EST Minister also requested that a specific analysis should be made of the cost of loans by Finance Wales as this may be an impediment to the availability of debt funding by Welsh SMEs. The evidence gathered suggests that not only have the interest rates they charged by Finance Wales to Welsh SMEs been higher than the reference rates which provide guidelines to the cost of loans by state banks, but there has also been a failure to fully utilise other state aid regulations to support lower interest rates to SMEs. One possible explanation for this approach is Finance Wales's mission, since 2007, to become an independent and self-funded investment fund. However, this is a strategy which seems to have taken precedence over a role that, during the difficult years of the economic downturn, should have focused on supporting SMEs in Wales as part of the Welsh Government's economic development remit.

Therefore, the Welsh economy is in position where SMEs are still facing difficulties in accessing funding from the banks and, as yet, there is no significant increase in alternative sources of funding although it is growing. Public sector financial support seems to be fragmented and more relevantly, the organisation tasked with providing debt and equity finance to SMEs is not fit for purpose, as it is not focused on developing the Welsh economy.

Given this evidence, the review has concluded that if Wales is to have an effective publicly supported financial ecosystem that benefits the economy and supports SMEs to grow and develop, then five principles must be adhered to. These are:

- Every viable business in Wales should get access to funding at an affordable price
- The primary role of government-backed funding for SMEs is to drive forward economic development
- It is not the role of the public sector to displace the private sector but to address a market failure in the provision of finance to SMEs
- It is critical that business and skills support is offered alongside financial support to businesses in Wales rather than as separate elements
- Funding solutions should be customer-oriented.

Therefore, the review recommends the establishment of a new Development Bank for Wales that would adhere to these principles and become the single source of public funding for Welsh SMEs. To achieve this, it will bring together the various business grant schemes within the Welsh Government, the funds managed by Finance Wales and various elements of Business Wales programmes. It will also partner with the UK Government to provide finance from programmes managed by UK Export Finance and the Business Growth programme.

Following careful consideration, we believe this is the most pragmatic and immediate response to get funding flowing into the SME sector to enable it to grow and develop its potential. Wales remains the poorest region of the United Kingdom and the future success of its economy will be determined by the ability of its businesses to become more competitive and innovative. To achieve this, the public and private sectors must work together and take advantage of every available tool that the nation has at its disposal to not only provide the funding the economy requires for growth and development but, through the creation of a Development Bank for Wales, create a model of excellence for others to follow.

Professor Dylan Jones-Evans
Bristol Business School

2. RECOMMENDATIONS AND ACTION FROM STAGE 1 OF THE REVIEW

The first part of the review into access to finance examined the current situation regarding various aspects of funding to SMEs in Wales and made sixteen recommendations. Following the publication of the review, it was agreed that Welsh Government officials would begin to implement the recommendations immediately and this section provides an update as to progress to date.

Recommendation	Action
<p><i>Recommendation 1</i> Welsh Government needs to ensure that Wales, and Welsh businesses, gets a fair share of funding from the new Business Bank.</p>	<ul style="list-style-type: none"> The Minister for Economy, Science and Transport has written to the Secretary of State for Business, Innovation and Skills, Vince Cable and met with the acting Head of the Business Bank, Keith Morgan, seeking to ensure that Wales is fairly served by the Business Bank.
<p><i>Recommendation 2</i> The Welsh Government needs to consider whether mechanisms such as micro-lending or community-based lending to smaller local businesses should be encouraged and supported.</p>	<ul style="list-style-type: none"> The Welsh Government will consider this recommendation within the broader framework of the review.
<p><i>Recommendations 3 to 6 relate specifically to bank lending policy.</i></p> <p><i>Recommendation 3</i> Security against the loan and affordability of repayment, rather than the cost of borrowing, have been cited in the interviews with banks, intermediaries and small businesses as being one of the main obstacles to accessing bank finance. Therefore any intervention by the Welsh Government should focus on these two critical obstacles.</p> <p><i>Recommendation 4</i> Local decision-making by banks is seen by many businesses as critical in ensuring that their business case is considered fairly. Yet there is very little evidence of this happening with higher-level credit decisions being made outside of Wales. Given this, Welsh Government is encouraged to open up discussions with the main banks to ensure that Welsh regional managers make the final credit decisions for all Welsh businesses.</p> <p><i>Recommendation 5</i> There needs to be greater transparency in the lending process. This is to ensure that SMEs, especially those without any formal financial support internally, know exactly what is required in terms of preparing an application to the bank (business plan, cash forecasts, support from an intermediary). In</p>	<ul style="list-style-type: none"> The Minister for Economy, Science and Transport has sent the Stage 1 Report to the Chief Executive of the British Banker's Association and Regional Heads and Chairmen of the main high street banks. The Minister has met with several high street banks to discuss the issues raised in the Stage 1 Report. A Guide to Welsh Government Business Funding Programmes has been produced by the Welsh Government and presentations have been made to several high street banks. Welsh Government officials are developing new joint initiatives with the banks to improve Welsh SMEs' ability to access finance. Welsh Government will maintain an open dialogue with the banks to continue to improve the funding landscape for companies in Wales.

<p><i>exchange for the provision of this information, banks would then agree to examine each potential funding request in more detail as opposed to basing their decision using the credit-scoring software that is normally applied to the majority of applications. Such “a banking covenant” could ensure greater transparency and accountability within the lending process and Welsh Government could work with the BBA to pilot such a scheme in Wales</i></p> <p><i>Recommendation 6</i> <i>Welsh Government should examine the disconnect between the business support programmes it offers and the funding supplied by the banking community in Wales. It needs to consider how it can work more closely with banks to ensure that they recognise the support available to Welsh firms and by promoting its take-up, improve the quality of business proposals and information supplied to the banking sector.</i></p>	
<p><i>Recommendation 7</i> <i>Welsh Government should raise the issue of the detrimental effect of Basel III rules on SME lending directly with the UK Treasury and BIS. This will enable the UK Government to make representations directly to the Basel Committee on Banking Supervision to recommend that SME lending should be excluded from consideration in terms of determining suitable capital and liquidity within the banking system</i></p>	<ul style="list-style-type: none"> • The Minister for Economy, Science and Transport has written to the Secretary of State for Business, Innovation and Skills, Vince Cable and the Bank of England highlighting the detrimental effects of the Basel III requirements on SME lending.
<p><i>Recommendation 8</i> <i>Welsh Government should examine how it can help facilitate better access to the wide range of commercial lending opportunities that are available to SMEs through non-bank lending channels. This could be achieved through partnership with organisations such as the NACFB and the development of a specific commercial portal on lending for SMEs.</i></p>	<ul style="list-style-type: none"> • Welsh Government officials are developing new joint initiatives with funding organisations to improve Welsh SMEs’ access to information on the funding options available and to improve their ability to access such finance.
<p><i>Recommendation 9</i> <i>There are currently low levels of informal investment in Wales that could be addressed by (a) raising awareness of equity investment by angels as a viable form of funding amongst growing SMEs and (b) developing an equity guarantee scheme to attract further investment by private individuals into Welsh businesses. These potential interventions, and the role of Welsh Government in supporting them, will be explored in further detail during the second half of the review.</i></p>	<ul style="list-style-type: none"> • This recommendation is examined further in the Stage 2 Report. The Welsh Government will consider this recommendation within the broader framework of the review.

<p><i>Recommendations 10 and 15 relate specifically to Finance Wales</i></p> <p><i>Recommendation 10</i> <i>Finance Wales has had a positive impact on formal equity investment within the Welsh business community. However, the Welsh Government will need to consider how it builds on this success, especially in terms of having a specific vehicle for equity funding in the future. It also needs to develop programmes that create demand for venture capital not only for new start-up businesses but also growth firms where equity investment is key for further development.</i></p> <p><i>Recommendation 15</i> <i>As the sole shareholder, Welsh Government needs to determine the future strategic direction of Finance Wales and, more importantly, the role it should play in the future financial landscape for Welsh business alongside other providers.</i></p>	<ul style="list-style-type: none"> • At the request of the Minister for Economy, Science and Transport these recommendations are examined further in the Stage 2 Report. The Welsh Government will consider these recommendations within the broader framework of the review.
<p><i>Recommendation 11</i> <i>The lack of availability of trade credit is an issue that leads to many smaller businesses seeking short term funding for working capital from banks. The Welsh Government should explore how it can use its power as the biggest purchaser in Wales to encourage its own suppliers to adopt supply chain finance or similar schemes to support their suppliers. In addition, it could set an example by ensuring that all contractors operating within the public sector in Wales have to pay their suppliers within a maximum 30-day period (and ensuring that it adheres to such a policy itself).</i></p>	<ul style="list-style-type: none"> • The Welsh Government is reviewing current procurement policies in light of this recommendation.
<p><i>Recommendation 12</i> <i>Further discussions will take place with building societies in Wales to assess their potential role in supporting SMEs to access finance, especially in terms of commercial property lending.</i></p>	<ul style="list-style-type: none"> • Following further discussions on the role of building societies in supporting access to capital within the Welsh economy there seems to be reluctance from building societies to expand into other forms of financial support for the business community. Instead, the message is that they want to focus on what they are doing already and doing it better for their customers. Full details of these discussions can be seen on page 24.
<p><i>Recommendation 13</i> <i>The Welsh Government should examine how UK Government funds can be used more effectively to support businesses in Wales, potentially through the provision of matched funding through its own resources. In particular, as it currently does not provide</i></p>	<ul style="list-style-type: none"> • On 14 October the UK Government funded Start Up Loans programme was introduced in Wales. This will form an integral part of the Business Start Up Service and be administered through the existing Business Start Up provider network.

<p><i>any loans to those start-ups that create the vast majority of jobs in the economy, the Welsh Government needs to develop an appropriate mechanism for this type of support, based on the Start-Up Loans programme operating in England, although this should be applicable to all new businesses and not only those started by 18-30 year olds</i></p>	<ul style="list-style-type: none"> • Welsh Government Officials continue to liaise with the UK Government Officials to explore how Welsh firms can better access UK Government funding initiatives.
<p><i>Recommendation 14 There is a major opportunity for Welsh Government to take the lead in supporting alternative sources of funding such as peer-to-peer lending and crowdfunding, either through partnership or direct funding. It could also raise awareness of both types of funding through its various business support programmes.</i></p>	<ul style="list-style-type: none"> • This recommendation is examined in the Stage 2 Report. The Welsh Government will consider this recommendation within the broader framework of the review.
<p><i>Recommendation 16 This review has shown that there is a lack of regional data, especially for Wales, as a devolved nation. If policymaking within the Welsh Government is to be based on evidence, then it is critical that UK organisations in both the public and private sector are made fully aware of the implications of devolution and the need for accurate data being collected at a regional level.</i></p>	<ul style="list-style-type: none"> • The Minister for Economy, Science and Transport has written to the Secretary of State for Business, Innovation and Skills, Vince Cable to highlight the issue of regional data collection. • The Welsh Government is also working with some of the banks on initiatives which could provide more useful, Wales-only data.

3. BANKS' LENDING PATTERNS TO SMEs

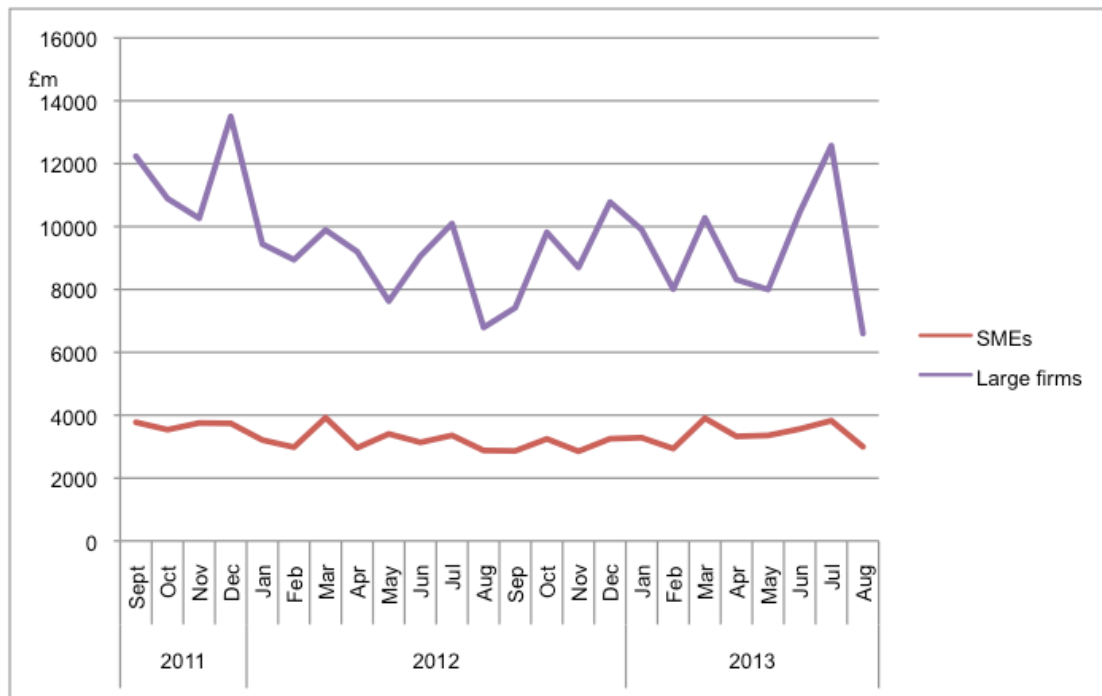
This section will update the data from the first report and will examine whether the situation regarding access to finance from the banks to the SME sector in Wales has changed since it was published in June 2013.

UK trends in bank lending

In terms of loans to businesses, the latest available data show that, in terms of gross lending, a total of £308 billion has been lent to all non-financial businesses in the UK since September 2011² (Figure 1). Of this, only 26 per cent (£80 billion) have been lent to SMEs³ and net lending, after repayments, for UK SMEs has gone down by £10 billion. This suggests that there continues to be little appetite by firms for bank lending or, as some suggest, a lack of credit being made available to smaller businesses.

As of August 2013, there was a total of £420 billion of fixed term loans outstanding to the banks from non-financial business in the UK, with SMEs accounting for 36.7 per cent (£154 billion) of this amount. Therefore, and contrary to expectation, the Bank of England's statistics suggest that there has been no substantial increase in the level of lending to SMEs during the last 12 months (September 2012-August 2013). In fact, there has been an overall decline of £1.2 billion during this period and the only monthly growth in net lending to SMEs (excluding overdrafts) since September 2011 has been in March 2013 and May 2013, despite claims from the high street banks.

Figure 1: Gross lending (excluding overdrafts) to non-financial businesses, 2011-2013.



² Bank of England Statistics on monetary financial institutions loans to non-financial businesses, by size of business, 2011-2013 <http://www.bankofengland.co.uk/statistics/Pages/bankstats/current/default.aspx>

³ SMEs are those businesses with annual debit account turnover on the main business account less than £25 million; large businesses are those with annual debit account turnover on the main business account over £25 million.