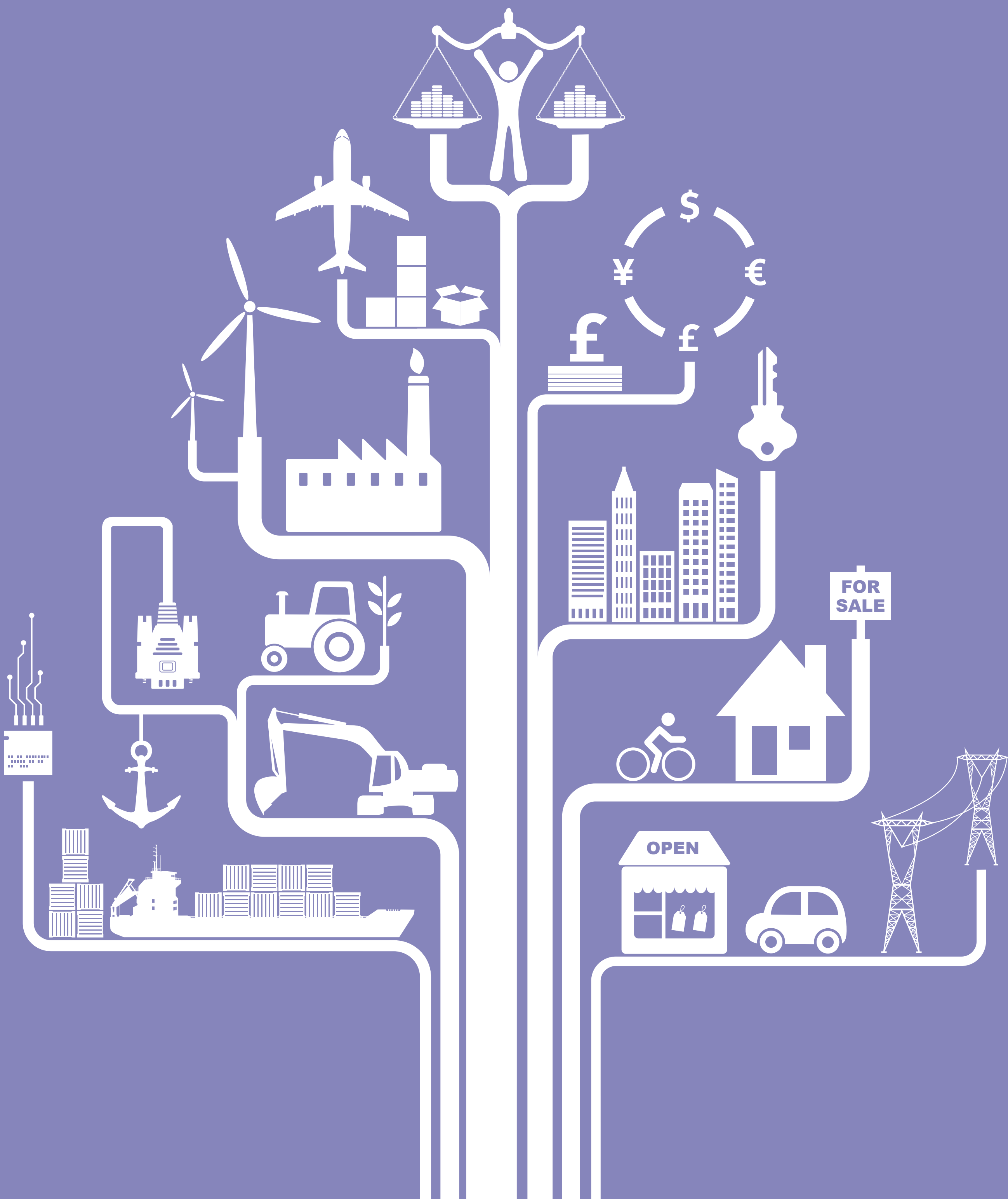
CBI
THE VOICE OF BUSINESS

Financing for growth

Refocused finance for a rebalanced economy



Contents

Foreword

The access to finance debate is stuck in a rut. Is lending depressed by a lack of demand? Is the supply of finance being constrained by cautious banks? Quite possibly both. But that is yesterday's debate.

Whatever the merits of these arguments, the simple fact is that we need raise the level of finance in the economy to support our growth aspirations.

This report shows that we are entering a 'new normal' for financing. A structural change in banking, driven by capital and liquidity reforms, will change the financing outlook for business. This transition is being made more acute by cyclical market turmoil driven by the eurozone crisis.

So our report points to two broad areas for action.

First, we need immediate action to smooth the transition to a 'new normal'. Actions here include ensuring that regulation does not choke off banks' ability to play their part in economic recovery, help for those parts of the economy that have seen bank finance retreat substantially, and bold action to overcome the substantial wave of refinancing facing businesses.

Second, we need to refocus finance so that it is squarely lined up behind our vision for a rebalanced economy. This sees a big role for high growth, medium-sized businesses. So we need urgent implementation of measures that will enable them to better access equity finance and capital markets. We also need to see reforms on trade finance, both regulatory and through new products, to support an export driven economy. And finally, we need moves to get large corporates investing so that they can play their full part in the recovery as growth anchors.

To achieve all of this needs bold action, such as putting quantitative easing to work directly into corporate assets. It also requires an 'action this day' approach to implementing reforms, because without the right financing in place we will continue to put the brake on jobs, growth and the transition to a rebalanced economy.

John Cridland
Director-General

Executive Summary

The current lending situation is showing signs of further deterioration. Pricing is edging up, investment intentions show little improvement, and reports of constrained lending remain.

Throw into the mix a significant refinancing challenge and the need to rebalance the economy to restore sustainable growth, and it is clear that a 'business as usual' approach to finance will not be enough. So something has to change.

With this backdrop, the reports sets out recommendations for action on two fronts:

First, measures to smooth the transition to a 'new normal'.

Our recommendations here include:

- **Ensuring financial regulation is fit for recovery:** immediate implementation of the re-think on UK 'super-equivalents' so that banks can play their full part in supporting the economy; a specific growth objective for the new financial regulators in the UK; and ensuring reforms do not stand in the way of attempts to diversify sources of finance, including by allowing insurers to play their part as long-term investors through getting the Solvency II reforms right
- **Actively supporting areas of the economy that have seen bank finance retreat substantially:** through enhancements and additional funding made available to the NewBuy and FirstBuy schemes; and by using part of the newly-announced Funding for Lending scheme to support the housing and construction sectors
- **Working to make sure that viable small and medium-sized enterprise (SME) and medium-sized business (MSB) lending propositions do not slip through the net:** awareness levels of alternative sources of finance and government interventions to support business lending remain patchy and a new approach is required, so we recommend a 'one-stop-shop' approach to business lending support
- **Taking action to overcome the substantial wave of corporate refinancing approaching over the next four years:** so we recommend that for any further rounds of quantitative easing the Bank of England should now seriously consider investing directly in non-government assets, such as bank bonds and high-grade corporate paper.

Second, we need to refocus our approach to financing so that it is squarely lined up behind our vision for a rebalanced economy.

This sees a big role for high growth MSBs, a significant increase in the UK's export performance, and private sector-led investment. Our recommendations to help finance all of this include:

- **Urgent implementation of measures to support high-growth, MSBs:** so we recommend that the costs associated with raising equity finance be made tax deductible, putting it on a par with debt finance. We also want to see the Enterprise Investment Scheme (EIS) expanded by increasing the threshold so that it can support the growth of MSBs, and the government make a relentless effort for State Aid approval for the expansion of the scheme. And we want the government to facilitate the introduction of retail bond products to support the deepening of the UK corporate bond market as a debt alternative to bank finance
- **A clear focus on boosting exports by shaping trade financing regulation, coupled with new products to support UK exporters:** the government must lobby so that the trade finance elements of CRD IV do not cut across a push to significantly raise our game on exports, and ask the FSA to review the liquidity requirements on UK Export Finance backed contracts. The government should also create a new UK export fund through which finance can be raised and lent to buyers of UK exports, either by government directly or by banks, and ask UK Export Finance to investigate the cost and feasibility of introducing an 'agreed guarantee limit' with partnering banks
- **A further incentive to encourage large firms to play their full part in economic recovery as growth anchors:** so we recommend that the government reinstate a corporate venturing tax incentive to encourage those large corporates, for whom it makes sense, to invest and get cash off their balance sheets and into the economy.

Section 1: Current levels of bank lending make a compelling case for action

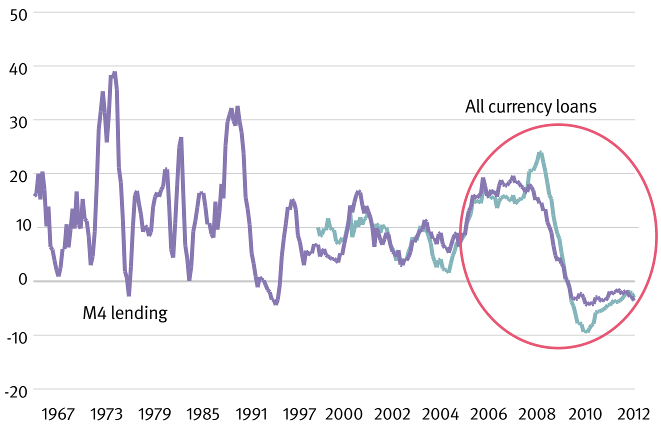
Lending levels in the economy are subdued, due to both depressed demand and constrained supply...

With a growth rate in the stock of lending to businesses in the years immediately prior to the financial crisis of over 15% on average, a sharp reduction in lending was somewhat inevitable (**Exhibit 1**).

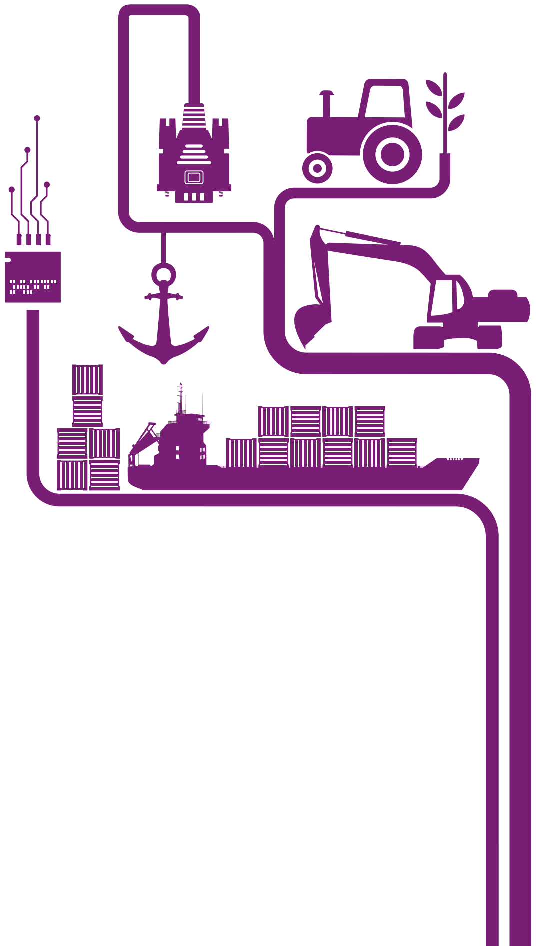
But, we have yet to see any sustained rebound in lending since the crisis, with the annual rate of growth in the stock of lending to UK businesses, both overall and for SMEs, negative in the three months to February 2012, contracting by around £9bn overall. The net monthly flow of lending in February was at its lowest in almost two years, and the overall stock of lending has been negative since mid-2009 (**Exhibit 2**).

Exhibit 1 **Lending to UK businesses**

Percentage changes on a year earlier



Source: Bank of England, *Trends in lending*, April 2012

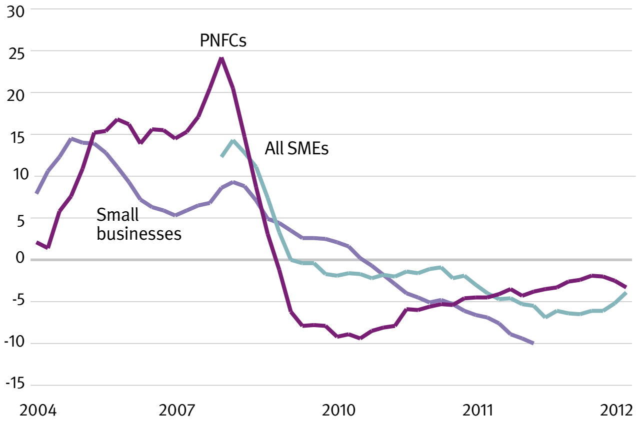


However, given the magnitude of the financial crisis, it is perhaps surprising that the supply of bank finance has not been even more stretched. Part of the reason for this is that demand for bank lending remains muted.

Demand for credit from firms of all sizes fell slightly in Q1 2012 according to the Bank of England Credit Conditions Survey. Although there was a slight rebound for small firms in Q2, overall the picture remains subdued (**Exhibit 3**). Further signs of a lack of demand can be found in the proportion of SMEs not applying for finance in the previous 12 months and being ‘content not to do so’, which has risen from 68% of firms in Q1 2011 to 74% by Q1 2012.[1]

Exhibit 2 Lending to small and medium-sized enterprises

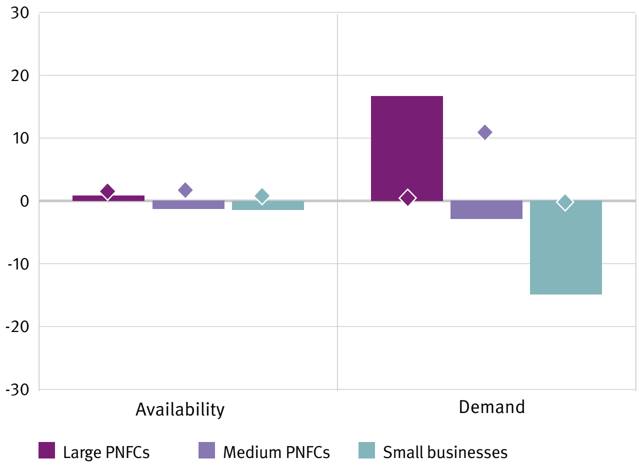
Percentage changes on a year earlier



Source: Bank of England, *Trends in lending*, April 2012

Exhibit 3 Credit conditions survey: availability and demand for credit across firm sizes reported in the 2012 Q2 survey (a) (b)

Net percentage balances



(a) The bars in the chart show the net percentage balance reported over the three months to early March. The diamonds show the associated expectations for the next three months.

(b) In the first panel, a positive balance indicates that more credit is available. In the second panel, a positive balance indicates an increase in demand.

Source: Bank of England, *Credit conditions survey*, Q2 2012

Uncertainty over the economic outlook is the biggest reason for firms being cautious. Among the 25% of SMEs who would like to apply for finance in the future but for various reasons will not do so, the current economic climate was cited by 54% of firms in Q1 2012 as the main reason for not seeking finance.[2] Chief Financial Officers of large corporates also see macroeconomic uncertainty and the outlook for demand as being far greater influences on investment decisions than the availability of finance – just 4% of CFOs in the June 2012 Deloitte Survey of UK Chief Financial Officers cited external finance as an influence on recent capital spending decisions.

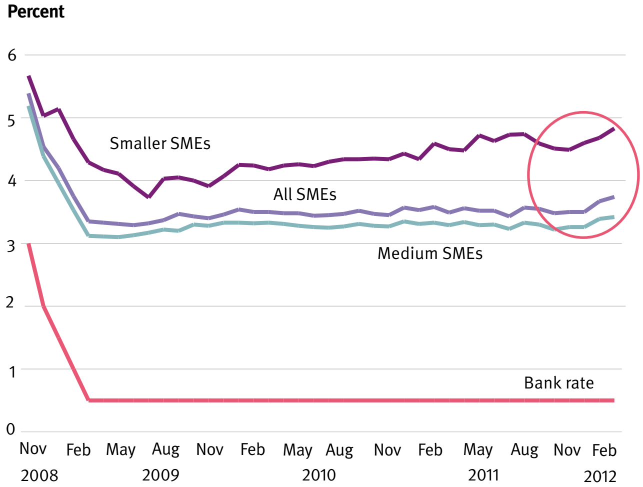
The lending situation is becoming more acute, with pricing edging up, investment intentions showing little improvement, and continuing reports of constrained lending…

Agents from the Bank of England are reporting that they are starting to see increases in loan pricing, with credit conditions tightening in recent months. Existing facilities are becoming more costly on renewal in many cases, arrangement fees have been rising, and collateral requirements on new lending have become more stringent.

This trend has accelerated in recent months. The latest Credit Conditions Survey reported tightening of price terms in Q2 2012, with further substantial tightening expected in Q3. Medium-sized firms in particular are now bearing the brunt, with fees and commissions, and spreads on lending, all rising substantially over the past quarter for these firms (**Exhibit 4**).

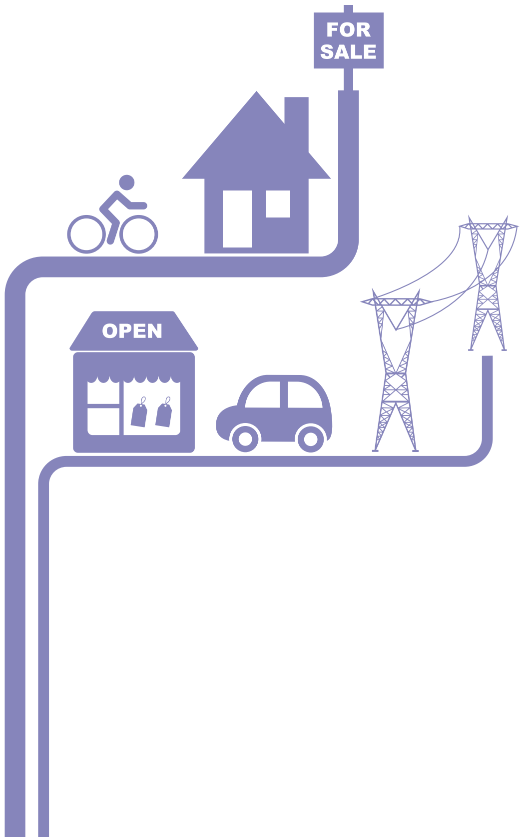
The reason for these tightening conditions is that higher wholesale funding costs, which began to pick up in the last quarter of 2011, are now feeding through into increased loan pricing. Higher wholesale funding costs reflect concerns over the indebtedness of a number of euro area governments and banks. A resolution of the eurozone difficulties appears to be fundamental for this price pressure to begin easing.

Exhibit 4 **Indicative median interest rates on new SME variable rate facilities** (a)



(a) Median by value of new SME facilities priced at margins over base rates, by four major lenders (Barclays, HSBC, Lloyds Banking Group and Royal Bank of Scotland).

Source: Bank of England, *Trends in lending*, April 2012



Whilst higher loan-to-value mortgages have been returning, conditions are set to tighten again…

Higher loan-to-value mortgages have been returning to the market, but expectations are that this trend will not continue.

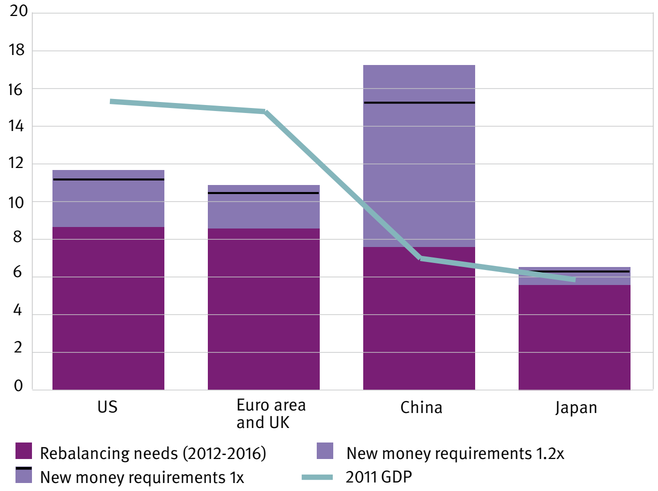
The economic outlook, and particularly tight wholesale funding conditions, weighed on the availability of mortgage lending in the second quarter of 2012. The availability of secured credit to borrowers with high loan-to-value ratios is predicted to decline markedly into the third quarter of 2012.[3]

The UK is facing significant financing challenges, including a substantial wave of corporate refinancing approaching over the next four years…

In addition to these pressures on day-to-day bank lending, there is also a global wave of non-financial corporate debt maturities coming due between 2012 and 2016. Estimates put the total amount of refinancing and new money requirements over the next five years at between $43tn and $46tn.[4] In the UK and euro area alone this amounts to just under $11.5tn (**Exhibit 5**). A worsening situation in the eurozone could have a significant impact on the ability of firms to refinance.

This poses both a direct challenge to ensure that the level of refinancing that businesses require is available, but it also helps to explain a reticence among firms to invest cash from their balance sheet now before being sure that their refinancing needs will be met in the coming years.

Exhibit 5 **The height of the wave**



Source: Standard & Poor's Ratings Services 2012

Financing our growth aspirations must be the priority

The debate about whether access to finance is a supply or demand issue rather misses the point. The simple fact is that we need to make sure that we can finance our growth aspirations, both in the short term to enable recovery and over the longer term to rebalance our economy and create sustainable growth.

Section 2: Structural change will lead to a 'new normal' in bank finance

Regulatory reform, bank balance sheet restructuring, and a more realistic pricing of risk are shaping a new normal for bank finance. This transition is being exacerbated given the historic reliance on bank finance in the UK, and made bumpier by cyclical pressures from the eurozone.

UK businesses need to wean themselves off an over-reliance on bank finance...

UK businesses have historically been over-reliant on bank finance, leading to an exaggerated impact on the ability of firms in the wider economy to secure finance when the banking system gets into difficulty.

In the UK, banks account for nearly three-quarters of all credit intermediation, compared to just 25% in the United States, where alternative sources of finance are widely available, and Australia, where a broader mix of options is present (**Exhibit 6**). Any headwinds facing banks therefore have a heavy negative impact on UK businesses' ability to raise finance.

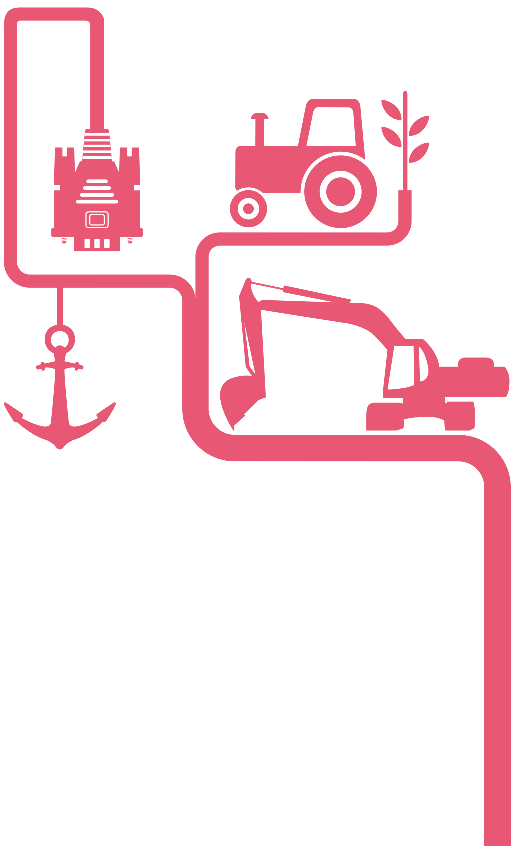
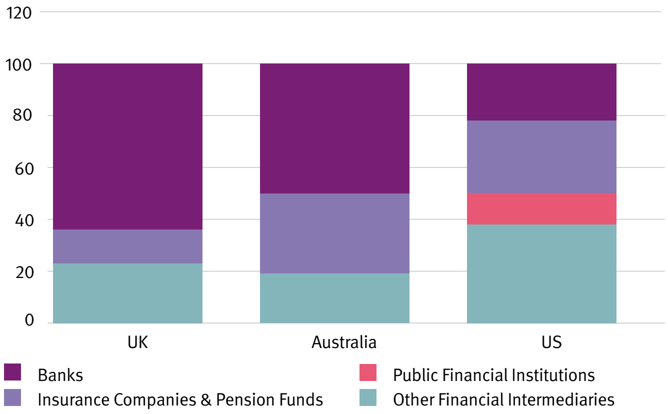


Exhibit 6 **Share of total assets by jurisdiction (%)**



Data source: Financial Stability Board, *Shadow Banking Strengthening Oversight & Regulation*, October 2011

Bank deleveraging still has some way to go, which could be a drag on lending for some time yet...

We all accept that bank deleveraging is an important and necessary reaction to the financial crisis. There are essentially three ways in which banks can deleverage: raise capital, sell assets, or reduce lending. The reality is that a combination of all three will occur. The key to avoiding a credit crunch, and the reinforcing economic downturn that would follow, is to get the mix and timings right in the deleveraging process.

With conditions for raising capital far from ideal, and asset shedding difficult in the current environment, the fear is that lending to business may be under threat as part of the deleveraging process.

The UK has not made as much progress on bank deleveraging as the US. Whilst levels have fallen, they remain elevated and still have some way to go to reach a sustainable level (**Exhibit 7**).

So far, UK banks have not used reductions in business lending as the primary tool for deleveraging. This is partly because the pre-crisis boom was fuelled by excessive lending in real estate and foreign asset purchases, rather than a build-up of ill-judged business lending (**Exhibit 8**). So to the extent to which banks use a reduction in business lending to deleverage, this is likely to fall most acutely on the construction and real estate sectors.

This correction already seems to be occurring. Firms in the commercial real estate sector have seen the amount of bank credit made available to them decrease disproportionately, with lenders in Q2 2012 noting they were taking a 'cautious and selective' approach to the sector.[5]

The major deleveraging shift that is occurring is that UK banks are prepping legacy assets for disposal, and getting rid of non-core assets.

For example, with much of the expansion in debt in the run-up to the crisis having occurred through overseas asset purchases, there is currently a 'retreat homeward' occurring, where banks dispose of foreign assets rather than reduce domestic lending to repair balance sheets.

However, this strategy will take time. In the current environment, many assets can only be disposed of at a very low price, often below book value, so time needs to pass for restructuring to occur and asset prices to stabilise, or at least not fall further. In the meantime, holding down lending is the most immediately available tool to help bank deleveraging.

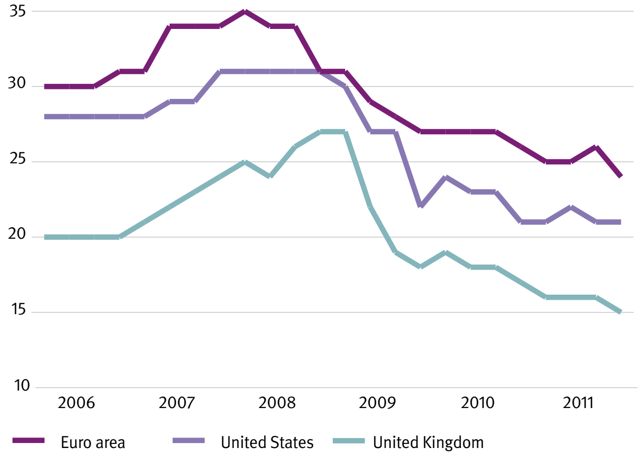
Capital and liquidity reforms are beginning to bite on bank lending…

Capital and liquidity reforms are critical to make banks more resilient and increase financial stability. These reforms are at the heart of what will become a new normal for bank financing, which will mean higher costs and changed risk appetites from banks. Over time, businesses will therefore need to re-adjust their expectation of how much, and at what price, finance is likely to be available .

There is rightly pressure for tighter regulation on the financial sector in the wake of the financial crisis and recent market practices. It is important that these reforms are forensic in stamping out unacceptable behaviour, whilst ensuring that banks can focus on supporting the economy.

Exhibit 7 **Bank leverage**

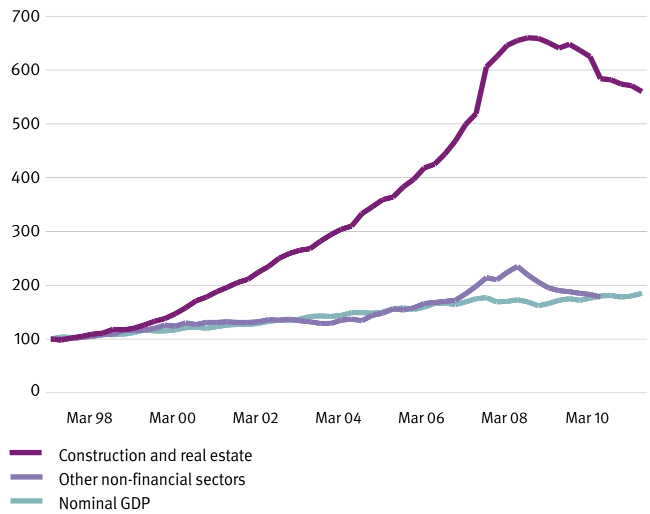
(Adjusted tangible assets to Tier 1 common capital)



Source: International Monetary Fund (IMF), *Global Financial Stability Report*, April 2012

Exhibit 8 **Growth in outstanding loans: credit boom bypassed much of the business sector**

Index (1998 Q1 = 100)



Source: Haver Analytics

But a consequence of introducing reforms to achieve greater stability now, when the economy is still in its recovery phase, is that lending will become more constrained and more expensive at precisely the wrong time (**Exhibit 9**).

There are three areas that are causing particular pinch points:

First, the *timing* of reforms which, if rushed through, will choke off credit before the recovery takes hold. The reforms are intended to be counter-cyclical, so it is important not to add to regulatory pressures when the focus should be on recovery and growth.

Second, the *calibration* of the reforms, which need to be carefully weighed up to strike a balance between financial stability whilst still enabling banks to support the economy.

Third, the UK has a tendency for *use of 'super-equivalents'* that go above and beyond internationally agreed reforms, both in front-running the implementation timetable and the quantum of what is required by regulators.

Pressure to maintain shareholder returns will push banks to shift capital to areas with the highest returns...

Banks have to maintain reasonable returns so that they remain attractive to investors. Returns are based on the risk that investors take on when investing in a particular company. Essentially, the higher the risk of capital loss the greater the return required by the investor.

The Basel III reforms (and the European implementation via CRD IV) are a fundamental part of the push for greater financial stability. But they also pose a conundrum for investor returns. The potential scenarios are that:

- Investors adjust to a lower return-on-equity environment, as banks hold more capital and increase liquidity reserves
- Banks increase pricing on borrowers and customers where feasible in order to maintain returns

Exhibit 9 **Example of current regulatory reforms and their effect on lending**

Reform	Effect	UK Super-Equivalence	Overall impact on UK lending
Capital Requirements Directive (CRD) IV: Capital	Increases the level of capital banks are required to hold, increasing the cost to banks of lending to business. Increases the cost associated with export products making them unprofitable for banks to offer – so may stop altogether – and more expensive for businesses to buy. Increases the charge that businesses would have to pay to buy hedging products due to the Capital Valuation Adjustment volatility charge, making it more difficult for them to manage their day-to-day business risk, export their products, and invest and grow.	The Banking Reform Bill, building on the work of the Independent Commission on Banking, will most likely require banks to hold increased levels of capital and other loss absorbency instruments on top of the CRD requirements, further increasing the cost to banks of lending to business.	Costs of borrowing for businesses increases Ability of banks to lend to businesses decreases
Capital Requirements Directive IV: Liquidity	Increases the amount and quality of liquid assets that banks are required to hold, reducing the amount they can lend to businesses.	The UK regulator – the Financial Services Authority (FSA) – dictate liquidity requirements go above and beyond the CRD requirements, requiring, for example, more narrowly defined liquidity buffers, making it harder for banks to increase lending at the current time.	

- Banks respond to the new rules by shifting capital away from areas that require significantly higher capital levels and produce relatively low returns (such as SME lending and trade finance) into areas that offer higher returns compared to the capital required.

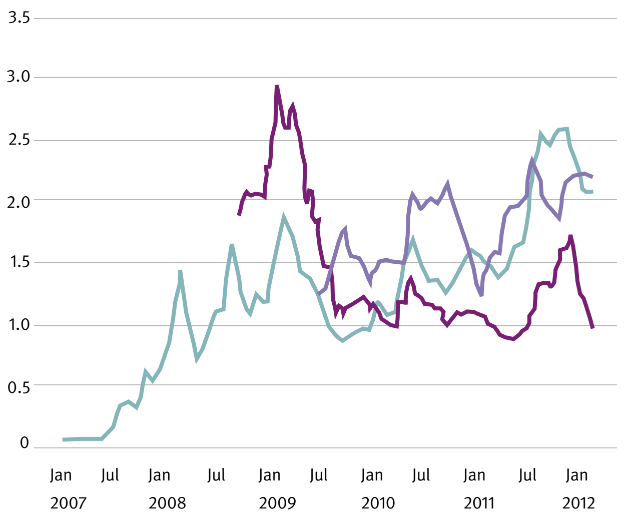
The reality is likely to be some combination of all of these scenarios. But expectations of shareholder return may need to fall if the focus on vanilla retail banking is to be maintained.

Turmoil in the eurozone is pushing pricing upwards and making it harder for banks to remove assets from their balance sheet…

Pressures from the eurozone, exacerbated by many UK banks' reliance on wholesale funding, rather than deposits, to fund lending, are keeping prices elevated and lending levels subdued.

The Longer-Term Refinancing Operations (LTRO) put in place by the European Central Bank led to some improvement to longer-term wholesale funding markets at the start of 2012.

Exhibit 10 **Indicative long-term funding spreads (%)**



Covered bond spread
Spread on three-year retail bonds
Five-year CDS premia for the major UK lenders (which acts as a proxy for the spread on long-term wholesale bonds)

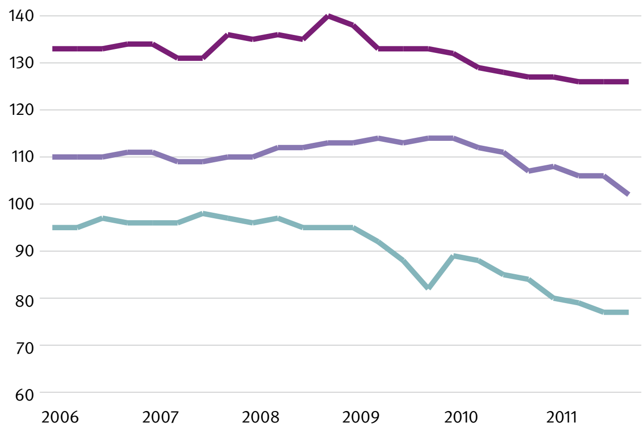
Source: Bank of England, *Trends in lending*, April 2012

But wholesale markets continue to be turbulent, driven by sovereign and bank uncertainties in large parts of the eurozone. Without a more sustainable solution to those issues, it is hard to see any pricing stability which could be passed onto business. The picture from the Bank of England points to lenders expected spreads on lending to businesses of all sizes continuing to increase (**Exhibit 10**).

Reductions in the volume of bank lending and increases in pricing driven by eurozone uncertainty are exacerbated by the funding gaps in European and UK banks. Since UK and European banks rely to a large extent on wholesale funding rather than deposits to fund the loans they make, rising wholesale funding costs will reduce their ability to lend, resulting in a dampening of lending. This is less the case for the UK than for euro area banks, but still has the potential to impact significantly on lending levels and prices in the UK (**Exhibit 11**).

Uncertainty from the eurozone crisis also impacts on asset prices, keeping these subdued and making it difficult for banks to remove assets from their balance sheets without accepting significantly and costly write-downs. This can slow the deleveraging process, or force banks to look elsewhere, such as business lending, for contributions to their deleveraging efforts.

Exhibit 11 **Bank Loan-to-deposit ratios (%)**



Euro area United Kingdom United States

Source: IMF, *Global Financial Stability Report*, April 2012

Section 3: Financing for growth – recommendations for action

The structural reforms that are taking place in the banking sector, coupled with cyclical pressures from the eurozone, mean we need to see action on two fronts:

- First, we need immediate action to smooth the transition to a 'new normal'
- Second, we need to refocus finance so that it is squarely lined up behind our vision for a rebalanced economy.

Smoothing the transition to a 'new normal'

There is currently a perfect storm facing bank financing which, if left unchecked, could see the UK sleep-walking into a new credit crunch. These pressures include regulatory reform, deleveraging and eurozone funding pressures on the supply side, and the need to meet a wave of corporate refinancing and a lack of financial expertise amongst the firms that most need finance on the demand side.

So we need to ensure that banks can play a full part in supporting the recovery right across the economy, and that other forms of finance, including equity, can start to help with the heavy lifting.

We recommend immediate action in four areas: targeted changes to reforms on financial regulation; more active intervention in parts of the economy where banks have pulled back the most; greater efforts to match demand with supply of finance to help SMEs and MSBs; and action to help meet the wave of corporate refinancing.

Ensuring regulation is fit for recovery

Bank finance will continue to be the dominant source of financing for most businesses in the future, notwithstanding efforts to diversify forms of finance. So it is critical that banks are equipped and have the firepower to play a full role in supporting economic recovery. The government can take specific action on a number of regulatory reforms that would otherwise put a brake on banks' ability to lend. These actions include:

Recommendation 1
Immediate implementation of the re-think on the use of 'super-equivalents' in the UK during periods of downturn in the economy

As the Chancellor acknowledged in his address to the Mansion House in June 2012,[6] a change of approach in the liquidity regime for UK banks could give an immediate boost to lending. The FSA has been front-running the international timetable for liquidity requirements that will be introduced in CRD IV, but it has also insisted on a very narrow definition of liquid, low risk assets that are permissable in liquidity buffers. As a result, the yield earned on the liquidity portfolio is very low, representing a cost to banks relative to their cost of funds.

The CRD IV definition of liquid assets allows for a wider definition, including for example high quality Covered Bonds (bonds backed by relatively high quality mortgages, where the investor has recourse to the assets of the issuing banks if the underlying loans default). Allowing UK banks to include Covered Bonds in their liquidity buffer could free up financing to be directed at lending to the wider economy rather than remain tied up in central bank cash deposits or government bonds. The government should ensure that the FSA urgently implements this re-think on super-equivalents.

Recommendation 2
Growth objectives cemented in legislation for the new financial regulators – the Financial Policy Committee (FPC), Prudential Regulatory Authority (PRA) and Financial Conduct Authority (FCA)

The new regulatory authorities should have a specific objective to support economic growth. In particular, the FPC will have substantial powers to influence lending levels in the economy, so we believe the FPC needs to have a more proactive focus on supporting economic growth. The Chancellor's recent announcement[7] that the FPC will have a secondary objective along the lines of the Monetary Policy Committee indicates the right direction of travel, but there should be a specific and explicit objective to support growth. The PRA and FCA should also have such a focus, as is the case for a number of regulators overseas.

Recommendation 3
It is important that reforms do not stand in the way of attempts to diversify and use new forms of financing to take some of the strain off our reliance on banks

To take the strain off banks, diversifying forms of finance and the investors involved will be vital. But a number of reforms threaten to shut down these alternative sources of finance before they can be given a chance to step into the breach. For example, we believe that insurers have a key role to play as long-term investors in infrastructure.

So we recommend that the European Commission should change its approach to the Solvency 2 directive to ensure that it makes commercial sense for insurers to invest in infrastructure, including BBB grade assets. The UK government must make this a top lobbying priority in Brussels.

Actively supporting areas of the economy that have seen bank finance retreat substantially

With banks significantly over-exposed to construction and real estate in the build-up to the financial crisis, it is not surprising that they have retreated most aggressively from those sectors.

Banks will acknowledge that whilst they are not closed to these areas of activity, the need to shrink their relative exposure to this part of the economy means that they will require an outstanding lending proposition relative to other parts of the economy for finance to be offered.

Whilst it is not desirable for banks to return to anything like the levels of exposure they had to property-related sectors pre-crisis, the sharp pullback has left firms in this area facing a cliff edge that needs to be addressed.

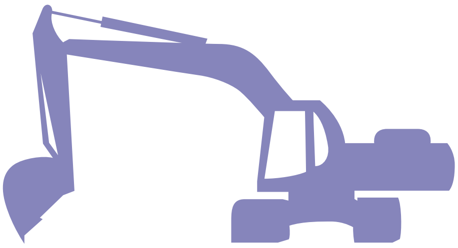
We believe that the housing market merits special attention. It is a vital part of the UK's national infrastructure, a crucial component of our economy, and impacts on consumer confidence and spending in the wider economy.

In 2011 the CBI lobbied the government to introduce a Mortgage Indemnity Guarantee, particularly to support first time buyers by enabling them to take out mortgages with a realistic deposit, which it did through the NewBuy scheme.

The CBI recommends action on the NewBuy and FirstBuy schemes, as well as use of the new Funding for Lending scheme, to give a further boost to the housing market.

Recommendation 4
The government should extend the NewBuy scheme to boost the number of people who can take advantage of the support on offer

Government should take two specific actions to extend the NewBuy scheme, getting around the lack of high loan-to-value (LTV) mortgages on offer under the 'new normal' and reducing mortgages costs further for households. It should increase its risk-share up from the current 5.5% to reduce the cost of mortgages, and also consider extending the NewBuy guarantee 'lower-bound' to include mortgages with an 85% LTV ratio, rather than the current 95% LTV ratio 'lower-bound', to allow more people to take advantage of the scheme's benefits.



Recommendation 5
The government should continue with the successful FirstBuy scheme beyond the currently budgeted period

Government should announce £400m of new funding over three years for the FirstBuy scheme, to enable it to continue at the current rate of 800 reservations per month.

Recommendation 6
The government should use part of the Funding for Lending scheme specifically for housing

Government should ensure that part of its newly announced Funding for Lending scheme, designed to reduce the cost of lending for banks, addresses current problems in the housing sector. This could be used either to support medium-sized housebuilders, or to bring down the cost of mortgages for homeowners.[8]

Working to make sure that viable SME lending propositions do not slip through the net

SME businesses have been impacted most by the credit crunch, and the smallest of businesses continue to find credit hardest to come by.

The debate about whether access to finance is a supply or demand problem is most acute in this space. Demand is undoubtedly subdued, but there is a nagging reality that some viable demand is not being met.

To ensure this demand does not slip through the net, the government needs to work with both business and finance providers to better match up supply and demand.

Recommendation 7
We recommend the creation of a government 'one-stop-shop' for business finance needs

By expanding a current institution, such as Capital for Enterprise, to house all government access to finance schemes, including signposting to export schemes, and continuing the work being undertaken to review and oversee banks' appeals processes, this agency could help match demand for finance to the relevant source of supply.

The goals should be ambitious. To be part of the long term future of our finance environment, the one-stop-shop needs to change the way government approaches the demand side.

For many of those small and mid-sized businesses seeking finance and failing to secure it, evidence suggests they can face three specific behavioural barriers:

- A lack of awareness of alternative sources of finance outside of existing relationships with their banks
- A lack of the financial expertise required to assess the appropriateness of alternative sources for their business model
- A lack of confidence in their ability to secure these alternative forms of finance.

The CBI already has work underway in this area, with our 'M-Clubs' initiative bringing together mid-sized businesses to facilitate knowledge sharing and peer-to-peer learning in an attempt to address some of these issues.[9] Government should support such efforts, incorporating lessons learned into its business-facing support schemes.

The government has introduced a number of measures to support small business lending, in an effort to bridge the gap and step in to support lending decisions that fall into a grey zone of 'almost commercially-viable' loans. We recommend that government should now focus its efforts on effectively and swiftly implementing those schemes it already has rather than announcing new ones.

The benefit of many government interventions is currently being held back by difficulties in getting them to market, and particularly by a lack of awareness among small businesses about the support on offer. For example, less than a quarter of SMEs are aware of the flagship Enterprise Finance Guarantee.

The old methods of marketing drives and product re-brands have had limited impact, and funding for them is less likely in the current fiscal climate. There are currently laudable efforts underway to think differently – including making it easier for businesses to assess online whether they are eligible for government support – but the expanded agency must have an explicit remit to think more innovatively about raising awareness and improving delivery.

The new Enterprise Research Centre, which will help drive government policy for SMEs, should be amalgamated into the 'one-stop-shop', and bolstered by support from the Cabinet Office's Behavioural Insights Team, which should be tasked with putting business front-and-centre of its work. We see significant opportunities to use behavioural insights to boost the information that businesses have at key moments in their progression, enabling them to make the right finance choices for their business.

Taking action to overcome the substantial wave of corporate refinancing approaching over the next four years

With the UK and eurozone facing a significant corporate debt refinancing between now and 2016, allowing banks to play a full part in recovery is key. But we think that additional firepower would be useful given the constraints on conventional sources of finance.

Recommendation 8

Further QE should be more directly targeted by investing in non-government assets

There are no silver bullets, but for any further rounds of quantitative easing the Bank of England should now seriously consider investing directly in non-government assets, such as bank bonds and high-grade corporate paper.

Refocusing finance to rebalance the economy

The UK needs to undertake a fundamental rebalancing of its economy to secure sustainable growth in the future.[10] To facilitate this shift we need to refocus finance so that it is squarely lined up behind our vision for a rebalanced economy.

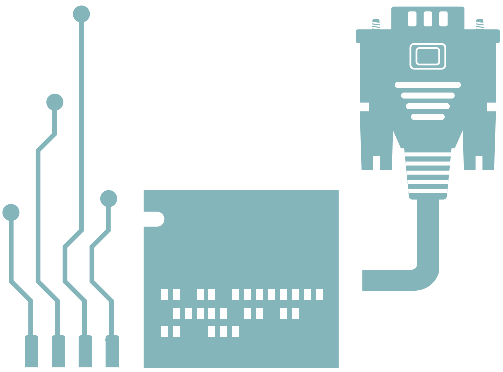
We recommend immediate action in three areas: ensuring that high growth MSBs have the finance they need to expand, by diversifying the finance options available; ensuring that we have the trade finance to support an export driven economy; and, finally, we need moves to get large corporates investing so that they can play their full part in the recovery as growth anchors.

Urgent implementation of measures to support high-growth firms, including MSBs

Ensuring businesses have the finance to survive is fundamental, but to boost the economy we also need to unlock sufficient growth capital for UK businesses to expand and grow. Our economic modelling shows that with a steady expansion rate of both high-growth and slow-growing firms, more akin to mid-sized business growth in Germany, the additional value to the economy could be £20bn by 2020.

With such economic potential it is critical that these firms are supported. And yet high-growth firms disproportionately cite access to finance as the most important barrier to growth that they face.

Currently, they are too heavily reliant on bank finance, which is constraining their ability to grow. This is driven largely by a lack of alternatives to bank finance for firms at the smaller end of the scale, and exacerbated by a lack of awareness and skills to access other forms of finance that are available.



Our recommendation to introduce a 'one-stop-shop' aims to improve awareness and boost demand for alternative sources of finance. On the supply side, effective and swift implementation of the recommendations of the Breedon Taskforce Report on Boosting Alternative Sources of Finance is required to boost existing alternatives further. But to increase supply with immediate effect, however, we recommend government take the following action now.

Recommendation 9
Reduce the cost of raising equity by making it tax deductible on a par with debt

An immediate step to making equity more attractive would be to make the cost of raising equity tax deductible for SMEs, putting it on a par with debt finance. We estimate the initial cost of this to the Exchequer would be something in the order of £159m per annum, were it limited to private companies seeking to raise up to £10m.

As soon as public finances allow, we urge the government to go further and ensure that a greater number of MSBs can benefit from this measure by increasing the ceiling up to fundraising amounts of £50m, which is approximately the point at which capital markets begin to open up for MSBs.

We believe this measure would be help to unlock some of the estimated £72bn of 'dry powder' funds in the Private Equity industry, which is committed but un-invested capital, of which at least £30bn has been earmarked for investment in the UK.

Recommendation 10
Expand the Enterprise Investment Scheme (EIS) to support the growth of MSBs by increasing the threshold and securing State Aid approval for the expansion of the scheme

The government should expand the EIS thresholds to support investment in the growth of medium-sized businesses, taking the threshold to 500 employees and increasing the investment limit. It should further relax the connected individual rules and increase the maximum individual holding limit for EIS, ideally to 50%. We estimate that the total cost of these measures to the Exchequer would be in the order of £100m. As a matter of urgency, the government must secure State Aid approval for recent enhancements to EIS.

Recommendation 11
Introduce retail bond products to support the deepening of the UK corporate bond market as a debt alternative to bank finance

Only around 5% of MSBs are currently able to access debt capital markets but, as the Breedon Review noted, the retail market for corporate bonds offers 'genuine growth potential'.[11]

By the early part of 2012, £1.4bn had been raised through 17 dedicated retail issues on the London Stock Exchange's order book for retail bonds, and it has been estimated that the potential size of the untapped sterling retail bond market could be as much as £20bn.

To attract investors down the chain, work needs to be done to make such investments attractive. We recommend that the government should look again at retail bond investment incentives to help maximise this potential source of debt finance. This would also help to increase liquidity in the secondary market, increasing the attractiveness of corporate bonds to investors.

Trade financing regulation needs to optimised and new products introduced to support UK exporters

Boosting the UK's export performance is critical to delivering a sustainable economic recovery.

The government has responded to this challenge, setting out in the 2012 Budget its commitment to doubling the UK's annual exports to £1tn by 2020. Businesses are doing their bit: earlier in 2012, sales to non-EU countries made up the majority of our total exports.

The CBI's report *Winning Overseas* detailed the barriers to boosting exports in the UK, and difficulty accessing appropriate finance was identified as a key constraint on growth. It was a particular barrier for MSBs, with one in four pointing to finance as the main constraint in accessing foreign markets.[12]

The combination of bank deleveraging and the impact of liquidity requirements is severely impacting traditional export finance market capacity, pricing, and lending tenors across the world. We set out below how a combination of regulatory changes and direct product intervention could help to get the right finance in place to support an export-driven economy.

Recommendation 12

Ensuring the trade finance elements of CRD IV do not inhibit export finance

Basel III imposes capital weightings on banks of 100% for letters of credit that have previously been weighted at only 20%-50% under Basel II, significantly reducing banks' ability to finance this vital part of the exporting process.

Under the Basel II regime, trade finance was treated favourably compared to other lending forms because it was recognised that trade finance is generally self-liquidating and asset-backed, and therefore relatively low risk.

Trade finance tools are recognised as low risk, but they also generate low returns for banks. If they also consume high levels of capital, as proposed under Basel III, it could result in many European banks ceasing to provide this type of financing, or at least lead to much higher costs to business as banks seek to maintain a return on the product.

The UK government should lobby in Europe for smart implementation of the trade finance rules of Basel III, recognising both the vital role of trade finance in exports and the relatively low risk nature of these products. Such a move would help the EU member states, including the UK, in their drive to break new markets and compete on the global stage.

Recommendation 13

Review the UK's liquidity requirements on UK Export Finance backed contracts to reflect the risk-profile of the transactions

Government should work with the FSA to review how the regulator treats UK Export Finance backed contracts for the purpose of liquidity requirements. The regulator should either permit new UK Export Finance backed loans to be exempt from liquidity mismatch requirements, or should allow UK Export Finance backed assets to be eligible as part of the required liquidity reserves.

Given that the government is underwriting the risk of these export finance contracts via UK Export Finance, enforcing liquidity-matching requirements to buffer against risk for these loans makes little sense. It is leading to a situation where foreign buyers are offered 100% risk cover by UK Export Finance to purchase UK exports, but liquidity requirements curtail banks' ability to provide the initial funding at a competitive rate that can secure this guarantee – meaning UK exporters lose the business.

Recommendation 14

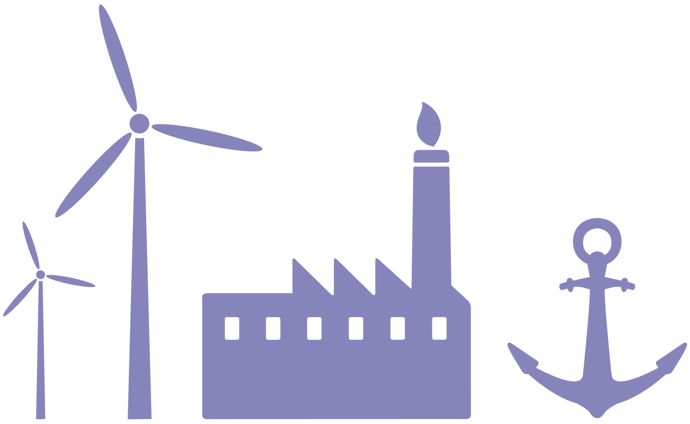
Create a new UK export fund through which finance can be raised and lent directly to buyers of UK exports

UK Export Finance recognised the impact of the financial crisis on the availability of trade finance and in 2011 it introduced a new range of guarantees for exporters, making UK exports more viable and attractive to foreign buyers. While these products are hugely important in sharing the burden of risk for exporters, risk is not the primary issue at the moment. Liquidity requirements mean that the long-term commitment of capital to trade finance is becoming less viable, even with the risk guarantee from UK Export Finance in place. This is impacting on the availability of funding at both ends of the scale. It restricts SMEs' and MSBs' access to trade finance, because the lower the return on investment the more difficult it is to justify the long-term capital requirement on bank balance sheets. It also has potential to significantly impact the ability of UK exporters to offer medium term financing for high-value opportunity export projects.

There is increasing evidence that export buyers, particularly national governments, seek the assurance that competitive medium term finance is available from export credit agencies (ECAs), committed and firmly priced at project inception. This is where US Export-Import Bank, and increasingly other ECAs within and outside the OECD, step in to lend directly to export buyers and borrowers. It works with the banks to facilitate the deal, but the importer gets finance at a US treasury-backed rate. Such loans are proving to be a significant factor in the winning of overseas deals, since finance to purchase UK exports is priced too highly in comparison.

The UK government must work urgently with stakeholders to introduce an equivalent UK export fund through which finance can be raised and lent to buyers of UK exports, either by government directly or by banks, to ensure the UK is not at a competitive disadvantage for winning export orders.

International experience suggests that such a vehicle need not necessarily add to the measured fiscal deficit. The US Export-Import Bank has a default rate of less than 2%, and delivers a net positive of return for the Treasury, returning more than $4.9bn since 1990.[13]



Recommendation 15
UK Export Finance should investigate the cost and feasibility of introducing an 'agreed guarantee limit' with partnering banks, under which applications for UK Export Finance guarantees can be fast-tracked providing they meet a pre-agreed risk profile

Applying for UK Export Finance guarantees, in terms of documentation and credit scoring in particular, is time-consuming and resource intensive for the exporter and for the bank or broker involved. The contract bond support application form, for example, is some 33 pages long and requires a raft of detailed information from the exporter in question, for each contract bond application. This in itself can act as a deterrent to the first time exporter, especially for smaller firms. While appropriate due diligence is essential, it should also be proportionate.

For exporters looking to react quickly to an export opportunity, the current model of applying for UK Export Finance support means that the time-frames can be too long, resulting in the buyer facing the choice of a non-ECA-backed finance option at too high a cost, or no export finance support at all. More often than not this simply results in a foreign competitor, with backing from its ECA, winning the contract in place of its UK rival.

Working with stakeholders, UK Export Finance should investigate the cost and feasibility of introducing an 'agreed guarantee limit' with partnering banks, under which applications can be fast-tracked providing they meet a pre-agreed risk profile. The partner bank would be able to make an export finance offer, backed by UK Export Finance, in a time frame fit for exporters to respond to short-term export opportunities and which would be viable in the mass market.

Encouraging large firms to play full part in recovery as 'growth anchors'

Large firms underpin much of the rebalancing that needs to take place in the economy. They are large contributors to the economy in their own right, for example employing almost half the private sector workforce. But they also act as growth anchors, with many high-growth firms in their supply chains, and account for more than half of R&D spend in 2012.[14]

Not all of these companies face access to finance constraints. Larger firms tend to have better access to capital and equity markets and so are less reliant on traditional forms of bank lending to finance their needs.

But many are reluctant investors with significant uncertainty still facing the economy.

If the government can address these concerns and we see confidence start to return, it should also then begin to look at ways to incentivise growth anchors to invest directly in the economy. Of course, investing directly will not be appropriate for all firms, but for those for whom it makes senses, government can encourage them further. The prize is significant, with large corporates currently sitting on significant cash reserves in the order of £350bn above their normal level.

Recommendation 16
Reinstate a Corporate Venturing tax incentive

Growth anchor business investment can be damaged if smaller firms, potentially in their supply chain, are constrained. So it makes sense to look for new ways to encourage these large corporates to put their cash reserves to productive use. We recommend the government reinstates a Corporate Venturing tax incentive to encourage those large corporates, for whom it makes sense, to invest and get cash off their balance sheets and into the economy.

Many large firms are also increasingly supporting their supply chains by sharing knowledge, best practice and helping to up-skill workforces. The government should look at ways to facilitate and incentivise this further.

It is understandable that large corporates are cautious about investing at the moment; muted demand makes holding fire an attractive option. But if the government can ease refinancing concerns, incentivise investment from those large firms for whom it makes sense, and strengthen links between growth anchor companies and smaller firms in relevant sectors, then we are confident that large corporates can play an even bigger part in economic recovery and growth than they already do.

Summary of recommendations

Measures to smooth the transition to a 'new normal'...

Ensuring regulation is fit for recovery	Regulators should put an immediate end to UK 'super-equivalents' on capital and liquidity requirements at this point in the economic cycle so that banks can play their full part in supporting the recovery. (**Rec 1**) The government must include specific growth objectives for the new financial regulators in the UK. (**Rec 2**) The government must lobby the European Commission to change its approach to the Solvency 2 directive to ensure that it makes commercial sense for insurers to invest in infrastructure. (**Rec 3**)
Actively supporting areas of the economy that have seen bank finance retreat substantially	The government should give a further boost to the housing and construction sectors by: • Taking action on NewBuy by increasing the government's risk-share and considering extending the scheme to a broader range of LTV mortgages (**Rec 4**) • Providing an additional £400m of funding for the FirstBuy scheme (**Rec 5**) • Utilising part of the Funding for Lending scheme specifically for housing. (**Rec 6**)
Working to ensure that all viable SME lending propositions do not slip through the net	The government should establish a 'one-stop-shop' approach to business lending support. (**Rec 7**)
Taking action to overcome the substantial wave of corporate refinancing approaching over the next four years	For any further rounds of quantitative easing the Bank of England should now seriously consider investing directly in non-government assets, such as bank bonds and high-grade corporate paper. (**Rec 8**)

Reforms to help refocus finance squarely behind a rebalanced economy...

Urgent implementation of measures to support high-growth, MSBs	The costs associated with raising equity finance should be made tax deductible, putting it on a par with debt finance. (**Rec 9**) The EIS should be expanded so that it can support the growth of MSBs by increasing the threshold and securing State Aid approval for the expansion of the scheme. (**Rec 10**) The government should facilitate the introduction of retail bond products to support the deepening of the UK corporate bond market as a debt alternative to traditional bank finance. (**Rec 11**)
A clear focus on boosting exports by shaping trade financing regulation, coupled with new products to support UK exporters	The government must lobby so that the trade finance elements of CRD IV do not cut across a push to significantly raise our game on exports. (**Rec 12**) The government should ask the FSA to review the liquidity requirements on UK Export Finance backed contracts to reflect the risk-profile of the transactions. (**Rec 13**) The government should create a new UK export fund through which finance can be raised and lent to buyers of UK exports either by government directly or by banks. (**Rec 14**) UK Export Finance should investigate the cost and feasibility of introducing an 'agreed guarantee limit' with partnering banks, under which applications for UK Export Finance guarantees can be fast-tracked. (**Rec 15**)
A further incentive to encourage large firms to play their full part in recovery as 'growth anchors'	Government should reinstate a Corporate Venturing tax incentive to encourage those large corporates, for whom it makes sense, to invest and get cash off their balance sheets and into the economy. (**Rec 16**)

References

1 BDRC Continental, *SME Finance Monitor*, May 2012

2 Ibid

3 Bank of England, *Credit Conditions Survey*, Q2 2012

4 Standard & Poor's, *The Credit Overhang: Is $46 Trillion Perfect Storm Brewing*, May 2012

5 Bank of England, *Credit Conditions Survey*, Q2 2012

6 Speech at the Lord Mayor's dinner for bankers and merchants of the City of London by the Chancellor of the Exchequer, Mansion House, 14 June 2012

7 Ibid

8 Banks and building societies that increase lending to UK households and businesses will be able to borrow cheaply relative to their own funding costs from the Bank of England, and do so at lower cost than those that scale back lending. For more details: http://www.bankofengland.co.uk/publications/Pages/news/2012/067.aspx

9 For more information about CBI M-Clubs, please see http://www.cbi.org.uk/campaigns/future-champions/m-clubs/

10 CBI, *A Vision for Rebalancing the Economy*, December 2011 – http://www.cbi.org.uk/campaigns/a-vision-for-rebalancing-the-economy/

11 Breedon Review, *Boosting Finance Options for Business*, March 2012

12 CBI, *Winning Overseas*, November 2011 - http://www.cbi.org.uk/campaigns/increasing-exports/

13 Export-Import Bank of the United States, 2011 Annual Report – http://www.exim.gov/about/reports/ar/2011/index.html

14 ONS, *Statistical bulletin: UK Business Enterprise Research and Development*, 2010 – http://www.ons.gov.uk/ons/rel/rdit1/bus-ent-res-and-dev/2010/stb-berd-2010.html

For further information on this report, or for a copy in large text format contact:

James Leviseur
Senior policy adviser
CBI
T: +44 (0)20 7395 8272
E: james.leviseur@cbi.org.uk

CBI
Our mission is to promote the conditions in which businesses of all sizes and sectors in the UK can compete and prosper for the benefit of all.

To achieve this, we campaign in the UK, the EU and internationally for a competitive business landscape.

www.cbi.org.uk

Product code: CAG_CAG_301