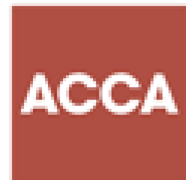


FINANCING A PRIVATE SECTOR RECOVERY

Evidence from ACCA
September 2010

Introduction

ACCA is the largest and fastest-growing international professional accountancy body with 131,500 members and 362,000 students in 170 countries, whom we support through a network of 80 staffed offices and centres around the world. ACCA is headquartered in London and 54,000 of our members and over 60,000 of our students are UK-based. More than half of our membership either work in or advise small and medium-sized enterprises (SMEs).

ACCA welcomes the opportunity to respond to the Government's consultation on *Financing a Private Sector Recovery*. Consistent with the activities of our membership, our response is focused on the financing conditions facing small and medium-sized enterprises (SMEs) and on the solutions that we believe are most suitable for such businesses.

Accountants are the financial advisers of choice for small and medium-sized enterprises; as such our members in the UK and around the world have been at the forefront of business support in these challenging times and will continue to support SMEs through the recovery. Our response is also guided by the views of the ACCA SME Committee, an independent panel that brings together small business owners, practicing accountants, leading academics, small business representative bodies and lenders. It is the only non-governmental group that encompasses such a broad membership.

General Evidence Base

1. Do you agree with the evidence base as set out in this paper? Are there any additional issues that should be considered?

1.1 Broadly speaking, ACCA agrees with the evidence base presented by the Green Paper. However we believe that the important issue of trade credit merits additional attention.

1.2 The Green paper suggests that SMEs are "almost entirely reliant on banks" for external finance, which is simply not the case. Trade credit is a very large financial market, with flows of credit to SMEs outweighing bank lending by a factor of two to one.[1] Even late payment, the more problematic aspect of this market, represents a substantial source of credit, with £24bn of payments to SMEs currently outstanding.[2] Our recent joint research with the Confederation of British Industry (CBI) suggests that SMEs have been more likely to tap their suppliers than their banks for credit over the last year (see Table 1), and that this trend is set to continue, especially among smaller or more cash-strapped SMEs.

1.3 This research, as well as findings from BACS and the Quarterly Survey of Small Business in Britain[3] suggests that SMEs have become much more proactive in tightening credit terms and chasing up late payments over the last year, with late outstanding payments falling by 7% in 2009.[4] This is good news and BIS should take some credit for its work with the Institute of Credit Management (ICM) and accountancy bodies in promoting the Managing Cashflow Guides for SMEs.[5] Our concern, however, is that SME owner-managers generally treat trade credit as a commercial, not a financial, issue. Credit risk is assessed in very informal ways, or against much more dated information than SMEs would tolerate for management purposes, and usually without recourse to important resources such as credit references. This suggests a need to educate SME owner-managers in credit management and improve the supply of credit information.

1.4. Overall, the Government needs to bear in mind that all SMEs are potentially trade creditors and that credit risk is systemic, carried across regions and sectors by supply chains.[6] However, unlike banks and other formal credit providers, government has no way of ensuring that SMEs in the real economy are properly capitalised to deal with credit risk, and this market can fail both in a downturn and in the subsequent recovery – therefore the need for better credit management is that much greater.

Table 1: Demand for finance over the last 12 months			
Source of new or additional finance	Demand	Success rate*	Use (Demand x Success Rate)
Banks – Overdrafts	33%	73%	24%
Banks – Term loans	22%	73%	16%
Banks - Factoring, invoice discounting or other asset-based	8%	75%	6%
Other commercial credit providers – Loans	11%	69%	8%
Other commercial credit providers - Factoring, invoice discounting or other asset-based	10%	82%	8%
Suppliers - within agreed terms	29%	91%	26%
Suppliers - through late payment	17%	89%	15%
Owners / Directors / Friends and family of owners / directors	21%	94%	20%
Customers (e.g. through discounts for early payment)	9%	87%	8%
Other creditors	7%	82%	5%

* "Success" indicates that the SME managed to obtain at least some of the funds applied for.
Source: ACCA & CBI (2010)

2. Do you think greater certainty over future tax and regulation would have a significant impact on current demand for or supply of business finance?

2.1 Earlier this year, ACCA's SME Committee called on the Government to proceed boldly with a programme of tax simplification, but noted that there should be clarity on the incentives that the tax system should provide before this is undertaken.[7] Tax influences the relative attractiveness of debt over equity financing, and of reinvestment over distributing earnings. If the government truly favours a rebalancing of SME capital structures away from debt and towards equity, this should be reflected in tax reform.

2.2 A major regulatory issue which deserves a great deal of attention is the implementation of enhanced banking regulation and capital requirements in the aftermath of the financial crisis of 2008-9. The past two years have seen a great number of proposals, in the UK and abroad, to help prevent a new crisis, of which many could have repercussions for lending and equity finance. Overall, we believe that no initiatives should be seriously considered, in the UK or abroad, without a thorough assessment of their impact on lending to or investment in smaller businesses. By way of illustration, we discuss in greater detail the impact of the most important of these, Basel III, in Section 13.

Equity Markets

3. Are there any regulatory obligations that may disproportionately deter SMEs from listing on exchange-regulated markets such as AIM and Plus Quoted? What can be done to address this?

3.1 Several of the costs involved in listings are fixed or fairly inelastic and can therefore increase the cost of capital for small issues to as much as 20% of the funds raised; lawyers' fees are often mentioned as the most important cost as regulatory requirements are largely inflexible.[8] A proportionate regulatory regime could thus achieve a substantial reduction in the fixed element of listing costs and pave the way for more SME listings.

3.3 It is, however, very important to note that the regulations responsible for the oversight of such markets are largely not British but European in origin. Therefore the Government should prepare for the possibility that it will have to use its influence in Europe (notably DG Internal Markets and the European Securities Markets Authority) to achieve the desired results. The regulations with the largest potential impact on SME listings are:

- The Prospectus Directive
- The Transparency Directive
- The Markets in Financial Instruments Directive (MiFID)
- The Market Abuse Directive (MAD)
- The Alternative Investment Fund Managers (AIFM) Directive
- The Undertakings for Collective Investment in Transferable Securities (UCITS) Directive
- The Solvency II Directive
- The Capital Requirements Directive (Basel III)

3.4 In particular, we would refer the Government to the findings of the report carried out for the French Ministry of Economy, Industry and Employment by Mr. F. Demarigny of Mazars.[9] Although ACCA does not endorse the recommendations of the Demarigny report in their entirety[10], we believe that this review at least offers an accurate and comprehensive diagnosis of the regulatory barriers to small listings in Europe.

3.5 Simplification of regulatory requirements should of course not be undertaken lightly, especially if a broader range of investors are to be attracted to (or allowed to invest in) small listings. In considering how disclosures can be made more proportionate, the Government may want to consider in some detail what disclosures are required by individual investors such as business angels, who can typically achieve a genuine improvement to returns through as little as 20 hours of due diligence.[11]

5. How can Government ensure that the best small businesses in all parts of the UK are visible to publicly backed venture capital funds? Should Government intervention to address the equity gap focus on the best firms regardless of geography, or seek explicitly to address regional economic disparities? The Government would be particularly interested in views on regional stock exchanges.

5.1 The 2007 Survey of SME Finances demonstrated conclusively that, all other things being equal, businesses with access to financially qualified managers and/or an external accountant's advice were more likely to be aware of regional venture capital funds and investment-readiness support schemes.[12] Additionally, the Rowlands Review also found that accountants provide an important source of referrals for Private Equity and Venture Capital funds.[13]

5.2 ACCA believes the Government should continue to work closely with professional accountants, which have consistently been found to be SMEs' preferred financial, regulatory and businesses advisers.[14] Developing more accountants into active equity intermediaries would go a long way towards establishing equity as a viable option for financing SMEs;[15] as a professional body we have a responsibility to contribute to this process and will be happy to collaborate with Government and other partners.

5.3 Apart from increasing awareness and referrals by further involving successful intermediaries, the Government needs to consider initiatives to improve investment-readiness among owners and managers of growth enterprises.[16] Even in these difficult times, equity investors such as business angels are more constrained by the lack of opportunities than by the lack of funds.[17] Helping SMEs understand the benefits of equity and how to better signal their value to potential investors should therefore be a priority. Investment-readiness training has been shown to improve a business' chances of receiving funding[18] and training for trusted advisers such as accountants, who can in turn help develop awareness among owner-managers, could amplify this effect.[19]

5.4 ACCA has in the past considered proposals for regional stock exchanges; we appreciate the need to rebalance many of the UK's regions economies away from the public sector and to release the development potential of growth SMEs, almost half (45%) of which are based in deprived areas.[20] As with any market, regional stock exchanges will need substantial liquidity to give investors confidence in price discovery and to assure entrepreneurs and venture capitalists that they will receive a fair valuation. A compromise must be struck, however, because strong regulatory and governance requirements attract liquidity but tend to limit the number of viable listings. Stock exchanges aimed at SMEs can only be a good idea if they can manage this trade-off, and evidence from around the world suggests that this is a difficult balancing act.

5.5 In reality, even fairly mature markets such as AIM can suffer from poor liquidity and tend to allocate a disproportionate amount of what liquidity there is to the largest listings by capitalisation. The Demarigny report suggests that the top 7% of listed companies (by capitalisation) attract over 93% of the available liquidity, creating massive disincentives for small issuers. These, in conjunction with regulatory developments to which the UK has also been subject, have contributed to a secular decline in small listing activity over the last decade.[21]

5.6 Second, it is important to specifically target early-stage equity investors and ensure that regional stock exchanges, if implemented, are specifically designed to provide appropriate exits for these investors, which are currently scarce.[22] This could benefit SMEs by not only increasing the amount of equity finance raised through listings but, perhaps more importantly, increasing the amount of equity finance raised through early-stage investment. Thus regional stock exchanges will require the development of clusters of cradle-to-grave financing *and* business support services if they are to succeed.

5.7 However, if such service clusters can be built successfully then the physical infrastructure of a regional stock exchange is not necessary: the regional financial and business support cluster could assist local firms to launch an IPO in London, or indeed any other financial centre, thus taking advantage of higher levels of liquidity. The passport provisions of the AIFM could in fact facilitate this.[23] Such a model would, in theory, allow the Government to maintain a regional focus in its investment but would not dictate sub-optimal capital allocations.

5.8 Regardless of the exact organisation of regional stock exchanges, we would urge the Government to consider the recommendations of the recent report on SME financing commissioned by the City of London Corporation, and in particular the options suggested for ensuring liquidity for small business listings.[24] The first is to allow AIM/Plus (and possibly regional stock exchange) stocks to be used for ISAs. The second is to enhance the Venture Capital Trust (VCT) schemes in order to allow tax breaks for equity investors in regional SME equity.

7. How could more high-net-worth individuals be encouraged to become Business Angels and participate in larger deals through syndicates? Are there specific issues impeding business angel activity that the Government should address, such as investor readiness or the structure of publicly-backed venture capital funds?

7.1 ACCA is proud to be part of the BIS Business Angels Data group, which in 2009-10 managed the production of the first-ever Annual Report into the Business Angel Market. The evidence compiled for this report suggests to us that the business angel market is consolidating rapidly around angel networks whose administrative, due diligence and capacity-building functions can generate value for investors. Business models for angel networks vary substantially and not all are equally successful, which suggests an important subject for further research.[25] Government could encourage or even subsidise appropriate structures, but will only be able to do so once it has a clear understanding of how successful angel networks work.

7.2 The findings of the first Annual Report suggest that, with time, the share of network members actively investing tends to fall, so the membership of angel networks needs to be continuously refreshed. Therefore the matter of recruitment of business angels is of crucial importance. Elsewhere in this response we discuss in some detail various incentives and disincentives for would-be investors to become business angels, so we will not repeat this analysis here. However, it is important to discuss a more structural shortcoming of the UK business angel market, highlighted in investors' feedback at the launch of the BIS report in July 2010: the lack of awareness and coherence of angel investment as an asset class. As with any asset class, would-be angel investors want to know:

- **how liquid the assets are:** this would involve an overview of the range of exit opportunities, from trade sales to public listings, the liquidity of SME equity markets and the level of interest from potential counterparties

- **how long they should expect to remain invested:** the average holding period is estimated at 3.6 years and could be lengthening in the aftermath of the financial crisis of 2008-9 as Business Angels find themselves participating in additional investment rounds

- **what returns investors can expect and what level of risk they are undertaking:** the average internal rate of return among angel investments is estimated at 22%, but the risk is very substantial, with the median rate of return estimated at just below zero[26]

- **how such investments are treated for tax purposes:** it is important to highlight the full range of incentive schemes for equity investors, without which about 24% of angel investments would not take place. Some investors may be unaware of recent changes to the geographical scope of these incentives which greatly improve access for investors interested in internationally focused businesses.[27]

7.3 The Government and its partners could do more to promote awareness of these facts and support research to provide better documentation. This is very important because an emphasis on tax incentives alone could lead to adverse selection by luring business angels away from the sectors in which they have appropriate expertise, or reduce the additionality of tax incentives by supporting investments that would have taken place regardless. Furthermore, as the Government moves to streamline business support and reduce costs, relying on support to investors and angel networks alone could be a very costly and complex approach to encouraging angel investment.

8. How can eligible businesses help themselves to become 'investment ready' for equity finance? Where should this be done by private sector, market-led solutions? What role is there for Government in supporting this, and should intensive Government support be focussed on businesses with high growth potential?

8.1 In our view, the question is not whether or not Government should focus on businesses with high growth potential. Equity finance on anywhere near commercial terms is only really available to such firms in the first place, and government interventions on any other terms would fall foul of European State Aid rules. The question, rather, is how Government should go about identifying high-growth businesses. Here the experience of two decades of business support suggests that Government should not be tempted into a return to "picking winners" – even experienced venture capitalists cannot do so more than half of the time.[28]

8.2 It is possible, however, to target growth firms indirectly. For instance, general support for exporters, or businesses investing in intangible assets, is bound to direct assistance towards businesses with high growth potential. We discuss this possibility in more detail in section 12.4.

9. How effective are current tax incentives for equity investment in small businesses, such as the Enterprise Investment Scheme (EIS) or Venture Capital Trusts (VCTs)?

9.1 At the smaller end of equity investment where market inefficiencies are greatest, Government can never hope to provide uniform incentives. A lot of angel activity is very informal and business angels are intensely private about their investments.[29]

9.2 Overall, however, we believe that EIS in particular provides an important and effective incentive. According to HMRC, the EIS has to date raised almost £6.3 billion, which has been invested for around 14,500 small companies, while VCTs have raised £3.5 billion for over 1,500 small companies.[30] Evidence suggests that the majority of business angels are aware of and use EIS, although appropriately only a minority of smaller investors rely on it exclusively.[31] All told, EIS is used in over half of all angel investment (57%) and is essential to about a quarter (24%) of it. It affects the investment decisions of about half (53%) of the angel population.[32] This suggests that the majority of EIS-enabled investment (though by no means all of it) would not have taken place without an incentive. Perhaps more importantly, it appears that EIS-enabled investment has been less sensitive to the economic downturn in 2009, falling by 25-30% instead of the 30-40% fall recorded by business angel networks overall.[33]

9.3 These facts will, for many, constitute a case for strengthening these incentives, but in our view the terms on which tax relief is provided are as important as the headline rate of relief. Recent changes undertaken to ensure State Aid compliance have made the venture capital schemes, including EIS and VCTs, as well as Enterprise Management Incentives (EMI) more flexible by relaxing the limitations on where target companies can carry on their activities and where VCTs can be listed.[34] Because UK businesses can generally only achieve rapid growth if they do business internationally,[35] lifting this restriction will, in our view, make a substantial difference to the use and effectiveness of these schemes.

Competition

11 What more could be done to promote greater competition in the provision of business finance?

11.1 The ability of customers to switch between different finance providers is the ultimate test of the competitiveness of small business banking. In a recent small-scale survey of ACCA members in practice, more than three quarters reported that their SME clients had considered switching banks.[36] As a rule, however, SMEs are not very likely to switch banks, even though they might often consider this. There is a general perception that switching banks is an arduous process even though SMEs that have tried this have found it to be fairly convenient.[37] This fact should be publicised much more widely.

11.2 However, many Government interventions have, over the past years, served to limit intervention rather than enhance it, and many proposals aimed at improving access to finance for SMEs could have the same effect. For instance, proposals for a process of SME credit arbitration could serve to further restrict competition by encouraging businesses to stay with lenders they are clearly dissatisfied with. Instead, support mechanisms should be biased towards increasing competition. Our preferred alternative to the process of credit arbitration would be one whereby loan applications rejected by a bank are forwarded, along with the relevant financial information and transaction histories, to rival banks who would then have a chance to offer the applicant the desired loan.

11.3 One further issue which we believe merits the Government's attention is the high level of concentration in the intermediation of government support. For instance, a single bank (Barclays) is known to provide about 40% of all EFG-guaranteed funding, while 65% of all European Investment Bank (EIB) loan guarantees in the UK are used by a single bank (Lloyds TSB).[38] The Government should consider why this is the case and try to ensure the participation of more lenders.

12. What other actions could be taken to help businesses (of all sizes) access a wider range of different finance options?

12.1 The Green Paper correctly points out that SMEs are not always willing or able to access adequate financial advice, thus often making financial decisions based on incomplete information. In fact, the average UK SME is more likely to go without any financial advice at all than use even the most popular source of financial advice (an accountant), despite clear evidence that those that do so are rewarded with access to a broader range of finance.[39]

12.2 Our concern is that SMEs' demand for financial advice is tied to the active demand for external finance, which is likely to remain subdued for some time, and that the damage to lenders' credibility could further limit SMEs' access to financial advice. These trends suggest that demand for advice could fall, as it has in previous recessions and recovery periods.[40] In this case, the lack of financial skills within SMEs themselves could become particularly problematic. Here too the evidence suggests that the skills of owner-managers as well as financial staff can make a great deal of difference, yet only around a quarter of SME owner-managers are aware of training opportunities available in this area.[41]

12.3 Our recent joint research with the CBI[42] suggests that, even when controlling for a range of relevant variables including the strength of their cash positions, micro-enterprises are genuinely more likely to be turned down when applying for bank loans and overdrafts than larger SMEs. In our view this is more likely due to a lack of collateral and information rather than a bias on the part of lenders. Of these, the latter can be addressed by educating micro-enterprise owner-managers to produce the kind of information that is of value to lenders. Here too we see a role for business support, whether privately or publicly funded.

12.4 One implication of the importance of cash and collateral to lending decisions is that more innovative SMEs that rely on research and development (R&D) or intangible assets could find themselves at a disadvantage when applying for finance.[43] These businesses need substantial amounts of finance but will often be unable to pledge assets of comparable value as collateral. While credit of one type or another may not be suitable for some of these,[44] our findings raise the question of whether outcomes could be improved for these crucial businesses[45] through appropriate business support. In particular, we believe that SME owner-managers need help identifying intangible assets, protecting them and reporting on their value.[46] We believe that appropriately trained and informed private sector advisers could, by advising on such issues, help SMEs achieve better outcomes when applying for credit or raising equity finance.

12.5 ACCA has been supportive of the decision to scrap Business Link and it would not make sense for us to advocate costly new business support solutions to these problems. Instead we (and other accountancy bodies) are working to make the most of the Funding Adviser Scheme, whereby SMEs can seek out professional accountants specialising in raising finance for business in their particular circumstances.[47] We would urge the Government to highlight this option in its guidance to SMEs and with us where possible to make the Scheme more effective. We have in the past also suggested that the Government could consider diverting a very small share of the UK's substantial but underutilised skills funding budget to upgrading the financial skills of owner-managers.[48]

12.6 Our joint research with the CBI has furthermore suggested that, as with bank lending, the system of business grants is also providing an uneven playing field for the smallest SMEs, which are much less likely to successfully tap into grants (see Table 2). As with public procurement, the grants system partly rewards the ability to navigate complex government structures and write successful tenders – a source of advantage for larger firms which are able to devote substantial resources to this task.[49] As the Government continues to streamline business support, we believe it will have to address the trade-off between the increased relevance of regional or sector-focused grants and the more level playing field provided by more centralised funding schemes. In this respect, the Government could learn valuable lessons from the progress made so far in improving small businesses' access to public procurement.

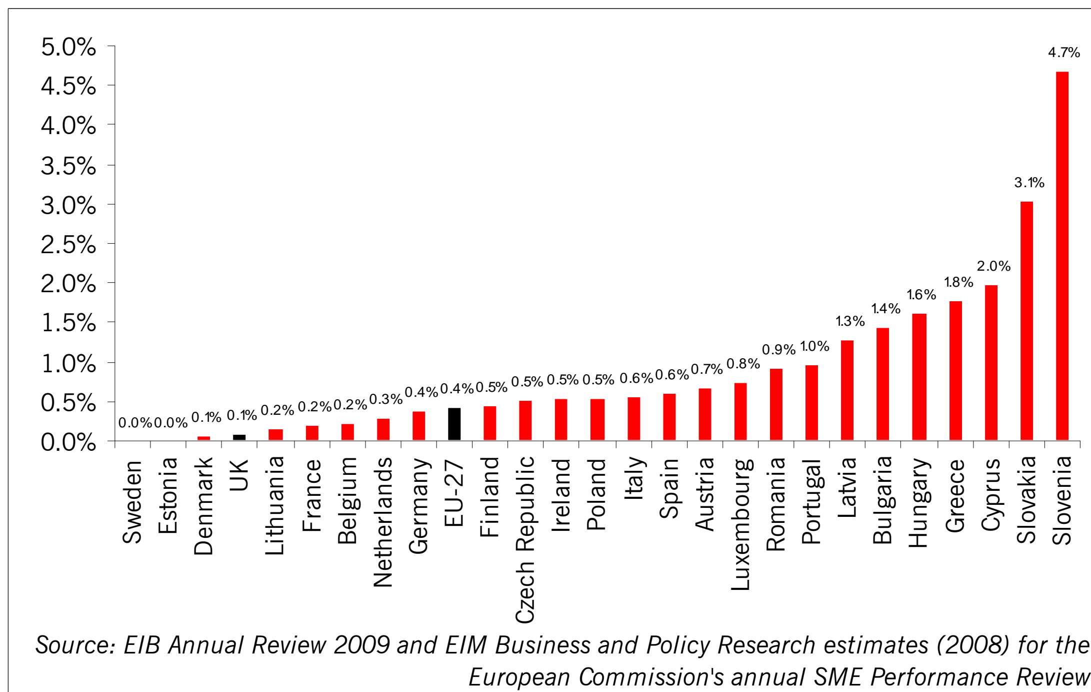
12.7 Finally, the Government needs to consider carefully the relative under-representation of UK SMEs among the beneficiaries of EIB loan guarantees. In 2009, UK SMEs used 3.9% of the EIB's total credit lines to European Businesses, down from 4.2% in the previous three years. These credit lines were equal to just 0.1% of UK SMEs' Gross Value Added (GVA). This is less than a quarter of the EU-wide ratio and substantially lower than the ratio for other major European countries such as France or Germany (see Fig. 1).[50]

Table 2: Awareness, interest in and use of government grants by business size

	Employment			Turnover		
	0 to 9*	10 to 49*	50 to 249	Less than £1m*	£1m to £5.6m*	Over £5.6m
Awareness	41%	30%	37%	44%	28%	37%
Interest, % of those aware	24%	39%	54%	30%	38%	52%
Use, % of those aware	9%	24%	40%	12%	32%	35%

Source: ACCA & CBI (2010) * Small sample (between 30 and 50 observations)

Figure 1: EIB credit to European SMEs by country as a share of SME GVA



Source: EIB Annual Review 2009 and EIM Business and Policy Research estimates (2008) for the European Commission's annual SME Performance Review

Addressing Future Risks

13. Looking ahead, what are your views on future risks to the provision of business finance, in particular bank lending? If you have concerns, do these reflect transitional factors in the wake of the financial crisis, or structural factors? Are there steps that the banking sector, regulators or policy makers should be taking to mitigate these risks?

13.1 As suggested earlier, this is a good opportunity to stress the importance of the new Capital Requirements Directive (Basel III) for the future of SMEs' access to finance. It is clear, in light of the financial crisis and recent concerns about the strength of European banks, that capital requirements and banking regulation in general need to be strengthened. Our concern, however, is that, with small business loans accounting for nearly half (46%) of the risk-adjusted assets of major retail banks,[51] there is a possibility that poorly-designed capital requirements or sub-optimal responses by the banks could hit the growth prospects of small businesses in the UK and elsewhere very hard. In its recent impact assessment, the Bank of International Settlements (BoIS) has estimated that higher capital requirements will only have a modest effect on economic growth, but has been unable to model their effect on lending to SMEs – something which it readily acknowledges as a risk to its estimates. We note the BoIS' expectation that the effect on SMEs is likely to be disproportionate.[52]

13.2 Of course, it is only fair that Governments should be willing to tolerate some reasonable loss of potential output and employment among SMEs in order to ensure a more stable banking system. However, in the absence of an appropriate impact assessment there is no way of knowing how great the impact of new capital requirements (Basel III) will be on lending to UK SMEs. This needs to be carefully assessed and, if possible, UK banks should be strongly encouraged to signal their intentions.

13.3 Based on the BoIS Impact Assessment and calculations carried out for the European Commission's research on the cyclicality of SME finance,[53] ACCA can offer some very tentative estimates of the impact of Basel III for the Government's consideration (Table 3). It is clear from these estimates that the impact of new capital requirements on SMEs' access to finance is likely to be substantial – especially considering the impact on overdraft lending, which has proven to be much more volatile than term loans.[54]

13.4 The effects of Basel III and even Solvency II on equity investment are likewise very likely to be substantial; here too a careful impact assessment (perhaps at the European level) will be essential if the Government is to fully appreciate medium-term trends in SMEs' access to finance.

Table 3: Simulation of the effects of Basel III on small business lending

	EIM simulation (2009) GDP contraction scenario			BoIS simulation, 18 months on Banks' use of capital conservation buffer	
% Changes				Use	Avoid
GDP	-1.5%	-2.5%	-4.0%	-0.6%	-1.1%
Bank loans to small businesses	-3.0%	-5.0%	-7.9%	-1.2%	-2.1%
Bank loans to medium-sized businesses	-4.4%	-7.4%	-11.8%	-1.8%	-3.2%
Factoring	-10.3%	-17.1%	-27.4%	-4.1%	-7.4%
Leasing	-6.8%	-11.4%	-18.2%	-2.7%	-4.9%
Venture capital	-19.2%	-32.1%	-51.3%	-7.7%	-13.9%

Sources: BoIS (2010) and Ruis et al (2009). Note: these estimates are based on the BoIS standards-based models with endogenous monetary policy (GDP weighted average of 11 models).

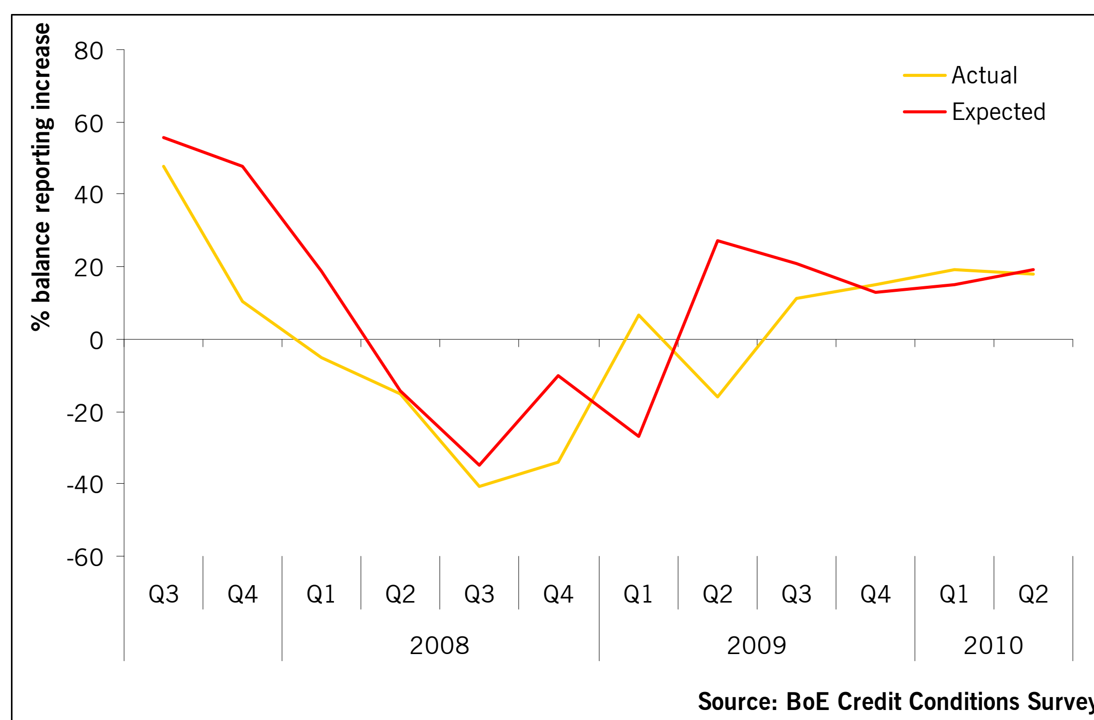
Banking Sector Environment

14. What steps can banks, industry or Government take to strengthen banks' relationships with their customers and ensure businesses are not discouraged from seeking finance? What steps can the banking sector and others take to improve the financial readiness of business?

14.1 Although it can be difficult to prove the existence of discouraged demand, ACCA believes there is significant evidence of this based on the borrowing intentions of SMEs.[55] What is sometimes overlooked by SME advocate groups and other commentators is that, when such perceptions are prevalent, publicly denouncing banks' lending policies can only exacerbate the problem as more SMEs become convinced that the banks will not lend to them. What few hard facts there are on lending to SMEs are in fact much more encouraging than the anecdotal evidence.

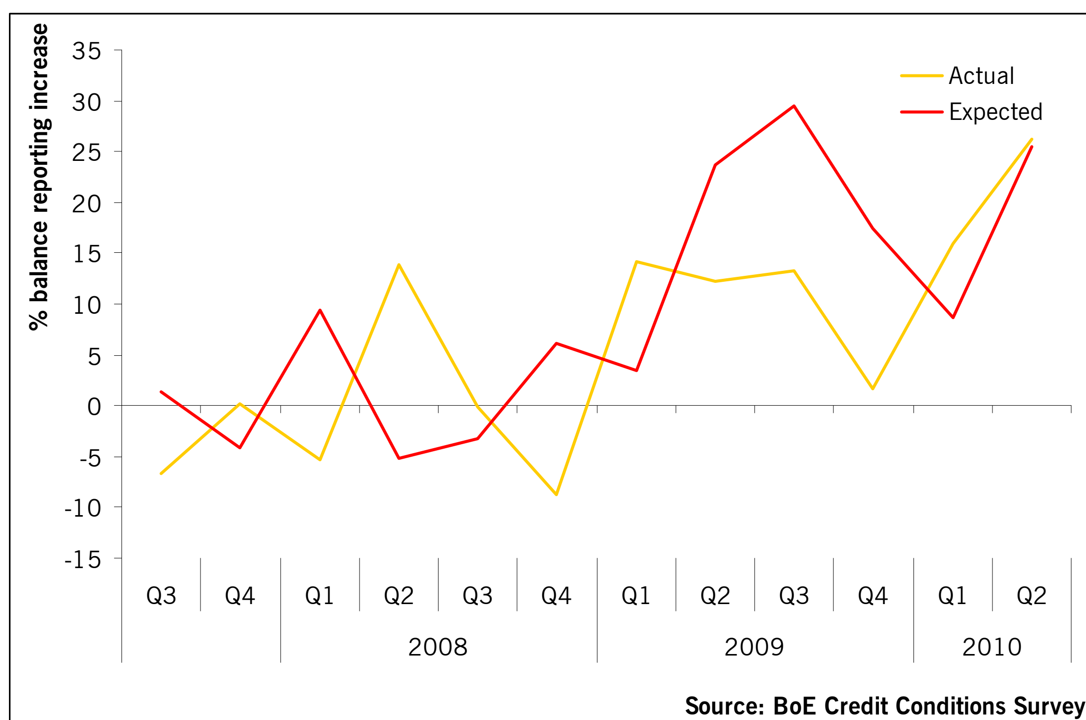
14.2 In the face of discouraged demand as well as genuine uncertainty about SMEs' financing needs and the strength of the recovery, we believe that the Government should avoid any further pronouncements of SME lending targets. Since the first glimpses of recovery in 2009, lenders have consistently overestimated small businesses' demand for finance (see Fig. 2 and 3),[56] and have therefore made commitments they were subsequently unable to meet. Additional commitments by the banks to particular levels of SME lending are unlikely to change SMEs' perceptions, and will almost certainly also remain unmet.

Figure 2: Small business' real and expected demand for secured lending



Source: BoE Credit Conditions Survey

Figure 3: Small business' real and expected demand for unsecured lending



Source: BoE Credit Conditions Survey

14.3 One important priority is for both the banks and the Government to communicate to SMEs that the majority of applicants for new finance tend to receive some or all of the funds they have applied for (see Table 4). Our joint research with the CBI suggests that approval rates are now as high as they were in mid-2007, with 73% of SMEs applying for new bank loans receiving at least some of the funds they were looking for.

14.4 Second, it is important to communicate the crucial influence of cashflow on lending decisions. Although SMEs with stronger cash positions are less likely to apply for additional bank loans and indeed most types of finance, they are much more likely to succeed in obtaining funds. When managing their cashflow, SME owner-managers are primarily concerned with maintaining liquidity, not reassuring lenders; but it is clear that a more proactive approach to managing cash and communicating these policies to lenders can make a very big difference to the financing of all but the smallest of SMEs.

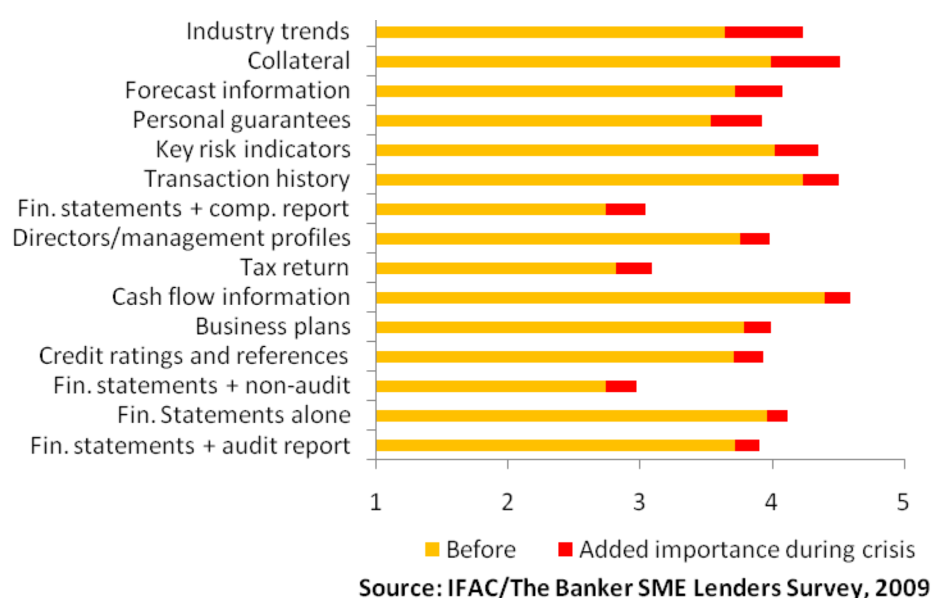
Table 4: Demand for finance and success rates, by strength of cash position

Type of credit applied for	Cash position: Weak or neutral	Cash position: Strong	Effect of cash strength	Cash effect significant after controlling for size & sector?
Demand				
Bank overdraft	48%	22%	-53%	***
Bank term loan	28%	17%	-40%	***
Banks - asset based	11%	7%	-42%	

Other commercial loans	16%	7%	-56%	***
Other commercial asset based	11%	8%	-27%	***
Suppliers within agreed terms	35%	23%	-35%	***
Suppliers through late payment	29%	9%	-68%	***
Owners' directors' family funds	32%	12%	-63%	***
Customers	16%	5%	-66%	**
Other creditors	11%	4%	-66%	***
Success rates				
Bank overdraft	64%	88%	+36%	***
Bank term loan	63%	84%	+33%	
Banks - asset based	71%	83%	+17%	
Other commercial loans	60%	92%	+54%	
Other commercial asset based	86%	80%	-7%	
Suppliers within agreed terms	86%	95%	+10%	*
Suppliers through late payment	89%	88%	-1%	
Owners' directors' family funds	93%	100%	+8%	
Customers	85%	90%	+6%	
Other creditors	79%	86%	+9%	
* p<0.1 ** p<0.05 *** p < 0.01. See Appendix 2				

14.5 Finally, it is important to clarify what information and other assurances banks want from SMEs so that businesses can be adequately prepared and engage appropriate advisers. Although as we suggested above cashflow statements and forecasts continue to be by far the most important type of information sought by lenders, research suggests that the priorities of lenders worldwide have shifted since the 2008-9 crisis and that more importance is now being placed on security and collateral, as well as forecasts and key risk indicators (See Fig. 4). [57]

Fig. 4: Factors affecting the decisions of lenders to SMEs, pre- and post-crisis



Source: IFAC/The Banker SME Lenders Survey, 2009

15. What options might Government consider to support increased lending to business (including possible expansion of the EFG or of payments to part of the supply chain)? How effective is the EFG in increasing access to debt finance for small businesses? What could be done to improve it and can more cost be borne by users?

15.1 ACCA has recently examined the effectiveness of the Enterprise Finance Guarantee (EFG) scheme in our joint research into SMEs' access to finance with the CBI. As Table 5 shows, awareness of the scheme is reasonably high, with only the Business Payment Support Service (BPSS) performing better, and interest is low but not unreasonably so. Success rates, however, are much lower than those for other types of financial support, which in effect means that only a very small number of SMEs (ca. 3%) have managed to obtain any funds through the EFG.

Table 5: Performance of Government finance schemes

Type of scheme	Aware	Interested, % of those aware	Successful, % of those interested
Tax deferral (e.g. BPSS)	48%	28%	79%
Loan guarantee from UK government funds (e.g. EFG)	43%	29%	23%
Direct grant	41%	41%	65%
Any scheme	87%	35%	70%

Source: ACCA & CBI (2010)

15.2 As the House of Commons Business and Enterprise Committee heard repeatedly in its recent inquiry into the effectiveness of the scheme, EFG is well-designed and well-calibrated. It is, however, severely limited in its scope by the types of financing needs targeted, by the restrictions of EU State Aid rules and by the fact that it is marketed solely by the lenders themselves, for whom it will only ever be a very marginal product. We refer the Government to our response at the time which is largely still relevant.[58]

15.3 Overall, we note that the dislocation in SME lending that was evident in late 2008 is not, barring a substantial double-dip recession, likely to be the Government's primary challenge over the next few years. Government will need to consider very carefully whether the EFG is still relevant in such an environment.

15.4 As early as December 2008, ACCA suggested to the House of Commons Business and Enterprise Committee[59] that the Government could, on a sector basis, encourage healthy and creditworthy large firms to finance or recapitalise their supply chains, offering credit facilities or obtaining stakes in small suppliers and other partners in return for injections of working capital. We therefore sympathise with proposals to facilitate supply chain finance and will be keen to work with the Government on such an initiative. Our joint research with the CBI has shown that interest in supply chain finance is on the rise among SMEs, even though the prerequisite levels of trust and information exchange will not always be present and first-time users of such arrangements will require a great deal of advice.[60]

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