

# Financing British Companies: evolution or revolution?

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# There is a long history of examinations of small firm finance in the UK



- The Macmillan Report in 1931 identified the ‘Macmillan Gap’: “the relations between the British financial world and British industry...have never been as close as in Germany and the United States.”
- Harold Wilson’s 1979 report on ‘The Financing of Small Firms’ argued that the gap remained.
- Bank of England reports on Small Firms Finance 1993 – 2004 saw problems of demand as well as of supply.

# The issue resurfaced in the financial crisis, and continues to generate controversy



“The Macmillan gap has blighted UK SMEs for perhaps a century, costing business jobs and growth. As the UK recovery reaches a firmer footing, there has been no better time to close it”

*Andrew Haldane, Bank of England, June 2014*

“SMEs rarely struggle to get credit if they want it”

*The Economist, October 2015*

1. Why is small business finance so important?
2. How are small firms funded?
3. How has that been changing and what can we expect in the future?
4. What lessons were learnt in the crisis and what is RBS/NatWest now doing differently?

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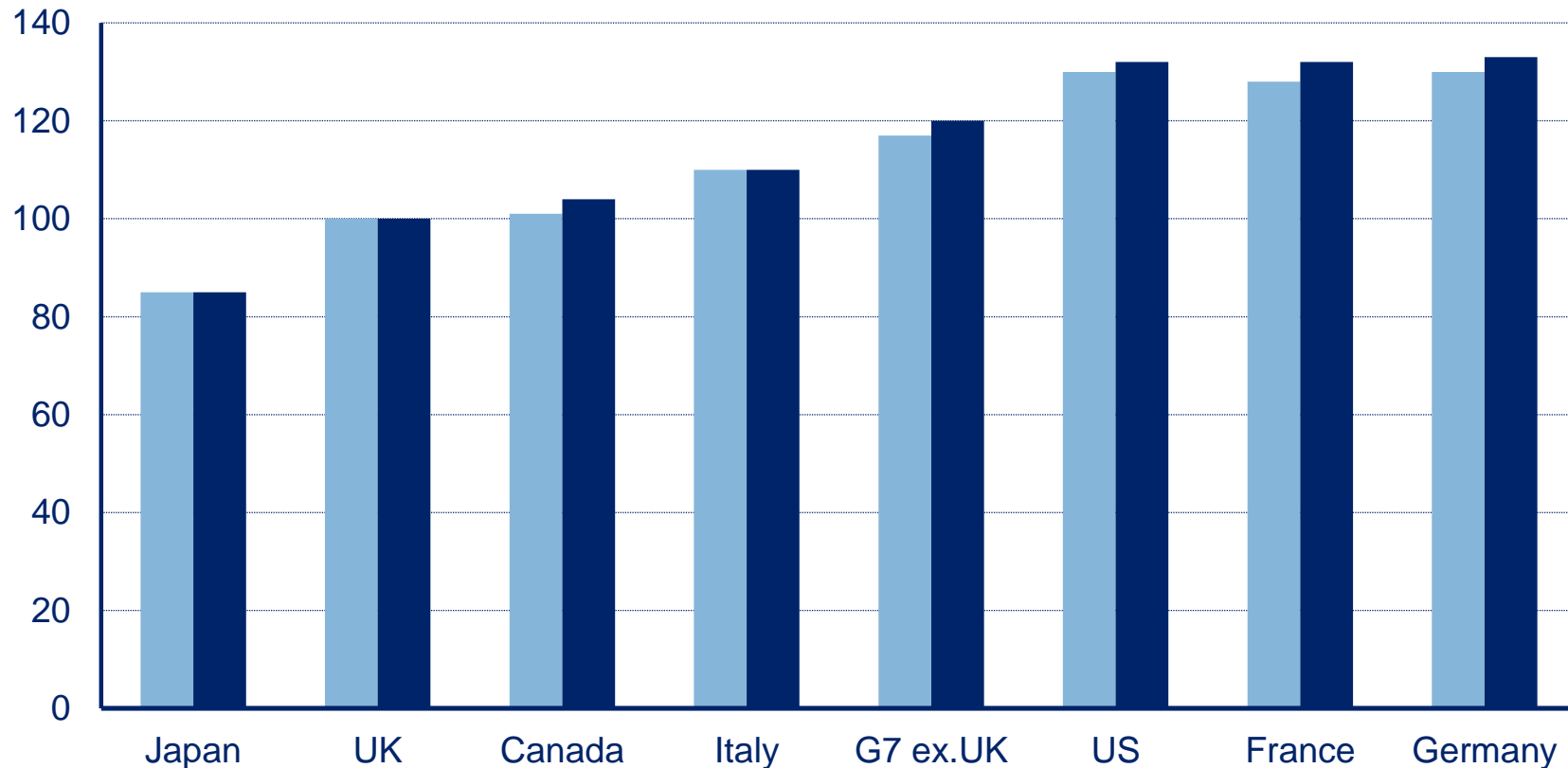
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# The biggest economic problem the UK faces is low productivity

## Productivity per hour worked in G7 countries

*Current price GDP per hour worked*  
*UK = 100*

■ 2013  
■ 2014



# There are a number of reasons for the UK's lower productivity



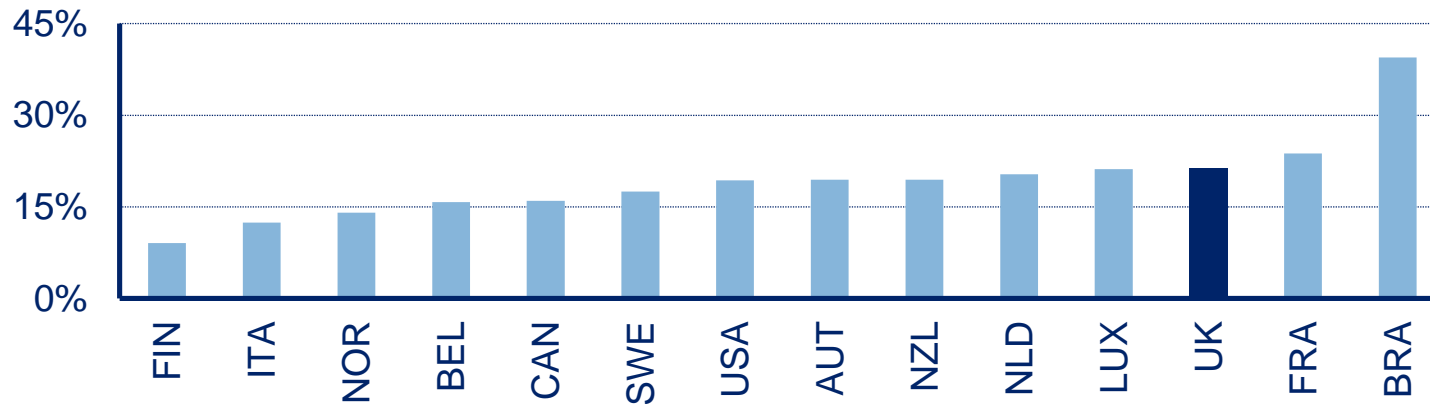
- Inferior skill levels
- Lower investment
- Weak management
- (in the past) Poor labour relations

## But crucially

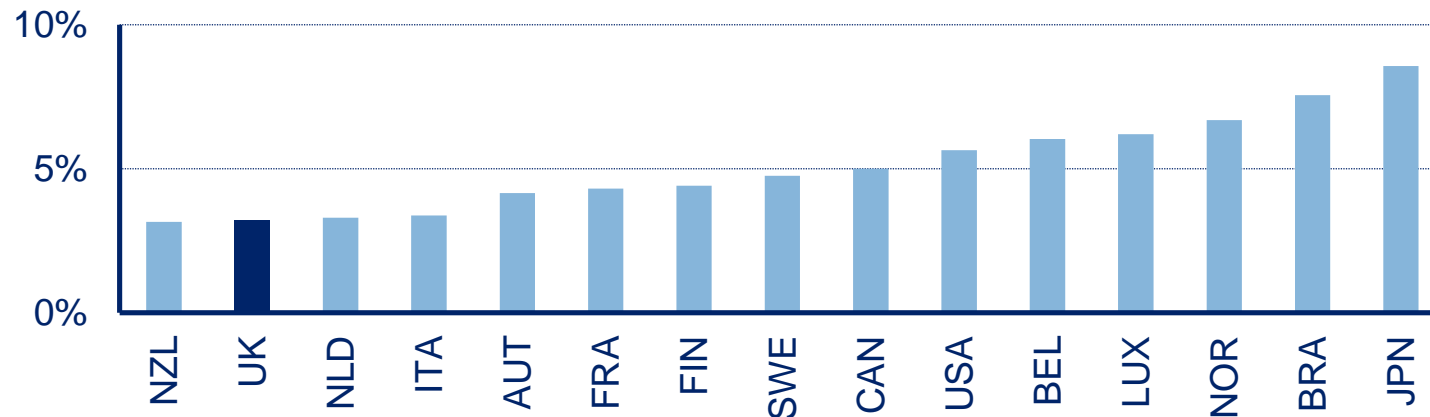
- Slower growth of SMEs, whose productivity performance is typically superior to large firms

# The UK does well with start-ups, but they do not grow as rapidly

*Start-ups (0-2 years old) as a proportion of all firms*



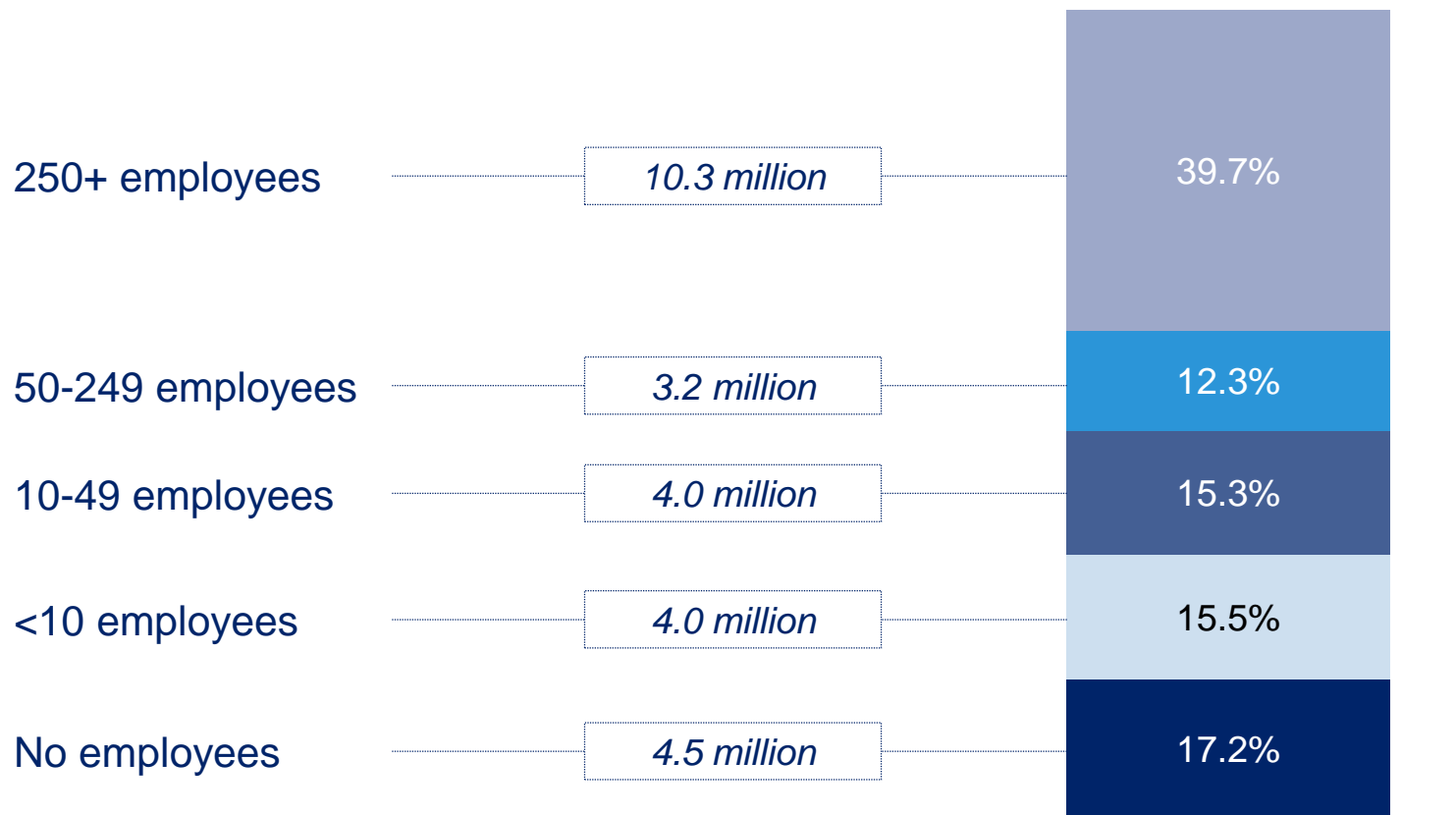
*Start-ups with 1-9 employees that grow to 10+ within 3 years*





# And SMEs are the dominant providers of employment

## Private sector business employment in the UK



Share of private sector employment

1. Why is small business finance so important?

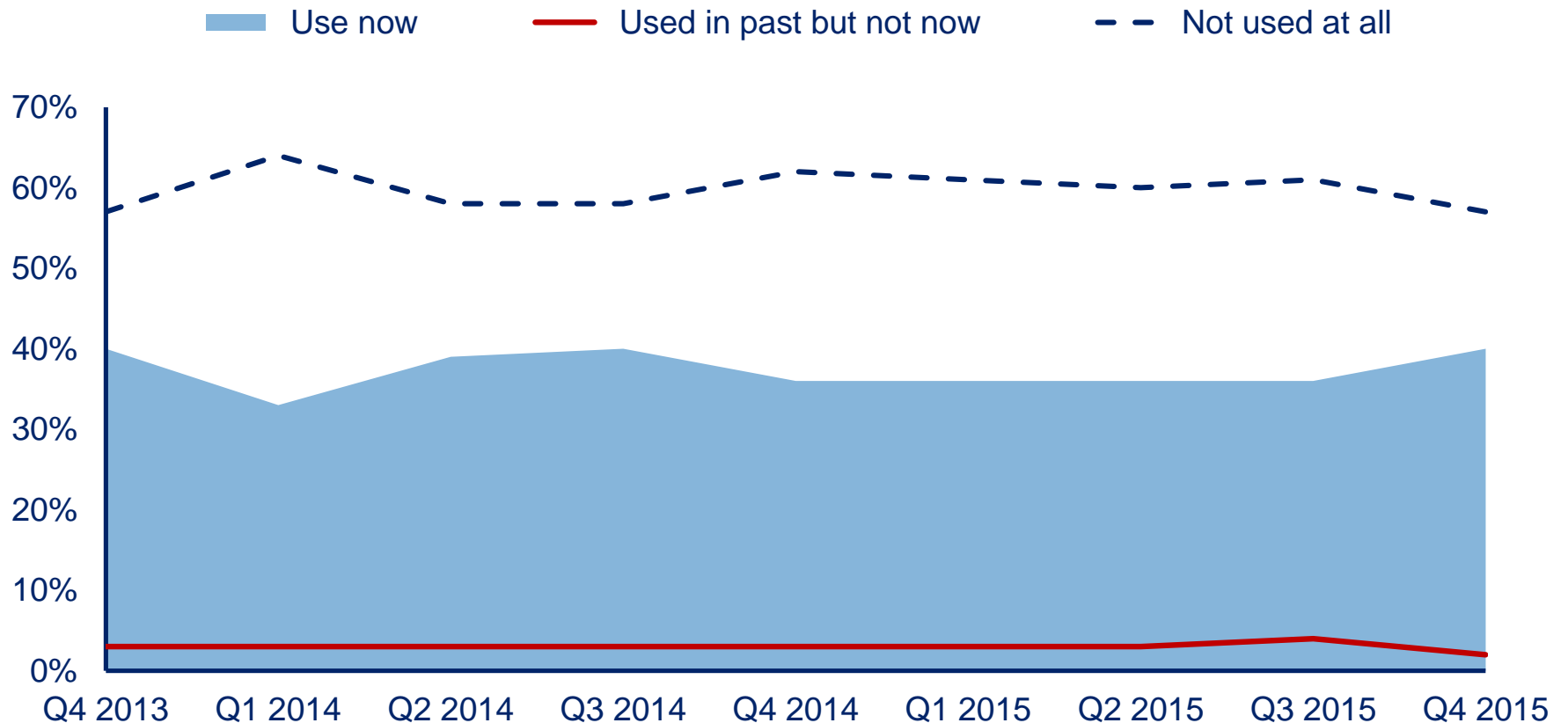
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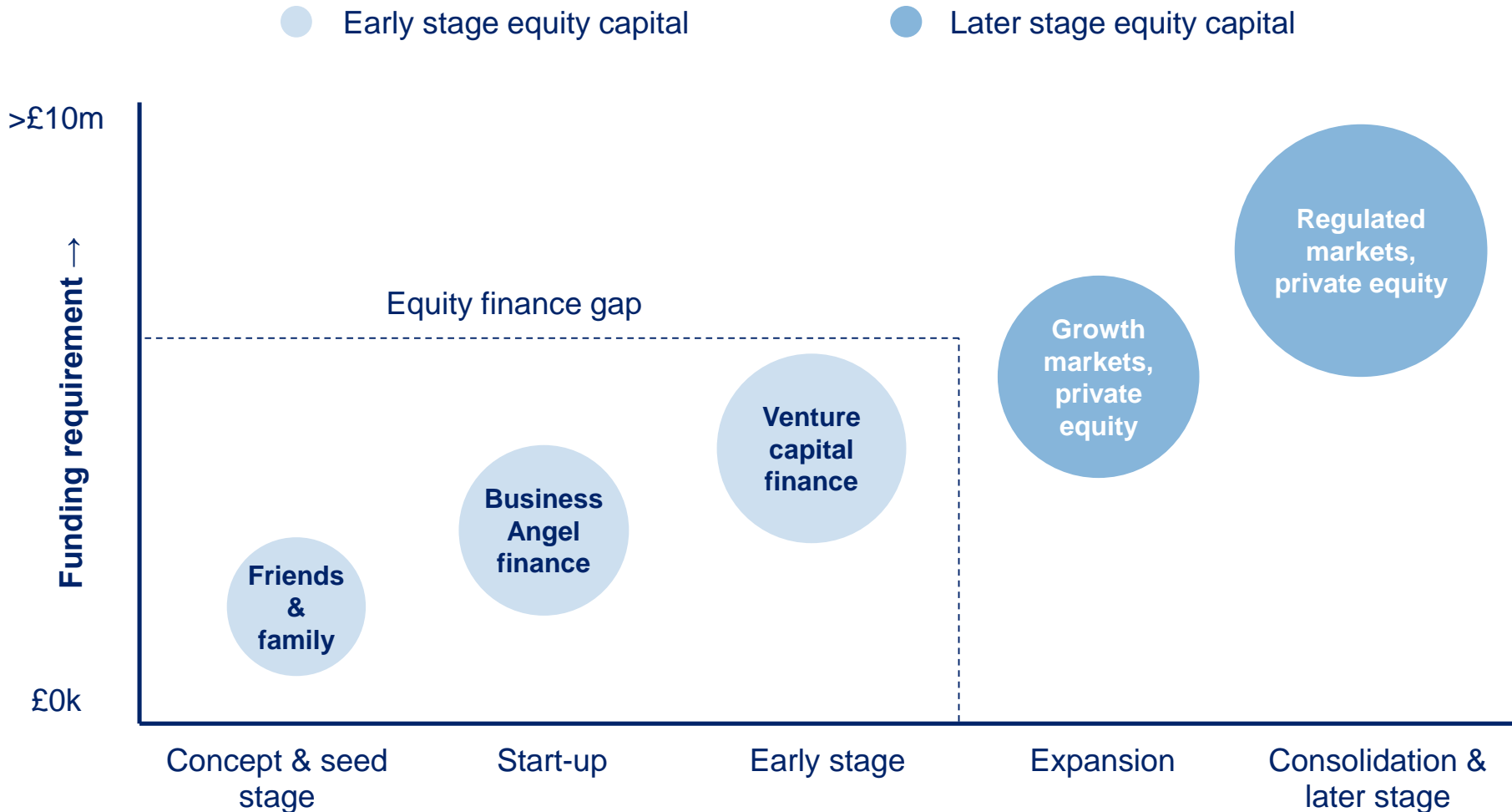
# Most small firms finance themselves from retained earnings

## Use of external finance by SMEs in the last 5 years



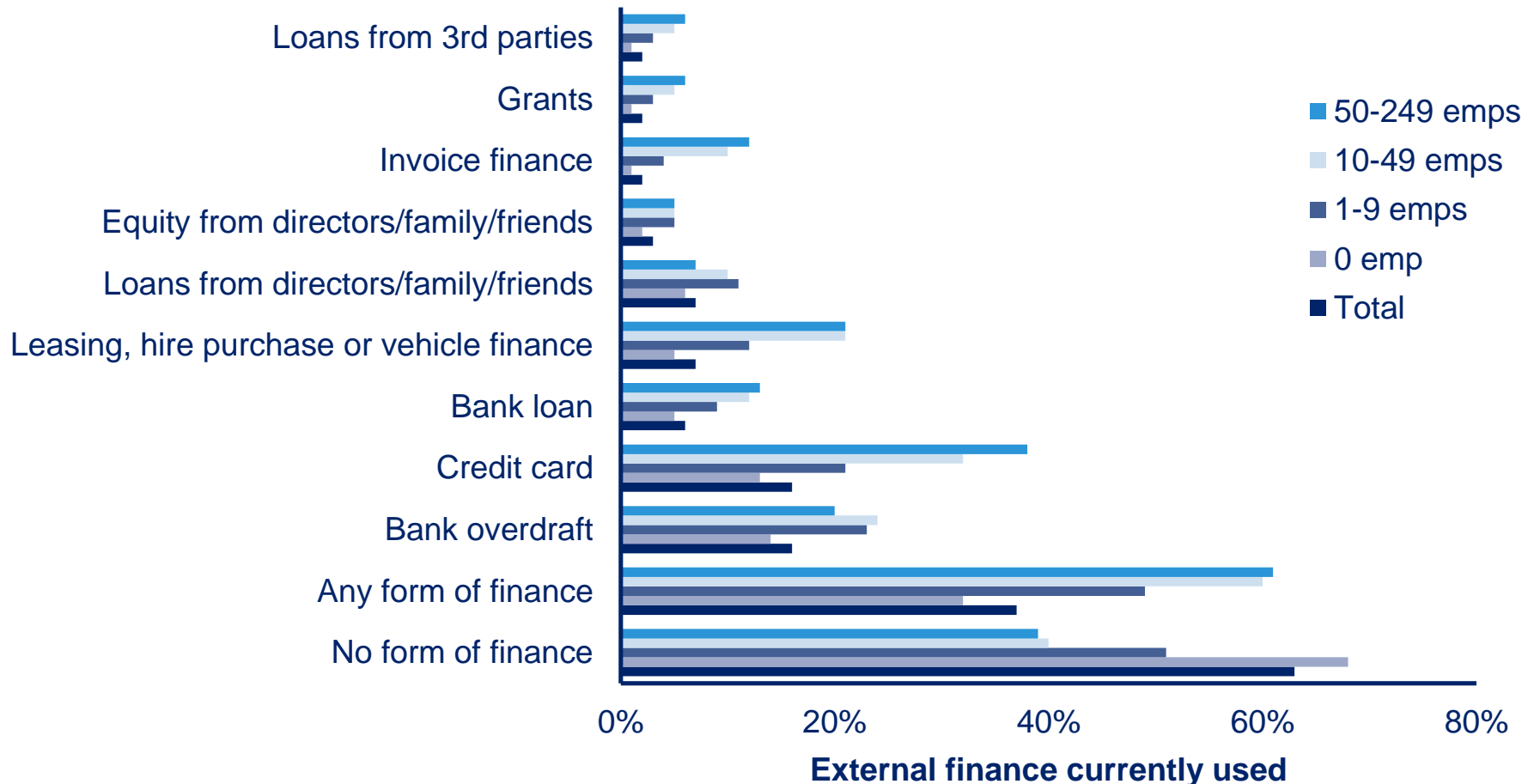
# But as and when they grow, so does their need for external finance

## The UK funding gap (funding escalator)



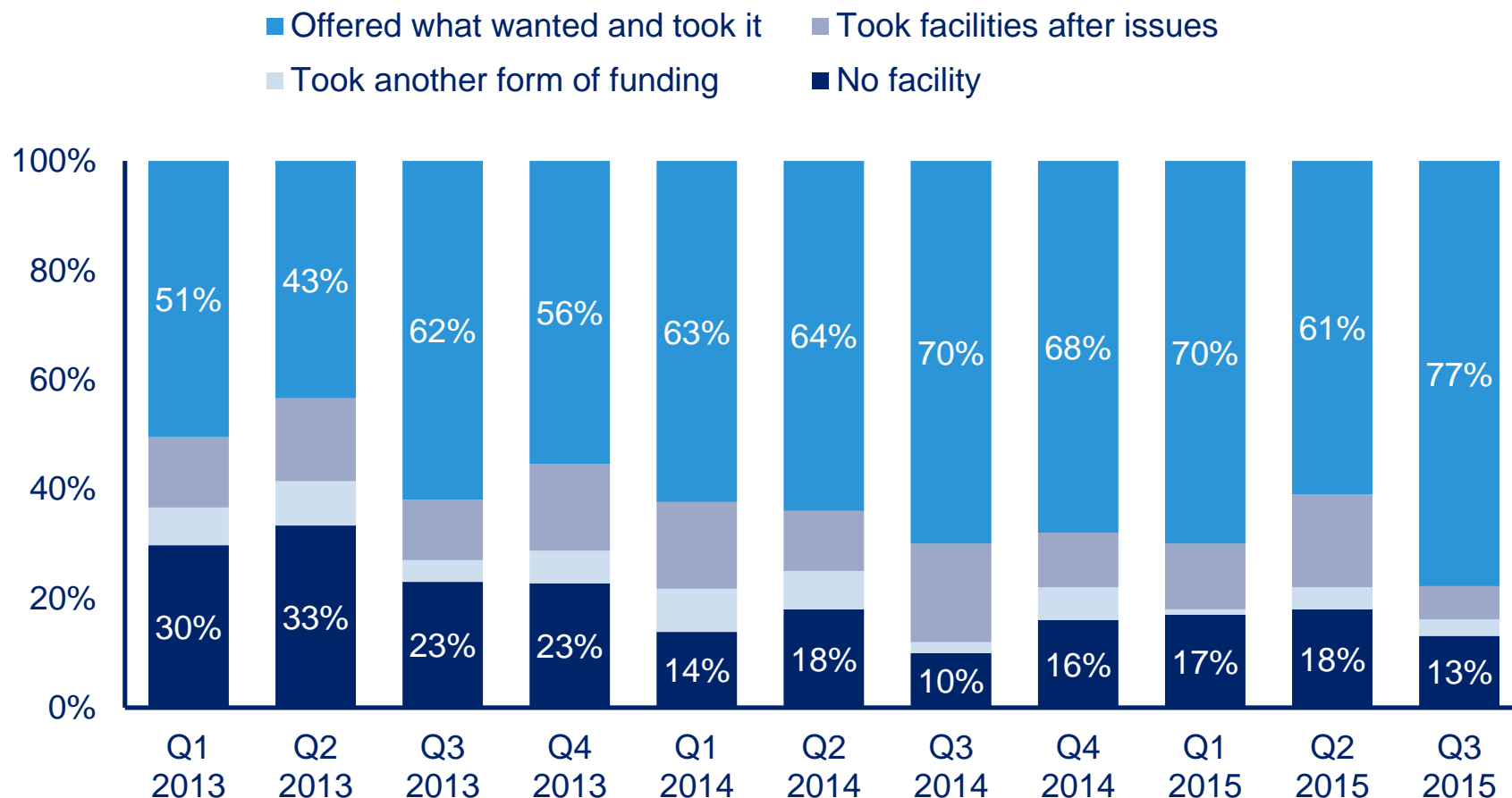
# External funding sources are varied, but overdrafts, bank loans and credit cards dominate

## External funding sources for UK SMEs



# In normal times, the great majority of loan applications to banks are successful

## Final outcomes (overdraft + loan) for SMEs seeking new/renewed facilities

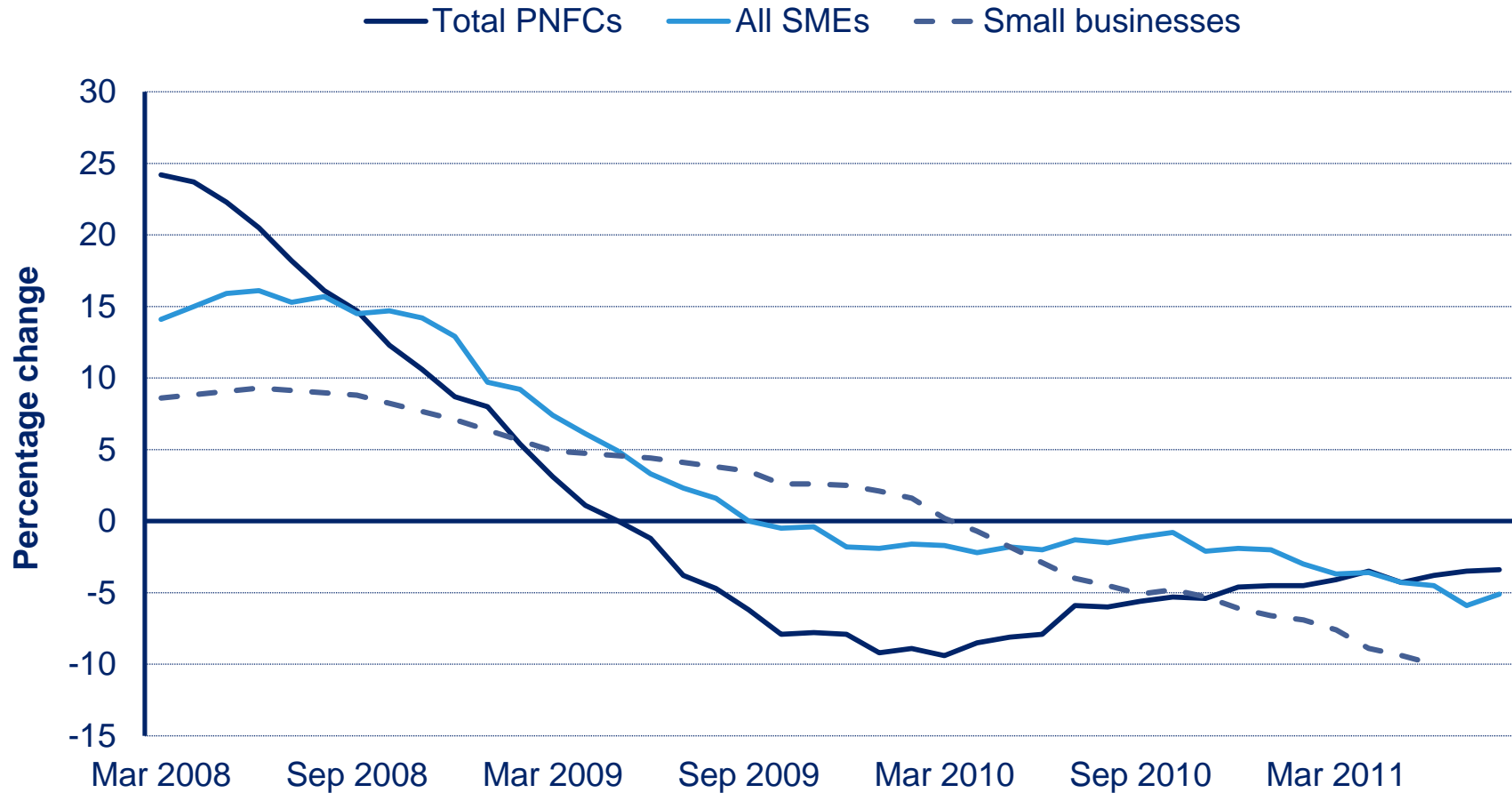


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# The financial crisis was a severe shock to the SME financial system: bank lending fell sharply...

## Lending to SMEs

*Percentage change on year earlier*

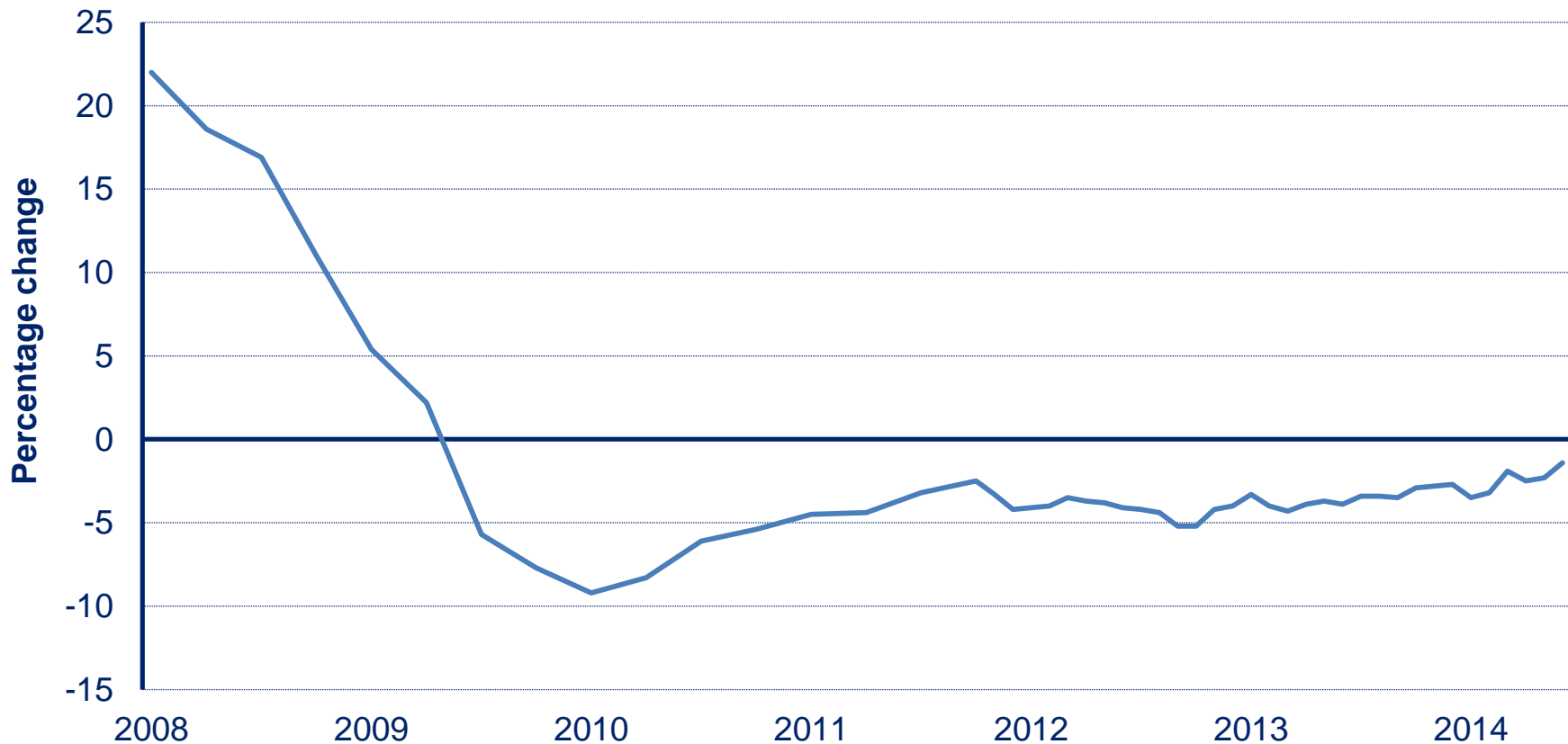




# And negative lending growth has persisted for some time...

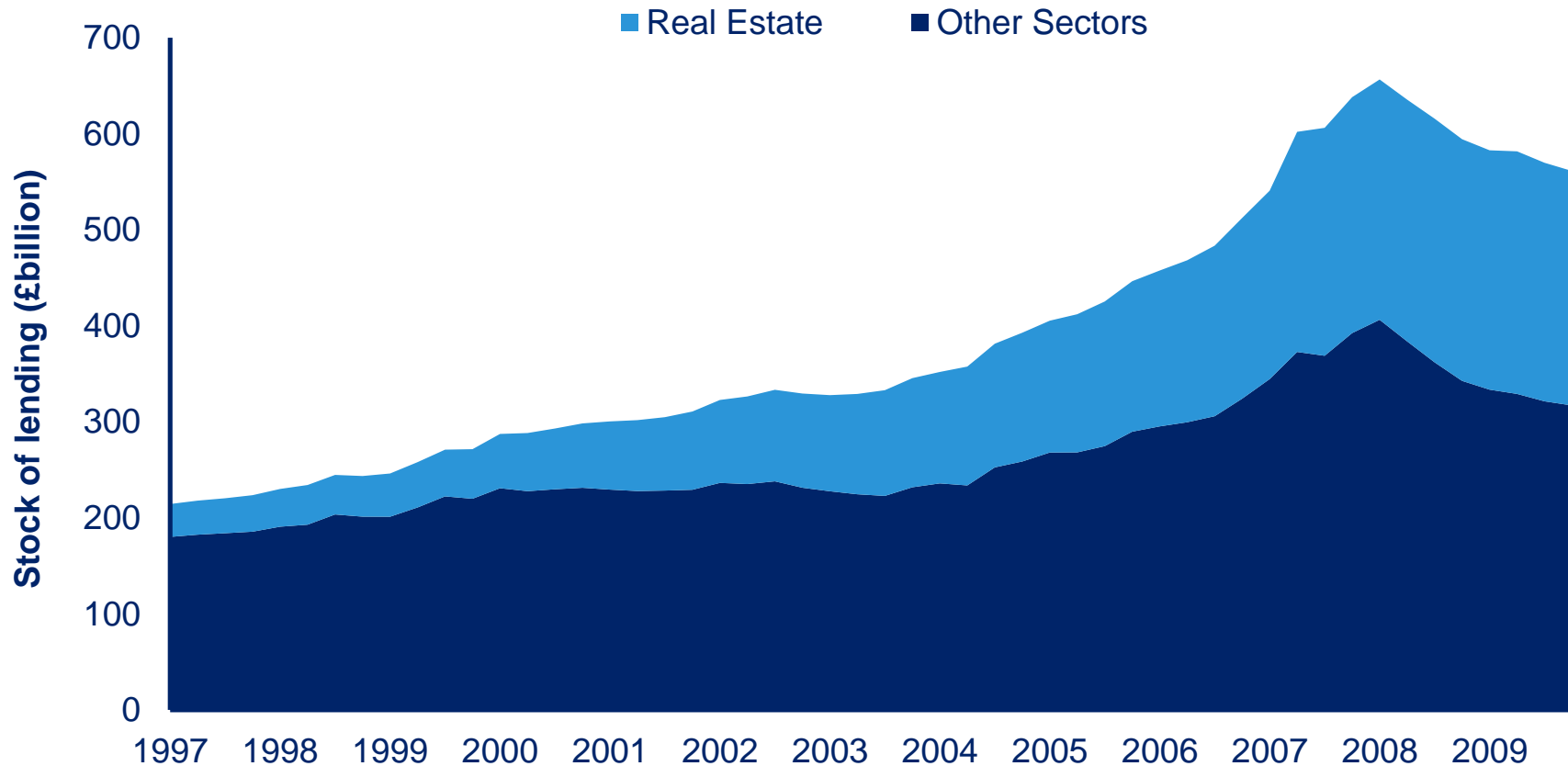
## Lending to UK non-financial businesses

*Percentage change on a year earlier*



# Though we should recall that much of the pre-crisis growth was in real estate lending

## Stock of lending outstanding to UK non-financial businesses



- In a recession, loan demand typically falls, as investment is put on hold, and the failure rate of small firms rises.
- Firms repay loans, fearing that excess leverage makes them vulnerable.
- Firms hoard cash: 23% of SMEs now hold > £10k in cash, up from 17% in 2011.

- Banks cut back on their risk appetite.
- They reined in lending to protect their balance sheets.
- Regulatory requirements to strengthen capital accentuated the need to cut risky exposures.

- The banks were too ready to call in loans, and sometimes benefited from seizing property assets.
- That banks insisted on repayments too quickly, from firms that could have survived, given time.
- That banks made small firms vulnerable by selling them unsuitable products, specifically Interest Rate Hedging Products.

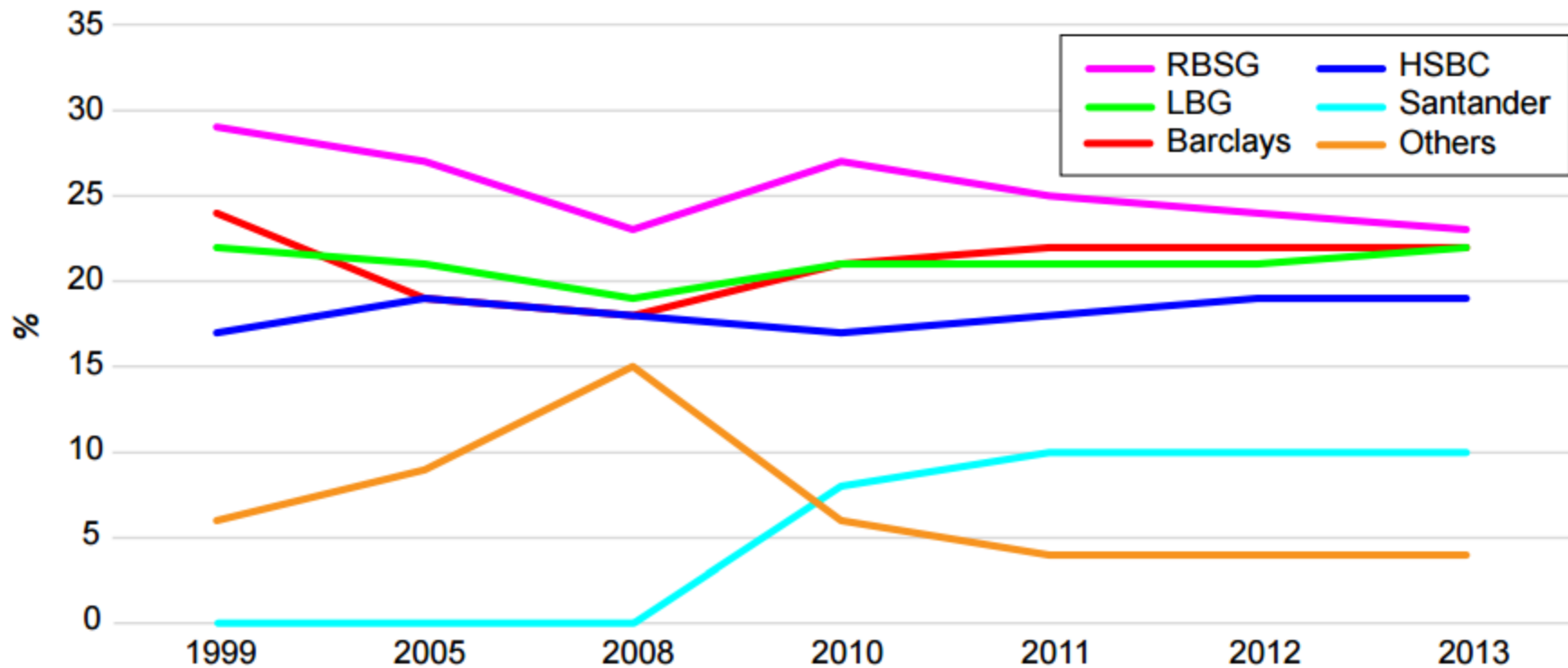
Legal actions and regulatory investigations continue in these areas.

- the Bank of England argued that banks kept too many non-viable firms afloat, tying up capital that could have been redeployed elsewhere
- ‘creative destruction’ is seen by economists as contributing to innovation and productivity growth

# There has been relatively little change in the provision of basic banking services to SMEs

## Market shares in the provision of BCAs to SMEs

*By volume of accounts / main banking relationships, England and Wales*



# But the mix of external financing sources is beginning to change



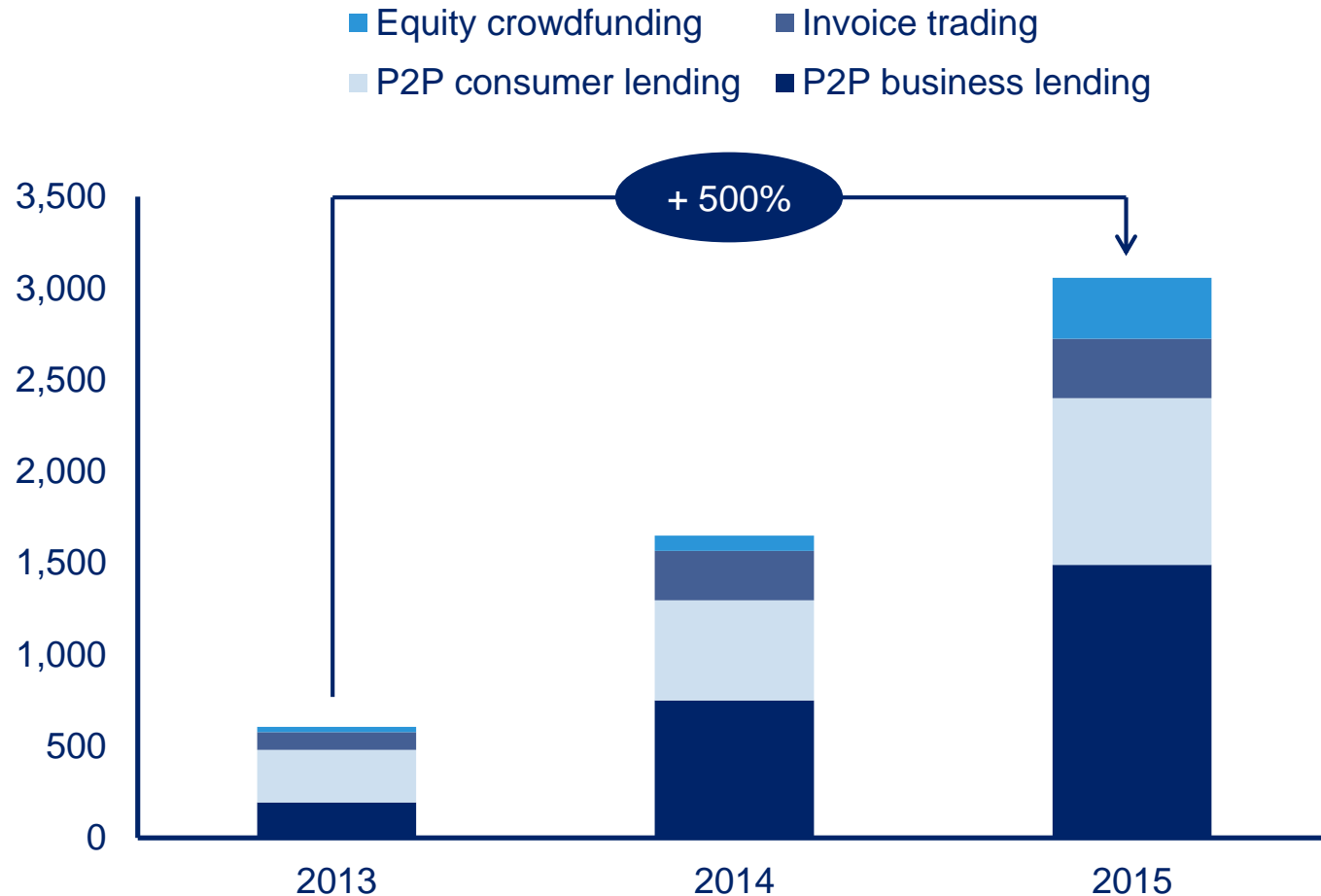
	2011	2012	2013	2014	2015	
<b>Bank lending</b>						
<i>Source: Bank of England</i>						
Outstanding amount (£bn)	189	176	166	167	163	To Dec 2015
Net flows (£bn)	-	-8	-4	-4	2	To Nov 2015
Gross flows (£bn)	-	38	43	53	53	
<b>Private external Equity (£bn)</b>	1.04	1.32	1.62	2.2	2.39	
<i>Source: Beauhurst</i>						
No. of reported deals	386	625	863	1060	870	To Sep 2015
No. of deals (known amounts)	279	435	612	804	699	
<b>Asset Finance (£bn)</b>	-	12.7	13.5	14.8	16.3	12 months to Nov 2015
<i>Source: FLA</i>						
<b>P2P Business Lending (£bn)</b>	0.02	0.06	0.25	0.72	1.26	To Dec 2015
<i>Source: AltFi Data</i>						



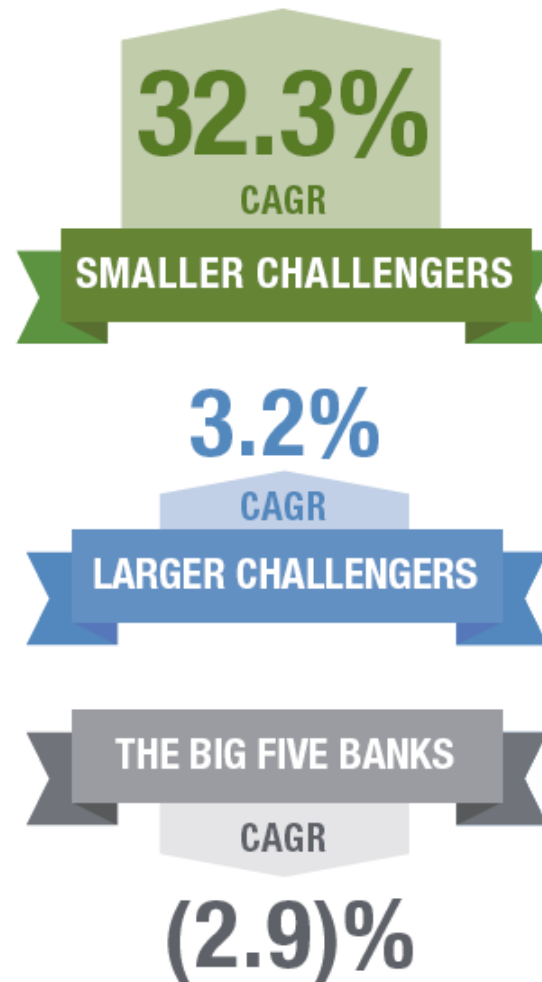
- The P2P lending market grew by 250 per cent from 2012 – 2014
- £58m of new loans were agreed in Q3 2015
- It is estimated that global P2P volumes will reach close to \$300 billion by 2020, with \$20-25 billion in the UK.

# Alternative finance flows are growing fast

## Gross flows of alternative funding, £million

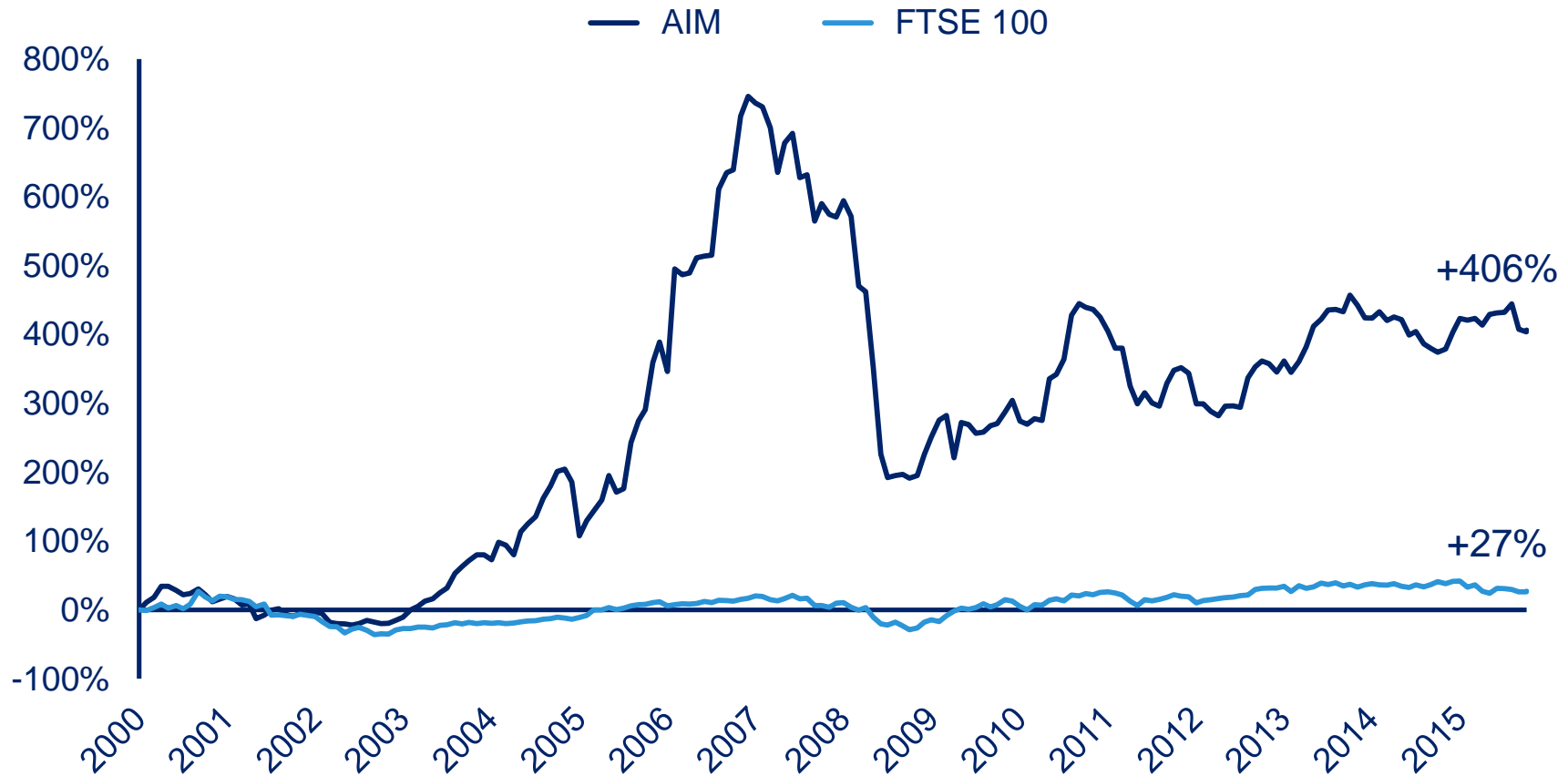


# And within the banking sector, new entrants are gaining share



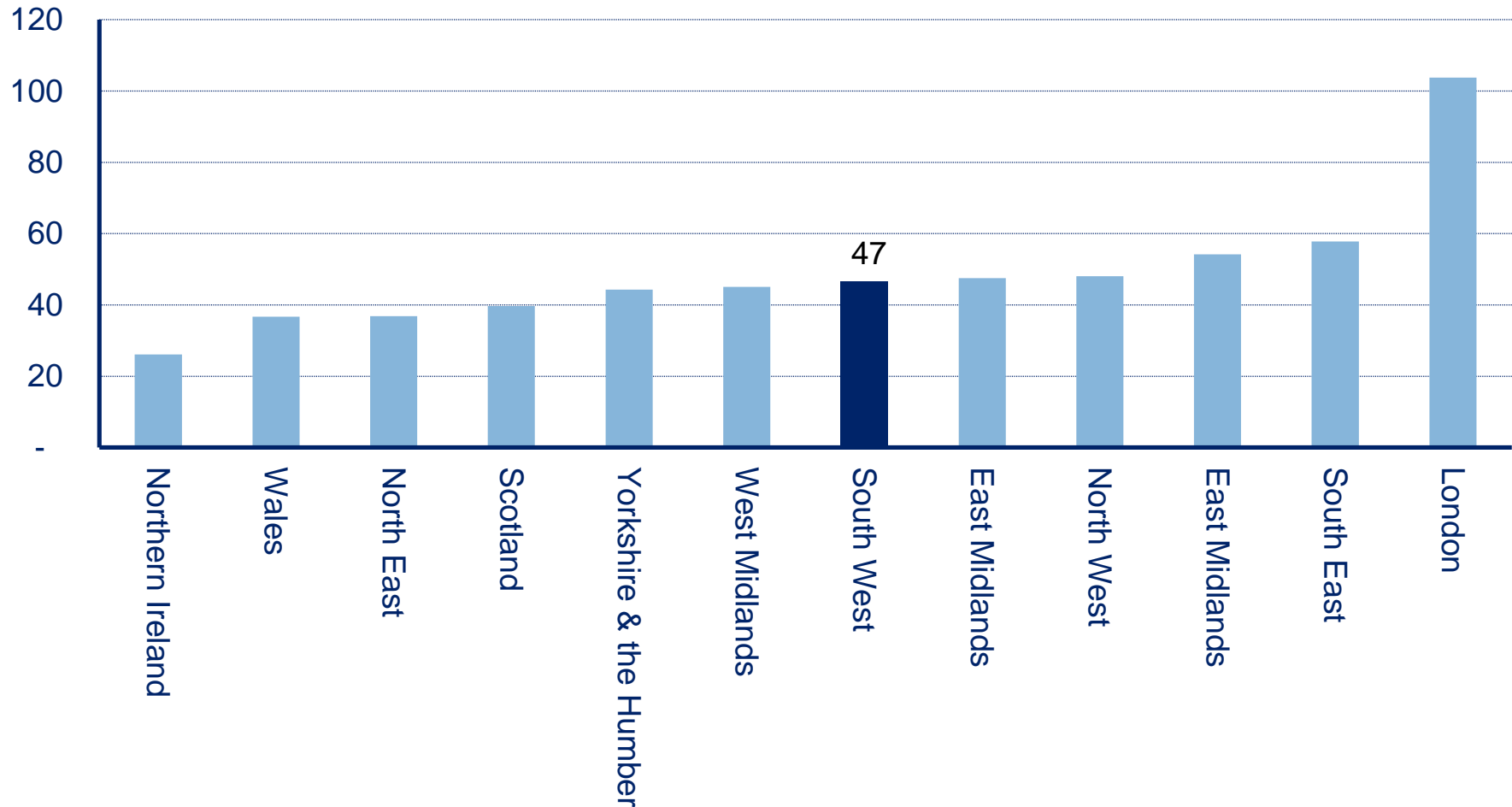
# The Aim market has grown over the last 15 years

## % change in market capitalisation since May 2000



# The South West is doing reasonably well in generating new businesses

## Births of new enterprises per 10,000 population

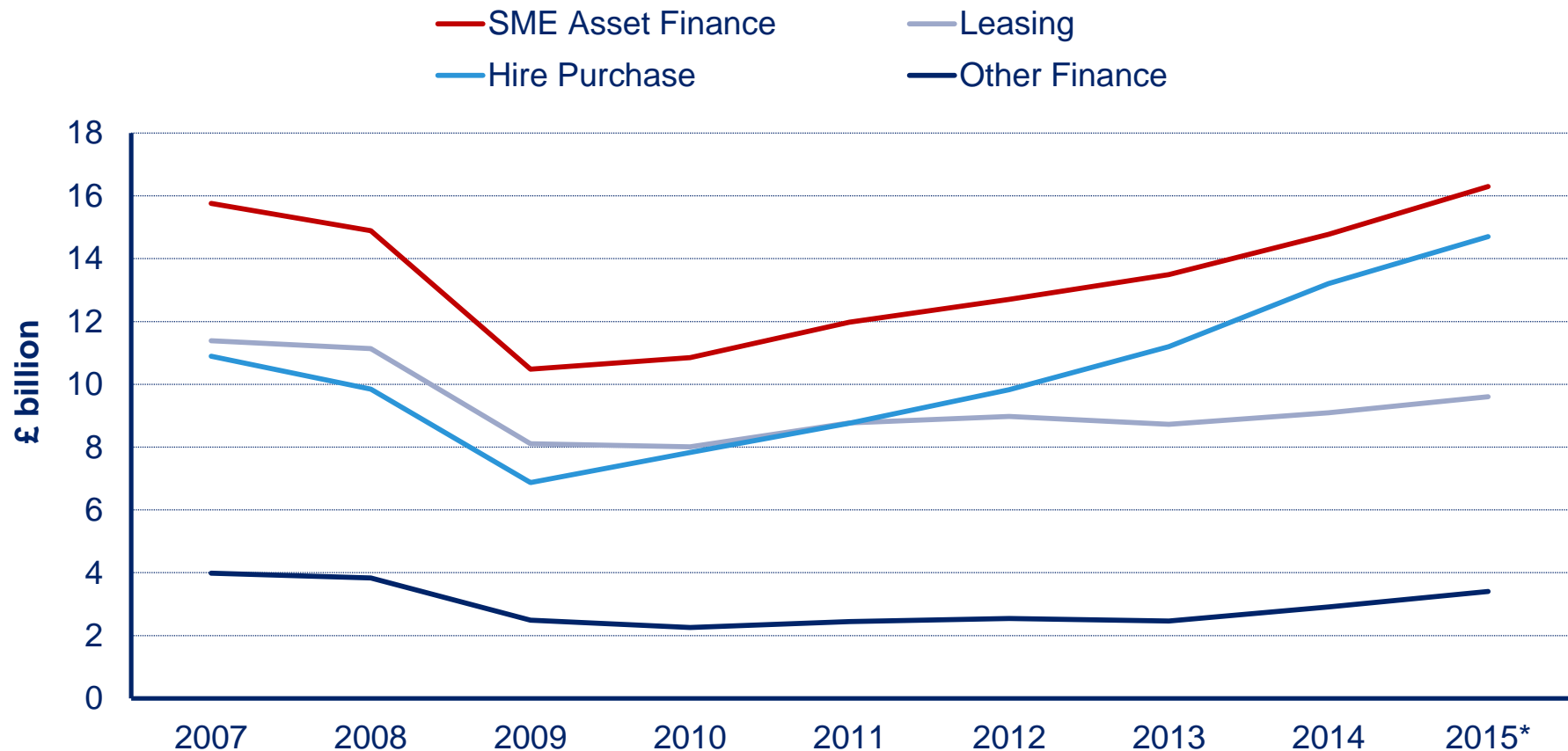


# And asset-based financing is expanding healthily



## Size of UK asset finance market 2007-2015

*New business written by FLA members, deal size up to £20m*



*\*estimates based on published figures for 12 months to November 2015  
Source: British Business Bank – Small Business Finance Markets 2015/16*

- Excessive reliance on bank finance can be dangerous in a credit crunch
- The Eurozone has struggled to recover from recession, in part because of the much higher proportion of bank finance than in the US: two-thirds vs 20%
- Recent economic studies show that a higher bank-market funding ratio reduces growth significantly

# But there remains an issue related to funding of crucial Knowledge Based Assets

Examples, investment and growth of Knowledge-Based Assets (UK)

Type of KBA	2010 Invest. (£bn)	CAGR (2000-2010)	Example of KBA	2010 Invest. (£bn)	CAGR (2000-2010)
Computerised information	26.5	5.1%	Software, databases	26.5	5.1%
Innovative property	34.7	4.5%	Scientific R&D	13.5	2.7%
			New architectural & engineering designs	14.4	5.5%
			Product development costs in financial industry	2.4	7%
			Media/Artistic Original + Mineral Explorations	4.4	6.3%
Economic competencies	71.1	3.1%	Market research + advertising expenditure	11.6	0.4%
			Training	16.2	4.3%
			Organisational Capital	43.3	3.6%

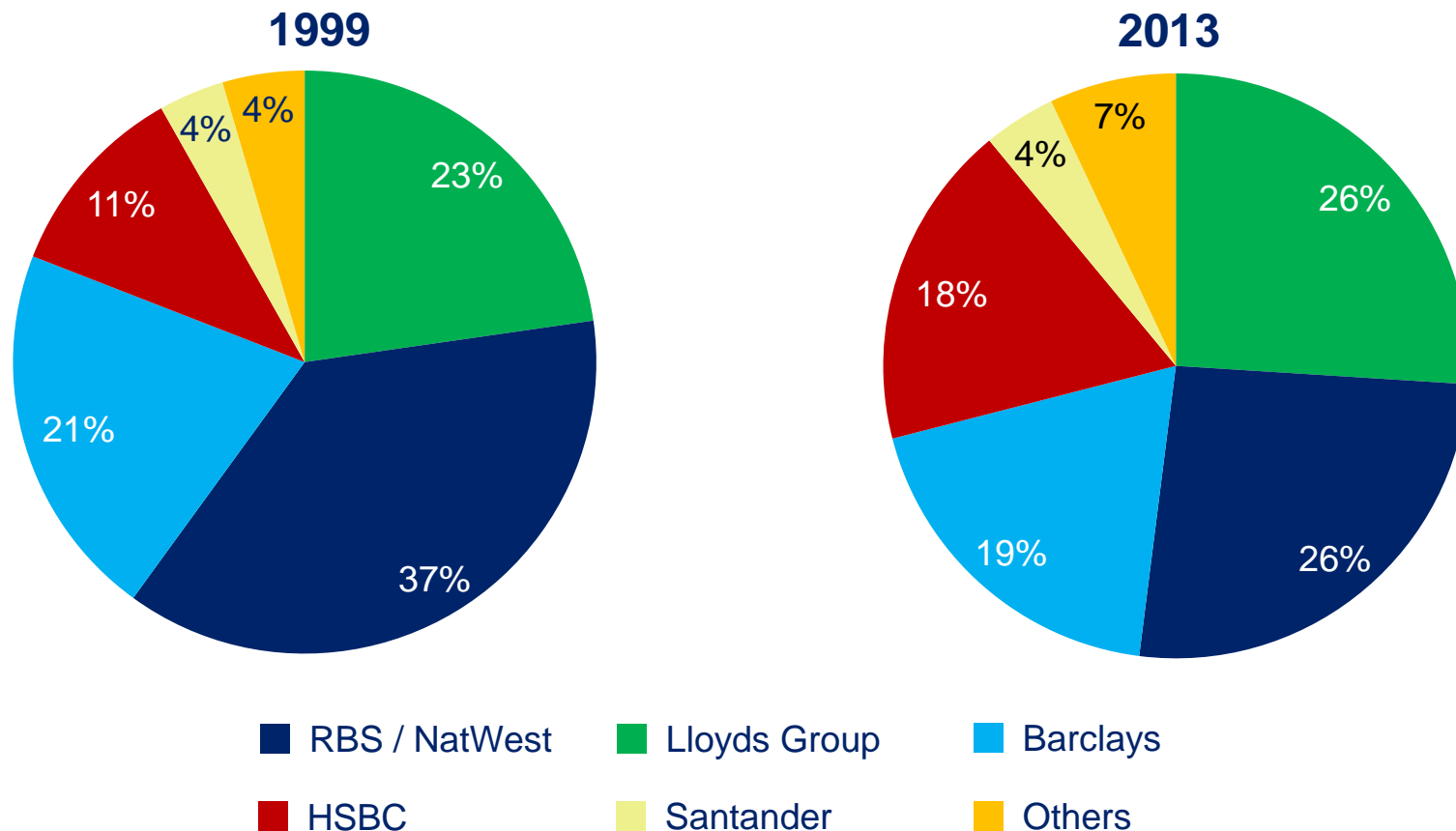
Source: Corrado, Carol, Jonathan Haskel, Cecilia Jona-Lasinio and Massimiliano Iommi (2014). "Internationally comparable macro-estimates of investment in intangibles at the industry level"



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RBS remains one of the biggest lenders to business, in spite of a fall in market share since the crisis

## Volume shares of business loans in England and Wales



Source: British Business Bank – Small Business Finance Markets 2015/16

# The bank's new strategy puts UK business lending at its heart

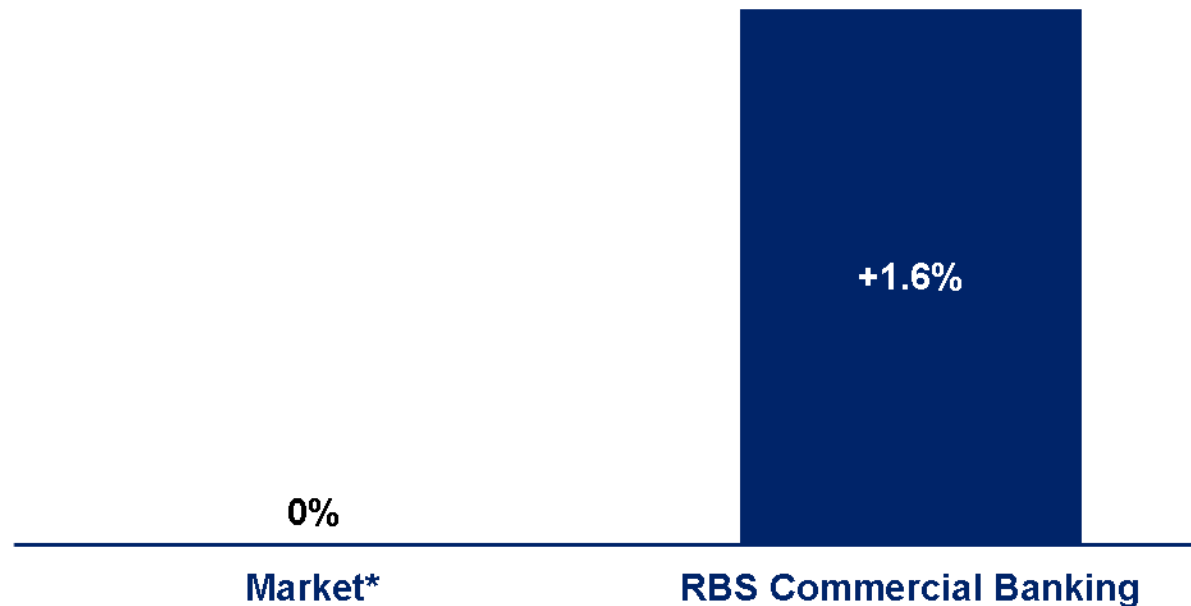


- Downsizing the investment bank sharply
- Concentrating on the UK and Irish markets
- Building on core strengths in domestic retail and commercial banking

# Our most recent financial results show that RBS increased its support for businesses during 2015



## Growth in stock of lending to businesses, FY 2015

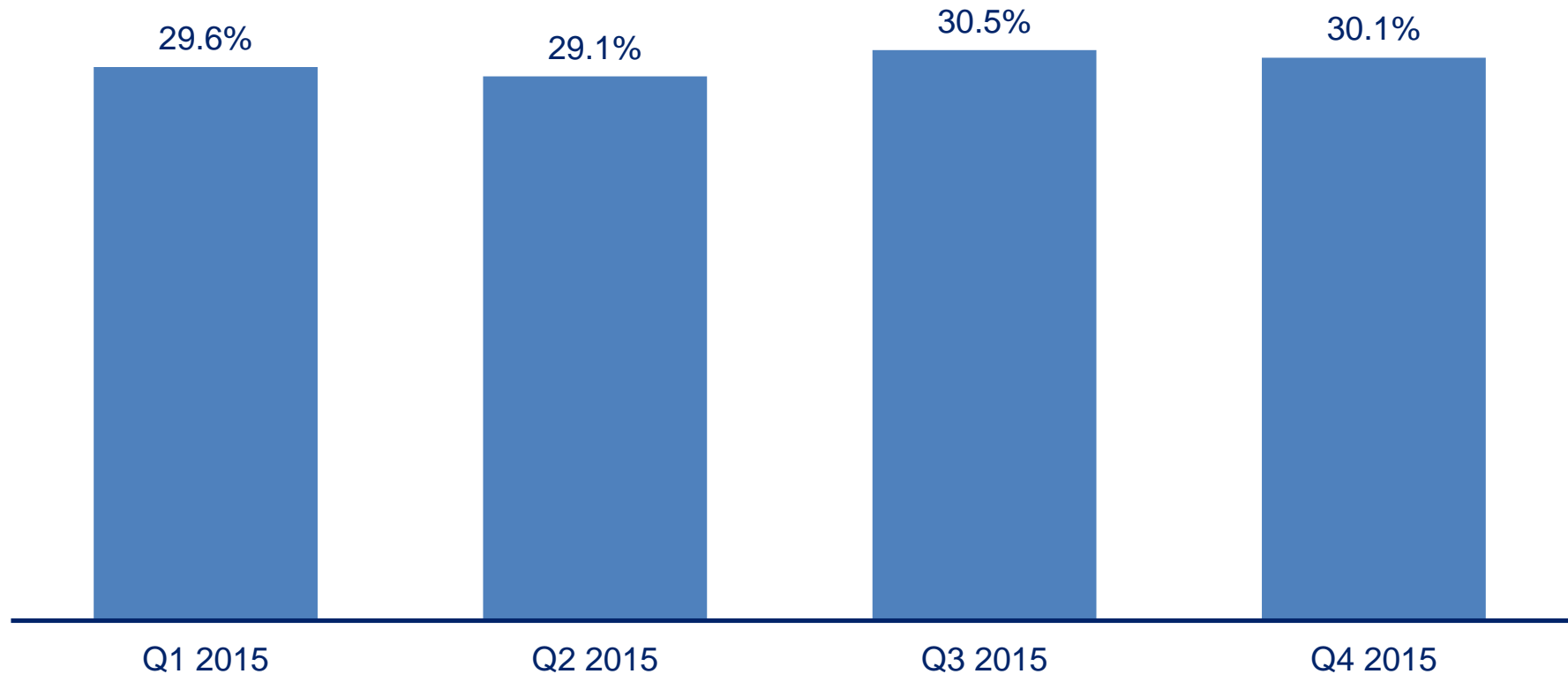


Net new lending of £1.4bn despite a £2.2bn net outflow in the legacy portfolio of Commercial Banking

*\*12 month growth rate at December 2015 of loans to Non-Financial Businesses*

*Source: Bank of England*

## RBSG Market Share (Charterhouse Research Ltd.)



*\*Source: Charterhouse Research Ltd Business Banking Survey. Data weighted by region and turnover to be representative of businesses in Great Britain. Main Bank share, including personal banking, 4 quarter rolling data, GB view. Sample size: Q1 2015 (971), Q2 2015 (851), Q3 2015 (882), Q4 2015 (877).*

# And we are well placed to participate in alternative financing channels



- Lombard is a very strong asset-based finance vehicle
- A partnership with Funding Circle is developing cross-referrals: often P2P lending is quasi-equity and outside the risk appetite of a traditional lender.

- 85 years on, the 'Macmillan Gap' has not been fully closed.
- But in the last few years the biodiversity of the market has grown, which is healthy.
- Big banks will need to adapt to the new environment and find ways of working with new competitors.
- RBS is devoting considerable efforts to repositioning itself in the new marketplace

# Q&A