HOUSE OF LORDS

Financial Services Regulation Committee

Corrected oral evidence: Growth of private markets in the UK following reforms introduced after 2008

Wednesday 3 September 2025

10.05 am

[Watch the meeting]

Members present: Lord Forsyth of Drumlean (The Chair); Baroness Bowles of Berkhamsted; Baroness Donaghy; Lord Grabiner; Lord Hill of Oareford; Lord Hollick; Lord Kestenbaum; Lord Lilley; Baroness Noakes; Lord Sharkey; Lord Smith of Kelvin; Lord Vaux of Harrowden.

Evidence Session No. 5 | Heard in Public | Questions 48 - 62

Witnesses

I: Louis Taylor CBE, Chief Executive Officer, British Business Bank; Martin McTague OBE, National Chair, Federation of Small Businesses (FSB); Irene Graham OBE, Chief Executive Officer, ScaleUp Institute.

USE OF THE TRANSCRIPT

1. This is a corrected transcript of evidence taken in public and webcast on www.parliamentlive.tv.

Examination of witnesses

Louis Taylor, Martin McTague and Irene Graham.

Q48 **The Chair:** Welcome to today's meeting, which is the fourth oral evidence session as part of the committee's inquiry into the growth of private markets in the UK following the reforms introduced after 2008. Thank you, Ms Graham, Mr McTague and Mr Taylor, for attending. It would be helpful to the committee if you might just introduce yourselves and say a few words about why this is a matter of interest to you, and then we will proceed to questions. Shall we start with you, Ms Graham?

Irene Graham: Good morning, everyone. I am delighted to be here. I am the chief executive of the ScaleUp Institute. The ScaleUp Institute was formed by the private sector to focus on our scale-up economy, which contributes over 50% of our SME economy. We have around 34,000 scale-ups—businesses growing at 20% or more in employment or turnover—and they are a critical part of our overall economy.

The segmentation of those businesses is critical. Some of their core challenges are access to talent, access to markets and access to funding. We should be clear that funding is not their top challenge. It is access to markets and then talent. Investment is about not just finance but also procurement. Those are some of the areas that we are focused on currently in our policy agenda.

Louis Taylor: Thank you for the invitation to give evidence this morning. I am the chief executive of the British Business Bank, which is a government-owned bank that is helping entrepreneurs to get access to the capital that they need in order to start and to scale businesses through a range of interventions involving debt and equity, with a particular mandate to ensure the diversity of sources of finance for small business at all stages.

Martin McTague: Hello, everybody. Thank you, Chair. We have existed for 50 years to represent the interests of all 5.5 million SMEs in the UK. The UK SME market is dominated by debt. At the last count, 98% of external finance was debt and only 2% was equity. It is very important that that access to finance for small businesses will prevent them from failing in those critical early years. Sixty per cent of them fail in the first three years. It is really important that, in their more mature stage, they have access to adequate working capital. Eighty per cent of them are not businesses that have adequate tangible assets that they can borrow against conventionally. They are asset-poor, and yet they are vital to the UK economy, so it is really important that we get this right.

The Chair: I should begin by just pointing out that this session is broadcast live and is subsequently accessible on the parliamentary website. We will take a verbatim transcript, which will be put on the parliamentary website. After a few days, we will send you a copy of that transcript in order to check it for accuracy, and it would be helpful if you could advise us of any corrections as quickly as possible. If you want to amplify or clarify any points made during your evidence or have any additional points to make, you are welcome to submit supplementary written evidence to us.

Perhaps I could begin by asking the key question. Are small businesses, start-ups and scale-ups experiencing challenges in accessing finance that constrain their ability to grow and to remain in the UK? Is there a geographical variation in their ability to do so?

Louis Taylor: There is a lot in there. The first thing to say is that there are different types of finance, debt and equity for different types of businesses, and the situation is different for those different types. I would say that, largely, for small businesses trying to start up, there is better access to finance than there has been for some time in this country, and the ability to start a business is quite strong. Some 850,000 companies were registered at Companies House last year, so we do not seem to have a problem with starting companies.

Getting access to working capital in terms of debt can be difficult for companies. If they have a good operating track record, it is easier, but the diversity of sources of finance for small businesses in that situation is much broader than it was certainly in 2008 and even 10 years ago, when the British Business Bank was set up. Even now, 60% of lending to small businesses comes from outside of the big five banks. That is up on the previous year. For years, challenger banks and non-bank finance lenders have been providing the majority, so that is all good.

Unlike debt, though, where the provision is pretty much available where GDP is generated—there are no regions where debt finance seems to be disadvantaged—equity finance is very different. It is well documented that there is a real dearth of equity finance outside what is known as the golden triangle of London, Oxford and Cambridge.

Not only is there that regional lack of equity finance, but there is also a lack of finance at a certain stage, which is scale-up companies. That lack of domestic institutional finance for scale-up companies—companies that have developed an innovative technology, have proven that the market needs it, have a product-market match and now need to scale it—is a real gap, which we are trying to fill. I am sure that I can talk later about how we are trying to do that. That would be my assessment of the finance markets in the UK at the moment.

The Chair: Some colleagues were quite struck by the fact that, looking at your literature, there is a great deal of emphasis on making partnerships with private-sector providers. Were you not set up in order to deal with market failure, and are you not meant to be filling the gap, rather than getting into bed with the people who are failing to provide the finance?

Louis Taylor: We are trying to help them get to the point where they do fill the gap. It is not the case that we are there to crowd out the private market. We are there to catalyse it into the parts of the market that it is not currently in.

The Chair: It is not crowding out the private market by intervening where the market is unable to provide support.

Louis Taylor: That is right, but there are areas of the market where there are people who do want to be in the market, but there are other barriers that we can help them overcome to enable them to get in. It was quite difficult for early-stage challenger banks whose business models were not proven to get access to wholesale funding. The British Business Bank supported a lot of those banks through guarantees on their lending, which enabled wholesale funders to have confidence to lend to them. You now have a range of challenger banks that are providing, as I mentioned, the majority of lending to SMEs in a way that the big banks are not.

Irene Graham: Just picking up some of the themes there, businesses in our scale-up economy use finance more than the general SME economy. Around eight in 10 are accessing finance. They use a blend of finance, so debt and working capital, as well as equity. As a country, we have long had a problem, picking up the themes from Louis, with our growth capital gap. Whether it is going back to Cruikshank, Rowlands or Buffini, there has had to be a focus on addressing the growth capital gap within the UK to help the scale-up economy. We are very good at start-ups—third in the world—but we are lagging on our scale-up economy.

We have estimated a gap of around £15 billion a year in that ability to drive growth, equity and capital into our scale-up economy. That has a very regional and sectoral focus as well. The more they (scaleups) are outside of London, the more our scale-ups feel they do not have access to that growth capital.

It is very important that we unlock the ability to generate venture and growth capital into the scaling businesses around the country, which is why the British Business Bank has aspects such as the regional angels programme, which is trying to drive up more angels in the regions to back these early-stage companies, and the enterprise capital funds.

We should remember that the European Investment Bank and the European investment facility were very strong backers of the growth capital private sector in the UK. The British Business Bank is now becoming that core supporter to those and building those regional funds that give access locally to scale-ups across the regions of the UK, including our development banks. The Development Bank of Wales and the Scottish National Investment Bank are critical factors too.

There is more choice, but there is that £15 billion growth capital gap, which is through the cycle, from the early stage right through to the crossover funds, and then how we open up the institutional marketplace. If we look historically, institutional money and pension funds going into our growth economy used to be over 50%. It is now at 4%. With the Mansion House reforms and the Leeds reforms, we are very keen, using institutional funds, to help scale the capital needed in the private sector into our growth economy. Those are very important aspects that are in current government policy and will be vital to be implemented. How the British Business Bank acts as a conduit for those funds, as well as other private sector vehicles, will be vital.

Martin McTague: The biggest inflection point, which will not come as a surprise to most members of this committee, was the financial crisis. Since then, lending to SMEs in the UK has dropped by £90 billion. There has been the innovation of new challenger banks coming in, and we estimate that they have added about £25 billion in additional lending, which means that we are still £65 billion short of where we were prior to the financial crisis.

The Chair: Where does that figure of £90 billion come from?

Martin McTague: That was done by one of the challenger banks, surprisingly. It did an analysis, which was checked by DBT and the Treasury, and both have validated those numbers.

Lord Lilley: Is it a cumulative or an annual figure?

Martin McTague: It is annual.[1] That is how much is available to lend that is not being lent in this current year. It is the biggest single issue for us. The big five have reacted by being very cautious. They are quite keen on deposits. They make good money out of deposits from SMEs. They are not so keen on lending. They are very slow. They are bureaucratic. They do not understand a lot of the regional markets. They do not understand niche markets. They have decided that they cannot make money from this and, therefore, have largely pulled out of SME lending.

The Chair: I am sorry to keep interrupting you but some people in previous inquiries have said that it is not a problem of them not wanting to lend. The problem is that people are not coming to them asking for the money.

Martin McTague: I have heard that many times as well. The reality is that, if you make borrowing expensive and difficult, you limit appetite. The reality is that lots of people want to grow their businesses. Certainly, they want to be able to get past the stage where they have survived the first few years and need to now grow. Access to funding is just not available at the size that it is needed.

Typically, if you talk about the UK market, 80% of SMEs are asset-light, so they do not have the security to borrow. That means that, when they then look at what options they have, there are very few. You could say equity, but equity is currently such a tiny percentage of the available market. They also tend to be focused on what are called the sexy sectors, so those that are likely to get the best return and are seen as being attractive at the moment. That means that most SMEs then go for

[1] Note by the witness: Correction: this is actually a cumulative figure.

bootstrapping. They think that that is the only reasonable response to it, and that makes them very vulnerable.

The Chair: Could you just explain what bootstrapping means?

Martin McTague: Bootstrapping is, in essence, no external borrowing. The profits that you generate each year are used to fund the following year's growth. Unless you are making significant profits, you have to grow at a very small rate just to be able to cope with that.

It then comes down to what available assets they have. For most small businesses, they are personal assets. What happens is that those people wanting to lend to the SME market start to look at personal assets and use them as security. I am sure that we will come on to this later, but that means that personal guarantees have become a dominant part of the lending market. Last time we surveyed our members, 80% were being asked for personal guarantees when borrowing money. It also means that, if you are borrowing and are in a fairly asset-rich area such as the south-east or London, it makes life a lot easier, because you have the equity in personal assets.

How would we address it? The BBB is a very important part of it. Start-up loans will certainly make a difference to people trying to navigate those first few years. The growth guarantee scheme is pitifully small in the UK when compared with comparable countries around the world. It means that, if you are asset-light and you have banks wanting to lend, they will not lend unless they are going to get some form of government guarantee. The growth guarantee scheme has been an enormous success, but it is far too small.

If the Government took action to limit the indiscriminate use of PGs, that would have a major impact. If you can imagine a small company whose owners are taking very little out of that business, but are being asked to put their principal private residence on the line so that they can get through the next few years, that is an unacceptable risk for most small business owners to take.

The development of intermediaries is really important. If you look at the housing market, about 90% of mortgages are through intermediaries. In small business lending, it is less than 30%, so there is enormous scope for improving the availability of good advice from people who understand the market and can navigate it for small businesses. I have clearly shown the passion that there is to get this right. It can make a dramatic difference to the growth that this country is currently trying to generate from its institutions.

Q49 **Lord Sharkey:** In the course of the evidence that we have seen so far, there is a suggestion that, since 2008, banks have become increasingly averse to providing growth capital to SMEs and scale-ups, and that this gap has been filled to some extent by private markets and other non-bank providers. First of all, do you agree with that? Secondly, what are your reflections on it?

Louis Taylor: There are some banks that have become more averse to lending to SMEs for regulatory, capital and, ultimately, cost reasons. A lot of that gap, as Martin has just talked about, has been filled by new forms of bank, which are technology-driven and whose inherent operating costs are lower. They can be online, not necessarily with a big branch network, and so some of that slack has been taken up.

The market is just very different from 2008. It is rather better in terms of number of banks and diversity of sources of finance. It is not just pure bank lending, which, as Martin says, very often requires a personal guarantee. The growth of things such as asset finance, leasing finance, invoice finance and merchant cash advance has been incredibly helpful and does not involve personal guarantees. Any security is linked to the specific asset that is being financed.

Some of the reluctance on the part of the big banks to lend to SMEs has been addressed in a different way, but has not necessarily allowed the market to grow, to Martin’s point about the lower levels of lending that there are in the market now.

Irene Graham: There is more choice. That was a deliberate focus post the financial crisis: to have open banking, to open up credit data sharing, to introduce the Small Business Act, and to create the FCA sandbox. There has been a lot more focus on the innovation of our banking arena, and so there is much more choice now.

As a consequence of that greater choice, you see shifting patterns of where the lending is now taking place and moving. As Louis said, there is the increase in asset-backed finance and supply chain finance. There is more knowledge within our business community of the choices and types of finance, and that is also included in the way that equity is now being seen as a force of funding for growth. There is more recognition of that as an asset class, if you like, to drive your growth, and more take-up of that. That blend and choice has shifted significantly.

I would also say that, in the banking industry as a whole, there is more evolution in some of the lending products. As we see our economy shift into tech, creative, life sciences and climate, we are seeing new products come in, whether that is IP lending or recurring revenue lending. They are looking at different types, which is why aspects such as the green finance guarantee that the British Business Bank has, and how we can leverage that further into the newer emerging sectors in the economy, are important. There is more choice and more variety, and a shifting of who is providing that finance, but there is also innovation happening, which is a good thing.

Martin McTague: I would agree that there is a lot of innovation and more choice, but it is still having a fringe effect, because the bulk of the market is still borrowing from the big five. That could be because they do not have the financial literacy to make sensible choices in the market. They are often driven by a passion about their particular product or service, and not by a knowledge of financial markets. It is true that there have been good changes, but they are at the margin. The bulk of the impact has been negative. For big banks, it is not difficult to see why deposit taking from small businesses, where they give them virtually nothing, is quite a lucrative business to get into. SME lending is difficult.

Lord Sharkey: I noticed that the British Business Bank's most recent small business finance market report highlighted that private debt investors are increasingly concentrating capital into fewer, larger funds. Does this trend reflect a reduction in private credit investors' appetite to lend to SMEs?

Louis Taylor: Debt funds are not prevalent in terms of small business lending, because a fund's structure has quite a cost to it that does not suit itself to small business lending. The private debt funds that you are talking about are largely lending to mid-market and above, and to private equity firms for leveraging companies that they bought. They do not really touch the SME market in the same way.

Lord Sharkey: Would anybody else care to comment on that?

Martin McTague: I agree with Louis.

Q50 **The Chair:** On this issue of personal guarantees and providing loan support, has the business bank been scarred by the experience of the Covid bonds, which resulted in losses of about £2 billion to the taxpayer? There has been some controversy about the zeal that people have taken to recover those loans.

Louis Taylor: We have published two evaluation reports, and are about to publish a third, on the Covid loans. For all the losses, which are regrettable, whether they are credit losses or fraud losses, around 650,000 businesses and 2.3 million jobs were saved by the Covid schemes. The costs of the schemes, I would argue, should be seen as a business continuity insurance premium for the economy in an emergency situation.

I do not think that we are scarred by the experience of that. We have learned some lessons about how we would do it in the future. It was the first time that we had had to do it, and we were the first institution to do that in the UK. Of course, we have learned lessons about how to do it next time, if there is a next time, which there probably will be.

The recoveries that we are making on Covid loans are very strong relative to similar schemes in other countries. The US Small Business Administration, for example, is seeing default rates of around 60% on the loans that it made. We are going to be well under 20% losses on all of the schemes in the UK, and we are continuing to work to get that money back.

In relation to personal guarantees, you are right. No personal guarantees were taken on Covid loans. The position of the bank now on personal guarantees is that we do allow banks, where they have our guarantee, to employ personal guarantees where it is in line with their normal business practice, on the basis that that normal business practice is subject to regulatory oversight and the appropriateness of the use of personal guarantees. Fundamentally, in the end, the use of personal guarantees requires a balancing of appropriately mitigating the risk to the banks while allowing the flow of credit and making sure that the cost of it all does not get out of hand.

The Chair: I do not want to hog this, but the Public Accounts Committee report is pretty critical. The problem was that there was no due diligence done, even to the extent of establishing that there was a business. That may have been because of the speed with which things had to be done.

Louis Taylor: There was due diligence done in the sense that the banks did due diligence on those who were existing customers and whom they knew. The point was that there were a lot of companies that had never borrowed at all, needed access to finance, and needed it very quickly. The inadequacies of due diligence were highlighted to Ministers, but they were willing to take the decision, entirely properly, within their authority, that the imperative to get money out was more important than to do an intense due diligence exercise on those companies.

Q51 **Lord Hollick:** There is a £65 billion gap annually in terms of unmet demand; let us put it that way. Over the last decade, the market has seen the introduction of a large number of new lenders that are replacing the traditional clearing banks, which now have only 50%, and yet that has failed to address the demand.

You have identified personal guarantees, bureaucracy, and the reluctance of clearing banks to get into the weeds of dealing with small businesses. What is the solution to this? Are there any regulatory changes that need to take place? Are there any risk capital weightings that need to be addressed in order to open this market up?

Louis Taylor: To your point about the gap, which is based on the figures that Martin just gave you, I would just caution on the £65 billion, because there is £25 billion of non-bank finance lending to SMEs. The gap is in bank lending and £25 billion has been taken up with asset finance, leasing finance and the other elements of it as well.

The British Business Bank has been incredibly supportive of a lot of these smaller banks, which were start-ups, over the last 10 years. For them to fill the gap left by large, established FTSE 100 banks in short order is quite a tall order. We have put in place these organisations and they are definitely growing.

The regulatory reform from 2008 has certainly had a dampening effect on the ability and willingness of the big banks to lend to SMEs, but it is not the business bank’s role to tell the regulator how to regulate, and so I would respectfully decline to be too explicit about any regulatory change.

Lord Hollick: Is anybody else brave enough to tell us what the regulators should do to improve the situation?

Irene Graham: I would add a couple of things to the commentary that has been made. I would look at—and I would be very happy to share this with you—the SME finance monitor that has been monitoring debt funding and the attitude of demand. That does show permanent non-borrowing there, so how do we encourage businesses to borrow? If you want evidence that is statistically robust, I would look at the SME finance monitor for that.

It is important that we now have regulators with a pro-growth agenda. Lending is traditionally based on cash flow. As we are seeing more and more IP-type companies emerging, we have to have a regulatory environment that supports IP lending, or other forms of lending, such as those that are emerging on recurring or predictable revenue, which is different from cash flow.

One needs to have a focus on those areas and to make sure that our regulatory environment can support the range of banks or finance providers that may be able to offer that. That is a shift from cash flow lending, which has been the tradition across traditional banks or even the newer banks coming in. There are important new forms of funding and lending that can be developed. Some of the large banks are already building those types of products, and we need to see how that can be accelerated.

Martin McTague: It is a question of balance. If you accept that the regulations that you have imposed post-financial crisis have had the impact of slowing up the availability of debt to SMEs, the Government have to recognise that, if that is how the market has reacted to it, they have to step in and provide more guarantees. At the moment, they are not providing those guarantees. You have a trap, where you have imposed more regulations and restricted the market, but are not prepared to guarantee it to free that market up.

Lord Hollick: Have any other countries managed to crack this problem?

Martin McTague: Certainly, as far as Germany is concerned, there is significantly better availability of finance to SMEs than there is in the UK.

Lord Hollick: What can we learn from that to change the landscape in the UK?

Martin McTague: They have a completely different structure, which is based on regional mutuals. They are much better at assessing local regional conditions and, therefore, prepared to lend. In the US, the Small Business Administration has provided a lot of support for regional banks, and there are thousands of banks in the US providing this kind of support at the local level.

Lord Hollick: Are any of the new lenders in the market focusing on increasing their book of SME lending?

Martin McTague: The ones that have become most active have decided that they will operate at what I call subprime level. They will typically charge up to 40% on loans, and they do only a cursory look at any kind of business plan. They are interested only in your personal assets, and will lend with a PG against those. Although it is notionally lending to a business, it is not really.

Louis Taylor: I would answer that question in a slightly different way. Over 60 banking licences have been granted since 2008, and over 40 of those are focused on SME lending. You saw that there is quite a healthy market. Just yesterday, Shawbrook Bank acquired ThinCats—another SME lender—to create a larger lending book in preparation for IPO. There are also other challenger banks whose business model is lending to SMEs and that are not charging 40% interest rates.

The Chair: You declined to comment on what regulatory changes should be made. Perhaps I should declare an interest as a former chairman of a challenger bank. The capital rules do limit the ability to provide lending, but you were not prepared to criticise the existing regime.

Louis Taylor: I would say that there is a tension here between the regulators ensuring that there is enough capital held against the risk of lending to SMEs and wanting to promote economic growth. I would go as far as to say that I am not sure that the balance is right at the moment.

The Chair: Where do you think it should be?

Louis Taylor: The banks should be able to lend more and to promote growth rather more. There is a lot less risk in a portfolio of SME lending than perhaps the regulatory position suggests at the moment.

The Chair: Should the risk weighting be changed?

Louis Taylor: That is one interpretation that you could have.

The Chair: I was not interpreting. I was just asking.

Lord Hollick: I am intrigued by your reluctance to trespass in this area. It seems to me that one of the brakes and one of the real problems is the regulation, and the capital risk weighting is slowing down this very important part of the economy. As three people who are intimately involved in the problems of this area, it would seem to me that it is very important that the Government understand what they need to do or consider to improve the situation of supply of credit to the SME market.

Louis Taylor: What I presented are alternative solutions to dealing with the capital weightings that you have at the moment, as evidenced by the challenger banks, which are using technology to lower their costs and enable them to make those loans and to fill some of the gap from the traditional banks. It is also the case, though, that this has to be a discerning market. Not everybody who wants money should have that money, and the banks need to have the ability to say no.

Q52 **Lord Hill of Oareford:** We have sort of started to get to where I wanted to go, following on from Lord Hollick's question. Mr Taylor, you were saying that there is more variety coming in and challenger banks setting up, which is all very good, but we have heard previously that one of the problems is that there is a cap, in effect, on the ability of challenger banks to grow, set by the capital rules. You get up to a certain level, and then the MREL rules kick in and you cease to want to lend to SMEs.

I was talking the other day to someone running a challenger bank, who said, "Great news, I can lend more". I thought, "You've obviously been growing", but he said, "We've had a bad year, so we've fallen underneath the level where we are caught by the capital requirements. Therefore, I can lend more to SMEs". This seems to me a rather strange business model.

Mr McTague made the point before that, because of the regulatory changes, which have been drying up the availability of capital to SMEs, one answer is to get government to deliver more guarantees to business. The other answer is to change the regulatory regime to free up more.

I just want us to keep going a bit on that theme. Is there a better solution to the availability of capital? Instead of trying to get the Government into the area of doing bank guarantees for tens or hundreds of thousands of small businesses up and down the country, for which they are entirely ill equipped and using taxpayers' money, if one changed the regulatory regime, we might get back to a situation where there was more money available from the banks in the first place.

Martin McTague: That is a fair challenge, but the big five are too big to fail. In essence, that means that, if you lower the capital requirements and they lend recklessly, we will probably all end up picking up the bill anyway. It is a question of finding the balance between having sensible capital requirements and, if that is not generating enough borrowing, the Government have to step in. In the case of these guarantees, the banks still have a significant chunk of risk involved in them, so they have to still manage them properly. It is not like they can lend willy-nilly without taking any consideration of the risks involved.

Lord Hill of Oareford: I just find it slightly odd that you think that the answer is government guarantees, rather than going back to a situation that we had only 15 years ago, where an extra £65 billion, on your figures, was made available by the big five retail banks.

Martin McTague: It is a question of how much risk we, as a nation, are prepared to take in increasing those capital requirements.

Louis Taylor: It is also fair to say that over 90% of the guarantees that we give are not to the big five. It is to challenger banks and earlier-stage banks, getting them going. I would agree with you that, in a free market economy, it would be undesirable for the Government to be guaranteeing the predominance of SME lending. That would not be a desirable place, and that is not what we seek to do.

In terms of our ability to give these guarantees, there was reference made at the very beginning to your interest in the fact that we operate only through delivery partners. They are making the loans and we are assessing their ability to underwrite. That is the extent of the work that we do. If they are properly regulated and we have properly diligenced their underwriting standards, we feel confident giving the guarantees. The track record of those guarantees is very strong as well.

Q53 **Lord Vaux of Harrowden:** I want to try to turn the question the other way around. You are unwilling to tell us what changes should be made to the regulations. Mr McTague has told us that there was a £90 billion reduction in lending, and you referred to regulations having a dampening effect. Can you be more specific about what the regulatory changes were that have had that effect? It is important that we understand the problem before starting to think about solutions. What were the regulatory changes that had that impact? We have talked about the capital requirements. Are there others?

Louis Taylor: It is vastly, preponderantly the capital requirements, but there are increased compliance costs as well, which have a dampening effect. At the same time, many of those compliance costs are associated with taking deposits as well, and yet there is not a problem for banks in doing that. That suggests that it is far more a capital issue than it is anything else.

Martin McTague: It is difficult, because my principal concern is the effect of those changes, not what has caused the changes. The banks are very vocal in describing what they think could improve it.

Irene Graham: I would just add that the regulation is set against the international context of Basel rules and, therefore, what the UK wants to do in that international playing field. It is important that you now have a pro-growth agenda baked in across the regulatory piece, including the range of the regulators.

Then you have to get into the specifics. One has to really look at the rules as they apply to the different sizes of organisations and the different types of lending. Certainly, we can come back with some of the specifics in that regard, if that is helpful. That is where we need to get to.

The Chair: Before you move on, are the Basel rules not a bit of a red herring, given the exceptionalism shown by the European Union and the United States?

Irene Graham: I am just saying that the UK has always wanted, and has always stated that it wants, to be part of that international dynamic.

The Chair: It is not an international dynamic. Europe and the United States take a different route.

Irene Graham: I understand how others may have chosen not to align. I am just making the point that there is an international context. That was all.

The next point I would make is that we have to get the balance between debt and equity. For some of our SMEs, more debt will not be the right answer. It is more about the equity that is available for their growth. That is where we are looking at a different set of regulations and at how we grow the institutional capital from our pension funds into the scale-up economy. That is another area where we have the regulatory dynamics to address, including that required of the trustees - we want to see more of that going into the economy.[2]

We do have to be careful. Debt is not going to be the sole answer to our growth and scale-up economy. We have to look at equity. Part of the crisis came from banks lending when it should have been more equity that was put in. There is a balance.

Q54 **Baroness Bowles of Berkhamsted:** I am glad that you have got on to equity, because that is where I want to go to in the sense of who is going to have skin in the game in this. If you look at the German model that has been referenced, the regional banks will have some skin in the game and take equity. Why can we not have some of that?

We are also going to be looking at private markets. We pride ourselves on the size of our private markets, but I do question who they are raising money for. Is it all for somewhere else, and not for the UK?

If we are looking at our pension funds hoping to invest, in a sense, privately in this kind of space, how are they going to take that over and deal with the small companies, bearing in mind the overheads of analysis?

As Louis has referenced, there is an overhead to having to analyse all these things, so how is that going to work? The smaller scale-ups, and especially the tech ones, will not have got to the stage of producing revenue, so it is no good looking at turnover. They are not a coffee shop that can say, "I'm going to have customers marching in". The UK Government still have not cracked it on procurement. How are we going to get that equity investment at small scale? Even with IP loans, they should be doing some work on the quality of that IP, not just the "weigh it in" type of things. How is that going to fit together?

It comes back to the regulatory points then. How are the Government going to be able to make them do this due diligence on the small companies and result with the equity investments?

Irene Graham: I am happy to start, and then Louis you will want to talk about the activities that you are taking on and the things that are being put in place.

It is really important that we have, as I said, the Mansion House accord and the commitment by the pension funds to voluntarily contribute more of their portfolio towards the growth economy. How you translate that

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[2] Note by the witness: This refers to wanting to see more institutional money going into the scaleup economy.

into the growth economy is vitally important, to your point, and that is why you have a range of them [the pension funds] looking at how they partner with venture capitalist firms and growth capital players. It is also why it is important that the British Business Bank has been asked to set up the British growth partnership, which I am sure Louis will talk more about, as well as building out the BBB regional network.

How we use existing players and scale them up with the institutional money, as well as how the British Business Bank plays its role as a catalyst in terms of getting those larger-scale amounts through the British growth partnership etc into the market through the range of partners that it is working with, is going to be important.

As you have noted, in the Mansion House accord, there is a backstop being suggested whereby, if the pension funds do not release that commitment towards the growth economy, there may be some legislation looked at. At the moment, it is looking at that voluntary aspect, and you have seen some of them, such as Phoenix and M&G, doing a range of things to look at how they get their funding through into that growth economy. That regional network/s they use and partnerships will be important.

Louis Taylor: The starting point that I have in this is just to recognise some of the good things that are happening, because it is not all awful. The UK is the third biggest venture capital market in the world, bigger than France, Germany and Sweden combined, but we could do so much better, in an economy that is second only to the US in terms of innovation generation and quality of academic research, with the opportunity that is here.

In the US, which is the largest venture market, 70% of venture capital comes from 401(k) money, or pension money. In the UK, 10% of venture capital is pension money and, if you take out foreign pension money, it is 3%. Our pension funds are not investing in the growth economy with long-term patient capital in the way that other markets do. Australia would be similar to the US. Canada, although with a defined benefit system, is again similar, with a far greater investment in the growth economy.

How do we get our pension funds to invest? There is a regulatory element, which, of course, is relevant to this committee looking at financial services regulation. Some of that has started to be addressed through the Mansion House accord, but the barriers to getting into smaller businesses, particularly the innovative growth companies that are going to be the big companies in 20 years’ time, are a conundrum.

The bank has been developing a solution that is getting to a good state of maturity. For quite some time, the bank has been investing in early and mid-stage venture capital funds. We are the largest limited partner in the UK in UK venture and growth equity funds. You might want to consider the position in a free market economy of a government organisation being the largest venture capital investor as an indicator of the position in the market for pension funds.

What we have found is that, by investing in funds, the fund managers are finding the companies to invest in. Through our British patient capital programme, we have 1,200 underlying growth companies in 40 fund managers, and over 80 funds with those 40 fund managers. We get to live with those companies for some time through the fund investment. When they need more money at a scale-up stage, we understand the companies. We know their trajectory. We know their history. We know where the technology stands relative to the market.

We are then willing to back them directly with more money at that stage and, through the spending review settlement we just got, through to the next stage. Historically, we have been able to write up to £15 million cheques into, say, a £50 million round. We are now going to be able to write £50 million to £60 million cheques into a £200 million round at that scale-up stage.

We have a continuum here of financial provision through the life cycle of the companies. We are now trying to open up that track record, which is difficult to create for a pension fund, but we have done it over the last 10 years. We want to open that up to the pension funds.

The Government have allowed us to set up a regulated entity, BBB Investment Services, which is going to set up a fund—we are raising money at the moment—called the British Growth Partnership, which will focus initially on series C+ companies coming out of our fund investments. These are later-stage science and tech-led companies that we are trying to get pension funds to take a position in. Once they see not only our model, but the quality of the companies that we are going to provide them with, we hope that they will want to be invested in the funds that we have already been investing in at an earlier stage.

Baroness Bowles of Berkhamsted: Who are those firms going to be pitching to that have done their C+ round?

Louis Taylor: They are going to be working with the fund managers who have already invested in them, as well as us. We will be a participant in the round. We will not necessarily lead rounds. There will be general partners who are leading the rounds.

Baroness Bowles of Berkhamsted: A lot of these are small businesses that do not have those links. They have raised a lot of their money from friends, family and other contacts.

Louis Taylor: There are seed funds. We are also investing in angel syndicates that invest in those very early-stage companies. Irene did a much better job than I have of talking about some of our programmes. The regional angels programme backing angel syndicates is disproportionately powerful, because those angel syndicates in the regions not only bring money but are backed by entrepreneurs who have experience and networks, and can bring so much more than the money. It is not just at that later stage that we are investing. We are investing at an earlier stage as well.

In terms of getting the pensions in there, they have been averse to investing in funds because of the perception on fees. They have been regulated to keep costs down rather than to focus on net-of-fee returns that they realise. We are trying to redress that balance. The Government are trying to redress that balance. They have stopped short of mandation, which, Lord Forsyth, you were starting to talk about. That is something that the Government are going to retain a reserve power to do in the forthcoming legislation, if necessary.

Martin McTague: As has been said, these are largely focused on later-stage investments. We would put the emphasis on angel syndicates. There is quite a lot of enthusiasm to get them started and running, but there is a lot of bureaucracy around setting up one of these syndicates, and the FCA fees can be really significant.

Louis Taylor: We have doubled the size of the angel programme. Also, to address Mr McTague's issue—

The Chair: I need shorter answers because we have quite a lot of questions. We can take it that we have all seen the business bank's report.

Louis Taylor: We are creating a regulatory umbrella for syndicates to come under in a more cost-effective way, but there is an element of need to professionalise syndicates and make sure that investors in those syndicates are protected as well.

The Chair: Could you elaborate on the point that you just made, Mr McTague, about FCA costs?

Martin McTague: One example that I can quote, just to keep it quick, is that of a bunch of angels who wanted to invest in female-led businesses and tried to establish a syndicate. The FCA fees for establishing that syndicate were £50,000, so it dampened enthusiasm for that group to try to focus on an area that they were quite passionate about.

Irene Graham: More angel investments from women are occurring now.

Martin McTague: They are. I am only using that as an example.

The Chair: The committee is interested in what we need to change to make things better, rather than reporting on what is happening at the moment.

Irene Graham: One thing that we need to focus on is connectivity. We have a range of public finance institutions. Innovate UK plays a very important role, as does the British Business Bank, but that connectivity between how we refer on businesses and treat them as a customer in the public sector, and making the transition between different types of funding easier, is a really critical matter. That is about organisation in the public sector and how the PFIs interact with each other.

Q55 **Lord Lilley:** Could I go back to the point that is fundamental to this, which was raised by Mr McTague, and others sort of accepted it? The fact is that things changed in 2008. Prior to that, we were growing at roughly the same rate as America. Our lending was growing at roughly the same rate as America. Since then, America, after two or three years of recession, returned to the previous rate of growth both of the economy and of lending. We, on this side of the Atlantic—not just in the UK, but, to some extent, in the rest of Europe—went back to a much lower level of growth of lending and growth of the economy.

The key question is this: is it the lack of growth of lending to business that is slowing the economy, or is the fact that the economy is slowing for other reasons leading to less demand for borrowing? That is question one.

If you think that it is a shortage of lending for business, is that the result of constraints on the banking system, because we, in effect, apply the Basel rules in most of our banks, whereas America has 800 regional banks that it does not apply to? Is it because investment equals saving? Economists do not agree on much, but they all agree that investment equals saving, full stop. Therefore, you cannot have more investment than you have saving. If we have a shortage of supply of savings in this country, however we fiddle around with the lending, that is the amount, unless we borrow more savings from abroad.

Is it lack of lending to business that slowed the economy, or lack of demand for lending that slowed the growth of lending? If it is the lack of supply of savings, where are we going to get it from?

Irene Graham: We did a piece of work to look at what drives scale-up growth at a local level. We looked at a series of dynamics to that. Is it transport? Is it the number of start-ups? Is it how long the start-ups survive? Is it bank lending? Is it equity? Is it skills? We did some regression analysis across multiple years.

We found three things that will make a difference to local scaleup growth, and it was not bank lending. We analysed that against postcode lending. The three things were access to talent and skills, the ability to develop clusters and hubs, so really focusing on the clusters, and the ability to access growth equity capital at a local level.

That is why we are very focused on how we get the regional equity from angels to funds to institutional money working effectively locally, aligned to the clusters that are developing locally and the infrastructure that needs to go around that, and aligned to getting the right talent available to those businesses, both at home and abroad. Those were the three drivers that were critically driving that local scaleup growth. It is outside of lending that will drive forward what the growth opportunity is.

Louis Taylor: My response would be that, as I am sure this committee knows better than me, it is not just about how regulation is drafted, but how it is enforced and the culture that that ends up creating. In that context, the short answer to your question is that, whether it is lack of supply or lack of demand, it is an iterative spiral. One feeds the other. That is because there is a culture of risk aversion, which has been brought about by the strength—or perception thereof—of the enforcement of regulation and an unwillingness to seek to be courageous in the lending that you are doing.

In terms of shortage of savings, I would take issue with you. In the UK, we have the second largest funded pension scheme in the world, at about £4 trillion. I do not believe that we have an issue with the amount of money available. It is an allocation issue, which again comes back to a risk appetite issue, culturally.

Irene Graham: That is also borne out when we look at the investors into our scaling economy. Our international investors have more risk appetite going into these businesses than our domestic investors. We have Canadian and Australian pension funds and sovereign wealth funds from overseas taking earlier-stage investment, and that is what we need to shift.

Martin McTague: The best way of looking at this is to go back in history. Every time we have managed to get significant growth in the economy, it has been generated by SMEs. SMEs are the ones that are going to innovate, take on new people, and take on new productive facilities.

Think about the average business owner who is thinking about either carrying out some innovative product development or wants to invest in some new form of productive equipment—it is easy enough to borrow for buildings, but less productive—or invest in people to generate growth. That is extremely difficult at the moment.

The key factors are that it becomes very expensive to do it; there are loads of conditions; and they do not have the advice and the confidence to navigate all this, so they tend to take the line of least resistance. There is no lack of enthusiasm to invest in their businesses; the people I meet up and down the country are very passionate about doing it, but, if you are asking them to risk all just to be able to grow their businesses, many of them will take the decision to grow more slowly. In fact, that is the response we get from something like 70% of survey respondents. They would rather grow more slowly than take the risk of borrowing.

Lord Lilley: One cannot explain a change by a constant. If the cause has not changed, the result will not change. Likewise, if there is a reluctance, what has made people more cautious since 2008, in both lending and investing—and the forms that it takes, whether it is in equity or otherwise—that did not apply before 2008?

Martin McTague: I would argue there has been a significant change, which has meant that it is much more difficult to access finance on the same terms that you would have done prior to 2008. The conditions are completely different.

Louis Taylor: In a particular area of the market, we have research from Professor Monder Ram from Aston University about ethnic-minority entrepreneurs self-deselecting from applying for lending, because they just do not think they are going to get a loan.

Lord Lilley: Did they not do that before 2008?

Louis Taylor: They might have done, but what I am saying is that the dampening effect I have talked about on bank lending has led to other businesses also self-deselecting and perhaps not asking for loans as much.

Irene Graham: We have to segment the SME economy. You cannot just talk of them as one homogenous group, because it is actually 34,000 that are really growing and generating over 60%[3] of that economy. That is why this scale-up capital element is vital. They are investing in R&D and capital investment. They are hungry to grow and go international as well, but they are seeing that there is friction in the system for raising capital between the different stages. How can we make that simpler and make sure we can cut through that?

Lord Lilley: What changed in 2008? Were there more of them before 2008 than now?

Irene Graham: There were fewer scale-ups. There was less equity funding available.

Lord Lilley: You have more of it, but less growth.

Irene Graham: Well, that goes back to some of the macro aspects. We said lending is not going to drive the growth. Your development of clusters, hubs and sectoral activities, your building of the talent base that we need and the building of the equity to drive that growth are going to be important. Those are key drivers of growth, and that includes how you bring the infrastructure around that. We are seeing many more science parks and hubs for specific sectors. How do you create more of those clusters and hubs regionally, and how do we get the funding in of equity to these to drive opportunities forward?

Q56 **Lord Grabiner:** Could I go back to the equity point that I and the committee are interested in? At the outset of your remarks, Mr McTague, you told us that 60% of new businesses fail within the first three years. That was at least in part, probably a significant part, the motivation for big lenders not to get involved and not to be supportive, no doubt because they make more money out of deposits, which I think was what you told us.

In a sense, what they are saying is, “Well, this is our market”, and then

[3] Note by the witness: This figure is 50%

there is a private market that might take a different view in terms of lending, because they are not such big deposit takers, for example, and so they may have a different business model that makes it more attractive. The private lender is presumably willing to approach the lending in a completely different way; it is willing to take a stake in the business, for example, and to become a partner.

If that is the case—and that is my understanding of the way that private equity, for example, works—why is it that the big lenders are not interested in a similar market? Is it because they have decided that they know what their market is and have decided what the private lending market is, and they are two different markets? Is there scope for greater encouragement of taking partnership in a new business than is currently the case? Is it possible that there might be improvements in the regulatory structure, which could do something about this, or not?

Is it the case that new businesses are reluctant to give away the equity, or part of the equity, in a new business? Is that an issue? I must say, to me, the choice between giving away some equity versus giving a personal guarantee is a no-brainer. You would be bonkers to give a personal guarantee in that situation; it is much better to give away some of the equity. Could you talk us through some of that stuff in terms of your experience or understanding of what the respective approaches would be of the two different sides of that market?

Martin McTague: Private equity is largely not very interested in the very bottom end of this scale of businesses. They tend to invest more in larger established businesses where they think leverage can be an effective way of making money.

As for your first point about taking equity and being more aware of how that could be a better alternative, part of the problem is that—without sounding too disparaging, if you are somebody who has decided, "I am the world's best widget maker and I want to make the best widgets around", you are generally not that well equipped to decide about financial mechanisms that could help you grow. You know what you are passionate about.

Therefore, in those situations a lot of people just reach for debt, and they reach for debt because it is obvious. It is the area that they perhaps need less financial acumen to understand. The equity market also tends to want a very rapid return at the bottom end. Typically, they will want 20% return a year. They want their money back in five years.

If you compare that with debt, for somebody who is not really prepared to consider the different risks, giving away a chunk of a business that they have probably just invested a significant amount of time and effort in, with that potentially costing them 20% a year, is something a lot of small businesses do not want to take up. Now, are they right to do that? Well, in some cases, no, but that is a common reaction.

Lord Grabiner: Who are the lenders on the private side, so to speak, that sit below private equity? Set aside private equity. Who else is out there? What is out there?

Martin McTague: They are non-bank lenders, largely. They are focused on asset-based lending.

Lord Grabiner: Of course, as you say, some of these businesses have no assets to charge.

Martin McTague: No.

Louis Taylor: There are some funds that are venture debt or preferred equity that are offering what is initially, at least, a non-dilutive financial instrument, a debt instrument, but, in the event that things do not go well, there is an equity element in there. That is quite a nascent market in the UK. It is one we think has a lot of potential, so we are backing the providers of that sort of debt. In terms of the banks taking equity stakes, that is a regulatory issue and a capital issue. Banks are, in effect, discouraged, from a capital point of view, from taking any material stake in any company.

You asked a question about whether there was a reluctance on the part of business owners to give away equity. In a lot of places we see a real reluctance among small business owners to raise money by selling equity. They do talk about giving away equity. Nobody gives away equity; you sell it. You get consideration for it. There is a cultural issue around this that we do see, particularly among small businesses. Of course, it is sometimes quite difficult for people to want to take the chance that a smaller piece of a much bigger pie is worth more than 100% of a smaller pie, which is really the calculus.

Lord Grabiner: My "give away" point was just a loose expression. Of course you are selling equity, because you are getting money in return. You are getting a loan in return.

Louis Taylor: You do see the mindset in the market. People think they are giving it away, and they are not.

Lord Grabiner: Mr Taylor, I am glad you have made reference to regulatory improvement. We are weaning you away from your reluctance. I just wanted to make one point as an observation—and we might encourage you perhaps to step a bit further into that mire—which is that suggesting regulatory improvements is not a criticism of the regulator. What we are concerned with are things that we might be able to recommend that would improve the regulatory structure. That is not a criticism of regulators or what the regulators are doing.

We are very concerned in this committee to try to identify improvements in the regulatory structure that will have an impact upon growth. That may lead you to some suggestions; if it does, we would be very grateful to receive them, if not here then subsequently in writing.

Louis Taylor: In part, my reluctance is that I am no regulatory expert, and here I am in front of a committee of regulatory experts. I have highlighted a factual point.

Lord Grabiner: It has nothing to do with that. It really is to do with the regulatory structure, which you are very competent with.

The Chair: It is probably best to point out that the committee has discovered that businesses and others are very happy to tell us what improvements could be made privately, but somehow do not want to do so publicly. It seems to me that that is not a healthy position.

Q57 **Lord Kestenbaum:** Good morning. Listening carefully to what you have said over the past hour and a bit, I wonder whether I could press you a little bit in terms of trying to understand your sense of the urgency and the gravity of the issue. Just restating the exam question, does reduced access to capital represent a material constraint on the ability of small businesses to grow? How urgent and how grave is that issue?

Listening to what you have said so far, the picture from the various witnesses seems mixed. Mr Taylor, you have spoken very persuasively and encouragingly about new entrants, diversity of sources of finance, and all the rest of it. Mr McTague, you have indicated to us that broadly speaking, to use your words, it is at the margins. Your words were, “It is a fringe effect”.

Absent any meaningful regulatory reform or incentives directed towards commercial banks to intervene more meaningfully in this space, we cannot expect the current 40% of participation in lending from commercial banks into this sector to do anything but come down. If you will appear in three years’ time, I am assuming that that percentage will come down. In the meantime, the picture that you present to us is of modest incremental improvements without a radical call for regulatory reform. Will that incrementalism do? How urgent and how grave is the issue? Mr McTague, you are smiling, so I am coming to you first.

Martin McTague: It is grave and urgent. On one hand, you have a Government who are very focused on growth, yet 60% of the economy is generated by SMEs. Most of their decisions are made based on what ability they have to grow. That is usually a function of the funds they have available. That has significantly reduced over the last 15 years. For me, it is an urgent problem. Some of it can be resolved through regulation, for example, on PGs. That has a significant chilling effect on what business owners are prepared to do. Government could take action on PGs; they could do a lot more on PGs.

The growth guarantee scheme, which sits at £1.2 billion, is tiny. If you are really going to make a difference, this is something that could make a significant difference. Louis would tell you that the demand for that growth guarantee scheme consistently outstrips the supply, over and over again.

Louis Taylor: It is different in different parts of the market. You can create a credit boom, but there is generally a bust afterwards. Doing anything with real pace and quantum in terms of broad lending in the market needs to be done with caution, but there is clearly an opportunity to create more growth in the UK. At the moment, demand and supply of credit are largely in balance, but that is in a market where there is quite suppressed ambition for investment among businesses. Were they to become more ambitious, I do not know whether the credit providers would really be there to satisfy the demand. Again, I come back to the iterative nature of some of this.

On the equity side, there are areas where there is real urgency. Last night I was at a round table dinner about investment into innovation in defence. We had some military personnel there who had had front-line experience in Ukraine. The sense you get is that this is right now, and we have to scale this up at pace. There is a real urgency to get more equity into innovation in the defence space.

There are other areas of the industrial strategy sectors where I would argue there is pretty much the same urgency. We cannot afford to miss AI. We cannot afford to miss preventive medicine. We cannot afford to miss a whole lot of clean technology and nuclear. There are a range of things that are fundamental to the future prosperity of the economy. We have an advantage in them and, unless we feed that advantage, we have an issue. That is primarily an equity issue, backing innovation, which is higher risk. That is genuine equity risk.

Irene Graham: I would re-emphasise that point. The pace of reform and regulation has to happen on the equity side. We have to see the results coming through of the Mansion House accord and the Leeds reforms, and that has to happen at pace. We have to see the implementation and delivery of what the British Business Bank is setting up with the British growth partnership. That really needs to come to the fore.

We have to make sure that capital is connected to the innovation firms. That means joining up the system much, much better than we are doing today, having referrals between the PFIs, and making sure that Innovate UK is referring into the British Business Bank, so there is follow-on funding, and then the next opportunities to the private sector as well. Private sector investment is coming in at scale[4], and at larger amounts than it is today. That is critical for driving our growth at the moment.

On the lending side, I have mentioned IP lending and other forms of lending. We need to make sure the regulatory structure enables all forms of bank lenders to provide that. There are some regulatory aspects there, but that is looking at different forms of lending, not against cash flow, but against IP. The pace that we need to see of the reforms that are taking place on pensions is vital. The listings regime reforms are vital to fully implementing PISCES. Getting that up and running is going to be vital. That is a really big focus.

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[4] Note by the witness: Private sector investment needs to come in at scale.

For this committee, looking at whether the regulation is fit for purpose in the pension environment is a critical matter, which enables that execution of what has been committed in the Mansion House accord.

Q58 **Baroness Noakes:** Can I just explore numbers a little bit? The SME sector has 5.5 million participants, of which just over 4 million do not have any employees. They are just sole operators. If you look at those with nine or fewer employees, that is another one and a bit million, so you are actually talking about a relatively small number of people in terms of scale. I believe, Ms Graham, you referred to 34,000.

Irene Graham: Scale-ups are at 20% growth, so another 16,000, yes.[5]

Baroness Noakes: Yes, which is where the growth is going to come from. What I am trying to grapple with is how you make sure you support growth in the ones that are important to the economy, and not dissipate anything across a much wider group. I am also interested whether Mr McTague agrees that the growth is going to come from the 34,000, not from the 5.5 million.

Martin McTague: I would not argue with Irene's numbers, because I do not know where she got 34,000 from. For me, yes, there has always been a case that growth is focused on maybe 10% or 15% of the small business population. That is where the bulk of it comes from. However, to get to the point where you have those potentially high-growing businesses, there are lots of hurdles to get over. They have to first be able to get adequate debt or equity at the very earliest stage to survive those early stages. They also need support in early growth stages where equity investors are just not interested; otherwise the funnel of new businesses that are coming through—let us say Irene's 34,000 is right—is going to dry up.

A classic example I had the other day was a graduate who had come out of Bristol University. In fact, he was one of the presenters at one of your events, Louis. He had sought to find finance, because it was a spin-out. It would have been a spin-out from his university. He had no end of offers to go and do it in the US. Ultimately, his desire to stay in the UK meant he had to raise money in the UK through a very difficult process. He is now running an internationally successful business that he needed help to get through those early stages; otherwise he would not have been in Irene's growth cohort.

Baroness Noakes: How can regulation stand a chance of identifying that small number in this very large population that are critical to our growth mission?

Martin McTague: Unless you create the conditions where highly motivated individuals with good ideas can get access to either equity or debt—and it does not matter what size they are at this stage—we are in danger of choking off any opportunity for growth in the future.

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[5] Note by the witness: Scale-ups at 20% growth or more number circa 34000, with another 16,000 at 10% or more growth.

Q59 **Lord Hill of Oareford:** This is a question for Mr Taylor about something you said earlier. It is just a factual thing. On this pension fund question, we all know the stats: the pension funds that are investing in UK start-ups often tend to be overseas pension funds, rather than domestic funds. There is clearly a risk aversion issue, but I think you said that some of that reticence is to do with regulation. What do you think is the underlying problem with UK domestic pension funds and the fact that their percentage of investment has been falling? If we are not going down the mandatory route, which seems to me not a good route, what are the underlying regulatory issues?

Louis Taylor: Again, it is a broad topic. In any pension scheme there will be a quantum of government debt, but there should also be an element of growth. Because of the way the pension funds, particularly DC schemes, were initially regulated, there was a real focus on minimising the costs that those schemes incurred, which drove them towards index funds and passive investing, which is at a very low cost. That morphed into global allocations, as well. That is why today we have around 6% of the UK stock market owned by UK pension funds, where 25 years ago it was 63%, or some number like that. The focus on cost has largely led to that.

There is an argument that the industry would make that the diversification of a global strategy makes sense, but I would argue that you have to have a qualitative overlay on this. The UK being an innovation ecosystem would mean that, if you are going to invest some money in growth, you should disproportionately focus on the innovation ecosystem of the UK because of the quality it represents relative to some other economies. It would be good for pension funds to be able to do that sort of thing.

To a large extent, the Government and the Pensions Regulator have removed the fee cap, but there is an entrenched competitive position here. If you are the first pension fund to say to your pension trustees, "Instead of running this at 12 basis points a year, next year it is going to be 15, but I am going to generate a load of return", the risk is that the trustees go next door for 12 basis points. This curve is going to be relatively slight to start with, but it may go quite exponential quite quickly if you get some decent-sized players focusing on net-of-fee returns and being able to market that to their savers.

The Chair: Can you help me on this point? Listening to the discussion so far, in my head there is a distinction between pension funds and others investing in secondary markets. Small businesses are at the front line, creating real jobs and new innovation. Listening to you and Mr McTague, that divide is apparent. It would seem to me that we are too focused on secondary markets, and not on the primary markets.

Baroness Noakes raised the question, "How do you know who the stars are?" Certainly in all of my political life it has been apparent to me that the big businesses of tomorrow start off as small businesses, and the big businesses tend to decline once they reach a particular size. Am I missing something here?

On the pension funds, are the Government not wanting to have it both ways? On the one hand, they want them to buy government debt, and we had regulatory issues concerning that; on the other they want them to get growth, but are we going to achieve real growth just by looking at secondary markets? Do we not need to actually feed the people who are making the products? Am I missing something?

Louis Taylor: I do not think that you are missing something, but the primary and secondary markets are absolutely interlinked here, because if somebody manages to sell something in the secondary market, and they are a primary market investor, they reinvest into the primary markets. I do not think that the secondary markets should be considered to be only the public markets; it should be the secondary market in private assets as well.

Some of the investments that we are making in venture require 20-year money. OrganOx last week was sold for £1.5 billion. We have been in that for over 10 years. This does require patience, but we should not have to put in 10-year money. The company may need 10-year money, but, five years on, there may be some other investors who want to take a slightly derisked position. Liquidity in the secondary markets, wherever they are, is important for risk assets.

The Chair: I completely understand that. I am with you, but I am just saying the tenor of the debate seems to be very much focused on secondary markets to get growth. To my mind, if those SMEs that are in the front line making real products and providing real services are not able to grow, have we not rather lost the place?

Louis Taylor: I absolutely agree that we need to increase the quantum of institutional money going into primary investment. There is no question about that.

Irene Graham: Just to pick that theme up, our institutional money has historically been in equity, at over 50%. It is now less than 4%. That is why you have a big swing towards government debt or corporates. We need to see that adjust and be more into the private sector in a primary way.

The secondary market is also important, because a lot of our businesses want to stay private, but they need liquidity into their cap table. That is why PISCES, which has been developed, allows that. You have to look both at the primary investment through the unlocking of the capital and through vehicles, and at the secondary liquidity, because companies themselves want to stay private.

The Chair: Mr McTague, I was making your argument for you.

Martin McTague: You have made it better than I would have done.

Louis Taylor: Chair, just to your point about the Government wanting it both ways, I do not think anybody is suggesting that the pension funds should not have significant holdings of long-term debt, to an extent; nor are they suggesting that they should be totally skewed to growth. There needs to be a diversification here. From the point of view of the business bank, what we want to see and are trying to engineer with the growth partnership is that every defined contribution pension scheme has a 1% to 2% allocation to venture. That would make a huge difference.

The Chair: I will not abuse my position and get on to the subject of quantitative easing and how Governments do it.

Q60 **Lord Vaux of Harrowden:** On the debt side of it, the Bank of England issues a quarterly report on supply and demand for debt in both household and corporate sectors. That tends to indicate that supply and demand are broadly in line with each other. There is a slight increase in debt in the last quarter, both supply and demand, for small and medium-sized businesses. That tends to argue the opposite of the fact that there is not any availability and your point about people self-deselecting from the market.

I have two questions. First, how do we explain that difference? The Bank of England is saying everything seems to be fine, according to these surveys, and you are saying there is a huge gap. Secondly, does that imply that the regulators really are not paying sufficient attention to this, because they think it is fine?

Martin McTague: There is a tendency for regulators to think it is fine, because they have convinced themselves there is a balance of supply and demand. It is probably a silly comparison, but if you imagine EVs and you ask, "Are supply and demand in balance?", yes, they are, because there are only a limited number of people who can afford to buy them, they have to have available charging points and so on. Supply and demand are in balance, but can you change that? Yes, you can significantly change that.

At the moment, what you have with the debt market for small businesses are lots of conditions applied, which make it very difficult for the average small business owner to comply. It is very slow and very clunky. A lot of the time, their customers come to them and say, "I have a new order for you. Are you prepared to carry on?" It is literally weeks. These guys take three months to process a business application. The market is dysfunctional. It is not supplying the needs of the small business community. If you want to say it is in balance, it is in balance, because it is so poor that it is in balance.

Louis Taylor: I did say that I felt at the moment supply and demand were roughly in balance, but my caveat was in an environment where investment ambition is quite suppressed and confidence is quite low. That is exemplary of the iterative process that I talked about. If credit is not really available, people do not bother asking and it becomes a downward spiral. We have the opportunity to address that.

Lord Vaux of Harrowden: Do you think the regulators are paying enough attention to this, or are they being complacent because they see the balance?

Louis Taylor: I am not sure that I can opine on whether they are being complacent, but they are not making any material change at the moment, for sure.

Irene Graham: I want to answer this slightly differently, but pick up Baroness Noakes's point as well. Some of the drive of the availability of finance and different providers has come from things such as open banking and open finance. The FCA has been critical in developing that and the sandbox that we now have, so there are other regulatory tools in play that need to continue to be leveraged in order to allow open banking to move to open finance, so looking at, for an SME, "What is the single identifier for that company?" There are other things that should smooth the pathway of accessing finance. One of the frictions in the system, actually, is getting the right finance at the right time.

Martin McTague: I certainly endorse Irene's point about open finance. That could be a game changer; it seriously could, because it changes the relationship between the SME and the lending market. The Government should be encouraging that at every turn.

Lord Vaux of Harrowden: Could you expand a bit more on that?

Irene Graham: We can provide further information. The open banking environment was about how you unlock data in a way that is shareable across players, such that it then comes much more into the hands of the actual business itself and the individual. How do you leverage that further? It gives you choice.

Some of you may get this and some of you may not, but the credit sharing that took place under the small business Act meant that more providers had knowledge of my credit or a business's credit. That means you can get proactively told—I get these all the time, now—"Here are the options for you. Here are the options of the debt and their costs. Here are the options of the lending". How do you change that so it is much more open across the piece? It means, rather than you being the seeker, you are proactively told, "Here are the options for you". I can certainly provide much more information on that.

Q61 **Baroness Donaghy:** I am concerned we have been concentrating on the exciting developments of science and technology because there is more money to be made. We have not really concentrated on the traditional small companies, the ones that may not make huge amounts of money, but will build those two houses on the spare corner of a car park, will unblock the drains, or will be available for some fairly important work for an individual private owner. It seems to me that the country is not geared up at all to encourage those people to expand.

For a lot of members of my family, if you say the word "bank" in their house they would probably ask you to leave. It is that bad. The attitude is that, as Mr McTague said earlier, they would rather not grow at all or grow slowly than take out loans that they feel they have no control over. I am interested in what we can do. It might not be a growth argument or a regulation argument, but what can we do to keep that show going in the regions? What role, if any, does the British Business Bank have in the pump priming? I naively thought that it provided money to these people; I now understand it is an intermediary, so would it matter if it did not exist?

Louis Taylor: I do not in any way want to convey that we only focus on exciting, high-growth businesses that are innovative, because an economy such as the UK, like any economy, needs a broad base of companies, the vast preponderance of which will never be a unicorn. That is fine, because, to your point, they are providing essential services. We have a range of programmes and interventions that are absolutely relevant to that, a lot of which we have discussed, but not in those terms, today.

On start-up loans, if you do not have rich friends and family, we can be your rich friends and family, and provide £500 to £25,000 of unsecured loan to start a business. Over 120,000 companies have been started. We have had our first unicorn. That is an incredibly powerful scheme. We are helping community development finance institutions get access to funding, which will be the next stage from a start-up loan, with lending of up to £200,000.

To the point I made, a lot of the support we have given the challenger banks has enabled them to make lending to exactly the sorts of businesses that you are talking about. At the moment, well over 60,000 businesses are supported by the British Business Bank through a range of those programmes, and they are not the innovative, high-growth companies at all.

Irene Graham: I would be clear that the high-growth companies go across all sectors. They do sit in the traditional sectors. The largest sector is wholesale and retail and food and drink is also significant. That is why the mayoral authorities and the regional growth plans are going to be very important in focusing on the clusters and sectors that are present locally, and on how we drive, with the local presence of British Business Bank and others, more local and regional funds into the economies.

The local growth plans and regional mayoral growth plans are going to be a critical factor, as you look at the SME strategy that was recently announced and how you get the scale-up element of that delivered across all sectors. It is not to say they [innovative, high-growth companies] are not in traditional sectors as well; we need to just focus on our scaling businesses across all sectors.

Baroness Donaghy: Can I just ask about where the concierge service should be to encourage people to start up for the first time, so the advice, the skills and all that? Where is the responsibility for providing that?

Irene Graham: We see that in two areas. We see that locally. You have the local growth hubs that have been born out in England. Scotland does this very well with Scottish Enterprise and Highlands and Islands Enterprise. We need to get the growth hubs in England leveraged in the right way, with the right account management within it. It has to happen locally. You will then have that backed off centrally as well.

A lot of the banks now have high-growth teams. You have them at a local level, right through to the central level, where you can have the large concierge service for those who need to access multiple forms of government activity. You need them locally and then through to the centre of that. Start looking at the customer, how their journey is, and how they are handed off from local to regional to national.

The Chair: Do you want to comment on that?

Martin McTague: I can only endorse everything you have said.

The Chair: I thought it was very brave of Baroness Donaghy saying that, sitting next to a former chairman of the British Business Bank. Lord Smith?

Q62 **Lord Smith of Kelvin:** I have a question on the British Business Bank. Louis, in 2024-25 the BBB supported a total of £6.8 billion to 24,000 companies. That is about half the level of finance provided in 2021-22, when we provided something like £12 billion to 96,000 businesses. Why is the bank doing less when small companies are finding it harder to get money? Incidentally, that is nothing to do with Covid loans, because in that same period there was £80 billion lent out to 1.5 million companies in pure Covid help. Why are these numbers down?

Louis Taylor: Lord Smith, that would be a surprise to me. I have not looked at those numbers. Can I get back to you about the reason for that?

Lord Smith of Kelvin: I have a copy of the 2021-22 accounts at home. Okay, come back to me.

The Chair: Are there any further questions? In that case, we have had a good run. Thank you very much, once again, for coming to the committee. That concludes the public session; we will resume shortly in private to discuss the other business before us. Thank you very much indeed.