



Treasury Committee

Oral evidence: [SME Lending](#), HC 204

Wednesday 16 July 2014

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Members present: Mr Andrew Tyrie (Chair); Mark Garnier, Mr Andrew Love, Mr Pat McFadden, Mr George Mudie

Questions 786 - 968

Witnesses: **Tim Hinton**, Managing Director, SME & Mid Markets Banking, Commercial Banking, Lloyds Bank, and **Rebecca McNeil**, Head of Business Lending, Barclays, gave evidence.

Chair: Thank you very much for coming to give evidence this afternoon, Mr Hinton. I hope that we have another witness. We do. Rebecca McNeil, good afternoon.

Rebecca McNeil: Good afternoon.

Q786 Chair: I would like to begin with you, Mr Hinton. Just before we began, I gave you a moment's notice that I am going to ask some questions about this. Lloyds has sent this Committee a letter in response to our request for information about the fake letters from solicitors. You know what I am referring to?

Tim Hinton: I am aware of the letters, yes.

Q787 Chair: Have you seen the letter?

Tim Hinton: I have seen the letter, yes.

Q788 Chair: And have you seen the accompanying example from SCM?

Tim Hinton: Yes.

Q789 Chair: Can I take you to that accompanying letter—or perhaps you do not have it with you?

Tim Hinton: I do not have a copy of the sample, but I have a copy of Antonio's reply.

Q790 Chair: All right. Let me tell you what the sample letter that you have sent us says. It begins, "We act for Lloyds Bank". If you received a letter like that, if it was headed "SCM Solicitors", would you conclude that it was from Lloyds Bank or from someone else?

Tim Hinton: I think it could be either. It is an in-house law firm—fully qualified solicitors, regulated and so on.

Q791 Chair: Yes, we know what it is because that is set out later on. I am asking you whether, if you received that through the post, you would conclude that that was from Lloyds, or from a firm of solicitors that act independently of Lloyds.

Tim Hinton: I would certainly think they were working in tandem on behalf of the bank.

Q792 Chair: I will have one more go asking this fairly straightforward question—I think you would agree it is a straightforward question. When you get a letter from someone who you are buying a home from, you know that it is from them, and when you get one from their solicitors, it normally begins, "We act for Mr Jones, whose house we are selling to you." Is that not correct? Therefore, is not the language, "We act for Lloyds Bank", extremely misleading?

Tim Hinton: I do not see it as misleading, no, but I guess you could argue it is. I would take "We are solicitors for Lloyds Bank" on that merit, and that you are a qualified solicitor working in tandem with the bank.

Q793 Chair: So would you assume that these people were part of Lloyds Bank?

Tim Hinton: I think the footnote makes that clear—that it is the in-house litigation department.

Q794 Chair: We will come on to the footnote in a moment. I just want to clarify what you would conclude from the first line of this letter before we go any further. After all, it is the line that is most likely to be read.

Tim Hinton: I think I would conclude that I am receiving a letter from a solicitor in relation to a matter with Lloyds Bank. That is what I would conclude. I would not reach any other conclusion.

Q795 Chair: Would you conclude that they had instructed independent solicitors, or that they had—

Tim Hinton: No.

Chair: You would not conclude that?

Tim Hinton: I don't know that I would conclude that, no.

Q796 Chair: Why have you withdrawn this?

Tim Hinton: I think some time last year the people in the legal department considered that this was no longer acceptable practice. The standards on transparency have changed and I think they felt that it was better not to do it this way, even though it had been in place for many, many years, and it was used only in a very select part of a debt-recovery process.

Q797 Chair: We need to be clear that this may be people who owe you money and who may be very difficult about repaying it.

Tim Hinton: Yes. It was about getting them to engage and face up to the situation, and to come to a mutually good conclusion for both sides. I genuinely think it was in that spirit that that practice grew up. We had in-house lawyers, qualified, regulated and so forth, and obviously had the volume to warrant an in-house law firm, as such, that had been there for many, many years. But it was probably recognised last year that transparency standards were different now and, therefore, we should go back to a more obvious letterhead.

Q798 Chair: It is not just different, is it? It is better. They are higher, aren't they, as you would expect them to be?

Tim Hinton: Yes. Higher standards.

Chair: Higher standards than you had hitherto.

Tim Hinton: Better standards.

Q799 Chair: Let's go back to this letter and look at the footnote. The footnote reads: "SCM Solicitors is part of the in-house litigation department of Lloyds Bank Group plc". Do you not think it would have been much less misleading if that was the first line of this letter, rather than, "We act for Lloyds Bank"?

Tim Hinton: Well, my letter says, "We are solicitors for Lloyds Bank".

Q800 Chair: Okay, you can read out all that, but the substance of the first line is, "We act for Lloyds" and it is headed "SCM". So the question is: do you think it would be much less misleading—indeed it would remove the misleading aspect of this letter—if that footnote began the letter?

Tim Hinton: Yes. I guess it could have been differently worded, but I think it is quite clear, to my mind.

Q801 Chair: What I cannot understand is that you are saying it is already quite clear to your mind, yet simultaneously you are telling us that the transparency levels were defective.

Tim Hinton: Yes. I think we have moved because standards have changed. I do not think we have moved because it was misleading. We have improved.

Q802 Chair: From an unacceptable to an acceptable level of transparency.

Tim Hinton: Not necessarily unacceptable, but less clear than it would be now.

Q803 Chair: You withdrew this practice when?

Tim Hinton: I believe the decision was made late last year. It has taken a while to get changed through the systems because a lot of these letters are automated, so I think those changes are still going through. I think that project will finish by the end of this quarter, so this practice will cease by the end of this quarter.

Q804 Chair: You are responsible for your relationship with SMEs

Tim Hinton: Yes.

Q805 Chair: Let us have one more go at this. If you were on the receiving end of a letter like this, which purported to be from solicitors, unless extremely carefully read—and this footnote is in virtually microscopic small print—would you feel aggrieved to have received a letter that was so misleading?

Tim Hinton: Speaking in specifics—in particular about my business—the SMEs that we look after within commercial banking are typically larger companies, so this type of debt-recovery process would not be occurring with my clients. It would be a much more bespoke discussion around these sorts of issues. I think this is more of a retail and asset finance-type of process.

Q806 Chair: Would you have permitted it if you had seen it?

Tim Hinton: At certain stages of the process, yes, I would have done, because we are trying to get to a conclusion.

Q807 Chair: It does say here that the letters are sent to customers of the retail and asset finance divisions of the bank, which could include both private individuals and SMEs.

Tim Hinton: And smaller businesses, yes, that is true.

Q808 Chair: But not the SMEs that you deal with?

Tim Hinton: That happens to be in my commercial banking world, where most of our lending takes place.

Q809 Mark Garnier: I am slightly confused about the legal status of this organisation, SCM Solicitors. It is quite clear in the letter from Antonio Horta-Osório that it was dissolved in July 2011, but the name “SCM Solicitors” was kept in its status as part of the in-house litigation team of disclosing correspondence. So you now have an organisation called SCM Solicitors which is a department of Lloyds Banking Group, although it is an independent registered company in Scotland. That is because it comes under Bank of Scotland. Then you look at this letter, which says, “We are solicitors for Lloyds Bank plc and act for them in relation to the above matter”, but it is signed with a squiggle on behalf of “Philippa Simmons, Solicitor” and then under that “SCM Solicitors”. “Philippa Simmons, Solicitor” is the authorised individual, so clearly this is a sham. This is a very well constructed fig leaf in order to try to make it look as if this is an independent firm of solicitors, and you have got by with the minimum amount of statutory disclosure that you possibly could.

Tim Hinton: All I know is that the solicitors within this department are all qualified, registered, regulated—

Q810 Mark Garnier: I am sure they are. Nobody is questioning that. What they are questioning is that this is a department within Lloyds Banking Group, yet clearly it is dressed up to look as if it is an independent firm of solicitors and that legal action is being sought by an independent firm. The sole intention of this is to menace somebody who is in default. Antonio Horta-Osório also goes on to talk at great length about the fact that this is used only in extreme circumstances when all other avenues have been exhausted. In my opinion, there can be no doubt, under any circumstances, that this is purely constructed to threaten individuals who are working in organisations to try to get them to pull their finger out. Discuss.

Tim Hinton: I do not think I can add much to the letter that Antonio has written. As I say, these are cases at the end of quite a long recovery process, a default process.

Q811 Mark Garnier: That is the whole point, isn't it? By the time you have done that, you create an organisation that makes it look like it is an independent solicitor in order to try to menace individuals. I ask two questions. Why don't you go to a genuine independent solicitor, if you think that is worth doing? Alternatively, why not have on the head of the notepaper, “SCM Solicitors, part of the Lloyds Banking Group”, so that everybody knows exactly what the legal status is?

Tim Hinton: These are genuine solicitors.

Q812 Mark Garnier: They are not. They are not regulated.

Tim Hinton: They are regulated.

Q813 Mark Garnier: No, the individuals are regulated. SCM Solicitors is a registered organisation that was dissolved and is not regulated as a solicitor. That is the point. The individuals working for them—this woman Philippa Simmons is a regulated individual. The organisation—the notepaper—is not a regulated solicitor; the individual is.

Tim Hinton: The other point is that I personally do not feel that the letter is menacing. It is simply pointing out, “There has come a time that we will have to take you to court in 14 days if we do not hear from you”.

Q814 Mark Garnier: Why did you use it? This is the question. Why would you feel—if you have exhausted all your internal Lloyds Bank-headed, notepaper-type correspondence—that you need to create this other fig leaf of a law firm before you go to a genuine law firm? Why would you not have a genuine law firm instead of this quasi structure?

Tim Hinton: Practically, I guess we are trying to get the right outcome and get things moving—to get people engaged in the process.

Q815 Mark Garnier: What advantage do you think this has—having a legal letter from an anonymised Lloyds Bank department?

Tim Hinton: I can only surmise, because I wasn’t there, so I imagine that because of the volume that was happening, rather than using external legal firms, it came in house because the house had the volume for a captive partnership over many years. That is all I can explain.

Q816 Mark Garnier: These are solicitors that were set up. It was a firm called Sechiari Clark and Mitchell that was formed as a law firm—

Tim Hinton: Which was a partnership.

Mark Garnier: —as a partnership, and then basically came into Lloyds Bank in 2009.

Let me ask you another question. Do you think this looks good? Are you comfortable standing up on behalf of Lloyds Bank, in front of the Treasury Committee, explaining that this is a perfectly valid and legitimate process?

Tim Hinton: As I said, I think the standards on this stuff have changed—have improved—so it does not look ideal, but I don’t think it is as sinister as you are suggesting.

Mark Garnier: We get the casework coming into our constituency surgeries. It is us who get people coming in, in an absolute blind panic, because they have had a legal letter such as this, when in fact this is merely a continuation of a normal process within the bank.

Q817 Chair: It is very regrettable that we have to begin a hearing like this. We have been looking at banks for some years. We have been told by banks, year after year, that have sorted out so many problems like this, and then we find that they have not been sorted out.

They just keep coming from the banking community, particularly with respect to retail customers, but also in the wholesale markets. Naturally enough, banks want to repair reputational damage. It is not going to be assisted by operations like this, is it?

Tim Hinton: I think it is a good thing that we are changing those practices.

Q818 Chair: You are saying it is a good thing you are changing it, but you are not admitting that, therefore, it was a bad thing that you were doing it beforehand. That is the central curiosity of the evidence you have given so far, Mr Hinton. There is no comment you want to make on that point.

Tim Hinton: No. I think we are moving with the times. We have made a lot of changes in the last few years in many areas. In my area, which I thought we were going to be talking about today, SME lending and SME banking—

Chair: So did I. So did we all, until we received your letter, which the Committee had a chance to see only minutes before this hearing began, and which we read during the course of the private session. I notified you that that was taking place immediately I realised that this was bound to be raised, to check that you had seen the correspondence.

Tim Hinton: That is fine.

Q819 Mr Love: I want to come back to the question that you simply refused to answer. It is really important that you respond to this question. Mr Horta-Osório says in his letter: “We believe that views on transparency and clarity have changed”. You have reflected that in the responses to questions that you have given so far. The only interpretation that anyone can place on that sentence is that, in the past, a lack of transparency and a lack of clarity was evident in how you ordered your business through these solicitors. Do you accept that?

Tim Hinton: To a point. I do not think it is a total lack. I think it could be improved. Like in many areas, we are constantly evolving—trying to improve our clarity in our explanations.

Q820 Mr Love: Would you then accept that it was a conscious policy on behalf of Lloyds Bank not to be entirely transparent, and not to be entirely clear about the solicitors that it was using for this purpose?

Tim Hinton: I am not sure that it would have been that way round. I think this was probably—

Q821 Mr Love: That is the only way we can interpret that sentence that is clearly included in Mr Horta-Osório’s letter. Do you accept that the consequence of that sentence is that there was a clear lack of transparency and a lack of clarity in Lloyds Bank in relation to the solicitors it was using to collect debts from small businesses?

Tim Hinton: I think there was an opportunity to improve the clarity. I will not say that there was a complete lack of clarity. I agree that it could have been better and it will be better, and that is important.

Q822 Mr McFadden: What is the purpose of this letter?

Tim Hinton: The SCM letter?

Mr McFadden: Yes.

Tim Hinton: I think this customer is in default and probably has been ignoring the letters from the bank over many weeks and possibly months. I do not know when the time frame changed.

Q823 Mr McFadden: So the purpose is to communicate to the customer that this is something different now.

Tim Hinton: That this is serious, yes.

Q824 Mr McFadden: This is not a letter from the bank. It is a letter from somebody called SCM Solicitors who are solicitors for Lloyds Bank and act for it.

Tim Hinton: Yes.

Mr McFadden: Now, in any plain-English understanding, if I act for somebody—if I act for you, I am not you—I am something different. Isn't the purpose of this letter to communicate to the customer that this has now been passed outside the bank to its lawyers?

Tim Hinton: I guess I would read it as it has passed outside the team in the bank, but is now with a legal team or whatever. I don't know exactly what it was intended to do except to bring the customer to the process, to get them engaged, and to try to reach a conclusion to the matter. That is what I think it is intended to do.

Q825 Mr McFadden: You are trying to tell me that the line "We are solicitors for Lloyds Bank and act for them" does not convey that it is somebody outside the bank.

Tim Hinton: No, I understand what you are saying.

Mr McFadden: Yes, well, I am asking you for your view on that.

Tim Hinton: I agree that could be misleading—that particular clause, yes.

Q826 Mr McFadden: I need to press you harder than that. "We are solicitors for Lloyds Bank and act for them." I think if I asked 100 people what that meant, 99 or 100 would say that was somebody outside the bank.

Tim Hinton: Okay.

Mr McFadden: Do you agree?

Tim Hinton: Yes, I agree. I know what you are getting at; I understand what you are getting at.

Q827 Mr McFadden: So if the purpose of the letter is to communicate that the matter is no longer being pursued through the normal processes of the bank, but has been given to someone outside the bank, the letter is fundamentally misleading, is it not, because that is not what has happened?

Tim Hinton: Yes. I do not think that was the intention but—

Q828 Mr McFadden: You say, “It is not the intention,” so I have to come back to this. When the bank says, “We are solicitors for Lloyds Bank and act for them”, you are not trying to communicate that. Is that what you are now telling us: you are not trying to communicate that it has been passed outside the bank?

Tim Hinton: I personally feel that the primary intention of the letter is to get the customer to engage and not to tear up the letter—not to ignore the letter.

Q829 Mr McFadden: By what mechanism is this intended to communicate that this is a step-up now—that this is more serious? It is intended to do that by giving the impression that the matter has been passed outside the bank to an external law firm.

Tim Hinton: That solicitors are involved and courts could become involved in 14 days, yes.

Q830 Mr McFadden: If that is the case, the letter is fundamentally misleading, because that is not what has happened. Isn’t that also the case?

Tim Hinton: I am not sure that that is the case. I know what you are saying but I do not think that is the fundamental driver of this letter.

Mr McFadden: I think it is, and I think any person reading it would conclude the same.

Q831 Chair: I think everybody who has looked at this correspondence round this table so far has concluded that this correspondence is not just misleading, as you said, but calculated to mislead. I think you are the only person in this room who has looked at this material so far who has come to a different conclusion. Is that correct?

Tim Hinton: Certainly those who have spoken, yes.

Q832 Chair: We have not been able to publish this because we only received it this morning, but other people are going to be able to take a look at it when we publish it at the end of this hearing. Are you going to be alone in saying this is not calculated to mislead?

Tim Hinton: I cannot say, because I did not construct the letter. All I am saying is it had a purpose in a process in a narrow part of the bank's operations, and there are lots of other things that happened before this as well. I just want to put it into context.

Q833 Chair: We are going to come on in a minute to other issues that we had been hoping we would cover in this hearing had we not received this letter just before it began. Rebecca McNeil, does Barclays send out letters like this?

Rebecca McNeil: I know that our chief executive has received your letter and, with the Committee's permission, I will let him respond to that. We are now looking into exactly what we do send out and the processes that we follow so that we can bring those together across the group and report them back to you.

Q834 Chair: It is not our job to advise banks, but in this curious environment, I am going to make a suggestion: once something is going wrong pretty badly, it is a good idea, if you want to rebuild trust with your client base, to tell them that it has gone wrong and make clear that you think it is wrong so that they can have some confidence that you have moved on from that kind of practice. If I may say so, Mr Hinton, so far that sense has not been conveyed by you this afternoon. Do you appreciate that?

Tim Hinton: Yes. Thank you, Chairman.

Q835 Chair: Okay.

Could I come back to you again, Ms McNeil? If you look at gross and net lending to SMEs, you get a completely different picture of what is really going on in this sector. The truth is, though, is it not, that net money is being withdrawn from the sector? Isn't that right, still?

Rebecca McNeil: I think it is fair to say there are almost two issues here. We face an issue, which we have discussed quite a lot, around supply and demand. I know that a lot of conversations have been held around the fact that there is a perception of a lack of supply and a perception that there is also a lack of demand. That is one issue that we face and that is probably most focused around banks.

The second issue we focus on—and we should focus on—is that bank lending is not all that should be out there in the market. When we look at lending to SMEs, what we should be considering is both bank lending and how we make sure that customers are aware that supply is there and supply is out there, and also raising awareness of that to stimulate demand and confidence in the economy. We should also be looking at other forms of lending out there in the market: more risk capital; more crowd-funding; more alternative sources of finance. There is certainly a perception of an issue around gross and net lending from a bank perspective, but I think there is also a conversation to be had—particularly in the UK—around the wider sources of finance that we should be focusing on.

Q836 Chair: From the data, it does look as though the SMEs are still not getting the money they need, doesn't it?

Rebecca McNeil: From our perspective, we have £17 billion-worth of stock out there. That is a slight increase year on year. It is about a 0.3% increase year on year.

Chair: It is pretty static.

Rebecca McNeil: It is broadly static, absolutely, but I think in a recessionary environment that is a relatively good performance. We have certainly seen a decline of around 3% across the wider bank market. What we have also seen, which has exacerbated that fact, is that peripheral lenders and overseas lenders have partially pulled out of the market. So the net effect of that is that it does perhaps feel worse for the consumer.

Q837 Chair: Is there anything you want to add to that, Mr Hinton?

Tim Hinton: Yes. The story at Lloyds is a little bit different. Lloyds is very focused on the SME sector, and we have been growing our net lending continually and increasingly for the last four years: in 2010 we grew at about 2% net; in 2011 it was 3%; in 2012 it was 4%; in 2013 it was 6%. This year—year to date—we have also grown by 5% net. So we are very focused on this segment and we are trying to support SMEs. I think eight out of 10 of our loan applications are approved. We have some appeals, but only about 15% of those appeals are turned round. So I am quite confident that we have the balance right between doing safe lending and supporting the real economy.

The other thing I would say is that the credit standards that we have applied throughout this period have not changed. We came up with a policy and a strategy that was through the cycle, so we have not flip-flopped in and out of this segment; we have been pretty consistent in trying to support our customers and so on. Although I agree with Rebecca that the alternative sources of funding are also very important and we should continue to help those—particularly on the equity side and things like commercial finance; they should have a bigger role to play and indeed they are growing—our story is a little bit different from the market at large. We have been bucking the trend now for four and a half years.

Q838 Mark Garnier: I want to start by looking at why businesses are rejected from funding. Mr Hinton, perhaps you would like to start. Survey data suggests that, in general, around one third of all businesses that put in lending applications fail to get some sort of facility as a result of it. Why do you think that is?

Tim Hinton: Generally it is in our interests to support companies and customers, so we do not try to turn down applications; it is our approach to approve them. Obviously in running a bank you have duties of care and responsible lending. You have duties to depositors and shareholders as well. So you have to get the balance right between risks that you think are worth taking, people you are willing to invest in and back, and so on, and those who you are not.

Q839 Mark Garnier: I think it is quite important and this is an opportunity for the bank to highlight some points. One of the things that has struck me—again with constituency surgeries, many people come to see me and say, “Banks are not lending to businesses”—is that when I look at the propositions, I can quite understand why. There is a lot of criticism of banks for not lending, but do you think it would be fair to say that quite a lot of businesses do not understand what it is that banks do—that they are not a free source of funding, and that there are risks and responsibilities that banks have to manage quite carefully—and that businesses could do with more education?

Tim Hinton: Yes. I think that is a very important part. Supplying mentors to that community, giving advice, helping them craft a business case and a plan with some contingencies around it—just helping them to present a better proposition—is a key part of our role. The other thing I will add is that when we do decline an application, we always explain why and try to give some guidance on how it might be seen differently next time around. We also try to point customers in the direction of other areas of potential support, as Rebecca was saying: crowd-funding, peer-to-peer lending—whatever it might be—some of the Government-backed schemes, the community-type funding places and so on. We do try to be proactive and helpful. It is not just a yes/no answer.

Rebecca McNeil: It is fair to say that, when we do decline a customer, affordability is key. That is probably one of the main reasons why we will decline a customer.

Q840 Mark Garnier: Affordability in terms of cash flow or in terms of—

Rebecca McNeil: Cash flow and future business plan so, “Does the business plan support the aspirations that the business has?” I think the duty of care is on us to lend responsibly and if we are lending to customers who cannot afford to pay that back, or when we do not believe that the business plan allows them to do that in the future, that is not where we should be lending. What we should be doing is making sure that the customer understands that and understands, first off, very clearly the reason why they have been declined. Fundamentally, a business needs to know that and to understand that, because then they can go and seek the appropriate help.

Also, our duty of care is then to make sure that we are signposting what other alternatives there are. In some cases, the reason we will have declined lending is because the business is just too new—it is just too young, and has perhaps only six months’ trading. Again, that is not a place that banks should be lending, but we do have a partnership at Barclays with the Start-up Loans company and will refer companies out to School for Startups, where they can receive not only the Government funding that that sits with, but mentoring, training and support to get their cash flow and their business plan to a place where, when they come back to Barclays in a year or two’s time, they are fit for lending from a bank perspective.

Q841 Mark Garnier: I am quite interested from this point of view: ACCA has said that a bias exists against innovative businesses. I think this is quite an important point that I would like to drill into. Clearly there are very traditional businesses—property development, asset management; that kind of stuff—but we are in a very dynamic and changing business environment and we are certainly seeing many, many self-employed people, for example,

who may need loans. How do you respond to that because, to a certain extent, you have to reinvent the wheel every time you go out to do potential lending?

Rebecca McNeil: Yes, we are. From our perspective, we try where we can to have industry specialists. For the more traditional industries that you refer to—things like agriculture or property—we will have specialists in those industries who understand the market through and through, and the sort of capital that those companies will need. For example, in the farming space, that will be largely working capital overdraft. Newer industries, we have to learn about. We also have to tool up our business managers so that they have the right tools to be able to work with those companies. We are tuning up our business managers to become more digitally savvy and to understand how to transact trade online internationally and so on. But partnerships with companies like School for Startups, which has a creative arm as part of that, enable us to seek that support and that guidance from specialists. We cannot be specialists in every single industry, and we know that, but we can partner with people who are.

Q842 Mark Garnier: Mr Hinton, one of the problems seems to be with newly set up businesses. A brand new business or one, as we heard, with less than six months' trading record is going to find it practically impossible to get any financing at all. Is there any situation where you can see Lloyds, for example, lending to a business like that, and is there an occasion when you might lend speculatively? Or, again, would you refer to other partners who may be more interested in taking up that kind of speculative investment?

Tim Hinton: That is definitely an area where we are trying to focus and do more. I think Barclays is stronger than us in this area in terms of real businesses coming through and start-ups. I think a lot of them borrow in their personal names in those early stages or they use friends or partners to help to raise funding of some kind. Obviously we would always look at that, within reason and within the affordability—the common-sense thing. Obviously it is easier once a company has two or three years' track record behind it, as then it is much easier to take it to that next level of growth and to help it at that stage. Certainly for my business, where we start at companies with a turnover of £1 million, or borrowing requirements of £50,000, that is where I would get involved. But Lloyds is generally trying to do its bit. I think we have pledged to help 100,000 start-ups. This year we have probably done more than 50,000 in the first half, so we are working with many of these new businesses.

Q843 Mark Garnier: Very quickly, you have pledged to 100,000 to do what?

Tim Hinton: To have their banking, and help them and grow their business.

Mark Garnier: Having their banking and financing them—that is a different thing, isn't it?

Tim Hinton: Yes. It is not 50,000 to which we lend necessarily, but it is 50,000 that we are banking.

Q844 Mark Garnier: The key thing, and what would be interesting, is to look at the data in terms of how many new businesses fail to get financing and how many innovative businesses that do have that six-month track record do not get financing.

Following on from that, my next question—Ms McNeil, if you could answer this—is: what can be done to try to improve that success rate? Is the traditional banking lending model the right way of doing it, or should we look at alternatives such as equity financing?

Rebecca McNeil: From our perspective, we should be looking at the alternatives. We should be looking at whether a business angel is appropriate, because it is about that mentoring and support that Tim referred to. This is critical at that stage of business development. That is not to say we will not lend to a business that is under 12 months, and when we will lend, we need to signpost that clearly.

One of the things that we have introduced over the course of the last 12 months is pre-approved limits. That is for slightly more established businesses, but what we are aiming at out there in the market is to say, “Here is the amount of money that you can borrow.” That is publicised on the business online banking portal. It is given to the business manager and to our telephony advisers as well, so they are aware of the amount that the customer can borrow, and it could be on an unsecured loan or an overdraft. For businesses that are coming back in, perhaps following a start-up loan or those that are relatively new to Barclays, once they have established that track record, as soon as we can, we will signpost the fact that they can now come to ask for finance.

Q845 Mark Garnier: What proportion of Barclays’ balance sheet is SME lending?

Rebecca McNeil: I couldn’t tell you offhand, but we have £17 billion-worth of SME lending out in the market.

Q846 Mark Garnier: What is your balance sheet in total?

Rebecca McNeil: I am afraid I would not be able to tell you.

Q847 Mark Garnier: Mr Hinton, do you know those numbers roughly?

Tim Hinton: Yes. For Lloyds it is £28 billion, which is roughly 25% of our commercial banking balance sheet and roughly 12% of the bank’s balance sheet.

Q848 Mark Garnier: So commercial banking is 12%, or SME is 12%?

Tim Hinton: No. The SME lending will be around 10% of the total bank balance sheet.

Q849 Mark Garnier: That would probably be similar for Barclays.

Rebecca McNeil: It would probably be proportionally similar.

Q850 Mark Garnier: How does that compare with mortgage lending?

Rebecca McNeil: I am not entirely sure what our mortgage-lending balance sheet is.

Mark Garnier: No, sorry, it is slightly unfair to ask questions like that.

Tim Hinton: I think that is still obviously the largest.

Q851 Mark Garnier: The reason I am asking is it is like coming back full circle to the original point, which is that absolutely you have a fiduciary duty to those depositors, and shareholders and the bank itself. As I understand it, SME lending is the most risky type of lending that a bank can do. Would you disagree with that?

Tim Hinton: It is certainly one of the riskiest.

Rebecca McNeil: It is high risk, yes.

Q852 Mark Garnier: Yes, so it is very high risk. Ultimately, allocating funds, for example, away from mortgage lending to SME lending is going to be quite an important decision. I suppose you get more back on your SME lending because you charge higher rates of interest but, none the less—

Tim Hinton: There will be more impairments as well, obviously.

Mark Garnier: There are more impairments, absolutely right. So is SME lending a more profitable business than mortgage lending because of that, or is it a more volatile business?

Rebecca McNeil: I do not think it is a more volatile business. Obviously we do price for the risk, so that will be part of the overall approach that we take. What I am hearing is perhaps the worry is that our focus would be more on mortgage lending than it is on SME lending for that reason, which is absolutely not the case. We are not capital constrained, so we are not looking to say, “We have this amount of money and that will only go over to this proportion of business.” We know that SME lending is critical. For as much risk as there is in there, there is also the next corporate of tomorrow that we need to make sure that we are bringing through the business.

Q853 Mark Garnier: My final question. Clearly banks’ risk appetite prior to the financial crisis was crazy—they were going for absolutely anything. Can you give us an indication of how your risk appetite has changed from prior to the financial crisis, through the depths of it and into recovery? Basically, what has happened? Mr Hinton, why don’t you start?

Tim Hinton: As I said, obviously credit policies evolve and change a little bit as you go through, and certain worry signs have come through but, generally, if it makes sense, we will lend, and that philosophy has been around for years. As I said, we have not been chopping and changing our policies or our support for this sector at all through this crisis. I think that is probably why we have stayed open for business and have managed to grow our share of that business in the last four and a half years.

Rebecca McNeil: I would absolutely second that.

Q854 Mr McFadden: Can I go back to a question Mark Garnier asked about the proportion of your assets that are made up of this? Andy Haldane from the Bank of England made a speech last month in which he said that SME lending was only 2% of UK bank assets. You are two of the biggest banks here. Did you say to Mr Garnier that it was more like 10% than 2%?

Tim Hinton: Yes. It is nearer 10% for us, I think.

Q855 Mr McFadden: It is a five times bigger proportion of your assets as two of the biggest banks than it is of the banking sector as a whole. Is that what you are telling us?

Tim Hinton: I do not know what figures he was referring to but, given that Lloyds is a UK retail and commercial bank, that could be the case where, for us, it is more important than for the banking sector in the UK overall. If you include all the foreign banks here, all the capital markets and so forth, it could be but I do not know.

Q856 Mr McFadden: Ms McNeil, the problem about lending to SMEs, coming back to Mr Haldane's speech, is twofold. A lot of SMEs have no track history and they have very little value of collateral or assets. It is a person with an idea and perhaps a PC in their kitchen or whatever. Would you agree that that is what makes it different from lending to either a big company or a household borrowing against a house?

Rebecca McNeil: Fundamentally, yes.

Q857 Mr McFadden: Mr Haldane put forward an idea in his speech as a way to try to get through this problem for banks and for customers, which was the Bank of England, or the industry as a whole, establishing a credit register. Are you familiar with this concept and, if so, what do you think of it?

Rebecca McNeil: I am, yes, and I am very supportive of the concept. I think the sharing of data between banks is absolutely critical so that the customer can have the best experience possible. To ensure that that happens, from a customer's perspective, what we need to make sure is that all banks and all finance providers—whether it be asset finance or crowd-funding; whoever is holding data on a customer—are contributing to that.

Q858 Mr McFadden: Would you support that?

Tim Hinton: Yes, we are supportive of that credit data project as well.

Q859 Mr McFadden: I think you are consulting on this with the Bank of England.

Rebecca McNeil: Yes.

Mr McFadden: You are submitting supportive responses to that.

Rebecca McNeil: Absolutely.

Q860 Mr McFadden: The other advantage he said that this could result in is securitisation of SME lending. What is your view on that?

Rebecca McNeil: I think that there is still scepticism in the market of securitisation. I think people are still nervous of it. I do not think that means that it is a closed door for the future.

Tim Hinton: Yes, it could be useful in the future, if capital constraints or capacity to lend is constrained by the bank and then you securitise, then you are free to do more again. It could be useful, but at the moment we do not have that constraint—and nor do you, by the sound of it. It is a useful mechanism, but it is not pressing for me at the moment.

Q861 Mr McFadden: Securitisation—properly done, I stress—is potentially a mechanism for spreading risk.

Tim Hinton: Yes.

Q862 Mr McFadden: Sixteen of the 28 member states in the European Union have some kind of credit register. In terms of operations abroad, this would be something you are familiar with too, is it?

Rebecca McNeil: It will be, yes. I focus on the UK, but it will be.

Q863 Mr McFadden: The other point I want to ask you about is how credit reference agencies work and can impact on SME customers at the moment. In its written evidence, HSBC told us that it had identified the problem that “Multiple credit searches negatively impact a customer’s credit score”. That seems unfair when the customer is simply trying to get the best deal and is shopping around, so people are checking on their credit history and that is impacting on their credit rating. Do you share HSBC’s view that that is a problem and that it could impact negatively on perfectly innocent customers who are simply shopping around to get the best deal?

Rebecca McNeil: Yes, but it can also be an indicator that a customer is having to go to a lot of places to seek that finance because they are being turned down elsewhere. It can be a credit indicator, too.

Q864 Mr McFadden: But they may be choosing to shop around.

Rebecca McNeil: They well be.

Q865 Mr McFadden: If you and I were buying something we would want to get the best price.

Rebecca McNeil: I think that is where the credit data register that you talk about can add the value.

Q866 Mr McFadden: But we do not have that at the moment.

Rebecca McNeil: No.

Q867 Mr McFadden: We have the credit reference agency. In the existing world of today, is it not unfair that if someone is simply shopping around, they are penalised for that?

Rebecca McNeil: I think if they are purely shopping around it is a difficult situation for them, yes, but how you separate out whether someone is shopping around or being turned down consistently is a difficult thing to do when you are dealing with external data.

Q868 Mr McFadden: Are you able to make that differentiation or do you judge—

Rebecca McNeil: We are through talking to the customer, so I think—

Mr McFadden: —the fact that if they have shopped around a lot, there is something a bit sniffy about this?

Chair: This goes to the heart of what is wrong with these algorithms and limitations on which these credit ratings are based, which have caused so much annoyance on lenders and borrowers.

Rebecca McNeil: What I would say is that we will not make a decision based purely on one variable, though. When we are looking at a customer, we are looking at them holistically, and we will try to understand, if that is the case, and if there is more that we can do.

Q869 Mr McFadden: Are you saying that the customer would have a full opportunity to explain that their poor credit rating was simply down to the fact that they had shopped around and that they would get the chance to explain this fully to you before any decision was taken?

Rebecca McNeil: They could, and there is also the right of appeal at the back end as well. If the customer felt that the decision made was unfair, they would be able to appeal at the end of the process.

Q870 Mr McFadden: Mr Hinton, do you share the view of HSBC that this credit rating system is potentially putting people at an unfair disadvantage?

Tim Hinton: I am not aware of how we use that information, so I would need to get back to you on that. I am not sure of on how many occasions we have declined customers, if any, who have that—

Q871 Mr McFadden: Surely you would look at the customer's credit rating?

Tim Hinton: In my business, we do our own assessment of the credit by talking to the client, listening to them, evaluating their performance and so on.

Mr McFadden: You would not take into account information from a credit rating agency?

Tim Hinton: We would not rely on that in isolation, no.

Q872 Chair: The problem is it is not whether or not you have refused any customers as a consequence of the fact that they have a higher rating, but that they have a weaker rating because they have shopped around. It is the perception in the marketplace for borrowing that this is the case, which deters people from shopping around and is an impediment to competition. Do you accept that that is a concern we need to address?

Rebecca McNeil: I think that that is a concern. That is why we need to make sure that we are talking to customers around how to get ready for borrowing and understand, with them, all the impacts of their actions, and explaining how we make our decisions better as well.

Q873 Mr Love: I want to be clear: what proportion of the loans that you offer are done through credit scoring and how many are done individually? Surely those who are credit-scored will be affected by a reduction in the credit reference.

Tim Hinton: My business is a relationship-managed business. It assesses businesses as part of a bilateral discussion and arrangement. We go beyond the pure scoring system. This is a discretionary lending decision that we take. So, none for me. That is why I could not answer the question, but in the lower end of the small business book, they may be using that and I will have to write to you about that book.

Q874 Mr Love: That would be instructive. What we are interested in is where you would not follow what the credit score had told you because of intervention. That would be the important figure because, I think, if the credit reference agencies are marking down people and that appears in their credit score, they end up being disadvantaged, especially at the lower end of the lending field.

Tim Hinton: It might affect their chances, yes.

Q875 Mr Love: Would you add anything to that?

Rebecca McNeil: Just to say that the majority of our businesses will also go through a manual process, and a lot of cases where it is marginal will be referred as well, which goes to the same point as Tim's.

Q876 Mr Mudie: We have had good evidence that on occasions, when it is in your interest or it is your wish, you use the excuse of revaluation of assets to move a customer into the distressed part of your organisation and then do various things. Do you think that evidence is wrong? I do not want long speeches; I just want to know. Do you contest it?

Rebecca McNeil: Yes.

Q877 Mr Mudie: You contest it from Barclays. Do you contest it from Lloyds?

Tim Hinton: I can't talk about specific cases but, generally, I am very proud of the record that we have in our business support unit and how we work with customers who get into financial difficulty and so on. It is not in our interest to reduce a valuation or not work through a problem with them, so I—

Q878 Mr Mudie: That is very encouraging. But say you had a rogue person in the unit who did that and the revaluation was much smaller and, therefore, as a result, wanted to do various things to the firm. If the firm contested the valuation, what is the policy of both your banks? What would you expect that person to do automatically?

Rebecca McNeil: I do not expect that to happen within Barclays and have not seen evidence of that in Barclays. But if that did happen, I would expect that to be managed by, first off, the individual's manager. As part of their performance and their disciplinary, that individual's manager would look at the case, review the case themselves, speak to the customer and engage with the customer directly, and if it required further escalation, that would certainly happen.

Q879 Mr Mudie: Would that all be internal? It would move up within the ranks.

Rebecca McNeil: It would be internal originally within our customer-facing colleagues within the network, but I would imagine then, if that needed escalation, it would also go to our risk department, because they will be looking at it from a credit risk perspective as well.

Tim Hinton: Yes, that sounds very similar in Lloyds as well. As I have said, you would work closely with the customer and try to work out a plan for resolution. If he or she felt that their asset was worth more than we did, you would try to work through that.

Q880 Mr Mudie: Failing a settlement with your customer, do you point them to an external independent person or organisation?

Rebecca McNeil: Not to an independent adjudicator of that.

Mr Mudie: Could you speak up because I am elderly and my faculties are failing and it would be appreciated.

Rebecca McNeil: Absolutely. Not to an independent adjudicator of that, but we would certainly point them to an independent valuer if that were appropriate. We would seek multiple valuations.

Q881 Mr Mudie: That is very interesting. What would be the independent valuer? Tell me.

Rebecca McNeil: We may have assigned an independent valuer at the beginning, because it may be the valuer that the customer chose to use.

Q882 Mr Mudie: Do you choose it or do you choose in agreement with the small business?

Rebecca McNeil: The customer can either choose to use a valuer that we will recommend in their local area, or they will choose to use their own valuer, and then we would be able to seek independent valuations from that if required.

Q883 Mr Mudie: That sounds good. Now, what about Lloyds?

Tim Hinton: I am not 100% sure. We obviously have a list of many valuers who are approved and who we—

Mr Mudie: I know, but I am just asking if you volunteer to the customer a right to go to an external valuer?

Tim Hinton: I would need to check that.

Q884 Mr Mudie: So you do not know.

Tim Hinton: In that scenario—where we are having these discussions about distress—I would need to check with the team what latitude they give, how many independent valuations they would seek and so forth. I would need to double-check that fact.

Q885 Mr Mudie: You do not know, which is strange—and bad, I think, because you head SME lending. You do not know if your people automatically point them to someone objective, like Barclays claims they do.

Tim Hinton: Common sense would tell me that we would get another valuation if the first one was in dispute, but I do not know how much latitude and at what point that stops.

Q886 Mr Mudie: What happens if the customer himself or herself comes with one or perhaps two valuations and says, “They are the same as my valuations; my property has not lost value,” but you have one that is 50% below? What happens then?

Tim Hinton: We would genuinely seek to come to an amicable agreement and an arrangement to get that customer back to good health and restructure—

Q887 Mr Mudie: Do you know that happens?

Tim Hinton: Yes, I do.

Q888 Mr Mudie: Is that policy?

Tim Hinton: More than 70% of the cases—

Q889 Mr Mudie: Let me just warn you that I have a constituent case with you—I am not discussing names or anything—where we have two valuations that match his and yours is a considerable amount lower. Our valuations are of little interest—have been dismissed.

Tim Hinton: Let us talk about specific cases.

Q890 Mr Mudie: No, I am not talking about specific cases. I am asking: do you have a policy and is that behaviour in line with your policy? Now, the question is: do you have a policy? If a customer comes with another valuation, what is the automatic policy?

Tim Hinton: That behaviour is not something that I recognise at all.

Q891 Mr Mudie: Do you have a policy?

Tim Hinton: I am saying that I need to check what the specific policy would be in that situation—

Q892 Mr Mudie: Okay, so you do not know.

Tim Hinton: But, generally, more than 70% of our cases that go into our business support unit come out again healthy and so on.

Q893 Mr Mudie: We will go with the saintly Barclays—that is because of Mr Jenkins—do you sell on any of these distressed loans? Do you have a policy of grouping them together and selling them on?

Rebecca McNeil: No. That is not my understanding.

Mr Mudie: Lloyds?

Tim Hinton: As you know, when Lloyds and the Bank of Scotland came together, we had a lot of non-core assets that we have successfully reduced over the last five years.

Q894 Mr Mudie: You have a policy of selling at Lloyds?

Tim Hinton: There are many ways to reduce that and, yes, we have sold assets.

Q895 Mr Mudie: The evidence we have is that you sell them on, and—it is interesting—there seems to be a relationship to the small valuations because you seem to get more for the ones with the small valuations that are worth a bit more. You seem to get, from the firm you sell them on to, more for those than you do for the other stuff you securitise or sell.

Tim Hinton: I can't comment on that.

Q896 Mr Mudie: You sell them to Cerberus and Deutsche Bank. Do you sell them in parcels?

Tim Hinton: I can't comment on that.

Q897 Mr Mudie: That is fair enough. In America, we would say, "I take the Fifth on the grounds I may incriminate myself." Embedded swaps is an easier one. Clydesdale were before us and, on the embedded swaps one, they have a voluntary agreement to look at those, even though, theoretically, under the FCA, they do not have to. Do you and do you?

Rebecca McNeil: I don't believe we have any embedded swap products out there. We did sell a tailored loan. We sold about 150 of those products, but I would not describe that as an embedded swap. The swap was internal to Barclays and not seen by the customer. What the customer saw was a standard fixed-rate product.

Q898 Mr Mudie: I would like to push on, if you don't mind, because we had that sort of language from Clydesdale. You can have an embedded swap if you like. That is your decision, but the basis of the complaint about embedded swaps was that the customer did not have explained what could happen, and was ruined or captured by you because they could not move because they could not afford to take that. Have you explained this and, more importantly, does it have the same financial result as the embedded swaps we have been discussing with Clydesdale and other banks, and that the FCA is looking at?

Rebecca McNeil: I can't comment on other banks' embedded swaps or tailored loans.

Mr Mudie: No, I am asking you. You have said, "We don't have embedded swaps. We have a tailored loan". Clydesdale described them as tailored loans; "packaged in Australia" was their excuse. Does the embedded swap part of it, or the hedged part of your tailored loans, have the same financial effect, as other banks demonstrated, of a very high price to end that customer's relationship with you?

Rebecca McNeil: We have not seen any complaints from customers on those loans, so I would take that as an indication that it is not.

Q899 Mr Mudie: Are you doing anything with the FCA? Are you looking at any of these loans?

Rebecca McNeil: We are not.

Q900 Mr Mudie: There is stuff that is covered by the FCA—the regulator—and the stuff that we are talking about, the tailored loans, is not. Are you looking, as an agreement with the FCA, through the first part?

Rebecca McNeil: Not to my understanding, no.

Q901 Mr Mudie: All right. Now, Mr Hinton, you have had time. Tell me.

Tim Hinton: We do offer a fixed-rate loan. It is a very popular product for companies that are buying an asset over a term.

Q902 Mr Mudie: I am sure it is, but do you have embedded swaps in them or do you have a hedge?

Tim Hinton: It is not an embedded swap. There is not a cap or a collar or anything in there. Ours are very plain vanilla. It is just what it says on the tin. It is a fixed rate for the life of that loan. There is no—

Q903 Mr Mudie: If I want to leave you, because that will probably be 8% or something—with the market dropping and interest rates dropping, I think I can save my business by moving to that bank—do I have to buy myself out?

Tim Hinton: Yes.

Mr Mudie: So there is a swap.

Tim Hinton: If you did break the loan, there would be a break cost because there is a market risk.

Mr Mudie: No, I understand that.

Tim Hinton: When you fix your rate, there is a floating rate on the other side, so there is some—

Q904 Chair: Can you explain the reason for the break cost? Sorry, just complete that piece, because I think it is important that we have a full and fair picture of that point.

Tim Hinton: When the company has entered into that fixed-rate loan, the bank—through its risk management mechanism and so on—basically squares all the positions so that it is not liable for changes in that interest rate itself. Therefore, if you came to break it, there are some consequences. It is the same as a fixed deposit. If you place a fixed deposit with a bank for three months and you break it early, there might be a loss of interest there as well, so there is—

Q905 Mr Mudie: Yes. Do you know the amounts we are talking about and the amount that small businesses are being charged and ruined with, or captured with so they cannot afford to go?

Tim Hinton: It could happen, but obviously you need to explain this. This is at the end of a very long process of working out what the best product is for you, so if the client—

Q906 Mr Mudie: That means you do, though. Mr Hinton, that means you do because you are going on to say, “Oh, but we explain these.”

Tim Hinton: Yes, there is a risk. There is a market risk there, but it is not an embedded swap in my opinion.

Q907 Mr Mudie: No, it is just a hedge.

Tim Hinton: It is ending a contract.

Q908 Mr Mudie: Are you working with the FCA on that area of work?

Tim Hinton: On the interest rate hedging products, yes, but with the FOS on the fixed-rate loans. We have about 39,000 of these fixed-rate loans and the numbers of complaints we have are very, very small.

Q909 Mr Mudie: The market was described as 60,000. Do you have 40,000 that—

Tim Hinton: They are the higher risk ones. We have a very simple fixed-rate loan product. It is not considered a swap; it is a simple loan.

Q910 Mr Mudie: Are you reviewing them as a matter of course to make sure there is no—

Tim Hinton: No.

Mr Mudie: You are not reviewing them?

Tim Hinton: We have had no exercise of that.

Q911 Mr Mudie: If a customer complains, are you reviewing them then?

Tim Hinton: The first thing to say is that we have very few complaints and most of the complaints are, indeed, if and when the customer does want to break it.

Q912 Mr Mudie: Wants to go, yes. Well, that is the time they would complain, isn't it?

Tim Hinton: But there is a handful of these things and we—

Q913 Mr Mudie: What do you do with them?

Tim Hinton: We work through it. We are quite confident that we explained this quite well.

Q914 Mr Mudie: Mr Hinton, what you are saying is that there are and when they complained, you describe to the customer what he signed up to, and tough. You do not—

Tim Hinton: Well, it depends. If there was a clear lack of understanding by that customer, and we discuss it with them and they clearly did not grasp the risk that they were entering, we might uphold their complaint. Obviously we do not want them to go out of business because of this kind of thing. Again, it is a very particular scenario but, as I say, it is a very small number of cases where this happens. That is why I think our process is quite sound, because you would not enter a fixed-rate term loan unless you were very, very certain that you did not want to break that loan, that you were happy with the interest rate and that you wanted that certainty over the life of the loan, and that is why you go into it. It is a very popular product.

Q915 Mr Mudie: No, Mr Hinton, it is a very nice set of words, but the claim with so many dealings with the banks is that the important stuff is brushed aside. It is left flexible or unexplained. The good stuff is pushed up front, “Sign here, look what you are getting”. It is only when something happens—

Tim Hinton: I think we have made a lot of improvements to our explanation and listening, and—

Mr Mudie: You needed to make improvements, did you?

Tim Hinton: Yes, I am sure that always you can improve, but we do not have many that are in dispute.

Q916 Mr Mudie: We had a very good witness, Tim Murphy, who said that banks need complaints procedures that have teeth and are viewed as independent. Do the complaints procedures of both of you meet those criteria and have teeth, and are they viewed as independent?

Tim Hinton: Our complaints department is within the bank, but it is taken extremely seriously. If the customer is still dissatisfied, they take it to the financial ombudsman, their MP or whoever it might be. I think it is a very genuine attempt to resolve things. As I said, we are here to keep our customers and to grow our business.

Q917 Mr Mudie: But is it independent or is it internal? Is your complaints independent?

Tim Hinton: It is independent from the salesperson, yes.

Q918 Mr Mudie: Do you not have anything outside? If I am complaining in both Lloyds and Barclays, I complain to higher ranks, and if I am not satisfied, it is the FOS?

Tim Hinton: Yes.

Mr Mudie: But there is a cut-off point for small businesses and many cannot go to the FOS. They have to go to law, which is a pretty scary procedure for a small business.

Tim Hinton: But all the fixed-rate loan cases would go to the FOS.

Chair: Thank you both very much for coming to give evidence to us this afternoon. I am sorry the session has taken longer than planned. We also regret that we have had to take up so much time at the beginning with the letter that we received, but we felt it needed immediate attention. Thank you very much indeed.

Examination of Witnesses

Witnesses: **Samir Desai**, CEO and Co-founder, Funding Circle, **Anil Stocker**, CEO and Founder, MarketInvoice, and **Tony Askew**, Chair of the BVCA Venture Capital Committee and Partner at Reed Elsevier Ventures, gave evidence.

Q919 Chair: Thank you very much, all three of you, for coming to give evidence. If I can start with a very simple straightforward question. What is it like out there? How difficult is it to compete with the major banks? Who wants to start?

Samir Desai: I am happy to start.

Chair: I will move from, as I am looking at it, right to left so you know who is coming next. Mr Desai.

Samir Desai: For those who do not know, Funding Circle is a peer-to-peer lender. We have lent over £315 million to nearly 5,500 businesses since we launched four years ago and nearly half of that has come this calendar year. From our perspective, as an alternative finance provider, increasingly becoming more and more mainstream, it is a very benign environment to be competing with banks. Obviously they have a lot of legacy issues that they are dealing with but—I am sure this has not escaped your attention—the UK is a very monopolistic market in terms of our banking sector. Funding Circle operates in both the US and the UK. In the US, there are thousands of regional banks that we compete with, whereas in the UK it is pretty much five banks doing 90% of the lending. I would say it is quite a good environment.

Tony Askew: I am here representing the British venture capital industry, which does not compete, per se, with banking. It is an alternative source of financing. Venture capital is very early stage, very hands on, very high risk. Pat, it might have been you talking about a guy with a PC and an idea. That is the kind of thing that venture capital gets involved with, at the seed end of the spectrum. It is very high risk in terms of the returns that you can get.

Venture capital is responsible for over 20% of the US economy right now, and 90% of software jobs, 70% plus of biotech jobs and roughly 11% of private industry employment. That has represented a massive impact on the success of the US economy over the years and the success of the reinvention of the US economy. I think the reason we are here today

is to interject into this hearing that there are other forms of financing we should be considering as a Government and that the Government can help to stimulate some real growth engines of the economy. I do not think we compete with banks.

Q920 Mr Tyrie: Mr Stocker?

Anil Stocker: I am here from MarketInvoice. The easiest way to understand what we do is to give an example of the business that we have helped this week. They are a business that was running big online advertising campaigns for beer companies at the World cup in Rio. They had done all the work. They have invoiced out to these big beer companies and are having to wait 120 days to get paid. In the meantime, they have to pay their suppliers and cover their costs from all the activity they did at the World cup in Brazil. They come to us and what we effectively do is fund that invoice early.

We pull that money from sophisticated investors, asset managers, family offices—people who are sitting on a lot of money that they give to the business so they can get on and pay their suppliers, and move to the next project. We funded £200 million through our platform. Some £100 million has come since the beginning of this year, so it took us three years to do the first £100 million and six months to do the second £100 million. We have helped over 600 businesses through repeated transactions—over 3,500 transactions since we launched.

I would agree with Samir. I view this time right now as a huge opportunity for us. We are competing in the factoring and invoice discounting market. When I look at the products that the banks have, there are so many negative features about them. There is so much lock-in. There are so many opaque things around the fees. Businesses do not understand what they are going to get charged, how they can exit and what collateral they have to give. Banks are constantly changing the goalposts. Right now I think there is a huge opportunity in the alternative finance market to make everything more transparent, faster and easier, and also to educate businesses that there are more options outside the top four banks that control 80% of the business market in the UK.

Q921 Chair: It is still a relatively small share so far compared to total SME lending.

Anil Stocker: Yes, but I think you have to look at the growth rates. We have grown 465% this year compared to last year. Yes, we are off a small base, but I think I speak also for other alternative funding platforms where, if you extrapolate our growth rates, we could become a serious force in SME lending. We will not be called alternative any more; we will be more called mainstream.

Chair: I am going to ask Mr Stocker and Mr Desai at the end of this hearing to tell us the one measure, which is not a public expenditure measure—I am not going to cost the bottom line to the taxpayer—or the one change in how this industry is regulated or structured that would help you most to increase competition.

Q922 Mr McFadden: I would like to ask you all some basic questions about size, and what is driving this and so on. I will begin with you, Mr Desai. Do you think this is

principally being driven by technological change, or is it being driven by the difficulty of start-ups and SMEs to get finance from the traditional bank lenders? Is it technology, or is it a problem elsewhere?

Samir Desai: I think there are a number of factors. I think technology is definitely a factor. On our board we have a guy called Ed Wray, who is one of the co-founders of Betfair. He always jokes to me that when they started Betfair, it cost them £1 million to buy a server to run that business, but his mobile phone is now more powerful than that server. The costs of technology and being able to use technology have come down dramatically.

The other big factor we have noticed is loss of trust and satisfaction with banks. That has helped us, probably more so on the investor side. Funding Circle is made up of 30,000 individuals that lend money to businesses every day. An average loan of, say, £60,000 is funded by 600 different individuals, and the loss of trust and satisfaction, combined with the low returns that individuals are getting on their money, has meant that both they and businesses are increasingly willing to try out new things. I think there are a number of different factors that are going on.

What we think is happening now—in the case of Funding Circle and the same with MarketInvoice—is that technology or the internet is starting to disrupt financial services. We have seen that disruption in the book industry and music, and what is happening now is that you have the digital equivalent of lending—digital loan and digital invoice finance—starting to take off. I personally think that is an unstoppable force.

Q923 Mr McFadden: You bring together lots of different people to fund the loan. We talked about securitisation in the last session, which is different loans being packaged up together. Do you have a view on that?

Samir Desai: I think it is very similar to the view that you expressed that there are similarities between what we do and securitisation. As you said, securitisation done right is probably a very powerful thing. We effectively allow thousands of individuals to buy part of a loan, which they have never been able to do. Another way of looking at it is that you are taking something that was only available to five banks—SME lending—and making it available to everyone as an asset class. It is a similar concept. I suppose the main thing is what you put into securitisation as opposed to the actual mechanism itself.

Q924 Mr McFadden: Yes. Mr Askew, you began your introduction by telling us what venture capital does in the UK and so on, but again that is quite small, too, isn't it? The Breedon report said that only 3% of small businesses use equity finance. You have been around a bit longer than the crowd-funding guys. Why has it been so small in the UK?

Tony Askew: I think it has been a systemic problem in this country. I would rate the UK behind Israel, for sure, on this particular point. We like to compare ourselves a lot with the US, but we should be comparing ourselves with other countries first because we have had a couple of stop-start cycles. I think there is more that can be done in the UK to join up. I think a lot of very good thinking and well-meaning initiatives are certainly coming out of Government and from private individuals, but we do not quite have what we in the venture capital industry would call the ecosystem humming in the same way as you certainly have in Israel, and you definitely have in multiple areas across the US. Personally I have

invested in the last 15 years in companies across the US and across Europe, Israel and the UK, and what I notice, time and time again, is that we have these sectors or classes that do well over a period of time but, on a systemic basis, this is not as caught up as elsewhere.

Q925 Mr McFadden: What do you mean by “systemic”? To describe something as “systemic problem”, what does that mean?

Tony Askew: What I mean by that is just repeatable entrepreneurs planning businesses, being successful, going back and doing it again, and going and doing it again—people who have made money giving their time to help other people to make money themselves.

Q926 Mr McFadden: That sounds like a reason why it should be growing. My question was: why is it not growing?

Tony Askew: Part of the reason it is not growing is there have been various issues around incentives and tax policies over many years, but there is a fundamental issue that we have to deal with in education and culture in this country. We have an education system that for many, many years has prioritised law, medicine and the professions at the elite end over things that are more entrepreneurial, which just has not happened in some of the other countries that we certainly invest in. Secondly, historically we have had—if you go back 50 years—a very strong science and development base in this country, but we have never quite latched the commercial engine on that we all hoped for when we had the brain drain in the 1970s, and to the extent that we have had a brain drain in the last decade and so on.

Q927 Mr McFadden: Every Secretary of State for industry for the last 30 years has said this.

Tony Askew: Exactly. You are trying to probe me for the reasons, and I think there are many reasons here that we are struggling with as well. At least at the BVCA, we are trying to hook as many of the people up together to try to get over this issue. One of the things that has happened in the last decade is that you have seen a genuine interest in creating entrepreneurialism, a genuine early-stage investor set of very high-quality, well-meaning seed funders and angels that are creating, as you will have read in the newspapers I am sure, the groundswell of start-ups—the gentleman next to me will be able to testify to that as well—that are coming out of the UK. We just need to continue with that momentum, but it is still behind where some of the other “ecosystems” are.

One of the funding gaps we see right now is what you call the series B—when you have a company that is robust, with 50-plus people, executing well with good revenue characteristics. There is surprisingly less funding available at that level than on what they call a “fire power” level—the big fund willing to put tens of millions of pounds or dollars into the business to get it going, which you find a lot in the US, Israel and other places. It is this stop-start over a period of time. We are playing catch up, but there is more to be done and that is what we are all working on right now.

Q928 Mr McFadden: Mr Stocker, I would appreciate your view on this technology or denial of supply question, but I also want to ask you about growth. You were quite bullish a minute ago when you said, “We do not want to be in the alternative finance space. We want to be part of the mainstream finance space.” I am going to quote your colleague just for speed’s sake. Mr Desai’s evidence to the Committee says: “In due course Funding Circle could represent 10% to 20% of lending to small businesses”. Can peer-to-peer credit funding—whatever term we want to use—get to that kind of level?

Anil Stocker: Definitely. I think we are already seeing it in the growth rates that have occurred over the past three years. If you add up all the platforms’ volume that they will do this year, it will be £1 billion. If you extrapolate forward with the growth rate, by 2018 to 2019, we can see alternative finance contributing £25 billion to £30 billion.

Q929 Mr McFadden: What is it about what you are doing that can break the size cap that the traditional non-bank venture capital industry has not been able to break? It has done some good innovative things, but it has never become a commonly used alternative to bank lending. Why are you able to do that when Mr Askew says he has issues?

Anil Stocker: We are not doing exactly the same thing. Finance is a very broad sector. You have equity, debt, asset-based finance, invoice finance, factoring and mortgages. There are some things the banks do very well, and mortgages is one of them. Banks like to go into sectors where they can grab a lot of collateral. Banks view everything as, “How much collateral can I get for the risk that I am taking?”

Mr McFadden: Yes. We talked about that in the last session.

Anil Stocker: You talked about that in the last session. What I think platforms such as ours and Funding Circle are doing is taking a whole new approach. We have better data now than ever before. We have a chance to redefine completely how we think about these products. We can introduce new products. We are not saddled by branches, big bloated infrastructure, cost bases and people. We can start afresh and build products. Businesses are voting with their feet. A business can leave MarketInvoice any month they want with no termination fee, yet they keep on coming back and using us. That proves that we are building products and also that there is demand for new financing products. The banks will say, “We want to lend but no one is asking for a loan.” That is because the products they offer are not desirable and not the ones that business owners want. They want to come to the next generation of finance providers such as ourselves, and that is how we can build sustainable models.

Q930 Mr McFadden: You are pretty bullish about size then in terms of the potential share of the market? If this 10% to 20% is correct, are we looking at a five-year timescale for that or less?

Anil Stocker: I think we can have a meaningful impact in the next four or five years.

Q931 Mr McFadden: I have been quoting your evidence, Mr Desai.

Samir Desai: Yes. Companies such as Funding Circle and MarketInvoice are backed by the venture capitalists that backed Facebook, Twitter and companies like that. These are networks. As Anil said, we have been called “small” for many years, but we are doubling to trebling to quadrupling every year and eventually that leads to very big numbers. The analogy I like to use is that if you look at big businesses, they do not have to borrow from banks. They can go to bond markets or equivalent syndicated loan markets and borrow the money directly from big investors. Platforms like Funding Circle allow smaller businesses to borrow directly from investors as well. If you look at bond markets or syndicated loan markets, they can be anywhere between 20% and 40% of finance markets, or even higher in the US. There is precedent for this in larger business finance. There is precedent for it in other markets like online music and online books. There is no reason to believe that it will not happen in this sector as well.

Q932 Mr McFadden: If the Chairman will indulge me, I want to ask one more, which is about the Government’s role in all this. Perhaps I will put this to you first, Mr Askew. The Government has tried various schemes over the years to support venture capital, such as the Seed Enterprise Investment Scheme. Can you give me your views on that? Then I am interested more generally in what you think of Government efforts in this area. I am not making a partisan point here, but I suspect that they have tried various schemes that are often not well known, and it has been quite difficult for the Government to design something that hits the sweet spot here.

Tony Askew: Yes to the last point, very true. Two of the most successful instruments have been the one that you referred to, SEIS—Seed IS as people call it—and EIS. I think that is one of the things that has led to this rather good state we are in at the moment, where the very early stage of capital is far easier to come by now than it was certainly five years and definitely 10 years ago, when the boom and the bust had finished. I think what Government can do typically is set the right taxation frameworks and level those out.

There are pockets around early-stage finance where, if you look at the regulation, it does not make sense. We could spend a whole afternoon on that and there are people who work on this day to day. Individually, they do not seem that big an issue, but when you take them as a whole, it creates this framework for an entrepreneur where they do not quite understand enough about the various different formats of the financing. It gets very confusing and I think we at the BVCA try to simplify that with standard terms and conditions across forms of investment documents, so that if you want to raise early-stage finance, you are not reinventing the wheel each time.

As I said in my preamble, I think the ecosystem here is a few years behind some of the others and we are getting there. What can the Government specifically do to address this issue of the later-stage funding, which I mentioned to you as being beyond? We are unusual in this country in having these massively fragmented Government-backed pension funds. In aggregate, each is very small; they do not have the capacity or the expertise to think about early-stage alternative investment.

You put that against what happens in the US, particularly, say, with CalPERS, which is mostly public money. These are vast funds and they are able to allocate a very small portion, so on a risk-weighted average on the whole fund, it is a very small amount. But, of course, a small amount of venture capital goes a hell of a long way. If you take a £1

trillion fund and allocate 0.5% to venture capital, that is an enormous stimulus that you give the venture capital industry. That is precisely what happens with these large pension funds in the US. We have nothing similar here. There is one very simple thing that would not change much at all, because you would still have the pension funds and you would still have the pension arrangements for teachers, firemen and so on, but actually thinking about how you could start to pool together these so far untapped sources of financing is something that would be very interesting to explore.

Mr McFadden: That is interesting. This is a diversion, but some of our public sector pension funds are what they call “funded”, which means a fund exists, and others are “unfunded”, which are just paid every year out of people’s taxes. I will leave that one there.

Samir Desai: Do you mind if I chip in?

Q933 Mr McFadden: Go ahead. The exam question is: what can the Government do?

Samir Desai: One of our biggest bug bears is that there is a major tax distortion that puts individuals that lend to small businesses at a huge competitive disadvantage to banks. We have been lobbying for a number of years to get this changed. Let me explain what it is. If an individual lends to a business and that business goes bad, they cannot offset any of the losses against the interest or tax. To put it in a very simple scenario, if an individual lent at 5% a year to a selection of businesses and 5% of those businesses went bad, their net return would be 0%, say, but they would still pay tax on the 5%. They would end up paying tax even though they had made no money.

To put it another way, if a bank were to sign up to Funding Circle and lend on exactly the same loan as an individual, the bank would, effectively, be able to pay no tax and offset all its losses, whereas the individual would have to. What this means is that for a vast selection of businesses that—for want of a better word—you would classify as “riskier”, those are the kinds of businesses that unfortunately we are unable to service at the moment, as individuals or the thousands of people in Funding Circle cannot really lend to those businesses profitably.

We have the US business, as I said. In the US this is not an issue. The irony is that if a US individual now were to come and lend on the UK Funding Circle platform, again they could offset their losses against tax, whereas a UK individual cannot. The biggest issue we face is around applying an outdated tax system to what is effectively a very innovative activity.

Tony Askew: I agree with Samir’s comments. The British Government have given quite a lot of attention to alternative finance. We participate in the Business Finance Partnership whereby the Government are deploying some of their wholesale funds to the platform. That is welcome. That helps the industry in terms of building trust and pushing into the mainstream. I think a key thing is that, like it or not, the big banks have a very captive relationship with SMEs. Small businesses will do everything with one bank and the bank effectively locks them in. If they have given them an overdraft, they cannot then go and shop around for invoice finance, asset finance or crane finance. They first have to go to the bank, and the bank then has to give them permission to go elsewhere.

Through the debenture system and the contracts that many businesses are signing up to with the banks, when they do not fully understand the terms that they are signing into, it means there is an oligopoly structure of the big banks controlling the SMEs and where they go. They cannot shop around. If they want to go elsewhere, they force them into their own product. I think there has to be a little bit of investigation into anti-competitive behaviour there by the banks as well.

Q934 Chair: I have been having conversations on and off with the venture capital industry for 30-odd years, in various capacities, and a conversation does not last very long when three or four venture capitalists gather together with somebody from Government before tax relief comes into view, and tax relief is now in view in this conversation. Mr Askew, you did say earlier that you wanted to level the tax playing field. Did you have a specific proposal there in mind? Where are you going to put the taxes up in order to shave off these edges where taxes are too high? You were nodding your head vigorously in agreement with what was said on either side of you—

Tony Askew: Yes, I was nodding my head at something that Samir said.

Chair: —both of which were tax reliefs being proposed in various forms.

Tony Askew: Yes. I think what we are asking for is just a level playing field. As Samir was mentioning, it is crazy that a corporation with massive balance sheets and the ability to hedge is essentially able to take a long-term view on how it manages its tax affairs, whereas an individual is on a point-by-point transaction. As I said in my response to Mr McFadden, it is very hard to go into each individual point, because there are so many in the UK tax code that it is not straightforward.

Q935 Chair: In other words, it is an extremely complicated tax system.

Tony Askew: Correct. If you talk to an American about this, their eyes start to glaze over, because you have to start hiring an accountant or a lawyer to figure this stuff out and once you start doing that, the barriers have gone up.

Q936 Chair: So you do in the United States. Do not think for a moment their system is straightforward.

Tony Askew: It is not; I invest there. It is also bad, but the tax code is somewhat simpler in this regard. In many ways for private financing, it is much simpler. My point is: although it is a nasty word in government to hear about tax incentives, they do matter. Incentives matter a hell of a lot. They matter a hell of a lot at the early stage because you are putting so much on the line. An entrepreneur is putting—

Q937 Chair: I am sorry to interrupt, but you are back to describing the proposal for tax relief or the justification for tax relief—which is a case that has often been made and is often well made—but the question I am asking you is: if we are going to level this playing

field without having to find a shed load of cash, we have to find the taxes from somewhere else in this part of the industry.

Samir Desai: I do not know, just to jump in. Using the specific example I spoke about, ordinarily you would think that if you just let people offset their losses, there will be less income tax paid, but start to consider all the secondary effects of it. Every business that borrows through Funding Circle employs, on average, two new people within six months, and 33% to 40% of those businesses would not have been able to access the finance if it was not for us. This is all independent research by Nesta.

What you are seeing is that a number of businesses that could not get access to finance are able to access it and employ more people. On top of that, those businesses—on average, again—increase turnover by 25%. Those businesses are making more money and are paying more VAT, and they are probably making higher profits, so they are paying more tax. On top of that, you get a number of additional people who probably would not participate in this type of activity ordinarily. By that, I mean that for the highest rate taxpayers in the UK, it is less advantageous to do peer-to-peer lending. They are likely to shift into this type of activity and there is likely to be more tax paid.

One of the things that we do not promote as much, but that will be an unseen side benefit of the rise of peer-to-peer lending, is that it will be a huge tax boon for the Government because what you will get is a number of individuals who will be paying tax on the gross interest, not the interest that has been paid after banks have taken all their costs and losses out of it. I think, perversely, that when you look at the secondary effects, this will increase the tax take.

Q938 Chair: The dynamic effect will come through once the—

Samir Desai: Exactly. In reference to our change, for instance, Labour's small business taskforce started recommending these changes a year ago, and I think this is the case with the venture capital stuff as well. On the surface of it, it always appears that there may be tax leakage, but I think, by encouraging this type of activity and by giving more businesses access to finance, it is unclear whether the tax take will go down, and it could go up.

Q939 Chair: Pat McFadden made another point, which was that there are quite a lot of schemes out there that many people might not fully understand and I think, Mr Askew, you said that SEIS and EIS were two of the better ones. We have several others on the go in the equity sector: the Venture Capital Trust Scheme, the Business Angel Co-Investment Fund, the Enterprise Capital Fund Programme and the UK Innovation Investment Fund. They are less worthy are they, Mr Askew?

Tony Askew: I would not say they are less worthy. I think the response was very specific around early-stage financing, which is where EIS and SEIS play in very strongly, because that opens up—

Q940 Chair: What I thought I heard you say earlier was that what we really need is less complexity and a level playing field. What I am trying to point out is that if we do that,

these schemes are going to go, aren't they, and we are going to be replacing them with lower, simpler taxes, but that means higher taxes for some people operating in some of these areas?

Tony Askew: I think what is happening at the moment is you have a series of fragmented Government support schemes, because what has happened is that the venture capital market is not mature enough yet. When it is mature enough and it becomes self-sustaining, a lot of those schemes tend to fall away. If you look at the history of the US and Israeli markets, these things were prevalent for 20 years or longer in the US.

Q941 Chair: These should have sunset clauses on them, albeit long sunset clauses?

Tony Askew: These will naturally sunset as the industry grows and matures. The reason why I think it is important is because if you do not have a vibrant entrepreneur base in an economy, you start to atrophy over time. I think that is precisely what happened for a period of time in this country when there were disincentives—taxation through to cultural—to take a risk and go for something with your life, when in other countries in the world that was not the case. They are now reaping the rewards of that, and what we are trying to do is to go, “Yes, of course, as you look at it point by point there are lots of different fragments,” and so on, so we want—

Q942 Chair: These are always set up with the best of intentions by successive Governments.

Tony Askew: Absolutely.

Chair: I have a list of seven here for straightforward lending.

Mr McFadden: There would be more than that.

Chair: There are more than that, yes. I just have the list of the seven main ones, and so it goes on. They may sound good when announced on Budget day, and they may benefit certain specific groups, but one has to ask whether this is really the way forward for trying to assist either lending or equity. What we are interested in hearing is not so much more specific schemes, whether it is for pension funds or targeted changes on personal tax relief, but something that at the cost of removal of some of these schemes or reduction and eventual removal can replace them with something that is simpler, better understood and can be of benefit right across the industry without the pluses and the minuses that come with targeting. Am I describing something that is of interest to the venture capital industry?

Tony Askew: I think what you said is true and where we are in the cycle at the moment is there need to have been Government incentives to move us through that period of the last 10 years.

Chair: All right.

Q943 Mr Love: While we are on this subject and being fruitful, perhaps you would put on record your organisation's attitude towards the equity gap. You talked about early-

stage finance. There is a gap there. We never seem to be able to construct schemes to be able to fill that gap. What would you and your organisation suggest?

Tony Askew: Sure. I think there are pockets of capital that can still be tapped. That is the trick if you want the Government to be removed long term through the incentives programmes. I think you have to stimulate that, whether it is through structural, regulatory, accounting or whatever practice we have in play. There are two big funding pools that I think we can tap more. One I have spoken about, and the other is corporate venture capital. My organisation, Reed Elsevier Ventures, is a corporately backed fund. We are one of certainly fewer than 10 on the FTSE, when you compare that with more than 50, I believe, on the Fortune 100 in the US. That is partly to do with cultural activity. It is partly to do with close proximity to the venture capital industry in the US. It is also partly that over the many years of various incentives and so on, organisations have just cut adrift the notion of very early support and venture capitalists. Deloitte estimated there is over half a trillion pounds sitting on corporate balance sheets, and there is certainly a hell of a lot of US money that is “trapped” through their tax regime in Europe and in the UK. That is another large pool of capital that would seem to be available if we can figure out the right way to unlock it. I think the answer to your question is to try to find these larger pools of capital in the same way that Samir and Anil are doing in trying to unlock the huge pools of capital that sit in people’s balance accounts in their personal lives, and have that flow into the early stage market.

Q944 Mr Love: You opened up a whole Pandora’s box there. I have to come on to the regulation of crowd-funding to get some of your attitudes. I would ask you the very obvious question—whether you welcome regulation. For whatever reason, the Financial Conduct Authority has introduced regulation in two specific areas, which I am sure you are only too well aware of. Those rules were obviously for consumer protection, but have they remained flexible enough to allow innovation to continue, Mr Desai?

Samir Desai: Funding Circle was one of the three founding members of the Peer-to-Peer Finance Association. We formed that with Zopa and RateSetter three years ago, and the entire purpose of that association was to lobby for regulation. What we felt was that the industry would be regulated eventually, so we did not want the tanks to turn up on the lawn at some point. We also felt that it was important that protections were put in place—especially if a platform were to fail—to make sure that investors could still get their money back.

We have welcomed the regulation and we have been working very closely with the FCA to put it in place. I would say we have had a very positive experience. We feel that the regulation that has been put in place has been very proportionate. They have been willing to listen to our concerns. Certainly, on the peer-to-peer lending side of the regulatory regime, we have been very happy with it. Now it is early days, and people have always said to us—

Q945 Mr Love: Okay, that is fine. Mr Stocker, MarketInvoice is not regulated. The FCA has decided against that. Are you in agreement, or would you like to join the other association and become regulated?

Anil Stocker: You are absolutely right: MarketInvoice is not regulated at this point in time. We joined the Peer-to-Peer Finance Association, alongside Funding Circle and other platforms, because we wanted to run ourselves as if we were regulated. The reason why we are not regulated is basically very simply because we are dealing with businesses and sophisticated investors at this point in time. We do not have any consumers putting money into the business and we are not lending to consumers, so we do not touch any regulated activity. As I said, we are running ourselves as if we were under the same regulation that Funding Circle and other platforms have right now, and we would embrace an element of regulation over what we do. With regulation, you always have to tread carefully because one of the reasons why you see companies such as ours and Funding Circle here in the UK is that it was relatively light-touch regulation that let us get into the market and become a presence here. What usually happens when regulation is heavy-handed is that it serves just to benefit the incumbents, and that is probably why—

Q946 Mr Love: That is my very next question because there is obviously concern that regulation it will be a barrier to entry for new platforms.

Anil Stocker: Exactly.

Q947 Mr Love: Mr Desai, did your association come into being in order to stop others coming into being—new platforms; competition?

Samir Desai: No, I would say the reverse. The capital requirements have been set at low levels to encourage innovation. What we used to do is that Zopa, RateSetter and Funding Circle used to sit in a room and we would all have our different legal opinions and we would say to each other, “You are doing this wrong,” and someone else would say, “You are doing that wrong.” No one could agree because the lawyers could never agree, whereas what is now in place is a standard framework for companies that want to enter the space. I would expect more new entrants now because there is not this grey area. Companies like Google—large companies—I would expect to enter the peer-to-peer lending space, which we think is a good thing. It will expand the market. We do not think we are necessarily competing against each other yet. We are really competing against the banks and the vast financial system. I would say the opposite: I expect it to encourage competition, as opposed to the other way round.

Q948 Mr Love: One of the rules that have been introduced is to restrict the amount that retail investors can put into schemes to a maximum of 10%. What is your attitude towards that and what impact has it had on the volume of funding that is coming through to peer-to-peer lenders?

Samir Desai: That particular piece of regulation you are speaking about is on the equity crowd-funding side. What the regulator did was to divide crowd-funding up into what it calls loan-based crowd-funding—what we call peer-to-peer lending, or is generally called peer-to-peer lending—and equity-based crowd-funding. What it says, which reflects the reality, is that equity crowd-funding tends to be more risky than, say, loan-based crowd-funding, so there is more regulation and more restrictions around that area. In terms of that particular policy, we have not seen any effect because it does not really apply to us.

Q949 Mr Love: How do you ensure that your investors are not investing more than 10% of their assets?

Samir Desai: We do not, and if it is someone like me, I probably have more than that in Funding Circle lending.

Q950 Mr Love: They self-certify themselves. Are there real dangers in that?

Samir Desai: No. Those particular restrictions do not apply to us. The loss rate on Funding Circle loans is about 2% a year. On some of the consumer platforms, it can be as low as 0.5% a year. What we do do is we diversify investors across lots of different businesses. What we found is that every investor that has lent to at least 100 businesses equally has a positive net return after fees, losses, everything, and 70% of those investors are earning between 6% and 10% a year. If you want to lend on Funding Circle automatically—if you do not want to pick and choose the businesses you lend to—you have to lend to at least 100 businesses. There are a lot of protections in place in terms of diversification. We have all the risk warnings on the site—“Your capital is at risk”; things like that—and this is a much lower risk activity than investing in equity.

Q951 Mr Love: Mr Stocker, in an earlier answer you said that your organisation only has sophisticated investors, high net worth individuals and people who can look after themselves in the marketplace, if I can put it that way.

Anil Stocker: For the moment, yes.

Q952 Mr Love: Why did you decide to do that, and are you looking actively at extending your list of investors?

Anil Stocker: Yes. Again, you have to remember that we set up MarketInvoice against the backdrop of mis-selling products to various people. We wanted to be a little bit safe in the sense that we wanted to stick with professionals, at least until we had proven the model was sustainable. We have a loss rate of 0.1%. It is extremely low. We have been able to build up experience. We have done a statistically significant sample of transactions. We have learned a lot. We have refined our model and, yes, now that we can see that it is safe—it is scalable, it is working—we will look to extend and open up a way for retail investors to deploy funds on our platform. Yes, that is definitely in our plans.

Q953 Mr Love: Let me ask, finally, both of you to respond. There has been quite a lot of concern that the internet as a platform gives opportunities for fraud in all sorts of different ways. It must be clearly on both your radar screens. How are you responding to that both in terms of dealing with suspected fraud, and also in reassuring your investors that they will be treated fairly?

Anil Stocker: We do a lot of anti-fraud. The internet obviously invites fraudsters, but that was happening in the offline world as well. There were fraudsters in the offline world as well as the online world. What we have at our disposal is using the internet to uncover

fraudsters in ways that they themselves do not even understand. You can trace, track, monitor and check a lot more things by looking at the digital footprint of someone than you can glean from having a relationship based on walking into an office or branch and having a conversation with someone. It is harder to hide yourself if you are a fraudster in the world that we live in with the digital insight that we have. Where we have uncovered—and we have—instances of fraud and genuine attempts to defraud us, we have done so through ways that were not face to face, looking at them in the eye. It has been through ways we have spotted it online. Of course the internet invites fraudsters, but it also gives you a better tool to combat it.

Q954 Mr Love: Mr Desai, in answering that question, perhaps you can just pick up—this is my final question—cyber-attack: what you are doing to prevent catastrophic attacks made upon you?

Samir Desai: It is obviously a constant worry and something that we take very seriously. We run penetration tests on our website every three months. What that means is that we basically pay a load of sophisticated hackers to try to break in and we make sure that there are clear delineations between the front-end site and any back-end data, in terms of financial data and things like that. It is constant vigilance and constant testing to see if others can break through our systems, because we know that it has been a common occurrence.

What we have also done is to separate out any financial transactions from the front-end site as well. Whenever money leaves or enters the Funding Circle system, it is always manually reviewed. To be honest, that has been the safest way of ensuring that financial data does not get stolen.

Q955 Mr Love: Do you separate the investors' funds from your own funds, and do you have a trail that someone could pick up if the organisation went—

Samir Desai: Yes. That is a regulatory requirement and, frankly, we were doing it before regulation even came in. On top of that, what Funding Circle has is a S&P-rated back-up servicer. What that means is that if, say, we were to go bust tomorrow, they would effectively step into our shoes and ensure that all the loan repayments still got collected from borrowers and distributed, and they would manage the client account. When you talk about systemic risk, there is no systemic risk with these platforms. We are not too big to fail; we can fail and there is an orderly workout.

Q956 Mark Garnier: Mr Askew, could we look at the relationship between venture capitalists and those entrepreneurs who seek their advice? Gil Dibner, who I think wrote some ethics and professionalism within venture capital for BVCA, quoted that venture capitalists need to ensure the right investment from the right investors at the right price at the right time. How do venture capitalists ensure that?

Tony Askew: That is everything. That is our job. Often, people get that wrong and that is the nature of the risk we take, which is why it is high risk, high return, because when it does pay off, it really does pay off very well. Typically, they do not work and that is the

way. If you look at the statistics of the venture industry, a huge number of the guys with a PC fail quite early. It is a little bit akin to medicine and drug discovery, in that the venture industry is structured ideally so that you fail cheaply and fail early. In the recent 10 years, we have seen an enormous advance in the underlying infrastructure that has become now rentable. Rather than having to go and buy a server for a million bucks, you can essentially now rent a server farm at a fraction of the cost and burst into it through Amazon. Of course that has reduced the level of capital that has gone in, but also increased the cycle time of failure, because now entrepreneurs can fail cheaply and fail quickly at home before they have even raised more than \$10,000 or \$20,000. I use dollars because I invest in dollars, you understand.

Mark Garnier: Yes.

Tony Askew: What you find is there is an enormous failure rate within early-stage capital, which is why as venture capitalists we ponder this very point that Gil is raising here. It almost seems, if you look back, that stuff obviously looked that it was going to win, but in the mix it can be very disconcerting. You have things that are working and then they do not work—they fall out of bed, and then you get it right. Every successful company I have invested in has had this crisis moment at some point when things do not look like they are going that well. You have to push on through and everyone has to take a deep breath, typically.

Q957 Mark Garnier: It is very labour intensive assessing a venture capital prospect, isn't it?

Tony Askew: Very much. Very much.

Q958 Mark Garnier: Your return has to be quite substantial in order to justify that labour, if nothing else?

Tony Askew: Yes. If you look at the gold-standard venture capital structure, it would be west-coast style—west coast US; I do not mean Cornwall—in that it is very much a hits-driven business where you will have one or two big return companies, like a Google, a Facebook or a Twitter, that essentially, to use the parlance of the industry, return the fund. In other words, if they have raised \$1 billion from limited partners, that one exit, as we call it, will pay for that \$1 billion and then all the other little ones that come through is where everyone in the fund makes their money. You get a few like Google and Facebook that blow through that and you get multiple returns on that, but typically that is the west-coast mindset. If you invest on the west coast of the United States, that is what everyone is in it for.

There is a lot of weeding out early on, which is why you find this notion, which particularly started on the west coast, of the acqui-hire, which you get less of in this country. The large technology companies in the US will buy young companies with 10 or 15 people that are struggling, but have really smart talent in them—they just have the smart talent working on the wrong stuff—and they will pay \$1 million or \$2 million per employee to acquire that company. That is the nature of the value of a strong talent pool

on the west coast because it is the difference between having a big win and an okay win. With the venture capital mindset, the big win is what pays for everything.

Q959 Mark Garnier: We are talking about equity or equity debt splits?

Tony Askew: Equity.

Q960 Mark Garnier: Only equity?

Tony Askew: Yes.

Q961 Mark Garnier: The problem for venture capitalists is that you have to identify it, you have to work out your deal in the first place, you have to run with it, you have to recover what assets you can when it fails—it sounds like they fail as often as they do not fail—and then, when you have a success story, you have to work out what your exit is going to be. Your exit can either be a trade sale or an IPO, such as Google or Facebook, at \$100 million.

Tony Askew: Exactly.

Q962 Mark Garnier: Clearly, if you are an entrepreneur who comes up with an idea and it is just a bad idea, you probably won on that. You had a free chance to try out your idea, or a relatively low-cost chance. Do you find on the other side that people feel that they are being slightly rolled over by the venture capitalists? If you do have a very successful business—I completely accept that some businesses just would not be successful were it not for the venture capitalists—do you get many complaints that people feel they have had a deal written that, with the benefit of hindsight, they would not have done? This is partly due to the fact that some of these venture capitalists may have identified something that the entrepreneur did not, but it also might be due to the fact that an entrepreneur is good at writing code or is good at producing fruit juice—whatever it happens to be—but what he is not as good at doing is writing business deals with people who do this for a living. How do you square that circle?

Tony Askew: That is a very important point because when that manifests it puts people off. It is like that whole customer service pyramid that used to be drawn: with every complaint there are at least 10 or 15 underneath that and underneath that and so on. That is true of all kinds of behaviour. Again, this is why I go back to what I think is the gold standard, which is what developed on the west coast of the United States and, in a sense, has been exemplified in social media where everyone talks about everything. In the US, if you get a bad reputation for that kind of stuff, you will see less good deals going down the line.

As you move into the other places to invest in the UK and elsewhere, which are less well developed, of course you end up with a bit of a patchwork between the understanding of an entrepreneur, how well educated they are at raising money and how aggressive individuals want to be as investors, and you cannot patrol that kind of thing on a point-by-point basis. But rather like in a marketplace, you can start to set the conditions as an

industry of what good practice is. Good practice leads to spectacular results, and bad practice typically leads to trouble, lawyers getting involved and failure. People are smart. Even the very aggressive types will very quickly realise the quick route—the best route to victory for everybody—is the win/win and that the win/lose approach does not pay dividends.

We absolutely pay attention to that, which is why we talk at the BVCA about the standard document. One way in which these can manifest, if you are not careful, is in a bubble, on a single-point basis. If the entrepreneur is not well skilled and clued up on this—the investor could be someone who is a bit more aggressive—and they are working to their own documents and they are working with their own lawyer, and no one is checking these documents have some sense to them—of course, you are going to get the potential for a bad deal to be done. But if you are working with industry standard documents that everybody has accepted and that have been invested on time and time again—the “vanilla-style” documents where you should not be discussing any of this stuff anyway, because it is just what everyone else does—you start to do two things. You skill up the industry with what to expect.

That was why I made a point a little bit earlier about the education system. I think education plays a big role in that and, responding to Mr McFadden’s question about what it meant by systemic, the more returning entrepreneurs you have, the better clued up the next generation of entrepreneurs are, because the best thing an entrepreneur can partner themselves up with is someone who has already done it and the big adviser networks that you find. We are beginning to build that at scale also in the UK through programmes like Seedcamp and Techstars, and all these other great programmes.

Coming back to the point I was making, what you can do as an industry, and what we heavily promote, is the notion of what best practice is. Talking about the BVCA, we have training courses and seminars, we get people together, and we encourage people to go to these early-stage programmes.

The third thing I would say in that an indicator of the advancement of the venture market ecosystem is the number of people who do understand what venture capital is. That is still a question mark for me in the UK. Just wandering around the City there is a massive misunderstanding of what venture capital is versus other forms of private finance, which you just do not get in Israel, you do not get in China and you certainly do not get in the United States.

Q963 Mark Garnier: Can you expand on that? It is interesting that you talk about the west coast of America being the model, but what you have there is a very innovative business environment—it is very different from our business environment. You also said that the UK venture capital is relatively new, but Ronald Cohen has been at this for 30 years and has obviously made quite a lot, having started it—

Chair: Very good at lobbying for tax breaks, too.

Mark Garnier: Very good. We cannot keep him out of the place.

Chair: He picked on Gordon Brown very well on the tax-break front.

Mark Garnier: It is interesting you talk about the City not quite understanding what venture capital is. Do you think it is because the City of London—in whatever form it takes—simply just has this ancient merchant banker-type mentality that has not caught up with the rest of the world, or do you think that it is because the types of businesses that you have in America generate that type of innovative thinking, and we are just not seeing that type of business here in the UK? Can you put your finger on it, aside from the obvious—tax?

Tony Askew: I think there is quite a lot in that. When I said that the UK industry was further behind, absolutely. Apax and Ronald Cohen have been around since the 1970s, but there has not been a scale platform in this country for venture capital for lots of reasons, which we could spend a whole afternoon going into. It is the fits and starts point that I made at the beginning when I first introduced myself. It is only in the past 10 years where we have seen a consistent push of entrepreneurialism. You have seen entrepreneurs written about across the press. We have TV programmes about it. We have early-stage funding programmes about it. We have people willing to put their own capital through forums like the two gentlemen next to me, and Seedcamp and so on, and more institutional money coming in. That is one thing.

The second part of this is when I say that the City does not understand it, some individuals do, but when I talk about venture capital, I often get misunderstood with what venture capital is.

Q964 Mark Garnier: Can you give me an example of that? Having been in the City for 27 years myself, I wonder whether I know what you are talking about. Where does the City get it wrong? What do you see as venture capital and how does that differ between, say, angel financing or what 3i was doing, for example?

Tony Askew: Right. Well, 3i used to be venture capital and then it moved into private equity. Apax used to be venture capital and then it moved into private equity. Where there is confusion in this country—more so than there is in the US—is the split between private equity and venture capital.

Q965 Mark Garnier: Private equity is looking to maximise existing businesses where venture capital is looking to start?

Tony Askew: Correct, using leverage usually, and venture capital is all equity, very high risk, very early stage. I think the reason that it is misunderstood is just that there has not been enough of it. I come back to the education system. If you think about the people you graduated with, most did not join entrepreneurially backed companies; they joined big companies so they could have a CV. They joined lawyers. They became a medic. They became accountants and consultants and so on. The UK became the service hub for the world, which was a good thing, but in doing that I think we had a prejudice against people just standing on their own two feet and getting on with it, and finding other people of like mind to back them. That is what we are dealing with now and have been dealing with for the last 10 years quite well.

What I have been expressing is that we continually need to push on that because of this lever effect that we have already spoken about—for every dollar and pound that goes into

venture capital, you have all these other benefits: jobs; cycling of the cash in the market; an opening of people's minds; and, hopefully, you have a return to some kind of value-added intellectual industrial base that would match the UK's position on a field-weighted scientific basis as being the No. 1 place to do scientific research in the world. It has just overtaken the US on that, according to the Business, Innovation and Skills Department, which did a report on this. We still have four of the world's top 10 universities in this country. Does that last? Why can't we put this commercialisation energy much more prominently on that intellectual output that we clearly have pouring out of our institutions every year?

Q966 Mark Garnier: Have you found that the bad press that private equity guys have been getting has spilled over into venture capital because of that misunderstanding, or do you think there is a clear distinction?

Tony Askew: Not with people who know about venture capital, absolutely not—no. Entrepreneurs who understand this and are dealing with venture capital understand what that is.

Q967 Chair: I am going to end by coming back to where I said I would begin—partly because Mr Stocker and Mr Desai have been very patient for the last 10 minutes, although it has been very interesting listening to some information about the venture capital industry—the single measure that can improve competition in your industry and help to get it going. Mr Stocker has been particularly patient this afternoon.

Samir Desai: I would just reiterate the change that I talked about, and I would call this less of a tax break but more of a tax common-sense simplification. Most of the investors who come to Funding Circle expect to pay tax on their net returns, just like every other investment product. I know you mentioned some points—

Chair: We have that one on board.

Samir Desai: You mentioned some points about tax breaks and I was waiting to come to the defence of Mr Askew. In terms of Funding Circle, we set it up five years ago. I and my two co-founders quit our jobs in the middle of the biggest recession there was—or that certainly we had experienced—and we raised £600,000 to build the initial IT and launch Funding Circle. I can tell you now that we would never have been able to do that if it was not for the EIS scheme. Investors were taking a chance, but they knew there were tax benefits to doing so. Funding Circle now employs 170 people globally; 120 of those are in the UK. We think we have had indirect job creation of 12,000 jobs through the Funding Circle platform from small business borrowing, and I have a number of letters that will testify to say there will be a number of small businesses that would not be trading if it was not for what we had come and done.

While it is very difficult to extrapolate the effects of some of these tax changes, what I would hope this gives is a small example. They are very beneficial. Changes that may appear small, and may not appear as potentially headline grabbing can make a huge difference to the ecosystem. Coming back to the tax that I am talking about, there will be tens of thousands more people lending through the Funding Circle platform within a year

if this tax change were to be made. We are not asking for people to pay no tax on their gains. We are just asking that, if they lose money by lending to a business, that can be taken into account and they can offset those losses.

Q968 Chair: That is helpful. Mr Stocker?

Anil Stocker: Yes. MarketInvoice is also an EIS-registered company and EIS did make a big difference for us when we got going—this is a similar story to what Samir has. I think the single biggest barrier is still awareness. Too many companies and businesses are either frustrated with how they are being dealt with, or with the choices that the bank is giving them, and they do not know where to turn. What that manifests itself in is a reluctance even to have a conversation with your bank manager, or even to go and request something from your bank, if you fear that you are going to be disappointed.

Chair: Or ripped off.

Anil Stocker: Or ripped off or turned away with nowhere else to go. It is quite a lonely place being an entrepreneur of a business. Let us say you are trying to get from £2 million to £10 million. You are juggling lots of different things. You might have contracts in different countries. You are travelling. There needs to be some way that we can either build awareness at the point of application, or build awareness alongside the banks and banking infrastructure. I think some things are already being debated and discussed around referrals and ways of signposting, just to build awareness, because I think that with awareness you are going to have a lot more businesses finding out about us, using us, and creating jobs. We have companies that had never exported to the US. They can only export to the US now because we helped them. It is the same with companies that are exporting to Africa, Asia, the Far East. British businesses want to export and take their talent across geographies. The banks should be doing this; they are not. We are filling that void and more people need to find out about us. We need to think about that in a structured way.

Chair: We have found it extremely interesting this afternoon. Thank you very much, all three of you, for coming to give evidence. As you put it, there must be some way of raising awareness, so if you have the inspirational thought—you cannot rely on politicians to have those inspirational thoughts—or any further points, please give them to us. We are very much in the market for them as we are thinking through this area of finance. Thank you very much indeed for coming to see us.