

Business, Innovation and Skills Committee

Oral evidence: Access to Finance, HC 84

Tuesday 28 June 2016

Ordered by the House of Commons to be published on 28 June 2016.

[Watch the meeting](#)

Members present: Mr Iain Wright (Chair), Paul Blomfield, Richard Fuller, Peter Kyle, Amanda Milling, Jonathan Reynolds, Amanda Solloway, Michelle Thomson, Craig Tracey

Questions 78 – 162

- I. **Gareth Oakley**, Managing Director, SME Banking, Lloyds Banking Group, **Rishi Khosla**, CEO, Oaknorth Bank, and **Marcus Stuttard**, Head of UK Primary Markets & Head of AIM, London Stock Exchange, gave evidence.
- II. **Chris Hulatt**, CFO & founder, Octopus Investments, and **James Meekings**, UK MD & co-founder, Funding Circle

Examination of witnesses

Witnesses: **Gareth Oakley**, Managing Director, SME Banking, Lloyds Banking Group, **Rishi Khosla**, CEO, Oaknorth Bank, and **Marcus Stuttard**, Head of UK Primary Markets & Head of AIM, London Stock Exchange, gave evidence.

Q78 Chair: Gentlemen, good morning. Welcome to our Committee; we are very grateful that you are here to give evidence. For the purposes of the record, could you give us your name, your title and which organisation you are representing, starting with you, Gareth?

Gareth Oakley: My name is Gareth Oakley. I am the managing director for the SME division of Lloyds Banking Group.

Marcus Stuttard: I am Marcus Stuttard. I am the head of AIM and the head of UK Primary Markets at the London Stock Exchange Group.

Rishi Khosla: I am Rishi Khosla, the CEO of Oaknorth Bank.

Q79 Chair: This inquiry, gentlemen, is about access to finance and problems for businesses getting access to that productive capital in order to grow. Is there a problem, Gareth?

Gareth Oakley: The environment has changed quite a lot in recent years. The Bank of England figures show that eight out of 10 businesses are now successful in getting finance,

and obviously the cost of finance has decreased quite substantially over that period of time. The Funding for Lending Scheme has helped a lot with that. The taskforce's SME Monitor also shows that only 6% of businesses, SMEs, are saying that access to finance is now a barrier. It is a pretty liquid market. More than 40% of SMEs in the same survey say that they are permanent non-borrowers. We have been able to increase our net lending over the last five years. We have grown our net lending by 25%, when the market has decreased by 13%.

Q80 Chair: Are we looking at the wrong thing now? Is this not business critical? Is access to finance not a structural problem in the British economy anymore?

Gareth Oakley: I believe that the environment has changed, as I said. Our own figures show that we have been able to grow our net lending. In fact, the marketplace now shows that net lending at the end of last year was growing by more than 1%. That is the first time we have seen that growing. It does feel like things have moved on quite a lot.

Q81 Chair: Marcus, what is happening? Is access to finance a problem? Are you seeing that?

Marcus Stuttard: There is still more work to be done. I agree with Gareth that we have seen some of the discussion among companies change. Over the last few years we have seen more conversations and more concerns about signposting and about education. Let us not forget that there are lots of different forms of finance. We are not just talking about bank finance or debt. In order to make sure that this country's smaller companies can grow to become large businesses we need to support them right the way through what I would describe as the financing ladder, from start-up to FTSE 100 companies at the top end. There is still a strong education job to be done.

Q82 Chair: Forgive me for interrupting; you raised an important point that was emerging in our earlier oral evidence session. Is the problem not that there is a finance gap but that there is an information gap? Is there a need to provide that clarity?

Marcus Stuttard: There is absolutely an education gap. There is a lot that is being done to try to help with that education gap. Some of you will be aware, for example, that the British Business Bank and the ICAEW published the updated version of their business finance guide two weeks ago. That covers all the different forms of finance, from bank lending through to angel/venture capital and public markets. However, I still think a lot of business owners and also early stage investors quite often do not know what the next form of financing might be.

There are a number of things that we have done from a London Stock Exchange Group perspective, such as the launch of our ELITE programme and our *1000 Companies to Inspire Britain* report, where we are just trying to create a bit more visibility and profile but also importantly bring together different providers of finance. Over the last four or five years we have certainly seen a greater willingness among providers of finance to collaborate and to talk about where their form of finance fits into the financing ladder. There is still more work to be done.

Rishi Khosla: I have a slightly different view. The larger question for me is the ambition for the country. If you look at debt penetration within SMEs in the US and

Germany, it is nearly double what it is in the UK. From my perspective, being an entrepreneur and having lived that life for over a decade and a half now, I have seen first-hand the challenges in accessing finance as a growing company. Respectfully, there is a major challenge when you go to high street banks on even being able to have a reasonable conversation around a non-standardised lend as opposed to a standardised lend—one that is property backed. I look at it in terms of a normal distribution curve. A lot of high street banks have gone to automated decision making, which means that they lend to the middle of the bell curve. Anything on the very far tails does not get lent to. That, to me, is the fundamental problem with access to finance for growth companies, which ultimately are the source of growth for the country, both employment as well as GDP growth.

I think a lot more needs to be done, both in terms of availability of finance as well as education on availability of finance. If you look at SMEs, 80% to 90% of them go to their current account provider for a loan. That goes down to the education point. Awareness needs to be raised around viable alternatives, but in terms of viable alternatives, having launched Oaknorth Bank in September, we have seen probably £500 million or £600 million worth of qualified, high-quality pipeline of demand from companies that have not been able to get the access to finance that they are looking for. When we were setting up, one of our challenges was getting real data about how large that gap is. That was why I made the ambition point: is our ambition to stay at the debt penetration levels that we have, or is it to increase them to effectively provide more financing to our growth companies?

The lack of information causes a viewpoint that the gap is not so substantive, and conversations I have had with the British Business Bank have also confirmed the challenge in getting good data on the size of the gap. Despite however much market research we did, the reality is that the only way you get a real sense is by actually going out and being in the market. Our experience of being in the market has been that the gap is very large.

Q83 Chair: Will it get worse in the light of what happened on Thursday? It is not exactly the most positive headline in the *Financial Times* today. Bank stocks are falling; the FTSE 250 has lost 14% of its value. It is the largest fall in FTSE 250 since the crash of 1987. In terms of the wider economy and flowing that capital through to good, growing businesses, will Brexit slow that down? What impact will Brexit have on access to finance, Gareth?

Gareth Oakley: It is far too early to say what the long-term outcome will be. From our perspective, we remain absolutely committed to our strategy of helping Britain prosper. We have not changed any of our products or services as a result, and we are very much open for business for our customers. But it is too early to say what the long-term prognosis is.

Marcus Stuttard: We need to look back at history to a certain extent. Markets have been through a number of shocks in the past, and I can talk from my perspective of being head of AIM. Following the financial crisis, whilst we saw the number of new companies and IPOs coming to AIM fall off, we saw companies on the market raising record amounts of finance. In each of the years post the financial crisis, we saw £5 billion, £6 billion and some years £7 billion raised by companies on the market. That was 90% of the money that was raised. The institutional investors continue to provide finance.

The other important point, which we have started to touch on, is that we need to have a mix of debt and equity. One of the things that we hear regularly from companies that do have equity finance is that it makes it easier for them to get loans from the banks, for

example, because it gives everybody confidence that there is a long-term form of finance there. Clearly, it is early days, but I am very confident that we have got a very deep pool of long-term institutional capital that supports companies from the relatively small level of £10 million through to the banks and the FTSE 100.

Q84 Chair: Can I push you on AIM? I am really interested in this. As head of AIM, Marcus, is there a viable future for AIM in terms of that £10 million to £25 million? In light of the vote on Thursday and the proposed merger between London and Germany, is that in doubt?

Marcus Stuttard: No, it is not in doubt at all. AIM is pretty much the only growth market in the world that has been in existence for 21 years. Most growth markets globally have been single sector, such as the technology, mining, oil and gas markets. They have had a very narrow spread of companies. But we have got a real maturity around AIM. Even in the uncertainty at the beginning of this year, we saw a good level of IPOs come through.

Just to put this into a bit of context, across the London markets we had 21 IPOs in the first quarter of this year at a time where there was only one on the New York Stock Exchange. We have seen businesses like Hotel Chocolat come through. We have seen spin-outs. We had an oncology company from Nottingham University raise a relatively small amount of money, actually—£11 million—but we have got a wide range of investors around. Some of those are the tax-incentivised investors, so people like the VCTs or the IS investors. They are really important, because we, and I in particular, are very cognisant that we have a wide range of investors, from retail individuals through to some of those investors that are tax incentivised, through to the big institutions, fidelities and the BlackRocks etc. Maintaining that wide investor base is important.

Q85 Chair: Will there not be an insistence, in light of Thursday's vote, that all operations switch to Frankfurt? German politicians are saying that now. Will you not be under enormous pressure, not just with AIM but all operations, in order to take advantage of the EU single market?

Marcus Stuttard: I should just say that clearly, because we are in a merger situation, we are subject to Takeover Panel rules. Therefore, I can only reiterate what we have said in our public documents, our prospectus and in the announcement that we made on Friday. We have a very strong commitment to SMEs in the UK and across Europe.

We can demonstrate that not just by our forward-looking statements but in that, as some of you will be aware, we merged with Borsa Italiana in 2007. At that time, from an AIM perspective, one of the easiest things for us to have done would have been to market AIM out of London into Italy. However, we formed a brand-new market in Italy to create an Italian ecosystem. We have now got 80-odd companies in Italy. We continue to think that sort of model is important. Similarly, out of that merger with Borsa Italiana, we have imported our ELITE programme into the UK. We have a very strong commitment to our domestic markets but also see a wider European opportunity.

Q86 Chair: Marcus, I just want to push you on the future of AIM, before I bring Michelle in. I do think this is a vital part of the ecosystem in terms of raising finance. What is the revenue of AIM?

Marcus Stuttard: We operate AIM for strategic reasons as well as pure revenue reasons. It is a profitable market.

Q87 Chair: Marcus, with the greatest respect, I did not ask that. I asked what the revenue is of AIM.

Marcus Stuttard: We do not report that segmentally in our annual reports.

Q88 Chair: It is tiny, though, isn't it?

Marcus Stuttard: It is. Compared with the group revenue, it is a small proportion.

Q89 Chair: What is the proposed combined revenue of the London Stock Exchange and the Deutsche Börse? You know where I am going with this.

Marcus Stuttard: I know exactly where you are going with this, but if we were looking at this purely from a revenue perspective, we would not have operated AIM for over 20 years.

Q90 Chair: But you are, Marcus. With the greatest of respect, one of the reasons is to provide competitiveness across global stock exchanges. That is the reason for the merger. Your prospectus proposes €450 million, about £355 million, of savings. AIM is tiny. It does not take a big leap of imagination to suggest that AIM will be jettisoned in order to make savings. Can you guarantee that is not going to happen?

Marcus Stuttard: I can categorically state that, in the same way that we have proposed savings, we have also absolutely reconfirmed our commitment not just to AIM but to all of our other SME programmes, such as the ELITE programme and our 1000 Companies to Inspire programme, in all of the public documents, which clearly are subject to Takeover Panel provisions. We have to make statements we can verify.

We also recognise the importance of AIM to the UK economy. For the last reported numbers, just the UK companies on AIM were responsible for a £25 billion contribution to the UK and 730,000 jobs. This is a very important form of financing and something we absolutely recognise. It is also strategically massively important to us, because it makes sure that we have got strong relationships with a wide range of the adviser investor community, but it is also a pipeline for companies for our main market. This is not purely about revenue terms. I can categorically assure you of that.

Q91 Michelle Thomson: I will carry on a little longer about the impact of last Thursday's vote. Prior to that I was already having conversations with senior people, particularly around financial services, about what I suspected might happen if there was a significant enough differential in voting patterns between Scotland and the rest of the UK. However, I must admit that even I was surprised by the differential that was expressed in Scotland, and obviously significant moves are afoot to ensure the mechanism for Scotland staying in. These senior people are suggesting to me that they have already, as a minimum, started to reach a hedge position, where they realise that Scotland represents an easier outlet for getting to Europe. Alternatively, they are even considering that they could see a time when they would headquarter in Scotland. This is particularly for Gareth and Marcus: I

would like to get an anecdotal view and your thoughts about that, because everyone will hedge but I would like your view.

Gareth Oakley: We are talking about a hypothetical question here. We have proactively contacted most of our customers. The tone is very much business as usual. It is clearly impossible for me to speculate on the future of the referendum.

Marcus Stuttard: Unfortunately it is four days in. It is too early to say. What I can absolutely say is that we remain committed to providing access to finance to companies right the way across the UK and to servicing all of the regions.

Q92 Michelle Thomson: I suspect it is probably a slightly unfair question, but I am putting it out there. Following on from that then, if I can just push a little more, we are all reading what is happening in the markets. With regard to the scope and scale that you, particularly Marcus and Gareth, are dealing with, has there just not been time to reflect yet? It may well be that other people within your organisation are looking at this, but do you genuinely believe there will not and cannot be any impact on lending to SMEs, given where they fit from a risk profile, for particularly a large corporate such as Lloyds? Do you genuinely believe that, or do you think people just have not worked it out yet? Obviously, events are still happening.

Marcus Stuttard: Clearly, what both the financing community and the business community are looking for has not changed since Thursday. Everyone is looking for certainty, because people can then plan and they know what they are planning for. We would expect that, from a company and a demand perspective, companies will probably delay making investment decisions and therefore requesting finance as well. The greatest thing that we can all do is remain collaborative but also provide as much certainty as quickly as possible.

Gareth Oakley: I genuinely think it is too early to say. It is possible that SMEs will continue to trade as normal, but from my perspective it is definitely too early to say.

Q93 Michelle Thomson: Rishi, if I could bring you in at this point, obviously you will have a slightly different take on this. Every happening also provides opportunities. From your business perspective, if you were to suggest an anecdotal view in terms of access to finance based on what you were saying earlier, what are your thoughts specifically in light of what happened last Thursday?

Rishi Khosla: We have already seen two opportunities come to us, not from Gareth's institution but from some of Gareth's peers, and between Friday and yesterday they have pulled out of financing for SMEs. Clearly, as Marcus said, uncertainty is the worst thing for any situation and especially for a country. However, through that obviously there are going to be a number of situations where the business owners themselves decide to delay investments.

As I said, we have already started to see other high street banks make the decision to not continue with the process even if they are quite far along and to not provide financing on particular opportunities where they may view the prospects of that company to be uncertain. To be clear, we are not going to take unnecessary credit risks because ultimately we are a retail deposit taker and we have that fiduciary responsibility. However, we need to measure that with wanting to do the work around understanding the likely experience for a business

during a downturn, and not having a broad-brush view around sectors but a much more micro view around the actual business, conducting peak and trough analysis etc., to be able to run scenarios and make a reasonable credit decision.

Michelle Thomson: That is helpful. Thank you.

Q94 Amanda Milling: Good morning. I am going to move off the EU for a bit, if that is all right. I will just go back to talking about the structure of the banking industry and particularly in terms of SMEs. I am just interested in understanding this. Rishi, your evidence indicates that around 90% of bank lending is with the big four banks. What are the implications of the dominance of the major banks in terms of access to finance for SMEs?

Rishi Khosla: One of the major implications is that, again, if I go back to the bell curve or normal distribution curve, a lot of the major banks have reverted to lending to the middle of that, reasonably based on property-backed lending. One of the largest problems with that in the UK is businesses not asking for debt financing and assuming debt financing is not available for a business such as theirs. Again, going back to the British Business Bank in terms of their research, that was one of the biggest issues as well. It is not viewing debt as an alternative or a possibility because we have almost been trained in a way to say that you can only raise debt if you fit very narrow criteria, especially on the smaller end of lending amounts.

There is a structural problem there. Again, it goes back to education and knowledge in terms of saying, “There are alternative providers out in the market.” Again, I would say they are very few and far between, but clearly there is the whole alternative finance sector, with players such as us trying to address that problem and solve the problem in the UK for access to finance for SMEs.

Q95 Amanda Milling: Gareth, I would be interested to get your view on the dominance of the big four in terms of banking and therefore the implications for access to finance as well.

Gareth Oakley: We have recently had an independent review from the CMA. My personal interpretation is that that review shows that it is a competitive market, although it does lead to the fact that SMEs probably could be more engaged in terms of the options that are available. We support all the remedies that come from the CMA. In terms of the points that have been raised, we do not operate a one-size fits all approach. We are one of the very few banks that give lending discretions of up to £1 million with our local managers on the high street. They are able to take a local view and adapt proposals towards businesses, and clearly we do not just lend to property as well. We have some public commitments in terms of manufacturing. We publicly commit to lend £1 billion to manufacturing, for example, every year. We do think that there is more to be done in terms of engagement and education, but we see this as a very competitive market.

Q96 Amanda Milling: Going back to the earlier point that you see SMEs typically as going to their main bank, it was probably a few years ago that the current account switching service was introduced. How is that working in terms of encouraging small businesses to switch their business account?

Gareth Oakley: The system itself works extremely well, but I do think there is more that can be done in terms of educating businesses that the system exists. We see a very healthy and competitive market. We will win switches from all of our competitors, including the challenger banks. We will switch more than 5,000 businesses this year, but we will also lose some businesses to competitors as well during the course of the year.

Q97 Amanda Milling: Can you just elaborate a bit further in terms of the required education and information? It seems to be a common theme coming through.

Gareth Oakley: The CMA remedies will certainly help with that. This includes making information available to businesses and making things transparent. We are very much supportive of the idea that there should be a comparison tool available. We have invested £5 million into a prize draw challenge along with some other banks as well, just to make it easier for businesses to see what is available to them.

Q98 Paul Blomfield: Following on from that theme, I am interested in Gareth's comments a moment ago. I want to put those back to Rishi if I can. What you described earlier in terms of automated decision-making from the big banks resonates with what I have heard from local SMEs. Gareth has made a robust defence of a new approach and giving more opportunity for local managers to make decisions, which does not resonate quite so closely. However, I want to explore your business model and where you think you make a distinctive and different contribution to improving lending.

Rishi Khosla: We are really focused on lending sub £20 million to UK mid-market growth companies. That is our core area of focus. My view is always that the best way of understanding the environment is to play in the environment, and that is why I said that getting data around the size of the gap was hard but launching the business shows the size of the gap. Playing within that market, we have probably done about 25 deals to date.

Within that we have not seen the same competitor in any more than one deal. That is, we have not seen the same competitor across two or three deals, which makes us feel like no one is really focused in providing bespoke finance. Again, I go to non-standardised, because if it is standardised financing it does typically lead to automated criteria decision making, and therefore it does get serviced well by the high street banks. However, if there is a need for a particular type of structure or understanding of the business that makes it non-standardised, that is where I feel the gap exists. That is where the British SME is not used to asking for debt financing, because they view that as a product that is not available in the market.

You have got the bank market and then the direct lending fund market, which effectively comes down to and does deals maybe in the teens but generally focuses on deals of £30 million, £40 million or £50 million plus. Those are the guys who we see more often than a high street bank or any other UK bank across the table. Those guys will be independent, private equity fund structures that focus on direct lending to UK or European businesses. Again, most of those funds will come infrequently down to numbers in the teens. As soon as you go below £10 million, again, with regard to non-standardised lending, that is where there is a real vacuum of activity.

Our business model is to have direct lending officers, people on the ground, who go out and spend all day, every day, with companies, meeting companies, owners and managers etc., so that they can identify where their business challenges are and how we can help play

into those. Again, we are doing this across the country. We have offices in London and Manchester. At the moment, our origination or lending team is based in London, but we have done deals up in Leeds. We are currently doing a deal in Birmingham. We are looking at a transaction in Scotland. Again, we are able to cover the country by leveraging technology etc.

Q99 Paul Blomfield: Your company talks about having a wider range of assets against which you lend and more unsecured lending. There is an issue there about how you assess risk and how you make those decisions. What you are saying is that that is done by having a more intimate, proactive, closer relationship with companies so that you can get a sense of the proposition they are making to you.

Rishi Khosla: It is both having much more interaction with the company and spending much more time with the company, as well as conducting much more fundamental credit analysis—the types of examples I was giving before about having a look at the impact of an economic recession on a particular subsector and doing that through, for example, the last two business cycles and using that as your sensitivity analysis to play into making your credit decision. We go through that depth of analysis in making a lending decision to a business that is predominantly a cash-flow based lend rather than a collateralised lend.

Clearly, that type of work takes a lot of heavy lifting, and the fundamental problem typically within debt lending at these quanta is that you almost do not make enough fees to conduct underwriting to the level needed to be able to underwrite a pure cash-flow based loan. I would say that my previous business was a financial research business where we had scaled up to 3,000 employees, and a lot of the research that we did was based in India, China, Argentina, Costa Rica etc. Within Oaknorth we have deployed that model. We have a research team based in India who support our fundamental credit research, again with skills from private equity, from distressed debt lending etc., to give us a much more holistic view around the business and the scenario analysis in play to make the credit decisions.

Q100 Paul Blomfield: Gareth, do you recognise that as a different model? You talked about ways in which you were giving some greater latitude to local decision-making but that sounds like a fundamentally different model.

Gareth Oakley: There are some similarities there and there are some differences. The only point that I would challenge is around the concept of standard lending. We do not have a one-size-fits-all approach.

Q101 Paul Blomfield: Why do you think companies feel that you do?

Gareth Oakley: I am not sure. Anecdotally you may get that evidence but statistically I do not necessarily see that. We do not have a one-size-fits-all, as I have talked about; managers have local discretions. But of course we do have a risk appetite, and therefore one of the big changes we have seen in the marketplace is new lenders coming in with different risk appetites and perhaps offering slightly different approaches and different products. We believe that is driving innovation, competition and is a good thing for businesses. Quite often this type of finance can be complementary to traditional bank finance as well.

Q102 Amanda Solloway: I will stick to the same theme. I am just thinking about signposting SMEs to finance options. How does that happen and who provides that advice for SMEs?

Gareth Oakley: As has already been mentioned, there is a collective responsibility, and I think we are getting better at that. I do support the view that we can be better at signposting what is available. Personally I think the Business Bank is a very good place for that and we have seen some real improvements over recent years. Ultimately, however, this remains a collective responsibility.

Q103 Amanda Solloway: How do people keep up to date with the finance options available?

Gareth Oakley: We make it our business to have a good relationship with the Business Bank. There are a number of schemes there that are available to businesses, a lot of which many businesses are unaware of. We take the responsibility to help signpost those. Of course we work with other bodies like the LEPs and other advisers as well and encourage those to do the same.

Q104 Amanda Solloway: You say you take responsibility to signpost. What does that mean?

Gareth Oakley: For argument's sake, somebody may approach us for traditional bank finance but it may be that the best option is equity. This is an area where we think there is a lack of awareness and education. We have our own equity arm, Lloyds Development Capital. We have committed £1 billion of funding there over the last few years. However, if it is not suitable for us we may refer them to the Business Growth Fund, which has been an excellent scheme over the last few years.

Q105 Amanda Solloway: Has anybody else got any comments on that?

Rishi Khosla: If I may, I would just stress the point that the signposting and the awareness of where to go is a challenge. We find, out in the market, that lawyers and accountants are probably the best guide, because they tend to be the trusted advisers to the SME. Therefore, it is one of the best channels for us to find the businesses that are struggling to raise finance from traditional means. One probably needs to look at the advisory network to help provide a role within signposting rather than purely looking at the providers of financing.

Q106 Amanda Solloway: I wonder if there are issues around trying to promote the availability to SMEs. I wonder how that happens as well. Is there anything that should be done to improve awareness among start-ups?

Rishi Khosla: Again, the British Business Bank plays a good role there. We have had many conversations and are at the last stages of joining one of their schemes, which is backed by the EIF. It will be interesting to see what happens there, but the British Business Bank does help take financing providers around the country. AIM does a certain amount of that as well in helping provide specifically themed events around sectors.

Marcus Stuttard: There are two points to add to that. You mentioned start-ups and smaller businesses. It is important that we also look at some of the larger scaling up

businesses as well. One of the positive things that has started to happen is that the agenda has moved away from just focusing on start-ups. We have got very high levels of start-ups in this country but a lot of the evidence points to the fact that the real employment growth and GDP growth comes from those businesses that have got the ability to scale up. I know one of the things that we are very focused on is that, when companies get to that sort of stage, they do not opt for an early trade sale, for example, because they think that is the only option open to them. It is about looking at companies right the way across the size spectrum in that funding ecosystem and also making sure that people understand the difference between debt and equity and the different forms of equity. Within equity you can go from friends and family, to business angel finance, to the VCs, and to the public markets. There are lots of different forms of both debt and equity. It is really important to make people aware that you can combine a mix of those. As Rishi was saying, we work extensively with the regional lawyers and accountancy firms because they are quite often the trusted business adviser to these businesses.

Q107 Amanda Solloway: I have just another quick question to you, Gareth, regarding something you said earlier around where applications are rejected. Do you actively then seek to pass those on to other places?

Gareth Oakley: Yes. If we decline a client's request, and eight out of 10 of our clients are successful in applying for finance, there is an appeal process and we effectively resolve 90% of those within 15 days. If we cannot help the client at that point, we will then make them aware of other finance providers.

Q108 Craig Tracey: I would like to come back to you, Marcus. Can you just tell us about how a company comes to be listed on AIM?

Marcus Stuttard: Certainly. The first thing that they would do is put the right advisory team around them. One of the reasons that we have always said it is important to operate a range of different markets, as AIM is distinct from the main market, is that we have a slightly different regulatory structure to make it easier for companies to access the market from an earlier stage. We have this concept of nominated advisers, who are basically smaller investment banks, who become the companies trusted adviser to help them prepare for the market. They will then work with the lawyers and accountants to make sure that there is the right due diligence and that these companies are introduced to the right and most appropriate investors.

One of the things that we have done over recent years, as I mentioned earlier, is launch this ELITE programme for private businesses that are not necessarily thinking about an IPO but will, at some point in the next 24 to 36 months, have some kind of a major financing need, whether that is a venture capital round, a round of debt or whether it is an IPO. We bring those companies together. We work in conjunction with Imperial College Business School to do that, and we basically introduce them to the adviser and the investor community from a much earlier stage so that these businesses know how to conduct themselves and how to prepare either for a VC round or an IPO.

Q109 Craig Tracey: Do you do the outreach? How do they become aware of the opportunity to do it?

Marcus Stuttard: It is a combination. We do a lot of outreach. I have a team of people around the regions. We also work with the early stage providers of finance, so with the business angel community and with the VC community, because not only do we provide access to finance to the businesses themselves but we also provide an exit option for early stage investors so that they can either take a partial stake back and recycle that or have a full exit. We work with the early stage providers of finance. We work with the advisory community. Increasingly we work with organisations like the universities and tech transfer offices so that they all know what the options are.

Q110 Craig Tracey: Once they are listed, how do you go about facilitating the finance for them?

Marcus Stuttard: A company will appoint a broker and it is the role of the broker to find the right investors, whether they are institutional investors or some of the small-cap funds that we have a very strong core of in the UK but tend not to exist in other European markets. Some of those have been developed because of policy support over the years, through things like the Venture Capital Trust Scheme and the EIS, so they can invest in AIM companies in the way they can in private businesses. The brokers will make the introductions to the investors that they believe are the most relevant for the company at that stage of its development.

Q111 Craig Tracey: Are there any sort of particular traits or characteristics that the companies that you list have?

Marcus Stuttard: It is a real variety. We have over 1,000 companies, of which nearly 850 are UK businesses, across 40 different sectors, so it is a real mix. I mentioned a bio-tech business earlier. It is at a relatively early stage and is very capital intensive. Equally we have got more traditional family owned businesses that are paying strong dividends. We have companies from £5 million in valuation up to companies like ASOS with a valuation of over £3 billion. It is a wide range, and providing that wide range of different companies and investors is really important for the vibrancy of the market.

Q112 Craig Tracey: You mentioned the ELITE programme a number of times. Can you just give us a bit more detail on that and how it works?

Marcus Stuttard: We originally imported the ELITE programme from Borsa Italiana two and a half years ago, and we take cohorts of about 20 private businesses twice a year. These are revenue generating, so they are not start-ups. Typically they have revenues in excess of £5 million. We put them through an 18-month intensive training and coaching course that looks at the different forms of finance but also looks at some of the other challenges around scaling up: making sure companies have got the right board composition for sustainable growth and how to deal with major shareholders or major customers.

One of the most valuable things is that the businesses themselves have obviously often gone through these scale up challenges, and so learn from each other how they have dealt with these across a range of sectors and regions. In addition, there is a good demographic. I think 40% of ELITE companies are run by a female, and we have a scholarship that Imperial provides for female entrepreneurs. We try to get a really good range of businesses and they really learn from each other. Obviously as a stock exchange we

have got a very wide network of advisers, investors but also entrepreneurs that have used our markets, and we can introduce all of these people to companies at a much earlier stage.

Q113 Chair: Gentlemen, each of you provides quite a distinctive offer and within your own organisations there is distinctiveness in terms of offers as well. I am very interested in regulation and how it helps and hinders. Regarding access to finance, how does regulation help or hinder providing that access to finance, starting with you, Gareth?

Gareth Oakley: I do not think it is appropriate for me to comment on regulation. That is ultimately for the regulator and the Government.

Q114 Chair: You are at the coalface. We, in Parliament, can have a view about regulation but you can advise us how it operates in practice. The purpose might be perfectly noble but it is not working out there. We want proportionate regulation; we want savers and investors to be safe. Is there anything that is hindering or indeed helping that access to finance?

Gareth Oakley: Personally I do not see regulation getting in the way of access to finance. Our record speaks for itself in that regard. Lloyds Banking Group is now one of the best capitalised banks in the world and, if anything, that makes it easy for us to not only support our clients but to do that at a very competitive price as well.

Marcus Stuttard: Regulation is clearly important and, to one of the points that you have already made, it is about trying to make sure that we have this balance so that companies do not have undue burdens and they can access capital at cost-efficient rates but we also have appropriate levels of disclosure so that investors feel confident. It is a balance. Going back to one of the earlier points I made, one of the reasons that we operate a range of markets is so that we can provide slightly tailored regulatory regimes. Clearly the full regulation that is appropriate on the main market for a FTSE 100 company, where they are subject to the full UK Combined Code, for example, and quite prescriptive ongoing regulations around disclosure when they raise further finance, is less appropriate for small businesses, so we do operate a distinct regulatory regime.

Clearly we work closely with all of the other regulators, so the regulatory framework around AIM is very similar to that around the main market with the role of the FCA and the FRC. Regulation is important; we just work to make sure that we have got differentiation but also that there is not a big difference between the hurdles for public companies versus private businesses. If regulation is appropriate for a public company in terms of disclosure, we would say it was probably also appropriate for a large private business as well, and we need to make sure that there is a level playing field from both a regulatory and a tax perspective.

Q115 Chair: What would a larger private company look like in terms of turnover? I am not asking you to name companies, but what do you have in mind?

Marcus Stuttard: If I look at the profile, the average market value of an AIM company is £80 million. If you took that as a benchmark for that sort of size of company, the sorts of standards that we expect around board composition, governance and disclosure should be equally applicable for a private business of that size.

Q116 Chair: Are you hearing that people do not want to list because they are concerned about regulation? Are we moving away from listed companies and people are taking things private in order to avoid that regulatory interference?

Marcus Stuttard: No. That is too stark a characterisation but we need to make sure that does not become the case. Whilst regulation and tax are both very important, there are plenty of additional advantages of being public around companies having higher profile and credibility. Often that then translates not into just raising finance but being able to secure certain contracts or provide services to large corporates, which I hear regularly from our own companies they were unable to do as a private business. Being public they can do that, so it is not as stark as regulation being a barrier.

Q117 Chair: Rishi, as a relatively new incumbent, what impact is regulation having on your business?

Rishi Khosla: Obviously we went through the whole licensing process very recently and I would say that was a very positive experience both with the PRA and FCA. That process was very iterative and at all times quite clear in terms of what our next steps were. We got our licence in March last year and started operations in September. Going back to Marcus' point about the London Stock Exchange and the proportionate level of requirements for AIM businesses—it is not the full set of requirements for main list—I would say in that way there is not a proportionate level of adjustment for smaller banking institutions versus larger banking institutions. In terms of all of our requirements, they fit very much a much larger institution. That obviously has a disproportionate impact on overall costs and burden on a smaller organisation.

There are also very good Government incentives like the Funding for Lending Scheme, which were designed clearly at the time of the financial crisis and then tweaked continually to help specifically today access to finance for SMEs. But if you look at a lot of the plumbing around collateral requirements and haircuts, they significantly disadvantage any new institutions, such as ours, who do not have a back book to pledge as collateral. You then have the PRA, which obviously limits the amount of existing book that you can pledge as collateral, and then you add a 50% haircut to that. Our ability to access those schemes and take advantage of them to the same level as established banks is significantly hampered. There are examples like that where more can be done.

The other area again where regulation can almost help is if you look at the FSCS. The FSCS obviously enables and provides guarantees across all UK banks. However, if you look at the majority of retail deposits, they are still stuck within the high street banks earning very low yields. Therefore, more education is needed from the Government across the population indicating that the alternative of moving to another bank provides them with a higher yield, with the same protection, and that can have the effect of benefiting the depositor through high yield, benefitting new entrants by helping reduce funding costs and therefore hopefully increasing the finance to the SME community.

Q118 Chair: Thank you. Marcus, may I start this with you? However, I would like to open it up to Gareth and Rishi as well. You mentioned scale up. I am very interested in this. It seems to me that we are relatively easy with providing finance to start-ups in terms of C-stage funding, which is not necessarily a problem. When you get into series B, you are

then starting to come into problems. As I said, I am starting with you, Marcus, but I would like views from everybody. Where do you think we should be focusing our inquiry? Should it be on that scale up and access to finance for scale up, and crucially what recommendations do you think we should be looking at?

Marcus Stuttard: I have a natural bias because that is the end of the market that I operate in and that is where public markets can serve companies best. We have got a fantastic crop of scale-up businesses, and some of those are profiled in this report that we produced and that a number of you have seen. It shows the regional diversity and also the industrial and sector diversity. If we can support these businesses, we have got a very bright future and they have got a real ability to drive job growth and GDP growth.

The area that I would encourage the Government and policymakers to continue to focus on is providing the sort of certainty that we have seen over the last five or six years. Some of that comes to the certainty around some of the tax breaks that are available for these types of businesses, and I have mentioned previously schemes like the EIS and the VCT scheme as crucially important.

Q119 Chair: Do you think in the light of Thursday we can still provide that level of certainty? In light of Lord Hill's resignation as EU commissioner who had the financial regulation brief, can that certainty still be provided?

Marcus Stuttard: Those sorts of schemes are UK schemes, so there should be no reason to not be able to provide that sort of certainty. Some of the other very positive recent changes from an AIM perspective that have been supported by all political parties, such as the abolition of stamp duty and the inclusion of AIM shares in ISAs, had a very obvious and direct impact and helped companies to raise capital but also increased the level of trading in those businesses. I would ask for a continuation of those sorts of policies to really support scale-ups.

Rishi Khosla: I would fully agree but probably for a different reason. I would say that helping support a mid-market growth company get to the next level and take the next step up is what provides both the success stories as well as the returns to investors, which then encourages an ecosystem of people who are willing to put capital in and take more risk with their capital at the earlier stages. It is much harder for the Government to play within the earlier stage angel/series A-type level. There is a lot of challenge there, but the best way to deal with that challenge and encourage that ecosystem of earlier stage financing is to show the success stories of mid-market companies being able to grow and becoming successful and having strong exits for their investors. I fully agree that is the right place to focus.

Gareth Oakley: I would also agree with what has been said so far. This is an area of opportunity for businesses. The Regional Growth Fund is something that we would quite like to see introduced; that was very popular. We were oversubscribed in that particular fund. Once again, more awareness and education is needed around different types of equity investment. The Business Growth Fund has been a really useful tool. This education piece needs to educate businesses around the opportunities that can come from equity investment as well. Many business customers that I speak to are often reluctant to release control of their business but perhaps do not understand the additional opportunities that can come as a result of having expertise on the board as well as the finance.

Chair: Gentlemen, thank you very much for your time and for your evidence. We are very grateful. Thank you.

Examination of Witnesses

Witnesses: **Chris Hulatt**, CFO & founder, Octopus Investments, and **James Meekings**, UK MD & co-founder, Funding Circle, gave evidence.

Q120 Chair: Gentlemen, thank you for coming to give evidence. Again, for the purposes of the record, could you tell us who you are and which organisation you represent?

James Meekings: I am James Meekings. I am one of the founders of Funding Circle in the UK. I am currently the UK managing director.

Chris Hulatt: I am Chris Hulatt, one of the founders of Octopus Investments.

Q121 Chair: Gentlemen, can you help me understand where you fit in a growing, complex financial ecosystem in terms of access to finance? What is your distinctive offer?

James Meekings: Funding Circle was born out of the last financial crisis and launched in 2010. We are committed and passionate about helping small businesses, and listening to the conversations that have just happened, one of the key differences, and to address the question, is that we are focused on the “S” in SME. The average loan that goes through the Funding Circle platform is £50,000. If you put that into context, versus some of the earlier conversation of £10 million to £20 million, these are the businesses in the UK that employ 60% of the workforce and account for 50% of GDP. It really is the “S” in the SME.

We sought to create a platform that was different from banking. We wanted to create a platform that had diversity in sources of finance. Today SMEs can borrow directly through our platform from investors like us, individuals, through to the British Government, from councils who lend as well, and pension funds. We have a vehicle listed on the London Stock Exchange as well to get capital into businesses. Since we launched, £1.3 billion has been lent to UK SMEs, to answer that question, and the platform is now one of the top five lenders to small businesses in the UK.

Chris Hulatt: I was one of the founders of Octopus in 2000. Since then we have grown to about £6 billion of funds under management. That is split across sectors like renewables, healthcare and property, but we have always had a particular focus on high-growth small businesses. That is also very much the “S” in SME.

Our AIM team has about £900 million or so invested in AIM-listed businesses. Our ventures team, which backs unquoted companies, has just north of £500 million. VCTs were mentioned quite a lot in the previous evidence session. To put that in some kind of context, we have about £650 million in VCTs and a similar amount in EIS, so we are very familiar with those funding mechanisms and the role that they have to play in helping high-growth small businesses. I certainly resonate with the comments made in the previous session about scale-ups and their importance and the job creation that comes from them.

I think some members of the Committee have seen the research we published a few months ago around high-growth small businesses; just in terms of the number of jobs that are created by those, they represent less than 1% of companies but around a third of job creation, which is three times more than comes from FTSE 100 companies. We are really passionate about smaller companies. We believe they need the air time; they need to be nurtured; and they need the right kind of funding mechanisms in place to allow them to grow and thrive.

Q122 Chair: Could I ask you about the pipeline for each of your individual offers? Where is there any blockage—if indeed there are any blockages? Are you getting a good flow of potential investments coming in? Is it evaporating? Sorry for trying to squeeze the metaphor further, but you have companies that are not dogs but real peaches in terms of how you can invest. Where is the problem? Is it supply or is it demand in terms of access to finance?

James Meekings: It is very easy for finance companies to sit up here and say, “It is all about the businesses. The businesses need to come to us. We are open for business.” That is the story that you hear from the main banks. In our mind, the challenge is small businesses need an easy way to access finance. 50% of registrations by businesses on our website happen when those businesses cannot get a meeting with their bank and have to go to get a meeting to get a small business loan. There are real challenges there. One in three businesses that borrow with Funding Circle believes that they could not have got a loan through their bank. As another way of looking at it, two in three believe that they could have got a loan from their bank, but they come to us because they see it as an easier and quicker way to access finance and they want to get on with running their business.

Q123 Chair: Are you suggesting there are companies that have not even tried to go to their bank?

James Meekings: Some will not have. When you look at the businesses that we lend to or investors lend to through our site, on average they have eight employees. The people who are filling in the forms are running their businesses; they are standing in shops; they are on shop floors etc. They do not have finance managers. They need to do these processes as quickly as they can. What you are seeing in the alternative finance sector is a focus on how we can get more demand in the door. Through bank lending, there is about £7 billion a month that goes out the door. I get asked the question, “How big is the SME lending market?” We typically say about £100 billion, but it could be £100 billion or £200 billion. When we go out to speak to small businesses to say, “Do you need finance? Would finance help you?” the categorical answer is, “Yes.” We say, “Have you been to your bank yet?” the answer is often “no”. “Why don’t you want to go?” “The process takes too long. I am just going to get on with it myself.”

Chris Hulatt: In my view, there is a plethora of schemes out there and businesses often do not know where to turn. I think, as you heard in the previous session, accountants and other types of advisers can be good at signposting the right route to go. Lots of early stage businesses go and talk to their bank and are rebuffed. Often, they should not have been seeking debt; they should have been looking for equity. They often have no assets and no cash flow, and seeking a bank overdraft or loan may not be the right route to go. Often at that point, lots of people just stop. They do not continue.

Having said that, I do think we have a thriving early stage culture here in the UK. That has deepened and strengthened over the last few years. Angel investing has become much more prominent. It has become more organised. It has become deeper. There are more syndicates. There are good signs that we have a strong start-up culture.

My concern has been to make sure that we have the right mechanisms in place to allow those businesses to progress along the conveyor belt. As they need more funding, how do they find the right places to go? VCTs and the EIS have a strong role to play once businesses progress out of seed stage, but there is definitely a shortage of capital as businesses progress into series B.

Q124 Chair: That is really important and I want to pick up on your written evidence, Chris, in two ways. You suggested, and it was reiterated in the earlier session, that the seed stage is not necessarily a problem, but when you get into series B that is when it is happening. You mentioned a really interesting phase in terms of how you need to ensure a “continuum of funding”. How do you do that? What recommendations would you suggest that we make in order to see that flow as companies need more and more funding? What do you suggest?

Chris Hulatt: We have things like Seed EIS. There are good mechanisms in place for early stage businesses. VCTs and EIS can take the path beyond that and help businesses scale. It is definitely the case that at series B there is a shortage. We have found ourselves that we are one of the few firms in London that is able to do a series B of say £10 million or £20 million.

Q125 Chair: Why is that, given that we are meant to be the world’s premier financial centre? I just find that amazing.

Chris Hulatt: It has taken us 10 years of hard work to develop our ventures team to the point where they have the track record and credibility to be able to raise bigger funds. There are 29 VCT managers out there. Very few of them have funds that can participate beyond that stage and this is the real problem for companies.

It is difficult to go and raise money from another backer, be it going to a European VC with a London office or going to the US. It causes big distractions for the senior management team. It takes a long time. All sorts of hindrances come from that. To be able to have a conveyor belt where we can invest £250,000 into a seed stage, £3 million, £4 million or £5 million at VCT stage, and then £10 million, £20 million or £25 million further down the line in our institutional funds is a really important component. For us, it gives us the ability to say to an entrepreneur, “We can be with you all the way.” We do not have to tell an entrepreneur, “Sorry we cannot back you any further. Maybe you should seek an exit.” I believe passionately that businesses should be able to develop via the right route for them; they should not be forced into an exit too soon; and they need access to money that can follow them on that conveyor belt.

Q126 Chair: I just want to finish by quoting your written evidence back to you, if I can. I am very interested in your views on the difference between the US and the UK when it comes to this financial ecosystem. You say that one of the big differences is one of “maturity”. What do we need to be doing here in the UK to ensure that we can have that healthy state of maturity?

Chris Hulatt: I think it will come with time.

Q127 Chair: Is it just, “Leave it in the oven and it will bake automatically,” rather than trying to help it?

Chris Hulatt: The US has been doing it a lot longer. They have a strong entrepreneurial culture. We are catching up, but they have had that for a lot longer. That breeds a situation where you have depth. The large tech companies are over there: they are cash rich, they are acquisitive; so you have that exit route for business too and you just have the sheer volume and level of activity. We are making some steps forward; there is some good progress, but there are also some clouds on the horizon.

Q128 Chair: I need to push you on this. Is there anything that we need to recommend to the Government in terms of nudging them in the right direction to ensure that that maturity is not compromised?

Chris Hulatt: You need to address, “What can we do to help create more series B in the UK from British VC firms rather than businesses having to go elsewhere?” If you are trying to raise around \$10 million or more as a British firm, 60% of those rounds will have a US VC involved. We should aspire to have that turned on its head so that most of those businesses can get the backing they need from British VC firms.

There are things that we need to watch out for. The European Investment Fund has historically been a big backer of European VC: they often cornerstone funds, maybe to the tune of 25% or 45% of a fund. Those things have a big impact on the ability to raise a VC fund in Europe. Now, following last Thursday, I do not know what the intentions of the European Investment Fund will be towards backing aspiring British VC funds in the future, but the Government needs to watch that really closely and be ready to step in with alternative mechanisms.

There are opportunities to look at things like the Chancellor’s plan to merge the 89 local authority pension funds into the six British wealth funds. I know there is an ambition to use those funds to help fund infrastructure, and figures of £25 billion to £30 billion have been talked about as potential allocations to infrastructure out of those funds. There should be scope to evaluate whether those funds should be much more active participants in the UK SME scene. Should they have an allocation to British venture capital as part of the strategic purposes through which those funds can be run in future?

Q129 Richard Fuller: I want to get back to your point, but first a declaration of interest: I was an adviser to a technology venture fund—it is in my register of interest—and prior to that I was a member of a technology venture capital fund. You were mentioning, Chairman, some of the shortages in certain people in terms of investment and how long it has taken to build up the team. I think you mentioned that, Chris. Is another difference between the US and the UK that people who are looking to invest either debt or equity into early stage and growth capital companies tend to have more of a banking background than an entrepreneurial background and in America it is the other way around or is that not an issue?

Chris Hulatt: That is not how we have built our team. Our team is full of people who have entrepreneurial experience. We specifically seek out people who have done entrepreneurial things in their life; it could be even when they were a student. It could be an

early job, but having that instinct and mindset is really important. We have beefed up our team over the last couple of years so that it includes people who have come out of the Israeli tech scene, say. We have someone from China on the team now. Those sorts of things bring a different perspective.

Q130 Richard Fuller: Is that typical? Particularly given that you mentioned that about 60% of raises over £10 million had a US co-investor, if you look at the £10 million plus series B, do you not start to get into post- or all-banker territory?

Chris Hulatt: It is important to separate out private equity that is looking for highly profitable businesses—businesses they can put debt against. Many of those tend not to be looking at the kind of companies we are talking about. We are talking about businesses that may be scaling really rapidly and are going to need tens of millions of pounds to do so and may not be profitable until further down the line. It is not private equity territory, which might perhaps have lots of people with a banking background. We just opened a New York office because we want to be able to help our businesses have the ambition to go global. Half of our portfolio companies now have a US presence. 10 years ago, I do not think the entrepreneurs we backed had that level of ambition. Now they do. It is really important that VCs are able to work with them to achieve that.

Q131 Richard Fuller: Chris mainly invests equity. James, you mainly provide debt financing. Has the Government got the tax arrangements correct from the investor point of view? My assumption has always been if you are trying to do something good like supporting small businesses, it should not matter whether you are putting it in debt or equity and therefore the tax arrangements should be the same. Do you agree with that or do you think the Government has got it right now? What changes would you like to see?

James Meekings: The Government has made great progress on that. When we launched in 2010, there were a number of intricacies in terms of how taxation worked that meant that there was an advantage to how a bank would lend through our platform versus how an individual would lend. We have engaged with the Government on that and tax legislation has been changed to adjust for that. In terms of increasing capital into the sector, the Government has launched an innovative finance ISA to help individuals lend money to small businesses within the ISA bracket. That is being launched this year. For me, when that comes out it will be an incredible boost for the industry. It is a growing up industry and it will get more money in. In terms of the EIS or SEIS, they are fantastic for equity. The ISA is the equivalent in our space.

Q132 Richard Fuller: In your evidence, you have talked about two things. You have talked about deeds of priority, which is an esoteric thing, but I think what you are essentially getting at there is some of the inefficiencies for banks with existing loan facilities. Do you want to explain a bit more to the Committee about what you feel we ought to be looking at in that area?

James Meekings: This can get quite technical, so I will try to keep it a high level. Let me know if you need more detail. We have a challenge. Our main product is the unsecured SME loan. On larger loans, we want to take security, and when we do that we have to go to the bank and essentially ask permission to sit behind them in the ranking order.

Q133 Richard Fuller: It is not that you are trying to take priority over them; you are just trying to add an extra sliver of debt subordinate to their debt.

James Meekings: Exactly.

Q134 Richard Fuller: You still need their permission.

James Meekings: Exactly. I think all, if not most, contracts that an SME has with their bank require them to do this. The challenge becomes that the process for doing that is incredibly slow and disjointed—not always but most of the time. Sometimes a business gets put off through that process and disappears and says, “I am going to get on with my life,” or the bank comes back and counter-offers. It creates an inefficient market. In the budget I think two years ago, the Chancellor put in a request to say, “This process should take seven days.” We understood that to mean seven days from when the small business wants the finance. The banks understood it to be seven days from when they have got all the information they need in the hands of the people who make the decision.

Q135 Richard Fuller: How many days does it typically take in your experience?

James Meekings: Typically it takes about 80 days.

Q136 Richard Fuller: Eight days?

James Meekings: 80 days.

Q137 Richard Fuller: Eight-zero days—10 times the amount; not one extra day.

James Meekings: Yes. It is a long time. We are working with the banks now to make that quicker. There could be a process of Treasury, of BIS, working closely with the BBA, with the alternative finance industry, to make sure that happens. The intentions are there, but the challenge is that it may fall down over the next few months.

Q138 Richard Fuller: Chris, you talked about pension funds and some of the change the Government is making in terms of the structure of some of the pension funds, but you also talk in your report about opening up and either requiring or providing the facility for pension funds to invest at an earlier stage. Do you want to say a bit more about that?

Chris Hulatt: Pension funds are such a deep pool of capital and too often they go down particular routes, which are driven by the consultants. Over the past few years, there has been a growing recognition that much of what the pension funds are trying to do, particularly public sector ones, could be better honed and used more strategically to benefit the country. I hope, as I said earlier, given the focus that the British wealth funds are going to have on infrastructure investing, there will also be scope for them to have an involvement in UK VC. There is scope here for the Government to look at how pension funds can be used, how they can be encouraged, how you can create the right framework for trustees and how can you work with pension fund consultants to understand the role that UK VC can play as part of the overall capital allocation. It surprises me that pension funds have meaningful allocation in things like emerging markets, which brings currency risk, political risk and all of

the challenges of backing businesses around the world, and yet they have almost negligible allocation to UK VC.

Q139 Richard Fuller: Is that a matter of educating pension funds or is it a matter of regulating? Are there restrictions on pension funds so they just cannot do that today?

Chris Hulatt: It is largely to do with the way that they are guided by the pension fund consulting landscape. Most trustees are not really in a position to actively think about this. They tend to take advice on the fairly standardised asset allocation spectrums that have been used over the years, with lots of allocation to UK equities, gilts and corporate bonds and little slivers of other things. UK VC needs to fight its corner so that it gets considered as part of the investment landscape. Clearly, it also needs funds available to be invested into to create that functioning market.

However, there are other things that the Government can look at to help create those pools of money that can follow on from where VCTs tend to stop. If you use the VCT as a basic framework, the Government should be looking at whether there is an opportunity to create more of a scale-up VCT that would have a lower level of tax incentive but would kick in beyond the point at which VCTs conventionally have to stop.

Q140 Richard Fuller: You also talked about the Angel CoFund. You said it had been a great success but “the demand from companies massively outstrips the supply of capital”. What has made the Angel CoFund a success and what would you like to do to it to supercharge it?

Chris Hulatt: This is a good example of a mechanism that does work well.

Q141 Richard Fuller: Can you explain a bit about what it does?

Chris Hulatt: It invests alongside angels in early stage deals.

Richard Fuller: And an angel is a high-net-worth individual who has money that he or she wishes to invest in early stage companies.

Chris Hulatt: Exactly. For many businesses, one of the challenges is that they are not able to raise enough money early in their life. Having a co-invest fund that is able to work alongside these high-net-worth individuals to get more money into a business early on gives it greater headroom and a longer runway before it is going to need more money. It just gives it a better ability to get up and running. This is part of what is now, to me, a strong functioning ecosystem for early stage companies. The particular challenge is to ensure that we have in place the mechanisms to allow these businesses to progress as they continue to develop. It is staggering that very few businesses manage to break beyond that point of the first 10 years; very few end up employing more than 10 people. How can we help catalyse a different trajectory and make it easier to get the finance that businesses need to kick out of that stasis?

Q142 Chair: You are raising an important point there. We might be intruding on a future inquiry on scale-ups, but why do people not grow their companies and employ more people? Is that a cultural thing in terms of not having access to finance? Corporate life might be somewhat risk averse in Britain.

Chris Hulatt: My personal view is that I have seen the environment change on this. 10 years ago most British entrepreneurs had more modest ambitions. That really has changed. People see in the digital world you can scale businesses very quickly if you have a model that can be taken global. If you do not take it global, someone else will. We need to be able to support businesses on that journey.

We have seen it in our own portfolio, where half of them have gone into the US within a few years of the start of those companies. That is a real change compared with a few years ago. We are working hard to support and encourage them in that. It will pay big dividends in terms of raising their profile.

The other important thing is—and perhaps Thursday will change this somewhat—20% of UK start-ups are established by a non-British person. 30% to 40% of the CEOs of our portfolio companies are from elsewhere. They have come here because we have not just the finance but the skills. We need to make sure we have the depth of both of those things. That is what creates the ecosystem that allows businesses to flourish.

Q143 Chair: Is that a risk to your business in terms of what happened on Thursday? Do you think there might be restrictions put in place in terms of movement of people, for want of a better term?

Chris Hulatt: I am not sure there is great clarity on exactly how things are going to pan out, but it is fair to say that there is worry in the entrepreneurial community about what this might look like. On Friday morning I saw emails from some of our investee companies saying, “Our tech team is 90% people from elsewhere in the EU. What is going to happen to them?” We have attracted entrepreneurs to come here from places like Finland to build their business, because we have said, “We can provide you with finance. We will nurture and support you and you will be able to access skills from the deep London labour market.” What will make those entrepreneurs choose to come to London in the future, as I say, is a serious concern.

Q144 Richard Fuller: Did you want to say something?

James Meekings: Yes, I just want to build on Chris’ point. We have helped about 15,000 small businesses across the country raise loans of on average £50,000. When I go out and see those small business customers—they have on average 10 employees—they have ambitions to grow from 10 to 20 to 30, but these are not businesses that want to grow to 200 or 300. It is important we remember that, because these are the shops, the factories across the country, that need finance, but they are looking for working capital and small growth. They are not trying to go to the US. We can focus on what is going to be the next Facebook or the global stories, but the backbone of the “S” in SME does not have those challenges and is slightly different.

On the labour point, that is a clear challenge for anyone in the tech industry. We have done some research since Thursday’s vote, and 50% of our tech team are EU nationals. There is a clear need there to have some form of guidance from Government. For us, staying in the single market with free movement of labour is absolutely key to a well-functioning tech market.

Q145 Richard Fuller: Can I ask one more question? This also is back to you, James. I remember meeting you five years ago when you were just getting started, and it is great to see you developing so well and the sector really growing. With that growth comes concern about investors: making sure they are not being sold something inappropriately. What have you learnt over the last five years about the importance and systems to ensure that the investor is protected and not put at risk by these new forms?

James Meekings: Let me reassure everyone: no one takes risk more seriously than us. We get asked about this challenge all the time. We have recruited in some of the best people we believe we could to help us manage risk. I say that both from a credit-risk perspective and from an operational-risk perspective. That is an important point to make, because a lot of people see us as a technology company and think we write code—and that is all we do. Our global CRO was the head of global analytics worldwide for risk at Barclays and was the CRO at Barclaycard. We built out that team. The thing I have learnt over the last six years is that I only know so much, the other founders only know so much and we have to get the best people in to take us on that journey.

We have also learnt that as we get more data we can build more robust models, and we have very robust credit models in the UK. We are fully transparent with those models, so you can go to the Funding Circle website and download the full loan book. You cannot do that at any bank. You can get an early sign of losses. That reassures investors that what we are doing is right and that nothing is being hidden.

In terms of how we market to customers, that is very important. There should be no illusion. We are not trying to be a bank. We are not a bank. We should not be regulated like a bank and we should not present ourselves like a bank. There is some concern in the market if players in our industry start to do that. We work with the FCA and the FCA reviews our website to make sure that that is not the case. As long as we present what we are in the correct way, we deliver value to investors and we deliver value to borrowers, ultimately we think we create a much stronger financial ecosystem for the “S” in SME in the UK.

Q146 Chair: James, you responded to Richard’s questioning about recommendations on deeds of priority, but I want to focus on the second recommendation in terms of further opening up of the VAT register. I am interested in how data, the use of big data and data analytics can help improve credit scoring and the robustness of access to finance. Can you tell me a little about what should be happening in terms of the use of data?

James Meekings: Yes, sure. This is incredibly important for the “S” in SME. When we were having the conversations before about going out to meet business owners, looking into the whites of their eyes etc., that is important, but as you go down the chain to smaller businesses, that is a challenge. That is the challenge with bank funding with small businesses. Banks do not want to go out and see businesses that are turning over £300,000. Therefore that lending model is very difficult for them. We get over that by combining data with human—manual—underwriters who do it on the phone etc. It is not a fully automated service. We think that gives the best service to small businesses. It is not fully automated.

To come back to the question about data, the better data we have, the better we can assess risk. The challenge we have in the UK is that we have about 4 million businesses in the UK. 2 million of them are limited businesses that submit accounts to Companies House. The remainder, which are sole traders, do not do that. We believe that by opening up more

data, more of them will be able to pass our credit models. We will be able to get a better understanding of them. This will ultimately increase lending to small businesses.

Q147 Chair: Chris, in terms of data and the use of that in order to improve the effectiveness of investment decisions, what else can be done?

Chris Hulatt: For us, it starts with the entrepreneur. We spend a lot of time working with business leaders, assessing them. We work carefully with them to make sure that they are building teams that have the complete range of skills. We are quite different from James in that we are making a relatively small number of investments every year into businesses that we then work very closely with, whereas James' business is clearly predicated on helping a very large number of businesses.

Part of the growing ecosystem is P2P lenders and so on, compared with the challenges of the banking sector, which you heard about earlier. Banks are great if you want to raise standardised loans. The thing that banks should be great at is the thing that they are delivering on the high street, and yet they seem unable to deal with anything a bit more bespoke. The fact that the banks have withdrawn from that raises a question over their future role relative to being disintermediated by the likes of the P2P lending community.

Q148 Amanda Milling: Can I just go back to explore regulation a little more? James, you said you were in dialogue with the FCA. Can you just describe the regulatory framework you are operating within? Then there are a few bits that I want to explore a bit further.

James Meekings: Sure. Regulation is clearly important. We came to Government in 2010 to say we thought this industry should become regulated. We set up a trade body, which is the Peer-to-Peer Finance Association with other leading peer-to-peer finance platforms to self-regulate before regulation happened. We have been working with the FCA for four years on what regulation would look like. We are currently going through the full authorisation process.

We are regulated as an electronic lending platform, which is under clause 36(h). That is the activity we do and that describes what the activity is. Therefore we are regulated by that. We then have to comply with the whole FCA handbook, whether that is client money, security, getting to know the customer, AML checks etc. It is every form of regulation that a fund or bank would have to do. We do not have to hold the same capital that a bank holds because we are not a bank and we are not pretending to be a bank. I want to be clear on that. We still have capital requirements. They are less than £1 million for our business. They are to protect investors against the risk that our platform ceases to trade: what happens to their money etc.

Q149 Amanda Milling: When you were speaking a little bit earlier on, one of the things you said was that you do not operate as a bank but you had concerns that others might move in that direction.

James Meekings: It is something we have to be cautious of as an industry. I do not think any of the main players are doing this at the moment. There is a risk of it happening. The FCA's regulation says that all of our advertising must be fair, clear and not misleading. They do reviews of us. I do not believe this is the case now, but it is very important that

players, us and competitors, do not say that we are a guaranteed product using the word “safe”—things by which consumers would then misperceive the risk of what we do. We believe we do a very controlled, low-risk investment, but there is risk in it. It becomes dangerous when people start saying, “There is not really any risk,” because there is. I do not think it is the case today. It is something we have to stay vigilant about and it is very clearly on the FCA’s radar to make sure that it does not happen.

Q150 Amanda Milling: In terms of where you are at the moment, how do you feel about the sense of balance in terms of providing that reassurance but also that degree of regulation and control?

James Meekings: Are you asking in terms of our internal operations?

Amanda Milling: I mean the regulatory framework and the position you are currently in.

James Meekings: We believe the regulation that we are under is proportionate to what we operate. As I said, we are not a bank; we are a peer-to-peer lending platform. The UK is the only country in the world that has a dedicated regulatory regime for peer-to-peer lending. We are currently going through that authorisation process. We believe that it is market leading. We operate in five countries around the world, and it is the easiest country, the UK, in which to understand what we need to do. To be very clear, I am not saying it is the easiest country to do what we do, but I am saying it is the easiest to understand—there is a blueprint. I think that is really important because it gives new companies a blueprint to understand what they need to do to become authorised and to succeed, whereas in other countries it is more challenging.

Q151 Amanda Milling: You mentioned that there are differences with other countries. What can we learn from other countries?

James Meekings: In the US, we comply with 52 regulators for the 50 states and the SEC etc. It becomes very complicated, so scaling it is challenging. It is similar in Europe. What is clear is that we need to continue to work with the FCA as this industry evolves, because it is a rapidly growing industry. What you see in Europe, which is challenging, is that there is a clear distinction between equity crowdfunding and debt-based peer-to-peer lending. We have proactively worked with the FCA. Obviously, it is in our interest to do that, to make that clear. In other countries that is more blurred and creates problems for the platforms.

Q152 Amanda Milling: Chris, do you have any input? You know what the broad structure of the question is.

Chris Hulatt: We are an FCA-regulated investment manager. We have to comply with a plethora of rules governing things like anti-money laundering, how we promote our products, client money rules—all of those sorts of things. To me one of the important attributes of VCTs is that they are a regulated product; they are listed on the stock exchange; they have to comply with a whole bunch of rules governing that; and they have been around for 20 years, so people have got to understand them. Financial advisers understand the role VCTs play and how they operate.

From that standpoint, the regulation around the VCT asset class has been helpful in terms of giving investors confidence. Where there is a lot of complexity for us is around the regulation governing how we invest the VCTs. That has evolved significantly over the years and there have been a lot of adjustments to it. Some of those have been driven by the requirements of EU state aid rules, and they are complex and cumbersome and hard to navigate through. It does require lots of specialist advice to make sure that investment rounds are being structured in a way that complies with all the minutiae of those rules.

I suppose in terms of other areas of regulation, there are some aspects of FCA rules that have been imposed on them as a result of some EU legislation. There are questions around things like how the passporting of funds will operate in the future, which allows us to take an institutional fund we are raising in London and market it in other EU countries. At the moment that is an easy and straightforward thing to do. The financial community will be questioning how those kinds of things are going to pan out in the future.

Q153 Amanda Milling: That is, I suppose, a consequence of Thursday in terms of the regulation in your sector and the impact of that. You said that some of it is quite complex. Is that complex good or complex bad? Complexity is not always necessarily a bad thing.

Chris Hulatt: It raises the threshold. We try to insulate our investee companies from it. When a business comes to us looking for finance, we do not say, "Here is the VCT rulebook. Go read it and figure out how to structure around." We internalise all of that and deal with that ourselves as part of what we do as an investment manager, but there is no doubt that the VCT rulebook has sprawled over the years. It now includes very complex interplay between the total amount of state-aid sourced funds that a business has had over the years and gross asset tests, and also a complex look back to when the business first started trading. When we first launched a VCT in 2001, some of those restrictions were not in place and it was easier and simpler to run a VCT than it is now.

Q154 Chair: Can I keep the regulation theme going? I asked the previous panel in terms of regulation what helps or hinders the access to finance. I ask you the same thing. James, I was interested that you said the regulatory regime you operate under is proportionate. Chris, you said the structure of investment rounds can be cumbersome. What is good and what is bad in the regulatory regime, specifically when it comes to access to finance? What would you recommend that we recommend to the Government?

James Meekings: That is a good question. If I think about regulation and its role on both sides of the marketplace, we have investors, and there the regulation is to safeguard their investment and make sure we look after their money etc. That is proportionate, and we are going through that authorisation; there is a review happening later this year on that.

On the other side, to do with small business and whether regulation hinders access to finance for those, clearly there is a difference between sole traders, consumers, and non-limited businesses and limited ones. Protections and regulation is more for sole traders and makes it more difficult for us to operate with them. I do not think that is a bad thing though. That is where there is a blurry line between consumer lending and SME lending. It is certainly more challenging for us, but I do not have a recommendation to make it easier.

Then on the limited company side, what is important is that the regulation is the same across all the different players in the market: so limited businesses do not have much regulation that sits over them—or anything at all. In terms of protections, they are considered to be grown-ups. I think that is right for that market.

The only thing that could be worthwhile is to have increased price transparency for those businesses. In the consumer market, you would have to present representative APRs to customers. You do not have to do that in the limited business space. That represents challenges. We do not do that, but you will see providers quoting flat fees and quoting monthly interest rates but not saying it is monthly until down at the bottom—those kinds of practices. Those are not the main players, but they are around the edges. There could be through your market reviewer an understanding of whether that is an issue that should be touched upon or not. I do not think it is a large-scale issue, but it is something we should certainly be conscious of.

In the intermediated market, there could be a challenge as to whether introducer fees, so broker fees etc., are always clear to customers—and whether they should be. In our view they should be. My thoughts are going around making sure that cost is transparent to the business, regardless of whether it is a sole trader or a limited business.

Q155 Chair: Chris, you must have to deal with regulation a lot.

Chris Hulatt: Yes, we do.

Q156 Chair: How does regulation help or hinder what you do in terms of providing capital?

Chris Hulatt: All I have ever done is run a business in the regulated sector. I accept that, when you run a financial company, you are in a regulator sector. I think that is really important. The vibrancy of financial services comes from investors having confidence and recognising that it is safe to put their money into a product. We have 60,000 investors in our VCTs and that has come about because we operate in an environment where there is a robust set of protections for investors.

In terms of how the landscape is changing, clearly we have new mechanisms. James mentioned crowdfunding earlier. That area just did not exist a few years ago. How is that going to interplay? How are investors going to be deploying their capital? Do they understand the risks? Are they getting enough diversification? Do they really recognise that most seed-stage businesses tend to fail? Is there an awareness of that kind of thing in a new structure like that? We know the FCA looks regularly at crowdfunding and other new areas to make sure that they get the balance right. That is probably the type of regulation you would want. It is alert to the evolving landscape and looking to work with the industry.

James described earlier his interactions with regulators in terms of the P2P sector. It is a similar story when it comes to venture capital. We and other managers in our sector work closely with Treasury and HMRC to ensure that what we do is understood and that the products that we operate are able to find their place in the ecosystem. In terms of the impact on businesses, I see my role as to try to insulate the businesses that we invest into from

having to deal with all of the baggage and complexity that goes with the nature of the capital that we provide.

Q157 Chair: May I ask about signposting? If there is a good company that may be not what you are interested in at the moment—it is a peach of a company but you are interested in plums—would you signpost them to your competitors in order to make sure that they get access to finance?

Chris Hulatt: To me, the culture that we have tried to build up has been one of helpfulness: working with entrepreneurs and guiding them as to why we are not the right place. It could be because we do not particularly look at businesses in that sector. It could be that the business is too early or has some reason why it would not qualify for our funds. It is really important that you help entrepreneurs go to the right place. It is a really complex environment to know where to go for funding.

Q158 Chair: Chris, are you the exception in terms of the ecosystem or is there a sense of, “We are not interested, but you can go to someone else”?

James Meekings: I do not think so.

Chris Hulatt: The VC world operates on the basis of businesses going to where they think they are going to get a good reception and often going on the basis of some kind of referral or recommendation. Say we have met a great team but they are just that bit too early. We refer them to a fund that we know specialises in businesses in that sector at an early stage. It is good for that fund to get the introduction. It builds a relationship with the entrepreneur and makes him more likely to come back to us when he is seeking full-on funding. This is probably a feature of how VCs operate in that we are in a community and it is important that there is a two-way flow of ideas if something does not work for a particular party.

Q159 Chair: Signposting works for Funding Circle as well, does it?

James Meekings: Yes, it does. No one likes to say “no”. Your whole marketing proposition is that you are going to help small businesses. Clearly there are cases where you have to say “no”. When we do that, we have a range of other funders who we work with. We do that. We also partner with RBS and Santander for exactly the same reason. They want to own the main banking relationship. They do not want to lose that relationship. They want to sell the foreign exchange. They want to sell the insurance etc. Therefore we work with them directly, so that when they cannot do the lending they can keep the relationship and partner with us. You will find that anyone in the marketplace wants to do that. Sometimes they do it on commercial terms; other times they just do it out of customer satisfaction.

Q160 Chair: This is the final question. What do we need to take away from your evidence? What are the key recommendations that we should be looking at?

James Meekings: In our response, we had creating an even market in terms of deeds of priority; the VAT register. Since Thursday’s vote there is something else that the Government should be looking at with the British Business Bank as well. We are a platform where many different types of investors, large and small, can lend. We have been working

with the European Investment Bank and the European Investment Fund to bring more investment to UK small businesses. We had just signed in the week before the vote a £100 million deal with the European Investment Bank. That was a start to create a multi-billion-pound programme for getting more funds into UK business.

Q161 Chair: Is that at risk?

James Meekings: The programme is at risk. If I am honest, it is very unlikely to happen now. Who knows? From our situation, we obviously want it to happen. It is unlikely to happen. We also had the German state development bank buy UK loans for securitisation earlier this year. Those loans were guaranteed by the European Investment Fund. In Europe we had the start of a programme for state money to help the “S” in SME. These are the £50,000 loans that employ 60% of the people around the country. There is a risk now. With that going, there is a hole.

When we started our business, we wanted to split the supply of capital from distribution, because if we can do that we have a much better financial ecosystem in the UK. Funders can fall away. If the Government say over the next few months, “There is this uncertainty; how do we get more money into small businesses?” it is a very different situation to 2008-2009. We now have a few platforms where the Government can put direct funds fast and efficiently into SMEs. If you think about the £250 billion Mark Carney just put aside to shore up liquidity for banks, that would cover SME lending four times over. It is obviously for other things as well. I am just trying to make the point that there could be a hole here.

There could be a role for the British Business Bank. We have been talking to them. They have had a strategy of saying, “How do we create a competitive market? There is a Funding for Lending Scheme for banks? How do we encourage other forms of finance?” To date we have had £60 million from the British Business Bank. During this time of uncertainty, the British Government should be backing small businesses and putting more money in. This is even starker given that the European investment deals that we have been working on could fall away. Our ask would be, “What are the programmes that the Government could put in place given this new world of uncertainty to help get public funds and encourage growth and money directly into small businesses?”

Chris Hulatt: I would echo many of those same principles. Clearly we are going to have a period of uncertainty and instability. Entrepreneurs have been questioning, “What does the landscape look like?” Government needs to make sure that there is stability and consistency for schemes like VCTs and EIS that work really well. The Government should look at how they can be enhanced and expanded. I touched earlier on the opportunity to look at a scale-up VCT concept that would take place beyond existing VCTs. There is an equivalent at seed stage, where seed EIS works really well. There is not an equivalent VCT structure that allows individuals to access those seed-stage deals on the same packaged-up basis that the VCT provides.

There are other ideas that should be examined. We need to have capital available for businesses. How are we going to do that? There is a limit to how much can be raised from individuals into VCTs. The schemes have been around for 20 years. The sector tends to raise £400 million or £500 million every year. If we want to have more money available through those constructions, we need to be looking at allowing corporates to invest into VCTs. There is a lot of cash sitting on corporate balance sheets that is underutilised and is

not going to be distributed following the change to dividend rules. Tapping into that money and allowing corporates to access VCTs and get corporation tax relief would be a significant step forwards.

Q162 Chair: Specifically, are there any measures that could help encourage that?

Chris Hulatt: It is a legislative change to allow corporation tax relief to be applicable to businesses investing in VCTs. There was a similar scheme a number of years ago called the Corporate Venturing Scheme that never really got any legs; it did not get promoted, and so it withered away. Now there is a much greater culture of entrepreneurialism. Business owners increasingly recognise the vibrancy and want to do something different with the money on corporate balance sheets. That would help expand the depth of capital available to VCT fund managers and therefore help promote more businesses.

There are other equivalents, such as allowing ISAs to invest into VCTs. There are many tens of billions sitting in ISAs. This is a bit like what James talked about earlier in terms of the Innovative Finance ISA allowing P2P to access that pool of capital. I do not see any reason why ISAs should not also be able to invest into subscribing for VCT shares and benefiting from the tax relief. At the moment individuals have to use cash outside their SIPP or ISAs to do their VCT investment; that is unnecessarily limiting.

You heard evidence from the AIM side earlier. To us, AIM is a really important part of the scale-up community. It is something we have been investing in for 15 years now and we are really keen to see that it thrives, particularly with the proposed merger at the moment. To us, as businesses develop and scale, they get to a point where they either go down the AIM route or they stay unquoted, and we need to make sure that there are the right types of funding mechanisms available to support businesses through both routes. To have a thriving AIM is a really important part of that whole ecosystem.

Chair: I would agree with that. Thank you, gentlemen. That has been really useful and we are very grateful for your time.