CBI
THE VOICE OF BUSINESS

FINANCING OUR FUTURE ECONOMY

AN ACTION PLAN TO HELP BUSINESSES MAKE, MOVE AND SELL

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FOREWORD

To secure a sustainable recovery the next five years must be about tackling the UK's major economic challenges. This means unleashing the potential of our medium-sized businesses, dramatically improving our exports performance and increasing investment in our infrastructure.

Seven years since the financial crisis laid bare the fragility of the financial system policymakers have undertaken a major overhaul of financial regulation and supervision. While it is absolutely right for the next government to see through vital work on stability and conduct much of the heavy lifting has now been done. What we need now is a relentless focus on how financial services can do their job of serving the wider economy.

Because for the economy to really hit its stride we need a vibrant financial services sector. We need basic banking and insurance so employees can be paid and sales made; we need trade finance and risk management to support more UK firms to export and we need efficient capital markets to move money to where it is needed most for investment.

Having a leading global financial centre in the UK helps with this. Which is why we need a long-term government strategy to both protect the UK's position as a financial services hub and ensure the sector serves our economic needs.

But as we set out in this report coverage gaps exist in the financial system's ability to support our economic ambitions. To fill them we need government action focused on unlocking long-term growth capital; increasing access to trade finance and boosting infrastructure investment.

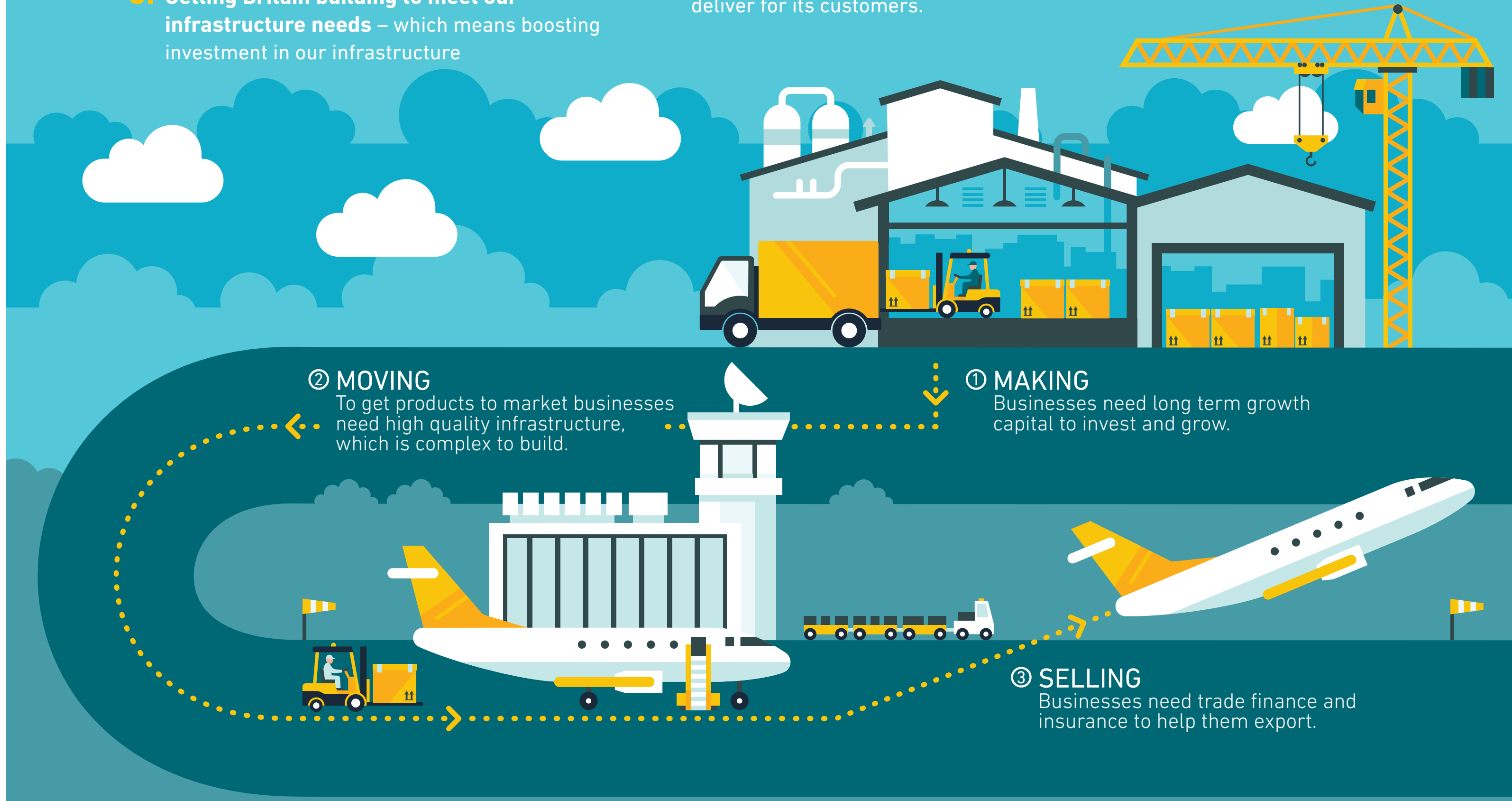
INTRODUCTION

This report takes as a starting point three of the most significant challenges facing the UK economy today:

1. **Forging our future economy to unleash business potential** – which means unlocking the potential of the UK's high growth medium-sized businesses
2. **Breaking into new markets to capitalise on the changing world** – which means drastically improving our exports performance
3. **Getting Britain building to meet our infrastructure needs** – which means boosting investment in our infrastructure

But in each of these areas the UK is facing a 'coverage gap' in the financial services sector's ability to deliver for customers.

In this report we set out what successful businesses need from the financial system; an assessment of the ability of the system to currently deliver this and recommendations to improve the ability of the sector to deliver for its customers.



1

Forging our future economy to unleash business potential

Access to the right types of finance is vital to a business' success. But while large companies are well-served by financial markets there are challenges for our medium-sized 'gazelle' firms.[1] To compete and grow these businesses need long-term growth capital.

Individual businesses have more sources of working capital than ever before...

The UK remains on the road to a new normal in finance. It is rebalancing away from traditional debt, driven by both bank balance sheet restructuring and the impact of regulatory change.[2]

The result has been welcome growth in the availability and use of 'alternative' forms of finance from both banks and non-banks:

- 60% growth in the flow of private external equity between 2011 and 2013 – up to £1.6bn
- 1.150% growth in the flow of peer-to-peer lending between 2011 and 2013 – up to £0.25bn
- 4.8% growth in the flow of invoice finance from 2012 to 2013 – up to £13.1bn[3]

And today the flow of bank lending is also improving with the net flow increasing 50% between 2012 and 2013, although still negative overall.[4]

The result is that accessing finance is easier today than at any point post crisis. The CBI's medium-sized members now commonly cite other issues, such as skills, as more of a concern than their ability to raise funds.

...but we need more sources of long-term growth capital to support business growth

Changing demand will exacerbate long-standing gaps in the availability of growth capital for our gazelle firms and as the recovery beds-in we expect a strong pick-up in business investment over the coming months.

- Average business investment as a percentage of GDP will rise from 9.5% between 2008-2013 to 11% between 2014-16
- 62% of mid-sized businesses view growth as a high priority in the next year – up from 46% who considered it a high priority last year[5]

This has implications for the quantity and type of finance businesses will need. Crucially, the demand for long-term growth capital, better suited to capital intensive activities, will grow faster relative to demand for short term working capital.

An action plan for long term growth capital

Politicians from all parties have done well to get behind alternative sources of finance but we can't afford to lose momentum. To match businesses' changing needs the new government must make sure gazelle firms have greater access to long-term growth capital.

ACTION 1: Kick-start a private placement market in the UK

The next step for alternative types of finance is opening access to wholesale funding for more businesses. The quick-win here is to get behind a UK market for privately placed debt. Aimed at larger medium-sized businesses this market would channel wholesale funds directly into successful UK firms. These loans are also typically longer-dated than traditional bank facilities.

But the UK market is under-developed and lags behind our international competitors:

- Between $40billion to $50billion is raised in the US each year through private placements and the German Schuldschein market raised €12.5bn in 2012[6]
- While only around £4bn was raised in the UK in 2013[7]
- The Breedon Review estimated it could unlock £15 billion of long-term growth capital in the UK[8]

Business needs the government to:

- Promote the long-term benefits that private placements can have for UK companies to boost awareness and demand
- Build on the good intention of a withholding tax exemption, announced in the Autumn Statement 2014, by lowering the minimum eligible issuance size to £5m and clarifying that it will apply to loans as well as bonds
- Fast-track and support industry efforts to standardise market documentation and encourage investors

ACTION 2: Put equity finance at the heart of plans for increasing access to long-term growth capital

Equity can be the best source of growth capital for firms with riskier business models but has long been under-utilised in the UK:

- 81% of small and medium sized businesses with direct experience of it would recommend equity to another business
- But only 1% of smaller businesses use external equity and only 18% and 5% of medium-sized businesses use private and public equity respectively[9]

Business needs the government to:

- Publically promote equity finance as a useful source of long-term growth capital to boost awareness and demand in the market
- The UK Listing Authority, as the gateway to the UK's capital markets, should be given clearer objectives for competitiveness and growth
- The British Business Bank should offer a public facing 'one stop shop' to help businesses navigate different financing options
- Launch a cross-department review including HM Treasury, HMRC and BIS, on boosting the use of equity finance by growing businesses and the role the tax system can play in achieving this

2

Breaking into new markets to capitalise on the changing world

High growth countries now account for a majority of world economic growth, underlining the importance of new export destinations to businesses' success. But exporters need the right types of trade finance and insurance.

Growing exports must be a top economic priority for the new government...

The UK's exports challenge is well known:

- The UK last ran a trade surplus in 1998
- Despite renewed focus, we are only set to meet 75% of the Chancellor's target of £1 trillion of exports by 2020[10]
- Globally the UK's share of exports was just 3.3% in 2013, down from 6.1% in 1980

We know finance is not the only barrier holding us back: ambition, knowledge and support are also key to success. The new government should stay ambitious with a stretching exports target, achieved through improved support and businesses raising their own international ambitions.

The UK last ran a trade surplus in 1998

...but a lack of access to trade finance can hold businesses back

Trade finance and services play a vital role in helping exporters overcome key challenges like: longer lead in times for deals; higher information barriers and the need to transact in foreign currencies. It does so through working capital, insurance and risk management and currency exchange. The global payments system is also vital so a business can move money around and get deals done.

But access to trade finance is becoming increasingly difficult for some markets. In a recent survey of global trade finance providers:[11]

- 69% of respondents cited anti-money laundering and know you customer requirements as a highly significant impediment to trade finance
- 41% of respondents cited Basel III regulatory requirements as a highly significant impediment with 78% saying it has increased the costs of providing trade finance
- 59% of respondents cited issuing bank's low credit ratings as a highly significant impediment to trade finance

An action plan for trade finance and insurance

Politicians have the right ambition on exports but translating this into progress means plugging the coverage gap for trade finance. We need the same momentum on trade finance as we've had on lending.

ACTION 3: Examine the impact of Anti-Money Laundering requirements and financial sanctions on the ability of UK businesses to export

To export and import businesses need to send and receive money around the globe and to facilitate this UK banks must have relationships with foreign 'correspondent' banks.

While the aim of Anti-Money Laundering rules and financial sanctions are absolutely right their detailed application is increasingly constraining the ability of banks to continue correspondent relationships and thus their ability to provide basic trade services for some markets.

Business needs the government to:

- Launch a joint HM Treasury/BIS review of the impact of anti-money laundering requirements and financial sanctions on the ability of businesses to export

ACTION 4: Make financial regulations work better for exporters

As necessary stability reforms are implemented, such as CRD IV for banks and EMIR for markets, it is important to protect businesses' access to trade products and services. In some instances overly stringent prudential treatment can reduce access for some businesses.

Business needs the government to:

- Make sure the upcoming review of the European Market Infrastructure Regulation (EMIR) works for growth. Specifically the government should push for a reduction in the requirements for non-financial businesses for prompt exchange of confirmations and reporting, using the US as a model
- Commit to protecting the exemption for non-financial corporates from the Credit Valuation Adjustment risk capital charge under the Capital Requirements Regulation

ACTION 5: Broaden the support offered by UK Export Finance focussing on medium-sized businesses

UK Export Finance has made good progress over this parliament, but more must be done to improve access and awareness of existing services to medium-sized businesses.

Business needs the government to:

- Allocate a portion of UKEF's Direct Lending Facility to fund working capital for general pre-shipment expenditure for smaller businesses
- Explore the introduction of a 'Tender to Contract Cover' (TTC) insurance product for small and medium sized businesses

3

Getting Britain building to meet our infrastructure needs

High quality infrastructure is a critical element of the UK's economic and social fabric but we are not currently getting the investment we need.

UK infrastructure investment has been too low for too long...

The UK's infrastructure challenge is well known:

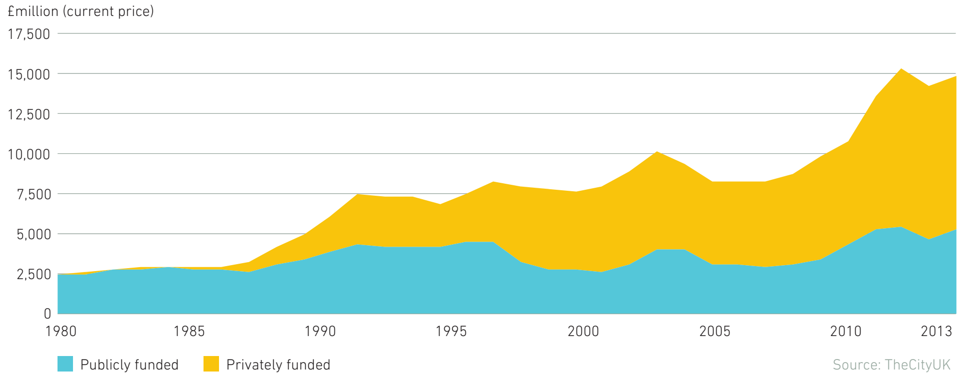
- UK ranked 27th in the World Economic Forum's Global Competitiveness Rankings[12]
- National Infrastructure Plan estimates we need £466bn invested by 2020[13]
- Despite a rise in public investment during this parliament capital spending (as a % of GDP) remains below France, the US and Canada
- 99% of respondents to the CBI's infrastructure survey cited quality and cost of infrastructure as either significant or very significant to their investment decisions[14]

...but constrained public finances means more funding must come from private sources

Government recognises this challenge and the National Infrastructure Plan has set out investments of around £466bn in infrastructure up to 2020.[15] But given the need to reduce the deficit, most of this investment will need to come from the private sector, a trend highlighted in Figure 1.

Luckily, institutional investors are well suited to providing this funding – matching their long-term liabilities to long-term infrastructure assets.

Figure 1: UK Infrastructure Output by Source of Funding[16]



An action plan for infrastructure investment

All parties recognise the need to unlock private investment into infrastructure. Ultimately investors want certainty and to attract globally mobile capital we need to make the UK's political and regulatory offer the best in the world

ACTION 6: Make the government offer to investors the best in the world by improving the project pipeline

Progress has been made to improve the pipeline of projects. The National Infrastructure Plan and Road Investment Strategy have been helpful. Businesses have also backed the innovative approaches taken by Infrastructure UK, with 87% positive about the impact of the UK Guarantee Scheme.[17]

Now we need to boost investor confidence in the future pipeline while focusing government measures where they are most needed.

- The 2014 CBI/URS Infrastructure Survey showed that in the long-run, businesses want to see a new approach, with 89% backing an independent body[18]

Business needs the government to:

- Establish an independent body to determine future infrastructure investment needs and how they should be met, without delaying projects already underway
- Review how to encourage innovative deal structures to boost private sector investment in infrastructure, for example the use of 'bundling' of smaller projects to create an attractive proposition for larger investors
- Ensure that government measures designed to support private investment do not end up 'crowding out' investors in the field, focusing instead on areas of infrastructure where the risks are too large or complex to be tackled solely by the private sector

ACTION 7: Implement Solvency II in a way that encourages insurers to invest in infrastructure assets

Business needs the government to:

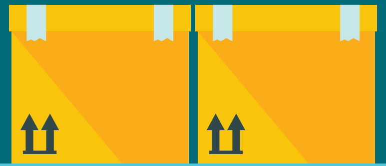
- Encourage the Prudential Regulatory Authority to take a proportional and pragmatic approach to internal ratings models, especially when dealing with newer asset classes with less experience data
- Help issuers understand asset eligibility requirements for insurers, without which insurers are not able to invest (e.g. Spens clause requirements)
- Promote an international regulatory approach to 'systemically important' insurers that recognises their need to take appropriate risks and make investments into infrastructure

"We need to boost investor confidence"

A financial services action plan to help businesses make, move and sell

MAKE

ACTION 1: Kick-start a private placement market in the UK



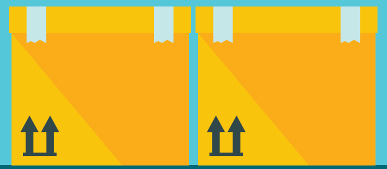
ACTION 2: Put equity finance at the heart of plans for increasing access to long-term growth capital

SELL

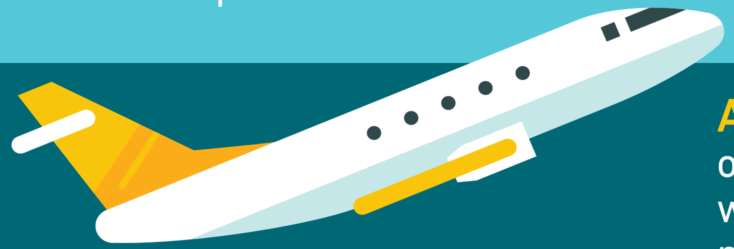
ACTION 3: Examine the impact of Anti-Money Laundering requirements and financial sanctions on the ability of UK businesses to export

ACTION 4: Make financial regulations work better for exporters

ACTION 5: Broaden the support offered by UK Export Finance focusing on medium-sized businesses



MOVE



ACTION 6: Make the government offer to investors the best in the world by improving the project pipeline

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