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Private Investment and Innovation

“Launch Version”¹

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Prepared for the Growth Commission

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Executive Summary

Investment in equipment and new ideas (both technological and managerial) are crucial for economic growth. A favourable investment climate is important for UK businesses to adopt new technologies and best practices. Investment is also central to innovation and the process of ‘creative destruction’ or reallocation (whereby more efficient and innovative firms grow and less successful firms shrink and exit). Much of the aggregate differences in productivity across countries and growth in productivity over time comes from this creative destruction (e.g. Bartelsman et al., 2012). A supportive environment for investment and innovation is therefore paramount for a dynamic and productive economy. Even though investment and innovation are key market-driven processes, the policy environment plays an important supporting role, including policies that affect competition, market access, finance, taxation and regulation.

Yet many UK businesses face a mixture of structural, transitional, and policy-related obstacles in raising finance from external sources. One consequence is that the UK has for decades invested less than other rich European countries at each stage of business development (NESTA, 2012a). In 2008, the UK’s share of total GDP devoted to R&D stood at 1.8 per cent, a lower proportion than in the US (2.8 per cent), Germany (2.7 per cent) or France (2.1 per cent). UK capital markets raised £2.9 trillion of capital in 2007, an increase of 355 per cent over 1998 levels. In comparison, business investment in innovation increased by only 54 per cent (NESTA, 2012a). This trend may have been reinforced by the financial crisis. The World Economic Forum Global Competitiveness Report 2012-2013 lists “access to financing”² as the most problematic factor for doing business in the UK. This is a troubling sign for the UK’s innovative capacity, since access to external finance and investment is vital for productivity and is a sign of an optimistic, dynamic, and entrepreneurial business sector (Beck, 2012). Low investment and innovation generate lower levels of labour productivity or GDP per hour. There has been a longstanding productivity gap between the UK and three close comparator countries: France, Germany and the US (see Pessoa and Van Reenen, 2012). In [2011](#), UK GDP per hour was 27 per cent below the level in the US, 25 per cent behind France and 22 per cent behind Germany.

In this paper, we argue that some of the problems with investment and innovation are directly linked to a series of failures in the functioning of capital markets, including a lack of competition in banking and short-termist behaviour in financial markets in general. While there are certain financing issues which are pervasive for firms of all sizes, a key focus is on SMEs and SME-specific funding shortfalls. SMEs are a large fraction of the UK economy, accounting for 99.9 per cent of all UK businesses and over half of private sector employment and turnover in 2011 (BIS, 2012). Even more important is the fact that young entrant firms, the source of many new radical ideas that shakeup older firms are going to start as SMEs. Financing problems for start-ups and lack of growth capital for young firms to enable them to reach scale will severely hold back aggregate productivity.

We also argue that poor management practices undermine private investment and productivity. In measures of management quality, the UK is mediocre by international standards, ranked significantly below the ‘premier league’ of countries, such as Germany, Japan and the US (Bloom, Genakos, Sadun and Van Reenen, 2012). This gap matters because recent evidence suggests that

² “Access to finance” is tied with “tax rates” as the most problematic factor for doing business in the UK (World Economic Forum 2012)

about a third of international productivity differences can be attributed to management (Bloom, Sadun and Van Reenen, 2013).

Finally, we discuss the role of industrial strategy in supporting investment and innovation. Since the late 1970s, industry-specific ‘vertical’ policies have been unpopular due to fears that the ambition of ‘picking winners’ turns into an outcome of ‘picking losers’. But some recent successes (such as foreign direct investment in the automotive sector) and the need to generate more green industries have caused a re-think of a more activist industrial strategy. The convening power and coordination role of government can help to bring parties together to recognise and solve problems. So there is a role for strategic thinking, especially as the government touches on almost every industry in some way.

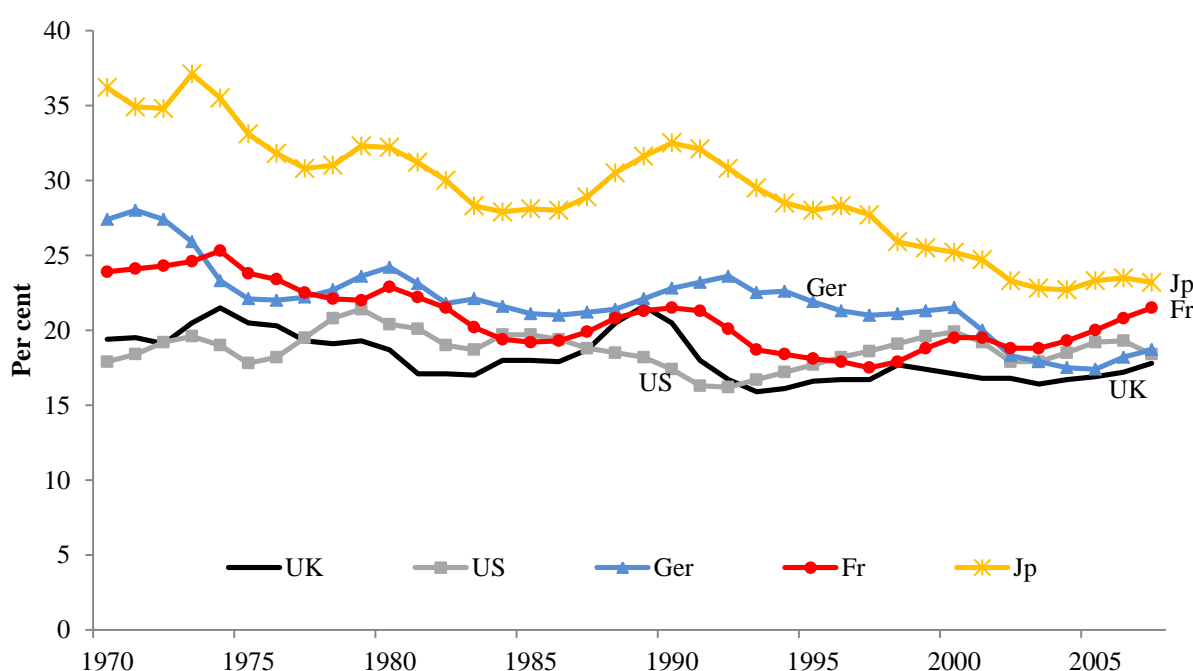
Other important impediments to private investment include a lack of skilled labour and relatively low levels of public investment in infrastructure. Efforts to increase human capital and improved infrastructure policies are likely to provide a boost to investment by firms. Issues related to human capital and infrastructure are discussed in the relevant papers.

Section 1 gives an overview of investment and innovation in the UK, highlighting shortfalls in performance. Section 2 describes a number of “gaps” in the market for firms accessing finance (with a brief overview of the financing conditions faced by UK firms in the Appendix). Section 3 describes in more detail some of the key financial market failures which may contribute to poor performance in investment and innovation. Section 4 discusses shortcomings in UK management practices and their impact on productivity and growth. Finally, Section 5 discusses the potential benefits from an improved strategic approach to UK industrial policy.

1. Investment and innovation in the UK

As Figure 1 shows, UK investment levels as a share of GDP have historically been lower than those of France, Germany and Japan (and similar to the US). In addition, the composition of fixed asset investment has worsened from an innovation perspective. According to NESTA's Innovation Index, in the period from 2000 to 2007, investment in fixed assets became increasingly dominated by buildings and property rather than “productive assets” such as machinery or technological equipment, which embody newer technologies (NESTA, 2009; NESTA, 2012a).

Figure 1: Investment as a percentage of GDP, 1970-2007



Notes: This indicator is calculated as the ratio of gross fixed capital formation to GDP. Data refer to fiscal year.

Source: Source: OECD (2012c) Factbook 2009 -Economic, Environmental and Social Statistics.

Moreover, the UK has not performed well in intangible investment in recent years. Between 1995 and 2008, intangible investment increased in most rich countries. In contrast, the share of intangible investment in UK national output remained constant for most of the 2000s, having risen mostly between 1995 and 2000 (NESTA, 2012a).

The UK is strong in the field of “fast innovations,” such as fund management, fashion, animation and architecture, where development cycles are relatively short and capital intensity is low (NESTA, 2012a). In those fields, the UK possesses expertise in both the upstream (design, new product development, research) and downstream (production, sales, marketing) aspects of business. In addition, OECD data shows that the UK is above average in pharmaceuticals, life sciences and aerospace. However, in general, for industries that involve longer product cycles and require more

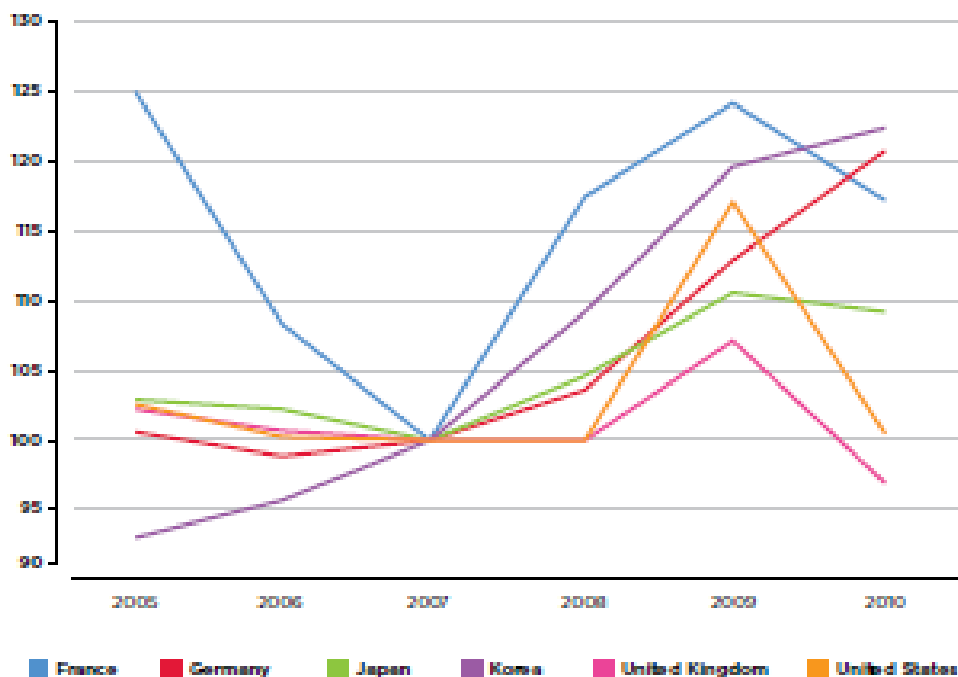
capital, there are few sectors where the UK is strong in both upstream and downstream aspects of the value chain (NESTA, 2012a).

On the global stage, much of UK scientific research is exploited in other countries and 21 per cent of business R&D is financed by foreign companies (NESTA, 2012a). The UK punches above its weight with a strong science base and an internationally dynamic higher education sector with supporting structures through the 'research excellence framework' administered by HEFCE. Fewer than 4 per cent of the world's researchers are based in the UK yet they manage to produce 6.4 per cent of all scientific articles and receive 10.9 per cent of citations. But commercialisation of their insights and inventions has been historically weak in the UK with lower R&D and patenting intensity than in other major countries.

The UK performs well in attracting inward investment but international competition for hosting R&D is intensifying. In addition, the UK does not perform well in terms of its ability to grow great global firms. There is a tendency for British firms in high-tech and capital-intensive sectors to be acquired by foreign businesses rather than raising finance to grow. The purchase of UK businesses by foreign companies, which in some cases leads to the transfer of operations out of the UK (e.g. in the semiconductor sector), has weakened the productivity of the UK's manufacturing sector (NESTA, 2012a). There is evidence that the situation is worsening as sectors where the UK performs relatively well are coming under threat. An example is pharmaceuticals as Pfizer closed its UK R&D facilities, allegedly due to a risk profile that has become unfavourable to private sector investment and a retreat in public spending. While these facts may simply reflect comparative advantage in the UK versus other countries, many of these issues are likely to be caused by financing constraints.

We note that it has also been argued that direct government spending on R&D is too small (NESTA, 2012a). In the current spending review (2010), public sector gross investment in 2013-14 accounts for only £1.4 billion for business, innovation and skills, compared with £1.9 billion for international development and £4.4 billion for health (HM Treasury, 2010). According to OECD data, other countries, including the US, France, Germany and Korea not only spent more than the UK before the crisis but they also increased their innovation budget much more quickly following the crisis (See Figure 2).

Figure 1: Government budget outlays or appropriations on R&D (weighted by size of economy, 2007=100)



Source: NESTA (2012a) based on OECD data

2. Failures in UK financial markets

Supply Side Market Failures

While the credit crunch exacerbated problems in UK SME access to finance, the existence of structural financing gaps borne by market failures has been documented from as early as 1931 (Macmillan Committee, 1931). The Department for Business, Innovation & Skills (BIS) periodically conducts a demand survey among SME employers. These surveys suggest that there are still market failures that prevent viable SMEs from accessing finance³.

Debt financing gap: There is a debt financing gap for businesses lacking track record and collateral. In general, it is costly for lenders to distinguish between high and low risk entrepreneurs (Beck, 2012). To avoid the costs associated with collecting information on potential borrowers, lenders often require them to provide evidence of a financial track record and/or collateral. Despite advances in credit scoring techniques which help lower the cost of assessing business proposals, these requirements remain a significant feature of current debt markets due to information asymmetries (HM Treasury, 2004). This, in turn, negatively affects young start-up businesses that require external sources of finance (BIS, 2012).

Equity financing gap: Due to the transaction costs of undertaking due diligence, private equity investors tend to favour fewer, larger investments in later stage businesses at the expense of early

³ The BIS found that although the percentage of SME employers seeking finance in the last 12 months rose from 23 per cent (2007-08) to 26 per cent (2010), there was evidence to show that demand for bank finance was declining. 56 per cent of SME employers that sought finance were seeking finance for working capital, while 21 per cent were seeking it for investment purposes (OECD 2012). 2011 survey evidence suggests that 74 per cent of SMEs seeking finance obtain it, but SMEs may not have obtained all the finance required and there are still market failures restricting viable SMEs from accessing finance (BIS, 2009; BIS, 2011; BIS, 2012).

stage venture capital for viable SMEs with high growth potential. The most recent assessment by BIS (2009) confirms that in normal market conditions, a structural equity gap exists between £250,000 to £5m (up to £15m for sectors requiring complex R&D or large capital expenditure, often with long investment horizons). These equity gap boundaries relate to the maximum which angel investors would provide and the minimum amount that private sector venture capitalists were willing to invest (BIS, 2012).

Growth capital gap: The Rowlands Review (2009) identifies a gap in the provision of growth capital for established businesses looking to expand. Raising growth capital has been a long standing challenge: banks have typically been resistant to providing growth capital due to limited data on financial returns to such investment. 64 per cent of the directors participating in the 2012 ECI Growth Survey indicated that raising growth finance is difficult or very difficult and thus are heavily biased towards depending on internal cash flow, as opposed to seeking external finance (ECI Partners, 2012). The Rowlands Review estimates that a growth capital gap exists between £2m and £10m. This reflects the £2m ceiling of existing government interventions and the £10m threshold below which private equity, including VC, rarely invest due to the structure of their business model (BIS, 2012). The Business Finance Taskforce recommended establishing a new Business Growth Fund (BGF) to fill the gap in availability of long-term equity growth capital identified in the Rowlands Review. The BGF became operational in April 2011. The investment provided is in the form of equity or equity-like capital (minority stakes). £2.5bn was committed by BGF's shareholders to fund investments and 6 regional offices were set up across the UK.⁴

Demand Side Market Failures

There are informational failures affecting the demand side of the market. SMEs may not recognise the potential benefits of external finance, may perceive that only debt finance is suitable, and may lack the skills to put their projects forward to investors in a professional way. Furthermore, businesses are increasingly reluctant to approach banks due to perceived tight credit conditions - it is feared that doing so would lead to an increase in the cost of existing borrowings, or reductions in overdraft limits (NESTA, 2011b). BIS (2012) found that, compared to the same period a year earlier, the value of applications by SMEs for new term loan and overdraft facilities in the six months prior to February 2011 decreased by 19 per cent. Moreover, to decrease the risk of adverse changes in price or availability of credit, small businesses are cautious about new investments. Rather, they are repaying bank debt and increasing cash holdings. The CBI's SME Trends Survey of manufacturers demonstrates that the proportion of manufacturers planning to invest only to replace existing capital in the year ahead rose to the highest level registered since the CBI began such a survey in October 1998 (CBI, 2011).

In most countries in which large sums of public money were used to rescue banks during the financial crisis, the government requested that banks supply the SME sector with sufficient credit. In some cases, the government required banks to report on their level of support for SMEs. Several OECD countries introduced credit monitoring and mediation systems. SMEs that are rejected by banks for credit can refer to monitors or mediators who then attempt to reconcile the differences between the parties. Despite the fact that mediators do not have formal authority to reverse the bank's initial decision, these measures have proved to be an effective way of easing access to credit

⁴ According to the first review of BGF's activities, 11 investments have been made since October 2011.

for SMEs in several countries, in particular France and Belgium (OECD, 2010). Unlike traditional guarantee programmes, which have been mostly used by medium-sized enterprises, mediation has mostly been used by smaller enterprises. The experience of these systems has highlighted some demand side factors that play an important role in credit rejections: communication problems between entrepreneurs and banks, lack of clarity of business plans put forward to the banks, and lack of skills of entrepreneurs in drafting viable business plans.

3. The roots of UK financial market failures

3.1. Lack of competition in banking

The lack of competitive pressures on UK banks has resulted in a lack of incentives to provide innovative services for SME customers. There are a number of dimensions to this: high concentration in retail lending, weak effective competition and the implicit “too big to fail” subsidy that large banks enjoy.

High concentration in the retail lending market

Concerns about the effectiveness of competition in the retail lending market are longstanding⁵. According to Vickers (Independent Commission on Banking, 2011), most of the problems highlighted by the Cruickshank report (2000) on competition in UK banking remain.

Numerous studies have expressed concern about the high levels of concentration in UK SME banking. In 2002 the Competition Commission (CC) found that the four largest clearing groups (Barclays, HSBC, Lloyds TSB and RBS) accounted for over 90 per cent of liquidity management services in each region. By 2007, the OFT concluded that competition had increased with the strongest challengers being HBOS and Alliance & Leicester. However, in 2008 the four largest banks still accounted for nearly 80 per cent of liquidity management services (OFT, 2010).

Furthermore, the financial crisis has led to an increase in concentration in the retail banking market through mergers and exits from the market. In particular the mergers of Lloyds TSB with HBOS and Santander with Alliance & Leicester have eliminated the strongest challengers identified by the OFT before the crisis⁶. According to the Independent Commission on Banking (2011), concentration is now higher than before the crisis in many retail banking sub-markets, including SME banking. SME banking was the most concentrated market in 2010 with a Herfindahl–Hirschman Index (HHI) of 1910⁷. In 2010, the four largest banks had an 85 per cent share of the market for business current accounts⁸.

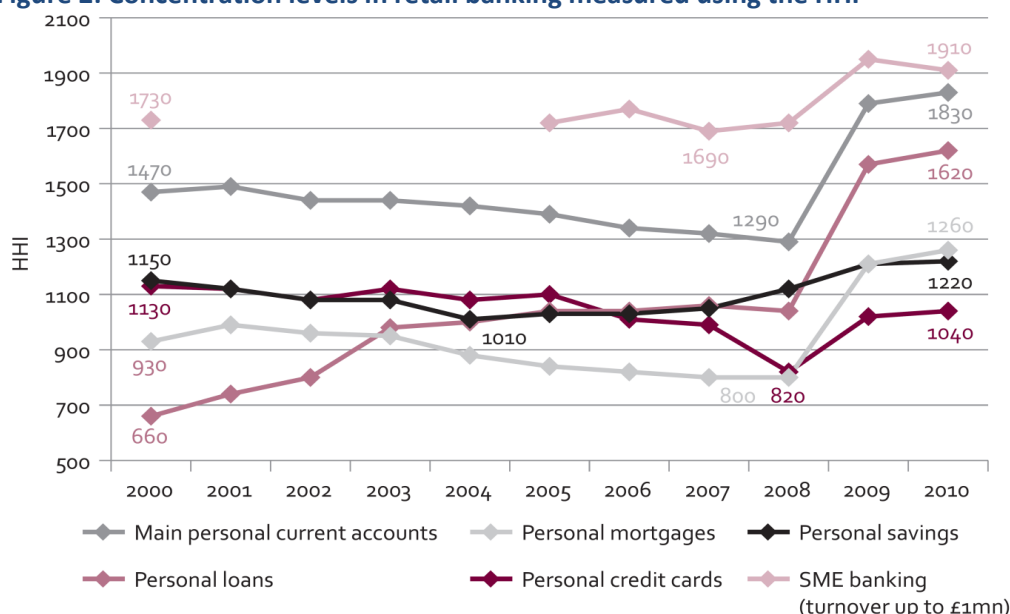
⁵ There have been several studies on this topic since 2000: the Cruickshank report into competition in UK banking (2000), the Competition Commission’s inquiry into SME Banking (2002), the OFT’s Survey of SME Banking (2006), the OFT’s Review of Barriers to Entry, Expansion and Exit in Retail Banking (2010) and the Final Report of the Independent Commission on Banking (2011).

⁶ Notably, the Lloyds TSB/HBOS acquisition was not referred to the CC despite the fact that the OFT had found that the test for reference on competition grounds was met for personal current accounts, banking services to SMEs and mortgages.

⁷ According to the OFT merger assessment guidelines, any market with a HHI exceeding 1000 (2000) may be regarded as “(highly) concentrated”.

⁸ Note that these figures do not take into account the impact of the LBG and RBS State aid divestitures.

Figure 2: Concentration levels in retail banking measured using the HHI



Source: Independent Commission on Banking (2011)

Weak effective competition in the retail banking market

Concentration is one criterion to assess the competitiveness of the SME lending market. While there is a tendency for markets to be less competitive when more concentrated (See Degryse and Ongena, 2008), the link between concentration and competition is not straightforward. In principle, competition can be strong in concentrated markets and weak in markets that are not highly concentrated, although this is likely to be the exception rather than the rule. Other reasons for the lack of effective competition in retail banking include barriers to entry and exit and consumer choice.

Barriers to entry and exit: Low barriers to entry and exit can sometimes result in a competitive market even if the market is highly concentrated. Recent work by the OFT (2010) concluded that new entrants face difficulties in attracting customers and gaining market share. The most challenging barrier to entry was the difficulty in attracting personal and SME customers, due to the latter's preference for banks with a large branch network, strong brand loyalty and low switching rates. According to an OFT survey (OFT, 2006), for 17 per cent of SMEs, one of the main reasons for choosing a specific bank was that its branch was located closest to their business. 34 per cent of SMEs declared that already holding a personal current account with that bank was one of the main reasons for adopting it as their business bank. This suggests that banks which are not active, or do not have a strong presence, in personal banking face a significant barrier in attracting SME customers.

In addition, the "too big (or too important) to fail subsidy" may also represent an important barrier to exit. A large body of evidence suggests that large banks benefit from implicit subsidies due to the fact that their creditors anticipate government bail-outs (e.g. O'Hara and Shaw, 1990; Morgan and Stiroh, 2005; Schmidt and Walter, 2009; Gandhi and Lustig, 2010; Bank of England, Financial Stability Review, December 2010). Banks which are perceived as too big to fail are protected from market discipline and derive benefits from their status in the shape of lower funding costs for reasons that have nothing to do with fundamentals. This may place new entrants and smaller banks at a disadvantage. The recent financial crisis has worsened this competitive distortion. The Bank of

England Financial Stability Review of December 2010 provided an estimate of government subsidies for banks and building societies split by size in 2007, 2008 and 2009. In all years, small banks are estimated to have received the lowest subsidy in proportion to their size.

Consumer choice: For competition to be effective, consumers must be well-informed and able to switch between providers at low transaction costs. Competition between banks can therefore also be undermined by the actual and perceived difficulties for customers in identifying the best banking products for their needs and switching between providers. Given consumers' low willingness to switch banks have weak incentives to provide better offers. The OFT study of personal current accounts (PCAs) in 2008 showed that a significant proportion of consumers believe that it is difficult and risky to switch accounts. These perceptions were found to significantly contribute to low switching rates. Few consumers spend time actively monitoring the relative competitiveness of their accounts. Similarly, the survey showed that many consumers are not aware of, or do not properly understand, the key fees attached to their PCAs. Similar problems apply in the market for business current accounts. As a result, switching rates in SME banking are very low compared to other services⁹.

3.2. Lack of economies of scale in SME financing

A key reason for the gap in SME lending may reside in the lack of economies of scale and limited fee-generating capacity in these types of activity. According to Skidelsky et al. (2011), the lack of economies of scale in the administration of loans to SMEs is a primary reason for banks' lack of interest in lending to them. There are important economies of scale in bank lending activities, for example in the production of information about borrowers. But economies of scale cannot be exploited at the typical borrowing scale of SMEs¹⁰. Consequently, banks will prefer large loans to larger firms. The lack of economies of scale is a problem everywhere, not just in the UK. However, market participants suggest that UK banks tend to focus excessively on fee-generating activities (such as merger and acquisitions activities). Since there is limited potential for small clients to generate fees in the current SME banking model, large and established companies get precedence.

The Breedon Review (2012) advocates the creation of an aggregation and securitisation platform for SME loans (the Agency for Business Lending – “ABL”), for which there is increasing support. In the same vein, the Association for Financial Markets in Europe (AFME) has proposed to set up a platform for SME securitisation which will need initial Government funding. Such a platform would remove the requirement for investors to analyse the credit quality of many small issuances from individual SMEs. This could help banks relax financing constraints when lending to SMEs (European Commission, 2007) and contribute to the creation of a corporate bond market for SMEs in the UK. Although SME loan securitisation has become more wide-spread in the EU, the market is still immature, especially when compared to other sectors such as mortgages where securitisation

⁹ In response to concerns raised by the OFT on the low levels of switching in retail banking and following the recommendations of the Independent Commission on Banking's Final Report, a new account switching system will be put in place by the Payments Council in September 2013 to benefit personal and small business customers. Importantly, this service includes: A guarantee that both consumers and small businesses will be able to switch all aspects of their current account from one financial institution to another in seven working days; a redirection service for customers' payments into and out of their account, including direct credits, debits, standing orders and regular card payments.

¹⁰ However, it is also true that some technologies applied to lending to SMEs benefit from the effects of economies of scale, for example credit scoring. Credit scoring systems rely on statistical models and hence a large number of clients and loans.

enabled banks to increase the production and affordability of mortgage loans¹¹. In addition, data from AFME/ESF¹² shows that the UK lags behind other EU Member states, with one of the lowest amounts of SME securitisation at the end of 2010 (European Investment Fund, 2011).

A related development is the pledge by the Business Finance Taskforce to increase SMEs', in particular mid-sized businesses', access to syndicated debt markets (Business Finance Taskforce, 2010). In the UK, most SMEs use a single bank to cover their entire needs for debt financing. The use of club and syndicated loans is less widespread in the UK than in other countries. Since syndicated loans can be re-sold on secondary markets, this may help increase the liquidity of the SME loan market, and make SME loans more attractive to investors.

3.3. Short termism

Short-termism may be characterized as a propensity to under-invest in physical assets or intangibles and/or hyperactive behaviour by executives, namely a tendency to focus on restructuring, financial re-engineering or mergers and acquisitions to the detriment of the development of the fundamental capabilities of the business (Kay Review, 2012).

The short-termism debate is not new. Excess discounting of future outcomes was already a familiar topic among Classical economists. Short-termism is a market failure, resulting in underinvestment, especially in long-duration projects and projects with high build or sunk costs, such as infrastructure and high-tech investments. These are often projects with the highest long-term (private and social) returns. Concerns with short-termism exist in equity markets, business, and banking. We also consider the issue of growing short-termism in institutional investment which is a manifestation of developments in equity markets.

3.3.1. Short termism in equity markets

Emphasis on short-term relative performance

There is increasingly clear evidence that equity markets systematically discourage long-term investment, particularly in risky endeavours like R&D or other forms of innovation (See for example Asker et al., 2011; Aghion et al., 2009; Haldane and Davies, 2011). Discussing these issues in the context of UK equity markets, the Kay Review (2012) has recently noted that the appointment and monitoring of active asset managers is too often based on short-term relative performance, whereas companies and savers should be largely interested in long-term absolute performance. In other words, there is a conflict between the business model of asset managers and the interests of UK businesses and investors.

¹¹ According to the European Commission (2007), it is estimated that only around 1-2 per cent of securitisable SME claims in bank balance sheets in the European Union have been securitised. By contrast, around 10 per cent of outstanding residential mortgage loans were securitised. The SME-securitisation market is developing relatively more slowly than other market segments due to a variety of factors, including the high degree of diversity in SME loan instruments, and the different types of collateral and legal forms of SMEs (European Commission 2007). This diversity makes it more difficult to securitise SME loans than other more standardised asset classes. In addition, securitisation of SME loans implies high market entry costs, which can be prohibitive for regional or smaller credit institutions which are those that tend to have high market shares in the SME-lending market.

¹² Association for financial markets in Europe/European Securitisation Forum

According to the Kay Review, competition between asset managers on the basis of relative performance is a zero sum game. The activities of asset managers can only benefit savers taken as a whole to the extent that they focus on improving the performance of investee companies. The pre-eminence of relative performance appears to be reinforced by regulatory requirements on the asset management industry. Respondents to the Kay Review mentioned that greater obligations on trustees to seek professional advice, as well as stronger transparency and disclosure requirements, had resulted in more extensive benchmarking, performance monitoring, and use of external consultants – all of which reinforce the tendency to focus on short-term relative performance.

Investors lack incentives or ability to counteract short-termism

Rajan (2006) argues that investors may have weak private incentives to actively prevent investment managers from focusing on short-term returns. Current investors in a fund benefit when new investors join because the fund's average costs decrease. By contrast, the movement of investors between funds has little social value (and potentially negative value) as there is very little robust evidence that past fund performance is an indicator of future results. Consequently, current investors have weak incentives to restrain managers from focusing on the short term and the private gains from attracting new investors to the fund through its superior short-term performance exceed social gains. Finally, even if investors were willing to restrain managers' short-term focus, they may not have complete control over the latter, owing for example to weaknesses in corporate governance.

Hyperactivity bias

The Kay Review (2012) also noted a bias towards action which is found at almost every point in the equity investment chain. Corporate executives dedicate a lot of attention and time to reorganisations, acquisitions and disposals; traders earn returns based on the volume of activity in the securities in which they deal; analysts are rewarded if their advice generates buy or sell recommendations; investment bankers and advisers generate earnings from transactions; and independent financial advisers are remunerated by commissions. This hyperactivity bias is a symptom of short-termism.

3.3.2. Short termism in business

Even if capital markets were rational, it is possible that short-termism among corporate management leads to short-termism and underinvestment. Stein (1989) develops a model of inefficient managerial behaviour in the face of a rational stock market. In the model, managers try to mislead the market about their firms' worth by forgoing good investment opportunities in order to boost current earnings. Two relevant areas are short-termism in M&A decisions and short-termism in executive pay.

Short-termism, M&A (hyper-)activity and foreign acquisitions of UK businesses

There appears to be a tendency for British businesses to sell rather than raise finance to grow, and to acquire rather than develop existing operations. Several leading British companies ceased to exist due to bad M&A decisions - they were either sold to foreigners or made bad diversification decisions. Famous examples include the sale of the glassmaker Pilkington to Japan's Nippon Sheet Glass in

2006 and the take-over of Imperial Chemical Industries by AkzoNobel, a Dutch conglomerate, in 2008.

NESTA (2012a) also identifies a tendency among British firms in high-tech and capital-intensive sectors to be bought by overseas businesses instead of raising and utilizing growth capital. While inward FDI can bring great benefits to the UK economy, the acquisition of UK businesses by foreign companies sometimes results in the transfer of much or all of the acquired operations out of the UK. The semiconductor sector is an example of this phenomenon. NESTA (2012a) provides evidence that this tendency has weakened the productivity of the UK manufacturing sector. According to NESTA (2012a), industries in which this does not happen, including aerospace and pharmaceuticals, are those where government has provided strong support in developing a complete innovation system. NESTA therefore suggests a role for competition authorities to intervene in take-overs of IP-based firms through requiring “binding commitments on [innovative] capacity as a condition for takeovers to proceed” (NESTA, 2012a).

Similarly, the Kay Review (2012) deplores the fact that some companies place too much emphasis on acquisitions relative to developing the competitive advantage of their existing business operations. Professor Kay argues that the short-term incentives of market participants, in particular those advising companies on takeover activity, have led to mergers and acquisitions which have destroyed long-term value for investors. This tendency for British businesses to sell rather than raise finance to grow, and to acquire rather than develop existing operations, may be due to short-termism in the financial sector, but also to agency problems in corporations, including managers’ “empire building” incentives; see, e.g., Jensen and Meckling 1979 and Jensen 1986)

Short-termism and executive compensation

In the financial services industry competition between banks and other financial institutions for bankers and traders is intense. As a result, bankers and traders receive pay focused too much on short-term revenues and performance. As a result huge risks built up in the financial system. This short-termism is believed to be one of the causes of the recent financial crisis. Globally, financial regulators are introducing new rules which determine the allowable structure of bankers' pay. But the concern that executives put short-term results ahead of long term value creation is not specific to financial services. A compelling narrative in the accounting scandals leading up to the Sarbanes-Oxley Act of 2002 in the US was that pressure to deliver short-term results resulted in profits being booked early and results being manipulated. In the scandals caused by major accidents in industries such as oil, it was again concluded that pressure for short-term results led executives to excessively discount possible future costs by neglecting due testing and delaying safety-driven interruptions to production. Similarly, executives that agree to take part in price fixing cartels overly discount the costs of fines and law suits their businesses will potentially incur in the future. There are clearly many instances across numerous industries when firms focus on the short-term at the expense of future profits. This raises the question of why firms choose to offer remuneration contracts which can induce managerial myopia in the first place.

The academic literature has generated several competing explanations as to why firms would find it optimal to hire executives with contracts which tolerate short-termism. Bolton, Scheinkman and Xiong (2006) argue that stock prices may deviate from fundamentals and include a speculative option element which is increased by short-term actions. Therefore, shareholders may use contracts

for their CEOs that induce them to take short-term actions that will maximize shareholders' profits from sales to overconfident investors. Froot, Perold and Stein (1992) make a similar argument.

Thanassoulis (2012) argues that firms must use some variable remuneration to induce effort, which introduces a myopia problem. Executives have an incentive to inflate early expected earnings at the expense of future profits. To manage this short-termism some bonus pay must be deferred. Convergence in size amongst firms makes the cost of managing the myopia problem grow faster than the cost of managing the effort problem. Ultimately the optimal contract can jump from one that deters myopia to one that tolerates it.

The idea that including stock options in executives' compensation packages would align the interests of shareholders and managers has also been questioned. Lazonick (2010) and FINNOV (2010) argue that stock buybacks, legitimized by the ideology that firms should maximize shareholder value, are a symptom of managerial myopia and undermine long-term investment and R&D. Lazonick's (2010) analysis of different industries suggests that the sharp increase in executive pay via stock options is happening at the expense of innovation in the US economy. The author argues that large US ICT companies, such as Microsoft, Cisco, IBM and Intel invest more profits into stock repurchases than they invest in R&D. Similar behaviour is found in pharmaceuticals. Large firms, such as Johnson and Johnson, Pfizer and Amgen often uphold their high drug prices in the US with the need to recover large R&D expenditures, while simultaneously reinvesting profits into stock repurchases.

Linking pay to longer-term performance may not be the panacea either. Inderst and Pfeil (2012) examine whether financial institutions should be required to defer bonus pay in order to align incentives with the longer-term risk of transactions. They derive conditions for when such mandatory deferred compensation curbs risk taking and improves the quality of assets. But they also show that such regulatory interference can have the opposite effect of leading to deferred but more high-powered incentives and thus, ultimately, to a lower quality of assets¹³.

3.3.3. Short termism in banking

Given that SMEs are more vulnerable to problems of asymmetric information and that, as we have argued above, they are much more bank-dependent than large firms, relationship lenders have an important role to play in the provision of external finance to SMEs (Carbo-Valverde et al., 2009; Canales and Nanda, 2012). In their capacity as relationship lenders, banks develop close relationships with borrowers over a long period of time, a costly process which facilitates monitoring and screening and can overcome problems of asymmetric information (Boot, 2000). In recent years, however, banking seems to have evolved towards more arms-length and transaction-oriented banking (trading) and away from traditional intermediation.

These movements have ramifications for long-term growth. According to recent work by Beck et al. (2012), the growth effects of finance come from a properly functioning financial intermediation function. Based on a sample of 77 countries for the period 1980-2007, the authors find that intermediation activities increase growth and reduce volatility in the long run. An expansion of the

¹³ In the model, deferring compensation allows the principal to observe a more informative signal on the quality of a closed deal. However, deferring compensation is costly as the agent is more impatient than the firm. Unintended consequences are possible when deferred compensation is too costly for what it delivers in terms of additional information.

financial sectors along other dimensions (non-intermediation activities including professional and business services) has no long-run effect on real sector outcomes. Following Beck (2012), recent policy approaches towards the financial system have focused more on the size of the sector rather than its intermediating function, which may have led to short-run growth at the expense of high volatility.

Moreover, the emphasis on arms-length and transaction-oriented banking impacts the availability of relationship lending services which are so important for SMEs. In what follows we examine two symptoms of short-termist behaviour in SME banking: excessive reliance on credit-scoring and the “advice gap”.

Lack of relationship lending: excessive reliance on credit scoring

Short-termism is reflected in banks’ “lending technologies”, in particular credit-scoring systems that emphasize short-term financial indicators rather than long-term industrial performance indicators such as productivity growth. According to market participants, the UK banking sector is unique in Europe in terms of the importance it gives to the credit scoring system. This issue has been raised by several commentators, for example the European Commission’s work stream on financing innovation (FINNOV) and the OECD. The academic literature on lending technologies and their impact on credit availability for SMEs is sparse (e.g. Berger and Udell, 2007; De Young et al., 2008) and tends to focus on the benefits of credit scoring for small businesses. Berger and Udell (2007) argue that small-business credit scoring has improved small businesses’ access to credit in the US in a number of dimensions, including (1) an increased supply of credit; (2) increased lending to relatively opaque, risky borrowers; (3) increased lending within low-income areas; (4) lending over greater distances; and (5) increased loan maturity. In the UK, however, there is mounting evidence that the credit scoring system does a poor job when it comes to financing small and innovative businesses. Given the high transaction costs of conducting due diligence on each and every individual SME, banks tend to be reliant on credit scoring, such as a company having a good track record and high level of collateral. This “tick box” approach automatically shuts out many SMEs, particularly start-ups, because they enjoy neither. Analysis by Experian and NESTA suggests that banks’ credit scoring ratings systematically favour low-growth over high-growth businesses, all other things being equal (NESTA, 2011a).

The Appeals Process launched by the Business Finance Taskforce in April 2011 showed that credit scoring is an important reason for the decline of loan applications by start-ups (See Appendix for more details). According to the Taskforce, this is because the personal credit scoring of small entrepreneurs is examined as much as the credit scoring of their businesses. This suggests that it is personal credit scoring (which is mainly done externally to the banks) rather than the banks’ own credit scoring process that needs to be reviewed.

Lack of relationship lending: advice gap

NESTA (2011b) argues that small businesses suffer from an advice gap, despite the presence of services such as corporatefinance.org.uk (a network of independent accountants and business advisers) and the Forum of Private Business. Survey data gathered for the SME Finance Monitor shows that most small business managers seek little or no external advice. Many exclusively depend on their accountant for advice. Small businesses who see their applications for loans or overdrafts rejected often complain about poor advice from their banks. Those problems are currently being

addressed by the UK's five largest banks through the Business Finance Taskforce. The key areas for improvement identified by the Business Finance Taskforce review of the Appeals process highlight the importance of a return to old-fashioned banking relationships¹⁴. First, banks need to retrain their own staff so that they are qualified to make credit judgements and lending decisions. The review highlights that branch staff often do not possess the skills to make credit judgements and instead rely on the "tick box approach" of credit scoring. In other words, branch staff has often become salespeople rather than lenders. Second, businesses also need training in how to approach banks and put their businesses cases forward. Third, the review highlights the need for early and continued dialogue between lenders and SMEs through relationship managers. Finally, customer feedback suggests that many smaller businesses are unaware of what type of finance options might be available to them. There is a need for banks to refer businesses which have been declined credit to other forms of finance. Businesses, in turn, need to be educated about the availability of alternative sources of finance. More details about the Business Finance Taskforce's review of lending technologies are given in the Appendix.

Relationship lending and competition in banking

Section 3.1 has identified the long-standing lack of competition as a major problem on the SME banking market. The present section has identified a potential lack of relationship lending in the UK, which may negatively affect SMEs (Carbo-Valverde et al., 2009). Therefore, the question arises whether competition and relationship lending are compatible aims.

The theoretical literature on the relationship between competition and relationship lending delivers conflicting results. The "information hypothesis" argues that competitive banking markets can weaken relationship lending because it prevents banks from extracting the informational rents generated by investing in their relationships with borrowers. This deters banks from investing in soft information (See for example Petersen and Rajan, 1995; Ogura, 2010). By contrast, the "market power hypothesis" states that less competitive banking markets are associated with more credit rationing and a higher price for credit – constraints that traditionally disproportionately affect SMEs. In addition, some authors argue that competition from outside banks (or arm's length lenders) may induce local banks to develop their competitive advantage in providing relationship banking services to small and informationally opaque borrowers in order to insulate themselves from pure price competition from those competitors (See for example Boot and Thakor, 2000; Yafeh and Yosha, 2001; Hauswald and Marquez, 2006).

The empirical evidence delivers more positive results on the role of competition. Across a wide swath of sectors competition has been found to improve productivity and firm performance, partly due to improving the managerial practices within firms (e.g. Van Reenen, 2011). Banking is unlikely to be an exception here. Many studies find a positive relation between interbank competition and relationship lending (Petersen and Rajan, 1995; Fischer, 2000; Ogura, 2007; Ogura, 2010). A few others do not (Mommel et al., 2007; Neuberger et al., 2008). A weakness of the empirical literature is that competition is often measured by an index of market concentration which is a crude proxy. By

¹⁴ According to Accenture (2011), the availability of innovative and relationship-based services is an increasingly important reason given by SMEs for switching banks, and the successful entry of Handelsbanken into the UK market is evidence of the attractiveness of and need for relationship lending.

contrast, Carbo-Valverde et al. (2009) employ the Lerner-index which measures the degree of excess profits and is arguably a much better proxy of monopoly power. The authors find that higher competition (i.e. a lower Lerner index) seems to improve credit availability for Spanish SMEs.

Presbitero and Zazzaro (2011) investigate the possibility that the relationship between competition and relationship lending depends on the organisational structure of the local credit market. In particular, they find that increased competition is particularly effective in stimulating relationship lending when markets are not concentrated by a few large incumbents. This is consistent with the finding that small banks have an advantage when lending to small firms due to their ability to engage in relationship banking and their decentralized lending structure (Canales and Nanda, 2012)¹⁵.

Competition is in general a beneficial force for improving industry performance. The evidence here suggests that the fears that greater competition will undermine relationship lending are mistaken. In fact, competition is likely to simulate more relationship lending to innovative SMEs.

3.3.4. The case of institutional investment

Institutional investors have specific characteristics that give them a potentially crucial role in channelling the nation's savings into long-term investment that supports sustainable growth. Firstly, they represent "patient capital"; institutional investors (in particular, pension funds and life insurers) are "natural" long-term investors due to the often long-term nature of their liabilities. Secondly, they have an important role in corporate governance: due to their long-term investment horizons, institutional investors may help align managers' incentives with the long-term interests of the investee companies. Thirdly, their size: much of the financial wealth of UK households is in pension funds and insurance companies. The total assets of insurance companies, pension funds and trusts were valued at around £3,000 billion at the end of 2010 (ONS). Hence their decisions play a critical role in the process of allocating capital within the economy. However, there are a number of signs pointing to growing short-termism among institutional investors.

Signs of short termism in institutional investment

Declining investment holding periods: Most OECD stock markets have displayed declining investment holding periods in the last few decades, including the London Stock Exchange (OECD, 2011d). While this trend is partly driven by the growing importance of investors that trade with a high frequency, such as hedge funds, there is evidence that even long-term investors have increasing portfolio turnover rates. According to the IRRIC Institute and Mercer¹⁶, 8.2 per cent of managers of UK equity strategies funds had portfolio turnover rates that exceeded the expected level during 2006-9. During the same period, 40.5 per cent of managers of European (including UK) equity strategies funds had portfolio turnover rates that exceeded expectations. Furthermore, pension funds are gradually becoming the most important investors in hedge funds, so they also contribute to the rapid increase in the frequency of trading observed in recent years.

¹⁵ Strahan (2008), however, note that large banks may be able to reap the benefits of small size banks (without losing the diversification advantages of large size) by breaking up their operations into small affiliate banks. Liberti (2004) suggests that granting more discretion to lending officers at large banks may also promote relationship building.

¹⁶ Mercer (2010) Investment horizons: Do managers do what they say?

Increasing allocation to hedge funds: Pre-crisis, the largest portion of capital for hedge funds came from non-institutional investors such as high net worth individuals and family offices. Institutional investors have now become the leading investors in hedge funds¹⁷. Not only were there a lot of redemptions from hedge funds by non-institutional investors during the crisis, the proportion of institutional assets being allocated to the global hedge fund industry has grown significantly in the years following the financial crisis. According to a survey by Natixis¹⁸, a long-only strategy of traditional assets is no longer viable as traditional assets are too highly correlated and deliver low returns. Therefore, institutional investors have started looking into liquid alternative investments as a way of managing portfolio risk, mitigating the impact of market volatility on portfolios and achieving higher returns.

Increased investments in short-term assets: The latest statistics on net investments of insurance companies, pension funds and trusts released by the ONS in September 2012 show that investment in short-term assets (those maturing within one year of their originating date) continued to be positive at Q2 2012. At Q1 2012, net investment in short-term assets was estimated to be £24 billion, the highest level since records began in 1983. Since Q3 2010 there have been six quarters of net investment in short-term assets and only one quarter of net disinvestment (Q3 2011). This contrasts with the period Q4 2008 to Q3 2010 when six of the eight quarters showed net disinvestment in short-term assets. Although these are recent developments, they should be monitored in the future.

Low allocations to long-term infrastructure assets: The surge in private infrastructure investment has only started recently (about 5 years ago) due to the fact that this sector has relied mainly on public sources of financing. In the UK, the level of infrastructure investment is estimated to be less than 1 per cent of pension funds' assets, compared with 8 per cent to 15 per cent in Australia and Canada (OECD 2011c). Insurance companies' levels of investment in infrastructure are also very low. However, according to the OECD future infrastructure investments will have to rely to a much greater extent on the private sector. This is due to both the sheer size of investment needs and strained public finances (OECD, 2007).

Infrastructure investments seem naturally suited for pension funds and life insurers as they can produce predictable and stable cash flows over the long term, matching long-term liabilities and reducing portfolio volatility. Nevertheless, so far institutional investment in infrastructure has been modest. Important factors that limit the involvement of institutional investors in the financing of infrastructure projects identified by the OECD include (OECD, 2011d):

- Investment regulations that discourage allocations to unlisted instruments.
- Weaknesses in governance and insufficient project scale.
- Inadequate general investment policy framework resulting in a lack of adequate investment opportunities.

Some of these issues are addressed in the chapter on public investment in infrastructure.

Decreased allocation to equities: In continental Europe, insurance companies and pension funds have traditionally had a much more conservative asset allocation than their counterparts in the UK

¹⁷ KPMG/AIMA Global Hedge Fund Survey 2012: The evolution of an industry

¹⁸ Natixis U.K. Institutional Investors Turn to Alternatives for the Long Term to Combat Volatility and Reduce Risk, 25 September 2012

and a large share of investment has gone into government bonds. In the UK, investments of both insurance companies and pension funds have been highly geared towards equities (See for example OECD, 2011a). However, pension funds' exposure to equities as a percentage of total assets has been decreasing since the mid-1990s. This trend may be partly driven by regulatory and accounting constraints (as discussed below).

There also appears to be changes in the composition of equity investments. The last ONS survey of the balance sheets of insurance companies, pension funds and trusts for the end of 2010, showed that for the first time the value of overseas ordinary shares held by these institutions then exceeded the value of UK ordinary shares. Since then there has been further disinvestment in UK corporate securities and investment in overseas securities.

Failure to exercise a voice in corporate governance: The lack of active engagement of institutional investors in the corporate governance of their investee companies is a long-standing issue that was already highlighted in the Myners Review in 2001¹⁹. Recently, the issue has been flagged up again by the Kay Review of UK equity markets (2012) and the OECD review of corporate governance and the financial crisis (OECD, 2009).

Origins of short-termism among institutional investors

There may be factors that are distorting decision making by institutional investors and preventing them from investing with a sufficiently long-term view.

Long-standing agency problems: The origins of short-termism for pension funds mainly lie in agency problems. Most funds, especially the smaller ones that lack the in-house expertise, rely extensively on external asset management firms, which may not always pursue the best interests of the ultimate asset owners. In addition, incentives and monitoring structures may be ill-designed²⁰.

Long-standing regulatory pressures: Regulatory-driven constraints can have a significant impact on the proportion of assets that can be directed towards long-term investing. Regulations in continental Europe have traditionally been stricter than those in the UK. But prudential and accounting standards may still create distortions in institutional investors' asset allocation decisions. The implementation of the UK Pensions Act in 1997 and the announcement of mark-to-market accounting as part of FRS17 in 2000 had a significantly negative impact on the proportion of funds that pension funds allocate to equities.

The Pensions Act 1997 required defined benefit funds to meet the Minimum Funding Requirement (MFR). This increased their incentives to invest in safer assets because this is the best way to ensure confidence about meeting defined pension liabilities. Mark-to-market accounting introduced in

¹⁹ Institutional Investment in the UK: A Review, Paul Myners, March 2001. More details on the Myners Review are provided in the Appendix.

²⁰ The main agency problems relate to differences in time horizons and the monitoring of agents. Investment managers and other advisers are likely to wish to optimise returns, and be monitored over a much shorter term than the investment horizon of the fund owners. Furthermore, the performance of investment managers is often evaluated in relation to a performance benchmark or index such as the S&P 500. The Myners Review (2001) argues that this tends to produce investment decisions – in particular asset allocation – based on what other funds are doing. Once most pension funds are not invested in a given asset class, it becomes very difficult for one manager to break ranks and invest differently, however good the prospects for that asset class might be.

FRS17 encourages investors to focus on short-term changes in market value, rather than the long-term prospects of an investment, which may also induce them to minimize risk-taking.

Pressures resulting from the crisis and new regulations: The financial crisis caused extreme market volatility in 2008-9. UK pension funds found themselves underfunded by about 15 per cent by the end of 2009 (OECD, 2009). According to the World Economic Forum (2011), the crisis created pressures to both de-risk and re-risk. As a result, investment management has become either hyperactive or excessively passive, neither of which is conducive to long-term and engaged investment on the part of institutional investors.

Pressures to de-risk: Regulated pension funds' underfunded positions constrain their ability to adopt a long-term investment strategy. Long-term investing indeed requires the ability to hold on to assets in the face of market volatility. UK pension funds face pressure from the regulator to maintain funded status in the short term and to make up for any shortfall in funding. These constraints, combined with the reporting of pension results to the market on a short-term basis, encourage some pension funds to set a lower risk appetite. Accordingly, for the more traditional parts of their portfolios, funds have incentives to increase the proportion of assets allocated to liquid, high-grade debt instruments.

The introduction of Solvency II²¹ for insurers in the European Union (expected in 2013) may also reinforce this bias for short-termism as it will penalise insurers for holding assets with high volatility, such as equity. Investment in common stock or illiquid investments require an institution to hold significantly more capital in reserve than an investment in high-grade corporate bonds. The need to maintain a high capital ratio therefore acts as strong encouragement to insurance companies to invest in low-risk assets. One may therefore expect a migration away from equity to fixed-income assets, discouraging life insurers from making longer-term investments in illiquid markets.

Pressures to re-risk: On the other hand, it is critical for funds to have sufficient capital to meet their shorter-term obligations. Therefore, there is pressure to increase risk in their portfolios. This search for returns may have contributed to the recent increase in exposure to hedge funds mentioned above.

Demographic pressures: Finally, life insurers and pension funds are subject to structural demographic pressures. As a result, the liability profiles of many pension plans are assuming a shorter duration, which will encourage these institutions to further de-risk and to place less emphasis on long-term investment strategies.

3.4. Excessive reliance on debt: overhang, forbearance and debt bias

Debt overhang and forbearance limit banks' capacity to make new loans

UK financial institutions are heavily leveraged and suffer from debt overhang. The accompanying lack of re-capitalisation prevents banks from extending credit to the UK economy. The phenomenon of forbearance aggravates the situation. While forbearance provides relief to struggling debtors and supports balance sheets in the short term, it also has a negative impact on banks' income and

²¹ Solvency II is an updated and expanded version of the Solvency I regulatory requirements for insurance firms in the European Union.

constrains new lending. Forbearance could also generate uncertainty over banks' capital positions, thereby limiting their ability to attract new funding. This may constrain new lending by banks whose capital buffers are already limited.

Despite difficulties involved in measuring the precise scale of forbearance, there is some evidence that it is happening in the UK. A recent review of forbearance by the FSA found that around a third of UK commercial real estate loans and 5 per cent to 8 per cent of UK mortgages are subject to forbearance. These levels of forbearance are material. Mortgages subject to forbearance exceed total net new mortgage lending to UK households over the past three years (Bank of England, 2012b). And there is evidence that this is constraining banks' ability to make new loans. In 2011, the UK banks with the highest levels of forbearance supplied significantly fewer new mortgage loans than banks with lower levels of forbearance (Bank of England, 2012b).

A decrease in credit supply can further weigh on economic growth. An example of this effect was witnessed in the 1990s during the Japanese 'lost decade'. There is a body of evidence which suggests that forbearance by Japanese banks significantly dragged down investment and employment levels of 'healthy' industries (See Caballero et al., 2008). Chari et al. (2002) make a similar point about the Great Depression in the United States.

Debt overhang and forbearance constrain business investment and productivity

According to the Bank of England (Bank of England, 2012c) business investment remains around 15 per cent below its pre-recession peak. At the same time, the level of productivity has on average been around 10 per cent below its pre-crisis trend since mid-2010. Numerous factors may help to explain this, including weak business investment and reduced innovation. In addition, forbearance may be contributing to the financial sector's failure to re-allocate capital resources efficiently across sectors of the UK economy. The Bank of England (2012e) provides some initial evidence that the financial system has failed to re-allocate capital resources across sectors in response to heterogeneous sectoral shocks since mid-2007. Evidence of capital misallocation includes a marked increase in the dispersion of output growth, price inflation and rates of return on capital at a sectoral level. As the health of the financial system improves, capital will be re-allocated efficiently across sectors, especially towards tradables. However, this process may be lengthy and in the meantime businesses with the potential to invest are unable to finance themselves, while "zombie firms" are allowed to continue operating. This could help explain the strikingly low rate of corporate births and deaths during the crisis and the continued weakness in business investment and productivity. Company liquidations have increased only slightly since the start of the recession, even though company accounting data suggest that the share of companies making losses has increased sharply since 2007.

Tax distortions create a general debt bias

We have seen that SMEs tend to rely on bank lending, since access to other types of finance is limited. However, an issue across firms of all sizes is a bias towards debt finance due to tax incentives.

This debt bias exists internationally (See IMF, 2009 and 2011). In most countries, financing investment by debt offers tax advantages, for example by allowing interest payments to be tax

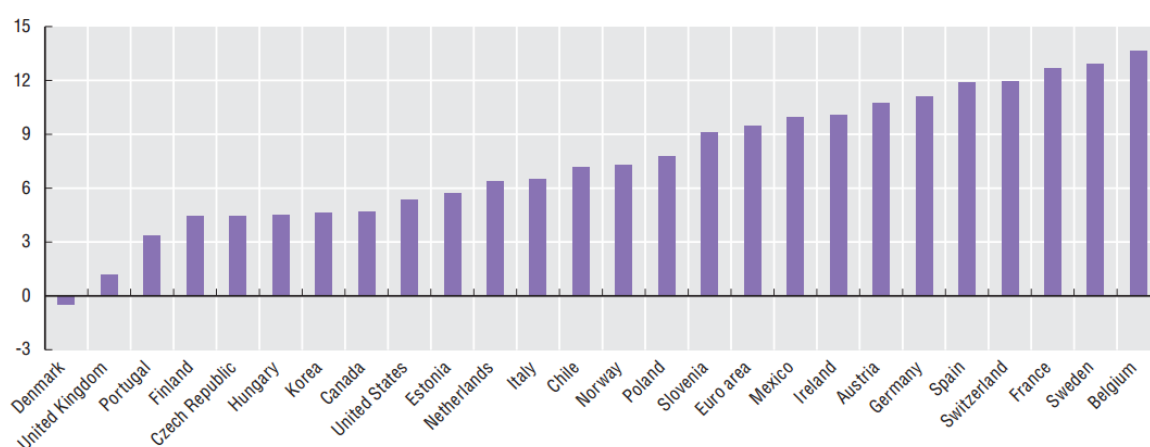
deductible. This bias is hard to justify on legal, administrative, or economic grounds (IMF, 2011). In addition, there is evidence that this bias creates significant economic distortions, including inefficiently high debt-to-equity ratios. But more importantly, it may constrain economic growth by leading to overinvestment by mature firms and underinvestment by innovative growth firms (IMF, 2011). Since credit constraints mostly affect the latter type of firms, a general deduction for interest will not benefit them, but rather firms that have easy access to external debt, i.e. large and mature firms.

3.5. Low private savings and excessive reliance on housing investment

Low private savings

Household saving is the primary domestic source of funds to finance capital investment (OECD, 2012b). In recent years, there has been considerable discussion of UK household savings. Concerns about pensions led to a 2005 report by the Pensions Commissions, which proposed reform of the state pension system and a National Pensions Savings Scheme. Simultaneously, concerns about the levels of indebtedness have been motivated by the risks associated with high levels of indebtedness and the implication that current indebtedness may foreshadow future household financial difficulties. In recent years, declining household saving rates have contributed to the general sense that UK savings might be lower than in many comparable countries (Bank of England, 2012d).

Figure 3: Household net saving rate (percentage of household disposable income, 2009)



Source: OECD 2012b

The UK savings ratio was at a historical low between 2000 and 2008. As economic uncertainty rose, weak consumption led to an increase in savings ratio. However since then, savings ratios have fallen again – this may be a result of improving household confidence, easing credit conditions, or households trying to maintain stable consumption in the face of reduced real income (Bank of England, 2012d; Financial Services Authority, 2012).

Households' direct savings are mainly held as deposits in banks and building societies (Bank of England, 2012a). Since the credit crunch, banks have faced a significant refinancing challenge to restructure their balance sheets while providing a consistent flow of long-term issuance and

providing the required amount of adjustment. As retail deposits represent a primary source of funding for banks, low household savings may constrain banks' cash reserves and ultimately, the amount of loans available to SMEs.

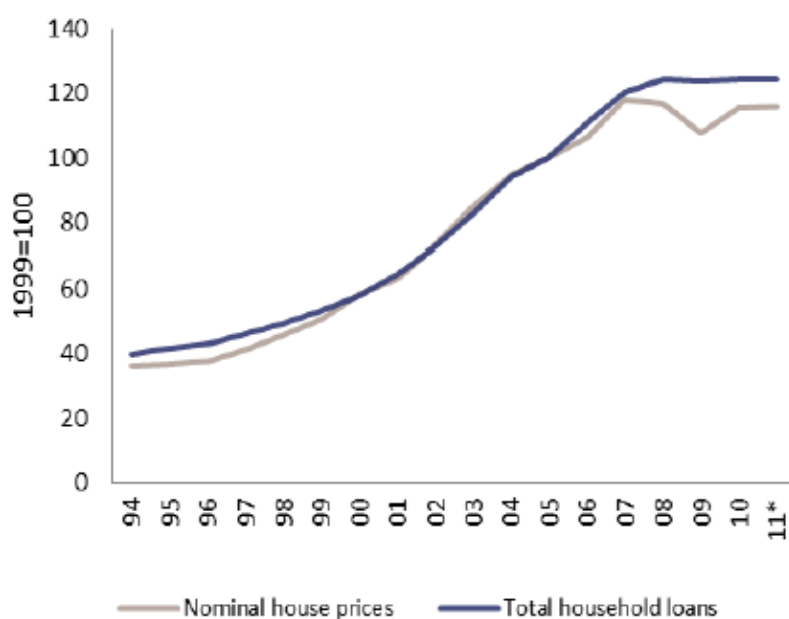
Housing market dysfunctions

Around 70 per cent of UK households are owner-occupiers. Typically, residential property is their largest asset and a mortgage their largest liability. In November 2011, the share of outstanding loans to households secured on residential property stood at 85.7 per cent of all household debt. This ratio has been rather stable in recent years. The remaining outstanding debt is in the form of consumer credit (European Commission, 2012). As a result housing market dysfunctions may have major ramifications on the financial market.

Household debt has been increasing steadily over the past decade, peaking at 89 per cent of GDP in 2009 when a deleveraging process started. The pre-crisis increase in household debt was mainly caused by lending secured on residential property. Despite recent deleveraging, by the end of 2011, mortgages still represented about 86 per cent of all household debt and 83 per cent of annual GDP (European Commission, 2012).

Figure 4 shows how household debt tends to track house prices.

Figure 4 House prices and household debt



Source: European Commission 2012, OECD, *Estimated

Though both levels of real household debt and real house prices have fallen, they remain relatively high. Potential rises in interest rates or in unemployment put highly indebted households particularly at risk. This has potentially destabilising effects on the whole economy, primarily through the financial sector. The prevalence of variable-rate mortgages in the UK makes households particularly vulnerable to interest rate rises. Households may face increased indebtedness if house prices increase again. While there are currently few signs that housing demand or interest rates will

significantly rise in the near future, the insufficient and rigid supply of housing in the UK will continue to expose the country to the risk of higher and volatile house prices in the future. This, in turn, may lead to further detrimental effects on the wider financial system (European Commission, 2012).

The marked rise and volatility in UK property prices was a result of a combination of rigid housing supply and rising demand. Demand was driven by unconstrained access to finance, loose credit conditions, expectations of rising house prices and incomes, and government incentives for home owners and renters. The housing supply shortage is largely due to an inflexible UK planning system which ignores market signals and has failed to evolve with changing socio-economic conditions (Cheshire and Sheppard, 2005).

Effect on financial stability and hence access to finance

Residential investment has consistently represented a low share of UK GDP. However, there are reasons to believe that the housing market has had an adverse effect on long-term economic performance and stability. Not only does the housing market have a significant impact on household consumption and debt, it may also affect economic performance via its impact on the allocation of resources in the wider economy. The strong link between economic and housing market stability in the UK is evidenced by Barrell et al. (2010) who show that house price bubbles are good predictors of UK economic crises.

Household solvency is vulnerable to rises in interest rates and unemployment. This was exemplified by the sharp rise in mortgage interest payments as a percentage of disposable income in the late 1980s and early 1990s, when official interest rates peaked at 15 per cent in 1990. This example shows how large levels of household debt accumulated through the purchase of residential property at high loan-to-income ratios on variable rate mortgages can have a destabilising effect on the economy.

Importantly, access to finance for SMEs is linked to conditions in the housing market. The Bank of England's Paul Tucker (2011) notes that a crucial element of SME finance has been the capacity of entrepreneurs to pledge their home to obtain loans that they are unable to obtain on an unsecured basis.

4. Management, productivity and growth

The large productivity differences between nations are mirrored in the huge variation in productivity differences between firms and establishments within countries even in narrowly defined industries. Syverson (2011), for example, estimates that there is a fourfold difference in labour productivity between plants at the 90th and 10th percentiles of the distribution in a typical four-digit UK manufacturing industry. Although some of these differences can be accounted for by inputs such as capital, skills and technology, a large residual remains. Many writers have believed that differences in management quality lie behind this heterogeneity in performance, but it has only been in the last decade that management practices have been measured in a systematic way across firms and countries to examine this hypothesis (e.g. Bloom, Genakos, Sadun and Van Reenen, 2012). This work

involves a mixture of traditional survey tools (e.g. Bloom, Brynjolfsson, Foster, Jarmin, Saporta-Eksten, and Van Reenen, 2013) or more in-depth “double blind” open question surveys (Bloom and Van Reenen, 2007). It turns out that what was long-suspected was true: a large fraction of the differences in productivity are related to management and this appears to be causal according to randomised control trials of exogenously improving the management of firms (Bloom, Eifert, Mahajan, McKenzie and Roberts, 2011).

What is true between firms also appears to be true between countries. Bloom, Sadun and Van Reenen (2013) suggest about a third of the cross country differences in productivity can be traced to simple measures of management quality (which is likely to be an underestimate as these are measured imperfectly).

Several factors appear to be systematic drivers of better management. Stronger product market competition, openness to foreign investment, better human capital (of workers and managers) and good governance (e.g. selecting CEOs through a meritocratic process) all appear to be very important. This is true in simple correlations and by exploiting more sophisticated policy experiments. For example, China’s entry to the World Trade Organisation in 2001 was a large competitive shock for European textile and clothing producers which appeared to generate large improvements in managerial quality, innovation and productivity (see Bloom, Draca and Van Reenen, 2012). The threat of extinction was a string motivator for improvement.

In measures of management quality, the UK is mediocre by international standards, ranked significantly below the ‘premier league’ of countries, such as Germany, Japan, Sweden and the US (e.g. Bloom, Genakos, Sadun and Van Reenen, 2012). The explanation for the weak UK position is a “long-tail” of badly managed firms. In the US, for example, such firms appear to be driven out of business much more ruthlessly. The two main weaknesses in the UK appear to be relatively low levels of human capital and a preponderance of “family firms” Being owned by a family is not a problem, managerial problems typically appear when the CEO of a second or third generation family owned firm is automatically a family member, typically the eldest son. In Germany, for example, Bloom and Van Reenen (2007) found similar rates to family ownership among middle sized manufacturing firms to the UK, but British family owned firms were three times more likely to use Primo Geniture to choose the CEO than their German counterparts. The higher rates of family firms in the UK than say the US are a mixture of long-term cultural factors and also the fact that inheritance tax is 100 per cent deductible for business assets passed down to family members. This is a reason for considering a change in this tax rule.

5. Recommendations on private investment and innovation

5.1. Core recommendations

Increasing competition

One important route with longer lasting benefits could be through spurring increased competition in retail banking. The direction of travel in recent years has been in the opposite direction since HBOS was absorbed by Lloyds-TSB in 2008. But there is a mounting case for formulating a plan to reduce concentration in the retail banking sector. This would be a radical intervention, so before taking the

step of referring such a proposal to the new Competition and Markets Authority with a narrow and time-limited remit, we recommend the measures that follow.

Liberalising entry conditions, including speeding up the process for obtaining a banking license, is essential. The OFT has committed to working with the Prudential Regulation Authority to review the application of prudential requirements to ensure that new entrants and smaller banks are not disproportionately affected, for example, by requirements to hold more capital than incumbents. It is important that the process is completed in a timely fashion.

In addition to the recently introduced automatic redirection service, further measures to reduce switching costs across banks are vital, including greater transparency. It should be as easy to transfer a bank account as it has now become to transfer a mobile phone number across operators.

Increased competition in banking would have a variety of benefits. It would encourage banks to seek out profitable lending opportunities more assiduously. It could also stimulate relationship lending as retail banks focus on more mundane finance rather than 'casino' activities. We document these potential benefits in more detail in section 3.3.3.

Business Bank

The Commission supports, with some provisos, current moves towards the creation of a Business Bank (more detail on the Business Bank is provided in the Appendix). At present, the remit of the bank is to deliver the existing programmes of the Department for Business, Innovation and Skills (BIS), with £1 billion (leveraged up to £10 billion) for additional lending to manufacturers, exporters and high-growth firms. The rationale is that the bank will be able to access funds on more favourable terms than commercial banks (especially those currently saddled with a legacy of poor past investment decisions) and will therefore have a lower cost of capital.

The Business Bank's lower cost of capital and remit to consider social returns would allow it to make loans that would typically be avoided by commercial banks. In particular, it would be able to take a wider economic view of the benefits of investing in certain sectors, including cases where there are potential long-term social returns from developing new technologies. This would mean a particular focus on lending for innovation investments to new and growing firms, which experience the most acute financial market failures and where the externalities will be greatest. Since this would include green technologies, there would be a case for folding the Green Investment Bank into the Business Bank.

The Business Bank should play an important role in creating a corporate bond market for SMEs. This would require a platform for SME loan securitisation along the lines advocated by the 2012 Breedon Review. By removing the requirement for investors to analyse the credit quality of many small issuances from individual SMEs, such a platform would relax SME financing constraints and kick-start institutional investment in these firms.

The Business Bank does carry risks. To be effective, its governance has to be removed from immediate political pressures and it needs to operate on the basis of clearly defined economic objectives. We recommend that it is run by an appointed independent board to oversee operational decisions independently from BIS. It should also operate under a charter that clearly articulates its mission and ensures that the bank is held accountable for delivering that mission.

The proposal for a Business Bank also has to be a long-term commitment supported by cross-party consensus to avoid the perennial process of abolition, reinvention and rebranding that has characterised much government policy in the past. These features are shared with our proposals for infrastructure institutions (including the Infrastructure Bank), but the skills required for the Business Bank are quite distinct so the institutions should be kept separate.

5.2. Other policies

Making the financial system more stable

The Commission endorses the Vickers Report on banking regulation and encourages the government to implement both the letter and spirit of its recommendations (Independent Commission on Banking, 2011). Some Commissioners wanted to go further and recommend the structural separation of the investment and retail arms of banks along the lines of the US Glass-Steagall Act. But the consensus was to wait and see how the current set of Vickers and Basel III reforms worked before deciding whether to press ahead with something more radical and potentially disruptive. Although such reforms would help make banking safer and more stable, in the short-term, higher capital requirements will often mean less lending, particularly to risky projects. Recent announcements that suggest a less stringent timetable for implementing the Basel III reforms therefore seem to be a sensible move so long as the delay is not too long.

Holding assets for longer

To combat short-termism, the Commission recommends that equity voting rights be linked to investment duration, with rights becoming stronger the longer the holding period. This would follow the spirit of the US Securities and Exchange Commission's proposal for a one-year holding period for shareholders to be able to amend or request an amendment to a firm's governing documents concerning nomination procedures for directors. A concern with this is that it could lead to control by insiders or 'tunnelling' as happens in many Southern European and developing countries. We view this as less likely in the UK with its strong rule of law, protection of minority investors and transparent contracting environment. But clearly the design of this proposal must be carefully crafted.

Tax policy and innovation

Debt finance is less attractive for an innovative firm than an equity stake because of the inherent riskiness of future revenue streams. Our current tax system creates a bias towards debt and against equity that distorts investment incentives generally and investment in innovation in particular.

Following the recommendations of the 2011 Mirrlees review, we support the introduction of an 'allowance for corporate equity' ([ACE](#)). This would offer a tax break on issuing equity to ensure equal treatment of equity- and debt-financed investments. There is a range of options under an ACE for creating a level playing field between debt and equity. Any resulting loss of corporate tax revenue could, in principle, be offset elsewhere in the tax system. For example, the Mirrlees review proposes using a broad-based tax on consumption rather than increasing the corporate tax rate.

The Mirrlees review estimates that introducing an ACE could boost investment by around 6.1% and boost GDP by around 1.4%. This is mainly because an ACE lowers the cost of capital. In addition, an ACE would help to rebalance the UK economy away from debt and towards equity finance. A corporate tax system of this kind has now been introduced in several countries. In addition to stimulating investment, an ACE has the potential to increase financial stability by reducing the bias towards debt finance.

The share of GDP devoted to business R&D has been rising in almost all OECD countries since the war, but it started *falling* in the UK in the 1980s. We view the R&D tax credit system introduced in the 2000s as a positive development, which helped to arrest this decline. HM Revenue and Customs defines R&D for tax purposes in a fairly narrow and formal way due to legitimate concerns over tax avoidance. So there needs to be ways of supporting investments in innovation directly without further complicating the tax code. One route is through the Business Bank as it can take a wider view of the social returns to innovative projects. This would help to address weaknesses in the commercialisation of inventions from the science base. The Business Bank could also be permitted to use a variety of venture capital-style financing approaches as well as making standard business loans.

Funding for innovative start-ups often comes from alternative sources, such as venture capital, angel funding and private equity in high-tech sectors. This is welcome and it is well-known that clusters like Silicon Valley have a deep seam of such liquidity. Unfortunately, such ‘agglomerations’ of high-tech activity are extremely hard for governments to manufacture, although it can certainly hold them back through onerous regulations. Finance often follows after high-tech clusters have got going due to other factors, such as the presence of world-class universities like Stanford and Berkeley in California’s Bay Area. Finance helps the next stage of development, but it is not the prime mover. Hence, we do not support introducing additional tax breaks for such alternative investments.

Industrial Strategy

Since the late 1970s, industry-specific ‘vertical’ policies have been unpopular due to fears that the ambition of ‘picking winners’ turns into an outcome of ‘picking losers’. But some recent successes (such as foreign direct investment in the automotive sector) and the need to generate more green industries have caused a re-think of a more activist industrial strategy. The convening power and coordination role of government can help to bring parties together to recognise and solve problems (e.g. Rodrik, 2007; Aghion et al., 2012). So there is a role for strategic thinking, especially as the government touches on almost every industry in some way (Van Reenen, 2011).

Empirical studies of the effects of industrial policy have generally been negative although it is acknowledged that there do appear to be some success such as South East Asian countries (e.g. South Korea) and in particular, China. More recent econometric work has tried to identify causal effects using natural experiments such as changes generated by European state aid rules that have exogenously induced some areas to be eligible for industrial subsidies. These have found a more positive role for investment subsidies, especially for smaller firms (e.g. Criscuolo, Martin, Overman and Van Reenen, 2011 and the studies surveyed there).

Of course, it is vital that industrial strategy does not divert attention from the importance of ‘horizontal’ policies, such as promoting competition, R&D, infrastructure and skills, which benefit all

sectors of the economy. Nevertheless, spotting cases where there is an impediment to the growth of a sector is an important role for the government. Supportive interventions need not take the form of direct subsidies – removing specific regulatory barriers is more important.

Underpinning new thinking on industrial strategy should be a view of where the UK has some actual or latent comparative advantage. For such sectors or firms so identified, it must then be considered whether these are areas of global growth. This means taking an appropriately dynamic perspective. For example, investment in low-carbon technologies is likely to be an important area in the future. We recommend a tight focus on what factors inhibit the growth of such sectors and what policies could encourage their growth. Moreover, it is important that this thinking is conducted transparently with the supporting analysis subject to independent scrutiny.

One example of how highly focused government intervention can help would be the relaxing of severe planning restrictions that are inhibiting the expansion of high-tech clusters in some parts of the country (such as Cambridge and Oxford) where the UK has strong comparative advantage in its universities. Planning restrictions on housing for workers, land use restrictions and slow roll-out of ultra-fast broadband are particular constraints on these dense centres of new economic activity. The infrastructure institutions we propose should help, but additional political attention needs to be focused on relaxing regulations that are impeding growth. Other examples are management training in the creative sectors; visa restrictions harming universities; and the prevarication over expanding airport runway capacity that harms our comparative advantage in international business services.

What kind of institutions can help to develop and deliver a better industrial strategy? We recommend creating an independent National Growth Council, which brings together expertise across all disciplines to review relevant evidence and to recommend growth-enhancing policy reforms that could be subject to rigorous evaluation. This body should also challenge government on why successful policies are not introduced and/or why unsuccessful ones are not closed down. The Council would work with BIS on formulating the evidence base needed to underpin an industrial strategy.

The lending strategies of the Business Bank and the Infrastructure Bank should be supportive of this type of industrial strategy. This could be important for industries where there is good evidence that access to finance is holding back investment and innovation. This is particularly true where large upfront investments are needed in an emerging area, such as developing low-carbon technologies.

Policies to improve management quality

Policies should be pursued that encourage good management practices. High levels of competition, meritocratic appointment of chief executives, proper management training and foreign direct investment all lead to improved management performance. But additional specific and directed efforts are warranted given the importance of management. For example, while business education is growing, it is still quite limited in the UK and is not helped by tough immigration controls. There is also evidence that family-run businesses suffer from managerial deficits, so targeted support for management training could be useful for this group. The inheritance tax regime, which allows tax breaks on passing business assets between generations, should also be re-evaluated as it discourages reallocation of assets away from family ownership.

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Appendix

Financing conditions faced by UK firms

In this section we set out the financing conditions faced by UK firms, which largely depends on firm size. Figure A1 sets out financing options open to firms of different sizes.

Figure A1: Financing options open to firms of different sizes

	Definition (turnover)	Bank lending	Equity markets	Private placements	Bond markets
SMEs	Under £25 million ¹	Yes	Limited	No	No
Mid-sized companies	£25 million to £500 million	Yes	Limited	Limited	No
Large companies	Above £500 million	Yes	Yes	Yes	Yes

Source: BIS (2010)

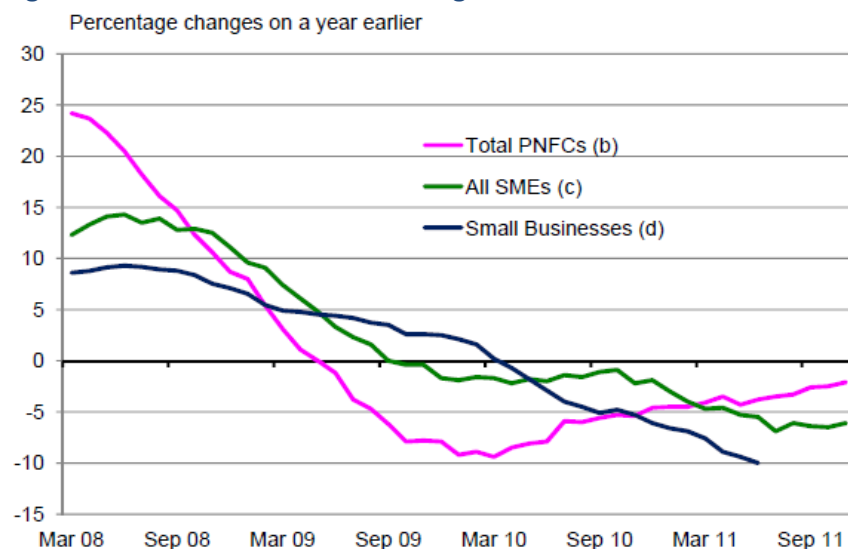
It is clear that the sources of finance available for SMEs are more constrained than those of their larger counterparts, and the situation has worsened since the financial crisis. Limited access to equity markets is a particular concern. Equity finance is considered “patient” capital, that can wait for long-term economic returns on investments and thereby meet the long-term financial needs of a young firm and allow it to innovate.

With a focus on SMEs, recent developments are examined for each type of finance in turn.

Bank loans

Bank loans are the primary source of finance for UK SMEs, however SME lending has declined since the financial crisis. This is due to a mixture of supply and demand side factors: on the supply side, banks have become more risk averse and firm credit quality has worsened due to lower sales; on the demand side, there has been increased deleveraging and lower demand for bank credit as businesses confidence, costs, and investments have fallen (BIS, 2012). The Breedon Review (2012) notes that the UK has one of the highest SME loan rejection rates in the EU.

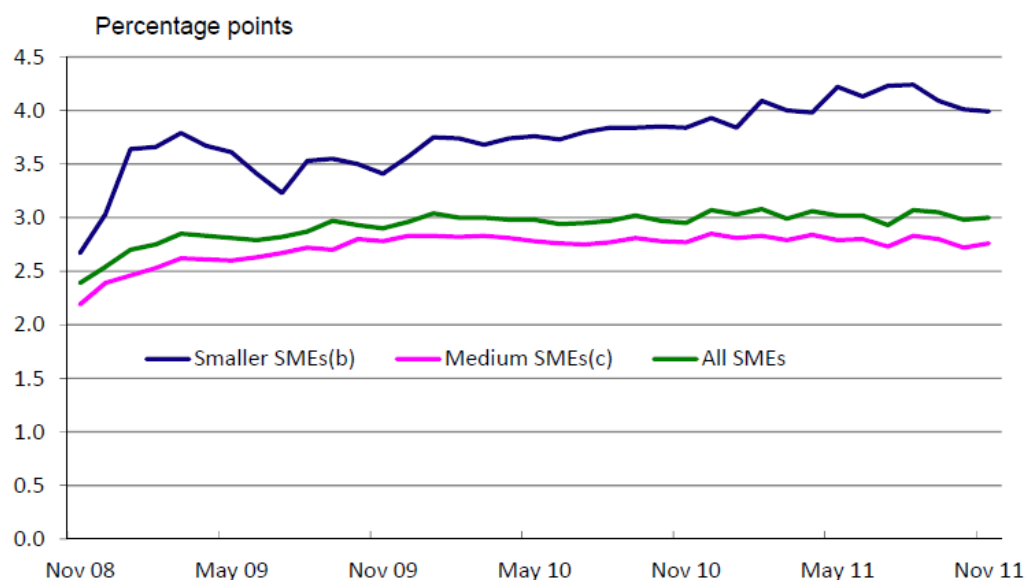
Figure A 2: Net fall of UK SME Lending



Source: Posen (2012) based on Bank of England, BBA, and BIS calculations

The cost of loan finance has increased via increased interest rates, shortened maturities and increased requests for collateral and guarantees, forcing many SMEs to switch to costly alternatives, such as asset-based finance discussed below (OECD, 2012a). Though SME interest rates trended downward, the interest rate spread between SMEs and large enterprises increased between 2008 to 2011 (Posen, 2012).

Figure A 3: Spread over bank rate of indicative median interest rates on new SME variable-rate facilities



Source: Posen (2012) based on Bank of England and BIS calculations

Importantly, according to the Business Finance Taskforce, most data (survey-based or sourced directly from businesses or banks) suggest that weak demand is the main driver of the reduction in bank lending. First, the utilisation of agreed but unused lending facilities across the range of British

businesses has returned to levels seen pre-crisis after peaking in 2009. Second, application levels have decreased significantly (by as much as 50 per cent in some segments). The reasons for this are to be found in businesses' reactions to the economic downturn, including running down stocks, cutting investment and repaying more debt than contractually required. While there is also evidence of a squeeze on the supply side, the Taskforce does not believe it was constraining demand at the time it reported (2010).

A further explanation for reduced lending has been the retrenchment of a number of foreign banks from the UK SME market. In October 2010, net lending from foreign banks was declining at a rate of £1.5 billion per month and the number of active players had decreased significantly compared to the pre-crisis period.

Equity finance

Private equity – Business Angels: Angel investors are important to seed and early stage SMEs (Mason and Harrison, 2011; OECD, 2011b). In addition to providing money, angel investors offer expertise, both strategic and operational, as well as social capital. Business angels have become an increasingly important source of external finance in the UK, with a contribution of £300m in 2012, comparable to venture capitalists (BIS, 2012). According to the OECD (2011b), the UK and in particular Scotland, has one of the most active angel markets in Europe. However, business angels have increasingly been moving their investment activity upstream in recent years (NESTA, 2012b).

Private Equity - Venture Capital: Venture capital typically serves early stage, risky firms that need significant levels of initial capital or require complex R&D (BIS, 2012). Venture capital requires a profitable exit strategy and is therefore less appropriate for businesses with longer time horizons and greater capital requirements. The UK has one of the best performing VC markets in Europe (BIS 2012), but still lags behind the US. The recent financial crisis has led to a decline in the number and value of venture capital investments (In 2009, UK VC investments were at the lowest level since the dotcom bubble and have not improved in the meantime, NESTA 2011). BIS (2012) reports that venture capital only represents 4 per cent of private equity by value, while the long-run 10-year trend stands at 6 per cent. Moreover, VC firms have been moving to later investment stages where risk is lower.

Public Equity: Raising finance through the issuing of shares via exchange regulated markets generally applies to larger firms, and has not been an important source of capital for new investment in the UK for many years; the Kay Review (2012) notes that many quoted large UK businesses are self-financing. Though listed firms are primarily large, SMEs can access public equity through exchange-regulated markets such as AIM (Alternative Investment Market) or PLUS-quoted markets. During the recent financial crisis, the liquidity of AIM was heavily constrained which significantly limited the trade of listed shares and new admissions. New listings peaked in 2005, fell to its lowest level in 2009, and began a slow recovery in 2010 (BIS, 2012).

Growth Capital: This is funding that allows established firms to expand—has structural properties that make it unfit for low risk, fully secured banks and high risk, high return private equity providers. The recent financial crisis has seen banks substitute growth capital funding with traditional short term or working capital debt finance. Moreover, increased risk aversion encourages private equity

investors to invest in larger firms and larger transactions (such as buyouts where risk is easier to calibrate and the returns are attractive) (BIS, 2009).

Debt markets and bonds

Debt Capital Markets: Private placements, corporate bonds or commercial paper are skewed towards large businesses due to barriers which prevent smaller firms from participating.

There are 4 primary barriers for private placement investors: 1) the lack of ratings amongst SMEs and the dearth of in-house credit assessment capabilities of UK-based investors; 2) maturity mismatch since many institutional investors prefer instruments with maturities (e.g. 10-15 years or more) significantly longer than the borrowing requirements of most companies; 3) regulation that places an emphasis on liquidity; and 4) price as UK investors require an illiquidity premium. The main barrier for private placement issuers is cost. Advisory and legal fees can be high, especially as there is no standardised private placement documentation in the UK (unlike in the US). Upfront legal fees can amount to over £120,000, as individual agreements need to be drafted for each transaction.

The need for institutional investors to invest in liquid securities poses the primary restriction on access to the public bond markets. Consequently, the size of most wholesale bond issuances is restricted to greater than £150m. The requirements of defined contribution pension schemes combined with the fact that investors are often benchmarked against indices, skews the market towards bond issuances issues that are liquid, large, and highly traded. As a result, mid-sized businesses can therefore issue public bonds only if they can find investors who are less concerned about liquidity, credit rating, or size of issue (Breedon Review, 2012).

Mezzanine finance: This form of debt shares characteristics of equity but ranks below senior debt. The Breedon Review (2012) reports that in 2010, only 1 per cent of businesses used mezzanine finance despite the fact that over a third of mid-sized businesses understand how mezzanine finance works. This may be driven by behavioural constraints: businesses are aware of this debt option, but lack familiarity in using it as a source of finance.

Other sources of finance

Although loans and overdrafts provided by the large banks still appear to be the default form of external finance for the great majority of businesses, some new sources of finance are becoming more important. However, they have also been affected negatively by the financial crisis.

Asset-backed finance: This includes hire purchase and leasing arrangements and provides longer-term finance (typically 3-5 years) to around 20 per cent of all SMEs. Since the financial crisis, leasing has slowed down in overall new business figures, though the overall stock of lease finance has remained stable (NESTA, 2011).

Asset-based finance: Asset-based finance encompasses secured business loans where borrowers use their assets (such as stock, invoices) as collateral. Data from the Asset Based Finance Association (ABFA) show that loaned sums have decreased across most SME categories since the financial crisis. The number of clients using asset-based finance has also been falling. However, the smallest businesses that still make use of asset-based finance appear to be making far heavier use of invoice discounting and factoring than previously. NESTA (2011) argues that this may be because their

access to conventional overdrafts for working capital has become more restricted or costly and that they are therefore, seeking alternative sources of external finance.

Equity Crowdfunding: This is an innovative method of raising finance, and involves the offering of securities by a privately held business to the public, usually through an online platform. The method allows anyone to acquire a stake in a privately held business, by allowing that business to offer a certain proportion of its equity for a set portion of capital (NESTA, 2012b). Despite the financial crisis, crowdfunding has been expanding rapidly in recent years. Technological advances and the growth of social media have made it easier for entrepreneurs to access a large pool of potential investors at relatively low cost.

Public support to early-stage capital

Over the years, UK governments have introduced a number of interventions to improve access to finance for early-stage businesses, including the establishment of several government-backed VC schemes and tax breaks. Figure A 4 provides a summary of these types of schemes. NESTA (2012a) reports that the UK government's efforts over the last two decades has stood out from other countries due to a focus on early-stage finance and the large number of small-scale interventions .

Figure A 4: Publicly-backed finance for early-stage businesses

Summary of publicly-backed finance for early-stage businesses

Fund type	Total funds available (during investment period)	Investment size range	End of investment period	Geographical scope
Early Growth Funds (EGFs)	£36.5m	Up to £200k	2014–2016	Regional
Enterprise Capital Funds (ECFs)	£185m	£500k–£2m	2011–2013	National
Scottish Co-investment fund	£72m	£100k–£1m	Currently investing	Scotland
Business Angel Co-investment fund	£50m	£100k–£1m	Currently investing	England
Venture Capital Trust (VCT)	£150m pa	Businesses can raise up to £5m via the scheme in a 12 month period	Not applicable	National
Enterprise Investment Scheme (EIS)	£260m pa	Businesses can raise up to £5m via the scheme in a 12 month period	Not applicable	National
Seed Enterprise Investment Scheme (SEIS)	£20m pa	Businesses can raise up to £150k via the scheme	Not applicable	National

Source: NESTA (2012a)

Support has been shored up since the financial crisis, involving the establishment of the Innovation Investment Fund (IIF), New Enterprise Capital Funds, the Enterprise Guarantee Scheme, the Business Finance Partnership, the Business Angel Co-investment Fund, an increase in the Enterprise Investment Scheme and the launch of the Seed Enterprise Investment Scheme (See NESTA Plan I for more details).

These interventions have had a positive impact, but NESTA (2012a) argues that efforts to help innovative businesses by directly promoting the VC industry are running into diminishing returns. In addition, there is concern that the venture model itself is broken as a way of investing in high-growth start-ups, due in part to poor returns. Similarly, generous government support to angel finance may also have reached its limits for now (NESTA, 2012a).

UK Business Finance Taskforce review of lending technologies

The chief executives of the major UK banks and the British Bankers' Association (BBA) agreed in July 2010 to set up a Taskforce to review the role of banks in supporting the UK economy and its recovery. The Taskforce was set up in response to concerns about the supply and price of credit and widespread perceptions that banks are not doing enough to support businesses, with a particular focus on SMEs. The Taskforce banks have committed to 17 actions across three broad areas: improving customer relationships, ensuring better access to finance, and providing better information and promoting understanding.

In October 2010 the Business Finance Taskforce set up a Lending Code of Practice to improve customer service standards. In addition, an Appeals Process was launched in April 2011²². Any business with a group turnover of up to £25 million which is declined any form of lending can appeal that decision to their bank. A full review of the case by an external party who has not been involved with the original decline is then launched. In the first year of the process 86 per cent of all loan applications at participating banks were agreed and only 14 per cent of all applications were declined. 2 per cent of declined applications were taken to appeal and 39.5 per cent of appeals resulted in the bank and the customer reaching a satisfactory lending agreement. These numbers were equivalent with extra funding of over £10 million of lending to SMEs.

Approx. 33 per cent of appeal cases were launched by SMEs (businesses with a turnover of up to £50K). Interestingly, the overturn rate was also largest for smaller firms. This reflects both the effect of the use of automated credit-scoring systems and the limited amount of time spent by relationship managers on applications for smaller scale loans. When dealing with larger companies and loans, banks typically exercise more discretion. Importantly, the main reason for credit being declined is credit scoring (in almost 40 per cent of cases). Credit scoring as a reason for decline is also higher for start-ups and those switching banks. According to the Taskforce, this is because the personal credit scoring of small entrepreneurs is examined as much as the credit scoring of their businesses. This suggests that it is personal credit scoring (which is mainly done externally to the banks) rather than the banks' own credit scoring process that needs to be reviewed.

The Myners Review and the UK Stewardship Code

In March 2000, HM Treasury commissioned Paul Myners to undertake a review of institutional investment in the UK²³. The Review identified a number of weaknesses in the governance and decision making processes of institutional investors. Areas of particular concern were: the skills and expertise of trustees; performance measurement and reporting; clarity of investment time horizons; shareholder engagement; and clarity of the role and relationships of trustees and investment consultants.

In light of these deficiencies, Paul Myners recommended that pension fund trustees should draft and follow a voluntary set of principles that would improve governance and decision making. In 2002 the Institutional Shareholders Committee (ISC) published 'The Responsibilities of Institutional Shareholders and Agents: Statement of Principles,' which the ISC converted to a code in 2009.

²² See Banking Taskforce Appeals Process, Independent External Reviewer Annual Report 2011/2012

²³ Institutional Investment in the UK: A Review, Paul Myners, March 2001

Following the 2009 Walker Review of governance in financial institutions, the Financial Reporting Council (FRC) took responsibility for the Code. In 2010, the FRC published the first version of the UK Stewardship Code. The Code was last updated in September 2012. It sets out the principles of effective stewardship for institutional investors and promotes greater professionalism in the governance of institutional investors. It has now gained widespread acceptance in the UK.

These initiatives have made the governance of UK pension schemes far more professional, and the UK serves as a model for other countries. The latest version of the Code makes clear that the concept of stewardship encompasses strategic engagement by institutional investors and not just monitoring companies' compliance with corporate governance. This is in line with the recommendations from the Kay Review.

Business Bank

In the Autumn Statement 2012, Business Secretary Vince Cable announced the government's intention to build a Business Bank aimed at addressing the long-standing, structural gaps in the supply of SME finance (HM Treasury, 2012a). Under the Business Bank, £1 billion of government funding will be combined with private sector participation (i.e. investment from pension funds and other long-term institutional investors) to support up to £10 billion of additional business lending to manufacturers, exporters, and high-growth companies.

With an aim to become fully operational by Autumn 2014, the Business Bank will operate through the wholesale markets, and will not replace or subsidise retail banks (HM Treasury, 2012a). The government has been clear that the role of the institution is to encourage, rather than compete with, private sector solutions for SME financing. The Business Bank's lower cost of capital and remit to consider social returns would allow it to make loans that would typically be avoided by commercial banks. In particular, it would be able to take a wider economic view of the benefits of investing in certain sectors.

Given the crisis of confidence in financial markets, the Business Bank may provide a demonstration effect to the financial markets. This may be particularly relevant as major structural changes are needed, in particular the need for more equity and debt capital markets financing intermediated by banks and the need for more innovative ways of financing SMEs. For example, the Business Bank could also contribute to the creation of a corporate bond market for SMEs in the UK by participating in a platform for SME loan securitisation such as the one advocated by the Breedon Review (2012). By removing the need for investors to assess the credit risk of many small issuances from individual SMEs, such a platform could relax SME financing constraints as well as kick-start institutional investment in SMEs (IPPR, 2012).

The Business Bank will house, review, and rationalize existing government schemes under the Department of Business, Innovation and Skills (BIS) aimed at boosting SME lending. By bringing all policies and schemes under the management of a single institution, policy continuity, consistency and scale may be improved substantially. Moreover, the Business Bank's singular strategy of raising funds on capital markets specifically to address structural financing gaps for SMEs may allow it to avoid the pitfalls of similar, less effective former and existing government policies: in 2011, the

government established 'Project Merlin' under which banks agreed aimed to provide £190 billion of new credit to businesses (Bank of England, 2011b). However, the scheme targeted gross, not net, lending. While banks were making new lending available, businesses have also massively repaid existing debts, so that net lending was negative. Launched in March 2012, the National Loan Guarantee Scheme (NLGS) was designed to make cheaper finance available to companies by providing government guarantees on unsecured borrowing by banks (HM Treasury, 2011). This was followed by the July 2012 Funding for Lending Scheme (FLS), under which the Bank of England will make cheap finance available to banks, if they pledge to use it to increase lending to firms and households (HM Treasury, 2012b). A drawback of NLGS and FLS is that they rely on banks' voluntary participation.

One issue the Business Bank will need to address is whether it should have an industrial policy mandate and target sectors in which the UK has a competitive advantage. Despite industrial policy being a very controversial topic, some recent work does suggest some role for industrial policies (Aghion et al., 2011). Corry et al (2011) suggest that an effective long-run growth policy requires government to consider: 1) where there are likely areas of growth and 2) where the UK has some comparative advantage. While it may be difficult to guess future growth sectors, healthcare, education, green technologies, business services and digital businesses stand out as potential candidates. Similarly the UK has clear comparative advantages in areas such as bio-pharmaceuticals, higher education, financial and business services, creative industries and some areas of ICT (e.g. ARM).

An additional area of concern is the type of institutional architecture that strikes a balance between the maintaining operational independence and ensuring strategic alliance with government policy (Skidelsky, 2011). According to the IPPR (2012), the most effective way to achieve this is through ensuring that there is a clear division between 'where the input of the government ends and the work of the bankers begins.' In an assessment of public investment banks, Skidelsky et al. (2011) conclude that 'a mandate-driven institution with governmental or parliamentary involvement at the strategic level and full autonomy on an operational level has proven to be a model which successfully marries the need for public control over public capital with the need for the maintenance of sound banking principles for market credibility.' The Nordic Investment Bank (NIB) offers a classic example: Finance ministers of the member-states comprise the Board of Governors, which sets the policy decisions for the bank. A Control Committee ensures that this policy is aligned with the NIB's mandate. Assisted by the Management Committee, the Credit Committee, the Finance Committee, and the ICT Council, the NIB's president is charged with bank's day-to-day operations. An in-house team sources potential projects and assesses each potential loan in reference to the Bank's mandate. This governance and operational strategy attempts to ensure that the NIB remains a politically independent organisation with no political influence over individual loans. For example, it is not uncommon for the Bank to withhold financial support for member-state government initiatives that do not further the Bank's mandate. However, Board members have the right to veto loans targeted for his or her country. This, in turn, ensures that that the Bank's policies are in line with the national industrial policies of his or her respective state (Skidelsky et al., 2011).