Centre for Policy Studies

NEW GENERATION

A New Era for Retail Bonds

How our savings could help SMEs grow

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ABOUT THE AUTHOR

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Before entering Parliament, Rishi spent his professional career in business and finance, living and working internationally. He co-founded an investment firm, working with companies from Silicon Valley to Bangalore. He then used that experience to help small and entrepreneurial British companies grow successfully.

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NEW GENERATION

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SUMMARY

Small and medium size enterprises (SMEs) are the lifeblood of the UK economy

- The overwhelming majority of British firms - some 99.9% - are SMEs. They generate £1.8 trillion in turnover, and are responsible for generating 60% of private sector jobs.
- They also play a disproportionate role in getting people into work. Almost 70% of all people moving from unemployment into the private sector do so via an SME.

SMEs cannot access the capital they need to fulfil their potential

- The UK boasts an impressive track record of creating firms. But when it comes to scaling up those businesses, something goes wrong. A survey of OECD countries found that Britain came 13th out of 14 in terms of the proportion of start-ups that have 10 or more employees within three years.
- Small businesses frequently cite insufficient access to capital as one of the key obstacles to growth that they face. This is also a problem highlighted by the recent Industrial Strategy White Paper.
- There are a range of estimates, but there is potentially a £35 billion "funding gap" between the capital that SMEs could prudently raise and the amount that they actually are.
- This contributes to Britain's productivity failings, which stem in part from the fact that our economy is under-capitalised. Between 1997 and 2017, the UK had the lowest level of investment as a percentage of GDP of any OECD nation. Private-sector investment is 2.5% lower than any other G7 nation, although this is partly due to our strength in services over manufacturing.

SMEs are far too reliant on banks and SME debt capital markets are underdeveloped

- Across Europe, companies of all sizes have long been reliant primarily on the banks for financing. They provide 80% of all credit accessed by EU firms, compared to only 25% in the US.
- The US and EU economies are broadly similar in size. Yet the US boasts a market for corporate bonds which is three times larger. By being able to issue their own tradeable debt, American firms can bypass the banks and tap into a far wider pool of investors for financing.

- UK SMEs are even more reliant than large firms on banks for debt financing. This is an increasing constraint on their growth.
- The corporate banking market is not particularly competitive, with just four banks responsible for 90% of business loans. Yet as a result of the financial crisis and tighter regulations, banks cut lending to SMEs by 20%. In 2016, 45% of start-up loan applications were rejected by banks, representing approximately 44,000 businesses. And the stock of lending is still £30 billion below pre-crisis levels.
- Although alternative sources of debt finance, such as peer to peer networks like Funding Circle, are growing, they still account for a tiny fraction of the overall SME credit market. Moreover, the bonds issued are generally not freely transferable or tradeable, which inhibits the development of a proper market.

We need to create better debt capital markets for SMEs

- The high costs and regulatory burdens of the UK's existing bond market (the Order book for Retail Bonds, or ORB) make it suitable mainly for large companies issuing debt of £100 million or so, not SMEs looking to raise £5m-£25m.
- The Government should therefore help support the creation of a Retail Bond Market in the UK.
- Such an exchange would allow SMEs to tap into new sources of debt capital from ordinary investors or smaller institutions.
- It would also provide savers with a high-quality alternative for their investments, especially valuable in an era of low interest rates.
- There is clear UK precedent for such a move. The Alternative Investment Market (AIM) has been a global success story. It is a more flexibly regulated alternative to the Main Market of the London Stock Exchange. The lower costs and hassle have enabled thousands of small, growing companies to raise billions in equity capital, in small amounts, from ordinary investors.
- There is also clear international precedent for a retail bond market. In Italy, hundreds of companies have raised over €1.5 billion on the ExtraMOT exchange, in bond issues averaging just €8 million. The Italian government supported the exchange through simpler regulation of listings and tax incentives. Similar exchanges exist in Germany, Spain and Scandinavia.

The Government needs to help foster a culture of saving in retail bonds

- Providing ordinary members of the public with greater opportunities to invest in retail SME bonds would democratise saving and broaden participation in the free enterprise economy. At the moment, 55% of US citizens have some sort of investment in the stock market, compared to just 19% of Britons.
- There is anecdotal evidence of consumer interest in this area. Several well-known companies such as Hotel Chocolat and Leon have successfully issued bespoke retail bonds (which can't be traded or transferred on an exchange).
- The Government should also issue more of its own debt as retail bonds on the new exchange (e.g. Gilts or indeed the recent Pensioner Bonds).
- The Government should create tax incentives for individuals to invest in SME retail bonds, either via direct tax reliefs or by allowing them to be included in ISAs.
- The British Business Bank is currently packaging a large portfolio of SME loans for securitisation. It could issue bonds for this portfolio on the retail bond exchange, giving ordinary savers access to the same opportunities as larger institutional investors.
- This new exchange would help to secure the investment that Britain's SMEs need to grow and expand, improve Britain's productivity, and democratise investment and access to capital.

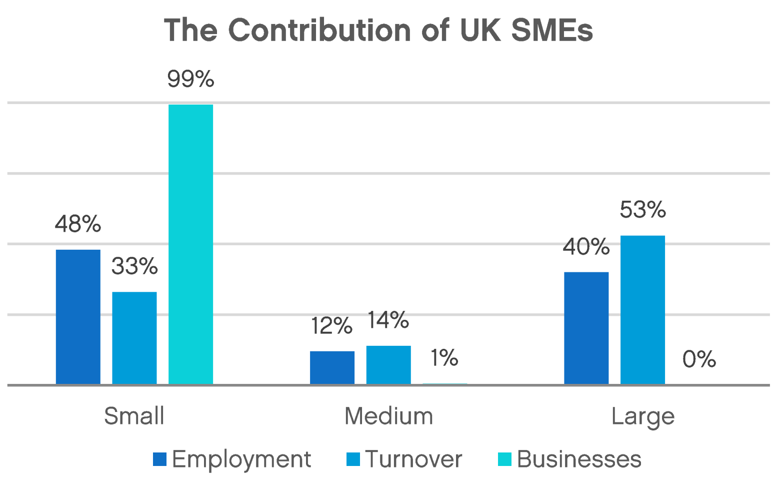
1. SMALL AND MEDIUM SIZE ENTERPRISES ARE THE LIFEBLOOD OF THE BRITISH ECONOMY

When the French statesman Bertrand Barère called Britain a "nation of shopkeepers" in 1794, it wasn't intended as a compliment. Yet the shopkeeper proved a formidable opponent. When Napoleon was defeated by a country with half the population of France, much of the credit belonged to the broad tax base of small business and more advanced credit markets that allowed Britain to outspend its continental rival.

Much has changed in the last 200 years, but Small and Medium-size Enterprises (SMEs) are still the backbone of our economy. Today, they account for a staggering 99.9% of the entire business population, generate £1.8 trillion of turnover and are responsible for more than 60% of private sector employment.[1]

They also help give millions of people better lives, with almost 70% of all moves from unemployment into private sector work occurring via an SME.[2]

In other words, when we talk about start-ups, entrepreneurs and small businesses, we are not talking about a small minority of teenagers with fin-tech apps working in London's Tech City - important though they are. We are talking about the remarkable people up and down the country who are responsible for creating most of our jobs, whether that be by running commercial cleaners, selling clothing or making Wensleydale cheese.



Source: BEIS[3]

1 Department for Business, Energy & Industrial Strategy, *Business Population Estimates for the UK and Regions 2016*, London, 2016, p.1 and *Federation of Small Business*

2 Federation of Small Business, *Back to Work: the role of small and medium businesses in employment and enterprise*, London, 2012, p.5

3 Department for Business, Energy & Industrial Strategy, *Business Population Estimates for the UK and Regions 2016*, London, 2016, p.1

2. SMES CANNOT ACCESS THE CAPITAL THEY NEED TO FULFIL THEIR POTENTIAL

Remarkable as the success of British SMEs has been in the last decade, much of their potential remains untapped due to their inability to access the capital they need to grow.

As a recent Select Committee investigation concluded, it is difficult to measure the exact scale of this "funding gap" between the debt capital UK SMEs could prudently raise and what they are actually able to access.[4] Estimates by industry participants, the National Audit Office[5] (who have also conducted their own investigation into the issue), and the British Bankers' Association[6] range from £1 billion to £30 billion. Recently, the Royal Bank of Scotland has estimated the total at between £30-35 billion.[7]

Yet all agree that whatever the exact scale of the problem, it is certainly a real one. By failing to provide proper access to credit – the lifeblood of SME growth – the British economy is failing to maximise the employment and dynamism that these businesses could deliver.

Certainly, businesses themselves feel there is a problem. In surveys listing the obstacles they face, small businesses frequently cite insufficient access to capital - and research by Nesta shows that this concern is most acute for those firms that are growing the fastest.[8] Nearly one in four businesses, according to Octopus Investments' recent High Growth Small Business Report, find it difficult to secure the funding they need on acceptable terms. Of those, 75% said this was a significant barrier to their growth.[9]

Without access to capital, growing enterprises cannot scale up by expanding operations, investing in new products, or exploring new markets.

This helps explain one of the great puzzles of the UK economy. We have a world-beating record when it comes to creating entrepreneurial start-ups. Some 21% of UK firms are less than two years old, a higher figure than even the US (19%).[10]

4 BEIS Select Committee Report, *Access to Finance*, (2016)

5 National Audit Office, *Improving access to finance for small and medium size enterprises*, (2013)

6 British Bankers Association, *Written Evidence*, (2016)

7 Royal Bank of Scotland, *RBS Independent Lending Review*, 2013, p.13

8 NESTA, *Barriers to Growth*, 2011, p.2

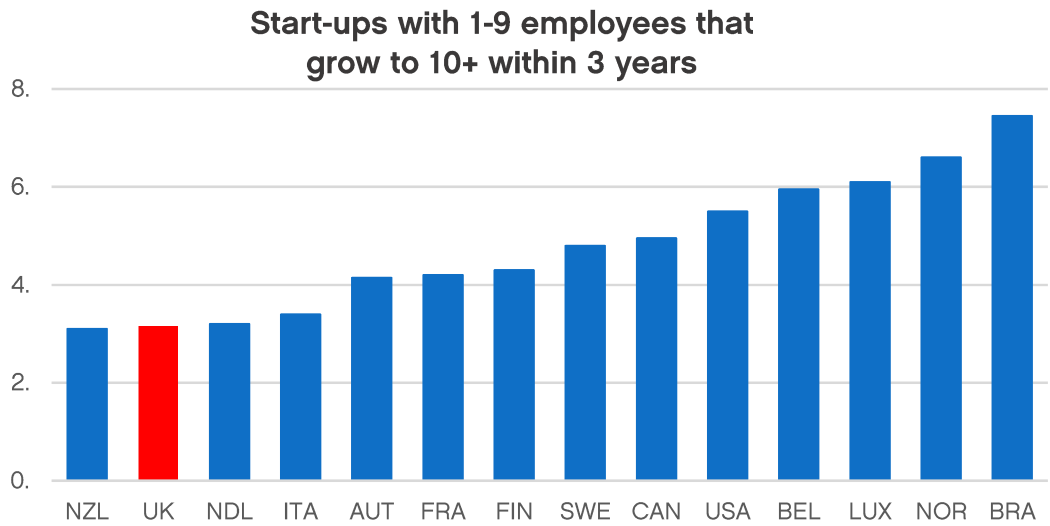
9 Octopus Investment, *High Growth Small Business Report*, (2015)

10 British Business Bank, *Small Business Finance Markets 2015/16*, Sheffield, 2016

Yet when it comes to growing those businesses – the stage at which access to capital is most crucial – Britain's record is dismal. In a ranking of 14 OECD countries, the UK comes a lowly 13th in terms of the proportion of start-up businesses that grow to having 10 or more employees within three years.[11] This issue has also been highlighted by the Government's Industrial Strategy Green Paper.[12]

Although access to capital is not the only issue behind Britain's weak performance, it is regularly cited as a significant one.

This also plays into another of Britain's big economic problems - our poor productivity record. Recent analysis by the Office for National Statistics found that, between 1997 and 2017, the UK had the lowest level of capital formation (ie, investment) of any OECD nation.[13] Private-sector investment is 2.5% lower than any other G7 nation. This is partly due to our strength in services over manufacturing. But it also reflects the fact that British firms are investing less than their rivals in improving their performance.



Source: British Business Bank[14]

11 *Ibid*.

12 HM Government, *Building our Industrial Strategy*, (2017)

13 ONS, *An International Comparison of Gross Fixed Capital Formation* (2017)

14 British Business Bank, *Small Business Finance Markets 2015/16*, Sheffield, 2016, p.15

3. SMES ARE FAR TOO RELIANT ON BANKS, AND SME DEBT CAPITAL MARKETS ARE UNDERDEVELOPED

Perhaps the key reason that Britain's SMEs cannot get the financing they need is that the SME credit market can be anaemic.

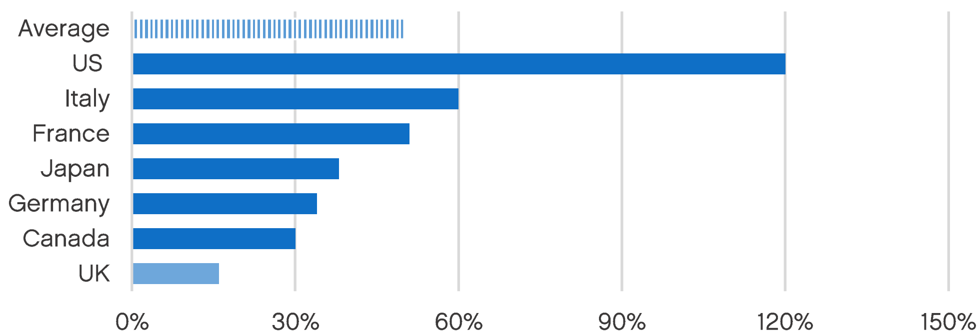
In particular, UK companies are far too reliant on banks for their credit financing needs rather than the capital markets. American businesses have access to much deeper capital markets, which enable a far broader range of financiers (private individuals, pension funds, insurance companies, charitable or educational endowments and foundations) to provide debt funding to American companies.

Compounding the problem is the lack of competitiveness in the UK banking sector and the overhang of the financial crisis and new regulatory rules. This has caused banks to shrink their balance sheets, especially with regard to SME loans.

Across Europe, banks have long been the gatekeepers of debt, providing 80% of all credit accessed by EU firms. The US market is far more diverse, with banks supplying only a quarter of all corporate debt.[15] The difference is that the US boasts an exceptionally deep market for corporate bonds. Despite the two blocs having economies of roughly the same size, the US boasts a corporate debt market around three times the size of the EU's.[16]

By being able to issue freely tradeable debt, American firms can bypass the banks and tap into a far wider pool of investors for financing.

Private Sector Bond Market Capitalisation (% GDP)



Source: Bank of England [17]

[15] European Banking Authority, *EBA Report on SMEs and SME Support Factor,* London, 2016, p.18

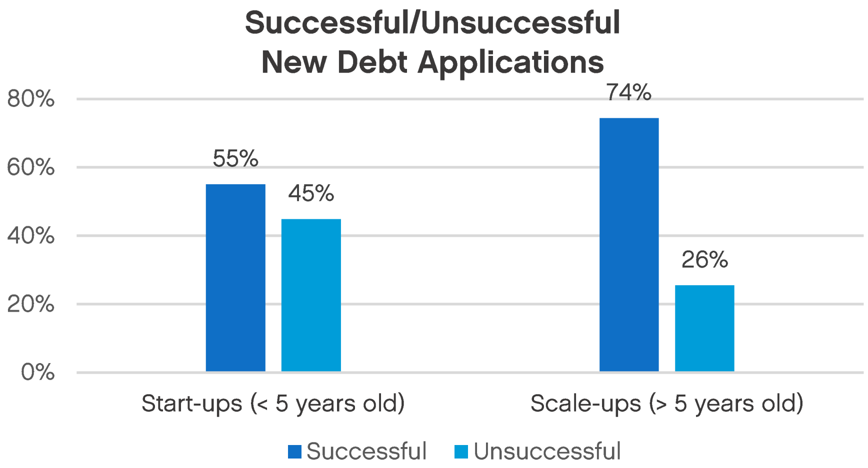
[16] European Commission, *Speech by Commissioner Jonathan Hill at the Seventh Bruges European Business Conference "Capital Markets Union"*, Brussels, 2016

[17] S. Posen, *Getting Credit Flowing: A Non-Monetarist Approach to Quantitative Easing*, Bank of England, 2009

To understand why this reliance on banks rather than capital markets hurts businesses, you only need to look at the daunting rejection rates faced by British SMEs that go to the banks for loans.

According to data published in 2016 by the British Business Bank, roughly 45% of start-up loan applications are rejected by banks, a figure which equates to the turning away of around 44,000 businesses a year.[18]

Clearly, not all of these proposals would turn into credit-worthy businesses. But this rejection rate is one of the highest in Europe - and Britain has seen a much sharper decrease in the loan supply in the wake of the financial crisis than elsewhere.[19] This suggests that the market for SME credit is not working as it should.



Source: British Business Bank [20]

In an environment in which the big banks have been trimming their balance sheets and increasing their capital reserves, the companies that are reliant on their financing have, unsurprisingly, been badly impacted.

In the three years following the financial crisis, new lending to SMEs fell 23% - not returning to positive growth until November 2015.[21] Between April 2011 and April 2017 the total stock of bank lending to SMEs declined by over £33 billion.[22] And while SME lending growth is beginning to pick up again, it still falls substantially short of pre-recession levels.

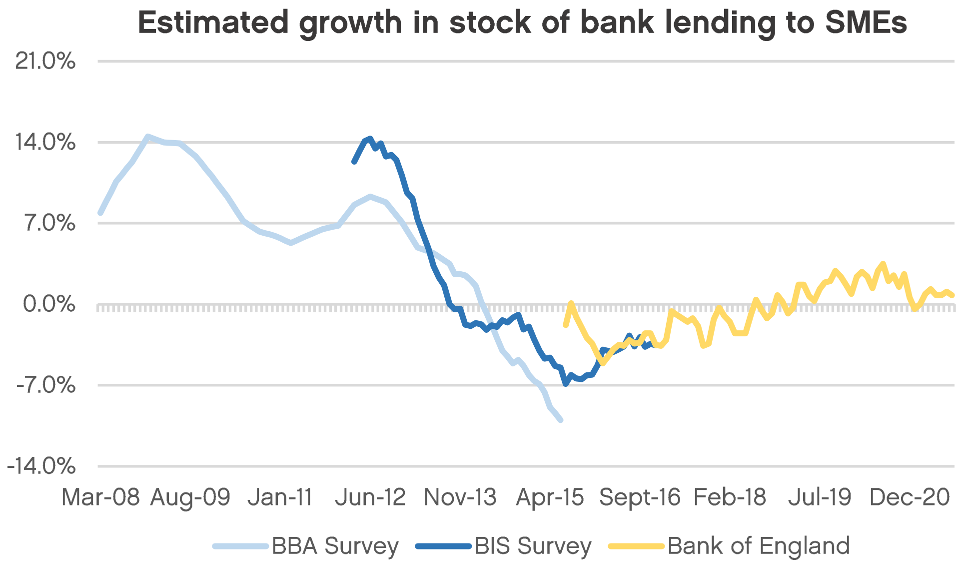
18 British Business Bank, *Small Business Finance Markets 2015/16*, Sheffield, 2016, p.17

19 *Eurostat study*

20 British Business Bank, *Small Business Finance Markets 2016/17*, Sheffield, 2017, p.46

21 BEIS Select Committee, *Access to Finance*, House of Commons, 2016

22 Bank of England, *Monthly amounts outstanding of monetary financial institutions' sterling and all foreign currency loans to small and medium sized enterprises (in sterling millions) not seasonally adjusted*, 2017



Source: British Business Bank [23]

One factor that contributes to the credit woes of British SMEs is that the banking sector, upon which they rely so heavily, is so highly concentrated. A recent investigation by the Competition and Markets Authority (CMA) showed that the "Big Four" banks account for some 90% of business loans.[24]

Such limp competition is likely to result in less availability of credit, higher prices, and poor service for SMEs. That makes it unsurprising that 40% of SMEs report being unsatisfied with their bank, while only 13% trust their bank to act in their best interests.[25]

Total flow of SME lending by provider type, £ billion

	2011	2012	2013	2014	2015	2016
Bank lending	N/A	38	43	53	58	54
Private equity	1.28	1.49	1.53	2.32	3.58	2.50
Asset finance	11.40	12.20	12.90	14.40	15.80	16.80
Peer-to-peer lending	0.02	0.06	0.20	0.59	1.01	1.31

Source: British Business Bank [26]

[23] British Business Bank, *Small Business Finance Markets 2014 – Data Tables*, Sheffield, 2015

[24] Competition & Markets Authority, *Retail banking market investigation*, 2016

[25] Competition & Markets Authority, *Personal Current Accounts*, London, 2014

[26] British Business Bank, *Small Business Finance Markets2016/17*, Sheffield, 2017, p.12

One might expect the lack of lending provision by banks to stimulate the supply of SME credit from alternative sources. Indeed some of these non-traditional options have been growing quickly, for example peer-to-peer lending networks such as Funding Circle, or the new challenger SME bank, Oak North.

But the growth in non-bank lending has struggled to make up for the shortfall left by more traditional financial institutions. Between 2011 and 2016, the combined increase in lending stock to SMEs from asset finance, private equity, and peer-to-peer lending made up for less than a third of the contraction of SME debt on bank balance sheets.

As the British Business Bank concludes, "there is an ongoing need to accelerate the evolution of a diverse and accessible range of finance options to drive competition and choice for smaller businesses".[27] The Breedon Report, which looked into boosting finance options for businesses, also stated that "more diverse financing gives businesses greater choice, promotes competition amongst finance providers, potentially reducing cost, and leads to greater resilience in the financial system".[28]

27 *Ibid*.

28 T. Breedon, *Boosting Finance Options for Business*, London, 2012, p.24

4. WE NEED TO CREATE BETTER DEBT CAPITAL MARKETS FOR SMES

With a bond market for SMEs that is underdeveloped even by European standards, Britain has a great deal to gain by following the US example of diversifying the supply of credit.

In fact, according to estimates, expanding the British bond market to the same relative size as its US counterpart would open up as much as £15 billion of non-bank lending – enough to halve the SME funding gap, as estimated by RBS.[29]

Establishing a proper retail bond market in the UK would not just give companies access to funding. By enabling the bonds to be traded, it would attract new investors, create a rich and deep pool of financing for companies, and open up investment opportunities for ordinary savers and smaller institutions - who currently face few attractive options in terms of where to put their money at a time of rock-bottom interest rates.

So how would it work? Well, we already have the perfect example. The Alternative Investment Market (AIM) has been a British global success story. It was conceived as a more flexibly regulated alternative to the Main Market of the London Stock Exchange (LSE) - a place for companies far smaller than the FTSE giants to list themselves and seek capital.

The lower costs and hassle associated with raising capital on AIM have enabled thousands of small, growing companies to raise billions of pounds of capital, from ordinary investors, in relatively small amounts (£10m-20m). The Government played its part by supporting the exchange with tax incentives for savers investing in AIM-listed shares.

There is also international precedent for giving SMEs better access to the bond markets. Across Europe, SMEs are able to raise relatively small amount of capital (c.€5-€15m) by issuing bonds on exchanges to retail investors or smaller institutions. Italy's ExtraMOT Exchange with its mini bonds is the best example, but similar exchanges exist in Spain, Germany and Norway.

The current British bond exchange (the Order book for Retail Bonds, or ORB), is the equivalent to the LSE's Main Market for equities. It is suitable for FTSE 100 companies, but the cost and regulatory burdens mean that it is not a cost-effective place for SMEs to raise less than £25m. An AIM-style market could fill the gap, bringing savers and SMEs together to drive Britain's entrepreneurs forward.

[29] *Ibid.*, p.22

A new market for retail bonds

The British public have traditionally proved more reluctant to invest their money in financial instruments than their US cousins. While 55% of the US population is invested in the stock market, the same can be said for only 19% of Britons.[30] [31] That division represents a vast store of underworked capital that could prove vital in reinvigorating SME finance - and in giving the British public a better place to put their savings. Indeed, with the Bank of England's base rate having not risen above 0.5% since March 2009, savers have rarely been more incentivised to find a productive home for their cash.

The result is that SME bonds offering more attractive yields ought to be appealing to retail savers. And there is anecdotal evidence that an appetite to invest in retail bonds already exists. In the aftermath of the credit crisis, and as banks retrenched, several well-known consumer businesses (including Leon and Hotel Chocolat) issued ad-hoc, bespoke retail bonds in amounts varying from £1m to £15m - with several paying back non-cash rewards designed to attract loyal customers.

These mini-bonds were innovative and successful. But due to stringent and restrictive regulations, they cannot be issued to more than 150 people, are not able to be issued on an exchange, and are therefore not freely tradeable or transferable like a typical corporate bond. This limits their appeal.

The impressive growth of peer-to peer lender Funding Circle also provides evidence of retail interest in this area. Yet Funding Circle loans are generally limited to £500,000 or £1 million.

At the other end of the scale, there is the Order book for Retail Bonds (ORB), launched in 2010 by the London Stock Exchange. This new exchange allows companies to issue tradable debt paying a regular interest coupon and redeeming for a fixed value upon maturity.

Yet while ORB has enjoyed success in attracting large issuers like Tesco, HSBC, and National Grid, it has proved out of reach for many SMEs. Since its creation the average issue on ORB has been £90 million, far more debt than most SMEs need or could prudently take on. The median market capitalisation of publicly listed ORB issuers is £2 billion - and RBS estimates that 90% of UK corporate bond issuers had revenues over £60 million and more than 2,500 employees.[32] [33] In short, SMEs are not using the ORB today and executives at the LSE believe it is unlikely to be economical for issues of less than £25m.[34]

30 E. Mayo & C. Millstone, *Unfinished Business: The ownership agenda, thirty years on*, ResPublica, 2015, p.15

31 Gallup, *Little Change in Percentage of Americans Who Own Stocks*, 2015

32 Author's analysis

33 Royal Bank of Scotland, *The UK Corporate Bond Wave*, London, 2013, p.3

34 L. Bowman, *UK's retail bond market still out of reach for many SMEs*, *Euromoney*, 2013

THE ALTERNATIVE INVESTMENT MARKET (AIM): *COMBINING PRAGMATISM WITH INNOVATION TO HELP SMES*

Founded in 1995, AIM is the world's most successful growth market, trading almost 10 times as much equity volume as NASDAQ's European Growth Exchange.

AIM has to date helped 3,700 companies raise over £100bn of capital. These businesses are almost all SMEs: today the median market cap of an AIM-listed firm is £29m.

For an SME, the prospect of trying to raise equity capital on the Main Market of the London Stock Exchange is daunting. Listing, prospectus and advisory fees can run into the millions and regulation is burdensome both at the time of listing and on an ongoing basis. There are also stringent eligibility criteria which makes it impossible for many SMEs to even consider.

AIM changed all of this with a pragmatic, lighter, more flexible regulatory approach, which made it cheaper, quicker and easier for SMEs to raise small amounts of equity capital. Over the past decade new companies have on average raised about £15m in their offerings, an amount that would be uneconomical on the Main Market. AIM has also disproportionately attracted retail investors, who own roughly 30% of the shares, three times the proportion of the Main Market.[1]

Many firms which are now household names achieved their potential with the help of AIM, including ASOS and Domino's Pizza. The Government has supported this growth by offering several tax incentives to investors. AIM shares are exempt from Inheritance Tax. Since 2013, they have been eligible to be held in ISAs, and since 2014 they have been exempt from stamp duty.

So what are the barriers to entry? One issue is that unlike the US, there are no standardised prospectuses, meaning that upfront legal fees can amount to over £120,000, with individual agreements for each transaction.[35] Because the ORB has been set up as part of the Main Market, the highest levels of regulated disclosure are required, with expensive prospectuses approved by the UK Listing Authority (UKLA).

The solution is standardisation and simplification. The ORB has already provided template prospectuses for charity issuances, allowing the charity Golden Lane Housing to cost-effectively make an offering of just £11 million in 2014.[36] Were the FCA to issue standardised documentation for issuers looking to make a smaller offering - perhaps on a new AIM-like debt exchange – legal costs could be reduced by as much as 75%.[37]

[35] T. Breedon, *Boosting Finance Options for Business*, London, 2012, p.24

[36] London Stock Exchange Group, *London Stock Exchange Today Welcomed Golden Lane Housing to ORB*

[37] T. Breedon, *Boosting Finance Options for Business*, London, 2012, p.24

UK MINI BONDS: EARLY MOVERS

King of Shaves (2009)[38]

Denomination: £1,000 (paid over three years)

Coupon: 6% as well as an annual sweetener of £30-£60 of the company's products

Total issuance: £627,000

One of the earliest adopters of retail mini-bonds was King of Shaves, with its now infamous 'shaving bond'.

Hotel Chocolat (2010)

Denomination: £2,000 or £4,000

Coupon: Complimentary chocolates with a value equivalent to 6.72% or 7.29%

Total issuance: £4 million

Hotel Chocolat – a firm that by May 2017 enjoyed a market cap of nearly £400 million39 – released its own retail bond shortly after opening its first café in London's Borough Market. The so-called 'chocolate bond' payed out the entirety of the interest coupon in chocolate rather than cash.[40]

LEON (2012)

Denomination: £1,500 or £5,000

Coupon: 10% or 15% in '£eon pounds', which can be spent at LEON stores, on LEON cookbooks, or on places at the LEON Cookery School

Total issuance: £1.5 million

The money was used to take the Leon brand from 11 stores across the UK to 21; a number that has now risen to 45.

Ecotricity (2016)

Denomination: £500

Coupon: 4.5% and 5% to Ecotricity customers

Total issuance: £15m

Ecotricity is a renewable energy company. They have successfully raised over £50m through four separate retail bond issues. The capital raised has help build a number of clean energy projects including the UK's first hybrid solar/wind energy park.

38 Financial Times, *SMEs tap customers with retail bonds*, 2011

39 Financial Times, *Equities: Hotel Chocolat Group PLC*

40 Financial Times, *SMEs tap customers with retail bonds*, 2011

The FCA has acknowledged a belief that retail investors should have greater access to debt issued by established companies, and noted that the disclosure requirements for equity investments are more onerous than apply to other debt platforms. Some improvements might come through the EU's new Prospectus Regime but more likely the FCA will have to take specific action itself.[41]

Any new exchange would also need to adopt a more pragmatic, faster, cheaper and less burdensome regulatory approach, similar to AIM, which would make it economical for small companies to issues less than £25m of debt in bonds.

And while London normally leads the world in financial innovation, in this instance we can look and learn from the experience across Europe where there are multiple examples of SME focused bond exchanges.

Europe's most successful SME debt market, ExtraMOT, is based in Italy - though owned by the London Stock Exchange. It has enabled hundreds of Italian SMEs to raise over €1.6 billion in debt capital through small bond issues, each averaging around €8 million.

When the Italian retail bond exchange was set up, the government simplified not only the legal and tax treatment of the bonds, but also companies' listing requirements - for example by replacing the need for a full prospectus with a simpler disclosure of financial statements and credit ratings.[42] These policies are credited with helping fuel the growth of the market for SME issuers.

41 Financial Conduct Authority, *Review of the Effectiveness of Primary Markets*, 2017

42 European Banking Authority, *EBA Report on SMEs and SME Support Factor*, London, 2016, p.25

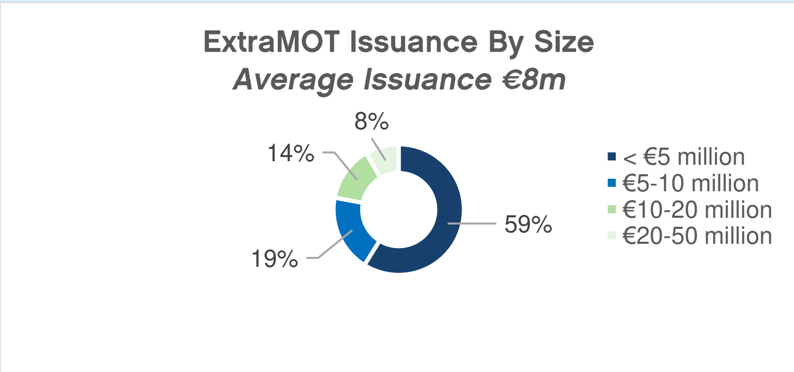
ITALY: A RETAIL BOND SUCCESS STORY

Created in 2009 by the London Stock Exchange-owned Borsa Italiana in Milan, ExtraMOT has been a remarkable success story.

The catalyst for that success came in form of Decree-Law No. 83/2012, legislation enacted by Prime Minister Mario Monti in 2012 that enabled unlisted companies to issue bonds for the first time. The Exchange also established a centralized retail distribution platform which made it much easier and cheaper for companies to access a large number of smaller investors.

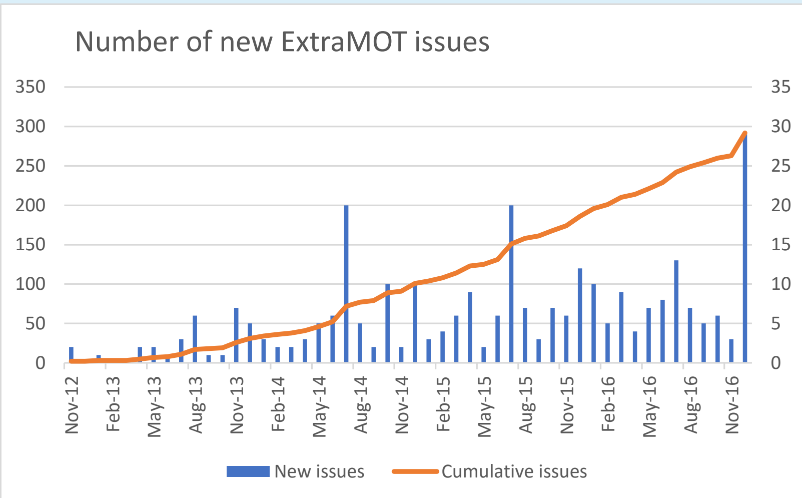
Since the reforms, ExtraMOT had enabled companies to raise over €1.6 billion in sub-€50 million issuances.

With an average issuance of just €8 million, and 58% of issues less than €5 million, this tranche of SME-focused capital has proved a valuable resource for Italy's smaller firms.[43]



Source: minibonditaly.it

Those impressive numbers have made Italy Europe's leading market for so-called mini-bonds, with more issuances than in any other EU country.



Source: Borsa Italiana [44]

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43 Minibonditaly.it, *Minibond Scorecard: Market trends*, 2017

44 WiserFunding, *Assessing the creditworthiness of mini-bond issuers*, 2017

Unsurprisingly, the rude health of Italian SME debt markets has fostered a wealth of case studies for the growth potential that market-based debt finance can offer smaller firms. Caar SpA, for instance, is an aerospace supplier had revenues of just €5 million in 2013. Since issuing a €3 million bond in June that year, the company has gone from strength to strength, hiring its 200th employee in 2016.[45] [46]

Other beneficiaries from the exchange include Fide S.p.A., a specialist in secured personal loans for retirees that raised €2.7 million, and Prismi, a web marketing and search engine optimisation business that was able to use ExtraMOT to raise just €1.7 million.[47]

SPAIN: FOCUS ON THE MIDDLE MARKET

As an economy that felt the 2008 credit contraction particularly acutely, Spain was particularly keen to extend bond issuance beyond its traditional customer base of large corporations, and thereby support credit-starved SMEs.

In a series of legislative changes, Spanish government sought to facilitate this shift towards marketable debt by changing the accounting requirements that restricted many companies' eligibility to issue bonds; simplifying the regulatory burden around listing documentation; and allowing pension funds to invest up to 3% of their assets under management in SME bonds.[48]

The result was the creation of Alternative Fixed Income Market (MARF). With a minimum issue value of just 100,000 euros, MARF specifically caters to smaller businesses, with the average company raising €20 million.[49]

By catering to a previously underserved segment of the market, MARF has experienced impressive growth. Trading on MARF tripled last year, to an outstanding balance of €1.1 billion in corporate bonds as of the close of the financial year.[50] This led to new funding for almost 30 growing Spanish firms.[51]

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45 RSM, *The Mini-Bond Market in Italy*, 2014

46 http://www.caar-to.it/

47 Orrick, *The Italian Mini-bond Market (Part 1)*, 2013

48 P. Guijarro & P. Mañueco, *MARF: Perspectives and risks for Spain´s new alternative fixed income market*, SEFO, Vol.2 N.6, 2013

49 OECD, *OECD Economic Surveys: Spain*, 2017

50 Zoido, Antonio, *Foro MedCap 2017: Opening Speech*, 2017

51 Bolsas Y Mercados Españoles, *Annual Report 2016*

GERMANY: A CAUTIONARY TALE

All investment involves risk, and the German experience of SME bond markets shows the importance of ensuring that the risks of investment remain transparent.

“Bondm", the first bond market catering to the fabled German Mittelstand, opened under the aegis of the Stuttgart exchange in 2010. It was swiftly joined by equivalent offerings from competitors in Düsseldorf (Der Mittelstandsmarkt), Frankfurt (Entry Standard), Hamburg-Hanover (Mittelstandsbörse Deutschland), and Munich (m:access).[52]

The primary innovations associated with these exchanges were a large reduction in the minimum issuance volume from €100 million to around €10 million, and a relaxing of regulation regarding investment prospectuses, making it more affordable for mid-cap firms to turn to the markets for finance.[53]

With coupons paying around 7% and an SME sector with formidable reputation for prudence and reliability, business was soon booming. By the end of 2010 these new bond markets had collectively channelled more than €1 billion into smaller German firms, a figure that by 2015 had burgeoned to nearly €7 billion.[54] In total, around 200 mid-sized German companies had sought funding through the bond markets with a median issuance of €30 million.[55]

For businesses like Bastei Lübbe – the independent Cologne-based publisher which rose to fame for its German-language edition of *The Da Vinci Code* – the new markets offered an attractive way to raise money without the sacrifices of independence that come with a bank loan. It raised €30 million with a bond issuance in 2011.

Unfortunately, not every listing on the new exchanges enjoyed Bastei Lübbe’s success. By 2015, default rates had soared to 17% - driven by the troubled German solar power industry.[56] With confidence rocked, the early flurry of activity on the exchanges dried up.

The root of the problem was that many of the businesses that listed on the exchange were not the financially conservative stalwarts that have come to typify the German middle-market. They were instead associated with much more high-risk investments than buyers realised.

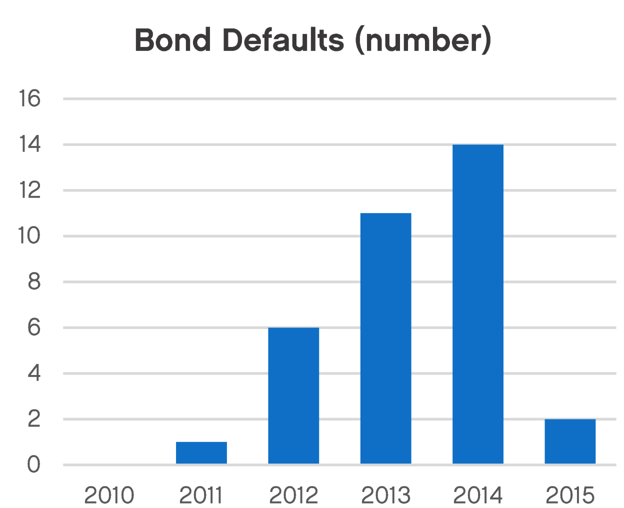
52 Creditreform, *Corporate Bonds in Germany 2013/14*, 2014

53 P. Feihle & J. Lawrenz, *The Issuance of German SME Bonds and its Impact on Operating Performance*, Schmalenbach Business Review, 2017

54 Financial Times, *Mittelstand goes into damage-limitation mode*, 2015

55 Creditreform, *Corporate Bonds in Germany 2013/14*, 2014

56 Scope, *Lessons Learned in the German SME bond market*



Source: FT[57]

That said, many analysts believe that this handful of bad apples tainted an exchange that was serving the majority of issuers well.

Accordingly, Deutsche Börse AG is now relaunching its "Entry Standard" SME bond market as "Scale Standard". The new exchange will have "higher transparency requirements and qualitative prerequisites", aimed at bolstering confidence in its issuers.[58]

Creating a culture for ordinary savers to invest in retail bonds

As the figures for equity ownership above suggest, increasing SMEs' ability to issue corporate debt is only half the equation. To create a successful retail market for corporate bonds, the UK also needs to stimulate demand.

The obvious way of doing this is via tax incentives: catalysing interest in the product either by allowing bonds on this new market to be included in ISAs or via a specific "SME bond" tax allowance.

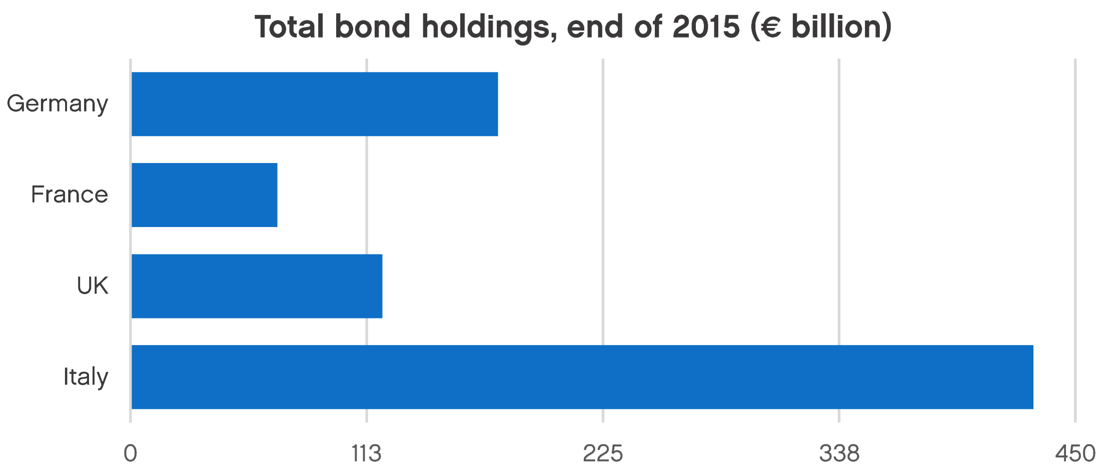
But stimulating demand isn't only a question of money. It is no coincidence that Italy, whose population are some of Europe's most avid bond-buyers, is also home to the continent's most successful SME bond market.

In order to help catalyse a culture of public investment in retail bonds, the UK Government should divert some of its own debt issuance towards retail bond investors, issuing bonds on the new AIM-like debt exchange.

Today, UK Government gilts are generally only offered on markets aimed at large, professional investors. By contrast, the Pensioner Bonds offered in 2014 and 2015 were issued direct to individual savers rather than being issued as tradeable bonds. These would have been a perfect product to kick-start retail bond investing.

57 Financial Times, *Mittelstand goes into damage-limitation mode*, 2015

58 Wall Street Journal, *German Exchange Aims to Revive Market for SME Bonds by Tightening Rules*, 2017



Source: Bloomberg[59]

In the future, the Government could - at almost no additional cost - establish a stronger culture of retail bond investment, by creating a new breed of gilts or other public debt (perhaps infrastructure Project Bonds[60]), offered in low denominations and marketed to household investors.

Similarly, the British Business Bank (BBB) is beginning a securitisation programme (ENABLE, see Appendix), which will package together individual SME loan portfolios from various smaller individual lenders into a consolidated large loan pool. This pool will then be securitised and sold to institutional investors.

It would make sense for the BBB to explore whether these securitized bonds should also be listed on a retail bond exchange, broadening its sources of credit and also providing ordinary savers with an opportunity to invest in a diversified set of SME loans, just like a large institution.

59 L. Casiraghi & T. Beardsworth, *Households on the Hook for Italy's Next Bailout*, Bloomberg, 2016,

60 George Trefgarne, *An idea whose time has come: project bonds*, CapX, 2015

5. RECOMMENDATIONS

1. The Government and the FCA should support the creation of an AIM-type exchange for SMEs to cost effectively raise debt capital from ordinary investors via tradeable corporate bonds in small issues. This will require a more flexible, low-cost regulatory approach.
2. The Government should help foster a culture of retail investment in corporate bonds by providing tax reliefs, either directly for these particular securities or allowing their inclusion in ISAs.
3. The Government should help foster a culture of retail bond investment by issuing more of its own debt on the new exchange, direct to the public, either via gilts, Pensioner Bonds or any future infrastructure or housing bonds.
4. The British Business Bank is currently packaging smaller SME loan books into a larger securitised portfolio through its ENABLE programme. It should issue part of this attractive SME loan portfolio as retail bonds on such an exchange.

APPENDIX: SECURITISATION

Boosting lending to SMEs isn't just about attracting ordinary retail investors. It's about making it easier for non-bank financial institutions with large pools of capital - such as insurers and pension funds - to invest in the sector.

To date, this has not happened for two reasons: scale and liquidity. A large institutional investor with, say, £100 million to invest is poorly equipped to invest in 50 individual £2 million SME loans. The diligence and monitoring costs of evaluating so many separate transactions make the overall investment economics unattractive. Furthermore, institutions often need assets within their portfolios that can be easily converted into cash to respond to internal changes. Loans fail to provide this liquidity, with their value being realised only over a long period of time as the borrower makes repayments.

Securitisation solves both problems at once. This entails a third-party entity buying many individually small and illiquid SME loans, packaging them together and then selling them on as larger size, tradeable bonds. This would effectively create a new investable asset class for non-bank institutions, while simultaneously freeing up capital at the original bank for further lending.

Through its ENABLE platform, the British Business Bank is starting to tackle this problem by aggregating multiple individual SME loan books and then securitising them.

In principle, the notion of SME securities has already achieved widespread backing including from: the Breedon Report which looked at improving finance options for businesses, a former Bank of England Policy Maker, the London School of Economics Growth Commission, the OECD/G20 Finance Committee, and the Association for Financial Markets in Europe.[61] [62] [63] [64] [65]

The policy also benefits from a robust body of precedent, notably in Germany (where packaging is carried out by the government-owned development bank KfW) and in the US (where it is done by the Small Business Administration). In both cases there is additional support provided through a degree of government guarantee for the securitised bonds.

The US Small Business Association also has multiple financial support programmes that increase the availability of debt capital to SMEs: it guarantees SME loan repayments to banks, helps issue tax-exempt bonds, and provides low-cost financing. In Germany, the government bank KfW has for years provided financing to private German banks to fund SME loans and share credit risk.

61 OECD Report to G20, *Opportunities and Constraints of Market Based Financing for SMEs*, 2015

62 T. Breedon, *Boosting Finance Options for Business*, London, 2012, p.24

63 Adam Posen, Bank of England External Monetary Policy Committee Member, *Speech*

64 London School of Economics Growth Commission, *Investing for Prosperity*, 2013

65 OECD Report to G20, *Opportunities and Constraints of Market Based Financing for SMEs*, 2015

Of course, while the securitisation has the potential to unlock billions in new capital for SMEs, it is important to ensure that potential risks are treated seriously. The failings of the US market in 2008 due to lax enforcement of regulations on securitised mortgage loans is well known. It is therefore important that the design of any securitisation agency ensures that loan originators retain meaningful capital in the securitisation portfolio, to ensure their interests are aligned with investors by forcing them to have “skin in the game”.

Rishi Sunak MP