ICAEW
REPRESENTATION 113/23

A SMARTER RING-FENCING REGIME, CONSULTATION ON NEAR-TERM REFORMS

Issued 27 November 2023

ICAEW welcomes the opportunity to comment on *A smarter ring-fencing regime, Consultation on near-term reforms* published by HM Treasury on 28 September 2023, a copy of which is available from this link.

This response of 27 November 2023 has been prepared by the ICAEW Corporate Finance Faculty with input from the Financial Services Faculty.

The Corporate Finance Faculty is ICAEW's centre of professional expertise in corporate finance. It contributes to policy development and responds to consultations by international organisations, governments, regulators and other professional bodies. It provides a wide range of services, information, guidance, events and media to its members, including its highly regarded magazine Corporate Financier and its popular series of best-practice guidelines. The faculty's international network includes member organisations and individuals from major professional services groups, specialist advisory firms, companies, banks and alternative lenders, private equity, venture capital, law firms, brokers, consultants, policy-makers and academic experts. More than 40 per cent of the faculty's membership are from beyond ICAEW.

The ICAEW Financial Services Faculty is a leading centre for thought leadership on financial services, the faculty brings together different interests and is responsible for representations on behalf of ICAEW on governance, regulation, risk, auditing and reporting issues facing the financial services sector. The faculty draws on the expertise of its members and more than 25,000 ICAEW members involved in financial services.

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GENERAL POINTS

1. ICAEW supports the policy objective of increasing availability and supply of finance for SMEs and earlier stage businesses. Our response seeks to inform the outcome of proposals to facilitate the provision of finance to SMEs, in Chapter 2, section C, in the consultation paper.
2. The inherent equity gap for equity finance for SMEs can be more pronounced in challenging economic conditions. Enabling ring-fenced banks (RFBs) to make equity investments can help in this context. However, RFBs will undertake equity investment if they can do so competently, responsibly, and profitably.
3. HM Treasury should explore in banks' responses to this consultation the impact of capital and liquidity requirements on their appetite to make equity investments, and potential barriers to undertaking the business such as the existence (or otherwise) of the necessary resources (people and expertise).

COMMENTS ON SPECIFIC QUESTIONS

Question 10 Do you agree with the proposal to permit RFBs to (i) make direct minority equity investments in UK SMEs, (ii) make investments in funds that invest predominantly in UK SMEs and (iii) acquire equity warrants in UK SME borrowers, up to 10% of tier 1 capital?

Question 11 To what extent do you think this proposal would help to unlock equity financing in the UK and address UK SMEs' financing needs? If responding as a ring-fenced group, would you undertake this type of activity?

Question 12 Is the UK CRR definition of SME viable as a size limit for equity investments, both directly and indirectly through funds? If you believe it is not, please suggest an alternative definition. The government is open to considering alternative definitions that may better reflect current market practices and investment strategies, provided that this supports the overall policy objective.

Question 13 On the proposal to permit investments in funds that invest predominantly in UK SMEs: (i) what do you perceive as the risks and benefits of this proposal? (ii) if responding as a ring-fenced group, can you provide further information on the type of funds you may consider investing in? (iii) would you consider establishing a fund that meets the conditions set out in the draft secondary legislation? (iv) do you consider that the proposed types of permitted funds capture those which are currently operating in UK SME markets?

4. The Skeoch Review concluded, inter alia, that there could be benefits to reviewing the excluded activities of the ring-fencing regime while maintaining appropriate financial stability safeguards. The government believes that limited provision of equity finance (up to 10% of an RFB's consolidated tier 1 capital) would have beneficial outcomes for consumers and banks and is unlikely to materially increase the risk to RFBs' safety and soundness.
5. Our members work in and trade with UK SME businesses, from micro businesses to the largest ones. They also invest in such companies and advise them - including on financing and capital structures. Drawing on our members' and ICAEW expertise, our comments are intended to inform the decision to relax this ring-fencing restriction or not. We thus focus on the following issues:
    - Is there a gap in finance that might be supported through RFB equity investment?
    - What are the factors that will influence RFBs' appetite to take equity stakes?

Availability of equity finance for SMEs

6. It is generally accepted that there is an inherent equity gap for SMEs due to relatively high risks of failure and information asymmetry. The past 10-15 years have seen an increase in the number and variety of funding sources, and initiatives to raise business awareness of funding options and the value of seeking advice. The equity gap can, however, be more or less pronounced depending on market and economic conditions. ICAEW provided evidence to the Treasury Committee[1] of recent constraints to SMEs' access to equity finance where declining investor risk appetite and economic and geopolitical uncertainty has played a part.
7. Broadening the availability of sources of equity finance would help ensure greater competition and resilience. In this context, enabling RFBs to make equity investments is to be welcomed, although it is unclear how much equity the proposed limit will make available in aggregate across RFBs, and if it would be available to different types of SMEs.
8. The venture capital and private equity sectors are established investors in UK SMEs. At any time, certain sectors or types of business will struggle to attract equity finance for later stage growth. Businesses that are more capital-intensive or R&D-based will likely require capital for a longer term than such investors typically provide. More patient equity investment is available from funds like the BGF and Future Fund: Breakthrough - investment by RFBs into such funds would increase their firepower.
9. The British Business Bank's funds aim to alleviate equity funding gaps, including by crowding in private finance. In further efforts to boost funding for business growth, the government is turning to institutional investors to facilitate investment by pension funds in certain UK businesses or sectors through, respectively, the Mansion House Compact and the Long-term Investment for Technology and Science (LIFTS). Permitting RFBs to take equity stakes in UK SMEs could help address the equity gap, including for businesses that are out of scope of those initiatives.

RFBs' appetite for equity investments in SMEs

10. We share the concerns in the consultation paper that the regulatory prudential treatment may discourage RFBs' appetite to pursue the benefits identified in the Skeoch review and, by extension, determine the extent to which equity financing for UK SMEs may be unlocked. We include other influencing factors below.

Capital requirements

Direct investment in SMEs

11. The capital requirements regime reflects the different levels of risk involved in equity investing versus conventional lending to SMEs. Exposures to private equity investments are assigned a risk weighting of 250% under the standard approach, or 190%/ 370% under the advanced approach (simplified method). This compares to a typical risk weighting for conventional SME lending of 75-85%.
12. RFBs' appetite for such investment will depend on whether the return they can generate from the investment, or the broader client relationship, is sufficient to compensate for the additional capital requirement coming from the higher risk weighting. RFBs will evaluate whether or not the proposed cap on equity investment is likely to mitigate risk to return on investment in earlier-stage SME businesses (too low), or the time to exit (too long).
13. With respect to the client relationship factor, we would remark that the difficulty for small businesses opening bank accounts is a long-standing issue. In its aforementioned evidence to the Treasury Committee, ICAEW reported challenges faced by SMEs such as banks'

[1] Call for Evidence: SME Finance (icaew.com)

prioritisation of larger businesses over smaller ones. At the smaller end of SMEs it is unlikely there would be a banking relationship manager. See also the point about specific expertise below.

Investment in funds

14. Banks' investments in funds would be risk-weighted using a look-through approach or mandate-based approach (to the underlying investments), to avoid a punitive risk weighting. Therefore they would receive a similar 190% /250% /370% risk weight to the direct investments, again higher than conventional SME lending.
15. Investment with other institutions in funds is complex and requires the capability to understand the allocation of risk. The BGF provides a precedent.

Concentrated exposures

16. Banks are required to manage the concentration of their exposures to various sectors of the economy as part of their Pillar 2 assessment. Equity investing could either increase or decrease this level of concentration depending on which sectors an RFB's SME clients operate in.
17. Moreover, banks' investments over certain thresholds (particularly if the investments are in other financial sector entities) are treated in the UK CRR as a deduction from regulatory capital.

Valuation

18. The fair value of equity investments will likely be subject to greater volatility compared to lending. This volatility will affect banks' financial projections and stress testing.
19. Depending on the accounting treatment chosen, changes in the fair value of equity investments would translate to a movement in reserves, which would have a direct impact on banks' regulatory capital resources.

Expertise in equity investment and risk

20. Some banking groups already make equity investments in SMEs through their non-ring-fenced banks (NFRBs) and transfer of appropriate skills within the group may be possible. RFBs will, otherwise, need to build very specific skills and expertise specific to equity investing in earlier stage businesses and SMEs. Such skills will be needed even if RFBs have close business banking relationships or deep knowledge of client business models - equity investment is very different to secured lending.