# Treasury Select Committee SME Finance Call for Evidence

## UK Finance Response

**01-09-2023**

UK Finance is the collective voice for the banking and finance industry. Representing more than 300 firms, we act to enhance competitiveness, support consumers, and facilitate innovation. We work for and on behalf of our members to promote a safe, transparent and innovative banking and finance industry.

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## Introduction and executive summary

**UK Finance is the collective voice for the banking and finance industry. Representing around 300 firms, we act to enhance competitiveness, support customers, and facilitate innovation. We welcome the opportunity to respond to the Treasury Select Committee's (TSC) call for evidence on SME Finance.**

## Summary

### Availability of Finance for Small and Medium Enterprises (SMEs)

- Banks and lenders have the capacity and willingness to support UK SMEs in accessing finance. 2022 saw £65 billion of gross lending (defined with respect to loans excluding overdrafts) to SMEs, the highest since comparable records began in 2012 (except 2020 owing to Covid), and credit to SMEs continues to flow at around £5 billion gross per month (Source: Bank of England). This flow of lending comes from an SME Finance market that is more diverse than ever.
- This comes on the back of £72.5 billion of lending provided under the Covid lending schemes to SMEs which has created a large legacy debt that needs to be managed and which will inevitably reduce over time. The overall stock of SME lending is £188 billion (Source: Bank of England), having reduced from its Covid peak, but still around £30 billion higher than before Covid.
- In many cases SMEs supported by the Covid lending schemes have also been able to build higher than average cash deposit levels which, although now reducing in size, are still at healthy levels and reduce the demand for new finance.
- Against this backdrop it is perhaps no surprise that despite the high levels of new lending to SMEs and the sector's capacity and commitment to lend to viable businesses, demand for finance from SMEs as a whole remains relatively subdued. This is in line with the longer-term norm of many SMEs being permanent non borrowers. In keeping with this longer-term pattern there is a notable difference in demand between more established SMEs and smaller/newer SMEs many of whom borrowed for the first time during Covid under the Bounce Back Loan Scheme and as highlighted above are now focussed on paying back existing debt.
- Inevitably economic headwinds are also presenting affordability challenges for some SMEs looking to take on more finance. Inflation, higher energy, and other input costs and the cost of living crisis, are all squeezing profit margins. Skills and labour shortages are adding to this challenging climate.
- In this context it is important to remember that banks and lenders provide more than access to finance. They provide a significant range of support schemes, including mentoring, networking, investment readiness programmes and signposting to other sources of help and information. It is important that all relevant stakeholders encourage businesses to make use of this support and information.

### Access to venture capital and equity investment and the role of the BBB

- Finance to SMEs is more than just debt finance provided on commercial terms. There is a significant opportunity to broaden access to venture capital and equity investment into SMEs, especially addressing regional and gender gaps in this market. UK Finance has also recently made recommendations on improving the functioning of the UK's public markets.

- The British Business Bank (BBB) has an important role in supporting the scale up and equity finance markets. The BBB should continue to lead on addressing market gaps where financing on commercial terms might not be possible, for instance for parts of the start-up market, and supporting with wholesale tools such as ENABLE guarantees, ensuring they are readily accessible and relevant.

### Importance of proportionate regulation and access to dispute resolution

- It is critical that regulatory interventions balance the need not to hamper an increasingly innovative and diverse SME Finance market, which is delivering for its business customers, with the need to ensure lenders keep acting on a responsible basis.
- Voluntary regulation (the Standards of Lending Practice for Business Customers), overseen by the Lending Standards Board and endorsed by the FCA, has driven up standards focused on outcomes and good conduct. These Standards have been expanded and broadened quickly in response to gaps, for instance over the role of business turnaround units. In addition, there are also specialist initiatives setting and enforcing standards for particular finance products, such as the Standards Framework for Invoice Finance and Asset-Based Lending, which is supported by UK Finance.
- The ability to focus on agile, outcome-focused standards, rather than costly and complex regulation which treats all SMEs the same as retail consumers (noting that at the smallest end a lot of lending to SMEs is already captured by the Consumer Credit Act) is a key factor behind what is an increasingly competitive sector in which over half of gross SME lending is done by challenger and specialist banks.
- An expansion of the formal regulatory perimeter could also have implications for the costs and availability of finance for SMEs, as would the proposed removal of the SME support factor under the Basel 3.1 proposals.
- It is, however, vital that SMEs are protected and, in addition to the standards outlined above, UK Finance supports the extension of the Financial Ombudsman Service as the Business Banking Resolution Service is wound-back as a means of seeking dispute resolution. This would provide access to the FOS for 99 per cent of UK SMEs and align with the Walker Review recommendations published in 2018.

### The PRA's proposal to remove the SME support factor, as part of the proposed Basel 3.1 capital requirements framework

- UK Finance is broadly supportive of many of the PRA's proposals with regards to Basel 3.1, but we do not support the withdrawal of the SME support factor. We believe that without the SME support factor, the cost of lending to a critical component of the UK economy will increase and borrowing demand consequently reduce.

### Business account closures

- In view of recent media coverage and political interest over the provision of banking services to business customers, we felt it would also be relevant to include further evidence on this topic to inform the Committee.

## The sector is rising to the challenge

- In summary, banks and lenders are fully committed to the SME sector, as demonstrated by the continued availability of credit and the SME Finance Charter adopted by the market as recently as 2022.
- Broader economic challenges, a higher interest rate environment, and the relatively high levels of borrowing taken on during Covid are dynamics impacting the market. There is also evidence of more subdued demand for finance as was the long run norm pre Covid, as well as some affordability issues, at the very smallest end of the market where further lending would not always be responsible.
- Any SME seeking to understand their finance options has a variety of tools to do this which we discuss in this response. Banks and lenders also provide a wide range of support on general business issues and are constantly innovating to engage with customers and give them access to the support they need.
- Any business with concerns around their current borrowing, including those which may be vulnerable or experiencing financial difficulty, should feel confident to engage with their provider at the earliest possible stage to receive the best support. In addition, borrowers with Bounce Back Loans, which numerically make up a very high proportion of loans to SMEs, have clearly accessible and standardised options under Pay as You Grow.

This response sets out recommendations to address some of the issues flagged above and by this enquiry. These are highlighted in the text below.

## Question 1. What are the key challenges Small and Medium-sized Enterprises (SMEs) face when seeking finance?

This response defines SMEs as businesses with an annual turnover of up to £25 million, in line with the Bank of England's definition. We would note however that there is no single clear definition of SMEs.

Banks and finance providers have the capacity and willingness to support new and existing SME customers, with a range of finance providers specialising in supporting these businesses. Our members report robust competition for new business and funding options for SMEs have never been more diverse. For credit worthy SMEs, the challenge is one of demand rather than supply. Increasingly credit worthy SMEs will invite several competitive offers for finance helping them to obtain the best price, product and structure.

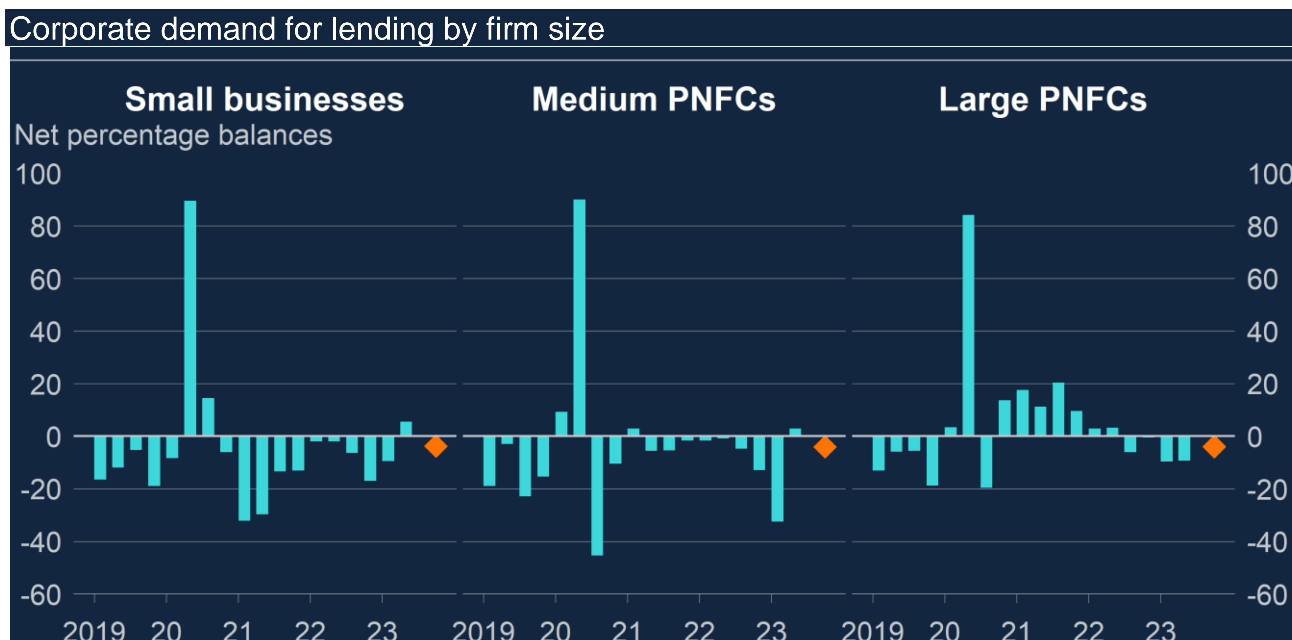
The Covid pandemic resulted in banks and finance providers providing unprecedented levels of support to UK SMEs, many of which could have failed, lending almost £80 billion through the Covid schemes. Lenders also continued to maintain normal lending and provided a variety of forbearance, re-financing and other options to their business customers to support them through the significant shock to cash flows across many sectors.

In recovering from the pandemic, SMEs bolstered by the continued support of banks and lenders have demonstrated resilience in the face of more challenging trading conditions and significant cost pressures. It should be noted that we expect these obstacles to ease gradually.

Despite healthy new levels of lending to SMEs, higher than seen pre Covid, for a high percentage of SMEs demand for finance post Covid has been relatively subdued. This is both reflective of the longer-term pattern of many SMEs being permanent non borrowers as well as a variety of current factors including a challenging economic climate, reduced business confidence, and the legacy of Covid borrowing. Muted investment intentions and recent rises in the Bank of England base rate are also likely in the short term to continue to act as a drag on demand for finance.

The Bank of England's quarterly Credit Conditions Survey data shows the broadly subdued demand for SME finance which has been seen since Covid:

Corporate demand for lending by firm size




**Source: Bank of England Credit Conditions Survey Q2 2023** Chart 5: Corporate demand for lending by firm size.

The survey asks the question 'How has overall demand for lending from small businesses, medium PNFCs and large PNFCs changed?' to lenders. A positive balance indicates an increase in demand.

Net percentage balances are calculated by weighting together the responses of those lenders who answered the question. The aqua bars show the responses over the previous three months. The orange diamond shows the expectation over the next three months

## Covid legacy

The Covid pandemic saw a dramatic increase in the level of borrowing taken on by SMEs, primarily though not exclusively, underpinned by the government-backed lending schemes launched because of the pandemic. The levels of borrowing taken on during that period, and the legacy of borrowing that needs to be repaid, combined with other factors such as levels of deferred or unpaid tax, will continue to be significant considerations for those finance providers that support SME businesses.

UK Finance SME data illustrates the impact of the Covid schemes with the number of loan accounts increasing from 470,000 (Mar 2020) to 1,750,000 (Mar 2021). The number of loan facilities approved/increased in month rose from 32,000 (2020 Q1) to 953,000 (2020 Q2).

Bank of England statistics show that total SME loan repayments were £73 billion in 2022. As at March 2023, £15.9 billion of Covid loan guarantee scheme debt, including CLBILS which was not available to SMEs, had been fully repaid by borrowers (COVID-19 loan guarantee schemes performance data).

Up to £33.5 billion was formally deferred under the VAT payments deferral scheme and whilst the majority owed by still-trading businesses will have been paid, UK Finance members report significant levels of crown arrears in certain sectors. Further commentary on the interaction between the tax and insolvency regimes on the one hand and on the access to finance and business support agendas on the other, including on the significant role played by HMRC as creditor, is provided in response to Question 18 below.

Gross lending to SMEs was fairly stable in the 2017-2019 period, at around £57-58 billion a year according to Bank of England data. During 2020, gross lending increased significantly to £105 billion. It returned to a pre-Covid level of £58 billion in 2021, before rising to £65 billion in 2022. Although this is a return to a more 'normal' level seen pre Covid, the 2022 figure is still higher than for any year between 2012 and 2019, which demonstrates the industry's capacity and willingness to finance UK SMEs.

Between the start of the Covid pandemic and March 2023, businesses drew a total of £46.6 billion through the Bounce Back Loan Scheme (BBLS), and £25.9 billion through the Coronavirus Business Interruption Loan Schemes (CBILS).

A corresponding increase in the amount of outstanding SME bank lending stock saw this rise from circa £150-160 billion pre-Covid to £205 billion at the end of 2020, £200 billion in 2021 and £188 billion in 2022, according to the Bank of England. Net lending numbers have been negative because SMEs as a whole have prioritised repaying Covid-related borrowing in recent years. We anticipate this to be a significant trend in 2023 and for the coming years with the extension of repayment terms. BBLS had a six-year repayment term as standard and CBILS permitted repayment terms of up to six years. Under BBLS, business have a variety of options under Pay As You Grow, which includes the right to extend their BBL to a ten-year term and the ability to take capital repayment holidays or capital and interest repayment holidays. Over 22 per cent or 340k of customers have extended their BBL to 10 years, in many cases along with payment holidays. See the COVID-19 loan guarantee schemes performance data as at 31 March 2023, table 5 on PAYG usage (COVID-19 loan guarantee schemes performance data).

A notable feature of BBLS was that most applicants were first-time borrowers, so they did not have other debt. As such many of these first-time borrowers do not have the desire to borrow further and are instead focussed on paying back their existing debt. Inevitably existing debts are also a factor considered by any responsible lender when assessing the affordability of further finance. It is important to stress, however, that for those servicing the borrowing satisfactorily, this demonstrates an ability to manage debt which would be seen as a positive lending assessment factor for any future borrowing requests.

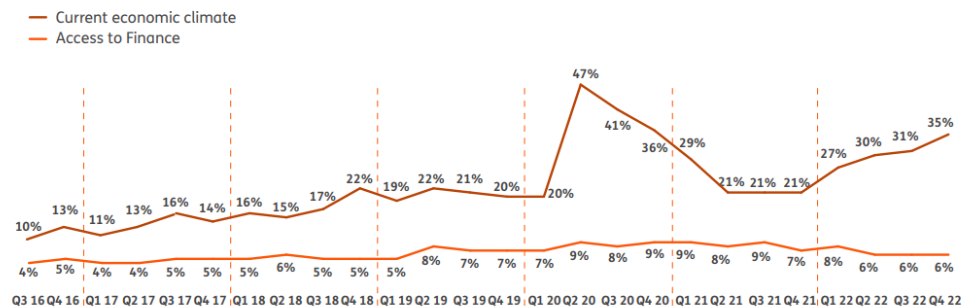
## Economic challenges

According to the latest annual SME Finance Monitor (Q4 2022), 41 per cent of all SMEs saw increasing costs as a high future barrier to their business, with little variation by size of SME but with more mentions from those in Hotels & Restaurants (63 per cent) and Transport (55 per cent). This has been the top barrier since this metric was included in Q4 2021, when 34 per cent of SMEs saw it as a barrier. Increasing concern about the economic climate was also reported by many businesses as a barrier. In 2022, the number of SMEs reporting this as a barrier to their business increased to 35 per cent of SMEs (approaching the 40 per cent seen in 2020). It was a particular concern for smaller SMEs, particularly those trading for 2-5 years (47 per cent), those in Hotels & Restaurants (48 per cent) and Import-only SMEs (58 per cent). Access to finance by contrast was reported as a perceived barrier to running their business by only about 6 per cent of SMEs in 2022, returning to its pre-Covid levels.

Although subdued interest in finance by many of the smaller SMEs is a longer run pattern, the correlation of economic uncertainty and rising costs to business confidence and growth plans represents another factor holding back demand for finance from some SMEs.

**Obstacles perceived to running business – Current economic climate and access to finance**

Time series: 8-10 major obstacle

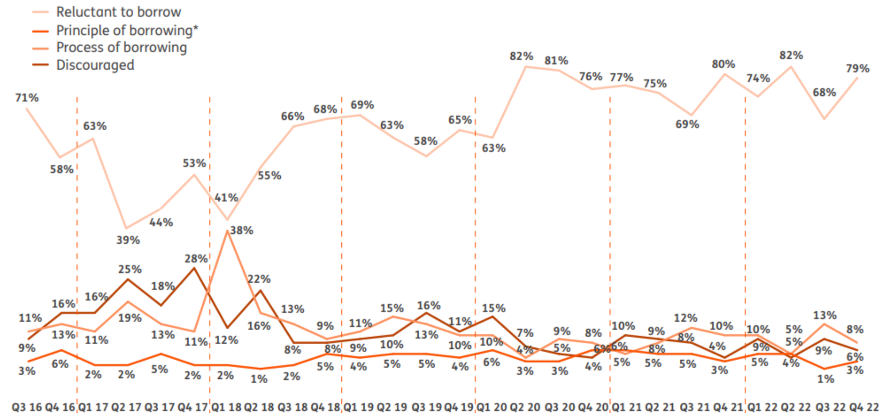



**Source:** [SME Finance Monitor Q4 2022] chart on obstacles perceived to running business – current economic climate and access to finance (p. 383).

The SME Finance Monitor also asks SMEs not currently seeking to borrow, but who are potentially future borrowers, the main reason for their current non-use of external finance. Reluctance to borrow has remained at relatively high levels since Covid, which supports the above analysis that the long run pattern of many businesses being permanent non borrowers as well as the current economic conditions are acting as a drag on demand, rather than borrowers facing discouragement from lenders or being discouraged by the actual process of borrowing.

**Main barriers for Future would-be seekers**

Time series: Main reason for not seeking borrowing amongst Future would-be seekers




**Source:** [SME Finance Monitor Q4 2022] chart on main barriers for Future would-be seekers (p. 385).

## SME lending: Supply and Demand

The summary table below provides a good overview of the flow and stock of external finance for UK SME's. Although flows of different types of finance are not directly comparable, the data demonstrates that bank lending remains the largest form of external finance used by SMEs.

**Estimates of the flow & stock of external finance for UK SMEs (£ billions) (a)**

| | | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|---|---|---|
| **Bank lending flows**<br>Source: Bank of England | Gross flows (b) | 57.3 | 57.8 | 56.9 | 104.9 | 57.7 | **65.1** |
| | Net flows (c) | 0.7 | 0.6 | 2.1 | 46.6 | -8.0 | **-8.4** |
| **Banking lending stock**<br>Source: Bank of England | Outstanding Amount (d) | 153 | 154 | 156 | 205 | 200 | **188** |
| **Bank overdraft stock**<br>Source: Bank of England | Outstanding Amount (d) | 12.5 | 11.9 | 11.4 | 8.3 | 8.7 | **8.9** |
| **Total bank stock**<br>Source: Bank of England | Outstanding Amount (d) | 165 | 166 | 168 | 213 | 209 | **197** |
| **Other gross flows of smaller business finance** | | | | | | | |
| **Private external equity**<br>Source: Beauhurst (g) | | 6.9 | 7.2 | 8.3 | 9.6 | 18.1 | **14.8**<br>(Q1-Q3) |
| | Number of announced deals | 1841 | 1899 | 2002 | 2244 | 2601 | **1932**<br>(Q1-Q3) |
| **Asset finance flows**<br>Source: The Finance & Leasing Association (FLA) | | 19.3 | 19.8 | 20.6 | 16.3 | 20.3 | **22.5** |

**Source: British Business Bank** Small Business Markets Finance Report 2022-23 Figure 1. Estimates of the flow & stock of external finance for UK SMEs (p.15).

(a) The information contained in this table should be viewed as indicative as data and definitions are not directly comparable across different sources. There can be some double counting across estimates in different parts of the table. Flows data are cumulative totals for the year or to the date stated. Non-seasonally adjusted. All numbers are in billions, except number of reported equity deals, and have been rounded appropriately.
(b) Data exclude overdrafts and covers loans in both sterling and foreign currency, expressed in sterling. The total may not equal the sum of its components due to rounding.
(c) Net flows does not always reconcile with change in stock due to differences in statistical reporting. The reported stock can include other adjustments made by banks but not detailed when reported, whereas flows data does not include these adjustments.
(d) Movements in amounts outstanding can reflect breaks in data series as well as underlying flows.
(e) Beauhurst is a data provider that records visible equity deals including crowdfunding deals.
(f) FLA's members make up 90–95% of the market.

Gross lending excluding overdrafts to small and medium sized enterprises (SMEs) by all banks has been relatively stable, apart from the record high seen in 2020 driven by Covid-19 lending. The 2022 figure of £65.1 billion reported by the Bank of England is higher than any year between 2012 and 2019.

2023 Bank of England non-seasonally adjusted data shows that £28.4 billion of new lending took place to May 2023, which demonstrates that finance continues to flow to SMEs and that supply is not constrained.

The stock of bank lending has declined, in part because SMEs with Covid-19 loans have started to repay them. At end-2022 the bank lending stock was £188 billion, down from £200 billion in late 2021 and the lowest since the end of 2019. SMEs have also returned to using working capital and short-term facilities, which increased dramatically in 2022.

A market change to note is that the high street banks no longer account for the bulk of this gross new lending by value. Bank of England data published by the British Business Bank indicated that in 2022, 55 per cent of gross lending to SMEs was provided by challenger and specialist banks. It should be further noted that the Bank of England dataset referenced does not include lending through non-bank specialist providers, indicating an even higher proportion of finance being provided by institutions outside the traditional high street banks. This is positive, reflecting a trend to a more competitive lending sector in which the high street banks continue to provide healthy levels of funding to SMEs, but now do so alongside newer competitors.

The increased diversity in the supply of SME finance, both in terms of institutions and products is also evidenced by the continuing growth of other sources of funding, including asset finance. SME asset finance new business increased 11 per cent in 2022 to £22.5 billion, according to Financing & Leasing Association data. This was the highest level on record.

There has been overall growth in the finance provided through working capital facilities since the end of the pandemic, but this recovery has been more nuanced for SME businesses.

Total advances to businesses of all sizes through invoice finance and asset-based lending (IF/ABL) facilities stand at near record levels (almost £21 billion being advanced to businesses of all sizes at the close of Quarter 1 2023). In 2022 UK Finance's IF/ABL members supported client businesses with a combined turnover of around £314 billion. However, reflecting trends seen in other products, advances to SME businesses have recovered more slowly as the impact of the various Covid interventions roll off.

At the end of Quarter 1 2020 (the last quarter prior to the impact of Covid being felt) the average advance to SME businesses (businesses with an annual turnover of £25 million or below) through IF/ABL facilities stood at £243,000. The average advance fell as low as £138,000 during the pandemic as the suppression of economic activity during the lockdowns and displacement by government interventions disproportionately impacted commercially provided working capital facilities. Average advances to SMEs recovered to pre-pandemic levels in mid-2022 and have broadly held steady since at around £245,000, with members reporting significant headroom within existing clients' facilities, as well as strong appetite for new business. (Source: additional analysis of UK Finance IF/ABL data; available on request).

Demand for finance from viable businesses is generally being met. It is also important to note that the SME market is characterised by a high percentage (47 per cent) of "permanent non borrowers", typically micro and smaller businesses that are not capital intensive and are traditionally self-funding.

Discussions of SME access to finance issues have a long pedigree, even pre-dating the Macmillan Gap discussions in the 1920s. In summary, it is best to distinguish between two different access to finance issues – one linked to debt and the other equity.

In the case of debt funding, independent research confirms that between 70-80 per cent of all credit applications from SMEs resulted in a facility pre-pandemic (self-reported by SMEs) although this figure has recently dipped due to current market conditions and the pressures this has put on affordability. Some businesses for whom overdraft or loan finance may not be appropriate may be better suited to a different finance product such as leasing, asset finance or working capital products such as invoice finance or asset-based lending.

However, certain groups of applicants do find it more difficult to obtain finance. These groups include firms with a poor or rapidly deteriorating credit rating, start-ups, new businesses and businesses new to borrowing. This is often due to a lack of trading history, relevant data and a lack of capital or security. Businesses with these characteristics present a greater risk of default and loss. The British Business Bank's Start-Up Loan Scheme and Recovery Loan Scheme (for smaller businesses with a turnover up to £45 million) are important policy interventions addressing this issue.

Some businesses will have a finance application declined due to a poor credit history, because they cannot fund the repayments or do not have the financial resilience to ensure adverse changes to the business can be managed. It is not responsible to lend where there is a sufficiently material risk that the business borrowing the funds may not be in a position to repay, in full. However, where there is a viable opportunity to lend, it is in a bank's best interest to do so.

At different times, businesses in some sectors may find it harder to raise finance than others due to current market trends affecting a particular sector, risk ratings and lender appetite. SME housebuilders are an example of a sector facing a range of different challenges which has led to government policy interventions such as the Levelling Up Home Building Fund which provides development finance to SME housebuilders, as well as infrastructure funding to support developers, master developers and landowners. The British Business Bank's ENABLE Programme has also supported the provision of finance to this sector.

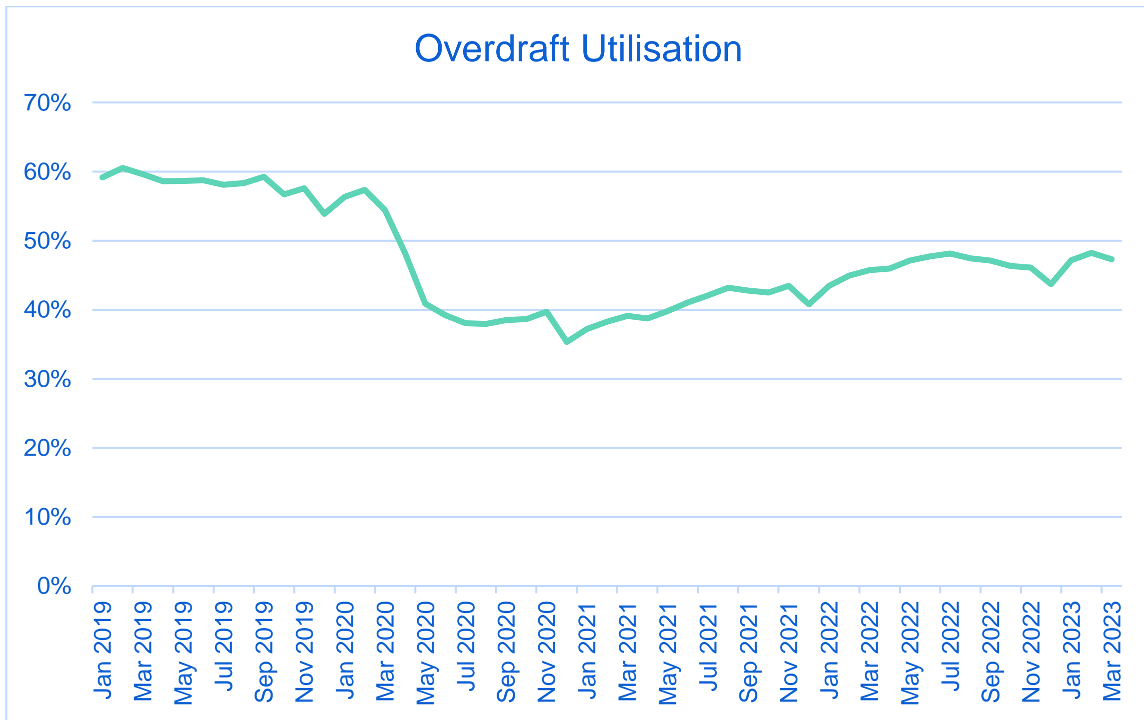
Equity is discussed under Question 5. The UK now has one of the most comprehensive SME equity markets in the world, particularly in the area of seed funding and venture capital. It was also an area of focus in the 2010 Business Finance Taskforce review which supported the creation of the Business Growth Fund which was established and capitalised by the major banks.

Substantial public resources have been successfully deployed to this issue for a number of years including those of the British Business Bank. However, it is still the case that some SME equity gaps are reported (mainly in what is termed "follow on" capital).

### Financial Headroom

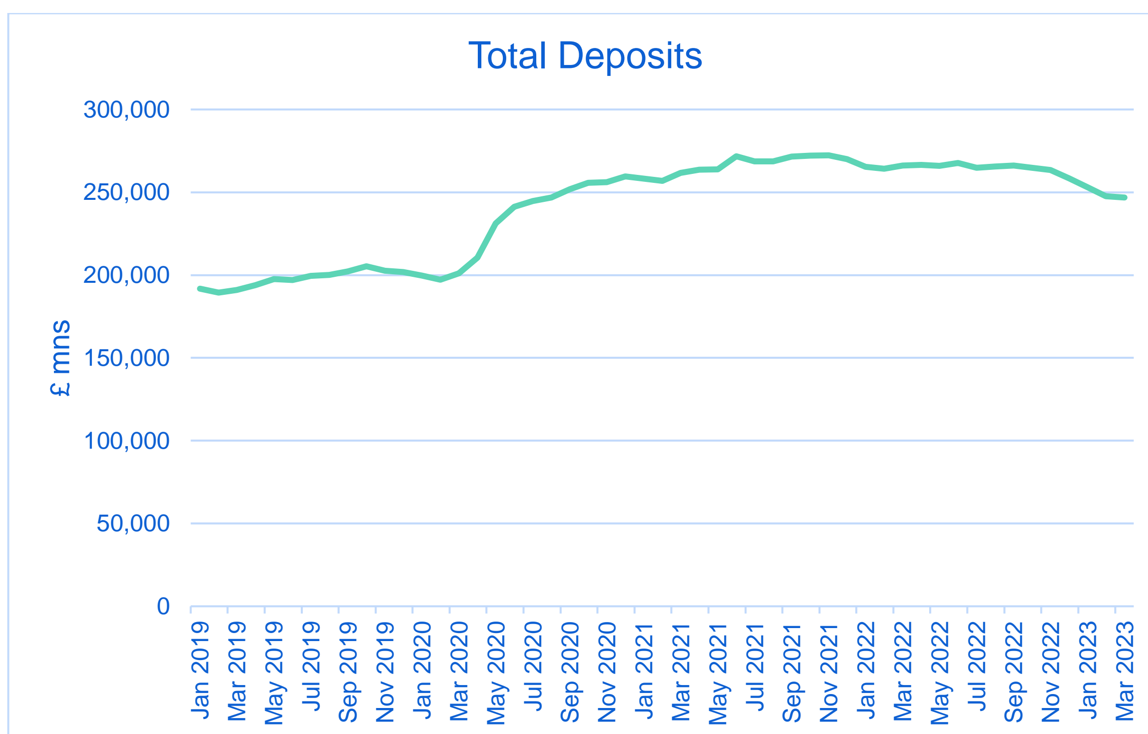
For the past two years the headroom that SMEs, in aggregate, have within their existing cash deposits and lending facilities has been notable. This is similarly reflected in IF/ABL facilities with usage dropping to well below 50 per cent of total availability during the Covid period and still not yet recovering to typical pre-pandemic levels of usage.

For many SMEs the cushion of cash deposits and/or capacity within their existing finance facilities has provided a safety net from the various economic challenges they have faced into, even after emerging from the pandemic. Weak growth, rising input costs and energy price spikes have impacted businesses over the past year. Nevertheless, we have seen minimal depletion of available resources over this period. UK Finance Q1 2023 data on overdraft utilisation and available deposits reveal a largely unchanged trend at the start of 2023.




**Source: UK Finance** **Business Finance Review Q1 2023** Chart 10: Overdraft utilisation, percentage (p.8).

Overdraft utilisation has averaged 48 per cent in the first three months of the year, only fractionally higher than the average seen across 2022 (46 per cent). There is, however, some sector variation. Notably the Accommodation and Food Service sector saw a stronger growth in overdraft demand than the SME average and more recently a significant uptick in utilisation relative to other industries. Average utilisation amongst the Accommodation and Food Service SMEs was just under a third last year, but this jumped to 44 per cent in the most recent quarter – potentially reflecting the ongoing cost pressures facing this sector. Larger than average increases in overdraft utilisation can also be seen in Wholesale and Retail, and Recreation and Personal Services. It should be noted that utilisation levels in other working capital facilities, particularly IF/ABL lines, have followed similar trends, with significant headroom within pre-agreed facilities.




**Source: UK Finance** **Business Finance Review Q1 2023** Chart 11: SME Deposits (p.8).

Many SMEs built up cash reserves during the Covid pandemic. UK Finance SME aggregated data shows that as of March 2023, SMEs have £53 billion more deposit and current account credit balances than they had in March 2020 (£194 billion in March 2020 vs £247 billion in March 2023).

SME deposits have been gradually drifting lower over the past year and at the start of 2023 took a slightly larger step down. At the end of the quarter total deposits were nearly five per cent lower when compared with the end of the previous quarter. This marks the largest quarterly decline since the pandemic and puts the level of deposits at the lowest level since August 2020.

Declining deposits were seen across all the main sectors within our sample, with the largest falls seen in Accommodation, Food, and Agriculture.

While the current level of deposits continued to provide a solid cushion for SMEs, it should also be noted that based on analysis of the SME Finance Monitor data, almost 312,000 SMEs hold more than £85,000 in credit balances, over the FSCS protection limit.

### Understanding SME Finance Regional Differences

The UK's 5.5 million SMEs in the UK are located across all regions and nations, and they are not homogeneous. Given differences of economic performance across the country, concerns have sometimes been expressed that regions outside of London and the South-East are disadvantaged in terms of access to bank finance.

When making regional comparisons it is important to reflect the profile of the economy of the region, including the number of businesses, the size of these businesses and other demographics such as industry sector, ambitions to grow and how the need to borrow drives demand.

The table below demonstrates that bank finance remains well spread across the UK and is consistent with the business population and size of firm in each region. It is importantly also true of the flow of new overdraft and loan finance.

**Bank Finance across the UK**

| | Total business numbers (a) | Total employment (a) | Total turnover (excluding VAT) (a) | GVA (b) | Stock of lending (Loans and overdrafts) | Gross lending |
|---|---|---|---|---|---|---|
| North East | 2.9% | 2.7% | 1.9% | 2.9% | 3.1% | 2.8% |
| North West | 9.5% | 9.6% | 8.6% | 9.9% | 9.8% | 9.9% |
| Yorkshire & Humber | 7.2% | 7.6% | 6.4% | 6.7% | 7.2% | 6.8% |
| East Midlands | 6.8% | 7.8% | 6.0% | 6.0% | 5.6% | 5.0% |
| West Midlands | 8.1% | 8.9% | 7.6% | 7.4% | 8.8% | 7.6% |
| East of England | 10.1% | 10.7% | 9.4% | 8.7% | 7.0% | 6.5% |
| London | 19.3% | 20.8% | 29.9% | 24.6% | 22.1% | 24.6% |
| South East | 15.7% | 14.4% | 17.5% | 15.2% | 13.1% | 11.6% |
| South West | 10.0% | 7.7% | 5.7% | 7.6% | 10.9% | 12.8% |
| Wales | 4.1% | 3.3% | 2.2% | 3.5% | 4.2% | 3.3% |
| Scotland | 6.3% | 6.4% | 4.9% | 7.6% | 8.0% | 9.1% |

**Source: UK Finance Business Statistics.** Available on request.

(a) Business population estimates for the UK and regions 2022
(b) Regional gross value added (balanced) by industry (2021)
(c) Table excludes Northern Ireland

However, there remain regional challenges with the availability of venture capital and angel investment which policy interventions are seeking to address (see answer to Question 5 below for more detail).

Overall, the continued flow of new lending demonstrates that the banking and finance industry is committed to the continued support of the UK SME sector across all regions.

The SME Finance Charter sets out five pledges from UK banks and finance providers to support SME customers. Each provider sets out how they demonstrate and deliver on these commitments on their websites. The commitments are that:

- We're open for business and ready to lend
- We'll help you build back better after COVID-19
- We'll support your application and signpost other options if needed
- We'll treat you fairly at all times
- We'll work with the government-owned British Business Bank (BBB) to support SMEs

### Diversity of finance market

A key development in recent years has been the increasing diversity in the SME Finance market, across both provider type and finance type. Bank of England data reporting by the British Business Bank shows that in 2022, over half of gross all new SME lending was provided from challenger and specialist banks.

Looking at working capital facilities, UK Finance's Invoice Finance and Asset-Based Lending members were advancing just under £21 billion to client businesses at the close of Quarter 1 2023, with just under half of funds advanced (£8 billion) supporting SME clients. Advance levels have recovered overall as the impacts of the government lending schemes have rolled off but still sit below the pre-pandemic highs seen in 2019. As noted above, there remains significant capacity within existing facilities to provide greater levels of finance. There is also significant appetite for new business across UK Finance's membership of IF/ABL providers which range from the main to the specialist banks and to specialist non-bank providers.

Invoice finance can also be provided in conjunction with bad debt protection (non- or limited-'recourse' facilities) providing businesses that trade on credit terms with other businesses greater reassurance against non-payment, making them more financially resilient. These products also help businesses mitigate and manage the risks associated with poor payment practices by their customers and can be combined with additional services such as ledger management and collections (in the case of factoring).

Another example of diversity in finance is the increasing role of commercial cards for working capital and some capital expenditure. For SMEs, commercial cards offer rolling credit as an alternative to overdrafts or other forms of debt and can also be used as a purchasing card, offering some supplier insolvency protection.

Finally, looking at finance provided to support the acquisition of business assets, according to the BBB's analysis of Financing & Leasing Association data, asset finance new business reached a new high in 2022 with SME asset finance new business increasing 11 per cent in 2022 to £22.5 billion, the highest level on record.

Increased diversity and competition in finance options needs to be supported by awareness and understanding of what is available, including those finance options that may sit outside of the main bank relationship. The UK's diverse and competitive commercial finance market means that different providers will have different appetites and capacities to support, and a specialist finance provider may be able to provide finance in circumstances where a bank cannot. It is important that SMEs have the information and guidance to support them in navigating the full range of finance options and how they may be appropriate at different stages in the growth cycle of a business. Sources of information include the BBB's Business Finance Hub and UK Finance's Better Business Finance website amongst other online tools. In addition, many lenders have extensive online information and support available to SMEs.

Accountants, commercial finance brokers and other professionals that advise SMEs have an important role to play. The advisory community plays a particularly important role providing greater information to SMEs and advising on the breadth of lenders and financing solutions in the market. A key challenge for SMEs is having the time, skills and knowledge to navigate to the right tools and then to use them effectively.

### Poor and Late Payment practices

Many small businesses struggle to manage their cashflow due to poor payment practices or late payment by or from their customers. These practices have a negative impact on the economy as a whole and affect smaller business the most. We have welcomed the significant steps the government has taken over recent years to address this issue, for example, the Reporting on Payment Practices and Performance Regulations 2017 (the Regulations) and the Office of the Small Business Commissioner.

Many lenders are signatories to the Prompt Payment Code and signpost SME customers to the Small Business Commissioner.

The Department for Business and Trade has recently undertaken a review of Payment and Cashflow issues, which UK Finance and our members submitted evidence to.

**UK Finance would encourage the government to bring forward its response to the review as soon as possible and move swiftly to enact any measures to enhance the powers of the Small Business Commissioner and improve the effectiveness of other measures to tackle this important issue.**

Tech innovation in the form of cloud accounting software also plays a valuable role in helping businesses manage cashflow, improving credit scores and access to credit. Many lenders now provide cloud accounting software integrated into business bank accounts.

### Where finance providers cannot support a business

Responsible lending means that it is not appropriate or possible to support all finance applications from SMEs. Where lenders are not able to support a business, the largest banks are committed to providing options to customers including:

- A Lending Appeals Process to enable businesses whose lending requests are declined or who are unhappy with the conditions offered to have their requests reviewed.
- A Referral Process as required under legislation to Government designated online finance platforms which seek to help them find a suitable alternative finance provider.

Many other lenders also offer signposting to alternative options if they are not able to support an SME finance application. For example, larger banks recruit alternative providers onto a panel after due diligence checks to further protect the customer.

We note in Question 4 that there are specific challenges relating to the very smallest and youngest cohort of SMEs, not all of whom will be suitable for external finance on commercial terms.

## Question 2. Through which channels do SMEs find the most success when seeking funding and why?

Technology and innovation are transforming the ease of SMEs to shop around and compare the options when looking for external finance. SMEs increasingly use and prefer online channels. The speed and ease of loan applications has significantly improved in recent years. According to the SME Finance Monitor, 56 per cent of finance applications were online, compared with around 30 per cent before Covid.  Many lenders provide indicative eligibility indications/quotes to SMEs on their potential ability to support them, for instance with pre-assessed credit limits. The volume of customers which are eligible for pre-assessed limits, along with the value of loans for which they can apply through digital channels, has substantially increased over the last few years. This gives even more SMEs the confidence that they will have a positive outcome.

Online eligibility tools and brokers also help to speed up applications for finance. Given the diversification of the lending market over the recent years, with more options and a wider range of less traditional forms of lending available to businesses, brokers have become more important in the lending market. In 2022 they facilitated £45 billion of lending which is up 10 per cent on the year prior (NACFB).

Although in many cases (due to existing relationships, pre-approvals, familiarity with product offering, and channels etc), an SME may wish to approach their primary lender, the tendency of SMEs to only approach their current banking/finance provider is diminishing.  SMEs now have greater access to multiple channels than ever before, so they can choose which channel best meets their needs. Equally, in terms of success when seeking funding, it is largely channel agnostic, i.e. a viable business proposition, supported by collateral where required, will, all things being equal, be able to access finance regardless of the channel.

According to British Business Bank research, historically, over 80 per cent of SMEs reported obtaining the entire amount of finance requested from their initial provider. This figure dropped to 64 per cent in 2022, reflecting the increased tendency of SMEs to seek financing from multiple providers, at 32 per cent. It is also indicative of businesses taking a more transactional approach to financial services, including finance.

## Question 3. What role can financial innovation play in SME finance? Is there more the government and the regulators can do to improve access to finance through innovative firms?

The Kalifa Review of UK Fintech is a landmark document setting out the value of fintech to the UK economy as well as a five-point plan of recommendations to protect and build on this success.

The review found that:

- The UK is a dominant force in fintech representing 10 per cent of global market share and £11 billion in revenue.
- The total technology spend by UK financial services firms was £95 billion in 2019.
- SMEs and corporates are all keen users of fintech. UK citizens are becoming digitally active and 71 per cent are now using the services of at least one fintech company.
- Investment into UK fintech stood at $4.1 billion in 2020.

**UK Finance supported the Kalifa Review and welcomed the recommendations. We believe it is now timely to assess progress against those recommendations.**

Open banking is just one aspect of innovation, although an important one. The Open Banking Impact Report (March 2023) found that:

- Around 750,000 SMEs were using open banking products.
- Despite more products being available to consumers, adoption by businesses is higher than consumers with a 16 per cent penetration rate versus 11 per cent.
- Small business use is dominated by data-driven account information services (AIS) which allow firms to see multiple accounts in one place, providing valuable real-time insights for cash flow and forecasting. This accounts for 79 per cent of business use.

Financial innovation connected to Open Banking has the potential to bring real benefits to business. For example, it has enabled:

- Data sharing to enable broader range of providers to easily consider an SME’s application for finance.
- Comparison tools to enable an SME to understand a variety of lending products and different providers available.
- Tools to enable SMEs to better understand their internal finances to get them into a better position to apply for finance.

**UK Finance is actively supporting the Joint Regulatory Oversight Committee (JROC) as it works with the industry to implement its recommendations for the next phase of Open Banking in the UK.**

We also support the digitisation of trade documents which the Electronic Trade Documents Act will enable. Research from the International Chambers of Commerce (ICC) highlights the benefits for digitising trade, including reducing the time of transactions and driving greater efficiency. This has the potential to free up £224 billion in efficiency savings, boosting SME exports and driving substantial economic growth. The ICC has estimated an increase in SME trade of 25 per cent by 2024 following digitisation.

This, along with the digitisation of trade products, has allowed business to access funding quicker with straight through processing of payments within an agreed facility.

UK Finance also supports further work to assess improvements to client onboarding and credit checks which technology and collaboration allows.

Financial innovation within this sector has included growing use of advances against card receipts. There are some acquirers and specialist firms (as well as online marketplaces) that will advance funds against future card receipts which support SMEs who have a reliable source of income but have yet to reach the scale or profitability, or level of asset security required for more traditional types of finance. Innovation in this space could include more widespread use of card transaction data (with merchant consent) to enable further use cases to develop, or to encourage more mainstream lenders to use this data in their credit assessment.

## Question 4. How accessible is finance for SMEs of different sizes?

As noted, there is no single clear definition of SMEs. It can include a broad range of businesses from sole traders through to incorporated firms with a turnover of up to £25 million (typically, though some definitions of SME use different turnover). Funding requirements for sole traders and start-up businesses are different to more established businesses with track records. Please see our response to Question 2.

Micro businesses are the least likely to access finance, compared with larger firms. According to the SME Finance Monitor, 39 per cent of micro-businesses are using external finance compared with 68 per cent of those with 10-49 employees.

Historically, micro-businesses are less likely to be successful when applying for finance than larger businesses, with approval percentages typically increasing in correlation with business size. Using 2019 as a baseline to remove Covid Loan scheme distortions, zero employee applicant success rates for loans and overdrafts were 65 per cent, compared to 88 per cent for businesses with 10-49 employees. (Source: SME Finance Monitor).

More than 80 per cent of referrals made to government designated platforms under the Small and Medium Sized Business (Finance Platforms) Regulations 2015 are for businesses with less than £250k turnover. (Source: Funding Xchange).

The reasons for lower acceptance rates are typically lower credit profiles, the increased probability of default and a lower capability to service additional debt.

UK Finance data collected from larger bank members reports £69.2 billion lent to those businesses each institution categorises as being within their small business segment (39 per cent of reported SME lending) in the years 2017-22. These figures are broadly flat across this period with the exceptions of a significant rise in small business lending to £38 billion in 2020 which is Covid-19 related and a fall to £4.4 billion in 2022.

Lending products are designed to meet the needs of businesses of different sizes and complexity. Small business loans are typically provided to smaller businesses with fixed interest rates over a term of up to five or six years and in some cases longer. Loans for small sums are often unsecured. Smaller businesses are also users of credit cards, overdrafts, asset finance and leasing products which are widely available.

The diversity of finance options, as well as diversity of providers is an important part of ensuring SMEs get the right type of funding for their needs.

As noted above, at the close of the first quarter of 2023, UK Finance's Invoice Finance and Asset-Based Lending members were advancing just over £8 billion to SMEs, an average of just under £250,000 per SME business, with levels of advances broadly recovering to pre-pandemic levels following significant displacement by the government-backed lending schemes. At the close of 2022, members were advancing just under £21 billion to businesses overall and in 2022 supported client businesses with combined turnover of £314 billion (Source: UK Finance IF/ABL data. Client turnover is not currently broken down by size of business).

The majority by funding by value and volume through these types of finance is secured against the debtor books of client businesses (broadly through factoring and invoice discounting facilities, collectively referred to as invoice finance). However, an increasing amount of finance is being provided through trade finance and asset-based lending (ABL) facilities. These facilities can be secured against assets including stock and work in progress, and existing business assets such as plant and machinery, and other tangible assets. In addition, some specialist finance providers can

lend against intangible property, but for UK Finance's members this will normally be as part of wider secured facilities. More traditionally used by larger businesses, advances in auditing and reporting technology means that ABL is increasingly becoming an option for smaller businesses as well. UK Finance and its members are pleased to be working with the BBB on a variation to the existing Invoice Finance variant of the Recovery Loan Scheme to enable its usage with ABL facilities.

As further noted above, there is both significant spare capacity within IF/ABL facilities in place for existing clients and considerable appetite amongst finance providers to support more businesses.

**UK Finance believes increasing understanding and awareness of the full range of finance options should be a key priority. Finance providers, as well as their representative associations, should work with the BBB and business trade associations to meet this challenge.**

There is a longer-term trend away from SMEs holding tangible assets which can act as security, to having many more businesses who have significant intellectual property. The role of intellectual property/intangible assets as potential security is something that is being looked at across the world, including in the UK. As noted above, some value can be attributed to such intangible assets through ABL facilities but normally only as a part of a wider secured facility. This continues to be an area that merits further work as the trend in the changing nature of SME balance sheets (as a whole) is one which is likely to increase.

## Question 5. Is finance available to allow SMEs to scale up from venture capital funding?

It has been widely noted that while the UK is world-leading for business start-ups, we have been less successful in creating an equally effective scale up environment. Given the economic benefits of addressing this, we support the various initiatives and bodies seeking to do so, including the Scale up Institute, the British Private Equity and Venture Capital Association (BVCA) and the British Business Bank.

The British Business Bank has published some of the most comprehensive overviews of the current market, for instance in their report UK Venture Capital Financial Returns 2022. It also has a critical role to play in supporting this market, including through British Patient Capital.

A key player in the SME equity ecosystem is the Business Growth Fund (BGF). BGF was set up in 2011 by five major UK banks and acts as the most active investor in UK SMEs, having made equity investments in more than 450 companies and holding a live portfolio of £2.6 billion of SME investments, investing £313 million into new deals in 2022 alone. 73 per cent of investments made have been outside London and the South-East.

UK Finance believes more can be done to support high growth SMEs' access to UK public equity markets. Our recent report *UK Capital Markets – Building on Strong Foundations* noted that SMEs find attracting the appropriate growth capital challenging especially in non-traditional or tech sectors.

We also note that a continued challenge reported by SMEs is obtaining the necessary support to incentivise R&D investment amidst recent changes to tax credits. New subsectors and technologies also report challenges in finding investors who understand their business model and plans. There is also a perception that the path to becoming a publicly traded company is too complex which deters SMEs from joining public markets to raise capital.

Our report recommendations include providing larger, sustained R&D tax breaks for targeted sectors, improving investment products (including EIS and SEIS, particularly important for innovative businesses) to help companies scale and grow, and providing a glide path to private companies who plan to access public markets to enable them to easily adjust to additional regulatory requirements imposed on them as publicly traded company.

Angel investment is also an important source of investment for those businesses that are too small to access venture capital. The UK Business Angels Association reports that £2.3 billion is invested by angels into UK businesses every year. However, awareness of Angel Investment remains low both among potential investors and as a finance option for SMEs. We would point the Committee to submissions from the BBB, BVCA, and UKBAA to this Inquiry on these issues. We would also like to flag the BBB's recent submission to the TSC review of venture capital and data contained in the BBB's Small Business Equity Tracker.

## Question 6. How successful has the Bank of England's Term Funding Scheme with additional incentives for SMEs (TFSME) been at encouraging banks to lend to SMEs?

The use and success of TFSME should be considered in the context of the Bank of England's and HM Treasury's overall policy response to the Covid-19 pandemic. Covid-19 had a significant impact on the functioning of core financial markets, seen in the market turbulence in the second half of March. This led to the Bank providing additional liquidity to banks including the HMT indemnified Covid Corporate Financing Facility to support cash-flows of eligible businesses that were disrupted by Covid. Schemes such as CBILS and BBLS were also introduced to support SMEs, saving businesses and jobs that would otherwise have been lost.

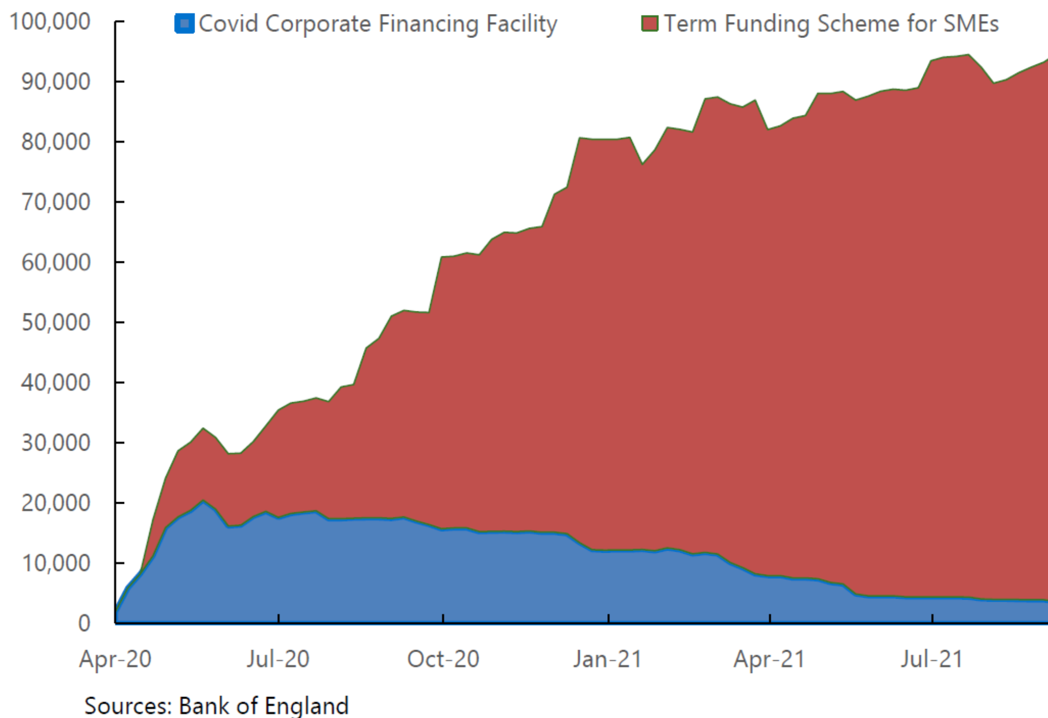
The Bank of England announced the introduction of TFSME in March 2020. It is comparable with the predecessor Term Funding Scheme (TFS) and the Funding for Lending Scheme (FLS). The aim of the TFSME was to help ensure that the cut in bank rate fed through to lending to businesses. The new scheme offered banks four-year funding at, or very close to, the base rate (i.e., 0.1 per cent). This provided banks with a cost-effective source of funding, which was insulated from any adverse conditions in bank funding markets. Banks were able to borrow an amount up to 10 per cent of the amount they lend to businesses and additional funding was available for banks that increased lending, especially to SMEs. When this scheme was first announced, the scheme was expected to provide "in excess of £100 billion" in funding to banks.

In May 2020, the Bank of England announced that TFSME participants would be able to extend the term of some of their TFSME funding to align with the term of loans made through BBLS. This provided vital support for lenders and helped to enable BBL lending at a fixed rate of 2.5 per cent.

There are over 70 firms using the facility including major banks, challenger and digital banks and building societies. The TFSME peaked at £192 billion but more recently we have seen early repayments reduce the current balance to £171,209 million as of 28 June 2023 (Bank of England data).

The effectiveness of the scheme in supporting SME lending is difficult to assess. However, Bank of England usage data shows the scheme was used widely.

Demand for TFSME was significant for the period for which the scheme was open (to October 2021).




**Source: International Monetary Fund United Kingdom Financial Sector Assessment Program April 2022.** Fig 16. United Kingdom: Bank of England Operational Response to the Covid-19 Shock. Volumes of outstanding in the CCFF and TFSME Facilities, 2020-21 (p.50).

Due to Covid-19, Non-Bank Lenders (NBLs) and Non-Bank Financial Institutions (NBFIs) faced a challenging trading environment. NBLs lost funding through the securitisation market and a fall in income was due to Covid related forbearance measures and increased arrears. In some cases, the loss of funding created an inability to fund new lending. NBLs were not eligible for the TFSME scheme which was only available to banks and building societies meaning that TFSME did little to support this part of the market.

In addition, incompatibility between some non-bank lenders' wholesale funding models and the government guaranteed lending schemes created challenges for large-scale deployment by some non-bank providers. This resulted in some distortion of the market across business models. For example, some specialist invoice finance providers ultimately used the term loan variant of CBILS to support their clients rather than the invoice finance variant due to incompatibility of the latter with their wholesale 'back-to-back' funding facilities.

The Bank of England Financial Policy Committee (FPC) acknowledged some of these points in the records of the September 2020 meeting by stating: "The non-bank financial system will always have some need for additional liquidity in stress. It is important to ensure that this need can be met in ways that avoid forced sales of assets and disruption to market functioning. Prudent management by non-bank intermediaries of their own liquidity positions is essential for their resilience to stress. Seeking to increase the supply of liquidity from banks to non-bank funders in stress by compromising on the resilience of banks would not be acceptable or effective. In addition, the FPC considers it important to examine whether central banks should have facilities to provide liquidity to the wider financial system in stress, to support market functioning. Any such backstop of liquidity would need to be provided in a way that is not just effective and efficient but that also, through appropriate pricing and accompanying regulatory requirements, reduces incentives for excessive risk taking in the future."

Non-bank finance providers play an important role in supporting SMEs in today's market and a solution for this funding issue is required to avoid market distortion and to maintain a level playing field should similar intervention be required in the future. Non-bank finance providers have, themselves, diverse business and funding models which present inherent challenges for a one-size-fits-all intervention.

**UK Finance urges Government and the Bank of England to actively review liquidity provision for non-bank providers that are unable to access Bank of England support. This will ensure they can play a full role in responding to future crises. This consideration should include both direct and indirect provision of wholesale finance through those banks that are able to directly access schemes, such as TFSME. This would ensure that the benefits of such interventions support the widest range of SME businesses and do not unnecessarily distort what is a diverse and competitive marketplace.**

### Question 7. What role do credit reference agencies play in supporting SME finance?

The UK has a relatively advanced credit information market, comparing favourably to many other countries both in terms of the depth and coverage of credit information, according to the FCA Credit Information Market Study. Credit information is vital to the SME finance market and has an important role in the process of credit assessment and availability of finance. The data provided by credit reference agencies performs the following functions:

a. Improves lenders' ability to verify the identity of a potential customer, mitigate against fraud, and supports anti-money laundering activities.
b. Enables lenders to assess credit risk and affordability thereby helping lenders to assess an applicant's risk of default and price for the risk.
c. Helps to ensure the finance offered is affordable, so helping customers avoid over-indebtedness.
d. Reduces the data advantage of individual lenders, particularly those that provide business current accounts. Without shared credit information, a lender would hold information about the financial standing of its own customers only, giving firms with a large market share of business current accounts a competitive advantage.
e. Helps to improve the management of debt, as arrears and failures to pay are recorded and made available to other credit information users.

The Small and Medium Sized Business (Credit Information) Regulations 2015 has the policy objective of increasing competition in the SME credit market by lowering the barriers to entry for alternative credit providers.

This is achieved by improving the availability of SME credit data to commercial lending providers, thereby leading to greater availability of credit for SMEs. The Regulations require nine designated banks to share credit data on SME customers with four designated Credit Reference Agencies. These banks and CRAs represented the majority of their respective markets at the time of designation. The CRAs must provide access to that data for alternative credit providers upon request, provided they commit to sharing their own data with the designated CRA within 12 months. In each case, the obligation is dependent on the SME customer having agreed to the provision of data.

There is evidence that points to the policy objective being achieved. Data reported by the British Business Bank in their SME Markets Report 2023 shows that circa 60 per cent of total gross lending was provided by the five largest banks and subsidiaries in in 2012, with just under 40 per cent provided by challenger and specialist banks. In 2022, the challenger and specialist banks share of gross lending to SMEs had risen to 55 per cent. Savanta survey data estimates that around half of start-ups open with a new entrant.

Furthermore, competition among CRAs has increased, with the number with access to the data doubling from two to four.

Commercial finance providers see CCDS as an important data source that supports a range of commercial credit decisions, including trade credit. Alternative credit providers are positive about the value of CCDS data in supporting their customer propositions and growth aspirations. Whilst designated banks have access to their own customer data, CCDS data provides additionality, giving a more complete picture of their customers' financial position.

### Question 8. What impact has the RBS bailout state aid Alternative Remedies Package and its various funds for SMEs (implemented by Banking Competition Remedies Ltd) had on SME access to finance?

Competition in the SME finance market has significantly increased in recent years. This increased competition has been supported by the funding provided to a number of players through the two Banking Competition Remedies (BCR) workstreams around incentivised switching and building capability. The BCR had a particular focus on the business current account market. It achieved some success with 69,571 SMEs switched through the Incentivised Switching Scheme (ISS). However, the Capability and Innovation Fund, which made up the second workstream, had a broader remit to develop and improve capability to compete with NatWest in the provision of banking services to SMEs and to develop and improve the financial products and services which are available to SMEs.

Evidence of the material contribution of newer players in the SME market, from the SME Finance Monitor, includes the fact that three additional banks have reached the current account threshold to be included in the CMA's mandated Service Quality survey (Starling were first included in published results in August 2021; Tide and Monzo in August 2022). As noted elsewhere, according to Bank of England data, challenger and specialist banks accounted for over half of gross lending to SMEs in 2022 which illustrates the diversity of the market compared to previous periods.

Whilst there are many reasons for this increased competition, a number of our members were recipients of funding through the Capability and Innovation Fund which has allowed them to initiate or scale an SME proposition. This resulted in:

- Nearly £1 billion of investment in business banking products and tools (£425m of awards distributed + matched funding).
- Accelerated development of a range of tools, products and services across the whole lending journey, increasing the amount of choice and improving the functionality available to SMEs.

We would draw the Committee's attention to the published public commitments and progress reports from recipients of the Capability and Innovation Fund, which sets out the impact on the business banking market.

**Question 9. Is securing access to SME finance particularly challenging for women, people from ethnic minorities, people from certain social classes, or any other group? Is so, what should be done about it?**

Women led businesses (WLBs)

The financial services sector has undertaken significant work in the last few years to consider the access to finance needs of women led businesses (WLBs) and ethnic minority businesses (EMBs). This includes extensive research as well as targeted programmes of activities to support these groups.

The Rose Review of Female Entrepreneurship, commissioned by HM Treasury in 2019, set out an ambitious agenda to improve support and access to finance for WLBs. The Review estimated that if WLBs received the same amount of investment and support as Male Led Businesses (MLB), it would unlock £250 billion of value to the UK economy. The 2023 Rose Review Update Report highlighted that over 140,000 all-female founded companies were created in 2022, up from 56,000 in 2018. A fifth of new incorporations (20.5 per cent) in 2022 were all-female led, up from 16 per cent in 2018. It means that in total over 20 per cent of new firms are now led by women, a record high. The 2019 Review set out an Investing in Women (IiW) Code with key requirements for signatories including collection of lending data broken down by gender (IiW Code data). This data provides one snapshot of the access to finance needs and experience of female entrepreneurs. Other sources of data, such as the SME Finance Monitor and the Gender Index help to provide a more rounded understanding of the extensive contribution women led businesses make to the UK's economy.

The Gender Index (which excludes sole traders) reported that in 2022, 16.9 per cent of companies in England were women-led; however, this figure fell to 8.7 per cent for high growth companies. In England, 17.3 per cent of micro-companies were women-led compared to 16.9 per cent of all companies. Among larger companies, levels of female-leadership are significantly lower averaging around 11 per cent in England, a broadly similar level in other parts of the UK.

The most recent IiW Code data was captured in Q2 2022 and is based on the 74 per cent of records that could clearly be identified by gender. The data showed that 20 per cent of new primary business bank accounts including those new to the bank (switching banks) and those new to business banking (start-ups) were opened by women, with 62 per cent opened by men.

For all business types applying for finance (this includes sole proprietors, single director limited partnerships, multiple director limited partnerships and partnerships), the 2022 Q2 data shows that 13 per cent were women-led businesses (WLB) and 50 per cent were male-led businesses (MLB).

Of those that did apply for finance, 72 per cent of WLBs were approved, compared with 79 per cent of MLBs. Of those loans approved, the average loan amount was around £174K for WLBs and £507K for MLBs.

Banks do not differentiate between male and female led businesses in the lending process. For example, gender markers are not used in the behaviour score algorithms. It is likely that the differences in approval rates are because WLBs are typically younger, slightly less likely to have made a profit than MLBs, and with any profits typically smaller, reflecting the business size. Women are less likely to apply for external finance, and when they do, they are likely to apply for a smaller

amount. This is due to greater risk awareness and participation in less capital-intensive industries. These differences in access to finance are not unique to the UK. Recent research by the European Investment Fund highlights ‘the existence of a credit gender gap in Europe’. To address such discrepancies, the industry has heavily invested in supporting women led businesses by improving guidance, networking opportunities and education. WLB’s access to finance can be ameliorated by information and support provided at the right time, by a variety of sources such as financial Services providers, government agencies and trade bodies.

As well as improved guidance, networking and education, research has shown that women would benefit from more flexible lending products, for example use of capital repayment holidays to cope with family care needs. Many banks provide this option and promote it to customers.

Technology can also help to bring firms to the point of application. It is now possible to give businesses a clearer idea of the likelihood of their application being accepted. Where they are existing customers, they may also be provided with pre-assessed lending, i.e., confirmation that they will be accepted for lending up to a stated value.

The wider use of open banking/finance will extend this capacity to lenders who do not have an existing relationship with a business.

### Ethnic minority entrepreneurs

The FSB released research in July 2020 that estimated that the economic contribution of ethnic minority entrepreneurs to the UK’s gross added value was £25 billion. But this could be higher if all entrepreneurs received more help and support. Since 2002, typically ethnic minority entrepreneurs have reported a higher Total Entrepreneurial Activity rate than non-ethnic minority entrepreneurs and are more likely to export goods and services. The 2022 Time to Change report commissioned by NatWest found that although ethnic minorities in the UK are consistently more entrepreneurial than the population generally, they are less likely to operate established or mature firms that generate stable income.

The BVA BDRC Ethnic Minority Business Report (March 2021) commissioned by UK Finance found that EMBs on average are ambitious, report high growth rates and innovate more than non-ethnic minority SMEs. EMBs report greater interest in funding growth through debt, but apply in similar proportions to non-ethnic firms, and use external finance in line with the SME average. However, they were more likely to see barriers to running their business, including political uncertainty and the current economic climate.

EMBs in the UK have equal access to debt finance products and lenders neither use nor capture data associated with ethnicity. However, EMBs are less likely to obtain the finance they applied for. The factors leading to lower success rates apply to all SMEs and are risk predictors such as business age, track record and credit histories. EMBs are also more likely to operate a business through a personal account meaning there is a lack of identifiable business banking activity which can lead to discouragement.

The Black. British. In Business & Proud report by Lloyds Bank, in partnership with the Black Business Network (September 2022), revealed that Black business owners are 21 per cent more likely to be self-financed than to use financing from banks.

The lack of personal wealth at the start-up stage has a negative impact on the entrepreneurial outcomes of ethnic minorities in the UK, whilst credit history and poor financial track record linked to creditworthiness add to the barriers. Many turn to external finance to help them realise their entrepreneurial ambition. Although EMBs in the UK have broadly equal access to bank finance products, comparable to wider SMEs, EMB owners are more likely to think it is difficult to access finance and are often discouraged from applying for finance for fear of rejection. The perception of barriers itself is a major obstacle, potentially preventing ambitious entrepreneurs who would otherwise be accepted for finance from seeking support they need to develop. 51 per cent of SMEs expect to receive approval on their lending application, versus 39 per cent of EMBs. This degree of pessimism is of a particular concern for those businesses that recognise they have a need for future funding but are reluctant to apply for external finance (about 3 per cent of all SMEs and 9 per cent of EMBs).

There are other deep-rooted socio-economic factors that serve to impede and disadvantage EMBs. Research points to the detachment of EMBs from mainstream business support networks and call on the need for greater mentoring to provide advice and industry contacts. Economic background and pre-existing pay gaps can also affect business outcomes as those with lower household incomes often have less resource and capital to begin with. As a result, they can struggle to support their business in periods of economic downturn. The British Business Bank's Small Business Finance Markets Report (March 2022) has more data on these issues.

To address this many lenders now provide extensive, targeted support programmes, such as mentoring, investment readiness training, networking, dedicated funds, and promotional activity.

UK Finance remains committed to building the evidence base and convening our members to share good practice on which types of support and advice have the greatest impact in improving outcomes.

More details can be found in UK Finance's report Supporting Ethnic Minority Entrepreneurship in the UK.

## Question 10. Do SMEs have adequate and appropriate access to a complaints procedure when in dispute with their bank or lender?

Most relationships between financial services suppliers and their business clients across the broad spectrum of day-to-day banking and finance services, transactions and lending are conducted and operate well and without any issues arising. However, as in any commercial relationship, there will be issues and challenges that arise from time to time. In some cases, these can lead to customer distress and a breakdown in relations between the business and the financial services supplier. UK Finance members therefore recognise the importance of access to an independent complaints process, where it is required, and that, where errors have occurred, they have a duty to correct them and, where appropriate, compensate customers.

Most small business complaints are resolved to the satisfaction of the customer 'in house' without reference to the Financial Ombudsman Service (FOS) or other Alternative Dispute Resolution (ADR) schemes, for example the Business Banking Resolution Service (BBRS).

Banks have invested heavily in developing their propositions and service offerings to facilitate the resolution of customer complaints in recognition that working with customers to remedy complaints when a mistake or error occurs is an important part of the customer journey.  Banks have worked on embedding a culture of continuous improvement in their complaints processes and there is evidence that some are using data from the complaints process to refine their service and product offerings to SME customers. Most banks now have well-defined, well-advertised complaints processes accessible to all SMEs, that are implemented in line with DISP, and which can be accessed through a variety of channels.

However, in the circumstance that a dispute between a small business customer and their provider persists, these ADR schemes provide an important option for an independent review of the complaint. Over 99 per cent of SMEs in the UK can therefore bring a complaint to the FOS or the BBRS.

In 2018, Simon Walker CBE produced an independent report, commissioned by UK Finance, on the complaints and alternative dispute resolution (ADR) landscape for the UK SMEs. This found that there was a gap arising from the scope of FOS eligibility and the prohibitive costs for an SME to pursue their claims through the courts. It also considered in detail the advantages and disadvantages of an ombudsman system based on 'fair and reasonable' judgments and a more legalistic tribunal style arrangement.

Mr Walker's review favoured an ombudsman-style approach as it requires no legal representation and is easier to administer.  Also, in assessing complaints on a "fair and reasonable" basis it provides additional redress ability for SMEs.  It is worth noting that many valid disputes arise where conduct was within the terms of the contractual relationship between the parties but nonetheless may be judged by an ombudsman as unreasonable. UK Finance believes that the current access to complaints procedures generally works well. Almost all SME complaints are handled and resolved without the need for external alternative dispute resolution options. However, since the Walker Review was undertaken these options have been considerably expanded with industry support.  As noted in the answer to Question 12, the FOS now covers businesses with less than 50 employees and/or £6.5 million turnover.

In addition, as a result of the Walker Review, the Business Banking Resolution Service (BBRS) was launched in February 2021 on a voluntary, interim basis by seven of the largest business banking providers to extend ADR services to SMEs with, broadly, £6.5 million to £10 million annual turnover. See our more detailed comments on the BBRS in our responses to Questions 13 and 14.

We set out in the answer to Question 13 that we believe the remit of the FOS could be expanded further, for example by aligning with the current Companies House definition of Small Business. This expansion could provide SMEs in this enlarged cohort with a single, simpler and more consistent provider of ADR services, and with the benefits of both relative scale and depth of capabilities, than currently exists. As above, the BBRS currently provides ADR services to customers in this cohort on a voluntary and interim basis.

We agree with the Walker Review's view that larger businesses with over £10 million turnover are sophisticated enough and have sufficient resources to be able to access legal redress options where disputes cannot be resolved bilaterally.

### Invoice Finance and Asset-Based Lending (IF/ABL)

For SME users of Invoice Finance and Asset-Based Lending (IF/ABL), UK Finance supports the operation of the IF/ABL Standards Framework, which sets out the standards that users of these products from UK Finance members can expect, along with independent means of review and, where necessary, redress, where client businesses believe they have not been treated fairly. The Standards Framework has three core components:

i) **IF/ABL Code**: The Code, along with supporting Guidance, sets the standards that UK Finance's IF/ABL members are required to meet in their dealings with clients. The commitments within the Code are broadly drawn from established 'Treating Customers Fairly' principles in statutorily regulated sectors. In brief, members commit to treating their clients fairly and responsibly, and to operate with integrity at all times.

ii) **Complaints Process**: The independent ADR Complaints Process investigates and enforces compliance with the Code. It is provided by the specialist dispute resolution organisation CEDR. The Complaints process has been designed to be independent, accessible and is particularly focused on the requirements of smaller client businesses that may lack the resources or confidence to otherwise take forward concerns about their treatment.

iii) **Professional Standards Council**: The PSC is the independent guardian of the Standards Framework. Its responsibility is to oversee the Code and Complaints Process and ensure they are working effectively.

UK Finance and its members believe that this type of independent but responsive framework for users of IF/ABL products is an effective way to establish and enforce standards and drive positive outcomes for client businesses in a diverse sector, whilst facilitating innovation and competition.

## Question 11. How effective has the Lending Standards Board's Standards of Lending Practice been?

The independently overseen Standards of Lending Practice have been effective in contributing to good customer outcomes and the protection of business customers.

Registration to the Standards helps to demonstrate how those subject to the Senior Management and Certification Regime are discharging their responsibilities for unregulated lending, by following an FCA recognised industry code.

17 registered firms, comprising 34 brands, are signed up to the Standards of Lending Practice for business customers. UK Finance engages with the LSB's regular reviews of current and thematic issues, to ensure that the Standards remain fit for purpose and best practice is shared. For instance, the LSB has provided useful insight and recommendations around vulnerability and ensuring accessibility for all.

UK Finance believes that the Standards demonstrate an individual firm's commitment to delivering good customer outcomes and treating customers fairly. UK Finance has signposted the benefits of the Standards to newer entrants to the SME finance market. We are engaging with the LSB's current review of the Standards and have suggested ongoing dialogue to ensure that the Standards remain relevant and retain broad market coverage.

The benefit of the Standards is that they are outcomes focused thus allowing them to be applied as appropriate for different cohorts of SMEs. They are also regularly reviewed so can adapt to changes in the market. The Standards are underpinned by the LSB's independent monitoring and evaluation regime.

As we note elsewhere, UK Finance believes that any regulatory change which would treat 'SMEs' as a homogenous group like 'consumers' would not be effective, may reduce competition and innovation, be less adaptable to changing economic and customer circumstances and potentially costly to implement.

**UK Finance believes that there is scope to provide greater clarity about what standards different types of finance provider work to, how those standards are enforced and what means of redress or support are available to business clients that need it. For example, through a single hub or central signpost, hosted by a relevant public sector agency such as the Office of the Small Business Commissioner, the BBB or potentially by the FOS itself.**

### Question 12. How well does the Financial Ombudsman Service (FOS) work for small business complaints?

UK Finance members believe that access to independent complaints procedures and/or associated Alternative Dispute Resolution processes is essential to enable redress where it is required, to demonstrate standards and to provide SMEs with confidence in accessing the range of finance options available. The FOS is an option for most small business complaints where these cannot be resolved to a customer's satisfaction and is complemented by specialist options such as those provided by the IF/ABL Standards Framework and the BBRS.

Whilst it is acknowledged that the FOS is managing and addressing a number of identified operational issues, we believe that the service generally works well. We supported an extension of eligibility for FOS which took place from April 2019. This raised the threshold from micro-enterprise (broadly those with < 10 employees, < £2 million turnover) to include all businesses with an annual turnover up to £6.5 million or fewer than 50 employee or a balance sheet below £5 million. The maximum compensation limit was also raised in 2019 and now rises with inflation rather than being fixed. This expansion enabled more SMEs to be eligible for the FOS, which now provides an important route to alternative dispute resolution for about 99 per cent of business customers.

The establishment of a small business team resourced with staff with SME expertise and focus to handle the FOS's expanded remit was particularly important. UK Finance had called for this at the time. UK Finance also attends, alongside business groups and other SME stakeholders, a FOS SME Advisory Group which allows the sharing of perspectives on issues and market challenges so that these can be addressed more readily.

We understand that the small business team of the FOS has resolved over 13,500 cases in its first four years, of which 5,000 were in the last financial year. Most complaints are resolved in house, but the FOS plays an important role for independently assessing small business complaints. This should continue to be led by small business experts within the FOS, recognising that business clients are of a different nature to consumers.

### Question 13. Is the FOS's existing role in SME finance appropriate? If not, how should it change?

It is broadly appropriate, but UK Finance members believe some adjustments to increase the existing threshold could further enhance its role. We believe the FOS' remit could, for example, be expanded to align to the current Companies House definition for Small Companies. This would be those with:

i) Annual business turnover – £10.2 million or less.
ii) Either balance sheet – £5.1 million or less (or in view of the minimal differential, and in the interests of operational simplicity and minimising customer change impacts, to align with the existing FOS threshold of £5 million).
iii) Or average number of employees – 50 or less.

This change could consolidate access to alternative dispute resolution across a larger proportion of SMEs and include over 99 per cent of the SME segment. It could also absorb the complaint base of the BBRS, which service was established as an interim solution and therefore does not have an indefinite life span. This could ensure SMEs receive a singular, more consistent treatment and reduce confusion about which ADR service they should approach, leading to a more efficient and enhanced customer journey.

A further key benefit of this expansion would be to extend the provision to SMEs and to participating firms of a provider of ADR services with both enhanced relative scale and depth of capabilities than currently exists.

These changes should be subject to evidence of ongoing need and demand for these ADR services as demonstrated by case volumes in the increased cohort; and confidence and assurance that FOS will have the required capabilities and appropriate control mechanisms to manage this expansion.

As with previous FOS expansions, we would propose that any such extended jurisdiction for the FOS should be forward-looking and apply only from the date of inception of the increased threshold.

In increasing the threshold to include larger SMEs we would emphasise the importance of assurance in the ability of the FOS to deliver, both currently and in the event of any future such expansion, consistently high-quality outcomes that do not significantly diverge from established legal or regulatory principles and the corresponding need for appropriate controls and protections to be considered. Whilst it is acknowledged that the FOS takes due account of what is considered 'fair and reasonable', any such significant divergence might risk an increase in the level of uncertainty for all participants in the SME lending market. This could have the unintended consequence of dampening the availability of credit and raising barriers to entry for new participants.

Clearly, any such expansion of the FOS perimeter would require further, detailed analysis to be undertaken in order to determine an appropriate threshold and UK Finance and our members would be willing to support this activity if required.

**As recommended above, any amendment to FOS eligibility could be complemented by a single information point setting out the various standards and redress options open to businesses.**

## Question 14. How effective has the Business Banking Resolution Service been, and what lessons can be learnt from it?

The Business Banking Resolution Service (BBRS) was launched in February 2021 on a voluntary basis by seven of the largest SME business banking providers. This was in response to the publication of the aforementioned 'Walker Review' in October 2018 and the publication of the UK Finance Walker Review Response (WRR) in December 2018. The WRR outlined the industry's proposals to provide alternative dispute resolution (ADR) services on a 'fair and reasonable' and free-of-charge basis to SME complainants as set out below.

As a result of the above, the industry voluntarily supported and funded the establishment of the BBRS under the direction and supervision of an independent Implementation Steering Group (ISG). The ISG comprised nominees from seven SME bodies and representative groups; the seven participating banks; an independent Chair with strong ombudsman industry credentials and with observers from HM Treasury, FCA, the FOS and UK Finance.

In line with the proposals set out in the WRR, the BBRS comprised two distinct and separate ADR schemes to meet the needs of SMEs as set out below. The rules for both schemes, including eligibility and other key operating procedures as well as other governance artefacts, were unanimously agreed by the ISG as constituted above.

In responding to the question as to how effective the BBRS has been, we believe that it may be helpful and instructive to set out the context to the creation and aims of the two respective schemes as follows:

### 1. Historical Scheme (HS)

The intention behind the creation of this Scheme was to give SME customers who had not previously had an opportunity to have their historical complaints reviewed by an independent third party the opportunity to do so. It was not intended to provide a vehicle to re-consider or to provide an 'appeal' mechanism for complaints that had already been reviewed by other bodies such as the FOS, legal proceedings or by other redress schemes.

More specifically, the Scheme was set up to review complaints made by SMEs relating to acts or omissions on the part of their bank that took place, initially since 2008, but subsequently extended voluntarily by the participants to include incidents that took place between 1 December 2001 and 31 March 2019. In view of the historical nature of these complaints and in common with similar initiatives of this type, the scheme was open for registrations to be submitted over a defined period up to February 2023.

Whilst views may vary as to the anticipated volume of eligible complaints that would be submitted, in April 2019 the ISG approved analysis that estimated volumes for planning and capacity purposes of up to c.2,100 cases in total for the HS (and c.110 cases per annum for the Contemporary Scheme; see below).

Despite highly proactive, targeted marketing campaigns and trade communication initiatives undertaken by the BBRS over the lifetime of the HS intended to promote awareness of the service and to stimulate case registrations, volumes in the BBRS were and remain lower than planned, with 61 'Determinations issued' in total over the lifetime of the two Schemes and a total of 35 cases currently remaining in the hand as 'Complaints progressing as eligible' (Source - BBRS Quarterly Report 30 June 2023).

The BBRS undertook two separate independent, external reviews of the service as part of an undertaking made by the ISG on transfer of governance to the BBRS Board. The results of both reviews were duly published and are available on the BBRS website.

This first review reported that, in line with their terms of reference, the BBRS had been correctly established according to the rules that had been agreed by the ISG. The second review reported that the service was delivering what it had been established to do in relation to the agreed scheme rules and operational plans. Importantly, it also concluded that cases were being assessed competently and that BBRS' decisions on the eligibility of cases and financial awards were being conducted independently.

In line with the agreed plans, the HS service was closed to new cases in February 2023. The BBRS continues to work with the parties to the complaints registered by that date to manage those cases through to either a formal determination or via other resolution mechanisms.

### Lessons Learned

It is inevitable and in the nature of dispute resolution that across all markets and industries there will be instances where the complainant is not satisfied with the outcome of the dispute resolution process that reviews their case. Whilst this is unfortunate, the learning point derived from the operation of the HS is that, despite significant and highly proactive marketing and communications, the volume of eligible cases did not turn out to be as high as had been anticipated or estimated by any of the parties involved in the creation of this scheme.

### 2. Contemporary Scheme (CS)

One of the key recommendations from the 'Walker Review' was that the FOS remit should be extended as the solution to providing affordable alternative dispute resolution (ADR) to SMEs with turnover up to £10 million (rather than needing to go to Court which is prohibitively expensive).

As the timing of such a change was not deemed appropriate at that point in time, the participating group of seven providers funded and established the Contemporary Scheme of the BBRS in February 2021. The CS was intended to be a temporary arrangement whilst the relatively new and expanded FOS services to larger SMEs with turnover up to £6.5 million embedded, following the launch of that extended service by the FOS in April 2019.

The Contemporary Scheme of the BBRS can consider complaints from larger SMEs with a turnover of less than £10 million or a balance sheet below £7.5 million (complaints from businesses with annual turnover up to £6.5 million and fewer than 50 employees or with an annual balance sheet below £5 million should go to the FOS).

As set out above, in April 2019, estimated volumes of c. 110 cases per annum were agreed by the BBRS ISG for operational planning and capacity purposes. Whilst the volume of complaints reported by the CS is not high in relation to the FOS reported volumes, this is not unexpected given the relatively small number of SMEs that fall into this larger segment. Although case volumes in the CS are also lower than estimated, with registrations currently understood to be running in single figures each month, the BBRS has functioned well for the complaints it has handled with a high level of reported customer satisfaction.

It should be noted that the comments set out under the 'Historical Scheme' above in relation to the proactive marketing campaigns undertaken and the results of the independent reviews of the BBRS service also apply to the Contemporary Scheme.

The BBRS, which was originally scheduled to close on 31 December 2023, has recently been extended in principle into 2024, pending the formal announcement of the outcome of the current FCA review of the threshold for SME complaints to be eligible for the FOS. In line with the original Walker Report recommendations, UK Finance would support an expansion to the existing FOS threshold criteria for SMEs.

### Lessons Learnt

The BBRS has played a role in providing ADR facilities to a cohort of customers that previously did not have access to such services, albeit that this number has been significantly lower than originally planned.

The estimated combined volume of cases for both the Historical and the Contemporary Schemes, operating in parallel, and the discrete nature of the two schemes, indicated that it was reasonable and proportionate to establish the BBRS operation with its current size and capabilities.

However, following the closure of the HS in February 2023, which represented a significant majority of total BBRS case volumes, the low volume of CS cases evidenced over an extended period, currently understood to be running in single figures each month, has proved not to be sufficient to sustain a viable, stand-alone BBRS operation going forward.

Correspondingly, as set in our response to Q10 and Q13, an expansion of the FOS threshold for complaints could provide an opportunity to strengthen the overall service provision to SMEs. The FOS is now recognised as an established provider of ADR services in the SME market with the important benefits of both relative scale and depth of capabilities. There is also the benefit of extending a greater simplicity and consistency of treatment more widely across the market from a single provider.

## Question 15. Should SMEs have the same level of consumer protection and deposit insurance limits as retail consumers?

UK Finance believes that the current Financial Services Compensation Schemes (FSCS) limits are appropriate. In general, both individuals and SMEs can claim compensation under the FSCS. In the case of deposits, large companies are also able to claim compensation, although some exclusions may apply. The maximum compensation sum payable for the aggregate eligible deposits of each depositor is £85,000.

This means that in due course, businesses with deposits under £85,000 with a single provider should be paid compensation in full. Those with deposits above £85,000 would only be paid £85,000, with the balance subject to the insolvency creditor hierarchy. In most cases, for deposits, FSCS aims to pay compensation within seven days of a bank failing. More complex claims may take up to 15 working days.

UK Finance commissioned research, undertaken by BVA BDRC with above £250,000 turnover businesses, reveals that 41 per cent of all respondents said they typically held more than £85,000 in credit balances, with a further 30 per cent saying that they sometimes do (due to seasonality etc). Half of these customers say that they hold more than £85,000 with a single provider. This cohort could be vulnerable in the event of a bank failure.

We believe that changes to the FSCS mechanism should be made to reflect modern banking and payment practice, with payments primarily made digitally rather than via cheque as is the current approach.

We also believe that work being undertaken by the Bank of England and HM Treasury following the recent failure of Silicon Valley Bank UK should include consideration of SME customers (we understand that the Bank of England are not currently prioritising SME customers in their work). While a successful outcome was achieved due the HSBC’s purchase of Silicon Valley Bank UK, many business owners would have been affected had this not been the case. The absence of an executable contingency plan creates a scenario whereby impacted businesses may be unable to access their deposits or make payments, for a period that might be prolonged. This is likely to create business interruption challenges for a significant number of businesses, which potentially could lead to business failure and job losses. This risk is likely to be highest amongst UK SMEs, many of whom do not multi-bank.

Delay in restoring access to liquidity and banking services could lead to situations whereby businesses are unable to pay employees because they cannot access their funds, draw on credit lines or have access to payment systems. Businesses might also be unable to pay suppliers and/or service debt obligations, placing them in default.

The evidence and events leading up to the HSBC’s intervention demonstrate that a contingency plan with supporting infrastructure is needed to address the numerous and complex issues that were encountered.

The industry is working with HM Treasury and members to consider contingency arrangements that could be deployed to support business customers should a similar event occur in future.

### Question 16. Should commercial lending to SMEs be brought into the regulatory perimeter?

UK Finance members hold a range of views on the regulatory perimeter. There is consensus that the regulatory perimeter for business lending should not be expanded, as this would risk dampening competition and innovation in the marketplace and ultimately reducing the availability of finance. Several members believe that business lending should be *removed entirely* from the scope of a revised Consumer Credit Act (CCA). This would be equivalent to the regime in Europe, where the Consumer Credit Directive simply regulates lending to true "consumers" – that is, a natural person acting for purposes which are outside their trade, business, or profession. Others are of the view that the perimeter should remain as is, namely applicable to lending up to £25k or less to sole traders and small partnerships as per the current CCA.

Whilst many lenders provide CCA regulated lending, prescriptive CCA requirements do discourage some lenders. A number of lenders, including new market entrants, start business lending from a minimum of £25k to avoid the burdens and inappropriate constraints of CCA regulated lending. The Committee will be aware of the challenges that the CCA posed in the rollout of the first iteration of the Coronavirus Business Interruption Loan Scheme (CBILS). A number of lenders did not offer CBIL facilities of £25k or less which left some of the smallest businesses without the same diversity of options. The Bounce Back Loan Scheme (BBLS) was only able to overcome this because the CCA regime was largely disapplied for BBLS loans of £25k or less.

It is also worth noting that many lenders split their business lending between CCA regulated and non CCA regulated business with different IT systems and processes for both, so if the perimeter were to change there would be a significant burden on them to adjust to this, taking resources away from being able to serve customers.

SME businesses, particularly limited companies, are fundamentally different to retail customers. UK Finance has already noted its reservations that (where applicable) Consumer Duty expectations for business customers should not just be a direct extension of those for retail customers, given the differences in the market.

To the extent that business lending remains within scope of the new CCA regime, HMT and the FCA must ensure that the new regime is sufficiently tailored to consider the fact that the borrower is a business customer.

Any *potential* extension should be preceded by clear analysis of the issues such expansion would be intended to address and should consider in depth the risks to competition, innovation, and the cost of finance to SMEs. It should also assess whether the outcomes sought by this can be addressed through other means. We believe that many important outcomes such as customer protection and good outcomes are better delivered through the existing self-regulatory frameworks. The Lending Standards Board's Standards of Lending Practice, which are recognised by the FCA, cover a significant proportion of the market, and are complemented by other specialist initiatives such as the IF/ABL Standards Framework.

### Question 17. What impact will the PRA's proposed Basel 3.1 capital requirements framework, and in particular the proposed removal of the SME support factor, have on SMEs in the context of the PRA's objectives?

While UK Finance is broadly supportive of many of the PRA's proposals with regards to Basel 3.1, we do **not support the withdrawal of the SME support factor.** We believe that without the SME support factor, the cost of lending to a critical component of the UK economy will increase and borrowing demand consequently reduce. We recommend that the SME support factor should **not** be completely and suddenly removed.

Should the PRA decide to remove the SME support factor, we believe that:

a) it should be maintained for existing lending;
b) the counter-intuitive higher 100 per cent risk weighting for secured lending to corporates should be reduced to 75-85 per cent; and
c) a transitional phase-out period should be introduced.

We note that there are four potential impacts on the withdrawal of the support factor.

### Impact on SME lending and the UK economy

The removal of the SME support factor in 2025 will directly impact SME lending to the UK economy. There will be a material reduction in the supply of SME lending and increases in the price of SME lending from the proposed removal. This is the clear result of the estimated one third increase in capital requirements in 2025. Firms will have to reduce their new loan supply to meet the expected capital requirements, while charging a higher price on lending they do make. Initial estimates from one bank are that this could result in up to £20 billion of reduced SME lending in the market, and a material 1-1.5 per cent rise in loan margins from the current 3.5-4 per cent average over base rate.

Given the weak economic environment in the UK, this reduction in SME loan supply and increased pricing will hit at the worst possible time, making SMEs disproportionally affected. If the proposals are solidified in 2023 with no continuation of treatment for existing loans, or transition period, banks will have to take immediate action resulting in a poor economic outcome for SMEs.

### Appropriate calibration of SME risk weights

There is no empirical evidence presented by the PRA on the calibration of SME risk weights. Previous detailed studies from the German and French central banks, in 2016 and 2019 respectively, found that retention of the SME support factor is appropriate in calibrating SME risk weights, due to SMEs showing materially lower systematic risk than larger corporates. The 2016 EBA study cited by the PRA states that more data is needed before drawing firm conclusions on the effectiveness of the SME support factor. However, the study does support the SME support factor being appropriately calibrated for SMEs for all exposure classes under standardised and for corporate SMEs in AIRB. This is the opposite conclusion to that which the PRA has drawn.

The proposal for new corporate SME exposure classes do not make up for the changes to the current risk weights, especially for exposures secured on property where there is no SME reduction. While Basel includes new risk weights for SME corporate exposures, the overall risk weights for SME lending that result from the PRA proposal are materially higher than currently applied, based on a typical SME lending product mix, capital requirements a circa third higher.

Members would be keen to see UK specific empirical evidence conducted by the PRA that evaluates both the appropriate calibration of SME risk weights and the impact of the SME support factor on SME lending, as other central banks have done.

### Impact on market competition / Impact on UK competition

The SME support factor has underpinned a thriving UK SME challenger bank sector. Over the past decade post the Global Financial Crisis, a thriving SME challenger and smaller bank sector has developed in the UK, helping to broaden SME access to finance. 2022 Bank of England data shows that challenger and specialist banks' share of SME gross lending is now 55 per cent, up from 34 per cent in 2013. The SME support factor has been vital in underpinning this.

It will have a material impact on the SME, high growth and mid-corporate market segments which, taken together, provide 50 per cent of UK income and 60 per cent of jobs. Given the market structure of SME and mid-corporate finance in the UK (largely provided by domestic banks with limited activity from international banks/or access to capital markets), these changes will increase capital requirements and the higher costs of providing this type of lending are certain to be borne by customers. Should the support factor be retained in the EU but removed in the UK, this would put both UK banks and UK SMEs at a disadvantage against peers, facing higher funding costs than EU SMEs.

The removal of the SME support factor, alongside the risk weight floor on secured business loans, will mean a one third increase in the capital requirements for SME challenger banks, substantially higher than the 6 per cent increase quoted in the PRA study across the banking sector. This will inevitably mean a pull-back in the SME challenger bank sector and less availability and higher pricing in SME lending.

### Impact on international competitiveness

Removing the SME support factor will hurt our international competitiveness. UK SMEs may face higher financing costs than EU SMEs and European banking groups with UK subsidiaries could deploy their capital towards SME lending in the EU rather than in the UK. They could also seek to lend from their European entity into the UK to receive lower capital requirements, putting UK banks at a material disadvantage to their European counterparts.

Our full response to the PRA's extension consultation is available online here. This response highlights areas of concern and where further clarity is required.

## Question 18. Should the Government do more to enhance SME access to finance? And, if so, what?

Government should consider the extent to which there are funding supply gaps because of the absence of European Investment Bank (EIB) funding following Brexit. The UK Infrastructure Bank and British Business Bank are part of the solution, but HMG should consider a GAP analysis.

SME access to finance could be enhanced by ensuring a regulatory landscape that is proportionate, predictable, and consistent across policy areas, a lack of which can reduce the attractiveness of investing in the UK SME market. The following are two examples where increased consistency and predictability could enhance access to finance as well as promoting the success of measures aimed at allowing the solvent rescue of businesses in financial difficulty.

The Covid loan schemes provided a lifeline to so many businesses in financial difficulty during the pandemic, allowing them to stay afloat and return to normal trading thereafter – see Question 19. Yet despite their very purpose, the terms of the Coronavirus Business Interruption Loan Scheme (CBILS) and Recovery Loan Scheme (RLS) guarantees make it difficult for lenders to provide certain types of forbearance; inject new finance such as invoice finance or super senior rescue finance; or support a debt restructuring including consenting to a Restructuring Plan. Terms that cause this difficulty include the restrictions on extending the term of a CBILS (or RLS) loan, requirements to grant certain forbearance *pro rata* across scheme and non-scheme debt, and the prohibition on subordinating security taken under a CBILS (or RLS) loan. Lenders will of course do what they can, consistent with their policies to support SMEs in financial difficulty. But there would be more options available to them absent these restrictions (particularly the rules on seniority of scheme security).

More broadly, we see conflicts between restructuring/insolvency policy, and policy in areas such as taxation and pensions where changes in effective priorities and the insolvency waterfall can have an impact on business rescue. For example, during the pandemic, the Corporate Insolvency and Governance Act 2020 introduced Restructuring Plans and moratoria as well as suspending winding up petitions and directors' wrongful trading, all aimed at giving businesses some breathing space and the possibility of a turnaround. HMRC also granted substantial VAT and other tax deferrals resulting in many businesses having significant tax debts. However, HMRC also at the end of 2020 had its status as a preferential creditor partially reinstated, giving certain tax debts priority above floating charge holders as well as various voting rights. HMRC is also currently considering seeking further rights to enforce payment of business tax debts.

As a result of the changes, access to finance is prejudiced by businesses having increased tax debts and reduced available security; existing floating charge holders have seen the value of their security reduced retrospectively; and we hear of HMRC robustly enforcing tax debts and challenging Restructuring Plans.

Clearly it is important, and in the public interest, that HMRC should be able to collect tax debts and enforce its rights as a creditor. However, the absence of a consistent policy across these related areas, which balances the Exchequer's interest along with the wider economic considerations of ensuring access to finance and the promotion of business rescue, has an under-appreciated economic impact and one which we would encourage policymakers to consider further.

### Question 19: What has the impact of the Covid Bounce back Loan Scheme (BBLS) which was followed by the Recovery Loan Scheme, been on SME finance?

The Bounce Back Loan Scheme (BBLS) was a unique Government lending initiative which at the height of the Covid pandemic saw lenders stepping up to provide urgent liquidity to SMEs. The scheme provided loans to over 1.5 million businesses, 99 per cent of which had a turnover of less than £5 million and a majority of which were first time borrowers (Source: Ipsos/ London Economics Evaluation Report). BBLS, alongside other schemes such as Coronavirus Business Interruption Loan Scheme (CBILS) and Coronavirus Large Business Interruption Loan Scheme (CLBILS) were vitally important programs through which the industry provided a lifeline to businesses impacted by COVID.[1] As of 31 March 2023, businesses have drawn a total of £46.6 billion through BBLS, £25.9 billion through CBILS and £4.56 billion through CLBILS, a £77 billion total drawn value.

Surveys from London Economics and Ipsos indicate that up to 34 per cent of BBLS borrowers (505,000 businesses) would have permanently ceased trading without the support of BBLS, saving as much as 2.9 million jobs and countless personal tragedies for those that would have been impacted. Options such as Pay as You Grow have been used by 32 per cent of BBLS businesses as of 31 March 2023 which also provided much needed flexibility for SMEs. As a result, largely of these Covid interventions, gross lending climbed to a record high of £105 billion in 2020, as shown in the Small Business Finance Markets Report by the British Business Bank.

However, BBLS and the other Covid schemes – alongside the impacts of the pandemic – have contributed to a dampening of demand for non-scheme finance provided on a commercial basis. As noted elsewhere in this response IF/ABL members of UK Finance reported a 39 per cent drop in the amount of funds being utilised by clients in the three months from April to June 2020 and suffered a 9 per cent reduction in the number of clients using the product in a single year following the introduction of the schemes. Similarly, the number of new bank overdrafts taken up by SMEs reduced by 61 per cent in the year following the introduction of schemes and take up of overdrafts today remains significantly lower than prior to the pandemic. The significant amount of outstanding debt under the Covid schemes will also continue to have an impact on both demand for finance and ability to access new finance.

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[1] Note that CLBILS was for businesses with a group turnover greater than £45 million per annum rather than SMEs.

Nonetheless overall the SME finance market remains strong. In 2022, gross lending was £65 billion, a 13 per cent increase from 2021 and higher than every year between 2012 and 2019.

As has been noted repeatedly, the nature of BBLS was unique. In particular, the removal of credit checks, while ensuring speed of delivery which was the priority at the time, ran contrary to normal parameters for lending. Fraud has also been front and centre of the industry's BBLS focus from the outset. Although most BBLS borrowers were bona fide businesses, and lenders performed their normal Know Your Customer (KYC) and Anti-Money Laundering (AML) checks, the scheme was inevitably more vulnerable to being defrauded than normal lending, which was being flagged by lenders at the time of the scheme's launch.

Because standard affordability checks were not permitted, eligibility for BBLS was based on borrower self-certification which increased the fraud risk. As of 31 March 2023, 2.46 per cent of the BBLS portfolio (i.e., £1.146 billion), was tagged by lenders as suspected fraud (this could range from organised criminal fraud to opportunistic inflation of turnover or using for purposes other than business and so in some cases may be recoverable). Lenders continue to invest significant resources, and to actively engage with law enforcement agencies, in anti-fraud activities relating to BBLS.

By contrast, CBILS and CLBILS were not reliant on borrower self-certification and these facilities were subject to credit and affordability assessments. It is not surprising therefore to see significantly better performance at the portfolio level for these schemes. 93 per cent and 98 per cent of CBILS and CLBILS facilities have been fully repaid or are on schedule, and 0.16 per cent of CBILS facilities have been tagged as suspected fraud. Zero were tagged as suspected fraud under CLBILS.

UK Finance, collectively with the British Business Bank, multiple government departments and law enforcement agencies formed a BBLS Fraud Collaboration Group in May 2020 and met weekly to oversee key BBLS fraud-prevention activities. This group continues to meet monthly to consider fraud and recoveries related issues.

**UK Finance believes that consideration should be given to how any future emergency scheme should balance the need for speed with risks around fraud, and what this means for the scheme design.**

As of 31 March 2023, 77 per cent of BBLS were repaid or on schedule, 6.1 per cent of BBLS borrowers were in arrears, 1.78 per cent in default, and the government guarantee was settled on 12.07 per cent of the BBLS loans (Source: Covid loan guarantee schemes performance data). As noted, the arrears levels are higher than CBILS and CLBILS which is a result of the nature of the scheme design. The outstanding balance of total BBLS drawn loans making payments on schedule is £22.2 billion and £5.4 billion has been fully repaid.

The Recovery Loan Scheme (RLS) marked a return to a more 'normal' government lending scheme environment. The current iteration of RLS provides up to £2 million for SMEs, providing a guarantee level of 70 per cent. This is lower than the pre-Covid Enterprise Finance Guarantee (EFG) Scheme (up to 75 per cent) and BBLS (100 per cent), CBILS (80 per cent) and CLBILS (80 per cent). Criteria is also more restrictive for the use of RLS relative to the Covid schemes, in part due to a desire not to distort market dynamics where lenders are able to support businesses without the benefit of the guarantee. RLS therefore plays a significantly more limited contribution in SME finance but provides a route for some businesses to access finance, especially those that lack security.

**UK Finance members believe that there are a number of elements of RLS' design which could increase its effectiveness. The level of the Scheme Lender Fee, the reduction in the guarantee coverage from 80 per cent to 70 per cent, and the Annual Effective Rate cap of 14.99 per cent have caused RLS to be an uncommercial proposition for many providers. In addition, the maximum term of 6 years can impact on affordability insofar as an applicant may be viable and meet core eligibility criteria but unable to repay the loan inside 6 years; whereas they could access RLS if longer tenors were permitted.**

**It also has elements that are more difficult for borrowers to navigate than EFG which was the BBB's mainstream Credit Guarantee Scheme prior to COVID-19. An example of this is the borrower requirements and attestations under the Subsidy Control Framework which, prima facie, is more complex than comparable disclosures for EFG which operated under the EU's de minimis regulation. UK Finance believes RLS can be improved by adjusting the scheme to reflect concerns in these areas.**

### Question 20. In the US the Treasury approved a fund, (State Small Business Credit Initiative (SSBCI)) for incentivising and supporting underserved businesses. Does the UK need similar provisions?

The State Small Business Credit Initiative (SSBCI) is a nearly $10 billion program to support small businesses and entrepreneurship in communities across the United States by providing capital and technical assistance to promote small business stability, growth, and success.

SSBCI includes two programs: the Capital Program and the Technical Assistance (TA) Grant Program. Under the Capital Program, participating jurisdictions implement credit and equity/venture capital programs to provide capital to small businesses. Under the TA Grant Program, Treasury supports programs that provide legal, accounting, or financial advisory services to qualifying small businesses.

In 2010, the UK Government introduced the Regional Growth Fund, a place-based fund that sought to address regional inequalities in access to finance for micro businesses while creating and safeguarding local jobs. The Fund played an important role in financing the UK's Community Development Financial Institution (CDFI) sector, which provides local place-based small business lending. The Fund also leveraged in private capital while supporting new and existing businesses and creating and safeguarding jobs.

The British Business Bank launched in 2014 now plays a significant role in supporting smaller businesses that are start-ups, high growth, or simply viable but underfunded and would be the appropriate delivery vehicle for any UK version of the SSBCI.

## Question 21. How useful is the British Business Bank (BBB)? Does its finance hub improve SME access to finance?

The BBB serves an integral purpose in terms of supporting SME access finance. This is across a wide spectrum of activities including but not limited to:

- Schemes, usually provided via lenders, to those SMEs that are viable but for various reasons, such a lack of security, may be unable to access conventional finance.
- Equity investments, through an extensive range of programs and funds, into fast growth SMEs.
- Supporting challenger and alternative funds to increase the diversity and supply of finance options available to SMEs.

Since its formation in 2014, the BBB has materially expanded its product and service range to SMEs and expanded both its regional footprint and its relationships with third party finance providers. The Start Up Loans scheme has a proven track record in supporting female, ethnic minority and youth entrepreneurs.

The BBB is the largest domestic Limited Partner (LP) investor in the UK, helping to support the UK's venture capital ecosystem, unlocking opportunities for founders and acting as a key enabler of the UK's innovation economy.

The industry and the BBB collaborate extensively. The collective response at speed to the COVID-19 emergency was a prime example of this (refer to response to Question 19).

### Credit Guarantee Schemes

Credit Guarantee Schemes (CGS) have been a core HMG intervention to support SME access to finance since the early 1980s. The BBB has managed these schemes since its own formation. Historically, these schemes have been used by a lower proportion of UK SMEs than SMEs in many other economies. However, **COVID-19 Scheme support was a noticeable exception; funding provided to SMEs was many multiples of that provided through the predecessor Enterprise Finance Guarantee (EFG) scheme in the entire 11 years it was on-sale since 2009**. Although successor Recovery Loan Scheme (RLS) volumes are modest in comparison to COVID-19 Schemes, similarly these volumes are higher than for EFG.

Although RLS is being used successfully, there are issues with the scheme which should be considered by the BBB:

- Rule changes for the third iteration of RLS (from RLS v 1 / v2) have reduced the origination opportunity; albeit this reduces conventional lending displacement which is beneficial.
- Lenders have highlighted RLS is complex. Challenges include increased reporting obligations and obligations relating to the Subsidy Control Framework. Delivering on these scheme requirements can necessitate additional investment (in people, process, and systems) that may outweigh the commerciality of participation, especially where volumes are likely to be modest.

Other Credit Guarantee Schemes, such as BBB's Enable Guarantee programme, provide a guarantee to a lender at a portfolio rather than individual facility level. This can reduce the amount of capital a lender has to hold to cover loans, enabling them to lend more to small businesses. This can be particularly useful in certain scenarios; for example, where a new or unproven technology or asset type does not yet have a track record. There are merits in considering further use of portfolio guarantee structures.

Given the learnings of the COVID-19 Schemes, there is a recognised need for some form of "off the shelf" scheme that could be adapted and brought to market at quick pace in any future emergency. The need for this was highlighted by the potential consequences for Silicon Valley Bank UK's customers had a successful takeover by HSBC not occurred. We are aware that this is firmly on the BBB's radar and are happy to support the BBB in this activity.

### Equity Provision

The BBB has a crucial and increasing role in the provision of equity finance to fast-growth SMEs. This is particularly important noting the decline in SME equity investment through Q3 2022 to Q1 2023 (Source: BBB/ Beauhurst Small Business Equity Tracker 2023). Through 2020 to 2022, BBB equity programmes supported circa 13 per cent of equity transactions with an increasing proportion of these to finance diverse founder teams.

Through equity provision, the BBB can also help to alleviate regional imbalances in access to finance. Its expanded range of Nations and Regions Investment Funds will be pivotal in reducing gaps in the provision of equity finance to SMEs across the UK. On a related theme, it should be recognised that government programmes have proportionally supported more of the equity transactions in Scotland, Northern Ireland, and Wales than the UK as a whole.

### Promoting alternative and challenger finance products and providers

The BBB also plays an important role in diversifying the funding marketplace for SMEs through programmes to support alternative and challenger finance providers. This includes initiatives such as its Investment Programme and Enable Funding, which can deliver capital markets access to smaller lenders, which strengthens access to finance across these range of suppliers.

### Finance Hub

The BBB's Finance Hub does not directly enable SMEs to access finance. However, it provides easily accessible information for SMEs in terms of:

- Providing a "plain English" synopsis of different types of finance and how they may play a part in supporting a business.
- Providing regionally based case studies and organisations that the SME can follow-up with to initiate funding dialogue.

Therefore, it is a beneficial tool to support SME awareness of finance options, particularly those that may have a lower profile or where misconceptions may exist.

## Supplementary Response: Business Account Closures

In view of recent media coverage and political interest over the provision of banking services to business customers, we felt it would be relevant to include further evidence on this topic to inform the Committee.

This is an issue that our members take very seriously.

Banks adopt a risk-based approach to account management and only withdraw services from customers after careful consideration. It is worth noting that many business current account closures are customer initiated or are not bank led. Reasons for this include account switching, insolvency, dissolution, liquidation, or the business ceasing to trade.

There are many reasons why banks may initiate business account closures which include cases where the account has been dormant or inactive for an extended period, credit default, economic crime (including financial sanctions), and customer conduct.

Banks are required to comply with Know Your Customer (KYC) and Anti-Money Laundering (AML) regulations and guidance both in the UK and other jurisdictions. This regulatory framework is essential to tackle criminality and terrorism but on occasion it can create challenges for some legitimate businesses.

Know Your Customer (KYC) standards are designed to help prevent fraud, corruption, money laundering and terrorist financing. KYC involves actions to identify customers, understand the nature of customers' activities and determine that the source of funds is legitimate; and assess money laundering risks associated with the customer's activities. To tackle criminal activities that use the financial industry to launder money, governments across the globe have extended the scope and reach of their KYC policies, creating strong regulations with high penalties for breaches which cover every aspect of the global financial ecosystem.

The KYC process involves financial institutions asking customers to provide a range of information about their business operations and individuals associated with the business. This information is supplemented with publicly available information and checks are made against records of individuals and organisations that have been identified as bad actors by law enforcement agencies, as well as lists of countries not meeting international AML standards as maintained and publicised by the Financial Action Task Force (FATF).

In most circumstances banks seek to have dialogue with customers when they have concerns and require information or evidence to confirm that account operation is legitimate. Customers are given every opportunity to provide this. If the customer is unable to do so or chooses not to engage, banks may give notice to close the account.

There are occasions when banks need to exit a relationship as rapidly as possible, particularly where there are crystallised economic crime issues involved. In such instances they are not able to explain the underlying reasons to customers for legal reasons, known as tipping-off.

Certain sectors are associated with higher levels of economic crime risk due to specific reference in the Money Laundering Regulations or the National Risk Assessment, for example, defence exporters and money services businesses. UK Finance continues to engage with trade bodies representing these sectors to support mutual understanding and to facilitate improved access to banking.

The government has recently announced there will be an increased notice period and more information provided around account closures. UK Finance is working with members, government, and regulators to support the workable implementation of these changes.

UK Finance is also supporting the FCA's data gathering exercise on payment account closures, which seeks to quantify the number of closures and the reasons for doing so.

## For more information

For more information on this submission, please contact Jennifer Tankard at
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