# Business Finance Review

UK Finance provides a regular analysis of how the finance needs of small and medium-sized enterprises (SMEs) are being supported through lending from mainstream lenders and specialised finance providers and looks at their deposit holdings. This latest *Business Finance Review* provides a round-up of lending activity to SMEs in the fourth quarter of 2023 and the year as a whole.

**David Raw, Managing Director of Commercial Finance, comments:**

*"2023 was another challenging year for SMEs as they continued to face uncertain demand and rising borrowing costs. As a result, demand for new finance flatlined across the year and lending by the main high street banks again trended below pre-pandemic norms.*

*"There were, however, more promising signs that demand may be turning a corner in the final quarter of 2023. Approvals for new loans and overdrafts increased and the rise was broad-based across all sectors. This could be a sign that confidence is gradually improving.*

*"We continue to see SMEs retain a good degree of flexibility within existing deposits and finance facilities. This should help them remain resilient as the economy picks up this year. While we also see SMEs continue to meet their repayment obligations, particularly those relating to Covid-era support. However, those concerned about their financial position or those planning for the future are always encouraged to have early conversations with their lender."*

## 2023 Q4 HIGHLIGHTS

- **Gross lending by the main high street banks unchanged in Q4 – the first quarter not to see a fall since 2022 Q2.**
- **However, 2023 marked third consecutive year of declining gross lending.**
- **Record client turnover supported by IF/ABL providers in 2023.**
- **Volume of loan and overdraft approvals rises over the quarter, with the value of loans approved the highest since 2022 Q3.**
- **Recovery in finance approvals broad based across sectors.**
- **Pace of decline in SME deposits slows compared with the previous quarter.**
- **Monthly repayment trends remain stable albeit with seasonal decline reported in December.**

## Economic outlook

The UK economy has struggled in recent years, but in the second half of last year provisional estimates from the Office for National Statistics (ONS) point to a contraction in GDP in both Q3 and Q4.

In the final three months of 2023 GDP fell by 0.3 per cent, this marked an acceleration in the pace of decline compared with the 0.1 per cent fall in Q3. This estimate shows the weakest performance of the UK economy since the start of 2021, when Covid-19 lockdowns were still in place. This leaves full year growth in 2023 at a stagnant 0.1 per cent.

While the conclusion of many commentators is to declare the UK in recession, this should come with a few important caveats. These data are often subject to revision, meaning that one or both of those quarterly falls in GDP could be revised away. And secondly, unless we see further declines in economic output – which forecasters, including the Bank of England, are not currently predicting – it would be a very mild recession.

While the overall decline in GDP in Q4 was modest, indeed there has been similar weakness in many parts of Europe, it was, nevertheless a broad-based decline. Services output fell for the third quarter running, with some consumer-facing sectors continuing to see tough trading conditions.

One of the biggest drags on services, which contracted 0.2 per cent in Q4, was wholesale and retail trade. In addition, transport and storage, and accommodation and food services both saw output contract in the second half of 2023. This reflects the ongoing pressure on households from nearly two years of elevated inflation and rising interest rates keep a lid on spending. This was felt by retailers with a rather disappointing festive period.

Manufacturing and construction also saw a fairly hefty fall in output in Q4, posting contractions of 0.9 per cent and 1.3 per cent respectively. Up to the final months to 2023, manufacturing activity had a good run of growth in the preceding year – subsectors such as transport equipment, pharmaceuticals and electronics have proved resilient in the face of softening domestic demand and a more subdued period of global trade growth. But growth fell away in all parts of manufacturing in the final quarter.

Similarly, construction also had a strong post-pandemic performance, but recent quarters have seen a sharp contraction in house building activity – down eight per cent in the final months of 2023 alone. Indications on new housing starts offer little encouragement for a near term turnaround.

The tangible effects of challenges across construction and consumer facing sectors has been a marked increase in insolvencies. In Q4 company insolvencies were 14 per cent higher than the same point a year ago and across 2023 as a whole construction, wholesale and retail trade, and accommodation and food accounted for half of company insolvencies.

Some of the growth challenges and cost pressures on businesses are, however, starting to ease. Producer input prices, for example, fell by over three per cent in the year to January, aided by falls in oil prices. Barring any further escalation of supply chain disruptions in the Middle East, businesses should see a more benign period on key input costs.

Continued pressure on pay growth is a possible exception to this. There are clearer signs that the labour market is cooling with vacancies trending down over the past 18 months, which firms are expecting to translate into moderating wage increases in the year ahead. But, as ever, sectors in which skills shortages are prevalent, may continue to see larger pay demands.

How these growth and domestic inflation trends play out in the coming months will be key to the Bank of England's decision on when to start cutting interest rates. Following recent statements from Monetary Policy Committee members, it does feel like a question of when, rather than if. CPI is now predicted to fall more rapidly with the new, lower energy price cap coming in from April.

However, any return of inflation to the Bank's target is expected to be temporary. A majority of the MPC will still need to see convincing data that domestic inflationary pressure is abating before Bank Rate starts to come down.

Alongside the Chancellor's recent spring Budget, the Office for Budget Responsibility left it's forecast for GDP growth in 2024 unchanged at 0.8 per cent but upped its growth expectations for 2025.

With the autumn statement announcement significant measures to boost investment across businesses and the proximity to a likely election, the spring budget measures were more squarely targeted towards personal taxation. However, full expensing will be externed to leased assets as public finances allow. The Recovery Loan Scheme will also be extended and rebranded as the 'Growth Guarantee Scheme'.

For households, the Chancellor announced a further 2p reduction in employee National Insurance Contributions, which, together with the cut in January, the OBR estimate will benefit basic rate taxpayers to the tune of over £600 per year. In addition to continued freezes in fuel and alcohol duty, which will amount to some £13 billion of fiscal loosening in the next financial year, offset by reform to tax regime for non-domiciled individuals.

## SME finance – 2023 round up

From a business lending perspective, the post-pandemic period has been characterised by an uncertain demand environment, the overhang of Covid-19 government loan schemes and rising interest rates. All of which have combined to depress SMEs' demand for new and additional finance.

Full year data show this was again the case in 2023. The year started on a particularly weak note with financial market turmoil at the end of 2022 depressing applications, but the picture appeared to stabilise as the year progressed. However, across all our key financing metrics, activity in 2023 was lower than a year ago and remains significantly below pre-pandemic norms (**table 1**).

***Table 1: Annual SME finance metrics***

| | | 2021 | 2022 | 2023 | % change 2022-2023 |
|---|---|---|---|---|---|
| **Lending** | | | | | |
| Gross Lending | *£mns* | 22,568 | 18,419 | 14,298 | -22% |
| Net Lending | *£mns* | -9,245 | -12,843 | -11,075 | -14% |
| Loan approvals | *No* | 157,344 | 42,248 | 36,631 | -13% |
| Overdraft approvals | *No* | 32,558 | 42,161 | 40,006 | -5% |
| Overdraft utilisation | | 41% | 44% | 48% | |
| **Repayments** | | | | | |
| Total Repayments | *£mns* | 31,814 | 31,262 | 25,373 | -19% |
| **Deposits** | | | | | |
| Sight | *£mns* | 166,500 | 159,257 | 133,480 | -16% |
| Time | *£mns* | 103,505 | 99,194 | 100,074 | 1% |

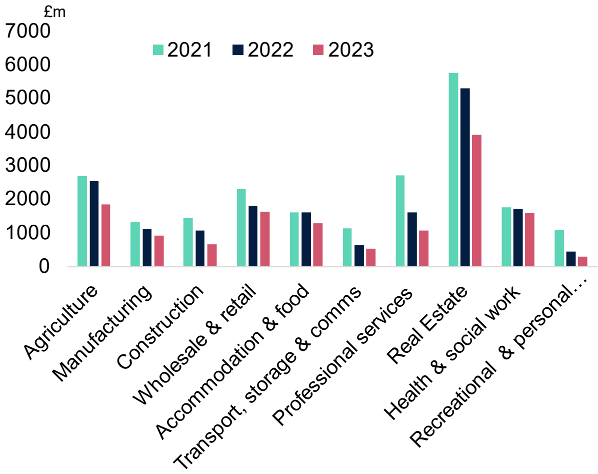
*Source: UK Finance*

This is consistent with a host of survey evidence relating to SME confidence and financing plans. The *SME Finance Monitor*, for example, shows a lower proportion of SMEs, across all size brackets, planning to apply for finance over the course of the past two years compared with rates seen before the pandemic. The *Monitor* also notes the persistence of cost pressures across most sectors last year, and that concerns about the economic climate remain elevated.

Given this challenging backdrop for small- and medium-sized businesses and the materially higher cost of finance as Bank Rate has increased, a third consecutive year-on-year decline in gross lending by the main high street banks was predictable. While our data covers a subset of the lenders to the SME market, more complete market coverage from the Bank of England confirms the relatively weak lending trends to SMEs in 2023.

SME aggregate changes are also replicated across all the main sectors, for which we report. As **chart 1** shows, all sectors recorded declines in gross lending last year, again marking the third year running in which this trend has been observed. This would confirm that the headwinds to SME growth and sentiment around taking on additional finance have been broad-based, rather than concentrated in any particular industry segments.

***Chart 1: Gross lending by sector***




Looking at the trends in finance approvals to SMEs, the path of loans and overdrafts approved has diverged somewhat in recent years. In 2022 we saw some recovery in demand for overdraft finance, which had fallen sharply in the preceding years as SMEs opted to draw on government-backed Covid loans. New or increased overdrafts also supported businesses with cashflow as they managed pressures from sharply rising input costs. Overdraft demand moderated somewhat in 2023, but the volume of approvals ran ahead of loan approvals for the first time since 2019.

Our full year data point to similar relative strength in invoice finance and asset-based lending compared with new loan financing, with advances continuing to run at over £20 billion per quarter through 2023.

There were also indications that SMEs were making somewhat greater use of headroom within existing finance facilities. Overdraft utilisation drifted higher through 2023, but remains some distance from pre-pandemic utilisation rates, which were around ten percentage points higher than the average across last year.

2023 also saw a more rapid decumulation of deposits built up during Covid-19. Current account balances ended the year 16 per cent lower, compared with a fall of four per cent in the previous year. Similar to the headroom available in overdrafts, the aggregate picture on deposits points to SME retaining a good degree of cushion relative to the pre-pandemic position. At the end of 2023 total deposits were still nearly fifth higher than at the start of 2020.

Finally, in the 2023 round up, there was also a year-on-year decline in repayments. The fall comes from elevated repayment rates in the previous two years as SMEs began to fulfil their repayment obligations on government-backed loans (mainly Bounce Back loans - BBLs). As businesses have steadily repaid these loans, our data continues to point to the more rapid reduction in the stock of lending on fixed interest rates. The latest data from the Department for Business and Trade (to September 2023) shows that 12 per cent of BBLs were fully repaid at the end of 2023 Q3 and 63 per cent are on track to be repaid.

In summary – SMEs have faced challenges aplenty in recent years with multiple factors limiting the appetite for finance. There may be some signs that the end of the declines we've seen across many of these lending metrics is in sight. While a turnaround may be in prospect, we are also conscious that many of the uncertainties that clouded the outlook in 2023 will spill over into 2024, with risks that some new challenges will emerge. The next section will look specifically at developments in the final three months of the year.

## Invoice finance and asset-based lending in 2023

Turning to invoice finance and asset-based lending (IF/ABL), the trends observed are broadly similar to those seen in the other key working capital product, overdrafts. Overall, in 2023 the sector supported UK businesses with a combined turnover of £316 billion, an annual record, just exceeding the £314 billion supported in 2022.

In turn, this turnover drove record availability within Invoice finance (IF) and asset-based lending (ABL) facilities, with UK Finance's IF/ABL members offering working capital facilities worth over £50 billion to clients at the close of the year. Advances drawn down by clients through those facilities were fractionally down, however, with utilisation (advances against funding available) settling at 60 per cent at the close of the year, down from 64 per cent seen in Q1.

The average utilisation rate across the year was 61 per cent, down from 64 per cent for 2022, again mirroring the significant headroom seen available within other types of facility, to which costs of finance and generalised economic concerns would have contributed.

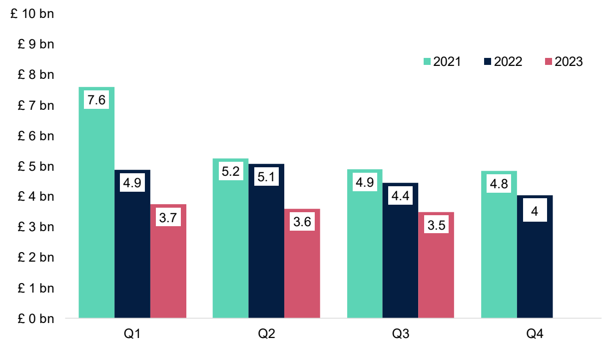
The average value of advance per client across the year was the second highest recorded, with the 'average' client drawing down £584,000 at any point in time. In addition, the average client supported by the products generating turnover of in excess of £9 million per year (another record). But with client businesses supported ranging from those with less than £500,000 annual turnover up to those with in excess of £100 million, that mean figure obviously covers a lot of variation.

Overall client numbers continued to broadly plateau, however, likely reflecting the reticence in taking out new finance facilities observed elsewhere, as well as impacts from the government loan schemes and near record levels of SME deposits.

## SME finance – 2023 Q4

As discussed above 2023 was another year in which demand for new finance and the flow of lending to SMEs remained subdued. However, the decline in gross lending that our data has shown in the previous five quarters came to a halt in the final months 2023. In Q4 gross lending posted the first increase, albeit a modest one per cent, since 2022 Q2 (**chart 2**).

***Chart 2: Gross lending to SMEs***




*Source: UK Finance*

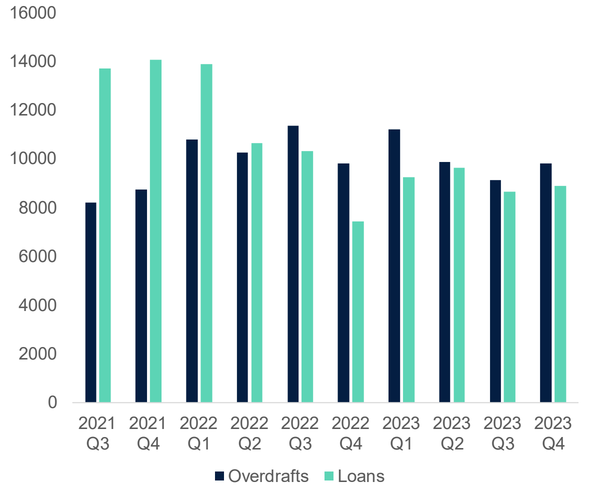
Lending to medium-sized businesses is the first to turn a corner and across this segment of the SME market, this was the first rise in gross lending in two years. Lending to the smallest firms, however, continued to trend down in the final three months of 2023 but at a slower pace compared with the previous quarter.

In the second half of 2023 our data also point to greater sector variation in lending patterns. Manufacturing and agriculture, for example, reported two consecutive quarters of increase in gross lending in 2023 Q3 and Q4, with only real estate and construction continuing to see falls in lending throughout the second half of last year. These sectors are particularly exposed to the higher interest rate environment and, as noted in the introduction, the sharp falls in house building activity.

In other sectors there are tentative signs that demand for finance is returning, and the main high street lenders are meeting these demands with new loan finance. Expectations that cost-of-living pressures will ease on consumers in the year ahead – not just in the UK, but as global inflation eases, as well as signalled interest rate cuts by the Bank of England, may be lifting business confidence in the year ahead.

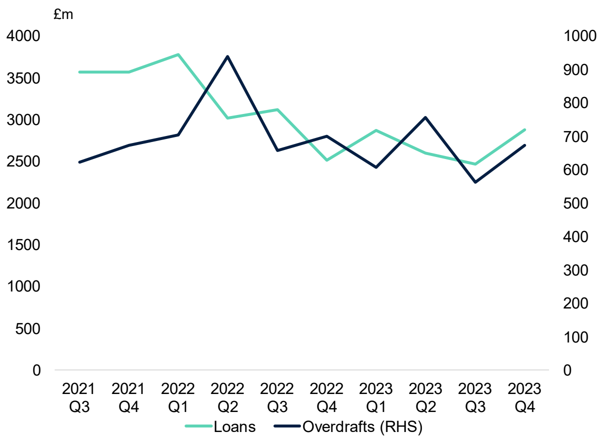
Moreover, approvals for new financing also increased over the quarter. The number of new loans and overdrafts rose by three per cent and seven per cent respectively compared with the previous quarter (**chart 3**). And there was a more significant increase in the value of approvals (**chart 4**), with the value of approved overdrafts rising by nearly a fifth and loan approvals values increasing by a healthy 17 per cent.

***Chart 3: Number of approved loans and overdrafts***



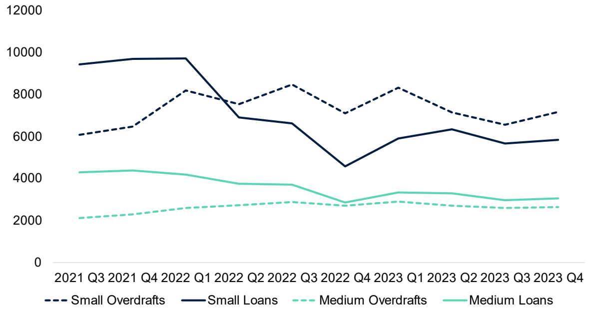

*Source: UK Finance*

***Chart 4: Value of approved loans and overdrafts (£m)***




A further encouraging sign of improvement in lending conditions is seen in the breakdown of approvals by business size ***(Chart 5)*** – again the picture is consistent with rises seen across small- and medium-sized firms in both the volume of loans and overdrafts approved.

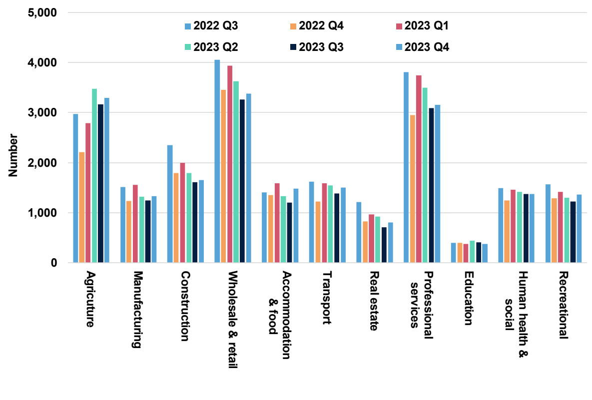
***Chart 5: Number of approved loans and overdrafts by size***




*Source: UK Finance*

Finally, **chart 6** breaks down the volumes of finance approvals by sectors, which again suggests that there has been a broad-based turnaround over the quarter. All major sectors saw an increase in the volume of loans and overdrafts agreed compared with the previous quarter. However, for most this was a partial reversal of the decline in Q3.

***Chart 6: Number of approved loans and overdrafts by sector***




*Source: UK Finance*

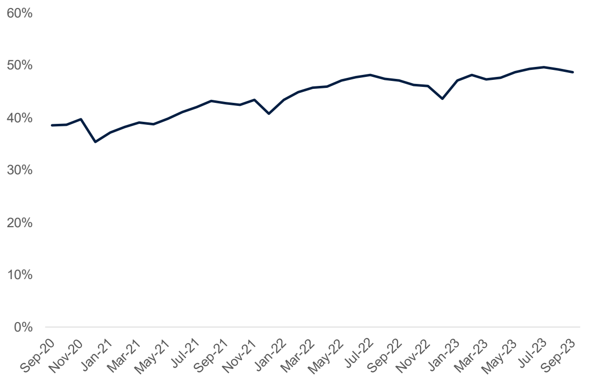
In terms of percentage increases, there was a particularly notable increase in accommodation and food services, and recreation and personal services. For the former of these, this takes approval numbers back to levels seen before the mini-budget in 2022. However, for most other industry sectors approvals are still lagging some way behind levels seen in the first half of 2022.

Overall, the positive trends in approvals seen in the final quarter of 2023 will likely have translated into some of the uplift in gross lending seen over the period, and perhaps also bodes well for a further uptick in lending conditions in the quarters ahead.

## Financial headroom

Utilisation of existing overdraft facilities remained broadly stable, on average over the quarter, but with the usual seasonal dip in December (**chart 7**).

***Chart 7: Overdraft utilisation, percentage***

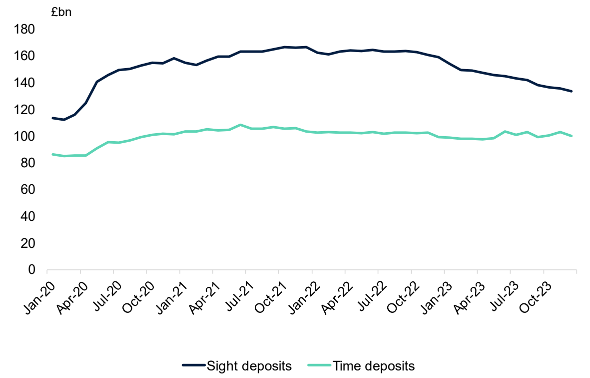



*Source: UK Finance*

As we have noted in recent *Reviews,* there has been variation in the path of utilisation rates around this aggregate picture. In the most recent quarter, the largest movement in utilisation rates was in accommodation and food services. We saw a similar pattern in previous years with utilisation rates rising towards year end and ratcheting up further in the subsequent quarter. This could reflect the timing of cost pressures arising across this sector, for example, rent on premises and salary increases. We might therefore expect to see utilisation rates across this industry increase again in the coming quarter.

Even with the increases in utilisation over the past year (an increase of some 11 percentage points), the accommodation and food sector continues to retain more headroom within existing overdraft facilities than before the pandemic. Indeed, this is the case across all industries.

***Chart 8: SME Deposits***

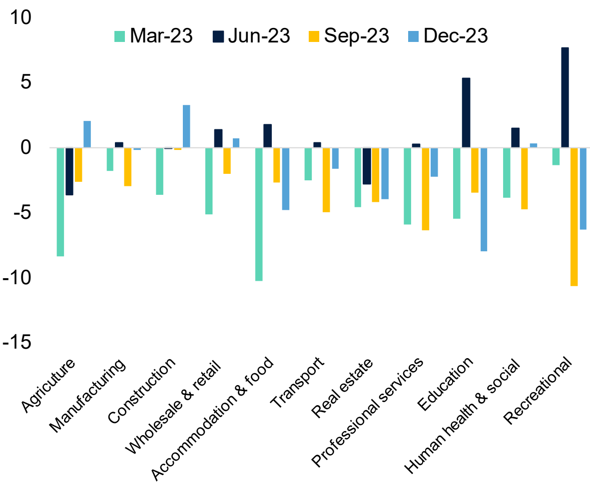



*Source: UK Finance*

While SMEs use of overdraft facilities, in aggregate, remained broadly stable over the quarter, the stock of deposits continued to trend down. The drop in Q4, at 1.6 per cent, represented something of a slowdown in the pace of decumulation compared with the previous quarter (a decline of 4.5 per cent). Declines in total deposits were recorded for both small and medium sized businesses over the period.

Within this, we again see some movement of deposits from current accounts to notice accounts, with the latter increasing by one per cent at the end of year compared with the end of Q3.

***Chart 9: SME Deposits by sector (% change)***




*Source: UK Finance*

Similar to other metrics, we see some divergent trends in deposits across sectors (**chart 9**). Larger than average drops were seen in accommodation and food services, real estate, and recreation and personal services. In contrast, there was a seasonal increase in agriculture and wholesale and retail trade.

In line with the picture on overdraft availability, while deposits continue to be drawn down by SMEs, the aggregate picture remains one where the level of available deposits is some 18 per cent, or £36 billion, higher than before the pandemic.

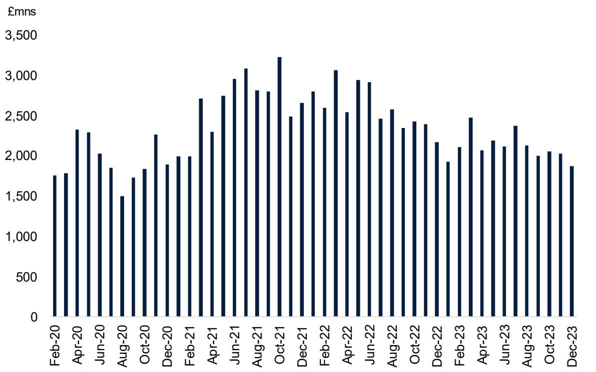
This is consistent with survey-based measures of available credit balances, such as the *SME Finance Monitor* which shows in the three months to November SMEs held the equivalent of 27 per cent of turnover in credit balances - still higher than reported between 2016 and 2019.

This level of credit balances should provide SMEs with some of the resources needed to take forward any investment plans or manage further challenges that may emerge. However, we also recognise that there will be many SMEs which may already have reached, or be close to reaching, the limits of this deposit cushion.

## Repayments

We continued to see a fairly stable picture on monthly repayment rates in October and November, with repayments falling away at the end of the quarter (**chart 10**). These movements over Q4, again, fit with trends noted in previous years.

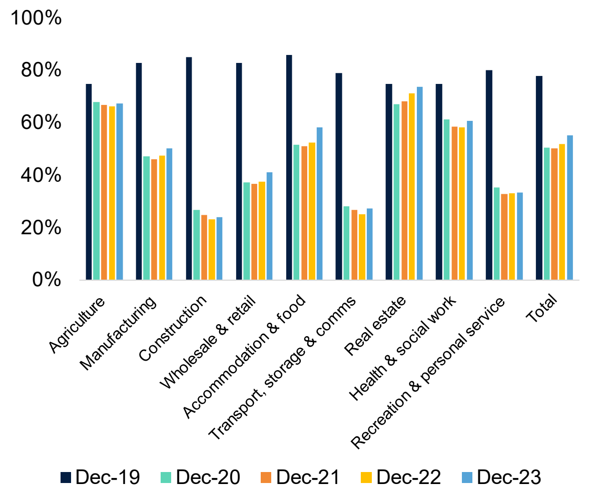
***Chart 10: Value of repayments***




*Source: UK Finance*

As discussed in the 2023 round up, the stock of lending on fixed interest rates has fallen more rapidly than that on variable rates as SMEs continue to pay down government-backed BBLs, although flows of new lending will likely be a combination of fixed and variable rate lending. There was no change in these trends in Q4 with the stock of fixed rate lending falling six per cent on the quarter and variable rate lending rising by one per cent.

***Chart 11: Proportion of loan stocks on variable rate***




*Source: UK Finance*

As Bank Rate has risen over the past two years, the exposure of SMEs to higher borrowing costs comes not just from new lending, but also existing finance. **Chart 11** shows that across most sectors SMEs are less exposed to the effects of higher interest rates than would have been the case in 2019. In relative and absolute terms, the stock of variable rate lending has declined appreciably, with the exception of agriculture and real estate.

## Outlook for SME finance

While 2023 was another challenging year for UK SMEs – stagnant growth, flagging consumer demand, the hangover of rising energy costs and higher interest years. However, economists' expectations are that these will subside in the year ahead.

Our Q4 data contain some of the most promising signs we've seen for more than a year that SMEs are starting to plan for the future and have a bit more confidence to take on new or additional finance, and lenders are meeting those requirements.

At this stage, we remains cautious in our optimism. The economic outlook remains fragile, and the persistence of geopolitical tensions means that new risks or the re-emergence of supply chain could yet materialise.