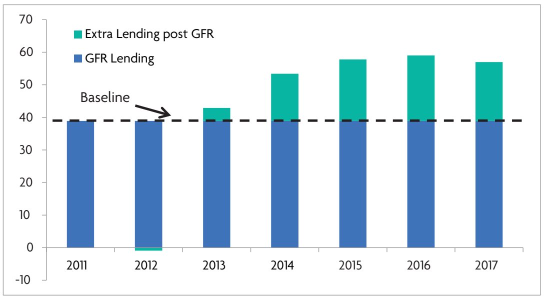
SME Finance – Where Are We Now?

This autumn marks a decade since the global financial crisis hit in 2008 and the shockwaves spread across all areas of the UK economy. The following two years saw both banks and businesses retrenching as a result of the tough economic environment, with new bank lending to SME customers falling to a low of just over £38 bn a year.

In response and as part of efforts to rebuild relationships with the SME community and support economic growth, the government-backed Business Finance Taskforce was set up in 2010 by banks including Barclays, Lloyds, RBS, Santander and Standard Chartered. Bank of England monetary policy also underpinned the supply of wholesale funds for some banks and reduced the cost of capital.

These and other actions, some of which remain operational today, helped to support growth in demand for credit. UK banks responded by increasing the gross supply of new loans to nearly £60 bn a year by 2015-2017 (see graph 1). The increase in new loans granted added up to nearly £75 bn by the end of 2017 and constituted more than 60 per cent of the additional finance facilities reported since 2011 (see table 1).

Graph 1: UK Bank Lending to SMEs since 2010 (£bn)



Source: BoE, Bankstats and author calculations

Yet despite the increase in new bank lending to SMEs, figures suggest the stock of SME loans outstanding fell by 12½ per cent, from £176 bn to £154 bn, between June 2011 and June 2018.

Over the same period, SME overdraft balances fell by 40 per cent, from £20 bn to £12 bn.[1]

Table 1: Gross New Funding for UK SMEs, Growth Rates 2008-17

Source of Funds	Since 2011 Cumulative "Extra" Supply £bn	2008/10 v 2015/17 Average growth (%)
- bank loans	74.9	38
- private equity	12.2	535
- asset finance	27.1	49
- P2P business lending	4.6	See footnote
- P2P Invoice funding	1.5	See footnote
- CDFIs	0.3	186
Total	120.6	49

Source: Bank of England Bankstats, British Business Bank, UK Finance and Responsible Finance
Note – P2P growth rates not cited as large % increases represent low base volume

[1] Bank of England, Bankstats, Section A, Money and Lending

Are banks turning down viable SME loan applications?

The focus on the stock of lending can sometimes distort perceptions of the lending landscape for SMEs. To a large degree the stock of lending is influenced by past events. It covers not just new business agreed by lenders but also scheduled repayments, loans being repaid in full at maturity and write-offs. The stock is not necessarily a good indicator of current market conditions.

More choice for SMEs

Another key factor in the drop in the bank stock of outstanding SME loans is positive – SMEs now have a wider range of suppliers to approach for external finance.

UK government policy since 2010/11, and particularly since the recommendations of the Breedon report in 2012, has sought to diversify the supply of external finance for SMEs. Breedon emphasised the importance of encouraging SMEs to look at a range of established and emerging sources of funding and types of product, many of which – often underpinned by fintech developments – have seen strong growth in recent years, supported in particular by the market investment activity of the British Business Bank. [2]

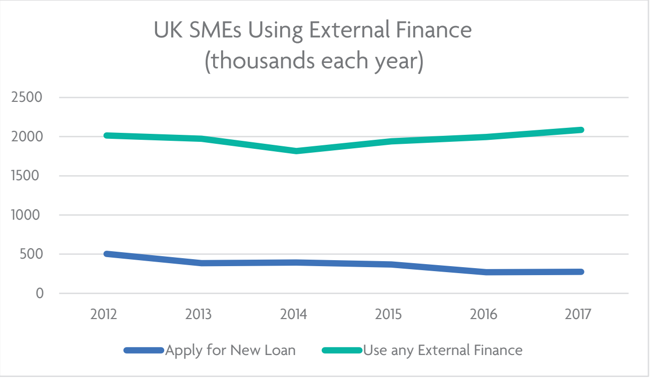
New sources of funding have both supplemented and displaced bank lending in different market segments. For example, new regulatory requirements have increased the cost of funding bank overdrafts for SMEs over the last decade, but more firms are using credit cards and there is a growing range of asset-based finance products. However, the decline of the overdraft market does not appear to be a constraint on the SME sector. Utilisation of SME overdrafts in high street banking – the percentage of agreed limits actually being used – at the end of 2017 was about 50 per cent, virtually the same as a decade earlier and indicating considerable operational headroom was available. [3]

Not every SME wants finance

Demand for SME bank debt can be affected for a number of reasons and is also subject to short-term cyclical pressures. Perhaps unsurprisingly in light of the ongoing economic uncertainty around Brexit, SME demand for credit tailed off during the spring and summer months of this year.

Moreover, not all SMEs are looking for external finance, nor is every application successful. The data collected on a regular basis from the UK SME Finance Monitor and by the Bank of England illustrates both points. As shown in graph 2, the number of SMEs reporting they have applied for a new bank loan has levelled off now but is still significantly lower than in 2012. [4]

Graph 2: Indicators of SME External Finance Supplier Diversity since 2012



[2] British Business Bank Annual Report, July 2018; Breedon Report, 2012

[3] UK Finance, SME Support Press Release, Q4 2017 and BBA Statistical Yearbook (2010)

[4] The percentage applying is still falling slightly in 2016-17 but the business population is growing, so number applying is stable (provisional data for H2 2017 alone may indicate the percentage has risen as well)

While most borrowing applications made to banks by SMEs are successful, the acceptance rate is not 100 per cent. Banks have a duty to lend responsibly and can only support viable applications where the applicant can show a sufficient degree of certainty that they will have the cash flow from trading or reserves to meet scheduled repayments.

Looking back through multiple waves of bank applications between 2011 and 2017 indicates average SME acceptance rates of 83 per cent for overdrafts and 69 per cent for loans. Success rates varied from over 99 per cent for overdraft renewals to just over 50 per cent for first-time loan applicants (many of which will be start-up or younger firms with limited assets or track record) (see table 2).

Table 2: Loan and Overdraft Application Success Rate (%)
(Average % acceptance rates for successive 18-month cohorts 2011-17)

Overdrafts		Loans	
All SMEs	82.6	All SMEs	69.1
-Minimal risk	97.1	-Minimal risk	92
-Worse than avg risk	73.6	-Worse than avg risk	54.6
-First time applicants	57	-First time applicants	51.6
-Other new facilities	76.6	-Other new facilities	75.6
-Renewals	99.1	-Renewals	88.6

Source: UK SME Finance Monitor

Banks have a legal duty to refer declined applicants to alternative sources of external funding. The reality check provided by a bank decline can also be an important part of the entrepreneurial process, encouraging business owners to look at their plan again and seek advice. In some cases, via signposting help delivered via the decline letter now sent to all unsuccessful applicants, an alternative finance product (e.g. leasing) can be identified. Alternatively, the formal referral service introduced by the Small Business, Enterprise and Employment Act in 2015 can be used with customer agreement to access an even wider range of funding providers.

Data from the UK SME Finance Monitor indicates that thousands of firms are recorded as discouraged from applying for bank funding

The issue of discouraged borrowers has received substantial attention in recent years. Yet while a proportion of would-be borrowers are discouraged from applying, the remainder do not apply for other reasons (see table 3).

Table 3: UK SME Population Split by Borrowing Market Activity, 2012-17

% of SME Population	2012	2013	2014	2015	2016	2017
Had a borrowing event	35	28	38	32	25	28
Wanted debt funding but did not look	15	10	8	6	4	4
Did not want to Borrow	50	62	54	62	71	68

Source: UK SME Finance Monitor; base excludes Permanent Non Borrowers

The percentage of SMEs in this category – who wanted to borrow but did not try – has fallen back since the crisis and stood at around four per cent of the stock in 2017. Closer to the low point of the recession, about 15 per cent of SMEs wanted to apply. Expressed in terms of actual business numbers, this is a decline from around 450,000 firms in 2012 to about 110,000 last year, a 75 per cent fall. In both cases, these estimates are based on the SME population excluding firms who classed themselves as permanently out of the debt market so as to get a more reliable measure of the scale of this issue.[5] The large decline in numbers illustrates the impact of the huge focus on SME finance in the years after 2010 and the range of initiatives introduced, including the work of the Business Finance Taskforce. [6]

While fewer SMEs sought bank debt after 2012, some switched to alternative funding sources and others decided to self-fund from rising cash flow. Moreover, other business owners did not seek new funds of any type at this time to allow profitability to rebuild, perhaps also because they did not see sufficient opportunity to invest in an uncertain business climate. Across the economy as a whole, the slow pick-up in business investment and borrowing post-crisis has been an issue of concern to policymakers as part of the "productivity conundrum". [7]

However, around 110,000 firms in 2017 still wanted debt funding but did not try. Research using the UK SME Finance Monitor data has highlighted that among these firms interested in applying the majority would have probably met the acceptance criteria for banks at the time, so the solution to this market gap would appear to have little to do with risk appetite.[8] Looking at the reasons why debt applications did not go ahead reveals a different set of potential solutions to the issue (see table 4).

Table 4: Main Reason for Not Seeking Finance (Would-be Seekers only, 2017)

% of Would-be Seekers only	2017
Discouraged	
- Direct	17
- Indirect	30
Process of Borrowing	29
Principle of Borrowing	10
Economic Climate	5
Other reasons DK	9
Total	100
(equal to 4% of all Businesses)	

Source: UK SME Finance Monitor, Q4 2017

[5] Permanent non borrowers (PNBs) in the UK SME Finance monitor. This was about 45% of all SMEs in 2017

[6] The recent ERC working paper on Discouragement using ASBS data covers similar ground to the UK SME Finance monitor but has no history to review trends. However it does not include the concept of permanent non borrowers so reports higher numbers of discouragement and appears to wider aspects of finance discouragement rather than just borrower issues. See ERC Working Paper 69 May 2018. Two earlier ERC papers by different authors offers greater clarity and results similar to the SME Finance Monitor, see notes 14 and 20 below.

[7] Fixing the Foundations – UK Government's 15 point plan, July 2015; Industrial Strategy, 2017

[8] S Fraser, Back to Borrowing – A Study of the Arc of Discouragement (ERC Working paper, 2014)

Overall, just under half of would-be seekers (about two per cent of the business stock) reported they have been discouraged from borrowing but only a fraction of these firms (less than one per cent of the stock) had any direct contact with a bank and been told not to apply. [9]

However, twice as many SMEs report they were discouraged from applying and have never approached a bank about it; they fear they will be declined or subject to poor treatment. Attempts to bring these firms back to borrowing need to focus on outward-facing initiatives by banks (such as pre-approved and advised limits and broader engagement with SMEs, local business communities and stakeholder groups).

Engaging with SMEs

The introduction of a standardised SME lending appeals process across most of the high street providers since the crisis has provided a valuable example of what can be achieved in this area. Each bank operates its own appeals scheme for declined applications, but these operate alongside an industry-wide independent audit and assurance process. By 2016/17, after nearly six full years of operation, the appeals process had considered about 19,500 applications with about one-third agreed in favour of the customer, adding about £100 mn of new lending facilities. The main benefit from the process is that it opens up better communication between applicants and the bank; the biggest single reason why declines are overturned is because the customer provides new information for the bank to consider. [10]

Meanwhile many creditworthy applicants did not apply in 2017 as they thought the process of borrowing was too complex, costly and time consuming. Applying for a loan is a big step for a business and it is correct that due process is followed. Business owners cannot expect a totally frictionless process and banks need to be able to charge a fair price for the service they provide with appropriate security as required.

This is an issue where fintech could be used very effectively to identify firms with a borrowing need and help them access information to complete the application process with ease. Fintech development work could do a similar job to widen the access of SMEs to less traditional banks and non-bank funding providers, stimulating further competition and lower transaction costs. With this in mind, the larger high street banks, as part of the remedies agreed following the recent Competition and Markets Authority enquiry, have invested £5 mn into the NESTA Open Up Challenge competition to exploit the opportunities of the introduction of Open Banking data.

Another group of firms are put off from applying to banks for funding because they fear a loss of control over business affairs. In most cases, these businesses would easily get a bank loan if needed but they prefer not to. Indeed, many of them use personal funds or family money to make a project happen rather than borrow from a bank.

How to encourage firms who need finance to apply for funding remains a key issue for the industry to address over the next few years. Rather than focusing on credit risk appetite, the solution is likely to be a combination of:

- a greater use of fintech products and services, either within banks or via third party providers using Open Banking data
- renewed efforts by banks to restore faith in SME relationship banking. Much of this will involve reforms to complaints and redress procedures on a wider basis than just lending (which already has a dedicated decision appeal process). Following a review by the FCA, the banks have already agreed in principle to the voluntary extension of current Ombudsman service to most SMEs. Furthermore, an independent review has been set up to look at dispute resolution and redress arrangements amongst larger SMEs
- support for more education and training of SME managers and entrepreneurs to help them understand appropriate funding choices and the opportunities this offers. This is particularly relevant to growing firms thinking about first time use of equity.

[9] Again, the % estimates in the remainder of this report exclude permanent non borrowers, see footnote 11

[10] Appeals Process Annual Report 2017