SME finance in the UK: past, present and future

UK FINANCE

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Acknowledgements and contacts

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Table of Contents

Introduction

The autumn of 2018 marks a decade since the full impact of the global financial crisis began to be apparent on the real economy in the UK. The following two years led to significant pressure on a number of key relationships in the UK economy, including the stakeholders in the market to supply external funding to SMEs (particularly between banks and their SME customers). As part of efforts to rebuild relationships and support economic recovery the Business Finance Taskforce was set up in 2010 and a number of actions and initiatives followed. This work continued at pace until 2014/15 and indeed a number of the key initiatives are fully operational now. UK supply of external funds to SMEs also rose sharply during a period of economic recovery.

In the last year economic growth has slowed and it is commonly understood that the UK economy faces a degree of uncertainty in the run up to and through Brexit. In an effort to ensure the external funding market for UK SMEs does not get damaged during this period of uncertainty, this report has been compiled to look at recent developments and future trends. The report also identifies a number of areas of future work for the UK finance sector and others in the enterprise stakeholder community to improve the health of the external funding market for SMEs which, in turn, will support UK economic growth.

The approach taken in this report is to look at the changing climate for SME external funding since the recession and then look forward to a period in the mid-2020s. The emphasis is on structural market developments and trends. In contrast, short-term market developments receive less detailed attention.

Past

SME Finance Developments Since the Global Recession

In response to the global recession, the quarterly average rate of UK GDP growth between 2008 and 2009 was – 0.7 per cent (the long-term average between 1998 and 2007 had been +0.7 per cent). While GDP growth returned in 2010 to 2012, the quarterly rate of growth was muted at +0.4 per cent. Only between 2013 and 2015 did the average rate of growth – at +0.6 per cent – get close to the long-term average, before a slowdown became evident post-2016. Although some aspects of UK economic performance have been positive – notably job creation – the recent slowdown in performance has been broadly based across domestic demand and trade performance, alongside a continued squeeze on public spending.[1] Business investment has remained particularly disappointing, especially after housing investment is excluded from the analysis.

Table 1: Summary of UK GDP – Expenditure Components of Demand[2]

Percentage changes on a quarter earlier

	Quarterly averages							
	1998-2007	2008-09	2010-12	2013-15	2016	2017 H1	2017 H2	2018 H1
Household consumption(b)	0.8	-0.5	0.1	0.6	0.8	0.5	0.2	0.2
Private sector investment	0.7	-4.5	2.0	1.1	0.5	1.2	1.1	0.1
of which, business investment(c)	*0.7*	*-3.4*	*2.2*	*0.6*	*-0.1*	*0.7*	*0.4*	*-0.4*
of which, private sector housing investment	0.6	-7.0	1.4	2.6	1.8	2.1	2.7	1.1
Private sector final domestic demand	0.8	-1.1	0.5	0.8	0.4	0.9	0.4	0.2
Government consumption and investment(c)	0.9	0.9	-0.2	0.3	0.2	0.3	-0.1	-0.8
Final domestic demand	0.8	-0.6	0.3	0.7	0.3	0.7	0.3	0.0
Change in inventories(d)(e)	0.0	0.0	0.1	0.0	0.2	-0.5	-0.3	1.0
Alignment adjustment(e)	0.0	-0.1	0.0	0.0	0.0	0.0	0.2	-0.7
Domestic demand(f)	0.8	-0.7	0.4	0.8	0.5	0.4	0.2	0.2
'Economic' exports(g)	1.1	-1.3	1.0	0.9	0.9	0.7	0.9	0.1
'Economic' imports(g)	1.4	-1.1	0.8	1.2	0.9	0.6	0.2	-0.1
Net trade(e)(g)	-0.1	0.0	0.1	-0.1	0.0	0.0	0.2	0.1
Real GDP at market prices	0.7	-0.7	0.4	0.6	0.4	0.3	0.4	0.2
Memo: nominal GDP at market prices	1.2	-0.2	0.9	0.9	1.2	0.7	0.7	0.8

(a) Chained-volume measures unless otherwise stated.
(b) Includes non-profit institutions serving households (NPISH).
(c) Investment data take account of the transfer of nuclear reactors from the public corporation sector to central government in 2005 Q2.
(d) Excludes the alignment adjustment.
(e) Percentage point contributions to quarterly growth of real GDP.
(f) Includes acquisitions less disposals of valuables.
(g) Excluding the impact of missing trader intra-community (MTIC).

[1] ONS, GDP Press Release Q2 2018; BoE, Inflation Report Q2 2018 (August 2018)
[2] Based on BoE Inflation Report, Q2 2018 (August 2018), Table 2A

SME demand for finance is driven by a range of factors

These economic developments have provided a mixed background for UK SMEs in terms of demand for external finance. Amongst SMEs, the level of demand for new external finance is driven by a host of factors. Some can be very short term – such as a time-limited tax incentive – while others may have more to do with succession planning between generations of family ownership or technological change. However, in addition to the overall trend in economic growth discussed above, it would seem appropriate to concentrate on a few key additional drivers of demand for SME external finance.

Business demographics can influence the need for external funding in a number of ways. Business start-ups often need to raise external equity to supplement personal funds, while fast-growth firms within the business stock require both debt and equity backing to achieve potential. While media attention is often focused on firms close to insolvency looking to obtain short-term cashflow support, in reality businesses go through several stages of a lifespan seeking loan and equity support to refresh business strategy and this goes on almost regardless of the underlying trends in the national economy. Overall, even if the percentage of SMEs looking for external finance remains the same year on year, the level of demand for funding can go up or down if the business population is changing as well.

A range of indicators of trends in UK business demographics is included in table 2. These suggest that despite a rise in closures in the aftermath of the global financial recession, new start-up activity has been strong for several years now with numbers currently around 400,000, significantly higher than volumes typically reported a decade ago. The overall business stock has increased as well, to approach nearly 5.7 million.

Since the global recession, the UK has reported a sustained upturn in entrepreneurial activity and intentions. In 2017, about one-fifth of the UK adult population was starting or running a business or planned to do so within three years.[3] This rise in entrepreneurial activity has not been evident amongst similar market economies, notably those in Europe. However, while the vast majority of

Table 2: UK Business Demography and Enterprise Indicators, 2008-2017

	2006	2010	2011	2012	2013	2014	2015	2016	2017
Number ('000)									
SME business population, start year	4,119	4,477	4,582	4,811	4,908	5,240	5,394	5,491	5,687
Self-employed, end year	3,725	3,964	3,992	4,193	4,191	4,384	4,528	4,710	4,792
Starts in year	256	235	261	270	346	351	383	414	382
Percentage									
GEM Total Entrepreneurial Activity	5.8	6.5	7.6	9.8	7.3	8.6	7.1	8.8	9.7
GEM High Value Growth Plans									
- Starts	21.6	16.4	16.3	16.8	16.9	16.3	16.5	16.5	
- Established owners	5.4	3.5	3.4	4.2	3.8	4.2	4.7	5.7	

Sources: ONS, Business Demography, Annual Report and GEM UK National Report, 2017

[3] GEM, UK National Report 2017

start-ups appear inspired by opportunity not necessity, much of this is still with low-value job expectations (high value expectation activity has fallen by one-fifth since the recession).

In contrast, amongst established business owners a rising proportion report high job expectations. This positive development is one area where UK and US expectations are currently similar to each other. However, in the UK especially, the recovery since the global recession has only returned confidence in high job expectations back to pre-recession levels of between five per cent to six per cent of the UK adult population who run an established business. This reinforces recent research on high growth firms (HGFs), indicating the significant impact of fewer start-ups during the recession on subsequent business demography – including a reduced need for funding and economic growth – along with the importance of nurturing scale-ups with specialised support, particularly as the business stock recovers (while only a small minority of start-ups survive and report high growth, those that do typically start to grow fast at aged six years, showing the importance of the post-recession rise in start-up volumes).[4]

Business financial health also underpins both the size and direction of change in the market for SME external funding. This can occur in a number of ways. Cash-rich firms, for example, may decide to self-finance, more especially in a low interest environment. Moreover, changes to the risk profile of the SME sector can have an impact. Firms with a strong credit rating are likely to be more confident in undertaking new projects and seeking funds (and face few difficulties in doing so). A deterioration in SME financial health, on the other hand, will often delay expansion plans and increase calls for short-term financial support amongst firms with low reserves (which may be difficult to secure). However, for larger SMEs especially, specialised turnaround funding may be an option from debt or equity sources.

Indicators of financial health in the SME sector are summarised in table 3. Overall, on average, they suggest a broadly improving financial profile for the SME sector since the global recession. In particular, the level of cash reserves held in business current accounts has grown sharply over recent years and remains high. An increasing number of SMEs typically have more than £10,000 in reserve. In part, economic recovery since the crisis has led to improved cashflow, but firms have decided to retain these savings rather than invest. Also, it has enabled many firms to self-fund spending plans or temporary shortages in cashflow more easily without the need to call on external funds. The low-interest rate environment has made this decision easier as well. Indeed, it may well have encouraged some firms to put more personal funds into their business.

Business investment spending is also a key determinant of demand for SME external funding. Many firms may have the option to self-fund capital projects either through retained cash flow or personal savings, but they have to have the business confidence to undertake such a venture.

Table 3: SME Business Financial Health Indicators

	2011	2012	2013	2014	2015	2016	2017
GB SME Population							
Business Deposits, £bn. end year	118	125	136	154	163	175	169
Ratio SME Borrowing: Saving	0.88	0.79	0.73	0.64	0.59	0.54	0.54
% of firms with > £10k on deposit		16	16	20	24	21	25
% of firms in profit		64	69	72	75	74	75
% of firms with poor credit rating*		53	52	51	48	51	49

Sources: UK Finance; SME Finance Monitor * poor= worse than average

[4] Enterprise Research Centre, High Growth Firms Demography Report 2018

Table 4: SME Business Investment Indicators

	2006	2010	2011	2012	2013	2014	2015	2016	2017
Percentage (net except*)									
FSB Expansion Index				0	11	17	0	4	-4
% SMEs with growth plans *				44	49	47	45	43	45
Small Firm Demand for Secured Loans	39.1	-26.9	-9.8	-7.5	33	12.9	-12.2	-44.9	-22
BOE Agent's Investment Intentions (0-5) *	2.6	1.7	0.6	0.6	1.4	1.5	1.4	0.2	1

Sources: FSB Business Voice Q2 2018; SME Finance Monitor, BoE Credit Conditions, Q2 2018, BOE Agent's Scores Q2 2018

Dedicated indicators of investment spending by SMEs are few in number. However, those included in table 4 suggest that the upturn in capital spending post the recession was modest in scale and fairly short lived. More recently, the uncertainties of Brexit may have made an impact as well as a slowdown in economic growth. This is particularly the case for external funding for secured lending, which in many cases would be easily funded through strong cash flow.

In order to visualise the main factors influencing SME demand for external finance in the years since the global recession, a "heatmap" approach is useful. This indicates period-on-period shifts to identify the overall direction of change in demand. This is presented in table 5 for the last 10-15 years.

The "heatmap" analysis, whilst indicative of a trend rather than absolute values, suggests the years since the recession have seen only modest growth in demand for SME external finance despite the rebound in economic growth, notably between 2013 and 2015. Whilst we have no comprehensive measure of demand for SME external funding to benchmark against the 'heatmap", evidence does suggest this conclusion is broadly correct in terms of SME credit (see graph 1 and 2). Reported use of external finance by SMEs has fallen steadily since the period before the global recession.[5] Loan and overdraft application volumes have remained below pre-recession levels across all providers.[6] Although – as discussed later and illustrated in graph 2 below – some of this may be accounted for by a switch to less traditional suppliers and finance products not fully incorporated into industry data, this is not sufficient in scale to overturn the general conclusion. It appears that traditional borrowing is increasingly left to a small group of established firms borrowing larger sums of money. SME equity market demand is more difficult to assess as volumes are small but data on the rebound in number of HGF and 'scale-ups' post the recession

Table 5: Heatmap of UK SME Demand for External Funding

	Pre GFR	2010	2011	2012	2013	2014	2015	2016	2017
Ec Growth	Good	Poor	Poor	Neutral	Neutral	Good	Neutral	Neutral	Neutral
Demography	Neutral	Neutral	Neutral	Good	Good	Good	Good	Good	Good
Enterprise	Good	Good	Good	Good	Good	Good	Neutral	Neutral	Neutral
Fin.heath	Good	Poor	Poor	Poor	Neutral	Neutral	Good	Good	Good
Investment	Neutral	Poor	Poor	Neutral	Neutral	Good	Good	Neutral	Neutral

Good Neutral Poor

[5] BDRC, SME Finance Monitor; pre GFR data on a comparable basis is available from the surveys in 2004, 2005/6 and 2007 undertaken by Warwick Business School and Cambridge University.

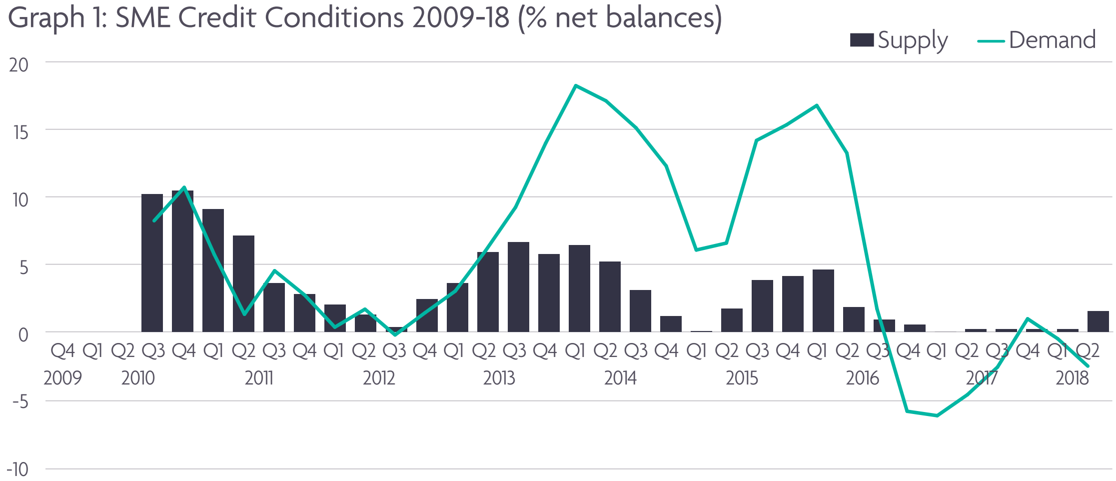
[6] UK Finance SME data tables

may indicate demand has been more buoyant than in credit-based products. However, overall many SMEs claim to use no external finance at all (especially if convenience products such as credit and fuel cards are excluded from the analysis).[7]

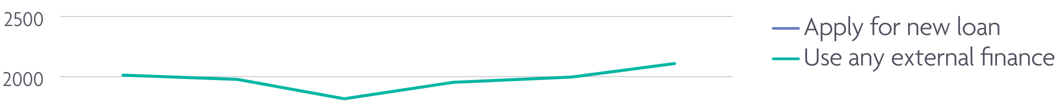
Indeed, the outturn for demand from SMEs for credit-based finance is broadly in line with the analysis presented in the 2010 report of the Business Finance Taskforce. The market analysis in the 2010 report did not solely cover SMEs but looked at long-term patterns of demand for corporate borrowing and GDP and suggested that a rise in GDP was normally followed by a turning point in borrowing with a 12-18-month lag. However, it was suggested that evidence from the 1970s and 1990s in particular pointed to this lag becoming longer the deeper the preceding recession. The long-run analysis has been updated to 2018 for this report (see Graph 3 and 4 below). Given the severity of the global recession the 2010 report highlighted the prospects for credit demand between 2011 to 2015 could be muted, especially for SMEs. This forecast outcome appears to have been the case.

Indeed, while graph 3 repeats the analysis in the 2010 report, graph 4 is new and excludes commercial real estate lending (CRE) as it was widely reported at the time that a boom in CRE related activity was an exceptional factor. While this new analysis can only be undertaken for a shorter time span (1998-2018), it shows that the early phases of the global recession followed the expected relationship between business lending and GDP. While in the subsequent period lending growth was stronger than total business lending, including CRE reported in Graph 3, it was still very subdued by historical standards. The lag between turning points in growth rates post the recession was about twice as long as seen after previous recessions. Also, even though GDP accelerated after 2012, lending slowed and was subdued.

Graph 1: SME Credit Conditions 2009-18 (% net balances)



Graph 2: UK SMEs Using External Finance (thou each year)



Sources:

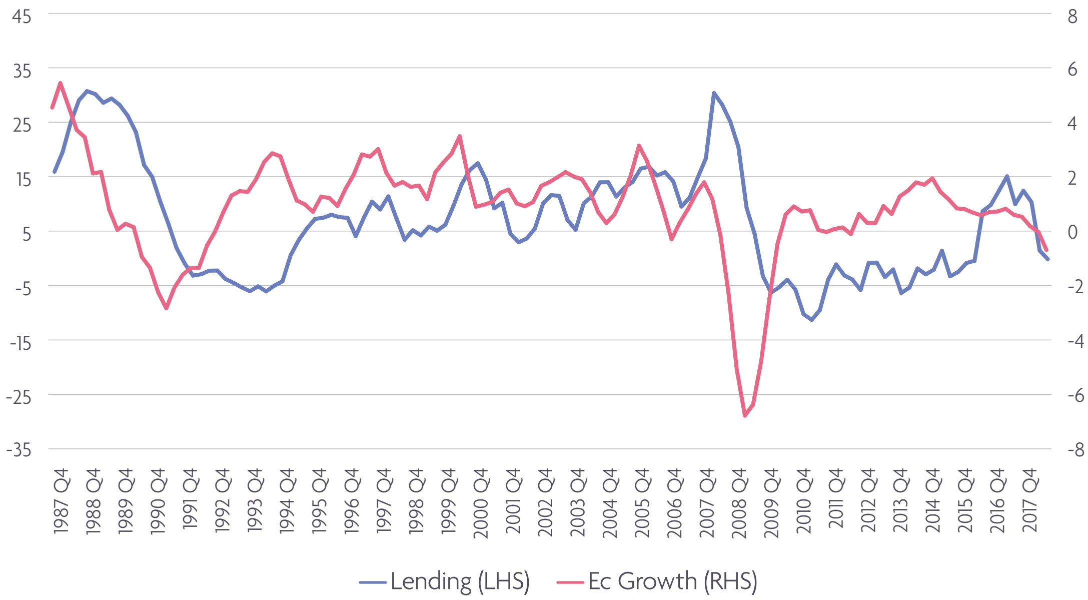
Chart 1 - BoE Credit Conditions Survey, 3m rolling balances. SME responses combined and weighted using Business Population Estimates.

Chart 2 – UKSMEFM database, Type 1 Borrowing events (Q26) and Use of External Finance (Q14/15) grossed up by Business Population estimates

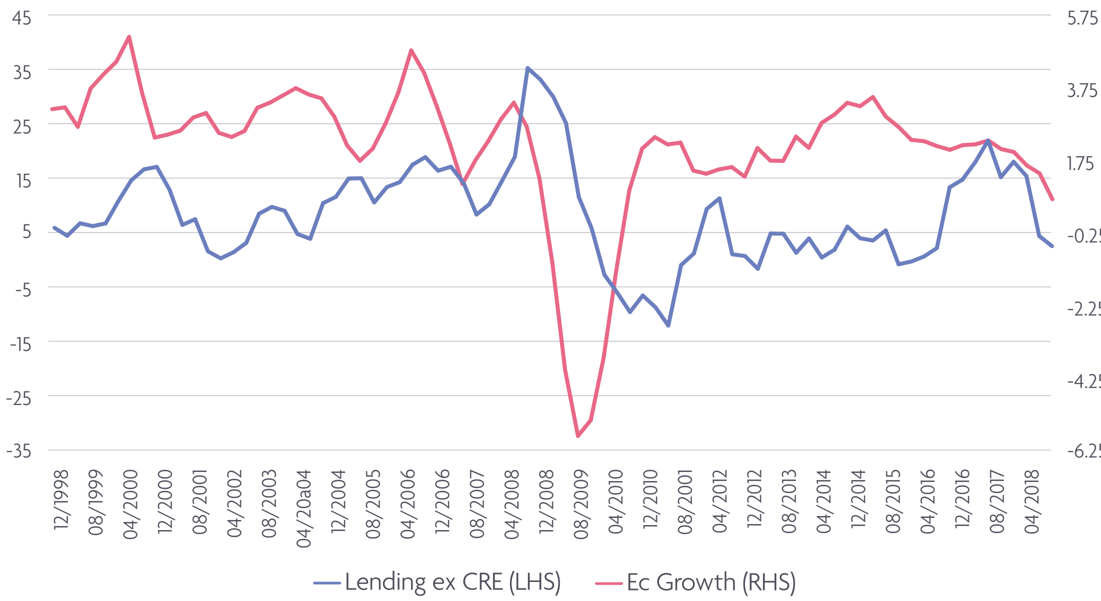
[7] BDRC, SME Finance Monitor

While it is important to acknowledge that the pick-up in demand for SME external funding post the global recession has been muted when compared with previous upswings in the business cycle, this is not the same as suggesting demand has remained unchanged over the last decade. Estimates of gross new supply of finance to SMEs from a range of sources are presented in table 6. Collectively, this data indicates this funding requirement has met with a strong positive response from the UK financial services sector. This has been underpinned by a range of public policy initiatives and reforms starting in the recession to secure finance sector stability as well as the ongoing work of the British Business Bank and the Bank of England. Some of these are discussed later on in this report, as is the topic of any remaining finance "gaps". However, this should not distract from the primary observation that SME external funding conditions are very different now than in 2010/2011.

Graph 3: Bank Lending to Business & Economic Growth 12m % growth rates



Graph 4: Non CRE Bank Lending to Business & Economic Growth 12m % growth rates



Source for both graphs BoE Bankstats and historical research database (see www.bankofengland.co.uk/research) and ONS National Accounts dataset

TABLE 6: Gross New Funding for UK SMEs, 2008-2017 (£bn)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Source of funds:										
Bank loans	44.5	41.2	40.4	38.9	38.0	42.9	53.4	57.8	59.0	57.0
Private equity	1	0.5	0.5	1	1.5	1.5	2.5	3.7	3.11	5.89
Asset finance	14.3	9.95	10.2	10.6	12.2	12.9	14.4	15.9	16.7	18.6
P2P business lending	0.001	0.001	0.001	0.02	0.06	0.25	0.59	0.8	1.2	1.8
P2P Invoice funding	0.001	0.001	0.001	0.003	0.04	0.1	0.27	0.3	0.35	0.5
CDFIs	0.03	0.03	0.02	0.03	0.05	0.07	0.09	0.10	0.08	0.06
Invoice Finance*	8.66	7.19	7.47	8.51	7.90	8.23	8.81	8.55	8.90	9.57
Total	59.8	51.7	51.2	50.5	51.8	57.7	71.2	78.6	80.4	83.9

* These figures are calculated on the basis of advances as at 31st December and do not show the flow of advances made throughout the year.

Sources: UK Finance, Responsible Finance, British Business Bank and BoE (Bankstats)

For the last three decades levels of finance provided to businesses through invoice finance and asset based lending have been increasing and, since the recession in particular, they have become a mainstream source of funding for many businesses. The products support client businesses of all sizes and they are particularly important for SMEs, with many smaller businesses lacking the 'conventional' security required to gain access to loans and other lending products. Invoice finance and asset based lending can help make clients' cash flow more predictable and can offer protection against poor payment practices.

Overall client numbers for the industry as a whole have remained constant over recent years. At least in part this reflects some generalised reluctance to borrow by smaller businesses in particular as analysed in the SME Finance Monitor. However the volume of finance provided has increased, with particular growth in the use of asset based lending by larger businesses. Within ABL facilities funding will be provided against debts (as represented by the invoices) but also against a wider pool of business assets, such as plant and machinery, property, stock, work in progress and also sometimes against some intangibles such as brands and other forms of intellectual property.

TABLE 7: Gross New Funding for UK SMEs, Growth Rates 2008-2017

	Since 2008 Cumulative Supply £bn	2008/10 v 2015/17 Average growth (%)
Source of funds:		
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: See table A
Note – P2P growth rates not cited as large % increases represent low base volume

Overall, since the Business Finance Taskforce Report in 2010, an additional £121 billion of external funding was supplied to UK SMEs by the end of 2017. In terms of annual data, this represents a rise in gross supply each year from an average of c £54 billion between 2008-2010 to c £81 billion between 2015-2017 (or about 50 per cent).

Looking at the various sources of supply, bank loans have still accounted for the biggest single share of the increase in supply, with cumulative new loans written of nearly £75 billion between 2011 and 2017. However, the market reforms now underway at pace in financial services have changed the structure of supply. In the three years to the end of 2017, gross new bank loans averaged c £58 billion a year (or about 71 per cent of total supply). Even though overall bank lending increased noticeably between 2011 and 2017, the market share of banks in total supply fell (from 77 per cent between 2008/10 to 71 per cent in 2015/17). Even more striking, the high street banks no longer account for the bulk of this gross new lending by value – they supplied about £25 billion a year in the three years ending December 2017. A much wider group of banks also provided an average of £33 billion a year during this period. This suggests in part a return of some non-UK banks to the market for SME commercial mortgages has been evident, but also the growing and important role of challenger banks in the SME market, especially for secured lending. Aldermore, for example, was only founded in 2009 and originated c £1.85 billion of new loans to SMEs in 2017. Banks such as Aldermore may have a small market share of the stock of total loans, but they are now very important in the gross supply of new loans to key market segments.

Despite lending more to SMEs, the reduced role of high street banks in the supply of UK SME finance is also evidenced by the continuing recent growth of other sources of funding, such as private equity and asset finance. An indication of this impact is provided by Graph 2 above. In many cases this greater diversification in supply is the direct result of a number of public policy initiatives, including the follow up to the Breedon Report (2012), the Young Report(s) (2012-2014) and the direct market investments made by the government via the British Business Bank, especially in SME private equity (to underpin the long-established work of the UK Venture Capital industry).

However, the role of public policy initiatives needs to be reviewed alongside other changes, notably the growing role of fintech in developing and unlocking new financial products and services, especially in invoice finance. Also, internet-based platforms feature strongly in the development of P2P funding (both debt and equity). The origins of many of these new developments were privately funded in response to the global recession and have subsequently been endorsed by government and other investors. Undoubtedly the emergence of many alternative finance providers was also assisted by some SME owners, who lost trust with banks during the recession and its immediate aftermath.

Moreover, it should be acknowledged that the growth in alternative finance for SMEs has also depended on the cooperation of the banking sector (particularly the high street banks). This has been evident in a number of different ways. In practical terms, many of the new finance providers "passport" a range of finance checks by using established current accounts held at high street banks. This has allowed new suppliers to operate largely without any local market operations and work almost exclusively via phone and internet (or through intermediaries). However, cooperation has also been mandated through regulatory reform and via the competition authorities, notably in the area of lending referrals. Even so, high street banks have moved beyond this and now increasingly regard alternative financiers as an important part of the overall funding landscape and a number of arrangements now exist either to signpost competitors' services or offer them services to bank customers, providing them with easier access to more choice in SME funding. NatWest, for example, now operates an alternative funders panel and several banks have signed arrangements to offer the MarketInvoice platform to customers.

Present

Current Market Conditions in 2018

Alternative finance funding to SMEs continues to grow

As outlined in the introduction, the objective of this review is to look at the longer-term structural evolution of the market for external SME finance, not to provide a commentary on 2018/19 activities. To repeat the analogy used earlier, it is a review of the climate, not the weather. Indeed, one of the positive developments post the recession was the improvements to the availability of data on SMEs from a number of providers, and the creation of the UK SME Finance Monitor. Put simply, this provides analysts with independent and reliable information on market trends.

Also, as part of its remit the British Business Bank now provides regular market updates. The latest for June 2018 was recently published[8] and concludes:

- The recent phase of bank lending growth to SMEs has come to an end. Indeed, higher repayments led to a slight fall in the stock and supply conditions may have tightened a little for smaller firms.
- Alternative finance funding to SMEs continues to grow at pace. Equity markets have picked up sharply.
- The use of external funding of any sort continues to fall.

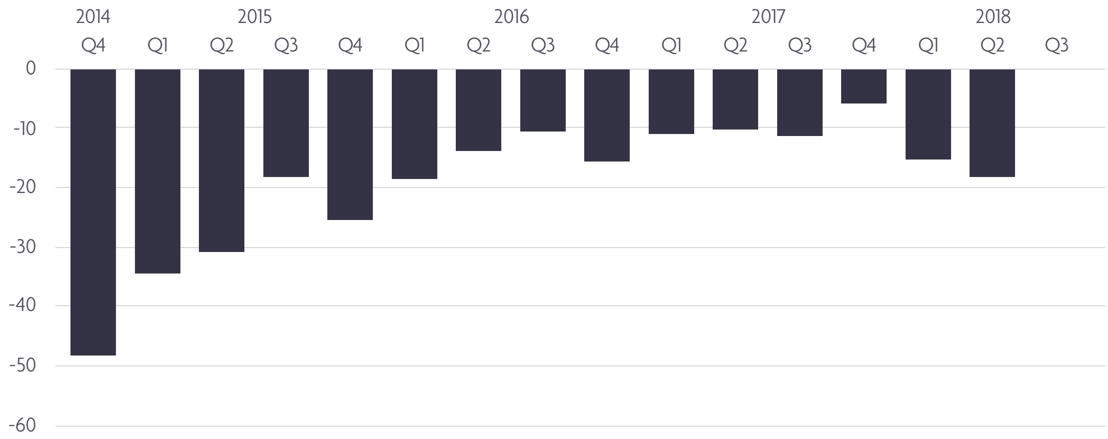
In terms of credit products from banks, these conclusions appear to be supported by the latest survey data from the Bank of England and UK Finance. Trade association surveys have also indicated some issues with funding this year, notably the FSB State of Trade Survey in Q2 2018.

Graph 5: BoE Agent's Index SME Credit Availability (Zero = Normal)

Source: Graph 5: BoE Agents Scores for small and medium firms weighted by the Business Population Estimates

[8] See BBB, SME Finance Markets June 2018 update

Graph 6: FSB Credit Availability Sentiment (% net)



Source: Graph 6: FSB Small Business Index, various issues

However, it should be emphasised that we are now at the end of the upswing in economic activity since the turnaround post the recession, so it should be expected that the rate of growth of bank lending in particular would slow down as well. This is illustrated in Graph 5 and 6 above. The BoE Agents, who offer an independent view of conditions, suggest that SME credit availability is not quite as good in the summer of 2018 as it was a year earlier. However, sentiment is still positive (where zero=normal). The FSB also reports on credit availability and the latest data suggests that the period of recovery post the recession has ended.

This period of subdued credit demand and supply is likely to be even more evident as uncertainty over Brexit developments continues. This is not the same as the significant issues in SME funding that were evident in 2008-2011. Moreover, the positive market developments in the last decade reported earlier should not be overlooked and suggest most SMEs should feel confident external funding will be available once current market uncertainties are over.

Future

The SME External Market Climate in the Mid 2020s

Looking forward inevitably involves making a number of key assumptions and forecasts. Such an exercise is even more difficult than normal at the moment in the run-up to Brexit. The solution adopted in this review – which is a “climate” report regarding the SME external funding market for nearly a decade in advance – is to leap forward to look at the mid-2020s. Two possible scenarios have been developed to underpin the subsequent market analysis and issue discussion.

Scenario 1 (S1) assumes that a more troubled period of economic growth is on the near horizon, but this is then followed by an upswing in the later part of the forecast period. The period of weak economic growth could be a consequence of an adjustment post-Brexit but could equally apply – for example – to a fallout from a deteriorating international trade environment. Despite these problems, GDP in 2024/2025 is still assumed to be about nine per cent higher in real terms than in 2017, with an even stronger growth in business investment and a UK SME business population of just over 6.5 million.

Scenario 2 (S2) is a more optimistic one, especially in terms of the pattern of economic growth. This assumes a steadier pattern for GDP growth over the next decade, allowing the recent strong enterprise environment to be fully embedded. Such a scenario generates a stronger end period outturn where GDP in 2024/2015 is nearly 14 per cent higher than 2017 in real terms, with business investment 25 per cent higher as well. The UK SME business population continues to grow very strongly and could be in the order of 7.2 million by the end of the forecast period.

Table 8: Key Scenario Inputs

	Average	Scenario 1	Scenario 2
	2015-17	Mid 2020s	
Base =100			
GDP	100	109.2	113.7
Business Stock	100	119.3	129.1
Capex	100	111.4	125.1

Before looking at the implications for the SME external funding market based on these scenarios, two points should be borne in mind:

- While these scenarios have been developed specifically to allow the examination of long-term trends in the SME finance market rather than a fully balanced economic outlook, both should be regarded as credible. For example, the upturn in the business population between 2017 and 2025 in S2 – in the order of 30 per cent - would actually imply the rate of growth was still fractionally lower than reported for the period 2009-2017. In terms of GDP growth projected in S1 of about nine per cent over the period, looking at the eight-year period starting with the onset of the recession (2007-2015), the level of economic activity at the end was still 7.5 per cent higher than the pre-recession peak level (and S1 does not envisage a re-run of the global financial crisis).
- The differences between S1 and S2 are overwhelmingly driven by the heat map components highlighted earlier.[9] Indeed, in other areas a number of the assumptions around deal size and the rate of growth of non-bank products are the same between S1 and S2. This is based on the view that since the recession a structural change in the supply environment has emerged, with firms increasingly likely to consider a move away from banks towards new suppliers, especially in the area of cash flow funding (mirrored in the banking sector by a move away from overdraft use towards credit cards). This trend will continue in future years and it is not appropriate to suggest the pace of change will differ significantly between S1 and S2. Competition reviews and public spending priorities since the recession have sought to achieve such a shift, which now appears well embedded. Another key assumption is that risk appetite is broadly unchanged for all funding providers throughout the period.

Table 9: SME External Funding Market Scenario Outcomes

	Average	Scenario 1	Scenario 2
	2015-17	Mid 2020s	
% firms borrow event	6%	5.3%	6.1%
No of firms	331,800	334,112	442,685
£ gross supply	57,900,000,000	58,303,381,297	77,249,648,083
Avg Deal size	174,503	174,503	174,503
% firms equity event	0.0266%	0.0495%	0.0495%
No of firms	1,463	3,309	3,579
£ gross supply	4,233,000,000	9,575,420,601	10,356,774,922
Avg Deal size	2,893,370	2,893,370	2,893,370
% firms lease event	3.50%	5.6%	5.6%
No of firms	193,550	374,745	405,324
£ gross supply	17,000,000,000	32,977,584,841	35,668,555,764
Avg Deal size	87,833	87,833	87,833
% use alt fin	0.597	0.8838	0.8838
No of firms	33,000	59,097	63,919
£ gross supply	3,300,000,000	5,909,690,125	6,391,920,840
Avg Deal size	100,000	100,000	100,000

[9] Note the October 2018 Budget announcement on proposed changes to IR35 rules for the so called "synthetic self-employed" is not regarded as impacting markedly on demand for SME finance, although if implemented they could reduce reported starts and the growth in the overall business stock

The summary market outcomes from S1 and S2 are presented in Table 9. These are shown against a baseline of the average for 2015/17.

In reviewing these scenario outcomes, attention is directed more to the overall trends implied rather than absolute numbers. The key points would appear to be:

- In both S1 and S2, the external funding market for SMEs will grow over the next decade. Gross new supply in 2015/17 was around £82 billion a year and under S1 this would be close to £107 billion a year by 2024/25 (or, allowing for inflation to future values, £119 billion). Under S2, these figures would be £130 billion and £145 billion, respectively.
- The contrasting outcomes in terms of market volumes between S1 and S2 illustrate well the importance of making credible assessments about the size and composition of the business stock. In S1, while the stock is projected to grow overall, business conditions are less favourable at the start and the UK's enterprise record over the last decade is disrupted followed by slower growth in the number of SMEs during the subsequent period of economic recovery. As well as less buoyant population growth, economic issues hold back firms' willingness to invest and seek external funds (especially bank customers).
- In S2, in contrast, the stronger and more sustained period of growth builds on the recent enterprise developments in the UK and leads to further strong growth in the number of firms. At the same time, many businesses that had put off capex and expansion in the recession and recovery phase are likely to return to the market again. This is the major reason for the higher projected market outcomes.
- In both S1 and S2 the impact of the structural shift in the supply of funding away from bank debt noted earlier is very apparent. Even in S2, with a more optimistic outlook, gross new bank lending will still be close to recent levels in cash terms (in reality reported numbers will be higher, due to inflation over the next decade). Under S1, parity with recent gross new bank lending activity in cash terms is even more evident. In contrast, other forms of new finance for SMEs would report stronger growth either under S1 and S2 (even holding the assumptions that deal size and risk appetite hold constant over time).
- In effect, both under S1 and S2 a re-ordering of the SME external funding environment will become fully apparent over the next decade. Bank lending will continue to report a decline in its share of gross new supply, from about 70 per cent in 2015/17 to between 55 per cent and 60 per cent under both S1 and S2. Banks will still hold a strong overall market position and exposure in SME funding, but flows of new supply will indicate a different trend.
- Overall, the cumulative additional gross new supply from all sources between 2018/2025 under S1 would be about £23 billion above the current rate (2015/17); this would be higher at around £100 billion under S2. Even the projected outturn of S2 does not look too challenging for the market to fund (the equivalent cumulative additional supply figure for 2008-2017 was £120 billion).

Table 10: Market Scenarios for the Mid 2020s: Summary data

	Average	Scenario 1	Scenario 2
	2015-17	Mid 2020s	
At Current Prices			
Gross Supply £ bn a year	82.4	106.8	129.7
At 2024/25 prices			
Infl. ad 2.5% p.a.	100	118.8	118.8
Gross Supply £ bn a year	82.4	119.4	145.1
Share by Source %			
Bank	70.2	54.6	59.6
Equity	5.1	9.0	8.0
Lease	20.6	30.9	27.5
alt fin	4.0	5.5	4.9

Future: Issues

The discussion of the whole market outlook up to the mid-2020s obviously highlights the underlying macroeconomic environment as a key determinant of outcomes. However, it would be wrong to conclude that the future health of the external market for SME finance in the UK is wholly in the hands of the strength and pattern of economic growth. The discussion above has also indicated that business sentiment and confidence is important and, to a degree, this is not wholly dependent on economic growth. This raises the possibility that the stakeholders' actions could deliver a healthier SME external funding market almost independently of trends in GDP. Perhaps more simplistically, even with a less buoyant economic environment over the short term (S1), we could see a growth in the external market for SME finance closer to that expected from a more stable and sustained period of growth (S2).

Banks and the UK financial services sector as a whole have a part to play in such a development, alongside other stakeholders. Following on from the Business Taskforce initiative in 2010-15, it would be helpful to highlight again a range of issues which could be addressed to help develop a healthier SME external funding market over the next decade, and some potential future areas of work between stakeholders to help achieve this common goal. Inevitably, most of these issues are inter-linked.

1. The Funding Gap, Advice and Investment Readiness

Discussions of various forms of SME funding gaps have a long pedigree in reviews of the SME finance market, even pre-dating the Macmillan Gap discussions in the 1920s. In summary, it is best to identify two different type of gap - one linked to debt and the other equity.

- In the case of debt funding, while independent research confirms that between 80 per cent and 90 per cent of all credit applications from SMEs are agreed, banks and other credit providers acknowledge that certain sub groups of applicants will find it more difficult to obtain funding (see table 11). In addition to firms with a poor or rapidly deteriorating credit rating, first time borrowers – especially start-ups or pre-revenue project applicants – have a lower success rate, regardless of the availability of security. Some of this can be addressed by using a different product such as leasing or in some cases invoice finance, but for others debt funding remains problematic. In many cases, these firms cannot support the repayment schedule of a new or extended credit facility and need a new cash injection (i.e. equity not debt).
- However, the debt funding gap is narrower than just looking at firms that are declined, as it assumes that the applicants have a viable[10] business plan. In some cases, a formal credit application is made and declined in error. Alternatively, informal advice – from a good or bad source – puts off a formal application (direct "discouraged borrowers"). Other business owners may take no advice but decide not to apply through fear of failure (indirect "discouraged borrowers"). The issue of discouragement will be discussed in more detail later in the report.
- In the case of equity funding, the Macmillan gap was discussed in the 1920s to highlight the problems of finding small scale equity for firms too small for the major public markets at the time. The composition of the UK equity market has changed beyond all recognition over the last 100 years. 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 Taskforce review which supported the creation of the Business Growth Fund. Substantial public resources have been successfully deployed to this issue for a number of years. However, it is still the case that some SME equity gaps are reported, mainly somewhere between start-up and full-scale development funding (sometimes loosely referred to as "follow on" capital).

[10] Viable indicates the business has a credible plan to fund debt repayments - e.g. an agreed order- or reserves to cover any shortfall until this funding stream is secured, subject to normal risk considerations.

Table 11: Loan and Overdraft Application Success Rate (%)
(Average % Acceptance rates for successive 18-month cohorts 2011 to 2017)

	Overdrafts	Loans
All SMEs	82.6	69.1
-Minimal risk	97.1	92.0
-Worse than avg risk	73.6	54.6
-First Time applicants	57.0	51.6
-Other new facilities	76.6	75.6
-Renewals	99.1	88.6

Source: UK SME Finance Monitor data tables

While the location and composition of different types of funding gap can be discussed, it is more difficult to agree on the size of the shortfall; or, looked at the other way, how much potentially valuable SME economic activity is being "lost" from lack of funding. Some estimates of the debt gap talk of a £30 billion shortfall in funding, but this appears to be based on including all firms that currently have decided not to apply for funds regardless of viability, and those that are too high a risk for a debt return and need equity. Work by the former British Bankers' Association in 2015 pointed to a figure of under £5 billion a year on the assumption of unchanged risk standards.[11] Most estimates suggest in 2014/16 it could have been in the range of between £3 billion to £9 billion a year; a mid-point in this range is equal to about seven per cent of new SME credit supply. The most comprehensive recent study suggested the number of creditworthy firms declined or discouraged was in the region of 70,000 (or about £2 billion of debt).[12] No reliable estimates of the equity gap are available, but although the number of deals would be small, they could potentially be very valuable.

Overall, we should acknowledge that despite a generally good supply of a range of SME external funding, some gaps will remain. On the debt market side, it is difficult to be sure about the loss of economic activity this creates. Indeed, through start-up and growth many SMEs displace other firms, but this creative destruction has an economic benefit as well. Issues in equity markets may have a more direct impact on HGFs in particular. Any attempts to reduce the funding gaps should be welcomed and, on balance, even modest success should be economically beneficial over the medium term.

A number of areas of activity can be suggested to address the issue of funding gaps. Most have been evident in SME finance policy discussions for many years. For banks and other credit product suppliers, along with business advisers and accountants, the activities that are most relevant to reduce funding gaps cover actions to encourage more SME owners to seek advice before looking for funding, to make sure an appropriate method of finance is used. This is not just about the difference between debt or equity, but a range of other funding options. Despite efforts to address this issue, the latest evidence still indicates that the majority of SMEs rarely, if ever, take advice and when they are looking for funding the time spent investigating options is woefully brief.

A related issue is investment readiness. Even the smallest firm can act to ensure it is primed to apply for various forms of external funding, such as ensuring the owners' credit reference data file is up to date. However, notably for firms moving towards HGF status such activity becomes critical. Getting a firm to think about the issues around seeking external funding is often the first step in making an appropriate funding choice.

[11] British Bankers Association, Comments on British Business Bank Consultation in Small Business Finance Markets, 2015

[12] See S Fraser, Back to Borrowing – A Study of the Arc of Discouragement (ERC Working paper, 2014; a wide range of possible causes and market sizes was discussed in the British Business Bank, Small Business Finance Markets 2015 (November 2015).

Official statistics for 2017 highlight that fewer than one in five SMEs sought any external advice or information in the preceding 12 months; this figure was even lower for smaller unregistered firms with no employees. Even amongst larger SME employers, only 29 per cent of businesses had sought advice or information. While this was a slight improvement on 2016, the figure was much higher (49 per cent) in 2010.

In contrast, the percentage of SMEs planning growth remained high at about 45 per cent in 2017 (62 per cent for SME employers). Consequently, even if all the SMEs that sought advice or information in 2017 had also been planning to grow, over half of firms looking to expand still did so unaided.

In practical terms, the format of any renewed commitment from stakeholders to address the advice issue would need further discussion. Banks in particular have some regulatory controls on offering advice, notably to avoid concerns of a shadow director role, suggesting much of the lead for activity should be from the accountancy profession. However, it should probably include greater use of Open Banking data, with fin tech suppliers especially looking to widen the reach of the support and advice environment. Amongst banks, larger SMEs and other stakeholders the work of the Scale-up Institute may be a useful template to develop and extend. An alternative approach may be for banks to look to more actively support firms thinking about exporting, which may be an appropriate point for a business to seek advice. Indeed, such a focus could be even more beneficial to the UK SME community than the current bank-led commitment to mentoring which was set up in 2010.

2. Future Public Support Initiatives

Another way of addressing funding gaps is through public policy intervention. Market failure can provide justification for public policy initiatives, providing the net cost of any scheme is more than covered via the overall impact on economic growth (especially in terms of higher tax receipts or lower benefit spend). The key point to remember though, is that market failure is a much narrower assessment of the SME external funding gap than discussed earlier, especially one as large as the £30 billion a year suggested by some commentators. A market failure is evident when a viable business proposition is denied funding. In the debt market, viability is linked to the certainty of income to repay any debts which, in turn, normally means the business has sufficient cash-flow and an order book etc. In equity terms, the viability assessment can be more speculative, especially with new technology or in a pre-trading environment. This is why a personal stake/savings and equity from the founders is normally required. External equity investors will accept less certainty of outcome at the price of a share in the ownership of a firm and – unlike debt providers – the potential of upstream profits are well beyond that needed to repay any loans or similar products. As we have discussed already, one of the problems in looking at some estimates of the funding gap is that many applicants do not have a viable proposition – including those that apply for debt funding but need equity support.

Nevertheless, policy initiatives play a key role in some parts of the UK SME funding landscape. They can currently be grouped as follows:

- National Loan guarantee/underwriting programmes where a public agency supports a commercial debt. In the case of the long-standing Enterprise Finance Guarantee (EFG), this seeks to identify viable SME credit applicants turned down for a loan or similar product because of a lack of security. The borrower pays a premium over the interest rate to cover up to 75 per cent of expected losses but the Exchequer provides the backstop if needed (and the loan provider only has to accept 25 per cent of the risk). An alternative is the Start-up Loans Scheme (SULS), initially aimed at young people (under 30 years old) setting up a business with fixed rate unsecured loans of up to £30k each. The loans are linked to a package of advice and support through intermediaries to improve viability, but 100 per cent of any losses are borne by the government. In 2017/18 these two schemes alone underwrote loans to SMEs of about £100 million. Similar smaller schemes are also in operation, often funded through the European Investment Bank or, less commonly these days, local authorities.

- Regionally focused SME funding programmes. Through the decades of EU membership, the UK has had a long tradition of regional schemes for economic regeneration. Most of these include an SME finance programme, often funded by the European Regional Development Fund (ERDF). These schemes allocate capital to be managed by a local intermediary[13] to develop specific funding schemes – debt and equity based – to address shortfalls in commercial funding that may delay or derail wider regional regeneration. More recently, alongside a move towards Brexit, such an approach has been used to provide regional SME funds for the Northern Powerhouse (NP), the Midlands Engine Investment Fund (MEIP) and a smaller fund for Cornwall and the Investors Overseas Service (IoS and CIOS). Further funding for these schemes and any new ones will probably use national rather than EU funding in a post-Brexit public spending environment. Most of these programmes contain a number of sub-schemes targeting specific issues based on local industries or geography. A common theme at the present time is to tie in most of the funding with HGF initiatives or university-based enterprise hubs. Local management offers greater flexibility in content than under national guarantee schemes such as the EFG (lack of security) and the SULS (applicants' experience). Repayment terms or details of shareholding and dividend payments can also be changed to improve take-up and targeting. In 2017/18 the NP, MEIF and CIOS schemes noted above announced plans to support £690 million of business funding, although this will be spread over at least three to five years.

- The national investment programme of the British Business Bank. Since its creation a few years ago, the British Business Bank has had a remit to improve the supply and mix of SME funding. This is mainly implemented through a national investment programme where the BBB makes an investment in - or places capital to be managed by - a specific new or existing finance supplier. This is to ensure that a new product or service for SMEs – or an extension of an existing activity – takes place. By implication such investments must be aimed at filling a gap in the market, but the choice of partner can also often be important in terms of the supply mix. Examples of such investment in 2017/18 include a £30 million investment in Atom Bank, £37.4 million ENABLE funding for Shire Leasing to boost asset finance for smaller firms, and £100 million for specialist lender Capital and Counties. However, the biggest national impact is in SME equity funding through a range of investments and programmes, notably the Enterprise Capital Fund, the Angel Co Fund and VC Catalyst Fund. These have created one of the most admired SME equity markets in the Organisation for Economic Co-operation and Development (OECD). Overall, in the four years to 2017/18 the BBB facilitated c £5.2 billion of additional funding for SMEs through its range of programmes; excluding the guarantee and regional programmes already discussed, this suggests that about £4 billion of remaining activity supported growth in SME funding.[14]

Looking back at the earlier comments on estimates of the SME funding gap, the performance and forward objectives of the BBB in particular suggest that the Bank also holds the view that any remaining funding gap on an annual basis will be at the lower end of the scale discussed; this is entirely consistent with the BBB's market-focused operations – the funding does not subsidise SME finance facilities or seek to support unviable projects. The Bank also makes a profit – although of course it does not have to raise capital in the same way as other financial firms.

Overall, the current scale of the publicly-funded SME finance programmes looks reasonably matched against most estimates of the UK funding gap and the BBB's wider objectives of improving supply diversity appear on track. However, it is still reasonable to review if some of the key programmes look "fit for purpose" under current market conditions and – perhaps more appropriately – those likely by the mid-2020s.

[13] Initially the British Business Bank has been given the role of managing these funds and appointing the local managers under a contract from the LEPs and the DCLG

[14] British Business Bank, Annual Report 2017/18

The two schemes of particular interest to most SMEs by number of loans are the EFG and SULS and the focus on debt finance. The EFG has a long history in a variety of forms dating back to the early 1980s. The SULS is a product of a more recent review of enterprise policy but has recently been transferred into the BBB, also bringing the scale and scope of the programme into its remit. Both the EFG and SUL programmes have provided support for a large number of SMEs, especially over recent years. However, questions can be asked about the market analysis underlying them both.

In the case of the EFG, the original policy intervention was designed in the 1970s and implemented in the early 1980s, at a time when SME bank lending in particular was dominated by the availability of security and personal guarantees. Both of these are still important but in recent years it has become more difficult for some suppliers to use the scheme because applicants are being declined for reasons other than lack of security – even though they are financially viable (see table 12). This may be because of issues on a credit file that cannot be corrected, or industry or portfolio considerations. These issues may be more evident in smaller SME applications but not exclusively so. Only applications that meet the supplier's standard acceptance criteria, except for security availability, can use the EFG. Looking to the next review of the EFG, the future impact of the scheme could probably be improved if it was modified to tie-in with these evolving issues.

The case of the SULS is different. When the scheme was first launched doubts were raised about market positioning and the risk profile of the applicants. Critics feared public funds were being used to support projects with lower than typical chances of viability (rather it was a populist measure to gain approval by young people). The focus on applicants under 30 was dropped in 2013. Significant reforms were introduced post 2016 and the risk profile improved and in turn the volume of new business declined; independent reviews of the first phase of the scheme have been encouraging as well.

Nevertheless, the problem with any "demographic" scheme is that it creates an artificial line in the marketplace which disadvantages anyone just out of scope. For example, the SULS has been put in place to address the market gap seen as hitting young entrepreneurs with few savings and little experience/track record. These issues do not disappear the day after an entrepreneur turns 30 and this particular criterion was not sustainable for very long.

Table 12: Reasons for Credit Decline by Commercial Providers

"Not Viable"	"Weak Finances"	"Due Diligence"	"No Security"
			Covered by EFG
Affordability	Weak balance sheet	Licence/patent ownership	
Serviceability	Insufficient stake/equity	Outstanding legal issues on firm/key staff	
	High gearing	CCJs	
	High short-term debts		
"Other Reasons"			
	Weak management	Main client credit score	
	Past account issues	Worries over premises/lease/tenancy	
	Business credit score	Over reliant on one contract	
	Personal credit score	Crown debts	
	Directors' debts	Sector or location specific worries	

The subsequent refocusing on start-ups by people with little or no business experience still raises issues, leading to calls for various forms of extension and follow on funding. It could be better to have a more generalised scheme looking at supporting first-time SME credit applicants (a loan or other forms of credit finance) without the age barrier (for the applicant or the business venture). The new programme could be moved into the EFG scheme and made a guarantee-based scheme as well, creating a better tie-in with commercial lenders.

Both the SULS and the EFG are subject to a periodic assessment and review by government. In the 2018 Budget the government extended the funding of the SULS to 2021 so it can continue to provide loans and mentoring to entrepreneurs. The EFG was extended in the November 2017 Budget until spring 2022. In both cases these two key policy interventions have an opportunity for optimisation and refocusing to ensure they make an even more significant role in addressing debt funding gaps.

3. Tackling Discouragement

One issue that emerged in the SME finance market during the years covering the global recession and the subsequent recovery period concerns funding discouragement. This occurs when a business decides not to seek additional external funding and potentially a viable proposal is wasted or delayed, to the detriment of business performance and overall economic activity. As discussed earlier, some confusion can occur about the extent to which discouraged applicants form part of any assessment of the funding gap, as normally the latter is based on applicants actively seeking support and failing. Discouragement implies that no formal application is ever reported.

Discouragement is normally considered to be mainly an issue for debt markets. The scale and nature of the issue of discouraged borrowers (DB) has been researched extensively in recent years. The incidence of DB in the SME population is still a matter of contention but, as discussed earlier, the most recent comprehensive study for the UK implied a debt funding gap as a whole equal to seven per cent of credit supply (or c 70,000 firms in 2014/16).

This does not look like too big an issue. However, as noted earlier, at the present time only about four per cent to six per cent of SMEs make a credit application each year. Consequently, if only a small reduction in the number of DBs could be achieved, spread over a few years this could make a noticeable impact on the SME debt market.[15] As a result, efforts to reduce the incidence of DB amongst firms with viable business plans should be widely supported by all stakeholders, as should encouragement for DB with weak business plans to seek advice to see if they can be improved.

Action to reduce the incidences of discouragement are already underway and recent research has indicated that a reduction in the number of DBs may have begun. However, completion of this work will be a key feature of the SME finance market over the next decade, especially for banks. The actions to address DB have to be seen as a package of measures, working over time to address different elements of the issue:

- Only a minority of DBs formally approach a bank or other credit provider to discuss an application. However, some do — perhaps 25 per cent of the total — and are actively discouraged from making an application. This may be sensible guidance for many firms with weak applications, but it raises issues again about advice and sign-posting to alternative funding options. Also, following the global recession the main high street banks set up an independent appeal process to encourage applicants to question lending decisions where they believe the decision is wrong. This is now fully embedded in high street bank SME lending. Since inception in 2011/12, the process has re-considered over 25,000 credit applications and about 30 per cent have subsequently been agreed in favour of the customer. From 2016/17, the high street banks were also required by law to support regulated referral platforms where alternative funding suppliers could see declined applications from banks to see if they could support them instead.

[15] Based on 2014/16 averages, if the incidence of DB was halved the number of SMEs each year reporting a borrowing application would rise from 6.5% to 8%.

- Activities such as appeals and referrals have begun to transform parts of the SME lending market in recent years and these should be well established and embedded by the mid-2020s. The work mainly in the banking sector so far has probably been the root cause of the reduction in DB that has been reported. More can still be done, and it looks like the next wave of activity should be linked to designing a common application form to allow a prospective borrower to seek multiple offers for funding. With government encouragement this work is already underway. The appeals and referrals reforms should also be extended away from the banking sector and — where possible — standardised in both coverage and eligibility. However, some stakeholders have questioned the pace of action and the commitment of the incumbent suppliers to adopt these changes. The number of appeals and referrals each year is still very low. This concern misses the point that the debt funding gap for viable business propositions is probably smaller than many commentators fear, as is the number of DBs.

- An even more significant problem is that the majority of DBs do not approach a bank or credit provider anyway and are therefore largely directly unaffected by the activities mentioned above, which relate to direct discouragement mainly for SME owners who approach a bank. Tackling indirect discouragement is a different issue and more complex as it involves rebuilding trust between SMEs and banks in particular. This has been hit hard during the period of the global financial crisis, combined with various scandals and associated media coverage. It is hard not to conclude that if you as an SME owner have little direct engagement in the first place, these consumer confidence/trust issues are anything but discouraging.

- In part, in its extreme form indirect discouragement can also be termed 'debt aversion' and appears to be linked to the scale and severity of a recent recession. For example, both in the SME Finance Monitor and the BEIS Annual Small Business Survey, a large number of firms still report they are not interested in borrowing and are not keen in principle in owing money to a credit provider. They would rather self-fund, even at the expense of business growth. Long-run data on this issue is not available but the suspicion is that the degree of aversion is high now because of the severity of the recession post 2008.

- However, some specific activities do appear worthwhile in terms of rebuilding confidence and trust. These look best targeted at firms that would consider debt but appear to be put off by a number of issues, some real and some imagined. Banks and the wider stakeholder community all have a part to play in addressing this and actions are still at an early stage. This is the area of work that should probably be the main focus of activity in the period up to the mid-2020s.

- For example, some research suggests that DB is enhanced in scale through financial disengagement by SMEs and that as banks in particular continue to move away from a bricks and mortar branch network to phone/digital, this has made the situation worse. The lack of a physical banking outlet in many local high streets is regarded as the cause. The evidence to support this idea is at best unclear. Indeed, many smaller SMEs like the flexibility of non-standard opening hours and larger flagship branches will be retained (with most relationship managers' location independent and visiting customer premises). However, as branch networks are likely to continue to shrink over the next decade, it is an example of where the financial services industry will need to work hard to persuade the business community they are still available to support funding. This is an area where trust between SMEs and banks has been challenged in recent years and will need to remain at the forefront of thinking for some time to come. This is more likely to be addressed on a bank-by-bank basis rather than collective action, as it is a competitive issue.

- Similarly, efforts to improve the perception and trust of SME owners in bank-funded business restructuring operations will inevitably be on a bank-by-bank basis. The well-publicised issues at RBS/Nat-West and the criminal actions of a few other ex-HBOS staff during the last decade has done much harm. This is despite the fact that many hundreds of UK SMEs are only trading now because they worked successfully with their bank to go through a restructuring during the recession and in the years since.

Banks will have to be judged over time on this matter. Some collective initiatives may help, such as seeking to strengthen and publicise the Standards of lending Practice, perhaps with external advocates having a clear role. It could even help if the banking industry published some data on the number of firms going through such a service and the jobs protected and saved as a result.

- However, more substantive collective action will also be necessary in rebuilding trust. For example, if the terms and conditions of loan arrangements were standardised and better understood by SMEs, this would be a key move towards a healthier funding environment. It will require commitment by the UK financial services sector, accountants and business advocacy groups to implement and promote but all moves in this direction should be welcomed.

- Also, over the last year the role of the Financial Ombudsman Service (FOS) as being sufficient to resolve bank-customer complaints, and business customer complaints in particular, has come under scrutiny. Well over 95 per cent of all complaints – most not to do with funding issues – are resolved in-house by banks within a matter of days. Nevertheless, the FCA has published near final rules to extend the Ombudsman service to cover firms with up to £6.5 million in sales a year which is expected to be implemented in April 2019.

The FOS extension will result in access for 99% of SMEs; leaving a gap of around 40,000 larger SMEs who are also more likely to borrow and may have more complex disputes if they arise.

In March 2018, UK Finance set broad terms of reference for an independent review into the complaints and alternative dispute resolution (ADR) landscape for the UK's SME market. Simon Walker CBE – the former Director General of the Institute of Directors – was selected as the chair of the review by a panel that included representation from the All-Party Parliamentary Group on Fair Business Banking. The Walker Review consisted of an evidence-based, comprehensive analysis of the scale and complexity of banking complaints from SMEs. It focused particularly on disputes between providers of financial services (excluding insurance products) and small business customers that remain unresolved through existing customer complaints procedures and may be unsuitable for court processes. The findings of the Review were published by Simon Walker in October 2018.

The industry formally responded to the Walker Review at the end of November 2018 agreeing to take forward a number of the recommendations. These initiatives and others could begin to address the issue of discouragement amongst potential borrowers. It also seems reasonable to suggest that with cooperation from the SME stakeholder community, a significant reduction in DB could be achieved.

While little is said at present about discouragement amongst SMEs that could potentially be candidates for equity funding, it is also an issue worthy of a brief mention. While equity discouragement is not formally considered it must surely exist. For example, we know from research that some SME owners avoid equity as they fear the loss of control of a firm. However, a number of the SME equity schemes developed over the last decade have deliberately subordinated shareholder rights or can create a governance arrangement to reduce this to a minimum. While the number of firms discouraged from using equity is not formally measured it will be much lower than in the debt market, but the issue highlights again the need to promote firms getting good advice and signposting to appropriate products and services, in order to minimise the issue.

Concluding Comments

The UK SME finance market has changed significantly since the years of the recession, boosted by a period of economic recovery and a strong underlying enterprise environment which has boosted the business population. At the same time, the supply of funding has shifted away from many traditionally bank-sourced products towards alternative debt finance and, in selected sectors, equity funding.

Looking forward, we are in a period of economic uncertainty in the run up to Brexit. However, looking forward to a position in the mid 2020s — even when considering two widely different paths of economic growth over the next decade — demand for SME external funding will be higher than at present. The minimum likely increase in gross annual supply, even under a weaker economic profile, is still about 25 per cent from a 2015/2017 baseline. Also, traditional sources of debt funding in particular will have a smaller share of the gross flow of funding than in the past.

While much of the future will be determined by economic trends, things can still be done by banks and other stakeholders over the short/medium term to improve the health of the SME external funding market under all likely forecast scenarios of GDP. Suggestions include:

- A renewed effort to encourage SMEs to seek advice, choose appropriate funding and to improve investment readiness
- The possibility of the refocusing of some public policy interventions to match the evolving requirements of debt funding in particular
- A series of inter-linked activities to rebuild trust and engagement between SMEs and financial service providers, notably around greater understanding of terms and conditions, complaint handling and dispute resolution

To maintain and enhance a healthy competitive market environment, some of what is needed is likely to be undertaken by individual suppliers in order to defend or gain market share. However, it still remains the case that a more collegiate approach will be required, in order to engage and tackle other issues - especially around policy reform and indirect discouraged borrowing, notably where this involves wider stakeholder cooperation. Only by achieving the correct mix of competitive pressure and stakeholder cooperation can the best overall impact be made on the UK SME external finance market and the UK economy as a whole.