Responsible Finance

Business, Energy and Industrial Strategy Committee: Small business and productivity inquiry

8th March 2018

About Responsible Finance's submission

Responsible finance providers extend credit to underserved markets, and therefore work directly on addressing barriers to small businesses accessing finance across the UK.

In 2017, responsible finance providers lent £67 million to 5,072 UK SMEs[1]. There are 27 responsible finance providers in the UK that lend to business that struggle to get finance from the mainstream banking industry. The businesses they lend to are often deemed too risky or unprofitable by mainstream banks due to a lack of trading history or small scale: 93% of business customers lent to by the responsible finance industry in 2017 were declined by other lenders.

Academic research into the sector has shown that for every £1 lent, responsible finance providers generate £7 of economic value, given the businesses and jobs they create and save. In terms of interventions, the sector is also excellent value for money; creating new jobs at 10% of the average cost of government programmes.

Responsible Finance welcomes the Business, Energy and Industrial Strategy Committee's inquiry into small businesses and productivity, and this submission will focus on access to finance for small businesses.

To ensure that small businesses can access the finance and tools they need to grow and enhance productivity Responsible Finance calls for the creation of a £150 million responsible finance fund.

About Responsible Finance

Responsible Finance is the trade body for responsible finance providers (formerly known as community development finance institutions (CDFIs)). Responsible finance providers offer finance and support to businesses and individuals who find it difficult to access lending from commercial banks. Responsible Finance's mission is to support the development of a thriving and sustainable sector that provides finance for underserved communities and, as a result, contributes to the increasing economic growth and prosperity of these communities.

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[1] Responsible Finance 2017, http://responsiblefinance.org.uk/policy-research/annual-industry-report/

Evidence

Access to finance for businesses wanting to scale-up

Access to finance is a key component for businesses across industrial sectors when making strategic decisions, and restricted access to finance is a key limiting factor for businesses seeking to expand in the UK. Business investment is also a key driver of productivity, and the decline of investment as proportion of domestic output in the past three decades has had an impact on the UK's low productivity[2].

The recent British Business Bank report on SME finance noted that whilst traditional banks are still the predominant source of finance, demand for bank finance is stagnating. In fact bank lending to SMEs as a proportion of all bank lending has decreased by a third in the past thirty years[3]. Smaller businesses are increasingly using a range of alternative finance options, but this market remains small[4]. A diverse supply side includes additional sources of funding, such as responsible finance providers.

The BDRC Continental SME Finance Monitor from Q2 2017 found that only 55% of SMEs were confident their bank would say yes if they applied for finance, and almost half of SMEs meet the definition of a permanent non-borrower. The percentage of non-borrowers was only 34% of all SMEs in 2012[5], and this increase is a concerning development for the outlook of productivity for SMEs. Demand for new or renewed finance has declined over time. Only 1.7% of smaller businesses sought loans in the last ten quarters; a record low since the SME finance monitor began in 2011[6].

The SME finance monitor shows that permanent non-borrowers are less likely to export than those that use external finance, and are less likely to grow, innovate, and make a profit[7]. This contributes to the productivity challenges that the UK faces and geographical disparities in output. This ultimately has an impact on the strength and resilience of local economies and the economic opportunities for their residents.

[2] Civitas, 2018 http://www.civitas.org.uk/content/files/closingthefinancegap.pdf
[3] Ibid
[4] British Business Bank, 2018 https://british-business-bank.co.uk/wp-content/uploads/2018/02/364-Small-Business-Finance-Reportweb.pdf
[5] British Business Bank, 2017, https://www.bdrc-group.com/wp-content/uploads/2017/09/BDRC_SME_Finance_Monitor_Q2_2017.pdf
[6] British Business Bank, 2018 https://british-business-bank.co.uk/wp-content/uploads/2018/02/364-Small-Business-Finance-Reportweb.pdf
[7] BDRC SME Finance Monitor, Q3 2015, http://bdrc-continental.com/wp-content/uploads/2015/11/SME-charts-Q3-2015-FINAL.pdf

Actual success rates for first time loan or overdraft applicants has declined to 53%, and the percentage of all recent successful applications has declined from 82% in 2015 to 78% in 2017. Smaller applicants have lower rates of success[8]. The influx of alternative online lenders has not proved to boost productivity. Evidence shows that peer-to-peer lenders are lending to low-risk bankable businesses, and not filling the finance gap for the businesses that cannot or are discouraged from seeking bank finance. A new market of online lenders potentially lend to these underserved businesses but as the market is unregulated there is little transparency on pricing and terms. Responsible finance providers are the only lenders that are actively targeting the gap in access to finance with fair and affordable products.

The lack of competition at the higher risk segment of the market is contributing to the UK having "one of the lowest proportions of micro enterprises that grow to more than 10 employees in three years" in OECD countries[9]. The British Business Bank report 'Small Business Finance Markets 2017/18' highlighted strong evidence that scale-ups in the UK are in need of more long-term patient capital throughout all stages of development. Whilst many businesses start small, they may have ambition and potential to grow.

These figures suggest that the process of navigating finance options, applying, and facing rejection is a major barrier to businesses that could make investment to scale up and grow. The Federation of Small Businesses (FSB) has recognised this problem and is lobbying the regional governments of the UK for measures to be taken to improve the lending environment for small businesses[10].

This gap in access to finance will ultimately affect small and new business' ability to grow, and stifle the potential of high growth businesses. As an example, a software developer and serial entrepreneur in the West Midlands was declined by a bank loan for his business, Synapse, in 2014. It was viewed as high risk, and the finance sought was too low to be profitable. He decided to explore alternative sources of finance, and was able to secure a £26,000 loan from ART Business Loans, a responsible finance provider. Since then he has grown his business from 3 employees to 28, and is generating a £1.5 million turnover[11].

SMEs like Synapse demonstrate this persistent gap in access to finance that small and early stage businesses still face, and the drag to the economy that a lack of access to appropriate finance creates.

There needs to be a focus on both improving access to alternative forms of finance such as responsible finance providers and creating a thriving supply and advice side so that businesses at all sizes and stages of growth can access the finance they need. As a viable alternative to mainstream banks for credit, responsible finance providers need access to patient capital to on-lend to small businesses to keep up with increasing demand. This is the reason why we are calling for a £150 million fund for the sector.

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[8] British Business Bank, 2017, https://www.bdrc-group.com/wp-content/uploads/2017/09/BDRC_SME_Finance_Monitor_Q2_2017.pdf

[9] Enterprise Research Centre, Goldman Sachs and British Business Bank, *Unlocking UK Productivity – Internationalisation and Innovation in SMEs*, http://www.enterpriseresearch.ac.uk/wp-content/uploads/2015/11/Internationalisation-and-Innovation-Report-web-pages-.pdf

[10] Federation of Small Businesses, *Access to Finance*, https://www.fsb.org.uk/standing-up-for-you/policy-issues/finance-and-the-economy/access-to-finance

[11] ART Business Loans, http://reinvest.co.uk/casestudy/synapse-2/

Policies to improve access to finance for small businesses

There is some precedent for policies that create a more inclusive financial system that supports growth and productivity. The Government launched a series of programmes targeted at underserved areas of the market following the financial crisis including the Regional Growth Fund (RGF), Start Up Loans Company and Big Society Capital. These programmes targeted businesses unable to access mainstream finance – such as start-ups microbusinesses, businesses outside of London and social enterprises – through locally-based financial intermediaries such as responsible finance providers. These programmes, along with the rise of financial technology ("Fintech"), have increased access and availability of finance, however we argue that they have not gone far enough to bridge the gap which still persists in certain industrial sectors and market segments.

Regional Growth Fund as a precedent for a responsible finance fund

The RGF programme aimed to increase access to finance for small businesses after the financial crisis, and allocated £30 million to the responsible finance sector. Matched by £30 million from Unity Trust and the Co-operative Banks, the £60 million of RGF delivered through responsible finance providers supported over 2,000 businesses and created or saved 8,000 jobs, easily meeting the targets set by the fund. 95% of the fund was lent outside of London into sectors that provide goods and services to the economy or support local supply chains. The cost per job supported was £3,500, compared to the programme average of £37,400. However, RGF was a one-off fund, as no new rounds have been announced since 2015.

The Regional Growth Fund (RGF) has demonstrated success in scaling the sector to meet the gap in finance that still persists nearly a decade after the financial crisis, and is a precedent for a responsible finance fund. The RGF model is a blueprint for a wider sector fund that can catalyse higher levels of commercial investment and scale its impact.

Responsible finance providers supported firms across a range of industries through the RGF programme – including manufacturing, clean energy, engineering, software and retail – all of which would otherwise not have accessed the finance they needed to succeed. The fund was successful because it was delivered through responsible finance providers – a sector specifically focused on underserved markets.

This type of targeted, good value for money and high-impact initiative is necessary to drive growth in small-scale ventures that feel unconfident or unwilling to engage in mainstream finance. Government interventions aiming to address the barriers of access to finance, in order to drive business growth, should recognise and promote the responsible finance sector. This will help ensure that all segments of the SME market are able to access the finance they need.

The discontinuation of the RGF programme could potentially widen the gap in SME access to finance if it is not replaced.

Fit for purpose tax reliefs and guarantees for responsible finance providers

Tax reliefs and guarantee schemes are tools widely used by the responsible finance industry to leverage commercial investment, thus increasing the impact on underserved communities. Responsible Finance welcomes the recent change that the Treasury made to allow the Enterprise Finance Guarantee (EFG) to be used on investments made through the Community Investment Tax Relief (CITR). This change will make a critical difference for the sector's ability to raise private investment and we are working with members to realise those benefits. These tools need to continue to be kept competitive to maximise social and economic return, including:

- Aligning the benefits of CITR with those of the Social Investment Tax Relief (SITR) so that the suite of reliefs for socially-oriented investors is easier to navigate;
- Expanding the wholesale EFG option to incentivise larger scale private investment;
- Ensure that tax reliefs, guarantee schemes, and other tools are appropriate and flexible to enable responsible finance providers to effectively serve the demand across demographic and industrial landscape. This includes inclusivity of industrial sectors and both rural and urban economies.

Lessons to be learned from other countries

Much can be learned from the United States' three-pronged approach to tackling the problem of SME financing. The CDFI (community development finance institution) sector in the USA was established in the 1970s to combat the exclusion of low income and minority communities from accessing loans and investment. It is the equivalent to the responsible finance sector in the UK. A range of support mechanisms were enacted in tandem with the establishment of the sector:

- *Community Reinvestment Act*: Legislation that requires banks to reinvest into communities they take deposits from. The legislation enables them to invest through CDFIs, given they have the reach and market knowledge. Banks are subsequently rated on their compliance with the Community Reinvestment Act, and the rating impacts on plans to expand, close branches, merge or acquire other banks. This created a more integrated ecosystem for providing access to people and businesses previously excluded from mainstream finance.
- *CDFI Fund*: A circa £200 million fund within the Treasury Department that provides grants and loans to CDFIs for on-lending, core capacity, and for first loss capital, to leverage in commercial finance.
- *Guarantee products and tax reliefs*: Financial instruments that enable more communities and businesses to access finance through intermediaries such as CDFIs.