

SME finance: help to match SMEs rejected for finance with alternative lenders – CDFA Response

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About the CDFA

The CDFA is the trade body for community development finance institutions (CDFIs). CDFIs provide loans and support to businesses and individuals who cannot access finance from commercial banks. The CDFA's mission is to support the development of a thriving and sustainable community development finance sector that provides finance for underserved communities and, as a result, contributes to the increasing economic growth and prosperity of these communities.

Summary of the CDFA's response

The CDFA's experience piloting a referral scheme for SMEs declined finance gives us a unique perspective on HMT/BIS' proposal and consultation, and our response is based on evidence and experience from operating the current scheme. **Overall, the CDFA, in association with SEUK, supports a mandatory SME referral scheme as part of a broader policy intervention that mitigates the issues and challenges within this complex market failure.** The summary below outlines the rationale for this response.

In partnership with the British Bankers Association (BBA), the CDFA has been operating a bank-to-CDFI referral scheme since late 2012, where seven participating banks voluntarily refer their declined SME customers to CDFIs. To date, the banks have referred a total of nearly 800 SMEs, less than half of which (350) accepted the referral and were subsequently matched with a CDFI.

Whilst this bank-to-CDFI referral scheme has led to a number of SMEs accessing finance when they were previously unable to, we have seen that banks participating purely on a voluntary basis has not effectively tackled the gap in SME finance that exists. Yet the developing referral relationships between banks and CDFIs have been important in serving the riskier SME market, and creating new market opportunities for CDFIs. Formalising and building referral relationships and referral networks is a key part of the financial services sector, and to increasing access to finance for consumers.

However, based on our experience, if such a scheme becomes mandatory, the following serious challenges would emerge, potentially exacerbating the market failure that this proposal seeks to remedy:

- Lack of understanding and awareness of the nuances of non-bank finance providers by both consumers and banks would be a barrier for making appropriate referrals. **Therefore, better education of alternatives is needed. Initially referring customers to a central website including all participating providers, such as <http://alternativebusinessfunding.co.uk/>, managed by the government would inform consumers of their options.**
- Non-bank finance providers, and even challenger banks, are not capitalised to meet the demand for SME finance. In order for non-bank finance providers to begin to achieve the scope and scale needed to meet this demand, they need to be able to access capital. **A CDFI Fund, or first loss facility is needed**, so that CDFIs and other providers can lend to the riskier SME markets and be able to leverage additional finance – including from banks. First loss cover, such as loan guarantee schemes, provides the confidence necessary for banks and other investors to invest at an impactful level.

- Whilst this proposal seeks to require banks to refer all declines to other providers, this may not be the appropriate incentive for them to do so. CDFIs in particular do not compete with banks, but instead complement them by serving a market that banks cannot reach. However, challenger banks and alternative providers such as peer to peer lenders, are in direct competition with banks, so banks may not be inclined to refer their customers to these competitors. There is already evidence of the vast number of “discouraged SMEs”, that do not even approach banks for finance as they assume they will be declined. Not wanting to refer their customers to competitors, banks may inadvertently perpetuate this reputation, adding to the number of discouraged SMEs that cannot even reach the stage at which they can be referred to other providers.

Given the above, and the severity of the issue of SMEs accessing finance, the CDFA does not believe that a mandatory referral scheme alone is enough to address the issues of competition and access to finance, and could even potentially make these challenges more difficult to address. **Therefore, the CDFA’s view on this proposal is that mandating banks to refer their declines is an important part of a larger policy that also:**

- Enhances the current public, bank, and government awareness on the non-bank finance options through investment and marketing of a central signposting website and materials
- Ensures banks serve the markets in which they are located, including through direct lending as well as participating in local community finance partnerships
- Requires banks to co-finance deals with CDFIs and other lenders to fill some of the capital gap
- Requires the analysis of bank lending disclosure and referral data

Response

Question 1

Do you agree that the government should create a mandatory process, as outlined above, to help match SMEs that are seeking finance with credit providers who are looking to offer finance?

As mentioned in the summary above, a referral process that is **part of a larger policy intervention** to raise widespread awareness about non-bank options for finance and incentivise bank investment in communities and CDFIs is welcomed by the CDFA. Developing a strong referral network is an important part of the financial services industry, and not only allows more customers to be served, but also increases competition between providers. A referral scheme on its own will provide SMEs with more options for finance, but has the potential to create additional challenges and barriers in this market.

As part of the multi-faceted policy intervention to address this market failure, the CDFA believes that banks should be required to provide declined customers with the option of being referred to another provider. If the customer opts in, they will be referred to a platform with information about non-bank financing options, so they can explore the options available to them. Based on the SME’s profile and the platform’s decision criteria, the SME will be referred to the appropriate provider.

Based on our experience operating the bank-to-CDFI referral scheme, some SMEs choose not to be referred, but for those that do, the CDFA’s own signposting website, <http://www.findingfinance.org.uk/>, helps inform them about the process and their available options.

Question 2

Should any requirement to share information on rejected loans apply to all SME credit providers or should there be exemptions for smaller providers and/or providers without a banking licence?

The proposal to share rejected SME information should be focused on the commercial banks, as a referral network involving all credit providers, including those without a banking license, will become difficult to manage and protect consumer information.

Question 3

Do you agree that information about rejected SME loans should only be shared where an SME gives its permission?

Given our experience with the bank-to-CDFI referral scheme, in which over half of SME customers declined to be referred, we firmly believe that **SME loan information should only be shared where the SME gives its permission**. As mentioned above, we believe that the SME should be given the choice to opt into the referral scheme, and if they do, they will be presented with information about their financing options.

In addition to potentially violating data protection requirements by sharing an SME's information without their permission, an SME is less likely to be responsive to non-bank finance providers if they did not agree to be referred.

Question 4

Do you think there should be additional protections in place to secure the data about rejected SME loans and what form would these take?

Written consent from the customer should be required for the SME's loan information to be shared, including the acknowledgement of the risks involved. This consent could be a physical or electronic signature.

Question 5

What information do you think banks rejecting SME applications for finance should be required to provide? Do you agree that this should include information about the SME's name, business type, and loan request parameters?

Only basic information about the customer and their loan should be provided. The CDFA's bank-to-CDFI referral portal includes the business name, contact information, location, legal structure (i.e. sole trader, limited partnership, limited company, etc. to indicate the type of business), loan amount, and the purpose of the loan. Similarly, it would be helpful to add Company Limited By Guarantee, Community Interest Company, and Industrial and Provident Society to the list of legal structures, as well as ask if the business is a registered Charity. This would help identify if it is in the VCSE sector and thus could be referred to finance providers that specialise in this market. This information allows the provider to contact the SME with more information on submitting an application for finance.

Question 6

Do you think there other types of finance applications that should be included in addition to SME business loan applications? If you think other types of finance applications should be included, please supply the reasons for your answer.

If other types of finance applications in addition to loans are to be included, it should be made clear what is available, how it will be marketed among finance providers, and standard practices among providers on how consumers will choose among them. Including other types of finance applications could potentially complicate the referral process and limit the providers who could serve the customer.

Question 7

Do you agree that information about SMEs rejected for finance should be referred on to private sector platforms? If you agree, how would this work alongside existing private sector referral arrangements?

Given the scale and complexity of a referral network, such as the one proposed, a central platform managed and monitored by the government (such as the British Business Bank), would be more effective than multiple private sector platforms. A referral portal managed by the government would be unbiased, and ensure that all referrals are treated with the same standards, and could be easily monitored for compliance. The government could also conduct due diligence on the credit providers included on the platform, to ensure that they are fair and responsible lenders. Multiple private sector platforms would become increasingly complicated for banks, and hamper the referral process.

Question 8

What factors would promote the development of a market of competing platforms?

As mentioned above, competing platforms would make the process confusing – so instead operating one platform that includes all non-bank finance providers would be more efficient. Keeping the referral process simple would ensure that more SMEs are referred and matched with the most appropriate non-bank provider.

Question 9

If you agree that rejected loan information should be referred (to a platform, or somewhere else), how do you think compliance with this requirement should be reported and then enforced?

A single platform, operated and monitored by the government, would track compliance. Incoming referrals from each bank could be monitored, and their progress through the application process could be recorded. Non-bank finance providers could also be monitored for their performance responding to referrals.

Question 10

What criteria should be used for designating platforms? How should ongoing adherence to these criteria be monitored?

Referrals made through the CDFA's bank-to-referral scheme are allocated based on the customer's geography (post code). This has been an effective approach, and we continue to support this as the primary method of assigning referred SMEs. Additional decision criteria, such as loan size, business type (i.e. social enterprise, start-up, etc.) can also help assign the referral to credit providers.

Question 11

Do you agree that all of the information that is made available should be accessible to all providers of SME credit? Do you agree that the information should also be available to commercial finance brokers, accountants and advisers?

While in theory, sharing customer information with all providers of SME finance as well as other providers of business services would encourage competition, it risks violating client confidentiality and data protection requirements. Depending on the providers included on the platform, it could also lead to the SME receiving unsolicited contact, the providers entering a bidding war for the client, and providers with more resources dominating the market. If the SME chooses to be referred, their information should only be shared with providers that are a match for their needs.

Question 12

Are any additional protections and reporting requirements or restrictions needed to ensure SMEs are protected from issues such as poor advice, malpractice and mis-selling?

As mentioned above, a referral platform monitored by the government, would ensure that irresponsible providers are not included on the platform. This is an essential part of developing a strong referral network, and requires a deep understanding by the government, banks, and public on the non-bank options available in the market.