Treasury Select Committee: SME finance inquiry
Responsible Finance Response

12 March 2018

About Responsible Finance's submission

Responsible finance providers extend credit to underserved markets and therefore work directly on addressing barriers to accessing to finance across the UK. The sector has been experiencing an upward trajectory, lending more and more each year and finding innovative ways to finance the start up and growth of businesses, which are so important to the economy[1]. Last year, responsible finance providers lent £235 million, £67 million of which was to SMEs[2]. 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. For responsible finance providers transparency is a central tenant to responsible lending. Part of treating customers fairly is ensuring that before taking out a loan the customer understands the cost and terms and how that will impact on their personal and/or business' finances. Responsible finance providers will not lend to a customer if debt and its associated costs will make the customer worse off. However these standards are not shared across the SME finance market, which makes it difficult for a business to navigate their options and make an informed decision.

For this reason, Responsible Finance welcomes the Treasury Select Committee's inquiry into SME finance. Business lending accounts for a large portion of responsible finance providers' loan books, so the chance to identify opportunities to increase the provision of finance to underserved segments of the SME market is welcomed.

About Responsible Finance

Responsible Finance is the trade body for responsible finance providers. Responsible finance providers offer loans and support to businesses and individuals who find it difficult to access finance 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] Evaluation of Community Development Finance Institutions (CDFIs), 2010, http://www.bis.gov.uk/assets/biscore/enterprise/docs/10-814-evaluation-community-development-finance-institutions

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

Evidence

The market segment that responsible finance providers primarily serve is SME lending up to £150,000. Due to this specialisation, we have focused our responses on this segment of the market.

- **Funding options available to SMEs**

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[3].

The recent British Business Bank report on SME finance noted that although 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[4]. Smaller businesses are increasingly using a range of alternative finance options, but this market remains small[5]. 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 34% of all SMEs in 2012[6], and this increase is a concerning development for the outlook of growth and productivity in the SME sector. 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[7].

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[8]. 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.

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[9]. The influx of alternative online lenders has not proved to boost

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

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 can 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.

There is a lack of competition at the higher risk segment of the business finance market. This 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[10]. 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[11].

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[12].

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, risk profiles 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. For this reason Responsible Finance is calling for a £150 million fund to capitalise the sector.

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 across businesses. 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 or alternative finance – such as start-ups microbusinesses, businesses outside

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[10] 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

[11] 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

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

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") which enables responsible finance providers to reduce decision times and improve the customer journey, 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 local economies 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 the sector's 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.

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 businesses. 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), Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS) so that the suite of reliefs for socially-oriented investors is easier to navigate;
- 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.

- **The regulation of SME lending**

Currently the business finance sector is unregulated and there is a wide range of practice amongst lenders, therefore there are very few protections in place for businesses. The precedent for these conditions is the consumer credit market prior to 2013. With only light touch regulation by the Office of Fair Trading (OFT) there was an influx of new entrants into the market and many, like Wonga, were viewed as innovative 'Fintech' firms. Without enforced regulation, consumer credit firms developed practices and pricing that maximised profit for lenders at the cost of the consumer. From debt management firms to brokers to lenders, firms were opaque within their terms and conditions so that hidden fees and charges could not be challenged. There was poor practice around affordability checks so consumers were extended loans they could not repay and would ultimately need to roll over, and debt collection verged on predatory. Significant consumer detriment was caused by this 'wild west' market. The government and the FCA intervened in 2013 and are still establishing policies six years on to create a fairer and more transparent market.

There is a risk that without regulation, similar trends could occur in the business lending market, and there are indications that some already are. There is evidence of little transparency around pricing and a lack of affordability checks. This can ultimately have a catastrophic effect on the small business market which is the engine of the UK economy.

Looking at business lenders' websites, very few have representative examples and they are not upfront about their fees. The table below demonstrates the variation in information presented.

	iwoca	**Capital On Tap (business credit card)**	**Funding Circle**
Representative example on website?	Yes	No	No
Monthly Advertised Rate	2%-6% per month	0.79%-7.4% per month	N/A
Current Annual Rate Range	40% per annum (fixed)	N/A	3%- 21.9% per annum
Maximum Term	12 months	N/A	60 months
Maximum amount	£150,000	£25,000	£500,000
Fees?	No fees	No information on fees other that they can 'be incurred'	1.5%-6% arrangement fee, up to 15% missed payment fees, up to 15% default fees

Although it is difficult to make a judgement on what is 'high cost' for businesses given the range of products, business' working capital needs and risk profiles, what is certain is that critical information is not presented consistently and therefore businesses cannot make informed borrowing decisions.

There is also evidence that affordability checks are not regularly conducted, and businesses are sold products with repayment terms that are not feasible for them. This means that a business may be offered a loan with a repayment schedule that is not compatible with its cash flow and therefore it would not be able to afford repayments.

Together these issues mean that businesses are not choosing the right product and are entering into unaffordable contracts. Then there is the additional risk that in an unregulated market, lenders can get away with extortionate interest rates and hidden fees as well as not exercising fair practice when a business encounters difficulty repaying; these are all trends occurred in the consumer lending market that could be latent in the business lending market. As business loans are term loans, the extent of detriment to businesses may not be realised until several years from now.

For responsible finance providers transparency and affordability are central tenants to responsible lending. Part of treating customers fairly is ensuring that before taking out a loan the customer understands the cost and terms and how that will impact on their personal and/or business' finances. Responsible finance providers will not lend to a customer if debt and its associated costs will make the customer worse off or not improve their business' trajectory. Responsible finance providers such as ART Business Loans and Let's Do Business Group display the full cost of borrowing to their customers upfront.

The current conditions in the business lending market creates a strong case for investigating transparency and affordability, and introducing regulation that mirrors the FCA's regulation of consumer credit. While industry codes and standards can have a positive impact, there are so many segments of the business lending market that there is not a single industry body that encompasses them all and enforces such standards. The implementation of the CMA's Retail Banking Order has already proven ineffective by exempting peer-to-peer lenders and not monitoring compliance in a systematic way. To rectify existing detriment caused and prevent future poor practice Responsible Finance calls for the FCA to regulate the business lending market alongside the consumer credit market.

Although it is critical to ensuring a fair and customer-centric market, regulation will have an effect on the supply of finance; not only will regulation restrict certain lending, there is evidence that firms become more risk averse. For example when the FCA introduced the payday lending cap 800,000 consumers immediately lost access to credit. Now as it is looking to further intervene in other high cost markets the FCA is working with the responsible finance sector to understand how it can fill the gap. Any regulation in the business lending sector should take into account how to support ethical lenders such as responsible finance providers to fill the supply side gap that will emerge from regulation. For this reason Responsible Finance calls for a £150 million responsible finance fund that will enable the responsible finance sector to scale up and mitigate a further gap in access to finance. As small businesses are the backbone of the UK economy it is crucial that they have access to responsible products and support that will enable them to grow and prosper.