Treasury Select Committee: SME lending inquiry – CDFA Response

28 March 2014

About the CDFA's submission

CDFIs' purpose is to extend credit to underserved markets and therefore work directly on addressing access to finance and financial inclusion issues in communities across the UK. The CDFI 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, CDFIs lent £123 million, £52 million of which was to SMEs[2]. Yet the sector has tremendous potential to do more; in the United States, where the CDFI sector is older and well established, CDFIs have lent more than $30 billion to communities in the last three decades[3]. The sector in the US experienced unprecedented investment and opportunities to reach more customers when the government investigated bank lending behaviour and identified CDFIs as important vehicles for meeting the credit needs of local communities.

For this reason, the CDFA supports the Treasury Select Committee's inquiry into SME lending activity. Enterprise lending accounts for a large portion of CDFI loan books, so the chance to identify market opportunities and explore ways to support CDFIs in filling the gap in access to finance in SME markets is welcomed.

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 find it difficult to 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 Evidence

Based on CDFIs' submissions of evidence, the following points summarise the response to the Treasury Select Committee's inquiry.

SMEs' access to finance

CDFIs have recorded record figures in demand for finance and lending annually for the past four years. In the past year alone, CDFIs served 257% more business customers than the

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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] Inside Community Finance, 2013 (http://www.cdfa.org.uk/about-cdfis/icf/)

[3] CDFIs: Investing in Opportunity Factsheet (http://ofn.org/sites/default/files/ABOUTCDFIs_Factsheet_051613.pdf)

previous year[4], indicating the huge demand for SME finance. As noted previously, CDFIs serve customers that cannot access credit (typically from banks but also other finance providers such as Crowd Funding), and in 2013 93% of CDFIs' nearly 10,000 business customers had previously been declined bank finance[5], meaning that more and more businesses cannot access credit through mainstream banks. While this information indicates a general market failure, the evidence submitted provides a nuanced perspective on where the biggest access to finance issues lie. Bank lending to SMEs has picked up slightly, but it is nowhere near pre-recession levels, given greater risk aversion and increased regulatory requirements. With regard to where there is a significant gap in accessing finance, CDFIs noted the following market areas where there has been a demonstrable trend in bank declines and discouraged applicants:

- **Micro businesses and small SMEs**
- **Loans under £50,000**
- **Start ups and early stage (less than 3 years trading history)**
- **Existing loss making (many turnaround projects rejected)**
- **Sectors including retail, hospitality, leisure, construction supply chain**
- **Unsecuritised proposals**

Competition

Banking competition has been the subject of recent banking reform and regulation, but according to evidence submitted, there has not been noticeably more competition in recent years.

- The OFT's review of SME banking from 11 March 2014 stated that more than 80% of SMEs' main banking relationship is with one of the largest four banks[6].
- Reports that banks are asking customers to also have a Business Current Account as a requirement of securing a loan with them indicates a practice that is not aligned with the principles of establishing competition and enabling greater access to finance.

Barriers to entry

Non-bank finance providers, such as CDFIs, fill some of the gap in SMEs' access to finance, however there are a range of barriers to entry or expansion that can significantly stunt their ability to reach the underserved and discouraged SME markets. These include:

- **Accessing capital funding –** CDFIs find it difficult to raise capital for lending and developing capacity. There are a variety of reasons for this, including their scale, reach, capacity and the higher risk markets they operate within, given they target markets where there is market failure. Consequently there is no wholesale investment by mainstream banks to help develop the sector. What investment has been made at any scale has only been achieved due to grant or guarantee mechanisms that sufficiently lower the risk for the bank, such as the CDFA's Regional Growth Fund Round 1 scheme.

[4] Inside Community Finance, 2013 (http://www.cdfa.org.uk/about-cdfis/icf/)
[5] Ibid.
[6] Review of banking for small and medium-sized businesses (SMEs) in the UK: Update on work to date, 2014) http://www.oft.gov.uk/shared_oft/markets-work/sme-update.pdf)

- **Cost of capital** – CDFIs often pay a higher price than banks on their capital to on-lend, a cost that is ultimately passed onto the customer. Typically, CDFIs have accessed funds at 3% - 7.5% over base. As stated above, this rate has also only been gained after the comfort of a first loss position and or substantial security cover, generally created through public sector grants or guarantee schemes. If these were not available, and assuming banks were still able lend, indicative rates have been quoted at or above 10% which is an unviable rate for both the CDFI and the ultimate end beneficiary.
- **Public awareness of alternatives** – Although CDFIs operate extensively both locally and nationally, customers are often unfamiliar with their services, and unaware that there are alternative options for finance**.** A comprehensive, accurate, and up to date information system on national and local lenders is needed, as is bank education on where to refer declined customers.
- **Regulation** – small sized community and social banks are limited by the fixed costs of managing their regulatory monitoring and compliance. These costs are substantial for new entrants and impact the amount of capital they need to raise.

Recommendations

Responses and evidence submitted to this inquiry support the trends that have been noted anecdotally; that SMEs (particularly small and micro, start ups, and those without sufficient security) face significant difficulty when accessing finance from the banks, the banking sector is still highly concentrated, and while there are tremendous opportunities for challengers and alternative providers to enter the market, there are significant barriers. Based on the feedback on this inquiry, the CDFA presents the following proposals for the Committee's consideration:

- We are operating in a new financial services landscape since the financial crisis; banks are unable to lend at previous levels, partly due to new regulatory requirements. Alternative finance providers are able to fill some of the gaps in the market, however **there is a need for an awareness and understanding by government, banks, regulators, and the business community on how bank and non-bank finance fit together in the provision of financial services.** If banks cannot serve a certain market, how can CDFIs and other finance providers be best equipped to fill the gap? A deep understanding by the government of the SME markets will enable more adaptive and flexible support to address the different needs of this complex market. **Equally, public awareness and education on available alternative finance options are needed.** While central portals and referral systems exist, they need to be made more comprehensive, robust, and accurate and marketed heavily to the public.
- In order for non-bank finance providers to begin to achieve the scope and scale needed to meet the demand for SME finance, 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 – such as 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. Additionally, patient capital, such as grants, is another part of the solution to this

first loss issue. Patient and unrestricted capital at affordable terms helps build CDFI organisational capacity and lending scale, as well as provides further capital to on-lend. In addition to enabling the CDFI sector to strengthen and grow, a first loss facility would unlock additional investment into these hard to reach SME markets to begin to narrow the finance gap and achieve public policy objectives such as economic growth.

- For the bank and non-bank sectors to function efficiently and effectively together, **transparency in financial services activities is needed**. Whilst the banks currently release limited data on a voluntary basis, much more robust data is needed from all finance providers in order to identify gaps in markets. Equally, the data needs to be monitored and scrutinized by a neutral regulator.

Evidence

The following bullet points are a representative selection of evidence that CDFIs submitted in response to this inquiry:

SMEs' access to finance

- Banks are generally unwilling to lend without adequate security and personal guarantees. They are also unwilling to lend at amounts below £50k+ as the revenue generated is insufficient to cover costs and risk of loss.
- Many SMEs are reluctant to approach their bank as they are fearful of both a) the request being turned aside, but more importantly b) the bank curtailing or restricting existing facilities. They also believe that if one Bank says 'no', they will meet the same resistance from all other High Street Banks.
- The other major shift that we have observed is the propensity of Banks to centralise their business centres. The Banks have been under pressure to cut costs and have therefore changed their models to handle their relationships with their business customers over the phone, which is a much cheaper commercial model for them. The result of this is a) a lack of experience in these 'call centre' environments where there is a high turnover of staff, b) an inability to spend the time and diligence on a lending proposition to make a reasonable decision, and c) a very process driven environment where if a customer fails an almost 'flowchart' process, the lending will be declined. This is not to say there are not capable individuals in these centres and that they aren't able to lend money soundly. But it does clearly mean that clients will find the process impersonal and not always be able to convey their businesses successfully, leading to great businesses being missed or simply giving up on asking.
- Despite what banks say about starting to lend to SMEs again – there is no evidence of that. When the customer is referred to Credit, we see that the policy has not changed, and that credit is blamed for the ultimate decision not to make the loan. There are situations where the customer has had a relatively weak performance recently, and the bank expects to lend against security; if bank does not like security cover, it will reject the proposal, and then the SME will struggle to fund their growth and the opportunities they have.

Competition

- One aspect that appeared to suggest that contrary to undertakings given in 2002, some banks have been insisting that a condition of a commercial loan is that they act as the provider of Business Current Accounts. The suggestion is that this could be considered to be anti-competitive.
- My perception of the market place at present is that there are two Banks who do demonstrate a desire to lend, Lloyds & Barclays, and the others are much more reluctant. HSBC seem to be moving away from SMEs who do not export. There is no doubt that Barclays & Lloyds have made much effort to lend to SMEs. Lloyds have seen an increase in lending balances over the past year of 6% - this has taken a huge amount of effort & activity. My contacts in Barclays indicate that despite efforts net lending balances have actually fallen. For the reasons that I mention above, my opinion is that competition among banks has, therefore, decreased and the availability of funds has become more difficult.

Barriers to Entry

- Excerpts from a social bank's submission to Parliamentary Commission on Banking Standards call for evidence:
    - 37. One consequence of the Bank's chosen business model is that both direct costs (e.g. staff employment costs) and indirect costs (e.g. professional fees) associated with regulatory monitoring and compliance represent a higher charge, as a proportion of total operating expenses, for the Bank than they do for many traditional lenders. Because regulatory costs do not have a linear relationship with the Bank's business volumes, the shape of the Bank's cost structure effectively mean they represent a fixed cost. This alone provides an incentive for the Bank to expand its business volumes.
    - 38. The Office of Fair Trading (the "OFT") recently examined the impact of regulatory frameworks on banking operations and whether regulatory costs and new regulatory capital requirements represent a barrier to the expansion of an individual bank (*Review of barriers to entry, expansion and exit in retail banking*, OFT, September 2010). In its Review (paragraph 5.14) the OFT recognised "a regulation imposing high fixed costs will have a more significant impact on smaller firms than larger ones."
- Wholesale money is too expensive to retail competitively.
    - Bank CITR is the cheapest source of funds if they make a profit (2.0% plus base plus 1% fee) otherwise the cost rises to 4% above base plus fee if they make a loss – a situation that we have no control over. If not CITR registered other sources are 3-5% plus base rate. Most sources of finance have strings attached (e.g. deprived areas/social) of course.
    - Banks have had the Government's Funding for lending scheme offering capital at cheaper (0.25%) than market rates making it impossible for CDFIs to compete.
- Difficulty accessing finance through mainstream banks and lack of competition means that SMEs have to look outside the realms of traditional banks to CDFIs, challenger banks, other niche providers, and peer to peer lenders such as Funding Circle. There is a great deal of scope for new or alternative providers to enter the

market. The one big problem is access to capital. Funding Circle have gotten around that in one way from sources capital from individuals. The delivery of the Regional Growth Fund through the CDFA is a workable model because the government takes first loss, which encourages a bank or other lender to become involved in the space.