Financing Small and Growing Firms

October 2013

James Barty & Guy Miscampbell

Summary of a public event and a roundtable discussion held in March and June 2013.

Executive Summary

Small and medium enterprises (SMEs) are a vital part of the UK's economy. In March and June 2013 Policy Exchange held two events to discuss access to finance for SMEs. This document summarises the points made at the events. The picture painted was of a complex and mismatched set of needs, incentives, and policies. Observations included that:

- There were substantial issues with the supply of finance to SMEs. These include regulatory disincentives to lend, as well as an inflexible system for assessing SME applications for finance. This often leads to SMEs having their applications for finance rejected, or being provided with unsuitable forms of finance.
- Problems with SME financing also existed on the demand side, including a lack of demand from SMEs for the types of finance available, and a lack of knowledge about alternative funding sources.
- The current system of assessing SME applications for finance is inflexible. A move towards relationship banking would be desirable and allow banks a much better understanding of the situation businesses are in. This would mean they could provide more appropriate finance and support than in the more rigid system of assessment which currently exists.

- There needs to be a longer term view of the effect capital requirements have on lending, including an awareness of the fact that if capital requirements on banks are too high it can create incentives which reduce lending.
- Alternative forms of finance, such as crowd funding, also offer some solutions to the financing needs of SMEs by providing new streams of funding for them to access. There is also potential for partnerships between traditional and new systems of finance.
- The role of the business bank was considered to be to tackle structural and long term problems as well as consolidating existing finance schemes. It would also attempt to increase the provision of finance to viable but under-served businesses by providing them with diverse sources of finance, as well as addressing the lack of longer term 'patient capital'.

In order to provide greater and more appropriate funding for SMEs, both the Government and the financial sector will have to acknowledge the diversity of their requirements and adopt a number of bank and non-bank strategies to help finance them. The discussion about these policies is detailed below.

Introduction

Small and medium enterprises (SMEs) are a vital part of the UK's economy, accounting for around 60% of employment and 50% of turnover. As such, their ability to operate and expand is vital and presents an important policy challenge.

Reacting to this challenge, the Government has resorted to a number of blunt tools such as direct lending targets for the banks. There have also been more direct interventions including the establishment of the Business Growth Fund to make long term capital investments and the creation of the business bank. However, the need for these interventions points to wider questions about why SMEs currently face barriers to obtaining appropriate finance.

To discuss these issues and what steps private entities or the Government could take to deal with them, Policy Exchange hosted a public event on the 12th of March 2013 and a roundtable discussion on the 12th June 2013. These events discussed how to improve the finance available to small and growing enterprises, including:

- What the evidence says about the barriers to SMEs accessing finance, and to what extent this holds back their operations.
- What the options are for the Government to do more to ease access to bank and non-bank finance for SMEs.
- What role banks and other financial organisations can play, and what businesses can do to access alternative forms of finance.
- What effect the implementation of the Vickers reforms and the Basel 3 capital requirements might have on UK based SMEs and their competitiveness, and how Government, the financial sector and SMEs can respond.
- What alternative finance solutions might be available to SMEs in light of the tighter debt finance conditions, and what role innovative solutions can play.What role banks can play in supporting non-bank solutions and what more businesses might be able to do to unlock different types of finance.

This note summarises, in the words of the authors, some of the key points made at the event and the roundtable (the latter was held under the Chatham House Rule). ***Points outlined in this summary do not necessarily reflect the views of Policy Exchange, nor of particular attendees at the roundtable.***

Remarks at the public event were made by the Rt Hon Michael Fallon MP, Minister of State for Business and Enterprise, James Barty, Senior Consultant for Financial Policy at Policy Exchange, Steve Pateman, the Head of UK Banking at Santander, and Julia Groves, Chair of the UK Crowd Funding Association. The public event was chaired by Sam Coates of the Times. At the roundtable event opening remarks were made by George Freeman MP, James Barty and Steve Pateman.

Opening Remarks

George Freeman MP

- As a backdrop to this discussion, we need to be honest with the public about the chronic state of public finances generally. We are a western democracy which is struggling with an ageing society and a structural deficit. There are also multiple underlying factors which are concerning such as the cost of pensions, welfare, health spending and debt interest.

- This lays down the need for an 'insurgency of small companies,' and the key question is how we unleash small businesses. Within this context, the question of how we encourage small businesses and what reforms are needed is absolutely vital to the UK economy.
- In America they have over 20,000 banks. In our sector we need more portability and local banking. Local banks could use their resources to do local financing for local investment so savers could see their money at work. The City of London would of course retain a huge but separate role.
- There is a need to have clarity over what type and size of SMEs we are discussing. Much smaller ones will require a completely different attitude and set of policies. This could include not levying NI or VAT on the smaller ones under a 'new deal for entrepreneurs.'
- These extremely small start-ups have a tendency to over or underestimate their success; either they will be unsuccessful, or they will often be making three or four times the amount they expected to. Very few will be somewhere in the middle.
- Banks are often risk adverse, though that is part of their job of looking after the money of their depositors. The role of financing extremely risky early stage ventures should fall to alternative forms of finance such as community finance networks. We should recognise and encourage these forms of finance.
- We should also consider measures which help free up the capital businesses have on their balance sheets.
- The need for SME finance should not lead to the Government taking equity stakes in businesses, but instead to encouraging an atmosphere which reduces risk when investing, rather than sharing in the risk.

The Rt Hon Michael Fallon MP

- The number of SMEs accessing finance is becoming smaller, with many being discouraged by the negative media portrayal of bank lending. Only one in ten SMEs applied for finance last year. Of those applicants 75% of overdraft applicants and 65% of loan applicants were successful.
- The 'Big Four' currently dominate lending to SMEs. There is a package of measures in place to address this, but it is also true that banks themselves need to do more.
- Unfortunately, Funding for Lending seems to be affecting mortgage lending rather than other forms of lending. This means that the intended finance is not getting through to small firms.

- Part of the reason that they struggle is the lack of collateral or a trading record. The Enterprise Finance Guarantee has helped 10,000 people by providing a guarantee. 80% of those businesses would not have been able to secure finance through conventional lending. Those businesses who have received finance through this scheme have grown at the same pace as other businesses.
- There is a view amongst SMEs that the 'Big Four' have lost touch with 'relationship banking,' though the real picture is probably more nuanced. Those banks are beginning to rebuild their networks, and the quality of the advice given is a particularly interesting area.
- The Government has committed to transparency and a greater level of disclosure so that all can see what the banks are lending and where they are doing it. They have asked the banks to be 'ambitious' in their approach to recording and disseminating this information, but if they cannot or will not then the Government will be ready to legislate.
- There is also a concern as to whether the banks are close enough to their customers to make proper decisions, and whether they rely too much on national credit scoring or the fulfilment of certain predetermined criteria.
- Too few SMEs are unaware of their right to appeal lending decisions, and 40% of 'declined' decisions which are appealed are overturned, indicating that the quality of the original decisions is not necessarily of the highest calibre.
- It cannot be considered right that 85% of SME lending is in the hands of the 'Big Four.' This situation is unhealthy and is reinforced by protective regulation and a privileged place at the heart of the payments system.
- The FSA review of barriers to entry should bring about real progress in the process and pace of authorisation of new banks, as well as giving them more time to build up proportionate capital requirements. Reforms to the payments system means that they should have equal access to the infrastructure they need to operate.
- Given the measures now in place, regulators now need to show more leadership. Otherwise there is a real danger that a risk-adverse micromanaging culture will inhibit the competition we want to see from new entrants.
- Much of the debate on lending focuses on debt, but equity and non-bank lending also have a crucial role to play.
- The Government is increasing its commitment to venture capital and bridging the equity gap for innovative SMEs. Enterprise Capital Funds provide around £300m to firms with the highest growth potential. The Chancellor has committed £110m to non-bank lending and £55m to peer-to-peer lenders, and successful bidders for the other £45m will be announced.

- The business bank is being built to tackle structural and long term problems. As well as consolidating existing finance schemes it will also increase the provision to viable but under-served businesses. In particular it will focus on long term finance and will receive £1bn of funding. £300m will be co-invested over the next two years to provide diverse sources of finance for SMEs.

Steve Pateman, Santander

- It is the ambition of Santander to be the SME bank of choice. As part of this it has developed a broader commitment to SMEs, as can be seen in its 'breakthrough programme.' Part of that programme includes a growth capital fund for fast growth SMEs, which in late 2010 totalled £200m and was comprised entirely from mezzanine finance.
- A key part of Santander's approach is that it focuses on more than just financing. It includes a network of support available for up to 5 years, including increased trade missions to foreign markets, business mentoring, and funded internships for young graduates.
- This approach reflects that Santander want to be a trusted partner bringing more value to the relationship than just financing. This is achieved by focusing on local relationships and more localised decision-making.
- Relationship managers are distributed across the UK in corporate business centres and only deal with businesses in that area. Local credit partners are also located there and work alongside the business and relationship managers, acting as an advocate for the business and helping them prepare their application.
- This model is good for both the bank and the businesses. By working closely the bank is able to provide finance suitable for the SME's needs, as well as to foster a stronger and more stable customer base.
- There is muted demand for financing compared to previous periods, but banks have also become more risk averse in their assessment. There needs to be more support to help businesses understand the process of applying for finance, and increased guidance to support them in doing so.
- Funding for Lending would be more beneficial for SMEs if it was focused solely on business lending or if the reporting requirements which make a distinction between mortgage and SME lending were dealt with. Current capital rules incentivise Funding for Lending to be directed towards mortgage lending.

- There is no doubt that it is essential to deliver a stable banking system, but the Government must be aware of the effect high or punitive capital rules may have, especially if they are introduced prematurely while the economy is struggling to recover.
- There is a need to adapt to innovative solutions for SME financing. Examples such as crowd funding and peer-to-peer lending are exciting prospects. However, in the shorter term it may be necessary for them to work within established distribution mechanisms to maximise their impact.

Julia Groves, UK Crowd Funding Association

- Crowd funding involves raising finance for investment from a large pool of individuals, all of whom invest a relatively small amount of money.
- It is used for equity and debt finance for existing businesses. The sector itself has experienced massive growth, with the last valuation being £2.8bn worldwide. The UK sector is valued at around £450-£460m, but is poised for growth.
- There is a need for alternative forms of finance to fill some of the spare demand for finance from SMEs.
- Crowd funding offers a way in which funding can be channelled to businesses, while also providing a transparent return for the investor.
- A low minimum investment amount means that even a very small investor can assemble a diverse portfolio.
- The range of projects and investments available is extremely diverse, and as such this method of funding should not be considered as only relevant to a particular investment type.

Key Points in the Discussion

Defining small and medium-sized enterprises

- The classification of small and medium-sized enterprises under a catch-all term of 'SMEs' disguises the fact that the nature of the businesses is extremely diverse. SMEs can vary hugely in size, organisation and financial need.

- This means that the solution to SME financing cannot be a 'one-size-fits-all' policy, and cannot be solved by one particular actor. Increasing SME lending will require an appreciation of how multiple sets of regulations, incentives, types of financing, and business plans interact.
- This will require a mix of traditional and innovative methods of financing, with methods of funding being tailored to the particular needs and preferences of SMEs. Alongside several steps which can be taken by the Government and financial institutions, this will also require a much better understanding of the overall needs of individual businesses.
- There was consensus that it was not the role of the Government to make direct investments in SME financing, but rather to encourage an atmosphere in which SME lending could occur, as well as to increase the effectiveness of schemes to encourage funding.

SME financing: A supply or demand problem?

- **The Supply of SME Financing**
    - It was unclear what the 'normalised' level of lending was, though there was consensus that reverting to a pre-crisis level of lending was undesirable, primarily due to the fact that it would involve lending to businesses which may not be viable in the longer term.
    - There was also a wider issue about the criteria used to decide whether or not SMEs received financing. In the absence of more nuanced information gained through relationship banking, there is a reliance on 'tick boxes' and the use of more standard credit rating tools. It was noted that in many cases these could misrepresent the financial situation of the businesses. For example, an individual whose personal finances were not particularly healthy because they had invested their resources in the business would be likely to be denied credit even if their business was extremely promising.

- **The Demand for SME Financing**
    - There was consensus that issues with SME lending did not merely reflect a lack of supply, but also that there were wider issues with demand.
    - This partially reflects a diversity of borrowing requirements, for which bank lending or debt were not always appropriate.
    - Similarly, many SMEs who needed to borrow to cover cash-flow issues or shorter term finance were unwilling to put up assets such as their house to cover the cost.

With banks frequently requesting such arrangements as a result of capital controls, there is a significant barrier to the demand for SME finance.

  - Similar barriers exist with equity funding. It was mentioned that many SMEs did not understand the offer made by venture capital and that it was only appropriate for certain businesses looking for growth capital.
  - There were also comments that the wider perception that SME funding is solely done through bank lending meant that few SMEs had knowledge of alternative forms of finance. In many cases, after an initial rejection they would not try again, and would not attempt to access the alternative finance market.
  - In summary; there are reasons to believe that there are also demand side problems to SME financing, including a lack of information about alternative financing models. However, most of these factors illustrate not that there is a lack of demand for financing, but rather that there is a mismatch between the type of finance available and the needs of SMEs.
  - Several attendees voiced the opinion that a large amount of the demand side issues could be solved by greater publicity of alternative forms of finance, and a greater education for businesses as to where and how they could obtain finance. It was noted that tools such as 'finance finder' were not particularly useful for this purpose.

Capital requirements and lending

- A reoccurring theme at both events was the extent to which current capital regulations may impact lending to SMEs.
- Lending to companies has fallen by more than £10bn every year since 2009, a total decline of around £57bn from the peak in 2008.
- Even with the Funding for Lending scheme, the requirement for capital buffers and the way that SMEs and mortgage lending is measured means that mortgage lending is much less capital intensive.
- The result is that banks are primarily incentivised to undertake mortgage lending. An example raised was that mortgage lending of £3bn and SME lending of £600m used up the same amount of capital. Often four or five times as much capital is required for an SME loan. As a result, due to capital requirements, banks have clear incentives to partake in mortgage lending instead of SME lending.

- When the Funding for Lending scheme was launched, if net lending went up then the capital put up could be offset against the capital buffer, at a later point the capital buffers were increased, with the effect of drying up SME lending.
- It was noted that the Federal Reserve and Bank of Japan have estimated that introducing capital standards equivalent to Basel 3 before the recession has fully ended could reduce GDP by around 2%.
- There are clear reasons that capital requirements are necessary, but as previous Policy Exchange research has noted, Basel 3 is not meant to be fully implemented until 2019. This gives a level of flexibility before implementation which regulatory authorities could take advantage of by relaxing capital requirements in the run-up to implementation.
- Failing a relaxation of capital requirements, a number of other steps which could be taken were discussed. These included getting the Bank of England to purchase SME loans and packaged mortgages from the banks instead of gilts. It was also mooted that this could be a role for the business bank.
- A central message was that there needed to be a longer term view of capital requirements and the effect they have on lending. If capital requirements on banks are too high then the immediate capital base reduction from making a loan is an incentive against lending. Similarly, if lending must be capital efficient this will inevitably affect the forms of finance available to SMEs. These effects should be considered when determining the implementation of capital requirements on the banks.

Relationship banking

- During discussions regarding the 'normalised' rate of lending, there was an emphasis that previous SME lending had overextended itself exposing banks to losses. This was to some extent attributed to a lack of knowledge about the businesses that were being lent to and a willingness to extend credit to businesses which were not necessarily viable. However, it was also noted that this model which previously encouraged a level of risk has been replaced by one which is less likely to undertake lending to deserving SMEs.
- When discussing the financing needs of SMEs it was established that whilst some SMEs have available finance in the form of cash, or are under-leveraged so can access resources, others have high debt and want to grow but cannot access funding. In this case, automatic rejection is not necessarily a sensible path – instead a greater understanding of the business model of these SMEs is required.

- This requires a greater attempt to understand whether the risk is 'good' or 'bad,' which can be established through a greater understanding of the growth opportunities, and a more comprehensive attempt to understand the business plan and the local economy the business is operating in.
- The advantage of relationship banking is that it allows businesses to be much more effectively judged on their individual merits and circumstances rather than by less flexible metrics. An appreciation of context allows a much better analysis of whether risk is 'good' or 'bad' and subsequently allows better lending decisions to be made. There was consensus that this was something the industry should return to, although only a few banks were already doing it.
- Greater local understanding of the economy and business needs, alongside relationship managers assisting with applications and acting as an advocate for the business can help improve the chances of accessing finance. Under this model the bank is more likely to be able to provide suitable finance for the needs of the business. This is the model pursued by Santander, and also by other banks such as RBS who are the only bank who have their relationship managers independently accredited.
- However, it was noted that a 'culture of blame' existed with regards to human decisions on risk. This means that whilst relationship banking may mean the best outcomes for SME lending, there is currently a culture which discourages relationship managers from taking on the necessary risk to lend to SMEs.
- Building a greater network of support for investment, and advice and support for businesses means that it is more likely that differentiation between 'good' and 'bad' risk can be made. It was noted that Santander have had some success, approving 70% of applications with a loss rate of around 15 basis points compared to an average of around 65 points.
- It was, however, acknowledged that despite the fact that a greater emphasis on relationship banking and local advice could be advantageous, it was limited by wider concerns about the disincentives for SME lending created by capital rules.

Supporting innovative financing methods

- There was a repeated emphasis on alternative forms of financing for SMEs other than bank lending. These included crowd funding, angel investors, or venture capital. As previously noted, many SMEs lacked knowledge about these forms of financing, or how to access to them.

- It was noted that one advantage of these alternative forms of finance is that they can appeal to the differing needs of businesses. For example, venture capital is more likely to appeal to a specific niche of high-risk high-growth businesses, whilst crowd funding can provide a broader finance base, as well as the potential for investors to combine investment with advanced purchasing of a product.
- These mechanisms could also allow new streams of finance to be diverted to SMEs. In the examples above, crowd funding can allow large amounts of small investments to be effectively channelled into SME funding, as well as providing small investors a competitive rate of return compared to current interest rates.
- However, whilst there was widespread consensus that the development of alternative financial models was desirable in the long term, there was also an acknowledgement that in the short to medium term models such as crowd funding may need to partner with more traditional forms of finance.
- Some of the potential for such partnerships was highlighted, with examples being that 50% of funding coming from traditional banking sources matching 50% which came from crowd funding. This could create credibility for the bidding process, as well as stimulating crowd funding activity.
- It was noted that until alternative forms of finance develop further they may have issues absorbing large losses, something which could impose limits on the level of SME lending they can undertake. Developing larger capital buffers is an option, but could mean that alternative financing models are subject to the same regulation as banks, reducing their usefulness for the purposes of SME financing.
- Some alternative forms of providing finance to SMEs were also discussed, including crowd funding or auctioning of invoices. It was mentioned that this was often an attractive route for large cash rich companies as they could get a return within a short period. As such it presented an opportunity to unlock corporate cash which would otherwise not go towards funding SMEs.
- There was agreement that in the long term development of innovative alternative forms of SME financing would be desirable for SMEs and for the financial industry as a whole. It would also have the added effect of introducing greater elements of diversity into SME funding, and diverting more varied resources towards funding it. However, it was also stated that currently there was little desire to change the industry substantially and that a longer term and more open view was needed. The opinion was stated that the business bank represented a missed opportunity to achieve some of this change.

- A barrier to alternative financing models which was highlighted was the message that lending was a matter for the banks, something reflected in the expectations of many SMEs. It was mentioned that several alternative models such as crowd funding would benefit from equal access to schemes such as Funding for Lending. However, it was also noted that they may lack the collateral to access these schemes.

The business bank

- When discussing the role of the business bank, it was noted that much of its function was a targeting of the gap in the provision of longer term 'patient' capital rather than attempting to get 'cash out of the door' immediately.
- However, it was also noted that this timescale meant it would be approximately 15 years before success or failure could be determined. This could be problematic as political preferences are generally for more immediate results.

Policy Exchange Concluding Comment

The discussions during both the panel and the roundtable revealed that the issue of providing SMEs with finance is a complex one and the solutions multi-faceted. Merely exhorting banks to lend more when they are capital constrained is not the right way forward and we believe the recent introduction of a leverage cap is particularly ill-thought through. While the banks have to make efforts to meet the criticisms they face head on, the regulators need to give the banks room to lend as well. BIS should consider whether the business bank can have a constructive role here by partnering with banks on SME lending. We would also like to see the Bank of England consider buying loan assets off of bank balance sheets to increase lending capacity.

SME finance is not just bank lending though, supply chain financing, invoice discounting, peer to peer finance all offer alternatives. These should not be seen necessarily as separate from bank finance but also as complements. Equity finance is also vital and the Government should consider how it can deepen the pool of such finance and its availability to SMEs. The provision of long term finance is a key area of failure in funding for SMEs historically. This has led many SMEs to turn to bank funding which is ill-suited to such a role.

Acknowledgements

Policy Exchange would like to thank Santander for its kind support of both the public event and the roundtable. We would also like to thank the Rt Hon Michael Fallon MP, George Freeman MP, Steve Pateman from Santander, Sam Coates from the Times, and Julia Groves from UKCFA for speaking at the events.

About Policy Exchange

Policy Exchange is the UK's leading think tank. We are an educational charity whose mission is to develop and promote new policy ideas that will deliver better public services, a stronger society and a more dynamic economy. Charity Registration Number 1096300. The authority and credibility of our research is our greatest asset. Our research is independent and evidence-based, and we share our ideas with policymakers from all sides of the political spectrum. Our research is strictly empirical and we do not take commissions. This allows us to be completely independent and make workable policy recommendations.

For more information please contact us at: Clutha House, 10 Storey's Gate, London, SW1P 3AY. Alternatively we can be contacted on 020 7340 2650 and at info@policyexchange.org.uk

About the Financial Policy Unit

The UK needs a competitive and thriving financial industry. It will be a key part of ensuring long term growth in the UK both in terms of the contribution it makes and the businesses that it provides finance and support to. However, too often today the debate is about the cost of supporting the financial sector and not about what it contributes. It is also clear that reform is needed and that this reform is not confined to the financial sector. In 2013 we will be furthering the debate and research across the financial space, including monetary policy, financial regulation, corporate governance, the euro area, the ongoing importance of the City and any other area that government affects the financial industry.

Trustees