



## Levelling up: Financing and capitalising the UK's SMEs – Session 3 Summary

6th July 8.30am - 10:00am

**Session 3:** Exploring solutions to challenges in the business lending market

### APPG inquiry panel:

- Kevin Hollinrake MP, Conservative
- Lord Holmes, Conservative
- Peter Dowd MP, Labour
- Lord Sharkey, Liberal Democrat
- Sarah Olney MP, Liberal Democrat
- Alison Thewliss MP, SNP
- Tonia Antoniazzi MP, Labour
- Ben Lake MP, Plaid Cymru (could not attend third session)

### Finance Witnesses:

- **Patrick Magee**, COO of the British Business Bank
- **Stephen Meurs**, CEO of Big Society Capital
- **Mike Conroy**, Director Commercial Finance at UK Finance

### Regulatory Witnesses:

- **Simon Hall**, Head of Division for Banking Policy, Bank of England
- **Dr Andrea Coscelli CBE**, CEO of the Competition and Markets Authority
- **Sheldon Mills**, Executive Director of Consumers and Competition at the Financial Conduct Authority

### Key themes:

- Government loan schemes including BBLS have increased the big four banks' share of the business lending market
- Due to the pandemic, many SMEs have accessed finance for the first time and the lending market is undergoing a great deal of change, the British Business Bank itself has grown immensely since the start of the pandemic and hopes to continue to adapt and progress without crowding out private investment
- Competition Law is not designed to be a barrier to good outcomes, and if there are industry agreements which can improve outcomes, such as might be the case with Regional Mutual Banks, they should be brought to the FCA's attention

**A full summary of the inquiry is below**

**What are the biggest challenges in the current lending market in regards to an increasingly diverse market?**

**(Kevin Hollinrake MP)**

- Patrick Magee (P.M) noted the fast growth the alternative finance market has shown and the smooth adaptation of the business lending market as a whole to the global pandemic. However he believes there is always more to be done and as a lender, the British Business Bank (BBB) has identified a lot of regional disparities in access to finance.
- Stephen Meurs (S.M) has found businesses' response to Covid-19 to be admirable, noting this response was aided by the hard work of P.M's colleagues at the BBB. S.M argued that a significant challenge in the current lending market is lending to small businesses with capital constraints due to the lack of diverse and flexible viability models. Therefore, S.M hopes that there will be a move away from mainstream lending models in the future.
- Mike Conroy (M.C) has noticed the changing landscape of the lending market over the last 10 years. There has been a reduced role for high street banks in financing SMEs, greater diversification in supply and an increase in public policy. As for challenges in the market, M.C discussed the existence of funding gaps, more specifically two types, debt and equity. However, M.C doesn't believe there is a lack of supply in funding, rather subgroups of applicants, like start-ups, finding it more difficult to obtain funding due to a lack of track records, creating market asymmetries.

**How do you approach regional imbalances given that we are the most regional unequal country in Northern Western Europe? (Peter Dowd MP)**

- P.M explained that the BBB always starts with research before designing a product. Through resources such as their equity tracker, overall market statistics, talking to stakeholders, business owners and MPs, the BBB identifies the gaps within the market and then looks at creating the right solutions. An example of this is the Northern Powerhouse Investment Fund which has provided over £500million of funding to businesses in the North West of England. However, it is important to find a balance as financing everyone is impractical and unsustainable.

**What levers does your organisation have to increase competition in the market particularly in regard to CDFIs and mutuals? (Peter Dowd MP)**

- P.M explained how the BBB has been working closely with Big Society Capital and CDFIs to support them to scale up and reach their potential by using the start-up loan scheme and the resilience fund. Due to the relatively low quantity of CDFIs, it's not necessarily about competition between CDFIs but making them more competitive in the market. P.M continued to explain that their cooperation with CDFIs has been extended to cooperation with mutuals and encouraging their growth across the UK. However, P.M discussed the difficulty of obtaining businesses' track records and data for CDFIs and explained that the BBB has recently begun collecting more data on this area in an attempt to understand the market's response to CDFIs and how CDFIs can operate most sustainably.

- S.M agreed with Patrick and noted that some CDFIs in the UK have the potential to scale up and reach more individuals but struggle to do so due to capital constraints. Big Society Capital has helped support some of the more developed CDFIs to increase their reach in an attempt to push through capital barriers.
- M.C flagged an area of policy that could be reviewed, namely, the bank referral scheme, whereby if you get rejected by a mainstream bank, they are mandated to make a referral to a government designated platform. While it is a good initiative, a flaw is that the platforms operate commercially so it's more difficult for a CDFI to be included. This isn't helpful for SMEs or CDFIs, therefore, UK Finance believes CDFIs could become more competitive if they were given a 'free pass' to these platforms.

**What lessons have you learnt from the CBILs and BBLs process that might help improve access to funding schemes for alternative lenders in the future? (Alison Thewliss MP)**

- P.M argued that the most important lesson has been understanding the demand in the market and finding the right level of support the BBB can supply as businesses move into the recovery phase. The BBLs was an emergency response, priced competitively and right for that time period, saving hundreds of thousands of businesses. Now that we are moving towards the recovery stage, many accredited lenders are looking to be accredited for the recovery loan schemes, allowing a more experienced group to be created. From working closely with lenders during the CBILs and BBLs process, the BBB further understood what would make loans more attractive, like sharing the risks of loans with the government.

**Are there any other structures that the BBB could design to meet wider demand for groups such as smaller businesses whose loans aren't securitisable? (Alison Thewliss MP)**

- P.M would like to think that over time the BBB can expand their products, especially as they scale up their client base and work with new clients to develop products. An example of this is improving the track record of SMEs through start-up loans, enabling the BBB to further understand the market and use this data for future products.

**What is the impact on SME loan volumes in the banking sector as a result of the banks having written so many CBILs and BBLs? (Lord Sharkey)**

- P.M discussed how 2020 was a record year in terms of SME lending due to the pandemic with many businesses borrowing for the first time. This made institutions like the BBB question how, prior to the pandemic, many businesses were more debt averse than was ideal for the economy. P.M argued that the increase in first-time borrowing has allowed businesses to appreciate the benefits and adapt to a changing economy. As for the BBB, they are always increasing their supply and hoping to meet higher demand through helping businesses find the right financing.
- M.C echoed P.M's thoughts and emphasised the recent increase in SME borrowing. He argued that many SMEs took the government loan scheme as 'a cushion just in case' due to the attractive interest rates. Along with 'Pay as you Grow' providing flexible repayment options, demand is staying steadily high, giving

the impression that the market is currently doing well. As for first-time borrowers, current signs show majority of lenders are comfortable with their debt and M.C believes that banks are capitalised enough to deal with potential struggles.

- S.M further emphasised the point on first-time borrowers making the most of the attractive government loans by explaining that many businesses have taken this opportunity to make changes to their business model to sustain them in the future. An example was many businesses using the loans to partially move their operations virtually, benefiting customers and increasing the durability of the businesses. The increase in loans, therefore, has given businesses the opportunity to adapt and become more resilient.

**Post-pandemic, how do you see the dividing line between private finance and public institutions such as the BBB? (Lord Holmes)**

- P.M explained the BBB doesn't exist to crowd-out the private sector but instead to work collaboratively. The BBB wants to bring expertise, government resources and the ability to guarantee funding in order to create a partnership instead of competition. P.M hopes that all the lessons learned in the past 18 months can help the BBB find a new place in the 'normal' world whereby they provide the appropriate level of support.
- S.M said that the positive response of government support during the pandemic creates an opportunity for the government to 'think creatively' on how guarantees from the government balance sheet can be used to achieve policy objectives and increase the finance flow as the UK moves out of the pandemic, such as financing businesses with wider social benefits.
- M.C identified the importance of market-led solutions to issues but believes government intervention is vital at times, especially during market failure. While government intervention can be tricky to get right, M.C thinks that the strong collaborative approach between government, the market and other financial institutions has created a situation whereby businesses are given the opportunity to thrive while still having mechanisms to solve arising issues.

**A recent report from Cambridge for Alternative Finance shows that alternative lenders in the UK (and US) only lend to banked and under-banked customers, whereas in other parts of the world they also lend to unbanked customers. Why do you think this is? (Antonia Antoniazzi MP)**

- P.M argued that there are appropriate rules at the moment for under-bankers. There has been collaborative work between the BBB, government and the lending industry on fraud and fraud prevention as this is always an issue with large amounts of capital becoming available for lending. P.M has found that there are lots of potential customers that don't have lending track records, meaning the appropriate checks are necessary which can often be more lengthy. However, these checks are in place to allow these individuals to find the appropriate alternative borrowing opportunities, and the BBB are keen on improving this area to make it more accessible.

### **How could the bank referral scheme be improved to increase both the referral rates and the take up rates?**

**(Sarah Olney MP)**

- M.C agrees that there are a lot of challenges in the customer journey of the referral scheme. When SMEs are rejected for business loans, they are referred to the referral platform. Most SMEs aren't aware of alternative financing options so find this platform overwhelming, especially following rejection from a bank. Therefore, M.C argued the need to increase awareness of the platforms and how they operate, as well as making the platform more accommodating for SMEs with different demands.

### **Panel 2**

**Does the current regulatory framework inhibit the ability of challenger banks to grow and compete? (Kevin Hollinrake MP)**

- a) Are there any plans to change the MREL threshold limit?**
  - b) Are there any plans to explore alternative ways to simultaneously tackle barriers to competition and growth whilst creating the same level of stability?**
- Sheldon Mills (S.M) explained that a review by the FCA found competitive disadvantages for challenger banks in terms of their ability to grow due to funding costs. Many challenger banks are unsustainably funded by repeated rounds of going out and obtaining capital. S.M also said the FCA has looked at proposals for a new simple prudential framework for non-systemic banks on capital requirements, as this seems to be a more 'sophisticated' way of approaching capital requirements for an increasingly diverse market. In terms of stimulating competition, S.M has found that the PRA's work has helped, especially in incentivising challenger banks to engage in business banking.
  - Simon Hall (S.H), brought attention to how current capital requirements are disproportionate for banks of different sizes. A move away from the current inherited regulatory system to a more proportional system that looks at the size of businesses may increase competition within the market. S.H, however, made it clear that this did not necessarily mean lowering capital requirements, but making it simpler in order to reduce costs. In terms of barriers within the market, S.H argued that information asymmetry between banks is a large issue, creating an administration barrier, preventing businesses from potentially moving between banks. As a solution, S.H is keen for transferable files that include financial histories of borrowers that can be easily transferred between banks.
  - Dr Andrea Coscelli CBE (A.C) finds the CMA in a different position than the Bank of England and the FCA. Since 2016, it has made more sense for the FCA and Bank of England to balance regulator competition considerations, while the CMA has focused on implementing remedies from prior inquiries, such as supporting open banking. A.C supported S.H's comments on the difficulties in lack of information between incumbent banks and challengers.

**Do you think there are any other levers your organisation would want to help increase market competition?**

**(Peter Dowd MP)**

- A.C brought attention to the balance between separate regulators like the CMA and the main regulators like the FCA and PRA. A.C believes that the FCA is a competent regulator, therefore, the CMA is almost like a 'plan B', and aims to support the FCA, especially in transitioning the work that the CMA historically did, to ensure no gaps are left.
- S.M thought that the FCA's approach of constantly reviewing practices is beneficial to help keep market competition at an appropriate level. However, S.M argued that the impact of the government loan schemes like BBLS has already changed and will continue to change the balance of the financial market, with larger banks widening their share of the market.
- S.H discussed the impact of government loan schemes during the pandemic and how many smaller SMEs have accessed funding more than they ever would have before. In turn, this has broken down information barriers in the market.

**What levers do you believe you have as organisations to help tackle regional imbalances? (Peter Dowd MP)**

- S.M said with competition, supply will meet demand, and that finance should eventually become more local. However, the impact of businesses working with the bigger banks for government schemes like BBLS during Covid may have a long-term impact on competition for challenger banks and alternative finance providers. S.M explained that the PRA would work on this to make it easier for challenger banks to regain that competitive aspect. He added that when talking with some larger banks, S.M found they were merging their profit-maximising approach with looking at how to serve communities.
- S.H emphasised the role of competition in improving regional disparities as an increase in competition will give all regions greater choice in alternative financing.

**How can we ensure that regulation (particularly Competition Law) doesn't prevent companies from cooperating in the interest of customers (eg, mutual banks sharing resources as cooperatives do in Germany)? (Lord Holmes)**

- A.C said Competition Law is about good outcomes and it is clear that there is a balancing act between restrictions and outcomes. If companies are particularly risk averse and worried about being challenged, the government can issue exclusion orders to exclude them from Competition Law. The government has done so recently with TV rights in the premier league, and arrangements between supermarkets. He argued it would be easy to exclude some agreements from competition laws and give confidence to a sector. Some would argue that it's a barrier, but A.C argued that Competition Law is an instrument to achieve good results.
- S.M agreed that one can reach the right outcomes while respecting competition. In relation to Regional Mutual Banks and CDFIs, one of the biggest barriers is instead funding. However, if the route through to getting the right scale is collaboration there might well be ways through that. One of the benefits in this area is that these organisations can take different levels of risk, working with potentially credit impaired

SMEs in a diverse range of geographies with local in-depth knowledge and understanding. If those benefits are available and can be shown to be available through competition, both the CMA and FCA can discuss to see whether there is a way forward.

- S.H said from a bank regulation perspective there isn't such an obvious barrier, this is more a discussion for the FCA and the CMA. However, he would not say that exclusions from Competition Law would negatively impact banks, but they would continue to monitor lending trends.

#### **What lessons can we learn from the Government's response to the COVID-19 pandemic? (Lord Sharkey)**

- a. What role is there for the Recovery Loan Scheme to combat stagnation in the SME market for example as a result of a future recession?**
  - b. Are there any obvious competition issues which result from CBILS/BBLs and RLS, and how could these be addressed? (banks have been able to access unlimited funding at close the Bank Base rate via TFSME whereas their smaller Alternative Lending competitors enjoy no such access to funding and as a result (1) have constrained borrowing and (2) have much more expensive borrowing, which must lead to less choice and higher prices for SMEs)**
- S.M argued that the government sought to, in a short space of time, provide the right funding to the right institutions. While using lessons from the past is important, the focus must be on moving forward and getting competition back to a normal state. On AML compliance, S.M said that it's important for all firms to follow the rules as these minimum requirements are necessary. As for one lesson that has been learnt from the Government's response to Covid-19, S.M believes the experience has further shown the importance of ensuring competition during a crisis, however, given the immense pressure the government was under, they did a good job.
  - S.H added with regard to funding size, it's worth looking at whether more can be done on the securitisation side of the banks and whether it can be used more in the future as a tool for financing SMEs. S.H believes that the Covid-19 response emphasised the importance of sustainable financing as medium-sized and challenger banks struggled to lend during the height of the crisis.
  - A.C thought that the impact on competition from the Government's response wasn't great but it is understandable given the size of the schemes and the short-time period given to produce. However, this is possible to rectify with the PRA and CMA finding the right time to reintroduce competition into the market. Therefore, a lesson learnt from Covid-19 is that short term decision making in a crisis can have long term effects.

#### **Useful documents**

- Grant Thornton - [UK banking sector: top ten themes for 2021 and beyond](#)
- Financial Conduct Authority - [Challenges and Priorities for the FCA](#)
- PwC - [Sustainability of CDFIs](#)



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