Levelling up: Financing and capitalising the UK's SMEs – Session 2 Summary

29th June 9:30am - 10:30am

Session 2: Alternative finance in the business lending market

Purpose of these sessions

- Look at where challenges are for SMEs in the business lending market and what the alternative solutions are
- To understand the issues facing alternative finance providers lending to small businesses
- Explore how more diverse funding models can deliver more choice and better outcomes for SMEs in the UK

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 (could not attend second session)
- Ben Lake MP, Plaid Cymru (could not attend second session)

Witnesses:

Alternative finance - 9:30 - 10:10am

- **Tony Greenham**, Executive Director at South West Mutual
- **Theo Hadjimichael**, Chief Executive Officer of Responsible Finance
- **John Davies,** Association of Alternative Business Finance Chair

Challenger banks - 10:10 - 10:30am

- **Steven Cooper,** CEO of Aldermore
- **Nick Lee,** Head of Government and Regulatory Affairs at OakNorth

Key themes:

- The current banking regulatory model is struggling to cater for an increasingly diverse market, with challenger banks thinking their growth is being limited by MREL, and CDFIs lacking capital to meet demand.
- There is an increasing need to change current loan eligibility algorithms to look at wider socioeconomic potentials and impacts when lending to SMEs in order to gain a wider understanding of their potential.
- The consultation on MREL is widely welcomed given the ceiling it effectively places on lenders, forcing them to abide by the same rules as the top four banks.

A full summary of the inquiry is below

How would you describe the current alternative finance market for SMEs looking for business funding? (Kevin Hollinrake MP)

- Tony Greenham (T.G) summarised the current market with the following piece of data - loans from the big 9 banks in the South West of England to SMEs over the 7 years following the GFC is down 12%, but in the same time period, the number of SMEs has grown 20%. 73% of SMEs agree they would rather grow slowly than borrow to grow more quickly. T.G explained SMEs do not feel comfortable approaching large banks because they don't trust entering a long-term contractual loan following the GFC. Furthermore, it was noted that a large quantity of loan applications being fulfilled does not mean demand is being met. There is a need for diverse options, lowering barriers for entry and an increase in diversity of banking models.
- Theo Hadjimichael (T.H) brought light to a gap in the market whereby small businesses find it difficult to obtain up to £100,000 in finance, shown by roughly a million SMEs expressing that access to finance is an obstacle for growth. Further research found that 230,000 SMEs face a financing gap. Moreover, the rejection rates for loans are higher for small businesses, new start-ups, businesses located outside key cities, and minority-led businesses. T.H argued that this is a long-term persistent structural gap in the market, further exacerbated by a lack of diversity, domination in the market by the banking-shareholder model, and a high level of regulation. All of these factors mean traditional lenders have to lend at a large scale to be economically viable, increasing dependence on algorithm-based lending, which doesn't account for wider socioeconomic impacts and consequences. T.H concluded with a story of a small ice-cream business in Cornwall who, following rejection by a traditional bank, was accepted by a CDFI. Within a few years, the company grew from 12 to 100 employees, supplied baked goods to supermarkets across the country and provided meal deals for cash-strapped families in the local community during the height of the pandemic.
- John Davies (J.D) highlighted the fact that the current system is a 'one-size-fits all' which is simply not efficient. As for SMEs, many individuals want the ability to sit and talk with a financial professional, something that we don't see as often anymore. Additionally, a lot of SMEs don't want to borrow because they're not necessarily looking to build a big business. The challenge is how to satisfy the diverse range of desires within the market.

What are the greatest barriers to the provision of lending to SMEs for alternative providers, including regulatory, liquidity, access to small businesses? (Lord Sharkey)

- T.G believes that the greatest challenge in providing finance to SMEs is the lack of soft information gathered and dealt with. Soft information refers to information that isn't necessarily easy to access and can't yet be put through AI for analysis, this could include potential socioeconomic trends in the current region and characteristics of the business. Most businesses are quite young and don't have a track record, increasing the importance of soft information. Without the relationship-driven approach and the opportunity to understand soft information, the current model does not allow lenders to effectively analyse the situation, meaning decisions are made without knowing all relevant information.
- T.H agreed with the previous statement and continued with 2 main barriers that alternative lenders face in terms of scaling their provision. The first being the gap in the market that SMEs fall into, awareness of this gap is vital to address it. T.H drew on examples from the United States whereby the government and traditional banks heavily rely on CDFIs to fill that gap, allowing for SMEs to positively impact the economy. Secondly, a lack of access to capital is a significant barrier for lenders. As non-deposit takers, CDFIs have to

raise their capital externally, limiting their capabilities. However, T.H praised schemes such as the Recovery Loan Scheme and expressed the need for larger yet similar programmes.

- J.D argued that a big challenge is the risk associated with lending to SMEs. There is always going to be risk when lending to SMEs, often due to a lack of business experience of the individuals, so the challenge lies with who will cover that risk. It definitely shouldn't be taxpayers, and thought needs to be given to how industry can play an increased role with tax break potentially provided to support innovative new businesses.

What are the most significant benefits and drawbacks of current alternative financing options for SMEs? (Lord Holmes)

- T.H finds that the wider benefit of going to a CDFI is the ability to talk to someone who will give you a chance and wants to see you succeed. Gaining advice, understanding and trust builds confidence which materialises when the business is struggling and the individual feels comfortable asking for help. When you compare this to submitting an online form to a big bank and waiting days or weeks for a response, there is a personal side to CDFIs. Moreover, 85% of businesses that CDFIs lend to fully repay the loan, as well as create jobs locally, help economic recovery and encourage economic growth in deprived areas. However, T.H explained that the most significant drawback is the lack of capabilities of CDFIs. Costs tend to be high due to serving a section of the market with higher risk, as well as offering more guidance and help.
- T.G supported T.H's opinions and explained that the same benefits and drawbacks are relevant to regional mutual banks. The UK is the only G7 economy without regional mutual banks, despite evidence confirming the presence of mutuals boosting economic growth, especially in areas further away from financial capitals, ensures financial stability and aligns the interests of customers with managers. Much like CDFIs, T.G confirmed, mutuals, especially start-ups, struggle to access capital. The challenge lies in finding who carries the risk. Another barrier in the UK is Competition Law, as it prevents smaller businesses from collaborating on areas such as procurement, in order to achieve economies of scale and become competitive. Therefore, T.G believes that there should be a government inquiry into whether Competition Law is actually preventing competition in the market.
- J.D expressed his support for T.G and T.H's ideas by emphasising the need for advice and support when running a business. It is often a lot of work and can be lonely, support from a knowledgeable and experienced individual could make such a difference. J.D also questioned the amount of money currently being hoarded by businesses in bank accounts right now, suggesting they could contribute to supporting innovative new businesses.

What is necessary to allow for greater alternative financing for SMEs at this time? (Kevin Hollinrake MP)

- T.H explained that in order to get more capital to more businesses, more investors need to come to the table. There needs to be more social banks such as the Co-op Bank, and it would be helpful if the government provided incentives.
- T.G agreed with the need for increasing capital and thought that dormant bank asset funds could be reallocated to the BBB to help capitalise regional mutuals and other non-bank lenders.
- J.D argued that taxpayer's money should not be funding SMEs and finance should come from business itself, essentially, businesses need to fund businesses.

Panel 2

How would you describe the current alternative finance market for SMEs looking for business funding? (Kevin Hollinrake MP)

- Nick Lee (N.L) explained that, from the perspective of a bank, lending purely to SMEs, barriers to scaling are a major issue. MREL, designed to fix the 'too big to fail' problem, enforces lenders to hold a minimum amount of equity and subordinated debt on top of existing capital requirements once balance sheets reach £15bn. For comparison, the exact same rules apply to US firms once they reach $250bn. This essentially creates a ceiling for lenders whereby they struggle to grow big enough to reach economies of scale.
- Steven Cooper (S.C) agreed with N.L and brought attention to how challenger banks, like Aldermore, are having to operate to the same structural regime as larger banks in terms of data and capital. While S.C understands the purpose of this, he explained that smaller banks struggle with the time and expenses it takes to adhere to those rules. S.C suggests that a more long-term framework without as much depth is necessary to level the playing field. Aldermore was confronted recently by an SME with large funding requirements who had been rejected by a large bank when he asked S.C's colleagues 'You're a challenger bank, but what are you challenging?' S.C felt that current regulations made it difficult for challenger banks to provide their service of offering alternative finance, and have, instead, become very similar to traditional banks.

What are the greatest barriers to the provision of lending to SMEs for alternative providers, including regulatory, liquidity, access to small businesses? (Peter Dowd MP)

- N.L mentioned that MREL continues to be a significant barrier and Oaknorth has collaborated with ten other challenger banks to provide feedback to the Bank of England and HM Treasury regarding MREL. A consultation paper on MREL is due to be published in the following months which is widely anticipated. The group of 11 challenger banks has found if the threshold were to be raised, £25bn of extra lending would hit the economy with a significant proportion of that going to SMEs.
- S.C supported N.L's comment saying that Aldermore is a part of that group. S.C added that MREL is important in order to hold institutions to account, but it's the fact of how quickly the threshold arrives to a challenger bank that is the problem.

What are the most significant benefits and drawbacks of current alternative financing options for SMEs? (Alison Thewliss MP)

- S.C has found that most SMEs get finance from a specialist because they are unable to receive it from a mainstream bank because they don't fit the typical model. Alternative financing tends to support those that struggle to fit into this model, often due to reasons outside of their control, and often to those who manage to restore their credit rating over the following years, yet mainstream banks and their model don't recognise this potential. However, a drawback to this is the higher price point.
- N.L notes his support for S.C's point that the main benefit is having a diverse range of funding options to choose from.

Do you think SMEs are aware of the options they have? (Alison Thewliss MP)

- N.L feels that due to the pandemic, awareness has definitely improved but there is still room for improvement.
- S.C also feels that awareness has increased, especially due to the role of financial advisers and intermediaries.

What are the wider benefits of greater alternative financing for SMEs at this time? (Sarah Olney MP)

- N.L thinks that the wider benefit is the alternative sources of funding out there. Different institutions use different funding structures and credit models, allowing SMEs to fit the criteria in some institutions but not others. All of this means that SMEs and individuals shouldn't be put off when they receive the answer 'no' from a highstreet bank.
- S.C finds that it pays off for businesses to have more than one option because every business has different appetites in terms of growth and different ways of working, therefore, they need financing to suit those specific needs.

Useful documents

- Centre for Policy Studies - Fair Business Banking for All
- New Economics Foundation - UK CDFIs: from surviving to thriving
- Peer2Peer Finance - Alternative Finance in the UK

Chair of the APPG on Fair Business Banking and Registered contact:

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