Banking Small Businesses:

Forging Closer Ties between Banks and the Real Economy

A Final Report of the BankingFutures Dialogue

This report, and the process that led to its creation, is a team effort. The report is authored by Sophia Tickell and Anne Wade, but would not have been possible without the research, project management and editorial support of the BankingFutures team – Sayo Ayodele, Becky Buell, Lydia Garrett, Marloes Nicholls, Prarthana Rao, Zoe Scabbiolo and Cassie Tickell-Painter. We are deeply appreciative of their work. Thank you also to Jane Garton and Corinne Welch, for their meticulous copy-editing and creative design work, but also for working so ably to such tight deadlines. Any misinterpretation or errors are the authors' alone.

Disclaimer: As a multi-stakeholder and collaborative project, the findings, interpretations and conclusions expressed herein may not necessarily reflect the views of all members of the group at all times. Members of all groups took part in a personal capacity.

BankingFutures

An Inclusive, Multi-Stakeholder Process

BankingFutures is a structured dialogue aiming to create a healthy, resilient and inclusive banking sector in the UK. It is a partnership run by Leaders' Quest and Meteos, two non-profit organisations committed to improving the role business plays in society.

The dialogue has taken place in two phases. Phase One began in June 2014 and sought to provide civil society, customer and regulatory input to a leadership group of senior banking executives, investors and experts on banking reform. The original leadership group committed significant time over the course of 14 months, for internal working group meetings and external roundtables with stakeholders. Over 200 stakeholders contributed views through these meetings and via interviews. The first phase of the project, which was described as one of the most societally inclusive projects on banking reform, concluded with the publication of the report, *Banking on Trust: Engaging to Rebuild a Healthy Banking Sector*.

This is a report on Phase Two of the project, which launched in May 2016 and created Action Groups to explore two topics in depth: how banks can better contribute to the real economy, and how communication and dialogue can be improved between banks, investors and other stakeholders in order to enhance banks' ability to deliver long-term value. The work of the groups was overseen by a Steering Group of senior banking leaders, investors, financial reform experts and civil society representatives (see Appendix A). Steering Group members agreed to use their positions of influence to further the project's final recommendations.

Action Group One sought to identify actions that would forge stronger links between the financial system and the small and medium enterprise (SME) sector of the real economy. The group was composed of bank leaders, representatives of SMEs, representatives of the responsible finance and community development financial institutions (CDFI) sector, and civil society organisations working on finance. Its work incorporated insights of academics, economists and policy-makers. The group met regularly over the course of 14 months and exchanged views between meetings; these took place in London, Bristol and Sheffield, with a view to engaging with cities and regions where there is a greater need for improved access to financial services. The meetings included site visits, with leaders from organisations working to understand and support the needs of the real economy.

Action Group Two was charged with exploring how to reintroduce a long-term culture into investing in banks, in partnership with the Investor Forum. It sought to identify practical measures to contribute to a longer time horizon in investment and management decision-making, as well as a more comprehensive definition of long-term value. This group was made up of bankers, investors and representatives of organisations seeking reform from within and outside of the investment community. This group met five times for day-long workshops over the course of the project's duration and, as above, participated in a combination of immersive learning with sector experts and site visits to underserved communities in London's East End, complemented by internal group discussions.

Introduction

from the BankingFutures Directors

We set up the BankingFutures dialogue three years ago to support the development of a healthy, resilient and inclusive banking sector in the UK, capable of underpinning UK economic development and enabling everyone to participate in the economy. This leadership dialogue is run jointly by our organisations, Leaders' Quest and Meteos, and in partnership with the Investor Forum for our work on long-termism. It is an invitation to senior bank leaders, institutional investors and civil society representatives to come together to agree what changes are needed in the sector, and to find common ground on how these can be achieved.

In this second phase of the project we have focused on two priorities: how banks can better support SMEs in the real economy, and how to improve communication and dialogue between banks, investors and other stakeholders in order to enhance banks' ability to deliver long-term value. The dialogue concludes with a separate report on each topic.

Although seemingly different, these topics are ultimately interdependent. The ability of banks to adequately address the needs of small and medium enterprises (SMEs) is already challenging due to the high or unknown risk of doing so. This long-term challenge has been made more acute by recent changes to the banks' business models, which are partly a result of an increased focus on the demands of capital markets. For investors, SME lending and banks' contribution to society are low priorities because they are a small part of a global bank's balance sheet. As a result, investors are more likely to focus on the introduction of efficiency measures – such as closure of bank branches – than to consider the effects of these closures on a bank's ability to meet the needs of small companies. This matters not only because it is vital that this part of the economy has access to the finance it needs, but also because it affects society's perception of banks.

Understanding how to encourage banks and investors to focus more on what is going to drive long-term value to all stakeholders, and less on short-term financial results, is a crucial part of what will permit banks to make investments in the real economy that require patient capital. The BankingFutures participants committed themselves to trying to square this circle. Our desire was for the project to strengthen the bridges between people in the financial system and real economies. Our groups embraced the opportunity to meet some of the most financially excluded people in the UK. Hearing from them helped focus our minds on the need to fix the system. The groups worked together with the intellectual rigour you would expect of such leaders, but they also worked respectfully and carefully, listening to each other's perspectives even when they were at odds, and with a commitment to finding joint solutions. We are deeply grateful for their openness to work in this way and to such good effect. We would also like to thank the many experts who allowed us to interview them, and who were more than generous with their ideas and suggestions.

The outcome of the process is this report on SMEs, banks and the real economy and its counterpart report on long-termism. Each report is a standalone. However, to come to solution to either will requiring tackling both issues simultaneously. There are ways to do this which we outline in each report, and we therefore encourage you to read them both.

We are proud to have achieved our original goal of identifying actionable things that can be done by specific people or institutions to make a difference. This is the result of adopting a comprehensive multi-stakeholder approach in which the views of all stakeholders are sought and actively considered. The virtue of this approach is that participants come to mutually acceptable outcomes. For some, the recommendations may be a stretch; for others, they may not go far enough. This is not a weakness. Along the way participants have heard and acted on each other's concerns, meaning that when the recommendations are finally launched, they are much more likely to get real traction in the real world. In this way, we hope that the creative energy that has gone into BankingFutures lives on in a tangible way that contributes to a healthy banking system, in service to society.

Sophia Tickell and Anne Wade • *July 2017*

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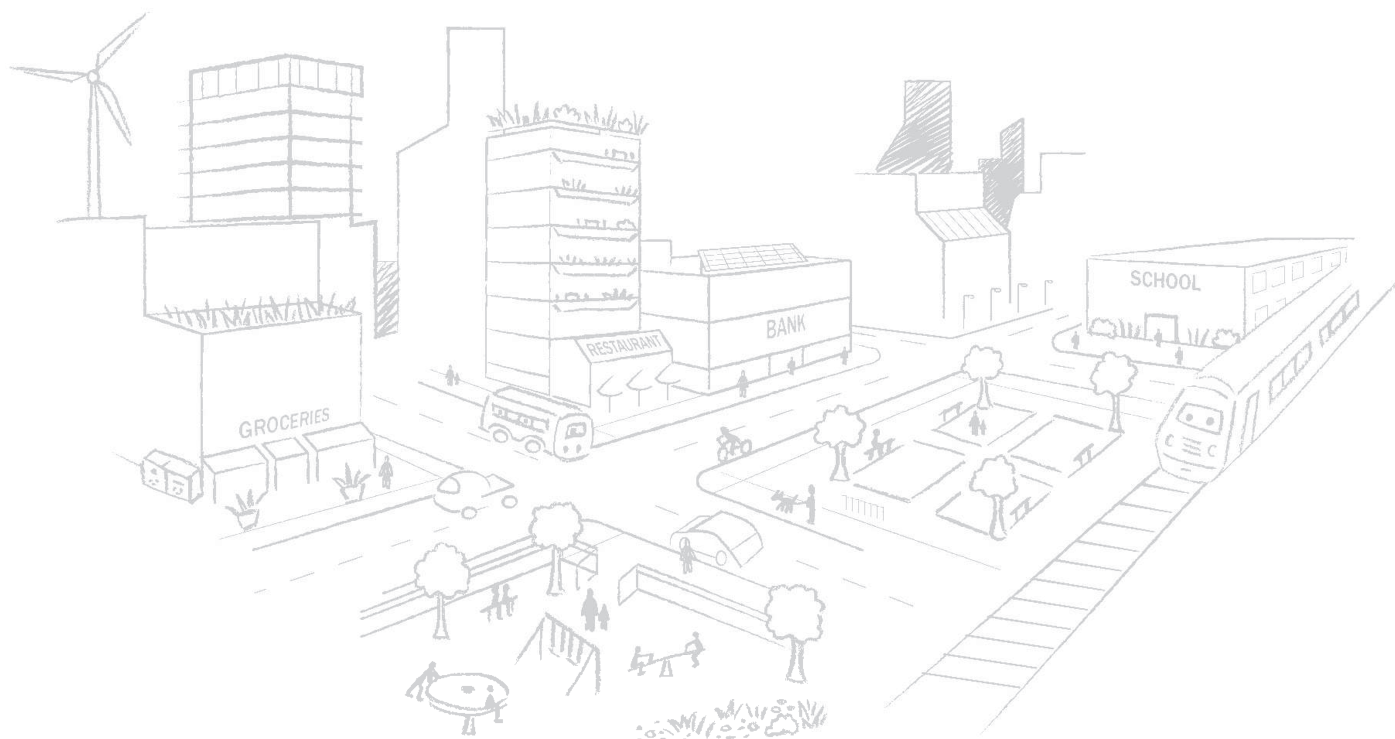
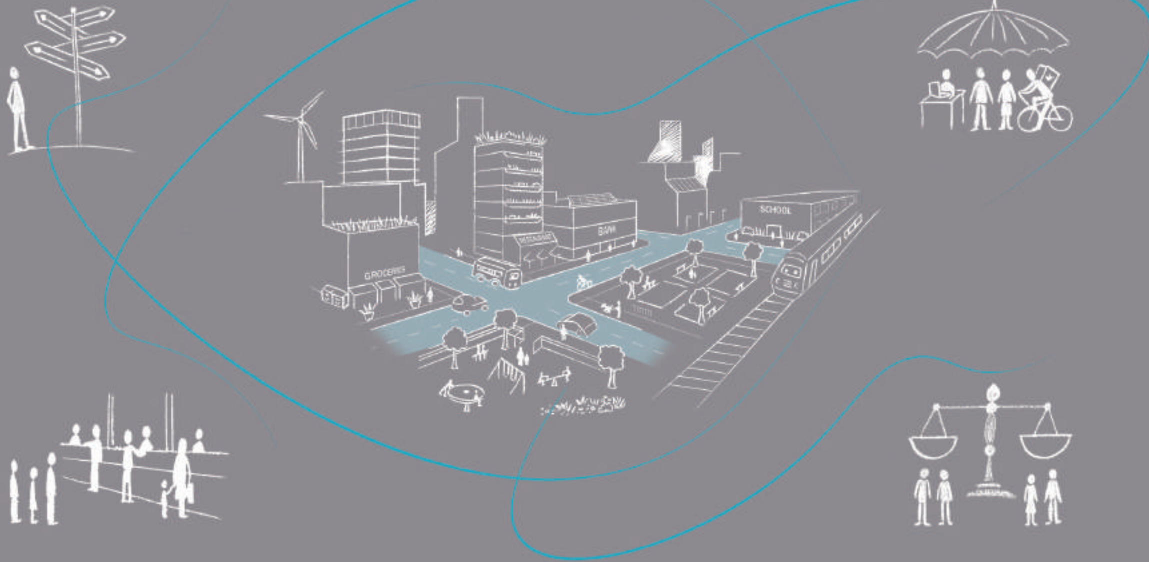




Executive Summary

This is one of two reports on the findings of the second phase of the BankingFutures dialogue. It identifies how government and banks in the UK can provide more support to the real economy (economic activities undertaken by households and businesses, as opposed to transactions between financial entities), and focuses specifically on support for the small and medium enterprise (SME) sector. BankingFutures was set up in 2014, on the underlying premise that banks have a vital role to play in the economy and that multi-stakeholder views on how to achieve a healthy UK banking sector should shape recommendations to achieve that goal.

The timing could not be more urgent. Prior to the Brexit vote, the SME sector was already in need of more support. Since June 2016 this imperative has been made stronger by the challenges posed by the UK's withdrawal from the EU and the importance of SMEs to the economy. There is real concern that Brexit will leave 'a business support black hole' that urgently needs filling if SMEs are to be the successful engine of growth the economy needs today. Therefore the focus on SMEs arises from:

- The significance of the sector to the economy – for its contribution to economic growth, employment, innovation and social cohesion.[1] There are 5.4 million SMEs in the UK, making up over 90 percent of businesses.[2] Total employment in SMEs is 15.6 million and represents 60 percent of all private sector employment.
- The current government interest in the sector, which is providing an opportunity to feed a multi-stakeholder perspective into timely regulatory and legislative debates.
- The fact that a number of banks have committed to focus on SMEs, coupled with structural changes to bank business models which are likely to make serving SMEs more challenging, in ways that banks, government and SMEs themselves are only beginning to understand.

Although banks remain the primary source of lending to SMEs, it is a challenging sector for them. SMEs often have little or no collateral, and new companies do not have a track record against which banks can measure the risks and opportunities they pose. This means SME lending has tended to be one of the riskiest activities on bank balance sheets.

These challenges are compounded by the structure of the UK banking market, which is unusual in that it is almost entirely served by for-profit, privately owned businesses. It has no significant mission-driven or social banking sector, and government intervention to provide early support to smaller and riskier enterprises, or to address financial exclusion, is significantly lower than it is in other countries. Additionally, banks are undergoing profound business model changes driven by unprecedented regulation, historically low interest rates and a global technological revolution. This has seen the

acceleration of digitisation and automation, the introduction of financial technology (Fintech) and artificial intelligence; it also places banks on the front line in fighting financial crime. One of the most visible signs of the pressure on banks is branch closures, which complicates local and regional financing of SMEs, and is particularly challenging for small businesses which manage cash, those faced with difficult or complex decisions and those preparing for the next stage of growth. These are radical changes for the banking sector with huge implications for customers, employees and shareholders.

Loans to the real economy (non-financial businesses) account for 18 percent of domestic lending of UK-based banks. The figure falls to 12 percent if selling and renting of real estate is excluded. Lending to SMEs now sits at around 4 percent of banks' balance sheets.[3] This lending is nevertheless crucial to SME success – it accounts for 80 percent of loans to SMEs today.

Government interest in SMEs has been increasing in recent years, and has been heightened by the Brexit vote. The past few years have seen a swathe of legislative and regulatory initiatives to address SME needs. Regulating to create the right balance between ensuring that finance is available and encouraging entrepreneurialism, promoting market confidence and providing protection for vulnerable SME customers is a complex and difficult undertaking, with strongly held views on all sides of the argument. It is clear, however, that government – guided by customers and industry – is uniquely placed to create the framework to capture comprehensive information about the nature and extent of SME needs, and to propose holistic solutions to meet them. Government also has a role to ensure consistency across its different departments, and to ensure that the implications of legislation or regulation on the range of economic activities are fully understood.

BankingFutures identified four priority areas for addressing the needs of SMEs:

- Access to finance (including non-bank finance and finance for social business).
- Access to advice.
- Access to protection.
- Access to redress.

Despite the plethora of welcome government and bank initiatives to improve support for the sector in recent years, SMEs – and smaller SMEs in particular – have ongoing and poorly met needs in each of these areas that should be addressed. Further, it is important that any attempts to do so take a holistic approach that recognises how interdependent the four issues are.

Pre-Requisites to Address the Four Priority Needs: Definition and Data

Successfully addressing the four priorities above can only be achieved by improving current definitions and by better data collection and analysis. Understanding the supply of and demand for SME finance is inherently complex, due to the size and diversity of the sector. It is made more so by the fact that definitions of SMEs are so broad. To fully address these challenges requires a more differentiated definition of SMEs, in order to separate out the wide variations in policy, financing, product, advice, legal and service needs of companies in the sector.

It also requires government to collate better, more granular, data about the supply and demand for finance for different types of SMEs, and how they fit together, as well as about their differentiated needs for advice. Data on smaller SMEs, micro- and nano-companies and the 'gig economy' is particularly difficult to obtain, but is much-needed, given the increasing numbers employed in these areas. Notwithstanding the need for more data, especially about the smaller end of the SME market, the current picture already reveals both provision gaps and potential solutions which form the basis of the BankingFutures recommendations.

Access to Finance

Banks remain the major source of finance for SMEs, but confidence and trust in their ability to provide finance on fair terms have diminished in recent years and this appears to be denting demand. This goes some way to explaining the recent upsurge in demand for alternative finance. SME experts and champions believe that government assumptions that banks are well-placed to meet the bulk of appropriate SME demand for finance are over-optimistic. Different stakeholders hold divergent views about the needs of the sector and the degree to which there is an investment

gap for SME financing. Many banks hold the view, based on their empirical experience, that there is more supply than demand for SME finance. SME representatives, on the other hand, believe that there is significant discouraged demand and unmet need.

The reality is that these different perspectives are probably simultaneously true. BankingFutures discussions revealed that banks may be approving most of those SME applications they believe to be of merit – not all small business plans are deemed to yield acceptable financial returns to banks, and not all are robust enough to deserve loans. However, sometimes the terms of those loans are not economic for the applicant, and at other times SMEs are not, for various reasons, requesting or completing applications to banks, and are therefore statistically invisible. There are also divergent views of the nature of that finance. Some financiers believe that many more SMEs could and should be seeking equity capital. SMEs themselves are more wary and prefer loans.

BankingFutures identified the following priorities to understand the SME investment gap:

- The need for better, more centralised data collection and collation from banks and other sources of SME finance to get a comprehensive picture of supply and demand.
- The need for a more disaggregated definition of SMEs to better understand the varied policy, advice and protection needs of the sector.
- The need to address specific SME sectors where demand for finance is poorly met, including, smaller SMEs, businesses in regions that are structurally underfunded, SMEs in the knowledge economy and those seeking growth capital, 'green' SMEs supporting the transition to a low carbon economy, and agricultural SMEs post-Brexit.

Access to Advice

There is an urgent need for SMEs to obtain better access to business, financial and legal advice – and in particular on how to ensure that their business is 'investment ready'. Despite a great deal of advice in the marketplace there is no one-stop-shop where SMEs can go for the full range of advice. The provision of advice is also complicated by a lack of clarity about when information (which can be freely given) becomes advice (which comes with legal liabilities and regulatory constraints). Comprehensive, independent, impartial advice needs to be easily available, readily accessible and affordable. Government does not have to provide this advice, but it is likely to have an important role in ensuring it meets the standards and high quality required. BankingFutures identified the following specific advice gaps for SMEs, that urgently need to be addressed:

- The need for advice on the impact that rising interest rates will have on their firms and how to manage growing debt. This is particularly important for newer firms which have only ever operated in a low interest rate environment.
- The need for advice about how to manage debt throughout the cycle of a business. There is currently a strong bias towards advice to start-up firms, and an advice gap about how companies which have successfully survived the most difficult first two years of existence should manage future growth and develop into employers of the future.
- The need for advice on how to navigate complex decisions about what types of investment are most appropriate for their business and stage of growth. In most places SMEs have very little understanding of equity and other finance options.
- The urgent need for advice to nano- and micro-businesses, which rely heavily on personal bank accounts and credit cards to finance their firms, to help them understand and manage the potential impacts on their businesses of new data protection requirements.

The availability of advice is only one part of the story. SMEs not only need to be aware of the available advice; they also need to use it. One of the greatest challenges is to encourage uptake and application of advice by business users in ways that work for them. This means, amongst other things, taking into consideration the behavioural traits of a wide variety of SMEs, and understanding which sectors use what information in what way.

Access to Protection

SMEs need protection against fundamental business risks and against the information asymmetry between them and those from whom they buy financial services, which may leave them vulnerable to manipulation and poor conduct. There is very limited regulatory protection afforded to SMEs today. BankingFutures discussions identified three significant protection gaps:

- Lack of protection for small and medium firms above the micro-business threshold that currently receive no protection from the Financial Conduct Authority (FCA), and for whom the only recourse is through the courts.
- The gap that arises from the fact that conduct regulations are not applicable to some new lenders and players in the financial sector.
- The lack of protection when unregulated products are sold by regulated entities to unregulated firms.

In creating any new protection there will be a trade-off between choosing simplicity (such as delineation on the basis of size) or a more nuanced approach which attempts to capture complexity (such as levels of financial sophistication). Although a one-size-fits-all 'blunt tool' may hinder a small number of more sophisticated smaller SMEs from obtaining finance, most stakeholders argue that the need for a clear and simple extension of protection provision to the majority of SMEs should prevail, especially as it is possible to introduce opt-in clauses for more sophisticated SMEs.

Access to Redress

Despite their hugely different abilities to access advice, resources and legal expertise, the law today views SMEs and banks as equal, and works on the assumption that most businesses are more financially and commercially sophisticated than individual customers. For SMEs with more than 10 employees, or annual turnover of more than €2m, this means that in the case of dispute, their only recourse is to take their case to court. Unless they opt for 'no win, no fee' lawyers, they are ill-equipped to do this when in deep financial difficulty. The Financial Ombudsman, to which many SMEs turn in the first instance, is only mandated to hear complaints from individual customers or micro-enterprises. Those small businesses that do fall within this threshold then discover that the Ombudsman is unable to consider certain unregulated products, and can only award up to £150,000 in compensation, which may fall far short of the losses they have incurred. Some SMEs who have sought a hearing with the Ombudsman have lost confidence in it, and complain that it is slow and lacks the resources needed to help them.

BankingFutures identified the need to address the following gaps in access to justice for SMEs:

- The need for a fair system that addresses the information asymmetries and power imbalances between SMEs and their finance providers.
- The need for affordable redress that is within reach of SMEs, even when facing financial difficulties.
- A dispute-resolution mechanism that:
  - Carries out its duties in an expeditious way.
  - Is legally binding and able to create case law.
  - Is mandated to handle both regulated and unregulated asset cases.

Call to Action

Action is needed now to ensure that the banking sector – in all its guises – is able to meet the urgent needs of the UK economy, and to serve smaller SMEs that appear to have particular unmet needs. The convergence of technological advances, Brexit, the inclusive growth agenda, the growth of the gig economy, the need to tackle cybercrime, and the imperatives of a low carbon future offers a massive opportunity to reset the relationship between finance providers and the society they are there to serve. Constructive action now would only create winners. The following recommendations outline what could be done to support SMEs in the UK at this unique point in its history.

Banking Small Business
Recommendations to Banks

RECOMMENDATION ONE:

Banks to provide more precise data and more narrative information on SME lending to the British Business Bank

i. Banks to provide the British Business Bank (BBB) with more data on loans, including loans requested, terms of outcome and drawdown in aggregated debt lending reporting, and requests for finance to allow SMEs to improve their sustainability and/or to expand provision of 'green' goods and services.

ii. Banks to introduce data collection processes to assess and understand the use of personal products for business use, and to make subsequent data available to government.

iii. Banks to work with the proposed government-convened Multi-Stakeholder Advisory Committee (see Recommendations to Government, below), set up to define what data points to use and to review the collection and collation process.

iv. Banks to provide narrative reports to the BBB on how the SME finance market is working.

v. Banks to augment efforts to understand the needs and opportunities in the Community Development Finance Institutions (CDFI)/Responsible Finance market by supporting the BBB to develop techniques to collect data, and informing the BBB about the referrals they make to CDFIs/Responsible Finance institutions. This should include the nature and size of loans referred, and to which CDFIs.

RECOMMENDATION TWO:

Banks to articulate a coherent strategy to address local and regional SME needs

i. All banks to provide clear and easily accessible information to SMEs about where and how credit decisions are made within the bank, and by whom.

ii. High Street banks to develop internal strategies to ensure that branch closures are accompanied by clear communications to current and potential small business customers about the financial service options – including Fintech options – that remain open to them, and how to access them.

iii. All banks, irrespective of business models, to contribute to ensuring that underserved communities retain or obtain access to banking services and financial inclusion. This will include working with the Post Office where it provides bank services; special provisions in places where bank services are no longer available; and a transition plan for businesses that are heavily dependent on cash.

iv. Banks to raise awareness of and improve access to 'green' financial products and services.

v. Banks to work constructively with Responsible Finance providers to ensure wider coverage of underserved customers and market segments, by:

a) Exploring how referral processes are currently working; and based on the findings, developing more robust processes.

b) Seconding bank staff and providing mentoring on request to Responsible Finance providers to strengthen their capacity and skills base.

c) Actively supporting government initiatives to encourage investment into Responsible Finance organisations that is sufficiently de-risked for banks to protect their own depositors.

RECOMMENDATION THREE:

Banks to introduce measures to support SME access to advice and improve investment readiness

i. All banks to continue to develop and make available user-friendly digital and online tools on SME lending eligibility criteria, and what constitutes investment readiness for the bank.

ii. Banks to develop diagnostic tools and offer personal feedback to SMEs on why loans are declined (e.g. lack of confidence in management, unconvincing business model) and what management might do to address this.

iii. Banks to develop packages that alert SMEs to availability of existing advice programmes on:

a) Financing options, including different types of loans, equity options, and how to distinguish their financial needs and evaluate the appropriateness of various forms of capital for initial funding.

b) Where to go for advice when the business is in financial difficulty.

c) How to approach and apply for working capital for growth.

d) Sources of finance available to support sustainability performance.

e) Sources of social investment advice, such as the Big Potential Fund of the Big Lottery Fund.

iv. All banks to systematically refer SMEs to a newly created British Business Bank Small Business Interactive Advice Platform (see Recommendations to Government, below), and to provide practical support to this government initiative, e.g. through secondments.

RECOMMENDATION FOUR:

Banks to introduce new internal protection thresholds and procedures

i. All banks to sign up to and adhere to the Lending Standards Board 'New Standards for Lending Practice' for business customers in the following ways:

a. All banks to comply with the spirit of the Standards for Lending Practice by introducing simplified lending agreements in the form of a standardised lending contract, which allows SME customers to compare indicative offers between banks, and includes a one-page summary of the main components of the deal.

b. Banks (including challenger banks) to commit to develop internal processes which embed the spirit of the Standards into their culture and into the structures that underpin decision-making.

c. Banks to support the publication of an annual Lending Standards Board 'State of the Nation' report on compliance with the New Standards for Lending Practice.

d. All signatories to the Standards for Lending Practice to commit to ensure that any contracts reflect the commitments in the Standards.

ii. All banks to introduce new internal SME thresholds (guided by Standards for Lending Practice, which recommends a threshold of £6.5m turnover), signalling the need for specific management training, monitoring and evaluation in dealings with firms below the specified threshold.

iii. All loan agreements with SMEs to require customer consent when the loan is established, for the loan to be sold on to other entities.

iv. Banks to cease using confidentiality agreements where their use could impede whistle-blowing or the development of policy or appropriate law.

Successful Implementation

To be effective, these recommendations will need to be adopted by individual banks. However, the creation of UK Finance (which brings together multiple providers of finance to SMEs, amongst others) presents a significant opportunity to provide sector-wide support for the BankingFutures recommendations. This could take the form of liaison with the FCA and SME representative bodies to convene multi-stakeholder roundtables designed to enhance data collection to fully understand the needs of the sector and oversee reporting on the uptake of BankingFutures recommendations.

Banking Small Business Recommendations to Government

RECOMMENDATION ONE:
Government to support enhanced data collection

i. Government to extend the mandate of the British Business Bank (BBB) to become the centralised, independent, credible and trusted body charged with collating anonymised data from all banks and other finance suppliers, and with ensuring that data is analysed in a way that supports the development of appropriate policy to support SMEs.

a) Government to set up a Multi-Stakeholder Advisory Committee to establish what data points to use and to review the collection and collation process. The Committee should include representatives of Responsible Finance, alternative finance and banks. A bespoke advisory board or committee should be created to ensure that the specific aims and needs of the CDFI/Responsible Finance sub-sector are met.

b) Government to provide the BBB with sufficient resourcing, including mandated support from the Office for National Statistics, to undertake data collection of supply and demand for SME finance, including peer-to-peer lending, alternative finance, CDFI/Responsible Finance, 'green finance' and postcode-level data.

c) Government to task BBB to identify data gaps that obscure discouraged demand, including collection of complaints, and to work with finance providers to identify credible sources of relevant information. This is likely to include a breakdown of loan applications between sectors (e.g. commercial property, intellectual property investments).

RECOMMENDATION TWO:
Government to support SME access to finance through provision of incentives as well as support for bank investment into the Responsible Finance sector

i. Government to provide future incentives to banks to lend, such as via the Funding for Lending/Term Funding Scheme and/or by refining capital requirements pertaining to SMEs. These incentives to focus particularly on areas of market failure.

ii. Government to actively encourage further take-up and extension of the Enterprise Finance Guarantee, and/or create a vehicle to encourage lending and investment into Responsible Finance providers, by providing a guarantee against loss and a commercial return to banks in order to protect bank depositors.

iii. Government to fund an investment readiness project for the Responsible Finance sector in anticipation of the above funding. This investment readiness project should be designed to encourage:

a) Agreement within the Responsible Finance sector to use common definitions on key metrics, such as loan loss and default rates.

b) A limited but standardised template that encourages common reporting, so that investors may better compare the financial health of Responsible Finance institutions.

c) Responsible Finance organisations to obtain independent ratings on financial viability to encourage investment readiness.

iv. Government to extend the Enterprise Finance Guarantee (EFG) to green finance.

RECOMMENDATION THREE:
Government support to improve SME advice services

i. Government to expand the mandate of the British Business Bank (BBB) to create a Small Business Interactive Advice Platform. This one-stop-shop would be a platform on which small businesses can obtain business development, risk management and legal advice, as well as financial advice from multiple sources. The Business Finance Guide should sit on this platform.

a) The BBB to develop interactive capabilities for its platform, including peer-to-peer advice and chat facilities on commonly used platforms (e.g. LinkedIn) to allow small businesses to exchange information and advice about key challenges they face.

b) The BBB to improve communications with target SME audience by using video, graphics and animation to promote ease of use.

c) The BBB to work with banks, alternative finance providers, accountants and CDFI/ Responsible Finance providers to develop ‘white labelled’ (i.e. non-branded) advice on a range of issues on which government and finance providers anticipate demand in the near future, e.g. interest rate rises.

ii. Government to fund these enhanced, centralised BBB capabilities with savings made from funds currently invested in multiple diverse offerings.

RECOMMENDATION FOUR:
Government to introduce new protections for small businesses

i. Government to agree a new definition of self-employed and micro-businesses (SEMs).

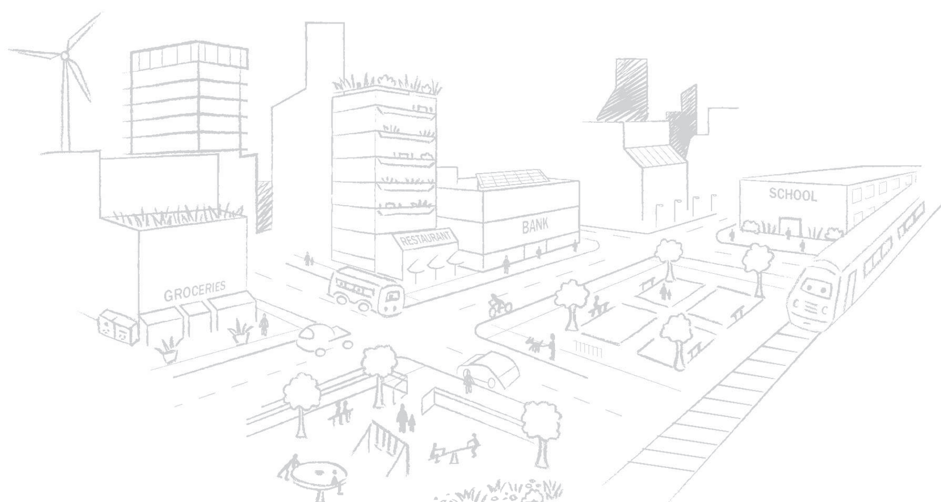
ii. FCA Handbook to extend FCA retail customer protections to SEMs falling below the £6.5m turnover threshold.

iii. Government to require banks to use standardised charging terminology and include a one-page summary in SME contracts.

iv. Government to forbid sales of certain products (e.g. those that contain embedded hedging products) to SEMs, unless they specifically opt in to have access to them.

v. Government to introduce new regulatory Transfer of Undertakings (TUPE) to cover onward sales of contracts, similar to those that apply in employment law, whereby the product that is being transferred (sold on) is subject to the original conditions of sale.

vi. Government to introduce a statutory duty of care to ensure that SMEs are given appropriate advice and protected from negligence or economic harm as a result of their contractual relations banks.



RECOMMENDATION FIVE:

Government to introduce new redress measures for small businesses

i. Government to introduce a new Financial Arbitration Service that is fast, affordable and available to all, by meeting the following criteria:

a) Fair – set up to address the information asymmetries between SMEs and their finance providers (including the fact that insolvency law favours the creditor) and the power imbalances between them.

b) Affordable – within reach of SMEs, even when facing financial difficulties.

c) Fast – carries out its duties in an expeditious way that does not leave SMEs facing uncertainty and long delays.

d) Legally binding – able to create case law.

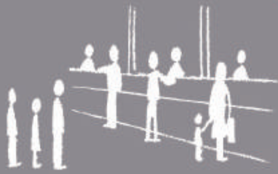
e) Comprehensive - able to handle both regulated and unregulated asset cases.

Two ways to achieve this goal are under discussion at the time of writing. The first is to scale up and expand the remit and resources of the Financial Ombudsman to cover cases of companies under the new protection threshold of the Lending Standards Board (£6.5m turnover). The other alternative is to create a new Financial Tribunal, as proposed by the All-Party Parliamentary Group on Fair Business Banking, funded by all providers of banking services to SMEs.

Successful Implementation

The Development of an Effective SME Legislative Strategy

The above recommendations can all be implemented separately by extending the mandates of existing government bodies and by building specific SME provision into finance bills that are already planned. However, given the multiple, interdependent and partially met needs of SMEs, and of smaller SMEs in particular, and the role this sector of the economy will need to play post-Brexit, BankingFutures proposes that the government include specific SME provision in the Industrial Strategy and consider the introduction of a Small Business Financial Services Bill as soon as the legislative agenda permits.

SCHOOL
BANK
GROCERIES


Introduction

Why BankingFutures?

In the years immediately after the financial crisis it was easy to forget how much a society needs the services of both banks and bankers. From the most financially-excluded homeless person to the wealthy landowner, we all need trusted entities to keep our money safe, to allow us to make and receive payments, and to create credit to fuel investment and economic prosperity. Without such bodies, it is impossible for people to engage in even the most basic economic activities or for advanced economies to function.

The precise nature of who provides those services is changing and fragmenting, and in the long run these changes are likely to prove revolutionary. For now, however – and despite significant disintermediation of financial services already – banks remain the principal agent through which most people deposit and save money, take out loans for goods and holidays, plan pensions and finance mortgages. And what is true for individuals is also true for companies – whether they are small, medium or global enterprises.

Given the importance of the sector, and in light of a lack of trust in banks, BankingFutures was set up in 2014 to articulate a multi-stakeholder view of a healthy UK banking sector and to recommend actions to achieve that goal. It sought to do this by addressing:

- A lack of visible leadership from within the banking sector on how to realign incentives to result in better societal outcomes.
- The limited direct civil society engagement with those undertaking banking reforms.
- The need for institutional investors to engage on their role in shaping bank behaviours.

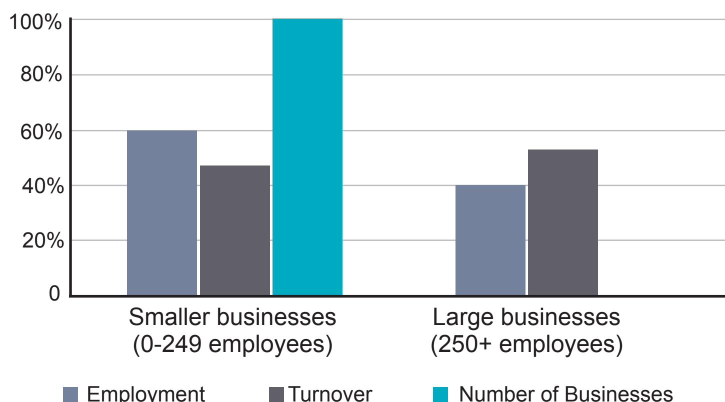
Successfully bringing together diverse perspectives on the purpose of banking and how it might be implemented, the initial dialogue concluded with three recommendations that would rebalance banking to better meet societal expectations and rebuild trust in the sector.[i] Since then, BankingFutures has been exploring two of those recommended topics in depth: how banks can better contribute to the real economy; and how to address the current focus on short-term financial results in communications between banks and investors, such that it enhances banks' ability to deliver long-term value to all stakeholders.

This is a report on the findings of our work on how banks can better support the real economy by supporting the small and medium enterprise (SME) sector in the UK. Given the challenges the withdrawal from the EU poses to the UK economy, the particular characteristics of the UK banking sector, and the importance of SMEs to jobs, growth, innovation and social cohesion (see Fig 1), the timing could not be more urgent. The Federation of Small Businesses (FSB) has expressed strong concern that Brexit will leave 'a business support black hole', and points to the importance of replacing the dedicated small business support that has come from the EU.[4] Others highlight similar needs for the agricultural sector.

A Sector in Flux

The UK banking market is structurally different to that of other countries, bringing with it particular challenges. The UK is almost entirely served by for-profit, privately owned businesses; it has no

Figure 1: **Contribution of smaller and large businesses to total business population, employment and turnover at the start of 2016**



Source: *BEIS Business Population Estimates 2016*

i. See *Banking on Trust: Engaging to Rebuild a Healthy Banking Sector*, Leaders' Quest and Meteos, February 2016.

significant mission-driven or social banking sector, and government intervention to provide early support to smaller and riskier enterprises or to address financial exclusion is significantly less than in other countries. Although it is beyond the scope of BankingFutures to promote an alternative structure for the UK banking sector, it is true that the current arrangements affect provision of services in a way that contributes to the fact that societal expectations for the sector to meet everyone's needs for banking services is sometimes at odds with what is commercially viable. This is one possible reason that societal distrust of the sector remains higher than in other countries.

Ten years on from the financial crisis, the sector is emerging from waves of unprecedented regulation, first to promote financial stability, and then to improve bank conduct, the other main cause of mistrust. This external reform has, in turn, been mirrored by deep restructuring processes inside the banks that are designed to achieve the same goals. Bank leaders are also coming to grips with a new Senior Manager's Regime and other regulation which has significantly altered internal processes. Meanwhile, the normal bank business model is itself highly challenged by persistently and historically low interest rates and a flat yield curve, making it difficult for banks to navigate long-term challenges.

All this is taking place as a global technological revolution continues unabated. Banks are on the front line in fighting financial crime, which has become a key priority for bank leadership. The sector requires significant resources and management time as – on behalf of society at large – it puts in place systems to track and identify fraudsters and those funding terrorism and criminal activities, and to address money laundering. At the same time, automation and digitisation are being used by banks themselves and have already paved the way for new entrants in the banking market, encouraged by government support of challenger banks. Fintech (financial technology) is accelerating this trend. The introduction of artificial intelligence into business models has barely begun, but it is already clear that it will herald further radical changes for the banking sector, with huge implications for customers, employees and shareholders.

These changes are taking place against a backdrop of severe economic and political uncertainty... At the very least, there is recognition that the UK economy will need to be a much more successful engine of growth.

These sector-specific changes are taking place against a backdrop of severe economic and political uncertainty. The UK economy faces significant headwinds. The initial (and surprising) post-Brexit economic buoyancy is being replaced by more cautious behaviours, and many predict a slowing of economic activities as people wait to see how the negotiations fare. At the very least, there is recognition that the UK economy will need to be a much more successful engine of growth. At the same time, not only is there a need to ensure that the loss of EU subsidies does not further disadvantage more marginalised businesses and communities. It is also essential that the services offered by the European Investment Fund and European Investment Bank – particularly relevant for 'green SMEs' – are replaced, and to make provisions for what happens when the Single Local Growth Fund[ii] spending round comes to an end in 2021. Politics is also moving away from its free-market focus, with political parties across the spectrum seeking to be associated with a new inclusive growth agenda. Finally, the slower burn but equally challenging imperative to respond to scientific evidence of climate change, embodied in the Paris Agreement, requires a restructuring of the economy to mitigate and adapt to its effects. In this context, the value of achieving a healthy banking sector cannot be overestimated.

Why the Real Economy?

The real economy comprises those economic activities undertaken by households and businesses (as opposed to transactions between financial entities), and includes business transactions and mortgage provision. In recent decades, the UK economy has become more service- and knowledge-based. At the same time, government policy has supported the financial sector, leading it to expand dramatically. It now overshadows the economy, with assets nearly 12 times annual GDP.[5] In the run-up to the financial crisis, bank lending to financial businesses began to rise faster than direct lending to the real economy, and this has continued.

Over this time, banks' business models have been changing. Banks have been replaced

ii. The Single Local Growth Fund was the outcome of a report produced by Lord Heseltine in March 2012 for the Chancellor and Secretary of State for Business at the time, with a brief to provide ideas to stimulate economic growth at a local level. His recommendation, which was accepted as part of the 2013 Spending Review, was to combine separate funding streams into a 'single funding pot' for local areas with internal ring fences, through the creation of a Single Local Growth Fund and Growth Deals.

SMEs are vital for their contribution to economic growth, employment, innovation and social cohesion. There are 5.4 million SMEs in the UK, making up over 90 percent of businesses.

by institutional investors, such as pension and mutual funds, as the largest providers of long-term capital to physical infrastructure projects, and mortgage lending has come to dominate most bank lending portfolios.[6] Loans to the real economy (non-financial businesses) account for 18 percent of domestic lending of UK-based banks. The figure falls to 12 percent if the selling and renting of real estate is excluded.[7] Lending to SMEs now sits at around 4 percent of banks' balance sheets, compared to 15–25 percent in Germany.[8] This lending is nevertheless crucial to SME success – it accounts for 80 percent of loans to SMEs today.[9]

Thus, while the UK is a global leader in international financial services, not enough of the benefit of being so has made its way to SMEs in the domestic UK economy. This matters. That the sector is so large relative to GDP – and is so central in public discourse about the economy – sits uneasily with this limited support to businesses, which are not adequately benefiting from the UK's position as a global financial hub. This may explain – at least in part – why 10 years on from the financial crisis, public trust in UK banks remains low relative to other countries, even though the crisis was global.

Productivity and investment are a challenge for the UK. Labour productivity was badly affected by the economic crisis and remains 14 percent below what it is estimated to have been had the stable, pre-crisis trend in productivity growth continued. The UK spends less on investment than any other G7 economy.[10] In the post-Brexit world of historic uncertainty and enormous risks as well as opportunities, it becomes even more significant. How the banking sector serves companies in the real economy will be one of the critical determinants of the UK's prosperity.

Why SMEs?

Prior to the EU referendum, BankingFutures had already chosen to focus its real economy work on how banks can better support the highly significant SME sector.[iii] This was for three reasons:

- The significance of the sector to the economy – for its contribution to economic growth, employment, innovation and social cohesion.[11]
- The current government interest in the sector, which is providing an opportunity to feed a multi-stakeholder perspective into regulatory and legislative debates.
- The fact that a number of banks have committed to focus on SMEs, coupled with structural changes to bank business models which are likely to make serving SMEs more challenging, in ways that banks, government and SMEs themselves are only beginning to understand.

At the start of 2016 there were 5.4 million SMEs in the UK, making up over 90 percent of businesses.[12] Total employment in SMEs was 15.6 million, representing 60 percent of all private sector employment.[13] Eighty-five percent of new jobs created between 2008 and 2013 were created by firms with fewer than 50 employees.[14] To these numbers should be added the more recent phenomenon of rising numbers of people in the 'gig economy' – self-employed individuals or nano-businesses – who are often essentially outsourced workers of larger companies. Although it is exceedingly hard to determine precise numbers, some put the number of workers employed in this way as high as five million people (see Fig 2).[15]

Figure 2: **Change in number of businesses 2000–2016 by size of business**

Size of business	Number of businesses 2000	Number of businesses 2016	% change 2000–2016
No. of employees	2,355,900	4,172,200	77%
Micro 1–9	914,300	1,081,400	18%
Small 10–49	162,900	203,500	25%
Medium 50–249	26,800	33,300	24%
Large 250+	7,200	7,200	0%

Source: *BEIS Business Population Estimates 2016*

iii. The UK government currently defines a company as an SME if it meets two out of three criteria: staff headcount of fewer than 250, turnover of less than £25m, or gross assets of less than £12.5m. The government also distinguishes between medium (50–249), small (10–49) and micro-businesses (0–9 employees).

The UK vote to leave the EU has brought to the fore the importance of a vibrant exporting SME sector, which will be needed if the UK is to trade internationally and beyond Europe. This means supporting and scaling up trade finance capabilities. Domestic business will also continue to be vital. And, at a time of pre-existing concern over UK productivity, the productivity of SMEs is crucial. Brexit makes it even more important to support those small and young firms that are more innovative and more productive, and equally vital to help less productive firms who need credit and advice to invest in productivity improvements. It also poses the challenge of how to replace EU funds which, the FSB argues, were particularly important for comparatively disadvantaged regions of the UK, such as Wales, the North East and Cornwall, and for specific sectors, such as agriculture.

The Role of Banks and their Changing Business Models

Banks are crucial to SME success as they account for 80 percent of loans to the sector today. For the economy to thrive it is vital that SMEs regard banks as trustworthy. They need to be confident that banks are safe and responsible custodians of their money, that the payments services they provide are reliable and fair, and that customer – not exclusively shareholder – interests, are at the heart of bank business models.

Winning this confidence will not be easy. The financial crisis cast a long shadow, and has not been helped by more recent stories of unscrupulous and at times illegal approaches towards SME restructuring and debt collection by firms who were sold SME loans by banks. In the long run, however, it is the ongoing, profound structural changes to the business models of large retail banks that are likely to be just as – if not much more – challenging to the relationship between banks and the SME customers they serve.

SMEs have always been challenging for banks because they often have little or no collateral, and new companies do not have a track record against which banks can measure the risks and opportunities they pose. This means SME lending has tended to be one of the riskiest activities on a bank balance sheet. In addition to this existing challenge, the acceleration of digitisation and automation, and the commercial imperative of a huge focus on cost reduction are already reshaping banks' relationships with their customers. The most visible sign of this is the empty High Street shop fronts up and down the country, where bank branches used to be. Though many customers are happy to go digital, significant numbers of companies – particularly smaller ones who manage cash, seasonal businesses and firms in rural areas, for example – are not. Others are happy for straightforward transactions to be digital, but want to talk to someone when faced with difficult or complex decisions, or when preparing for the next stage of growth.

New technology is also affecting employees. Those local bank managers with the skills and expertise to understand the local economy are already lamenting the loss of personal autonomy and their ability to interact with local firms, brought about by an increased use of algorithms and digital calculations. How much more challenging is it going to be when artificial intelligence and automation compel them to engage in even fewer interactions and, possibly, lead to significant job losses? These are revolutionary changes, which even bank analysts and investors are hard-pressed to understand and evaluate.

In the past few years most banks have undertaken radical internal reforms to re-emphasise and focus on the importance of customers. They have made important and positive inroads into culture. Despite this, there is still much more to be done to reintroduce what BankingFutures participants described as the 'human touch' to banking. The optimal balance between the opportunities for efficiency that new technologies offer, and customer desire for an appropriately personalised service offering, is still being sought.

The Role of Government

Some participants in the BankingFutures project point to growing government interest in SMEs; this has heightened since the Brexit vote as the government looks to the sector to be a key engine of growth. The past few years have seen a swathe of legislative and regulatory initiatives to address SME needs, which include the establishment of the operationally independent British Business Bank in 2014, the Small Business, Enterprise and Employment Act 2015, the Financial Conduct Authority's SME Review, the Competition and Markets Review, the creation of a Small Business Commissioner, and the introduction of Open Banking. Despite these advances, it is still true that over 28 percent of government proposals for new regulation received red flags from the Regulatory Policy Committee, with some of those

alerts explicitly being for failing to provide evidence on how likely the proposed regulation was to affect small and micro-businesses, and for a lack of robust analysis about the policy consequences of exclusions or mitigations for small businesses.[16]

Regulating to create the right balance between ensuring that finance is available and encouraging entrepreneurialism, promoting market confidence and providing protection for vulnerable SME customers is a complex and difficult undertaking, with strongly held views on all sides of the argument. It is clear, however, that government – guided by customers and industry – is uniquely placed to create the framework to capture comprehensive information about the nature and extent of SME needs, and to propose holistic solutions to meet them.

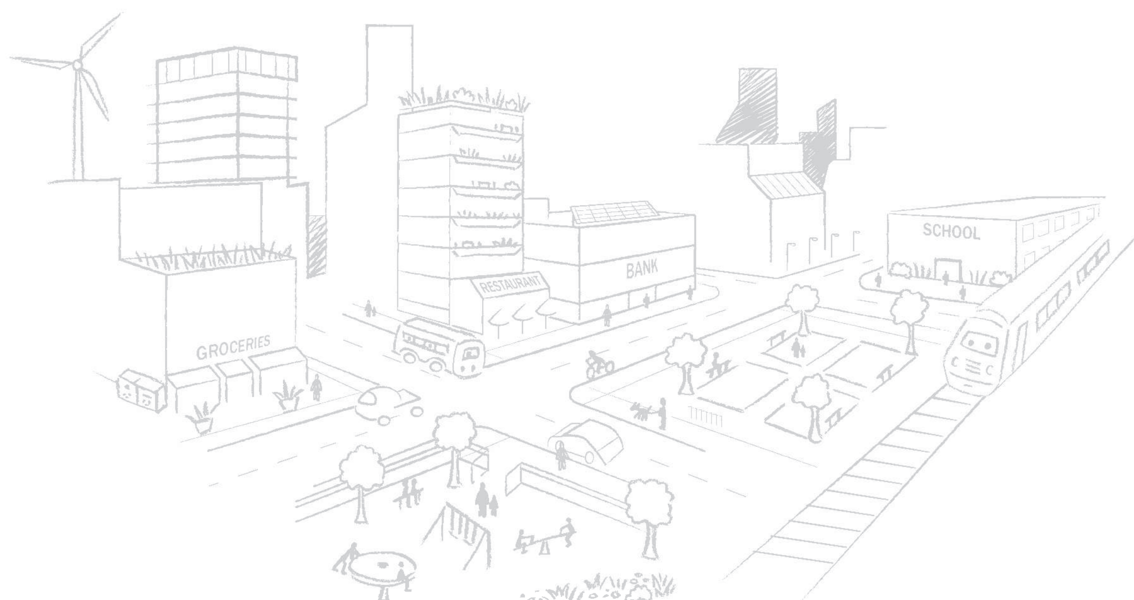
Government also has a role to ensure consistency across its different departments, and to ensure that the implications of legislation or regulation on the range of economic activities are fully understood. BankingFutures representatives expressed their concern, for example, about Basel III requirements, which significantly increase capital requirements for corporate and collateralised lending.

Typical risk weightings require banks to hold six to seven times more expensive equity capital for every pound of secured lending to an SME, compared to every pound of secured mortgage lending to a household. This further skews lending away from small businesses. In an environment where bank margins are already compressed, they believe the outcome may well be a reduction in the range of products available to SMEs. Others believe those same capital adequacy requirements are contributing to the sale of some SME loans to unregulated firms with different – and at times much more aggressive – debt collection processes.

Call to Action: Four Priorities

Action is needed now to ensure that the government works with the banking sector – in all its guises – to meet the urgent needs of the UK economy, and to better serve those smaller SMEs that appear to have particular unmet needs.

Constructive action now would only create winners. BankingFutures identified four priority areas for its SME work: access to finance (including non-bank finance and finance for social business); access to advice; access to protection; and access to redress. Each of these areas is explored in greater depth in Section Three below. Section Four outlines specific recommendations on what could be done by banks to support SMEs in the UK at this unique point in its history. This section also calls for government to introduce a Small Business Financial Services Bill as soon as the legislative agenda permits. The Bill would bring together attempts to support SMEs in a package that recognises how interdependent the four areas are. It would allow for a holistic approach and ensure that intended and unintended consequences are managed to achieve the right balance between supporting improved access to finance, and the need for appropriate protection.



Understanding SMEs – A Diverse and Highly Differentiated Sector

The Definition of SMEs

To understand the needs of the extraordinarily diverse SME sector is a complex undertaking. This is in part because of the loose definition of what constitutes an SME. It is worth noting that most SMEs do not identify themselves as such at all. The government considers a company to be an SME if it meets two out of three criteria: staff headcount of fewer than 250, turnover of less than £25m, or gross assets of less than £12.5m. It also distinguishes between medium (50–249 employees), small (10–49 employees) and micro-businesses (0–9 employees). These broad definitions cover over 96 percent of UK businesses (including sole traders), they direct government policy and regulation, and are used by other institutions such as the Bank of England, British Banking Association and the British Business Bank. These and other organisations, including private banks, also use their own definitions.

The fact that these definitions uncomfortably bundle micro- and nano-enterprises with much larger firms, is problematic. It obscures the widely varying policy, financing, product, advice, legal and service needs of companies in the sector, making it very hard to tailor advice, services and regulation to meet specific SME needs and obfuscates problems. Current definitions appear to be particularly damaging for very small companies and sole traders, who are often assumed to have a greater understanding and ability to manage complex financial relationships than is actually the case.

The Investment Gap

Although banks believe they are meeting the needs of SMEs, there is growing, recent evidence of important financing gaps for SMEs – and again, this seems to be particularly problematic for smaller firms. Many of the smallest companies rely on personal loans from friends and family to finance their businesses, making data on these micro- and nano-business transactions very difficult to capture. Nevertheless, recent Bank of England research into finance for productive investment shows that while large firms appear able to obtain finance, there is evidence of supply-side problems for SMEs. As size is the most important determinant of access to funding, this is likely to affect the smallest companies the most.[17] This chimes with other recent research that finds that although medium-sized and larger companies are being financed by banks, small companies and micro-enterprises are not getting what they need. For instance, loan and overdraft applications by smaller SMEs are less likely to be approved than those of larger firms, and rejection rates for start-ups seeking new loans exceed 50 percent.[18] This may in part reflect the fact that start-up companies have higher loan default rates than other firms. There are two further notable gaps in official attempts to capture data. There is a lack of data collection about very small companies and micro-enterprises, and about socially-driven finance that is targeted to small firms seeking to achieve social, environmental and economic impacts, but which are not sufficiently profitable from the perspective of High Street banks.

As well as the issue of access to credit, there is a question about the appropriate design of products and services available to SMEs. For example, small ‘green’ companies seeking finance to decarbonise the economy need new financing products that can support their businesses across the enterprise cycle and are targeted to specific opportunities, such as energy efficiency (See Box A).[19] The British Business Bank finds the main reasons small businesses opt for a particular provider to be ease of application, most suitable option and long-term cost. A lack of tailored, good-value options may be one reason that the smallest businesses also often use personal loans to fund their businesses, rather than business products.[20] The Deane Review and the RSA have called for new, more flexible products to better serve the rising numbers of self-employed businesses (the smallest of SMEs) too.[21]

Measuring Supply of Finance: Official Data

The most comprehensive data to assess the supply of finance to SMEs is produced by the Bank of England, which, amongst other things, produces aggregated monthly data on bank and building society lending to UK non-financial businesses, and a quarterly Credit Conditions Survey.[22] This data is based on drawn balance information provided by the banks. Data on lending is also reported by participants in the

Funding for Lending Scheme (FLS) Extension. The British Banking Association provides monthly data on lending volumes, aggregates data to measure SME net borrowing, and publishes quarterly SME Statistics. The British Business Bank, established in 2014 to make finance markets work better for SMEs, also undertakes and commissions research and analysis to produce its annual Small Business Finance Markets report.

All this data underpins policy and banking decisions; yet, though invaluable, it does not provide the full picture. The UK does not run a comprehensive loan registry as some other countries do (though the Bank of England is running a pilot programme, based on data bought from Experian rather than collected directly from banks). Nor is the data from banks exhaustive. It does not, for example, capture approaches to banks that do not result in applications or loans whose terms are uneconomic for SMEs. This means that official statistics potentially overstate the degree to which supply is meeting demand. A further complication is that around a third of all financial products taken out by small businesses are taken out in the owner's name rather than that of the business, making it extremely difficult to capture as the transaction passes through personal, rather than institutional, bank accounts.[23]

An important finding of the BankingFutures dialogue is that the absence of complete and reliable data is a major obstacle to a comprehensive understanding of SME supply and demand for finance.

There are other sources of information about SME demand for finance, and there have been improvements in data collection. Nevertheless, recent Bank of England research concludes that there is room for significant improvement in disaggregated data collection to really understand what makes investment productive, and where and what finance is most suited to the task.[24] An important finding of the BankingFutures dialogue is that the absence of complete and reliable data is a major obstacle to a comprehensive understanding of SME supply and demand for finance. There is a need for better and more granular data on different types of SMEs, and how they fit together. And this is particularly true for the smallest SMEs, where the distinction between personal and business lending is often blurred. As will be seen, BankingFutures identified the following priorities to understand the SME investment gap:

- The need for better, centralised data collection and collation from banks and other sources of SME finance to get a comprehensive picture of supply and demand.
- The need for a more disaggregated definition of SMEs to better understand the varied policy, advice and protection needs of the sector.
- The need to address specific SME sectors where demand for finance is poorly met, including, for example, smaller SMEs, businesses in regions that are structurally under-funded, SMEs in the knowledge economy and those seeking growth capital, 'green' SMEs supporting the transition to a low carbon economy, and agricultural SMEs post-Brexit.

Four Priorities: Finance, Advice, Protection and Redress

Access to Finance

Supply

A growing number of people and institutions, including the British Business Bank, now point to the importance of diversity in the supply of SME finance, and there has been important growth in the number and types of alternative finance providers in recent years (see Fig 3).

Equity finance, asset and asset-based finance, and peer-to-peer business lenders are amongst the providers of alternative products and approaches to SMEs.[25] Responsible Finance (previously known as Community Development Finance Institutions, CDFIs) is also growing. This provides both interim and bridge finance to SMEs, as well as social finance (loans or grants made available on the basis of social purpose and outcomes, as opposed to return on equity or repayment with interest).

This diversity of business model is crucial in order to meet the range of needs of the SME market, particularly as banks experience size, commercial return and risk constraints on their ability to fully meet the needs of all SMEs. This has been especially true since the financial crisis, as regulatory requirements to de-risk bank balance sheets have made SME lending even more challenging. Other countries offer government subsidies or mandate national development banks to support SMEs. Some also mandate networks of regional stakeholder banks with an explicit social mission to serve markets that are unprofitable for large commercial banks. The UK market, by contrast, is almost entirely commercial, which brings with it the challenge of who is able to service riskier and lower-profitability business models. Better, more granular, data on SME needs would help identify who could do this and how.

Nevertheless, banks have historically been by far the most important source of finance

Figure 3: **Estimates of the flow and stock of external finance for UK SMEs £ Billions**

		2011	2012	2013	2014	2015	2016	
Bank lending stock £ billions *Source: Bank of England*	Outstanding Amount	189	176	166	167	164	**164**	*to end Nov 16*
Bank lending flows £ billions *Source: Bank of England*	Net flows	–	-6	-2	-2	2	**3**	*to end Nov 16*
	Gross flows	–	38	43	53	58	**54**	*to end Nov 16*
Other gross flows of SME Finance								
Private external equity investments £ billions *Source: Beauhurst*		1.28	1.49	1.53	2.32	3.58	**2.50**	*to end Sep 16*
	No. of reported deals	462	706	972	1309	1408	**880**	
Asset finance flows £ billions *Source: FLA*		11.4	12.2	12.9	14.4	15.8	**16.8**	*to end Nov 16*
Peer-to-peer business lending flows £ billions *Source: AltFi Data*		0.02	0.06	0.20	0.59	1.01	**1.31**	*to end Dec 16*

for SMEs, and continue to be so today. Many SMEs remain unaware or wary of alternative finance options, and the market is very static, with very limited appetite to switch providers.[26] The Competition and Market Authority's review into switching proposed a number of remedies to this problem, but even so, it is vital to ensure that enthusiasm for new entrants does not detract from the importance of ensuring that banks appropriately and adequately meet SME financing needs.

Bank Finance

A core purpose of the banking sector is to serve the real economy, and the big UK retail banks remain the main suppliers of finance to small and medium-sized firms. Banks today account for more than 80 percent of lending to business, with the big four High Street banks – HSBC, Barclays, Lloyds and RBS – holding 78 percent of loans.[27] These banks dominate the business current account market too, with a combined share of 83 percent in 2015.[28] Access to bank finance is particularly important for SMEs, which find it hard to access other sources of finance.

It is nevertheless true that in the past two decades bank business models have changed significantly, in ways that directly impact on their lending to SMEs. Regulators, banks and SMEs themselves are only recently waking up to this reality. In the years leading up to the financial crisis of 2007/08, as part of a general acceleration in lending, bank lending to financial and non-financial business sectors diverged.

Today, 75 percent of bank credit remains concentrated in loans to households, the largest share of which is mortgage lending.[29]

In business lending too, banks still show a marked preference for the property sector (which in February 2016 accounted for 30 percent of the stock of loans to businesses).[30] There has been, nevertheless, an increase in the stock of bank lending to other industrial sectors since 2014, with the distribution, transport and communication sectors seeing most of that growth in the past few quarters.[31] Likewise, the fortunes of SMEs have improved, albeit marginally.

The Persisting MacMillan Gap …

SMEs have always been challenging for banks. Nearly 90 years ago, the 1929 MacMillan Committee on Finance and Industry talked about the 'MacMillan gap', a reference to the gap between the demand and the supply of finance to SMEs. In 1976, former Prime Minister Harold Wilson chaired the Committee to Review the Functioning of Financial Institutions, which also tried to understand the relationship between banks and SMEs. In 1979, Martin Binks, researcher for the Wilson Committee, argued that the fundamental explanation for the persistent finance gap for small businesses is their high or unknown risk (still today, only 60 percent of SMEs will be in business after three years), which means they are not suitable for traditional bank loans.[32] Banks are concerned with capital gearing, which looks back at a firm's performance and the value of its assets. With little or no collateral, and no track record against which to measure the potential risks and opportunity an SME poses, alternative investment options may seem more prudent to a bank. This is exacerbated by the persistently flat yield curve, which in recent years has reduced the ability of banks to generate profits.

… Exacerbated by Changes to Bank Business Models

There is evidence that this long-term challenge has been heightened by recent changes to the banks' business models. Banks are commercial entities competing in the global marketplace and subject to investor expectations of return on equity. The sector has seen significant structural reforms in recent decades, including a great deal of consolidation and an increased focus on capital markets.

These changes have had a number of consequences, one of the most significant of which was a profound culture change in the relationship between banks and their customers, including SMEs. The use of technological expertise in financial intermediation (e.g. mathematics for complex modelling and data analysis) increased dramatically, and the resulting rise in data-driven assessments of clients has increasingly replaced

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For more complex transactions or significant financial decisions, even those customers who are happy to go digital retain an overwhelming preference for in-person service

human skills, experience and local knowledge.[33] These technological advances accelerated and facilitated internal culture changes in which employees felt encouraged to undertake aggressive selling – and at times mis-selling – of certain products such as Payment Protection Insurance (PPI) and Interest Rate Hedging Products (IRHP), and to illegally 'game the system', as was the case in exchange-rate and LIBOR fixing. Since then, encouraged by new leadership – and the very significant fines levied on them – banks have moved to address some of the more egregious of these behaviours.

New technology has also spawned the vibrant UK Fintech market, which is proving to be a gamechanger by introducing technology that speeds up processes, cuts costs and facilitates new forms of intermediation between lenders and borrowers. This is posing challenges and opportunities for banks on how to successfully collaborate and compete with new market entrants to persuade customers that the way they are using digitisation and automation is in the customer's best interests. The application of these new technologies can be tremendously positive. In mainstream banking they are being deployed for a range of uses, from alerting customers who are particularly vulnerable to changing interest rates, to advising people that they are about to go overdrawn, and helping them avoid penalties for doing so without authorisation. Technology is also a prerequisite for the Competition and Markets Authority's promotion of more switching between providers, which will only work if people trust the Application Programming Interfaces (APIs) that are designed to allow for a more personalised customer service.

When successfully and selectively applied, technology has the ability to challenge the perception of some SMEs that their relationship with banks has been 'dehumanised'. To do so, however, will require banks to address concerns about the loss of relationship managers with expertise in business development and investment (e.g. including how businesses work, the local economy, what makes for a successful entrepreneur), and the perception that branch staff are no longer able to exercise discretion as they are increasingly required to follow standardised criteria to make decisions. One impact of this has been a tendency for banks to focus on lending to larger, more profitable SMEs.

The decision to reduce the number of bank branches is underpinned by commercial reality, which requires banks to make difficult decisions about the allocation of limited resources.

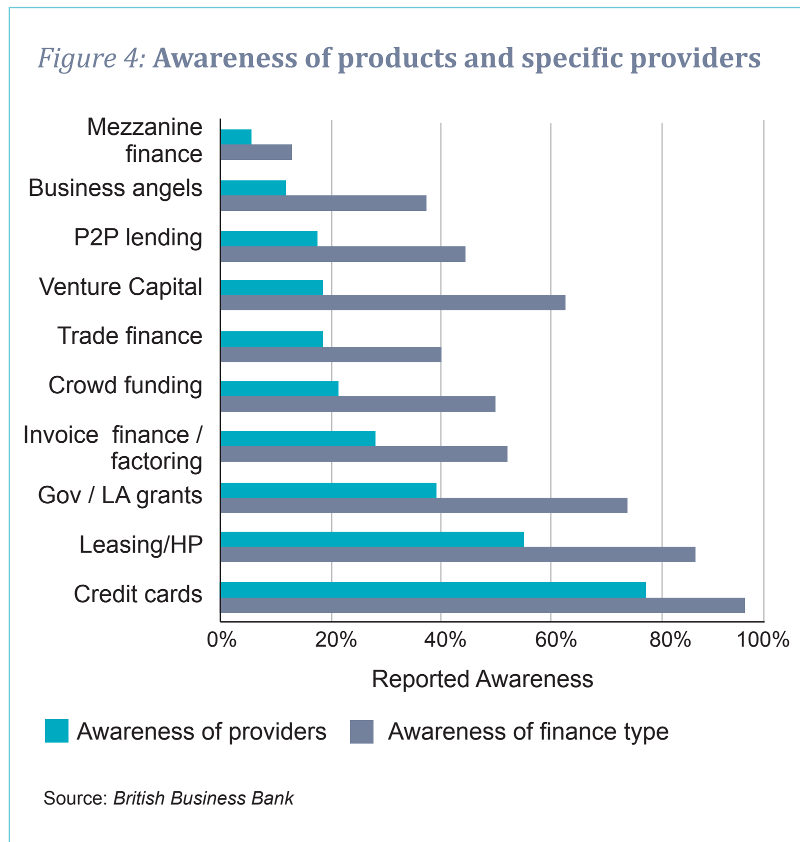
It will be necessary for SME customers to be convinced that the closure of local bank branches is not to their detriment. Many SMEs embrace the advantages of going digital, and business lending is not typically reliant on branches. However, for more complex transactions or significant financial decisions, even those customers who are happy to go digital retain an overwhelming preference for in-person service.[34] The loss of relationship managers has had a particular impact on loan applications which are not clear-cut and which require specialist knowledge of the local economy and soft data. It makes local and regional funding of SMEs even more challenging. Sixty-eight percent of SMEs say that a bank branch is important, with 66 percent citing its important role in discussing issues face-to-face.[35] FSB members also value the advice they can access in a branch.[36]

There are some SMEs – firms who operate day-to-day payment and cash handling services, and rural and seasonal businesses – for whom branch closures are particularly difficult.[37] The FSB finds that some small businesses struggle to access services online due to poor internet connectivity and a digital skills gap, and that they are concerned about security issues.[38] Some believe that moves to a cashless economy will solve this problem, but others urge caution and argue that more needs to be understood about data

protection, privacy, behaviour changes and financial exclusion before the choice of using cash is removed.

The decision to reduce the number of bank branches is underpinned by commercial reality, which requires banks to make difficult decisions about the allocation of limited resources. Banks have sought to address this by putting in place arrangements with the Post Office, to enable their customers to use transactional services in the 11,500 Post Offices across the country and thereby extend local and regional reach. While these moves are to be welcomed, campaigners caution that the Post Office itself is closing branches, meaning that it will not solve everyone's needs. With significant further bank branch closures in sight, the Access to Banking Protocol – an industry-wide agreement on how banks should go about closing branches – is important. Following criticisms from customers and civil society, its effectiveness at supporting continued access to banking and financial inclusion in communities where branches are closed is under review. Whatever the results of that review, it is clear is that where face-to-face branch services are not available, the success of all finance providers – and not just High Street banks – will be predicated on finding the balance between the technology and personal service that works for their customers.

Figure 4: **Awareness of products and specific providers**



Source: *British Business Bank*

Alternative Finance

Partly as a result of these limitations on High Street retail banks, and partly because new technologies have created opportunities for new market entrants, the alternative finance market for SMEs has grown rapidly in recent years, as has awareness of these new products (See Fig 4).[39] Importantly, family and friends remain the most common funding source for SMEs, but the alternative finance sector, though small today, already accounts for 12 percent of lending to SMEs and is growing rapidly.[40] Providers include the so-called 'challenger banks' – a few of which are focusing on the SME market – and other alternative providers, such as peer-to-peer lenders. There have also been a number of product innovations (particularly around payments and cash flow) driven by the rise of Fintech, which could result in SME needs being better served. There is some evidence that business current accounts provided by new entrants have higher satisfaction scores than those provided by larger, long-established banks.[41]

Alternative finance grew by 34 percent in 2016 (following bumper years of 2014 and 2015, when it grew by 179 and 79 percent respectively). Peer-to-peer (P2P) business lending amounted to around £1.3bn in 2016, compared to £54bn of gross bank lending to SMEs, while equity-based crowd funding is estimated to account for just over 15 percent of total UK seed and venture equity investment.[42] Some BankingFutures participants argue that recent regulatory capital requirements, which are extremely challenging for new businesses, are preventing SMEs from making faster inroads. Others are concerned that P2P lending has not been tested through the economic cycle, and that the sector remains worryingly unregulated.

Finally, there is asset-based finance, which typically, for a percentage fee, extends loans to SMEs on the basis of approved invoices or the assets held by the firm. Savings on administration costs and faster customer payments reduce the

cost of borrowing, and therefore reduce interest charges. Asset-based finance has grown from finance flows of £11.4bn in 2011 to £16.8bn in November 2016 and appears to be particularly important for smaller SMEs, as it often reflects the slow payment systems of the large corporations they serve. P2P business lending and asset-based finance have both weathered the impact of the EU referendum well, compared to equity and bank finance.

Equity Finance

The preferred form of finance for the vast majority of SMEs is debt finance – loans sought from banks or alternative finance providers. Despite this, there is a widely held view amongst some financiers that many more SMEs could and should be seeking risk capital. SMEs themselves are more wary. The reasons they choose not to seek equity include being unaware of options open to them, feeling unready for this type of finance, being concerned that they will be unable to secure favourable terms, and a reluctance to yield control of the company to outsiders.

Equity investment in the SME sector grew steadily from £1.28bn in 2011 to reach a peak of £3.8bn in 2015, before falling back notably to £2.5bn following the result of the EU referendum, which has affected all equity markets. The fast-growing Business Growth Fund (BGF) set up in 2011 and capitalised to £2.5bn by Barclays, HSBC, Lloyds, RBS and Standard Chartered, has succeeded in making loans to 165 SMEs across the nations and regions of the UK.[43] Despite this, awareness and take-up of equity investment remains starkly concentrated in London

The business models of CDFIs often allow them to accept a lower financial return, take on a higher level of risk, and frequently to apply 'social good' criteria to their lending.

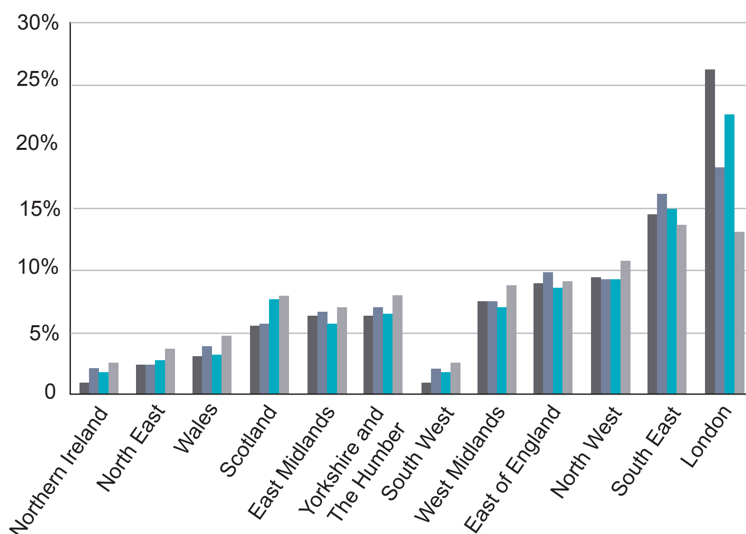
and the South East, which account for 58 percent of total deals and 68 percent by value of all equity investment. By contrast, the figure is well below 10 percent in almost all other regions, compared to debt lending, which is well spread.[44]

Responsible Finance/CDFIs

The Responsible Finance sector, previously known as Community Development Finance Institutions (CDFIs), plays a vital role in banking for the SME sector. Responsible Finance addresses the very real challenge posed by the fact that as bank finance has become more centralised, and local branches have closed, it has further increased the bias in funding towards London and the South East (see Fig 5). Responsible Finance providers are highly localised and have a detailed understanding of their local and regional economies. This allows them to assess smaller and often riskier businesses better than banks, and to ensure that vital funding is available in structurally underfunded regions of the UK. Their business models often allow them to accept a lower financial return, take on a higher level of risk, and frequently to apply 'social good' criteria to their lending.

Government statistical analysis does not attempt to capture data on the Responsible Finance sector, despite its importance to the economy, employment and social cohesion. While data about

Figure 5: **Proportion of total UK business start-ups, business population, gross value added and population by region**



Source: *British Business Bank*

the detailed needs of this part of the SME market is inadequate, there is clear evidence of the benefits Responsible Finance offers to the economy.

Representatives of the sector say they finance firms that are typically two to three years old (picking up those firms not covered by start-up capital), with 10 or fewer employees, and with loans of under £25,000. They say that they are able to finance those firms that are problematic for banks because their applications are projection-led (rather than based on a track record) and lack loan serviceability evidence (or where it can be evidenced, lack security to back it up). They argue that they are meeting demand for loans that currently do not show up in statistics, as the applicants do not go through the bank's formal appraisal process and are therefore not formally declined. They also claim to be meeting the finance needs of sectors, such as retail, that are particularly difficult for banks.

In addition to lending to these small businesses, Responsible Finance providers play a vital role in lending to micro-businesses and sole traders – one of the largest and fastest-growing segments of the Responsible Finance market (and of employment in the UK). The sector also provides finance to vulnerable and socially excluded individuals and small business owners, though the business model for this work is largely philanthropically funded.

In 2016, the sector lent over £100m to nearly 10,000 micro- or small businesses, creating or saving 15,000 jobs; and a further £116m to social enterprises, creating or saving 5,600 jobs.[45] Representatives of the sector are convinced that, were the capital to be available, there is massive untapped demand for their services. They used data to extrapolate that the theoretical unmet demand just in Yorkshire and Humberside three years ago could be as high as 1.4bn; and in Cornwall, local CDFIs believe they could increase their lending six-fold before demand is fully met.[46] Responsible Finance default rates are low due to providers' ability to respond flexibly to business cycles, and because their business models are sometimes cross-subsidised.

Responsible Finance providers very rarely compete with banks. Rather they step in and fill the gaps left by their larger, more commercial peers who face business model pressures and increasingly decentralised decision-making, which make smaller, riskier (and at times more localised) loans commercially unviable. Given this unmet need and the inability of banks to reach the businesses CDFIs can, BankingFutures unearthed ambitious hopes for the sector's role in future lending. This ambition, however, is challenging for a sector whose business models accept more risk, as CDFIs sometimes struggle to remain financially viable themselves.

For Responsible Finance to play a greater role in meeting the needs of smaller SMEs, several things need to happen. First, bank and Responsible Finance providers could work together more systematically. During the BankingFutures dialogue, many people pointed to an opportunity for banks to provide technical, infrastructure and human skills support to the Responsible Finance sector, and in particular to provide mentoring support.

There is also an opportunity for improved communications flows between banks and Responsible Finance providers about their respective understanding of demand for finance. Specifically, there is work to be done to improve communications on referrals; this includes the existence of platforms, such as Ask-if.com, which match small businesses that have been turned down by traditional lenders with Responsible Finance institutions. At present when Responsible Finance providers receive a referral from a bank, they don't know who it comes from or why it was referred. The same is true in reverse, leaving banks, CDFIs and SMEs to describe the current referral system as a 'black hole'.

The sector needs to be significantly better resourced if it is to meet the demand. Although lenders in the sector are often compared unfavourably to their CDFI cousins in the US – who have a much larger market share of small business and community lending – the comparison is unfair. At inception, the US funds were encouraged to invest heavily to build up a strong asset base to drive financial independence and sustainability. The government seed funding of the UK sector brought with it significant restrictions on how the money could be used, making similar investments impossible. As a result, the growth of US CDFIs has massively outpaced those of the UK.

To encourage additional investment into Responsible Finance, the sector could do more to demonstrate its own investment readiness. Although calls to align their processes are often rejected by Responsible Finance providers on the grounds that doing so would compromise their ability to respond to local

needs, the lack of comparability between providers discourages investment. A move towards creating common definitions, and at least some move towards more standardised reporting on lending by individual providers, would make it easier to attract investment while allowing providers to retain their local roots.

Finally, there is a role for government to work in partnership with others to provide much more significant support to this important sector. At a minimum, it can play an important role in gathering better data from regional bodies on their estimates of unmet regional demand. A more ambitious role would be for the government to build on the London Loan Fund, which encouraged significant bank investment by de-risking the investment for banks' own depositors.[iv] BankingFutures research and interviews identified some concrete gaps in SME financing. The British Business Bank is collecting important data about alternative finance, but its focus on assessing and supporting the supply of finance to SMEs that wish to grow, and not on 'steady-state' firms or Responsible Finance providers, may mean it is missing important unmet demand.

CASE STUDY: Green SMEs and the Real Economy

BankingFutures revealed segments of the SME market that have additional unmet financing needs. One example is the need for specific financial services for SMEs whose work supports the UK's commitment to transition to a low carbon economy. Building on interviews with 'green' SMEs and the work of the United Nations Environment Programme (UNEP) *Inquiry into the Design of a Sustainable Financial System*,[47] the dialogue discussed the role of banks and government in supporting a 'green finance agenda', designed: a) to support the provision of finance to allow conventional SMEs to improve their sustainability performance (what UNEP describes as 'green performers'), and b) to meet the needs of SMEs seeking to expand provision of green goods and services (UNEP's 'green innovators').[48]

Like other SMEs, green SMEs may be hindered by the sweeping definition of the sector that fails to capture their specific requirements for policy, products and services. At the same time, as official data does not seek to understand their specific needs, it is harder to cater for them. Finally, advice remains hard to come by, particularly for their business models. Also in common with other SMEs, green SMEs struggle to access finance at all stages of their lifecycle. Recent shifts in government policy, e.g. on the feed-in tariff, have led to further constraints.

From government, green SMEs want explicit commitment and greater local, regional and national policy consistency to encourage further investment in the sector. They would also like to be able to apply for different financing channels simultaneously. The establishment of the Green Investment Bank was seen as a particularly positive step.[49] However, its subsequent sale and privatisation was criticised for shrinking the pool of available capital and sending a signal from government that the sector was being de-prioritised. The additional withdrawal of tax incentives and renewable subsidies (e.g. in the solar industry) has hurt smaller businesses and led to the contraction of available capital.

From banks, green SMEs would like all banks to follow the lead of those that already integrate environmental risk into their commercial loan assessments and offer cheaper capital to green businesses (a trend many SMEs appear largely unaware of). Ideally banks would develop specific, well-publicised green finance strategies for SMEs, that offer products to support measures such as energy efficiency.

In highlighting the needs of green SMEs, BankingFutures revealed not only their particular requirements, but also showed that the process of disaggregating the needs of a sub-sector gives service providers and policy-makers clearer and more granular information that can be used to develop policy and products.

iv. The £5m London Loan Fund from Greater London Enterprise (GLE) supports established SMEs across London which have issues in accessing finance, with loans of up to £50k. The facility has been mostly drawn, and first annual repayments of £1.25m each have been made from profits on the loans, as bad debts have been well within the maximum forecast figure. Loan covered by EPMF European Guarantee and UK Enterprise Finance Guarantee.

Demand for Finance

The quarterly SME Finance Monitor, conducted by independent research consultancy BDRC Continental, is the most comprehensive, regular survey of SME demand and how these firms feel about their ability to access credit. In its most recent report it surveyed 4,500 SMEs, and reported a persistent reluctance amongst small businesses to use external finance.[50]

Although over three-quarters of SMEs have been described by the SME Finance Monitor as 'happy non-seekers' of finance since 2013, the British Chambers of Commerce describes this as 'discouraged demand'.[51]

The British Business Bank reports that the main financial products used by small businesses are debt products – loans, overdrafts and credit cards – and remain primarily sourced from banks.[52] Gross bank lending to SMEs grew year on year from the fourth quarter of 2014 to the third quarter of 2016, and now totals £54bn. Despite the increase in SME lending, there is a clear trend since 2012 of fewer smaller businesses using these products, with applications for new debt facilities falling to 6 percent in the first half of 2016 (down from 11 percent in 2011).[53] Of particular concern is the evidence that certain SMEs – young and growing firms in particular – face structural problems in obtaining bank loans. This may in part be explained by the view expressed by BankingFutures participants that digitisation and automation are making it difficult for banks to provide adequate feedback to those SMEs whose debt-funding applications are rejected, but whose businesses might qualify for alternative sources of finance.

Trust in suppliers and confidence in the market are both hugely significant drivers of (and brakes on) demand. One impact of the financial crisis was that significant numbers of companies found themselves at the receiving end of bank demands to rapidly pay back agreed overdrafts and loans, as this was a quick way for banks to de-risk their loan balances. The lingering legacy has dented SMEs' belief that banks would see them through bad times as well as good. This view has been compounded in recent years by the mis-selling and, in some cases, outright fraudulent and illegal behaviour concerning debt collection on insurance products.

Mistrust can also arise from a poor understanding of the economics of bank lending. Without understanding that their businesses are a risky proposition for which banks require adequate return, SMEs may perceive that they are not being given a fair deal. The generally low level of financial literacy in the country also affects SME demand for finance. It can contribute not only to a misunderstanding of the legal liabilities that being a company director might incur, but can also lead to a lack of understanding of business models and appropriate financing options. Where banks used to be a source of trusted advice, both bank conduct and regulation now prevent this happening.[54]

It is not only a lack of confidence in banks that appears to be dulling demand. SMEs are also worried about the general economic outlook, meaning they are reluctant to take on further liabilities and may also lack confidence in demand for the particular products or services they provide. Demand for credit from businesses of all sizes weakened in the third quarter of 2016, in part because of uncertainty related to the EU referendum result.[55] Although this has now recovered, many predict that demand will at best be volatile while negotiations on the nature of the UK's future relationship with the EU are taking place.

A truly reliable expression of demand would require an aggregation of loan approvals and – crucially – uptake, not only bank by bank but by alternative suppliers of finance as well. It would also include bank reports of rejections 'at source' – i.e. approaches to managers that never result in applications, as managers say there is no prospect of success. As with supply, the limitations on data availability and collation are leaving some people questioning whether these official attempts to assess demand provide a full picture of what is going on, especially as academic data would support the view that, for the size of the UK economy, SME investment demand should be much larger.

Access to Advice

SMEs need access to independent information and advice on a range of topics. Arguably the most important is advice to support them to ensure that their business is 'investment ready' – i.e. that the business plan is sufficiently compelling to merit consideration for debt or equity finance. Other important topics include:

- Finance (profit and loss, positioning of the balance sheet, when and where to obtain the right kind of finance).
- Business development and management (leadership and management skills).
- Risk management (to understand financing options, interest rate fluctuations, insurance options, etc.).
- Legal liabilities (including those incurred as a company director or in entering into contracts).
- Education about the risks and rewards associated with incorporating and not incorporating the business.

Widespread low levels of financial literacy in the country, coupled with the growth of micro- and nano-businesses, make the need for this advice even more compelling. Despite there being a great deal of advice in the marketplace, the closure of Business Link[v] means there is no longer a one-stop-shop where SMEs can go for the full range of advice. The situation is also complicated by the lack of clarity about when information (which can be freely given) becomes advice (which comes with legal liabilities and regulatory constraints).

In his 2015 report on the changing nature of business, the then Prime Minister's Enterprise Advisor, Lord Young, found that only 30 percent of small businesses take such external advice. This is partly because they are unaware (or unconvinced) of the benefits such advice would bring; partly because they are often simply too busy running their businesses; and partly because entrepreneurs often operate with an optimism bias that may militate against taking a precautionary approach.[56] A recent study shows that geographic location also plays a part, as does the nature of the business – newer entrants are more likely to seek advice than traditional sectors. The cost (or fear of the cost) can also be a disincentive.[57]

BankingFutures participants identified three specific and current concerns about SME access to advice:

- The need for advice on the impact that rising interest rates will have on their firms and how to manage growing debt. This is particularly important for newer firms which have only ever operated in a low interest rate environment.
- The need for advice about how to manage debt throughout the cycle of a business. There is currently a strong bias towards advice to start-up firms, and an advice gap for companies which have successfully survived the most difficult first two years of existence on how to manage future growth and develop into employers of the future.
- The urgent need for advice to nano- and micro-businesses, which rely heavily on personal bank accounts and credit cards to finance their firms, to help them understand and manage the potential impacts on their businesses of new data protection requirements.

There is no lack of information available, but it is complex to navigate. Former sources of trusted advice (such as bank managers, accountants or brokers) are no longer available. The inappropriate – and at times illegal – sales techniques that were damaging to customers have led to significantly tightened regulatory constraints on what advice banks can give to whom, and have combined with internal bank cost-cutting measures to reduce support services. This diminishing supply of advice is coupled with the significant growth in the number of self-employed and micro-entrepreneurs, who, it can be argued, have greater needs for advice than other SMEs.

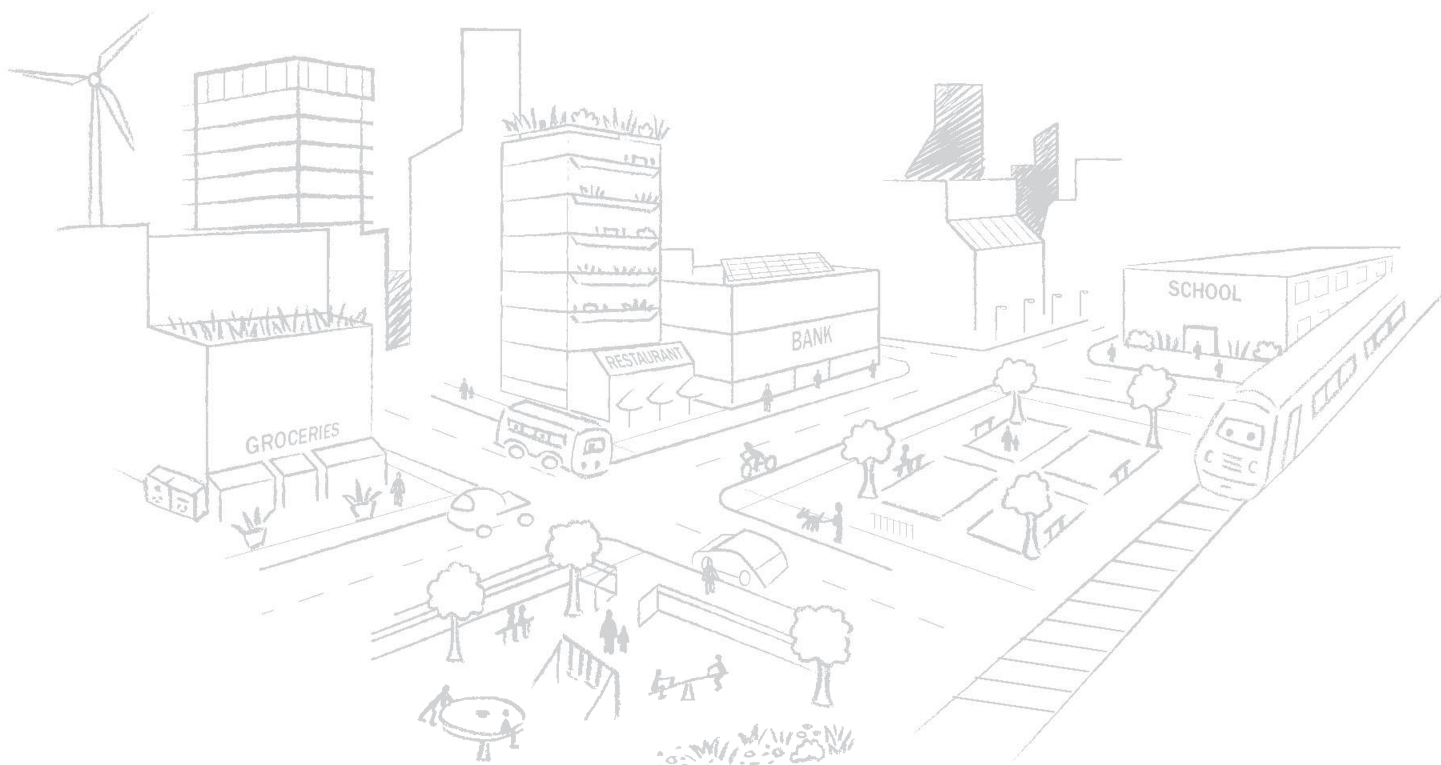
Some businesses interviewed in the BankingFutures process lamented the closure of Business Link, which was closed in 2011 after 19 years of providing national, centralised

v. Business Link was a government-funded business advice and guidance service in England. It consisted of an online portal managed by HM Revenue and Customs (HMRC) and a national telephone helpline. The network of local/regional advisors (under the auspices of the Department for Business, Innovation and Skills) was axed in 2011. The online portal was replaced (along with Directgov) by the Gov.uk website on 17 October 2012, although the telephone helpline was retained.

There is a difference between legal advice, for which the adviser has legal responsibility, and discretionary advice, which falls to the SME if there is an unfavourable outcome for the business.

and regional advice services to SMEs. A review of the programme shortly after it closed, argued that it was underused (only 20 percent of anticipated uptake) and consequently expensive. It also pointed to a clash of mindset between the public sector providers and entrepreneurial users. Its closure was also justified on the grounds that it was too focused on human interaction and not enough on digitisation. However, this final conclusion sits uneasily with evidence that one of the key SME requirements is for face-to-face advice (even though they may not have time for it!).

The provision of advice to SMEs is complex. There is a difference between legal advice, for which the adviser has legal responsibility, and discretionary advice, which falls to the SME if there is an unfavourable outcome for the business. Many SMEs do not understand that due to the nature of most contracts, advice they do receive cannot necessarily be relied in on law. Mentoring can play an important role in raising SME director awareness of issues, and much more could be done to encourage, support and enable people to find mentors.



Access to Protection

There is currently a debate about the extent to which SME directors can reasonably be deemed financially 'sophisticated' and whether existing protections are adequate to meet their needs. The Financial Conduct Authority (FCA), one of two statutory bodies set up to regulate finance after the financial crisis, has issued a consultation document on the topic, and there is now an All-Party Parliamentary Group on Fair Business Banking exploring ways to ensure that SMEs get adequate access to justice.

SMEs range from nano-businesses and micro-enterprises with little or no access to financial expertise or professional advice, to highly sophisticated larger companies with both in-house financial expertise and the ability to buy in further services.

The timing is in large part due to the campaigning efforts of a number of inexperienced small-business bank customers who have found themselves – and others – unprotected in the face of egregious mis-selling of insurance products or of fraudulent behaviours which have led to the loss not only of their businesses, but in many instances their homes as well.

The need to address the issue is made more urgent by the boom in sole traders and business start-ups since the financial crisis and subsequent recession; these are often set up by people with little or no previous business experience. British law makes it extremely easy to set up a business. All you need is a company director, a name and address, and a shareholder or two to agree the Memorandum and Articles of Association at Companies House. A full 96 percent of UK SMEs are now micro-businesses (including the subset of nano-businesses).[58] The Young Review of 2015 talked of a 'golden age' for small businesses. Driven primarily by their ability to reach customers through the internet, more people than ever before were turning their good ideas into viable businesses.[59] Though Lord Young heralded a change of culture, with growing numbers of people choosing to be their own boss, the reality is that many had no choice in the face of the economic retraction following the financial crisis.

Some people who set up their own firms are entirely new to business. Even those with business experience may have been employed in large corporations, which operate in a business environment of highly segmented, specialised divisions and competencies, very different to the 'Jack of all Trades' skills needed to run a small business. At the other end of the spectrum are those SMEs, including many small ones, run by highly successful and experienced serial entrepreneurs.

Further, SMEs' access to professional advice also varies widely. SMEs range from nano-businesses and micro-enterprises with little or no access to financial expertise or professional advice, to highly sophisticated larger companies with both in-house financial expertise and the ability to buy in further services. This disparity, which the broad definition of SMEs makes invisible, is further complicated by the fact that within the sector some smaller firms – accountancy consultancies, for example – may be better equipped to understand and manage financial risk than a much larger business – for example a pottery that employs 200 people, with limited accountancy skills.

Any provision to protect SMEs against risk needs to evaluate a complex set of trade-offs. These include: balancing the requirement for directors to take responsibility for the decisions they make, with an acknowledgement of the asymmetries of information and power between them and their financial service providers; ensuring that regulation does not further limit access to finance for a sector that is already struggling to obtain it; and guaranteeing that restrictions to protect vulnerable SMEs do not unnecessarily limit the ability of more sophisticated firms to access more complex and risky products and services.

Protection Against What?

SME representatives are often resistant to the idea of being seen as vulnerable, a term they think of as patronising or even derogatory. The very act of running a business brings with it uncertainty and opportunity, upon which many entrepreneurs thrive.

Nevertheless, there are two principal types of risks facing SMEs. The first is protection against fundamental business risks – such as exchange-rate fluctuations, the incapacitation of key staff in the business, and cyber-security risks.

The second type of risk from which SMEs need protection arises from the fact that the law considers large banks and small SMEs as legally equivalent. It does not take into account the information asymmetry between SMEs and those from whom they buy financial services; this leaves SMEs at best greatly disadvantaged in the relationship, and at worst vulnerable to manipulation and poor conduct.

The mis-selling of financial products, particularly derivative-based insurance products, and interest rate swaps are recent examples of this. Products originally designed for large, sophisticated customers were aggressively sold to smaller and smaller businesses in ways that were inappropriate, often poorly understood and sometimes illegal. Some such products contained contingent liabilities which placed risks on the customer's balance sheet and reduced their credit-worthiness because of the break cost of the loan. The discrepancy between the accounts sent to the bank, which did not reflect this unknown risk, could then be treated as a breach of covenant, allowing the bank to put the company into special measures. One consequence is that these loans are then sold on to private equity firms with a different culture to the originating banks.

This has had catastrophic impacts on some SMEs, and has provoked a rise in mistrust in banks; this in turn is likely to have significantly contributed to the problem of under-protection against basic business risk. While it is impossible to guard against criminal activities by individual employees entirely, bank managements can create organisational cultures that make it clear that there will be severe repercussions for people who choose to operate at the boundaries of what is ethically (and legally) acceptable. How they learn lessons and respond to victims of incidents such as these, is a vital part of embedding the bank's culture and communicating it to the public.

SME Protection Today

Although it often comes as an unpleasant shock even to seasoned business people, SME protection today is very limited. Lending to SMEs as a customer group in the UK remains largely unregulated. SME owners cannot turn to the FCA and so must rely on the good faith of banks, enshrined in (industry or individual bank) voluntary codes. Instead, the FCA regulates *products* that are bought and sold in ways that are designed to meet its mandate to enhance market integrity, promote competition and protect consumers. It is subject to various pieces of UK and EU legislation that use different definitions to determine who qualifies for specific types of legal protection or redress.[vi]

The FCA has just released a review of its mission.[60] This high-level document confirms what the organisation is set up to do, and what to expect of it. The vast majority of FCA protections today cover individual consumers, and protection of SMEs is limited to micro-enterprises. The term 'SME' does not occur in the FCA glossary, nor does its Handbook apply a single set of enterprise thresholds to its rules, though some do refer to 'micro-enterprise' or 'small company' or 'small business'. The FCA decides when to regulate following an assessment of the capability of the consumer as well as the complexity of the product or service, and, at the time of writing this report, appears not to view SMEs as vulnerable.[61] A recent FCA occasional paper on consumer vulnerability, which aimed to broaden understanding of vulnerability and to provide practical help and resources to banks in developing and implementing a vulnerability strategy, did not address the fact that 'vulnerable' currently only applies to individuals, not to companies.[62] The FCA Mission states that further consultation on vulnerability will take place in the near future.

It is therefore a significant challenge for SMEs to understand what is regulated, and which consumer protection is attached to which products. The FCA requires firms who undertake specific activities to

vi. The FCA uses the following terms:

- Micro-enterprise defines an enterprise which 1) employs fewer than 10 persons and has a turnover or annual balance sheet that does not exceed £2m.
- 'Small business' describes a firm with an annual turnover of less than £1m. The term SME does not appear in the FCA Handbook.

The EU definition, which some UK law adopts, includes:

- Micro-enterprise: fewer than 10 employees and an annual turnover (the amount of money taken in a particular period) or balance sheet (a statement of a company's assets and liabilities) below €2m.
- Small enterprise: fewer than 50 employees and an annual turnover or balance sheet below €10m.
- Medium-sized enterprise: fewer than 250 employees and annual turnover below €50m or balance sheet below €43m.

The UK Companies Act's definition for small companies is also used, which requires small companies to have a turnover that is not greater than £6.5m and a balance sheet with no more than £3.26m, and fewer than 50 employees.

Most SMEs only come into contact with the FCA when they are in trouble, and turn to the regulator expecting some form of protection.

seek and obtain authorisation to do so. Once obtained, the firm becomes a regulated firm, and those products or services for which authorisation was obtained are regulated products. This means they are subject to certain rules and standards, which have to be monitored and audited. However, being a regulated firm does not necessarily mean that all its products and services are regulated. Some may not be. It is important to note, however, that under the FCA's Senior Managers' Regime, regulated firms are now required to manage conduct risk and are closely monitored in relation to customer treatment and outcomes. As a result, an unregulated product sold by a regulated firm is now likely to be safer for customers than one sold by an unregulated firm. This benefit does not extend to products sold on to third parties who are unregulated.

For sales of regulated products, firms must comply with the FCA's Principles for Businesses. However, not all principles apply where the firm is providing products that are not regulated, and in some cases, certain products are not regulated when sold to particular types of SME. The FCA also has important, detailed Conduct of Business rules, which are taken into consideration in disputes. How these rules apply to a firm's dealings with SMEs depends on the products and services offered.

In recognition that some SME directors may not be financially sophisticated, and that SME vulnerability can be created by unscrupulous behaviours, the FCA is reviewing its role in protecting SMEs. MPs and lawyers are seeking to close what they describe as a protection gap in coverage for those SMEs that are larger than micro-enterprises (which get similar protections to individual consumers) and firms involved in disputes about complex products of over £50m in value, which require specialist expertise, or those which are deemed to reflect issues of systemic importance. The results of the FCA consultation on SMEs, launched in November 2015, are soon to be published.[63]

The consultation paper cites a number of reasons for increasing SME protection, including the fact that for most SMEs, purchasing financial services and pursuing claims and complaints are not core business operations. This means they get advice if they can afford to pay for it; but if not, they rely on non-expert, time-poor individuals without relevant industry or product expertise. It also acknowledges that, like individual consumers, the need for protection may arise from the fact that many SMEs have limited access to finance, reserves and the ability to diversify their investments, making it hard for them to withstand cash flow interruptions or major investment losses.

Most SMEs only come into contact with the FCA when they are in trouble, and turn to the regulator expecting some form of protection. They are then shocked – and often dismayed – by the limits on the FCA's mandate as they discover that they are not eligible for protection, or that regulation does not distinguish between the levels of sophistication of different users. For some, it comes as further bad news that it is legal for an unregulated product to be sold to an unregulated entity, removing previous protections and meaning that the new firm may operate entirely different standards to those of the original lender. BankingFutures identified the following significant protection gaps:

- Lack of protection for small and medium firms above the micro-business threshold that currently receive no protection from the FCA, and for whom the only recourse is through the courts.
- The gap that arises from the fact that conduct regulations are not applicable to some new lenders and players in the financial sector.
- The lack of protection when unregulated products are sold by regulated entities to unregulated firms.

Access to Redress

Despite their hugely different access to advice, resources and legal expertise, the law today views SMEs and banks as equal, and works on the assumption that businesses are more financially and commercially sophisticated than individual customers.

Voluntary Protections

When an SME gets into financial difficulties, its first port of call is the bank itself. High Street banks are investing to ensure that their staff are better at identifying SMEs at risk and are entering into early warning discussions to alert them to their options. This is a response to calls from within banks themselves, as well as from customers, for the reintroduction of a 'human touch' to dealings with SMEs, which supports middle managers to exercise discretion and provide appropriate support at two critical points in the interface between banks and their SME clients. First, the point at which local bank managers would like to use discretion on a range of issues – such as when and how to opt for innovation and digital services when a personal service is needed – based on their understanding of the local context and its implications for the business. Second, the point at which bank managers are faced with SMEs in difficulty.

In recent months there has been a growing recognition from individual banks and their associations of the need for change that encourages and rebalances the respective responsibilities of SMEs, finance providers and regulators, and to reflect this fact in contractual relations.

To address this, in March 2017 the Lending Standards Board – an industry body designed to promote fair lending through self-regulation as a credible alternative to statutory regulation – replaced provisions for micro-enterprises in its Lending Code with new 'Standards of Lending Practice for business customers'. The new Standards cover principles for lending, product information and product sale – including declined applications, product execution, credit monitoring, financial difficulty, vulnerability, portfolio management, and governance and oversight. Critically, the new Standards highlight the importance of ensuring that SME customers are fully aware of what they are purchasing, by providing key product facts – including covenants and break clauses – similar to the summary terms and conditions sheets now used for regulated mortgages.

Despite their hugely different access to advice, resources and legal expertise, the law today views SMEs and banks as equal, and works on the assumption that businesses are more financially and commercially sophisticated than individual customers.

The updated Standards,and the Charter it contains, have been welcomed by the Federation of Small Business for extending coverage across the business lifecycle, and for expanding coverage to include all firms with a turnover of up to £6.5m, rather than the previous restriction to micro-businesses.

The Standards are an important step to rebuild the trustworthiness of banks, and provide an opportunity for banks not just to adopt the Standards, but to actively embrace them by embedding their spirit into banks' cultures and processes. Some industry critics are withholding judgement until there is evidence of bank compliance, while others argue that the absence of any legal obligation to adhere to the Standards will make them ineffectual. Further, they argue that until the contracts that underpin transactions between banks and SMEs reflect the Standards (including the removal of basis clauses), they will not achieve their goal of rebuilding trust in the banks. They point to the fact that even with these voluntary standards, in the vast majority of cases – given the difference in legal expertise, access to advice and resources – banks and SMEs are not equal when entering into the original contract, nor when things go wrong. There is an opportunity here for the banks to show leadership and to demonstrate evidence of culture change in support of the customer.

Legal Protections

When voluntary measures fail, an SME in difficulty has very limited options beyond hiring a lawyer – by definition something they are usually financially ill-equipped to do unless they turn to a no win, no fee lawyer. The UK offers no equivalent mechanism to

the US Chapter 11 provision, which provides a three-month moratorium to allow companies facing insolvency to sort out their finances before action on loan defaults or other breaches of contract can be taken by banks. Once a firm is in trouble and put into formal insolvency, the process cannot be stopped. Individuals, whose livelihoods are on the line, lose all rights to information about what is happening – even when they are facing legal action and bankruptcy. The business is then in the hands of the creditor – i.e. the bank.

Compared to regulatory protection, legal provision for SMEs is relatively straightforward, albeit deeply unbalanced. Once directors incorporate their company – which they are actively encouraged to do by HMRC – the directors (often without knowing) forgo the legal protections they had as individual consumers. They enter the common law world of 'Caveat Emptor' or 'buyer beware', meaning the buyer bears the consequences of any contract entered into, even if the contractor acts in bad faith. Private persons have a general statutory right of action for damages under section 138D of the Financial Services and Markets Act 2000, but business clients must rely on claims under the general law and seek redress through the courts. Under the Caveat Emptor, the purchaser of a financial product (a loan, for example) who regrets buying it normally only has two courses of action: misrepresentation of fact at common law (as supplemented by statute); and negligent breach of a duty at common law to advise with care.

Under these circumstances, it is unsurprising that many SMEs do not make it to court, due to what are, by then, prohibitive costs. The few that do, do not fare much better. Some SME representatives argue that they are in a 'David and Goliath' situation when it comes to legal redress, as in a dispute, banks have the financial resources to draw out the legal process until the SME capitulates. They argue that banks can be reluctant to provide access to case notes, and have a disincentive for disputes to come to court because they wish to avoid precedent or case law being met. Some bank representatives refute these claims, arguing that banks do not want extended processes. Although legal reforms are intended to result in courts favouring conciliation and settlement, SME representatives say they do not see this happening at all, and remain convinced of the need for arbitration and conciliation to be legally binding. For its part, the FCA has acknowledged that courts may still expect businesses to be more financially and commercially sophisticated than individual consumers, even when they are not.

A further problem for SMEs is that some banks may seek to limit their potential general law liability to SME customers through contractual terms, and many law firms that do business with the banks have clauses in their contract that prevent them from taking action against the bank.[64]

The Financial Ombudsman

An important part of the FCA's mandate is to ensure that consumers can obtain cheaper and faster redress than they would through the courts. While the FCA cannot take action with respect to breaches of voluntary codes, such as the banks' Lending Code, or compel firms to adopt them, its Financial Ombudsman Service (FOS) can take such breaches into account. The remit of the FOS is, however, limited to the complaints of businesses with a turnover of less than €2m and fewer than 10 employees (micro-enterprises). The current binding award limit is £150,000, although at times banks can and do pay more.

In theory, the FOS offers a faster and less formal alternative to the courts. In practice, for many SMEs it falls short of these goals. In particular, to get access to information requires SMEs to follow an expensive process of discovery, which leads to a court judgement on whether the SME has a good or bad case. These concerns over costs, delays and the current eligibility threshold have led to calls to reform the FOS. In 2013, the Parliamentary Commission on Banking Standards recommended that the FCA consider changing the eligibility criteria of FOS. The British Banking Association is calling for small businesses with a turnover of up to £6.5m to be eligible to access FOS (they think this would cover 97 percent of SMEs).

More recently, the All-Party Parliamentary Group on Fair Business Banking has argued that even making these changes will be too limited. It points out that all SMEs with more than nine employees are in need of protection, as they are the ones that have fallen victim to unscrupulous restructuring departments. Further, it indicates that though only 3.7 percent of SMEs are not covered by the FOS, the small percentage hides the fact that they represent an enormous amount of economic activity; they employ 67 percent of the workforce in private enterprise (17 million people), and generate 82 percent of the

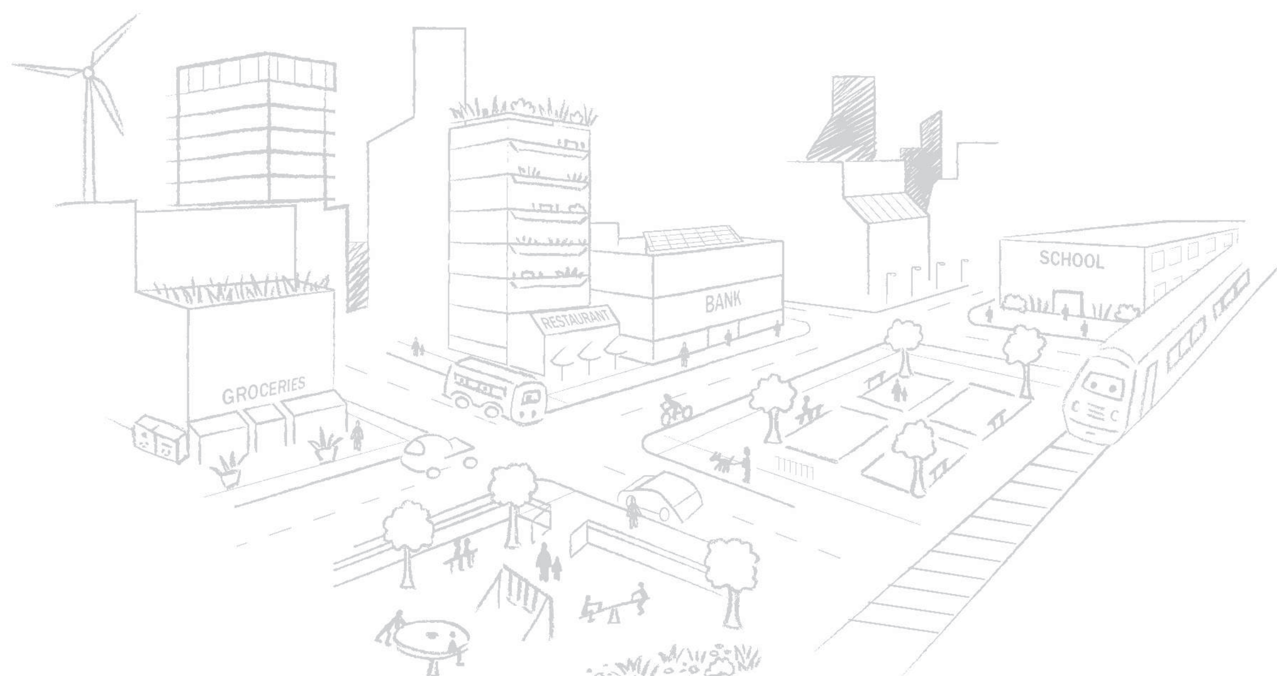
sector's total turnover (£2.9 trillion pounds).

The Ombudsman's 2017 annual review concludes that it has been working more flexibly and resolving complaints more quickly than ever before, resulting in growing numbers of people giving more positive feedback. Unfortunately, however, partly due to its limited remit, the Financial Ombudsman does not command high levels of trust amongst many SMEs, who argue that the FOS lacks the knowledge and sophistication to deal with complex financial disputes. Therefore, they are seeking an expert judicial platform that offers them access to justice, in a simple, timely and free (or at least affordable) manner. Such a body, they argue, needs to be tasked with dealing with regulated and non-regulated cases and empowered to exercise its discretion about settlements, and its rulings should be binding (unlike mediation). As a result, BankingFutures has identified the following gaps that need to be addressed to ensure that SMEs have access to justice:

- The need for a fair system that addresses the information asymmetries and power imbalances between SMEs and their finance providers.
- The need for affordable redress that is within reach of SMEs, even when facing financial difficulties.
- A dispute-resolution mechanism that:
  - Carries out its duties in an expeditious way.
  - Is legally binding and able to create case law.
  - Is mandated to handle both regulated and unregulated asset cases.

Conclusion

The BankingFutures dialogue on the real economy concluded with a 'call to action' to government and banks to address the four priority issues identified in this report. The following recommendations outline what could be done to support SMEs in the UK at this unique point in its history.



Banking Small Business
Recommendations to Banks

RECOMMENDATION ONE:

Banks to provide more precise data and more narrative information on SME lending to the British Business Bank

i. Banks to provide the British Business Bank (BBB) with more data on loans, including loans requested, terms of outcome and drawdown in aggregated debt lending reporting, and requests for finance to allow SMEs to improve their sustainability and/or to expand provision of 'green' goods and services.

ii. Banks to introduce data collection processes to assess and understand the use of personal products for business use, and to make subsequent data available to government.

iii. Banks to work with the proposed government-convened Multi-Stakeholder Advisory Committee (see Recommendations to Government, below), set up to define what data points to use and to review the collection and collation process.

iv. Banks to provide narrative reports to the BBB on how the SME finance market is working.

v. Banks to augment efforts to understand the needs and opportunities in the Community Development Finance Institutions (CDFI)/Responsible Finance market by supporting the BBB to develop techniques to collect data, and informing the BBB about the referrals they make to CDFIs/Responsible Finance institutions. This should include the nature and size of loans referred, and to which CDFIs.

RECOMMENDATION TWO:

Banks to articulate a coherent strategy to address local and regional SME needs

i. All banks to provide clear and easily accessible information to SMEs about where and how credit decisions are made within the bank, and by whom.

ii. High Street banks to develop internal strategies to ensure that branch closures are accompanied by clear communications to current and potential small business customers about the financial service options – including Fintech options – that remain open to them, and how to access them.

iii. All banks, irrespective of business models, to contribute to ensuring that underserved communities retain or obtain access to banking services and financial inclusion. This will include working with the Post Office where it provides bank services; special provisions in places where bank services are no longer available; and a transition plan for businesses that are heavily dependent on cash.

iv. Banks to raise awareness of and improve access to 'green' financial products and services.

v. Banks to work constructively with Responsible Finance providers to ensure wider coverage of underserved customers and market segments, by:

a) Exploring how referral processes are currently working; and based on the findings, developing more robust processes.

b) Seconding bank staff and providing mentoring on request to Responsible Finance providers to strengthen their capacity and skills base.

c) Actively supporting government initiatives to encourage investment into Responsible Finance organisations that is sufficiently de-risked for banks to protect their own depositors.

RECOMMENDATION THREE:

Banks to introduce measures to support SME access to advice and improve investment readiness

i. All banks to continue to develop and make available user-friendly digital and online tools on SME lending eligibility criteria, and what constitutes investment readiness for the bank.

ii. Banks to develop diagnostic tools and offer personal feedback to SMEs on why loans are declined (e.g. lack of confidence in management, unconvincing business model) and what management might do to address this.

iii. Banks to develop packages that alert SMEs to availability of existing advice programmes on:

a) Financing options, including different types of loans, equity options, and how to distinguish their financial needs and evaluate the appropriateness of various forms of capital for initial funding.

b) Where to go for advice when the business is in financial difficulty.

c) How to approach and apply for working capital for growth.

d) Sources of finance available to support sustainability performance.

e) Sources of social investment advice, such as the Big Potential Fund of the Big Lottery Fund.

iv. All banks to systematically refer SMEs to a newly created British Business Bank Small Business Interactive Advice Platform (see Recommendations to Government, below), and to provide practical support to this government initiative, e.g. through secondments.

RECOMMENDATION FOUR:

Banks to introduce new internal protection thresholds and procedures

i. All banks to sign up to and adhere to the Lending Standards Board 'New Standards for Lending Practice' for business customers in the following ways:

a. All banks to comply with the spirit of the Standards for Lending Practice by introducing simplified lending agreements in the form of a standardised lending contract, which allows SME customers to compare indicative offers between banks, and includes a one-page summary of the main components of the deal.

b. Banks (including challenger banks) to commit to develop internal processes which embed the spirit of the Standards into their culture and into the structures that underpin decision-making.

c. Banks to support the publication of an annual Lending Standards Board 'State of the Nation' report on compliance with the New Standards for Lending Practice.

d. All signatories to the Standards for Lending Practice to commit to ensure that any contracts reflect the commitments in the Standards.

ii. All banks to introduce new internal SME thresholds (guided by Standards for Lending Practice, which recommends a threshold of £6.5m turnover), signalling the need for specific management training, monitoring and evaluation in dealings with firms below the specified threshold.

iii. All loan agreements with SMEs to require customer consent when the loan is established, for the loan to be sold on to other entities.

iv. Banks to cease using confidentiality agreements where their use could impede whistle-blowing or the development of policy or appropriate law.

Successful Implementation

To be effective, these recommendations will need to be adopted by individual banks. However, the creation of UK Finance (which brings together multiple providers of finance to SMEs, amongst others) presents a significant opportunity to provide sector-wide support for the BankingFutures recommendations. This could take the form of liaison with the FCA and SME representative bodies to convene multi-stakeholder roundtables designed to enhance data collection to fully understand the needs of the sector and oversee reporting on the uptake of BankingFutures recommendations.

Banking Small Business
Recommendations to Government

RECOMMENDATION ONE:
Government to support enhanced data collection

i. Government to extend the mandate of the British Business Bank (BBB) to become the centralised, independent, credible and trusted body charged with collating anonymised data from all banks and other finance suppliers, and with ensuring that data is analysed in a way that supports the development of appropriate policy to support SMEs.

a) Government to set up a Multi-Stakeholder Advisory Committee to establish what data points to use and to review the collection and collation process. The Committee should include representatives of Responsible Finance, alternative finance and banks. A bespoke advisory board or committee should be created to ensure that the specific aims and needs of the CDFI/Responsible Finance sub-sector are met.

b) Government to provide the BBB with sufficient resourcing, including mandated support from the Office for National Statistics, to undertake data collection of supply and demand for SME finance, including peer-to-peer lending, alternative finance, CDFI/Responsible Finance, 'green finance' and postcode-level data.

c) Government to task BBB to identify data gaps that obscure discouraged demand, including collection of complaints, and to work with finance providers to identify credible sources of relevant information. This is likely to include a breakdown of loan applications between sectors (e.g. commercial property, intellectual property investments).

RECOMMENDATION TWO:
Government to support SME access to finance through provision of incentives as well as support for bank investment into the Responsible Finance sector

i. Government to provide future incentives to banks to lend, such as via the Funding for Lending/Term Funding Scheme and/or by refining capital requirements pertaining to SMEs. These incentives to focus particularly on areas of market failure.

ii. Government to actively encourage further take-up and extension of the Enterprise Finance Guarantee, and/or create a vehicle to encourage lending and investment into Responsible Finance providers, by providing a guarantee against loss and a commercial return to banks in order to protect bank depositors.

iii. Government to fund an investment readiness project for the Responsible Finance sector in anticipation of the above funding. This investment readiness project should be designed to encourage:

a) Agreement within the Responsible Finance sector to use common definitions on key metrics, such as loan loss and default rates.

b) A limited but standardised template that encourages common reporting, so that investors may better compare the financial health of Responsible Finance institutions.

c) Responsible Finance organisations to obtain independent ratings on financial viability to encourage investment readiness.

iv. Government to extend the Enterprise Finance Guarantee (EFG) to green finance.

RECOMMENDATION THREE:

Government support to improve SME advice services

i. Government to expand the mandate of the British Business Bank (BBB) to create a Small Business Interactive Advice Platform. This one-stop-shop would be a platform on which small businesses can obtain business development, risk management and legal advice, as well as financial advice from multiple sources. The Business Finance Guide should sit on this platform.

a) The BBB to develop interactive capabilities for its platform, including peer-to-peer advice and chat facilities on commonly used platforms (e.g. LinkedIn) to allow small businesses to exchange information and advice about key challenges they face.

b) The BBB to improve communications with target SME audience by using video, graphics and animation to promote ease of use.

c) The BBB to work with banks, alternative finance providers, accountants and CDFI/ Responsible Finance providers to develop 'white labelled' (i.e. non-branded) advice on a range of issues on which government and finance providers anticipate demand in the near future, e.g. interest rate rises.

ii. Government to fund these enhanced, centralised BBB capabilities with savings made from funds currently invested in multiple diverse offerings.

RECOMMENDATION FOUR:

Government to introduce new protections for small businesses

i. Government to agree a new definition of self-employed and micro-businesses (SEMs).

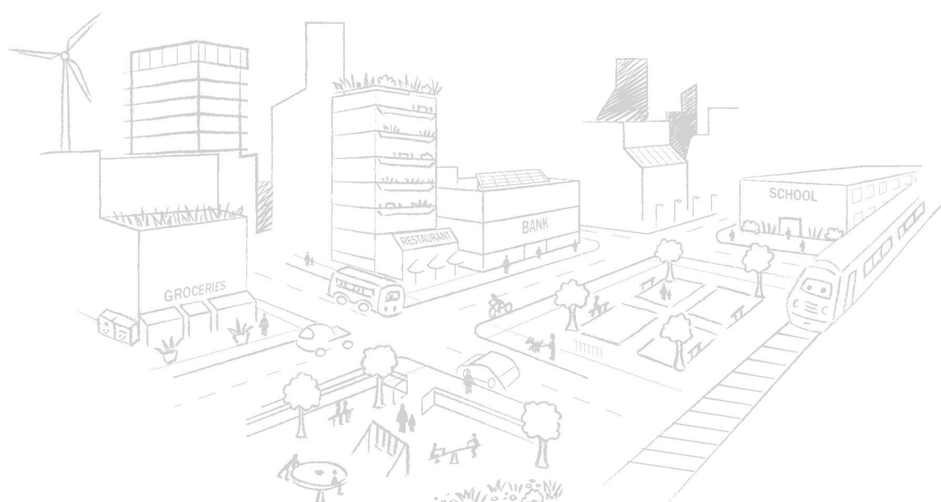
ii. FCA Handbook to extend FCA retail customer protections to SEMs falling below the £6.5m turnover threshold.

iii. Government to require banks to use standardised charging terminology and include a one-page summary in SME contracts.

iv. Government to forbid sales of certain products (e.g. those that contain embedded hedging products) to SEMs, unless they specifically opt in to have access to them.

v. Government to introduce new regulatory Transfer of Undertakings (TUPE) to cover onward sales of contracts, similar to those that apply in employment law, whereby the product that is being transferred (sold on) is subject to the original conditions of sale.

vi. Government to introduce a statutory duty of care to ensure that SMEs are given appropriate advice and protected from negligence or economic harm as a result of their contractual relations banks.



RECOMMENDATION FIVE:

Government to introduce new redress measures for small businesses

i. Government to introduce a new Financial Arbitration Service that is fast, affordable and available to all, by meeting the following criteria:

a) Fair – set up to address the information asymmetries between SMEs and their finance providers (including the fact that insolvency law favours the creditor) and the power imbalances between them.

b) Affordable – within reach of SMEs, even when facing financial difficulties.

c) Fast – carries out its duties in an expeditious way that does not leave SMEs facing uncertainty and long delays.

d) Legally binding – able to create case law.

e) Comprehensive - able to handle both regulated and unregulated asset cases.

Two ways to achieve this goal are under discussion at the time of writing. The first is to scale up and expand the remit and resources of the Financial Ombudsman to cover cases of companies under the new protection threshold of the Lending Standards Board (£6.5m turnover). The other alternative is to create a new Financial Tribunal, as proposed by the All-Party Parliamentary Group on Fair Business Banking, funded by all providers of banking services to SMEs.

Successful Implementation

The Development of an Effective SME Legislative Strategy

The above recommendations can all be implemented separately by extending the mandates of existing government bodies and by building specific SME provision into finance bills that are already planned. However, given the multiple, interdependent and partially met needs of SMEs, and of smaller SMEs in particular, and the role this sector of the economy will need to play post-Brexit, BankingFutures proposes that the government include specific SME provision in the Industrial Strategy and consider the introduction of a Small Business Financial Services Bill as soon as the legislative agenda permits.

BankingFutures Participants

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Robert Swannell	Chairman	Marks & Spencer
Bob Wigley	Incoming Chairman	UK Finance
Stuart Woollard	Managing Director	Maturity Institute
Farida Yesmin	Chief Executive	Limehouse Project

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