Market solutions for SMEs lending in the UK

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Abstract

This Q&A section starts with the description of the impact of bank regulation on SMEs lending, stressing the urgency of dealing with the issue of Non-Performing-Loans. It then discusses the solutions adopted, and their working mechanism, in the UK to overcome the informational barriers that limit SMEs access to finance.

Questions on the reform of bank regulation and SMEs' financing

Will new regulations reduce the incentive for banks to finance SMEs (e.g., risk weighting)?

Recent European proposals will result in increases in risk weight for SME lending. Ultimately the cost of the additional capital that will require to be held by lenders will result in an increase in cost of debt for such entities, otherwise, it will be value destructive for the lending banks and will not be sustainable in the longer-term. However, one of the main challenges in lending to SMEs is that they are inherently heterogeneous and therefore require more in-depth analysis to understand sufficiently well to assess their creditworthiness. As they do not lend themselves to standardized methods, it makes it more costly for banks (or any lender) to offer a lending service to SMEs if the bank is to conduct its activities

56. Pollen Street Capital

safely and soundly. Attempts to standardize the approach through credit scoring systems go some way to standardizing the approach but there are fewer opportunities to remove judgment and experience completely and hence cost of the underwriting process is greater. This cost will necessarily be passed on to the SME borrower. New tools are being created that permit standardization of analysis of information from SMEs. These will go some way to reduce the cost of underwriting and hence the cost of debt but are unlikely to remove judgment completely.

Will some sectors and/or countries suffer more than others from the impact of new bank regulations on SMEs' financing?

Those businesses that do not have real estate or other tangible assets with readily realizable value may find it more difficult to attract funding. The use of specialist equipment and machinery in the manufacturing sector could make it more difficult to attract debt funding also.

Will European banks be able to face the problems of non-performing loans without public support or some forms of public/private coordinated actions?

Loss rates in lending to SMEs are significantly higher than those related to other forms of lending e.g. real estate or consumer debt. There are three main ways to address this:

1. Conduct significant in-depth analysis so that only the best SMEs are granted credit. This is administratively expensive and excludes the vast majority of SMEs from access to credit;
2. Increase the cost of debt to fund the higher loss ratio
3. Or, public support through guarantees for the losses such that the public sector is subsidizing the true cost of debt to the SME community.

However, there is a question as to whether this is sustainable in the long term. In many cases the SMEs require equity capital rather than loans where they cannot meet the payment terms and fostering and supporting an environment where equity capital is available for SMEs may be a more sustainable solution long term.

Would it be possible to promote the creation of a European market for non-performing loans?

The market for NPLs is extremely international already. The key players have European and, often, international, franchises and they are able to apply their skills and knowledge to different jurisdictions where the returns are sufficiently attractive to attract the capital and resources.

Questions on information asymmetries, risk taking, risk diversification and the role of the public sector

Is there a corporate governance problems for SMEs, limiting the willingness of arm's length investors to buy their equity and debt, and can they be solved with adequate policy interventions?

Low levels of corporate governance can be prevalent in SMEs due to the historic ownership of these entities. In many cases, individual founders, family members have created the businesses with limited focus on standardization or transparency of information. In some respects, the lack of standardization of information is as much of a hurdle as lack of transparency. New tools are being created that will enable banks and other financial information to extract data from SMEs on a standardized basis. This would enable external investors to have greater confidence in the information provided and it will be more efficient for them to analyse between companies. Formalisation of corporate governance could improve the quality of information from SMEs but it will come at a cost to the SME directly and this has to be assessed against the improvement in funding that could be achieved.

What might be the role of the public sector and of collective guarantee schemes in reducing information asymmetries and/or riskiness?

Collective guarantee schemes can certain increase the funding into certain markets. They can enable banks and other lenders to expand their risk appetite and to adopt a less selective or prescriptive approach in the absence of information or information in a standardised form.

Are small banks better at financing small firms?

There is no inherent advantage that small banks have to understand SMEs over large banks. However, given the non-standard nature of SMEs, it can be the case that smaller banks have a more familiar and personal approach which enables them to understand the particular aspects relevant to an SME that enable them to make an individual judgement that is appropriate for the SME. The question is always how to scale the availability of credit to SMEs in a way that is cost efficient to deliver.

Questions on SMEs' alternatives to loan financing and the role of banks in promoting the market for equity and debt

What alternatives to bank financing of SMEs (trade credit, venture capital and new sources of funding such as peer to peer lending and crowd funding)?

There are a number of sources of lending being created that offer an alternative to bank lending, but each of them have the same challenge of how to efficiently assess entities which are inherently heterogeneous. These new platforms do offer funding where the banks will not do so, but such lending does come at higher than "standard" bank terms. They are charging rates that reflect the true cost of assessing SMEs and of the loss rates associated with such lending.[57]

In the UK there are a considerable number of emerging alternative lending businesses. These comprise peer-to-peer platforms as well as non-bank lenders, and offer a broad range of products types including unsecured and secured term loans, invoice finance, asset finance, trade finance, merchant cash advance, and other specialist forms of finance such as pension-led funding.

Where the SME is borrowing for short term working capital purposes, typically where funding is required in a matter of days, interest rates offered by lenders such as Iwoca, Ezbob, Fleximize, and Capital On Tap are typically 2-7% per month. Whilst these solutions are neither designed to be nor typically used as longer term financing options, borrowing at such high rates can still be economic for the SMEs. It enables them to cover short term adverse swings in cash flow, or meet payroll and other required expenses, without the need for further equity capital.

Several new specialists, such as those mentioned above, are attempting to use technology to overcome some of the traditional barriers to SME lending. These firms draw upon new sources of information on business performance that are instantly available, and subsequently can make rapid and more automated lending decisions. These information sources may include governmental divisions

57. See Figure 1 for a detailed list of institutions active in the UK SMEs loan market.

such as HMRC and the land registry, ecommerce companies such as PayPal, Amazon and eBay, and other information and analysis providers such as credit reference agencies or other service providers such as Yodlee. These sources are all capable of transmitting data on SMEs rapidly to the lender (with the SME's permission) in a standardised format, to enable the lender's decision. By utilizing technology in this way, in both data gathering, analysis, and underwriting, lenders are becoming able to reduce the overall cost of making a lending decision through increased process efficiency.

These new institutions are regulated by the Financial Conduct Authority (FCA), which introduced legislation limiting the rate that could be charged on "high cost shorter term credit", set at 0.80% per day.

In cases where loan terms are longer and the funds are not required within a very short time period (thus allowing for a more detailed underwriting process), rates are generally available in the 7-15% per annum range on an unsecured or secured basis from non-bank lenders including Funding Circle, Funding Knight, GLE, Growth Street and OakNorth. This compares to rates of c.3-5% over LIBOR for SMEs managing to obtain finance from a major UK bank (source: Bank of England).

These specialised institutions operate differently than standard banks as, generally, they will accept risks that the standard banks won't, for example smaller or newer companies, or companies with less stable financial profiles, in exchange for higher interest rates. They are mostly online offerings backed by a call centre team, due to the reduced need (or ability) to incur overheads associated with large scale branch operations.

Are there regulatory impediments to the development of a market for equity and debt of SMEs arising from the regulation of banks, pension funds, life insurance companies and other financial institutions?

Generally no. Lending to SMEs generally requires less regulation than to consumers. It is the difficulty of being able to build an efficient, scalable model that is the largest impediment.

Is there a role for banks in promoting a market for equity and debt instruments for SMEs?

The banks could support a market for lending to SMEs. In the UK, there is a project being run by HM Treasury and the British Business Bank which will require mainstream lenders who have declined an SME to offer that SME the opportunity for their details to be passed to one of 4-6 nominated platforms. The aim is for these platforms to facilitate the matching of these SMEs to the most appropriate small business lender. This seems like an efficient approach, as it encourages SMEs to continue their search for finance beyond their traditional high street bank, and provides an efficient channel for alternative finance providers to access SMEs who are actively in the market for their products. The platforms themselves may also play an important role in educating SMEs as to their various options, and impartially helping them select the most appropriate provider from a "whole of market" population of lenders.

How to these platforms function, and who are the participant on the lending side?

At the moment, these platforms have not been formally designated, so it is not clear how they will function. We believe the primary candidates at this stage are existing online SME loan brokerages. It is envisaged that formal designation of the platforms will take place before the end of 2015. Based on the draft legislation[58], any SME lender would be technically eligible to access details of declined customers for the purpose of offering them finance. We would anticipate that the participants mentioned above would seek to access these customer leads.

Whilst banks face regulatory and technical issues in implementing schemes such as this, making the extra effort to help their SME customers via promoting new markets in which they could find finance could also benefit banks in the long run. Customers are more likely to maintain their everyday banking relationships with a provider who is seen to have provided good customer service, rather than simply saying "no". Additionally, helping their customer find funding for growth may well lead to increased procuration of services from the bank in the future – including those lending products which at present are out of reach. As such there is not simply a role for banks to play in promoting markets – there are benefits to them doing so.

58. The Small and Medium Sized Business (finance platforms) Regulations, 2015, available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/389210/The_Small_and_Medium_Sized_Business__Finance_Platforms__Regulations_2015_Regulations_draft_statutory_instrument.pdf

Figure 1 – The UK Unsecured – Short Term SMEs loan market

Company	Interest Rate (annual)		Interest Rate (monthly)	
	Low	High	Low	High
Ashley Business Finance	60.0%	72.0%	5.00%	6.00%
Capital On Tap	9.5%	88.8%	0.79%	7.40%
Credit4	N/A	30.0%	N/A	2.50%
ezbob	18.0%	60.0%	1.75%	5.00%
Fleximize	36.0%	48.0%	3.00%	4.00%
Funding Circle	6.0%	11.0%	0.50%	0.92%
Funding Knight	8.8%	12.0%	0.73%	1.00%
GLE Business Loans	5.0%	16.0%	0.42%	1.33%
Growth Street	8.0%	15.0%	0.67%	1.25%
iwoca	24.0%	72.0%	2.00%	6.00%
Just Cashflow	18.3%	146.0%	1.52%	12.17%
Merchant Money	24.0%	24.0%	2.00%	2.00%
Ultimate Business Cash	18.2%	18.2%	1.52%	1.52%

Source: *these figures provide a partial overview of unsecured – short term SMEs loan in the UK. The information provided are collected from the company's website, with the exception of Ashley Business Finance and Fleximize.*