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Treasury Committee
House of Commons
London
SW1A 0AA

29 March 2017

Dear Sir / Madam

SME finance inquiry

The Financial Services Consumer Panel is an independent statutory body. We represent the interests of individual and small business consumers in the development of policy and regulation of financial services in the UK. In 2015 the Panel set up an SME network to understand better the needs and concerns of small business users of financial services. We welcome the opportunity to respond to the Treasury Committee's inquiry into SME finance.

SMEs are vitally important to the UK economy. At the start of 2017 there were an estimated 5.7 million private sector businesses in the UK. Almost all (99.3%) were small businesses (0 to 49 employees) with the vast majority of these being microbusinesses (0-9 employees), while 99.9% were small or medium-sized (SMEs, 0-249 employees). In total, 16.1 million people either owned or worked for an SME (60% of all private sector employment), with small businesses (0 to 49 employees) accounting for 12.8 million of these. The combined annual turnover of SMEs was £1.9 trillion (51% of all private sector turnover in the UK), of which small businesses accounted for £1.36 trillion¹.

The importance of small businesses to the UK economy cannot be overstated. Yet many of them face problems when dealing with the financial services sector that make them less commercially effective, in turn compromising the proper functioning of markets, and hampering growth in UK productivity.

Funding options available to SMEs

Lending from traditional banks remains the predominant source of finance for small businesses, although this has reduced slightly recently². Smaller challenger banks are beginning to enter the market, which should expand choice. In addition, equity investment (up 79% in value in 2017), asset finance (up 12%) and peer-to-peer business lending (up 51%) all showed significant growth in 2017, though they still account for a very small share of lending to small businesses³.

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https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/663235/bpe_2017_statistical_release.pdf

² "The quarterly value of new loans to SMEs in Great Britain was almost identical in the second, third and fourth quarters last year. The £5.6bn of new loans drawn by SMEs in Q4 was, however, some 11 per cent lower than in the final quarter of 2016", SME Finance Update, UK Finance, 28 February 2018

³ <https://british-business-bank.co.uk/wp-content/uploads/2018/02/Small-Business-Finance-Markets-2018-Report-web.pdf>

However, overall demand for finance remains weak among small businesses. Over the last ten quarters, only 1.7% of SMEs sought new loans, the lowest since 2011⁴. Almost half of SMEs now describe themselves as 'permanent non-borrowers', up from one in three in 2012⁵.

Not every small business is looking for external finance. Some may not need it, for example, if they have other sources of finance. Those that do, do not know where to go. They may not understand the options available, and are too focussed on making their business a success to spend time searching the market. Many small businesses take the easiest route, which is to approach the bank with which they have their transactional account. Bank finance may not be the best option for them, and if they are turned down, they may not look at other options. Even if they know what is available apart from bank loans and overdrafts, they may not have confidence in alternative products, or understand the regulatory framework.

An increasing reluctance to borrow⁶ could be a response to the way that incumbent banks have treated smaller businesses, for example:

- Complex terms and conditions, and a failure by providers to explain their products and services clearly and without jargon;
- Lack of banks' expertise in the relevant sector – lending is often centralised and inflexible⁷, failing to provide the small business with personal relationships which might provide more tailored support, helping them not just to apply for finance but to produce financial information and business plans;
- Lack of appropriate products - most financial services products are designed either for individual consumers or for larger, more sophisticated, business customers. There are few products designed specifically for the smallest business consumers. In addition, banks assume that smaller businesses are more sophisticated than they are, and often think the needs of a smaller business are the same as those for a larger business, only on a smaller scale;
- Widely publicised failings of banks' treatment of smaller businesses in the past. The mis-selling of interest rate hedging products to small businesses and some of the cases emerging from the RBS Global Restructuring Group and HBOS Reading branch demonstrate how vulnerable small businesses can be to poor conduct by financial services firms. Issues of this kind have far-reaching impacts on individual businesses and the small business sector generally by destroying confidence in banks.

Open Banking should in theory loosen the hold that traditional banks have over small businesses, making it easier for them to compare a wide range of products based on their individual requirements. However, small businesses feel tied to their main bank. This is partly convenience, but the prospect of changing their transactional bank account is daunting for them. They believe they have a relationship with their bank, and that this will give them an advantage should they wish to borrow⁸. Smaller businesses want concrete benefits if they are to switch away from their main banking relationship, however bad it may be. These include an allocated business banking manager, someone to organise the switch, lower/more transparent charges, and the confidence that the bank will get it all right⁹. This reluctance to switch means that challenger banks, offering innovative products and better service, will struggle to get market share, and there is no incentive for incumbents to improve.

⁴ ibid

⁵ https://www.bdrc-group.com/wp-content/uploads/2018/03/RES_BDRC_SME_Finance_Monitor_Q4_2017.pdf

⁶ The British Business Bank reports "record low demand for traditional bank loans in 2017" at <https://british-business-bank.co.uk/wp-content/uploads/2018/02/Small-Business-Finance-Markets-2018-Report-web.pdf>

⁷ Banking services to small and medium-sized enterprises, CMA and FCA, July 2014 - https://assets.publishing.service.gov.uk/media/53eb6b73ed915d188800000c/SME-report_final.pdf

⁸ ibid

⁹ https://www.fs-cp.org.uk/sites/default/files/fscp_banking_culture_-_report_-_final.pdf

Small businesses need help to navigate the market. The Business, Energy and Industrial Strategy Committee in its 2016 'Access to finance' report found that "*a recurring theme in our evidence is that access to information and advice on finance options is a more significant barrier to SMEs than the availability of funding. Furthermore, businesses that seek and receive advice greatly enhance their chance of securing finance.*"¹⁰ Yet mainstream banks have closed their small business centres, and the government has withdrawn funding from schemes it used to sponsor. Authoritative, independent and impartial guidance would enable small businesses to make informed decisions about whether to borrow or not, and the most appropriate options open to them, as well as help with their wider financial arrangements. It would give them the confidence to look beyond their main bank to find more suitable products and better service. This long-standing problem needs attention, and we would urge the committee to put pressure on the government to expand the remit of the Small Business Commissioner to enable him to develop solutions.

The ability of SMEs to resolve disputes and access fair and reasonable compensation when they borrow money

The current arrangements for SMEs to resolve disputes and gain redress are clearly inadequate.

The Panel welcomes the recent FCA consultation on widening access to the Financial Ombudsman Service (FOS) for small businesses¹¹. The Panel has previously argued that small businesses should not be regarded as sophisticated until they reach a stage where they have a specified individual responsible for financial matters, typically a finance director or employed accountant. It continues to take this view generally but supports the FCA's proposal to introduce an objective threshold (based on headcount, turnover and balance sheet) for the purpose of access to the FOS.

The regulation of SME lending

Consumer protection regulation in general assumes that a consumer, merely because he or she is engaged in business, is more financially sophisticated and thus does not need the same levels of protection as an individual. Whilst this may be reasonable at the larger end of the SME spectrum, the small business consumer is often simply an individual consumer wearing a business hat, and needs the same protection as an individual. To expand statutory protection to small businesses, we recommend that the government should bring forward an amendment to Section 138D of the Financial Services and Markets Act, which concerns the rights of 'private persons' to bring an action for damages, so that it applies to small businesses' interactions with financial services firms.

The Lending Standards Board's (LSB) Standards of Lending Practice for business customers sets a useful voluntary benchmark for good lending practice. The standards cover loans, credit cards, overdrafts, and chargecards. The Panel welcomes the LSB's intention to extend this to other forms of lending, such as asset based lending and peer to peer lending. However, compliance with the LSB standards is voluntary and does not cover all lenders.

We have long argued that the Financial Services and Markets Act should be amended to require the FCA to make rules specifying what constitutes a reasonable duty of care that financial services providers should exercise towards their customers. The FCA has committed to consult on a duty of care later this year, and we will argue in our response that a 'reasonable' duty of care should apply equally to small businesses to take account of the fact

¹⁰ <https://publications.parliament.uk/pa/cm201617/cmselect/cmbeis/84/84.pdf>

¹¹ <https://www.fca.org.uk/publication/consultation/cp18-03.pdf>

that many are unsophisticated users of financial services, so need the same protection as individual consumers.

Yours faithfully,

Sue Lewis
Chair, Financial Services Consumer Panel