

AT/BPC

Submitted online

28 March 2014

SME LENDING INQUIRY – WRITTEN EVIDENCE FROM ICAS

Dear Sir/Madam,

1. ICAS welcomes the subject of this inquiry and the opportunity to comment. We are a leading professional body for chartered accountants with over 20,000 members working across the UK and internationally. Almost two thirds of our working membership work in business; others work in accountancy practices ranging from the Big Four in the City to the small practitioner in rural areas of the country.
2. ICAS's Charter requires its committees to act primarily in the public interest, and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members' views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

Access to SME finance

i) Are Small and Medium sized Enterprises (SMEs) able to access credit?

3. We believe that the range of businesses covered by the SME classification is too wide to identify the real problems in obtaining borrowing facilities. Policies should be targeted at specific sub-sections of this broad grouping.
4. Feedback from our members suggests that it is most difficult to obtain funding of between £100,000 and £1 million. This difficulty seems spread across a range of business activities with differing growth opportunities and historical track records.
5. Part of the problem at this level seems to us to be caused by the lack of availability of general purpose overdraft facilities, on which historically many SMEs with this level of funding requirement have relied. Support for overdraft lending is generally based on an understanding of the business's working capital fluctuations which are often seasonal. Such facilities seem generally to be unavailable from banks because:
 - from a reserve weighting perspective such lending carries the highest risk rating and so uses up more of the banks' available lending capacity;
 - forming a sufficient understanding of the borrowing capacity of the business requires time being spent by the bank in analysing the business.
6. Broadly we see banks encouraging companies to enter into structured invoice discounting and asset based borrowing type products because, we believe, of the more favourable treatment for their own banking reserves. This does not seem to us to be meeting the requirements of SMEs. Complex debt products can be a disincentive to small companies with limited financial expertise.
7. Banks must build trust with customers and providing simple flexible facilities is likely to help build trust better than complex structured products geared to meet the particular requirements of the banks, and not their customers.
8. We believe that trust will also be built if banks are encouraged by Government to be more transparent in their reporting of lending to SMEs. Gross and net lending statistics present only an aggregate and sometimes distorted picture. Banks should publish statistics on the number of

applications from SMEs, and specifically on sub-groups within this broad range, and the success rates of these applications. We would also like the banks to explain better how they are improving behaviour within their operations by, for example, increasing the numbers of local relationship managers targeting SMEs and explain the impact of these improvements and how it is meeting the objective of greater levels of SME lending.

9. In our opinion the funding of SMEs is a utility type service which has a tacit social obligation – the starting point should be that all companies have a right to expect a fair hearing and treatment from the banks. We would encourage the adoption of this perspective across bank lenders.
10. Transparency within the banks' processes should extend to the credit decision itself. We would welcome greater transparency on the decision making criteria and applicants should be given clear and honest feedback when applications have not been successful, including what they should do to turn the application into a successful one or alternatively signpost to other finance providers if it is not believed this would be a viable option for bank lending.
 - ii) *If not, what are the reasons SMEs do not obtain credit, including for example:*
 - *how the pricing or terms of credit restrict credit availability*
 - *whether firms have been discouraged from seeking credit by a perception that banks are unwilling to lend. What are the reasons SMEs do not obtain credit?*
11. Our impression is that broadly it is not pricing that prevents SMEs from borrowing from banks. More frequently it is burdensome conditions, complex and daunting covenant terms and the inadequate level and term of the facilities that cause SMEs not to borrow.
12. One specific aspect in smaller SMEs is the requirement for a personal guarantee from directors to underpin the bank borrowings. We would suggest that further evidence should be obtained from the banks on how widespread this requirement is, across the various sub-groupings of SMEs. Our impression is that personal guarantees may dampen demand for lending and that in practice banks will only rarely call that guarantee.
13. We agree that there does seem currently to be a broad concern amongst SMEs that the banks are unwilling to lend. We are aware of initiatives such as the Better Business Finance and the Appeals Process which in time should help to build confidence in the banks. There is a fine line for Government in continuing to discredit the past behaviour of banks and to build the case that behaviour is now improved.
14. More broadly we would suggest that Government should require banks to demonstrate, first what they are doing differently to achieve higher levels of SME lending, and secondly, how effective is that action in achieving the goal.

Why hasn't the market filled the gap?

- iii) *Whether competition amongst banks in the UK retail market has increased or decreased since the crisis, and the effect this has had on SMEs.*
- iv) *The scope for new or alternative providers of credit to enter the SME lending market, including the barriers to entry facing them.*
15. We believe the absolute dominance of the main clearing banks continues to limit the extent of competition in lending to SMEs. We consider that innovations such as the emergence of retail bonds and crowdfunding remains, as yet, of only marginal significance and so creates no real competitive pressure on the banks.
16. We are particularly encouraged that the Government is seeking to consolidate the plethora of previous funding initiatives for business within the British Business Bank (BBB). We are pleased also that the BBB will focus on a longer term more strategic approach to identify gaps in funding support and to avoid duplication across initiatives. We welcome the impetus created by the BBB to promote alternative channels to bank funding and expect that more innovative funding models will evolve.

17. The key barriers to entry for new challenger banks seem to us to be scale and burdensome regulatory compliance. We understand that the BBB is looking at providing guarantees to support the reserves of the challenger banks to allow them easier access to the SME market. This must however be matched by a commitment from these challengers to provide the type of lending SMEs need.
18. We would ask the banks to explain why they appear to be less interested in providing smaller loans to the smaller end of the SME market. It may be helpful to obtain from the banks greater visibility on the areas in which the banks make profitable lending. Perhaps there is an issue of undercharging for SME funding and an incentive to cross-subsidise which may not be in the best interests of SMEs.
19. We recommend that the BBB seeks genuine innovation in funding and is more risk seeking. Too often past Government initiatives have been too risk averse, or are managed by people who are too risk averse such as bankers and venture capitalists. In our experience, a market gap is not those at the top of an investor's attractiveness list which can attract bank funding or private equity; it is the tier below – those companies which are viable prospects but less likely to receive funds from banks. In our view, BBB initiatives will be most effective in encouraging growth if they focus on the identified gaps and not simply compete and replicate existing funding channels.
20. We would urge Government to consider tax incentives to encourage companies and individuals to lend directly to bona fide commercial companies. These incentives would have to be carefully crafted to discourage tax avoidance schemes but the evidence of the EIS and Seed EIS frameworks is that significant progress can be made when these incentives are applied to the genuine commercial opportunities for which they were designed.

We hope this is helpful.

Yours sincerely,

Alice Telfer
 Assistant Director
 ICAS