Treasury Committee
ICAS response to SME Finance inquiry

20 March 2018

Introduction

1. ICAS welcomes the opportunity to comment on this inquiry. 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.

Specific responses to inquiry questions

3. **Funding options available to SMEs**

4.1 The availability and uptake of different sources of funding for SMEs, including banks, peer-to-peer lenders and crowdfunding

4.1.1 The main sources of funding for the SME market are banks, angel investment and crowdfunding with equity being the most appropriate for early businesses. Government supported co-investment initiatives, such as those which have been offered by Scottish Enterprise and the Scottish Investment Bank, are also important. We have not found peer to peer lending to be very active in this market however do note that it is picking up (e.g. businesses linked with Entrepreneurial Spark).

4.1.2 Overall our view is that the supply of different forms of finance, particularly equity and bank based working capital funding, is limited. Alternative providers take time to develop and are currently too small scale or niche to fill the gap.

4.1.3 Businesses are not necessarily in a good negotiating position when seeking funding and covenant conditions can be complex. Banks should take responsibility for ensuring that conditions are fair, and customers fully understand. We believe that the prevalence of personal guarantees required by banks and the way they are set up is disproportionate and dampens demand[1]. Although a personal guarantee is most relevant in the first few years of a new lending relationship (being the riskiest period for the bank) in our experience, such personal guarantees tend to remain in place indefinitely. We believe that there would be greater demand for lending generally if banks were encouraged to put fixed caps on personal guarantees in terms of monetary value and time. We believe this would remove a barrier to funding.

4.1.4 With alternative finance there is an increasing variety of risk exposure, so greater education and explanation is needed so investors are fully informed of the risks as well as the opportunities. Some investors are better suited to certain types of investment product but there is a significant potential risk of mis-selling. The challenge for the FCA is to manage this process and further development without stifling innovation with too much regulation.

4.2 The level of competition in the SME lending market and the impact of recent regulatory initiatives

4.2.1 More competition would be welcome to help stimulate innovation and customer choice. We need more innovative sources of finance. Their comparatively fast decision-making process offers an interesting comparison with the increasingly impersonal and centralised lending decision-making frameworks used by banks.

4.2.2 There is some scepticism around reliance on centralised credit functions in banks to assess and judge lending risks. Devolving decisions to a more local level would enable judgement to be applied on a more individual and sensible basis which enables risk (an essential part of growing a business).

[1] Also raised in our response to the Business, Energy and Industrial Strategy Committee inquiry - Access to Finance 2016 noting our concern that EFG has been less successful, due to the interpretation of the banks generally that the Scheme requires them to take personal guarantees.

4.2.3 Centralisation risks focusing on the average company which is not always an appropriate fit given the wide range and high volume of SMEs.

4.2.4 We observe that service-based businesses are more likely to struggle to obtain an appropriate bank loan/ financing product (despite the service industry forming the most significant part of the UK economy). Asset and invoice finance are traditional offerings which are not always appropriate for less asset-based businesses. We need more competition and choice of products.

4.2.5 We question if a combination of the cost of due diligence, limitations in potential income from SMEs and the capital requirements under the capital adequacy rules may make this a more marginal business for banks and therefore potentially a less enthusiastic lender to SMEs.

4.2.6 There is space to increase the range of bank offerings and also to create a lighter due diligence, cash flow informed method for working capital funding (similar to the PayPal concept). As a major provider of business funding, perhaps banks need to review further their business model for lending to SMEs and service companies to keep pace with the changing environment. We also suggest that banks consider collaborating on a multi-bank only crowdfunding model that would reduce bank risk whilst increasing SME access to lending.

4.3 Trends in SME finance and how potential changes to regulation and redress may affect the market

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4.4 Any sources of finance which SMEs will not consider or approach and why

4.4.1 Generally no, our experience is that SMEs keen to raise funding will be willing to consider many sources. There are additional risks to borrowing from overseas investors, so businesses should ensure they are well informed and have access to sound advice.

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

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6. The regulation of SME lending.

6.1 The level of protection currently afforded to SMEs when they borrow money

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6.2 The case for bringing lending to SMEs within the regulatory perimeter, including (i) the likely impact on the supply of, and demand for, credit; and (ii) lessons learned from past misconduct

6.2.1 The risk of introducing regulation is that it can act as a barrier to entry and reduce the pool of lenders. We need to carefully balance protection versus competition and encourage innovation.

6.3 Other non-regulatory or quasi-regulatory options for policing SME lending, such as the establishment of industry codes and standards

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