ACCA

SME LENDING INQUIRY

Written evidence submitted by to the Treasury Select Committee by ACCA

13 March 2014

About ACCA

ACCA (the Association of Chartered Certified Accountants) is the global body for professional accountants. We aim to offer business-relevant, first-choice qualifications to people of application, ability and ambition around the world who seek a rewarding career in accountancy, finance and management.

We support our 162,000 members and 428,000 students in 173 countries through a network of over 89 offices and centres and 8,500 Approved Employers worldwide, who provide high standards of employee learning and development.

ACCA is the professional accountancy body most closely aligned to the SME sector. About 40% of our nearly 70,000 UK members work either in the finance functions of SMEs of for small, and mid-tier practices with a predominantly SME clientele.

SMEs' access to finance is a permanent research and policy theme at ACCA. Throughout the recovery, we have been the only accountancy professional body represented in three of the most significant UK stakeholder fora on this subject:

- The Advisory Group of the independent Enterprise Research Centre (ERC).
- The Stakeholder Steering Group of the independent SME Finance Monitor, the definitive account of UK SMEs' access to finance (2011 to date).
- The Department for Business, Innovation and Skills (BIS) Access to Finance Expert Group (until 2013).

www.accaglobal.com

For further information, please contact:

Emmanouil Schizas
Senior Economic Analyst
Email: emmanouil.schizas@accaglobal.com
Telephone: 0207 059 5619

SUMMARY AND RECOMMENDATIONS

- It is important to avoid aggregation when discussing SMEs. An appropriate segmentation of the market reveals that some types of businesses are indeed credit-rationed, and have been even during times of rapid economic growth; the typical UK SME, however, is almost certainly not credit-rationed, whether by the banks or by suppliers, and has most likely seen a distinct improvement in credit and cashflow conditions in late 2013. Credit-rationed UK SMEs are down to about a quarter of their peak numbers – numbering some tens of thousands. Among these, however, are some particularly important businesses.

- Broadly speaking, four types of UK businesses are genuinely credit rationed: young and/or informationally opaque businesses; fast-growing, intangible-capital-intensive businesses; internationalised SMEs; and businesses experiencing a sudden stop in trade credit. The first three types of rationing are mostly due to structural problems which predated the last recession and are likely to widen in the future at the expense of economic growth. These justify government intervention in the long-run, which should be led by the British Business Bank.

- Credit is not a suitable means of financing all business finance needs and should not be promoted as such. Nor are different types of debt and equity finance interchangeable.

- Most would-be borrowers cannot provide the volume and quality of financial information on which business credit depends. In-house finance resources are critical to producing this – external advisers alone cannot always address the issue. Improving SMEs' financial capabilities is also likely to stimulate the demand for finance as well as unlock supply. However, this is likely to require government support, including an expansion of the Growth Voucher Scheme.

- The underlying price of credit to SMEs has been on the rise for years, mostly due to the influence of financial regulation. Cost is not a primary concern for entrepreneurs, and is unlikely to deter would-be applicants for finance. However, wholesale reviews of a bank's pricing and fees could discourage borrowers by introducing de facto restrictions on the use of their facilities and signalling that their custom is not welcome. Two recent cases of this (Barclays and HSBC) might produce interesting evidence for the Committee.

- SMEs have typically underestimated their chances of getting finance from a bank by 7-16 percentage points. This expectation gap has been closing gradually since

2011, as discouraged borrowers are becoming more realistic (and thus more optimistic). Surprisingly, low expectations tend to be driven mostly by a poor relationship with the SMEs' bank – not media coverage or word-of-mouth.

- In some ways, the market is trying very hard to fill the gap left by retreating banks. The growth and financing rounds of alternative lenders, in particular, are so substantial that they could grow to rival the banking sector in just four years' time at their current pace. However, the offering of most challengers, as well as the profile of their prospective customers, are too similar to those of the main banks to truly make a difference to credit rationing. An exception to this is the significant rise of invoice discounting as a financing option, which has been particularly successful in helping finance mid-market companies, innovators and exporters – thus filling a genuine gap in the market.

- SME owners and managers are not as cynical about the banks' pledges as commentators might assume – greater awareness of the Lending Code and other similar initiatives is likely to reduce discouragement among SMEs by reinforcing perceptions that they will be treated fairly. The banks can build on this 'Code effect' in particular by committing to support SME customers who suffer trade credit rationing through no fault of their own.

- Policymakers do not have access to adequate information on the state of competition in the SME banking sector, and should not assume that figures on market concentration are a useful indicator. The SME market does appear to have become less competitive over the last two years, but this is partly because SME clients are expensive to acquire and their lifetime value to lenders has fallen – SMEs may no longer be worth competing over. Policies designed to improve access to finance have also had unintended consequences, limiting competition.

- The independent Loan Appeals process has been a success, but needs to be publicised further. Its true contribution, however, is not the millions of credit it has unlocked, but rather the experimentation it has prompted within banks, leading to more efficient and informed ways of assessing small borrowers.

- Regulators need to set up a single, simple framework for when financial services providers can and cannot consider an SME client as a 'sophisticated' buyer. This should be proportionate, bearing in mind how the business' internal resources match the complexity and impact of the product in question. SMEs with less than £5m in turnover should not generally be treated as 'sophisticated' buyers.

EVIDENCE

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

1.1. The volume of gross lending to SMEs has been rising throughout 2013, and growth has accelerated from June onwards. As of November 2013, gross lending to SMEs was up 11% year-on-year.[1] The percentage of UK SMEs reporting access to finance as a significant barrier to pursuing their business objectives (8%) was lower in Q4 2013 than it has ever been since the independent SME Finance Monitor surveys began in early 2011.[2] This figure only rises to about 12% after excluding SMEs disengaged from the banking sector, and has been falling across size-bands in any case. This is part of a medium-term trend suggesting an easing of the credit crunch that followed the last recession. Previous studies [3] [4] suggest that the number of genuinely credit-rationed SMEs had already fallen to a third of its 2009 peak by November 2011, and extrapolating from the BDRC findings would suggest that it's fallen to about one quarter of its peak in late 2013. This suggests that SME access to finance is definitely not as pressing a concern for the UK business population as it was a few years ago.

1.2. Of course, not all demand for finance manifests itself through arms-length applications for bank credit. Indirect measures of distressed demand would include late payment of suppliers, emergency cash injections from SME owners, and use of non-bank asset-based lending (ACCA & CBI 2010).[5] Here too, the available evidence points to fewer SMEs endangered or severely disadvantaged by a lack of external credit. The share of SMEs requiring emergency cash injections from their owners has been falling steadily since 2012, from a peak of 26% in Q3 2012 to 15% in Q4 2013. This was the first quarter since 2011 in which 'forced' injections of owners' cash into SMEs did not outnumber voluntary cash injections, and also the first quarter in which micro-enterprises were more likely to apply for external finance in the future than receive a cash injection from their owners.[6]

1.3. The evidence, then, suggests that the typical UK SME is not credit-constrained, and that access to finance is significantly easier now than in early

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[1] Bank of England [BoE] (2014) *Trends in Lending – January 2014* London: BoE. http://www.bankofengland.co.uk/publications/Documents/other/monetary/lendingtoukbusinessesandindividualsJanuary2014.xls

[2] BDRC (2014) SME Finance Monitor Q4 2013: The year in review London: BDRC http://www.bdrc-continental.com/EasySiteWeb/GatewayLink.aspx?alId=7397

[3] Cowling, M., Liu, W. and Ledger, A. (2012), 'Small business financing in the UK before and during the current financial crisis' *International Small Business Journal* vol 30, no. 7 http://isb.sagepub.com/content/early/2012/07/24/0266242611435516.full.pdf

[4] Cowling, M., and Liu, W. (unpublished) 'Small business financing in the UK four years into the current financial crisis'

[5] ACCA & CBI (2010), *Small Business Finance and the Recovery.* London: ACCA http://www.accaglobal.com/content/dam/acca/global/PDF-technical/small-business/pol-af-sbf.pdf

[6] BDRC (2014) op cit.

2011, not to mention 2009. That said, ACCA has repeatedly cautioned against aggregation when discussing SMEs. The 'SME' label, applicable as it is to 99.9% of businesses in the UK, is so broad as to render most statistics and anecdotal evidence meaningless. This is even more true because demand for finance is significantly skewed, and a minority of SMEs will always account for the bulk of demand. Having attempted a segmentation of the SME credit market, ACCA believes that only four types of businesses are likely to be under-served:

- Young and informationally opaque businesses,
- Fast-growing, innovative SMEs relying heavily on intangible assets,
- Internationalised SMEs, and
- SMEs experiencing sudden credit rationing from suppliers.

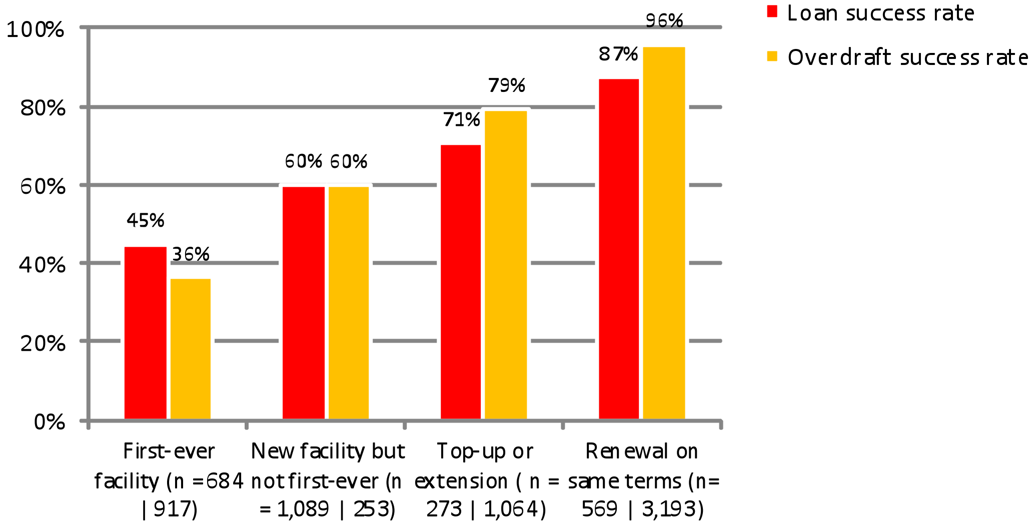
1.4. Young and informationally opaque businesses.

Evidence from the SME Finance Monitor suggests that, while almost all applications for renewed loan and overdraft facilities are successful, only a minority of first-ever applications are approved (see Figure 1), and this gap has widened over the last two years.[7] Unsurprisingly, approval rates increase as the applicant develops a track record in business, becomes better known to the bank and more tried-and-tested as a user of the specific facility. This is partly because repeat borrowers are larger and more established, but also partly because the banks generate and use proprietary information, both financial and non-financial, in order to assess the creditworthiness of SMEs. In their authoritative review commissioned by the Department for Business, Innovation and Skills (BIS), Armstrong et al (2013)[8] document all of these information effects in the long run, and also find that SMEs missing standard information such as a credit score are assessed by the banks as highly risky. Interestingly, BDRC's analysis has suggested that this informational disadvantage may be tempered by the presence of a professional finance function, at least in the case of term loans: first-ever applicants suffered less of a penalty if they produced regular management accounts, while applicants for new money suffered less of a penalty if they had a financially trained person in charge of their finance functions.[9]

Figure 1: Success rates of bank financing applications, by type

[7] BDRC (2014) op cit
[8] Armstrong, A., Davis, E. P., Liadze, I., and Rienzo, C. (2013) *Evaluating changing in bank lending to UK SMEs over 2001-2012 – Ongoing Tight Credit?* London: BIS https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/193945/bis-13-857-evaluating-changes-in-bank-lending-to-uk-smes-2001-12.pdf
[9] BDRC (2013) *SME Finance Monitor Q4 2012: The Year in Review.* London: BDRC http://www.bdrc-continental.com/EasySiteWeb/GatewayLink.aspx?alId=6035

29 LINCOLN'S INN FIELDS
LONDON WC2A 3EE
UNITED KINGDOM
T +44 (0)20 7059 5000
F +44 (0)20 7059 5050
www.accaglobal.com



Source: BDRC SME Finance Monitor, Q1 2011 to Q3 2013
Success rates exclude applicants who 'took other funding'

1.5. Fast-growing, intangible capital-intensive businesses.

1.5.1. Ever since our submission to the Rowlands Review in 2009, ACCA has maintained that fast-growing, innovative, intangible-capital intensive businesses were *already* credit rationed in the heady days of 2006-7, not only in the UK but throughout Europe. We believe that this is part of the reason why high-growth firms' share of UK job creation has fallen consistently since the early 2000's.[10] More recent evidence confirms that the bias against innovative businesses did not emerge during the recession, but is a structural problem of the UK finance market.[11] Fast-growing businesses are less likely to be successful when applying for loans, indicating a preference among the banks for stable, non-contingent growth.[12] This is consistent with the banks' business model, as they are only indirectly exposed to the upside risk in their clients' investments, but are directly exposed to the downside.

1.5.2. With this in mind, the banks' attitude towards intangibles may not be optimal but it is rational. Default rates among intangibles-intensive SMEs are higher than those among other SMEs,[13] and their assets are virtually 'unbankable', as banks are able to factor them into lending decisions only in a very crude fashion that severely underestimates their value.[14] In response to the European Commission's Green Paper on the long-term financing of the EU economy, ACCA pointed to a decades-long trend for advanced economies to

[10] Hart, M. and Anyadike-Danes, M. (2014) 'Moving on from the 'Vital 6%' *ERC Insight* February 2014. http://enterpriseresearch.ac.uk/default/assets//File/ERC%20Insight%20Report%20Feb%202014(1).pdf
[11] Lee, N.. Sameen, H. and Martin, L. (2013) 'Credit and the crisis: access to finance for innovative small firms since the recession' Big Innovation Centre, June http://www.biginnovationcentre.com/Assets/Docs/Reports/SME%20Finance%20BIC%20version%20FINAL.pdf
[12] Armstrong et al (2013) op cit
[13] Gupta, J., Gregoriou, A. and Healy, J. (2013) 'The effect of internationalisation on modelling credit risk for SMEs; Evidence from UK market' Under Review: *The British Accounting Review* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2189200
[14] Brassel, M. and King, K. (2013) *Banking on IP?* The IP Office, November http://www.ipo.gov.uk/ipresearch-bankingip.pdf

build intangible as opposed to tangible capital, and argued that the providers of debt finance, and banks in particular, would find it difficult to finance such assets under their current business models.[15] ACCA believes that other types of finance, including quasi-equity and mezzanine finance, need to fill this gap.

1.6. Internationalised SMEs

1.6.1. As of mid-2013, 13% of UK exporters had had financing problems severe enough to impact their overseas activity in the last six months.[16] This percentage was unchanged on 2012, but down from its peak in 2011. This may not appear to be a large number, but it's important to consider that, among SMEs globally, external credit was *the* least popular means of financing exports during the recession.[17] Most export SME activity is financed from either retained earnings or using traditional credit products, even when other products might have been more suitable. In the UK, only about 1-3% of internationalised SMEs (depending on sizeband) use specialist import-export products, and only 1% of them had applied for specialist products in the 12 months to Q4 2013, even though 9% had applied for finance of some kind.[18]

1.6.2. Financing exports is more problematic for businesses that have only recently begun exporting, and becomes easier as businesses grow more experienced. High growth expectations, as well as innovation (however defined) are also correlated with a greater likelihood of financing problems,[19] and, after controlling for other variables, SME exporters consider themselves to be significantly *less* competent at raising external finance than other SMEs do.[20]

1.6.3. Although internationalisation does not in itself increase default rates among SMEs or significantly alter the range of determinants of default rates, it can make banks' risk models less reliable. Therefore, unless banks can tailor their approach to internationalised SMEs, a genuine, information-based market failure could emerge.[21] BDRC's annual reviews of the SME Finance Monitor data certainly suggest that internationalisation can affect access to bank credit. In 2013, first-time applicants were more likely than other SMEs to obtain loans if they were internationalised,[22] but in 2012, first time overdraft

[15] ACCA (2013) *The Long-Term Financing of the EU Economy: Comments from ACCA.* London: ACCA http://ec.europa.eu/internal_market/consultations/2013/long-term-financing/docs/contributions/registered-organisations/association-of-chartered-certified-accountants_en.pdf
[16] OMB Research (2013) *International Business Strategies, Barriers and Awareness monitoring survey 2013*. London: UKTI http://www.ukti.gov.uk/uktihome/aboutukti/item/623100.html
[17] Forbes Insights (2010) *Small and Medium Sized Enterprises: Rebuilding a Foundation for Post-Recovery Growth.* New York: Forbes Insights. http://www.cga-canada.org/en-CA/ResearchReports/ca_rep_2010-12_sme_A2F.pdf
[18] BDRC (2014) op cit.
[19] OMB Research (2013) op cit.
[20] Mion, G. and Novy, D. (2013) Gaining further understanding into the factors affecting export engagement among UK SMEs. London: UKTI http://www.ukti.gov.uk/uktihome/aboutukti/item/502040.html
[21] Gupta, J. Gregoriou, A. and Healy, J. (2013) 'The effect of internationalisation on modelling credit risk for SMEs: Evidence from the UK Market.' Under review: the British Accounting Review. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2189200
[22] BDRC (2014) op cit

applicants were less likely to do so.[23]

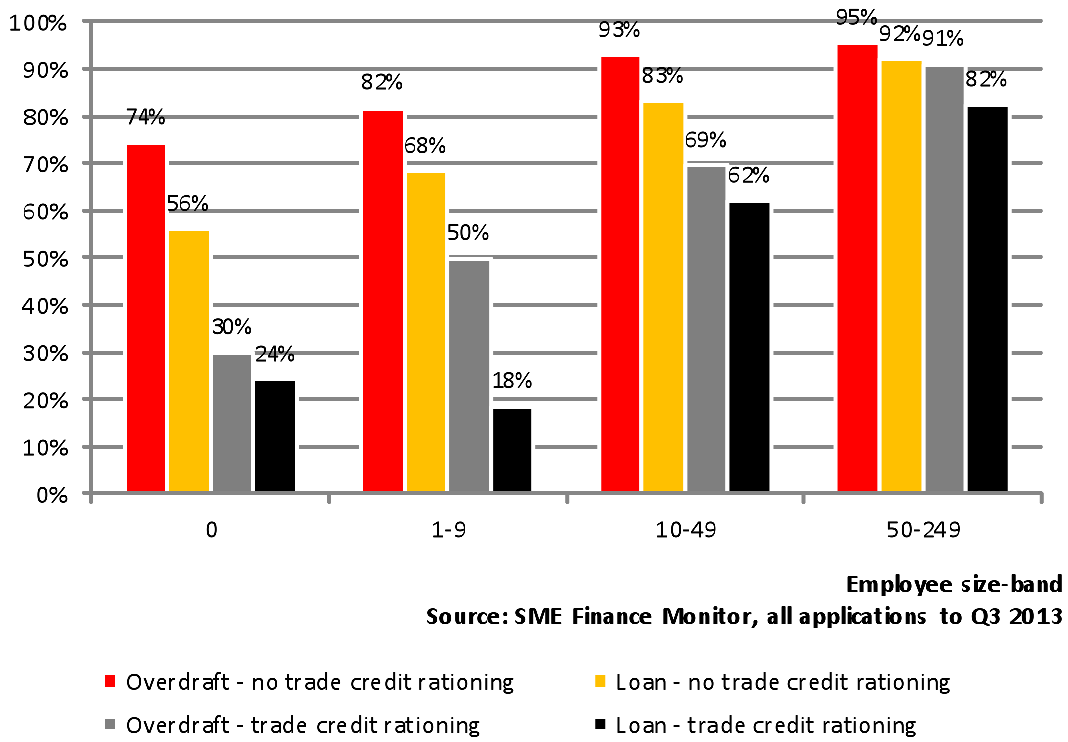
1.6.4. The UK British Exporters' Association cites support for SMEs as the single area in which UK Export Finance (UKEF) most strongly underperforms comparable organisations abroad. BExA also lists increasing awareness of UKEF among SMEs as its top advocacy priority, while also prioritising actions to allow UKEF to take advantage of EU small company exemptions and introduce foreign currency bidding cover for SMEs. Their rating of UKEF products noted that the otherwise very successful Bond Support Scheme needed to be more flexible with regards to the level of collateral required of SMEs, while the Overseas Investment Insurance scheme needed to be simplified in order to make it usable for SMEs.[24]

1.7. SMEs experiencing sudden credit rationing from suppliers.

1.7.1. Lenders to SMEs face an adverse selection problem – the businesses that need finance the most also tend to be the least creditworthy.[25] Trade credit rationing is often treated by banks as the sign of a failing business, since suppliers have access to better and more timely information about their customers than banks do. An SME's inability to access trade credit tends to influence banks' lending decisions more strongly than any other measure of cashflow stress, even after accounting for credit scores[26] – chances of rejection among trade-credit rationed SMEs are double those of similar-sized businesses that aren't credit rationed (see Figure 2). But this effect is asymmetric: smaller businesses, with fewer suppliers to choose from and less collateral to offer lenders, tend to face a bigger penalty.

Figure 2: The effect of trade credit constraints on application success rates

[23] BDRC (2013) op cit
[24] BExA (2013) *UK Export Finance: Supporting the National Export Challenge*. London: BEXA http://www.bexa.co.uk/docs/eca%20benchmarking%202013%20final.pdf
[25] ACCA & CBI (2010) *Small Business Finance and the Recovery* London: ACCA http://www.accaglobal.com/content/dam/acca/global/PDF-technical/small-business/pol-af-sbf.pdf
[26] Armstrong et al (2013) op cit.

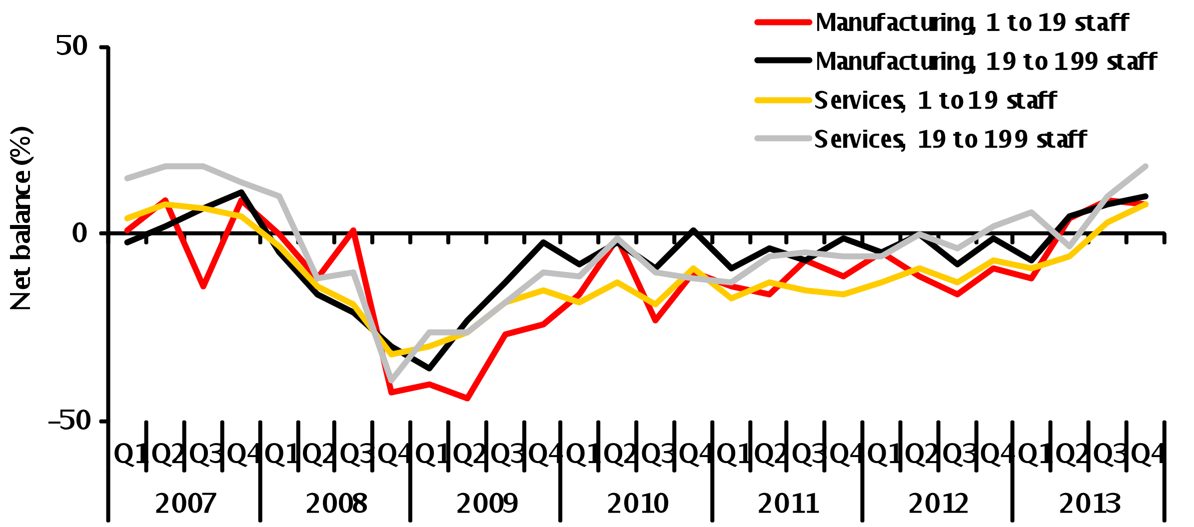


1.7.2. Of course, trade credit rationing isn't always a signal of a failing or badly-run business. It can also originate from late payment or failing customers further up the supply chain. ACCA and the CBI (2010) found that suppliers were quicker than banks to cut credit to their customers during the recession, while Graydon found that 41% of small businesses that are paid late pass at least some of the cashflow shock on to their own suppliers.[27]

1.7.3. As of Q4 2013, about 2-3% of UK SMEs across size bands were experiencing credit rationing from suppliers, down from 3-6% in early 2011.[28] A consistent downward trend can be observed over time, across size bands. Similarly, BACS' estimates of late payments outstanding to UK SMEs (a proxy for sudden credit rationing) have fallen from a peak of £36.4bn in July 2012 to £30.2bn in early 2013.[29] Finally, the British Chambers of Commerce's economic survey suggests that cashflow conditions have returned to 2007 levels (see Figure 3). These developments are cyclical, however, so a renewed downturn will see trade credit rationing rise again.

Figure 3: Cashflow conditions for SMEs – an overview of the last 7 years

[27] Graydon (2012) *Research on Payment Culture* London: Forum of Private Business.
https://www.fpb.org/images/PDFs/FPB_Graydon_research_report.pdf
[28] BDRC (2014) op cit
[29] BACS (2013) 'Payment terms ignored as SMEs wait eight weeks for money' BACS News Release, 24 April 2013
http://www.bacs.co.uk/Bacs/DocumentLibrary/PR_Payment_terms_ignored_as_SMEs_wait_eight_weeks_for_money.pdf



Source: BCC Quarterly Economic Su

2. If SMEs are not credit rationed, what are the reasons they do not obtain credit?

2.1. The rise of the non-borrower

2.1.1. Credit is not appropriate to all of the SME sector's financing needs, and, unlike many public commentators, business owners generally know this. Credit is an appropriate means of financing relatively low-risk, consistently cash-positive projects with uncertain but not unknown returns, and even then it is not appropriate for businesses that are already highly leveraged, or where the returns are unlikely to exceed the cost of capital. When business' needs deviate from this template, it is only reasonable that they should try to avoid debt altogether, or at least seek out loans on non-commercial terms, from directors and their families or professional networks. As the Bank of England's latest figures demonstrate,[30] repayments by SMEs have consistently outstripped gross lending; moreover, the SME sector is a net lender *to* the banks.[31]

2.1.2. That said, the share of SMEs that are disengaged from external finance has been rising consistently since 2011.[32] Only 7% of SMEs applied for any new funding in the twelve months to Q4 2013, down from 9% in the last quarters

[30] BoE (2014) op cit.
[31] British Bankers Association [BBA] (2014) 'Bank Support for SMEs – 4th Quarter 2013' London: BBA. https://www.bba.org.uk/wp-content/uploads/2014/03/BBA01-427174-v1-Taskforce_SME_Stats_Release.pdf
[32] BDRC (2014) op cit

of both previous years. ‘Disengaged’ SMEs or ‘permanent non-borrowers’[33] made up 41% of the UK SME population on last count, up from only 30% in early 2011; even among medium-sized businesses more than one in six (17%) businesses are disengaged. The rise in the share of ‘permanent non borrowers,’ however, appears to be driven mostly by very small, relatively young (<10 years) and riskier businesses – for whom approval rates will have been lower anyway. Yet these permanent non-borrowers tend to be happier with their banks than other SMEs[34] – it is hard to put the rise of non-borrowers down simply to past low approval rates or mistrust of the banks.

2.2. The importance of financial capability

2.2.1. Financial information is the primary raw material of business financing, yet many UK SMEs are not particularly well-equipped to produce it. Even after excluding zero-employee businesses, most SME loan applicants (63%) have no financially trained staff, about 60% intertwine the owner’s personal finances with the business’ finances, about half (50%) have no formal written business plans, and more than a third (34%) do not produce regular management accounts (See Figure 4).[35] Many of these factors are known to directly influence the outcome of credit applications, which suggests a genuine, information-driven market failure. To make matters worse, only a small minority of finance applicants take any advice before applying – 11% for overdraft applicants v. 19% of loan applicants.[36] In the medium-term, the exemption of micro-companies from the obligation to file annual accounts is likely to only exacerbate the shortage of financial information on SMEs.

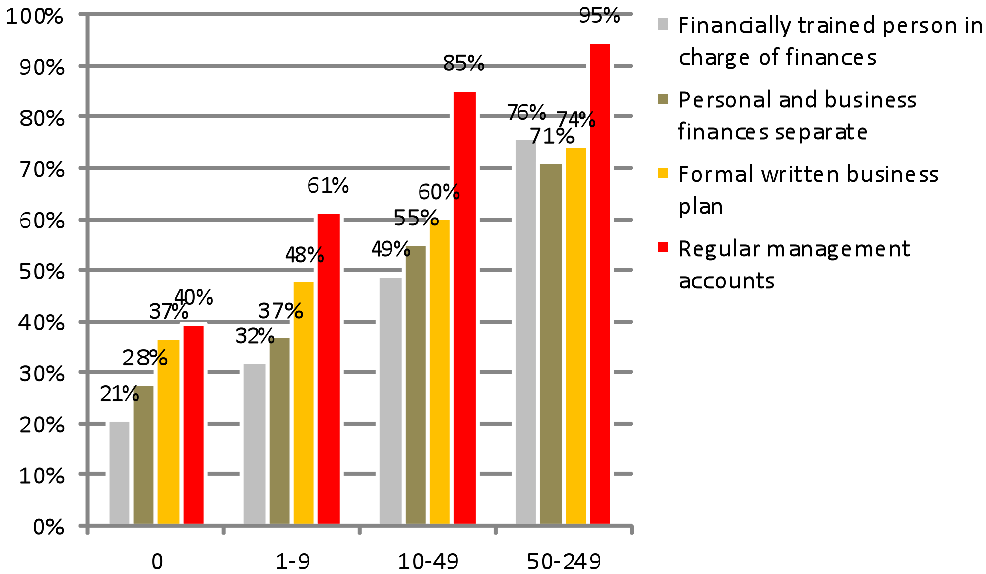
Figure 4: Capabilities of SME applicants by size-band

[33] This term refers to businesses not currently using external finance, which are not planning to apply in the near future (3 months) and have not used external finance in the past five years

[34] BDRC (2014) op cit.

[35] Figures relate to the pooled SME Finance Monitor sample from Q1 2011 to Q3 2013. The raw data for Q4 2013 have not been made available to the public yet.

[36] BDRC (2014) op cit.



Source: SME Finance Monitor (Q1-2 2011 to Q3 2013)

2.2.2. Insufficient planning (whether cashflow or general business planning) is also a substantial, and negative, influence on the *demand* for finance. As of Q4 2013, 17% of SME owners or managers would like to apply for finance over the next three months but admit they most likely will not: almost all of these have no identified plans on how to use such funds.[37] Among this group of non-planners/non-seekers, a reluctance to borrow is the leading reason for not applying, by a widening margin, but it is only a secondary barrier among those with plans. It is clear that, in the absence of robust planning, SMEs find it harder to commit to investment and, by implication, to external financing.

2.2.3. Among smaller businesses, the need for external finance does not automatically trigger the development of financial capabilities. ACCA research suggests that UK SMEs with less than £1m in turnover or 50 members of staff will tend not to develop the necessary financial expertise in-house in response to financing needs.[38] This evidence also points to market failure in the supply of business information. ACCA has further demonstrated that 'permanent non-borrowers' are often businesses in which owner-managers have chosen to maintain control over the growing business by taking only the most manageable risks and keeping the amount of information needed for decision-making to a minimum.[39] As a result, permanent non-borrowers tend to have less developed finance functions, and in particular they are less likely to produce management accounts, even after accounting for other factors. ACCA believes that encouraging and helping businesses build up their in-

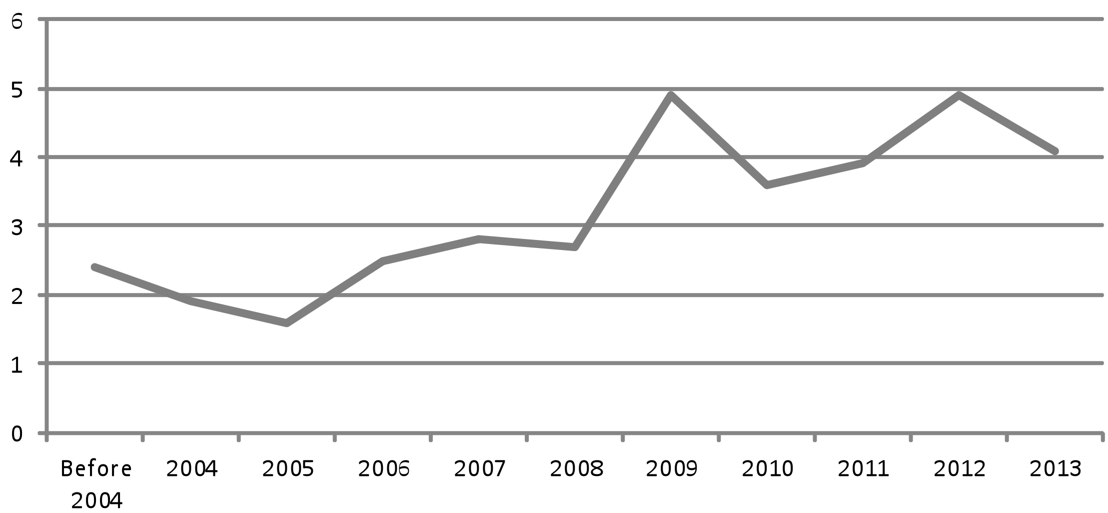
[37] BDRC (2014) op. cit
[38] ACCA (2012) *Driving SME growth through an evolving finance function.* London: ACCA.
http://www.accaglobal.com/content/dam/acca/global/PDF-technical/finance-transformation/pol-afb-dsgt.pdf
[39] Schizas, E. (2013) 'Finance for Growth – A Review' *The ACCA Blog,* 23 September 2013
http://blogs.accaglobal.com/2013/09/23/finance-for-growth-a-review/

house finance capabilities early on could help steer them away from disengagement.

2.3. The Pricing of credit

2.3.1. There is a reasonable amount of evidence to suggest that the underlying cost of credit to UK SMEs has been rising over the past decade (see Figure 5). Margins on term loans have risen relatively consistently since bottoming out in 2005, with the exception of a temporary spike in 2009.[40] While margins have fallen in 2013, this is almost certainly the result of the introduction of the National Loan Guarantee (NLGS) and Funding for Lending (FLS) schemes, both of which have explicitly aimed to reduce the banks' cost of capital and shave one percentage point off the interest rates charged to SMEs. After allowing for this reduction, it is almost certain that the underlying upward trend in margins would have persisted in 2013.

Figure 5: Variable interest rate margins for SME term loans, by year[41]



Source: Armstrong et al (2013)and BDRC (2014)

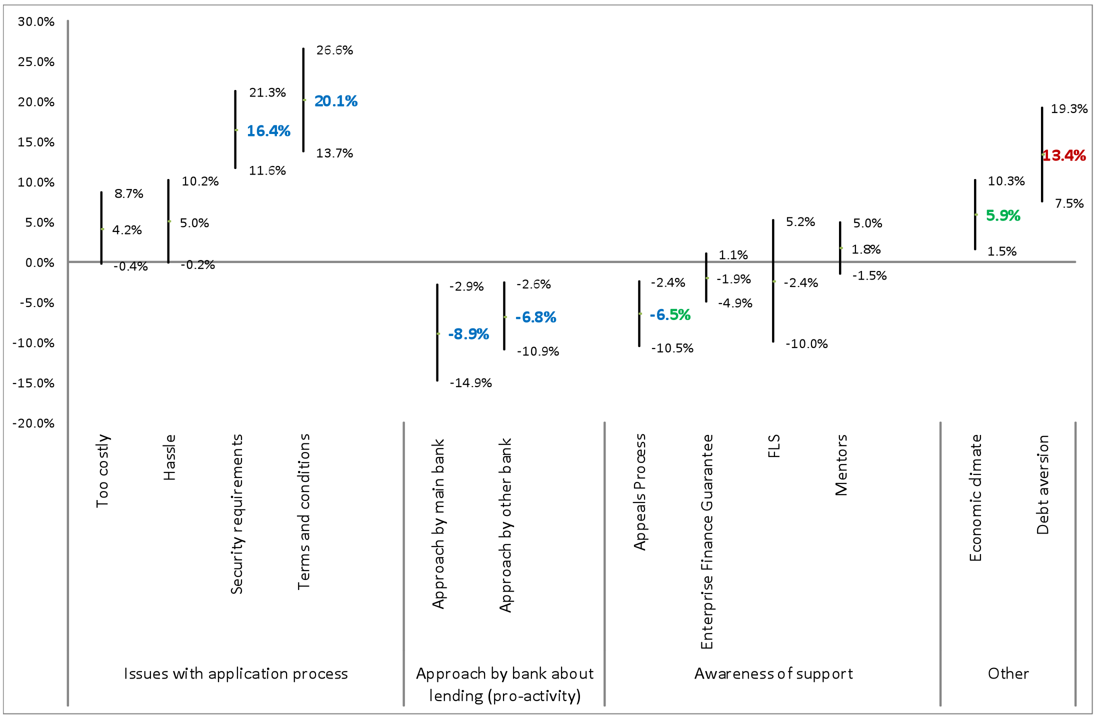
2.3.2. Increasing capital and liquidity requirements could be partly responsible for this trend. Even before proposals for Basel III/CRD IV were finalised, small businesses accounted for 46% of the capital requirements of large European retail banks, but only 27% of retail banking income.[42] More recently, UK banks' efforts to raise their capital ratios post-crisis have impacted the supply of credit to SMEs more than they have the supply of credit to large

[40] Armstrong et al (2013) op cit.
[41] 2013 figures from BDRC (2014) are based on a small sample which includes H2 2013. This suggests that the average margin in the first vintage of 2013 variable-rate loans is lower than suggested by the Figure 4.
[42] CapGemini (2010) *Small Business Banking and the Crisis: managing development and risk* London: CapGemini, Unicredit & EFMA http://www.capgemini-consulting.com/resource-file-access/resource/pdf/World_Retail_Banking_Report__Special_Edition_2010.pdf

businesses, and the supply of overdrafts more than that of term loans.[43] Meanwhile, ACCA's work on the likely impact of Basel III/CRDIV on SME lending anticipated that, due to the structural characteristics of the UK market, most of the impact would manifest itself in terms of rising interest rates rather than outright credit rationing.[44]

2.3.3. There is, however, less evidence that the rising cost of capital is putting SMEs off *applying* for finance. It is true of the UK, as indeed many of ACCA's major markets, that entrepreneurs worry more about the availability, restrictiveness and timeliness of credit than its price. Some evidence of this has been provided recently by Fraser (2014)[45], who suggests that the perceived cost of credit is relatively less significant in discouraging loan applications than perceptions of 'hassle' in credit applications, a poor economic climate, perceived security requirements, aversion to debt, and perceived onerous 'terms and conditions', in that order (Figure 6). Certainly, only a near-negligible number of businesses reject loan offers on the basis of an unaffordable interest rate.[46]

Figure 6: Determinants of the minimum perceived success rate required to trigger an application (effects plus confidence intervals):



Source: Fraser (2014)

[43] Armstrong et al (2013) op cit.
[44] ACCA (2012) *Framing the Debate: Basel III and SMEs.* London: ACCA http://www.accaglobal.org.uk/content/dam/acca/global/PDF-technical/small-business/pol-af-ftd.pdf
[45] Fraser, S. (2014) *Back to Borrowing? Perspectives on the 'Arc of Discouragement.'* London: ERC
[46] BDRC (2014) op cit

2.3.4. Some more tangible evidence of the relative irrelevance of the cost of credit is provided by the dramatic growth of Peer-to-Peer lender Funding Circle, which has until recently focused only on relatively high-quality business borrowers and yet consistently charged much higher interest rates than the banks. Although it's impossible to compare like-for-like, the average fixed rate for A+ rated borrowers on Funding Circle (6.8%), is the same as the average fixed rate for bank borrowers with 'average' or 'worse than average' credit ratings in the 18 months to Q4 2013.[47]

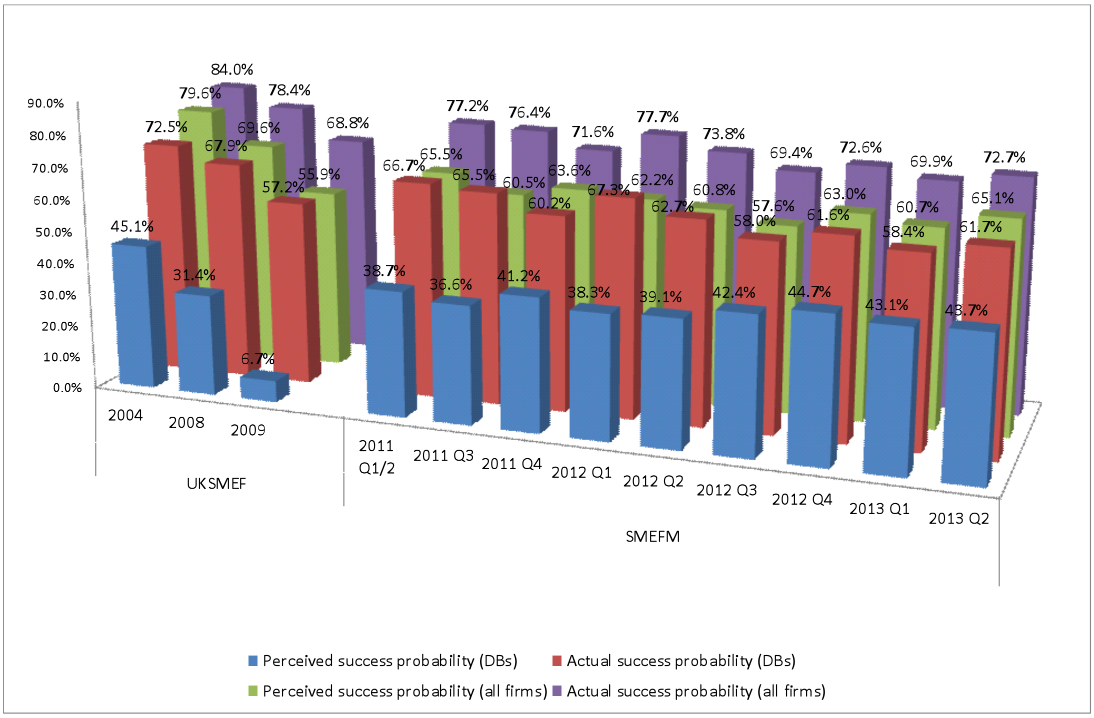
2.3.5. While marginal or gradual increases in the cost of credit might have a limited effect on the willingness to borrow, ACCA believes that a wholesale review of a bank's pricing structure can discourage would-be borrowers in two ways. First, pricing can set up behavioural cues regarding what clients can and cannot do, equivalent to actual restrictions;[48] we would expect these to have an effect above and beyond the effect of cost of credit, similar in magnitude to that recorded for 'terms and conditions' by Fraser (2014). Second, by signalling that their custom is not welcome or valued, such reviews could reduce SMEs' perceptions of the likelihood of success, and reduce their level of satisfaction with their banks, both of which should lead to fewer applications. Two natural experiments for this were created by HSBC and Barclays which announced, in August 2013 and January 2014 respectively, significant reviews of their business banking fee structures affecting hundreds of thousands of SME clients.[49] The Committee should, if possible, enquire as to the impact of these changes on the two banks' customer base.

2.4. Perceptions of the banks' willingness to lend.

2.4.1. There is a substantial amount of evidence indicating that UK SMEs generally under-estimate their chances of getting credit from the banks. Fraser (2014) estimates this perception gap at 7-16 percentage points (see Figure 7), while noting that the gap between perceptions and reality has been closing steadily throughout the recovery. This is because discouraged borrowers' expectations are becoming more realistic and thus more optimistic. This is significant because, when discouraged borrowers do not significantly underestimate their chances of success, discouragement can actually help *improve* the efficiency of the credit market. Moreover, as discouraged borrowers become more confident of their ability to access finance, their numbers should dwindle.

Figure 7: Perceived, actual and modelled success rates for UK loan applicants as estimated by Fraser (2014)

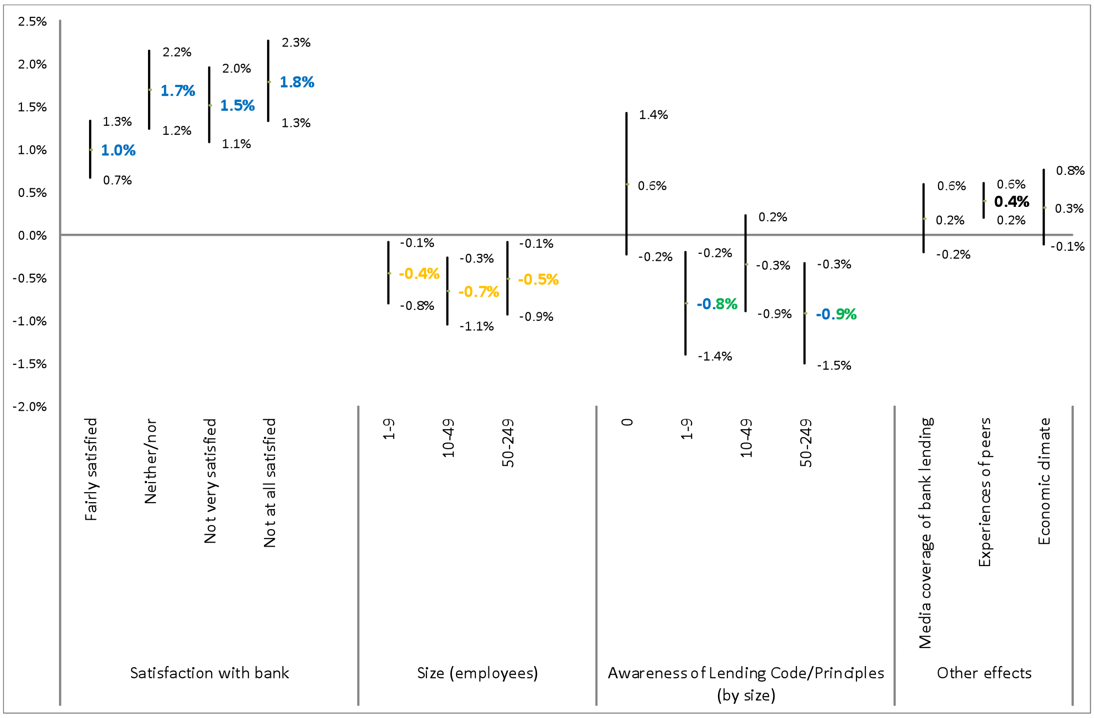
[47] ibid
[48] An example would be limiting the number or timing of transactions of certain kind that can be carried out for free.
[49] By way of illustration, HSBC's new terms can be found here: http://www.business.hsbc.co.uk/1/PA_esf-ca-app-content/content/pdfs/en/Summary_of_main_changes_to_Bus_Banking_Price_List.pdf



2.4.2. The key reason for the aforementioned perception gap is not media coverage, the experience of other businesses or general economic conditions. In fact, after controlling for other factors, the effect of media coverage does not appear to be a statistically significant influence at all. Rather, the key influence is the quality of an SME's banking relationship, since this sets up the client's expectations of how they will be treated (see Figure 8).[50] Far from being cynical about banks' promises, micro and medium-sized businesses that are aware of the Bank Lending Code are significantly less likely to under-estimate their chances of getting credit. Unfortunately, only 15% to 28% of SMEs (depending on size-band) were aware of the Code as of Q4 2013 and awareness does not appear to have risen over the past year.[51]

Figure 8: What determines the gap between SMEs' real and perceived chances of funding success?

[50] Fraser (2014) op cit.
[51] BDRC (2014) op cit



3. Why hasn't the market filled the gap?

3.1. ACCA's perception is that market participants and new entrants are definitely *trying* to supply more funding to SMEs. We note the substantial cohort of challenger lenders launched in the last three years; their rising media profile; the substantial investment of venture capital into challenger banks such as Aldermore, peer-to-peer lenders, receivables trading platforms and supply chain finance. All of this activity is premised on the assumption that a substantial finance gap awaits to be filled.

3.2. Between them, Peer-to-Peer business lenders, invoice trading platforms, debt-based securities platforms and microfinance providers lent £293m to UK businesses in 2013, up from £99m in 2012 and £25m in 2011.[52] Although the UK banks still dominate the credit landscape, with £20.4bn of new facilities agreed in 2013[53] it would only take the alternative lenders four years to rival today's banks for lending volumes if their current growth rates are maintained.

3.3. Unfortunately, we believe that most of the challengers' efforts are focused on serving essentially mainstream SME customers with mainstream needs, as opposed to serving the groups highlighted earlier as credit rationed. Trade-credit-rationed SMEs may be one exception, but their numbers are

[52] Collins, L, Dwart, R. and Zhang, B. (2013) *The Rise of Future Finance* London: NESTA http://www.p2pfinanceassociation.org.uk/wp-content/uploads/2013/09/The-Rise-of-Future-Finance-The-UK-Alternative-Finance-Benchmarking-Report.pdf
[53] BBA (2014) op cit

dwindling. The result is that, while challengers may be chipping away at the dominance of the major banks and salvaging some borrowers from discouragement, they are not yet making serious inroads into the financing gap for UK SMEs. Other challengers such as Williams and Glyn or TSB have been spun off from the main lenders, as opposed to winning business from them or bringing new business into the sector.

3.4. Of course, alternative *products* may be as important to the cause of financing SMEs as alternative *lenders*. Between 2011 and 2013, there has been a steady fall in the use of 'core' finance products (term loans, overdrafts and credit cards) among SMEs, and a slow rise in the number of SMEs using *only* non-core products, such as leasing or invoice discounting.[54] ACCA has certainly noted for the past three years a new-found acceptance of invoice discounting and asset finance among small businesses – despite the fact that invoice discounting has in the past sometimes conferred the stigma of a failing business. According to ABFA[55], customer numbers and advances volumes in the UK and Ireland are only growing among businesses with a turnover of £10m or more, and much of this growth appears to be driven by exporters. Still, this supply of finance to mid-market businesses does appear to address some of the genuinely credit-rationed SMEs we described earlier.

4. Has competition amongst banks in the UK retail market increased or decreased since the crisis, and what effect has this has had on SMEs?

4.1. ACCA was not surprised by the referral of the small business banking sector to the Competition and Markets Authority (CMA), although we believe that the current evidence base on competition in the SME banking sector is inadequate to the needs of policymakers. Since the CMA's work is likely to focus on conscious or controllable anti-competitive behaviours among market participants, we believe it would be most beneficial for our submission to focus on ways in which market participants restrict competition unintentionally.

4.2. Our view is that the financing landscape has become less competitive for most UK SMEs over the last two years, following a surge in competition in the early days of the recovery. The share of multi-banked SMEs has fallen significantly in the two years to Q3 2013 (see Figure 9), while the share of loan applications made to banks other than a business' main bank is also on a broadly downward trajectory. Similarly, among SMEs that were not permanent non-borrowers, the probability of being approached by another bank indicating its willingness to lend has been falling over the

[54] BDRC (2014) op cit
[55] ABFA (2014) Statistics Q4 2013. https://www.abfa.org.uk/statistics/2013/Q4/ABFA%20Association%20HistoryQ4%202013.xls

past two years, while the probability of being approached by one's *own* bank has been more stable (see Figure 10).[56] A tipping point appears to have been reached in mid-2012, after which the SMEs' main banks became more active than their competitors, which they have continued to be ever since. These trends suggest to us that competition is weakening in part because the banks' incentives to win over other lenders' customers are weakening. In many cases banks, including challenger banks, may simply not be able to produce an adequate return on the substantial spending required to acquire SME clients,[57] and increased capital requirements under a ring-fencing regime could exacerbate this problem.[58] Lenders could, however, reduce the cost of acquisition through more targeted communications – the SME Finance Monitor data suggest that banks have been just as likely to contact permanent non-borrowers of all sizes to indicate their willingness to lend as SMEs actually interested in lending.

Figure 9: Incidence of multibanking among selected UK SME sizebands

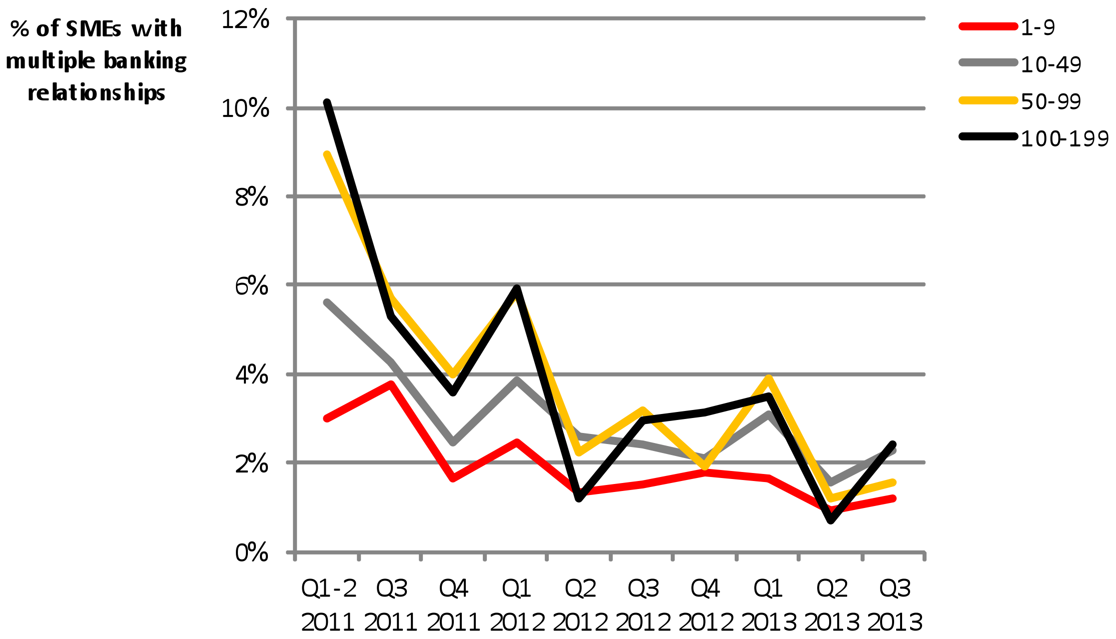
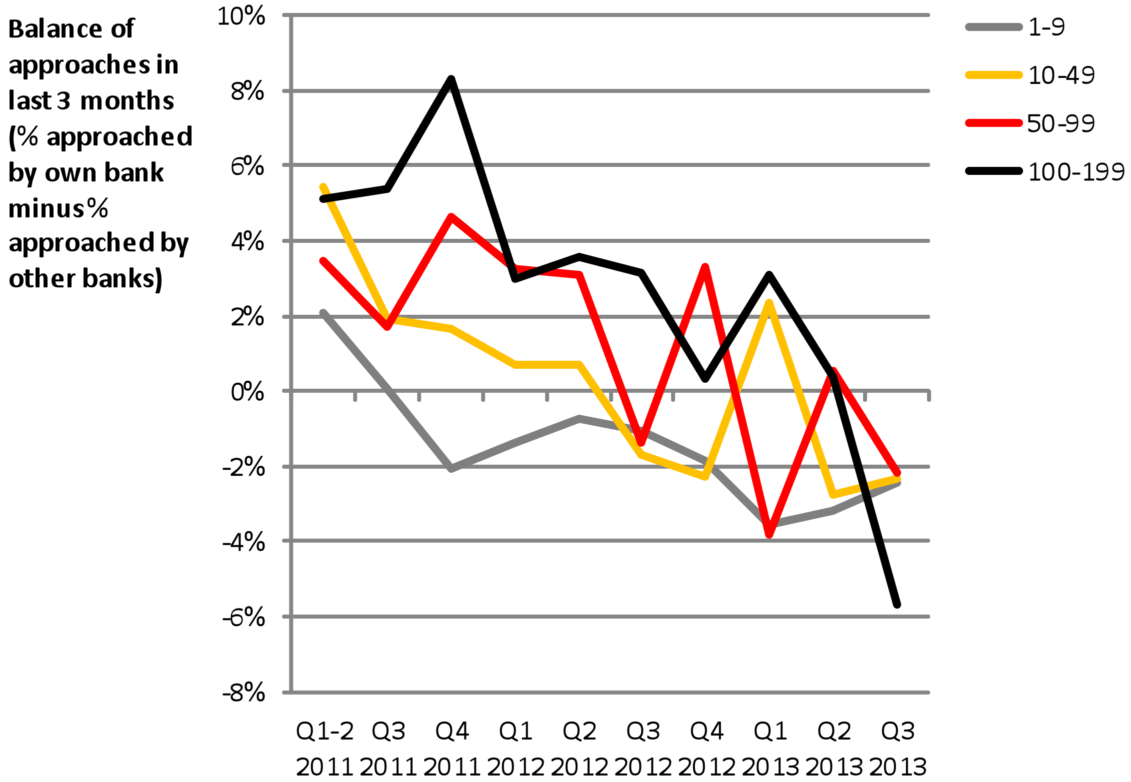


Figure 10: SMEs approached by own vs. other banks, among selected sizebands

[56] BDRC (2014) op cit. Published datasets do not yet cover Q4 2013.
[57] Goff, S. (2014) 'Challenger banks face uphill struggle against 'Big Four' lenders' *Financial Times*, 24 January 2014 http://www.ft.com/cms/s/0/d9e00192-8439-11e3-b72e-00144feab7de.html#axzz2vhG0Xo00
[58] Schizas, E. (2012) 'Smart Banks, Dumb Banks and the Amazing, Terrible Future of Small Business Lending in the UK *The ACCA Blog*, 14 September 2012 http://blogs.accaglobal.com/2012/09/14/smart-banks-dumb-banks-and-the-amazing-terrible-future-of-small-business-lending-in-the-uk/



4.3. The reliance on relatively crude credit scoring is another barrier to greater competition that is unrelated to anti-competitive practices. Under some credit scoring methodologies, individuals and SMEs can harm their scores by making repeated financing applications and opening multiple accounts within a short period of time. While such behaviour often correlates with financial stress, it also correlates with 'shopping around' for a good deal. One repercussion of this is that the SMEs most likely to consider changing banks are penalised. Currently, the banks' collective advice to customers is to avoid asking for more than a simple quote when shopping around, in order to avoid impacting their credit score.[59] This may need to change.

4.4. ACCA believes that, in addition to the impact of commercial practices, Parliament and the government should also examine the unintended impact of policies meant to improve SME access to finance on banking competition. As a rule, the leading banks by market share have been under the greatest political pressure to sign up to the Government's Access to Finance schemes, the Project Merlin pledges, or Funding For Lending (FLS). Given this asymmetry, policy outcomes are likely to come at the expense of competition. Furthermore, most government guarantees are ultimately administered by the banking sector as marginal products, which means that they are only likely to confer an advantage to an SME's current

[59] Better Business Finance (2013) *Business Credit Scoring Explained* London: BBA
http://www.betterbusinessfinance.co.uk/images/fact_sheets/Credit_Scoring_Guide.pdf

bank – which can afford to promote such alternatives as they aren't putting their resources into winning over the customer in the first place. Likewise, the independent Loan Appeals process, regardless of its many merits, has the unintended consequence of encouraging creditworthy but ill-treated SMEs – the ones most likely to successfully switch banks – to salvage their existing banking relationships at the expense of the competition, even when the SME's current bank has clearly failed to provide good service. This 'competition effect' is not in itself a reason to reconsider these schemes – however, it should be included in any assessment of their outcomes.

4.5. Finally, the presumed negative correlation between concentration and the various measures of competitiveness in retail banking is far from proven. Empirical evidence suggests that, in more concentrated banking sectors as well as sectors where decision-making is more centralised, credit rationing for SMEs is less likely and lower-quality applicants are less likely to be discouraged, even though the cost of finance might be higher.[60] Likewise, the presumed benefits of competition for SMEs as consumers and for financial stability as a whole may be highly contingent on features of the regulatory framework: competition tends to increase systemic risk and the incidence of bad loans when it puts pressure on retail banks' profit margins.[61]

5. Do banks' existing appeals and complaints systems work effectively for SME customers, for example with regard to declined lending applications, sales of interest rate hedging products, changes to loan facilities and related allegations of mistreatment?

5.1. Our concerns regarding competition aside, ACCA believes that the independent loan appeals process works very well. The rate of overturned decisions for non-credit card applications is consistently above one quarter and often above 30%. While this may not be a large number in absolute terms, a 25-30% improvement in the perceived probability of success would return the expectations of discouraged borrowers to optimal levels (see 2.4.1).[62]

5.2. ACCA believes that the banks should treat the appeals process as a testing ground for more efficient ways of dealing with smaller borrowers in particular. As things stand, banks rely substantially on personal and business credit scores when assessing smaller loan applications. Most

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[60] ACCA (2011) *Framing the Debate: Basel III and SMEs*. London: ACCA http://www.accaglobal.com/content/dam/acca/global/PDF-technical/small-business/pol-af-ftd.pdf
[61] Davis, E.P. and Karim, D. (2014) 'Exploring the Long-and Short- term links between bank competition and risk- Reconciling conflicting hypotheses?' NIESR Discussion Paper no. 421 http://www.dodsmonitoring.com/downloads/misc_files/dp421.pdf
[62] Griggs, R. (2013) *Banking Taskforce Appeals Process Independent External Reviewer Quarterly Review Period to End September 2013.* http://www.betterbusinessfinance.co.uk/images/pdfs/Q1-Q2_Review_2013_(Year_3)_Final.pdf

29 LINCOLN'S INN FIELDS
LONDON WC2A 3EE
UNITED KINGDOM
T +44 (0)20 7059 5000
F +44 (0)20 7059 5050
www.accaglobal.com

declined applications for amounts below £25,000 (56%) are rejected as a result of poor credit scores, as opposed to only 6% of applications for larger amounts.[63] Banks often struggle to go the extra mile to assess these applications, for fear of making their SME banking operations unprofitable. However, in response to the appeals process, individual banks have proven that it is possible to adjust the decision-making process in order to gather more information on applicants before the formal application is made, or even before the applicant can meet with a bank manager at all.[64] We see this as a more important legacy of the appeals process even than the millions of extra lending released to SMEs.

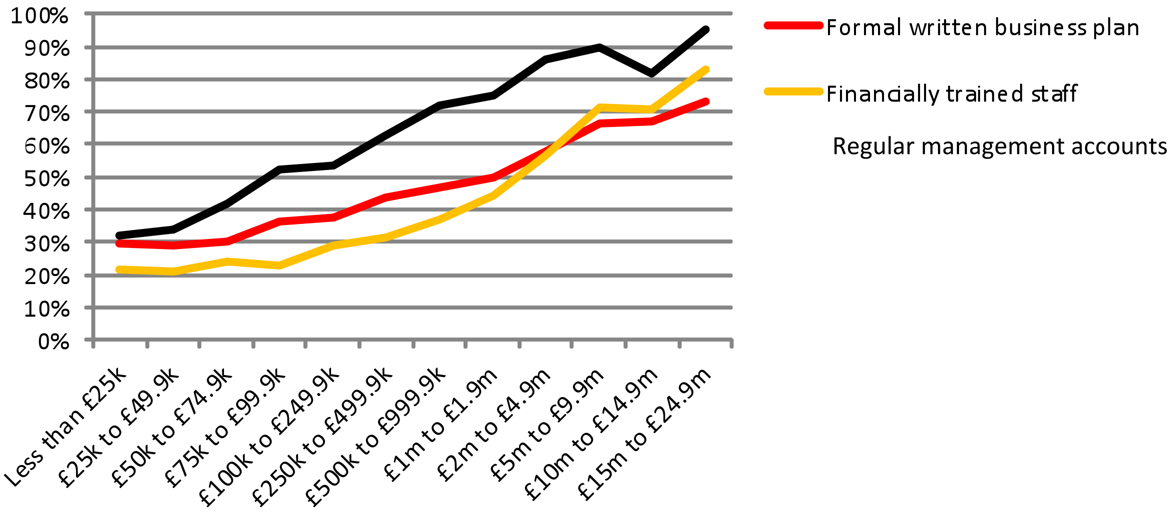
5.3. While the effectiveness of the appeals process itself is satisfactory, the effectiveness of its communication needs to be boosted. The likelihood of banks volunteering information on appeals to their clients rose significantly in 2013, but remains low in absolute terms – only 16% of declined loan applicants and 19% of declined overdraft applicants were made aware of their options by their banks. Since the trend in awareness of the appeals process among the wider SME population is flat, it is reasonable to assume that it is currently the banks that are responsible for most of the increase in awareness.[65] The objective should, instead, be for awareness to grow among *aspiring* applicants, and all stakeholders need to take responsibility for this.

5.4. From a regulatory perspective, there is a need for a clearer, universal definition of the notion of a 'sophisticated' or 'professional' business client, so that owners and managers of SMEs can correctly anticipate how they will be treated by financial services providers in different settings. The interest rate swap mis-selling scandal of 2013, in particular, exposed several different definitions of a 'sophisticated' buyer. Indicatively, businesses with more than £1.7m in turnover cannot generally take cases to the Financial Ombudsman[66] – even though at least a third of these do not have financially trained staff, another third don't have a written business plan, and one in six do not produce regular management accounts. A £5m turnover threshold would be much more sensible, ensuring that most businesses above the threshold have appropriate financial capabilities in place (Figure 11). But ideally, sophistication should be considered in terms of the adequacy of business' resources and expertise in relation to the complexity and significance of the financial decisions they are required to make.

[63] Griggs (2013) op cit.
[64] ibid
[65] BDRC (2014) op cit.
[66] Prosser, D. (2013) 'Small Talk: Small firms find justice hard to come by in swaps scandal' *The Independent* 20 May 2013. http://www.independent.co.uk/news/business/sme/small-talk-small-firms-find-justice-hard-to-come-by-in-swaps-scandal-8623066.html

29 LINCOLN'S INN FIELDS
LONDON WC2A 3EE
UNITED KINGDOM
T +44 (0)20 7059 5000
F +44 (0)20 7059 5050
www.accaglobal.com

Figure 11: SMEs' financial capabilities by turnover



Source: SME Finance Monitor (Q1 2011 to Q3 2013)