Department
for Business
Innovation & Skills

HM Treasury

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Open consultation

SME finance: help to match SMEs rejected for finance with alternative lenders

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0.1 Context

Budget 2014 announced that the government will consult on whether and if so, how, to take legislative action to help match small and medium sized enterprises (SMEs) that have been rejected for loans with challenger banks and alternative finance providers who are looking to offer finance. The government believes that positive action in this area would be an important step to improve access to finance, and would encourage a more competitive banking sector. The consultation complements proposals, announced by the government at Autumn Statement 2013, to require banks to share information on their SME customers with other lenders through Credit Reference Agencies.

At present the largest four banks account for over 80% of UK SMEs' main banking relationships. Many SMEs only approach the largest banks when seeking finance. Although a large number of these applications are rejected - in the case of first time SME borrowers the rejection rate is around 50% - a proportion of these are viable and are rejected simply because they don't meet the risk profiles of the largest banks. There are often challenger banks and alternative finance providers with different business models that may be willing to lend to these SMEs.

Although the largest banks will sometimes refer these SMEs on (e.g. to brokers), in many cases challenger banks and other providers of finance are unable to offer finance as they are not aware of their existence and the SMEs are not aware of the existence of these alternative sources of finance. This is a market failure, of imperfect information, resulting in SMEs that are viable loan propositions not receiving the finance they need.

Some attempts have been made to address this market failure, but they are limited in scope and have been slow in achieving results. The government is committed to helping small businesses access finance, and believes that more can and should be done. The subject of this consultation is whether or not to address this market failure through a much more ambitious government intervention that would increase the amount of information that is available to challenger banks and other providers of finance about businesses seeking finance, but which are rejected for finance by the major banks. The consultation asks whether this government intervention is needed and, if so, for views on how the government should deliver this, including via a preferred option of referral to private sector platforms.

1. Introduction

The government is committed to fostering a strong, diverse and competitive banking sector to ensure that UK consumers and the economy can benefit from high quality banking products and services at efficient prices. One of the impacts of the financial crisis has been an increase in the level of concentration in the UK banking market, including the market for SME lending. At present the largest four banks account for over 80% of UK SMEs' main banking relationships. The government believes that such high concentration levels are bad for consumers and business and is determined to see a step change in competition in the UK banking market and make it easier for alternative and innovative finance providers to enter and compete in this marketplace.

The government has already taken significant steps to address the situation. Interventions have included:

Levelling the playing field by removing distortions in the market that favour large, incumbent banks	The government legislated through the Banking Reform Act to ring-fence banking services and increase banks' capacity to absorb losses. Introducing ring-fencing and measures on loss absorbency are key steps in helping to create the right environment for competition in banking to flourish.
Reducing barriers to entry and expansion in the banking sector	In July 2012, the Chancellor of the Exchequer asked the Financial Services Authority (FSA) to conduct a Review of Barriers to Entry and Expansion in the banking sector which resulted in major changes to the capital requirements for new banks, making it easier for them to enter the market and compete.
Creating a new competition-focused regulator for payment systems	To ensure that smaller banks and non-bank providers can get fair access to payments systems, helping drive innovation and choice for consumers. The government legislated through the Banking Reform Act to create the new regulator, which will be incorporated in April 2014.
Making it easier for	Through the launch of the new 7 day switching service. This has already had a positive effect, with a 17% increase in switching in Q4 2013 in comparison to Q4

consumers to move their bank accounts to a provider that meets their needs	2012.
Improving transparency	Through a voluntary agreement with the major lenders to publish bank-by-bank lending data across 10,000 postcodes, enabling smaller lenders, both banks and non-banks, to see where lending is low and pursue new business in these areas.
Creating the right regulatory environment to foster competition	The Financial Conduct Authority (FCA), created through the Financial Services Act 2012, has been given a powerful mandate to promote effective competition in the interests of consumers, and a duty to consider competition in pursuing its consumer protection and market integrity objectives. The government also legislated in the Banking Reform Act to further enhance the competition powers of the FCA and to provide the Prudential Regulation Authority (PRA) with an explicit competition objective.
Increase the supply and the diversity of funding for SMEs	In October 2013 the government launched the British Business Bank to supply funding and guarantees to providers of finance for SMEs. The institution generated £660 million of new lending and investments in 2013 and is projected to double this in 2014 and again in 2015.

The government announced at Autumn Statement 2013 that it would consult on proposals to require banks to share information on their SME customers with other lenders through Credit Reference Agencies (CRA). The government launched this consultation on 26 December 2013 and intends to legislate as soon as parliamentary time allows. The proposals are intended to improve the ability of challenger banks and alternative finance providers to conduct accurate SME credit scoring and, by levelling the playing field between providers, make it easier for SMEs to seek a loan from a lender other than their bank. A better understanding of the SME sector should also stimulate competition and innovation in SME lending, improving the cost and quality of services offered.

Building on this policy, the government then announced, in Budget 2014, that it would issue a consultation on matching rejected SME loan applicants with alternative providers of finance. This consultation document therefore asks whether the government should legislate to help match SMEs that have been rejected for loans with challenger banks and alternative finance providers who are looking to offer finance. The consultation also asks questions about the mechanics of delivering such a measure, if the government decided to legislate, and sets out the government's preferred approach of requiring banks to refer details of SMEs that have been rejected for loans to a platform or platforms so that they can be accessed by challenger banks and other providers of finance.

This measure is designed to work together with the government's intervention on SME credit data to drive a significant change in the way that SMEs access credit in the UK. If the outcome of this consultation leads to a decision to require banks to share details of SME applicants who are turned down for a loan, then an alternative provider will not only be able to identify SMEs that are seeking finance but, with an SMEs permission, will be able to quickly and accurately assess credit quality and make a lending decision. This will drive competition in the SME lending market leading to better outcomes for SMEs who have been struggling to access the finance they need from the big banks.

1.1 Supporting evidence

The evidence that a government intervention is needed to help match SMEs who are seeking finance with credit providers who are looking to offer finance has been steadily building. Anecdotal evidence has long suggested that most SMEs only approach the largest banks – who account for over 80% of UK SMEs' main banking relationships – when seeking finance. The question was tested in the recent Department of Business, Innovation and Skills (BIS)/BMG Research study[1] which estimated that the majority (71%) of businesses who seek funding only approach one provider. The study also noted that in more than half of all cases, the provider the SME approaches will be their main bank.

Although the largest banks will sometimes refer these SMEs on, in particular to brokers, this is not happening systematically. And although there are challenger banks and other providers of finance that may be willing to make a loan, most SMEs do not consider these alternatives and the challenger banks and other finance providers do not currently have a way to identify which SMEs are seeking finance. The BIS/BMG Research study found that 37% of businesses appear to give up their search for finance and cancel their spending plans after their first rejection.

Some efforts have been made to address this problem. In 2010 the major banks committed in the British Bankers' Association Finance Taskforce Report, Supporting UK Business, to signpost alternative sources of finance, giving customers helpful information and advice if a loan is declined and raising awareness about the financial solutions they should consider. Building on this commitment, the government worked with the British Bankers' Association (BBA) and the major banks to pilot a voluntary referral system with Community Development Finance Institutions (CDFIs). The referral system allows the major banks to refer viable businesses to which they are unable to offer finance to CDFIs. CDFIs can then assess whether they are able to offer finance.

While some progress has been made, these interventions are limited in scope and have been slow in achieving results. The BIS/BMG Research study found that only 6% of SMEs declined for loans are referred to alternative funding by their bank, and just a further 11% are offered alternative funding or advice. Furthermore the National Association of Commercial Finance Brokers point to the still widespread perception that high street banks are the only source of funding for small businesses. Challenger banks and alternative finance providers also continue to note that they lack information about SMEs seeking finance. This market failure of imperfect information is therefore still impeding the efforts of challenger banks and alternative finance providers to help to offer the finance the SMEs need.

This consultation asks whether or not to address this market failure through a much more ambitious legislative government intervention to help match SMEs that have been rejected for loans with challenger banks and alternative finance providers who are looking to offer finance.

2. Diversifying the supply of SME finance

When an SME is rejected for finance by a major bank, there are a number of steps the SME can, but often doesn't, take. For example, an SME may choose to speak to another finance provider, use the Appeals Process to have the decision reviewed, or approach a commercial broker who can then seek finance on the SMEs behalf. Alternatively, the SME may be referred by the bank to a commercial broker, to another type of specialist financier who covers the type of finance the SME needs, or to a CDFI under the BBA's voluntary agreement.

Despite this, as set out in Chapter 1, referral levels have been low. Given that previous self-regulatory efforts by the major banks have not led to an effective system of referrals, the government believes there may be a case for using legislation to mandate a flow of information on rejected SME loan applications. The government's preferred approach is that rejected loan applications would be referred from a bank to a 3rd party platform or platforms that would be accessible to other lenders. The government would like to ensure that any intervention it makes complements existing private sector referral arrangements, by increasing the flow of information about SMEs rejected for finance to challenger banks and alternative providers of finance.

Question 1

Do you agree that the government should create a mandatory process, as outlined above, to help match SMEs that are seeking finance with credit providers who are looking to offer finance?

The remainder of this consultation asks, if you agree with this proposition then:

- Which parts of the market should be covered?
- What information should be shared?
- How should information be shared?
- Who would be able to access this information?

2.1 Which parts of the market should be covered?

If, following the consultation, the government decides to mandate that banks must refer details of declined loan applications, it will need to consider whether the requirement will apply to all providers of SME credit or whether some smaller providers should be exempt from sharing this information, in order not to impose any unnecessary burdens on smaller SME lenders. Also given that the banks are in most cases the first port of call for SMEs looking for a loan, the government needs to consider whether the obligation to share information should be limited to finance providers with a banking licence or whether other non-bank providers of credit should also be included.

Question 2

Should any requirement to share information on rejected loans apply to all SME credit providers or should there be exemptions for smaller providers and/or providers without a banking licence?

2.2 What information should be shared?

If the government were to mandate the supply of such information, it would also need to deal with privacy and data sharing concerns by ensuring that such information could be shared only where the SME has given permission for this to happen.

Question 3

Do you agree that information about rejected SME loans should only be shared where an SME gives its permission?

Question 4

Do you think there should be additional protections in place to secure the data about rejected SME loans and what form would these take?

It is important that any information provided, alongside credit data from the Credit Reference Agencies, would enable challenger banks and alternative finance providers to reach an informed decision about whether they are able to offer SMEs finance. The government proposes that this information will therefore need to include as a minimum reference to the SME’s name, business type and loan request parameters.

Question 5

What information do you think banks rejecting SME applications for finance should be required to provide? Do you agree that this should include information about the SME's name, business type, and loan request parameters?

It is also necessary to consider which types of finance applications should be part of mandatory information sharing. The government is of the view that, as a minimum, applications for SME business loans would be covered. However, the government also wants to consider whether other types of business finance application to the major banks would be eligible for referral.

Question 6

Do you think there other types of finance applications that should be included in addition to SME business loan applications? If you think other types of finance applications should be included, please supply the reasons for your answer.

2.3 How should information be shared?

If the government legislates to require that the major banks must share information about rejected SME loan applications, subject to the SMEs permission to do so, a decision must be taken about how the information should be shared.

The government's preferred approach is that this information would be provided to designated private sector platforms. Lenders and commercial finance brokers would then be able to access the information about the SME directly from the platform and consider whether they could offer the SME a loan. The platforms could be designated by the Treasury on advice from the British Business Bank. Designation decisions would be based on a defined set of criteria. The government envisages that one or more private sector companies would provide the platforms, and that a market would develop between platforms competing for business based on the service they offer.

Question 7

Do you agree that information about SMEs rejected for finance should be referred on to private sector platforms? If you agree, how would this work alongside existing private sector referral arrangements?

Question 8

What factors would promote the development of a market of competing platforms?

Question 9

If you agree that rejected loan information should be referred (to a platform, or somewhere else), how do you think compliance with this requirement should be reported and then enforced?

Question 10

What criteria should be used for designating platforms? How should ongoing adherence to these criteria be monitored?

2.4 Who will be able to access this information?

Improving access to information about SMEs seeking finance would give challenger banks and alternative finance providers greater opportunity to offer finance. Coupled with the government’s announcement on SME credit data, which will enhance challenger banks and alternative finance providers’ capability to assess the level of risk attached to particular loans, this will constitute a major step forwards in levelling the playing field between the major banks and smaller players in the SME lending market.

The government therefore proposes that all of the data shared about rejected SME loan applications would be made available to all providers of SME credit, commercial finance brokers, accountants and advisers.

Question 11

Do you agree that all of the information that is made available should be accessible to all providers of SME credit? Do you agree that the information should also be available to commercial finance brokers, accountants and advisers?

Question 12

Are any additional protections and reporting requirements or restrictions needed to ensure SMEs are protected from issues such as poor advice, malpractice and mis-selling?

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1. SME Journey Towards Raising Finance, BMG Research Report on behalf of the Department for Business, Innovation and Skills (2013)