FLA response to Treasury Committee Inquiry on SME Finance

Summary

1. The Finance & Leasing Association (FLA) is the leading trade body for the UK asset, consumer and motor finance providers of leasing and hire purchase. Our members include banks, subsidiaries of banks and building societies, the finance arms of leading retailers and manufacturing companies, and a range of independent firms.

2. Our members play a crucial role in allowing SMEs to access finance. Asset finance, (hire purchase and leasing) is a key part of the funding "mix" available to businesses. It allows businesses to acquire plant and machinery at a fixed monthly cost, aiding budgeting and avoiding large capital expenditure up front.

3. Small independent providers play a particularly important role in the lending market by financing smaller businesses with a higher risk profile. Since the Credit Crunch, the lending market evolved with new players entering the sector and the large High Street Banks providing finance to them.

4. A regulatory and policy environment which supports a diverse credit market will in turn allow SMEs to have access to the right finance options for their needs, supporting investment and business growth.

5. We would welcome the opportunity to discuss our responses and proposals with the Committee.

We recommend the following:

6. Reform of the Mandatory Bank Referrals scheme so it can be deployed more flexibly, helping SMEs become 'Match Fit for Finance'.

7. Inclusion of leasing in the full expensing capital allowances regime, to support business investment in plant and machinery.

8. The creation of an Emergency Warehouse Finance Liquidity Scheme for independent non-banks, so they can support SMEs in times of crisis.

9. Reforming the way commercial credit data is shared and submitted to ensure that accurate data on businesses is collected and SMEs can benefit from this information.

10. Removing red tape and FOS regulation which deters business lending, ensuring SMEs continue to have access to a diverse credit market. The regulatory perimeter must not be expanded further.

11. No introduction of the enhanced Basel rules in the UK, in line with the approach taken by peer countries, until the business environment is much stronger and only then if the prudential risk is fully established

12. Replace the British Business Bank (BBB) Recovery Loan Scheme (RLS) with a permanent targeted Business Finance Growth Guarantee and establish a Green Finance Growth Guarantee variant.

13. Ensure the BBB is adequately resourced.

Industry issues

What are the key challenges Small Medium-sized Enterprises (SMEs) face when seeking finance?

14. SMEs need access to the most appropriate form of finance for their needs. This might be an overdraft, a simple loan, or asset finance (hire purchase and leasing).

15. We know from our own research and working with other representative bodies such as the Federation of Small Businesses (FSB), that SMEs do not always know what finance options are available or where to obtain them. SMEs face a complex regulatory and tax burden with a range of economic challenges to face. This means that they are time limited when seeking finance, which reduces the opportunity to find the right finance at the right time.

16. We have worked with the FSB, British Business Bank, ICAEW, ACCA and others to address this demand-side issue. While awareness of finance and finance options has increased there is still more to be done to support SMEs.

17. Ensuring SMEs can obtain the right finance they require at the right time, means that they need to be 'match fit' for finance. To address this, we have recommended to the Government that changes are made to the Mandatory Bank Referrals (MBR). We are also running our own 'Match Fit for Finance' Campaign with the ACCA. We will continue to do this and work with other bodies to fill the knowledge gap SMEs have.

18. The transition to net zero is an additional challenge that SMEs are now addressing. Our members are working to assist them in this. This requires time away from the core business and extra cost. Financing a net zero asset can be more expensive due to a range of factors including the risk of funding new technology. This is why we are recommending to the Government a permanent replacement to the British Business Bank's Recovery Loan Scheme (RLS) that includes a green finance growth guarantee variant.

19. The regulatory and policy environment can sometimes drive the choice of finance, rather than an SME's business need. Capital allowances (including the full expensing regime) do not currently apply to leased assets.

20. HM Treasury and HMRC are currently exploring whether and how to extend full expensing to assets used for leasing. The FLA are participating in this process and would urge a broader review of the capital allowances regime to ensure it does not unduly discourage the use of leased assets by SMEs where they may be the most appropriate form of finance.

Through which channels do SMEs find the most success when seeking funding and why?

21. SMEs often have success applying for asset finance products as the security is the asset itself. This year's BBB Small Business Finance Markets (2022/23) study reported on the "strong growth in asset finance" with a 11% increase in new business.

22. Given the strength of asset finance and our members appetite to fund small businesses, it is critical that those firms understand the finance options available.

What role can financial innovation play in SME finance?

Is there more the government and the regulators can do to improve access to finance through innovative firms?

23. Changes to regulations surrounding Mandatory Bank Referrals (MBRs) and simplifying access to business credit data can support innovative approaches to help SMEs access finance.

24. In 2016 MBRs were introduced that required banks to refer declined finance applications from SMEs to alternative finance providers. MBR assumes lenders' risk appetite to be the main reason for declining an application when it could be that the application itself is flawed or that the business does not have a fundable profile.

25. MBR simply cascades applications which, having failed once, are likely to do so again. In fact, 9 out of 10 businesses using the MBR are unable to secure funding through the referral process.

26. We propose that the MBR system is reviewed to ensure it can more effectively deliver support to SMEs. Instead of simply cascading down referrals which are still likely to fail, funders including banks should be able to deploy the MBR

process in a more flexible way, which allows them to access a greater range of services including tailored advice.

27. For example, there may be alternative approaches or funding opportunities which can be used to support a business. It may be that MBR can be used to leverage alternative funding sources, allow funders to deploy innovative lending products, or be expanded to allow for referral to a wider range of products, advice and services for businesses that cannot access traditional bank funding combined with supporting SMEs to become 'Match Fit'. Use of business credit data can help identify what businesses can do to make them more fundable. SMEs will have a far better chance to get the right finance at the right time.

How successful has the Bank of England's Term Funding Scheme with additional incentives for SMEs (TFSME) been at encouraging banks to lend to SMEs?

28. The Bank of England's Term Funding Scheme was not available for independent non-bank funders. This means during a liquidity freeze, such as occurred at the height of the pandemic and lockdowns, these funders were severely limited in the support they could offer to small businesses. Of the £22.6 billion of asset finance new business that went to SMEs in 2022, £7.9 billion was provided by non-bank members. This is why we are recommending an Emergency Warehouse Finance Liquidity Scheme be established which supports independent (non-bank) funders. Our proposals for such a scheme are outlined below.

What role do credit reference agencies play in supporting SME finance?

29. Businesses should be able to access their credit data more easily. Business owners need help to improve their credit profile, and this begins with getting easy access to the data held on them under the Commercial Credit Data Sharing Scheme (CCDS).

30. Consumers can readily access their credit file from credit reference agencies and receive tailored advice from service providers on improving their credit score.

31. Whilst Businesses have the right to access their CCDS data, this is rarely exercised. Data may also be provided in a proprietary format by the CRA which is difficult to interpret for the business or for a third-party service provider.

32. This means that SMEs are unable to benefit from the same insights that consumers do when they access their credit data. HM Treasury should review the way in which businesses are able to access the data held on them by the CCDS.

33. We recommend that the CCDS mandating process is reviewed to ensure that banks who were new entrants to the market when it was established and have now grown are included. We also recommend that the way data is submitted to CCDS is standardised.

Regulatory issues

Do SMEs have adequate and appropriate access to a complaints procedure when in dispute with their bank or lender?

34. The FLA operates a robust Business Finance Code and associated complaints process to support customers who are unhappy with the behaviour of their funder. It provides an important means of alternative dispute resolution, particularly for customers outside of the regulatory perimeter.

35. We believe such industry-led solutions provide an effective and appropriate means of dispute resolution over and above the extensive and robust complaints procedures already in place by funders.

How well does the Financial Ombudsman Service (FOS) work for small business complaints?

Is the FOS's existing role in SME finance appropriate? If not, how should it change?

36. The FLA did not support the expansion of the FOS's remit to cover more SMEs in 2019, as we felt that there were alternative means of redress available to these customers.

37. We also felt there was a risk that expanding access to the FOS to customers not covered by the Consumer Credit Act could create confusion with respect to the regulatory perimeter, and that the compliance costs would make it harder to offer funding on a competitive basis to SME customers, particularly for smaller funders.

38. We remain concerned about the impact of the current rules on SME customers, particularly the increase in regulatory action affecting funders in this area, including the application of the new Consumer Duty.

39. We are aware that funders are facing increased costs to comply with regulation including the Consumer Duty and this cost could potentially lead to market withdrawal for some funders. The regulatory perimeter should more explicitly exclude lending for business purposes.

40. We also remain concerned that the extension of access to the FOS for businesses not under the regulatory perimeter creates the possibility of confusion for both the customer, who may feel they have access to regulatory protections which may not apply to them, and for the FOS, who may misapply the rules. The FLA continues to engage closely with FOS on consistent interpretation of FCA rules. Extending the perimeter risks further inconsistency and associated costs to firms.

Should commercial lending to SMEs be brought into the regulatory perimeter?

41. The FLA would not support the extension of the regulatory perimeter to include SMEs. The smallest businesses are already subject to regulatory protections, which creates a sometimes inconsistent, unclear, and poorly understood boundary. This means SMEs may not understand what regulatory framework applies to them.

42. The CCA currently requires that many small businesses are treated as individual consumers for regulatory purposes. This means that rules which are often wholly inappropriate for business transactions are applied. This creates a significant administrative burden, delaying the decision-making process.

43. Funders may end up having to make repeated requests for information that has already been provided or is not applicable for business customers to comply with the rules. The current regime also imposes significant costs on the businesses concerned. This applies both to businesses preparing information for funders and to funders required to spend considerable amounts of time and money ensuring staff are trained in all aspects of the rules. This is because business funding incorporates these to ensure consistency across the business even if they are unlikely to apply to most of their customers.

44. The current regulatory requirements in the following areas are particularly unsuited to business lending: customer information and documentation; front line sales; and creditworthiness assessment.

45. Extension of the perimeter would lead to market withdrawal due to the significant costs of compliance for funders. This would create a much less competitive market for SME finance which would be the exclusive preserve of larger banks.

46. Accordingly, we would not support any further expansion of the regulatory perimeter and would instead recommend that business lending is more explicitly excluded from the scope of regulation.

What impact will the PRA's proposed Basel 3.1 capital requirements framework, and in particular the proposed removal of the SME support factor, have on SMEs in the context of the PRA's objectives?

47. Our members have raised concerns regarding the implementation of the Basel 3.1 standards and the potential for unintended consequences, particularly with respect to SME customers.

48. The increase of risk weightings may have the unintended effect of reducing access to finance for SMEs, and increasing the cost of such finance where it is able to be offered at all. Application of the Basel 3.1 standards in the way

which is proposed by the PRA would result in capital requirements which would be out of proportion to the risk presented by SME lending.

49. This could mean that funders become more risk-averse and less willing to lend to SMEs, particularly those with weaker credit profiles. Such a reduction in the availability of credit for SMEs could limit their ability to grow and invest in their businesses.

50. There is also the risk that application of the standards could disproportionately affect smaller banks and independent lenders, who would face higher securitisation and compliance costs.

51. Removal of the SME supporting factor could create a material risk to economic growth and limit the ability of the market to serve these customers, which could in turn result in a less competitive and diverse credit market, to the detriment of all customers.

52. The supporting factor is a key acknowledgment of the importance of SME lending and of the need to serve these customers to support the wider UK economy. Removing it ignores the need to support these customers particularly in times of economic hardship when some SMEs may be less lendable propositions, potentially creating an illiquid credit market.

53. The application suggested by the PRA goes beyond the lighter touch approach taken by peer countries and means that UK SMEs may struggle to access some forms of credit.

54. The proposed changes should therefore not be introduced in the UK, until the business environment is much stronger and only then if the prudential risk is fully established.

Government policy issues

Should the Government do more to enhance SME access to finance? And, if so, what?

What has the impact of the Covid Bounceback Loan Scheme (BBLS) which was followed by the Recovery Loan Scheme, been on SME finance?

55. The British Business Bank's (BBB) various support schemes: Enterprise Finance Guarantee Asset Finance Variant, Coronavirus Business Interruption Loan Scheme (CBILs) and temporary Recovery Loan Scheme (RLS) have all supported FLA asset finance members in providing finance to small business.

56. When RLS expires in 2024, we want to see a permanent scheme established. This would provide our members with certainty and allow long-term planning with their customers: mainly small and medium-sized businesses. A Business Finance Growth Guarantee Scheme would be a targeted scheme modelled on the Enterprise Finance Guarantee. However, retaining the removal of the cap and the assignment of guarantee is critical to the success of the Guarantee.

57. We also want to see a targeted green variant of the RLS replacement: a Green Finance Growth Guarantee that enables lenders to fund green assets that are outside of the risk criteria due to a lack of a secondary market or residual value data.

In the US the Treasury approved a fund, (State Small Business Credit Initiative (SSBCI)) for incentivising and supporting underserved businesses. Does the UK need similar provisions?

58. In the event of a future credit crisis, lenders will need rapid access to liquidity beyond support schemes such as the Recovery Loan Scheme (RLS) and the Enterprise Finance Guarantee (EFG) schemes. These schemes play an important role in helping business get access to finance but need to be reinforced by a liquidity solution which can support small lenders.

59. Non-bank lenders provide support for underserved customer groups and lack access to the support structures available to banks, such as Term Funding for SMEs, potentially putting them at risk of a liquidity squeeze in times of crisis in turn limiting the support they can offer their SME customers.

60. To ensure we avoid a liquidity freeze in the future, we recommend a twin-track approach: a permanent Business Finance Growth Guarantee Scheme which replaces the Recovery Loan Scheme and an Emergency Finance Warehouse Guarantee.

61. The Business Finance Growth Guarantee Scheme, run by the BBB, would be a permanent scheme with assignment of guarantee to wholesale funders and investors. During a crisis, the BBB should be authorised to quickly adapt the scheme to the situation. For instance, the guarantee may need to be increased as was done in 2020.

62. As well as the above, a new Emergency Warehouse Liquidity Finance Scheme is required to address the liquidity gap that may arise. The EWFLS would provide a top slice guarantee to wholesale funders and investors who are financing independent non-bank SME lenders. This would allow the lender to provide payment deferrals to viable SME customers and support them as required through the crisis as well as allowing businesses to continue business as normal e.g., acquire assets.

63. We also recommend that the British Business Investment (BBI) has a liquidity pool that can be deployed if required to support the independent non-bank lender. This would be modelled on the BBI's existing mezzanine and senior debt programmes.

64. The EWFLS should be established now as an off the shelf emergency mechanism to deal with a future crisis.

How useful is the British Business Bank? Does its finance hub improve SME access to finance?

39. The BBB plays a crucial role in supporting the growth and success of SMEs and scale ups in the United Kingdom. Its guarantees have helped to support scale-ups and SMEs that might otherwise struggle to access finance. Its products have also enabled non-bank funders to deliver asset finance products to businesses that might otherwise have overlooked hire purchase and leasing as options to fund the acquisition of equipment.

40. To ensure it has the necessary resources and tools to effectively support SMEs and growing businesses, we believe the BBB's remit should be reviewed with a view to expanding its offering. This review should aim to provide the BBB with increased funding to bolster its cash reserves, allowing it to scale up its operations, deploy its products more quickly, and provide greater financial support to SMEs.

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About the FLA

The Finance & Leasing Association is the leading trade body for the asset, consumer and motor finance sectors in the UK. Our members include banks, subsidiaries of banks and building societies, the finance arms of leading retailers and manufacturing companies, and a range of independent firms.

In 2022, members of the Finance & Leasing Association (FLA) provided £150 billion of new finance to UK businesses and households, £51 billion of which helped consumers and businesses buy new and used cars, including 84% of private new car registrations. £34 billion of finance was provided to businesses and the public sector to support investment in new equipment, representing almost a third of UK investment in machinery, equipment and purchased software in the UK last year.

FLA members comprise banks and their subsidiaries, the finance arms of leading retailers and manufacturing companies, and a range of independent firms, helping to boost UK production, support demand for UK goods and services, and secure jobs.