“Challenging myths about the funding of small businesses...”

FINANCE FOR GROWTH

Andrew Freeman

DEMOS FINANCE

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Special effort has been made to ensure accuracy of the many numbers quoted in the report. Any errors that remain are the responsibility of the author.

Andrew Freeman
September 2013

Foreword

With this report Demos Finance is properly born. Helping to create a mainstream financial services think-tank that influences both the expert and the public debate and is respected by the industry and its many critics has been an ambition of mine for many years.

When, more than ten years ago, as editor of Prospect magazine I created the annual think-tank of the year awards it struck me as odd that so little think-tank attention was expended on finance, the single most important feature of Britain's economy. The gap where a neutral, authoritative, ideas space should have been – operating between the abstractions of academia and the instantness of journalism – became even more glaring after the 2007/8 crash.

Of course finance has never been short of analysis and there are many people in the industry and its regulatory bodies, in universities and business schools, in newspapers and, indeed, in some of the general think tanks (and the CSFI) who produce excellent work.

But none of them bring the attributes of a good think-tank to the subject by combining under one roof the publishing of original, independent research; organising topical events that bring together the different 'tribes' in the sector; responding swiftly to events with briefings and media comment and, finally, providing a public education function by translating for general audiences some of the specialist language of the financial experts (and making it all freely available).

Demos Finance, operating as a unit within the cross-party think-tank Demos (where I am director), is less than a year old but under the leadership of Andrew Freeman and Jodie Ginsberg it is beginning to make its mark. We have already produced several briefing papers, most notably on the LIBOR crisis and John Kay's short termism review, and hosted some memorable events, including one with the Parliamentary Banking Commission and another with Anat Admati, co-author of the remarkable book The Banker's New Clothes, about how to make banks safe with much higher levels of equity.

But the publication of our first major piece of research – *Finance For Growth* – takes us to a new level. And Andrew Freeman's report sets a template for the kind of research we want to do in the future. It is on one of the perpetually topical financial subjects: bank lending (or lack of it) to business. It challenges a widely held assumption about lending to small and medium sized businesses and asks whether we have been looking in the right place for sustainable economic growth. It is based on a sharp-eyed overview of the existing literature plus some original research and insights. It provides practical suggestions for retuning policy in this area. It is also clearly written for a general reader audience and is pleasingly brief.

Finance is of course an enormous field that touches all our lives every day, from the money in our wallets to the national and global economy. Demos Finance's scope is similarly broad: other current research projects include consumer finance, bank technology, Islamic finance, accounting rules, payments infrastructure, 'alternative' lenders, and online currencies.

The financial sector will remain at the heart of all modern economies. Understanding it better, including how parts of it failed in recent years and can best be mended, is a national priority both for politicians and for all of us as individual citizens and consumers. That is easier said than done; it is an unavoidably complex world marked by powerful vested interests. But if Demos Finance can help in a small way to increase that understanding, especially in the political and media class, it will have served its purpose.

David Goodhart
September 2013

Executive summary

There is an ongoing and heated debate in the UK about the importance of small and medium-sized enterprises (SMEs) for economic recovery, and the willingness or otherwise of traditional banks to lend to these businesses. Despite repeated efforts to stimulate lending by the Government and the Bank of England, net lending to SMEs has been steadily falling.

Clearly, something is not working. The SME sector is widely misunderstood and misrepresented; most significantly it is far from obvious that SMEs as a group are in fact major contributors to economic growth, despite the crucial role they play as existing employers, customers and suppliers.

This is because the majority of SMEs are focused on remaining in business, and have no intention of aiming to be the next Google. Their challenges are cashflow and day-to-day financial management, not growth finance. By contrast, companies with realistic ambitions of growth are found in all sizes.

The starting position of public policy has been to focus on size, with interventions aimed at smallness, rather than at enabling growth and financing risk. In addition, our research shows that most SMEs do not wish to borrow from a bank and of those that do, 90 per cent have no problems getting the financing they want.[1] Further, not enough attention is given to the appropriateness of bank loans for the very few businesses that require risk capital and struggle to secure it. A better source of funds in these cases would be equity or an alternative source.

This report therefore argues for two fundamentally changed assumptions. *First, rather than thinking small, we should think growth.* If most SMEs have no immediate ambitions to grow, we should focus our efforts on those businesses with the will and potential to deliver significant growth in the future regardless of size. Even if most growth businesses are SMEs (which is far from certain), it certainly does not mean most SMEs are growth businesses.

Second, we need to look outside traditional bank lending to address this challenge. If we want to target the parts of the economy where growth is achievable, we need to devise a funding environment able to support the risks associated with innovation and start-ups. As this report shows, that is not the job of bank lending, but at the moment the UK has precious few non-bank finance alternatives.

To the extent that there is an SME funding problem, and we would argue that where there is a problem it has been grossly overstated, the solution lies not with traditional banking activity, but rather with the UK's broader business culture and funding environment.

Growth policy should be directed away from subsidising the SME sector as a whole towards targeted interventions aimed at those whose ambition is for growth and innovation rather than ongoing stability.

These interventions should aim to improve business education and mentoring of existing businesses that have a propensity to grow, as well as develop alternative finance markets suited to funding growth risk. *It is clear that much more attention and effort is needed to re-build an equity culture in the UK.*

This is not to let banks off the hook. They have a continuing responsibility to support the market for bank lending, and should also think deeply about whether they can help to address the non-bank finance gap, and help to close the clear business skills gap among UK SMEs. The banking sector has an unmatched ability to reach businesses of all sizes and should put its distribution mechanisms to work in delivering solutions.

It is apparent that SMEs have been poorly served by policy that conflates their needs with those of growth companies. There is a need for a renewed focus on policy interventions that meet the actual challenges they face, for instance by providing more effective cash flow support, a growth-positive tax and regulatory environment and commercial skills support. A further report on the real challenges faced by the small business community would be very welcome.

This report makes a number of recommendations, which flow from the two changed assumptions outlined above. They have at their heart a belief that the UK's best chance to deliver sustainable long-term business growth, rather than short-term growth subsidised by the taxpayer, is to create an environment that meets the needs of growth companies, regardless of size.

Summary of recommendations

Develop a genuine pre-capital market investment house

The British Investment Bank is a welcome intervention, but the UK lacks a genuine pre-capital market equity investment house. Returning to a model of the Industrial and Commercial Finance Corporation, the precursor to 3i, could strongly benefit the UK economy.

Learn from Canada to develop a reliable SME registry

The UK lacks adequate and reliable data on the SME sector – we do not even have up-to-date numbers on how many SMEs there are. The UK Government should instruct either the Bank of England or the Office for National Statistics to emulate the Canadian model and address this gap.

Create SME impact assessments

The World Bank has published an impact assessment framework specifically on SME funding and this could be used as a blueprint for UK assessments.[2] Indeed, the UK could volunteer to work with the G20 and the World Bank as a pioneer of cost-effective SME impact assessments, creating the additional benefit of insights that can be exploited in the developing world.

Focus on increasing the growth potential of our SMEs rather than simply increasing the number of SMEs we have

Policy emphasis should be on encouraging growth potential so that businesses are more able to survive and more likely to do so in a way that makes a positive contribution to the economy and society. Unfortunately, this requires the kind of long-term policy that is notoriously difficult to synchronise with electoral cycles. It would involve thinking through not just how to direct more help to the existing stock of businesses in the form of mentoring, education and so on, but also how to build relevant literacy in the generations of future business founders and owners.

Establish a 'business academy' network able to support businesses as they develop

Many businesses struggle because of a lack of professional management capability across a range of issues including marketing, access to finance and business administration. Business academies backed by the Government could address these skills gaps and significantly increase the success rates of UK SMEs.

Create a central database of lender information to allow banks and new entrants to make more informed lending decisions

The technology platforms required for this could be considered a public good and a utility created to provide lenders with information about would-be borrowers and monitoring services for existing borrowers. The Government and the Bank of England should encourage exploration of this and related ideas, not least as a mechanism by which new entrants could accelerate their SME activities and enhance competition.

Address the lack of an equity culture in the UK

A working group led by the Treasury and the Department for Business, Innovation and Skills (BIS) could examine the full tax and economic impact implications of a radical change to the UK's equity culture and make recommendations.

Infrastructure and UK business culture pose much greater challenges than access to bank loans – our national debate should reflect this

The most useful policy discussions should have almost nothing to do with bank funding and much more to do with the broader infrastructure and culture in which UK businesses operate. That is where the debate should be conducted.

Don't let the banks off the hook

Banks have a huge distribution system through their branch networks and an unmatched contact book of businesses and investors. They should be encouraged or even mandated to innovate to find ways of distributing alternative finance and addressing knowledge and skills gaps in businesses.

A further report is needed into the specific needs of SMEs

SMEs are poorly served by a policy approach that assumes they are focused on growth. A further report should consider the specific challenges faced by these companies and identify policy interventions that would materially enhance these businesses' survival rates and economic output.

1 Introduction

There is a broad assumption that small and medium-sized enterprises (SMEs) matter a great deal to the UK economy. As a consequence, there is an extraordinarily diverse literature on a topic that might, at first glance, appear to be straightforward – how the sector is funded.

In recent decades, these firms have been attributed great significance in national economies, as drivers of economic growth, employment, innovation, research and overall societal wellbeing.

In the foreword to *Financing SMEs and Entrepreneurs 2013*, Angel Gurria, Secretary General of the OECD said:

Small and medium-sized enterprises (SMEs) and entrepreneurs must continue to be key players in national strategies for growth, job creation and social cohesion. SMEs and entrepreneurs are crucial for tracing new paths to more sustainable and inclusive growth, thanks to their role in developing and diffusing innovation. However, they can only fulfill this potential if they obtain the finance necessary to start and grow their businesses.[3]

(Ironically, the only truly substantiated finding that small businesses contribute to wellbeing is that their owners are 'happier' than the average citizen, but we will come back to this later.)[4]

Thanks to this attribution, SMEs have often received substantial subsidies in the form of grants and tax breaks from central and regional governments and they remain the focus of great political attention. That SMEs are heavily subsidised is never mentioned in the debate about their role. In fact, the subsidy is huge – more than the annual budget for the police force.

But are we asking more of our small and medium-sized businesses than is fair or reasonable?

Many SMEs do not currently expect to grow, and they would largely define success as continued trading, and perhaps greater profitability. The owners of a family restaurant, for example, may be far more focused on keeping open from year to year than on opening a second premises, let alone a third or fourth.

Simply by keeping going, the restaurateur provides employment and economic activity, but it would be unreasonable to expect significant growth from this activity.

Consequently, it is far from clear that unfocused support for SMEs as a category, rather than the high-growth companies which form a relatively small sub-set of them, is either particularly effective or offers good value for money in pursuit of economic growth.

In the UK, there is a widespread and cross-party perception that a lack of SME funding remains a serious problem, potentially thwarting short-term economic recovery and limiting long-term economic robustness and competitiveness.

High-street banks in particular have faced significant criticism for their unwillingness to lend to SMEs. There is a broad consensus that since the onset of crisis in 2007, the banks have contributed to exceptionally slow general recovery of the economy by reining in their lending officers. It is assumed that by stopping the flow of credit to the economy via small business lending, banks have effectively stopped recovery itself.[5] The criticism of some banks' struggles under the Funding for Lending scheme illustrates how potent this assumption seems to be.

This deeply flawed argument has taken hold in the media. Stories on the no-growth state of the economy are illustrated by reference to a disgruntled small business owner denied a loan by an uncaring bank, but frequently fail to ask deeper questions about whether this is a representative experience or why the business was unable to access finance.

Equally, many MPs will have heard from business owners who have been unable to access funding, which drives political concern that banking is not doing its job. A highly specific issue can appear to politicians to be a far wider, more general concern. We need to consider the sample size before we come to conclusions.

We have been in a similar situation before. In the early 1990s, there was a

breakdown of both communication and confidence between many SMEs and their main finance providers, notably the commercial banks. SMEs complained that reductions in (interest) base rates were not being fully passed on and that banks prematurely cut back on loans and so pushed viable businesses into receivership. Meanwhile, the banking sector suffered bad debts among loans to the small business sector.6

In response at the time, the Bank of England initiated a major ongoing review of the relationship between banks and SMEs, aiming to 'bring facts into debates typified by anecdote, assertion and assumption'.[7]

More than two decades later it is as if we are back where this began. A close examination of the academic, regulatory and commercial literature shows that much of the rhetoric and available analysis of SMEs and their role in the economy remains riddled with poor thinking and muddled conclusions, problems compounded by a plethora of issues relating to the availability and quality of relevant data.

This Demos Finance report aims to unpack the debate around SME funding in the UK. The time is ripe for some myth busting, and in some cases relearning earlier findings that have apparently been forgotten or ignored. And we can start by repeating a conclusion from the Bank of England's *Finance for Small Firms*: 'Access to finance is not a barrier for most SMEs.'[8] So much so that the Bank concluded, 'There is no longer a need for the Bank to be involved in these issues.' It passed the matter off to a specialist body that would focus in future on this non-issue.

An immediate objection might be that 2004 is a silly place to begin a report on SME funding in 2013. After all, in 2004 the credit crisis was not far off and there was no suggestion in the report referred to here or in any other report at that time that there was something brewing that might turn out to be exceedingly damaging. In other words, the lack of a perceived problem was highly correlated with the fact that at that time credit could be obtained by businesses of all sorts looking to borrow. Credit was certainly freely available in 2004 and became more so in subsequent years before catastrophe struck. Among the biggest borrowers were the banks themselves, several of which leveraged up their balance sheets until they were greater than the entire gross domestic product (GDP) of the UK.

Surely these conditions were different and banks are now behaving differently? They were and they are. But banks are not the real issue. A closer look at the small and medium-sized business sector in the UK shows clearly that the boom years after the early 2000s until the bust of 2007–08 were anomalous from a funding perspective. And insofar as we have returned to a more typical environment, we can be much clearer about how and why some, but a tiny minority of, SMEs ever want to borrow money.

And this is the really odd thing about the issue: most SMEs never borrow from a bank, they borrow from the people who set them up or from friends and family, and they do their utmost not to get into debt, instead ploughing earnings back into the company or business so that they can remain debt-free.

Which raises a question rarely asked and even more rarely answered. Why are we specifically concerned with SMEs and whether banks are lending to them? Why would we want to encourage UK businesses to borrow more when we have right in front of our eyes the strongest possible evidence that too much debt, or the wrong kind of debt, can be extremely dangerous?

Why, in fact, do we assume that SMEs as a group want to grow, and that bank lending is the right way to fund that ambition?

Structure and a note on sources

This report is structured as follows:

- Chapter 2 lays out the SME landscape in the UK.
- Chapter 3 explains how banks measure and report the extent of SME lending.
- Chapter 4 gives a brief history of SME funding in order to support the case that historical comparisons need to go back long before the 2007 credit crisis and its aftermath.
- Chapter 5 explains that SMEs receive large government subsidies with very little evidence that they deserve them.
- Chapter 6 lays out some surprising truths about how SMEs actually fund themselves and the actual role played by banks.
- Chapter 7 looks at the SME lending front line – how decisions get made by the big banks.
- Chapter 8 explores the relationship between SMEs and economic growth.
- Chapter 9 examines the tricky boundary between equity and debt.
- A final chapter examines the policy implications and suggests ways the SME funding debate might be reconfigured to be of greater relevance and impact.

There is a plethora of reports on SME and business funding more generally, and this report is not an attempt to summarise or synthesise them. Numerous taskforces and policy groups have addressed the issue, including sensible work on how the UK might seek to improve non-bank funding alternatives.[9] Arguments about SME and business funding are closely linked to parallel debates on growth and entrepreneurship and some of the relevant literature is reviewed here. Similarly, there is much available research on how business funding is organised in other countries, with a noticeable focus on Germany and the US.[10] Again, this report makes no effort to repeat this work, but refers to it where appropriate.

This report was largely written before the Parliamentary Commission on Banking Standards published its June 2013 final report.[11] This does not focus specifically on SME lending, although some of its oral and written testimony discussed the issue. However, the final report addresses some of the cultural failings in the lending and sales cultures of banks, for instance in selling interest-rate swaps to SMEs. This is not looked at below because there is very little to add to the Commission's findings, which stand on their own merits.

Rather, this report seeks to give accurate numbers for SME activity in the UK in order to address a notable gap in our understanding of the national economy.

It draws on a wide range of sources, from interviews and field research to detailed use of statistics. Particular emphasis has been placed on the new findings from the SME Finance Monitor, as these represent the most comprehensive available view of actual current SME practice. Other statistical sources include the Bank of England, the British Bankers' Association, the Organisation for Economic Co-operation and Development (OECD), the International Finance Corporation (IFC) and the Office for National Statistics (ONS).

The Bank of England's report *Finance for Small Firms* referred to above was published in 2004. As there are subsequent gaps in data collection, followed by changes in statistical methods, there is no reliable data series for very long-term comparisons. And there are almost always questions about the reliability of data. For example, even in government reports, we find disclaimers such as, 'The time series is not consistent throughout due to changes in the methodology. The series has therefore been adjusted to take account of these differences. Figures are indicative and should be interpreted with caution.'[12] We acknowledge the awkward fact that we cannot be totally precise at many points where it would be most helpful. However, where something is 'indicative', it is often strongly so and this should not be grounds for undermining or rejecting the analysis or conclusions that follow.

2 Mapping the SME population – what are we talking about?

Let us begin with a description of some of the main challenges facing anyone wanting to paint a clear picture of the SME population and its needs. What is an SME? How many of them are there?

Although there are some agreed definitions of SME characteristics, these are not universally adopted, so any effort to assess SMEs and their financing needs invariably runs into intractable problems of irreconcilable or simply missing information. A subject of great importance to many experts and policymakers is, in reality, poorly understood and often misrepresented.[13]

Figure 1 shows the European Commission's definition of the different categories of SMEs. The important thing to note for the UK debate is that the EU suggests a combination of at least two factors is appropriate, but gives the option of looking at balance sheet or asset size instead of turnover. This element is almost never mentioned but arguably should be part of the discussion about SME funding. Depending on their sector, businesses will have quite different financial profiles.

The main factors determining whether a company is an SME are:

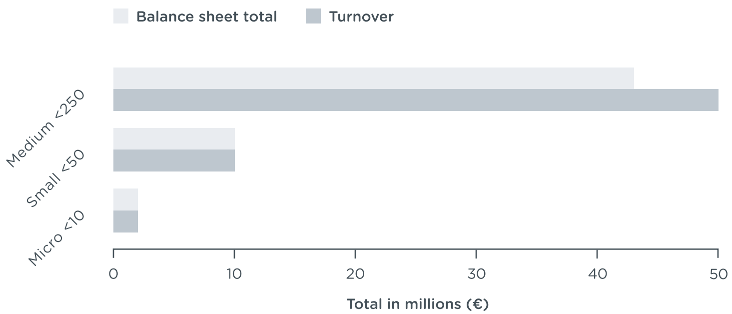
- number of employees and
- either turnover or balance sheet total

Any discussion about SMEs needs to start with some simple numbers. What is the actual stock of UK small businesses? How many are there? Here we see the semantic and data-related issues faced by participants in this debate.

For example:

- There are at least five ways of defining small businesses. There are roughly 5 million people registered with HM Revenue & Customs (HMRC) as self-employed.
- There are just over 1 million registered companies, although many of these are holding vehicles for property management, so are not typical small companies.
- Approximately 1.9 million entities are registered for VAT, while there are more than 2 million people using the pay as you earn (PAYE) system.[15]

Figure 1 **The European Commission's definition of different types of SMEs**

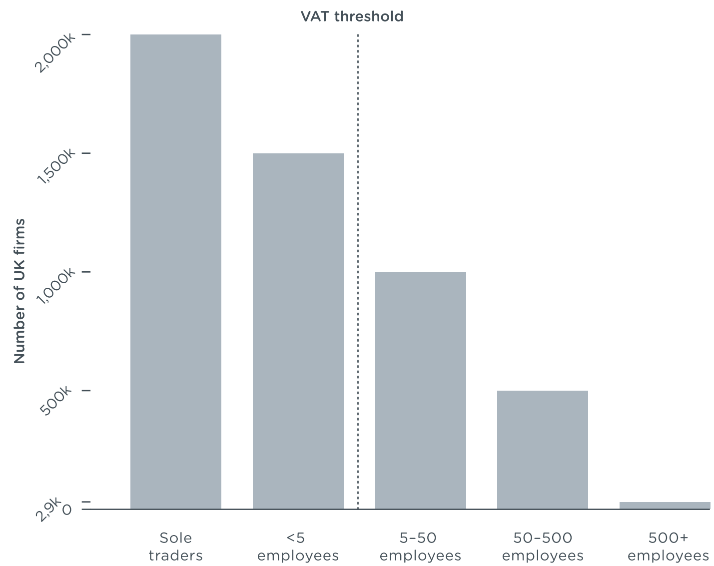


Source: Enterprise and Industry, 'What is an SME?'[14]

If everybody concerned with the SME debate used the same measures consistently, then policy discussions would be a lot easier. But politicians, academics and other lobby groups often float between definitions, sometimes in support of a particular case.

Often they simply ignore the best potential source, the Government's Inter-Departmental Business Register, which aggregates information across various government departments.[16] It is published with a time lag, but offers the most comprehensive view of UK business activity. It suggests that in 2013 there are 4.8 million businesses in the UK – a much higher number than the 1.9 million VAT-registered entities, and an increase of almost 500,000 from the equivalent figure in 2008.

Figure 2 **The UK business population, by firm size**



It is important to note that these figures do not, as is often claimed, include the 'grey' economy. Each entity has some form of official registration, so cannot be considered as being part of the shadow economy.

The numbers immediately tell us that most of the businesses in the UK are very small, with insufficient turnover to be VAT-registered. In fact, BIS estimates that three-quarters of these businesses are sole traders with no employees, while there are nearly 1 million 'micro' firms employing between one and nine people.[17]

According to Professor Alan Hughes of the Centre for Business Research at the University of Cambridge, the vast majority of these firms employ fewer than five people.

By way of comparison, there are 1.2 million businesses employing between 1 and 499 workers, but a mere 2,900 firms employ more than 500 people and these businesses account for 44 per cent of all UK employment and 41 per cent of all turnover.[18]

Figure 2 shows the UK business population represented in simplified and rounded terms.

It is already clear that this is a diverse population, and we should be suspicious of any effort to treat it as homogenous. As we will see below, there is no such thing as a typical SME, and in fact smallness is a a poor indicator of the importance of a business to the momentum of the national economy.

In addition, there are some 3.3 million business current accounts held with UK-based banks, demonstrating that there is a large number of businesses operating in ways not easily captured by statistics. These might be people trading on auction sites such as eBay, or simply taking advantage of 'free' personal banking and mingling their personal finances with those of the business. They might be running what amounts to a fairly substantial small business, but in a way that requires no external finance and is almost entirely unnoticed by official statistics.

It is extremely difficult to know whether this business stock – how many businesses there are currently trading – is changing, for better or worse. But we can make one observation. While the headline number of business entities is relatively stable, indeed is a lot higher than it was a few decades ago, there is considerable annual churn as existing businesses die and new ones are created. Tracking this 'flow' is not easy, however.

The guiding principle of policy in this area is the belief that an efficient, well-organised SME sector is an important economic asset. Yet while there are rich data on how people as individuals enter and exit the labour market, there are no equivalent data for businesses and most estimates are unreliable.[19]

We know very little about why a new business is launched and even less about why it might subsequently exit (does it fail, become insolvent, or leave for personal reasons including exploiting capital gains tax rules?), so in effect we have very little understanding of how and why the stock of SMEs is changing. Filing requirements for Companies House are such that there is no information on why a particular company ceases trading, but we do know that there can be good reasons as well as bad ones for this decision.

Table 1 **Use of business finance across different sized firms**

	Turnover	Broad characteristics	Use of regular finance	Use of specialist finance	Typical providers
Smallest micro businesses	Below £50k	Cash-based firms, often part-time businesses; few tangible assets; local operations	Limited mainly to overdraft, loans and credit cards or personal finance products	Limited. Some asset-backed lending (ABL) – mainly vendor finance	Banks, credit card providers and point of sale (vendor assistance)
Micro businesses	£50k to £1m	Increasingly full-time firms with staff, premises and assets; local activity normally limited to a single region; occasional exporting	Overdraft, loans and credit cards	Increased use of structured ABL. Occasional use of trade finance products	Banks, credit card providers, specialised providers for ABL and trade products
SMEs	£1m to £25m	Full-time, larger multi-regional and national firms; increasing export/import activity	Overdraft, loans	Still some use of ABL, factoring and invoice discounting, export finance, some equity finance	Banks, credit card providers, specialised providers, business angels, private equity

Note: Definitions have been developed for the purpose of the Taskforce and may not reconcile with other definitions of SMEs.

Source: Supporting UK business: the report of the Business Finance Taskforce, October 2010, p.14 [20]

In other words, we have limited insight into the SME business population and its evolution over time. This problem is exacerbated by the differing methodologies of business lobby groups, many of which conduct and publicise their own small-sample surveys on business activities and attitudes. It is a matter of logic that any company that is a member of a lobby group or trade association is, by definition, not a typical SME.[21] Indeed, it might help the debate if we abandon the very notion that there is such an entity.

Table 1 shows one effort to classify business size and the related financial requirements and providers of finance. Its own footnote is illustrative of the issues discussed above.

The difficulty of estimating the UK business stock in aggregate is mirrored by the equivalent problem at the level of individual businesses and companies. Even the simple rounded numbers used earlier in this report show that the vast majority of UK businesses are unincorporated and employ one person or no one (but mostly one person, the founder or owner, who has no current intention of employing anyone else – therefore they create no employment, as we will explore below). They are not required by law to file information on their activities, although some of this is captured in HMRC data, particularly via individual tax returns.

Where a business is incorporated, a long-standing drive against ‘red tape’ has resulted in a progressive reduction in filing requirements, particularly for the smallest entities, which are not asked to file a profit and loss statement (P&L) and are offered lengthy time lags before they must file their accounts. By the time their balance sheets can be accessed the information is so old as to be effectively useless as a basis for assessing the market, its profitability and its performance.[22]

For their own reasons, some companies volunteer information about themselves to credit agencies such as Experian and Dun & Bradstreet, both of which gather extensive data in order to compile credit files on individual entities. However, this creates an obviously biased sample and leaves by far the biggest group of entities opaque to meaningful external analysis.

Interestingly, banks are in the privileged position of having access to the management accounts of some companies that are or wish to be borrowers. In these cases, they can see whether an entity is profitable and they can assess from its transactions whether, for example, it is exporting goods and services. However, these data are also highly selective. They cover only the universe of companies that has dealings with each bank, and they are not aggregated in a way that might allow a national picture to emerge. Moreover, only a minority of companies are sophisticated enough to warrant management information at this level of detail.

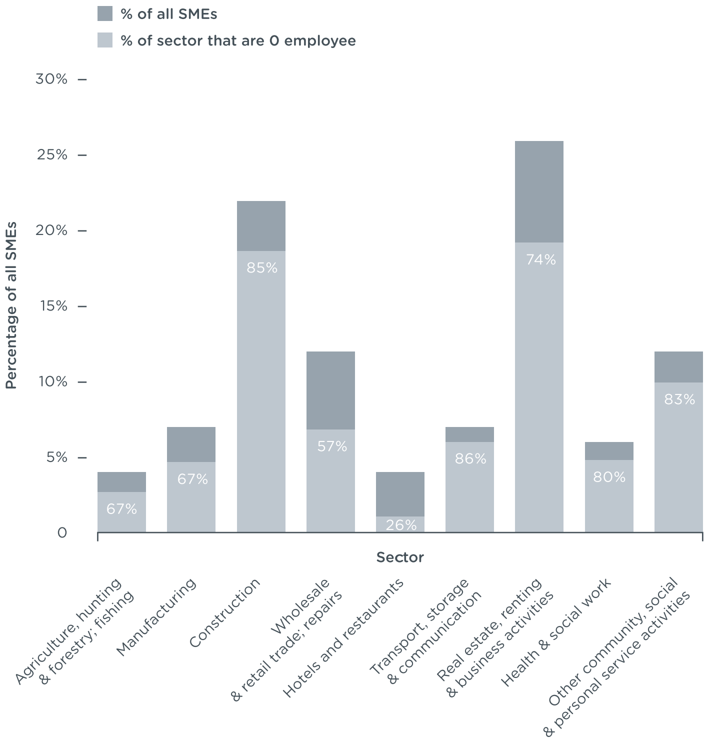
Nevertheless, there is a source of information about bank and other lending to SMEs that is gradually building a more reliable picture and is worth describing in a little detail.

In July 2010 the Business Finance Taskforce was set up to review the role of UK banks in lending to the UK economy and to make recommendations and commitments. The Taskforce was a response by the six main UK banks and the British Bankers’ Association in light of sustained criticism of banks in the wake of the credit crisis and subsequent recession. The widespread perception, fuelled by a constant flow of political interventions, was that banks were deliberately withholding funds and making it difficult or impossible for firms to borrow or to refinance on favourable terms. The British Bankers’ Association’s report in October 2010 included in its recommendations the funding of an independent survey to create an ‘agreed and authoritative set of data on business finance demand and lending supply’.[23]

The result is the SME Finance Monitor, a quarterly publication based on a rolling survey of 5,000 businesses since the first quarter of 2011 – as of Q1 2013 some 40,000 interviews have been conducted.[24] This offers the most detailed view of SME attitudes and practices with regards to funding. It is important for this report, then, to explain its findings in some detail.

The SME Finance Monitor is sufficiently well established that we can begin to see something of the shape of the SME

Figure 3 **Proportion of SMEs and single-owner businesses in a number of sectors, UK, Q1 2013**



population. For example, Figure 3 confirms the prevalence of single-owner businesses in sectors such as construction, transport and health and community services in the first quarter of 2013.

In addition to the SME Finance Monitor, which looks only at the UK market, important new analysis of SMEs internationally has been developed in recent years by the OECD.[25] Aware that there are significant challenges connected to data quality, the recently updated SME scorecard allows

Figure 4.1 **Trends in SME and entrepreneurship finance in the UK, 2007–11**

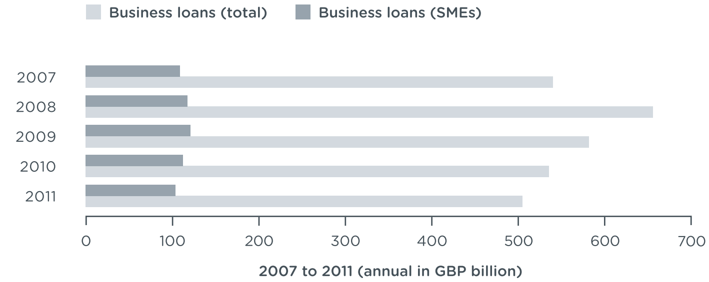
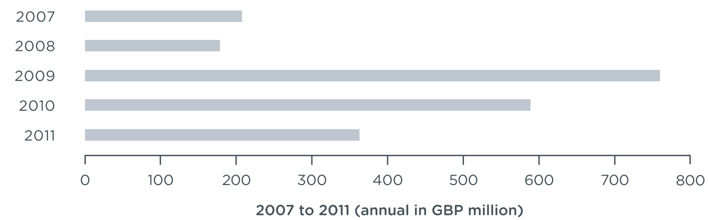


Figure 4.2 **Government loans guaranteed to SMEs (offered)**



Source: Centre for Entrepreneurship, SMEs and Local Development, *Financing SMEs and Entrepreneurs 2013*.

some international comparisons, but also offers a picture of the UK market, albeit with a time lag. The latest scorecard for the UK is shown in figures 4.1 and 4.2.

What do we learn from the scorecard? By this measure, SME lending actually increased after 2007, and even in 2011 was only a little below its 2007 level. As a proportion of total business lending, it looks remarkably stable at around 20 per cent. This time series and the comparisons it allows will become much more valuable over time.

3 Where do banks come in?

A measure of the difficulty facing anyone aiming to take an evidence-based approach to SMEs and the importance of funding in supporting their role in the UK economy is that the Bank of England tracks one set of numbers and the British Bankers' Association another. The OECD summary statistics shown in chapter 2 reflect this confusion. Hence a caveat – the numbers in this chapter are highly likely to be somewhat rounded because it is impossible to generate completely reliable data, but this should not reduce their credibility, as they have been extensively tested among market participants.

According to the Bank of England's numbers, the total SME market is some £174 billion of bank loans,[26] but the British Bankers' Association estimates the market is only £103 billion – a gap of more than £70 billion. The reason? The Bank's data capture all lending to SMEs by so-called M4 lenders, and this includes foreign banks, leasing companies and so on. By contrast, the British Bankers' Association reporting banks are the so-called high-street banks plus a few others such as the Co-operative Bank (although it withdrew from new business lending in May 2013).

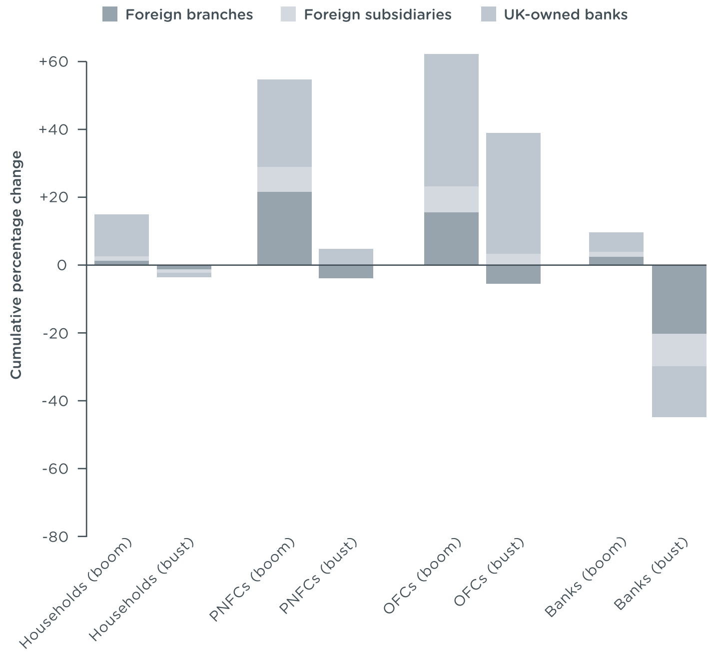
Whereas the Bank of England requires reporting based on the simple metric of company or entity size, the British Bankers' Association allows some discretion. Thanks to its relationships with its customers, a reporting bank has an understanding of their actual status and intent. For instance, some businesses choose to operate as a series of small affiliates that link together, have financial and organisational motives for remaining separate, but actually operate as one overall entity. Do you reflect this in what you record or do you record each entity as a standalone SME?

Let us take the case of Barclays as an example of this tricky point. Its Bank of England filing suggests it lends £28 billion to SMEs as of the end of Q1 2013, but its British Bankers' Association number is somewhere between £22 billion and £24 billion, reflecting the Association's discretionary knowledge of its customers. The difference of between £4 billion and £6 billion is accounted for by just a few hundred customers, which Barclays judges are not SMEs, but in reality bigger, connected businesses. It believes this gives it a truer picture of the actual SME market. Anecdotal evidence from the other big UK banks suggests that they view the world in similar fashion.

It is important that these numbers are understood. Take the insight that £70 billion of SME lending is not provided by the high-street banks. Their lending amounts to roughly £103 billion, so is not a huge amount more. Yet the presence in the UK market of foreign banks, leasing companies and so on is almost never mentioned in the political debate about SME lending. Nor is an important consequence of this observation. Foreign banks entered the UK market aggressively in the period from 2002 until the blow up in 2007–08 of the entire financial system. During that time, they competed hard, typically using mortgages on commercial property as collateral for lending. A feature of the market since the credit crisis has been the wholesale withdrawal of foreign banks providing net new lending – they cannot afford to lend on an unsecured basis in the UK and they certainly cannot trust UK commercial property as the basis for secured lending. If anything, they want to call in loans.

This helps to explain why SME lending has become such a canard. At the very time UK banks are under pressure to lend more to SMEs, following the withdrawal of foreign banks and others, the overall figures on lending show a remorseless decline, although UK banks might be trying their best to lend more.[27] The banks feel under strong political pressure since the exposure of some business practices and attitudes that leave a lot to be desired, but in fact are much more willing to lend, and have been making much more effort to lend, than they are credited with in almost every influential channel in UK public life.

Figure 5 **The change in total stock of credit outstanding in each UK lending market, 2005–09**



PNFC = private non-financial corporations; OFC = other financial corporations
The boom period is 2005 Q1 to 2007 Q3 and the bust is 2007 Q3 to 2009 Q3. Data are not adjusted for securitisations. Excludes intragroup lending and assets held at the Bank of England.

Source: Bank of England.

Evidence for this comes from the Bank of England in the form of a chart clearly showing the extent to which non-UK banks ramped up the stock of lending in the boom years before exiting with haste after the bust (figure 5).[28]

On the flip side, banks' insistence that UK SMEs actually don't want to borrow very much at present tends to be ignored or dismissed as special pleading. There is good evidence, reviewed below, that they are correct in their assertion.

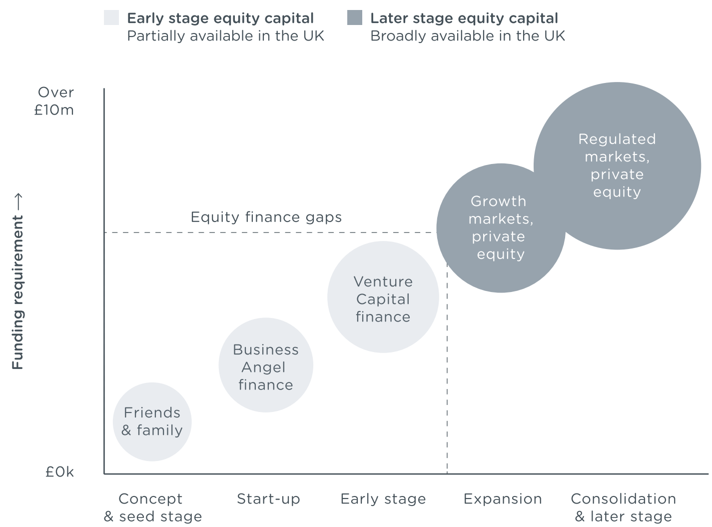
There is an additional irony here. On the one hand, banks face criticism for lending too little to SMEs. On the other hand, there is growing awareness that if they lend too much they risk sustaining a generation of ‘zombie’ companies that continue to live by recycling debt, but which in ordinary times would have gone bust (assuming they would have been able to borrow money in the first place). These zombies are marginal, likely to be ex-growth or even shrinking, but they are also potentially damaging competitors who can distort markets. The trouble is no one knows how many such companies exist, making it tricky to argue for specific behaviours or policies.

This is by any standards a shame and the SME debate in the UK is further impoverished. What could be a genuine argument about how best to stimulate company performance, which in theory should lead naturally to employment growth and an escape from economic stagnation, remains stuck in sterile rhetoric based on lazy use of statistics and economic populism, combined with simple ignorance.

4 A brief history of SME funding in the UK

In the 1980s UK businesses had a range of options for how they funded themselves externally. This has been described as a funding escalator, as shown in figure 6.

Figure 6 **The UK funding gap (funding escalator)**



Source: Dr. Richard Roberts

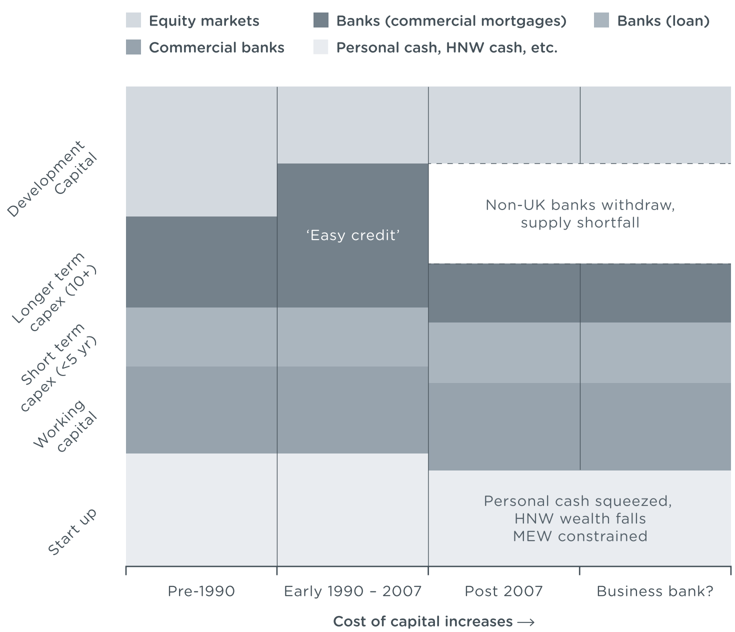
Another way of looking at this is to compile a 'menu' of funding options for businesses of all sizes:

1 Working capital
2 2–5 year cap ex/asset purchases
3 Development capital
3A Pure start-up capital
4 Equity

Each step of the escalator had different participants. The banks' role was largely confined to 1 and 2 with the expectation of three- to five-year payback periods on what was effectively secured or partially secured lending in the case of 2. 3 and 4 were the territory of 3i, venture capital specialists and some specialist banking units. 3A was typically provided from personal wealth or by friends and family, and more rarely by so-called 'angel' investors.

The recent history of UK business funding and our two current problems is shown in figure 7.

Figure 7 **UK business funding from before 1990 to 2007**



HNW – High Net Worth; MEW – Mortgage Equity Withdrawal.

The first problem is that there is a potential lack of development and equity capital, thanks partly to the absence of competition from foreign banks and partly to the weak equity culture.

Box 1 **Don't sugar the pill**

Sir Alan Sugar gave a typically pithy speech in the House of Lords on 24 March 2011:

To reflect on the past 15 years or so, it has been customary for a person dressed in a nice pair of designer jeans and a nice blue blazer with a white open-collared shirt, a bottle of Evian in one hand and a wonderful Microsoft spreadsheet in the other, to walk into a bank, mention the word dotcom and walk out with £5 million. Those days, I am afraid, are over. We all know what went wrong there; and we also know what a mess the banks got into recently; but the penny has not dropped with some people. We still have in some cases an expectancy culture, where people still think that there should be money freely available to finance lost causes, poorly run companies or a whim of an idea…

True, the banks were irresponsible, and they have been told in no uncertain terms to get their act together. However, having told the banks to get their house in order, the current Government are constantly bleating that the banks are not being helpful in lending money to small businesses, whereas the message to the small business community should be one of realism in understanding that no one is going to lend money to a lost cause. The banks are now looking at the traditional criteria of showing some assets or having some historic record of profits before parting with their money. They are definitely open for business. That, I remind your Lordships, is how they make some of their money. In my recent seminars, I have received comments from some people along the lines of, 'The bank has been outrageous. It has actually asked me to put up some collateral – my house, for example'. Well, I am very sorry, but why not? Why should it take a risk on you if you are not prepared to take a risk on yourself?[29]

The second problem is that life is trickier for start-ups, particularly because there is rarely the option to fund a start-up using the mortgage equity withdrawal that was a feature of the go-go years. Moreover, funding from 'friends and family' is harder to come by. Although at the very top of the wealth spectrum there has been little hardship, many potential equity funders of start-ups lower down the cohort have been distracted by concerns about pensions, care bills, university fees and so on. An unintended consequence of the withdrawal by the state from areas such as these has been that the propensity for personal investing in risky start-ups has dropped. This element of the funding menu is clearly broken.

Before the early 1990s, banks' business lending balance sheet consisted of 80 per cent overdrafts and working capital and 20 per cent secured loans. From today's perspective, this might look like a funding nirvana, but it was actually dangerous for SMEs. Unlike a loan, an overdraft is repayable on demand, so if a bank thinks a business is in trouble or merely shifts its risk appetite, an overdraft can be cut or cancelled. A loan, by contrast, cannot be called in unless the borrower has failed to make a due payment. Overdrafts, by definition then, are inherently short term and contingent – they can be reduced or withdrawn, and the borrower has no right of appeal. This type of SME funding was not nearly as appropriate as it appeared to be.

In the recession of the early 1990s banks made significant losses on their SME loan portfolios.[30] As a consequence they changed the way they lent, increasingly moving to a fully secured basis and relying heavily on commercial mortgages as collateral. They quickly reversed their balance sheets, in effect changing their role in the day-to-day funding needs of their business clients. When new capital rules were introduced banks mostly closed down their development capital operations.

Before the crisis of 2007 rising property values suggested that this was a successful strategy. Some start-ups were able to fund themselves using mortgage equity release rather than traditional channels. Some marginal businesses were able to fund themselves thanks to a willingness among banks to compete during a time of abundant credit.

But that all changed. As noted above, foreign banks, which had been aggressive competitors in the UK market, withdrew. There was no more equity to be released. Borrowers who had received credit in the boom years no longer seemed like plausible candidates, but needed to find ways to deleverage or refinance their existing debts. And the banks questioned whether their participation in medium- to long-term business lending made economic sense given capital requirements and the costs associated with understanding individual business borrowers. In particular, they essentially withdrew from lending with maturities from 10 to 15 years on the grounds that this type of long-term funding is better suited to equity.

Put simply, SME debt finance is difficult to lend profitably at scale, and this problem is by no means confined to the UK. We will explore this further below.

The important point is that banks' role in SME funding changed significantly prior to 2007 and is in the process of changing again. As part of that process, the banks themselves are assessing how they participate, how they make a profit over the cycle, and how they reconfigure customer relationships and customer attitudes so that there is a better meeting of expectations and reality. *It goes without saying that successful borrowers pre-2007 will naturally find it strange that their bank might no longer be willing to offer funding either on the same terms or at all. But the change reflects the fact that the period from roughly 2000 to 2007 was anomalous.*

Some aspects of the change are particularly vexing for some borrowers, but seem more reasonable when viewed from the perspective of the lender. After 2007, banks increasingly asked for personal guarantees on new SME loans, to the consternation of many existing customers seeking either new or rollover funding. They also reviewed and often revised their overdraft facilities and assessed the covenants on outstanding loans to see whether these could be called in.

In simple terms, for the lender a loan is a commitment, while for the borrower it represents an option on future success. The outcome for the bank is clear – it gets repaid on time in full (or partially) or it does not and loses everything. The borrower or business owner has a different risk–reward trade off. If the loan helps the business to add value, then all of the benefit goes to the borrower or owner. If not, the option is, in effect, put back to the lender and is either worthless or worth less. Depending on the duration of the loan, a bank is constantly vulnerable to this mismatch in outcomes.

Moreover, lenders are acutely aware that there can be a 'lemons' problem in the SME market.[31] Businesses and their owners will always know more about their actual health and situation than the lender, despite its best efforts to gather and monitor information. There is a tendency for businesses to turn to bank funding precisely when they know something is going wrong and that external finance might help to avert a financial problem. As one banker puts it, 'Among the most dangerous words a banker can hear are "back me!"'

The tension goes both ways. Bankers describe the 'Friday afternoon' syndrome whereby a business owner phones to ask for an emergency short-term increase in their overdraft, typically to pay staff wages that would otherwise go unpaid. If the bank manager declines, then it is easy to see why the business owner will think that this decline is the true reason for the failure of the business, when the truth is very different and much more deep-seated.

The problems associated with the information asymmetries between lenders and borrowers have been the subject of much academic research. One finding of interest is that successful SMEs, the tiny minority that grow in a sustained way, can actually end up paying more for bank loans than their less successful peers because banks are aware of the difficult underlying economics of lending. With SME lending there is a portfolio effect whereby the population of 'good' borrowers is effectively subsidising the 'uneconomic' borrowers by paying a higher rate of interest than would apply if they were treated individually.

Indeed, you might think that a visibly successful client would be offered more favourable terms and encouraged to borrow more in order to consolidate growth. But it appears not to be the case. Banks are slow to reduce interest rates on loans, for example, even if a successful company is clearly less risky and should therefore benefit from some form of risk-based price reduction.

At the portfolio level, banks use price inflexibility to keep a small portion of the upside being generated by the successful clients, with the effect that debt finance is more expensive than clients might have expected. This could partially explain why firms generally seek equity finance only when they have reached a certain size.[32]

5 Why do governments love SMEs?

This background partly explains why the Government and other groups are so focused on banks' role in the SME economy. But to understand the issue we need to look harder at why SMEs are the subject of so much political attention. The funding debate seems often to assume that SMEs face a form of financial discrimination. In fact, they are heavily subsidised by taxpayers, despite a lack of robust evidence that as an aggregate group they fulfil many of the claims made on their behalf for incremental growth rather than (welcome) stability.

Professor David Storey conservatively estimated in 2006 that the 'annual total financial support for small business is equivalent to a public expenditure of £7.9 billion', more than the then annual budget for the nation's police force.[33] Are they worth it?

That might seem like a heretical question, but it is justified by the evidence – or lack thereof. In recent years a major European Commission research project has been exploring the role of finance in growth, employment and competitiveness.[34] Some of the most striking findings cast doubt on whether the SME sector deserves the support it receives from governments all over Europe.

In their paper 'Muppets and gazelles', published in September 2011, Paul Nightingale and Alex Coad, of the University of Sussex, claimed convincingly that there is no solid proof that SMEs and entrepreneurs are especially beneficial to the economy.[35] Their arguments are worth close attention as they go to the heart of the SME problem.

Academic work over recent decades has established that developed economies, including the UK, are disproportionately influenced by a few very successful companies, which drive innovation, create wealth and generate new jobs. The flipside is that most companies, in fact the vast majority of them, have little positive impact, are not innovative, and generate no or few new jobs. They are in effect post-growth, regardless of the size of the firm.

Most companies are SMEs, including start-ups, so these will make up most of the group that makes little impact. We can run the same observation for growth (of which more below) – only a few companies are capable of sustained growth and, given the size of the SME sector as a fraction of the economy, it follows that the majority of companies that do not sustain growth are SMEs.

Small company survival rates support these analyses. An accepted broad finding is that roughly half of new firms in the UK fail to survive for more than two years. Even if this is overly pessimistic, it is directionally correct. In Canada, for example, which has some of the best statistics on SMEs thanks to a long-running data-collection effort, 85 per cent of SMEs (with up to 250 employees) survive a full year after starting up, 70 per cent survive through a second year, but only 51 per cent survive for five years.[36]

Nightingale and Coad ask why the relatively poor performance of so many companies receives so little attention when the question is crucial for industrial and economic policy. The underlying point is that this is an intensely political issue. Broadly speaking, since the 1970s support for SMEs has been seen as a convenient proxy for supporting growth in the economy. Furthermore, small business owners are part of a large and vocal constituency – they are good at getting attention and they have a lot of votes.

Rather than asking why so many SMEs don't want to grow, all the attention is given to the few successful enterprises, which motivates a range of responses from untargeted public subsidy to criticism of banks for their unwillingness to lend. A good analogy made by Professor Storey is that of a lottery – we hear plenty about the incredibly rare winners, but nothing about the millions of routine losers.[37] Professor Hughes notes that this also holds true for product and process innovations – large firms dominate these activities, but 'there are many more innovating small enterprises than there are larger innovating enterprises', and this skewed reality has shaped the policy agenda.[38]

There is an argument in the academic literature that a combination of cultural and ideological biases in favour of entrepreneurs has crowded out a proper examination of the issue, a dilemma exacerbated by the problems of data quality already discussed above:[39]

Rather than entrepreneurship being a universally good thing, the evidence for positive impact is at best weak and highly skewed towards the impact of atypical firms… small firm jobs are more volatile, less productive and less well-paid, have fewer benefits, and have higher rates of accidents. Entrepreneurial firms are less innovative, less productive, and are not associated with GDP growth.[40]

In fact, some argue that there may be excessive entrepreneurship in an economy if public policy encourages too much market entry.

A more productive policy route may be to focus attention on the growth potential of new businesses rather than the quantity. Interestingly, this is a feature of some current UK efforts to improve new business success rates. For example, the 10,000 small businesses project funded by the Goldman Sachs Foundation and run by Aston Business School offers selected businesses close mentoring and support in several UK regions. Its self-description does not challenge conventional thinking, however – the programme 'aims to support the vital role played by small businesses in creating jobs and driving economic growth'.

Nightingale and Coad note that the 'typical entrepreneur is not Bill Gates', but rather

someone who starts from an underprivileged position (25% of start-ups in the UK come from unemployment, for example), uses their savings to start a low-productivity firm such as a fish and chip shop, in a town with two fish and chips shops, but a market that can only support one… if they are still around in two years, which is *very unlikely, it is only because they have displaced a similar marginal firm. Such firms create a lot of jobs, but also destroy a lot of jobs, and while they make their owners happier, they have a fairly marginal impact on the rest of the economy and only make up a small proportion of employment.*[41]

Nightingale and Coad suggest that the majority of start-ups should be classified as marginal undersized poor performance enterprises (hence the 'muppets' of their title). More usefully, the authors argue that market entry generates three kinds of firms. In addition to the muppets, there are businesses with potential that fail to realise it thanks to bad luck or poor judgement, along with the few firms that achieve their potential. 'By far the largest share comes from the first of these,' they conclude.

Few sources better illustrate the divide between academic research, for all of its drawbacks and difficulties, and policy makers. This is surely an area where evidence-based research in the public sphere deserves more attention.

6 Some numbers on funding of SMEs – they might surprise you

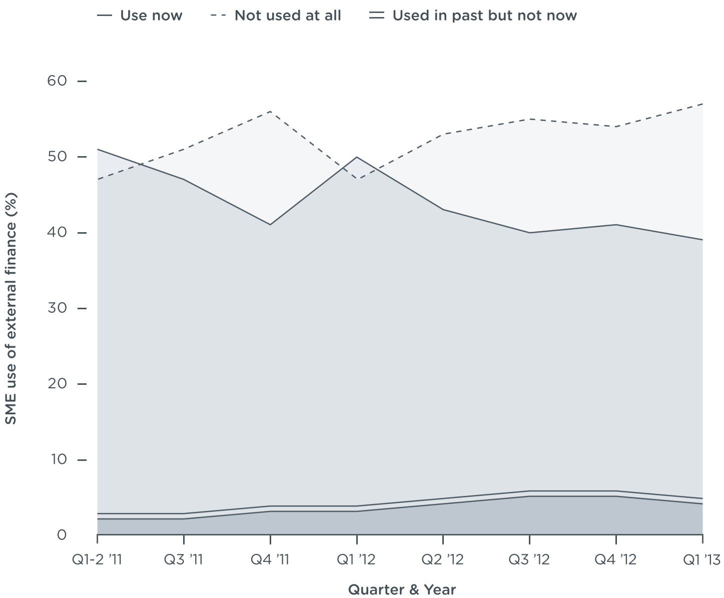
We noted above that SMEs in the UK rely overwhelmingly on banks for their funding. But this type of generalisation risks precisely the misdirection pointed out by Nightingale and Coad. We need to unpack the numbers before we can understand whether or not there is a problem.

An HM Treasury and BIS report on SME financing noted in its overview of financing options that 'SMEs, in particular, suffer from long-standing challenges in accessing bank and equity finance, and have therefore been historically the main target of government action.'[42]

This creates an initial potential confusion by conflating bank and external equity financing. In fact, equity finance is extremely unusual in the SME sector and represents arguably one of the biggest opportunities for future reform of overall business funding. How many SMEs seek equity funding in any given year? Only 2 per cent – 20 in every 1,000. The number is a signal that these 'seekers' might be of policy interest, if only because they are so unusual. Any solution here might involve banks, but is certainly not their primary responsibility.

The report goes on to note, 'Around a third of SMEs do not use formal sources of external finance at all, relying instead on retained earnings or personal finance to fund investment and growth.' This is highly significant, but also contains a serious misdirection. It is significant because it points to an easily overlooked fact about SMEs – they don't borrow very much and most simply don't borrow at all, at least from a bank.[43] And the misdirection is that investment and growth are two very different things, again conflated. We will come back to the question of SME growth below.

Figure 8 **Use of external finance by UK SMEs, 2011 to Q1 2013**



By date of interview
Source: *SME Finance Monitor*, Q1 2013, p 41

We run into some dispute about the precise numbers here. The Treasury and BIS report figure looks low compared with other research that suggests only 20 per cent of SMEs use bank finance, until we realise that there is an important difference between external finance and bank finance, the latter being a sub-category of the former.[44] Anecdotally, banks believe that the 20 per cent number feels about right given their knowledge of local business populations. The annual report of SME Finance Monitor in 2012 reported that somewhat over half (54 per cent) of SMEs have not used external finance at all over the last five years.[45] Figure 8 gives the breakdown for these figures between 2011 and the first quarter of 2013; we can see the proportion of SMEs that have not used external finance is increasing.

We also know from the SME Finance Monitor that roughly 40 per cent of SMEs meet the definition of 'permanent non-borrowers' – they have not borrowed in the past five years and indicate no intention of borrowing in the foreseeable future – this tallies exactly with the Treasury's number. This group is over-represented among smaller SMEs, which makes sense because that very large population includes many businesses that have no need for external finance at all and they are unlikely to turn to a bank in the event that they were to do so.

This category of 'permanent non-borrowers' is mildly problematic, not least because it is a supplement to the earlier designations of 'happy non-seekers' and 'would-be seekers', but it represents an important analytical insight. Indeed, it allows us to put some other aspects of SME funding into perspective. *It demonstrates that any assertion about the demand for and supply of external funding for SMEs can apply at best to less than two-thirds of the population.* In other words, one could say, 'Of the 60% of SMEs that have any interest in seeking external finance, xx% etc etc' – or only 40 per cent of SMEs are currently using external funding, and only a proportion of that, albeit a large one, comes from banks.

Critics have argued that no one can be sure that they will not borrow in future and that the assumption of permanence is therefore questionable. However, whatever the semantics, it seems that there is validity in identifying those SMEs that are highly likely to remain financially independent. The SME Finance Monitor sets a tough hurdle before an SME is considered to belong in the group of SMEs that seem firmly disinclined to borrow, because they meet *all* of the following conditions:

- are not currently using external finance
- have not used external finance in the past 5 years
- have had no borrowing events in the past 12 months
- have not applied for any other forms of finance in the last 12 months, said that they had had no desire to borrow in the past 12 months *and* reported no inclination to borrow in the next 3 months

Thus during the research process there are sequential opportunities for an individual respondent to drop out of the category.

Most SMEs have always funded their activities entirely from internal sources, namely accumulated capital and retained earnings. The SME Finance Monitor is showing that there is growing reliance on these sources of funds, perhaps because of debt aversion post the credit crisis or because business owners know that in the current climate they are unlikely to look like an attractive proposition to a potential lender. More than half of SMEs have a personal element in their business finances, whether a personal bank account, a funding facility in a personal name, an application for such a facility or an injection of personal funds into the business. The latter is by far the most common – some 40 per cent of SMEs say that in the last year they injected funds either because they wanted to or had to. Most of the capital injections were pretty small though – 60 per cent were for £5,000 or less. Again, this makes sense. Hundreds of thousands of small business owners routinely tap in and out of their companies partly because they are optimising their personal taxes, for example using director loans that must be repaid and taking dividends in lieu of salary.

We can make a useful international comparison here. Recent research by Oliver Wyman, a consulting firm, found that while many US SMEs (or 'small businesses' defined as 'in business for at least one year and with fewer than 100 employees') used credit cards, car loans or first mortgages to fund their business, 'only 15% report having an "operating loan" or an "equipment loan or lease"'. Thus small businesses don't actually have many 'small business loans'.[46] The researchers noted something equally striking: 70–80 per cent of small business owners report that 'access to credit' is high up the list of things they look for when choosing a bank. While they don't want a traditional line of credit or a term loan, they overwhelmingly want something that can act as a reserve or buffer against an occasional cashflow gap, typically to cover an amount equivalent to between half and one month's revenues.

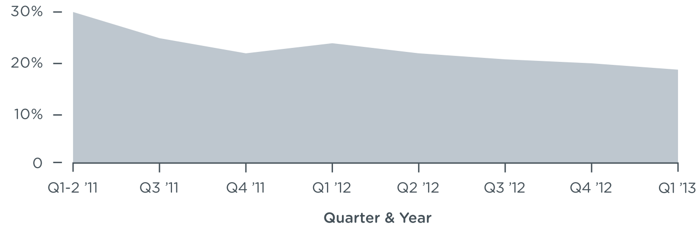
One completely overlooked aspect of the relationship between SMEs and banks is that over time SMEs have been a remarkably stable source of net funding for banks. Deposits from small businesses routinely were larger than their borrowings for at least three decades prior to the mid-1980s. The Bolton Inquiry into small firms, which reported in 1971, made precisely this point.[47] Only from the late 1980s to the mid-1990s did a higher percentage of SMEs borrow from the banks to the extent that the group as a whole became net borrowers. Interestingly, this reversed in the late 1990s, with a brief dip into net indebtedness in 2005.[48] SMEs in general entered the current turmoil with relatively good net liquidity and the rate of business failures since 2007 has been correspondingly low, in contrast to the earlier recession when banks were hit hard by losses from their SME portfolios.[49]

This raises another important but subtle point about the role of SMEs in the economy and their symbiosis with the financial system. *As a group they generally lend money to banks rather than borrow it*. Banks then seek productive uses for those funds, lending them on and seeking value-creating opportunities. Among the borrowers is a sub-set of the SME sector, those companies that are growing and need external funding short of being ready to raise equity. So the general population of SMEs helps the atypical tiny minority, albeit obliquely and unwittingly.

We can go further. If we look at the amounts borrowed, the biggest borrowers come overwhelmingly from the biggest SMEs – those companies on the cusp of escaping the classification – that are not yet able, or are unwilling, to tap funding sources other than banks. Simply by their own borrowing, they greatly reduce the net deposits of the SME sector, so the typical picture we see understates the sector's actual contribution to banks' funding. It is like looking down a telescope the wrong way.

This has important implications for such matters as overall financial stability. While most SMEs are fairly conservative in their finances, they contribute to overall stability, even if failure rates within the sector remain high.

Figure 9 **Use of bank overdraft as finance by UK SMEs, 2011 to Q1 2013**



Source: *SME Finance Monitor*, Q1 2013

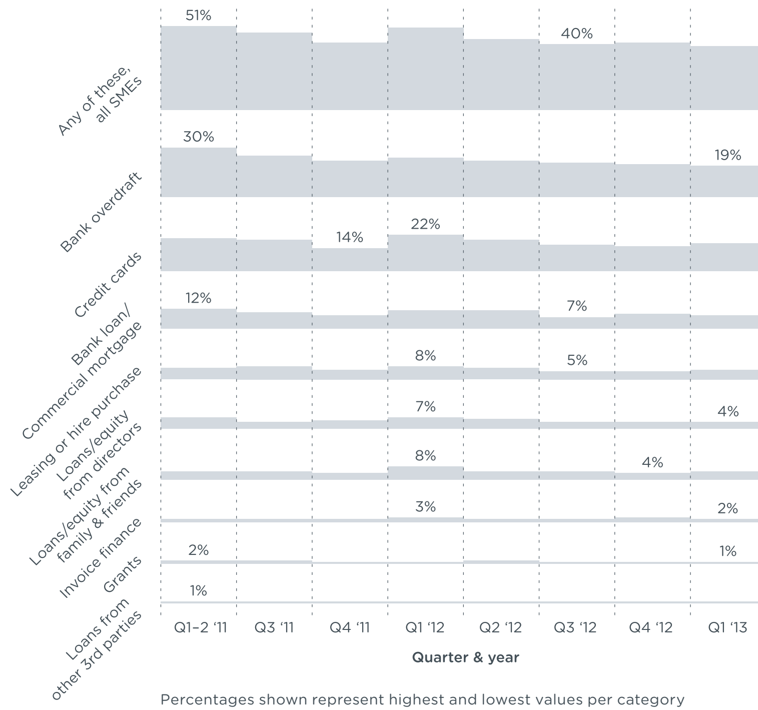
Where they do use external finance, overdrafts from a bank are the most common source of funding. But only just, as Figure 9 shows, and the number of overdrafts has fallen sharply in the last few years. This is in part because capital requirements have made it much more expensive for banks to advance overdrafts, so they have responded by introducing annual fees even if the overdraft is not used.

One interesting finding concerns those SMEs using a credit card for their business. Three-quarters of them report that they usually pay off their balance in full each month, which suggests that the cards are more a source of short-term liquidity and a payment mechanism than they are actual loan finance as such. In addition, small business owners are shrewd and know that bank charges on card balances can be substantial and should be avoided if possible by regular clearing.

Only 8 per cent of SMEs has a bank loan or a commercial mortgage. But as Figure 10 shows, in 2011 the figure was only 12 per cent – the difference is hardly dramatic. This again raises the question of why SME funding should require so much attention.

Figure 11 lists the reasons why businesses apply for overdrafts or bank loans. The SME Finance Monitor looks at the motivation of SMEs that actively sought to have a new overdraft or to renew an existing overdraft in the last 12 months – a surprisingly small number of just 326,000 firms as of the first quarter of 2013, or 7 per cent of all SMEs.[50]

Figure 10 **Use of external funding by UK SMEs, 2011 to Q1 2013**



Percentages shown represent highest and lowest values per category
Source: *SME Finance Monitor*, Q1 2013

We can see clearly that overdrafts overwhelmingly act as a liquidity mechanism – put another way, an overdraft can be seen as protection against cashflow volatility as per the Oliver Wyman US research cited above. This fits with our knowledge that many overdrafts are actually not fully used. In fact, there is a very large pool of unused credit in the UK SME sector – according to the Business Finance Taskforce, facilities across the board are utilised by only 75 per cent, with rates of utilisation ranging from 50 per cent in manufacturing to 85 per cent in real estate. One bank says that its overdraft facilities are only 40 per cent drawn and

Figure 11 **Purpose of overdrafts sought by UK SMEs, June 2010**

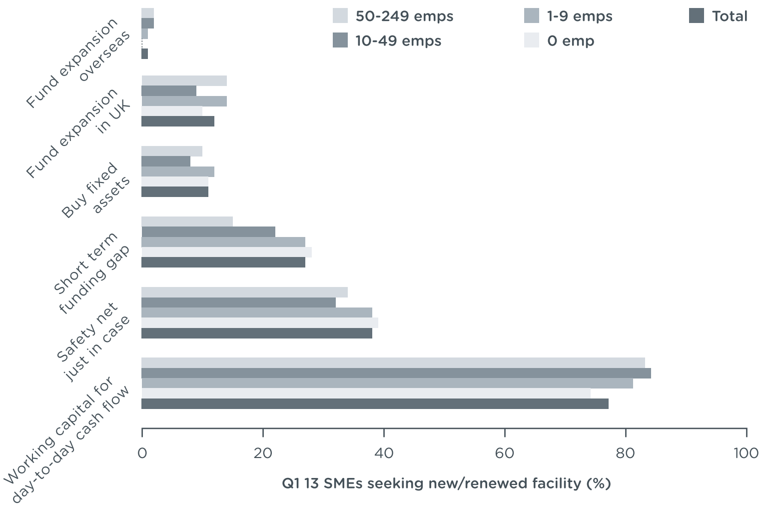


Figure 12 **Types of loans UK SMEs applied for, Q1 2013**

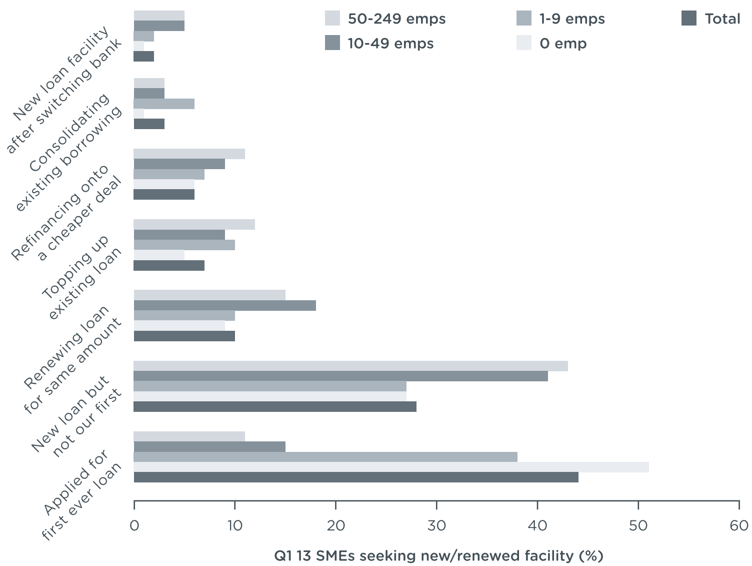
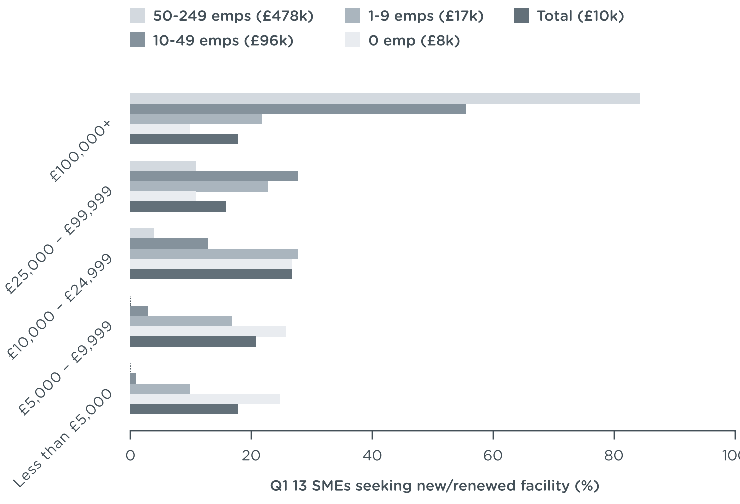


Figure 13 **Amount UK SMEs initially applied to borrow, where stated, Q1 2013**



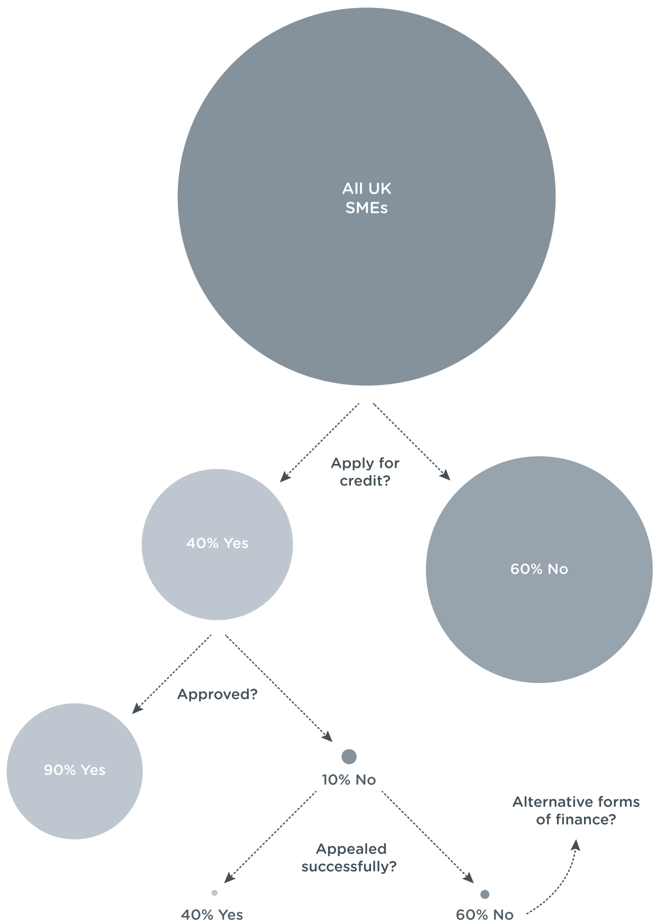
that the trend is falling: 'Across the industry, undrawn committed facilities from banks exceed £85 billion. There is a further £70 billion of committed, undrawn facilities available from other lenders.'[51]

To put that into context – the stock of undrawn credit is greater than the stock of all SME loans.

The equivalent figures for loans made to SMEs in the last two years is also revealing (figure 12). Only 4 per cent of all SMEs, or some 163,000 businesses,[52] applied for a loan during this period.

Further, we can see that those SMEs that do want to borrow don't want to borrow very much (figure 13). As you would expect, only the larger firms want to borrow significant amounts and it is likely that it is in this sub-group that we will find the true pressure point between would-be borrowers and bank lenders.[53] Many of the smaller SMEs want a loan to purchase a car or van, or to purchase fixed assets such as office equipment, while larger firms want to fund expansion within the UK or to purchase office premises.[54]

Figure 14 **Business credit applications by UK SMEs, 2013**



Preliminary analysis suggests that roughly 70 per cent of the applications for loans and overdrafts were successful, 24 per cent were unsuccessful and 5 per cent ended with the borrower taking some other form of funding. Thus roughly 39,000 businesses wanted to borrow from a bank in the form of a loan or an overdraft, but were unable to do so. Why?

From the lender's perspective, the biggest single reason for declining an application for a loan or overdraft from an SME is that they judge the potential borrower as being unlikely to be able to service the debt. Even with collateral or a government guarantee, if a loan has only a small chance of being repaid – let's say less than 50 per cent – it would be irresponsible to advance the money.

Many of those refused credit were recently-started small businesses looking to borrow for the first time. Others were established businesses seeking to renew an existing loan or take on additional debt, and we can put that figure into some context. One high-street bank has a business banking arm that lends only to SMEs up to a turnover limit of £5 million. It processes roughly 100,000 credit applications annually and says that 90 per cent of applicants are successful.[55]

Let us assume it has a 25 per cent market share and that the other big banks have roughly the same number of applications – reasonable, but not 100 per cent accurate assumptions. That would suggest there are something in the region of 400,000 applications annually. The 39,000 businesses that fail to get funding reflect proportionally almost exactly the 10 per cent of applicants refused by the one bank (figure 14). We can say with some confidence, then, that the SME funding problem boils down to this – *a fraction of the SME population wishes to borrow and 10 per cent of that fraction fails because the bank or lender deems them unacceptably risky or simply inappropriate.*[56] It hardly seems the stuff of frantic national debate.

7 The front line of SME lending

It was mentioned above that it is difficult to lend to small businesses at scale while making a profit. This is an important issue with a distinct lack of hard data, but there is some persuasive evidence. In the report cited above, Oliver Wyman explains that in the US market, which is much bigger than that in the UK, 'small business loan portfolios typically show positive accounting profits but negative economic profits "through the cycle"'.[57] Why? The researchers identified the main factors that determine SME lending profitability as:

- unit cost
- cost of funds
- loan losses
- economic capital
- loan pricing

Unit cost – the cost associated with booking an individual loan – is by far the biggest factor, followed by capital and inadequate loan pricing.[58] It made apparent sense to try to cut unit costs by introducing techniques borrowed from consumer lending, in particular semi-automated methods relying on credit scoring of a business or its owner, or both. But banks in the US used these new techniques only on the 'easy' cases – those applicants that were obviously good or bad, so 'relatively few loans ended up being decided only via the 'automated path', which in turn ensured that unit costs remained stubbornly high.

The truth about automation

This is useful background to something almost never mentioned in the SME funding debate. It is something of a cliché that UK banks' collective aversion to SME lending has its roots in our own version of 'automation'. Across the relevant literature is a never-challenged narrative: in the olden, golden days, local bank branch managers knew their business customers and knew exactly how much to lend them. Put aside the fact that they could be highly prejudiced, not just in business lending but, for example, in their decisions about whether they viewed someone as 'fit' to be granted a mortgage so they could buy a house. In the harsh, modern environment, greedy banks took away the branch manager role, replacing him (not many women here) with automated decision-making systems based on credit scoring.[59] Nowadays, cold calculation replaces the nuance and judgement of the past. Banks have forgotten how to lend, hence the deficiencies of their SME offerings.

We can see that, based on everything above, this is already looking like another myth to be questioned. The US evidence is that SME lending is tricky precisely because there are so many exceptions to automation – it only works well for the obvious duds or must-haves, so exceptions crowd out the cost-saving potential of the data-based analysis.

How does a loan get decided?

What informs whether a request for credit is approved or turned down? What happens on the front line of SME lending?

To answer these questions, let us look in some detail at the role played by a 'sanctioner' in the SME lending unit of one of the high-street banks.[60] The unit has 15 staff whose job is to approve, query or decline requests for loans by businesses with a turnover of up to £5 million. The term 'sanctioner' sounds forbidding, but suggests that these staff are pre-disposed to approve loan requests. Their job is to act as independent judges of whether loans should be granted off the back of customer credit files put together by colleagues on the ground who interact directly with the would-be borrowers. Depending on their experience, they are authorised to sanction loans at different levels, but the maximum loan before a request moves to a different area of the bank is £3 million. These are coveted and senior jobs: each sanctioner in the bank's national team has an average of 25 years' experience; they usually began working in a branch and then worked up through consumer to business credit.

The lending requests for overdrafts or actual loans begin overwhelmingly in the bank's branches, of which it has roughly 2,000. In each branch there might be between 100 and 200 business customers, and new potential borrowers invariably go to the nearest branch of the bank to which they are applying.[61] So, *in fact, it is the branch business manager, who supposedly no longer exists (but who may not be the same person as the actual branch manager), who makes the initial call on whether or not to advance a request. The 'no' decision often happens exactly where no one suspects – right in the branch.*

But here is where automation comes in. The branch manager's request or recommendation to advance credit is sent to the bank's internal systems. A credit-scoring technique then determines not whether or not the loan should be approved or denied but instead suggests where decision rights over the approval should lie. In one-quarter of cases, it gives the choice right back to the branch. In the remaining three-quarters of cases the sanctioners decide, but even then the branch-based colleague can appeal a decision on behalf of the applicant.

Any decline is subject to a second opinion. Appeals can work.[62] Roughly 40 per cent of 'no' decisions are over-turned internally, mainly because during the process new information emerges that gives the lender more comfort – remember the discussion above of the 'lemons' problem in SME lending. *The point is that people, not machines, make the lending decision.*

There is a twist in the story at this point, and one that helps to explain why banks get so much flak for apparently being tough on SMEs. The one-quarter of applications that get sent back to the branch have a higher failure rate than those processed centrally by the experienced sanctioners. So it is actually in the high street that businesses feel rejection most directly. Why?

The answer is that a different process kicks in at branch level, which is defined by the economics of small business lending. Most of the requests are for fairly small, unsecured loans. These would be prohibitively expensive for the bank to process using central underwriting. The customer would not see the costs as reasonable if they were passed on, but if the bank absorbed them then SME lending would be instantly unprofitable.

Thus many of these requests are sent back to the branch and are treated less as idiosyncratic one-offs and more like a retail product where the yes–no decision is based on a set of absolute rules rather than the manager's discretion. That difference between decision and discretion is vital. If the rules say 'no', then that must be the branch manager's response, hence the higher proportion of refusals in the branches.

Does that still seem different in a bad way from 30 or 40 years ago? Banks accept that these days there is less deep business expertise, and certainly less discretion, in their branches. Branch staff have less experience and training than might be needed to make lending decisions for large amounts. But, once again, economics is key. Thirty years ago there were roughly one-quarter of today's number of business entities, so the many fewer requests could be handled at branch level by experienced business lenders and the economics worked. Today, the business has such high volumes that central processing is the only possible economic route for the majority of loan requests. But, as we will see, central processing is not the terrible thing it is often made out to be.

Interestingly, the 'centralised' loan sanctioners make the yes–no decision, but they do not set the price of the loan. Prices are set centrally, so this aspect of the 'automation myth' has some truth. That said, even pricing can be appealed at the branch level. The bank maintains a specialist pricing desk to allow for exceptions to the norm.

There might therefore also be a disconnect between centre and satellites as to the true costs of what is, in effect, idiosyncratic decision making. A senior sanctioner explains that on average there are numerous daily requests with spikes at month-end, and that treatment is highly dependent on the nature and extent of the request. Some are nodded through because the business case is so well set out by the business manager at branch level. Others lead to almost forensic inquiry. If the applicant has their personal bank accounts with the bank, then the sanctioner can look closely at the connection between the two, but clearly this is impossible if the customer banks elsewhere. Google Earth might be used to assess the shape and state of a piece of land. Detailed credit files are accessed where they exist. Companies House records are checked to make sure what the bank has been told is correct. And so on.

When one sits alongside a sanctioner it is clear that the bank wants to lend – after all, that is its business purpose, despite it reporting 'flat' demand. But what is impossible to appreciate from outside is the care with which the decisions are made. In one case the sanctioner approved a refinancing for an existing customer, investigating to allow them to look beyond several indicators that there were underlying risks that were deteriorating or at least suggested a need for further investigation. But the sanctioner only did so after making careful checks about the development status of a piece of land that had been key to the original lending decision a few years earlier. The sanctioner also checked on the personal finances of the borrower to assess whether trouble in the business was mirrored there. Reassured on both counts, the loan extension was approved. The sanctioner explained that the rationale was that this increased the chance of eventual repayment, a better outcome than forcing the customer into default. In another case, a large new loan for an existing borrower was also approved, but only after the sanctioner had spoken directly to the business manager to check some facts that were unclear in the application. This was as about as far from machine lending as one can imagine. Time-consuming and costly. And certainly not impersonal.

8 SMEs and growth

Following the logic of the numbers set out above, we can also bring some light to the debate about whether and how SMEs are crucial to overall economic growth. Anyone who runs or owns a small business will be familiar with a question that is routinely asked by financial advisers and accountants – is the business something you are intending to grow? If not, then it is a reasonable assumption that the company in question will aspire to a given level of turnover and no more. Equally likely, it will have no intention of creating jobs because the turnover is intended to meet the owner's lifestyle needs and little else. Such a company is likely to be profitable and, depending on the sector, might trade with very high margins. But it is not a growth company.

This is not to denigrate the contribution of these businesses to the economy, a great many jobs, and a good deal of multiplier benefits via the supply chain rely on them. But it is important to note that while small, these businesses are post-growth.

Further, although it is not directly the topic of this report, company growth is a vexed subject in its own right. Academic studies suffer from many of the same issues that afflict the SME debate. For example, what is the correct definition of growth? Some look at employment, others at turnover. Some start-ups demonstrate exponential growth rates because the starting point is zero, but the survival rates mentioned above are a reminder that very few companies go on and grow consistently for a sustained number of years. As businesses get larger it becomes ever more challenging to maintain high growth rates, while the tendency towards mergers and acquisitions can complicate our ability to tease out underlying growth rates. Some top-line growth can be at the expense of sustainability of growth, so how should we measure 'good' growth as opposed to absolute growth in the short term? Some growth among larger SMEs that are heading towards raising equity might occur because a management team has set that goal and is deliberately managing towards it, but it might be cutting into corporate 'fat' in order to get there. The methodological problems are myriad.

Nevertheless, it is clear that the few companies capable of growth contribute a disproportionate amount to the overall performance of the economy. Pioneering research by Nesta published in 2009 studied a cohort of roughly 250,000 firms that were new in 1998. It concluded,

> *High-growth companies represent only 6 per cent of all UK firms employing ten or more people, but accounted for more than half the growth in jobs. More specifically, 11,530 high-growth firms were responsible for 1.3 million out of the increase in 2.4 million new jobs in established businesses employing ten or more people between 2005 and 2008 (54 per cent).*[63]

This finding goes a long way to explain the enduring interest among politicians in identifying and facilitating growth companies – a tiny minority are engines that can create jobs. But other headline findings in the same report have received much less attention. In fact, Nesta noted that efforts to target a few firms with higher growth potential 'are likely to be more efficient than general business support policy for all SMEs, many of whom lack the ambition to grow'.[64] This is another way of saying, as Nesta itself also did, that *efforts to focus on quality and growth potential might do better than those focused on quantity.* The Nesta report also points out that 70 per cent of high-growth firms are at least five years old. Only one-third of the initial cohort from 1998 survived to 2008, and only around 8,000 of the survivors employed more than ten people.

It is clear that size is a poor proxy for growth potential, and that it would appear more rational for policymakers to focus their attention directly on growth as a characteristic than on size. This leads us to a changed assumption: *rather than thinking small, policymakers should think growth – if most SMEs have no immediate ambitions to grow, we should focus our efforts on those businesses with the will and potential to deliver significant growth in the future. Even if most growth businesses are SMEs, it certainly does not mean most SMEs are growth businesses.*

Loans are not always the best finance

All of this is consistent with the idea outlined above that SMEs are not a single category and that there will always be a high proportion of them that must be excluded from any attempt to generalise. Intelligent analysis of them and their financing needs requires a lot of specification, but this is typically missing from the debate. We can look a little closer at the growth challenge to develop this point. An important, but largely overlooked, question relates to the different needs for finance that companies in different industries might have at various points in their life cycles.

We have established that a majority of SMEs, regardless of industry sector, have no or only little need for external finance beyond plain-vanilla, transaction banking services. The minority of businesses that do require external finance, indeed depend on it for their development, typically have needs that are determined by the industry in which they are competing. A growing manufacturing firm, for example, will require term loans in order to make capital purchases – machine tools, production facilities and so on. From the lender's perspective this is fine because there are some recoverable assets in the event that the business fails and the term of the loan can be linked to the lifetime of the assets.

An agricultural business will have seasonal needs from sowing to harvest, but might also need capital investment for machinery, so requires a combination of term loans and overdrafts. Here, as with the manufacturer, the lender can assess asset values and the history of the shorter-term direct financing of the business – is this a business that regularly pays on time or manages its overdrafts well, thereby avoiding fees? Note that the bank is concerned mainly with the security of repayment, not other measures such as the profitability of the business.

A high-tech start-up with no prospect of profits for several years, no positive cashflow in its first three years and few assets against which to secure a loan obviously requires quite different financing. The sort of venture funding that it needs is very unlikely to come from a bank, although a bank will be involved in the more prosaic funding needs and doubtless watch overdraft and other limits with care.

Paradoxically, it might be the high-tech start-up that generates jobs in the short term, with no guarantee that those jobs will survive beyond the company's initial efforts. But this also brings us up against one of the fundamental issues of SME funding in general. As a lender, a bank is asked to extend a loan that exceeds the visible lifetime of the asset securing that loan. Should it make the loan? In recent history, specifically the anomalous period before 2007, it tended to, because the loan could be secured additionally against property and also because credit was cheap in an extremely competitive environment. Cheap credit is no longer available now, so the lending decision is more complicated. If there has been a reversion to the mean, this is it.

But we can also see this is a way of explaining that there is a boundary, somewhat fluid and definitely somewhat cyclical between what banks should finance and what should come from other sources. This boundary is key and it leads to our next section.

9 Debt–equity: the lender's dilemma

In the UK there is a cultural assumption that it is somehow preferable for the owner of the business to take on a loan rather than to raise capital by selling equity. We noted above the option-like nature of a loan for the borrower. And surely debt is cheaper than equity?

As always, real life is more complicated than neat theory. By the time a borrower has finished negotiating a loan, the costs can double from the initial quoted interest rate to something not far off the cost of equity. Moreover, debt can behave in funny ways, especially in bad times. We noted above that many indebted SMEs found that their lenders' attitudes changed once the credit crunch began. Banks seeking to deleverage scanned their loan agreements for covenants that the borrower might have breached and if they found any they called in the loan or altered its terms. One of the reasons this was so upsetting was that debt was actually behaving like equity – the lender became the *de facto* owner of the business, able to dictate terms and potentially even to put the business into administration. Equity, on the other hand, only conveys control if an owner sells a majority stake.[65]

There is a fundamental issue related to the financial structure of equity and a traditional loan, which is at the heart of the unsuitability of lending as a mechanism for absorbing development, innovation or start-up risk.

A loan requires certainty of income to meet interest payments, and in the case of secured lending a defined asset on which to secure the loan. A classic example might be an established manufacturer seeking finance to fund the purchase of a new machine, the output of which is predictable, with the loan addressed within the lifetime of the asset. As noted earlier in this report, this finance remains available to the market.

Equity finance does not demand interest repayments, and does not require assets on which to secure the finance. It is structured to allow the investor exposure to potential open-ended capital growth, but asks the investor to accept losses in the event that the investment fails.

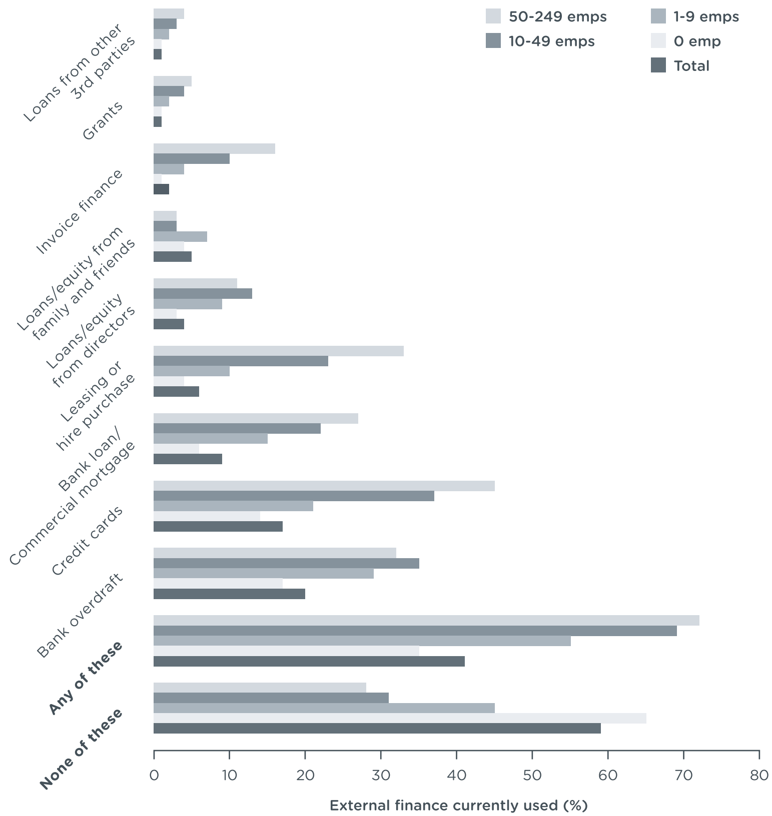
It is therefore the most appropriate structure to finance risk. As an example, a pre-profit high-tech business may well have no cash flow and no certainty over future cash flow. It may also have no assets other than its emergent intellectual property. It therefore represents significant investment risk, but might offer significant potential. Equity finance would be the most appropriate solution for the business and for the investor or 'lender'.

It is often remarked that UK business owners have a cultural disposition against selling equity and that this contrasts with the more open attitude among, for example, US entrepreneurs. Figure 15 shows how little equity is used by SMEs and how relatively little difference there is by company size. But the SME Finance Monitor went further, asking those SMEs that are incorporated whether they used equity from third parties. The response? Only 1 per cent reported using this form of external funding.[66]
This seems like a more profound issue than whether or not banks are lending to SMEs. Indeed, it could be argued that the preponderance of bank lending is a problem not because there is too little of it but because there is too much.

Tim Ward, Chief Executive of the Quoted Companies Alliance, makes the neat analogy of an engine designed to grow the economy. It requires both fuel and lubrication. The latter can be bank debt, exactly as it is used for day-to-day purposes, but in recent times it also became the fuel, replacing or displacing equity, which is a much more natural form of growth capital.[67] He reiterates the point made above that *bank debt used for long-term finance can put a company at risk in ways that are not evident until it is too late.*

One much-noted problem with Britain's lack of an

Figure 15 **External funding sources for UK SMEs, Q1 2013**



equity culture for business is that it receives less favourable tax treatment than debt. A few tentative steps have been taken to alter this. For example, in March the Government abolished stamp duty on shares for medium-sized business listed on the Alternative Investment Market (AIM). That alone cut the cost of equity capital for SMEs by 15 per cent, according to the chief executive of the London Stock

Exchange.[68] But much more could be done. As the veteran financial commentator Anthony Hilton pithily remarked, 'If the Government is serious in its desire to support SMEs, it needs to stop flogging the disabled horse of bank finance and instead commit itself to making equity more attractive.'[69]

10 Conclusions and policy implications

This report has uncovered a good deal of well-meaning, and at times hugely expensive policy activity in support of SMEs, which has proved unsuccessful both in supporting these businesses and in delivering growth for the wider economy.

We believe that this activity needs to be fundamentally reframed, and a new approach developed, underpinned by two changed assumptions about the nature of the growth challenge:

- *Rather than thinking small, we should think growth* – If most SMEs have no immediate ambitions to grow, we should focus our efforts on those businesses with the will and potential to deliver significant growth in the future regardless of size. Even if most growth businesses are SMEs (which is far from certain), it is not the case that most SMEs are growth businesses.
- *We need to look outside traditional bank lending to address this challenge* – If we want to target the parts of the economy where growth is achievable, we need to devise a funding environment able to support the risks associated with innovation and start-ups. That is not the job of bank lending, but at the moment the UK has precious few non-bank finance alternatives.

From this new position, we propose a series of recommendations which we believe can together materially improve matters.

Recommendations

Develop a genuine successor to the Industrial and Commercial Finance Corporation

The British Investment Bank is a welcome intervention, but the UK lacks a genuine pre-capital market equity investment house. Returning to a model of this 3i precursor could strongly benefit the UK economy.

Effective policy options have been around for decades but have been ignored or sidelined. One is the British experience with the Industrial and Commercial Finance Corporation (ICFC), set up in 1945. Its history is neatly summarised in a recent book by Professor Colin Mayer, and some points are important here.[70] The ICFC was owned by the UK clearing banks, but these institutions were not especially happy at having what they viewed as a competitor focused on financing small manufacturing companies, often via equity stakes. The ICFC actively monitored its borrowers via the attention of loan officers who had technical expertise and were committed to long-term lending. After years of success the ICFC became 3i and by the late-1980s was the largest provider of venture capital in the UK. But after it was floated on the stock exchange in 1994 it changed its nature, becoming mainly a buy-out firm. As Professor Mayer notes, 'By the beginning of this century, Britain had once again returned to being a country in which there was little serious long-term funding of SMEs and limited venture capital to finance seed-corn, start-ups, and early stage ventures.'[71]

It seems like a winning move to attempt to recreate the 3i of old and it is possible that the state-funded British Investment Bank could try to emulate some of its characteristics. However, as currently envisaged this appears not to be likely, as the bank is being set up mainly as a provider of funds to other lenders rather than as a specialist provider of risk capital directly to the SME sector. This is something that could be reconsidered before the bank's formal launch in the second half of 2014. The Business Bank could be given an explicit mandate to address the long-term structural problem of UK business funding rather than facing political pressure to focus more on short-term cyclical issues. With the right structure it could occupy a strategic place in the market.

Learn from Canada to develop a reliable SME Registry

The UK lacks adequate and reliable data on the SME sector – we do not even have up-to-date numbers on how many SMEs there are. The UK Government should instruct either the Bank of England or the Office for National Statistics to emulate the Canadian model and address this gap.

As this report has consistently noted, there are significant problems with the integrity of data about this topic. Given the extent of public subsidy directed at SMEs, there is likely to be a strong cost-benefit case for (re-)investing in SME statistics. The SME Finance Monitor is an important addition. Although the Monitor is industry-funded, it is produced independently by BDRC Continental and the data are publicly available. However, it remains the case that there is no central data warehouse for SME information. Not only are SME data fragmented, but many are simply lost, for example when an individual bank closes its files on a business customer that switches its business or simply shuts down. An unfortunate consequence of data fragmentation is that SMEs themselves lack the ability to measure how well they are performing, or how well they should be performing given the economic and sector conditions in which they are competing.

The UK can learn valuable lessons from other countries' efforts to understand their SMEs and to provide services to them based on more comprehensive data. In Canada, for example, in addition to excellent base data the Government provides a simple, but effective, benchmarking service via a website. A business can test how it is performing against other similar firms nationally or regionally, looking for example at whether its margins are in line with typical levels for its industry. This can give managers and would-be lenders extremely useful insights. The UK Government should instruct either the Bank of England or the Office for National Statistics to design and implement an SME registry that emulates the Canadian model and acts as a central gatherer and provider of reliable SME data.[72] It should also form an expert group to report on the relationship between size and growth, addressing many of the issues raised on this report.

Work with the G20 and the World Bank to create SME impact assessments

Better data in future will allow governments to make better policy choices. And policies can be assessed for their impact systematically so that only the most effective ones receive valuable public support. The World Bank has published an impact assessment framework specifically on SME funding and this could be used as a blueprint for UK assessments.[73] Indeed, the UK could volunteer to work with the G20 and the World Bank as a pioneer of cost-effective SME impact assessments, creating the additional benefit of insights that can be exploited in the developing world.

Focus on increasing the growth potential of our SMEs rather than simply increasing the number of SMEs we have

We commented above that a potential policy route is to advocate that what the UK needs is not more but better SMEs. The emphasis should be on encouraging growth potential so that businesses are more able to survive and more likely to do so in a way that makes a clear positive contribution to the economy and society. This requires the kind of long-term policy that is anathema to successive governments hooked on electoral cycles. It would involve thinking through not just how to direct more help to the existing stock of businesses in the form of mentoring, education and so on, but also how to build relevant literacy in the generations of future business founders and owners.[74] This challenge links directly to the vexed issue of general financial literacy, of which business literacy is a close cousin. While there are some interesting programmes seeking to engage secondary schools in business ventures and innovation, these could be much more systematic.

Establish a 'business academy' network able to support businesses as they develop

Building on this point, the UK Government needs to look at whether taxpayers' money is better spent in the form of very large financial subsidies (direct and indirect) to SMEs rather than on specific funded efforts to improve the growth potential of UK business. This report has argued that there is no particular problem with SMEs having access to finance in the UK, although there is less finance around at present and there are issues about which forms of finance are appropriate for particular types of borrowing. Nevertheless, the Government is intent on handing hundreds of millions of pounds to SMEs in the form of debt that is cheaper than it otherwise would be. That money might be much better spent on creating a series of regional or targeted business academies designed to support firms and help them develop in a sustainable way. David Sainsbury's recent book *Progressive Capitalism* lists a series of existing and past interventions that can be highly effective without requiring the handing over of cheap debt.[75] His concept of the 'enabling state' is also relevant for the way governments can help to create conditions in which businesses can flourish, without that amounting to an 'industrial policy' that repeats mistakes made in the past. This is a role which local enterprise partnerships, given renewed support from the Government in the 2013 budget, can help fill.

Create a central database of lender information to allow banks and new entrants to make more informed lending decisions

Blaming banks for not lending to SMEs in the current environment is misleading. Not that the banks are blameless, far from it, and they thoroughly deserve some of the criticism they have been receiving. But the right policy for Britain is to create a stable banking system with appropriate exposures, rather than use it as a route to unsustainable or inappropriate lending.

So might the banks be able to serve the SME sector better in ways that do not involve lending per se? We referred above to research carried out in the US by Oliver Wyman on small business banking there. The report made the parallel observation for that market that small businesses overwhelmingly want short-term liquidity, but currently they obtain this using overdrafts and credit cards. It then makes an intriguing suggestion that what it calls 'new-form lending' has the potential to transform how banks serve the SME sector. The underlying idea is that a business's cashflows can be a strong 'real-time indicator' of its creditworthiness. Banks can have a window into cashflows via merchant servicing accounts (for businesses that take payment via credit cards) and via primary current accounts. The Oliver Wyman report contains useful detail on how new-form lending works and how it has the potential to improve banks' traditional SME lending. Not only will unit costs be lower, but the funding on offer should be more relevant for the borrower and less risky for the lender.

The UK Government would arguably have greater positive impact by actively encouraging banks to consider this type of service innovation than it has had by focusing on their supposed unwillingness to lend to SMEs. But this raises important issues linked to competition. SME lending in the UK is an oligopoly and banks are therefore forbidden from tying loans to other services such as credit cards or current accounts. So new-form lending, for example, will only work if the lender can actually see the relevant cashflows. The technology platforms required for this could be considered a public good and a utility created to provide lenders with information about would-be borrowers and monitoring services for existing borrowers. The Government and the Bank of England should encourage exploration of this and related ideas, not least as a mechanism by which new entrants could accelerate their SME activities and enhance competition.

This report has deliberately not focused on alternatives to bank funding for SMEs, for two reasons. The first is that its principal aim has been to blow away much of the fog around the existing debate. The second is that this ground has been extensively covered elsewhere and there is little new to add beyond calling attention to new-form lending as above. There is rich material in the Breedon Report and those interested can also refer to the report by Andy Davis mentioned above.[76] The recent report from the Commission on Banking Standards strongly endorses the idea that bank alternatives are of growing interest and importance for funding UK business.[77]

Address the lack of an equity culture in the UK

A working group led by the Treasury and BIS could examine the full tax and economic impact implications of a radical change to the UK's equity culture and make recommendations. More work is needed to rebuild an equity culture. This challenge links directly to the broader long-term 'literacy' issue, but has some discrete elements, particularly related to the tax treatment of different instruments. Stamp duty exemptions could be extended and there is no shortage of policy suggestions by SME trade lobbies, many of them worthy. An often-suggested route by which SMEs can be supported is via government procurement, and this could be usefully linked to the creation of new equity markets or to the repopulating of existing ones.

Infrastructure and UK business culture pose greater challenges than access to bank loans, and our national debate should reflect this

The intensity of the SME funding debate is remarkable given that there is no problem. But as this final chapter makes clear, this is not quite the same as saying that there are no problems among SMEs in the UK and that there is no need for a loud policy debate. It is just that the most useful discussions have almost nothing to do with bank funding and much more to do with the broader infrastructure and culture in which UK businesses operate. That is where the debate should be conducted.

Don't let the banks off the hook

Banks should innovate to find ways of distributing alternative finance and addressing knowledge and skills gaps in businesses. They have huge distribution networks and a deep understanding of the challenges faced by small businesses; they also have an unmatched contact book of businesses and investors. These are strengths that the banks should be encouraged to leverage. Banks should innovate to find ways of distributing alternative finance and addressing knowledge and skills gaps in businesses.

Growth SMEs need appropriate financing, but just because this is not a role for bank lending does not mean that this is not a problem for the banks.

A further report is needed into the specific needs of SMEs

SMEs are poorly served by a policy approach which assumes they are focused on growth. A further report should consider the specific challenges faced by these companies and identify policy interventions which would materially enhance these businesses' survival rates and economic output.

Appendix A
Data and research methodology issues for SMEs and entrepreneurship

Nightingale and Coad make the important point that as the breadth and quality of research into SMEs and entrepreneurship has grown, so has reasonable scepticism about some of the earlier 'findings', concluding that both the sector and the phenomenon are 'good things'. Indeed they suggest that 'more nuanced conclusions' are required in light of better evidence and understanding.[78]

They explore six ways in which research in these areas is easily compromised:

- Poor data quality: the desire to lift 'red tape' was mentioned above. Further, conventional datasets often miss whole areas of SME activity. For instance, roughly half of new businesses fail in their first three years, so are effectively invisible. Data might be non-existent or inaccurate. And the available data will over-sample successful firms while under-representing SMEs that are unsuccessful.
- This generalises into a problem with unrepresentative samples both for entrepreneurs and SMEs in general.
- A general feature is the skewness of the statistics. Most start-ups and entrepreneurial firms perform poorly, but a tiny minority bring up the average performance of a cohort, so any discussion of 'average' is likely to highly misleading. As the authors note, 'It is fallacious to ascribe the properties of one atypical subsample to the entire population of firms.'
- As definitions of SMEs and entrepreneurs are so flexible there is no consensus on research objectives and findings, which can leave policymakers wildly confused. 'While most (but not all) new firms are small, most small firms are old,' the authors remind us.
- Another common statistical fallacy relates to regression to the

mean and how initial classifications can lead to misleading subsequent analysis. A small firm that grows large will typically be categorised as a high-growth small firm, but if it later shrinks it will be seen as a fast-shrinking large firm, leading to the fallacious conclusion that small firms grow while large ones decline.

- The literature is riddled with conceptual slides, for example between net and gross figures (in job creation, for example, but also in bank lending to SMEs). It is vital to take starting points into account when examining such things as growth rates because often, small firms show very large rates from very low bases.[79]

Appendix B
A case study on Canada's SME statistics

Summary of the 2011 results

Below are the key results from the 2011 survey.[80] For further descriptive statistics by business size, industry, region, census metropolitan area, age of business, export status, innovation activity and owner age, gender and education see the data tables. Comparable statistics are also available for the years 2000, 2001, 2004, 2007, 2009 and 2010.

Financing characteristics

In 2011, 36 per cent of SMEs requested some type of external financing, with 26 per cent requesting debt financing, 7 per cent requesting leasing financing, 8 per cent requesting trade credit, 4 per cent requesting government financing and 2 per cent requesting equity financing.

Chartered banks were the main suppliers of financing to SMEs in 2011, serving 55 per cent of financing requests, followed by credit unions or caisses populaires (16 per cent), government institutions (7 per cent), leasing companies (4 per cent), family and friends (2 per cent), venture capital funds or angel investors (1 per cent) and foreign banks (0.4 per cent).

In 2011, 90 per cent of debt financing requests were approved. Both request and approval rates for debt financing increase with business size (see table 2), suggesting that the larger the business, the more likely they are to require debt financing and the more likely they are to obtain debt financing.

SMEs paid an average interest rate of 6.7 per cent for their debt financing in 2011. Two-thirds (65 per cent) of SMEs were required to provide collateral to obtain their loan: 48 per cent pledged business assets, 26 per cent pledged personal assets and 1.3 per cent pledged intellectual property.

Table 2 **Debt request and approval rate by size of business, Canada, 2011**

	Employees	Request rate	Approval rate*	Amount authorised/ Amount requested ratio
All SMEs	1 – 499	25.5	89.9	94
Size of business	1 – 4	19.9	88.4	90.4
	5 – 19	29.9	88.5	88.6
	20 – 99	36.9	97.1	97.2
	100 – 499	47.6	97.7	99

*A request that was fully or partially approved was considered 'approved.'

These are some of the SME owner characteristics:

- In 2011, 60 per cent of SME owners were 50 years of age or older, 28 per cent were between 40 and 49, and 12 per cent were younger than 40.
- 77 per cent of SME owners had over 10 years of management or owner experience.
- Most SME owners were male: 66 per cent of SMEs were majority male-owned, 16 per cent were majority female-owned, and 18 per cent were owned equally by men and women.
- 78 per cent of SME owners were born in Canada while 22 per cent were born elsewhere.
- The majority of SME owners possessed some form of post-secondary education with 32 per cent having a college, CEGEP or trade school education, 22 per cent having received a bachelor's degree and 13 per cent a master's degree or above. For 24 per cent of SME owners, high school was the highest level of education obtained and 10 per cent of owners had not completed high school.

Notes

1 This figure is the internal metric used by a major high street bank and represents applications for secured and unsecured lending by SMEs. Given the difficulty in defining what constitutes an 'application' (and for example how much triaging takes place before an application is put forward) it is unsurprising that these numbers are heavily contested. The SME Finance Monitor, for example, which is produced for a group of organisations including business trade groups, banks and the Department for Business, Innovation and Skills (BIS), uses a different number. It finds that in the year ending Q1 2013 where applicants applied for new money, but not for the first time, 77 per cent of overdraft applications and 69 per cent of loan applications resulted in a facility. Among first time applicants, 38 per cent of overdraft applications and 41 per cent of loan applications resulted in a facility.

2 See World Bank and Global Partnership for Financial Inclusion, *Impact Assessment Framework: SME finance*, Oct 2012, www.gpfi.org/sites/default/files/documents/SME%20Finance%20Impact%20Assessment%20Framework%20GPFI.pdf (accessed 31 Jul 2013).

3 A Gurria, introduction, Centre for Entrepreneurship, SMEs and Local Development, *Financing SMEs and Entrepreneurs 2013: An OECD Scoreboard*, 2013, https://www.sanayi.gov.tr/Files/Documents/cfe-sme-2012-12-final-eng-1862013103336.pdf (accessed 31 Jul 2013).

4 The happiness finding is widely available in academic literature and seems to hold across countries where this

research has been undertaken. See P Nightingale and A Coad, 'Muppets and gazelles: rooting out ideological and methodological biases in entrepreneurship research', FINNOV discussion paper, Sep 2011, www.finnov-fp7.eu/publications/finnov-discussion-papers/muppets-and-gazelles-rooting-out-ideological-and-methodologica (accessed 31 Jul 2013).

5 Examples are too numerous to list, but the following is typical: 'Inadequate access to finance for small and medium sized enterprises is one of the biggest risks to economic recovery. We need bold action to fix what has always been a weakness of the UK economy, and since the financial crisis has become an urgent problem. Whilst we are making great strides to reform the banking system in the UK, more needs to be done to ensure that it sufficiently serves the manufacturers, exporters and high growth firms that drive economic growth.' From the Foreword by Vince Cable in foreword to BIS, *Building the Business Bank*, Dept for Business, Innovation and Skills, Mar 2013, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/203148/bis-13-734-building-the-business-bank-strategy-march-2013.pdf (accessed 31 Jul 2013). See also testimony given to the House of Lords Select Committee on SME Exports, Chapter 4: Financing exports.

6 Bank of England, *Finance for Small Firms: An eleventh report*, 2004, www.bankofengland.co.uk/publications/Documents/financeforsmallfirms/fin4sm11.pdf (accessed 31 Jul 2013).

7 Ibid.

8 The foreword continued 'there are some specific challenges facing certain types of SME, notably those seeking small amounts of risk capital'; see Bank of England, *Finance for Small Firms*.

9 An excellent example is *Seeds of Change* by Andy Davis, which contains what at the time was a comprehensive table of alternative finance suppliers; see A Davis, *Seeds of Change: Emerging sources of non-bank funding for Britain's SMEs*, Centre for the Study of Financial Innovation, Jul 2012, www.csfi.org/files/Seeds_of_Change_by_Andy_Davis_PDF.pdf (accessed 31 Jul 2013). See also the Breedon report: BIS, *Boosting Finance Options for Business: Report of industry-led working group on alternative debt markets*, Dept for Business, Innovation and Skills, Mar 2012, www.bis.gov.uk/assets/BISCore/enterprise/docs/B/12-668-boosting-finance-options-for-business.pdf (accessed 31 Jul 2013).

10 For example see the Doughty report: Small Business Taskforce, *Fulfilling the Promise of British Enterprise*, Dec 2011, www.labour.org.uk/uploads/5c176b69-38c4-19b4-05d0-ff3eae06b37d.pdf (accessed 31 Jul 2013), which contains useful material on US small business funding and its origins in the 1940s and 1950s. The final report of the Small Business Taskforce contains additional materials on Germany and its network of local and regional business lending banks: Small Business Taskforce, *An Enterprising Nation: The final report of the Small Business Taskforce*, Dec 2012, www.labouremail.org.uk/files/uploads/b6e7fa23-1132-0364-1560-7898854ed07b.pdf (accessed 31 Jul 2013).

11 Parliamentary Commission on Banking Standards, *Changing Banking for Good – Fifth Report*, HL Paper 27, 2013, www.publications.parliament.uk/pa/jt201314/jtselect/jtpcbs/27/2702.htm (accessed 1 Aug 2013).

12 BIS, *Building the Business Bank*.

13 A useful, if somewhat technical, note on SME lending statistics that also gives a sense of the complexity of the issues can be found in an article by Michael Lyon and Sylaja Srinivasan; see M Lyon and S Srinivasan, 'Lending

to business – a new data source', *Monetary & Financial Statistics*, Mar 2012, www.bankofengland.co.uk/statistics/Documents/ms/articles/art2mar12.pdf (accessed 31 Jul 2013).

14 Enterprise and Industry, 'What is an SME?', European Commission, nd, http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/sme-definition/ (accessed 1 Aug 2013).

15 These numbers vary over time, particularly the VAT-registered numbers. Sources include HMRC, HM Treasury and BIS. See J Frankish, R Roberts and D Storey, 'Measuring business activity in the UK', 2012. See also Lord Young's *Growing Your Business: A report on growing micro businesses*, Dept for Business, Innovation and Skills May 2013, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/198165/growing-your-business-lord-young.pdf (accessed 31 Jul 2013). Special thanks to Dr Richard Roberts for help with this material.

16 See Office for National Statistics, 'Inter-Departmental Business Register (IDBR)', nd, www.ons.gov.uk/ons/about-ons/who-we-are/services/unpublished-data/business-data/idbr/index.html (accessed 31 Jul 2013).

17 The International Finance Corporation tracks SMEs globally via the SME Finance Forum, but divides them by micro, small and medium categories or MSMEs. Its most recent figures show that in 2010 the UK had 1.66 million SMEs, of which 1.47 million were micro, or 88 per cent of the MSME population. Small companies were 10 per cent of the population, while medium-sized companies (defined as employing between 50 and 249 people) accounted for just 1.6 per cent of the population. The IFC estimated that MSMEs account for just under 35 per cent of total UK employment.

18 See A Hughes, 'Entrepreneurship and innovation policy: retrospect and prospect' in V Uberoi et al (eds), *Options for Britain II: Cross-cutting policy issues – changes and challenges*, Oxford: Wiley-Blackwell, 2010, pp 133–52.

19 The Labour Force Survey captures individuals moving in and out of self-employment, which gives us a loose proxy for changes in one aspect of the SME population, but it offers no understanding of why individuals' circumstances are changing.

20 The SME Finance Monitor records that 25 per cent of SMEs belong to one or other.

21 Business Finance Taskforce, *Supporting UK Business: The report of the Business Finance Taskforce*, Oct 2010, www.betterbusinessfinance.co.uk/images/uploads/Business_Finance_Taskforce_report.pdf (accessed 31 Jul 2013).

22 Research on the US market cited in the main text below by Oliver Wyman notes that typical US bank underwriting procedures for SME loans ask the business owner to provide two years of accounts and/or two or three years of personal tax returns and remarks, 'either way, these data are essentially out of date by the time the bank reviews them – and may not have been that accurate to begin with'. It is not just a UK problem, then.

23 pH, 'Overview of bank borrowing by businesses in the £1 million–£100 million turnover bracket', for British Bankers' Association, 2010, www.bba.org.uk/downloads/bba/pHGroup_report.pdf (accessed 31 Jul 2013).

24 BDRC Continental, SME Finance Monitor, 'Q1 2013: The uncertainty of demand', p 18, www.sme-finance-monitor.co.uk/ (accessed 31 Jul 2013). Data in the quarterly reports

are typically presented based on YE QX, or the last four quarters, which explains the reference figure of 20,000 given in many of the tables below.

25 Centre for Entrepreneurship, SMEs and Local Development, *Financing SMEs and Entrepreneurs 2013: An OECD Scoreboard*.

26 The July 2012 issue of *Trends in Lending* concluded that, of the £450 billion of total business loans, some 35 per cent can be attributed to SMEs, or £158 billion. The way the statistics are released makes it extremely difficult to follow a reliable time series. And these data do not cover all M4 lenders, hence the lower total. In general, figures quoted in this report are correct as of May 2013.

27 The outstanding stock of UK SME loans rose by 7.9 per cent in 2008 and by 3.0 per cent in 2009, but fell by 7.4 per cent in 2010 and by the same amount in 2011, according to Centre for Entrepreneurship, SMEs and Local Development, *Financing SMEs and Entrepreneurs 2013: An OECD Scoreboard*. The share of the overall business loan market accounted for by SME loans was 20.2 per cent in 2007, falling to 18.0 per cent in 2008 but returning to 20.6 per cent in 2011.

28 G Hoggarth, J Hooley and Y Korniyenko, 'Which way do foreign branches sway? Evidence from the recent UK domestic credit cycle', Bank of England, Financial Stability Paper 22, Jun 2013, www.bankofengland.co.uk/publications/Documents/fsr/fs_paper22.pdf (accessed 31 Jul 2013). The chart is on page 10.

29 *House of Lords Debates*, 24 Mar 2011, col 852, www.publications.parliament.uk/pa/ld201011/ldhansrd/text/110324-0001.htm (accessed 31 Jul 2013).

30 The Bank of England suggested that the major clearing banks had to make provisions of around £3 billion. See Bank of England, *Finance for Small Firms*.

31 This is the idea that there is an adverse selection problem owing to information asymmetries, first identified by George Akerlof in the market for used cars. A 'lemon' is American slang for second-hand car that turns out to be a dud.

32 This is well described in S Dolan, F Brouard and A Riding, 'Financing growing firms and the importance of banking relationships', working paper, 2012, www.swinburne.edu.au/lib/ir/onlineconferences/agse2011/000054.pdf (accessed 13 Aug 2013), including a literature summary. The key theoretical work was by R Rajan, 'Insiders and outsiders: the choice between informed and arms-length debt,' *Journal of Finance* 48, no 4 (Sep 1992), pp 1367–400.

33 DJ Storey, 'Evaluating SME policies and programmes: technical and political dimensions' in *The Oxford Handbook of Entrepreneurship*, Oxford: Oxford University Press, 2006. See also Hughes, 'Entrepreneurship and innovation policy'; Hughes attributes the figures to research undertaken in 2006 on behalf the then government department responsible for business.

34 The FINNOV project began in March 2009.

35 Nightingale and Coad, 'Muppets and gazelles'.

36 Industry Canada has an excellent website, for this reference see Industry Canada, 'Small business statistics – July 2012', www.ic.gc.ca/eic/site/061.nsf/eng/02713.html (accessed 31 Jul 2013).

37 See DJ Storey, 'Optimism and chance: the elephants in the entrepreneurship room,' *International Small Business Journal* 29, Aug 2011, pp 303–21.

38 Hughes, 'Entrepreneurship and innovation policy'.

39 Because these issues are so fundamental, they are explored in more detail in appendix A, but this material is excluded from the main text for reasons of length.

40 Nightingale and Coad, 'Muppets and gazelles.'

41 Ibid.

42 BIS, *Financing a Private Sector Recovery*, Cm 7923, Dept for Business, Innovation and Skills, 2010, section 3.3, www.bis.gov.uk/assets/BISCore/corporate/docs/F/10-1081-financing-private-sector-recovery.pdf (accessed 31 Jul 2013).

43 For more evidence on this, see pH, 'Overview of bank borrowing by businesses in the £1 million–£100 million turnover bracket'.

44 See Business Finance Taskforce, *Supporting UK Business*, p 19, which is referenced to the UK SME Finance survey for 2008 and 2009.

45 For comparison and as an indication that these numbers are reliable, see the Industry Canada equivalents. Its latest survey covering 2011 notes that 36 per cent of SMEs requested some type of external financing, with 26 per cent requesting debt, 7 per cent requesting leasing, 8 per cent requesting trade credit, 4 per cent requesting government financing and 2 per cent requesting equity financing

46 See SME Finance Forum, 'Oliver Wyman – how "new-form lending" will reshape banks' small business strategies', 2013, smefinanceforum.org/post/oliver-wyman-how-new-form-lending-will-reshape-banks-small-business-strategies (accessed 31 Jul 2013).

47 *Report of the Committee of Inquiry on Small Firms*, Cmnd 4811, London: HMSO, 1971.

48 See Young, *Growing Your Business*.

49 The Bank of England noted in 2004 that 'deposits appear to have generally exceeded total lending in the SME market since 1997 and suggest that the health and liquidity of the small firms sector has, in the aggregate, improved over the past decade' (Bank of England, *Finance for Small Firms*). On 3 July 2013 the head of RBS's corporate lending business said on the *Today* programme that his bank then had £57 billion of SME deposits.

50 BDRC Continental, SME Finance Monitor, 'Q1 2013', p 87.

51 Ibid, p 20.

52 Ibid, p 91.

53 Ibid, p 93.

54 Ibid, p 95.

55 This figure is the internal metric used by a major high street bank and represents applications for secured and unsecured lending by SMEs. Given the difficulty in defining what constitutes an 'application' (and for example how much triaging takes place before an application is put forward) it is unsurprising that these numbers are heavily contested. The SME Finance Monitor for example, which is produced for a group of organisations including the business trade groups, banks and BIS, uses a different number. It finds that in the year ending Q1 2013 those applying for new money, but not for the first time, were given a facility in 77 per cent of overdraft applications and 69 per cent of loan applications. Among first time applicants, 38 per cent of overdraft applications and 41 per cent of loan applications resulted in a facility.

56 The 'turndown' proportion is exactly the same in Canada – see Appendix B.

57 SME Finance Forum, 'Oliver Wyman'.

58 Ibid, pp 2–3.

59 A fine example of this can be found in Small Business Taskforce, *An Enterprising Nation*.

60 For obvious reasons this material has been anonymised, but the author would like to thank the sanctioner who generously worked through real case examples in real time in order to explain the credit process. This field research was conducted in June 2013.

61 An important caveat here is that SME loans are increasingly sourced via specialist brokers, some of them former loan officers, some independent financial advisers. This is an area where there is very little information, but one implication of a growing role for brokers, including internet-based services, is that SME lending competition is actually healthier than the purely bank-sourced numbers imply. The job of the broker is to shop around on behalf of the SME to secure the best rate available, on a commission basis. Clearly, there is also scope here for the next mis-selling scandal were a bank sanctioner to enter into a corrupt relationship with a broker.

62 There is now a formal independent appeals process, run by Professor Russell Griggs. Its first annual report noted that, 'In the first year of the process there have been 2177 appeals and 39.5 per cent have been overturned. An overturn is where the bank and the customer reach a satisfactory conclusion to a lending application. This does not mean that the business has received exactly what they asked for initially, but that they have reached a lending agreement with which both parties are satisfied.' See Better Business Finance, *Banking Taskforce Appeals Process Independent External Reviewer Annual Report 2011/2012*, 2012, www.betterbusinessfinance.co.uk/images/uploads/Annual_Report_Master_2012.pdf (accessed 31 Jul 2013). Any controversy about this relates mainly to whether banks correctly inform applicants that they have a right to appeal. The SME Finance Monitor suggests that only about 11 per cent of rejected applicants are aware of the scheme, so there is room for improvement.

63 Nesta, *Measuring Business Growth: High-growth firms and their contribution to employment in the UK*, Oct 2009.

64 Ibid.

65 An important point here is that, unlike an overdraft, a loan cannot be recalled unless the borrower is in breach of its terms or has failed to make scheduled repayments.

66 BDRC Continental, SME Finance Monitor, 'Q1 2013', p 46.

67 See numerous speeches and articles on the Quoted Companies Alliance website: www.theqca.com (accessed 31 Jul 2013).

68 See London Stock Exchange, 'Abolishing stamp duty on aim shares is a bold and decisive policy from the government', press release, 21 Mar 2013, www.londonstockexchangegroup.com/newsroom/2013pressreleases/stampduty.htm (accessed 31 Jul 2013).

69 A Hilton, 'Small firms need nurturing, and fast', *Evening Standard*, 7 Mar 2013, www.standard.co.uk/business/markets/anthony-hilton-small-firms-need-nurturing-and-fast-8524568.html (accessed 31 Jul 2013).

70 C Mayer, *Firm Commitment: Why the corporation is failing us and how to restore trust in it*, Oxford: Oxford University Press, 2013, especially pp 127–40.

71 Ibid.

72 See appendix B.

73 See World Bank and Global Partnership for Financial Inclusion, *Impact Assessment Framework*.

74 A recent report sponsored by Royal Bank of Scotland and produced by Aston Business School on closing the generational start-up gap contains much useful information on this topic. See M Hart, J Levie and MK Shamsul, *Closing the Generational Start-Up Gap*, Royal Bank of Scotland, 2012, www.rbs.com/content/dam/rbs/Documents/News/2012/09/Youth-Enterprise-Closing-the-Generational-Start-UpGap.pdf (accessed 31 Jul 2013).

75 D Sainsbury, *Progressive Capitalism: How to achieve economic growth, liberty and social justice*, London: Biteback Publishing, 2013, especially Chapter 9 passim.

76 See BIS, *Boosting Finance Options for Business*; Davis, *Seeds of Change*.

77 Parliamentary Commission on Banking Standards, *Changing Banking for Good*.

78 Nightingale and Coad, 'Muppets and gazelles'

79 Ibid.

80 Industry Canada, *Key Small Business Statistics*, 2012, www.ic.gc.ca/eic/site/061.nsf/eng/h_02689.html (accessed 13 Aug 2013).

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There is an ongoing and heated debate in the UK about the importance of small and medium-sized enterprises (SMEs) for economic recovery, and the willingness of traditional banks to lend to them. Despite repeated efforts by policymakers to stimulate this lending, it has not been forthcoming, and this, so the argument runs, is holding back growth.

This report, the first from Demos Finance, the new financial services research unit at Demos, uses new analysis of the sector to explore this question, and explode some myths. It finds that most SMEs do not wish to borrow from a bank and of those that do, 90 per cent have no problems getting the financing they want. Equally, the majority are not significant contributors to economic growth, despite the crucial role they play as existing employers, customers and suppliers.

The report therefore argues for two fundamentally changed assumptions. First, rather than thinking small, we should think growth, focusing our efforts on those businesses with the will and potential to deliver growth regardless of size. Second, to target the parts of the economy where growth is achievable, we may need to look beyond bank lending and devise a funding environment able to support the risks associated with innovation and start-ups. Such an approach would help to ensure that those businesses with the capacity to grow receive the funding they need, paving the way for economic recovery.

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