Newable

Submission to SME finance inquiry

Treasury Committee

March 2018

Executive Summary

- A lack of access to fast and fair finance is currently the most serious issue affecting SMEs across the UK – preventing them from scaling up and boosting their productivity.

- While we welcome the increasing diversity in the lending market, we are concerned by the relative lack of uptake by SMEs. Ensuring that businesses refused finance by retail banks are referred to alternative sources must be part of any measure to address this issue.

- Simple lending is adequate for many smaller businesses, but equity investment is crucial for high potential, knowledge-intensive businesses in the sectors identified by the Industrial Strategy. Such businesses need a ready supply of patient capital to help them to scale up and make the maximum possible contribution to UK plc.

- Dispute resolution and the regulation of SME lending are two further areas that require attention. We welcome calls for a new “tribunal” body. The Government’s focus should, however, be on preventing disputes arising – by introducing affordability rules and other measures to ensure that SMEs are able to borrow sustainably.

- Underpinning all of these areas – and government policy around small businesses more widely – is a problem of definition. The term “SME” captures a huge swathe of businesses, of all shapes and sizes. We urge a recognition of this fact when recommending policy change, and an avoidance of “one size fits all” measures.

Introduction to Newable

What Newable does

Newable is a company limited by guarantee. While we are profit-making, not having shareholders allows us to re-invest that profit back into expanding our products and services – to further support SMEs to thrive.

Established in 1982, we help around 15,000 businesses each year, supporting those working at the heart of the economy. We help them start, scale and internationalise their enterprises through our four main areas of activity:

- **Lending** – In the first 12 months of operation, Newable Business Finance provided SMEs with £11m of Responsible Finance-compliant, unsecured loans of between £26,000 and £150,000.
- **Equity investment** – Newable Private Investing (formerly London Business Angels) closed 35 deals in 2017 that delivered £35m of funding into knowledge-intensive businesses.
- **Advisory services** – Working on behalf of the Department for International Trade, we support smaller businesses in London and the South East to reach target export markets. In the year to April 2017, we helped more than 900 businesses export for the first time.
- **Workspaces** – We have developed 11 light industrial parks around London, turning neglected brownfield sites into economically productive land. These parks currently provide homes to 300 businesses.

Why Newable does it

Newable believes in creating economic growth. We recognise that SMEs account for 99% of all businesses in the UK, and that all big businesses were small once.

A lack of access to fast and fair finance is currently the most serious issue affecting SMEs across the UK – preventing them from scaling up and boosting their productivity.

That is why much of our focus – across the lending and investment arms of our business – is on alleviating this problem.

Inquiry themes

Funding options available to SMEs

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

Lending

1. The current market offers a wide variety of options for SMEs seeking finance – including specialist lenders, peer to peer lenders, and traditional bank finance. Indeed, the British Business Bank's Small Business Finance Markets report, published in February 2018, reported that such markets have continued to provide "significant volumes of finance" to smaller businesses. It further noted that increases in the flow of finance provided through many products, alongside a largely unchanged level of bank lending, have resulted in an "increasingly diversified finance market". Funding is also available across a range of timescales.

2. While the diversity of the market is to be welcomed, our experience is that many SMEs lack awareness of this diversity. Indeed, the same British Business Bank report referenced survey data showing that "most UK SMEs are not aware of financial products beyond standard term bank loans, overdrafts and credit cards. And, even where they are aware of a product, often they may not practically know a trusted provider of that product to contact". Our own experience suggests that this may be a result of the fragmented nature of the market, and of the fact that many SMEs do not frequently seek out finance, leading to a lack of knowledge of the market.

3. The problem is compounded by the fact that traditional retail banks are often the first port of call for SME owners. Such banks have a poor record in referring SMEs refused finance to alternative providers, and when an application is rejected, or the conditions attached appear unfavourable, many SMEs will not seek out alternatives of their own volition.

4. Therefore, although the availability of finance is generally good, awareness – and by extension uptake – is not. The bank referral scheme, introduced by the Small Business, Enterprise and Employment Act 2015, was intended to address this problem. Its poor performance was widely reported last year, and remains a serious concern.

5. We also wish to emphasise the importance of good access to mentoring services. Many lenders, including Newable, provide such services both prior to a loan application and after the funding has been received. Pre-loan mentoring can make a particular difference, as many SMEs can fail to secure finance due to avoidable errors in application forms. Once funding has been secured, mentorship can also ensure that it is put to use in the most effective and efficient manner.

6. **Recommendation** – To address the problem of a lack of awareness around the funding options available to SMEs – both in the lending and equity spaces – the remit of the Small Business Commissioner should be extended, to give the office the power to examine, and provide recommendations on, the availability, awareness and uptake of different funding options for SMEs.

7. **Recommendation** – The British Business Bank should do more to support lenders providing pre- and post-loan mentoring. It should enable such lenders to extend mentoring support from 12 to 24 months after funds have been received.

8. **Recommendation** – The Government should compel major retail banks to promote lenders which provide pre- and post-loan mentoring to SMEs refused finance.

Equity investment

9. For some businesses, debt finance is not appropriate or viable. This is particularly true for high potential, knowledge-intensive businesses in the sectors referred to in the Government's Industrial Strategy, and in receipt of support through the Industrial Strategy Challenge Fund. These include artificial intelligence, life sciences, and space technology. These high potential businesses often require finance at the pre-revenue, pre-profit stage. At this stage, the only viable sources of finance are grants, "friends and family", and "angel" equity investment. Businesses in these sectors are, however, inherently risky – which has traditionally acted as a barrier to investment.

10. The Prime Minister herself has said that, in identifying such industries, and creating a partnership between government and industry to nurture them, the Industrial Strategy "will help propel Britain to global leadership of the industries of the future". If this vision is to be fulfilled, incentivising long-term (patient) investment in these areas will be essential. Both the Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS) have been successful in this regard. Indeed, more than £16bn has been raised through EIS since its launch in 1994.

11. Hummingbird Technologies, a business that Newable Private Investing (NPI) has invested in through its EIS fund, provides an illustrative example of the value that EIS investment can create. Hummingbird combines drone technology, big data from space and artificial intelligence to provide farmers with crop analysis that will help maximise yields and reduce cost. The NPI fund participated in a £1.5m EIS investment round in Hummingbird, which will support the business to spread to new markets.

12. As a relatively young business, it is too early for Hummingbird to attract mainstream fund investment – meaning its success is dependent on private investors who are prepared to take a risk, which is precisely the audience that EIS is aimed at.

13. Despite the success of EIS and related schemes, it is widely recognised that the availability of patient capital in the UK lags behind international competitors. The Government's recent consultation, Financing Growth in Innovative Firms – part of the wider Patient Capital Review (PCR) – noted the UK's "historically thin" market for patient investment. Indeed, while angel investment in the UK is double that of the rest of the EU as a whole, it is only 10% of that in the USA.

14. We were encouraged by the Government's response to this consultation in the Autumn Budget. The measures taken in NPI's speciality area – EIS – are particularly welcome. NPI's EIS fund is designed to address an investment gap in the UK market between post-seed and pre-series A. This is a space where start-ups have moved from concept to a working model, but have not yet achieved the numbers to attract institutional investment from Venture Capital Funds or Private Equity. Doubling both the annual allowance for investors and the annual investment companies can receive through the scheme (to £2m and £10m respectively) will improve both the availability and uptake of this kind of patient capital.

15. **Recommendation** – The Government's response to the Financing Growth in Innovative Firms consultation was a welcome boost to high potential small businesses. Going forward, it will be essential to further raise awareness of EIS and related schemes, and maintain the current direction of travel. We are encouraged by the consultation on a new EIS knowledge-intensive fund structure in the Spring Statement, and look forward to responding.

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

16. The level of competition in the SME lending market varies hugely between different types of lending. As indicated above, there is significant variety in the market in general – but this conceals other problems.

17. The availability of finance covering different timespans is one such problem. It is rare, for example, for lenders to extend finance for a period of more than five years. This is primarily because non-bank lenders find it difficult to raise finance to fund this type of lending, as most institutions consider the risk to be too high. There is also limited historical performance data on this asset class as a whole in the UK – and given the timescales involved, proving the model takes a significant length of time.

18. There are some cases, however, where there is no competition - export finance being one example. UK Export Finance's products and services are designed to be used by banks – whose poor record in serving smaller SMEs results in a significant section of the market being effectively excluded.

19. Recommendation – Current policy around the provision of export finance discriminates against smaller businesses. The Government should review its export finance programme, with a view to allowing as many small businesses as possible to access the service.

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

20. Given the increasing awareness of the variety of lenders available, there remains a surprisingly high proportion of non-bank finance that originates through introducers and brokers. Understanding why this is the case should be a key focus for the Government, as better understanding the process that SMEs go through will help to ensure that interventions have maximum impact.

21. More broadly, we note the finding in the British Business Bank's most recent Small Business Finance Markets report that 70% of small businesses are willing to accept a slower growth rate, rather than borrow to grow faster. This represents a serious constraint on productivity, and is of significant concern.

22. **Recommendation** – The fact that 70% of small businesses are willing to accept a slower growth rate, rather than borrow to grow faster, is deeply concerning. The Government should urgently undertake research to look in to the driving factors behind reluctance to borrow, so as to better target interventions to encourage prudent borrowing.

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

The effectiveness of existing arrangements for dispute arbitration and settlement

The merits of the Financial Conduct Authority's proposals for expanding SME access to the Financial Ombudsman Service

The case for establishing a new "tribunal" body for settling SME banking disputes and the means by which such a body could be created

The design, governance and operation of such a tribunal body, and the potential relationship between it, the Financial Ombudsman Service, and the Financial Conduct Authority

The impact of additional avenues for redress on (i) the balance of power between SMEs and lenders; and (ii) the supply of, and demand for, credit

23. Dispute resolution is a common difficulty that small businesses face. Indeed, in December 2016 research from the Federation of Small Businesses (FSB) suggested that 70% of small businesses had faced at least one dispute in recent years. Smaller businesses are also less likely to be able to afford legal services – the cost of which can sometimes pose a real threat to the business's future.

24. The FSB research referenced above suggested that, on average, £18,000 is under dispute. It further found that it can cost a small firm a further £17,000 when having to spend time and money on the problem.

25. We therefore support the proposal to establish a new "tribunal" body for settling SME banking disputes, and would urge that its design takes into account the systemic issues that we have set out in this submission.

26. We also welcome the Financial Conduct Authority (FCA)'s consultation, published in January, around SME access to the Financial Ombudsman Service. As the FCA said, it is concerning that only individual consumers and the smallest of businesses can access the service.

27. In our view, attention should also be paid to preventing disputes from arising. We address this issue in the section below.

The regulation of SME lending

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

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

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

28. We would support bringing SMEs within the regulatory perimeter. Indeed, there are a number of specific areas where we believe that regulatory improvements are required. We have identified three particularly worrying areas.

    a. **Affordability rules.** Currently, there are no industry-wide rules around affordability, with businesses themselves responsible for deciding the level of debt that they believe they can sustain. While this may be appropriate for larger businesses, it is not for many SMEs.
    b. **Availability of real-time information for lenders.** Similarly, lenders currently find themselves making decisions with relatively little knowledge of the financial positions of the businesses they are dealing with. There is no requirement for businesses to declare any other loan commitments, or any personal guarantees their director(s) may have entered into – whether for the business in question, or other businesses they may be involved with. Improved access to real-time information on these matters will help lenders to make prudent decisions.
    c. **Information displayed on loan agreements**. Current regulation does not set out the precise information that must be displayed on loan agreements. This can, for example, mean that punitive charges for late payment can be buried in small print. While larger businesses tend to have the internal resource to fully understand the agreement they are entering into, many SMEs lack such resource.

29. **Recommendation** – To ensure that lenders have the information they need, and that small businesses are not exploited, new regulation should address the following areas:

    a. **Affordability rules** – Industry-wide rules should be developed to prevent loans being made to businesses or individuals who are unlikely to be able to afford them.
    b. **Availability of real-time information for lenders** – Lenders cannot be expected to make good decisions if they do not have access to the necessary information. Businesses applying for finance should be required to disclose all other financial obligations, including personal guarantees.
    c. **A centralised record of personal guarantees** – The prevalence of personal guarantees presents a particular problem, with there currently being nothing to stop a business owner making a number of such obligations, even covering multiple businesses. A centralised record of such undertakings would significantly alleviate this issue.
    d. **Standardised information on loan agreements** – Our experience tells us that a small number of lenders can conceal punitive charges for late payment (or similar) in 'small print'. The Government should develop regulation to set out the precise information that must be displayed on loan agreements.

For further detail on any of the information included in this document, contact:

Nick Wright
Marketing and Communications Director, Newable
020 7940 1520 / nick.wright@newable.co.uk

Newable