The Clerk
Treasury Select Committee
House of Commons
London SW1A 0AA

1 September 2023

Dear Madam/Sir

Inquiry on SME finance

The Institute of Directors is an independent, non-party political organisation representing approximately 20,000 company directors, senior business leaders, and entrepreneurs. We represent businesses of all sizes and across all industries, regions and nations of the UK. The average IoD member's organisation has a turnover of around £15m and employs around 75 people. Over half are based outside London and the South East.

The IoD has a role under our Royal Charter among other things to 'promote a climate of entrepreneurship'. To this end, we are pleased to have the opportunity to submit evidence to your current inquiry on SME finance. The terms of the enquiry are wide-ranging; we have chosen to respond to the specific questions detailed in the sections below as these appear of greatest current concern to our members.

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

Cyclical factors
Our evidence suggests that cost of finance is probably a key challenge but that this varies over time and is linked to the macroeconomy. We ask a quarterly tracker question in our member surveys that invites participants to identify from a large range of issues those that are currently having a negative impact on their organisation. One of the options, among many others, is 'access to or cost of finance'. Prior to the pandemic a typical proportion of respondents selecting this option was 15%. In the early weeks of the pandemic in April 2020 this rose temporarily to 22% but then as government-backed loans became available it fell back to around 10% where it remained for some time, only returning to pre-Covid levels of around 15% in early 2023. However as interest rates have risen this year, it has been harder to access finance. In our most recent survey, conducted in August 2023, 21% of members identified 'access to or cost of finance' as having a negative impact on their organisation.

Demand factors
It is also worth noting the importance of demand factors: SMEs may not seek finance for expansion or investment if they perceive the overall business environment to be risky. We find a statistical correlation between our members' level of confidence in the UK macroeconomy and their propensity to say that they intend to increase investment (R=0.75). It is therefore important not to attribute lack of investment purely to supply side issues, such as lack of finance, when demand-side issues of confidence are equally as important, if not more so.

How accessible is finance for SMEs of different sizes?

In August 2023 21% of our members said the the cost or availability of finance was having a negative impact on their organisation. Analysing this by size suggests that among the SME category, the difficulties are concentrated in firms with between 10-49 people, as the data below shows. Larger firms (250+ employees) are also reporting greater difficulties.

Which of the following, if any, are having a negative impact on your organisation.... 'access to or cost of finance'? *(Source: IoD Policy Voice survey August 2023)*

Size of company	% stating access/cost of finance was having negative impact
0-1 employees/self-employed	21
2-9 employees	21
10-49 employees	24
50-99 employees	16
100-249 employees	19
250+ employees	26
Total	21

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

No. The complaints landscape for SMEs is unnecessarily complex and fragmented with some companies being eligible to go to FOS, others to the BBRS and others having no redress system apart from via the courts, either because they do not meet the eligibility criteria for the FOS scheme or because their bank has not signed up to the BBRS system. This is then complicated by the BBRS scheme being due to expire at the end of 2023. We do not think it appropriate that any SME should be required to incur the cost of legal representation in order to escalate a complaint against their bank or lender.

How well does the Financial Ombudsman Service (FOS) work for small business complaints? Is the FOS's existing role in SME finance appropriate? If not, how should it change?

We support the recommendations of the 2018 Walker Review that proposed that all SMEs have access to an appropriately-resourced FOS complaints procedure, with a limit aligned to the standard government definition of a small or medium-sized company, namely under 250 staff with a turnover of under € 50m and a balance sheet of under € 43m (Source: BEIS small and medium enterprises action plan: 2022 to 2025, published 26 January 2023).

How effective has the Business Banking Resolution Service been, and what lessons can be learnt from it?

According to the 2022 report of the chief adjudicator of the BBRS, the workload has been lower than anticipated. Under 200 cases were registered that year, around one in four led to a settlement. For those that had eligible cases, it was a useful service. However the low volume of cases could indicate that brand awareness is low, suggesting it would be better to fold the service into FOS as we propose.

Should SMEs have the same level of consumer protection and deposit insurance limits as retail consumers?

The cash requirements of businesses vary enormously. We see merit in having the same levels of protection as retail consumers in order to maintain simplicity and promote understanding of the system.

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

Yes. Many SMEs to not have the resources to obtain expert professional advice in their relationship with their financial services provider, so would benefit from regulatory oversight of the products and services they are offered.

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

We oppose the withdrawal of the SME support factor because we are concerned it will lead to less finance available to our members compared to the current situation and that this decision is being taken without an appropriate evidence base for change. Our view is that the PRA has not made the case for change in the context of its role to promote financial stability, and is in danger of acting against its additional remit to 'support dynamic and competitive markets'.

Our members rely on the health of the business banking sector to conduct their daily operations. We want to see a well-capitalised sector with a robust and well-evidenced approach to risk, that can provide our members with value-for-money access to finance for investment and working capital purposes as well as day-to-day business banking services. It is therefore also in the interests of our members to have a competitive market for business banking to increase choice and drive down fees. The SME support factor was introduced in 2014 to reduce the potential adverse impact of tighter capital requirements on lending to SMEs with a turnover of less than €50m, applying a variable discount rate of between 15% and 24% determined by the type and total amount borrowed by a specific SME. The PRA consultation paper suggests that there is limited evidence of the impact of the SME support factor and proposes to abolish it. However, it draws on an EBA paper dated 2016, when the scheme had only been in place for two years (paragraph 3.129). More recent evidence by Standard and Poor's in 2022, for example, suggests that the impact of the measure is to reduce the difference in financing costs between smaller and larger companies. A literature review conducted as part of a wider report published by Oxera in March 2023 (p.18 onwards) also concludes that the SME support factor has had a positive impact on SME lending and moreover that the current arrangements are appropriate from a prudential perspective.

We therefore suggest that the PRA has failed to provide sufficient evidence to justify the removal of the SME support factor. We recognise that the PRA is separately maintaining the 25% retail risk discount for qualifying SME exposures and is concerned about doubling-up if a lending institution applies both regimes simultaneously. However, given this is currently possible, the removal of the SME support factor will lead to a greater capital requirement for SME lending overall, running the risk of reducing the availability of finance for our members. Similarly, while the introduction of a new 15% discount for unrated corporate SME exposures is welcome, by the PRA's own admission "this new concession would not represent a full replacement for the SME support factor" (para 3.134).

We also have concerns around the additional proposal in the PRA consultation around introducing a higher risk rating for secured lending to individual businesses (consultation question 14) which has led to an anomaly in the proposals where lending to a business that is secured against their building is given a higher risk rating than unsecured lending, which may lead to a perverse incentive on lenders to engage in riskier lending. Please refer to our full response here.

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

Overall the impact was strong and positive, providing access to cashflow and balance sheet support at a time of great economic risk and uncertainty. Our own data shows, as indicated above, that access to finance was better during the pandemic once the scheme had been introduced than it was before the pandemic began, indicating the hugely positive impact it had supporting businesses during a crisis situation.

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

The British Business Bank is useful both for SMEs and policymakers but it could have greater impact. Its finance hub is an intuitive way to explain and signpost the available options to less experienced firms. During the pandemic, the BBB was invaluable in channeling resources to where it was needed.

Its impact would be improved if it focused on raising demand for investment finance among SMEs in geographic areas of the UK and, separately, demographic groups within the UK where the entrepreneurial culture is less advanced. In these underserved communities it may not be economic for private sector financial service providers to go looking for business. However, a state-backed provider such as the BBB has the potential to do more research into the barriers to entrepreneurship in particular areas or communities – whether those barriers relate to knowledge, culture or appropriate availability of finance products – and develop bespoke solutions to increase availability of appropriate support and products.

I hope these reflections are useful.

Yours faithfully

Kitty Ussher
Chief Economist, Institute of Directors