Rebooting SME Finance to Unlock Growth

From Overdrafts to Obstacles:

a long run analysis of SME Finance trends and policy levers

Allica Bank

April 2025

About this report

This document analyses evidence on long run trends in UK credit provision, finding a significant divergence between household and business lending, disproportionately affecting SMEs with up to a £65 billion gap in the stock of SME credit (~£15-20bn on an annual flow basis) vs trend.

This credit shortfall has developed particularly in productive SME lending for growth and working capital, and so appears to be a driver of the UK economy's persistently low GDP growth and productivity.

The evidence points to a heavy shift towards collateral backed lending (primarily real estate) by banks, with the key drivers being regulatory and accounting changes, changes in banks' operating models and risk appetite, and the ongoing shift to a service sector economy.

Associated with this, there has been a collapse of overdraft provision, exacerbating working capital constraints for SMEs, with overdrafts now only accounting for 5% of bank finance.

In addition, bank SME loan margins are lower than the 1990s, despite a material increase in capital requirements, with lending focused on very low risk outcomes as a result.

The UK has reached a position where record low levels of SMEs are seeking finance – the UK is a real outlier here both against its own historical periods, and international comparison. There has been a growing aversion to debt, with the substantial majority of SMEs preferring to grow slower than borrow. There seems to have been a build-up of discouragement over time, and while there is now a highly diverse range of lenders in UK SME finance market, in part due to this, SMEs can also face a discovery problem in finding suitable financing.

It seems a negative structural equilibrium has been reached, and this contributes to the UK's investment rate being the lowest in the G7 (and particularly low for SMEs).

To jolt the UK out of this position, we recommend an immediate doubling of the Growth Guarantee Scheme alongside making the scheme permanent, and then expanding to 3-4x over time to bring it into line with similar schemes in economies such as the US and Germany.

This should be focused on productive credit for growing companies (rather than price subsidy for collateralised lending that is already well served). If there is a need for fiscal neutrality, fee levels could be varied by product type. This expansion is crucial for fostering SME investment, productivity, and economic growth.

Alongside this, the Bank of England (BoE) should have a specific focus on SME finance, just as it did in the 1990s, focusing particularly on challenger banks. These institutions provide 60% of the supply of UK SME lending, while equity capital ratios are meaningfully higher in smaller banks than major banks. The prudential framework is of vital importance to challenger banks and needs revisiting to improve both the certainty and level of capital requirements that determine their ability to expand lending to SMEs.

Finally, there needs to be cross industry research into solving the problem of discovery of SME finance options by SMEs, and how lending can be hyper-personalised to meet the very diverse nature of SME businesses. We believe use of generative AI by fintechs will play a key role in this, alongside renewing more traditional local relationship models (from brokers, accountants, banks, and CDFIs).

Contents

Allica Bank

Introduction

Finance for small and medium sized enterprises is a central passion of mine, and at the heart of Allica's mission.

I undertook this research over the past few weeks after realising that most commentary on SME financing in the UK focusses only on short term developments in the last few years - which may be obscuring far more significant long-term trends.

Looking back three to four decades is stark and thought provoking. Despite having lived through this period, I had not actually appreciated the scale of change. The UK's position today, both relative to its own history and to international peers, does not read well.

There are certainly positives - not least that challenger banks now provide more than half of new SME lending. But the evidence is inescapable that the overall economic outcomes from the UK SME finance market have substantially worsened.

It seems of vital importance to address this position, not as a narrow market issue, but as a key enabler of reinvigorated UK economic growth and productivity.

My thanks to all those at Allica who have reviewed and input to this work, particularly Alan Dunmur, John Maltby, Patrick Magee, and Paul Marston, and to the team at 56 Degrees North for some excellent editing.

Richard Davies

Executive Summary

1. Lending has drifted toward property, not productivity

- Over the last 30 years bank lending in the UK has increasingly biased towards residential mortgages, with bank lending to companies well below the historic trend over the last 15 years in particular. This accompanied a period of low economic and productivity growth.
- The US has not seen below-trend growth in lending to companies and has had better economic growth.
- The total bank lending gap vs historic (1997-2004) trend is ~£140bn at the end of 2024, with a ~£50bn gap for Corporates and ~£90bn for SMEs.
- Corporates have benefitted from the rise in Private Credit substituting for bank lending, and with estimates of Private Credit lending in the UK at £100bn, including this there does not appear to be any Corporate lending gap vs trend.

2. SMEs are missing out on credit

- However, SMEs have little access to Private Credit funds, and growth in non-bank credit provision such as asset finance is estimated at £25bn, leaving a substantial SME credit gap of up to £65bn on a stock basis (~£15-20bn on an annual new lending basis).
- This £65bn estimate is an upper bound estimate of the stock credit gap, supported through triangulation against various studies post the global financial crisis (GFC).
- This gap is widespread but is most pronounced in the construction sector, and is dramatic in terms of the collapse in overdraft provision - which was 31% of SME bank lending in 1998 and just 5% today. Working capital is the most common funding need to SMEs, particularly as companies grow.
- It is important to note this is about far more than 'intellectual property' (IP) lending, i.e. lending to firms typically with advanced technology secured on the IP. These firms are very important, but are only a small sliver of the overall SME economy, and it is these mainstream SMEs that should be growing which this paper focuses on.

3. Lending practices are increasingly rigid

- Challenger banks have grown their share of UK SME lending hugely over the last decade, making up 60% of SME finance today. However, SME lending has increasingly focused on tangible collateral, particularly real estate, and that this is the case for both challenger banks and high street banks.
- Academic studies find mixed evidence on whether bank credit drives economic growth, given this is bi-directional and that the type of bank credit matters significantly. Credit extended to good quality companies for productive investment contributes to GDP growth, whereas increasing credit for existing real estate assets does not.
- With the UK economy having moved more towards the service sector (now 81% of UK GDP), these SME businesses typically lack tangible collateral, so will find it hard to borrow to invest in growing their business – particularly as this investment increasingly takes the form of intangible assets in terms of IT, training and process innovation.
- Growing businesses also tend to have more difficulty in proving the serviceability of their debt as future income (and future cash-flow needs) are higher than historic. The rational

focus of bank lending on collateralised and historic debt service ratios risks stifling funding to the very companies that create growth.

4. SMEs have been discouraged from borrowing

- The evidence shows a substantial drop in SMEs seeking external funding over the last three decades, and a rise in loan rejection rates from ~5-10% to ~40%. There seems to have been a significant build-up of discouragement in SME's appetite to borrow. The Bank of England's 2024 SME survey finds 77% of businesses would accept a slower growth rate rather than borrow to grow at a faster rate.
- Loan margins are actually currently lower than in the 1997-2004 period, despite bank capital requirements being materially higher which logically should have increased pricing, representing a shift where banks are increasingly supporting only low risk, highly secured loans. Concerns from SMEs over loan pricing are driven by a higher base rate (currently 4.5%) from the near-zero rates of 2010-2020. To support a wider range of productive investment, lending margins would actually need to be wider so as to be able to incorporate greater risk.

5. Low investment is dragging down productivity

- The UK has the lowest business investment rate of the G7. The BBB's annual review found that 'Low business investment in the UK has contributed to low productivity', and that SMEs of up to 49 employees have far lower investment rates than larger firms.
- The Bank of England published research in 2022, establishing the link between investment in intangible assets and productivity growth.
- As the BBB (2016) put it *"Due to both supply and demand side factors, there are potentially productive businesses that are not maximising their prospects due to a lack of external finance which, subsequently, acts as a drag on possible economic output."*
- All this builds a picture of a clear gap in productive credit provision to SMEs that is holding back investment, productivity and economic growth.

6. The UK SME credit market is stuck in a negative cycle

- The current very low application rate by SMEs for finance makes the UK an outlier both by our own historical application rates and against all international comparators tracked by the OECD. The market has settled in a negative equilibrium position due to various structural trends over the past two decades. Similarly to UK domestic pension investment, this negative equilibrium must be considered unacceptable by policy makers and regulators as it weighs heavily on productivity and growth.

7. Policy tools must now be scaled and targeted

- The BBB Growth Guarantee Scheme is 3-4x smaller than comparable schemes in US, France and Germany - and should be immediately expanded to address non collateralised loans and working capital finance, in a bid to jolt the UK SME economy out of the settled negative state it has reached. If the constraint is fiscal neutrality, the expansion can be paid for by having scheme fees tailored to product / pricing levels (though some degree of subsidisation of the highest risk borrowers likely makes sense, if it brings economic benefit by addressing market failures). This needs to be promoted heavily so that SMEs are aware of measures to fill this historic gap in the market, to

encourage disillusioned SMEs to try again. The additional £500m announced on 13th April is welcome but is directed only at tariff impacted companies, and does not address the issues raised in this paper.
- There should be a specific focus on SME finance within the Bank of England & Prudential Regulatory Authority (in line with the Chancellor's November 2024 Financial Policy Committee Remit Letter). This needs to have particular focus on challenger banks, given these now represent 60% of the supply of UK SME lending. The prudential framework is of vital importance to growing banks, as both the certainty and level of capital requirements determine the ability to grow lending to SMEs. There has been a threefold rise in capital requirements since 2008 across all banks, with the IFRS9 accounting framework accounting as a further buffer on top (as expected credit losses are now set aside when a new loan is made – this particularly impacts banks growing non collateralised lending to SMEs). On top of this BoE data shows that equity capital is meaningfully higher in smaller banks than major banks.

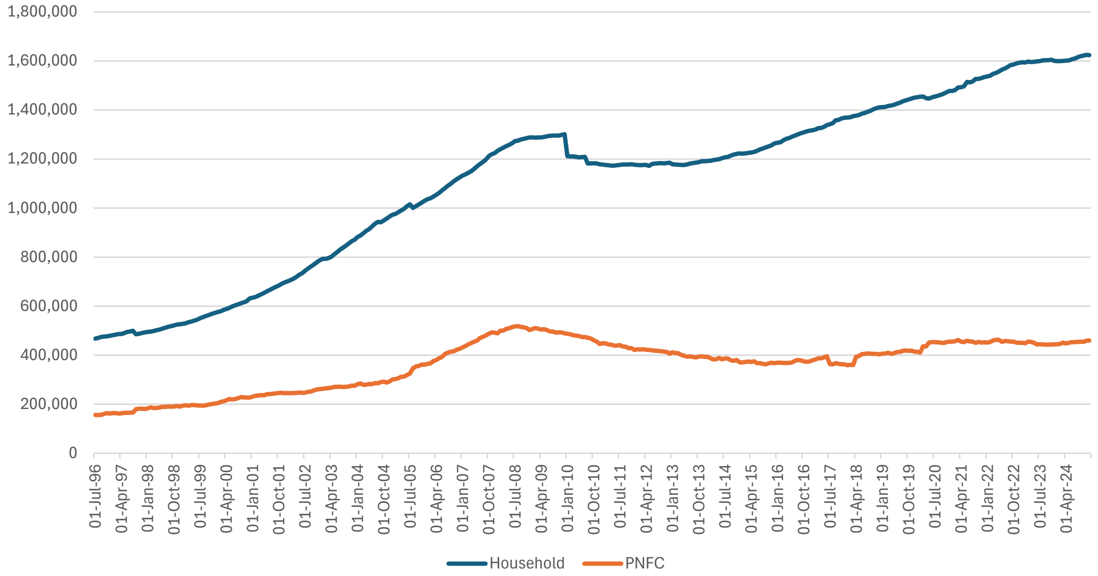
8. Innovation can fix SME finance discovery

- We further recommend ongoing industry research and development into both how the problem of SME finance option discovery can better be solved, and how lending can become increasingly hyper-personalised.
- It must be recognised that the one person IT consultancy looks nothing like the 50 person logistics company, which looks nothing like the SME housebuilder. The SME segment is extremely diverse and therefore no one dimensional solution will solve the problem described here.
- We believe fintechs properly harnessing generative AI technology can play a key role in solving for the required hyper-personalisation, alongside renewing traditional local relationship models (from brokers, accountants, banks, and CDFIs).

Long Run Trends in Credit to the Real Economy

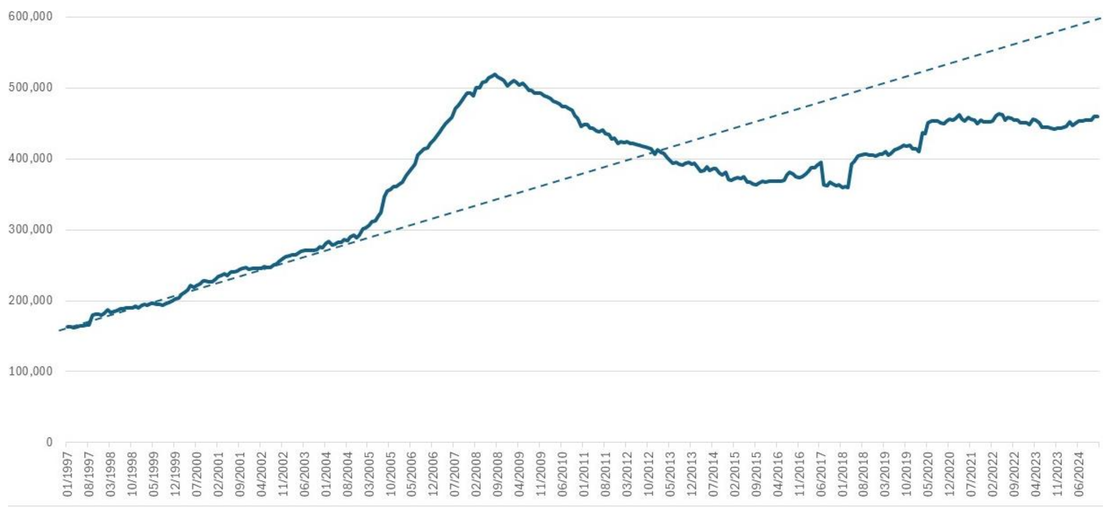
Bank of England data on total bank loans outstanding shows a marked long-term divergence in credit provision to households – mainly mortgages – compared to businesses or Private Non-Financial Companies (PNFC).

Figure 1: Total credit outstanding to household sector vs non-financial companies



Looking more closely at the data on loans outstanding to PNFCs - to both corporates and SMEs – it is clear that loan growth has been materially below trend over the last decade.

Figure 2: Lending outstanding to private non-financial corporations



The 1997-2004 period – which I refer to as the normative trend period – saw lending growth in line with historic average levels vs GDP. From documents from the time (e.g. BoE Finance for

Small Firms annual reports) it was widely viewed as a sustainable period of SME finance, leading to the BoE ceasing these reports in 2004.

The excess lending then in the 2005-2008 period that led to the Global Financial Crisis can be clearly seen, rapidly expanding upward in excess of the dotted trend line (see footnote 5 below for a summary of areas of excess).

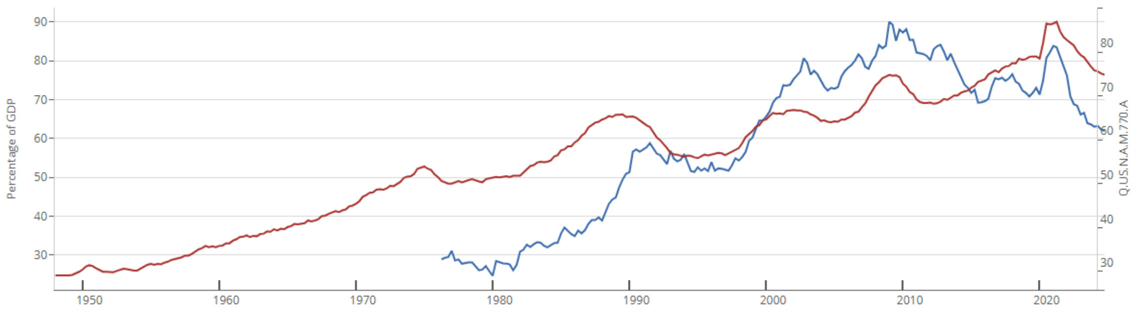
The debt overhang from the excess was worked off by ~2013, but since that point business lending growth has been materially slower than the normative trend period.

If business lending had been in line with this period there would be ~£600bn of business borrowing in the UK currently, when in reality there was just £460bn at the end of 2024, implying a gap of £140bn.

Using long run Bank for International Settlements (BIS) data to compare[1] the UK (blue) with US (red), on business lending (Corporate and SME) as a % of GDP, this clearly shows the UK having had near continual falling credit provision over the last 15 years since the financial crisis, bar a one-off 'blip' in 2020/21 with the Covid government guaranteed loans.

The US on the other hand saw a recovery from the GFC from 2012 (albeit in the last two years it has seen a fall, likely driven by the collapse of a number of regional banks post the collapse of Silicon Valley Bank).

Figure 3: Divergence in business lending: UK vs US as a share of GDP



Academic studies provide mixed evidence on whether bank credit drives economic growth, given this can be bi-directional and the type of bank credit matters significantly. However, there is a clear body of studies that find that credit being extended to good quality companies and productive investment contributes to GDP growth, whereas increasing bank credit primarily financing existing (typically residential real estate) assets does not aid economic growth and can lead to credit bubbles, as the credit is not financing an increase in economic output in the economy[2].

Bezemer et al summarised this effect in their 2016 publication on credit allocation. Looking at evidence across 46 economies in the period 1990-2011, they found that higher bank lending to

[1] Comparative view of United Kingdom - Credit from All sectors to Non-financial corporations at Market value, Percentage of GDP, Adjusted for breaks

[2] For a summary see Credit policy and the 'debt shift' in advanced economies (Bezemer et al, 2021)

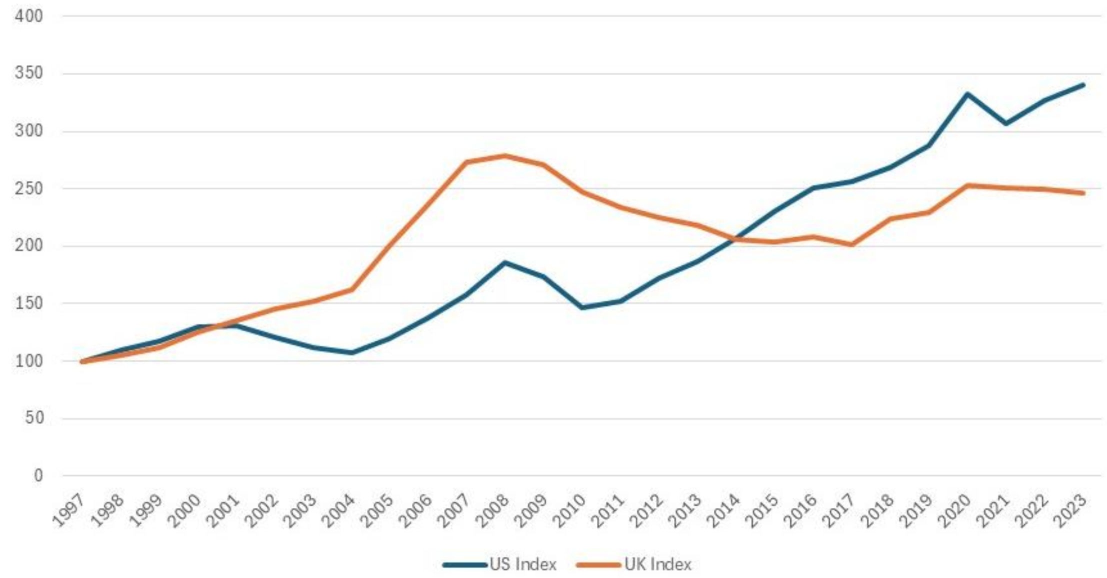
domestic real estate was linked to weaker economic growth, while lending to non-financial businesses supported income growth:

"Bank lending is a key to economic growth, but it is also part of the wider financial-market tendency to instability, theorized by Minsky. This involves the 'debt shift' towards asset-backed credit, which produces sub-optimally high levels of credit for real estate and the financial sector, and not enough credit for productivity-enhancing investments in the real sector. Banks do not take these externalities into account in their lending decisions. This provides the case for public involvement in credit market though credit policies."

In this context, during the normative trend period UK real GDP growth averaged 3.2% per annum. However, in the past decade (2015-24) real GDP growth averaged just 1.3%, and has been close to 0% in both 2023 and 2024.

By contrast, the US witnessed less of an excess of business lending in the GFC (having had its own drop in business lending following the 2001 dot-com bust), and experienced a resumption of trend business lending growth for the last decade. The US has seen far better GDP growth, averaging 2.3%.

Figure 4: Bank business loans outstanding (1997-2023) in the UK and US



Figures indexed to 100 in 1997 for comparison.

From an SME perspective the US presents a very different environment to the UK.

Firstly it has a long established and widely used Small Business Administration loan scheme which – relative to GDP – is around four times the size of the equivalent UK scheme., In addition there are approximately 4000 community banks that maintain a very traditional SME banking model, with local relationship managers in all towns. It is worth noting, however, that the US SME banking market is higher cost as a result, with the combined level of fees and margin on SME banking services roughly double those in the UK.

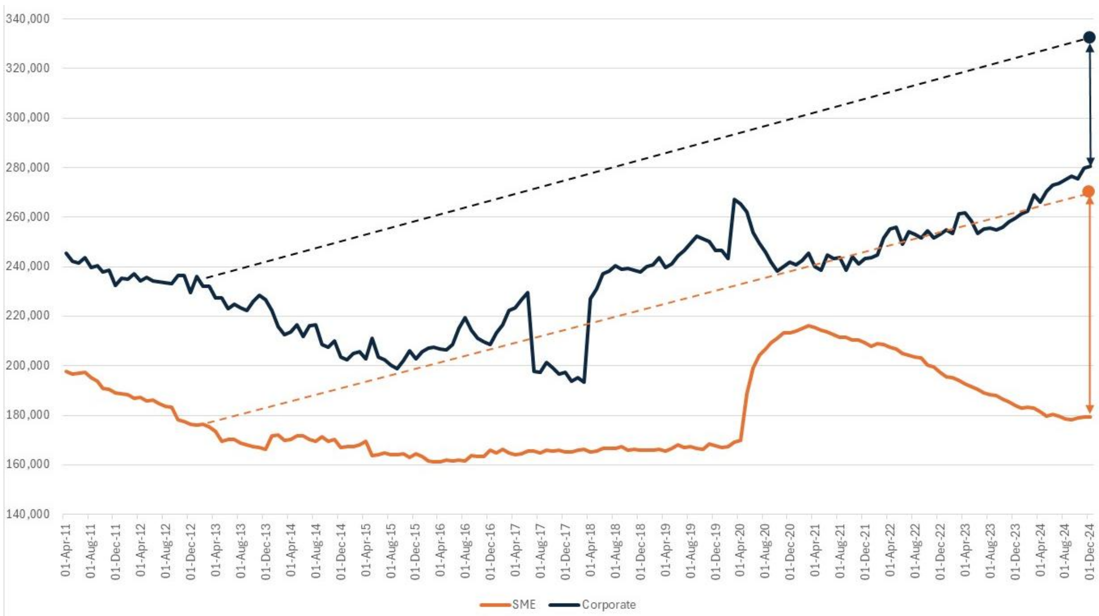
An instructive comparison can also be made with Australia, which - despite having an economy that is essentially half the size of the UK's in terms of GDP - has a stock of SME lending greater than the UK's.

At around £330bn[3] compared to ~£250bn, Australia sees more than twice the level of SME lending relative to GDP compared to the UK. SME loans account for 51% of business (PNFC) lending compared to 39% in the UK. This stronger lending environment is linked to higher investment rates: Australia's stands at 26% versus the UK's 18%, the lowest in the G7.

Assessing the UK SME Credit Gap

Breaking down the UK data in full detail between SME vs corporate lending is only possible in the Bank of England data from 2011. However, this shows quite a stark difference between SMEs and Corporates:

Figure 5: Lending outstanding to SMEs vs corporates, 2011-2024 (£m)



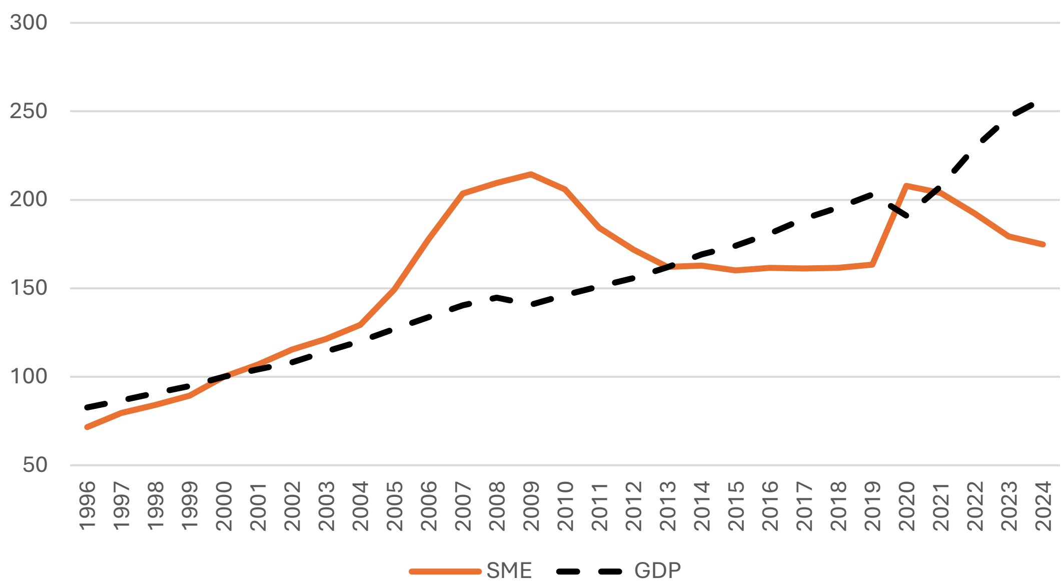
Both saw similar reduction from GFC excess up 2014. Then over the last decade, corporate borrowing has grown much faster than SME which has been almost flat. SME did see a huge spike with Covid but that was temporary and now been repaid and is back on the post 2015 minimal growth trend.

[3] RBA data for Feb25 shows AUD 696bn of SME lending, RBA states this represents at least 95% of the SME lending market in Australia. Converted to GBP at 0.48 x AUD

The dotted lines take the 1997-04 growth trend and apply them to each of Corporate and SME – thereby visually showing the £140bn gap broken down between Corporates and SMEs. The Corporate bank lending gap vs trend is ~£50bn, while the SME gap is larger at ~£90bn.

Cross checking this by comparing stock of SME lending with GDP on an annual basis over a longer run period[4], again shows the GFC excess[5] and then a significant current gap (note this is in nominal (rather than constant) prices for both GDP and SME lending):

Figure 6: SME lending vs GDP growth, 1996-2024 (indexed to 100, year 2000)



Corporates have benefitted from very substantial growth in Private Credit provision which has come to increasingly substitute bank credit over the last decade, with estimates from the Alternative Credit Council that around 2,000 corporate firms in the UK are in total, receiving an estimated £100 billion from Private Credit Funds. Adding in Private Credit to bank lending, it seems Corporates have access to lending at least in line with historical trends.

However, SMEs have far less access to Private Credit (for example British Business Bank MI on private credit funds that it works with made only £158m of SME lending in the year to Q2-2023).

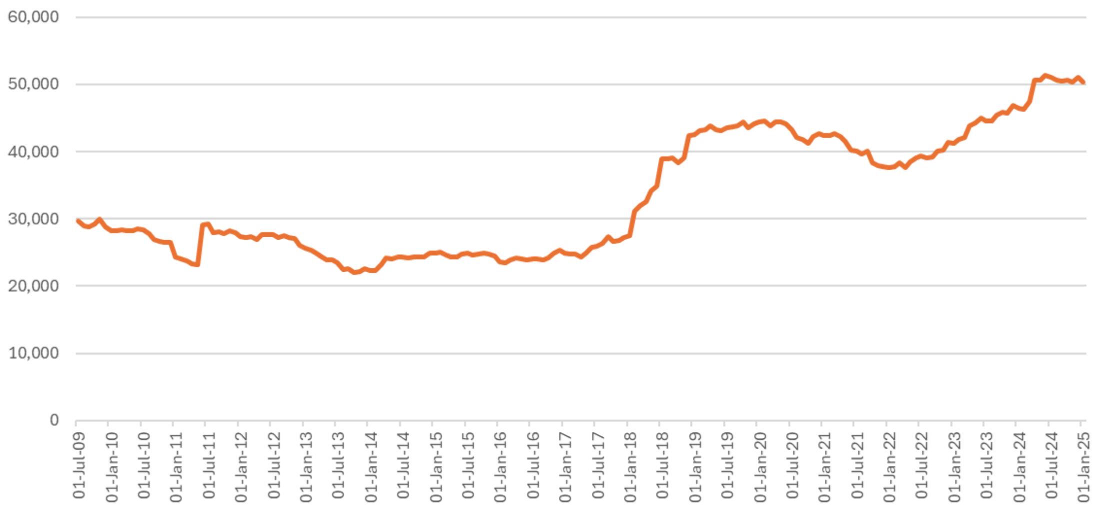
There has been a rise in non-bank lenders to SMEs over the last decade, supported (along with the growth in challenger banks) by interventions by the British Business Bank. The majority of these are actually funded by banks. This is typically either on a forward flow model (where it will already show in the BoE bank SME lending data), or a wholesale model where the BoE reports

---

[4] To extend pre BoE data start of 2011, data has been taken for 2000-10 from the Sir Andrew Large report (2013), and for 1996-99 the % SME out of PNFC has been held constant at 45% (as it was stable 2000-04)
[5] Examples of key areas of excess were: continuous releveraging to high loan to value and low interest coverage ratios on commercial property; poorly controlled residential development finance by generalist RMs; loose use of RM discretions for smaller unsecured positions; aggressive smaller ticket leveraged finance by Clydesdale and HBOS

data since 2009 for bank lending to a) leasing companies, b) factoring companies, c) ‘credit grantors’ (some of which are subsidiaries of banks themselves). For example, for leasing:

Figure 7: Sterling bank loans outstanding to leasing companies, 2009-2024 (£m)



It’s important to note also that this is not all SME lending, a material portion of leasing lending is to Corporates. By cross tabbing with data published on SME leasing and factoring from the FLA and UKF, we estimate the SME portion.

In aggregate we estimate that SME lending not reported under the BoE SME bank lending data, grew by ~£25bn from 2009 to end 2024.

This therefore still leaves a gap of ~£65bn in the stock of SME lending vs historic trend. Given the bi-directional nature of credit<> GDP relationship this is an upper bound estimate. However, it seems apparent there is a large SME funding gap against historical trends, and that this could be a significant factor in the UK’s poor GDP growth and productivity performance, given SMEs represent 61% of employment and 51% of turnover in the UK.

To check the robustness of the £65bn estimate, we have triangulated against prior data and studies: Breedon Report (2012), Sir Andrew Large Report (2013), BIS/Deloitte (2013), UK Finance (2018). A summary is presented in the appendix.

To estimate the annual flow gap, we divide the £65bn by 3-4 years average life of SME lending (current market stock is 3x annual new lending) for a £15-20bn estimated flow gap.

Areas Where the SME Credit Gap is Particularly Acute

Turning then to where within SME has been particularly impacted, BoE data is available breaking down SME lending by sectors since 2016, which shows the following:

Figure 8: SME lending by sector, 2016 vs 2024 (£bn)

	End 2024 £bn Loans	Dec24 v Jan16 % Change	Diff. to % growth if at 97-04 trend[6]
Real Estate	79	25%	3%
Manufacturing, Transport	19	18%	-4%
Other	27	15%	-7%
Retail, Hospitality	26	-1%	-23%
Health, Education	15	-12%	-34%
Construction	14	-20%	-44%

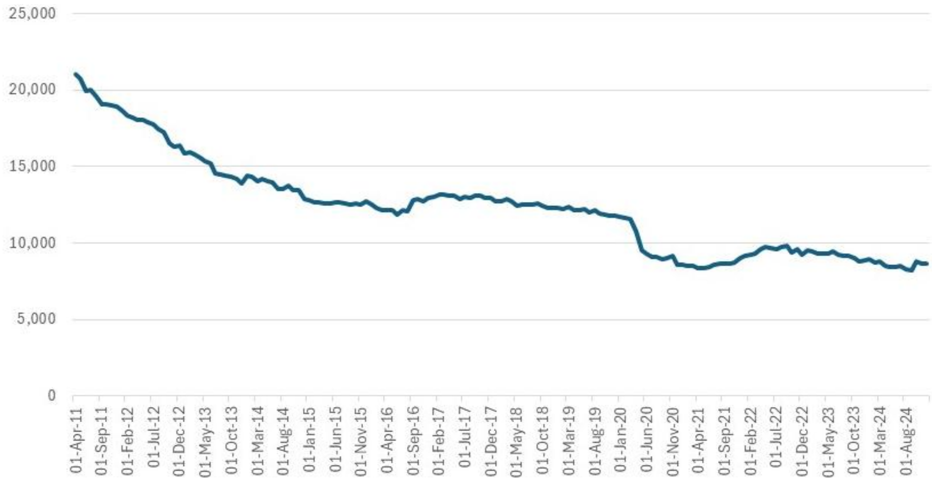
Real Estate sector SME lending has grown and is the only sector that is above the 97-04 trend predicted growth. Manufacturing and transport sectors have also grown though a little lower than trend. However, Construction SME lending has fallen substantially, as has lending to Health and Education SMEs.

Within Construction, it is development finance (e.g. for housebuilders) that has been particularly hit, being 48% lower at end 2024 vs start 2016, a nearly £5bn drop. This is in line with a London School of Economics report in 2024 that stated the number of SME housebuilders halved from 2007 to 2022 driven by the pull back of development finance to the SME sector from major banks.[7] With the government's 1.5m housebuilding goal, this is a critical issue to solve in delivering this goal.

Across all SMEs, overdraft provision has been hit very hard – indeed collapsed – with overdraft balances outstanding falling 59% from when the published data starts in April 2011 to the end of 2024. This is a £12bn fall, when the historic trend should have seen increased provision.

[6] 22% average SME lending growth at 97-04 trend: using overall forecast trend SME total lending stock at end 2024 (~£270bn) subtracting estimated £25bn growth in non bank SME lending, divided by Jan 2016 trend forecast stock (~£200bn)
[7] LSE and FMB (December 2024)

Figure 9: SME overdrafts amount outstanding, 2011-2024 (£m)



Over a longer timeframe, the fall off in overdrafts is even more stark. Both the Bank of England and UK Finance (including in its previous guise as the British Bankers' Association) have published data on small business (<£1m turnover) overdrafts from high street banks (very few challenger banks offer current accounts and overdrafts so this will be representative).

Over the long run this shows a dramatic shift in overdrafts for small businesses (and these are in nominal prices – in real terms, adjusting for inflation, the decline would be even steeper):

Figure 10: Small business overdraft balances, 1990-2024 (£bn)

	Small Business Overdraft Balances[8]
1990	£27.1bn
1997	£9.1bn
2000	£10.0bn
2005	£8.8bn
2011	£5.4bn
2018	£3.7bn
2024	£2.7bn

Overdrafts were definitely excessive in the early 1990s. The BoE commented in 1999 that overdrafts represented 49% of SME bank financing in 1992 falling to 31% in 1998 and that this "*has addressed one of the problems highlighted by the early 1990s recession—small firms' over-reliance on the overdraft facility to finance anything from working capital to long-term investment projects—and has reduced the vulnerability of small firms to the economic cycle*".

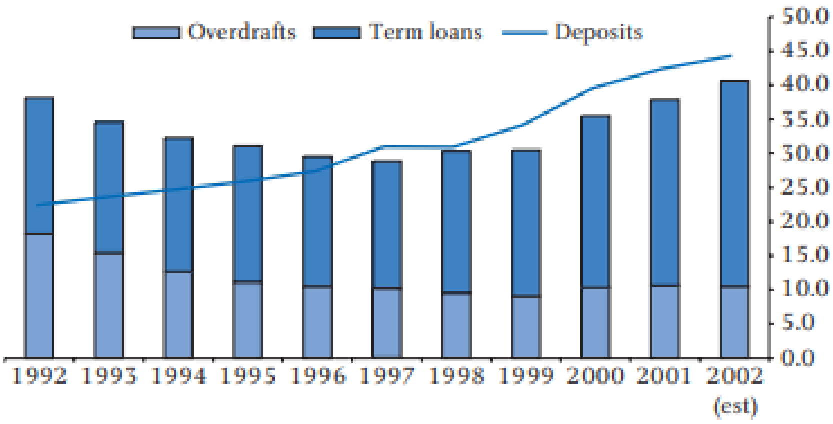
[8] Data from BBA 1990 to June 2011, then UKF July 2011 onwards. There is a discontinuity between the two series – the total of loans and overdrafts being very similar in 2011 but with a ~£1.5bn shift from overdraft to loans. It is likely this represents the correction of one bank's reporting in the prior data series.

Around half of finance being in overdraft was clearly too high and the BoE viewed 31% as a more sustainable level in its 1998 Finance for Small Firms report:

"The Bank anticipates the ratio of term lending to overdraft will now remain reasonably constant. The overdraft will always be important to small businesses as a flexible source of working capital."

Indeed, subsequent data to 2002 in the last BoE report (2004) on Finance for Small Firms overdraft balances can be seen to have started to grow slightly from 1999 (though slower than term loans) with overdrafts being 26% and term loans 74%. As of 2000 there were £10bn of overdraft balances for small businesses - which adjusted for inflation would be £18bn in 2024 prices.

Figure 11: Small business borrowing and deposits at year-end,1992-2002 (£bn)

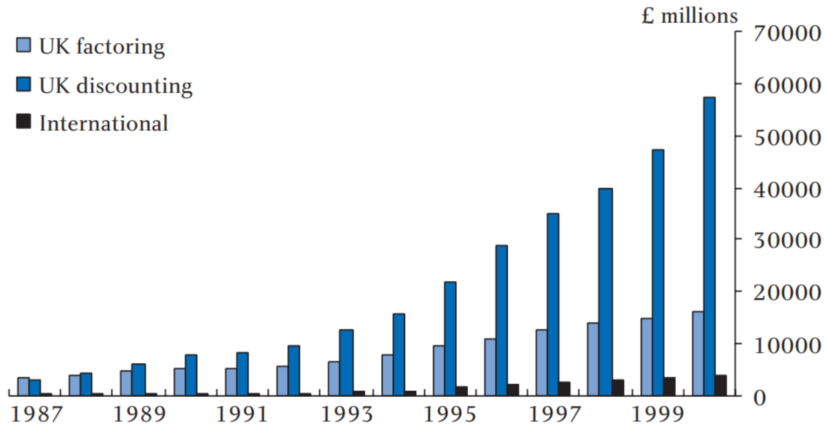


However, if we fast forward to 2024, this ratio has now fallen to just 5% with just £2.7bn of small business overdraft balances at end 2024! It seems almost certain that this current level of overdraft provision will be constraining the working capital needs of SMEs and thereby inhibiting growth.

With the reduction of overdrafts during the 1990s as well as the growth in term loans, the Bank of England reported in its annual Finance for Small Firms reports how invoice finance/factoring saw rapid growth, as these could be a substitute for overdrafts. A chart to 2000 using FDA data showed the very fast growth of volume of invoices financed during each year:[9]

[9] Client sales volumes do not equal the actual funds advanced (lending) as only a portion of the invoice is funded, and invoices are typically outstanding on average for 40-50 days

Figure 12: Clients sales volumes for factoring and invoice discounting, 1987-2000 (£m)



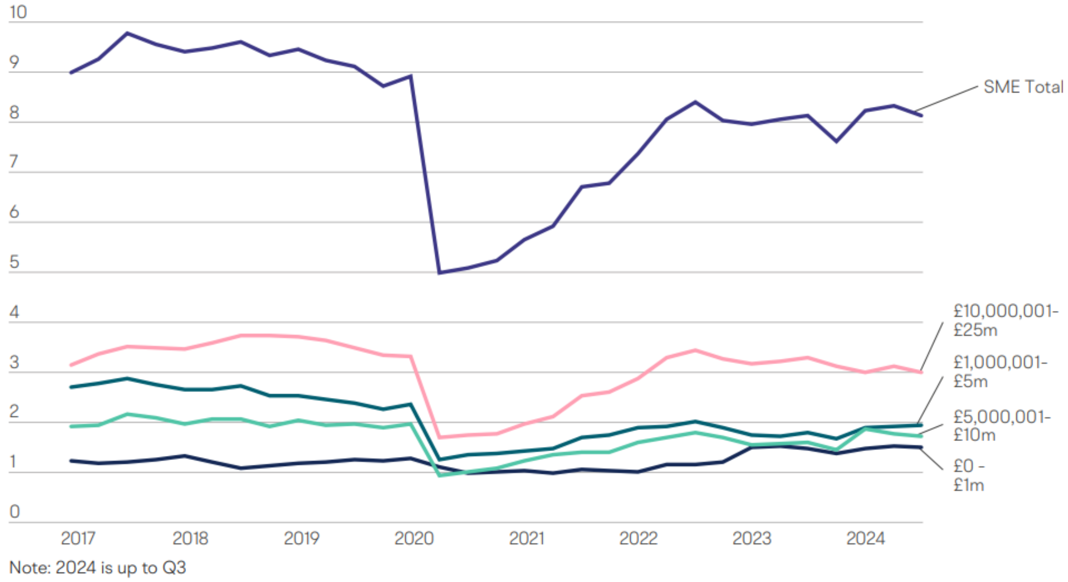
Discounting would have been almost exclusively for firms >£1m turnover and factoring primarily for firms <£1m.

There was also an impact from the Brumark judgement that weakened banks claims on a debenture secured overdraft - the BoE in 2003 in its Tenth Finance for Small Firms remarked *"There was considerable anecdotal evidence that banks were seeking to migrate overdraft customers to invoice finance, in order to protect better their position as senior secured lenders."*

More recently, Crown Preference – such that HMRC claims rank above floating charge claims from a lender (which is the typical overdraft where no tangible collateral) in insolvency – was reintroduced in December 2020, having previously been removed in 2002. This should be driving further move towards invoice finance.

However, it is no longer the case that invoice finance is growing to replace overdraft provision – over the last decade, invoice finance lending to SMEs is actually declining from 2017 to 2024:

Figure 13: Quarterly advances of invoice and asset-based lending, by size cohort, 2017-2024 (£bn)



Source: British Business Bank analysis of UK Finance data

There remains an ongoing need for working capital provision today - BBB Ipsos found in their 2024 survey that 51% of SMEs seeking finance needed 'working capital', and data from BDRC SME Finance Monitor (Q4 2023) shows 'working capital to help cashflow' as the most common reason for a financing need for SMEs (31% of SMEs that had a funding need).

A number of non-bank fintechs have over the last decade sought to address working capital loan supply in various forms (e.g. merchant cash advance, <1-year short term loans), including for services sectors. These are generally at much higher costs than traditional overdrafts finance (typically at a 10%-30% spread over base rate), which does limit market uptake as typically not used by 'prime' SMEs, though now represent estimated outstanding balances of £1-2bn.

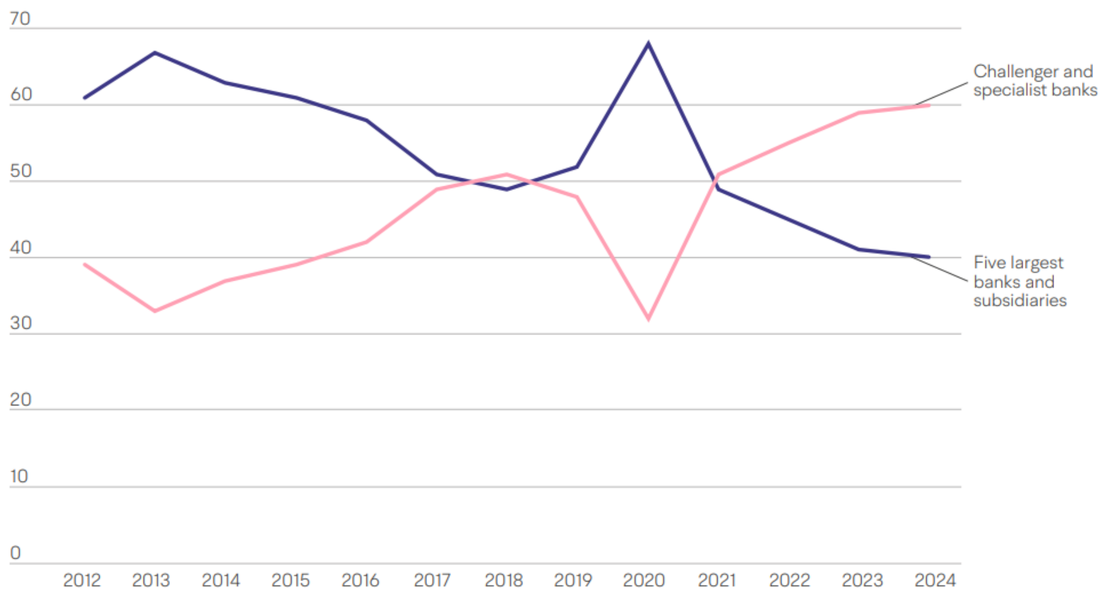
OECD Financing SMEs and Entrepreneurs 2024 data shows that across a wide range of countries 70-80% of the stock of SME lending is >1 year duration, with 20-30% <1 year which are typically overdrafts and short-term lines of credit. In the UK adding SME overdrafts, invoice finance, and fintechs that supply working capital loans together represents only ~10% of total SME lending.

The long run collapse in overdraft provision and stalled invoice finance growth in the last decade, suggests UK SMEs working capital needs are not being well met. Overdrafts are important as the most flexible form of working capital financing and are typically needed by fast growing businesses whose order book may rapidly change, seasonal businesses, and those in service sectors that are not suitable for invoice financing.

The Role of Challenger Banks

The British Business Bank publishes data in its annual review that shows the rise of challenger banks in SME lending over the last decade – these now make up 60% of new SME lending:

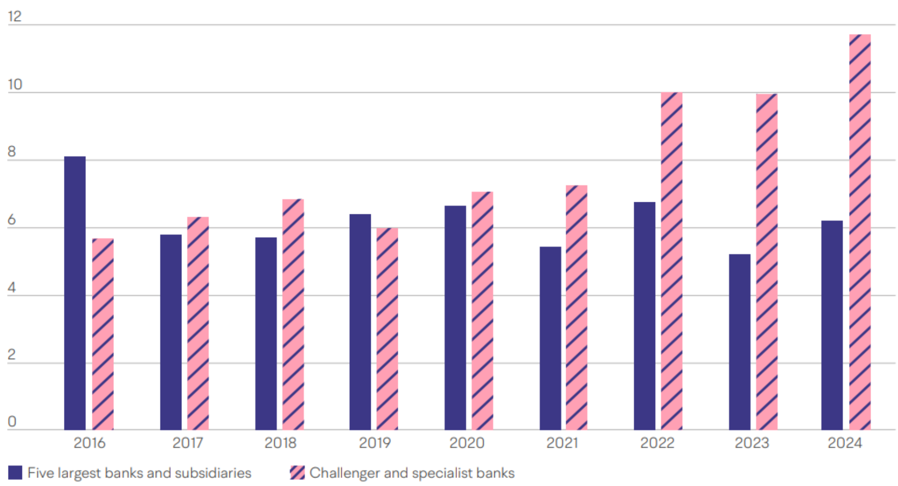
Figure 14: Share of annual total gross bank lending to SMEs, 2012-2024 (%)



Source: BoE and British Business Bank calculations

However, a further chart in the BBB's review shows SME real estate lending broken down by high street and challenger banks. This shows that the growth in challenger bank lending is heavily in real estate:

Figure 15: Annual gross bank lending to SMEs in the real estate sector, 2016-2024 (£bn)

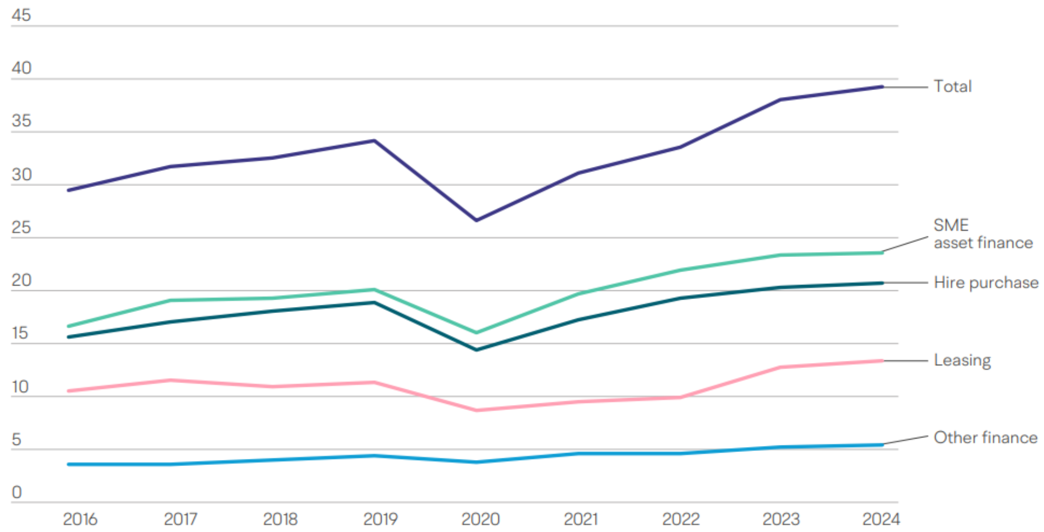


Source: BoE and British Business Bank calculations

The other class of lending which has seen good growth over the same period, is finance secured on equipment (e.g. trucks, cranes, or other plant and machinery). This also provides tangible collateral for the lender, though in many cases (other than refinancing, or replacement equipment) is expanding productive capacity of the business taking out the finance.

However, service sectors, that are now 81% of the UK economy, utilise less equipment, so while this asset finance expansion is positive, it is only for a minority of the economy.

Figure 16: Size of UK asset finance market for businesses 2016-2024 – new business in £bn[a]



a Asset finance new business for deals of up to £20 million.

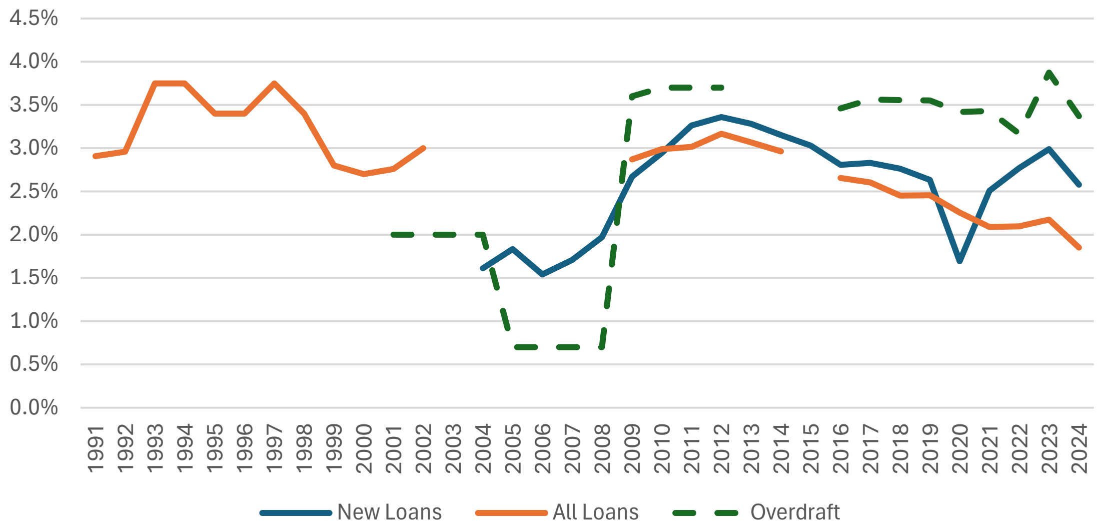
Source: Finance & Leasing Association (FLA)

SME Loan Pricing over the Long Run

The recent call for evidence suggests a concern that SME loan pricing is too high currently. The data does not support this position – average loan margins today are somewhat lower than the last positive period of SME credit in 1997-2004. Rather it is likely what is driving concern from businesses is the rise in the base rate, which at 4.5% currently is materially higher than the near zero rates of the 2010-2020 period (though that period is the historical anomaly).

The chart below compiles data from various sources to look at the margin over base rate on bank SME lending over the last three decades:

Figure 17: Floating rate SME lending – margin over base rate, 1991-2024



Source: Data compiled from: BoE - Finance for Small Firms Reports (1994-03), BoE Trends in Lending (2014), BIS - Evaluating changes in bank lending to UK SMEs over 2001-12 – ongoing tight credit? (2013), BoE Bankstats

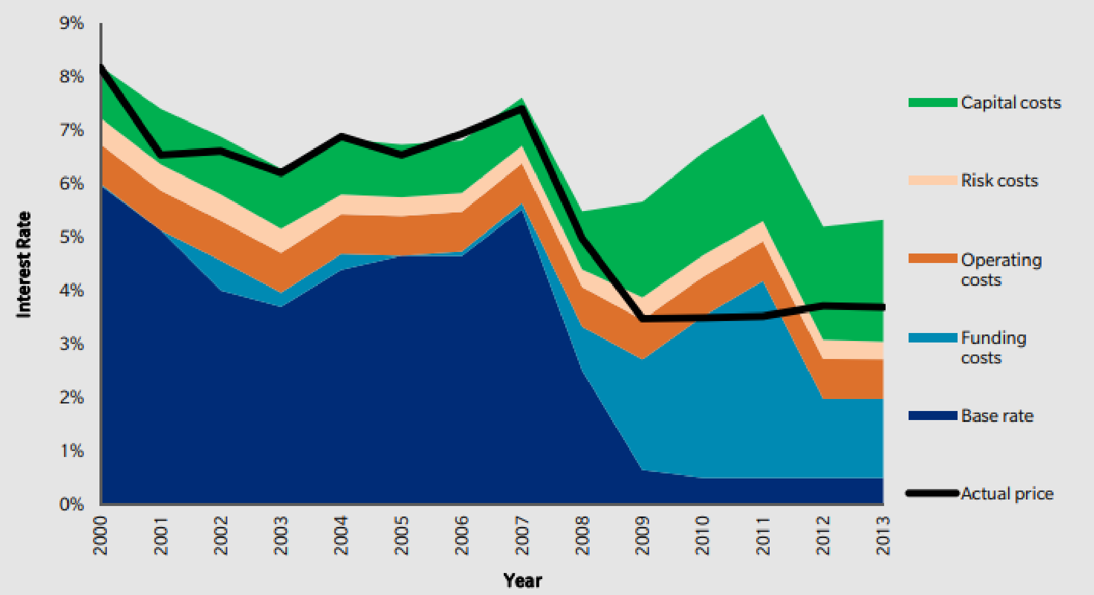
In the 1990s SME loan margins were consistently in the 3-4% range. There was then a period of very low loan margins in the period of excess (2004-08) in the immediate run up to the Global Financial Crisis (GFC), primarily driven by loans secured on commercial real estate (CRE) as CRE prices soared. However, this is the abnormality against the rest of the period. The other year with low loan margin was 2020, which was due to the government guarantees on SME lending in that year (the guarantee reduces bank capital required and so allows for lower pricing).

Capital requirements have increased materially for banks since the GFC, and so it would actually be expected that SME loan margins would have risen vs the 1990s. The fact they have not is because banks have focused their SME lending on the lowest risk, very well secured loans, unlike the 1990s – i.e. bank financing of higher risk debt for growth and working capital purposes has reduced markedly, meaning the average loan margin has reduced despite the increase in capital requirements.

The Sir Andrew Large Report (2013) gives an excellent description and visual depiction of how banks loan pricing changed over time:

"From 2007, the interest rate charged to customers fell as the BoE base rate was reduced sharply, although this reduction in the base rate was not fully passed on to customers and therefore the banks' margin over base rates increased from ~2% in 2007 to 3% in 2011. However, in the same period, the incremental funding costs for banks increased (from <0.5% to ~3.5%), as the financial crisis made it more difficult for banks to access funding. The overall cost of capital also increased (from ~1% to ~2%), as Regulators responded to the financial crisis by increasing the amount of capital banks are required to hold against lending. Because the increase in funding and capital costs was greater than the increase in the banks' margin over base rates, lending to SMEs became less profitable to banks than it was in the pre-crisis period."

Figure 18: Average economics of UK SME lending for banks, 2000-2013



Source: Bank of England Trends in Lending; Oliver Wyman analysis

Actual price is measured by the Bank of England as the industry median price at which new variable rate loan facilities were originated. It is shown here as the full price paid by the customer (i.e. the base rate plus the interest margin charged by the bank).

The Business Finance Taskforce (2010) cited Basel (BCBS[10]) work that showed a similar impact of the increase in capital requirements on SME loan margins:

"Higher capital requirements for banks will increase the cost of lending, as expensive equity will necessarily replace cheaper debt in the capital structure of each loan. The BCBS has prepared a long-term economic assessment which suggests that for every 1% increase in capital requirement, the price of credit will rise by 13 basis points (0.13%) across representative international banks. SME pricing is further under pressure because SME lending is typically riskier than the average corporate, and banks are required to hold more regulatory capital against an equivalently sized loan as a result. This magnifying effect means that SME loan pricing could increase by even more than credit pricing on average."

Similarly, the Breedon Report (2012) drew the same conclusion citing a different paper:

"Capital adequacy rules have tightened considerably including higher capital ratios and new specific rules on risk weightings on SME loans and overdrafts (Slovik et al (2011) estimate Basel 3 will lead to higher bank margins, as banks pass on the rise in funding costs due to the higher capital requirements.)"

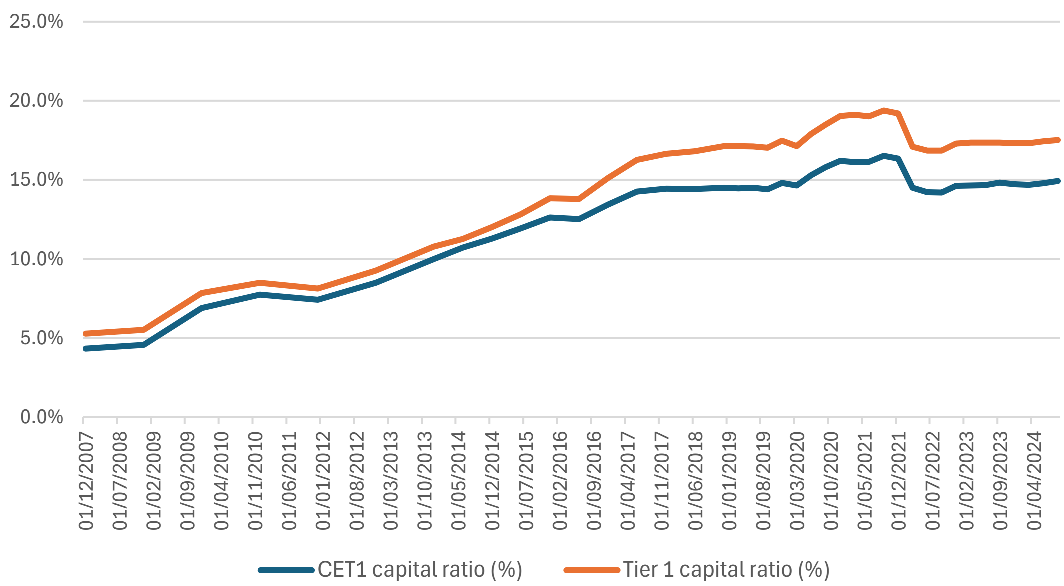
The increased costs (and procyclicality) of bank lending were exacerbated by the introduction of IFRS 9 accounting in 2018. Previously, banks recognised bad debts under an "incurred loss" accounting model whereby losses are recognised in the bank's P&L as it becomes evident a

[10] http://www.bis.org/publ/othp10.pdf

customer would be unlikely to pay what they owed. The move to the IFRS 9 expected loss model requires an upfront recognition of a proportion of losses, thus effectively consuming capital / acting as an additional buffer. This is particularly difficult for banks growing their lending books as they have to recognise the expected loss in advance of receiving the related income (and particularly impacts on non-collateralised lending as the expected loss is higher). This impact was recognised by regulators through the introduction of the IFRS 9 capital "add back" transitional arrangements. These have rolled off in 2025 meaning banks now recognise the full impact of IFRS 9 in their capital ratios.

The chart below shows UK bank capital ratios over time (CET1 being ordinary equity). The pre GFC position was definitely too low, but there has been a near threefold rise since then.

Figure 19: UK banks capital ratios, 2007-2024



Source: Bank of England FPC countercyclical buffers core indicators

Capital ratios are quoted on an end state basis ignoring IFRS 9 transitional arrangements.

Supporting the evidence that the cost of finance is not a particular barrier, the BBB Ipsos survey in 2024 (post base rate rises) found "*four in five SMEs that accepted a finance offer are not concerned about their ability to repay*".

Therefore, it would be entirely the wrong approach and counterproductive to economic growth to seek to drive down current SME loan margins from banks. These are already low by historical standards in the context of the increased capital requirements, and represent the banks move to predominantly low risk real estate lending at lower margins. The actual gap in the SME lending market vs the 1990s is for 'productive credit' - growth finance and working capital, which would need a higher margin (particularly with the different capital requirements) to support it.

The Lack of Productive SME Credit

It seems there is clear evidence of the focus of bank lending increasingly over time onto residential mortgages vs business credit. Within business credit, SME lending has fallen and is increasingly focused on collateral backed assets, particularly real estate, and also equipment. This is the opposite of the trend in the mid to late 1990s, when last the UK appeared to have sustainable SME lending growth. For example:

Governor of BoE in a speech January 1994: "there was a common recognition of the need to focus on the cash flow and performance of the business rather than to rely largely on security- though it will clearly continue to be true that the availability of security can reduce the risk to the lender and hence improve the cost and availability to the borrower."

BoE Quarterly Bulletin 1996: *"Much more use is now made of business plan and cashflow-based approaches to lending, rather than reliance on property-based security. One impetus for that change has been the depressed state of the property market, but it has meant that banks have been obliged to become more familiar with the dynamics of the businesses to which they lend, which will have important positive effects in the future."*

The shift in focus to tangibly collateralised lending seen in the last two decades is likely a result of a response to the GFC. Frontline bankers typically had underwriting discretions for smaller loans and overdrafts – for example BoE Finance for Small Firms (1998) stated: *"The majority of banks maintain that over 90% of lending decisions for small businesses are taken at the local level"*.

In the run up to the GFC there was a deskilling of frontline bankers with a strong emphasis on bringing in sales focused people from various backgrounds. This resulted in some poor decision making, and very little monitoring of these smaller loans and overdrafts as the GFC hit. Banks then saw higher losses on these loans, and moved fully to a centralised model of underwriting, with a focus on secured term lending (where the ongoing repayment of the loan acts as a form of monitoring) – i.e. a continued emphasis on less skilled frontline roles than in the 1990s, and without replacement via advanced technology that can solve for the highly diverse and complex needs of the SME segment.

The move to fully collateralised lending was also driven by the introduction of Basel 2 Internal Ratings Based models in 2006 that require a Loss Given Default estimate (where secured will be much lower than unsecured) and then exacerbated by the move to IFRS 9 impairment (2018) which requires a greater up front P&L charge to cover lack of security.

A final key regulatory driver will be the introduction post the GFC of heightened regulation for mortgages on residential property, which also applied to business loans where residential security was provided. The majority of lenders ceased providing business loans secured on residential property as a result. In markets like Australia, where SME lending is more than twice the size of UK SME lending as a % of GDP, a business loan with residential security is one of the most common, and cheapest business loan types. Clearly residential property ownership among business owners is widespread, though linking a loan to the principal family residence has serious consequences if the business fails, which was why the regulation was introduced – however it does not appear the current position with the evaporation of this type of lending is the right outcome for the UK economy.

As the economy has shifted more and more to service sector led (being now ~81% of GVA[11]) this focus on lending that is tangibly collateralised with business assets has particularly hit SME led growth lending and working capital provision.

This is in line with the academic research (Bezemer et al, 2021): *"Due to asymmetric information, banks ration credit—not incidentally, but chronically. Banks are reluctant to raise interest rates to ameliorate perceived risk, for fear of attracting risky borrowers. This is the very definition of market failure: prices do not clear markets. As a result, creditors are more likely to reduce default losses by issuing loans backed by collateral. Despite offering potentially higher returns, riskier productive investments may therefore not obtain funding in private credit markets"*

With the Bank of England concluding similarly in March 2020 *"This problem (of SME loans requiring collateral) appears to be getting worse, as an increasingly large number of SMEs are reliant on the value of intangible rather than tangible assets. The shift towards online business means there is less need for commercial property – even large companies now share office space flexibly – meaning businesses have less collateral to offer a prospective lender."*

Bank of England Survey on Barriers to Productive Investment

In 2024 the Bank of England published a survey specifically on SMEs and productive investment.

This found that 22% of SMEs said they had underinvested, with 76% saying they had invested the right amount, and 2% too much.

The main types of investment were in IT, plant and equipment, and staff training:

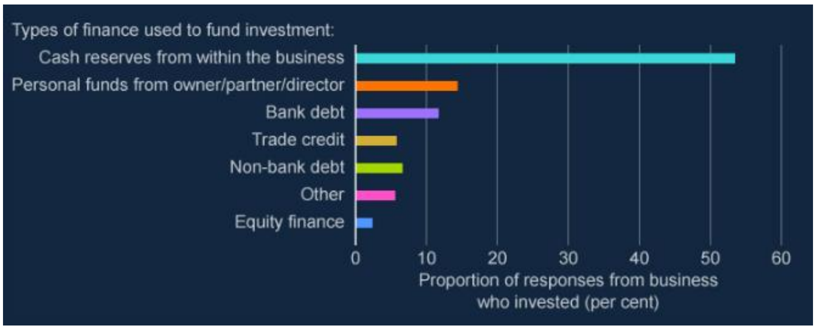
Figure 20: Investment types carried out by businesses, 2024

The biggest reasons for investing were to boost growth and productivity, followed by maintaining the business.

[11] Service industries: Economic indicators - House of Commons Library Oct-Dec 2024

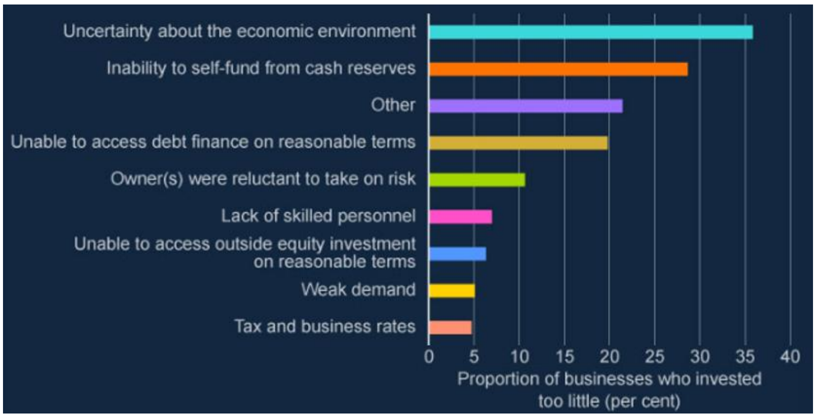
Investment was funded primarily from internal funds, with just over 10% using bank debt, and around 7% using non-bank debt:

Figure 21: Types of finance used to fund investment, 2024



For the 22% of firms that reported under investing, the most common reason had been economic uncertainty, followed by insufficient internal funds and inability to access debt finance on reasonable terms. ‘Other’ had free text repeating similar themes of inability to access debt finance on reasonable terms, economic uncertainty and reluctance to take on risk.

Figure 22: Sentiment – reasons given for investing too little, 2024



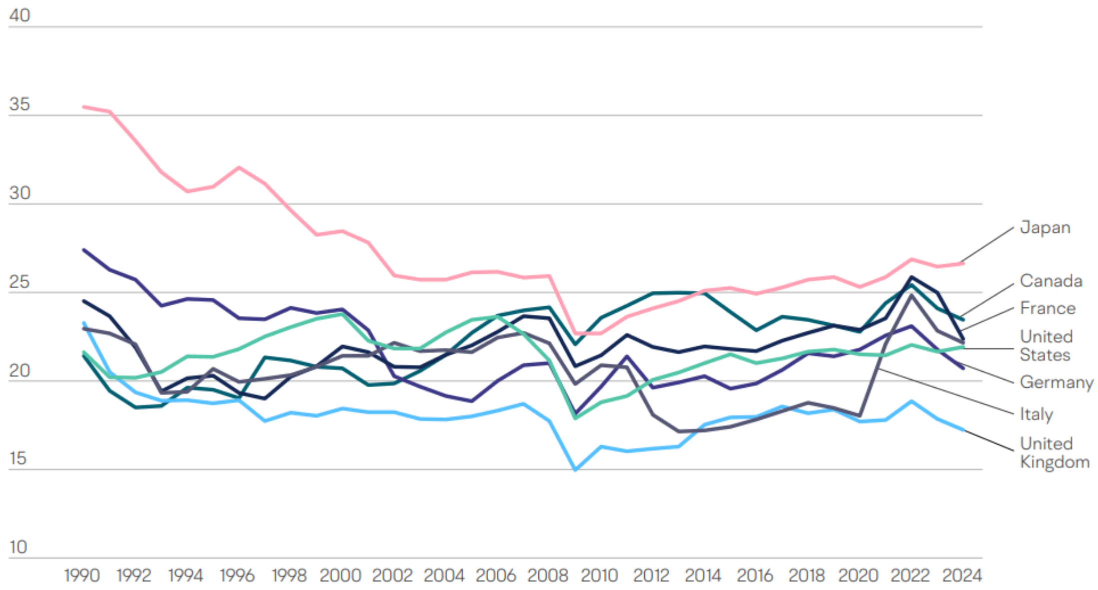
Firms that had underinvested were much more likely to feel that external finance was too expensive, not available due to a lack of collateral, or an application would be rejected.

The rise in base rate will have increased the perception of the cost of finance, though low-cost bank finance is only available for lower risk collateralised loans, so it is very likely that complaints about external finance being too expensive relate to pricing quoted by non-bank lenders for alternative unsecured lending, where the SME did not have collateral to offer.

Linkage to Investment, Productivity and Growth

The British Business Bank in its Small Business Finance Markets 24/25 review analyses UK investment, finding that the UK has the lowest investment as a % of GDP in the G7. The BBB states that "*Low business investment in the UK has contributed to low productivity*":

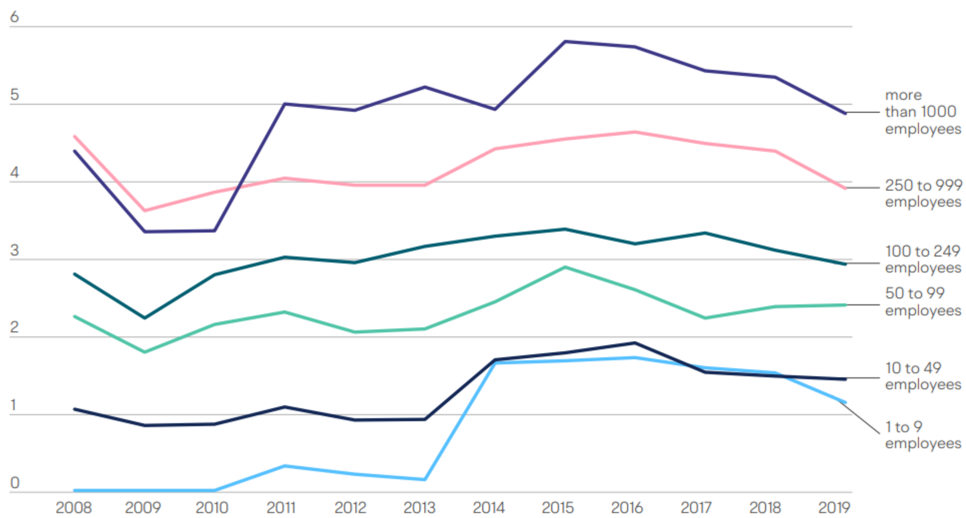
Figure 23: Total investment as a percentage of GDP, 1990-2024 (%)



Source: World Economic Outlook (WEO) database

The BBB then looks at the investment rate by size of firm, which shows that SMEs have very low investment rates:

Figure 24: Median investment by firm size, 2008-2019 (per cent of GVA)



Source: DBT – Business Investment Analysis

The BBB states that:

"Smaller businesses often have less capital and investors have less information and certainty about these businesses. This can lead to lower access to capital for small businesses and more expensive borrowing costs due to what is perceived to be higher risk, thus hindering potential business growth and the positive economic effects of this."

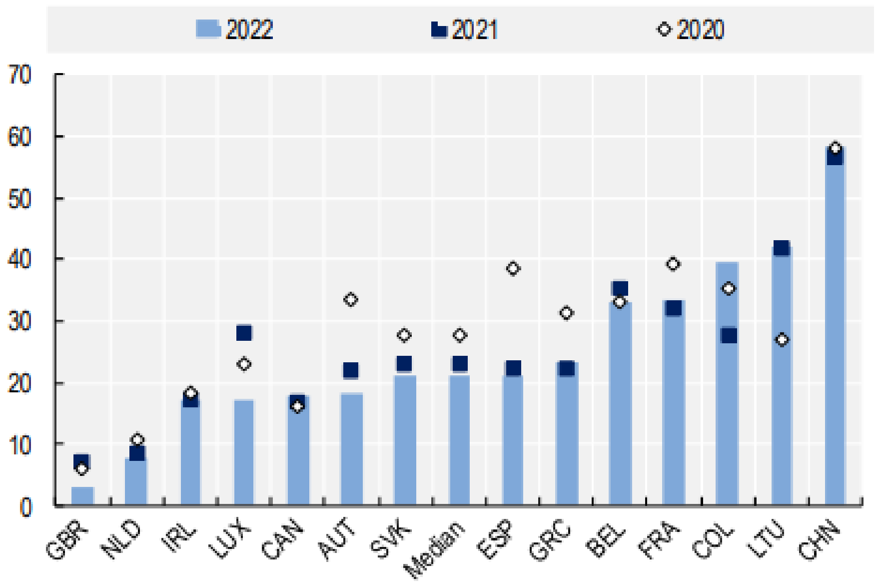
"If we are to achieve the growth we all want in the UK economy, it is important that we continue to make the case for business investment which can help drive economic growth, lift wages and improve living standards. By investing, businesses can profit in many ways – including through better productivity, increased efficiency, greater innovation or simply having greater production capability for their products and services. These investments can include anything from upgrading or buying new vehicles and equipment, to innovating and investing in new technologies, intellectual property, software, research and development or new premises."

The Build Up of Discouraged SMEs

There has been a marked drop in the actual seeking of funding by SMEs over the last 35 years. The Bank of England Quarterly Bulletin 1999 cited ESRC research that *"39% of small businesses sought external financing of any kind between 1995–97, compared with 65% between 1987–90."* BDRC SME Monitor Q4 2023 then shows 4-5% of SMEs had a need for funding over prior 12 months (similar across sizes of SME). ~50% of these actually went on to apply for finance. Multiplying the BDRC data threefold would leave the % seeking external finance seemingly very substantially down on the 1980s and 1990s. The BBB Ipsos survey in 2024 found that over the 2022-24 period *"one-quarter of SMEs sought external finance in the past three years"* – and this a) includes 2022 which had elevated rates on the back of exiting Covid, and b) included personal funds and directors' loans which would be typically wider than the traditional definition of 'external finance'.

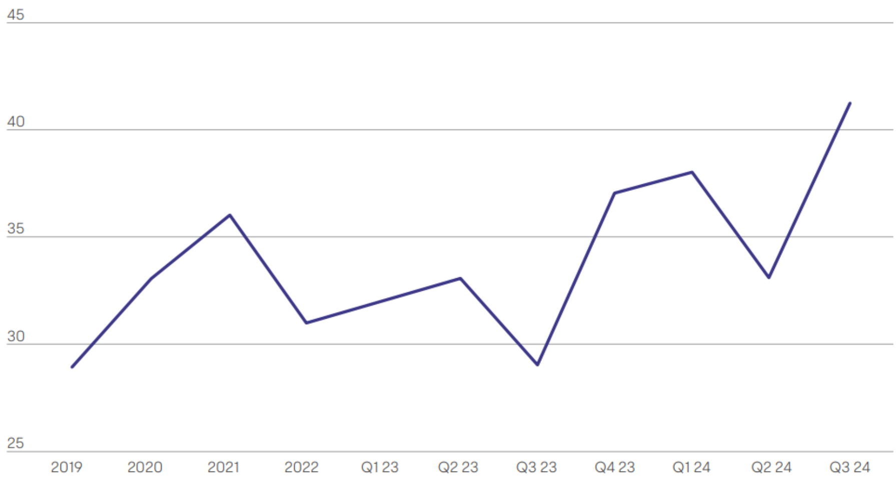
This fall in the UK's SME loan application rate over time is very much supported by the OECD (2024) which shows a comparison of SME loan application rates across a range of countries, with Britain being significantly the lowest internationally:

Figure 25: SME loan application rates by country, 2020-2022



The most recent data from the BBB shows that over the last 5 years only 30-35% of SMEs would be happy to use external finance to grow, though does show this picture improving in 2024:

Figure 26: Proportion of smaller businesses happy to use external finance to grow and develop, 2019 – 2024 (%)



Source: UK Finance BVA BDRC SME Finance Monitor

It is likely (compared to the 80s/90s) that in the decade post the global financial crisis that there was some ongoing 'scarring' in SMEs appetite to borrow from higher rejection rates in the aftermath of the GFC as credit supply tightened materially, and also well as highly publicised GFC era SME focused issues such as interest hedging mis-selling, and the RBS Restructuring Group and HBOS scandals.

NIESR (2025): states "*British Business Bank (2022) shows that, in 2021, the most common reason for not making an application to finance was fear of rejection, corresponding to 41 per cent of SMEs who had a need for finance in the previous 12 months but did not apply"*

Rejection rates have growing materially – *NIESR (2025) states "Overdraft and term loan applications had a rate of rejection of 11 per cent and 5 per cent, respectively, in 2001-2004 (BIS, 2013). In 2017, these increased to 15 per cent and 33 per cent, respectively".* Looking at the BDRC SME Monitor to Q4 2023 shows that the % of SMEs turned down for a facility (overdraft + loan) then grew from 18% in 2017/18 to 43% in 2022/23. This is much higher than cross country OECD data show where SME rejection rates tend to be 10-20%.

This heightened rejection of applications leads to ongoing 'scarring' where SMEs are permanently discouraged from seeking to borrow again – research by Cowling et al in 2021 found that 72% of previously rejected borrowers are reluctant to request loans (though found that the supply of government loans in Covid helped to reset some of this).

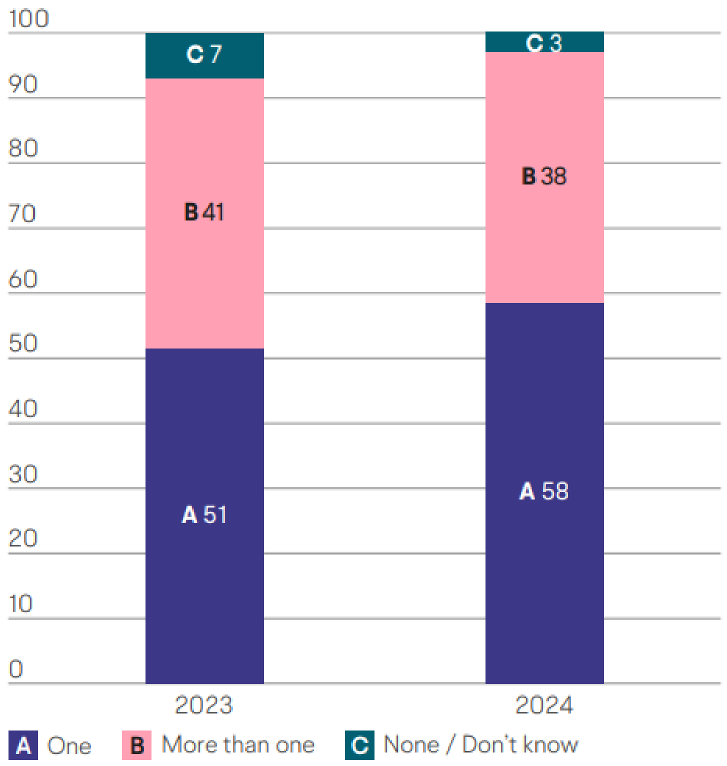
The BoE SME survey in 2024 provides further evidence that we have reached a position of demand side discouragement / scarring in the UK: *"77% of businesses agreed with the statement that they would accept a slower growth rate rather than borrowing to grow at a faster rate. Only 7% of businesses disagreed with the statement, showing SMEs strong aversion to having debt"*

The BoE have also researched (Karmakar et al, 2022) the link between investment in intangibles and productivity, finding that debt financed intangibles investments are strongly linked to productivity enhancement, and that "*around a tenth of the TFP (productivity) slowdown in the UK since the global financial crisis can be attributed to weaker intangibles investments*"

If there is a lack of business investment by SMEs that is holding back productivity and growth, and a key cause of this is the lack of productive credit provision, and appetite from SMEs to use finance to grow is finally increasing, it is critical that appropriate credit solutions are provided to SMEs now, and they are not deterred by high rejection rates.

The problem is heightened by the tendency for the majority of SMEs to not shop around (whether because they are not aware of options, or they are time poor), with most SMEs only considering one provider, which is likely to be their current account bank:

Figure 27: Number of finance providers considered by SMEs, 2023-2024 (%)



Source: British Business Bank 2024 Business Finance Survey - Ipsos. Base sizes vary by year.

Many in the industry will rightly advocate the need for greater training and financial skills for business owners. We are supportive of this, and definitely agree that business owners that have some financial skills are more likely to be successful in both raising finance and growing their business. However, our review of the evidence from the 1990s saw the problem of a lack of SME financial skills also being raised regularly then as in need of addressing. So, while training and business support is an important area for government to continue to work on, we do not believe it is the driver of the dramatic changes seen in the last 30 years in the UK SME Finance market described in this paper. Financial education for millions of business owners is also a very hard problem to solve, and in policy intervention three below we cover higher leverage channels such as accountants and brokers to help SMEs, as well as the use of technology.

Policy Intervention One - Growth Guarantee Scheme

One solution to lack of collateral in lending to growth SMEs is the Growth Guarantee Scheme (GGS) from the British Business Bank. This builds on predecessor schemes (including the Recovery Loan Scheme, and Enterprise Finance Guarantee), and is now viewed by the industry as a highly effective mechanism. It provides for a 70% guarantee to the lender in exchange for a 1.5% fee. This reduces the risk and capital at stake for the lender where the SME cannot offer collateral.

Most countries operate a similar scheme, and Allica has undertaken research on how the UK scheme compares to its global peers. This is summarised in the table below and shows that relative to the size of GDP, the UK's SME loan guarantee scheme appears to be 3-4x smaller than comparator major economies such as the US, Germany, Spain and France:

Figure 28: Snapshot of government SME loan schemes by country

Country[3]	Scheme Description	Scheme Provider	GDP (LCY[1], Tn)	Annual scheme size (LCY, Bn)	Scheme % of GDP	No. of SMEs (Mn)	Scheme size /SME[2] (GBP)
United States	Small Business Administration (SBA) loans offer benefits such as such as lower down payments, fixed rates, flexible pre-payment and up to 75% govt. guarantee	SBA Loan Programs	27.36	56.0	0.20%	33.2	c. £1,350
Germany	The KfW Guarantee Program supports businesses by providing guarantees for loans to mitigate risk and enable access to credit, particularly for SMEs	KfW SME Schemes	4.19	8.1	0.19%	3.4	c. £2,000
Spain	The government-backed guarantee of up to 80% of loan provided by ICO enables lenders to extend credit to SMEs	ICO Mediation Scheme	2.13	2.5	0.17%	2.8	c. £750
France	Bpifrance guarantees a up to 80% of loans, making it easier for SMEs to access financing	BpiFrance Guarantees	2.82	4.3	0.15%	4.2	c. £850
Netherlands	The SME Credit Guarantee Scheme (BMKB) guarantees up to 75% of loans up to €266,667 for SMEs, and 50% for larger amounts	RVO, arm of Dutch govt.	1.07	1.5	0.14%	1.56	c. £800
Italy	Credit Guarantee Scheme for SMEs is a government-backed initiative designed to facilitate access to financing by guaranteeing up to 80% of loans	CDP in collaboration with SACE	2.13	2.4	0.11%	4.3	c. £450
Canada	Canada Small Business Financing Program (CSBFP) is a federal initiative designed to assist small businesses in accessing financing by sharing the risk with lenders	ISED Canada	2.14	1.8	0.08%	1.2	c. £850
United Kingdom	The Growth Guarantee Scheme succeeded the RLS 3, and is aimed at facilitating SME financing as the govt guarantees a portion (up to 70%) of the lending	British Business Bank	2.54	1.2	0.05%	5.5	c. £200

We understand that the fee level does not necessarily cover the expected credit losses on the guarantee the government has to account for, where the SME is both of higher risk of default and does not have collateral to offer. Some degree of subsidisation is arguably beneficial in addressing identified market failures, and doing so will produce economic growth and thereby increased future tax revenue. However, given the constraints on the government's finances, there may be a desire for direct fiscal neutrality in expanding the GGS. A solution to this would be to introduce different tiers of guarantee fees that map broadly to different risk levels (for example based on the end product and pricing[12]). Application of the guarantee will still reduce the price of this finance to the end customer (as volatility of losses is reduced by the guarantee),

[12] E.g. a fully unsecured loan of £150k at an 20% interest rate to the customer will have materially higher expected credit loss to the government than a debenture secured loan of £1.5m at an 8% interest rate.

and overall we believe the issue to be solved here is primarily the need to increase the supply of productive credit to UK SMEs that want to invest and grow, rather than of price.

We see a range of use cases for a 3-4x expansion in the GGS:

1. Various lenders requested higher limits in 2024 and 2025 than were available under the current scheme, indicating unmet demand.
2. Providing increased coverage for overdrafts to service sector businesses, given the collapse in overdraft provision over the last 30 years which indicates severe market failure.
3. Increasing the maximum loan size to £5m specifically for growing businesses that are in sectors that lack tangible security. While larger businesses can access private credit options, there is a gap between £2m and £5m that is crucial for scaling these companies.
4. Supporting green finance – we are aware the British Business Bank is already working on this and see highly beneficial applications in green asset finance and upgrading EPC of commercial property stock.
5. Given the government's hugely ambitious targets for new home building, and with construction SME credit having seen the largest sectoral impact (see Figure 8), we believe a specific focus on construction companies is warranted.

The GGS should not be allowed to be used to subsidise the price of well collateralised lending (which has been allowable in prior schemes) given there is no shortage of market provision in this area. The scarce resource of the government's balance sheet should be deployed where it is addressing the clear market failures described here.

We believe the GGS scheme should be doubled for the 2025/26 fiscal year then expanded 3-4x to bring it in line with other advanced economies over the course of the rest of this parliament. Expansion of the scheme needs to be accompanied by substantial promotion, to seek to entice previously discouraged SMEs back into the market to take productive credit to invest.

We would also note the following:

- The scheme needs to be made permanent and put on a long term footing – for example, it is currently very 'hand to mouth' with lenders allocated limits only for 6-9 months (in the context of many commercial loans taking 3-6 months to complete origination), making it hard for lenders to plan to use the scheme to maximum effect.
- The additional £500m announced by the Chancellor on 13th April is welcome but appears to only be a short term measured directed at relief for tariff impacted companies, and so the issues raised in this paper remain in need of focus.
- Beyond the GGS, there is also the Start Up Loans scheme for very new businesses – we believe this is also an important aspect in the market, and a review of the maximum loan size from £25,000 to £40,000 would be warranted.

Policy Intervention Two – BOE/PRA Focus and Prudential Framework

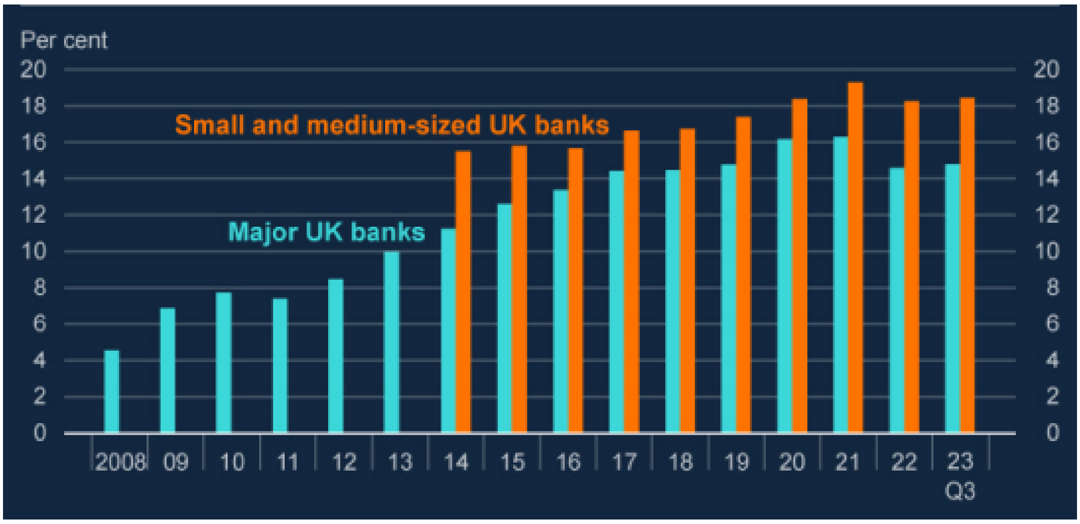
There needs to be a specific focus on SME finance and banking within both the Bank of England and the Prudential Regulatory Authority (as there was in the BoE in the 1990s, where the BoE regularly published a report on Finance for Small Firms, and convened banks to discuss). This would necessitate a renewed focus on challenger banks which now make up 60% of the supply of UK SME lending.

Recent BoE/PRA publications (e.g. initial Basel 3.1 and Small Domestic Deposit Takers proposals) show the need for this focus, as they did not focus on SME credit, inadvertently penalising it (since corrected for in the final Basel 3.1 post strong industry feedback; Small Domestic Deposit Takers output is pending where SME credit was penalised in the consultation proposal by being lumped in with Wholesale and thereby attracting higher capital add on).

This BoE/PRA focus would be entirely in line with the secondary objectives both for competitiveness and growth and competition, and vital for supporting growth in the UK real economy.

The prudential framework is of vital importance to growing banks, as both the certainty and level of capital requirements determine the ability to grow lending to SMEs. BoE data shows that equity capital is meaningfully higher in smaller banks than major banks:

Figure 29: Aggregate CET1 ratio of UK banks and building societies, 2008 - 2023



Both larger and smaller UK banks have robust aggregate CET1 ratios.

We have five specific recommendations in particular:

1. Delays and uncertainty have been consistently shared by participants at roundtables by many challenger banks on capital related processes; this uncertainty deters investors in challenger banks. Building on the success of the PRA's Start Up unit, a Scale Up unit should be implemented that ensures increased frequency, and timely delivery, of capital

related processes for growing scale up challenger banks. Reported metrics for the PRA should be expanded to include frequency of capital supervisory reviews (for fast growing firms these should be every two years at a minimum); and speed of authorisation of capital instruments such as securitisations (this should be within 3 months as with other capital instruments that require non objection, and in line with the EU). Fast growing banks are willing to pay a levy to pay for the increased specialist resource required.

2. The Pillar 2A adjustment announced to offset the removal of the SME Support Factor under Basel 3.1 (which otherwise would have increased capital for SME loans by c.25%) needs clarity to ensure lenders have certainty as to how this will balance out the removal of the SME Support Factor. This needs to address the significant concerns among challenger banks that there will be insufficient offset available in the Pillar 2A capital stack (i.e. thereby capital requirements for SME lending will rise against the pre Basel 3.1 position), and over the material lag growing lenders will experience between advancing SME loans and applying the adjustment (if this is in the capital supervisory review process mentioned in point 1 on the current retrospective three yearly basis).

3. Challenger banks that only lend in the UK receive a capital add on for ‘geographic concentration risk’. This 1.33% capital add-on must be changed or removed. In the light of the enhanced small bank resolution capabilities, having additional capital for domestic focus does not seem aligned to the government’s UK growth agenda. If the PRA wants to measure geographic diversification of smaller banks it should do this on a UK regional basis which would also align to levelling up by ensuring smaller banks are not just concentrated in e.g. London.

4. There needs to be a clear statement that smaller banks should not hold buffers on top of the PRA supervisory buffers, particularly in the context of IFRS9 being an additional buffer in a growing bank. We believe that one of the reasons that smaller banks are holding buffers on buffers is due to the volatility smaller banks can see in their capital requirement with the counter cyclical buffer set by the FPC, and the firm specific (Pillar 2A and 2B) buffers set by PRA, and Boards being afraid of being in breach so holding large contingency buffers, particularly if they are growing. We feel that this would be resolved by the PRA: a) reducing the uncertainty around the P2A and P2B buffers, and b) giving a clear message that buffers on buffers are not required. Further evaluation of the interaction of IFRS9 and capital requirements and buffers should also be undertaken by the PRA, given the issues raised in this paper.

5. The MREL asset threshold should be increased materially which has been raised across the industry in response to the recent BoE consultation (we would propose aligning to the ringfencing asset threshold), and revising the transactional account definition (9 in 3 months is very low to qualify an account for what is meant to protect ‘critical economic functions’ - with the rise of electronic payments the typical account is making 3x the debit card payments and 10x the faster payments they were in 2015 when this was set), so MREL does not provide a cliff edge for challenger banks.

Policy Intervention Three – Research Alternative Innovations

Beyond the specific need for substantially scaling up the Growth Guarantee Scheme, and Bank of England focus on a successful prudential framework for SME lending, there are a range of areas that need work to innovate in the field of SME lending:

1. With the highly diverse number of SME lenders, there is a problem of discovery for SMEs that needs solving, as well as financial education for business owners to put together an appropriate lending application. We believe brokers, who often have a local relationship with that business owner, definitely play an important role in this, as can accountants who often play a key role in business owners' financial decisions. Generative AI should also be able to play a key role in both enabling customers to discover the best lending solution, and packaging together the required application for the lender. The Bank Referral Scheme is widely acknowledged as a failure, and there should instead be a focus on helping SMEs with the problem of discovery and financial education

2. More generally it is clear that advanced technology and data is needed that can solve for the highly diverse and complex needs of the SME segment. It must be recognised that the one person IT consultancy looks nothing like the 50 person logistics company, which looks nothing like the SME housebuilder. For truly effective productive lending there is a need for hyper-personalisation. Again, generative AI likely supports this, as will work that has started from CFIT. CCDS has been a strong intervention in data availability since 2018, and further mandatory data availability can support this hyper-personalisation.

3. We are also supporters of the development of traditional alternative models such as CDFI which have a highly localised relationship approach (which is the traditional form of hyper-personalisation). Diversity of business models in a highly diverse SME segment is important. However, it must be recognised that given that total CDFI lending is very small to start with (at c.0.3% of new SME lending in 2023), the impact here will take a long time to come through.

Conclusions

Over the last 15 years there has arisen a substantial SME credit gap vs the long run trend. The UK has a low business investment rate by international standards, particularly among SMEs. It is very likely that these are highly interlinked – i.e. low SME appetite or ability to borrow leads to low investment, and in turn this will hold back productivity and economic growth. The causes of this are complex and reflect the interaction and build-up of various factors over time.

1. Service sectors have continuously grown as a percentage of the UK economy and now represent more than fourth fifths of economic activity.

2. Banks have rationally moved to heavily collateralised lending, primarily with real estate or equipment security. Service sectors are much less likely to have this security. The move to highly secured lending has been driven by:

   a. Losses experienced in the early 1990s recession and GFC from overdrafts and small unsecured loans sanctioned under frontline discretion
   b. Increases in bank capital requirements and the introduction of IFRS9 accounting for future credit losses, leading to a focus on very low loss lending
   c. The complexity of established SMEs (a very diverse segment), while frontline business banking staff have been steadily cut back to save cost as credit processes became centralised and focused on low risk 'tick and turn' loans

3. Experience gained by SMEs builds up over time – i.e. the market learns the type of finance provided and does not seek beyond this as that effort is viewed as likely futile. This is amplified by events that create 'scarring' of SME's view on borrowing, such as the well-publicised RBS and HBOS scandals in the GFC.

4. Despite the rise in capital requirements, due to banks focus on low-risk lending, SME loan margins have actually narrowed (though some non-bank lenders offer high margin lending particularly for short terms). For banks to supply more productive credit to SMEs, there would need to be a somewhat higher price on this type of credit to reflect the increased risk and capital requirements. However, as the economic theory predicts, banks seem to not offer this in the absence of traditional deeper relationship models or a replacement via data, due to fear of adverse selection.

5. There are a very wide range of SME lenders now in the UK market looking across high street banks, challenger banks, and non-bank/fintech lenders – ~200. This would suggest there should be adequate supply. Alongside the problem that discouragement of seeking finance seems to have built over time, there is a significant problem of discovery of the right lender and product given the huge range of lenders, with over half of SMEs only considering one lender (typically their main bank). Brokers can play a key role in helping connect a SME to the right lender, and their use should be encouraged, and accountants also have a vital role to play. The British Business Bank via initiatives such as Enterprise Hub can also be developed to play an increasing role.

6. The market seems to have reached a highly sub optimal position of a fear from SMEs to borrow to invest to grow, driven by a build-up of multiple structural factors over the last two decades.

7. There needs to be investment in lending skills, data and technology to solve better for the supply of uncollateralised productive credit.

8. Covid does seem to have driven some reset in the historic discouragement, as a substantial portion of SMEs took government backed loans in 2020/21. With most of these now repaid, the recent SME Monitor data shows more SMEs starting to look for finance, however rejection rates are also much higher.

9. In this context there is both a chance and a critical need to shift away from the negative equilibrium that solidified in the last decade. Expansion of the Growth Guarantee Scheme to a similar level to other countries (3-4x) could be a key force that underpins a recovery in SMEs propensity to borrow to invest for productivity and growth. There would be a need for heavy promotion of this scheme to shift the SMEs' perception.

10. There should also be a specific focus on SME finance within the Bank of England, as there was in the 1990s, and particularly on challenger banks which are now 60% of the supply of UK SME lending. The prudential framework is of vital importance to growing banks, as both the certainty and level of capital requirements determine the ability to grow lending to SMEs. BoE data shows that equity capital is meaningfully higher in smaller banks than major banks, and this needs to be addressed.

11. Finally, we recommend ongoing industry action on solving the problem of discovery of SME finance options by SMEs, and how lending can be hyper-personalised to the very diverse nature of SMEs. We believe generative AI will play a key role in this, alongside renewing traditional local relationship models.

Appendix - Triangulating with Prior Reviews of SME Lending

UK Finance (2018) reviewed the gross flows of new SME funding including alternative finance over the 2008-17 period:

Figure 30: Gross new funding for UK SMEs, 2008 – 2017 (£bn)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Source of funds:										
Bank loans	44.5	41.2	40.4	38.9	38.0	42.9	53.4	57.8	59.0	57.0
Private equity	1	0.5	0.5	1	1.5	1.5	2.5	3.7	3.11	5.89
Asset finance	14.3	9.95	10.2	10.6	12.2	12.9	14.4	15.9	16.7	18.6
P2P business lending	0.001	0.001	0.001	0.02	0.06	0.25	0.59	0.8	1.2	1.8
P2P Invoice funding	0.001	0.001	0.001	0.003	0.04	0.1	0.27	0.3	0.35	0.5
CDFIs	0.03	0.03	0.02	0.03	0.05	0.07	0.09	0.10	0.08	0.06
Invoice Finance*	8.66	7.19	7.47	8.51	7.90	8.23	8.81	8.55	8.90	9.57
Total	59.8	51.7	51.2	50.5	51.8	57.7	71.2	78.6	80.4	83.9

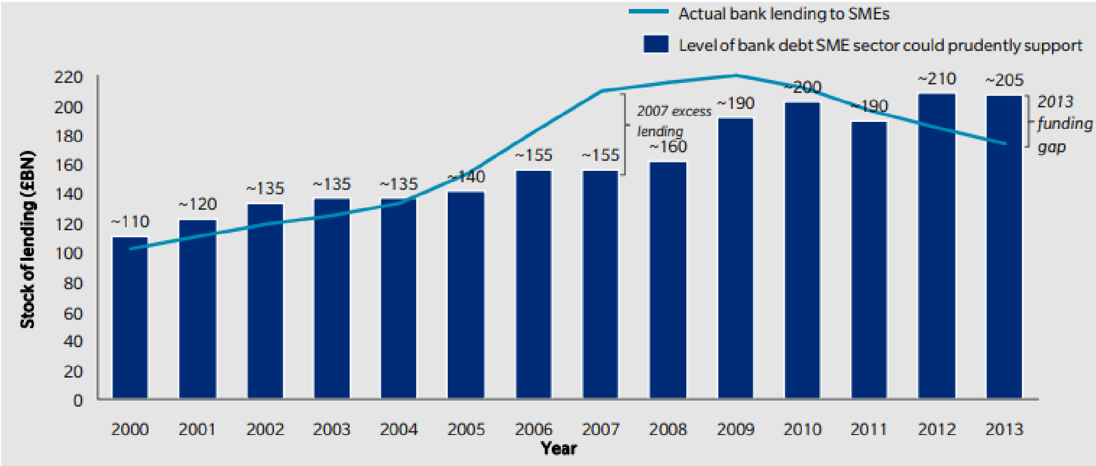
UKF then went on to estimate two scenarios of expected gross SME funding flows by the mid 2020s. Excluding equity this projected £97bn-£119bn of gross SME lending per annum. Allica maintains a similar database that shows ~£88bn[13] of actual UK SME lending in 2024. This is therefore £9-31bn less than expected in 2018, so the mid-point estimate would be £20bn. The ratio of SME lending stock to new lending is ~3x, therefore the expected gap in current UK SME credit stock against UK Finance's 2018 projections would be £60bn - very similar to the estimate derived by Allica from the long run time series data above.

The Sir Andrew Large report (2013) included detailed analysis by Oliver Wyman of the supply of SME lending against the debt capacity of SMEs to borrow (using SME cashflow/profitability data).

This showed that in the period up to 2004, total borrowing was in line with or slightly below SME's debt capacity to borrow – supporting the stance taken in Allica's research that 1997-04 was a period of sustainable SME lending and economic growth. SME lending then went materially in excess of debt capacity, peaking at a £50-60bn excess in 2007 on the eve of the financial crisis. SME lending then fell back while SME debt capacity improved, resulting in a material funding gap of £30-35bn by 2013.

[13] Allica's database includes UKF Great Britain lending data, to compare to UK picture we have added £2bn of Northern Ireland gross lending pa estimated based off UKF NI stock data of £6bn

Figure 31: Estimated UK SME debt capacity vs actual bank lending to UK SMEs, 2000 – 2013 (£bn)



Source: Department for Business Innovation & Skills; Bank of England; British Bankers Association; Orbis; Oliver Wyman analysis

1. SME lending stocks are extrapolated backwards from 2011 using a range of sources including BBA Small Business Survey data, and BoE PNFC data, due to a lack of published data

2. Stocks are measured as yearly averages

3. Level of bank debt that total market could prudently support is based on Debt Service Cover (by Net Cash Flows) of 1.5, and pricing at economic cost

We do not have the data to update this analysis, though SME credit is essentially flat end 2024 vs end 2013, so it is very likely the gap would have widened meaningfully if the OW analysis was rerun (although the recent rise in base rate will have increased debt service costs).

The Breedon Report (2012) created modelled estimates of the potential credit funding requirement five years out – i.e. 2016 – which found that 'between £26bn and £59bn is estimated to relate to smaller businesses' – actual SME credit fell by £23bn from £189bn end 2011 to £166bn end 2016, therefore the gap in 2016 vs the report's estimates of SME funding requirements was £49bn to £82bn, the mid-point of which is £65bn.

Finally, the National Audit Office (2013) cited Deloitte research commissioned by BIS, that showed a gap of £10-11bn at the point, projected to grow to a potential £22bn SME gap by 2017. This was then quoted by the Bank of England in reports in 2018 and 2020. The original Deloitte research could not be found, and so it is not clear whether the gaps quoted related to new lending flow or stock. We would presume these are new lending flow numbers given the £30-35bn gap in stock identified at the same time in the Large Report. On the basis they are flow, that would imply a £66bn gap in stock in 2017.

These past studies of the potential SME credit gap are materially in line with Allica's estimate of a £65bn gap in the stock of SME credit.

The British Business Bank has not published estimates of the SME lending gap, though did publish a consultation seeking view on a potential methodology to estimate the gap in 2016 – key points include:

- BBB recognise that both supply and demand drive the credit gap:
  "Lenders often look at previous track record as an imperfect indicator of future performance and/or seek to take security to de-risk the lending"
  "Smaller businesses may perceive that their chances of successfully applying for finance are lower than they are in reality."
- BBB proposed using SME self-reported via survey reasons for rejection, with a focus on new loan applications, seeking to allow for some rejections being valid. However, with applications having reduced, this does not then cover structural discouragement that builds over time as the BBB foresaw in its document *"this means that calculations for unmet demand for finance will be an underestimate."*
- The methodology focused on traditional debt products, specifically bank loans. Of those seeking new loan facilities at that time 55% were successful. An estimate of £4bn rejected a year is quoted – with the average behavioural life of a bank loan at 5-6 years, this would therefore indicate a stock gap of ~£20bn for bank loans at that time.
- This should in our view be viewed as a lower bound estimate for the SME credit gap, given it only covers bank loans, and does not account for the build up of structural discouragement.

Allica Bank