Securing the foundations for growth and trust

The SME Manifesto 2024

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WPI ECONOMICS

appg Fair Business Banking

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Table Of Contents

About the All-Party Parliamentary Group (APPG) on Fair Business Banking

The APPG is a cross-party group with members from the House of Commons and the House of Lords which puts forward policy recommendations to Government that encourage a finance system which allows enterprise to flourish and business to thrive. The Group acts as a forum and focal point for the SME community and financial services industry to deliver reforms in their long-term interest.

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Foreword | Access to Finance

SMEs are the lifeblood of the British economy. They employ more people and contribute more to national turnover than anyone else in the private sector. More than that – small businesses are the backbone of our high streets. Nothing is more British than your local family-run cafe, that life-saving hardware shop which has been passed through the generations, or that pub where you had your first job pulling pints.

To be British is to be entrepreneurial, to be innovative. But that spirit is being stifled. Small businesses are not being incentivised to grow, to employ, to take risks. Either too many small business owners are not aware of the financing options available to them, or those options are simply insufficient. Either way, something needs to change.

The recommendations in this manifesto could help to restore Britain's reputation as the best place in the world to do business. Maximising the value of every penny spent and ensuring businesses are matched to the best lenders is surely a no-brainer. And just making sure that businesses know where and how they can access finance is key to unlocking the various schemes, grants and programmes which are already out there.

Non-traditional lenders, Community Development Finance Initiatives, regional mutual banks and credit unions, can all reach people and places that high street lenders either cannot or will not. We've got to build a lending ecosystem which works for everyone, whatever its size, wherever it's based. It's not that there isn't enough finance out there for everyone, it is just a case of using the best vehicles we have to distribute it.

Challenger Banks, which are so important for providing alternative options for businesses and indeed giving high street banks something to think about when it comes to business lending, have bounced back from the pandemic lull. But we have to make sure that this growth is sustained and accelerated.

It doesn't matter what political party you're from, we all want a thriving, regionally balanced economy which encourages innovation, supports smaller businesses and creates employment opportunities. The will is there, and the means too. Now we just need to get on with the job.

Paul Scully MP, former Business Minister

Foreword | Redress and Compensation

Small and medium-sized businesses are vital for creating jobs, driving innovation, and building communities. We know that when SMEs thrive, the wider economy prospers.

However, to confidently take risks and invest, small business owners need assurance that there are protections in place as well as a reliable and trustworthy ways of to resolving disputes and, if necessary, swift and fair redress when issues arise with lenders. At the moment, this is far from guaranteed.

Despite a series of high-profile scandals, like Interest Rate Hedging Product mis-selling and business banking failures at RBS and Lloyds, business lending remains largely unregulated. Small businesses rely on the Financial Ombudsman Service to sort out relatively simple disputes, but larger SMEs and more complex, contentious and high value cases are excluded. Often, when faced with misconduct and malpractice, small and medium sized businesses have nowhere to go.

Even when individual disputes do swell into mass financial scandals, small businesses are often not given access to proper compensation. Evidence from past redress schemes show how victims have been failed again by the very mechanisms established to put things right. Can we blame small business owners for feeling like it's not worth the risk of borrowing to grow?

The case for urgently needed reform was clearly set out in reports produced by the Financial Conduct Authority, the Treasury, the Treasury Select Committee and UK Finance in 2018. The financial services sector elected to implement a voluntary scheme, known as the Business Banking Resolution Service, as a solution. Plainly, this has been an abject failure which clearly highlights that voluntary schemes do not work, and that we can no longer avoid a statutory mechanism.

So how do we fix this? This manifesto shows we do not have to reinvent the wheel. We could use existing tribunal models - such as Employment Tribunals, to establish a Financial Services Tribunal, which would provide a single forum for accessible and expert dispute resolution.

This would not be a radical move, but it could have a radical effect. Just as with employer-employee relations, a tribunal could have a dramatic impact on the power imbalance between small businesses and large financial institutions. By bringing to light unfair practices it could also provide an impetus for the financial services industry to improve their standards, and create a deterrent against future scandals.

It's within our reach to create a lending environment which allows our small businesses to have the confidence to invest in jobs, skills and innovation, safe in the knowledge that they are properly supported if things go wrong. It's time to jump that final hurdle and back our SMEs.

Peter Dowd MP, Co-chair of the APPG on Fair Business Banking

Executive Summary

Helping small businesses to succeed is critical for boosting economic growth, increasing productivity, and strengthening communities across the UK. At present, our banking sector is not working for the UK's Small and Medium-sized Enterprises (SMEs),[1] and many businesses do not or cannot access the lending they need to grow. Addressing this problem should be a priority for whoever forms the next government.

This manifesto sets out a series of policy recommendations for the next Parliament which would shift the dial on how SMEs interact with lending.

1. **Turbocharging the challenger and non-bank lending sector** – the new Government should set a target for increasing the supply of finance to social purpose lenders, such as Community Development Finance Institutions (CDFIs), from the banks, with the option of mandating this in future through a 'Fair Banking Act'.

   Furthermore, the Government should ensure the implementation of reforms under Basel 3.1 do not reduce lending to SMEs, as this would be catastrophic for the economy.

2. **Extending the regulatory perimeter** – there is no good argument for excluding SMEs from the protection we rightly insist on for consumers. As a result, commercial lending to small and medium sized businesses should be subject to Financial Services and Markets Act (FSMA) and they should have a right of action to pursue banks for damages for breaches of the FCA Principles.

3. **Create a Financial Services Tribunal (FST)** – a FST is urgently needed to support greater access to justice for SMEs, replace the failed Business Banking Resolution Service, provide a permanent route for resolving larger and more complex cases and increase the competitiveness of the UK banking sector, especially internationally.

4. **Extend the Financial Ombudsman Service (FOS) threshold** – it is not viable for larger SMEs to resolve disputes with banks and seek compensation through the courts but there is no route for meaningfully addressing dissatisfaction and detriment faced by this group. Subject to its interaction with the FST, we should extend the FOS threshold to allow more companies to refer complaints to the Ombudsman.

5. **Supporting SMEs to 'be ready to borrow'** – businesses need help and support that they can trust to be able to access the finance appropriate to them. We should address the complex and fragmented advice and support system for SMEs through a new common approach to signposting.

6. **Longer term British Business Bank (BBB) support schemes** – put the Growth Guarantee Scheme on a 5-year funding footing so that lenders can plan and invest in their offerings over the longer term. This is critical for supporting non-bank lenders such as CDFIs to be able to scale their offering and improve access to lending for the most underserved SMEs.

7. **Green Finance support** – decarbonising the mass market of UK SMEs will be a major challenge in the coming years, and critical for achieving the UK's climate targets. To support this, Government should prioritise funding a BBB-backed asset finance product to support small businesses to adopt products and technology that reduces their emissions.
8. **Improve guidance and support to SMEs on greenhouse gases (GHG) reporting** – lack of a consistent approach to data collection and no common framework for emissions reporting has impacted sustainability management practice for various stakeholders. Government should improve existing guidance and take on a bigger role in harmonising measuring and reporting processes.
9. **Introduce a set of principles for compensation schemes** – current schemes have been designed and administered in an ad hoc manner and are plagued with issues that ultimately fail to provide fair and timely compensation to victims. There should be a clear set of guidelines based on principles of fairness and justice to ensure all future schemes help the victim.
10. **Increase FSCS insurance limit on credit balance from £85k and keep under review** – the current FSCS insurance threshold of £85,000 has remained unchanged since 2010 despite SME deposits more than doubling, thus increasing the risk of SMEs losing their deposits in case of bank failures. This results in overdependence on High Street banks who offer low interest rates but whose risk is perceived to be smaller. Government should increase this limit to mitigate this risk and enable SMEs to reap the benefits of higher interest rates offered by other financial firms.
11. **Overhaul the Bank Referral Scheme** – the Bank Referral Scheme has failed to match customers and lenders at anything close to the scale needed to amplify access to finance. The new Government should refresh the Bank Referral Scheme to bring more banks in scope, with the option of mandating bank participation, and review and improve the consumer journey of businesses using the scheme.

Based on extensive evidence from expert witnesses, academic research, and experiences internationally, we believe these recommendations could make the UK a radically better place to start, run and grow a small business. Supporting SMEs is important not just for those businesses themselves – it is a critical part of any strategy to address the country's major challenges around economic growth, addressing regional inequality, and greening the economy.

The APPG stands ready to work with the government to ensure these policy priorities are made a reality.

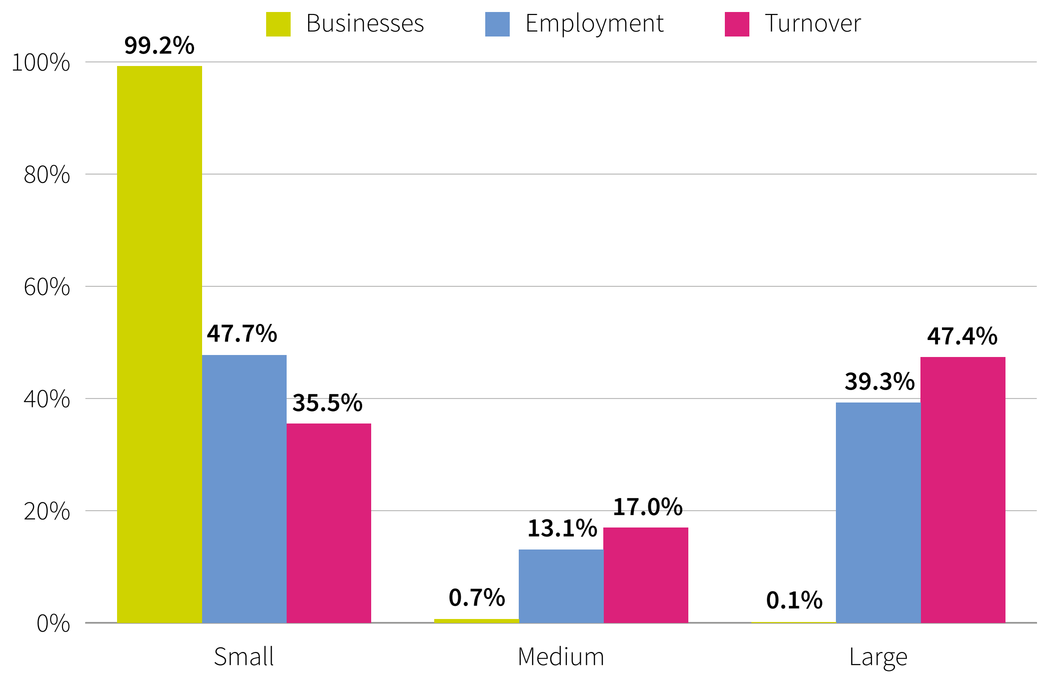
Introduction

This manifesto sets out the APPG on Fair Business Banking's asks of a future Government during the next parliament.

A major focus of the new Parliament, whoever forms the next government, will be strengthening the UK economy. In their recent landmark report, *Ending Stagnation*, the Resolution Foundation highlighted how a slowdown in productivity gains has led to 15 years of lost wage growth which has cost the average worker £10,700 a year.[2]

A return to stronger growth and rising incomes will not be possible without supporting the UK's small and medium sized businesses to hire, invest and thrive. At the start of 2023 there were 5.6 million SMEs in the UK, about 1.4 million of whom employed staff. SMEs in the UK employ around 16.7 million people, which is 61% of total private sector employment, and have a combined turnover of an estimated £2.4 trillion.[3]

Figure 1: Contribution of different sized businesses to total population, employment and turnover, start of 2023



Source: ONS[4]

Improving access to finance is a vital tool for supporting the UK's SMEs to grow. In particular, greater access to working capital for smaller and newer enterprises is key for ensuring as many entrepreneurs as possible have a chance of success. As this manifesto sets out, many businesses either do not or cannot access lending, which is a major brake on economic growth. We set out the steps needed to address this in Chapter 3.

A growing economy is a vital objective for any new Government. Equally critical is addressing the injustices experienced by business owners across the country in their dealings with lenders and preventing further detriment to businesses by changing the behaviour and approach of lenders. To deliver this, there is a need for a robust regulatory, compensation, and redress framework to level the playing field between banks and their customers. Previous work by the APPG on Fair Business Banking has set out the need for reforms in this area, calling for clear and compulsory guidelines for redress schemes and the creation of an arms-length body to oversee them as well as creating a Financial Services Tribunal (FST), with rights to pursue damages under section 138D of the Financial Services and Markets Act extended to companies.[5]

In turn, delivering this will help to build firms' trust in the banking sector, therefore ensuring that SMEs feel more comfortable accessing lending, which will support a growing and thriving economy.

Why does this matter?

The real-world consequences of not supporting SMEs to access finance are significant. Today 77% of SMEs say that they would rather grow more slowly than grow more quickly while borrowing.[6] Limiting SMEs' opportunity to grow in this way has a direct impact on the wider economy. Tackling these challenges will therefore be a priority for the next Government:

- **Communities across the country miss out on higher employment and good work** – SMEs employ more people than larger firms in the UK.[7] Without the support they need to grow and thrive, they cannot hire more workers or invest in the training needed to close the UK's skills gaps and improve people's incomes over the long term.

- **High streets and community and social infrastructure suffer** – regenerating high streets is critical for restoring the social fabric of left-behind communities. The closure of local shops is a major contributor to people saying they feel their local town is in decline.[8] Supporting bricks and mortar SMEs is vital to breathe new life into the UK's high streets, something all major parties have pledged to do.

- **Suppressing innovations which improve society** – SMEs are at the heart of the UK's innovative and globally competitive industries, which need to access finance to grow. Analysis by The Data City finds that 98% of people at emerging companies in sectors such as Artificial Intelligence, Advanced Manufacturing, and Digital Creative Industries work for SMEs.[9]

Our collective failure to improve how lending works for SMEs means that we don't get more high-quality jobs, the UK's high streets continue to decline, and we aren't taking the global lead in the industries of the future.

This cannot continue, and whoever forms the next Government, the recommendations of this manifesto should represent a set of priority actions for supporting businesses across the UK and delivering a fairer and more prosperous society.

What's the problem?

SMEs often face greater barriers to accessing finance and dispute resolution and redress than well-established and larger companies. As of Q2 of 2023, 59%[10] of SMEs say that they find it more difficult to access the finance they need to grow as compared to five years ago, while 73%[11] feel that institutional lenders fail to understand the way SMEs work, and this is reflected in their inability to access funding.

The crux of the problem can be summarised as firms not seeking finance in the first place and not being approved for loans when they do – even if many of these businesses ought to be creditworthy. Institutional barriers, gaps in existing schemes and low confidence and awareness levels of SMEs are some driving causes for this. This section tries to unpack some of these underlying factors to better understand why access to fair finance and dispute resolution and redress mechanisms poses a challenge for SMEs.

The barriers that SMEs face fall under three main categories: supply side, demand side and policy & regulatory.

Figure 2: SME barriers to accessing finance and seeking dispute resolution and redress

Supply side

- Complex lending practices of big banks
- Disadvantage to minorities and other marginalised groups
- Regional imbalances in funding
- Changing nature of SME business models

Demand side

- Low financial literacy
- Lack of awareness
- SMEs face higher risks

Policy and regulatory

- Gaps in current financial support schemes
- Lack of regulatory protections
- Hard to access and costly dispute resolution mechanisms
- Fragmented and ad-hoc redress schemes
- Regulatory barriers

Source: WPI Economics analysis

Supply side barriers

1. **Complex lending practices of big banks:** The lending practices and policies of big banks often do not align with the resources, capacity and technical capabilities of SMEs, who may struggle to meet banks' requirements. The Institute of Chartered Accountants in England and Wales (ICAEW) reports frequent cases of SMEs finding it difficult to comply with requests for account audits and independent confirmations of future performance.[12] Often these requests are made for businesses who qualify for audit exemptions.[13]

   SMEs often face difficulties in opening and operating bank accounts. It has been reported that banks are reluctant to take on new customers and, when they do, it can take as long as three months to open an account.[14] Not having access to lending can be catastrophic to a SME's ability to trade. Banks and other investors have started employing stringent yet unclear criteria for lending because of diminishing 'risk appetites' – a term that does not have a consistent definition across the industry. There has also been an increase in debanking, with over 140,000 SME accounts being closed in 2023 with at least 4,214 of them being attributed to 'risk appetite'.[15] It is also a fundamental feature of newer businesses, where banks have a limited track record to assess before opening a new bank account. Perhaps as a result of this, the common sources of finance for small businesses are less suitable and secure ones, such as credit cards.[16]

   Lastly, high bank charges are a concern for many small businesses. The ICAEW's Business Confidence Monitor (BCM) for Q2 2023 found that 17% of SMEs were concerned about high bank charges, up from 12% in the same period last year.[17] Additionally, big banks offer less than 1.6% interest on credit balances on average, a sharp contrast to the best challenger bank rate of 4.33% and much lower than the 5% base rate set by the Bank of England. There is also a discrepancy in the interest rates offered to SMEs and other business accounts.

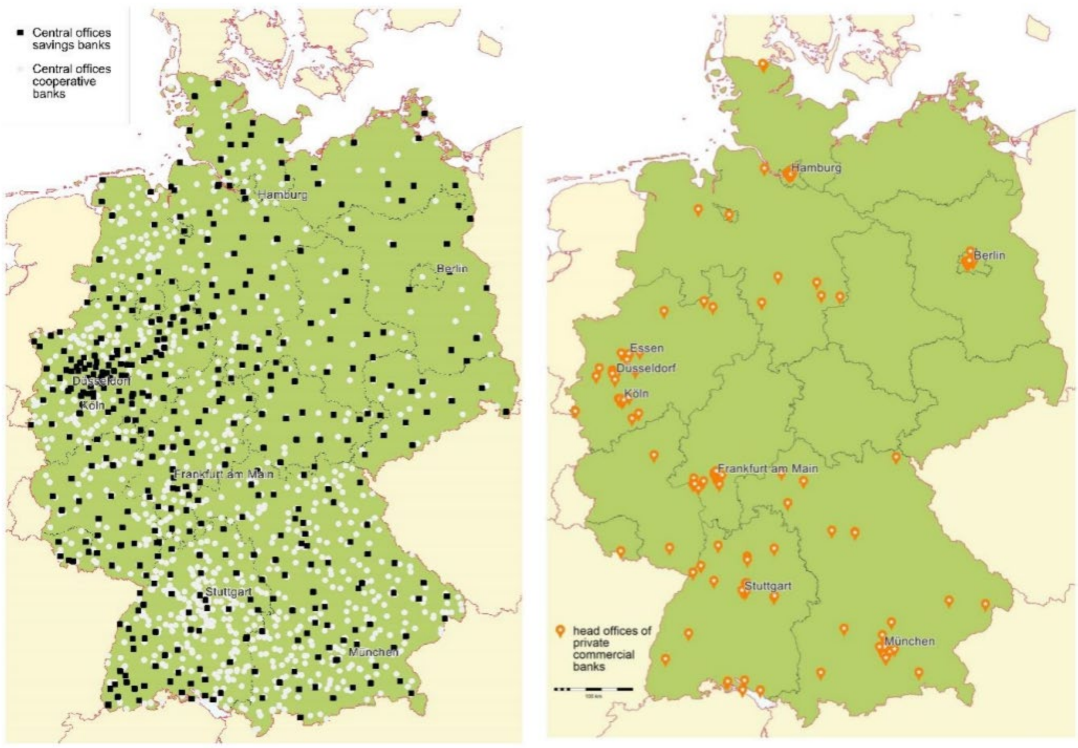
2. **Disadvantages to minorities and other marginalised groups:** Most SMEs and start-ups rely on external funding such as owner-guaranteed bank loans, business bank loans and business credit lines.[18] Enterprises led by women, ethnic minorities and other disadvantaged groups may find it difficult to establish creditworthiness, often having limited financial records and a lack of collateral to raise finance against.[19] Many minority owned businesses often need microloans to scale up and it is difficult to access loans of low amounts.[20] As there are not many restrictions on how personal guarantees are used to secure business loans, there have been cases of lenders requiring them for loans for small amounts,[21] which is not always feasible for small businesses. This particularly hits social enterprises or businesses that operate in deprived areas.[22] Additionally, banks' increasing reliance on digital tools for conducting operations often works towards the detriment of disadvantaged groups.[23] This fundamental inequality highlights the need for reforms which improve access to finance for underserved groups.

3. **Regional imbalances in funding:** Not all SMEs across the country have equal opportunities to access all forms of finance. There is a 35% equity funding gap for businesses between the most deprived regions of the country and the rest. These regions – the Midlands, the North West, Yorkshire and the Humber, Scotland and Wales — captured only 15% of equity deal flow from 2019 to 2022. This gap exists despite these regions contributing 45% of the UK's Gross Value Added (GVA) and being home to 50% of SMEs.[24]

   Though less extreme, there are also variations in debt finance. The regional share of bank lending to SMEs is distributed by SME population and contribution to GVA. This distribution suggests that, in the aggregate, lenders allocate finance in proportion to economic activity.[25] In lower GVA regions of the country, such an allocation can be damaging to the prospects of high street businesses who could rely on lending to develop and grow.

   This debt finance distribution stands in contrast to countries with a more regional lending structure, such as Germany, where access to finance is spread across the country. The map below shows how the central officers of Germany's cooperative banks, as well as savings banks ("Sparkassen and Landesbanken") are spread across the country. We also know that CDFIs target their lending towards more deprived parts of the country, based on data from this sector. This analysis highlights why policy must support regionally-based lending with a social purpose, such as via CDFIs.

Figure 3: Central offices of savings banks, cooperative banks (left) and private banks (right)



Authors' maps. Source: ECB, 2014

Source: Flogel and Gartner

4. **Changing nature of SME business models:** Asset-light business models are increasingly prevalent among SMEs, especially with start-ups and small businesses. This change in business model necessitates a shift in the traditional way of lending where assets would be offered as security and collateral. [26] One way that lenders and SMEs address this shift is through invoice finance, where the lender uses an unpaid invoice as security for funding.[27] This type of finance has a quick turnaround time and funding can be accessed as early as 24 hours. However, such a strategy is not a panacea for addressing SME lending needs. It can only be used to solve specific issues of insufficient cash flow and not for other requirements for working capital. Furthermore, new businesses or firms with low volumes of sales may find it difficult to find lenders. [28]

   Another trend points to an increase in the demand for asset finance, with a 7% increase in new business in this sector from 2014 to 2023.[29] Despite this increase, there is a lack of awareness for this option among SMEs, with only 16% viewing it as an ideal form of business finance. The Federation of Small Businesses (FSB) estimates that almost 79% of small businesses applying for finance still pursue traditional bank loans or overdrafts despite high chances of being turned down or being charged high interest rates. More that 2/3rds of SMEs (69%) with an annual turnover higher than £10 million have ideal conditions for seeking asset-based finance to allow more liquidity, causing massive missed opportunities.[30]

Demand side barriers

1. **Low financial literacy:** SMEs and start-ups often lack the necessary financial expertise to navigate the complex systems of obtaining finance. Only 37% of small businesses think that the process for seeking loans is easy while only 38% feel that their queries on the subject are easily answered.[31] As a result, many turn to brokers to avoid having to deal with banks directly and get loans faster. However, they end up taking loans at higher rates or other increased costs. [32]

   Many business owners feel the need to have an advisor to help them navigate the process of borrowing. However, with changes in the way banks function post the Covid-19 pandemic, businesses with annual turnover below certain thresholds don't have access to relationship managers. The personalised experience and business understanding that relationship managers bring to the table is replaced by digital interfaces and system generated checklist-based evaluations that don't make holistic decisions. Many business owners feel that the decisions that come out of this are binary, inflexible and do not accommodate the needs of their particular business.[33]

   Often, the barrier to accessing finance is not the quality or state of the business but the quality of the application for finance. [34] Seeking help from experts is also intimidating, especially for less-seasoned business owners who are not 'finance ready'.[35]

2. **Lack of awareness:** Small businesses tend to have a low level of awareness of available options for funding. Further, they don't always have the capacity, resources, knowledge and networks to closely examine available finance options and make an informed decision. Even when it comes to seeking help, they may not be able to identify relevant experts.[36] Just as with seeking advice, many SMEs may not be aware of alternative options to traditional banks such as CDFIs.[37]

3. **SMEs face higher risks:** SMEs often resort to using personal guarantees, putting at risk their personal assets, including their homes. Additionally, there is a significant power imbalance between stakeholders in the current landscape of SME finance and SMEs often bear the brunt of any conflicts that may arise with banks. SMEs have suffered greatly because of notorious banking sector scandals, including the HBOS Reading fraud, interest rate swap mis-selling and Royal Bank of Scotland's (RBS) Global Restructuring Group's (GRG) activities. When it comes to seeking compensation as a result of these scandals, the shortcomings of various mass redress schemes have further compounded this lack of protection. Some examples include:[38]

    - Schemes often exclude groups of victims with no prospect of independent assessment. In the Interest Rate Hedging Products (IRHP) case, rather than setting out to proactively identify all customers eligible for redress and quantify their losses, the scheme took a negative approach, seeking first to eliminate one third of customers based on an arbitrary "sophistication" test which had no statutory basis.

    - In both the IRHP scheme and RBS GRG scheme it is clear that the total amount awarded for consequential loss in each was insufficient. The original HBOS review did not produce a single offer of redress for Direct and Consequential loss.

    - Many compensation schemes suffer from inherent or perceived conflicts of interest. Notably the Cranston review highlighted the need for both substantive independence, and the appearance of independence, to ensure they have the trust of participants.

    - Schemes suffer from a lack of transparency of processes, information and outcomes, and a corresponding lack of accountability. In the IRHP case the Lessons Learned Review by John Swift KC found that there was "a serious gap in the FCA's accountability for the implementation and outcomes of the Scheme, both substantive and in terms of fair process."

Policy and regulatory

1. **Gaps in current financial support schemes:** The British Business Bank (BBB) is the main policy delivery body for addressing some of the challenges that smaller and newer businesses have in accessing finance. While support programmes such as the Recovery Loan Scheme (RLS), Start Up Loan Scheme (SUL), and new Growth Guarantee Scheme (GGS) are important and worthwhile interventions, their time limitedness and low scale prevent them from having a more significant impact on boosting SME access to finance.

   There are other available avenues for finance such as CDFIs. Some of them include ART Business Loans- West Midlands, Business Development Grant Scheme – Scarborough and Business Enterprise fund - North East England. As their names indicate, they are region specific and are not available across all geographic areas. Often their capacity is limited due to a lack of sustainable funding.[39]

   With as many as 26%[40] of UK SMEs finding it challenging to access finance through traditional banks, a robust mechanism for government loans and grants is necessary to support the industry. Without these, entrepreneurs who would otherwise go onto make a big and positive contribution to the UK's economy and society will not be able to grow their business.

2. **Lack of regulatory protections:** As the backbone of the country's private sector, it is important that SMEs be protected against detriment in their dealings with banks. Lending to SMEs is largely unregulated.[41] This is despite the widespread use of personal guarantees which have the potential to bring people's home and personal assets into the equation in their dealings with banks.[42] Furthermore, the Standards for Lending Practice for business customers are only applied voluntarily. [43] In addition, SMEs neither have the resources nor the capability to enforce any rights they do have against lenders.

3. **Hard to access and costly dispute resolution mechanisms:** Since the 2008 financial crisis, the banking sector's reputation has suffered from a number of disturbing instances of misconduct and malpractice, many of which have had a catastrophic effect on thousands of individuals and livelihoods.[44] In order to prosper, when disputes arise, SMEs need to have confidence that they will be dealt with fairly, efficiently and effectively. Indeed, affordable, independent dispute resolution is critical to business confidence, yet very few businesspeople would be able to fund and fight a legal claim against a bank or lender. Issuing proceedings in the courts is unthinkable for most SMEs – the costs would be too great and the consequences of failure potentially catastrophic.

   There are essentially three avenues for dispute resolution available (but not always accessible) to SMEs. Litigation is costly and risky as under the law of contract it may be difficult to establish any legal wrongdoing. As a consequence, rather than accessing acceptable compensation, the claimant may become liable for hefty adverse costs.[45]

Businesses do not have the same right of action that private individuals do to pursue damages for breaches of financial regulations under section 138D of the Financial Services and Markets Act (FSMA). The Financial Ombudsman Service (FOS), which aims to provide a quick, free, impartial and informal process for relatively low-value financial services disputes is unavailable to medium enterprises (those SMEs with a turnover over £6.5m and with more than 50 employees).[46] The FOS is also not equipped to deal with complex and high value disputes: it lacks the legal expertise, businesses experience, or resources to deal with complex financial cases. In turn the BBRS, designed to fill the gap between the FOS and the courts,[47] has failed abysmally to deal with both legacy and contemporary complaints. In short, most SMEs are left with nowhere to go to resolve contentious disputes with financial firms.

4. **Fragmented and ad-hoc redress schemes:** Too often, we have seen disputes swell to form vast financial scandals, such as the mass mis-selling of IRHP or systemic and widespread mistreatment of SMEs by RBS. Ad hoc compensation or redress schemes are vehicles deployed to remedy the most sensitive problems in financial services. However, no guidance exists on when and how a compensation scheme should be established. Each scheme has its own unique rules, prepared by the institution that perpetrated the wrongdoing (and sometimes by the same lawyers who defended the claims that gave rise to the need for the scheme).

   Reinventing the wheel each time a scandal emerges inevitably means that victims are failed yet again by the very system that is meant to provide them redress. These compensation schemes are often set up by the institutions responsible for the misconduct, which creates the risk of a real or perceived conflict of interest. Far too often, the experience of attempting to secure redress becomes more traumatic than the original injustice. Schemes are frequently shrouded in secrecy, blighted by a refusal to learn from past mistakes, unnecessary complexity, interminable delays, and an undue burden on victims in both a legal and an emotional sense. Further, many SMEs ultimately become insolvent during the process of seeking redress and so are never ultimately able to get compensation.[48]

5. **Regulatory barriers** – prudential regulationshould ensure that there is a diverse and competitive range of financing option for SMEs. Proposed reforms under Basel 3.1 to remove the SME supporting factor will make it more expensive for banks to lend to SMEs, with analysis suggesting it could reduce the supply of SME lending by up to £44bn.[49] These reforms are also out of step with the European Union (EU) and the United States (US). This could be hugely damaging to the competitiveness of UK firms, and must be urgently addressed.

   These are all significant challenges for policy makers to address in the next parliament. Solutions which could make a real dent in tackling these issues have been identified as part of our research and stakeholder engagement and are summarised in the next chapter.

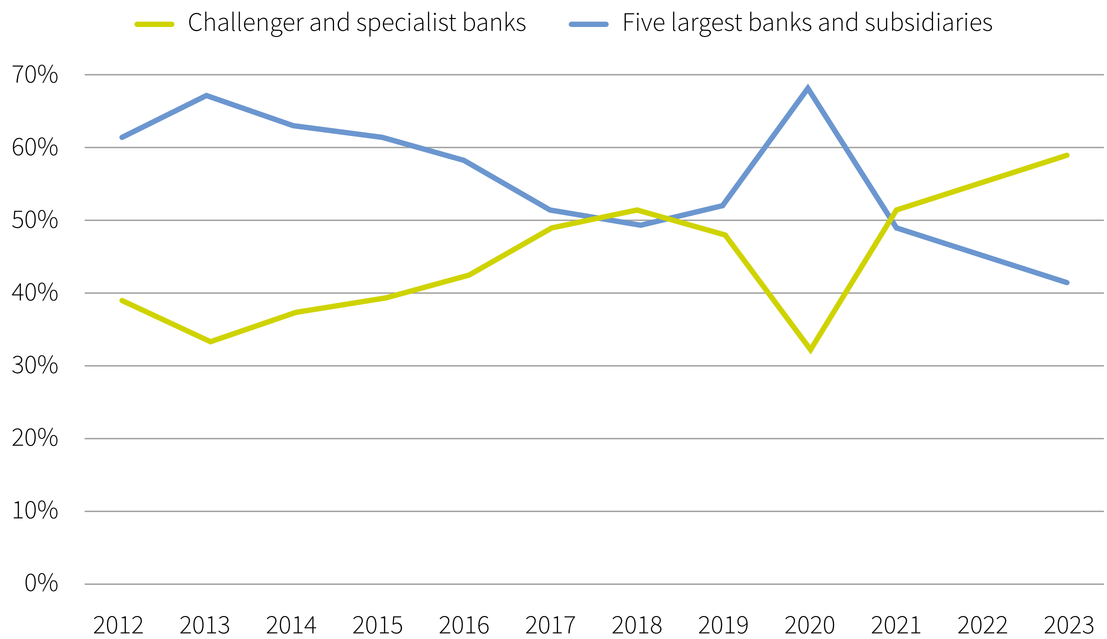
Our manifesto asks:

Supporting UK SMEs to thrive is in everyone's interest, given their important role as employers, innovators, and as hubs of communities across the country. This report identifies a series of steps to improve how SMEs interact with finance, that should all be a priority for any incoming administration. The APPG stands ready to work with policymakers to ensure these proposals become a reality.

Turbocharging the challenger bank and non-bank lending sector

Challenger, specialist and non-bank lenders play an important role in boosting access to finance for SMEs. They have provided effective challenge to the major banks, with challenger and specialist banks providing nearly 60% of total gross bank lending to smaller businesses in 2023.[50]

Figure 4: Share of total gross bank lending to smaller businesses

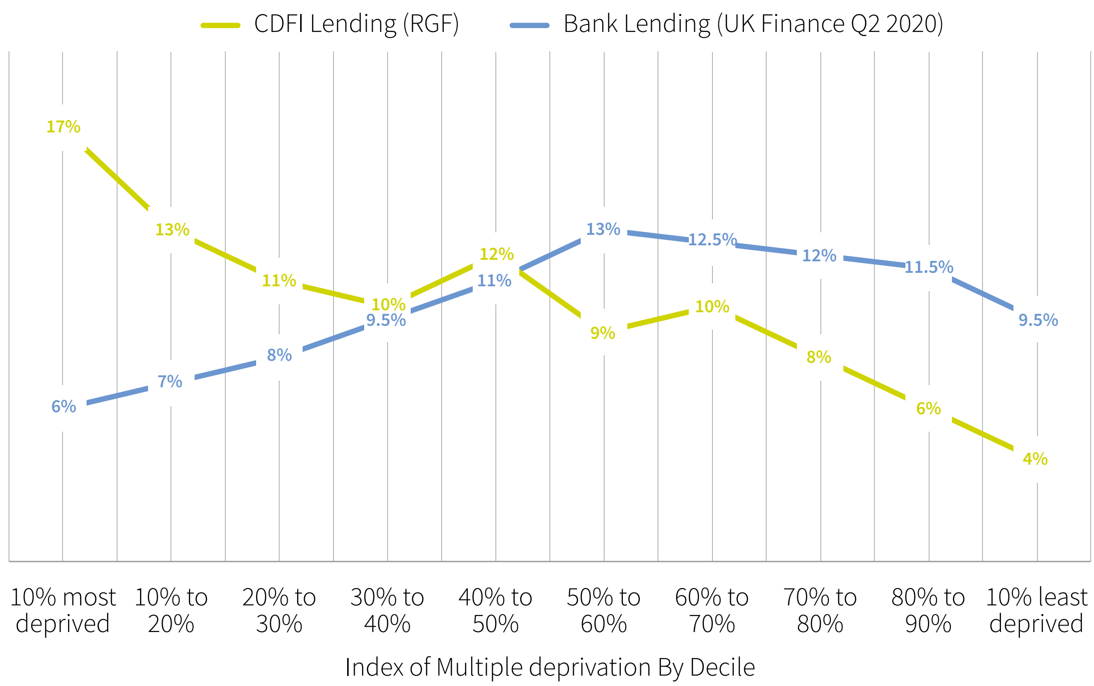


Source: BBB[51]

A more competitive and diverse supply of finance is a good thing for SMEs. As a result, it is critical that policy and regulation as far as possible supports greater competition in the supply side for SME lending.

CDFIs in particular play a critical role in supporting businesses across the UK to grow, lending disproportionately to areas of higher deprivation according to data collected by the sector (See below). CDFIs are also well placed to provide loans of under £100,000, where there is a particular gap among SMEs.[52]

Figure 5: CDFI and Bank SME lending by area of multiple deprivation



Source: Evidence submission from Responsible Finance

Despite this, CDFIs are underutilised as a policy tool in the UK at present, particularly in comparison the US, where bank financing of CDFIs is incentivised through the Community Reinvestment Act (CRA). However, the sector has seen significant progress in bank engagement in 2024, with Lloyds Banking Group being the lead investor in a £62m fund to support CDFI lending across England and Wales.[53]

In order to maintain this momentum, we urge the Government to work with Better Society Capital and other organisations to encourage more banks to boost their investment of CDFIs, as well as other purpose driven finance models such as credit unions and the nascent regional mutuals. This should include setting an overarching target during the first 100 days of additional capital being made available to CDFIs and other purpose driven lenders from the major banks.

Ultimately, without a significant shift in momentum, an intervention along the lines of the CRA will be required in order to scale CDFI lending sufficiently to address the challenges set out in this manifesto. This could build on the work to develop a 'Fair Banking Act' led by the Fair Banking for All Coalition.[54]

Case study 1: Fair Banking Act[55]

As a response to the embedded problem of financial exclusion for individuals, SMEs and social enterprises in the UK, the Fair Banking for All Coalition has put forward the Fair Banking Act. The Act will require banks and building societies to disclose the extent to which they meet the needs of financially excluded people and businesses. Additionally, they will also be asked to assess the level of action needed to address the issue and offer mechanisms for doing so. All retail banks with a banking licence – including challenger banks and building societies – will be in the remit of the Act.

The Act ultimately aims to offer a permanent and practical solution to the country's financial exclusion challenge. It will do so by enabling the provision of a transparent and publicly available data disclosure framework. It will also identify which banks are doing well and which need to improve by establishing a ratings system. Furthermore, it will identify ways to help banks improve their provision of finance by expanding responsible lending and providing fair services, either directly or in partnership with a purpose-driven finance institution.

Furthermore, our research with stakeholders highlighted major concerns with the implementation of Basel 3.1 capital requirements in the UK, particularly around the removal of the SME supporting factor. These were echoed by the Treasury Select Committee.[56] Any new Government must urgently act to ensure that these changes are not implemented in a way that harms the supply side of lending for SMEs, which would be catastrophic for the UK's economic recovery.[57] Furthermore, in case of future rounds of Term Funding there needs to be an equivalent structure put in place for alternative lenders and smaller banks which don't meet the stringent requirements.[58]

Extending the regulatory perimeter

Currently SME lending operates outside of the FCA's regulatory perimeter, other than loans under £25k to unincorporated businesses which are captured by the consumer credit act.

Given the fundamental imbalance of power and resources between banks and their customers, we have come to the view that bringing SME lending within the regulatory perimeter is a necessary step to protect borrowers. Ultimately, the case for excluding SMEs from the basic consumer protections that rightly exist for individuals accessing financial services, is a weak one. The APPG is mindful that a balance needs to be struck to ensure that no new regulation can dampen the supply side of lending, which would harm competitiveness and be bad for businesses. As a result, we propose a balanced approach whereby the overarching FCA principles become actionable in disputes between SMEs and banks. To give an example of these principles in practice, two of them are:

- **Customers' interests:** A firm must pay due regard to the interests of its customers and treat them fairly

- **Communications with clients:** A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.

The new Consumer Duty placed more obligations on banks to treat customers fairly. However, it does not give customers private law rights to compel banks to comply with those obligations. Extending the regulatory perimeter should not increase the regulatory burden on banks because banks should be treating SME customers fairly in any event, but it will give customers effective legal means to obtain remedies to match their rights, and so 'self-regulate' their banking arrangements.

Create a Financial Services Tribunal

One of the recommendations of the Treasury Select Committee's 2018 inquiry into SME finance was to establish a Financial Services Tribunal (FST) in light of the FOS not being suitable to handle large and complex cases. This was rejected by the government because it would entail building a foundation to regulate SME lending first and would also require passing primary legislation.[59] Instead, the BBRS was established in 2021. This was an unsuccessful attempt to solve disputes between big banks and SMEs that were too big to use the FOS. This scheme only had funding until 2023[60] and there is widespread agreement that it is not fit for purpose in providing alternative dispute resolution to the SMEs that fall outside the FOS's threshold and it is due to close soon.[61]

As a result, larger SMEs, whatever the size of their claim, have no alternative to dispute resolution other than going to court, which is a complicated, expensive and unequal process. The creation of a FST will fill this institutional gap and provide a means for SMEs of all sizes to seek redress in large and complex claims and decrease the workload of courts. It will also support the growth and international competitiveness of the UK banking sector. At the moment, overseas banks and borrowers are cautious about doing business in the UK because of the high cost of English litigation. A FST providing cost effective dispute resolution will help the City win more international business.

Another benefit of creating a FST is that it will build a body of publicly recorded case law that can be used to set precedents for similar cases and help resolve them without need for additional intervention.[62]

Extend the Financial Ombudsman Service (FOS) threshold

The Financial Conduct Authority (FCA) amended its rules to enable more SMEs to access the FOS in 2019. As per the new rules, SMEs with an annual turnover below £6.5 million and who engage fewer than 50 employees, or those with a balance sheet total of less than £5 million can seek support in resolving complaints about financial services firms. [63] In 2023, the FCA conducted another review after requests from various stakeholders and rejected any amendment to the 2019 rules. This means that the eligibility threshold for access to FOS is unchanged and almost 55,000[64] larger SMEs are still not allowed to access the FOS for dispute resolution.[65]

The only option that larger SMEs now have is to approach courts, which is not an easy process for these businesses to navigate. They are forced to take on high expense and additional risk that come with taking banks to court. Additionally, large SMEs often have claims that are relatively low value which does not justify their approaching courts to resolve them. Despite falling on the larger end of the SME spectrum, these businesses still face a significant power imbalance in going up against banks, who are well-equipped with both monetary and legal resources. Additionally, hearing cases that can be resolved on other platforms also increases the burden on courts.[66]

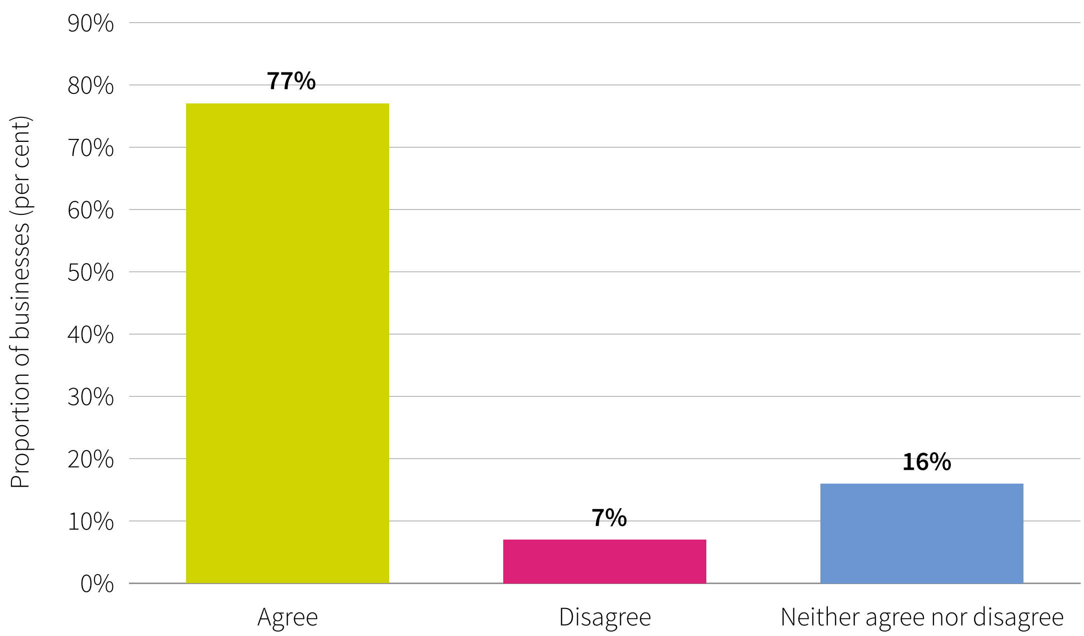
It is necessary that there be a structured way for this cohort to access dispute resolution if they need it. Reassessing the threshold limits for FOS, in tandem with those proposed for any FST, and making amendments to include larger SMEs will be a worthwhile step.

Supporting SMEs to 'be ready to borrow'

Better diversity and accessibility in the supply side of SME finance is a *necessary* but not *sufficient* condition for addressing the challenges identified in this report. As we have set out, there are also a whole set of demand side barriers to accessing finance, with many firms instinctively risk averse to accessing finance.

The 2023 Bank of England Finance and Investment Decisions Survey found that 77% of business respondents agreed with the statement *"as a business, we will accept a slower growth rate rather than borrowing to grow faster"*, with only 7% disagreeing. This suggests that firms being put off from borrowing to grow creates a massive brake on the overall rate of growth across the economy.

Figure 6: 'As a business, we will accept a slower growth rate rather than borrowing to grow faster'



Source: Bank of England[67]

There is an urgent need to support businesses to be more confident in accessing finance in order to boost investment and growth. Despite this, we have heard in our evidence gathering sessions that the support for businesses can seem patchwork at times, and the various different schemes run by the BBB, Growth Hubs, and others can have limited cut through to firms themselves. However, we have also heard that reinventing the wheel with a new single source of advice is also not likely to be an effective use of resources. The priority should be to better connect firms to existing sources of advice and information from trusted experts.

As a result, Government should work with banks, Growth hubs, business representatives, and civil society groups to develop a common approach to signposting firms to appropriate advice and support for accessing finance. This effort should include a mapping exercise of existing advice routes and their relevance to different groups of firms.

Long term British Business Bank (BBB) support schemes

The various programmes run by the BBB have played a role in addressing some of the market failures in SME lending set out in this report. In particular, it is positive to see the Growth Guarantee scheme as a successor to the Recovery Loan Scheme.

However, the scale of the impact that these schemes can have is currently held back by their lack of longevity. The current Growth Guarantee scheme is scheduled to remain in place for 2 years. This is insufficient to provide the certainty for the finance supply side to invest and plan for the long term, particularly for those lenders who need to raise investment such as CDFIs and other non-bank lenders. As a result, we recommend that the next spending review puts the Growth Guarantee Scheme on at least a 5-year funding footing, with the assumption that this will be extended into the future.

Green Finance support

As well as supporting economic growth, decarbonising the UK economy will also be a key mission of the UK Government. Again, SMEs are an important part of the picture here, but there is insufficient evidence that firms are decarbonising businesses quickly enough. Project Perseus is one key initiative to support the better measurement of SME emissions in order to support emissions reduction.

Better access to finance could play a role in supporting SMEs to decarbonise, alongside other interventions. Our stakeholder engagement highlighted a potential market failure in relation to SMEs being able to access asset finance to support decarbonisation, as lenders may have limited data to be able to secure loans against green assets such as Solar PV or a Heat Pump, as opposed to fossil fuel assets. There may be a discrete role for the BBB to launch a product which supports asset finance against these types of investments.

Improve guidance and support to SMEs on greenhouse gases (GHG) reporting

There is a gap in current guidance for SMEs on GHG measuring and reporting. As a result of this, numerous carbon accounting solutions and technologies that gather data from SMEs have come up in recent years. A 2024 study from Icebreaker One, commissioned by the BBB, revealed over 270 carbon reporting tools aimed at SMEs in the UK.[68] Without a common framework for emissions reporting, there is no consistent approach to collecting, measuring and storing data. Additionally, there is no common process for SMEs to report emissions and other sustainability data to stakeholders such as financial institutions that require it of them due to their own mandate to report emissions. Since there is no common process, SMEs often find it difficult to navigate the technically challenging data requests from corporate customers, banks and other finance providers. This is a problem for the latter too as irregular and inconsistent data received from SMEs is not comparable or admissible within their Scope 3 disclosure frameworks. This directly affects their sustainability performance and impacts the credibility of their climate risk management practice. Project Perseus is one key initiative to support the better measurement of SME emissions in order to support emissions reduction.

Case study 2: Project Perseus

The 5.5 million SMEs in the UK account for half of the country's business greenhouse gas (GHG) emissions.[69] The significant potential for emissions reduction in the sector was considerably slowed down by a lack of common reporting process for SMEs. As a result, stakeholders like banks and corporate customers had to work with low-quality data based on reports made with inaccurate estimates. [70] Additionally, emissions reporting increased burden for SMEs that were already strapped for resources and capacity.

As a solution to this, Bankers for Net Zero and Icebreaker One developed Project Perseus to automate emissions reporting and reduce compliance burden for SMEs. It aims to "help unlock access to finance that reduces emissions faster by automating sustainability reporting for every SME business in the UK".[71] It will do so by developing rules and processes to enable automated reporting. These rules in turn will enable the development of products and services like accounting platforms, emissions calculators, and reporting software to capture high-quality data. All of this will ultimately work towards informing investment decisions, increase decarbonisation interventions, reduce reporting burden for SMEs and unlock green finance. [72]

At the moment, there is no mutually agreed process for SMEs to report GHG emissions and sustainability impacts to customers, industry, finance institutes and government procurement practices.[73] The government must fill this gap by assuming a stronger role in supporting SMEs on GHG reporting by issuing new guidance and harmonising existing processes for measuring and reporting.

Introduce a set of principles for compensation schemes

As previously mentioned, various ad-hoc and voluntary compensation schemes have been marred by a whole range of issues. Lessons have not been learned and schemes have repeated the same flaws, including a lack of transparency of processes, information and outcomes, and a corresponding lack of accountability. Most have also failed to put victims back in the position they would have been prior to their loss, adding to lack of trust between parties. While each compensation scheme is different and tailored to the individual needs of the case, there are some underlying principles that are applicable across the board to ensure a fair and free redress process that prioritises the victim. We urge the government to introduce guidelines for compensation schemes together with an independent Arms-Length Body to set-up and administer schemes, based on the following principles:

1. A collaborative approach and process where the victims are consulted and their concerns are taken into account while designing the scheme
2. Clear timelines for design and implementation of the scheme as well as administering and adjudicating the scheme to ensure speedy resolution
3. An independent process managed by an independent adjudicator is important to guarantee fair outcomes
4. A recognition of adversity which should have not happened and incorporating it into redress calculations
5. Transparency of processes and outcomes with all pertinent information being made publicly available
6. Broad eligibility criteria where the scheme actively identifies who is eligible for redress rather than who isn't
7. Accessibility and simplicity of process so it doesn't become too complex for the victims to handle and provision of legal costs where required
8. An appeals mechanism consisting of an internal review and after that an independent appeal panel in case of dissatisfaction
9. A process and scheme design where fairness and efficiency is the key objective

Increase FSCS insurance limit on credit balances from £85k and keep under review

The current FSCS insurance limit on credit balance has been set at £85,000 in 2010[74] and not been updated since then. This is problematic as the average SME deposit in 2023 has grown to £72,210 from £32,400 in 2013. Many SME deposits now exceed the FSCS threshold which has not changed in 14 years despite the average SME deposit more than doubling in that period. SMEs are aware of the danger of losing deposits above the insurance limit if the bank were to fail. This may impact the operations of their business and set them back. As a result, SME customers are wary of using financial firms other than High Street lenders as their primary source of deposits,[75] as the risk is perceived to be greater in the former. This also deters SMEs from making large deposits above the threshold as that amount is currently unprotected. According to data by Allica Bank, 42% of SME customers have deposits between £75,000 and £90,000 while 16% have deposits over £90,000. A good portion of the 42% have more cash than they have deposited and have held back because of the £85,000 limit.[76]

This also leads to missed opportunities to leverage interest earnings. As of March 2023, £149 billion[77] or almost 55% of SME cash is in current accounts that earn no interest. The remaining 45% is held in savings accounts that pay less interest as compared to corporate savings accounts. Clearly, SMEs are missing out on potential interest on positive credit balances in institutions that offer better rates than incumbent banks. These structural problems have resulted in missed interest of £7.5 billion annually.[78]

The risk of losing a large amount of deposited cash is very real for SMEs and often guides decisions on the choice of financial firm and nature of deposits. Therefore, the FSCS limit must be increased from the current £85,000 to £250,000 to reduce risk for SMEs and prevent them from falling behind due to missed opportunities. Additionally, this threshold must be reviewed at regular intervals and be updated to factor in external influences like inflation.

Overhaul the Bank Referral Scheme

There are many firms that are declined finance from a mainstream bank, but could potentially access credit from a different lender. Commercial brokers operate prominently in this market, but many responsible lenders cannot afford to pay the commission required to secure their business. As a result, an effective referrals system is key to ensuring that the supply and demand of finance are matched more efficiently.

The current major mechanism for delivering this – the Bank Referral Scheme (BRS) – has helped to match some lenders with new customers. However, it has not succeeded in shifting the dial to the extent needed to address the UK growth challenge. The latest data suggests that referrals through the scheme are not making a sufficient impact, with only 2,584 successful referrals between November 2016 and September 2020.[79]

We are calling for a refresh of the BRS to support a higher number of successful loan outcomes for SMEs turned down by mainstream banks. This should include a new campaign to bring more banks into the scope of the scheme, with the consideration that participation becomes mandatory, as well as a review of the 'consumer journey' through the scheme to help more businesses to remain in the process until a formal credit decision is reached. In addition, new platforms could be considered that are better equipped to signpost firms to CDFIs, who have a strong track record of providing lending to companies that have been turned down for a loan by the major banks.

Summary and conclusion

Whichever party wins the next election, the Prime Minister will face a set of complex policy challenges in the coming years and decades. This includes putting in place the measures needed to return to the economy to consistent growth, restoring social infrastructure in communities across the UK, and building green and globally competitive industries.

The analysis in this manifesto demonstrates why improving access to finance for the UK's SMEs is vital to address all of these challenges.

The recommendations we have set out provide a roadmap for making substantial progress in this space - helping to make the UK the best place in the world to start, run, and grow a business. The APPG and its supporters urge all parties to adopt these clear and actionable measures in their forthcoming manifestos.

Endnotes

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