03 FINANCE MARKETS – FURTHER DIVERSITY NEEDED

The British Business Bank has been active in supporting greater diversity in the supply of finance to smaller businesses. The majority of British Business Bank support (61% in 2013/4), is channelled through new, emerging or smaller providers. And schemes such as the Enterprise Finance Guarantee encourage lending to viable smaller businesses that would otherwise be declined for lacking collateral, with over 2,750 smaller businesses benefiting from this scheme in the year to Sept 2014. But even greater diversity would give smaller businesses a wider range of options in terms of financial products and suppliers, to meet their financing needs.

Traditional bank lending remains the predominant source of finance in the UK

The majority of businesses are able to access finance without difficulty, however structural information failures meaning that young or small viable businesses are denied finance persist.

As evidenced in the table on page 9, flows of bank lending are much larger than other forms of finance. The recession saw a tightening in credit conditions which disproportionately affected lending to smaller businesses. And while the decline in bank lending to SMEs has slowed, any recovery is tentative at best.

A wider range of finance sources would offer more options to smaller businesses

Challenger banks have entered the market in recent years, but lending to SMEs is still concentrated with the four largest banks accounting for almost 90% of business loans by volume.

In addition, forthcoming research by NIESR for the British Business Bank suggests that the securitisation market for SME loans is small but could play a role in increasing the supply of finance to SMEs in future.

New sources of finance which serve to improve diversity of supply exist and are growing, but from a low base

Online technology has enabled the emergence of Fintech companies, an example being Innovative Online Platforms, with lenders and investors able to meet the finance demands of small businesses in innovative ways.

Business financing through these platforms has grown significantly, albeit from a low base, but remains very small compared to more established forms of finance. Despite their current small scale, these platforms also have the potential to diversify small business finance markets, by competing on non-price aspects.

The following chapter presents trends in bank lending to smaller businesses, followed by an analysis of Innovative Online Platforms that enable lending to smaller businesses.

3.1 BANK LENDING TO SMALLER BUSINESSES

- The recession had a severe impact on SME lending, as the risk taking capacity of lending institutions reduced
- More recently, gross lending to SMEs has increased but so have repayments resulting in net lending remaining negative
- A large proportion (up to 30%) of flows of bank lending are to the commercial real estate sector, which has dragged on net lending
- Despite some new entrants, including challenger banks, the UK banking sector for smaller businesses remains a concentrated market
- SME lending is capital intensive and regulation has increased banks' capital requirements

Chapter 1 showed that bank lending remains the dominant form of lending to smaller businesses. As such, it has a large effect on smaller business finance markets more generally. This chapter explores recent trends in bank lending, and considers competition, and regulation to improve financial stability – both of which have an impact on the level and diversity of supply of finance to smaller businesses.

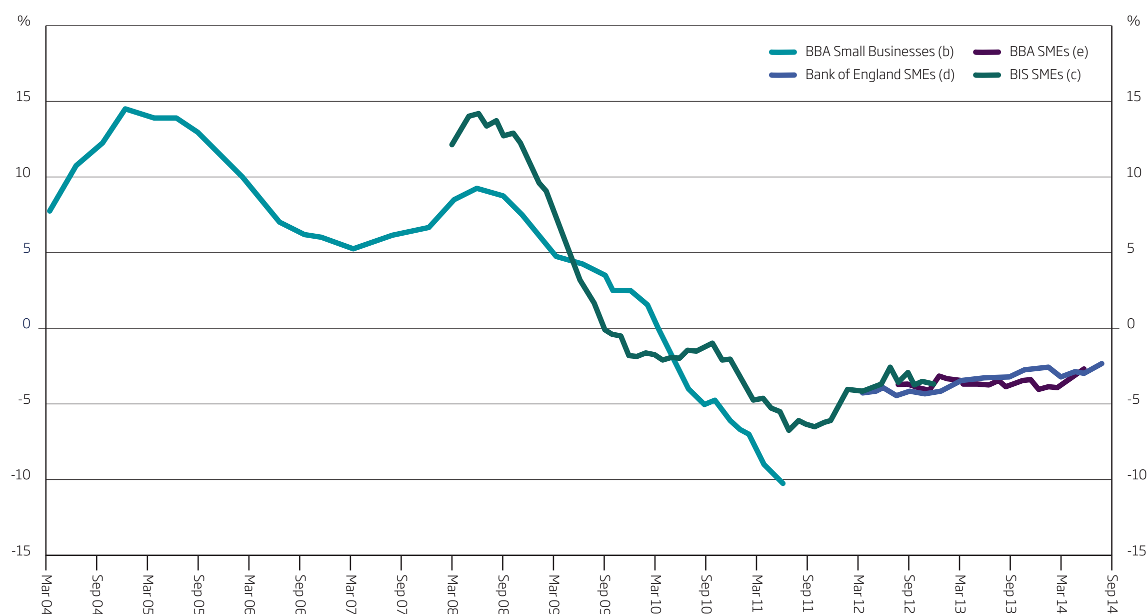
The recession had a severe impact on SME lending, as the risk taking capacity of lending institutions reduced

Following the recession, the SME loan stock fell back sharply as credit conditions tightened, leading to less new lending to smaller businesses.[82] The tightening in credit since 2008-09 disproportionately affected lending to small businesses – there were significantly higher rejection rates for smaller businesses, reflecting constraints to the supply of credit, and suggestive of a partial withdrawal from smaller business lending as an asset class.[83] Cyclical impacts accentuated the effects of longer term structural issues that mean viable small businesses are underserved. These structural market failures have been a concern in the UK since the Macmillian Committee (1931) and the Wilson Committee Report (1980) identified difficulties faced by smaller businesses in raising finance.

Under tightened credit conditions, viable firms which could afford to service debt but have limited track record or insufficient security are more likely to be denied bank loans or overdrafts, because they are less able to demonstrate their viability to banks. A restricted supply of finance to viable businesses, caused by this information failure, is likely to lead to lower levels of investment, which may lead to lower levels of output and employment in the short and long term.

FIG 23 *Source: BoE Trends in Lending, April 2014. BBA SMEs and BoE SMEs updated by authors*

ANNUAL GROWTH IN SMALL BUSINESS AND SME LENDING STOCK (a)



Notes:

(a) Non seasonally adjusted. Includes loans and overdrafts. BBA Small Businesses series (2004-2011) applies a different definition of business size than other sources.

(b) Lending by seven UK lenders to commercial businesses with an annual bank account debit turnover of up to £1mn. The growth rate prior to September 2009 is presented on a quarterly frequency and monthly thereafter. Sterling. The survey terminated in June 2011.

(c) Source: monthly BIS survey and Bank calculations. Lending by four UK lenders to enterprises with annual bank account debit turnover less than £25mn. Data cover lending in both sterling and foreign currency, expressed in sterling terms. The survey has been terminated.

(d) Lending by UK monetary financial institutions to UK SMEs with annual debit account turnover on the main business account less than £25mn. Data cover lending in both sterling and foreign currency, expressed in sterling and are to February 2014.

(e) Lending by a BBA panel of lenders to SMEs in Great Britain. SMEs are defined as businesses with turnover up to £25mn. Data cover lending in both sterling and foreign currency, expressed in sterling and are to December 2013.

More recently, gross lending to SMEs has increased but so have repayments

Since 2013, the growth in the stock of loans and overdrafts has become less negative.[84] However, the bank loan and overdraft market has not yet recovered. As mentioned above, NIESR research found that approval rates declined as a result of the recession. And while long-run consistent data is not available, business survey data suggests that they have been generally stable since 2011, although there is variation within this. For instance, nearly all renewals are approved, however, smaller and younger SMEs, and those applying for their first facility were less likely to have been successful in applications for overdrafts or loans.[85]

According to the Bank of England (BoE) bank lending data, the gross flow of loans (exc. overdrafts) increased to its highest quarterly level in Q3 2014 since the start of the data series in April 2011. However, as repayments of loans by firms also increased, net lending was negative, estimated at -£473mn in Q3 2014. More timely monthly data suggests that the gross flow of loans to SMEs increased further in October 2014, contributing towards a positive net loans figure in that month.

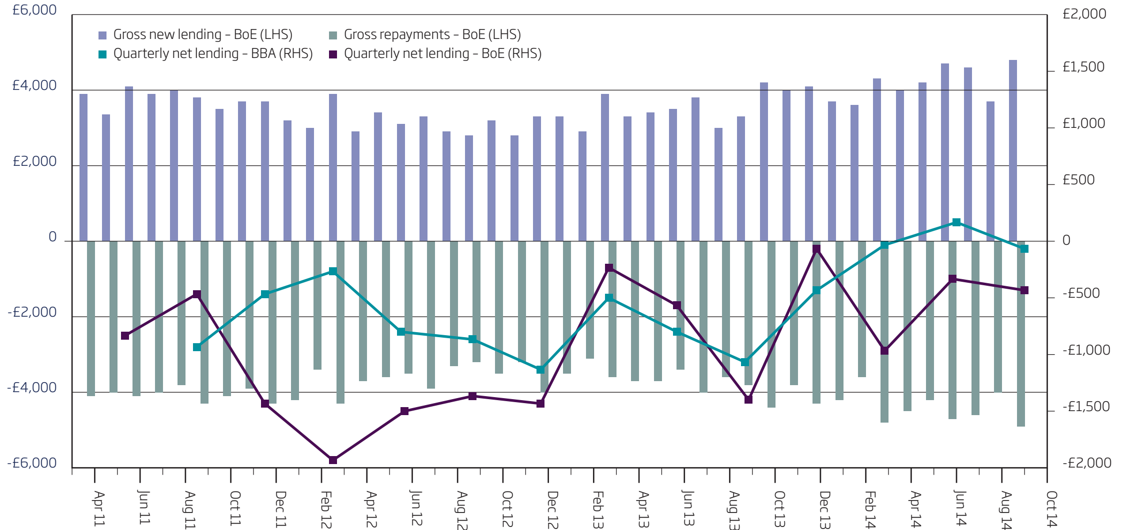
Data from the British Banking Association (BBA) suggests that the quarterly net flow of loans (excluding overdrafts) to SMEs was less negative in Q3 2014, at - £42mn. This was also because the value of new loans increased slower than the value of repayments between Q2 and Q3 2014.[86]

BBA data, which allows a more disaggregated view to the BoE's data suggests that recent improvements have been seen among medium, rather than small businesses. In addition, the value of approved loans for medium sized businesses has been increasing, and reached its highest value since the end of 2011 in Q2 2014, although it fell back slightly in Q3 2014. This has remained relatively stationary for small businesses in recent periods.

The value of outstanding overdrafts has been decreasing over time (see fig 25), as SMEs reduce their levels of debt – contacts of the BoE's network of Agents continued to report that many SMEs preferred to repay debt in the recent period[87] and Q3 2014 SME Finance Monitor data shows that 68% of SMEs agreed that they aimed to pay down debt and then remain debt free. In contrast, the stock of overdrafts held by large businesses (non-SMEs) has been increasing since 2012, and has increased particularly quickly since spring 2014.[88]

FIG 24 *Source: Bank of England Bankstats and BBA SME Statistics*

GROSS AND NET FLOWS OF BANK LOANS TO SMES (£MILLIONS)

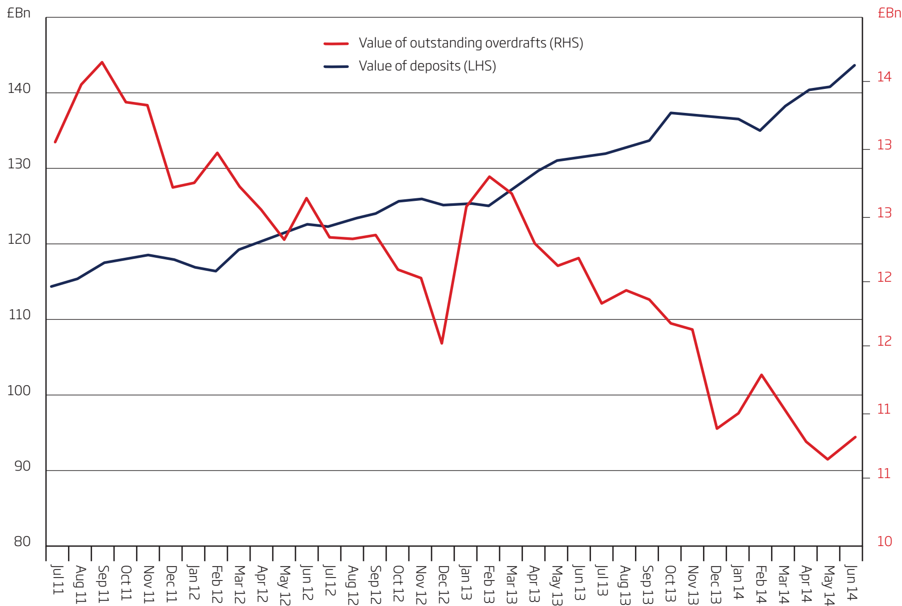


Notes:

All figures exclude overdrafts. There are various coverage and methodological differences between BoE and BBA data which help to explain the difference in net lending figures. Further detail is outlined in report footnotes.

FIG 25 *Source: BBA SME Statistics*

STOCK OF OVERDRAFTS AND VALUE OF DEPOSITS, ALL SMEs

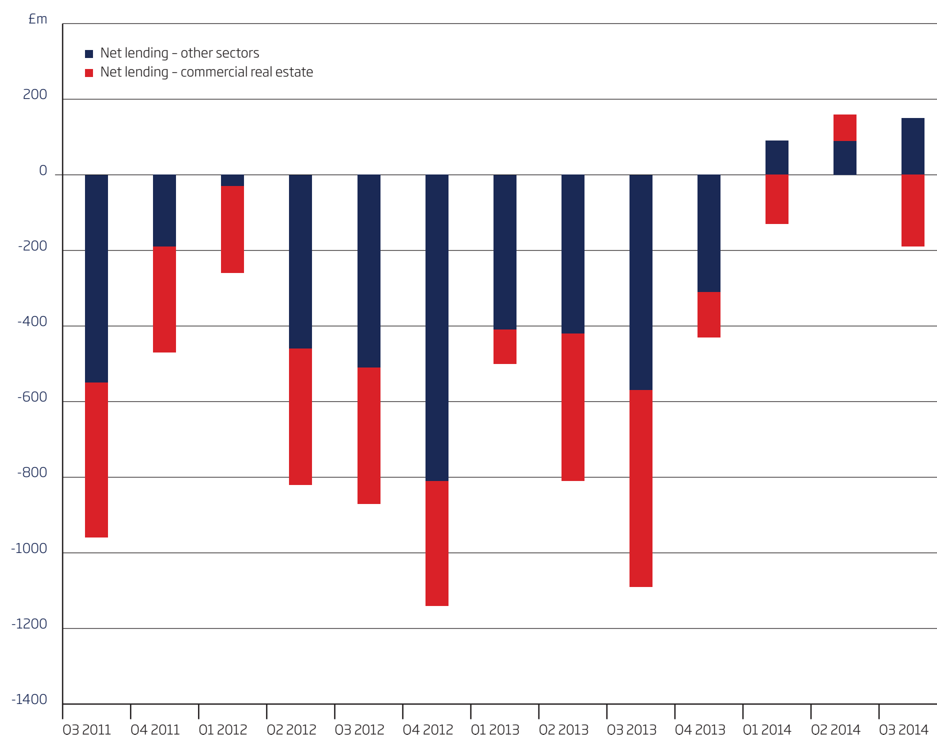


Notes:

Deposits include both current accounts and deposit accounts

FIG 26 *Source: BBA SME Statistics*

NET LENDING TO THE COMMERCIAL REAL ESTATE SECTOR



Notes:
Loans exclude overdrafts. Commercial real estate sector refers to SIC code 10a in BBA statistics: Buying, selling & renting own or leased real estate.

According to SME Finance Monitor, in Q2 2014 18% of SMEs had an overdraft, compared with 26% in 2011, and applications as well as renewals of overdraft facilities by SMEs have declined since 2011.[89] This decline has coincided with a significant increase in cash deposits held by banks on behalf of SMEs. This is an increase of 30% since the series began, much higher than the 6.7% increase in CPI inflation, or the 6.4% increase in the GDP deflator over the same period. SME deposit levels now exceed borrowing by more than £48bn. The BBA judges that this increased stockpile of cash among SMEs in contributing towards a reduction of demand for external finance among SMEs.[90] And according to SME Journey data, the vast majority of SMEs that intended to grow (74%) planned to fund this from internal cash flows only.

Interventions through partial guarantee schemes, such as the Enterprise Finance Guarantee Scheme, have encouraged lending to viable smaller businesses that would otherwise be declined for lacking collateral. Within the last year the EFG scheme supported lending to over 2,750 smaller businesses.

A large proportion of flows of bank lending are to the commercial real estate sector, which has dragged on net lending

According to the BBA, the commercial real estate sector (CRE) accounts for 25-30% of smaller business lending.

The Bank of England has reported[91] that the commercial real estate sector has acted as a drag on growth in the stock of bank lending to all businesses. Data from the BBA suggests that this argument applies to some extent for smaller businesses. Fig 26 shows that the net flow of loans to smaller businesses in the commercial real estate sector has generally been a large negative contributor to the overall net lending position.

Despite some new entrants, including challenger banks, the UK banking sector for smaller businesses remains a concentrated market

There have been numerous reviews that focus on competition in the UK SME banking sector.[92] Previous conclusions include:

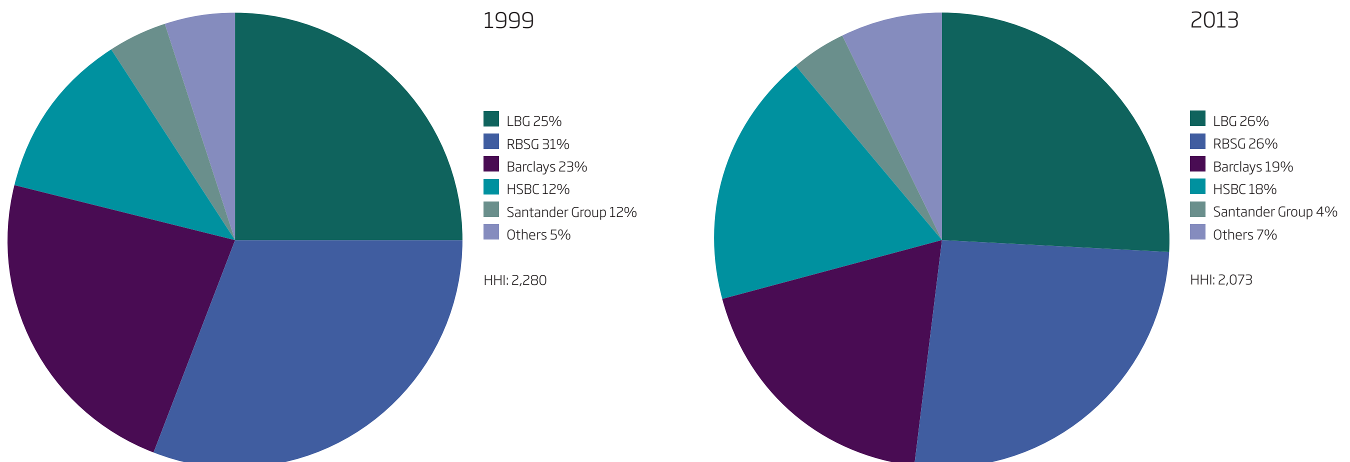
- The SME banking market was highly concentrated in 2002, although in 2007 the OFT suggested that competition may have increased slightly with a small increase in market share from challenger banks;[93]
- The UK banking sector was found not to be as competitive as it should, and that retail and business customers alike were often denied sufficient choice or access to enough information to exercise effective judgement;[94] and
- The Vickers review (2011) made recommendations to separate retail and investment arms of banks to improve financial stability, as well as concluding that banks should make it easier to switch bank accounts and recommending that the sector should be referred for a competition investigation.

Following a consultation earlier this year, the Competition and Markets Authority (CMA) has announced the launch of an in depth market investigation in to the SME retail banking sector, as well as conducting a review of the competition undertakings put in place following the Competition Commission's 2002 report. The CMA and FCA's most recent market study suggested that the UK market for business loans and business current accounts is concentrated among a small number of large banks: In England, Wales (Fig 27) and Northern Ireland, the four largest providers of business loans by volume had a market share of around 90%, whereas in Scotland the three largest providers served around 90% of the market. According to the CMA, these levels of concentration do not differ significantly across SMEs with different levels of turnover.

While concentrated markets do not necessarily imply a lack of competition, the CMA suggests that the SME banking sector does not exhibit many of the characteristics of a well-functioning sector, and many of the conclusions from previous studies remain relevant today. In addition, poor competition is likely if there are also high barriers to entry and expansion. The CMA's market study suggests that despite recent banking developments such as use of online and mobile banking (which in theory could reduce barriers to entry), significant barriers to entry and expansion remain.

FIG 27 *Source: CMA market study: 1999 figures from CC, 2013 figures from Charterhouse release Q1 2013*

VOLUME SHARES OF BUSINESS LOANS IN ENGLAND AND WALES, YEAR TO Q1 2013



Notes:
Percentages may not sum to 100 because of rounding. All banks in the 'others' as a single entity for the purposes of calculating the HHI in 2013. However, if others were treated separately and it was assumed that they each had a market share of less than 1%, then the HHI figure would drop to 2,057. There are methodological differences between the calculations made in 1999 and 2013, including the inclusion of commercial mortgages in the 1999 figures.

As new entry, or potential new entry, is one of the key competitive constraints encouraging existing providers to compete on price, service and innovation, such barriers result in a reduced incentive on the largest banks to compete. The report also found that the SME banking sector has low rates of switching compared with other sectors, which can mean that there are insufficient profitable customers to incentivise new entrants to the market or smaller providers.

A recent BoE discussion paper on the availability of UK credit data[95] also identifies that when credit data are not adequately shared between lenders, it can create barriers to new entrants, inhibit the effectiveness of existing challengers by restricting their ability to assess the creditworthiness, and reduce the degree of competition between incumbents.

A number of challenger banks have emerged since the financial crisis – not all of these have large business banking arms. These include new entrants to the market, disvestments from large banks following Government bail outs and existing smaller banks buying viable parts of failing competitors.

A number of policies are being introduced with the aim of improving competition in the small business banking sector. The Small Business, Enterprise and Employment Bill (SBEE) includes provisions to require banks to share information on their SME customers with other lenders through Credit Reference Agencies (CRAs), and to require those CRAs to provide equal access to that data for challenger banks and alternative finance providers. The Bill also includes provisions to require banks to forward on information on the SMEs they reject for finance (where consent is given) to Online Platforms that will help match them with alternative finance providers. The SME appeals process allows smaller businesses that are declined any form of lending to appeal that decision and the transparency brought by the publication of postcode lending data helps alternative finance providers and challenger banks identify under-banked areas.

The impact of challenger banks on the supply of bank lending to SMEs is an issue that will be considered as part of the Competition & Markets Authority in-depth investigation into the personal current account and SME retail banking announced on 6th November.

Uncompetitive markets can result in inefficient allocation of resources, usually reflected in prices that do not reflect their true market value and are often characterised by a lack of supply, or diversity of options for consumers. This is a sub-optimal outcome for consumers, and improvements in competition can lead to increases in business efficiency and economic welfare.

SME lending is capital intensive and regulation has increased banks' capital requirements

Regulatory changes motivated by the need to improve financial stability are, of course, important. Our aim here is to assess the impact of these on smaller businesses.

Following the financial crisis new macro-prudential policy regimes have been constructed across the globe, including the UK, under which minimum capital ratio requirements for banks will be employed to control the supply of bank credit. The raising of capital requirements has two main effects on financial resilience: first, it improves the capital position of banks. Second, to the extent that the capital requirement increase reduces future aggregate supply of credit, it may prevent credit-driven asset bubbles from forming in the first place.

It might be expected that banks pass on the impact of regulation to their customers via price increases or by decreasing the supply of finance to less profitable sources. A recent Financial Policy Committee (FPC) paper summarised a range of studies that analyse the quantitative impact of increases in capital requirements on banks' lending behaviour.[96] Most of the studies find that an increase in regulatory capital requirements leads to a modest tightening in credit conditions. A 1 percentage point increase in capital requirements is estimated to lead to an increase in the interest rate on bank loans of between 4.5 and 25 basis points and a decline in aggregate bank lending of between 0% and 3.6% relative to baseline, except for one study which finds a somewhat larger impact on bank lending. The OECD have estimated that the medium term impact of Basel III implementation is a small but negative impact on OECD GDP growth, due to an increase in bank lending spreads as banks pass on the cost of increased capital requirements.[97] Recent evidence suggests that the interest rates charged on lending to SMEs in the UK has been coming down.[98]

The Funding for Lending Scheme is designed to reduce bank funding costs and provide participants with strong incentives to boost their net lending to businesses. In 2013, it was extended and refocused to provide stronger incentives to lend to SMEs.

Capital market techniques such as securitisation can help to diversify the supply of funding to lenders, although there can be risks. Currently securities backed by smaller business loans are only a small portion of the UK securitisation market. The box that follows considers the role of securitisation in further detail.

ROLE FOR SECURITISATION IN INCREASING DIVERSITY OF SUPPLY IN FUNDING OPTIONS FOR SME FINANCE[99]

Securitisation: an example of a funding and risk management technology

Securitisation is an example of a financial technology used by lenders to raise funds and manage their risk exposures. Assets, which are often illiquid individually, are pooled together and are used to back different "tranches" of debt securities issued to investors. Tranching enables issuers to create various classes of financial instruments with different risk and reward profiles. The majority of risk is concentrated in "junior" tranches that yield higher returns, while "senior" tranches are more insulated but offer lower returns. This allows issuers to use their existing assets to access funding or transfer risk, and to tap a broad range of investors.

Mortgages and credit cards lead the way

Many financial institutions in the UK are active issuers of securitisation transactions. However, they tend to use their residential mortgage and credit card portfolios for that purpose. That is primarily driven by the fact that both of these asset classes are characterised by relatively high levels of homogeneity. Thus, the risks embedded in them are easier to analyse than the risks in some of the less traditional asset classes such as small business loans. That is attractive to investors, who are prepared to accept lower returns on mortgage or credit card-backed securities. As a result, many lenders find it more economical to use these well-understood types of receivables in their transactions.

Small business loan securitisation has attracted considerable level of attention in the recent times from different bodies and institutions interested in improving funding conditions for smaller companies. It is believed that securitising SME loans could help lenders to increase their business funding activities, and to create an indirect link between small business borrowers and institutional money. Many large investors would be attracted to SME debt-backed securities due to their relatively higher spreads[100] and potential for diversifying their portfolios. However, it is debatable whether in the near future small business loan securitisation could gain a significant market share versus other asset classes given that from the issuers' perspective SME securitisations is still a relatively expensive funding source.

A funding tool for specialised lenders

Even if SME securitisation does not become as "mainstream" as mortgage securitisation, more niche lenders that cannot rely on traditional assets as their sole sources of liquidity may turn to small business debt for an alternative. Indeed, we have recently seen Investec, a specialist bank, successfully securitising its asset finance receivables twice. As the economy improves and appetite for financing from businesses grows, it is likely that other smaller lenders, including non-bank financial institutions, will seek to access secured capital markets. Whether they succeed will depend on many factors, including the availability of sufficiently large portfolios and the associated verified historic performance data.

Risk mitigation technique for lending portfolios

Securitising small business loans may also prove helpful for capital management purposes. As discussed above, risk associated with small business lending tends to be not only higher than that linked to, say, mortgage lending, but it is also arguably more difficult to analyse. Therefore, financial institutions allocate relatively more capital to SME lending activities, a practice that is further enshrined in bank capital regulations. As a result, small business lending sometimes does not offer very high risk-adjusted returns and may consume comparably high amounts of available capital. One way to overcome this issue is for banks to purchase protection on certain tranches of their portfolios to effectively insure themselves from credit risk exceeding a certain level. This may shift portion of SME portfolio exposure to investors that provide the protection, and free up banks' capacity to make more loans.

3.2 ONLINE PLATFORMS

- Internet technology has enabled the emergence of Online Platforms, a subset of FinTech
- Financing through Online Platforms has grown significantly, but remains less than 2% of bank funding
- The emergence of new Platforms has seen a rise in the proportion of business lending
- SME awareness of Online Platforms is increasing
- Businesses most often seek financing to fund expansion/growth plans and working capital, with speed and ease of use attracting them to Platforms
- Online Platforms have the potential to diversify the finance markets for smaller businesses, despite current small scale
- Strict credit controls are often imposed by Platforms, meaning viable businesses without a track record may still be missing out on finance
- Risks expected due to developing nature of market, but Platforms are optimistic about the future, particularly given the UK's prominence in this area

The mainstream high street banking sector has faced numerous challenges in the wake of the financial, and then economic, crisis. Banks were deleveraging their balance sheets, restricting the supply of finance. Adapting to these challenges, the financial landscape has changed, seeing the emergence of alternative forms of finance. As this landscape continues to develop, the range of alternative finance options– those arising outside of the traditional banking sector – has increased.

Internet technology has enabled the emergence of Online Platforms, a subset of FinTech

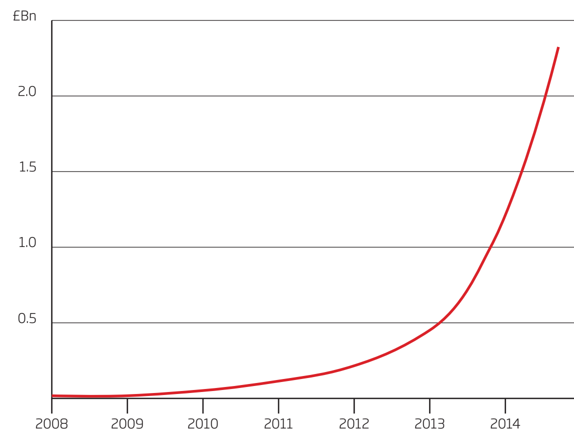
One channel of alternative financing that has grown significantly in recent years is Online Platforms. They are enabled by online technology, meaning they form a subset of FinTech,[101] and act as a means of connecting parties wishing to obtain finance with those wishing to provide it, i.e. the funds pass from lender to borrower without passing through the balance sheet of a financial institution. They therefore fall outside of the traditional banking sector and are highly innovative, with each platform aiming to differentiate themselves from their competition. AltFi,[102] a data provider for this rapidly growing sector, notes that, "There are almost daily innovations as Platforms seek to carve out new niches and come up with new ways of financing."

Some types of Online Platform are detailed below. The content of this section predominantly focuses on P2P business lending and debt based crowdfunding (sometimes referred to collectively as P2P business lending).

- Peer-to-Peer (P2P) Lending
  - P2P Consumer Lending – individuals lend money to other individuals (consumers) in return for interest and capital repayments
  - P2P Business Lending – lenders lend money to businesses in return for interest capital repayments
- Investment Crowdfunding
  - Debt (or Loan)-based Crowdfunding – lenders buy a security, normally a form of bond, in return for interest and capital repayments
  - Equity-based Crowdfunding – investors buy shares in early stage businesses with the expectation of capital growth and dividends
- Invoice Finance Platforms – lenders buy invoices at a discount, then sell them back to firms at a profit
- Reward-based Crowdfunding – individuals give money in return for a reward or recognition, product or service

FIG 28 *Source: Liberum AltFi*

LIBERUM ALTFI VOLUME INDEX (CUMULATIVE FINANCING VOLUMES)



Financing through Online Platforms has grown significantly, but remains less than 2% of bank funding

Zopa, the world's first P2P platform was established in 2005, with loans focused on the consumer. Since then, there has been a notable expansion in the number of platforms operating, as well as the finance they facilitate.

The value of finance originated through Online Platforms has grown exponentially over recent years, with latest figures from the Liberum AltFi Volume Index indicating that £2.3bn of financing had been arranged as at the end of October 2014 (data collection began in 2008). AltFi estimate that roughly c£0.7bn worth of transactions occurred in 2013, with transaction values at the end of October 2014 totalling c£1.3bn (already outstripping the 2013 total).

A recently published report by Nesta and the University of Cambridge[103] estimates that gross financing flows through Platforms will total c£1.7bn in 2014. The Nesta-University of Cambridge data covers a broader sub-set of Online Platforms than the Liberum AltFi Volume Index, albeit the additional Platform types covered by Nesta-University of Cambridge represent a relatively small proportion of total financings.

Both data sets point to high growth of the sector, with Nesta-University of Cambridge data pointing to a 161% increase in the size of the market between 2013 and 2014. AltFi Data suggest that year-to-date totals for 2014 already show growth of around 90% compared with 2013 figures.

The emergence of new Platforms has led to a rise in the proportion of business lending

P2P consumer lending dominated until 2010, which saw the emergence of P2P business lending, and later, invoice financing and equity-based crowdfunding. Subsequently, the market share of consumer lending has decreased notably, with the proportion of total transaction volumes originated through business-focused Platforms rising.

The Nesta-University of Cambridge data echoes this trend. They report that the average growth rate of P2P business lending between 2012 and 2014 was 250% compared with 108% for P2P consumer lending. Invoice trading and equity crowdfunding have also shown strong growth (174% and 410% respectively).

Data providers covering Online Platforms are emerging. However, granular data on the market is not readily available, meaning it is difficult to identify the exact amount of finance provided to smaller businesses. For example, it is possible that some P2P consumer lending is being used to finance business ventures, with the owner taking out the loan in a personal capacity. Equally, within the P2P business lending, invoice finance and crowdfunding channels, the proportion of funding provided to smaller versus larger companies is not clear.

Bank of England data show gross flows of lending to SMEs, which was circa £24.8bn for the first half of 2014, excluding overdrafts. AltFi Data suggest that the value of loans originated through P2P business lending and invoice finance for the first half of 2014 was £0.4bn. On this basis, funding provided to smaller businesses sourced through Online Platforms represents less than 2% of that sourced through the traditional banking sector, when using these figures as approximations for comparable funding provided to smaller businesses, where granular data is not available.

SME awareness of Online Platforms is increasing

SME journey data indicates that awareness of P2P lending and crowdfunding has increased significantly since 2012: 35% of SMEs were aware of P2P lending (24% in 2012) and 32% were aware of crowdsourcing (13% in 2012).

By broad sector, awareness of both finance channels is highest amongst business services companies and lowest amongst construction companies. Awareness is also higher amongst younger businesses (those aged 0-5 years), particularly for P2P lending.

Despite rising awareness, the SME Journey data shows extremely low usage of both forms of finance by SMEs in the previous three years. Only 1% of smaller businesses obtained financing through a P2P platform during that period. All sources of equity investment totalled 1%, with the use of crowdfunding in this category very low.

FIG 29 *Source: AltFi data*

ALTFI DATA SHOWING MARKET SHARE BY PLATFORM TYPE (BASED ON 12-MONTHS TO OCTOBER)

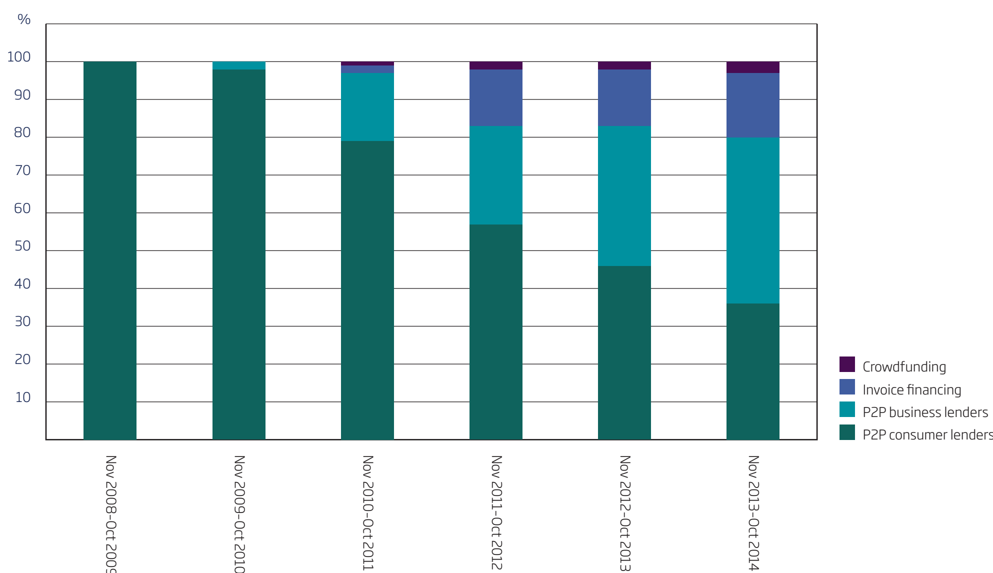
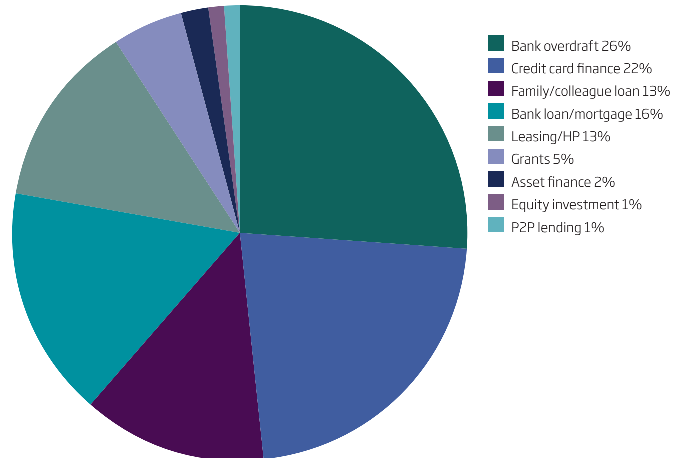


FIG 30 *Source: BMG, SME Journey Survey*

EXTERNAL FINANCE USE BY BUSINESSES THAT USED EXTERNAL FINANCE IN THE PREVIOUS 3 YEARS, 2014



Businesses most often seek financing to fund expansion/growth plans and working capital, with speed and ease of use attracting them to Platforms

The British Business Bank has collaborated with Bryan Zhang of the University of Cambridge (who with Nesta produced a recent report on alternative finance) on a series of 110 qualitative interviews with Platforms, smaller businesses and lenders/investors.

The aim of the research was to obtain more granular insight into the sector and assess the underlying motivations of those businesses using Online Platforms. This is supplemented by survey data collected by Nesta-University of Cambridge, where available. The predominant focus of the interviews is on P2P business lending (which also covers debt-based crowdfunding).

Nesta-University of Cambridge data indicate that, where businesses are pursuing funding through a P2P lending platform, the top reasons for applying were to fund 'expansion/growth', 'working capital' and 'asset purchases'. Invoice trading platforms also provide debt funding to businesses, estimated at £270mn in 2014 by NESTA-University of Cambridge, and are likely to skew motivations towards finance for working capital.

The Nesta-University of Cambridge data indicates why the popularity of Online Platforms continues to gain traction. Respondents (those who had already approached a Platform, whether that be successfully or unsuccessfully) were asked to state the importance of a number of factors in their decision to approach a P2P business lending platform.

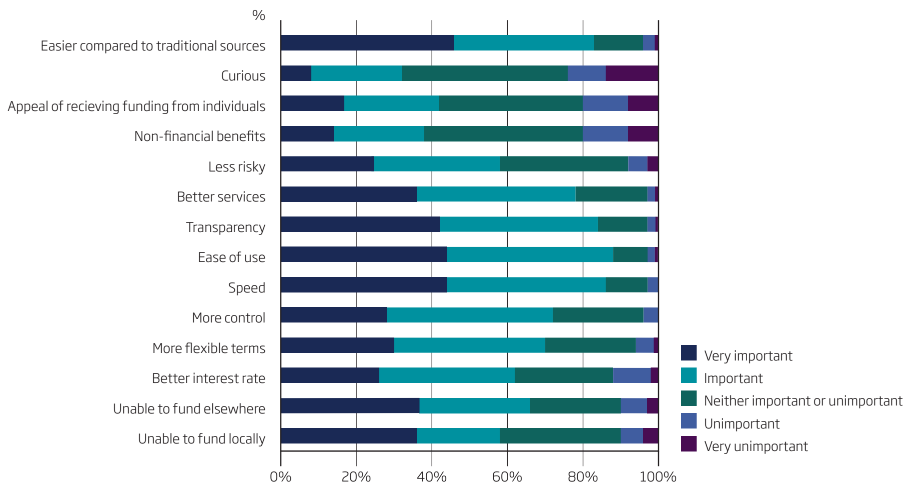
When combining responses of 'very important' and 'important', the top factors influencing businesses to approach Platforms were ease of use and speed. This was followed by the perception that it is easier to obtain funding through Platforms than through more traditional sources and the transparency provided by the Platforms.

Similarly, for those respondents successful in obtaining funding through a P2P business lending platform, 87% reported that the registration process was easy or very easy and 82% reported that the application process was either easy or very easy.

Exploring this further, the University of Cambridge qualitative research notes that, "SMEs interviewed reported that the fundraising process with banks is normally long, complicated and unpredictable, with lending decisions not normally made in their local branches but far away or outsourced with strict conditions attached to them."

FIG 31 *Source: Nesta-University of Cambridge*

MOTIVATIONS FOR APPROACHING AN ONLINE PLATFORM FOR FINANCE



Online Platforms have the potential to diversify the finance markets for smaller businesses, despite current small scale

The Competition & Markets Authority (CMA) notes that, "Effective competition to provide SMEs with high quality and responsive banking services, at the lowest possible cost, is critical in ensuring that SMEs are able to get what they need from their banks."

Early evidence suggests that Platforms are emerging as an alternative provider of debt finance for smaller businesses, despite not providing the day-to-day services offered by mainstream banks. Interestingly, it is the key motivations for usage, e.g. speed, ease of use, that provide the main source of competition and not a perceived desire of smaller businesses to source cheaper finance. The wider Nesta-University of Cambridge research indicates that interest rates for smaller businesses are typically around 8-9% (17-18% for higher risk loans), meaning that the cost of funding through Platforms is likely to be comparable to bank finance, rather than a cheap source of finance for many borrowers.

The trend in the contribution that Platforms can make in terms of diversifying options and choices for smaller businesses is positive, albeit scale would need to increase for this impact to be more significant. The University of Cambridge interviews with investors and smaller businesses indicates that both groups welcome the emergence of Online Platforms, noting that they provide, "Viable, healthy and necessary competition to the status-quo." Both groups expect Platforms to continue to grow, but do not expect them to displace traditional sources of finance.

Strict credit controls are often imposed by Platforms, meaning viable businesses without a track record may still be missing out on finance

Emerging evidence from the University of Cambridge would suggest that smaller businesses receiving finance through the P2P lending platforms generally have, "Good business track records, strong credit ratings and, sometimes, sizeable fixed assets."

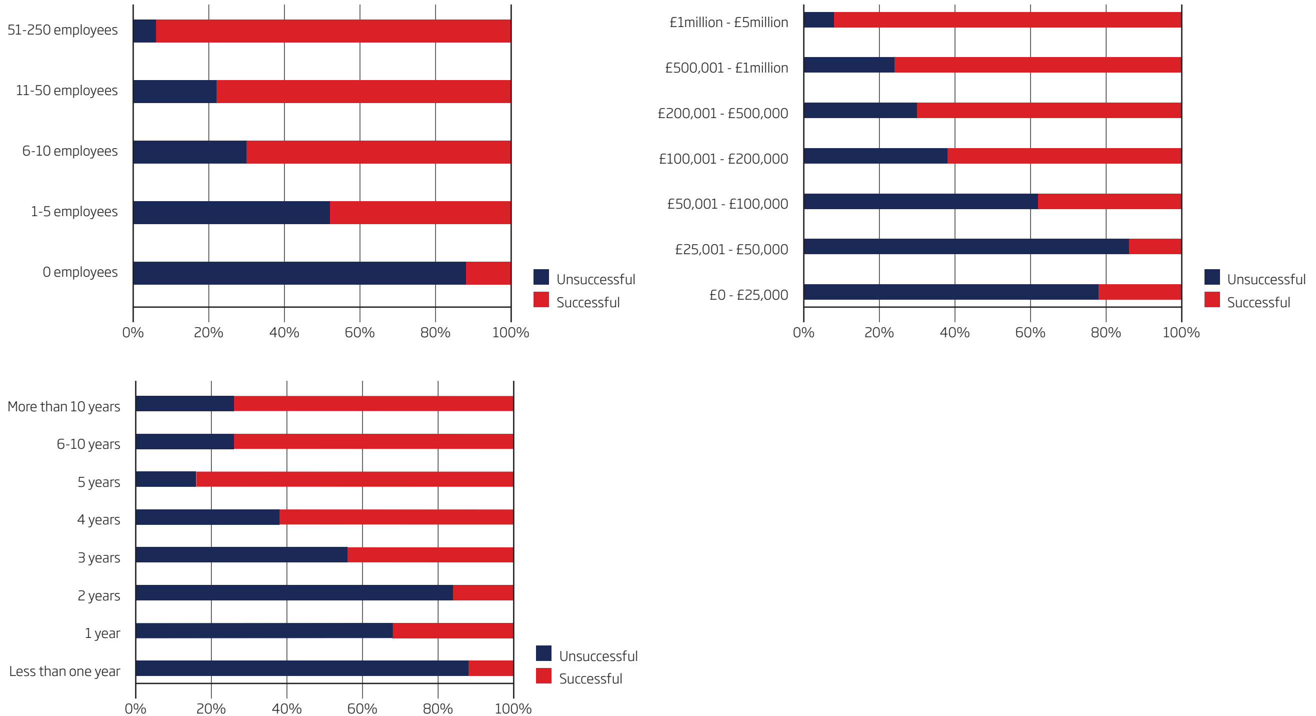
Further data obtained from the Nesta-University of Cambridge highlights these borrower characteristics. Looking at data on number of employees, turnover in 2013 and age of business, we can see that as a proportion of respondents in each category:

- Sole traders were more likely to be unsuccessful in obtaining funding through a P2P business lending platform. However, those with 6 and more employees were more likely to be successful (with the likelihood increasing with the number of employees).
- Businesses with higher turnover (above £100,000) were more likely to be successful in obtaining funding.
- Businesses that had been trading for 4 years or more were more likely to be successful in obtaining funding. Those who had been trading for two years or less were more likely to be unsuccessful in obtaining finance.

FIG 32

Source: Nesta-University of Cambridge

APPLICATIONS TO ONLINE PLATFORMS - PROPORTION SUCCESSFUL/UNSUCCESSFUL BY NUMBER OF EMPLOYEES, TURNOVER AND AGE OF BUSINESS



Anecdotal findings from the small sample of users of P2P lending and crowdfunding identified through the SME Finance Monitor echo these findings. Initial analysis suggests that users are less likely to be sole traders and appear more likely to be planning to grow and more likely to have someone in charge of finances who is qualified.

Typically, viable businesses without a demonstrable track record or collateral will find it more difficult to obtain funding from banks, due to the higher credit risk that they present.

The qualitative interviews conducted with Online Platforms emphasised that the credit processes they put in place are often designed to be conservative and approve the highest quality credits. This is not altogether surprising; Platforms are businesses operated for profit, where management teams are often experienced in credit assessment and want to establish a stable business.

Processes that ensure only viable businesses obtain funding are important for the longevity of the Platforms and for the protection of investors. However, if viable businesses are being turned down, then it is possible that access to finance market failures evidenced in the traditional banking sector are also prevalent for businesses trying to obtain funding through Online Platforms.

Initial analysis of the Nesta-University of Cambridge data on borrowers through P2P business lending and debt-based crowdfunding platforms suggests that roughly 65% of respondents had attempted to gain funding from a bank prior to approaching a Platform, although only 16% were successful in receiving finance from a bank. However, this relationship is complex, as anecdotal evidence derived from the interviews suggests that as Platforms become more established, borrowers have been more inclined to approach them first, without previously applying to a bank.[104]

A more rigorous and robust investigation would be required to examine whether market failures exist for smaller businesses trying to obtain funding through P2P business lending and debt-based crowdfunding platforms.

Nonetheless, due to the array of Online Platforms existing, there are sources of finance available for younger businesses or start-ups, albeit with financing volumes at a smaller scale, for example, equity-based and reward-based crowdfunding platforms. The major advantages of both these types of Platforms are the potential networks of supporters and customers gained, testing through the crowd of demand for their products or services, and verification of the business, which can be useful for future funding requirements.

Risks expected due to developing nature of market, but Platforms are optimistic about the future, particularly given the UK's prominence in this area

Anecdotal evidence received from the qualitative interviews suggests that Platforms are optimistic about the potential for growth in the sector. There are good opportunities in the domestic market, with anecdotal evidence suggesting that Platforms are increasingly seen by businesses as a 'first choice' when considering debt finance options. The perceived advantages of the P2P business lending and debt-based crowdfunding platforms, with regards to speed and ease of use, are unlikely to be eroded in the near term. Furthermore, the UK is seen as a leader in its development of Online Platforms, opening up opportunities to export models elsewhere.

There are, however, a number of risks that could impede the growth or stability of Online Platforms. Firstly, in line with the emerging nature of this finance channel, many Platforms are yet to establish a robust track record. As previously discussed, many Platforms enforce stringent credit checks on applicants for finance, although it is acknowledged through responses to the interviews, that a 'rogue' Platform could damage the reputation of the industry or reduce investor confidence, which could restrict growth.

The Platforms rely on new investment and financing requirements in order to grow. A number of the Platforms interviewed noted the need to promote awareness, both amongst investors and smaller businesses, to ensure that high-quality borrowers continue to request funding and that there is a sufficient network of lenders to meet this demand.

Attractive default rates presented by Platforms are, in some instances, based on limited trading periods. If these were to increase over time, the perceived risk-reward payoff for lenders may change and impact on their investment decisions. This is particularly true for equity-based platforms, where it may take a number of years to determine the proportion of deals that are successful and earn returns, versus those that fail. Related to this, it is important that Platforms play their role in protecting the position of investors, particularly in equity deals, to ensure that they receive the expected share of returns when these arise.

Aligned with the increase in the number of Online Platforms, we would also expect there to be some turbulence among operators, where competition will potentially drive some out of business, with the more successful models surviving. Alternatively, there may be consolidation in the market. Both these factors may create some instability in the market that may impact negatively on investor confidence.

The emergence of associations such as the Peer 2 Peer Funding Association (P2PFA) and the UK Crowdfunding Association (UKCFA) mean that member Platforms work in accordance with certain rules or codes of practice. The P2PFA states that, "Members of the P2PFA are required to meet our robust rules and operating principles for the transparent, fair and orderly operation of P2P lending." These may help to improve consistency of standards amongst operators. Additionally, as data providers for the sector continue to develop, they may work with operators to standardise data across the sector and improve transparency.

Furthermore, some of the Platforms are putting in place measures to increase liquidity of investments, should this be required, through secondary trading markets or similar. Some are also looking at ways to reduce the impact of bad debt on investors through, for example, contribution funds that act as an insurance policy if a borrower is unable to repay a loan.

In addition, FCA regulation of Crowdfunding came into effect in April 2014. These regulations also help to protect investors. The FCA regulates two types of activity:

- Loan-based crowdfunding platforms – P2P lending typically falls under this category. The P2PFA notes, "The regulation requires peer-to-peer lenders to have minimum operation capital requirements, meet client money requirements and adhere to a disclosure based regime."
- Investment-based crowdfunding platforms – debt- and equity-based crowdfunding typically falls under this category.

Invoice trading and reward-based crowdfunding is currently not regulated. More information on the FCA regulation can be found on their website.[105]

EXPERT VIEW

JAMES MEEKINGS
CO-FOUNDER, FUNDING CIRCLE

WE SEE OURSELVES AS A NEW INFRASTRUCTURE FOR LENDING

The market for small business finance is diversifying and innovative platforms such as Funding Circle have grown incredibly in the past three to four years.

You often hear that demand for finance among small businesses is low, but while it may be less than before the recession, we do see it in the market, especially for business loans that are relatively painless to access.

The British Business Bank has played an important role in helping draw attention to the alternatives out there. It has been bold in not just supporting banks and existing infrastructure, but working to build a diverse and competitive market.

By supporting platforms such as ours, British Business Bank is not supporting one lender but over 30,000: all types of people, from individuals to family offices, local councils and pension funds. We want to get more people lending to businesses, increasing the supply from a small handful of players to a much broader range. British Business Bank's support has been instrumental in helping us create a more diverse set of investors.

As a marketplace lender, not taking deposits but facilitating the flow of money on a risk basis, we can support lending to more and different types of businesses. We see ourselves as a new infrastructure for funding, with thousands of people and players using us.

In the next decade, we expect alternative lending to account for as much as 20% of the overall market, but there's a journey to get there. A better functioning market will mean clear signposting so businesses know what type of finance to go for and where to look. We need to educate businesses and show them the range of opportunities available and our challenge is to market what we are doing and the benefits it offers.

People talk about increasing competition in the banking sector, but effecting wholesale change will be difficult given the size of institutions, even with the growth of the challenger banks. A healthy market will be one where the banks service current accounts and some loans, while working in harmony with innovative non-bank lenders, who help lending but don't compete for banking customers.

There needs to be a flow between traditional banks and non-bank lenders, which is what we are seeking to achieve through our partnership with Santander, who refer customers they will not consider for a loan to Funding Circle. Clearer indications of the different options available are what will help create a harmonious marketplace and one that gives small businesses the best possible chance of obtaining the funding they need to succeed and grow.

EXPERT VIEW

RHYDIAN LEWIS
FOUNDER AND CEO, RATESETTER

THE UK HAS BEEN AHEAD OF THE CURVE IN DEVELOPING ONLINE FINANCE PLATFORMS

The great benefit of peer-to-peer lending is its dynamism: it offers an open exchange where lenders and borrowers can transact, resulting in better value for both parties.

The fact that we were able to launch in Australia this year is indicative of a growing appetite for this form of finance: people are starting to identify that this model can be a game-changer for their businesses. It is going to accelerate enormously – there is currently just over £100mn in new lending every month in this market, and that is a figure only set to rise.

Although the default option for businesses is still to approach their bank when seeking finance, that is starting to change. There is still an important role for banks to play in delivering funding to larger companies, but small business owners are now seeing the benefits that Online Platforms can offer: ultimately I would expect to lose the 'alternative' finance tag altogether.

The challenge for the peer-to-peer sector is credibility. You can't shortcut your way to trust – credibility is something you have to earn, and we have gone a long way down that road.

Westminster has helped in this by supporting and raising awareness of Online Platforms. It is great to see that they are promoting choice for borrowers – so important for small business borrowers. More broadly, the UK has been ahead of the curve in supporting the growth and development of online finance platforms: creating a regulatory framework and potential tax incentives such as an ISA for people who lend through peer-to-peer platforms.

Small businesses are the posterchild of economic recovery and growth and the British Business Bank has a crucial role to play in encouraging their growth. Getting finance to small businesses, micro-businesses, and sole traders is difficult, but with the support of British Business Bank we are delivering funding where it is most needed. British Business Bank's partnership model, working through providers such as RateSetter is the right one: what businesses want is to deal with is institutions that they recognise and can work at the grassroots level.