Federation of Small Businesses
The UK's Leading Business Organisation

ALT+ Finance

Small firms and access to finance

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ALT+ Foreword

Banks and small business loans are never far from the news. The Federation of Small Businesses (FSB) has been actively representing its membership to make sure viable small businesses can get access to the credit they need to invest, grow and create jobs.

Recent public policy changes and agreements have shown that Government does have an appetite for reforming the banking structure and to help consumers, mortgage seekers and small businesses. The Vickers' report, and the full acceptance by the Chancellor, showed that reform is important to protect the tax payer and help small businesses. The Project Merlin targets were less successful and from the start, the FSB stated that a target simply puts off the real discussion for 12 months.

The momentum however must not stop now. To bring true stability to the financial system, we need not just more competition between the high street banks but also viable channels and modes of non-bank finance providers. The FSB does not intend to 'bank bash' or go down the road of calling for all banks to be broken up, but we do need a discussion about Alt+ Finance.

Alt+ Finance shows how the Government can look at good policy measures in the US and a number of European countries that have installed principles in certain financial institutions, which take into consideration the social aspects as well as the commercial.

The FSB does not ask those systemically important banks (or even just the state funded banks), disregard profits, are broken up or forget about commercial activities. We do however ask why these countries small firms did not suffer to the same extent as their counterparts in the UK. When we start looking at these nations, key themes start to resonate: *transparency, diversity, and local rather than central*.

Moving away from traditional banks, we have also looked at what options there are for the Government in terms of realistic alternative finance providers. These are not blue-sky-thinking operations but realistic methods, which are lending to small businesses now, and which the Government should look at when finalising how credit easing will work.

Once again, the FSB suggests themes that the Treasury should look at: *scaling-up working models, looking at example from other nations and utilising public policy to foster non-bank channels*.

With this publication and the work of Tim Breedon at BIS through the non-bank finance taskforce, we hope that Government will come forward with creative and realistic options that will give small businesses the confidence to explore alternative routes of credit, but also the confidence to the non-bank providers to start investing and promoting themselves to a far larger extent with small businesses

As always, the FSB is here to represent members and the wider small business community, and are ready to help the Government where positive change is the objective. I would also like to thank the New Economic Foundation (**nef**) for their valuable input and thoughts, which have contributed to the overall outcome and recommendations in this report.

Mike Cherry
FSB Policy Chairman

Executive Summary

This report has been born by the FSB's longstanding interest in finance, and the ability of our members and other small businesses to access finance on reasonable terms. With our shared interest in this area, this report has benefitted from the considerations and input from **nef** – the New Economics Foundation.

As has been well documented, since the credit crunch of 2008 small businesses have faced considerable challenges accessing finance through traditional high street banking routes. This raised questions about the structure of the UK banking sector, and the systemic risks it poses to the UK economy. It also highlighted that many small businesses felt that the relationship with the banks had been broken.

Many of these issues have been addressed by the Independent Commission on Banking's (ICB) report which put forward a range of recommendations that the FSB fully supported, especially the specific recommendations to increase competition among UK high street banks. While welcome, the FSB believes there is still a case for a more fundamental re-evaluation of the UK banking model, to see whether it really supports small businesses and their finance requirements both in times of economic growth and, perhaps more importantly, during economic contraction. The fact that the UK taxpayer owns a significant proportion of two high street banks may provide this opportunity.

The report therefore looks beyond the current banking structure, and examines alternative ways that small businesses might access finance from non-bank sources and ways to stimulate that market.

Lessons from Germany and the US

The report examines the contrasting banking models of the US and Germany, to see what lessons could be drawn. Though they take contrasting approaches, and there are difficulties in taking their experience and transplanting it wholesale into the UK context, it is striking how successful these countries have been in maintaining credit flow to small businesses.

"The report therefore looks beyond the current banking structure, and examines alternative ways that small businesses might access finance from non-bank sources and ways to stimulate that market"

For example, between 2007 and 2010, there was a 24 per cent fall in the number of successful loan applications made by small and medium-sized enterprises (SMEs) in the UK, compared to a nine per cent fall in Germany over the same time period.[1] Similarly, in the US, the Small Business Administration (SBA) increased its small business loans in 2010.

Signs such as these suggest other countries have a banking model far more effective in distributing credit to small firms than the UK. Some themes emerge in the report that explain why that might be the case, including:

- **The effects of competition.** As was recognised by the ICB report, the UK banking market is highly concentrated with high barriers to entry. In contrast, entry into the US retail banking sector is relatively straightforward, thereby increasing competition. Similarly, the more regulated German model has a much lower level of market concentration.

- **The benefits of a local banking network.** In both the US and especially Germany, where the Sparkassen market is geographically defined, banks have a strong local focus. Banks' performance is often linked directly to their local economy.

- **Transparency.** In the US, financial institutions are obliged to reveal the amount of money they keep in their local areas under the terms of the Community Reinvestment Act. Similarly, the boardroom structure of the German banks with stakeholder representation achieves similar results.

- **Investment approach.** In Germany, the dual focus of regional banks on both their financial position and their wider social role has meant lower rates of return on capital but delivered greater stability and long-term support for small businesses – attributes small firms value highly.

- **An active state role.** In the US, the SBA has used the wide network of local financial institutions to distribute quickly SBA loan programmes for small businesses as part of its recovery strategy. Similarly, the German Sparkassen has played a critical role in keeping credit flowing to small firms through the credit crisis.

- **A small business administration.** Alongside its banking structure, an important further element in the US model is the role of its SBA to develop and tailor Government backed loan products for small firms, and to orchestrate their distribution through the banking network.

Non-bank finance

This report shows that there is a suite of non-bank finance alternatives available to small businesses. Currently these provide a small level of finance for small businesses in the UK, but none yet have the scale to challenge seriously traditional banking sources of finance. Many are innovative, reflecting the wealth of financial expertise which the UK has in abundance. Given this position of strength, these alternatives should be expected to flourish as the financial services industry spots new opportunities. Alternative sources of finance examined by the report covers:

- Community development finance institutions
- Business-to-business credit
- Peer-to-peer lending
- Business angels and small business private equity
- Asset finance and leasing
- SME debt bonds

The FSB would like to see what additional measures can be made by the Government to increase the scale of non-banking channels. Combined with the ICB's reforms, these channels could provide additional competition to the banking sector once they have achieved sufficient scale. These models should also help introduce a dynamic element into the sector, as new entrants bring their innovative 'disruptive' business models into the market, giving greater choice and flexibility for the small business sector.

The report comes forward with a number of recommendations to boost these non-bank means of accessing finance, some of which require finance, others changes to regulation. It asks the Government to look closely at these and to bring forward clear and tangible measures to increase the presence of these models in the small business lending market place.

Recommendations

Banking

- Once the banks are on a firm financial footing, the Government should consider ways to develop a more local banking structure, building on and using the existing framework of the taxpayer-owned banks. The benefit of a local banking structure, with decision makers close to their customers,

is a key strength of both the US and German banking models.

- The Government should also consider how it might help create 'plain vanilla' financial institutions not beholden to their shareholders and returns on capital but with a wider set of public obligations. Again, the German Sparkassen is a model that could be considered. Similar objectives could be reflected in the terms of a UK banking licence.

- In the short-term, the Government should introduce a UK Community Reinvestment Act to increase transparency in the sector, and help direct credit to where it is needed most. Consumers and businesses can then see the extent to which their banks are using deposits to serve the needs of local markets.

- A bolder step would be to consider the creation of the UK's own Small Business Administration, similar to that of the United States. A UK institution would then be charged with developing loan products suited to the needs of small firms, and provide a distribution mechanism to help get finance to small businesses

Non-Bank Access To Finance

Community Development Finance Institutions (CDFIs)

- Responsibility for CDFIs is currently somewhat unclear and fragmented, with different government departments (BIS, DWP, OCS) responsible for different aspects. The Government should identify one department which co-ordinates community development finance. The FSB and the industry body, the Community Development Finance Association (CFDA), suggest it should be HM Treasury.

- CDFIs need to be brought into the mainstream. Currently there is an ad hoc referral scheme from local banks. If CDFIs are to grow and expand, a formal referral route, as outlined in the Project Merlin agreement, should be implemented.

- The Government should look to the US experience, and see how best to use public resources to help these institutions expand and lower the cost of capital for those starting-up and operating businesses in less advantaged areas.

- Further, the FSB recommends the Government to review and consult on a Community Reinvestment Act in the UK to see how that might support the development of the UK CDFI community.

- When affordable, well targeted tax incentives could help boost the sector. The FSB is pleased that the Government is looking at the Community Investments Tax Relief and hopes any reforms will go some way to change the behaviour of investors.

Peer-to-peer lending

- The Government and regulators must show the future importance of this funding model by fully engaging the p2p Finance Association along with the key players in this market. This should start by bringing these players into a fully recognised

"This report shows that there is a suite of non-bank finance alternatives available to small businesses"

regulatory environment that would help them attract a greater number of institutional investors to meet the demand from small businesses.

- Once within the regulatory environment, the Government should create investor accounts in the peer-to-peer firms that lend to small businesses and use this as an alternative route to the banks under the credit easing umbrella. This type of intervention would fit into the ICB recommendation of increasing competition within the SME credit market and also help increase the scale of this model.

Business Angels and small business private equity

- The FSB recommends that greater research is carried out into business angels as data is hard to compile, mainly due to the varied network of business angel networks and ad-hoc providers. Without such research, policy shifts will be hard to define.

- The new Seed Enterprise Investment Scheme is a beneficial move and the one year capital gains holiday should be made permanent if it proves successful at increasing deals, and the re-investment of profits in new deals which benefit small businesses.

- It is also important that businesses that have the potential to access and benefit from this type of finance should be targeted in terms of advice. This can be done through more work being done by provider networks, business groups and the Government. It is important that the benefits are shown, as well as the pre-application work (becoming 'investment ready') and the funding profile needed over a period of time.

Asset Backed Finance

- Asset backed finance needs a greater market penetration and awareness amongst businesses. The Government should look at bringing this finance route into the £1 billion Business Finance Partnership and other Government lending schemes (such as the Enterprise Finance Guarantee).

- More sensitivity is needed when changing the tax system. Changes to the capital allowance rate have had an adverse impact on investors, as has regular changes to the tax system. When relevant changes to the tax system take place, impact assessments should reflect this sensitivity.

SME Debt Bonds

- To evaluate the viability of an SME bond market, the Government should put in place a pilot scheme to see the demand and supply from small businesses and investors for an SME bond and its operational viability. This could be done quickly using existing FSA licensed Recognised Investment Exchanges (RIE).

- The Treasury should use credit easing to enhance the credit rating worthiness of singular debt bonds or of bundles of bonds issued by small firms.

- If the pilot is successful and the relationship between credit easing and the RIE works on a basis of full transparency, the same offering by the Government should be extended to the entire RIE network in the UK.

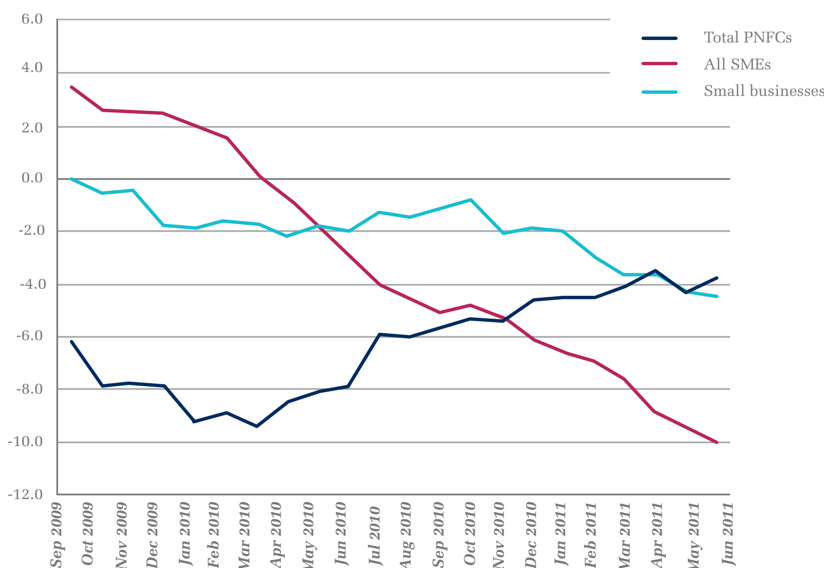
Business to business mutual credit schemes

- Though it has been in operation for some time, the Swiss invoice factoring model is little known in the UK. Nonetheless, the evidence shows it can offer benefits for small businesses. The Government should therefore examine what, if any, barriers there are to this form of finance in the UK and to consider if there is an opportunity for large institutions to support their foundation.

1. Introduction

The bank route of finance is the pre-eminent source of formal finance for small businesses in the UK. As is well-documented, following the banking crisis of 2008 credit conditions worsened for the small business community as wholesale banking markets seized up (Figure 1). But even before the crisis, concerns about the concentration of the UK retail banking sector and its effect on competition had been raised. Small firms had begun to raise concerns about their relationship with their high street banks, and the extent to which decisions were being made at the local level. The crisis emphasised some of the weaknesses of the model which the ICB has begun to address, setting out a wide-ranging series of reforms endorsed by the Government and warmly welcomed by the FSB.

Figure 1: Lending to UK SMEs by banks



PNFC – private non financial companies

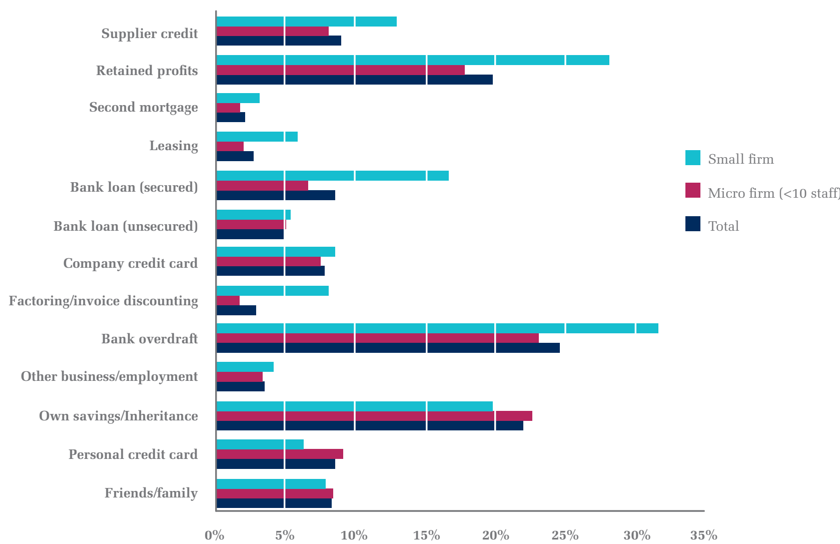
Bank of England April 2011[2]

Though welcome, the ICB's reforms will bring benefits in the longer term and are necessarily focussed on the banks. Small firms face more immediate challenges accessing finance and continue to face challenges obtaining finance from banks on reasonable terms, with interest spreads over larger firms' loans increasing.[3] As a consequence, many small firms have missed their growth opportunity or, in the worst cases, been forced to close as lines of credit have dried up or new unfavourable terms been offered.

Current finance sources for small businesses

The 2011 FSB 'Voice of Small Business' Member Survey (of more than 11,000 FSB members) shows that bank overdrafts and loans

Figure 2: FSB 2011 Member Survey (multiple choices for major source of finance)



Q23a Which of the following sources, if any, have you used to finance your main business in the past 12 months? Base 11,367

still dominate the external finance portfolios of many small firms (Figure 2). Even when the totals are split by micro businesses (below 10 staff) and small businesses (above 10 and below 249), banks still dominate.

The split between micro and small is shown by the amount of businesses using factoring or other invoice products. Many of these are bought through the banks and can be labelled generically as 'accounts receivable finance' but are different to loans and overdrafts as they free up cash-flow and depend on the invoices a firm generates or are secured on them. The larger the business, the more likely it is to use account receivable products: 2.1 per cent of micro firms use these products against 7.2 per cent of small businesses.

Often there is a risk associated with Factoring or Invoice Discounting as they are not suitable for the majority of businesses being most appropriate for those with high growth. There are usually additional fees and charges associated with this form of financing.

Data from the Office for National Statistics (ONS), comparing data from 2007 and 2010, shows the application success rates of different finance products. Table 1 shows that only two forms of finance – advance payments and mezzanine financing – increased the success rates of applications over that period. All other forms of finance, including bank finance, saw a decrease the rate of successful applications, even though separate ONS data shows that applications as a bulk number increased.

The period between 2007 and 2012 was defined by the financial crisis, the prolonged technical recession and then subsequent flat growth patterns, which may have played a role in decreasing the generic credit rating of all businesses, and especially those in cash disposable sectors. However, this generic approach misses businesses that are innovative and creative and which might have had strong business plans. It also disregards local economic patterns.

To address these issues around access to credit and the terms on which is it offered, the FSB has been at the forefront of calling for reforms to the banking sector and promoting ways to create a more competitive, pluralistic credit market for small firms other than through the traditional banking system. Our approach has been based around three core principles:

1. **Increasing competition:** In keeping with the ICB report's recommendations, Government intervention should encourage competition in the market and

Table 1: ONS credit success data (source: ONS 2011)[4]

Source	2007	2010	Change
Leasing	99.8	92.7	-7.0
Factoring	98.3	86.9	-11.4
Bank overdraft or credit line	94.3	83.0	-11.3
UK government subsidies	94.0	92.0	-2.0
Trade credits	87.9	86.5	-1.4
Advance payments	79.7	88.1	8.4
International trade facilities	100.0	99.4	-0.6
Mezzanine financing	24.1	79.3	55.2
Other finance sources	97.9	93.2	-4.7

Box 1: Types of finance

Trade, factoring and leasing	The use of unpaid invoices to free up cash, selling commercial unresolved debt, pre-payment and use of supply chain or rental of assets from a provider in return of repayments and interest, and the possibility of purchase at closure of lease contract
Private equity	Investors or funds that purchase segments of businesses in return for equity within the business
Periphery finance	Peer-to-peer finance, crowd funding, personal (including family and friends)
Micro finance	Friend and family finance, saved personal finance, redundancy finance, etc.

aim to address the market dominance of a few large players. As this paper sets out, policy should also aim to stimulate the non-bank methods of accessing credit and thereby increase competition in this market segment via those channels. One risk of current credit easing proposals is that for the sake of speed of implementation, it unavoidably uses these banking channels thereby reinforcing the existing market structure.

2. **Increasing access to credit for start-ups and the smallest companies:** To encourage business start-ups and to ensure young, small companies have every chance of thriving, a key objective should be to improve the supply and price of credit to the lower end of the market, where start-up firms have had particular problems raising finance through traditional retail banking routes.

3. **Community development:** Where possible, Government intervention should aim to improve access to credit in areas of the economy such as rural areas, areas that have experienced industrial decline, and inner city areas.

This paper aims to build on the FSB's three principles. Chapter two first looks at the options to reform the banking sector, notably lessons that can be learnt from a regional retail banking system that is focused on nurturing the wellbeing of their local economies rather than shareholder returns. By moving to a more local level, this restructuring will go some way to reconnecting banks to the communities they operate in.[5] In that light, the chapter highlights the positive effect the Community Reinvestment Act (CRA) has had on banking institutions in the US in increasing access to finance for previously harder to reach sectors of the economy, and suggests the Government looks at enacting something similar in the UK.

Chapter three then goes on to look at a range of alternative non-banking routes plus periphery channels and products that already exist on the market. Currently these represent a small share of the market, but if the right conditions are in place, have the potential to offer other routes for small firms to access finance and start to put competitive pressure on retail banks in that market segment.

Small businesses have different approaches to identifying and categorising finance types and need requirements. Within this paper, the FSB will use four non-bank categories of finance (Box 1).

Many of these finance types can be subdivided into additional products and the size of businesses or scale of finance needed. The key difference that will inform borrowers is what the finance is needed for. For example, does the business owner need finance for short-term purposes and cash-flow flexibility or is it for mid to long-term needs? Questions will help point the potential borrower to different types of alternative finance products and providers.

Chapter four concludes by setting out areas for reform and policy actions for the Government to take forward, based on the evidence, and looks at good practice from other nations.

2. Banking

The ICB's final report made good recommendations on the future of retail banking and the structure of those organisations that provide finance to small businesses. The majority of the organisations that provide small business banking in the UK are systemically important banks and as such, the FSB welcomed the ICB's loose ring-fence proposal along with the recommendations on increasing competition.

The FSB was therefore fully supportive of the Chancellor, who accepted the ICB final recommentations in full. The reforms should remove the systemic risks posed by the UK banking sector. On the specific area of improving competition in the sector, the FSB strongly supported the following recommendations:

- Encouraging a **'challenger bank'** to enter the market and increase competition.
- Easier **switching accounts between banks**, with a free seven-day switching service – with automatic transfers or direct debits and lasting 13 months – which should encourage competition.
- The creation of a **Financial Conduct Authority (FCA)**, with a key role in promoting effective competition in financial services markets. The FSB welcomed this proposal, which should mean that at the highest levels within the Bank of England, competition will be a key policy driver and lever, instead of ad-hoc reviews and papers. The FCA should start by looking at a regional level, and then product ranges.

Though these reforms are welcomed, and should be implemented as soon as is feasible, the FSB believes they are predicated on the status quo of a high street banking system dominated by a few large players. It is unlikely that the new challenger bank will operate a significantly different business model, thereby forcing a change in the incumbent banks. In themselves, these reforms do not address underlying concerns that high street banks have become increasingly detached from the communities they serve, and whether alternative models could better serve those needs.

The following analysis looks at other banking models from Europe and the US, which provide some useful insights into how – if policy makers are bold enough – the UK banking sector could be reformed.

International experience

While the FSB has welcomed the Government's resolve to tackle structural weaknesses in the banking sector, and to remove the systemic risks it poses to the UK economy, it believes that lessons can be learnt from other banking models and potentially be applied in the context of the UK, to improve credit flows to small businesses.

The following analysis will look in detail at alternative banking models used in other developed countries, drawing on evidence

from the US and Germany and also Swiss community banks. These can provide some insights into how the UK banking system might be remodelled so it is more responsive to the needs of small firms and the communities in which they operate.

Competition

To put the competition issue that the ICB grappled with in some perspective, and in sharp contrast to the UK's banking landscape where five banks dominate the sector, there are more than 15,000 financial institutions competing in the US market – around 7,700 banks and 7,600 Credit Unions. Barriers to entry into the sector are relatively low – banks can be set up using off-the-shelf packages – and there is good evidence that the high level of competition in the US market has stimulated lending. The majority of banks are independent, locally owned and operated institutions with assets ranging from less than $10 million to multi-billion dollar institutions.

Another model with a distinctly local aspect is the German Sparkassen network comprising 431 locally controlled banks with public interest criteria in their governing constitutions.[6] In the UK, more than 80 per cent of mortgages are in the hands of the top five banks, as is more than 90 per cent of SME accounts. In comparison, 70 per cent of the German banking sector is in small or community banks (Sparkassen), serving a tightly defined geographic market. Similarly, in Switzerland there are 24 Cantonal banks which explicitly recognise both social and economic responsibility towards their customers, employees and sponsoring cantons.

Germany

In Germany, Sparkassen, are regulated by a set of federal and regional government rules around local and regional banks that obliges them to invest primarily in local businesses. They answer the issue of scale economies and accessing finance at a competitive rate by acting as a group, providing mutual insurance and pooling certain financial services, such as leasing and factoring. Their combined balance sheet is over €1 trillion, and they have more than 15,600 branches and 248,000 employees.

A 'dual' bottom line orientation means they give regard to their financial position and their public legal obligations, and they do not invest in high-risk investment activities or proprietary trading: the emphasis is on 'plain vanilla' banking, offering a simple range of savings and loan products.

The tight geographical role of the Sparkassen is critical to the German model as most lending to German SMEs comes from these sources. Devolved decision making coupled with a high degree of autonomy allows the branches the freedom to use their expert local knowledge to make their lending decisions.

While in the past Sparkassen have been criticised for the low rates of returns on investments, this turned out to be its strength when economic conditions declined. Both German and Swiss local banks remained profitable and continued lending throughout the financial crisis, while large banks made losses and contracted lending. Figures 4, 5 and 6 provide evidence of the benefits of this kind of bank and from the graphs we show the return on capital and credit provision in German and Swiss banks over the period of the banking crisis.[7] They reflect the over-riding feature of the Sparkassen: that they are a prudently managed public interest institution, offering a range of 'plain vanilla' financial products with explicit social as well as economic objectives.

Figure 3: German Banks – Return on Capital: Profit after tax as a percentage of the average capital shown on the balance sheet

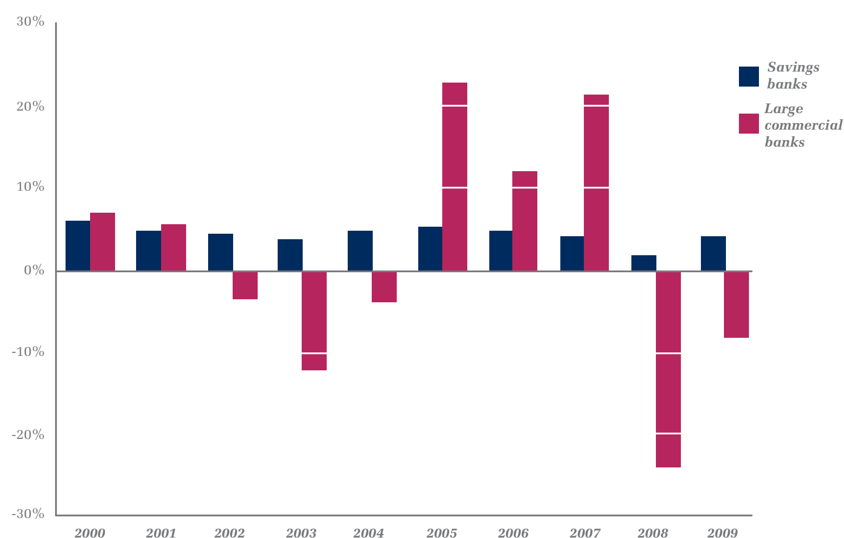


Figure 4: German Banks – Credit Provision: Change in annual lending compared with the year to June 2008

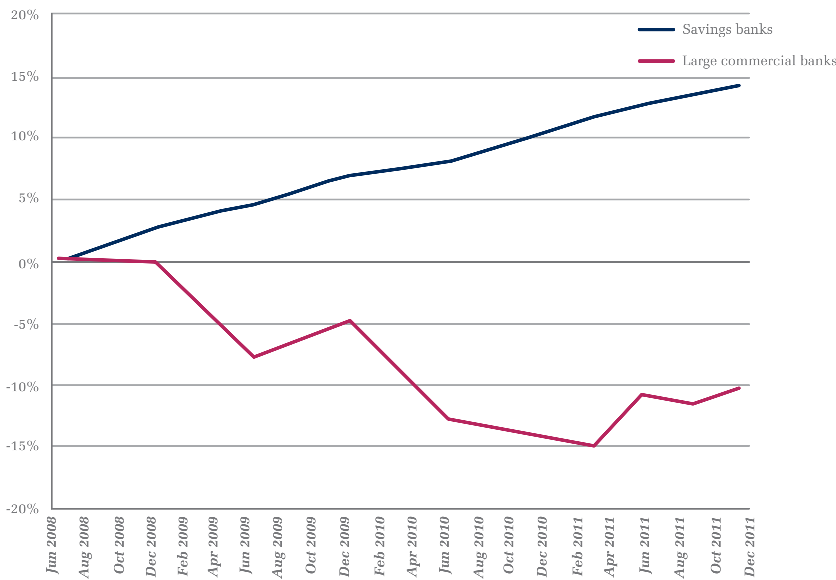
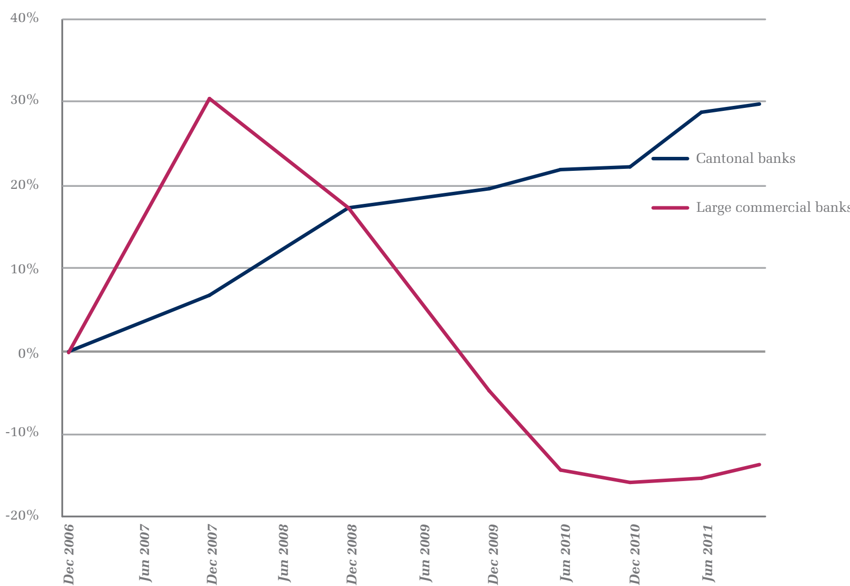


Figure 5: Swiss Banks – Credit Provision



Source: **nef** graphs based on Civitas report "German savings banks and Swiss cantonal banks, lessons for the UK" by Stephen L. Clarke, 2010

In both these examples, there is a stable line throughout the period that is represented by small banks. In contrast, the large international commercial banks such as Deutsche Bank and Credit Suisse demonstrate volatile returns on capital, and rapid credit expansion followed by equally rapid credit withdrawal from the economy. The key point about these graphs is that the performance of the large international German and Swiss banks are analogous to the performance of the UK's big banks, and is largely driven by the search for high returns, achieved in part through wholesale banking activities and the attendant risks that involves but also their approach to lending to business.

Crucially, the UK entirely lacks a sector can that produce the stable lines of steady but moderate profitability, and careful and gradual credit expansion provided by these local banking sectors. It is this feature of the German banking model that is attractive. By eschewing riskier forms of investment, the investment decisions and overall business mission of these local banks has sheltered small businesses (and individuals) from the worst effects of the global financial storms.

A further key feature is that the Sparkassen are resolutely focussed on serving the local area; lending decisions are made at the local level. The branch manager has the authority to back his or her judgement – the absence of which is a common complaint of small businesses in the UK. By being linked to the fortunes of the local economy it provides a clear incentive to back and nurture new business ventures and stay with customers for the long-term, even if times are tough. If the local economy

prospers, so does the bank, and the local economy's strength is reflected in the wide range of sizes of banks from the Hamburger Sparkasse with total assets of nearly €38 billion and 5,500 employees in 2009 to the smallest one, Stadtsparkasse Bad Sachsa, with around €130 million of assets and 45 employees.

It is true that the German banking system is not without its problems. The seven regional banks, or Landesbanken, did get into trouble during the last decade after the European Commission forced the withdrawal of state guarantees from the sector in 2005. Chasing increased short-term profit to offset this withdrawal, some invested heavily in structured credit products (ironically originating from the US) which went toxic in 2008. It would also be surprising if the prudent Sparkassen were to escape completely unscathed from the global economic situation faced by its personal and business customers. However, they still represent a stability and usefulness to the real economy that is almost entirely lacking in the UK.

The United States of America

The US provides a contrasting model which nonetheless offers some further insights into how the UK banking market could be reformed. An overview of the sector once again makes the contrast clear with the highly concentrated UK market:

- Nearly half the deposits in the USA are lodged in small banks, which control approximately $1.4 trillion assets.
- The 6,700 local banks have loans worth $257 billion invested in small businesses and farms.
- The four biggest US banks have $5.4 trillion in assets (40% of the US total) but only $85 billion in small business loans[8] – evidence which suggests that big banks are not as well adapted to meeting the needs of the small business sector.

These assets are likely to grow given the way that small banks are rising up the political agenda at state level. New Mexico passed legislation in 2010 requiring the state to shift public assets into banks based in the state, in order to make that money available for lending to local businesses. Similar proposals have emerged in places like Oregon and Los Angeles.[9]

The reason for this political interest is that it is increasingly clear that smaller banks are more effective at creating jobs. They are also a vital conduit through which the SBA distributes its various Government backed loan products that have played an important role in ensuring small firms have been able to access to finance and play their part in restoring economic growth (see Box 2).

Transparency and the Community Reinvestment Act

A key feature of the US banking market is transparency and the disclosure of how much money stays in a local bank, and how much leaves to be deployed elsewhere in

Box 2: The SBA and access to finance

The network of local banks provides a conduit for the American (SBA) to administer its loans. The SBA guarantees against default, certain portions of business loans made by banks and other lenders that conform to its guidelines. Credit facilities are made on more generous terms than those normally offered by banks, meaning some businesses are able to borrow more than they otherwise would. Financial institutions do however need to act prudently: loans are not generally available for firms with bad credit history.

Accredited financial intermediaries (and not just banks) help dispense the two main forms of Government-backed finance. There is a further element for micro loans, generally valued between $35,000 and $50,000.

The 7(a) Loan Guarantee Program helps businesses to start up or expand their businesses, and is made available through bank and non-bank lending institutions.

The 504 Fixed Asset Financing Program is administered through non-profit Certified Development Companies throughout the country. This program provides funding for the purchase or construction of real estate and/or the purchase of business equipment/machinery. Of the total project costs, a lender must provide 50 per cent of the financing. A Certified Development Company provides up to 40 per cent of the financing through a 100 per cent SBA-guaranteed debenture, and the applicant provides approximately 10 per cent of the financing.

Box 3: How the CRA works

The CRA monitors the level of lending, investments, and services in low and moderate income communities excluded or under-served by the mainstream financial sector. The legislation requires regular examination and grading of a lending institution's activities in poorer communities. It has penalty mechanisms in place, including barring merger activity if a lender is neglecting its community by extracting deposits without reinvesting through loans and branch presence.

Evidence suggests that the CRA has driven the growth of CDFIs in the US, and that a vibrant CDFI sector can effectively complete the jigsaw of private sector finance in areas where both small businesses and individuals are underserved.

Arguments that the CRA helped to cause the sub-prime crisis in the US are refuted by evidence which in fact enhances the case for the CRA, revealing it as part of the solution to responsible and sustainable lending practices rather than part of the problem.

By entrenching principles of transparency and fairness in the banking system and tackling financial exclusion for individuals and small enterprises, the CRA can thereby ensure fuller participation in economic life and enhanced opportunities for disadvantaged communities and so simultaneously promote social justice and economic efficiency.

the banking group. Though this transparency is achieved by different means in Germany, the results are the same: customers have a clear idea how their money is being used by the financial institution. Box 3 examines evidence from the US about the impact of disclosure by looking at the impact of the Community Reinvestment Act (CRA).

In the UK, it is not possible to assess the performance of the UK banking sector in serving geographical markets, or the different types of customer within those markets, though some banks have taken the laudable step of publishing some useful data, such as Barclays in its *Corporate and Social Responsibility Report*, but in general the information is not available.

If a customer in Newcastle were to ask the question, *"In which bank can I put my savings and be sure that they will most benefit my local economy?"* it would be impossible to find the answer.

This is unsatisfactory for two reasons. First, one of the core principles of an efficient and effective free market is transparency and information. This puts power in the hands of the customer (and indeed the voter). Second, the retail banking sector is unique in its importance to the health of local economies. It can act as a siphon, draining capital out of already marginalised communities, or it can act as a pump primer, invigorating a local economy with investment and basic financial infrastructure. If we can see which is happening then there is a possibility of change for the better.

State banks

There has also been increasing interest in the idea of state banks, like the Bank of North Dakota.[10] The Bank of North Dakota was set up in 1919 – the same year that Neville Chamberlain launched the Birmingham Municipal Savings Bank along similar lines – in response to a wave of farm foreclosures at the hands of out-of-state Wall Street banks. It is profit making, and has contributed over $300 million in dividends to the state's finances over the past decade. The main role of the bank is to partner with local banks to provide the loan finance for small business lending on specific deals.

Its lending portfolio of $2.8 billion is mainly these participation loans, which allow local banks to make more loans. That is why North Dakota has 35 per cent more local banks than South Dakota and four times the US average.[11] There have been no local bank failures since 2008 in North Dakota, and no bank in the state has more than 10 per cent of local deposits – the existence of a powerful 'partnership bank' has succeeded in underpinning a diverse banking system.[12]

Other states are planning similar institutions. Oregon, Washington and Massachusetts introduced bills in their state legislatures in January 2012 to launch their own state banks. Maryland has followed suit since. Illinois, Hawaii and Virginia are

already looking into the idea. Virginia has gone even further, giving itself the power to issue its own currency in the event that the Federal Reserve defaults.

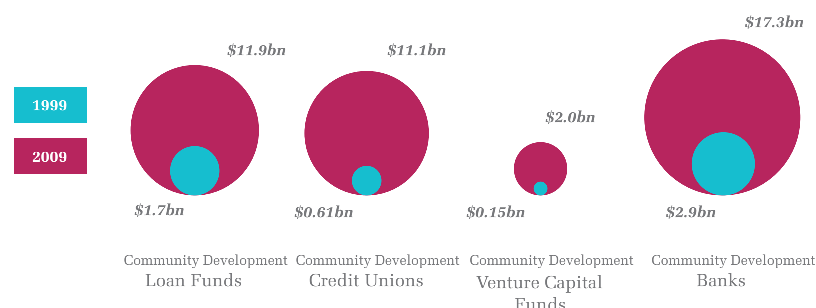
Community Development Finance Institutions

The Community Development Finance Institutions (CDFI) sector in the US has $30 billion in assets, serving low-income communities, both inner city and rural, with a specific remit for serving people who are financially excluded. The sector includes mainly community development banks and credit unions, which are involved with both lending and investing. There are also some community development loan funds, which finance small businesses, housing and community service organisations, operating usually on a not-for-profit basis, as well as community development venture funds.

The growth of the sector is again linked to the CRA, which laid duties on all financial institutions to lend in neighborhoods where they were prepared to accept deposits. After 1995, the resources to CDFIs were boosted because investment in CDFIs qualified as community reinvestment under amendments to the law.

The various structures for community investment in the US help to leverage private investment of many multiples of the injections of federal money thereby effectively 'filling in the gaps' of solely private provision. (US CDFIs also demonstrated lower default rates on loans to sub-prime borrowers than larger banks, indicating more responsible lending practices).[13] Further boosts have been given

Figure 6: Growth in US Community Finance Assets (1999-2009)



Source: US SIF - The Forum for Sustainable and Responsible Investment, 2010 Trends Report

to the sector since 1995. A major injection of $100 million came from the Federal Government into the CDFI fund in 2009. Designed for lending on, the evidence suggests that this had been achieved within 90 days. This year, a further $300 million will go into the sector from the fund to support small businesses.

The US community finance sector is 10 to 15 years ahead of the development of similar institutions in the UK, and the expansion in the US over the past decade gives some indication of the potential here if the right policies and investment structure are put in place in the UK (Figure 6). This is examined further in Chapter three.

What can we learn?

Though they take contrasting approaches, and there are difficulties in taking their experience and transplanting it wholesale into the UK context, both the US and Germany have been successful in maintaining credit flow to small businesses. For example, between 2007 and 2010, there was a 24 per cent fall in the number of successful loan applications made by SMEs in the UK compared to a nine per cent fall in Germany over the same time period.[14] Similarly, in the US, the SBA raised its small business loans in 2010. Signs such as these suggest other countries have a model more effective in distributing credit to small firms than the UK.

Some themes emerge in the report, which explain why that might be the case, including:

- **The effects of competition**. As recognised by the ICB report, the UK banking market is highly concentrated with high barriers to entry. In contrast, entry into the US retail banking sector is relatively straightforward, thereby increasing competition. Similarly, the more regulated German model has a much lower level of market concentration.

- **The benefits of a local banking network**. In both the US and especially Germany, where the Sparkassen market is geographically defined, banks have a strong local focus. Banks' performance is often linked directly to their local economy.

Box 4: Recommendations for further banking reform

- Once the banks are on a firm financial footing, the Government should consider ways to develop a more local banking structure, building on and using the existing framework of the taxpayer-owned banks. The benefit of a local banking structure, with decision makers close to their customers, is a key strength of both the US and German banking models.

- The Government should also consider how it might help create ‘plain vanilla’ financial institutions not beholden to their shareholders and returns on capital but with a wider set of public obligations. Again, the German Sparkassen is a model that could be considered. Similar objectives could be reflected in the terms of a UK banking licence.

- In the short-term, the Government should introduce a UK Community Reinvestment Act to increase transparency in the sector, and help direct credit to where it is needed most. Consumers and businesses can then see the extent to which their banks are using deposits to serve the needs of local markets.

- A bolder step would be to consider the creation of the UK’s own Small Business Administration, similar to that of the United States. A UK institution would then be charged with developing loan products suited to the needs of small businesses, and provide a distribution mechanism to help get finance to small businesses.

- **Transparency**. In the US, financial institutions are obliged to reveal the amount of money they keep in their local areas under the terms of the Community. Reinvestment Act. Similarly, the boardroom structure of the German banks with stakeholder representation achieves similar results.

- **Investment approach.** In Germany, the dual focus of regional banks on both their financial position and their wider social role has meant lower rates of return on capital but delivered greater stability and long-term support for small businesses – attributes small firms value highly.

- **An active state role.** In the US, the SBA has used the wide network of local financial institutions to distribute quickly SBA loan programmes for small businesses as part of its recovery strategy. Similarly, the German Sparkassen has played a critical role in keeping credit flowing to small firms through the credit crisis.

- **A small business administration.** Alongside its banking structure, an important further element in the US model is the role of its SBA to develop and tailor Government backed loan products for small firms, and to orchestrate their distribution through the banking network.

3. Non-Bank Channels

Introduction

When the Government announced credit easing in 2011, it described this as a route to make loans cheaper to small businesses through the banks. It also said that they would be looking at options to provide finance to providers in areas such as leasing, online platforms and other viable routes. As the experience of the US has shown, well-targeted public interventions can leverage significant private funding for institutions such as CDFIs and the FSB welcomed this approach.

This chapter looks at a number of small business funding models operating in the UK and elsewhere, to see where opportunities for growth are and where Government can help boost these business models. These examples are not unrealistic nor are they outside of the principle of competition as recommended by the ICB, or the policy tool of credit easing. In accessing which models we have described below, the FSB chose working models which can be scaled-up and those with a proven track record in supplying finance to small businesses.

The options which the FSB has chosen are:

- Community development finance institutions
- Business-to-business credit
- Peer-to-peer lending
- Business angels and small business private equity
- Asset finance and leasing
- SME debt bonds

The FSB did consider other options for non-bank channels but did not include those in this document as they proved either too risky in the use of public finance, or unachievable. These included items such as crowd funding and regional stock exchanges, along with dismantling the state owned banks through UK Financial Investments Limited. The options which are discussed and the recommendations are practical and currently operational.

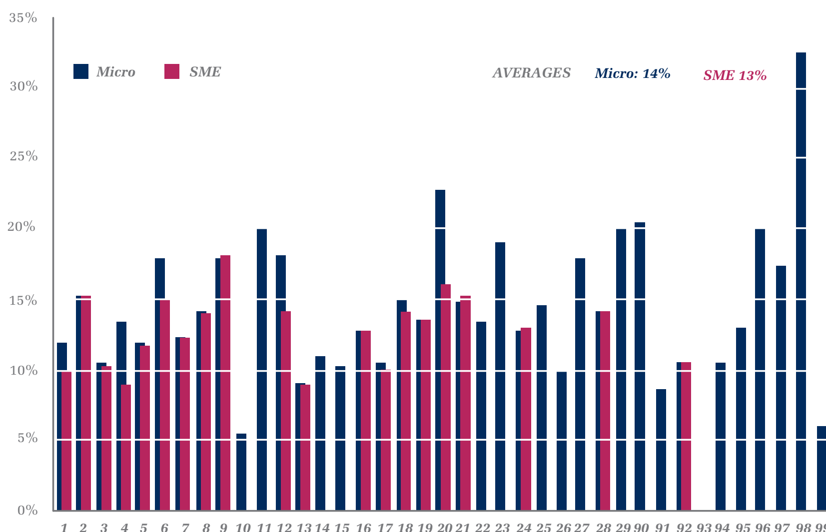
Community Development Finance Institutions

CDFI's are social enterprises which operate in all regions of the UK. Their main objective is to target finance at a non-exploitative rates to underserved markets that are unable to secure mainstream finance. As Chapter two showed, it is a long-established institution in the lending and savings market in the US. One of the beneficial aspects of CDFIs is the willingness to lend to micro and start-up businesses, which are facing a particular problem in the current climate.[15]

As CDFIs lend in specialist areas and sectors, they are able to serve a section of the business community that often finds it hard to access finance, namely start-ups as well as areas of deprivation. Business start-ups are often categorised as higher risk for banks and as such, CDFIs can play an important part in filling this gap.

Research conducted by the CDFA demonstrated the role CDFI's have played in these challenging areas. It found that between March 2011 and early 2012, CDFIs provided 1,500 loans worth £23 million and created and protected 1,350 UK businesses and nearly 6,000 jobs.

Figure 7: CDFA Annual member survey 2010/2011, CDFA (bars represent each CDFI)



Demand for loans from CDFIs has outstripped supply, reflecting the difficulties some businesses have had in sourcing finance from bank sources. Instead of being the last resort, CDFI is becoming the first choice asking the question whether more could be done to stimulate this market to meet demand.

Additionally, many CDFIs plug a mentoring capacity to develop the skills of business people and the knowledge base of the owners into loans for small businesses and start-ups. This in turn makes the investment slightly less risky, however, it is still predicated on a sound business model.

Anecdotal evidence from FSB members and from the CDFA highlights that the cost of finance through this model can be more expensive than bank finance (Figure 7). Though the cost of money reflects the risk, CDFI loans are for businesses that have been rejected by the high street banks or unable to raise the finance or security from elsewhere – it adds to the case that Government funding, as seen in the US, could bring down the cost of capital for these businesses who are often starting-up and operating in challenging environments.

In comparison to the US, the CDFI movement in the UK is much smaller, even when data is adjusted for the size of its economy.[16] Some of this can be represented by the Community Development Banks which do not exist in the UK, and Community Development Credit Unions, which are not considered part of the business finance portfolio of the UK. But even discounting the contribution of Community Development Banks

Box 5: Recommendations for CDFIs

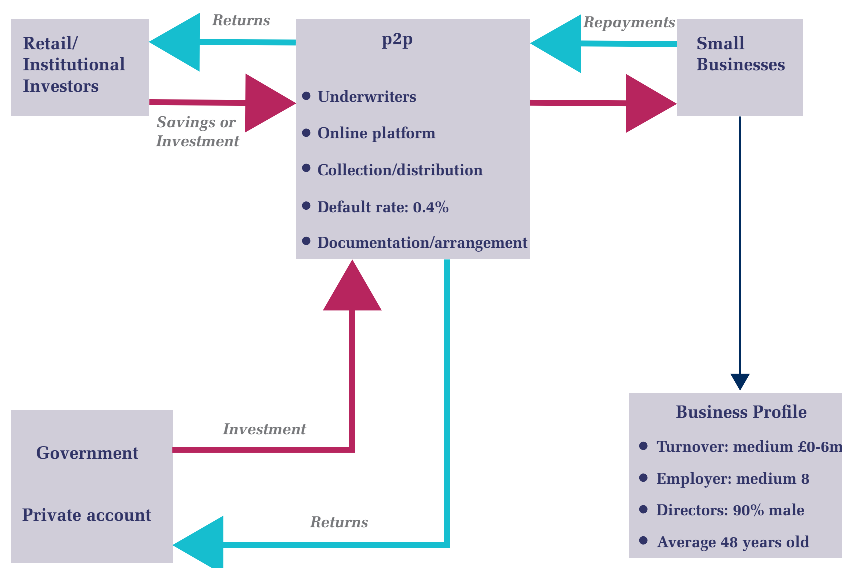
- Responsibility for CDFIs is currently somewhat unclear and fragmented, with different government departments (BIS, DWP, OCS) responsible for different aspects. The Government should identify one department which co-ordinates community development finance. The FSB and the industry body, the Community Development Finance Association (CFDA), suggest it should be HM Treasury. CDFIs need to be brought into the mainstream. Currently there is an ad hoc referral scheme from local banks. If CDFIs are to grow and expand, a formal referral route, as outlined in the Project Merlin agreement, should be implemented.

- The Government should look to the US experience, and see how best to use public resources to help these institutions expand and lower the cost of capital for those starting-up and operating businesses in less advantaged areas.

- Further, the FSB recommends the Government to review and consult on a Community Reinvestment Act in the UK to see how that might support the development of the UK CDFI community.

- When affordable, well-targeted tax incentives could help boost the sector. The FSB is pleased that the Government is looking at the Community Investments Tax Relief and hopes any reforms will go some way to change the behaviour of investors.

Figure 8: Peer-to-peer lending and possible Government involvement



and Credit Unions, the Community Development Loan Funds and Community Development Venture Capital Funds still account for £2 billion in outstanding loan portfolio compared to £273.6 million in the case of the UK.

Peer-to-Peer Lending

Of all the finance models in the UK, this is the newest and can be seen as one of the most innovative methods of both raising capital and investing. While problems remain in this model (start-up companies cannot access finance through it), many businesses now see this model as a tool to entirely remove the banking structure from debt books.

Funding Circle, RateSetter and Zopa are the major operators in this market. They have increased their business by attracting greater numbers of investors and small firms, and acting as the channel to bring those to groups together. As of December 2011, Funding Circle had lent nearly £20 million to 480 small businesses, and 42 per cent was of growth finance (investment, additional staff, etc).

The step-change that is needed for it to become a model that can address the supply side (i.e. investors) to meet the demand (from small businesses) is where the Government can use the principles of increasing competition and the tool of credit easing to promote these models. An example of Government intervention is shown in Figure 8.

Government intervention to boost this business model is an option as stated by HM Treasury:

"In addition to its intention to invest through managed funds, HM Treasury will also consider the potential to invest through other non-bank lending channels. This could include providers of alternative types of finance (such an invoice financing and leasing), and non-traditional lending relationships (such as online platforms, and other ways of directly accessing investors)."[17]

The figure above shows a simplistic illustration of how peer-to-peer organisations work and their relationship with both investors and small businesses, and a possible route for Government involvement. Investment from the Government in these areas would replicate the public/private relationship that is occurring in

Box 6: Recommendations for peer-to-peer lenders

- The Government and regulators must show the future importance of this funding model by fully engaging the p2p Finance Association along with the players in this market. This should start by bringing these players into a fully recognised regulatory environment that would help them attract a greater number of institutional investors to meet the demand from small businesses.

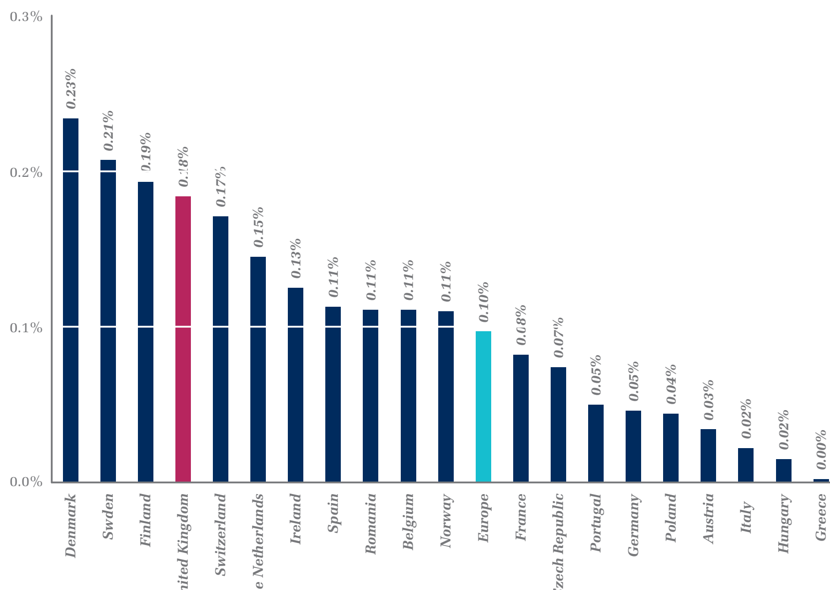
- Once within the regulatory environment, the Government should create investor accounts in the peer-to-peer firms that lend to small businesses and use this as an alternative route to the banks under the credit easing umbrella. This type of intervention would fit into the ICB recommendation of increasing competition within the SME credit market and also help increase the scale of this model.

the Business Finance Partnership and previous equity schemes.

To establish scale in this market, the Government could therefore consider creating its own investor accounts in the recognised peer-to-peer funders. As such, the Government can decide the risk profile of the firms it wants to invest in (or it can be done through Government agencies such as Capital for Enterprise, or by private funds) and will provide a level of confidence to leverage funds from other retail investors. Government should then use a simple dividend-invest mentality and keep investing through the account.

As stated, this model does not at the moment support start-up financing – businesses need a credit history to apply for funds. For peer-to-peer lenders to reach their full capacity as disruptive business models, they need to bring these businesses into the fold, as well as offering more diversified financing which helps cash-flow. However, even with these small shortfalls, the model is well-liked by businesses that use this as a source of finance, and for investors looking for returns.

Figure 9: Venture capital deals as proportion of GDP, 2007 (EVCA Yearbook 2008)



Private Equity and Business Angels

The UK has a thriving business angel community and leads Europe in terms of the amount of SME venture capital raised. In terms of venture capital deals as a proportion of GDP in 2007, the UK is above the European level and achieves the fourth highest scale of venture capital activity of any European country (see Figure 9).

It is important for policy makers to understand that from a business perspective there is difference in terms of value and perception between venture capital and business angel finance. For many small businesses they are comfortable with business angels and know the networks around the country. They are also aware that business angel finance often brings with it an experience level and soft-mentoring process which is not always available through venture capital finance.

While this form of finance is not right for all small businesses the Government should continue looking into this area for additional growth and promotion to the UK SME sector. Research conducted by the City of Lending[18] shows that the few firms that currently take advantage of this model of finance produce a larger weight of job creation and profits than less entrepreneurial start-up businesses.

Moves by the Government to stimulate lending through the Seed Enterprise Investment Scheme (SEIS) are welcomed as is the capital gains holiday for the financial year 2012–2013. The FSB recommends that policy is reviewed regularly in this area, especially after the one year grace period of capital gains received though the SEIS.[19] If this proves a successful policy item and changes behaviour among investors – in terms of initial investing and action on profits – it should be considered as a permanent reduction. The review should also look at the extent to which small businesses are promoting themselves through the SEIS.

The FSB would like to see a greater Government emphasis on this form of finance for specific sectors (as the Danish Copenhagen Cleantech Cluster[20]), and additional research by BIS to ascertain a fuller picture of the business angel environment in the UK. While the sector remains strong, clear data and trends are needed for policy shifts.

Box 7: Recommendations for business angels

- The FSB recommends that greater research is carried out into business angels as data is hard to compile, mainly due to the varied network of business angel networks and ad-hoc providers. Without such research, policy shifts will be hard to define.
- The new Seed Enterprise Investment Scheme is a beneficial move and the one-year capital gains holiday should be made permanent if it proves successful at increasing deals, and the re-investment of profits in new deals which benefit small businesses.
- It is also important that businesses that have the potential to access and benefit from this type of finance should be targeted in terms of advice. This can be done through more work being done by provider networks, business groups and the Government. It is important that the benefits are shown, as well as the pre-application work (becoming 'investment ready') and the funding profile needed over a period of time.

Asset finance and leasing

Asset finance is the provision of finance to businesses and public sectors for fixed capital investment, and accounts for a quarter of all UK fixed capital investment. It is used by around one in three small businesses with any external borrowing. Around 750,000 small businesses are currently relying on it to some extent. Finance is used to buy or rent equipment through hire purchase and leasing, on longer agreements than many bank loans to purchase capital equipment such as plant and machinery, technology and vehicles.

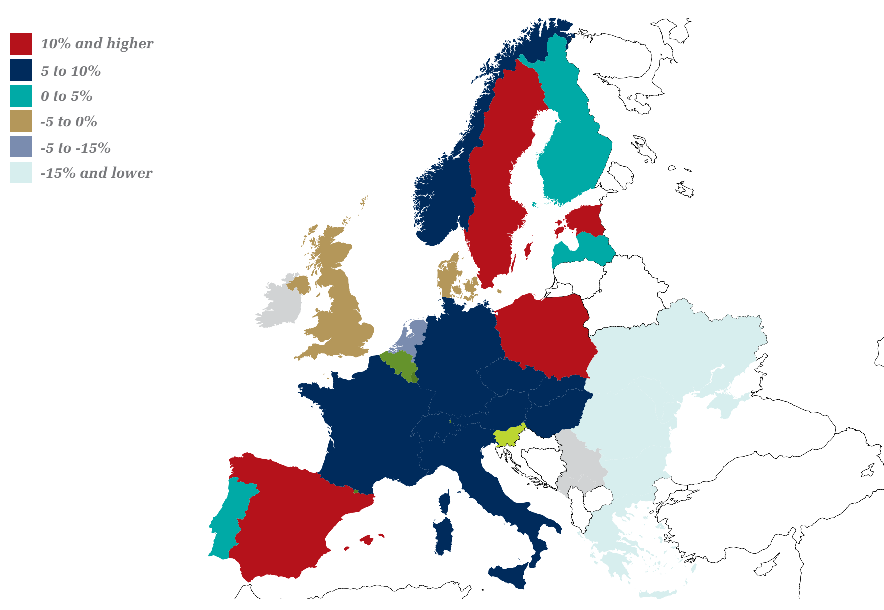
The attractiveness of asset finance is that it is more predictable. Asset finance agreements will not be cancelled by lenders (due to the structure and contractual nature of deals), which helps all businesses, especially those with limited capital. A further key benefit of this finance form is the method of security. Usually the credit line is secured entirely on the back of the asset being leased rather than any other business or personal asset.

Across Western Europe, leasing is a growth area for SME financing. However, as Figure 10 shows, new leasing business in the UK is contracting (2010).[21]

This should be of concern for UK policy makers as leasing is an ideal method of business investment and will help SMEs who want to build in flexibility to their debt finance and asset purchase strategy. This means should be an attractive alternative to bank finance, and while the rate of success by application has decreased, from only one per cent being declined in 2007 to the current seven per cent now, success rates are higher compared to standard bank loans.

An additional concern for non-bank asset finance organisations is the complex and shifting tax system. Changes to the tax system, including the lower rate of capital allowances, the 'long-funding' lease rules, and especially the introduction of time-

Figure 10: New leasing growth rates by country 2010 (source: Leaseurope)



Box 8: Recommendations for asset backed finance

- Asset backed finance needs a greater market penetration and awareness amongst businesses. The Government should look at bringing this finance route into the £1 billion Business Finance Partnership and other Government lending schemes (such as the Enterprise Finance Guarantee).

- More sensitivity is needed when changing the tax system. Changes to the capital allowance rate have had an adverse impact on investors, as has regular changes to the tax system. When relevant changes to the tax system take place, impact assessments should reflect this in the future.

apportionment of capital allowances in 2008, have further impacted adversely on the cash-flow of independents, making it harder to grow the business.

SME Debt Bond Market

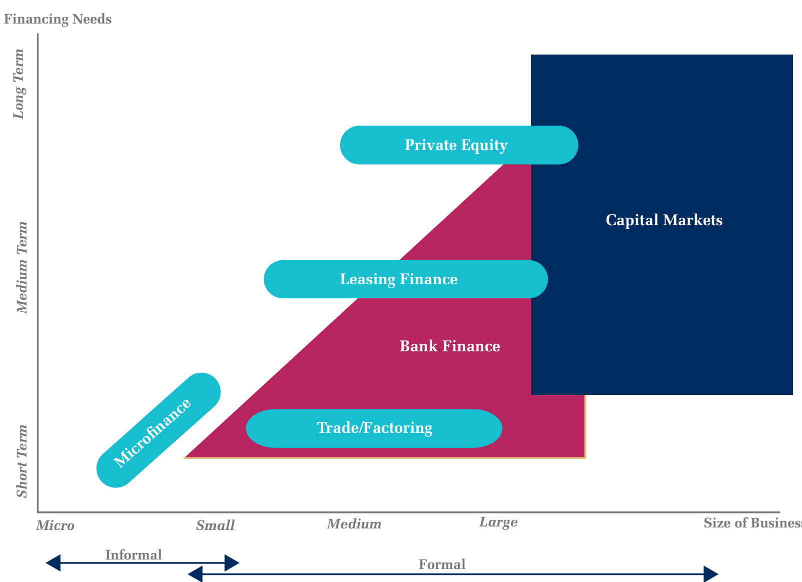
The FSB understands the reticence of many small businesses and start-ups to draw equity finance and reduce the ownership structure. However, for a minority of small firms with a need for greater funding and an eye on growth, Recognised Investment Exchanges (RIEs) can be an attractive route to issue shares. They also offer the potential for small business bonds.

The FSB would now like the Government to explore an imaginative, but very realistic route for small firms to access the capital markets through RIEs.

The benefit for small businesses that have high growth potential and a strong entrepreneurial spirit would be to access finance through investors while retaining full ownership of the business. The benefit for investors, over the tax incentives which already exist, is a diversification of portfolio and potential rates of return above the standard rate.

The FSB suggests that this would be appealing for small businesses as it removes one of the barriers of equity finance. While the capital markets and private equity remain open to large and larger medium businesses, smaller firms with the attributes of high growth potential remain locked out. A proposition which allows small businesses to raise sums of £250,000 and above would fill the funding gap for micro and small businesses that need investment grade finance for the mid to long-term (see Figure 11).

Figure 11: Forms of finance and firm size



To make a small business debt bond work, the Government could use the same mechanism for credit easing – using its AAA credit rating to lower the cost of borrowing – to guarantee a portion of an individual debt bond, or a bundle of debt bonds. The bundles of debt bonds can be issued by region or by sector and may prove attractive for specific investors who have experience of preference when investing.

As such, a market does not currently run in the UK. To test the viability of this business model, one option could be to run a pilot with a recognised RIE that has experience in the small business community. As no new licence from the FSA would be required, a pilot scheme would be easily set up (in a matter of weeks from the discussions the FSB has had with one RIE). As with the bank route of cheaper finance, credit easing could be used to reduce the risk to investors through an enhanced credit rating on the debt bond or bundle. While appreciating the commercial realism for investors and a privately-owned RIE, a bundle

Box 9: Recommendations for a SME debt bond market

- To evaluate the viability of an SME bond market, the Government should put in place a pilot scheme to see the demand and supply from small businesses and investors for an SME bond and its operational viability. This could be done quickly using existing FSA licensed RIEs.
- The Treasury should use credit easing to enhance the credit rating worthiness of singular debt bonds or of bundles of bonds issued by small firms.
- If the pilot is successful and the relationship between credit easing and the RIE works on a basis of full transparency, the same offering by the Government should be extended to the entire RIE network in the UK.

mechanism would allow firms to raise smaller levels of finance than single-issue debt bonds.

Mutual credit schemes and complementary currencies

Invoice factoring is not the only way that small companies can release cash from their outstanding debtors. There are various ways in which SMEs can create mutual liquidity using their invoices, of which perhaps the longest running example is the Swiss WIR. This was founded in Zurich in 1934 in response to the difficulty that many smaller companies experienced in obtaining working capital finance from banks. It currently has 60,000 members and made CHW 1.627 billion in transactions in 2010. It is a not-for-profit organisation. According to the co-operative's statutes

"Its purpose is to encourage participating members to put their buying power at each other's disposal and keep it circulating within their ranks, thereby providing members with additional sales volume."

The WIR operates effectively as a complementary currency system, with businesses able to trade with one another using WIR credits alongside Swiss Francs. The credit is issued by the Co-operative WIR Bank in just the same way as a standard loan but at zero or very low rates of interest and can be used for settlement between all participating SME members. Originally these WIR credits were effectively mutually accepted IOUs based on trust. However, as the scheme grew, businesses were required to provide collateral to back their WIR. Businesses that are willing to accept WIR are listed in a directory, and academic research has concluded that the currency is highly counter-cyclical.[22] In other words, use of the currency increases during recessions whereas bank finance tends to contract at the down stage of the economic cycle.

A large scale scheme is currently being introduced in Uruguay with the backing of the Government, The Commercial Credit Circuit (C3).[23] The Uruguayan C3 (commercial credit circuit) model involves monetising small firms' invoices to enhance their liquidity. The credits can be spent with all other participating SMEs and are accepted in lieu of taxes by the Government and utility payments by national energy suppliers. (The tax office, the national pension fund and several important companies offering electricity, gas, housing, telephone and internet-services are all members of the scheme).

Such schemes are analogous to large multi-national companies with many trading subsidiaries. The subsidiary companies in the group do not need cash to trade with one another – the inter-company accounting system maintained by the group can net off debtors and creditors within the system without requiring each subsidiary to access potentially expensive bank credit to finance their working capital.

Box 10: Recommendations for mutual credit schemes

- Though it has been in operation for some time, the Swiss invoice factoring model is little known in the UK. Nonetheless, the evidence shows it can offer benefits for small businesses. The Government should therefore examine what, if any, barriers there are to this form of finance in the UK and to consider if there is an opportunity for large institutions to support their foundation.

4. Conclusions

The background to this paper has been the FSB's longstanding interest in finance, and the ability of our members and other small businesses to access finance on reasonable terms. The credit crunch of 2008 raised questions about the structure of the UK banking sector, including the level of competition in an area dominated by a few large players, and the general issue of how small firms accessed finance to support their activities.

Many of the systemic issues highlighted by the credit crisis and subsequent Government intervention to support the UK's major banks have been addressed by the ICB's report, which put forward a range of recommendations. The Government adopted these recommendations in full, something the FSB strongly supported.

While the ICB has put forward recommendations to increase competition among the high street banks, it is largely predicated on a 'business as usual' model. One of the aims of this report was to look beyond the current banking model, and to see what lessons might be drawn for the UK from the contrasting banking models found in the US and Germany to improve the credit market for small firms in the UK.

The lessons from Germany and the US

Though they take very contrasting approaches, both these countries' models have allowed credit to flow to small businesses even during the economic difficulties of recent years. Between 2007 and 2010, there was a 24 per cent fall in the number of successful loan applications made by SMEs in the UK compared to a nine per cent fall in Germany over the same time period. In 2010, the SBA increased credit to small businesses through its loan programmes.

A number of themes emerged that might have explained the trends lending to small firms, including the local nature of the banking system, the degree of transparency and the investment approach, with the German banks having a wider social remit written into their constitutions, and the discipline of the CRA in the US.

Many of these attributes are not present in the UK's institutional framework. While the ICB's recommendations are welcome, they are unlikely to deliver such benefits, with barriers to entry to the UK banking market remaining high. Other approaches need to be looked at to see if similar benefits can be captured in the UK.

Options for banking reform

With two large banks effectively under public ownership, the Government should look at its shareholdings and consider using them to create models that could deliver the benefits seen in the US and Germany. The FSB appreciates this is a radical option. However, it is hard to see the market producing an outcome that delivers a banking system that answers the needs of small business and certainly not in the immediate future by itself.

The FSB accepts that the immediate focus of the taxpayer-owned banks

is rightly on restoring their financial position; such a restructuring would therefore be for the medium-term. Nonetheless, the FSB believes this should be given serious consideration and for the costs and benefits of adopting this model for UK-plc be thoroughly examined. In the short-term, the FSB can see no reason why a functioning CRA in the UK could not be put in place to shine a light on the provision of banking services at the local level. One option that could be closely examined is to remodel these banks, making their activities geographically defined along the lines of the German Sparkassen, with a similar backing of a large institution with all the scale economies that would bring.

More radically, what comes through from the German and Swiss examples is a counter-argument to the notion that focused and 'plain vanilla' banks do not make commercial sense in modern-day banking. This report highlights that when banks are not beholden to their shareholders and markets, returns on capital can be made and profits enjoyed. A similar approach would run counter to the management model of the UK banks, and may require either ongoing state involvement or legislative changes to reorient the banks' objectives to include wider social goals and an acceptance of lower returns in exchange for supporting a wider range of businesses.

Non-bank finance

This report has shown that there is a suite of alternatives available to small businesses. Many are innovative, reflecting the wealth of financial expertise which the UK has in abundance. Given this position of strength, these alternatives should be expected to flourish as the financial services industry spots new opportunities.

While banking products in the form of overdrafts and loans (both secured and unsecured) remain the main provision of credit to small businesses, the FSB expects other options for small business to become more widely available: leasing for machines and vehicles; CDFI's; business angel networks; or innovative 'disruptive' business models such as peer-to-peer lenders who bring the investor and the credit seeker together.

What is needed to achieve that goal is for policy makers to be bold and imaginative in their approach, and put in place reforms that bring these models into the mainstream, and bring about a behavioural shift among small businesses. To do so, the report has highlighted a number of ideas to boost these non-bank routes to finance, and to provide a further element of competition and innovation in the small business market. Many either have no or low cost, or money has already been identified.

The FSB hopes these thoughts and recommendations are a helpful addition to the debate around small business finance, and will be reflected in the review being undertaken by Tim Breedon of Legal and General, who has been tasked with looking at alternative finance by BIS. Our hope is that the review will bring forward clear and tangible policy moves to increase the scale of alternative forms of finance in the years to come, and that these currently 'alternative' forms of finance will become mainstream and widely available to micro and small firms.

"Given this position of strength, these alternatives should be expected to flourish as the financial services industry spots new opportunities"

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Glossary

FSB	Federation of Small Businesses
nef	New Economics Foundation
SME	Small and medium sized enterprises
ICB	Independent Commission on Banking
SBA	Small Business Administration
DWP	Department for Work and Pensions
HMT	Her Majesties Treasury
BIS	Department for Business, Innovation and Skills
CDFA	Community Development Finance Association
CDFI	Community Development Finance Institutions
FSA	Financial Services Authority
RIE	Recognised Investment Exchange
ONS	Office for National Statistics
CRA	Community Reinvestment Act
GDP	Gross domestic product
EVCA	European Private Equity and Venture Capital Association
SEIS	Seed Entperprise Investment Scheme
EFG	Enterprise Finance Guarantee
CHW and WIR	Alternative complimentary Swiss currency

Federation of Small Businesses

The UK's Leading Business Organisation

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