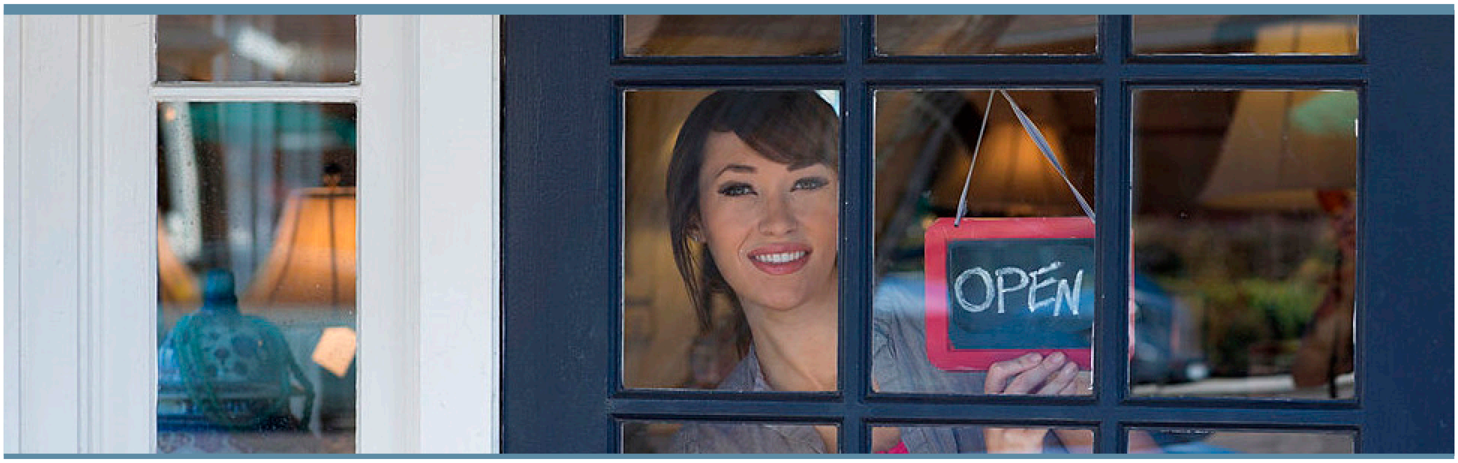

Executive Insights

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Funding the U.K.'s Growth Engine: Four Ways to Close the SME Lending Gap

Small and medium-size enterprises (SMEs) are a critical part of the U.K. economy, representing 99.9% of private-sector companies and 60% of private sector jobs.[1] However, there is a shortage of financing for such businesses, which is constraining their growth, restricting the U.K.'s ability to compete internationally, and may be damaging the culture of U.K. entrepreneurialism.

This L.E.K. Consulting estimates the lending gap at between £50 billion and £100billion over the economic cycle. While we are not suggesting that all of this gap should be funded — some business ideas, after all, are simply unsound — this is undoubtedly a very substantial problem.

The shortfall stems, at least in part, from an unwillingness by banks to back SMEs, especially smaller SMEs and startups. High operating costs and sometimes hard-to-predict loan losses have convinced many banks that lending to these types of SMEs can be a low-return or even unprofitable activity (See Figure1). Furthermore, the problem is unevenly distributed across sectors of the economy and geographically, with businesses in the government's so-called "Northern Powerhouse" especially short of financing options. A key issue is that the U.K.'s commercially operated banks, especially larger banks, lack the specific (micro-) sector knowledge and access to consistent, high-quality underwriting information to provide unsecured lending to small businesses on a profitable basis, and lack the incentives to address these issues.

This paper sets out four potential interventions for tackling the lending gap.

The economics of SME lending

Banks' reluctance to lend to SMEs comes down to simple economics: the potential cost outweighs the likely benefits. In other words, when considered in terms of profit and loss, the projected interest margins from lending look insufficient compared with bank operating costs such as branches and staff, capital costs of meeting regulated capital requirements and hard-to-predict amounts of loan loss. If banks cannot see a worthwhile profit in lending to SMEs, taking into account the risks, they will not do so. This explains why the government telling banks just to "do more" is unlikely to solve the problem — banks are not being "difficult"; they are simply acting rationally in line with their objectives and interests.

If SMEs are to continue to fuel the U.K. economy, a different approach is needed. L.E.K. has identified four potential solutions which, in combination, could help to reduce the lending shortfall. In considering these solutions, we have found it useful to bear in mind an indicative P&L for an institution lending to smaller or early-stage SMEs. Many institutions consider RoI and / or RoE frameworks for a similar purpose, but we find the P&L method simpler to relate to potential "real life" actions to help address the problem identified here (see Figure 1).

[1]Confederation of British Industry

Funding the U.K.'s Growth Engine: Four Ways to Close the SME Lending Gap was written by **Diogo Silva** and **Peter Ward**, Partners in L.E.K. Consulting's Financial Services practice, and **Robert Wild**, a Consultant. Diogo, Peter and Robert are based in London.

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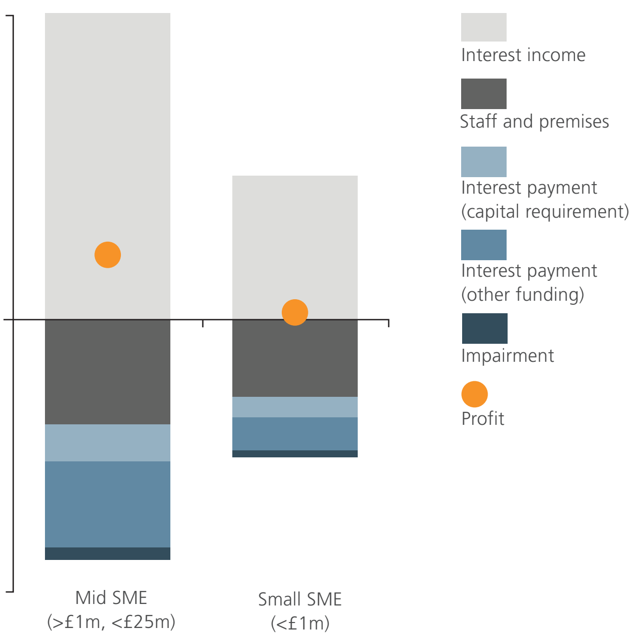
Figure 1
Illustrative P&L for SME lending by size of SME



Source: L.E.K. analysis

Schematically, this P&L shows that the balance between income and costs is out of kilter. Our solutions focus on addressing the individual components of income and costs to redress this imbalance.

Solution 1: Reducing operating expenses

Banks could release funds for SME financing by using technology to reduce the cost to serve. First and foremost, cost per customer acquisition is a problem for small and early-stage SME lending. Harvard Business School research identifies that underwriting and set-up costs for micro-SMEs are no smaller than for larger SMEs; for example, it costs as much to underwrite a $100,000 loan as a $1 million loan and the same result in time for the U.K.[2] Given the smaller borrowing requirements and hence revenue from smaller businesses, the process of getting started can be uneconomical. In this context, the recent retail banking market investigation by the Competition and Markets Authority and the European Commission's revised directive on payment services (PSD2) have made recommendations that could radically improve the quality of information available to banks, reduce the effort needed for underwriting activity, and help with lowering loan losses (see Solution 3).

Private-sector technology groups and start-ups are already creating opportunities in this area, and some big banks outside the U.K., such as Spain's BBVA, have begun to invest in innovative financial technology in an effort to improve services.

[2] "State of Small Business Lending: Credit Access During the Recovery and How Technology May Change the Game", July 2014

Solution 2: Capital cost reduction

The government and / or U.K. and European regulators could provide additional incentives for banks to finance SMEs and start-ups by reducing capital weightings and hence capital costs for this type of lending. Currently, SME lending faces varying risk weightings, and there is no SME-specific risk weighting. The European Banking Authority has introduced a supporting factor to help reduce the capital requirements for SME lending, and this is likely to reduce the burden, though it is unclear whether the adjustment factor is sufficient. Capital weightings, however, must accurately represent the risks against which capital is held, and regulators should maintain a prudent and balanced approach to mitigating against irresponsible risk-taking by banks.

Solution 3: Tackling loan losses

As described above, bad loans are a significant concern for lenders to small businesses and entrepreneurs, but there are ways of mitigating the risks, and banks should ensure they take full advantage of the options on offer.

First, better quality information could help banks to minimise loan losses, and the type of painstakingly gathered experience required to underwrite specific micro-segments is becoming more accessible to sophisticated generalists. The combination of intervention discussed in solution 1 and investment in digital data gathering, including behavioral information, by the more tech-savvy banks and non-bank lenders, is helping them to improve their understanding of customers.

Second, guarantees are available for lenders to help them minimize their losses through the U.K.'s Enterprise Finance Guarantee (EFG) initiative. Launched in 2009, the scheme provides lenders with a government-backed guarantee for 75% of the value of each individual loan. A range of funding options are covered (including new term loans, revolving facilities, invoice finance facilities, term loans for debt consolidation or refinancing and trade credit guarantees), and almost all business sectors are eligible on loans of between £1,000 and £1.2 million. While the government provides a guarantee to the lender, it has no role in the decision-making process and is not party to the agreement between the borrowing business and the lender. Banks can thus operate according to their own policies and business priorities, with the benefit of the safety net provided by the EFG.

Solution 4: Take a much wider perspective — U.K. plc

The solutions outlined above could prove effective in making a greater part of the "universe" of smaller and early-stage SME lending viable for banks. However, given the scale of the problem, we expect that more radical measures will be required to address a large proportion of the shortfall.

As discussed above, in current circumstances, addressing some aspects of the lending gap is simply not viable for commercially run lending institutions. Yet if the shortfall is considered more broadly, in the context of the U.K. economy as a whole, we believe there is an argument for stronger government support.

Some support is already available. For example, the British Business Bank, launched in 2014, is a step in the right direction, but its funding commitment of £225m is insufficient to address the £50 billion-£100 billion problem, even taking into account the indirect impact of third-party funding it enables. However, other models of government support do exist that are proven to have the scale to successfully address the issue.

A solution that creates a bank across “U.K. plc” would share the operating costs and losses, either between banks or between the banks and government. Funding small and early-stage SMEs may often be loss-making from a short-term, lending-only perspective. However, from a whole U.K. perspective, taking into account external benefits such as higher employment and increased tax revenues, in addition to the lending activity, the SME lending profit-and-loss balance starts to look very different, and businesses that may ultimately be successful and profitable on a long-run basis can rationally be funded through the early loss-making stages. In a situation where such a bank has government support, higher losses can also be taken in downturns in the business cycle to ensure U.K. plc maintains the SME sector and jobs the U.K. requires.

The U.K. created one of the first SME funding institutions, the Industrial and Commercial Finance Corporation (ICFC), which ran from 1945 until 1987. At the time, it was the U.K.’s largest provider of growth capital for SMEs and was seen as a highly successful and profitable enterprise. However the ICFC is now better known in its FTSE-listed form as 3i, the venture capital group, and in this new guise its purpose and activities have changed, and it no longer performs the same function for the U.K. is now

International best practice for business development banking

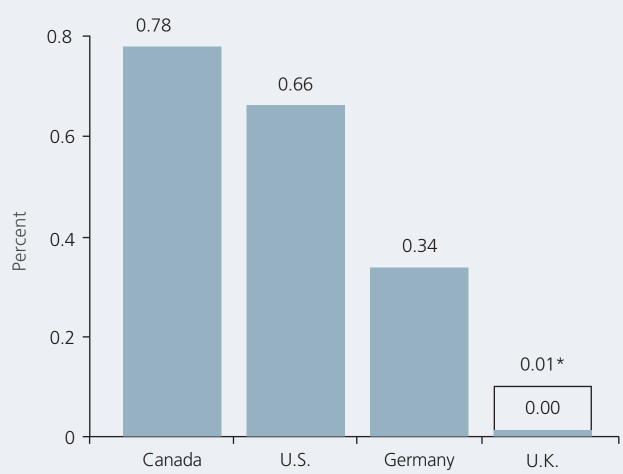
Best practice in business development banking involves direct and local participation in funding of SMEs, underpinned by advisory and educational services. Successful examples include the U.S. Small Business Administration, Germany’s KfW Group (formerly Kreditanstalt für Wiederaufbau, or the Reconstruction Credit Institute) and Business Development Bank of Canada (BDC).

The BDC supports Canadian SMEs both via debt (C$18.4 billion) and venture capital investment (C$690 million) to create an estimated impact of C$75 billion. The Canadian government currently funds C$15 billion or about £7.5 billion of outstanding loans compared with the British Business Bank’s remit of about £225 million — that is roughly 33 times greater than the U.K. contribution from an economy half the size of the U.K. (see Figure 2).

The BDC was founded as the Industrial Development

Bank in 1944, an arm of the Bank of Canada, with a view to providing loans for converting heavy industry back to peace-time operations as the Second World War came to an end. Its vision is to be “dedicated exclusively to Canadian entrepreneurs,” going on to state that “ambitious and innovative entrepreneurs are the engine of our economy, and it is our role, as Canada’s development bank, to help them succeed.” It offers direct lending to SMEs with no prepayment penalties, filling the private sector gap. The government is the most active venture capital investor in Canada, involved in 15% of all transactions. The BDC is willing and able to take longer-term investments in small firms. It also provides SMEs with market intelligence and digital marketing, as well as a range of consulting services.

Figure 2
Debt lending allocations to SMEs, 2014 / 15, in Canada, U.S., Germany and U.K.



	Canada	U.S.	Germany	U.K.
Debt lending equivalent to local GDP (£bn)	14.6	12.3	6.3	0.2

Note: *BBB ambition by 2018; in 2018, comparators will be higher
Source: World Bank data, 2014; Government websites; L.E.K. analysis

better known in its FTSE-listed form as 3i, the venture capital group, though in this new guise its purpose and activities have changed, and it no longer performs the same function for the U.K.

Using the original ICFC model and a range of international best-practice comparators for inspiration (see "International Best Practice for Business Development Banking" on page 4), L.E.K. believes that a new SME lending institution, backed by a consortium of private businesses, including major banks, either with or without additional support from the government, could close a substantial part of the SME lending gap within 10 to12 years.

Actions for lenders to the SME sector and their investors

In order to adopt all or part of these potential solutions, banks should take action or increase their focus in a number of specific areas:

- Invest to reduce cost to serve. Financial institutions need to be nimble and invest in platforms that reduce the cost to serve their smaller clients.
- Lobby for a different methodology to assess risk in SME lending. This methodology should take into account the longer-term returns and benefits of this type of lending and allow for a smaller amount of capital requirement (within reasonable prudential limits).
- Invest in tech-enabled data gathering to add accuracy to underwriting processes, but avoiding the costs and activities of the "traditional" hard-won experience gathering process.
- Lobby for extended guarantees on the loans made to small businesses.
- Consider collaborating create, or lobbying for the creation of, a form of ICFC, possibly a form of ICFC, possibly working with the government to create a government-supported ICFC equivalent, which would allow for longer-term thinking on SME investments.

Likewise, investors in the space should be looking to identify and back assets focusing on these areas.

The SME sector is fundamental to the growth and prosperity of the U.K. economy, and lenders have a crucial role to play in providing the finance that smaller businesses and entrepreneurs so desperately need. We believe that our four proposed solutions can together make an important contribution to funding growth in the U.K. SME sector.

About the Authors

Diogo Silva is a Partner in L.E.K.'s London office. He began his L.E.K. career in 2006, having completed an MBA at INSEAD. Diogo left in 2010 to join Barclays, where he held roles in the COO office of the Investment Bank and also in Group Treasury. Since re-joining L.E.K. he has focused almost exclusively in the financial services sector, specifically in retail and corporate banking, payment services, specialist lending and asset and wealth management.

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About L.E.K. Consulting

L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and rigorous analysis to help business leaders achieve practical results with real impact. We are uncompromising in our approach to helping clients consistently make better decisions, deliver improved business performance and create greater shareholder returns. The firm advises and supports global companies that are leaders in their industries — including the largest private and public sector organizations, private equity firms and emerging entrepreneurial businesses. Founded more than 30 years ago, L.E.K. employs more than 1,200 professionals across the Americas, Asia-Pacific and Europe. For more information, go to www.lek.com.

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