CREDIT WHERE CREDIT'S DUE

Small businesses and the need for external finance for investment and growth

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Experts in Business

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WHO WE ARE

The Federation of Small Businesses (FSB) is a non-profit making, grassroots and non-party political business organisation that represents members in every community across the UK. Set up in 1974, we are the authoritative voice on policy issues affecting the UK's 5.5 million small businesses, micro businesses and the self-employed.

Our lobbying arm starts with the work of our team in Westminster, which focuses on UK and England policy issues. Further to this, our expert teams in Glasgow, Cardiff and Belfast work with Governments, elected members and decision-makers in Scotland, Wales and Northern Ireland.

CREDIT WHERE CREDIT'S DUE

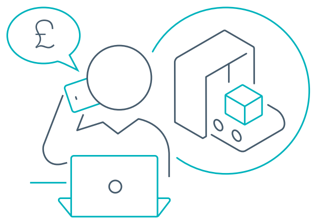
Small businesses and the need for external finance for investment and growth

Just **37%**

of small firms find the **application process** for traditional loans easy

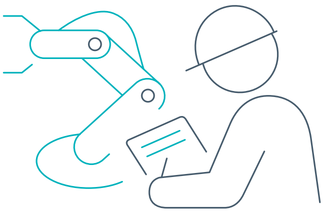
59%

of all small businesses have **applied for external finance** over the last five years



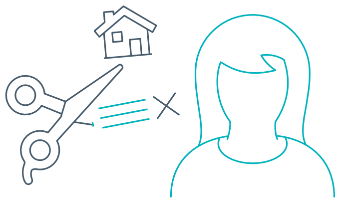
70%

of manufacturing small firms have **applied for finance** over the last five years



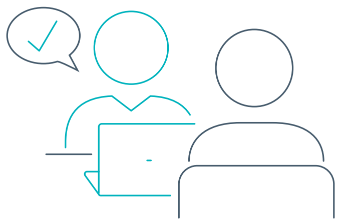
1 in 4

small businesses in **manufacturing** had **planned to invest in R&D** within the next 24 months



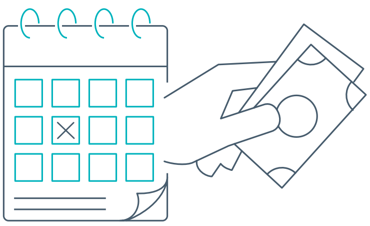
19%

of **women business owners** say they have been **rejected for a mortgage** in comparison to 10% of men



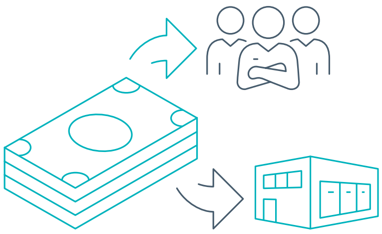
Less than **1 in 3**

small business owners find it easy to **speak to the right people** to get help with their **financial applications**



84%

of small businesses agree **funds are delivered in a reasonable time** once approved



66%

of small businesses **planned to invest** over the next two years

22%

of small businesses had **green investment plans** over the next 24 months

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FOREWORD

Small businesses disproportionately rely on external finance for their business operations, cashflow, and investment opportunities. By virtue of their size, these are not businesses that often have capital available to expand and invest without outside funding. Given the recent economic turmoil of the pandemic, Russia's invasion of Ukraine, the stagnating of the economy, and inflationary pressures, there is a risk that the UK financial market may begin squeezing lending to small businesses, reminiscent of the period following the 2008 financial crash.

As we approach 2023, small businesses are inundated with debt that is holding back economic growth and will take years to fully repay. This is not evenly distributed, with the small businesses in sectors more adversely affected by the lockdown measures having accrued greater proportions of relative debt. This unprecedented level of debt is something that both the Government and financial institutions will need to keep in the forefront of their decision making as it will dictate the rate at which demand for external finance and debt changes over the short term for small businesses.

The vast majority of the UK's business population is small, and no one-size-fits-all approach to finance will be appropriate. The greater the diversity of lenders and financial products in the market, the more efficiently the market will operate. However, awareness of financial products and lenders is a limiting factor – the average small business owner is not a finance expert, and the myriad complex options can be overwhelming.

Access to finance is crucial to increase small business investment. There is now a very low concentration of small businesses planning green investments over the short term despite the need to shift businesses towards the net zero target. This may be driven by the fact that many green investments have a very long-term financial return on investment and when evaluating options in light of the current economic turmoil, businesses will be prioritising shorter-term growth initiatives or cash savings. To improve progress towards net zero, the Government needs to incentivise investments in this area.

An emerging concern around small business access to finance is the success rate of applications. Since the peak in success rates during the pandemic in mid-2020, the rate of success has halved, with our own Small Business Index data showing it falling to an all-time low of just two-fifths of applications. However, the low success rate alone does not adequately demonstrate the variety of obstacles small businesses face when applying for different forms of finance.

Small businesses have difficulty acquiring finance for a variety of reasons, and the form the finance takes also plays a big part – traditional bank loans, despite being commonly associated with small business finance, are considered the second-most difficult to acquire, ahead of only equity. The primary reason for difficulties accessing different forms of finance is due to application processes being too long and the inability to speak to anyone about the process itself.

Small businesses need Government support to improve this access. The Government should expand and encourage uptake of programmes like the Bank Referral Scheme, expand access to British Business Bank-backed loans, and deliver on its 2019 manifesto promises to improve the Business Banking Resolution Service. It is vital that the credit tap doesn't turn off in the same way it did following the financial crash.

Robin Abrams

FSB, Finance and Banking Policy Champion

KEY FINDINGS

Access to finance

- Small businesses rely primarily on traditional debt finance. Of those that have applied for finance over the past five years:
    - 72 per cent applied for UK Covid loans
    - 37 per cent applied for overdraft facilities
    - 19 per cent applied for credit cards
    - 14 per cent applied for asset finance
    - 13 per cent applied for traditional bank loans.
- Only a small minority applied for alternative forms of finance, including:
    - equity (4%)
    - start-up loans (3%)
    - trade finance (1%).
- Success of small business finance applications varies by form applied for:
    - Coronavirus business loans schemes had the greatest success rates at 97 per cent – this was likely driven by the streamlined application process in place for Bounce Back Loans
    - Applications for credit cards, asset finance and invoice financing all had success rates of 90 per cent or higher (95%, 94% and 90% respectively)
    - The forms of finance with the lowest success rates were equity (47%), start-up loans (66%), and traditional bank loans (68%).
- Some forms of finance are considered much easier to apply for and acquire than others:
    - The easiest type was Covid loans (77% net easy)
    - The most difficult form of finance to apply for was equity – only 29 per cent found applying easy
    - The primary reason for difficulty across the various types was the length of application (62%), the inability to speak to anyone to explain the process (36%), and the application requiring information the individual could not access (26%).
- Small business views on financial applications:
    - Only two-fifths (38%) of small businesses agreed that they could easily find the answers to questions they had
    - Three in ten (29%) felt that there were provisions and clauses included in the application that were unfair
    - Nearly half (49%) felt fully aware of the different types of financing options available to their business.

Small business investment

- Two thirds of all small businesses (66%) planned some form of investment within two years:
  - 37 per cent planned to invest in capital expenditure, purchasing, upgrading, or replacing old plant and machinery
  - 28 per cent planned to invest in software, cloud computing and data services
  - 28 per cent planned to invest in training schemes
  - Only 22 per cent had plans to invest in green initiatives despite the central focus on the environment.

RECOMMENDATIONS

Banking

- The British Business Bank should encourage the use of the Bank Referral Scheme, and expand the number of banks and approved alternative lenders in the scheme. (p.18)
- The Small and Medium Sized Enterprise Finance Charter should be expanded, and uptake should be encouraged for all lenders with significant SME portfolios. (p.19)
- The Financial Conduct Authority should reverse the minimum fees and levies increase outlined in the CP21/33 consultation and re-instate a progressive fee system. (p.19)
- A set of Key Performance Indicators should be created for Banking Hubs that will replace closed bank branches in communities, with data published monthly to assess their effectiveness as alternatives to financial institutions for small businesses. (p.20)
- The Start Up Loans scheme should be expanded from 11,000 to 15,000 loans per year. (p.44)
- The Prudential Regulation Authority should not seek to implement policies as part of its implementation of Basel III standards in the UK, which seek to impose additional capital requirements on banks which subsequently affect funding to SMEs. (p.20)
- The Government needs to deliver on its 2019 manifesto pledge to improve self-employed people's access to mortgages. (p.21)
- The Business Banking Resolution Service needs to adequately address outstanding cases and clear its backlog, passing on compensation and delivering value for money. The deadline for historic cases also needs to be extended beyond February 2023. (p.21)

Business investment incentives

- The Government should reverse direction from its announcement on Research and Development tax credits at the Autumn Statement that will seriously reduce SME R&D in the UK economy. (p.32)
- The Government should simplify the existing SME R&D tax relief scheme, so it is easier for small businesses to apply directly or through their usual accountants rather than using specialised intermediaries, and cap intermediaries' payment share to 25% of the relief received. (p.32)

- All future capital allowances should include second-hand capital purchases to allow small businesses to offset the cost of upgrading their machinery without the requirement of the asset being new. (p.32)
- The Government should introduce a VAT-based capital investment incentive, to drive up the amount of small business investment in a faster, simpler way rather than the outgoing big business-friendly super deduction. (p.33)
- The UK Government should make clear it is removing the sunset clause of 2026 within the Seed Enterprise Investment Scheme to provide greater certainty and longevity to investment plans, and uprate the investment limit with inflation each year. (p.54)

Business ecosystem

- The Treasury should review the processes by which small businesses acquire finance from the main high street lenders and identify areas where the process can be streamlined. (p.18)
- Companies House should add an ethnicity field to the annual registration process and include additional questions as part of the Management and Expectations Survey. (p.45)
- The Department for Business, Energy and Industrial Strategy (BEIS) should introduce a Help to Grow Bitesize for all micro-businesses and sole traders which includes a selection of optional modules. (p.44)
- BEIS should amend formal Financial Reporting Council guidance, or legislate, to give audit committees oversight of payment practices, along with a duty to report on payment practices within annual reports. (p.33)
- BEIS should set up a ‘Help to Green’ initiative, to issue £5,000 vouchers for businesses to spend on qualifying energy saving-products and services, a suggestion supported by the Institute of Directors and the Confederation of British Industry. (p.34)
- The Government and the Financial Conduct Authority should work with industry leaders to address barriers that disproportionately affect women-owned businesses when trying to access certain financial products. (p.44)

THE SMALL BUSINESS FINANCE MARKET

Small businesses are heavily reliant on external finance for their business operations, cashflow, development of products and general investment. As a function of their size, small businesses rarely have the capital in-house to be able to invest and grow without external funding, which is what makes the small business finance market so vital. Given small businesses' importance to the UK economy, as drivers of employment, income, and innovation, we need to create an environment where all small businesses are able to access finance and understand exactly what it is they're signing up to.

Small businesses frequently struggle to acquire adequate finance at an affordable rate and are often at the whim of lenders as to what extent credit will be offered. Small businesses, rightly or wrongly, are generally considered riskier to lend to and often experience a 'squeeze' in ability to access finance during times of economic turmoil.

FSB's *Small Business Index* (SBI) shows that of those small firms that applied for finance, the share who were successful peaked in quarter two of 2020 at 81 per cent of applications being successful. This, of course, was inflated by the introduction of the Coronavirus Business Interruption Loan Scheme (CBILS) and Bounce Back Loan Scheme (BBLS).

Since the pandemic, the success of SME finance applications has declined significantly, with 46 per cent of small firms being successful in Q3 2022. For context, the pre-Covid success rate trend between Q4 2014 and Q4 2019 was 64 per cent; almost 50 per cent higher than rates seen now.[1] FSB research shows that the smaller the business, the less likely it is to be approved when applying for credit.

Bank lending

During the financial crash there was a steep decline in net lending to all businesses in the UK, falling from a year-on-year increase in lending of 19 per cent in January 2007 to a year-on-year net lending decrease of -4 per cent by March 2010 where annual change in lending remained negative until September 2015, i.e. a persistent period of reduced lending (Figure 1).

FSB analysis of data from the Bank of England shows that the net lending year-on-year change to SMEs shows a more negative trend than the *All Businesses* trend, i.e. smaller businesses faced a harsher decline in available finance from April 2012 to January 2020. Likewise, when the year-on-year financing began to grow for large businesses from 2015 onwards, the rate of increase for SME lending was much lower.

1 FSB, FSB Voice of Small Business Index, Quarter 1, 2022, May 2022 https://www.fsb.org.uk/resource-report/sbi-q1-2022.html

Recent Bank of England data shows that the volume of lending has declined following the large expansion during the pandemic because of BBLS and CBILS, where £47.4 billion and £26.4 billion were lent respectively.[2] CBILS provided financial support to smaller businesses affected by loss of revenue as a result of the pandemic. BBLS was designed to enable smaller businesses to access finance more rapidly. FSB lobbied continuously during the pandemic for this support, including speeding up the application process for small firms.

> **"The Bounce Back Loan Scheme stopped us going bankrupt. We invested everything into our business and could have lost it all if not for the loan. When Covid hit, our business stopped and cashflow disappeared; we only expected it to last six months. We took out a full loan and used our existing overdraft to help us through the pandemic. We are now out the other side and can go from strength to strength – it was a very clever idea that saved our business. Our business didn't qualify for other targeted support aside from the furlough scheme, so the loan really saved us.**
>
> **As with any rushed interventions, it was a bit topsy-turvy when it was launched, but once we were through to the application, the whole process was very quick and easy. Pay As You Grow has been excellent too, really allowing us the flexibility to manage repayments without being too painful on our cashflow. The Covid finance really did help to save a lot of businesses that would have gone to the wall otherwise."**
>
> Terry McArdle, Hest Bank Kennels, North West

2 HM Treasury, HM Treasury coronavirus (COVID-19) business loan scheme statistics, July 2021, https://www.gov.uk/government/collections/hm-treasury-coronavirus-covid-19-business-loan-scheme-statistics

The impact of Covid loans is visible in Figure 1, with the year-on-year change in net lending spiking to +26.3 per cent in January 2021 before quickly declining to reach a year-on-year change of -5.2 per cent for both March and April 2022. In contrast, net lending to larger businesses has seen a sharp increase since the initial fall, reaching +7.1 per cent in April 2022. This initial negative year-on-year change is to be expected following the end of CBILS and BBLS applications. However, it is our concern that small businesses could be heading towards another period of persistent negative year-on-year financing – another squeeze in the lending environment.

Figure 1: Annual growth of net lending to non-financial businesses[3]

Source: Bank of England, FSB analysis

3 Bank of England, Annual growth of lending to businesses, https://www.bankofengland.co.uk/boeapps/database/fromshowcolumns.asp?Travel=NIxSUx&FromSeries=1&ToSeries=50&DAT=RNG&FD=1&FM=Jan&FY=2012&TD=12&TM=Sep&TY=2022&FNY=&CSVF=TT&html.x=113&html.y=13&C=1PW&C=OC8&C=OCD&Filter=N
Note: SME and Large Business net lending data only begins in April 2012 and is not seasonally adjusted. The "All Businesses" lending is seasonally adjusted.

Business debt

There has also been a drop in demand for debt by small businesses. FSB's SBI highlights this, with only 13 per cent of small businesses having applied for any form of finance in Q3 2022. This includes those applying for non-debt related finance such as seed or angel finance, or venture capital.

The demand for credit has significantly fallen since the Covid peak where 34 per cent had applied in Q2 2020, and remains below the pre-Covid trend of approximately 14 per cent. Many small businesses took on debt for the first time during the Covid pandemic, as outlined in FSB's 2020 report, *A Fighting Chance,*[4] and relative debt burdens remain high.

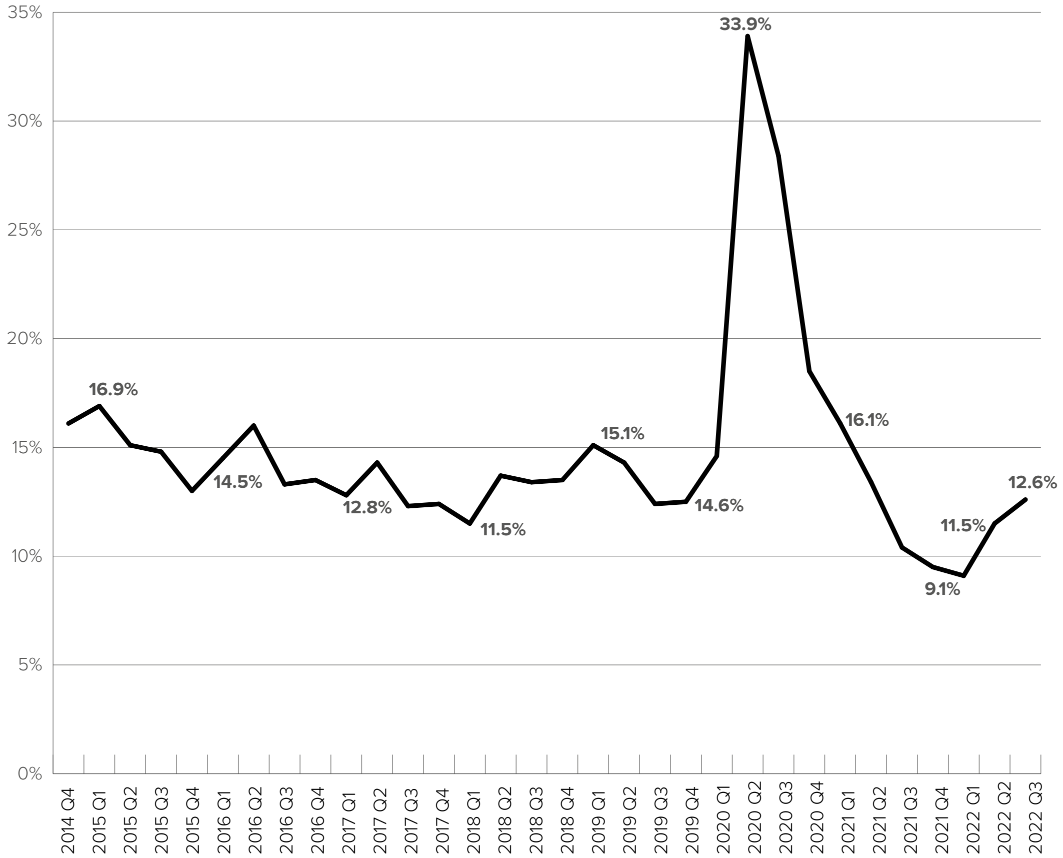
> **"The debt our business took out from Covid loans during the pandemic takes a big chunk of our available cash each month that we could otherwise invest."**
>
> FSB Member, Financial services, South East

Many small businesses face substantial periods of repayments of these debts – six to ten years depending on whether Pay As You Grow has been utilised – and many have much greater liabilities than would otherwise have been the case if not for the economic turmoil of the pandemic. Demand for additional debt or external finance is likely to be subdued by the scale of borrowing, the level of relative debt incurred over the past 24 months, and an uncertain economic outlook. As a result, it seems very likely that over the short term, appetite for borrowing among small businesses will be low.

4 FSB, A Fighting Chance, December 2020, https://www.fsb.org.uk/resources-page/a-fighting-chance-december-2020-pdf.html

Figure 2: Share of small businesses that applied for any form of finance in the previous three months

Source: FSB Small Business Index, Q4 2014 – Q3 2022



As of September 2022, outstanding loans to SMEs are 21.7 per cent greater than in January 2020, equivalent to an additional £36.2 billion of accrued debt.[5] This is up from the pre-pandemic stock of £167.0 billion in January 2020, but down from the peak of £216.0 billion reached in March 2021, as a result of Covid loan repayments kicking in.

5 FSB analysis of Bank of England Money and Credit Statistical Releases, https://www.bankofengland.co.uk/statistics/money-and-credit/2022/september-2022

"Many small businesses have been pushed into a position of drawing down their pensions to pay off the debt they've accumulated across the pandemic, the results of Brexit, and the cost-of-living crisis. Not only that, but pension pots have also been adversely affected from the economic crises, adding to the financial pressure of retirement plans. This is just the tip of the iceberg as you can imagine but made worse as the high street banks have reduced the advice they offer whilst also closing branches."

FSB member, Finance and mortgage advice, South West

The relative debt burdens also significantly vary sector-to-sector and those most exposed to the headwinds associated with lockdowns and downturns in consumer confidence have taken on the greatest liabilities. SMEs in the wholesale and retail sector, for example, now have on average 42.2 per cent more debt than in January 2020. In pound value terms, the total value of SME debt in the wholesale and retail sector has grown from £14.5 billion in January 2020 to £20.6 billion as of September 2022.

Interest rates

Between 2011 and 2019, the average rate of interest offered to large businesses was 2.41 per cent compared to an average rate of 3.41 per cent offered to SMEs; one percentage point greater, but 42 per cent more expensive on average.[6] There is concern that this may be what small businesses are heading towards now as the base rate is sequentially increased and passed through into commercial interest rates faced by small businesses. Indeed, our own SBI data shows that of those that applied for finance in Q3 of 2022, nearly a third (31%) were offered rates of 10% or more.

Choice and innovation

In the UK there has traditionally been a significant reliance on the 'Big 4' banks. Indeed, in 2021, the 'Big 4' accounted for 67 per cent of all micro-business current accounts.[7] There is a risk that the uniformity of large financial institutions can stifle access to finance for smaller businesses as these lenders typically have similar risk profiles given their positions.

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6 OECD, Financing SMEs and Entrepreneurs: An OECD Scoreboard – United Kingdom, https://stats.oecd.org/Index.aspx?DataSetCode=SMES_SCOREBOARD#

7 FCA, Strategic Review of Retail Banking Business Models – Final Report, January 2022, https://www.fca.org.uk/publication/multi-firm-reviews/strategic-review-retail-banking-business-models-final-report-2022.pdf
Note: FCA categorises micro-businesses as any SME with less than £2 million in turnover.

Despite still accounting for two-thirds of all micro-business accounts, there has been a decline of 9.5 per cent in small business accounts at the Big 4 since 2019. One of the main reasons for this decline has been the growing popularity of digital banking challengers.

In August 2014, the then-Chancellor George Osborne declared his intention to make Britain the global centre of financial innovation:

> *'It's only by harnessing innovations in finance, alongside our existing world class knowledge and skills in financial services, that we'll ensure Britain's financial sector continues to meet the diverse needs of businesses and consumers here and around the globe and create the jobs and growth we all want to see in the future.'*[8]

Following on from this, the Small Business, Enterprise and Employment Act 2015 (SBEEA 2015) and the Small and Medium Sized Business (Finance Platforms) Regulations 2015, SI 2015/1946 were introduced.[9, 10] Combined with the finance platforms, the Bank Referral Scheme was launched in November 2016, with regulations intended to create a mandatory process whereby lenders were required to share details of SMEs they rejected for finance, so those businesses could be approached by alternative lenders.

Of the 45,507 referrals made by banks between Q4 2016 and Q3 2020, only 25,100 contacted an alternative lender – a rate of just 55 per cent. The greater issue, however, is the conversion rate of those referrals. Between Q4 2016 and Q3 2020, the average conversion rate was just 10.3 per cent; however, this has been on a downward trend since Q1 2019, from 17.1 per cent to just 4.7 per cent in Q3 2020.[11]

Our evidence shows that small businesses are still finding it hard to access finance, thus further widening the gap between small businesses and large corporates. The British Business Bank found that the primary reason for choosing a finance provider was the provider being a trusted brand (21%), followed by the lender being the most suitable or appropriate for the business's needs (14%). Only 8 per cent chose their lender based on

8 HM Treasury and The Rt Hon George Osborne, Plan to make Britain global centre of financial innovation set out by government, https://www.gov.uk/government/news/plan-to-make-britain-global-centre-of-financial-innovation-set-out-by-government, 6 August 2014

9 Legislation.Gov.UK, Small Business, Enterprise and Employment Act 2015, https://www.legislation.gov.uk/ukpga/2015/26/contents/enacted/data.htm

10 Legislation.Gov.UK, The Small and Medium Sized Business (Finance Platforms) Regulation 2015, https://www.legislation.gov.uk/uksi/2015/1946/contents/made

11 HM Treasury, Bank Referral Scheme: Official Statistics, December 2020, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/947409/201208_Bank_Referral_Scheme__Official_Statistics.pdf

a pre-existing relationship.[12] Given this, there is significant scope for small businesses to expand their usage of lenders, but an element of trust needs to be gained beforehand. As alternative lenders and challenger banks become more commonplace, it looks likely that the small business financial market will continue to diversify; this is an area the Government should focus on and encourage.

It is estimated that there is an SME funding gap of £22 billion, and that 1.3 million SMEs are in need of external finance. The UK financial market requires innovative solutions for small businesses to better access available finance, be it from traditional high street lenders or alternatives. Technology firm Codat's proposal of an SME Funding Passport, offering a digital file containing the financial data necessary for underwriting in a format that is easily shareable with lenders, presents an opportunity to maximise the scale of applications while minimising the administrative burden for the businesses looking to borrow funds. The Government should explore all available avenues, and utilise the advancements in Open Banking to streamline and improve the access to finance for small businesses.

There is no one-size-fits-all approach to small business financing. Where one financial product may be appropriate for one business, it may be unsuitable for another. The greater the diversity in financial products, stemming from greater diversity in financial institutions, the better the lending market will operate. Small businesses need external finance to invest; having access to a variety of financial products increases the likelihood of finding a product that is best suited to them and hence will bolster investment and growth across the UK economy. However, awareness of financial products and lenders is a cornerstone of this development – the average small business is not an expert in finance and the myriad of complex options can be overwhelming.

12 Ibid.

Recommendations

- **The British Business Bank (BBB) should encourage the use of the Bank Referral Scheme, and expand the number of banks and approved alternative lenders in the scheme.** There are currently only three approved alternative lending platforms that small businesses get referred to if rejected by the nine banks in the scheme. Both sides of the scheme should be widened. All banks with significant small business banking deposits should be part of the scheme – this should include challenger and mid-tier banks. Small businesses tend to rely on their primary bank for finance and if rejected often do not seek alternative sources[13] – if their primary lender is not part of the scheme, these businesses may be left high and dry. Referrals should also be done with minimal delay to increase the likelihood of the business securing the finance.

  On the other side of the scheme, the fact there are only three approved alternative lending platforms (Alternative Business Funding, Funding Options and Funding Xchange[14]) limits the potential availability of the alternative finance market to small businesses. This should be expanded to include other alternative lenders with a range of financial products. Likewise, the scheme should be expanded to Community Development Financial Institutions (CDFIs) that will offer not just alternative finance, but localised finance, advancing the Levelling Up agenda concurrently. Lenders should be able to join the scheme at a minimal cost and should not face disproportionate fees for referring or being referred to. The BBB should also publicise annual figures of referrals and conversions to track the success of the scheme more transparently.

- **HM Treasury (HMT) should review the processes by which small businesses acquire finance from the main high street lenders and identify areas where the process can be streamlined.** The primary barrier raised by small businesses with respect to financial applications was the length of the process (62%) – this is a friction that should be minimised. HMT should conduct a review of the processes, the information required, and the steps small businesses take to apply for and receive finance – this should be done for traditional debt-loans, overdrafts, and asset finance, as the primary forms utilised.

  Understandably, many of the frictions faced by businesses applying for finance will be due to regulatory burdens on the lender's side, such

13 Ibid.
14 British Business Bank, Finance platform referrals – designated platforms, https://www.british-business-bank.co.uk/finance-platform-referrals-designated-platforms/

as complying with anti-money laundering rules. By reviewing all of the practical steps that lenders need to take to comply with regulation, it is likely that the length of application process could be reduced without undermining the regulatory benefits.

If identifiable processes and frictions are discovered, HMT should then work with lenders to create a framework for improvement to aid the pace and ease at which small businesses can acquire finance. This review should be semi-regular, occurring every five years to ensure that the application processes are as streamlined as possible across the range of financial products.

- **The SME Finance Charter[15] should be expanded, and uptake should be encouraged for all lenders with significant SME portfolios.** The SME Finance Charter commits those lenders that sign up to a minimum service to SMEs, and will be incredibly valuable over the next few years following the pandemic and market turmoil the UK has experienced. It already has a significant number of lenders signed up.

  FSB would like to see commitments to the SME Finance Charter made by all mid-tier and challenger banks, which will ensure a uniform level of service to small businesses irrespective of their chosen lender. In the case of Northern Ireland, at the time of writing, three popular lenders have yet to sign up, which leaves a significant gap of commitment to SMEs in Northern Ireland.

- **The Financial Conduct Authority (FCA) should reverse the minimum fees and levies increase outlined in the CP21/33 consultation and re-instate a progressive fee system.** As outlined in the FCA's CP21/33 consultation, businesses with credit-related income will be required to pay £1,100 from 2024 to be regulated under limited consumer credit permission. This is an increase from £106 for those with credit-related income less than £10,000. For those with full authorisation, it is an increase from £318 to £2,200.[16] Importantly, the progressive fee structure which existed in 2020/21 has been replaced by a flat rate which is highly regressive in nature.

  The FCA should immediately cancel these plans to increase the fees and levies in the proposed way. Small businesses are facing an existential cost of doing business crisis and should not be put under further pressure by regulatory fee burdens increasing to a regressive

15 Gov,uk, The SME Finance Charter: what the 5 pledges mean for business, https://www.gov.uk/government/publications/sme-finance-charter/the-sme-finance-charter-what-the-5-pledges-mean-for-business

16 FCA, Regulatory fees and levies: policy proposals for 2022/23, November 2021, https://www.fca.org.uk/publication/consultation/cp21-33.pdf

system. Those who earn more should pay more – a flat fee does not support a competitive market as it drives out competition at the lower end, worsening market outcomes across the economy as a whole.

- **A set of Key Performance Indictors (KPIs) should be created for Banking Hubs, with data on them published monthly to assess their effectiveness as alternatives to financial institutions for small businesses.** Banking Hubs are opening across the country to aid communities that have seen their access to financial institutions and access to cash diminish. Although they cannot fully replace a bank, they do offer local communities financial services, deposits and withdrawal facilities and hence are important substitutes aiding regional growth.

  The Government should continuously monitor and review the success and use of Banking Hubs as they are rolled out, to ensure that they are in fact a suitable alternative for small businesses rather than the business needing to travel greater distances to access the facilities they need. A set of monthly KPIs should be established that include business deposits, business withdrawals, number of bills paid by businesses and number of business owners seeking financial advice. This data should be published each month for every Hub, allowing progress checking and comparison between Hubs.

  Should a particular Banking Hub be underused by small businesses, we would expect an evaluation into why said Hub has not been a suitable alternative to a local bank. The success of this scheme requires continuous monitoring and ensuring that facilities are available across all communities with significant small business populations.

- **The Prudential Regulation Authority (PRA) should not seek to implement policies as part of its implementation of Basel III standards in the UK, which seek to impose additional capital requirements on banks which will subsequently disincentivise funding to SMEs.** The worsening macroeconomic environment and expectation of recession further highlights the importance of regulation which supports economic growth and maintains access to finance for small businesses.

  The SME supporting factor, which reduces capital requirements to 0.7619 for lending to SMEs, aimed to increase lending and alleviate regulatory burden changes that were expected to have a disproportionately negative effect on SME lending levels.[17] It is important that the SME supporting factor is maintained as part of the Basel III

17 European Banking Authority, EBA report on SMES and SME Supporting Factor, Mach 2016, https://www.eba.europa.eu/sites/default/documents/files/documents/10180/1359456/602d5c61-b501-4df9-8c89-71e32ab1bf84/EBA-Op-2016-04%20%20Report%20on%20SMEs%20and%20SME%20supporting%20factor.pdf?retry=1

standards, to ensure that SME financing is not reduced artificially and that small businesses do not struggle to acquire finance as a result of regulatory changes.

- **The Government needs to deliver on its 2019 manifesto pledge to improve self-employed people's access to mortgages.** As laid out in the Conservative manifesto:

  "Supporting enterprise is not just about championing businesses – more people than ever are moving into self-employment, especially women. We will therefore launch a review to explore how we can better support the self-employed. That includes improving their access to finance and credit (not least mortgages), making the tax system easier to navigate, and examining how better broadband can boost homeworking."[18]

  The Government needs to deliver this review, increasing access to finance more broadly but also primarily enabling the self-employed to acquire mortgages. Following the September 2022 Mini-Budget, there was a steep decline in mortgages available on the market and a significant cost increase among remaining products – it is now more difficult to acquire an affordable mortgage. This is especially true for women entrepreneurs, who our own data has shown have a higher rejection rate than men in mortgage applications.

- **The Business Banking Resolution Service (BBRS) needs to adequately address outstanding cases and clear its backlog, passing on compensation and delivering value for money. The deadline for historic cases also needs to be extended beyond February 2023.** As of June 2022, just 22 cases had been determined.[19] This is a miniscule fraction of the 829 total cases registered to the BBRS and highlights the scale of backlog the BBRS is currently facing.

  Small businesses with complaints ought to be reviewed in a timelier fashion, receiving the compensation they are owed. The current speed of progress by the BBRS needs to be improved upon, well before historic cases can be no longer be submitted. The current deadline of February 2023 is too soon and should be extended to allow sufficient time for businesses to submit cases to the BBRS.

18 Conservatives, Conservative Party Manifesto 2019, 2019, https://www.conservatives.com/our-plan/conservative-party-manifesto-2019 p.34.
19 Business Banking Resolution Service, BBRS Quarterly Insight Report, July 2022, https://thebbrs.org/news/bbrs-quarterly-insight-report-july-2022/

SMALL BUSINESS INVESTMENT INTENTIONS

As of 2022 estimates, there are 5.5 million SMEs, accounting for 99.9 per cent of all businesses, contributing £2.1 trillion in turnover and 60 per cent of all UK private sector employment.[20] The SME contribution to the economy cannot be overlooked and by extension, achieving investment goals cannot be done without their contribution; creating a conducive small business investment environment is a key requirement in the post-pandemic economy and in solving the UK's productivity puzzle.

Two-thirds (66%) of small businesses had planned to invest in their business, when asked about their investment intentions over the next 24 months. However, this data was collected in January 2022 prior to the war in Ukraine, the energy crisis, the increase in interest rates and turbulence in financial markets. Therefore, it is likely that since the question was asked, a proportion of the investments which had been planned would have been delayed or cancelled in response to those changes in the business environment.

> **"A lot of businesses are going to get caught in the energy crisis. I'm in the situation where I say, do I invest, or do I not invest? I want to invest because I want to move my business forward to improve my carbon footprint, but with everything going on I'm thinking, do I go ahead with the investment, or do I hang on and see where we're going to go with our energy prices?"**
>
> FSB Member, Food manufacturing, East Midlands

Small businesses located in Yorkshire and the Humber (45%), and the East of England (43%) were the most likely to say they do not have plans to invest. Plans to invest varied quite considerably by sector.

Types of business investment

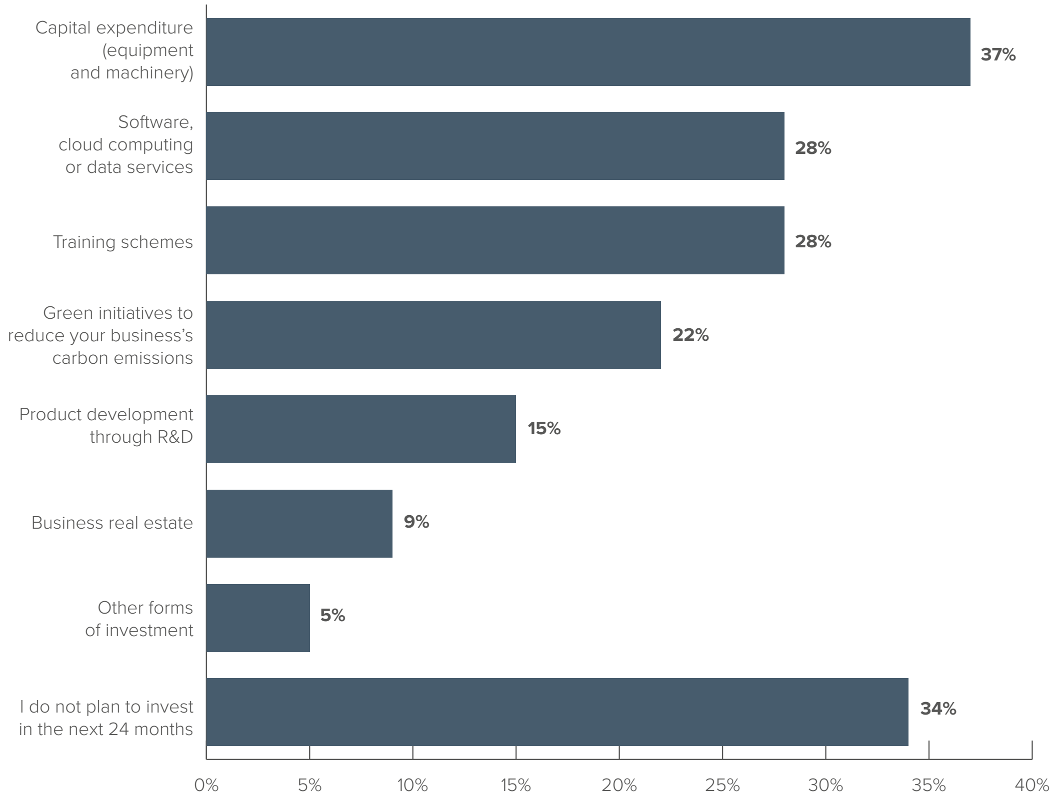
The most common form of planned investment was in capital expenditure (37%). The second most common form of investment planned was in software and digital, non-tangible assets (28%). This may be a consequence of the pandemic which has led to an increase in digital adoption by small firms. FSB's pre-pandemic research on innovation found that "*less than half of small businesses have used cloud services (40%), online data storage or back-up (37%), and File Transfer Protocol (FTP) e.g., Dropbox (33%). Twenty-*

20 BEIS, Business population estimates for the UK and regions 2022: statistical release, October 2022, https://www.gov.uk/government/statistics/business-population-estimates-2022/business-population-estimates-for-the-uk-and-regions-2022-statistical-release-html

nine per cent have adopted a bespoke software or applications."[21] Digital capability helped many businesses to provide or enhance the provision of products during the pandemic, and our evidence suggests that this has translated into investment goals.

Figure 3: All small businesses planning to invest within the next 24 months by type of investments

Source: FSB Insurance and Finance survey 2022



Three in ten small firms (28%) had plans to invest in training schemes. This makes sense as access to skilled staff has been noted as a persistent barrier to growth, with 34 per cent of small firms citing it as one of the main barriers to achieving growth across Q2 2021 to Q3 2022 SBI surveys.

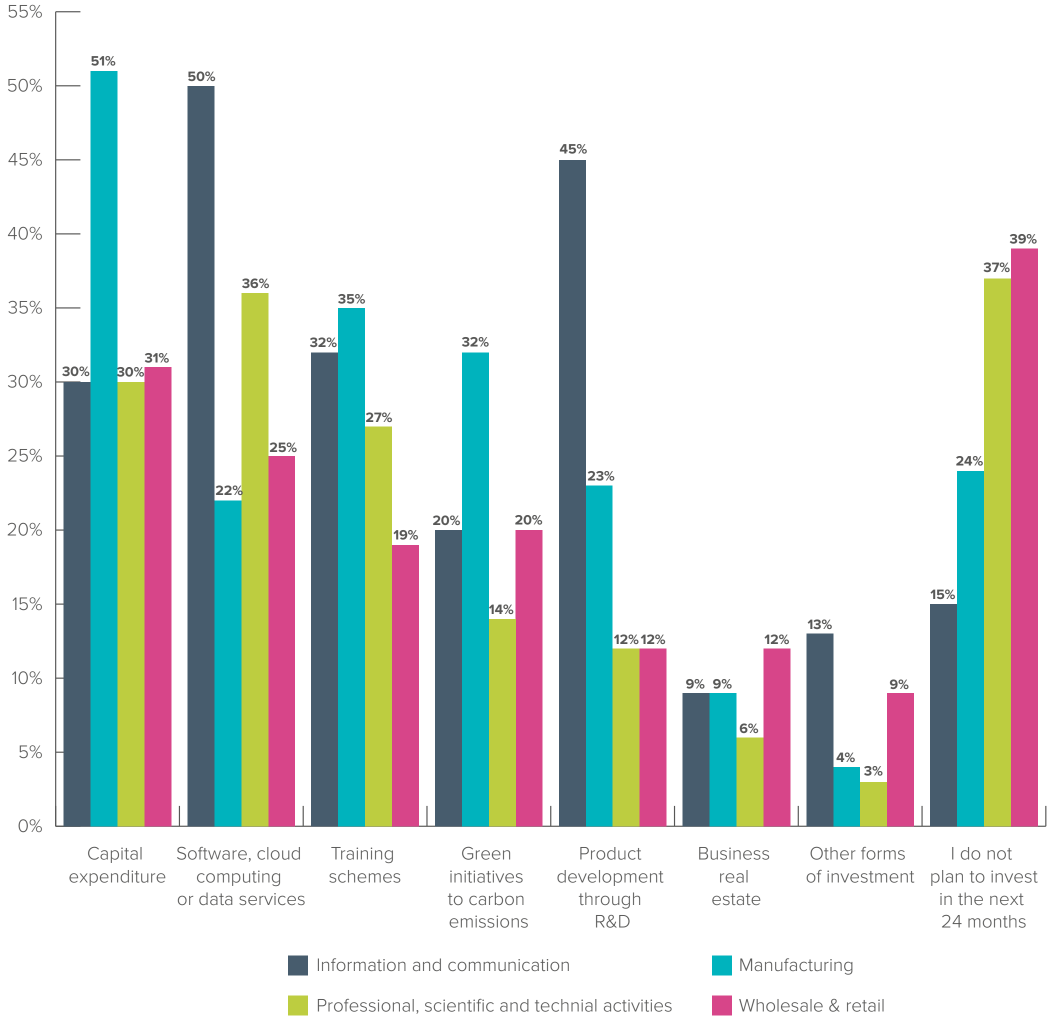
FSB's report, *Scaling Up Skills*,[22] found that investment in training is the second most common response to recruitment challenges by small firms, with six out of seven firms already providing training days for their staff. It is therefore likely that the 28 per cent who say they planned to invest in training schemes were referring to more substantial investments in sizeable new training programmes.

21 FSB, 2019, Spotlight on Innovation: How Government can unlock small business productivity https://www.fsb.org.uk/resources-page/innovation-report-final-pdf.html

22 FSB, Scaling Up Skills, August 2022, https://www.fsb.org.uk/resource-report/scaling-up-skills.html

Figure 4: Investment intentions of small businesses within the next 24 months by sector

Source: FSB Insurance and Finance survey 2022



Plans to invest vary quite considerably by sector. The retail (45%) and professional, scientific and technical activities sectors (37%) were more likely to say they had no plans to invest. Small businesses in manufacturing had the greatest plans for investment in capital expenditure at 51 per cent. This is the highest share of planned investment by sector and by different type of investment, followed closely by the 50 per cent of small businesses in the information and communication sector who planned to invest in software, cloud computing or data services.

A quarter of small businesses in the East Midlands (25%) and 23 per cent of small firms in the East of England planned to invest in capital expenditure compared to 37 per cent of all small businesses. Interestingly, 15 per cent of small firms in the South West planned to invest in business real estate compared to a 9 per cent average countrywide.

Research and development

Innovation will play a crucial role in ensuring that UK can address its productivity puzzle, with productivity levels in the UK notably below those observed in other comparable economies. Research and development (R&D) tax credits enable many small firms to invest in R&D when they might not have otherwise done so. Over one in seven small businesses (15%) planned to invest in product development through R&D within the next 24 months.

> **"We are a high-value business creating software. We make new products all the time, so we are constantly investing. There are only six people in the business and two of them do R&D, I do it part time as our product guy. We have to invest to grow out of where we are... we have to keep on innovating. From a generic point of view the business climate is not conducive to investment."**
>
> FSB member, Software business, South East

Small firms in the information and communication (45%) and manufacturing (23%) sectors reported higher levels of intention to invest in R&D. Interestingly, small firms in the North West and East of England also report slightly higher intentions to invest in R&D for the purposes of product development.

FSB research from 2021 shows that one in ten small businesses (10%) had successfully applied for R&D tax relief in the past two years.[23] This is higher in manufacturing (21%) and in information and communication (15%). In contrast, less than one per cent of small businesses have used Innovate UK grants.[24]

SMEs spend more on R&D than large businesses, universities, or the Government.[25] The latest data from the ONS found that total business expenditure for 2021 on R&D was £46.9 billion, of which £24.3 billion (52%) was performed by SMEs.[26] In 2020, the ONS found that total business R&D spend was £44 billion, of which £23.3 billion (53%) was from SMEs. SMEs

23 FSB, A Duty to Reform, October 2021, https://www.fsb.org.uk/resource-report/a-duty-to-reform.html

24 FSB, Spotlight on Innovation, July 2018, https://www.fsb.org.uk/resources-page/innovation-report-final-pdf.html

25 ONS, Gross domestic expenditure on research and development, UK: 2020, November 2022, https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/researchanddevelopmentexpenditure/bulletins/ukgrossdomesticexpenditureonresearchanddevelopment/2020

26 ONS, Business enterprise research and development, UK: 2021, November 2022, https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/researchanddevelopmentexpenditure/bulletins/businessenterpriseresearchanddevelopment/2021

make a far higher contribution to R&D expenditure than previously thought among policymakers: In the ONS's estimates from November 2021 for 2020, for example, it estimated that large businesses contributed almost three-quarters (74%) of the total business R&D spend.

The UK Government launched its R&D roadmap in 2021, with the goal that by 2027 R&D investment will account for 2.4 percent of GDP.[27] Previous estimates of R&D spending were around 1.7 per cent; however, the revised estimates from the ONS suggest that the UK has already reached the target set by Government.

The latest ONS data is a strong sign that R&D tax credits have worked well. Tax administration data indicates that R&D tax credits are having a particularly positive impact at the extensive margin – meaning there are far more small firms and start-ups doing R&D than would otherwise be the case. Despite this, the Chancellor announced in the Autumn Statement 2022 that he would be changing the amount of support.[28] The SME additional deduction will decrease from 130% to 86%, and the SME credit rate will decrease from 14.5% to 10%, with the Research and Development Expenditure Credit (RDEC) rate being improved.

A study commissioned by HM Revenue and Customs found that when the additional rate was increased in April 2012, there was a significant increase in the level of claims in the following financial year.[29] The scale of the impact of reducing the support offered through the tax system to pre-2010 levels should not be underestimated, especially at the extensive margin. It is important for Government to build on the success of the SME R&D tax credit scheme, by continuing to simplify the rules and the process for claiming tax credits.

Previous FSB research found ethnic minority-led businesses (EMBs) engage in both process and product/service innovation on average more often than non-EMBs; 21 per cent of EMBs reported process innovation, six percentage points higher than the rest of the respondents. The results for product or service innovation were even stronger in favour of ethnic minority-led firms than non-ethnic minority-led firms, to the value of 11 percentage points.

27 BEIS, UK Research and Development Roadmap, January 2021, https://www.gov.uk/government/publications/uk-research-and-development-roadmap/uk-research-and-development-roadmap

28 HM Treasury, Autumn Statement 2022, November 2022, https://www.gov.uk/government/publications/autumn-statement-2022-documents

29 London Economics, Evaluation of the research and development tax relief for small and medium-sized enterprises, November 2020, https://www.gov.uk/government/publications/evaluation-of-the-research-and-development-tax-relief-for-small-and-medium-sized-enterprises

Many ethnic minority-led businesses contributed to the £24.3 billion in R&D investment in 2021, an increase of £4.3bn from 2018. A cut to R&D tax credits will impact negatively on the growth abilities of EMBs, and indeed of many thousands of small businesses, at a time when the UK economy needs to raise productivity and growth.

Green investment

Over a fifth of all small businesses (22%) said they planned to invest in green initiatives to decarbonise – this equates to a third of all those who had investment intentions.

The plan to invest in green initiatives is very split by size of business. Sole traders with no employees (10%) had the lowest propensity to invest in green initiatives. For those with 1 to 9 employees this rose to the average (22%), and for those with 10 to 49 employees, a third (34%) planned to invest in green initiatives.

It is our view that this relatively modest level of green investment plans is likely more a result of the economic conditions small businesses are facing, rather than indicative of a lack of desire to decarbonise. FSB's *Accelerating Progress* report from 2021 found that 56 per cent of small businesses believe the planet is facing a climate crisis and 37 per cent reported wanting to do more to achieve net zero and sustainability. However, 28 per cent say it would be extremely difficult to transition, and 69 per cent don't know how to measure their emissions.[30]

> **"I'm working on a project right now to fit solar panels on my factory. The whole project will cost me half a million pounds. Do I invest half a million pounds, or do I keep that half a million pounds aside for potential headwinds? I know I'm going to be hit with extremely high energy bills, so I may need the cash. Now, I'm sitting here with my team thinking, do we invest, or do we hibernate?"**
>
> FSB Member, Food manufacturing, East Midlands

One of the crucial issues around investing in decarbonising a business is that the financial return on investment is minimal and very long-term. The majority of small businesses will currently be behind the majority of larger businesses in their journey towards net zero, although there will of course be outliers in both categories. Large businesses have engaged with various pieces of regulation for the past few years, which have been aimed at helping them improve their understanding of their energy use and consequently lowering their emissions and costs. While it is right that small

30 FSB, Accelerating Progress, November 2021, https://www.fsb.org.uk/resource-report/accelerating-progress.html

businesses have not been included in many of these regulatory initiatives, the consequence is that they will have less clarity on how to measure their energy usage, are less likely to have a plan, and on average have taken fewer steps to cut their carbon usage.

It would be wrong to seek to correct this by imposing large swathes of additional regulation on small businesses. We also cannot expect price signals alone to be sufficient incentive to help small businesses take the next steps on their transition, as small businesses are not only trying to rebuild following the pandemic but are also trying to survive the 2022 cost of doing business crisis. What is needed is a policy framework where governments help to overcome the precise barriers that small business face in the transition (such as access to capital and the landlord/tenant split). Smart investment incentives will play a part in this. The Enterprise Research Centre also recommended UK Government needs to develop appropriate incentive financial support mechanisms to encourage going green, particularly for laggard SMEs (majority of UK SMEs).[31]

Diversity and business investment

There are demographic differences in terms of investment intentions. Business owners aged under 45 had a higher propensity to invest; 84 per cent of those in the 16 to 44-year-old bracket planned to invest compared to 63 per cent of those in the 55 to 64 brackets. FSB research shows that 41 per cent of women-led businesses planned not to invest within the next two years compared to 32 per cent of male-led businesses (34% of all small businesses planned not to invest).

> **"I've raised finance a few times – I've used a bank loan to move the business from one property to another, I've used asset finance for a large capital investment in equipment, and I've used lease finance where I didn't want to purchase equipment. We also have a credit card and an overdraft facility. I've never had any problem raising finance, but I do always use industry specialist brokers.**
>
> **I've only ever considered finance where I've needed it to grow the business for a specific purpose. I haven't considered bringing in an external investor to grow the business exponentially. However, I say that following the shattering experience of the Covid pandemic. In September 2019, I would have probably said that I would like to bring in an external partner to finance serious growth. Right now, however, I don't want to grow the business, I want to capitalise on it and pay off debt."**
>
> FSB member, Commercial laundry, London

31 https://www.enterpriseresearch.ac.uk/publications/exploring-external-finance-links-to-build-back-better-a-green-uk-sme-economy/

The Alison Rose review found that a '*sustained and concerted effort to help women succeed as entrepreneurs could add around £250 billion of new value to the UK economy.*' [32] The review also found that many women were so pessimistic about their chances of securing finance that they do not apply for loans at all. Almost half (46%) of all female would-be borrowers did not seek finance because they expected issues with the loan process, nearly double the proportion of men fearing this. The assumption that they would simply be turned down deterred 40 per cent of women, compared to three in ten men.

> **"I started a business and needed a leg up via external finance at the start, so I sought external finance to grow the business. I approached my bank and the BBB but was told I would need to put my home up as collateral. At the time I was single parent with a disabled child. I've owned my home since 19 and I was not prepared to take that risk for £5,000. This had an impact on my business for nine months and my business was dormant. Since then, I have chosen not to seek external finance but to self-fund through my own earning or community partnerships."**
>
> FSB member, Business trainer, Northampton

Our research found that mortgages had a relatively low rate of rejections, at just 12 per cent. However, when splitting by gender, males experienced rejection 10 per cent of the time compared to 19 per cent for females.

Cash

Crucially, finance underpins small business investment and subsequent growth. Although cash deposits have grown over time, the average small business still requires external finance to be able to adequately invest and expand their business – this is especially true for sole traders and microbusinesses whose cash holdings are much smaller than the larger small or medium businesses. Of those small businesses that applied for finance in Q3 of 2022, 46 per cent did so to manage cashflow as opposed to expansion or investment.

The average SME between 2019 and 2021 grew its deposits by £7,000. This is likely a direct effect of the scale of lending in 2020 and 2021 from the Covid financing. However, despite this scale of borrowing and level of deposits, appetite for investment is still somewhat subdued. According to our analysis of the SME Finance Monitor report by BVA BDRC, looking at

32 HMT, the Alison Rose review of female entrepreneurship, Mach 2019, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/784324/RoseReview_Digital_FINAL.PDF p.18

credit balance as a share of turnover, this has increased steadily from 23 per cent in 2016 to 37 per cent in 2021.[33]

These averages do hide a large range of balances between sole traders, micro, small, and medium businesses. Where 33 per cent of all SMEs in 2021 held balances in excess of £10,000, only 25 per cent of sole traders did so compared to 83 per cent of those with 10 to 49 employees.[34] Equally, the share of those with no deposits doubled between 2015 and 2021.

Figure 5: SME credit balances held over time

Source: BVA SME Finance Monitor, FSB analysis

	2015	2017	2019	2021
No deposits	3%	4%	4%	6%
Greater than £0, less than £10,000	73%	70%	72%	61%
£10,000 to £50,000	17%	17%	16%	23%
Greater than £50,000	7%	8%	8%	11%
Average Balance	£39,000	£37,000	£38,000	£45,000

Late payments

Before the 2022 cost of doing business crisis, poor payment practice was embedded as one of the most serious impediments to small business growth and survival. Small businesses and the self-employed depend on cashflow for their very existence – 'cash is king'. Our SBI Q3 research shows that over half (54%) had some form of late payment in Q3 of 2022 and over a quarter (27%) said that the situation was worsening.

However, the UK average hides the significant variance experienced between sectors. Those in business-to-business (B2B) industries face much greater levels of late payments than business-to-consumer (B2C) industries. Two-thirds (67%) of small businesses in the manufacturing sector report having late payments in Q3, up from 63 per cent in Q2.

Similarly, 64 per cent of those in construction had late payments this quarter. In contrast, 28 per cent of those in accommodation and food services report having late payments, a seismic difference. Of all the small businesses applying for finance in Q3 2022, the primary reason was for

33 BVA BDRC, SME Finance Monitor Q4 2021, March 2022, https://www.bva-bdrc.com/wp-content/uploads/2022/03/BVA-BDRC_SME_FM_Q4_2021_Report_Final.pdf
34 Ibid.

cashflow purposes (46%) rather than to expand their business (25%) or upgrade equipment (10%).

One of the primary issues with this is that small businesses are having to pay for cashflow they otherwise should have. This is compounded by rising interest rates in 2022. One-fifth of applications made in Q3 2022 were met with an interest offer in excess of 11 per cent. Indeed, we found that the average rate offered this quarter was approximately 7 per cent – this is a significant debt burden to take on just to manage business operations because many are having cashflow issues caused by poor payment practices.

Recommendations

- **The Government should reverse direction from its announcement on R&D tax credits at the Autumn Statement that will seriously reduce SME R&D in the UK economy.** Small businesses spend a huge and increasing amount on R&D, this is primarily due to the success of the R&D tax relief policy. Reducing the rates at which the tax relief is set for SMEs would deter many small businesses from investing in R&D when they might have otherwise done so. If needed the Government could examine other areas of the UKRI and Innovate UK budgets where they have little or no efficacy or relevance in driving more small businesses R&D.
- **The Government should simplify the existing SME R&D tax relief scheme, so it is easier for small businesses to apply directly rather than using intermediaries and cap their payment share to 25 per cent of the relief received.** Previous FSB research shows that 84 per cent of those that successfully applied for the R&D tax relief did so via third party intermediaries (accountant, agency, or R&D specialists). FSB analysis suggests that on average intermediaries take 16.1 per cent of the resulting savings from the relief as payment. Of the £4.4 billion spent on the R&D tax relief scheme in the 2019-2020 fiscal year, we estimate that £640 million went to intermediaries as payment.

  The reason small businesses use these intermediaries is due to the complex nature of the scheme – small business owners are not experts in tax. Easing this administrative burden through simplifying the application process would be highly beneficial as small businesses could apply themselves and keep the relief they are entitled to. We know that one in ten intermediaries charge at least 25 per cent as payment. Capping this at 25 per cent would limit this rent seeking behaviour, increase the savings for SMEs and bolster total R&D spend in the economy.
- **All future capital allowances should include second-hand capital purchases to allow small businesses to offset the cost of upgrading their machinery without the requirement of the asset being new.** Small businesses often rely on second-hand purchases of assets as it can be much more affordable than brand new capital expenditure. Future capital allowances rules should always include second-hand asset purchases within their eligibility to maximise their uptake. The super deduction, for example, did not include second-hand purchases within its eligibility, and had a very low uptake among small businesses. The logic is that used assets are is much more affordable for small businesses and will often be a significant improvement on current

asstes are the business has, improving efficiency, carbon emissions and overall business development.

- **The Government should introduce a VAT-based capital investment incentive, to drive up the amount of small business investment in a faster, simpler way, rather than the outgoing big business super deduction.** Under normal conventions, a VAT-registered business usually files a return to HMRC every three months. We propose that when the small business makes an eligible purchase, it is able to claim back 150 per cent of the VAT cost rather than the typical 100 per cent, i.e. a 50 per cent return, to incentivise eligible purchases.

  Qualifying purchases would need to be those that can be considered an investment into one's businesses. We suggest taking the plant and machinery eligibility criteria found in the Annual Investment Allowance, while also expanding them to intangible assets such as software and digital assets and qualifying green products, to reflect the variety of small businesses across the UK and the net zero agenda. The VAT rebate should also be classified as a non-taxable form of income in the accounting treatment, ensuring that the investment incentive is maximised and additional tax accounting minimised.

  One of the clear benefits of this approach is the speed at which funds could be delivered. Given that small businesses generally file quarterly, these businesses would see the cashflow benefit within three months of the eligible purchase rather than as an end-of-year tax deduction.

  For clarity, we provide a worked example below:

  Within a three-month period, business A collects £50,000 in VAT from customers and pays £30,000 of VAT to suppliers. During this period, Business A purchased £50,000 plus VAT worth of eligible machinery from Business B, accounting for £10,000 of the £30,000 VAT liable.

  In the ordinary course of events, Business A would be liable for a £20,000 net VAT payment to HMRC.

  Under the 150 per cent reclaim scheme, the expenditure on the £50,000 machinery qualifies for additional VAT relief. Therefore, Business A actually reclaims £15,000 worth of VAT on that purchase rather than £10,000, meaning its net VAT liability is reduced to £15,000. This therefore offsets 10 per cent of the cost of the qualifying purchase, providing an immediate incentive to invest.

- **The Business, Energy and Industrial Strategy (BEIS) Department should amend the formal Financial Reporting Council guidance, or legislate, to give Audit Committees oversight of payment practices, and compel them to report on payment practices within annual**

reports. Late payment is one of the leading causes of business failure and action by BEIS has been repeatedly delayed, despite agreement around necessary measures. Delivery of action on late payment is critical to establishing the UK as the best place in world to start, run and grow a business.

- **BEIS should issue £5,000 vouchers for businesses to spend on qualifying energy saving-products and services under a 'Help to Green' initiative.** This would be similar to vouchers issued via the 'Help to Grow Digital' scheme. The voucher could, for example, be used to fund an audit to measure a firm's energy consumption with relevant advice on how to reduce energy consumption or to enable firms to replace equipment and materials to become more energy efficient. The Institute of Directors has endorsed the need for 'Help to Green', highlighting that "additional direct help is needed to facilitate energy efficiency", and the Confederation of British Industry has also recently supported the idea.

TYPES OF LENDING

Small businesses are very diverse and there is no 'one-size-fits-all' type of finance that will work and be beneficial to all the 5.5 million small businesses in the UK. The small business finance market and available financial products need to be varied, to account for the uniqueness and diversity of small businesses – what may work for one firm in one sector may be inappropriate for another.

A total of 41 per cent of small businesses say they have not applied for any form of finance, including any of the Covid loans, over the past five years. Some 59 per cent of small businesses say they have applied for finance over the past five years - the most common being the UK Government Coronavirus loans (BBLS, CBILS, the Recovery Loan Scheme). Given the size of Covid-era lending and the urgent need among applicants, it is not surprising to see the scale of this compared to the other forms of finance (Figure 6).

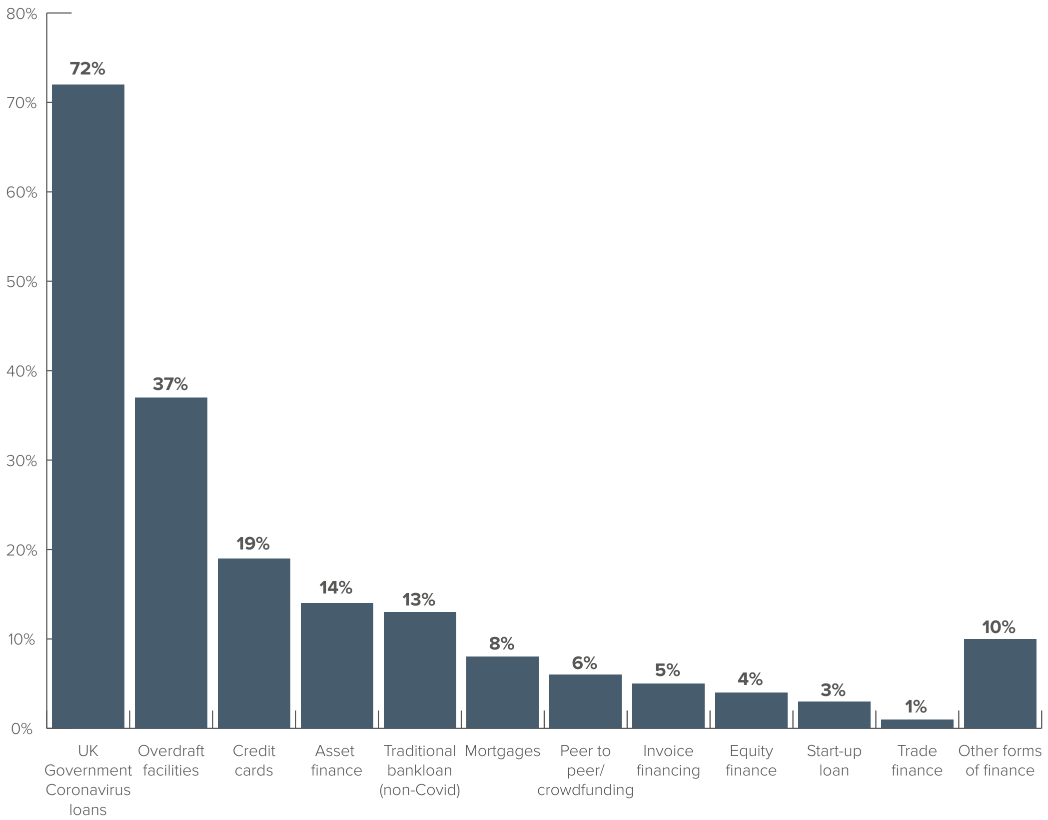
Types of financing

Of those small businesses that have applied for finance over the last five years, the most common form of finance sought is an overdraft facility, with 37 per cent stating they have applied for one, followed by credit cards (19%), asset finance (14%), and traditional loans (13%).

At the other end of the spectrum, the more alternative forms of finance are quite underused by small businesses. Over the past five years, only 1 per cent of small businesses say they have applied for trade finance, and 4 per cent for equity finance.

Figure 6: Types of finance applied for by small businesses that have applied for any finance over the past five years

Source: FSB Insurance and Finance survey 2022



One of the primary reasons for the low take-up rates of alternative forms of finance may be a lack of awareness. Small businesses will not necessarily have detailed knowledge of the full range of financial products available to their businesses, and therefore they typically stay within the remit of their main financial provider, which may be why we see a tendency towards overdrafts, credit cards, asset, and traditional loans.

It is also worth highlighting that, excluding Coronavirus business loans, applications by small businesses across all finance types over the previous five years are relatively low. Only 59 per cent applied for any form of finance, i.e. two-fifths of small businesses have taken on no external funding over the past five years. Of those that did, only 37 per cent applied for overdrafts, 19 per cent for credit cards, 14 per cent for asset finance and 13 per cent for traditional loans. It appears that small businesses' general engagement with external finance is quite low.

> **“You don’t really get the personal touch anymore. You’re applying to a panel of faceless people that don’t understand your business or possibly don’t want to understand your business. We applied for a CBILS loan and the great thing about that was that we didn’t have to go through all the hoops we normally do to get any other kind of working capital. We found the whole process was so easy compared to how difficult it normally is to get funding from the banks.”**
>
> FSB Member, Financial services, South East

Financial applications and use of a range of financial products over the past five years also correlates with age of business owner. Younger business owners are more likely to have applied for external finance and applied for a greater number of financial products.

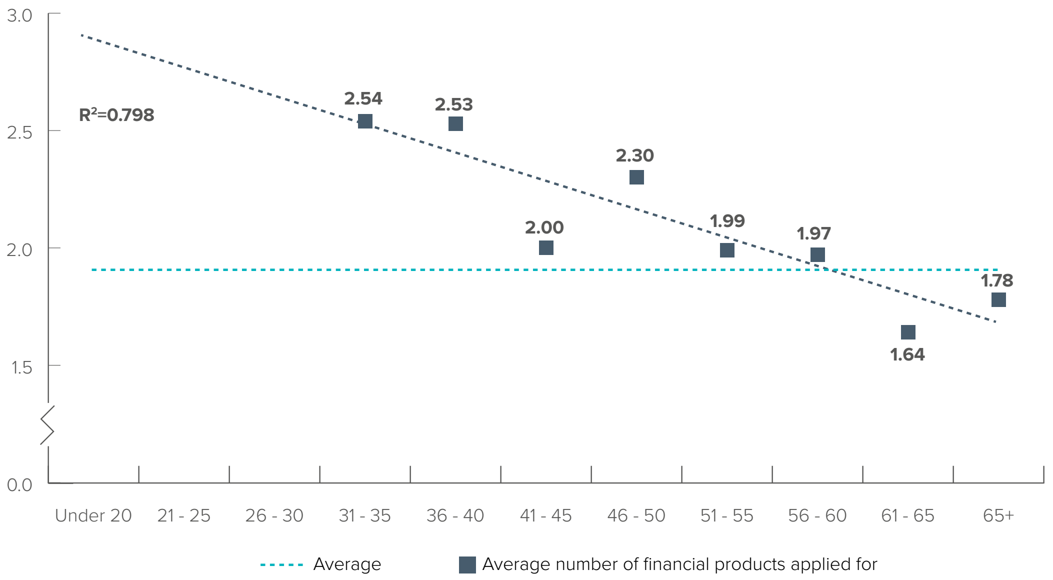
> **“Our business was incredibly cash-intensive at the beginning, and we struggled to acquire any forms of funding. Luckily, we could rely on the Enterprise Finance Guarantee scheme. It’s very difficult to get any financing from traditional lenders as a start-up and so we had to become quite creative rather than relying solely on banks – this is despite winning several start-up awards. Where we could get funding, the interest rates offered were astronomical, sometimes up to 60 per cent annualised. We have found that as we’ve now got two years of accounts, it’s been a little easier to get finance from mainstream lenders. However, we’ve now put a project on hold partly due to the drop in consumer confidence and market conditions but also because we just don’t think we’d secure the funding we’d need to complete it. This is while a separate part of our businesses has grown four times in size in the past 12 months and is going through a £3 million funding round currently to support future growth.”**
>
> Tom Filer, Family Adventures Group, South West

On average business owners under 45 apply for a greater variety of products and have a greater rate of overall applications. A total of 66 per cent of those in the 16 to 44-year-old category have applied for some form of finance and have, on average, applied for 2.4 different products. In contrast, only 49 per cent of those above 65 have applied for any form of finance in the past five years and typically only for 1.7 different products.

These differences could be borne out from the business owners viewing their finance needs in different circumstances and at different points in their businesses’ lifecycle. Younger owners may be more willing to take on additional finance through debt or equity compared to older owners who may be looking more towards retirement or handing the business over, and less towards expansion. Risk appetite likely plays a large part in the demand for finance and the types of finance these owners engage with.

Figure 7: Correlation between number of different financial products applied for and business owner age[35]

Source: FSB Insurance and Finance survey 2022



Small business financial applications also vary considerably by sector in both proportion of applications and type of finance applied for. Small businesses operating in manufacturing have the highest propensity to apply for finance (70%). This is significantly more than wholesale and retail, where 59 per cent have applied for finance over the past five years. Those operating in the professional, scientific, and technical activities sector had the lowest (48%) propensity to apply for finance.

Manufacturing small businesses also rely much more heavily on asset finance than any of the other sectors; 22 per cent say they have applied for it over the last five years, compared to wholesale and retail (4%) and professional, scientific, and technical activities (3%). Manufacturing tends to rely more on physical equipment than other sectors, and asset financing allows businesses to acquire the use of physical assets with a relatively low initial outlay, or to borrow against the value of equipment they already own.

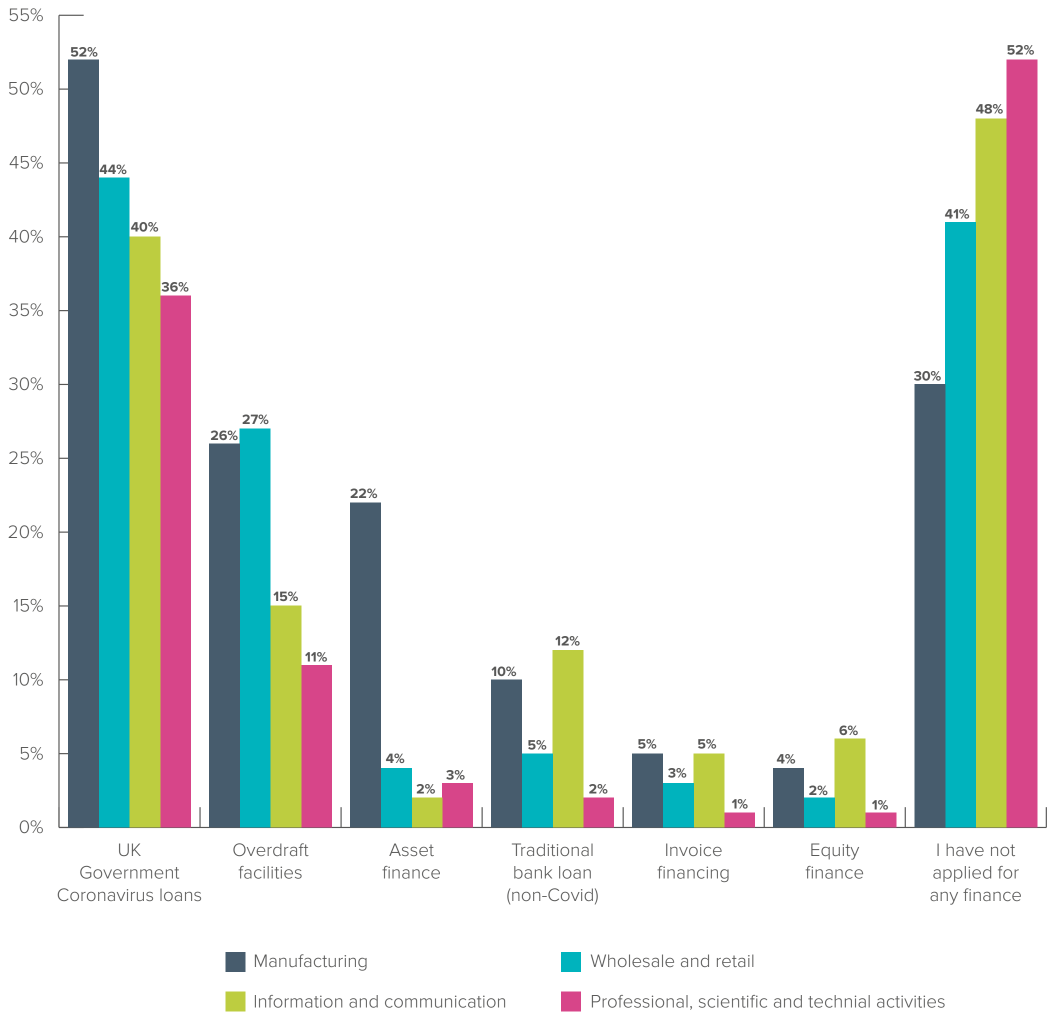
Meanwhile, the value inherent to the assets gives the finance provider a higher level of security, as non-payment of lease or asset finance liabilities can lead to repossession of the equipment in question, allowing assets to be re-leased or sold.

35 NB: Due to an insufficient number of responses, we are unable to produce estimates for business owners in the "under 20", "21 to 25" and "26 to 30" age brackets

The most common form of finance applied for across sectors were Coronavirus loans (CBILS and BBLS) – 27 per cent only applied for a Coronavirus business loan. Although there have been issues raised with the levels of fraud within the Covid schemes, specifically BBLS, their importance in aiding business survival during the height of the pandemic cannot be overstated. The fraud issues came about due to the self-evaluation and reporting mechanism of the application, a necessity in order to ensure that funds were delivered speedily. The Government needs to acknowledge and account for the rapid dispersal of funds and the numbers of small businesses saved when assessing the success of the scheme, not just the subsequent levels of fraud.

Figure 8: Types of finance applied for by small businesses by sector

Source: FSB Insurance and Finance survey 2022



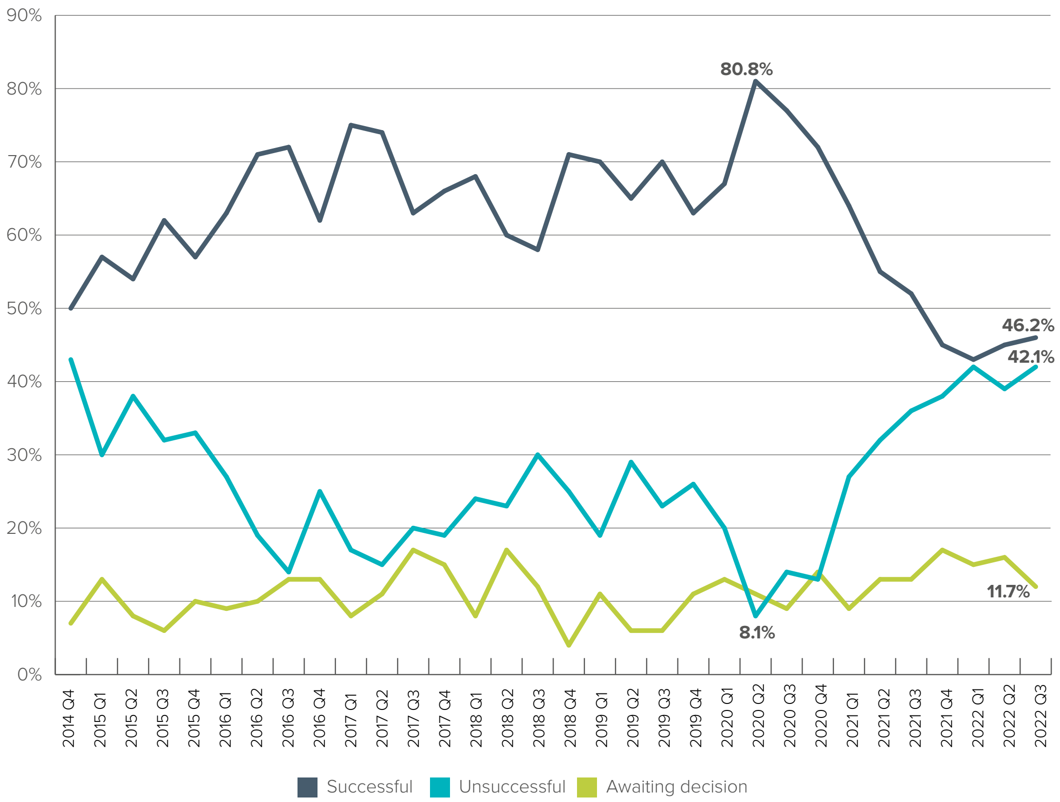
SUCCESS RATES

Somewhat concerningly, small business success rates of financial applications (any type) have been on a sharp downward trend since the explosion of lending in mid-2020. Research from FSB's SBI shows a steep decline in the application success rate – only 46 per cent were successful in Q3 2022, down from a high of 81 per cent in Q2 2020.

This sharp decline is illustrated below in Figure 9 which also shows a mirroring of the rates of rejected applications, from a low of 8 per cent in Q2 2020 to 42.1 per cent in Q3 2022 – a level unseen since 2014. This is particularly worrying as it is very reminiscent of the post-2008 squeeze on finances small businesses felt, and how the situation develops will be a benchmark for how small businesses grow and recover following the pandemic and the current economic stress they are under.

Figure 9: Small business success rates for financial applications 2014–2022

Source: FSB Small Business Index Q3 2022



When turning attention to specific types of finance, certain types of financial products generally have a much greater success rate compared to others. Unsurprisingly, 97 per cent of small firms say they had the highest share of successful applications for Covid loans. Legislative changes which came into force in May 2020 to remove from the scope of consumer credit regulatory regime loans of £25,000 or less made by commercial lenders to sole traders, unincorporated associations and partnerships of fewer than four people under BBLS enabled small firms to access loans quickly. FSB lobbied significantly during the pandemic to ensure small firms could access Covid loans.

Small businesses that apply for credit cards and asset finance (95% and 94% respectively) also report high acceptance rates. One in eight small firms (13%) say they have been unsuccessful in applying for an overdraft over the past five years. However, this number rises to 21 per cent for women-led businesses in comparison to 8 per cent for male-led small businesses, i.e. one in five overdraft applications by female business owners are rejected.

Programmes such as the Start Up Loans Company play a vital role in the health of the small business sector, disproportionately benefiting women and EMB business owners: *"More than one in five loans administered through the Start Up Loans scheme have gone to ethnic minority entrepreneurs since 2012."*[36]

> **"I seem to see very small amounts or very huge amounts, say £25,000, so the amount is either too small or too big. I wouldn't necessarily need that amount now. It would be good to see more grants that come along with training and support.**
>
> **I can only speak for the black community, but historically we are used to doing things by ourselves, so if we've requested and haven't received help, we are more guarded. I had a bad experience at the bank with the business manager which has coloured my perception of banks. So, do I feel confident enough that if I was asking for a loan, they would give it to me? I'm not entirely sure. I bank with a new bank, and everything is done digitally, the contact that I have had with them has been positive as they deal with me as an individual business."**
>
> Social enterprise, Retail, Essex

Equity finance was the form that had the greatest share of rejections of any of the types applied for by small businesses, at 38 per cent.

Only 4 per cent of all small businesses say they have applied for equity finance over the past five years, which indicates that many small businesses are either not aware of it, find it difficult to understand and access, or don't want to give up shares in their business. The rate of success suggests that those that do attempt to acquire investment struggle to do so, with less than half being successful.

36 British Business Bank, Start Up Loans passes £750m funding milestone, delivering more than 85,500 loans across the UK, https://www.startuploans.co.uk/media-centre/start-up-loans-passes-750m-funding-milestone-delivering-more-than-85500-loans-across-the-uk/

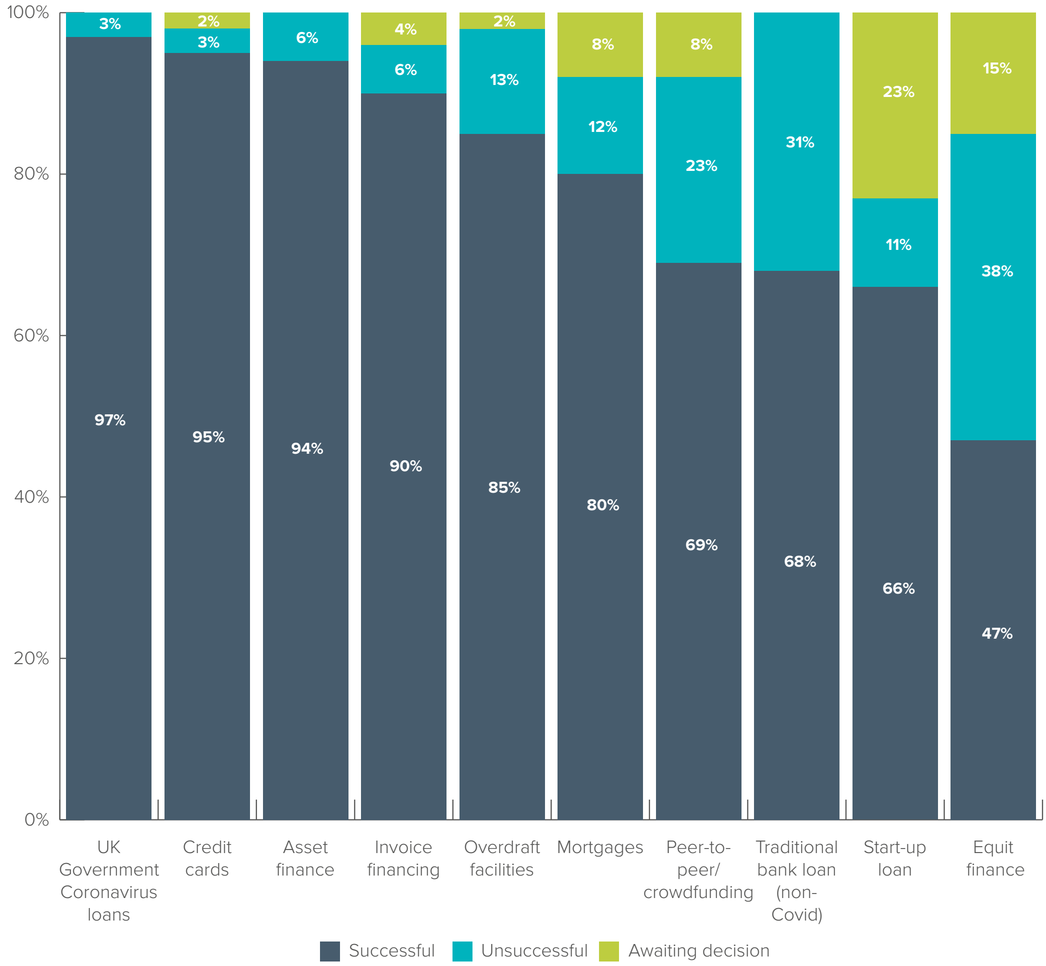
Equity finance is not suitable for all businesses; however, it can be a very lucrative finance channel for small businesses that want to grow and expand. Increasing awareness of equity, demystifying it, and providing information on how best to present an investment-ready case will benefit that subset of businesses wishing to explore equity finance.

Given small businesses' typical reliance on traditional debt finance, it is interesting to see that, on average, only two thirds of applications for traditional loans are accepted. Traditional bank loans have the second highest rejection rate (31%) after equity. It is our concern that the rate of rejection for traditional loans may continue to grow, as mainstream lenders typically reduce their risk appetite during periods of economic stress, increasing the importance of alternative finance and alternative lenders in the short to medium term.

> **"Once you cross the two million revenue barrier you start seeing more benefits from the finance world coming to you. It's difficult if you're in a turnaround situation; all the banks run for hills and frankly we just need a more supportive business environment. It can be very difficult when you've got the frustrations of running a business at the same time as trying to manage a fundraising exercise, be it debt or equity; it's much more time-consuming than people give it credit for."**
>
> FSB Member, Financial and insurance activities, London

Figure 10: Small business success rates for various types of financial applications

Source: FSB Insurance and Finance survey 2022



Recommendations

- **Improve access to mortgages and other financial products for women-owned businesses. The Government and the Financial Conduct Authority (FCA) should work with industry leaders to address barriers that disproportionately affect women-owned businesses when trying to access certain financial products.** For example, credit reference agencies should consider reasonable adjustments to assessment where a gender bias could affect credit scores. Reasonable adjustments should be considered and implemented to mitigate the disproportionate effect of systematic bias, such as the wage gap, and episodes of economic inactivity, such as pregnancy and maternity, that can contribute toward a lower credit score among women applying for business finance. These reasonable adjustments could level the playing field and demonstrate that a lower credit score doesn't always equate to a riskier individual or business. Additionally, the sector must actively work to tackle unconscious bias. Industry leaders should do more to promote gender equality and female representation from the workforce to the boardroom, as female business owners would feel more comfortable applying for credit from businesses where women are more visible.
- **Expand the Start Up Loans scheme from 11,000 per year to 15,000 loans per year.** The Government announced funding for 33,000 Start Up Loans from 2022-23. Evidence from the BBB shows that Start Up Loans have consistently helped more female and ethnic minority entrepreneurs to establish and grow their businesses; a commitment to increasing the provision of Start Up Loans will encourage and boost enterprise across the UK.
- **BEIS should introduce a Help to Grow Bitesize for all micro-businesses and sole traders which includes a selection of optional modules.** The Help to Grow scheme is invaluable to businesses that need guidance on a range of topics ranging from business strategy and digital adoption to building a brand and organisational design. The module on finance and financial management is also very important, allowing small businesses to truly understand and make use of their financial data.

  However, Help to Grow Management could be better tailored to the smaller businesses in the economy by creating a 'Bitesize' scheme available to those currently excluded due to their size. In this scheme, sole traders and microbusinesses would have access modules currently found on the standard Help to Grow Management scheme, but could tailor their use to what they need, minimising their commitment, i.e. creating an optional module set-up.

Alongside this, a modular Help to Grow Management scheme could include a more specific module on external finance. This module should include a full explanation and practical examples of the different forms of finance, from asset-based and trade finance to alternative forms such as equity, angel and peer-to-peer. Small businesses often respond well to practical case studies as it becomes easier to relate to the information rather than providing abstract technical concepts.

- **Companies House should add an ethnicity field to the annual registration process and include additional questions as part of the Management and Expectations Survey. FSB supports the All-Party Parliamentary Group (APPG) for Ethnic Minority Business Owners, recommendation for the Office for National Statistics (ONS) to explore this issue.** Companies House collects a number of social characteristics at registration, some of which are partially protected by not being fully shared on the public register (e.g. full date of birth). Currently ethnicity data is not one of the required fields for registration at Companies House.

FSB's 2020 report, *Unlocking Opportunity*, recommended that a comprehensive and regular national level study of ethnic minority entrepreneurship be conducted, measuring entrepreneurship levels among ethnic minority groups, along with improving data collection on this important part of the UK business population. We support the Government's plan in the *Inclusive Britain* report[37] for BEIS to work with signatories to the 'Investing in Women Code' from the Alison Rose Review of Female Entrepreneurship and their trade associations to pilot data collection on the ethnicity of entrepreneurs applying for finance. This pilot will inform future options for data collection and follow-up actions designed to improve access to finance for ethnic minority entrepreneurs. However, we are disappointed with the slow progress of this work, and it is our view the work carried out by the APPG and recommended by the ONS is an effective and swift starting place for resolving this perennial problem. Ethnicity data is critical to evidence-based policy making and will enable more effective targeting of investment and support.

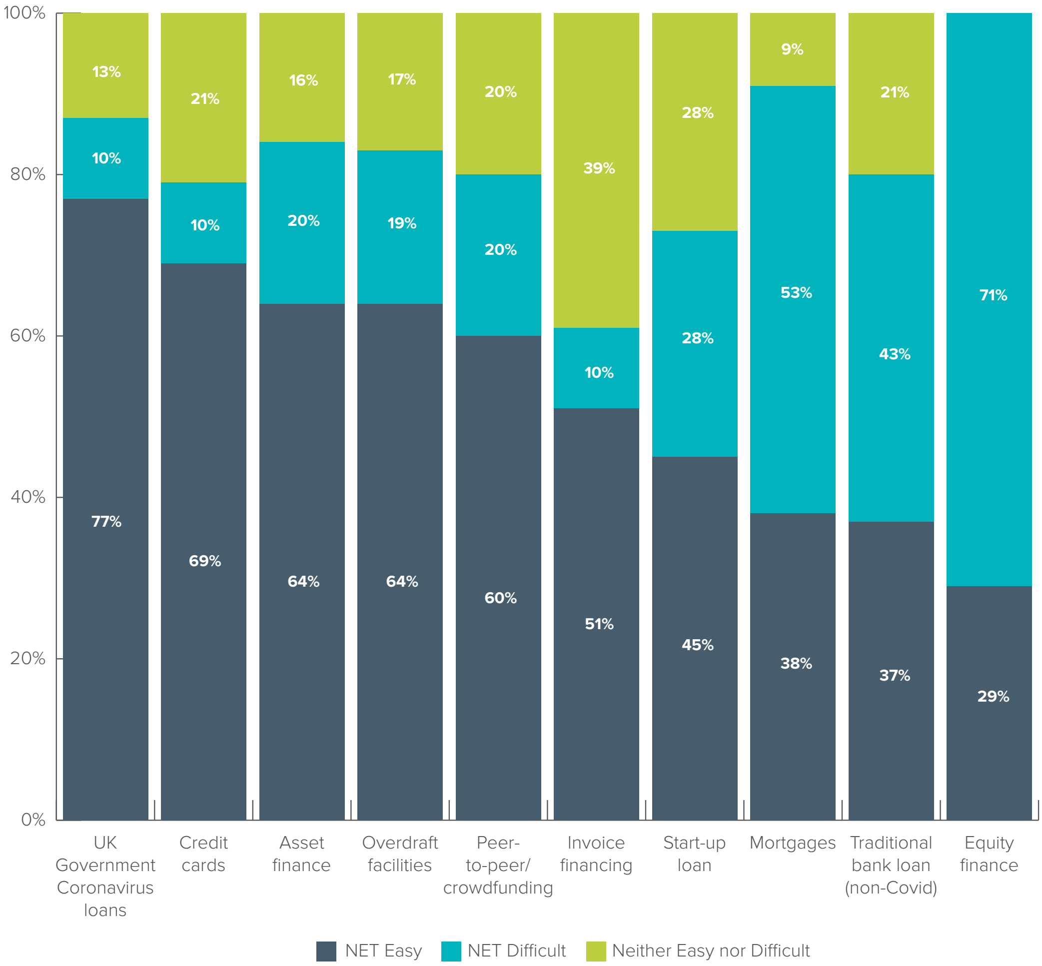
37 Department for Levelling Up, Housing & Communities and the Race Disparity Unit, Inclusive Britain: government response to the Commission on Race and Ethnic Disparities, March 2022, https://www.gov.uk/government/publications/inclusive-britain-action-plan-government-response-to-the-commission-on-race-and-ethnic-disparities/inclusive-britain-government-response-to-the-commission-on-race-and-ethnic-disparities

DIFFICULTY IN ACCESSING FINANCE

There is considerable variation in how easy small businesses find it to apply for different forms of finance. A total of 77 per cent of small businesses consider applying for CBILS and BBLS to be the easiest – likely due to BBLS not requiring any formal credit checks. This is followed by credit cards (69%), asset finance (64%), and overdrafts (64%). Small businesses say the most difficult types of finance to apply for are equity (71% find it difficult), mortgages (53%), and traditional loans (41%) (Figure 11).

Figure 11: How easy or difficult small businesses found different types of financial applications

Source: FSB Insurance and Finance survey 2022



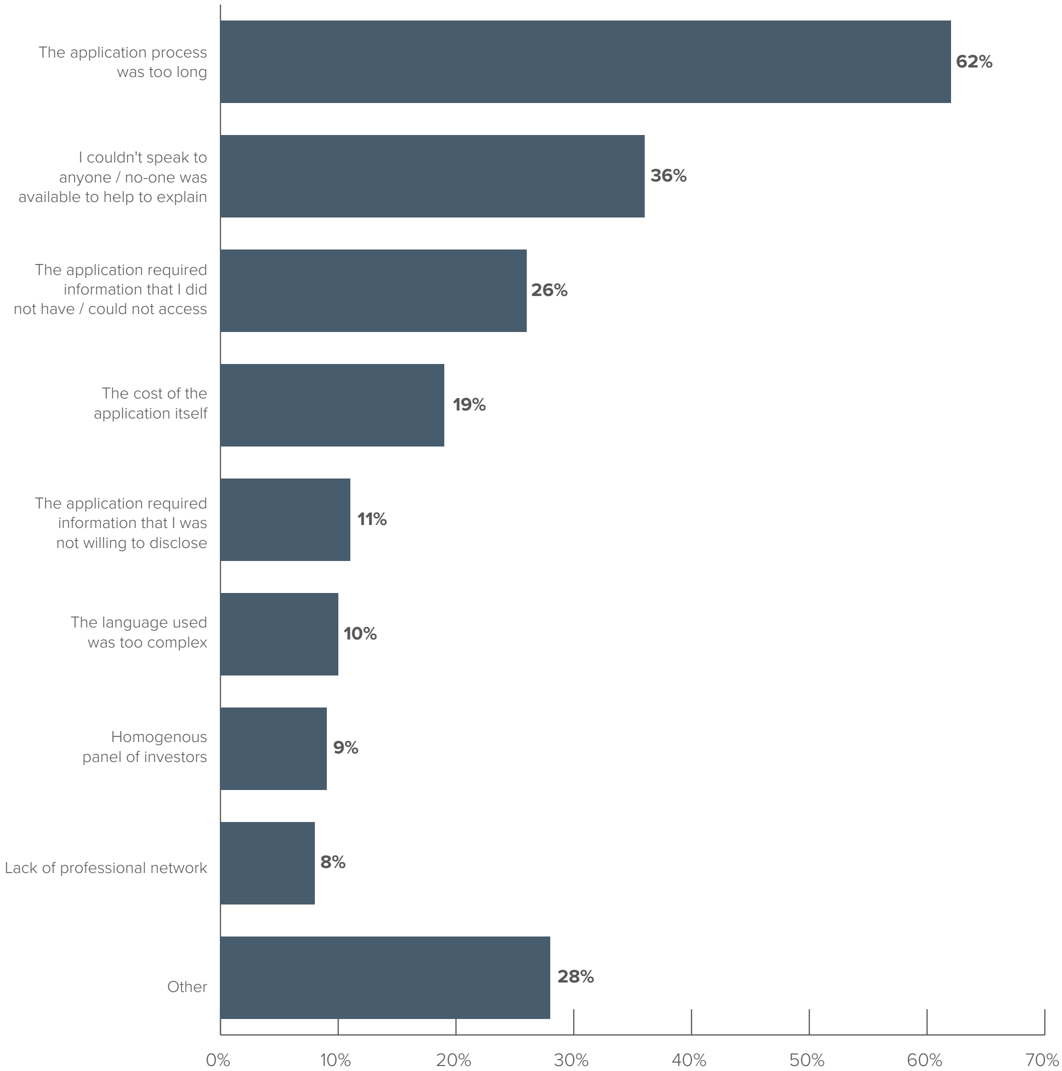
The primary reason small businesses find acquiring finance difficult is due to the application process being too long – this was cited by three fifths (62%). The second most common reason is due to the inability to speak to someone about their application to aid the process (36%), and the application requiring information that the individual cannot access (26%).

Other reasons include the individual or business's credit rating affecting their application, the individual not having a previous relationship with the lender, what the individual considered to be unjustly high interest rate offers, or the lender requiring that the business open a business account before any funds could be delivered.

One in five (19%) small businesses say that the actual cost of the application itself causes difficulty. This is problematic as small businesses should be able to access finance without the actual cost of applying being a barrier – it biases applications to those that can afford to apply.

Figure 12: Reasons why small businesses found financial applications difficult

Source: FSB Insurance and Finance survey 2022

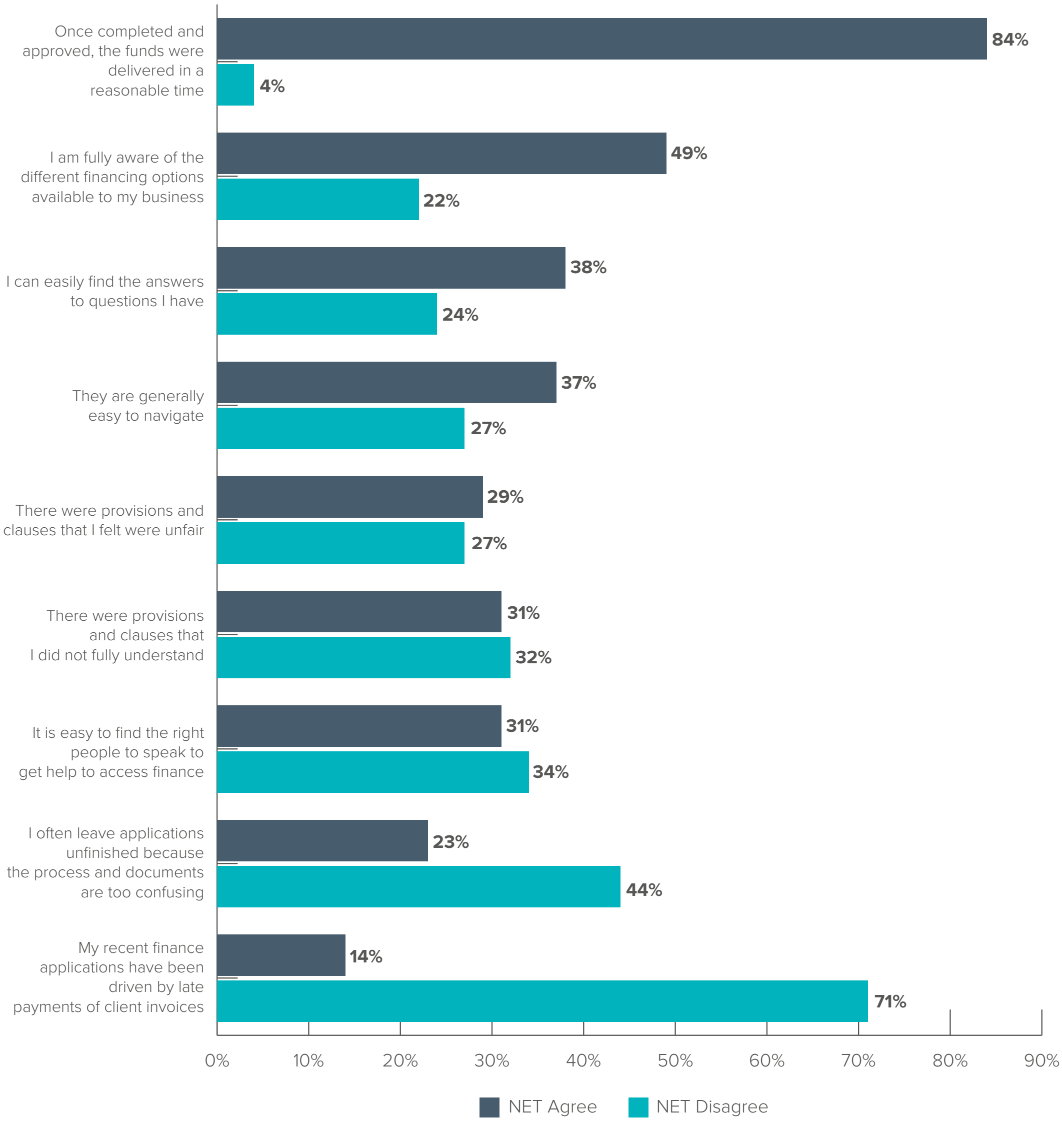


However, despite the difficulties small businesses often face, positively, 84 per cent agree that once they are approved, the funds are delivered into their account in a reasonable time. And encouragingly, half of all small businesses agree that they are fully aware of the different financing options for their business.

Less positively, only two-fifths (38%) of small businesses agree that they could easily find the answers to questions they have, around the same proportion (37%) agree that financial applications are generally easy to navigate, and three in ten (29%) felt that provisions and clauses in the applications are unfair.

Figure 13: Small business views on financial applications

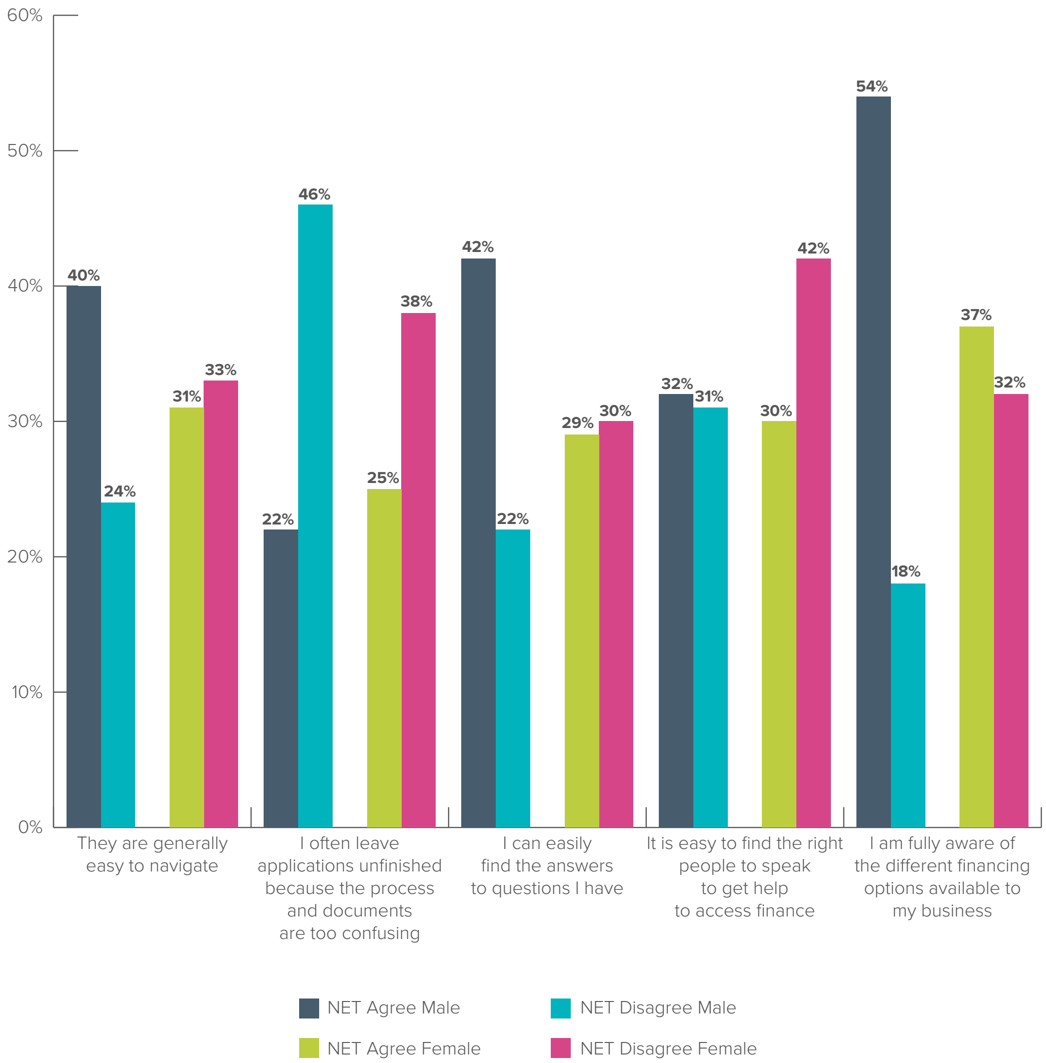
Source: FSB Insurance and Finance survey 2022



There are also some key differences when split by gender of the business owner (Figure 14). Male business owners are on average much more confident (54%) about their awareness of all the different forms of finance available to their business compared to female-led businesses (37%). Male-led businesses also report having an easier time navigating the financial applications than female-led small businesses, and female-led small businesses also have more difficulty in finding the right people to speak to about accessing finance.

Figure 14: Small business views on financial applications by gender of business owner

Source: FSB Insurance and Finance survey 2022



Equity finance is often considered difficult to acquire. One possible reason for this may be due to the unequal distribution of funds throughout the UK – this is highlighted below in Figure 15.

London accounts for 19 per cent of all SMEs, but in 2020 accounted for 47.2 per cent of all SME equity deals, equivalent to 66 per cent of the total equity value provided. London hence accounts for 3.49 times the proportion of SME equity value relative to its SME population. Not a single other region or nation in the UK has an equity value representative of its SME population equal to 1; the East of England comes in at second with a SME-to-equity value ratio of just 0.68. At the far end of the spectrum, Northern Ireland's ratio is only 0.08. Excluding London, the average SME proportion to SME equity value ratio is 0.37 – this highlights the extent to which non-London SMEs struggle to acquire equity funding. In contrast, the proportions of SME loans and overdrafts approved to the SME population matches relatively evenly across the UK, highlighting that this issue with equity funding is not a subset of wider unequal distribution of general SME finance.[38]

> **"Equity can take you a long time to acquire and is case by case. Investors that have had issues investing in a sector before are often unwilling to invest in that sector again, irrespective of your business's potential."**
>
> FSB Member, Financial and insurance activities, London

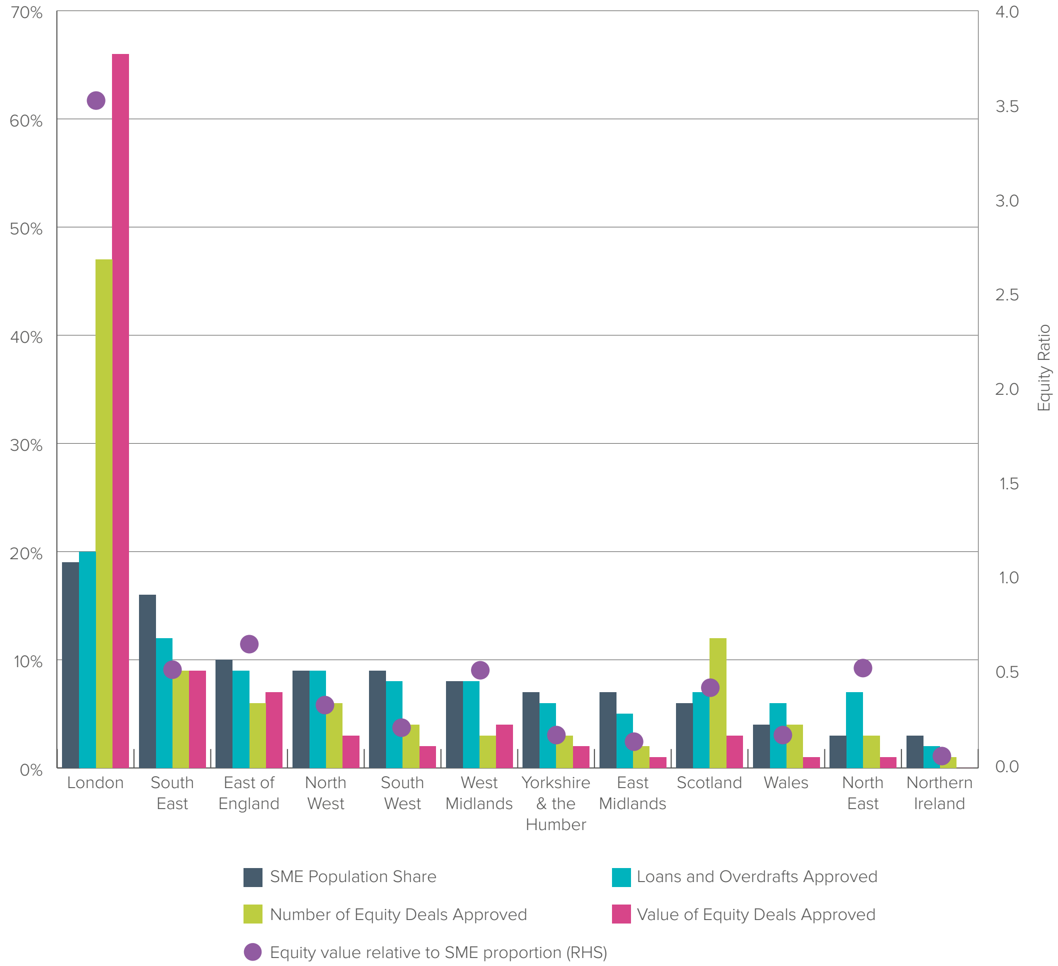
Although equity finance is not appropriate for or desired by all small businesses, sufficient access needs to be available for those that do wish to apply for this form of finance. Equity finance is centred on London, and if the Government wants to achieve its levelling up agenda, it needs to become wider-spread throughout the UK.

Given that finance is so central to small businesses operations, ability to grow, invest, and manage cashflow, more needs to be done to address the issues they face. The Government and the British Business Bank need to ensure that the metaphorical tap is not turned off following the economic turmoil the UK economy is undergoing.

38 British Business Bank, Regions and Nations Tracker: Small Business Finance Markets 2021, https://www.british-business-bank.co.uk/wp-content/uploads/2021/10/J0018_Regional_Tracker_Report_AW.pdf

Figure 15: Distribution of SME population, loans and overdrafts approved and equity finance throughout the UK, 2020

Source: British Business Bank, FSB Analysis



Recommendations

- **The UK Government should make clear it is removing the sunset clause of 2026 within the Seed Enterprise Investment Scheme (SEIS) to provide greater certainty and longevity to investment plans, and should uprate the investment limit with inflation each year.** FSB views the SEIS as particularly useful for small businesses, albeit a scheme that is underused. Our report *A Duty to Reform* found that small businesses were typically under-aware of and by extension under-using a range of tax reliefs available to them. FSB strongly believes small businesses should make greater use of the available reliefs to bolster their business position. Indeed, the Government itself views the SEIS as an important relief to businesses and is expanding the limit that businesses can receive through the scheme, from the previous limit of £150,000 to £250,000 in 2023.

  In this case, small businesses need to be made aware of the availability of the SEIS through promotional campaigns. FSB is encouraging the Government to remove the Sunset Clause on the SEIS of 2026 and to make the scheme permanent, as small businesses require consistency and long-term planning to undertake investment plans. The SEIS also needs updating in line with multi-year inflation. We would like to see the £250,000 SEIS limit formally linked to an inflation measure to ensure the relief's value is not eroded over time.

METHODOLOGY

The FSB Insurance and Finance survey was conducted with members across the UK. Individuals were invited to participate in the survey via email and social media channels. The survey was administered by the research agency Verve and was in the field between 10 and 25 January 2022. The survey questionnaire was completed by a total of 819 small businesses. The survey findings are all weighted according to FSB membership weighting (to reflect the demographic balance of FSB members throughout the UK).

A structured focus group of FSB members was conducted via Zoom on 1 September 2022 which produced qualitative insights that have shaped the report. This panel included small businesses across a variety of sectors across the UK.

FSB's Small Business Index Surveys used throughout are conducted with members across the UK on a quarterly basis, with the most recent being Q3 2022, which was in the field between 20 September to 4 October. Individuals were invited to participate in all surveys via email and social media channels. All SBI surveys were administered by the research agency Verve.

The report also includes references to and analysis of data from the Bank of England and the British Business Bank.

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