Title: Help to Match SMEs Rejected for Finance with Alternative Lenders **IA No:** RPC14-HMT2153(2) **Lead department or agency:** HM Treasury **Other departments or agencies:** BIS	**Impact Assessment (IA)** **Date:** 21/03/2015 **Stage:** Final **Source of intervention:** Domestic **Type of measure:** Secondary legislation **Contact for enquiries:** Rob Wareing, HM Treasury 020 7270 4504

Summary: Intervention and Options

RPC Opinion: GREEN

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2009 prices)	**In scope of One-In, Two-Out?**	**Measure qualifies as**
-13.27	-13.27	1.16	Yes	Zero Net Cost

What is the problem under consideration? Why is government intervention necessary?

At present the largest four banks account for over 80% of UK Small and medium sized enterprises (SME) main banking relationships. Evidence shows that SMEs tend to approach their main bank when seeking finance. Evidence shows that when applicants are declined, a large number of SMEs cancel their plans rather than exploring alternative options that may be more suitable. As other finance providers with different business models may be willing to lend to these SMEs, this represents an informational market failure. Previous voluntary schemes by banks to refer businesses declined for a loan to alternative providers have not resolved this market failure.

What are the policy objectives and the intended effects?

This measure is designed to work together with the government's intervention on SME credit data to drive a significant change in the way that SME access credit in the UK. As a result of this measure, alternative providers will more easily be able to contact SMEs that are seeking finance and, due to the government's intervention on credit data, they will be able to quickly and accurately assess credit quality (with the SME's permission) and make a lending decision. Together these measures will drive competition in the SME lending market, leading to better outcomes for SMEs which have been struggling to access the finance they need from the big banks.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

Option 0: do nothing. This would mean SMEs are not referred to finance platforms after a loan application rejection. Consequently, the market failure would not be addressed.

Option 1: Legislate to require designated banks to refer details of SME applicants, with the SMEs permission, who are turned down for finance to private sector platforms that will facilitate contact with alternative finance providers that are looking to offer finance. This is the preferred option.

Will the policy be reviewed? The policy will be reviewed on an ongoing basis.

Does implementation go beyond minimum EU requirements?			N/A		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** No	**< 20** No	**Small** No	**Medium** No	**Large** No
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** N/A	**Non-traded:** N/A	

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs.

Signed by the responsible Minister: Andrea Leadsom Date: 21/03/2015

Summary: Analysis & Evidence

Policy Option 1

Description: Legislate to require banks to refer details of SME applicants who are turned down for finance to private sector platforms that will facilitate contact with challenger banks and alternative finance providers

FULL ECONOMIC ASSESSMENT

Price Base Year 2015	PV Base Year 2016	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: -16.76	**High: -9.51**	**Best Estimate: -13.26**

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low	3.7		0.7	**9.5**
High	9.8		0.8	**16.8**
Best Estimate	6.9		0.8	**13.3**

Description and scale of key monetised costs by 'main affected groups'

Designated Banks. The main cost for banks will be transition costs, namely the additional IT required to collate and transmit the data needed for the referral. Central assumptions provide a best estimate of £6.3 million across the population of 9 designated banks. Designated banks will also incur an ongoing cost of transmitting referrals to designated platforms as well as compliance and transparency costs. It is expected that ongoing costs will be low, a maximum of £0.5 million across the population of designated banks, as it is anticipated this will be a highly automated process.

Designated Platforms. The main cost for platforms will be transition costs. They will need to adapt their IT systems to enable them to receive and process the data received from the designated banks and share the data with SME finance providers that request it. Central estimates place transitional costs (which includes enabling IT to handle the specified information and other familiarisation costs) across all designated platforms at approximately £0.5m. Designated platforms will also incur a low level of ongoing costs in sending and receiving the specified information. It is expected that ongoing costs will be low, approximately £0.2 million across the population of designated platforms, as it is anticipated this will be a highly automated process.

Other key non-monetised costs by 'main affected groups'

N/A

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low				
High				
Best Estimate	N/A		N/A	**N/A**

Description and scale of key monetised benefits by 'main affected groups'

It has not been possible to monetise the benefits of this measure.

Other key non-monetised benefits by 'main affected groups'

Small businesses will benefit from improved access to alternative finance providers. A proportion of small businesses that previously would not have got finance from their bank may secure finance from an alternative finance provider.

The total cost of a financial product includes the cost of acquisition and origination costs which are passed on to customers in the form of interest rates or charges. The referral system will ease the process of origination and these costs will be significantly reduced.

Finance providers, particularly smaller providers who currently face barriers to their ability to compete, will benefit from increased opportunities to compete for smaller business customers. In addition, the creation of platforms will likely improve market visibility and awareness for alternative lenders, both through word of mouth and if platforms created have a public facing presence. Additionally, greater competition could spur innovation and product enhancement amongst providers the benefits of which would be passed on to SMEs.

Platforms providers will generate profits from commercial relationships with lenders.

Key assumptions/sensitivities/risks	**Discount rate (%)**	3.5

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OITO?	Measure qualifies as
Costs: 1.2	**Benefits: 0.0**	**Net:** -1.2	Yes	Zero net cost

Evidence Base (for summary sheets)

Background

1. The government is committed to fostering a strong, diverse and competitive banking sector to ensure that UK consumers, businesses, and the economy can benefit from high quality banking products and services at efficient prices. One of the impacts of the financial crisis has been an increase in the level of concentration in the UK banking market, including the market for SME[1] lending. At present the largest four banks account for over 80 per cent of UK SMEs' main banking relationships[2]. The government believes that such high concentration levels are bad for consumers and business and is determined to see a step change in competition in the UK banking market, making it easier for alternative and innovative finance providers to enter and compete in this marketplace.
2. The government has already taken significant steps to drive up competition in banking. Interventions have included:

Levelling the playing field by removing distortions in the market that favour large, incumbent banks	The government legislated through the Banking Reform Act to ring-fence banking services and increase banks' capacity to absorb losses. Introducing ring-fencing and measures on loss absorbency are key steps in helping to create the right environment for competition in banking to flourish.
Reducing barriers to entry and expansion in the banking sector	In July 2012, the Chancellor of the Exchequer asked the Financial Services Authority (FSA) to conduct a Review of Barriers to Entry and Expansion in the banking sector which resulted in major changes to the capital requirements for new and smaller banks, making it easier for them to enter the market and compete.
Creating a new competition-focused regulator for payment systems	The government legislated through the Banking Reform Act to create a new Payments Systems Regulator, which was incorporated in April 2014. The regulator has been created to ensure that smaller banks and non-bank providers can get fair access to payments systems, to help drive innovation and choice for consumers.
Making it easier for consumers to move their bank accounts to a provider that meets their needs	The 7-day switching service launched in September 2013. In its first year of operation the number of customers switching current accounts increased by 22% compared to the year prior to its launch. At Autumn Statement 2014 the Government announced improvements to the service, so that from the end of March 2015 it will be available to 99% of SMEs and the redirection guarantee will be increased from 13 to 36 months to provide further assurance that no direct debits or standing orders will fail.
Improving transparency	The government has secured a voluntary agreement with the major lenders to publish bank-by-bank lending data across 10,000 postcodes, enabling smaller lenders, both banks and non-banks, to see where lending is low and pursue new business in these areas. A new Business Banking Insight Survey[3] has been created, which allows for a public ranking of banks based on the services and products they provide for SMEs is also a welcome development.
Creating the right regulatory environment to foster competition	The Financial Conduct Authority (FCA), created through the Financial Services Act 2012, has been given a powerful mandate to promote effective competition in the interests of consumers, and a duty to consider competition in pursuing its consumer protection and market integrity objectives. The government also legislated in the Banking Reform Act to further enhance the competition powers of the FCA and

[1] http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/sme-definition/

[2] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/346931/SME-report_final.pdf

[3] http://www.businessbankinginsight.co.uk/

	to provide the Prudential Regulation Authority (PRA) with an explicit competition objective.
Increase the supply and the diversity of funding for SMEs	The Government launched British Business Bank's programmes are already delivering significant results, facilitating more than £900 million of lending and investment to smaller businesses and a further £600 million to midcaps, benefiting over 43,000 businesses. The Bank will unlock £10 billion of new finance by 2017-18.

3. The government also announced at Autumn Statement 2013 that it would consult on proposals to require banks to share information on their SME customers with other lenders through Credit Reference Agencies (CRA). The government launched this consultation on 26 December 2013 and is legislating through the Small Business, Enterprise and Employment Bill. The proposals are intended to improve the ability of challenger banks and alternative finance providers to conduct accurate SME credit scoring and, by levelling the playing field between providers, make it easier for SMEs to seek a loan from a lender other than their bank. A better understanding of the SME sector should also stimulate competition and innovation in SME lending, improving the cost and quality of services offered.

Public consultation

4. Building on this policy, the government then announced, at Budget 2014, that it would issue a consultation on helping to match rejected SME loan applicants with alternative providers of finance. The consultation was launched on 28 March 2014 and closed on 25 April 2014. During the consultation period, the government held workshops with representatives of the banking sector, small businesses, alternative finance providers, and the UK technology industry. The government has also had discussions with relevant bodies in other jurisdictions which operate similar or comparable systems.
5. The consultation asked whether the government should legislate to help match SMEs that have been rejected for loans with challenger banks and alternative finance providers who are looking to offer finance. The consultation also asked questions about the mechanics of delivering such a measure (if the government decided to legislate) and set out the government's preferred approach of requiring banks to refer details of SMEs that have been rejected for loans to a platform or platforms so that they can be accessed by challenger banks and other providers of finance.

Problem under consideration

6. The evidence that a government intervention is needed to help match SMEs which are seeking finance with credit providers which are looking to offer finance has been steadily building. Anecdotal evidence has long suggested that most SMEs only approach the largest banks for finance, and at present the largest four banks account for over 80 per cent of UK SMEs' main banking relationships. The question was tested in the study 'Small and medium-sized Enterprise (SME) Journey towards raising external finance', October 2013, by the Department of Business, Innovation and Skills (BIS)/BMG Research[4], which estimated that the majority (71 per cent) of businesses who seek funding only approach one provider. The study also noted that over half the SMEs that sought finance in the past three years went directly to their main bank.
7. Data from 2014 shows that a large number of applications are rejected. In the case of first time SME borrowers, the rejection rate was 43 per cent[5]. It is likely that a proportion of these are viable and are rejected simply because they do not meet the risk profiles of the largest banks. There are often challenger banks and alternative finance providers with different business models that may be willing to lend to these SMEs.
8. Although the largest banks will sometimes refer these SMEs on to other providers or advisors on a bilateral basis (for example Royal Bank of Scotland and Santander UK have a Strategic

[4]http://british-business-bank.co.uk/wp-content/uploads/2013/10/SME-Journey-Towards-Raising-Finance.pdf

[5]SME Finance Monitor Q4 2014: http://bdrc-continental.com/products/sme-finance-monitor/

Partnership with FundingCircle), this is not happening systematically. There are challenger banks and other providers of finance that may be willing to make a loan, however, most SMEs do not consider these alternatives, and the challenger banks and other finance providers do not currently have a way to identify which SMEs are seeking finance. The BIS/BMG Research study found that of those SMEs that were turned down for finance; were offered a smaller amount; or who rejected the terms and conditions of their offer, 37 per cent gave up on their plans[6].

9. The Independent Lending Review of the Royal Bank of Scotland, led by Andrew Large, found that a lack of awareness of the alternative sources of finance available to SMEs was a major structural problem with the UK lending market.

10. This is a market failure of imperfect information resulting in SMEs that are viable financial propositions not receiving the finance they need and which they may obtain from providers with different risk profiles in a better functioning market.

What is the Case for change?

11. SMEs play an important role in the UK economy. Around 99.9% of the UK's 5.2 million private sector businesses are small or medium-sized (employing less than 250 people). SMEs are responsible for almost half of the £3,500 billion private sector turnover and 60 per cent – or just over 15 million – of private sector employment. Around three quarters of businesses, approximately 4 million, have no employees at all[7].

Table 1: Estimated number of businesses in the UK private sector, by size of business, start of 2014.

Business size	Number of Businesses
All UK private sector businesses	5,243,135
SMEs (0-249 employees)	5,236,390
With no employees	3,965,775
1-9	1,044,385
10-49	194,755
50-249	31,475
250 or more	6,745

(Source: Business Population Estimates for the UK 2014)

12. It is essential that SMEs can access the appropriate finance to manage cash flows and fund investment. The SME Finance Monitor[8] estimates that in 2014 8 per cent of SMEs had applied for a new or renewed loan or overdraft. However, not all applications result in funding. In the 18 months to Q4 2014 almost a quarter of these applications did not result in a facility.

13. The importance of finance to SMEs, and their difficulties in finding it, strengthen the case for change. In 2010 the major banks committed in the British Bankers' Association (BBA) Finance Taskforce Report, Supporting UK Business, to signpost alternative sources of finance, giving customers helpful information and advice if a loan is declined and raising awareness about the financial solutions they should consider. Building on this commitment, the government worked with the BBA and the major banks to pilot a voluntary referral system with Community Development Finance Institutions (CDFIs). The referral system allows the major banks to refer viable businesses to which they are unable to offer finance to CDFIs. CDFIs can then assess whether they are able to offer finance.

14. While some progress has been made, these interventions are limited in scope and have been slow in achieving results. The SME Finance Monitor found that only 10 per cent of SMEs initially declined for loans by their bank were offered alternative funding or referred to alternative sources. Furthermore, just 4 per cent were referred to external sources of advice or help[9].

15. Data from finance platforms suggests that only 15 per cent of platform users arrive via a referral. Assuming that 93,000 SMEs were referred to platforms (see below for calculation and

[6] british-business-bank.co.uk/wp-content/uploads/2013/10/SME-Journey-Towards-Raising-Finance.pdf

[7] www.gov.uk/government/statistics/business-population-estimates-2014

[8] SME Finance Monitor Q4 2014: http://bdrc-continental.com/products/sme-finance-monitor/

[9] SME Finance Monitor Q4 2014: http://bdrc-continental.com/products/sme-finance-monitor/

assumptions) referrals would become the majority, more than 95 per cent, of platform traffic and increase the number of SMEs on platforms by approximately 1000 per cent.

16. The National Association of Commercial Finance Brokers (NACFB) points to the still widespread perception that high street banks are the only source of funding for small businesses, based on feedback from NACFB members. In roundtable discussions and feedback on the consultation, challenger banks and alternative finance providers also continued to note that they lack information about SMEs seeking finance. This market failure of imperfect information is therefore continuing to impede the efforts of challenger banks and alternative finance providers to support SMEs that need finance.

Rationale for intervention

17. Information is needed for a market to operate efficiently. Buyers need to know the quality of the good or service to judge the value of the benefit it can provide, which includes being able to compare goods and services between different providers. Where this information is not available a market failure may result, known as 'asymmetry of information'[10].
18. Given the concentration in the SME banking market, and the fact that previous self-regulatory efforts by the major banks have not led to an effective system of referrals, an asymmetry of information persists. The government therefore believes there is a case for using legislation to mandate a flow of information on rejected SME loan applications, and consulted on this basis.
19. The government's preferred approach is that rejected loan applications would be referred from a bank to a 3rd party platform or platforms that would be accessible to other lenders. These platforms would be designated by the government.
20. The government is keen to ensure that any intervention it makes complements existing private sector referral arrangements, by increasing the flow of information about SMEs rejected for finance to challenger banks and alternative providers of finance. The consultation asked for views on this proposition.
21. Over 50 responses were received to the consultation. The majority agreed that there was a case for mandating a flow of information on rejected SME finance applicants (extending beyond loans to include other common finance products). There was also significant support for the government's preferred approach that rejected finance applications would be referred from a bank to a third party platform or platforms that would be accessible to other lenders.

Policy Objective

22. The policy objective is that all smaller businesses that are declined finance should be given the option to be referred to third party platforms to facilitate contact with potential alternative financers. This is intended both to improve access to finance for these businesses, and to improve competition in the SME lending market by giving smaller players access to a wider range of potential lending opportunities. The policy is intended to address a current market failure, where businesses which may be able to secure finance are not matched with willing lenders owing to a lack of accessible information.

Options

Option 0: do nothing

23. Under this option, the government would do nothing.
24. Under this option, the market failure in the current system would be likely to remain intact. Existing informal and voluntary referral mechanisms would continue to function, but there is no evidence to suggest that these are having a significant effect on those businesses that are declined for finance

[10] The Green book : Appraisal and Evaluation in Central Government, Annex 1: Government intervention, P52, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/220541/green_book_complete.pdf

or discouraged from seeking it. In the medium to long-term, market-led platforms may develop to provide an alternative route for SMEs seeking finance (some such platforms already exist, offering access to differing ranges of lenders). However, they would not benefit from the flow of lending opportunities created by mandatory referrals, and may be held back by low awareness and inertia amongst the small business community. Respondents to the consultation strongly favoured some form of mandatory sharing by banks as a means of addressing the problem under consideration and so this option has been rejected.

Costs

25. There would be no direct costs associated with this proposal.

Benefits

26. No additional benefits would accrue from this option.

Option 1: Legislate to require lenders to refer declined finance applications to third parties

27. Under this option, where an SME has given their permission, SME lenders above a certain market share threshold will be required to refer information about SMEs rejected for finance on to private sector platforms. These platforms will be designated by HM Treasury on advice of the British Business Bank. At Autumn Statement 2014 the Government announced that it intended to designate Royal Bank of Scotland, Barclays, Lloyds Banking Group, HSBC, Santander, Clydesdale and Yorkshire Banks, Bank of Ireland, Allied Irish Bank and Danske Bank. These banks represent the majority of SME lending in the UK by market share.
28. Those designated platforms will be required to give access to information on those borrowers to any finance provider that has the SMEs permission.
29. The information that will be shared was determined by consultation. Banks will be required to share the following specified information:
    a) name of the small or medium sized business;
    b) the postal address, email address and telephone number of the business;
    c) the amount of finance requested by the business;
    d) the type of finance requested by the business (where a specific type of finance has been requested by the business);
    e) the legal structure of the business (limited company, limited partnership, partnership sole trader, or other);
    f) the period in years and months for which the business has been trading and receiving income;
    g) the date by which the business requires finance or, if such date is not known, the date by which the business has requested finance.

Costs

30. Officials have been in ongoing discussions with the banking industry, potential platforms and other market participants to understand the costs to businesses involved in this proposal. Cost estimates have therefore been informed by formal and informal consultation as well as the experience of other relevant policies.

Table 2: Summary of costs of legislation on market participants[11]

Costs (£mn)	Designated banks	Designated platforms
Transition costs	6.30	0.55
Of which:		
IT set up costs	*4.41*	*0.39*
Familiarisation costs	*1.89*	*0.17*
Annual costs	0.50	0.17

[11]The assumptions for these costs are detailed in the section below. Costs are central estimates on a nominal cash basis, aggregated across the population of market participants.

Costs for designated banks

One off costs

31. As above the legislation will require that the designated group of banks must offer any SME which is declined for finance the chance to have its details shared with a designated platform. It must share this data at the end of each working day.
32. The main cost involved in this will be the additional IT required to collate and transmit the data needed for the referral. This includes collation and any infrastructure needed to share it with the platforms.
33. In terms of collation, banks already collect much of the data required for the referral, and will operate similar processes for collating and transmitting data to another party, to comply with other requirements (for example Anti Money Laundering and data sharing/reporting regulations). It is important to note that a criteria for designation as a platform will be that it is able to accept commonly used and accepted commercial formats for data sharing. This helps minimise the necessary IT costs. However, there will be costs involved with adding additional data fields to what is already collected, and in developing the internal process necessary to send this data to platforms.
34. In addition, there will be upfront familiarisation costs involved. These include training staff in how to comply with the legislation and in setting up the necessary internal processes to ensure compliance.
35. A number of banks have provided estimates for the costs associated with making the necessary changes to their IT systems and familiarisation costs. These estimates are informed by similar projects, notably the new legislative requirement to share data with CRAs, the existing CDFI referral programme mentioned above and strategic partnerships already in operation.
36. Bank estimates put the range of costs for an individual bank at between £400,000 and £1 million. Our assumption is that the upfront cost of infrastructure is a fixed cost and therefore will not alter significantly with lending volumes. Therefore, the total cost to designated banks will be equal to the number of designated banks multiplied by the cost estimates. This generates a cost range of between £3.6 million and £9 million. Given the uncertainty around these estimates at such an early stage of development our central estimate is the mean point of these costs; £6.3 million.
37. The breakdown of these costs is expected to be heavily weighted towards IT set-up costs with approximately 70 per cent of expenditure on software delivery. The remaining 30 per cent of expenditure is made up from familiarisation costs such as business change delivery and staff training.

Ongoing Costs

38. Banks will also incur an ongoing cost of transmitting referrals to designated platforms as well as compliance and transparency costs.
39. It is expected that compliance and transparency costs will be nominal. Given the on-going reporting relationships between banks and regulators it is expected that this will be integrated into existing processes.
40. Furthermore, it is expected that ongoing costs in sending specified information will be a highly automated process and costs will therefore be low. Bank estimates therefore place ongoing costs, (inclusive of compliance, transparency and information transfer) at a maximum of £500,000 for the industry as a whole. This cost is dependent on information flows, therefore, bank cost estimates received have been weighted by current market share before being extrapolated across the 9 designated banks to provide this upper bound estimate.

Costs for Platforms

One off costs

41. Finance platforms will be required to make changes to their IT systems to enable them to receive and process the data received from the designated banks and share the data with SME finance providers that request it. These system changes will need to ensure platforms can meet the necessary data protection standards as set out in the Expression of Interest documents. Platform

estimates place transitional costs (which includes: enabling IT to handle the specified information and other familiarisation costs) across all designated platforms at approximately £558,750.

42. The costs for platforms are several magnitudes lower than bank cost estimates. In the course of market competition platforms have been developed and designed to be able to handle the specified information that will be passed on by designated banks. It is assumed that to be in a position to be designated the platform will already have this capability. Therefore, costs are primarily incurred in ensuring systems have sufficient capacity to handle the increased flow of data that designated banks will supply.

43. Platforms estimate that initial set up costs will range from approximately £40,000 to £115,000 dependent upon the design of the information transfer mechanisms. Industry negotiations as to the design of this system are ongoing. Given this uncertainty the central assumption is the midpoint of this range; £74,500. Using this as a baseline for the costs for all platforms, the total cost to businesses will be determined by the number of designated platforms. This calculation has assumed, for simplicity only[12], that there are between 5 and 10 platforms designated. This provides a cost estimate of between £372,500 and £745,000 with a central estimate of £558,750.

44. The proportion of the transition costs accounted for by familiarisation costs has been estimated at £168,000. For simplicity, this estimate is based on the assumption that familiarisation costs for platforms will be proportionate to those faced by designated banks. As bank estimates suggest this is approximately 30 per cent of transitional costs, the same ratio has been applied for platforms.

45. It should be noted that no platform will be required to seek designation. Therefore, we anticipate that potential platform providers will only choose to incur these costs if they consider it to be commercially beneficial to their business.

<u>Ongoing Costs</u>

46. Designated platforms will incur a low level of ongoing costs in sending and receiving the specified information. It is expected that this will be a highly automated process and costs will therefore be low. Platform estimates place ongoing costs at approximately £168,750 per year. This cost estimate assumes 140,000 referrals per year are transferred to each platform. This estimate includes all costs associated with complying with the legislation as well as maintenance work on IT systems.

47. Market share for platforms is unknown, however, the legislation provides for all designated platforms to receive specified information equally. Furthermore, market intelligence suggests that most finance providers will, at least until competitive forces shape the market, place themselves on all designated platforms. Therefore we have assumed that platforms will have consistent costs. Platform estimates place ongoing costs at £22,500 per year. Consequently, assuming there are between 5 and 10 platforms, a cost range of £112,500 and £225,000 has been generated. Consistently, the central estimate is the mean point of this range.

Costs for finance providers

48. The government's proposal is that referrals should be implemented through third-party providers; we anticipate these will emerge from the private sector. In order to generate profit, it is likely that platforms will charge alternative finance providers (whether via subscription or on a per transaction basis) to access business data in order to make expressions of interest in providing finance. These costs are a business decision between platforms and alternative finance providers. Alternative finance providers will only accept the terms of the platform only if it represents a viable business opportunity. The Government's proposal will encourage platforms it is expected that competition between designated platforms will ensure that any costs to finance providers will be set at a market clearing rate.

49. It can be argued that these costs are actually net zero across business. The costs incurred by finance providers represent profits for the designated platforms hence offsetting this cost to providers. It should be noted that the Legislation prohibits platforms from charging SMEs for services carried out in complying with the legislation.

[12]These assumptions are not an indication of future Government policy, they are for indicative cost estimates only.

Costs of designation

50. The Business Bank will incur costs in advising HMT on designation of finance platforms and Credit Reference Agencies (CRAs). These costs will be met from its returns, but if they make the difference between meeting its return target and not meeting it, then the Business Bank will still be deemed to have met its target. These costs have no direct impact on business.

Costs for regulators

51. The FCA will have proportionate regulatory oversight of the process. This will include oversight of banks requirement to comply with their obligations to share information with platforms, and oversight of designated platforms' requirement give fair access to lenders. The FCA will publish a consultation on the intended regime for oversight in due course.

52. The FCA already has a working relationship with the designated banks reflecting the compliance monitoring they undertake in many areas of their business. It is expected that monitoring compliance with this legislation can be undertaken as part of the FCA's Business as Usual contact with the banks and will therefore generate only negligible costs. The FCA will also be required to monitor the compliance of the designated platforms and this will result in an annual fee for designated platforms. This is purely a matter for the FCA and this impact assessment does not seek to pre-judge this process. However to give an idea of magnitude we use as a rough proxy the output of the FCA's fee estimate website for an equivalent sized firm, which generates an annual fee of £2,500[13]. Aggregated across between 5 and 10 platforms this gives a cost range of between £12,500 and £25,000 per year with a central estimate of £18,750.

Benefits

Benefits for small businesses

53. Small businesses will benefit from improved access to alternative finance providers. A proportion of small businesses that previously would not have got finance from their bank may secure finance from an alternative finance provider.

54. Small business survey data[14] estimates that 200,000 businesses applied for a new loan or renewal in 2014, and 291,000 applied for a new or renewed overdraft. Based on rejection rates from the same survey this would suggest that approximately 93,000 businesses were rejected for finance[15].

55. Data from a running, voluntary platform suggests that approximately 55 per cent of SME visitors to its portal end up contacting an alternative finance provider. Applying this to all rejections would mean more than 51,000 SMEs rejected for credit would apply for credit from a provider other than their bank. Some of these firms will not be creditworthy, however, assuming a success rate of 50 per cent, in line with the SME finance monitors rejection rates for SMEs, would still see 25,500 firms gain credit where they would not have previously. The table below, based on BBA statistics from Q4 2014 shows the average value of loan and overdraft requests from SMEs[16].

56. Applying these averages across the 25,500 successful businesses seeking loans from alternative providers via platforms suggests that this policy could increase the supply of credit to SMEs by approximately £1.4 billion[17]. This may not tell the full story as businesses have more options than just loans and overdrafts when applying for finance so the above population, and therefore credit supply estimate, may be an underestimate.

57. Additionally, Nesta data[18] asserts that the average amount borrowed by businesses on a peer-to-peer platform in 2014 was £73,222. Using this figure and the same methodology as above, provides

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[13] This calculation assumes that platforms are classified in FCA Fee Block A013 (Advisory only firms and advisory, arrangers, dealers, or brokers (NOT holding client money or assets, or both); and have an annual income of £500,000

[14] Calculation made based on BIS Business population estimates and SME Finance Monitor data

[15] Based on overall success rates for new loans/overdrafts and renewal loans/overdrafts for 18 months to 2014Q4.

[16] BBA definition of small business is turnover below £1/2 million. Definition of small business is turnover below £25 million.

[17] Calculation applies small business finance averages from table 2 to all 51,000 SMEs as the BBA definition of small applies to the whole sample taken from the Small and Medium Enterprises in the Business Population Estimates.

[18] http://www.nesta.org.uk/sites/default/files/understanding-alternative-finance-2014.pdf

a theoretical, upper bound for the increase in SME credit that could result from this policy of approximately £1.9 billion[19].

Table 3: SME credit data, 2014 Q4

Business size	Product type	Number of approvals	Total value of approvals (£mn)	Average value of approvals
Small	Loan	22,164	1,948	£87,907
	Overdraft	29,663	556	£18,740
Medium	Loan	9,606	4,048	£421,366
	Overdraft	6,335	640	£101,009

(Source: British Banker's Association, Banking Support for SME statistics, 2014 Q4)

58. Furthermore, greater competition could spur innovation and product enhancement amongst providers, as well as platforms potentially reducing costs of origination (see below). These benefits could be passed on to business.

Benefits for alternative finance providers

59. Lenders, particularly smaller providers who currently face barriers to their ability to compete, will benefit from increased opportunities to compete for smaller business customers. In addition, the creation of platforms will likely improve market visibility and awareness for alternative lenders, both through word of mouth and if platforms created have a public facing presence.

60. The total cost of a financial product includes the cost of acquisition and origination costs which are passed on to customers in the form of interest rates or charges. Based on discussions with industry stakeholders, these acquisition and origination costs are made up of the costs of marketing, product preparation, targeting customers, market research of customer base, application preparation, and manpower hours on securing the individual lending opportunity. If the referral system eases the process of origination, then many of these costs will be significantly reduced. These costs will be reduced for major players as well as for smaller providers who may face much larger proportionate costs of origination than those with economies of scale.

Benefits to Platforms

61. Platforms providers will generate profits from commercial relationships with lenders. The value of these profits will be dependent on market forces and competition between platforms and is not therefore possible to quantify at this stage.

62. Mandating referrals is expected to generate a major increase in traffic for platforms should they secure designated status, supporting the development of this market. All platforms are likely to experience some benefits owing to the increased visibility of this model as part of the finance landscape.

Scope of intervention

63. In 2014 29 per cent of all SMEs used of 'core' forms of finance which includes: loans; overdrafts; and credit cards. 17 per cent of SMEs used one or more 'other' forms of finance which includes invoice finance; leasing; and asset finance.

64. The SME Finance Monitor estimates that in total 8 per cent of all SMEs experienced a 'borrowing event', which equates to more than 400,000 businesses in total[20]. Given the increase in use of 'non-core' credit products by SMEs this legislation will incorporate certain forms of non-core finance products alongside traditional lending products. The list of products in scope as defined by the legislation are:

    a. loans;
    b. overdrafts;
    c. invoice finance;

[19]It should be noted that the increased supply of credit to SMEs as a result of this measure will, in reality, depend on the size and number of facilities created. Therefore, the numbers presented here have been calculated to provide a sense of scale only and do not represent Government forecasts for the impact of this policy.

[20]Calculation made based on BBA dataset: www.bba.org.uk/news/statistics/sme-statistics/bank-support-for-smes-4th-quarter-2014

d. asset finance;

e. credit cards;

Wider impacts

Increase competition resulting in better SME access to finance

65. Non-bank finance providers will often have a different risk appetite to the major banks and may be willing to lend to SMEs that the major banks are not willing to serve, particularly during periods of heightened stress in the credit market. The proposals will allow a broader group of lenders to find SMEs who require finance but are unaware of alternative providers. This will improve competition in credit markets and as a result the overall efficiency in the economy will improve. This will have much wider economic benefits as SMEs are key employers and investors, and hence act as key contributors to economic growth in the UK.

66. Around 99.9% of the UK's 5.2 million private sector businesses are small or medium-sized (employing less than 250 people) and SMEs are responsible for almost half of the £3,500 billion private sector turnover.

67. The performance of SMEs impacts heavily on labour market outcomes. Approximately 60 per cent, or just over 15 million, of private sector employment is accounted for by SMEs. The smallest businesses constitute a large portion of the UKs workforce; approximately 31 per cent of per cent of private sector employment is accounted for by businesses with between 1 and 50 employees[21].

68. On top of this, SMEs are drivers of job creation. Between 1998 and 2010 a total of 2.61 million jobs were created, of which existing small firms of fewer than 50 employees contributed 34 per cent of the total jobs, and start-ups contributed a further 33 per cent[22]. This means that ensuring SMEs can access the appropriate finance they need to invest in their business to grow and create jobs is essential for the UK economy.

Lower barriers to entry

69. The proposals will mean smaller providers of finance will be given access to a wider range of potential lending opportunities, thereby helping to improve competition in SME lending. Additionally, smaller providers who do not offer universal banking services face potentially prohibitive origination cost barriers, and are therefore likely to charge higher premiums, as well as offer less mass marketable or commoditised products (e.g. sub £25k). The policy could help level that playing field by reducing origination costs, helping smaller providers to effectively compete and reduce their cost of lending to SME customers. The policy could additionally help non-bank providers and challenger banks, that do not provide current accounts, break into what can be considered a 'captive market'.

Stimulate a diversified banking market for SMEs

70. The current market for SME banking has evolved around the current structural asymmetries that exist in this market. The dominance of the major current account providers presents a barrier to entry for alternative finance providers if those large providers become the 'default' for businesses seeking finance, preventing alternative finance providers finding SMEs who want to borrow. Removing this barrier to entry will enable potentially new alternative finance providers to enter the SME credit market, and also allow smaller players already in the market to compete more easily and increase market share.

Equalities Impact

71. The government expects the equalities impact of this measure to be neutral. Religion, pregnancy and maternity, and sexual orientation (based on current analysis) do not appear to generate significant issues in terms of access to finance. The government does recognise that there are impacts regarding age, ethnicity and gender on the availability of finance to SMEs, but these

[21] www.gov.uk/government/statistics/business-population-estimates-2014

[22] Job Creation and Destruction in the UK:1998-2010, BIS and Aston Business school, 2011 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/32244/11-1326-job-creation-and-destruction-uk-1998-2010.pdf

impacts are indirect rather than direct, and reflective of wider access to finance issues. The government is of the view that, as this measure is anticipated to increase access to finance more generally, the above groups will benefit in equal measure from the intervention.

Families Impact

72. This measure is not expected to have any impact at the level of the family.

Small and Micro Business Assessment

73. At Autumn Statement 2014 the Government announced that it intended to designate Royal Bank of Scotland, Barclays, Lloyds Banking Group, HSBC, Santander, Clydesdale and Yorkshire Banks, Bank of Ireland, Allied Irish Bank and Danske Bank. This decision was based on a market share threshold in Britain and Northern Ireland that ensured this proposal capture the majority of the SME lending by stock of lending, while minimising impact on challengers and newer lenders.

74. Small lenders who opt to join platforms will benefit from an increased range of opportunities. Government legislation will ensure that small lenders can access platforms on fair terms.

75. Significantly, survey evidence demonstrates that it is disproportionally smaller and micro-businesses who are rejected main stream bank finance, and these businesses tend to be less sophisticated with few or no 'financial officers', and therefore this intervention is, though not explicitly targeted at, predominantly geared to benefit those businesses. As outlined above we expect that the proposals will have a positive, indirect impact on small to medium size businesses that seek finance.

Post Implementation Review

76. This policy will be reviewed on an ongoing basis.

One in Two Out (OITO)

77. This policy is a pro-competition measure. The SME banking market is extremely concentrated: the largest four banks currently account for over 80 per cent of UK SMEs' main banking relationships.
78. Many SMEs only approach the largest banks when seeking finance. 2014 data shows that, in the case of first time SME borrowers, the rejection rate was 43 per cent[23]. A proportion of these businesses are viable and are rejected because they do not meet the risk profiles of the largest banks. There are often challenger banks and alternative finance providers with different business models that may be willing to lend to these SMEs.
79. Therefore, the market suffers from significant information asymmetries. Banks are currently not required to pass on information about SMEs which they reject. Although the largest banks will sometimes refer these SMEs on to brokers or 'strategic partners'. In many cases challenger banks and other providers of finance are unable to offer finance as they are unable to determine which SMEs require finance and, additionally, SMEs are not aware of the existence of these alternative sources of finance.
80. This represents a barrier to entry for alternative finance providers as banks control access to information on rejected SMEs. Access to data on rejected SME borrowers would stimulate competition by helping alternative finance providers and challenger banks to lend to SMEs.
81. As such, the costs of this measure fall outside the scope of the One in Two Out calculation of new regulatory burdens.

[23] SME Finance Monitor Q4 2014: http://bdrc-continental.com/products/sme-finance-monitor/

82. To go into more detail, the Better Regulation Framework Manual sets out criteria by which to judge whether a policy is pro-competition for the purposes of qualifying for this exemption (at least one criterion must apply). This policy meets a number of those criteria, as set out below.

Indirectly increasing the number or range of sustainable suppliers

83. The current market for SME banking has evolved around the current structural asymmetries that exist in this market. The dominance of the major business banking providers presents a barrier to entry for alternative finance providers if those large providers become the 'default' for businesses seeking finance, preventing alternative finance providers finding SMEs who want to borrow. Removing this barrier to entry will facilitate market entry for new alternative finance providers for SMEs, and also allow smaller players already in the market to compete more easily and increase market share.

Strengthening the ability of suppliers to compete

84. This measure will enhance the ability of non-bank finance providers to find SMEs who want to borrow. As alternative finance providers may have materially different risk appetites from that of the major lenders, these proposals can help these lenders to increase market share.

Increasing suppliers' incentives to compete vigorously

85. The dominance of the major current account providers presents a barrier to entry for alternative finance providers if those large providers become the 'default' for businesses seeking finance, preventing alternative finance providers finding SMEs who want to borrow. Removing this barrier to entry will enable potentially new alternative finance providers to enter the SME credit market, and also allow smaller players already in the market to compete more easily and increase market share.

86. The net impact of the measure is expected to be an increase in competition with an expected overall additional economic benefit. The measure is designed to level the playing field in the market for SME lenders. It will lower barriers to entry and enhance the ability of non-bank finance providers to compete.

87. It would be reasonable to expect a net social benefit from the policy, even where all the impacts may not be monetised. SMEs are disproportionately reliant on bank finance in a highly concentrated market. The financial crisis has both increased this concentration yet at the same time has impaired the ability of those incumbent banks to lend to SMEs.

88. This measure is designed to work together with the government's SME Credit Data intervention to drive a significant change in the way that SMEs access credit in the UK. As the outcome of the consultation led to a decision that requires banks to share details of SME applicants who are turned down for a loan, the alternative provider will not only be able to identify SMEs that are seeking finance but, with an SMEs permission, will be able to quickly and accurately assess credit quality and make a lending decision. This will drive competition in the SME lending market leading to better outcomes for SMEs who have been struggling to access the finance they need from the big banks.

Summary

89. The government is legislating to require the largest UK SME lenders to refer SMEs they reject for finance to platforms that will facilitate contact with potential alternative financers.

90. Platforms will be designated to receive these referrals by HM Treasury on advice of the British Business Bank. Designation will be subject to the platforms meeting certain standards of operation on an ongoing basis.