



How the budget can unleash the potential of small businesses

iwoca's submission to the
Budget 2020



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Summary

There are 5.9 million SMEs in the UK, making up over 99% of the total number of businesses in Britain. These range from one-person outfits to businesses with 250 employees, providing 60% of private sector employment and generating over half (52%) of private sector turnover¹. Some are trying to be the next big thing, but the majority are just pursuing their passions and running independent businesses. Whatever they do, small businesses are the backbone of our economy, keeping our high streets and local communities vibrant.

As such, support for small businesses must play a central role in the upcoming Budget. Implementing smart policies can unlock a huge amount of growth, resulting in hundreds of thousands of additional jobs and greater prosperity. Just months after the election, the Government has an opportunity to show it is on the side of entrepreneurs and small businesses: the job and wealth creators of Britain.

The small business community is still facing the consequences of the financial crisis. Since 2008, the UK's SMEs have suffered from not being able to access finance to keep their shops, stores and offices up and running. According to the Bank of England, they are currently facing an estimated gap in finance of up to £22 billion².

iwoca was founded in 2012 to help serve small businesses and give a boost to the economy by providing much needed liquidity – something the banks were not prepared to do. Many small businesses were being denied finance, being left to wait too long, or expected to jump through too many hoops in order to access relatively small pots of finance they need to help them thrive. We specialise in offering loans custom built for micro businesses, which now make up over 95% of the total number of SMEs in the UK. Since we launched eight years ago, we have made funding available to over 50,000 businesses and lent over £1 billion to customers across Europe.

We regularly talk to our small business community, and ahead of the Budget they've outlined what actions they want to see from the Government. Central to this is improving access to finance, with **66% of small businesses we spoke to believing that this should be prioritised in the upcoming Budget**. Indeed, over a third (35%) of our customers felt that it should be the main focus of the Government over the next five years. High street banks remain the first port of call for the vast majority of businesses seeking a loan or overdraft, however since the financial crisis these same banks have reduced the level of finance provided to small businesses. Whilst the rise in digital lenders, such as iwoca, has helped fill the funding gap, small businesses still want the

Government to take more action to make it easier to access the finance they need to grow.

Many small businesses operate on fine margins, where any sudden or significant rise in costs can have a detrimental effect on their business. Because of this, our customers have raised concerns about changes to the tax environment and policies which will increase their operating costs. Following the Government's announcement over Christmas of its intention to increase the National Living Wage, 42% of our small business customers wouldn't like to see any further rise in the Budget. Business owners have also expressed concerns at the freezing of Corporation Tax cuts (38%), reforming Pension Tax relief (31%) and scrapping Entrepreneur's Relief (29%).

The ongoing talks about the UK's future relationship with the EU is also front of mind for many small businesses and their supply chains. The election result and passing of the Withdrawal Agreement has helped contribute to a rise in business confidence – 57% of small business owners are either very confident or reasonably confident that the business environment will improve over the next 12 months. However, only 23% of iwoca's business community believe that the uncertainty over Brexit is over. Negotiating a trade deal with the EU is regarded as very important to 63% of businesses, far higher than signing a deal with the US (39%), China (35%) or India (27%).

It's clear that small business owners want the Government to prioritise a trade deal with the EU over other major economies.

As one of Europe's fastest growing small business lenders we believe there are three steps that the Government can take to make it easier for companies like ours to support the UK's business community.

Firstly, the Government should look at reforming the Bank Referral Scheme. The BRS has the potential to transform the small business lending market but the latest figures show that since it was launched, it has only resulted in 1,695 deals worth around £32 million. According to the most recent data, in 2018 10% of SMEs planned to apply for finance but only 4% went on to do so. This means 6% of SMEs – around 300,000 small businesses in 2018 - were dissuaded from applying for finance³. Based on the average loan amount in that year of approximately £21,000 for BRS funding, this represents an unmet demand of at least £6 billion⁴. We therefore urge the Government to take action to increase the number and value of referrals by regularly reviewing the scheme, incentivising banks to refer more small businesses and creating a more seamless referral process for business owners.

Secondly, HM Treasury should also support the Bank of England's Open Finance initiative to create a portable KYC and credit file. One of the key blockers to increasing competition and choice in the small business lending market is the friction that comes with

customer onboarding. The processes as they currently are can be cumbersome to small business owners attempting to switch providers. As a first step we propose that the Government allows Companies House to share information on directors with accredited financial services firms in order to help remove unnecessary friction during customer onboarding.

Finally, the Government should make the guarantee schemes operated by the British Business Bank more flexible by making them more accommodating for unsecured lenders. This would lead to significant innovation in the finance market by removing, for example, the need for personal guarantees which could reach 720,000 businesses, who would benefit from finance, but many of which avoid it due to the personal guarantee barrier.

We believe that implementing policies to support the SME community and improve access to finance will spearhead a rise in economic growth.

What small businesses tell us they want

The new Government brings in a fresh start for the country, small businesses and the tech industry. The UK is a great place to invest, start and grow a business, and the newly-elected administration provides an opportunity for the Government to strengthen the UK's pro-business credentials. We welcome the commitments made in the Conservative Party manifesto to promote entrepreneurship and innovation, and look forward to working with HM Treasury and other Government departments to support the growth of small businesses.

We talk to businesses everyday, not only to discuss their finance requirements but also to understand their priorities and concerns. Ahead of the upcoming Budget, we heard from almost 500 of our customers through iwoca's 'Small Business Survey - 2020 Budget' to identify what our community wants the Government to focus on and key actions ministers can take which will help businesses grow, create jobs and make a real contribution to the economy.

Brexit

The backdrop of the Budget follows two major political events: the Conservative Party's election victory in mid-December, and the UK leaving the EU on 31 January. After more than three years of uncertainty following the Brexit vote, these two events now provide a clearer picture of the political landscape and gives businesses a better idea as to how Government policy will affect their day-to-day activity. This appears to have translated into a rise in confidence amongst small businesses within the iwoca community, with 41% of respondents saying they are more confident in the business environment than this time last year (29% are less confident). Looking ahead, 57% of small business owners are either very confident or reasonably confident that the business environment will improve over the next 12 months (23% are either not very or not at all confident). Given the uncertainty the business community has faced in recent years, both of these figures are encouraging.

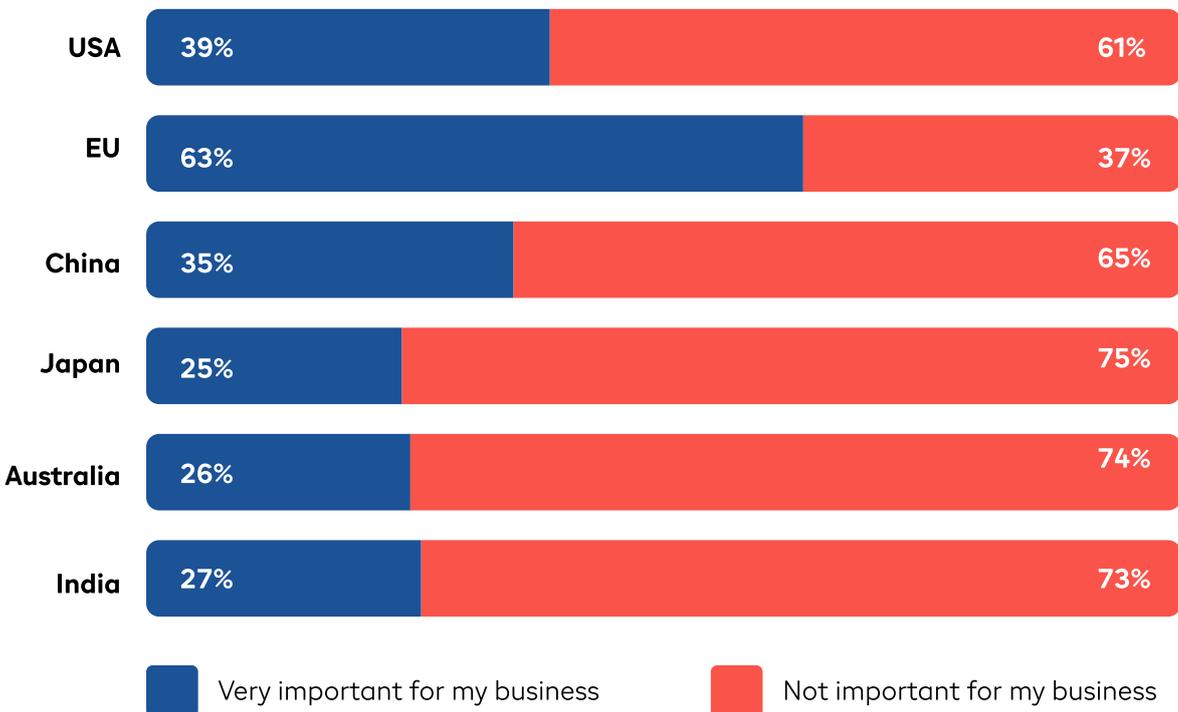
But, with the Withdrawal Agreement passed, there are now questions over the UK's future trading relationship with the EU. The Head of Taskforce Europe, David Frost, has set out the Government's broad negotiating position, however there is a significant gap between how the UK and EU see the landing zone of the final relationship. It is likely that because of this, only 23% of respondents believe that the

uncertainty over Brexit is over (61% don't).

The Government has made clear that it is willing to reject a trade deal with the EU if our European neighbours don't accept key provisions, and that instead it will focus on building new trading relationships with other major economies such as the United States and Japan.

However, this approach does not align with the needs of small businesses. Our research reveals 63% of small businesses we asked view a trade deal with the EU as very important to their businesses, whereas only 37% see it as unimportant. In comparison, 39% of iwoca's small businesses said that a trade deal with the US is important to their operations. Indeed, when asked about the importance of trade deals with the EU, US, China, Japan, India and Australia, the EU was the only deal which more respondents viewed as important for their business, rather than unimportant. This finding is in keeping with HMRC analysis which found that 82% of SME exporters export to the EU⁵.

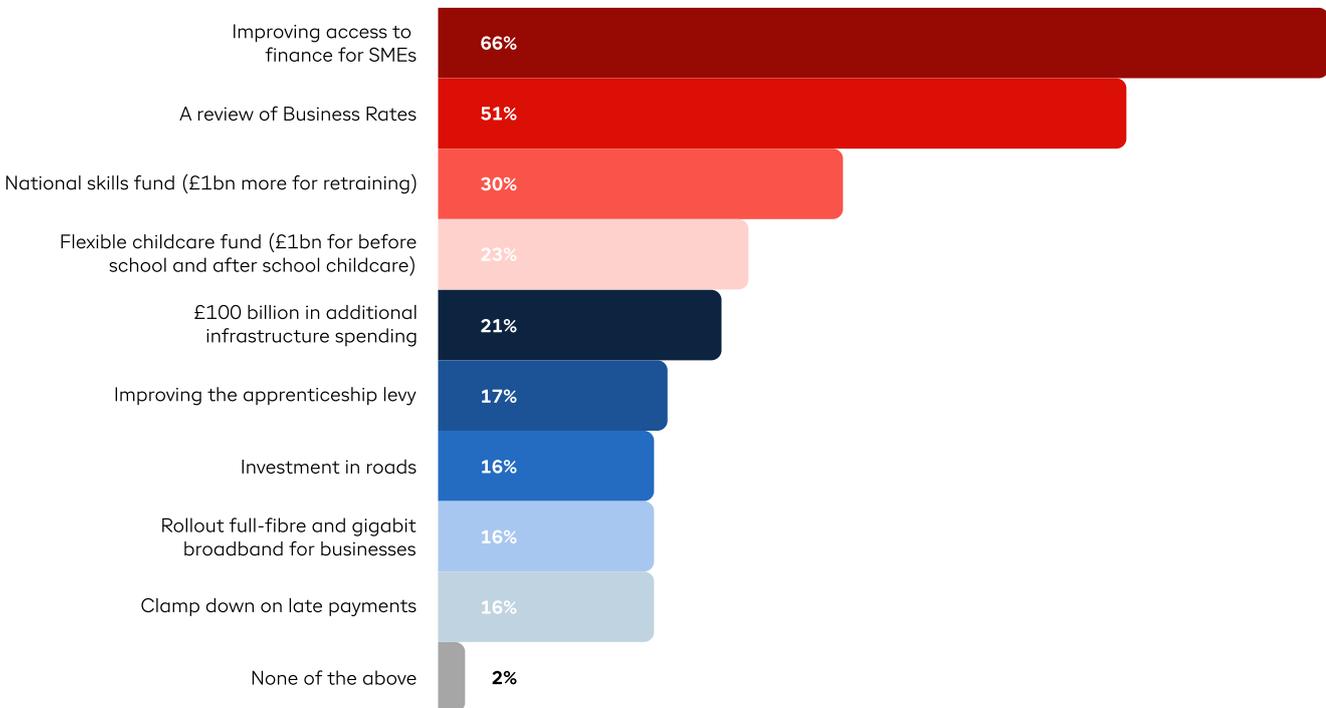
How important is it to your business that the UK government negotiates a trade deal with the following countries



This shows that iwoca's **SME community needs the Government to prioritise a trade deal with the EU before engaging in negotiations with the US or other major economies.**

What small businesses want the Government to prioritise...

Of the following policies please select the top 3 you think the Government should prioritise in the upcoming Budget



The years following the financial crisis have been extremely challenging for SMEs and they continue to be squeezed. Outstanding loans to SMEs Q4 2014 on Q4 2019 was stagnant, increasing just 0.2%⁶. Although many initiatives have been introduced by the Government since the financial crisis, getting access to finance and being approved for credit is still proving very difficult for small businesses. SMEs have told us that they are still not able to access finance when they need it, citing that the available options were too expensive (39%) or that they thought it would be rejected (39%).

Such is their concern, that **66% of SME owners in iwoca's study believe improving access to finance should be prioritised by the Government in the upcoming Budget.** Indeed, over a third (35%) feel that it should be the main focus of the Government over the next five years. These results are in stark contrast to claims by the banking industry who argue that demand for SME finance has fallen in recent years.

The reality is that, whilst high street banks have been happy to provide personal and corporate finance, SMEs have seen their funding channels squeezed. While SME lending was stagnant Q4 2019 on Q4 2014, over the same period, quarterly net lending to

individuals increased by 19.5%⁷ and quarterly outstanding loans to large-sized businesses increased by 19.9%⁸.

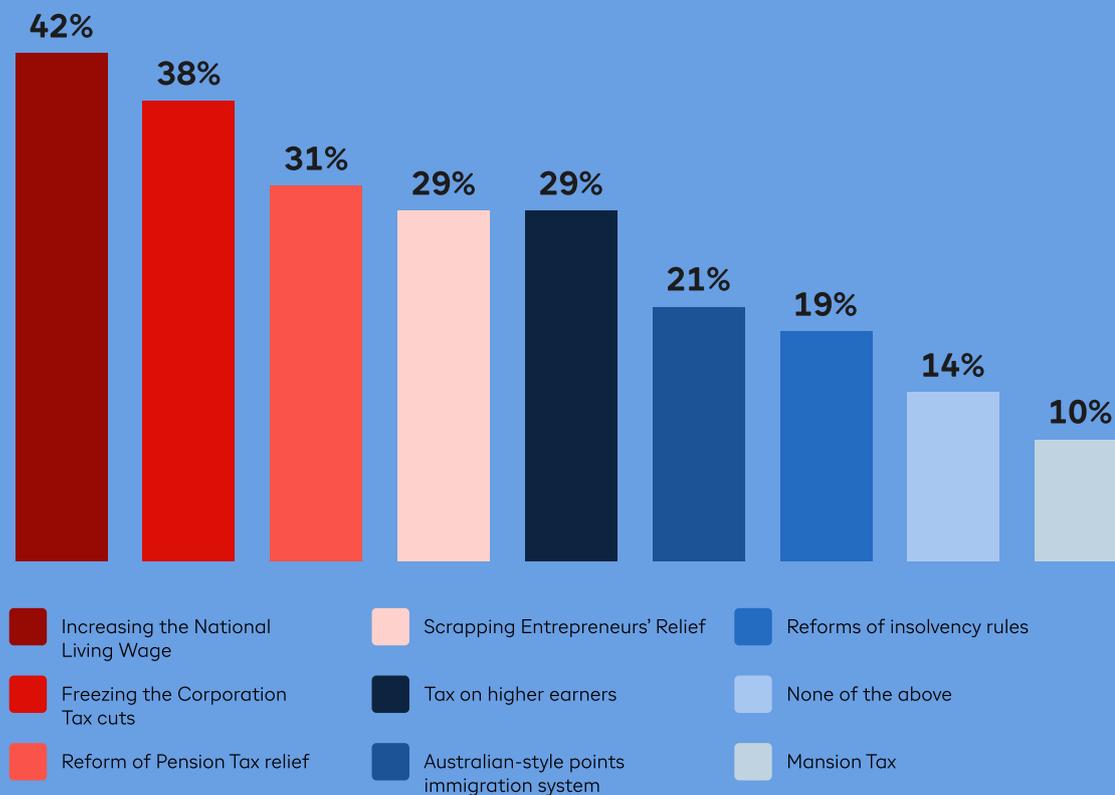
The second most popular issue that small businesses want to see addressed is business rates. Since 1990, when business rates were introduced in their current form, business rates receipts have increased by 210%, well above inflation over the period⁹. An inquiry carried out by the Treasury Select Committee found that in order to combat business rate hardships for SMEs, many different rates reliefs have been introduced which has created a complicated and inconsistently applied system. There are 361 billing authorities that SMEs must contend with around the country, and not one of them currently has an obligation to apply business rate relief automatically or support business owners to understand what is available to them. Further, there are many rates which disincentivise investment and growth by penalising businesses which improve existing buildings with things such as solar panels. This is why we and the SME community welcomed the Government's recent announcement for a review on business rates. **Indeed, over half of iwoca's small businesses (51%) want to see such a review prioritised in the Budget**, with real action taken rather than simple cosmetic changes to the system. Over one in six (17%) small businesses told us that reviewing the current tax arrangements for small businesses should be the key priority for the Government over the next five years.

There is an ongoing leadership and management skills problem in the SME sector which has been affecting UK productivity for many years¹⁰. UK productivity rests very firmly on the success of its SMEs which have been struggling with productivity since the 2008 financial crisis¹¹. Productivity per head is well below the UK average in places like North East, Yorkshire and the Midlands, but above average in London and the South East. These regional differences are the largest amongst OECD countries¹². The Government has made productivity in the SME sector a central feature of the Industrial Strategy, which we and our customers strongly welcome, but have also identified digital, management and leadership skills as the key to improving current levels.

Small business owners therefore are keen for the Government to prioritise skills funding, such as the National Skills Fund first announced in the Conservative Party manifesto in 2019. According to our research, close to a third (30%) of our small businesses wish to see this in the top three policies prioritised by the Government and are looking forward to further detail on this. When prompted to look ahead over the course of the current Government's time in office, 15% of small business owners told us that the one policy Government should focus on is skills and training across the country.

...and what they're worried about

Of the following policies, please select the top 3 you would be most concerned to see in the upcoming Budget?



Rising workforce and operating costs for SMEs have been a concern for a number of years. Changes to national insurance contributions and pensions over the last few years have placed a great deal of pressure on SMEs, which added to climbing business rates makes doing business more challenging. In our research we have found that the biggest concerns to small business owners are policies which will place greater pressure on their working capital.

Our survey found that the greatest concern (42%) to small business owners are increases to the National Living Wages.

SMEs, and particularly microbusinesses who were the most common respondents to our survey, typically have fine margins and not much working capital. Research carried out by the Money Advice Trust found that the majority of businesses that contacted the Business Debtline had up to 10 debts at any one time. It also found that the average business surplus for those that contacted the Debtline was just under £900 per month¹³. This means that any slight changes or shift in running costs can have a large impact on their businesses. The Government has already announced an increase, but any further changes or increases should not prevent SMEs growing or taking on new staff.

The second most common concern for small businesses in our survey was **Freezing Corporation Tax cuts**. Over a third (38%) of small business owners indicated that they were concerned about this move, announced by the Prime Minister in November. In light of the heavy cost pressures that have been and continue to be placed on small businesses, it is likely that many business owners were looking towards this move as respite.

Our research has also identified considerable concerns with changes to current reliefs SME owners use. Nearly one third (**31%**) **are concerned about potential reforms to Pension Tax Relief**. You will know that many small business owners often struggle to save for a pension, but those that do are clearly concerned that they could lose a crucial relief which supports them to prepare for retirement. In addition to this, **29% of small business owners in iwoca's community suggest that they have concerns with the scrapping of Entrepreneurs' Relief**. There is a feeling in the SME sector that scrapping this relief is short sighted, and that the characterisation that it only helps wealthy business owners is incorrect. Business groups have noted that many small business owners depend on this relief to fund their pension¹⁴. Applying such relief retrospectively will therefore come as a large surprise to business owners who expected this relief to fund their pension, and therefore cause a severe impact on the community.

Changes to the National Living Wage, Pension Tax Relief and Corporation Tax were the top three concerns of small business owners. This suggests quite clearly that policies which will increase day-to-day costs of running a business are of the greatest concern.

A number of small businesses also highlighted to us - unprompted - their concerns surrounding the reform of IR35. For many smaller businesses, reform of IR35 could lead to a greater tax burden which would place even greater pressures on the tight margins SMEs are already operating in. There are also broader concerns around this issue that many smaller businesses might struggle to apply the IR35 to some of their contractors due to the complexities around the tax.

Policy changes to improve access to finance

iwoca has lent over £1 billion worth of loans to small businesses since our launch in 2012 – £398 million in 2019 alone – helping to support microbusinesses who can't access finance through traditional high street banks. We want to do more, and have ambitious targets to support small businesses in the UK over the coming years. Following the £10 million award through the Capability and Innovation Fund from Banking Competition Remedies Limited, we have committed to expanding our customer base to 150,000 small businesses and making at least £5 billion of financing available by the end of 2023.

Indeed, our focus is ensuring that businesses right across the country receive the financial support they need. In March 2018 we committed to lending £100 million in the North within two years – we reached this figure by January 2020. Last December we opened an office in Leeds, with the aim of creating 100 jobs in the city by 2023.

Whilst the growth of new sources of finance for small businesses is beneficial for the economy, there are a number of steps the Government should take to make it easier for business finance providers – such as iwoca – to support small businesses and help them grow.

We urge the Chancellor to consider the following recommendations:

1) Reform of the bank referral scheme to unlock £6 billion of unmet borrowing demand from small businesses

When it was launched in 2016, the Bank Referral Scheme (BRS) marked a significant step forward for the SME industry. In what has been an extremely challenging 12 years for small business owners since the crash, opening up new ways for them to access finance has been crucial. We believe that it has the potential to be transformational for the SME market, and we remain one of its biggest supporters. We continue to be a major stakeholder and last year announced that we had funded around half of all loans facilitated through the scheme.

However the BRS has only resulted in 1,695 deals since it launched¹⁵

resulting in around £32million worth of finance. When you consider that the total stock of SME lending in Q2 2019 by UK banks was £92.8 billion, it is clear that this is a drop in the ocean confirming

that the scheme has failed in its current form compared with the real unmet demand¹⁶.

Almost a third of small business owners (30%)¹⁷ cancel plans if they do not receive the full amount of the finance required, which in light of the UK's productivity crisis, is a problem for the economy. **We believe the Government should take steps to open up the BRS to ensure that business owners are not prevented or discouraged from accessing the finance they need to grow or to stay afloat.**

There are a number of new initiatives we think could be introduced to build on the BRS.

Establish a BRS Taskforce. The Government should consider establishing a Taskforce of relevant industry leaders and policy makers to meet quarterly to review the effectiveness of the scheme and to develop solutions to unlock its potential.

Introduce incentives for banks to refer SMEs that fall outside of their eligibility criteria. As part of the BRS the Government should consider introducing a referral fee so that banks can cover the costs of promoting financing to small businesses, even if they fall outside the banks' eligibility criteria. This would mean banks could ensure that SMEs are still being encouraged to access finance when they need it. The main banks are still the most popular initial port of call for business owners who need finance, so ensuring that no one is deterred at any stage could ensure fewer fall through the cracks and are referred to alternative providers.

Leverage OpenBanking technology to create a more seamless referral process for business owners.

OpenBanking technology could be used to remove additional form-filling which can be onerous on business owners who are required to go through several different applications to get approved. This could avoid creating unnecessary discouragement.

Boost awareness of the scheme among SME owners who have been declined when trying to access finance. When asked, only 11% of SME owners said that they had been made aware of the scheme when they were denied finance¹⁸. The Government should do more to advertise the scheme to small business owners when they have been denied finance, for example as part of the frequent interactions between small businesses, HMRC and Companies House.

2) Support the Open Finance initiative by Bank of England to improve customer onboarding processes and shake up the SME loan market

Our experience shows that more seamless processes unsurprisingly make switching easier which results in more competition and better outcomes for small businesses. Surprisingly though there are still far too many unnecessary barriers that businesses need to overcome when switching providers which creates inertia and holds back competition. While there are rightly a number of checks lenders must complete when taking on new customers, such as KYC (Know Your Customer), AML (Anti-Money Laundering) and credit history, the process could be made significantly easier from a customer perspective and more reliable for lenders. A smoother onboarding system, such as a portable KYC and credit file as proposed by the Bank of England, would make it easier for customers to sign up with multiple lenders at once to get the best deal, which would create a boost to competition and more finance options for business owners.

We therefore propose that the Government backs the Open Finance initiative by the Bank of England to create a portable KYC and credit file, and as a first step to achieve this allow Companies House to share information on directors and persons with significant control with accredited financial services firms to make customer onboarding more seamless.

3) Open up the British Business Bank's guarantee schemes

The British Business Bank (BBB) was created in 2012 to help the SME industry that had been struggling to get the access to finance it desperately needed. The support comes in the form of business advice and guarantee schemes which help get finance to SMEs which don't have the requisite security needed. The Enterprise Finance Guarantee and Enable Guarantee are two of the schemes which are helping small businesses to access finance, however we believe that if they were to broaden out to support non-bank lenders, they could help even more. Non-bank lenders are launching innovative lending solutions which have a vast potential to increase competition in the market, but lack the track record to attract competitive refinancing terms.

We propose that Government reforms BBB guarantees in order to:

Make guarantee schemes more accommodating of finance solutions for micro and small businesses that replace the unpopular but compulsory personal guarantees with more appropriate debentures that are currently primarily only available to medium sized businesses.

Introduce an umbrella guarantee. Rather than bolting on

the BBB agreement to each deal negotiated, agree a certain level of criteria and come up with a blanket agreement which covers all future financing deals.

Improve the small business borrower experience. The customer flow needs improving and streamlining. With the EFG, there is currently an obligation for the small business borrower to pay the guarantee fee directly to the BBB, which could be streamlined by repaying this directly to the lender, reducing the number of parties involved. The lender would then forward this fee directly to the BBB, streamlining the process for all.

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