



Treasury Committee

Oral evidence: SME Lending, HC 1008

Tuesday 25 February 2014

Ordered by the House of Commons to be published on Tuesday 25 February 2014

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Members present: Mr Andrew Tyrie (Chair), Mark Garnier, Stewart Hosie, Mr Andrew Love, Mr Pat McFadden, Mr George Mudie, Jesse Norman, Mr David Ruffley, John Thurso

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Witnesses: **Professor Russel Griggs OBE**, Independent External Reviewer of the Banking Taskforce Appeals Process, **Priyen Patel**, Senior Policy Advisor, Federation of Small Businesses, and **Matthew Fell**, Director of Competitive Markets, Confederation of British Industry gave evidence.

Q1 Chair: Colleagues have had a good breakfast this morning. Thank you very much for coming in, Professor Griggs. I hope you have had a good breakfast as well. Can I begin by asking you what are the criteria that the banks use in assessing each appeal?

Professor Griggs: Let me turn it round the other way and let me tell you how a customer can appeal, which will answer the question, I guess. The way this works is that a customer can appeal against any lending item that a bank has offered to them. This is everything from, at one end, a commercial credit card to, at the other end, a structured loan, through EFG and all those variants. He can appeal for any reason, including, "I just don't think it is fair."

Q2 Chair: That is clear from the documentation that you have published. I am sorry to rush you but my question is very different. Once that appeal has gone in, it is seen by another bank. What criteria do the bank use to assess that appeal?

Professor Griggs: What the bank will do is that for each appeal that comes in it goes to another person within the bank, and usually a more senior lender than has done the first one.

Q3 Chair: From another bank?

Professor Griggs: No, not from another bank; from the same bank. Nine times out of 10 what happens is that, having read the case, the other person will ask for more information.

They will look at the information they have. It can be very black and white, that there will be very specific reasons why the bank won't lend. It could be that it is very clear that they can't afford it or there are things in the customer action that would not make it happen. What they look at is, is there a basis for changing the bank's mind? As I say, nine times out of 10 they will then go and ask for another piece of information. On the basis of that other information, in 37% of the cases they overturn the original decision that the bank has made.

Q4 Chair: All that is happening really is the introduction of another bank—
Professor Griggs: Another person.

Q5 Chair: Of another bank. The banks review one another, don't they?
Professor Griggs: No, the banks don't review each other. If you are a customer of HSBC and the appeal is to HSBC, it goes to another part of HSBC who we verify are independent and they do it properly. It is usually a more senior lender within that bank.

Q6 Chair: All we are doing is increasing the resource intensity of the scrutiny of each decision?
Professor Griggs: Absolutely correct.

Q7 Chair: We are increasing on the cost side the review of that particular loan. In exchange for that we get a higher level of accuracy or precision on the decision about whether to lend.
Professor Griggs: Correct. One of the things we have worked hard with the banks on over the last two and a half years is looking at why they make that decision and getting the initial decline rate down since we know now that adding this extra piece of information in many cases makes a difference. Lending is a very linear process in that you can borrow and then how much information you get does it. We ask people to take more information before they make the final decision.¹

Q8 Chair: Looked at in economist speak, what we are doing is seeking more efficient use of capital by creating a better scrutiny method, albeit at some cost, which should improve competition?
Professor Griggs: Absolutely correct.

Q9 Chair: I think I have more or less understood it. Is this a market that is basically competitive, or is it a market that is basically already so interfered with by, for example,

¹ *Note by witness:* "Lending is a very linear process in that you have at one end little information to base the decision on and at the other all the information you will ever need. If you make the decision on little information then that leaves it open to risk and not always getting it right. Therefore I have been working with the bank to ensure they get enough information to make good decisions or they will have a lot of appeals many of which will be overturned on appeal."

regulators telling banks how much capital they need that you would not describe it as competitive?

Professor Griggs: I think it is competitive in terms of all the banks are different. There seems to be this view that all the big banks are the same, but they are not in how they operate and make decisions. I come from the point of view that banks are like any other business in the UK, in that they can choose who to sell to, they can decide if they want you to be a customer or not, and they can make that decision as a business decision, so they are competitive in that sense. Do they offer the same type of products? Some do and some don't, but they all offer basic overdrafts and loans. Some of the products are the same, but in terms of how they operate they are all very different.

Q10 Chair: Therefore, this is a competitive market and we are dealing largely with a problem of perception by the would-be borrowers that they can't shop around when they can. Is that a fair summary of your findings so far, Professor Griggs?

Professor Griggs: It is. I am of an age that I can remember that disputes between SMEs and banks have been going on for decades. This is not something that has just happened since 2008. Banks and customers from time to time have always had disputes. In answer to your question, yes, the banks are competitive.

Chair: I am going to move on because we have a lot of ground to cover this morning, not because what you are saying is not interesting. It is very interesting.

Q11 Stewart Hosie: Professor Griggs, in your first review you said that better SME lending requires relationship managers to have knowledge of clients beyond pure financial information, which in itself does not tell the whole story. In your view, is the current relationship manager model fit for purpose?

Professor Griggs: In the judgmental space, yes. This comes back to how a bank operates in that a bank is like any business. If you go and buy one widget from it, they will give you the time that one widget is worth. If you go and buy a million widgets from it then they will give you the space. Do bank relationship managers have entirely the same information about every one of their customers? No, they don't. Banks stratify how they deal with businesses generally in terms of the turnover of the business or the size of the lend. I will answer your question, Stewart.

In the areas where they have to have intimate knowledge of the business, they have got a lot better. One of the things we have seen over the last two and a half years is a real increase in training within banks, going back to the old ambits that you are only allowed to lend at a certain level when you have been trained for that type of level and you have the experience to do that. There is still a lot to do. No, I don't think that in some areas relationship managers still know enough about their customers.

Q12 Stewart Hosie: I will come back to the training aspect in a moment. In terms of the generality then, what improvements could be made? What could they do better?

Professor Griggs: What they can do better is make sure that the relationship manager understands the totality of the decision. If you are an RM in the under £25,000 lending space, probably you will have some discretion you can make yourself but in others you may have to pass that on to somebody else in the bank. If they make a decision and don't

tell you why they have made that decision in totality then you can't go back and have a sensible conversation with your customer. I think there is still more to be done in terms of how banks own their corporate decision. Once they have made a decision to lend or not to lend to somebody, it is making sure that the person who is going to have the dialogue with the customer understands that in totality.

Q13 Stewart Hosie: Is there not a huge problem in terms of SME lending that someone, a relationship manager, a bank manager, can't even make a decision up to £25,000—

Professor Griggs: I didn't say that.

Stewart Hosie: —in some circumstances, without having to be referred further up the food chain?

Professor Griggs: That is absolutely correct. Do I think that is good? I guess that is not in my bailiwick to look at, but that is how banks run their business and how they all manage their risk appetites. Some will give discretion to some of their managers and some won't.

Q14 Stewart Hosie: Have you seen alternative models that would help the SME sector if the banks were to deploy them? What do you think the best model is from all of the banks you have seen?

Professor Griggs: The best model in all the banks I have seen is where the relationship manager knows exactly why he is saying yes or no to a customer and also at the outset when a customer comes to him that he knows exactly what he needs from them to make the proper decision. There are things within banks that they call declined at source, which is that you might go and say to the bank, "Can I have £10,000?" and they will say no, and that is not a conversation that you have. Our view is that the minute you pass some information to the bank, so they say, "To make that decision, can you give me a copy of your current financials?" we then deem they have entered into a conversation. Where we have seen the best practice is where people understand the business as much as they do the people. That is especially important in the micro space where the best practice again is that you read the business plan before you speak to the person, which does not always happen.

Q15 Stewart Hosie: Would training improve that, or is that merely driven by experience?

Professor Griggs: Both. There is some nuts and bolts stuff that you need to understand to train. There is some good experience that you learn. If we talk about best practice, we have seen a bank where all parts, because of where they are located—so the people that lend the big amounts and people who lend the small amounts—happen to be situated in the same room. That has encouraged good walking about and talking to each other, if I can call it that, and that has been good training. That is not always possible practically because of the size of some of these entities. Experience does play a part, but there are basic nuts and bolts you can do as well.

Q16 Stewart Hosie: I am going to rush this last question simply because of time. In terms of training and relationship management generally, are the banks and the relationship

managers actually capable of meeting their clients' needs when the clients are going through periods of financial stress? Let me ask that another way. Do the relationship managers understand businesses enough through the entire business or economic cycle?

Professor Griggs: The majority do, I would say. One of the things that has been interesting to watch since the financial crisis has been how each of the banks has dealt with types of businesses. I think a goodly number have put in place plans with businesses that are stressed from before in 2008, which you know you will not be able to lend to for, let's say, a couple of years until you have reshaped their balance sheet. Some of them have worked very well to work with the businesses, to understand their businesses and see how they can move, perhaps, some overdraft into longer-term loans. There are particular problems in certain parts of the UK about property overhang of businesses that went into the buy-to-let market that are now left with redundant assets on their books, on which they are still paying off the loans. Yes, there are good examples, but there are also examples where they could have done it better.

Stewart Hosie: That is helpful.

Q17 John Thurso: Professor Griggs, I would like to follow up on the question of relationship managers but, first, can you tell us what is the size of the market that we are looking at with SME finance?

Professor Griggs: That is a question I don't think I know the answer to because it is not something that I focus on. My focus is on making sure that my little bit of it, which is the appeal side—I am sure the gentleman who is sitting right behind me and to my right will be able to answer that question when you speak to him.

Q18 John Thurso: If I was to guess that it was somewhere in the order of £42.6 billion, you would not dispute that?

Professor Griggs: I would agree with you.

Chair: Will the gentleman nod his head? He has nodded his head, John.

John Thurso: I did have to find out just before we kicked off. In your quarterly review for the period to the end of September, it shows that, in year 1, the total value of appeals overturned was £10 million; in year 2, £18.5 million; and in year 3, to the end of September, it is £6.8 million, which is £35.3 million in two and three-quarter years. Put against the scale of the market of £42.6 billion that, if you will forgive me for saying so, looks like a complete pimple.

Professor Griggs: It is small, but my view is the opposite to yours, I guess. We are just about to touch £40 million now. By the end of this year, we will have put £40 million back into the economy in lending that would not have been there. In terms of the total £42.6 billion, it is small, but to those businesses who have got that £40 million who would not have had it before in a huge number of cases it has made a material difference to how they will move on.

Q19 John Thurso: The point I am getting at is that the scheme that you look after so admirably is held forth by the BBA and the banks as showing how wonderful they are in doing everything possible to help SMEs get finance. Yet £40 million over three years out of

an annual market of £40 billion-plus, excluding overdrafts, is actually miniscule, is it not? Is all that you are doing even touching the surface of the problem?

Professor Griggs: Interestingly enough, if I put it the other way, one of the things you would then have to ask is that, of the people that do not appeal, how many of them would have the right to appeal if you went and looked at them. We have just done that exercise across all the banks because the Treasury were interested in asking that question about the people who did not. Of all the ones we have done to date, the level of people who could have appealed but did not is well below 5%, so there is only a small portion of those who did not appeal who could do it. We could argue statistics all morning. My view is that it is £40 million going back into the businesses. If you speak to one of the businesses that has got the money, I am sure they would be saying to you that having it is much better.

Q20 John Thurso: I do not dispute that. I am merely saying that for every one that did and got some money, there are probably 100 who did not. But let me move on, because I want to come back to this question of relationship managers. What constitutes a relationship?

Professor Griggs: To me, a relationship between a bank and customer is understanding each other.

Q21 John Thurso: If I look at the majority of the SME lending, and particularly at the smaller end, I would say there is very little understanding. For most of these, it is a call centre relationship pretty much.

Professor Griggs: It depends.

John Thurso: It is very difficult to argue this without giving specific cases, but one that came in last week was an RBS customer, banked for 40 years, £7,500 overdraft, picture framing business, was ill last year, stopped taking drawings, and had a telephone call saying, "You've got no overdraft any more," insurance cancelled because they have bounced it. I don't see a relationship in there. He goes back and talks to the "relationship" manager who then says, "All right, instead of £7,000 you can have £5,000," and two weeks later comes back and says, "Sorry, higher-ups say you can't have it." I do not call any of that a relationship and that is very typical of a huge number of what comes across my desk from my constituents. Are we living in a slight fantasyland, where the banks at the top think they have relationship managers dealing with SMEs, but in actual fact we have salespeople in call centres, roughly on a par with an Atos decision-maker?

Professor Griggs: Before 2008, I would probably agree with you, but I don't now. I think for as many of the cases that you could quote to me, I could quote cases back to say where I have seen real understanding between a bank and a customer.

Q22 John Thurso: Forgive me, the fact they occasionally get it right is not what is at issue. It is the number of times they get it wrong.

Professor Griggs: Yes, I guess that is true, but we don't just take the bank's word for it; we go and look at them ourselves to see if we agree with where the bank has got to. I am not defending the banks; I am not sitting here being a defender for them, but what I am saying is that I have seen as many examples of good RM practice as perhaps you have seen bad.

Q23 John Thurso: This is just a comment because we have to move on. My worry is that there are good practices. We are all seeking to support your process to root out the bad practice. RBS are making very public statements about this, they are writing reports about how badly they have done it, but the people down at the coalface don't know that that is what they are meant to be doing.

Professor Griggs: Well, no, but I can tell you in two banks we have been working with over the last two and a half years have materially changed the way they deal with customers and that has dropped the number of declines quite substantially. That is why, when you see my quarterly chart, it starts to go down in periods because in two of them we have seen substantial drops in declines just generally. That is because we have now worked with them to change the way that they work with customers and that has been generally about gathering more information at the beginning before you make a decision.

Q24 Chair: What we are talking about is moving from an algorithm-driven relationship to one that is based on exchanges between human beings on the basis of much more information at the beginning, as you put it. Collecting that costs money. Are you or is anybody doing any work on the cost effectiveness of doing that work? In other words, are the banks themselves missing out on profitable business, or are they doing this because they feel they have to under pressure, knowing that it is probably coming out of their bottom line?

Professor Griggs: No. Let me answer that in two ways. There are lots of good longitudinal academic data that will show you that, over the last 30 years, financial decisions and banking decisions based on examining a customer and seeing whether they can afford to take on lending gives you good lending. Let me go to the second bit of that. The number of customers that go through the bank have grown and grown, and I would not disagree that perhaps there was a period when we moved to relying too much on electronic scoring, but that is changing. I am pressing hard for all the banks, if they use electronic scoring, to understand the data that makes it up, so that they can go back to a customer and say, "The reason we are saying no to you is because of that. If you can change that then we might well be able to lend to you." We are beginning to see examples where that is happening.

Q25 Chair: Is your answer to the question that, yes, this is profitable lending that the banks are missing?

Professor Griggs: Yes, it is. A number of the banks, because of the point that a couple of gentlemen have made, have taken the appeals book and put it to one side so they can compare it with the standard book, and in the majority of cases the appeals book is exactly the same in terms of default as the standard.

Q26 Chair: Your answer to my first question, which was why is competition not filling the gap, lies on the consumer side. It is that the consumers think the banks are all the same. They should shop around, but they don't. Is that correct?

Professor Griggs: Yes, and the answer to your question—

Chair: I am very sorry. It looks as if I am straying into an area that Mark Garnier is about to ask.

Professor Griggs: I think the answer to your question depends on which part of the country you are in. There are parts of the country where, if your dad was in this bank, you are in it.

Chair: Don't go on. You will only get me in deeper trouble. I am handing over to Mark Garnier.

Q27 Mark Garnier: Thank you, Chairman. I want to carry on, Professor Griggs, if I may, about the perceptions in the marketplace about what is going on. You say in your review that relationship managers believe the message from the media and elsewhere, that message being that banks are not lending, is still harming demand and stopping businesses that are looking for credit from approaching them. Do you think that is genuinely causing a drop-off in lending volumes?

Professor Griggs: I think it was. I think it is less so now and there has been some interesting work done recently that shows that the media has become less of a tool. In the time just after the crisis, probably 2009, it definitely was a reason. I think it has become less so. Part of the reason now is to do with where businesses are in the cycle. I was speaking to a friend of mine who runs quite a large hotel business across the UK and he was saying, "I have got plenty of banks out there who want to lend to me, but this is a year of consolidation so we are just thinking about what we do." I think the mood has changed. I am not saying the media are by any means perfect, but I think their effect has lessened.

Q28 Mark Garnier: Can I turn this argument slightly on its head? To what extent do you think that businesses that have rubbish business models or are not prepared to put up the covenants are trying to hide behind the fact that it is the banks that are at fault and not their business models and that the media is to a certain extent misreporting what is really going on in the marketplace?

Professor Griggs: Having not seen every one of the cases that are in the newspaper, I would not comment on individual cases. However, I do think you are quite correct. One of the interesting things that has become known recently is that a number of the businesses that have not gone to a bank have not done so because they know what the answer is going to be. They know their business is in a state and they are going to get a decline. My view has always been—and one of the reasons I think it is important to increase the awareness of the appeals process—that we human beings are an odd lot and when we know there is a safety net there we tend to take risks that we perhaps would not take before. Therefore, knowing that there is an appeals process probably will encourage some more businesses to go forward and try, which they may not have done before. It lessens the risk for them; they will get two bites of the cherry.

The answer to your question is, yes, of course there are but there have always been those businesses out there. In specific parts of the UK, Northern Ireland especially at the moment, there are a lot of businesses that were caught in the buy-to-let market. Manufacturing businesses decided to go and spend their money on buying properties and now they have a balance sheet that you could not lend against. We have to think about what we want to do about that, but it makes it very difficult for them to support their base businesses.

Q29 Mark Garnier: What about the role of business advisers in all of this? Clearly, it is a fairly rare event for the average business to go along and borrow. Do professional advisers have a far bigger role to play and do you think they are providing a useful service at the moment, or is there more to do?

Professor Griggs: The answer to the question is, yes, I do. To the second part of your question, some are good and some are not, and I think that is part of the problem. It is very difficult to figure out whether your accountant or your lawyer will give you good advice. A lot of accountants do still stick to the, “I will do your books for you but that is all.” Others work harder. I think the intermediary community, if we can call them that, have a large role to play in this, perhaps more than they have done in the past.

Q30 Mark Garnier: A larger role to play?

Professor Griggs: A larger role to play, yes.

Q31 Mark Garnier: My final question is a similar type of question but to do with the Government-supplied advisers. We have seen that the Regional Development Agencies and Business Link are not what they were, or they are not at all, and those are replaced by the LEPs and, to a certain extent, the chambers of commerce. Although it is relatively early days yet with the LEPs in particular, do you think that they are stepping up to the mark in the way they should be in helping businesses? Do you think there is a bigger role to play for the chambers of commerce, perhaps like we see in Germany, that we do not have anywhere near at the moment? Do you think the Government has basically got it wrong in getting rid of the Regional Development Agencies and Business Link?

Professor Griggs: Let me try to answer that in a couple of ways. I think when the Regional Development Agencies and Business Links went it was an unfortunate time. It took away a lot of places that businesses in England—and this is a peculiarly English view—could go and there was a gap. I think the challenge with LEPs and chambers is a lack of consistency across the country. If you go to Manchester, for example, it has always had a very good chamber and I think they do exceptionally well, and you could go to other areas where perhaps they do not. The thing with Regional Development Agencies and Business Links—and I am not proposing they should go back, I am just answering your question—is that there was beginning to be some sort of consistency across them. I think that is the bit that you need to get to, where there is more consistency in the advice that you get. If you are relying on a good chamber one way to be not as good as a chamber in another way then you are always going to have disparities. There was no doubt at the end of my first year when I did this and speaking to businesses, especially in England, that there was a gap in where they could go for advice. LEPs will come on at the pace they come on because they are not being driven to become consistent in any local area, so you will still have the vagaries of localities.

Q32 Mr Love: Professor Griggs, can I turn to the issue of the use of credit scoring? What proportion of SME lending is dependent on credit scoring?

Professor Griggs: Basically anybody that borrows under £25,000 is liable to be credit scored. I don't have the exact total figures to hand, but in our terms that is a large proportion of what we do. It is not that simple, because credit scoring is a hugely diverse

subject that we could sit all morning and discuss, but we won't. It also depends on what the banks buy and what they do. Does the credit scoring come from their own internal algorithm, for which they buy data, so they buy data on you and they put it into their algorithm but they know what the data is, or do they just buy a credit score from a credit reference agency that they then apply and say yes or no on? It is a significant proportion.

Q33 Mr Love: Do you have any idea what proportion is bought in, in other words, the decision is effectively hived off from the bank to the credit reference agency or whoever it is does the score?

Professor Griggs: It is not a huge proportion of it. Most of the banks now buy in the data and put it in themselves. There are still some that just buy in the scores, but it is not by any means the majority.

Q34 Mr Love: If you take the issue of less than £25,000, the figure is 47% that are declined but that rises to over 50% for start-ups and those who switch banks. What more should the banks be doing to address that particular failure?

Professor Griggs: In terms of start-ups, this became quite a personal issue for me last year. I don't think that a lot of micro-businesses realise that they get judged first and their business gets judged second when they go in as a start-up.

Q35 Mr Love: Does the business get judged at all? Is it entirely a personal judgment in the credit reference?

Professor Griggs: It will depend. But the answer to your question is that in some cases yes and some cases no. The banks are different in how they do this. Some banks will always look at the business plan first before they meet the person. Some will see the person and if the person fails may not go further. So, yes, you are absolutely correct on that. One of the things we try to do is make micro-businesses understand that they as a person get judged as much as the business does so it is important for them to have control over their credit history. Also, as they write a business plan when they go into a bank that tells them all about their business, they should also be writing a plan about themselves. If there is anything you know in your past that you think might affect your credit rating, you should be telling that to the bank on day one. When you get into a situation where the bank understands that this might be positive rather than negative then in a lot of the cases they will go away and look at it and in many cases will change the decision, but you have to know to do that in the first place.

Q36 Mr Love: In your report, you mention the need for education of relationship managers and customers, and you have just touched upon this. Is it really an educational issue, or should we just be informing the customer, and indeed the relationship manager—I was interested in the discussion you had earlier about the role of relationship managers—and understanding what the role of credit scoring is and how banks and credit reference agencies go about doing that?

Professor Griggs: The answer to that particular question is yes, but I think behind that you then still have to know if you are turned down why you are turned down. That is as important to the relationship manager as it is for the customer. If the RM does not know

why the credit scoring failed then they can't tell you why you have been declined, other than you failed the credit score, which to me has never been a sensible answer to give to anybody.

We came across one young lady recently, who in the end got her money, who was turned down even though when you met her you would say, "This lady runs a really good business". It was because she had moved in with her boyfriend and had moved areas and had not changed her place on the voters register, so she had dropped off the voters register. That has a bad effect when it goes through the credit scoring. We have come across colleagues of yours who have got into situations like that through no fault of their own. Once that young lady knew the effect, she went away and fixed it and the bank lent her the money, but she had to go through the process of doing it and it took the RM a little while to find out why she had been turned down as well. To me, the RM should always know why somebody has been turned down and therefore have the ability to tell the customer.

In all of this, there is what I call black data and white data. Black data is where a customer has had bad CCJs, where they have defaulted on loans, where if you looked at them with your own money you would think would you lend to them because they have a bad history. On the other side, there is white data, which is things like not on the voters register or minor infringements in your bank account. Mobile phone companies are dreadful at pursuing people for very small amounts of money, which can clock up on your credit scoring as well.

In fact, there is a famous story of one bank RM who was turned down because he allowed his garage to apply for finance for him and the car company rang six different agencies over a half hour period. That triggers out in a credit rating agency as bad because if somebody rings up six times to do that that must mean you can't get the money, not somebody just looking round for a better deal.

There are all sorts of things in there that you have to understand and that if you understand you can actually do something about. That is why I go back to the point that John Thurso asked me about understanding. If the RM understands that and has a conversation with the customer about that then in most cases you reach a positive outcome if you know about that.

Q37 Mr Love: These are all what you refer to in your report as adverse data and you have separated out white data compared to black data. Whose responsibility should it be? Is it a matter of providing a leaflet to the customer, so that they understand how it works, or is it the relationship manager?

Professor Griggs: Both. This is two sides of an equation. For one side to understand the data and not the other side does not work. If you both understand the data, you can work towards a conclusion. The RM needs to know about it and so does the customer.

Q38 Mr Ruffley: In your review you comment that customers do not seem to want to consider alternative forms of finance. Why do you think that is?

Professor Griggs: I think a lot is to do with businesses being generally quite conservative in terms of how they look. Overdrafts and loans are the way that they have always done this. From my days of chairing the CBI's SME council, I know that to get businesses

interested in equity was always a big challenge because they did not want to give up shares. One of my own personal mysteries in all of this is the number of people that don't, for example, look at invoice discounting, which to a large degree for some businesses is the cheapest form of finance you can do.

Q39 Mr Ruffley: Is it because there is insufficient signposting, insufficient publicity about, for instance, invoice discounting?

Professor Griggs: Everybody could do their job better on this. They are trying harder on invoice discounting, but on other external forms of finance there is a good side and a bad side to this, and it goes back to the question that the gentleman was asking about the chambers. If you go to some places, if the RM took out of his bottom drawer the number of places he can send you in a locale and the number of different loan schemes he could send you to that exist outside the bank, it is quite a long list. I think one of the things we need to look at is how we make all the things that LEPs and local authorities and everybody else does out there much simpler for businesses to understand. What the banks do now—and we monitor it to make sure that they do that—is in every decline letter that a business gets it is pointed to somebody else. It may be a CDFI, which is usually something that is run by the local chamber, and so on. I think the challenge is making the business understand what each of these other things can do, but there is a lot more we could do. Like in everything in this, there is a lot more we can do.

Q40 Mr Ruffley: Where a bank refuses credit to an applicant, in what percentage of cases of refusals do you think there is a clear signpost to go to an alternative provider?

Professor Griggs: They have to put it in every decline letter. It is part of the deal that they have to do it.

Q41 Mr Ruffley: Do they send a long list, or do they identify a local provider?

Professor Griggs: That will depend on the bank.

Q42 Mr Ruffley: I think it is in your report that some banks direct SMEs who are refused credit to lenders like the Community Development Finance Initiatives. What would you say the approximate take-up is in the case of those who approach the Community Development Finance Initiatives?

Professor Griggs: I couldn't give you the total data but, for the ones I have looked at, again it goes back to it depends on locale because CDFIs are all run by different people over the country. Let me try to backtrack a bit. It would be foolish for a bank to pass somebody on to somebody that they knew were just going to say no again, because they would not do their relationship with them any good. So banks are taking more and more care now to pass on customers to people that they think might lend. In terms of CDFIs, I could not tell you what the total statistics are, but there are a goodly number of small businesses now—because we are talking about small amounts here—who do get money through that system.

Q43 Mr Ruffley: Is data produced on this?

Professor Griggs: The answer to your question is I don't know.

Q44 Mr Ruffley: If you just repeat the answer, the proportion of those refused by banks who then successfully get lending from an alternative lender is what approximately?

Professor Griggs: I have no idea. I am not trying to be difficult.

Q45 Mr Ruffley: Don't you think that is a rather interesting question to have an answer to?

Professor Griggs: I think it is a very interesting question, and I shall go and ask the question. The lady who is watching this will make a note to remind me to do that.

Chair: She is nodding her agreement behind you, for your information.

Q46 Mr Ruffley: In your review you say that one alternative source of finance, invoice discounting—and I am using your words here and I think we would agree with this—continues to get a bad press due to the wide number of operators involved in it and the misdemeanours of some of them. One of my colleagues will be asking in more detail about invoice discounting, but could you just say what your impressions are? Is it sufficiently well regulated, for instance?

Professor Griggs: I have not looked at that in its entirety. I think within the banks it is well regulated, but the banks do their own invoice discounting and it is regulated because it is covered by the standard regulation within the banks. Where all the press has been is around the smaller operators who have gone into this who charge quite large amounts of interest and handling fees to do this.

Invoice discounting is very interesting. The banks are now starting to do some very good models comparing the cost of an overdraft with the cost of doing invoice discounting. On a lot of occasions, there is hardly any difference between the two costs and I think that is something they need to sell better to the customers. There is a perception out there that invoice discounting is expensive and you only give it to customers who are about to fail, both of which are rubbish, but that is a lot of the perception that has been out there. Some of us around the table are old enough to remember factoring, and factoring and invoice discounting sadly have the same name and they are entirely different things.

Q47 Mr Ruffley: From your experience, who would you say have the best reputation as invoice discounters?

Professor Griggs: I think the banks themselves have the best reputation, those that do it well. I am not allowed to say which of the banks or I will get thumped by the other banks, but I think the banks themselves. The banks that really sell invoice discounting do it well.

Q48 Mr Ruffley: Let's just focus on the banks, by which you mean the big five?
Professor Griggs: Yes.

Q49 Mr Ruffley: What proportion of the big five, if they refuse a bog standard loan, a term loan, to me would say, "We can't give you a straight term loan but—you know

what?—we can do invoice discounting.”? What proportion do you think successfully go the invoice discounting route from a bank?

Professor Griggs: I don’t know, is the answer to that question. I don’t have a statistic on that, but I can try to find out.

Mr Ruffley: If you could provide that.

Professor Griggs: Let me answer the question in a different way. I think again it goes back to how well an RM understands his business. Let me give you an example. I spend a lot of my time now out working with RMs and customers to understand what all these numbers mean. There was a lovely family business who were going very well, very profitable, all in their mid-50s, and they had got to a point where they needed to extend their overdraft beyond the limit at which time security was needed. The bank said, “We are happy to give you the overdraft, but to do that we will need to take personal security,” and they did not want to do that. The good RM then said back to them, “However, if you move to invoice discounting, you don’t need to put security in,” and that is what they did. They very happily now have all their money supplied on invoice discounting.

On the other part, a big company that I spoke to, as I was fascinated about why they had moved everything to invoice discounting, tender all the time. Invoice discounting allows you to tender accurately because you know exactly when you are going to get paid, so you can work out your cost of money exactly in the tender. You can really hone your price down to the margin in a tender. You are not worried about what the cost of money is because you know exactly when it is coming in. If you are on invoice discounting, it gets paid at a particular time every month and so on.

Mr Ruffley: Interesting. Thank you.

Q50 Chair: Could you ask your high-powered team to provide the Committee with a high-powered note on the spectrum of options from factoring through to—how should I describe it—somewhat second tier invoice discounting all the way through to the gold standard invoice discounting that you were discussing a moment ago?

Professor Griggs: Yes, I will do that.

Q51 Jesse Norman: As you can appreciate, Professor Griggs, every member of this Committee—indeed, every Member of this House—has a very strong concern about the well-being of small businesses in their constituencies.

Professor Griggs: Absolutely, as they should do.

Jesse Norman: I am in Herefordshire and I am certainly no exception. We have lots of businesses that desperately rely on the work that you are doing to be well performed, and I know it is being. I have only a couple of quick questions. You have said that 40% of appeals get overturned. You have also said that random changes that have nothing to do with credit scoring, such as the decision of someone to move house or move in with their boyfriend, can completely destroy the credit basis for their business. You have also said that the performance of the appeals book is comparable, indeed financially equivalent or close to the performance of the book that the banks actually take on. Doesn’t this suggest to you that the banks are adding no value at all in this area?

Professor Griggs: No, it doesn't. I think what it suggests is that because they are trying harder, the banks are starting to realise that this is good lending. I think that is why they are now putting a lot of effort internally into doing this because they have suddenly decided that this is a good way of getting extra lending. All the banks are using the appeals process very positively to increase their lending. People somewhat forget that if a bank does not lend it goes bankrupt. If you are just take people's money and don't do anything with it, you will sadly run out of business. I do believe that the banks have realised now that perhaps after 2008 the risk went too far the other way and they became very risk averse. I think it is now slowly coming back again. To demonstrate this, it is not just that their appeals numbers are going up, but also we sit down with them and say, "Why are you doing it that way? You have got declines up, your appeals are up and you are overturning 70% of them. That cannot be good business for you because"—as the Chairman said—"that is double resource you are putting into it, so commercially why don't you just do it a different way?" We have a number of the banks working with us to make decisions lighter.

Q52 Jesse Norman: I don't understand. How can they be adding value if the business they turn down does as well as the business they accept? Mathematically, how can they be adding value?

Professor Griggs: I am not quite sure what you mean by adding value.

Q53 Jesse Norman: You would expect that a bank would be receiving some form of value or premium for being able to identify successful businesses that are seeking finance from unsuccessful businesses that are seeking finance. You are telling us that in the appeals process, those who do not succeed in getting credit are doing at least as well as those that do.

Professor Griggs: In certain banks. Some banks would say that is not the case.

Q54 Jesse Norman: Some banks, according to your criteria, are not adding value, because the ones that get turned down are doing as well as the ones that don't get turned down, and others are. Which are the ones where the book is doing as well when they turn them down?

Professor Griggs: I can't tell you that.

Q55 Jesse Norman: You can't tell us that?

Professor Griggs: I am not allowed to tell you that.

Q56 Jesse Norman: We are not allowed, as parliamentarians, to have any insight into how effective the banks' own performance is in their ability to determine which credit is profitable, successful and valuable and which is not?

Professor Griggs: That is not a question for me, if I can be bold.

Q57 Jesse Norman: You have the numbers. Why isn't it a question for you? We are asking you these questions in public now.

Professor Griggs: I made it quite clear when I came to give evidence that I could not talk about individual banks. I will happily talk about banks generically, but I can't talk about individual banks.

Q58 Jesse Norman: So you can't tell us that? Okay, that is fine. Let me ask you another question. Obviously, you deal in the question of the granting of credit. We have heard a great deal of testimony already about the concerns that people have had about what happens to banks where credit has been granted and the abuses that have taken place. We have had testimony from Sir Andrew Large and from Lawrence Tomlinson. Have you read that testimony and have you reflected on it?

Professor Griggs: Yes. In fact, I have met with both of them.

Q59 Jesse Norman: Are their conclusions consistent with your experience?

Professor Griggs: I don't think there would be anything I would disagree with in what Sir Andrew Large said. I met with Lawrence Tomlinson, but I haven't looked at all the cases, so I can't comment on the individual cases. I understand where he was coming from, but I have not looked at the individual cases.

Q60 Jesse Norman: You will recall that some of Lawrence Tomlinson's allegations have been that businesses have been deliberately downgraded for profit.

Professor Griggs: Indeed.

Q61 Jesse Norman: Sir Andrew Large said he found some of those allegations plausible. Do you also find them plausible?

Professor Griggs: That particular bit of the bank is not one I look at. When the appeals process started, the care departments of every bank were excluded. They were excluded quite sensibly because when businesses get into that part of the bank, they are usually in financial difficulty and therefore their ability to appeal becomes less. Care departments of banks were excluded from this process at the outset, so I have not looked into that area.

Q62 Jesse Norman: Does the broad experience that they have had, which is that banks are at best occasionally, and perhaps sometimes often, heedless of the well-being of the companies they are deciding to work with, fit with your experience? After all, many of them are turning down these appeals that are then being overturned.

Professor Griggs: From all the ones we have looked at, and we have looked at just over 8,000 now, I have not seen a bank that has deliberately gone out of its way to upset a customer, if I can put it that way.

Q63 Jesse Norman: That is very interesting. So you would imagine with 8,000 data points in a bell curve, some would be at one end of that curve and therefore would have—

Professor Griggs: I am not saying the customer was happy with the decision, but I have not seen them do it in the kind of vindictive way that has been insinuated, not by yourself.

Q64 Jesse Norman: You would disagree with the Tomlinson report in the allegations about deliberately crashing—

Professor Griggs: I didn't say that. I said I have not seen Mr Tomlinson's cases and they are from a bit of the bank that I don't go near.

Q65 Jesse Norman: Excuse me; I just want to clarify this. There are specific claims being made about some banks crashing those businesses.

Professor Griggs: I have not seen any.

Jesse Norman: You have not seen any. You are disagreeing with that. That is helpful. Thank you very much.

Q66 Chair: It is very helpful. Could I go back to the interesting question that Jesse Norman began with, which is the question of what do the banks add if right across the spectrum, between accepting loans, grabbing the customer as fast as they can at one end to saying no pretty quickly at the other, when it goes to appeal there is no difference in the performance? I think indirectly you answer that question in your own executive summary, don't you? You define an overturn as a case where the bank and the customer reach a satisfactory conclusion but that might not be what they originally set out intending to do. Indeed, you make it clear that that might be a different financial relationship to the one they began with. I should not lead the witness. Is the answer to the question that, when this piece of would-be lending is put under more careful scrutiny, it is discovered very often that another arrangement, not quite the one that was initially refused, is one that can be made profitable?

Professor Griggs: Yes. That happens in a huge number of cases and that has always happened throughout time. Businesses will go to a bank and ask for a £10,000 overdraft and then when they sit down and have the discussion they agree that £7,500 will do for both parties, and there is nothing wrong with that.

Q67 Chair: Therefore, it is supporting your view that the banks have under-resourced, historically, this area of activity, reinforced by risk aversion during the crash?

Professor Griggs: I think that is correct. However, there is a counter to that that says this is like any business and if we want banks to go on making profits, as they are, you have to figure out how you operate that large number of businesses that are in the small lending space in an effective and efficient manner. That is a big challenge and it is not easy.

Q68 Mr Mudie: Can I carry on with what Mr Norman was dealing with? Do you only look in appeal terms at an initial application for funds?

Professor Griggs: Sorry, could you explain that?

Mr Mudie: I will do my best. As an appeal body, do you only look at a case where someone has been refused a loan initially or partly through the relationship?

Professor Griggs: No, we will only look at something that has been turned down on a formal application.

Q69 Mr Mudie: Yes. What Mr Norman was saying and what Mr Tomlinson said, apart from the stuff that is being looked at for legality, was that it is the mid-term behaviour of the banks to small businesses that concerned him. We saw during the recession when the banks were in trouble that that trouble was moved across to customers. We see that when a long-term customer does hit a rocky patch, there is no consideration given that he or she is a long-term customer. Is that not something that, if it were happening to me, I could ask you to look into? Does that back up Lawrence Tomlinson's assessment that the relationship is one-sided in favour of the bank and that something has to be done to give the customer a better negotiating position with a lender?

Professor Griggs: No. I think I have seen many cases where we have had the application and where the bank has—

Q70 Mr Mudie: No, Professor Griggs. I am not asking about the initial application. If you only look at the initial application and you are not there to appeal for mid-term blues, if you like, why could you speak with authority about mid-term blues?

Professor Griggs: All I was going to say was that a lot of the applications come from companies that are in exactly the situation you are, where they need a little help along the way when they are in difficulties and, yes, we do look back. We will look, like the bank does, back at what the performance of that business has been over time and what the relationship with the bank has been.

Again, I come back to the point that we have seen many good examples, and I am not saying anybody is perfect, of where a bank has looked at the company and its current situation and has helped them through a tricky situation rather than hindered them.

Q71 Mr Mudie: Professor Griggs, I have seen a company put in distress that was up to date with all payments to the bank. They were put in distress and there was nothing wrong with their business. Once you get into this bank's distress area there is no saving you. The other parts of the bank are not interested in offers. You are in distress and they want rid of you as soon as they can, from the bank's point of view. Have you not come across that?

Professor Griggs: No, and in fact I was speaking to a bank the other day about this.

Q72 Mr Mudie: You were speaking to a bank?

Professor Griggs: I speak to banks all the time.

Q73 Mr Mudie: I know, but do you speak to customers who have had that sort of experience?

Professor Griggs: Yes, I go out and visit customers all the time. I have not visited any of the type of customers that you are talking about because, as I said a little while ago, I do

not get involved in this with the banks. However, just answering your question, I was speaking to one of the banks who said, taking the point you made, that they put back into proper banking about 70% of the customers they take into their care section, so they do not all die. A good proportion comes back out again.

Q74 Mr Mudie: I think John Thurso used an example where you run into trouble and they offer you a long-term overdraft cross-referenced to your long-term loan. If you default on the overdraft, they have the ability to pull the long-term loans in at immediate notice. Do you think that is a fair practice?

Professor Griggs: Goodness me. We would have to have a very detailed—

Q75 Mr Mudie: No, that is the basis of the relationship. I am tied to you for 25 years. I have given you a loan for 25 years. You run your business. Seven of the years you are working well. You have a rocky period. I come in, I want some more money and you say an overdraft and it is cross-tied to the long-term loans. I have absolute power now to finish you off, and they do. They pull in the overdraft because there is nothing to stop them, but because the person cannot pay the overdraft at short notice the other loans are called in. Are you suggesting that sort of behaviour does not exist?

Professor Griggs: No, I did not say that.

Q76 Mr Mudie: Okay, so it exists. If that sort of behaviour exists, should there not be some protection for SMEs to level the playing field? Surely, that is what a relationship is about—good times and bad times.

Professor Griggs: It is, but this is why it is a difficult discussion to have, without looking at an individual case to find out what the chances of the business ever surviving were. That is why it has to be done on a case-by-case basis, because some businesses might never survive.

Q77 Mr Mudie: Let us take the example that you say can exist and I know does exist. The business is profitable. At a given stage, they need some more money, so they get an overdraft and they are paying the overdraft. In every aspect of that business, the customer is behaving himself in terms of money and the bank suddenly decides, “We want your overdraft,” and in doing so they are forcing him to fire sale his other assets. Do you find that acceptable?

Professor Griggs: I would have to look at the individual case. In the description that you are making perhaps not, but without looking at the individual case, I cannot comment.

Q78 Mr Mudie: Just a question to finish off in terms of what the Chairman started asking you. What criteria do you use? I appeal to you; you have another bank look at it.

Professor Griggs: No, the same bank.

Q79 Mr Mudie: The same bank, a higher person, but on what basis is the action of the bank judged right or wrong? Is it their policy, a subjective policy, an outside policy?

Professor Griggs: It is their policy and their policy is based on a number of things, mainly to do now with affordability. We can discuss affordability above £25,000 and below £25,000 because the Consumer Credit Act gives you different rules to look at under £25,000, but over £25,000 affordability and the ability of the management team of the business to deliver what they say they have got to do. If both of those look okay in the vast majority of cases I have seen, the bank will generally say yes.

Q80 Mr Mudie: In subjective terms, if a bank had a fierce policy, an immediately unforgiving policy, you could not fault it because that is their policy?

Professor Griggs: No, I can fault whatever I like, so if I thought the bank was wrong and that was not the right way to do it I would tell them that.

Chair: Thank you very much. Extremely interesting evidence. The odd extra thing is going to come by, and we are as grateful to you for saying very straightforwardly what you do not have to hand, as we are for what you did tell us, both of which were valuable.

Examination of Witnesses

Witnesses: **Priyen Patel**, Senior Policy Advisor, Federation of Small Businesses, and **Matthew Fell**, Director of Competitive Markets, Confederation of British Industry, gave evidence.

Q81 Chair: Thank you very much for coming to give evidence this morning. I will start with Mr Fell and then I will ask the same question to Mr Patel. Clearly, something went very wrong with small business lending. Are we going to have five more years like the last five?

Matthew Fell: Clearly, something went very wrong in 2008. I do not think the situation is going to continue for the next five years as it has for the last five. I think quite a lot has changed since then. I do think particularly in the straightforward bank lending sector, we are seeing something emerge that we at the CBI have described as a new normal. Regulatory reform, particularly additional capital structural reform hitting banks, the banks themselves having to restructure their balance sheets and, frankly, a more realistic pricing of risk has changed the rules of the game. More encouragingly, I think banks' balance sheets are in better shape than they were five years ago, so their appetite for lending is on the increase. We have seen quite a lot of exciting developments happen to increase choice and competition, both in the banking sector and with alternative forms of finance, which we can come on to. I also think that even within the last six or nine months on the demand side of the equation, which has been as much a problem in previous years, small and medium-sized firms' appetite for growth and investment is returning and they are now more actively seeking finance than they were at the height of the crisis.

Q82 Chair: We are going to come on to that issue in a bit more detail with questions from colleagues. On the competition side, you will know that this Committee, and the Banking Commission as well, have pressed very vigorously for changes, some of which are now being implemented, to try to generate a more competition-friendly environment.

Mr Patel, is there anything that you would like to add to Mr Fell's initial analysis of the conditions for small business lending?

Priyen Patel: In terms of what we are saying at the FSB, there is steady, positive progress. We have seen, over the course of a year or so, a slight reduction of spread that small businesses are getting on their credit, whether that be loans, overdrafts, credit cards, whatever they happen to be. You can put that down to a generally slightly more upbeat economy, so the general stock of credit small businesses around the country is slightly higher, or we could put it down to FLS, the Funding for Lending Scheme.

Q83 Chair: Do you think that is a success?

Priyen Patel: I think the Funding for Lending Scheme has been relatively good in terms of its business side. There was a lot of discussion at the start of the scheme that it was quite focused on the mortgage side, and one can understand that because of the relatively simplified range of products in the mortgage market compared to the very diverse applications and processes banks have to do to lend to even relatively small businesses with relatively small loan applications. We have seen nearly 1%. The FLS ambition is to knock at least 1% off a loan or an overdraft. We have not quite seen 1% but it is not far off.

Q84 Chair: What is the average spread at the moment?

Priyen Patel: For our members, it is roughly 4.2% or 4.3%. That has come down over five or six quarters, certainly in the time FLS has been alive. It has come down steadily progressively over that period to about 0.8% or 0.9%. There are areas where it is slightly different when you start segmenting businesses, sizes, turnovers, and so on.

Q85 Chair: What is the variance? How big a range is there of the spread? Are we talking about most businesses being concentrated within a percent or so, or 100 basis points of that central rate, or are we talking about a very diverse lending market?

Priyen Patel: In our quarterlies, you would see roughly 70% within a 2% spread of the average.

Chair: That is very helpful.

Q86 Mr McFadden: Good morning. I want to ask you about whether the politicians' perceptions of this situation have become out of date, which touches on your answers a minute ago. We have been operating for five or six years with this dichotomy where small businesses were saying it was really tough to get credit or the terms have changed adversely or if they default on one thing the banks are down on them like a ton of bricks, and the banks are saying it is all about demand, they want to lend, and so on. We have all struggled with that in recent years. Do you think that the change in the economic conditions—and I will start

with you, Mr Patel, given what you were saying a minute ago—means that that sort of dialogue is becoming a bit out of date and the situation is changing?

Priyen Patel: I think there was, and there probably still is, a debate, and I am putting it very simply, from maybe the business side, the press and maybe parliamentarians, saying businesses cannot get money, and on the other side, once again simplifying, banks and financial institutions saying the demand is not quite there. That is probably not the most helpful argument in the world, because it is probably, like most things, somewhere in the middle.

We have seen gradually more businesses asking for loans and to the credit of the banks, certainly under FLS, but before that under a variety of other schemes, banks have been sending letters out to businesses not pre-approved but saying, “You can get roughly this amount of money at roughly this sort of price if you want it.” There is a debate and there is quite a lot of evidence in terms of both the work we do and I am sure what Matthew does but also in terms of the Finance Monitor where businesses are repaying quite a lot of debt, so this gross and net lending figure is often discussed. The net lending figure is often quite down, but I am sure you hear from banks that their gross lending is up, and that is quite accurate.

I think events maybe have moved on from five or six years ago. I think they have moved on from two years ago. While we think the market is not quite perfect, the volume stock of businesses being able to access some form of credit, maybe not the credit or the price they wanted, is steadily improving.

Q87 Mr McFadden: Is the credit crunch over?

Priyen Patel: I will get back to you on that one.

Matthew Fell: I agree that the debate was frustratingly generalised and had this chicken and egg element about whether it was an issue of demand or supply while the economy was really subdued.

A few thoughts on that. Firstly, getting a bit more forensic analysis into where the problems lie is a really important part of this, and for us we still see it is not an issue of sheer availability right across the board. Where problems continue to exist, it is much more around terms, conditions and covenants, particularly at the smaller end of the market, and I do think there are particular sectors of the business community that still find things tougher than others. If I was to pick out two, I would say anything that is exposed to construction and commercial property and so on, where banks particularly have their balance sheets overexposed to those sectors. That still needs an outstanding lending proposition relative to anything else. The other parts of the economy that I think still find things trickier are in sectors such as the creative industries, areas that rely on intellectual property and are more ideas-based businesses than have physical assets on which banks can secure lending against. Things are trickier there.

I would agree, though, that we are now approaching the moment of truth where the economy is beginning to pick up and we will flush out whether this is a supply or demand issue. Things are encouraging so far and some of the Bank of England’s latest data suggests that things in terms of availability of finance are starting to pick up, particularly at the medium-sized end of SME as opposed to the smallest firms where they have yet to see the full benefits kick in.

Q88 Mr McFadden: Do you think that the credit crunch is over?

Matthew Fell: I do think that the credit crunch is easing.

Q89 Mr McFadden: You mentioned ideas-based businesses. Surely, it is worrying if these cannot get access to finance. This is a great British strength. It is going to be an area of growth for us. It is internationally fantastically important. Politicians right across the piece want to see our creative industries go from strength to strength. If they cannot get access to finance, that is really worrying.

Matthew Fell: That is a problem that has existed for them before 2008, before the credit crunch hit and has clearly been exacerbated by it. Our sense is that banks historically have been much more confident lending against businesses with physical assets to secure that lending against than they are for intangible assets such as the creative industries, and we do think that is an area that should continue to be looked at and explored. There is scope for improvement there.

Q90 Mr McFadden: You mentioned the Funding for Lending Scheme. Would you share Mr Patel's view that this has been good for business?

Matthew Fell: Yes, it has had a positive impact. It is very difficult to judge and assess what the situation would have been had Funding for Lending not been in place, so what the counter-factual would be. I would also agree with the sentiment that it had a positive impact first on the housing and mortgage markets and that has now clearly been refocused on to the business banking sector, where it is starting to have an impact. I agree it had a net positive benefit.

Q91 Mr McFadden: One final area I would like to ask both of you is about the number of very small businesses that are using credit cards as their form of credit or debt. Professor Griggs estimated that over 80% of funding for micro-businesses comes from credit cards. Why do you think so many small businesses use credit cards for finance and is this a good thing or is it something that we should be worried about? I will start with Mr Fell.

Matthew Fell: On use of credit cards for micro-businesses, I think this is perhaps less at the CBI's core constituency for small and medium-sized businesses. Most of our members in this space would operate in the medium-sized end of that spectrum, as opposed to micro-businesses, so I have less expertise on this. Clearly, if you are using credit cards for business there are a number of advantages to that in terms of flexibility, ease of payment and swiftness. You do not have the same sort of approval processes as you would do for more formalised lending.

One of the issues I think the credit crisis in 2008 flushed out was that right across the spectrum businesses were not always using the most appropriate form of finance for their particular need, and that is as true in the credit card space for short-term lending as it would be for using bank loans when other forms of finance or equity would be more suitable. I do think there is a need to have a sharper focus on what form of finance provision is most suitable for the business situation.

Q92 Mr McFadden: Mr Patel, is it a weakness of the British setup in this area that so many very small businesses run on their credit card?

Priyen Patel: I am not sure it is a weakness. I agree with Matthew that we do have a concern across probably most business sizes of businesses accessing the most appropriate forms of finance. You heard from Professor Russel Griggs about invoice discounting. There are a range of other things out there in the marketplace. Specifically on credit cards, I suppose if we go down to the micros and talk about start-up businesses as well, the easiest sort of finance to put into the business is the finance you already have and that could be a personal credit card. For lots of our members the difference between the commercial and the personal is often very grey, and they often mix quite regularly. We see a lot of use of personal credit cards in the business environment. We also see a lot of commercial credit cards being used as part of the business environment, mainly as a replacement for or an alternative to short-term credit, be that invoice discounting or small amounts of overdraft money. Credit cards generally are perceived as slightly more expensive than an overdraft, but for a small business starting up that is the credit you have automatically or the credit you already have without going to the bank. There is a mentality that, “Instead of going to the bank, I am going to start using this right now,” because they may not know better.

Mr McFadden: I think we are going to get into alternative forms of credit finance, but that will be covered by other people. Thank you.

Q93 Mr Ruffley: Mr Patel, on standalone swap mis-selling, I imagine you have a bit of experience with that with your members. Jeremy Roe of Bully-Banks has suggested that the sophistication test applied in the case of the interest rate hedge product review has ruled out many unsophisticated SME customers and, he says, “including care home owners, garage owners, manufacturers, retailers and property companies”. Is that your experience from among your membership?

Priyen Patel: I have spoken to Jerry Roe a number of times.

Q94 Mr Ruffley: Yes, but his basic point is about the sophistication test and that it seems to have branded quite a lot of small business owners as “sophisticated” and therefore outwith the review. Is that your experience?

Priyen Patel: Yes, it is. We have a number of members who have been sold these products, mis-sold these products. We do not know exactly if they have been mis-sold because they have not had a chance to go through the process but, as they are excluded from the process, the only mechanism of redress they have is to go down the legal route and because of their relative small scale that is quite an expensive process for them.

The three or four tests the FCA instigated to judge sophistication—balance sheet, turnover, the number of employees and so on—is not something that we would disagree with as a whole in principle. Those sorts of tests are used across Whitehall for a vast number of things. In this instance, for example, agriculture businesses were particularly hit by this because they were turning bits of property that were once used for farming and agriculture into office space or cottages or whatever it might be, and were being sold these products. They are relatively large in turnover scale and have lots of employees, albeit relatively low-skilled and low-paid. They ticked two of the three and they are now sophisticated, therefore

excluded from the cohort who can go through the FCA redress process. There is a concern there and that concern has been flagged up by us to the FCA, to Martin Wheatley and to a number of Ministers as well. In terms of the process itself—

Q95 Mr Ruffley: If I can just stop you there, what has been the response from Ministers and Wheatley?

Priyen Patel: While being very sympathetic to it and in some cases looking quite in-depth at particular cases, the formal structure of the scheme, sophistication versus unsophistication, has not altered.

Q96 Mr Ruffley: What percentage of your members would feel a grievance at being deemed to be sophisticated and thus outwith the review?

Priyen Patel: In terms of our membership, it tends to be at the smaller end of SME, so we have heard from maybe half a dozen or so businesses who think they have been mis-sold but are outside of the redress process because of their scale or perceived scale. They are not members of ours, but I imagine there are quite a few businesses out there who feel that they are unsophisticated.

Q97 Mr Ruffley: Mr Fell, do you want to come in on this?

Matthew Fell: Only to point out that I think almost the reverse is true, so for the CBI's constituent base of small and medium-sized businesses even at the smallest end they are typically companies with pretty rapid, high-growth aspirations, so they would have slightly more sophisticated management structures in place earlier in their life cycle, so that would be the only point of clarification.

Q98 Mr Ruffley: Understood. Back to you, Mr Patel. On the proposal where banks have admitted culpability, they are offering businesses 8% interest on the amount of any redress as distinct from consequential loss. They appear to be offering this 8% interest on redress as a substitute for consequential loss. Do you have any views on behalf of your members on that?

Priyen Patel: I am not sure if that is exactly how I understand it. The 8% is part of one of three outcomes from the redress scheme, the first outcome being complete tear-up, a cheque plus 8%, the second outcome being, "No, this product was sold to you correctly so no redress," and the third outcome being, "Yes, you were mis-sold, but the most appropriate thing for you is a different product, so it is not just a money product; it is not just a cheque; it is maybe some other type of facility that protects your interest rate."

In terms of the 8%, I think the way we have understood it and the way the FCA has explained it to us is that because of the swiftness that they want to get through this cohort, they will look at, in the first instance, the redress mechanism and then at a later date, pretty soon after the three outcomes have been judged, the consequential loss will be looked at. The reason for that and the reason why we support it is looking at both in one go is a very long process. You would have to include the banks, plus the loss adjusters, and that would take quite considerable time, and some of these businesses frankly do not have that much time to wait.

Q99 Mr Ruffley: Barclays appear to be the only remaining big bank not to have split initial redress from consequential loss claims and settlement. Why did they do that?

Priyen Patel: You would have to ask Barclays.

Q100 Mr Ruffley: What is your understanding?

Priyen Patel: My understanding is that, informally, they have done that. Formally, they have not announced it. Informally, we think all the banks have split the redress and the consequential. The three other large banks came out on a single day and all announced it at the same time through, I think, it was a BBA. From my understanding from conversations we have had with customers affected through Barclays, they have certainly had redress through the first part and consequential is being offered as a secondary part.

Q101 Mr Ruffley: What percentage of your members who have gone through this redress process would you say judge themselves satisfied with the outcome?

Priyen Patel: I would judge very few, for two main reasons. One is the length of time from the FCA first deeming a problem in this marketplace to a mechanism being set up that they can go to and, secondly, the mechanism itself. There is a strong perception out there that the independent assessors who are there to look over the shoulders of the banks are not as independent as they could have been. We were suggesting a different type of mechanism—a mechanism quite commonly used for consumers—but the FCA chose this model. In those two aspects, I would judge many of our members have been through this and have had either a different product or a cheque back and are not that happy.

Q102 Mr Ruffley: What are the grounds for thinking that they are less than purely independent?

Priyen Patel: I do not have a concern, for example, that a large auditing firm who works for a bank or who has been appointed by the FCA to a bank is not impartial. I think they are.

Q103 Mr Ruffley: Is there a conflict there?

Priyen Patel: The perception among lots of our members is that there is a conflict and auditing firms generally work for businesses within a bank in all sorts of areas.

Q104 Mr Love: In the answer given to Mr McFadden earlier on the issue of the credit crunch, one said that the credit crunch was easing and the other that things had improved. That leads obviously to the question, is the lack of bank lending now the biggest problem faced by small businesses? Mr Patel?

Priyen Patel: It is certainly a very big problem. In terms of pure numbers, we do a quarterly report and we ask what the barriers of growth for our members are, and generally the top three tend to come out as general economic climate, which encapsulates consumer confidence, and then skills levels. Bank finance, access to bank finance and bank finance in terms of cost of finance are still very high on that list. Combined, they would be higher, but, as I mentioned to Mr McFadden, there is steady progress in this area, both in terms of what the banks are doing but also in terms of some of the reforms to the market, both

regulatory and the capital, that the Government and regulators have been doing in the past three years.

Q105 Mr Love: Mr Fell, according to the SME Finance Monitor, access to bank finance comes a lowly fourth in the order of priorities of the small businesses themselves. Do you find that in your surveys?

Matthew Fell: Yes. I do not think access to finance is the biggest problem or challenge facing small businesses. I think that remains due to uncertainties on the economic outlook and being confident enough on the demand side for their businesses. I think that is the single biggest problem. In our own surveys, we have indicators from businesses right across the piece that ask around access to finance as a constraint on business and that survey data has pretty much normalised at the level it was at prior to the credit crisis. As a constraint on business, we do not think it is top of the list.

Q106 Mr Love: I am almost minded to ask you whether you think this inquiry is relevant, since we are looking at bank finance and it may not be the major problem, but let me go on. I am really harking back to answers you gave earlier on. At the top of the list of the monitor came the state of the economy. It was mentioned as a major priority for a quarter of all businesses. Does that justify the banks' insistence all the way through this whole process that it was the lack of incentive to invest that was the problem and not bank finance? Mr Fell?

Matthew Fell: I do not think that was the sole reason. I think there were constraints going on on both the demand and the supply side. The lack of demand appetite was certainly true from 2008 to 2011-2012, when the economy was at its most depressed. There was a reluctance from firms to be seeking expansion, and that held down the demand for finance. Even for those firms that were looking to invest and expand where they were able to do so, our experience was that they were self-financing that expansion rather than seeking it from banks, because to some extent they had been deterred by their experiences in 2008.

Equally, I think it is true that on the supply side there were constraints, particularly for those parts of the economy that I mentioned earlier, where banks were either overexposed to those sectors or had insufficient expertise or confidence to lend to those. I think the answer was genuinely on both sides supply and demand and it was not wholly the answer that demand was suppressed due to a downturn in the economy.

Q107 Mr Love: One of the interesting and rather surprising things that came out of the monitor report was that legislation and regulation came higher than external finance among the small businesses that they were surveying. What sort of response have your members given, Mr Patel, in relation to how they rank the major priorities? There are different figures for lesser priorities, but how did they rank the major priorities for them looking forward?

Priyen Patel: I will just clarify the monitor compared to the work that we do, or Matthew does. The monitor has population surveys, which is the entire SME population from the very small to the medium-sized businesses. Our membership tends to be at the smaller end of the scale, so results do differ because we are asking slightly different people.

In terms of where Government legislation and regulation comes, it is slightly below other topics such as access to finance, but not the cost of finance, the level of skills out there in the

employment and labour market and things like energy prices, for example, and generally just the economic climate as a whole. Regulation and legislation do play a part, but it is slightly lower down than where the monitor puts it.

Q108 Mr Love: I think we have agreed that access to bank finance is a priority but not the only one. Which other areas in our inquiry should we be looking at with particular reference to the future success of small enterprises? Mr Fell?

Matthew Fell: I think in the whole access to finance space, broadening it out beyond bank finance is quite important. Bank finance clearly continues, and will in the future, to make up a significant share of the overall finance that business uses, but I do think it is really important to continue to look at competition and particularly choice in the market—and I would make a distinction between the two—in terms of answering some of the issues that the previous evidence session and Professor Russel Griggs got into around looking at where companies turn to if they are refused by a particular bank. I think that is important to address.

I also think that alternative sources of finance, and particularly equity finance to support growth businesses, are very important to look at in terms of broadening out the whole access to finance landscape.

There are two other areas where we could see major contributions from the small and medium-sized business community going forward. I would have a look at the whole skills agenda and particularly the internal and management capabilities of businesses. I would look at the level of aspiration in some of those businesses to kick on and grow still further, which is perhaps a cultural issue in the UK. The last area I would point to is our export capability. Not enough of our medium-sized businesses in particular are looking to export, particularly to some of the faster-growing economies around the world, and that is something where having an uptick in the performance there would help to drive forward the performance of the SME economy.

Q109 Mr Love: You have just expanded our inquiry immensely. Are there any other issues? I can understand that equity finance might not be appropriate for federation members, but others will cover alternative sources in further questions. Mr Patel, is there anything you would like to add?

Priyen Patel: I disagree. I think equity is really important. A lot of start-up businesses will get themselves into a situation where they are over reliant on debt finance, whatever form that debt looks like, but we see a space for a lot more thinking to be done around the equity space and how equity can become more apparent to the start-up sector but also more available to those types of businesses.

The other parts you may want to focus on, I suppose following on from what Russel was saying earlier on, is the sub-25 category. Those businesses tend to be loss leaders for banks. We have heard about how they are credit scored; we know from the monitor their success rates. Their interest rate levels tend to be worse than if they were a slightly larger type of business, so those two areas are important. I agree with Matthew about the financial capability in skills. I know you had a conversation earlier as well about professional advisers and there are schemes out there. The ICAEW run a scheme and there are lots of mentoring schemes, but that landscape can be cleared up a little bit. It is quite cluttered, and so a start-up business, a business that has been ticking along for a while and wants to grow, can just access

those types of products. That can help them improve as a business and then make themselves a little bit more attractive to banks as well.

Q110 John Thurso: I would like to turn to the area of embedded swaps and tailored business loans. If I start with you, Mr Fell. What representations have you had from your members or businesses on this subject?

Matthew Fell: Not a huge number of representations to us directly on this. On the issue around embedded swaps, my one observation would be that it is less clear-cut than some of the other interest rate mis-selling issues on the face of it. If I just take the example of fixed-rate loans, which often would have embedded swaps in them to make them work, on a fixed-rate loan the ultimate issue for the regulator to judge is was there a case of mis-selling? A fixed-rate loan, both for an individual or a business—

Q111 John Thurso: Can I just stop you? Which regulator do you think is going to make that judgment?

Matthew Fell: That is a conduct issue, so I think it is for the FCA to make that judgment.

Q112 John Thurso: Martin Wheatley says it is nothing to do with him because it is consumer product, because the hedge is embedded. Their legal advisers have told them it is a credit product, so there is a lengthy correspondence that we can show you that we published over the fact that the FCA have held their hands up and said it is nothing to do with them.

Matthew Fell: My view on that would be that if the charge is mis-selling or not, then surely mis-selling is a conduct issue.

Q113 John Thurso: We are trying to persuade them, but we are not there yet.

Matthew Fell: My broader point was that for a fixed-rate product if you take out a fixed-term loan for three or five years, it is a fairly straightforward product. You know what you are buying at that stage and you know if it performs against that description or not. I think there is a bit of an issue to be made about was something genuinely mis-selling or was it the benefit of hindsight? That is the reason I say I do not think it is as clear-cut as some of the other issues that have been debated around mis-selling.

Q114 John Thurso: Mr Patel, what representations have you had on this?

Priyen Patel: We have had a number of representations, certainly not as much as the interest rate swaps issue. We are starting to see and hear more and more members complain about this or bring this to our attention. The only thing I would add to or repeat from what Matthew has said is that we have certainly discussed this with the FCA at official level, and while not asking them to do anything at the moment because we are still forming a judgment and looking at as much evidence as we can before we state a position, we would certainly deem this as a conduct authority matter.

Q115 John Thurso: Can I just save you the bother? I would refer you to the letter from Martin Wheatley to the Financial Secretary to the Treasury dated 9 May 2013 that was finally published after this Committee insisted on it. I would refer you to the letter from Martin Wheatley to myself on tailored business loans of 4 June 2013, also published. I would

refer you to the oral evidence by Martin Wheatley to the Treasury Committee on 10 September to myself and the oral evidence by Martin Wheatley to the Treasury Committee on 4 February to Mr Hosie, in all of which he makes it abundantly clear that he has written to the Minister stating, “We do not legally have anything to do with this. We do not control it. It is a consumer product. Minister, this is a problem. Minister, what do you want to do about it?” I am paraphrasing slightly, the language is somewhat fluffier. The point I am driving at then is here we have two representatives. Between you, you cover everything from the tiny business at one end to the largest plcs at the other end. You both do not know what is happening in the regulation. I attended your dinner a couple of weeks ago and sat next to the chairman for Scotland, who told me it was one of the biggest problems they are facing in Scotland. Forgive me, but you are here to represent business: you do not know the size of the problem; you do not know who is regulating it. Do we need to ask if you really have a handle on the problem?

Priyen Patel: If I look at the swaps issue, for instance, when we starting hearing about that—

Q116 John Thurso: I am particularly interested in the tailored business loans and the embedded swaps, because I have a file this big of people who were sold this product. Some of them were told, “This is a fixed-rate interest. No problem, when you sell your piece of land, you repay the loan,” completely unaware there were break costs involved. That is one set of people. Other people who were told what they were getting into is a different matter. As you point out, hindsight is a wonderful thing, but quite a lot of people are in some severe difficulty now because they had no idea there were break costs.

You then have particularly the Yorkshire Bank, who are arbitrarily transferring people from Yorkshire Bank to the National Australia Bank Recovery Unit in Leeds, who then tell them, “We now need a valuation. Your covenant is broken, so you have to repay,” and they are triggering deliberately—or that is how it seems—many thousands of pounds of costs that businesses do not need to face. I am being told by all the FSB people that I know in Scotland that this is quite a serious problem. I am concerned that here before us, you do not seem to know this.

Priyen Patel: We are certainly getting representation. I think I mentioned that. It is just the—

Q117 John Thurso: But what are you doing about it?

Priyen Patel: We are looking at all the representation coming through to us to try to make some form of judgment. There are issues around firm level problems we are getting, so there are certain institutions where complaints seem to be higher than other ones, but we are just trying to figure out, I suppose, if it is a market-wide problem. I think there is a consensus building that it is. In our representation to the FCA and to the Government about swaps, it took us a bit of time from the first representations coming to us to putting forward a judgment to the FCA and to the Financial Secretary. I suppose we are still in that process of trying to work out, first, the scale of this problem because it is very difficult to know numbers and, secondly, the regulatory space this lives in. We have had this discussion with the FCA and with other Government Departments, and there is confusion.

Q118 John Thurso: You know then that FCA does not consider itself to have the legal authority from Parliament to regulate this. That is its inhouse legal judgment. You know that they have written to the Minister responsible to inform him of that. We do not yet know what the Minister is doing about it, but I am hopeful that we will be able to ask the relevant Minister that question when they come before us. But it is particularly, I would suggest to you, a small business problem, because these are the kind of products that were originally sold—possibly mis-sold—to small businesses who would under no circumstances have the sophistication to unpick a plain vanilla swap, let alone one deeply embedded into what they thought was an ordinary fixed-term loan. You are here representing business as we look into what the scale of this problem is. Forgive me for saying this again, but it worries me that the representatives of business are as unaware of the scale of the problem as it would seem that parliamentarians are.

Chair: The source of concern is reinforced by the fact that when interest rate swap mis-selling first was broached as an issue, the representative bodies were slow there too, to come and inform us, and the regulators were certainly not on the case at all, even though the information was already around. The important thing here is to discover whether we are dealing with another sizeable problem or not. Perhaps you would like to come back to us, having had a chance to look at your respective records, and give us some more information.

John Thurso: I do not think I will ask any more questions at this point.

Q119 Stewart Hosie: Mr Fell, you said in relation to some of these embedded swap products a little while ago that you knew what you were buying. With the greatest of respect, we all have constituents who went to the bank and said, “Hold on. You have sold me a product with an embedded swap.” Behind it was a macro hedge the bank did not know it had sold, let alone the customer knowing what they had bought. I think that is part of the problem.

However, can I turn to you, Mr Patel? The Government has granted the FSB the power to make a super-complaint or to make super-complaints to the FCA. Are they or are you considering using that power to complain about any of these ongoing problems, such as the embedded or standalone interest rate swap issue?

Priyen Patel: Yes. We received the status from the Treasury and the FCA very late in December. We are now looking at a range of areas that we have heard from members they have had problems with. This is one. This is very high up the scale. There are a number of others as well. I will not go through all the details, but to put a super-complaints status in is a long, laborious process. What we have done so far on this is we have spoken to the FCA quite regularly. We understand very clearly they do not think it is in their ballpark, but the conversations will have to happen in terms of where they can advise us to go, where the most appropriate Government body is.

The super-complaint status applies to the FCA. If the FCA and the Government agree that this problem is not one that can be sorted out by the FCA, then obviously we would have to make a judgment whether a super-complaint was appropriate or not. We will obviously carry on making representations to relevant institutions in terms of this, but just in terms of the super-complaint, we can only obviously put it into the FCA where the FCA can then statutorily action—

Q120 Stewart Hosie: Of course, of course, of course. When would a decision be taken to move forward the super-complaint if you were able to do that?

Priyen Patel: As I said, we have only had this since December 2013, so we are looking at part-examples from other bodies. I suppose we are in a different space. We are the only SME body to ever have this. All the others have been consumer bodies, but generally when they have put in super-complaints—the PPI one, for example, that was a good eight months in work. There is a financial regulatory approach you have to take, there is a legal approach you have to take and, in certain regards, especially nowadays, there is a European regard you have to take, and you have to combine the three into a document, in effect.

Q121 Stewart Hosie: So even if you were able to, it would be some time yet before such a formal super-complaint could be made. Does the power to raise a super-complaint apply only to FSB members or to all SMEs or against a given product or range of products?

Priyen Patel: It applies to all SMEs, and it could apply theoretically to all businesses, so they do not have to be a member of the FSB.

Q122 Stewart Hosie: That is helpful. If I can just turn to you, Mr Fell. Clearly, even larger so-called sophisticated businesses have had the same or similar difficulties. You said there were small numbers that you have come across, which is interesting given that I have had businessmen with me in front of Treasury Ministers pulling their hair out at the way they have been treated by the banks, so I was quite surprised when you said that. But given these are in some cases more sophisticated and certainly larger businesses, would the ability to raise a super-complaint be something that the CBI would like to have?

Matthew Fell: No, that is not how we have ever thought or wanted previously.

Q123 Stewart Hosie: Is there a reason for that?

Matthew Fell: I think it is that we see ourselves as primarily a lobbying organisation, rather than one that has that capability to do that. We do not have a significant inhouse legal team or anything of that order to have the ability to take out super-complaints, if we wanted that power.

Q124 Stewart Hosie: No, I understand the answer—it was a very clear answer—but is that not something that you might want to consult with the membership on? It might well be the kind of function that even the larger businesses might like their membership organisation to undertake.

Matthew Fell: We do regularly survey all our members in terms of satisfaction and what they want from us. It is not an issue that has been raised with us to date.

Stewart Hosie: That is helpful. Thank you.

Q125 Mark Garnier: Mr Patel, can I turn to your report where you talk about the German Sparkassen, a different type of banking model, which you talk about being locally controlled banks with public interest criteria in their governing constitutions and 70% of the

German banking sector is covered by these smaller community banks. What do you think would be the benefits of more of this type of bank within the UK market?

Priyen Patel: Primarily the report—I think it was alternative class reports—that we wrote was around looking at competition in retail banking, so not just banks, although Sparkassen obviously is a bank, but looking at a more pluralistic SME finance arena. I do not think there is a single bullet. I think even if you move Sparkassen to the UK, you would still have to do a lot of extra work in terms of all the technology-based platforms. We mentioned CDFIs and a range of others. I think the benefit it brings is there is a move afoot, I suppose, of banks shutting branches down in certain areas, and we have a concern around last bank/sole bank villages or towns. Those banks tend to be very important hubs of those communities. They tend to be actual small economic drivers in those communities; you remove those and you lose that driver. Those Sparkassen models—and there are other models around the world—

Mark Garnier: Yes, the cantonal banks and various other ones as well.

Priyen Patel: —have a commercial remit, but they also have a social remit as well, and we think there is a driver there that they can play. We think also they have a slightly more centred approach to lending. They have a lot of expertise in what the government is doing, so if the government has launched a scheme that can help in mentoring, for example, those Sparkassen managers tend to be very well plugged into what other bits of Government support and advice businesses can get.

Q126 Mark Garnier: Who are their shareholders, just out of interest?

Priyen Patel: Their shareholders are primarily a Sparkassen corporate body, but also individuals can buy those through German trusts—can buy shares in Sparkassen through trusts.

Q127 Mark Garnier: But it is not a traditional shareholder model that we would be familiar with?

Priyen Patel: No, it is not.

Q128 Mark Garnier: So it is more sort of a utility/social bank?

Priyen Patel: Yes.

Q129 Mark Garnier: I am quite interested in this particular area of alternatives to the kind of current banking model we have, but isn't one of the problems with them though that if you have a Sparkassen type of model in a certain area—and step in, if you want, at any point, Mr Fell—that you are potentially amplifying the local problem? Zürcher Kantonalbank is a very big bank because you have Zurich as the area from where it is deriving its deposits, so therefore it is very successful, whereas other less prosperous cantons in Switzerland do a lot worse and their local cantonal banks do rather badly. You are amplifying the problems, because you cannot derive those deposit bases because there just is not the money there. Can these local banks potentially amplify problems as opposed to resolve them?

Priyen Patel: Sparkassen and other similar models all have a commercial remit, so they all have to make a profit. If they do not, they go out of business. I think the learning and the

teaching from the Sparkassen, which is really valuable, is more at the regulatory stage. The Sparkassen in Germany have what is effectively known as a black box model, so if a new Sparkassen wants to start, they can effectively apply for a franchise to the central Sparkassen—and these are people with all the requisite regulatory approvals—and receive almost a toolkit version of the back office operations.

Q130 Mark Garnier: So it is like a white label utility bank that you can plug into?

Priyen Patel: Yes, and they can offer very simple retail products. When you speak to start-up banks and small banks here, one of the problems you often hear is the back office operations risk and IT. The Sparkassen German model offers a very simple model, admittedly, where people can apply to that.

Q131 Mark Garnier: This is similar to what we see in America. I think there are 7,500 banks over in America where you can buy effectively a bank in a box and set it up, sort of a vanilla bank, relatively straightforward. Did you want to add anything?

Matthew Fell: Just to echo that the barriers to entry and growth for start-up and challenger banks are primarily around the requirement for IT infrastructure, the level of collateral you need to access the payment system and the overall regulatory capital. I think they are quite significant hurdles to overcome for challenger banks.

Q132 Mark Garnier: Going back, Mr Patel, to your report, you have a very helpful chart showing profit after tax and the percentage of the average capital shown on the balance sheet going from 2000 to 2009. The one thing with the German savings banks is it is pretty much a straight line. It does drop a little bit in 2008, but it is a pretty consistent return, whereas the volatility of the large commercial banks is absolutely staggering in terms of it going on down. What is it that is driving this straighter line return? Is it legislation? Is it specific business model? Can you enlarge on that?

Priyen Patel: I think it is the business model but also the culture there as well, so the culture is while the volatility of normal commercial banks does go up and down, dividends do follow those lines up and down, whereas the straight line approach, dividends are still going out but at a more consistent level. That culture is bought into by people who maybe want to make fewer returns but have a slightly more steady return outlook, whereas possibly the model operated by the commercial banks is to have peaks and troughs and for their dividends to follow those models.

Q133 Mark Garnier: They would argue it is peaks and peaks that would maximise shareholder return.

Priyen Patel: But it is primarily the culture and the boards of those organisations that drive that culture of very steady operations. It is also them walking away from certain types of business products and certain types of commercial products that have a lot of exposure to wholesale markets. They tend to look at everything from the retail space and then work up, rather than the other way down.

Q134 Mark Garnier: In outcome, and not necessarily in the structure, how do they differ from the mutual model?

Priyen Patel: The mutual model is a lot more based on a CDFI, to a certain extent, where the owners tend to be the people who have invested in it, small-scale investments, not quite charity sums but slightly larger, but also those people who use those organisations as well. The mutual banking sector in the UK is relatively small and has not the greatest reputation in the world, because the people who go through their doors tend to be the people who have been refused at X, Y and Z, so the people going through their doors generally tend to be higher risk; therefore they are priced at a higher risk. That perception is out there in the market, where people do not want to use mutual banks or CDFI banks because they fear the price is higher. It is not; it is just because of the people walking through their door and their customers, if you like, tend to be higher priced.

Q135 Mark Garnier: One last question, if I may. What do you think the dynamic is that is going on in the UK that has restricted our banking market? I think there are 47 banks outside the top four or five, but we never ever hear of them and, as we know, the vast majority of people, be they businesses or retail customers, bank with the big four. What do you think the dynamic is that is going on in the UK that has resulted in that, whereas in America, Germany, Switzerland and various other places around the world you still have this very strong local and flourishing bank market?

Priyen Patel: There are many. If I just pick one from America, for example, they do have regulations around size and community investment. If you want to activate an M&A, for example, if you want to take over a competitor bank or another bank or another financial institution, you do have to prove on the side of the scorecard that you are providing services to low-income areas, to business start-ups, slightly riskier things, and that does put a constraint on certain banks. But also flipping the coin, the other side, it activates a positive outcome where certain banks either invest by themselves or through third parties into areas that have slightly higher risk models. That puts, on the negative for a bank, a constraint on it; on the positive, it means small banks or state banks stay and want to stay in those types of geographical areas. We do not have the size of country as America or as geographically split in terms of states. We have counties or other areas, but that ethos we do not have to the same extent as in America.

Matthew Fell: The one piece I would say on the customer side of things is that we are starting from a very low base. We are starting to see, I think, some signs of improvement that SME customers are starting to look more at those challenger banks. Previously, if they were turned down on a loan application from one of the mainstream five or six banks, they would pack up and go home. I think now they are in a situation where they are starting to approach those challenger banks to see if it is a proposition that would be attractive to them. I think the next step on still would be the ideal, that they are approaching those challenger banks at the same time and in parallel with applications to the mainstream banks. Clearly, there is still a very significant dominance of market share within the main five or six players, but we are starting to see, driven from the customer side of things, an appetite to use those challenger banks more because they do not want that over-reliance on that single relationship that caused them so many problems previously.

Chair: You will have heard today the depth of concern about aspects of SME lending from this Committee. This Committee considers recovery in the SME market absolutely crucial to

sustaining the economic recovery more widely, and put their interest in things that might get in their way as certainly very high on the agenda for this Committee to try to do something about. You have heard considerable concern expressed about embedded swaps. A number of businesses are coming to us because they feel they cannot go anywhere else, and I think it would be extremely valuable if the representative bodies feel able to be early warning centres for this, rather than find out about it to some degree, as appears to be happening, from the politicians. I would be very grateful if you could come back to us on any further information that is already in your organisations. Thanks very much for your evidence this afternoon.