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Dame Meg Hillier MP
Chair, Public Accounts Committee
House of Commons
Westminster
London
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Dear Dame Meg,

I am writing to the Public Accounts Committee to provide you with an update on recommendation 6a from the Fiftieth Report of Session 2021-22, Department for Business, Energy & Industrial Strategy, Bounce Back Loans Scheme: Follow-up. The recommendation is as follows:

The Bank should develop a strategy to mitigate the negative impact of the Scheme on the SME lending market and publish its findings in its next Small Business Finance Market report.

We provided you with an update in May: *The British Business Bank is building upon the findings from their Small Business Finance Markets report and using its business planning process for the financial year 23/24, which is concluding shortly, to inform its ongoing strategy supporting SME lending markets. This work continues to identify any mitigating actions the BBB sees necessary following the impact of BBLS on SME lending markets. The BBB will update the Committee on its strategy, actions taken and further findings by the end of the Summer 2023.*

The British Business Bank's role in supporting diversity of lending

One of the Bank's core strategic objectives is to 'Drive Sustainable Growth: ensuring smaller businesses can access the right type of finance they need to start, survive and grow'. As detailed in our business plan 2023/24, this objective focuses on improving the debt finance markets that serve most smaller businesses, including supporting the diversity of providers and products in these markets, and stepping in to support those markets in times of economic downturns.

Through our investment and guarantee programmes, we have supported the diversity of financial markets by delivering over £4bn of lending to over 67,000 SMEs through over 40 alternative lenders, including challenger banks, asset finance, peer to peer lenders, and debt funds.

Our performance assessment is set out in our latest Annual Report and Accounts, which details that we exceeded our set target to deploy the vast majority of finance in our core finance schemes outside of the largest UK banks; as of 31 March 2023, the percentage of stock of finance supported outside of the "Big-5" banks was 99.0%, c.200 bps ahead of the 97.0% full year target. In doing so, we achieved our goal of creating a more diverse finance market for smaller businesses, with greater choice of options and provider.

A key element of our strategy is providing choice in debt finance for smaller businesses by supporting a range of challengers and specialist providers. We do so through a number of interventions:

1. ENABLE Guarantees offer 2nd loss protection and give capital efficiency to banks and funding efficiency to non-bank lenders, with the "ENABLE Build" variant focusing on supporting smaller housebuilders.
2. ENABLE Funding helps smaller non-bank lenders obtain efficient access to capital markets by providing them temporary funding to lend to SMEs and helping them to subsequently refinance these portfolios of loans via securitisation or other capital markets instruments.
3. Investment Programme which invests in and supports:
    - Challenger Banks with their capital requirements acting as a funder of regulatory (Tier 2) capital.
    - Asset Finance and Asset-based lenders.
    - Technology-enabled finance (Fintech) providers such as marketplace lenders.
    - Private Debt funds focusing on UK SME finance.

These wholesale guarantee and funding programmes, accompanied by our direct credit guarantee scheme, the Recovery Loan Scheme (RLS) and our Start Up Loans (SUL) programme, make up a comprehensive and diverse suite of options to support the development of a diverse lending market over the economic cycle.

In the last year, working with HMT and DBT and recognising the challenges in the market, we took further action to enhance our ability to support challenger and specialist lenders:

a) Increased Investment Programme commitments by £100m to £300m in 2023/24. This additional funding will support challenger banks access capital and will increase funding to private debt funds supporting high growth companies;
b) Reformed the ENABLE Guarantee programme by opening it up to non-bank lenders, offering capped guarantees and allowing existing loans to be included in the guaranteed portfolios, increasing our additionality, and reaching more lenders; and
c) Removed the RLS interest rate cap, which was inconsistent with current BoE rates, leading to increased deployment of the scheme, and added a new Asset Based Lending variant to RLS.

Findings: diversity of supply within lending market for SMEs

The British Business Bank's latest Small Business Finance Markets (SBFM) report published earlier this year showed encouraging signs of increasing diversity in SME lending markets. Largely due to their significant deployment of Covid-19 debt guarantee schemes in 2020, and particularly Bounce Back Loans, the UK's five largest high street lenders were estimated to make up 68% of gross bank lending to SMEs compared to 32% for challenger and specialist banks. This contrasted with the previous year in which they made up 52% of gross bank lending. Our latest findings reveal that challenger and specialist banks' share of total gross lending by the end of 2022 rose to 55% – a record high – and early indications suggest that this share has further increased in 2023.

This marks a continuation of increasing diversity of finance provision in the bank SME lending market away from the larger providers. These figures represent a second consecutive year in which challenger and specialist banks' share exceeded that of the largest five lenders (up from 51% in 2021).

As well as supply of finance, our analysis also considers SMEs' behaviours in terms of awareness and use of different forms of finance and finance providers. Some encouraging signs are emerging here too. The Bank's Business Finance Survey showed that the proportion of SMEs considering more than one finance provider in 2022 (32%) was the highest since 2019. Anecdotally, the Bank's extensive contact with firms in these markets reported that challenger and specialist banks were operating in areas where larger lenders were unwilling to. This echoes Bank of England agent reports which found evidence in early 2022 that challenger banks were more willing to lend to companies affected by the pandemic compared to the major banks.

Outside of bank lending, data related to alternative finance providers indicates a more challenging year for the sector largely driven by the higher interest rate environment and increasing risk averseness of wholesale funders. That has meant the funding landscape for alternative finance providers became increasingly difficult throughout 2022, with wholesale funding costs increasing for smaller banks and non-bank lenders. Since February 2022, increased interest rates have meant the cost of wholesale funding for marketplace lenders, smaller asset finance providers and Community Development Financial Institutions (CDFIs) has sufficiently risen.

With respect to lending market product diversity, data suggests some positive trends around asset finance, which helps businesses to invest in vehicles, equipment and plant and machinery without relying on traditional term loans. In 2022, SME asset finance markets reported a nominal increase in new business of 11% to £22.5bn – a new high. For invoice-based finance, which describes funding against a range of business assets as another alternative to term loans, the value of advances to SMEs continued to recover in 2022 and stood 69% above Q4 2020 levels as they approached pre-covid amounts.

With the above data and market trends in mind, the Bank concludes that there have been improvements to lender diversity since the PAC Committee's finding in relation to 6a, and that the focus should now be on ensuring that this momentum continues.

Ongoing evaluation

The Bank is committed to the ongoing evaluation of the Bank's schemes. This has been in place since the Bank's inception and is embedded as part of our 'business as usual' activity as it is vital to identify 'what works' and where improvements can be made.

Because of their importance, the Bank conducts a specific three-year rolling evaluation of Covid Loan schemes. The Year 1 report was published in Summer 2022 andthe Year 2 report was published on

November 28th 2023. These reports examine the impact to the SMEs, rather than the diversity of the lending market.

We are also in the process of conducting an evaluation of RLS 1.0 (expected in Spring 2024). This will similarly examine the early impacts of the first iteration of the scheme on SME performance, such as survival and growth. There will also be an analysis of how the scheme supported lenders to provide finance to SMEs, covering a range of lender types and not just larger banks. Findings from this and all our evaluations will continue to inform the ways in which the British Business Bank designs and implements our products.

Conclusion

The Bank remains committed to supporting diversity of lending to the very best of our ability and we continue to evaluate and review the impact that our products have on the market, across all of our schemes, and modify them where necessary to improve their impact.

I trust that the Public Accounts Committee is satisfied that the Bank has fully addressed recommendation 6a in the Fiftieth Report of Session 2021-22, Department for Business, Energy & Industrial Strategy, Bounce Back Loans Scheme: Follow-up.

If you would like to discuss the information included in this letter or any have any further questions, please do contact me or the team at bbbpublicaffairs@british-business-bank.co.uk

Yours sincerely,

Louis Taylor

Louis Taylor
Chief Executive