House of Commons

Treasury Committee

SME Finance: Government Response

First Special Report of Session 2024–25

HC 517

Treasury Committee

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Publication

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First Special Report

The Treasury Committee in the previous Parliament published its Eighth Report of Session 2023–24, SME Finance, (HC 27), on 8 May 2024. On 2 December HM Treasury provided a Response to that Report. The Committee issued its Report during the previous Government. The new Government has responded to the Report. The Government Response is Appendix 1 to this Special Report.

Appendix 1: Response from HM Treasury

Introduction

1. The Government welcomes the report on SME finance from the Treasury Select Committee of the previous Parliament. The report underscores the significant contributions of SMEs to the UK economy, with these enterprises providing around 16.7 million jobs and generating an annual turnover of £2.4 trillion . As of October 2024, there were over 5.48 million SMEs in the UK, compared to just 8,250 large businesses . The Government recognises the crucial role that SMEs play in driving economic growth and is committed to ensuring they have access to the finance and services they need.

2. Small businesses are vital to our high streets and communities, and essential to the success of the Government's Growth Mission. To that end, the Government is planning to take action across a wide range of areas to deliver on the commitments we set out in our manifesto–especially on strengthening small businesses' ability to invest and grow. These include:

   - Committing to continued funding for key business support programmes in 2025–26: We will continue funding the 41 Growth Hubs in England, offering businesses free, impartial advice and support at any stage via a single point of contact. They provide a triage, diagnostic, and signposting service so all businesses can access the right support at the right time.

- We are also continuing funding for the Help to Grow: Management programme, which is open to firms with 5-249 employees. This programme has supported over 9,000 small businesses since 2021, helping SME leaders develop skills in financial management, innovation, and growth plan implementation to improve productivity.
- We have published post-implementation reviews on the Bank Referral Scheme and Commercial Credit Data Sharing with a view to launching consultations by Spring 2025 on how these can be further enhanced.
- The SME Digital Adoption Taskforce will be extended by at least 6 months. They will produce an interim report early in the new year with practical steps and recommendations to enhance SME digital technology adoption, using insights from local and international experiences. Additionally, the Department for Business and Trade will soon announce details of a £4m pilot package to encourage tech adoption for SMEs. These measures aim to focus on important tasks, automate costly admin, and reduce the time required from citizens by a modern digital Government.
- To drive further progress on our commitments, as part of the growth mission, the Government will also bring forward a Small Business Strategy Command Paper next year.

Basel 3.1 and the SME supporting factor

The removal of the SME supporting factor under Basel 3.1 threatens to undermine the UK's SME finance market by increasing capital requirements on lenders to SMEs. This will drive up the cost of finance for SMEs and may restrict the supply of lending as banks shift their loans away from the market. At a time when costs are tight and acceptance rates for finance low, anything that unnecessarily damages the availability of finance to SMEs is unacceptable. Other jurisdictions like the United States and European Union are also not pursuing as strict an interpretation of Basel with regards to SME lending so removal of the SME support factor risks putting the UK out of step with international peers and competitors, with negative consequences for the competitiveness of the UK market. (Paragraph 25)

The PRA must ensure that the final implementation of the Basel 3.1 standards leaves capital requirements on SME lending no more stringent than they are under the current system and that international competitiveness with the EU and the US is not harmed. (Paragraph 26)

3. We acknowledge the Committee's concerns regarding the removal of the SME supporting factor under Basel 3.1.

4. The Government notes since the publication of the SME Finance report, the Prudential Regulation Authority (PRA) has sought to make adjustments in this area. In September 2024, the PRA published its second policy statement, detailing requirements for firms' lending activities. The PRA also announced a six-month delay to the UK's implementation of Basel 3.1 standards, with the new start date set for January 2026 to align with the EU's timeline for the trading elements of its package.

5. The Government welcomes the PRA's Basel 3.1 package and commends its thoughtful consideration of feedback, which has led to well-considered adaptations. This included evaluating the impacts of all aspects of the Basel 3.1 package on growth and competitiveness. Notably, the PRA seeks to ensure that the overall capital requirements for SME and infrastructure lending do not increase.

6. While the PRA is proceeding with its proposal to remove the SME supporting factor to align with international Basel standards, this change will not result in higher capital requirements for lending to small businesses. The PRA has confirmed that it will make structural adjustments to another part of the capital framework to maintain the current capital requirements for SME lending.

7. In September 2024, the Treasury published draft legislation necessary to implement Basel 3.1. By revoking the current capital requirements from the statute book, the Treasury will enable the PRA to implement its Basel 3.1 package effectively. The Treasury will also ensure that firms have the necessary certainty to implement the new requirements before they come into effect in January 2026.

8. The PRA's Basel 3.1 package is tailored to the UK and aims to address weaknesses exposed during the financial crisis while supporting UK economic growth. We recognise that significant uncertainty remains regarding the US implementation of Basel 3.1. Both The Government and the PRA are alive to changes in the US position. We will continue to monitor this.

Dispute resolution

We support the Financial Ombudsman Service in its role as the primary mechanism for SME banking disputes. We note concerns that the FOS is primarily equipped to deal with less complex cases but note the efforts undertaken by the organisation to improve specialist resource. (Paragraph 32)

HM Treasury and the FCA should continue their dialogue with the FOS and keep resourcing under active review, to ensure that it has the prerequisite capacity and capability to serve the majority of the SME community. (Paragraph 33)

9. The Government also supports the work of the Financial Ombudsman Service (FOS). The FOS plays an important role in providing consumers and small businesses with a cost-free service that enables the proportionate, prompt and informal resolution of disputes with financial services firms. It is designed as an alternative to consumers and small businesses having to take a case against a firm to court, which would be expensive and time consuming for both parties. The FOS therefore provides firms with an extra incentive to comply with their regulatory requirements and provides consumers with confidence to invest in regulated products.

10. As the Committee notes, the FOS is currently undertaking a programme of work to improve its service, following an independent review of its operational effectiveness in 2021. We will continue maintaining regular engagement with the FOS, addressing relevant operational issues, ensuring that FOS rules are aligned with the current financial services landscape, and facilitating effective cooperation with the FCA.

11. More generally, the Government also believes it is important that the FOS works effectively with the FCA to deliver consistent outcomes for both firms and consumers. This is why at Mansion House the Chancellor announced a package of measures being taken forward by the FCA and the FOS, working closely with Government, to modernise the framework underpinning the FOS and help create a predictable and attractive environment for investment, as well as supporting the operational effectiveness of the FOS in dealing with mass redress events.

12. This includes a Call for Input on modernising the redress framework, an updated Memorandum of Understanding between the FOS and the FCA, and a newly strengthened Wider Implication Framework which gives both industry and complainants clearer routes to raise concerns.

The BBRS has seen a far smaller number of cases than some expected. This could be due to low demand, but is also likely to be due to the nature of the eligibility criteria attached to it, as shown by the rejection

rate of cases. In the best-case scenario, the 55,000 businesses outside of the FOS' remit would never have been fully served by the scheme, because only the seven participating banks were in scope. (Paragraph 58)

There is no clear evidence that the seven participating banks control the BBRS on an operational level. However, the structure and remit of the BBRS were determined with their consent. Dispute resolution must be independent, and perhaps as importantly, be seen to be independent of the financial services industry. Despite the assurances we have been given to the contrary, this does not appear to have been the case with the BBRS. (Paragraph 59)

The BBRS is not fit for purpose in providing alternative dispute resolution to the 55,000 SMEs who fall outside of the FOS' thresholds and this service should close as originally planned. (Paragraph 60)

13. The Government notes the Committee's conclusions in this area, and notes the decision that has been taken for the Business Banking Resolution Service (BBRS) to close to new registrations on 13 December 2024. Decisions regarding the future of the Business Banking Resolution Service (BBRS) are a matter for the BBRS, as an independent service, decided in discussion with participating banks and SME representatives.

HM Treasury must find a way to continue to meet the dispute resolution needs of those SMEs ineligible for FOS access (including considering whether the FCA was correct in assuming that expanding the FOS' thresholds would be a disproportionate cost). A consultation on a replacement mechanism must take place by year end 2024. (Paragraph 61)

14. The Government is committed to ensuring that SMEs have appropriate access to redress now and in the future, with proportionate regulation and oversight of business banking.

15. As the Committee's work has noted, more than 99% of UK businesses currently have access to independent dispute resolution through the FOS, without prejudice to the ability to pursue litigation as a means of redress.

16. As a new Government, we consider that a full consultation is not warranted at this stage, and are doubtful there is a sufficient volume of customers to justify a new dispute mechanism (outside the FOS' perimeter).

17. We will continue to monitor the area of SME disputes–as the FCA does in relation to determining the jurisdiction of the FOS–and will inform the Committee as needed of any developments.

HM Treasury and the FCA should also continue to keep resourcing of the FOS under active review to ensure that it has the prerequisite capacity and capability to serve the majority of the SME community. (Paragraph 62)

18. We refer the Committee to our response above: we will continue our engagement with the FCA and the FOS, ensuring we are addressing relevant resourcing issues, ensuring that FOS rules are aligned with the current financial services landscape and correctly serving the SME community.

Business de-banking

Any SME with a legal business should be able to access a bank account. Banks may need to close business accounts because of regulatory requirements and concerns around financial crime, but thousands of accounts are being closed for vaguely defined reasons relating to "risk appetite" or "reputational risk". What qualifies for this type of account closure varies from bank to bank with little regulatory guidance. SMEs deserve to know why their account has been closed, and the lack of transparency, alongside inconsistency in how criteria are being applied, is unacceptable. (Paragraph 77)

19. Banking services fulfil a vital role in the lives of millions of people and businesses across the UK, and the Government is committed to ensuring high standards of protection and financial inclusion across the financial services sector.

20. We agree with the Committee that current requirements relating to the closure of accounts could be improved, including to ensure greater transparency for customers. The Treasury intends to bring forward legislation to ensure that customers receive a detailed and specific explanation when providers close their accounts, along with a longer period of notice–unless certain exceptions apply, such as in financial crime situations. This is intended to ensure fair treatment and greater transparency for customers, recognising the essential importance of banking and related financial services.

21. Clearer requirements and transparency, including signposting recourse to the FOS, may also assist with disputes in this area. The Government recognises the importance of bank accounts for businesses and individuals, and the legislation seeks to raise awareness of the ability to register a complaint with the FOS if a customer thinks they have been treated unfairly.

22. We will continue to monitor for evidence of debanking of legitimate businesses and the work of relevant bodies, including the FCA.

The FCA should continue their work into better understanding how financial institutions are using criteria like "reputational risk" or "risk appetite" and report their findings by the end of Q2 2024. It is essential that the FCA publish clear instructions by Q3 2024 to the market about how such criteria can and cannot be used within the existing regulations. These instructions should be designed to ensure consistency between institutions and prevent the above criteria from being applied more broadly than the law permits. HM Treasury should keep the findings and subsequent action taken by the FCA under review, and it should be prepared to widen the FCA's remit as needed should the action taken not be robust enough under the current regulations. (Paragraph 78)

The FCA should also require banks to submit quarterly data on business account closures to assist their wider review. The FCA should publish an aggregated form of this data on a periodic basis to improve transparency over business debanking and allow SMEs to make informed decisions on their choice of finance provider. The FOS should also continue to publish statistics on complaints from businesses around account closures. We would not want Environmental, Social and Governance SME Finance measures requested by investors to be interpreted as meaning that businesses engaged in perfectly legal defence or energy activities were unable to open a bank account. (Paragraph 79)

23. The Government welcomes the FCA's work to date to better understand why banks might reject or close bank accounts. Where the FCA has found areas where firms need to improve customer outcomes, the Government expects firms to consider the FCA's findings and next steps. We also value any evidence from business relating to their accessing banking services as we continue to explore the issues relating to account access, working with the FCA.

24. However, these recommendations are primarily for the FCA to address as an independent non-governmental body.

We welcome the Treasury's proposed rules changes on de-banking, which will provide a greater deal of transparency to customers who suffer from an account closure. HM Treasury should introduce these regulations before the parliamentary summer recess, 2024. (Paragraph 80)

25. As set out above, the Government intends to bring forward legislation to enhance customer protection in cases where their bank account is terminated by their provider in the near future. We will notify the Committee when the relevant statutory instrument is laid.

Role of the British Business Bank

We commend the British Business Bank for its role in providing support to SMEs. We would like to see more smaller businesses visiting the Finance Hub and making use of its resources, as well as wider BBB programmes. (Paragraph 87)

Government, including HM Treasury and the Department for Business and Trade, should consult with the BBB on an ongoing basis to ensure that everything possible is being done to raise awareness and increase engagement from the SME community. This should include assessing whether the BBB has sufficient resources to publicise its services effectively. Government should subsequently implement criteria by which they can assess the effectiveness of the BBB in reaching SMEs, which they should publish annually. (Paragraph 88)

26. The Government agrees with the Committee that the British Business Bank (BBB) plays an important role in providing support for SMEs. We will work with the BBB to improve the access to finance landscape for SMEs, stimulating supply and demand through targeted interventions. We plan to build on the work the BBB has done to date as it strives to create the opportunity for smaller businesses to invest and grow, generating additional jobs and elevated economic activity.

27. To the question of assessing the effectiveness of the BBB's reach, the BBB published its first SME Impact Report earlier this year which sets out the impact of BBB's activity on smaller businesses across the UK's Nations and regions. The report shows that BBB deployed £3.5bn of public funding into UK smaller businesses in 2023, funding around 23,100 UK smaller businesses, 84% of which were outside of London. The expected impacts over the life of this finance are the creation of 39,400 additional jobs and £19.8bn of additional business turnover, equivalent to £8.4bn of Gross Value Added (GVA)[1].

28. The BBB improves access to finance to help businesses invest and grow, generating additional jobs and economic activity. Its programmes are designed to bring benefits to businesses that are start-ups, businesses with high growth potential that are looking to scale up, and those looking to stay ahead in their market.

29. We also agree with the Committee that BBB's finance hub is an important resource that helps smaller businesses understand the finance landscape and provide information on the options available based on their needs. This information is key in assisting SME access the finance they need, and we would like to see more SMEs utilising this service.

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30. The Government wants to empower BBB and ensure that it has sufficient resources to support the SMEs it serves. This is why at Autumn Budget, to help support the Government's mission to kickstart economic growth, the Department for Business and Trade's (DBT) settlement will allow them to invest over £1 billion across 2024–25 and 2025–26 for the BBB to enhance access to finance for small businesses, including over £250 million each year for small business loans programmes, including Start Up Loans and the Growth Guarantee Scheme.

The Recovery Loan Scheme appears to have been successful in supporting SMEs with access to finance throughout the pandemic and beyond. We welcome HM Treasury's decision to extend and rebrand it into a "Growth Guarantee Scheme", which can provide support to many more businesses seeking to access finance in the coming years. (Paragraph 95)

HM Treasury and the BBB should consult on the merits of making the Growth Guarantee Scheme permanent, in order to provide a foundational support programme, which can be scaled up appropriately in a crisis. This would build long term security in the accessibility of finance for the SME population and provide a greater level of certainty. (Paragraph 96)

31. We agree with the Committee that the Growth Guarantee Scheme (GGS) scheme has an important role in supporting SMEs and driving growth.

32. GGS has supported over £5.3bn of finance to SMEs since its introduction in April 2021. Of the businesses supported by GGS more than 90% had fewer than 50 employees. More than half of the offered facilities were for growth capital for UK smaller businesses, with the majority of the remaining facilities for working capital.

33. The scheme also attracts a wide variety of lenders, including social lenders, Community Development Finance Institutions (CDFIs), and other specialist lenders which are aimed at underserved sections of the debt market.

34. The scheme has now been extended to the end of March 2026 and any decision regarding making the scheme permanent will be taken at Spending Review.

Personal guarantees

Disproportionate use of personal guarantees may be a factor in driving down access to finance, either owing to lack of collateral or simple risk aversion from businesses who do not wish to take them out. We support the FCA's investigation into the fair and proportionate use of personal

guarantees that fall within its existing remit. The FCA's remit is set by Parliament, and we do not feel that widening it would be appropriate at this time. This is because the unintended consequences of introducing new regulatory frameworks to deal with specific issues in the SME lending market could actually result in a reduction in the accessibility of finance for SMEs. We may revisit this in the future and will monitor the FCA's progress on the matter of personal guarantees. (Paragraph 110)

35. The Government agrees with the Committee that it is important to introduce regulation only where there is a clear case for doing so, to avoid imposing additional costs on lenders that could ultimately lead to higher costs for business customers.

36. As a general observation, the use of a personal guarantee may be proportionate, for example in cases where a business has limited or no trading history or assets to be able to access debt finance. This may help enable lending to SMEs that otherwise would not be advanced, or at a price that deters SMEs from accessing finance. We fully agree with the Committee, however, that practices relating to the use of personal guarantees should be fair and proportionate.

37. We will take a close interest in the outcomes of the FCA's investigation into this issue, and will continue to monitor for evidence of the effect and proportionality of the use of personal guarantees.

We agree with the FOS that the current approach to personal guarantees on business lending represents a gap in its remit that fails to provide the kind of support to SMEs that the service exists for. The fact that the FOS cannot assist business owners or directors over misapplied guarantees, but can do so for consumers, represents an unfair inconsistency in how the FOS supports consumer versus business cases. (Paragraph 111)

The FCA should provide the FOS with the necessary powers to address personal guarantees for SMEs, so that their service is consistent with consumers. The FCA should also investigate widening the FOS's remit to cover the other gaps they identified and keep the Committee informed of their conclusions. (Paragraph 112)

38. The Government notes these recommendations are mainly intended for the FCA to consider, given its status as an independent, non-governmental organisation, and its role in relation to the FOS.

Unfair use of personal guarantees has the potential to constrain growth and investment for SMEs, particularly the smallest businesses. We welcome HM Treasury's review on this matter, and look forward to seeing what it will do to ease the burden on the smallest businesses. (Paragraph 113)

39. Since the Committee's report was published, Treasury officials have been in dialogue with various stakeholders about the use of personal guarantees to try and better understand market practice.

40. In October 2024, UK Finance published a set of commitments made by 19 of its corporate finance members aimed at ensuring the proportionate approach to the taking of these guarantees. A copy of these commitments can be found here:

https://www.ukfinance.org.uk/system/files/2024-10/Industry%20commitments%20on%20personal%20guarantees_0.pdf

41. We consider this to be a positive step, and one that ought to engender greater trust and transparency in the use of these guarantees. We would encourage more lenders to sign up to these standards.

42. In addition, we will continue to monitor for evidence of the effect and proportionality of the use of personal guarantees, and will consider how best to amass relevant data so there is a clearer picture of this issue. We will write to the Committee with an update in due course.