Autumn Budget 2021

Submission by Innovate Finance

Rt Hon Rishi Sunak MP
Chancellor of the Exchequer
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

30 September 2021

Dear Chancellor,

Ahead of the autumn Budget and Spending Review, I am writing to offer a perspective on the next steps that the Government could pursue to fuel the further success of the UK FinTech sector, ensure its continued international growth and competitiveness, and unleash the potential of FinTech to support the growth of SMEs across the country.

UK FinTech firms are now entering a complex phase of maturity. This year we are seeing record levels of investment. In the first half of this year, UK FinTech raised a total of $5.7bn (USD). This already outstrips the total investment secured in the whole of 2020 ($4.3bn) and breaks the record year set in 2019 ($4.6bn). FinTech founders made up 17 of the Financial Times' recent Top 100 list of UK Entrepreneurs, and of the 150 firms which the Government's Future Fund has taken stakes in, 25 are FinTechs. We are seeing new waves of innovation and adoption, as embedded finance, open banking applications, new forms of unsecured credit, development of blockchain applications and new ESG products and services come to market. The pandemic has only served to further accelerate adoption.

FinTech firms mobilised to support households and small businesses through the pandemic. Funding Circle alone approved 27% of all Coronavirus Business Interruption Loan Scheme (CBILS) loans since it became involved with the scheme, making it the UK's third largest CBILS provider. In addition, as we approach COP26, FinTechs are leading the way in enabling financial institutions, consumers and businesses to transition to Net Zero through innovative tools and technology.

This success story endorses the faith and support your Government has placed in the sector and the priority given to the *Kalifa Review*, published in February. Your backing of the recommendations of the *Kalifa Review*, across its five themes (policy and regulation, skills, investment, international and national connectivity) has been welcomed by the UK FinTech ecosystem. In particular, we have been heartened by the commitment and progress in areas such as the FCA scalebox, the listings review, scale up visas and integration of FinTech into trade policy (such as the Singapore-UK digital trade negotiations).

We look forward to hearing further progress on the *Kalifa Review* recommendations at Budget, including confirmation of your proposals to extend R&D credits, and plans for a Centre for Finance, Innovation and Technology (CFIT), and would welcome further steps to extend the Enterprise Investment Scheme, Seed Enterprise Investment Scheme (SEIS) and Venture Capital

Trusts (VCTs) to support investment in StartUps and ScaleUps engaged in regulated financial services. We also eagerly anticipate expansion of the Enterprise Management Incentives (EMI) scheme, following your consultation earlier this year, to support employee recruitment and retention in more high growth firms.

We are pleased with progress so far on *Kalifa Review* implementation. However, we would emphasize that this momentum cannot be a one off; maintaining the UK as a centre for global FinTech is a continuous task. The market has accelerated in the six months since the *Kalifa Review*, and it is critical that government, regulators, and industry work together to keep looking at new ways to maintain its competitiveness.

Innovate Finance believes the following is needed now to support the FinTech sector:

1. **Enable FinTech to power growth across the UK economy -** encompassing further reform of the small business lending market, promoting well paid jobs in FinTech clusters, and championing innovative financial solutions to NetZero.
2. **Maintain and develop the UK's position as the world-leading regulatory regime**, going faster and further on regulatory and policy reforms that enable innovation; in particular leading the world on Open Finance and Digital ID, and integrating innovation and competitiveness into the objectives of regulators including FCA, PRA and the ICO.
3. **Strengthen cross government and regulator coordination and cohesion on FinTech** strategy, to ensure every part of the system is moving in the same direction and cement the UK's position as THE place to set up and scale a business.

A focus on these three key priorities will deliver a UK vision for FinTech where:

- FinTech plays a full role as a leading soft and hard power tool for Global Britain.
- The UK develops its world-leading regulatory regime, supporting innovation through competitiveness and consumer trust**.**
- We unleash the power of FinTech to improve the financial wellness of consumers and SME growth across the UK.

I would welcome the opportunity to discuss these ideas with you or your officials, and to share more direct feedback from Innovate Finance members on the specific challenges they face, which these proposals seek to address.

A copy of this letter will be shared with the Secretary of State for Business, Energy and Industrial Strategy and the Economic Secretary.

Yours sincerely,

Janine Hirt
Chief Executive
Innovate Finance

Innovate Finance Autumn Budget 2021 representation

1. *Enable FinTech to power growth across the UK economy*

FinTech has the power to turbo charge the economy, by combining the capital and financial tools needed for growth with technology that creates solutions to new and deep-seated challenges. There is a huge opportunity to unleash the UK's FinTech strength to support:

- **SME growth**, drawing on the ability of alternative lenders to reach SMEs in every part of the country and every sector of the economy in ways that best meet their growth needs.
- **Levelling up** across the country, through the UK's leading FinTech clusters.
- **Net zero growth**, including SME transition.

1.1 SME Growth: unshackle alternative lenders to power our small firms

Our data analysis shows:

- Alternative lenders and challenger banks led an increase in lending to small and medium sized enterprises (SMEs) from 2014 to 2019 (from £69bn to £83bn), increasing their contribution to the total SME lending from 51% in 2014 to 65% in 2019

- This was reversed in 2020 in the face of the Covid pandemic. During 2020, we estimate the large banks grew their market share from 35% in 2019 to 56% in 2020, largely off the back of government guarantees such as Bounce Back Loans, together with access to very low-cost term funding from the Bank of England (TFSME).

- Despite initial obstacles and delays to obtaining accreditation for the Coronavirus Business Interruption Loan Scheme (CBILS), we estimate alternative lenders and smaller banks provided around 30% of all CBILS Loans to businesses in 2020. Peer-to-peer (P2P) and other FinTech lenders punched above their weight with over 20% of all CBILS loans from when they joined the scheme, considerably above their overall SME market share.

Government and regulatory policies, including the British Business Bank and Open Banking, helped support the growth in new finance for the UK's small firms from 2014-19. By the start of the pandemic, alternative lenders and challenger banks were providing around 65% of SME debt finance in the UK. Innovative new lenders grew the total finance available to Britain's small firms and replaced the large banks as the dominant players in the SME lending market as the large banks reprioritised their capital allocation away from SMEs for a Basel III world .

SME lending in 2020 was largely driven by the Government's lending guarantees: bounce back loans and CBILS. Most alternative lenders were unable to provide bounce back loans as the Government scheme required interest to be pegged at 2.5% - a rate lower than the rate at which they were able to obtain wholesale capital to lend on to SMEs. In contrast, the banks were able to obtain very low-cost term funding via the Bank of England TFSME scheme, at a rate significantly below 2.5% (TFSME - the Term Funding Scheme with additional incentives for SMEs – offered banks 4 year funding at or very near to Bank Rate).

Initially alternative lenders were not eligible for the CBILs scheme. Advocacy by Innovate Finance and others helped make the case for their inclusion and, despite a delayed start, we estimate that alternative lenders delivered around 30% of CBILs during 2020 – demonstrating their ability to provide finance to Britain's small firms.

Since April 2021, CBILS has been replaced by the Recovery Loan Scheme (RLS). Again, the alternative lenders have suffered delays in being authorised as lenders – with the large banks securing approval at the outset. Some alternative lenders are still in the application queue.

Innovate Finance understands that during the pandemic it was essential to prioritise the routes to market used by the British Business Bank and Bank of England to pump finance into the economy. Alternative lenders nonetheless demonstrated their ability to do this, rapidly and at volume.

Alternative lenders and challenger banks are committed to turbo charging growth through our small firms. We need a level playing field to enable them to do so. Innovate Finance is calling for measures in three areas:

1. **Reduce capital requirements** for small and medium sized UK banks. Bank capital rules are disadvantageous to smaller, challenger banks, which feeds directly through to lower volumes of SME lending. EY estimates this will reduce SME lending by £42bn over 5 years (20% of lending)[1]. The Bank of England should raise the threshold for MREL and clarify some of the transition arrangements. MREL is a scheme designed to prevent the 'too big to fail' approach but applied to many banks that are not big and where any corporate failures would be absorbed by the wider market. The PRA should also make it easier for the Challenger banks to use IRB (the internal ratings-based approach to capital requirements for credit risk- large banks are allowed to use a 'modelling approach' which enables more efficient capital provisions) for their SME loan risk weightings, and where IRB isn't permitted/used, the PRA should reduce standard risk weightings for SME loans to reflect the underlying risk of the asset class. At present these increase capital requirements which challenger banks could otherwise put to productive use by lending to small firms.

2. **Provide term loans for alternative lenders and challenger banks**: the big banks have access to cheaper wholesale capital that the alternative lenders are denied. This reduces SME lending volumes, increases prices for SME borrowers and reduces competition. The Bank of England or British Business Bank should introduce a new facility to end this disparity.
   We estimate this policy initiative could increase employment by SMEs by c.25,000 and could add c.1.5% to SME lending. This will also make a significant contribution to the Levelling Up agenda by increasing lending outside London.

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[1] EY report: *MREL financial implications for mid-size and challenger banks*

3. **Recovery Loan Scheme extension:** The Recovery Loans Scheme is currently due to end on 31 December 2021. Alternative lenders and their customers must be given fair and equal access to this and any future guarantee scheme. In the immediate short-term we request that the scheme be extended on its existing terms until 31 March 2022 so that Alternative Lenders who were accredited late to the scheme have a reasonable opportunity to participate in the initial scheme. In the longer term, we believe the RLS should be used to provide continuing but reducing guarantees to provide a gentle landing post-Covid and subsequently to stimulate lending in the market after 2022 as an ongoing tool as required. RLS should be amended and extended as required by economic conditions over time without the need to create a new scheme, and so Lenders accredited for RLS should automatically be accredited for successive extensions of RLS.

Taken together these proposals could increase SME lending by at least 10%.
In addition we would also welcome implementation of the Bank of England's proposals for an open data platform to boost access to finance for SMEs[2] and reform of the SME bank referral scheme to make it more effective.

We have worked with a group of our members supporting SME finance across the FinTech ecosystem, including challenger banks, platforms, asset finance and P2P lending. We have developed detailed proposals with this group of FinTechs. These detailed proposals on SME lending are set out in the Annex to this paper.

Alternative lending and challenger banks have been a great British success story, providing more finance to British businesses over the last decade. Now is the time to unleash their potential and give them a fair chance to continue to power SME growth and create jobs. Alternative Lenders significantly outperformed on the delivery of CBILS and this demonstrates that Alternative Lenders will deliver loans to SMEs rapidly and in size and can do even more if they have equal opportunities.

1.2 Levelling up across the country, through the UK's leading FinTech clusters

The *Kalifa Review* identified nine FinTech clusters across the UK: Newcastle & Durham, Birmingham, the Pennines, Northern Ireland, Scotland, Bristol & Bath, Reading, Cambridge and. Wales. These include cluster specialisms, such as cyber security and RegTech in Northern Ireland, insurtech in Bristol, quote aggregators in Cardiff, payments in the Pennines and Scotland, and wealthtech in Newcastle and Durham. Cluster leadership has developed and Innovate Finance has supported this through the FinTech National Network. The *Kalifa Review* made three recommendations on nurturing the high growth potential of these FinTech clusters, to optimise their particular areas of excellence:

- Each cluster to produce a three-year strategy to support their continued growth, foster specialist capabilities, and enhance national connectivity
- Connectivity across these clusters, through CFIT, a new Centre for Financial Innovation and Technology

[2] Bank of England: *Open data for SME finance*

- Accelerate the development and growth of FinTech cluster excellence to take advantage of domestic opportunities and increasing research and development investment.

As well as establishing a new industry-led CFIT, we would welcome a commitment in the Comprehensive Spending Review and Budget that any initiatives and programmes for local and regional growth and investment, as well as national innovation and R&D funding, will be open and welcome to bids from FinTech clusters.

1.3 Accelerating the transition to a Net Zero economy:

The transition to a Net Zero economy will be powered by financial services, deploying capital to enable and accelerate change, and by technology, to provide the innovation and solutions needed to achieve the adoption of change at unprecedented scale and speed across economies and society. FinTech sits at the apex of the two Net Zero enablers, and therefore has a critical role to play in building climate risk resilience and enabling Net Zero transition. This also creates a huge opportunity in global markets for UK FinTech.

The UK is a leading centre for Green FinTech, with world-beating solutions on transparency, analysing data to provide reporting and verification of claims, including through supply chains. UK FinTechs are now developing solutions to the next phase of green finance: re-tooling and rebuilding financial markets for a Net Zero economy, using digital solutions.

This brings together two key components of the UK Government's strategy for financial services; the UK as a global centre for green finance and for technology and innovation in finance.
We welcome the Government's support for green FinTech, such as the recent trade mission to the New York climate week. We would encourage a focus on the role of FinTech in Net Zero including:

- **Recognise and champion Net Zero FinTech and promote partnerships** with Financial Institutions
- **Open up data** - including supply chain data - to enable more digital solutions
- **Accelerate standardisation of reporting** (as recommended in the Kalifa Review) and sectoral net zero pathway models, and ensure international interoperability
- Ensure **regulatory approaches embed and encourage technology solutions**, including RegTech; and building on the current FCA digital sandbox
- Support R&D and adoption of **net zero technology solutions for high performance computing**
- Work with alternative lenders to support **innovative solutions to finance SME net zero transition**, where a number of Innovate finance members are keen to support the development of an SME net zero standard that would unlock capital for SME transition

The UK's FinTech strength can accelerate solutions to the challenges of Net Zero transition and seize the rapidly growing international market opportunities.

2. Regulatory reform to enable innovation

The UK's supportive regulatory environment for FinTech is a major competitive advantage in the global race to be the most advanced hub for financial innovation. Over the past few years, the UK has led the way, supported by HM Treasury and the FCA. However, countries in Europe, north America and south east Asia are catching up quickly, unrolling regulatory innovation which is chipping away at the UK's position as the global leader.

New technological developments and innovations in financial services offer a considerable opportunity for the UK market. In order to be realised, they require concerted regulatory support and enablers. The biggest priority areas for FinTech are (in no particular order):

Open Banking / Open Finance (and the Smart Data economy more generally)
Open Banking and Open Finance could provide numerous financial benefits to UK consumers, especially cheaper and more accessible financial advice and access to more tailored products and services. Open Banking could also act as a catalyst for payments innovation. To date, the UK has made considerable progress in this area. Use of open banking applications is snowballing: recent research by Zopa showed that in January 2020, there were one million monthly active users; by September 2020, this had reached two million and hit three million at the beginning of 2021. Open Banking provider TrueLayer expects that based on current growth rates, 60% of the UK population will have tried Open Banking services by September 2023[3]. However, there is a real danger of fast followers in the EU, US and Singapore taking our position as the global leader.

It is crucial the UK stays ahead of the curve, maintains its international leadership and competitive advantage, and continues developing in this field – including in areas such as insurance, pensions and asset management. To date, favourable regulation has been a key part in open banking innovation in the UK, and going further and faster on open data would cement the UK's leadership in innovation. Rather than a gradualist approach of extending open finance one sector at a time, we believe that a more radical approach is now needed to maintain forward momentum and maximise societal and economic benefits. To truly unleash the potential of consumer powered data sharing, the UK needs a Smart Data Right: equipping consumers with the right to consent to share their data between firms in real time, opening up innovation across financial services and other parts of the economy, and putting citizens in control.

Digital ID
Digital ID will play a critical role in underpinning the next wave of financial innovation in the UK. It will be an important tool to meet societal needs, create value for citizens, and raise the productivity and growth of our economy. The UK has a golden opportunity to set the global standard for digital ID and make it a valuable export.

[3] https://www.datocms-assets.com/23873/1631532521-open-banking-to-open-finance-report.pdf

Central bank digital currency (CBDC)
As highlighted in the *Kalifa Review of UK FinTech*, the introduction of a CBDC (wholesale and / or retail) would be a significant development which could help support the adoption of new technologies (e.g. blockchain) in financial services and deliver huge efficiencies in the payments system. Innovate Finance supports the work of the Bank of England in exploring the potential of CBDC and other forms of digital money, such as stablecoins. However, urgency is required if the UK is to develop a globally-leading position in this area.

Cryptoassets
Innovate Finance appreciates that the growth of cryptoassets, especially cryptocurrencies, presents multiple complex challenges for the government and regulators. At present the UK has no clear strategy for regulating cryptoassets, which is simultaneously creating uncertainty for crypto businesses, and giving other jurisdictions the opportunity to act as leaders in this area. Publication of next steps following the HM Treasury January 2021 consultation on regulation of cryptoassets[4] would be most welcome.

Buy now, pay later (BNPL)
The growth of BNPL providers, such as Klarna and Clearpay, over the last 18 months has been remarkable. These providers deliver considerable value to retailers and consumers. BNPL providers recognise the need for proportionate regulation, for the good of consumers, retailers and the providers themselves. With new entrants, adoption by established credit providers, and new services joining the market on a weekly basis, these innovations in unsecured credit are growing exponentially. BNPL providers (and their retail customers) need certainty on what their future position within the regulatory perimeter will look like, so Innovate Finance strongly supports the speedy launch of HM Treasury's consultation process on this area.

A roadmap and resources for forward-looking regulation
Taken as a whole, these areas represent the next wave of financial innovation. The UK must provide regulatory certainty in these areas to give innovators a clear framework for developing their business models. If the UK does not lead the charge, other jurisdictions across the world will take the opportunity to do so. This will harm the UK's reputation as a FinTech leader, ultimately undermining financial services innovation here, and in turn, SMEs and consumers. In these areas, regulation is needed to either open up new market opportunities or to provide the consumer trust needed to support widespread sustainable adoption. The regulatory approach must be proportionate and technology neutral, to support continued innovation and competitiveness.

Innovate Finance would encourage HM Treasury to:
1. **Publish a clear roadmap with a timetable for the above areas**
2. **Provide the necessary resources to deliver on this plan of action**.

[4] *UK regulatory approach to cryptoassets and stablecoins: Consultation and call for evidence:* https://www.gov.uk/government/consultations/uk-regulatory-approach-to-cryptoassets-and-stablecoins-consultation-and-call-for-evidence

This would act as a strong, pro-innovation message. More certainty will be very warmly welcomed across the industry.

Innovate Finance would welcome:

- Resources for the FCA to push forward with the development of Open Finance, following its Call for Evidence in 2019-2020.

- Resources for the rollout of digital ID, particularly for:
  - The establishment of a funded long-term statutory oversight body with legal powers to oversee the trust framework, monitor adherence to standards and rules and provide enforcement as required. The establishment of this body is critical to oversee market certification and give digital identity legitimacy in the eyes of other sector regulators and market participants who see the government role of establishing trust as critical to the success of digital ID for consumers and businesses.
  - The development of the market through sandbox style testing of the different components (e.g. certification, the broader trust framework, attribute checking), both domestically and with international partners. This will be essential to understand the correct commercial model and to build trust between providers and consumers of identity, as well as with sector regulators.
  - Implementation of a communications campaign to help citizens understand digital identity and reassure them about the safety of the approach. This will be particularly important to ensure that we are able to develop an inclusive approach, which will ultimately support broader financial inclusion.

- Greater resource for the Bank of England to push ahead and prioritise its consultation process for digital money, including CBDC.

- Greater resource for the FCA to prioritise is regulatory approach to cryptoassets

- Short term assistance for the registration of crypto businesses under the AML / CTF regime will be an added benefit.

- Resources to “escalate” the regulatory approach to BNPL, and treatment of this as an area that needs immediate attention by HMT then FCA.

We would like to identify three other areas where regulatory agility and certainty, to support innovation, could be advanced in the Budget:

- announcing as part of the Future Regulatory Regime for Financial Services that the **regulators will all have a statutory competitiveness objective** and be bound to promote innovation and apply proportionality. This should include the Information Commissioner’s Office and the CMA.

- publication of feedback to the **Payments Landscape Review**, and an understanding of what next steps the Government plans to take in light of the Review process.
- resources for the development and implementation of the **FCA's Scalebox**.

The autumn Budget provides an opportunity to set out the future regulatory regime for the UK, underlining to UK start-ups and scale ups and to the rest of the world that the UK is developing the most innovative regulatory regime, maintaining our role as the centre for financial innovation.

3. Strategic cohesion of government departments and regulators

The Government paper ‘A New chapter for Financial Services’ on 1 July provides a clear strategic direction, endorsed by the Bank of England and FCA and supported by the UK FinTech ecosystem. We believe that in the same way that this provides a high-level guiding star for UK financial services, there is an opportunity for further coordination and strategic cohesion between Government departments and the regulators in supporting a vision of UK FinTech.

Innovate Finance and its members believe that we need to see greater coordination. This could be in the form of a task force as recommended by the *Kalifa Review* - but we are open to any form of cross-governmental coordination with the primary mission to achieve a more cohesive approach. We believe the aim should be to strengthen cohesive delivery of strategic aims; it is for the Government to decide how best to achieve this.

For this submission, Innovate Finance mapped the areas of regulatory and policy work that has significant impact on the activities, competitiveness and future growth potential of UK FinTech currently being undertaken by HM Government. 13 different government departments (including regulators) are involved in areas that affect the FinTech sector. Therefore, it should not be a surprise that trying to navigate this is often bewildering for FinTech companies, especially new and smaller startups

When we map these 13 government organisations against the five strategic areas identified in the *Kalifa Review*, we see a very complex picture (fig 1, below).

If we look at two specific and related areas of policy and regulatory development – Open Finance and digital ID (identified above as a priority for UK competitiveness) – we also see that there are many players involved. It is not always apparent which organisation sets the overall strategy and how the actions of these different organisations are coordinated (fig 2, below).

Our members regularly highlight the need for more cohesion across government – to ensure all regulators and departments are pointing in the same direction.

The *Kalifa Review* noted that “Multiple departments and regulators have important FinTech competencies and functions” and recommended a strengthening of strategic coordination to ensure “delivery of the Government’s stated objectives for FinTech through executing an impactful and coherent FinTech strategy and ensuring a joined-up policy approach on cross cutting issues related to digitalisation and digital finance”.

The UK Government has faced a similar challenge with the life sciences industry and has developed a formidable joined up strategy and ways of working that have significantly increased UK competitiveness as well as the agility, capability and capacity that we have seen come to the fore in meeting the health challenges of the pandemic. One of the most impressive aspects of the UK *Life Sciences Vision*[5] is the section dedicated to delivery and discusses the factors that will be key in execution. FinTech companies are adamant that above all they want to see delivery, with the commitment of the kind made in the *Life Sciences Vision*.

Adopting something like the approach taken with life sciences could deliver enormous benefits. In particular it would ensure that investment and resources in FinTech initiatives are maximized and deliver more than the sum of their parts.

[5] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1013597/life-sciences-vision-2021.pdf

Fig 1:

Organisations delivering on priority areas for UK FinTech growth

Fig 2:

Open Finance and Digital ID: organisations, objectives and activities

Organisation:	Enabling innovation	Protecting consumers	Financial inclusion	Investment & skills	Competition	FinTech competitiveness
HMT		Anti-money laundering and financial crime inititatives	Financial inclusion action plan			Key driver in HMT activity Core theme from Kalifa Review
DCMS	Digital ID Trust Framework	Digital ID Trust Framework	Digital ID Trust Framework Inclusive Economy Partnership			
BEIS	Smart Data working group Net Zero data		Smart Data working group			
DfE				FinTech skills requirements		
ICO		May have a specific role, beyond GDPR				
CMA (& OBIE)	Governance of Open Banking	Governance of Open Banking			Core CMA objective	
FCA	Open Finance roadmap Sandbox and Scalebox	Core FCA objective			Core FCA objective	
PSR	Core PSR objective	Core PSR objective				
Bank of England	Open data for SME finance				Open data for SME finance	
Innovate UK				Grant programmes		

Another potential approach to consider could be similar to that taken by the Office for AI. The Office is a joint DCMS-BEIS collaboration and has established a national strategy for AI. This strategy has three clear and succinct overarching aims. Under each aim it has clear action points and a roadmap of activity, divided into short, medium and long-term initiatives.

To reiterate a point made above, FinTech companies want to see a unifying strategy combined with delivery. The clarity the Office for AI has given for the artificial intelligence sector would be very welcome if it could be similarly formed for the FinTech sector.

A strengthening of strategic oversight, to steer FinTech policies in a single direction that maintains the UK's global Fintech position – would be immensely valuable.

Please note the policy submissions in this document have been prepared in consultation with selected Innovate Finance members and reflect the view of Innovate Finance across the UK FinTech ecosystem. Accordingly the policy submissions do not necessarily reflect the views of all Innovate Finance members and views may differ between Innovate Finance members on specific policy issues.

Annex: Innovate Finance – SME Lending proposals

This paper sets out more detail of proposals on SME lending.

Please note the policy submissions in this document have been prepared in consultation with selected Innovate Finance members. Accordingly the policy submissions do not necessarily reflect the views of all Innovate Finance members and views may differ between Innovate Finance members on specific policy issues.

Recommendation	The policy issue	Specific proposal
Reduce capital requirements for small and medium sized UK banks	Bank capital rules are disadvantaging smaller, challenger banks, which feeds directly through to lower volumes of SME lending. EY estimates this will reduce SME lending by £42bn over 5 years. The Bank of England should raise the threshold for MREL and clarify some of the transition arrangements. The PRA should make it easier for the Challenger banks to use IRB for their SME loan risk weightings. Where IRB isn't permitted/used, the PRA should reduce standard risk weightings for SME loans to reflect the underlying risk of the asset class.	**MREL** Innovate Finance members have submitted a response to the Bank of England Consultation paper dated July 2021 as part of a wider group of mid-tier and specialist banks. This group has previously highlighted their concerns that the MREL regime disproportionately impacts mid-tier and specialist banks, disincentivises growth and impairs their ability to compete with the larger banks. We also note that EY has prepared an estimate[6] of the expected reduction in gross lending to SMEs arising from the introduction of the MREL capital requirements as envisaged. They assess that: - Gross lending will be reduced by £42bn over 5 years versus the expected growth of this group of lenders. - Their funding costs will increase by c.11bp which if passed on to the end borrower will increase customer interest costs by c.£175m p.a. The group of mid-tier and specialist banks have made some specific proposals to the Bank of England, which Innovate Finance supports, including: - Notice period: clarity on when MREL will apply for firms already above, or forecast to exceed, £15bn and for firms caught by the Transaction accounts threshold - Glide path: greater flexibility to avoid potential cliff edge for issuance in year 2 of transition and to avoid potential negative market interpretations of the Flexible 2-year extension

[6] *Ernst Young: MREL: Financial implications for mid-size and Challenger banks August 2021*

		- Indicative thresholds £15-25bn: £50bn is an appropriate threshold, together with a review of FSCS in due course It is worth noting that the European Banking Authority (EBA)and US equivalent thresholds for banks to fall within scope of the higher capital requirements are €100bn and $250bn respectively. It is important that the smaller banks in the UK, which are delivering an increasing proportion of total SME lending, are not disadvantaged compared to international markets as the UK moves into a position of greater autonomy over capital regulation. **Loan asset risk weightings** Mid-size and Challenger banks are at a considerable disadvantage to large banks because for the most part they have not been approved by the PRA to use IRB (internal ratings-based approach, where banks use their own modelling to calculate credit risk)for the risk weighting assessments. This means they must use Standardised risk weightings for their loan assets which are typically higher than IRB-assessed risk weightings. This means they must hold more capital against an SME loan compared to a large bank, resulting in reduced lending to SMEs. We therefore support the proposal that mid-size and Challenger banks should be permitted to adopt IRB earlier than is currently permitted by the PRA where they have data to support their internal model A mitigant to remaining on Standardised risk weightings instead of IRB would be a reduction in Standardised Risk Weightings for SME loan assets. This was envisaged in part by the SME Supporting Factor in Basel III. However, we understand the PRA was not wholly supportive of the SME Supporting Factor and in any event it is designed mostly for financial crisis situations. We support the proposal that SME risk weightings should be reduced, which would mean if IRB is not available, mid-size and Challenger banks can still compete on a level playing field with larger banks and meet demand from SMEs

Recommendation	The policy issue	Specific proposal
Provide term loans for alternative lenders	The big banks have access to more and cheaper wholesale capital that the alternative lenders are denied. This reduces SME lending volumes, increases prices for SME borrowers and reduces competition The Bank of England or British Business Bank should introduce a new facility to end this disparity	The policy objective is to provide access to funding for Alternative Lenders to (1) increase SME lending over the next several years and (2) address the significant reversal of market share towards the large banks in 2020 caused by the structure of the Covid guarantee schemes and the access to TFSME for the large banks. These Covid emergency funding schemes while necessary to maintain access to finance for SMEs in the crisis were skewed heavily in favour of the large banks resulting in a significant dislocation of competition in the SME financing market. The policy proposal is the provision of term loan facilities to Alternative Lenders by the British Business Bank (BBB) totalling £2bn, a scheme which would sit alongside the existing ENABLE Funding programme. This will (1) increase the £volume of lending to SMEs and (2) increase competition and choice in the SME lending market. These in turn will increase the reach of £volume lending to regional borrowers and borrowers from diverse backgrounds. We note for comparison that the Bank of England provided funding for banks' SME loans under TFSME at 0-25bp cost and that £95bn has been drawn under the scheme[7], which is almost equivalent to the total gross lending to SMEs by banks in 2020. We also note that in Q2 2021 net lending to SMEs by banks participating in TFSME was £(1.4)bn **Policy impact** Research[8] indicates that the UK has long had a sizeable and structural SME lending gap, recently estimated at 7-15% of total annual lending. Many other countries have SME lending funding gaps, and direct lending schemes and guarantee schemes (see separate recommendation below) are well documented policy solutions. We estimate this proposal for term loans could increase employment by SMEs by c.35,000[9] and could add c.3% to SME lending [10]. This will also make a significant contribution to the Levelling Up agenda:

7 *https://www.bankofengland.co.uk/markets/bank-of-england-market-operations-guide/results-and-usage-data*

8 *Research by Frontier Economics on behalf of Funding Circle, September 2021*

9 *Innovate Finance estimate*

10 *Based on Innovate Finance estimates of the total market size in 2019, pre Covid*

Regional lending – unlike the large banks, many Alternative Lenders market and service their loans online and therefore their geographic reach is unconstrained by branch footprint. Others are regional-based lenders who have local presence. For example, activity outside of London by some Alternative Lenders:

- Funding Circle: 85% of loans outstanding are to SMEs outside London [11]
- Iwoca : has lent £80 to SMEs in Yorkshire since 2012 and in March 2021 set up a new forum for female business owners in Yorkshire providing workshop sessions from industry leaders and partners[12]
- Assetz Capital: has funded the construction of over 5,000 new homes, including over 1,000 in the Midlands, and in 2019 funded the building of 1 in every 100 new homes built in the UK[13]

Therefore, *ceteris paribus,* any increase in £volume of lending funded by the BBB will flow through to greater regional lending via the existing operations of Alternative Lenders. Additional actions that could disproportionately increase regional lending (possibly as a condition of term loans) include

- Greater online marketing spend targeted at specific regions
- Combining the additional funding with RLS guarantees to cover marginal loan applications from borrowers in specified regions who wouldn't ordinarily meet the lender's credit criteria

This approach could also be used to target finance for SMEs' transition to NetZero.

Inclusive lending – an increase in £lending volumes may not in and of itself reach borrowers from diverse backgrounds. Additional actions that could disproportionately increase lending to these groups (possibly as a condition of term loans)) include

- Greater online marketing spend targeted at specific types of borrower
- Initiatives such as the Yorkshire female business forum mentioned above

[11] *Source: Funding Circle website 15.9.21 https://www.fundingcircle.com/uk/statistics/*
[12] *https://www.iwoca.co.uk/news/yorkshire-female-businesses/*
[13] *https://www.assetzcapital.co.uk/blog/1-billion-of-lending*

- Combining the additional funding with RLS guarantees to cover marginal loan applications from borrowers in these groups who wouldn't ordinarily meet the lender's credit criteria

Impact of digital money
This may also help prepare the market for the impact of digital money: The Bank of England discussion paper on *New forms of digital money*[14] explores the potential effect of digital money on bank lending rates and credit provision, in particular the impact of deposits migrating to new forms of digital money. It notes that the cost of lending for SMEs will increase and provision of lending to SMEs could reduce. A Term Lending Fund may provide one market adjustment mechanism.

Can Alternative Lenders deliver extra funding to SMEs?
Alternative Lenders were accredited to CBILS later than the banks. However once accredited they delivered the scheme loans very effectively. For example, Funding Circle has a market share of SME lending (in its defined target market) of c.4%[15] whereas it placed c.11.3% of all CBILS loans. Therefore, given the means, the Alternative Lenders can deliver extra funding to SMEs

What is the proposed facility?
The proposed facility is an extension of the existing ENABLE Funding programme (whose acceptance criteria are too narrow for many Alternative Lenders) but with no exit into the Asset Based Security (ABS) market. Instead of a market take-out, the BBB would retain the loan facility. We are proposing total funds available under the scheme of £2bn, with specific features:

- individual lender facilities in the range £10-200m
- structured as senior facilities with appropriate junior funding sourced by the Lender
- priced at an appropriate risk margin over the cost of funds to BBB
- use of proceeds by the Lender consistent with RLS terms

[14] *https://www.bankofengland.co.uk/paper/2021/new-forms-of-digital-money*
[15] *Funding Circle investor presentation 9.09.21*

		How would this programme be funded? There are number of options: 1. The Bank of England provides funding to BBB 2. HMT provides funding to BBB 3. The large banks provide funding to BBB on commercial terms **Summary** **A £2bn term loan facility provided by BBB to Alternative Lenders would increase SME lending by c.3% and at the same time start to address the regional levelling up and inclusion objectives for SME financing. We estimate c.35,000 jobs could be created by SMEs as a result of this initiative.**

Recommendation	The policy issue	Specific proposal
Recovery Loan Scheme extension	In the longer term, RLS should be used to provide continuing but reducing guarantees to provide a gentle landing post covid; and subsequently to stimulate lending in the market after 2022 as an ongoing tool, as required. It should also be capable of being easily moved back up the risk curve in the event of future economic turbulence without the need to design	The RLS scheme was welcomed by Innovate Finance members as a path back to Business as Usual lending, to help the SME lending market return to normal. However, delays in accreditation have meant once again Alternative Lenders have been disadvantaged versus the large banks, who were the early participants. **Additionality** Research[16] indicates that countries such as Germany and the US have historically used guarantee schemes to address SME lending gaps but on a larger scale than the UK schemes to date (mainly EFG). EFG is regarded as cost effective however since 2014 lending £volume has declined and it has had limited impact on overall lending. For example, the US SBA's flagship 7(a) scheme, which was designed to create additionality in the SME lending market, is c.10x larger than EFG. The research estimates that an outside-of-crisis guarantee scheme (RLS re-named and reconfigured) would expand overall SME lending by 5% p.a. and create/save c.58,000 jobs, with £3.7bn net economic impact.

[16] *Research by Frontier Economics on behalf of Funding Circle, September 2021*

	a new scheme or a requirement re-accredit existing approved lenders	**Proposals** ***Initial extension*** In the immediate short-term we request that the scheme be extended on its existing terms until 31 March 2022 so that Alternative Lenders who were accredited late to the scheme have a reasonable opportunity to participate in the initial scheme. This is because there is considerable time and expense incurred in setting up and launching a new product, and for Alternative Lenders this includes negotiating new dedicated financing facilities. It is very important however, that whenever the scheme terms are changed going forward there is sufficient notice given before the end date of the current terms because Alternative Lenders will need to discuss the changes with their own funders and novate existing funding agreements to take account of the new terms. A minimum of 3 months' notice should be given for any change in terms. **Glide path post Covid** We believe the terms should be amended post March 2022 to help lending return to normal market terms, and reflect experience data for the SME lending market in the immediate aftermath of the Covid crisis. Specific terms that we believe should be reviewed are: - The 80% guarantee level to be reduced over time based on experience data - Personal guarantees for loans below £250k to be permitted i.e. normal market terms - A 6 month window to complete applications received by the new extension final date but not approved by that date - The borrower turnover cap and the 2019 borrower reference year to be lifted - Scheme fees set at a level which don't render the economics unworkable for Lenders, and possibly used to incentivise specific objectives e.g. regional levelling up. With the benefit of more time to design scheme terms the fee structure could be more tailored (in the same way that currently CDFIs have a lower fee)

		Longer term The RLS should be the core guarantee scheme going forward, replacing EFG. We believe the scheme should remain in place over the longer term to provide intervention stimulus in areas of need and a ready-made guarantee scheme for the next economic recession. ***Intervention stimulus*** RLS should be used in the coming years to stimulate lending to further the Levelling Up agenda. For example - lenders could be asked to increase regional lending by providing loans to applicants in specific areas that would otherwise not meet the Lender's required credit score - lending for businesses that commit to building energy efficient/eco housing, science-based net zero path or investment for transition This approach could also be used to target finance for SMEs' transition to NetZero. ***Ready-made guarantee scheme*** The UK will be able to respond to any future global economic turbulence with greater agility if the RLS is retained and active in the intervening years. This means keeping it active and relevant to ongoing SME lending in the medium term and ensuring that as large a universe as possible of Lenders remain accredited for the scheme so that no re-accreditation process is required.

Recommendation	The policy issue	Specific proposal
Reform the Bank Referral Scheme to make it effective	The scheme is welcomed by Alternative Lenders in principle but, as currently configured, it hasn't delivered.	The Bank Referral Scheme is laudable in its objectives and intentions but ultimately has failed to make meaningful impact on SME lending. The scheme has delivered a paltry £56m of loans to date or c.0.02% of SME lending[17]. The scheme started in 2016 and to date the total number of referrals is c.46,000 resulting in c. 2,600 loans. The absolute number of referrals is significantly below the estimated of volume of unmet demand, and the conversion rate is unsustainably low reflecting a combination of the poor customer journey and that

[17] *Based on BRS official statistics December 2020 and Innovate Finance estimates for the total market size*

		only the lowest credit quality applicants are re-directed. Based on the conversion rate, the implied referral volume of loans since the scheme started is c.£1bn whereas the large banks wrote c.£158bn of SME loans from 2017-2020, suggesting that there is a large volume of rejected applicants that don't reach the scheme. Issues noted by scheme participants (Lenders and referring platforms) include: - Inconsistent and incomplete data provided by the banks on referred applicants - A lack of awareness among SMEs that the scheme is available. When asked, only 11% of SME owners said that they had been made aware of the scheme when they were denied finance[18] - Many applicants don't complete the customer journey - A lack of incentivisation (or penalty) for the banks for failure to refer applicants Innovate Finance members believe that a Task Force should be established comprising inter alia the BBB, the large banks, the three accredited referral platforms, a number of Alternative Lenders and the [CBI] to reform the structure of the BRS. This Task Force could for example be part of the SME Finance coalition recommended by the Kalifa Review. Specific terms of reference for the Task Force would include: 1. Publication of quarterly data of successful loans made under the scheme categorised by referring bank 2. Redesign the referral rules to identify more potential applicants, for example an applicant who doesn't complete a full application but is still interested in borrowing 3. Financial incentivisation of banks to be paid for referrals that convert into loans

[18] *Source: According to the SME Finance Monitor, just 13% of SMEs who were turned down for finance by their main bank between Q1 2018 and Q4 2019 said that they were offered the opportunity to have their applications referred (p198). Only 11% of all SMEs are aware of the referral process (p304).*

Recommendation	The policy issue	Specific proposal
Open banking, credit decisioning and new products	Open Banking has stimulated new products and enabled better credit decisioning. The development of open finance, including extension to other areas of business finance will expand the opportunities for innovation and competition and – linked to wider smart data – green finance.	Fintech is creating the means to drive data sharing between the large banks and other organisations such as Alternative Lenders, credit brokers and rating agencies. This will allow SMEs much wider and faster access to financial products with greater pricing transparency and choice. Examples include the proposal for permissioned data sharing standards to deliver an Open Data Platform and a "portable credit file" that makes it easier for SMEs to apply for credit. Drawing on Ron Kalifa's review of FinTech, there is an opportunity to develop an innovation coalition to look at new data-driven products for SME finance, perhaps bringing together the British Business Bank and FCA sandbox with providers to test and develop new products. In addition we would also welcome implementation of the **Bank of England's proposals for an open data platform to boost access to finance for SMEs**[19].
Regulation of High Return Investments	We need to ensure that regulatory development does not hamper the alternative finance sector. There is a need to ensure FCA reforms to 'high-risk' investment markets do not stifle lending and equity platforms: the current consultation (DP 21/1) could impose burdensome requirements for platforms to verify investor status which would make the platforms unviable.	Innovate Finance submitted a response to the FCA in respect of DP 21/1 in July. The key points in the response are: - P2P investments have very different investment characteristics to the other investments on the FCA's High Return Investment list and a common set of financial promotion rules isn't necessarily appropriate - Unlike many other investments on the High Return Investment list, P2P platforms are required to maintain a Risk Management Framework which, if adequately implemented, should ensure that appropriate investment assets are made available to P2P investors - A key area minimising potential investor harm in P2P is to educate investors about the benefits of diversification - If the financial promotion rules are tightened so as to restrict further the universe of investors who can access to P2P investments then it may make the economics of P2P platforms no longer viable.

[19] https://www.bankofengland.co.uk/paper/2020/open-data-for-sme-finance

About Innovate Finance

Innovate Finance is the independent industry body that represents and advances the global FinTech community in the UK. Our mission is to accelerate the UK's leading role in the financial services sector by directly supporting the next generation of technology-led innovators.

Innovate Finance's membership ranges from seed-stage startups and global financial institutions to investors, professional services firms, and global FinTech hubs. All benefit from Innovate Finance's unique position as the single point of access to promote enabling policy and regulation, talent and skills, business opportunity and growth, and investment capital.

By bringing together and connecting the most forward-thinking participants in financial services, Innovate Finance is helping create a global financial services sector that is more transparent, more sustainable and more inclusive.