



House of Commons  
Treasury Committee

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**Government and  
Financial Conduct  
Authority Responses  
to the Committee's  
Twenty-Fourth Report:  
SME Finance**

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**Ninth Special Report of Session  
2017–19**

*Ordered by the House of Commons  
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## The Treasury Committee

The Treasury Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of HM Treasury, HM Revenue and Customs and associated public bodies

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### Committee staff

The current staff of the Committee are Sarah Rees (Clerk), Peter Stam (Second Clerk), Marcus Wilton, Dan Lee, Aruni Muthumala (Senior Economists), Adam Wales (Chief Policy Adviser), Nicholas Berry (Committee Support Assistant), Matt Panteli (Senior Media and Policy Officer), Anne Stark (on secondment from HM Revenue & Customs), Tom Ludlow (on secondment from the Bank of England), Carolyn Draper (on secondment from the Financial Conduct Authority), Ria Gill-Williams (on secondment from the National Audit Office) and Sarah Goodwin (on secondment from the Prudential Regulation Authority).

### Contacts

All correspondence should be addressed to the Clerk of the Treasury Committee, House of Commons, London SW1A 0AA. The telephone number for general enquiries is 020 7219 5769; the Committee's email address is [treascom@parliament.uk](mailto:treascom@parliament.uk).

# Ninth Special Report

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On 24 October 2018 the Treasury Committee published its Twenty-Fourth Report of Session 2017–19, [SME Finance](#) (HC 805). The Government response was received on 20 December 2018 and the Financial Conduct Authority response was also received on 20 December 2018 and are appended below.

## Appendix 1: Government Response

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### Introduction

The Government welcomes the Treasury Select Committee’s report into SME finance. As the report notes, SMEs make a vital contribution to the UK economy, accounting for 99.9% of all private sector businesses, 60% of all private sector employment and 52% of all private sector turnover.<sup>1</sup> The Government is committed to supporting SMEs, enabling them to grow and create jobs by providing an environment in which they can thrive.

A large part of the Treasury’s focus in recent years has been on encouraging competition in the SME finance market, to help stimulate a strong and diverse market for SMEs which offers high quality products and services at efficient prices. The Government has taken action across a wide range of areas to support this goal:

- British Business Bank (BBB) programmes are supporting more than £5.5bn of finance to over 78,000 smaller businesses.
- identifying market failures and making innovative policy interventions, with the Bank Referral Scheme and the Commercial Credit Data Sharing scheme designed to increase SMEs’ awareness of their finance options and helping alternative lenders to be more competitive by increasing the data available to them.
- bringing P2P lending into regulation. P2P lenders lent more than £2bn to UK businesses in 2017.<sup>2</sup>
- working with the regulators to lower barriers to entry for new banks, creating a regulatory environment where challenger banks can more easily enter, expand and compete with incumbents. Since the Government set up the Prudential Regulation Authority in 2013, it has authorised 17 new UK banks.

These measures are having a direct impact on the SME finance market. For example, while net bank lending to SMEs has been only marginally positive since 2015, alternative sources of finance such as asset finance and peer-to-peer (P2P) lending have been growing significantly over the same period.<sup>3</sup> However, we recognise that further progress can always be made, and acknowledge the Committee’s concerns around subdued demand for finance in particular. The Government will be monitoring the ongoing implementation and operation of a number interventions which will have a significant cumulative impact on both the supply and demand sides of the SME finance market. These include the

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1 [‘Business population estimates 2018’, Department for Business, Energy & Industrial Strategy, October 2018](#)

2 [‘5th UK Alternative Finance Industry Report’, Cambridge Centre for Alternative Finance, November 2018](#)

3 [‘Small Business Finance Markets Report 2018’, British Business Bank, February 2018](#)

increased offer and uptake of products utilising data shared via Open Banking, the RBS Alternative Remedies Package, the BBB's new Finance Hub, ongoing work to better enable pension schemes to invest in patient capital, and the Bank Referral and Commercial Credit Data Sharing schemes.

The Government also acknowledges the fact that while the banking industry has changed significantly in recent years, there is more work to be done for the industry to regain the trust of SMEs. We have been clear that inappropriate treatment of SMEs is wrong and that affected businesses should be compensated. The Government continues to monitor the progress of the complaints and redress schemes that have been established to deal with specific cases, and welcomes the banking industry's commitment to establish a voluntary ombudsman scheme to address unresolved historic complaints from SMEs which have not already been addressed by an independent review process.

Looking to the future, it is vital that appropriate mechanisms are in place to ensure that SMEs are able to resolve disputes with their financial services providers quickly, cheaply and fairly. The Government therefore supports the Financial Conduct Authority's (FCA) plans to expand the number of SMEs who are eligible to take a complaint to the Financial Ombudsman Service (FOS), ensuring that it covers over 99% of businesses, and the banking industry's proposal for a voluntary ombudsman scheme to resolve complaints from businesses with a turnover between £6.5m and £10m. We believe that these proposals, when implemented, will deliver the best outcomes for SMEs.

The Government will continue to monitor the SME finance market closely. The response below goes into further detail on the actions that the Government and other bodies are taking, the benefits of these actions for UK SMEs, and our response to the recommendations made in the report.

## Response to recommendations

### *The SME finance market*

**1. It is naive to expect all business owners to possess a detailed understanding of the various financing options available to them. For many, the demands of running a business will leave little time for building financial expertise and searching the market. This points to a need for concise and easily accessible information targeted at the non-expert seeker of finance. As the centre of expertise on smaller business finance in the UK, the British Business Bank has an important role to play, and its Business Finance Guide and Finance Your Growth initiatives are to be welcomed. These tools must be maintained and promoted effectively to ensure they reach as wide an audience as possible. (Paragraph 10)**

The Government agrees with the Committee that business owners have limited time and need straightforward, relevant information to enable them to secure the right type of finance. The increasing diversity of the UK finance market is a competitive advantage for businesses, but only if business owners know how to access it. Providing high-quality, readily-accessible information is a priority. The Government welcomes the Committee's recognition of the Business Finance Guide and Finance Your Growth initiatives and its encouragement to promote these as widely as possible.

The BBB has six high-level objectives, one of which is “to encourage and enable SMEs to seek the finance best suited to their needs.” In pursuit of this objective, the bank has recently launched a ‘Finance Hub’ to be the online destination of choice for independent, impartial information suitable for all SMEs who want to understand the finance options available to support their growth ambitions. The Finance Hub offers guidance for businesses using interactive content, so that entrepreneurs can use a simple diagnostic tool to identify the options that are right for them and then learn more about those options using videos and case studies. The Finance Hub and diagnostic tool provide information relevant for all SMEs thinking about using finance, and are promoted by the BBB through a range of channels – online, email and events. A new “Demand Development Unit” has been created within the Bank with responsibility for maintaining and promoting these resources.

**2. The Small Business Commissioner is also well placed to assist SMEs in building awareness and understanding of the financing options available to them. The Government should expand the remit of the Commissioner to provide it with a formal role in helping small businesses to access the finance they need, particularly by improving levels of awareness and understanding of financing options.** (Paragraph 11)

The Small Business Commissioner (SBC) was appointed to support the UK’s 5.7 million small businesses in resolving payment disputes, and to drive cultural change in private sector payment practices. He currently does this by providing general information and advice about good payment practices and signposting small businesses to existing support, including access to finance, such as the BBB’s Finance Hub. The SBC also handles complaints about payment issues between small business suppliers (with fewer than 50 staff) and their larger customers. The SBC is therefore well placed to assist SMEs in building awareness and understanding of the financing options available to help them manage late payments.

The Government agrees that we need to tackle the scourge of late payment, and support SMEs in continuing to grow and thrive. The Department for Business, Energy and Industrial Strategy recently conducted a Call for Evidence on this issue, which included questions on how we may be able to strengthen existing measures designed to tackle late payment in private sector contracts, including the role of the SBC in further supporting SMEs.

The Call for Evidence closed on 29 November and received almost 300 responses. The Government will give careful consideration to the views submitted and intends to publish a response next year.

**3. Data on SME attitudes to external finance are concerning. The reluctance amongst many business owners to seek external finance is driven by a variety of factors, though it is clear that a lack of trust in lenders and an often misplaced fear of rejection are key contributors. The Economic Secretary recognised the challenges that stem from an entrenched unwillingness to apply for finance. The Treasury should conduct or commission work to identify why this attitude is commonplace amongst SMEs, and develop a strategy to ensure the UK’s small businesses have the confidence to seek the external finance that is right for them. Efforts should also be made to ensure SMEs are aware of the options available to them if they are turned down for finance; specifically the Lending Appeals Process and the Bank Referral Scheme.** (Paragraph 16)

The Treasury closely monitors the SME finance market, including SMEs' attitudes towards external finance, working with stakeholders across Government and industry and paying close attention to key publications such as Bank of England Bankstats and Credit Conditions Surveys, the BBB's annual 'Small Business Finance Markets' report and BDRC's SME Finance Monitor.

The most recent SME Finance Monitor (up to Q2 2018) reports that SMEs have higher trust in their own bank than the banking industry as a whole, with 56% of SMEs reporting a high level of trust in their main bank compared with 25% reporting a high level of trust in the industry. This demonstrates that the banking industry does indeed have more work to do to regain the trust of businesses, but that individual firms are working hard to do so through their existing customer relationships.

As the Committee notes, SMEs' attitudes towards using external finance are driven by a number of factors which go much wider than trust in their lenders. Very few SMEs (6%) think that access to finance is a major obstacle to their business, compared with those who cite political or economic uncertainty as an obstacle (16% and 15% respectively), and 73% of SMEs would rather grow more slowly than borrow to grow more quickly.<sup>4</sup>

The Government is aware that many SMEs currently prefer to be self-reliant, rather than take on more risk and borrow to grow. That is why the Government is funding Sir Charlie Mayfield's Be the Business organisation and their activities to provide the inspiration, tools and resources to help businesses see their potential and get started on improving their performance. At the same time, SMEs' concerns regarding political and economic uncertainty are currently heightened as the UK negotiates its exit from the European Union. It would therefore be premature for the Government to commission further work on SMEs' attitudes towards finance at this time, especially given the quarterly data already available through the SME Finance Monitor, but the Treasury will continue to keep the matter under review.

The Government remains committed to ensuring that SMEs are increasingly aware of the different finance options available to them, which is why the BBB have built on the success of the Business Finance Guide by launching their Finance Hub to target high growth potential SMEs with information on their finance options. At the same time, the Bank Referral Scheme offers SMEs not only another chance at obtaining finance if they don't meet their bank's risk appetite, but also the opportunity to be matched with a wider range of alternative lenders.

Awareness of both the Bank Referral Scheme and the Lending Appeals Process is higher among SMEs who have applied for finance than the general population, and the Government continues to work with the designated finance platforms, designated banks and the BBB to optimise the Bank Referral Scheme – particularly how the offer of a referral is made to SMEs, to ensure that they understand the benefits of the scheme and can make an informed decision regarding whether the referral is right for them.

**4. The Committee welcomes the Treasury's recognition of the challenges faced by high-growth, scale-up businesses seeking investment. The Treasury should assess what can be done to improve the extent to which these companies benefit from the capital of the UK's long-term investors. (Paragraph 19)**

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4 ['SME Finance Monitor Q2 2018', BDRC, October 2018](#)

The Government welcomes the Committee's recommendation to explore ways that long-term UK investors can support UK businesses and the wider economy. At Budget 2017 the Treasury announced a £20 billion action plan to finance growth in innovative firms by co-investing with the private sector. Within this, the Treasury committed to setting up a taskforce of industry and regulatory representatives to identify and address some of the regulatory and other barriers preventing pension funds from investing in long-term illiquid assets and supporting the UK economy. The Treasury focussed on Defined Contribution (DC) pension schemes, as assets under management are expected to grow to over £1 trillion by 2025 and their long-term time horizons are well placed to support long-term investment.

At Budget 2018 the Chancellor announced a package of measures that better enable DC pension schemes to provide patient capital. Firstly, the FCA has published a consultation reviewing its permitted links rules. To date, these rules have limited greater unit-linked investment in a broad range of patient capital assets. Accompanying this, the FCA published a Discussion Paper seeking views on how effectively the UK's existing fund regime enables patient capital investment. The Treasury's Asset Management taskforce is continuing to explore with industry how the UK fund framework can be improved. Secondly, the Pensions Regulator's updated October guidance for pensions trustees considers investment in patient capital and reinforces the message that an allocation to patient capital can be a prudent investment decision as part of a diversified portfolio. Finally, in order to overcome barriers of scale, several pension funds are working collaboratively to explore options to develop a blueprint for collective investment in patient capital. A BBB-led feasibility study will be working to address some of the operational and commercial challenges in the first half of 2019 with the aim of establishing a structure tailored to the specific requirements of DC pension schemes.

**8. Despite welcome changes to the PRA's regime in 2017, capital requirements remain a specific source of dissatisfaction for the UK's smaller banks. The Committee is clear that the UK's exit from the EU should not herald a new era of laxity in capital regulation, but considers that there is an opportunity to consider how the regime can better support competition without compromising safety and soundness. The Government should provide its assessment of how this could be achieved. (Paragraph 31)**

The Basel package of post-crisis reforms recommends prudential requirements for internationally- active banks. The new rules have enhanced global financial stability by strengthening capital and liquidity rules and establishing a more effective framework for cross-border supervision. The final elements of the reforms were agreed in December 2017 and will phase in globally from 2022. The UK has committed to the full, timely and consistent implementation of these reforms.

The EU implementation of Basel (through the Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD)) extends the application of the framework to all credit institutions and certain investment firms. The Government recognises the need to consider proportionality in the application of the Basel framework to smaller non-internationally active lenders, and to avoid creating distortions to competition.

The rules for determining capital requirements for credit exposures are divided into two categories: the Standardised Approach (SA), used primarily by smaller firms, which

prescribes risk weights for credit risk exposures; and the Internal Ratings-Based (IRB) approach, used primarily by larger firms, which allows firms to use internal models to determine risk weights for credit risk exposures.

For some asset classes, the use of IRB, which requires higher standards of risk measurement and management, results in lower capital requirements than for exposures under the SA. Ensuring a level playing field between the outcome of SA and IRB has been the intent behind recent domestic and forthcoming international regulatory changes.

### *Changes to the UK framework*

The Bank of England's Prudential Regulation Authority (PRA) has recently implemented changes to its capital regime and promoted changes to international standards that support the needs of the UK's financial sector. These changes aim at ensuring that the application of capital requirements is proportionate, and that the regulatory environment for challenger banks and smaller lenders is competitive. Important changes include:

- increasing accessibility to IRB for challenger banks and smaller lenders by clarifying the requirements for obtaining PRA permission and improving the application process;
- implementing refinements to the prudential framework to reduce the likelihood that capital standards are overly prudent for firms using the SA for credit risk; and
- introducing a leverage ratio framework for large banks and systemic ring-fenced bodies, which guards against the danger that models or standardised requirements fail to assign risk weights that reflect the true underlying risk of assets. This also helps to reduce the risk of a competitive imbalance between firms using IRB and the SA for credit risk.

### *EU developments*

In the context of ongoing CRR 2 negotiations, there is focus on reducing the administrative burden on smaller institutions as much as it is possible to do so. EU legislators are currently considering how to reduce reporting and disclosure requirements for smaller non-complex firms. The UK supports these developments.

### *Basel developments*

The most recent Basel reforms will enhance the risk-sensitivity of the SA for credit risk. Relative to the current framework, capital requirements will be lower for low-risk exposures, and higher for high-risk exposures. With the specific aim of supporting SME financing, Basel will introduce a new SME corporate exposure class, further reducing capital requirements applicable to unsecured SME loans.

**9. The Economic Secretary told the Committee that there is more that needs to be done to improve the Alternative Remedies Package. This is unfortunate, as the opportunity for the Treasury to adjust the package has long since passed. The Committee views the initiative as a rare and critically important opportunity to provide a meaningful boost**

**to competition in the SME banking market. Both the Treasury and the independent body administering the package must take a similar view, and should not see this initiative simply as a compliance exercise to satisfy the European Commission's State aid requirements. (Paragraph 37)**

**10. It is disappointing to hear that the industry is expressing concerns about the package's design and implementation. Delays to implementation are not without cost, and given those witnessed to date, it is all the more important for Banking Competition Remedies Ltd to administer the Alternative Remedies Package in as timely a manner as possible. (Paragraph 38)**

The Government agreed the RBS-funded Alternative Remedies Package (the Package) with the European Commission in September 2017 as a resolution to the Royal Bank of Scotland's (RBS) final State aid commitment to divest the part of its business known as Williams & Glyn. The Package was agreed on the basis that it was capable of having an equivalent positive impact on competition in the UK business banking market to the original State aid commitment. The final design of the Package was decided following a period of extensive consultation with banks, other financial service providers, and UK regulators.

As well as marking a significant milestone in addressing a major legacy issue for RBS, the Government agrees that the successful implementation of the Package has the potential to significantly enhance competition in the UK business banking market, helping SMEs benefit from greater choice and offers on banking services.

The Government welcomes the significant progress made in recent months by the independent Banking Competition Remedies Ltd (BCR) in implementing the Package. BCR has communicated to the market key dates and further detail on Package timelines, including the planned launch of the Incentivised Switching Scheme (ISS) and the planned announcement of the first Capability & Innovation Fund awards in February 2019. These communications allayed concerns about delays to implementation, which lay behind the Economic Secretary's comments to the Committee, and the Government welcomes BCR's announcement on 19 December 2018 confirming the banks that will take part in the ISS.

**11. The UK's alternative finance sector has demonstrated impressive growth in recent years. This is beneficial for SMEs seeking funding, and is in part down to measures introduced by the Government to encourage the sector's development. However, it still accounts for a relatively small portion of the overall SME finance market, and it is likely that potential for further growth still exists. The Government must not rest on its laurels; further work will be required to ensure the UK's alternative finance sector fully realises its potential while maintaining appropriate standards of protection for consumers. (Paragraph 49)**

The Government is pleased that the Committee recognise the impact of the measures it has introduced to nurture the UK's alternative finance sector, and remains committed to encouraging competition in financial services in order to stimulate a strong and diverse market for SMEs.

The growth of alternative sources of finance such as asset finance – which grew 12% in 2017<sup>5</sup> – and P2P business lending – which was the equivalent of almost 10% of new bank loans to SMEs in 2017<sup>6</sup> – demonstrates that they are playing an increasingly important role in the SME finance market, and providing genuine competition to the big banks. The Government continues to support alternative sources of finance, as demonstrated by the BBB's ongoing commitments to lend money to SMEs through a variety of UK alternative lenders. The Government agrees with the Committee that maintaining appropriate protection for consumers is vital, and is therefore supportive of the FCA's current review of the regulatory regime for crowdfunding and P2P lending to ensure that it keeps pace with a growing and maturing market.

The Government remains committed to ensuring that its structural interventions in the SME finance market – the Bank Referral Scheme (BRS) and the Commercial Credit Data Sharing scheme (CCDS) – deliver on their objectives of increasing SMEs' awareness of alternative finance options and helping alternative lenders to be more competitive by increasing the data available to them. In its first two years the BRS has helped 1,158 SMEs obtain an additional £23m that they otherwise would not have raised; and as a result of CCDS alternative lenders are able to use data and products which they otherwise would not have had access to, helping them to make better- informed decisions when lending to SMEs.

The Government actively monitors the implementation of both policies, and continues to work with the designated finance platforms, designated Credit Reference Agencies, designated banks and the BBB to optimise their ongoing operation. It is also worth noting that since the introduction of the BRS in November 2016 some banks and trade bodies, recognising the benefits of such initiatives, have launched their own propositions to help customers and members find finance. The Government welcomes any scheme which aims to help SMEs find finance where previously they may not have done so.

**12. Open Banking has the potential to bring significant benefits for SMEs seeking finance. Its impact on the market to date, however, has been muted. As an initiative based fundamentally on the sharing of private financial information with third parties, its success will depend heavily on the willingness of consumers and SMEs to trust those firms. Perhaps understandably, given the frequency of high-profile IT failures and data breaches, that trust appears to be seriously lacking. The Treasury told the Committee that it expected the impact of Open Banking to be slow to materialise, but the Committee urges it to take a more ambitious stance. Working with the Competition and Markets Authority, the Treasury should provide an assessment of the initiative's effect on the market to date. The authorities should also set clear and challenging milestones for the industry in relation to the timely development of Open Banking services, and deliver a comprehensive strategy for combatting the clear public trust issues that threaten to undermine the initiative.** (Paragraph 50)

The Government recognises that Open Banking – a key remedy coming out of the Competition and Markets Authority's retail banking market investigation – has enormous potential to make it easier for SMEs to access the finance they need to grow. Open Banking is still at a relatively early stage of development, but we have already seen significant numbers of bank customers use Open Banking products. The Government

5 ['Small Business Finance Markets Report 2018', British Business Bank, February 2018](#)

6 ['5th UK Alternative Finance Industry Report', Cambridge Centre for Alternative Finance, November 2018](#)

expects that the number of customers using Open Banking products will increase over the coming years, including in SME finance markets, and it will continue to monitor the situation to ensure that there are no barriers that might prevent firms offering Open Banking products entering financial services markets, or market failures that inhibit their ability to scale within those markets. The Open Banking Implementation Entity continues to convene the major retail banks, challenger banks, third party providers of financial services, consumer representatives and regulators on a routine basis to take strategic decisions about the future of Open Banking in the UK, including any measures that might need to be taken to bolster consumer confidence in Open Banking products.

### ***Misconduct and regulation in SME banking***

18. **Experience has shown that the justification for leaving commercial lending outside the regulatory perimeter is feeble, and it is unclear whether this issue was subject to sufficient public debate when the regulatory perimeter was first established. Many small business owners are no more financially sophisticated than everyday consumers, yet they will often be required to engage with relatively complex financial products. They may also lack the resources to purchase the appropriate advice or expertise externally. To deprive them of regulatory protection because of an assumed universal sophistication is wrong, and this unfairness is compounded by the fact that most SMEs are unaware of the regulatory position. In addition, the interconnection between personal finances and business finances can mean that the potential for personal catastrophe due to SME banking misconduct is significant. The Treasury and the FCA should introduce a regulatory regime that protects SMEs. The scope of the regime must be based on an appreciation of the varying levels of financial sophistication within the SME community. This will require analysis of the financial sophistication of the UK's SMEs that goes beyond blunt metrics covering headcount and turnover. (Paragraph 85)**

19. **The Committee recognises that bringing commercial lending within the regulatory perimeter will not be a 'silver bullet'. But doing so would afford the FCA a significant amount of discretion as to how to design and implement a regulatory regime. This regime would need to be proportionate—taking account of the potential impact on the supply of credit to SMEs—and targeted at those SMEs that show the greatest need for additional protection. (Paragraph 86)**

21. **Mr Bailey told the Committee that if the initiative does not work, the regulatory perimeter will need to be reconsidered. The Committee considers it unwise to take a 'wait and see' approach; the authorities should get on the front foot by taking action that they know will provide adequate protection to SMEs. It is clear that extending the regulatory perimeter is now necessary. Waiting for another high profile misconduct scandal before pursuing it would be irresponsible. This episode has raised wider questions about the perimeter of regulation, which the Committee continues to consider. (Paragraph 88)**

The Government is committed to regulating only where there is a clear case for doing so, to avoid putting additional costs on lenders that could ultimately lead to higher costs for businesses. Loans of less than £25,000 to the smallest businesses (sole traders, partnerships consisting of 2 or 3 partners and unincorporated businesses) are already treated as regulated consumer credit agreements for the purposes of the Financial Services and Markets Act 2000 (FSMA). This protects consumers where there is the potential for detriment in their

dealings with banks and alternative finance providers, even when operating in a business capacity. In terms of numbers, approximately two thirds of the 5.7 million UK SMEs are sole traders, partnerships consisting of 2 or 3 partners and unincorporated businesses.

The Government believes that the financial services industry has changed significantly since the very challenging period following the financial crisis. For example, all of the major SME lenders have signed up to the Standards of Lending Practice (SLP), which contain clear guidance on best practice. As industry standards and codes of conduct are taken into account by the FOS, the SLP are part of how the FOS decides what is fair and reasonable when adjudicating. And the FCA now also has the ability to take enforcement action against individuals through the Senior Managers & Certification Regime.

Given these factors, the Government does not believe that there is a clear case for bringing SME lending into regulation, as there would be a number of direct and indirect costs associated with such a move. Direct costs would include annual FCA fees, product reviews and increased compliance and monitoring costs; while indirect costs would include stifled product innovation, narrower product choice for SMEs, and higher barriers to entry leading to reduced competition in the SME lending market. These changes could in turn impact on the price and availability of credit for small businesses, which is not a desirable outcome.

### **Redress**

**26. Expanding the remit of the FOS, as proposed by both the FCA and Simon Walker, will still leave a gap in the market for dispute resolution. Larger, more complex SME disputes will be either ineligible or unsuitable for the Ombudsman, yet those bringing these disputes may lack the resources required for litigation. The Committee believes that a Financial Services Tribunal is required to handle these disputes, and that such a body would usefully complement the expansion to the FOS's remit proposed by the FCA. (Paragraph 135)**

**29. The Committee therefore recommends that the Treasury brings forward proposals for the creation of a Financial Services Tribunal. This must be accompanied by an amendment to s138D of the Financial Services and Markets Act 2000 to enhance the legal rights of SMEs. The Treasury should also consider drawing upon the expertise of the Law Commission to aid its consideration of this issue. Taken together, these changes will ensure that the UK's small businesses will no longer be denied justice, as so many have been in the past. We must introduce a system for dispute resolution and redress that gives the UK's SMEs the confidence to engage with financial services providers, safe in the knowledge that they are not vulnerable to exploitation and mistreatment. (Paragraph 138)**

The Government is pleased that there is a consensus that expanding eligibility to take a complaint to the FOS to more SMEs is the right thing to do. The introduction of 'small business' as a new category of eligible complainant for the FOS (defined as businesses with a turnover of less than £6.5m and either fewer than 50 employees or a balance sheet of less than £5m) will give an additional 210,000 SMEs access to the FOS, meaning that well over 99% of businesses will be eligible to take a complaint to the FOS from 1 April 2019. The Government expects the FOS to ensure it has the necessary skills and expertise to take on additional SME cases, and welcomes the FOS's commitment to creating a ring-

fenced, specialist unit supported by a panel of external SME experts. The Government notes the Committee's ongoing interest in the FOS's readiness to take on these additional SME cases, and welcomes the FCA's commitment to carrying out a post-implementation review of business outcomes under the expanded FOS remit within 2 years of 1 April 2019.

The FCA estimate that the current FOS award limit of £150,000 is sufficient to cover over 90% of the complaints that newly-eligible SMEs will bring. Nevertheless, if larger and more complex SMEs are able to complain to the FOS, it is right that the FCA look again at the award limit. The Government therefore supports the FCA's consultation on increasing the FOS award limit to £350,000.

The Government believes that these reforms create a strong dispute resolution mechanism for UK SMEs. We also note the suggestions of both the All-Party Parliamentary Group on Fair Business Banking and Simon Walker that there should be access to dispute resolution services for businesses above £6.5m turnover. The Government believes that the banking industry's proposal to establish a voluntary ombudsman scheme by September next year to resolve complaints from businesses with a turnover between £6.5m and £10m rises to this challenge. It is the Government's view that businesses with a turnover greater than £10m can reasonably be expected to be in a position to go to court.

The Government's position is that an ombudsman-style approach is preferable to a Tribunal for a number of reasons. Firstly, and as outlined above, the Government does not believe that there is a clear case for bringing SME lending into regulation, given the likelihood of such a move impacting on SMEs' ability to access finance. Secondly, there is a real difference between how an ombudsman and a Tribunal make adjudications. A Tribunal must have a strict legal basis upon which to make a judgement. An ombudsman, by comparison, has the ability to make a judgement based on what is 'fair and reasonable' in the circumstances of the case. If a contract allows a bank to act in a certain way, then a Tribunal can simply make a judgement about whether either party has broken that contract. An ombudsman, on the other hand, can decide whether such a contract was fair in the first place. Applying the 'fair and reasonable' test is therefore more likely to lead to better outcomes for SMEs than a Tribunal's more legalistic approach.

Thirdly, it is important to consider the costs of a Tribunal for SMEs. While access to a Tribunal might be cheaper than going to court, it is highly likely to still involve SMEs paying for expensive legal expertise. An ombudsman, by contrast, does not require legal representation for either party. As such, it represents a much less expensive process for SMEs, thereby reducing a barrier to them getting justice. Fourthly, the process operated by an ombudsman allows for decisions to be made faster than in a Tribunal. By operating in a more informal fashion, and with mediation and reconciliation built into the earliest stages of the process, an ombudsman can resolve a case far more swiftly than a Tribunal could. Ensuring that disputes are resolved swiftly and efficiently will allow SMEs to move on and get back to running their business.

Finally, establishing a new Tribunal would require primary legislation, with the requisite time that it would take to pass this legislation through Parliament and then establish a Tribunal. The Government does not believe that this would be a proportionate response, given FCA estimates that the expansion in eligibility for the FOS will result in no more

than an additional 1,300 cases from businesses, on top of the existing 6,000 cases from micro-enterprises. To put this into context, the Employment Tribunal received over 109,000 cases in the 2017/18 financial year alone.

For these reasons, the Government is therefore supportive of both the FCA's planned expansion of the FOS to include 'small businesses' as well as micro-enterprises, and the banking industry's commitment to establishing a voluntary ombudsman scheme to address future complaints from SMEs with a turnover of £6.5m-£10m. The Government looks forward to the next steps in these vital pieces of work, which will ensure that SMEs have access to appropriate dispute resolution mechanisms should they ever have a problem with the financial services that they receive.

In addition, the Government also welcomes the banking industry's commitment to establish a voluntary ombudsman scheme to address unresolved historic complaints from SMEs which have not already been addressed by an independent review process. Established independently of the banking industry, and overseen by a former senior judge, this scheme will make decisions on a 'fair and reasonable' basis, be adequately resourced to deal with more complex disputes, and operate in a transparent manner.

**32. More generally, it is concerning that, under existing law, the FCA cannot respond to a breach of its regulatory requirements by establishing an industry-wide redress scheme for SMEs. This inability to act in response to demonstrable misconduct has damaged trust and confidence in the regulator. At the next opportunity, the Financial Services and Markets Act 2000 should be amended to allow the FCA to establish industry-wide redress schemes for incorporated businesses that have been affected by a breach of regulatory requirements. (Paragraph 141)**

The Government believes that the planned expansion of the FOS to include 'small businesses' will provide the right mechanism for complaints to be handled in the future, and will deliver the best outcomes for UK SMEs. In addition, in its response to the Committee's 2015 Report into Conduct and Competition in SME lending, the FCA committed to undertake a review of the IRHP redress scheme after legal proceedings related to the scheme have concluded. The Government looks forward to the conclusions of that review.

## Appendix 2: Financial Conduct Authority Response

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I am writing to you in response to the Committee's SME finance report of 26 October, published following its inquiry into the SME finance market, regulation in SME banking and redress.

### Extending the regulatory perimeter to cover lending to SMEs

The Committee's report notes that 'many small business owners are no more financially sophisticated than everyday consumers, yet they will often be required to engage with relatively complex financial products; and purchase them without 'appropriate advice or expertise'. The Committee therefore considers it wrong and unfair to deprive these businesses of regulatory protection and advocates the extension of the regulatory perimeter to cover lending to SMEs.

We broadly agree with the Committee's analysis of the imbalance of power between small businesses and financial services firms. As the Committee is aware, some small businesses are already protected by our rules on lending. For example, our consumer credit and mortgages rules cover some credit, hire/leasing and mortgage agreements, where the borrower is defined as an individual, such as a sole trader or certain specified types of partnership. According to the BEIS business population estimates, there are around four million such businesses in the UK, representing around 70% of all SMEs. Where these SMEs borrow up to £25,000 it is likely they would be protected by our rules.<sup>7</sup> The Committee's report recommends that regulatory protection should be extended to other lending activities by amending the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO).

As I have previously said, the decision on where to draw the boundary between regulated and unregulated activities is a decision for Government and Parliament, not the FCA. When I wrote to you in January 2018, in response to your request for a fuller explanation of the parameters of the FCA's regulation, I said it would be wrong for the FCA to ignore the choice expressed in legislation about the degree of regulatory scrutiny expected. However, as an organisation we recognise that regulation cannot be static, and must reflect the conditions of the times.

As public expectations of the scope of regulatory protection change, we think it is reasonable to assess the appropriateness of the perimeter.

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<sup>7</sup> Our consumer credit rules apply to credit agreements and hire/leasing agreements of no more than £25,000, where the borrower is defined as an individual, such as a sole trader or certain specified types of partnership. Our mortgages rules apply to sole traders and unincorporated partnerships if the mortgage is secured on land, of which at least 40% is being used for a home. Our mortgages rules may also apply to these types of businesses if they are borrowing to acquire or retain property rights in land or in an existing or planned building. If the customer is a limited company (or another type of incorporated business), credit, hire/leasing and mortgage agreements are not regulated.

We seek to strike a balance between focusing on the conduct identified in legislation as subject to full regulatory scrutiny, and ensuring that firms and individuals authorised by us behave responsibly, even in areas where their activities are outside our core jurisdiction. As I set out below, we have taken some key actions in recent years that demonstrate how we seek to strike an appropriate balance between these goals.

I said to the Committee on 13 June 2018 that one of these actions - the combination of the Senior Managers and Certification Regime (SMCR) and voluntary codes of conduct - could have the same effect on firms' conduct towards small businesses as the extension of the regulatory perimeter by amending the RAO. I believe the extension of the Financial Ombudsman Service's (FOS) jurisdiction will \_ also help create the right incentives for firms to treat their business customers well. However, as I have previously stated, if initiatives like the SMCR and the FOS extension do not have the desired effect, then Government and Parliament should reconsider the perimeter.

### ***The Senior Managers and Certification Regime***

Coming from the recommendations of the Parliamentary Commission on Banking Standards, the Senior Managers and Certification Regime (SMCR) has now replaced the Approved Persons Regime for deposit takers, dual regulated investment firms and insurers. Importantly, the SMCR conduct rules are not limited to the conduct of senior managers, those performing certified functions or other relevant employees, in relation to a firm's regulated activity. The SMCR conduct rules can also apply to a firm's unregulated activity. The rules require, among other things, that individuals act with integrity, have due regard to consumers' interests and observe proper standards of market conduct, including complying with any voluntary codes of conduct the firm may be signed up to.

### ***Extension of the Financial Ombudsman Service to larger business complainants***

We have recently made final rules extending the jurisdiction of the FOS to larger businesses from the intended date of 1 April 2019. From that date, businesses with an annual turnover below £6.5 million and fewer than 50 employees or an annual balance sheet total below £5 million will be able to refer complaints about both regulated and unregulated lending (and many other financial services) to the FOS. Firms will also be required to handle these complaints in accordance with our rules in the Dispute Resolution: Complaints (DISP) Sourcebook. Additionally, we have recently consulted on proposals to increase the FOS's award limit to £350,000. If implemented this change will further help to close the access to dispute resolution gap for small businesses, which are, on average, likely to have higher value complaints.

### ***Explaining the application of the FCA Handbook provisions, including the Principles for Businesses, to unregulated activity***

More generally, we have explained in our 2017 Mission document the circumstances in which we are more likely to act on a firm's unregulated activity. While most of the FCA's Handbook provisions only apply to a firm's regulated activity, some of our rules, including our Principles, can apply to unregulated activity in certain contexts. In summary, we are

more likely to act where an unregulated activity is illegal or fraudulent; has the potential to undermine confidence in the UK financial system; or is closely linked to, or may affect a regulated activity.

### ***Whether the Financial Ombudsman Service is appropriately resourced to handle larger SME disputes from April 2019***

In July 2018 the FCA Board agreed in principle to the extension of the FOS's jurisdiction, providing it received assurance of the FOS's readiness for the extension, including the FOS's progress towards meeting the recommendations of the independent Lloyd Review.

The Board delegated scrutiny of the FOS's plans for the extension of their remit to its Oversight Committee, which is tasked with reviewing the FOS's annual plan and budget. The Oversight Committee met twice with members of the FOS's Board and Executive before deciding to recommend to the Board that it published a policy statement with near-final rules on the extension of the FOS's jurisdiction. The policy statement was published on 16 October 2018. The rationale for publishing near-final rules was that they would enable the FOS to start planning in earnest for the extension, including commencing recruitment of people with the right skills, put provide the FCA with an opportunity to further scrutinise the FOS's approach and readiness.

On 20 November 2018, the Oversight Committee received further detail on the FOS's approach, including the key milestones, gateways and budgetary provisions that will ensure the FOS is ready ahead of 1 April 2019 to start handling complaints from the new complainants. The FOS has confirmed to us that its internal auditors will be asked to provide assurance on the successful implementation of the FOS's project plans for the extension.

The Oversight Committee also assessed the FOS's progress towards delivering on the recommendations of the Lloyd Review, including those related to complex complaints and quality assurance, which are likely to be most relevant to the extension. The Committee recognised that it will need to follow closely the execution by FOS of the Lloyd Review's recommendations in order to provide the necessary assurance.

With these reassurances in place, the FCA Board agreed to make final rules on the extension at its 13 December meeting in order to enable preparations to be made with greater confidence on timing.

In summary, before making rules, we went through an extensive process of oversight. This involved three meetings of the Oversight Committee and increasingly granular scrutiny of the FOS's proposals, plans and progress towards meeting the recommendations of the Lloyd Review. At present, I believe that the FOS will be ready to handle complaints from the new complainants from 1 April 2019. That said, it would be open to the FCA to make a waiver to the new rules, which would delay implementation in the event that we assess the FOS not to be adequately prepared.

### ***RBS GRG***

The Committee's report sets out your views on the response to the treatment of SMEs by the Royal Bank of Scotland's Global Restructuring Group. We have discussed the process

which has guided our actions in response, but I would like to take this opportunity to reiterate several points. Firstly, we are confident in Sir William Blackburne as overseer of the complaints process. Secondly, as the report notes, under the Senior Managers and Certification Regime, there is greater scope for us to act with regard to the behavior of individuals subject to the conduct rules under the Senior Managers Regime, even if it relates to activity which sits outside our perimeter.

Thirdly, we are well advanced in providing the fuller account of our findings given the significant public interest in this matter. We expect that the account will need to be maxwellised. We will do so using the principles and recommendations of Andrew Green's report to the Treasury Select Committee.

Andrew Bailey

Chief Executive