



# SMALL BUSINESS FINANCE:

Life after the overdraft

A white paper from Funding Options Ltd  
Autumn 2015  
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## Abstract

New research from Funding Options shows that the small business overdraft is in terminal decline and – despite the rise in alternative finance – there is still a ‘knowledge gap’ among business owners, who are often unaware of the alternative options available, or struggle to access them. Our specially commissioned survey of small businesses shows that for UK SMEs to grow, more work is required to provide access to and understanding of alternative finance.

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# SMALL BUSINESS FINANCE: LIFE AFTER THE OVERDRAFT

## Introduction

Since the credit crunch, much has been made of the reduction in bank lending to businesses. Successive governments have created whole policies and institutions to address the problem – including Project Merlin, the Enterprise Finance Guarantee scheme, the Funding for Lending Scheme and the British Business Bank.

But the squeeze in lending is not as uniform as many think, especially where small and medium enterprises are concerned. The media narrative often focuses on the reduction in term lending to SMEs, but as we will see, the data shows that this is outdated – lack of term lending is no longer small businesses' main problem.

For small- to medium-sized businesses – often overlooked in discussions about bank lending – it is the withdrawal of the bank overdraft that is causing pain. Overdrafts have traditionally been the go-to source of working capital finance and a valuable cashflow management tool; without the overdraft, small business owners are looking elsewhere at new, innovative financial products.

In this research paper, we will assess just how sharp this reduction in overdraft lending has been, examine small businesses' and alternative lenders' responses to decreased working capital availability, and find out how Britain's growing small business community is adapting to life without overdrafts.

Finally and most importantly, using the results of a survey commissioned by Funding Options, we will find out how small business owners feel about the myriad forms of alternative finance, what kind of lenders they trust and understand, and how wide the 'knowledge gap' is for small businesses seeking alternative funding.



*“The Funding Options specialist was just a pleasure to work with; extremely helpful and we wouldn't have been able to do this without him. He was, quite literally, the last resort. He gave us another option and he will even be helping with additional funding that we require as part of the next stage.”*

Joyce Hibbert —  
Owner, Mother Goose

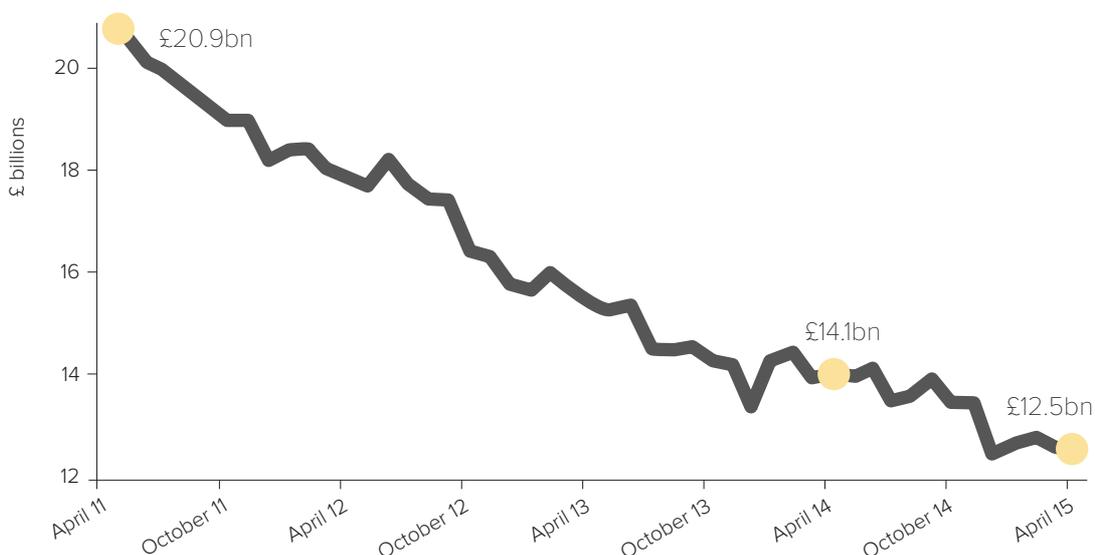
## Funding Options small business survey: key findings

- 30% of small businesses have had their overdrafts reduced or removed in the last two years alone
- Only 23% of small business owners trust their banks to support their businesses
- 13% of businesses have been completely turned down for a bank loan in the last two years
- 82% of small businesses that sought **alternative** finance in the last two years got the funding they needed
- 21% of business owners say they have no workable understanding of any of the forms of alternative finance

The scale of the problem:  
how sharp has the reduction  
in small business overdrafts been?

The scale of overdraft reductions is staggering: since 2011, banks have withdrawn overdrafts from SMEs at the rate of more than **£5 million per day, every single day.**

SME bank overdrafts reduced by £8.4bn since 2011  
— that's £5m every single day



Source: Bank of England

The reasons for this reduction in overdrafts are structural, and for all intents and purposes, permanent.

The Basel III regulatory framework, agreed following the financial crisis, implemented strict and onerous new capital requirements on banks, sharply restricting their ability to lend to borrowers seen as carrying higher levels of risk. And this is hitting unrated small businesses particularly hard.

While the implementation of these new capital requirements was important for macroeconomic stability, they have also played a critical role in preventing small businesses from accessing working capital through the ongoing credit lines that are bank overdrafts. And without working capital, small businesses struggle to survive, invest, and grow, even as the economic recovery continues.

Our survey of over 250 small businesses in the UK showed that 17% of them had experienced a complete withdrawal of their bank overdraft in the last two years alone. A further 13% said their bank had reduced their overdraft limit in the same time period.

With a third of UK small businesses affected, we can see the market is hungry for working capital to drive business growth. The shortfall in funding presents two major risks, in particular for the scale-up businesses that repeated studies have shown are vital for economic growth:

- 1) The risk of overtrading as expansion outpaces available funding, sinking promising firms.
- 2) The risk of growth being hindered by a lack of finance for investment in the business.

So as the banks continue to pull back from the provision of working capital for Britain's small businesses, what can business owners do about it?

*“Saved me hours of time of submitting applications to lenders that don't fit our business. The team were helpful and we obtained the funding required to grow our business.”*

TREMAINE

Trustpilot review



Great Support - Obtained the funding needed

Alternatives are available: and they're not just crowdfunding or peer-to-peer lending

The UK is perhaps second only to the United States in its diversity of alternative finance provision for businesses, with technology and innovation two key drivers of its growth since the credit crunch.

Particular attention has been paid to two relative newcomers to the sector: peer-to-peer lenders, such as *Funding Circle* and *FundingKnight*; and crowdfunders, like *SyndicateRoom*.

While these providers have certainly captured the imagination of policy-makers, parts of the media, and the public, they still only provide a tiny fraction of the SME funding delivered by other longer-established forms of alternative finance.

Indeed, in our survey of small business owners, only 4% had tried to use crowdfunding for their business, making it the least-used form of alternative finance, and just 11% had accessed funds through peer-to-peer lending. Both are a long way behind the most commonly-used forms of alternative finance – leasing and hire purchase – which were used by 31% of respondents.

Less-heralded than crowdfunders or P2P lenders, but far more important in providing working capital for small businesses in the UK, is the growth in challenger banks and specialist lending funds, which are often funded with overseas capital.

The finance provided by these specialist funds is often in the form of proven types of lending, such as asset-based finance, leasing, and commercial mortgages. All of these forms of funding already provide tens of billions of pounds to UK businesses each year, and both retain considerable appetite for further expansion.

Figures from the *Finance & Leasing Association* show that asset finance and leasing providers supplied **£28.2bn** of funding to businesses in the 12 months to the end of July 2015, up 15% on the previous year.

Meanwhile, statistics from the *Asset Based Finance Association*, the trade body representing the invoice finance industry, show that its members were providing **£19.3bn** in funding to businesses at the end of June – almost a third more than five years ago.

*“Funding Options helped us get finance when others could not.*

*The Funding Options team have been instrumental in helping our business grow - they found specialist lenders that could support the business despite being based in the remote parts of the North of Scotland!”*

CAMPBELL DICKSON

Trustpilot review



Funding Options helped us get finance when others could not

The expansion in alternative lending is accelerating and filling the working capital gap left by the withdrawal of business overdrafts, but the variety of choices within alternative finance can seem daunting for many small business owners.

On the Funding Options platform, for example, businesses can access funding from more than 50 lenders across the full spectrum of business finance, including those providing:

- Invoice finance
- Bridging loans
- Alternative overdrafts
- Property-based finance
- Pension-led funding
- Asset finance
- Unsecured short-term loans
- Trade finance
- Crowdfunding
- Merchant cash advances

All of these options have different advantages and suitability depending on businesses' circumstances; the difficulty for business owners lies in knowing which products are best for their own situation.

The table below shows how different sources of finance match up with the various funding requirements of small businesses when accessed through the Funding Options platform:

		Type of Finance			Total by Source of Capital
		Property & Asset Finance	Longer-Term Finance	Shorter-Term Finance	
Source of Capital	Deposit-Taking Bank	12%	16%	0%	14%
	Wholesale Facilities & Debt Funds	16%	16%	36%	68%
	Crowd & High-Net-Worth (HNW)	0%	12%	6%	28%
Totals by Type of Finance		28%	30%	42%	100%

This shows how wholesale facilities and debt funds – often backed by overseas capital – have a far greater capacity and capability to lend across the spectrum of small business needs. This is in contrast to the banks, who focus on lending secured against property and other assets; and the peer-to-peer and crowdfunding providers, whose impact is mainly in longer-term funding.

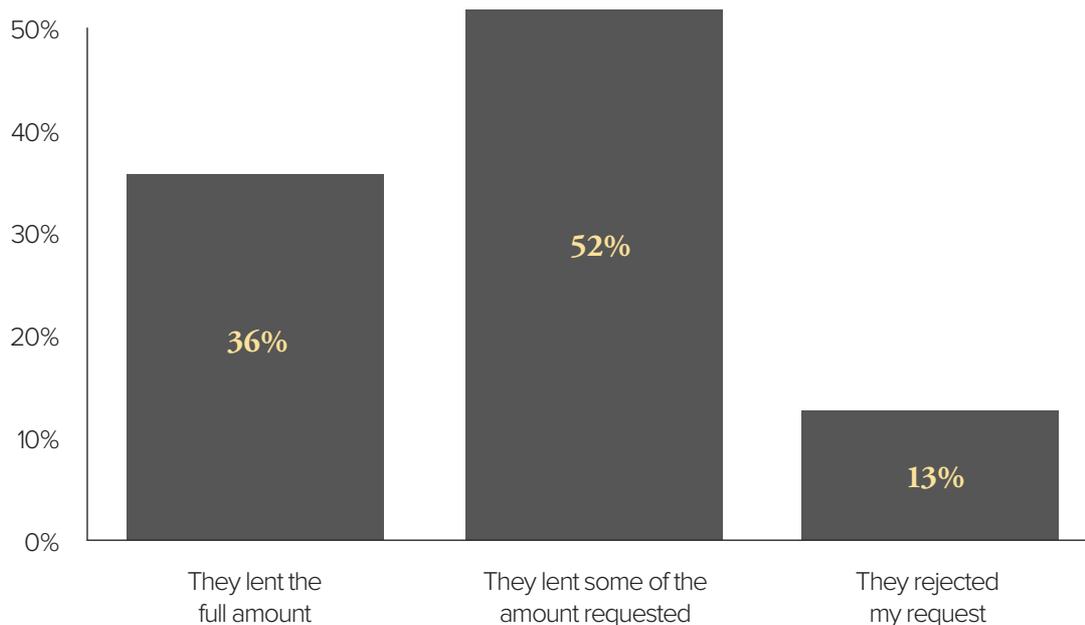
The truth about banks' appetite to lend to small businesses is more complex than many realise

Of small businesses that have applied for a bank loan in the last two years, only 36% have been given the loan they were looking for. 13% have experienced being turned down completely in the last two years, while the rest (52%) got part of the funds they were seeking.

As we mentioned earlier, the widely-held belief that 'banks aren't lending to small businesses' is one that's now outdated, and the responses to this question perhaps give some further insight into the true, more nuanced picture. When approached for term loans, banks are now substantially more open to small business requests than they were in the immediate aftermath of the credit crunch.

However, when a business doesn't fit the profile of a bank's ideal customer, whether due to its size, sector, credit history, or age, banks are still sharply constrained in how much risk they are able to take – resulting in many small businesses only getting part of the funding they need.

How did your bank respond to your loan application?



Businesses aren't all that keen on their banks, and that's creating opportunities for FinTech companies

Most businesses' view of their main business bank isn't particularly positive – only 23% of respondents agreed that they trusted their bank to support their business. The largest group of respondents (35%) were simply indifferent, while 8% agreed with the statement “I don't like them, they don't like me”.

For businesses that broadly offer the same services, customer service can be a key differentiator; high-street banks appear to have very little goodwill in reserve from their small business clients. This underlines the opportunity for FinTech companies to use their agility – something that's impossible for an organisation on the scale of a global bank – to provide the service that small businesses are looking for.

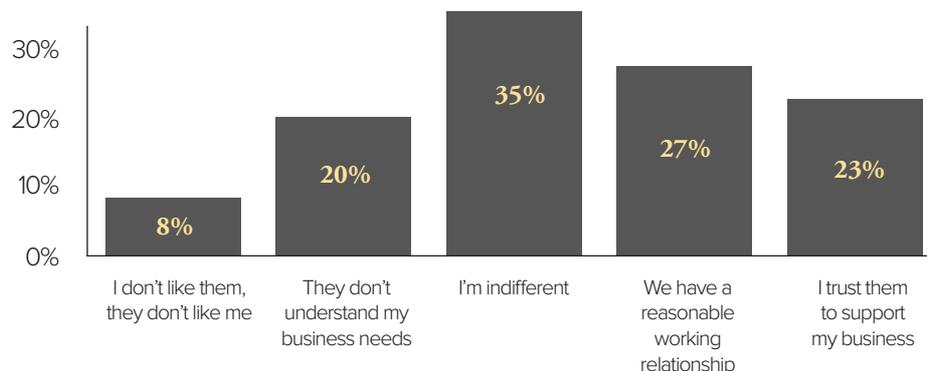
We believe this loss of goodwill also reflects a loss of expertise among the banks due to downsizing sharply during the credit crunch, with banks' inability to value certain assets (IT equipment for example) making it more difficult for businesses to speak to someone at the bank who 'understands their business'.



*“Funding Options were the first company that listened to my story, believed in the concept and had the same enthusiasm for the business as I have. They have supported me every step of the way through the process – I recommend them highly.”*

Shelley Dickinson - Owner,  
Shelley's Pie & Mash Shop

What is your attitude to your main business bank?



What marks specialist providers out as different is their focus – many have developed a unique understanding of the nuances of particular sectors or business types. This contrasts sharply with the ‘one-size-fits-all’ approach of major banks, providing fundamentally the same proposition for all small firms whether they're hauliers, builders, consultants or hairdressers.

Small businesses are investigating alternative finance

With the October 2015 findings of the Competition & Markets Authority into current accounts and business banking once again spelling out the need to make it easier for small firms to shop around for loans, it is clear that alternative finance is going to be key to growth in the UK. Fortunately, many small businesses have already started to notice the opportunities available to them.

When we take a wider view of alternative finance than simply crowdfunding or peer-to-peer lending, among small business owners there is a growing appetite to explore the options available. 40% of respondents to our survey said they have applied for some form of alternative finance for their businesses, and – in stark contrast to bank approval rates – 82% of these had secured the funding they needed.

**While banks only say yes a third of the time, alternative lenders say yes to more than four-fifths of applications – illustrating the strong appetite to lend among alternative finance providers, and their willingness to tailor a funding agreement to fit a business's needs.**

The government's forthcoming Bank Referral Scheme (whereby SMEs turned down for bank finance will have the option of being referred to alternative providers) will go some way to helping small businesses find the funding they require. However, as we shall see below, awareness of the different types of lending and the working knowledge required to make informed decisions is still lacking.

There is still a knowledge gap for small businesses seeking alternative finance

Bridging the 'knowledge gap' that faces the majority of small businesses once their banks say 'no' is a critical issue.

Research by the British Business Bank in 2014 found that "Awareness of alternative sources of debt finance outside banks is not yet comprehensive enough," while there is also a particularly acute lack of knowledge of who to approach to discuss particular alternative options.

The British Business Bank study found that while 53% of small businesses were aware of asset finance, only 30% knew

who to approach to access it – this is just one example of the ‘knowledge gap’ we see on a daily basis.

That’s why we commissioned a survey of more than 250 small business owners, to find out what they really think about the different forms of finance – from their high-street banks to the most innovative new forms of business funding. Some of the results were eye-opening.

21% of respondents said they had no workable understanding of **any** of the forms of alternative finance, a worryingly large number given the withdrawal of high street banks from small business overdrafts.

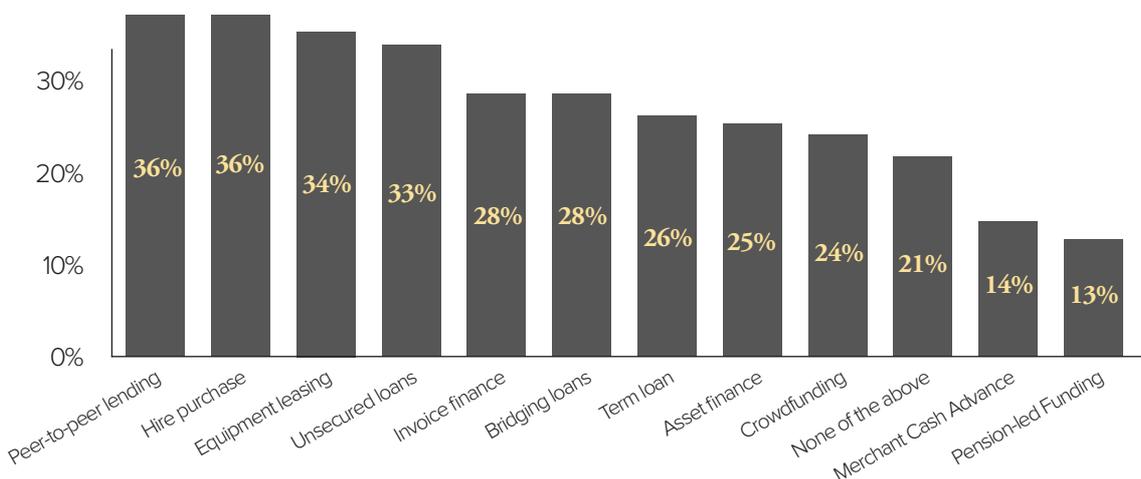
Essentially, many of these businesses have been cut off from finance completely – which will likely have a sharply negative effect on their future growth.

Unsurprisingly, the best-understood forms of alternative finance were: peer-to-peer lending (36%), due to the widespread media coverage it has received; and the well-established leasing (36%) and hire purchase (34%).

The least-understood included some alternatives still regarded as niche options, such as pension-led funding (13%) and merchant cash advances (14%). These finance types, however, offer significant benefits for many specific business circumstances.

With so many potential options out there for small businesses looking to access alternative forms of funding, it seems that many are – understandably – overwhelmed. The practical implication of this is that business owners struggle to understand which product is most appropriate for their individual circumstances. Bridging this knowledge gap is, in our view, the single biggest challenge facing the alternative finance industry.

Which types of alternative finance do you have a workable understanding of?



*“As a fast-growth business which operates with an ‘alternative’ model in a highly traditional sector (legal), we needed an ‘alternative’ form of finance to help achieve our aims.”*

LIZZIE

Trustpilot review



Great service!

## Conclusion: bridging the knowledge gap

The results of the survey are clear, and they bear out the statistics from the Bank of England: banks are making a sharp withdrawal from the provision of overdrafts for small businesses. That's bad news for businesses, and bad news for the UK economy.

The good news is that almost half of small businesses have now applied for some form of alternative finance, and a very large majority did so successfully.

But for us, the key takeaway from the survey was that more than a fifth of small businesses have no workable knowledge of any of the forms of alternative finance. In the current climate, that represents a major concern. The knowledge gap is real, and it is hindering small business growth.

That's why we support the Government's scheme to signpost alternative finance to **every** small business turned down for lending by their banks, through a referral system.

However, we believe the bank referral scheme is only part of the solution; a government-led awareness campaign, closely supported by industry groups and the industry itself, would also go a long way to raising understanding of alternative funding solutions for SMEs.

We believe both projects in tandem could close the knowledge gap, and ensure that **every** small business owner seeking finance has the opportunity to learn about their options — and perhaps discover that one of the many alternatives is just what they need.

### What needs to happen?

The **Government** needs to maintain momentum on the Bank Referral Scheme for SME finance. Providing business owners with easy-to-navigate alternative options if they have been rejected by their bank is fundamental.

The **Major Banks** need to voluntarily, quickly and effectively implement the provisional findings of the new Competition & Markets Authority (CMA) enquiry into business banking, to make it easier for SMEs to shop around for loans.

The **Alternative Finance** industry needs to work harder, and more collaboratively, at educating the market about how its products work and who they are appropriate for, and be clear about any potential risks or limitations.

And **Small Business Owners** need to keep an open mind regarding where business funding might come from, and to quickly get up-to-speed on the alternatives to a business overdraft.

In many cases, there are suitable alternatives available if you just know where to look.

# fundingoptions

Funding Options is the UK's leading online alternative business finance matchmaker, having helped UK businesses to access tens of millions of pounds in funding. We work with providers across the entire alternative funding spectrum to find the right finance deal for businesses, from challenger banks to invoice finance, leasing, crowdfunding, peer-to-peer lending and property-based funding.

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