Title: SME Credit Data **IA No:** RPC14-HMT-2060 **Lead department or agency:** HM Treasury **Other departments or agencies:** N/A	**Impact Assessment (IA)** **Date:** 28/03/2014 **Stage:** Final **Source of intervention:** Domestic **Type of measure:** Primary Legislation **Contact for enquiries:** Ian Searle, HM Treasury, 0207 270 5503

Summary: Intervention and Options

RPC Opinion: GREEN

Cost of Preferred Option				
Total Net Present Value -14.00	**Business Net Present Value** -14.00	**Net cost to business per year** -1.63	**In scope of One-In, One-Out?** YES	**Measure qualifies as** Zero net cost

What is the problem under consideration? Why is government intervention necessary?

Small and Medium Sized Enterprises (SMEs) play an important role in the UK economy. They represent over 99% of the total number of enterprises in the UK; almost half of the UK's private sector output, and account for around half the net growth in jobs in the UK. It is essential that SMEs can access the appropriate finance to manage cash flows and fund investments. The SME credit market suffers from significant information asymmetries which make it difficult for lenders to differentiate between high and low risk borrowers. These information asymmetries raise the cost of credit as incumbent lenders undertake additional credit assessments that are not shared with other lenders. This acts as a barrier to entry for newer lenders. As a result, competition in SME credit markets is reduced. This raises costs for SMEs which are unable to access the right volume of credit or credit at the right price in an un-competitive market. Credit Referencing Agencies (CRAs) can help reduce these information asymmetries, make risk assessment more efficient and transparent and foster greater competition. Government intervention is necessary to improve the effectiveness of CRAs, which is being unnecessarily limited and to reduce barriers to entry in the market for SME lending.

What are the policy objectives and the intended effects?

The policy objective is to increase the competition by lowering barriers to entry in the SME credit market. This will provide a wider choice for SMEs beyond their existing credit provider leading to an increased availability of credit for SMEs. This will be achieved by improving the availability of SMEs credit data amongst lenders to reduce information asymmetries and therefore enable newer lenders to differentiate high and low risk SME borrowers. This should remove a barrier to entry for newer credit providers. Improving access to SME credit data would improve SME credit scoring, and therefore the availability and price of credit to SMEs, particularly for smaller and newer businesses which have no credit footprint and which are potentially denied access to credit.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

Option 0: In the baseline scenario, the government would take no action. This means that the existing market structure would persist. The baseline is used to measure the costs and benefits of taking the action described in the Government's preferred option (option 1). The costs and benefits of the option to take no action are zero as nothing will change.

Option 1: Where the SME in question has given their permission, SME lenders above a certain market share threshold will be required to share credit data on their SME customers with CRAs for the purposes of credit scoring. CRAs will also be required to ensure that there is equal access to this data for alternative credit providers.

Will the policy be reviewed? If applicable, set review date: The policy will be reviewed on an ongoing basis

Does implementation go beyond minimum EU requirements?			No		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** **No**	**< 20** **No**	**Small** **No**	**Medium** **No**	**Large** **No**
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** N/A	**Non-traded:** N/A	

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible SELECT SIGNATORY: Sajid Javid Date: 28/03/2014

Summary: Analysis & Evidence

Policy Option 1

Description

FULL ECONOMIC ASSESSMENT

Price Base Year 2009	PV Base Year 2014	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: -19.25	**High: -8.75**	**Best Estimate: -14.00**

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	8.8	0	0	**8.8**
High	19.3		0	**19.3**
Best Estimate	14.0		0	**14.0**

Description and scale of key monetised costs by 'main affected groups'

1. Lenders that will fall within a threshold set by HM Treasury will be required to make changes to their IT systems to allow them to share the additional data with CRAs.

2. CRAs will be required to make IT changes to their systems to enable them to receive and process the additional data, and share the data with SME credit providers that request it, on an equal basis.

Other key non-monetised costs by 'main affected groups'

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant	Total Benefit (Present Value)
Low				
High				
Best Estimate	N/A		N/A	**N/A**

Description and scale of key monetised benefits by 'main affected groups'

Benefits are not possible to quantify.

Other key non-monetised benefits by 'main affected groups'

1. Improved data transparency would lead to a more diverse credit market for SMEs by increasing competition. SME credit scoring will lead to increased availability of credit and more competitive pricing of credit for SMEs. This will improve economic efficiency and could raise benefits from additional investment and economic growth in the UK.
2. Credit scoring data would enable lenders to better assess credit risk of SMEs. This could reduce losses to lenders associated with defaulting customers.
3. There could be increased competition in the CRA market.
4. Reduced barriers to entry in the SME credit market would benefit new credit market entrants and smaller credit market participants.
5. Improved competition in SME credit markets would improve the resource allocation of capital in the UK economy. This would benefit the productivity of the UK economy and economic growth.
6. There could be benefits from financial deepening as more transparency on risk in financial products could enable products such as securitisation and more sophisticated transformation and diversification of financial risk, making SME loans more attractive. This would make the allocation of credit more efficient.

Discount rate	3.5

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: 1.6	**Benefits: 0**	**Net: -1.6**	NO	Pro-Competition

Evidence Base (for summary sheets)

Background

1. At Budget 2013 the Government committed to "investigate options for improving access to SME credit data to make it easier for newer lenders to assess loans to smaller businesses". At Autumn Statement 2014 the Government announced that it would consult on proposals to require banks to share information on their SME customers with other lenders through Credit Referencing Agencies (CRAs). This consultation was launched on December 26 and closed on February 21.
2. The SME credit market suffers from significant information asymmetries, which make it difficult for lenders to differentiate between high and low risk borrowers. The provision of credit relies on good credit information to assess the risk and required return from lending to a business. The lack of transparent and available credit data raises the costs of credit provision, as lenders are required to undertake additional credit assessments.
3. This can disproportionately affect smaller or newer businesses because a credit rating is determined from information about a business's financial track record. The information asymmetry therefore increases when a potential lender has less sources of information available about the business.
4. These information asymmetries are one of the reasons that that the banking sector is highly concentrated as it acts as a barrier to entry to the SME credit markets for new lenders. The UK SME credit market is currently highly concentrated. At present the largest four banks account for over 80 per cent of UK SME's main banking relationships. The negative knock-on effects are seen in terms of the price and availability of credit to SMEs.
5. One of the most important sources of information about a business is its past financial performance. This information is only held by a business' existing lender and it is not yet widely shared. A new lender therefore does not have access to the same level of information as a business's current lender, so will find it more difficult and expensive to allocate funds to such a business and assess the associated credit risks appropriately.
6. The problem of a lack of credit data has been highlighted by a range of commentators considering issues affecting SME access to finance. The Office of Fair Trading, the Competition Commission and the Breedon Review have all highlighted a lack of information about the creditworthiness of SMEs as a potential barrier to competition in the SME banking market and SME lending in particular.
7. This issue was identified in the OFT 'Review of barriers to entry, expansion and exit in retail banking' (2010). The OFT noted that:

"a*ccurate information about a customer's financial situation is a crucial component enabling providers to offer retail banking products, such as credit, to customers effectively. In the absence of accurate information about potential customers' risk profiles, providers may be forced to use less reliable information, resulting in credit being over- or under-provided. One consequence of this might be providers ceasing to offer certain products for customers for whom they cannot accurately calculate risk. Thus, a lack of accurate information can potentially become a barrier to entry in certain product markets or consumer segments."*

8. This built on the findings of the Competition Commission that while financial information about larger SMEs was available from Credit Reference Agencies (CRAs) or from company accounts for corporate SMEs, such information was not readily available for smaller SMEs that did not file accounts. As this information was only available to the SMEs' current banking service providers, the Competition Commission concluded that new entrants were at a disadvantage in competing, as they could not 'market their services in a targeted way to individual customers or therefore build up market share quickly'.
9. The OFT found that several finance providers faced barriers to acquiring information about customers which made it difficult to retain or attract certain customers. Some pointed out that the incumbent bank's monopoly on the information provided through its provision of that SMEs current account gave it access to data on income and expenditure, as well as wider product holdings, giving them the ability

to more accurately target and price products. This allowed incumbents to check customers' creditworthiness without the need for detailed applications and verification, giving them a competitive advantage in attracting those customers which did not want to go through a lengthy application process. Access to current account data is also a key way that banks can mitigate credit risk by monitoring the ongoing creditworthiness of the borrower over the lifetime of the loan. This can result in the incumbent bank being able to price a loan more competitively.

10. Information is also likely to be much more readily available for larger SMEs, where the commercial provision of information is extensive. For SMEs with a turnover of under £1 million a year, financial information can be scarce. Furthermore, the smallest SMEs often use personal banking services rather than dedicated business services, which means there will not be a track record of information available on their business banking profile when they come to seek business banking services.

11. In the UK, the provision of credit information has evolved around private CRAs. CRAs are privately owned enterprises that collect a wide range of financial and non-financial data from a variety of sources to support credit approval and focus on building individual borrower profiles. Financial information is combined with relevant non-financial information, such as county court judgements, to build a more complete picture of a borrower's creditworthiness. CRAs play a key role in providing credit risk information to inform lending decisions. Banks and non bank lenders all use CRAs as part of their credit risk assessment process. The Business Information Providers Association (BIPA) comprises the five principal commercial CRAs in the UK – Creditsafe Business Solutions, Dun & Bradstreet, Equifax, Experian and Graydon. There are also consumer focused CRAs such as Call Credit. The sharing of data is not currently mandated by law or regulation. Finance providers that share data do so on a voluntary and commercial basis and in accordance with their legal obligations towards data protection.

12. The important role CRAs can play in increasing competition was highlighted in 2012 by the "Taskforce on boosting finance options for businesses", headed by Tim Breedon. The remit of the taskforce was to examine the financing of UK SMEs, which it did through a three month call for evidence. In particular, the report was concerned with the development of alternative finance for SMEs. The report made the following observations:

- Credit information presents a barrier to entry for new providers if existing providers control access to credit information;
- A number of finance providers raised the issue that a lack of access to credit information represented a barrier to entry for them in lending to SMEs This was also raised by the Independent Commission on Banking in its final report to Government;
- CRAs can make risk assessment more efficient and improve overall outcomes for businesses. The commercial sharing of credit data had the potential to foster greater competition between banks and other finance providers;
- The scope of data sharing should be broadened to include non-bank finance institutions in order to support a more diverse financing landscape;
- The Government also has a role to play through the disclosure of data that sits within public bodies.

13. The Breedon Taskforce recommended that:

a) The British Bankers' Association should explore greater credit data sharing with non-bank providers; and

b) Government should consider whether further data could be made available to support the development of new finance products and markets to benefit businesses[1].

[1] The Government has already taken steps to increase the availability of public data for use in SME credit scoring. In July HMRC published a consultation on a number of proposals for potential uses of public tax data. This included sharing detailed (but non-financial) VAT registration data on a restricted basis for specific purposes, such as credit

What is the problem under consideration?

14. Since the Budget 2013, work by HM Treasury and the Bank of England has identified two areas where a lack of SME credit data can produce barriers to entry in the market for SME lending. The first relates to the content of the data that is currently shared.

15. CRAs can offer a high coverage of larger UK SMEs due to the mandatory filing of annual financial statements at Company's House. This will not, however, always capture sole traders or smaller SMEs. In terms of the data provided, lenders can currently buy data about: payments and missed payments relating to existing credit facilities; aggregate risk scores showing the businesses' likely propensity to repay or miss repayments; and warning flags of any debt management plans the business owner might have. CRAs can therefore offer business data (turnover, region, sector etc), owner/director data (credit history etc) and default history. Alternative finance providers can purchase a score from a CRA that incorporates this information or, under certain conditions, purchase the underlying data. However certain data is not always shared, including positive payment performance data and data on business current accounts. It is also not always possible to understand the total debt exposure levels of an SME.

16. Even if this information were fully available, it would not in itself address a key informational gap faced by newer entrants in the credit markets as highlighted by the OFT. This is because, for many SMEs, and in particular those that are smaller or newer, the most relevant financial information accrues only to that SME's current account provider. In terms of making an initial assessment of affordability, an alternative finance provider can request this information from a customer directly, though doing so represents an additional operational cost.

17. There have been recent initiatives to empower SMEs to transfer this data electronically, but these are not widely used. Even if they were, the ability to monitor the ongoing creditworthiness of an SME through current account performance data still provides the incumbent bank with a competitive advantage to assess credit risk and price any credit facilities, and as such this acts as a barrier to entry.

18. Current account data is also now shared (to a limited degree) via 'closed users groups' of the CRAs of which a creditor has to be a member. Through these closed user groups, current account providers can share additional information such as:

- Balance Type
- Credit Turnover
- Primary Account Turnover
- Indictors of missed payments.

19. However, the sharing of SME current account performance data by banks is inconsistent and the data is that is shared is only shared within closed user groups. Greater sharing of this information would significantly augment SME credit scoring. Improved credit scores can help close the gap between incumbent and alternative finance providers in terms of information on SME creditworthiness as the score incorporates more information relevant to a judgment on creditworthiness. However, even a credit score that incorporated perfect information would still not produce a level playing field, as the lender in question would be reliant on the modelling and judgement of the CRA in question. CRAs therefore also sell the underlying data that lies behind credit scores.

20. Currently there is not a level playing field in terms of access to this data. This is the second area where a lack of SME credit data can produce barriers to entry in the market for SME lending. The voluntary sharing of credit performance and related data via CRAs is currently governed by the principles of reciprocity - a set of guidelines overseen by the Steering Committee of Reciprocity

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referencing. The consultation noted that controlled release of this data 'could have...an impact on economic growth by materially increased access to credit, especially for non-incorporated SMEs, as a result of improved credit scoring'.

(‘SCOR’). SCOR is a cross industry forum made up of representatives from credit industry trade associations, credit industry bodies and CRAs. The intention of these guidelines is to ensure that all companies that use and/or subscribe to shared data do so on a reciprocal basis such that “‘*subscribers receive the same credit performance level data that they contribute, and should contribute all such data available*”.

21. In theory these rules allow for scenarios where a lender is not able (rather than not willing) to provide comparable data, for instance because a lender does not offer a product type (e.g. current account) or is new to the market and does not yet have sufficient data to share. For example a new bank which only had loan data to share should be able to access a reciprocal level of data from CRAs about other products, including current accounts. In practice, however, not all data is shared within this framework. There is therefore not equal access to the data shared via closed user groups of CRAs. Lenders that do not offer current accounts cannot see all the underlying data.

22. Therefore the current system does not offer a level playing field for lenders to compete. Lenders that do not offer current accounts, for example, are not able to access the same level of data on current accounts that is available through CRAs to those that do offer current accounts. This puts new entrants or smaller participants in credit markets at a disadvantage in taking well-informed credit decisions. This is why the Breedon Review recommended that the British Banker’s Association (BBA) should explore greater credit data sharing with non-bank providers.

What is the Case for Change?

23. The SME credit market remains particularly concentrated. The Government considers that a lack of data on the creditworthiness of UK SMEs acts as a barrier to entry for newer finance providers, reducing competition in the SME credit market.

24. CRAs can help overcome this information asymmetry for smaller lenders. The OFT and The Breedon Review noted the potential that the sharing of this data has to stimulate competition, particularly if equal access is given to non bank finance providers. However, currently the sharing of a range of data (including positive payment and current account turnover data) with CRAs is not widespread and there is no equal access through the CRAs to the underlying data provided.

25. This can give rise to number of knock on concerns:

26. **Barriers to entry for smaller banks and alternative finance providers** – a lack of SME credit data presents a barrier to entry for new providers. If existing providers control access to that credit information it can prevent newer lenders from accurately assessing credit risk. Operational challenges can amplify this for smaller lenders. The incumbent bank’s monopoly on the information provided through its provision of SMEs current account gives it access to data on income and expenditure, as well as wider product holdings, giving it the ability to more accurately target and price credit products. This allows incumbent lenders to check customers' creditworthiness without the need for detailed applications and verification, giving them a competitive advantage in attracting those customers who do not want to go through a lengthy application process.

27. Access to current account data is also a key way that an SME’s lender can mitigate credit risk by monitoring the ongoing creditworthiness of the borrower over the lifetime of the loan. This means that the SME’s existing lender has a competitive advantage. In a perfect market where every lender had perfect information on the ongoing creditworthiness of any borrower, there would be no such advantage.

28. **Inefficient credit allocation** - accurate information about a borrower’s financial situation enables lenders to make a more informed decision when offering credit products to customers. Where this information is not available, providers may be forced to use less reliable information, resulting in credit being wrongly assessed and as a result, credit could be allocated to unworthy businesses; while worthy businesses unable to prove their creditworthiness are not allocated any credit. The availability of additional data would make credit scores for businesses more accurate and this will result in a better allocation of credit and capital within the economy. This would reflect a more accurate understanding of the credit risk associated with borrower’s and as a result of a more efficient allocation, losses associated with bad-credit or default would be minimised, while gains associated with allocating credit to more productive businesses would be maximised.

29. **Lack of finance for newer or smaller SMEs** – SMEs are disproportionately reliant on bank finance and so are adversely affected by impairments in credit markets. Non-bank finance providers often have a different risk appetite to banks, and so may be willing to lend to SMEs that banks may no longer be willing to lend during periods of heightened stress in credit markets. A lack of data allowing lenders to differentiate between high- and low-credit risk borrowers can therefore lead to a lack of finance for creditworthy SMEs, or credit that is not optimally priced.

Policy Options

Option 0: Baseline scenario – Do nothing

30. In the baseline scenario the Government would take no action. The baseline is used to measure the costs and benefits of taking the action described in the Government's preferred option (option 1). The costs and benefits of the option to take no action are zero as nothing will change.

Option 1: – Preferred measure

31. Where the SME in question has given their permission, SME lenders above a certain market share threshold will be required to share credit data with CRAs that collect data on businesses for the purposes of credit scoring. These CRAs will be designated by HM Treasury

32. The amount of data that will be shared was determined following the consultation.

33. The consultation also considered limiting the mandatory sharing of data to certain institutions, for example those with a certain market share of SME credit. Again this has determined the potential adaptive costs. The policy is expected to apply to the largest seven SME lenders which account for the vast majority of the SME credit market and as a result the vast majority of the credit data to be shared.

34. There will also be a requirement on CRAs to provide a level playing field in terms of access to that data. The proposed legislation would therefore require that non-bank finance providers will be able to access credit data on a level basis with lenders where the SME in question had given permission.

Costs

35. The costs associated with option 1 are broken down into categories below.

i) Upfront cost to lenders of associated IT changes

36. The proposal requires that a subset of SME lenders will share all relevant credit data on their SME customers with CRAs that hold information on businesses for the purpose of credit scoring. The main cost involved in this will be the additional IT required to collate new data and share it with other CRAs. This involves banks adding new data items to existing collection feeds to capture the new data that must be shared, most importantly business current account data.

37. A number of banks have provided estimates of the costs associated with making the necessary changes to their IT systems. These estimates are based on how much it cost banks to share personal current account data for the first time previously. The costs of adding additional fields on SME customers will be equivalent to this.

38. The policy is expected to apply to the largest SME lenders which account for the large majority of the SME credit market. At present the largest four banks account for over 80% of UK SMEs main banking relationships, with the largest seven banks accounting for the vast majority of the SME lending market. We have therefore assumed that these costs would apply to seven banks. Based on the figures provided by banks, we therefore estimate the following upfront costs to banks:

    a. Lower estimate is based on one-off cost of £1m for each bank: £1m x 7 = £7m

    b. Higher estimate is based on one-off cost of £2m for each bank: £2m x 7 = £14m

c. **<u>The best estimate (based on medium of bank's estimates) is: £1.5m x 7 = £10.5m</u>**

39. There will also be an additional cost of sharing this data with multiple CRAs. The Government does not expect this cost to be material for established banks. HM Treasury is working with the industry to agree common definitions and formats that will allow this data to be shared without significant additional marginal cost. On the consumer side where data sharing is more developed, CRAs use each other's file formats making additional sharing less costly.

40. The cost of establishing legal and commercial relationships with multiple CRAs could however disproportionately affect smaller lenders and new market entrants. That is why Government is proposing a market share threshold for mandatory data sharing. HM Treasury will base its decision on a threshold that will capture the vast majority of SME borrowers, while minimising impact on challengers and newer lenders.

ii) Ongoing costs to banks of collating and sharing the data with a wider range of CRAs

41. As a requirement of the regulation, this subset of SME credit providers will have to provide the additional data on a monthly basis with CRAs. As the large SME lenders already share some of this data with CRAs, discussions with lenders during the consultation have suggested that once lender's IT systems are updated to share the additional data, the ongoing costs of sharing the data will not be significant. This is because there will be no additional requirements from CRAs on lenders so they will continue to share the additional data within the current avenues.

iii) Cost to CRAs of updating IT systems to receive additional data

42. CRAs will be required to update their IT systems to enable them to receive the additional data, collate it and feed that into the products they offer to lenders. Only a small number of CRAs currently receive SME credit data, so these costs are likely to differ across the CRAs. The number of CRAs that are likely to be designated to receive this data is not certain at this time. The Business Information Provider's Association (the trade body for commercial CRAs) currently has six members. It is not certain at this time that all of these CRAs would meet the standards required for designation. However to ensure a full estimate of the possible costs we have assumed that they will and assumed there could be an additional market entrant as a result of this measure.

43. Based on estimates from a number of CRAs during the consultation period, we have been able to make the following estimates:

a. Lower estimate (based on one-off cost of 250,000 for each CRA) - £250,000 x 7 = £1.75m

b. Higher estimate (based on one-off cost of £750,000 for each CRA) - £750,000 x 7 = £5.25m

c. **<u>Best estimate (based on medium of CRAs estimates) - £500,000 x 7 = £3.5m</u>**

iv) Costs to CRA of sharing data on an equal basis

44. The proposal would require that alternative finance providers should have equal access to the underlying data of an SME where that SME has given its permission (on approaching that finance provider for a loan). This would represent a change from the current system where some data is only shared through closed user groups. There would be cost associated with IT systems for CRAs in changing how their customers access the data they hold. These costs are likely to differ across CRAs. From discussions during the consultation period, these costs are expected to be minimal and likely to be significantly outweighed by the increase in business that CRAs will experience as a result of the proposal.

v) Increased cost to banks of purchasing credit score or underlying data from CRAs

45. The fact that this proposal will result in CRAs obtaining much better data on SMEs, will mean that CRAs are in control of more valuable data. As a result, this could in theory increase the price that CRAs charge to banks for a SME's credit score or the underlying data on an SME. This additional

cost to banks could filter through to the price that banks charge SMEs on their borrowing. We do not consider this to be a risk. The measure will increase competition in the CRA market which should produce a downward not upward effect on prices.

46. Moreover any increased cost to banks of obtaining the data will be significantly outweighed by the reduced risk cost to banks, as better information on SMEs will lead to fewer loan impairments and reduced capital requirements for banks. We therefore think that the proposal will lead to much more accurate pricing of loans, with many businesses seeing the cost of borrowing fall.

Benefits

47. **Increase competition resulting in better SME access to finance** - Non-bank finance providers often have a different risk appetite to the major banks and are willing to lend to SMEs that the major banks are not willing to serve, particularly during periods of heightened stress in credit market. The proposal will allow a broader group of lenders to differentiate between high- and low-risk borrowers and assess credit risk more appropriately. This will improve competition in credit markets and as a result the overall efficiency in the economy will improve. The volume of credit flowing to SMEs will be priced more appropriately, and overall we expect a more efficient flow of credit to SMEs. Smaller and newer firms would particularly benefit. This will have much wider economic benefits as SMEs are key employers and investors and hence act as key contributors to economic growth in the UK. The effect is likely to be most pronounced for unincorporated and incorporated businesses which do not have a credit footprint and are therefore potentially denied access to credit based on a lack of available credit data.

48. Around 99.9% of the UK's 4.5 million businesses are small or medium-sized (employing less than 250 people). Around 74% (3.3m) businesses have no employees at all i.e. are self-employed individuals. Around 24% (1.1m) businesses employ 1-50 people, 30,000 employ 50-250 people and there are only 6,300 large firms that employ 250+ people. SMEs are responsible for almost half of the £900 billion private sector output and 60 per cent, or almost 14 million, of private sector jobs. On top of this SMEs continue to create jobs, accounting for around half the net growth in jobs. Between 1998 and 2010 existing small firms of fewer than 50 employees contributed 34 per cent of the total jobs created in an average year. Start-ups contributed a further 33 per cent. This means that ensuring SMEs can access the appropriate finance they need to invest in their business in order to grow and create jobs in essential for the UK economy.

49. **Improve SME credit scoring** – Improved provision of SME credit data to CRAs would deliver significant benefits through improved SME credit scoring. This would increase competition and improve access to finance, while lenders would be better informed to assess the credit risk they would be taking on board. This can help minimise losses for lenders associated with bad credit risk and business defaults; while it would maximise gains associated with a better assessment of creditworthy businesses.

50. **Efficient Credit Allocation** - The benefits are particularly important because SMEs are disproportionately reliant on bank finance and so are adversely affected by credit channels and changing risk appetite among the major lenders. Improved SME credit scoring, by better enabling lenders to differentiate good and bad credit risks at the smaller end of the market can translate into a more efficient allocation of credit among those businesses that need it most. This would have a positive impact on economic growth by materially improving the way in which lenders make decisions to allocate credit. As a result, productivity in the economy would be improved, resulting in higher economic efficiency and growth.

51. **Lower barriers to entry** – A lack of transparent SME credit data presents a barrier to entry for newer lenders if existing lenders control access to credit information, preventing newer lenders from accurately assessing credit risk. Access to data on business income and expenditure, as well as data on credit and current account products held by businesses, would give new lenders the ability to target and price products more competitively. This would allow lenders to assess customers' creditworthiness more appropriately and timely without the need for detailed applications and verification, allowing them to compete for businesses for effectively.

52. Non-bank finance providers and smaller banks are currently able to buy credit scores but these do not reflect all the information possessed by the incumbent bank. Augmenting credit scores with improved financial information would help close this gap. In and of itself improved credit scoring is not sufficient, however. Some alternative finance providers want access to the underlying data on an equal basis so they can model their own credit decisions and not rely solely on credit scores. Requiring that CRAs provide a more level playing field in terms of access to that data will further remove barriers to entry.

53. **Reduce barriers to switching** - currently a business's current account provider can offer preferential rates on a loan. This is because the data provided by that current account makes the ongoing monitoring of that loan easier and so helps mitigate credit risk in the form of the deterioration of the creditworthiness of that borrower. Making this data more readily accessible should help weaken the link between providing a current account and being able to monitor the loan and this should reduce that price differential, making it easier for an SME to switch provider.

54. **Stimulate a diversified banking market for SMEs** - The current market for SME banking has evolved around the current informational asymmetries that exist in this market. A large amount of SME lending is, for example, secured against some collateral asset. Increasing the availability of this data through CRAs could help develop new credit products that are more tailored to SMEs. This benefit has been seen in the consumer credit market where credit data is already more readily shared which has resulted in a more competitive market, in part a result of more transparent risk assessments reflected in more accurate pricing. If SME credit scoring can be more transparent, lenders could develop more sophisticated credit products that could make SME loans more attractive. This financial deepening could improve the allocation mechanism in credit markets.

55. **Benefits to Credit Reference Agencies** – The additional data that CRAs receive will likely lead to a significant increase in new business due to a higher demand for credit scores as well as the underlying data. These benefits will comfortably outweigh the initial IT set up costs explained above. Ensuring that the data is shared with a wide number of CRAs will stimulate competition in the CRA market for SMEs which is currently dominated by one or two players.

One in Two Out Regulatory Costs

56. This policy is a pro-competition measure. The SME credit market is extremely concentrated with the largest 4 banks holding a market share of around 85%. The market suffers from significant information asymmetries, which hamper the ability of lenders to differentiate between high and low risk borrowers. This represents a barrier to entry for new or small lenders as existing providers control access to that credit information, preventing other lenders from accurately assessing credit risk. Access to better data on SME borrowers would stimulate competition by helping smaller and newer banks and non-bank finance providers to lend to SMEs.

57. As such, the costs of this measure fall outside the scope of the One in Two Out calculation of new regulatory burdens.

58. To go into more detail, the Better Regulation Framework Manual sets out four criteria by which to judge whether a policy is pro-competition for the purposes of qualifying for this exemption. This policy meets each of those criteria, as set out below:

59. The measure is intended to promote competition by:

- **Indirectly increasing the number or range of sustainable suppliers** – the lack of SME credit data presents a barrier to entry for new providers if existing providers control access to that credit information, preventing newer lenders from accurately assessing credit risk. Operational challenges can amplify this. The incumbent bank's monopoly on the information provided through its provision of that SME's current account giving it access to data on income and expenditure, as well as wider financial product holdings, giving them the ability to more accurately target and price products. This allows incumbents to check quickly customers' creditworthiness without the need for detailed applications and verification, giving them a competitive advantage in attracting those customers who do not want to go through a lengthy application process. Removing this barrier to entry will enable new lenders to enter the SME credit market, and also allow smaller players already in the market to compete more easily.

- **Strengthening the ability of suppliers to compete** – This measure will enhance the ability of non-bank finance providers to differentiate high- and low- risk borrowers strengthening the ability of non-bank finance providers to offer products for SME borrowers within their risk appetite. Since this can differ materially from the risk appetite of the major lenders, this can help these lenders to increase market share.

- **Directly increasing the number or range of sustainable suppliers –** the measure will ensure that a number of CRAs have access to SME credit data that they do not currently have. This will allow these CRAs to immediately compete in providing a new service to lenders alongside those businesses currently active in the CRA market for SMEs.

- **Increasing suppliers' incentives to compete vigorously –** Improved SME credit scores resulting from this measure will enable lenders to better assess credit risk of SMEs. This should reduce losses to lenders associated with defaulting customers. This will reduce the cost and overall risk to lenders in providing credit to SMEs. This should incentivise lenders to compete more vigorously with the incumbent banks.

60. The net impact of the measure is expected to be an increase in competition with an overall additional economic benefit. The measure is designed to level the playing field in the market for SME lenders. It will lower barriers to entry and enhance the ability of non-bank finance providers to compete.

61. The policy is intended to address the highly concentrated SME lending market which suffers from significant information asymmetries and high barriers to entry.

62. It would be reasonable to expect a significant net social benefit from the policy, even where all the impacts may not be monetised. SMEs are disproportionately reliant on bank finance in a highly concentrated market. The financial crisis has both increased this concentration yet at the same time impaired the ability of those incumbent banks to lend to SMEs. Improved SME credit scoring, by better enabling alternative lenders to differentiate good and bad credit risks at the smaller end of the market can translate into a more efficient allocation of credit among those businesses most in need of it. The data would help CRAs make more reliable judgements about an SMEs creditworthiness. This could have a significant effect on credit scores and therefore on the availability and pricing of credit. This effect is likely to be most pronounced for unincorporated or newly incorporated businesses which have no credit footprint, and thus are potentially denied access to trade credit. This could have an impact on economic growth by materially increasing access to credit, especially for non-incorporated SMEs, as a result of improved credit scoring.

Equalities Impact

63. The Government expects the equalities impact of this measure to be neutral. Age, religion, gender, pregnancy and maternity, race and sexual orientation do not generate significant issues in terms of the availability of SME credit data. Credit scoring is by its nature blind to these considerations so to the extent that credit scoring is made more effective the result could be marginally positive.

Impact on small firms and micro-business

64. This policy will not come into force until second half of 2014 so is out of scope of the micro-business moratorium.

65. There are two types of small firms and micro-businesses for which this policy may create impacts.

1. Smaller lenders
2. Users of financial services

1. <u>Smaller lenders</u>

The proposal will require that a subset of credit providers are required to share all relevant credit data on their SME customers with CRAs that hold information on businesses for the purpose of credit scoring. The threshold above which lenders must share the data will be set by HM Treasury. No lenders that are micro-enterprises will fall inside this threshold and therefore face any costs. Small lenders will then be able to access the data on an equal basis which will have a positive impact on these small lenders as asset out above.

2. Business users of financial services

As outlined above we expect that the proposals will have a positive, indirect impact on small to medium size businesses that seek finance.