Sage response to Treasury Committee Inquiry on SME Finance

About Sage

Sage exists to knock down barriers so everyone can thrive, starting with the millions of small and mid-sized businesses served by us, our partners, and accountants. Customers trust our finance, HR, and payroll software to make work and money flow. By digitising business processes and relationships with customers, suppliers, employees, banks, and governments, our digital network connects SMBs, removing friction and delivering insights. Knocking down barriers also means we use our time, digital tech, and expertise to tackle digital inequality, economic inequality, and the climate crisis.

Introduction

Sage welcomes the opportunity to input into the Treasury Committee Inquiry on SME finance. Sage is a FTSE 100 technology company and the global market leader for software that provides small and mid-sized businesses with the visibility, flexibility, and efficiency to manage finances, operations, and people.

We are actively working on projects which aim to help our SME customers become credit ready to better access finance. The current landscape remains uncertain. Sage anonymised customer data of 120,000 small business records shows that the real debt position in Q1 2023 remained negative, in line with Q4 2022. This suggests that many businesses are in credit. The high interest rate environment as a result of the Bank of England's tightening has made borrowing much more expensive for businesses. Though it is not sustainable for businesses to borrow for day-to-day spending, in normal trading conditions, businesses typically borrow to invest in capital such as technology or machinery that will help their business to grow. The fact that businesses are so reluctant to borrow highlights the level of uncertainty in the UK macroeconomy.

Having reviewed the call for evidence, we have chosen to set out our thinking through responses to specific questions where we believe Sage is best placed to provide feedback. We have been experimenting with how we can help our customers better understand borrowing and become credit ready to invest and grow. We are pleased to share our perspective and suggestions with the Committee and would welcome further engagement on any points you wish to raise directly with Sage or our industry partners.

Summary

Overall, we believe that upskilling SMEs on how to access funds, encouraging technology innovation to support borrowers, expanding data sharing between borrowers and lenders, and promoting digital adoption will significantly improve access to finance for small businesses in the UK.

Our response highlights the key challenges faced by SMEs when seeking finance. For lenders, accurately assessing the risk of individual businesses poses difficulties, especially for smaller businesses with less sophisticated financial records and less product knowledge. This knowledge deficit results in suboptimal loan applications and funding decisions, leading to good businesses being unfunded or incurring higher costs due to weaker applications.

We believe that financial technology innovation can play a vital role in SME finance. Technology providers, like Sage, are working to develop tools and partnerships that assist borrowers to better understand funding options and improve their creditworthiness. However, we believe better regulatory distinctions can and should be made between technology providers and lenders to help encourage more innovation.

Further, credit reference agencies, through the introduction of Open Finance and data sharing, can support SME finance by helping them understand and improve their creditworthiness. Making Commercial Credit Data Sharing (CCDS) available to SMEs (via their financial management software) would help them understand and improve their creditworthiness.

Finally, the Government should encourage SMEs to adopt financial management technologies, such as accounting software, to present their financial position more effectively to lenders. Expanding capital allowances to include operating expenses for digital technology could incentivise tech adoption and help overcome financial barriers. Additionally, promoting e-invoicing will streamline financial reporting, improve cash flow, and make SMEs more attractive to lenders, thus improving access to finance.

What are the key challenges Small and Medium-sized Enterprises (SMEs) face when seeking finance?

A key problem for a lender is how to accurately assess the level of risk of an individual SME. In the Bank of England's report on Open data for SME finance,[1] this is described as an information asymmetry for which data portability might be the solution. We would argue that as the Commercial Credit Data Service (CCDS) already provides lenders with comprehensive cash flow information for loans below £500,000, more information sharing will not materially improve access for most small business loans. Instead, we believe the challenge is more fundamental.

For medium-sized business, lenders can better and more accurately assess the level of risk for two reasons. The first is verified historical records which are captured in audited financial and management accounts and show the performance of the business over several years. The second is access to experienced in-house finance teams or external advisers who are familiar with different borrowing options, understand the criteria of lenders and can interact personally with them using the correct terminology.

In contrast, for smaller businesses, it is more difficult for lenders to risk assess because they may suffer from one or more of the following:

- A lack of audited financial and management accounts, suggesting no independent oversight.
- Annual financial accounts, prepared only for tax purposes offering modest additional value to a lender over historical CCDS data.
- Potentially a shorter trading history, making management competence harder to assess.
- Less financial product knowledge and less understanding of a lender's requirements, leading to less informed decisions about which lenders and products to consider.

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

- Less access to personal interaction with a lender which reduces the chance to bridge the knowledge gap and results in weaker applications.

As a result, better information sharing for larger or medium-sized businesses may help with faster decisions and better outcomes. However, **for smaller businesses, the challenge is a knowledge deficit** that adds a bigger risk component to the overall business risk calculation in a lending decision. The result of this means that good businesses with weak applications are not funded and many of those that are funded might have avoided higher costs with a better application.

What role can financial innovation play in SME finance? Is there more the government and the regulators can do to improve access to finance through innovative firms?

The Bank of England's Open data for SME finance report observed that "most policy interventions have focused on the supply of SME lending, rather than demand."[2] We agree and believe the key challenge with demand for SME finance is not only data sharing but the deficit in a business' knowledge of which product is most suitable for their needs and those of lenders. This results in suboptimal applications and lending decisions. Part of the solution requires direct support to businesses long before they need funds so they can become credit ready.

Financial management software, such as accounting software, is well positioned to deliver tailored information needed to help SMEs become borrowing ready. At Sage, we are working with partners in pursuit of this goal and are offering alternative ways for small businesses to access funds. One example of this is our partnership with Satago, which is an advanced project, aimed at helping our customers with cash flow management.

This innovation allows our customers to access live credit ratings on their customers to be able to set the appropriate invoice payment terms (90, 60, 30 days, or no credit) and identify clients who pose a risk of late or non-payment. It also automates credit chasing processes to help collect payments promptly and reduces the overall need for working capital. Finally, it offers SMEs the ability to sell invoices to access working capital via a non-traditional method known as "invoice finance." This is a form of secured lending that is available on a single invoice and can be cheaper and faster to arrange than more common methods such as credit cards, overdrafts, and loans.

We are also working with Funding Circle to make it easier for small businesses to secure funding via a data sharing journey inside our Sage Accounting product and have partnered with Swoop to help customers source non-debt finance, such as grants or equity finance.

These practical projects are part of our journey towards a long-term solution where we would like to develop a "virtual treasurer" for our customers to access in our accounting products. Eventually, we would like to be able to provide tailored information to a business owner, via their software and their accountant, which shows their borrowing and savings options and actions to take to improve their creditworthiness. This would typically be the same type of information that a traditional bank manager or financial advisor would have provided in the

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

past before the customer needed to borrow. We believe there are some recommendations the Committee can make to help accelerate our ambition.

It is our view that regulation targeted at lenders extends too easily to technology providers like Sage, who are seeking to innovate new technology that can educate customers (potential borrowers) based on the specifics of their data. We would therefore like regulators to make a clear distinction between technology used to help or educate a customer (potential borrower) versus that of the lender. This will encourage innovation that will ultimately generate demand.

Ideally, we would like to be able to offer actionable information about borrowing, safe in the knowledge it would not be considered financial advice under current regulations. This is because any lender that the borrower might subsequently interact with is regulated. Our view is that financial information that is machine generated and designed to educate and inform a business of lending options, as opposed to the lending itself, should not be regulated.

Currently, the desire to minimise our exposure to regulations designed for and aimed at lenders is having a detrimental impact on our ability to innovate at Sage. For example, the projects above (e.g., Funding Circle/Satago) exclude sole traders so that they do not risk falling into scope of the regulations under the Consumer Credit Act. This therefore prevents a large cohort of businesses from accessing innovative solutions which are likely to benefit them.

We would therefore suggest a period of time or a regulatory sandbox, where innovators such as Sage, can experiment with ways to support borrowers through education, safe in the knowledge that it is out of scope of existing regulations. This will spur on innovation which ultimately will benefit SMEs needing to access funds whilst ensuring that borrowers are still protected by regulations covering lenders.

What role do credit reference agencies play in supporting SME finance?

Building on the success of Smart Data schemes like Open Banking, the UK can improve access to finance by expanding Open Banking to deliver Open Finance.

The Bank of England's March 2020 Open data for SME finance report highlighted that SMEs would benefit from bringing their data together into a portable credit file that could be shared more easily with banks and other credit providers.[3] As part of Open Finance, we ask that credit agencies make Commercial Credit Data Sharing (CCDS) available to SMEs, free of charge, so they can understand and improve their creditworthiness. This could be done via their software providers and accountants who could interpret it within their wider financial accounts and offer actionable information.

Currently, the rules which govern CCDS, allow credit agencies to share data with lenders for a fee but not the owner of the data, the business. We believe this type of data sharing is crucial to improving SME access to finance as credit agencies hold important data about a business that a bookkeeping or accounting system does not, e.g., missed loan payments. At Sage we would be able to use this data to help inform a customer of specific actions they could take to improve their creditworthiness long before they might need to borrow. For example, a growing

[3] Bank of England, 'Open data for SME finance: what we proposed and what we have learnt', https://www.bankofengland.co.uk/paper/2020/open-data-for-sme-finance

business with constrained working capital may need to understand the impact of delaying a stock purchase for a week versus a loan repayment. If they intend to raise capital soon, the red flag of a missed repayment may be more damaging. CCDS data could also help businesses software better explain a lending decision, for example, where a business might have been turned down for funds and what actions could be taken to improve their next application.

We therefore support the call by industry actors such as Funding Xchange, to amend the Mandatory Bank Referral (MBR) system and use those funds to expand access to CCDS. By giving third parties access to credit data, SMEs will be able to improve their creditworthiness and benefit from responsible lending.

Should the Government do more to enhance SME access to finance? And, if so, what?

In comparison to the international community, small businesses in the UK are under-adopters of digital technologies. A 2021 report by the Enterprise Research Centre (ERC) found that 25% of UK SMEs do not use basic digital tools such as E-commerce or Accounting and HR Software.[4] Accounting software helps businesses organise their finances and present their financial position in an appealing way to lenders. Further, with the right technology interfaces, it can also do so in an automated way that lenders will understand. The Government therefore needs to continue to encourage SMEs to adopt digital solutions.

Existing incentives, such as the Annual Investment Allowance, R&D tax credits and the Help to Grow: Digital scheme do not effectively incentivise digital adoption. We believe a more flexible intervention will have greater impact. We would like to see capital allowances extended to include operating expenses for digital technology such as software subscriptions. By doing so, SMEs would be able to claim relief on investment in productivity software like cloud accounting for a limited time. This would help scale tech adoption and help SMEs overcome financial barriers to digitalisation, whilst helping businesses access capital.

Widespread adoption of digital technology could also be achieved through the mandation of e-invoicing. Across the EU, US and beyond, there has been a slow but steady increase in the use of digital technology to support invoicing and tax reporting. This is driving all sectors to adopt modern financial software to record, process and report transactions and manage payments. E-invoicing leads to faster access to financial products, such as loans with more favourable rates. This is because e-invoicing provides an SME with instant and more accurate data on the status of an invoice, for example, who has paid and who requires payment on the customer and supplier side, as well as Days Sales Outstanding (DSO). This information is highly valued by banks as it offers them insights on a company's cash flow, liquidity and working capital, all of which affect the creditworthiness of a business and is required by lenders. Companies that automate their Accounts Receivable processes typically have a more favourable DSO figure, as well as better cash flow. This all results in better payment terms, lower interest rates and improved access to credit.

E-invoicing also provides a transparent record of business transactions that can integrate with accounting systems. This integration streamlines financial reporting and makes it easier for lenders to understand the financial health of a business. Having a clear picture of an SMEs financial performance increases the likelihood of obtaining loans or credit facilities. Overall,

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[4] https://www.enterpriseresearch.ac.uk/publications/digital-readiness-digital-adoption-and-digitalisation-of-uk-smes-amidst-the-covid-19-crisis-2/

e-invoicing significantly enhances an SMEs financial management capability, making them more attractive to lenders and helps improve access to finance.