FINANCIAL INNOVATION: DIRECT LENDING PLATFORMS HAVE OPENED UP THE SME LOAN ASSET CLASS FOR THE FIRST TIME

By Sachin Patel

Ten years on from the financial crisis, small businesses (SMEs) around the world are still underserved by traditional lenders. Direct lending platforms have evolved to successfully address this problem; in doing so they have opened up the SME loan asset class to a variety of investors thereby ensuring that the engine of the real economy has access to much-needed finance.

SMALL BUSINESSES ARE THE ENGINE OF THE REAL ECONOMY BUT STRUGGLE FOR FUEL

Small businesses are the driving force of our global economy, providing about 50-60% of economic value and around 60-70% of jobs.[1] Since the nadir of the financial crisis, the number of small businesses has continued to grow and has been responsible for a large proportion of job creation. Across Europe, the small business environment is also in a strong position: interest rates and unemployment remain low and SME insolvency rates are stable.

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Despite all of this, SMEs continue to struggle to access finance through traditional lenders. The reasons are now well understood and widely accepted - banks have structural and regulatory constraints and therefore it no longer makes commercial sense for them to serve this part of the market. This is compounded by a lesser long-term strategy and focus on these customers as SMEs have never neatly fitted into either the retail or corporate divisions of a bank and are often moved from one division to another. This results in little expertise that is consistently dedicated to their needs.

In times of uncertainty, banks will typically retreat even further from small business lending in order to retain capital. A classic example of this is the UK after the EU Referendum in 2016. At this time, net lending (i.e. total lending minus repayments) by the entire UK banking system fell significantly, dropping to negative levels for the first time since the financial crisis in the last quarter of 2017.[2]

The Netherlands is no exception. According to Dutch central bank figures, year-on-year growth of net lending to small and medium sized businesses was 2.4% in the first two quarters of 2018. However, when we look at net lending to just small businesses in the same period (where the loans made are under € 1 million), we see that it has also fallen.[3]

EFFICIENTLY CONNECTING THE SUPPLY OF CAPITAL TO BORROWER DEMAND

Where traditional lenders do serve SMEs, the process is still as burdensome now as it was ten years ago. Loan applications are typically made in person and it can take months to get a decision either way.

The advent of sophisticated data analytics over the past decade has catalysed the development of direct lending platforms to serve SMEs. Small business owners can now apply within a few minutes at any time of the day, receive a loan decision within hours and the funds within days.

Furthermore, direct lending platforms have developed strong underwriting processes by combining proprietary risk models and cutting-edge technology with a wealth of industry-leading credit assessment expertise. With lending commitments from the largest institutional investors[4], these platforms undergo the same level of scrutiny and thorough due diligence as traditional financial institutions.

A key feature that sets the direct lending platforms apart from traditional lenders is the wide variety of investors lending to SMEs through the platforms. Many partnerships have been forged between these platforms and large institutional investors, including many traditional lenders themselves.

OPENING UP THE SME LOAN ASSET CLASS TO A WIDE VARIETY OF INVESTORS

As the industry has matured, retail investors have been augmented by larger institutional investors such as asset managers, pension funds, local and regional governments, public investment banks and supranational entities.

Diversifying the sources of funding helps to mitigate the impact of potential problems in the banking sector on the SMEs and their access to finance.[5] Consequently, the European Commission has explored ways to accelerate this diversification of funding from the capital markets, venture capital,

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crowdfunding and the asset management industry.

At the same time, investors suffering from a decade-long environment of low interest rates have been searching for yield in the private credit markets. SME loans answer this demand as they can provide attractive yields in a relatively short duration asset. Investors then receive the returns they need whilst also being provided some mitigation in the event of interest rates rising in the future.

The relatively small loan sizes allow granular and diverse portfolios to be built that naturally lend themselves to securitisation. In an earlier joint paper, the Bank of England and the European Central Bank explained that securitisation, when properly done, is an important funding tool for smaller borrowers to access the largest pools of institutional capital.[6] Investors can buy a tranche of risk and return that they prefer in a listed and rated bond format. It also allows asset-backed security (ABS) investors to further diversify their own portfolios, which are typically concentrated in mortgages, credit cards and auto loans.

Well-functioning securitisation markets enable non-bank financial institutions to raise funding for their real economy lending, thereby providing an important alternative to traditional bank lending. Institutional demand for securitised loans is expected to grow significantly over the coming years.

A BETTER DEAL FOR EVERYONE

For the first time, direct lending platforms have opened up a traditional asset class previously only available to the banks who were able to originate the loans via their branch networks.

These platforms can now support the growth of small businesses, which in turn drives much-needed job creation and powers the economy. Research from Oxford Economics found that when a business accesses finance through a lending platform, a ripple effect is seen through supply chains further boosting local communities. In 2017 alone, this activity unlocked 75,000 jobs and boosted global GDP by € 4.4 billion.[7]

Direct lending platforms have demonstrated their relevance and the important role they can play in the broader financial ecosystem. As the industry develops, the initial mission has remained unchanged; to increase the supply of funds to small businesses across the world by allowing the widest variety of investors to lend to them.

Welcoming a diverse mix of investors will help in creating a sustainable sector for the long term, where small businesses have multiple sources of potential credit rather than relying solely on banks as they have done in the past. «

1 OECD. Enhancing the Contributions of SMEs in a Global and Digitalised Economy, 2017.
2 Data taken from Bank of England 'Bankstats (Monetary & Finacial Statistics)' – Table A8.1 'Monetary financial institutions' loans to non-financial businesses, by size of business' under 'Net loans (exc overdrafts).
3 De Nederlandsche Bank. Economische Ontwikkelingen en Vooruitzichten, Nummer 16, December 2018.
4 AltFi. New institutional investor to fund £1bn of UK loans through Funding Circle, December 2018.
5 European Commission. Capital Markets Union: an Action Plan to boost business funding and investment financing, September 2015.
6 Bank of England & European Central Bank. The case for a better functioning securitisation market in the European Union, May 2014.
7 Oxford Economics, The Economic Impact of Lending, June 2018.

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