There once was an ugly duckling

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Everyone agrees that there is a lending problem for small and medium-sized enterprises (SMEs) in the UK. The stock of lending to UK SMEs has been falling for at least the past four years and the stock of lending to all UK businesses has fallen by a quarter from its pre-crisis peak.

This problem is not new. In 1931 Hugh Macmillan, a Scottish judge, chaired a commission into the problems of finance and industry. It unearthed structural fault-lines in the provision of SME finance – the so-called "Macmillan gap". The Macmillan gap was re-exposed by the financial crisis, but today's problem is even more acute because SMEs now account for more than half of UK employment.

To plug this gap, it is important first to understand why problems are more acute for SMEs than for large companies or some households.

Large companies tend to have a proven track record of profits and performance. This makes assessing their creditworthiness, and hence pricing and extending loans to them, relatively easy. Household loans are usually small enough to benefit from the "law of large numbers" – if you buy enough raffle tickets, you are sure to win a prize. Most are also backed by tangible collateral - a house. Both make assessing household creditworthiness relatively straightforward.

Many SMEs have neither of these advantages: no track record because they are new kids on the block; no collateral because many starts-ups these days need only a good idea and a PC. This makes the job of assessing SME creditworthiness time-consuming and expensive. Facing these problems, many banks have sought easier lending targets. SME lending has been the ugly duckling, representing only around 2pc of UK banks' assets. SME lending officers have become a lost tribe; where once we had banks that liked to say yes, today we have computers programmed to say no.

If this diagnosis is right, then one important way of improving matters is to make assessing SME creditworthiness easier and one way of achieving that is to create a high quality database on companies' credit history and revenues, making it freely available to prospective lenders, new and old.

At present, there are obstacles to accessing and sharing this information. Around 80pc of SMEs' banking relationships are centred on the big four banks. Their data is not shared widely, locking in their informational advantages. This makes it hard for new entrants to get a foot in the SME financing door and for existing borrowers to switch to these new entrants.

Measures proposed by the Government last year ought to help to lower these barriers. These will require banks to share the company information they collect with all lenders, new and old, through Credit Reference Agencies (CRAs). They are also minded to require banks to refer SMEs to alternative lenders if they turn them down for credit.

But it is worth considering building on this with a complementary, more ambitious proposal– to create a one-stop-shop for information on companies which is available to all prospective lenders. This is called a credit register. Two weeks ago, the Bank of England published a consultation document setting out the potential benefits of creating one.

A credit register could build on and enhance the information available from the CRAs – for example, by using records held by government agencies such as HMRC. It could also be a made available to a broader range of potential credit providers, such as other companies offering trade credit (who, rather remarkably, contribute more to the financing of business than banks), pension funds and insurance companies.

Academic evidence has demonstrated that the benefits can be considerable. For example, large banks use their data to run credit risk models; this allows them to benefit from preferential capital treatment on SME loans of as much as 60pc, relative to a small bank. This is a significant barrier to small banks and new entrants. By enabling small banks to run models themselves, a credit register could level this playing field.

A second advantage is that company-level information could then be used in the packaging and onward sale of loans – so-called securitisation. A lack of transparency contributed importantly to the pre-crisis failures in the securitisation market; a credit register could help rectify these deficiencies, making securitisation more attractive to pension funds and insurance companies and boosting their financing of the corporate sector.

The benefits to policymakers are also clear. Lowering barriers to entry would boost competition in the SME lending market, reducing costs and improving access to credit. By increasing the diversity of SME financing sources, it would also improve the resilience of the financial system. There could be benefits, too, to regulators who would have better data to assess company financing.

For the UK, a credit register would be a big step. It would not, however, be a step into the unknown. Almost 100 countries internationally already have a credit register, as well as more than half of the countries in the European Union, with a further half dozen planning to introduce one soon.

The Macmillan gap has blighted UK SMEs for perhaps a century, costing businesses, jobs and growth. As the UK recovery reaches a firmer footing, there has been no better time to close it. Radically improving the information available on UK companies could help transform the SME lending landscape. We all know what the ugly duckling turned into.