FINANCIAL INCLUSION FOR EUROPE'S SMEs

Building a Circle of Trust

FOREWORD

The unparalleled power of today's technology confers a responsibility on all of us, across the industry, to make affordable, innovative financial services available to even the hardest to reach customers.

For Banking Circle, a company on a mission to improve access to global financial services, and to give firms the freedom to trade wherever they see opportunity, we believe it's our duty to help make this a reality.

In Europe, small and mid-sized companies make up an astonishing 99% of all businesses – and over the last five years they generated 85% of all new jobs in the region. At a time of accelerating economic uncertainty and technological change, it would be irresponsible for those of us with the power to act not to do what we can to give the drivers of Europe's economy the tools they need to succeed.

In a fast-changing world there are many reasons SMEs have to fight for their survival. At Banking Circle we're committed to making sure that access to essential financial services – from lending to bank accounts, cross border payments and transactions – is not one of them.

Take the most common complaint – unequal access to finance for smaller companies compared to larger firms. Still today, without access to finance, a quarter of SMEs say they would have to make staff redundant and four out of ten would be unable to afford the equipment they need to stay competitive[1]. For small companies banking still means the difference between increased sales and selling up.

It's not just for convenience that we've named this report Building a Circle of Trust. In today's connected economy no financial institution or company, small or large, is an island. Successful innovations and the smartest solutions are the product of collective action – not individual isolation.

Taking in the views of lenders, banks, Payment Service Providers and SMEs across Europe, we hope this report gives you a fresh perspective on where the gaps in access now lie and what those collective solutions and opportunities might look like. And, we hope, it will inspire you to act with us to help close the loop.

Anders la Cour
Chief Executive Officer
Banking Circle

CONTENTS

[1] SME Survey, Banking Circle, September 2018

INTERVIEWEES

Research interviews were carried out for this report with the following companies and individuals:

SME INTERVIEWEES

Dr Barbara Fretter
Co-owner,
Solids Development Consult

Clive Jordan
Franchise Owner,
Dream Doors

David Selves
Owner,
Selves Group of Companies

Maarten Lammens
Co-Owner,
Solids Development Consult

Nick Warmerdam
Co-Owner,
EE Care

FINANCIAL SERVICES INTERVIEWEES

Alex Park
Director of Digital,
Metro Bank

Amir Nooriala
Chief Operating Officer,
OakNorth

Daniel Mayhew
UK Country Manager,
Payoneer

Ivo Gueorguiev
Chairman,
Paynetics

Kent Vorland
Chief Executive Officer,
SmartTrade App

Michael Ault
Chief Executive Officer, Universal Transaction Processing (UTP)

Patty Zuidhoek
Director of Business Banking,
Triodos Bank

Phil McGriskin
Chief Executive Officer,
Vitesse

Rob Israch
Chief Marketing Officer,
Tipalti

Roger Vincent
Chief Innovation Officer,
Trade Ledger

Vidar Thorkelsson
Chief Executive Officer,
Valitor

The research was conducted by MagnaCarta in March 2019.
Interviews were carried out with payment service providers,
FinTechs, banks and small businesses and compared with available data on small and mid-sized businesses across Europe.

EXECUTIVE SUMMARY: SMALL ENTERPRISE IS BIG BUSINESS

The story of financial inclusion among Europe's SMEs is a complex one. As we discuss in this paper, there are plenty of support mechanisms available, but what they offer falls within very narrow parameters and is not necessarily what SMEs[1] need or indeed want.

While policy-makers and financial institutions discuss access to flexible funding mechanisms, many traditional institutions remain averse to providing merchant accounts to sole traders, extending credit to small businesses, or simply providing basic business bank accounts. This is despite the size of the opportunity. There are more than 24 million SMEs in Europe. They make up more than 99% of all the region's businesses, account for two thirds of all employment, and contribute more than half of all business turnover in the non-financial business sector[2]. In 2016, the value add generated by all SMEs totalled €4,030 billion, which represents 56.8% of total European value added that year[3].

Not everybody is behind the curve. In March 2019, PayPal announced that its Working Capital programme had provided £1 billion in cash advances to UK small businesses against future online sales and had increased the upper limit for advances in response to demand for this alternative form of finance.

At a policy level, the EU has put in place programmes to provide better access to finance for SMEs, recognising that financial inclusion enables:

- Sustainable and efficient business growth
- Skills development and job creation
- Innovation in product and service development
- Internationalisation and export growth
- Diversification and resilience of the wider economy
- Social integration and community cohesion

However, there is no single solution, and no single provider that can address the issue of financial inclusion among SMEs, largely because there is no single issue to be addressed. As this report finds:

01

One size can't fit all:

The vast differences among Europe's SMEs is a barrier to providing effective and viable financial solutions at scale.

02

Access denied:

Inaccessible services are self-reinforcing, which keeps prices high, maintains barriers to entry, limits the appeal of SMEs, and stunts growth opportunities.

03

Think global, act local:

The days of catch-all banking services are over: SMEs are a unique category that is not best served by either corporate or retail-focused offerings.

04

Are you worth it?

To improve take-up and help SMEs overcome the perception that they are not valued customers, the benefits and availability of alternative financial services must be better communicated.

05

Joining up the ecosystem:

Digital innovation and pan-European regulation is creating pressure for greater collaboration between providers – of all sizes – to build bridges between disconnected, uncoordinated activities and initiatives, giving rise to so-called 'islands of innovation'.

In other words, vicious circles are in play. To transform them into virtuous circles – of provision, availability and use – will require a more collaborative and creative approach. In this way it will be possible to create a mutually supportive ecosystem in which SMEs can thrive and improve their contribution to the region's economies.

I: EUROPE'S SMALL BUSINESS SPHERE: THE SIZE OF THE PRIZE?

SMEs may form a substantial part of the European economy, but they are by no means a uniform sector. "[SMEs are] dispersed, there's no data available on them, and therefore it's expensive to reach out to them," says Ivo Gueorguiev, the Chairman of Paynetics, an infrastructure payments provider to FinTechs and smaller players. "For this reason they're either underserved or the products they are being offered are offshoots from products developed for corporates and thus often unsuitable."

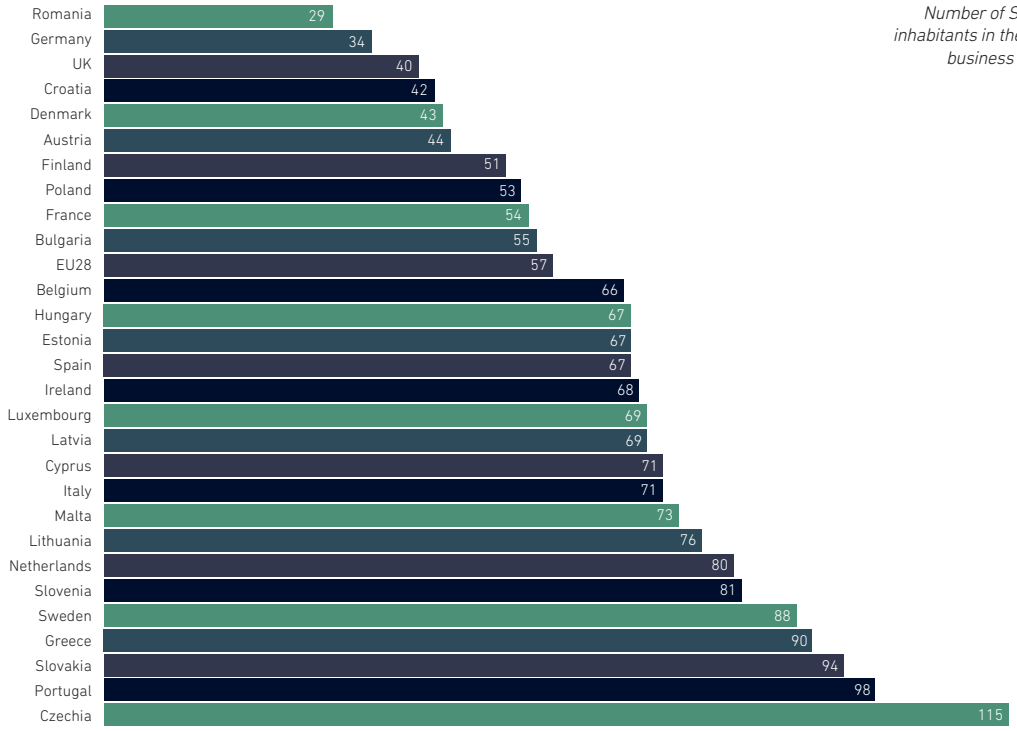
The geographical distribution of small businesses illustrates this point. The number of SMEs per 1,000 inhabitants is strikingly different across the region (see Figure 1). The baseline is 57 SMEs for every 1,000 head of population in the EU as a whole – that is nearly double the proportion in Romania but half that in Czechia (previously known as Czech Republic).

> *"[SMEs are] either underserved or the products they are being offered are offshoots from products developed for corporates and thus often unsuitable."*
>
> *Ivo Gueorguiev, Paynetics*

KEY FINDING 1

SMEs' contribution to the wider economy, their distribution, their nature and their ambitions are often very different, with no obvious inter-regional patterns emerging. This diversity, seen across a number of metrics, is often a barrier to providing financial solutions at scale – and consequently the viability of providers.

Figure 1: Geographical distribution of Europe's SMEs



[4] *Source: Eurostat, National Statistical Offices, DIW Econ*

There is also no obvious correlation between regions and the number of SMEs. Germany, whose famed Mittelstand has long been seen as a key driver of its economy, actually has one of the lowest proportion of SMEs, whereas the Netherlands has one of the highest. In Scandinavia, Denmark is just a few rungs above Germany, while Sweden has more than twice as many.

Technology, knowledge and innovation

SMEs also operate in a broad range of industry sectors (see Figure 2), although wholesale and retail trade dominate.

The European Commission has classified more than 260,000 SMEs (excluding micro-businesses), as Innovative Enterprises[6]. Impressive, but still a relatively small proportion of small and medium-sized businesses – as is the number of SMEs that can be described as knowledge intensive or highly technology intensive. In fact, low-knowledge intensive and low-technology intensive businesses together still account for two-thirds of all SMEs in Europe (see Figure 3).

Separate research also shows that the adoption of digital technologies in general is a challenge for SMEs. As Figure 4 shows, SMEs lagged behind larger enterprises in a number of key areas including ecommerce, cloud computing, and data analytics.

Since the adoption of these kinds of technologies has been so rapid in the past few years, we can realistically expect deployment rates to have increased substantially in small and large businesses alike. But the gap between the two business classes is still illustrative. It is also another area in which national differences can be seen. "The UK is becoming very digital," says Phil McGriskin, CEO of Vitesse, an international payment service provider. "Some other European markets are not."

Figure 2: SMEs in industry sectors[5]

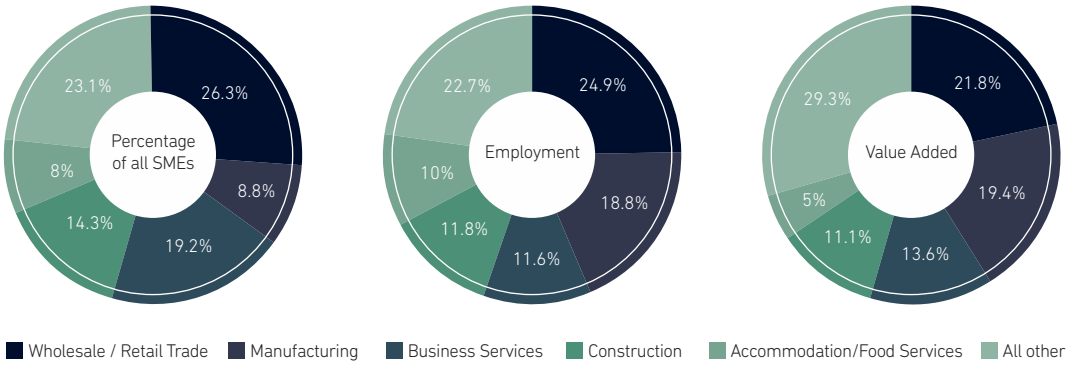
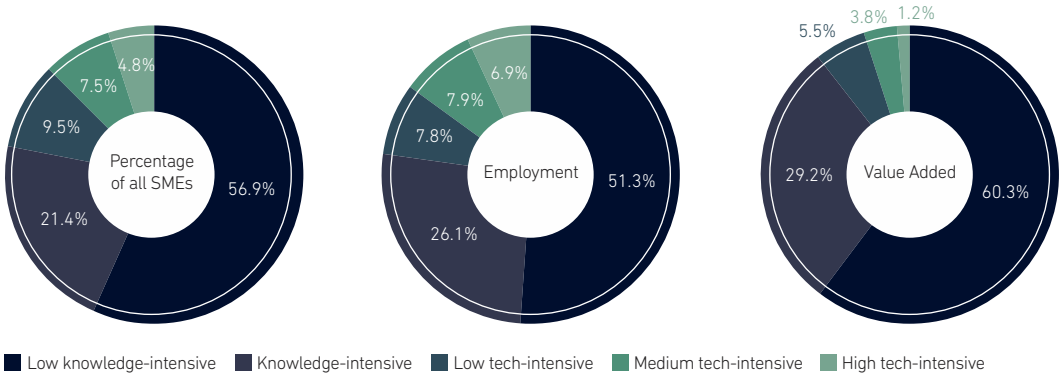
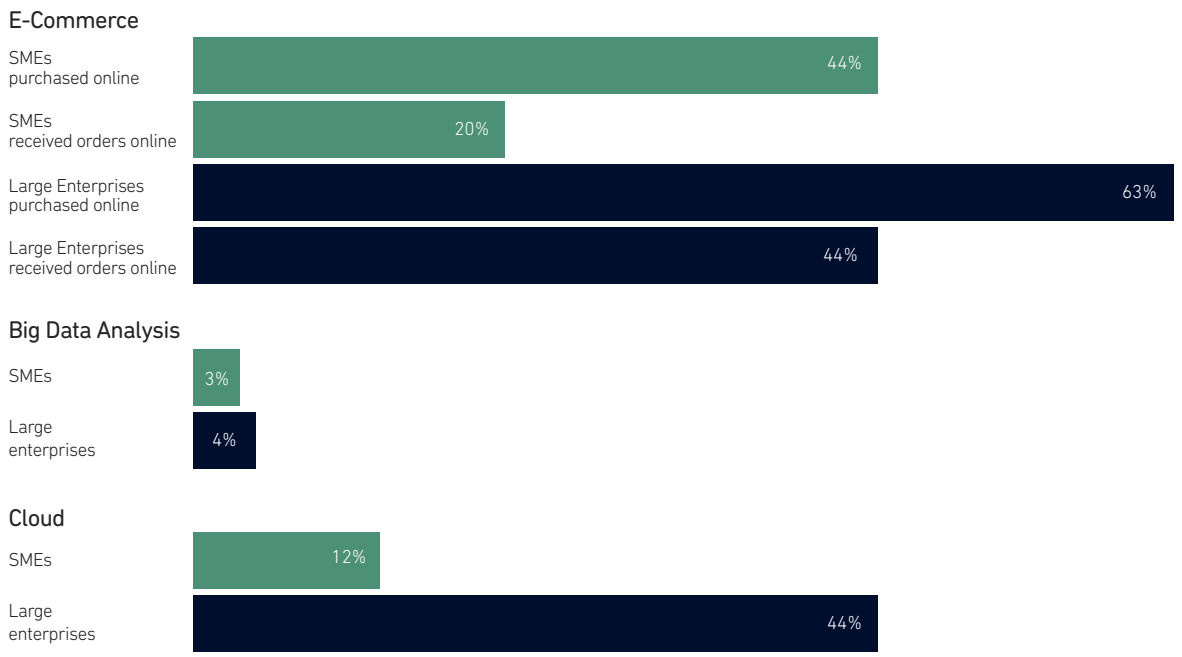


Figure 3: SMEs in knowledge-intensive and technology-intensive sectors[7]



[5] *Source: Eurostat, National Statistical Offices, DIW Econ*
[7] *Source: Eurostat, National Statistical Offices, DIW Econ*

Figure 4: Take-up of common digital technologies among European SMEs in 2017[8]



THE DIGITAL CHALLENGE OR DIGITALLY CHALLENGED?

Speaking of the financial services market in the UK, Roger Vincent, Chief Innovation Officer at Trade Ledger, a corporate banking platform, says: "As an industry, if we manage to properly embrace and adopt the opportunities that are being created from technology then we could see the UK cement its position as one of the global leaders in the financial services sector. This is a once-in-a-generation opportunity to truly revolutionise an industry."

Business analysts across the board agree. But the connection between digitalisation, innovation and business growth is not universally understood. SMEs cite uncertainty about the net benefits of digitalisation[9], lack of awareness about the potential gains and the high levels of uncertainty about suitability[10]. But the main barrier to digitalisation is financial constraint – particularly in comparison to larger enterprises[11].

This perfectly illustrates the vicious circle of financial exclusion. SMEs do not have the finances to invest in digital tools, which stalls growth, and in turn restricts access to funds. Lack of funds slowly translates into lack of interest and lack of necessary skills, further alienating the business from digitally enabled growth.

[8] *BMG Research and Durham University, Digital Capabilities in SMEs: Evidence Review and Re-survey of 2014 Small Business Survey respondents, 2015.*

Recovery, growth and ambition

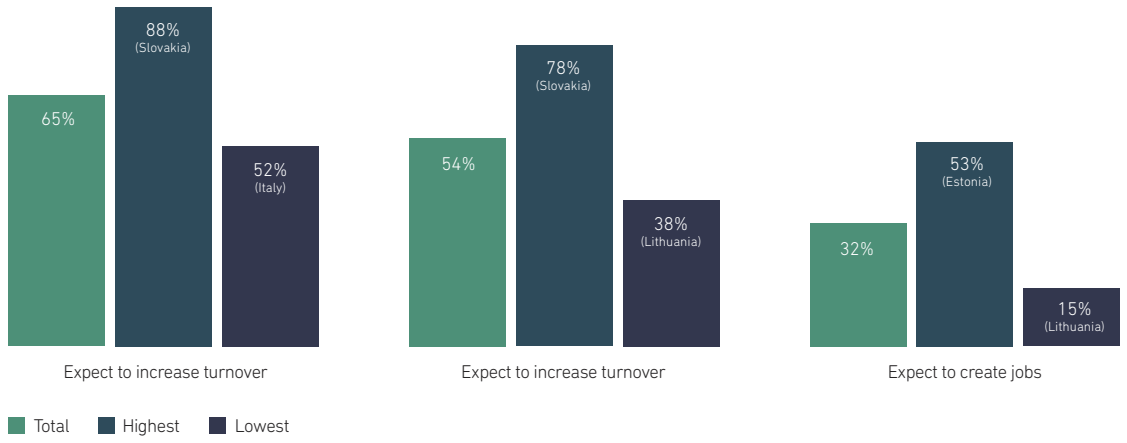
As Europe's economies continue to recover, SMEs are sharing in the potential growth and showing confidence about the future. The Enterprise Europe Network reports that 65% of small businesses expect to increase their turnover[12], a confidence that is particularly strong among businesses with plans for internationalisation.

More than half also expect to increase market share and 85% expect to create or preserve jobs in the next year. Of the SMEs that expect to grow their turnover, most also plan to bring greater levels of innovation to their products or services. Although again, national differences can be fairly stark (see figure 5).

The role of innovation is crucial to Europe's SMEs. With internationalisation and digitalisation it is one of the key factors driving competitiveness and growth. The number of small businesses seeking external funding to either develop and launch new products or invest in skilled labour is increasing[14] - yet more evidence of the connection between financial inclusion and growth.

However, as the next section of this report shows, these ambitious and creative companies need providers of financial services who are equally committed to innovation and growth. Without access to financial services, in all its forms, many SMEs will be unable to fulfil their own plans for growth driven by innovation, digitalisation or internationalisation.

Figure 5: SMEs' confidence in the future[13]



TRADING BEYOND BORDERS

Since 1990, global production of goods has increased, roughly by a factor of three. In the same period, worldwide exports and foreign direct investment (FDI) have increased by a factor of five[15]. This increasing internationalisation of the global economy has also been felt by Europe's SMEs. EU SMEs exported goods worth €1,757 billion or 12% of EU GDP in 2018, an increase in value of almost 20% since 2012[16].

But international trade is not straightforward for SMEs and it's a gap that several PSPs are looking to fill. "The idea behind Vitesse was to avoid the problem faced by many – often online – retailers who receive payments from customers in another country. Due to bank fees, the amounts actually received vary from the amount expected. If you're paying an invoice, it's difficult to know how much you need to add for transaction fees," explains Phil McGriskin, Vitesse's CEO.

At Payoneer, the online money transfer and digital payment service, UK Country Manager Daniel Mayhew says their goal is to "remove the barriers to cross border trade, either by helping them access new markets or providing new technologies that enable frictionless connections between buyers and sellers globally."

[13] *Enterprise Europe Network: SME growth forecast 2017-18*

II: FINANCIAL SERVICES AND SMES: ROUND PEGS, SQUARE HOLES

Despite the EU's commitment to improving access to finance at the policy level, including through the European Investment Bank (EIB) and the European Investment Fund (EIF)[17], many SMEs are yet to reap the benefits.

"The industry is moving far too slowly, and the statistics unfortunately indicate that many SMEs are still drastically underserved by their banks or grossly exposed in the event of an economic downturn," says Roger Vincent, Chief Innovation Officer at Trade Ledger. "Regulation will protect the banks. But it is still a major concern that the right balance of risk and innovation has yet to be fully unlocked by leveraging new technology in the largest incumbent banks, who are best placed to serve the majority of the SME sector."

Banks and financial access

One of the challenges here is the lack of a standard definition of what constitutes financial exclusion. When the European Commission talks about support for SMEs, it references its work with financial institutions to improve available funding through the provision of loans and venture capital, and sharing good policy in areas such as loans and guarantees, venture capital, business angels, growth stock markets and crowd funding.

This focus on funding is reflected in its flagship report: the Survey on the Access to Finance of Enterprises (SAFE). SAFE paints a relatively rosy picture of financial access for Euro-area SMEs, who reported that among their major business challenges, the availability of skilled labour was at the top of their list, closely followed by finding customers (see Figure 6.) Access to financing was bottom of the list – although the smaller the business, the more challenging access to finance is.

There's more evidence in a similar vein. The European Banking Federation (EBF)[19] says: "The banking relationship – underpinned by proximity and the range of services – plays a central role in meeting SME needs." Its report shows:

- The proportion of firms who claimed that access to finance was their major challenge has halved since SAFE was first conducted in 2009.
- SMEs' ability to access bank lending has improved every year between 2012 and 2017.

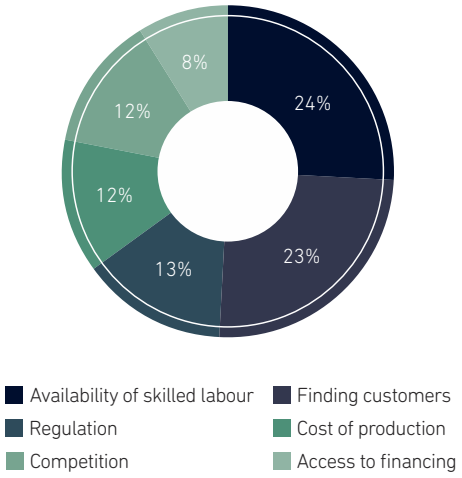
Elsewhere, the European Investment Bank's Investment Survey[20] also shows:

- Bank loans account for the highest share of external finance for both SMEs and large companies.
- Rejection rates for bank loans are decreasing and approval rates increasing steadily since 2014
- Bank financing accounts for almost 70% of external SME financing.

Even when SMEs take advantage of other forms of financing, the EBF suggests that banks have a central role to play: "European structural and investment funds are delivered most efficiently through the banking system, benefiting from the expertise, tools and the proximity of banks, also helping to leverage private finance especially for those SMEs with a short credit history, lack of collateral or a risk profile which to some extent keeps them out of traditional financing."

> *"The right balance of risk and innovation has yet to be fully unlocked by leveraging new technology in the largest incumbent banks who are best placed to serve the majority of the SME sector."*
>
> *Roger Vincent, Trade Ledger*

Figure 6: Challenges for Euro-area SMEs[18]



[18] Source: Survey on the Access to Finance of Enterprises in the euro area. October 2017 to March 2018

Needs, availability and hurdles

Focusing on this narrow interpretation of financial inclusion, there is good news to be had. Just over half of Euro-area SMEs considered bank loans and credit lines to be relevant to their needs, ahead of leasing, hire purchase, grants and subsidised loans, trade credit, internal funds and market-based instruments, such as equity, debt securities and factoring[21].

There has also been a slight but notable upward trend in both the need for and availability of bank loans and credit lines – albeit with national disparities still firmly embedded.

Nonetheless, the European Parliament still takes a cautionary tone. Despite progress in the availability of loans, guarantees and venture capital, it says that the financial markets often fail to provide SMEs with the financing they need; and the Small Business Act (SBA) still identifies access to finance as the second-largest problem faced by individual SMEs[22].

> *"A lot of large banks withdrew from SMEs because they want to take a standardised approach which doesn't work in this sector."*
>
> *Patty Zuidhoek, Triodos Bank*

It is also worth reiterating that, according to SAFE, bank lending alone is not meeting the needs or requirements of almost half of Europe's small businesses. Even as SMEs continue to report improvements in the availability, size and maturity of bank financing, the terms and conditions have not necessarily improved with them. Interest rates have, on balance, declined but charges, fees and commissions remain high, and overall SMEs report increases in collateral requirements[23].

Outside the lending bubble

But access to credit lines is not the only problem that SMEs have when it comes to financial inclusion. In its focus on lending and credit, it fails to take into account essentials such as access to payment services or foreign transfers, the time it takes to open a merchant account, or support for essentials like accounts payable that are just as critical to survival and growth.

Smaller companies are underserved - "The quality of service is at times awful," says Vidar Thorkelsson, chief executive of Valitor, an international payment solutions company headquartered in Iceland. The average churn for SME customers of financial institutions can be over 20% in the UK. The problem is that financial fees are unclear to SMEs. There's a big opportunity here and across Europe to simplify the offer for SMEs, providing relevant products coupled with more self-service and automation."

Alex Park, Director of Digital at UK challenger bank, Metro Bank, agrees. Established banks focus on retail customers and larger commercial customers to the detriment of smaller firms: "SMEs are being underserved," he says, and it's not just about financing. "For example, you can open a bank account in less than a day, as a consumer, but it still takes 15-20 days to open an SME account."

Patty Zuidhoek, Director of Business Banking at the Dutch Triodos Bank, which focuses on sustainable and ethical banking says that the whole banking sector is struggling with the 'gatekeeper' role. "Criminals are getting smarter, and we and the regulator are constantly raising the bar. All these checks and balances are discouraging for SMEs who find it a real hassle. But our gatekeeper role is of great social importance, so we are strict when it comes to checking where their capital is coming from. Are they compliant with all regulations? It is a challenge. A lot of large banks withdrew from SMEs because they want to take a standardised approach which doesn't work in this sector."

In fact, the portrait of easy access to flexible financial services is muddied by late payments, limited access to efficient transaction services and restricted credit lines.

> *"Changes in the way payments are made – such as growth in mobile payments – add complexity for SMEs. Payments is not at the heart of their businesses but it's important to be able to receive payments from customers. We need to simplify payments for SMEs – for instance switching payments providers can be difficult."*
>
> *Vidar Thorkelsson, Chief Executive Officer, Valitor*

For example:

- UK small firms are owed £14.9 billion in late payments, with one in two businesses saying outstanding debt slowed investment.
- On average nearly 42% of the total value of business to business receivables in Western Europe was paid late according to the Atradius Payment Practices Barometer[24].
- The EU's smallest firms are still twice as concerned about access to financial services as large and medium-sized firms.
- Financial exclusion has the greatest impact on the weakest – one in five SMEs in southern Europe find access to finance difficult.

Alternative providers are also challenging the idea that big banks are serving SMEs well. Ivo Gueorguiev of Paynetics, says that because SMEs are notoriously hard to reach they are rarely a major part of a bank's or financial institution's strategy. That in turn means that payment products are usually priced-up with the obvious cost implications.

"There are very few value-added products available; usually products for SMEs are the very basic banking or payment services. That hinders the SMEs' ability to offer more attractive products to their clients, improve their efficiency, increase profitability and ultimately, reinvest in the business," says Gueorguiev. "This has only started to change with digitisation," which can overcome the traditional hurdles associated with scaling to meet a diverse SME market.

KEY FINDING 2

Access to SME-smart financial services is self-reinforcing. When services for SMEs are hard or impossible to access, they keep prices high – which reinforces barriers to entry. High costs have to be passed on to customers, which limits their appeal and stunts growth opportunities.

Circulating value

A recurring issue is the time it takes for cleared funds to be available. "The main difference between banks in the past and now is that banks don't know their customers or their businesses in the same way. It takes too long for them to make decisions, especially with business loans," says David Selves, an entrepreneur and Owner of the Selves Group, a family owned leisure and hospitality business in the UK. He adds: "Three to five banking days for card payments as cleared funds is still the norm, which causes considerable issues for many small businesses. SMEs have bills to pay, the funds are guaranteed and banks settle between each other in real time electronically but customers have to wait days for value."

At Universal Transaction Processing, CEO Michael Ault reiterates the need for speedier processes. "One of the most common complaints we hear from SMEs is the time it takes to get funded. They've already been through an arduous process to get a merchant services account, and then it takes days to get their funds. In today's tech-enabled world, they want faster processing within an hour of taking a transaction."

Kent Vorland, the CEO of SmartTrade App, which has created a platform for micro-businesses and sole traders, is clear that "Small businesses – especially micro-businesses – have specific requirements," which are not being met by banks, or indeed other providers of key software solutions like CRM.

The problem is the same regardless of provider, he says: "We've seen consumer products try to attract SMEs, but they are not agile enough and have little knowledge of small businesses. On the other hand, the big boys have complicated functionalities, but nothing optimised for small merchants who often don't have software knowledge and skills needed."

Given this lack of understanding it is perhaps not surprising that some SMEs are also reporting a lack of flexibility from their banks. Dr Barbara Fretter and Maarten Lammens, who co-own Solids Development Consult in Germany, which operates in the gap between pharmaceutical research and manufacturing systems engineering, have faced just this problem.

"The difficulty as a young but experienced company is that, if we ask for financial support, we are automatically treated as a high-risk investment," they say. "We couldn't convince banks that as a spin-off from the University of Bonn, our activities and experiences go back for more than 10 years. They just see the date of founding the company."

Fretter and Lammens have experience of inflexible or unavailable bank financing leading to a lengthy delay in their growth plans. They are not alone. In the UK, high overall satisfaction levels with banks still cannot disguise

> *"Three to five banking days for card payments as cleared funds is still the norm, which causes considerable issues for many small businesses".*
>
> *David Selves, the Selves Group*

the fact that almost a quarter of SMEs said they had lost at least one opportunity in the past 12 months because of lack of funding. Loan applications are considered slow, and most SMEs were not confident that they would get a loan from their existing bank[25].

For many, this is exactly what financial exclusion looks like – and it is damaging business prospects.

KEY FINDING 3

Service providers looking to serve the SME business class successfully must consider solutions that are localised and SME-specific, and even specific for different sizes of SME. The days of the catch-all service in retail banking, where small business customers were covered by personal banking services, are over.

In the Loop

The conversation surrounding financial inclusion is not just about availability and timing. Smaller staff numbers than corporate peers make it inevitable that SMEs have fewer experts on hand and less time available to spend on non-core activity - particularly where the benefits of doing so are not clear.

> *"SMEs... currently spend large amounts of finance personnel's time on onboarding suppliers, collecting tax IDs, processing invoices, making global payments and reconciling, which they would rather dedicate to new hires and to marketing and sales."*
>
> *Rob Israch, Tipalti*

Rob Israch, the Chief Marketing Officer at Tipalti, a global payables automation software business, highlights the issue: "We're seeing huge demand for Accounts Payable from SMEs who currently spend large amounts of finance personnel's time on onboarding suppliers, collecting tax IDs, processing invoices, making global payments and reconciling, which they would rather dedicate to new hires and to marketing and sales."

Not only does this repetitive manual activity absorb valuable time and capital, CFOs who are buried in the minutiae of accounts payable, payroll and financial operations do not have the capacity for more valuable activities like forecasting and building new products. Automate these tasks, and SMEs gain a more strategically focused finance function, argues Israch.

Banks are not seen as potential sources of these kinds of services – or even able to advise on where these services might be sourced. According to Fretter and Lammens "The bank is helpful with daily things like account administration and even troubleshooting, but they don't come up with new ideas or technology. If we have a problem, such as how a workshop participant can pay us directly with a credit card at the seminar, we have to search for a solution ourselves. It is not our core business, so we don't have the time to figure it all out."

Nick Warmerdam, Co-Owner of EE Care, a business that provides energy advice in the Netherlands, agrees. As he puts it: "Automation and products are just presented from the banks' perspective. I have to take the initiative to find out more. They do not think about it from the clients' perspective. [EE Care] has to personalise our services to our clients – why can't our bank do that with us?"

KEY FINDING 4

All elements within the financial services industry need to do a better job at communicating value to SMEs, and making it easy for SMEs not just to access financial services but, crucially, to make use of them. If SMEs aren't using services available to them, it reinforces the perception that this is a market not worth serving.

III: THE ECOSYSTEM: CREATING A CIRCLE OF TRUST

Creating a wider range of financing instruments that are available both to established SMEs and more entrepreneurial start-ups will, says the OECD, not only address the financing needs of this diverse cohort of businesses, it will also "increase SMEs' resilience to changing conditions in credit markets, and improve their contribution to economic growth."[26]

"SME financing requires that you consider different stages of the SME itself," says Patty Zuidhoek, at Triodos Bank. "The different stages need a different quality of money. Banking money is not always appropriate for every stage. Some SMEs may need high-risk money – that's not banking money."

In Europe, Governments are stepping up to the plate, and have implemented measures designed to increase SMEs access to finance (see Figure 7).

Nonetheless, more needs to be done – if not necessarily by state actors. Effective financial services for SMEs enable investment and consequent growth, thereby making it easier for founders and owners to do business and creating a positive environment that incentivises business formation. That less than half of EU Member States have established a one-stop-shop to support SMEs in accessing funds is a strong suggestion that a broad and effective ecosystem for SMEs is still some way off.

Roger Vincent of Trade Ledger agrees. One of the problems he observes is the lack of interoperability and collaboration in the financial services sector. "This has essentially resulted in an explosion of new commercialised 'islands of digital innovation', created by financial service companies who are each vying for the custom of SMEs by holding them captive in their 'spheres of influence'," he says.

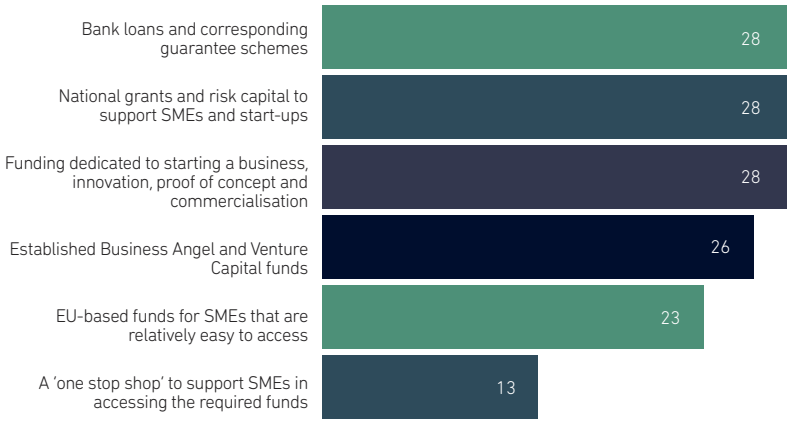
Many of those islands of innovation are focused on consumer services, but as the OECD points out, digital transformation holds potential to improve SME access to finance, offering as it does "unprecedented solutions to address barriers related to asymmetric information and collateral shortage."

"Technology is a major catalyst for change in the financial services sector, and I would certainly say that it's starting to have an impact on how SMEs are serviced by their banks," agrees Vincent. Access to "swathes of new datasets" through the use of APIs – as mandated by PSD2 - is happening rapidly, and is "poised to change the way value is created in every industry including banking and financial services."

The challenge is to make sure that technology is also a catalyst that can kick-start greater collaboration.

> *"[We have] an explosion of new commercialised 'islands of digital innovation', created by financial service companies who are each vying for the custom of SMEs by holding them captive in their 'spheres of influence'."*
>
> *Roger Vincent, Trade Ledger*

Figure 7: Number of EU Member States that have implemented the following measures



KEY FINDING 5

The combination of digital innovation and regional regulation is creating pressure for greater collaboration between providers. To reduce information asymmetries, and identify untapped or un-served demand, the financial services ecosystem needs to create bridges between the islands of innovation that are floating in the middle of Europe's lakes of data.

Behind the digital curve

As discussed in earlier sections, SMEs have a mixed relationship with digital transformation overall. But in the UK, arguably one of the most advanced markets for financial technology, two in five small businesses regularly experience technological problems when accessing accounts online. As a result, nearly half reported that they would move to a non-bank provider – depending on how far their banking needs could be met in new and innovative ways. Crucially, fees or service levels are very much a secondary factor[27].

There is a message here for challenger banks, payment services providers and digital-first FinTechs alike: SMEs are a receptive, valuable and attractive market. Rob Israch from Tipalti explains: "We believe that people creating start-ups should consider the SME market, where the greatest need is. SMEs value their time and cannot afford to just keep throwing people at their manual problems."

Alex Park at Metro agrees. "Digital technology is now mature in the retail market but not for SMEs. The SME market is an arena where as a challenger bank, you can really make a difference."

Amir Nooriala, Chief Operating Officer at OakNorth, the UK-based FinTech providing property financing and loans to SMEs, also agrees. He points out that his company's success is built on using digital technology to overcome one of the most common problems that SMEs face when it comes to securing working capital: "We are lending to SMEs more quickly than traditional banks, because we use AI to help our team make swifter, more informed credit decisions – without losing that human touch. That capacity to offer SMEs customised mid-market loans in a much shorter time frame has proved highly popular."

In fact, AI and robotic process automation (RPA) are increasingly used in back offices, for example to reduce audit processing times, automatically match payments to invoices or identifying suppliers likely to pay late.

For Michael Ault at Universal Transaction Processing, technology like AI offers the means to dynamically assess transactions for fraud in real time. "If the transaction is okay," he says, "it's paid straight away."

Elsewhere in London, FinTech Previse is using machine-learning algorithms to analyse large companies' data, so it can predict which invoices are unlikely to be paid and ensure the remainder are paid instantly by third-party funders, such as a bank – improving cash-flow and saving time and money on chasing payments.

> *"Digital technology is now mature in the retail market but not for SMEs. The SME market is an arena where as a challenger bank, you can really make a difference."*
>
> *Alex Park, Metro Bank*

Park also believes that greater access to customer data should reduce the bank's risk when lending to SMEs, which in turn will lead to increased availability of credit – although he offers a caveat that this depends on developing AI models that avoid existing inbuilt biases.

EAST DOES NOT MEET WEST

When it comes to payment service provision, how far does location matter? Merchants and traders in Western Europe typically have access to better services, simply because the infrastructure, including a wide network of PSPs, is in place. In South Eastern Europe, with a more limited number of PSPs, firms typically need to negotiate directly with their bank. A similar situation prevails in Southern Europe, which can be characterised as vibrant – but inefficient.

In Central and Eastern Europe, it's a mixed picture. As a larger market, Poland is well serviced with bigger institutions that have an international presence. In contrast, Bulgaria and Romania are characterised by smaller local banks and absence of infrastructure. Good products are being developed, but investment decisions are largely confined to London and Berlin, and the big acquiring banks stay away. The upside however is that CEE markets do not have the same legacy problems as those in the west, and can leapfrog stages of development. Its younger generations are also technologically savvy, open-minded and welcoming of new trends. Poland's embrace of contactless payments, and Estonia's pioneering of electronic government are just two examples.

Round the merry-go-round? The collaboration carousel

As for the established financial institutions, surviving and remaining profitable in the age of digital requires them to focus on what Vincent calls 'networked value creation', rather than assuming the traditional 'closed' model of banking innovation will persist.

These banks will therefore need to do two things, neither of which is straightforward. The first is to build their own ecosystem platforms. The second is to design interoperable services that can be distributed through other value ecosystems. Doing this requires a move away from a dependence on vertically integrated 'whole-of-banking' relationships.

It also requires a degree of collaborative activity and partnership with smaller players and FinTechs alike. Daniel Mayhew, the UK Country Manager at Payoneer sums up the different capabilities that partners can bring to the table.

"FinTech's ambition is to provide users with a more digital, cheaper, faster and more transparent solution that's suitable for modern-day global e-commerce. However, incumbents have the advantage of ready-made existing services like Direct Debit, alongside connections to the Faster Payments network [in the UK], SWIFT, underwriting capabilities and deep liquidity networks."

At the same time, FinTechs and smaller players also need to recognise the potential in the SME market. To date, even the most disruptive FinTechs and financial service providers have focused less on SMEs than either large businesses or individual consumers.

Metro Bank's Alex Park sums it up: "It's not straightforward how to best serve SMEs. The differentiator will be who best understands the problems they face, not who has the best technology. Those problems are not always obvious."

EXAMPLES OF RECENT COLLABORATIONS AND PARTNERSHIP INCLUDE:

- The pan-European lending platform, October, has entered a strategic agreement with large business groups in its native France. With partners that range from AccorHotels, the Adecco Group, to ENGIE, and JCDecaux, October's initiative is intended to give its SME customers and suppliers access to alternative financing.
- In London, Tide, the SME-only digital bank, has partnered with ClearBank to bring its digital banking platform together with ClearBank's payments infrastructure to give small business owners a real scale alternative to high street banks.
- London's Railsbank has partnered with Hong Kong's Neat to give SMEs and start-ups access to financial services needed for cross border business, helping them to break into global markets, expand trade with customers worldwide, make and accept instant payments internationally and eliminate international transfer fees and charges when conducting business around the world.

Show and Tell

There is an interesting twist to this tale. Many of the alternative providers and FinTechs are themselves SMEs. In their day-to-day operations, they demonstrate the value that digital tools bring to a small business and can pass on the cost savings generated by digital distribution, scale, product enhancement and exponential development. The lingering belief that big banks focus on serving big business can be turned on its head, with smaller businesses better serving their own small-business counterparts.

This is important because the role of digitalisation requires a broader education among business owners and operational managers than simply focusing on financial products and services. The industry needs a mechanism to kick-start adoption and create a virtuous circle of product availability and utilisation. Certain providers can lead by example – although there is still a bridge to be built to connect those providers and a large number of SMEs in the first place.

Don't just tick the boxes - Play the part

How can different actors build the ecosystem to support SMEs?

Financial institutions and lenders	PSPs and payment intermediaries	FinTechs and other alternative providers of finance
• Provide easy access to finance-adjacent services and advice such as tax advice, compliance support or even technology reviews • Choose your role: Make digital tools available to SMEs, either through partnership, acquisition or in-house development • Talk to SMEs' CFOs regularly for insight into what they need. They appreciate the personal touch • Build the conversation: Communicate effectively with SMEs, PSPs, and FinTechs to create financial awareness	• Find your niche: Where to collaborate and where to dominate the market • Develop SME-specific services that challenge traditional ways of doing things • Focus on reducing costs of services, speeding up access to finance and keeping everything simple and intuitive • Build the conversation: Communicate effectively with banks, FinTechs and SMEs to increase understanding of the infrastructure landscape	• Don't forget SMEs when building new solutions. Consider how digital and alternative services can meet their very specific needs • Explore relationships with incumbents: Can they provide market access, liquidity, customer data to help build business? • Demonstrate the value of digital to small business through your own experience • Build the conversation: Communicate effectively with SMEs, PSPs, and banks to enhance technology awareness

CONCLUSION

TIME TO SQUARE THE CIRCLE?

It is not often that availability of technology, legislation, standards, and strategy come together at the same moment, as they appear to be in relation to financial inclusion for SMEs.

The recognition is there. From state actors to software developers, FinTechs and financial institutions, SMEs and NGOs recognise that financial inclusion for small businesses is a critical necessity. There is a growing commitment to improving access to commercial banking, transaction services and lending for SMEs across Europe. As one interviewee put it, "This opportunity is the chance to solve one of the world's largest socio-economic problems, the £1.2 trillion undersupply of credit to SMEs."

There are plenty of ambitious, but still underserved, businesses with specific needs that could be met by an open, joined-up ecosystem. There are plenty of potential providers of innovative 'point' solutions.

But as this report highlights there is still a lack of connection between the two, apart from individual, often ad hoc series of collaborations. The bigger picture of a connected ecosystem – a circle of trust – is often obscured by a virtual tidal wave of statistics, audits and promotions.

However, financial inclusion based on digital technologies is not an isolated process: It has to take place within a broader narrative – one that connects technology to communications and collaboration strategies, as well as to analytics. Even to society as a whole.

The industry is now at an inflection point. To move forward, all ecosystem participants must continue the conversation with each other, to build collaborative models and solutions that can fit this diverse and disparate market. If they can, it will help build a larger marketplace from which providers old and new can benefit.

As we are learning from the initial responses to PSD2, so far mainly in the consumer sphere, transformative finance is possible. We have evidence that the gains to be made by all participants can be significant. But rather than relying on top-down directives from state institutions, this needs to be a circular, grass-roots movement, led by participants, who can find solutions from the bottom up.

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FOREWORD

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EXECUTIVE SUMMARY, I, II, III

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2 According to NACE, the Eurostat statistical classification of economic activities in the EU, the non-financial business sector includes all sectors of the economy except the following: agriculture, forestry, and fishing; financial and insurance activities; public administration and defence; compulsory social security; education; human health and social work activities; arts, entertainment and recreation; other service activities; activities of households as employers; undifferentiated goods- and services-producing activities of households for own use; and activities of extraterritorial organisations and bodies

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ABOUT BANKING CIRCLE

Banking Circle is a global scale financial utility that gives financial institutions the ability to enhance their customer proposition.

Leading the rise of a super-correspondent banking network, Banking Circle is helping FinTechs and banks increase financial inclusion by providing their customers with faster, cheaper banking solutions, including banking accounts, local and cross border payments and lending, without the need to build their own infrastructure and correspondent banking partner network. As such, Banking Circle is empowering financial institutions to support their customers' international trading ambitions, without the need for multiple banking relationships, whilst reducing risk and the operational cost of transactions. And that is enabling them to remain competitive.

When Banking Circle launched the aim was to address the time and cost challenges of existing business payment solutions which had led to many businesses being financially excluded and unable to achieve their potential. The company has remained committed to this mission, developing and delivering effective, valuable solutions to help businesses of all sizes improve payment efficiency and cashflow.

Banking Circle has created a suite of innovative solutions to meet changing market needs and increase financial inclusion.

BANKING ACCOUNTS AND BANKING CIRCLE VIRTUAL IBAN

Through Banking Circle, Banks and Financial Tech businesses can provide customers with accounts in 25+ currencies. Financial institutions can issue multi-currency physical and virtual IBANs for customers in their own name, in multiple jurisdictions. Accounts deliver full transparency and faster settlement, enabling Financial Institutions to offer merchant customers a full transactional service.

Banking Circle Virtual IBAN enables financial institutions to give clients their own virtual IBANs, negating the need for several banking relationships. Improvements are experienced across payments acceptance, screening time, reconciliation/settlement times, and customer experience. Payments are made and received at low cost per transaction, delivering a valuable competitive advantage previously unavailable to smaller firms.

BANKING CIRCLE LENDING AND BANKING CIRCLE INSTANT SETTLEMENT

Banking Circle commissioned a study of 500+ SMEs to uncover pain points they experience in accessing funding through traditional lenders. In response, the company built two propositions: Banking Circle Lending and Banking Circle Instant Settlement.

These innovative solutions provide financial institutions with the capability to offer merchant customers a fast, transparent, flexible, low-cost, and easy-to-manage loan solution. Where once smaller businesses were unable to achieve global ambitions due to a lack of necessary funds, Banking Circle is improving financial inclusion by giving financial institutions the ability to offer SMEs fast access to loans with flexible repayment options.

Banking Circle Instant Settlement enables PSPs to offer their merchants instant access to cash, while they wait for payment from customers or marketplaces – taking up to 90 days. Banking Circle Instant Settlement, a receivables financing solution, gives Merchants access to the cash flow they need to run their business effectively.