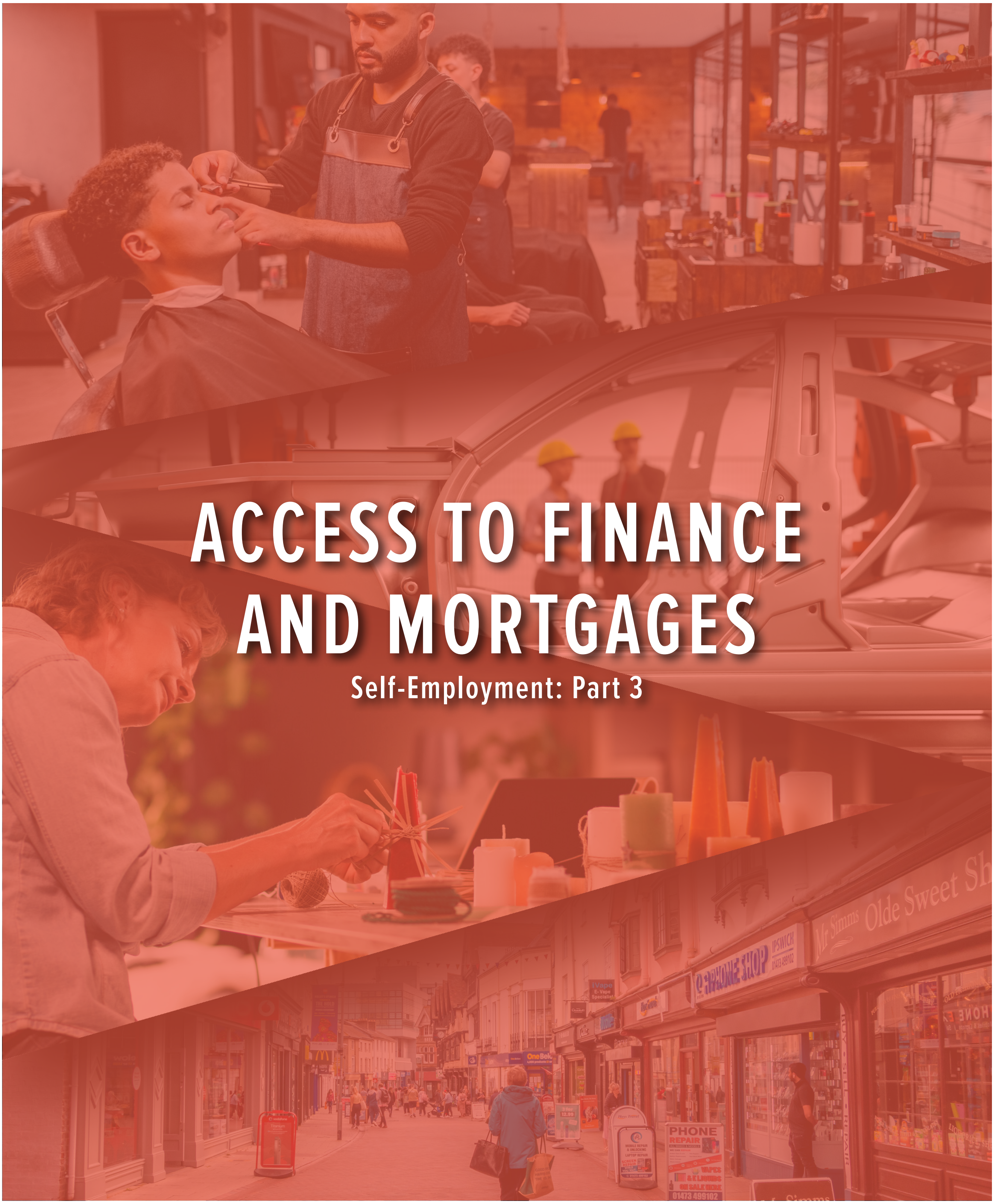

ACCESS TO FINANCE AND MORTGAGES

Self-Employment: Part 3

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Federation of Small Businesses

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WHO WE ARE

The Federation of Small Businesses (FSB) is the UK's grassroots business organisation. We are a cross-party non-profit body that represents small business and self-employed members in every nation and region. For over fifty years, FSB has been the authoritative voice on issues affecting the UK's 5.5 million small businesses, microbusinesses and the self-employed.

FSB is the UK's largest business group and leading business campaigner, focused on achieving change which supports smaller businesses to grow and succeed. We also provide our members with a wide range of vital business services, helping them to start, run, and grow successful businesses through high quality protection and support. This includes 24/7 legal support, financial expertise, training and events, debt recovery and employment/HR advice – alongside a powerful voice heard by governments at all levels.

Our local, national and international activism helps shape policy decisions that have a direct impact on the day-to-day running of smaller businesses. We work for their interests through research and engagement with our members and by effective campaigning - influencing those in power through policy analysis,government affairs, media and public relations activity. Our advocacy work starts with our expert external affairs team in Westminster, which focuses on UK and England policy issues, the UK Government, Parliament and media and communications engagement. Further to this, our teams in Glasgow, Cardiff and Belfast work with governments, elected representatives and media in Scotland, Wales and Northern Ireland.

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FOREWORD

People who decide to take a leap into the unknown by embracing entrepreneurship are taking on many risks – not least that of no longer being able to rely on a secure income.

This has consequences for entrepreneurs' personal finances. Income volatility adds additional barriers to accessing finance products such as mortgages and external finance for their business. This can often be due to not being able to verify past income, or to demonstrate a regular future income, with lenders concerned over the ability of borrowers to afford repayments.

Income volatility also affects levels of home ownership among entrepreneurs. The dream of owning your own home is firmly entrenched in our national culture, but it should not be a privilege reserved for those in conventional employment. However, as this report shows, entrepreneurs face disproportionate barriers to accessing mortgages. From higher rates and premiums, and a greater amount of information required, there is not only a lender bias against entrepreneurs, but a widespread culture of risk aversion amongst lenders that has not kept up with the times or taken into consideration the nature of entrepreneurship.

The number of self-employed people fell sharply following the pandemic; as the recovery in self-employment levels gathers pace, anyone choosing the path of entrepreneurship and being their own boss should not be deterred from doing so by the prospect of greater difficulty in accessing a mortgage or securing funding for their business. As the Government develops its Small Business Strategy for publication later this year, it must cater to the needs of the self-employed.

Entrepreneurs, and their fledgling businesses, face numerous challenges on the road to profitable trading. The impact of their employment status on their ability to get a mortgage, or access other forms of personal finance, should be minimised, to encourage more people to take the leap without worrying that they will be locked out of common financial milestones as a result. Getting this right will enable self-employed people and entrepreneurs to do what they do best – innovate, adapt, and create. By solving the finance conundrum too many entrepreneurs and self-employed people find themselves in, we can help to unlock the growth we need to get the economy on track.

Tina McKenzie
FSB Chair, Policy and Advocacy

ACCESS TO FINANCE AND MORTGAGES

25%
say being an entrepreneur has made it **harder to get a mortgage**

1 in 14
entrepreneurs have taken on an **additional job to pay for their mortgage**

27%
of entrepreneurs with a mortgage have a **variable mortgage**

MOST COMMON TYPE OF FINANCE USED BY ENTREPRENEURS

Bank overdraft: **17%**
(success rate: **81%**)

Credit cards: **16%**
(success rate: **91%**)

Government or local authority grants: **11%**
(success rate: **80%**)

Nearly **2 in 10**
ethnic minority entrepreneurs rely on **financial support from family and friends**, compared to 1 in 10 non-ethnic minority entrepreneurs

18%
say they **did not apply for finance**, because they **did not want to increase business debt**

This figure rises to **26%** for those that **started a business in the last 3 years**

Asset finance has the **highest success rate** of finance **(94%)** for entrepreneurs

Loans from alternative providers had the **lowest success rate** at **76%**

RECOMMENDATIONS

Mortgages

The Prudential Regulation Authority should:

- **Change Solvency II rules to encourage insurers to participate in the mortgage market, increasing competition and delivering lower mortgage rates to small businesses and homeowners.** FSB supports the Tony Blair Institute's recommendation to include life insurers in the UK mortgage market to increase competition, forcing lenders to offer more attractive mortgage products.

Mortgage lenders should:

- **Develop affordability assessment frameworks tailored to self-employed borrowers. This would not only allow the mortgage market to respond to fluctuations in income but also allow self-employed people to save capital and invest it into their business.** Lenders should apply affordability assessments tailored to the self-employed, factoring in fluctuating earnings rather than relying on frameworks designed for those with regular salaries. This will improve how lenders assess affordability and ensure self-employed people are properly considered.
- **Take into account whether a self-employed borrower has income protection insurance and provide them access to lower mortgage rates if so.** Mortgage insurance income protection (MIIP) exists in the UK and mostly covers health issues or redundancy preventing the homeowner from making mortgage repayments. If the self-employed are willing to purchase MIIP, they should be able to access a lower mortgage rate and be given better access to mortgages. Taking out insurance will reduce the risk to the lender if mortgage repayments were to be impacted.
- **Increase the availability and awareness of long-term fixed-rate mortgage loans.** Whilst long-term loans may have a premium attached due to the time frame of the loan, if taken out in a low-interest rate climate, they can offer stability of repayments. Mortgage lenders and broker rules should be amended to clarify that recommending a long-term mortgage is not mis-selling or a breach of consumer duty, even if mortgage rates reduce, as long as the risk is explained to the customer.

The Financial Conduct Authority (FCA) should:

- **Enforce standardised documentation requirements across lenders to simplify the mortgage application process for the self-employed.** Currently it is at the discretion of the lender to decide what information it requires to proceed with an application. A standardised approach across lenders would help the self-employed be better prepared when it comes to which information they will be required to provide to a lender.

Department for Business and Trade should:

- **Address the needs of the self-employed in both the Small Business Strategy and the Business Growth Service.** Where there are deterrents to becoming self-employed, like increased difficulty securing a mortgage or renting a property, the Small Business Strategy could look to address these.

Access to finance

HM Treasury should:

- **Include personal guarantees within scope of the FCA's Consumer Duty, to deter the over-use of personal guarantees by lenders.** Personal guarantees have a legitimate role in lending to businesses, but their over-use can have a chilling effect on the economy, causing limited company directors to put personal assets such as their homes on the line when taking on a loan. According to Bank of England data, 77% of small businesses state they would accept slower growth rather than borrowing to grow faster. This regulatory solution would increase demand for finance by ensuring that the personal guarantee was subject to the Consumer Duty, while keeping lending to limited companies outside the FCA's regulatory remit.
- **Commit to support open finance and recognise its transformational potential for self-employed people and the wider UK economy, jointly with the financial sector.** By committing to smart data initiatives in Government agencies (e.g. HMRC) and in financial institutions, open finance can bring data together in a single dashboard and deliver better financial understanding and outcomes for the self-employed. Open finance can also increase lenders' appetite to lend to self-employed people by generating accurate data to allow them to assess an appropriate financial response on an individual basis without relying on assumptions and profiling.

The British Business Bank should:

- **Increase awareness of mixed equity and debt financing alongside financial institutions.** Entrepreneurial self-employed people who want to take their business to the next stage and grow should be encouraged to explore options for mixed equity and debt financing as a first step into equity. Hybrid financing allows small businesses to familiarise themselves with equity finance whilst still retaining aspects of debt financing. Combining finance types can help businesses reduce the cost of capital. Because debt funding tends to be cheaper than equity, businesses can blend the two to reduce the overall cost of finance as well as reassuring debt providers that funding can be repaid.

- **Encourage uptake of financial products that are targeted at sole traders.** The British Business Bank (BBB), working alongside financial institutions, should promote affordable and available financial products that are designed primarily for the self-employed. The BBB's endorsement of these products would provide the self-employed community with reassurance and certainty that they are appropriate products to consider. These products should be clearly signposted on websites. The BBB's current 'Guide to self-employed loans' has a click depth of four, meaning that an individual has to click on four links to get specifically to that page.

The Financial Conduct Authority should:

- **Commit to creating an agreed benchmark with industry leaders for the uptake of access to credit for women-owned businesses.** All major lenders should be mandated to publish data showing acceptance rates for different demographic groups when applying for finance, to build trust and encourage more applications.
- **Establish an Ethnicity Code to provide a framework for improving lending standards to ethnic minority-owned businesses (EMBs).** FSB supports the recommendation from the All-Party Parliamentary Group (APPG) for Ethnic Minority Business Owners and from the Lending Standards Board to establish an Ethnicity Code, to provide a set of regulated standards that lenders could sign up to in order to commit to reducing barriers and improving access to financial products and services for ethnic minority business owners. Through a regulatory framework for inclusive lending standards, this can address systemic and structural barriers in order to improve access to lending for EMBs, particularly those who are self-employed.
- **Require financial institutions to provide credit reports or credit reference files for all potential borrowers they have rejected.** Currently banks have to provide credit reports only on request. Self-employed people tend to rely on debt finance (such as loans or overdrafts); potential borrowers may not be aware of this service, and risk going to another lender without understanding the potential negative implications to their credit report. The financial system for self-employed borrowers must remove administrative barriers that prevent them from accessing and understanding finance.

Financial lenders should:

- **Provide a relationship manager when 'financing for growth'.** Applying for finance is mostly done online, with limited face-to-face interactions, although many lenders do provide a relationship manager when a certain threshold of borrowing is reached. For many self-employed business owners, this threshold is high, and they miss the opportunity to have personalised expertise for their financing requirements. Providing a relationship manager, whether face-to-face or virtual, to provide advice and expertise can assist entrepreneurs to channel funds into the most appropriate ventures for growth, generate returns, and manage their business debt sustainably.

ACCESS TO FINANCE AND MORTGAGES

This report sheds light on two personal challenges that face the people behind many of our well-loved small enterprises: namely, access to mortgages and other forms of personal finance to achieve common financial milestones, as well as finance to realise their business aspirations.

Self-employed entrepreneurs often face bigger hurdles when looking to obtain a mortgage than employees on permanent contracts. Obtaining and paying for a mortgage can also be a challenge for entrepreneurs, due in large part to fluctuating and uncertain income. From higher rates, premiums, and levels of information required, there is not only a lender bias against the self-employed, but a widespread culture of risk aversion amongst lenders that has not kept up with the times or taken into consideration the nature of self-employment. As the number of entrepreneurs in the UK grows, it is important that mortgages are not a deterrent to those who choose to 'go it alone'.

For many entrepreneurs their business aspirations can only be truly realised by accessing finance to invest in their business. As our research has highlighted, 45 per cent of entrepreneurs see building wealth as a benefit of entrepreneurship.

Finance is crucial for new entrepreneurs and those seeking to undertake growth-oriented activities, enabling them to realise their business aspirations and expand. Sole traders and microbusinesses whose cash holdings are much smaller than small or medium enterprises require access to finance. Many entrepreneurs lack the capacity to self-finance, especially entrepreneurs with limited networks for accessing informal funds from family and friends. In addition, the self-employed often lack the resources or time to navigate the increasingly complex financial landscape. These problems can be particularly significant for entrepreneurs in certain parts of the UK and for minority entrepreneurs.

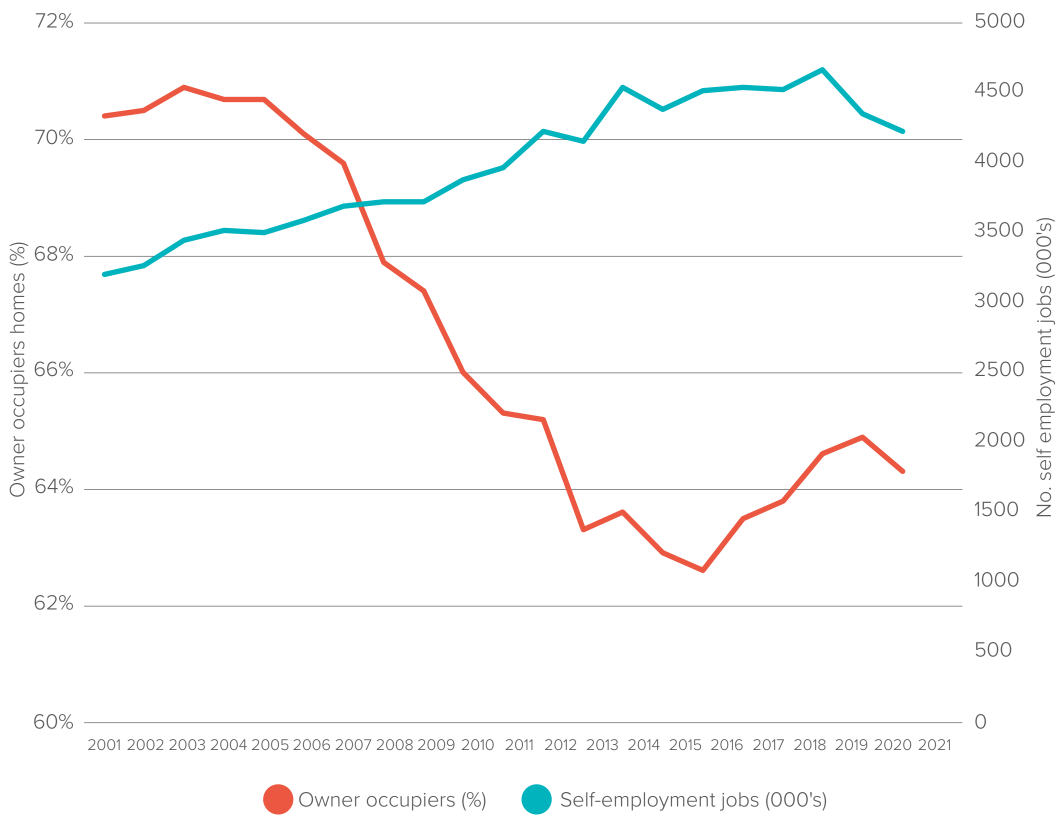
Entrepreneurs need confidence and support from lenders so that they can access affordable finance. However, at present, many are deterred from growing their business out of fears of accumulating business debt, a lack of trust towards lenders, and a sense of discouragement. These factors need to be addressed to ensure entrepreneurs can obtain affordable and accessible financial products to allow them to grow and invest in their businesses.

MORTGAGES FOR ENTREPRENEURS

As the number of entrepreneurs in the UK has grown cumulatively over the last decade, the percentage of individuals who own their own homes has been in decline. The UK mortgage market has remained resilient despite weathering a period of economic turmoil, and yet it has not evolved to adapt to the changing structure of the UK workforce and the need for a dynamic, innovative economy.

Figure 1: Owner-occupied homes in the United Kingdom

Source: Statista: property tenure distribution; ONS: UK Self-employment jobs, Labour Market Statistics



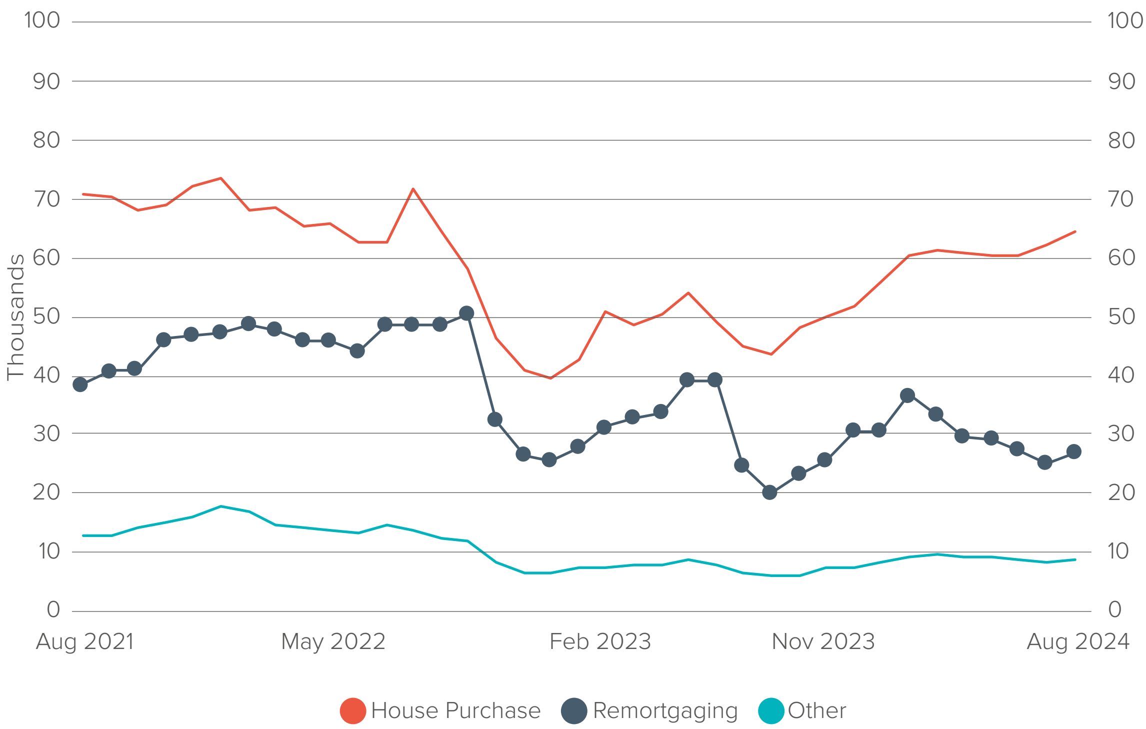
The difficulties that many entrepreneurs face in accessing affordable finance are also reflected in the experience of entrepreneurs trying to get a mortgage. At present, there is very little by way of public and private sector support or initiatives to address the barriers that entrepreneurs find when applying for a mortgage or making repayments.

The UK is experiencing a housing shortage and significant affordability issues that are rooted in the mortgage market. In 1999, the median house in England cost 4.4 times median income, compared to an exorbitant 8.3 times income in 2023.[1] With entrepreneurs having to have autonomy over their business finances, home ownership and managing a mortgage are out of reach for many.

1 ONS, Housing purchase affordability, UK https://www.ons.gov.uk/peoplepopulationandcommunity/housing/datasets/housingpurchaseaffordabilityingreatbritain

Figure 2: Approval of loans secured on dwellings

Source: Bank of England, Money and Credit August 2024 Statistical Release, Table E



The predominant mortgage offered in the UK is the fixed interest rate mortgage, typically offered for between two and five years, and making up 74 per cent of the mortgage market. The remaining 26 per cent are variable-rate mortgages.[2] FSB research found the rate of entrepreneurs with variable-rate mortgages is slightly higher than the national average, at 27 per cent. Variable mortgages, coupled with entrepreneurs' often variable monthly income, makes it more difficult to manage finances, with 42 per cent of entrepreneurs identifying income volatility as one of the main challenges of being in business.

Some entrepreneurs may have chosen a variable rate mortgage because it offered a more suitable deal at the time, particularly in the previous years of low rates; between 2020 and 2022, for example, variable interest rates on mortgages in the UK averaged 2.7 per cent.[3] For others, it may have been a default choice, as they could not commit to a fixed-rate mortgage due to the instability of their income, or as they came to the end of a fixed-term mortgage and were automatically enrolled onto a variable-rate mortgage instead.

2 Financial Conduct Authority, Switching in the Mortgage Market – Update, August 2022 https://www.fca.org.uk/publication/research/switching-in-the-mortgage-market-update-august-2022.pdf

3 Monthly average effective interest rate of all mortgages broken down by interest rate type and Official Bank rate, UK, 31 January 2004 to 3 November 2022. Source: Bank of England - Effective Interest Rates & Official Bank rate

FSB data show that 21 per cent of entrepreneur homeowners with a mortgage are on a fixed-rate mortgage that was due to end before 2025. For that one in five, there remains the possibility of remortgaging onto a higher rate. The Bank of England's current forecast, as of November 2024, expects the bank rate to be cut to 3.7 per cent by Q4 2025 and to remain at 3.7 per cent by Q4 2026, with some mortgage holders expected to see increased monthly mortgage payments when their current deal ends. FSB data show that 12 per cent of entrepreneurs with a mortgage have already remortgaged onto a higher rate in the last two years compared to their previous rate. An estimated 1.8 million households across the UK had fixed deals end in 2023.[4] The pressure on household finances has seen an uptick in mortgage arrears, with an estimated 105,600 cases of arrears in 2023 expected to rise to a predicted 128,800 by the end of 2024.[5]

Figure 3: Entrepreneur homeowners with mortgages

Source: FSB, Self-employment and start-up survey, 2023

All interviews	Percentage
I have a fixed rate mortgage that will end after 1st January 2025	42.4%
I have a variable rate mortgage	26.9%
I have a fixed rate mortgage that will end before 1st January 2025	20.8%
I have remortgaged in the last two years with an interest rate higher than the rate I was on beforehand	12.3%
None of the above	5.6%
I was offered a higher interest rate compared to what I expected	2.5%
I was offered a lower interest rate compared to what I expected	1.6%

Throughout periods of rising interest rates, there is the risk of repayments becoming unaffordable as homeowners refinance onto a higher interest rate. One solution is for mortgage lenders to increase the availability of long-term fixed-rate mortgages, such as fixing the rate with a particular lender for 10 or 15 years. While long-term deals may have a premium attached to them due to the timeframe of the loan, if taken out in a low interest rate climate, they can offer stability of repayments. Mortgage lenders' and brokers' rules should be amended to clarify that recommending a long-term mortgage is not mis-selling or a breach of consumer duty, even if mortgage rates fall, if the risk is explained to the customer.

4 UK Finance, "Mortgage Market Forecast for 2023-2024", December 2022 https://www.ukfinance.org.uk/news-and-insight/press-release/mortgage-lending-fall-15-cent-next-year-returning-pre-pandemic

5 UK Finance, "Housing and Mortgage Market Forecast for 2024-2025" , December 2023 https://www.ukfinance.org.uk/news-and-insight/press-release/mortgage-lending-fall-in-2024

Renting

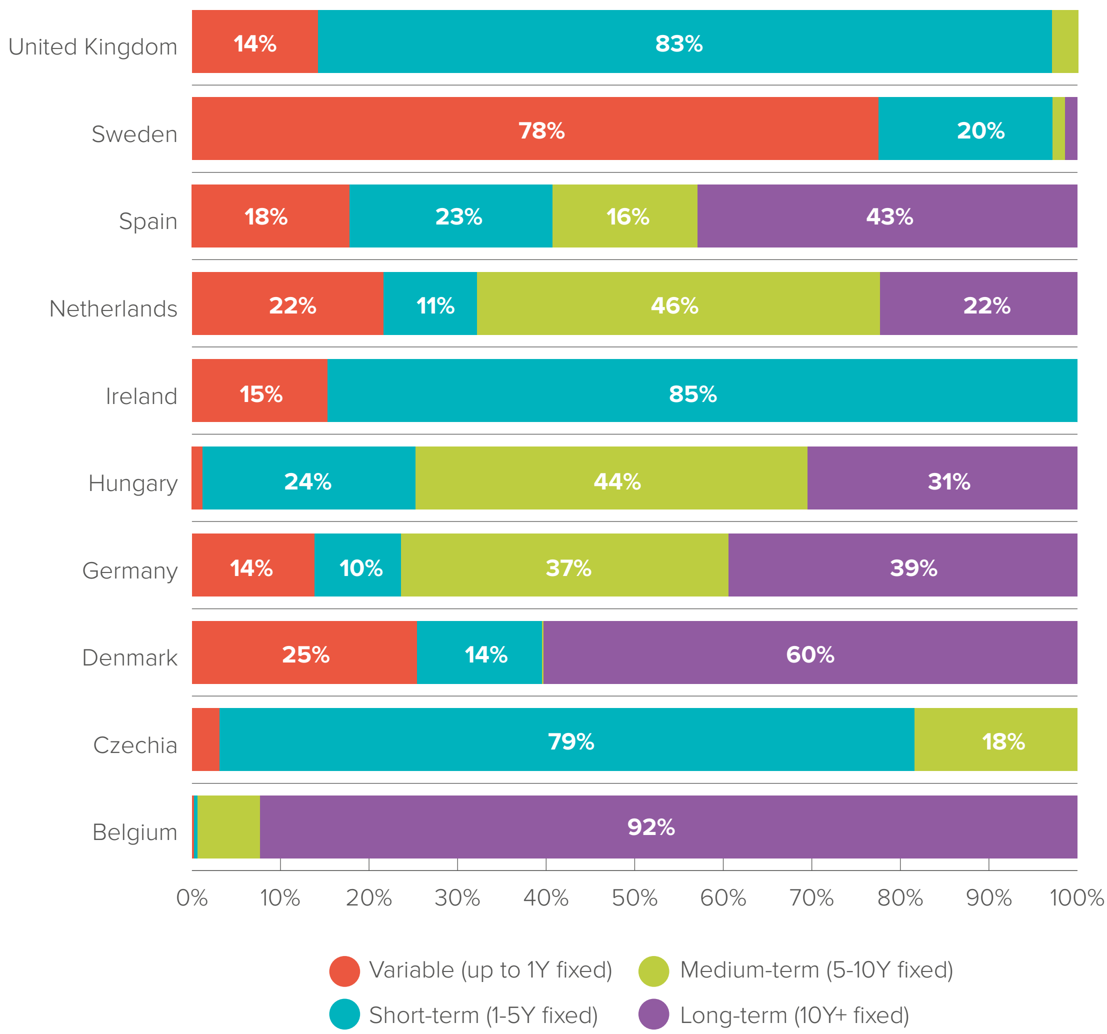
One in six (16%) self-employed individuals rent; however, this figure is more than doubled to 34 per cent for self-employed people who are under 40 years of age. This aligns with the national trend of rates of home ownership among young adults falling over recent decades.

Renting can present a barrier to entrepreneurs. Self-employed renters may find landlord preferences and acceptance of reference checks are skewed to PAYE employee renters, a similar experience as those who are applying for mortgages. This may delay or deter their plans to become fully self-employed and encourage them to maintain dual incomes from a PAYE job to improve their rental prospects.

Renting may also reduce the range and value of loans offered to self-employed people, such as secured loans which are offered against personal guarantees or assets pledged as collateral. In the ‘Access to finance’ section below, we look at the impact of personal guarantees on entrepreneurs and small businesses.

Figure 4: Mortgages by term in various countries

Source: European Mortgage Federation Data (new loans), Bank of England - Distribution of balances within effective interest rates (UK only)



The mortgage market in the UK is predominantly operated through banks and building societies, which are reliant on short-term deposit funding. In other advanced economies, such as Australia and Canada, life insurers play a key role in funding for long-term fixed rate mortgages, as they are a buyer of bonds that back these products (e.g. government 10- or 15-year bonds). Including life insurers in the UK mortgage market could increase competition, forcing lenders to offer more attractive mortgage products.

Currently, life insurers in the UK do not hold long-term assets due to Solvency II regulations making it unattractive. Since if there were a mismatch in the maturity of assets and liabilities held, the life insurer would be ineligible for lower capital requirements. A mismatch between assets and liabilities may occur if a borrower repays their mortgage earlier than planned, for example. If insurers were allowed to hold these mismatches between longer-term mortgage products, deposit finance and other short-term liabilities which are the usual source of bank financing, then they could provide lending terms designed to reflect borrowers' objectives and interests.

FSB supports the recommendation from the Tony Blair Institute, calling for the Prudential Regulation Authority (PRA) to adjust Solvency II regulations to allow for life insurers with prepayment risk to be eligible for the matching adjustment if capital is provided to insure against the prepayment risk.[6]

One of the challenges that many entrepreneurs face is the widespread experience and justified belief that lenders have a bias against providing mortgage loans to entrepreneurs as opposed to those who are classified as employed and earning wages. FSB research found one in four (25%) entrepreneurs who have a mortgage report that it was difficult to obtain, and for those who do manage to obtain a mortgage, they say they are faced with additional burdens of higher rates and less favourable terms.

> **"The amount of information you need to collect can feel overwhelming. You need to provide many lists of information from business and personal account statements to how much you have on other outstanding loans such as a car. There are additional fees you may need to prepare for such as if the mortgage company comes and pays a visit to your property."**
>
> FSB member, health and wellness business, Somerset

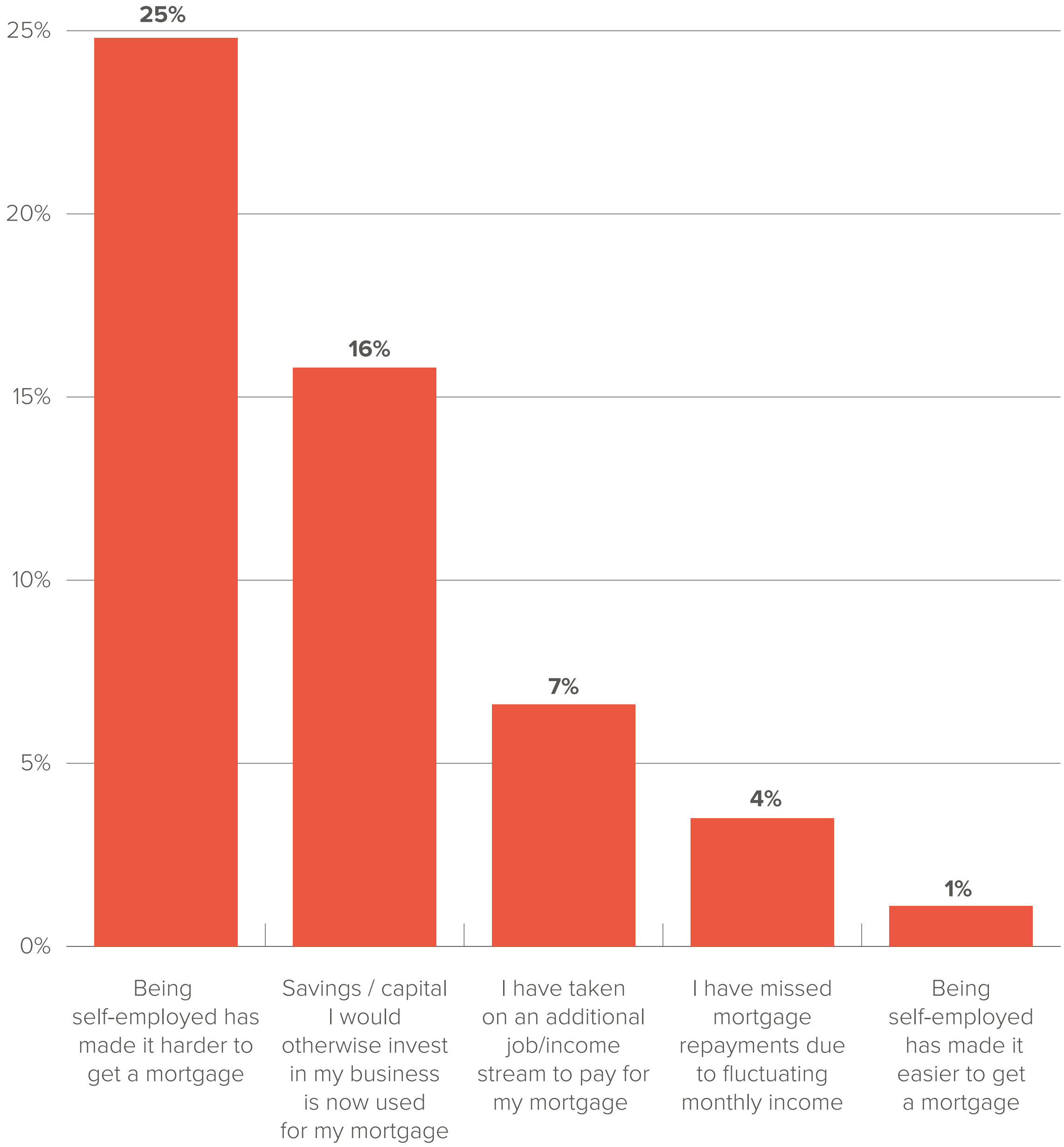
As also mentioned in relation to access to finance, below, the frustrations and experiences of entrepreneurs when dealing with lenders can be mitigated by lenders and brokers providing suitable expertise and support to entrepreneurs. Mortgage lenders should be trained to understand the financial perspectives of entrepreneurs, or have dedicated specialists to assist the self-employed. At a minimum, lenders should operate in a system where if they choose to reject entrepreneurs for a mortgage, they should offer follow-up support by recommending alternative lenders or referrals.

6 Tony Blair Institute, Raising Home Ownership by Reforming Mortgage Finance, May 2022 https://www.institute.global/insights/economic-prosperity/bringing-it-home raising-home-ownership-reforming-mortgage-finance

FSB's 2022 report on the insurance market for small businesses, *Paying a Premium?*, found that one in ten (11%) small business owners say they have income protection insurance, which covers an individual in the event of not being able to work due to illness, and can include mortgage cover.[7] For entrepreneurs, those who choose to have mortgage protection insurance should be able to access lower rates or be offered more favourable mortgage terms. However, eligibility conditions are strict, and this can act as a barrier for entrepreneurs when trying to arrange this type of cover in addition to the high premiums they may be obliged to pay.

Figure 5: Challenges experienced by homeowners with a mortgage

Source: FSB, Self-employment and start-up survey, 2023



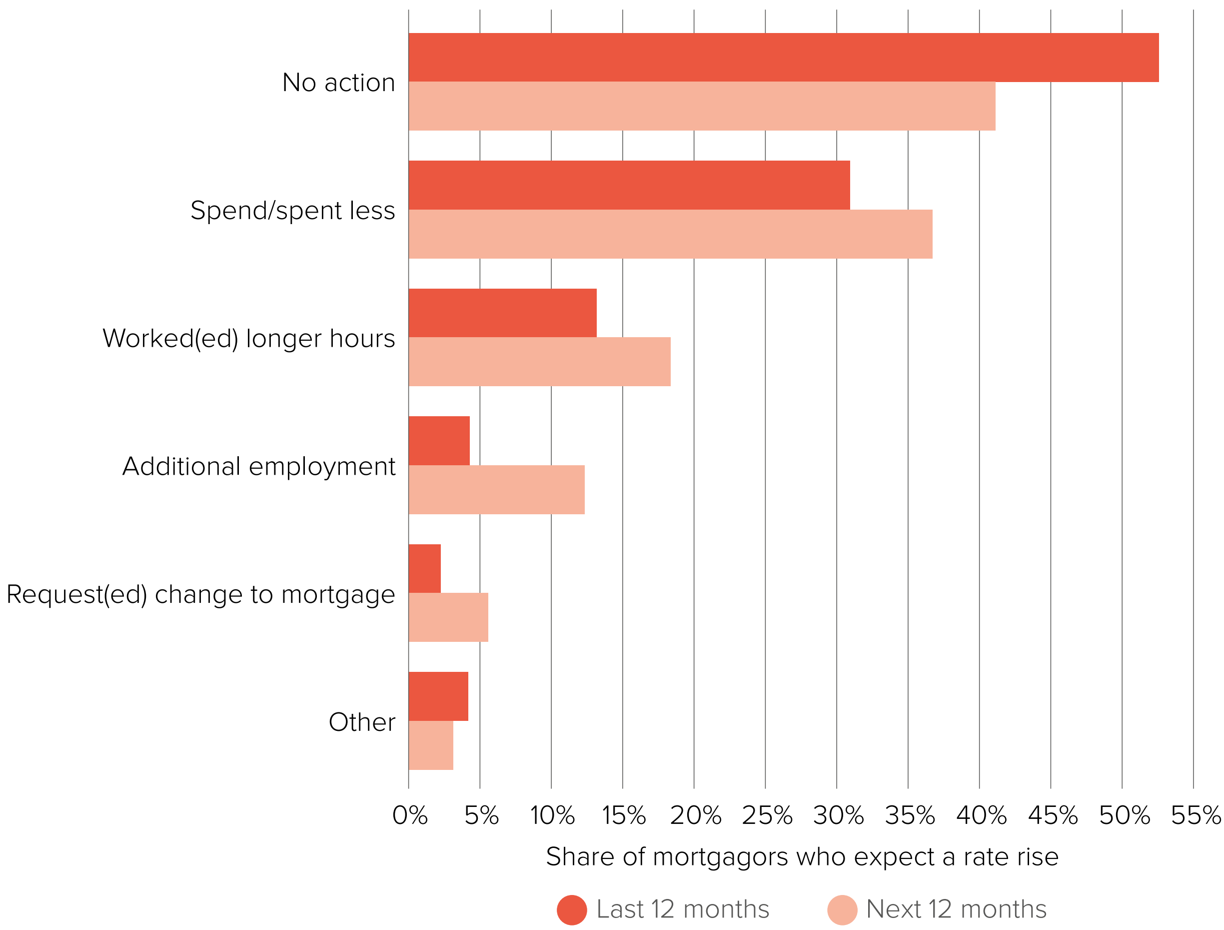
7 FSB, *Paying a Premium?*, July 2022 https://www.fsb.org.uk/resource-report/paying-a-premium.html

FSB research shows that approximately one in six (16%) entrepreneur homeowners spend capital that they would have otherwise invested into their business on their mortgage instead. It is likely that this has been exacerbated by rising interest rates over recent years. The average detached UK property saw its monthly mortgage rise to £2,041 in 2022 (up 60.7% on December 2021), and the average semi-detached property saw monthly mortgage costs rise by 61 per cent to £1,262.[8] Of the estimated 1.6 million self-employed people who have a mortgage, an estimated 260,000 therefore had to reduce their business capital to maintain mortgage repayments. This quarter of a million businesses could instead be increasing in scale and productivity.

Moreover, FSB data found one in fourteen (7%) entrepreneur homeowners have taken on an additional job to pay for their mortgage. Similarly, Bank of England data showed that over the last 12 months, roughly 18 per cent of mortgagors who are bracing for a rate rise have taken on additional employment in anticipation (see Figure 6). By reducing their own utilisation of human capital to run their business, entrepreneurs also reduce their opportunities to innovate and grow their business.

Figure 6: Actions taken by mortgagors in anticipate of higher mortgage rates

Source: Bank of England biannual household survey, December 2023



8 ONS, "Monthly mortgage repayments up 61% for average semi-detached home in the UK", www.ons.gov.uk/peoplepopulationandcommunity/housing/articles/monthlymortgagerepaymentsup61foraveragesemidetachedhomeintheuk/2023-03-08

"A customer had been self-employed in the film industry for the last 20 years. He wanted to remortgage his current property to a new lender on a better rate. The mortgage application was submitted. The latest two years' signed business accounts were required by the lender. When assessed by the lender they asked why there was a significant decrease in turnover, profit and s hareholder's funds in the latest year's accounts. I explained this was due to the Actors' Strike from May to November 2023 that had affected the entire industry. The lender did not accept this explanation. We were unable to find another lender and the customer had to remain with the existing lender on a new rate but at a less competitive price."

FSB member, financial services, Cornwall

Recommendations

The Prudential Regulation Authority should:

- **Change Solvency II rules to encourage insurers to participate in the mortgage market, increasing competition and delivering lower mortgage rates to small businesses and homeowners.** FSB supports the Tony Blair Institute's recommendation to include life insurers in the UK mortgage market to increase competition, forcing lenders to offer more attractive mortgage products.

Mortgage lenders should:

- **Develop affordability assessment frameworks tailored to self-employed borrowers. This would not only allow the mortgage market to respond to fluctuations in income but would also allow for self-employed people to save capital and invest it into their business.** The majority of mortgage lenders already consider an entrepreneur's income over a longer-term period typically two years of trading, to allow for seasonality in income. Mortgage lenders may also recognise one size does not fit all and therefore different lenders have innovative ways of supporting these customers. Encouraging affordability assessment frameworks specific to the self-employed will improve how lenders approach assessing affordability and ensure that the self-employed are considered within their lending capacity.

- **Take into account whether a self-employed borrower has income protection insurance and provide them access to lower mortgage rates if so.** Mortgage Insurance Income Protection (MIIP) exists in the UK and mostly covers health issues or redundancy preventing the homeowner from making mortgage repayments. If the self-employed are willing to purchase MIIP, they should be able to access a lower mortgage rate and be given better access to mortgages. Taking out insurance will reduce the risk to the lender if mortgage repayments are impacted.

- **Increase the availability and awareness of long-term fixed-rate mortgage loans.** While long-term loans may have a premium attached due to the time frame of the loan, if taken out in a low-interest rate climate, they can offer stability of repayments. Mortgage lenders and brokers' rules should be amended to clarify that recommending a long-term mortgage is not mis-selling or a breach of consumer duty, even if mortgage rates reduce, as long as the risk is explained to the customer.

The Financial Conduct Authority should:

- **Enforce standardised documentation requirements across lenders to simplify the mortgage application process for self-employed individuals.** Currently, it is at the discretion of the lender to decide what information it requires to proceed with an application. A standardised approach across lenders would help the self-employed to be better-prepared with regard to the information they will be required to provide to a lender.

The Department for Business and Trade should:

- **Address the needs of the self-employed in both the Small Business Strategy and the Business Growth Service.** Where there are deterrents to becoming self-employed, like increased difficulty securing a mortgage or renting a property, the Small Business Strategy could look to address these.

ACCESS TO FINANCE

Entrepreneurs rely on external finance to help them grow. In the last two years, the most common types of external finance used by those running their own businesses include bank overdrafts (17%), credit cards (16%), government or local authority grants (11%), financial support from family/friends (9%) and a traditional bank loan (8%) (Figure 1). Many entrepreneurs initially seek debt finance as they simply require funding to get their business to the next step. The choice of finance is also influenced by the success rate of applications; for example, bank overdrafts and credit cards have above-average success rates (Figure 1).

> **"Lenders don't want to lend these days. You have to spend time looking for a willing lender and if you find someone, they offer higher rates than otherwise."**
>
> FSB member, entertainment sector, Wales

Figure 7: Types of finance entrepreneurs have applied for in the last two years
Source: FSB, Self-employment and start-up survey, 2023

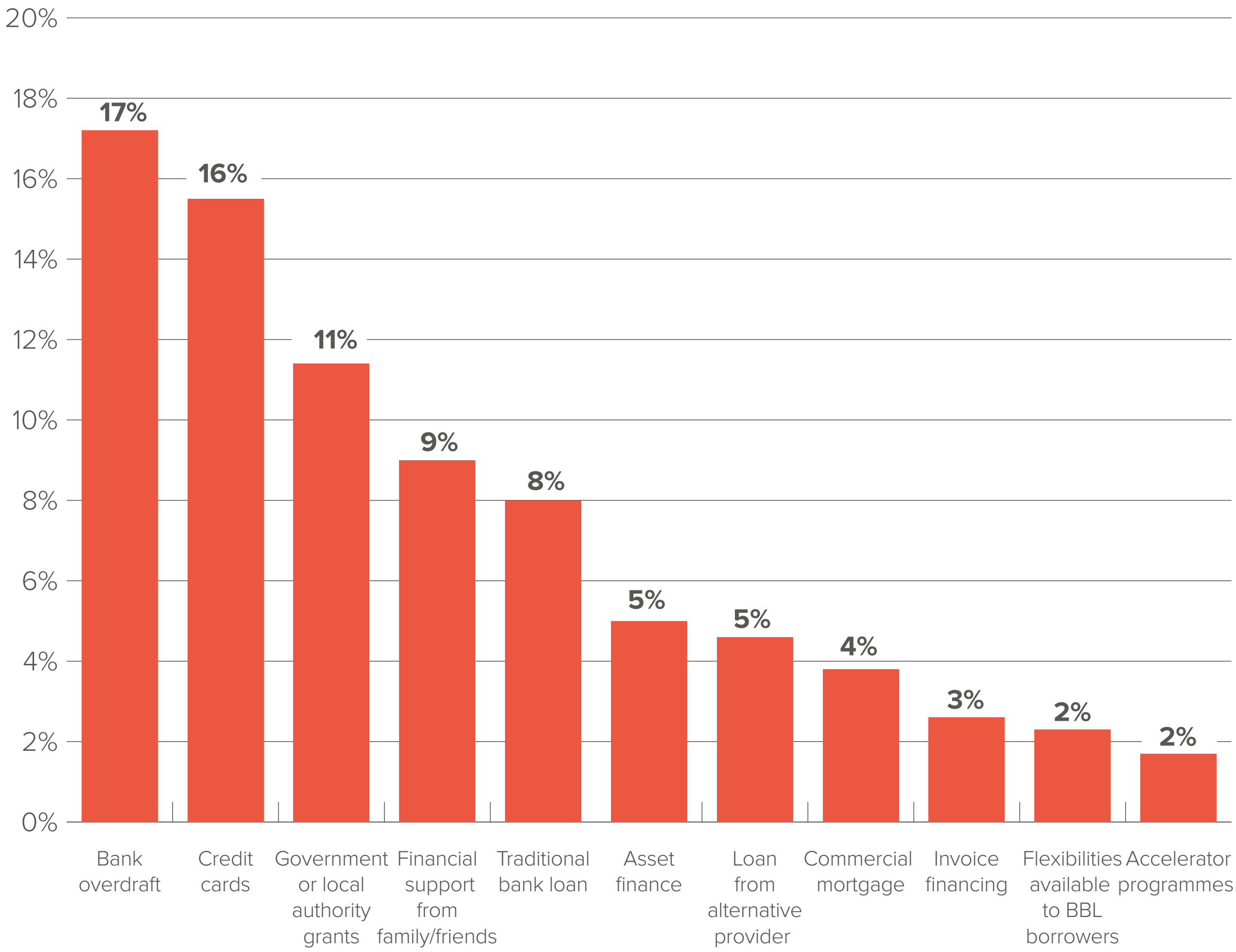
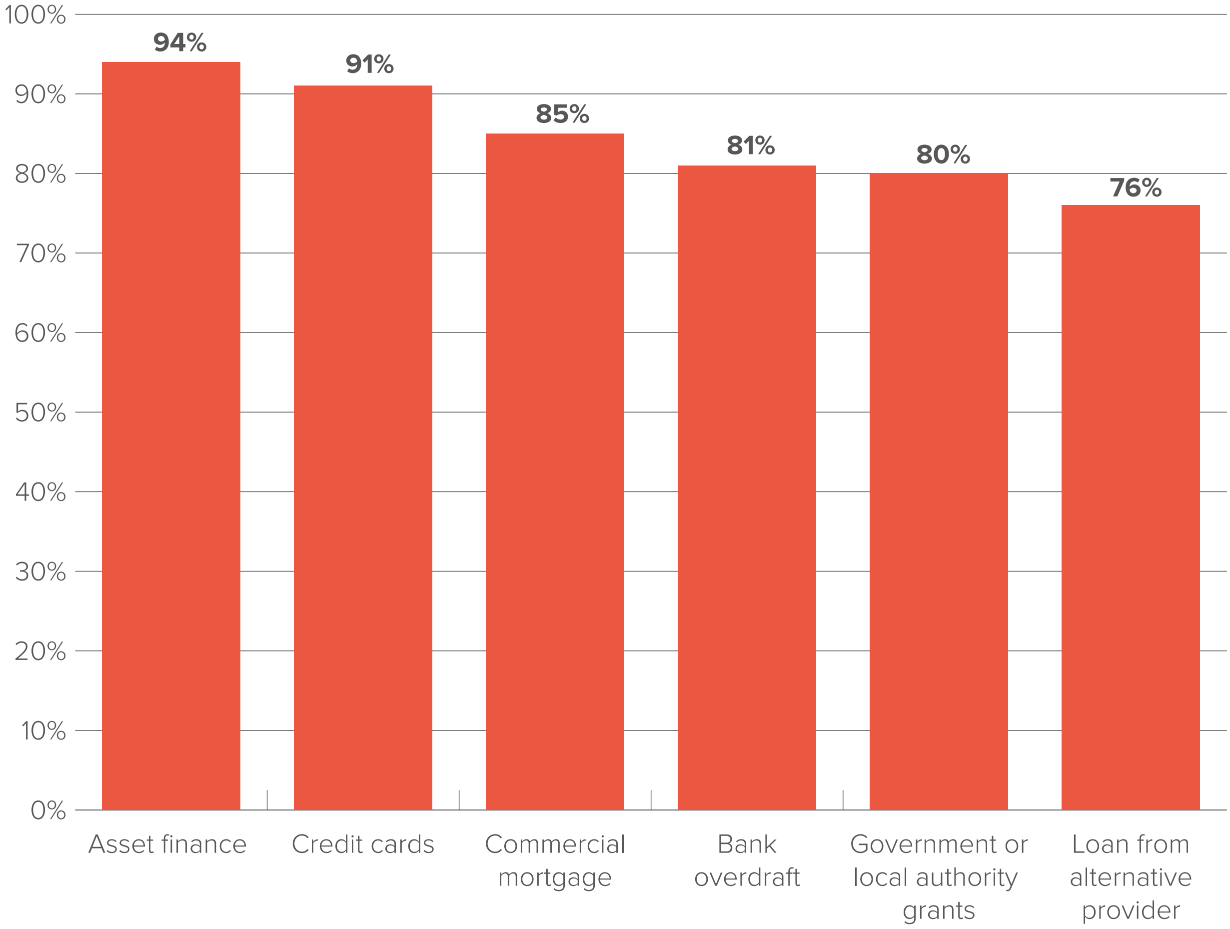


Figure 8: Success rate of finance applied for in the last two years

Source: FSB, Self-employment and start-up survey, 2023



Findings from FSB's 2022 report on small businesses and finance, *Credit Where Credit's Due*, demonstrated that small businesses are most likely to apply for traditional debt finance, with only four per cent of small businesses applying for equity. This preference for debt finance has continued; FSB data shows that in the last two years, only one per cent of entrepreneurs applied for equity finance.

Several factors may help to explain low equity take-up, such as that equity finance is perceived as more complex than other forms of finance. Other factors may be that only half (49%) felt fully aware of the different types of financing options available to their business.[9] For many business owners, time constraints and the responsibility of running a business mean that they do not have the time or resources to adequately research the suitable finance options available. However, another factor is the structure of their business; unincorporated businesses such as sole traders cannot access equity finance as the founder cannot issue shares as a sole trader.

9 FSB, *Credit Where Credit's Due*, December 2022 https://www.fsb.org.uk/resource-report/credit-where-credit-s-due.html

Lenders, as well as the Government can take more proactive action to improve the accessibility of equity finance for entrepreneurs whose business structure allows them to receive equity financing and who want to scale up their business. More support and information should be given to entrepreneurs as they grow their business and restructure, as they may transition to equity financing through using hybrid schemes which blend debt and equity finance.

Geographical differences and access to finance

Access to finance is a widespread issue for small business owners across the United Kingdom and regional differences impact the decisions entrepreneurs make regarding how and why they choose to access finance.[10] One factor that influences choice of finance is the advice received; in Scotland, data shows only 35 per cent of start-ups feel they have access to sufficient financial advice, compared to 65 per cent of those operating for two years or longer. In addition, 43 per cent of sole traders in Scotland do not feel they have access to sufficient financial advice, compared to 31 per cent of limited companies.[11]

Entrepreneurs prefer to stick to forms of finance they are familiar with, which have straightforward processes and high rates of approvals. In Wales, the most common choice of finance was bank overdrafts at 29 per cent, well above the UK average of 17 per cent. For Scotland, similarly, the most common choice of finance was a bank overdraft, at 18 per cent, close to the UK-wide average.

In Northern Ireland, two in five (40%) SMEs stated they thought it would be difficult for their business to obtain finance. This impacts SME behaviour, with three in five (61%) stating they would be less likely to apply for finance if the cost of credit increased.[12] Northern Ireland's entrepreneur population, whilst continuing to grow to 114,000 individuals as of Q2 2024, is still down 15.9 per cent compared to the pre-pandemic population, and access to affordable finance is a key component in encouraging its self-employed population to grow. [13]

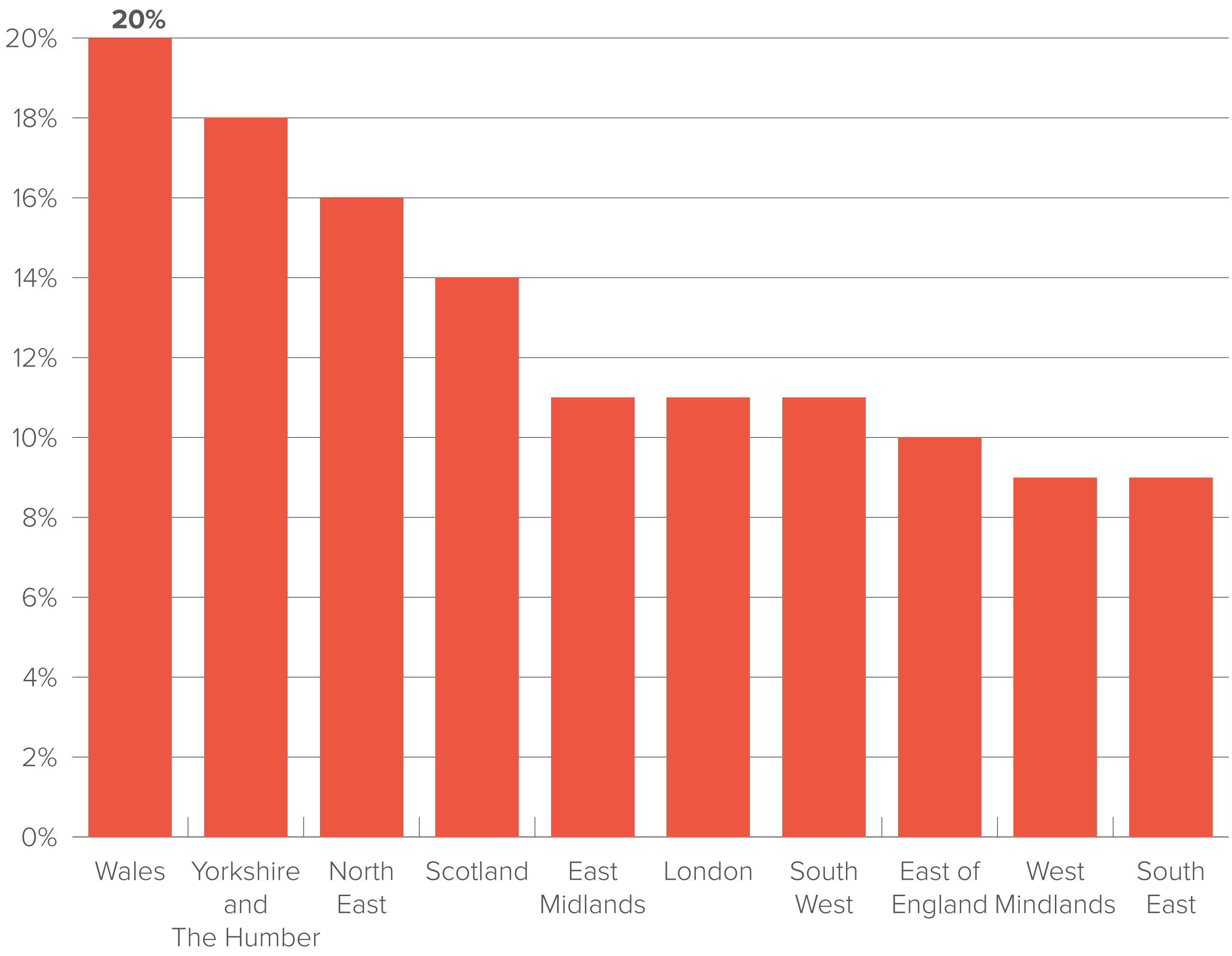
Regional and devolved differences emerge with government or local authority grants, which offer a variety of support schemes for entrepreneurs and start-ups. Growth hubs have become a valuable way of signposting the local and regional business support available to entrepreneurs. However, funding arrangements vary across different programmes and local authorities. For entrepreneurs who applied for government and local authority grants, the UK average was 11 per cent (see Figure 7). For Wales, this figure was nearly double at 20 per cent, with Scotland also above the UK average at 14 per cent (Figure 9). The regional breakdown shows that Yorkshire and the Humber (18%) have higher applications compared to the South East at only 9 per cent.

10 Sample size for Northern Ireland is insufficient for accurate reporting
11 FSB, *Big Small Business Survey*, June 2023 https://www.fsb.org.uk/resources-page/big-small-business-survey.html
12 BVA BDRC SME Finance Monitor, Devolved Nations and English Regions Q4 2022 https://www.bva-bdrc.com/sme-finance-monitor/
13 Northern Ireland Labour Market Report, July 2024 https://datavis.nisra.gov.uk/economy-and-labour-market/labour-market-report-july-2024.html

Devolution, whilst an important lever for regional economic growth, must ensure coordination. Grants for entrepreneurs at the local authority level can be tailored appropriately to their local labour market, but must achieve a consistent rate of take-up and success across the UK. Local authorities should publish the outcomes of their grant applications and work together to ensure that a strong and consistent uptake of grant applications occurs across the UK.

Figure 9: Government and Local Authority grants entrepreneurs have applied for in the last two years, by region

Source: FSB, Self-employment and start-up survey, 2023



Personal guarantees

Personal guarantees are a legal agreement included in some loan contracts, whereby the borrower becomes personally liable for repaying the loan if the business defaults on its repayments or becomes insolvent. FSB has heard increasing complaints from the small business and self-employed community around how personal guarantees have been imposed on them, even for relatively small loans. There has been an uptick in lenders adopting an overly risk-averse approach to lending capital, including by becoming much more likely to demand personal guarantees on small loans. Self-employed individuals are put off from proceeding with loan applications, thereby either forgoing the capital necessary to grow or being forced to seek out more expensive forms of funding.

FSB raised these concerns in a super-complaint issued to the FCA in late 2023, requesting that the FCA undertake a data exercise to understand exactly how personal guarantees are imposed and enforced, given the unregulated and limited oversight of them.[14] Personal guarantees play a role in the lending landscape; for small business owners who take on a large loan with only a limited credit history, a relatively new business and no assets to provide as collateral, a proportional personal guarantee may provide them with the opportunity to access capital. However, proportionality must be fair across all amounts of lending; if entrepreneurs only require a small loan and cannot access the funds they need without agreeing to a personal guarantee, this has a chilling effect on borrowing. Personal guarantees sit in a 'twilight zone' in terms of regulation, as they turn a loan to a limited company into a personal liability, yet the individual borrowers are not covered by the consumer protections that rightly exist for other kinds of lending.

"My business experienced a significant shock when the market got into difficulties and clients fell away. I had to make two people redundant as a result. I didn't want to wind the business up or reduce it in size any further, but I found that banks were unwilling to lend. I then found a loan provider under the Recovery Loan Scheme. Under the terms available, I had to borrow £25,001 even though I only really needed £20,000.

The personal guarantee was on page 40 of the documentation, and I didn't realise at the time that I was responsible for all the amount rather than the 30% which the government wasn't guaranteeing under RLS. If I had known this, I would most likely have made all of the staff redundant and tried to keep the business going by myself."

FSB member, digital marketing, North East

14 FSB, "Super-complaint calls out banks' use of harsh personal guarantees which can force small business owners to put their homes on the line", December 2023 https://www.fsb.org.uk/resources-page/super-complaint-calls-out-banks-use-of-harsh-personal-guarantees-which-can-force-small-business-owners-to-put-their-homes-on-the-line.html

> **"Initially, I kept the business going but as time passed it was obvious that the business could not be turned round, so I decided to wind it up. On doing this, I was sent an e-mail demanding repayment of the balance owed, but I missed it due to being busy with the business wind-up and shutting down IT systems. I only realised that I was being pursued for the whole amount when I received a pre-action court letter in the post later.**
>
> **This experience has taken a toll on my mental health, and I am planning to use this as evidence in challenging the debt as I do not believe it is fair that I am being pursued personally for the whole amount."**
>
> FSB member, digital marketing, North East

Entrepreneurs are generally considered riskier to lend to and are often at the whim of the lender when it comes to the extent to which credit will be offered. Many struggle to find a lender, and for some the only lenders that will provide them with credit are those who offer a blanket policy of taking personal guarantees regardless of the loan amount. Entrepreneurs in general also have limited funds to take protective measures against personal guarantees, and may not have the ability to take out insurance to cover their personal guarantee, which is often an unnecessary additional expense in cases where the guarantee relates to a loan which is easily affordable for the borrower. In addition, to avoid any scenario where a personal guarantee is called upon, entrepreneurs may run their business in an overly-cautious fashion, limiting their entrepreneurial ambition and innovative drive.

There has been no central data-gathering exercise taken to date on personal guarantees, despite the negative, life-changing impacts personal guarantees can have on those who find them called upon. The FCA's regulatory perimeter does not cover personal guarantee lending, even though loans backed by personal guarantees can be viewed as a type of personal lending as the risk falls on the individual director. FSB is calling for the Treasury to expand the regulatory perimeter to include all personal guarantees within the Consumer Duty, and for the Financial Ombudsman Service (FOS) to consider backdating its remit to earlier than 2019, given the lag between when personal guarantees are imposed at the outset of a loan period, and when they are called upon. The Government's Industrial Strategy and the upcoming Small Business Strategy are prime opportunities to address the significant barrier to growth and investment that the over-use of personal guarantees is causing.

Ethnic minority businesses

Ethnic minority businesses (EMBs) rely on financial support from family and friends at nearly double the rate for non-EMBs entrepreneurs, at almost two in ten (17%) compared to non-EMBs' rate of one in ten (9%) (Figure 10). FSB research also shows EMBs are less likely to have applied for a traditional bank loan compared to non-EMBs (2% vs 8%). There is a notable disparity between EMBs and non-EMBs when it comes to using overdrafts in the last two years, with seven per cent of EMBs stating they have used an overdraft compared to 18 per cent of non-EMBs.

The Centre for Research in Ethnic Minority Entrepreneurship (CREME) has called for a focus on tackling the perception of barriers to finance amongst EMBs, as this could significantly increase EMBs' uptake of bank finance and help them grow. CREME[15] found:

> **'Although EMBs in the UK have broadly equal access to bank finance products, comparable to SMEs, EMB owners are more likely to think it is difficult to access finance and are often discouraged from applying for finance for fear of rejection. The perception of barriers itself is a major obstacle, potentially preventing many ambitious entrepreneurs who would otherwise be accepted for finance from seeking support they need to develop.'**

Interestingly, FSB data suggests ethnic minority entrepreneurs use a combination of community and technology, with five per cent of EMBs stating they use peer-to-peer lending/crowdfunding in comparison to one per cent of non-EMBs. Previously investors have been limited to comparatively wealthy individuals and institutions who tend to ring-fence their investments into a select number of entrepreneurial businesses. However, in recent years UK crowdfunding has received boosts from the Enterprise Investment Scheme and the Seed Enterprise Investment Scheme, which offer generous tax incentives to UK-resident individual taxpayers to invest in young companies. By expanding the opportunities for more UK residents to become involved in crowdfunding, coupled with the increase in impact investing, entrepreneurial EMBs can benefit from increased capital and scale up.

> **"Crowdfunding offers an alternative source of external financing to help entrepreneurs fund early-stage projects. Like other forms of alternative financing, crowdfunding has become increasingly appealing to small and medium-sized enterprises because of widespread retrenchment in traditional bank credit since the financial crisis."[16]**

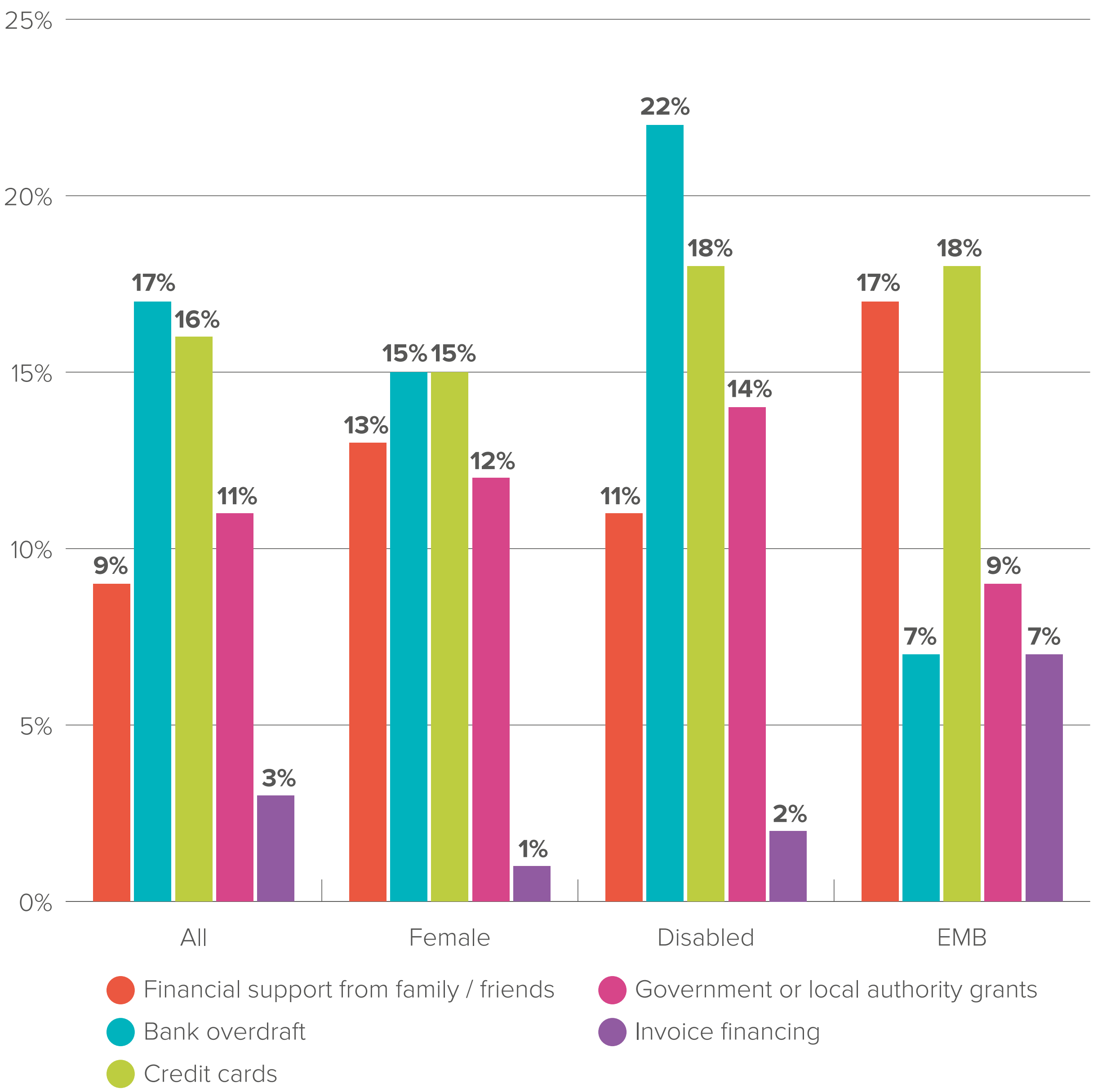
15 CREME and NatWest, Time to Change: A Blueprint for advancing the UK's Ethnic Minority Businesses, 2022, https://www.natwestgroup.com/news-and-insights/latest-stories/diversity-equity-and-inclusion/2022/may/advancing-the-growth-potential-of-uks-ethnic-minority-businesses.html

16 Desamparados Cervantes-Zacarés, Myriam Martí-Sánchez, Marcos Pascual-Soler, José-Miguel Berné-Martínez: "The relevance of crowdfunding in the entrepreneurial framework from a specialized media perspective", Journal of Business Research, Volume 158, 2023, https://www.sciencedirect.com/science/article/abs/pii/S0148296323000231

> "Starting a new business and relying on my savings meant I ran out of money, when I reached out to my local bank for finance they put me on the former New Enterprise Allowance program.
>
> As part of the program, I was given a mentor who helped me apply for finance. I had never written a business plan before, and my mentor highlighted the importance of writing a business plan in order to get funding. With the funding I received, I was able to get my business off the ground."
>
> FSB member, Professional services, London

Figure 10: External finance comparison by demographic breakdown

Source: FSB, Self-employment and start-up survey, 2023



Recommendation

- **The Financial Conduct Authority should establish an Ethnicity Code to provide a framework for improving lending standards to EMBs.** FSB supports the recommendation from the All-Party Parliamentary Group (APPG) for Ethnic Minority Business Owners and from the Lending Standards Board to establish an Ethnicity Code, to provide a set of regulated standards that lenders could sign up to in order to commit to reducing barriers and improving access to financial products and services for ethnic minority business owners. Through a regulatory framework for inclusive lending standards, this can address systemic and structural barriers in order to improve access to lending for EMBs, particularly those who are self-employed.

Female business owners

The gap between women and men entrepreneurs applying for finance has narrowed, with differences mostly emerging in their choice of external finance. On average over 2023, 12 per cent of female-led small businesses applied for external finance compared to 14 per cent of male-led small businesses, with the high cost of borrowing over 2023 being a possible deterrent.[17]

The gender bias in investment-decision making, regardless of the potential of a business idea, may occur due to a lack of information about a borrower's ability to repay or grow their business, and in such situations, stereotypes may be applied to individual borrowers. Women make up just 37 per cent of entrepreneurs and lenders have limited data to assess them accurately.[18] Furthermore, the Bank of England has stated that SME lending has historically worse information asymmetries between the borrower and the lender than elsewhere in the financial ecosystem.[19] In addition, gender discrimination in access to finance may occur at any time, and often worsens in periods of financial uncertainty, when tougher eligibility criteria are applied to potential borrowers.[20] This highlights the importance of lenders using alternative credit scoring to review entrepreneurs' credit applications, such as analysing cash flow and business performance as well as social performance, rather than relying solely on traditional collateral-based assessments.

17 FSB, Small Business Index (Q1 2023 – Q4 2023)
18 House of Commons Research Briefing, 'Women and the UK economy' March 2024 https://researchbriefings.files.parliament.uk/documents/SN06838/SN06838.pdf
19 Bank of England, Open data for SME finance, March 2020 https://www.bankofengland.co.uk/-/media/boe/files/fintech/open-data-for-sme-finance.pdf?la=en&hash=FD4BC43BBD61EDEC5F8460C6BB7488EFDE647581
20 Cowling M., Liu W., Ledger A. Small business financing in the UK before and during the current financial crisis. Int. Small Bus. J. 2012

In addition to discrepancies in success rates for finance, women-led businesses receive smaller amounts of loan finance than male entrepreneurs. Concerningly, the 2023 Investing in Women Code report highlighted that the gap widened in 2022, with the average amount approved in respect of women-led businesses standing at £174,000, which was a mere third (34%) of the average of £507,000 approved for their male-led counterparts.[21]

It is crucial to improve access to finance and financial products for women-owned businesses. The Government and the Financial Conduct Authority (FCA) should commit to creating an agreed benchmark with industry leaders for the uptake of access to credit for women-owned businesses. Lenders must centre women in the design process of financial products, for example, by offering flexible loans that do not require tangible assets as security, as female entrepreneurs may lack traditional collateral such as property or equipment.

Not only do female entrepreneurs access less finance; over a quarter of female entrepreneurs (26%) also struggle to get impartial advice/support (e.g. financial advice, support to grow their business, etc.) compared to 18 per cent of men. This challenge can directly impact business creation as well as the growth and sustainability of a business, with 40 per cent of women stating that their ability to start and/or grow their business would improve with access to free or subsidised mentoring (compared to only 28% of men). Similarly, more women emphasise the benefit of free or subsidised training for entrepreneurs to start or grow their business (37% women vs. 28% men).

Business debt

FSB research found that, among business owners who do not apply for external finance, almost one in five (18%) stated it was because they did not want to increase their business debt. Many entrepreneurs seek external finance to manage cash flow, at a rate of 39 per cent for those with no full-time staff (sole traders or limited companies with a single director) and 57 per cent for those with one to nine employees.[22] Business debt has become further exacerbated following the pandemic and the cost-of-living crisis, with many forced to take up loans, some for the first time, and take on additional external finance to keep their business afloat.

A quarter (26%) of those who have started a business within the last three years identified not wishing to increase business debt as a reason for not applying for finance. These businesses were set up through the period of the remainder of the pandemic and the subsequent cost of living crisis where external finance was costly, while uncertainty in the economy saw lenders' appetites diminish. Comparatively, for those running their own business who have owned it for more than three years and who employ staff, only 16 per cent said they did not apply for external finance due to concerns about increasing business debt.

21 British Business Bank, Investing in Women Code Annual Report 2023, https://www.british-business-bank.co.uk/about-us/our-values-and-culture/investing-in-women-code/annual-report-2023/

22 FSB, Small Business Index Q1 2024, https://www.fsb.org.uk/resource-report/small-business-index-quarter-1-2024.html

Furthermore, the attitudes of entrepreneurs towards business debt are influenced by the lack of available support and understanding. Taking on additional capital must be communicated to entrepreneurs as a managed growth opportunity.

Lenders and the Government must provide tailored support for flexible debt management plans and low-cost interest and debt repayments, as well as extra lending capacity. Existing schemes such as the British Business Bank's Start Up Loan programme were granted additional funding in the 2024 Autumn Statement, to enhance access to finance for small businesses.[23] Financial institutions and lenders must also grow their mentoring capabilities, especially in less documented areas such as debt diversification and debt refinancing, to ensure that entrepreneurs benefit from changes in the market.

Rejections

Entrepreneurs also do not apply for external finance on the assumption that they will be rejected. For entrepreneurs who chose not to apply for external finance, six per cent stated that this was due to their fear of being turned down. FSB's Q2 2024 Small Business Index recorded that the rate of successful credit applications for small businesses was 61 per cent, notably below the pre-covid average of 65 per cent.[24] For those small businesses who employ no other workers, the rate of successful credit applications in Q2 2024 was even lower at 56 per cent.

Moving into the new territory of starting a business can lead entrepreneurs to create assumptions about their finances. Many may be concerned they do not have the credit history or background to be approved, and fear rejections may hurt their chances of obtaining finance later. This assumption is higher among those who have entered entrepreneurship within the past three years, at 12 per cent, double the average for entrepreneurs (6%).

> **"Relationship lending can have additional benefits, including providing the added function of counselling small businesses while monitoring the loans. About ¾ of borrowers [in the US] ask bankers for financial advice, making these sustained relationships valuable for the borrowers, who can run more successful businesses as a result, and for the lenders, who can provide more credit and other financial services to those businesses over time."**
>
> Karen G. Mills: Fintech, Small Business and the American Dream: How Technology is Transforming Lending and Shaping a New Era of Small Business Opportunity

23 Autumn Budget 2024, 4.86 https://www.gov.uk/government/publications/autumn-budget-2024
24 FSB, Small Business Index Q3 2024, https://www.fsb.org.uk/resource-report/small-business-index-quarter-3-2024.html

Finance providers need to re-evaluate how they assess entrepreneurs' applications for external finance. Circumstances such as divorce, living abroad, or the industry the applicant has worked in can be factors which influence their assessment. Open finance could help improve matters, by allowing technology to inform entrepreneurs of their eligibility for products, and to help them understand their finances better when putting forward applications.

Open finance also supports lenders by providing tools to assess applicants more fairly and accurately. For example, the Centre for Finance, Innovation and Technology (CFIT) demonstrated the successful pilot of a financial institution utilising open finance solutions. The pilot analysis showed that accessing new datasets and auto-populating business loan applications led to a significant boost in approvals in lending decisions, where 25 per cent of SME loans, which had been referred for manual underwriting, and which would potentially have failed to receive an offer of credit, could justifiably be given access to finance.[25]

Recommendations

Access to finance

HM Treasury should:

- **Include personal guarantees within the scope of the FCA's consumer duty, in order to deter the over-use of personal guarantees by lenders.** Personal guarantees have a legitimate role in lending to businesses, but their over-use can have a chilling effect on the economy, causing limited company directors to put personal assets such as their homes on the line when taking on a loan. According to Bank of England data, 77% of small businesses state they would accept slower growth rather than borrowing to grow faster. This regulatory solution would increase demand for finance by ensuring that the personal guarantee was subject to the consumer duty, while keeping lending to limited companies outside the FCA's regulatory remit.
- **Commit to support open finance and recognise its transformational potential for self-employed people and the wider UK economy, jointly with the financial sector.** By committing to smart data initiatives in Government agencies (e.g. HMRC) and in financial institutions, open finance can bring data together in a single dashboard and deliver better financial understanding and outcomes for the self-employed. Open finance can also increase lenders' appetite to lend to self-employed people by generating accurate data to allow them to assess an appropriate financial response on an individual basis without relying on assumptions and profiling.

25 CFIT, Open Finance Blueprint https://cfit.org.uk/wp-content/uploads/2024/02/CFIT-Open-Finance-Blueprint.pdf

The British Business Bank should:

- **Increase awareness of mixed equity and debt financing alongside financial institutions.** Entrepreneurial self-employed people who want to take their business to the next stage and grow should be encouraged to explore options for mixed equity and debt financing as a first step into equity. Hybrid financing allows for small businesses to familiarise themselves with equity finance whilst still retaining aspects of debt financing. Combining finance types can help businesses reduce the cost of capital. Because debt funding tends to be cheaper than equity, businesses can blend the two to reduce the overall cost of finance while reassuring debt providers that funding can be repaid.
- **Encourage uptake of financial products that are targeted at sole traders.** The BBB, working alongside financial institutions, should promote affordable and available financial products that are designed primarily for the self-employed. The BBB's endorsement of these products would provide the self-employed community with reassurance and certainty that they are appropriate products to consider. These products should be clearly signposted on websites. The BBB's current 'Guide to self-employed loans' has a click depth of four, meaning that an individual has to click on four links to reach that page.

The Financial Conduct Authority should:

- **Commit to creating an agreed benchmark with industry leaders for the uptake of access to credit for women-owned businesses.** All major lenders should be mandated to publish data showing acceptance rates for different demographic groups when applying for finance, to build trust and encourage more applications.
- **Establish an Ethnicity Code to provide a framework for improving lending standards to EMBs.** FSB supports the recommendation from the All-Party Parliamentary Group (APPG) for Ethnic Minority Business Owners and from the Lending Standards Board to establish an Ethnicity Code, to provide a set of regulated standards that lenders could sign up to in order to commit to reducing barriers and improving access to financial products and services for ethnic minority business owners. Through a regulatory framework for inclusive lending standards, this can address systemic and structural barriers in order to improve access to lending for EMBs, particularly those who are self-employed.
- **Mandate financial institutions to provide credit reports or credit reference files for all potential borrowers they have rejected.** Currently, banks have to provide credit reports only on request. The self-employed tend to rely on debt finance (such as loans or overdrafts); potential borrowers may not be aware of this service, and risk going to another lender without understanding the potential negative implications to their credit report. The financial system for self-employed borrowers must remove administrative barriers that prevent them from accessing and understanding finance.

Financial lenders should:

- **Provide a relationship manager when 'financing for growth'.** Applying for finance is mostly done online, with limited face-to-face interactions, although many lenders do provide a relationship manager when a certain threshold of borrowing is reached. For many self-employed business owners, this threshold is high, and they miss the opportunity to have personalised expertise for their financing requirements. Providing a relationship manager, whether face-to-face or virtual, to provide advice and expertise can assist entrepreneurs to in channelling funds into the most appropriate ventures for growth, generate returns, and manage their business debt sustainably.

METHODOLOGY

This report is based on the views of FSB members as well as the wider self-employed population across the UK. The survey was nationwide in its reach and participants were invited to complete the survey via email and social media channels.

The survey was administered by the research agency Verve and was in the field from 23 October 2023 to 2 November 2023. The survey questionnaire was completed by a total of 1,378 self-employed individuals. The survey findings are all weighted according to FSB membership weighting (to reflect the demographic balance of FSB members throughout the UK).

All percentages derived from the survey are rounded to the nearest whole number, which is why some percentages presented in the figures do not sum to 100 per cent.

FSB undertook a mixed research approach consisting of a quantitative online survey, and three focus groups which took place in November via Zoom, which purposefully drew from a variety of regions, sectors, and population demographics. Interviews took place between November and July 2024.

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