

# Responsible Lending Report

An analysis of SMEs' risk awareness when taking out finance

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## Foreword

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Commercial lending has played a vital role in helping UK SMEs survive the pandemic.

According to the British Business Bank, gross small business lending rose to **£104bn** during 2020. Much of this will have been used to overcome cash flow issues or invest in new working methods that suited lockdown restrictions.

The need for financial support, coupled with the ready availability of government grants and loans, saw businesses that would typically avoid borrowing experience commercial lending for the first time.

For some SMEs, this showed them that borrowing was a quick and easy process. As a lender, we've seen how this experience has changed attitudes to borrowing across the finance sector.

In particular, some independent lenders are obliging SMEs' demands for fast cash by putting **due diligence aside in favour of quicker service.**

Some lenders are not clearly explaining the level of personal risk that their clients take on when they borrow money, nor are they properly assessing the SME's suitability to take on debt.

We wanted to investigate this phenomenon further and commissioned independent research on SMEs' attitudes to and understanding of business borrowing.

The results were astounding. In particular, we found that almost half of all businesses that have taken out a loan did not fully understand the level of personal risk they were accepting.

The findings indicate that lenders need to take a more responsible approach and clearly advise SMEs to get independent legal advice before signing a loan agreement. SMEs themselves need to know the signs that a lender may be acting irresponsibly.

Thank you for reading this report. If you have a question or would like to discuss the issues raised in this publication, please do get in touch with us; we'd love to hear from you.

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**Steve Richardson**

Director, Reparo Finance

## Executive summary

### About the survey

We surveyed more than 200 SMEs during April 2021. All of these businesses had taken out external funding for their business in the last 12 months.

We asked questions about their attitudes to and understanding of business borrowing.

The research was conducted independently by Sapio Research and interviews were performed via email invitation and an online survey.

Overall, results are accurate to  $\pm 6.8\%$  at 95% confidence limits, assuming a result of 50%.

### Key findings

Our research explores attitudes towards and understanding of business borrowing amongst SMEs.

Nearly half of SMEs that recently took out business finance do not know what a PG is or understand the level of risk they have accepted.

This is despite the fact that they would have signed one in their loan agreement. Agreed during the completion of business borrowing, a Personal Guarantee (PG) is an individual's legal promise to repay the credit their company has taken on.

The findings also highlight mistaken beliefs amongst some SME owners.

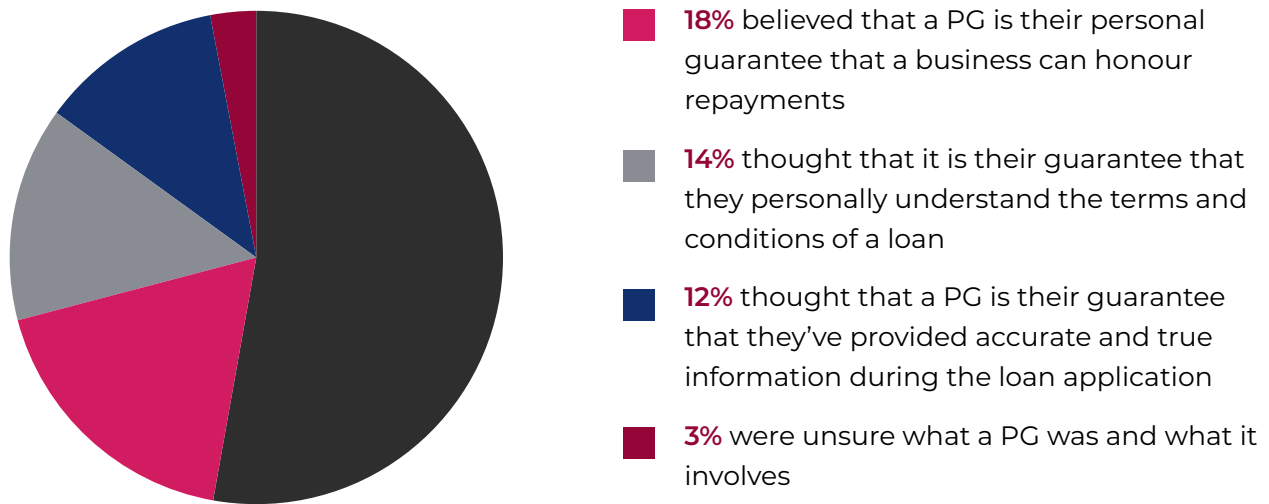
For example, some thought that being a limited company protected them from personal liability over their company's borrowing.

The report also reveals that the appetite for borrowing is high amongst SMEs. 64% of small businesses that recently took out finance intend to borrow more in the next three years.



## 1. Almost half (47%) of SME owners do not properly understand PGs when taking out loans

According to our research, 47% of SME owners and shareholders that have recently borrowed money for their business do not understand what PGs are.



## 2. A fifth (21%) of SME owners wrongly think that limited company status protects them personally from their company's borrowing

One-fifth of SME owners wrongly believe that they will be personally protected from their company's debts because they run a limited company, irrespective of whether they've agreed to a PG.

Roughly one in ten (11%) of those surveyed believe a PG wouldn't be enforceable should their business become insolvent.



### 3. 64% of SMEs are likely to borrow more money in the next three years

64% of businesses that have taken out external finance for their business in the last 12 months intend to borrow more money in the next three years due to the pandemic. This suggests that the need and appetite for business finance is still strong amongst small businesses.

Despite this, many businesses aren't taking precautions to ensure that they understand the personal risk they are taking on.

Nearly a quarter (24%) of businesses did not take any independent legal advice to check T&Cs when taking out their loan. When asked why they didn't take this advice, 27% said that they did not think it was worth it because the PG would never be activated. A further 27% were not aware that they should consult with legal experts.

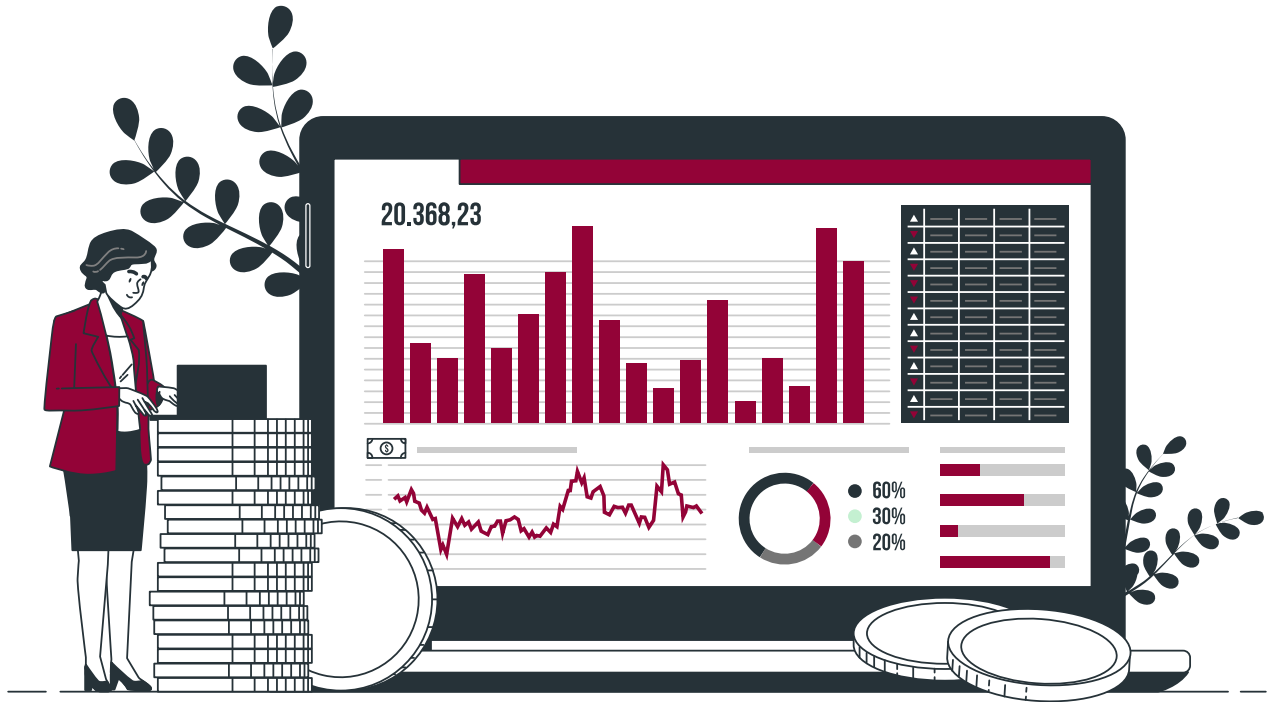
#### Conclusion: Lenders should encourage clients to take independent legal advice

A significant portion of SME owners that take out business loans clearly do not understand the level of personal risk they agree to when signing a PG. A large number are also not being made aware of the importance of getting independent legal advice to fully understand the terms of their loan.

This would be concerning in normal times. However, the pandemic is driving more businesses towards repeat borrowing. With so many businesses increasing their debt during difficult times, responsible, transparent lending has become vital to maintaining stability in the finance sector and the wider economy.

SMEs should always draw on legal expertise to check they are comfortable with the finance agreements they make—especially when it comes to PGs.

Equally, lenders should always encourage their clients to take independent legal advice as part of a responsible and sustainable approach to business lending.



## Five Things to Consider Before Taking Out a Business Loan

For most SMEs, the affordability of monthly repayments and interest rates are the main considerations when taking out a loan. However, it is equally important to find a responsible lender that is clear about its terms and conditions. In this article, we explain five things all SMEs should consider when approaching a lender or credit broker.



## Five Things to Consider Before Taking Out a Business Loan

Business financing can be a complex topic—so much so that many SMEs avoid it. However, difficult times often leave company owners with no option but to seek out credit.

Our research has shown that 50% of SMEs that have taken out finance would usually avoid borrowing and have only done so because of the pandemic.

Despite this, two thirds (64%) have indicated that they will be more likely to borrow more money in the next three years due to the impact of the pandemic.

Our research shows that many UK SMEs don't fully understand the lending process, yet the figures above suggest that their appetite for borrowing will continue to be strong.

Unfortunately, this demand for finance is encouraging lax practices in the lending community—around a fifth of our survey respondents were not requested to seek independent legal advice by their finance provider.

SMEs need to know the warning signs that a broker or lender may not be lending responsibly and may not have their best interests at heart.

With this in mind, here are five things all SMEs should consider when approaching a lender or credit broker:





## 1. Customer Treatment

It pays to look for responsible lenders who treat their customers with due care and respect. In our research, finding a responsible provider was cited as a critical aspect when choosing a lender. 22% of survey respondents said that it was most important to them.

The Financial Conduct Authority (FCA) has a set of guidelines on Treating Customers Fairly, which focus on delivering fair outcomes to borrowers. Where possible, SMEs should opt for lenders with these policies since this gives them recourse should things go wrong.

## 2. Independent Legal Advice

Reputable lenders follow best practice rules when issuing business loans. This includes recommending that clients take independent legal advice (ILA) before they can sign a deal.

Our research shows that nearly one in five (18%) of SMEs surveyed cited a clear explanation of terms and conditions as the number one reason why they would choose a lender. Despite this, 19% had not been advised to seek legal advice before signing a deal.

SMEs should always seek independent legal advice when taking out a loan, even if their lender fails to recommend it to them. Making such an agreement without being fully informed could put your business at risk, and it could jeopardise your personal finances if you sign a personal guarantee.

## 3. Lender Involvement

Responsible lenders take the time to understand a company and its business plan before approving a deal. This helps them ensure the client can afford the finance and that they have an acceptable risk profile.

Failing to meet with a client, review their business plan or conduct thorough due diligence could all point to the fact that a lender is more interested in profits than offering responsible credit that's suitable for your organisation.

## 4. Broker Commission

Your lender should be willing to tell you the rate of commission your broker takes for securing a deal. In many cases, this will be disclosed during the application process—but this isn't always the case.

A recent judgment by the UK Court of Appeal recognised that there is an issue with 'secret commissions', wherein brokers are sometimes remunerated without the knowledge of borrowers.

## 5. Reviews and Recommendations

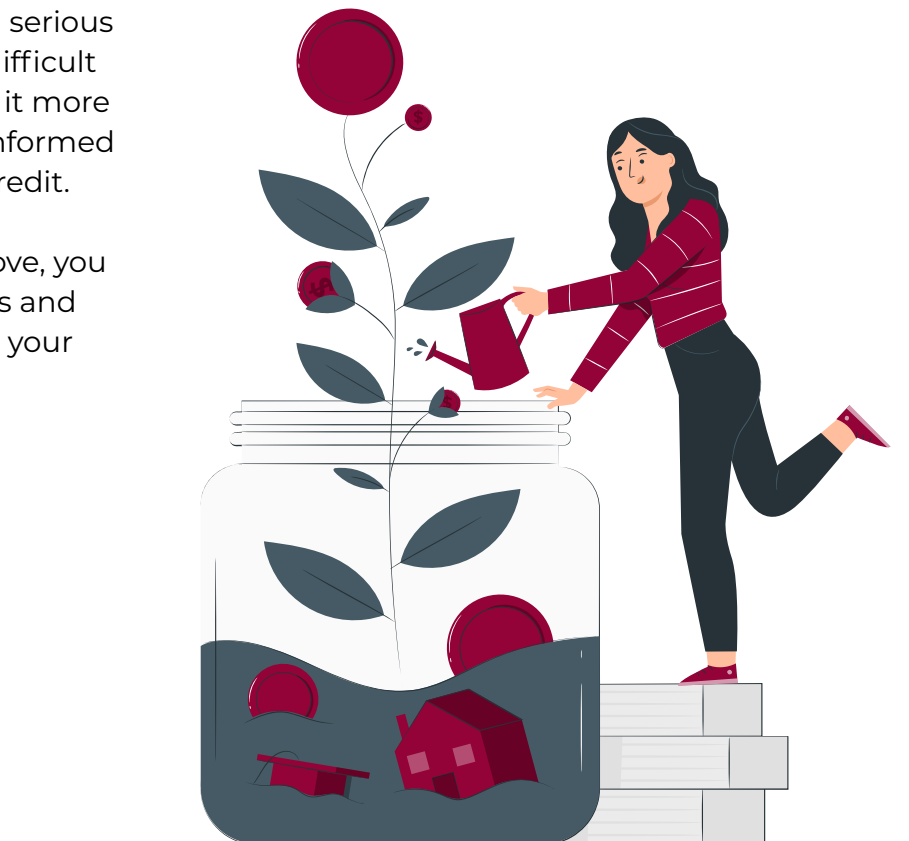
Tying all of these points together, it's well worth considering what clients and other firms say about a lender or broker.

Our study showed that 11% of SMEs valued lenders that had a positive online reputation through reviews, news stories and social media comments.

## Best Practice for Business Borrowing

Taking out a business loan is a serious matter. The pandemic and a difficult economic outlook have made it more critical for UK SMEs to make informed decisions when applying for credit.

By following the five steps above, you can avoid irresponsible lenders and secure finance that is right for your business.





# The Importance of Understanding Personal Guarantees

The COVID-19 pandemic drove many SMEs to seek emergency funding, causing a dramatic rise in business lending. According to our research, many of these businesses are now likely to borrow more in future. In this article, we explore the implications of this increased appetite for borrowing and dispel a number of common misconceptions surrounding personal guarantees.

# The Importance of Understanding Personal Guarantees

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According to UK Finance, gross lending to SMEs in the first three quarters of 2020 was double that seen during the whole of 2019.

This rise was facilitated by government loan schemes, which offered fast access to emergency funding in response to the pandemic.

As a result, many companies have experienced borrowing for the first time and have become more open to borrowing money.

According to our research, 64% of businesses that have recently taken out finance intend to borrow more in the next three years. As a lender, we've seen how coronavirus loans have changed SME attitudes, with many now expecting finance to be fast and easy to access.

Brokers and lenders are naturally keen to satisfy these expectations. As a result, due diligence and responsible financial practices may have taken a back seat in favour of rapid delivery.

## Greater Transparency Required Over Personal Guarantees

Personal guarantee agreements commonly accompany commercial loan offers. In simple terms, they require company directors and business owners to accept responsibility for the debt if the organisation can't pay. Many of these agreements include a clause that advises borrowers to take independent legal advice before signing.

While such provisions are common, they are typically hidden away in the small print of the contract, leaving most clients unaware of the need to take qualified advice.

This is an issue because a significant number of SME directors end up signing

a personal guarantee without fully understanding its implications.

This allows lenders to push deals over the line quickly. However, it's irresponsible to allow clients to sign serious personal liability agreements that could lead to the repossession of assets and property.

Lenders themselves can also be put at risk if clients do not take independent legal advice. Should the matter end up in court, the customer could claim that they didn't understand their obligations and weren't properly informed of them.

## Personal Guarantees: Three Common Misconceptions

Our research identified a number of misconceptions over personal guarantees. These indicate that some lenders aren't making their customers aware of the risk they are agreeing to when signing a personal guarantee.

In the section below, we dispel three of the most common misconceptions:

### 1. A Limited Company Doesn't Equal Limited Risk

According to our research, almost one in five business owners believed that a personal guarantee did not present a financial risk to them because their business was a private limited company.

While the structure of a limited company can prevent financial risk from being passed onto directors, this is not the case with a personal guarantee. These are separate agreements with a commercial lender, which means that the signatory will become responsible for the full outstanding debt if their business is unable to pay.

In broad terms, signing a personal guarantee is similar to agreeing to be the guarantor for any other type of financial arrangement. Regardless of your business's status, you are accepting a level of personal risk should things go wrong.

### 2. It's Not Just a Standard Agreement

16% of respondents to our survey believed that signing a personal guarantee was just another part of taking out a business loan and that it was something they simply needed to agree to. Another 14% thought that it was their guarantee that they had understood the terms of the loan.

In reality, personal guarantee agreements relate directly to the handling of your personal finances if your business cannot repay what it owes.

Any business owner or company director considering a personal guarantee should therefore read the terms very closely and seek independent legal advice where appropriate.

### 3. Personal Guarantees Aren't Discounted In Insolvency

More than one in ten respondents (11%) said that their personal guarantee wouldn't be enforceable if their business became insolvent.

In actual fact, the very purpose of a personal guarantee is to protect the lender in such circumstances. Regardless of the solvency (or otherwise) of the business, a failure to repay could see the lender take action to recover the debt from anyone who has signed as a personal guarantor.

### Encouraging Responsible Lending

All of this makes for troubling reading at a time when 50% of respondents said that they planned to borrow more money in the near future. It is clear that personal guarantees are a widely misunderstood part of commercial lending. Lenders, brokers and accountants all have a role to play in encouraging responsible lending and ensuring that SMEs understand the risks they are taking on when signing such agreements.



## Expert insight

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### Graeme Lipman, Director, Begbies Traynor Group

**Graeme Lipman has decades of SME experience. First through running his own firm in the printing and publishing business, with a multi-million-pound turnover and over 50 staff, and now as a director at Begbies Traynor, assessing SMEs through independent business reviews for banks and other financial clients.**

Lenders have a legal obligation to inform their clients that they should seek independent legal advice when taking out a loan.

Things go wrong when the client thinks it's ok to sign a loan agreement without taking this advice.

This exposes clients to immense personal risk. The situation becomes even more complicated when others close to them are affected. An excellent example of this is when a client puts a PG on their family home; not only is their wealth at risk but so too is the welfare of partners and children.

Equally, there are lenders out there who take on a PG without investigating their client's personal circumstances.

As a result, when the client defaults on their loan, the lender discovers that PG's security is worthless.

For example, we recently worked with a business that had run up an overdraft of £350,000. The company was under pressure from their bank to repay and didn't want to go into liquidation.

After doing our research, we found that securities on the bank's PG were only worth around £50,000. As a result, liquidation was a favourable option for the company and the bank was left to shoulder the bad debt.

Funders need to conduct rigorous due diligence and clients need to be made aware of the importance of taking advice—otherwise, both parties are exposing themselves to undue risk.



## Expert insight

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### **Leanne Dawson,** Head of Regional Broking, Newable

**Leanne Dawson has worked in commercial finance and banking for more than 15 years. She heads Newable's broking services in the North of England, helping business owners and decision-makers source the right finance to achieve their goals.**

PGs will always have a place in certain finance transactions and allow the lender to get comfortable with the proposed deal and provide funding.

The difficulty is that an increasing number of lenders have come to use a PG as a default rather than looking at the deal and the security that is provided within the business.

There is also a question over who should outline the implications of a PG in a gone scenario.

The lender will advise the client to seek third party legal advice before signing. At that time, the need for the money often outweighs the desire to pay for a solicitor and have the documentation reviewed—this is especially the case with smaller SMEs.

As a commercial finance brokerage, we aim to provide awareness to our clients. There have been too many occasions to count when a client has adamantly believed that they have not provided a

PG, only to find upon review of original agreement documentation that one has been provided. In some cases, this could even be an unlimited PG as opposed to a limited PG.

There needs to be more awareness of PGs and what they mean to the client, especially if lenders start using them as a default point.

It also needs to be explained that the balance owed may not just be limited to the outstanding loan amount and may include additional penalties and charges.

It is vital that the client is fully aware of what they agree to and that an assets statement has been taken to support the guarantee.

# Reparo Finance

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