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Policy brief

Financing small and medium enterprises to support a just transition to net-zero emissions in the UK

Headline issues

- Small and medium enterprises (SMEs) are essential to delivering a just transition to net-zero greenhouse gas emissions in the UK.
- SMEs need finance and advice to reach the UK's climate target of net-zero emissions by 2050.
- These businesses also need a policy regime that provides a clear, sector-specific road map for decarbonisation.
- Bank and non-bank finance will be crucial to support SMEs in the just transition.

Summary

Small and medium enterprises (SMEs) make up 99 per cent of firms in the UK. They are essential to delivering a just transition to net-zero greenhouse emissions due to their role in generating employment, economic prosperity, innovation and social cohesion, especially in 'left behind' regions, and because in aggregate they contribute a large proportion of the UK's emissions.

All SMEs need to meet the legal requirement of net-zero emissions by 2050. To do this they require better access to business, financial and legal advice; and to be persuaded of the commercial importance of adapting and the negative consequences of not doing so. The transition also needs to account for the additional challenges facing SMEs created by COVID-19.

SMEs need a policy regime that corrects market failures, regulates the financial system and allocates public finance to generate public goods to support their transition.

SMEs will need finance to support them in the just transition. Banks have an important role to play, in providing new products and services, working in all regions and entering into multi-stakeholder partnerships. Non-bank finance is also important, including equity.

Policy briefs provide analysis on topical issues, presenting specific recommendations to inform ongoing policy debates. Drawing on the Grantham Research Institute's expertise, they summarise either our research findings or the state of knowledge about a particular issue.

This policy brief has been written by **Sophia Tickell** and **Nick Robins.** It complements the full-length report *Financing climate action with positive social impact: How banks can support a just transition in the UK* by Nick Robins, Sophia Tickell, Will Irwin and Andrew Sudmant.

Definitions

The UK government defines an SME as a firm meeting two out of three of these criteria: staff of fewer than 250; turnover of less than £25m; gross assets of less than £12.5m. In early 2019 99.3 per cent of SMEs were small or very small businesses, including 4.4m sole traders (British Business Bank, 2020).

The just transition is a systemic and whole of economy approach to sustainability, based on maximising the social benefits of the transition, mitigating the social risks, empowering those affected by change, anticipating future shifts and mobilising public and private investment.

Financing SMEs to support a just transition

To rebuild the UK economy after COVID-19 in a way that combines climate action with positive social impact requires a transition that is inclusive, sector-specific and grounded in place-based realities. This just transition also needs to respond to the needs of its key stakeholders; these include small and medium enterprises (SMEs) as a core part of the economy and source of greenhouse gas emissions.

In this brief we set out the transition requirements for SMEs and how issues of demand and supply of finance for the transition can be addressed.

SMEs' place in delivering a just transition

SMEs are critical to the UK economy, making up 99 per cent of firms, 61 per cent of the private sector workforce and contributing £2.2trn in turnover (British Business Bank, 2020).

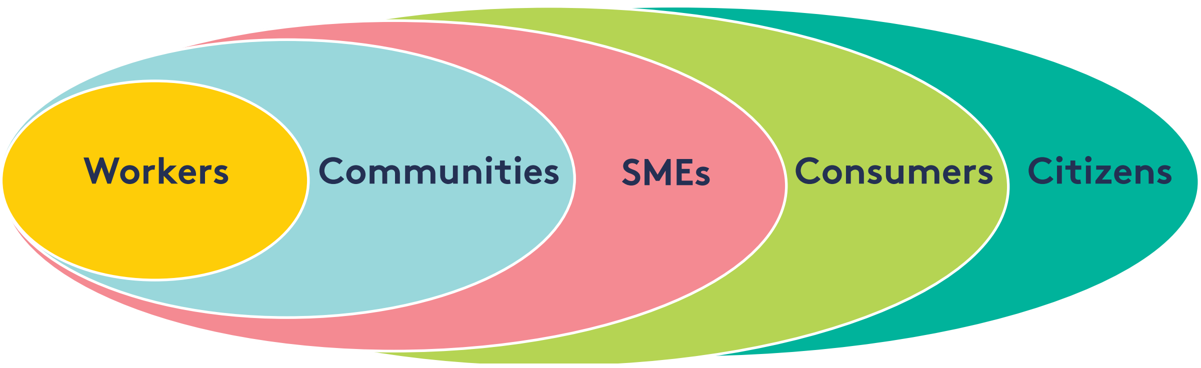
SMEs are essential to delivering a just transition due to their role in generating employment, economic prosperity, innovation and social cohesion. Further, while individual SME greenhouse gas emissions may be small, in aggregate they contribute a large proportion of overall UK emissions. An EU study estimates UK SMEs contribute 53 per cent to 'environmental impact', including greenhouse gases (Constantinos et al., 2010). SMEs are also crucial to attempts to 'level up' the UK economy, given their disproportionate presence in deindustrialised areas and in regions without cities that attract large firms with agglomeration effects.

All SMEs need to decarbonise by 2050 in order to play their part in meeting the UK's net-zero target. The considerable challenges SMEs face in decarbonising have been compounded by the COVID-19 crisis, which has left many businesses highly indebted, some in need of recapitalisation, and others bankrupt. Box 1 provides examples of sectors where SMEs will be particularly impacted by the net-zero transition.

Understanding the transition requirements of SMEs

Post-COVID-19 reconstruction will be extremely challenging to SMEs, but it also offers an opportunity for them to reimagine their businesses in terms of sustainability. Any attempts to support them move to net-zero should start from an understanding of the sector (Revell and Blackburn, 2007), which is diverse and complex. Culturally, SMEs will want fairness and to believe that requirements to make change are not falling on them

Figure 1. Key stakeholders in the just transition



Box 1. Examples of sectors where the net-zero transition will have a strong impact on SMEs

- **Construction.** Nearly a fifth of all SMEs operate in construction, particularly as suppliers to large firms. The sector will need to transform heating, upgrade energy efficiency and adapt for greater resilience.[1] A significant barrier to small businesses' engagement in environmental management is a lack of internal resources.
- **Transport.** An estimated 357,000 SMEs work in the transport sector. SMEs will be important suppliers to the contractors of huge infrastructure investments designed to increase mass transportation, improve railway connectivity and install charging points for electric vehicles. SME transport providers (taxis, buses) will also be affected by the switch to zero emissions vehicles.
- **Wholesale and retail trade and repair** account for 14 per cent of all SME employment and a third of SME turnover. This sector is likely to require capital outlay for new equipment and the development of new skills and business models.

1. See our accompanying policy brief, *Financing a just transition to net-zero emissions in the UK housing sector*, for more on this (Robins and Tickell, 2020).

disproportionately (Drake et al., 2004). They are likely to act if they understand the commercial importance of becoming more sustainable and the negative consequences of not doing so (Masurel, 2007). Finally, small business owners are far more likely to be influenced by peer-reported success stories than other means of influence.

Transforming the market for finance

Diversity of supply: debt and equity finance

For SMEs to contribute to the just transition, issues of both demand and supply of finance need to be addressed. SME access to finance is uneven across the regions and devolved nations of the UK. A diverse range of suppliers of finance will be necessary to meet the differing needs within the sector.

Large banks remain the most significant source of lending to SMEs, with flows to the sector showing a marginal increase from £53.4bn to £56.7bn between 2014 and 2019. Their presence across the whole country will be particularly important to the Government's 'levelling up' agenda. Bank lending to SMEs across regions is broadly in line with the distribution of the SME population, though some regions, notably the North West, Yorkshire and the Humber, and the East Midlands, fare worse than others (British Business Bank, 2019).

Despite its continuing importance, bank lending as a proportion of external financing has fallen dramatically. Non-bank finance is now the fastest growing source of external finance to SMEs. Equity, asset-based finance and marketplace lending (peer to peer business loans) jumped from £18bn to £27.5bn over the past five years. Combined, they provide nearly 50 per cent of provision (up from 33 per cent five years ago) (British Business Bank, 2020). New funders are proving adept at assessing the collateral value of SMEs, particularly of new technologies. Specialist finance providers can use this expertise to support the emergence of next generation sustainable entrepreneurs (e.g. in recycling).

Equity finance continues to be concentrated in high growth firms, 20 per cent of which are concentrated in London and the

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South East (compared with 10 per cent in the North West, for example), and there is further uneven distribution within regions (OECD, 2017). Limited research about the regional and local distribution of alternative finance suggests marketplace lending platforms are also concentrated in London and the South East (Cambridge Centre for Alternative Finance, 2017).

Community and responsible finance institutions are also significant due to their local knowledge, social outcomes focus, flexible approaches and experience of blended finance opportunities. This means they reach SMEs and social enterprises that commercial finance may not. This includes loans to businesses focused on sustainable, people-centred outcomes and business models. These institutions may also be more attuned to the needs of minority and ethnic groups and have a history of support for diversity.

Finally, a growing number of firms are being set up to raise capital from the inhabitants of a particular geographical region – and to reinvest it there. This might take the form of share issuance for community energy projects or municipal bonds.

Awareness-raising and advice

SME awareness of the legal requirement to be net-zero by 2050 is often limited (Hillary, 2020). Where the knowledge does exist, individual SMEs may not know how to invest in achieving decarbonisation effectively. Therefore, for SMEs to participate fully in the transition they need to be made aware of what will be required of them, as well as more business, financial and legal advice, tailored specifically to this often hard-to-reach group.

How banks can support SMEs

Banks can do a great deal to support SMEs make the just transition. First and foremost, they can offer financial products and services tailored to the diverse needs of the sector and offered on the principle that polluters should pay and sustainers should gain. There are three discernible categories of SME demand for just transition financing: those who offer

Box 2. Categories of SME finance demand

- **Green solutions:** Banks can reduce the cost of funding to SMEs offering solutions, technologies and business models that enable the transition to be made. For those at an early stage of growth, access to grant and equity funding with also be required (e.g. finance for a start-up investing in hydrogen boilers or batteries).
- **Green adopters:** Banks can reduce the cost of funding of debt finance for SMEs seeking to decarbonise their operations, e.g. a loan to an SME that wants to replace a gas boiler with a hydrogen one or a logistics company seeking to upgrade its van fleet to hybrid or electric vehicles.
- **Transition-exposed:** Banks can increase the cost of funding for 'grey' SMEs (those in high carbon sectors, regions or supply chains), managed in ways that permit re-skilling and redeployment. 'Grey' SMEs are likely to be hardest hit by the transition and require the most help. Suppliers to airlines, for example, are likely to need bespoke products like specialist private debt loans.

Banks can reduce the cost of funding to SMEs offering solutions, technologies and business models that enable the net-zero transition to be made, such as installers of solar panels. Our accompanying brief on the housing sector looks at these kinds of businesses in more detail (Robins and Tickell, 2020).

green solutions, green adopters and firms that are exposed to the transition in potentially negative ways (see Box 2).

Banks can support SMEs in supply chains, introducing innovative schemes that provide financial incentives and certainty to approved SME suppliers of large corporations and projects whose aims are aligned with the transition. This could include offering preferential credit rates or invoice financing to cover the costs of transition/investment expenditure.

Despite the withdrawal of many high street banking facilities, banks still have significant geographically-specific understanding of SMEs and their financing needs. Banks can therefore play a crucial role in the regions. For example:

- Banks can be champions of small firms in multi-stakeholder initiatives for regional regeneration. They can participate as representatives on place-based climate commissions and bring financial service expertise to local enterprise boards (LEPs).
- Banks can ensure that SMEs are active participants in pilot projects that blend commercial finance with public funds and philanthropic capital. For example, banks could design combined funding packages to support pro-just-transition SMEs to participate in housing decarbonisation projects.
- Banks can create specialist units across the regions to offer SMEs sustainability consulting services designed to help raise awareness, provide referrals and certain types of regulatory compliant advice. Such services can include referrals to the British Business Bank and other alternative finance providers for funding.

Beyond their provision of lending and advice banks can use their considerable influence to engage government to provide a predictable policy environment, not least via the roadmap we propose below, which would reduce volatility of demand, something that can be difficult for SMEs to manage due to cash flow considerations.

Finally, banks can collect further data on access to loans from women, BAME and other entrepreneurs to enable banks to understand and find ways to support a diverse range of new business leaders to thrive.

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How non-bank finance can support SMEs

Many of the suggestions outlined above also apply to asset finance, equity finance and market-based finance. In addition, commercial non-bank finance, and equity finance in particular, can do more to find and support firms beyond London and the South East. Venture capital, particularly if supported by policy, can be a game-changer for innovative cleantech SMEs (Owen et al., 2019). Specialist financiers can also work with banks to improve their understanding of depreciation and amortisation of the SME sector, possibly obtaining a fee for expertise.

Market creation: government direction and regulation

A policy roadmap is needed

SME experts and SMEs themselves argue that for the sector to align with the goals of climate action and positive social impact, a clear roadmap is required from the Government. To help small firms plan, this roadmap should identify goals, timelines and interim deadlines needed to meet the 2050 net-zero target. It should also be well presented, widely publicised and backed with regulation.

To best support SMEs the roadmap would contain sector- and theme-specific targets that acknowledge the widespread variation in SME contributions to carbon emissions and sectoral challenges. Government also needs to make clear to SMEs, through incentives and awareness-raising initiatives, how business prospects will be improved by becoming more sustainable, and regulate to make the consequences of inaction clear.

How public finance can support SMEs

Public finance can also help SMEs transition to the new economy by aligning development fund expenditure, public procurement and tax policy to support SMEs to be aligned to the just transition.

Development finance: The British Business Bank (BBB) was created to help make finance markets work better for small business. It does not currently have explicit sustainability or climate objectives. In light of the UK's new net-zero target and the post-COVID-19 challenges, extending the BBB's mandate to support a just transition would allow it to apply its existing suite of tools and mechanisms to support SMEs in the UK to contribute to this goal.

Regional funding: Some EU development finance (European Social Fund, European Regional Development Fund and European Angels Fund) makes specific provision for SMEs. For the UK after exiting the EU, this provision needs to be built into the remit of the new entities such as the Shared Prosperity Fund, which will replace these funds from April 2021. The latter fund could help create the zero-carbon market by prioritising funding of SMEs contributing to that goal.

Public procurement and expenditure on roads, schools and electricity could also build in incentives for SME suppliers, as could public procurement contracts, which could stipulate the importance of supporting green SMEs.

Fiscal reform: SMEs are extremely sensitive to fiscal requirements, including VAT. The VAT system could be adjusted to introduce a differentiator that provides tax relief to those SMEs focusing on decarbonisation and social value, with care taken to ensure that this does not negatively affect already impoverished regions.

Policy recommendations

In our wider project we identified eight steps that banks can take to support the just transition across sectors in the UK, and six major policy steps for government (Robins et al., 2020). This brief builds on these recommendations to identify how banks and financial institutions can support the SME sector, and also highlights the relevant steps for government.

Recommendations to banks and finance providers

1. Serve SME customers by developing a core portfolio of financial products and services that are explicitly designed to help them achieve net-zero in a socially inclusive manner. This will involve differentiating between the needs of SMEs that offer green solutions, green adopters and firms that are transition-exposed.

2. Introduce flexibility in product offerings, e.g. on interest rates, maturity and repayment timelines, in acknowledgement that the transition may involve a degree of short-term volatility while not affecting the long-term viability of the business.

3. Develop innovative mechanisms to support SME suppliers in the transition, e.g. providing financial incentives and certainty to approved SME suppliers of large corporations and other anchor institutions by offering preferential credit rates to cover the costs of transition.

4. Build support for SMEs into regional, place-based regeneration projects, e.g. by providing finance to SMEs in the regions, championing small firms in initiatives for regional regeneration and linking to place-based climate commissions.

5. Ensure that blended finance pilot projects seek explicitly to source locally and from within the SME sector.

6. Offer sustainability consulting services to SMEs to raise awareness of their net-zero obligations and how they can be met, provide referrals to alternative funders, including the British Business Bank and alternative finance, and certain types of regulatory compliant advice.

7. Provide the British Business Bank with data on loan requests from female and BAME founders and leaders, including loans requested and outcomes, to improve understanding of and action on their needs.

8. Advocate for a predictable policy environment, via the roadmap, and call for changes to incentives and regulation to reward zero-carbon outcomes.

Recommendations to government

1. Introduce a sector-specific just transition roadmap with clear goals, timelines and interim deadlines.

2. Extend the mandate of the British Business Bank to support SMEs in making the just transition.

3. Make specific provision for SMEs in the Shared Prosperity Fund and other development funding, prioritising funding of SMEs contributing to the just transition and encouraging engagement with British Business Bank regional programmes.

4. Introduce changes to fiscal policy, public procurement and expenditure to provide support to those SMEs focusing on decarbonisation and social value.

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5. Encourage diversity of supply of finance to SMEs in recognition of the importance of bank and non-bank finance and alternative finance providers to the sector.

What's next?

The importance of the just transition as a core part of the UK's strategy for action on climate change has been propelled forwards by the COVID-19 crisis. There is huge potential to make the just transition come to life, with banking and non-bank finance and alternative finance as key agents of change.

To help realise this, a Financing the Just Transition Alliance could now be formed to support this system-wide approach. The Alliance would bring together banks and investors, local and national policymakers, business and trade unions, civil society and researchers across the country. The Alliance would seek to co-create breakthrough financial innovations that show how climate action can deliver with positive social impact and do this at scale. It would pay particular attention to the needs of SMEs in the reconstruction of the UK economy, ensuring that they are supported to participate actively in the co-creation of breakthrough financial innovations that connect climate action with positive social impact. Supporting this wide-ranging, diverse set of businesses across the country will be a critical part of showing how the just transition can help the UK to build back better.

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