Key challenges facing SME lenders

SME lenders need to carefully manage their own financial and operational resilience as their borrowers struggle in the current macro-economic environment. Chris Laverty explains how SME lenders can mitigate key challenges.

SMEs are facing multiple headwinds. A combination of a higher interest rate environment, increasing input costs, and dampening demand due to a higher cost of living continues to put pressure on all businesses, but SMEs often don't have resources to see them through extended periods of turbulence.

Latest figures from the Insolvency Service reveal the stress firms are under: insolvencies in July 2024 were 16% higher than the same period last year. The number of company insolvencies remains much higher than those seen both during the pandemic and also between 2014 and 2019.

What does this mean for lenders who back SMEs? The following key issues may be impacting SME lenders' financial and operational resilience.

Increased default rates puts pressure on lenders' liquidity

SME lenders will be seeing higher default rates in their portfolios. Liquidity for these lenders must be tightly managed to stave off working capital issues. Where lenders rely on repeat business from SMEs, the knock-on effect of higher default rates can be magnified.

When combined with the current higher cost of finance, liquidity can quickly become an issue. As lenders update their own probability of default (PD) assumptions, they should understand the impact on their working capital and debt serviceability and be mindful of how this will feed through to provisioning levels. How will it impair lenders' own balance sheets? For example, is there sufficient covenant headroom within a lenders' own debt facilities? Lenders should also consider the likelihood of their owners/investors also experiencing liquidity requirements and whether they will want to withdraw cash from the business.

Lenders should review their ability to reduce costs. Operational efficiencies may include assessing headcount or considering outsourcing relevant functions. Granular cash flow forecasting should be undertaken on a regular basis to ascertain whether firms have enough liquidity headroom. At a corporate level, management also need to plan for any debt facilities due to mature in the short to medium term.

Higher interest rates risk being over-leveraged or asset / liability mis-matches

The IMF Financial Stability Report highlights particular challenges that non-bank lenders such as SME lenders may be facing in this current period of higher interest rates, including lenders themselves being over-leveraged.

The sustained period of low interest rates from 2009 to 2022 incentivised many investors to use leverage to boost returns. This can bring increased risk of financial distress when interest rates rise rapidly, as they did in 2022-2023 and SME lenders may face burdensome debt service commitments. Leverage can also make SME lenders more vulnerable to sudden changes in asset prices, which we're seeing with the current weakening in the real estate market.

SME lenders may also be vulnerable to asset / liability mis-matches, where the borrowing rate exceeds the return on assets, particularly as interest rates have risen so quickly. This is impacting some of the clients that we're working with.

Lenders should undertake detailed scenario planning, including a wide range of interest rates and asset prices, which can help support the resolution of any problems. They should review their hedging strategy and look at what their options are if they need to realise cash quickly.

SMEs increasingly vulnerable to cyberattacks

SME lenders should be aware that there has been a marked increase in cyberattacks against SMEs. Research has shown that:

- 50% of all UK businesses have reported a cyberattack so far in 2024. Of these, the vast majority (81%) are SMEs
- In 2022, the average average cyberattack cost £4,200. In 2024, the average cost to remedy an attack has increased to £21,000
- Only 22% of UK businesses have a formal cybersecurity plan in place

For SMEs, the stakes of a cyberattack are high including lost data, business disruption and reputational damage. As such, when subject to ransomware attacks, previous research has shown that 59% of SMEs have paid the ransom fee, with 93% paying more than £8,400. Unfortunately, 37% of those who paid didn't get some, or any of their data back. Losing such sums of money can significantly affect the viability of SMEs.

SME lenders need to undertake cyber due diligence and incorporate cyber risk into their credit assessment processes – and be aware of the risk of cyberattacks on their own business. Our market leading cyber team and help assess lenders' cyber risks or those of their borrowers, plan and implement a pragmatic and proportionate cyber strategy, test security controls and scan networks and systems for vulnerabilities or other indicators that a firm may be under attack.

Greater risk of SME fraud

Detecting and preventing fraud in SMEs is an ongoing challenge for lenders – but the risk increases when SMEs are under stress. As financial pressure on both individuals and businesses builds, company directors may resort to fraud, for example overstating asset valuations, pulling income from or pushing expenses to future periods, creating fake invoices, or misusing a directors' loan account as an alternative source of income.

Fraud can account for a significant proportion of credit losses. Lenders are approving loans based on falsified information, which therefore have a significantly higher risk of delinquency.

Anti-fraud legislation introduced as part of the Economic Crime and Corporate Transparency Act includes the 'failure to prevent fraud' offence.

SMEs are exempt from this legislation. However, there are concerns that this loophole could lead to even more fraud in SMEs by encouraging fraudsters to use SMEs to act as intermediaries in their crimes, or organised crime groups breaking up their business into smaller entities to get around the legislation.

Lenders should be aware that while dealing with SMEs always comes with a certain level of fraud risk, that risk is likely to increase. We've been approached by some of the big banks asking for fraud awareness training and fraud risk management benchmarking, which only speaks to the importance that SME lenders should attach to this issue - both from the perspective of increased fraud losses as well as compliance with the new legislation.

Detecting and preventing fraud requires significant resources and investment in anti-fraud measures, conducting due diligence and hiring staff to investigate potential fraud cases. SME lenders should consider seeking advice on fraud detection technologies from our market leading forensics team at Grant Thornton.

For more information or advice, contact Chris Laverty**.**