



**POLITICAL  
INTELLIGENCE**

# SME Finance and Capital Reform: Balancing Growth, Competition and Stability

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## Introduction

The UK Government has placed financial services reform at the centre of its growth agenda, with the 2025 Financial Services Growth and Competitiveness Strategy and the Mansion House Leeds Reforms signalling a material shift in how regulation is framed: not merely as a tool of stability, but as [an instrument to boost investment](#) and productivity.

SME finance sits at the intersection of these ambitions. Smaller and medium-sized businesses [account for 99.9 percent of UK firms](#) and remain central to employment, innovation and regional economic rebalancing. Nevertheless, persistent constraints on access to finance continue to limit their capacity to invest and scale.

This briefing examines how recent changes to bank capital requirements interact with that access challenge, with particular attention to the growing role of challenger banks and the structural implications for policymakers and financial services stakeholders.



## Context: A Regulatory Framework in Transition

The current Government's approach to financial regulation marks a departure from the post-financial crisis consensus in which stability considerations dominated all others. The 2025 Financial Services Growth and Competitiveness Strategy and the associated Leeds Reforms - announced at Mansion House - [reflect](#) a deliberate effort to make the UK [a more attractive destination](#) for capital, business formation and international investment, without abandoning the prudential foundations established after 2008.

This shift is driven by several converging pressures. Brexit has raised persistent questions about the UK's capacity to retain financial services activity that once benefited from EU passporting. Domestically, sluggish productivity growth and persistent regional inequality have increased pressure on the Treasury to identify supply-side levers. Internationally, the UK faces competitive pressure from jurisdictions, notably the United States and Singapore, that have been willing to signal a lighter regulatory touch.

The result is a recalibration rather than a reversal. The Prudential Regulation Authority's [decision](#) to delay Basel 3.1 implementation to January 2027 reflects these pressures directly, acknowledging competitiveness concerns without abandoning the underlying capital framework. The Financial Policy Committee has similarly reviewed the overall level of bank capital requirements, with particular attention to whether leverage-ratio constraints are appropriately calibrated for domestically focused lenders.

Against this backdrop, SME finance has become a focal policy concern. Smaller and medium-sized enterprises [dominate](#) the UK business sector and account for the majority of private-sector employment, and a significant share of local economic activity. Their persistent underinvestment, whether in equipment, working capital, innovation or expansion, represents one of the most consequential weaknesses in the UK's growth model.



## State Of Play: The Market Structure and Rising Challengers

The structure of UK SME lending has changed significantly over the past decade. In the aftermath of the global financial crisis, [around 90 percent of SME lending](#) was provided by four largest incumbent banks. Since then, technological improvement and the rise of fintech, combined with regulatory support for competition, has led to a much more diverse lending landscape.

Challenger banks and specialist fintech lenders, including Revolut, Monzo, Starling and OakNorth, have expanded rapidly, capitalising on digital infrastructure, lower fixed costs and the capacity to underwrite at scale without the branch networks and legacy IT systems that constrain incumbent institutions. Since 2014, [more than 30 new banking licenses](#) have been issued to SME-focused lenders. Now the shift is more evident than ever: according to the [British Business Bank](#), challenger and specialist banks accounted for around 60% of gross lending to smaller businesses in 2024/25.

The British Business Bank's 2024/25 findings confirm that this structural shift has now reached a tipping point: challenger and specialist banks [accounted for 60 percent](#) of gross lending to smaller businesses, surpassing the large incumbent banks for the fourth consecutive year. The recent award of a full UK banking licence to Revolut - one of the sector's most watched regulatory decisions - underscores the growing systemic relevance of these institutions.

This matters for capital policy in two ways. First, challenger banks tend to operate more concentrated business models, with a higher proportion of their balance sheets allocated to SME and retail lending. Capital requirements therefore bite more directly on their growth trajectories than on the diversified majors. Second, their technological agility gives them a genuine underwriting advantage, particularly in cash-flow-based lending, where traditional collateral models are less relevant. However, this advantage can only be deployed at scale if the regulatory framework accommodates their model.

Incumbent banks, by contrast, face a different constraint. For large institutions with diversified balance sheets and multiple revenue streams, the question is rarely whether they can lend to SMEs at all; it is whether SME finance is competitive with mortgages, consumer credit and corporate lending for balance-sheet space. The practical effect is that capital reform at the



margin is more likely to open room for challengers to grow than to materially alter the strategic behaviour of the majors.



## The Policy Problem: Persistent Gaps in Access

Despite headline lending volumes that appear broadly stable, the British Business Bank's 2026 Business Finance Survey [shows](#) continuing unevenness in SME access to finance. The gaps are most pronounced in three areas:

1. Unsecured borrowing, where smaller firms without sufficient collateral remain underserved, particularly in the early stages of growth.
2. Growth and expansion capital, where the gap between what banks offer and what scaling businesses require is often bridged by personal savings or informal networks rather than institutional finance.
3. Flexible funding structures that accommodate uneven cash flow - a near-universal feature of small business operations - rather than requiring the predictable repayment profiles that suit bank underwriting models.

The consequences are not merely commercial. SME underinvestment is one of the most frequently cited structural contributors to the UK's weak productivity performance relative to comparable economies. When smaller firms cannot finance the equipment, processes or talent that would raise their output per worker, the aggregate effect compounds across hundreds of thousands of businesses and entire regional economies.

The geographical dimension is particularly significant. Access gaps are notably [sharper outside London and the South East](#), where challenger bank penetration remains lower and traditional bank branch closures have reduced the relationship-banking infrastructure that many SME owners relied upon for both credit and financial guidance.



## How Capital Rules Shape Lending Behaviour

Capital requirements influence lending by determining how much equity a bank must hold against a given loan or portfolio. The higher the requirement, the more expensive it is to expand lending, particularly into segments characterised by higher risk weights, less standardised collateral or limited credit history. SME finance tends to attract all three features.

For challenger banks, which typically lack the diversified revenue streams that allow large institutions to absorb capital costs across a broad portfolio, these requirements can be directly constraining. Tighter leverage-ratio requirements, internal model restrictions and supervisory expectations around risk calibration can all limit the pace at which a challenger bank can grow its SME book, even when commercial demand exists and underwriting capability is demonstrably sound.

The reform agenda therefore has direct structural consequences. If capital rules become more proportionate, calibrated to the actual risk profile and systemic significance of each lender rather than applying a common framework regardless of size or model, then challenger banks gain competitive headroom. If reform is poorly designed or delivered too slowly, the effect may instead be to push newer lenders toward lower-risk, less SME-intensive products, reducing competition precisely where it would be most beneficial.



## Political And Stakeholder Views

HM Treasury [frames](#) SME finance primarily as a growth and access issue. Its 2025 call for evidence highlights relatively subdued demand for finance alongside a structural shift in supply, with challenger banks now providing the majority of SME lending. The department's policy stance focuses on widening lending choice, strengthening alternative finance channels and using institutions such as the British Business Bank to broaden the financing base available to smaller firms.

By contrast, the Bank of England and the Prudential Regulation Authority approach SME lending through the lens of financial stability and credit conditions. The Bank of England [monitors](#) SME lending as part of wider credit transmission, focusing on pricing, availability, and macroeconomic impact rather than treating it as a direct policy target. The PRA's 2025 policy adjustments, including changes to Pillar 2A requirements, [reflect](#) a cautious but supportive stance, aiming to avoid unintended increases in capital requirements for SME exposures while maintaining overall resilience in the banking system.

[UK Finance](#) emphasises the continued role of banks in supporting SMEs, consistently highlighting strong lending volumes and the availability of finance for small businesses. It has also called for policy measures to sustain lending flows, including making the Growth Guarantee Scheme permanent and expanding its capacity to support further investment.

[TheCityUK](#) takes a broader competitiveness-focused approach. Its Financing Britain's Future strategy frames SME finance as part of a wider agenda to drive long-term economic growth and job creation. It emphasises the need to reduce friction in financial markets – including through the digitalisation of SME lending processes – and views improved access to credit as a key component of the UK's productivity performance.

[Innovate Finance](#), representing challenger banks and fintech lenders, argues that the current regulatory framework remains insufficiently proportionate for newer, technology-led institutions. It advocates for a more level playing field that enables alternative lenders to expand their role in SME finance. Its analysis highlights the importance of fintech and non-bank lenders in widening access to credit, particularly for businesses underserved by traditional banking models, and points to their growing contribution since the financial crisis and during periods of stress such as the Covid-19 pandemic.



Taken together, these perspectives highlight a central policy trade-off. While regulators prioritise stability and resilience, industry stakeholders emphasise the need for a more flexible and proportionate framework to support competition, innovation, and SME lending. The challenge for policymakers is to balance these objectives without undermining either financial stability or the UK's growth ambitions.

In practice, this suggests that current reforms are unlikely to produce a straightforward increase in lending. Instead, their primary effect is likely to be structural, reshaping how credit is allocated across the banking system. The implication is that capital reform operates less as a direct stimulus to lending and more as a mechanism for reallocating credit across the banking system.



## Policy Responses

### British Business Bank

The most direct policy instrument available to ministers is the British Business Bank. Its expanded mandate and increased permanent financial capacity, confirmed in the 2025 government mandate, are designed to widen supply, support underserved regions and sectors, and crowd in private capital where market incentives alone are insufficient. In practice, this means a portfolio of guarantees, co-investment structures and sector-specific lending programmes that reduce risk for private lenders and thereby extend the commercial frontier.

The BBB's role is especially important in the current environment because capital rule reform alone cannot substitute for it. Even a well-calibrated prudential framework will leave some segments of the SME market unviable for unsubsidised private lending. The BBB exists precisely to address those residual gaps — and its effectiveness depends on both the scale of its mandate and the sophistication of the instruments it deploys.

### Proportionate Regulation

The Leeds Reforms point toward a more tailored capital framework: lighter requirements where systemic risk is genuinely lower, and a more responsive supervisory regime for institutions that are not of systemic importance. For challenger banks and specialist SME lenders, this is potentially the more structurally significant reform, since it directly addresses the competitive asymmetry that currently advantages incumbents.

The design challenge is considerable. Proportionality requires regulators to make fine-grained distinctions between institutions, distinctions that create both opportunity for genuine tailoring and risk of regulatory arbitrage. The PRA's track record suggests a cautious approach, and the timeline for Basel 3.1 implementation indicates that change will be phased rather than rapid.

### Open Finance and Data Infrastructure

A dimension of the SME finance problem that is frequently underweighted in capital-focused discussions is the cost of credit assessment. For many SME lenders, the primary constraint is not capital adequacy but the expense of evaluating small, heterogeneous borrowers at scale — businesses with limited credit histories, complex ownership structures and highly variable cash flows.

Open finance and related data-sharing innovations have the potential to reduce these costs substantially. Better access to transaction data, tax records and accounting information can enable lenders, particularly technology-enabled challengers, to assess SME creditworthiness more accurately and at lower cost, expanding the viable lending frontier without requiring additional subsidy or capital relief. The Government's Innovation Measures associated with the Leeds Reforms signal awareness of this dimension, though implementation timelines remain uncertain.

### **Assessment and Outlook**

Recent capital rule changes are more likely to shift the composition of SME lending than to generate a dramatic near-term increase in total volumes. The structural effect, reallocating market share toward more active SME lenders, particularly challengers, is commercially significant and directionally welcome. But composition effects alone will not close the productivity investment gap that underlies the Government's growth agenda.

Three conditions are needed for the reform package to deliver its stated ambitions. First, capital reform must be genuinely proportionate rather than nominally so - applied in ways that materially change the economics of challenger bank lending rather than producing symbolic adjustments. Second, BBB capacity must be sufficient to address the residual gaps that market reform cannot reach, and the Bank must be willing to use structured instruments that move capital rather than simply provide guarantees. Third, data infrastructure reform, through open finance and related initiatives, must progress at a pace that matches the ambition of the prudential changes, since underwriting cost remains as significant a barrier as capital cost for many lenders.

For the financial services sector, the near-term implication is a market structure in transition. Challenger banks that can demonstrate sound credit performance and operational resilience will find the regulatory environment more hospitable than at any point since the post-crisis frameworks were established. Incumbents will face pressure to respond through product innovation, partnership or acquisition as the competitive landscape shifts.

For SMEs, the policy significance is conditional: more flexible capital rules can improve competition, choice and pricing, but only if matched by the complementary interventions



described above. The reforms are best understood as a reallocation mechanism, not a standalone solution to the UK's persistent small-business finance gap.

### **Key Issues for Stakeholders to Monitor**

**PRA Basel 3.1 implementation detail (January 2027):** how proportionality provisions are drafted and applied in practice will determine whether challenger banks benefit materially or marginally.

**British Business Bank mandate review:** whether the expanded mandate translates into genuinely additional risk capacity, or consolidates existing programmes under new framing.

**Open finance legislative timeline:** the Government has signalled intent but implementation requires primary or secondary legislation; delays here constrain the data-infrastructure lever significantly.

**Leverage ratio calibration:** the FPC's review of overall capital levels — particularly its implications for retail and SME-focused lenders — remains ongoing and is closely watched by challenger bank investors.

**Revolut and post-licensing growth:** the full banking licence awarded to Revolut is a bellwether. Its subsequent growth trajectory in SME lending will provide early evidence of whether the regulatory environment is functioning as intended.



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