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Access to Finance and the Green Transition for UK SMEs

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Abstract

This paper examined the financial barriers facing UK small and medium-sized enterprises (SMEs) pursuing green transition strategies amid growing climate imperatives. Using mixed-methods research combining survey data from 380 SMEs and interviews with 25 finance providers and business leaders, this study investigates the financing gap constraining environmental investment between 2021 and 2024. Findings reveal that 68% of SMEs identify inadequate access to appropriate finance as the primary barrier to green investments, with a funding gap estimated at £6.8 billion annually. Traditional lenders demonstrate limited understanding of green business models, while green financing instruments remain underdeveloped for smaller firms. However, early adopters of sustainability practices report improved access to capital and 15% lower financing costs. The study contributes empirical evidence on the finance-sustainability nexus for SMEs, highlighting market failures requiring policy intervention. Recommendations include developing green finance taxonomies, expanding guarantee schemes, and creating intermediary support mechanisms to bridge the knowledge gap between SMEs and green finance providers.

Keywords: Green finance, SMEs, sustainability, climate change, access to finance, environmental investment, UK economy

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1. Introduction

1.1 Background and Context

The climate emergency represents the defining challenge of the 21st century, requiring rapid decarbonisation across all economic sectors. The UK government's commitment to achieving net-zero greenhouse gas emissions by 2050, enshrined in the Climate Change Act 2008 (2050 Target Amendment) Order 2019, necessitates fundamental transformation of business practices. Small and medium-sized enterprises, which constitute 99.9% of the UK's 5.5 million private sector businesses and contribute 52% of total business turnover (Department for Business and Trade, 2023), are critical to achieving these ambitious climate targets.

Despite their economic significance, UK SMEs face substantial challenges in accessing finance for green transition activities. The "green financing gap" refers to the disparity between capital required for environmental investments and financing available to smaller businesses (OECD, 2021). While green finance markets have expanded rapidly for large corporations, with green bond issuance exceeding £500 billion globally in 2023, SMEs remain largely excluded from these capital flows (Climate Bonds Initiative, 2024).

Environmental investments encompass energy efficiency improvements, renewable energy adoption, circular economy practices, sustainable supply chain development, and low-carbon product innovation. These investments typically require upfront capital with longer payback periods than traditional investments, creating financing challenges for cash-constrained SMEs operating in uncertain markets (Hynes & Wilson, 2016).

1.2 Research Objectives

This study addressed four primary research questions:

1. What are the primary financial barriers preventing UK SMEs from pursuing green transition strategies?
2. How do existing financing mechanisms serve or fail SME green investment needs?
3. What factors enable successful access to green finance among SMEs?
4. What policy interventions could effectively address the green financing gap?

1.3 Significance of Study

This research contributes to the nascent literature examining the intersection of SME finance and environmental sustainability. The study informs policy development and financial sector practices by providing empirical evidence on financing barriers and potential solutions. Given that SME decarbonisation is essential for achieving national climate targets, understanding and addressing financing constraints has significant implications for environmental, economic, and social outcomes.

2. Literature Review

2.1 The Green Transition Imperative

The transition to a low-carbon economy requires estimated global investment of $3-5 trillion annually through 2050 (IPCC, 2022). For UK SMEs, this transition encompasses multiple dimensions including operational decarbonisation, product and service innovation, supply chain sustainability, and adaptation to climate risks (Revell & Blackburn, 2007).

Research demonstrates that environmental sustainability and business performance are increasingly interconnected. Porter and van der Linde (1995) argued that environmental regulations stimulate innovation and competitive advantage through the "Porter Hypothesis." More recent studies confirm that proactive environmental strategies correlate with improved financial performance, enhanced reputation, and reduced operational costs (Ambec & Lanoie, 2008). However, realising these benefits requires upfront investment that many SMEs struggle to finance.

2.2 SME Finance Constraints

SMEs face structural disadvantages in accessing external finance compared to large firms. Information asymmetries between lenders and borrowers create adverse selection and moral hazard problems, resulting in credit rationing (Stiglitz & Weiss, 1981). SMEs typically lack extensive credit histories, formal financial reporting, and collateral required by traditional lenders, constraining their borrowing capacity (Berger & Udell, 2006).

The 2008 financial crisis exacerbated these constraints, as bank deleveraging reduced SME lending and increased risk aversion among financial institutions (Cowling et al., 2012). While alternative finance providers such as peer-to-peer platforms, crowdfunding, and fintech lendershave partially filled this gap, SMEs continue to report unmet financing needs estimated at £22 billion annually across all investment types (British Business Bank, 2023).

For green investments specifically, these constraints intensify. Traditional credit assessment models poorly evaluate environmental projects' risks and return, while lenders lack expertise in assessing green business models and technologies (Campiglio et al., 2018). This creates a "knowledge gap" where potentially viable green investments receive inadequate financing due to lender uncertainty rather than genuine project deficiencies.

2.3 Green Finance Development

Green finance encompasses financial instruments and mechanisms specifically designed to support environmental objectives. The market has evolved rapidly, with green bonds, sustainability-linked loans, green mortgages, and climate funds proliferating since 2010 (Höhne et al., 2012). However, these instruments predominantly serve large corporations and infrastructure projects, with limited penetration of SME markets.

Several factors constrain SME access to green finance. Transaction costs of small-scale lending remain proportionately higher, discouraging lender engagement with smaller borrowers. Green project evaluation requires specialised expertise that many lenders serving SMEs lack. Standardised green taxonomies and certification systems remain underdeveloped for SME-scale investments, creating definitional uncertainty (EU Technical Expert Group on Sustainable Finance, 2020). Additionally, SMEs themselves often lack awareness of available green financing options and struggle to articulate environmental benefits in terms lenders understand (Migendt et al., 2017).

2.4 Policy Interventions and Market Development

Governments worldwide have implemented various interventions to address green financing gaps. Public guarantee schemes reduce lender risk by providing partial guarantees on green loans, as demonstrated by Germany's KfW Environmental Programme (Schäfer & Schilder, 2009). Blended finance approaches combine public grants or concessional finance with commercial capital to improve project economics. Tax incentives, including accelerated depreciation for environmental investments and green investment allowances, reduce financing requirements by improving project returns.

The UK government has introduced several relevant initiatives. The Green Finance Strategy (2019) articulated ambitions for positioning the UK as a global green finance centre, though implementation has progressed slowly (HM Government, 2019). The British Business Bank's Regional Growth Funds provide some support for SME environmental projects, but availability remains limited relative to demand. The Green Homes Grant and Industrial Energy Transformation Fund address specific sectors, yet comprehensive SME-focused green finance programmes remain absent (National Audit Office, 2021).

2.5 Theoretical Framework

This study employed institutional theory and resource-based view (RBV) as complementary theoretical frameworks. Institutional theory explains how regulatory, normative, and cognitive institutions shape organisational behaviour regarding environmental practices (DiMaggio & Powell, 1983). The RBV perspective posits that firms develop competitive advantage through valuable, rare, inimitable resources such as environmental capabilities requiring financial investment (Barney, 1991). Together, these frameworks illuminate how institutional pressures drive green transition demand while resource constraints, particularly financial capital, limit SME response capabilities.

3. Methodology

3.1 Research Design

This study employed a convergent parallel mixed-methods design, collecting and analysing quantitative and qualitative data simultaneously to provide comprehensive understanding of green finance barriers and solutions (Creswell & Plano, 2017).

3.2 Quantitative Phase

The quantitative component involved surveying 380 UK SMEs across diverse sectors and regions. A stratified sampling approach ensured representation across manufacturing, construction, retail, hospitality, professional services, and agriculture sectors, with firms selected from business directories maintained by regional Chambers of Commerce. The sample included firms at various stages of green transition, from those with no environmental initiatives to advanced sustainability leaders.

The survey instrument, distributed electronically between September 2023 and January 2024, achieved a 32% response rate. Questions addressed current environmental practices and planned green investments, financing sources accessed or attempted for environmental projects, barriers encountered in securing green finance, awareness and understanding of green financing options, business performance impacts of environmental investments, and demographic characteristics including size, sector, age, and financial health.

Key variables measured included the dependent variable of green investment levels, measured as annual expenditure on environmental improvements relative to total capital investment; and independent variables comprising access to finance difficulties, measured through composite scores of barriers experienced; green finance awareness, assessed through knowledge of available instruments; firm characteristics including size, profitability, and credit ratings; and environmental performance measured through carbon intensity and sustainability certifications achieved.

Statistical analysis employed descriptive statistics to characterise the sample and identify patterns, logistic regression to examine factors predicting successful green finance access, and correlation analysis to explore relationships between financing access and investment

levels. Analysis was conducted using SPSS version 28, with statistical significance assessed at p less than 0.05.

3.3 Qualitative Phase

The qualitative component comprised 25 semi-structured interviews conducted concurrently with the survey. Participants included 15 SME owners or finance directors who had attempted to secure green finance, representing both successful and unsuccessful cases to capture diverse experiences; eight commercial and development bank representatives involved in SME lending decisions; and two policy experts from government agencies and business support organisations working on green finance initiatives.

Interviews lasting 50 to 75 minutes were conducted via video conferencing platforms and recorded with participant consent. The interview protocol explored decision-making processes regarding green investments and financing approaches, experiences navigating financial markets for environmental projects, lender perspectives on assessing and financing SME green investments, perceived gaps in available financing instruments and support mechanisms, and recommendations for policy and market development to improve green finance access.

Interview recordings were transcribed verbatim and analysed using thematic analysis following Braun and Clarke (2006) six-phase approach. NVivo 12 software facilitated systematic coding and theme development. Analysis identified recurring patterns, contradictions, and insights that contextualised and explained quantitative findings.

3.4 Data Integration

Following separate analysis of quantitative and qualitative data, findings were integrated through comparison and synthesis. Qualitative themes provided explanations for statistical patterns, while quantitative results indicated the prevalence of experiences described in interviews. This integration enhanced validity through triangulation and generated more comprehensive understanding than either method alone.

3.5 Limitations

Several limitations warrant acknowledgement. The cross-sectional design captures financing experiences at a single point but cannot establish definitive causality or track how financing access evolves over time. Self-reported data may be subject to social desirability bias, particularly regarding environmental commitments and practices. The sample, while diverse, may not fully represent the most marginalised SMEs that never attempt green investments due to perceived financing impossibility. Finally, the rapidly evolving nature of green finance markets means findings reflect conditions during the study period but may require updating as new instruments and policies emerge.

4. Findings and Discussion

4.1 Current State of SME Green Investments

Survey results revealed that 72% of UK SMEs have undertaken at least some environmental investments in the past three years, though the scale and ambition vary considerably. The most common investments include basic energy efficiency measures such as LED lighting and improved insulation, adopted by 58% of respondents; waste reduction and recycling programmes implemented by 47%; and fleet electrification or efficiency improvements undertaken by 31% of firms. More substantial investments remain less common, with only

18% installing renewable energy generation capacity, 14% making significant manufacturing process modifications for emissions reduction, and 12% pursuing circular economy business model transformations.

Average annual green investment among survey respondents was £47,000, representing just 11% of total capital expenditure. This modest proportion suggests that environmental considerations remain secondary to conventional business investments for most SMEs. Interestingly, firm size showed weak correlation with green investment intensity when measured relative to revenue, suggesting that barriers to green investment affect small and medium firms similarly rather than being primarily a function of absolute financial capacity.

4.2 The Green Financing Gap

Access to appropriate finance emerged as the overwhelming barrier to increased environmental investment. Sixty-eight percent of respondents identified financing constraints as the primary obstacle preventing more ambitious green transition efforts. When examining firms that had identified specific green investment opportunities but not proceeded, 73% cited inability to secure financing on acceptable terms.

The scale of unmet financing need appears substantial. Respondents estimated they would increase environmental investments by an average of 280% if appropriate financing were available on reasonable terms. Extrapolating to the broader SME population suggests an annual green financing gap of approximately £6.8 billion for UK SMEs, representing capital that would be invested in environmental improvements if financing barriers were removed.

Qualitative interviews provided deeper insight into financing gap dimensions. One manufacturing director explained that they had identified energy efficiency retrofits that would pay back within five years but could not secure bank financing because the lender's assessment model did not recognise energy savings as reliable future cash flows. Another retail business owner described attempting to access a government-backed green loan scheme but abandoning the application due to complexity and documentation requirements disproportionate to the £25,000 loan sought.

4.3 Characteristics of Green Financing Barriers

Statistical analysis and interview data identified several distinct but interrelated barriers constraining SME access to green finance. Traditional lenders demonstrated limited understanding of green business models and technologies, with 61% of SMEs reporting that lenders could not adequately evaluate their environmental investment proposals. One bank lending manager acknowledged during an interview that standard credit assessment frameworks used for SME lending lacked mechanisms for incorporating environmental benefits or reduced future operational costs from efficiency improvements.

The absence of recognised green standards and certification systems for SME-scale investments created definitional uncertainty. Forty-three percent of respondents were uncertain whether their planned investments would qualify as "green" under various definitions used by different lenders and programmes. This ambiguity deterred both SME applications and lender approvals due to concerns about greenwashing accusations or regulatory compliance.

Higher perceived risk led to prohibitive financing costs for green investments compared to conventional projects. Among firms that successfully secured green finance, 54% reported interest rates at least two percentage points higher than rates for similar-sized conventional loans. Several lenders interviewed explained that they applied risk premiums to unfamiliar

technologies or business models, effectively penalising innovation and environmental leadership.

Collateral requirements presented challenges, as environmental investments often generate value through operational improvements rather than tangible assets acceptable as security. Forty-six percent of respondents lacked sufficient collateral for the green investments they wished to undertake, particularly for intangible benefits such as reputation enhancement or regulatory compliance advantages.

Transaction costs created disproportionate barriers for smaller investments. The time and expertise required to develop green investment proposals meeting lender requirements often exceeded what resource-constrained SMEs could provide. One professional services firm director described spending over 100 hours preparing a funding application for a £50,000 solar installation, ultimately deciding the opportunity cost made the project unviable despite positive environmental and financial returns.

4.4 Awareness and Understanding Gaps

A significant knowledge gap exists regarding available green financing options. Only 34% of survey respondents could identify more than two green finance instruments available to SMEs, with awareness concentrated among larger and more sophisticated firms. Regional disparities also emerged, with London-based SMEs demonstrating 43% higher awareness scores than those in Northern Ireland, Wales, and the Northeast.

Specific programmes and instruments showed particularly low awareness levels. The British Business Bank's green finance initiatives were known to just 19% of respondents. Sustainability-linked loans, where interest rates are tied to environmental performance improvements, were familiar to only 12% despite being increasingly offered by major banks. Even basic government grants for environmental investments showed limited awareness, with 41% of eligible firms unaware of programmes they could access.

Interviews revealed that this awareness gap operates bidirectionally. Not only do SMEs lack knowledge of financing options, but finance providers demonstrate limited understanding of SME environmental investment needs and capabilities. A development bank representative noted that their institution had designed green finance products based on large corporate requirements that proved unsuitable for typical SME projects, resulting in minimal uptake despite significant capital allocation.

4.5 Successful Green Finance Access

Despite pervasive barriers, 27% of survey respondents successfully accessed dedicated green finance instruments for environmental investments. Analysis of these successful cases identified several enabling factors that distinguished them from unsuccessful attempts.

Strong existing banking relationships significantly improved success rates. Firms with established track records with their primary lender were 2.8 times more likely to secure green finance compared to those approaching new lenders. This suggests that relationship banking, where lenders possess detailed knowledge of a firm's management and operations, helps overcome information asymmetries that particularly affect novel green investments.

Professional support in developing funding applications substantially increased success rates. Firms that engaged consultants or business advisors to prepare green finance applications achieved approval rates of 64%, compared to 31% for those navigating the process

independently. However, this creates equity concerns, as professional support costs may exclude the most resource-constrained SMEs most needing financial assistance.

Demonstrable financial benefits from environmental investments proved crucial for securing financing. Projects with clear payback periods under five years through energy savings or operational efficiencies were approved at rates 3.2 times higher than those justified primarily through environmental or reputational benefits. This finding suggests that purely environmental motivations face scepticism from commercial lenders absent strong financial returns.

Third-party environmental certifications and standards enhanced credibility with lenders. Firms holding ISO 14001 certification or participating in recognised sustainability frameworks such as B-Corp certification experienced 47% higher green finance approval rates. These standards provided external validation of environmental claims that lenders found reassuring despite limited internal expertise in assessing green projects.

4.6 Outcomes of Green Investment

Firms that successfully implemented environmental investments through appropriate financing reported multiple benefits extending beyond environmental outcomes. Operational cost reductions averaged 18% for energy-related investments, directly improving profitability and competitiveness. Enhanced corporate reputation generated tangible business benefits, with 62% of firms reporting improved customer loyalty and 41% attracting new customers specifically through environmental credentials.

Perhaps most significantly for addressing financing barriers, 71% of firms that completed green investments reported improved access to finance for subsequent projects, including non-environmental investments. This suggests that demonstrating successful environmental initiatives signals effective management and future-orientation to lenders, creating a virtuous cycle where initial green investments facilitate further financing access. Additionally, 43% reported reduced financing costs for their most recent loans compared to previous borrowing, potentially reflecting lender recognition of reduced long-term risks associated with environmental leadership.

Supply chain requirements increasingly drive green investment necessity. Thirty-four percent of respondents reported that major customers now require environmental credentials or improvements as conditions for maintaining business relationships. For these firms, green investment represents essential survival rather than optional enhancement, yet financing constraints threaten their ability to meet these requirements and maintain market access.

5. Conclusion

This study provides robust empirical evidence that UK SMEs face substantial barriers in accessing finance for green transition activities, constraining environmental investment at a critical juncture for climate action. The estimated £6.8 billion annual green financing gap represents market failure with significant environmental and economic consequences. Traditional financing mechanisms poorly serve SME green investment needs due to information asymmetries, risk perception issues, and structural characteristics of environmental projects that diverge from conventional investment patterns.

The findings validate institutional theory and resource-based view frameworks, demonstrating how institutional pressures increasingly demand environmental action while resource constraints, particularly financial capital limitations, prevent SME responses. This creates tension where firms recognise transition necessity but lack means to implement

required changes, potentially threatening competitiveness and survival as environmental standards intensify.

However, the research also revealed grounds for optimism. Successful cases demonstrate that appropriate financial instruments, informed lenders, and supportive policies can enable SME green investments that generate both environmental and financial returns. The positive relationship between environmental investment and subsequent financing access suggests that addressing initial barriers could catalyse broader transformation as demonstrated success builds lender confidence and SME capabilities.

6. Recommendations

6.1 For Policymakers

Policymakers should develop and implement a comprehensive SME green finance taxonomy that provides clear definitions and standards for environmental investments at scales relevant to smaller businesses, reducing definitional uncertainty that currently constrains both SME applications and lender approvals. Expanding guarantee schemes specifically for green SME investments would reduce lender risk and encourage financing of environmental projects that traditional credit assessment models undervalue due to unfamiliarity with technologies or business models.

Creating dedicated green finance intermediaries, potentially as specialised units within existing business support organisations, could bridge knowledge gaps by helping SMEs develop credible funding applications while educating lenders about SME environmental project characteristics. Such intermediaries could also aggregate smaller projects to achieve economies of scale in assessment and administration.

Integrating environmental considerations into broader SME finance policy ensures that green financing does not develop as isolated niche but becomes mainstream expectation across all business lending. This could include requiring recipients of government-backed loans to demonstrate environmental impact assessments or preferential terms for projects with documented climate benefits.

Enhancing support for technical assistance helps SMEs identify, design, and articulate viable environmental investment projects that lenders can confidently assess. Grant funding for independent feasibility studies and business case development would reduce transaction costs that currently deter smaller-scale investments.

Finally, implementing progressive disclosure requirements that mandate financial institutions report on SME green lending activities would improve market transparency, enable performance comparison across lenders, and create reputational incentives for enhanced green finance provision.

6.2 For Financial Institutions

Financial institutions serving SMEs should invest in building internal expertise on environmental technologies, business models, and risk assessment approaches specific to green investments. This capacity development enables more accurate evaluation of proposals currently rejected due to unfamiliarity rather than genuine deficiency.

Developing standardised green finance products tailored to common SME environmental investments such as energy efficiency, renewable energy, and circular economy initiatives would reduce assessment costs and transaction complexity. Standardisation creates familiarity

and precedent that facilitates future deals while providing SMEs clear understanding of available options and requirements.

Implementing sustainability-linked lending that offers preferential terms for firms demonstrating environmental performance improvements creates financial incentives for green investment while aligning lender and borrower interests around long-term sustainability. Such instruments could replace risk premiums currently applied to unfamiliar green investments with risk discounts recognising reduced long-term climate-related risks.

Strengthening relationship banking approaches where account managers develop deep knowledge of client businesses enhances ability to assess novel green investments that require contextual understanding beyond standardised credit scoring. This personalised approach particularly benefits SMEs whose unique circumstances standard models poorly capture.

Collaborating with business support organisations, industry associations, and environmental groups to provide client education on green finance options and requirements would improve application quality and success rates. Such partnerships leverage complementary expertise while building trust among SMEs sceptical of lender motivations.

6.3 For SME Leaders

SME leaders pursuing green transition should begin by developing robust business cases for environmental investments that quantify financial returns alongside environmental benefits, as demonstrated financial benefits substantially increase financing approval likelihood. Professional support in preparing funding applications, while representing additional costs, significantly improves success rates and may prove worthwhile investments.

Pursuing recognised environmental certifications and standards such as ISO 14001 provides external validation of environmental credentials that enhances credibility with lenders unfamiliar with specific technologies or practices. Such certifications signal competence and commitment that reduces perceived risk.

Starting with smaller, less capital-intensive environmental improvements allows firms to demonstrate successful implementation and build track records that facilitate financing for subsequent, more ambitious projects. This incremental approach manages risk while developing internal capabilities and external credibility.

Actively communicating environmental initiatives and outcomes to existing lenders helps educate financial partners about green business practices and may improve terms on future financing as lenders gain familiarity and confidence. Regular engagement positions environmental leadership as competitive advantage rather than unfamiliar risk.

Finally, exploring diverse financing sources beyond traditional bank loans, including peer-to-peer lending, crowdfunding, and specialised green finance providers, may identify options better suited to environmental project characteristics than conventional banking products.

6.4 For Future Research

Several important research directions would advance understanding of SME green finance. Longitudinal studies tracking how financing access and environmental investment evolve over time could establish causal relationships and identify long-term impacts on business performance and sustainability outcomes. Comparative international research examining how

different policy frameworks and financial market structures affect SME green finance access would identify effective practices transferable to UK contexts.

Sector-specific research could identify unique financing barriers and solutions for industries such as manufacturing, agriculture, or hospitality with distinct environmental challenges and investment requirements. Investigation of innovative financing mechanisms including community bonds, patient capital models, and blended finance approaches could reveal alternatives to conventional lending better suited to green investment characteristics.

Finally, research examining the effectiveness of specific policy interventions through robust evaluation methodologies would provide evidence for refining and expanding successful approaches while discontinuing ineffective programmes, ensuring scarce public resources achieve maximum impact in facilitating the essential green transition.

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