

Graham Review

of the Small Firms Loan Guarantee



Interim Report

June 2004

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CONTENTS

	Page
Executive Summary	1
Chapter 1 Introduction	3
Chapter 2 UK Debt Market for Small and Medium-Sized Firms	7
Chapter 3 SFLG Data	15
Chapter 4 Next Steps	31
Annex A History of scheme changes	35
Annex B Call for submissions	39

EXECUTIVE SUMMARY

In November 2003, the Chancellor and the Secretary of State for Trade and Industry commissioned a review of the Small Firms Loan Guarantee (SFLG). The aim of the review is to examine, and make recommendations regarding the structure and rules of SFLG and their appropriateness to the scheme's effective operation and whether SFLG, as the Government's principal intervention in the supply of debt finance to SMEs, is sufficient to tackle the barriers faced by start-ups and small businesses in the current market.

This report contains the interim findings of the review. It presents data on the current use of SFLG against an analysis of the debt market for SMEs.

Key Findings

The evidence indicates that access to finance does not appear to be a significant barrier facing the generality of established businesses. The market in which businesses raise debt finance has changed since the introduction of SFLG. In particular, developments in credit assessment techniques appear to have reduced banks' recourse to collateral for smaller loans to established businesses.

Despite these developments, the review has found that above around £25,000 collateral is still frequently required, although practice differs between lenders. In addition, new scoring techniques, though beneficial for the majority of borrowers, favour those with a proven track record and good credit history. As a result, some start-up businesses, businesses with non-standard characteristics and those businesses seeking to expand beyond their current asset base may continue to face difficulties accessing finance.

The changes made to SFLG in April 2003, notably the reinclusion of certain sectors, has led to a major increase in the total number and value of loans, following a period in which the number of loans had been falling. In 2003/04 SFLG supported 5,966 loans, worth £409m. Over half of SFLG loans were made to start-ups and young businesses.

The evidence suggests that regional and local delivery of SFLG is patchy, both for demand-side reasons such as the availability of alternative sources of finance and for supply-side reasons such as differences in individual lenders' appetite for the scheme.

During the 1990s, default rates on SFLG loans were around 35% per year, by numbers of loans made. This is likely to be a result of a number of factors, including the fact that the guarantee rate enables lenders to make a commercially viable return at these default levels, allowing the lenders to provide debt to a riskier group of propositions. In addition, younger businesses have historically had a higher propensity to default on SFLG loans and are disproportionately represented among SFLG borrowers.

Responses to the call for submissions to the review have raised a number of questions about the rules for SFLG, the eligibility criteria and the administration of the scheme. The review team understands that these are extremely important issues for the effective operation of SFLG and will take them into serious consideration when formulating their recommendations. The final report, to be issued later in the summer, will consider SFLG in the context of the Government's wider interventions to improve access to finance for SMEs and identify where SFLG should be best targeted in order to maximise its impact.

INTRODUCTION

The small and medium-sized enterprise (SME) sector makes a vital contribution to the UK economy, accounting for 52% of private sector turnover and 56% of private sector employment. The Government's policy is to create the conditions in which SMEs flourish, "providing a supportive business environment and tackling barriers to SME formation and growth". One important issue in this context is the availability of external funding for SMEs. The Small Firms Loan Guarantee has for 23 years aimed to assist small firms to access finance to fund their start up and development.

Government's productivity agenda

1.1 The Government has, in a number of recent publications, set out its approach towards enterprise and the context for its strategy in this area. In *Enterprise Britain*¹ it acknowledged that the UK faces a significant and long-standing productivity gap with its major competitors and set out its objective to raise levels of productivity in the UK. The Government's strategy to narrow the productivity gap over the longer term consists of two elements: first a macroeconomic framework that aims to deliver stable economic growth and low inflation, and second, a series of microeconomic reforms based around the five identified 'drivers' of productivity. Enterprise has been identified, alongside competition, innovation, skills and investment, as one of the five areas that can influence the UK's productivity performance.

Productivity and enterprise

1.2 As described in *Bridging the Finance Gap*², the level of entrepreneurship is positively correlated with both the level of per capita GDP and the rate of GDP growth. The small business sector can, as a result, contribute to economic performance in a number of different ways. First, the creation and growth of new entrepreneurial firms contributes to a beneficial process of 'productive churn', by which more productive growing businesses increase their market share at the expense of less productive businesses. Second, entrepreneurial SMEs are also an important source of competition and innovation within the economy, driving productivity growth both within the SME sector and among other large businesses. As a result of this, the Government's approach to encouraging enterprise has centred on two main objectives:

- €# building a supportive business environment which encourages people to start and grow businesses, investing for the long-term; and
- €# correcting market failures that create obstacles to successful enterprise, investment and business growth.

Access to finance

1.3 Historically, one such market failure, identified as early as 1931, concerned the ability of firms to access small amounts of finance. Concerns about access to finance for small firms in the early 1990s prompted the Bank of England to publish the first in its series of Annual Reports, analysing the relationship between small firms and their lenders. At that time it was apparent that, following the recession, there had been a breakdown of communication and confidence between many SMEs and their finance providers and some SMEs complained that the actions of lenders were pushing potentially viable businesses into premature receivership.

¹ HM Treasury (November 2002) *Enterprise Britain: a modern approach to meeting the enterprise challenge*.

² HM Treasury (April 2003) *Bridging the finance gap: a consultation on improving access to growth capital for small businesses*.

1.4 Studies conducted since the early 1990s have shown a marked improvement in access to finance for small firms, such that, in its eleventh report, the Bank concluded that access to finance is not a barrier for most SMEs, but that there are some specific challenges facing certain types of businesses³. One such challenge is the ability of businesses to raise small amounts of risk capital. At this level, the high transaction costs and fixed ongoing running costs, combined with the high risk of lending to businesses at an early stage of development, may make the provision of small amounts of money unattractive to investors. This market failure, commonly referred to as the ‘equity gap’, has been the focus of a number of recent Government interventions, such as the Regional Venture Capital Funds and the forthcoming Enterprise Capital Funds.

Barriers in the debt market

1.5 Market failures have also been identified in the debt market, where the information needed by lenders to make judgements on individual loan applications may be expensive, or difficult to obtain. Although the evidence suggests that new credit assessment techniques have helped to overcome these difficulties, barriers resulting from a lack of information may still be faced by certain types of business, in particular those that lack an established track record. The ability to provide collateral or to inject personal capital into a business may help an entrepreneur provide reassurance to a lender that they believe their business to be a viable proposition. Entrepreneurs that lack collateral may therefore face difficulties in obtaining a loan.

SFLG 1.6 In order to address this barrier, one of the longest standing government interventions has been the Small Firms Loan Guarantee (see Box 1.1). Set up in 1981, it provides a guarantee to encourage banks and other financial institutions to lend where small firms are unable to raise conventional finance for viable projects because of a lack of collateral. Its intention is not to replace loans that would otherwise be made by the market and it therefore operates on a relatively small scale, comprising an estimated 2% of the market for term loans. Following the reinclusion in 2003 of a number of business sectors, including retailing, catering and vehicle repair, use of the scheme has risen by approximately 50%, taking the number of guarantees issued in 2003/04 to just under 6000.

Box 1.1: Small Firms Loan Guarantee

Main Terms and Conditions

The SFLG guarantees loans from banks and other financial institutions for small firms that have viable business proposals but who have tried and failed to get a conventional loan because of lack of security.

Loans are available for periods of between two and ten years on sums from £5,000 to £100,000 (£250,000 if the business has been trading for two years or more). SFLG guarantees 75% of the loan. In return for the guarantee, the borrower pays DTI a premium of 2% a year on the outstanding amount of the loan.

To be eligible, the SME must be a UK company with an annual turnover of no more than £3m (£5m if a manufacturer). Many business activities are eligible but there are a number of exclusions. Loans are available for most business purposes although there are some restrictions.

The commercial aspects of the loan are matters between the borrower and the lender only. The Government plays no part in commercial discussions and decisions.

³ Bank of England (April 2004) *Finance for Small Firms – An Eleventh Report*.

1.7 As identified in *Bridging the Finance Gap*⁴, the market in which businesses raise debt finance has become more sophisticated since SFLG was first introduced in 1981. The paper argued that equity finance is making a more significant contribution to SME financing today, and new forms of financing are coming to the market. In particular, the structure within which financial intermediaries operate has changed and the way in which small firms and start-ups are assessed for loans is more sophisticated. The authors argued that the use by banks of centralised scoring systems should make smaller loan amounts more easily accessible for firms with good behavioural records, perhaps addressing some of the barriers discussed above. However, there were concerns that some businesses may continue to face obstacles when raising debt finance, for example start-ups that lack a track record; those businesses without collateral seeking to borrow larger loan amounts; and businesses with non-standard characteristics or entrepreneurs associated with a failed enterprise.

Graham Review **1.8** It was in this context that the Chancellor of the Exchequer and the Secretary of State for Trade and Industry commissioned an independent review of SFLG; to consider its effectiveness in this changing market environment. The full terms of reference for the review are set out in box 1.2.

1.9 This report constitutes the interim findings of the review. The aim of this report is to allow readers to assess the current use of SFLG against an analysis of the debt market for SMEs. To this end, Chapter 2 is an assessment of the debt market and aims to identify any situations in which SMEs continue to face difficulties in accessing finance. It is based on a review of the existing literature, combined with consultation with financial institutions, SMEs and business support organisations. Chapter 3 goes on to analyse the use of SFLG, based on data obtained from the Small Business Service, and on consultation with lenders and businesses. Finally, Chapter 4 sets out the key outstanding questions for the review and outlines the issues that will be addressed in the final report of the Graham Review.

1.10 The review team will continue to consult stakeholders before preparing a final report later in the Summer (2004). This final report will consider not only the way in which SFLG is currently helping to address any identified gaps in the provision of finance to SMEs but also will make the necessary recommendations to ensure that SFLG is positioned in a way which will allow it to operate effectively in the debt market.

⁴ HM Treasury (December 2003) *Bridging the finance gap: next steps in improving access to growth capital for small businesses*.

Box 1.2: The Graham Review of the Small Firms Loan Guarantee**Terms of Reference****Context**

Enhancements to the Small Firms Loan Guarantee (SFLG) introduced in April 2003 have proved popular, and take-up has increased by more than 50 per cent. The Government welcomes this increase and believes that SFLG continues to play a valuable role in supporting small firms in the UK.

The Government is nevertheless aware that the market in which businesses raise debt finance is more sophisticated now than when SFLG was first introduced in 1981, and wishes to build upon the recent success of the scheme by examining its effectiveness in this changing market environment.

The Review

The Government has therefore asked Teresa Graham to conduct a review of SFLG to ensure that it is working effectively, and that through SFLG and other interventions, the Government is doing all it can to help start-ups and small firms overcome the obstacles that they face when raising debt finance.

Scope

The review will work closely with the main SFLG lenders and will examine and if appropriate make recommendations regarding:

- the structure and rules of SFLG and their appropriateness to the scheme's effective operation; and
- whether SFLG, as the Government's principal intervention in the supply of debt finance to SMEs, is sufficient to tackle the barriers faced by start-ups and small businesses in the current market.

Note: This is the original ToR text – the latest figures are that take-up increased by over 50% in 2003/04.

2.1 The SME population can be defined in a variety of different ways, according to, for instance, independence, turnover, employment and balance sheet size. The thresholds for the Small Firms Loan Guarantee (SFLG) currently in place restrict eligibility to those businesses with up to £3mn turnover (or £5mn for manufacturers) and up to 200 employees. As such, it is concentrated at the smaller end of the SME market. Little data exists on the SME finance market against which to assess the performance of SFLG. The British Bankers Association collects and publishes data on banks' lending and deposits to business customers with under £1mn debit turnover (using flows of funds out of a business' current account as a proxy for sales turnover), but, as yet, no analysis by sector or age of business is available. Although these data capture the majority of SMEs by number¹, businesses above this level of turnover are likely to have increasingly complex financing needs.

FINANCE FOR SMES

2.2 As has been acknowledged², small businesses are not just scaled down versions of larger businesses, particularly in the context of finance. More than larger businesses, they tend to suffer both from internal constraints, such as poor financial and management skills and a reluctance to surrender control to external investors, and from external constraints, the nature of which will be discussed later. Small businesses are likely to have less market power in their relations both with customers and financiers, and, as a result, tend to be price takers.

Demand for finance

2.3 It should be remembered that a large proportion of businesses do not use external sources of finance. Data provided to the British Bankers' Association has shown that businesses with a turnover of under £1mn have, in aggregate, been net-creditors to the banking system since the mid-1990s, with the level of deposits consistently above the total value of outstanding lending³. Cosh and Hughes (2003)⁴ found that only 40% of their sample of manufacturers and business service firms had sought external finance in past two years. Similarly, the Competition Commission (2002)⁵ found that 35% of small businesses had some form of external finance. Those firms that do not use external sources of finance will tend to rely instead on their own personal resources, particularly at start-up, and, once the business is trading, use retained profits to fund working capital.

2.4 Cosh and Hughes (2003)⁶ investigated the reasons why a high proportion of businesses had not sought finance over the past two years. Rather than indicating constraints on the supply of finance, their findings appear to reflect a lack of demand: the dominant reason given was that internal cash flows were sufficient (chart 2.1), although the risk of borrowing, and, to a lesser degree, the cost of finance, were also

¹ 94% of businesses employ fewer than 10 people but these make up only 22% of the business population by turnover (Small Business Service *SME Statistics UK 2002*).

² KPMG Management Consulting (1999) *An Evaluation of the Small Firms Loan Guarantee Scheme*.

³ British Bankers Association, cited in Bank of England (2003) *Finance for Small Firms – A Tenth Report*.

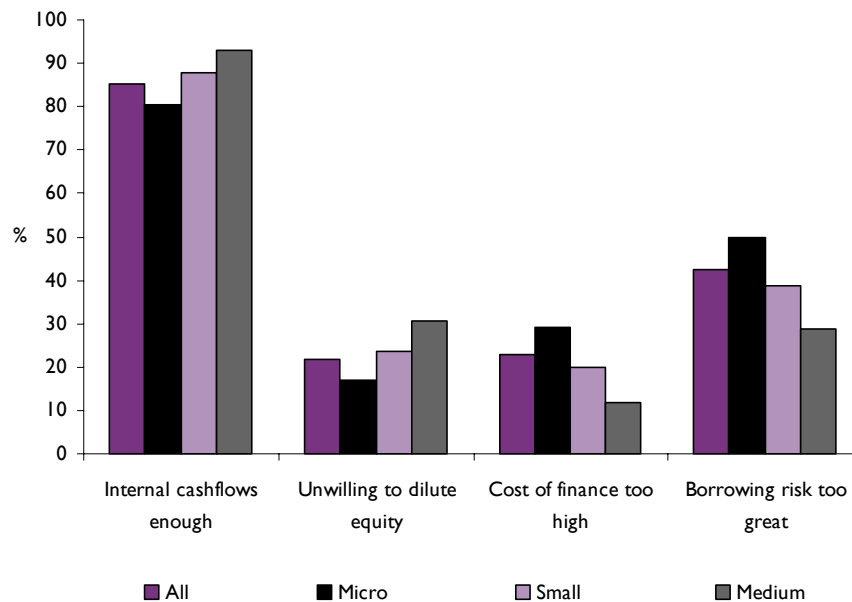
⁴ Cosh A. and Hughes A. (2003) *Enterprise Challenged: Policy and performance in the British SME sector 1999-2002* ESRC Centre for Business Research.

⁵ Competition Commission (2002) *The Supply of Banking Services by Clearing Banks to Small and Medium-sized Enterprises*.

⁶ Cosh, A. and Hughes, A. (2003) *Op cit*.

cited, particularly by micro and small firms. This evidence does not indicate whether or not businesses that do not seek finance are restricting their growth because of insufficient capitalisation. Nevertheless, it does not suggest that difficulties of access are limiting established firms' use of external finance.

Chart 2.1: Reasons given for not seeking additional external finance



Source: ESRC Centre for Business Research (2003)

Access to finance 2.5 Evidence from other recent business surveys concurs with this conclusion and suggests that, for established businesses, rejection rates are below 15%:

- ⚡ The NatWest SBRT survey⁷ found that only 1% of small firms cited access to finance or the level of interest rates as the main problem facing their business.
- ⚡ The Institute of Directors latest Business Finance survey (2003)⁸ reported an increase in the proportion of directors that said they thought that it was difficult to access finance compared with 2002 (25% compared with 18%). However, 85% of directors said they had never had a request for finance turned down by their bank.
- ⚡ Cruickshank (2000)⁹ established that term loans had the highest rejection rates of all forms of finance, at 13% compared with 2 to 4% for credit cards and asset finance. 60% of the declines were reportedly due to applicants having insufficient collateral or track record, which the authors took as a possible indication that, at the margin, some viable projects may fail to get bank funds.

⁷ Small Business Research Trust (December 2003) *NatWest Quarterly Survey of Small business Customers*.

⁸ Wilson R, *Business Finance 2003* (Institute of Directors).

⁹ Cruickshank, D. (2000) *Competition in UK Banking*.

£# Cosh and Hughes (2003)¹⁰ found that the failure rate of firms approaching banks for finance between 2000 and 2002 was 11%. This was significantly higher among micro businesses (fewer than 10 employees); a group which tends in any case to have a greater reliance on banks as the main source of finance.

2.6 Whilst the picture for established businesses appears to be relatively positive, surveys of pre-start up or early stage businesses indicate that these groups face greater barriers to accessing finance. The Global Entrepreneurship Monitor (2003)¹¹ reported failure rates among a sample of new and young enterprises seeking finance of 22% for an unsecured bank loan and 17% for a secured bank loan. According to the Small Business Service¹², finance remains the most frequently cited barrier to start-up among those thinking of setting up in business. Banks acknowledge that it is more difficult to assess the risk of a proposition with no trading record, and, very often, an entrepreneur will be required to provide a cash contribution to the business in order to leverage in a loan. Other research has found that credit assessment techniques designed to assess the generality of businesses may not be well placed to analyse those businesses with unusual structures or characteristics, with the result that certain groups also report greater difficulties in obtaining bank finance¹³.

2.7 Survey evidence, therefore, suggests that access to finance is not considered problematic for the majority of established businesses. There are indications that for certain groups, such as start-ups and early stage businesses, micro businesses and businesses with non-standard characteristics, difficulties may remain. For such groups, the challenge for analysts and policy makers is to establish whether reported difficulties reflect credit rationing or the rational rejection of bad business propositions. This will be discussed further later in the chapter.

ALTERNATIVE SOURCES OF FINANCE

Personal sources of finance

2.8 SFLG is designed to enable SMEs to access term loans, the majority of which are provided by the clearing banks. Term lending is not, however, the only option available to established businesses and the range of possible finance sources has increased over the life of SFLG. One area on which little empirical evidence exists is the use of personal sources of finance to finance a business, for example through credit cards and consumer loans. This is likely to have increased over recent years, particularly as house price inflation has allowed many home-owners to access the increased value of their property by remortgaging. This trend is believed by many of those consulted during the review to have been a factor behind the observed decline in SFLG loans under £30,000. Credit cards and unsecured personal loans are likely to be relatively expensive means of financing a business compared with term loans, particularly where collateral is provided. However, access to personal sources of finance may be more easily available to an entrepreneur, particularly at start-up before a trading record has been established. Banks and business advisors expressed concern that the ease of access to personal loans and credit cards can leave firms with an inappropriate structure of finance, and may result in the entrepreneur taking money from the business to service high levels of personal debt.

¹⁰ Cosh, A. and Hughes, A., (2003) Op cit.

¹¹ Harding, R. (2003) *Global Entrepreneurship Monitor United Kingdom 2002* (London Business School).

¹² IFF Research Ltd (2002) *Household Study of Entrepreneurship: Follow-up Survey* (Small Business Service).

¹³ See for example Bank of England (2003) *The Financing of Social Enterprises*, which found higher rejection rates among social enterprises applying for bank finance than among a matched sample of other businesses.

Asset-based finance 2.9 Apart from traditional bank loans, a range of other financial products are available to businesses. Asset-based finance products such as leasing and hire purchase are useful for businesses looking to buy specific tangible assets, while factoring and invoice discounting are sources of working capital. These products are suitable for businesses that are generating revenue and have existing creditors. Over the lifetime of SFLG the availability and use of these products has increased such that by 2002 they comprised over 30% of finance raised in the debt market¹⁴.

2.10 Businesses use a combination of these products to finance their business. The Competition Commission (2002)¹⁵ found that loans were the most common form of finance, and the largest by value, followed by overdrafts, leasing and hire purchase (see table 2.1).

Table 2.1: Proportion of SMEs with types of external funding

	Types of funding (%)	Largest type of funding (%)
Loan	38	28
HP	22	10
Leasing	22	9
Overdraft	23	8
Overdraft facility	24	6
Commercial mortgage	7	5
Invoice discounting	5	3
Factoring	3	1
SFLG	2	1
Cards	7	1
Other	10	8
Don't know	16	18

Source: Competition Commission (2002)

2.11 Surveys confirm that banks continue to be the dominant source of finance for SMEs. Total borrowing by small businesses (turnover under £1mn) fell through the early 1990s but has risen steadily since 1997 to levels of £38.9bn at end 2003¹⁶. Interestingly, other research suggests that medium-sized firms' use of bank finance, as a proportion of the total finance raised, has declined since 1991, in favour of hire purchase, leasing and invoice finance, whilst micro firms returned in 2002 to their 1991 levels of dependence on bank finance¹⁷. The implication that medium sized firms (defined as having 100-500 employees) have greater access to other forms of finance, such as equity, asset-based lending and trade credit, is intuitively attractive, and consistent with anecdotal evidence provided to the review.

¹⁴ Cosh, A. and Hughes, A. (2003) *Op cit*.

¹⁵ Competition Commission (2002) *Banking Services to SMEs*.

¹⁶ Bank of England (2004) *Finance for Small Firms – An Eleventh Report*.

¹⁷ Cosh A. and Hughes A. (2003) *Op cit*.

THE MARKET FOR TERM LENDING TO SMEs

2.12 The Competition Commission (2002)¹⁸ found that the SME banking market was characterised by significant market concentration, particularly in the markets for liquidity management services. In the market for term lending, the four largest clearing banks¹⁹ together accounted for around 90% of the share of loans to SMEs by number. In Scotland, over the same period, the market was dominated by RBS Group, Clydesdale and Bank of Scotland, which together accounted for about 90% of the market. A similar proportion of the Northern Irish market was accounted for by Northern Bank, Ulster Bank, First Trust and the Bank of Ireland. The main development since 2002 has been the merger of Halifax and Bank of Scotland, which is believed to have led to an increase in the combined institutions' share of the SME market in England. This market concentration is mirrored in the pattern of banks' use of SFLG.

2.13 Concerns over access to finance for certain types of businesses, that for a variety of reason may not be able to borrow money from the bank, have led to the emergence in the UK of a new type of financial institution, falling under the umbrella term of Community Development Finance Institution (CDFI). Funded by a mix of public and charitable grants and private sector investment, CDFIs on-lend to businesses that are not able to borrow from mainstream banks, most often because of a lack of track record or of personal capital to invest or use as collateral²⁰. In 2003 the CDFI sector controlled funds for on-lending of £220mn²¹. Currently, two CDFIs are registered as SFLG lenders.

ECONOMICS OF BANK LENDING TO SMEs

2.14 Much theoretical work has been done on the economics of lending to SMEs. It has long been argued that the relationship between SMEs and their banks is characterised by information asymmetries, whereby, due to the lack of market information about small businesses, an entrepreneur is likely to know more than the lender about the probability of success of his or her proposition, and particularly about the use to which he or she intends to put bank funds. As a result, the lender is unable to price lending accurately according to the risk of an individual proposition. To compensate for this, interest rates may rise for all borrowers, with the result that borrowers have an incentive to divert funds to riskier projects with potentially higher returns. At the same time, low risk ventures may choose not to borrow at the higher rates. In order to avoid lending to high risk ventures, therefore, the lender may ration credit, such that for a given interest rate, debt may not be available to all borrowers who want it. In fact, the little empirical research that has been done to test these theories has not found conclusive evidence that credit rationing is a feature of the SME finance market in the UK²².

2.15 The literature describes how collateral may be used as a sorting device. 'Good' borrowers may be more prepared to put their own or their business' assets at risk, because they perceive the probability of failure to be low. 'Bad' borrowers may prefer to pay a high price for debt, rather than risk losing assets, particularly personal assets. However, this assumes that all borrowers have access to collateral in order to make a

¹⁸ Competition Commission (2002) *Op cit*.

¹⁹ RBS Group, HSBC, Lloyds TSB and Barclays.

²⁰ Brown, H. (2003) *Finance for Small Firms – A Ninth Report* (Bank of England).

²¹ McGeehan, S (2004) *Inside Out – the State of the Community Development Finance Association 2003* (CDFA).

²² See Cowling, M, (2002) *The Role of Loan Guarantee Schemes in Alleviating Credit Rationing in the UK*.

choice whether or not to use it to demonstrate the riskiness of their proposition. This is unlikely to be the case, and, where collateral is required, a proportion of good, low risk borrowers may be denied access to credit. This is the rationale behind a loan guarantee scheme such as SFLG.

How banks lend to SMEs

2.16 In assessing a loan application banks are essentially looking for reassurance that the customer has the ability to generate sufficient income to service a loan. The way in which they obtain that reassurance may differ from one institution to another. One of the biggest changes in the financing environment over the life of SFLG has been in the introduction by banks of automated credit assessment procedures to supplement to a greater or lesser extent the discretion of individual managers. Scoring systems make use of two types of data: first, data about the business and the entrepreneur provided by the applicant or from credit reference agencies such as Experian or Equifax; and, second, data on the management of an applicant's or the business' current account. Both models of scoring use statistical techniques to predict the likelihood of default of a new application, based on the bank's experience of its existing and past customers. The central conditions are, therefore, that past performance is a good predictor of future behaviour, and applicants with similar backgrounds and characteristics are likely to perform similarly. If these two conditions hold, then models using a recent data sample from a similar set of people will be a reliable predictor of a new group's or individual's likely credit performance or financial risk.

Credit Scoring

2.17 Credit scoring has long been used in the retail market, but has only been introduced in the UK for SMEs relatively recently, because of concerns about whether the SME population is sufficiently homogenous. US banks have used credit scoring to assess applications from SMEs for much longer, and there is, as a result, more literature available²³. The results suggest that credit scoring is associated with a higher availability of loans for SMEs. It enables banks to assess risk more quickly and cheaply than traditional methods, and should make a decision less subject to bias than the decision of an individual manager. The disadvantage of credit scoring is that it is perceived as inflexible and impersonal. In addition, businesses with non-standard characteristics may score badly for reasons other than the viability of their business plan.

2.18 For banks, credit scoring has the advantage of correcting information asymmetries traditionally associated with lending to this market. Previously the argument has been that SMEs have much greater knowledge of their business than banks, so that banks have no means of distinguishing low from high-risk customers. In contrast, with the developments in scoring techniques, it could be argued that the statistical analysis provides banks with a better knowledge than the applicant of the type of business that is likely to default.

2.19 Banks in the UK do not all use the same lending techniques and although most use some form of automated credit scoring, the extent to which it guides the final decision will vary between institutions. Because the dataset from which a scorecard is derived is based on an individual bank's own customer portfolio, each bank will develop its own scorecard and there is no one industry-wide model. Details of the credit scoring models are strictly guarded by banks to avoid any attempt by managers or applicants to alter behaviour in order to manufacture a good result. Credit scoring is generally not used for larger businesses, although the maximum size of loan for which credit scoring is used varies between banks from around £35,000 to £100,000. This is due, in a large part, to the complexity of the financing needs which increase with size,

²³ See, for example, Frame, W.S., Srinivasan, A., and Woosley, L., *The Effect of Credit Scoring on Small Business Lending* in *Journal of Money, Credit & Banking* Vol 33, no3 (August 2001).

and the fact that larger businesses are more likely to have several bank accounts, possibly with different banks, which means that it is impossible to design an automated credit scoring system based on bank account behaviour that will reflect the performance of the business as a whole. With size comes increased market power, and, as a result, more scope for negotiation and individual terms. Differences are also observed in the way in which banks structure their small business banking. Some have very centralised procedures, in which most applications are passed to a central credit function that makes the ultimate decision to sanction or decline. Others continue to devolve responsibility to their front line staff, albeit with guidance from centrally designed computer scoring systems.

2.20 Scoring systems that use financial account information or that are based on the flow of funds through an applicant's current account clearly lend themselves to established businesses. Assessing the viability of an application from a start-up with no track record is more difficult. Some banks are beginning to develop scorecards which can be used to assess applications from new entrepreneurs, based either on their personal account behaviour or on characteristics of the entrepreneur and their business proposition. However, these developments are still at an early stage. Start-ups are often required to provide a cash contribution to the business before a bank is prepared to lend. In the bank's view, this shows commitment on the part of the entrepreneur to the success of their venture as well as providing an equity base on which to leverage debt.

The role of collateral

2.21 Relevant to an assessment of SFLG is the question of whether these changes in the structure and automation of banks' processes have improved SMEs' ability to access finance. As discussed above, one of the advantages of credit scoring is quicker and more consistent decision making across a single institution. It has also been argued, not least as one of the bases for this review²⁴, that credit scoring has resulted in less of a reliance by banks on collateral, which, for small loans, can be disproportionately time consuming and expensive to arrange. Conversations with banks by the review team have indicated that loans under around £25,000 are more likely now to be made unsecured than in the early nineties. This concurs with evidence from Ram, Smallbone and Deakins (2002)²⁵, who found in their analysis of lending to ethnic minority businesses in the UK that lending up to £35,000 was likely to be unsecured (except for start-ups). This average inevitably hides a degree of disparity between banks; some banks are moving towards credit assessment in which the availability of collateral is more likely to affect the price rather than access to a loan. Other banks continue to take the view that collateral is not only a means of providing additional security to the bank, it also indicates the commitment of the entrepreneur, and may act as a signalling device, as discussed above. Banks' practices on security are likely to vary depending on the economic cycle; Cowling (1997) found that in a tight economic climate, banks are more likely to require collateral²⁶.

2.22 Empirical evidence on incidence of loan collateralisation is limited and not recent enough to reflect the recent developments in credit assessment techniques described above. Cowling (1997, working with a survey of UK small firms carried out in 1991) established that, among businesses that had borrowed, security was required in 79% of cases. For the most part the loans were fully secured. More recently the biennial survey for the Forum of Private Business (Binks 2002) has shown that the ratios of

²⁴ HM Treasury (2003) *Pre-Budget Report*

²⁵ Ram, M., Smallbone D. and Deakins D. (2002) *Ethnic minority businesses in the UK; access to finance and business support (BBA)*.

²⁶ Cowling, C. (1998) *The Incidence of Loan Collateralisation in Small Business Lending Contracts: Evidence from the UK Applied Economic Letters*.

collateral to lending value on both overdrafts and loans fell between 2000 and 2002, but remain over one. Around 19% and 15% of respondents said that they had not had to provide security on overdraft and loans respectively, a slight rise on 2000. Larger businesses borrowing larger sums were more likely to have to provide collateral than those borrowing smaller amounts.

2.23 As mentioned earlier, even in cases when a small loan might be offered unsecured, the bank is likely to want to see some personal investment of cash by the entrepreneur, particularly at start-up. This improves the gearing of the business and is also taken to be a sign of the entrepreneur's commitment to the success of the enterprise. This requirement is likely to inhibit business creation among entrepreneurs that have no access to a source of equity. Some grant and soft loan schemes exist to help in these circumstances, particularly at the pre-market stage.

2.24 Banks were asked to provide the review team with data to show the incidence of collateralisation over the past ten years. Unfortunately only one of the banks was able to supply us with an estimation of these data. **However, based on this evidence, on discussions with banks at head office and branch level, and on the empirical evidence outlined above, it seems sensible to conclude that developments in credit assessment techniques have reduced banks' recourse to collateral for smaller loans to established businesses. It is likely that start-ups, with no track record or proven income stream, are still required to provide a cash commitment and/or some form of collateral or personal guarantee. Also, established businesses borrowing above around £25,000 are still required to provide security in the majority of cases. The current divergence in practice between banks suggests that, as credit scoring techniques become more sophisticated and more consistently used, it may be that security will become more important in influencing price rather than access, given a favourable economic climate, and may lead to an increase in unsecured lending at higher amounts. However, at present it would appear that a lack of personal and business assets continues to act as a borrowing constraint at start-up or for established businesses requiring loans over £25,000. Furthermore, collateral alone will not assist an entrepreneur that has no cash to invest in his or her own business at start-up.**

CONCLUSION

2.25 The evidence assembled above indicates that access to finance does not appear to be a significant barrier facing the generality of established businesses. However, as collateral still appears to be a major consideration in lending over around £25,000, those borrowers without business or personal assets to offer as security may struggle to access finance, or to access it at a price they are willing to pay. In addition, scoring techniques, though beneficial for the majority of borrowers, favour those with a proven track record and good credit history. As a result of these two factors, the review believes that some start-up businesses, businesses with non-standard characteristics and those businesses seeking to expand beyond their current asset base continue to find it more difficult than the majority of businesses to access debt finance.

3

SFLG DATA

3.1 Chapter 2 of this report looked at the situation facing SMEs seeking to access debt finance. Chapter 3 sets out a selection of data on how SFLG is being used by lenders in that market. The section sets out the data, and an overview of the arguments that have been put to the review team as to why SFLG is being used in these ways, but does not reach conclusions on the merit of such usage.

HISTORY OF SFLG

3.2 Whilst there have been many changes to the rules and to the key commercial parameters of SFLG, the fundamental purpose and structure of the scheme have remained unchanged since 1981. This section looks briefly at the key changes, and the trends in overall take-up by volume and value since 1981.

3.3 Table 3.1 (overleaf) shows the most significant changes made to SFLG since 1981. A full list of all the changes that have been made to SFLG can be found in Annex I.

Table 3.1: Significant changes made to SFLG

Phase	Duration	Guarantee (percent)	Premium (percent)	Other changes
I	Jun 81 – May 84	80	3	A pilot Scheme offering an 80% guarantee
II	Jun 84 – Dec 84	70	5	Temporary extension to the Scheme
III	Jan 85 – Mar 86	70	5	Scheme continued but with increased monitoring and appraisal required by lenders
IV	Apr 86 – Mar 89	70	2.5	Small Loans Arrangement introduced on loans up to £15,000
V	Apr 89 – Jun 93	70	2.5	Maximum loan size increased to £100,000. Exclusion of a number of sectors including retailing and hairdressing
VI	July 93 – Mar 03	70 or 85	1.5 or 0.5	Loan limit increased to £250,000 for established businesses. European State Aid rules exclude various sectors
VII	Apr 03 – present	75	2	Inclusion of a number of sectors including retail, catering, and motor vehicle repair/service. Service sector turnover limit increased to £3m.

Table 3.1. Notes:

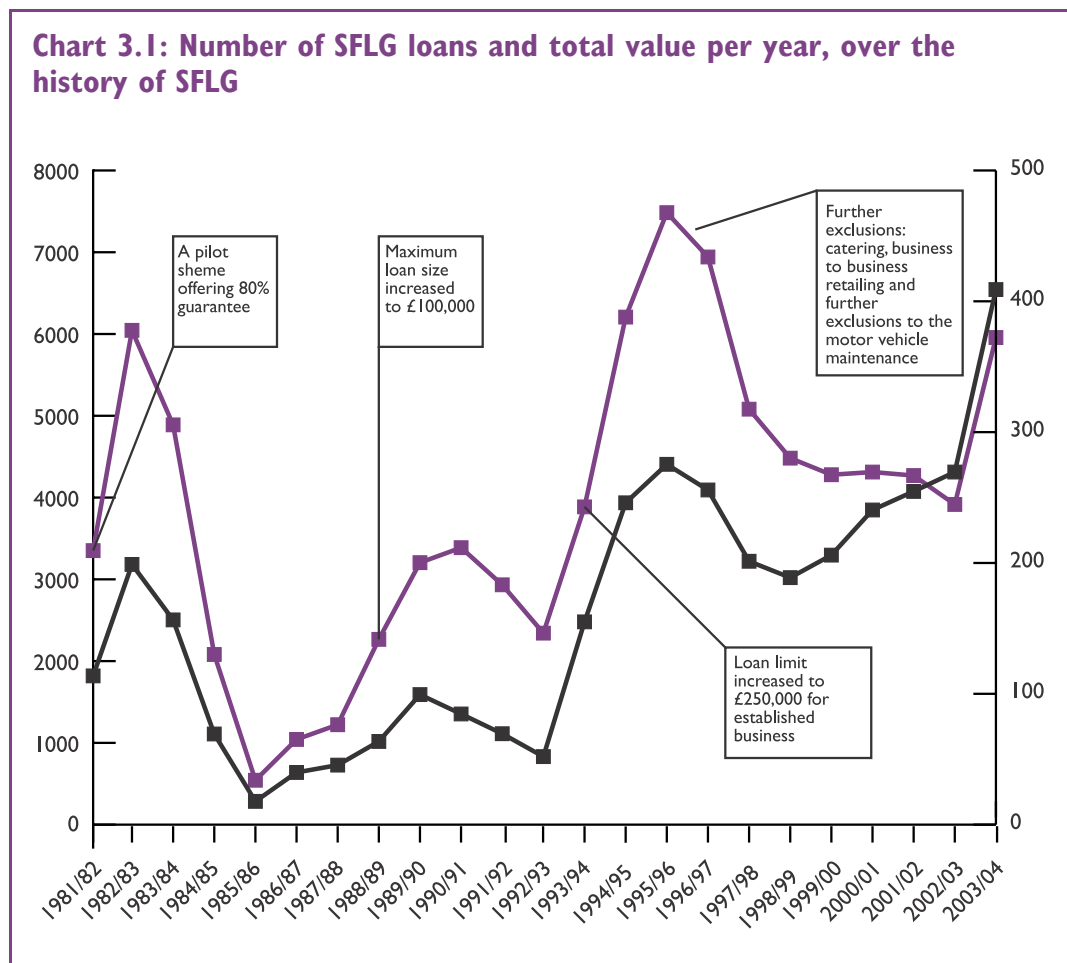
1. The 70 percent guarantee in phase VI is applicable to firms trading less than two years and the 85 percent guarantee to established firms who were trading for 2 years or more before application.
2. The 1.5 percent premium in phase VI is applicable to firms taking a variable rate of interest and the 0.5 percent premium to firms who take a fixed rate of interest.
3. The premium was charged on the guaranteed amount in phases I-V, but is based on the whole amount in phase VI.

Source: KPMG (adapted for 2003 changes)

3.4 In 2003/04 – the most recent year - SFLG supported 5,966 loans, worth £409m. This represented a 52% increase on 2002/03 lending. The data is not available to allow a precise indication of the percentage of the term debt market for SMEs represented by SFLG: however using Bank of England¹ statistics it is estimated that SFLG represents in the region of 2% of all term lending to SMEs.

¹ Bank of England (2004) Finance for Small Firms – An Eleventh Report

3.5 Throughout the lifetime of SFLG there have been significant variations in the volume and total value of the loans supported (chart 3.1). Various influences underpin the level of uptake of SFLG, and these are discussed below.



FACTORS DRIVING CHANGES IN THE VOLUME AND VALUE OF SFLG LENDING

3.6 Internal factors, such as maximum loan size, eligibility criteria and paperwork, plus the commercial realities of the prevailing guarantee rate and government premium, will directly impact upon the attractiveness of the scheme to both lenders and SMEs.

3.7 However, external factors are also important in driving both demand from SMEs and supply from the lenders. On the demand side, factors such as the state of the economy, level of public awareness, and alternative sources of financing (for instance housing equity) influence the number of entrepreneurs specifically seeking an SFLG loan, and the number of entrepreneurs who do not seek an SFLG specifically, but who seek a loan in circumstances where they are likely to need SFLG. On the supply side, the state of the economy affects lenders' appetite for risk, and the scale of publicity affects the number of frontline staff using the scheme.

3.8 At different stages in the history of SFLG, different factors have been the primary influence on uptake. For instance, the initial demand peak is attributed to the scale of initial publicity. However, the proceeding drop in usage has been attributed largely to a

reduction in the guarantee rate and an increase in the premium, whilst the sustained increase from 1986 has been attributed to the introduction of a higher maximum loan size and a reduced administrative burden.

3.9 The changes introduced in April 2003 included - on the recommendation of the KPMG² review – a standardised guarantee rate. A lower guarantee rate for established businesses had been expected to lead to a proportional reduction in demand. In fact, the proportion of the SFLG portfolio has fallen less than expected. Indeed, despite this reduced guarantee rate and the higher flat rate 2% premium, the effect of the sectoral inclusions has been a large increase in the use of the scheme: as has been seen, 2003/04 saw a 52% increase by volume and by value from the previous year. The new sectors introduced in 2003 represent around 80% of this increase. It is clear that at any one time a complex mixture of factors influence uptake of SFLG, and that identifying the key drivers of SFLG uptake is difficult.

Maximum loan size

3.10 The introduction of a new, higher, maximum loan size in 1989 (£100,000), and the 1993 increase from £100,000 to £250,000 for established businesses, are associated with an upturn in usage and, as would be expected, an increase in the average size of SFLG loans. It is therefore interesting to note the change in relationship between the volume and value of lending since 1998 (chart 3.1), in the absence of new loan size limits. In this period, the overall volume of loans has fallen, whilst the value of lending has increased significantly: in other words, the average size of SFLG loans has been increasing. The reasons for this shift are examined in more detail below.

WHAT TYPE OF COMPANIES, AND WHAT TYPE OF PROJECTS, DOES SFLG SUPPORT?

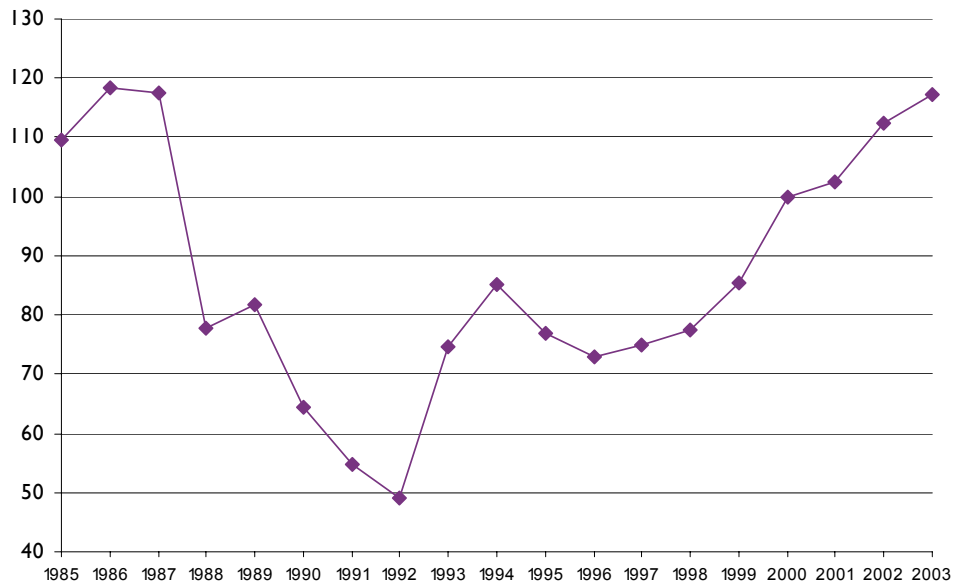
Introduction 3.11 The purpose of SFLG is to assist SMEs who have a viable business plan but lack the collateral necessary to secure the loan that they seek. It is worth noting that the stated purpose of SFLG is not to support lending to SMEs without a track record or to facilitate riskier propositions per se. This in no way precludes such SMEs from SFLG – indeed many of those SMEs without a track record (i.e. start-ups) will also lack collateral and so very legitimately make use of the scheme – but it is important to remember, in considering the current usage data, that the rationale for government intervention remains a shortage of collateral in an otherwise viable lending proposition.

Size of loans

3.12 From 1998 to April 2003 the take-up of the scheme by volume dropped slightly, whilst the total value of loans increased: i.e. the average loan size has increased sharply. The effect of these movements on average loan size is set out in chart 3.2 below.

² KPMG (1999) An Evaluation of the Small Firms Loan Guarantee Scheme.

Chart 3.2: Inflation-adjusted index of average SFLG loan sizes, 1985-2003 (2000=100)



3.13 Two trends have driven this change. First, as charts 3.3 – 3.6 below demonstrate³, the number of loans with a value under £30,000 has reduced sharply, both in absolute terms and as a percentage of total annual lending. As would be expected, the trend is magnified when the monetary value of the loans is considered (charts 3.5, 3.6). Second, the number of loans above £100,000 has increased - again, the impact is magnified when the cash value is considered: these loans are now around 34% of total value of new lending, compared to around 25% in 1996/97.

Chart 3.3: Usage by loan size (volume) per annum (%)

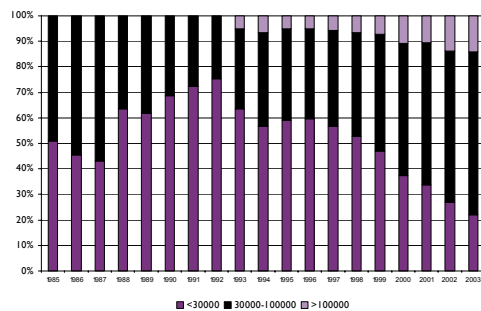
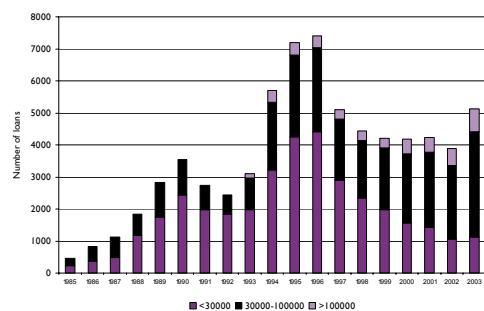
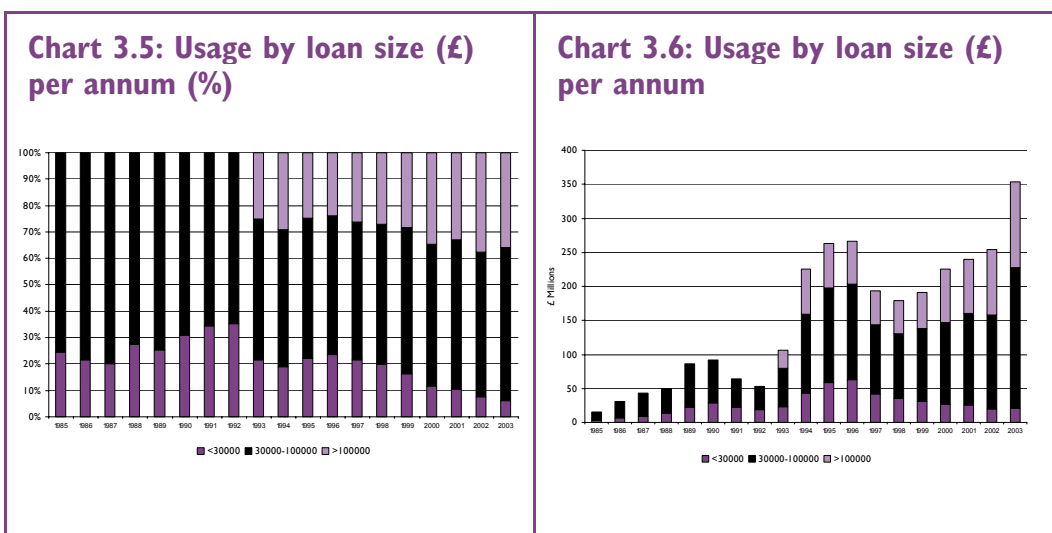


Chart 3.4: Usage by loan size (volume) per annum



³ Please note that for simplicity, charts 3.3-3.6 do not adjust for inflation.



3.14 An important issue for the final report will be to establish whether the reduction in sub-£30,000 loans reflects success, i.e. that SMEs have access to these amounts without the need for SFLG, or failure, in that lenders are less able to lend to this end of the market. Likewise, should the increase in large loans be interpreted as reflecting new difficulties facing SMEs seeking large amounts of financial support?

3.15 A number of drivers have been proposed:

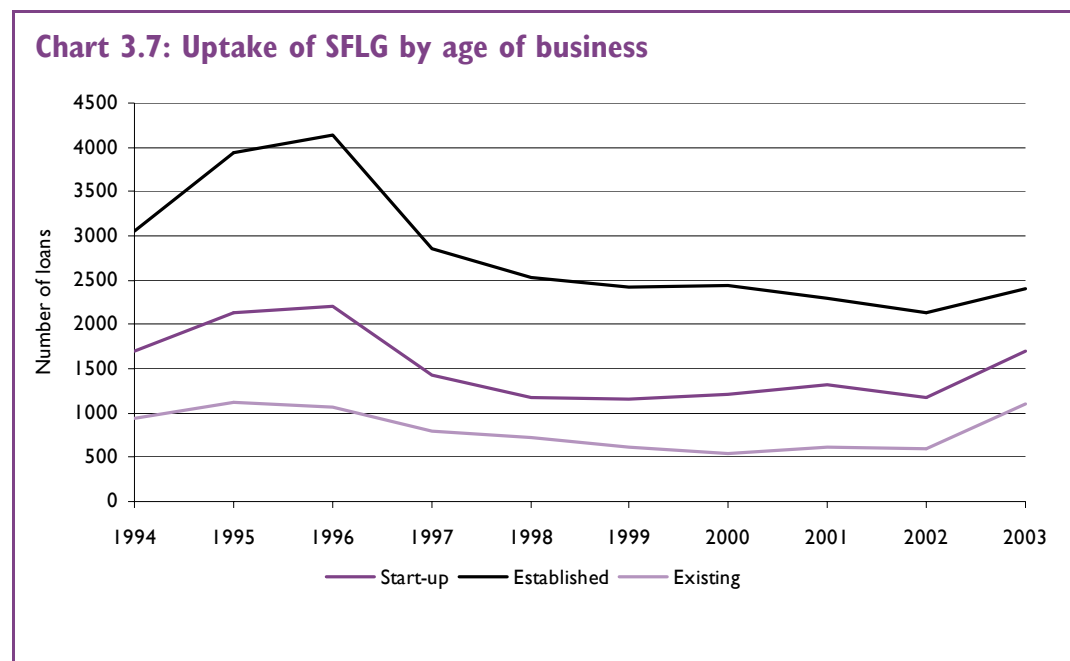
- ⚡ The introduction of credit and behavioural scoring techniques has meant that banks are able to lend small amounts of finance unsecured. Data from the banks would seem to support this argument, as the number of all loans under £30,000 has not fallen significantly in this period.
- ⚡ Even with new techniques, the transaction costs associated with due diligence has meant that the return on small loans is poor, therefore reducing the incentive for the lenders to operate at this level (within SFLG or otherwise). However, the evidence of non-SFLG lending does not seem to suggest the banks are significantly withdrawing from this end of the market.
- ⚡ The strong macroeconomic picture in recent years has improved the availability of personal debt (home equity, personal loans and credit cards), providing entrepreneurs with quicker and more straightforward financing options other than bank financing.
- ⚡ It has been argued that the costs associated with business investment have increased beyond simply the effect of inflation, due to increased competitive pressures and the greater need for niche products, and so the demand for smaller loans has decreased.
- ⚡ Views about the increase in loans above £100,000 are less common. Although the SBS does not collect data on the use of SFLG in packages of finance, discussions with lenders have indicated that an important factor in driving this increase may be the prevalence of SFLG within larger financial packages, including support for management buyouts.

3.16 It is likely that a set of factors are responsible for these changes: but it is clear that understanding the dynamics is important in determining if SFLG is adapting to address, or merely reflecting, the changing barriers in the wider debt market.

Age of business using SFLG

3.17 Chart 3.7 below shows how the use of SFLG by the age of business has changed over recent years. As would be expected, the number of established businesses (over two years trading) supported by the scheme increased proportionately after the lending limit for established businesses was raised to £250,000 in 1993. Since then, the proportion of young businesses (start ups and existing SMEs trading under two years) using SFLG has increased from 44% to 55%. Indeed, start-ups represented 32% of all SFLG lending in 2003/04. This is disproportionately high when compared to the SME sector as a whole (there is no official published figure but Barclays⁴ estimate that around 10% of UK SMEs are start-ups).

3.18 Young firms often lack collateral and some overrepresentation is likely. It has been suggested, in light of the difficulties faced by start-ups in accessing debt finance and the difficulty in using credit scoring to assess young SMEs, that the heavy emphasis reflects the use of SFLG not only to cover a lack of collateral, but also to reduce the wider uncertainty associated with lending to start ups and young businesses.

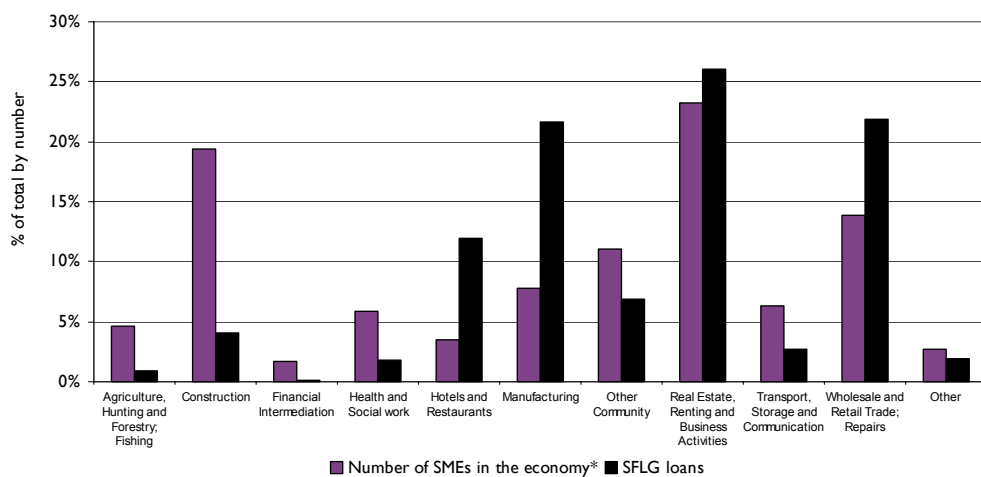


⁴ Barclays Business Survey – Start ups and Closures 2nd quarter 2002

Sectoral breakdown

3.19 The data on sectoral use of SFLG (chart 3.8) suggests that the scheme is used throughout the economy. Manufacturing, services, retail and catering are well represented. As has been discussed, the overall increase in SFLG usage was driven primarily by the re-inclusion of retail and catering in the scheme in 2003/04.

Chart 3.8. SFLG use by sector, 2003-04



*2002 data taken as a proxy.

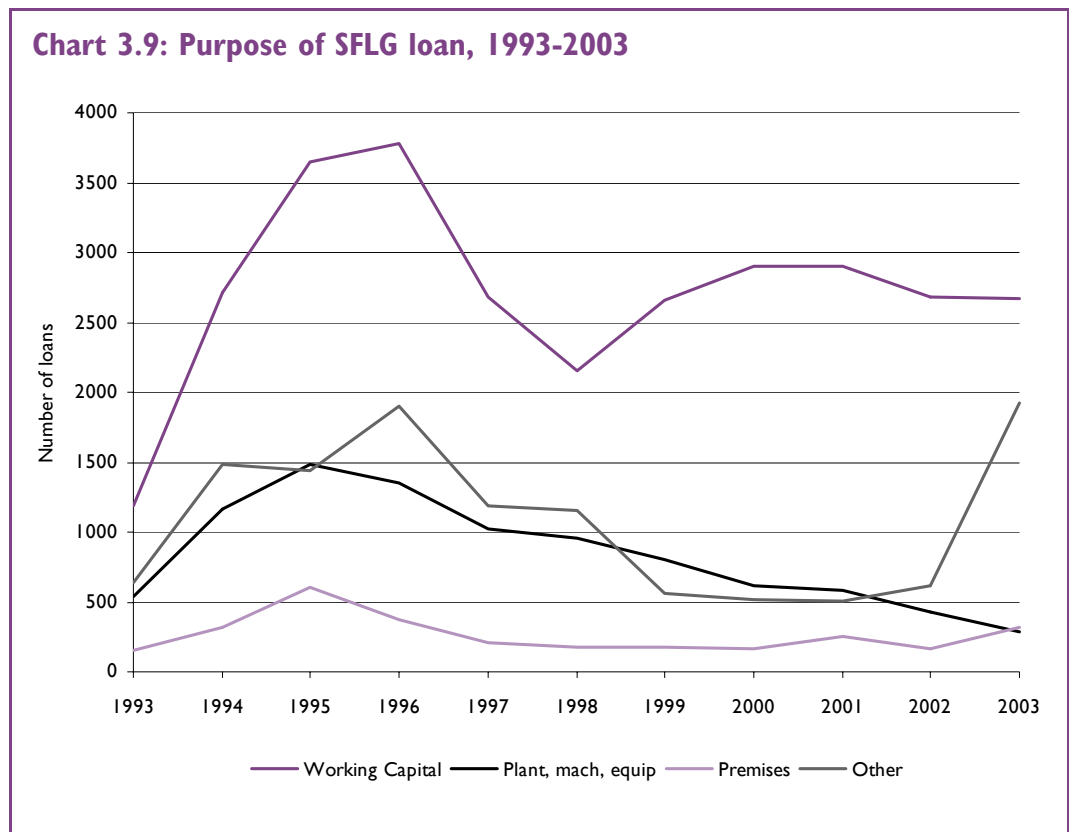
Source: Small Business Service

Purpose of loan

3.20 There are only four categories within the SBS database to record the purpose of the loan (chart 3.9). The majority of loans are used for working capital, and this has been the case since 1993. Only a small number of loans are used for business premises, and the use of loans for tangible fixed assets has been on a steady decline since 1995. This is not unexpected, given the growth in property prices and the increasing use of asset finance and leasing in recent years.

3.21 It is interesting to note the rapid increase in the use of the 'other' category since 2002. It has been suggested that 'other' and 'working capital' have become largely interchangeable, and that they are used as a catch-all to cover a variety of businesses purposes.

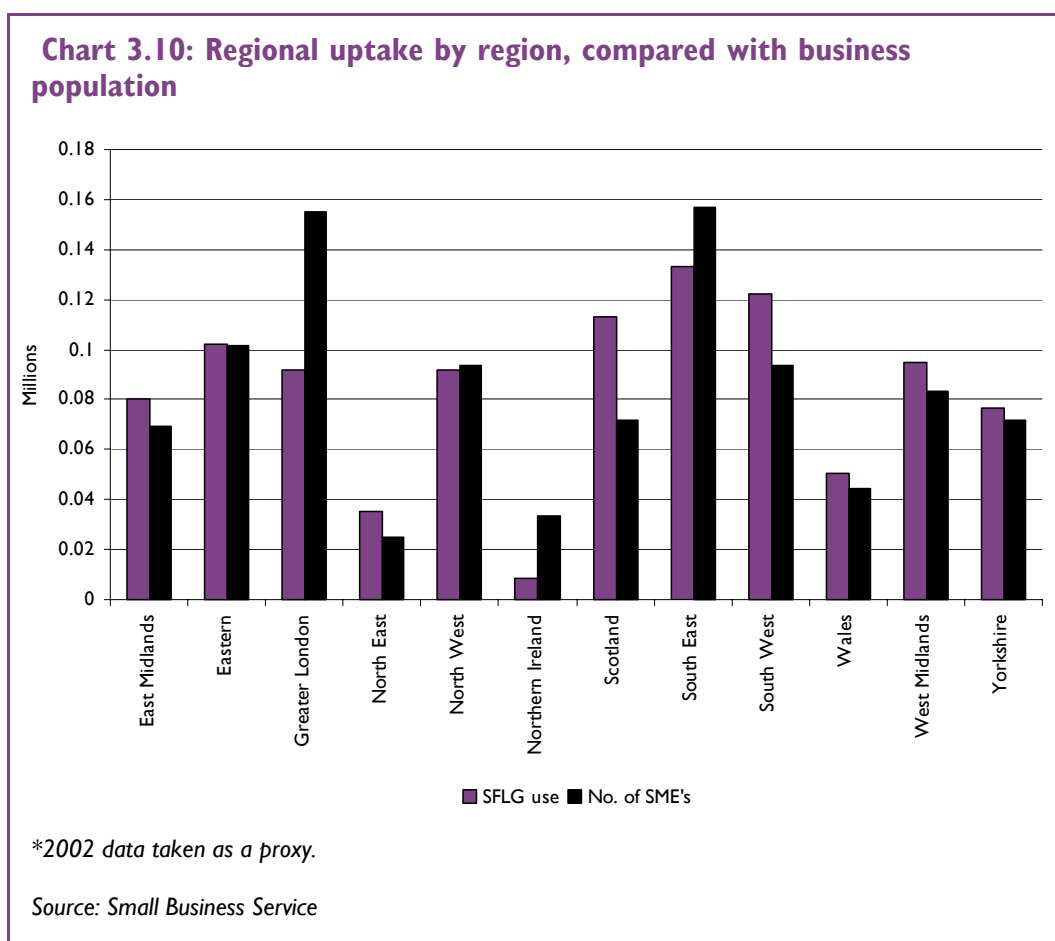
3.22 The lack of data on the purpose of SFLG lending makes analysis of this issue difficult. The final report will include more detailed research on this issue.



Regional aspects of SFLG

3.23 KPMG⁵ noted in 1999 that there is a limited understanding of the regional and national take-up of SFLG. In chart 3.10 we have compared the regional take up of SFLG with the general SME business population in that region or Devolved Administration.

3.24 Greater London, the South East and Northern Ireland see a relatively low usage of SFLG, whilst the South West, West Midlands and Scotland see a relatively high take up. A number of explanations have been proposed, including the importance of other government-backed SME support services in driving demand, the variable prevalence of housing equity, and the role of the local banking system in building expertise in SFLG (for instance some respondents have cited the importance of the Scottish banks in delivering high SFLG penetration in Scotland).



3.25 The delivery of SFLG also varies considerably at a local scale. Many respondents report that in a particular locality some lenders are more inclined to use SFLG than others, and indeed that within the same organisation some managers will make regular use of SFLG, whereas others do not use SFLG at all.

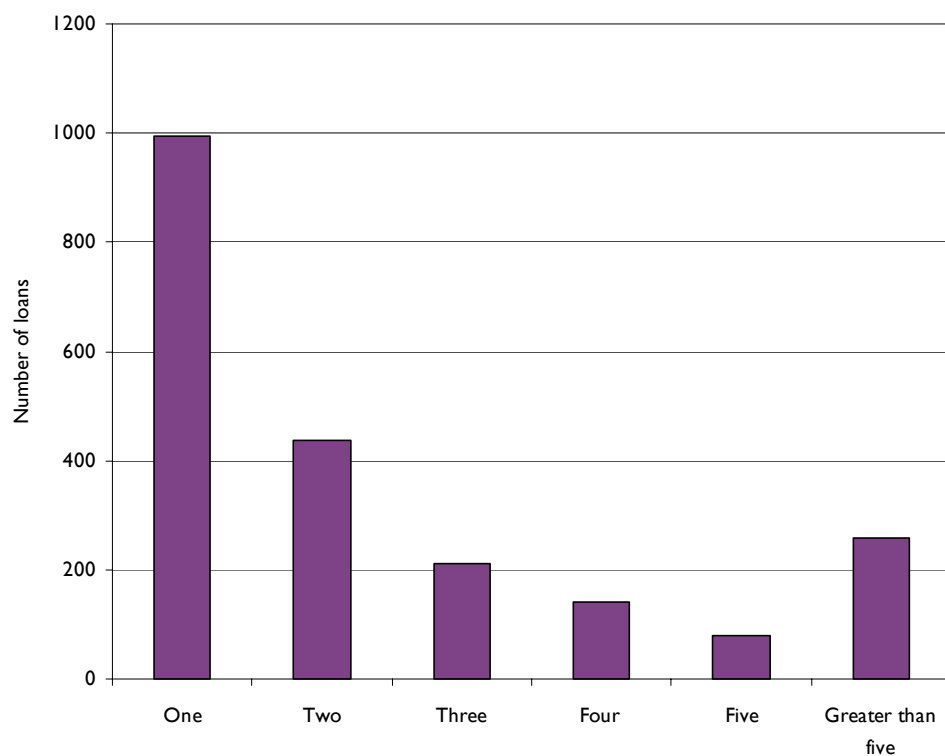
3.26 These views are supported by the data. Although it is difficult to be precise given the nature of sort codes, it seems possible that as many as 50% of sort codes do not use SFLG. Furthermore, of those managers that do use SFLG, a few use SFLG on a regular basis, whilst the great majority use it only once or twice a year. This information is set out on chart 3.11 (which illustrates the frequency of use of SFLG in 2003/04 by those

⁵ KPMG (1999) An Evaluation of the Small Firms Loan Guarantee Scheme.

sort codes that do make use of the scheme). Whilst this data strongly supports respondents' views about the patchiness of delivery, it may also reflect, in part at least, a sensible concentration of SFLG expertise in one branch or location.

3.27 This variation in availability is a source of real frustration to many SMEs and business advisors, and the review is considering how best to incentivise all decision makers in lending institutions to consider using SFLG in the appropriate circumstances, as one of the range of mainstream products or options available to them when considering a lending proposition. A number of steps have been suggested, including raising awareness through better publicity; better provision of information and guidance on the process for completing an SFLG application; and further streamlining of the administration process for gaining approval of an SFLG. The review intends to make recommendations on these issues in its final report.

Chart 3.11: Frequency of use: bank sort codes using SFLG in 2003-04

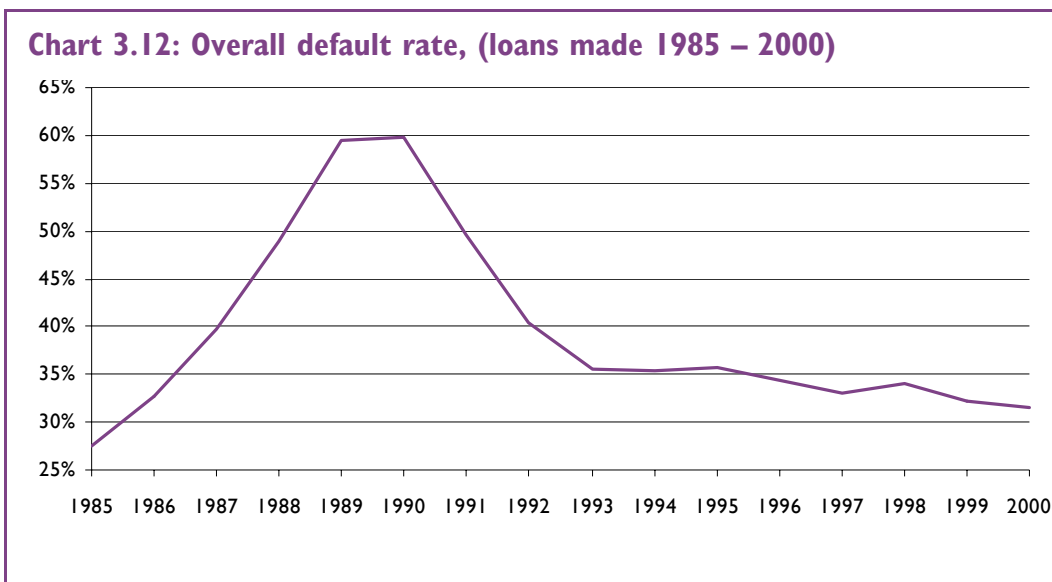


RISK LEVELS

3.28 It is the expectation of most commentators that SFLG lending, in addressing the gap in the market where small firms have a viable business proposal but are unable to get finance because of a lack of collateral, should not see a significantly higher default rate than for mainstream commercial SME lending.

3.29 Chart 3.12 shows the default rates for all loans over time since the start of the scheme in 1985. In the chart, the default rate is defined as the proportion of loans on which the lender has called in the government guarantee. Chart 3.13 illustrates default rates by age of business: as expected, established businesses are less likely to default than young SMEs.

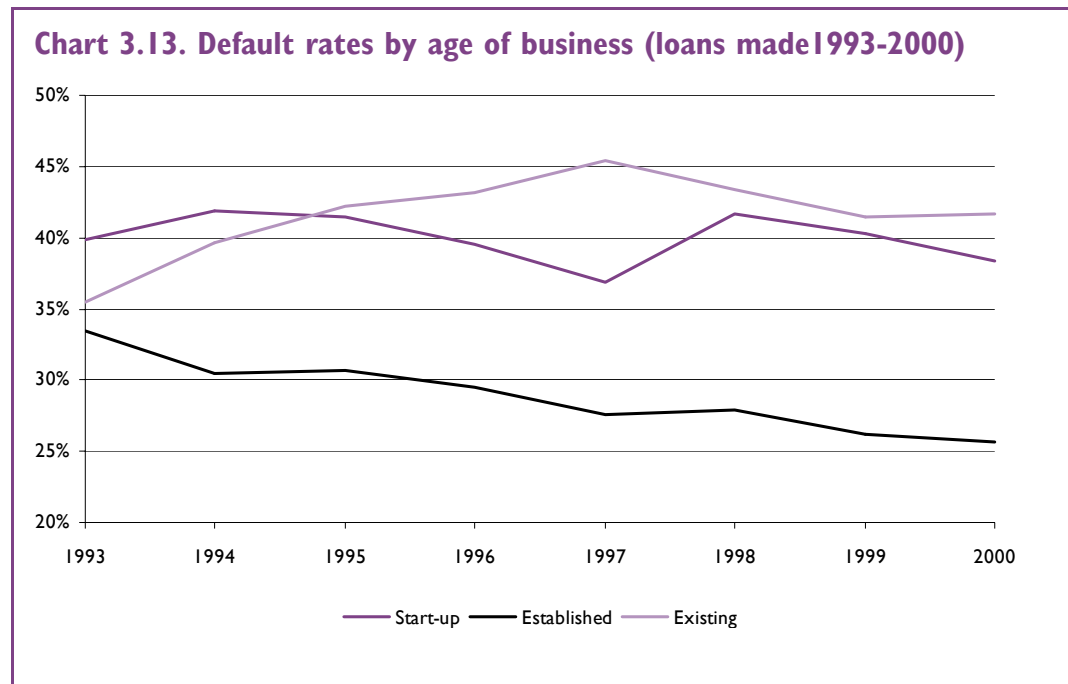
3.30 In contrast, typical default rates on secured lending are less than 3% on a corporate loan book, and slightly higher on loans to SMEs alone (around 4%). Therefore, default rates on SFLG loans are considerably higher than for mainstream commercial lending. The question that follows is whether default rates are due to sound reasons or due to inefficiencies in the scheme that incentivise its use for poor credit propositions.



3.31 A second measure of risk is the bad debt rate - the cash losses on the portfolio taking into account capital repayments made before default and recoveries from secured assets after default. The precise figure is difficult to quantify, but the SBS model forecasts a bad debt rate of 20% for the existing portfolio (as at 31 March 2004). This compares to less than 1% for mainstream corporate lending. However, in making this comparison it is important to note that SFLG loans are by definition unsecured: recoveries are therefore low and it would be expected that the difference between the default rate and the bad debt rate for SFLG would be higher than for mainstream lending.

3.32 Many stakeholders have been surprised at the high default rates on the SFLG portfolio. It is important to establish why the risk in the SFLG portfolio is higher than mainstream lending. A number of factors may be at play:

- ⌘ **As over half the loans in the SFLG portfolio are to businesses at risky stages of life – start-ups and SMEs seeking a step change in their growth – higher default rates would be expected.** This is likely to part of the reason, but the matched data made available to us suggests that allowing for age, size and sector only explains a small percentage of the difference in default rates.

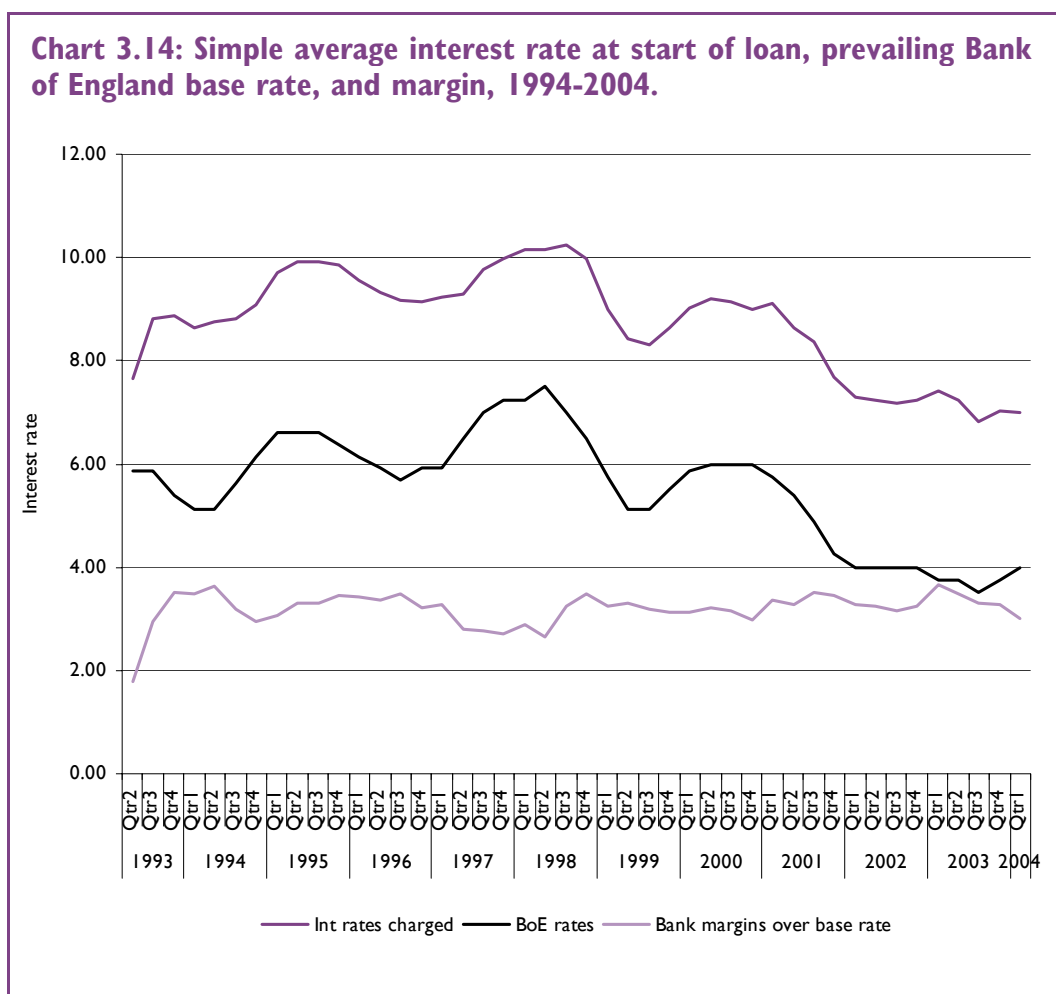


- ⌘ SMEs without collateral are inherently riskier than those who are in a position to offer collateral, regardless of the age or sector of the SME. There are two aspects to this argument: (i) that a lack of collateral is an indicator of a poor proposition from a risk perspective – the SME is already over leveraged, or is not generating enough cashflow to finance itself; (ii) ‘moral hazard’ – that borrowers’ attitudes to what are perceived as soft loans influence their subsequent efforts to avoid default.

- ⌘ At current guarantee rates, lenders will make a commercially viable return on these default levels, allowing the lenders to provide debt to a riskier group of propositions. As mentioned earlier, the forecast cash losses on the existing SFLG portfolio are 20% of gross lending. Taking the effect the government guarantee into account, this translates into a bad debt rate for the lenders of c.5%, which is higher than a normal commercial portfolio but is still commercially viable.

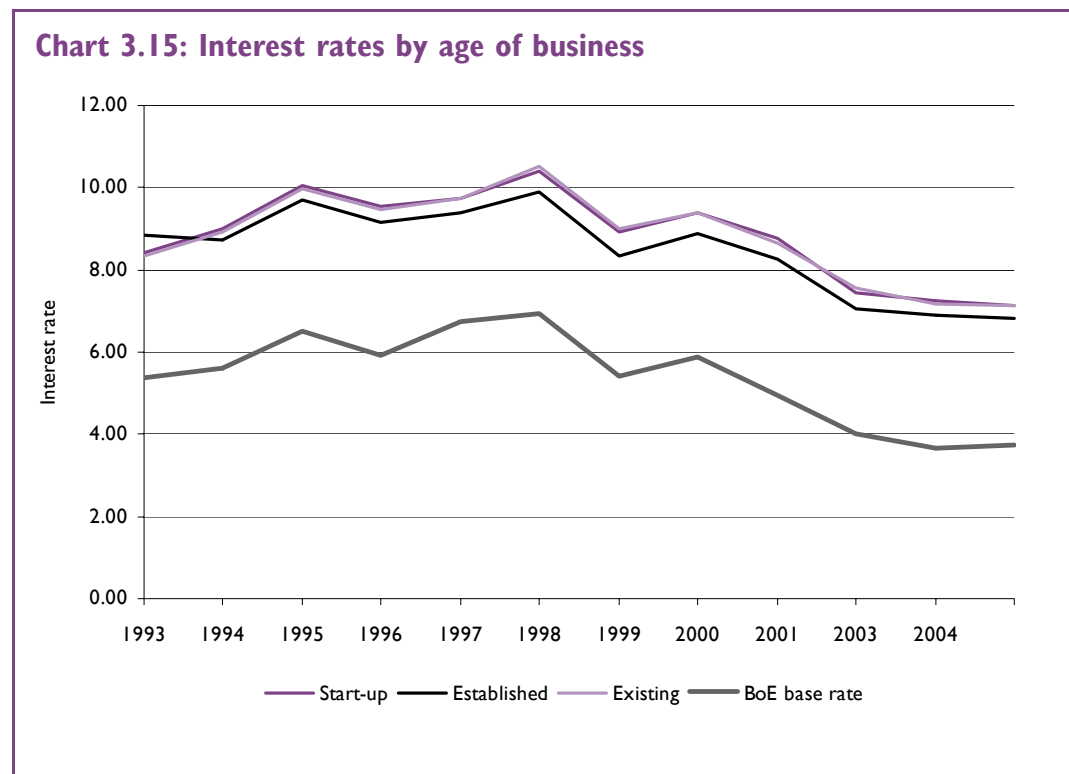
3.33 A key task for the review will be to establish the key factors driving the level of defaults, and to make a judgement about the value for money of the resulting call on government expenditure.

INTEREST RATES



3.34 The average interest rate margin for SFLG loans has been within a fairly narrow band for a considerable period of time. Interest rates charged on SFLG loans (for flexible interest rate arrangements, the figure used is the rate agreed on approval of the loan) are between 300-350 basis points above the Bank of England base rate (chart 3.14). From the data we have received, this average is between 50 and 100 basis points above the rates charged on mainstream SME lending.

3.35 As might be expected, established businesses enjoy lower interest rates than young firms (chart 3.15). The difference is a fairly constant 50 basis points.



SUMMARY AND CONCLUSION

3.36 The evidence in this chapter provides important information about the use and impact of SFLG and raises a number of issues, which will be addressed in the review's final report. The main highlights are:

- ⌘ Use of SFLG has varied over its lifetime, depending on changes in demand, eligibility criteria, lenders' appetite and the economic climate. The re-inclusion in April 2003 of retail and catering sectors led to a major increase in the total number and value of loans, following a period in which the number of loans had been falling.
- ⌘ The proportion of loans under £30,000 has fallen steadily, and the average loan size has increased in real terms, since 1996.
- ⌘ The evidence suggests that regional and local delivery of SFLG is patchy, both for demand-side reasons such as the availability of alternative sources of finance and for supply-side reasons such as differences in individual lenders' appetite for the scheme.
- ⌘ During the 1990s, around a third of all loans made under SFLG defaulted. Younger businesses have historically had a higher propensity to default on SFLG loans and are disproportionately represented among SFLG borrowers. The question of whether this and other factors mean that such high default rates are to be expected will be addressed in the final report.

4

NEXT STEPS

OUTSTANDING QUESTIONS FOR THE REVIEW

4.1 The analysis of the barriers facing SMEs seeking capital from the debt market and the evidence on how SFLG is being used today throw up a series of fundamental questions about the current and future role of SFLG.

4.2 As set out in the first chapter of this report, the central task for the review now is to consider what, in the light of the barriers faced by SMEs seeking capital in today's debt market, the objectives of SFLG should be. Clearly, SFLG should not operate in areas of the market already well served by the private sector; instead SFLG should focus upon reaching those SMEs who face the most difficulties in accessing debt finance.

4.3 In addition, SFLG cannot seek to remedy every barrier faced by SMEs seeking capital. However, by providing access to finance for start-ups, young and established firms in various sectors and at various stages of growth, SFLG can and does contribute to increasing competition, enabling innovation and supporting enterprise. The review will seek to identify how SFLG can best continue to contribute to these goals, but in particular will work to identify where SFLG should be better targeted in order to maximise its impact.

4.4 Alongside the task of maximising the impact of SFLG, the review will need to consider SFLG in the context of the Government's wider interventions to improve access to finance for SMEs. For instance, whilst SFLG is the Government's primary intervention in the debt market, some of the data presented in this report could be interpreted as evidence that SFLG is used - in some instances - alongside or instead of equity-type investments. If this is the case, then it would be important to review SFLG in relation to the Government's support in the venture capital market, such as the new Enterprise Capital Funds and, given the size of investment under SFLG, the Enterprise Growth Fund.

4.5 Alongside these fundamental questions about the role and purpose of SFLG, there are a number of questions about the operation of SFLG and its design. In particular, are the costs of the scheme – a function of the high default rates – appropriate in order to ensure that those SMEs the Government wishes to support can access debt finance, or do they reveal a problem with the scheme that should be addressed in order to enhance its effectiveness and value for money?

4.6 The final report will bring the answers to these questions together, and will make the necessary recommendations to ensure that SFLG is positioned in a way that will allow it to operate effectively in the debt market.

SCHEME RULES AND DEFINITIONS

4.7 In addition to the wider questions outlined above, there are a number of important administrative issues, concerning the scheme rules and definitions, which needed to be considered in the context of SFLG's objectives. Many of these issues were first picked up by respondents to the original Bridging the Finance Gap¹ consultation: a series of proposals were identified to streamline the rules and regulations surrounding

¹ *Bridging the finance gap: a consultation on improving access to growth capital for small businesses* (HMT and SBS, April 2003).

SFLG. As expected, many respondents to the review’s call for submissions, and stakeholders with whom the review has discussed SFLG in depth, picked up the same issues. Furthermore, a series of additional points have been raised in the course of our discussions.

4.8 The list below sets out the issues that have been raised most frequently. Whilst it is clear that these issues are of real importance both to the lenders and to SMEs, their inclusion below reflects the strength of concern amongst stakeholders rather than an indication that the review will make recommendations in these areas. At this stage, the review team is considering the arguments around the issues, and if appropriate will make recommendations in the final report.

Maximum loan amounts

⚡ Few in the sector argue that the maximum loan size of £250,000 is a significant limiting factor. However, the current limit of £100,000 for start-ups is considered by many to be restrictive, and that this limit should be raised.

Term length

⚡ The rules stipulate that the maximum loan term should be 10 years. Although rarely a limitation, if the banks are prepared to lend beyond ten years it has been argued that the government should be content. Likewise, some respondents suggested the length should be shortened, given the life cycle of many SMEs.

Maximum turnover limit

⚡ In comparison with many other international schemes, the current UK turnover limits - £3m and £5m for manufacturing – seem very low. However, few people argue that they should be significantly raised, and we have not come across significant evidence that SMEs beyond this size have difficulty accessing debt finance. However, it has been suggested that the limit is aligned with the definition of an SME as defined in Company Law (currently £5.6m), which would simplify the rule across all sectors. It would also ensure that the limit was reviewed periodically as Company Law thresholds were reviewed.

Maximum employees limit

⚡ In light of the SME turnover limits, the 200-employee limit is perceived as redundant. We have received calls for it to be dropped and for turnover limits only to be used to define size eligibility.

Definition of an “established” firm

⚡ Currently a firm becomes established after two years’ trading activity. However, many would argue that this does not reflect the nature of modern businesses and that a three-year cut off was more appropriate. They also sought clarification on terminology such as “carrying out business activities”.

Ten-year rule

⚡ A business, or an individual connected with a business, can have more than one SFLG loan but only up to the maximum allowable total amount

(£100,000 or £250,000 according to the age of the business). Until April 2003 all loans from June 1984 onwards counted towards these limits. In response to the changing face of business practice this was changed in April 2003 to a system whereby only loans guaranteed over the previous ten-year period count towards the limits. This move was widely welcomed in the SME sector. However, respondents have suggested that even this step works against serial entrepreneurs and that, in tandem with the connected persons rules (see below), it can result in a situation where minority investors prevent an SME using an SFLG. The respondents therefore suggested that the ten-year period should be shortened. One option would be to rely only upon a limit to the total amount outstanding to any one individual at any one time, perhaps subject to safeguards in relation to defaults.

Connected persons

⌘ When an individual is defined as connected to an SME, the SME becomes bound by the rules surrounding maximum SFLG loan amounts to that individual. As a result, it can be that minority shareholders - such as business angels - can negatively impact an SME's ability to qualify for SFLG. It has therefore been suggested that the definition is amended, effectively to raise the current 20% ownership threshold at which minority investors are considered to be connected.

Treatment of personal security

⌘ Many respondents cite the different treatment of personal security as a real issue for SFLG. Others, however, argue that it is right that SFLG should simply build on individual lenders' own policies. Giving borrowers certainty is important, however achieving a good balance between respecting lenders' own policies and ensuring a level playing field is tricky: it is also clear that attempting to define fixed rules in this area would be fraught with difficulty.

Who pays the 2% premium?

⌘ It has been argued that it would be simpler, fairer, and easier for the borrower to make price comparisons if the lender paid the 2% premium. We would expect the premium to be passed on to the borrower: but it would allow easier price comparison and may therefore promote price competition.

Administration of SFLG

⌘ A vast majority of stakeholders made suggestions for improving the basic administration of the scheme. Suggestions ranged from a greater use of the internet to make electronic applications and make instant eligibility checks, to extending the existing £30,000 SLA limit to all loans. Any proposals in this area will depend on any other changes to the scheme, but it is very clear that there is a strong desire in the sector to remove bureaucracy and improve the speed of response.

A

HISTORY OF SCHEME CHANGES

Phase	Date	Changes made to Scheme
I	June 1981	A pilot Scheme offering an 80% guarantee on loans up to £75,000. Premium charged at 3%
II	June 1984	Temporary extension to the Scheme. 70% guarantee and 5% premium
III	January 1985	Scheme continued but with increased monitoring and appraisal required by lenders. 70% guarantee and 5% premium
IV	May 1986	Scheme continued. 70% guarantee and 2.5% premium
	January 1988	Small Loans Arrangement introduced on loans up to £15,000 made by some approved lenders
	June 1988	85% guarantee introduced for businesses trading from an address within one of the Inner City Task Force Areas
V	April 1989	Maximum loan size increased to £100,000
	April 1990	Premium reduced to 2% for Inner City Task Force Areas
	April 1993	Inner City variation extended to cover successful City Challenge areas. Premiums in these areas reduced from 2% to 1% A minimum loan size of £5,000 introduced, except in those areas that benefit from the inner city variation Exclusion of a number of local services - retailing, hairdressing, taxi and cab hire and motor vehicle repair
VI	July 1993	Premiums reduced from 2.5% a year, on the guaranteed portion of the loan, to 1.5% a year on the whole loan for loans at a variable rate of interest and 0.5% a year for loans at a fixed rate of interest For loans to businesses covered by the inner city variation premium reduced from 1% a year on the guaranteed portion of the loan to 0.5% a year on the whole loan for both fixed and variable interest rate loans For businesses that have been trading for two years or more, at the time of application, the maximum loan size increased to £250,000 and the guarantee level increased to 85% Maximum loan size under the Small Loans Arrangement increased from £15,000 to £30,000
		January 1994

VI	November 1994	Announcement in Budget Statement of review of Scheme's rules. Consultation paper issued in March 1995
	March 1996	Exclusions resulting from European State Aid rules – agriculture/horticulture/forestry, coal, fisheries, shipbuilding, steel, transport and finance for export purposes
	September 1996	Simplification of size definitions (from six to two categories) Increase in maximum term from 7 to 10 years Increase from 10% to 20% in the “shareholders’ disregard” level Introduction of capital repayment holidays for loans under £30,000 Further exclusions under the displacement principle (catering, business to business retailing and additions to the motor vehicle maintenance exclusion) Discontinuation of the inner city variant Reduction from 2 years to 6 months in the time allowed for initial draw down of the loan.
	November 1998	Re-introduction of Agriculture with added restrictions to comply with EU state aid rules
	February 1999	Re-introduction of Fisheries with added restrictions to comply with EU state aid rules
	January 2001	Restrictions on childcare nurseries offering structured education lifted
	April 2001	Manufacturing turnover limit raised from £3m pa to £5m pa Temporary extensions to deal with outbreak of foot and mouth disease – some normally excluded sectors allowed access and increased flexibilities in repayment terms for existing loans. Extension to last until 30 June 2002-01-18
	May 2001	Shipbuilding re-introduced following changes to EU state aid rules

VII	April 2003	<p>Sector eligibility widened to include, retail, catering, motor vehicle repair/service, travel agents, libraries, museums and cultural activities, steel and coal, hairdressers, estate agents.</p> <p>Single guarantee rate of 75%</p> <p>Service sector turnover limit increased to £3m.</p> <p>Premium of 2% for all new borrowers</p> <p>Re-qualification cut-off extended to March 1993</p>
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B

CALL FOR SUBMISSIONS

The review has received over 80 submissions and comments following the call for submissions issued under the cover of the 17 February letter from Teresa Graham. These have been taken into account in the drafting of this interim report and continue to inform and assist the review team's decision making ahead of the recommendations to be made in the final report. Teresa and the review team were extremely grateful for the invaluable contributions received from a wide range of individuals and organisations.

In particular, we are indebted to a number of organisations who have engaged in the review on a regular basis:

- Abbey National
- Barclays Bank
- Halifax Bank of Scotland
- HSBC
- Institute of Chartered Accountants in England and Wales
- Lloyds TSB
- RBS Group
- Small Business Investment Taskforce (SBIT)

SUBMISSIONS

- Abbey National
- Ambrec International
- Anglia Business Resources Ltd
- Association of Chartered Certified Accountants (ACCA)
- Aston Reinvestment Fund
- Backroom Business Solutions
- Barclays
- BDO Stoy Hayward LLP
- British Institute of Innkeeping
- Business Link Oxfordshire
- Campi & Co Ltd
- Confederation of British Industry
- East Midlands Development Agency
- Investor Advisory Services
- Ethnic Minority Business Forum
- Federation of Small Businesses
- Finance South East Limited
- Finance Wales
- Forum for Private Business
- The Finance & Leasing Association (FLA)
- Furness Enterprise

Glasgow Opportunities
Grant Thornton Chartered Accountants
Halifax Bank of Scotland
Headway Management
HSBC
ICAS Business Law Committee
Institute of Chartered Accounts in England and Wales
Lloyds TSB
London Development Agency
Manchester Chamber of Commerce
Message Transfer Ltd
Moore Stephens Chartered Accountants
The National Endowment for Science, Technology and the Arts (NESTA)
Northern Enterprise Ltd
NW Brown Ventures Ltd
RBS Natwest
RF Engines Ltd
Small Business Lending Services Ltd
South West Business Finance
Technical and Strategy Directorate
Ten Sixty Six Enterprise
The Co-operative Bank plc
The Mid Yorkshire Chamber of Commerce and Industry Ltd
Ulster Society of Chartered Accountants in Ireland (ICAI)
Stewart Fleming
Stuart Williamson

COMMENTS

AK Consulting
Alex Ball
Balast
BLBW
Business in Focus Ltd
Busy Bodies Health and Fitness Club
Campaign for Community Banking Services
Commercial Finance and Business
Enfield Council
European Investment Fund
Hygeni House Limited
Kingston Smith
Machine Building Systems Ltd
Occam Systems
OPM London

QM System Limited
Rainer Security Products
SAYA Ltd
Stafford Corporate Finance
The Football Fans Census
Vittles Food Ltd
Wordmap
Zenosis Ltd
Zintu Crafts and Jewellery
Ken Burgess
Martin Gott
Jackie Howse
Mr Mody
Vasudev Patel
William Smith

We have endeavoured to ensure that all organisations and individuals are included here. However, if we have inadvertently left anyone or any organisation out of this list, please accept our apologies: it was not intentional.

