CBI
THE VOICE OF BUSINESS

CBI SUBMISSION TO THE GRAHAM REVIEW OF SMALL FIRMS LOAN GUARANTEE

1. The CBI recommends the continuation and enhancement of the Small Firms Loan Guarantee scheme, which is supported by business. Since its introduction over two decades ago, the scheme has facilitated growth and created employment in 70,000 businesses where no other financing alternatives were available.

2. Despite the changing debt market the evidence still shows that one of the main reasons that small businesses fail to obtain the requisite debt finance is their inability to provide adequate collateral. A fundamental market failure still exists, and SFLG continues to have a major role in addressing this gap.

3. However, since the inception of the scheme, the small business environment has changed considerably. The CBI therefore believes that now is an appropriate time to review the purpose, role and operational process of the scheme.

4. The CBI recommends building on the success of SFLG, and puts forward a number of recommendations to streamline the process and increase the promotion of the scheme. However, if government is minded to adopt a more radical approach in reviewing the scheme, the CBI recommends that thresholds are increased and the role of the major clearing banks is strengthened to encourage greater usage by both singular and serial entrepreneurs.

What role does SFLG play?

5. There are currently a number of financial options for early stage firms. Personal capital and equity from friends and private investors can be supplemented by bank debt.

6. The SFLG complements these by guaranteeing loans from banks and other financial institutions for small firms that have otherwise viable business propositions, but are unable to get a conventional loan because of a lack of security.

7. There remain some specific areas where amounts of finance under £250k are difficult to raise, and there is a case for government intervening to cater for these needs through a range of financial instruments. These include:

   - 'Seed' finance for pre start-up activity.

   - Finance for companies that have only just begun trading and are not yet generating profits, i.e. the 'start-up' and 'high-tech' business sectors.

   - The contracting sector, where financial institutions disregard debtor books as security.

   - Knowledge-based SMEs. Due to the nature of the assets of these companies, lenders struggle to assess the risk, and are less likely to offer finance for sound propositions.

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Summary of recommendations

8. If there is scope for a radical approach to changing SFLG, the CBI recommends that government looks at increasing the thresholds, encouraging use by serial entrepreneurs and strengthening the role of the major clearing banks:

Increase the thresholds

- Increase the maximum size of loan
- Increase the turnover limits
- Allow the use of the loan for business restructuring and transfer of ownership

Encourage use by serial entrepreneurs

- Change to a rolling basis
- Increase to 40% the maximum shareholding limit

Strengthen the role of the major clearing banks

- Allow banks to issue full sanctions

9. As well as these proposals, we also recommend other ideas to improve promotion of the scheme and streamline the process:

Improve promotion

- Clarify the role of the scheme
- Improve marketing by SBS to business
- Improve marketing by lenders
- Increase the number of lenders

Streamline the process

- Improve the SBS service level
- Reinforce guidance against use of personal guarantees
- Simplify administration for businesses
- Develop use of information technology
- Review the 2% premium paid to government

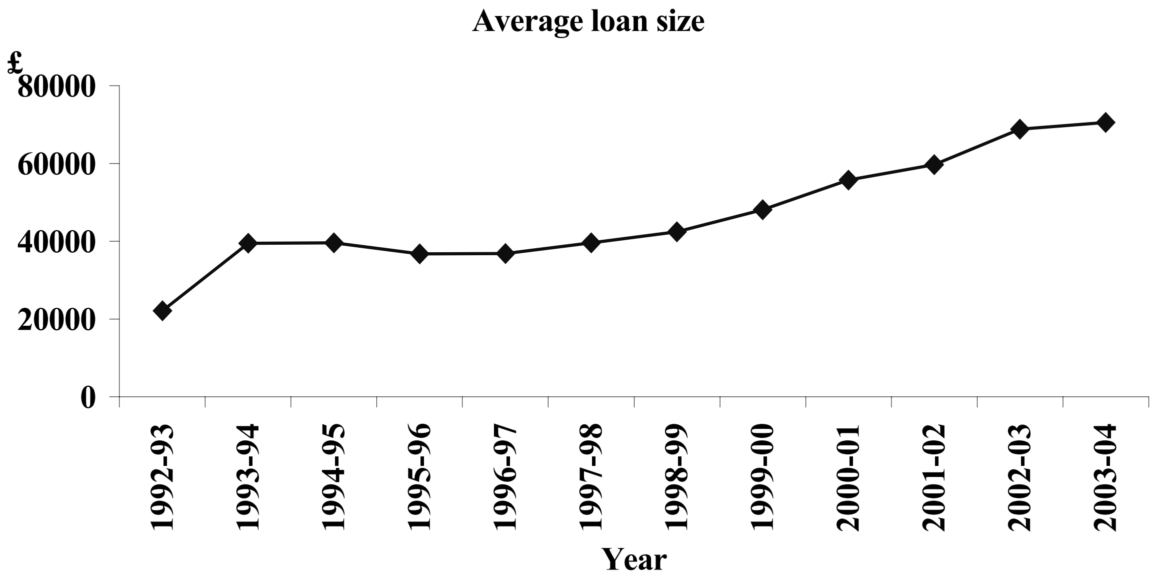
THEME ONE: INCREASE THE THRESHOLDS

10. The evidence suggests that the eligibility expansion in April 2003 had a positive impact on the volume of businesses using the scheme. We therefore suggest that government should further expand eligibility.

Increase the maximum size of loan

11. Since 1981, the maximum size of loan has remained the same at £250,000. If this had been increased in line with inflation, the level would now be around £600,000 (for 'new' businesses the level would now be around £250,000).

12. Since the early 1990's, the average loan size has trebled from around £22,000 to over £60,000.



13. It is also widely acknowledged that there is a finance gap that exists from around £250k to around £2m to £3m.

14. It therefore seems to be an appropriate juncture to increase the maximum loan size. However, we accept that increasing the level to £600,000 would perhaps be too dramatic a move at one time. Instead, we suggest that it is increased to £500,000. This level should then be reviewed at an appropriate time - possibly two years following its introduction.

Increase the turnover limits

15. The turnover limit for service sector businesses was recently increased to £3 million. This increase reflects recent changes in the market, which have increased the 'funding gap'.

16. This limit should now be indexed and increased annually with inflation until the maximum limit is reached according to the EU definition of a small firm.

17. The manufacturing turnover limit of £5 million should also be increased. We suggest that it is increased immediately to £5.6million - the threshold used for the government's small company definition.

Allow the use of the loan for business restructuring and transfer of ownership

18. The rules should be changed to allow SFLG to be used for use in restructuring and transfer of ownership of a business. In many instances this can result in productivity gains, and more fundamentally could potentially save a business from closure or downsizing.

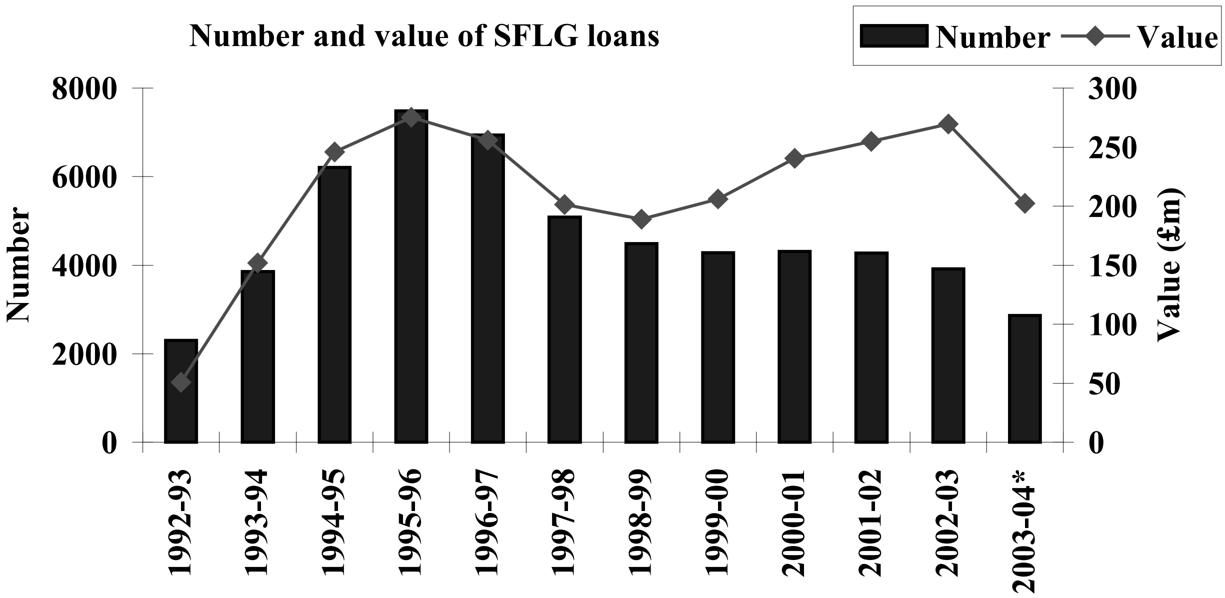
THEME TWO: ENCOURAGE USE BY SERIAL ENTREPRENEURS

Change to a rolling basis

19. Directors / owners who have previously utilised the maximum SFLG before 1993 can obtain further SFLG up to the maximum available for the business. We understand the scheme will operate on a rolling 10-year basis with each director/ owner entitled to a maximum of £250,000 over the 10-year period.

20. We recommend that this is changed so that any individual is entitled, at any particular time, to have a loan outstanding of the maximum amount permissible (provided they meet the other SFLG criteria). However, if government is not prepared to do this, then at the very least it should reduce the current ten-year period.

21. This would facilitate the use of the scheme by serial entrepreneurs and reflect the recent changes in the Enterprise Bill, which attempted to remove the stigma from failing as an entrepreneur.



*April 2003 to October 2003 only.

Increase to 40% the maximum shareholding level

22. Entrepreneurs who have been involved with a business that has received an SFLG loan must declare it to the lender. Previous involvement of individuals includes all directors and shareholders with 20% or more of a shareholding.

23. Such a low figure discourages serial entrepreneurship. We believe that it should be increased to 40%. This would allow more businesses to use SFLG whilst also benefiting from the knowledge of experienced Directors.

THEME THREE: STRENGTHEN THE ROLE OF THE MAJOR CLEARING BANKS

Allow banks to issue full sanctions

24. The major clearing banks were responsible for 98% of all SFLG loans granted in the year to March 2003. We understand that each of these Banks have specialist SFLG Units to assess the applications for the scheme through the customer relationship managers. These units are very aware of the SFLG rules and we understand will rarely have an application rejected by the SBS Loans Unit.

25. We suggest that banks should be allowed the authority to approve the loan up to the full amount. Over the last 20 years, banks lending policies have become increasingly sophisticated. Over the past 12 years the average loan size guaranteed under the scheme has more than trebled. We therefore suggest that a move away from constant referrals to one of 'audit' would be preferable. This would improve efficiency within the system, and reduce problems associated with the process and administration of the scheme.

THEME FOUR: PROMOTION / AWARENESS

Clarify the role of the scheme

26. Government needs to clarify the role that SFLG plays, and the eligibility criteria. In particular, business advisors need to be made aware that only small business who have a sound business proposition (as judged by the lender) but lack security are eligible for the loan. Government literature should also make this clearer.

Improve marketing by SBS to business

27. The 1999 KPMG report indicates that 13% of borrowers approached the lender requesting SFLG as being the preferred financing option and 58% were aware of the scheme before applying for SFLG. This shows a surprisingly high level of knowledge amongst businesses particularly as we understand the scheme is not actively marketed by the SBS other than through their website.

28. The promotion of any government scheme is important. We believe business should be made aware of the SFLG as it would encourage new and growing businesses to suggest SFLG to lenders when other funding alternatives are not appropriate.

29. The SBS is responsible for promotion of the scheme directly to businesses. It is important that SBS takes more of an active role in both promotion of the scheme generally, and the eligibility criteria in particular for the scheme. Currently, the picture is mixed. For example, whilst a section on the SFLG is easy to find on the main business link website, the picture is much more mixed across the Business Link network. A typical example is a search on Business Link Cumbria website for the SFLG, which brings up no results. SBS should ensure that the Business Link network is fully aware of the scheme, and its use.

Improve marketing by lenders

30. There is significant disparity in the promotion of the scheme by region, by lender and even by individual customer relationship manager. However, the availability of SFLG is partly dependent upon individual customer relationship managers promoting the scheme to businesses as a possible source of finance where other more traditional loans or overdrafts are not appropriate.

31. Each participating organisation should be provided with sufficient promotional material from the SBS to be distributed to all relevant employees within their organisation. This would heighten awareness of the product and its workings and enable employees to better promote the scheme to potential entrepreneurs. Nominated 'points of contact' within each participating organisation should also be provided with a comprehensive procedures guide reducing the time spent contacting the SBS.

Increase the number of lenders

32. The CBI supports the moves to increase the number of lenders operating SFLG. The scheme can be successfully operated beyond the existing major banks, which currently account for approximately 98% of SFLG. Lenders such as those offering factoring and invoice discounting should be encouraged to offer SFLG as part of an integrated financial solution to match the business requirements.

THEME FIVE: STREAMLINING THE PROCESS

33. As explained in *paragraphs 24 and 25*, we believe that banks should be allowed to issue full sanctions. This would reduce problems associated with the process and administration of the scheme.

34. However, if this proposal is not adopted, we believe that at the very least the service level agreement that exists between the SBS and the lenders should be improved, the use of information technology should be further developed, and administration should be simplified.

Improve the SBS service level

35. If a query is raised on an application then there is currently no service level agreement for the period to resolve the query. We recommend that the SBS provide a service level agreement to the lenders for responses to queried applications.

36. It is also our understanding that since the increase in applicants for the scheme in April 2003, service levels have fallen. This is causing concern at a number of the banks about the ability to deliver the scheme efficiently. It would therefore seem appropriate to review the resources allocated to the SFLG unit at the SBS.

Lessons from the United States

The US Small Business Administration '7 (a) Loan Guaranty Program' is a similar system to the UK SFLG. However, it has a much larger reach. The SBA can guarantee 75 percent of the loan amount up to $750,000. For loans of $100,000 or less, the guarantee rate is 80 percent.

They also operate a 'Low Doc' system to reduce the paperwork involved in certain applications. The applicant must first of all satisfy the lender's requirements. The lender may then request a Low Doc guarantee. The SBA uses a one-page application and relies on the strength of the individual applicant's character and credit history.

The SBA also has a system named 'SBAExpress'. This encourages participating banks to use their own documentation and procedures to approve, service and liquidate loans of up to $150,000.

Simplify administration for businesses

37. Currently, there are two different types of loans in the UK. The documentation required for the two unnecessarily varies. The CBI recommends standardisation. However, this should not result in increased documentation needed for the schemes:

Main scheme documentation	***Small scheme documentation***
Details of security held or to be taken	*Not required*
Not required	*Dates of birth for Directors and shareholders*
Not required	*Details of a business telephone number for the applicant*
The application form must be signed, dated and witnessed	*Not required*
Documentation signed for and on behalf of the lender	*Not required*

Develop use of information technology

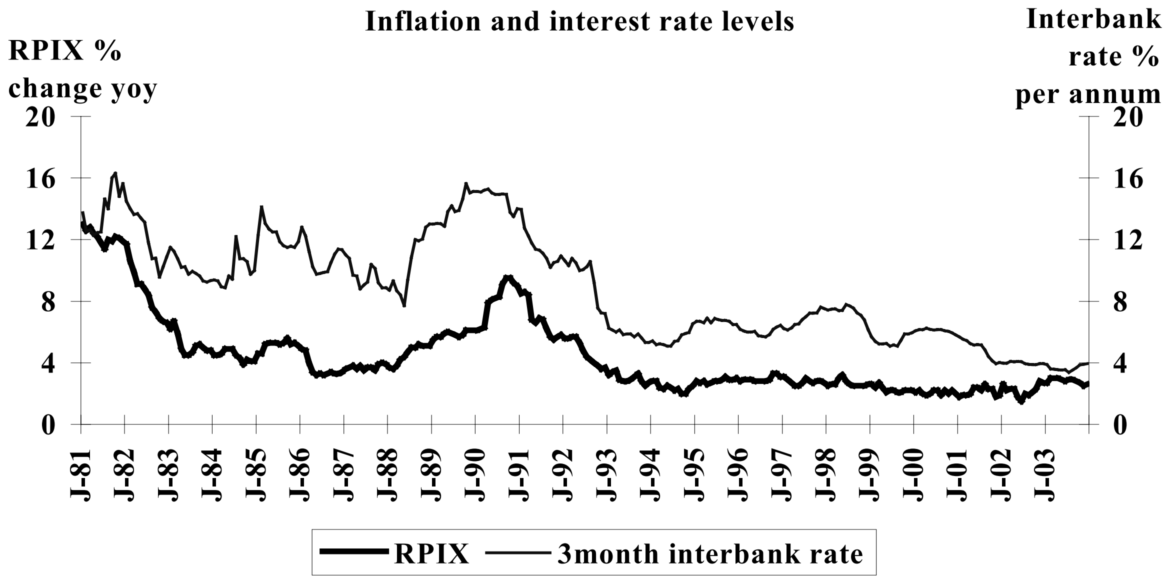
38. It is apparent that the current application system is being hampered by being primarily paper-based. These processes could be made more efficient by the use of technology. We therefore recommend that government look at ways in which the SFLG system could become more efficient. It may be useful for government to look at the application processes for other loans in the major clearing banks, or look at methods used for similar schemes in other countries.

Reinforce guidance against use of personal guarantees

39. SBS guidance specifically excludes the use of personal guarantees in addition to the government guarantee for SFLG. This is complicated where SFLG forms part of a package of lending and the personal guarantee is requested against other aspects of the lending proposition. We understand that certain businesses, which have obtained SFLG, believed the personal guarantee requested by the lender related to the granting of the SFLG. We recommend that the SBS strengthens its current guidance to lenders that they should not take personal guarantees.

Review the 2% premium paid to government

40. During periods of relatively low inflation and interest rate levels, the 2% premium paid to government is proportionally higher than during periods of higher inflation and interest rates.



41. We therefore believe that it is an appropriate time to review this 2% premium level. This should focus on what impact it has on usage of SFLG and whether in light of the current economic situation it should be reduced.

CBI Enterprise Group
April 2004

ANNEX – QUESTIONS FROM THE GRAHAM REVIEW

What do you consider to be the most significant developments in recent years in SME finance?

There have been a number of significant developments in recent years, including:

- The use of more sophisticated credit scoring.
- A reduction in the cost of borrowing.
- A trend towards unsecured personal debt.
- A significant move upwards in equity finance levels typically provided by venture capitalists.

Do you agree that the availability of debt finance for SMEs has improved over the past decade?

The evidence suggests that the availability of debt finance has improved over recent years. However, despite this the evidence still shows that the main reason that small businesses fail to obtain debt finance is their inability to provide adequate collateral. A fundamental market failure therefore still exists, and SFLG continues to have a major role.

Are there any types of businesses for whom this is not the case, for example (as suggested in Bridging the Finance Gap) start-ups, firms with non-standard applications or entrepreneurs associated with failed enterprises?

The CBI believes that there remain some areas where amounts of finance under £250k are difficult to raise. These include:

- 'Seed' finance for pre start-up activity.
- Finance for companies that have only just begun trading and are not yet generating profits, i.e. the 'start-up' and 'high-tech' business sectors.
- The contracting sector, where financial institutions disregard debtor books as security.
- Knowledge-based SMEs. Due to the nature of the assets of these companies, lenders struggle to assess the risk, and are less likely to offer finance for sound propositions.

What is your view of the suggestion that the development of scoring systems may be reducing banks' reliance on collateral?

We agree that the development of more sophisticated scoring system may reduce the banks reliance on collateral. This is a consideration, but banks or other providers should adopt flexibility in the result of adverse credit scoring and be prepared to accept collateral if this is a worthy option offered by the borrower.

How has the growth in other forms of finance, such as asset-backed finance, invoice finance and equity, affected SMEs' use of, or access to, debt finance?

Despite the growth in other forms of finance, debt finance remains the most used form of finance. According to the Centre for Business Research, banks account for 50% of external finance.

2. Understanding how SFLG is used today

Does the structure of SFLG mean it is a valued option for decision-makers in the lending institutions? Does SFLG address the right problems in the market, i.e. those that matter to lenders and borrowers, and thus form an important part of the commercial decision-making process? Are there changes that might be made to increase the incentive for lenders to use SFLG in appropriate circumstances?

Government should recognise the benefits of the use of SFLG as part of a portfolio approach.

How do lenders use the guarantee as part of their regular business? How effectively does it operate alongside mainstream lending practices?

There is variability of use of the scheme by banks and region.

The Government is committed to making it easier for lenders to become approved SFLG lenders. What are your views on the choice of SFLG lenders and on the advantages or otherwise of broadening the lender base, to include, for example, Community Development Finance Institutions?

The CBI supports the moves to increase the number of lenders operating SFLG. The scheme can be successfully operated beyond the existing major banks, which currently account for approximately 97% of SFLG. Lenders such as those offering invoice discounting should be encouraged to offer SFLG as part of an integrated financial solution to match the business requirements.

What types of businesses use SFLG, in terms of sector, size, stage of growth and other characteristics?

Government is best placed to answer this question.

For what commercial purpose do they borrow under SFLG?

A major use of SFLG is to provide working capital for growing businesses.

What is your view of the fact that the number of smaller loans guaranteed (under £30,000) has been declining as a proportion of all SFLG loans, and that this decline has been steeper since 2001/2? Should the shift be a cause for concern?

Part of the reason for this decline is inflation. However, over recent years the ability to raise personal finance for amounts under £30,000 has increased substantially. It is now much easier for example to get unsecured personal loans. This shift should not be a cause for concern.

Is it common for SFLG loans to be used as part of a package of finance? What type of businesses might use SFLG in this way, and what role does SFLG play in these deals? In your view, are SFLG loans likely to have a different risk profile to non-guaranteed loans?

It is common for SFLG loans to be used as part of the package- particularly with business angels, venture capital deals and most recently, regional venture capital funds.

Are there regional factors that affect take-up of SFLG loans? Does the type of business, or purpose of the loan, show regional variation?

The evidence suggests that use of the scheme is higher in Scotland and the South West, and lower in Northern Ireland, London and the South East. However, it would be useful to receive information on the use of the scheme broken down by banks in each region.

What impact does the level of the guarantee (currently 75%) and the premium paid by the borrower to Government (2%) have on the level of use of SFLG?

During periods of relatively low inflation and interest rate levels, the 2% premium paid to government is proportionally higher than during periods of higher inflation and interest rates. It therefore has a disproportionately negative effect. Government should therefore review this level in light of the current economic situation.

Are there any changes to the current structure of SFLG that could be made to improve the impact of SFLG in assisting businesses that otherwise could not access finance?

We put forward detailed proposals in our full paper to improve the impact of SFLG.

Delivery and administration of SFLG

Respondents called for greater consistency in the way available assets are considered for use as security. What type and level of security is it appropriate to take into consideration before recourse is made to SFLG

Government should strengthen its guidance on the use of personal guarantees. They should not be used as part of SFLG.

A large majority of respondents saw merit in further amending the ten-year cut-off for considering any previous SFLG borrowing which counts towards the maximum allowable loan amount. What are your views on the potential options, which included reducing the time limit further or relying solely on a limit on the maximum amount any one person or business can have outstanding? Additionally, is there scope for considering changes to the rules with regard to connected persons?

Directors / owners who have previously utilised the maximum SFLG before 1993 can obtain further SFLG up to the maximum available for the business. We recommend that this is changed so that any individual is entitled, at any particular time, to have a maximum loan outstanding of £250,000 (provided they meet the other SFLG criteria). This would facilitate the use of the scheme by serial entrepreneurs and reflect the recent changes in the Enterprise Bill, which attempted to remove the stigma from failing as an entrepreneur.

A number of respondents proposed raising the current £30,000 limit above which lending institutions must get approval from the SFLG unit of the Small Business Service. Would borrowers and lenders welcome such a move, and, if so, what should the limit be?

We suggest that banks should be allowed to issue full sanctions and guarantee up to the full amount. Over the last 20 years, banks lending policies have become increasingly sophisticated. Over the past 12 years the average loan size guaranteed under the scheme has more than trebled. We therefore suggest that a move away from constant referrals to one of 'audit' would be preferable. This would improve efficiency within the system.

Are the maximum loan amounts of £100,000 for new and £250,000 for established businesses still consistent with the aim of targeting those businesses with most need for a guarantee?

The distinction between 'new' and 'established' is irrelevant. The same limit should be available for all.

What are your views on the turnover criteria, which currently stand at a maximum £5m for manufacturers and £3m for all other eligible sectors?

The turnover limit for service sector businesses was recently increased to £3 million. This increase reflects recent changes in the market, which have increased the 'funding gap'. This limit should now be indexed and increased annually with inflation until the maximum limit is reached according to the EU definition of a small firm.

The manufacturing turnover limit of £5 million should also be increased. We suggest that it is increased immediately to £5.6million- the threshold used for the government's small company definition.

What are your views on the current exclusions from SFLG?

The broadening of eligibility of the Scheme in April 2003 has had a positive impact on take-up. Aside from those sectors that are ineligible due to State Aid restrictions, all sectors should be eligible for SFLG.