

1. Understanding the market	
(i)	<p>What do you consider to be the most significant developments in recent years in SME finance?</p> <p>There has been considerable development to assist SME's in acquiring finance in the manner appropriate to their needs.</p> <p>Historically, satisfying SME's financial needs would have been restricted to overdraft and loans and possibly asset finance. These products would have been fairly basic in structure but lack of choice left SME's with little alternative than to utilise what was available.</p> <p>In recent times, sign posting, general advertising and promotion coupled to product development has increased the SME's awareness of the range of funding providers and how to access them. There has been growth of products designed to specifically meet niche sector requirements and non-traditional bank finance has played a more prominent role.</p>
(ii)	<p>Do you agree that the availability of debt finance for SMEs has improved over the past decade?</p> <p>Yes – see Q1 above</p>
(iii)	<p>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?</p> <p>In terms of debt finance there will be less availability for those types of business mentioned, where quality, track record and experience of management together with available assets to fall back upon will be key lending considerations.</p> <p>Notwithstanding a growth of regional development and technology funds it also remains difficult for them to source risk capital, especially for start ups at figures below £1m where inherent costs of investing and monitoring the performance of the SME seem less attractive to venture capitalists.</p>
(iv)	<p>What is your view of the suggestion that the development of scoring systems may be reducing banks' reliance on collateral?</p> <p>While the development of credit scoring for SMEs will reduce reliance on collateral there is a danger that lenders utilising such systems will find themselves all targeting a minority of high credit rating SME's and others outside of this group will be forced to more expensive and secured lending. Credit scoring may speed the process of lending and aid quicker access to funds but this will tend to be at more modest levels of funding (see later re impact on loans under £30,000).</p>

- (v) 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?

The growth in other forms of finance has led to SMEs having a greater choice and the ability to negotiate the best deal available for them. Some of the main clearers, who leverage their relationship to maintain all forms of facilities under 'the same roof', provide these types of finance. As a consequence, SMEs need to research outside their clearing bank group to obtain the best deal available.

In many cases the availability of asset backed or invoice finance will enable funding to be obtained that could not be provided by traditional debt finance. However, our experience is often that such funding is in addition to bank debt (loans and overdrafts). Moreover, in our own case we seek to build close relationships with these lenders in order to work together and provide the customer with a complimentary package.

2. Understanding how SFLG is used today

- (i) 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?

SFLG is a valued financing option.

In a high number of cases the applicant is requesting debt finance via SFLG although risk analysis would suggest that equity finance would be more appropriate (especially start-ups) and this results in a high number of our rejected applications. The focus of the scheme parameters is on the lender's satisfaction that the only reason finance is not offered is that there is insufficient security for a "conventional loan". Bringing in new lenders that are prepared to accept an increased risk profile in consideration of higher returns (i.e. not conventional bank finance) will increase take up. It would also increase claims on the scheme which no doubt DTI would need to carefully model.

Incentive for lenders :

- **Increase the level of guarantee from 75%**
- **Lenders to have prior recourse in respect of recovered eligible proceeds**

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

The SFLG guarantee is a valuable funding option, which is considered for an SME with a viable business proposal, where conventional funding is viewed as being unsupportable due to the lack of sufficient security.

It is reasonably effective albeit, before a guarantee can be considered, a high number of scheme parameters need to be met. These parameters are encapsulated within the scheme brochure but it is probably beneficial to consider the provision of a one page summary sheet covering all the main terms so that borrowers and lenders can see at a glance if the SFLG scheme is an available funding option.

- (iii) 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?

Broadening the number of lenders should bring a welcome improvement to customer choice and widen the net to help increase awareness and take up of the scheme. It would be interesting to analyse over time whether the new entrants have a different appetite for risk and whether decline, success and default rates change.

Currently lenders are required to adopt a consistent approach to the application of scheme parameters, possess the ability to undertake a thorough credit assessment of the proposal and continue to monitor the business post initial draw down of SFLG support. This is carefully adhered to by the Bank and should apply to new entrants.

These requirements are covered in detail within the consolidated agreement between the Lender and the Secretary of State for Trade and Industry. An executive summary detailing the expected standards to adopted by all parties may be beneficial.

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

On the basis of our size when compared with the major banks, we tend to operate in niche market segments, a high proportion of which are not eligible for SFLG support. While the SFLG is a recognised part of our toolbox we do not actively pursue large volumes of debt with a risk profile that matches many applicants for the scheme and, as a consequence, our SFLG involvement is relatively low.

On the basis that we possess a relatively small block of SFLG facilities (c.30 loans) our sample is unlikely to reflect national trends of business characteristics for the scheme.

- (v) For what commercial purpose do they borrow under SFLG?

See 2 (iv) re size of sample – we broadly see an even split between start-ups and funding of business expansion.

- (vi) 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?

Generally, the administration cost / profitability equation (and the use of credit scoring) has raised the bar below which banks would not pursue collateral for facilities and unsecured finance at lower debt levels is more readily available to SMEs negating the need for SFLGs in this range.

Over the last few years, the majority of house owners have experienced significant increases in the values of their properties. Mortgage borrowing is one of cheapest forms of finance and this has been actively utilised by SME entrepreneurs to fund SME business ventures.

- (vii) 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?

Yes, it is common for SFLG loans to be used as part of a package of finance. These are usually to assist with Management Buy-Out or Management Buy-In transactions. SFLG support in these transactions is usually for working capital support.

- (viii) In your view, are SFLG loans likely to have a different risk profile to non-guaranteed loans?

SFLG loans generally possess a riskier risk profile to non-guaranteed loans.

SFLG proposals tend to include a greater percentage of businesses which are still in an infancy stage of development and/or are in the process of introducing a major change to the business, which could create a significant impact (beneficial or adverse) on the future of the business.

- (ix) 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 relatively low number of loans which we transact through the scheme does not provide sufficient data for us draw any firm conclusions on regional factors.

(x) 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?

Guarantee level

- The guarantee level is an issue for lenders.
- The current 75% was altered c.12 months from a two tier system where 85% was available for established businesses and 70% other businesses.
- The reduction in the guarantee level for established businesses means that loan amounts, which are approaching the maximum available within the scheme, may require intense assessment and there is an increased chance of the proposition not progressing.

Premium

- The premium is an issue for borrowers although lenders will have an interest in the ability of the borrower to fund this amount (either upfront or profiled over the term of the facility).
- This was changed 12 months ago when the premium was 1.5% for variable rate loans and 0.5% for fixed rate loans.
- The primary purpose of the premium is to provide the SBS with a funding pot to cover potential guarantee claims. The rationale for the increase in the premium is appreciated especially in view of the relaxation of various other scheme parameters.

(xi) 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?

As recommended elsewhere in our reply; increased guarantee level and maximum amounts, together with welcoming new entrants prepared to take greater risks (but with the emphasis of SFLG to move from simply providing security for “conventional loan” finance in the absence of personal / business security).

3. Delivery and administration of SFLG

- (i) 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?

There is not normally an issue regarding business assets where customers understand that these must be made available as security for the loan. Accordingly, there is an extremely wide range of business assets taken into consideration, usually under a debenture.

There are however more issues surrounding personal security. It is our understanding that lenders should consider the availability of personal security for all shareholders, who possess a minimum business interest of 20%, and, if it is available and sufficient to cover the loan, then any funding request cannot be supported by SFLG finance but should be provided through conventional funding.

Currently, it is the lenders decision whether personal assets are available for use against conventional lending. On the basis that there are currently 23 SFLG lenders, this leads to the adoption of different approaches. One of the main issues is in relation to the treatment of joint ownership of personal security where the co-owner is not involved with the SME. If the co-owner is not willing to pledge security then should the security be regarded as available or unavailable? What if the co-owner had agreed to the security for a previous / existing facility but has drawn the line at the new request? If the business comprises 2 (or more) shareholders / directors and the spouse of one will not allow a personal property to be used and therefore the other director will not commit his assets as security in order that their respective risks in the business are the same – is this a valid reason for the second director's security being unavailable? There is a need for more clarity where the FAQs in the brochure leave much to a bank's "commercial decision".

Increased take up of SFLG loans would follow a relaxation of the wording that "If you are not prepared to allow all your available assets to be used to secure conventional lending, you will rule out the use of SFLG". Perhaps allowing for limited guarantees on conventional lending that permit say £50k equity retention without ruling out the use of SFLG would be acceptable.

- (ii) 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 amount¹. 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?

Ten years is a long time frame for a business and there is merit in considering a reduction in the cut-off period to say 7 or even 5 years provided there is no more than £250,000 outstanding at any one time.

Should the cut-off period and/ or maximum allowable loan amount remain with the person? The longer the time period then there is an increased likelihood that the person may become involved with another business, which is otherwise unconnected with the original business. We recommend that the maximum allowable loan amount restriction should only relate to the original business provided the person does not have greater than a 50% shareholding other scheme guaranteed ventures.

- (iii) 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?

On the basis that the SBS has experienced a general increase in the average SFLG loan amount, there is a strong case for raising the current £30,000 approval limit for specified institutions.

Any increase could reflect the percentage increase which may be introduced for loan amounts (see 3 iv below)

- (iv) 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?

These maximum loan amounts have not been increased since the Bank originally became involved with the scheme. There is merit in considering an increase in these limits. An impact analysis of any proposed increase would need to be completed by the SBS and we would suggest increasing these limits :

- **up to a maximum of £200,000 for new businesses**
- **and up to £500,000 for established businesses.**

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

In our experience, these parameters have not proved to be too restrictive.

It very much depends on the definition of an SME utilised by the SFLG financing model / its target market. In some circles, an SME could represent a business with turnover of up to c. £30 million so, on that basis, the current scheme turnover parameters would only appear to be catering for the 'Small' element of the SME market.

- (vi) What are your views on the current exclusions from SFLG?

Appendix A of the brochure lists business activities with exclusions and restrictions and this is fairly clear has not caused particular difficulties.

4. Other issues

Capital & Interest repayments

The current repayment structure in respect of SFLG loan facilities is that the repayments of capital and interest are covered separately. On this basis, a fixed monthly repayment covers the capital element for the duration of the loan (assuming no restructuring of the facility during the period) and a separate repayment following its application to the loan account covers the interest. The loan balance is higher at the start of the loan and, as a result, the SFGL borrower needs to cover higher interest repayments at this stage of the facility although it is recognised that the borrower will benefit in cash flow terms at the end of the facility term.

The repayment structure for the majority of our conventional funding incorporates one monthly repayment which includes both capital and interest elements. These repayments will remain fixed for the duration of the loan, albeit, loans, which are subject to variable, interest rates, are reviewed annually and altered to ensure full amortisation of the facility over the loan term.

There is a case for considering a repayment structure that mirrors conventional lending (there will be implications in respect of premiums and the nature of the SBS guarantee).