

To: Teresa Graham, OBE

Dear Teresa,

Thank you for your letter of 23 February 2004 inviting us to express our views on the Small Firms Loan Guarantee.

I attach documents from two of my colleagues who have experience in this field which respond to the issues set out in the note attached to your letter.

We hope you find these comments useful in compiling your final report to the Government.

Kind regards,

Richard Moore

THE GRAHAM REVIEW OF THE SMALL FIRMS LOAN GUARANTEE

1. Understanding the market

- (i) *What do you consider to be the most significant developments in recent years in SME finance?*

There is now a much greater variety of financial products available to SMEs. 10 years ago, most businesses we dealt with were financed by traditional bank lending, with only the more adventurous or desperate businesses using debt factoring. Asset based finance is now much more widely accepted and it is becoming increasingly rare to find a company financed solely by clearing bank lending. Private equity is also a much more significant source of finance for SMEs.

- (ii) *Do you agree that the availability of debt finance for SMEs has improved over the past decade?*

In general, yes.

- (iii) *Are there businesses for whom this is not the case, for example start-ups, firms with non-standard applications or entrepreneurs associated with failed businesses?*

Businesses looking to raise between £250,000 and £500,000 have difficulty attracting finance, particularly if the business does not have assets that can be pledged as security. The funding required is too high for the SFLG but too low to easily attract equity finance. If the business does not have its own assets to pledge as security, lenders will require the personal assets of the owners. However, the owners' personal assets are often insufficient to secure lending of this level.

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

This is noticeable for very small loans. However, for lending above £100,000, banks still appear very keen to have collateral for their lending.

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

See (i) above. The growth in these forms of finance has given SMEs much greater access to finance and they have taken full advantage of this.

2. Understanding how SFLG is used today

(i), (ii), (iii), (iv), (v), (vi), (vii), (viii), (ix), (x)

No comment.

(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?*

It would create a level playing field between the young and reckless, without any assets to their name, and the mature and prudent, who have built up assets over time, if it was not necessary to provide all available personal assets as security before qualifying for a SFLG. It is quite common to see experienced and capable managers who are forced, or decide, to leave employment to set up their own business. They are willing to risk a cut in their income and leisure time in order to get the business started. However, they are generally unwilling to risk their family home by offering it as security for a loan. Arguably, it is precisely this sort of entrepreneur, with experience and a strong sense of family responsibility, which will provide the least risk for SFLG. Also, particularly for people over 50 who have lost their jobs, the alternative to starting a business may be living off state benefits.

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?*

See comments in 2 (xi) above. The requirement to make personal assets available as security is a barrier to the use of SFLG. It is generally appropriate for security to be taken by way of fixed and floating charges over all of a company's assets and its undertaking.

(ii) and (iii)

No comment.

(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 with most need for a guarantee?*

No. See comments in 1. (iii) above. The limit of £250,000 for established businesses should be raised to £500,000.

(v) and (vi)

No comment.

4. Other issues

No comment.

SMALL FIRMS LOAN GUARANTEE

1) **How developments in the debt market for SME's have affected the rationale for, potential impact of, a loan guarantee scheme. In particular:**

i) The most significant developments in recent years in SME finance is the availability of alternative sources of finance to the traditional secured loan/overdraft namely:

cash flow lending, debtor finance, asset finance, trade finance, stock finance.

- ii) There is no doubt the availability of debt finance for SME's has improved over the past decade due to:-

Increased competition from lenders, the availability of alternate/supplementary sources of finance.

- ii) There are however businesses for whom the above is not the case, these typically being start-ups, and entrepreneurs associated with failed enterprises.
- iv) The development of scoring systems by certain banks appears to have little or no effect on their requirement for collateral.
- v) The growth over the past decade of the other forms of finance ((i) above) has increased the access and use of debt finance.

2) Understanding how SFLG is used today:

- i) Decision makers in the lending industry rarely if ever consider the structure of SFLG as a valued option and thus it fails to form an important part of the decision making process. To incentivise lenders to promote and use SFLG would undoubtedly lead to increased utilisation. However, any such incentive must not be detrimental to the SME in terms of increased arrangement fees or interest rate charges.
- ii) Few lenders actively promote the SFLG as part of their regular business, there being a tendency to use SFLG as a last resort in an endeavour to gain new business. It is therefore ineffective in operating alongside mainstream lending practices.
- iii) The lender base should be broadened to include more debtor financiers and regionally based Community Developed Finance Institutions.
- iv) Utilisation of SFLG is predominantly by SME's in manufacturing, distribution and service sectors within a turnover range of £0.5 to £5.0 million.
- v) Funding utilising the SFLG is generally utilised for additional working capital purposes.
- vi) The numbers of smaller loans guaranteed (under £30,000) as a proportion of all SFLG loans is perhaps related to a general apathy amongst the major Clearing Banks to fund start-ups together with an increased documentation requirement for a relatively small funding advance. The decrease in the numbers of small loans guaranteed should be a cause for concern for it is generally start-ups which require these smaller amounts.
- vii) It is common to utilise an SFLG facility as part of an overall funding package particularly so in the case of management buy-outs/buy-ins when the provision of SFLG is used to bridge the 'funding gap' to make the deal happen where otherwise it may not.
- viii) SFLG's have by their very nature a greater risk profile than non-guaranteed secured loans with associated performance covenants.
- ix) Whilst the type of business purpose of the loan would not be expected to vary significantly on a regional basis, awareness of the facility appears more pronounced away from major conurbations.
- x) The guarantee (75%) is crucial to use of SFLG whereas the premium paid by the borrower to government (2%) is not an influencing factor during the present low interest rate climate.
- xi) SFLG cannot presently be utilised for or towards the purchase of shares. This is inhibiting the impact of SFLG in management buy-outs/buy-ins when it can only be utilised in the case of asset purchases (which are far less common than share purchases) or for working capital purposes.

3) Delivery and administration of SFLG

- i) Greater consistency amongst lenders in the way available assets are considered for security is required. Consistency with regard to land and buildings, (particularly environmental impact or otherwise upon valuations/risk assessment) trade debtors, and plant/machinery, and stock valuations are required prior to recourse to SFLG.
- ii) There is significant merit in amending the ten year cut-off for considering any previous SFLG borrowing which counts towards the maximum loan amount whilst reducing the ten year cut-off to (say) seven years would be beneficial, it would also be more beneficial to rely solely on a limit on the maximum amount any one person or business can have outstanding. Consideration of changes to the rules with regard to connected persons would have little or no effect on utilisation.
- iii) Borrowers would generally welcome an increase to £50,000 above which lending institutions must obtain approval from the SFLG unit of the Small Business Service in Sheffield.
- iv) The £100,000 ceiling for new businesses is more than adequate. However consideration to a scale relating to the number of years the business has successfully operated should be given as follows:-

	£/Loan
New Businesses	75,000
2-5 years trading	250,000
Over 5 years	350,000

- v) In order to assist, more manufacturers' consideration should be given to an increase in maximum turnover for that sector to £7.5million.