

JEB/BLC-SUB

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Dear Teresa

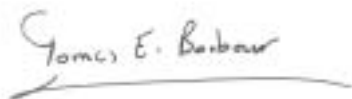
THE GRAHAM REVIEW OF THE SMALL FIRMS LOAN GUARANTEE

The Institute's Business Law Committee welcomes the opportunity to comment on the above consultation paper and I am pleased to set out its comments below.

We believe that in general the scheme is fundamentally effective and is vitally important in ensuring that firms in the small business sector gain access to debt finance. We would not advocate major changes to the scheme although we believe that there are areas where improvements could be made. In our specific comments to the questions in the consultation paper (Appendix A), we highlight these areas and offer suggestions as to the improvements required.

We hope that our comments are of assistance to you. If you wish to discuss any of these further, please do not hesitate to contact me.

Yours sincerely



JAMES E BARBOUR
Secretary to the ICAS Business Law Committee

APPENDIX A**RESPONSES TO THE SPECIFIC QUESTIONS IN THE CONSULTATION
PAPER****“THE GRAHAM REVIEW OF THE SMALL FIRMS LOAN GUARANTEE”****Deadline Date: 13 April 2004****1. Understanding the market****(i) What do you consider to be the most significant developments in recent years in SME finance?**

We believe the following to be the most significant developments in recent years:

- The growing importance of “business angels”. They have become heavily involved since the withdrawal of the venture capitalists from the sector. The importance of the Small Firm Loan Guarantee (SFLG) scheme is evidenced by the number of “business angels” who arrange debt finance via the scheme as a matter of course.
- There has been a rapid reduction in the number of smaller deals being completed.
- The SFLG scheme is still very important and now forms part of the overall package of funding.
- The average price of deals is now considerably lower than it was. This has implications on the type of funding package that is put together to finance such deals.
- Statistics may be obtained from the Young Company Finance publication to support the above comments.
- The structure of finance packages is becoming more piecemeal i.e. the total package invariably now comprises various components of funding from different sources. This is in stark contrast to five to 10 years ago, when you would probably have only gone to one funder, who would have given a definitive answer on the complete funding package required. Nowadays, a package of funding is necessary, even where only a low level of funding is required. This can add to the time taken to put funding packages in place.
- In general, the Banks’ attitudes in this sector have changed. There is a lack of consistency across the banking sector, and also within banks, in their support of SMEs, and in the type of funding packages available.

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

In general, we do not feel that the availability of debt finance has improved over the past decade. This is particularly true at the smaller end of the market where the availability of debt finance has got worse. We believe that this is due to the following reasons:

- In the past 5 to 6 years the availability of debt finance has fluctuated in the sector and it has also fluctuated by bank. In this respect, it can be frustrating when there is a lack of consistency in the packages offered by the various banks.
- The ‘point scoring systems’ used by retail banks i.e. the “tick-box” approach doesn’t necessarily match the attached risk to the project under consideration. This can lead to a bank taking a very narrow viewpoint and not properly considering the risk of the project in question.
- Many branch bank managers do not have the experience to make quick informed decisions on such matters. As a result, personal contacts within the banks are now even more vital.
- There are probably fewer providers than previously.

(iii) 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?

As noted we do not agree with the statement in question 1(ii). However, we agree with the list of businesses given, where the availability of debt finance has not improved i.e. start-ups, firms with non-standard applications and entrepreneurs with failed enterprises.

We believe that this is due to the following reasons:

- There has been no change in the culture of not accepting failure.
- In certain cases it appears as though the project proposal is not being effectively communicated via the bank to the DTI. Furthermore, inconsistent messages are given by the banks in relation to the information that they already have and the information that they still require to enable them to make their decision. It would be most beneficial if banks could speed up their decision-making process. Banks are prone to claiming that it is the DTI who are holding up the provision of the finance. This is more likely to be due to the banks’ own internal processes. It would therefore be helpful to be able to communicate directly with the DTI to try and ascertain the true position. Many projects are time critical and in some cases a delay can be as bad as a refusal.

We would add that it would be beneficial to remove the need for DTI approval. Please refer to our comments in 3 (iii) for further details.

- Banks use different criteria as to how they assess personal assets and how these are assessed by their respective credit teams. This can have a major impact on whether a project is approved or not. There is a need for greater consistency in the assessment procedures used by banks.
- Bank managers with large portfolios do not have the time available to properly consider smaller deals.

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

We do not agree with this suggestion.

(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?

It is easier to access these forms of finance but using them limits an entity's access to other forms of debt finance. It also has to be remembered that such other finance when used, merely forms an element of the overall package. They are not an effective tool in terms of start-ups. Such entities do not have credit ratings therefore do not have access to these sources of finance. Additionally, it depends to an extent on what you want the scheme to be e.g. is it a quasi-equity product.

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?

We believe that SFLG is of fundamental importance to decision makers in the lending institutions.

We believe that it does address a gap, i.e. where there is no available security a loan would not be given without the scheme. We believe the problem is that the scheme is not used on a consistent basis by lenders. We believe that this is due to the functionality of the banks and as long as they persist with a "tick box" approach the scheme will never reach its true potential.

An increase in the guaranteed percentage amount might increase the uptake.

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

We are not in a position to answer the first point of the question but in our view the scheme appears fundamentally effective and is working well in practice alongside mainstream lending practices.

(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?

We believe that there is already a broad choice in terms of approved lenders.

If the scheme was extended to Community Development Finance Institutions, there is the possibility that the decision making process would not be as rigorous. This would potentially allow more 'bad' loans to be given which would ultimately damage the future existence of the scheme.

We believe that a 'one-stop-shop' idea would be a good idea for smaller loans and are aware that certain local agencies are already providing a service of this nature in areas of social deprivation. We also recognise, however, that most local agencies are providing debt but not through the SFLG scheme.

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

We categorise these as follows:

- New start-ups;
- Expansions;
- Young companies primarily in the technology sector; and
- Invariably small businesses.

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

We believe that they borrow for the following reasons:

- Working capital requirements;
- Identified funding requirements; and
- Gap Funding.

(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?

We are not aware that it has been declining but are obviously concerned if this is the case. We believe that this might be due to the following:

- The type of bank manger now in place, who is inexperienced and merely ticks boxes and forwards such applications to the bank's credit departments, i.e. the banks' systems are not geared towards assessing applications made under the SFLG scheme.
- Such amounts can generally be obtained from other sources, therefore, it is not worth the effort to do.
- Additionally, in many cases the client's assessment is well short of the overall funds that will be required, hence the need to ask for a loan of a greater amount.
- Bank mangers do not have the time to deal at this level.
- Difficulties experienced in dealing with banks in circumstances where personal guarantees are not available. Some banks do not have the awareness that SFLG loans might fit their requirements.

(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?

It is very common to include SFLG loans as part of a package of finance.

The businesses concerned are as per 2 (iv) above. SFLG loans form an essential role in these deals. Many would not be completed without access to such funds.

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

We believe that by their very nature they do have a different risk profile to non-guaranteed loans. They are filling a funding gap where there is a lack of available security. They are effectively a loan of last resort for many small entities.

(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?

Unfortunately, we do not have the information available to answer these questions.

(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?

We believe that the 25% non-guaranteed element does present some banks with a difficulty i.e. it could in some cases deem the loan unviable depending on their set criteria. We do appreciate that this ultimately depends on the individual bank manger responsible for assessing the loan. We would strongly resist any move to lower the guarantee threshold from its existing level of 75%.

We do not believe the current level of premium to be an issue although some small business owners perceive it as being rather expensive.

(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?

We believe that the following changes would improve the impact of SFLG:

- An increase in the percentage guaranteed would be likely to lead to an increase in the uptake.
- A streamlining of the process would be beneficial. Banks are not given enough of an incentive at the lower end of the market.
- Clearer, and consistent application of the scheme's rules amongst the banks and indeed, within banks, would be most beneficial.
- Having written confirmation from the DTI would help answer why funding was not provided and whether it is worthwhile going to another lender to try and gain access to funds under the scheme.
- The application of consistent criteria by the banks in relation to the assessment of personal assets e.g. their varying treatments of marital assets. Some banks take into account such assets whilst others do not. Such inconsistencies can increase the time involved and when the time factor is critical it can severely hinder the proposed project.

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?

We believe that the security should be commensurate with the level of risk of the project. Some lenders are more flexible than others. In relation to the credit assessments performed by banks, there should be clear guidance as to what assets are excluded to ensure consistency across banks.

(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 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?

We believe that there is merit in doing this as companies change their form over time and by nature their needs become different. In this respect we believe that there is merit in changing the criteria from entity based to project based i.e. if you have two good ideas then why should you be penalised from having access to funds to pursue the second initiative merely because you have already used the scheme. We want to promote people who have more than one viable idea and who have met the financial covenants set by the lender. Obviously, if the entity has previously defaulted on a loan then we can understand the reluctance behind providing further finance.

We question why there should in fact be a time limit. The true test should be the bank's own commercial criteria.

We are also keen that increased flexibility should be introduced across the board.

In relation to the connected person rule as it applies to investors, we appreciate that this is normally not an issue for "Business Angels" as they are unlikely to have more than 20% of the share capital of an entity. However, this rule can provide problems in relation to very small companies. Raising the investor limit from 20% to 30% would effectively remove this burdensome restriction.

(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?

We would welcome the installation of a quicker approval process. In this respect, we believe that there should be no need for DTI endorsement of such loans, but rather that a process of self certification by the banks should be accepted by the DTI, subject of course, to a suitable monitoring process being put in place. We recommend that this would involve test checks (but not on a case by case basis) subject to any European legislation that would prohibit this.

(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?

The scheme is working well but increased flexibility would be beneficial. We would promote the possibility of further funds being provided at a later date if certain additional financial targets are met.

(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?

We believe these to be satisfactory.

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

We believe these to be appropriate.

4. Other issues

In addition to the themes raised above, the Graham Review is tasked with examining all aspects of SFLG. Do you have any further suggestions for improving the rules, structure or administration of the Guarantee?

We question the relevance of having a criteria based on the number of employees. Different businesses require different numbers of employees due to the nature of their business. We do not believe that this should be an obstacle to the accessing of such loans. On the contrary, we believe that the DTI should be encouraging entities to employ more people.

One additional area where there is a problem is at the round two or three financing stage when entities are seeking to increase the level of SFLG to £250K. At this stage, the total funding package would typically be over £1 million with the additional £150K SFLG forming part of that. In order to qualify entities have to be “successfully trading” for over two years to be able to apply for the additional £150K loan. There is an inconsistency in the interpretation of what is meant by “successfully trading”. The DTI’s interpretation of this seems to be two years sales experience, whilst the Banks are only looking for the ability to service and repay the loan going forward. Early stage high technology companies spend most of their first two years developing their product and very rarely have two years sales experience until they have been in existence for three to four years. We would therefore appreciate the application of a consistent approach in this area based on the banks’ interpretation of “successfully trading”.