

THE GRAHAM REVIEW OF THE SMALL FIRMS LOAN GUARANTEE SCHEME (SFLGS)

Response from the Finance & Leasing Association (FLA)

1. At the FLA's meeting with the Review team on 14 April, we promised to record our views on how asset finance might be covered in a restructured SFLGS.
2. The FLA is the major UK industry body for the asset finance, consumer finance and motor finance sectors. Our full members provide asset finance to business, consumer credit, point of sale, credit card and instalment finance. Our associate members provide services or goods to those industries and support the Association's vision.
3. FLA members achieved £89.7 billion of new business in 2003. Of this £25 billion was provided to the business sector and UK public services, representing over a quarter of all fixed capital investment in the UK in 2003 (excluding real property). The remaining £64.7 billion was provided to the consumer sector and FLA members represented 29.7% of all unsecured lending in the UK. Included in the above total is £19.0 billion of finance provided to the motor sector. FLA members financed at least 50% of all new car registrations in the UK in 2003.
4. The FLA is a strong supporter of the Government's view that the UK's productivity performance needs to improve; and that our investment performance is a major contributor to our relative productivity performance; and that investment by the SME 'tail' is a key element in that. We see the SFLGS as one of the policy tools that the Government can use in that context. In particular it can help finance growth by firms which are beyond the start-up stage but do not have a sufficiently long track record to meet finance providers' normal lending criteria: businesses we refer to below as 'intermediate' businesses.
5. Asset finance is a major source of finance for investment by SMEs. In 2003 FLA members provided £ 24.7 billion of asset finance. Around 53% went to firms with a turnover below £5 million, and 27% to firms below £1 million.¹
6. Providing asset finance to the private sector involves credit and asset risks for the finance providers.
7. In the case of intermediate businesses, credit issues are acute. The short life-span of these businesses in particular means that they

¹ All figures in this paragraph are provisional, pending publication of the FLA 2004 Annual Business Survey.

cannot provide the levels of assurance that finance providers normally expect.

8. Asset risk varies significantly from asset to asset. Some assets, such as telecoms equipment or much IT, decline in value to near zero over relatively short periods. Other assets, such as cars and some machine tools, suffer an early drop in market value but retain sufficient value for there to be a thriving secondary market.
9. Asset risk does not vary if the customer is a start-up or an intermediate business necessarily (though it may if the business lacks experience at using the assets), but combined with credit risk it compounds the finance provider's difficulties in providing finance to such businesses, especially, though not exclusively, where asset quality is relatively poor.
10. Asset risk (with other factors) can impact on the nature of the asset finance on offer. For assets with a low or non-existent residual value after a period, a finance lease (with the finance provider retaining title usually and finance made available for the whole economic life of the asset) or hire purchase (where the customer owns the asset at the end of the finance contract, and the finance relates to the total value of the product) may well be more appropriate. For assets with a strong secondary market the customer may find it more economic to take finance as an operating lease, with title remaining with the finance provider and finance and use by the customer relating only to part of the economic life of the product.
11. Asset finance can have the following advantages for the intermediate business and other SMEs:
 - It will certainly be cheaper than unsecured finance and is competitive with finance secured on the business or in other ways;
 - Security is only taken in the asset being financed. So the business's other credit lines, such as its bank overdraft facility, are not affected. It is worth remembering that asset finance is provided by bank subsidiaries and non-banks, such as finance houses and the finance arms of manufacturers ('captives', in industry parlance). Failure to keep up payments would result in the finance provider taking back the asset and expecting full repayment for any balance due, but the business would not suffer any other effects.
 - Asset finance is flexible. Repayment schedules and the duration of a finance contract can be tailored to the customer's circumstances to a significant degree. For example an early stage business might well find it convenient to pay relatively low instalments with a larger 'balloon' payment at the end of the contract.

12. Asset finance providers are generally not significant users of the SFLGS. The reason for this include:
- Asset finance is transaction based. Typically for an established business a deal can be completed within 24 hours. Newer customers may take a little longer to process but in a highly competitive industry there is always a premium on the speed of transactions. The asset finance industry, like many others, therefore finds the procedures of the current SFLGS too slow, cumbersome and costly, except in fairly rare cases. This must be solved if asset finance providers are to apply to join the list of approved lenders in greater numbers.
 - The guarantees on offer are much more tailored to loans than to asset finance. What is needed for asset finance is support related to the credit and asset risks that the finance provider will be taking.
 - The limits set on loan size and eligible firms are not in themselves an issue, though we see no commercial or economic case for treating manufacturing and other businesses differently. The turnover limit for both should be set at the current manufacturing limit of £5 million. We would also like the limit above which financing institutions have to refer decisions to the Small Business Service raised, to £50,000, in line with commercial practice in the asset finance industry.
13. To make the scheme much easier to access by asset finance and eligible firms seeking asset finance, we propose a new mechanism, in addition to the current scheme's incentives, which would be related to the asset risk being borne by finance providers. The guarantee would apply to finance provided less the residual value if the asset were recoverable. The current rules on taking security would have to be adapted to meet the circumstances of asset finance. We would be glad to work with Government on the details of such a mechanism, if the principle is accepted.
14. If such a mechanism were added to the SFLGS, with a streamlined administrative procedure, we believe that Members could increase their contribution to financing the SME market, with a particular focus on intermediate businesses, by something in the range of 5-10% of the current volumes. In cash terms that would mean an increase of around £0.6 -1.2 billion.² Default rates are low, so even a significant increase in volumes of this order should result in a very low Exchequer cost, remembering the scheme would alleviate, not remove, finance providers' risks.

² All figures in this paragraph are provisional, pending publication of the FLA 2004 Annual Business Survey.

Finance & Leasing Association
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