

## **The London Development Agency's Response to the Graham Review of the Small Firms Loan Guarantee Scheme (SFLG).**

### **1. Summary**

Generally, the LDA offers its qualified support for the continuation of some form of Guarantee. It is considered to be a useful measure in circumstances where all the conditions for making a loan exist, save for the availability of adequate security. However, modifications may be needed if the Scheme is to satisfactorily meet the changing requirements of entrepreneurs, as well as the concerns of financial institutions.

### **2. Supply side**

2.1 The SFLG scheme was principally introduced to support firms in the manufacturing sector, at a time when manufacturing made up a much larger proportion of the economy than at present. In addition, at that time banks operated on a traditional basis with loans agreed personally between the bank manager and customer, following a detailed review of a proposal and often an established business relationship. Under these conditions, a good proposition might materialise, and if a lack of suitable security were the only difficulty, an SFLG facility would be a good solution. Since the inception of the SFLG scheme banks have, in the main, moved to an operating model which is more centralised and streamlined, reflecting their need to operate with lower overheads and on a virtually risk free basis in order to continue operating commercially with the small lending margins that are possible.

2.2 Despite current practice to the contrary, our view is that the SFLG scheme is not a suitable instrument for the financing of early stage technology, creative or similar firms where there is unlikely to be a reliable revenue stream from which to make loan repayments.

2.3 It is important to distinguish between the requirements of businesses with high growth potential and those with more modest prospects. For the former, finance is more appropriately provided in the form of equity. It may be helpful to consider a new loan instrument instead with a higher margin to reflect the additional risk of lending to such firms. This might look like a mezzanine instrument, but the panel's view is that that the term should be avoided so as to give it the appearance of a fresh product. Our view is that the current scheme is seen by the investment community, and especially amongst business angels, as a source of cheap money to make up a funding package for high-growth businesses. However, it is considered a misuse of the SFLG scheme to reduce the exposure of equity investors.

2.4 In order to reach more companies that could benefit from the scheme, probably those with only modest growth aspirations, there is merit in extending the number of institutions able to participate in the scheme. The guarantee may be an appropriate tool for Community Development Finance Institutions (CDFIs), which may have better access to some smaller company deals than the mainstream banks as they still lend under a traditional person-to-person model. It was also suggested that factoring companies might find SFLG scheme-backed

loans an attractive add-on product, again addressing a sector of the market that may be difficult to reach

through the banks. However, it will be important to ensure close monitoring and quality management as new institutions are brought into the scheme.

2.5 There are concerns about the operation of the scheme. At present it is understood that DTI approval is required for all decisions relating to loans over £30K. This creates undue delay and we would recommend a higher threshold. There is also concern that it is the perception of many small firms that the SFLG scheme is/should be cheap public money and not a loan made on normal commercial terms. There may well be a need for clearer promotion of the scheme to educate the market about its purpose, and thus inform expectations.

### **3. Demand Side**

3.1 The increased use of scoring systems for lending assessment to smaller firms by the high street banks is having the effect of drawing the SFLG scheme away from the earlier stage, smaller end of the market. In the main,

Propositions are not appraised through a meeting with the client and reviewing a business plan prior to the consideration of security. A computer system will consider client characteristics such as:

- industry sector
- length of time trading
- length of time a customer
- bank account activity and behaviour
- audited financial statements.

3.2 A further problem is a lack of clarity in the market place about the operation of the scheme. Customers are confused by the inconsistent application of the scheme both *between* and *within* banks. There is a difference of view amongst banks on issues such as eligibility of borrowers and the use of collateral. It is clearly confusing to clients if the banks are using the scheme in an erratic manner, with different conditions of acceptability being used within the branch network of the same bank. The reason for this is, in our view, that credit teams of banks have never been committed to promoting the scheme. It is only their more innovative or more aggressive managers who “step outside the box” and utilise the product to any degree.

3.3 In part there is a fundamental difficulty for the banks, in that, although the government guarantee provides 75% security, they are unable to adequately and separately secure the remaining 25%. Whilst the design that the banks should share the risk is understandable, it is for the reasons stated above, a significant barrier to its use. However, banks do seem to appreciate the availability of the scheme and agree that it should continue in some form as long as its limitations are accepted. It might help to stimulate the market if the government were to publish league tables of the performance of institutions writing SFLG scheme loans.

3.4 The LDA welcomes the extension of the scheme to include sectors such as retail, catering and car mechanics where there is a large representation of black and ethnic minority businesses that find it difficult to raise finance for start up and growth. Government might consider ethnic monitoring in the application of the SFLG scheme, to stimulate the market to better serve these

communities. It may also wish to work with RDAs and others to promote the scheme to groups where there has been disproportionately low take up in the past.

#### **4. Conclusions**

4.1 The SFLG scheme is not the right tool for assisting high growth SMEs, including new technology start-ups, but it does have a role in meeting the needs of businesses which meet the criteria for the scheme. The possibility of a new, publicly supported instrument should be considered to support high growth businesses, with lending margins reflecting the increased level of risk.

4.2 For those businesses that have more modest prospects, we would suggest Government improves their access to SFLGS in two main ways: firstly by canvassing bank credit teams rather than their sales or business growth personnel; and secondly by engaging more CDFIs of quality with the SFLGS. Their personalised approach could help to overcome the limitations posed by the banks' credit scoring procedures.

4.3 There is a need to clarify the objectives of the scheme, and its target clients. This will ensure the public understands the scope and limitations of SFLGS. Improved understanding should help to enable all the players in the market, including the SMEs themselves, to make best use of the opportunities that SFLGS can offer.

#### **Note**

*This response has been informed by a discussion of the key issues amongst a panel assembled by LDA to help it consider SME finance issues. The following individuals contributed to our deliberations:*

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*However, the views expressed in this response are solely those of the LDA and do not necessarily reflect those of the organisations listed above.*

London Development Agency,  
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