

The Graham Review of SFLGS

1. Understanding the Market

- 1.1 SME finance in the lower end of the market, i.e. start ups and micro businesses, has not changed in recent years. Banks have changed the presentation of products such as factoring to be both attractive to the SME and be less risky lending than an overdraft. In the same way leasing is seen as an easier way to fund capital equipment. While initiatives such as this are seen to provide further choice in the market place, in reality any business which would not have been lent money on an overdraft or loan will not be accepted for any other product. The bank view is to reduce risk. Factoring secures the book debts, leasing allows security over the vehicle which would not be available to them otherwise. It should be remembered that SFLGS also operates across all business types whereas some of the "new" products are aimed very specifically e.g. factoring only for limited companies.
- 1.2 The number of products which could be used has increased but access to the funds still relies on the Banks lending criteria. Their lending criteria have not changed substantially in recent years and while some products could ease the risk to the bank, the question should be asked of the Banks are they using that to reduce risk or lend to "riskier" proposals.

Debt finance to SME's has also benefited from the availability of equity in Director's homes at a level which has not been seen in the recent past. The inflation in house prices has provided an easy lend with business debt secured against the principles home. This availability of home equity to use as collateral may be evidence that the reduction in smaller loans supported under SFLGS is not a sign that the market place has developed and debt is easier to obtain. The availability of cheap, easy access personal debt, again sold on the benefits of house price inflation, for "any" purpose may also have contributed to the decreased in demand for SFLGS. These loans do not need a business

plan, provide a cheque within days with no verification of the purpose of the loan and are extremely competitively priced. It is entirely likely that entrepreneurial individuals have used a home improvement loan for business purposes.

This availability of such security is a short term feature within the economy as it is government policy to reduce inflation within the housing market. The housing market is also changing. Higher prices are changing the way first time buyers enter the housing market and the number of first time buyers has reduced greatly in the past few years. This produces an almost two tier system with those already on the property ladder having available equity in their home to support their business and those not on the ladder taking longer to be in that position. At no point should the position on the housing ladder be a defining moment on whether a business can raise the necessary funds to grow.

SFLGS was put in place to support businesses where no security was available from either the business or the principle and bank support was therefore not available. The features within the market place above provide evidence that demand for the scheme can be increased in the future.

1.3 See above

1.4 Credit scoring is used by the lending agencies for two reasons. The first is to reduce the incidence of bad debts. It is accepted by any organisation using credit scoring techniques that these may result in perfectly good applications being refused, but this is acceptable in the aim to reduce risk. The second point is experience. A massive change in the way that banks deal with SMEs has occurred in the past few years. Most SMEs at the lower end are now dealt with in call centres, by lower paid and less experienced bankers. This lack of experience probably means more reliance on automated systems, and tighter credit criteria which make debt harder to access. Conversely the larger SMEs are enjoying more time with more experienced lenders and this will allow better access to debt, as shown in your research. In addition larger and

more established SMEs have better asset availability for security and longer trading records, which should allow the banker to place less reliance on SFLGS. In the larger SME market are cases using SFLGS to again reduce risk, where the proposal without the support is still an “acceptable risk”?

- 1.5 Equity finance in particular is still not available and perhaps is unsuitable for the smaller SME. Most equity investors wish to be part of a package of support and the minimum investment is usually higher than the smaller SME actually needs.

2. Understanding how SFLGS is used today

- 2.1 The two key questions being asked between a borrower and a lender are simple. Can I have the money I need? & Can I lend with confidence that the debt will be repaid? No scheme can ever provide a positive answer to both in all cases, however, SFLGS provides that if the potential borrower has a well thought out plan and the lender want to lend but can't because of a lack of security then support will be given. If the business case is not good enough then support is unjustified. If the business case is good then the bank should support with security being the only basis for not going forward with a good proposition. In this way the original scheme is ideal. Recent changes have reduced the benefits loading towards existing businesses which was apparent in the old tiered scheme. It should be noted that a business with a trading record is a much better lending risk than a new or recently started business. As such perhaps the guarantee available to new start businesses should be higher to reflect this profile of risk.
- 2.2 It is difficult for anyone outside of banking to answer this question effectively, however the lack of consistency amongst lenders, even from the same institution, in their knowledge and use of the scheme is great. It is not the first client who has been told Bank A does not deal with SFLGS when they are an approved lender.

- 2.3 At present the list is acceptable if the Bank's are deemed to be the main point of funding. The use of the fund within CDFI's would be an excellent way of allowing these institutions to increase their lending fund and increase the life of the fund. One drawback may be that most community or development finance schemes only fund a proportion of the amount required and act as a lever for additional, usually bank funding. If SFLGS was used by the CDFI would this remove one of the ways in which a bank could support the remainder of the package? If so this would remove the ability of the CDFI's to make an impact.
- 2.4 The role of an enterprise trust is to assist in the creation and development of SME's within our local area. This means that the majority of clients are under 25 employees and the sectors are representative of a small geographical area. Hence any comments on sector and size would not be representative of national trends. I would imagine DTI's information would be much more representative.
- 2.5 See 2.4 above
- 2.6 See 1.2 above. The trend should be a cause for concern if it can be identified that Bank policy in reducing risk is acting as a barrier to finance for SME's. If the cause is related to the housing market then provision must be made for both those who have not benefited and the inevitable slowdown in house price inflation which will reduce equity available.
- 2.7 In all lending no one institution wishes to have sole liability. This includes large syndicate deals for many millions or a small enterprise where the risk is shared between the lender and principle, usually 50% each. In this way all deals can be described as packages. In the case of SFLGS it is usual that the principle as well as having no security to offer may not have the contribution to make either. In these cases SFLGS can assist in leveraging other monies from Development agencies, leasing or other financial assistance.

- 2.8 As the lending decision still rests with the lending institution only they can answer this question. In principle the only difference between a SFLGS and a non supported loan is the availability of security.
- 2.9 See 2.4 above
- 2.10 The level of guarantee does not effect the borrower in deciding to use SFLGS. The level of guarantee does influence the lenders ultimate decision to lend based on the amount left unsecured and the risk profile of the lend. The premium level, with the current low levels of Base Rate, represents a significant extra finance cost to the business. Eg 33% extra finance cost based on bank lending at 2% over Base Rate at 4%. Business principles however place that cost against the cost of a lost opportunity to grow their business. If SFLGS is the only alternative then the will take up the funding.
- 2.11 The only improvement would be a much more consistent use of the scheme throughout the approved lenders. The scheme in its current guise provides an excellent framework to facilitate SME growth.

3. Delivery and administration of SFLGS

- 3.1 There is inconsistency in dealing with a number of types of potential security. Some Banks will now remove the matrimonial home from consideration. Other areas of inconsistency revolve around assets being built up for retirement. In the current climate these may be a variety of investments and, whilst a pension fund may be included, may be assets such as rental properties which would normally be utilised. Given the governments wish for individuals to take pension planning seriously it is difficult to then force individuals to use such assets prior to obtaining SFLGS support. Some way of formally tagging such assets would be beneficial. In addition most lenders use a system of discounting security value to take into account a forced realisation value. It could be that a formal list of further discounting could be produced by DTI which

would provide a consistent and transparent way of dealing with this issue.

- 3.2 SFLGS is seen as a way to kick-start growth in a business through the introduction of finance at a time right for the business. This principle should then allow the business to become larger and more profitable thus becoming self sufficient and "fundable". The question of a cut off must therefore address how long is it reasonable to predict that a company will have seen the benefits of the past support. Whilst businesses will have growth period which require support regularly throughout their life, intervention should be possible from a variety of sources as they grow. A ten year cut off from obtaining the first SFLGS should be introduced limiting the applications from companies to a ten year window. The maximum amount outstanding at any time during that 10 year period could be raised to £350K meaning that short sharp interventions are used to boost growth with a time limit for applications removing the ability to use the scheme as a crutch. Over the ten year period the growth in the business should be sufficient to allow other avenues for funding to become available.
- 3.3 The current £30K limit is a purely internal process between DTI and the lenders. Its impact on applicants can be a slightly shorter approval time but its main impact is to remove some of the administration required. It may be that £100k is now a suitable amount bearing in mind the effect of inflation over the years on the £30k limit. This would assist greatly in reducing the administration burden, or perception of burden, on the lenders and may increase the usage of the scheme.
- 3.4 The turnover criteria are again based on the need for intervention at certain levels. It is acceptable to think that a prudently run company turning over £5M per annum should have the ability to raise finance based on the value within the balance sheet. Whilst the business may not be able to raise vast sums the, sums involved within SFLGS would be seen as small in relation to the sums which should be available readily. Given the recent changes in eligibility

and the fact that manufacturing businesses remain under pressure in the UK it would be appropriate to retain the differential between manufacturing and other sectors.

- 3.5 The recent changes in eligibility have produced a well rounded scheme and have allowed a much greater proportion of the business community to take advantage of the scheme.