

Consultation on future role and development of the Small Firms Loan Guarantee Scheme (SFLGS)

Submission by London Small Business Growth Initiative (LSBGI) on behalf of the Steering Group of the London South Central 'Generator' Project

Who we are

London Small Business Growth Initiative (LSBGI) is a London based enterprise agency, working with SMEs and social enterprises, and with particular experience of BMEs.

Our focus

The 'Generator' project brings together LSBGI as project leader with the economic development units of the London Boroughs of Lambeth, Southwark and Wandsworth, as well as Business Link for London, Brixton online, the South Bank Employers Group, and oneLONDON.

Our focus is on developing an area approach to economic re-generation in the London South Central area which contains some of the most deprived wards in the UK.

A number of consultant reports have been completed and we are about to submit a Report to the LDA on an Action Programme. Access to Finance is a critically important part of our Report.

Given the deadline for comments on the future of the SFLGS we are submitting separately this short memorandum.

Support for SFLGS

We welcome the 'Graham initiative' and the open way in which it is being conducted.

Whilst we have a number of comments and ideas on how the Scheme might better serve SMEs, we welcome very much the decision to retain the Scheme. We believe it is a potentially useful form of economic assistance to SMEs, especially in the sort of deprived areas on which LSBGI and the 'Generator' project is focused.

We would not want to see the Scheme ended or curtailed.

Role of SFLGS

The role of SFLGS is to offer protection to lending institutions on loans they would otherwise turn down for prudential or other economic reasons. We would have expected to have seen a higher incidence of use in deprived areas, and a higher level of bank lending therefore in such areas than would otherwise have occurred.

We cannot comment on this from a national perspective, but from our limited surveys and our experience, knowledge and use of SFLGS is not significant amongst SMEs in deprived areas such as LSC.

We note that London has the lowest take-up of SFLGS support in GB yet has a high concentration of the most deprived wards in the UK.

A more focused *area* approach with more effective marketing, and simpler ways of accessing the Scheme are worthy of investigation.

Collateral lending and Credit Scoring

A requirement of eligibility for use of SFLGS is that other forms of security have been exhausted, such as personal or business assets as collateral.

We believe this works unfairly against low net wealth businesses and individuals in deprived areas. To put up collateral for example of £25,000 to support a small loan when the business or individual's personal net worth is only marginally more is a very different proposition to providing a similar level of backing when the net worth is ten times greater. One of the characteristics of deprived areas is the low level of existing wealth.

We are also concerned with the process of how businesses in the 'shadow' economy can be brought into the mainstream. Total disclosure of assets is unlikely to be useful in achieving this. It is worth noting that the Bank of England has described this segment as one with a "latent demand for business finance".

We would suggest that some level of personal and/or business net worth should be ignored when determining eligibility.

The precise structure of credit scoring engines currently used

is unclear to us. We believe the operating principles underpinning them should be published so that any potential discrimination against SMEs in deprived areas can be assessed, for example if the perceived risk is affected by neighbourhood crime rates.

Financial risk versus resource costs

In reaching a decision whether to lend to a SME in a deprived area, the lending institution has both to consider the pure financial risk of default and the costs of serving the type of customer. Start-up and early stage businesses in principle require a higher level of monitoring and support than established businesses. So whilst use of the SFLGS will reduce the financial exposure of the lending institution, the higher costs of serving the customer may reduce considerably the value of the customer to the Bank.

From our experience there is little business support available for SMEs from mainstream banks operating in the area we serve. The linkage of business support and the use of SFLGS funding would assist in overcoming this, though it is more likely to be achieved by using specialist organisations, such as oneLONDON, who can combine both aspects.

As part of our 'Generator' project we are exploring the case for such a lending institution focused on deprived areas of South London. Being an approved institution under the Scheme will be an important part of its role.

SFLGS premium rates and borrowing costs

Our understanding of the application of SFLGS is that a premium over the lending cost is charged to the borrower for the use of the Scheme, currently 2%. The Bank of England has cited evidence that in deprived areas there is typically a premium of 1.4% charged by Banks to SMEs. We have two points:

- 1 If the Bank's analysis is correct then the SFLGS premium is too high; it more than compensates for the average market risk premium
- 2 If the SFLGS premium is added onto the lending institution's own lending rate, as we believe it is, then the SME is paying the risk premium twice over.

The actual borrowing costs experienced by SMEs denied access to normal bank finance is considerably higher. Lenders under micro-loan

schemes find demand at APRs of around 20%. For many SMEs in deprived areas, there is a blending of personal and business finance, with the use of credit cards and other sources of high cost borrowings.

Whilst over-charging for risk is undesirable, access to finance is more important than the cost itself, within limits.

SFLGS as an insurance product

As an insurance product the Scheme has an unusual characteristic: the assured is the lending institution but the premium is paid by the SME. And for each SME included, there is an individual policy issued to the lending institution, which adds to transaction costs.

A more traditional insurance approach would be for the Assured to plan a level of exposure and to buy the level of protection required, for a negotiated premium. In this context, a lending institution would agree an aggregate level of lending to higher risk SMEs (for example those who fail the collateral test and/or credit scoring). This would be covered by the insurance offered under the SFLGS. They would negotiate a premium based on the historic loss experience of their lending experience.

One attraction of this approach would be to make public the level of 'higher risk' lending to SMEs undertaken by lending institutions.

It would also encourage new institutions to enter into the segment because of the existence of broad insurance coverage. And traditionally this is the precise function of insurance, i.e. to encourage institutions to undertake more risky activities.

Area lending and 'distortions'

As part of our 'Generator' project approach to area development we have been focusing on 'business clusters', which emphasises the benefits to individual businesses of being part of a network. This extends to borrowing as well, as a specialist lender is better able to discriminate between good and bad business cases.

We believe the SFLGS has a role to play as part of the financing packages that can be developed for SMEs in designated clusters served by a specialist lender or specialist lending unit of a mainstream lender.

The SFLGS has had some effect but not so far a major impact. We are aware of the theoretical risk to existing businesses of offering cheaper finance to start-up SMEs. (In LSC several of the firms we surveyed had remained SMEs for well over 100 years) In practice we believe that the access to finance is only one of the determinants of business success, and so believe this is likely to be overstated as an area of concern.

Exposure limits and SME life-cycle

For start-up and early stage businesses, when the existence of other assets is least likely, the amount available for guarantee is restricted to £100k, whereas for firms well on their way to being fully established (> two years trading) the limit is higher at £250,000. Start-ups and early stage businesses are required to present a business plan. But businesses without a track record have the greatest difficulty in being precise about financing needs.

If the purpose of the scheme is to encourage SME growth and development and to offset a market failure, then there seems a case for allowing the higher amount to be available for early stage firms and start-ups as well.

Financing packages and the role of SFLGS

The Government has introduced a number of initiatives to encourage private finance to support SMEs. We welcome these. Several are helpful in improving access to equity including for social enterprises.

We believe that there should be no restrictions on the use of SFLGS in underwriting loan elements of financial packages which depend on these tax favoured incentives if the aim is to assist in the imaginative financing of dynamic SMEs.

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