

# Graham Review

of the Small Firms Loan Guarantee



## Recommendations

September 2004



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# FOREWORD BY TERESA GRAHAM OBE

September 2004

Dear Chancellor and Secretary of State for Trade and Industry,

Small firms are the lifeblood of our economy. We all – government, businesspeople and the UK as a whole – have a real interest in ensuring that the environment in the UK for small firms is as supportive and exciting as possible.

During nearly three decades of working with growing businesses and two decades of involvement with the world of better regulation, I believe much has been done to create a supportive environment for enterprise - but more can always be done and I have approached this Review with a clear goal: to maximise the support that the Small Firms Loan Guarantee (SFLG) offers to small firms.

Access to finance has been the subject of considerable debate. I have spent almost 30 years advising small firms seeking finance and I know how hard, and sometimes how easy, it can be to access funding. Overall, I believe (like many others, including the Bank of England) that the UK is a good place to access finance. But it is not perfect - gaps in the finance market exist and government has an important role to play to help address those gaps. However, I don't believe that entrepreneurs have a divine right to financial support: sometimes the dreams of entrepreneurs need the reality check of the market to ensure proposals are viable. It is in no one's interest that bad propositions get financial support.

SFLG, the Government's principal intervention in the debt market, has, for over 23 years, sought to help SMEs with viable business propositions but insufficient collateral upon which to secure a loan to access the debt finance that they need. The Review's Interim Report noted that collateral still appears to be a major consideration in lending over around £25,000, and that borrowers without business or personal assets to offer as security may struggle to access finance. We also noted that start-up businesses, those with non-standard characteristics and those seeking to expand beyond their current asset base continue to find it more difficult than the majority of businesses to access debt finance.

My main conclusion is therefore that the principal gap in the UK debt market remains the need for collateral: SFLG still has an important role to play.

However, SFLG is far from perfect. It has a mixed reputation amongst entrepreneurs and lenders – for every success story there is a tale of frustration and delay. Its objectives are not well understood and its impact on UK productivity even less so; its availability is patchy; and its administrative structure is showing its age. Small firms need SFLG, but they need an updated, focused and modern intervention.

This Report sets out my vision for the new SFLG, and the package of recommendations that I believe will enable SFLG to fulfil that vision.

## **The vision**

SFLG is a bureaucratic and unstrategic programme, which focuses on establishing the eligibility of individual businesses. I believe SFLG needs to evolve into a modern intervention characterised by strategic and targeted usage, a high level of understanding about its performance, which is monitored through light touch regulation and focused on the achievement of broad policy goals.

To do this, I recommend that Government targets SFLG at those most in need of support and those who will benefit most: start up and young businesses. These are the very businesses that are most likely to lack collateral and for whom there are few alternative financing options, but they are also the businesses of the future: it is these businesses that will drive growth, competition and innovation – and so boost UK productivity.

I recommend massive deregulation of the scheme's administration. This Report recommends the adoption of a 'portfolio' approach – moving the scheme away from a focus on individual loans to understanding the impact of the portfolio; it also recommends the removal of many of the complex eligibility rules and simplifying those that remain. Perhaps most importantly, we propose that the Small Business Service is taken out of the loan approval process: lenders should be free to make SFLG loans without prior approval. There should be a light touch annual audit process, but otherwise the SBS role should focus on high level annual discussions with the lenders, aimed at keeping SFLG fresh and modern and focused on where the need is greatest as the debt market evolves.

Contrary to the perceptions of many, SFLG costs the taxpayer considerable amounts of money (around £60m last year), driven by the high default rate on SFLG loans (which average around 30-35%). I am pleased that at no point did Government seek to shrink away from this expenditure and that you are committed to continuing the scheme. My package will not add to the scheme's costs and indeed establishes a mechanism for capping Government's spending, but I believe the most important financial aspect of the package is that the SBS will be required, each year, to make a judgement on how best to spend the money allocated to the scheme to maximise its impact and to maximise the amount of lending that can be supported. For the first time, SFLG will have a strategic objective, linking expenditure to impact.

I believe that this Report contains a significant and radical set of recommendations. In taking them forward, Government has an important role in educating stakeholders about the new objectives of the scheme and the new strategic approach to its operation. In addition, if the new SFLG is to be successful, I am in no doubt that the lenders will need to change their approach to dealing with SFLG; but the Government too will need to up skill its people and to put in place the right structures to incentivise the maximisation of SFLG's impact: a change in approach from both partners is a prerequisite to successful implementation of a new SFLG. I am pleased that the lenders and key SME stakeholders, with whom I have discussed these recommendations, welcome the direction and objectives of the Report. I hope Government will accept them in full and will implement the recommendations as soon as possible.

I would like to express my thanks to all those who assisted me in producing this Report. Many individuals and organisations gave generously of their time and effort to propose ideas and supported me in reaching these conclusions. A full list of contributors is at Annex C. I would also like to thank the team who have supported me throughout: Oliver Jones, Hilary Brown, Barrie Morris, Ros Eales, Odette Fioroni and Jan Shah.



Teresa Graham OBE

# EXECUTIVE SUMMARY

## Introduction

The Graham Review of SFLG was commissioned by the Chancellor and the Secretary of State for Trade and Industry in December 2003. The Review was tasked with examining the structure and rules of SFLG and whether SFLG is sufficient to tackle the barriers faced by start-ups and small businesses in the current market.

The Review's Interim Report (June 2004) presented evidence about the current use of SFLG in today's SME debt market. It concluded that SFLG continues to play an important role in supporting businesses that lack collateral, particularly at start up and growth stages of development. However, responses to the Review highlighted a number of important practical difficulties affecting the operation of SFLG that could usefully be resolved.

## Objectives of SFLG

An independent review presents a good opportunity to reassess the programme's objectives, which have inevitably evolved since it was set up in 1981. The aim of SFLG is to assist viable, debt-appropriate businesses that lack sufficient collateral to access loan finance in the market. In line with other interventions, SFLG should be used only in circumstances of market failure, where a viable business is unable to raise finance under conventional terms. SFLG forms part of the Government's portfolio of interventions in the debt and equity markets, and, as such, it is designed to support the Government's objectives of increasing UK productivity and promoting enterprise.

## Aims of the Review

In light of these issues, the key objectives of the recommendations set out by this Review are to:

- Maximise SFLG's impact on UK productivity
- Target SFLG onto small firms which face the greatest difficulties in accessing finance
- Encourage a more consistent availability of SFLG so that more small firms can access the programme
- Ensure firms can access a greater level of funding to support their needs
- Reduce the administration and bureaucracy of operating SFLG so that they do not limit the availability and popularity of the programme.

## Focussing SFLG and improving availability

Chapter 3 summarises the evidence that suggests that barriers to accessing finance are more acute for start-ups and early stage businesses than for established businesses. Established businesses have access to a wider range of financial products and are more likely to have retained earnings. In addition, surveys indicate that young businesses are more likely to have high growth ambitions and contribute positively to UK productivity.

For these reasons, the Review recommends that SFLG be focussed specifically on start up and young businesses, from commencement of trading in the first year of assessment, and for the next four years of tax assessment. In order to ensure that these businesses are adequately funded, the Review recommends raising the maximum amount of outstanding borrowing to £250,000.

There is frustration among the small business community about the perceived inconsistency of delivery of SFLG by lenders in different parts of the country. The Review believes that commitment to ensuring that all front line managers are aware of SFLG and the circumstances in which it should be used should be a key part of becoming an SFLG lender. It recommends that SBS monitor regional and local usage and that this should be a key input to the annual negotiations between SBS and lenders.

#### **Risk and reward**

Chapter 4 recalls the conclusions of past evaluations of SFLG, that the programme represents value for money in meeting Government objectives of encouraging enterprise. However, as outlined in the Interim Report, default rates of around 35% mean that the programme represents a net cost to government, which in 2003/4 rose to around £60million. The Review believes that default rates are higher than can be explained by risk profiles of the borrowers alone and notes that lower rates would enable more lending to be done at the same cost to government. Whilst acknowledging that high default rates should not be assumed to be undesirable in themselves, the Review recommends that default rates are kept under review to ensure that they are appropriate to the overall goals of SFLG.

#### **Portfolio approach**

Chapter 5 describes how the unrestricted and demand-led nature of SFLG allows the scheme to be used in an untargeted and unfocused way. The Review would like to see a change in how both the SBS and lending institutions view, utilise and oversee SFLG in order to increase strategic oversight and active direction. To facilitate that shift, the Review recommends that management of SFLG be conducted by SBS on a portfolio basis as opposed to a loan-by-loan approach. Significantly, the Review recommends that lenders should have the freedom to decide to use SFLG, within the parameters of the programme, without prior recourse to the SBS for approval.

#### **Simplifying eligibility**

In response to comments from a wide range of stakeholders, chapter 6 sets out recommendations to simplify the rules of SFLG. These changes, combined with the greater autonomy given to lenders, will make it easier and more attractive for lenders to make use of SFLG in appropriate circumstances and will focus the decision on the quality of the business proposition rather than unrelated eligibility rules.

**Managing resources**

Chapter 7 establishes the need for government to set a cap on the total value of SFLG lending in order to avoid unforeseen contingent liabilities accruing to government and to provide for the proper management of public spending. The Review recommends that the cap should apply to the total amount of lending carried out by each lender. It is essential that a facility should exist to allow new lenders to begin to use SFLG, and to reward those lenders that are particularly effective in using SFLG to reach growth businesses, and the Review recommends that a dedicated pot of money is set aside to support these goals. The Review recognises that managing a limited supply of SFLG will require significant change in the way in which lenders operate the programme, and recommends that the cap on each lender be set high enough in the transition period (the first few years of operation) in order to have sufficient flexibility for the impact of the other changes to be understood.

**Delivery and impact**

Chapter 8 acknowledges the fact that the recommendations outlined in this Report challenge both SBS and lenders to change the way they operate SFLG, with the view to increasing availability among start ups and young businesses. If the Government accepts the recommendations outlined in this Report, the SBS will need to work with lenders to ensure a smooth transition to the new arrangements. Once the changes have been implemented, annual discussions between SBS and lenders will allow an assessment of the overall impact of SFLG and the effectiveness of the delivery mechanisms in reaching the types of businesses most in need of government support.

**Conclusion**

The Review believes that the recommendations outlined in this report provide an opportunity to refocus this important and long-established intervention more effectively on those businesses that benefit most from government assistance. Success will depend on the commitment of the SBS and lending institutions to change they way they manage SFLG, with long-term benefits to government, lenders and the small business community.



# SUPPORTING ENTERPRISE IN THE UK: THE CONTEXT AND ROLE FOR SFLG

## INTRODUCTION TO THE GRAHAM REVIEW

**1.1** The Chancellor of the Exchequer and the Secretary of State for Trade and Industry commissioned the Graham Review of the Small Firms Loan Guarantee (SFLG) in December 2003, with the following terms of reference:

To undertake a review to ensure that, through SFLG and other interventions, the Government is doing all that it can to help start-ups and small firms overcome the obstacles that they face when raising debt finance. The review should work closely with the main SFLG lenders and will examine, and if appropriate make recommendations regarding:

- the structure and rules of SFLG and their appropriateness to the scheme's effective operation; and
- whether SFLG, as the Government's principal intervention in the supply of debt finance to small and medium sized enterprises (SMEs), is sufficient to tackle the barriers faced by start-ups and small businesses in the current market.

**1.2** On 17 February 2004, the Review published its call for submissions, seeking stakeholders' comments and views on SFLG. The call for submissions closed on 13 April. The responses received have been instrumental in assisting the Review's analysis and helping to firm up the conclusions set out in this Report. The call for submissions initial document, plus the responses received, can be seen on the Review's website<sup>1</sup>.

**1.3** In June 2004, the Review published its Interim Report<sup>2</sup>. The Report presented evidence about the current use of SFLG in today's SME debt market. It concluded that SFLG continues to play a useful role in supporting businesses that lack collateral, particularly at start-up and growth stages of development. However, responses to the Review highlighted a number of important practical difficulties affecting the operation of SFLG that could usefully be resolved.

**1.4** This, the Review's Final Report, sets out the Review's recommendations, placing the scheme in the context of the UK debt market and the Government's other interventions in the finance market, and, in response to stakeholder views, proposes a radical agenda for administrative reform to simplify SFLG and to reduce bureaucracy.

## PRODUCTIVITY AND ACCESS TO FINANCE: THE CONTEXT FOR SFLG

**Enterprise** **1.5** The Government has identified enterprise, along with competition, innovation, skills and investment, as a key driver of productivity<sup>3</sup>. A thriving SME sector makes a vital contribution to output, employment and productivity in the UK. However, rates of entrepreneurial activity in the UK remain only moderate by

<sup>1</sup>See the Review's website: [www.hm-treasury.gov.uk/graham](http://www.hm-treasury.gov.uk/graham)

<sup>2</sup>The Graham Review of the Small Firms Loan Guarantee: An Interim Report, June 2004. Available on the Review's website at: [www.hm-treasury.gov.uk/media/3AE1F/ACF148B.pdf](http://www.hm-treasury.gov.uk/media/3AE1F/ACF148B.pdf)

<sup>3</sup>Bridging the Finance Gap: a consultation on improving access to growth capital for small businesses. HM Treasury and Small Business Service, April 2003, Chapter One.

international standards<sup>4</sup> and it is clear that, if the UK is to close the productivity gap with its major competitors, then it is important that levels of enterprise are increased and barriers to business growth removed.

**Access to finance** **1.6** Efficient access to finance is an essential ingredient if firms are to achieve their growth objectives. As discussed in the Review's Interim Report, the majority of businesses in the UK have few problems in accessing the finance they need. Similarly, the Bank of England recently concluded that access to finance is not a barrier to most SMEs, but that there are some specific challenges facing certain types of businesses<sup>5</sup>. However, it is widely believed that a small but important minority of small businesses may be the victims of structural market failures giving rise to 'finance gaps'.

### Addressing finance gaps: SFLG and other interventions

**1.7** Firms seek finance in various forms. Although a recent study found that only 40% of SMES have sought external finance in the past two years<sup>6</sup>, external sources of finance are particularly important for start-ups and small businesses that often lack retained profits to re-invest to support their own growth. Those firms that seek external finance will choose between a spectrum of options, covering debt, equity and mezzanine-type finance. There is no single answer to the type of finance required: businesses at different stages will require different types of finance, and will often seek a package of support that contains a range of financing solutions.

**1.8** The Government has, for many years, sought to address gaps that arise in both the debt and equity markets. The measures are designed to harness rather than stifle market forces, to target those businesses that will benefit most (i.e. where additionality is greatest) and to direct support towards those business propositions with real prospects of ongoing success. Importantly, SFLG is just one of a range of measures designed to tackle the difficulties some SMEs face in raising external finance. Existing Government schemes include the Enterprise Investment Scheme (EIS), which encourages private investors to invest in small companies by providing tax reliefs in respect of direct equity holdings in small companies, and the Early Growth Funding Programme (EGF), which operates at the same funding level as SFLG and can be used to support high interest rate debt products. Facilitating smaller investments around the lower end of the equity gap are the Regional Venture Capital Funds (RVCFs), which provide finance in the range of £100,000 - £500,000, Venture Capital Trusts (VCTs) and the forthcoming Enterprise Capital Funds (ECFs).

### Intervening in the debt market: SFLG

**1.9** The economic rationale for an intervention such as SFLG has been set out at length elsewhere<sup>7</sup>. In short, it has long been argued that collateral may be used as a sorting device: 'Good' borrowers may be more prepared to put their own or their business' assets at risk, because they perceive the probability of failure to be low. However, this assumes that all borrowers have access to collateral in order to make a choice whether or not to use it to demonstrate the riskiness of their proposition. This is

4 *Global Entrepreneurship Monitor Executive Report, 2002*, Reynolds, Autio, Cox & Hay, Babson College/London Business School/Ewing Marion Kauffman Foundation.

5 Bank of England (June 2004) *Finance for Small Firms – An Eleventh Report*.

6 Cosh A. and Hughes A. (2003) *Enterprise Challenged: Policy and performance in the British SME sector 1999-2002*. ESRC Centre for Business Research.

7 For a summary, see *Chapter Two, The Graham Review of the Small Firms Loan Guarantee: An Interim Report*, June 2004.

unlikely to be the case, and, where collateral is required, a proportion of good, low risk borrowers may be denied access to credit.

**1.10** SFLG seeks to address this market failure by providing a government guarantee in cases where a business is unable to secure a loan solely because of a lack of collateral. It should therefore be used only where the lender would provide a loan anyway were it not for the lack of collateral, i.e. for debt appropriate businesses. SFLG is therefore additional to, rather than in competition with, commercial lending.

**1.11** Nearly 6,000 loans, worth over £400million, were made under SFLG in 2003/04, demonstrating the value of the existing banking network as a route to market for the scheme. This partnership, between government and the lending institutions, is a unique strength of the SFLG programme.

**Cost of SFLG** **1.12** It is important to note that – contrary to the understanding of some commentators – SFLG is not a programme that covers its own costs. The 5,966 loans in 2003/04 had a value of £409million, at an estimated future cost to the taxpayer, net of receipts, of around £60million<sup>8</sup>. Costs are driven in large part by the default rates on the portfolio. As set out in the Interim Report, default rates on SFLG loans averaged between 30% and 35%, which in the recent past has translated into a bad debt rate (cash losses taking into account capital repayments before default and security recovered post default) of around 20%. This is significantly higher than for mainstream SME lending.

### The role of SFLG in today's debt market

**1.13** The Review's Interim Report set out that developments in credit assessment techniques have reduced banks' recourse to collateral for smaller loans to established businesses. It found that start-ups, with no track record or proven income stream, are still required to provide a cash commitment and/or some form of collateral or personal guarantee.

**1.14** The Report also argued that established businesses borrowing above £25,000 are still required to provide security in the majority of cases, although, as credit scoring techniques become more sophisticated and more consistently used, it suggested that security will become more important in influencing price rather than access. In addition, the Report argued that scoring techniques, though beneficial for the majority of borrowers, favour those with a proven track record and good credit history.

**1.15** As a result of these two factors, the Report concluded that some start-up businesses, businesses with non-standard characteristics and those businesses seeking to expand beyond their current asset base continue to find it more difficult than the majority of businesses to access debt finance. The latest statistics - an increase in usage of 52% in one year, and 55% of SFLG being used by businesses under two years old - demonstrate continued demand for a programme fulfilling the role of SFLG.

**Collateral remains key to eligibility** **1.16** A lack of collateral therefore remains an important barrier to SMEs seeking debt finance and so the central condition of SFLG – the absence of sufficient collateral – should remain at the core of SFLG eligibility.

<sup>8</sup> Precise costs depend upon future repayments and defaults: this figure is a forecast only.

**Recommendation 1**

The fundamental criterion for the use of SFLG should remain a lack of sufficient collateral to secure a loan for an otherwise viable business proposition.

**International comparisons**

**1.17** In this context, it is interesting to compare SFLG to other, international, loan guarantee programmes. SFLG is unique in tackling the specific problem of lack of collateral. Other programmes the Review examined fulfilled much broader functions. For example, the US Small Business Administration's loan guarantee programs aim to provide credit not available elsewhere and therefore to fill multiple gaps: high risk lending, start-ups, lack of track record, length of term as well as collateral shortfall. Across Europe, loan guarantee programs are often part of mainstream SME lending. For example, French state-financed guarantees account for over 65% of start-up financing and over 20% of bank loans granted to SMEs<sup>9</sup>.

**1.18** It is therefore difficult to make direct comparisons with international programs given SFLG's unique focus. However, valuable lessons can be learnt from the design and operation of other programs, and the experiences offered by these programmes have informed a number of the Review's recommendations for improvements to SFLG.

**When should SFLG be used?****Debt appropriate businesses**

**1.19** SFLG is not a soft loan and therefore should continue to be used only to assist *debt appropriate* businesses: i.e. a business that has a viable business plan that will enable it to service interest payments and capital repayments. The Review does not seek to define what type of business is debt appropriate, not least since many firms would benefit from a mix of debt, equity and mezzanine finance. The decision to lend should be taken by those individuals within the lending institutions with the necessary expertise: if the lender considers debt finance appropriate, then SFLG can be used.

**1.20** Likewise, SFLG is appropriate for viable business proposals only: SFLG does not make a bad prospect good, and should not be used on poor lending propositions. However, that is not to argue that SFLG cannot be used for projects that have a higher risk profile than normal. There is no reason that SFLG should not be used for debt products with high risk / high reward characteristics: again, the central condition is that, if the lender considers debt finance appropriate for such a business, then SFLG can be used.

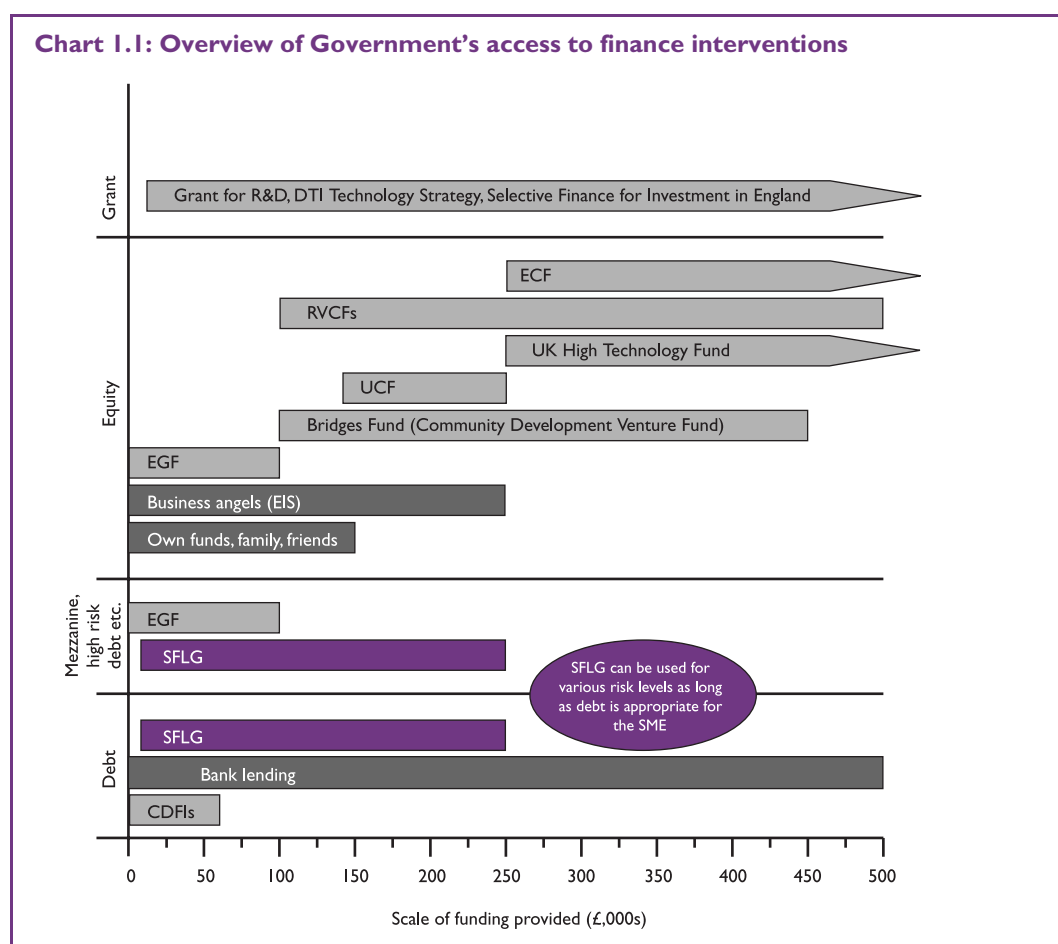
**1.21** The Review also notes that SFLG is designed to share risk between the government and the lenders. Although the Review does not believe that misuse of SFLG is common, respondents have quoted several examples where individual lending managers have sought to offload risk, including a requirement on the SME to insure itself against their lender's losses in the event of default, effectively making SFLG risk-free for the manager. The Review believes that such practices are contrary to the spirit of the programme.

**SFLG and the Government's equity interventions**

**1.22** Figure 1.1 provides an overview of the Government's interventions, which illustrates how each is designed to tackle a specific part of the funding gap. SFLG

<sup>9</sup> Annex A sets out the key aspects of the international programmes that the Review has studied in depth.

guarantees loans up to £100,000, or up to £250,000 if the business has been trading for two years or more and as can be seen there are also a series of interventions at the same funding level, principally in the equity market. SFLG, as a debt instrument, is designed to be used only for debt appropriate businesses (in practice those able to service interest payments and capital repayments) and therefore operates in different financing circumstances to the equity-based interventions. However, the Review believes that judgements about the effectiveness of SFLG should not assess the scheme in isolation, but as a complement to these government, and other private sector, financing solutions.



**1.23** Although banks supply the majority of external finance obtained by SMEs, debt-based finance may not be suitable in all circumstances. In particular, equity finance may be more appropriate for projects with a higher risk-return profile, or where positive returns are expected to accrue only after a number of years. In addition, debt and equity finance are often used alongside one another as part of the same financing package. Start-ups and growth businesses with a high risk-return profile are likely to require different mixtures of debt and equity at different stages of their lifetime. Consequently SFLG can be, and is, used in conjunction with other government schemes as part of an overall financing package.

**1.24** The Review does not believe that there is significant overlap with other interventions, since SFLG is the major intervention designed to assist in the debt market. Where SFLG is used alongside equity interventions, the Review considers that this a useful synergy that works with the reality of financing packages, rather than evidence of overlap or duplication.

## Conclusion

**1.25** Lenders, business advisors and SME representatives have welcomed the conclusion that SFLG retains an important role in SME financing, despite the changing nature of the debt market. In light of this, and the Review's terms of reference, the task for this Review is to ensure that SFLG is targeted on those SMEs facing the most barriers to accessing debt finance, and to make recommendations regarding the rules and structure of SFLG and their appropriateness to the scheme's effective operation.

**1.26** Chapter 2 sets out the objectives of the Review's recommendations. In doing so, the Review places SFLG within the Government's productivity priorities, highlights the importance of reaching as many of the firms facing relevant financing difficulties as possible, and responds to the many comments raised by respondents to the Review's initial call for submissions.

# 2

## OBJECTIVES

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### AIMS OF THE REVIEW

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**2.1** As set out in Chapter 1, SFLG continues to play a valuable role in assisting SMEs' access to finance. It is a popular and well-used scheme, and there remains a clear rationale for intervention in the market. However, a series of major changes are required to improve the operation of the scheme and to better target resources to those most in need. Chapters 3-7 set out the reasons why the Review believes that these changes are necessary in detail. In summary, there are a number of reasons why changes are desirable:

- In order to maximise the impact of the programme within finite resources, SFLG needs to be targeted onto those SMEs that would benefit most from the support and so where assistance would be most additional, and to be focused at those SMEs that will contribute most to UK productivity.
- In light of the changing debt market, small businesses have more financing options than ever before, and SFLG may no longer be required in circumstances where previously it had been valuable.
- Many SMEs were frustrated that the availability of SFLG varied both between and within lenders, and there is little doubt that steps need to be taken to ensure that all eligible SMEs, throughout the UK, can access the programme.
- Respondents to the call for submissions, and stakeholders consulted in meetings held throughout the UK, often cited frustrations with the complexity of the rules surrounding SFLG, and with the bureaucracy required to complete an application, and sought radical improvements to the operation and administration of the scheme.

**2.2** The Review therefore has five objectives that, if taken forward together, should lead to a fundamental step change to the operation and delivery of SFLG. The five objectives are to:

- maximise SFLG's impact on UK productivity;
- target SFLG onto those small firms which face the greatest difficulties in accessing finance;
- encourage a more consistent availability of SFLG so that more small firms that would benefit from SFLG can access the programme;
- ensure those firms can access a greater level of capital to support their needs;
- reduce the administration and bureaucracy of operating SFLG so that they do not limit the availability and popularity of the programme.

**2.3** This Report expands on these themes in detail. [Chapter 3](#) recommends measures to target SFLG at those SMEs that most contribute to UK productivity and that most need support, whilst expanding the amount of funding available and increasing the size of business eligible for the programme. The chapter also sets out how the Review proposes to incentivise wider availability of SFLG. [Chapter 4](#) looks at

the risk/reward balance within the programme, and in particular discusses the high level of defaults. [Chapters 5, 6 and 7](#) cover the administration and operation of SFLG, and propose a series of major reforms to reduce bureaucracy, radically streamline the loan agreement process, and to manage the government's contingent liabilities.

**2.4** The overall impact of the recommendations outlined in this Report will be to increase significantly the number and value of loans made to new and young businesses. In addition, although young businesses borrowing under SFLG have a higher propensity than more established businesses to default, the expectation is that the greater degree of monitoring by lenders of their SFLG portfolios should lead to downward pressure on default rates, thus freeing up more resources to reach more eligible SMEs. The overall impact of the recommendations is discussed in more detail in [Chapter 8](#).

### **Delivering these objectives: a step change in approach**

**2.5** The current structure and operation of SFLG provides for the scheme to be used in an unfocused way - as would be expected, as the scheme is demand-led and open-ended, and so there is no requirement or incentive to target usage at those most in need. The result is poor targeting; little understanding of impact; variable volumes and availability across networks; and real confusion about the objectives and purpose of SFLG. Whilst there is a degree of understanding about the overall volume and value of lending achieved under SFLG, there is patchy knowledge of the size and type of SMEs that benefit or of the circumstances in which SFLG is used. Very little is known about the cost of the scheme and the default rates seen on the portfolio. There is very little control of the volume or value of lending from year to year leading to significant annual fluctuations in usage. Finally, it is clear that the scheme's fundamental purpose is not well understood by many stakeholders.

#### **Understanding SFLG's impact**

**2.6** This unfocused approach to SFLG is a direct consequence of the scheme's current structure. Nevertheless, the Review has been surprised by how little is known or understood about the scheme's impact or purpose. SFLG needs to be targeted, consistently available across time and across lending networks, and well understood. Therefore, underlying the more tangible measures outlined in detail in this Report, the Review also seeks a change in how all partners view, utilise and oversee SFLG – the scheme would greatly benefit from a real increase in strategic oversight and a much enhanced level of active direction. The recommendations in this Report will help to achieve this, but it will be for the Small Business Service (SBS) and the lending institutions, working together, to make the decision to embrace such a change. The Review believes that the future success of the scheme depends on it.

**2.7** At a practical level, the proposals will result in a much higher level of autonomy for lenders, allowing them to develop a greater degree of ownership and strategic oversight than previously seen with SFLG. Likewise, the SBS, whilst continuing to provide strategic vision for SFLG, will need to match the lenders' commercial expertise in order to move towards a partnership based on trust and shared goals.

**2.8** This more intangible shift in the approach to SFLG from all partners is fundamental to achieving these objectives. The requirement for proper strategic oversight of SFLG is crucial to the programme's future value: the second half of [Chapter 8](#) sets out the changes in approach that the Review believes will be necessary for both the lenders and the SBS to adopt in order for the recommendations to be successful.

**Recommendation 2**

The Small Business Service and the SFLG lenders should undertake a step change in how they view, utilise and oversee the scheme, in order to support a significant increase in the strategic oversight, and proactive management, of SFLG.



# 3

## TARGETING SFLG AND IMPROVING AVAILABILITY

### ACCESS TO FINANCE AND AGE OF BUSINESS

#### Established SMEs

**3.1** The Graham Review Interim Report concurred with other assessments of the SME market that access to finance did not appear to be a significant barrier facing most established businesses in the UK<sup>1</sup>. A combination of better economic conditions, improved risk management techniques and an increase in the number of different financial products available to SMEs has led to a real improvement in the financing environment during the 1990s.

**3.2** Surveys of established businesses Report low rates of rejection and provide little evidence of difficulties in accessing finance. This is likely to be due to a combination of factors. A business that has been trading for a number of years has the chance to build up a relationship with their bank and establish a track record of performance, which can be used in automated scoring programmes. Established businesses are better able to finance themselves from retained profits than new firms and may have succeeded in developing an asset base that can be used as collateral to secure finance. In addition, as discussed in the Interim Report, the range of possible finance sources available to established business, such as venture capital, factoring and invoice discounting, has increased over the lifetime of SFLG. For these reasons therefore the Review believes that assistance targeted at young businesses is likely to be more market-additional than assistance targeted at established businesses.

#### Particular problems faced by start-ups and early stage firms

**Start-ups** **3.3** However, while surveys of established businesses Report low rates of rejection and dissatisfaction, those of start-ups and early stage businesses indicate that these groups face greater barriers in accessing finance, both in reality and in perception<sup>2</sup>. Problems can be encountered at different stages by different types of business. At start-up, for example, lenders find it more difficult to assess the viability of a loan application because of the lack of a trading record. As little as six months', and certainly a year's, trading record can be enough for a lender to make a statistical analysis of a business' probability of default. Where this is not available, however, the ability to signal good intent by providing collateral in the form of a cash injection or security can become very important. Where both track record and security are lacking, a new entrepreneur may struggle to raise business finance.

**Early growth** **3.4** Barriers may also be encountered after start-up. In some cases an entrepreneur may have enough security or personal resources to finance the initial start-up costs, but then find that he or she has nothing against which to secure a loan at the point at which he or she wants to take the business to its next stage of development. This second stage of financing is important in the growth of a business.

<sup>1</sup> See, for example, Bank of England (April 2004) *Finance for Small Firms – an Eleventh Report*

<sup>2</sup> For example, research commissioned by the Small Business Service found that finance remained the most frequently cited barrier to start-up among those thinking of setting up in business. IFF Research Ltd (2002) *Household Study of Entrepreneurship: Follow-up Survey*

**3.5** Data on the use of SFLG reflect the fact that start-ups and young businesses find it proportionately more difficult to raise finance than established businesses. In 2003/4 the majority (55%) of SFLG loans were made to businesses less than 2 years old, and loans to start-ups represented 32% of all SFLG loans made. Since start-ups are estimated to comprise about 10% of the total business stock<sup>3</sup>, these data show that they are disproportionately represented in the population of SFLG borrowers.

**3.6** Start-ups and young businesses are likely, in aggregate, to represent a higher risk to lenders, not only because of the difficulty of identifying a viable proposition at an early stage, but also because of the fact that around half of all business start-ups are no longer operating three years later. While closure does not always imply failure or default on debt, the Bank of England cite unpublished data from National Business Debtline which suggests that three years is a key stage in which many businesses experience difficulties. Similarly, the SFLG statistics show that start-ups and businesses under two years old are more likely to default on an SFLG loan than established businesses. This aggregate high probability of default puts additional responsibility on the individual businesses to demonstrate the viability of their proposal to a lender.

### Young businesses and the economy

**3.7** As discussed in Chapter 1 above, the Government has an interest in supporting businesses because of their contribution to the productivity of the UK economy. In particular, new and small businesses contribute to productivity growth in a number of ways:

- The formation of new entrepreneurial firms contributes to a beneficial process of ‘productive churn’ by which more efficient, growing businesses increase their market share at the expense of less productive firms.
- New firms also have a positive effect on labour productivity growth; evidence shows that new firms typically enter the market with a more efficient capital-labour mix than incumbents<sup>4</sup>.
- The competitive threat posed by SMEs is also an important driver of productivity growth within larger firms<sup>5</sup>. In attempting to increase market share, firms of all sizes provide a continual incentive for competitors to invest, innovate and to seek greater efficiency. In attempting to enter a market, new firms with significant growth ambitions are particularly likely to provide a stimulus to productivity growth amongst rival firms.
- Entrepreneurial SMEs are an important source of new product and process innovations, experimenting with new ideas and putting them in to practice. Whilst larger firms have an advantage in their ability to finance and diversify research and development activities, studies have found that large firms are not significantly more active in innovation than smaller firms<sup>6</sup>. Younger and smaller firms are less likely to resist change, allowing easier implementation of new ideas.

<sup>3</sup> p 21 Graham Review Interim Report

<sup>4</sup> Scarpetta, S., Hemmings, P., Tressel, T. & Woo, J. (2002): *The role of policy and institutions for productivity and firm dynamics: evidence from micro and industry data*, OECD Working Paper 329.

<sup>5</sup> Disney, R., Haskel, J. & Heden, Y. (2000) *Restructuring and productivity growth in UK manufacturing*, Centre for Economic Policy Research discussion paper 2463

<sup>6</sup> OECD (2002) *Competition, innovation and productivity growth: a review of theory and evidence*, Economics Department Working Paper 317.

## FOCUSING SFLG ON YOUNG BUSINESSES

**3.8** In summary the Review believes that start-ups and young businesses have, in aggregate, more difficulties accessing finance than established businesses, and fewer alternatives to traditional overdraft or term loan finance. In addition new and entrepreneurial firms have an important impact on UK productivity. For these reasons, the Review recommends that SFLG be targeted at start-ups and early stage businesses, in order to contribute to the Government’s enterprise and productivity agenda and to focus SFLG on those businesses that most benefit from government assistance. The evidence shows that many businesses cease trading within the first few years of trading, which indicates that this is a vital period in which businesses seek to establish themselves, and in which they are likely to have the most difficulty in accessing finance because of a lack of collateral and track record.

### Recommendation 3

In order to maximise the scheme’s additionality and its impact on UK productivity, eligibility for SFLG should be limited to start-ups and early stage businesses.

## Defining the maximum age limit

**3.9** In order to implement this focus on new and early stage businesses, a maximum age limit needs to be adopted, with a clear definition so that lenders and borrowers can have certainty over which firms are eligible. The Review’s objective is to target SFLG on those borrowers that are most likely to lack both the collateral and the track record to obtain finance in the market. To this end the intention was to set a definition of three years from the time at which a business starts to receive income from sales. However, it has proved very difficult to find a workable definition of the date of first sales that would be easily verifiable by the business and the bank.

### Commencement of trading

**3.10** The Review believes an alternative would be to link the SFLG definition to the date agreed between the business and the Inland Revenue as the “commencement of trading”. However the Review was concerned that this notification would often take place a considerable period of time before the business started to receive income from sales and might therefore disadvantage businesses with longer set up periods, caused by inactivity following incorporation or extensive R&D activity (the exact length of this period will vary from business to business, but may be significantly more than a year in some circumstances). In addition, the Review felt that identifying a specific date of commencement might be difficult, particularly several years following the event. Therefore, in order to make sure that the definition both captures the start-up and first growth phases and also does not disadvantage firms with longer set up periods, the Review recommends that: the commencement of trading definition is used, but that businesses should be eligible for SFLG from commencement of trading in the first year of assessment (or accounting period in the case of companies), **and for the next four years of tax assessment (or accounting periods in the case of companies)**. For example, if they started trading on August 1<sup>st</sup> 2000 they would be eligible for SFLG until April 5<sup>th</sup> 2005. It should be noted that the intention of this definition is to impose a maximum age limit, not a minimum age limit.

### Self-certification

**3.11** The Review proposes that the borrower should self-certify that it is not over the age limit for SFLG. This will be checked in the audit process and only if it were found that clear evidence had been in the immediate possession of the lender through the

normal banking relationship that showed the business did not meet the eligibility criteria, would the guarantee be reconsidered.

#### Recommendation 4

There should be no prescribed start date for SFLG eligibility, subject to the business being debt appropriate. Businesses should be eligible for SFLG no later than four years of tax assessment/accounting periods following the first year of assessment/ first accounting period.

## Growth businesses

### Profile of SFLG borrowers

**3.12** As discussed in Chapter 1, it is growth businesses that make the most positive contribution to UK productivity. Government, lenders and other investors all have an interest in supporting successful, high growth ventures. Although SFLG has never been explicitly targeted at high growth businesses and is valued by the market as a means of helping a broad range of businesses to develop, a recent survey of SFLG borrowers suggested that SFLG is reaching growth-orientated firms<sup>7</sup>. A survey of 200 successful SFLG borrowers (i.e. excluding those that had defaulted on their loan) found that 76% of respondents had grown (moderately (45%) or substantially (31%)) in the five years prior to obtaining an SFLG loan. Furthermore, 83% of borrowers had increased their turnover since obtaining an SFLG loan; of which 19% of businesses had increased by over 50%. 72% of those interviewed had met or exceeded their 12-month turnover forecasts and the median benefit to the bottom line profit was an increase of £75,000. The evidence from this survey, therefore, suggests both that SFLG reaches growth firms, and that firms grow as a result of receiving an SFLG loan.

### Growth and young businesses

**3.13** Furthermore, the evidence suggests that the proposed focus on start-ups and early stage businesses will in itself mean that SFLG is directed towards a set of businesses that are planning to grow. Another recent study has found that younger firms grow faster than older ones and that, in the sample surveyed, 81% of the firms that grew quickly and sustained this growth were start-ups<sup>8</sup>. Several other recent studies provide evidence that start-up and young firms are more likely to have growth potential than more established firms<sup>9</sup>. A recent survey by the Small Business Service found that younger businesses were much more likely to anticipate growth<sup>10</sup>.

**3.14** The Review is therefore not proposing that growth businesses should be an explicit criterion for SFLG eligibility. However, the Review recognises that government has an interest in using its limited resources to the best effect for UK productivity. The Review proposes, therefore, that innovative uses of SFLG by lenders to target high growth businesses should be incentivised. It is proposed that this should be achieved by reserving a proportion of the total SFLG funding pot for allocation to lenders that demonstrate that they have a strategy to reach high growth businesses. Chapter 7 will go into this in more detail.

<sup>7</sup> Synovate (2004) DTI Business Support Cross Product Monitoring Survey SFLG

<sup>8</sup> Bullock, A., Cosh, A., Fu, X. Hughes, A. and Yang, G. (2004) *Centre for Business Research*, Cambridge University.

<sup>9</sup> Including Federation of Small Businesses, Biennial Membership Survey, 2004; Omnibus Survey of Small Businesses in Scotland 2002. Scottish Executive Social Research 2003

<sup>10</sup> Atkinson, J. & Hurstfield, J. Small Business Service: Annual Survey of Small Businesses (2003) Institute for Employment Studies.

**Recommendation 5**

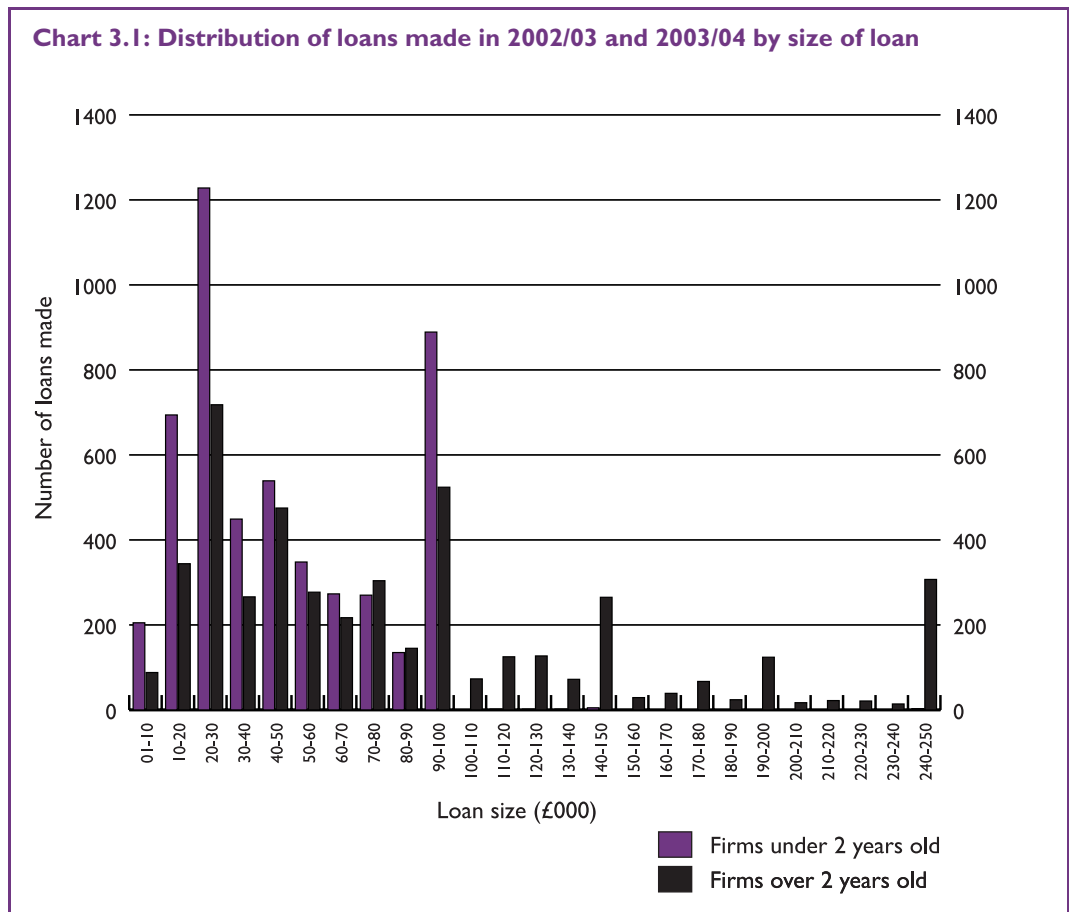
Innovative uses of SFLG by lenders to target high growth businesses should be incentivised through the allocation of specific funding separate to the main SFLG pot.

**Size of loan**

**3.15** The average loan size for SFLG has been increasing. In 2003/04 the average loan across the whole scheme was £69,000, varying between around £50,000 for businesses under two years old, and £90,000 for those over two years old. The increase in the average loan size has been driven by an increase in the number of loans made with a value of above £100,000, combined with a decrease in the number of loans under £30,000. The Review has considered whether SFLG borrowers are in any way constrained by the various limits on the amount they are able to borrow.

**Maximum lending to an SME**

**3.16** The Review considered whether the current maximum lending limit was acting as a limiting factor on potential borrowers. The data for 2003 show that there are distinct peaks in the use of SFLG at three key points (see chart 3.1 below).



**3.17** First, there appears to be a peak at £30,000. This is the maximum size of loan that a lender can make without getting prior approval from the SBS. There is, therefore, an incentive for lenders to restrict loans to £30,000 or below. Anecdotally the Review has heard of situations in which a bank has initially limited the amount of money a business

can borrow to £30,000, and has subsequently made a second loan of a further £30,000, both of which can be made under the Small Loan Agreement. While this does not represent misuse of SFLG it means that the financing decision is being driven by factors other than the consideration of the amount of finance required by the business at any one time. The Review's proposal, to allow banks the same degree of autonomy to make all SFLG loans as they currently enjoy for loans under £30,000, should remove this potentially distorting incentive and remove the unnecessary bureaucracy of completing two small loans where one large loan was more appropriate.

**3.18** Second, there are a large number of loans of exactly £100,000. This is the maximum amount allowed for borrowers less than two years old. While it is to be expected that there might be a tendency to move towards the maximum allowed, the size of the peak at £100,000 indicates that this might be acting as a constraint on firms under 2 years old. Interestingly, some of the peak can be attributed to established businesses that are eligible for loans up to £250,000. This could be the result of established businesses constructing packages of finance of which an SFLG loan contributes the first tranche, or it could be that individual bank managers set self-imposed limits on the amount they feel comfortable in lending under SFLG.

**3.19** Third, as might be expected, there is also a slight peak at £250,000, the maximum amount available to established businesses.

**3.20** Most responses to the Review did not advocate a rise in the total maximum lending per SME of £250,000, but some were concerned that the £100,000 limit on younger SMEs was restricting businesses operating in sectors with high start-up costs. The limit of £100,000 has been in place since 1989. Accounting for inflation alone, £100,000 in 1989 would have been worth £158,000 in 2003. In addition some respondents argued that in certain sectors start-up costs have risen over and above inflation in recent years, because of increased competition and cost of new product development.

### Standardising the maximum loan amount

**3.21** As a result of the evidence presented above, the Review recommends that the maximum lending limit be raised to £250,000 for all eligible businesses. This represents a significant expansion of the amount of money available to those businesses that find it most difficult to raise finance in the market and simplifies the rules surrounding availability of funding. It should provide the opportunity for viable businesses to obtain the investment they need at a critical time in their development. However, this should not be seen as an encouragement to increase the size of SFLG loans across the board. The new maximum lending limit does not imply that all businesses are in some way entitled to an SFLG loan of £250,000. The Review stresses that the onus remains on the lender and the borrower to act responsibly to ensure the business is not taking on more debt than it is able to service.

#### Recommendation 6

Business of under two years old should no longer be limited to a maximum of £100,000 of SFLG: all eligible SMEs should be entitled to a maximum of £250,000.

## Fall in loans under £30,000

**3.22** The Interim Report discussed whether the fall in the number of smaller loans was a matter of concern. On balance it seems likely that the main drivers have been developments in the market, such as the increased use of credit and behavioural scoring and the greater availability of personal finance. It may well be that, while businesses seeking small amounts of finance at start-up are able to use their own personal resources, it is those seeking amounts above around £30,000 that most benefit from the additional assistance of the government guarantee.

**3.23** The Review believes that availability of SFLG for loans under £30,000 remains valuable, as borne out by the fact that loans under £30,000 represent over 20% of the total number of loans made in 2003. It is likely that smaller loans are particularly valuable among borrowers for whom alternative personal sources of finance are not available and in areas where property values have not increased as much as in other areas. In addition, although other sources of finance might be readily available to borrowers in the current, benign economic climate, in different conditions, for example following a fall in house prices, demand for loans under £30,000 may rise. In view of the proposal to focus SFLG on start-ups and early stage firms the Review believes it is important that small loans continue to be eligible under SFLG.

**3.24** For lenders, clearly the transaction costs of making small loans are high relative to the potential reward. Proposals to decrease the bureaucracy of SFLG, by building on the existing Small Loans Arrangement<sup>11</sup> and by further simplifying the rules are outlined in Chapter 5. Furthermore the Review recommends that the SBS keep under consideration the issue of whether a cap on the amount lenders can charge as an arrangement fee (currently 1%) remains appropriate (this is discussed in Chapter 4).

## AVAILABILITY AND ACCESSIBILITY OF SFLG

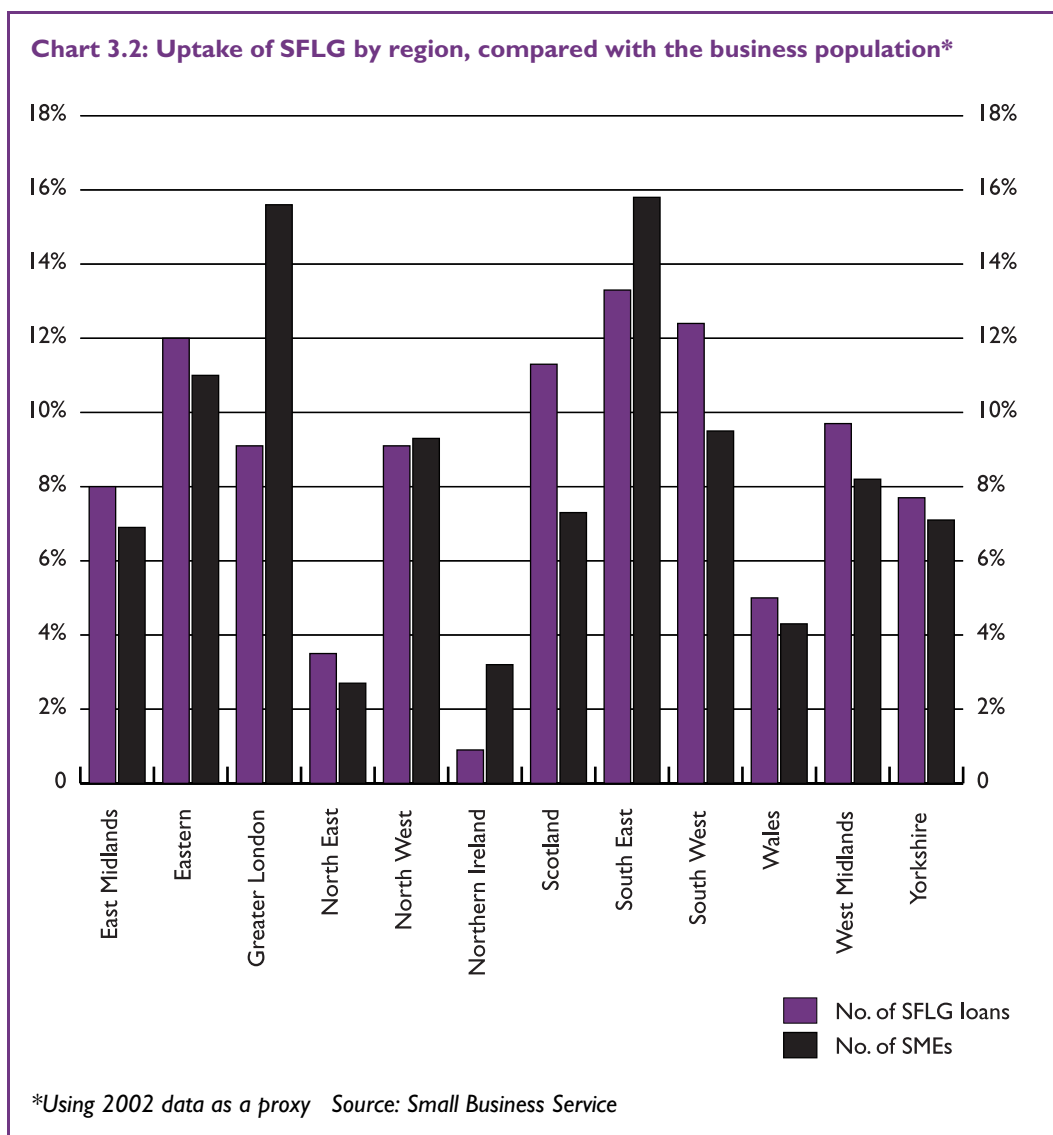
### Variance in the delivery of SFLG

**3.25** The proposals outlined above to focus SFLG on start-ups and early stage firms, and to extend the amount of money available to each eligible business to £250,000 should help to increase the amount of support available to those businesses that would benefit most from government intervention in the market. That provision, however, will only be effective if lenders are aware of SFLG and willing to use it as part of their portfolio of products.

#### Regional variation

**3.26** The Interim Report reported evidence, both from SFLG statistics and from responses to the consultation process, of variation in delivery of SFLG. This occurs at two levels. First, as Chart 3.2 shows, some areas of the country appear to have a much higher usage of SFLG relative to their small business population than others. Some reasons for this variation were put forward in the Interim Report, for example the variance in house prices and the role of other government interventions in driving demand.

<sup>11</sup> The Small Loans Arrangement enables lenders to make SFLG loans under £30,000 without prior agreement with the SBS.



**Variation between lenders** 3.27 Second, the delivery of SFLG also varies considerably at a local level. Respondents described instances in which the same application had been turned down by one bank and accepted by another, or, in some cases, accepted by a different branch of the same bank.

3.28 Such variation can cause frustration among borrowers, many of whom feel that a government backed programme should be delivered consistently, and should not depend on the agency delivering it. Some went so far as to suggest it should be delivered by other, non-bank agents, specialising in SFLG. On consideration, however, the Review believes that the wide distribution network of the main small business lenders remains a key strength of SFLG. In addition, the fact that the decision to make an SFLG loan is taken by finance experts as part of their normal credit assessment procedures should be in the interests of borrowers and government alike.

3.29 The Review accepts that different lenders will have different appetites for using SFLG. This can be for positive reasons: for example, the government should not look to intervene via SFLG if lenders have managed to find other ways of lending to businesses that lack collateral. In addition, a bank may choose to use SFLG in a particular way, and reduce or increase its use to certain types of applicant. In theory, this should lead to competition between banks to use SFLG to explore new markets and attract customers.

In this respect, the Review supports previous attempts by HM Treasury and SBS to increase the number of lenders that use SFLG, and extend it to other types of lenders such as investment houses and Community Development Finance Institutions.

## Improving the availability of SFLG

**3.30** However, the Review believes that improvements can and should be made where inconsistency in the availability of SFLG is due to lack of awareness of the scheme or an unwillingness among individual bank managers or other lenders to deal with what they perceive to be an unwieldy and bureaucratic programme. Better availability within lending institutions should be an integral part of being an SFLG lender and therefore a clear goal for all lenders. **The Review believes that both the SBS and lenders need to make proactive efforts to improve this situation and proposes the following steps:**

- Reducing the administrative burden

The Review recognises that SFLG has not kept pace with developments in banks' internal credit procedures. For example, the administration for SFLG is often still done using paper forms rather than electronically. Recommendations put forward in Chapter 5 concerning the administration of SFLG should go a long way to improving the efficiency in which SFLG is delivered. For example, giving banks the autonomy to make their own decisions about using SFLG without recourse to the SBS should significantly speed up the process of agreeing a loan, cited by lenders as one of the main barriers to its use. In addition, moving from a loan-by-loan paper based administration to the electronic delivery of aggregate data should help to reduce the bureaucracy currently faced by lenders.

- Incentivising lenders to ensure widespread availability

In return for proposed reduction in the administrative burden on lenders the Review would like to see lenders making more genuine efforts to ensure that all business managers are aware of SFLG, and able to offer it in appropriate circumstances. **Commitment to this aim should be an integral part of being an SFLG lender.** As a result, evidence on consistent availability of SFLG across each lenders' network will be a key input to the annual discussions between lenders and the SBS and might affect the amount allocated to lenders in future periods.

### Recommendation 7

Wider availability of SFLG throughout the branch network of the major lending institutions should be an integral part of being an SFLG lender and should be a clear goal for all lenders.

## Promoting SFLG

**3.31** Responses to the Bridging the Finance Gap and the Graham Review consultations suggested that more could be done to promote SFLG. Respondents proposed both that the SBS should publicise the scheme more widely amongst the SME and business advisor community; and that lenders should be required to do more to publicise the scheme within their own organisations.

**3.32** The two proposals reflect an ongoing debate about the promotion of SFLG. On the one hand, there is clearly an advantage in SFLG being well known and understood by borrowers, lenders and advisors, so that as many businesses as possible which would genuinely benefit from SFLG do so. On the other hand, it may be that SFLG is not always the best financing option for a business, and the scheme should not crowd out the normal commercial market but only act where the business lacks sufficient collateral for the deal to be done commercially. Lenders recount situations in which a borrower comes to the bank to ask for an SFLG loan when in fact the bank might be quite willing to lend to them under normal terms and conditions, which are likely to be cheaper than the government guaranteed loan. In addition, anecdotally, there has been a rise in the number of instances in which a borrower approaches a bank, perhaps with an advisor, having designed their business plan around the possibility of obtaining an SFLG loan, in some circumstances in order to protect their own personal assets.

**3.33** These situations are clearly unsatisfactory - it is important that SFLG is available only to businesses that genuinely do not have the collateral to support lending and the Review would be concerned if entrepreneurs that were able to secure loans through other means were structuring their proposals with the sole aim of obtaining SFLG. For these reasons, the Review believes that it is important that the decision for making an SFLG loan is taken by the lender on the basis of the viability of the business proposal and in the light of other financing options that might be available. Therefore the Review is not proposing a widespread publicity drive for SFLG aimed at borrowers and business advisors.

**3.34** However, despite these concerns the Review believes that SFLG benefits from the fact that it has been in existence for over twenty years and is well known, relative to other government interventions, and that clear, publicly available, guidance should be available for businesses considering SFLG. The Review also believes that SFLG would benefit from a higher profile throughout the lending institutions, as discussed in paragraph 3.30 above. As a result the Review proposes that:

- The SBS should ensure that the documentation available to lenders and borrowers clearly communicates the purpose of, and businesses' eligibility for, SFLG.
- The SBS should monitor the geographical distribution of SFLG use and, where there are variations usage, such as in the South East, Scotland and Northern Ireland, work with the lenders and local business support organisations to understand the causes of the variability, and - if justified - to take action to ensure SFLG is available to appropriate SMEs that are eligible for SFLG.

#### **Recommendation 8**

The SBS should improve the documentation that is available to lenders and borrowers to help clarify the purpose of SFLG and businesses' eligibility for SFLG.

## Encouraging new lenders

**3.35** The Review believes that new entrants to SFLG would broaden availability and promote its uptake, making the programme more accessible for the small business community. Encouragingly, many potential new lenders have also indicated that they would be interested in using SFLG in innovative and dynamic ways, which suggests that new entrants may help boost the scheme's impact. The recommendations in this Report are designed to provide a simple and easy entry route into SFLG for new lenders, by minimising bureaucracy and maximising the incentives on new entrants to bring an innovative and dynamic approach to the SFLG programme. Paragraph 7.27 sets out how new lenders will be able to join SFLG, through the availability of a funding stream for new lenders.

**3.36** The Small Business Service is keen to encourage access to SFLG from a wide lender base, and has announced that any existing lenders who wish to operate SFLG are now able to apply at any time to become an approved lender<sup>12</sup>.

## Specialist lenders

### Community Development Finance Institutions

**3.37** Government has stated it is keen to encourage applications to operate SFLG from community development finance institutions (CDFIs)<sup>13</sup> and other lenders serving disadvantaged groups<sup>14</sup>.

**3.38** The Graham Review supports this objective. Although, as discussed elsewhere, five institutions dominate the delivery of SFLG, the Review believes that it is extremely important that other lenders should be able to use SFLG in their own markets. Not only will this enhance competition, but it will also help SFLG reach beyond the customer base of the main high street banks.

**3.39** The Review believes that a number of the recommendations made here will make it easier for CDFIs and other smaller organisations to use SFLG. Most significantly, the autonomy given to accredited SFLG lenders to make SFLG-backed loans without prior recourse to the SBS will make SFLG a more attractive proposition to CDFIs that already face high transaction costs, because of the support and development assistance required by their borrowers. In addition, smaller lenders will not have to provide any additional monitoring data, beyond the information registered with the SBS after the loan is made.

**3.40** There are, however, some issues specific to the CDFI sector that might discourage use of SFLG. These were raised in the responses to HM Treasury's Bridging the Finance Gap consultation and to the Graham Review call for submissions. Most notably, state aids rules do not permit public guarantees (including SFLG) to be used in conjunction with the Community Investment Tax Relief (CITR), which rewards investors in CDFIs by providing them with tax relief of 5% per annum on the value of their investment. Government judges that to intervene both to reduce the risk to an investor (i.e. by providing a guarantee on the amount invested) and to enhance the reward the investor receives through the tax system represents a double subsidy.

<sup>12</sup> Further details about becoming an approved lender can be obtained by contacting the DTI's SFLG unit: [sflgs@sbs.gsi.gov.uk](mailto:sflgs@sbs.gsi.gov.uk)

<sup>13</sup> CDFIs are "sustainable, independent financial institutions that provide capital and support to enable individuals or organisations to develop and create wealth in disadvantaged communities or under-served markets." Community Development Finance Association website, [www.cdfa.org.uk](http://www.cdfa.org.uk)

<sup>14</sup> HM Treasury (April 2003) *Bridging the finance gap: a consultation on improving access to growth capital for small businesses*.

**3.41** Working within the existing state aids restrictions there is still scope for some CDFIs to become SFLG lenders. Larger CDFIs have greater capacity than small organisations to manage different pots of ring-fenced capital. For such institutions it might be possible to make use of both CITR and SFLG provided the CDFI has raised capital not covered by CITR, that can then be used on FLG guaranteed lending. In the long term, as CDFIs become more sustainable, and are better able to attract investment on the back of a strong credit record, this may become a more attractive option.

**Social  
enterprise  
lenders**

**3.42** Some lenders, including some CDFIs, specialise in lending to charities or to social enterprises, defined by the Government as “a business with primarily social objectives whose surpluses are principally reinvested for that purpose in the business or in the community, rather than being driven by the need to maximise profit for shareholders and owners”<sup>15</sup>.

**3.43** In addition to the issues discussed above surrounding use of funds raised under CITR, one specific barrier hinders the use of SFLG in lending to social enterprises. SFLG operates under powers set out in section 8 of the Industrial Development Act (1982). DTI guidance requires that the activities of businesses receiving assistance must be commercial and for a business to receive SFLG support more than 50% of its income must derive from commercial activity. Many social enterprises, particularly young organisations and those that have developed from voluntary sector organisations or form part of charities, do not meet this criterion and are therefore excluded from using SFLG, unless they locate their trading activity within a separate entity to their social or charitable activity. Given the difficulties in supply of finance to social enterprises, documented in the Bank of England’s recent report on this subject<sup>16</sup>, it would be helpful if SFLG, or a similar product, could be used to provide reassurance to lenders that are unfamiliar with this market, and increase the reach of those that are already specialist in this area.

**Asset  
financiers**

**3.44** The Review consulted with a range of finance providers, including asset financiers, through their trade body the Finance and Leasing Association. Asset finance allows firms to borrow money to buy a specific asset, using that asset as security. SFLG can be used by asset financiers for additional lending to cover costs associated with the introduction of a new asset, for example, to cover building alterations necessary when introducing the new asset.

**3.45** Currently there is one asset lender accredited to use SFLG. Responses to the Review suggest that the barriers to its use by other lenders concerned the time taken to make an SFLG loan compared to a normal loan and the bureaucratic burden of administering the programme. In addition, the risks faced by asset financiers concern the quality of the asset rather than the lack of an asset, which is the situation addressed by SFLG.

**3.46** The Review would like to encourage a range of lenders to use SFLG where appropriate, in order to reach as many businesses as possible that would otherwise be unable to raise finance in the market. It believes that the recommendations to devolve to lenders the ability to make loans without prior recourse to the SBS and the reduction in the complexity of the rules will make it easier for new and smaller lenders, including asset financiers, to use SFLG.

<sup>15</sup> DTI (2002) *Social Enterprise - a strategy for success*.

<sup>16</sup> Bank of England (2003) *The Financing of Social Enterprises*.

**Recommendation 9**

The Government should continue to encourage CDFIs, asset finance providers and other specialist lenders to use SFLG, working with them to address specific issues. SBS should explore whether there is scope to work within the IDA legislation to make it easier for lenders to use SFLG to lend to social enterprises.

**SUMMARY**

**3.47** The aim of the recommendations outlined in this chapter is threefold:

- First, to focus on the SMEs that will benefit most, which the evidence shows are start-ups and early stage businesses.
- Second, to make sure that eligible businesses are able to access enough finance to be adequately funded and ensure they have a good chance to develop and grow.
- Third, to ensure that SFLG is widely available to businesses across the country.



# 4

## RISK AND REWARD

### DEFAULT RATES, INTEREST RATES AND PREMIA

**4.1** Past evaluations of SFLG have concluded that it represents value for money in meeting government objectives of encouraging enterprise. The KPMG evaluation conducted in 1999 attributed to SFLG a positive net impact on employment of between 0.3 and 0.6 jobs per firm. In addition they found a positive impact on net sales and turnover. In a recent survey of 200 successful SFLG borrowers, conducted by Synovate on behalf of the DTI's Business Support Unit, 83% of respondents reported that the SFLG loan had had a positive impact on their turnover<sup>1</sup>. However, against these positive indicators of economic impact, it is important to bear in mind the cost of SFLG both to government and to the lenders. This chapter outlines the default rates on SFLG and the return required by lenders.

#### Default rates

**4.2** The Interim Report presented the key statistics concerning the risk of SFLG lending. To summarise, default rates – that is the proportion of loans by number that fail - on SFLG loans made between 1993 and 2000 averaged between 30 and 35%. This compares with typical default rates on normal SME lending by banks of around 4%. Loans made to start-ups and young businesses are more likely to default than those to established businesses and small loans are more likely to default than large loans.

**4.3** Responses to the Interim Report have expressed surprise at these default rates. Officials running other countries' government loan guarantee schemes also indicated that default rates on their guaranteed loans were much closer to that of normal SME lending than appeared to be the case in the UK. Clearly the proportion of loans that default has a direct impact on the cost of SFLG to government and lenders and, as a result, on the number of businesses that can be assisted through this programme, particularly if the total amount of money available for SFLG is capped in future (see Chapter 7).

#### Cost of delivering SFLG

**4.4** The cost of delivering SFLG depends on the bad debt rate, which is a function of the default rate but also takes into account capital repayments made before default and any recoveries after default. The bad debt rate is estimated to be around 20% on the portfolio as at 31 March 2004. Of this, only 25% falls on the lenders, as a result of the 75% sovereign guarantee. Once premiums and interest payments are taken into account, this bad debt rate represents a net cost to government (around £60m in 2003/04). KPMG, reviewing SFLG in 1999<sup>2</sup>, found that since 1993 the lenders had consistently made positive net revenues on their SFLG lending, mainly accounted for by proceeds from loans to established businesses.

**4.5** The guarantee of 75% is, of course, fundamental to the lenders' ability to support default rates of between 30 and 35%. The guarantee rate was standardised to this level in April 2003, following recommendations made by KPMG. Between 1993 and 2003 two guarantee rates were in operation: 70% for start-ups and businesses under 2 years old and 85% for established businesses. The original rationale for this split, to assist firms coming out of a recessionary period, was no longer thought to be relevant, and it

<sup>1</sup> Synovate (2004) DTI Business Support Cross Product Monitoring Survey SFLG

<sup>2</sup> KPMG (1999) An Evaluation of the Small Firms Loan Guarantee Scheme.

seemed counter intuitive to offer a lower guarantee rate for younger, and therefore riskier, firms. Although, historically, a change in the guarantee rate has impacted on take-up of SFLG, the standardisation of the guarantee rate does not appear to have dampened demand for use of SFLG by established businesses, which previously benefited from the higher rate. Any negative effect was offset by the increase in the number of eligible sectors to include, for example, retail and catering firms.

**4.6** KPMG's 1999 study stated that a 70% guarantee level was the minimum guarantee that lenders perceive as acceptable. Many of the stakeholders consulted by the Review have expressed similar views. As the average loan amounts rise, the 25% non-guaranteed portion of an SFLG loan will also rise, representing a greater risk for a lender that would normally look to have a higher level of collateral cover. The Review did consider reintroducing a menu of guarantee rates, rising according to the risk of the borrower. However, responses indicated that the simplicity of one guarantee rate applicable to all helped to make SFLG more easily understood by lenders and borrowers and hence increased its use. In addition, any rise in the guarantee rate would lead to increased costs to the government.

**Recommendation 10**

The current guarantee rate of 75% should not be changed.

**4.7** The guarantee rate of 75% allows lenders to support a higher level of risk than they would be prepared to take unsecured, but it does not in itself explain why a high proportion of SFLG loans default. As described above, loan guarantee programmes in other countries have similar guarantee rates, but much lower levels of defaults. The following section discusses the reasons behind default rates on SFLG loans.

**Factors driving default rates**

**4.8** The Review has concluded that there is no one single explanation for the high default rates; rather that they are the result of a number of factors, and particularly the following:

- A high proportion of loans (55% in 2003) are made to start-ups and early stage businesses that are likely also to lack a trading record. The viability of loan applications from this group is harder for lenders to judge than those from established businesses. This is undoubtedly part of the explanation for the high default rates; however, data provided to the Review, comparing a matched sample of SFLG and non-SFLG borrowers, suggested that allowing for age, size and sector actually explained only a small percentage of the difference in default rates.
- To qualify for SFLG a borrower must have no assets to offer as security. This may be an indication that the business has already borrowed up to the limit of its asset base and is as a result highly geared. At the worst extreme this could mean that the borrower is using SFLG as the last resort to keep the business afloat, when the chances of success are slim.
- SFLG loans are, in some cases, erroneously viewed as 'soft money'. It has been suggested that the fact that the borrower has no personal assets at risk leads to a situation of moral hazard, in which the borrower's incentives to avoid default are reduced. This theory is to some extent borne out by the evidence that SFLG loans to unincorporated businesses (sole traders and partnerships, i.e. where the owners have personal liability for business

debts) are 10-15 percentage points lower than those to limited companies, where the directors' assets are not at risk (chart 4.1).

- Because SFLG represents a small proportion of the market of term lending to SMEs (estimated at around 2%), the survival rate of SFLG loans as a portfolio is lost within the performance of a lenders' overall SME portfolio. The Review has found that some lenders have little knowledge of the performance of their own SFLG loan book, which would seem to give support to this view.

### Are high default rates acceptable?

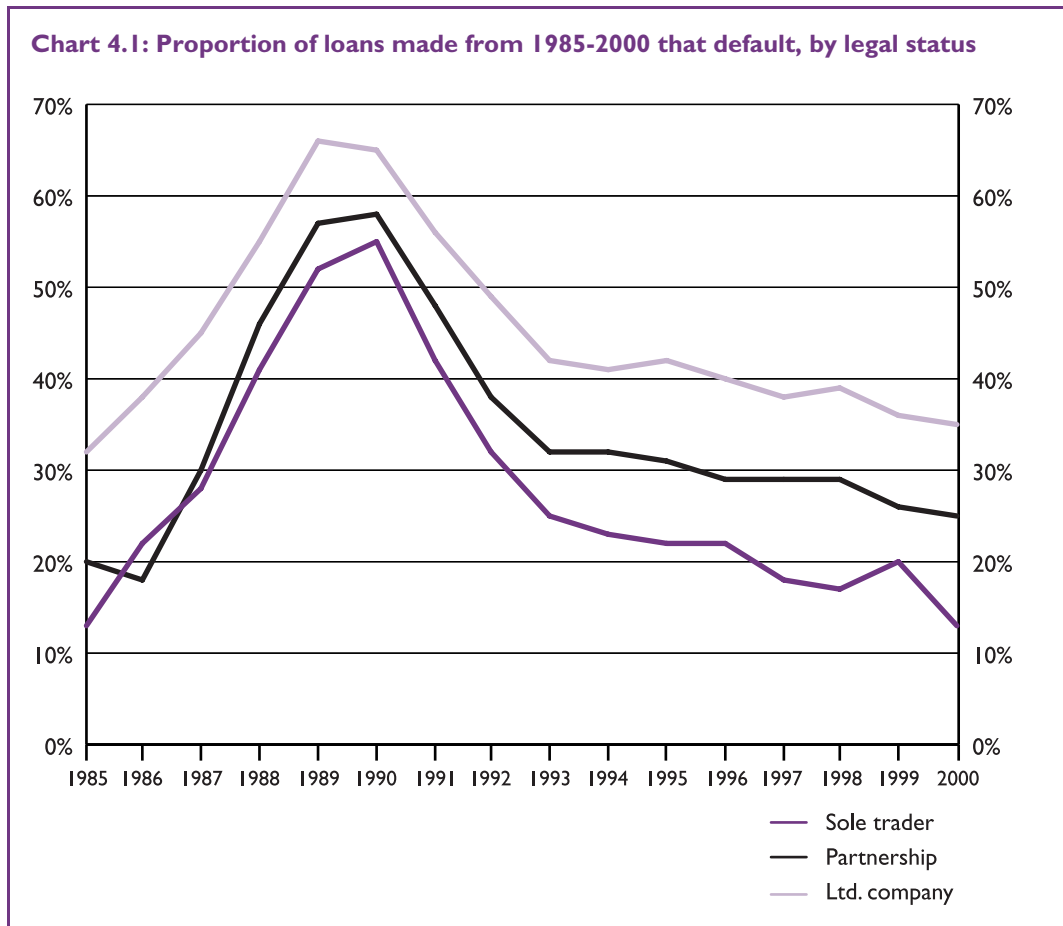
**4.9** The Review believes that high default rates should not be assumed to be undesirable in themselves. High default rates should, in part, reassure us that SFLG is being used to lend to businesses that the lenders would not otherwise consider. This emphasis on market additionality contrasts with the rationale behind some loan guarantee schemes in other countries and may explain the UK's higher default rates.

**4.10** For example, the US Small Business Administration's (SBA) loan guarantee programs aim not only to reach businesses that are unable otherwise to access finance, but also to improve the terms and conditions available to SMEs. As such, the SBA markets itself alongside commercial lenders as a 'lender of first resort'. In the UK, if the default rates were thought to be high because the businesses borrowing under SFLG were young, and lack a trading record, or because they had insufficient collateral to expand rapidly, it is likely that government would be willing to underwrite the risk of lending in order to support the broader enterprise agenda.

#### Personal Guarantees

**4.11** However, if default rates were thought to be high because of negative incentives created by the existence of the 75% guarantee, such as a lack of commitment by the borrower to repay the loan, or a lack of due diligence on the part of the lender to monitor and support the business, the government would have an interest in acting to lower default rates. Discussions with officials responsible for other countries' loan guarantee schemes revealed that the UK is unusual in not requiring some form of tangible commitment from the borrower and it was suggested that this could be a reason for the UK's higher default rates.

**4.12** With this in mind, the Review considered whether it would be appropriate for government to allow lenders to take a limited personal guarantee against an SFLG loan. In the case of a limited company, a personal guarantee would make the director personally liable for a proportion of the loan, should his or her business default. It was suggested to the Review that this would place an increased incentive on the borrower not to default on the loan. As described earlier in this chapter, default rates on loans to sole traders and partnerships that are not protected by limited status are lower than those on loans to limited companies.



**4.13** However, many in the small business community consider believe that the way in which a personal guarantee raises the stakes of default is detrimental to the entrepreneur's ability to manage the business effectively. In addition, as pointed out by several stakeholders, including the Federation of Small Businesses and the Confederation of British Industry, SFLG is designed to help those without personal assets to secure business finance, so to allow lenders to take a guarantee based on personal wealth would be counter to the objectives of the scheme. As a result the Review has decided not to recommend a change to the current rules, which do not allow lenders to take a personal guarantee on any part of an SFLG loan. However, it acknowledges the potential downward pressure on default rates that personal guarantees might generate, which in turn would increase the amount of funds available for other SFLG loans to be made. If, in the future, the level of defaults continues to give the SBS cause for concern, the Review recommends that the introduction of personal guarantees be considered.

**Future trends 4.14** The Review believes that default rates are higher than can be explained by the risk profile of the borrowers alone. It would be difficult, however, to define and target a 'correct' default rate. Some lenders maintain that improvements in risk management techniques applied to their whole SME portfolio, and specifically to their SFLG procedures, have reduced the probability of default on their SFLG loans since the end of the 1990s. It is too early to judge whether these changes have resulted in a reduction in default rates. The package of recommendations set out in this Report should, through the adoption of a portfolio approach to SFLG and the accompanying degree of increased oversight, encourage lenders and the SBS to monitor key indicators such as the default rates and analyse trends in the data, which might shed further light on the reasons behind default. The Review does not, therefore, recommend that lenders

should target a ‘correct’ default rate. However, as a greater degree of understanding and oversight develops, and as it becomes clear whether lenders have succeeded in lowering default rates since the 1990s, the Review recommends that default rates are kept under annual review to monitor the impact of the other proposed changes, and to ensure that they are appropriate to the overall goals of the scheme.

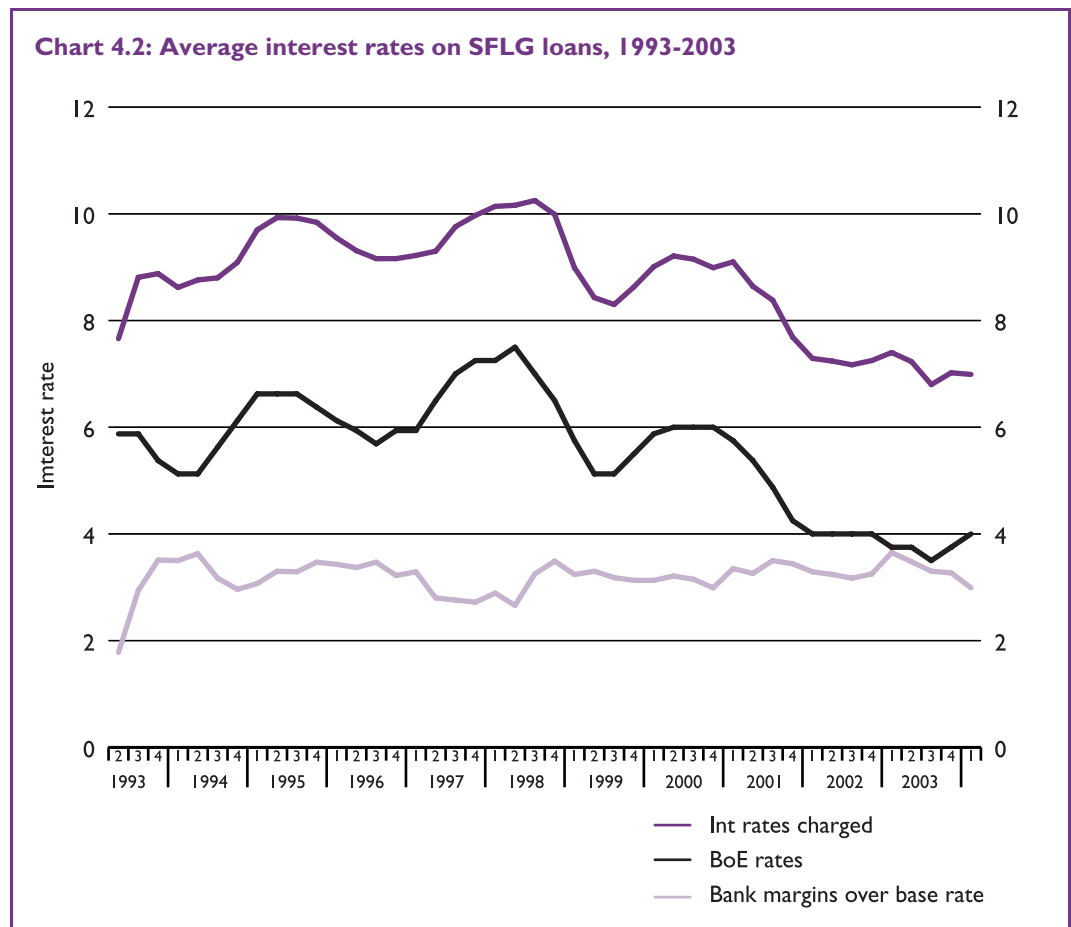
**Recommendation 11**

Default rates should be kept under annual review by the Small Business Service, to monitor the impact of the Review’s proposals and to ensure that default rates are appropriate to the overall goal of the scheme.

**Interest rates**

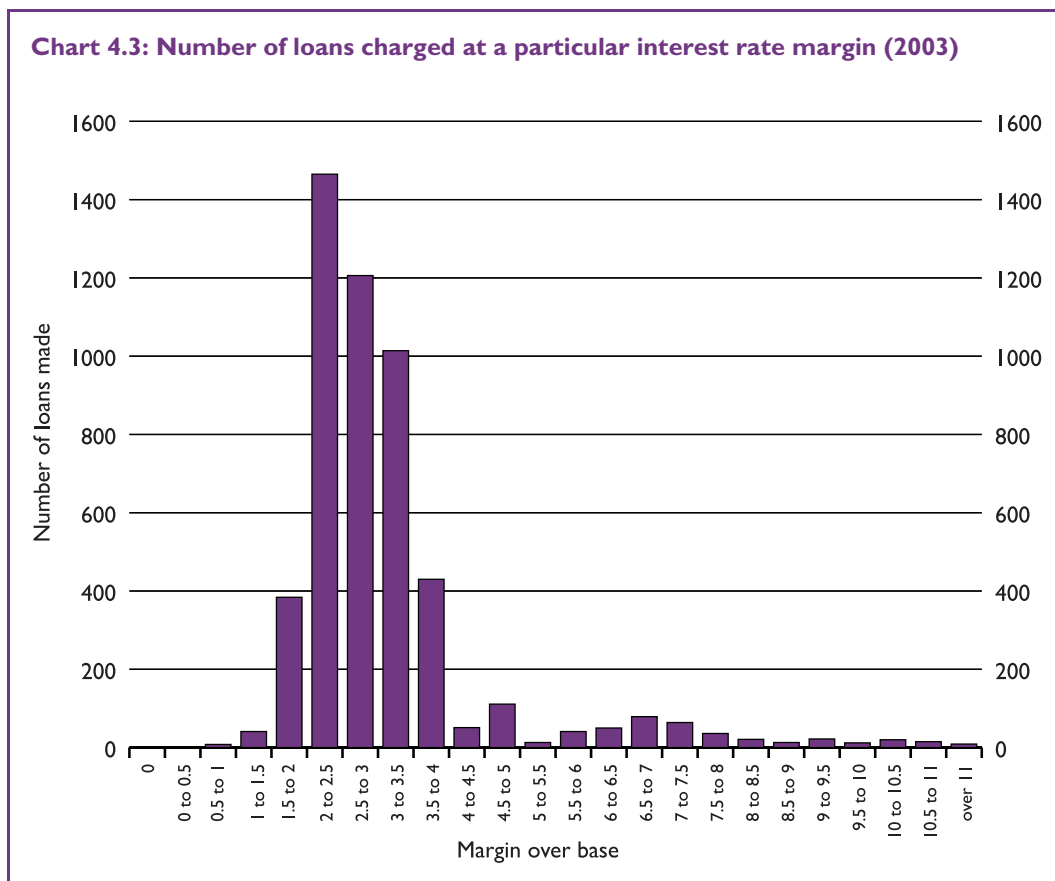
**4.15** This section considers whether SFLG lenders expect a high return in response to the higher risk of making SFLG loans.

**Historic trends 4.16** The data from the SBS database shows that the average interest rate on variable SFLG loans is approximately 350 basis points over base (Chart 4.2). This rate has stayed broadly within a 325-375 basis point band since 1993.



**4.17** As would be expected given the different risk profiles, interest rates on SFLG loans are lower on loans to established businesses than young businesses and on large loans than on small loans. Setting the interest rates for SFLG loans is the responsibility of the lender and over time lenders have charged broadly similar margins, with a

variance of up to 150 basis points that is likely to reflect the composition of each lenders' individual portfolio. The vast majority of SFLG loans are priced at a margin of under 400 points above base (see chart 4.3). As described in the Interim Report, the average SFLG interest rate of between 300-350 basis points above base would appear to be approximately 50 and 100 basis points higher than the interest rate charged on mainstream SME loans.



#### Risk versus reward

**4.18** The Review considered whether, in setting the price, lenders are taking full account of the risk associated with SFLG loans. Evidence provided to the Review suggests that lenders' bad debt rate - after the payment of the sovereign guarantee - of 5% on SFLG compares with around 1% on lenders' mainstream SME portfolio. It would appear, therefore, that lenders charge higher margins relative to risk on normal SME loans than on SFLG loans (normal lending sees a margin of around 250 points on a bad debt rate of 1%, whilst on SFLG the margin is 350 points on a bad debt rate of 5%). This could be for a number of reasons: first, lenders may be unwilling to be seen to lend at very high rates to the SME community, especially where the borrower also has to pay an additional premium of 200 points per annum to the SBS. Second, it might be that factors distinctive to SFLG that affect the likelihood of default, such as the moral hazard issue discussed above, are not taken into consideration at the time the loan is agreed, because lenders tend not to analyse the credit characteristics of the SFLG portfolio separately from their normal SME loans.

**4.19** SFLG as an intervention is not designed to subsidise lending to SMEs, because the market failure it is aiming to correct concerns access to finance rather than the cost of finance. In general the Review believes it is appropriate for the market to price according to risk and that there is no reason why SFLG should not be used for appropriately priced high risk lending, to businesses with an ability to service the debt,

providing that risk can be managed by the lender in line with its normal lending procedures.

**Basel II 4.20** Other analyses have concluded that the new Basel Accord on regulatory capital requirements for internationally active banks will not have a significant effect on either the availability or the price of debt finance to SMEs<sup>3</sup>. The risk weight accorded to government guarantees is 0%, where government commits to honour the guarantee in the case of all loans that default. This would not be the case if, for example, the government were to set a limit on the total amount that a bank could claim overall. In this scenario higher capital adequacy requirements might result in an increase in the interest charged to the borrower. However, there is no intention or expectation that any changes proposed in this report will alter the current capital requirements for SFLG loans.

### High risk lending and quasi equity

**4.21** Responses to the Review, combined with statistics on SFLG use, indicate that SFLG is sometimes used in situations where equity capital might also have been an appropriate choice of finance. This is not surprising given the high proportion of start-up businesses among SFLG borrowers, and the indications that many others borrow under SFLG in order to expand into new product areas.

**Debt and equity 4.22** The precise mixture of debt and equity financing appropriate for a business depends on a number of factors, many of which will be individual to that business. SFLG should not restrict this, and the Review does not propose a fixed rule for capitalization levels or minimum/maximum gearing ratios in order to discourage lending where, arguably, equity could also be used. SFLG is a debt product and is not designed to be used as the sole form of finance in situations where equity would be a more appropriate financing option for a business than debt, for example where a business has a long product development phase but is then anticipating high growth. The key requirement remains that SFLG should only be used where debt is appropriate for the SME but the SME lacks the collateral to secure a loan. Provided there is a viable business proposition that will be able to service the debt and to repay the capital, then SFLG can be considered.

**4.23** The Review has received evidence of SFLG being used in conjunction with other financial products, including government-backed equity products such as Regional Venture Capital Funds. The Review believes that SFLG can be and is used effectively alongside interventions such as the RVCs, and is often beneficial in encouraging RVCs and other equity investors to form part of a package of finance.

#### Recommendation 12

SFLG should continue to be used only in circumstances in which debt is the appropriate financing option for the borrower.

### Premium payments

**4.24** The premium paid by the borrower to the Government for the SFLG loans has changed several times since 1983, and currently stands at 2% of the outstanding loan

<sup>3</sup> See for example Bank of England (2004) *Finance for Small Firms – An Eleventh Report*

balance. Premiums received by HMG in the year 2003/04 were worth £11.1m. The original objective that the premium should cover the costs of loan defaults has never been achieved. The cost in 2003/4 of SFLG to government, net of receipts, was £60million.

**4.25** Some of the volatility in the take-up of SFLG over its lifetime has been associated with changes in cost of the premium to borrowers. In the 1980s the premium reached 5%, which is now interpreted as one of the reasons why the popularity of the scheme fell to an all time low, resulting in a total of only 543 loans made in 1986.

**4.26** The premium has two important functions. First it provides an important source of income to government, which helps to offset the cost of defaults. Second, imposing an additional cost on the borrower through the premium should ensure that only those businesses that cannot raise finance in the market under normal terms would choose to borrow under SFLG. It is important that SFLG does not crowd out lending that could be done without government intervention.

**4.27** As has been noted earlier in the chapter, SFLG was designed to respond to perceived market failure in SMEs' ability to access finance and is not set up to subsidise the cost of borrowing. In general price is not thought by most commentators to be an inhibiting factor for most SMEs, and that the 2% premium does not deter borrowers from using the scheme. However, some respondents to the Review have noted that at times of low inflation and interest rates, such as now, the premium represents a large proportion of the total cost of the SFLG loan. These respondents have suggested that the premium should move in line with movements in the base rate. However the Review considers that such a change would add to the bureaucracy of the programme, as the burden of this interest rate calculation would be borne by the lenders.

**4.28** Various other methods of charging the premium have been considered, including a balloon payment system whereby the payments in the early years of the loan are lower, when cash flows are more critical, but rise towards the end of the repayment period, by the which time the business is on a surer footing. However, again the Review has concluded that the benefits of maintaining a simple fixed rate, which is easy for borrowers to understand and for lenders to calculate and monitor, outweigh the benefits.

**4.29** The Review believes that it is important that the premium acts as a signal to maintain additionality and a contribution towards government costs, but also that it should not be so high or complex that it disincentivises take up of SFLG. The Review therefore recommends that the premium is maintained at 2% per annum on the outstanding value of the loan. However, it recommends that this is one of the parameters that SBS continue to keep under review.

**Recommendation 13**

The premium should be maintained at 2% per annum on the outstanding value of the loan.

## Loan arrangement fees

**4.30** In addition to the premium and the bank margin, the borrower must pay an arrangement fee. At present, this fee is limited to 1% of the loan balance. Some responses to the review argued that the fee cap meant that, particularly on the smaller loans, it was not possible for the lender to cover the fixed costs of making the loan. The

cap therefore acts as a potential disincentive to make small loans under SFLG. There are strong arguments for allowing the market to recoup the costs of making SFLG loans, just as lenders are free to set the interest rates for lending. However, raising the upfront cost of SFLG to businesses at start-up and early stage might be detrimental to the ability of that business to service the cost of borrowing and to develop and thrive. The Review has concluded therefore not to recommend an increase in the cap at this stage.



# 5

## MODERNISING THE OPERATION OF SFLG: THE PORTFOLIO APPROACH

### CURRENT OPERATION OF SFLG

**Case by case approach** 5.1 Since the programme's launch in 1981, the operation of SFLG has been based on a case-by-case, bottom-up procedure. First, the lending manager, in discussion with the small business, identifies the need for an SFLG-backed loan. Second, in larger organisations, the manager checks internally with central policy units that an SFLG loan is appropriate: usually an SFLG unit to check eligibility and a credit policy unit to check commercial viability. Third, each loan is then sent to the Small Business Service team in Sheffield to confirm its eligibility. Fourth, only when the SBS has confirmed eligibility can the manager formally agree the loan with the customer.

**Small Loans Arrangement** 5.2 Since January 1988, the Small Loans Arrangement (SLA) has operated for loans under a fixed amount (currently £30,000). The lender can immediately agree loans under this limit on a self-certification basis: the lender certifies eligibility criteria such as business sector without the need for SBS approval. This allows the manager to give a rapid response to the customer, matching normal commercial timescales for loan agreement. However, the same case-by-case procedure and bureaucracy applies following agreement and, where significant errors are made, the sovereign guarantee may be withheld.

5.3 Lenders using SFLG are not currently required to collect data, or report, on how they use SFLG. Although most do collect some data for internal purposes, the data provided to the lenders by the Review on their individual use of SFLG has often surprised the lenders themselves. The aggregate data on SBS usage, published in the Review's Interim Report, was equally surprising to a wider audience.

### What are the consequences of this approach?

5.4 The current system has a number of important consequences:

1. It takes a considerable amount of time to agree each loan. In comparison with mainstream SME lending, which can often be agreed on the same day or within 24 hours, the timescale to reach agreement on SFLG (often several weeks) acts as a genuine disincentive to both lenders and SMEs. The responses to the call for submissions revealed a real sense of frustration at the timescales, and it is clear that many managers avoid using SFLG for this reason alone.

The timescale is driven by a number of factors, including the time taken to achieve internal clearance, as well as the need for SBS clearance of each loan. However, the Review notes that the process for agreement by the SBS - often identified as the main cause for delay - in practice takes under five working days. From the evidence provided to the Review, it seems clear that the informal dialogue between the lenders and the SBS to check eligibility before a formal application is made, together with internal lender processes, are responsible for the majority of the time between application and final agreement of SFLG loans.

2. Agreeing each loan on a case-by-case basis is a highly bureaucratic process. Paperwork needs to be sent internally within the lending institution and to the SBS, covering a range of prescribed information. The Review does not consider that the content of paperwork itself is problematic - the information requested is immediately available to the lending manager - but the process of creating additional forms and sending to SBS can act as a disincentive to use SFLG.
3. The rules determining eligibility for SFLG are complex and difficult to understand. As many managers do not understand eligibility and the time required to ascertain eligibility can be considerable, this acts as a further disincentive to use SFLG. This is particularly acute for lending managers who use SFLG only once or twice each year.
4. Use of SFLG is essentially demand-led. In other words, SFLG is used where the SME, business advisor or lending manager seeks to use it. In consequence, the decision to consider SFLG at all can often depend upon a combination of awareness and previous experience amongst borrowers and lenders, and not simply on the financing requirements of the business.
5. There is little understanding at an aggregate level of how SFLG is being used or which SMEs are benefiting from the programme. The Review believes it is important all participants (government, lenders and SMEs) understand how SFLG is being used and are aware of the costs of borrowing and default rates. This will enable judgements to be made about the value of the programme and any particular issues that arise.
6. This lack of understanding, coupled with the bottom-up nature of SFLG, result in few instances of strategic and targeted use of SFLG by lending institutions. Whilst there are clear advantages of a bottom-up approach in terms of meeting demand and maintaining additionality (i.e. using SFLG only where it is needed), the Review has not seen widespread evidence of lenders taking a decision to use SFLG to overcome the barriers to secured debt finance difficulties faced by particular types of business, such as start-ups or SMEs utilising intangible assets. The Review believes that greater targeted use of SFLG would enable SFLG to reach those SMEs that face the most difficulties accessing finance and that would benefit most from the programme.
7. There is no management of SFLG volumes. Provided the loan fits within the lenders' existing credit policy, the loan will be agreed. As a result, the volume and value of SFLG has varied significantly throughout the lifetime of the programme<sup>1</sup>, and so the call on government expenditure is uncertain, making proper budgetary planning difficult.

## Why are changes to the operation of SFLG necessary?

**5.5** It is clear from discussions with lenders and borrowers, and from a large majority of responses to the call for submissions, that simplifying and streamlining the administration of SFLG would have a very positive impact on the programme. Reducing the bureaucracy and time involved in completing a SFLG loan, and simplifying the eligibility rules, will make the process more time- and cost-efficient, and therefore make

<sup>1</sup> For more detail, see *The Graham Review of the Small Firms Loan Guarantee: An Interim Report, June 2004*

SFLG more attractive and easier to understand for lenders, borrowers and small business advisors.

**5.6** The Review believes that the case-by-case authorisation of each SFLG loan is no longer necessary. It is, in effect, a comprehensive front-end audit of the programme, putting a significant burden on both lenders and the government. Misuse of SFLG is uncommon and it is in the lenders' interests to keep to the rules, if they wish to continue offering SFLG. It is not clear that such a comprehensive audit process is either proportionate or necessary.

**5.7** The Review therefore believes a change of approach to SFLG is required, to replace the current bottom-up, case-by-case approach in which little is known about the nature of the SME benefiting from the programme and little attempt is made to reach those SMEs facing the most acute barriers to finance. The Review believes that lenders and the SBS need to develop a greater overall understanding of SFLG. It is important that lenders see their lending under SFLG as a portfolio, and that they feel incentivised to own SFLG and to develop its use in a strategic manner. Such an understanding of the portfolio characteristics - at an aggregate and individual lender level - would allow the lenders and the SBS to respond to changes in usage and to adjust the scheme to maximize its impact.

**5.8** In short, the Review intends that SFLG should evolve from a bureaucratic and unstrategic programme which focuses on establishing the eligibility of individual businesses, to a modern programme monitored through light touch regulation, characterised by strategic usage and a high level of understanding about its performance, and focused on the achievement of goals.

## Recommendations

### Removal of upfront checks

**5.9** Building on the experience of the SLA, the Review proposes that lenders are not required to seek SBS approval before they can agree an SFLG loan with the customer. On agreement, lenders should be required only to notify SBS that an SFLG loan has been agreed by providing basic information to enable SBS to maintain the database of SFLG lending. The information should be an online process, and would not be checked at this stage: the information would be for reporting and monitoring purposes only.

#### Recommendation 14

Lenders should no longer be required to obtain SBS approval for SFLG loans before the loan can proceed.

**5.10** Lenders would be required to retain the normal commercial paperwork for the loan in order that, if selected for audit<sup>2</sup> in the future, the circumstances around loan can be examined. There would be no requirement to send this - or any other - paperwork to SBS on agreement of the loan.

**5.11** The Review proposes to remove a series of eligibility rules in order to make the self-certification process as simple as possible. Where it is unavoidable that the lender will need to check eligibility, the lender will be able to do so through a new online service to be provided by the Small Business Service. Further detail of the new eligibility rules and the self-certification process can be found in Chapter 6.

<sup>2</sup> See paragraph 5.23 for further detail on proposed auditing arrangements.

**SFLG web portal** **5.12** The Review recommends that the SBS develop an SFLG web portal, providing a restricted notification facility for lenders, and resources to support self-certification, in addition to a dedicated help line for difficult cases.

**Recommendation 15**

The SBS should develop a dedicated SFLG web portal to enable lenders to check eligibility in difficult cases.

**Portfolio guarantee** **5.13** The Review recommends that SFLG operate on a portfolio guarantee basis, where the government guarantees 75% of the portfolio. Lenders should seek one aggregate payment from Government, paid on a quarterly basis in arrears and based on actual defaults arising, with subsequent adjustments in the event of recoveries. The total value of the payments would not be affected.

**Premium payments** **5.14** To reinforce the portfolio approach, the lending institutions should collect the premium payments<sup>3</sup> from borrowers, and the premium income should be transferred to the SBS on a quarterly basis in arrears or, if desired, directly offset against claims made on the guarantee.

**5.15** The mechanisms of the premium collection will be a matter of discussion between the SBS and the lenders during the implementation phase. However, the Review believes that the most straightforward approach would be for the lenders to include the 2% premium within the interest cost charged to each borrower. This would have the advantage of streamlining the payments and making transparent the cost of borrowing. It will be important that the lender makes it clear to the borrower that the interest rate includes a 2% charge payable to the Government in return for the guarantee provided.

**5.16** The payment of the premium by the SME should remain a requirement of the validity of the guarantee. When a lender identifies that the premium has not been paid, as now, it would be required to take steps to reinstate payment by the borrower to prevent the guarantee becoming invalid after a further six months.

**5.17** To support the proposed post-hoc audit<sup>4</sup>, the lender will be required to make available records of their premium collection, and, for the sample of loans selected for audit, show that the premium has been managed according to the rules (i.e. that a guarantee has not been claimed if the borrower has failed to pay the premiums).

**Recommendation 16**

SFLG should operate on a portfolio basis: payment of the guarantee should be on 75% of the portfolio; and the premium should be collected from lenders in one aggregate payment.

**Defaults** **5.18** At default, lenders should be required to alert SBS via the online registration system that the guarantee is likely to be called: at that stage, no further information would be required. When seeking payment of the guarantee using the single aggregate figure for the portfolio, lenders would be required to provide information on each defaulting loan, including details of the date and reason for default.

<sup>3</sup> See paragraph 4.24 for further discussion of the government premium.

<sup>4</sup> See paragraph 5.23 for further detail on proposed auditing arrangements.

**Audit process 5.19** The changes in the loan approval process would represent a very significant level of deregulation and devolution of responsibility by the Government. Given the requirement to monitor and control the use of public money, the Review recommends that government should establish an audit process to ensure that public money is being used properly, and to inform judgements about the value for money of public spending.

**5.20** However, the Review believes this process should be light touch, proportionate to the risk of abuse, and should not increase the bureaucratic burden of the SFLG scheme. SBS should audit a sample of SFLG lending for each lender, adjusted to reflect portfolio characteristics. It should not be assumed that all defaulting loans would be audited; however it would be sensible for the audit to look at a higher proportion of defaulting than non-defaulting loans. The process should follow three key principles:

- To give lenders the certainty they seek, the guarantee should stand for all loans except where the lender has not acted in good faith or in cases of fraudulent behaviour by the lender.
- If the need for sanctions as a result of misuse did arise, they should be agreed on a case by case basis: the spectrum of options available to SBS would include increased monitoring, the withdrawal of automaticity of guarantee payment, the reintroduction of upfront checks, and ultimately the removal of approved lender status.
- The audit should not consider the quality of the commercial lending decision, but only the eligibility of the business. Any concerns about poor targeting or poor lending decisions would be a matter for the annual SBS-lender discussions at a portfolio level.

**5.21** The audit should be an annual process, carried out by the SBS or experts contracted to the SBS. For each loan to be audited, lenders would be required to retain lending paperwork (as above) and to provide copies of that paperwork to the auditors on demand.

#### **Recommendation 17**

SBS should adopt a light touch post-hoc audit process that is proportionate to the risk of abuse. The audit should cover eligibility and financial propriety, and not the commercial decision whether to lend.

## **Reporting and monitoring arrangements**

**5.22** The requirement for lenders to seek management accounts from SFLG borrowers on a quarterly basis should be removed. However, lenders would be expected to pursue due diligence on SFLG loans as with their normal loans.

#### **Recommendation 18**

The requirement for lenders to seek management accounts from all SFLG borrowers on a quarterly basis should be removed.

**5.23** In addition to the provision of basic information on approval of each SFLG loan, the Review recommends that lenders should be required to report annually on the performance of their SFLG portfolio. This should include annual information summaries covering basic information such as the volume and value of lending, size and sector of the businesses using SFLG, loan size and term data, interest rates, default rates and bad debt rates, and local and regional availability of SFLG. This information would provide the basis for the discussion between SBS and each individual lender on the size of the cap for the next period and to assist consideration of the value of the SFLG lending.

**Recommendation 19**

Lenders should only be required to provide an aggregate annual report on the performance of their SFLG portfolio, covering basic information such as the volume and value of lending, the type of SMEs receiving SFLG, and default rates.

**5.24** The Review recommends that the SBS should publish an annual report, covering SFLG lending at an aggregate level, and high-level breakdown of each lenders' use of SFLG (as previously published by the Bank of England), so that Parliament and the public can see how SFLG is being used.

**Recommendation 20**

The SBS should publish an annual report on SFLG, so that Parliament, stakeholders and the public can judge the impact of SFLG on the UK economy.

**5.25** This Report does not seek to cover every detail of the reporting and auditing arrangement, and further detailed discussions will be necessary between experts in SBS and the lending institutions when the new arrangements are implemented.

## Low volume lenders

**5.26** There are currently 23 lenders that have signed agreements with the DTI to authorise them to make loans under SFLG. However, in 2003-4, 98% of loans by number and 97% by value were made by the main five high street lenders (HSBC, HBOS, RBS NatWest, Barclays and Lloyds TSB). The dominance of these five lenders is in great part a reflection of their market share of the SME term lending market, but also suggests that there are economies of scale in operating SFLG that favour large institutions. For example, all five of the main lenders have a central unit to act as a 'back office' for SFLG, liaising with front line managers and channelling communication with the Small Business Service. These units build up expertise and familiarity with SFLG's rules and eligibility criteria, which reduces the time needed to deal with each individual application and gives confidence to front-line staff.

**5.27** The large lenders therefore represent the main conduit, in volume terms, for delivery of SFLG, and any changes to the way one or all of them operate the programme will have a significant impact on the overall take up of SFLG. However, it is important that government continues to encourage other lenders to use SFLG. In addition to the important argument that a wide field encourages competition, the smaller lenders authorised to deliver SFLG are in many cases operating in specific, sometimes niche, markets. State Securities, for example, is an asset-based lender and Triodos Bank specialises in lending to environmental and social businesses.

**5.28** The Review believes that it is important that SFLG is accessible to smaller lenders to use in appropriate circumstances for their customer group. Complex procedures and lack of clarity over rules is certain to discourage use among all lenders, but particularly among those without central support within their institution. For this reason, recommendations proposed in this Report to allow lenders to make loans under SFLG without prior referral to the Small Business Service, and the removal of several eligibility rules, should have particular benefit for smaller lenders.

**5.29** The Review has also given serious consideration to the impact of its recommendations on existing small lenders and potential new lenders. The burden of administration of SFLG should be in proportion to the use made of it by the lender. The review therefore proposes that low volume lenders (defined as those making fewer than 50<sup>5</sup> loans per year) will be exempt from the annual portfolio statistics reporting requirements and that they should be able to choose whether to collect the premium payments themselves or whether to continue with the current arrangements under which the premium is arranged directly between the SBS and the borrower.

#### **Recommendation 21**

Low volume lenders should be exempt from the following requirements:

- They should not have to report annual statistics on their SFLG portfolio to the Small Business Service.
- They should be able to choose whether to collect the premium payments themselves or whether to continue with the current arrangements under which the premium is arranged directly between the SBS and the borrower.

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<sup>5</sup> Suggested de minimis level based on current use of SFLG.



# 6

## SIMPLIFYING THE RULES

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### Why is simplification necessary?

**6.1** The majority of responses to the Review’s call for submissions sought a simplification of the eligibility rules for SFLG. It is clear from those responses that the complexity of the criteria makes the operation of SFLG difficult and time consuming, and that, in some circumstances, the resulting uncertainty can cause lending managers to ignore SFLG, even when the SME may be eligible. Furthermore, it is apparent that some of the rules mean that good business propositions are ineligible for SFLG. A particular concern raised by respondents is that the limit on lending to individuals, in combination with the connected persons rules, results in many good businesses missing out on SFLG solely because of the previous SFLG lending to a director or minority investor.

**6.2** There is a further objective driving simplification. Changes recommended elsewhere in this Report are designed to bring the quality of the business proposal to the fore and to empower the individual lending manager to make the judgement on the merits of the business case and to choose the appropriate terms and conditions for the deal. Simplification of the eligibility criteria is crucial to achieving this goal, by removing criteria that are unrelated to the business case and removing inflexibilities around the terms and conditions of lending. However, the changes are not designed to encourage inappropriate lending: normal credit assessments should be applied to SFLG lending and lenders should not diverge from normal commercial lending parameters simply because SFLG allows that flexibility.

**6.3** Unfortunately, it is not immediately possible to remove all the rules that give rise to complexity, particularly sector exclusions, which are driven by the legal constraints imposed by the Industrial Development Act 1982 and European State Aid rules. The Review proposes that the new web portal provides online support on the remaining areas of difficulty, to enable the process of determining eligibility to be as quick and straightforward as possible.

#### **Recommendation 22**

The new SFLG web portal should provide a tool for lenders to check SFLG criteria where eligibility is uncertain or the necessary information is not directly available to the lenders.

### PROPOSED CHANGES TO THE RULES

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#### **Maximum lending to an individual**

**6.4** At present, an individual can only be associated with a maximum £250,000 of lending under SFLG. Recent changes have, in effect, introduced a ten-year horizon for this ruling, so that borrowing over ten years before is discounted. Any SFLG lending to a business with which an individual is deemed to be “connected” (see below for connected person rules) will contribute to that individual’s limit. Successful repayment of loans is not taken into consideration. Thus, eligibility for SFLG is determined not only by the quality of the business case and the collateral shortfall, but also by previous lending to connected persons. The different lending limits for age of company introduce a further layer of complexity.

**6.5** There are sensible arguments for such a rule – principally, that it protects SFLG from repeated abuse by an individual. However, in addition to the administrative complexity caused by the rules, the rule works against serial entrepreneurs and business angels, and furthermore can result in a good business proposition being denied SFLG because a person connected with the business has reached their individual lending limit.

**6.6** The Review proposes to remove the limit on the amount of lending available to any one individual. This proposal will remove a considerable administrative burden on lenders and the SBS, and will ensure more businesses can access the scheme. The proposal should not be interpreted as encouraging a more relaxed approach to an individual’s previous lending history under SFLG. If an individual’s lending history (SFLG or otherwise) would normally give rise to concerns, then these should apply equally to decisions about SFLG.

**Recommendation 23**

The limit on the amount of lending available to any one individual should be removed.

**Connected persons** **6.7** A direct result of this proposal is that the set of rules determining whether an individual is connected to a business are no longer necessary. Therefore the current rules – currently interpreted as treating full time directors, and any shareholder holding above 20%, as connected – will no longer be necessary.

**6.8** The removal of these rules is expected to lead to an increase in demand for SFLG. Lenders predict that the key beneficiaries are likely to be entrepreneurs and business angels who are involved in a series of SMEs. Therefore the increase is likely to be small in scale but well targeted.

**Recommendation 24**

In conjunction with recommendation 23, all ‘connected persons’ rules should be removed.

**Maximum turnover limit** **6.9** The Review is proposing to raise the turnover ceiling from £3m (£5m for manufacturing) to £5.6m, to enable more SMEs to receive SFLG. This move also aligns the ceiling with current EU definitions of a small company and the recent Company Law Act definition. Importantly, the Act will periodically review the definition: the Review recommends that the SFLG ceiling is pegged to the Act’s definition, thus ensuring the turnover limit is revised in line with the changing business environment.

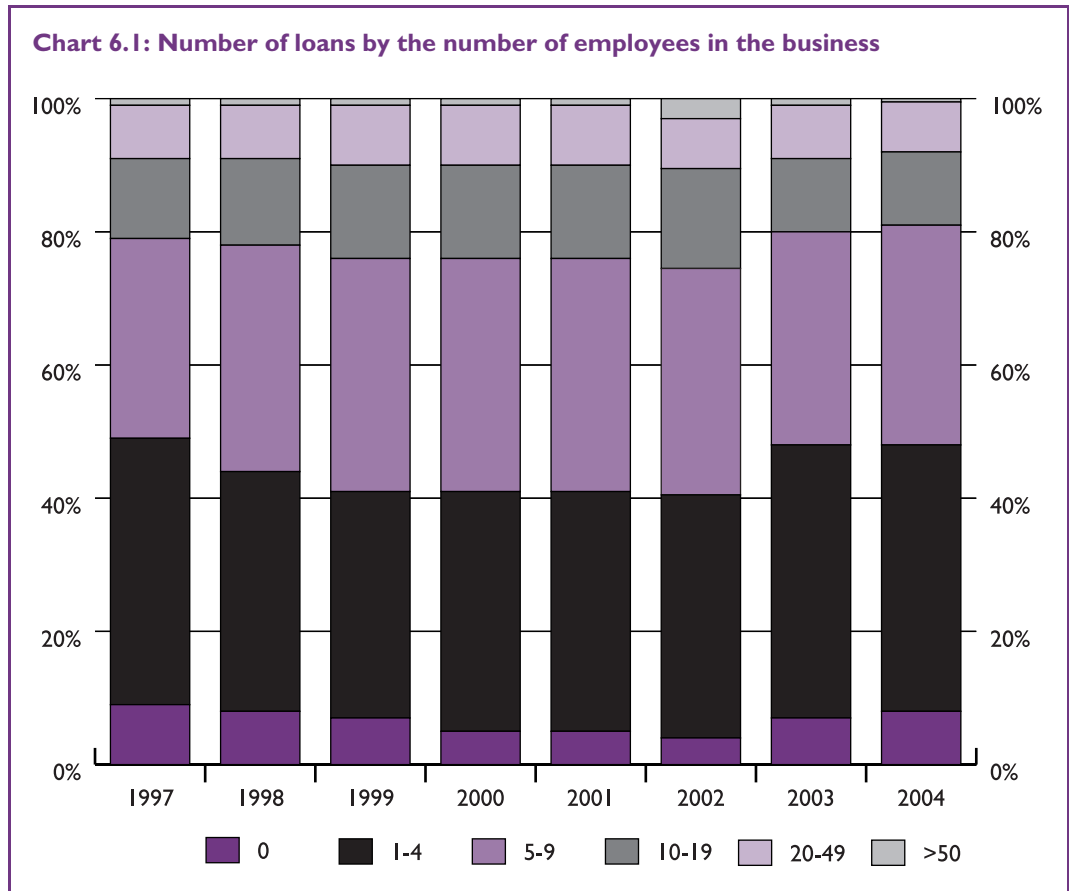
**6.10** This change will increase the number of SMEs eligible for the scheme. However, due to the availability of other financing options for larger businesses, demand for SFLG from larger SMEs is low: just 5% of businesses receiving SFLG have a turnover of above £1.5m, and 1% goes to manufacturers with a turnover of £3-5m. Therefore this change is unlikely to add significantly to the value of the SFLG portfolio.

**Recommendation 25**

The maximum turnover limit should be aligned with the Company Law Act definition of an SME.

**Maximum employees limit** **6.11** The size of business eligible for SFLG is determined at present by turnover and by number of employees. However, in practice, the maximum employee limit (200 employees) is very rarely relevant to the eligibility of an SME (see chart 6.1). To aid

simplicity, the Review therefore proposes to remove this rule and for SFLG to rely solely on turnover to define the size of SMEs eligible. It is not expected that this will lead to any significant increase in the value of the SFLG portfolio.



**Recommendation 26**  
 The maximum employee limit for eligible businesses should be removed.

### Loan parameters

**Maximum loan amounts** **6.12** As set out in paragraph 3.16, the Review is recommending that all eligible SMEs should be eligible for SFLG support up to £250,000, and that the age differential for lending limits are removed. The maximum limit of £250,000 is unchanged.

**Capital repayment holidays** **6.13** Respondents to the Review were clear that the flexibility to adopt capital repayment holidays provides a useful, if infrequent, option for lending managers. The Review therefore proposes to maintain that flexibility, and further to remove the maximum length of the repayment holiday.

**6.14** This increased flexibility is not intended to encourage longer holiday periods and is therefore subject to the central criteria that the lending manager considers the holiday appropriate for the specific circumstances of the business. The increased flexibility should be seen as reinforcing the importance of the commercial decision in setting the most appropriate terms and conditions of the loan. If the manager judges a

holiday period to be appropriate, then the Review does not believe that the decision should be constrained by SFLG rules.

**6.15** Similarly, the current inflexibilities in determining the capital repayment schedule of SFLG loans cuts across the principle of allowing the lending manager to adopt the commercial terms most appropriate for the business involved. This is a complex issue with implications for the simplification of the premium collection process. Nevertheless, the Review believes that the SBS should explore the potential for removing the constraints on managers in this area.

#### **Recommendation 27**

The limit on the length of capital repayment holiday should be removed, and the SBS should explore the potential for removing the existing constraints on capital repayment schedules.

### **Treatment of personal security**

**6.16** The Review received a series of submissions seeking clarification of the rules in regard to the level and type of personal security that should be taken before SFLG can be used. The concern, as identified, is that different lenders operate different policies, leading to confusion in the market.

**6.17** The Review would be uneasy if the current approach - building upon lenders' existing policies rather than adopting prescriptive and complicated rules - encouraged some lending managers to take a different approach on SFLG than for normal lending, whether that approach was more or less rigorous. However, the Review is not attracted to the adoption of a prescriptive set of rules: first, because the Review believes it should be for the market to decide on the treatment of personal security; and second, because each lending proposition is unique, the Review does not believe it would be possible to set out a set of rules that would be understandable to borrowers and lenders and that would be fair in each circumstance.

**6.18** The Review therefore does not propose to create a new set of rules in this area. However, the Review wishes to reiterate and reinforce the existing rules, and notes in particular that, in all cases, lenders should exhaust all personal security that would normally be taken on commercial lending before using SFLG. Lenders should not adopt a more liberal policy, i.e. using SFLG when other available security exists, but equally they should not adopt a more stringent policy before turning to SFLG. Additionally, the Review believes that lenders should continue to determine whether personal assets are available for use, i.e. a borrower should not be able to access SFLG just by declaring their own assets unavailable if the lender would otherwise be prepared to lend them - secured on those assets - under commercial terms.

**6.19** In short, if a lender would, in the absence of SFLG, have taken an asset as security, then it should do so before turning to SFLG.

### **Self-certification and the SFLG web portal**

**6.20** Whilst these changes will simplify the process of determining eligibility, there will remain a number of rules for eligibility that will require verification. In particular, these include determining the age and sector of the business, the quantity of other State Aid support for the project, and establishing the level of previous SFLG borrowing by the SME.

**6.21** Under the portfolio option, it is important that lenders will be able to determine eligibility quickly and easily, or the bureaucracy will remain an obstacle to increased SFLG uptake. Involving the SBS in decisions will add to the bureaucracy of dealing with SFLG. Therefore the Review proposes that lenders should be free to self-certify (i) the age of the business on the basis of the definition at paragraph 3.10, (ii) that the business purpose is eligible, and (iii) should make reasonable efforts (as now) to ensure that the business declares previous State Aid receipts.

**Recommendation 28**

Lenders should be able to adopt a self-certification process for determining the age of the business and for confirming that the business purpose is eligible, and should only be required to make reasonable efforts to ensure that the business declares any previous State Aid receipts.

**6.22** In order to self-certify these categories, the lender should simply be required to make reasonable efforts – for instance a signed declaration from the borrower – to check the various criteria. If the lender does not make reasonable efforts to check eligibility and an error is subsequently detected, it is proposed that the SBS may choose to withhold the guarantee payment. However, where the lender must by necessity rely on the borrower’s declaration, in the event of a misdeclaration the lender will not become liable for the guarantee provided it acts in good faith.

**6.23** For eligibility checks requiring information not directly available to the lender, the Review proposes that the new SFLG web portal should contain a restricted tool for registered users to check eligibility directly online. The web portal should provide a restricted access database of SMEs previous SFLG borrowing so that previous SFLG support to the business can be ascertained. The portal should also include assistance to determine the eligibility of the business sector in difficult cases, including in sectors that are currently referred by the SBS to DEFRA.

**6.24** The Review is aware that determining eligibility is a difficult area and therefore recommends that the SBS publishes clear guidance on eligibility criteria, including publishing guidance outlining which criteria can be self certified and which must be checked via the online database.

**Recommendation 29**

SBS should publish guidance on eligibility criteria to assist lending managers during the process of self-certification of SFLG eligibility.



# 7

## MANAGING RESOURCES AND MAXIMISING THE IMPACT OF SFLG

**Introduction 7.1** Use of SFLG by volume and by value both grew by 52% last year, greatly increasing the Government's liabilities and causing an unexpected increase in public spending. The Review does not believe it is credible or desirable to maintain an open ended public spending commitment to spending on SFLG: at present, there is, in effect, a blank chequebook. The Review also notes that widely accepted amongst stakeholders that it is right for government to establish a cap on the total value of SFLG lending, in order to avoid contingent liabilities accruing to government and to provide for the proper management of public spending. This chapter sets out recommendations for the introduction of a cap, and the mechanism for its operation. The second half of the chapter explains how the likely future rationing effect of the cap can be used to help achieve a number of improvements in SFLG, including encouraging new lenders to enter the scheme, incentivising consistent availability, and directing SFLG towards growth SMEs.

### Introducing a cap

**7.2** The Review considered a number of options for capping lending under SFLG. The first option was the introduction of a competitive bidding system for SFLG support. The main advantages of a bidding system are twofold: (i) that it offers a clear and simple way to allocate a finite pot of money between lenders; (ii) that the competitive nature of a bidding process would result in lenders becoming increasingly innovative and dynamic in their use of SFLG, competing against one another to provide the most attractive and pro-growth SFLG product. The attractions of this approach, however, need to be balanced by the reality that SFLG represents only a marginal (2%) section of the term lending market for SMEs.

**7.3** It is clear to the Review team that it is unrealistic to introduce an allocation system that demands a considerable degree of cost and time from the lending institutions to develop a series of bids for SFLG support. There is a real risk that if the barriers to entry to the SFLG market are raised too high, then some lenders will decide to leave the SFLG market. The problem would be more acute for smaller lenders, for whom the costs would be proportionately higher. Therefore the Review is not proposing to introduce a competitive bidding system to allocate SFLG funding.

**7.4** A second option considered by the Review would have been to set an annual lending cap for the whole of SFLG lending, but not to introduce individual lender caps. This, broadly, is the current situation in the United States' Small Business Administration's 7(a) loan guaranty programme. The Review is not attracted to this option, primarily because it does not incorporate a system to control supply so that total lending does not exceed the cap. As a result, there is a very real possibility that the programme will run out of money before the end of the financial year, necessitating a curtailment of the programme. This situation occurred in the US early in 2003.

**7.5** In order to create a system where supply can be controlled, the Review therefore recommends that in addition to an annual cap for the whole of SFLG lending, each lender should be allocated an individual lending cap.

**7.6** Each lender would be able to lend up to the lending cap each year, but will not be permitted to exceed that cap. The cap should be expressed in cash value terms: lenders should be allocated a maximum value of lending each year. Importantly, each lender will be responsible for ensuring that the cap is not exceeded.

**Recommendation 30**

Individual lenders should each be allocated an annual cap on the value of their SFLG lending. Lenders should be responsible for managing supply to ensure the cap is not breached.

**7.7** Once government has determined the total lending cap, the key issue is how to calculate the individual cap, i.e. how to determine distribution of the overall lending pot between the SFLG lenders. The Review believes that the allocation mechanism should be transparent and simple, should reward strong usage of SFLG, should allow lenders to grow or reduce their proportion of the SFLG lending market and should allow for new entrants to the SFLG market.

**7.8** It will be for government to determine the annual value of the total SFLG lending pot, depending on the prevalent economic and policy conditions, the state of the debt market for SMEs, and reflecting GDP growth as appropriate.

### Allocation mechanism

**7.9** The Review proposes that the foundation of the allocation mechanism should be the lenders' current share of the SFLG market, thus ensuring that the mechanism is directly linked to actual SFLG usage performance and that the mechanism incentivises the maintenance or growth in SFLG usage.

**7.10** Thus historical usage would lie at the heart of the allocation process. It is important to note that, if the government were to decide on a reduction in the total funding available for SFLG, then a lender's share of the new pot may be, in monetary terms, less than the year before, despite maintenance of market share.

### Calculating market share

**7.11** It would be possible to calculate current market share using either volume of loans or value of lending. It has been argued that, given the importance of expanding SFLG to as many eligible SMEs as possible, market share should be calculated using the volume of loans made, thus providing an incentive to make an increased number of smaller loans. However, on balance the Review believes that an allocation basis that is neutral in terms of influencing lender behaviour is more appropriate, and therefore recommends that SFLG is allocated by share of the market by value. This allows each lender to adopt the volume to value ratio that best fits its own commercial interests, by providing enough funding to support the lending, regardless of the volume of loans that are being achieved.

**7.12** In order to closely match future allocation with existing demand, it is proposed that the market share is based on the previous year's usage data alone. For example, if a lender was responsible for 15% of actual SFLG lending in year 1, it would be entitled to 15% of the year 2 pot of lending.

**7.13** The Review is aware that the transition to the new SFLG system will be difficult. It is recommended that flexibility is introduced for the first year, and further that for that first year, an average of the previous three years be used as a baseline, in order not

to incentivise a rush on SFLG lending ahead of the commencement of a capping regime.

**7.14** The Review recommends that each lender be allocated, on an annual basis, a percentage by value of the overall supportable lending pot, based on that lender's share by value of the previous year's SFLG lending. However, in order to assist planning, and to further reduce the administration of SFLG, the SBS may wish to agree longer allocation periods with lenders, perhaps with a 'rolling' element to provide greater flexibility.

**Recommendation 31**

The allocation of the main SFLG lending pot between lenders should be expressed in value terms and based on market share of SFLG lending by value in the previous financial year.

## Managing supply

**7.15** The Review recommends that the lending caps are fixed and that it should be the clear responsibility of the lenders to manage supply, so that they do not reach their cap before the end of the financial year. Extra funding should not be made available in-year to cater for unplanned oversupply by an individual lender. Pre-planned growth would be catered for by the pre-allocation of a higher cap, as set out in paragraphs 7.26 to 7.36 below.

**7.16** This is an important and fundamental shift in how SFLG is managed by lenders. Although the allocation mechanism will seek to match funding closely to demand, it is likely that, following a transition period when the overall cap is likely to be in excess of demand, the cap on lending will mean that lenders will need actively to manage supply of SFLG and to prioritise SFLG on particular categories of SME or business proposals. Whilst this is a consequence of the need to avoid the uncertainty of contingent liabilities on the taxpayer, it also provides an incentive to lenders to focus SFLG on those businesses that face the greatest difficulties accessing finance and that will contribute most to growth and productivity.

**SFLG should not hinder innovation**

**7.17** In recent years many lenders have made very significant and innovative steps in the development of other financing solutions for SMEs, including the greater use of unsecured term lending. The cap provides an opportunity to develop these options still further by extending the solutions to those SMEs on the margins of SFLG eligibility, which may be excluded as a result of the capping process. The Review believes that providing such an incentive to innovate is important: SFLG should not stifle the innovation or development of the private market and should allow lenders the freedom to develop their own solutions to the problem of missing collateral.

## Potential options if exceeding the cap is unavoidable

**7.18** However, in exceptional cases where a lender will exceed the cap, the Review recommends that lenders should have a number of options to manage the situation. Lenders will be required to approach the SBS, no later than the end of the third quarter, to advise that they are likely to overshoot the cap at the end of the year. The SBS and the lender will then enter into discussions about how to manage the situation. Various options would be available and the options are discussed from paragraph 7.19 to 7.23 below.

**End year flexibility** **7.19** In the first instance, lenders should have the option to make use of end year flexibility to continue lending under SFLG. In circumstances where lending caps are set on an annual basis, a two-year indicative rolling allocation mechanism would be adopted, to allow lenders to ‘borrow’ allocation from year 2 to meet demand in year 1. This flexibility should be limited to a specific percentage of the year 2 allocation, to avoid situations where a majority of the year 2 allocation had already been used. This would give lenders the flexibility to manage a peak in demand by bringing forward allocation and restricting usage in year 2. Box 7.1 sets out in more detail how this would work in practice.

**Box 7.1: End year flexibility**

Lender A is allocated £100m for year 1 and a *provisional* £100m for year 2.

In normal circumstances, at the end of year 1, lender A’s actual year 2 allocation would be calculated on the basis of its market share performance in year 1. Thus, all other things being equal, if lender A carried out £100m of lending, it would be allocated £100m in year 2 and a provisional allocation of £100m for year 3 would be recorded.

However, in the event of lender A overshooting the cap in year 1, the provisional year 2 allocation would allow lender A to borrow allocation from year 2 to year 1:

Lender A borrows £10m from year 2, and therefore carries out £110m of lending in year 1. The borrowed portion would count against year 2 and not year 1: i.e. lender A would be considered to have carried out £100m of lending in year 1. Lender A would then be allocated £100m in year 2 (based on the year 1 performance, not including the borrowed portion). However, since £10m of that year 2 £100m has already been used, the real value of the cap would be £90m. In year 3, lender would be allocated £100m: the £90m + the borrowed £10m.

**Further options for handling unexpected excess demand** **7.20** There are, potentially, a series of further options available to the lenders. Given the complexity of the options, these are not expected to be attractive solutions, but if a lender wishes to consider these – or any other – options, the Review recommends that the SBS should be prepared to discuss them with the individual lender.

**7.21** These options derive from the fact that a particular level of government funding through the guarantee, coupled with the prevalent default and guarantee rates, plus the premium income, will be able to support a specific and calculable level of total lending. For example, in 2003/04, the cost to government of making provisions for the £409m of SFLG lending delivered in that year came, net of receipts, to around £60m. If, for example, default rates were to fall, the calculated level of supportable lending could increase without an increased call on public spending.

**7.22** It is this flexibility that offers further options for the lenders. For instance, if the lender was confident that it was lending to a portfolio with lower default rates than had been assumed in the calculation of the total supportable lending limit, and could provide evidence to support this view, then the government might agree to a temporary increase in the lending limit as it would allow a higher amount of lending for the same cost. However, this should only be in the context of an agreement between the lender and the SBS that if the default prediction was incorrect, the lender would pay for the difference between government’s predicted and actual costs.

**7.23** Similarly, a lender could opt for a lower guarantee rate for the portfolio in the remainder of that year, in return for a higher lending limit, thus absorbing more of the costs within the lender in order to sustain lending volumes in that year.

**Specificity of the cap** **7.24** It would be sensible to create a degree of administrative flexibility when measuring lenders' performance against the cap. Therefore it is proposed that, where lenders are within +/- 5% of the precise value of the cap, for administrative purposes the lender will be considered to have hit the cap: i.e. end year flexibility or adjustments to market share will only come into play when performance is over 5% from the cap.

## Transitional arrangements

**7.25** As discussed above, the changes to SFLG proposed in this Report will have significant implications for the way it is managed by the SBS and lenders. It will be necessary therefore to ensure that there is some degree of flexibility in the transition to the new arrangements. One important factor in this respect will be that the lending cap on each lender be set high enough in the transition period (the first few years of operation) in order to have sufficient flexibility for the changes to bed down and to not unduly constrain lenders. This will enable the impact of the other changes to be felt and understood, such that in future periods lenders will be better able to forecast demand for SFLG and thus manage its use.

### Recommendation 32

During a transitional period, the individual lending caps should contain sufficient flexibility to allow the changes in the scheme to bed down, and to allow lenders to increase lending to eligible SMEs.

## Ensuring flexibility for growth, new entrants and good performance

**7.26** As discussed above, the main SFLG lending pot would be allocated solely according to the previous year's market share. However, there are a number of circumstances in which it would be desirable to increase or decrease the level of the lending cap to a particular lender. There are four key circumstances in which the Review recommends that SBS should make separate funds available to lenders, in the context of the new high-level discussions between lenders and the SBS on the usage of SFLG:

**New entrants** **7.27** It is essential that new entrants can participate in SFLG. Therefore, funds should be made available to new lenders to join the SFLG. The value of funds available would depend on the new entrant's share of the mainstream SME term lending market, and the extent of their expansion plans.

**Growth** **7.28** Lenders wishing to grow their total use of SFLG would be able to access increased funding by agreement with the SBS. The lender would need to demonstrate to the SBS how they intend to grow their usage and which SMEs would benefit.

**Availability** **7.29** It is an important objective for government, lenders and small firms that a viable business lacking collateral has the same chance of obtaining an SFLG loan from their lender, irrespective of where in the United Kingdom it is located. The Review believes that commitment to making positive efforts to ensure good awareness of SFLG among front line lenders is an integral part of being an SFLG lender, for example through training on SFLG for all regional managers, or establishing regional champions for SFLG. This should be a mainstream aim of all lenders, and should not be considered an add-on to good SFLG performance.

**7.30** Although greater availability should therefore be a goal for all lenders, funding should be made available for specific plans to increase availability throughout a lender's network – such as growth in a particular target region or sector. In order to monitor the success of their plans, lenders would be required to provide the SBS with data on use of SFLG by sort code, compared with the total number of business banking sort codes, to provide an indication of the success of those plans.

**Innovation 7.31** Funds should be available to enable lenders to use SFLG in an innovative way to reach high growth businesses. Lenders wishing to make use of these funds would need to demonstrate that they have a strategic plan to use SFLG for particular purposes, for example, by certain specialist lending teams that target high growth businesses. Lenders will need to report on the success of these plans by providing the SBS with data on the use of SFLG by these teams and the growth characteristics of this part of their portfolio. Alternatively, lenders would be able to supply the SBS with data on the growth in turnover of their SFLG customers (using, for example, debit turnover as a proxy for sales turnover, where current account information is available). Evidence of very positive growth in turnover of SMEs in the SFLG portfolio should be rewarded with allocation of funds from the separate pot.

**7.32** The Review recommends that, to support the provision of funding for these objectives, a separate 'pot' should be created, which is reserved to provide support for new entrants, growth, innovation and wider availability. The precise value of this separate pot will be a matter for the SBS. The Review envisages that it will be in the region of 15-20% on top of the main lending pot; however, the exact amount will depend on the prevalent economic and policy conditions and the state of the debt market for SMEs, as well as the historic performance of lenders against their respective caps. For all four circumstances, the lender would need to enter into an annual dialogue with the SBS in order for the SBS to be in a position to allocate extra funding on the basis of the information provided.

**7.33** It is likely that there will be excess demands on the pot in any given year, and therefore the SBS will need to make the decision to fund the extra lending that most contributes to the programme's objectives: i.e. in some circumstances, requests for increased lending allocations will be refused (a situation that is inevitable given the existence of the overall cap). However, in light of other changes to SFLG, the Review does not envisage the cap being restrictive in the early years of the new SFLG, allowing for a period of transition for borrowers and lenders.

**7.34** The Review recommends that any extra allocation made available through the extra pot to support organic growth, wider availability or new entrants will be considered as actual SFLG market share, so that the lender's new market share is reflected in the allocation of the main pot for subsequent years. However, funding for 'innovative uses' would need to be renewed on an annual basis.

**Recommendation 33**

In addition to the main SFLG funding pot, a separate pot should be created to provide funding for new lenders, growth, wider availability and innovation.

**Reducing market share** **7.35** It may be that some lenders will wish to reduce their market share of SFLG – for instance where lenders develop alternative financing options for young SMEs without collateral. Therefore lenders would not be obliged to meet their lending cap: when a lender did not do so, the next year’s allocation, as it is based on previous market share, would automatically reflect lower usage.

**Dealing with high default rates** **7.36** As discussed in paragraph 4.9, the Review believes that current default rates on SFLG lending are higher than can be explained by the risk profile of the borrowers alone, but does not recommend that a target default rate should be set for SFLG loans, instead relying on a greater degree of oversight and management to bring about a reduction in the default rate. If a particular lender’s default rate in fact rises significantly, then this would be a cause of concern. Importantly, since the cost to the taxpayer of supporting a certain level of lending will rise if defaults rise, the SBS will need to reflect that rise in the annual calculation of the lender’s lending limit. In short, the lender’s lending limit would need to be reduced to reflect the increased cost of supporting the lending. This should not be backdated to cover existing lending: the reduction would be forward looking, thus providing a disincentive for high default rates but not compromising the integrity of existing guarantees.

### More radical options for expansion

**7.37** Looking to the future, the new system would provide a mechanism that would enable a move towards an SFLG where individual lenders could increase their total lending limit by adopting different parameters on the SFLG scheme.

**7.38** The adoption of a lower guarantee rate, or a lower default rate, would enable the same amount of public funding to support a higher amount of lending. An agreement would need to be reached to ensure that, if the lender did not meet its target default rates, government’s costs did not rise – implying the effective adoption of a cap on government’s liability as opposed to a cap only on total lending. Government would, of course, need to be convinced that changing the parameters of SFLG did not jeopardise the purpose of the programme, namely to reach those SMEs in most need of support.

**7.39** The Review does not recommend a shift to fully flexible parameters at this stage. However, in the future, if lenders were interested in changing the parameters, then SBS should give the option genuine consideration.

#### Recommendation 34

Should lenders wish to expand the value of their lending without seeking increased public funding, SBS should be ready to consider proposals from individual lenders to amend the parameters of the scheme in order to expand total SFLG lending.

### Maintaining simplicity for low volume lenders

**7.40** Clydesdale, Bank of Ireland, Ulster Bank and Venture Finance PLC use SFLG for well under 50 loans each year. The next set of lenders use SFLG on under 10 occasions each year. The Review believes that bureaucracy and administration should be kept to a minimum for these lenders.

**7.41** It is therefore proposed that a ‘de minimis’ concept applies to low volume lenders. The Review suggests that low volume lenders should be subject to a simple volume cap on the number of SFLG loans they are able to make in a year, and that

market share should not be a factor for these lenders. Based on 2003/04 usage, the Review suggests that the cap be set at 50 loans a year, which is higher than the current use by any one lender excluding the large five institutions. There should be no obligation on a lender to make use of the de minimis rule: any low volume lender wishing to breach this the cap would need to discuss with the SBS its projections for future use and, going forward, could opt to receive an allocation based on market share, thus allowing expansion beyond 50 loans on the same basis as the high volume lenders.

**7.42** These measures are intended to enable any type of organisation that wishes to join the SFLG programme to do so, subject to the standard suitability criteria. This would include CDFIs, asset-based lenders and other lending institutions.

**Recommendation 35**

A simple de minimis cap (proposed at 50 loans per year) should apply to all low volume lenders to reduce the administrative burden for smaller organisations.

## DELIVERY OF THE NEW SFLG

**8.1** The recommendations proposed in this Report represent a change in the way an important government intervention is managed and delivered. The benefits of the changes will be: wider availability of SFLG for those businesses that most need it; an increase in the amount of lending available to each business; and faster delivery as a result of simplified administration.

**8.2** Over the lifetime of SFLG the Small Business Service has developed good relationships with the relevant staff in lending institutions that are responsible for using the programme. The Review believes the recommendations provide an opportunity to build on these relationships. The aim of treating SFLG as a portfolio, rather than as a collection of individual loans, is that both SBS and lenders can take a more strategic and considered approach to SFLG, and, within the stated criteria of the programme, use it to respond more swiftly and consistently to demand from the SME market that they would not otherwise be able to meet.

### Small Business Service

**8.3** One of the main aims of the review is to reduce any unnecessary bureaucracy in the delivery of SFLG. For example, removing the requirement for lenders to refer each loan to the SBS (see Chapter 5) should decrease the time needed to agree the loan, thereby addressing one of the main criticisms of SFLG from borrowers and lenders alike. There will continue to be a need for the SBS to provide advice to lenders on particular issues of eligibility and to administer the payment of guarantees in the event of default. However, overall, the changes will free SBS resources to take a high level view of how SFLG is being used, to monitor statistics provided by lenders and to discuss with lenders on an annual basis their strategy for using SFLG over the next period. One of the main tasks for the SBS will be the allocation of the SFLG ‘pot’ among lenders and to monitor take up against the pre-agreed limits, with a view both to managing excess demand, but also to encouraging lenders to make full use of their allocation.

**8.4** These tasks will require a different skill set than is currently needed to manage SFLG, including an increase in staff with specialist finance, particularly commercial banking, and accountancy skills. Furthermore, the Review notes that the Government proposes to establish a company that will operate at arm’s length from government to deliver other government interventions such as the Enterprise Capital Funds. The Review considers it essential to the successful implementation of the new scheme that the same approach should be adopted for SFLG, in order to provide the blend of skills and market experience that the new scheme will require, and to create the necessary incentive structures for the operation of SFLG.

#### Recommendation 36

SBS should continue to acquire new specialist finance skills, particularly commercial banking and accountancy, to run the new SFLG. SFLG should be delivered within the same organisational and incentive structure as is intended for the new Enterprise Capital Funds.

## Lending institutions

**8.5** The SFLG lending institutions are key partners in the delivery of the scheme, and are vital to its future success. They have also been vital, of course, to the scheme's previous 23 years of operation.

**8.6** However, just as the proposals in this Report will require a change in the way SFLG is managed by SBS, so will they necessitate a different approach by lenders. In order to ensure that lenders use SFLG to meet both government priorities of supporting enterprise and growth, and their own objectives of extending their reach into the SME market, the proposals are designed to encourage lenders to take a more strategic view of SFLG.

**8.7** At the moment, SFLG is largely demand-driven. This has many advantages, and the Review has concluded that it is important that the small business community is aware of SFLG and the circumstances in which it can be used. However, the Review would like to see lenders do more to increase awareness of SFLG among their front line staff so that when a lender is approached by a borrower asking about SFLG, they are equipped to judge whether or not SFLG is appropriate in that instance. Ways of incentivising lenders to improve awareness are discussed in Chapter 3.

**8.8** Furthermore, the Review's recommendations are designed to encourage lenders to look at their use of SFLG on a portfolio basis, with a view to increasing its use where it is most effective and where it can help lenders move into new areas and assist more SMEs. In order to benefit from the greater autonomy to use SFLG proposed in this Report, some lenders may need to implement changes in their internal management of the programme. Most of the large lending institutions that use SFLG, however, already have a central unit that manages the administration of SFLG and liaises with the SBS on behalf of front line managers. It is envisaged that the recommendations outlined here would reduce the administrative burden on these teams, for example by facilitating online registration of loans, which in turn would free resources to take a more high level view of the institutions' use of the programme.

**8.9** The aim of these changes is not to require lenders to make significant investments in new IT or in an increased number of staff dedicated to what is, after all, a very small part of most institutions' overall SME portfolio. However, the Review believes that combined efforts by government and lenders to implement the changes proposed here regarding the administration and delivery of SFLG will have large benefits for government, borrowers and lenders alike.

## The European Investment Fund

**8.10** The European Investment Fund, a branch of the European Investment Bank, currently provides significant support for a variety of financing schemes for business throughout the European Union and the Accession States. The EIF's strategy includes the provision of loan guarantees to support the availability of debt finance to small businesses, via government schemes and also directly through individual private sector lending institutions.

**8.11** The Review understands that the EIF is keen to support the UK Government's loan guarantee scheme. However, for a variety of reasons, until now the UK government has not sought the financial support of the EIF for SFLG. The Review believes that the implementation of the recommendations outlined in this Report provides an important opportunity for the Small Business Service to work with the EIF and to secure EIF

support for the new SFLG. The Review therefore recommends that, as a matter of urgency, the SBS hold discussions with the EIF about how best the EIF can support the new SFLG scheme.

**Recommendation 37**

The SBS should hold discussions with the EIF about how best the EIF can support the new SFLG scheme.

## Impact of the recommendations

**8.12** Overall, the impact of the recommendations will be to increase significantly the number and value of loans made to new and young businesses, as a result of the deliberate focus on this group, the rise in the maximum loan size to £250,000, and the emphasis in improving availability through branch networks. Meanwhile, while young businesses borrowing under SFLG have a higher propensity than more established businesses to default, the expectation is that the greater degree of monitoring by lenders of their SFLG portfolios should lead to downward pressure on default rates, thus freeing up more resources to reach more SMEs.

**Financial impact** **8.13** Quantifying the precise effect of the recommendations proposed in this Report is not a straightforward task, as take-up of SFLG depends to a large extent on demand, which itself is a result of many factors outside the influence of the SBS or even of lenders. For example, the change implemented in April 2003, which brought in a number of additional sectors, including retail and catering, led to an increase in take-up of around 50% by volume. This was far in excess of the anticipated increase, based on the proportion of the SME market operating in those sectors.

**8.14** In overview, these recommendations will lead to a broadly cost-neutral outcome. On the one hand, targeting the scheme at a smaller eligible population (start-ups and young firms), plus lower default rates as a result of greater strategic oversight, will reduce costs. On the other, since the recommendations will increase the number of loans made to the eligible business population; lead to a rise in the average size of loan; provide extra funding to incentivise wider availability and streamlining administration; and extend SFLG to more SME through the higher turnover limit, costs will increase.

**8.15** The Review believes that it should be for Government to decide the overall funding available for SFLG, consistent with policy priorities and the prevailing economic climate. However, as described in paragraph 7.2, the Review does believe that an annual cap should be adopted in order to manage expenditure, limit contingent liabilities on the public purse, and provide a mechanism to incentivise better availability and targeting of SFLG. The existence of the cap will provide greatly increased control of expenditure, although it should be noted that it will not impose a full cap on the government's exposure, given that future default rates may vary, increasing or decreasing government's eventual costs.

**8.16** The Review's modelling suggests that the package of improvements recommended in this Report can be supported within the scheme's current budget, and the Review therefore recommends that the scheme's current budget should be maintained.

**Recommendation 38**

In order to support the recommendations contained in this Report, the Review recommends that the scheme's current budget should be maintained.

**Maximising lending under SFLG**

**8.17** The recommendations also create the conditions in which high-level discussions between the lenders and the SBS can lead to a greater overall value of lending being supported by an unchanged level of public funding. This principle is discussed in more detail in paragraphs 7.37-7.39 and enshrined in recommendation 34.

**Evaluation of success**

**8.18** It is important that SFLG is kept under review and the full impact of the recommendations outlined in this Report evaluated. There are mechanisms built into the new system to facilitate this; both through the annual audit of lenders to determine that adherence to the rules is maintained, and also through the annual discussions between lenders and the SBS. This annual stocktake should be used as an opportunity to assess the overall impact of SFLG and the effectiveness of the delivery mechanisms in reaching the types of businesses most in need of government support.

**8.19** The Review anticipates that it will take two to three years for the full impact of the recommendations to be felt, in particular the impact on default rates of refocusing SFLG on younger businesses. At that point the Review judges that the changes can be viewed as successful if the following benchmarks have been achieved.

1. The numbers of young businesses accessing SFLG has increased.
2. The evidence gathered from banks and from the audit process indicates that SFLG is having a positive effect on the UK economy in terms of growth in turnover and employment among recipient businesses.
3. Lenders are making effective use of their allocation for SFLG lending, both in terms of the proportion of their allocation used, and in terms of the type of business reached.
4. Lenders are managing to work within the capped amounts allocated to them on an annual basis, without having to withdraw access to SFLG within the year or borrow excessively from the following year's allocation.
5. The number of institutions authorised to lend under SFLG has increased. In addition, the number of individual lenders within each institution that use SFLG has increased (measured according to sort code data).
6. Default rates decline, as a result of improved credit assessment techniques in lenders and better monitoring of the use of SFLG.
7. Lenders can provide clear evidence of a plan for strategic and innovative use of SFLG across their networks.

**8.20** The Review recommends that the SBS keep these issues under review in its annual negotiations with lenders.

# 9

## SUMMARY OF RECOMMENDATIONS

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### Recommendation 1

The fundamental criterion for the use of SFLG should remain a lack of sufficient collateral to secure a loan for an otherwise viable business proposition.

### Recommendation 2

The Small Business Service and the SFLG lenders should undertake a step change in how they view, utilise and oversee the scheme, in order to support a significant increase in the strategic oversight, and proactive management, of SFLG.

### Recommendation 3

In order to maximise the scheme's additionality and its impact on UK productivity, eligibility for SFLG should be limited to start-ups and early stage businesses.

### Recommendation 4

There should be no prescribed start date for SFLG eligibility, subject to the business being debt appropriate. Businesses should be eligible for SFLG no later than four years of tax assessment/accounting periods following the first year of assessment/ first accounting period.

### Recommendation 5

Innovative uses of SFLG by lenders to target high growth businesses should be incentivised through the allocation of specific funding separate to the main SFLG pot.

### Recommendation 6

Business of under two years old should no longer be limited to a maximum of £100,000 of SFLG: all eligible SMEs should be entitled to a maximum of £250,000.

### Recommendation 7

Wider availability of SFLG throughout the branch network of the major lending institutions should be an integral part of being an SFLG lender and should be a clear goal for all lenders.

### Recommendation 8

The SBS should improve the documentation that is available to lenders and borrowers to help clarify the purpose of SFLG and businesses' eligibility for SFLG.

### Recommendation 9

The Government should continue to encourage CDFIs, asset finance providers and other specialist lenders to use SFLG, working with them to address specific issues. SBS should explore whether there is scope to work within the IDA legislation to make it easier for lenders to use SFLG to lend to social enterprises.

### Recommendation 10

The current guarantee rate of 75% should not be changed.

### Recommendation 11

Default rates should be kept under annual review by the Small Business Service, to monitor the impact of the Review's proposals and to ensure that default rates are appropriate to the overall goal of the scheme.

#### Recommendation 12

SFLG should continue to be used only in circumstances in which debt is the appropriate financing option for the borrower.

#### Recommendation 13

The premium should be maintained at 2% per annum on the outstanding value of the loan.

#### Recommendation 14

Lenders should no longer be required to obtain SBS approval for SFLG loans before the loan can proceed.

#### Recommendation 15

The SBS should develop a dedicated SFLG web portal to enable lenders to check eligibility in difficult cases.

#### Recommendation 16

SFLG should operate on a portfolio basis: payment of the guarantee should be on 75% of the portfolio; and the premium should be collected from lenders in one aggregate payment.

#### Recommendation 17

SBS should adopt a light touch post-hoc audit process that is proportionate to the risk of abuse. The audit should cover eligibility and financial propriety, and not the commercial decision whether to lend.

#### Recommendation 18

The requirement for lenders to seek management accounts from all SFLG borrowers on a quarterly basis should be removed.

#### Recommendation 19

Lenders should only be required to provide an aggregate annual report on the performance of their SFLG portfolio, covering basic information such as the volume and value of lending, the type of SMEs receiving SFLG, and default rates.

#### Recommendation 20

The SBS should publish an annual report on SFLG, so that Parliament, stakeholders and the public can judge the impact of SFLG on the UK economy.

#### Recommendation 21

Low volume lenders should be exempt from the following requirements:

- They should not have to report annual statistics on their SFLG portfolio to the Small Business Service.
- They should be able to choose whether to collect the premium payments themselves or whether to continue with the current arrangements under which the premium is arranged directly between the SBS and the borrower.

#### Recommendation 22

The new SFLG web portal should provide a tool for lenders to check SFLG criteria where eligibility is uncertain or the necessary information is not directly available to the lenders.

#### Recommendation 23

The limit on the amount of lending available to any one individual should be removed.

#### Recommendation 24

In conjunction with recommendation 23, all ‘connected persons’ rules should be removed.

#### Recommendation 25

The maximum turnover limit should be aligned with the Company Law Act definition of an SME.

#### Recommendation 26

The maximum employee limit for eligible businesses should be removed.

#### Recommendation 27

The limit on the length of capital repayment holiday should be removed, and the SBS should explore the potential for removing the existing constraints on capital repayment schedules.

#### Recommendation 28

Lenders should be able to adopt a self-certification process for determining the age of the business and for confirming that the business purpose is eligible, and should only be required to make reasonable efforts to ensure that the business declares any previous State Aid receipts.

#### Recommendation 29

SBS should publish guidance on eligibility criteria to assist lending managers during the process of self-certification of SFLG eligibility.

#### Recommendation 30

Individual lenders should each be allocated an annual cap on the value of their SFLG lending. Lenders should be responsible for managing supply to ensure the cap is not breached.

#### Recommendation 31

The allocation of the main SFLG lending pot between lenders should be expressed in value terms and based on market share of SFLG lending by value in the previous financial year.

#### Recommendation 32

During a transitional period, the individual lending caps should contain sufficient flexibility to allow the changes in the scheme to bed down, and to allow lenders to increase lending to eligible SMEs.

#### Recommendation 33

In addition to the main SFLG funding pot, a separate pot should be created to provide funding for new lenders, growth, wider availability and innovation.

#### Recommendation 34

Should lenders wish to expand the value of their lending without seeking increased public funding, SBS should be ready to consider proposals from individual lenders to amend the parameters of the scheme in order to expand total SFLG lending.

#### Recommendation 35

A simple de minimis cap (proposed at 50 loans per year) should apply to all low volume lenders to reduce the administrative burden for smaller organisations.

**Recommendation 36**

SBS should continue to acquire new specialist finance skills, particularly commercial banking and accountancy, to run the new SFLG. SFLG should be delivered within the same organisational and incentive structure as is intended for the new Enterprise Capital Funds.

**Recommendation 37**

The SBS should hold discussions with the EIF about how best the EIF can support the new SFLG scheme.

**Recommendation 38**

In order to support the recommendations contained in this Report, the Review recommends that the scheme's current budget should be maintained.

# A

## SUMMARY TABLE OF INTERNATIONAL LOAN GUARANTEE PROGRAMMES

	US 7a loan	US SBAExpress	Netherlands BBMKB	Denmark Vækstskatation	Belgium SOWALFIN	France SOFARIS	Germany Burschaftsbanken
<b>Guarantee</b>	Up to 85% up to \$150,000 Up to 75% over \$150,000	Up to 50%	Up to 50% Up to 75% for start ups and innovative companies	66.67% up to €350,000 50% from €350,000 to €700,000	Up to 75%	Varies - generally around 50% (average of 45% for 2001) Up to 70% for start ups	Up to 80% (average between 50% - 80%)
<b>Maximum size of loan</b>	\$2 million (maximum guaranteed amount is \$1 million)	\$250,000	€1 million	€700,000 (minimum size €10,000)	€2.5 million	No limit on loan size, but SOFARIS' risk is limited to €750,000 (up to €1.5 million for SME transmission and development)	€1 million
<b>Cost of loan</b>	Premium of 1% for loans \$150,000 and less 2.5% for \$150,000 - \$700,000 3.5% for loans over \$700,000 Annual fee of 0.25% of balance of guaranteed part of loan	As per 7a	One off commission of 2% - 3.6%	3% pa in first two years, 1.5% thereafter	1% pa on guaranteed exposure (paid as an upfront and one-off fee)	Annual fee of 0.45% - 0.60% on the outstanding amount	0.75% commission on amount guaranteed Premium of 1% pa (can be 1.2% for first operation, then 0.8%)
<b>Interest rate</b>	Fixed by lender, but subject to SBA limits (between 2.25% - 4.7% above prime)	As per 7a	Fixed by Government (usually equal to a low-risk rate, but the commission is passed on by lenders to borrowers)	Fixed by lender	Fixed by lender	Fixed by lender (subject to restrictions ensuring it is a market rate)	Fixed by lender
<b>Length of loan</b>	Maximum 7 years (up to 10 years for working capital) Maximum 25 years for real estate & equipment	Maximum 7 years	Maximum 6 years (maximum 12 years for real estate financing)	3 - 10 years	Maximum 10 years (but lenders can request longer)	Length of loan guarantee matches length of underlying loan	Up to 15 years (average 10 years)
<b>Target firms</b>	Vast majority of SMEs (definition of SME varies depending on sector)	As per 7a	Firms up to 100 employees Special conditions for start ups and innovative companies	SMEs in 6 focus areas	All SMEs	All SMEs in all phases of their existence - are 10 different guarantee funds managed by SOFARIS	All with focus on start ups



# B

## DEFINING THE AGE OF A BUSINESS

**B.1** The Review has recommended that SFLG be limited to start-ups and early stage businesses (see Chapter 3). It is important that this should be defined in a way that is clear to both borrowers and lenders. The Review has put forward a definition that it believes captures the objective of this recommendation. It recognises, however, that the detail will be a matter of further discussion between the Small Business Service and lenders during the implementation phase.

**B.2** Ideally, the Review wanted eligibility to be restricted to three years, measured from the point at which a business begins to make sales, in order to allow a business that has taken time on research, development or marketing at the start of its life still to have access to SFLG when it begins to trade. However, it is difficult to define the date of first sale in a way that is easily verifiable.

**B.3** Therefore, in order to make sure that the definition captures both the start-up and first growth phases, and so as not to disadvantage firms with longer set up periods, the Review recommends that the date of “commencement of trading” be used, as agreed between the business and the Inland Revenue, and a longer period of eligibility be given, to account for the development phase at start-up. Businesses should be eligible for SFLG up to and (if appropriate) in the year of assessment in which trading commences and for the next four years of tax assessment (accounting periods in the case of companies). For example, if they started trading on August 1<sup>st</sup> 2000 they would be eligible for SFLG until April 5<sup>th</sup> 2005. Note that the intention of this definition is to impose a maximum age limit and not a minimum age limit.

**Subsidiaries B.4** In order to discourage older businesses from setting up a subsidiary solely in order to secure SFLG funds the Review recommends that a group of companies or businesses controlled or owned by the same people (or a broadly similar group of people) count for the purposes of the SFLG as one firm. The maximum age limit therefore applies to all the companies in the group, just as, under the current rules, the turnover over limits are for all the companies added together.

**Transfer of trade B.5** The maximum age limit should relate to the principal trading activity rather than the corporate form. Therefore, in the case of any business being transferred to a new corporate body, the principal trading activity should itself fall within the age limit in order for the application to be approved.

**Bankruptcy, franchises and management buyouts B.6** The Review recommends that SFLG should be focussed on start-ups and early stage businesses. In considering cases involving transfer of ownership, the Review draws a distinction between the purchase of a business out of bankruptcy and management buy-outs (MBOs) or other examples of take-overs of a going concern. In the case of the purchase of a business out of bankruptcy, the age of the business, for the purposes of eligibility for SFLG, should be measured according to the commencement of trading under the new ownership. Similar, franchises should also be considered as new business start-ups. In the case of the purchase of a going concern, the Review feels that a buyer has a better chance of raising finance against the assets and track record of the business. Its view is therefore that SFLG should be used in such cases only if the business to be purchased is eligible according to the age limit. However, on this issue, the Review recommends, that during implementation, the SBS take into account the findings from their current review of business transfer.



# C

## CONSULTATION PROCESS

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In addition to the formal consultation process<sup>1</sup>, Teresa Graham and the review team carried out various consultations with key stakeholders, through a series of meetings, regional roundtables, and trips to benchmark the UK scheme against other international loan guarantee schemes. The Review is grateful to all those individuals and organisations that contributed to the work of the Review. Teresa Graham is particularly grateful to Mike Yates and the Small Business Service team in Sheffield for all the help they gave to the Review. All content, errors and omissions in the Report are, however, the Review's alone.

### MEETINGS WITH KEY STAKEHOLDERS

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The Review team met with a number of individuals and organisations including:

David Eyles	Abbey
John Brooks	Abbey
Martin Evans	Alliance and Leicester Commercial Finance
Steve Walker	Aston Reinvestment Trust
Mike Young	Bank of England
Neil Charley	Barclays Bank
Richard Roberts	Barclays Bank
Bob Roper	Barclays Bank
Kevin Harris	Barclays Bank
Joanna Elson	British Bankers' Association
David McMeekin	Capital Fund London
Danyal Sattar	Charity Bank
Roger Ong	Charity Bank
Alan Reid	Clydesdale Bank PLC
Sarah McGeehnan	Community Development Finance Association
Matthew Fell	Confederation of British Industry
The SME Finance Group	Confederation of British Industry
Sam Gemmell	Creative Media
Stephen Alambritis	Federation of Small Businesses
Craig Pickering	Finance and Leasing Association
Nick Goulding	The Forum of Private Business
Andrew Mowlah	The Forum of Private Business
Jake Karia	Global Fine Foods
Bill Duncan	Halifax Bank Of Scotland
John Rendall	HSBC
Ian Moore	HSBC
Tamara Glenn	HSBC
Chris Marland	HSBC

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<sup>1</sup> A list of respondents to the Call for Submissions was set out in the Review's Interim Report. See [www.hm-treasury.gov.uk/graham](http://www.hm-treasury.gov.uk/graham) for more detail on the consultation process.

Clive Lewis	Institute of Chartered Accountants in England & Wales
Simon Beechcroft	ICAEW
Alpa Viridi	ICAEW
David Richards	IGF Invoice Finance Ltd
Richard Reed	Innocent Drinks / Small Business Council
Peter Denison-Pender	Interregnum
Ken Olisa	Interregnum
Andy Cosh	Judge Institute of Management, Cambridge University
Professor Alan Hughes	Judge Institute of Management, Cambridge University
John Tomlinson	Lombard
Julian Franks	London Business School
Anthony Clarke	London Seed Capital
Stephen Pegge	Lloyds TSB
Frank Gilhooly	Lloyds TSB
Chris Rowell	Lloyds TSB
Mary Rogers	Lloyds TSB
Caroline Cross	National Australia Group
Claire Martin	RBS NatWest
Philip Davies	RBS NatWest
Nick Williams	RBS NatWest
Arthur Smith	RBS NatWest
James Braithwaite	SEEDA
Gillian Calder	Scottish Enterprise
Luke Charleton	Scottish Enterprise
Dr Marc Cowling	The Work Foundation
Myra Lloyd	DPW Enterprises Ltd
Louise Shafar	Louise Shafar Ltd / Small Business Council
Alex Ball	

### Small business investment taskforce

The Review Team is very grateful for the help and advice offered by all the members of the Small Business Investment Taskforce, and in particular to Sir David Cooksey, Chairman of the Taskforce, and to the members of subgroup that engaged in depth with the Review on SFLG:

David Marsden  
 Jennifer O'Neil  
 Peter Ibbetson  
 Steven Walker  
 Steve Sharratt  
 Mike Young

## INTERNATIONAL

### European Investment Fund

John Holloway	EIF
David Walker	EIF
Edward Claessen	EIF
Alessandro Tappi	EIF
Christa Karis	EIF

### USA

The Review team visited Washington, Detroit and Chicago. Individuals and organisations met were:

Ron Bew	Small Business Administration
James Hammersley	Small Business Administration
Kevin McCall	Small Business Administration
Joseph Loddo	Small Business Administration
Ivan Irizarry	Small Business Administration
Janet Tasker	Small Business Administration
Daniel Hook	Small Business Administration
Judith Roussel	Small Business Administration
Robert Esquivel	Small Business Administration
James Ballentine	American Bankers Association
Melissa Fischer	Bank of America
Troy King	Comerica Bank
Brad Berryman	Fifth Third Bank
Darlene Nowak-Baker	Franklin Bank
Cathy Schassberger	Franklin Bank
Thomas Doherty	LaSalle Bank
Charles Tansey	Neighborhood Reinvestment Corp
Lorenzo Rasetti	Office of Management and Budget
Edward You	Shorebank
Chelsea Cicekoglu	Shorebank
Charlene Soby	Shorebank
Kevin Wilson	Shorebank

### Belgium

Albrecht Mulfinger	European Commission Enterprise DG
André Douette	AECM
Jean-Noël Libert	Sowalfin
Nicolas Pirotte	Sowalfin

## The Netherlands

Drs Roland Starmans	Senter
Drs Dick Witteveld	Senter

## Denmark

Rolf Kjaergaard	Vaekstfonden
Thomas Nielsen	Vaekstfonden

## ROUNDTABLES

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The Review visited five different parts of the UK – some on more than one occasion - to hold round-table discussions with lenders, borrowers and Government officials. The Team met with a very wide range of stakeholders at these events. Where possible, we have listed them below:

### South East

Clive MacKenzie	Business Link Surrey
Iain Brown	Business Link Surrey
Peter Webber	Business Link Wessex
Graeme Finch	Business Link Solutions
Helen Cracknell	Business Link Berkshire & Wiltshire
Mark Perrin	Morley & Scott
Ian Johnson	Chantrey Vellacott
Barry Lewis	Chantrey Vellacott
Nigel Ball	Decorative Additions
David Robson	Burnside Telecom
David Thompson	Swan Retail Ltd
Alwyn Ellis	Venture Finance
Paul Coleman	Finance South East
Richard Holmes	Finance South East
Andrew Cheetham	Halifax Bank of Scotland
Rupert Robinson	Barclays
Dave Rushbrook	Barclays
Gordon Beach	HSBC
Mark Jones	The Royal Bank of Scotland
Andrew Wilson	The Royal Bank of Scotland
David Cole	Lloyds TSB

## South West

Alison Clark	Institute of Chartered Accountants in England & Wales
Frank Sanders	Business Link Wessex
Robin Edwards	Business Link Wessex
Peter Webber	Business Link Wessex
Steve Richards	South West RDA
Eamonn McArdle	Business Link Berkshire & Wiltshire
Richard Whittall	Eclipse
Howard Chesterton	White Eagle Foundry Ltd
Cedric Clapp	Baker Tilly
Sandhu Hellings	Riskhive
Mike Scott	Barclays Bank
Roger Snary	Barclays Bank
Tim Pezzack	Lloyds TSB
Ian Crompton	Lloyds TSB
Ed Preedy	UK Business Incubation

## Scotland

Jim Glasgow	Scottish Executive
Gillian Calder	Scottish Enterprise
Mike Davidson	ICAS
Robert Patullo	ICAS
Pat McHugh	Scottish Enterprise
Tony Quinn	Scottish Enterprise
Luke Charleton	Scottish Enterprise
Gordon MacLennan	Scottish Enterprise
Neill Sinclair	SERAD

## Wales

Adrian Piper	Bank of England
Ray Pearce	Bridgend
David Leron	ICAEW
Nigel Keane	Wales Social Partners Unit
Sarla Langdon	Markmaid Ltd
Gerald Clark	Kaiak Ltd
Mark Jones	Broomfields
Keith Nicholls	
Russell Lawson	Federation of Small Businesses
Graham Johnson	Welsh Assembly Government

Anna Coleman	Welsh Assembly Governmnet
Phil Godding	Welsh Assembly Government
Mike Davies	Finance Wales
Alun Jones	HSBC
Keith Beaves	HSBC
Ian Lewis	HSBC
Peter Chubb	HSBC
Nick Moon	Finance Wales
Colin Venables	Barclays
Martin Leach	Barclays
Martin Dean	Lloyds TSB
Andy Morris	UK Steel Enterprise Ltd
Marcus Love	UK Steel Enterprise Ltd
Chris Price	RBS

### Northern Ireland

Jill Coulter	Invest Northern Ireland
Ian Murphy	Creative and Design Based Industries
Charles Harding	Invest Northern Ireland
Alan Gourley	Invest Northern Ireland
Gillian McKenna	Invest Northern Ireland
Susan Emerson	Invest Northern Ireland
David Clements	PriceWaterhouseCoopers
Michael Jennings	BDO Stoy Hayward
Michael McAllister	ASM Horwath
John Hansen	McClure Watters Co Ltd
Brendan McCoy	Twin Spires Centre
Margaret Patterson	Ards Business Centre
Liam Quinn	ENI Loan Fund
Sharon Usher	Ulster Bank Ltd
Elvin Henry	Ulster Bank
Andrew Markey	Bank of Ireland
Graham Hunter	First Trust Bank

### West Midlands

Norman Gascoigne	Advantage West Midlands
Norman Price	Advantage West Midlands
Mary Martin	Advantage West Midlands
Andrew Powling	Advantage West Midlands
Andy Smith	Bank of Ireland
John Bartlett	Bank of England

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Ian Mansell	Halifax Bank of Scotland
Bob Cox	Barclays
Graham Crookson	Co-operative Bank
Karen Wolfe-Hermon	HSBC
Gary Miller	HSBC
Richard Jeffries	RBS NatWest

We have endeavoured to ensure that all organisations and individuals are included here. However, if we have inadvertently left anyone or any organisation out of this list, please accept our apologies: it was not intentional.



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