FINANCE FOR SMALL FIRMS

A FIFTH REPORT

BANK OF ENGLAND JANUARY 1998

DEFINITIONS

For the purpose of this report, the Bank focused mainly upon small businesses with a turnover of up to and including £1mn per year. Many of the issues touched on in this report are also relevant to somewhat larger firms.

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SUMMARY

Economic background

- DTI estimates showed that the number of small firms and their proportional contribution to GDP had remained relatively constant. (Paragraph 2.1)
- The proportion of employment accounted for by small firms fell slightly. It is usual for some of the self-employed to return to paid employment during an economic upturn. (Paragraph 2.1)
- Although state of trade indicators of small firm activity remained generally steady, there were signs of an increasing divergence in the performance of small firms according to their sector and main market. (Paragraph 2.3)
- Those small firms which relied on export trade were under increasing pressure to cut margins or reduce costs to maintain export volumes. (Paragraph 2.5)

Bank finance

- The clearing banks remain the main providers of external finance to small businesses, particularly when other types of finance supplied through their subsidiaries are considered. (Paragraph 3.1)
- Small businesses continued in 1997 to increase their level of deposits held with the banks, while remaining wary of borrowing more. (Paragraph 3.3)
- The trend away from overdrafts towards term loans has stabilised, with approximately two-thirds of borrowing taking the form of term loans. (Paragraph 3.6)
- The range of margins normally paid on small business borrowing remained between 2% and 7% with average margins nearer to 4% than to 3%. (Paragraph 3.9)
- The market for small business banking became more competitive during 1997, with many of the banks offering packages to encourage small businesses to change banks. (Paragraphs 3.11 and 3.12)
- The availability of telephone and PC banking has increased and the banks are now making use of the internet. (Paragraph 3.19)
- The banks continued to invest heavily in training and in systems providing business managers with facilities for quick access to small business information. (Paragraphs 3.21 - 3.23)
- There was an increase in the number of enquiries made to the Banking Ombudsman Scheme, which now has 76 members. (Paragraph 3.32)
- There is greater awareness among banks and businesses of the potential benefits of Alternative Dispute Resolution. (Paragraph 3.39)

Other sources of finance

- Small businesses continue to make use of asset-based finance. (Paragraph 4.1)
- The factoring and invoice discounting sector continued to expand, with a 17% increase in the number of businesses utilising these facilities (although the total number of clients is still relatively small). (Paragraph 4.4)
- The factoring industry is very competitive, resulting in reduced costs for services and an increased opportunity for businesses with smaller turnovers to benefit. (Paragraph 4.6)
- Formal venture capital investment increased by 31% during 1996. Reported business angel investment opportunities declined slightly. (Paragraphs 4.10 and 4.13)
- The secondary equity markets continued to expand. (Paragraphs 4.18 - 4.23)
- Pilot mutual guarantee societies have been established. (Paragraph 4.25)

Small businesses

- A number of commentators observed during 1997 that small businesses seemed to be more professionally managed. (Paragraph 5.1)
- Franchising is growing rapidly in the UK and Europe - there are 136,061 franchises within Europe, of which 19,700 are in the UK. (Paragraph 5.9)
- About one in ten UK businesses are owned by members of the ethnic communities. Banks are making efforts to improve the cultural awareness of bank staff. (Paragraph 5.15)
- The number of women starting up their own business is increasing - a trend which looks set to continue. (Paragraph 5.16)
- In spite of a high degree of PC penetration among small firms, they are not exploiting these IT resources to the full. (Paragraph 5.17)

The financing of technology-based small firms

- Government sees its major role as developing the climate needed to encourage innovation, without becoming directly involved in commercialisation. It is well placed to act as a collector and disseminator of information and best practice. (Paragraph 6.15)
- A task force has been established to examine ways of boosting Britain’s record of investment in early stage technology-based ventures, and a steering group has been set up to co-ordinate action in this area. (Paragraph 6.16)
- The Bank has been encouraged by the way the clearing banks have responded to the challenge of adopting new approaches and developing innovative products to assist in the financing of this sector. (Paragraph 6.18)
- It is hoped that information barriers to the successful matching of informal investment

opportunities will be reduced by building on the current combination of national and local introduction networks. (Paragraph 6.20)

- Institutional investors in the US have a more positive attitude towards classic venture capital (as opposed to development capital) than in the UK. (Paragraph 6.25)
- Outside the technology clusters, technology-based small firms in the US face very similar financing problems to those of UK-based firms. (Paragraph 6.27)

Public policy - UK and Europe

- On 11 December, the Government published a Bill on the statutory right to interest on the late payment of commercial debt. (Paragraph 7.2)
- The DTI Small Firms Minister, Barbara Roche, outlined the Government's commitment to excellence in Business Links. Emphasis will be placed on the quality and accountability of the network. (Paragraph 7.8)
- The Government is planning to establish Regional Development Agencies. (Paragraph 7.11)
- The July Budget was generally well received by the small business sector. (Paragraph 7.14)
- The Financial Reporting Standard for Smaller Entities was introduced in November 1997. (Paragraph 7.19)
- The "Amsterdam Special Action Programme" has led to the establishment of the European Technology Facility, targeting SMEs in technology sectors. (Paragraph 7.30)
- Late payment of commercial debt continues to be a problem across Europe. The European Commission intends to adopt a directive on late payment in 1998. (Paragraph 7.37)

Particular challenges ahead

- The level of preparation for the single currency among small businesses generally appears to have been limited in 1997. (Paragraph 8.1)
- Forty two per cent of SMEs believe that EMU will have beneficial effect on their business. (Paragraph 8.6)
- The 'Millennium Bug' has the potential to affect seriously the trading activity of all firms, large and small. (Paragraph 8.10)
- The Government has announced its Action 2000 initiative, the goal of which is to encourage businesses to turn awareness into action. (Paragraph 8.16)
- The year ahead will be a challenging one for the small business sector and for those who provide finance to it. Forecasts point to a slowing in economic activity and, if sterling continues to be strong, SME exporters will face particular challenges. Preparation for the year 2000 and for EMU (even though the UK will not be joining from the outset) will also be an important preoccupation for many small firms.

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SECTION ONE: INTRODUCTION

The Bank of England and small firms finance

1.1 The Bank's first report on finance for small firms was published in January 1994, and the present report is the fifth in this annual series.

1.2 The question posed in 1993 was: why was there so much evidence of dissatisfaction with the financing arrangements available to small firms at a time when their number and significance had been growing so steadily? Relationships between finance providers - particularly the clearing banks - and small firms were then still overshadowed by the traumas of the recession. Today, relationships are on a much more constructive footing, against a background of steady economic growth and relatively low inflation.

1.3 Previous reports in this series have noted progress on the financing of small firms under three broad headings: availability, appropriateness and accessibility. This fifth report identifies further progress during 1997, against a background in which competition between finance providers in this market has intensified. For some time now, small business banking has been profitable again, although the proportion of that profit deriving from lending has fallen, while that from other sources (deposits, money transmission, other services) has risen.

1.4 There will, however, be many challenges for small firms and finance providers in 1998. Most forecasts suggest a significant slowing in economic activity. However, we do not expect major problems to emerge: small firms are now much more cautious in their borrowing and banks make advances more prudently (with a clear preponderance of term debt over overdraft). An increasing amount of finance is asset-based.

The Government

1.5 The election of a new Government in May led to some new emphases in small firms policy, although there has been much continuity as well. Mrs Barbara Roche, Parliamentary Under-Secretary of State for Small Firms, has focused particular attention on late payment of commercial debt, the quality of service provided by Business Links, and the financing needs of technology-based small firms. All of these subjects are touched on in the present report.

The Bank's work during 1997

1.6 The essential foundation of the Bank's work on the financing of small firms is the regular exchange of information and views that we have with the clearing banks and other finance providers, small business representative organisations, the professions, academics specialising in the field, and the relevant Government departments. We are grateful for the time and trouble that is taken to keep the Bank informed, thus enabling us better to perform our catalytic role

1.7 As in the previous year, the Bank devoted a lot of time in 1997 to issues surrounding the financing of technology-based small firms. Carrying forward this work continues to be a major priority. Particular attention has also been paid to small firms and export opportunities. As explained in Section Nine, the Bank will be issuing a separate report on this subject in the near future.

This report

1.8 The structure of this report is similar to its immediate predecessor. After considering the economic background, the report deals with bank finance and finance from other sources, as well as a number of other issues of specific importance and relevance to small firms themselves. A series of special sections follow: on technology-based small firms, on public policy, both in the UK and Europe, and on the particular challenges facing small firms in 1998, namely the euro and the Millennium Problem. The final section concludes and highlights areas of focus for the Bank's work this year.

1.9 The Bank welcomes comments on this report. The names and telephone numbers of the Bank's Small Firms Finance Team are given on page 2.

SECTION TWO: ECONOMIC BACKGROUND

KEY POINTS

- **DTI estimates showed that the number of small firms and their proportional contribution to GDP had remained relatively constant.**
- **The proportion of employment accounted for by small firms fell slightly. It is usual for some of the self-employed to return to paid employment during an economic upturn.**
- **Although state of trade indicators of small firm activity remained generally steady, there were signs of an increasing divergence in the performance of small firms according to their sector and main market.**
- **Those small firms which relied on export trade were under increasing pressure to cut margins or reduce costs to maintain export volumes.**

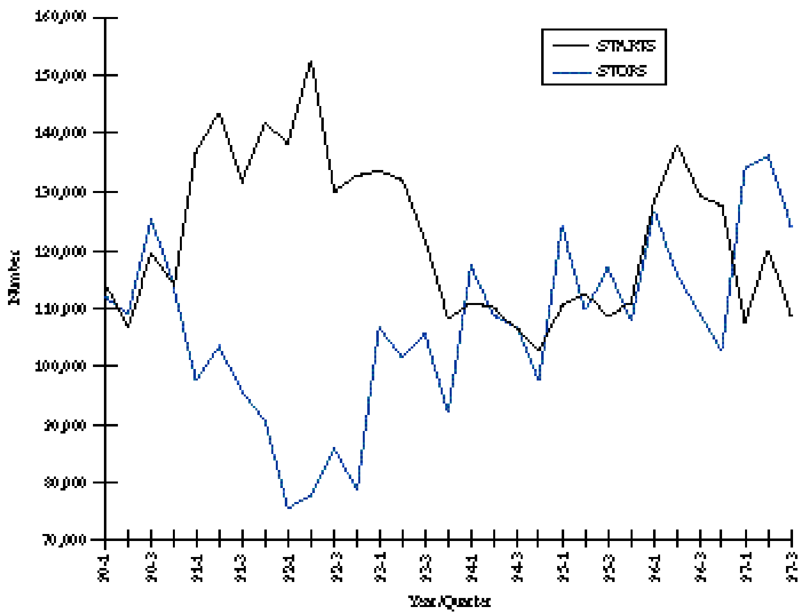
The contribution of small firms to the economy

2.1 According to DTI estimates for 1996, the latest year for which figures are available, the number of small firms in the UK (3.7mn) and their proportional contribution to GDP remained relatively constant. Firms with less than 100 employees accounted for 99.5% of the total business population and 44.3% of total turnover (compared with 99.6% and 44.3% in 1994). The proportion of employment they accounted for fell slightly from 53.7% to 51.2%. This was unsurprising given that, during an economic upturn, it is usual for some of the self-employed to return to paid employment. This could account also for the increase in the proportion of employment accounted for by large firms (500 plus employees), from 34.1% in 1994 to 36.4% in 1996.

2.2 According to estimates produced by Barclays Bank, the number of closures of mainstream[1] businesses during 1996 was greater than the number of start-ups. This trend, however, did not continue into 1997. From Q1, the number of start-ups increased and, over the first nine months of 1997, the number was up 10% on the same period in 1996. The closure rate for those three quarters fell as a proportion of the total business stock. This upward trend in the mainstream business stock was mirrored by the number of businesses started up as a secondary occupation - it appeared that a number of would-be entrepreneurs were waiting to see how business progressed before leaving paid employment.

1 Mainstream businesses refers to those businesses which have been set up as a sole occupation.

Chart 1
Business Openings and Closures 1990 to 1997



Source: Barclays Bank Small Business Bulletin/Barclays Economics Department.

State of trade

2.3 At the end of 1996, trading conditions overall were not as buoyant as had been anticipated and opinion was divided as to whether this slowing in trading conditions would continue into 1997. It did. Although, in the opening months of 1997, the state of trade indicators of small firm activity remained generally steady, there was an increasing divergence in the performance of small firms according to their sector (service v. manufacturing) and main market (domestic v. export).

2.4 The growth in sales of the service sector remained robust as the sector continued to benefit from a healthy level of consumer demand in the domestic market, buoyed by the building society 'windfall' payouts. By contrast, small UK manufacturers experienced a more significant easing in output growth in the domestic market as a result of increasing import penetration

2.5 Reports on the business activity of small firms highlighted the continuing strength of the domestic market relative to the export market, in clear contrast to the position in 1996, when growth in export sales was leading the recovery. The effect of the combination of sluggish European markets and the continued appreciation of sterling began to be apparent early in 1997. Those small firms which relied on export trade were under increasing pressure to cut margins or reduce costs to maintain export volumes and small manufacturing exporters cited prices as the most important constraint on the growth of their business. The level of export sales from the service sector appeared to be much more resilient early in 1997, but this soon started to decline, until the experiences of the manufacturing and service sector were very similar, with the level of growth in their sales at their lowest for several years. This description bears little resemblance to the trend highlighted by the official statistics on export activity in this period, where it appeared that UK exporters had managed to maintain their sales levels. This could be because only a very small proportion of export trade is accounted for by small firms. It also masks the indirect effect of the appreciation of sterling on small firms, as a much larger number of small firms are suppliers to large exporters. In order to keep export markets, these large firms have placed increasing pressure on their cost base. As a result, small suppliers have either seen their own margins progressively squeezed or their customers switching to international markets to source cheaper inputs.

2.6 These differences in trading performance impacted on the level of investment by small firms. Investment in plant and machinery dropped slightly, although some firms took advantage of the appreciation of sterling to purchase imported capital goods. Many small exporters deferred investment unless it was for efficiency gains. By contrast, there was a tightening of the labour market. The shortage of skilled labour was seen as an increasing constraint on growth and it was felt that recruitment difficulties, especially in IT, management and the professions, might lead to wage inflation. As a result, there was an increasing emphasis on investing in staff training. Employment creation was strongest in the service sector.

2.7 Understandably, the level of business confidence has fallen among small exporters. Overall, however, most small business owners are relatively optimistic about future trading conditions. Although it is anticipated that the economy will continue to grow in 1998, forecasts predict a significant slowdown in growth during the year.

SECTION THREE: BANK FINANCE

KEY POINTS

- **The clearing banks remain the main providers of external finance to small businesses, particularly when other types of finance supplied through their subsidiaries are considered.**
- **Small businesses continued in 1997 to increase their level of deposits held with the banks, while remaining wary of borrowing more.**
- **The trend away from overdrafts towards term loans has stabilised, with approximately two-thirds of borrowing taking the form of term loans.**
- **The range of margins normally paid on small business borrowing remained between 2% and 7% with average margins nearer to 4% than to 3%.**
- **The market for small business banking became more competitive during 1997, with many of the banks offering packages to encourage small businesses to change banks.**
- **The availability of telephone and PC banking has increased and the banks are now making use of the internet.**
- **The banks continued to invest heavily in training and in systems providing business managers with facilities for quick access to small business information.**
- **There was an increase in the number of enquiries made to the Banking Ombudsman Scheme, which now has 76 members.**
- **There is greater awareness among banks and businesses of the potential benefits of Alternative Dispute Resolution.**

3.1 The majority of small businesses still rely on internal funds as their primary source of finance. A recent survey by the British Chambers of Commerce[2] reported that 79% of small businesses had used retained profits and 72% had used cashflow to fund their activities over the last five years. The main external source of finance used by small businesses is still banks. According to data from the ESRC Centre for Business Research in Cambridge, 52% of external finance is traditional bank finance (overdrafts and term loans). Although this percentage is declining, the banks still provide the majority of external finance for the sector - not least through the provision of other types of finance through their subsidiaries. The move in emphasis away from collateral and towards business plans and cashflow projections as a base for making lending decisions has continued. However, lack of collateral is still cited as a significant barrier to growth by some small firms.

2 British Chambers of Commerce, *Small Firms Survey No.24: Finance* (July 1997).

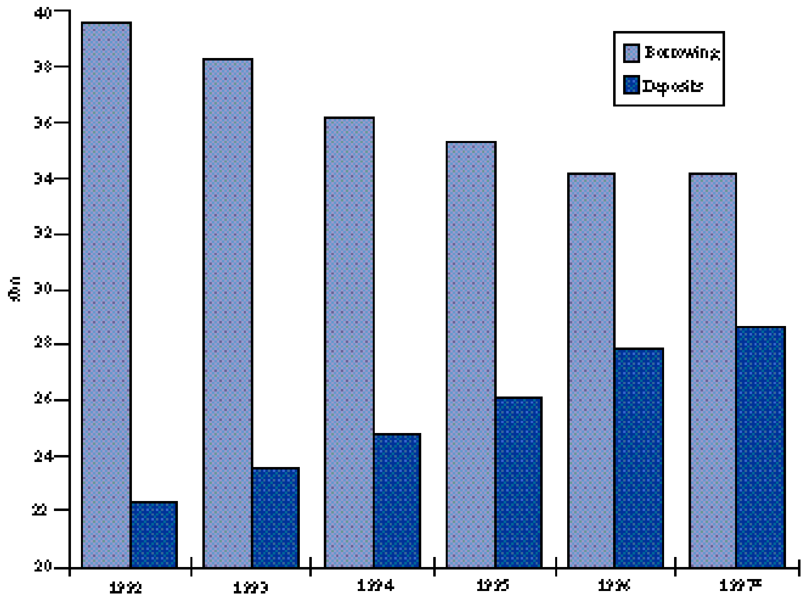
British Bankers'Association figures

3.2 The most recent figures from the British Bankers Association (BBA) showed that total bank borrowing (term loans and overdrafts) by the small business sector increased slightly for the first time in eighteen months. Banks' total lending at end-June 1997 was £34.1bn, an increase of £100mn since December 1996. This marginal increase did not, however, signify a move from the overall trend of falling borrowing levels. Over the last five years, total borrowing by the small business sector has fallen by 14% from £39.5bn[3] at end-December 1992. The relatively high level of borrowing at that time - 1991 and 1992 were clearly the peak years - primarily reflected the financial pressures exerted on small firms by the recession. Accordingly, since the recession ended there has been, as expected, a reduction in the external borrowing requirement of small firms, which have been able to rely more on retained earnings. This reliance may also have been accompanied by a reluctance of business owners to expose themselves again to a high level of debt finance, following the problems experienced in the last recession. Alongside this, there was a positive move away from traditional debt finance towards a wider range of alternative financing products which, in certain cases, provide a more appropriate source of finance. This trend has been particularly noticeable in the increased use made of asset-based and receivables financing. The Bank of England has worked with the BBA, Factors and Discounters Association, and the Finance and Leasing Association, to improve the statistical information on the levels of financing made available through the banks' factoring and leasing subsidiaries. This work will be continuing into 1998, alongside the Bank's and the Government's commitment to produce more comprehensive data on the range of external sources of finance accessed by the small business sector.

3.3 Total bank deposits held by the small business sector continued to increase. Figures for the first half of 1997 indicated that deposits increased by £900mn over December 1996, to a total of £28.7bn. This figure equates to 84% of the total level of borrowing by the small business sector. Over the last five years, deposits held by small businesses have increased by £6bn, with deposits rising by £2bn in the year to June 1997. The trend for small businesses to hold increasing levels of deposits can be attributed to several reasons. Firstly, evidence shows that small businesses tend to rely heavily on internal funds both for operating and investment purposes, preferring to use internal sources of finance rather than incur the cost of borrowing. Secondly, there is still concern among businesses that the current stable economic climate will not continue indefinitely. Consequently, businesses are building up reserves to act as a buffer in the event of a downturn. This cautious behaviour reflects in part the disproportionate level of damage caused to the small business sector in the last recession.

3 British Bankers Association.

Chart 2
Banking Trends in the Small Business Sector, 1992 to 1997



Source: British Bankers Association

* June figures

3.4 Provisions against small business lending remained low in 1997 compared with previous years, although the trend in provisions, which had previously been falling, levelled out. There was a slight improvement in the quality of loan books, although the improvement was small compared with previous years. Overall, the last four years have witnessed a dramatic decline in provisions against small business lending, as the quality of loans books has increased steadily.

Packaging of finance

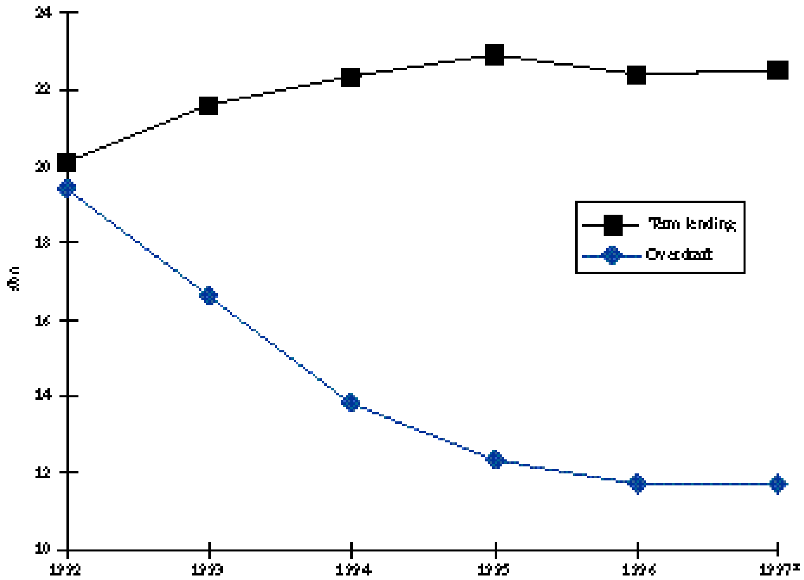
3.5 Recognising the importance of matching appropriate finance to the needs of small businesses, banks have become more proactive in developing financing packages. All of the major UK banks have their own factoring and leasing subsidiaries, and some of them also offer quasi-equity products. The banks have also become more sophisticated at segmenting the marketplace. Start-up companies and their particular financing needs have been a key focus of marketing attention. The recent British Chambers of Commerce survey[4] on the small firms sector suggested that 81% of all respondents were content with the range of financing products available, although this figure rose to 100% for firms employing 51+. The sector believed that the availability of finance was improving year-on-year. Use of the full range of products available depended on understanding and information. Understanding of bank finance, leasing and factoring was very high, while understanding of equity finance and the Small Firms Loan Guarantee Scheme remained disappointingly low.

3.6 The Bank of England expressed concern in its earlier reports at the dependence of small businesses on overdraft facilities for purposes other than working capital. Evidence in the early 1990s suggested that many businesses were using overdrafts to finance long term business expansion. This dependence on overdrafts has declined significantly over the past four years, as small businesses have made more use of term loan facilities. The latest BBA figures showed that there had been a small increase in term lending to £22.5bn during the first six months of 1997.

4 British Chambers of Commerce, *Small Firms Survey No.24: Finance* (July 1997).

Borrowing on overdrafts remained constant at £11.7bn, and so there was a marginal shift in the ratio of term loans to overdrafts, which now stands at 66:34. In 1993, it was 44:56. In addition, fixed rate term lending has increased in relation to variable rate lending. This slight trend towards fixed rate loans resulted in a ratio of 30:70 fixed rate to variable rate lending in 1997. This is approximately the same proportion as in the US. The Bank anticipates that the ratio of overdraft to term lending will now remain reasonably constant. The overdraft facility will always be important to small businesses as a flexible source of working capital.

Chart 3
Small Business Sector Borrowing, 1992 to 1997



Source: British Bankers Association

*June figures

3.7 Information is now provided by the BBA on the structure of major banks' term lending to small firms. Most loans had a residual maturity by value of five years or more.

Table 1
Residual Maturities

	Dec-96	%	Jun-97	%
Less than 3 years	£5.40bn	24%	£5.60bn	25%
3-5 years	£2.40bn	11%	£2.60bn	11%
5-10 years	£6.40bn	28%	£6.30bn	28%
10+ years	£8.20bn	37%	£8.00bn	36%

Source: British Bankers Association

3.8 Most banks are looking innovatively at how to provide appropriate finance for small high growth companies. Lloyds launched an Equity Option Loan on 1 August 1997, which provides finance in return for an equity option on the business. NatWest has developed the Debtor Finance Facility (DFF), which provides a flexible overdraft facility reacting to movements in debtor levels. The other clearing banks also continued to offer a range of equity products. The banks have also become involved, to varying degrees, in business angel finance. NatWest runs the NatWest Angels Service, which matches business angels with appropriate investment opportunities, and some of the other banks provide sponsorship for Business Angel Networks (BANs), such as the Local Investment Networking Company (LINC) (see paragraph 4.14).

Risk pricing/charges

3.9 Average bank lending margins to small business customers remained between 3 and 4% above base rate during 1997. This figure has been reasonably constant over the last five years, although margins were closer to 4% during 1993/4 and then fell towards 3%. They are at present closer to 4% again. Margins vary between banks, and between term loans and overdrafts. The **range** of margins charged also remained reasonably constant in 1997, with the majority of authorised lending falling between 2 and 7%. Some of the smaller banks continued to have a larger spread. Unauthorised borrowing continued to command very high penal rates of interest. The margin charged by a bank is dependent on the risk profile of the business and the amount of security available. The banks claim that they are becoming more flexible in their lending criteria, with less emphasis on small businesses providing collateral, and more acceptance of business plans and cash flow projections as assurance of ability to make repayments. Despite this, small businesses continue to cite lack of collateral as a major barrier to growth[5] (see paragraph 7.20).

3.10 Nominal bank unit transaction charges remained largely unchanged, with most banks freezing their tariffs for the third or fourth consecutive year. This has resulted in bank charges falling, in **real** terms, continuously over recent years, according to the Small Business Perspective Bank Charges Index. This fall has been more notable for the big four banks than for the others, although the indices are beginning to converge. Over recent years, banks have gained an increasing proportion of their small business sector income from non-interest sources, obtaining approximately one third of this income from bank charges. Charging policy has become more transparent. The banks also gain income from the high level of deposits held by the small business sector, which tend to be in non-interest bearing accounts.

Competition in the market

3.11 The issue of the level of competition in the provision of finance to the small business sector is raised from time to time. One of the main concerns centres around the limited number of active players in the market. Although the Lloyds TSB merger reduced the number of banks, it did mean that the new group could compete more effectively. This has resulted in the closure of a number of branches in areas where there is a duplication of resources, which might be perceived as a reduction in choice by customers in the locality. On the other hand, the merger has also resulted in extensions of service to customers of both brands. In particular, many Lloyds customers based in the North who formerly needed to travel some distance to access bank services now benefit from having more branches available to them through access to the TSB network and vice versa for TSB customers. Although building societies can now lend to small businesses following deregulation, they have not yet entered this market generally. However, the banks are facing increasing competition in the market for money transmission services and other products, both from other banks and non-bank entrants. Building societies are used by small businesses that do not want to borrow and there is the increasing threat from other types of organisations, such as supermarkets. Other new entrants, such as Virgin, are competing in the provision of other financial products.

5 The Institute of Chartered Accountants in England and Wales (ICAEW), *Going for Growth* (October 1997).

3.12 This competition in the non-lending market means that the banks are looking to attract new customers. They have targeted the start-up market by offering initial periods of free banking. They are offering packages to ease the costs to customers of switching banks, while trying to develop packages to retain their good customers. Some bank managers are maintaining shadow portfolios of good, bankable companies. Research carried out by the banks found that ‘switchers’ were generally growth businesses, run by highly educated people, and often needed to borrow. This group tended to move because of dissatisfaction with their current bank rather than because they had been positively attracted to another. The banks believed that they could profit from this small proportion of business customers. Cost tended to be an inhibiting factor in any decision to change banks and, therefore, many of the banks now offer transfer packages - these usually include reimbursing transfer fees and free banking packages for a limited period of time, combined with standardised documents/letters to change standing orders and direct debits to reduce the administrative burden. There has also been an increase in multi-banking by smaller firms. Such firms might not switch their entire account to another bank, but would seek the best deal for specific products.

Relationships

3.13 The clearing banks have continued their efforts during 1997 to improve relationships with their small business customers. All of the banks have adopted the BBA’s Statement of Principles, *Banks and Businesses Working Together*. The statement sets out how banks will work with smaller businesses if they get into difficulties. It emphasises key elements of best practice both for banks and businesses, stressing the importance of transparency in the relationship right from the outset and the benefits of taking early advice if things begin to go wrong.

3.14 These efforts have resulted in higher levels of customer satisfaction. Results of surveys of the small business sector are far removed from those of the early 1990s, when relationships between banks and small businesses had been severely damaged by the impact of the recession. The extent to which present levels of satisfaction reflect the current stable economic climate is yet to be seen, although the banks are confident that they have established relationship structures that can adapt to the needs of small businesses throughout the economic cycle. It is recognised that constant effort is necessary to maintain improvements.

3.15 The increased level of transparency has played a vital role in the improvement of relationships over the last few years. This has been accompanied by more effective communication between banks and their small business clients, enabling bank managers to gain a greater understanding of their customers. According to a recent survey of small businesses[6], small firms felt that their banks had a better understanding of their business - 65% of businesses thought their bank’s personnel knew and understood their business, compared with 55% in 1994. Communication between small businesses and their banks also improved, with over 60% of small businesses meeting regularly with their bank to pass on both good (62%) and bad (69%) news. Sole traders were less likely to have regular meetings.

3.16 The clearing banks are distinguishing to a greater extent the needs of lifestyle and growth businesses. Growth businesses often demand a close relationship with their account manager and appreciate their bank being proactive in the relationship. They expect the bank manager to offer advice on financing and related issues, and seek standards of service and commitment more

6 British Chambers of Commerce, *Small Firms Survey No.24: Finance* (July 1997).

characteristic of larger business customers. Lifestyle businesses may use their banks primarily for transactional purposes and consequently be less in need of a relationship manager.

3.17 Relationships are often threatened by changes, particularly of the relationship manager. Complaints frequently arise at this stage. Lack of continuity creates uncertainty for the business owner, who anticipates having to spend time informing the new manager about the needs of the business. Banks now place much greater emphasis on maintaining the relationships and easing transitions between managers. At present, relationship managers in the major banks tend to stay in the same post for between three and four years - a significant reversal of previous trends.

3.18 Over the past few years, the whole banking sector has gone through a major rationalisation programme, in part arising from the increased degree of automation. The resulting branch closures have been inevitable on economic grounds - the alternative would have been higher charges. Although the benefits of technology within banking - such as telephone and PC banking - are beginning to be appreciated by small businesses, the reduction in counter services in some towns and inner city areas has been a source of concern to some small business customers. Small retail businesses have been particularly affected by this development, as they predominantly use their bank for counter services (including depositing cash). Running counter to this trend, however, Girobank (in conjunction with Post Office Counters Ltd) targets businesses which may be affected by such closures to encourage them to change banks so that they can continue to enjoy counter services via the local Post Office (there are 19,300 branches). In addition, business customers of the Co-operative Bank can, by prior arrangement, also obtain counter services at their local Post Office.

Telephone and PC banking

3.19 The use of telephone and PC banking by small businesses continues to increase. All of the major UK banks now operate PC banking facilities. Some banks are developing lower cost versions of their corporate PC services so as to market them to the small business sector. These facilities provide small businesses with immediate access to their account information and the ability to make certain transactions at any time of the day. This overcomes the limitations of the banks' opening hours, as well as saving the business owner time. These developments are particularly helpful for businesses that use their banks mainly for money transmission and related purposes, and simply require the most cost and time efficient service available. Internet banking is also recognised as an important development opportunity. Some of the major banks have started to make use of the internet by establishing specific business banking and small business banking web sites. Banks are also looking into other ways of incorporating future IT developments into business banking.

Lending structure

3.20 Over the past five years, the banks have become more decentralised in their approach to making lending decisions. The benefits of this move have been reflected in increased levels of customer satisfaction. At present, the majority of banks maintain that over 90% of lending decisions for small businesses are taken at a local level. Decisions that cannot be made at the local level will be referred to regional offices or direct to head office, where the banks seek to ensure that loans are sanctioned as quickly as possible. The demands of businesses have become increasingly complex over the last few years, which has meant that certain loan applications (especially from technology-based firms) have to be referred to specialist managers at regional centres or in other locations. The banks have, over recent years, improved their risk assessment procedures and are now placing increasing emphasis on the use of credit scoring systems. These developments should improve the efficiency of lending decisions and result in reduced costs for small business customers, although work on dealing with the Year 2000 problem has slowed progress on some of these developments.

Training of staff

3.21 During the past five years, the increasing emphasis placed on the need for relationship managers to understand their business customers, and the growing use of cashflow projections and business plans as a foundation for making lending decisions, have resulted in the need to increase resources devoted to training. Initially, the banks concentrated their training budgets on the provision of general advice to their business managers. The Banking Industry Training and Development Council (BITDC)[7] has been conducting research to benchmark the skills of managers dealing with small businesses against the skill levels in other countries. Initial results showed that UK compared well with other EU member countries. Detailed results should be published later this year. The research will also look at the delivery of training, where it is felt more can be achieved by mentoring and distance learning than by traditional classroom-based learning.

3.22 The banks continue to provide general training, while also devoting more resources to specific sector training. Some of the banks have developed PC-based packages to give business bankers quick and easy access to information relevant to the small business sector - providing local information and trade specific data, as well as information on other sources of advice and funding. These systems enable the lending manager to gain a clearer understanding of the external factors affecting the firm. Consequently, when combined with the internal accounts data and management information provided by the business, managers are able to make more informed and accurate lending decisions. The banks also continue to make use of universities and business schools, as well as business clubs and local forums with business owners themselves, to gain more understanding of the pressures faced by entrepreneurs.

3.23 NatWest has developed an externally accredited programme for staff dealing with small businesses. The process consists of a three-part assessment, carried out internally at NatWest, then by Durham University Business School and, finally, by the Institute of Business Advisers. Barclays has committed £4mn to their training initiative ‘Understanding Small Businesses’. All their small business staff will have completed the training by the end of 1997. The other banks also operate training packages to ensure that their small business managers are aware of the issues faced by the small business sector. Lloyds TSB’s ‘Developing the Business’ course which places great emphasis on the need to put managers in the position of the customer to enable them to appreciate the needs of small business.

7 The BITDC has now merged with the Building Societies Association Training Link to form the Banks and Building Societies National Training Organisation.

New initiatives

3.24 The competitive nature of the small business banking sector at present has resulted in a range of new products and facilities for start-up and small businesses.

- Midland's Franchise Loans were launched in April and are aimed at providing flexible finance for franchisees. They also developed a package of facilities in August relating to Vehicle Finance.
- Lloyds TSB have extended their franchising service and the sale of general insurance policies to the client base of former TSB customers.
- To encourage customers to change banks, Barclays has introduced a free business account transfer service for small business customers switching to Barclays.
- NatWest launched its Information Technology Fund on 1 September 1997. This provides equity investment for growth-orientated IT companies with a turnover of £1mn or above.

3.25 The banks have also been active in the production of information regarding the Year 2000 (see Section Eight). Many of the banks are also currently developing products geared towards technology-based small firms (see Section Six), as well as ethnic minority businesses.

Complaints procedures and dispute resolution

3.26 Since 1991, the banks have all developed small business codes of practice or charters, one component of which is a formal complaints structure. If a small business has a complaint it will be addressed initially through the bank's internal complaints procedure. This starts at branch level, but if a settlement is not reached there it may have to go on to the regional and head office levels. Deadlocked cases can be referred to the Banking Ombudsman if they fall within his terms of reference. The whole process can be arduous and time consuming. In recognition of this, some of the banks have reduced the three-tier internal structure to a two-tier structure - disputes not solved at branch level now go straight to head office. A welcome development is the BBA's Statement of Principles, *Banks and Businesses Working Together*, which came into effect on 1 July 1997. This statement sets out how banks should work with smaller businesses in difficulties. It outlines key elements of best practice both for banks and businesses, emphasising the need to get relationships right at the outset; the benefits of taking early advice; and action required if things begin to go wrong. The statement will be reviewed by the BBA in 1999, in consultation with the Government, small business representative groups and the Banking Ombudsman.

3.27 The Bank is also aware of recent publicity regarding overcharging of small business customers by banks. Media attention has focused on the findings of research carried out by organisations such as the Independent Banking Advisory Service (IBAS) and Anglia Business Associates. An IBAS report on bank customers in litigation claimed that banks make use of the legal system to prevent the Office of the Banking Ombudsman investigating claims fully. Anglia Business Associates, an organisation that checks accounts for cases of overcharging, suggested that banks were deliberately obstructive about releasing documents when claims were brought against them. This issue was also addressed in a BBC Watchdog programme. Such problem cases are thought to represent a small minority, but they tend to draw a disproportionate degree of media attention and consequential reputational damage to the banks.

The Banking Ombudsman

3.28 The Banking Ombudsman scheme is an independent industry-based dispute resolution system. The Banking Ombudsman, currently David Thomas, is appointed by and responsible to an independent council. This council consists of eight members, five independents and three appointed by the banks. The role of the council is to ensure the independence of the scheme, to give general advice and guidance to the Banking Ombudsman and to monitor the terms of reference. The council does not get involved in individual complaints. The scheme is constituted as a company, the Office of the Banking Ombudsman, and the member banks appoint the board. The Board is responsible for financing the scheme through subscriptions from the member banks (currently 76).

3.29 The Banking Ombudsman has always been able to deal with claims from sole traders and unincorporated businesses. His powers were extended to cover small companies (designated as those with a turnover of less than £1mn) on 26 January 1993, subject to his terms of reference. Claims must not exceed £100,000 and must be referred to the Banking Ombudsman within six months of the claim reaching deadlock. The complaint must not have arisen before the member bank joined the Scheme and must relate to a banking service provided in or from England, Wales, Scotland or Northern Ireland. Disputes arising from banks' commercial decisions - for example margins and lending decisions - are excluded from the scheme unless there has been maladministration. Since 1 July 1997, the Banking Ombudsman has had the power to take on any case where he believes the BBA's Statement of Principles has been breached. The new Financial Services Authority has published a consultation document 'Consumer Complaints' considering the future of Ombudsman schemes. The Government's intention is to consolidate the various ombudsmen and arbitration schemes into a single entity.

3.30 The Banking Ombudsman's annual report for 1996/7 showed that, in the year to 30 September 1997, business accounts represented 10% of the total 26,561 telephone enquiries and 17% of the 8,818 written complaints. Many cases were settled by conciliation but, of the 674 cases that needed to go on to a full investigation, 22% were business complaints. Full investigations into business complaints take up a disproportionately large amount of time, as they tend to be more complex than personal disputes. Complaints arising from overcharging on small business accounts are often complicated for three reasons. First, they tend to occur and accumulate over a number of years; secondly, it is often hard to establish the extent of the damage to the business that can be attributed to the bank's errors; and, thirdly, the claimant will sometimes have unrealistic expectations of the outcome, hoping to receive much more compensation than can be realistically justified. This last factor means that, even when cases go in favour of the small business, the latter is often still dissatisfied with the result. Customers are entitled at this stage to proceed to litigation (if they can afford to do so).

3.31 Although the Scheme - put in place by the banking sector itself - has undoubtedly contributed to increased customer satisfaction, problems still occur. These generally fall into two categories: first, complaints that, for one reason or another are excluded from the Scheme, and secondly, problems arising within the current complaints procedure. Some complaints fall outside the Banking Ombudsman's terms of reference. These cases sometimes force small businesses into litigation against their banks on a "loser pays the costs of winner"[8] basis. This is often too costly and time consuming for the business to pursue. There are also some complaints

8 Lord Irvine has proposed new rules that will widen the category of cases where solicitors acting for a plaintiff can work on the basis that, if they win the case, they can take a percentage of the award. This might be beneficial to smaller businesses.

that never reach the Banking Ombudsman, although they do fall within his remit. This may be due to a lack of awareness or to a reluctance on the part of the complainant to pursue complaints, either because of the time involved in the process or a misplaced fear that the Scheme is biased in the bank's favour. Difficulties may also occur, because once a case has become the subject of litigation, it is no longer eligible for investigation by the Banking Ombudsman. Both the legal profession and the Banking Ombudsman have argued that it should be possible for cases to be removed from court proceedings if the industry-specific ombudsman is considered a more appropriate route.

Alternative Dispute Resolution

3.32 There are many different forms of Alternative Dispute Resolution (ADR) including arbitration, mediation, conciliation, neutral evaluation and "mini-trials" or executive tribunals. Arbitration is often not classified as a method of ADR as it is governed by a series of statutes, principally the Arbitration Acts, and is the only alternative to litigation where a legally binding decision is required. The parties involved in arbitration will appoint an independent 'expert'[9] to settle their dispute. Mediation is by far the most common form of ADR. It is non-binding and is facilitated by a neutral mediator. Mediation is stated to have a 90% success rate[10] and can reduce both the cost and time involved in resolving a dispute. The 'average' dispute concludes within 5-7 hours with a mediator, after preliminary preparation sessions have taken place. Some organisations will not levy any charges until the case has reached the mediation stage. Mediation can allow flexibility in solving problems, as it is not limited by a strict legal framework. Some organisations will, with the consent of both parties, allow solicitors to be brought in to draw up a contract or "consent award", once a conclusion has been agreed.

3.33 ADR is quicker and cheaper than litigation and it allows the parties to be involved in the dispute settlement procedure. It is a private process that consequently tends to be less damaging to relationships.

Recent developments

3.34 Because of imperfections in the system of disputes resolution, small (and other) businesses have begun to look beyond the internal bank complaints procedure towards alternative dispute resolution. Since 1990, several ADR organisations have been established, providing either arbitration or mediation services. This has increased the level of awareness of ADR. The courts are already taking a proactive and positive approach to ADR, as required by Mr Justice Waller's practice statement of June 1996. There have been other important developments in this area, supported by key initiatives such as the 1996 Arbitration Act and Lord Woolf's "Access to Justice" report. These encourage increased use of ADR in dispute settlement, as well as a higher level of integration between the legal profession and ADR organisations (especially industry-specific ombudsmen). The hope is that ADR will become a filter system for the courts.

3.35 As well as improving their small business complaints procedures, banks have become increasingly aware of the benefits of ADR in settling disputes with small business customers that cannot be resolved internally and fall outside the Banking Ombudsman's remit. Some of the major UK banks are currently carrying out pilots with ADR organisations to test the effectiveness

9 It is recommended by most organisations, including the Chartered Institute of Arbitrators, that the arbitrator be an expert in the field of the dispute, as opposed to someone from the legal profession.

10 Careful analysis will take place to test the suitability of a case for mediation. This is why such a high success rate can be achieved.

of the approach. They believe that ADR could be potentially very beneficial in providing a private settlement that both satisfies the complainant and keeps the case out of the media. The Bank is encouraged by this trend, and will continue to monitor developments.

SECTION FOUR: OTHER SOURCES OF FINANCE

KEY POINTS

- **Small businesses continue to make use of asset-based finance.**
- **The factoring and invoice discounting sector continued to expand, with a 17% increase in the number of businesses utilising these facilities (although the total number of clients is still relatively small).**
- **The factoring industry is very competitive, resulting in reduced costs for services and an increased opportunity for businesses with smaller turnovers to benefit.**
- **The formal venture capital investment increased by 31% during 1996. Reported business angel investment opportunities declined slightly.**
- **The secondary equity markets continued to expand.**
- **Pilot mutual guarantee societies have been established.**

Asset-based financing

4.1 Operating leases and hire purchase continue to be the forms of asset-based finance most frequently used by small firms. Both offer the business the ability to spread the initial cost of purchasing an asset over all or most of the asset's lifespan. They also enable a business to purchase an asset without increasing its capital gearing ratio. There is no comprehensive data available on the total value of leases extended to the small business sector, although a survey[11] carried out by the ESRC Centre for Business Research in Cambridge suggested that, in 1995, hire purchase and leasing accounted for 31% of all external finance utilised by small firms.

4.2 Research carried out by the City University Business School[12] found that leasing was size dependent, with smaller companies more heavily dependent on asset-based financing than their larger counterparts. The research showed that 50% of SMEs used leasing, amounting to 19% of their total debt, compared with only 7% for companies of all sizes. The report also indicated that businesses of different sizes had different reasons for making use of leasing. Smaller businesses tended to use leasing to finance their survival and growth, whereas larger companies used leasing because of tax advantages. Within the category of SMEs, it was the growing companies which made the most use of asset finance. The use of leasing was dependent on the economic cycle - predictably, in the last recession the volume of leasing activity declined substantially.

4.3 During 1997, the Finance and Leasing Association (FLA) expressed concerns about two measures included in the July Finance Bill. First, in the FLA's view, the apportionment of capital allowances in respect of finance and leasing companies placed this means of finance at a competitive disadvantage. This, combined with the exclusion of leased assets from the doubling (for one year only) of first year capital allowances for SMEs effectively raised the cost of investment for SMEs using leased assets as compared with those which were in a position to

11 ESRC Cambridge Centre for Business Research, *The Changing State of British Enterprise* (1996).

12 City University Business School, *The role of leasing in the financing of small and medium-sized companies* (1997).

claim capital allowances themselves. These measures, however, ultimately formed part of the Finance Act.

Factoring

4.4 Factoring has become increasingly important to small businesses as a source of working capital over the last few years. A recent survey by the British Chambers of Commerce showed that there was a discernible move towards the use of factoring/invoice discounting through 1996, with 11% of respondents using receivables finance. The same percentage of businesses also believed that this would be a more important source of finance in the future. Factoring is a flexible form of financing that enables businesses to grow in line with their sales. In general, a factor will advance up to 80% of the invoice value immediately, with the remainder (minus the service charge and interest) being paid once the transaction has been completed. The factor can dedicate more resources to credit management than the small business, which can have a beneficial effect on payment periods. During 1997, figures from the Factors and Discounters Association, which accounts for over 90% of the factoring industry, showed a 19% increase in funds provided by factors and discounters, and a 17% increase in the number of firms using their services. Although the industry is rapidly expanding, there are still only just over 20,000 businesses making use of factoring, so there is still scope for expansion. In June 1997, the total level of prepayments - finance actually advanced to businesses - was £3.4bn, a rise of 14% on the first half of 1996.

4.5 The UK's international factoring business has been growing at a significant rate, although this is from a very small base. International factoring accounted for £650mn of factoring volume in the first half of 1997, compared with total domestic factoring volume of £5.8bn. Export factoring offers a range of benefits to small businesses wishing to operate in overseas markets - information on overseas buyers' creditworthiness, advice on trading terms, and protection against exchange rate risk.

4.6 Small business clients continue to benefit from intense competition within the factoring industry - in terms of reduced costs and of the willingness of larger factors to consider smaller clients. Small businesses also benefit from the on-line information technology that factors use. This enables them to access a wide range of information on finance available for drawdown, individual customer accounts, and reports on the whole sales ledger.

Equity finance

4.7 Despite the benefits external equity finance can offer, very few small businesses actually make use of it. Research[13] undertaken by the ESRC Centre for Business Research in Cambridge indicated that only 3% of external financing to small businesses in 1996 was in the form of equity. A recent BCC survey[14] found that only one third of businesses were prepared to consider equity financing as a way of expanding their business. There are two possible reasons for this reluctance. First, there may be a lack of understanding of equity finance among small businesses. Secondly, the desire of many UK entrepreneurs for independence may make them unwilling to sacrifice any degree of ownership, even if it could result in higher profits. This contrasts with the US, where wealth creation is thought to be a more important motivator. Use of

13 ESRC Cambridge Centre for Business Research, *The Changing State of British Enterprise* (1996).

14 British Chambers of Commerce, *Small Firms Survey No.24: Finance* (July 1997).

equity finance is positively correlated to the amount of funding that a business requires. According to a report by the Institute of Chartered Accountants in England and Wales[15], equity financing was seldom used for financing of less than £30k. For amounts of between £30-500k, however, venture capital, both formal and informal, became more important - 20% of respondents approached business angels and 18% approached venture capitalists. These results are consistent with the theory that small businesses will only consider equity finance once internal sources and debt finance have been exhausted.

4.8 Banks have become more active in the provision of equity finance. Some of the banks have launched equity option loans of varying types and all own venture capital arms. The banks have been proactive in promoting the role of business angels through supporting business angel networks (BANs) (see paragraph 3.8). In Scotland, the Scottish Equity Partnership, which makes equity investments of between £50,000 and £500,000 in Scottish businesses, has continued to be active and has recently established - jointly with 3i - the Scottish Technology Fund, which will make investments of up to £100,000 in start-up companies.

Merseyside Special Investment Fund

4.9 The Merseyside Special Investment Fund (MSIF) is funded jointly by the European Regional Development Fund (£5mn) and the UK Government (£5mn), with further support from the Merseyside local authorities' pension fund (£4mn) and Pilkington's pension fund (£1mn). The European Investment Bank provides guarantees. The MSIF was established as an experimental investment fund for small and medium sized businesses on Merseyside. It operates as an umbrella for three funds: a £10mn fund to provide equity finance, a £10mn fund providing unsecured mezzanine loans and a £5mn fund to provide loans to small businesses, particularly geared towards businesses in inner city areas. Since August 1996, the fund has made 130 investments. It has committed £5mn of funds, which have levered a further £19mn from private equity providers and banks. There are suggestions that the MSIF might be used as a model for encouraging investment in other parts of Europe.

Venture capital

4.10 The venture capital industry continued to grow substantially during 1996, with the amount of investment in the UK by BVCA members increasing by 31% to £2,806mn. The total value of venture capital invested in early stage deals reached its highest level since 1990 (£131mn). Although such early stage investment showed a substantial rise (up 54% compared with 1995), it still accounted for only 5% of total financing by value.

4.11 In 1996, £2,445mn was raised in the form of new commitments to independent funds (as opposed to 'captive' venture capital organisations which are owned by banks and other institutions). This was substantially higher than the £749mn raised in 1995, but less than the £2,551mn raised in 1994. This financing came principally from pension funds and insurance companies.

15 ICAEW, *Going for Growth* (October 1997).

Venture Capital Trusts and Enterprise Investment Scheme

4.12 Venture Capital Trusts (VCTs) were created by the 1995 Finance Act. The VCTs invest principally in new shares and securities, including loan stocks, of unquoted companies. These can include shares and securities of companies that are listed on the Alternative Investment Market (AIM). In the period from August 1995 to September 1997, over £360 million was raised by eighteen VCTs, of which £90.6 million was invested[16]. The level of investment increased substantially between June and September 1997. Sixteen per cent of funds (£14.6mn) were invested in early stage situations.

4.13 The Budget on 2 July drew attention to some misuse of VCTs and the Enterprise Investment Scheme (EIS) and announced a review of these schemes. The proposed changes could include preventing VCTs from making investments where a substantial part of the return to investors is guaranteed, and reviewing the position of investments with high asset backing. The suggested changes to the EIS could result in investments with predetermined exits and fixed or minimum returns being ineligible for tax relief.

Business Angels

4.14 The BVCA reported a slight decline in the number of business angel investment opportunities in the year to June 1997[17], despite the record number of registered business angels (5,600). In 1996/97, over £19mn (1995/6: £22mn) was invested by 373 business angels in 192 UK companies (1995/6: 212 companies); 44% of the business angel investments were as part of a larger financial package provided by the banks and others; and 77% were amounts of £50k or less. The slight decline in investment opportunities does not, however, detract from the overall trend of rapid expansion over the last five years. Moreover, reported business angel activity is only a small proportion of total informal venture capital investment, as the market is largely invisible.

4.15 Research carried out by the University of Southampton[18] suggested that the number of business angels registered in the current BVCA directory involving both under- and over–counting. Some business angels are registered with more than one business angel network (BAN), while many are not registered at all (only 20% of business angels are believed to register with a BAN). Taking these and other factors into account, it is estimated that there are around 18,000 active and potential business angels in the UK. The research also suggested a "ballpark" estimate of current annual business angel investment activity in the UK of around £500mn in 3,500 businesses. Business angels are thought to make approximately 10 times as many investments as formal venture capital funds in early stage businesses, and to invest nearly four times as much in total.

4.16 Although this is an increasingly important source of finance, the UK still lags behind the US, where business angel finance accounts for five times as much investment in technology-based firms as the formal venture capital sector. Research carried out by LINC[19], between 1994 and 1996, showed that the majority of businesses invested in through LINC were either start-ups

16 Coopers and Lybrand, *Venture Capital Trusts - Issue 3*.

17 The University of Southampton on behalf of the BVCAanalysed investment data provided by 36 of the 43 listed networks for the year ending June 1997.

18 Working Paper No 15 *Supporting the Informal Venture Capital Market: What More Needs to be Done?* (1997).

19 LINC, *The Informal Venture Capital Experience* (1997).

or at an early stage in their development - 71% of businesses were less than three years old. LINC found that the average cost of raising funds, including professional fees, was 5.1% of funds raised for the entrepreneur and 2.8% for investors; and 98% of funds were transferred within three months of the initial meeting.

4.17 There are at present 43 business angel networks (BANs) which aim to bring potential investors into contact with business opportunities. Concern has been expressed over the fragmentation of these networks, pointing the need of a single national network. There is debate, however, as to the extent to which this fragmentation affects investment, given that many business angels, with the exception of technology angels, tend to invest within a limited geographical area. The DTI is considering this issue with interested bodies. The internet could play an important role, building on the Enterprise Zone (the Government's internet site for small businesses - see paragraph 7.27). Recently, attention has been focused on encouraging business angels to co-invest in projects, either with each other or with formal venture capitalists. The promotion of co-investment might encourage more investors to act as business angels. This would be especially beneficial for first time investors, who might appreciate the security of investing alongside an experienced business angel.

4.18 There have been uncertainties surrounding the restrictions imposed by the Financial Services Act (FSA) on introduction services which match business angels and business opportunities. This issue has been of concern to professions involved in the provision of business advice, particularly accountants. According to the ICAEW, some general practice members of the accountancy profession are unclear of the boundaries of the Act and therefore were reluctant to participate in business angel introduction services. The DTI are currently investigating this issue and will be discussing any findings in the context of the review of the FSA.

Secondary equity markets

4.19 The development of secondary equity markets has enabled smaller companies to access reasonably liquid markets for the transfer of their shares. They also provide important exit routes for venture capitalists. At present, these markets are generally performing well, although secondary markets have, in the past, proved to be more volatile than the London Stock Exchange (LSE). This volatility would be reduced if the markets succeeded in gaining a higher proportion of institutional investors. This is a hard task, however, as many institutions have found investing in small companies to be too high risk, too labour intensive and difficult to research.

AIM

4.20 The Alternative Investment Market (AIM) was established by the LSE in June 1995. It was designed to provide cheaper and easier access to equity capital than a full listing on the LSE's official list. AIM has grown rapidly since its opening and has generally been considered a success. As at end-September 1997, it had 294 companies (including 20 from overseas) with a total market capitalisation of £5.5bn. AIM has less onerous regulation and lower costs than a full listing. Regulations, however, have been tightened during the last year, causing some companies to question the benefits of an AIM listing. The estimated cost of a floatation is 6-9% of total proceeds, although this can rise to 10-11%. This cost is only marginally less than that of a full listing, although the ongoing costs of AIM are lower. AIM is maintained as a broad-based market to avoid undue suceptibility to changes in any specific sector.

4.21 AIM does not market itself as a stepping stone to the official list. Many nominated advisers are keen to see companies remain on AIM, because of the more suitable environment and increased visibility it offers. A number of venture capital firms have favoured exit routes via an AIM flotation, because the greater visibility in a smaller market can attract more interest than a full listing. A recent survey carried out by AIM[20] found that, although institutions put up 62% of capital in AIM flotations, they owned only 22% of the market. Directors and founders held the largest share (38%), followed by private investors (31%). Venture capital firms retained holdings worth 5% and 'others' accounted for the remaining 4%. The organisers of AIM tried to encourage more institutional investment, but progress has been relatively slow - some institutions have had to change their articles of association to allow them to invest in AIM stocks. There have been some concerns over the liquidity of the market, although the survey showed that 66% of companies found the trading in their shares as good as, or better than, expected. However, it was pointed out that small or tightly-held companies needed to have realistic expectations about the level of trading they could achieve.

OFEX

4.22 OFEX, which is independent of the LSE, was established in September 1995. It is operated by J P Jenkins and is an unregulated market. OFEX is often seen as a feeder to AIM, although there are some well established companies that have stayed on OFEX because of the more relaxed listing conditions. At end-November 1997, there were 117 companies trading on OFEX with a total market capitalisation of £2.1bn. On average, 25% of the shares registered are actively traded at any one time - either on a matched bargain basis, or in a conventional market-making fashion. The cost of registering is approximately £4,000 - £5,000 to produce the application and there is an annual fee of £3,500, which compares well with AIM. However, costs are dependent on the financial and legal advice taken during the process.

EASDAQ

4.23 EASDAQ, launched in September 1996, is a quote driven market modelled on NASDAQ in the US. It is intended to bring high-growth enterprise companies, investors and financial intermediaries together in a highly liquid, pan European stock market. It is geared towards the trading of technology shares. At end-November 1997, EASDAQ listed 23 companies, of which at least 7 had a listing on NASDAQ as well, and a total market capitalisation of US$5bn. EASDAQ was originally aimed at small companies, but found that many small companies favoured listing on domestic markets. In practice, EASDAQ targets medium sized firms - the average capitalisation of EASDAQ companies is US$260mn, compared with US$107mn for Euro.NM companies (see below). Each company is required to retain a sponsor and at least two market makers.

Euro.NM

4.24 In March 1996, the Paris and Brussels exchanges commenced the Euro.NM initiative, which was formalised in a collaborative agreement in December 1996. This pan-European

20 *AIM News*, London Stock Exchange (October 1997).

initiative now involves a number of continental European stock exchanges (Paris, Amsterdam, Brussels and Frankfurt) and aims at facilitating the listing and trading of small European start-up, technology-based and high growth companies on member exchanges. The Euro.NM agreement is based on common procedures for listing, trading and sponsoring of high technology and high growth companies by a sponsor/market maker. It is not a market per se, like EASDAQ, but more a means of joint promotion of the member exchanges' domestic markets for smaller companies. It is planned that Euro.NM will have a common trading feed between the member exchanges in place by mid-1998, allowing market makers and brokers on one exchange to view and trade on individual member markets, using the single market provisions of the Investment Services Directive. Trading on Euro.NM markets is a hybrid system, involving a combination of call auctions (for retail orders) and market makers (for institutional investors). As for listing procedures on a member exchange, companies are required to have at least one sponsor and one market maker, who has a contractual obligation to make a market in the company's stock for the first twelve months after floatation. At end-November 1997, Euro.NM had 57 listed companies with a total market capitalisation of £6.1bn.

Grants

4.25 Grants are potentially a very useful source of additional finance for small businesses. There is still some lack of awareness among businesses of the grants available and how to access them. Organisations such as the Enterprise Advisory Service hold databases of information on grants, which businesses can access for a fee. The Royal Bank of Scotland provides up-to-date information on nearly 2,000 central and local government and EU grants from around 400 ources. NatWest also produces a publication *Help for your Business* giving information on grants. Business Links have improved their facilities offering advice and signposting customers to relevant grant and soft loan schemes as well as providing assistance in preparing applications.

Mutual guarantee societies

4.26 Mutual guarantee societies are a relatively recent development in the UK. They are much more prominent on the continent where they are often supported by public funds. There are at present eight pilot societies in operation in the UK with support from the EU. The National Association of Mutual Guarantee Societies hopes to launch seven or so societies each year, with 50 to 100 members. Mutual guarantee societies are structured as industrial and provident societies, similar to building societies. Businesses join together to provide cash security against which banks can lend. The intention is that members can borrow according to their financial needs against the pooled security of the society. The Government has been supportive of this initiative. The Co-operative Bank has agreed to reduce its normal interest rates on business loans by two percentage points to mutual guarantee society members and the Unity Trust Bank is also supportive. The banking industry has, in the past, questioned the viability of mutual guarantee societies where there is no public funding. However, they are closely monitoring recent developments to assess the effectiveness of the societies and the extent to which mutual guarantees justify reduced lending margins.

SECTION FIVE: SMALL BUSINESSES

KEY POINTS

- **A number of commentators observed during 1997 that small businesses seemed to be more professionally managed.**
- **Franchising is growing rapidly in the UK and Europe - there are 136,061 franchises within Europe, of which 19,700 are in the UK.**
- **About one in ten UK businesses are owned by members of the ethnic communities. Banks are making efforts to improve the training and cultural awareness of bank staff.**
- **The number of women starting up their own business is increasing - a trend which looks set to continue.**
- **In spite of a high degree of PC penetration among small firms, they are not exploiting these IT resources to the full.**

Survival rates and training

5.1 The continuous cycle of business start-ups and closures are the natural components of the competitive process and this will evidently be affected by the economic climate. As pointed out in paragraph 2.2, the number of start-ups was greater than the number of closures in 1997. Although there is still no robust empirical evidence that formal training in financial and other management skills helps a business to succeed, it is acknowledged, also by the businesses themselves, that these skills are an important tool in running a business. A number of commentators observed during 1997 that small businesses seemed to be more professionally managed.

Skills and training

5.2 The British Chambers of Commerce Quarterly Economic Surveys have shown that skills shortages were rising as activity in the UK economy picked up. A survey carried out by Lloyds Bank indicated that one in four small businesses had lost out on contracts because of a shortage of skilled labour. Despite this, many admitted that they still considered recruitment to be a low priority and that they had no overall recruitment strategy. A CBI survey suggested that shortages occurred in specific pockets of industry rather than across industry as a whole. However, initial findings from the sixth annual European Business Survey, carried out by Grant Thornton, suggested that the skills shortfall was across the board. Their results showed that 42% of UK small firms expected to increase their training in the coming year. One commentator emphasised the role of the Training and Enterprise Councils (TECs) in underlining the importance of the Investors In People (IIP) scheme. The Government is to allocate £500k to the TECs to enable them to assist small businesses in gaining IIP.

Small Firms Training Loan Scheme

5.3 Participation in the Small Firms Training Loan Scheme was disappointingly low in 1996 and the Department for Education and Employment felt that there might be a need to relaunch it. Although official statistics are not available, it appears that participation has picked up a little, with Barclays Bank being the first to lend over £1mn to small businesses through this Scheme.

Financial and other management training

5.4 The Institute for Small Business Affairs organised a one-day seminar in June 1997, hosted by the Chartered Association of Certified Accountants (ACCA), on ‘How Small Businesses use Financial Information’. It concluded that the majority of owner-managers had a good understanding of their firm’s financial position. They were especially aware of the cashflow situation, but this was not formalised into a set of internal accounts or management information. Small business owners do not understand the language of accounts and so this terminology becomes a barrier between the owner-manager and the accountant. This creates a situation where small business owners detach themselves from the accounts process. It was suggested that the role of the accountant dealing with a small business should be broader, going beyond the provision of financial information and involving more general advice for small businesses. This, however, does give rise to concern over where to draw the boundaries between accountants and the support services, like Business Links.

Small Business Initiative (SBI)

5.5 The SBI (initiated by NatWest Bank), which provides business skills training for small businesses, sometimes with a financial incentive of an interest rate discount or reduction in bank charges, was extended to South Derbyshire in 1996. The businesses participating in this scheme had a different profile to those participating in the initial pilot schemes in Norfolk and Suffolk - they made more use of Business Link services and a higher proportion had participated previously in other training courses.

5.6 Lloyds TSB Bank commissioned research[21] to evaluate the impact of the SBI in South Derbyshire and, more specifically, the Golden Key Package, the course designed to improve financial management in businesses. Results, published in 1997, from interviews conducted after one month showed that participants perceived their financial management skills to have increased by 60% as a direct result of the course. However, only 12% of accountants and 37% of bankers had noticed a change in their client’s behaviour. Thirty per cent of participants said that their profits had increased as a result of the training. Unfortunately, a poor response rate from the control group meant that no firm conclusions on the link between training and performance could be drawn from these results.

5.7 SBI pilots currently operate in Norfolk, Suffolk, Teeside, Hereford and Worcester, and South Derbyshire. The participating banks, through the BBA, and the DTI are funding a rigorous evaluation study, undertaken by the ESRC Centre for Business Research in Cambridge, to assess whether this short course in financial management training does affect subsequent business performance.

21 The Research Centre, City College Norwich, *Small Business Initiative Derby: Evaluation Report April 1997*.

The Financial Management Working Group

5.8 The Treasury established the Financial Management Working Group in 1996 to consider the problem of poor financial management in small firms, including the effectiveness of existing initiatives and ways in which financial management might be improved. A number of sub groups were formed to inform the Working Group on various aspects of financial management. The sub groups expect to report to the main group shortly, with the final report due later in the year.

Franchising

5.9 Franchising is the leasing of a business system by the franchisee from the owner, the franchisor. A franchisee normally pays for the right to set up in business under an already established brand name, with a reliable track record, for a specific period, working to a tried and tested blueprint.

5.10 Franchising is growing rapidly in the UK and Europe. The European Franchise Federation conducted a survey[22] recently, sponsored by NatWest. Looking at franchising from a European perspective, the survey found that there are 136,061 franchises within Europe, of which 19,700 are in the UK. 1,276,358 people are employed in the franchise industry, with France leading the way with 355,500 people and the UK in third place with 222,700 people.

5.11 Research[23] from the University of Westminster, however, suggested that the failure rate in franchised businesses was higher than was normally perceived. The research suggested that half of all new franchisors failed within a four year period, and about 66%-75% failed within ten years. Despite this, however, franchising remained an effective way of entering a market. Success rates were higher when the project was backed by good market research and dedicated support staff, and when a number of pilot sites had already been trading successfully. Business Link London Central have launched a new service which will identify the resources needed and provide cost effective advice.

5.12 Although raising money to finance the purchase of a franchise is treated in the same way as any start-up proposition, a lower risk may be attached to a franchise of a successful chain. Most established franchise companies have already negotiated funding arrangements with banks, and so franchisees will be regarded more favourably. Most banks have specialist units to assist people wishing to buy and operate a franchise.

Performance and marketing

5.13 Research conducted by the Centre for Small and Medium Sized Enterprises at Warwick Business School, on behalf of the Stoy Centre for Family Business in 1997, found that 64% of privately owned UK businesses were classified as family businesses. Results showed that these businesses were more likely to be older, and hence more likely to survive and provide secure employment for family members. They were also more focused on tactical product marketing, perceiving that they would have a greater degree of customer loyalty from their superior quality. However, there was no difference between these and non-family businesses in terms of overall performance.

22 *Franchising in Europe*, British Franchising Association (August 1997).

23 *Franchising your business: getting started*, Lloyds Bank (1997).

5.14 Low turnover and lack of business has remained the main problem facing small businesses in 1997. There may be a need for the business support industry to help these firms develop sales and marketing techniques. Research[24] carried out by Barclays found that, while small businesses spent on average £1,500 a year on marketing, less than 40% monitored the effectiveness of this activity. Nearly two thirds of the small businesses surveyed still relied on word of mouth to promote their business. Only a quarter of small businesses properly calculated prices to cover their costs. The majority worked them out in an unsystematic and informal way.

Ethnic businesses

5.15 About one in ten UK businesses are owned by members of the ethnic minority communities. Clearing bank efforts towards meeting the financing needs of these businesses are focused on the training and awareness of bank staff and the establishment of special banking units. NatWest has created more than 40 business "Centres of Excellence" which have expertise in many cultures, and the bank has also supported research on the issue[25]. Midland has appointed specialist business managers in key branches specifically to serve the British Asian business community. Lloyds TSB is keen on employing more members of staff from the ethnic minority groups, and working on increasing cultural sensitivity among its existing staff. Barclays recognises the increasingly important role of ethnic minority businesses within the small business sector, and has supported a number of initiatives[26] aimed at promoting better cross-cultural understanding.

Women entrepreneurs

5.16 Research undertaken by Barclays in 1996 showed that the number of women starting up their own business was increasing and had reached the highest level since the end of the 1980's. Thirty per cent of business start-ups were run by women, compared with 25% in 1993. With 87% believing that it was easier to set up in business than in the past, these numbers look set to grow. Lloyds TSB launched its Female Focus 2000 on 1 December 1997 at the European conference, "Female entrepreneurship in Europe: Is a woman's business different?". This initiative was generated by evidence that women face different challenges in business from men. It will include the Millennium Monitor, a scheme to track the bank's 100,000 female business customers at six monthly intervals until November 2000. Early findings suggested that women have greater financial understanding, especially in a start-up, and have a more structured and long-term approach.

IT and small business users

5.17 In a survey[27] conducted for Lloyds by the Small Business Research Trust on small business use of, and attitudes to, technology, 90% of respondents said that they used a computer in their business. Nearly half spent over two hours a day at a computer, but 17% did not use the computer themselves. In spite of this high degree of PC penetration, a number of surveys have shown that small businesses are not using their IT resources to their full. The Institute of

24 *Barclays Review: Marketing and the small firm*, Barclays Bank (1997).

25 Most recently, *Asian Businesses and their Banks*, NatWest (September 1997).

26 For example, by commissioning research on ethnic minority businesses, *Cultural Change and the Small Firm*, Barclays Bank (February 1997).

27 'Information Technology', *Quarterly Small Business Management Report*, Lloyds Bank/SBRT (October 1997).

Management/Compaq survey[28] confirmed that managers in such businesses were less likely than those in larger organisations to exploit fully existing IT or to keep in touch with latest developments. In spite of 60% of managers reading computer magazines, only 7% claimed to be at the leading edge in their use of new technology. However, a third planned to increase their use of e-mail and the internet over the coming years. Research[29] at Insead in France found that Europe's small firms were jeopardising their growth prospects because of their failure to exploit fully IT resources. The internet and the advent of electronic commerce had removed traditional barriers to growth. However, they were failing to keep up with their larger competitors, who tended to be making more use of external links. The Spectrum Business Survey, commissioned by the Information Society Initiative, found that, while 89% of large firms in Europe had PCs with modems, only 39% of micro firms did.

5.18 To encourage the more effective use of IT, Microsoft has set up a Small Business Task Force, including representatives from a wide range of organisations. They have issued a guide for small businesses to reduce the gap between IT and business advice.

5.19 Increasing the use of IT by small firms could significantly increase the potential of businesses based in rural communities. The Lincolnshire Regional Access Centres, funded by Europe, is an initiative to help people to develop their business skills through the use of IT. Working with the local university, authorities and support agencies, the project's objectives are to encourage the greater use of IT in the running of the business, and also as a means of accessing business advice and distance learning courses.

Environment

5.20 Banks are not, and cannot be, environmental experts, but they do have a legitimate interest in the environmental performance of businesses. Many lenders are already contributing to the growing environmental awareness of their business customers. On 18 November, the NatWest Group and the World Wide Fund for Nature launched the "Better Business Pack". This kit, which had been jointly developed by the two organisations, is designed to help SMEs increase their profits by reducing their environmental impact. As part of this process, the BBA published a leaflet in June 1997 - "The Environment - a Challenge for Business and Banking". It was targeted at SMEs and especially those which might not be able to devote resources specifically to environmental management. It is a guide to the practical effect of environmental legislation on business and, in particular, on the possible implications for SMEs and the business banking relationship.

28 *IT means business,* Institute of Management/Compaq (July 1997).

29 Prof. S. Dutta, 'The European Small Enterprise ITStudy', INSEAD Working Paper (1998).

SECTION SIX: THE FINANCING OF TECHNOLOGY-BASED SMALL FIRMS

KEY POINTS

- **Government sees its major role as developing the climate needed to encourage innovation, without becoming directly involved in commercialisation. It is well placed to act as a collector and disseminator of information and best practice.**
- **A task force has been established to examine ways of boosting Britain's record of investment in early stage technology-based ventures, and a steering group has been set up to co-ordinate action in this area.**
- **The Bank has been encouraged by the way the clearing banks have responded to the challenge of adopting new approaches and developing innovative products to assist in the financing of this sector.**
- **It is hoped that information barriers to the successful matching of informal investment opportunities will be reduced by building on the current combination of national and local introduction networks.**
- **Institutional investors in the US have a much more positive attitude towards classic venture capital (as opposed to development capital) than in the UK.**
- **Outside the technology clusters, technology-based small firms in the US face very similar financing problems to those of UK-based firms.**

6.1 In October 1996, the Bank published a report on *The Financing of Technology-based Small Firms*[30], after an investigation into the extent to which these firms face particular problems in raising finance. In last year's *Fourth Report on Finance for Small Firms*, where the findings of that report were summarised, it was noted that a report on progress would be made in the Bank's fifth annual report. This section highlights developments of the past twelve months.

CBI report *Tech Stars - Breaking the Growth Barriers for Technology-based SMEs*

6.2 This report, published in February 1997, was the culmination of the Confederation of British Industry's study on technology-based small firms, which ran in parallel with the Bank's own work. At the start of the research it was agreed that the CBI would focus primarily on the issues of management, training and corporate alliances - topics aligned naturally with its membership profile. The CBI's key observations and recommendations were grouped under five main headings: building management teams; developing entrepreneurship and market focus; realising the potential of corporate alliances; raising finance; and increasing awareness and support. The section on finance drew heavily on the Bank's report, but with some additional recommendations covering fiscal issues:

- allow SMEs to offset R&D expenditure against other tax streams;

30 An article in the February 1997 edition of the *Quarterly Bulletin* summarised the Bank's report, listing the main findings and outlining the Bank's recommendations. This article was followed by another in the May edition, which was an up-date on developments since the publication of the report.

- tax relief on costs of raising equity, for reinvestment in one's own company and for corporate venturing activity; and
- full debate on the reform of Capital Gains Tax, to encourage investment in growth businesses.

In the final section, the CBI proposed that the DTI should establish a dedicated unit to co-ordinate action in this area. As will be noted later (paragraph 6.16), a steering group, involving a wide range of representatives, has been set up to this end.

'Partners in Business' Conference

6.3 The Bank noted in its report on *The Financing of Technology-based Small Firms* that its recommendations were put forward primarily as subjects for further debate and proposed, therefore, to co-host a conference with the Royal Society and the CBI.

6.4 This event took place on 3 March 1997 at the Royal Society, bringing together representatives from the scientific, financial and business communities to discuss the way forward in promoting technology-based small firms. The following summarises the main points made[31]:

- Although the UK has one of the most creative science bases in the world, it has not reached the same level of practical innovation. In spite of the existence and endeavours of an innovative UK financial system, it remains difficult for technology-based firms to secure early stage finance on appropriate terms.
- The importance of high quality management in fast growing technology-based firms was stressed. A strong management team alongside good technology and finance is necessary for the development of a successful technology-based firm; in particular, to obtain finance.
- Business angels (individual investors of high net worth with commercial experience) are an important and increasing source of finance and business advice. There is a need to improve the matching of opportunities and funding, and to develop further complementarity between the formal and informal venture capital markets.
- Only a small number of long-term fund management institutions have significant investments in private equity, and only a small proportion of these are in early stage technology-based firms. The challenge is to convince them that it makes commercial sense to have a stake in this sector - either directly, or indirectly through venture capital funds.
- Although the clearing banks cannot be expected to provide risk capital to technology-based small firms, they can act as facilitators in directing businesses towards the appropriate source of finance, as well as providing a full range of banking services.
- The potential benefits of developing corporate alliances were explored. There is a need for strong networks around technology-based firms to create the linkages that will facilitate and ensure an increase in the number of alliances.
- The Government's approach to public purchasing might be developed to encourage the participation of more innovative small firms.

31 A fuller summary of conference proceedings is available on request from the Business Finance Division, Bank of England, Threadneedle Street, London, EC2R 8AH.

House of Lords Select Committee on Science and Technology

6.5 On 21 March 1997, the House of Lords Select Committee on Science and Technology published a report on *The Innovation-Exploitation Barrier*, which followed an earlier report *Innovation in Manufacturing Industry*, produced in 1991. The 1997 report concentrated on innovation, the point at which inventions are exploited for commercial interest, and on the interface between universities and small businesses.

6.6 The Select Committee welcomed the reports produced by the Bank and the CBI, using them as a guide to their investigation. In particular, the Bank's report was used as the primary source of written evidence on financing issues, although the Bank also gave oral evidence to the Select Committee.

6.7 The Select Committee concluded that, in spite of improvements in recent years in the availability of finance for the exploitation of new ideas by small start-up companies, there remained evidence of a market failure in the provision of this seed capital.

6.8 Business angels were recognised as an important source of risk capital and of hands-on business advice, but there were problems of awareness and information dissemination. To overcome these barriers, it was recommended that the role of business angels be examined further by Government, universities and financial institutions, with particular attention paid to business angel introduction services, with the possibility of a national network.

6.9 It was recommended that the DTI examine the due diligence issue further as the relatively high costs were seen as a barrier to investing small amounts.

6.10 The US Small Business Innovative Research Program (SBIR) - which sets aside a small fixed percentage of government contracts for small innovative firms - was seen to have an 'accreditation' effect and to attract private investors. Although it was recognised that the existing SMART and SPUR award schemes had a similar effect in the United Kingdom, it was recommended that the Government should examine ways in which its existing schemes might be used to support innovation, along the lines of the SBIR programme.

6.11 The Government's Foresight[32] exercise was thought to serve a useful purpose in the identification of broad research priorities, and in developing a network of contacts between academics and industry. However, the Select Committee was concerned about the lack of awareness among small firms of this initiative. It recommended, therefore, that the Government and industry should raise the awareness of innovators, both within academia and outside, and make future Foresight reports more accessible to small businesses.

6.12 Based on experience of industrial clustering, the view was taken that a critical mass had to be achieved before new firms were attracted in significant numbers. It was felt that this was also relevant to the success of science parks, in addition to organisational and sectoral considerations. The Select Committee also recommended additional research into the effectiveness of incubators in promoting technology-based small firms and industry-university relations.

6.13 Emphasis was placed on developing business skills and promoting management education among scientists and technologists, as well as improving the scientific and technological

32 The Foresight programme brings together business people, scientists and representatives from Government to identify wealth creation and quality of life opportunities in markets and technologies, and the actions and investments required to exploit these opportunities.

understanding of financiers. To this end it was recommended that business schools should play a greater role in teaching management skills to science and engineering students, and that financial institutions should be encouraged to develop an awareness of science and technology.

Response to the reports

6.14 A number of the issues highlighted by the Bank, the CBI and the House of Lords Select Committee have been taken up by either the Government or the private sector.

6.15 Government sees its major role as developing the climate needed to help the process of innovation, without getting directly involved in commercialisation. However, there is a need for a partnership approach and, to this end, the Government is well placed to play a role as a collector and disseminator of information and best practice. In this context, it has welcomed CBI's campaign to increase the adoption of benchmarking and best practice.

6.16 In his Pre-Budget Report on 25 November 1997, the Chancellor made reference to a Government-backed task force which had been established to examine ways of boosting Britain's poor record of investment in early stage technology-based ventures. Under the chairmanship of Keith McCullagh (Chief Executive of British Biotech plc), the Working Party on Financing of High Technology Businesses will carry out a six month review, paying particular attention to the financing of technology-based firms at the start-up phase. An interim report will be produced by mid-January. The group consists of City investors and managers of high technology companies as well as representatives from the DTI, Treasury, the CBI and the Bank of England. The Chancellor also announced a steering group, supported by the DTI, the Treasury, the CBI and the Bank of England, which will look at the barriers to growth of emerging technology firms.

6.17 On 7 November, the Minister for Small Firms introduced a debate in the House of Commons on innovation and small firms. She confirmed that the need to involve SMEs in the Foresight programme had been recognised, following the House of Lords Select Committee report. As a result, it was planned to involve these firms in the next phase of the Foresight programme, possibly through the supply chain - that is , offering them an insight into what their customers are likely to demand in five years time.

6.18 Although it was recognised in the Bank's report that the clearing banks were not normally an appropriate source of risk capital for technology-based firms, they were encouraged to look more closely at this sector. Once they had a better understanding of the risks involved (high technology should not necessarily be equated with high risk) it was considered that they could provide such firms with working capital and banking services from an early stage. They could also develop packaged finance for these firms. The Bank has been encouraged by the way the clearing banks have responded to this challenge. They are adopting new approaches and developing innovative products to assist in the financing of this sector.

6.19 Through the BBA, the banks have co-operated closely with the Government in a review of the Small Firms Loan Guarantee Scheme with the aim of improving access for technology-based firms. This review was announced in the Pre-Budget Report and is one of a number of initiatives the Government is considering as a part of its review of the financing of technology-based small firms. There was also a commitment to make an announcement on the current review of the Venture Capital Trust scheme and the Enterprise Investment Scheme (see paragraph 4.12).

6.20 In spite of the increase in the supply of informal venture capital, business angels in this country play a less prominent role in the financing of early stage technology-based firms than in the US. As mentioned earlier, there is an information barrier to the successful matching of investment opportunities with the appropriate investor. It is hoped that this will be improved by building on the current combination of national and local introduction networks. The DTI is working with interested bodies to see whether there is a role for a national organisation to facilitate informal investment in small firms of all sectors. Research has also suggested that business angels would welcome the availability of an independent technology appraisal service as part of their due diligence procedure[33]. It has also been suggested that the Financial Services Act represents a regulatory barrier. This Act is currently under review (see paragraph 4.17).

6.21 The Bank's report noted the recognised reluctance on the part of most institutional investors, such as pension funds and insurance companies, to have any significant involvement in this area. This was partly performance-related, with investors looking for a higher rate of return than was demonstrated in the British Venture Capital Association's performance figures. The BVCA has since endeavoured to develop the presentation of these figures. During the summer of 1997, the Bank conducted a series of interviews with institutional investors and venture capital funds. The Bank found that a large number, following the heavy losses of the 1980s, were reluctant to make investments in the unquoted sector and, therefore, had made very small, if any, allocations to invest in 'alternative assets'. Those that did, preferred to concentrate on the safer MBO/MBI investments. Some made *ad hoc* investments in early-stage technology firms if the entrepreneur was known to them. The issue of scale and efficiency of investment size given the costs of due diligence, was mentioned as a barrier, but few were prepared even to invest in a dedicated seed fund. No-one raised the issue of regulation as a barrier to investment.

6.22 A number of commentators, including the BVCA, have focused strongly on the importance of building management teams in which the contrasting but complementary skills of technologists and business people can be brought together. Early stage technology-based firms may need to be able to offer appropriate incentives to attract executives from larger and more established companies.

6.23 Both the Bank and the CBI highlighted the potential benefits to technology-based small firms of developing corporate alliances. We recommended that further research was necessary to assess the extent of corporate venturing currently undertaken in the UK and to understand better the drivers behind this corporate strategy. In March 1997, Withers, a firm of City solicitors, published the findings of a survey of leading UK firms on this topic. The results suggested that corporate venturing was being successfully undertaken in the UK, but only a very small number of companies were involved. Kevin McNally's book *Corporate Venture Capital: Bridging the Equity Gap in the Small Business Sector*, published later in the year, suggested that corporate venturing was less developed in the UK than in the US, and possibly even than in the rest of Europe. The Small Firms Minister, in her address to the House of Commons, highlighted the Government's interest in the area of small firm/large firm co-operation and said that they were examining the motivations for it. The DTI has begun discussion with many of the FTSE 100 to assess the current state of activity.

6.24 In the summer of 1996, the Enterprise Panel (set up by HMT in 1995 and sponsored by Midland Bank) reported on the current position of business incubation in the UK. One of its

33 Colin M Mason & R T Harrison 'Stimulating investments by business angels in technology-based ventures: the potential of an independent technology appraisal service', in R Oakey (ed) *New Technology Based Firms in the 1990s: Volume 5* (1998).

recommendations was the establishment of a national incubator centre to raise the profile of business incubation and to disseminate best practice. Having won its bid for funding under the Government's Sector Challenge initiative in May 1997, the Centre for Business Incubation Policy will be set up in Aston. It will be launched on 3 February 1998 by the Minister for Small Firms. The Enterprise Panel will meet once or twice a year to oversee the running of the centre.

International comparisons

6.25 Throughout the investigations into the financing of technology-based small firms, comparisons were frequently made with other countries, in particular the US. The Bank has attempted to assess the validity of the many claims of a more favourable environment for these firms in the US. It found that, with the exception of the Silicon Valley Bank, a specialised high technology bank, few commercial banks were interested in financing this sector. On the private equity front, institutional investors had a much more positive attitude towards classic venture capital (as opposed to development capital) than in the UK. The buoyant IPO market for technology shares, in particular NASDAQ, was an important driver of this activity. Although deal size was becoming larger and later stage, business angels were filling the gap left by providing earlier stage finance in a 'partnership' approach - strong networks existed between entrepreneurs, professional advisers and formal/informal venture capital providers. Although corporate venturing in the US has been cyclical in nature, it plays a relatively important role at present, particularly in the IT sector. It is not, however, as prevalent as some claim.

6.26 Cultural differences should not be overlooked. Attitudes to risk taking, wealth creation, entrepreneurship, employment mobility, and collaboration between universities and businesses, are very important factors in the commercialisation of technology in the US. By contrast, the imbalance between risk and reward in the UK was seen to exacerbate an already innate conservatism. One of the most striking features of Silicon Valley was the way in which people networked - accountants, attorneys, finance providers and entrepreneurs made up a web of business contacts who worked towards increasing business activity.

6.27 This said, one of the most important lessons learnt was that, outside the technology clusters - much of the angel activity was concentrated in technology cluster areas like Silicon Valley and around Boston, Seattle and Austin - technology-based small firms in the US were faced with very similar financing problems to those of UK-based firms. Speakers at a recent conference in Ottawa on clusters, "Technopolis '97", confirmed this view - firms looking to start up or operating in a successful cluster found it relatively less difficult to raise capital than those looking to locate elsewhere. The UK is already developing some successful clusters - for example, Cambridge, Oxford and the Thames Valley corridor, and 'Silicon Glen' in Scotland.

6.28 How the UK compares with other EU countries will be assessed in a European benchmarking study on the financing of innovation. This project, in which Denmark is acting as the lead country with the work is co-ordinated by DGIII at the European Commission, will use a series of indicators to assess how technology-based small firms are financed in different European countries. A report is due in autumn 1998.

SECTION SEVEN: PUBLIC POLICY

KEY POINTS

UK

- **On 11 December, the Government published a Bill on the statutory right to interest on the late payment of commercial debt.**
- **The DTI Small Firms Minister, Barbara Roche, outlined the Government's commitment to excellence in Business Links. Emphasis will be placed on the quality and accountability of the network.**
- **The Government is planning to establish Regional Development Agencies.**
- **The July Budget was generally well received by the small business sector.**
- **The Financial Reporting Standard for Smaller Entities was introduced in November 1997.**

EUROPE

- **The "Amsterdam Special Action Programme" has led to the establishment of the European Technology Facility, targetting SMEs in technology sectors.**
- **A number of initiatives aimed at encouraging an enterprise culture will feature during the UK's presidency of the European Union.**
- **Late payment of commercial debt continues to be a problem across Europe. The European Commission intends to adopt a directive on late payment in 1998.**
- **The Round Table of leading representative of the banking sector and European SME organisations, published its final report in February 1997.**

UK

Late payment

7.1 Late payment has continued to have a disproportionate effect on small businesses. When severe it can limit growth opportunities, create serious cashflow pressures and, in extreme cases, force insolvency. During recent years, a series of measures have been taken to tackle the late payment culture - for example, the CBI's Prompt Payers Code (1994) and the British Standard BS7890 (1996). Government departments and some other public bodies have set targets for payment times, and will publish performance figures. The last Government also introduced a requirement for public limited companies and their large subsidiaries to disclose their average payment **times** as well as their payment **policy** in the Directors' Report and Accounts for years ending on, or after, 31 March 1996. It is yet too early to assess the impact this measure might have had. Other initiatives have also been established to address the late payment issue. One example is the pilot project run by Tempus Argentum Est, which is aimed at assisting SMEs in the Birmingham area to improve their cash flow management.

Statutory Right to Interest

7.2 On 11 December, the Government published the Late Payment of Commercial Debts (Interest) Bill giving companies the right to claim interest on the late payment of commercial debt. This followed a period of consultation with interested parties based on the Government's Green Paper *Improving the Payment Culture* (July 1997). There were mixed reactions to this Green Paper, with general acceptance that legislation would be introduced, combined with some scepticism over the impact the right to claim interest would actually have on payment culture. The statutory right to interest will be introduced as part of a package of measures, including league tables and initiatives to improve the credit management skills of small businesses. The Government has also set up the "Better Payment Practice Group". This Group is discussing a broader approach to the late payment problem and is intending to announce a number of action points to be addressed alongside the implementation of the statutory right to interest.

7.3 The Forum of Private Business has long campaigned for the introduction of a statutory right to interest and has emphasised the potential benefits it holds for small businesses. Other small business representative groups - including the Federation of Small Businesses and the British Chambers of Commerce - are less convinced. The Federation of Small Businesses is currently working with Dun & Bradstreet to produce league tables which are due to come out in Autumn 1998, showing the average length of time it takes businesses to pay their debts. The Bank's own view is that statutory right to interest is an issue for Government and business.

7.4 Regarding the details of the Green Paper, a great deal of discussion arose about the proposed rate of interest - suggested at 4% over base rate. Many organisations pointed out that this rate was too low to recompense many small firms suffering the effects of late payment. This resulted in the Government changing the rate of interest in the Bill to 8% over the base rate. There was also concern over the practicality of claiming interest, as court procedures could be very costly and time consuming. Generally, the need for the close monitoring of the effect of any legislation was highlighted, together with the need for improved data on payment periods.

Small business support services

7.5 There have been many changes and developments in the small business support network over the last five years. The present structure consists of a range of support service providers including Training and Enterprise Councils (TECs) and Business Links, as well as many membership-based organisations. There are currently 89 Business Link partnerships and over 280 offices, 79 TECs in operation in England and Wales, and 62 Approved British Chambers of Commerce.

Reform of Business Support

7.6 Concern about duplication and lack of co-ordination among business support organisations prompted the British Chambers of Commerce to produce a report, *The Future Chamber*, calling for the restructuring of the current network. The report proposed that a network of regional economic partnerships should be set up to integrate the work of the Chambers, TECs and

Business Links. At the time of writing, there had been 13 mergers between BCCs and TECs to form Chambers of Commerce, Training and Enterprise (CCTEs) and a further 6 are being processed. Research carried out on the performance of the CCTEs has shown them to be more effective in all areas, including lobbying the Government.

7.7 The Government have placed a strong emphasis on improving the quality of support service provision across the country. A Training Standards Council, which will receive £4mn funding, has been established in co-operation with the TEC National Council, to inspect the work of the TECs. It will consist of 15 members representing employers and other interest groups, and will oversee the work of the Chief Inspector and Senior Inspectors, as well as 20 regional full time inspectors and 400 part time associate inspectors. Inspections will begin in April 1998. Monitoring has also become a key feature of the Government's approach to Business Links. The BCC are also reviewing their accreditation process - launched on 1 January 1997 - to raise standards further.

Business Links

7.8 Business Links are a 'one-stop shop' for businesses, providing a signposting service to other sources of advice and financing. Since their establishment, there has been continued concern about the variability of standards of service provision across the network. In response to this, the DTI Small Firms Minister, Barbara Roche, outlined the Government's commitment to excellence in Business Links[34]. The main emphasis is on improving the quality and increasing the accountability of the network. Business Links will be monitored against the performance of the local businesses that they have served. Performance measurement will be based on a combination of turnover, profitability, net assets, employment and export performance, and national league tables will be compiled. The Government are also committed to establishing centres of expertise, specialising in areas such as exports and technology. This approach has been generally welcomed by the small business sector, although there has been some concern as to whether quantifying the performance of Business Links for league table purposes is practicable.

7.9 Concerns have also been expressed regarding the lack of integration between Business Links and the professions. In an attempt to address this, the Chartered Association of Certified Accountants (ACCA) and the Institute of Chartered Accountants in England and Wales (ICAEW) presented a joint submission to the Business Link Chief Executive Forum. The key suggestions were: Business Links should be required to demonstrate evidence of established relationships with professional bodies as part of the accreditation procedure; a qualified ACCA or ICAEW accountant should always be part of the accreditation panel; and at least one independent professional should sit on every Business Link board. They also felt that lack of small business representatives on the boards of the Business Links needed to be addressed.

7.10 The quality of the advice given by the Personal Business Advisers (PBAs), Innovation and Technology Counsellors (ITCs) and the Export Development Counsellors (EDCs) has come under scrutiny over the last two years. This has been combined with concerns about possible conflicts of interest when Business Links are competing with other service providers on a remunerated basis. The DTI has published information about the business experience of

34 DTI, *Enhanced Business Links - A Vision for the 21st Century* (October 1997).

Advisers and Counsellors[35], and this has helped to alleviate fears. Some have suggested that PBAs should be put through a more rigorous testing of their suitability, and that higher remuneration packages are necessary if the desired quality is to be achieved.

Regional Development Agencies

7.11 The Government's proposals on Regional Development Agencies (RDAs) were published on 3 December 1997, as part of the *Building Partnerships for Prosperity* White Paper on the English regions. The nine RDAs would be business-led and seek to integrate the roles of national, regional and local partners in economic development. Key functions would include the development and implementation of regional economic strategies. Economic regeneration would involve the administration of the Single Regeneration Budget Challenge Fund and accessing European Union structural funds. RDAs would also be involved in technology transfer and facilitation of local investment, in partnership with the private sector. In the area of business support, they would provide a regional focus for Business Links.

Small Firms Loan Guarantee Scheme

7.12 In 1996/97, the number and value of loans guaranteed under the Small Firms Loan Guarantee Scheme fell for the first time since the terms of the scheme were enhanced in 1993. This trend continued into the first half of 1997/98, during which 2,773 loans were guaranteed with a cumulative value of £105.6mn - both these figures represent less than half of the 1996/97 totals for a full year. The Government has announced its intention to review the Scheme to improve access for technology-based small firms (see paragraph 6.19).

7.13 On 5 November 1997, the Bank of England hosted the latest in its series of academic-led workshops. On this occasion, it discussed the effectiveness and the scope of the Small Firms Loan Guarantee Scheme. Participants examined the objectives of this area of public policy and the way in which it was administered by the finance providers. One of the main points to arise from the discussions was that information on the scheme should be more systematically collected and disseminated in order to evaluate better its effectiveness.

July 1997 Budget

7.14 The Government's first Budget was generally well received by small businesses groups, although some commentators believed that the changes would make little practical difference. The main benefits arose from the reduction in the small firms corporation tax rate and the doubling of the first year capital allowance on investment in plant and machinery.

7.15 The small firms corporation tax rate was reduced by 2% to 21%. This reduction was backdated to April 1997. This broke the former relationship that tied the small firms corporation tax rate to the basic rate of income tax. The Chancellor at the same time reduced the loss carry-back period to one year from three. This could be costly to some small companies, especially those involved in cyclical businesses. Capital allowances for small and medium sized firms on investment in plant and machinery were doubled (25% to 50%) for the first year, in an attempt to boost investment. The threshold for VAT registration increased by £1,000 to £49,000 from December 1997. Some small business organisations believe this figure to be too low to reduce

35 The survey was carried out in April 1996 and involved 500 PBAs.

the regulatory burden on small businesses. The Chancellor committed £5mn to a public-private partnership to fund the ‘University for Industry’, which is intended to operate through satellite, cable and interactive technologies. This should be of particular benefit to small businesses as they do not have the financial resources to fund skills training. The budget also drew attention to the misuse of Venture Capital Trusts (VCTs) and the Enterprise Investment Scheme (EIS) and proposed a review of these schemes (see paragraph 4.12).

Green Budget

7.16 The Chancellor’s pre-budget statement on 25 November 1997 outlined changes to the corporation tax system, introducing a system of quarterly payments for large and medium sized companies. Small companies were exempt from this change and will continue to pay corporation tax on an annual basis. The statement also highlighted the Government’s commitment to a statutory right to interest and the refocusing of Business Links. An announcement on the current review of Venture Capital Trusts (VCTs) and the Enterprise Investment Scheme (EIS) is expected shortly. The 1998 budget announcements will occur on 17 March 1998.

Regulation

Accountancy Issues

7.17 The accountancy profession still believes that the discipline of the audit procedure can improve the financial management of small businesses, but they have accepted that the traditional audit has too narrow a focus. ACCA are currently looking at developing a wider audit procedure, including aspects of management accounting, IT analysis and benchmarking. ACCA believed that the banks would also find this approach beneficial.

7.18 The Audit Exemption Regime (AER) was extended in April 1997 to small firms with turnovers of up to £350,000. Prior to this date, firms with a turnover between £90,000 and £350,000 were allowed to substitute the standard audit with an independent accountant’s report. Research carried out among ICAEW members suggested that 20% of businesses that were now exempt from the audit procedure would continue to have an audit carried out, partly because of a perception that finance providers would require audited accounts.

7.19 The Financial Reporting Standard for Smaller Entities (FRSSE) was approved by the Accounting Standards Board (ASB) in November 1997. Both the ICAEW and ACCA were supportive of the introduction of a separate standard for small businesses, although they differed over whether it would have been beneficial to include cashflow information.

Limitations to Growth

7.20 The ICAEW produced a report, *Going for Growth*, in 1997, the third in a series - ‘Burdens on Smaller Businesses’ (1995) and ‘Barriers to Growth’ (1996) being the first two. The report summarised the responses of ICAEW members. The main finding was that, while the high street banks remained the main source of external financing for smaller businesses, they might be inhibiting growth because of their continued focus on collateral. This finding was supported by a report on small firms carried out by the BCC[36], which found that lack of collateral remained the dominant constraint on access to finance. This had increased steadily since 1994, from 43% to

36 British Chambers of Commerce, *Small Firms Survey No.24: Finance* (July 1997).

67%. Despite banks' claims of a shift in emphasis away from collateral towards lending decisions based on business plans and cashflow projections, 57% of businesses also cited the banks' reluctance to accept business plans as a problem. Forty five per cent of businesses believed that the banks' approach to lending was more stringent now than in the last recession. The DTI had also commissioned research[37] on the growth constraints on medium and small firms. This was carried out by the ESRC Centre for Business Research in Cambridge and the Public and Corporate Economic Consultants, which found management and employee development and expertise to be the keys to sustained growth over a period of years.

7.21 Government regulation is still perceived to be a serious problem for small firms. The last government established groups, such as the Deregulation Task Force, in an attempt to combat this problem. However, perceptions of the overall burden of regulation have changed little over the past few years. The current Government have dropped the commitment to deregulation in return for 'better' regulation. An independent advisory task force has been established and is due to publish its conclusions in September 1998. In addressing the Institute of Small Business Affairs (ISBA) on 19 November 1997, the Small Firms Minister acknowledged the problems of regulation and the need to reduce red tape.

7.22 With the ever increasing integration of Europe, national regulation is no longer the only problem faced by small businesses. Some small business representative groups have expressed concerns at the UK signing up to the Social Chapter. This occurred in June 1997 and since then the UK has been subject to the Working Time Directive and the requirement for equal rights to be given to part-time employees in line with full-time employees.

7.23 The last government was not able to implement its intention to exempt lending to unincorporated businesses from the requirements of the Consumer Credit Act (CCA). The new Government intends to increase the maximum regulated loan under the CCA from £15,000 to £25,000, but does not plan to exempt unincorporated businesses. Many banks feel that this will restrict some of the lending products and services they currently offer to unincorporated businesses, because the requirements of the CCA will make them uneconomic or impossible to deliver.

Taxation

7.24 Commentators have suggested that the implementation of self assessment has been problematic, resulting in a considerable burden on small businesses. The ACCA intend to research the cost of the self assessment system during 1998.

7.25 Some of the small business representative bodies have pressed for a commitment to review the Uniform Business Rate (UBR). The UBR has a disproportionate effect on small businesses, which pay relatively higher rates then larger businesses. According to research[38], the UBR as a proportion of annual sales turnover is approximately five times larger for firms with a turnover of less than £50,000 per annum than for businesses with a turnover between £500,000 and £2mn.

37 *Growth constraints on small and medium-sized firms*, Department of Trade and Industry (April 1997).

38 Chittenden, Poutziouris and Watts, *The First new Labour Budget and Small Business Taxation*, NatWest (1997).

Government Initiatives

Welfare to work

7.26 Small firms can take advantage of the subsidised labour offered through the Welfare to Work and New Deal scheme. Under the New Deal scheme, businesses employing people between the ages of 18 and 24, who have been unemployed for over six months, will receive a £60 subsidy per week for up to six months to support the cost of training. Those employing staff over 25 years old, who have been unemployed for two or more years, will receive a £75 subsidy.

Enterprise Zone

7.27 The Government launched the Enterprise Zone[39] on 4 November 1997. This is an internet site for small businesses, with a particular emphasis on sources of finance. It was developed following research carried out by Business Links into the reasons why small businesses use the internet. The site will promote other internet sites that are considered to offer good quality advice for small businesses.

Minimum Wage

7.28 The Government's commitment to introducing in 1998 a national minimum wage, following advice from the Low Pay Commission, has caused concern to some small businesses. At a recent meeting of BCC members, 50% said that a minimum wage of £3.50 would cause an employment problem, and 58% predicted that prices would go up. At levels above £4.50, many said that they would employ a different set of people. In contrast, the NatWest/SBRT Survey of Small Business found that the number of businesses considering a minimum wage of £4 per hour to be a bad idea had fallen from 57% (October 1994) to 50% (July 1997). Unsurprisingly, the businesses which employed people at rates of less than £4 per hour were more likely to oppose a minimum wage.

EUROPE

Support for SMEs

7.29 The European Commission has stressed repeatedly the essential role played by SMEs[40] in the internal market in promoting growth and employment in the European Union. A number of initiatives have been proposed or implemented in 1997: they are aimed at SMEs at varying stages of their development.

7.30 The Amsterdam Summit in June 1997 gave special attention to labour and product market efficiency, technology innovation and the potential of SMEs to create jobs. The important role of the European Investment Bank (EIB) and the European Investment Fund (EIF) in creating employment through investment opportunities in Europe was recognised and a financing facility for technology-based small firms is being introduced (see below). The EIB was also asked to step up its interventions in the area of large infrastructure networks. As a response to the first objective, the EIB has created the "Amsterdam Special Action Programme" (ASAP) which will run until the end of 2000:

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39 The Enterprise Zone can be found at: http://www.enterprisezone.org.uk.

40 The Commission defines SMEs as having fewer than 250 employees, a turnover not exceeding Ecu40mn, or a balance sheet not exceeding Ecu27mn, and being independent. More than 99.8% of the 17.9mn enterprises in the EU are SMEs.

- The first of several proposals that will constitute the ASAP is the European Technology Facility (ETF), financed by the EIB and administered by the EIF. The EIB has committed a total of Ecu1bn to the ASAP, of which Ecu125mn will be allocated to the ETF. The ETF will target SMEs in high technology sectors, leading to a considerable expansion in the EIF's involvement in the venture capital market. The ETF will invest in independently managed funds, with a view to making five to twelve year commitments. Funds will be targeted at early stage and technology funds and, secondly, at development capital funds. Investments will only be made in European venture capital funds which invest at least 85% of their funds in the EU. The ETF will make minority investments of up to 25% of the capital of each fund, limited to 10% of the total amount managed by the Fund. The intention is that the EIB will set up other similar funds with other market intermediaries in due course.

- Another important development to come out of the ASAP is the strengthening of the EIB commitment to technology-based SMEs. The new investment programme will also include the creation of a "special window" designed to support new forms of finance, backed by appropriate recourse to the annual surplus of the EIB.

7.31 In July 1997, the Commission and the EIF launched the pilot scheme I-TEC, one measure to come out of the First Action Plan for Innovation[41]. The scheme is intended to assist venture capital funds in meeting the costs of initial appraisals and hands-on management of technology investments. I-TEC will contribute up to 50% of the cost of initial appraisal and management of such investments. The maximum I-TEC contribution for any one venture capital fund is 5% of the investment made, with a ceiling of Ecu500k.

7.32 The Luxembourg Summit in November 1997 approved a joint action plan for job creation. This included financial support for the EIB to raise an extra Ecu10bn to finance SMEs and new technology ventures. The EIB estimates that such an injection would generate a total volume of investment of Ecu30bn in Europe. The EIB is to create a new budget heading, aimed at helping SMEs to create sustainable jobs, which will receive funds of Ecu450mn over the next three years.

7.33 For the more established businesses, the Commission approved a support mechanism for the creation of transnational joint ventures for SMEs in the EU on 5 November 1997. Under this initiative, also referred to as the "Joint European Venture", the Commission intends to contribute to the expenses incurred in setting up a joint venture. The objective of the venture must be to create new economic activities, involving investment and employment creation with the EC. The maximum contribution by the Commission would be Ecu100k in the form of a subsidy covering 50% of the eligible expenditure, or up to 10% of the total investment cost, with a total budget of Ecu100mn over three years.

7.34 There are also proposals for a special guarantee fund for SMEs within the EIF to increase the risk-taking capacity of institutions financing these firms. The Commission proposes to cover payment by the EIF of guarantee premiums in order to increase the volume of high-risk loans granted by the EIB or other financial intermediaries in connection with their SME operations.

7.35 Another milestone during the year was the proposal for the Fifth Framework Programme for Research, Technological Development and Demonstration Activities (1998-2002), which was

41 The First Action Plan for Innovation (adopted by the Commission at the end of 1996) identified the lack of early stage capital as one of the main barriers to innovation in Europe.

published in 1997. This has been given an overall allocation of Ecu16.3bn, and will be dedicated to support for research and technological development, not least in SMEs.

7.36 During the UK's presidency of the EU in the first half of 1998, the Commission is expected to take forward work on a number of areas affecting SMEs. An update of the Commission's Competitiveness report and a report on benchmarking pilots, particularly the finance for innovation pilot, are expected early in 1998. A number of initiatives aimed at developing and encouraging an enterprise culture across Europe will take place - for example, "Enterprising Europe", a DTI conference scheduled for April 1998.

Late Payment in Europe

7.37 The *Fifth Survey of International Services Provided to Exporters,* commissioned by the Institute of Export and NCM Credit Insurance (July 1997), established that 32% of respondents trading in the EU experienced payment delays in the year under review. Countries where payment delays were reported as being serious were Germany, Italy and Spain, possibly on account of their position in the economic cycle. In addition, a *Trade Indemnity Survey* (July-September 1997) singled out customers in France and Ireland as slow payers.

7.38 In 1995, the Commission adopted a Recommendation on Payment Periods in Commercial Transactions, aimed at improving payment culture across Europe by encouraging adherence to contractual and reasonable payment periods. An evaluation of the effects of the Commission's Recommendation was carried out two years later, including an analysis of average payment periods. This showed that the situation had deteriorated slightly since the Recommendation, and that little progress had been made in member countries to introduce new policies (see paragraphs 7.2 - 7.4 for a discussion of the progress made in the UK).

7.39 The Commission has adopted an action plan for the Single Market of measures to be taken before 1 January 1999, which includes the adoption of a proposal for a directive on late payments in the absence of an appropriate response by member states. All European member states are required to report to the Commission, by the end of 1997, on the actions they have taken to tackle late payment. At the time of writing, 114 written responses have been received, of which 80% were in favour of an EU directive. Consequently, the Commissioner responsible for Enterprise Policy has confirmed his intention to propose a directive, containing minimum requirements to be incorporated into national legislation. These requirements should include a statutory right to interest on late payment, efficient and inexpensive redress procedures for obtaining payment, and a maximum payment period for public procurement contracts[42].

Access to finance and credit

7.40 The Round Table of leading representatives of the banking sector and European SME organisations, launched in September 1995, published its final report[43] in February 1997. The report outlines what banks have done to develop and improve the services and products they offer to SMEs and the ways banks have reshaped their organisations in order to respond more efficiently to the needs of their SME customers. The recommendations are based on best practice, and are addressed at a variety of target groups.

42 Report from the Commission to the European Parliament, the Council, the Economic and Social Committee and the Committee of the regions, Commission document COM (97) 610 final.

43 *Round table of Bankers and SMEs: Final Report,* Commission of the European Communities (1997) XXIII/53/97.

SECTION EIGHT: PARTICULAR CHALLENGES AHEAD

KEY POINTS

Euro

- **The level of preparation for the single currency among small businesses generally appears to have been limited in 1997.**
- **Small firms involved with the financial markets or exporting directly to countries which will adopt the euro from the start will be affected sooner than businesses that trade only domestically.**
- **Forty two per cent of SMEs believe that EMU will have a beneficial effect on their business.**
- **The Government has established a Business Advisory Group to help businesses in the UK to prepare.**

Year 2000

- **The 'Millennium Bug' has the potential to affect seriously the trading activity of all firms, large and small.**
- **Many small businesses appear unaware of the time and resources needed to be Millennium compliant.**
- **As this may seriously affect the viability of businesses, it has significant risk implications for the providers of finance to those businesses.**
- **The Government has announced its Action 2000 initiative, the goal of which is to encourage businesses to turn awareness into action.**

Euro

8.1 The level of preparation for the single currency among small businesses generally appears to have been limited in 1997. This contrasts with financial institutions and many large companies, which were well advanced in planning and implementation. Barclays found that 65% of business customers with turnovers below £50mn have made no plans to deal with EMU[44]. A survey carried out by Office World[45] established that nearly 60% of small businesses had not calculated by December 1997 what the cost of adapting their business to EMU would be.

8.2 Preparations by small businesses may have been limited because they are unsure as to what exactly is required of them. Small firms generally have less time and resources to commit to forward planning, in the same way that large companies can. The difficulty is accentuated by the Year 2000 problem which is already putting IT resources under pressures (see second part of this

44 *Barclays Business Banking Survey*, Barclays Bank (October 1997).

45 *Office World Quarterly Small Business Survey* (December 1997), Vol. 4, No 2.

Section). A survey undertaken by Lloyds TSB[46] found that 69% of companies were uncertain about the future implications of a single currency for their business. While companies across all turnover bands shared the apparent confusion, respondents in smaller turnover bands admitted to a lower understanding of the issues. This uncertainty may lead to unrealistic assessment of the task ahead - a Barclays survey[47] indicated that 47% businesses think it will take less than three months to prepare for a single currency.

8.3 The business community generally welcomed the Chancellor's statement on 27 October as it provided clarification of the Government's position on EMU. The option to join between 1999 and the end of the current Parliament has not been officially renounced but, barring unforeseen circumstances, business can now plan on the basis that the Government does not propose to enter a single currency in this Parliament. While the implications for the average small business in the UK are less imminent under the envisaged timetable, there is no room for complacency. In his announcement to the House of Commons, the Chancellor confirmed the Government's commitment to joining a successful single currency, when the economic benefits of joining for business and industry are clear and unambiguous.

8.4 In the circumstances, all firms would be well advised to consider the possible implications for their business. There are effectively two dates to be considered - the first being 1 January 1999, and the other being the possibly date of entry of the UK. While the UK remains 'out', small businesses trading only domestically will not be affected directly. Some may, however, experience the knock-on effect of the euro through the supply chain. Some larger companies have already announced that they will deal in euro from 1 January 1999. Not only their immediate suppliers, but also the contractors to such suppliers may have to follow suit. There are no firm data on the number of small UK firms which are either supplier or subcontractor to larger firms, but these are likely to be significant in numbers. A survey by 3i[48] suggested that 30% of firms employing fewer than 19 staff, and 43% of firms employing between 20 and 49 staff, produce goods which are sold to other UK companies for subsequent exports.

8.5 For some small firms, the introduction of the single currency will involve bigger and more immediate changes. Small firms involved with the financial markets or exporting directly to countries which will adopt the euro from the start will be affected as soon as 1 January 1999. There are at least 60,000 firms engaged in financial intermediation in the UK, and about 115,000 active exporters in the UK, according to the latest figures from the DTI. While there are no official figures on how many of these are dealing with customers in European member states, it is likely that a large proportion are smaller businesses. Traditionally, small firms have been more likely to export to Europe than to other parts of the world, attracted by the proximity. Research by the Forum of Private Business, published in its last quarterly survey of 1997, reported that 79% of exporting SMEs trade with European Union countries. For businesses with turnover of less than £1mn, 88% regard the European market as important[49]. It is unclear from survey evidence we have seen whether small exporters are better prepared for the single currency than small, domestically-oriented, firms. Data from the latest IoE/NCM exporter survey[50] suggests that 39% of exporting businesses with turnover below £1mn, and 41% with turnover between

46 *The Fourth Survey of International Services Provided to Importers,* Lloyds Bank/DHL(October 1997).

47 Barclays Bank, op. cit.

48 *3i Enterprise Barometer - Report No. 40* (November 1997).

49 *Realising your Export Potential*, Barclays Bank (February 1996).

50 *The Fifth Survey of International Services Provided to Exporters,* Institute of Export/NCM (July 1997).

£1mn and £10mn, are actively planning for the euro, but it is not possible to draw any firm conclusions from this.

8.6 If and when the UK is 'in', EMU will mean a change in the business environment, even for small firms whose activity is largely confined to this country. Some initial conversion costs will fall disproportionally on smaller companies - some changes are labour-intensive (for example, dual display of prices), and small firms may be less able to take advantage of economies of scale (for example, modification of IT systems). A Lloyds/SBRT report[51] estimated the average cost of entry to the single currency at just under £2,000 for each small firm. The introduction of a single currency is also likely to lead to increased competition in the domestic market, already an important problem facing small firms. Whilst opportunities will be opened up for UK firms when continental European markets become more accessible, only 42% of small and medium-sized companies believe that EMU will have a beneficial effect on their business, according to a survey by BDO Stoy Hayward[52]. UK small firms may benefit from extensive competition between banks for business in the euro area.

8.7 Further integration of the European Single Market will be an important opportunity for small British firms, in particular, to expand their sales and to establish a new customer base. UK SMEs rank highest in foreign buyers' regard in terms of quality, promptness and flexibility, according to a survey carried out by the Institute of Export[53]. In addition, a single currency will reduce some of the costs of cross-border trading for exporters. Small businesses are likely to notice this more than larger firms[54]. The euro will also remove exchange rate uncertainty for trading between the European member states. This is an important factor for small exporters, given that the cost of hedging foreign exchange transactions is estimated to be between 1% and 2% of the sales and purchases of small companies[55].

8.8 Whether the UK is 'in' or 'out', a timely and well-informed evaluation of the issues is important for all small businesses, both to prevent difficulties arising and to benefit from the commercial opportunities. The precise implications of EMU depend upon the nature of the business activity carried out, as outlined above. For small firms whose business is purely domestic-oriented, the priority is to be aware of the potential issues for their business, and to monitor developments. They should also think about actively preparing for the possibility of the UK joining from early in the next parliament. Those small businesses that trade with Europe directly, or are customers or suppliers of companies that are switching to the euro from 1 January 1999, will need to consider, at an early stage, the potential impact on their trading partners, their competitors' intentions, on IT and staff training.

8.9 Information and assistance is being provided from a number of sources - including the European Commission, the Treasury, the Bank[56] and business organisations. The Government has established a Business Advisory Group to help businesses in the UK to prepare. This reports to the Standing Committee chaired by the Chancellor. Among the issues to be considered are lead-times, transition arrangements and pricing arrangements. Advice from business

51 *Quarterly Small Business Management Report: Europe*, Lloyds Bank/SBRT (March 1997).

52 "The Real Business: BDO Stoy Hayward/Growing Business Monitor" in *The Real Business Magazine*, Caspian Publishing (December 1997).

53 *International Study of Export Support Services*, Institute of Export/Graham Bannock & Partners Ltd (1995).

54 *EMU - Practical Information for Business*, HM Treasury (1997).

55 *Euro Preparation Guide for Companies*, Association for the Monetary Union of Europe (1997).

56 *Practical Issues Arising from the Introduction of the Euro*, a guide prepared by the Bank, can be obtained from the Public Enquiries Group on (0171) 601 4012.

organisations is being used to inform the Government's position. Guides and newsletters specifically aimed at small businesses have been published by, among others, the Federation of Small Businesses, the Forum of Private Business, and banks with small business customers. The banks are also helping small firms by giving talks and seminars at Chambers of Commerce and Business Links, and at least one bank has set up a telephone help desk.

Year 2000 problem

8.10 Many computer systems and other microprocessors have been programmed with year dates of only two digits. Therefore, on the first day of the Year 2000, these computerised systems will show the year as 00, causing them to fail or to operate erroneously. This problem, often known as the Millennium Bug or the Year 2000 (Y2K) problem, has the potential to affect seriously the trading activity of all firms, large or small. Therefore, the entire business community needs to assess the extent to which they could be affected and to take the necessary steps to become Y2K compliant.

8.11 Many small business owners believe wrongly that, because they do not use a computer, they will not be affected by the Y2K problem. However, there is a whole range of machinery and equipment which, although lacking programmable year codes, do have susceptible embedded chips. These embedded systems are found in anything from telephones to fire alarm systems, bar code readers to lifts, franking machines to air conditioning units. This raises even greater problems as, not only is the non-compliance less obvious, but the embeddedness of the system often makes it more difficult to assess. No small firms can assume that they will not be affected and all must take early, appropriate action.

8.12 The official size definitions of a firm are not totally appropriate in relation to information technology issues. Small businesses can be divided into two main categories. With the micro, lifestyle, business the problem is more contained and the solutions are more obvious. The business will typically have an isolated PC using standard software for which a number of off-the-shelf 'fixes' and/or upgrades are available. These businesses will also need to be aware of a small number of embedded chips. However, the problems will be more extensive, and less easily soluble, in slightly larger firms. These may have a network with more than one terminal, running from a file server or mini/midi mainframe with external links, possibly connected to their banks to make salary payments. Many of these will have customised software, possibly developed by a small software company which has since ceased to operate. Many of these companies will not have an in-house IT resource and so will need external help. Shortages of skilled labour in the IT industry represent a constraint on preparations. Cost will be a consideration (and this increases as the Year 2000 approaches). However, the main concern is the time needed to become fully compliant. Forty eight per cent of respondents to the DTI survey (see paragraph 8.13), who had a good/comprehensive knowledge of Y2K and its impact, believed it would take them 12 to 18 months to prepare their IT systems. Running out of time could jeopardise the viability of these businesses.

8.13 Recently published research[57] by the DTI and Sage, the accounting software supplier, showed that 97% of SMEs canvassed claimed to have an "understanding of the business implications" involved. This knowledge, however, had not led them to take action. Only 13% said that they had compliant systems, 45% had not even completed an audit of their systems and

57 *The DTI/Sage Study for Taskforce 2000*, Sage (October 1997).

14% had done nothing at all. Many businesses appeared unaware of the time and resources needed to be millennium compliant; 57% were not allocating any resources in their 1997/98 budgets to tackle the problem and the majority intended only to take proactive steps in 1999.

8.14 As the Y2K problem may seriously affect the viability of a business, so it has significant risk implications for the providers of finance to those businesses. As there is no robust way of certifying that a business either is already compliant or is taking the necessary steps to be compliant, the providers of finance need to assess the extent of their exposure to potentially non-compliant businesses. The clearing banks are currently developing models to assess the risk to their loan books. They are also seeking to reduce the potential risk by raising awareness among their small business customers and encouraging them to take appropriate action. All of the main clearers and the BBA have published guides to get the Y2K message across to business owners and one bank has set up a helpline to deal with queries.

8.15 Some of the major corporates have expressed concern over the ability of their smaller suppliers to deal with this problem. Insurers have also indicated that they may not cover losses caused by the failure of systems because of the Y2K problem. The banks are also developing, in co-operation with the BBA, a self-assessment checklist which will help businesses to have the appropriate compliance dialogue with insurers, auditors and customers, as well as with their banks.

8.16 In view of the seriousness of the problem, the Government, under the direction of the Small Firms Minister, has launched its Action 2000 initiative, the goal of which is to encourage businesses to turn awareness into action. The work is likely to revolve around four main areas, each of which will be addressed by a working group:

- (i) PR and promotion;
- (ii) advice, best practice, information and assessment;
- (iii) people and skills; and
- (iv) progress monitoring.

The second group is working to establish a register of good practice and sources of information and help targeted at SMEs in particular, which was published in January 1998. A telephone hotline (0845 601 2000) and website (http://www.open.gov.uk/bug2000.htm) are also available.

SECTION NINE: CONCLUSIONS

Five years on from 1993

9.1 As noted in the Introduction, this annual report is the fifth in a series since the Governor's initiative on finance for small firms began in the summer of 1993. Each successive report has noted progress in the rebuilding of relationships between finance providers (particularly the clearing banks) and small businesses, and the development of more appropriate ways of financing this sector.

9.2 Key themes that have emerged over the past five years are the need for a partnership approach, based on mutual trust, and a free and open two-way exchange of information between lender and borrower. These themes were epitomised in 1997 by the introduction of the BBA Statement of Principles, *Banks and Businesses Working Together*. In many ways this document - mentioned on a number of occasions in this report - simply confirms good small business banking practice, which has been developing since the excesses of the last boom and recession. It emphasises the common interests and mutual responsibilities of both banks and small business customers.

9.3 Competition in the provision of finance for small firms is keener now than at any time in the last five years. This competition is both between the banks themselves and, to some extent, from other providers - particularly in the asset-based finance market. This should work to the advantage of small business customers, especially where the competition is in terms of quality of service and product range.

9.4 Some small firms do, of course, still encounter difficulties in obtaining external finance. On the other hand, there is greater recognition that the solution lies partly in their own hands - both in terms of shopping around for the best deal available, but also in presenting their case as effectively as possible. There is also evidence of much greater understanding of finance issues on the part of businesses themselves, and the organisations that represent them.

9.5 Enhanced training of small business banking managers and loan officers has been a high priority for all the clearing banks, and this looks set to continue for the foreseeable future. There is general acceptance that more still needs to be done to strengthen financial and other management skills among entrepreneurs, despite the progress that has been made. This is partly a matter of improving the training available, but also of helping small businesses to make the most effective use possible of a wide range of information sources - the Enterprise Zone is a welcome development in this respect.

9.6 The emergence of Business Links (and Business Shops in Scotland and Business Connects in Wales) over the past three years has been significant. The Bank welcomes the Government's commitment to building on this foundation, with a strong emphasis on the quality of the services provided.

Technology-based small firms

9.7 During the last two years, the spotlight has been very much on the financing needs of technology-based small firms. This has not been intended to be detrimental to the needs and aspirations of the wider small business sector. The issue is that such firms are potentially very important in terms of innovation and wealth creation. Their need for long-term, committed equity finance at start-up and early stages has not, in the past, been well met in the United Kingdom or other parts of Europe. Progress is now being made, but this subject is likely to remain on the agenda for some time to come.

Smaller exporters

9.8 Previous annual reports on finance for small firms have included a section on smaller exporters. Because of the importance of the issues currently facing such firms, the Bank is, on this occasion, publishing a separate report, "Smaller Exporters". This is being published simultaneously with the present report.

Challenges ahead

9.9 The year ahead will be a challenging one for the small business sector and for those who provide finance to it. Forecasts point to a slowing in economic activity and, if sterling continues to be strong, SME exporters will face particular challenges. Preparation for the Year 2000 and for EMU (even though the UK will not be joining from the outset) will also be an important preoccupation for many small firms.

9.10 What is equally clear, however, is that realisation of the vital contribution of small firms to the UK economy is increasing all the time. The President of the Board of Trade, in her foreword to "Enhanced Business Links - A Vision for the 21st Century" (DTI, October 1997), expressed it like this:

> "It is particularly important that we help and support small and medium sized enterprises. In many ways they are likely to be the engines of our future growth and the source of our future prosperity. Over the next five years, I want to see an economy in which our small and medium sized businesses flourish. In the 21st century, I want to see our country developing the most successful and fastest growing SME sector in the world."

The Bank's work in 1998

9.11 During 1998, the Bank will continue to monitor developments covered by this report, and the Smaller Exporters report. The central issue that the Bank continues to pursue is the availability of appropriate finance for the small firms sector.

9.12 More specifically, the Bank will do further work on:

- The financing of **technology-based small firms**.
- Monitoring small business preparations for **EMU and the Year 2000**.
- The financing needs of **ethnic minority small businesses**, a sector of the market to which the banks are paying increasing attention.

9.13 The Governor launched his initiative in 1993 with the objective of ensuring that lack of appropriate finance did not impede the growth and success of the small business sector. Five years on, the Bank continues to be fully committed to this area of work.