# FINANCE FOR SMALL FIRMS

## A SIXTH REPORT

BANK OF ENGLAND JANUARY 1999

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## DEFINITION OF A SMALL FIRM

There is no single definition of a small firm. In this report we have drawn on a range of sources of data and consequently have used more than one definition. Therefore, we have included a list of the most commonly used definitions of firm size.

### DTI

| | Employees |
|---|---|
| **Micro firm:** | 0 – 9 |
| **Small firm:** | 0 – 49 |
| **Medium firm:** | 50 – 249 |
| **Large firm:** | over 250 |

In practice, Government schemes that are nominally targeted at small firms adopt a variety of working definitions depending on their particular objectives.

### European Commission

| | Micro firm | Small firm | Medium firm |
|---|---|---|---|
| **Turnover** | not applicable | max €7mn | max €40mn |
| **Balance sheet** | not applicable | max €5mn | max €27mn |
| **Employees** | max 10 | max 50 | max 250 |
| **Independence criteria*** | not applicable | 25% | 25% |

*The independence criterion refers to the maximum percentage that may be owned by one, or jointly owned by several enterprises not satisfying the same criteria.

To qualify as an SME, both the employee and the independence criteria must be satisfied, and either the turnover or the balance sheet total criteria. A large firm is any not satisfying the above criteria.

### Companies Act

| | Small company | Medium company |
|---|---|---|
| **Turnover** | max £2.8mn | max £11.2mn |
| **Balance sheet** | max £1.4mn | max £5.6mn |
| **Employees** | max 50 | max 250 |

A company qualifies as small or medium if it meets two of the three criteria above in any year.

### BBA

For statistical purposes, the British Bankers Association (BBA) define small businesses as those having an annual account turnover of up to £1mn.

Copies of this report are available from Bank of England Public Enquiries (0171) 601 4878
For further information please contact Adrian Piper, Melanie Lund or Jane Wright.

# EXECUTIVE SUMMARY

## Introduction

This, the sixth annual report in the 'Finance for Small Firms' series, seeks to identify some key themes that have emerged in the provision of finance for small firms since the last recession.

## Business environment

The current slowdown in economic growth, and expectations of below trend growth throughout 1999, have had a significant impact on business confidence in the small firms sector. While the sector as a whole appears more resilient than in previous economic cycles, it is important to note that many businesses are concentrated in the most vulnerable sectors.

The external environment is challenging for small firms not only because of the cyclical downturn but also as a result of changes caused by the introduction of the euro and the preparations required ahead of the Year 2000.

Small firms issues continue to be a priority on the Government's agenda. This has been reflected in the policies announced in the Budget (March 1998), the Pre-Budget Report (November 1998) and the DTI's Competitiveness White Paper (December 1998).

## Changing face of small firms finance

Small firms now appear to be more appropriately financed than in the early 1990s. They have a higher dependence on internal sources of finance, with many of the smallest businesses net creditors to the banking system. Those that do require external finance make more use of a wider range of finance products. They have reduced the proportion of finance accounted for by traditional bank lending and increased the proportion of asset-based and receivables finance. This reflects not only a more cautious approach to finance by both the providers and the small firms themselves, but also suggests that some small businesses are now run by people with more business acumen than in the last recession.

- 39% of small businesses sought external finance between 1995-97, compared with 65% in the 1987-90 period.
- Total bank lending to the small firms sector has declined from £39.5mn at end-1992 to £36bn by mid-1998.
- The balance of bank lending has moved away from short-term variable rate lending (overdrafts) towards more term (and to some extent fixed rate) finance.
- The quality of the banks' small business loan books has improved consistently over the past six years, although banks are alert to possible deterioration in the current climate.

## Debt finance

Traditional bank finance (overdrafts and term loans) remains the most important type of external finance for small businesses. Since the last recession, the small business sector has reduced its reliance on overdraft finance while increasing its use of term loans. There have been general improvements in the relationship between small businesses and their finance providers which has been reflected in levels of customer satisfaction. Contractual trade credit continues to be an important source of finance for all businesses, with many small businesses choosing to offer customers favourable credit terms to gain competitive advantage. The role of asset-based and receivables finance has continued to increase as a proportion of external finance for small firms.

- Bank finance accounts for 47% of all external finance to small businesses.
- The ratio of overdraft to term lending by value has fallen from 49:51 in 1992 to 31:69 in 1998.
- Over a third of all term loans have a residual maturity of ten years or more.
- Volume growth in the factoring and invoice discounting industry has averaged at 20% p.a. over the last ten years. Prepayments provided more than £4bn of liquidity to the market.

## Equity finance

Only a small proportion of small businesses are prepared to accept a reduction in ownership and control in return for equity finance. Growth-oriented, non-family businesses are more likely to seek external equity finance than family and lifestyle businesses.

Technology-based firms tend to require equity finance, often at an earlier stage than more traditional industries. The role of venture capital (both informal and formal) is crucial for these businesses, many of which require finance from the seedcorn stage. The role of public equity is also important for growth-oriented smaller companies. Second tier equity markets enable smaller companies to access public equity at an earlier stage than would otherwise be the case. Such markets not only enable businesses to raise finance but also offer earlier exit routes to business angel and venture capital investors.

- Venture capital finance accounted for only 3% of all SME external finance in 1995-97. This proportion has remained reasonably stable over the past ten years.
- Business angel networks invested £34.6mn in 1997/98, an increase of 28% compared with the previous year.
- Early stage investments by venture capital firms accounted for 20% of all companies financed but only 5% of the total amount of finance provided.

## Conclusion

Improvements in the relationship between small firms and banks over the last five years have reduced the risks of the banks making losses on their small business loan books on the same scale as in the early 1990s. Small businesses have a greater understanding of their financing needs and are less vulnerable to any deterioration in trading conditions than in the early 1990s.

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# SECTION ONE: INTRODUCTION

## The Bank of England's objectives

1.1 The statutory responsibilities of the Bank of England are set out in the Bank of England Act 1998. In particular, this forms the basis for the functions of the Monetary Policy Committee. Furthermore, a Memorandum of Understanding between the Bank, HM Treasury and the Financial Services Authority, agreed in October 1997, establishes that the Bank is responsible for the overall stability of the financial system. This includes, among other responsibilities, ensuring the efficiency and effectiveness of the financial sector.

## The Bank's small firms finance initiative

1.2 The Bank's current involvement in small firm financing issues dates back to 1993, in the aftermath of the last recession. At this time, there was evidence of a breakdown in communication and trust between small firms and their finance providers, specifically the clearing banks, which threatened the effectiveness of the provision of finance to this sector. Also, in the late 1980s and early 1990s, the banks had large exposures to the small business sector and made substantial losses as a result of the recession. This posed a reputational threat to the banking sector and had a destabilising effect on small businesses. Since that time many structural changes have occurred, improving the provision of bank finance to small businesses.

1.3 The Bank's first report on Finance for Small Firms was published in January 1994. This report is the sixth in this annual series.

## The Bank's work during 1998

1.4 The foundation of this report, and all other work in this area, is the regular contact we have with the clearing banks and other finance providers, small business representative groups, professional bodies, trade associations, academics and relevant Government departments. We also rely heavily on first-hand information from across the UK gained primarily through the small firms contacts of our 12 regional Agents. We are grateful for the time and effort that is spent on keeping the Bank informed on current small firms issues.

1.5 This year the Bank has also considered the issues surrounding the financing of ethnic minority businesses, and a separate report will be published on this in the near future. We have also continued to monitor the needs of small firms operating in, or seeking to enter, export markets.[1] The Bank has been actively involved in follow-up work on the financing of technology-based firms,[2] participating in both domestic and European working groups on the subject. Developments on both of these subjects are referred to throughout the report.

1 Bank of England *Smaller Exporters – A Special Report* (January 1998).

2 Bank of England *The Financing of Technology based Small Firms* (October 1996).

## The report

1.6 Previous reports have been based on a broad analysis of the small firms sector, addressing aspects of finance, public policy and business support. While this report takes all of these areas into consideration, it is focused more specifically on financing issues.

1.7 The key themes identified in this report are as follows:

- many small businesses are now more appropriately financed than they were in the early 1990s. This is important from both the financial stability and efficiency perspectives. Overall, the level of small firms indebtedness has fallen, while the range of types of finance has increased;
- the relationships between small businesses and their finance providers, specifically the banks, have improved significantly since the early 1990s and continued to do so in 1998. There is now a more open, two-way exchange of information between the banks and their small business customers;
- the quality of the small business stock is generally higher now than in the late 1980s. In the 1980s, a combination of government policy and more relaxed credit criteria on the part of the banks resulted in a large number of small businesses being established that proved not to be viable in the long term. The result was a substantial rise in business failures as the economy turned down. Since the last recession, it has been generally acknowledged that new businesses have been established by entrepreneurs with more business acumen.

1.8 Given these developments, small businesses should be less vulnerable to a downturn in the economy than in the last business cycle. This reduces the level of risk faced by finance providers, particularly the banks, in their exposure to this sector.

1.9 The Bank welcomes comments on this report and the names of the authors can be found on page 2.

# SECTION TWO: BUSINESS ENVIRONMENT

2.1 The financing needs of small businesses will be profoundly influenced by the general macroeconomic environment and, therefore, by the overall stance of monetary and fiscal policy. In this opening section, therefore, we consider recent developments in these areas.

## General macroeconomic background

2.2 Since 1995/96, when the growth in export orders started to slow, the performance of small firms in the service sector has exceeded that of manufacturing companies. In 1997, as sterling continued to appreciate and large exporters put increasing pressure on their, often small, suppliers to reduce costs, the divergence in performance of the two sectors widened. Small firms in the manufacturing sector were faced with increasing competition from import penetration, while growth in the service sector remained robust, as consumer demand was buoyed by windfall pay-outs. By the closing months of 1997, however, small firms in the service sector were also reporting a slowdown in demand due to a deterioration in export activity. From the opening months of 1998, the rate of growth of both sectors slowed.

2.3 Recent surveys of business activity[3] indicated that the downturn (evident in the opening months of 1998) has continued and intensified. Confidence fell sharply in Q3, with indicators reaching record lows. Contracting demand is now evident in the manufacturing sector for firms of all sizes, with sales and orders falling for both the domestic and export markets. Not surprisingly, this trading performance is now impacting on their employment expectations and investment. Small and medium-sized manufacturing firms were expecting to shed labour in the last quarter of 1998, although there was still a small positive balance of micro manufacturers expecting to recruit. The number of these firms planning to invest had fallen sharply. In the service sector, smaller firms had experienced a greater slowdown in domestic demand growth than larger firms, and further contraction in their export markets. This had resulted in a fall in the number of service firms planning to take on more labour, and their investment plans had also been affected.

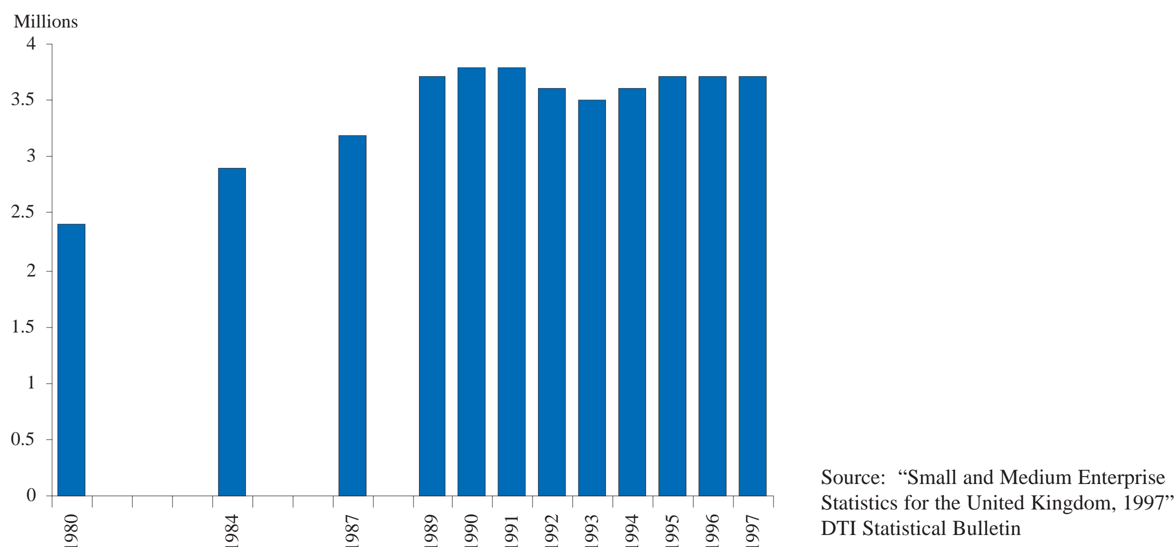
2.4 Our expectation is that this slowdown in domestic demand growth will continue in 1999, as will negative contributions to growth from net trade. The Bank of England's November *Inflation Report* described a central projection which involved a further decline in output growth during 1999 before a recovery towards trend growth by the second half of 2000, with the balance of risks to growth on the downside. This represented a weakening of prospects compared to the previous *Inflation Report* and was partly a reflection of the sharp deterioration in business optimism and the onset of world financial turbulence which have occurred since the summer. Business confidence has fallen especially sharply in the manufacturing sector, which in common with other traded goods sectors had been affected by the deterioration in the prospects for world economic activity following the Asian crisis and by the high levels of sterling. Although output growth as a whole remains positive, the *Inflation Report* warned of the possibility that the level of business investment could fall in 1999.

3 BCC Quarterly Economic Survey, NatWest Quarterly Survey of Small Businesses in Britain & CBI/Pannell Kerr Forster: Small and Medium Enterprise Trends Report.

## UK business stock

2.5 The business population in the UK grew during the 1980's, peaked in 1990/1991 at 3.8mn and then stabilised during the 1990's. There was a slight drop between 1992 and 1994, reflecting the lagged effect of the recession. There are currently 3.7mn businesses in the UK.

### Chart 2.1
### Number of enterprises




Source: "Small and Medium Enterprise Statistics for the United Kingdom, 1997" DTI Statistical Bulletin

2.6 According to the DTI, much of this growth in the business stock is a direct result of the growth in the number of sole traders and partnerships. This is a reflection of the changing industrial landscape in the UK over this period, involving downsizing by large corporates, leading to an increase in sub-contracting, and a shift from more traditional industries towards newer service industries.

2.7 Figures from the DTI[4] show that the proportion of the business population accounted for by firms with 49 or less employees has remained stable over the past 4 years at 99%. However, the actual number of micro firms (0-9 employees) has increased over this period, while the number of small (10-49) and medium-sized (50-249) firms has fallen slightly.

### Table 2.1: Changing composition of UK business stock

| Number of businesses % | Micro (0-9 employees) | Small (10-49 employees) | Medium (50-249 employees) | Large (250+ employees) |
|---|---|---|---|---|
| 1994 | 94.37 | 4.63 | 0.91 | 0.09 |
| 1995 | 94.50 | 4.63 | 0.79 | 0.08 |
| 1996 | 94.70 | 4.43 | 0.78 | 0.09 |
| 1997 | 94.90 | 4.24 | 0.76 | 0.09 |
| **Employment %** | | | | |
| 1994 | 28.17 | 15.92 | 19.38 | 36.54 |
| 1995 | 31.66 | 16.28 | 17.93 | 34.12 |
| 1996 | 30.58 | 15.27 | 17.78 | 36.37 |
| 1997 | 30.22 | 14.47 | 17.38 | 37.93 |
| **Turnover %** | | | | |
| 1994 | 18.43 | 14.75 | 26.03 | 40.78 |
| 1995 | 20.67 | 16.89 | 24.99 | 37.45 |
| 1996 | 24.98 | 17.30 | 21.07 | 36.65 |
| 1997 | 23.05 | 16.41 | 22.22 | 38.32 |

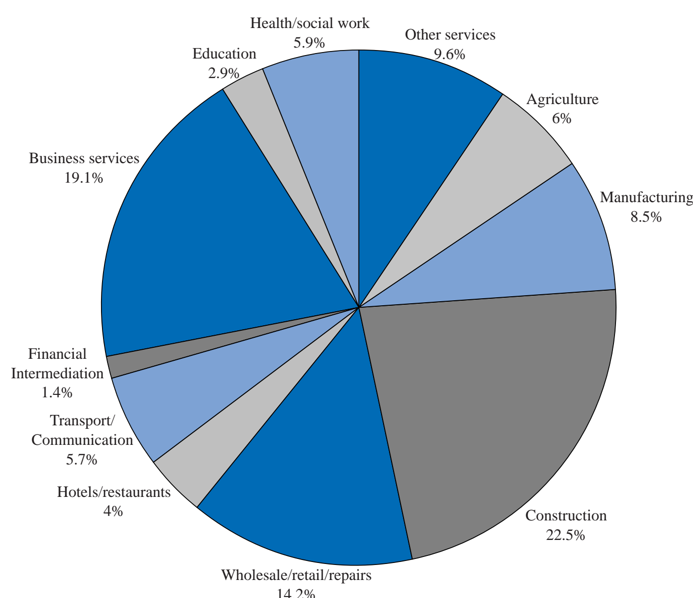
Source: "Small and Medium Enterprise Statistics for the United Kingdom, 1997" DTI Statistical Bulletin

4 These figures cover all private sector businesses, with employment including the number of employees plus the number of self-employed persons. Turnover refers to the value (excluding VAT) of sales, work done and services rendered.

2.8 In 1997, smaller firms with 49 or less employees accounted for about 45% of total employment. Although this proportion has been relatively stable in the last four years, it masks the changes by size of firm – employment by micro and large firms has grown, while that of small and medium firms has fallen. Smaller firms also accounted for a significant proportion (39.5%) of turnover[5] in 1997. This contribution has grown steadily between 1994 and 1996, although it fell back slightly in 1997, while that of medium-sized and large firms has continued to decline.

2.9 In terms of the sectoral breakdown, a relatively large proportion of the total stock of smaller firms are located in the construction, business services and wholesale/retail sectors, accounting for 22.5%, 19% and 14% of the 1997 total respectively. The composition of the small business stock has changed over the past four years – in 1994 the construction, business services and wholesale/retail sectors accounted for 19.8%, 17% and 17.3% respectively – which can to some extent explain changes in the proportion of employment and levels of productivity of the small firms sector.

### Chart 2.2
### Smaller firms (under 50 employees) by sector*




* sectors <1% excluded from chart

Source: "Small and Medium Enterprise Statistics for the United Kingdom, 1997" DTI Statistical Bulletin

2.10 Only 9% of these firms are classified as manufacturers[6], compared with 34% of large firms. Survey evidence and Z score indicators suggest that certain sectors are suffering disproportionately from the current slowdown in economic growth – namely the extractive industries, construction, media and telecommunication, manufacturing and agriculture. Thirty six per cent of small firms operate in these sectors.

5 These figures exclude the financial intermediation sector, as the turnover figures of large companies cause a significant distortion to the distribution.

6 This is based on the DTI definition which uses SIC codes. Surveys of business activity generally use a much broader definition of manufacturing which encompasses construction and other non-service sectors.

## Public policy

2.11 Government economic and fiscal policy has a significant impact on the environment in which businesses trade. The current Government believes that there is a need for more active encouragement of entrepreneurship in the UK. Its March 1998 Budget sought to foster a more favourable environment for small firms, mainly through a package of tax reforms. Further measures were proposed in the Chancellor's Pre-Budget Report, published in November 1998.

2.12 Research[7] produced prior to the 1998 Budget has assessed the overall burden of tax, combining financial and compliance costs, for sole traders, partnerships and small limited companies. The results showed that the burden of taxation rose marginally in 1995/6 before falling in 1996/7 and again following the July 1997 Budget. The model that was developed estimated that, in 1997, sole traders and partnerships contributed £20bn of taxes, equivalent to 7% of Government revenues. Small limited companies contributed £45bn to the Exchequer, 16% of total Government income. Combined, the small firms sector provided 20% to 25% of the Treasury's income. The research also found that the main barriers to the growth of small businesses were the low VAT registration threshold, the high costs of employment, and the current incentives to withdraw rather than retain profits.

### *Highlights of 1998 Budget*

#### *Corporation tax*

2.13 The small firms corporation tax rate (which applies to companies with taxable profits up to £300,000) was reduced by 1% to 20% from 1 April 1999, thus increasing the divergence with the basic rate of income tax (paid by unincorporated businesses). The threshold below which companies were exempt from paying corporation tax in quarterly instalments was raised to include medium-sized firms in the exemption. The change was in response to concerns regarding the negative impact quarterly payments would have on medium-sized firms' cashflows.

#### *Capital allowances*

2.14 The enhanced capital allowances available to small and medium-sized businesses[8] were extended for a year, although at a reduced level. The Government made a commitment to review how best to encourage investment by small and medium-sized businesses, and the role of capital allowances.

#### *Capital gains tax (CGT)*

2.15 The CGT regime was simplified and reformed, partly to encourage entrepreneurial activity by rewarding longer-term investment. Indexation was removed and was replaced by tapering, under which the rate of CGT on assets held for 10 or more years was reduced from 40% to 10% for higher rate tax payers, and from 23% to 5.75% for basic rate tax payers. As part of the overall reform of CGT, retirement relief will be phased out from 6 April 1999, and cease to be available from 6 April 2003.

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7 Francis Chittenden and et al, Manchester Business School, *Small Business Taxation And The '98 Budget* (1998).

8 Qualifying criteria are based on the Companies Act definition of small and medium-sized businesses.

*The Enterprise Investment Scheme (EIS)*

2.16 EIS and capital gains tax reinvestment relief were merged, taking effect from 6 April 1998. The £1mn limit on the amount that companies can raise through the EIS each year was abolished (for further details see Section Five).

*National Insurance Contributions (NICs)*

2.17 NICs were restructured to reduce the burden on lower paid employees.

*VAT*

2.18 The VAT threshold was increased to £50,000 from 1 April 1998.

***Pre-Budget Report (November 1998)***

*Banking*

2.19 An independent review of the services provided by the banking sector in the UK was announced by the Chancellor. The review team, led by Don Cruickshank, will examine the current levels of innovation, competition and efficiency in this sector, making use of international comparisons. One key theme will be the provision of finance to small and medium-sized firms. Mr Cruickshank is expected to report in November 1999.

*Tax reform*

2.20 As noted above, the March 1998 Budget included a package of tax reforms to encourage enterprise in small firms. These measures are being taken forward on a number of fronts in the run up to the March 1999 Budget. The Treasury will be considering effective overall rates of tax borne by small businesses, including the corporate tax rate and the case for continued enhanced first year capital allowances. It will also be considering whether the taxation of capital gains arising from investment in smaller growing firms might be modified to encourage entrepreneurial investors to recycle their gains from one company into another.

*Corporate venturing*

2.21 The Government is seeking further to encourage direct corporate venturing, whereby large companies provide support and investment in smaller businesses. The rationale behind this concept in part is that corporate investors are better placed to judge investments in firms operating in their own industries, particularly in high-technology sectors, than general venture capitalists. In addition, corporate venturing can create synergies, combining the dynamism and creativity of smaller firms with the capacity and market reach of larger corporates. The Government intends to consult on methods of incentivising corporate venturing, perhaps through the tax system.

*Administrative burden*

2.22 Small businesses tend to lack the back-up to administer National Insurance, income tax, VAT payments and payroll systems. In order to reduce the burden, there are plans to create a ‘one stop shop’ for tax advice, to facilitate closer co-operation between the UK’s tax authorities. The Treasury confirmed that a comprehensive advice service would be created, administered by a helpline, and backed up by local offices, providing entrepreneurs with advice on a wide range of

issues. The new arrangements will also include VAT administration, which is currently the responsibility of Customs and Excise.

### *Research and development*

2.23 Following the earlier review of R&D launched at the March 1998 Budget, the Government concluded that there was a case for examining new tax-based incentives to encourage R&D investment by smaller enterprises. The Government will consult business in the coming months on the feasibility and effectiveness of a volume-based R&D tax incentive for SMEs. One suggestion from the report of the Treasury Working Group on the Financing of High Technology Businesses (see box on page 15-16) was that loss making companies with significant R&D outgoings should get a PAYE and NIC rebate to help ease cashflow constraints in early years. As a first step, the Inland Revenue and DTI will review the definition of and association guidance on business R&D for fiscal purposes.

2.24 Intellectual property (IP) is one of the key outputs of firms' R&D investment. The Government intends to consult business in the coming year on the best means of simplifying the taxation treatment of IP transactions, e.g. by bringing it into line with accounting treatment, and the taxation of royalties arising from IP.

### *Enterprise*

2.25 The forthcoming launch of an entrepreneurship campaign by the BCC, CBI, IOD and Federation of Small Businesses is another venture aimed at promoting small business. It will among other things provide mentors for new businesses, and facilitate improved understanding between banks and small businesses.

## ***Competitiveness White Paper***

2.26 The DTI published their 1998 Competitiveness White Paper (CWP) on the 16 December. The key theme of the report was to create an entrepreneurial 'knowledge-driven' economy, enabling British businesses to compete more successfully in an increasingly global market. The CWP suggested that UK businesses face a range of barriers to growth, including fiscal and cultural barriers, a lack of access to the right finance for growth and a lack of business skills to manage it, and regulations which impose excessive or unnecessary burdens on new business. In response to these barriers the Government reiterated the need for taxation reforms (outlined in both the March 1998 Budget and the Pre-Budget Report), announced a review of arrangements for business rescues, and committed to working with the banks and venture capital industry to address the problems faced by smaller firms, especially in the high technology sector, in obtaining finance.

2.27 The CWP announced the development of an Enterprise Fund worth £150mn over three years, aimed at raising more start-up and early stage funding for the smallest enterprises. This fund will provide finance for the Strawman initiative, a national venture capital fund that will support very early stage, high technology businesses. Regional venture capital funds will be established to provide small-scale equity to businesses with growth potential and help will be given to the finance industry to develop innovative financing ideas to assist growth businesses. The Fund will also encompass finance for the Small Firms Loan Guarantee Scheme (see box on page 34/35).

### *The Social Exclusion Unit*

2.28 The Social Exclusion Unit was established by the Prime Minister in 1997 to look across the range of Government policies and departments for solutions to problems of social exclusion. Its September 1998 report on neighbourhood renewal highlighted some of the problems of access to personal and business finance in Britain's most deprived areas. The Treasury, in conjunction with other Government departments and outside experts, is now taking forward a review of policies in the following areas:

- access to personal financial services, including insurance, in light of recent trends for high street banks to close branches in less profitable locations;
- access to finance and support services for small firm start-ups and continuing enterprises operating in deprived areas.

Both reviews are due to recommend policy actions by July 1999.

2.29 In its forthcoming report on the financing of ethnic minority small firms, the Bank identifies no evidence of redlining by banks in the UK, and little demand for CRA-style legislation.

### Technology-based small firms

Both the UK Government and the European Commission have increased their interest in and commitment to the creation and development of technology-based firms (TBFs) during 1998.

In November 1997, the Paymaster General commissioned an independent review on the barriers to the financing of high-technology businesses. The Working Group, chaired by Sir Peter Williams of Oxford Instruments, published its report to coincide with the Pre-Budget Report, in which a number of its recommendations were endorsed in principle.

The main recommendations were:

- a zero rate of CGT for early stage high technology investments after 5 years – if not, a 20% rate after 3-5 years and 10% after 7 years. This regime to be combined with roll-over arrangements to encourage serial investors;
- a new tier of tax incentive, "Technology Venture Capital Trust (VCT)", to be established under the existing VCT/EIS schemes, specifically targeted at TBFs and accessible to insurance companies;
- equity incentives for key managers in TBFs which would be taxed as capital gains at time of sale of shares;
- an Emerging Growth Rebate, to allow these firms to offset losses against various tax payments, such as PAYE and NICs;
- an annual forum of senior representatives of the major financial institutions and early stage TBFs, to be hosted by the Bank of England, to investigate the main barriers to institutional investment.

The Bank is considering how to respond to this final recommendation.

A DTI-backed steering group, chaired by Mr Ronald Cohen of Apax Partners, was also established in 1997, with the broader remit of assessing the barriers to growth of emerging technology firms. The main areas of its focus are the commercialisation of university research, the better protection of intellectual property and the establishment of a pan-European capital market for technology-based firms.

The European Commission has focused more resources on the financing of technology-based and other growth-oriented small firms in the European Union. Following the Luxembourg Employment Summit (20-21 November 1997) it proposed three new financial instruments to support SMEs: the European Technology Facility Start-up (ETF Start-up), the Joint European Venture and the SME Guarantee Facility. ECU 450mn has been allocated over three years (1998-2000) for this programme of initiatives.

DGXIII, as a part of its Innovation, Creation of New Businesses and Jobs initiative, has undertaken a wide-ranging process of consultation across Europe to determine what national governments and the European Union might do to promote new innovative firms. The First European Forum for Innovative Companies was held in Vienna in November 1998.

A DGIII-backed Expert Working Group has produced a report on the Benchmarking of Finance for Innovation, looking at how the European Union compares with both the US and Israel in its provision of finance for small technology-based firms. The report, presented to the Industry Council in November 1998, has been published.

### EMU and Year 2000

2.30 Finally, two other events – the introduction of the euro on 1 January 1999 and the Year 2000 - will impact on the business environment and so represent additional challenges to UK small businesses.

2.31 The introduction of the euro on 1 January 1999 will mean substantial changes for businesses in the eleven euro zone countries, in terms of greater price transparency, exchange rate certainty and lower transaction costs. Although the main direct impact will be on UK businesses which export to, import from, or operate in those countries (or which supply other businesses doing so), businesses of all sizes have been encouraged to consider the competitive threat or opportunity it presents.

2.32 A survey[9] on the single European currency for the Financial Times by MORI found that only 35% of small companies felt either 'very or fairly well informed' about plans for the euro and the Government's proposals for UK participation, compared with 65% of large companies. Some 64% of small companies felt either 'not very or not at all informed'. Only 17% of small companies said they had taken some action to prepare for the single currency, compared with 60% of large companies. The vast majority of small firms, which do not trade directly with international markets, believe that the euro will not affect their business. However, there is real concern that the larger exporters will seek to reduce their foreign exchange exposure by invoicing their suppliers in euro.

2.33 Many computer systems and other microprocessors have been designed or programmed in such a way that they will not be able to recognise the year date in the Year 2000, possibly causing them to fail or operate erroneously. This problem has the potential to affect seriously the

9 Financial Times, 28.9.98.

trading activity of all firms, large or small, and that of their customers and suppliers. There is a need for all businesses to take action to ensure that they are Year 2000 compliant.

2.34 Research[10] by Action 2000, the DTI initiative to help companies of all sizes overcome the Millennium date change problem, found that only 4% (9%) of the smaller companies[11] surveyed in July 1998 said that they were Year 2000 compliant at that date. Some companies had started the process of tackling the problem, with 9% (20%) reporting that they had done enough to be able to function from 1 January 2000, and 10% (20%) had completed an impact assessment. However, 26% (22%) still had no formal programme and 36% (12%) had not taken any action.

2.35 Both these events will impose additional exceptional costs on businesses. They will also have implications for the trading conditions of firms and so affect their need for, and ability to raise, finance. The level of preparedness of small firms in the face of these impending changes may well influence the perceived risks, and hence lending decisions, of the providers of finance.

2.36 A key issue is whether these two events will affect the number of small business failures. Research by Barclays Bank[12] has shown that 1.5mn small businesses do not use a PC and, of those that do, usage tends to be limited to word-processing and accounting applications. Although there is always the danger of problems arising from non-compliant embedded chips, it is suggested that the business activity of the vast majority of small firms will not be radically affected. For those that are affected, the extent of the problem will be felt immediately. By contrast, the effects of the introduction of the euro on trading will probably not have an immediate impact and so small firms need to maintain awareness of the potential threat to business.

10 Action 2000, *State of the Nation – Wave Two Results* (July 1998).

11 Figures outside brackets refer to companies with 1-9 employees, those in brackets refer to those with 10-249 employees.

12 Barclays Bank, *Barclays Small Business Bulletin,* Issue 2 (1998).

# SECTION THREE: THE CHANGING FACE OF SMALL FIRMS FINANCE

3.1 The small firms sector represents a large (and growing) market for banks and other finance providers. Although it offers considerable scope to enhance banks' profitability, there are significant risks which can arise. In the last recession, for example, the banking sector suffered large losses from its loans to the small business sector. The major clearing banks had to make provisions of around £3bn against this part of their loan book. The problems experienced by the banks were intensified by the collapse in the residential property market, against which a high proportion of their lending was secured. While these losses were not considered a threat to the financial system as a whole, they did represent a reputational risk to the banks and impacted on their profitability. Moreover, these problems served to highlight that many of the firms in this sector had been inappropriately financed.

3.2 Since that time there has been a steady improvement in the ways in which finance providers service this market. Against a macroeconomic background of steady growth, however, it is difficult to distinguish the improvements resulting from the structural changes in the approach to financing these firms from those resulting merely from better trading conditions. The current and prospective slowdown in the growth of economic activity will test the robustness of the improvements.

## STABILITY ISSUES

### Finance for small businesses since the last recession

3.3 To compare the current risks to the banks from their small business portfolio with those faced in the last recession it is necessary to assess the main changes in small firm financing patterns since the early 1990's.

3.4 Small firms, in aggregate, are markedly less dependent on external finance. Recently published research has shown that only 39% of small businesses sought external financing of any kind between 1995-97[13] , compared with 65% in the 1987-90 period.[14]

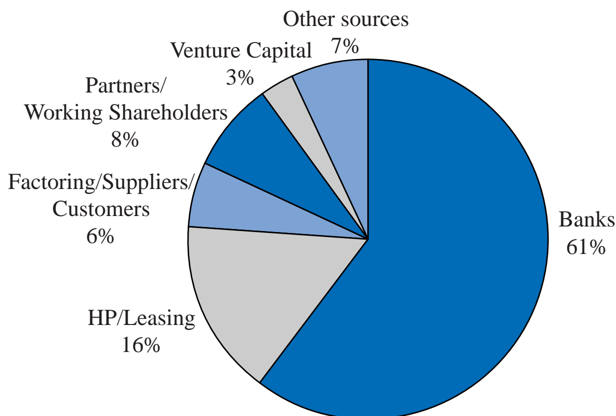
3.5 The proportion of external finance for small businesses accounted for by traditional bank borrowing has also declined. This partly reflects shifts towards factoring and asset-based finance[15] (see Charts 3.1 & 3.2) - although much of this is itself provided by finance subsidiaries of the main clearing banks.

13 ESRC Centre for Business Research, Cambridge, *Enterprise Britain 1994-1997* (1998).

14 Small Business Research Centre, University of Cambridge, *The State of British Enterprise* (1992).

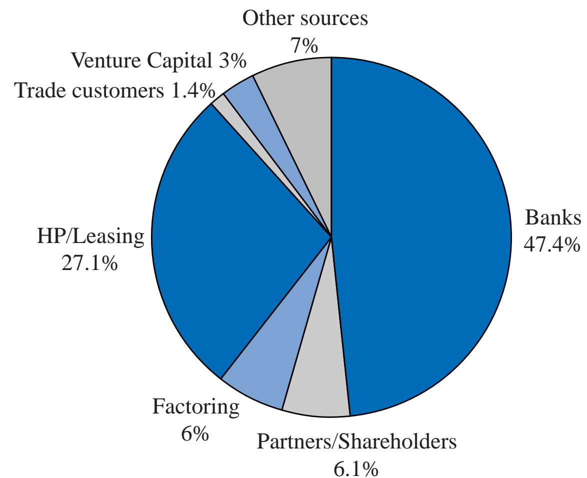
15 ESRC Centre for Business Research, Cambridge, *Enterprise Britain 1994-1997* (1998).

**Chart 3.1**
**Sources of external finance for SMEs 1987-90**




Source: ESRC Centre for Business Research, Cambridge *The Changing State of British Enterprise 1986-1995.*

**Chart 3.2**
**Sources of external finance for SMEs 1995-97**

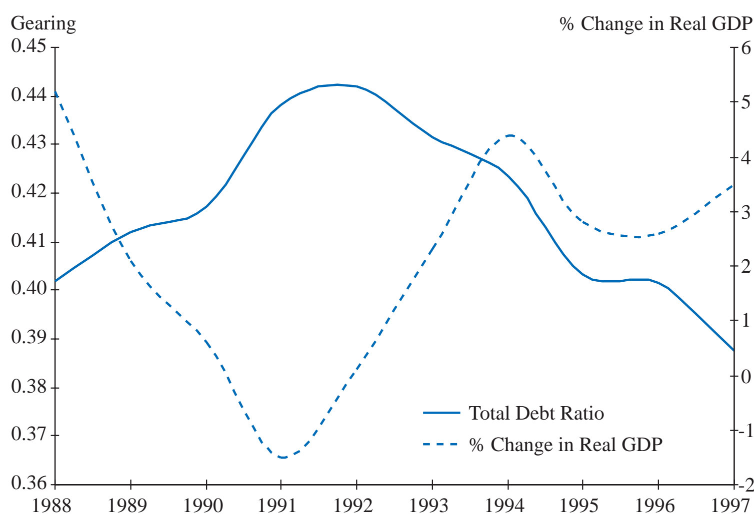



Source: ESRC Centre for Business Research, Cambridge *Enterprise Britain 1994-1997.*

3.6 It also reflects a more cautious approach by small businesses, which has resulted in an absolute decline in the net indebtedness of the sector in aggregate. Total small business deposits at banks amounted to 86% of total bank borrowing[16] in June 1998, compared with 56% at end-1992 (see paragraphs 4.1 and 4.2 in Section Four). The June 1998 figures did, however, report that total deposits decreased for the first time since the series began, falling by £0.7bn (2%) since December 1997, to £30.9bn.[17]

3.7 The general trend in levels of indebtedness of small, privately-held firms[18] was investigated by the Manchester Business School.[19] This showed that the strong inverse relationship between debt gearing levels[20] and GDP growth, evident between 1988 and 1993, has been much less

**Chart 3.3**
**Gearing ratios of private companies over the economic cycle**




Source: *The Financial Affairs of Private Companies* Manchester Business School

16 British Bankers' Association figures based on businesses with a debt turnover <£1mn.

17 This is despite the inclusion of another reporting bank.

18 A panel database of 3500 firms with less than 200 employees.

19 Poutziouris, Chittenden and Michaelas, Manchester Business School/Tilney Fund Management, *The Financial Affairs of Private Companies* (1998).

20 Gearing defined as total debt to total assets.

clear-cut since 1994. Average gearing levels of small, privately-held firms continued to fall between 1994 and 1996, notwithstanding some moderation in GDP growth. It was suggested that this might reflect the impact of the last recession on borrowing and/or lending behaviour. However, other research has indicated that the borrowing behaviour of the 1980s was atypical for small firms (traditionally net creditors with the banking industry). On this hypothesis, present behaviour indicates a return to the norm. Both of these possible explanations suggest that the current economic slowdown might not result in an increase in the indebtedness of the small firms sector on the scale of that experienced in the last recession.

3.8 Reflecting these trends, the stock of total bank lending to the small firms sector has declined, from £39.5bn at end-1992 to £36bn by mid-1998. That said, the June 1998 figures reported that total lending to small firms had increased by £1.9bn since December 1997.[21]

3.9 The structure of bank lending has shifted away from short-term variable rate lending towards more term (and to some extent fixed rate) finance. The ratio of overdraft to term lending has fallen significantly from 49:51 in 1992 to 31:69 in 1998, while fixed rate lending has risen from 28% to 33% of term lending since 1996.

### Risks to finance providers

3.10 The main concern of the clearing banks in the provision of finance to the small firms sector is, of course, that businesses will fail and default on outstanding commitments. Given that approximately 35%-40% of banks' income derives from fees and charges, a reduction in the small business stock adversely affects the banking sector even if the closures do not result in bad debts.

3.11 Small firms do have a higher probability of ceasing to trade than large firms.[22] There is no evidence to suggest that this is because small firms are more vulnerable to changes in trading conditions, although this is widely believed to be the case. However, there are other factors, apart from insolvency, which might explain these lower survival rates, including the retirement, return to employment, or death of the self-employed business owner, and low expectations of future success.

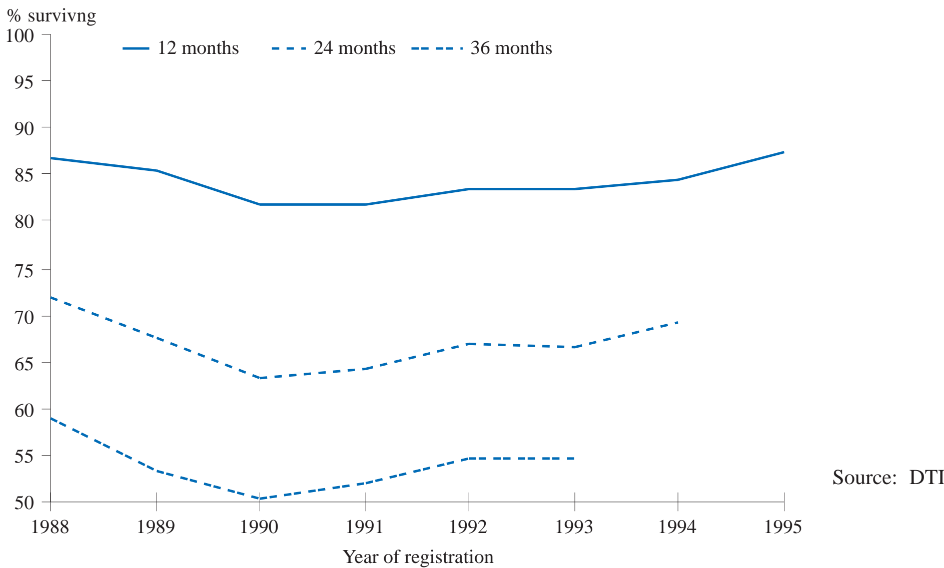
3.12 Evidence has shown that, for all of these reasons, small business closures occur throughout the economic cycle, with slightly less than half of businesses closing in their first three years irrespective of the economic conditions. As the graph shows, of those businesses registered for VAT in 1993, only 55% were still registered after 3 years.[23]

21 A minor part of this will, however, be accounted for by the additional bank in the sample.

22 Ganguly P, *UK Small Business Statistics and International Comparisons* (1985).

23 The survival rates in the graph are based on VAT deregistrations. The drop in survival rates of those registered in 1989 and 1990 could be due to firms falling below the threshold following the increase in 1991.

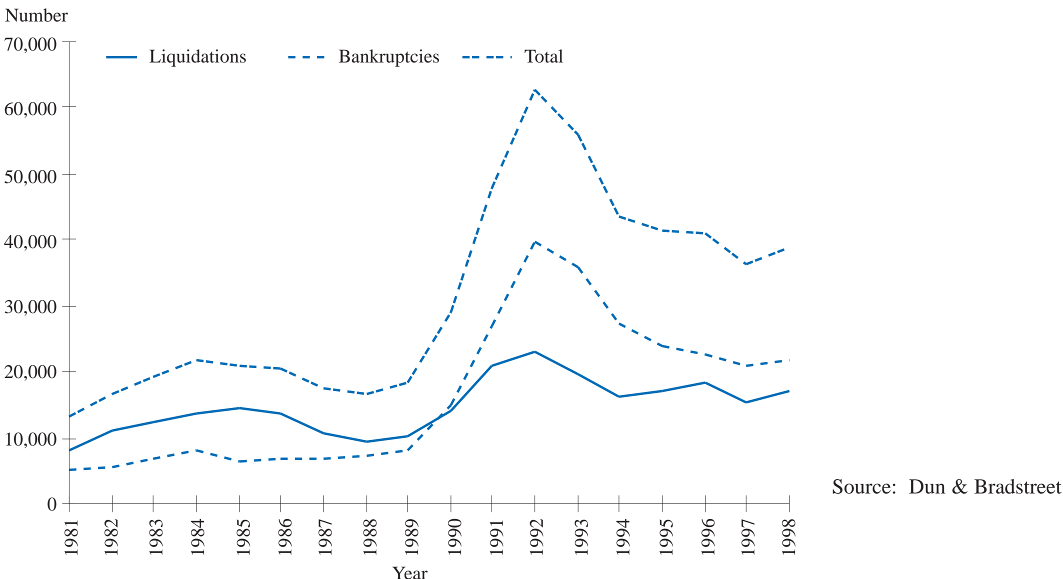
## Chart 3.4
## UK survival rates for VAT registered businesses




Source: DTI

3.13 In the majority of cases, small businesses will close without banks, and other finance providers, incurring any loss due to the non-repayment of a loan/overdraft.[24] However, the number of those failures that do result in losses to creditors fluctuates, and the trend in bankruptcies and company liquidations is clearly linked to the state of the economic cycle. This is supported by academic studies[25] that found that there was a relationship between the number of small business failures and macroeconomic conditions.[26]

## Chart 3.5
## Business failures figures




Source: Dun & Bradstreet

24 It has been shown that business closure was 12 times more likely than 'entrepreneurial bankruptcy'. Storey DJ, *Firm size and performance* in Acs and Audretsch (eds) *The Economics of Small Firms: A European Challenge*, Kluwer Academic Publishers.

25 Storey DJ, *Understanding the Small Business Sector* (1994).

26 The results were sensitive to definitions of business failure used.

3.14 It is likely, therefore, that the number of small business closures will increase as the economy slows, but we do not expect the level of small business failures to rise by as much as in the early 1990s, for a number of reasons.

3.15 Firstly, business start-ups grew rapidly in the 1980s as a result of a combination of government schemes[27] and deregulation of credit controls. Among these start-ups there were probably a large number of businesses that were not viable propositions and had a relatively high probability of failure. In addition, the credit boom encouraged many small businesses that were traditionally net lenders to the banking sector to take on debt finance. This weakened the banks' capital base while increasing their exposure. As trading conditions deteriorated and collateral values slumped, the banks started to call in uncommitted funds, which in turn increased the number of failures.

3.16 Secondly, as noted above, small businesses are now more appropriately financed than in the 1980s, accessing a wider range of financing sources. They are no longer so dependent on overdraft financing and are more reliant on committed funds, with fixed repayment streams. This reduces their vulnerability to the economic cycle and, where fixed rate borrowing is used, removes the risks associated with adverse movements in interest rates. That said, locking into fixed rate agreements imposes a cost on small businesses when interest rates are falling and trading conditions deteriorating.

3.17 The change in the structure of bank finance to small businesses, while increasing the stability of the small firms sector, has also altered the type of exposure held by the banks. Banks now have a higher amount of committed funds than in the last recession (term loans up from £20.1bn to £24.8bn since 1996). The majority (64%) of these committed funds have residual maturities of over 5 years and over a third (36%) have residual maturities of over 10 years. Therefore, the banks are more locked into the provision of finance to the small firms sector throughout the economic cycle. The banks have, however, built terms and conditions into term loans to protect their position.

3.18 Thirdly, individual small business banking codes of practice and the *Statement of Principles: Banks and Businesses Working Together* (March 1997) have led to a more open, two-way relationship between banks and small businesses. Banks now have improved warning systems in place to detect at an early stage when businesses are encountering trading difficulties. Small firms are more prepared to share information with their banks. Better relations and a higher degree of co-operation should help to avoid some of the antagonisms of the last recession, which contributed to increased business failures and seriously affected the reputation of the banks.

3.19 Fourthly, it is generally acknowledged that small firms today are more professionally managed – by people with more business acumen – and are assisted by a wider network of support agencies. There is still no robust empirical evidence supporting the case that businesses run by people who have received formal training in financial management and other management skills are more likely to succeed. However, it is believed that these skills are important in running a business and in communicating effectively with finance providers, and were the primary motivation for the establishment of the Financial Management Working Group (see box).

27 The Enterprise Allowance Scheme encouraged unemployed people to become self-employed and small firms' corporation tax was reduced from 42% to 25%.

3.20 In conclusion, even in the event of a downturn comparable to that of the early 1990s, the banks are unlikely to experience bad debt problems in relation to small firms on the scale of the previous recession.

### The Financial Management Working Group

The Treasury established the Financial Management Working Group in 1996 to consider the problem of inadequate financial management in small firms, and to review the effectiveness of existing initiatives and ways in which financial management might be improved. The following main observations and recommendations made in the report published in October 1998.

#### The main observations

- A wide range of initiatives and services are available to small firms, but these are of varying quality.
- *Accountancy practices* have an important role in helping small firms improve financial management skills, and are well placed to direct clients toward services available elsewhere.
- *Business Links* provide independent advice and have a vital role in helping small businesses understand the importance of a professional approach towards financial management.
- Greater co-operation and co-ordination among providers is needed to improve financial management of small firms.
- *Financial Health Checks*, designed to demonstrate to a small business any financial management deficiencies and to highlight areas for training and improvement, could be used to attract entrepreneurs and stimulate demand for further advice and training.
- *Mentoring* can play a role in strengthening financial management in small firms.

#### The key recommendations

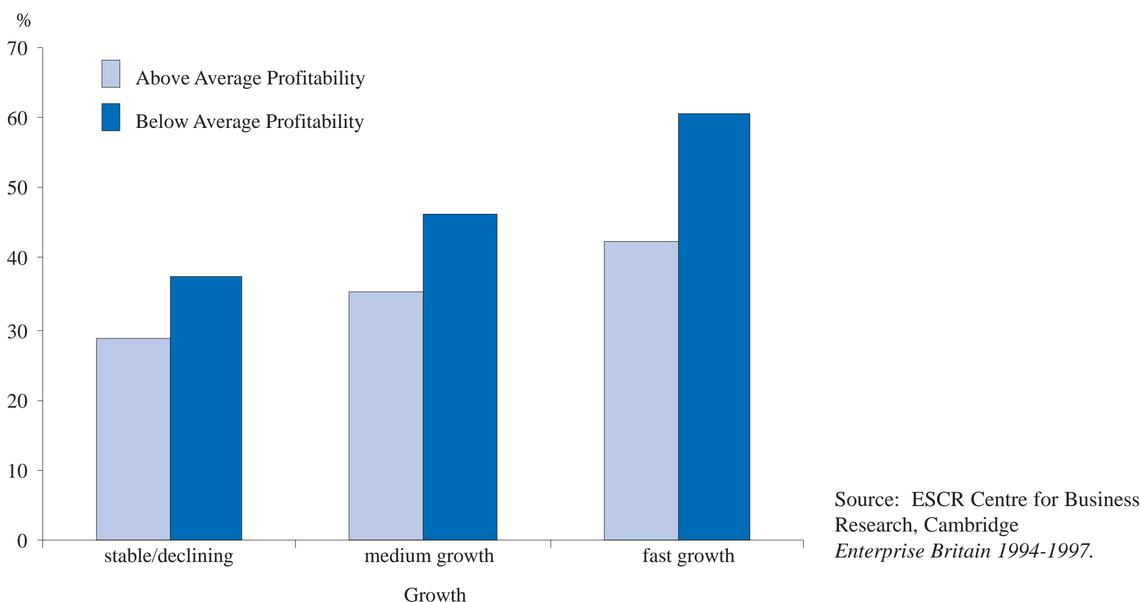
- Representative bodies, trade associations and service providers to raise awareness of the importance of good financial management.
- The Government and others to play a key role in the development of Financial Health Checks.
- Business Links to make available a free comprehensive local guide to financial management training, support and services.
- The professional accountancy bodies to provide relevant financial management training and best practice for their members and to encourage them to provide more specialised services including financial management.
- An independent evaluation of the role of formal mentor and non-executive director networks and search organisations to be undertaken to establish their impact and examples of best practice

## EFFICIENCY ISSUES

3.21 The Bank of England, in its monitoring of finance for small firms, is not solely concerned with the implications for financial stability of the potential losses that finance providers, in particular banks, might make in servicing this market. Its other main objective in this context is to ensure that financial markets and institutions are efficient and effective in providing finance to UK businesses.

3.22 In fact, as already noted the small firms sector is highly dependent on internal resources to finance its activities. Research from Manchester Business School[28] reported that internal resources – a combination of retained earnings and owner's equity - accounted for 63% of the financing of private SMEs in 1996. The degree to which internal resources are available will of course depend on the profitability of the firm and the state of the economic cycle.

### Chart 3.6
### Percentage of firms who sought finance in 1995-97 by profitability and growth




Source: ESCR Centre for Business Research, Cambridge
*Enterprise Britain 1994-1997.*

3.23 Demand for external finance is also positively correlated with business size. Adopting the definitions used in research by the ESRC Centre for Business Research[29], 30% of micro businesses (0-10 employees) sought external finance in 1995-97, compared with 45% of small (10-99 employees) and 49% of medium (100-499 employees)[30] businesses. Turning to sub-sectors within the small business sector, manufacturing firms, newer businesses and – particularly – growth-oriented businesses are now more likely to seek external finance than service firms, older and lifestyle businesses.

3.24 One of the main lessons learnt from the last recession, which the Bank has highlighted in its previous reports, is the importance of the 3 A's of small firms finance - **availability, appropriateness** and **accessibility**.

### Availability

3.25 Ready access to finance when needed is often a more compelling consideration for small firms than its actual cost. There are a number of factors that might affect the availability of finance to small firms.

28 Poutziouris, Chittenden and Michaelas, Manchester Business School/Tilney Fund Management, *The Financial Affairs of Private Companies* (1998).

29 ESRC Centre for Business Research, Cambridge, *Enterprise Britain 1994-1997* (1998).

30 Based on the number of employees in 1996/7.

### *Changing macro-economic conditions*

3.26 It is a standard feature of credit management that banks should adjust their risk assessments of small firms as trading conditions alter. It is always possible, of course, that credit will be rationed in anticipation of an economic downturn, and by more than might be explained by any deterioration in the creditworthiness of the borrower (perhaps because of concerns over banks' returns on equity). The subsequent lack of availability of credit could restrict businesses from accessing the greater financial support they need during such periods.

3.27 The key question is whether there is a danger of lack of availability of bank finance for small firms in the current conjuncture. Although there has been anecdotal evidence of banks withdrawing some overdraft facilities – in anticipation of a downturn – from the end of 1997, this is not sufficiently robust to confirm that there will be a problem for small firms in the months ahead. Many of the problems faced by banks in this sector in the recession of 1991/1992 were the result of excessive and indiscriminate lending in the late 1980s. More discerning lending policies have been pursued in the last five years, and this points to less likelihood of a sudden reduction in credit as the economy slows down.

### *Collateral*

3.28 Although banks now take more account of business plans and cashflow projections in lending to small businesses, they do still take collateral in order to overcome the risks from adverse selection and moral hazard.

3.29 There is a debate in the academic literature regarding the direct implications of housing assets as an important source of collateral for entrepreneurs. Certain studies[31] have found that housing wealth is an important factor in the rate of new business formation and, as a result, its lack could act as a constraint on entrepreneurship. Other research has shown that the availability of collateral does not impact on the birth of new firms, but on survival rates, for two reasons. Firstly[32], existing firms with unpledged security are more likely to have access to external finance to help them trade through difficulties. Secondly[33], the larger the initial capitalisation of a business, the lower the risk of failure in the short term.

3.30 There is evidence, therefore, that the availability of debt finance to small firms is affected by the size and value of those assets which can be taken as collateral.[34] This is of particular concern to small technology-based firms which often have few tangible assets against which to raise debt finance. There is currently a debate about how intangible assets, such as intellectual property, could be more appropriately valued and accounted for in these circumstances. If such intangibles could be valued more explicitly in balance sheets, it could have a beneficial effect on the ability of firms to raise finance at finer rates.

### *Competition in bank lending*

3.31 The providers of bank finance to small businesses operate in a concentrated industry. The four main English clearing banks account for 83.7% of the market, with NatWest and Barclays together accounting for 50% of the total.

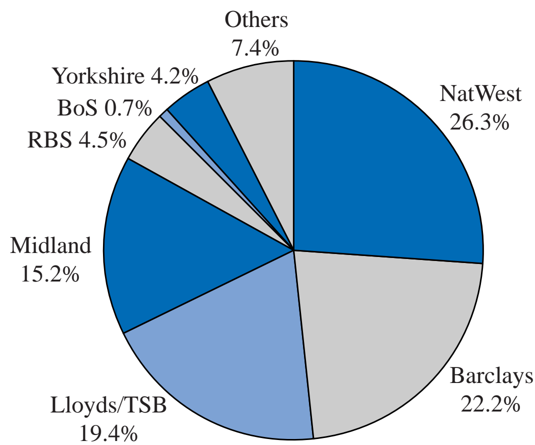
31 Black, de Meza and Jeffreys *"House prices, the supply of collateral and the enterprise economy" The Economic Journal* (1996).

32 Robson *"Housing wealth, business creation and dissolution, in the UK regions" Small Business Economics* (1996).

33 Cressy R *Why do firms die young?* Warwick Business School (1998).

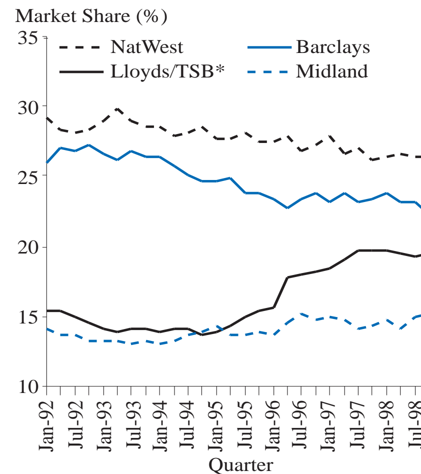
34 Poutziouris, Chittenden and Michaelas (1998) *The Financial Affairs of Private Companies*, Manchester Business School.

## Chart 3.7
## Bank market share October 1998




Source: Taylor Nelson Business Line

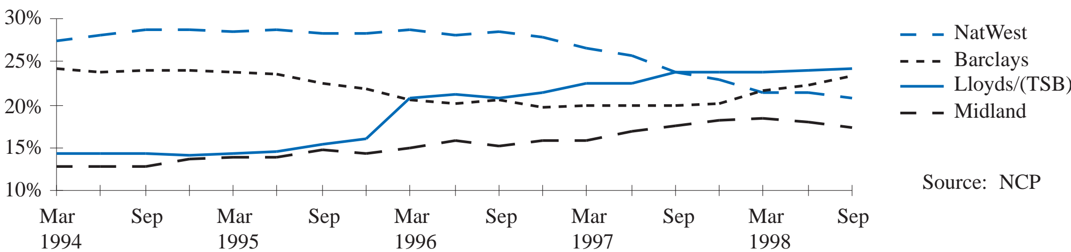
## Chart 3.8
## Bank market shares 1992-1998




Source: Taylor Nelson Business Line

3.32 The market shares of the four large banks have converged during the 1990's, with the dominant two losing shares to the smaller two. The market share for start-ups shows an even greater convergence as banks have competed for new business - the difference between the first and fourth placed bank fell from 15 percentage points in March 1994 to 7 percentage points in June 1998.

## Chart 3.9
## Market share of start-ups




Source: NCP

3.33 The banks have developed a range of new products targeted at the small business sector. These tend to be aimed at attracting new start-up businesses through offering an initial period of free banking or reduced rates on loans, or alternatively providing packages of benefits for 'switchers' to reduce both the costs of finance and the administrative burden of changing banks. Further competition between the banks can be seen in their relationship banking policies and through their marketing of new delivery channels.

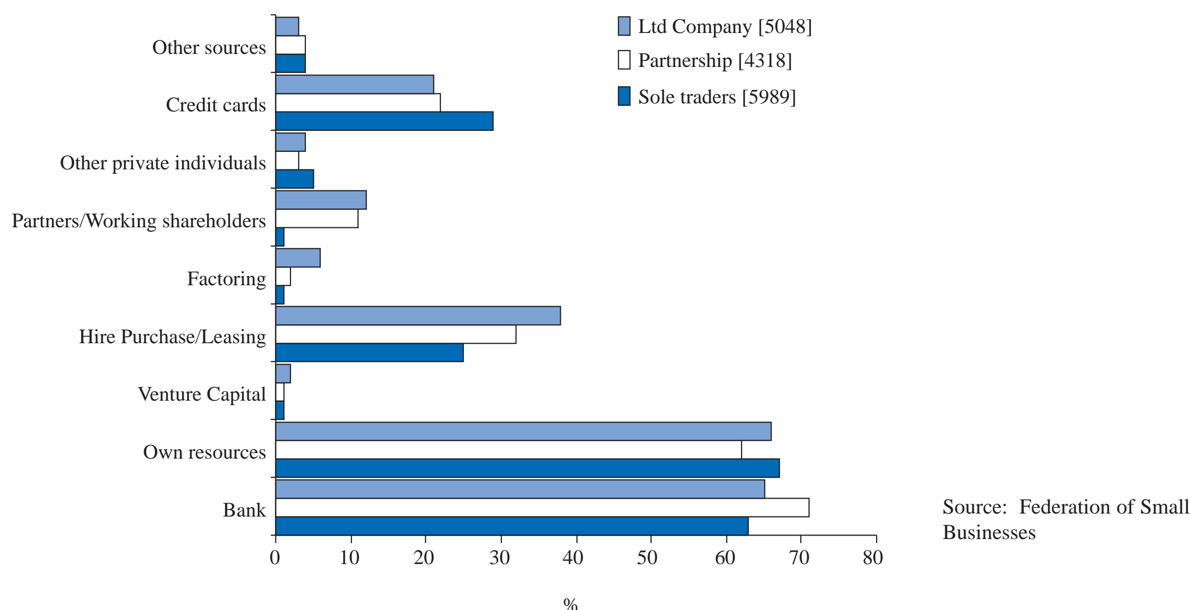
3.34 The provision of finance to small firms is not confined to the major clearing banks, although they account for a large share of the market. Competition in this market is increasingly coming from the smaller banks, the Scottish banks, finance houses and from new entrants, i.e. building societies and other finance providers.

## Appropriateness

3.35 One of the problems highlighted by the last recession was small firms' over-reliance on the overdraft facility to finance anything from working capital to long term investment projects. A feature of the work of the Bank over the last five or six years has been to emphasise the importance of finance being appropriate for the use to which it is put by small businesses. As stated earlier, the banks have now moved their emphasis to some extent away from the use of overdrafts and towards term lending. There is also a much wider range of potential sources of finance for small business. A small business may not meet all its needs from any one source and so may require a "package" of finance, tailored to its individual requirements.

3.36 Different types of business - sole traders, partnerships and limited companies – have different financing structures. These can be attributed mainly to the different sizes of the firms.

## Chart 3.10
## Products used to finance business



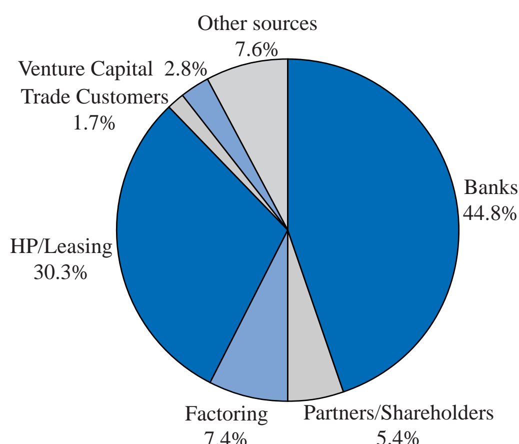

*The responses are not weighted by volume.

3.37 Assuming that sole traders are the smallest businesses in the sample - followed by partnerships, with limited companies being the largest - the use of most sources of external finance is positively correlated with the size of the business. The use of hire purchase and leasing, factoring, working shareholders/partners and venture capital all increase with the company's size. In contrast, the use of credit cards is inversely correlated with the size of business. It is commonly believed that the smallest businesses use personal finance for business purposes, and this is highlighted in the higher use of credit cards (of which we are assuming a proportion are personal credit cards) by sole traders.

3.38 Further differences exist between the manufacturing and service sectors in their use of external finance. The manufacturing sector is less dependent on bank finance and more dependent on hire purchase and leasing. The latter constitute around 30% of these firms' external finance. This may be a result of the types of assets used and the appropriateness of this type of finance for these assets. In addition, the manufacturing sector is twice as dependent on factoring

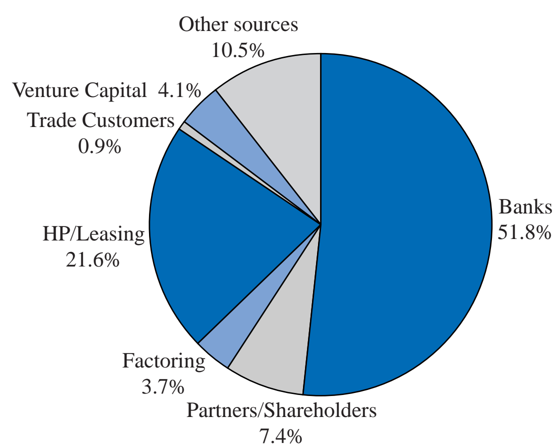
as the service sector, although this still only accounts for 7% of external funds. Manufacturing firms are more likely to meet the eligibility criteria of the factoring company, having a lower proportion of their sales subject to trade disputes. A significant proportion of the service sector will receive payment either in advance, or at the time, of purchase and therefore there has been no need to use a factor. However, outsourcing providers such as manpower agencies are now making increasing use of factoring and invoice discounting.

### Chart 3.11
### Sources of external finance for manufacturing SMEs 1995-97




Source: ESRC Centre for Business Research, Cambridge *Enterprise Britain 1994-1997.*

### Chart 3.12
### Sources of external finance for service sector SMEs 1995-97




Source: ESRC Centre for Business Research, Cambridge *Enterprise Britain 1994-1997.*

## Accessibility

3.39 Banks and other finance providers have also attempted to make themselves more user-friendly to the small business customer. This has resulted in access to finance rarely being cited as an important problem facing small businesses - research from the British Chambers of Commerce[35] found that 78% of respondents were satisfied with the range of external finance available to their firm. One of the lessons learned by the banks in the last recession was the importance of training staff to deal with the particular needs of small businesses in an efficient, but also cost-effective, way. Banks have devoted substantial resources to increasing the awareness and skills of lending managers and staff at the branch level. As a result many small firms believe that banks understand their business better. This has enabled banks not only to improve the quality of their loan books, but also to develop better relationships with their small business customers. This should lead to a better, more constructive dialogue if firms encounter financing difficulties as and when trading conditions deteriorate. Moreover, some of the banks are encouraging their small business customers to consider the impact of the current slowdown in activity and to re-evaluate their financial needs. New technology has meant that small businesses can have direct access to the banks themselves outside working hours. The impact of recent changes in delivery mechanisms in the finance industry is assessed in the next section. For their part, small firms have increasingly understood that banks require up-to-date financial information, and an early warning if things are starting to go wrong.

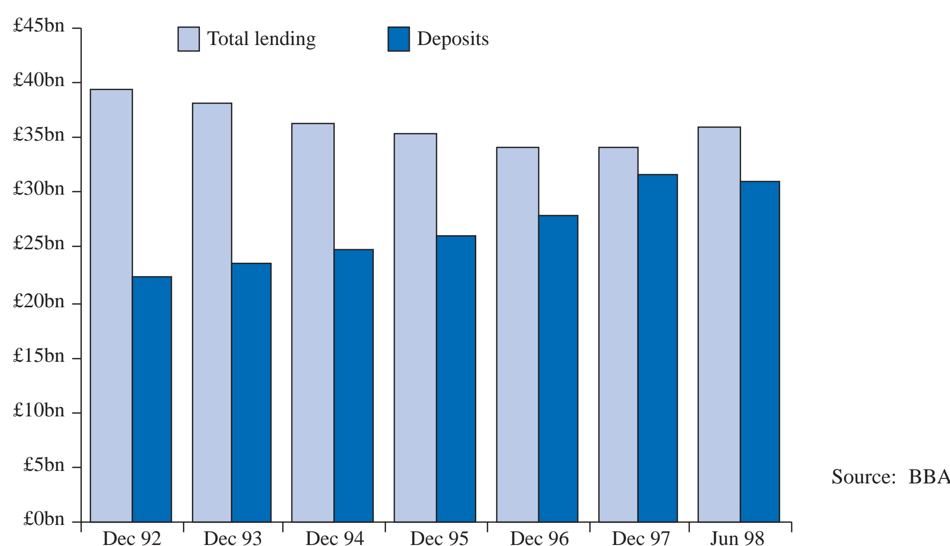
35 British Chambers of Commerce, *Small Firms Survey: Finance* (1999).

# SECTION FOUR: DEBT FINANCE

## Structure of bank finance

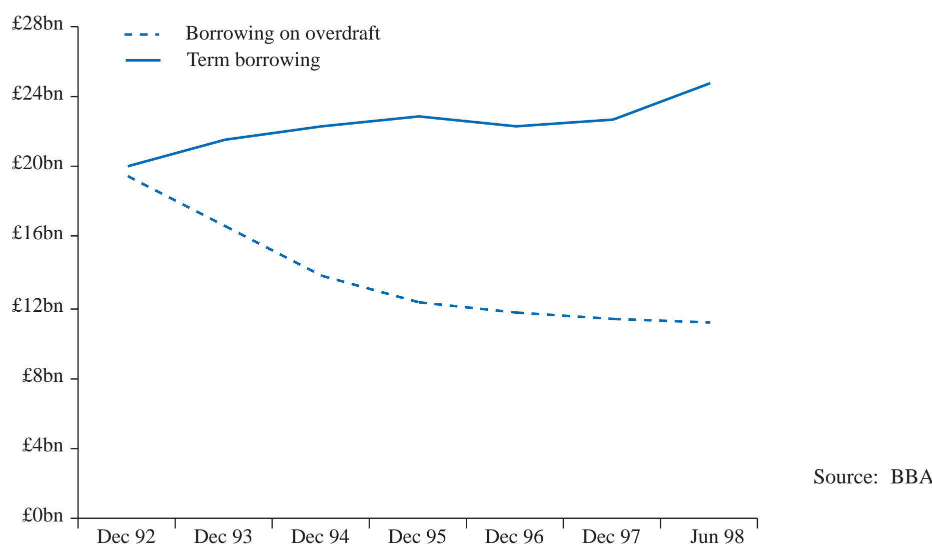
4.1 Traditional bank finance (overdrafts and term loans) remains the most important type of external finance for small businesses. It accounts for 47% of all external finance and is used as additional finance by 69% of businesses.[36] As explained in the preceding section, however, (see paragraphs 3.3 to 3.9) the characteristics of bank finance have changed over the past six years.[37] Charts 4.1 and 4.2 highlight some of the key trends analysed above, that is the decline in the net bank indebtedness of the small firms sector and the growth of term borrowing at the expense of overdrafts.

### Chart 4.1
### Total small business lending and deposits




Source: BBA

### Chart 4.2
### Small business sector borrowing: 1992-98




Source: BBA

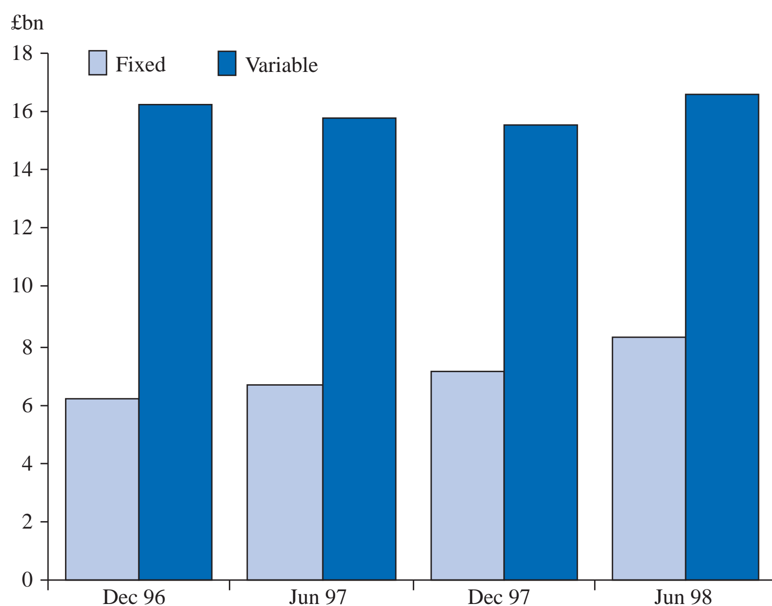
36 ESRC Centre for Business Research, Cambridge *Enterprise Britain 1994-1997* (1998).

37 Data taken from the British Bankers' Association. Comparable data only available since December 1992 and the latest figures available are June 1998.

4.2 The most recent figures reported by the British Bankers Association (BBA), in June 1998, do, however, appear to represent a partial reversal of the trends of the last five years. This can be partly attributed to the inclusion of Clydesdale Bank on the BBA's reporting panel for the first time. Total bank lending increased by £1.9bn, to £36bn, in 1998 H1. This increase was entirely attributable to an increase in term lending - up by 9.25% compared with the December 1997 figure, the largest increase since this data has been collated – while lending on overdraft continued to decline, albeit at a slower rate than in the first half of the 1990s. The ratio of overdraft to term lending has fallen significantly since early 1992 (49:51) and now stands at 31:69. Alongside the increase in lending, deposits held with the banks fell marginally for the first time since 1992, by 2% compared with December 1997. This resulted in deposits falling from 93% of total lending in December 1997 to 83% in June 1998. The combination of reduced deposits and increased lending could suggest that the worsening trading conditions reported in small business surveys since the second half of 1997 are now beginning to impact on small business reserves and possibly increasing pressure on small businesses to obtain loan finance.

4.3 Since the recession, small businesses have to a small extent increased their reliance on fixed rate loans, which now account for 33% of total term lending compared with 28% in 1996. Fixed rate lending may inflate somewhat the overall lending and deposit figures. While businesses often repay variable rate loans as soon as possible, they tend to avoid making early repayment of fixed rate loans. This is because they may incur early repayment penalties. Moreover, if they have repaid the loan and then require further finance, they risk paying a higher rate if interest rates have moved against them. Therefore it is common for businesses to keep servicing fixed rate term loans for the whole duration, even if the facility is no longer needed. At the same time, they may be building up deposits. Consequently, growth of fixed rate lending may be – other things being equal - accompanied by a greater build-up of deposits than is the case if there is a high proportion of variable rate lending. The banks will benefit from this behaviour, gaining income from the margin on the loan as well as from any non-interest bearing deposits.

**Chart 4.3**
**Term lending to small businesses**



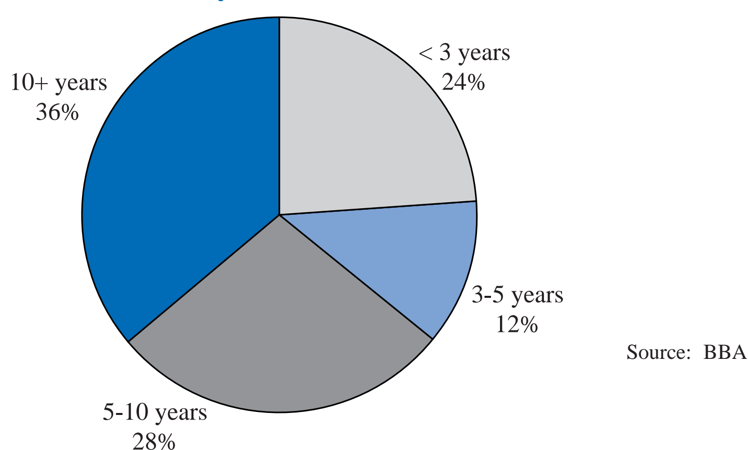

Source: BBA

4.4 While lending at fixed rate continued to increase over the first half of 1998, so too did variable rate lending. Fixed rate lending gives small businesses certainty of expenditure streams which assists business planning. This is beneficial to small businesses because it enables them to operate in a more certain financial environment and removes the adverse risks of interest rate moves. Logically, small businesses should endeavour to obtain fixed rate lending at times when interest rates are expected to rise. It is not therefore surprising that small businesses increased their demand for variable rate debt in the first half of 1998, given the market and media predictions of reductions in interest rates. What is perhaps less clear is why fixed rate lending also rose in 1998 H1, in view of the risk of getting locked into such a loan facility when interest rates were likely to fall.

### *Duration of Bank Finance*

4.5 A key issue relating to bank finance in the past has been the extent to which banks take a long-term view of the provision of finance to the small business sector. Figures on the maturities of bank loans show that, in June 1998, over a third of loans had a residual maturity of over ten years. Less than a quarter of the loans had residual maturities of less than three years. These figures have remained reasonably stable over the last 2 years.

**Chart 4.4**
**Residual maturity of bank loans June 1998**




Source: BBA

## Cost of bank finance

4.6 Banks gain income from the small business sector through fees and charges, sales of other products, interest gained on deposits, and the margins charged on borrowing. Over recent years, the banks have placed more emphasis on boosting income from fixed charges rather than interest margins. Fees and charges now account for approximately 40% of total bank income from small businesses. Despite the increase in the proportion of income obtained from non-interest sources, however, the indexed value of bank charges has fallen consistently since 1992, as the majority of banks have frozen their fee structure. The fall in the level of bank charges has been more significant in the 'big-four' bank index than in the non-big four. However, although the banks in aggregate have reduced charges, small businesses still cite charges as one of the main driving forces behind bank switching (see paragraph 4.13 on complaints). This is partly because charges are more rigorously enforced now than in the past.

### *Margins*

4.7 Margins charged on overdrafts are currently slightly higher than those charged on term lending. Survey evidence from the Forum of Private Business showed that, in 1998, average margins over base rate on overdrafts were 2.9% compared with 2.8% on loan finance.[38] Higher margins tend to be charged on overdraft financing, despite the fact that it is an uncommitted line of finance, because interest is only charged on the amount of finance used rather than the entire facility. Some of the banks also offer managed overdraft facilities that cost more but are less susceptible to changes in interest rates.

4.8 The weighted[39] median margin over base rate for small business lending was between 3 and 4% in 1998 H1. This has remained fairly stable over the past four years. The weighted average mean margin range from the high street banks was between 2.5% and 4.5%, while the complete margin range was between 2% and 8% over base rate. The distribution of the banks' margins raises an issue regarding the availability of finance for higher risk businesses. It is apparent that there is a reluctance on the part of banks to carry out any authorised lending at rates of 8% over base rate or above, while only limited amounts of lending occur at rates above 6% over base rate. This situation might be eased as risk assessment techniques improve or other forms of risk sharing develop.

### *Loan book and provisions*

4.9 The quality of the banks' loan books has not altered significantly over the twelve months to June 1998, despite an increase in the number of businesses on the banks' watch lists in the first half of 1998. However, the overall quality of loan books has improved significantly since the last recession, partly because of improved credit scoring and risk adjustment pricing policies and also reflecting better early warning mechanisms. This trend has been accompanied by a decline in the level of bank provisions against small business lending over the same period. Although the level of provisions continued to fall in the first half of 1998, it was at a much slower rate. This flattening off of provision levels is to be expected given the current trading conditions faced by small businesses.

#### Small Firms Loan Guarantee Scheme

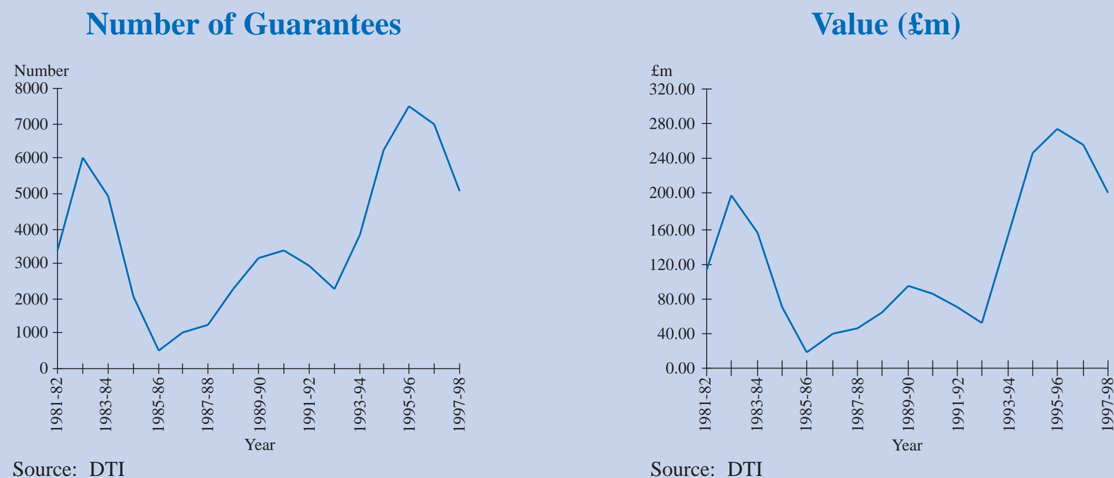
The Small Firms Loan Guarantee Scheme (SFLGS) was established in 1981 by the DTI. The aim of the Scheme is to improve access to debt finance for viable businesses which are unable to gain conventional finance because of a lack of collateral or trading record, or a combination of both. Since 1981, the SFLGS has been regularly reviewed and altered to ensure that it continues to meet its objectives.

Since 1993, there has been a differentiation between the treatment of established and start-up firms. Established firms can obtain guarantees of up to 85% and are charged premiums of 0.5%, while new businesses can only access guarantees for 70% of their loan and are charged a premium of 1.5%. The maximum loan provided under the scheme has increased over time and currently stands at £250,000 for established businesses. The majority of loans tend to be either for amounts of less than £30,000 or for approximately £200,000.

38 Forum of Private Business *Private Business and their Banks* (1998).

39 Margins data was provided on a bilateral basis by the banks and then the figures were weighted by volume of lending.

The latest changes to the Scheme were made in 1996 and included a reduction in the number of size definitions and an increase in the maximum loan term to 10 years. Also, from September 1996, retailing, catering and motor vehicle maintenance were excluded. These changes impacted on both the number of loans taken out and the total volume of lending under the Scheme. During the first nine months of the 1998/99 financial year, 3352 loans were guaranteed under the SFLGS with a cumulative value of £138.7mn. This was somewhat lower than the value of loans guaranteed in the first nine months of the 1997/98 financial year (£151.6mn).




Source: DTI

Source: DTI

The SFLGS remains an important tool for assisting collateral-constrained small businesses. A recent survey by the BCC[40] found that while 87% of respondents felt the Government could do more to assist small businesses, 35% of these thought that easier access to the SFLGS would be beneficial. An independent evaluation of the Scheme will be published in Spring 1999. It will recommend a few specific improvements, rather than any fundamental change. The Scheme will however be incorporated into the DTI Enterprise Fund (announced in the 1998 Competitiveness White Paper, see paragraphs 2.26 and 2.27) so that loans and other forms of finance can be considered together within a single framework.

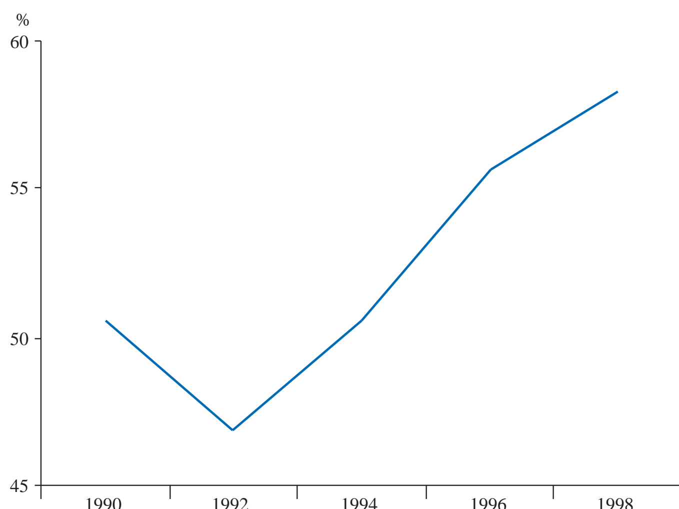
## Bank relationships

4.10 Relationship banking is still very important to many small businesses. This is despite the shift in delivery mechanisms away from traditional branch banking and towards technology solutions – for example, telephone and PC banking (see paragraphs 4.21 to 4.23).

4.11 Most indicators suggest that relationships between banks and small businesses have improved significantly over the last five years. Chart 4.5 shows that the aggregate performance index for the banks has improved by 10 percentage points since 1992. The FPB research also found that small businesses benefited from having a good, participative relationship with their banks both in terms of lower charges and collateral requirements. Research by the BCC showed that 87% of respondents found their bank supportive and 78% believed their bank offered sound advice. The extent to which the improvement in relationships is attributable to the cyclical economic upturn of recent years, as distinct from structural changes in the provision of bank finance, is yet to be tested.

40 British Chambers of Commerce, *Small Firms Survey: Finance* (1999).

**Chart 4.5[41]**
**Aggregate bank performance index**




Source: FPB

4.12 The banks have taken steps over the past five years to ensure that relationships with small business customers have been either maintained or, if necessary, rebuilt. As part of this process, all the main banks have implemented codes of practice and adopted the BBA's *Statement of Principles: Banks and Businesses Working Together* (March 1997) document. The banks have also placed increased emphasis on training their relationship managers to understand the specific issues faced by small businesses. Some are now providing sector specific training for small business managers dealing with, for example, agricultural or medical firms. Policies have also been implemented whereby relationship managers are required to spend a minimum of 3 to 4 years in the job, reflecting evidence that the majority of problems between banks and their small business customers occur when the relationship manager changes. There has also been a move by most banks towards allowing locally-based managers to make lending decisions (within certain limits), rather than operating a centralised system. This should result in faster confirmation of lending decisions.

### *Bank complaints*

4.13 While general satisfaction with the banks has improved among small businesses, there is still room for further development.[42] Chart 4.5 shows that, in aggregate terms, customer perception of the banks continued to improve in 1998, although at a slower rate than reported in 1994 and 1996. Research by the FSB[43] reported that 34% of small businesses had considered changing their bank, although only 4% had switched bank in the last year and 15% had switched in the last five years. The most frequently cited reason for changing banks was that charges were too high – 72% of all switchers mentioned this as an important factor. Unsatisfactory lending agreements was the second most cited factor, classed as important by 69% of switchers.

4.14 All the banks have internal complaints procedures either operating on a two-tier or three-tier basis. If a complaint cannot be solved at the local level it will be passed up to the regional level, and if this still does not resolve the issue it will be taken to head office. These internal complaints mechanisms are sufficient for the majority of complaints, with most being

41 The aggregate bank performance index is calculated by weighting a range of characteristics of bank service by the importance assigned to them by the respondents (see Forum of Private Business *Private Business and their Banks* 1998).

42 Forum of Private Business *Private Business and their Banks* 1998.

43 Federation of Small Businesses *Small Businesses' Finance and the Economy Survey of the FSB Members – Full Report.*

resolved at the first level. If the complaint cannot be resolved internally, it is said to have reached "deadlock". At this point the complaint is eligible (subject to meeting the other relevant criteria) for investigation by the Office of the Banking Ombudsman (see box). Some of the banks have also made use of private alternative dispute resolution (ADR) companies. The benefit of private ADR companies, compared with the Banking Ombudsman, is that they can investigate any complaint and carry out mediation or arbitration at any stage and the process is often much quicker and therefore less damaging to client relationships. However, the Banking Ombudsman service is free.

### The Banking Ombudsman

The Office of the Banking Ombudsman was established in January 1986 to resolve (free of charge) individuals' (including sole traders and unincorporated businesses and partnerships) complaints about their banking services. In January 1993, the service was extended to cover complaints made by small companies, defined as those with a turnover of less than £1mn. The Scheme is financed by the banking industry but accountable to its Council. The Council is responsible for ensuring the independence of the Scheme and monitoring and reviewing its progress, as well as appointing the Banking Ombudsman, currently David Thomas. The Council consists of eight members - five independent members and three who are appointed by the banks.

The terms of reference for the scheme are:

1. claims must be for less than £100,000;
2. claims must be referred to the Banking Ombudsman within six months of reaching "deadlock" (when a satisfactory solution cannot be found through the individual bank's internal complaints procedure);
3. the complaint must not have arisen before the member bank joined the scheme;
4. the complaint must relate to a banking service provided in or from England, Wales, Scotland or Northern Ireland;
5. disputes arising from a bank's commercial decisions are not eligible unless maladministration has occurred.

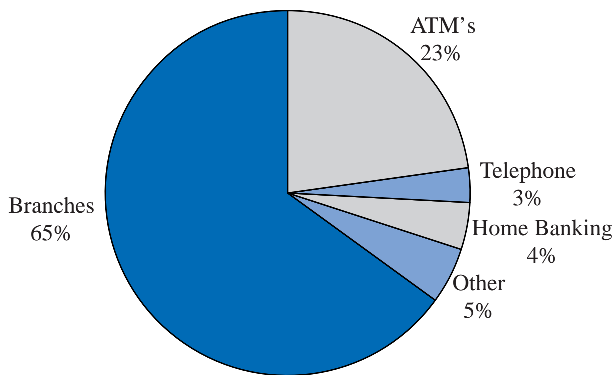
The latest data from the Office of the Banking Ombudsman, covering the year ended 30 September 1998, showed that a total of 11,874 written complaints were received, an increase of 35% compared with the previous year. Of these complaints, only 10% related to business accounts, with 746 from unincorporated businesses and 337 from incorporated businesses. However, because complaints on personal accounts are more likely to be settled by conciliation than complaints on business accounts, a higher proportion of business complaints went on to investigation – of the 741 complaints investigated, 103 were from unincorporated businesses and 46 from incorporated businesses. The largest number of complaints for both unincorporated and incorporated businesses arose from problems relating to current accounts, although there was a broad spread across the complaint categories. Complaints relating to business accounts tend to be more complex than those relating to personal accounts and therefore business complaints took longer than average to resolve both through conciliation and at the full investigation stage.

The Government has decided to amalgamate the five ombudsman schemes dealing with financial services into a new statutory Financial Services Ombudsman Scheme. This is likely to take effect from the end of 1999 or during 2000.

## Changes in bank delivery mechanisms

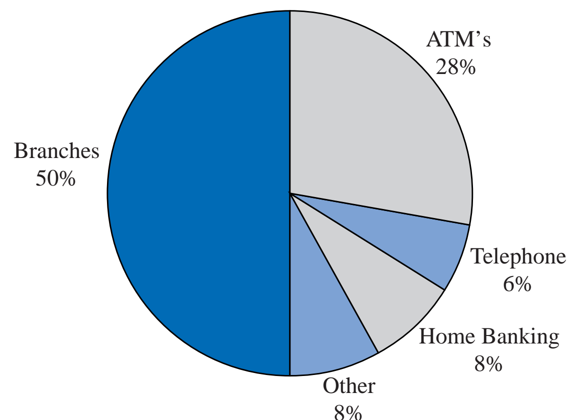
4.15 The traditional branch remains the primary delivery channel for banks providing services to personal and small business customers. However, its dominance is falling steeply, as can be seen in the following charts.

**Chart 4.6**
**Bank delivery channels (1995)**




Source: The Building Societies Association

**Chart 4.7**
**Bank delivery channel predictions (1998)**



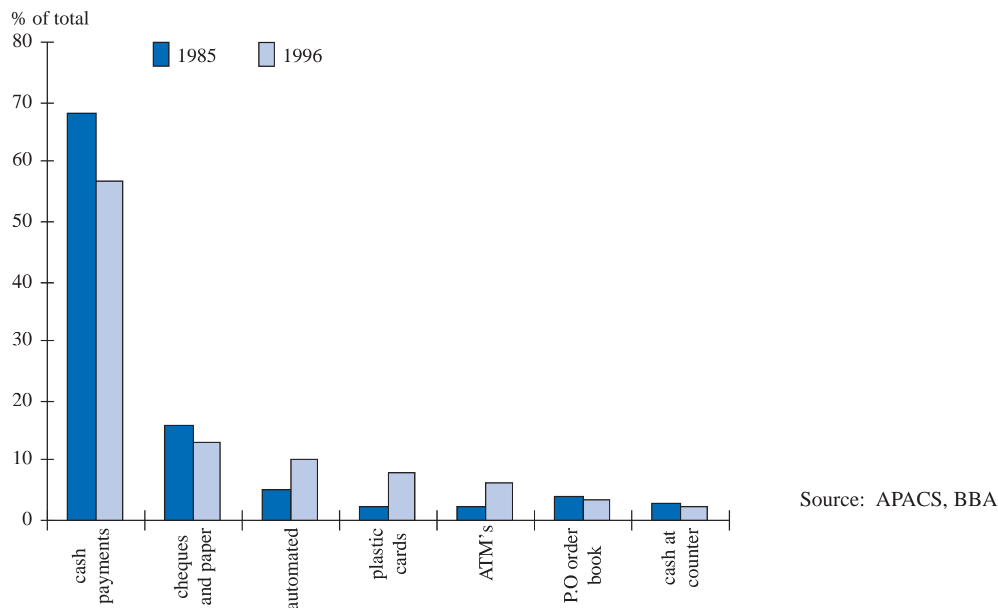

Source: The Building Societies Association

4.16 The changes in delivery mechanisms appear to be driven both by demand side factors, reflecting customer desire for greater convenience in banking, and supply side forces, through which banks are striving to serve customers more efficiently and economically.

4.17 These changes, which have arisen mainly to address the needs of personal customers, have been less beneficial in some cases for small businesses. They tend to be more reliant on traditional branch services than personal customers, for a number of reasons. In particular, they may require cash handling services for the day-to-day running of their businesses. Furthermore, they rely on their bankers having an in-depth knowledge of their business, and require far more frequent contact with their banks than personal customers. Significantly, research by Midland Bank showed that 75% of small businesses visit their branch at least once a week.

4.18 That said, it is important not to overstate the importance of these new delivery mechanisms, as the following chart shows.

**Chart 4.8**
**Volume of transactions**




Source: APACS, BBA

4.19 The new delivery mechanisms mean that the proportion of cash based transactions is falling, but it remains the case that the vast majority of transactions are still undertaken using cash, for which, at present, branch banking is usually required. Indeed, the pace of rationalisation in branch banking appears to have slowed down greatly in the most recent past.

### *ATM's and Kiosks*

4.20 Charts 4.6 and 4.7 demonstrate the extent to which the use of ATM's has increased. Perhaps of more relevance to small businesses, the creation of kiosk self-service centres by banks such as Nationwide and NatWest addresses, to a certain extent, small firms' requirements for cash handling services, allowing businesses to deposit takings and thereby eliminating the need to visit branches purely for this purpose.

### *Electronic banking*

4.21 Electronic banking covers developments such as Internet banking and PC banking, which have been successfully introduced in the recent past, allowing customers instant direct access to their accounts. Take-up of these products is dependent on two factors: ownership of the hardware and confidence to use it. Small businesses tend to be disadvantaged in both these respects- for example, a Small Business Research Trust survey[44] found that while 90% of small firms have a PC, only 53% have a modem link allowing them to use internet or PC banking.

4.22 Certain banks have plans to capitalise on the introduction of digital television, to permit customers to undertake transactions interactively without the need for a PC. The use of television banking could open up electronic banking to a wider audience, in particular the small business owner working from home.

44 Lloyds Bank Quarterly Small Business Management report no.3, vol 5 1997.

*Telephone banking*

4.23 Telephone banking provides an easy way for customers to avoid visiting their branch to undertake routine transactions, and as such has been taken up to a degree by some smaller businesses. Access outside normal working hours is particularly important and attractive to small businesses.

### ***New players in the market for financial services***

*Supermarkets*

4.24 Supermarket banking schemes tend to be provided by different clearing banks. The services offered by the supermarkets differ, but none provides a business banking service at present. There are plans to extend the services provided by the supermarkets, including the creation of current accounts with overdraft facilities, and credit cards. While at present there are no facilities for depositing cash, the development of such facilities could make this medium ideal for small firms which run their businesses through their current accounts, given the convenience, the fact that interest is paid on credit balances, and the ability to handle cash transactions.

*Branches in supermarkets*

4.25 Following the example set in the US, a number of banks have set up mini-branches in supermarkets - for example, there are currently Midland branches in a number of Morrison stores. This gives customers convenience, while avoiding some of the overheads associated with operating a branch in an area. While neither the branches in supermarkets nor the Post Offices (see paragraph 4.26) offer a business banking service at present, research shows that a large number of small businesses run their business affairs through their personal accounts, and as such these providers of banking services are of relevance here.

*Post Office*

4.26 The Post Office is well placed to extend its range of services in the banking market, given the large number of branches nationally, over half of which are in rural areas. It has, of course, been offering a basic corporate and personal banking service for a number of years, through the Alliance and Leicester (incorporating Girobank). In addition, Cooperative Bank customers can cash cheques and make deposits at post offices. Moreover, since April 1998 a number of post offices offer Lloyds-TSB customers basic personal banking services on a trial basis. Co-operation with the Post Office could be an ideal way for banks to lessen the impact of branch closures, especially in rural communities.

*Former Building Societies*

4.27 Capitalising on their extensive branch networks, the former building societies are beginning to enter the small business banking market. A potentially significant entrant is Abbey National. The converted building societies offer a particular opportunity to the small business sector because it is estimated that around 75% of small businesses keep their accounts in credit, but the banks tend not to pay interest on credit balances on business current accounts.

### *Impact of the changes on small firms*

#### *The increasing focus of banks*

4.28 The rationalisation of branches has affected small businesses in two ways. Firstly, there is the negative impact caused by local branch closures, especially in rural and certain inner city areas. However, at the same time, the remaining branches are becoming more specialised, focusing more on the needs of the small business sector. This has involved more tailored training of staff, and the number and availability of small business managers in the major banks has increased.

4.29 Furthermore, the rationalisation appears to have slowed greatly in the more recent past; the banks have said that they do not intend to carry out a substantial further phasing-out of branches in favour of new delivery mechanisms, since they realise that there are certain functions that must be provided through branches.

#### *The relevance of the new players*

4.30 The introduction of new players into the market for small business banking has increased competition; in addition, the introduction of delivery channels such as the Internet has made access to, and information about, financial services more freely available. This has encouraged customers to seek different services from different sources, rather than obtaining everything from one bank, as tended to be the case in the past.

4.31 The degree to which the new players address the needs of small businesses varies, as discussed above. However, it is certainly true that small businesses have recognised the convenience offered by some of the new delivery mechanisms, and have also come to appreciate that it is not necessarily in their best interest to meet all their financing needs through traditional bank services. This is especially so given the quest for more appropriate sources of finance for small firms, such as factoring and leasing.

## Trade finance

4.32 In general, small exporting firms are able initially to support their expansion via normal forms of bank finance. But there may come a stage when gearing rises above the level where banks feel comfortable with advancing additional funds against the security of fixed assets. As outlined below, though, trade debtors can be one of the main assets on a firm's balance sheet and matching finance to outstanding receivables can represent a way of overcoming this problem. Accessing factoring or invoice discounting is one way of doing this. Another is trade finance schemes and the major banks provide this form of finance as part of their specialised product range for exporters.

4.33 However, by shifting the security taken from standard fixed assets to receivables, the banks open themselves up to two particular risks. These are the risk that the exporter will not deliver the goods to the specifications outlined in the contract ("performance" risk) and the risk that the overseas buyer will not pay for the goods in question ("payment" risk). The presence of these risks works against new and smaller exporters in two ways. First, these exporters have little or no track record of performance or of negotiating with overseas buyers. Second, the resources that the banks utilise in attempting to overcome information deficiencies make these products disproportionately expensive to provide on a smaller scale.

4.34 The primary way in which banks attempt to limit payment risk when providing trade finance products is by requiring that credit insurance (see box on page 45) is in place against the receivables in question. However, credit insurance itself presents another risk - the potential failure of the exporter to comply with the terms of the credit insurance policy. Such failure prevents reimbursement under the policy and so removes any benefit to the bank of taking the receivable as security. Consequently, banks providing trade finance will need to be confident that exporters have sufficient credit management expertise to meet this requirement and claims experience indicates that small firms are a higher risk. Although credit insurers have made significant efforts to simplify their policies in recent years, banks are still very wary of the smallest exporters when making this judgement.

4.35 As banks attempt to simplify their trade finance products and utilise technology to reduce both risks and costs, trade finance may become available to exporters with a lower turnover than was previously the case. Nevertheless, these products remain almost exclusively available to exporters with turnover of at least £1 mn.[45] For exporters with lower turnovers, export factoring may be more appropriate.

4.36 Another area in which providers of trade finance are seeking to improve their products is by simplifying the delivery mechanism by which finance is provided. For example, Barclays and Royal Bank of Scotland have taken the step of merging trade finance with customers' existing overdrafts.

4.37 Because the provision of specialised trade finance and advice is not relevant to all customers, it is most efficient for banks to pool these resources in regional or central locations. Consequently, the accurate communication of products to relationship managers, who act as the initial 'gatekeepers' for these services, becomes extremely important. This can be difficult as some schemes are necessarily quite complex or are bespoke to some degree. Staff dealing with small businesses are already required to be aware of a large number of other products, many of which will be far more commonly utilised than trade finance. Nevertheless, the mutual benefits of trade finance should not be overlooked.

4.38 Another institutional barrier to efficient referral is managers' perceptions, misconceived or otherwise, that they are losing "their" lending when trade finance schemes are used in place of traditional forms of debt finance. Some banks have rebalanced their incentive procedures in an attempt to develop trade finance usage.

## Trade credit

4.39 Trade credit is an important, yet often overlooked, source of finance for businesses, especially small businesses. Research by the Credit Management Research Group at Bradford University[46] found that stocks and flows of trade credit were twice the size of bank credit in both the UK and US. In the UK corporate sector, more than 80% of daily business transactions are on credit terms resulting in trade debtors being one of the main assets on corporate balance sheets, accounting for 35% of total assets for all companies. Further data on UK manufacturing companies[47] showed that 96% of sales were on invoice and, on average, less than 50% of invoices were paid on time.

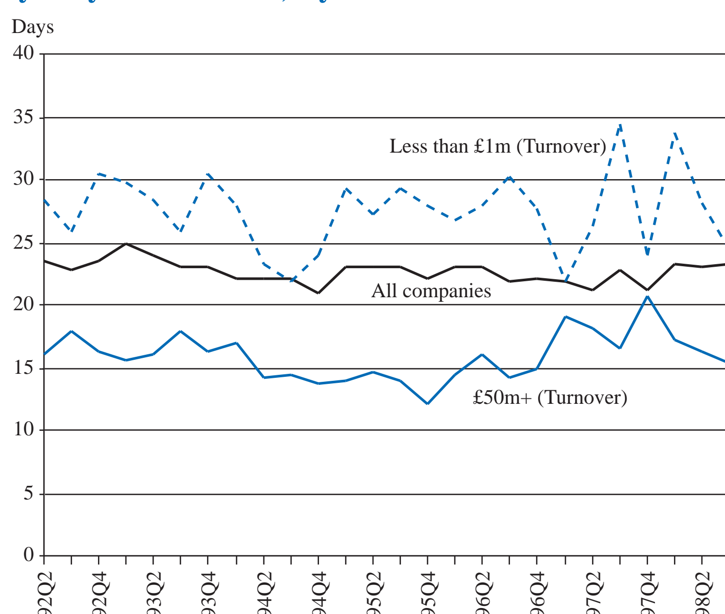
45 That said, some of the Bank's contacts have suggested that it is exporters above this threshold that experience the greatest need for such products.

46 Singleton and Wilson *Sources and use of external finance: an empirical study of UK small firms* (mimeo).

47 Wilson, Watson and Summers *Trading Relationships, Credit Management and Corporate Performance: A Survey* (1995).

4.40 Recent statistics collected by Euler Trade Indemnity reported that UK customers were, on average, 23 days late in their payment of invoices in Q3 1998. This figure was unchanged from the previous two quarters, and as Chart 4.9 below illustrates, there has been very little movement in this measure for all firms since 1992. However, this average does mask the fact that small firms suffer disproportionately from payment delays and that, in the last two years, there has been greater fluctuation, and hence uncertainty, in the extent of these delays. In response to small businesses' concerns about the impact of late payment, the Government introduced the Late Payments of Commercial Debts (Interest) Act, which took effect from the 1 November 1998. Also the Better Payment Practice Campaign was launched on 27 October 1998. This campaign was devised jointly by financial institutions and SME representative bodies and provides advice on topics relating to credit management.

**Chart 4.9**
**Payment delays from UK customers (days beyond due date) by firm size**




Source: Euler Trade Indemnity

4.41 It is claimed that the decision to export leads to longer payment times, either due to longer payment periods in the country in question, more difficulty in chasing overseas debtors or shipping time.

4.42 While surveys give a good indication of the importance of trade credit in financing business, it is hard to quantify accurately the role of trade credit in the provision of finance to small businesses. Businesses often only consider trade credit to exist if a customer is offered a two-part termed contract and they forego on the early payment discount. However, a broader definition of trade credit would encompass any situation whereby a customer is allowed to take possession of goods, or to receive services, and pay at a later date.

4.43 There are many reasons why small businesses will give and seek trade credit with customers and suppliers. The majority of businesses do not consider trade credit as a formal means of financing their business, but rather as a short term measure, often to balance cash flow - particularly if they are exposed to late payment. Trade credit is therefore used to smooth cash flows, enabling businesses to reduce expenditure when income is stretched and increase

expenditure when funds are high. This role of trade credit is particularly important for seasonal businesses.

4.44 There is some evidence[48] that trade credit is often used as a substitute for bank credit. This is particularly evident in firms that have reached their bank finance limits. Businesses may be prepared to offer trade credit to their customers even when banks are not prepared to extend finance, because they believe they have more information on the customer's overall standing or they think they can gain a competitive advantage by doing.

4.45 Trade credit (within agreed contractual terms) does not have to be used as a substitute for bank finance and can offer advantages to businesses that are not credit constrained. The ability to draw on trade credit reduces the level of precautionary holdings a business needs to hold, largely because it can plan its payment outgoings to coincide with its income stream. This improves cash management and reduces the opportunity cost of holding large deposits or the financial cost of borrowing to meet payment requests. Also, for the length of time a business can delay payment, it might be able to earn interest on the money. If the business is in a position where, without access to trade credit, it would need to arrange bank credit to meet payments, it might follow that, even if premium prices are charged, trade credit offers a cheaper form of finance both financially and in terms of administrative burden.

4.46 The main problem with trade credit is that it is very risky. While businesses trading within certain sectors generally can be confident of gaining extended payment periods, the ability to stretch these terms or renew trade credit cannot be relied upon. The role of trade credit may be reduced somewhat as a result of the 'Late Payment of Commercial Debts (Interest) Act (1998)'. The government introduced this Act to give businesses a right to claim interest on late paid debts in an attempt to reduce the pressure placed on businesses' cashflows through unauthorised use of trade credit. The Act is to be phased in over four years (as outlined in the 1998 Diary of Small Firms Events) and initially will enable small businesses to charge interest on any late paid commercial debts due from larger businesses. While the Act should not reduce the role of authorised trade credit, it could have an effect on the number of businesses delaying payments beyond the invoice date, but only where preservation of relationships ceases to be important.

4.47 Firms that give or receive credit in foreign currency are of course exposed to foreign exchange risk. Among exporters that do protect foreign exchange exposures, forward contracts and currency accounts seem to be the most frequently used tools in order of importance.[49] The same pattern has been noted among importers in receipt of trade credit.[50] However, firms at, or near, their bank finance facility limits may be constrained in the extent to which they can hedge exposures. This is because an amount is generally ringfenced within a firm's facility under, say, a forward contract to reflect this future financial obligation.[51]

4.48 Many exporters seek to avoid foreign exchange risk by invoicing solely in sterling. But the introduction of the euro may make UK exporters less able to invoice in sterling to buyers

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48 Keasey and Watson *Investment & Financing Decisions & The Performance of Small Firms* (1992).

49 See, for example, *The Sixth Survey of International Services Provided to Exporters*, undertaken for the Institute of Export/NCM Credit Insurance Limited by Major Issue Limited (1998).

50 *The Fourth Survey of International Services Provided to Importers*, undertaken for Lloyds Bank plc and DHL Worldwide Express by Major Issue Limited (1997). NB: this annual survey of importers started after the corresponding exporter series.

51 Banks feel that this is necessary because, in event of default, the bank must fulfil the contract on behalf of the firm. Eleven percent of exporters responding to the *Sixth Survey* said that their foreign exposure strategy was restricted by their banking facilities.

located in "In" countries. Importers currently purchasing in sterling may also find themselves under more pressure to accept invoices in euro.

### Credit insurance

As noted in paragraph 4.39, outstanding invoices can be one of the main assets on a business's balance sheet. But it is never certain that a firm will be paid in the time expected or even at all if the buyer defaults as a result of insolvency, contract dispute or even malice. Consequently, it is surprising that more small firms do not use credit insurance to protect themselves against an event which may be critical to the survival of cash constrained firms.

Credit management may be even more vital for exporters given the added difficulty of checking the credit standing of overseas buyers[52] and chasing cross-border debts. Indeed, a 1997 survey by the British Chambers of Commerce[53] found that, of these exporters which had experienced an unsuccessful export venture, 29% cited inability to obtain payment as a cause of failure.

The Bank of England's recent report on smaller exporters[54] noted the difficulties faced by credit insurers in providing a commercially viable product to small exporters, which limited the availability and appeal of products. However, it also noted that insurers had tried to remedy this situation in recent years, using improved technology and information systems. This had involved the marketing of new products with relatively low premium rates, which usually also offered domestic cover– something that may be particularly valuable to firms as the economy slows.

Although take-up of these products has grown significantly during 1998, they still appear under-utilised. Some of the Bank's contacts have suggested that exporters still perceive credit insurance to be expensive[55], but the cost should be compared with the impact of even a single default on cashflow and profitability. There may also be a lack of awareness among exporters and their advisers of the full benefits provided by credit insurance, including improved credit management and a potential for improved access to trade finance. Indeed, credit insurers themselves are increasingly marketing these additional benefits. Joint ventures between banks and credit insurers, e.g. Barclays' new Credit Insurance Scheme, backed by NCM and Coface, also have the potential to increase awareness.

## Factoring and Invoice Discounting

4.49 Factoring and invoice discounting enable businesses to gain access to finance against outstanding invoices. Depending on the type and size of business, factors and invoice discounters will immediately advance between 80% and 90% of the value of invoices. The remainder of the finance is transferred to the business after the invoice has been paid, less the charge for the service (approximately 2%) and the interest payment. This type of finance assists a firm's cashflow because it is sales-based rather than fixed asset-based.

4.50 Factoring and invoice discounting may be particularly useful for small growing firms and for exporters that are too highly geared to gain access to further overdraft facilities, but are not yet within reach of bank trade finance schemes. Furthermore, finance increases proportionally in line with sales, whereas any increase in an overdraft limit (if available) will be more lumpy,

52 A recent survey of ICAEW members engaged in advising smaller exporters found that establishing the financial status/creditworthiness of overseas buyers was the most common critical issue facing their clients. *Small and Medium-Sized Enterprises: Going Overseas*, The Institute of Chartered Accountants in England & Wales (1998).

53 "Exporting", *Small Firms Survey No. 22*, British Chambers of Commerce (May 1997).

54 *Smaller Exporters – A Special Report*, Bank of England (January 1998).

55 Perhaps particularly at a time when margins are already constrained by the strength of sterling since H2 1996.

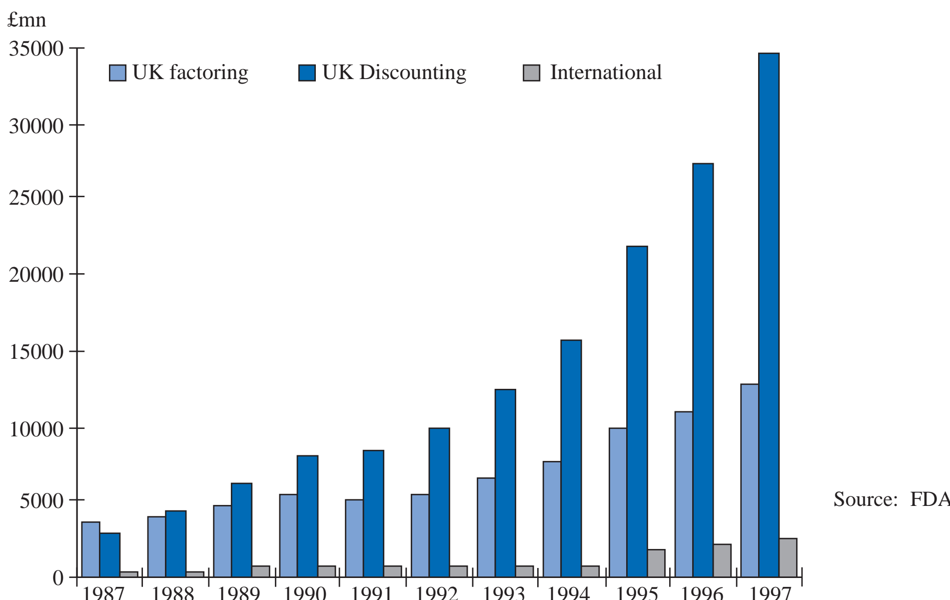
potentially causing delays in a viable expansion of export sales. Firms with access to bank trade finance schemes may still prefer to utilise factoring - for example, if they prefer to outsource the management of their sales ledger or because, on average, factors advance a higher proportion of the value of an invoice to an exporter.

4.51 Most small businesses use factoring rather than invoice discounting. This is because factoring allows the business to outsource its financial management controls. This enhances access to cashflow and removes the problems incurred from late payment. Factors can provide expertise and economies of scale in credit risk assessment. As well as providing cover (if required) for potential bad debts, the factor may have more power in the marketplace when collecting debts because of its size and role in assessing creditworthiness for a number of businesses. These additional benefits can prove particularly advantageous for exporters, given the increased difficulty of managing trade credit granted to overseas buyers (see box on pages 45).

4.52 Although most small business users seek factoring to benefit from out-sourcing their credit management responsibilities, some small businesses are forced to use factoring rather than invoice discounting, despite wishing to keep the credit management in-house. This is because they are too small to be considered for invoice discounting. Invoice discounting is only offered to larger businesses because it is not economic to provide it on a small scale at a price that would be attractive. Therefore, very small businesses have to use factoring services to gain access to a finance facility.[56]

4.53 The factoring and invoice discounting industry[57] has grown rapidly over the past 10 years, with volume growth averaging 20% p.a. This growth has mainly occurred since 1993, and has been heavily concentrated in domestic invoice discounting.

**Chart 4.10**
**Volume of transactions**

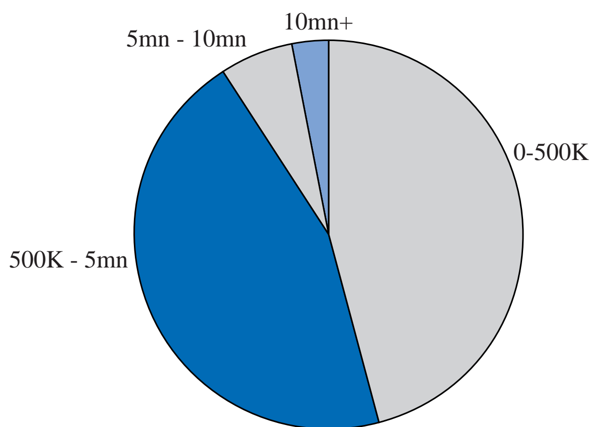



Source: FDA

56 Summers and Wilson *Motives for the use of third parties in credit management: a theoretical review with some empirical findings for factoring* (mimeo).

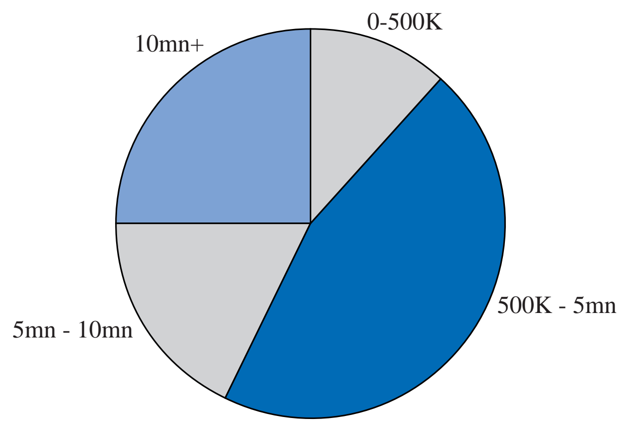
57 Factoring is the purchase by the factor and the sale by a company of book debts on a continuing basis, usually for immediate cash. The sales accounting functions are then provided by the factor who manages the sales ledger and the collection of accounts under the terms agreed by the seller. The factor may assume the credit risk for accounts within agreed limits (non-recourse), or this risk may be retained by the seller. Invoice Discounting is the purchase by the discounter and the sale by a company of book debts on a continuing basis (occasionally selectively) for immediate cash. The sales accounting functions are retained by the seller, and the arranged facility is usually provided on a confidential basis: credit protection can also be provided if required.

**Chart 4.11**
**FDA clients by client turnover (£)**




Source: FDA

**Chart 4.12**
**FDA advances by client turnover (£)**




Source: FDA

4.54 The latest figures from the Factors and Discounters Association (FDA) show that the increase in factoring continued during 1998. The figures for the third quarter of 1998 reported that prepayments broke through the £4bn level for the first time, showing a year-on-year increase of 13%. Prepayments equate to approximately 10% of total clients' sales. Domestic invoice discounting continued to account for approximately 70% of total clients' sales, showing growth of 16% compared with the previous year.

4.55 As would be expected, while a large proportion of FDA clients have turnovers of less than £500,000, the proportion of advances to clients of this size was considerably less given that the volume of funds required is lower.

4.56 Factoring and invoice discounting activity is highly concentrated, with 60% of activity in 1997 being accounted for by the top 4 firms. In 1997, all of the top four companies were bank-owned subsidiaries, with three of them owned by the English clearing banks.

4.57 Although this is a fairly concentrated industry, there are strong signs of competition. Apart from Bank of New York, the results of the top four companies for 1997 all showed falls in market share, while strong growth was reported by Lloyds TSB, Royal Bank Invoice Finance, Barclays and Kellock. These figures suggest that the market, having previously been dominated by UK clearing banks, is now becoming increasingly attractive to American banks. BNY is now the largest factoring company in the UK.[58] These competitive forces have caused the largest companies to focus on different segments of the factoring industry. There are also a significant number of smaller, independent factors in the membership of the FDA.

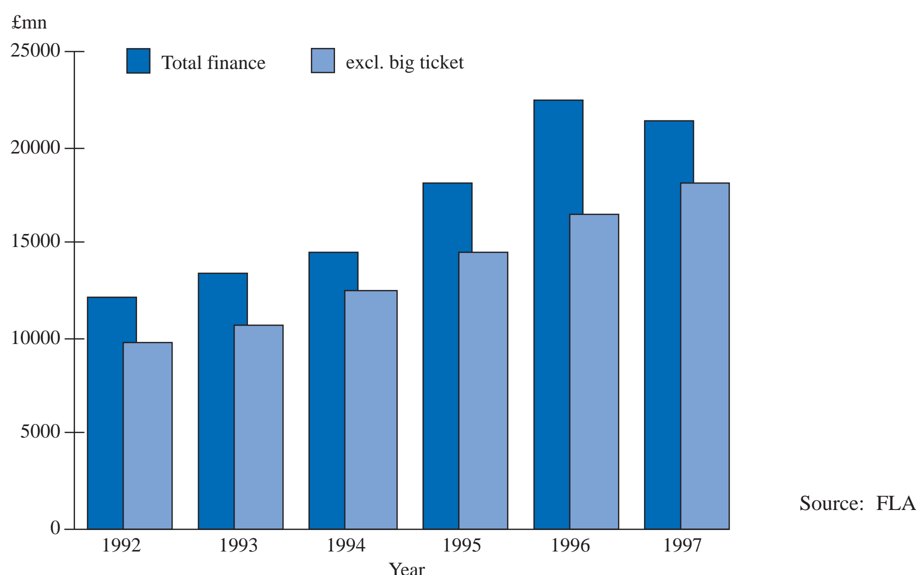
4.58 The increased competition in the provision of factoring and invoice discounting has benefited customers, because factors now offer smaller packages and more flexible terms. Advances in IT have also assisted the development of the factoring and invoice discounting industry, allowing businesses to obtain direct access to their account information while enabling the factoring companies to develop substantial databases on company and country information.

58 In terms of factoring volume.

## Asset-based finance

4.59 Asset-based finance encompasses both leasing and hire purchase. The leasing industry began its rapid expansion in the 1970s, encouraged by the tax regime. From 1971 to 1985 buyers of capital equipment gained a 100% first year allowance (FYA), while the corporation tax rate stood at 52%. Between 1984 and 1986 FYAs were phased out and corporation tax was cut from 52% to 35%, removing the major tax advantages for leasing. Since then the corporation tax rate has continued to decline and is currently charged at 31%, and will fall further to 30% with effect from April 1999. Despite the reduced taxation benefits of leasing, the leasing and hire purchase industry has continued to grow.

### Chart 4.13
### Leasing-related business finance 1992-1997




Source: FLA

4.60 Figures obtained from the Finance and Leasing Association (FLA), which at end-October 1998 had 102 full members and 55 associate members, show that business finance (excluding big ticket finance) has grown consistently over the last six years. However, recent figures suggest that the current economic conditions have had a negative impact on demand for business finance particularly for commercial equipment.

4.61 Since the last recession, the proportion of external finance to small businesses accounted for by leasing and hire purchase has grown significantly, mainly at the expense of traditional bank finance. Between 1995 and 1997, 50% of businesses used leasing or hire purchase for additional finance, accounting for 27% of all external finance. A higher proportion of UK SMEs use asset-based finance than in any EU country other than Ireland (see Chart 4.14).

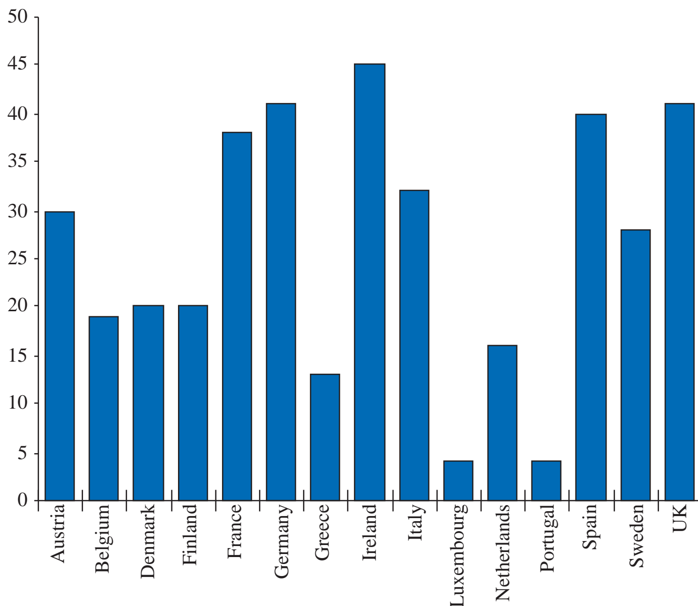
4.62 Although hire purchase and leasing are often grouped together for the purposes of collecting data, they are very different financing products. Hire purchase results in the purchaser building up ownership of the good over a pre-determined period, while under leasing contracts the ownership of the good remains with the lessor. There are essentially two types of lease, a *finance* (or full payout) lease[59] and an *operating* (or residual risk) lease.[60] Small firms are more

59 A finance lease is defined as a long-term non-cancellable lease, generally requiring the lessee to pay all maintenance costs.

60 An operating lease is defined as a lease in which the period of contract is less than the life of the asset and the lessor pays all maintenance and servicing costs.

dependent on operating leases because of the increased flexibility regarding maintenance of the asset and future upgrades.

**Chart 4.14**
**% of SMEs using leasing/hire purchase for external finance**




Source: Grant Thornton/Business Strategies European Business Survey (1998)

4.63 The decision by a small business to lease or purchase an asset tends not to be tax sensitive, as is the case with larger firms, but rather dependent on the available resources of the business. Both leasing and hire purchase provide the business with access to 100% financing without reducing capital reserves or increasing gearing levels. They also allow businesses to spread out payments over the life of the asset, with the payments structured to accommodate the asset's expected pattern of income generation.

4.64 According to research by City University Business School[61], small growth companies are more likely to use leasing than small mature companies. Growth companies are characterised by lower profits than their cash-generative mature counterparts, and consequently need to expand production to meet growth in demand, subject to limited resources. Mature, cash-rich, small companies tend to finance replacement or expansion capital out of retained earnings.

4.65 The leasing industry is fairly concentrated with the majority of leasing activity occurring through the leasing arms of the clearing banks. According to 1996 figures, of the leasing carried out by FLA members, 43% is carried out by the five largest market participants. In total, the top 40 companies in the UK account for 95% of all the FLA activity.

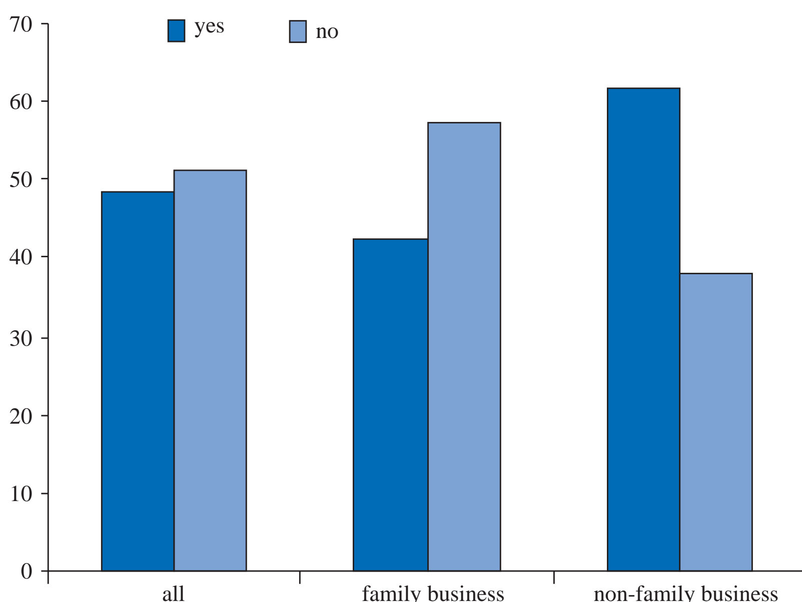
61 City University Business School, *The role of leasing in the financing of small and medium-sized companies* (1997).

# SECTION FIVE: EQUITY FINANCE

5.1 Information on the use of equity finance by small businesses is very limited. However, there is data on the use of venture capital finance which accounted for only 3% of all SME external finance in 1995-97, and was used as an additional source of finance by only 5.2% of respondents.[62] These proportions have remained fairly stable over the past ten years. This suggests that equity finance plays a small role in the financing of small business activity.

5.2 In general, UK entrepreneurs establish their own businesses partly because of a desire for independence. This contrasts with the wealth creation motive in the US, and the desire for expansion on the continent.[63] Consequently, UK entrepreneurs are more reluctant than their US and Continental counterparts to give up a proportion of ownership in return for equity finance. This attitude was highlighted in a survey carried out by the British Chambers of Commerce[64] that reported that only one third of UK businesses were prepared even to consider using external equity finance. Research by Manchester Business School on private SMEs showed that the desire to maintain ownership is particularly evident among family-owned businesses.[65]

**Chart 5.1**
**Would you consider using external equity?**




Source: Manchester Business School
*The Financial Affairs of Private Companies*

5.3 Equity finance tends only be sought once internal resources and debt finance has been exhausted. At this point, businesses will decide whether they would rather remain at their current size and maintain complete ownership or give up a degree of ownership in return for further growth. The survey evidence suggests that this decision is dependent on a combination of both personal and business aspirations.

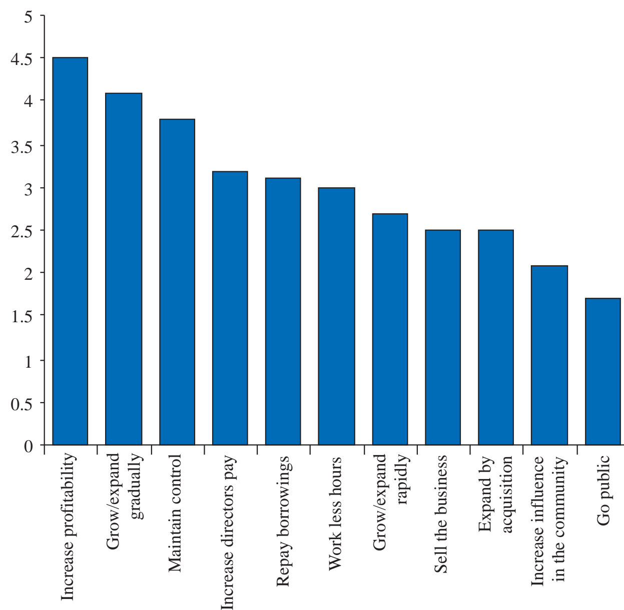
62 ESRC Centre for Business Research, Cambridge *Enterprise Britain 1994-1997* (1998).

63 Grant Thornton International, Business Strategies Ltd *European Business Survey* (1996).

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

65 However, it must be borne in mind that many firms do not have growth aspirations and so respond negatively to raising equity are not likely candidates for such funding

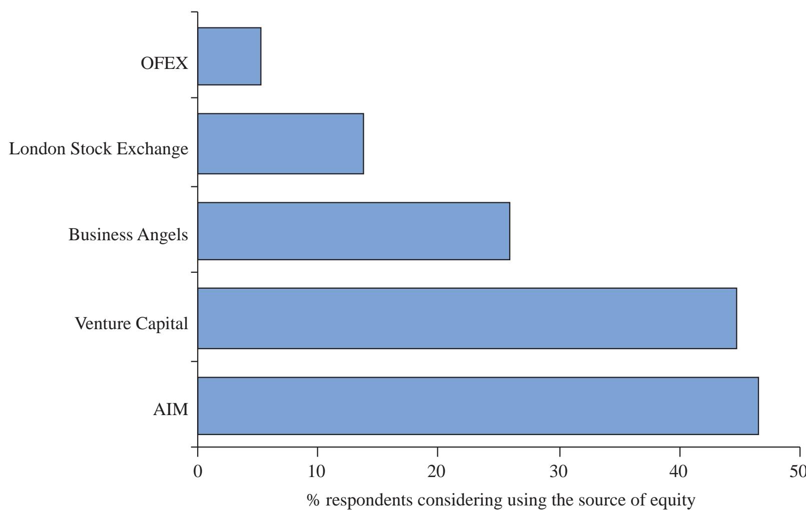
## Chart 5.2
## Goals for future of business




Source: Manchester Business School
*The Financial Affairs of Private Companies*

5.4 The reluctance among small businesses to use external equity finance could result in some businesses becoming over-geared and therefore more vulnerable to changes through the business cycle.

## Chart 5.3
## Sources of equity finance




Source: Manchester Business School
*The Financial Affairs of Private Companies*

5.5 While only a small proportion of small businesses require external equity finance, it is important that the provision of equity finance is sufficient to meet their needs. The suggestion that an equity gap exists in the provision of finance to businesses was first formalised in the MacMillan report in 1930. At that time, the MacMillan Committee found that an equity gap existed for firms wishing to raise equity of between £50,000 and £200,000. This gap would equate to £1.35mn to £5.4mn in 1998 values. It is no longer suggested that an equity gap for investments of this size exists, rather that SMEs find difficulty in gaining access to much smaller amounts of financing, i.e. between £50,000 and £200,000.

5.6 External equity finance is more important for limited companies than partnerships and sole traders, which suggests that the use of equity finance is positively correlated with the size of a business. It is more likely to be demanded by young, growth-oriented, non-family businesses and has a larger role in the financing of the service sector than the manufacturing sector. The types of external equity demanded depend on both the volume of equity finance required and the regulatory framework within which the business wishes to operate.

5.7 Equity finance is particularly important for technology-based firms at start-up and early stage. The problems faced by this sector were outlined in the Bank's report, *The Financing of Technology-based Small Firms* (October 1996). This report, and the follow-up work on this sector undertaken by the Bank, CBI and other interested parties, has shown that technology-based small firms tend to require equity finance at a much earlier stage (often at start-up) than other more traditional businesses, as debt finance is often inappropriate.

5.8 There are two types of equity finance, private equity and public equity. These two sources cater for different segments of the market. For example, private equity is often the most appropriate source of finance for technology-based small firms. Businesses can obtain equity from a range of sources – banks, business angels, venture capital companies and special investment schemes. All these equity finance providers are aiming at different segments of the market and therefore their impact on small businesses varies.

## Venture Capital

### *Bank equity products*

5.9 The main clearing banks offer a range of equity products for smaller companies, as well as supporting the role played by business angels. Barclays, Midland, Lloyds TSB and the Royal Bank of Scotland all provide sponsorship to LINC (Local Investment Networking Company), a national non-profit network of registered private investors who are prepared to offer finance of between £10,000 and £250,000.

5.10 Midland now operates nine Midland Enterprise Funds, following the merger of East and West Midlands funds and East Anglia and Thames Valley funds. These provide investments of between £5,000 and £150,000 and therefore can cater for the smallest and start-up businesses. Midland has committed £18.75mn to these funds so far, of which £14.3mn has been invested in 142 companies. The average investment value is £101,000. In October 1998, the European Investment Bank committed £20mn to assist small high growth businesses. This funding was to be directed towards the nine Midland Enterprise Funds and into a tenth fund, to be established, that would invest in innovative technology-based businesses. The Bank of Scotland does not make direct equity investments in smaller companies but does invest in the Scottish Equity Partnership and the West Lothian Venture Fund, both of which provide investments aimed at the smaller end of the market. Scottish Enterprise and 3i jointly launched the Scottish Technology fund last year. This £2mn pilot offers early stage finance to technology start-ups in Scotland, up to the value of £150,000.

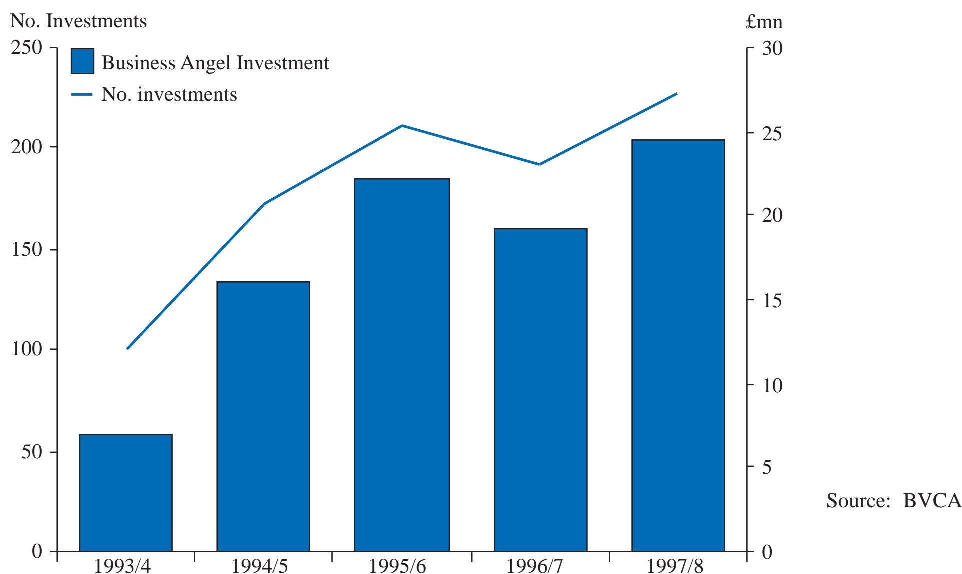
### *Business Angels*

5.11 The business angel market (also referred to as the informal venture capital market) consists of private individuals who invest risk capital in smaller unquoted companies. This market is largely invisible. Activity taking place through business angel networks can be monitored, but

this undoubtedly accounts only for a small proportion of the overall activity. Business angels tend to fill the gap between debt finance and formal venture capital investments and are more geared towards investing in early stage or start-up businesses. They tend to invest smaller amounts than it is economic for venture capital funds to do and therefore play an important role in reducing the impact of any 'equity gap'.

5.12 Research by Southampton University, on behalf of the British Venture Capital Association (BVCA), on the activity carried out through the listed business angel networks[66], showed that a record amount of investment occurred in the 12 months to June 1998. In 1997/98 the networks made introductions that resulted in 398 registered business angels making 227 investments in 223 registered companies. A total of £34.6mn was invested, an increase of 28% compared with 1996/7. However, the 1996/7 figures reported a fall in both the number and total volume of investments compared with 1995/6.

### Chart 5.4
### Trends in business angel investment 1993-98




Source: BVCA

5.13 As would be expected, this type of investment focused on smaller deals, with 68% of investments in amounts of less than £50,000. Most investments were between £10,000 and £50,000. Investments were geared towards start-ups and early stage financing - which together accounted for 50% of total investment - while MBOs and MBIs accounted for only 8% of investments.

5.14 Technology-based firms received the highest proportion of investment, when broken down by sector, and this proportion has increased since 1994/5. Despite this, business angels still appear to play a considerably less prominent role in the financing of technology-based firms in the UK than in the US. The main barrier to business angel investment which is generic to all firms is the lack of information on investment opportunities. Business angels operate most effectively through local networks (therefore geographical considerations are important), and adopt a hands-on approach to their investment, offering the benefit of their expertise as well as their financial commitment. However, some locally based business angel networks are not able to achieve the critical mass for them to become viable. Commentators have therefore suggested

66 Research monitors activity of 42 of the 45 listed business angel networks.

that further co-operation and co-ordination between the business angel networks in the UK could result in an increasing flow of informal venture capital to SMEs. The DTI, with banks and other interested organisations, is supporting the development of a new national organisation which will enhance the services available from the existing business introduction agencies.

5.15 It is important to recognise the complementarity of business angel investment and formal venture capital investment and more encouragement should be given to business angels and venture capital firms to co-invest in businesses. However, there is an important demand-side issue that needs to be addressed if smaller companies are to gain access to either informal or formal vanture capital. This arises because some smaller companies are not adequately prepared for venture capital investment and therefore potential investors are required to dedicate significant resources in undertaking due diligence. This increases the cost in terms of time and money in investing in smaller companies, making them less attractive. To reduce this barrier, it has been suggested that 'venture catalysts', i.e. advisers that assist smaller companies in their preparations for obtaining venture capital investment, could play an important role.

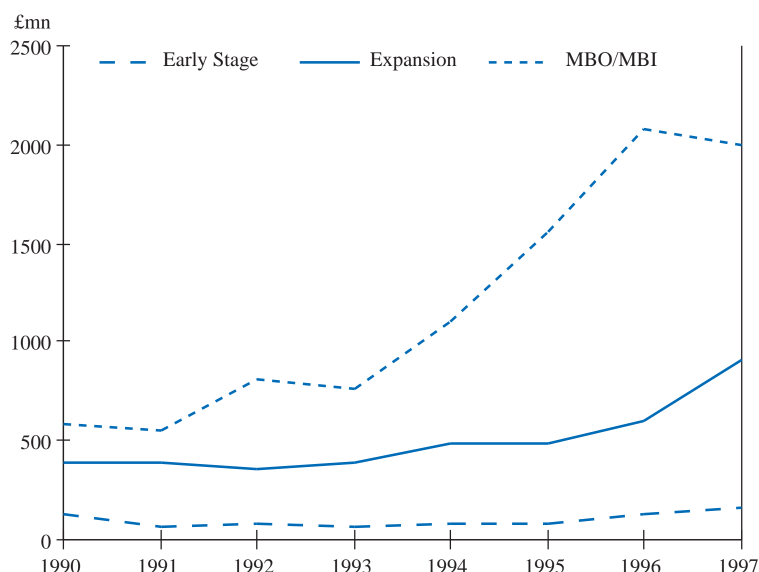
5.16 There are restrictions on introducing business angels to investment opportunities. This activity is currently covered by Section 57 of the Financial Services Act 1986. This will be modified as part of the proposed Financial Services and Markets Bill. Given the concerns that have been raised about the regulation of investment activity forming a barrier to the development of business angel networks and other forms of informal equity, the Treasury will seek views on facilitating informal fund-raising in its public consultation on the proposed new financial promotion regime early in 1999.

### *Formal venture capital*

5.17 Venture capital can be used to fill the equity gap that exists prior to a company gaining a public listing. Venture capital firms can provide investment into any size of company at any stage in its development. However, in practice, they tend to focus on investments of at least £1mn in medium-sized fast growth companies. Some venture capital firms, however, invest smaller amounts and the latest BVCA *Sources of Business Angel Capital* directory listed 23 venture capital companies that make investments of less than £100,000.

5.18 Although there has been a significant increase in the volume of venture capital investments since the last recession, with the most rapid growth having occurred since 1993, this has been concentrated on the financing of MBOs and MBIs (private equity finance rather than true venture capital). The volume of finance for early stage activity has remained fairly constant over the 1990s, and therefore has decreased significantly as a proportion of total venture capital finance since 1993. The availability of early stage and seedcorn finance is particularly important for the establishment and development of technology-based firms.

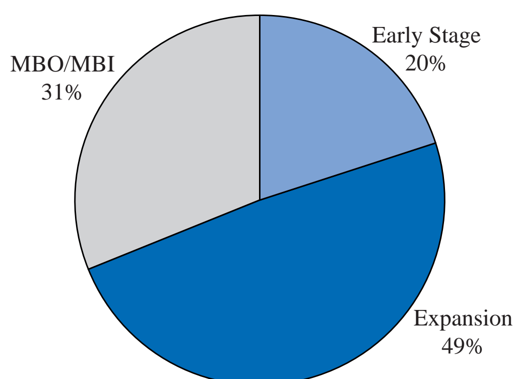
**Chart 5.5**
**Amount of finance**




Source: BVCA

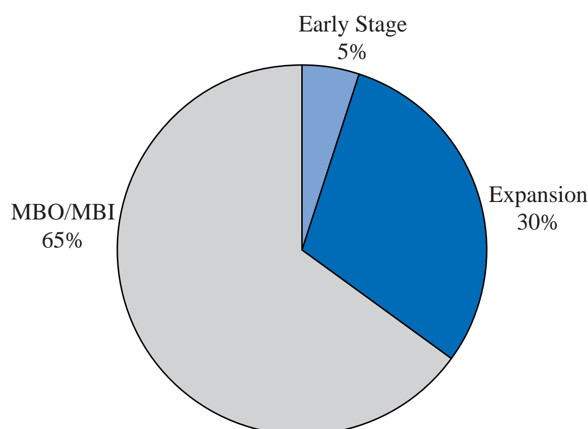
5.19 While early stage investments currently account for 20% of all companies financed, they only account for 5% of the total amount of finance. There is a bias in the volume of venture capital funding towards technology-based firms. In 1997, £690mn was invested in 295 companies - this was 15 times larger than the amount invested in 1984.

**Chart 5.6**
**Number of financings %**




Source: BVCA

**Chart 5.7**
**£mn amount %**




Source: BVCA

5.20 These trends reflect the fact that venture capitalists, and in particular the institutional investors on whose behalf they act, are not usually interested in making small investments in early-stage and start-up companies, largely because of cost structure considerations. This is a particular problem for technology-based firms, because they are more dependent on risk capital than other, more traditional, businesses that can more readily access bank finance. The reluctance on the part of the institutions to make smaller scale investments through seed and venture funds in start-up or early stage firms was highlighted in the Bank's report[67] and follow-up work has identified some key barriers to small-scale institutional investment. The main barrier relates to the scale and efficiency of investment size, given the costs of due diligence. It can be

67 Bank of England *The Financing of Technology-Based Small Firms* (October 1996).

particularly costly to carry out the required appraisal and monitoring, and the investment management is likely to be more expensive, for a given rate of return, than with a larger-scale investment. Also the buoyant MBO/MBI market of the last few years has enabled institutional investors to gain high returns on relatively straightforward reduced-risk investments with early exit routes if desired. This has reduced further the attractiveness of investing small amounts in high-risk early stage projects, especially where exit routes may not be available for many years. We will be carrying out further work on this topic throughout 1999 (see paragraph 6.12)

## Venture Capital Trusts and the Enterprise Investment Scheme.

5.21 Venture Capital Trusts (VCTs) were created in the 1995 Finance Act to encourage investment in unquoted companies. This includes investment in new share and securities of companies traded on AIM. Since August 1995, £535mn has been raised by 26 VCTS, of which £187mn has been invested in 236 companies. So far, 20% of the £187mn invested has been in high-tech companies; some 19% of funds have been invested in early stage investments, and 36% in MBOs and MBIs. Some 48 AIM companies have raised new funds from VCTs, accounting for £41.5mn (22%) of total funds invested.

5.22 VCTs only have five years in which to invest the money they have raised if they wish to gain the tax benefits on the investment.[68] Therefore, any VCT that was established in August 1995 now only has 18 months in which to invest its capital. With only 35% of total funds raised so far actually invested, this could result in a boost in equity investment in unquoted companies over the next 18 months. This could have a significant impact on activity and liquidity in the AIM market.

5.23 The Enterprise Investment Scheme (EIS) was established in January 1994, to replace the Business Expansion Scheme. The EIS allows individuals investing in qualifying assets to gain tax relief at the lower rate. In the March Budget (see paragraph 2.16), the Chancellor announced some important changes to the EIS - although the Treasury is still being lobbied on the details of the new scheme. Capital gains reinvestment relief was merged into the EIS from April 1998. The £1mn limit on the amount that companies can raise through the EIS each year was abolished. The new EIS still, however, limits participation in the scheme to companies with gross assets of less than £15mn before an investment. The limit on the amount an individual will be able to invest in new shares through the scheme was increased by 50% to £150,000. Investors also gain unlimited deferral relief from capital gains tax where chargeable gains on disposals are invested in eligible shares. The limit on the amount that an individual can invest in shares issued in the first half of a tax year qualifying for income tax relief for the previous year was increased from £15,000 to £25,000. Although the EIS has been welcomed as a useful tool for encouraging investment in small companies, some businesses have expressed concerns that, in practice, the benefits of the EIS are diminished by the complex regulations surrounding it.

5.24 As announced in the July 1997 Budget, the EIS and Venture Capital Trusts (VCTs) are to become more focused. Property-backed activities have been excluded under both the new EIS and the VCT Scheme. Guaranteed loans and securities will no longer form part of the fixed proportion of qualifying investments which a VCT must hold, and VCTs will be required to hold a minimum of 10% of their total investment in any company in ordinary, non-preferential shares.

68 Individuals are exempt from tax on dividends from VCTs and on capital gains tax when they dispose of shares in the trusts for investments of up to £100,000 a year. Investments in new ordinary shares will also be entitled to income tax relief at 20% provided shares are held for a minimum of five years.

These changes applied for accounting periods ending on or after 2 July 1997. Investors will not qualify for EIS relief if special guarantee or exit arrangements exist before or at the time of the issue of shares. This will apply to any shares issued on or after 2 July 1997.

## Public equity

5.25 Prior to the 1980s, companies only had two routes through which to raise public equity. One was the main stock exchange, which had strict entry requirements and was highly regulated (and was therefore unattainable and inappropriate for many smaller companies). Alternatively, they could gain admission to the OTC market, which was completely unregulated and therefore only attractive to specific investor groups. This gap was subsequently filled, to some extent, by the development of second tier equity markets. Second tier equity markets provide smaller companies with access to public equity at an earlier stage than would occur if the only source of public equity was a full listing. They also result in earlier exit routes for private investors, possibly increasing the liquidity of the private equity market. The development of second tier equity markets means that most European countries now have a three-tier capital market structure; an official list, a semi-official market or section of the official list with less onerous admission and trading requirements for smaller companies, and an OTC market falling outside all formal regulation.

### *UK second tier equity markets*

5.26 In November 1980, the Unlisted Securities Market (USM) was established in the UK. The USM was successful at first, attracting most companies formerly traded on the OTC as well as new entrants. However, the recession in the early 1990s caused the number of new entrants to fall and investor interest to wave. Together with the tightening of the USM's regulatory framework, this caused liquidity to dry up and, in 1992, the LSE decided to close the USM (although pressure from investors and issuers meant that the USM was not finally closed until 1996).

5.27 In 1994, the LSE undertook a consultation exercise which once again found that the official list alone was insufficient in the provision of finance to smaller companies. The result was that, despite the problems previously encountered by junior markets, the Alternative Investment Market (AIM) was established.

5.28 There are continuing concerns as to whether the current structure of UK equity markets provides an adequate service for smaller quoted companies. A recent report to the Paymaster General by a group chaired by Derek Riches, sponsored by HM Treasury[69], suggested that the London Stock Exchange could do more to provide a supportive market environment and increase the profile of smaller companies' shares.

### *UK equity markets*

5.29 The UK currently has a three tier market structure consisting of the official list on the LSE, AIM, and OFEX, the unregulated OTC trading facility. The latter is not a market although its sponsor is subject to stock exchange rules.

69 *Treasury Working Group Report on Small Quoted Companies* (November 1998).

*Official List*

5.30 The official list is segmented by market capitalisation. Smaller companies will be categorised in the FTSE Smallcap (market cap of £65mn to £400mn) or FTSE Fledgling (market cap of less than £65mn) indices. The LSE has also recently launched the All Small market index, which combines the FTSE Fledgling and Smallcap indices.

*AIM*

5.31 As noted above, AIM was established in June 1995 to provide earlier and easier access to public equity by smaller companies. AIM has grown rapidly over the past three years and, at end-September 1998, it consisted of 314 companies (including 21 from overseas) with a total market capitalisation of £4.7bn. In order to limit the costs and extent of regulation of the market, it has no minimum trading record, no minimum assets or profit levels, no minimum capitalisation requirement and no minimum free float of shares. However, while the regulatory framework on AIM is less onerous than on the official list, regulations have been tightened since AIM was first established. This was designed partly to encourage institutional investment, but has caused some businesses to question the benefits of AIM. Institutional investors currently own 37% of AIM companies, while directors and founders owned 34%. While some companies use AIM as a stepping stone to admission to the official list, many choose to remain on AIM given the favourable regulatory framework and perhaps also reflecting a belief that it is better to be a larger company on AIM than a small company in the tail of the official list.

*OFEX*

5.32 As mentioned, OFEX is an off-market trading facility provided by JP Jenkins, a market maker/ agency broker which previously specialised in Rule 4.2 stocks. JP Jenkins is keen to ensure that OFEX maintains its market identity and does not become a regulated exchange. OFEX is not regulated, although JP Jenkins is bound by Stock Exchange and SFA rules. OFEX was established in September 1995 and was intended to replace the Rule 4.2 market for companies that did not wish to join AIM or the official list. OFEX is intended to feed into AIM, although some companies have chosen to remain on OFEX despite qualifying for AIM or even the official list because of the advantages of an absence of regulation.

*Pan-European equity markets*

5.33 There has been a recent drive towards developing pan-European markets. Work undertaken for the European Commission[70] on the financing of technology-based firms identified the need for a substantial pan-European risk capital market, similar to NASDAQ. While EASDAQ (see paragraph 5.35) is aiming to fill this gap, it is not of a size or liquidity to attract European entrepreneurs, many of which still choose to list on NASDAQ. The main barriers to the development of a deep, liquid pan-European market were identified as fragmentation, both institutional and regulatory; taxation; paucity of high tech SMEs; human resources and cultural. The European Union currently has 33 regulated stock markets and 18 regulatory organisations. Each national market has lower capitalisation and liquidity, and consequently less exit routes, than a combined market. The diversity of regulations and taxation systems across the member countries makes the integration of national exchanges complicated, as is the case with Euro.NM. There are also major differences between the entrepreneurial and investor cultures in the US and Europe.

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70 Commission of the European Communities *Risk capital a key to job creation in the European Union* (April 1998).

*Euro.NM*

5.34 Euro.NM is largely an agreement between the Paris, Brussels, Frankfurt and Amsterdam stock exchanges to promote the listing and trading of European start-up, high tech and growth companies on member exchanges.[71] From May 1998, trading platforms at the Brussels Euro.NM and the Paris Nouveau Marche have been linked and since July there has been a common membership between these two exchanges. There has been discussion about widening Euro.NM. The Milan, Stockholm and Copenhagen stock exchanges plan to adopt the Euro.NM market standards next year. As of October 1998, Euro.NM currently has 144 companies listed, of which 16 have dual listings, with a total market capitalisation of $28bn. The growth of this market is expected to continue as more comapnies demand access to a pan-European investor base.

*EASDAQ*

5.35 EASDAQ was established in September 1996 as a pan-European market for small and medium sized companies with a bias towards the hi-tech sector. However, the market is now seen more as an exchange for high growth mid sized businesses – for a company to be listed it must have total assets of Ecu 3.5mn and capital reserves of Ecu 2mn. EASDAQ was modelled on NASDAQ (which originally took a 5% stake) and is regulated by the Belgian Ministry of Finance and supervised by the Belgian Banking and Finance Commission. Its authorisation enables it to operate EU-wide under the passport of the Investment Services Directive. As of October 1998, EASDAQ had only 37 companies listed with a total market capitalisation of $13bn.

71 In December 1996 the Markets Harmonisation Agreement was signed, which set out minimum common standards in listing, membership, trading and disclosure requirements.

## SECTION SIX: CONCLUSIONS

6.1 Government policy affects small businesses in a range of ways, but its most important role is to maintain a stable, low inflation environment. This provides small businesses with the certainty against which they can make decisions, especially long term commitments on employment and investment. It is also important that there is a fiscal and regulatory regime that encourages both enterprise and growth. These issues were important themes in the development of the Enterprise Fund, announced in the DTI's Competitiveness White Paper in December 1998. The Bank continues to work closely with the DTI and other relevant Government departments to help to ensure that public policy closely reflects the needs of the small firms sector.

6.2 The current slowdown in economic growth, which has been reflected in the adverse trading conditions faced by small businesses, particularly small exporters, has resulted in business optimism falling to the same levels as those reported in 1991. However, while small businesses are pessimistic about the overall performance of the economy over the next few months, on an individual basis they are confident of their ability to survive the slowdown. This confidence suggests that the small business sector is less vulnerable to cyclical changes now than at the same time in the last business cycle. This increased stability is partly the result of a number of structural changes that have occurred since the early 1990s in both the provision and use of finance by small firms.

6.3 Small businesses are now more appropriately financed than in the early 1990s. They are more dependent on internal sources of finance - with many of the smallest businesses being net creditors to the banking sector – while those businesses that do require external finance now access a wider range of finance products. This has been reflected in the continuing growth of the asset-based and receivables financing sectors, which now account for a higher proportion of external finance for SMEs than in the early 1990s.

6.4 Traditional bank finance does, however, remain the most important source of external finance for small businesses. Within bank finance, small businesses have moved away from variable rate uncommitted finance products towards more fixed term borrowing, sometimes at fixed rates of interest.

6.5 Although there have been moves by many small businesses to use more appropriate types of debt finance, some UK entrepreneurs continue to be reluctant to give up any degree of ownership in return for equity finance. This is particularly apparent in family-owned and lifestyle businesses.

6.6 High growth, and particularly technology-based, small firms typically require equity finance at an early stage in their development. However, supplies of seedcorn and early stage equity finance are limited. The economics of investment mean that many formal venture capital firms tend only to invest in amounts of £1mn and above while the informal venture capital market (business angels) is still underdeveloped compared with the US.

6.7 The banks have played an important role in improving the structure of finance for small firms, and encouraging a more open, constructive relationship with their small business customers. This has been based on more transparent lending policies and charging structures,

supported by the banks' codes of practice and the BBA's *Statement of Principles: banks and businesses working together*. The banks have also improved their credit scoring and risk assessment techniques, helping them to differentiate to a greater extent between different small firms, and ensuring that interest rate margins more closely reflect the true risk of the individual firm.

6.8 The provision of finance to small firms is not confined to the major clearing banks, although they account for a large share of the market. Competition in this market is increasingly coming from the smaller banks, the Scottish banks, finance houses and from new entrants, i.e. building societies and other finance providers. This should benefit small business customers both in respect to the cost of finance and also the range of products offered. The growth in the factoring and leasing industries has encouraged this process, although it should be noted that a large proportion of this activity is carried out through subsidiaries of the main clearing banks.

6.9 In conclusion, therefore, the improvements made by both the small firms and the banks have reduced the risks of the banks making losses on their small business loan books on the scale of those which materialised in the early 1990s.

## Particular challenges ahead

6.10 The Year 2000 and EMU continue to pose challenges for small businesses. While awareness of these issues is high, survey evidence still suggests that a large proportion of small businesses have made little preparation for these events. The impact will, of course, vary considerably depending on the type of business.

## The Bank's work in 1999

6.11 During 1999, the Bank will continue to monitor the issues covered in this report within the overall context of seeking to ensure that the small firms sector is appropriately financed.

6.12 More specifically, the Bank will carry out further work on:

- the financing of technology-based small firms;
- monitoring the effects of EMU on small businesses;
- monitoring small businesses' preparedness for the Year 2000;
- following up the work undertaken in our special report on the financing of ethnic minority firms.

6.13 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. Six years on, the Bank continues to be fully committed to this area of work.

# 1998 DIARY OF SMALL FIRMS EVENTS

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|---|---|
| **3 February** | UK Business Incubation launched. Midland Bank undertake £60,000, three year sponsorship of the Centre, which aims to help the formation, survival and growth of new and technology-based businesses. |
| **17 March** | The Budget - see Business Environment section. |
| **26 March** | European Commission adopts proposal for European Parliament and Council of Ministers Directive combating late payments in commercial transactions. Aim of proposed Directive to encourage adherence to payment periods, while respecting principle of contractual freedom in private sector. |
| **30 March** | Prime Minister announces at Year 2000 conference for SMEs an increase in budget for Action 2000, the Government-funded initiative. Action 2000 now has budget of £17mn. He also commits the Government to spending £70mn of £100mn allocated in Budget to improving UK's technology skills on Year 2000 problem. |
| **31 March** | NatWest launches business credit card to provide businesses with alternative to overdraft facility. Businesses can use card either as chargecard or credit card. |
| **March** | DTI publishes second edition of *Money and Machines* – a guide to capital investment for SMEs in manufacturing sector. |
| **6-7 April** | Enterprising Europe Conference. Hosted by UK during presidency of EU, to open up debate and promote enterprise and entrepreneurship throughout Europe. |
| **April** | Co-operative Bank advances first loan (£25,000) to a member of a Mutual Guarantee Society. |
| **19 May** | European Council Decision on Growth and Employment Initiative formally adopted. |
| **May** | HMT's Euro Preparations Unit (EPU) set up website (http://www.euro.gov.uk) and phone line (08456 01 01 99) for businesses to order factsheets on EMU, what euro will mean for organisations, and working with the single currency. |
| **May** | Business Environment Simplification Taskforce (BEST) report published. Among other recommendations, report calls for better public administration, new approaches in education and training, better access to finance and more favourable tax regime and encouragement of innovation. |
| **2 June** | Conference on Venture Capital, Growth and Employment in the European Union held at Guildhall. Aim is to increase the availability of venture capital for SMEs. Chancellor unveils three new or enhanced venture capital funds with support from either European Investment Bank or European Investment Fund. |

**4 June** Midland launchs new business start-up package available to start-up businesses with estimated annual sales turnover of up to £1mn. Includes two year free banking (providing owner or partner/director personally banks with Midland) and new Business Information CD-ROM containing business software, discounted Internet access and local area directory of Business Links, TECs and Midland branches.

**16 June** Trade and Industry Committee publishes report on Small and Medium Sized Enterprises. Among recommendations is that Government should define the objectives of SME policy, and that conclusions reached by academic research be channelled into the Government's policy making process. Where Business Links are found to be failing, improvements should be swiftly made. Government should publish evaluation of policies towards smaller exporters within the next two years.

**18 June** Government announces it will introduce minimum wage of £3.60 per hour, to become operational in April 1999.

**June** Government publishes consultative document *Innovating for the Future: investing in R&D* to raise awareness and stimulate wider debate.

**July** EPU launches information campaign, in press and on television, to alert SMEs to likely business impact of introduction of euro on 1 January 1999.

**July** NatWest publishes guide to informal investment. *Sharing Experience* is compilation of articles by leading UK practitioners in the field of business angel investment. Guide aims to provide private investors with information on seeking and managing successful private investments as well as supplying entrepreneurs, seeking equity finance, with insights into requirements of business angels.

**August** BBA publishes *Your Business and the Euro*, booklet containing information for SMEs to ensure they are prepared for impact on their business of euro.

**August** DTI publishes consultation document on co-ordinated business support strategy to provide framework for all business support activities. DTI aim to respond to widely expressed view from business on importance of UK having co-ordinated business support structure, which provides businesses with help required in efficient and effective way.

**August** Treasury commissions working group on Smaller Quoted Companies. Its report published on 3 November.

**August** Lloyds TSB launches initiative to provide specialist managers for SMEs in six business sectors - vets, pharmacists, doctors, dentists, accountants and solicitors. Specialist bank managers will have expertise in these different sectors - understanding issues, legislation and trends.

**August** Government issues consultation paper on future role of Training and Enterprise Councils (TECS), to explore ways of raising performance of TECS.

**22 September** *Private Businesses and their Banks 1998*, sixth biennial report by Forum of Private Business and University of Nottingham was published.

**19 October** Report of the Financial Management Working Group published.

**27 October** The Better Payment Practice Campaign is launched, essentially as relaunch of CBI's *Prompt Payment Code* by Better Payment Practice Group. Aim is to highlight range of techniques open to businesses to deal with late payers and to emphasise benefits of paying on time.

**28 October** 1998 achievement awards and launch of new SFEDI (Small Firms Enterprise Development Initiative, formerly Small Firms Lead Body (SFLB)). SFEDI is a founder partner, with Management Charter Initiative (MCI), in National Training Organisation for Management and Enterprise (METO) –Government-recognised partnership between public and private sectors.

**October** European Commission SME euro-Programme, managed in the UK by the FPB (the UK's representative on UEAPME) announced.

**October** KPMG evaluation of the SFLGS (93-98) completed, to be published in due course.

**1 November** Government's Late Payment of Commercial Debts (Interest) Act takes effect. During first stage of Act, small businesses (less than 50 employees) will be entitled to charge interest on any outstanding debts from large companies or public organisations. This phase to last for two years, after which small businesses able to claim interest on any outstanding debt. Finally, probably after further two years, Act will entitle all businesses to charge interest on overdue invoices.

**3 November** Pre-Budget Report published, and Government asks Don Cruickshank to undertake review of banking sector to examine levels of innovation, competition and efficiency in various sub-markets, including relationships with SMEs.

**3 November** Treasury Working Group on the Financing of High Technology Businesses (chaired by Sir Peter Williams) publishes report.

**3 November** Treasury Working Group on Smaller Quoted Companies (chaired by Derek Riches) publishes its report.

**16 November** *Small is Bankable* report published by New Economics Foundation and sponsored by Joseph Rowntree Foundation.

**16 December** Competitiveness White Paper published by Department of Trade and Industry.