Bank lending to small businesses

This report (1) was written in response to the Chancellor's request that the Bank should look again at bank lending to small businesses. It updates the findings of a previous report which was published, together with the Chancellor's announcement of its findings, on 17 July 1991.

Introduction

The report is based on the responses from seven major banks involved in lending to small businesses (Barclays, Natwest, Lloyds, Midland, TSB, Bank of Scotland and Royal Bank of Scotland). Together these account for about 80% of the market. Each bank has different management information systems. Their ability to supply precisely the data sought varied, particularly given the tight timescale for the production of this report. However, the findings and conclusions in this report provide a valid picture of the current conditions.

The principal allegation arising from anecdotal evidence in the press is that banks have not passed on reductions in interest rates to small businesses. These are defined as firms having a turnover of less than £10 million, although, wherever possible, we have obtained information covering two turnover bands—less than £1 million and £1–10 million. The lower turnover band probably covers the bulk of 'small' firms, with the second probably including some which banks and other commentators would class as mid-corporates.

The customer base

The total number of small business accounts has fallen from about 4.4 million in June 1991 to about 4.1 million now (-7%). The banks were able to supply data relating only to the number of *accounts*. This overestimates the number of *customers*, because some firms hold a number of separate accounts. Over the same period, total lending has fallen from about £45 billion to about £43.6 billion (-3%). The falls in the customer base were not uniform across all banks, ranging from small increases to falls of 15% in the number of accounts.

The number of accounts in credit has increased from 66% to 67% of the total. The number of accounts in debit has fallen by around 10%. Anecdotal evidence from the banks suggests that this reflects the trend amongst small businesses towards repaying debt and the paucity of new borrowing applications for investment.

Almost all of the banks experienced an increase in the proportion of accounts in credit. However, two banks had a significantly smaller proportion of accounts in credit than the others. Across all the banks, the proportion of accounts in credit was much higher in the lower turnover band of up to £1 million (67%) than in the £1–10 million band (56%). Overall, we found no evidence that any bank is seeking to withdraw from or significantly reduce its involvement in small business lending. Indeed, many pointed to the significant resources they have devoted to this sector in recent years—eg the production of codes/charters and moves to pre-notify charges. A number of banks pointed to significant increases in provision for bad debts in this sector, in some cases leading to overall losses in this sector of their business.

Types of lending

Total lending fell from £45.0 billion to £43.6 billion between June 1991 and now (-3%). The make-up of this lending is set out in Table 1 below. There seems to have been a small switch out of base rate related lending into the other two forms.

Table 1
Bank lending to small firms

£ millions; *percentages in italic*

	June 1991			November 1992		
	Number of accounts	Amount of lending		Number of accounts	Amount of lending	
Base rate related	966,950	37,226	*83*	848,183	35,061	*80*
Managed-rate	157,028	1,789	*4*	159,373	2,225	*5*
Fixed-rate	416,022	5,977	*13*	363,046	6,312	*15*
	1,540,000	44,992		1,370,602	43,598	

The average amount borrowed for each type of lending is set out in Table 2 below.

Table 2
Average size of borrowing

£s

	June 1991	November 1992
Base rate related	37,900	38,400
Managed-rate	11,400	14,000
Fixed-rate	14,400	17,400

Not surprisingly, the average borrowing was much smaller for firms in the lower turnover band, averaging a little over £20,000 for overdrafts in November 1992. Given that most small-firm customers are in this lower turnover band, the average benefit for them of each 1% cut in the interest rate is £200 per annum.

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We also asked about the incidence of borrowing limits being changed over the period. About a third of facilities had been increased, the average increase being about £12,500. About 40% had seen no change; and about a quarter had had borrowing limits reduced or withdrawn, by about £21,000 on average. These figures cover only accounts in existence at the beginning and end of the period ie they do not include new facilities granted during that time. Two banks were able to give additional data on new facilities granted during the period—134,000 accounts with total borrowing *limits* of £4.0 billion (average limit £30,000). They were also able to show that where limits had been reduced 57% had been withdrawn completely and 43% remain but at a lower level. Such changes could have been at either the customer's or the bank's request. One bank further pointed out that 22% of their reduced or cancelled overdrafts had been replaced by term loans.

Average margins

Where lending is directly related to base rates, any changes are automatically passed on to customers within one or two days. Banks' computer systems mean the changes are input centrally and the systems cannot pick and choose which customers should receive the change. Since June 1991, base rates have fallen by 4.5%. Margins over base are reviewed at agreed intervals, usually annually, though new firms or those facing difficulties may be reviewed more frequently. A review may also be triggered when the customer asks for an increased facility or exceeds an agreed borrowing limit. Table 3 below shows the changes in average margins since June 1991.

Table 3
Average margins over base rate (per cent) weighted by debit balance(a)

	Turnover < £1 million	Turnover £1–10 million
June 1991	2.91	2.69
November 1992	2.96	2.67

(a) Includes lending on managed rates, which were converted to equivalent margins over base. Individual bank data were weighted according to the proportion of total variable-rate lending.

Overall, it was hard to see any trend in *average* margins across all the banks. What increases there have been in average margins (in both turnover bands) have been quite small—for the bank with the largest average increase it was only 0.5 percentage points. There have also been a number of reductions in average margins in both turnover bands. There was a degree of differentiation between the banks in the levels of average margins. For firms in the lower turnover band, average margins vary from 2.3% to 4.2%; and in the higher band from 1.8% to 3.8%.

In addition, some banks were able to provide current average margins not weighted by debit balances. These were about 3.9% for lower turnover band firms and 2.7% in the higher band. As with the weighted figures, there was a degree of differentiation between banks. Average unweighted margins varied from 3.0% to 4.7% in the lower turnover band and from 2.3% to 2.9% in the higher band.

This year we asked an extra question to identify the proportion of lending in a series of margin bands. The responses are summarised in Table 4 below.

Table 4
Proportion of lending in margin bands

Per cent

	Turnover <£1 million		Turnover £1–10 million	
	June 1991	Nov. 1992	June 1991	Nov. 1992
Margin bands				
0%–2%	21	20	56	35
2%–4%	59	61	40	61
4%–6%	16	16	3	3
6%–8%	4	3	1	1
>8%	—	—	—	—

These show the bulk of lending is within the 2%–4% margin band. However, despite the banks' attempts to widen margins, there is still a significant amount in the 0%–2% band. Above 4%, the proportion of lending drops away markedly. Over the period the most noticeable change has been the movement of the higher turnover band firms from the 0%–2% band into the 2%–4% band. However, such firms currently rarely pay a margin greater than 4%.

We also asked the banks for data on the incidence of changes in margins, both up and down. The results from the three major banks which were able to supply these data are summarised in Table 5 below. Overall, 61% of base rate related accounts saw no change. Margins widened on 30% of accounts, about half by less than 0.5%; and they narrowed on 9%. Thus, 7 out of 10 customers seem to have received the full benefit of the base rate cuts or more.

Table 5
Incidence of changes in margins since June 1991

+<0.5%	+0.5% to 1.0%	+1.0% to 2.0%	+>2%
14%	9%	5%	2%
-<0.5%	-0.5% to 1.0%	-1.0% to 2.0%	->2%
4%	2%	2%	1%

Again, banks seem to have behaved differently with some banks widening margins—in one case on almost a third of their borrowing accounts—more than others. By contrast one bank was more prominent than the others in reducing margins.

Minimum interest rate floors

Lloyds, Midland, TSB and Bank of Scotland have no minimum interest rate floors or only a tiny number of accounts with floors. For the other banks, minimum rates exist if they are explicit in agreed facilities letters.

The majority of Barclays' business customers with base rate linked borrowing facilities have a minimum base rate. Generally, this is 6% (recently reduced from 7%) but in 15% of cases there is a lower minimum base rate. The customer margin is on top of this.

For Natwest, all base rate linked accounts (about two thirds of borrowers) have floor clauses. Floors, to which customer margins are added, are related to the margin and would begin to operate if base rate fell below 6% (recently reduced from 8%). Customers with margins of 1.5% or 1.0% would be affected only when base rates fell below 5.5% and 5.0% respectively. Natwest have also set a ceiling on their margins of 6.5%.

For Royal Bank of Scotland, the majority of floor clauses are set at a minimum base rate of 4% with the customer's margin on top.

Interest rates and charges for unauthorised borrowing

Expressed as a margin over base, current interest rates on unauthorised borrowing range from 15% to 29% (although most are expressed as a fixed rate, not linked to base). These rates apply *only* to the excess over any authorised facility. They are undoubtedly penal—and are meant to be so. Banks point out that:

- Borrowing in excess of agreed limits is entirely the fault of the customer, who has no *right* to that money.
- If customers feel that they might breach their borrowing limits they are encouraged to discuss this with their manager *in advance*. Increased facilities may well be agreed; and, if they are not, the customer should not take the extra amount.
- A penal rate is needed to act as a deterrent. Otherwise, a bank's only alternative is to bounce every cheque once the limit has been breached. This can have serious implications for the firm's standing with, for example, trade creditors.
- In general, banks prefer to pay cheques which would breach agreed limits and to rely, therefore, on the deterrent of a high excess borrowing rate. Where the unauthorised borrowing continues, banks tend to bounce cheques as the last resort.
- Encouraging customers to stay within agreed facilities and to discuss any potential increases in advance is an important way of ensuring the customer is managing the business properly.

In addition to a higher rate of interest on the excess, unauthorised borrowing may incur charges for warning letters/telephone calls (from £10 to £15) and for bounced cheques (from £20 to £25). A number of banks have pointed to a significant (and welcome) reduction in unauthorised borrowing since June 1991.

Fees and charges

The average increase in income from fees and charges since June 1991 was just over 5%. This compares with inflation over the seventeen-month period of 4.2%. This has been despite the overall fall in the customer base. There seems to have been a more thoroughgoing attitude to implementing charges—a trend identified in last year's report. Again, there were divergences between individual banks. Two saw revenue from this source fall, by a little less than the decline in the customer base; and increases in revenue for the rest ranged from 4% to 22%.

All banks review their tariffs annually and are committed, through their codes and charters, to giving customers one month's notice of any changes. The annual review does not always mean an increase. At their annual review in March 1992, Midland decided to freeze all charges for a further year. Lloyds, Natwest and Bank of Scotland have recently announced their price changes for 1993, which are made up of some increases, some reductions and some with no changes. A comparison of the principal charges for each bank in June 1991 is shown in the Appendix. A number of banks continue to offer charge-free accounts in the first year for new firms.

Fixed-rate lending

Fixed-rate loans do not, of course, vary in line with base rates. The change in the average rate quoted for new loans during this period has, with the exception of one bank, reduced by between 2% and 4%. There are, typically, a variety of different loan products available and, thus, a divergence in the rates available. Table 6 below shows the typical rates borrowers could be expected to pay at present for new loans.

Table 6
Fixed rates available on term loans(a)

Term			
3 years	5 years	10 years	20 years(b)
14.60	14.64	14.27	14.44

(a) Figures are selected typical rates. Banks typically have a variety of term lending products. Individual bank data were weighted according to the proportion of total fixed-rate lending.
(b) Rates are normally reviewed after 10 years.

As noted in Table 1 above, fixed-rate lending (which is almost invariably for term loans) now amounts to 15% of all lending to small firms. Table 7 below shows that the bulk of this lending is for terms between 5 and 20 years, although some banks do not offer loans in excess of 10 years; and those that do will review rates after 10 years for the remainder of the loan.

Table 7
Proportion of term lending by maturity band

<3 years	3–5 years	5–10 years	10–20 years	>20 years
14%	12%	32%	27%	15%(a)

(a) Includes 4% where loans have no maturity date.

The identifiable trend towards term borrowing by small firms is to be welcomed (including variable-rate term loans as well as fixed-rate), given their apparent tendency to rely on overdrafts for core financing. Banks seem keen to encourage this trend. For example, in their guidance to managers one bank urged them to persuade start-up firms to take a term loan rather than an overdraft. Another pointed out that their standard small-firm loan product was available for up to 20 years and can be on an unsecured basis. A capital repayment holiday of up to two years is also available on these loans. There was also some evidence that term loans were being used to refinance short-term debt over a longer period and even for increases in working capital as part of planned expansions.

Guidance given to managers

Five main themes emerge from the papers sent to us in response to our question on what new guidance had been given to managers since June 1991.

First, there is repeated emphasis on the need for *proper implementation of the codes and charters*. Particular emphasis is placed on giving customers a month's notice of any changes. Second, and closely related, is the importance attached to *communicating more and better with customers*. The need to commit time and effort, preferably face to face, to explain the rationale behind any increases (in fees or margins) is often emphasised. Guidance on points to make and on comparisons with competitors is given. More recent guidance from banks with minimum interest rate floors has pointed out a need to explain the bank's policy and justification clearly but not apologetically.

Third, a number of banks have issued *guidance on target margins*. In two cases the target minimum was increased by 0.5% but one bank reduced its targets. Some banks do not set their managers target margins. Managers are also expected to use their discretion. For example, one bank told its managers that they 'are expected to *negotiate* margins appropriate to the risks involved'; and another said, 'The overall pricing decision for individual customers remains the responsibility of the relationship manager'. Fourth, and closely related to the guidance on target margins, the banks seem to have been implementing the outcome of work done at head offices or in pilot projects to *formalise credit/risk assessment techniques*.

Finally, it is clear that the guidance to managers on the *thoroughgoing implementation of fees and charges*, which was mentioned in the 1991 report, has continued. For example, one bank told their managers to, 'ensure that all income due is properly charged'; and another said, 'always take fees where they are justified'.

Appendix

Current bank charges (a)

	Credit (paper)		Debit (paper)		Account management fee per quarter		Arrangement fee		Returned cheque		Night safe per annum		Unauthorised borrowing		Next review
	June 1991	Dec. 1992	June 1991	Dec. 1992	June 1991	Dec. 1992	June 1991	Dec. 1992	June 1991	Dec. 1992	June 1991	Dec. 1992	June 1991	Dec. 1992	
Bank of Scotland	42p	46p	42p	46p	Nil	Nil	1%	1%	£6	£20	£35 (b)	£50 (b)	15% (c)	18%(c)	Dec. 1993
Barclays	63p	66p	63p	66p	£5	£6	1.25%	1.25%	£20	£25	£20–40	£18–36	15% (c)	15%(c)	May 1993
Lloyds	70p	75p	70p	75p	£7.50	£7.50	1%	1%	£25	£25	£25	£40	31.2%	28.8%	Early 1994
Midlands	60p	60p	60p	60p	£7.50	£7.50	1.25%	1.25%	£20	£20	£24	£24	32.8%	29%	Mar. 1993
Natwest	64p	66p	64p	66p	£6	£7	1.5% (d)	1.5% (d)	£20	£27.50 (e)	£60–120	£80–150	33.3%	32.3%	Dec. 1993
RBS	(f)	(f)	(f)	(f)	(f)	(f)	(f)	(f)	£6–15	£20	£36 (b)	£50 (b)	7% (c)	25%	Mar. 1993
TSB	63p	67p	48p	53p	£4	£6	1%	up to 15%	£15	£20	£144 (b)	£144 (b)	26.5%	30%	April 1993

(a) This table has been slightly revised and updated from that published in the report.
(b) Includes all lodgement fees.
(c) Margin over base rate.
(d) For term loans. Arrangement fees for overdrafts on sliding scale.
(e) Includes advice letter, where appropriate.
(f) No published smaller business tariff. Charges are negotiable.