The financing of small firms

In a speech[1] to the Scottish CBI and Scottish Enterprise, the ***Governor*** *discusses the problems of financing small businesses. Such businesses are an increasingly important sector of the economy and have been a significant source of employment growth. The* ***Governor*** *describes how, during the recession, the relationship between banks and small businesses has been strained. Small firms have seen banks as benefiting from their difficulties, but banks have seen the sector as unprofitable and problematic. The* ***Governor*** *suggests that one of the most important things that the authorities can do to improve the climate for both small firms and banks is to achieve and maintain a stable macroeconomic environment. But there are other areas in which progress can usefully be made. The* ***Governor*** *outlines the encouraging response from the series of meetings that the Bank has had with the CBI, small business representatives, a number of academic experts and the major retail banks. At these meetings there was a good measure of agreement on the nature of the issues and on how each party, together with the government, could contribute to improvements in this area. The* ***Governor*** *explains that no one single measure will bring a dramatic or sudden improvement, as there are many separate issues to be addressed to improve the financing of different small businesses with different needs; each will need a tailored approach. But the* ***Governor*** *says that, as a result of the discussions, he is reasonably confident that small firms will not be constrained by any general lack of availability of bank finance, and that many of the difficulties and misunderstandings that have arisen are being addressed. He says that the Bank will continue to review progress in this area.*

Mr Chairman, let me begin by saying how grateful I am to our joint hosts—CBI Scotland and Scottish Enterprise—for providing me with a very welcome excuse to come north of the border again and for giving me this opportunity to share some thoughts with you all this evening. I propose to talk about small businesses—or more specifically about the financing of small businesses. I do so here because it is a field in which Scotland has always had a strong tradition—a tradition which our hosts tonight have maintained with great vigour. And I know we can all learn a great deal from your activities. But I will speak more generally about finance for small firms tonight because, in an environment of intense global competition—in which larger scale enterprises in particular are being forced continuously to seek productivity gains and cut back on their workforce—small businesses play a hugely important role as a source of growth of employment and of national prosperity. If I may illustrate the point—research carried out by Newcastle University for the Department of Employment suggests that between 1982 and 1991 firms with less than 20 employees created nearly $2\frac{1}{2}$ million jobs, whereas larger firms actually reduced their number of jobs by $\frac{1}{4}$ million. That is a measure of how important small businesses are to the economy—and why the problems facing small businesses are, quite rightly, attracting increasing attention.

The tragedy is—and it is a human tragedy for the small business men affected as well as a tragedy for the macroeconomy—the tragedy is that tens of thousands of small firms have gone *out* of business in recent years. Of course not every business venture can succeed—there will always be a large number of failures. But Dun and Bradstreet calculate that through the recession—from 1991–93—the *number* of business failures rose to around 55,000 a year compared with a more normal rate through the 1980s of less than 20,000 a year. It is not surprising in these circumstances that there should have been a great upsurge of resentment on the part of small business men and women working all hours to *avoid* failure. And it is not surprising that much of this resentment should have been directed at the banks. They, after all, provide the great bulk of the external finance outstanding to the small business sector. They are the natural villains of the piece because it is they, in the end, that withhold the additional credit that might just enable the business to turn the corner. It is the banks that impose higher margins or additional collateral requirements, or lower borrowing limits, just when the going gets rough (and the credit risks correspondingly greater); and it is the banks, quite often, that eventually pull the plug and enforce their security (extending even to the family home) when the loan falls into default. The perception very often seems to be that the banks actually benefit from the difficulties of their small business customers and are simply waiting for an opportunity to pounce.

The reality is that the banks suffer too, when their small business borrowers run into difficulties. It is obviously not in their interest to behave in this alleged predatory way if a

(1) Delivered in Glasgow on 17 January. A related paper was released at the same time and is available from the Bank of England's Information Division.

more accommodating approach would produce more secure, profitable, banking business. The fact is that, over the $2^1/_2$ years to the middle of 1993, when business failures were at their peak, the retail banks between them had to provide over £3 billion against possible losses on a total small business loan book of some £45 billion. That lending is financed by the banks' depositors, and the losses arising from it fall, in the first instance, on the banks' shareholders. Banks are not—as sometimes seems to be implied—publicly owned utilities and they must be able to limit their risks and achieve competitive returns for their shareholders if they themselves are to remain in business. (Even if they *were* public utilities they would have corresponding responsibilities to their creditors and to the taxpayer.) So the banks, for their part, too, feel misunderstood and resent much of the criticism as unjust. There are no prizes for guessing whose side the media typically take in what they see, very understandably and with some justification, as an uneven struggle between David and Goliath.

Now, what strikes me as obvious in all of this, is that the damage inflicted on *both* sides has its roots in an important *common* cause—in the volatility of the macroeconomy. The most recent boom—in the late 1980s—encouraged the start-up and expansion of small businesses as well as the ready availability of credit to finance them; and then the inevitable bust, in the early 1990s, following the restrictive action that eventually had to be taken to control escalating inflation, falsified the assumptions on which the earlier decisions of both the banks and the small businesses were based. I frankly find it hard to believe, after that traumatic experience, that anyone can doubt that the most helpful thing that the authorities—and I include in this the Bank of England—can do, to encourage the small business sector and bank financing of that sector, is to achieve and maintain a stable macroeconomic environment in which *both* sides can function more effectively and with more confidence.

I know you will all tell me that the business climate remains ferociously competitive, and I agree that it is. But we have now restored a stable basis on which the economy is now clearly moving ahead and unemployment coming down. Inflation is lower than it has been in a generation; and nominal interest rates too are lower, and have recently been more stable, than for very many years. We need now to build steadily on that foundation. If we remain patient, I see no reason why the non-inflationary growth of output should not be sustained well into the medium term, which is as far as anyone can hope to look ahead. That would be, in my judgment, the best possible macroeconomic climate for *both* the small business sector *and* the banks; and it would go a very long way to reducing the tensions that have grown up between them.

But perhaps not *all* the way. Some of the tensions seemed to go deeper than this, and it was to learn more about these problems that the Bank of England has had a series of bilateral discussions since the summer. These involved the CBI and small business representative organisations, with a number of academic experts and with the major retail banks. The objective was to get a better-informed view on whether there is, or is likely to be, a *general* shortage of bank finance for small businesses—or some problem in the means by which it is delivered—that could unnecessarily hold back the overall economic expansion, and frustrate in particular the contribution that small businesses might otherwise be able to make to increasing employment.

The purpose of the exercise, and of the seminar last November in which we brought all the parties together, was not—as has been suggested—to bash the banks. I have to admit that the Bank of England did become quite popular when people thought that it was! That was an unfamiliar experience for us—and it did not last very long! The purpose of the exercise was not to 'whitewash' the banks either. Indeed, in some respects, the banks would acknowledge that they had been their own worst enemies. While pointing out that the problems affect only a small proportion of their $2^1/_2$ million small business relationships, the banks recognise that they need to improve their understanding of the small business market. But the purpose of our exercise was not to recriminate, it was to listen and learn, and see what lessons there were for the future.

What is immediately clear is that the term small business covers in fact a very wide range of businesses, of different sizes, from microbusinesses with just one or two employees, to those with turnover running into millions, operating in almost every sector of the economy, and with widely differing aspirations. Their financial needs are accordingly enormously varied, so that we are talking about a complex and multidimensional problem. It means that the banks—at the point of delivery—have to be able to understand the particular needs of small business customers that are in degree *sui generis*, as well as being fully conversant with the appropriate range of financing products; and it equally means the borrowers need to understand the banks' requirements and why they may think that financing in one form is preferable to another. There was a good deal of emphasis from both sides in our discussions, therefore, on the need for training, education and technical assistance.

Within this context there was a good deal of common understanding on particular aspects of types of financing. There was, for example, quite general acceptance that excessive reliance had been placed on the secured overdraft. Many borrowers, as well as the banks, see the advantages—assured financing at known cost—of term loans that have to be set against the famous flexibility of the overdraft. And there was a common recognition of the need to focus on the cash flow and performance of the business rather than to rely largely on security—though it will clearly continue to be true that the availability of security can reduce the risk to the lender and hence improve the cost and availability to the borrower. Both sides could see the merits of factoring or invoice discounting, and of leasing, in appropriate cases. There was a shared appreciation of the role of equity and on the desirability of encouraging the growth of informal sources of outside capital which could often bring with it additional financial expertise, which was seen as a helpful development. But there was recognition, too, of the reluctance of many small business owners to dilute their ownership. More generally there was a common emphasis on the importance of the banks being able to offer financial packages appropriate to the particular borrowers, and of the borrowers themselves being able to appreciate their advantages.

It was understood that all of this was inevitably resource-intensive, and therefore potentially expensive. For *both* the bankers *and* their small business borrowers, time—whether spent on training or financial management—is money, but both sides recognised that it could be money well-spent if it improved the chances of the business succeeding, and hence the risk to the lenders. The banks have quite generally made massive attacks on their cost structures and, as we have recently seen, they continue to do so; and a variety of imaginative computerised techniques for credit assessment and monitoring are also helping to contain costs and improve risk management.

And both sides found it easy to agree—as you might perhaps expect—on a range of measures that the *Government* could introduce to assist small businesses and their financing. They appreciate the more recent initiatives of the Department of Trade and Industry in promoting training and education, as well as technical assistance and 'marriage-broking', for example, through the Business Links project. And they will, I am quite sure, have welcomed the Chancellor's Budget proposals, including the proposal to review the policy action that might be taken to reduce the problem of late payment of commercial debt which, everyone understands, can be especially serious for small firms.

Now it is obvious from all of this that improving the financing of small business is an amorphous sort of problem. There is no single solution which will bring about sudden *or* dramatic improvement—it is essentially a question of progressing by many small steps across a wide front involving borrowers, banks and government. But I must tell you that I was very encouraged by what we learned. I was impressed by the extent and variety of the initiatives that are being taken on all *three* sides. Whatever the popular image, the retail banks *are* fully committed to the small business sector, and necessarily so. It is an area where they retain comparative advantage in an environment where their larger corporate customers have ready access to direct borrowing in the money and capital markets, as well as to international sources of finance. They each have distinctive individual strategies for competing for the viable business in the small firms market, which they were only prepared to discuss with us bilaterally, with different emphases on different segments of the market. The effect is that all segments are covered in some degree, with, on what we were told, strong competition *between* the banks particularly in the faster growth segments.

I come out of this exercise reasonably confident that small firms will not be constrained by any *general* lack of availability of bank finance, and with a sense that many of the difficulties and mutual misunderstandings that have arisen are being addressed. It is in the nature of things that *particular* tensions will persist and I am not for a moment suggesting that the finance for every borrowing proposition, in the form and on the terms sought, will be immediately forthcoming—though it should be possible for borrowers increasingly to shop around. There will no doubt continue to be mismatches between what particular borrowers demand and what the banks are prepared to supply—cases in which, as one of the small business representatives put it, 'we want tomatoes and you offer potatoes'. But on the basis of what we have heard so far there is a gradually improving understanding both of the consumers' needs, and of what it is realistic to expect from the suppliers, and the important thing is that this improving understanding should be carried further.

We have agreed—with the CBI and the small firms' representative bodies, with academic experts and the banks—that we should meet again periodically to review that progress. We will be looking to encompass a wider spectrum of opinion in our discussions, and to try to develop criteria on the basis of which we can monitor progress more objectively. The whole subject is a continuing one.

In the meantime, Mr Chairman, to revert to my starting-point, the Bank of England will be doing all that *it* can to ensure that the macroeconomic environment continues to support sustainable noninflationary growth. This will do more than anything to encourage the small firms sector, along with the rest of the economy.