Finance for small firms

*The **Deputy Governor**, Howard Davies,*[1] *pointed out that relationships between banks and their small business customers have continued to improve during the past year. Banks remain the most significant source of external finance (49% of funds) and competition remains strong, especially for higher quality small business customers. Changing banks does not appear to be a significant problem for these customers, although those that do wish to change face some significant direct and indirect costs. Lending to small firms fell slightly again during 1995, reflecting the continued lack of demand. Term loans now account for 63% of bank lending to small firms and this trend away from borrowing on overdraft appears to be slowing.*

The Bank of England's annual report on Finance for Small Firms[2]—the third in the series which flowed from an initiative taken by the Governor in 1993—has been published.

In 1993, the best that could be said about the relationship between banks and their small firms customers was that both sides were in a state of armed neutrality. There were some 'safe areas', but much of the ground on which both sides camped was bitterly contested. And the Bank of England had been asked twice by the then Chancellor, in 1991 and 1992, to examine the structure of bank lending to small firms and, in particular, to assess whether reductions in base rate were being passed through. Those reviews found no guilty men, but did not resolve the underlying problem—one rooted in suspicion and distrust. The Governor's initiative was designed to address that.

At the time, I sat on the other side of the table, representing firms both big and small at the Confederation of British Industry (CBI). And I well remember wondering what value the Bank's work could add in such unpromising territory.

You will expect me to say that I have now been converted. But that conversion occurred well before I joined the Bank.

The Bank of England's quarterly reports on small business statistics have quickly become one of the most useful sources of data on the development of small business, for one thing. The regular seminars with small firms' representatives, and the banks, are valuable fora for the exchange of views. And the annual reports conveniently summarise progress.

But after more than two years work it is worth asking whether anything has changed, on the ground. While it is undoubtedly true that there has been a deeper and closer dialogue between providers and users of finance in the last two years, has that dialogue resulted in measurable improvement in the availability of appropriate financing packages for small businesses—which is the prime purpose of the exercise?

The picture painted by the third report is, overall, a positive one. The number of new start-ups has grown in the last year, though not as rapidly as in 1994. But the trends in overall numbers and activity have more to do with the state of the economy as a whole. Small firms, and large ones, have benefited from a period of price stability and steady expansion. What can we say more specifically about the provision of finance for growth?

Here it is fair to say that there is both light and shade though, on balance, the picture is brighter than before. Certainly small firms themselves, and their representatives, are now more positive about their relationships with banks than they were in 1993. But while the mood music surrounding their relationship is not without significance, it is more important to assess the extent to which practice in the provision of finance has changed.

On the credit side of the account, we can see a number of positive developments:

- Bank charges have continued to fall over the last year and the process of determining charges has become more transparent. Average lending margins have remained largely constant at between 3% and 4% over base rate, but small firms themselves recognise the need for banks to price risk accurately if the market is to remain attractive to them.

- There has been an important change in the composition of advances. It is no longer true to say that small firms are excessively reliant on variable rate overdrafts, as they were five years ago, which left them more vulnerable to the economic downturn of the early 1990s. Over the last three years the proportion of lending to small firms represented by overdrafts has declined from 49% to 37%,

(1) In a speech to the Manchester Merchant and International Bankers Association on 17 January 1996.
(2) For further information or a copy of the report, 'Finance for Small Firms', please contact Adrian Piper (0171–601 4117), Melanie Lund (0171–601 4430) or Stuart Cooper (0171–601 4814), in the Bank's Business Finance Division.

with term lending of one sort of another making up the balance of 63%. That is a big, and important shift.

- There is evidence that banks are becoming more sophisticated at segmenting the marketplace, and tailoring appropriate packages to different sorts of small business. They are increasingly dividing the sector into 'lifestyle' and 'growth' businesses, and delivering financial products differently to the two categories. That allows bank charges for simple transactions to fall, and facilitates a more proactive and flexible approach for growth businesses to which banks can pay more attention.

- Much more use is now made of business plan and cashflow-based approaches to lending, rather than reliance on property-based security. One impetus for that change has been the depressed state of the property market, but it has meant that banks have been obliged to become more familiar with the dynamics of the businesses to which they lend, which will have important positive effects in the future.

- Surveys of small firms show some evidence that their relationships with their banks are seen as more positive than at any time in the last five years. In one survey, 85% of firms report a constant or improved relationship with their banks.

So far, so good. And the Bank's latest report gives chapter and verse in each area. But there is a debit side to this balance sheet, as well. And a dispassionate observer would have to point to some continuing difficulties, which make it hard to say with confidence that, as a nation, we are getting the most out of the entrepreneurship evident in our smaller firms.

It is clear that equity finance remains a difficult area, as it has been at least since 1931, when the 'MacMillan gap' was first identified. This is not solely a problem for the providers of finance. Many small business owners continue to be reluctant to open up the ownership of their firms, even when future growth depends on it.

The formal venture capital industry invests relatively little at the smaller end of the market. Only 5% of UK venture capital investment goes into startup and early-stage companies. Informal 'business angel' venture capital networks can be highly successful. But their spread is very patchy. Venture capital trusts may have an important role to play, but they have only just got off the ground. The Enterprise Investment Scheme has raised disappointingly small sums so far. The Stock Exchange's Alternative Investment Market, by contrast, made an extremely encouraging start in the second half of 1995.

A second difficult area is the availability of finance for high-technology and science-based companies, in particular. Venture capitalists have particular problems recognising and understanding the commercial prospects of high-technology projects. As a result, relatively little finance has been flowing into infant technology-based firms. And corporate venturing—investment by large corporations in the equity of growing technology-based companies—has not occurred in the United Kingdom to anything like the extent it has in the United States. It is hard to see any but cultural obstacles to that development. It is a disappointing gap in the United Kingdom's corporate armoury.

Among small firms themselves, financial management remains unsatisfactory in many cases, as small firms' representatives are themselves very ready to acknowledge. It is more difficult to know how to correct that weakness. One promising route is the Small Business Initiative, launched in East Anglia two years ago. This offers the incentive of a 1% reduction in overdraft rates for three years for small firms whose managers complete a financial training course. It is too early to assess the benefits rigorously. But an academic assessment of the first year's participants argues that their financial management skills index rose by over half as a result of the course. The completion rate is almost 100% and 88% of participants thought the course would improve their long-term decision-making. These results suggest, at the very least, that such schemes may have broader application. Other pilots are already operating and it would be good to see them expand across the country.

There are concerns, too, about government support programmes. The Bank of England is not, I think, in a good position to evaluate government support. But small-firm representatives are concerned about the long-term viability of the Business Link network, whose introduction they generally have welcomed. Will it prove self-financing, once the first three years of government funding has expired? Will the Personal Business Advisors recruited prove to be up to the demanding job? And there are concerns about the impact of the end of the Enterprise Allowance Scheme/Business Start-up Scheme in March of last year. By contrast, the volumes of lending under the Small Firms Loan Guarantee Scheme have risen sharply after the changes introduced in 1994.

This analysis suggests that there remain a number of important areas in which change would be beneficial. And some of these are susceptible to the kind of analytical and collaborative approach which the Bank of England has been taking in its small firms initiative to date.

In 1996, therefore, we shall be focusing attention, in particular, on initiatives to improve financial and management skills, on encouraging increased use of equity finance by growth oriented small businesses, and seeking to improve the availability of that finance at the same time, and on monitoring the effectiveness of Business Links in meeting the requirements of small businesses for information and financial advice.

Our fourth report will cover those issues in more detail. In the meantime we shall be working with small firms organisations, and with the banks, both centrally and regionally through the Bank's network of agents.