Speech

Speech by the Governor at the KPMG profitability seminar

Speech given by

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I’m sure I don’t need to emphasise to this audience the importance of the Small and Medium Sized Enterprise sector to the UK economy. Defined as businesses employing less than 250 people, the sector accounts for over 60% of both total employment and total output. But the importance of the sector lies not just in its size. It lies too in its particular capacity for specialisation and its related ability to respond quickly and sensitively to the needs of the marketplace. Such adaptability and flexibility is crucial not just to the individual business but to the strength of the economy as a whole in today’s world of continuous, rapid, change.

Huge efforts are being made across a very broad front by the various arms of government – at national, regional and local level – in conjunction with the whole range of private sector organisations to promote the growth of the SME sector. It begins with the education system to encourage an entrepreneurial culture, the idea that starting a business is a viable career option. It extends to technical support, including training and advice as well as direct financial assistance in various forms. And it includes encouragement through the tax system as well as efforts to relieve the administrative burden of all the various forms of government regulation. It’s not easy, I must confess, for anyone who tries to keep a broad overview of the SME sector, to keep tabs on the range and precise scope of the plethora of initiatives that have been taken in this field in recent years – especially when so many of them, and the particular vehicles promoting them, are referred to simply by their acronyms! But perhaps you all find it easier to find your way through the maze than I do.

In part this complexity simply reflects the extraordinary diversity of the SME sector itself – with some 3.7 million individual businesses, ranging in size from the one-man band to some 250 employees, in every sector of economic activity from handcraft to the highest tech, and with varying business objectives from the lifestyle to the next generation global company. Their needs for support are all very different. So, too, are their needs for finance, which is where the Bank of England can sometimes make a contribution – not I hasten to say by actually providing finance ourselves, but in a catalytic way by encouraging those whose job that is to be responsive to the needs of the market.

Grossly oversimplifying for the purpose of my remarks this evening, I will divide the SME sector into three: micro-business finance, where start-up capital in particular is often not available through the conventional banking system; mainstream debt finance, through the banking system; and equity finance, particularly for medium-sized and rapidly growing companies.

Micro-business finance

There are about 3½ mn micro-businesses, that’s to say businesses with up to 9 employees, in this country – that’s about 95% of the total number of all businesses; and together they make a very major contribution on the jobs front, accounting for about 30% of total employment and nearly 25% of total output.

A particular problem at this end of the scale is access to start-up or early stage finance for disadvantaged groups in poor neighbourhoods. Potential sources of such finance include some 700 credit unions in this country – with total assets of around £100 mn serving some 400,000 members. They also include other community finance organisations which provide micro-business finance alongside personal credit, such as community loan funds, often set up with the help of the commercial banks, and social banks. And they include finally special micro-finance funds, the best known of which is the PYBT, which had total assets of £21 mn and has provided mirco-finance, in the form of low cost loans and grants, as well as business mentoring and advice, to over 42,000 mostly unemployed young people since 1986. Altogether these other community finance initiatives control about £170 mn of capital and serve around 100,000 people.

Notwithstanding these increasing efforts, questions clearly remain about the adequacy of access to capital of existing or potential small businesses in low-income communities, and the Social Exclusion Unit established by the Government in December 1997 has set up a Policy Action Team (PAT 3) to look at those questions. Its remit is to explore whether more can be done to encourage new business start-ups in those areas; how to improve access to finance – taking account of recent new initiatives; and to look at the role of business support agencies in this context. The Bank of England is in close contact with this work.

Similar issues arise in the context of the financing of ethnic businesses. The Bank has over the past year spent a good deal of time reviewing the evidence on the financing of ethnic minority businesses in the UK. Taking advantage of our regional agent network, we have spoken to a wide range of ethnic business people in different localities; we hosted an academic workshop in the Autumn of last year at which leading academics, bankers and officials exchanged views; and we hosted a dinner at the Bank last Summer for a number of leading ethnic business people. Our report on the issue will be published in early March.

The main conclusions of our work are that, firstly, notwithstanding a lack of clearly documented evidence, some ethnic minority businesses, particularly African-Caribbean, perceive access to finance to be a disproportionate problem; secondly, the response to this perception needs to come from various quarters, including not only banks and other finance providers but also Government support agencies and ethnic businesses themselves; and thirdly, there are encouraging signs of action on all these fronts. But what is also clear is that much more research needs to be done in this area.

Mainstream debt finance

Much the largest source of external finance for the SME sector as a whole is the commercial banking system, which currently provides nearly half the total.

At the time of the recession in the early 1990's it became clear that there was a serious breakdown of confidence and communication between SMEs and their main finance providers. The borrowers complained bitterly that the banks cut back their loans just when they needed them most; while the banks for their part

suffered very large losses on lending which they were unable to recover. The true culprit, of course, was the exaggerated boom and bust cycle, for which we, the authorities, ought to bear at least most of the responsibility. But whatever the history, there was a clear need to try to reassert a better relationship between the two sides.

The Bank's part in that process has been essentially to organise a dialogue. Since 1992 we have regularly consulted with the SME community, through their representative organisations and through the contacts of our regional agents around the country. And we have consulted too with the individual banks. And then we have brought the two sides together, with some of the key academic observers of SME finance, for an annual symposium. This process has enabled us to monitor progress in the relationship between borrowers and lenders – and what we have seen has been very encouraging. Notwithstanding the current economic slowdown, it was evident at our latest symposium in January that there has in fact been real progress. The banks have devoted considerable efforts to understanding the diverse nature of the business of their SME customers and of their financing needs, helping to reduce their risks in the process. This is reflected, for example, in a fall in the proportion of finance accounted for by traditional bank borrowing (from 61% in 1987-90 to 47% in 1995-7); and a shift away from short-term lending towards more term finance, which now accounts for nearly 70% of the total. There is now less emphasis on collateral and more on the progress of the business. And leasing and receivables finance has also risen (from 22% in 1987-90 to 33% in 1995-97).

As the banks' understanding of the needs of their customers has improved, so too, the small business community has developed a better understanding of the banks' need for up-to-date financial information and for early warning if things start to go wrong. The British Chamber of Commerce, for example, reported on their research which now finds that 87% of their respondents now regard their bank as supportive. The Forum of Private Business reported that its aggregate bank performance index has improved by about 10% points since 1992 – and they found that SMEs which had developed a more participative relationship with their banks, with a better two-way information flow, were benefiting from lower charges and collateral requirements.

As a result of this progress, there is little doubt that both the banks and the SMEs are less vulnerable to a slowdown than they were in the last business cycle. And of course we expect the slowdown to be comparatively mild and short-lived.

That doesn't mean that everything in this particular garden is perfect. We live, as I said, in a world of continuous change. So we welcome recent government initiatives, including the Cruickshank Review, designed to identify further possible improvements in this crucial area of SME finance, which we will continue to monitor.

Equity Finance

Let me finally turn now very briefly to SME equity finance, where there has been talk of an "equity gap" ever since the MacMillan Report in 1930.

In fact there still appears to be a marked reluctance on the part of many, particularly family-owned small businesses in this country to use external equity finance, because they prefer to remain independent or are not looking to expand.

But it is nevertheless important for the economy as a whole that the market should provide equity for those companies that do need it, especially since they will tend to be among the younger, growth-orientated, businesses.

There does in fact appear to have been a significant increase over the past few years in the provision of relatively small amounts of equity through "business angel" networks, and through the banks, though the aggregate sums involved remain of course quite modest. And there has been a more substantial increase in formal venture capital provision, though much of this has gone to finance MBOs and MBIs. Early stage investment by venture capital firms accounts for about one fifth of the total number of their investments but only some 5% of the total value. This suggests that venture capitalists may be deterred from small start-up or early-stage investments by the relatively high cost of researching and managing them. And in this area, too, potential borrowers could help themselves by better understanding investors' needs for more comprehensive and timely information.

Equity finance is a particular issue for high-tech firms, of course, because they tend – understandably – to be more dependent on equity capital than more traditional businesses with readier access to bank finance. The issue was explored in our own Report on Financing Technology Based Small Firms and by a Treasury Working Group chaired by Sir Peter Williams, and the Bank will be convening a new forum in April bringing together institutional investors, venture capitalists, and representatives of high-tech companies to investigate some of the particular obstacles to equity investment in this sector.

There may also be a more general problem in the context of public equity, particularly in relation to Smaller Quoted Companies. Although over the longer term such companies have outperformed the market in terms of returns on equity, there has more recently been a marked under performance in share prices. The FTSE Small Cap Index for example has fallen by nearly 30% relative to the All-Share Index since early 1996. This may in part be cyclical. There is some evidence to suggest that small firms tend to under-perform in economic slowdowns. And it is particularly relevant in the present international economic environment that the Small Cap Index is more heavily weighted to sectors more exposed to overseas markets – "general industrial" shares, for example, make up 22% of the Small Cap Index compared with only 5% of the FTSE 100. But the recent under-performance of Smaller Quoted Companies may also reflect the growing

concentration of the fund management industry, and the growth of index-tracking, which would concentrate investment on the larger, more liquid, stocks. Some recent very useful research by KPMG would, I think, support this latter view. In any event, if it persists the recent under-performance is likely to deter smaller company floatations and encourage reversion to the private equity market.

The issue has been considered by a Smaller Quoted Company Working Group chaired by Derek Riches of Merrill Lynch, but I suspect we need a good deal more research before we can conclude whether this development reflects the evolution of the structure of savings in this country or whether the illiquidity problem might be addressed by development of the equity market mechanism for small stocks.

A separate report, by a working group chaired by Paul Myners of NatWest, emphasises the importance of better dialogue between Smaller Quoted Companies and fund managers and in particular the need for better information from the companies themselves.

Mr Chairman, there is no doubt that the importance of the SME sector to the supply side of the economy is much more widely appreciated now than it used to be; it has moved up the policy agenda and there are a whole host of initiatives in train to provide more encouragement to the sector, including initiatives to improve the provision of SME finance. But Rome wasn't built in a day. The problems facing the sector – including the problems of access to finance - are as varied and diverse as the sector itself. I have touched upon some of the current priorities in relation to SME finance, which we at the Bank of England, working with Government and with private sector financial institutions will be seeking to address over the period ahead. But it is an ongoing, incremental, process through which we need to look for continuous improvement across the board. To the extent that we can strengthen the supply side in this way, it will make for a more robust economy and make our monetary policy job on the demand side that much easier.