BANK OF ENGLAND

Speech

The Entrepreneurial Economy: A Collaborative Approach

Speech given by

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The Entrepreneurial Economy: a collaborative approach

Ladies and Gentlemen.

I am delighted to have the opportunity to address you at the end of - what I am sure has been - a thought-provoking day.

For the Bank, this conference has a two-fold importance.

First, it has, we hope, helped to promote discussion and, more important, action to strengthen entrepreneurial activity in the UK economy.

But secondly, we are delighted to have this opportunity to work closely with the ICAEW, especially given the important role of your President as Chairman of our Non-Executive Directors.

The Bank's interest

A good place to start my remarks might be to ask why the Bank of England, as a central bank, is interested in this subject. In fact the Bank has for many years taken a broad interest in the efficient functioning of UK industry, and especially in the provision of finance to industry. This falls within the third of the Bank's three core purposes.

The first of our core purposes is to promote monetary stability in the United Kingdom. A huge number of column inches in the press and elsewhere are now devoted to watching our conduct of monetary policy, as the MPC seeks to meet the Government's Inflation Target of 2 ½%. And, of course, our interest in low and stable inflation is not just to create Monetary Stability but more widely to create a stable macro-economic environment in which firms of all sizes have the confidence to plan ahead with some certainty.

Thus there is a strong overlap between our monetary role and our second core purpose, which is to ensure that the financial system remains stable and sound. Our MOU with the Treasury and the FSA provides us with a responsibility for the financial system as a whole, requiring us to look for possible shocks, emanating internally or from overseas, that might disrupt the stability of financial markets.

The third of our core purposes is to ensure that the UK financial system works as efficiently and effectively as possible in meeting the needs of the wider economy. One dimension of this is to try to ensure that small and medium-sized businesses in the UK can obtain funding on a competitive basis. In creating an entrepreneurial economy, small companies continue to be one of the vital engines of innovation and growth.

The background environment

Today you will have heard a great deal about what underpins an entrepreneurial economy. It involves both the public and private sectors, and most importantly successful partnership between the two. A prime example of this is the nurturing of an enterprise culture through an alliance of the higher education system with initiatives, like business incubation, which often involve the private sector. You have heard today of the important contribution that can be made by both formal and informal venture capital, as well as the role of financial institutions such as the London Stock Exchange.

The accountancy profession itself also has a key role to play. As the Governor said in his speech to the Institute's Annual Dinner on 28 March – I hasten to add in the serious part - we could not do without accountants. The accountancy profession provides financial information and frequently more general company advice to small firms. Alongside this there are various channels of government support. As outlined by David Irwin, the Small Business Service – in partnership with others - will provide this service in England and Wales.

The role of small firms in creating the entrepreneurial economy

It is now widely acknowledged small firms are a source of dynamism, wealth creation and employment. As such, they have not only made a significant and direct contribution to UK growth in the last 10 years but also to the development of a more flexible labour market, and the introduction of new technology and ideas.

Market failures in the provision of finance to small firms could potentially, therefore, have far reaching consequences for economic performance. All firms need to work hard to overcome the information asymmetry which is inherent in any bank lending relationship, but which is especially challenging perhaps for the small company sector. While market failures in provision of small company finance will never wholly be removed, there is very little evidence to show that at least in the United Kingdom they are important in practice today. Nonetheless, it can only be helpful to improve the flow of information between business owners and finance providers, thereby ensuring a better appreciation by both of the relevant risks and rewards attached to particular business plans.

The Bank has long been interested in the financing needs of small and medium sized enterprises. Going back some way, an example of the Bank's early involvement was our instrumental role following the Second World War in the formation of the Industrial and Commercial Finance Corporation – which evolved into 3i. We would not have described that then as seeking to promote the entrepreneurial economy, but that is precisely what it was. Our role has, of course, evolved since then, in particular highlighting the importance of information sharing and increased understanding between the relevant parties.

The Governor has, since 1993, hosted an annual meeting bringing together some of the key players in the SME market. Finance providers, policy makers, business representatives and advisers join together to discuss the key issues relating to the financing of small firms. The main themes to arise from these meetings are published, under the editorship of Adrian Piper and his team, in our annual reports on 'Finance for Small Firms'. The seventh such report was published in January this year. One of the most encouraging trends we have been able to report during these seven years has been the improved relationship between banks and their small business customers. Research by the Forum Of Private Business shows that the performance of the banks had improved significantly since 1992. The improvement is the result of a number of factors, for instance the implementation by the banks of codes of practice and the increased emphasis on training relationship managers to understand the specific challenges faced by small businesses. There is, of course, always room for improvement, but the increased degree of information sharing and trust has been notable. The reports have mapped other positive developments - for instance, a changed balance between term lending and overdrafts.

The Three A's

In monitoring finance for small firms, we have sought with others to ensure that the types of finance on offer and the finance providers themselves are efficient and effective. We like to think of this in terms of the three "As": availability, appropriateness and accessibility.

In many cases, the **availability** of finance is a bigger issue for small firms than its actual cost. Availability is likely to be affected by a number of issues, above all the prevailing macro-economic environment. Banks adjust their risk assessments of small firms as trading conditions alter: this can mean that in an economic downturn credit is rationed. There was evidence of this in the last recession. However, more discerning lending policies have been pursued in the last few years, and this should reduce the chance of a sudden reduction in credit during any future economic slowdown.

Another feature of our work over the last seven years has been to emphasise the importance for small businesses of using the most **appropriate** forms of finance – the second "A". Many improvements have been observed. There have been important changes in the provision of bank finance and the use of non-bank finance has increased. It is now more widely accepted that 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. This is particularly true for high growth firms.

The characteristics of bank finance in the United Kingdom have changed considerably during the 1990s, most notably the decline in the net bank indebtedness of the small firms sector and the continued growth of term lending at the expense of overdrafts. The ratio of overdrafts to term lending has fallen significantly and now stands at 28:72, compared with early 1992 where it stood at 49:51. Notwithstanding the recent rise in bank borrowing by SMEs, the net bank indebtedness of the SME sector has continued to fall. The ratio of deposits to lending was 96% in December 1999, compared with 56% in December 1992.

Small businesses have also, since the mid-1990s, gradually increased their use of fixed rate loans. In December 1999 fixed rate loans accounted for 34% of term lending compared with just 28% in December 1996. Fixed rate loans provide SMEs with greater certainty of expenditure streams, assisting business planning and enabling businesses to operate in a more certain financial environment. UK small businesses have also increased their use of non-bank forms of finance, such as factoring, leasing and, more recently, equity finance. A recent survey showed that a higher proportion of SMEs used asset based finance in the UK than in any other EU country except Ireland. This trend, to move away from the reliance on short-term overdraft financing that prevailed in the early 1990s, towards a wider variety of types and sources of finance, is to be especially welcomed.

It is widely acknowledged, however, that rapidly growing businesses require equity as well as debt finance. The formal venture capital industry often finds it difficult to help at the very small end. That makes it all the more important to develop the informal venture capital market, including the considerable potential contribution of business angels. In addition to their ability to inject smaller amounts than are viable for formal venture capital firms, business angels are also able to provide considerable technical expertise and general management advice. Estimates from Mason and Harrison suggest that business angels already invest £500million per year: true, it's a long way below the US but it's a significant contribution and one that should be encouraged.

I have mentioned that finance for small firms should be available and appropriate, but it also needs to be **accessible**. UK banks and other finance providers have recognised this and have attempted to make themselves more user-friendly to their small business customers. Banks have devoted substantial resources to increasing the awareness and skills of lending managers at the branch level. As a result, many small firms now believe, and perception is important, that banks understand their business better.

In recent years, the NatWest/SBRT Quarterly Survey of Small Business in Britain has consistently found that access to finance is not a significant problem for UK small businesses, with just 2% of respondents currently rating it as a key problem facing their business.The Cruickshank Review found no evidence that small firms currently have difficulty obtaining bank finance. The Review, however, did highlight some barriers to the raising of equity, including – again - problems of asymmetric information, the risk level associated with financing new firms with no established track record and the costs for the investor in structuring finance. It also raised issues about conditions in the banking market for SMEs; these have been referred to the Competition Commission.

Technology-based small firms

Perhaps I could conclude with some words about technology-based small firms.

Technology-based firms are vital to the UK economy in maintaining competitive advantage in global markets. Technology-based firms are often themselves entrepreneurial. But just as they have a unique role in the economy; they also have unique financing needs.

The Bank has taken a particular interest in the financing of technology-based firms. In October 1996 we published a report, 'The Financing of Technology-Based Small Firms'. The report acknowledged that these firms often face a number of challenges distinct from those facing the general small business population, particularly at start-up. The complexity of the technology, the intangibility of assets and the unpredictability of cashflows, mean that they are perceived as being especially risky. The banking sector in the United Kingdom is developing ways of better servicing the high technology sector, but debt finance is not usually the answer, at start-up and early stages. Risk capital is often a more suitable option.

The report identified the need for more assistance for early stage technology-based firms, particularly in developing financial and other management skills. As we have heard today, the newly launched Small Business Service will hopefully contribute to delivering this. Other important recommendations included, first, encouraging the venture capital industry to review the opportunities as well as the risks of investment in early stage-technology based firms, secondly, developing closer relationships between science and technology departments of Universities and business schools; and, thirdly, technology-based small firms taking responsibility for improving their human capital skills, including presentational skills, to instil confidence in potential investors.

The Bank hopes to produce, before the end of the year, a follow up to the 1996 report. We expect to be able to demonstrate encouraging progress in a number of areas (particularly the provision of seed, start-up and early stage new capital).

Closing remarks

Much of the focus of today's conference has been on high-growth, entrepreneurial firms – the gazelles. It is important also to remember the great majority of small firms that are not intent on breaking speed limits and are quite content driving in the middle lane, do not have .com in their names, but are steadily contributing to output and employment.

These firms are important. Nonetheless, it is the high growth firms that will continue to remain at the leading edge of the creation of an entrepreneurial economy. Continued public and private sector support for these firms is vital. The Bank of England will seek to continue to play its part, both in maintaining macroeconomic stability and in encouraging the better financing of growing businesses.