

17 February 2004

Dear Colleague,

The Graham Review of the Small Firms Loan Guarantee

The Government has asked me to lead an independent review of the Small Firms Loan Guarantee, to ensure that it is working effectively and that, through SFLG and other interventions, the Government is doing all that it can to help start-ups and small firms overcome the obstacles that they face when raising debt finance.

The context for the Review was set out in the Pre-Budget Report 2003. The Government believes that SFLG continues to play a valuable role in supporting small firms in the UK. However, it is nevertheless aware that the market in which businesses raise debt finance is more sophisticated now than when SFLG was first introduced in 1981, and wishes to build upon the recent success of the scheme by examining its effectiveness in this changing market environment and ensuring that it is useful and practical for both lenders and borrowers.

I have therefore been asked to examine the structure and rules of SFLG and, more broadly, whether SFLG is effective in tackling the barriers faced by start-ups and small businesses in the current market. I am personally keen to use this opportunity to encourage fresh thinking about the role of a guarantee scheme in the SME debt finance market.

This letter is being sent to banks and other finance providers, small businesses and their representative organisations, accountants, business support providers and local and regional bodies. Over the next few months I and my team will speak to as many people and organisations as possible, but in order to ensure that all views are heard and taken into account, written submissions would be most welcome.

In the attached note I have set out some of the issues on which my team and I would welcome your views. This is not intended to be a comprehensive list of the issues that the review will be considering, and your responses need not be restricted to the specific questions listed. If there are other points that you want to raise, then please feel free to do so.

The deadline for submissions is 13 April. This will leave time for follow-up discussions before we submit our final report to Government in the summer. Details of how to contact the team are in the attached note.

Your input would be extremely valuable and I would be very grateful for your help on this review.

Yours sincerely,

Teresa Graham OBE

The Graham Review of SFLG - Call for Submissions

1. Understanding the market

The following is an extract from the Government's Pre-Budget Report 2003:

The market in which businesses raise debt finance has become more sophisticated since SFLG was first introduced in 1981. Equity finance is making a more significant contribution to SME financing today, and new forms of financing are coming to the market. In particular, the structure within which financial intermediaries operate has changed and the way in which small firms and start-ups are assessed for loans is more sophisticated. For instance, the Bank of England, in its latest report on finance for small firms, said that the "development of scoring systems may be reducing banks' reliance on collateral. However, some concerns have been voiced that scoring systems can work against some firms, because 'non-standard' information that may support their case cannot be taken into account in automated systems."

This changing market environment will inevitably affect the way in which public sector interventions such as SFLG are applied and the impact that they have on the market. The use by banks of centralised scoring systems should make smaller loan amounts more easily accessible for firms with good behavioural records, reducing the traditional reliance upon collateral. However, as the Bank of England notes, some concerns have been raised that reliance on scoring systems alone could work against some firms who have non-standard loan applications. They may also work against serial entrepreneurs who have been associated in the past with failed enterprises. In such an environment the importance of SFLG is potentially enhanced for start-ups who lack a track record and where larger loan amounts are concerned.

The above analysis raises a set of questions about how a guarantee scheme can be most effectively employed in the current finance market for SMEs. We would therefore welcome views on how developments in the debt market for

SMEs have affected the rationale for, and potential impact of, a loan guarantee scheme. In particular:

- (i) What do you consider to be the most significant developments in recent years in SME finance?
- (ii) Do you agree that the availability of debt finance for SMEs has improved over the past decade?
- (iii) Are there any types of businesses for whom this is not the case, for example (as suggested in Bridging the Finance Gap) start-ups, firms with non-standard applications or entrepreneurs associated with failed enterprises?
- (iv) What is your view of the suggestion that the development of scoring systems may be reducing banks' reliance on collateral?
- (v) How has the growth in other forms of finance, such as asset-backed finance, invoice finance and equity, affected SMEs' use of, or access to, debt finance?

2. Understanding how SFLG is used today

During 2002-3 a total of 3,916 loans were made under the scheme, with a value of £270m. This is forecast to rise to around £400m in the current financial year. The average loan size has risen to around £69,000, driven by a fall in the number of smaller loans, and a rise in the number of loans with a value of between £30,000 and £100,000.

In order to assess the effectiveness of SFLG, and its attractiveness to lenders and borrowers, the Review team seeks views on how SFLG is currently used in the market and, in particular, views on the innovative uses of the scheme that have developed in response to changing market conditions. We would therefore value responses on the following issues:

- (i) Does the structure of SFLG mean it is a valued option for decision-makers in the lending institutions? Does SFLG address the right problems in the market, i.e. those that matter to lenders and borrowers,

and thus form an important part of the commercial decision-making process? Are there changes that might be made to increase the incentive for lenders to use SFLG in appropriate circumstances?

- (ii) How do lenders use the guarantee as part of their regular business? How effectively does it operate alongside mainstream lending practices?
- (iii) The Government is committed to making it easier for lenders to become approved SFLG lenders. What are your views on the choice of SFLG lenders and on the advantages or otherwise of broadening the lender base, to include, for example, Community Development Finance Institutions?
- (iv) What types of businesses use SFLG, in terms of sector, size, stage of growth and other characteristics?
- (v) For what commercial purpose do they borrow under SFLG?
- (vi) What is your view of the fact that the number of smaller loans guaranteed (under £30,000) has been declining as a proportion of all SFLG loans, and that this decline has been steeper since 2001/2? Should the shift be a cause for concern?
- (vii) Is it common for SFLG loans to be used as part of a package of finance? What type of businesses might use SFLG in this way, and what role does SFLG play in these deals?
- (viii) In your view, are SFLG loans likely to have a different risk profile to non-guaranteed loans?
- (ix) Are there regional factors that affect take-up of SFLG loans? Does the type of business, or purpose of the loan, show regional variation?
- (x) What impact does the level of the guarantee (currently 75%) and the premium paid by the borrower to Government (2%) have on the level of use of SFLG?
- (xi) Are there any changes to the current structure of SFLG that could be made to improve the impact of SFLG in assisting businesses that otherwise could not access finance?

3. Delivery and administration of SFLG

Responses to the consultation *Bridging the Finance Gap* (April 2003) provide an important basis on which the Review will build in addressing some of the issues associated with the smooth delivery of SFLG. The Government has already committed to work with its partner lenders to simplify the administrative requirements of SFLG wherever possible. The following questions are based on specific suggestions made by respondents to the consultation. However, we would value views on all aspects of the rules and structure of SFLG¹:

- (i) Respondents called for greater consistency in the way available assets are considered for use as security. What type and level of security is it appropriate to take into consideration before recourse is made to SFLG?
- (ii) A large majority of respondents saw merit in further amending the ten-year cut-off for considering any previous SFLG borrowing which counts towards the maximum allowable loan amount². What are your views on the potential options, which included reducing the time limit further or relying solely on a limit on the maximum amount any one person or business can have outstanding? Additionally, is there scope for considering changes to the rules with regard to connected persons?
- (iii) A number of respondents proposed raising the current £30,000 limit above which lending institutions must get approval from the SFLG unit of the Small Business Service. Would borrowers and lenders welcome such a move, and, if so, what should the limit be?
- (iv) Are the maximum loan amounts of £100,000 for new and £250,000 for established businesses still consistent with the aim of targeting those businesses with most need for a guarantee?
- (v) What are your views on the turnover criteria, which currently stand at a maximum £5m for manufacturers and £3m for all other eligible sectors?

¹ A full explanation of the rules and structure is available at www.dti.gov.uk/sflg/

² The current ten-year cut-off was introduced in April 2003 to allow a degree of “re-qualification” and replaced the previous cut-off under which only loans prior to May 1984 were disregarded.

(vi) What are your views on the current exclusions from SFLG?

4. Other issues

In addition to the themes raised above, the Graham Review is tasked with examining all aspects of SFLG. Do you have any further suggestions for improving the rules, structure or administration of the Guarantee?

How to submit your views

The Review welcomes responses to the issues and questions raised in this paper by 13 April 2004. We would prefer electronic submissions where possible.

All responses received may be made public unless specifically requested otherwise. In the case of electronic responses, general confidentiality disclaimers that often appear at the end of e-mails will be disregarded for the purposes of publishing responses unless an explicit request is made in the body of the response.

Responses should be sent to:

E-mail: graham.review@hm-treasury.x.gsi.gov.uk

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www.hm-treasury.gov.uk/graham