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Dear Colleague,

Graham Review of the Small Firms Loan Guarantee (SFLG)

When I launched my call for submissions to the review in February, I said that, in addition to posting the submissions to the review on our website, I would publish a short document setting out my initial findings. I am writing to let you know that the responses and my interim report have been published on the review website today (www.hm-treasury.gov.uk/graham). I have attached a copy of the report itself with this letter.

Call for submissions

I am extremely grateful to everyone who has taken the time to respond to the call for submissions. My team received nearly one hundred responses from organisations and individuals: a full list can be found on the review website. The information, experiences and proposals they contained have been invaluable in moving the work of the review forward. In publishing the responses I have, of course, respected respondents' requests for confidentiality. In addition, I have taken the decision to treat the majority of the responses from the owners of small businesses as confidential, since many of those responses contained commercially sensitive information.

Interim report

I hope you will take the time to read the interim report. It begins by putting the review in the context of Government policy for encouraging enterprise and growth. This is followed by an analysis of the current state of the debt market for SMEs and then publishes overview data on the current use of SFLG.

I would like to share with you my observations on what I have found so far:

When SFLG was created in 1981, its purpose was to assist SMEs which have a viable business plan, but which lack the collateral necessary to secure the loan that they seek. In other words, it is only used where a bank would, anyway, provide a loan were it not for a lack of collateral. The rationale for government intervention is that collateral is taken in order to compensate for the

lack of information the lender has about the business rather than the true quality of the proposition (economists would call it an information asymmetry): the argument runs that SMEs should not therefore miss out simply because they lack collateral. One of the reasons for holding this review was the widely held view that new developments in credit and behavioural scoring had allowed lenders to lend unsecured to SMEs. I would highlight that one of our main findings is that this view significantly overplays the role of credit scoring: our conclusion at this stage is that unsecured lending is only commonplace for loans with a value below £25,000.

However, both the debt market and the use of SFLG have moved on in that period. In particular, the evidence we have seen suggests that SFLG is regularly used to serve additional purposes, such as facilitating lending to SMEs without a track record, or supporting high risk lending. Over half of SFLG loans are going to start-ups and young businesses and, by volume, 35% of the loans default: not the profile that might be expected if SFLG is being used only to make up for collateral missing from standard lending deals, which experience far lower default rates than under SFLG.

In light of this evidence, I believe it is critical that we define what the objectives of SFLG should be in the context of today's debt market. The first step is to identify the barriers that exist and how these various barriers interact with each other in a fluid and dynamic market - for instance, do the changes in SFLG usage suggest that there are wider barriers facing SMEs that government should consider addressing? Is SFLG, in some instances, being used as an equity substitute and, if so, what would this suggest about the equity market as opposed to the debt market? It is also important to ask whether SFLG is being used additionally - it cannot be government's role to crowd out mainstream commercial lending.

However, SFLG is not simply about filling gaps in the market: we also need to consider where government should focus its intervention in order to maximise the impact on UK productivity - by supporting entrepreneurship, innovation and growth.

In considering these issues, it will be important that any recommendations I make gain the support of the lenders. In particular, I want to encourage lenders to take a fresh look at the application of SFLG, so that we ensure that SFLG is positioned in a way, which will allow it to operate effectively in the market over the next few years.

Final report

I was asked to make my recommendations public in the summer. At this stage, it is my intention to publish the review's final report in July.



Teresa Graham OBE