Small firms loan guarantee scheme

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This note examines the small firms loan guarantee scheme (SFLGS) which provides loan guarantees for firms with viable business funds but limited track records and collateral which would not otherwise be funded by banks. As from 1 April 2008 the scheme has been operated by Capital for Enterprise Limited (CfEL), a newly created Non-Departmental Public Body (NDPB) operating under contract to the Department for Business, Enterprise and Regulatory Reform (BERR) and in conjunction with various banks and other financial organisations. Details for potential applicants are available from these lenders or from Business Link.[1] A number of changes to the scheme were introduced in April 2003 following a review of business support by the Department for Trade and Industry (now BERR).[2] A further review by Teresa Graham was launched in February 2004. Changes to the SFLG took effect from 1 December 2005 to reflect the recommendations of the Graham Review.[3] The Graham Review was published on 4 October 2004 and reported that since the scheme's launch in 1981, over 88,000 loans had been guaranteed, worth approximately £3.5 billion in total. Changes to the eligibility criteria made in April 2003 led to an increase in use of more than 40 per cent.[4] In the financial year 2007/08 2,619 loans (FY 2006/07: 3,019) with a total value of around £207 million (06/07: £236m) were guaranteed. The average loan value was £78,950 (06/07: £78,300).[5]

Contents

1 How the Small Firm Loans Guarantee Scheme (SFLGS) works 2

1.1 Terms 2

1.2 Lenders 3

1 Business Link, *The Small Firms Loan Guarantee* [on 20 October 2008]

2 HM Treasury, *Pre-Budget Report: Steering a steady course: Delivering stability, enterprise and fairness in an uncertain world*, Cm 5664, November 2002 para 3.46

3 HM Treasury, *The Graham Review of the Small Firms Loan Guarantee* [on 20 October 2008]

4 HM Treasury, *Teresa Graham OBE Recommends Targeted and Modernised Support for Small Firms and Greatly Reduced Bureaucracy in her Independent Review*, 4 October 2004

5 Small Firms Loan Guarantee *Annual Report for Financial Year 2007/08*, July 2008, p2

1.3 Eligibility 5

1.4 Review 5

1.5 Changes 6

2 Access to credit for small firms 7

2.1 Finance 7

2.2 Credit crunch 7

3 History 9

1 How the Small Firm Loans Guarantee Scheme (SFLGS) works

The SFLGS guarantees loans from the banks and other financial institutions for small firms that have viable business proposals but who have tried and failed to get a conventional loan because of a lack of security. This is explained further in the SLFG annual report for financial year 2007/08:

> There are 4.5 million SMEs in the UK, of which around 1.7 million are VAT-registered. 23% of SMEs sought external finance during 2006. 75% were successful on their first attempt but 13% failed to attract any external finance. In almost 70% of the latter cases, insufficient security was cited as the principal factor. While these figures suggest a market gap of 135,000 businesses, it must be borne in mind that almost 80 per cent of SMEs have a turnover of less than £100,000 and the total finance sought in some cases was below the SFLG minimum threshold of £5,000 or required over a period outside the SFLG loan term range of two to ten years. A proportion of these businesses will also have been seeking other forms of finance, such as equity finance, which is not supported by SFLG but is enabled by other measures. Nevertheless, it is essential that SFLG remains appropriately structured to be an effective intervention in this market.
>
> SFLG seeks to address a market failure in the provision of debt finance by providing a Government guarantee to the lender in cases where a business with a viable business plan and apparently able to service borrowing is nevertheless unable to raise finance because they can not offer security for their debt. SFLG covers up to 75% of qualifying loans of up to £250,000. In return for the guarantee, the borrower pays BERR an annual premium of 2 per cent of the outstanding balance of the loan, assessed and paid quarterly.[6]

1.1 Terms

The main features and criteria of the scheme are:

- A guarantee to the lender covering 75 per cent of the loan amount, for which the borrower pays a two per cent premium on the outstanding balance of the loan.
- The ability to guarantee loans of up to £250,000 and with terms of between two and ten years.
- Availability to qualifying UK businesses with an annual turnover of up to £5.6 million.

[6] Small Firms Loan Guarantee *Annual Report for Financial Year 2007/08*, July 2008, p1

- Available to businesses in most sectors and for most business purposes, although there are some restrictions.[7]

Paragraphs B5 and B6 of the Graham Review (page 83) recommended a Five Year Business Age Eligibility rule. In particular, the Review stated that:[8]

> The maximum age limit should relate to the principal trading activity rather than the corporate form. Therefore, in the case of any business being transferred to a new corporate body, the principal trading activity should itself fall within the age limit in order for the application to be approved.

In summary, the 'Five Year rule' was a requirement that a business must have been trading for no more than five years to be eligible for an SFLG guaranteed loan. However, this cap was removed in April 2008, as announced in the accompanying *Enterprise Strategy*[9] to the *Budget 2008*:[10]

> In line with its renewed commitment to assist firms with growth ambitions, the Government will extend the eligibility of SFLG to businesses with growth ambitions that are more than five years old, including, but not limited to, those that have changed ownership. This will enhance the provision of debt finance for growing SMEs that lack loan collateral. In support of this change, the major SFLG lenders have committed to a renewed focus on promoting the appropriate use of SFLG to enable businesses who might otherwise not be able to access debt finance to fund their start-up and growth ambitions.[11]

1.2 Lenders

Applications should be made direct to one of the lenders who are involved with the scheme. The government has announced that it is keen to encourage access to SFLG from a wide lender base. Any existing lenders who wish to operate SFLG can apply to become an approved lender. Further details about becoming an approved lender can be obtained by contacting BERR. The current lenders are:

Lenders with National Coverage

- Alliance and Leicester Commercial Bank
- Bank of Baroda
- Bank of Scotland
- Barclays Bank
- Clydesdale Bank
- HSBC Bank
- Lloyds TSB Bank

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7 Department for Business, Enterprise and Regulatory Reform website, Small Firms Loan Guarantee [on 20 October 2008]

8 HM Treasury, The Graham Review of the Small Firms Loan Guarantee, 4 October 2004

9 HM Treasury and Department for Business, Enterprise and Regulatory Reform, Enterprise: unlocking the UK's talent, March 2008

10 HM Treasury, Budget 2008, March 2008, para 3.7

11 HM Treasury and Department for Business, Enterprise and Regulatory Reform, Enterprise: unlocking the UK's talent, March 2008, para 4.28

- National Westminster Bank
- The Co-operative Bank
- The Royal Bank of Scotland
- Triodos Bank
- Yorkshire Bank

Geographically Specific Lenders

English Regions

- Doncaster Business Advice Centre (Donbac) (South Yorkshire)
- The Enterprise Fund (Greater Manchester and Cheshire)
- Enterprise Loan Fund (North and West Yorkshire)
- Foundation East (Eastern)
- NEL Fund Managers (North East)
- One London (London)
- South West Investment Group (South West)
- UK Steel Enterprise (North of England, Yorkshire, Humberside and the Midlands
- YFM Group (Yorkshire)

Scotland

- Airdrie Savings Bank (North Lanarkshire)
- DSL Business Finance (West Central Scotland)
- UK Steel Enterprise

Wales

- UK Steel Enterprise

Northern Ireland

- Bank of Ireland
- First Trust Bank
- Northern Bank
- Ulster Bank

Factoring and Asset Finance Providers *(SFLG lending is only offered in combination with Factoring or Asset Finance products)*

- Bibby Financial Services
- Cattles Invoice Finance

- GAMLTD (General Asset Management)
- State Securities
- Venture Finance[12]

Information about the SFLGS is available from all scheme lenders as well as BERR.

1.3 Eligibility

The scheme sets certain restrictions on the activities an applicant may be involved in, and on the purposes for which a loan made be put. These generally arise from either the *Industrial Development Act* of 1982, which provides the statutory basis for SFLG, or from European Union State Aid rules. Activities where restrictions apply include: agriculture & horticulture; authors, music composers & certain other own-account artists; banking, finance & associated services; betting & gambling; commission agents; education; fisheries; forestry; insurance & associated services; medical & health services & veterinary services; owning & dealing in real estate; postal services; professional sports players & sporting organisations; public administration, national defence & compulsory social security; ticket & travel agents; tied public houses; and, transport.[13]

Loans are available for most business purposes. For example, finance may be used for developing a project, starting up trading, expanding an existing business or improving efficiency. An ineligible purpose would include buying a company's shares, buying out members of a partnership, replacing existing loan and overdraft facilities or financing interest payments or exporting.

1.4 Review

In March 2002 the Cabinet Office published a report prepared by the Performance and Innovation Unit (PIU) on the Government's use of loans, including the operation of the SFLGS.[14] The annual number of loans made under the scheme since its introduction in 1981 has varied significantly, dipping to below 1,000 in the mid 1980s and rising to over 7,000 in the mid 1990s. As the PIU report observes:

> a number of factors are at play here. Changes in Scheme parameters have a strong impact on take-up: eg, increase in the premium in 1984 led to a sharp fall in demand. External factors also help determine SFLGS demand: eg, overall state of the economy, real interest rates and house prices.[15]

A number of changes to the scheme were introduced in April 2003 following a review of business support by the DTI.[16]

There had been concern that most of those benefiting from the scheme were at the higher end of the turnover threshold and not enough start-up operations were being reached, where the greatest need for finance arises. Banks are becoming more sophisticated in their lending

[12] Department for Business, Enterprise and Regulatory Reform website, SFLG Approved Lenders [on 20 October 2008]

[13] Department for Business, Enterprise and Regulatory Reform website, Small Firms Loan Guarantee - Sectoral restrictions [on 20 October 2008]

[14] Cabinet Office, *Lending support: modernising the Government's use of loans*, March 2002 see p.131

[15] HM Treasury, *Pre-Budget Report: Steering a steady course: Delivering stability, enterprise and fairness in an uncertain world*, Cm 5664, November 2002 para 3.46. A regional breakdown of the number of loans guaranteed under the scheme from 1981 to 2000 was given in a PQ (HC Deb 5 June 2000 cc 113-4W).

[16] *Pre-Budget Report* Cm 5664 November 2002 para 3.46

procedures such as the checking and credit scoring systems used to test a company's creditworthiness. This has raised issues such as the effect on companies whose value is not measured effectively by the factors used in a bank's credit assessments.[17]

In February 2004 the government launched a review conducted by Teresa Graham into the scheme which invited comments and views to be submitted by 13 April 2004. The final report of the Graham Review was published in October 2004.[18] The background to the review is given on the HM Treasury website:

> The 2003 Pre-Budget Report announced that the Chancellor and Secretary of State for Trade and Industry had asked Teresa Graham OBE of Baker Tilly to lead an independent review of the Small Firms Loan Guarantee (SFLG). The SFLG guarantees loans from banks and other financial institutions for small firms that have viable business proposals but who have tried and failed to get a conventional loan because of lack of security.
>
> The review was asked to work closely with the main SFLG lenders and to examine, and if appropriate make recommendations regarding: the structure and rules of SFLG and their appropriateness to the scheme's effective operation; and whether SFLG, as the Government's principal intervention in the supply of debt finance to SMEs, is effective in tackling the barriers faced by start-ups and small businesses in the current market.[19]

1.5 Changes

As explained above, the *2003 Pre-Budget Report* announced an independent review of the SFLG led by Teresa Graham after criticism that the SFLG was often: a tale of frustration and delay; its objectives were not well understood and its impact on UK productivity even less so; its availability patchy; and its administrative structure showing its age.[20] In response to this criticism the report recommended that the SFLG should focus on those most in need of support and those who would benefit most: namely start up and young businesses. It also recommended deregulation of the scheme's administration, removing complex eligibility requirements and rules and simplifying those that remain; and that lender's should be free to make SFLG loans without prior approval.[21] In response to the review, the Government on 4 October 2004 accepted these key recommendations.[22] However, criticism of the SFLG still remains. In February 2007 the House of Commons Public Accounts Committee reported that more than one-third, 35 per cent, of loans under the SFLG scheme end in default, compared with only 4 per cent of commercial loans to small –businesses.[23]

On the subject of default rates, the SFLG *Annual Report for Financial Year 2007/08* reported that the levels were difficult to quantify, but said that this is a priority area going forward:

> Efforts were made during the year to establish the equivalent default rates across lenders' portfolios of comparable lending, as measured by customer characteristics, loan value and loan term. This proved challenging because of the commercial confidentiality which lenders attach to that data and the way in which they segment

17 "Loan Scheme's effectiveness to be probed" *Financial Times* 17 February 2004
18 HM Treasury, *The Graham Review of the Small Firms Loan Guarantee* [on 20 October 2008]
19 HM Treasury, *The Graham Review of the Small Firms Loan Guarantee*, background [on 20 October 2008]
20 Graham Review of the Small Firms Loan Guarantee, *Final Report*, September 2004, p1
21 Graham Review of the Small Firms Loan Guarantee, *Final Report*, September 2004, p2
22 HMT/ DTI Press Release, *Government To Offer More Generous And Targeted Support For Small Firms*, 4 October 2004
23 Public Accounts Committee, *Supporting Small Businesses*, HC 262 session 2006-07, 6 February 2007

their data. Interim findings suggest that the extent of the differential remains higher than can be explained solely on the basis of the availability of security. A priority going forward is to quantify what constitutes both an appropriate comparison and an acceptable default rate.

The greatest number of demands arising in FY 2007/08 were from new loans to businesses in the wholesale & retail sector defaulting. Expressed as a proportion of the loans in the portfolio, demands were most prevalent in the construction, manufacturing & production and wholesale & retail sectors.[24]

2 Access to credit for small firms

2.1 Finance

On the subject of access to finance more generally, the Association of Chartered Certified Accountants (ACCA) published a policy briefing in March 2006, *Improving access to finance for small firms.* It found that the finance markets do not always fully meet the needs of small firms who can find it harder than large firms to acquire finance that is accessible, appropriate and affordable.[25] This 'equity gap', by-where businesses with viable investment propositions are unable to attract investment from informal investors or venture capitalists, was also identified by the 2003 HM Treasury report, *Bridging the finance gap: next steps in improving access to growth capital for small businesses*.[26] Similarly, a report by the CBI in July 2006, *Improving access to finance: Enabling the enterprise revolution*, said that there is an emerging gap in the finance market: that raising finance for innovation which is unlikely to raise high levels of return is becoming an increasing problem.[27] The report identified 20 recommendations that it thought would improve the situation. The key recommendation was that government should begin working with finance providers to look at how business demand for finance can be catered for over the coming years.[28]

The Department, for Business, Enterprise and Regulatory Reform website sets out the various sources of finance for small businesses.[29] These include schemes such as grants for research and development; early growth funds; and regional venture capital funds. The Government has recently begun to establish a series of further funds, known as Enterprise Capital Funds, to help to increase the availability of growth capital to small and medium-sized enterprises (SMEs) affected by the 'equity gap'.[30]

2.2 Credit crunch

Small businesses have recently been reporting financial and economic difficulties. A London Chamber of Commerce and Industry survey published 4 July 2008 found:

[24] Small Firms Loan Guarantee *Annual Report for Financial Year 2007/08*, July 2008, p6

[25] Association of Chartered Certified Accountants (ACCA), *Improving access to finance for small firms*, March 2006

[26] HM Treasury, *Bridging the finance gap: next steps in improving access to growth capital for small businesses*, December 2003

[27] CBI, *Improving access to finance: Enabling the enterprise revolution*, July 2006 p1

[28] CBI, *Improving access to finance: Enabling the enterprise revolution*, July 2006 p3

[29] Department for Business, Enterprise and Regulatory Reform website, *Sources of Finance for Small Business* [on 20 October 2008]

[30] See the Department for Business, Enterprise and Regulatory Reform webpage on *Enterprise Capital Funds* for more information [on 20 October 2008]

> that 60 per cent of its members expected economic conditions to worsen, while 43 per cent said their cash flow was down compared with just three months ago [31]

The extent of the impact on small firms of the current problems with credit supply is emerging but is not yet clear. The Federation of Small Businesses suggests that things are generally getting worse.[32] Announcements by the Government regarding the recapitalisation of RBS and Lloyds TSB/HBOS seem to suggest that there would be requirements that these banks maintain mortgage lending and small-business lending at 2007 levels. This is considerably more than they are currently lending.[33] However the announcement is significant given that a shortage of credit is largely behind concerns over the prospect of economic recession and is of obvious concern for small firms, both in terms of start-ups and ongoing financial needs for business growth.

In the United States the central bank (the Federal Reserve) and the US Treasury have announced that liquidity support and capital will be available directly to broad array of small and medium-sized banks and thrifts across the country, who can agree to sell preferred shares to the US government, on the same terms that will be available to the larger institutions. The hope is that as these institutions increase their capital base, they will be able to increase their funding to consumers and businesses.

The SLFG *Annual Report for financial year 2007/08* speculates on the effects of the credit-crunch for the SLFG in the current financial year:

> Banks advise that the rate at which they have received new SME lending propositions has declined over the last year. The credit crunch and less certain market conditions have made both lenders and borrowers more risk-averse, which may be expected to result in lower SFLG take-up. On the other hand, greater caution in lending, for example the application of lower loan-to-value ratios than previously when property is offered as security, would imply that there is increased need for SFLG in particular situations.
>
> Against this background SFLG lending has declined further to 2,619 loans annually, despite informed feedback from lenders suggesting that, with SFLG being available to enable lending to businesses up to five years old, take-up of around 4,000 loans per annum might be expected.[34]

The rise over the summer 2008 in energy costs could potentially have severe consequences for many small firms. One consequence of the ongoing disturbances in credit markets is that energy bills may remain high despite decline in the price of oil. This is because energy suppliers are less able under current financial conditions to take advantage of these reduced prices. A secondary consequence for small businesses may be that they may have difficulty obtaining credit to tide them over until retail energy prices normalise.[35]

An article in the *Times* from September 2008 reports that many small businesses face problem with the late payment of debts.[36] It states that some large companies are delaying payment to small businesses by more than 100 days and changing terms and conditions with

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31 Bob Sherwood and Helen Warrell, "London's small companies feel the pain of tough times in City", *Financial Times*,16 October 2008; See also London Chamber of Commerce and Industry

32 FSB, *Credit Crunch Shuts Business*, 16 October 2008

33 BBC News, *Mortgage plan is 'an aspiration'*, 13 October 2008

34 Small Firms Loan Guarantee *Annual Report for Financial Year 2007/08*, July 2008, p1

35 BBC, Robert Peston's blog, *Why power prices aren't falling,* 20 October 2008

36 "Small businesses must prepare to fight for survival; Recession special, *The Times* 20 September 2008

little notice. It notes that small businesses are afraid to use legislation to step in and help here for fear of losing large contracts. The Government announced in October 2008 that it and Government Agencies will try to ensure that bills are paid within 10 days rather than 30 days in order to support small business.[37]

3 History

In his 1981 Budget speech the then Chancellor Geoffrey Howe announced the introduction of loan guarantee scheme to help those who found it difficult, for a variety of reasons, to borrow money to start or develop a business. As Mr Howe noted, often this difficulty arose for the potential borrower lacking the necessary collateral.[38] The scheme was formally launched in June 1981.[39] Initially it was proposed that for successful applicants, government guarantees would be available for 80 per cent of each loan, for loans up to £75,000 made for between two and seven years – which the bank in question would not have made in the absence of this guarantee. An annual commercial premium of 3% was charged on the principal of the loan outstanding, so that the scheme might be self financing.[40] A key part of the scheme was that the lending appraisal and the decision to lend resided with the bank in each case. The scheme was open to all types of small business – from the limited company to the sole trader – though certain activities were excluded: for example, agriculture & horticulture, banking and financial services, education, medical services, railways, recreational services and other cultural services.[41]

Following a three year pilot programme, a number of changes were made to the scheme: the share of the loan guaranteed by the government was cut from 80 per cent to 70 per cent, and the annual premium charge raised from 3% to 5%.[42] The scheme was extended the following two years, and in his 1986 Budget the then Chancellor Nigel Lawson announced a further three year extension, as well as a cut in the premium charged to 2.5%.[43] In subsequent years a lower premium and higher guarantee limit were introduced to encourage take-up in inner-city areas. In evidence to the Public Accounts Committee in 1989 the Department argued that the scheme had been 'very successful', citing a study carried out by the National Economic Research Associates that found '60 per cent of the firms they studied could not have raised finance without it.'[44] Over this period the take-up of the scheme peaked in its second year of operation, at just over 6,000 loans in 1982-83. After a fall-off in applications in the mid 1980s, take-up levelled out at about 3,000 loans a year. It does not appear that the scheme has ever proved self-financing.[45]

Changes to improve take-up were announced in the 1993 Budget: in particular, the annual premium charge was cut from 2.5% of the guaranteed portion of the loan: to 0.5% on the whole loan (for fixed rate loans), or to 1.5% on the whole loan (for variable rate loans). In addition for establishment businesses (those trading for more than two years), the maximum

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37 HC Deb 15 Oct 2008 c785
38 HC Deb 10 March 1981 c 781
39 HC Deb 2 June 1981 c 332W
40 Department of Industry press notice 53, *Loan guarantee scheme*, 11 March 1981
41 DTI, *Loan guarantees for small businesses: guidance notes for applicants*, 1981
42 HC Deb 25 May 1984 cc 593-5W
43 HC Deb 18 March 1986 c 175
44 Committee of Public Accounts: *Eighth report: assistance to small firms*, 15 February 1989 HC 219 1988-89 para 11
45 HC Deb 10 February 1992 cc 383-4W; HC Deb 27 November 1992 c 902W. Figures for expenditure on the scheme given in the first of these PQs only covers the period 1985-1992; apparently figures for earlier years were not available. Figures for the cost of the scheme up for 1997-98 are summarised in a third PQ (HC Deb 9 July 1988 c 631W).

loan level was raised – from £100,000 to £250,000, as was the guarantee limit – from 70 per cent to 85 per cent.[46] In the event the increase in applications was significantly greater than forecast,[47] and this – along with criticism that the scheme's rules were too complex – lead to the DTI issuing a consultation paper 'to examine all key aspects of the scheme.'[48] One issue the paper discussed was the current list of excluded activities, noting that most of these dated from the beginning of the scheme. An annex to the paper gave more details:

> Many of the current exclusions and restrictions date from the start of the scheme in 1981, although there have been a number of changes over time. There are a variety of reasons for excluding or restricting certain business activities including legislation, other external regulations and the result of evaluation studies.
>
> Banks and insurance companies are specifically excluded from the scheme under the terms of the *Industrial Development Act 1982.* Additionally the Act precludes assistance to businesses that do not derive their income from commercial activity.[49] … A number of activities were recently excluded following evaluation studies which showed considerable displacement amongst local services and therefore arguably little economic benefit. Retailing, hair dressing, motor vehicle repair and taxi cabs were all excluded from April 1993 on the basis of displacement. Displacement occurs when assistance to one business, through the scheme, results in a reduction of trade for other businesses in the area.
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> There is an anomaly concerning retailing where, currently, sales to the public are considered retailing whilst sales to another business are not, even if the business is the end user. Commission agents, tied public houses and, in some cases, ticket & travel agents could be considered to be 'tied agents'. Here it is reasonable to expect such businesses to obtain financial backing from their principal …. [The exclusions of agriculture and horticulture] are to comply with investment restrictions imposed by the EC.[50]

A series of changes to the scheme were announced in March 1996, to simplify the rules for applications and to 'refocus' the scheme:

> **Dr. Twinn:** To ask the President of the Board of Trade if he will make a statement about the outcome of the recent review of the small firms loan guarantee scheme and proposed changes to the rules.
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> **Mr. Page:** Following the announcement of a review of the scheme made by the Chancellor of the Exchequer in his November 1994 Budget Statement a consultation document was issued in March 1995. A wide range of organisations was consulted, including scheme lenders, small firms organisations and other Government Departments. After considering all the representations made about the scheme I am today announcing a number of changes aimed at simplifying the rules. These changes follow a very significant increase in use of the scheme over recent years. Following changes made to the scheme in 1993 the Government are now guaranteeing over three times the number of loans, at around five times the value, compared to the period

[46] These changes took effect on 1 July 1993 (DTI press notice P/93/210, *DTI launches greater support for small firm loans*, 26 April 1993).

[47] Take-up rose from 2,342 loans in 1993-94 to 6,207 loans in 1994-95 (HC Deb 13 July 1995 cc 748-9W).

[48] DTI press notice P/95/180, 10 March 1995. This review had been announced by the then Chancellor Kenneth Clarke in his November 1994 Budget speech (HC Deb 29 November 1994 c 1100).

[49] The legal basis for the scheme remains section 8 of the *Industrial Development Act 1982*. This allows assistance only to *industry* – that is, where income is derived from commercial activity, thus excluding any business that does not receive the major part of its income from commercial sources. When introduced, the scheme operated under section 8 of the *Industry Act 1972*.

[50] "Annex 6" in DTI, *Loan guarantee scheme: a consultation document*, March 1995

immediately before those changes. The changes that I am announcing today will help to ensure that this increased support remains focused on those areas where it can be of maximum benefit.

Firstly, I am reducing from six to two the number of size definitions used to determine eligibility for the scheme. Manufacturers will retain their current limit of £3 million a year turnover whilst all other eligible sectors will have a new limit of £1.5 million. As well as simplifying the present system this will give a considerable boost to the service sector which is currently restricted to a turnover level of £0.5 million a year. In order to allow more businesses which have the involvement of an outside equity investor--particularly "business angels"--to benefit from the scheme, I am doubling the shareholding of such investors which can be disregarded for eligibility purposes from the current "under 10 per cent." to "under 20 per cent". In order to help the smallest businesses, I am introducing the possibility of capital repayment holidays for loans up to £30,000 guaranteed under the streamlined arrangements available for loans of this size.

Some small businesses, particularly those in high technology areas, often face additional problems in obtaining finance. To help address this issue I will be seeking to add a limited number of specialist lenders to the current list of 20 and will be particularly looking for lenders with expertise in lending to high technology small businesses. Since the increase in the maximum loan to £250,000 in 1993 the present maximum term of seven years is no longer always the most appropriate. Therefore, I will be raising the maximum term of scheme loans to 10 years. A number of further changes will be made to focus more closely the available support.

These are:
(i) following the changes made in 1993, a further range of businesses where support is often at the expense of displacement of business from other firms in the locality will be excluded from the scheme. The sectors affected are catering (except businesses offering accommodation), business to business retailing, and car valeting and associated activities.

(ii) the discontinuation of the present enhanced terms for businesses in city challenge and inner city task force areas;

(iii) adjustments and additional exclusions to take account of revised European state aid rules. The sectors affected are agriculture and fisheries, coal, shipbuilding, steel and transport;

(iv) a reduction from two years to six months, after the granting of a guarantee, in the limit for drawing down the loan or the initial stage of a loan if it is to be released in stages.

Except for exclusions due to state aid rules which will be put into effect forthwith, the changes will be implemented on 1 September 1996, following negotiation with the lenders of the necessary legal and administrative changes.[51]

In December 1998 the new Labour Government published a white paper on competitiveness which, among its recommendations, proposed the establishment of an 'Enterprise Fund' to finance a series of projects to improve finance for small businesses – including the SFLGS.[52] Speculation that this would result in the scheme being axed[53] has proved mistaken, although

51 HC Deb 22 March 1996 cc 371-2W
52 *Our competitive future: building the knowledge driven economy* Cm 4176 December 1998 p 19
53 "Businesses criticise axing of loan guarantee scheme", *Financial Times*, 18 December 1998

in May 2000 the Government announced that it would be evaluated as part of a wider review of small business finance by the Small Business Service: [54]

> **Mr. Pollard:** To ask the Secretary of State for Trade and Industry what plans he has to improve access to finance for small businesses through the Small Firms Loan Guarantee Scheme.
>
> **Ms Hewitt:** David Irwin, Chief Executive of the Small Business Service, will be taking a close look at the problems faced by small businesses in accessing finance and what improvements might be made to existing forms of financial support provided by the Small Business Service, including the Small Firms Loan Guarantee Scheme. To assist this work the Small Business Service will shortly be setting up a dedicated finance division.[55]

Notably the Trade and Industry Committee had argued that the scheme should be reviewed in their report on small business published in September 1999:

> We heard in the USA about the principal weapon in the armoury of the US Small Business Administration, the guarantee of loans made under s7(a).[56] There are a number of structural differences, not least in the number of lending institutions involved and the degree of securitisation of these loans, which no doubt reflect differences in economic and financial systems and traditions. Other contrasts are however of more potential relevance:
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> - the scale of guarantees provided
> - the "failure" rate, on which we encountered some difficulty in finding truly comparable figures, but where it would seem that around 1 in 10 US SBA guarantees are called in, compared to a rate of around 3 in 10 in the UK SFLGS
> - the public exposure given to the US scheme and those who benefit from it, whereby public attention can be focussed on particular firms and their achievements
> - the extent to which the SBA seeks to become self-funding, by taking equity under some circumstances, compared to the rather conventional financing arrangements of the SFLGS.
>
> **Although the Small Firms Loan Guarantee Scheme has been the subject of a recent evaluation, we consider that there would be value in a more radical examination of its purposes and structure: and that the Small Business Service which is to be responsible for its management should be funded to commission such a study, drawing in particular on experience of similar but different schemes in the USA and elsewhere, and of similar schemes in the UK run by The Prince of Wales Trust and others.[57]**

In March 2000 the Government published a report on banking services in the UK, commissioned from Don Cruickshank in autumn 2000. In this Mr Cruickshank argued that

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54 The Chancellor Gordon Brown announced the creation of a new agency within government to champion small business in his March 1999 Budget (HC Deb 9 March 1999 c 179). The SBS was formed in April 2000 and has since been abolished in 2007.

55 HC Deb 15 May 2000 c 27W

56 This is a similar program to the SFLGS operating in the USA

57 *Thirteenth report: small business and enterprise*, 14 September 1999 HC 330 1998-99 pp xiii-xiv. In its initial response to the Report, the Government did not take up the Committee's specific recommendation for a study drawing on the American experience (*First report*, 9 December 1999 HC 49 1999-2000 para 35).

there existed an 'equity gap' for firms seeking to raise between £100,000 and £500,000, and to tackle this problem resources should be directed to a venture capital programme. In analysing this market failure, Mr Cruickshank he was strongly critical of the SFLGS, noting the high default rate of loans made under the scheme:

> The scheme supports around 5,000 loans each year, worth some £200 million. This represents a tiny fraction of loans overall. In 1998, for example, more than 600,000 loans worth some £36 billion were made to small companies alone … The SFLGS is an inefficient mechanism for meeting the gap in high risk, high reward, finance. As the outturn results demonstrate the loans that are being made under the scheme are not just filling in the gap where firms have low risk propositions but no collateral to satisfy the commercial lenders. The default rate of around 20 per cent suggests that what is being financed is high risk activities, not low risk. If these activities are, as a class, both high risk and high reward, then equity finance is more appropriate and, for the same level of funding, will produce much better value for money for the public purse. If, as seems likely, many of these loans are actually for high risk, low reward, activities, then there is a strong case that they should not be funded at all. In aggregate, they represent a subsidy to uneconomic businesses. If, for other public policy reasons, such funding is required it is unlikely that having no collateral is an efficient indicator of which business should receive such subsidy.[58]

In its formal response to the report in August 2000 the Government acknowledged that there "remain substantial weaknesses in the market for small scale risk capital in the UK (the so called "equity gap") and that these weaknesses should be addressed primarily through significantly enhancing support for its venture capital fund programme." It went on to say that it would "consider the report's recommendation on switching resources from the DTI's Small Firm Loan Guarantee Scheme as part of its periodic reviews of this measure" though it had "no plans at present to withdraw the SFLGS."[59]

The Bank of England presented more positive evidence of the SFLGS in their annual report on finance for small firms published in March 2001:

> The Cruickshank Report … recommended that the Government should progressively switch financial support away from the scheme and instead focus on market imperfections in the provision of small-scale risk capital to certain segments of the SME population. But independent evaluations of the scheme (for example, by KPMG in December 1998) have suggested that it continues to play an important role in supporting businesses that lack a track record or collateral. Another study[60] found evidence that the scheme did help to meet genuine market gaps in the provision of finance to SMEs. In addition, it was found that, over the period 1984-98, between 55% and 72% of loans issued under the scheme had been repaid successfully or had not defaulted.[61]

As part of its ninth report in April 2002, the Bank included a report on finance for small businesses in deprived communities; this drew on work it had commissioned (from Professor Elaine Kempson of Bristol University) to analyse data compiled for the Family Resources Survey, to establish whether there were significant differences in the characteristics of self-

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58 HM Treasury, *Competition in UK banking: a report to the Chancellor of the Exchequer*, March 2000 para 6.23-6.25

59 "Response to recommendations 47 & 48" in, HM Treasury, *Competition in UK banking: Government response*, August 2000

60 Cowling, M & Mitchell, P, *Is the Small Firms Loan Guarantee Scheme Hazardous for Banks or Helpful to Small Businesses?*, Birmingham Business School Research Centre for Industrial Strategy (March 2000)

61 Bank of England, *Finance for small firms: an eighth report*, March 2001 p 29

employed people in deprived areas compared with elsewhere in Britain. In discussing the policy implications of this work, the Bank referred to the SFLGS:

> Certain sectors, notably retail, catering, hairdressing and motor repairs, have traditionally been ineligible for the SFLGS because of fears of displacement.[62] Professor Kempson' analysis has shown that a greater proportion of businesses in deprived areas fall into these sectors and a such are unable to apply for the guarantee. Since an objective of public policy is now to promote enterprise in deprived areas, it might be sensible to review whether any displacement effects in deprived areas would outweigh the benefits of extending the scheme. However, it is important to bear in mind that attempts to refine the scheme in the past, in the form of an inner city variant that gave high guarantee levels for inner city businesses, resulted in high levels of displacement and low take-up.
>
> The SFLGS applies to loans from £5,000 to £100,000.[63] Just under half the guarantees issued are for loans of up to £30,000; however, the average SLFGS loan is larger than the average small business loan, perhaps suggesting that the administration cost associated with using the facility are a disincentive to it use with smaller sized loans. Section One [of this report] showed that businesses in deprived areas tend to have smaller loans than elsewhere ... One approach to encourage the use of SFLGS with smaller loans might be to involve other organisations in promoting the scheme in disadvantaged communities, and possibly enlisting non-bank lenders a agents for the scheme on behalf of the DTI and banks in exchange for a proportion of the administration fee.[64]

The Bank went on to note that the DTI was "currently conducting a review of all its business support operations, including the SFLGS."[65]

On 6 April 2001 the then Trade and Industry Secretary Stephen Byers announced that the SFLGS would be temporarily extended to apply to tourist and retail businesses suffering cash-flow problems due to the effects of the foot and mouth disease. Specifically, the SBS would:

- extend the sectors which can apply for loans under the scheme, including tourism, retailers (except farm shops), caterers (except tied public houses), hairdressers and beauty parlours, motor vehicle repair and servicing, estate agents, theatrical companies and other local services.
- introduce greater flexibility for lenders on existing loans, the maximum time for the repayment of loans will be increased by one year to 11 years and capital repayment breaks will be increased from two to three years.

The changes would only apply to existing businesses adversely affected by the foot and mouth disease.[66] At the time it was anticipated that this extension would be purely temporary, and would be reviewed at the end of December 2001, although, as the SBS' site confirmed, the changes continued to be applied until 30 June 2002:

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[62] (Displacement is the term used to describe the process in which the establishment of new businesses leads to closure of existing competing businesses, rather than to net additions to the stock of firms in the local economy.)

[63] £250,000 if the business has been trading for more than 2 years.

[64] Bank of England, *Finance for small firms: a ninth report*, April 2002 p 55

[65] *ibid.*

[66] Department of Trade and Industry press notice P/2001/223, *Government announces cash-flow help to businesses hit by foot and mouth*, 6 April 2001

NOTICE OF TEMPORARY CHANGES TO THE SCHEME: UNTIL 30 JUNE 2002 For businesses affected by the Foot and Mouth epidemic.

Please note this change is only effective for existing businesses trading as at 6 April 2001. All applicants must demonstrate to the Lender that the Foot and Mouth epidemic has adversely affected their business to a significant degree.

The restrictions on the following business activities have been temporarily lifted:

- Retail (except Farm Shops)
- Catering (except tied Public Houses)
- Hairdressing and Beauty Parlours
- Motor Vehicle Repair and servicing
- Estate Agents
- Libraries, Museums, Art and other display galleries
- Theatrical Companies

All other terms, conditions and restrictions on business activities remain the same.[67]

In spring 2002 the Government confirmed that the scheme was "currently being considered as part of the DTI's wider review of business support."[68] As a consequence of this review it was announced in the *Pre-Budget Report* that the SFLGS would be significantly extended to a wider variety of businesses, including firms in the retail and catering sectors *from April 2003*. In a Treasury paper accompanying the PBR, it was noted that these changes "will especially broaden enterprise opportunity within the two thousand Enterprise Areas and amongst ethnic minority groups, where these business sectors are strongly represented. Removal of these sector exclusions will also reduce unnecessary bureaucracy that inhibits take-up of the scheme."[69] Full details were given in a press notice, from which the following text is taken:

From next April, a whole new raft of sectors - including retailers, caterers and motor mechanics - will be eligible for the Small Firms Loan Guarantee Scheme, whereby the Government provides a guarantee encouraging banks to lend to small firms. It's estimated that the move will mean a 25 per cent increase in loans granted under the scheme - another 1,000 a year. Last year the scheme provided over 4,000 loans, the average being just under £60,000 per loan …

The changes to the scheme will mean:

- retail, catering, motor vehicle repairs and servicing, travel agents, libraries, museums and cultural activities, steel and coal businesses, hairdressers and estate agents will become eligible for the scheme;
- the maximum turnover limit for the service sector will increase from £1.5m to £3m per year;

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67 http://www.sbs.gov.uk/sflgs/ (retrieved April 2001, website no longer available)

68 HC Deb 6 March 2002 c 349W

69 HM Treasury, *Enterprise Britain: a modern approach to meeting the enterprise challenge*, November 2002 para 4.14

- a single guarantee rate of 75 per cent will apply, rather than the current 85 per cent for established firms and 70 per cent for younger businesses;
- previous beneficiaries will be able to apply again - as loans granted prior to April 1993 will no longer count towards the maximum loan amount; and
- a 2 per cent premium will be paid by the borrower on all new loans ...

The Government will also be looking to increase the number of participating lenders. Currently, 23 lenders are included in the scheme.

… The changes to the SFLGS will apply from 1 April 2003. In taking forward these changes the DTI is in discussion with the European Investment Fund (EIF) over possible co-operation under the European Commission's Multi Annual Programme. In the agriculture and fisheries sectors, because of the specific rules that apply to them, the changes are subject to EC approval.[70]

[70] DTI press notice P/2002/750, 27 November 2002