

Access To Finance Review Stage 1 Report

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Introduction

Back in 1931, the UK government commissioned the MacMillan Review¹ in response to public opinion, following the World financial crisis of two years earlier, that banks were not supporting the industrial base of the nation. In particular, it noted that investments of relatively small amounts of money were riskier and more costly for lenders, which put small businesses seeking loans at a relative disadvantage. Since then, other reviews have been undertaken by various governments during the intervening period to address this issue² but seemingly with little success to date.

Nearly three years ago, the UK Coalition Government recognised, within two months of taking office, that the lack of access to finance for SMEs was one of the key areas that needed to be addressed if the British economy was to recover from recession. One of the first reports produced by the UK Government, *“Financing a private sector recovery”* demonstrated that one of the major issues for SMEs is that they *“have generally experienced greater difficulties than their larger counterparts in accessing finance primarily due to the higher risk they represent, especially those without a significant credit history or track record. Around a third of SMEs do not use formal sources of external finance at all, relying instead on retained earnings or personal finance to fund investment and growth. Those SMEs that do seek external finance are almost entirely reliant on banks”*³.

Given this, much of the focus of the UK Government in supporting lending to smaller firms has been on developing and strengthening initiatives that would enable banks to lend money to businesses, including the Enterprise Finance Guarantee Scheme, Funding for Lending and the announcement of a new Business Bank. In addition, it commissioned an industry-led taskforce (chaired by Tim Breedon, Chief Executive of Legal & General Group plc) that examined how businesses could gain access to non-bank lending channels⁴. Yet despite all of these efforts by government at a national level, the latest data on lending from the Bank of England⁵ indicates that there remain significant problems in getting capital from the high street banks to SMEs in the UK.

With a devolved system of government within the UK, there has been increasing interest in the role of SMEs as engines for developing prosperity and growth at a regional level. In Scotland and Northern Ireland, the devolved administrations have commissioned two reports that have specifically examined the financial environment within each nation. In its study, the Scottish Government⁶ focused specifically on how to develop a strategy to set out the key principles of a “sustainable, responsible and healthy banking sector

1 Committee on Finance and Industry – Macmillan Committee (1931) *Report of Committee* (Cmd. 3897)

2 These include: Bolton, J.E. (1971), *Report of the Committee of Inquiry on Small Firms*, Cmnd 4811, HMSO, London; Wilson Committee (1979), *The Financing of Small Firms, Interim Report of the Committee to Review the Functioning of the Financial Institutions*, Cmnd 7503, HMSO, London; Cruickshank, D. (2000) *Competition in UK Banking: A Report to the Chancellor of the Exchequer*, Stationery Office; Rowlands, C. (2009) *The Provision of Growth Capital to UK Small and Medium Sized Enterprises*, Stationary Office.

3 Department for Business, Innovation and Skills (2010) *Financing a private sector recovery*, July, p 14

4 Independent taskforce on non-bank lending (2012) *Boosting Finance Options for Business*, Department for Business, Innovation and Skills, March 2012

5 <http://www.bankofengland.co.uk/statistics/Pages/bankstats/2013/Apr13/default.aspx>

6 The Scottish Government (2013) *Sustainable, Responsible Banking: a strategy for Scotland*. Edinburgh 2013

in Scotland, including providing access to finance for SMEs. In contrast, the Northern Ireland report⁷ focused more specifically on the availability of finance to Northern Ireland SMEs in order to establish the support currently available, the level of uptake and the potential reasons for any deficiencies in the market. To date, there has been no detailed review undertaken on access to finance for SMEs in Wales. Following representations from various small businesses on the problems in accessing funding from the banks, the Minister for Economy, Science and Transport announced an independent review of the availability of funding for SMEs in Wales on 16th January 2013. Supported by a voluntary advisory panel⁸ from academia and business, the aim of the review is to examine how effectively SMEs in Wales are served by existing sources of funding, identify areas of particular challenge and provide recommendations for action. This will include the following areas:

- Whether Welsh businesses are less successful in accessing bank funding compared to SMEs operating in other areas of the UK;
- What particular characteristics of Wales might explain any discrepancies identified;
- How UK Government initiatives can benefit Welsh businesses' ability to access finance;
- The role culture plays in Welsh business' appetite for growth and risk;
- How to ensure Welsh businesses maximise their chances of securing funding from existing sources;
- How to address any barriers that exist to UK and international investors funding more businesses in Wales;
- What international best practice solutions might be considered for Wales.

During the last four months, an extensive consultation with over 90 representatives of the banking sector and other financial institutions, the Welsh and the UK Governments, intermediaries, academia and businesses has been carried out. More detailed discussions have also been held with members of the Institute of Directors (IOD), Confederation of British Industry (CBI) and the Institute of Chartered Accountants for England and Wales (ICAEW). The Welsh Government also conducted an online consultation on its website and over 30 responses were received including a detailed response from the Federation of Small Businesses (FSB). The consultation exercise has been supported by a substantial amount of data collated from various sources including Welsh Government, Finance Wales, individual high street banks, the Bank of England, British Bankers' Association (BBA), Department for Business, Innovation and Skills (BIS), FSB, IOD, HM Revenue and Customs (HMRC), the Office of National Statistics (ONS), NESTA, the British Private Equity and Venture Capital Association (BVCA) and various universities within the UK and abroad.

7 EAG (2013) *Review of access to finance for NI businesses*. Belfast, March 2013.

8 These advisory board members are: John Antoniazzi, former partner at Deloitte in Wales; Katy Chamberlain, Chief Executive of Business in Focus; Professor Robin Jarvis, Head of SME Affairs, The Association of Chartered Certified Accountants (ACCA) and Professor of Accounting, Brunel University; Professor Phil Molyneux, Dean of the College of Business, Law, Education and Social Sciences and Professor of Banking and Finance, Bangor University; Huw Morgan, former Head of Business Banking, HSBC Bank plc; Chris Nott, Chair of the Financial and Professional Services Sector Panel and Managing Partner of Capital Law LLP; Professor Stephen Thomas, Professor of Finance, CASS Business School, City University London; Mark Woolfenden, Managing Director, Afonwen Laundry

This first report therefore analyses the current situation regarding the access to finance of SMEs in Wales, focusing specifically on the role of banks. It also presents information on other forms of finance that are available to SMEs. As part of the review, a number of preliminary recommendations regarding access to finance in Wales, a number of which the Welsh Government should implement immediately to improve the current situation and others that need further consideration as part of the second stage of the review. Whilst reports and policy announcements from bodies as diverse as the Welsh Conservatives⁹, Plaid Cymru¹⁰ and the TUC¹¹ have already suggested that there should be one solution to the problems facing SMEs in accessing finance in Wales, the report suggests that there may not be a “one size fits all approach” to funding Welsh businesses, especially given the potential use of various forms of alternative sources of finance¹². Nevertheless, these models will be examined in detail during the next stage of the review, which will focus on examining the options as to how the Welsh Government could, or should, help develop a new financial ecosystem in Wales that will support the development of a strong, sustainable and vibrant SME sector.

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9 Welsh Conservatives (2013) *Invest Wales*, January

10 Plaid Cymru (2013) *Plan C – a plan to move the Welsh economy forward*, May

11 New Economics Foundation (2013) *Towards a Welsh industrial strategy* – a nef report commissioned by Wales TUC

12 Such a continuum of different sources of finance for firms is described in detail in Berger, A.N. & Udell, G.F. (1998). “The economics of small business finance: The roles of private equity and debt markets in the financial growth cycle,” *Journal of Banking & Finance*, Vol. 22(6-8), pp. 613-673. We will look in more detail at how this model can be adapted for new sources of finance for SMEs

Initial recommendations

Banks

1. Welsh Government needs to ensure that Wales, and Welsh businesses, gets a fair share of funding from the new Business Bank given concerns that the funding will not be distributed regionally across the UK and may be concentrated in the more prosperous areas of the UK.
2. For both loans and overdrafts, smaller and younger SMEs remain less likely to have been successful in securing funding from their bank. If banks continue to have difficulties in fulfilling the lending role for this part of the business community in the future, other forms of funding will need to be considered for smaller firms, especially micro-businesses. The Welsh Government therefore needs to consider whether mechanisms such as micro-lending or community-based lending to smaller local businesses should be encouraged and supported.
3. Security against the loan and affordability of repayment, rather than the cost of borrowing, have been cited in the interviews with banks, intermediaries and small businesses as being one of the main obstacles to accessing bank finance. To date, the Enterprise Finance Guarantee Scheme (EFG) has done little to address either issue especially for smaller businesses. Therefore any intervention by the Welsh Government should focus on these two critical obstacles.
4. Local decision-making by banks is seen by many businesses as critical in ensuring that their business case is considered fairly. Yet there is very little evidence of this happening with higher-level credit decisions being made outside of Wales. Given this, Welsh Government is encouraged to open up discussions with the main banks to ensure that Welsh regional managers make the final credit decisions for all Welsh businesses.
5. There needs to be greater transparency in the lending process. This is to ensure that SMEs, especially those without any formal financial support internally, know exactly what is required in terms of preparing an application to the bank (business plan, cash forecasts, support from an intermediary). In exchange for the provision of this information, banks would then agree to examine each potential funding request in more detail as opposed to basing their decision using the credit-scoring software that is normally applied to the majority of applications. Such “a banking covenant” could ensure greater transparency and accountability within the lending process and Welsh Government could work with the BBA to pilot such a scheme in Wales.
6. Welsh Government should examine the disconnect between the business support programmes it offers and the funding supplied by the banking community in Wales. It needs to consider how it can work more closely with banks to ensure that they recognise the support available to Welsh firms and by promoting its take-up, improve the quality of business proposals and information supplied to the banking sector. This could be achieved in a number of simple ways such as having regular meetings between the banks and Welsh Government officials and encouraging the development of specialist managers and support providers in the key sectors identified by the Welsh Government.

7. Welsh Government should raise the issue of the detrimental effect of Basel III rules on SME lending directly with the UK Treasury and BIS. This will enable the UK Government to make representations directly to the Basel Committee on Banking Supervision to recommend that SME lending should be excluded from consideration in terms of determining suitable capital and liquidity within the banking system.

Other forms of funding

8. Welsh Government should examine how it can help facilitate better access to the wide range of commercial lending opportunities that are available to SMEs through non-bank lending channels. This could be achieved through partnership with organisations such as the NACFB and the development of a specific commercial portal on lending for SMEs.
9. There are currently low levels of informal investment in Wales that could be addressed by (a) raising awareness of equity investment by angels as a viable form of funding amongst growing SMEs and (b) developing an equity guarantee scheme to attract further investment by private individuals into Welsh businesses. These potential interventions, and the role of Welsh Government in supporting them, will be explored in further detail during the second half of the review.
10. Finance Wales has had a positive impact on formal equity investment within the Welsh business community. However, the Welsh Government will need to consider how it builds on this success, especially in terms of having a specific vehicle for equity funding in the future. It also needs to develop programmes that create demand for venture capital not only for new start-up businesses but also growth firms where equity investment is key for further development.
11. The lack of availability of trade credit is an issue that leads to many smaller businesses seeking short term funding for working capital from banks. The Welsh Government should explore how it can use its power as the biggest purchaser in Wales to encourage its own suppliers to adopt supply chain finance or similar schemes to support their suppliers. In addition, it could set an example by ensuring that all contractors operating within the public sector in Wales have to pay their suppliers within a maximum 30-day period (and ensuring that it adheres to such a policy itself). With over £4.3 billion being procured via the public sector, this could have a major effect on the cashflow of a significant number of smaller businesses. The Welsh Government could also build in such conditions into other programmes that it currently manages.
12. Further discussions will take place with building societies in Wales to assess their potential role in supporting SMEs to access finance, especially in terms of commercial property lending.
13. The Welsh Government should examine how UK Government funds can be used more effectively to support businesses in Wales, potentially through the provision of matched funding through its own resources. In particular, as it currently does not provide any loans to those start-ups that create the vast majority of jobs in the economy, the Welsh Government needs to develop an appropriate mechanism for this type of support, based on the Start-Up Loans programme operating in England, although this should be applicable to all new businesses and not only those started by 18-30 year olds.

14. There is a major opportunity for Welsh Government to take the lead in supporting alternative sources of funding such as peer-to-peer lending and crowdfunding, either through partnership or direct funding. It could also raise awareness of both types of funding through its various business support programmes.

Finance Wales

15. As the sole shareholder, Welsh Government needs to determine the future strategic direction of Finance Wales and, more importantly, the role it should play in the future financial landscape for Welsh business alongside other providers.

Data Collection

16. This review has shown that there is a lack of regional data, especially for Wales, as a devolved nation. If policymaking within the Welsh Government is to be based on evidence, then it is critical that UK organisations in both the public and private sector are made fully aware of the implications of devolution and the need for accurate data being collected at a regional level.

The Welsh SME sector

This section will look briefly at the structure of the Welsh SME sector¹³ to place its funding requirements into context. This is because not only will the size of the business potentially have a direct impact on the amount of funding applied for but the industrial sector in which it is based may also influence the finance it will be able to access. For example, a manufacturing business with assets such as a factory and equipment should find it easier to attract funding than a marketing or advertising firm where the intangible creative talents of its staff are its main assets and cannot be used as collateral or monetised.

Table 1: Number of businesses in the private sector and their associated employment and turnover, by number of employees in Wales, start 2012¹⁴

	Number			Percentage of total (2)		
	Enterprise count	Employment	Turnover (£ Billion) (b)	Enterprise count	Employment	Turnover
Micro (0 – 9)	199.3	339.2	16	94.6%	33.3%	15.6%
Small (10 – 49)	7.9	148.3	10.6	3.7%	14.6%	10.3%
Medium (50 – 249)	2	128.1	12.9	0.9%	12.6	12.6%
Large (250 +)	1.6	401.9	63.2	0.8%	39.5%	61.5%
All	210.7	1017.5	102.8	100.0%	100%	100%

(a) This is a count of enterprises that are active in Wales, including multi-region enterprises registered outside Wales. (b) This excludes turnover in the financial and business services sector. Turnover data are not comparable from 2010 with prior years due to the move to SIC2007.

As table 1 illustrates, there are an estimated 210,700 enterprises active in Wales in 2012, employing an estimated 1.02 million people and having an estimated combined annual turnover of £102.8 billion. The majority of enterprises active in Wales are small and medium sized enterprises (SMEs) accounting for 99 per cent of the total in Wales in 2012, with micro enterprises (0-9 employees) accounting for 95 per cent of the total. SMEs accounted for 60.5 per cent of employment and 38.5 per cent of turnover in 2012 with large enterprises accounting for the remainder. Whilst there are regional differences, the business structure in Wales is comparable to that of the UK in terms of active enterprises and employment in each size-band. This differed when looking at turnover, with the large size-band accounting for 62 per cent of total turnover in Wales, compared to 54 per cent in the UK.

13 The definitions used for micro (0-9), small (10-49) and medium (11-249) are universal across Europe, but the banks and other financial institutions tend to adopt a very different definition that is based on turnover. For example, in data analysis by the BBA, SME customers are segmented between 'small' and 'medium' sized businesses. The 'small' segment reflects SMEs that typically fall within banks' 'business-banking' operations, whilst the 'medium' segment reflects SMEs that typically fall within banks' 'commercial-banking' operations. A notional distinction between small and medium sized businesses is that small businesses have less than £1m or £2m annual debit turnover, medium businesses have greater annual debit turnover of £1-2m, but less than £25m.

14 Welsh Government (2012) *Size analysis of Welsh business*, 25th October

By sector, the wholesale, retail, transport, hotels, food and communication are the largest sectors in Wales (by number of enterprises) at 56,000 followed by financial and business services (41,000 enterprises). These two industries account for 46 per cent of all enterprises active in Wales and 54 per cent of total employment in enterprises active in Wales.

Given the differences in the financial needs of micro, small and mid-sized enterprises, it is worth noting that 92 per cent of businesses in agriculture, forestry and fishing were micro enterprises (considerably higher than the 75.6 per cent for the UK). 65 per cent of construction firms were also micro enterprises. In contrast, the production sector (which includes manufacturing) has a higher proportion of medium and large businesses compared to the UK. If, as data from the Welsh Small Business Survey in table 2 suggests, it is micro enterprises in Wales that will be facing the biggest difficulties in gaining finance, then these two sectors will be disproportionately affected by any decrease in lending to the smallest category of businesses. This should therefore be part of any future consideration of financial support for the SME sector in Wales going forward.

Table 2: Eventual outcome of application by Welsh firms for finance, by size, 2012¹⁵

	All who applied for finance in Wales	Micro (1-9)	Small (10-49)	Medium (50-249)
	%	%	%	%
Obtained all they needed	57	53	67	84
Obtained some but not all	9	11	5	3
Obtained none	26	29	18	9
Don't know/still pending/refused	7	7	10	3

Despite the sectoral differences across Wales and the different concentrations of industries within various size categories, interviews with banking representatives suggest that there is little consideration of sectors when it comes to developing the specialist funding needs of different businesses in Wales. Very few of the banks have any industry or sector specialists. Given that the Welsh Government's current approach to economic development is based largely on a sector driven strategy, this shows the lack of connectivity between those who provide business support in Wales and those that provide the finance for those businesses. We will examine this in more detail later in this report.

15 Welsh Government (2013) *2012 Small Business Survey*, BMG Research

The role of Government

UK Government

Governments of various political colours have introduced a number of schemes during the last thirty years that have attempted to ensure that they help small firms in the UK gain access to finance. Currently, there are a number of key initiatives that the UK Government is supporting:

- The **Funding for Lending Scheme**¹⁶ (FLS) was launched in July 2012 by the Bank of England and HM Treasury to encourage lending to households and companies. It offers funding to banks and building societies for an extended period and encourages them to supply more credit by making more and cheaper funding available if they lend more. This easier access to bank credit, consumption and investment by households and businesses is expected to boost leading to increased economic activity. In April 2013, an extension to the FLS was announced which contained incentives to boost lending skewed towards small and medium sized enterprises (SMEs).
- The **Enterprise Finance Guarantee Scheme** (EFG) is a loan guarantee scheme that enables banks and other lenders to lend to small businesses that lack security or a proven track record. EFG has not been set up to be a replacement for commercial products and is designed to account for 1-2 per cent of total lending to SMEs. It provides lenders with a 75 per cent guarantee on each individual loan issued under the scheme, subject to a 20 per cent limit on total claims arising from a lender's portfolio. This shares the risk of the loan defaulting between the business (that pays a premium), the government and the lender. Currently 46 lenders are part of the scheme, including all main UK high street banks, community development finance institutions and invoice finance providers. We will look at the Wales data for EFG later in this section.
- The **Business Finance Partnership** (BFP) aims to increase the supply of capital through non-bank lending channels and, in the longer term, help diversify the sources of finance available to businesses. It will co-invest a total of £1.2 billion through these channels, matched by at least equal private sector capital, to help create and support new sources of lending for SMEs in the UK. The first strand of the BFP has invested five funds to manage £700 million of government investment alongside over £1 billion from private investors. The second strand of the Business Finance Partnership invests in non-traditional lenders that provide an alternative source of lending for small businesses with turnover up to £75 million. Seven different lenders have received £85 million of government investment and will lend more than £240 million to small businesses by attracting matching private sector investment.
- The **Business Angel Co-investment Fund** (or Angel CoFund) was launched in November 2011 with a £50m grant from the UK Government's Regional Growth Fund and invests alongside business angel syndicates from across England. As a private-sector body, it is able to make initial equity investments of between £100,000 and £1 million into SMEs alongside strong syndicates of business angels, subject to

16 Churm, R. and Radai, A. (2012) *The Funding for Lending Scheme*, Bank of England Quarterly Bulletin, Q4, pp. 306-320.

certain geographical restrictions and an upper limit of 49 per cent of any investment round. The fund will only make investments alongside syndicates of business angels who must be investing in the business for the first time. It has been designed and established by a consortium of private and public bodies with expertise in business angel investment. It is a private sector body with clear objectives to boost the quality and quantity of business angel investing in England, and to support long-term, high quality jobs in growing companies.

- **UK Innovation Investment Fund (UKIIF)** was established in 2009 as a £150m venture capital fund of funds that aims to drive economic growth and create highly skilled jobs by investing in innovative businesses where there are significant growth opportunities. It invests in technology-based businesses in strategically important sectors to the UK including digital technologies, life sciences, clean technology and advanced manufacturing. To date, it has raised an additional £180 million in private investment, giving the fund a total of £330 million to invest in businesses.
- **Enterprise Capital Fund (ECF) Programme** is intended to address a long-term structural weakness in the provision of risk capital for SMEs in the UK. Currently this gap is considered to be most severe in investments of under £2 million. Launched in 2006, ECFs are commercial funds that bring together a combination of private and public money in order to support high growth businesses. The programme operates by providing gearing on private investments in the funds, in effect offering enhanced profits to private investors when funds are successful. This gearing is designed to offer investors returns at the same level they might achieve in later stage venture capital funds. It is designed to be cost neutral for the Government over the medium term and has so far proved successful in attracting high quality management teams to the equity gap. There is now a portfolio of twelve active funds with commitments totalling nearly £400 million, of which HM Government has committed £240 million. To date, £176.4 million has been invested through the funds in 149 fast-growing UK businesses with several strong exits and significant follow-on financings for portfolio companies already achieved. £4.3 million has been invested in three Welsh-based companies, which represents 2.5 per cent of the ECF.
- **Start-Up Loans¹⁷** is a £112 million initiative that was launched in 2012 to provide 18-30 year-olds living in England who want to start a business with low cost loans and expert advice from mentors. The scheme offers unsecured loans of around £2,500, charged at a 6 per cent interest rate and repayable within five years. To date, it has provided around 3,000 young entrepreneurs with £13 million in start-up capital. Earlier this month, it was announced that the scheme would remove the age restriction on the programme.

The UK Government also provides financial guarantees to exporters via its export credit agency, UK Export Finance, which helps exporters and investors by providing credit insurance policies, political risk insurance on overseas investments and guarantees on bank loans. More specifically, it (a) insures UK exporters against non-payment by their overseas buyers (b) helps overseas buyers to purchase goods and services from UK exporters by guaranteeing bank loans to finance the purchases (c) shares credit risks with banks to help exporters raise tender and contract bonds, in accessing pre- and post-shipment working capital finance and in securing confirmations of letters of credit

17 <http://www.startuploans.co.uk>

(d) insures UK investors in overseas markets against political risks. In 2012, it offered guarantees and insurance policies of £2.32 billion to UK exporters although no separate information on support for Welsh businesses was available.

Whilst a number of these programmes, notably the EFG and Export Finance, are available to Welsh businesses, others such as the Angel Co-Fund are not. Initially the Start-Up Loans programme was restricted to England only but later this year, these funds will be made available to Wales. However, a number of respondents felt that many Welsh businesses were either unaware of many of these UK programmes or weren't being encouraged to utilise them properly. This means that millions of pounds of potential funding is being lost to Welsh businesses every year. In addition, given that the Welsh Government, as will be discussed later, has its own funding programmes to support SMEs, it was considered that there should be better co-ordination between the two sources of support so that opportunities are maximised.

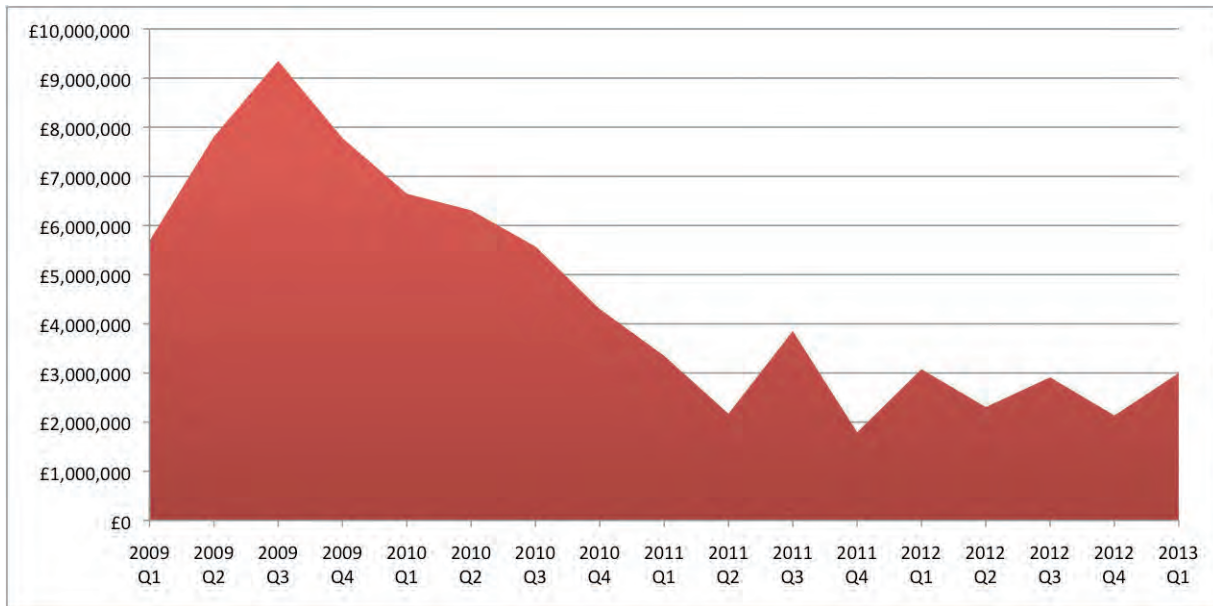
The Enterprise Finance Guarantee Scheme in Wales

As noted earlier, the EFG is a loan guarantee scheme that addresses the issues of lack of collateral or track record affecting some viable SMEs, enabling the lender to lend when it would otherwise not do so. It is not designed for the majority of viable businesses to whom banks should lend and forms around 2 per cent of UK bank lending to SMEs with a turnover of up to £25 million. EFG is only considered when the lender has decided that the business is viable, but there is inadequate security to meet lender's commercial lending criteria. As of the end of March 2013:

- 841 Welsh firms had been offered £78 million through the EFG, representing 4 per cent of the UK total. This represented an average loan of £92,000 as compared to £102,000 for the UK as a whole.
- The ratio of loans relative to the region's business population is highest in the North West of England. Wales is slightly below the UK average but higher than the East of England, South East England and London.
- As figure 1 demonstrates, in Wales there has been a gradual decrease in the total value of loans offered via the EFG on a quarterly basis since 2009. This follows a similar pattern in the supply of EFG within the rest of the UK. In 2009, 392 loans were offered at a total value of £30.6 million to businesses in Wales by the scheme. By 2012, this had fallen to 91 loans offered at a total value of £10.4 million.
- Analysis shows that of the loan facilities approved by banks in Wales in 2012, only 1.2 per cent came from the EFG. This is lower than the UK average and only South West England and the North East of England had a lower take up of the initiative.
- During the period 2009-2013, the average loan offered in Wales has increased from £78,000 in 2009 to £111,000 in 2013.

In terms of sectors, manufacturing has received the most funding in Wales (26.2 per cent of all loans offered) from EFG, with £20.4 million offered since 2009. This is twice the amount of funding given to this sector across the UK and represents its relative importance to the Welsh economy. This is followed by wholesale and retail activities (26 per cent), which has also seen the largest number of loans offered, and accommodation and food service activities (9.2 per cent). Despite the economic downturn, sixty six construction firms have been offered EFG loans, proportionally the same as for the UK as a whole.

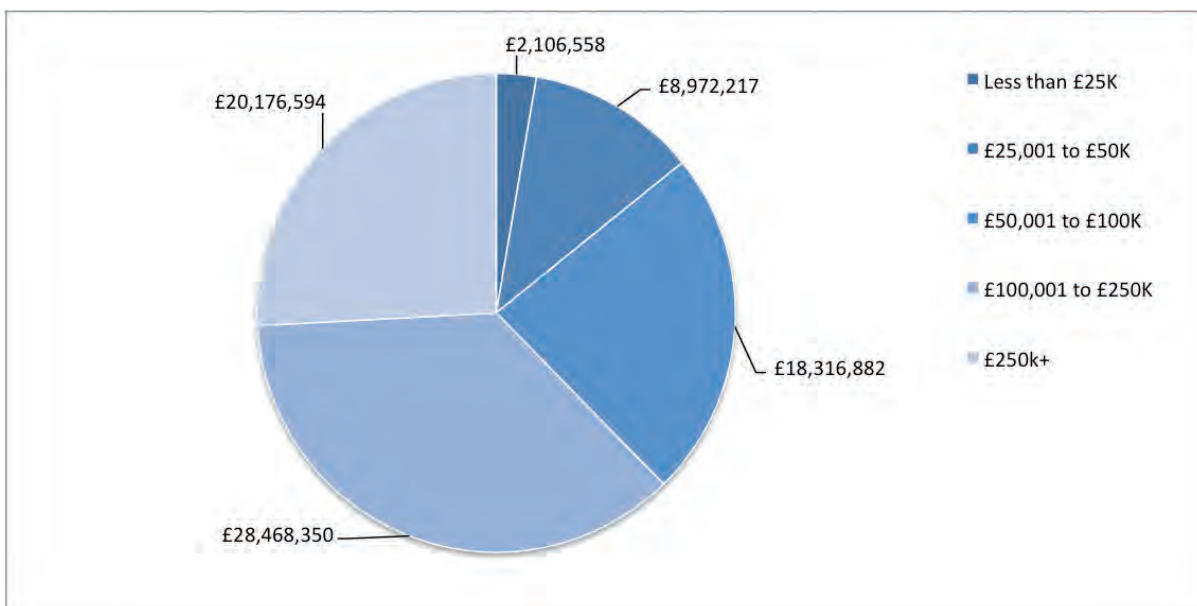
Figure 1: Value of EFG loans offered (£m) in Wales, Jan 2009-Mar 2013



However, other sectors deemed important by the Welsh Government, such as creative industries, information and communications technologies (ICT) and financial services, have received only 7 per cent of the EFG funds during the last three years, suggesting that more needs to be done to support these sectors.

In addition, the data suggests that smaller businesses are increasingly failing to get access to the EFG scheme and that this has been getting progressively worse over the last few years as the average loan size increases. Whilst loans of a value of less than £50,000 accounted for 44 per cent of all loans offered, they made up only 14 per cent of the value of loans given out through the programme in Wales since 2009 (Figure 2). Banks also seem to have different criteria in terms of qualifying limits for firms to apply for the scheme. Only Barclays and NatWest offer loans from £1,000 to £1 million with the other banks applying a different lower limit restriction – £10,000 (or £25,000 for sole traders and partnerships) at HSBC and £25,000 at Lloyds Bank and Santander.

Figure 2: Value of EFG loans offered in Wales, by size of loan



As the UK Government is only guaranteeing a small proportion of the overall tranche of funding for businesses (20 per cent) per funder rather than the 75 per cent which is advertised for individual businesses, this means that banks are asking for security on the total loan which against the spirit of the whole initiative. Given that EFG has been shown to be an enabling catalyst for these businesses affected by lack of collateral or track record to help them fulfil their growth potential¹⁸, it has been suggested by a number of respondents that Welsh Government could provide additional guarantees to increase the limit for loans to Welsh firms, especially smaller enterprises, and reduce the perceived risks for banks.

Recommendation

Security against the loan and affordability of repayment, rather than the cost of borrowing, have been cited in the interviews with banks, intermediaries and small businesses as being one of the main obstacles to accessing bank finance. To date, the Enterprise Finance Guarantee Scheme (EFG) has done little to address either issue especially for smaller businesses. Therefore any intervention by the Welsh Government should focus on these two critical obstacles.

Tax incentives for investors

In addition to the direct provision of funding for loan and equity initiatives, the UK Government also has three main schemes, operated by HMRC, to encourage investors to fund SMEs in the UK through tax incentives:

- The **Enterprise Investment Scheme** (EIS)¹⁹ is designed to help small higher risk trading companies raise finance by offering a range of tax reliefs to investors who purchase new shares in those companies. Investors can invest up to £1 million in qualifying shares and receive 30 per cent of the cost of the investment as a relief against income tax. Capital gains tax liability on disposal of an existing asset can also be deferred if reinvested in EIS shares within a certain period. The scheme applies to individuals investing in companies of less than 250 employees with assets of less than £15 million. In Wales, there have been 146 EIS investments during the period 2008-11, raising £23 million (or 1.4 per cent of all investments).
- The **Seed Enterprise Investment Scheme** (SEIS)²⁰ was set up in April 2012 to complement the EIS scheme by focusing on helping small, early-stage companies to raise equity finance by offering tax reliefs to encourage individual investors to purchase new shares in qualifying companies. Shares must be held for at least three years and income tax relief is available at 50 per cent of the cost of the shares, up to a maximum annual investment of £100,000. For 2012-13 only, there is an exemption from capital gains tax where gains on the disposal of an asset are reinvested in shares qualifying for SEIS income tax relief. The scheme will apply to individuals investing in small companies of less than 25 employees with assets of fewer than £200,000. Companies can receive a maximum of £150,000 under SEIS. No Welsh data is available for this scheme as it has just been initiated.

18 Department for Business, Innovation and Skills (2013) *Economic evaluation of the Enterprise Finance Guarantee (EFG) Scheme*, February.

19 <http://www.hmrc.gov.uk/eis/index.htm>

20 <http://www.hmrc.gov.uk/seedeis/>

- The **Venture Capital Trust (VCT)**²¹ scheme encourages individuals to invest in small, unlisted higher-risk trading companies indirectly through the acquisition of shares in a VCT. VCTs invest their funds into eligible small companies which can receive both debt and equity investment with potential investors encouraged through tax incentives. The maximum investment in VCT shares by any individual in any year is £200,000, which will qualify for relief against income tax at a rate of 30 per cent of the amount invested. Shares must be held for at least five years from the date of their issue by the VCT and there is an exemption for capital gains tax on disposal of shares in a VCT, with dividends on VCT shares exempt from income tax. At the time the VCT invests, an eligible company must have less than 250 employees with assets of fewer than £15 million. No specific Welsh data is available for this scheme.

Whilst the Welsh Government does not have any direct control over these three schemes, it should consider how it could enhance these under its current powers. This will be discussed in more detail later in the report in the section on informal investment.

Therefore, this examination of UK Government funding initiatives to support finance for SMEs suggests that the Welsh business community is not fully participating in those programmes developed and available for all UK firms. The question remains whether this is because of the nature of the businesses themselves, the lack of marketing by those funds in areas such as Wales, or simply a lack of awareness of these financing opportunities. There may also be an in built bias in some funding programmes. For example, only 2.2 per cent of the innovation funding provided by the Technology Strategy Board comes to Wales. If these funds had been ‘Barnetised’, an additional £43 million would have been available to Welsh businesses and universities during the last six years to invest in innovation.

More research will be undertaken to examine this issue but it is critical that Welsh firms get their fair share of UK funding programmes and, more importantly, there is greater joined-up thinking between the different funding streams available at a UK and Wales level. However, it is particularly disappointing that, given the lack of any specific loan programmes for new businesses, Wales did not (or could not) participate in the Start-Up Loan initiative that has proven to be successful in England in supporting young people, especially as it has its own specific strategy for youth entrepreneurship²². As will be discussed later in this review, new businesses are those that face specific challenges with regard to access to finance and the Welsh Government needs to examine how they can access this funding to support start-ups.

Recommendation

The Welsh Government should examine how UK Government funds can be used more effectively to support businesses in Wales, potentially through the provision of matched funding through its own resources. In particular, as it currently does not provide any loans to those start-ups that create the vast majority of jobs in the economy, the Welsh Government needs to develop an appropriate mechanism for this type of support, based on the Start-Up Loans programme operating in England, although this should be applicable to all new businesses and not only those started by 18-30 year olds.

²¹ <http://www.hmrc.gov.uk/guidance/vct.htm>

²² According to the 2012 GEM data, 51.4 per cent of those involved in starting a business believe that there are adequate sources of start-up funding in Wales

The Business Bank

The major initiative that is being developed by the UK Government to get funding to SMEs is the Business Bank²³. Announced in the Autumn Statement of 2012 by the Chancellor of the Exchequer, it will increase the amount of lending to businesses and provide more diverse sources of finance by bringing together and building upon existing government schemes aimed at supporting access to finance for businesses under a single organisation. In addition, there will be a single entry point for the various government advice and support schemes. Its success will be measured by its impact in attracting new finance for businesses and stimulating competition. Therefore its aims are to:

- Support the development of diverse debt and equity finance markets for businesses, promoting competition and increased supply through new finance providers;
- Increase the provision of finance to viable but underserved businesses, in particular improving the provision of long term finance;
- Bring together the management of the Government's existing business finance schemes, creating a single portfolio and simplifying access for businesses;
- Consolidate the provision of and increase the awareness of available support and advice to high growth businesses and those needing specialist support; and
- Function on commercial terms to use taxpayers' funds most effectively.

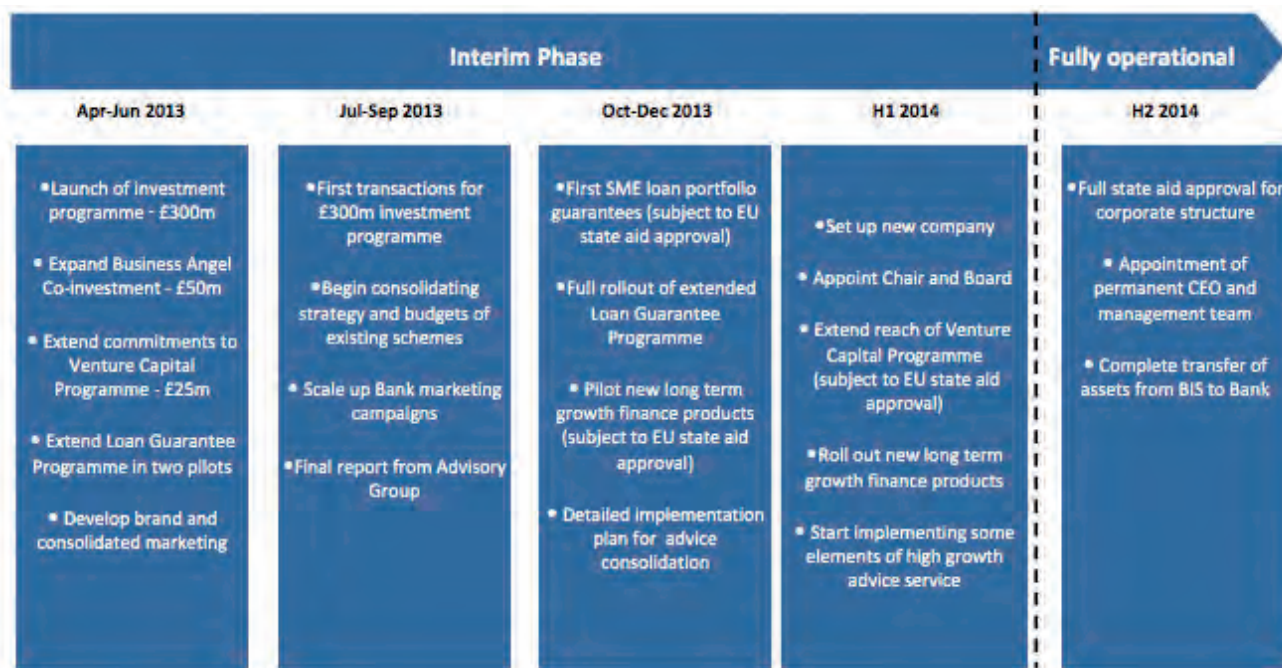
The Business Bank will not directly lend to or invest in businesses nor use taxpayers' funds to prop-up businesses with little chance of success. It will instead work with the private sector to support and increase the capacity of current channels of finance, rather than simply replace private sector provision. The Business Bank's programmes have already started operating with £300m of funding allocated in April 2013 to encourage new entrants and the growth of smaller lenders in the market (figure 3). However, the Bank itself is not expected to become a fully operational new institution until Autumn 2014 due to state aid rules.

Whilst many of the interview respondents welcomed the creation of the Business Bank, a number of them raised concerns, given the way business activity since the recession has been focused in the South East of the UK, that the poorer regions such as Wales would not get the investment required to boost the SME sector on the basis of the usual 'first come, first served' approach. This is reflected in the analysis in the previous section, which showed that Welsh firms were not getting as much access to UK Government programmes as they should. The Institute for Public Policy Research raised similar concerns in their recent examination of strategies for local authorities to promote investment in the North of England²⁴, suggesting that any national business or investment bank must respond to the different regional economic contexts of parts of the UK.

23 Department for Business, Innovation and Skills (2013) *Building the Business Bank – strategy update*, March.

24 Cox, E. and Schmuecker, K. (2013) *Beyond banks and big governments – strategies for local authorities to promote investment*, Northern Economic Futures Commission, Institute for Public Policy Research, March 2013

Figure 3: The development of the Business Bank 2014-2014 (Source: BIS 2013)



Recommendation

Welsh Government needs to ensure that Wales, and Welsh businesses, gets its fair share of funding from the new Business Bank given concerns that the funding will not be distributed regionally across the UK and may be concentrated in the more prosperous areas of the UK.

Welsh Government

Since devolution in 1999, the Welsh Government has had formal responsibility for most aspects of economic development. During the last fourteen years, a number of strategies have been written to provide direction and purpose to activities to support Welsh business including “A Winning Wales” (2002), “Wales: A Vibrant Economy” (2005) and “Economic Renewal: A New Direction” (2010). These have been supplemented by other more specific strategies such as the Entrepreneurship Action Plan (1999), the Innovation Action Plan (2002), the Skills and Employment Action Plan (2002) and the Wales Spatial Plan (2004). The centralisation of economic and business support, through the abolition of the Welsh Development Agency and Wales Tourist Board in 2006, ensured that all business and financial support was to be co-ordinated and largely delivered through the Welsh Government. In addition, there have been various reviews of support for business that have been undertaken, starting with the Driscoll review in 2001²⁵. These have resulted in delivery bodies such as Business Connect, Business Eye, Flexible Business Solutions and, most recently, Business Wales. Direct grant support has also been reorganised several times over the last fourteen years. For example, a Single Investment Fund was created in 2007 to replace the main capital schemes used at that time by the Welsh Government (including Regional Selective Assistance, Assembly Investment Grant,

25 National Assembly for Wales (2001) *Economic Development Committee: Review of Business Support and Development Services*, 31 January 2001

SMART Cymru, Property Development Grant, Business Property Improvement Grant, Tourism Grants and Environmental Goods and Services support). However, three years later, the Economic Renewal Programme²⁶ removed direct grant aid to most firms only to have it partly restored again in 2011 through the creation of the Economic Growth Fund²⁷.

This report is not meant to focus specifically on business support, although given that the aim is to ensure that Welsh businesses maximise their chances of securing funding from existing sources, the recommendations will refer to elements of that function within the Welsh Government. However, it is worth noting that the Welsh Government has a number of business funding programmes which operate alongside private investment (table 3) and which have the potential to fill these 'funding gaps'²⁸. This funding is only deployed as 'funding of last resort' and available after private sector sources have been exhausted. It is also only applicable where "additionality" is proven – i.e. a project, without Welsh Government funding, would either not go ahead, go ahead on a reduced basis or its completion is delayed. Welsh Government will only provide the minimum funding necessary and all applications are subject to Welsh Government due diligence to ensure a sensible delivery risk, value for money and compliance with state aid regulations.

Support is also prioritised to eligible businesses within priority sectors, namely Advanced Materials and Manufacturing; Creative Industries; Construction; Energy and Environment; Financial and Professional Services; Food and Farming; ICT; Life Sciences and Tourism. Consideration is also given to strategically important projects outside of the priority sectors and to 'anchor businesses' i.e. those companies that are significant global or international players, have headquarters or a large corporate presence in Wales or provide significant employment within a particular region or sector.

Relationship between Welsh Government and the banking community

During the interviews, a number of respondents noted the fact that there was very little regular discussion between the Welsh Government and the high street banks at all levels. This is despite the fact that one is responsible for all business support for SMEs in Wales and the other is responsible for the majority of funding to the SME sector. Whilst there was some interaction on the ground between the banks and enterprise agencies, this was not widespread. One business support agency noted that banks did not engage early enough with them in terms of support for start-ups which, as research has shown, are the most likely to be turned down for loans and overdrafts.

A potential option would be for all businesses that have been turned down by the bank for a loan to go on a specific "Access to Finance" course to address the key concerns raised by the bank in refusing the funding. This could be managed at a local level in a partnership between the banking sector and Business Wales with banks referring any loan applications that look as if they need support to either intermediaries, such as accountants, and the organisations that deliver Welsh Government business support. In addition, research does suggest that there is a supply side issue in terms of businesses

26 Welsh Assembly Government (2010) *Economic Renewal: A New Direction*, July 2010, <http://wales.gov.uk/docs/det/report/100705anewdirectionen.pdf>

27 "Edwina Hart announces new £55m funding to stimulate Welsh economy", 15th Nov 2011, <http://wales.gov.uk/newsroom/businessandecconomy/2011/111116funding/?lang=en>

28 Welsh Government (2013) *Guide to Welsh Government Business Funding Programmes*

Table 3: Summary of Welsh Government Business Funding Programmes

Programme	Eligible Sectors	What it is	Maximum Funding	Minimum Funding	Maximum Intervention Rates
Repayable Business Finance (RBF)	9 priority sectors; strategic projects outside of priority sectors; and 'Anchor firms'	Major programme to fund projects delivering job creation.	£Ms+	£10,001	From 10% to 50%, subject to geography and business size
Processing and Marketing Grant Scheme	Food and Farming	Capital investment grant scheme to provides assistance for projects that add value to agricultural and forestry products	£1,000,000+	£500	From 20% to 50%, subject to geography and business size
Tourism Investment Support Scheme (TISS)	Tourism	Scheme for tourism businesses of all sizes (SMEs and large), undertaking capital investment	£500,000	£5,000	25% is guideline intervention. Will consider up to 50%, subject to geography and business size
SMARTCymru – Research, Development and Innovation	All*	Programme to support technologically innovative research and development of new products and processes with commercial potential	£200,000 – higher if world-leading R&D and huge market potential	£5,000	Variable
Enterprise Zone Business Rate Scheme	All*	Competitive grant available for SMEs in all seven Welsh Enterprise Zones (offset against business rates)	Up to £55,000 or actual business rate paid per annum	Not applicable (see max. funding definition)	Not applicable (see max. funding definition)

Programme	Eligible Sectors	What it is	Maximum Funding	Minimum Funding	Maximum Intervention Rates
Advanced Materials and Manufacturing SME Growth Fund	Advanced Materials and Manufacturing	Fund to support revenue costs in business development activity	£50,000	£1,000	50%
Digital Development Fund	Creative Industries	Fund to develop digital opportunities	£50,000	£5,000	50%
Energy and Environment SME Growth Fund	Energy and Environment	Fund to support revenue costs in business development activity	£50,000	£1,000	50%
Innovation Vouchers	All*	Programme to support innovative research and development of products and processes	£25,000	£2,000	50%
Overseas Business Development Visit Support	All*	Provides support and assistance to develop new export business in overseas markets	£10,000	£500	50%
Local Investment Fund (LIF)	All* (but subject to certain regional restrictions)	Only available in Convergence Area of Wales to support a range of capital investment projects relating to business start-up, expansion and growth	£10,000	£1,000	40%

being refused funding from a range of sources – data from the 2012 GEM Wales shows that 41.2 per cent of nascent entrepreneurs and 25.6 per cent of new businesses stated that they had been turned down for finance because they were not investor ready. There also seems to be very little appreciation of the key sectors identified by the Welsh Government. Whilst these key sectors account for over 75 per cent of the Welsh economy, the banking sector has almost no industry specialists within any of these growing sectors.

Discussions with the banking community in Wales on how the Welsh Government could work more closely with their organisations to support SMEs produced the following recommendations:

- Provide training for pre-starts and established businesses that do not have the experience or expertise required in assessing various funding options available
- Bring all information on how to access various SME funding – including Government support programmes – in one place (possibly under the Finance Wales brand). The hub/portal could provide pre-application support such as lending checklists and business plan templates and act as a clearing house for declined lending applications by effectively signposting SMEs to suitable alternative sources of finance.
- Establish better communication channels between the Welsh Government, the banks and the professional community working around SMEs.
- Provide mentoring to SMEs (for example PRIME Cymru is currently trialling different types of business support).
- Set up a small fund aimed at supporting professional due diligence costs, primarily financial but possibly at wider diligence requirements.
- Consider how to fund a gap in the provision of “microfinance” (£1k-£20k) – possibly via local CDFIs.
- Launch a scheme in Wales similar to Start Up Loans initiative operating in England and available for 18 to 30 year old applicants.
- Consider outsourcing the management of the Government funds – including finding customers, evaluating their suitability and decision-making.
- Give positive messages about the banks being “open for business”
- Bring companies and potential equity investors together through a number of targeted, sector specific ‘matchmaking’ events/roadshows in partnership with the relevant trade associations, investor bodies and others.
- Entrepreneurial relief could be enhanced to support recovery in the Business Angel market or to create direct incentives for equity investors.
- Develop tax incentives and other encouragements to promote large corporate companies investing in smaller companies.

This is a positive step forward in developing a stronger relationship between the banking community and the Welsh Government. As a number of respondents have noted, bringing the public and private sectors to work more closely together in Wales, with each understanding their role in the wider financial ecosystem, could be a model that succeeds in overcoming some of the key barriers in getting funding to SMEs.

Recommendation

Welsh Government should examine the disconnect between the business support programmes it offers and the funding supplied by the banking community in Wales. It needs to consider how it can work more closely with banks to ensure that they recognise the support available to Welsh firms and by promoting its take-up, improve the quality of business proposals and information supplied to the banking sector. This could be achieved in a number of simple ways such as having regular meetings between the banks and Welsh Government officials and encouraging the development of specialist managers and support providers in the key sectors identified by the Welsh Government.

Finance Wales

Background

The case for an enterprise development fund for SMEs in Wales was first made in the late 1990s²⁹. It concluded that there was considerable scope for a fund to improve the allocation of resources in the Welsh economy by offering a range of loans and equity based finance. This was subsequently supported in the Entrepreneurship Action Plan that proposed that the Welsh Assembly should develop an “Enterprise Development Fund for Wales which will provide a comprehensive range of funds to support the growth of SMEs in Wales”³⁰. The strategy for the European Commission Objective 1 programme for West Wales and the Valleys³¹ also emphasised the importance of financial support for SMEs. This would supply adequate financial support to viable start-ups; increase access to funding for viable existing SMEs where market failure exists; provide equity investment as well as loan finance to encourage the growth of the SME base and underpin financial support with a comprehensive management support programme offering mentoring and guidance services to SMEs.

In response, the Welsh Assembly confirmed its commitment to address this funding issue and established Finance Wales in 2001 to assist Welsh businesses to realise their true potential for innovation, growth and economic impact in the region. Its main objective to improve access to capital and commercial expertise through the provision of funds and services that would be sustainable and would meet identified gaps in entrepreneurial activity as well as funding for businesses in Wales.

Initially, Finance Wales utilised a number of funds that had been developed by the WDA including the following:

- Wales Innovation Fund to provide equity and mezzanine loans of up to a maximum deal size of £500,000 (Size: £6 million);
- Small Loan Fund to provide loans of up to £50,000, which also incorporated a Community Loan Fund to encourage community enterprises (Size: £3 million);

29 Snee, H. (2000) “The case for an Enterprise Development Fund for Wales”, Venture Capital, Vol. 2 No 4. pp.343-355.

30 Entrepreneurship Action Plan Strategy Document, March 2000

31 Objective 1 Single Programming Document 2000-2006

- UK Steel Enterprises Technology and Enterprise Fund to target high growth businesses with novel or innovative products or services (Size: £2 million);
- Wales Spin-out Fund to provide loans of up to £25,000 to potential businesses arising from the university sector in Wales. This funding was aimed at securing the establishment of spin-out businesses which can then approach a larger funding provider for financial investment (Size: £1.4 million).

The funds were to be supported by the activities of other services, operating throughout Wales, which would help to provide deal flow for the funds:

- xénos business angels network – helping SMEs to access business angels as potential investors;
- The Wales Spin-out Programme – providing a framework of support to universities including physical space, equipment and consulting services to the potential businesses targeted by the spin-out fund;
- The Venture Brokerage initiative – making consultancy support available to “near miss” SMEs who have been initially referred to finance by a funding provider;
- “Mentor Wales” – providing access for SMEs to experienced executive mentors who have been successful in business at the highest level and can provide commercial expertise.

Current funds

Since then, Finance Wales has developed a number of other funds, predominantly through accessing European Structural Funds. These include a mix of loan, mezzanine and equity funds, as well as specialist vehicles such as the Creative IP fund. Table 4 shows the details of these primary funds that have been used by Finance Wales to support SMEs in Wales with over £256 million invested in Welsh businesses. As will be discussed later, this represents just over 5 per cent of the lending that high street banks provide to Welsh SMEs, placing the role of Finance Wales in context.

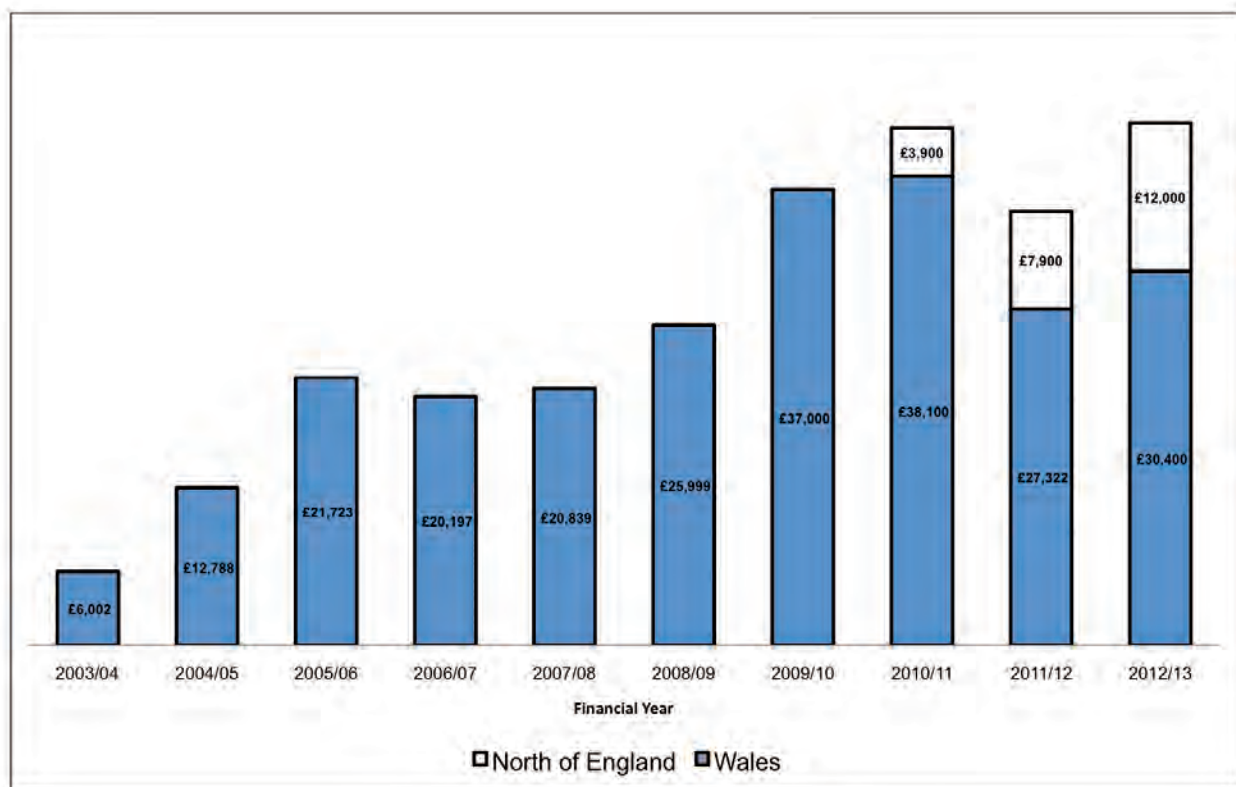
The three remaining active funds – Jeremie, Wales SME fund and the micro-loan fund – have approximately £81 million available to invest. A total of £67 million has specific provision for bad debts or has been written off, an average of 28 per cent across all funds. However, the performance of the funds has improved over time. Provisions for the Objective 1 fund managed between 2003 and 2007 was 46.4 per cent. In contrast, the Jeremie fund is currently showing provisions of only 16 per cent. As expected, the largest losses are found within the higher risk equity funds, with provisions amounting to £34.4 million (or 39 per cent of the fund). In contrast, debt funding through loans have provisions of only 14 per cent of the funds.

It is also worth noting that the average investment for Finance Wales across all the funds has been £105,865, which suggests that the focus is on the larger SME rather than the majority of small firms. The three remaining active funds – Jeremie, Wales SME fund and the micro-loan fund – have £81 million available to invest. A total of £67m has specific provision for bad debts or has been written off, an average of 28 per cent across all funds.

Table 4: Finance Wales funds

	No of firms invested	Total investment per fund	Average investment per firm
Creative IP Fund	34	£11,939,064	£351,149
Interim Fund	152	£30,222,498	£198,832
Jeremie	479	£108,262,032	£226,017
Objective 1 equity	36	£18,078,310	£502,175
Objective 1 Loan	614	£14,733,886	£23,997
Objective 1 Mezzanine	73	£10,005,806	£137,066
Objective 2 equity	13	£6,204,161	£477,243
Objective 2 LIF	94	£676,662	£7,199
Objective 2 loan Fund	111	£5,940,522	£53,518
Objective 2 mezzanine	23	£4,919,562	£213,894
Rescue and recovery	28	£4,318,724	£154,240
Small Loan Fund	487	£28,524,187	£58,571
Spin Off Fund	143	£2,744,450	£19,192
Transitional equity	1	£855,359	£855,359
Transitional LIF	41	£317,082	£7,734
Transitional loan	51	£1,886,300	£36,986
Transitional mezzanine	3	£1,080,438	£360,146
Micro business loan fund	26	£388,530	£14,943
Wales SME Fund	18	£5,836,366	£324,243

Figure 4: Finance Wales Investments, 2003-2013 (£ million)



However, the performance of the funds has improved over time. Provisions for the Objective 1 fund managed between 2003 and 2007 was 46.4 per cent. In contrast, the Jeremie fund is currently showing provisions of only 16 per cent. As expected, the largest losses are found within the higher risk equity funds, with provisions amounting to £34.4 million (or 39 per cent of the fund). In contrast, debt funding through loans have provisions of only 14 per cent of the funds.

Whilst there have been recent complaints that the visibility of Finance Wales amongst Welsh businesses is low³², this must be taken in the context of the funds available through Finance Wales. For example, the average investment is around £106,000 per firm, which is far higher than the requirements of the vast majority of Welsh businesses. Whilst debt funds such as the Objective 1 fund have been focused on smaller businesses at an average loan size of around £25,000 per business, the latest Jeremie fund show a distinct change of strategy away from the supply of funding to the general SME population towards one that seems more targeted towards larger SMEs. In that instance, one would expect Finance Wales to work more closely with intermediaries and existing banks to develop these funding offerings rather than through any direct marketing channels to raise awareness amongst the entire Welsh SME population. However, with an average investment of £226,017 by the Jeremie Fund, this also suggests that Finance Wales has not reflected the needs of the overall SME population, especially as it is smaller and newer businesses that have the greatest difficulty in accessing funding. Whilst it may be easier to undertake a smaller number of larger investments, such a strategy does not fulfil the economic development function of Finance Wales, which is wholly owned by the Welsh Government and is in receipt of public funds. In fact, whilst some have noted the need for Finance Wales to become more self-sustainable through managing other funds in England, others have questioned whether an organisation that is wholly owned by the Welsh Government should be undertaking such tasks outside of Wales.

Therefore, whilst there may be an expectation that Finance Wales serves as a development fund for all Welsh businesses, the reality is somewhat different, despite the fact that it has reluctantly taken on the management of the recently announced micro business loan fund. This suggests that whilst Finance Wales may have its own strategic view of its place within the Welsh financial ecosystem, some politicians and business organisations do not share that view. As a result, there needs to be clarification about the role of Finance Wales going forward. If it is to be a specific fund for larger growth businesses, then the Welsh Government should let it focus on that mission whilst creating other mechanisms to support the vast majority of the Welsh SME population, usually start-ups and micro enterprises, that require smaller amounts of capital³³.

During the interviews, a number of bankers and intermediaries stated that Finance Wales had been invaluable in the period following the financial crash in 2008 and had, for a considerable number of Welsh firms, been the only source of available finance at a time when banks were withdrawing/rationing credit from businesses. Figure 4 shows that funding to SMEs from Finance Wales increased substantially after 2008 although

32 Crawley, A; Munday, M; Delbridge, R. (2012). *Small Businesses in Priority Sectors*. <http://www.fsb.org.uk/policy/rpu/wales/images/cu%20fsbw%20small%20businesses%20in%20priority%20sectors.pdf>

33 It is worth noting that the median estimate of funding required for new start-ups in Wales, according to the GEM UK data is £5,000, with 60 per cent of this provided by the entrepreneur.

there has been a drop in Wales in the period 2011-2013. In addition, some noted that this has happened at a time when Finance Wales has taken on the management of funds in the North of England. Some have also praised the quick decision-making and relationship management that exists within Finance Wales, although others were critical of their simplified approach to equity funding and a tendency to change policies without informing stakeholders.

Equity investments

A number of interviewees noted that venture capitalists based in London were generally reluctant to come to Wales to seek out new deals. Therefore, despite criticisms of the organisation, Finance Wales has begun a process by which equity investments are now being considered by owners of Welsh businesses as an alternative to debt finance. In fact, a review of the Finance Wales' various funds show that 23 per cent of the money distributed to date, equivalent to £60 million, is in the form of equity investments. Whilst the default rate has been predictably much higher across these funds than those for loans, Wales now has the makings of a government backed venture capital house investing specifically in Welsh businesses that it has previously lacked, although it may be worrying that in over half of the 'live' equity investments, the Welsh Government owns more than 25 per cent of those businesses.

Given this, is there a case to be made for spinning off the equity function away from the debt function within Finance Wales? This may be a strategic improvement in that it would enable any new equity house to consider its investments as a separate portfolio rather than as part of the overall targets of Finance Wales as an organisation. This option will be considered in more depth during the second part of the review, especially given that the Welsh Government has already commissioned a report into the potential for a Welsh equity fund in the future. In this context, it may also be worth exploring the potential for Welsh small firms to raise capital through the sale of equity on the public market³⁴.

Interest rates

Various respondents complained that Finance Wales' interest rates and additional costs were punitive, especially within an environment where the Bank of England base interest rate has been at its lowest level in history. In response to this criticism, Finance Wales noted that it had to comply with European Commission regulations that set out the minimum pricing guidelines for loans based on collateralisation (security) and company rating categories (table 5). Based on these regulations, Finance Wales has developed a matrix pricing policy and has set out the criteria for definitions of levels of collateral/security, as well as risk categorisations. According to Finance Wales, most of the businesses that it would invest in would be classified as bad/financial difficulties according to the European Commission ratings and therefore their interest rates reflect the riskiness of transactions of this type of SME.

In addition, Finance Wales' interest rates are fixed for the lifetime of the loan to individual SMEs and therefore there is a need to factor in base rate changes over the life of the loan. It is also worth putting the rates into context by considering the default rate assumptions that underlie the Jeremie model agreed with the European Investment

34 Huggins, R. and Prokop, D. (2010) *Regional Systems of Equity Finance: The Case for a Wales Stock Exchange*, Report to the Welsh Assembly Government, Cardiff

Bank (which provides the funds to Jeremie) as it assumes a base case in which loans and mezzanine investment default rates range between 20-28 per cent over the life of the fund. Whilst Finance Wales has accessed its funds from different sources, including the European Investment Bank, European Commission and the Welsh Government, it actually applies one pricing policy for all funds under management to ensure price consistency and compliance with State Aid regulations. Finance Wales' also argue that in setting its interest rates, it must ensure that it does not displace any private sector lending.

Table 5: Finance Wales interest rates vs. effective EC interest rates based on EC regulations.

	High collateralisation & satisfactory rating		Normal collateralisation & weak rating		Low collateralisation & bad rating	
	Effective interest rates based on EC regulations	FW pricing guidelines	Effective interest rates based on EC regulations	FW pricing guidelines	Effective interest rates based on EC regulations	FW pricing guidelines
01/07/2008	6.66	7.50	9.66	10.00	15.66	16.00
01/01/2009	6.70	7.00	9.70	9.00	15.70	12.50
01/02/2009	5.81	7.00	8.81	9.00	14.81	12.50
01/03/2009	4.58	7.00	7.58	9.00	13.58	12.50
01/04/2009	3.84	7.00	6.84	9.00	12.84	12.50
01/06/2009	3.20	7.00	6.20	9.00	12.20	12.50
01/08/2009	2.85	7.00	5.85	9.00	11.85	12.50
01/10/2009	2.53	7.00	5.53	9.00	11.53	12.50
01/12/2009	2.20	7.00	5.20	9.00	11.20	12.50
01/01/2010	2.16	7.00	5.16	9.00	11.16	12.50
01/07/2010	2.35	7.00	5.35	9.00	11.35	12.50
01/01/2011	2.48	7.00	5.48	9.00	11.48	12.50
01/01/2012	2.74	7.00	5.74	9.00	11.74	12.50
01/01/2013	2.19	8.00	5.19	10.00	11.19	12.00
01/04/2013	1.99	8.00	4.99	10.00	10.99	12.00

This does not explain why its interest rates remain well above what is currently being offered by the high street banks and why Welsh Government funding is being used to fund extremely high interest rate loans for Welsh SMEs. In fact, as the FSB has indicated³⁵, over half of SMEs are reporting interest rates of less than five per cent. Also, the interview with UKSE (UK Steel Enterprises) showed that they were offering unsecured loans at a range of between 5-8 per cent, below the lowest rate offered by Finance Wales. One respondent noted that a business they had been working with had been offered a loan that was secured on property with a debenture on debtors. In addition, there was a two per cent set-up charge on the loan and an annual 1 per cent management fee. There was also the need for personal guarantees from the directors on

35 FSB (2013) *FSB Voice of Small Business Index: Q1 2013* <http://www.fsb.org.uk/frontpage/assets/q1%20vosb.pdf>

that loan. The question is whether such conditions are normal practice for Finance Wales investments that would make them more onerous than some banks in Wales.

There is also the issue of what constitutes breach of state aid. As the section on current banking practice will show, small businesses are being turned down for lending by banks for reasons such as collateral, affordability, perceived risk and sectors. In such circumstances, Finance Wales would be compliant with state aid rules as they would not be competing with other providers because they are essentially out of the market by refusing to provide the funding. As a result, Finance Wales must revisit its state aid regulations to examine whether there can be greater flexibility in its approach to interest rates, especially given evidence that 'state-owned banks' tend to charge lower interest rates than privately owned banks³⁶. This does not mean that it should be offering artificially low rates to businesses but, at the same time, a publicly funded bank should be offering interest rates on loans to SMEs in Wales that are well above the average being offered to businesses by the high street banks.

The future

Therefore, there remains confusion about the exact role of Finance Wales. Is it an economic development arm of its 100 per cent shareholder (the Welsh Government) or is it a commercial funding organisation? Should it be focused on supplying finance to growth firms only or should it, as has recently happened, take on quite diverse funds such as the £100m Wales Life Sciences Investment fund, the £6m Wales Micro-Business Loan fund launched and the £10m Property Development fund secured. Given that a number of organisations have already called for the development of a publicly owned bank in Wales for SMEs, it could be argued that organisation is already in place in the shape of Finance Wales if some key changes could be made to its mission. On the other hand, should it focus on being the provider of capital to growth companies only as part of a wider financial ecosystem in Wales? There will be a greater examination on the role of Finance Wales during the second phase of the review given its important role in ensuring that there is adequate funding available to Welsh SMEs, especially in comparing its performance and management with other similar organisations in Europe and elsewhere.

Recommendation

As the sole shareholder, Welsh Government needs to determine the future strategic direction of Finance Wales and, more importantly, the role it should play in the future financial landscape for Welsh business alongside other providers.

36 Sapienza, P (2004) The effects of government ownership on bank lending, *Journal of Financial Economics*, Vol 72., pp.357-384.

The Banking Sector

SMEs and the banking sector

As various studies have shown, banks remain the primary source of external funding to the SME sector in the UK. This is despite the fact that many SMEs are disadvantaged, because of their nature, when it comes to accessing funding from such financial providers for a number of reasons³⁷.

First of all, SMEs are perceived as being more risky than large firms. This is so for a variety of reasons including lower levels of collateral available for security and lower monitoring/reporting requirements that lead to a lack of information on the business. This has a number of consequences in lending practices, especially for younger smaller firms that due to their shorter credit histories may be perceived as having a high-risk profile. In a situation where banks are being forced to boost their regulatory capital requirements they may be reluctant to accept credit risk with such businesses. This can lead to expensive short-term debt funding for such businesses or, in a growing number of cases, outright rejection. In fact, a number of the interview respondents have suggested that the owner managers of SMEs in Wales were being asked to provide higher levels of collateral, with guarantees becoming increasingly important in securing bank lending. It has also been noted that banks were asking for more information before they make a credit decision requiring more documentation on factors such as cashflow information, collateral, audited accounts and customer history. These factors are assuming greater significance in influencing credit decisions, together with other key industry trends³⁸.

In terms of collateral required for smaller firms, this is best encapsulated by a comment from one of the accountants interviewed who noted, *“For small deals, banks want everything – charges, debentures, personal guarantee for double the amount they are in for, supported personal guarantee – simply because the level of risk they would prefer to take is negligible”*. In addition, a number of respondents noted that as many loans had been secured on property, the fall in commercial values since 2008 has meant that Wales is disadvantaged as compared to other more prosperous parts of the UK, such as the South East of England, where property prices have remained steady, if not grown during this time.

Another key issue faced by many small firms is the growing importance of credit ratings used by banks as an important determinant of whether an individual or a company will get a loan or overdraft. In fact, there is a far greater weighting being placed by banks on credit scoring, particularly for small firms where behavioural scoring is used as the main proxy as to whether an individual gets his or her business funded, rather than the business plan. As many respondents have noted, this is becoming a major barrier for newer and younger businesses in accessing funding and whilst the banks consider the system to be a reliable credit worthiness assessment tool, the data collected as part of the Appeals Process established in 2011, as will be discussed later, show that a high proportion of SMEs that apply for funding and have been turned down get their rejection overturned on appeal.

37 *SME financing, market innovation and regulation*, Speech by Benoît Cœuré, Member of the Executive Board of the ECB, Eurofi High Level Seminar organised in association with the Irish Presidency of the Council of the EU, Contribution to plenary Session 11: Challenges and feasibility of diversifying the financing of EU corporates and SMEs, Dublin, 11 April 2013

38 IFAC/the Banker Survey (2009) *Advancing with Caution: SME lending Supplement*

Finally, there is increasing evidence that despite being rejected by their own banks, SMEs are often unable to switch from bank credit to other sources of external finance. For example, a recent report noted that despite the issues over charges, lending terms and complaints, few SMEs actively look around for alternative banking suppliers with three quarters of those surveyed rarely searching for a better provider, and whilst 15 per cent had tried to switch provider in the past two years but only 8 per cent had succeeded³⁹.

Changes In Bank Lending Since 2008

Environment for SME lending

It is generally accepted that, following the financial crisis of 2008, it has become an increasingly difficult environment for SMEs to access finance, despite the fact that banks still insist that this is down to a lack of demand rather than lack of credit. However, an increasing number of studies show that not only has funding become more difficult to access, but has also become relatively more expensive, despite the fall in interest rates. For example, a study by Fraser⁴⁰ demonstrated that the principal effect of the financial crisis had been to reduce the availability of bank debt and increase its cost for both loans and overdrafts. This finding was supported by the Bank of England⁴¹ which suggested that indicative data on loans to SMEs, available from late 2008 onwards, point to a rise in interest rate spreads for some borrowers and that margins over the banks' own base rates for overdrafts in 2008 were significantly higher than they had been in earlier years (although UK plc as a whole did a higher risk profile in 2009 than it did pre crash in 2007).

In Wales, recent research from the FSB found that, across firms in the key sectors of the Welsh economy, nearly half had seen their interest payments on borrowings over the course of the last year increase during the last year with only 6.1 per cent seeing a decrease⁴². In addition, it was noted during the interviews that a number of banks have been revisiting their existing loan books and found reasons to renegotiate the terms of the original agreement, usually resulting in higher rates and a shorter term loan.

A paper from the UK Government's Department of Business Skills and Innovation⁴³ which examined changes in bank lending over the last decade showed that, even allowing for risk factors, rejection rates for overdrafts and loans were significantly higher from 2008-09 onwards, including for those firms with low or average risk ratings. The study also showed that margins for both business loans and overdrafts were also significantly higher, a finding that was also supported by NESTA⁴⁴. In fact, the banks, mainly due to Basle III

39 YouGov/SixthSense (2012) *SME Banking Report*

40 Fraser, S. (2012) *The Impact of the financial crisis on bank lending to SMEs – Econometric Analysis from the UK Survey of SME Finances*, Department for Business Innovation and Skills, July, 2012

41 Bell, V. and Young, G. (2010) *Understanding the weakness of bank lending*, Bank of England Quarterly Bulletin, Q4, pp.311-320

42 Crawley, A., Munday, M., Delbridge, R. (2012) *Small Businesses in Priority Sectors* <http://www.fsb.org.uk/policy/rpu/wales/images/cu%20fsbw%20small%20businesses%20in%20priority%20sectors.pdf>

43 Department of Business Skills and Innovation (2013) *Evaluating changes in bank lending to UK SMEs over 2001-12 – ongoing tight credit. Econometric analyses using data from the UK Survey of SME Finances and the SME Finance Monitor*, April 2013

44 Davis, A. (2011) *Beyond the Banks: Innovative ways to finance Britain's small businesses*, Research summary: September 2011

perceptions of risk, have less capital in the short term and are encouraging SMEs to move away from using overdrafts towards more costly and possibly inappropriate alternatives such as invoice discounting⁴⁵. Even the Governor of the Bank of England, in evidence to the House of Commons Treasury Committee in 2011, admitted that SMEs were still under great pressure: *"I think there is no doubt that anyone who goes round the country and meets small to medium-sized businesses meets a lot of people who feel that they have been denied access to credit. I just find it very, very hard not to go round the country and get that impression [...] credit conditions have improved for bigger companies, but there's no real sign that they've improved for small to medium-sized companies. I can understand why people running those companies still feel under great pressure"*⁴⁶.

Competition

To an extent, part of the issue is the lack of competition for bank lending to SMEs in the UK, which has been exacerbated by the withdrawal of various foreign banks from the market since 2008⁴⁷, and has recently prompted a major review by the House of Commons Treasury Committee. In Wales, the withdrawal of commercial banks such as Clydesdale⁴⁸ has prompted concern that there is increased concentration within what is seen as a peripheral market for high street banks, with more alternatives being available to firms located in more prosperous areas such as the South East of England. Currently, it is estimated that the five big banks in the UK (Barclays, HSBC, Lloyds, RBS and Santander) have over 85 per cent of the business banking market⁴⁹ and given the recent collapse of the Co-Operative Group deal to purchase 600 branches from Lloyds⁵⁰, the likelihood of a mid-sized challenger being created in the near future is unlikely although there is increased interest in the growing role of the Swedish Bank Handelsbanken, with its localised approach, as a supplier of capital to the SME sector in Wales⁵¹, although as the average loan size in Wales is between £500k and £5 million, it is not generally aimed at the micro enterprise or start up market. Recently, the Chancellor of the Exchequer has asked the Office of Fair Trading to consider what more can be done to foster competition in providing banking to small businesses.

45 Financial Times (2013) Alternative funding grows as UK companies struggle for finance, May 19th <http://www.ft.com/cms/s/0/13714bb6-be3b-11e2-bb35-00144feab7de.html#axzz2Vx7mE9tj>

46 House of Commons Treasury Committee (2011) Competition and choice in retail banking, Ninth Report of Session 2010–11 Volume I, 24th March 2011.

47 BIS (2012) SME Access to External Finance, BIS Economics Paper No. 16, January 2012

48 Western Mail, "Clydesdale 'still committed to Wales' as office shuts" 10th July 2009.

49 Financial Times (2013) Rivals sought for big five banks, May 30th <http://www.ft.com/cms/s/0/ff25bf24-c944-11e2-bb56-00144feab7de.html#axzz2VeLb7znT>

50 BBC (2013) Lloyds branch sale to Co-op falls through, 24th April, <http://www.bbc.co.uk/news/business-22276082>

51 Various studies emphasise that concentration may not be a good indication of competitive behaviour, although even this literature suggests that very high levels of concentration need to be investigated thoroughly from a structural and cost/ pricing perspective. This is because the potential for collusion (implicit and explicit) is high. See 'Competitive Conditions in European Banking' *Journal of Banking and Finance*, May 1994, 18, 3, 445-460 by P. Molyneux, M. Lloyd Williams and J. Thornton; and also 'Cross-Country Comparisons of Competition and Pricing Power in European Banking', *Journal of International Money and Finance*, 28, 1, February 2009, 115-134. (by S. Carbó, D. Humphrey, J. Maudos and P. Molyneux)

Non-bank commercial lending

It has been suggested in discussions with various intermediaries that one of the issues in terms of competition is the lack of awareness of alternative sources of finance by SMEs in the UK. One of the key organisations in accessing commercial funding is the National Association of Commercial Finance Brokers (NACFB). Founded in 1992 to establish measurable standards of proper professional practice in sourcing commercial funding, its main objective is the regulation of the commercial finance industry and it assists the wider SME market to find funding for their business. As a result, it has established contacts with all SME groups and have a number of different commercial finance lenders specialising in commercial mortgages, leasing and asset finance, factoring and invoice discounting, vehicle finance and development finance.

In 2011-12, it is estimated that NACFB members were responsible for £9 billion of lending in these areas. NACFB currently has over 1000 finance brokers, of which twenty-nine are based in Wales. It also has ninety five different providers of funding which are available for use by the business community which includes the main banks but also a range of other funds. The role that finance brokers and the funds they can access could play in a more coherent financial ecosystem for SMEs in Wales will form an important part of the second part of this review. A key issue raised by respondents during the review, including the chief executive of NACFB, was the lack of a single portal where businesses can find out more about funding quickly and easily. Whilst the UK Government has established a simple portal for information⁵², this does not operate in the same way as consumer orientated websites such as moneysupermarket.com, confused.com and gocompare.com (all of which are, incidentally, run by Welsh companies). Therefore, there may be an opportunity here for the Welsh Government to examine, in partnership with one of these providers, whether such a portal, based on the existing offerings to consumers, could be set up for businesses in Wales.

Recommendation

Welsh Government should examine how it can help facilitate better access to the wide range of commercial lending opportunities that are available to SMEs through non-bank lending channels. This could be achieved through partnership with organisations such as the NACFB and the development of a specific commercial portal on lending for SMEs.

The impact of BASEL III on SME lending

During the interviews, a number of respondents suggested that the chief cause of the problems in lending to SMEs did not originate directly from the banks themselves but from the Basel III agreement that has been developed by the Basel Committee on banking supervision. The aim of this agreement is laudable, namely to raise the capital reserves of banks in order to avoid any future financial crisis as happened in 2008-9. However, the unintended consequence of this action has been a limiting of credit to SMEs as banks are forced to hold more money on their balance sheet thus reducing their capacity to lend to businesses. In addition, loans to SMEs are assigned a higher risk weighting which means that, over time, loans will become more expensive⁵³. Given that SMEs are the engines

52 <https://www.gov.uk/business-finance-support-finder>

53 ACCA (2012) *Basel III and SMEs: getting the trade-off right*, ACCA, London

that drive economic growth following a recession, this restriction in the ability of banks to lend to the business community is having a major dampening effect on recovery. As the ACCA has noted⁵⁴, it has been disappointing that there has been no high profile discussion on the way that Basel III is affecting the SME sector. It is generally accepted that it was not lending to the SME sector that caused the problems during the financial crash of 2008 and yet, due to the way that Basel III has been constituted, SMEs are the one part of the economy that is being hit the hardest as a result of this decision.

Recommendation

Welsh Government should raise the issue of the detrimental effect of Basel III rules on SME lending directly with the UK Treasury and BIS. This will enable the UK Government to make representations directly to the Basel Committee on Banking Supervision to recommend that SME lending should be excluded from consideration in terms of determining suitable capital and liquidity within the banking system.

Bank Lending In The UK

Much of the focus when considering access to capital by SMEs has been on the banking sector. Yet, increasing evidence shows that small businesses are not as dependent on banks as is commonly thought. For example, as the BBA recently noted⁵⁵, SMEs have £125.9 billion on deposit, up from £119.2 billion a year earlier, an increase of 5.6 per cent. Smaller businesses have built up deposits even faster – a 7.8 per cent increase from £56.1 billion to £60.5 billion over the same period.

In addition, the SME Monitor⁵⁶ reported that in Q1 2013, only 39 per cent of SMEs were used external finance (loans, overdrafts, credit cards), the lowest level since this study began in 2011. In fact, 41 per cent of all SMEs met the definition of a “Permanent non-borrower”, expressing no interest in external finance, with only 32 per cent now using any of the core bank products (overdraft, loan or credit card), a fall of 8 per cent since the first quarter of 2012.

Nevertheless, for those firms that do look for external capital to grow their businesses, banks are still the main provider of finance. And, as NESTA⁵⁷ has suggested, whilst only 6 per cent of companies are growing and are therefore looking for funding to fuel this growth, they create over half of the jobs in the economy. Given this, one cannot simply dismiss the role of banks. In fact, it is not the number of small businesses they support which is important, but which small businesses are given the funding to grow.

In terms of loans to businesses, the latest available data available shows that, in terms of gross lending, a total of £312.4 billion has been lent to all non-financial businesses in the UK since May 2011⁵⁸ (Figure 5). Of this, only 26 per cent (£82.4 billion) has been lent

54 ACCA (2011) *Framing the debate: Basel III and SMEs*, ACCA: London.

55 Anthony Browne “The real SME lending story isn’t so gloomy”, BBA, 07/06/2013, <http://www.bba.org.uk/blog/article/the-real-sme-lending-story-isnt-so-gloomy>

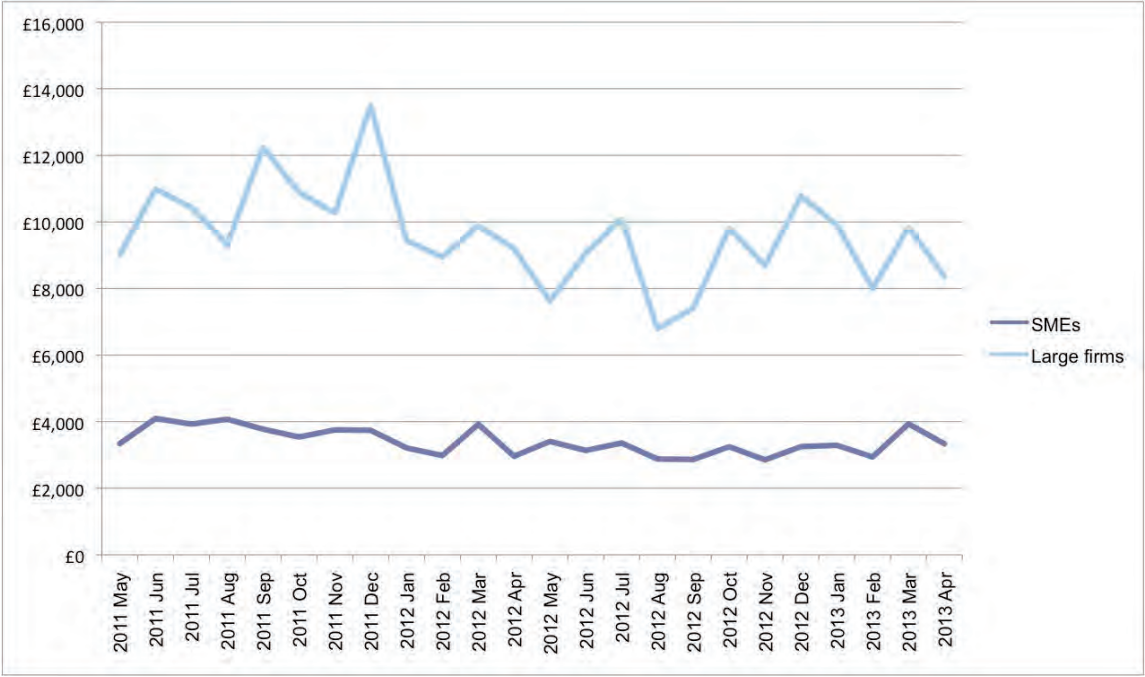
56 BDRC Continental (2013) *SME Monitor, 2012 Q4 report*, March

57 NESTA. (2009) *The vital 6 per cent. How high growth innovative businesses generate prosperity and jobs*. NESTA, London.

58 Bank of England Statistics on monetary financial institutions loans to non-financial businesses, by size of business, 2011-2013. <http://www.bankofengland.co.uk/statistics/Pages/bankstats/current/default.aspx>

to SMEs⁵⁹ although net lending, after repayments, for UK SMEs has gone down by £9.6 billion, suggesting either a lack of appetite by firms or, as other evidence suggests, a lack of credit being made available to smaller businesses. There is a total of £435 billion of fixed term loans outstanding to the banks from non-financial business in the UK as of April 2013. SMEs account for 36.4 per cent (£158 billion) of this amount.

Figure 5: Gross lending (excluding overdrafts) to non-financial businesses (£M), 2011-2013⁶⁰



The other main form of debt funding from banks to SMEs is via an overdraft. An overdraft is a short-term loan that banks grant customers, giving them the right to overdraw their bank account by an agreed amount and it is normally repayable on demand. There has been a steady decline in the use of overdrafts by small businesses over the last two decades – according to the ACCA⁶¹, overdrafts as a proportion of all lending to SMEs had fallen from 58 per cent in 1991 to 17 per cent in 2008. Given the pressures being applied through Basel III, it is likely to fall further over the next few years. There is a total of £34.5 billion of overdrafts to UK businesses, with SMEs accounting for 45 per cent (or £15.5 billion) of this amount.

Therefore in terms of total loans and overdrafts, SMEs owe a total of £174 billion or 37 per cent of all lending to businesses in the UK. Many outside the financial communities would be surprised at this low proportion of lending from banks to SMEs. Whilst SMEs make up the majority of businesses in the UK, they are not well served in terms of loans and overdraft lending by current banks compared to larger firms.

However, it is not only in terms of supply of lending that SMEs are disadvantaged but also in the terms of the cost of lending, especially smaller businesses. According to the

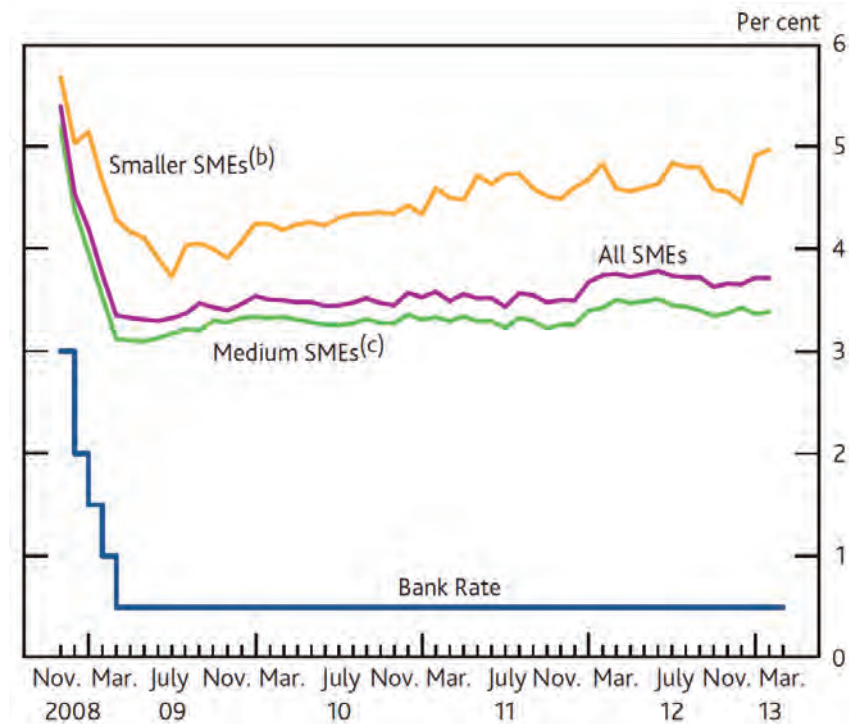
59 SMEs are those businesses with annual debit account turnover on the main business account less than £25 million; large businesses are those with annual debit account turnover on the main business account over £25 million.

60 SMEs are those businesses with annual debit account turnover on the main business account less than £25 million.

61 ACCA (2008) *Financing SMEs in the recession*, Policy briefing paper, October 2008

latest report on trends in lending from the Bank of England⁶², there has been a small reduction in total borrowing costs for large firms in the past twelve months due to lower interest rates. The net balances of small and medium-sized firms indicated some increase in costs over the same period and there is a considerable difference between the cost of borrowed money to small firms with less than a £1 million turnover and other businesses (Figure 6).

Figure 6: Indicative median interest rates on new SME variable-rate facilities, 2008-2013⁶³



Lending appeals procedure

If a business is declined lending following a formal application for a loan, it has the right to appeal the decision. This is because Britain's largest banks have agreed a new set of principles for appeals that are monitored and scrutinised by an independent and external team of reviewers, ensuring that the banks have implemented a fair, prompt and transparent appeals process. Since the inception of the Appeals Process in April 2011, the banks have received almost 5,500 appeals of which 39 per cent have been overturned in favour of the customer.

However, according to the SME Monitor⁶⁴, awareness of the appeals process amongst those declined remains low with only 15 per cent of those declined for an overdraft and 9 per cent of those declined for a loan said they were made aware of the appeals process by their bank. Very few of those aware of the process actually appealed, others stated a lack of time and a feeling that it would not change anything as their reasons

62 Bank Of England (2013) *Trends in Lending*, April

63 This is the median by value of new SME facilities priced at margins over base rates, by four major UK lenders (Barclays, HSBC, Lloyds Banking Group and Royal Bank of Scotland). Data cover lending in both sterling and foreign currency, expressed in sterling (b) Smaller SMEs are those with annual debit account turnover on the main business account less than £1 million. (c) Medium SMEs are those with annual debit account turnover on the main business account between £1 million and £25 million.

64 BDRG Continental (2013) *SME Monitor*, 2013 Q1 report, May

for not doing so. This suggests that the banks need to do more not only to explain their decisions to customers and therefore enable them to improve their applications in the future, but to also ensure that customers are fully aware of the appeals procedure.

Detailed case data on a regional basis is only collected on those appeals which have been reviewed and the case selection is predominantly skewed towards reviewing those cases overturned in favour of the customer so that there is a better understanding of the reasons for overturns and whether any process improvements may be appropriate. In those cases, 46 per cent of the appeals were overturned in favour of the customer in Wales, suggesting that the banks' use of credit scoring is not as infallible as presented by banking representatives during their respective review interviews.

Bank Lending SMEs in Wales

Lack of bank lending data

During this review, it has been disappointing that, despite numerous requests to the BBA and various banks for detailed information on lending to SMEs in Wales, this information has not been forthcoming. The explanation provided is that banks in the UK are no longer organised on a geographical regional basis and that it would be difficult to collect the information as a result of this. This is despite the fact that aggregated data from the banks, including a regional component, is supplied by the banks to the BBA on a monthly basis and that the banks themselves have spent tens of millions of pounds individually on customer relationship management systems that could give detailed information, by region, on bank lending. The same is true of other bodies that have only supplied information to this review after considerable pressure or, in a number of instances, do not collect regional information at all. The recent review of finance in Northern Ireland made the same point⁶⁵, namely that *"trends in lending to businesses in Northern Ireland specifically have been difficult to establish"* with the BBA *"only agreeing to provide the EAG with the most recent regional lending statistics on the proviso that the data would not be disclosed or published"*.

There has been considerable debate within the House of Lords over this matter *"with a call for the Financial Conduct Authority to require each holder of a banking licence to publish relevant data on a quarterly basis by post code, including the total amount of lending to small and medium sized enterprises"*⁶⁶. Since then, the UK Government has committed to work with the banking industry to get it to make a voluntary commitment to publication of this data. Nevertheless, this review has shown that the banks and the BBA have been generally unwilling to co-operate on this matter, providing only limited data that is already publicly available on their websites. After fourteen years of devolution, there is simply no excuse for detailed information on bank lending not to be collected and made available on a regional basis for use by policy-makers within the three devolved administrations. It is also unacceptable that government bodies such as UK Export Finance are unable to provide data on their support for Welsh firms. The Scottish, Northern Ireland and Welsh Governments should also begin discussions with other membership and trade bodies to ensure that regional data can be generated through their statistics departments.

65 EAG (2013) *Review of access to finance for NI businesses*. Belfast, March 2013.

66 Hansard Vol No 740, part 65, Financial Services Bill Report (2nd Day), 12th Nov 2012.

Recommendation

This review has shown that there is a lack of regional data, especially for Wales, as a devolved nation. If policymaking within the Welsh Government is to be based on evidence, then it is critical that UK organisations in both the public and private sector are made fully aware of the implications of devolution and the need for accurate data being collected at a regional level.

British Bankers Association (BBA) data

As stated above, the BBA does publish limited regional data on a quarterly basis, although this information only dates back to the third quarter of 2011. The latest data⁶⁷ shows the following:

- Current value of the loan book in Wales at the end of 2012 was £4.285 billion with an overdraft balance of £623 million. This represents 5 per cent of the total UK lending by banks (loans and overdrafts) to SMEs. 87.3 per cent of all banking in lending in Wales is in the form of loans, slightly lower than the UK (88.4 per cent).
- A total of 11,250 of loan facilities were approved for Welsh SMEs in 2012, representing 7.0 per cent of the number approved in the UK. Their value of £891 million represented 4.6 per cent of loan facilities in the UK in 2012. The average loan for SMEs was £79,190, the lowest of any UK region (table 6) with an average loan of £62,322 for small firms and £185,242 for medium-sized firms;
- A total of 17,176 overdraft facilities were approved for Welsh SMEs in 2012, representing 7 per cent of the number approved in the UK. Their value of £300 million represented 5.6 per cent of the UK level. The average overdraft for SMEs was £17,017, the lowest of any UK region with an average overdraft of £12,782 for small firms and £61,284 for medium-sized firms.

The fact that the average loan for businesses with a turnover of less than £1 million (i.e. small firms according to banking definitions) is relatively high suggests that micro enterprises may not be getting access to the smaller loans they require. This limited data supports many of the comments from interviewees in the review, namely that whilst bank funding is available to businesses in Wales, this is only for businesses of a certain size and that many newer and smaller businesses are being starved of funding. This supposition seems to be supported by table 7, which examines the change in borrowing in Wales over time as compared to the rest of the UK.

Overall, the comparison shows that the amount of loans and overdrafts to SMEs in Wales has actually increased by £72 million (or 1.5 per cent) between quarter 4 of 2011 and quarter 4 of 2012. In contrast, lending to SMEs at a UK level has decreased by £5 billion, a fall of 4.8 per cent. However, if we examine the data closely, we see that there is a considerable difference in the lending profile of small firms (with a turnover less than £1 million) and medium-sized firms in Wales. In fact, whilst medium sized firms in the UK are facing difficulties in accessing finance, the number of loans to this size of firm in Wales has increased by 10.7 per cent over this period. In contrast, there has been a decline of £175m in the value of bank loan balances to small Welsh firms, which is the

⁶⁷ British Bankers' Association (2013) Banks' support for SMEs – Quarter 4 2012 <http://www.bba.org.uk/statistics/article/banks-support-for-smes-quarter-4-2012/small-business/>

Table 6: Value and number of bank loans and overdrafts for SMEs, by region, 2012

	Value of overdrawn balances	No. of overdraft facilities approved	Value of overdraft facilities approved	Value of loan balances	No. of loan facilities approved	Value of loan facilities approved
	£mn		£mn	£mn		£mn
London	1,316	35,898	748	18,496	23,575	4,029
SE England	1,345	31,172	642	11,979	16,849	2,229
SW England	1,396	30,906	703	9,832	20,265	2,391
East Midlands	693	14,235	382	4,965	10,179	1,279
West Midlands	1,045	21,326	431	7,657	12,814	1,357
East of England	926	22,629	496	6,563	15,460	1,800
Yorks/Humber	973	17,802	437	5,983	10,483	1,351
NE England	316	12,323	218	2,690	9,017	782
NW England	1,326	21,414	466	9,345	15,324	1,729
Wales	623	17,197	293	4,285	11,250	891
Scotland	1,536	19,739	512	5,776	10,792	1,389
UK	11,495	244,640	5,329	87,571	156,008	19,226

Table 7: Change in loan book and overdraft balances, Wales UK, 2011-12

	£M	% change 2011-12
All SMEs		
Change in loan book 2011-2012 Wales	£43	1.0%
Change in overdrawn balances Wales	£27	4.7%
Change in loan book 2011-2012 UK	-£3,808	-4.2%
Change in overdrawn balances UK	-£1,202	-9.5%
Small firms		
Change in loan book 2011-2012 Wales	-£176	-8.0%
Change in overdrawn balances Wales	-£11	-3.4%
Change in loan book 2011-2012 UK	-£318	-1.0%
Change in overdrawn balances UK	-£204	-3.8%
Medium-sized firms		
Change in loan book 2011-2012 Wales	£219	10.7%
Change in overdrawn balances Wales	£39	1.9%
Change in loan book 2011-2012 UK	-£3,490	-27.5%
Change in overdrawn balances UK	-£999	-10.5%

largest overall decline of any UK region over this period. In fact, this decline accounts for 55 per cent of the total UK fall in loan book balance for small firms. In contrast, lending to small firms in Scotland increased by £246 million over the same period. There has also been a 3.4 per cent fall in overdraft balances for small firms during this period (£11 million), which is slightly lower than the UK average.

This view is also evidenced by the findings from the most recent Bank of England Agents' summary of business conditions⁶⁸, which suggests that there was some increase in the availability of bank credit to mid-tier corporates and to some larger SMEs with strong balance sheets but that *"many smaller firms without suitable collateral found their access to finance remained constrained, with little change in banks' risk appetite reported – sometimes exhibited in protracted decision-making processes around loan applications. More generally, firms that were seeking to enter new markets reported that access to bank finance remained difficult"*. Data from the CBI and the ACCA has also shown, in their survey of SME lending, that there was a strong correlation between bank approval rates and business size, especially in the case of term loans⁶⁹.

SME Monitor data for Wales

In the absence of actual data from the banks on regional lending to SMEs, the most credible source of information on SME access to finance is the SME Finance Monitor, which surveys some 5000 SMEs on a quarterly basis and has been doing so since the summer of 2011. The second annual report, published at the end of April 2013, provides regional data covering Scotland, Wales, Northern Ireland and the nine English regions and is based on a sample of over 20,000 businesses, with up to 249 employees, interviewed in 2012. The main findings for Wales the study are as follows:

External finance

- It is estimated that 51 per cent of Welsh SMEs (93,000)⁷⁰ had not used external finance in the last five years (vs. 52 per cent for the UK). In this case, external finance includes bank overdrafts, credit cards, bank loans or commercial mortgages, leasing or hire purchase, loans/equity from directors, loans/equity from family and friends, invoice finance, grants, loans from other 3rd parties, and export/import finance. This suggests that the majority of Welsh businesses are self-funded from either the owner or from retained profits and have no external funding requirements.
- This is supported by the finding that 33 per cent of Welsh SMEs (60,000) are permanent non-borrowers (vs. 34 per cent for the UK)⁷¹. This proportion of permanent non-borrowers has increased from 30 per cent in 2011. It is also worth noting that only 8 per cent of Welsh SMEs perceive access to finance as a major obstacle in running the business over the next 12 months (vs. 10 per cent for the UK).

68 <http://www.bankofengland.co.uk/publications/Documents/agentssummary/agsum13may.pdf>

69 ACCA & CBI (2010) *Small Business Finance and the Recovery*, London, October 2010

70 We extrapolate the number of Welsh firms from the business population weighting used within the SME Monitor so as to give an estimation of the number of businesses facing such issues in Wales.

71 These are SMEs who seem firmly disinclined to borrow because they meet all of the following conditions: they are not currently using external finance, have not used external finance in the past five years, have had no borrowing events in the past twelve months, have not applied for any other forms of finance in the last twelve months, said that they had had no desire to borrow in the past twelve months and reported no inclination to borrow in the next 3 months.

Bank lending

- 69 per cent of Welsh SMEs (126,000) are classed as “happy non-seekers” i.e. those SMEs that had not had a borrowing event with a bank and also said that they had not wanted to apply for any (further) loan/overdraft funding in the previous twelve months. Therefore, only 31 per cent of SMEs in Wales (63,000) have had a borrowing event from the bank⁷² or would have liked to have a loan/overdraft during the previous 12 months.
- Of these, 23 per cent of SMEs (42,000) reported a borrowing event with a bank (same as the UK) whilst 8 per cent of Welsh SMEs (15,000) are “would-be seekers”: those SMEs that had not had a borrowing event but said that they would have ideally liked to apply for loan/overdraft funding in the previous twelve months (vs. 10 per cent for the UK). When asked, 62 per cent of the ‘would-be seekers’ in Wales remained most likely to cite the current economic climate as the main barrier to future applications (vs. 50 per cent for the UK). They were more likely than others to cite the principle of borrowing as the main barrier to future borrowing (17 per cent vs. 12 per cent for the UK), and somewhat less likely to cite discouragement (12 per cent vs. 17 per cent for the UK).

Loans and overdrafts

- 9,000 Welsh SMEs applied for a new or renewed loan and only 44 per cent of these loan applications reported in 2012 were successful (vs. 57 per cent for the UK). Alternative sources to bank funding were taken up by some Welsh applicants (5 per cent vs. 9 per cent for the UK) and so 52 per cent of Welsh loan applicants ended the process with no facility at all (vs. 34 per cent for the UK) the highest regional score. Whilst this is extremely worrying, it is important to place this in context as it only equates to around 5,000 businesses in Wales. With further analysis of this tranche of firms, especially the reasons for refusal, Welsh Government could examine how it could potentially support viable companies through its own programmes.
- Applicants for a new/renewed overdraft were less likely to be renewing a facility for the same amount (38 per cent Wales vs. 46 per cent for the UK), down from 2011 (45 per cent Wales vs. 49 per cent for the UK). 65 per cent of overdraft applications reported in 2012 were successful (vs. 73 per cent UK) which equates to around 13,000 Welsh SMEs receiving overdraft facilities. 6,500 of those applying in 2012 ended up with no facilities. It is also worth noting that overdraft applicants in Wales were less likely to have been offered the facility they wanted and taken it (50 per cent vs. 61 per cent for the UK). They also were more likely to be first time applicants (46 per cent Wales vs. 31 per cent for the UK) and more likely to be consolidating existing borrowing (13 per cent vs. 3 per cent overall), suggesting that this is still seen as the main form of debt financing in Wales by new firms. This may provide an explanation as to why there are higher rates of refusal for Welsh businesses, as many first time applicants would have very little idea of the requirements of banks when applying for a loan, an issue that has been reiterated strongly within the interviews with intermediaries.

⁷² A borrowing event happens when SMEs report any Type 1 (new application or renewal), Type 2 (bank sought cancellation/renewal) or Type 3 (SME sought cancellation/reduction) borrowing event in the 12 months prior to interview, or the automatic renewal of an overdraft

It also suggests that more needs to be done to ensure that those who apply for funding are aware of the requirements of the banks and, more importantly are given the right advice and support to submit a quality application for funding.

The SME Monitor data confirms that whilst the majority of businesses in Wales either do not access funding from banks or do get access, there is a sizeable minority that are still seeking the funding they require. These consist of the 15,000 firms that are “would-be seekers” as well as the 12,000 that have been turned down for an overdraft or a loan. We estimate that this accounts for approximately 15 per cent of the Welsh SME population or 27,000 businesses. This number could be further reduced if we assume that around two thirds of the “would be seekers” applying for overdrafts and half of those applying for a loan would receive funding from the banks and that none of those businesses refused funding would get a negative decision on loan or an overdraft overturned via appeal.

Therefore, we estimate that the funding problem for SMEs in Wales approximates to around 20,000 firms (or 11 per cent of the SME population). As stated, given that this data is based on the survey of the SME Monitor, it is an estimate but it is the first time the Welsh Government has been given an idea of the number of SMEs in Wales that are struggling to get funding. However, the question is what type of business is having difficulty in gaining access to funding? Whilst the Welsh data does not give us an accurate picture of this, the latest data from the SME Monitor for quarter 1 of 2013 suggests that the majority of those looking for bank funding will be micro enterprises i.e. applicants with fewer than 10 employees for both loan and overdrafts were less likely to have been offered, and taken, the funding they wanted and so were less likely to have a borrowing facility in place. In fact, the bigger the SME, the more likely they were to have had an event and the less likely they were to be a ‘would-be seeker’ of external finance. This is supported by other studies – the 2012 Small Business Survey⁷³ for Wales showed that bank finance, including loans, overdrafts and mortgages, was more likely to be sought by micro enterprises (58 per cent) than by small businesses (31 per cent).

Microfunding as a solution?

This clearly suggests that the vast majority of businesses with difficulties in gaining access to funding in Wales are microenterprises that will also include start-ups. As has been demonstrated, these are businesses that neither the high street banks nor Finance Wales (despite the creation of the Wales microloan fund) are able or willing to fully service. Indeed, whilst banks do provide funding facilities for micro-firms and start-ups, a number of the interview respondents suggested that the impression is that banks are looking for a smaller number of larger transactions at the bigger end of the SME market and if you were a business of a certain size, then you would find little trouble in finding a loan from the bank although there may be concerns about the actual terms of that loan. The same was not true about micro enterprises. This suggests that further research is needed into the development of microcredit facilities in Wales to complement the funding that is available for both small and medium sized businesses. It reinforces the view of various other reports⁷⁴ that there is a market gap in this area as banks move away from supplying funding to this type of business.

73 Welsh Government (2013) 2012 *Small Business Survey*, BMG Research

74 Kraemer-Eis, H. and Conforti, A. (2009) *Microfinancing in Europe- a market overview*, Working Paper 2009/001, EIF Research and Market Analysis.

As the latest report from the European Investment Fund⁷⁵ suggests, microfinance is an important contribution to overcome the effects of the economic crisis as capital is more difficult to obtain by smaller firms. Therefore, the potential role of Community Development Finance Institutions (CDFI), which has been shown to be successful in the USA, should be considered further. This may be particularly relevant to Wales as there is already a UK Government scheme in place to support investment in disadvantaged communities by giving tax relief to investors who back enterprises in disadvantaged areas through investing in accredited CDFIs⁷⁶. A detailed discussion with the only CDFI in Wales – Robert Owen Community Banking – demonstrated the enormous potential that exists for this approach for supporting local businesses and according to recent data, the 50 UK CDFIs have dispersed over 11,000 loans to micro enterprises and SMEs, totalling over £157 million worth of lending⁷⁷. These options will need to be examined in detail, along with other local solutions such as the Pembrokeshire Lottery Loan Fund⁷⁸ and the Gwynedd Loan Fund⁷⁹ as well as more innovative ideas such as Mutual Guarantee Institutions⁸⁰.

Recommendation

For both loans and overdrafts, smaller and younger SMEs remain less likely to have been successful in securing funding from their bank. If banks continue to have difficulties in fulfilling the lending role for this part of the business community in the future, other forms of funding will need to be considered for smaller firms, especially micro-businesses. The Welsh Government therefore needs to consider whether mechanisms such as microlending or community-based lending to smaller local businesses should be encouraged and supported.

Other issues raised on banking during the review

Demand-side issues

In addition to the supply of finance from the banks, there is also the issue of whether small firms are properly prepared i.e. investment ready, when they submit their funding applications to the banks. A number of respondents suggested that smaller businesses were not fully prepared when submitting their applications. This view is supported by evidence from the ACCA/CBI⁸¹, which indicated that smaller businesses have not been very pro-active in preparing financial information for third parties. This is not a new problem as back in 1994, the very first Bank of England report into financing the SME sector suggested that there was a general acceptance of the need to improve the financial and management skills of small firms⁸². As a number of business organisations noted, there needs to be a basic understanding by owner-managers on how to manage

75 Kraemer-Eis, H., Lang, F. and Gvetadze, S. (2013) *European Small Business Finance Outlook*, June

76 Department for Business, Innovation & Skills (2013) *Community Investment Tax Relief (CITR): accreditation of Community Development Finance Institutions*, 24th April

77 Lord Young of Graffham (2013) *Make Business Your Business – supporting the start-up and development of small business*, May

78 <http://www.pembrokeshirelottery.co.uk/loan-terms-conditions.asp>

79 http://www.gwynedd.gov.uk/gwy_doc.asp?doc=26697&Language=1&p=1&c=1

80 http://www.gwynedd.gov.uk/gwy_doc.asp?doc=26697&Language=1&p=1&c=1

81 ACCA & CBI (2010) *Small Business Finance and the Recovery*, London, October 2010

82 Bank of England (1994) *Finance for Small Firms*, first report, January

and present financial data. There also needs to be a greater use of intermediaries such as accountants as part of the business support framework to help businesses prepare a simple plan and financial forecasts for the bank. In fact, it was suggested that all stakeholders in the business – bankers, accountants, local business advisors and the owner manager – could be utilised to put together viable loan proposals for smaller inexperienced businesses.

Recommendation

There needs to be greater transparency in the lending process. This is to ensure that SMEs, especially those without any formal financial support internally, know exactly what is required in terms of preparing an application to the bank (business plan, cash forecasts, support from an intermediary). In exchange for the provision of this information, banks would then agree to examine each potential funding request in more detail as opposed to basing their decision using the credit-scoring software that is normally applied to the majority of applications. Such “a banking covenant” could ensure greater transparency and accountability within the lending process and Welsh Government could work with the BBA to pilot such a scheme in Wales.

Renegotiation

A number of intermediaries raised the issue of banks renegotiating the terms of loans with existing clients, particularly with larger SMEs. The consensus was that banks would try and minimise risk and maximise return with clients facing significant cost increases without any increase in risk for the bank. To some, this was seen as ‘correcting the mistakes of the past’ when debt agreements were far more favourable and there has been a tendency over the last few years, when businesses are requesting new finance, to consolidate previous loans with such a request into a newer, more expensive loan for the business. There was also concern expressed that banks are increasing the fees they charge to SMEs for new loans without any justification for the increases. Many intermediaries felt that such an approach was unjustified and that banks should be there to take modest risks on deals to and generate a decent return and should support customers through the long term.

Local decision-making

During the review, there have been concerns that banks, in general, are moving away from relationship management with the small business client towards a system that is based on credit scoring for the vast majority of businesses before the business plan is even considered. The evidence we have gathered is that whilst banks do rely on such a system within Wales for many start-ups and micro-businesses, there is, nevertheless a system of relationship management across all the banks for firms of a certain size and this can be beneficial to those ‘larger’ SMEs that fall within this remit. However, this does mean that the majority of SMEs in Wales are at the mercy of whatever credit scoring system is in place within each individual bank which, as discussed earlier, is not infallible given the success of the appeals process against refusals. This is not surprising, as the role of loan officers is to provide the soft information on those SMEs which any credit scoring system will not be able to assess in detail⁸³.

83 Uchida, H., Udell, G., and Yamori, N. (2012) Loan officers and relationship lending to SMEs, *Journal of Financial Intermediation*, Vol. 21, No 1, pp. 97-122

Respondents have also suggested that the decision by most of the banks to use credit committees based outside of Wales is a key concern and it was considered that the absence of head office functions responsible for credit being located in Wales (as was the case in the 1990s) is an issue. There is a certain degree of local discretion across all banks, decisions for some loan applications from SMEs, especially larger ones, still have to be submitted to a credit committee for final approval. Whilst some of the banks argue that this is good practice, it was felt by many intermediaries and businesses that this interfered with the process of relationship management i.e. if the SME has spent several months working with the local bank to put together a proposition for funding and it had been accepted locally, then why should it then have to go to a faceless credit committee which would have little idea of the business, the local economy or the context of the proposal. As one intermediary noted, in the past they would identify and work with good corporate managers who could trust and could manage their credit committee. That is no longer the case with an increasing number of banks with local bank managers becoming increasingly disenfranchised. It can only be beneficial to have decision-making nearer to the source of business and having decision-making that understands the local business market, which is why Handelsbanken, with their approach and philosophy, is making inroads into the corporate market in Wales.

It was also argued by a number of respondents that having to have the final decision made by a credit committee caused undue delays to their businesses, especially when “in principle” approval had already been given by the local manager. Some firms were exceptionally frustrated at the lack of local decision making within Welsh banks, with one suggesting that without *“knowledgeable, informed middle management with the authority to make considered decisions assessed on real time information, on local knowledge and local facts, and a genuine willingness to help, the future of enterprise and growth will look very bleak for quite some time to come.”*

As a partner in one of the leading accountancy companies in Wales noted over a specific proposal *“The most telling factor that relationship managers were supportive but then it went to credit, and they were not interested. The people on the ground in Wales were divorced from credit and the minute they go upstairs, the risk attitude changes immediately”*. In addition, by having decisions made locally, the speed by which that decision can be made is improved which may be critical for SMEs requiring specific funding for a new opportunity.

Recommendation

Local decision-making by banks is seen by many businesses as critical in ensuring that their business case is considered fairly. Yet there is very little evidence of this happening with higher-level credit decisions being made outside of Wales. Given this, Welsh Government is encouraged to open up discussions with the main banks to ensure that Welsh regional managers make the final credit decisions for all Welsh businesses.

Other types of lending to SMEs

The second part of the review will examine how other type of lending to SMEs in Wales can help close the finance gap that currently exists for some businesses. This section provides a brief introduction to the alternative sources of funding currently available and raised by participants in the interviews. These will be examined in the second part of the review.

Role of Building Societies

Building Societies must, under legislation, ensure that at least 75 per cent of its “business assets” must be fully secured against residential property. This means that up to 25 per cent of a building society’s assets could be used to support commercial lending secured against commercial property although many of them have been reluctant to lend any money anywhere near this limit. In addition, the FSA has restricted lending by certain size category of building society, thus reducing their exposure but also the potential availability of funding for commercial lending. During the interviews, it was suggested that despite this reluctance, there could be potential for building societies to become involved in more lending to the SME sector, especially in commercial mortgages where they have previously specialised. As one respondent suggested, the Welsh Government may wish to discuss, with the UK Government, whether, in a situation where building societies may wish to change their strategy into further commercial lending, any restrictions currently in place can be relaxed. In a response to the UK Government, the Building Society Association (BSA)⁸⁴ suggested that whilst there may be opportunities to expand commercial and corporate lending operations, there might be constraints in doing so as a result of both regulatory and legal limits. Some building societies may also be reluctant to expand into such operations because this would mean a departure from core business and additional resources, especially commercial lending staff, would be required to establish such an operation. Nevertheless, they may well be able to play a greater part within the commercial property market in partnership with the Welsh Government and this issue will need to be explored further.

Recommendation

Further discussions will take place with building societies in Wales to assess their potential role in supporting SMEs to access finance, especially in terms of commercial property lending.

Trade credit

Another key issue that may be worth examining in terms of improving access to finance is the current situation regarding trade credit to Welsh SMEs. It is estimated that more than 80 per cent of all business-to-business sales are made on credit, allowing SMEs to ask suppliers for twice as much short-term credit as they obtain from banks, demonstrating its importance to the sector. In fact, SMEs in the UK typically owe their suppliers an amount equal to a fifth of their total assets and the role that large companies can play in supporting smaller suppliers was one of the key recommendations of the Breedon

84 Building Societies Association (2010) *Financing a private sector recovery*, September

review⁸⁵. In fact, given the close relationship between large and small firms within the supply chain, it may be possible for cash positive businesses to extend credit to their suppliers, especially as existing commercial relationships enable greater control over the recipient. In addition, alterations and simplifications to procurement processes to make contracts more accessible to small businesses would also generate business and cash flow for them, thus reducing reliance on bank lending.

However, trade credit can also work negatively for SMEs in the form of late payment, or payment outside of agreed credit terms, which is seen as one of the biggest problems faced by the SME sector in the UK⁸⁶. According to the Forum of Private Business (FPB), over a million SMEs in the UK face late payment difficulties, equivalent to 20 per cent of the business population (or approximately 40,000 SMEs in Wales). The amount tied up in late payment across the UK had risen to nearly £37 billion⁸⁷. Extrapolated to Wales, this would mean that £1.5 billion is owed to Welsh SMEs, equivalent to a third of the total loan book of the banks. This is most acute within the construction industry, one of the most micro enterprise intensive sectors in Wales.

A number of respondents noted this as a key issue, especially for the smallest of companies that can often get into serious financial difficulties if their customers refuse to pay them on time. It is not only the amount of money owed but also the uncertainty of the payment which, coupled with amount of management time involved in chasing payments, can put pressure on the creditor's relationship with their own bankers.

Recommendation

The lack of availability of trade credit is an issue that leads to many smaller businesses seeking short term funding for working capital from banks. The Welsh Government should explore how it can use its power as the biggest purchaser in Wales to encourage its own suppliers to adopt supply chain finance or similar schemes to support their suppliers. In addition, it could set an example by ensuring that all contractors operating within the public sector in Wales have to pay their suppliers within a maximum 30-day period (and ensuring that it adheres to such a policy itself). With over £4.3 billion being procured via the public sector, this could have a major effect on the cashflow of a significant number of smaller businesses. The Welsh Government could also build in such conditions into other programmes that it currently manages.

Invoice discounting and factoring

One of the solutions that have been used by companies to deal with late payment whilst improving cashflow is that of factoring and invoice discounting. In factoring, a provider pays an agreed proportion (usually 80-85 per cent) of approved invoices to the company on receipt of a copy of the invoice. The balance, less a charge (usually around 0.75-2 per cent of turnover), is paid upon client payment with credit management and collection being the responsibility of the factoring provider. Invoice discounting is similar to factoring, except the company remains responsible for credit management. Currently,

85 Independent taskforce on non-bank lending (2012) *Boosting Finance Options for Business*, Department for Business, Innovation and Skills, March 2012

86 Wilson, N. (2008) *An Investigation into Payment Trends and Behaviour in the UK: 1997-2007*, Credit Management Research Centre, Leeds University Business School

87 Bacs, *Payment Scheme Ltd Survey*, July 2012.

around 42,000 businesses in the UK use factoring and invoice discounting. Nearly half of these are small firms with less than a £1 million turnover⁸⁸ and this form of finance provided them with £1.1 billion of funding in Dec 2012. Unfortunately, there is no disaggregated data on factoring is available for Wales.

Whilst factoring and invoice discounting is suitable for some businesses, there is a concern from some interviewees that high street banks are moving customers onto this type of funding because the risk is perceived as being lower, certainly for those with overdrafts. The question is whether such funding is actually appropriate for the business, which may not be the case where there is high concentration amongst a few customers, for example. One of the banks, when questioned, agreed that there was enormous pressure on businesses to take up invoice discounting instead of overdrafts which was seen as a more expensive product by many customers. Another bank argued that this was the right approach as, in many cases, overdraft facilities could not be increased to accommodate business's requirement for further funding without appropriate security. In addition, many of those growth companies would see invoice discounting as a suitable option that would give the directors of those firms their personal guarantees back.

Asset finance

Asset finance is becoming a more important source of funding for SMEs across the UK, especially in funding plant and equipment (vehicles, machinery). It includes:

- Hire purchase where the company pays a deposit and gradually pays off the remaining balance along with interest accrued;
- Operating leases: the company borrows the asset for a particular length of time against periodic lease payments before returning it to the lessor at the end of the lease term.
- Finance leases: similar to an operating lease, but the rental cost usually covers the whole cost of the asset.

According to the Finance and Leasing Association (FLA)⁸⁹, their members fund just over a quarter of all business capital investment, other than property. They comprise of bank subsidiaries that provide around 75 per cent of asset finance, and non-banks (including manufacturer subsidiaries) who provide the remaining 25 per cent. The FLA has 60 full members that provided almost £21 billion of finance to businesses and the public sector in 2011, supporting about 27 per cent of the UK's fixed capital investment. According to its latest report:

- £11.7 billion of new finance went to support investment by SMEs
- Approximately 250,000 SMEs used asset finance in 2011 to invest in new vehicles and equipment;
- Asset finance for deals of up to £20 million grew by 10%, including particularly strong growth in commercial vehicles, plant and machinery, and business equipment;

88 ABFA (2013) Statistics on factoring, <http://www.abfa.org.uk/members/statistics.asp?type=public>

89 FLA (2012) Annual Statistics 2012,

- Around one in three small businesses that have any external borrowing use asset finance. Amongst these, independent research shows that the use of asset finance is particularly high in Wales, the North East and the North West, with agricultural and manufacturing making most use of leased equipment⁹⁰;
- Again, there is no separate data available for asset finance provision in Wales.

In addition, a key report from the European Investment Fund emphasized the importance of leasing for and newer or younger enterprises without credit track record and limited possibilities to provide collateral to purchase capital equipment⁹¹. However, as the Federation of Small Businesses notes⁹², whilst leasing is a growth area for SME financing, new leasing business in the UK is contracting and the UK Government needs to help to ensure greater market penetration and awareness amongst SMEs, as well as potentially including asset finance as part of its lending programmes. The potential for intervention by Welsh Government will be examined in more detail with asset finance providers in stage two of the review.

Informal investment

Business angels are *“an individual, acting alone or in a formal or informal syndicate, who invests their own money directly in unquoted businesses in which there is no family connection in the hope of financial gain and who, after making the investment, takes an active involvement in the business, for example, as mentor, adviser or member of the board.”*⁹³ Angel investment is ‘informal’ in the sense that it is individuals rather than financial institutions that invest venture capital in a more controlled environment and are therefore important additions to the early stage risk capital market, both in their own right and as co-investment partners. Accordingly, the angel market has a critical role to play in ensuring a strong private sector-led recovery within the UK economy. But what has been the impact of the angel market in Wales?

There is very little detail available on informal investment (or business angels) on a regional level. The best proxy for this, at least in terms of investment by individuals into SMEs, is the Enterprise Investment Scheme (EIS) although because the region is based on the registered address of the company, which may be different from the region in which the business activity is carried on, caution must be exercised in interpreting the following data⁹⁴. The latest data from HMRC⁹⁵ show a concentration of investments in companies registered in London (48 per cent) and the South East (17 per cent) between 2008 and 2011. From 2006/07 the proportion of investment in companies registered in London and the South East has been greater than 60 per cent. There was a peak in 2009/10 where 68 per cent of all investment was in London and the South East, with 51 per cent in London alone. As noted earlier, there have been 146 EIS investments in Wales during the period 2008-11, raising £23 million. This represents 2.5 per cent of the number of

90 Open University Business School (2009) *Asset Finance and SMEs*, Finance and Leasing Association

91 Kraemer-Eis, H. and Lang, F. (2012) *The importance of leasing for SMEs*, Working Paper 2012/15, EIF Research & Market Analysis

92 Federation of Small Businesses (2012) *ALT+ Finance, small firms and access to finance*.

93 Mason, C.M. and Harrison, R.T. (2011) *Annual Report on the Business Angel Market in the United Kingdom, 2009/10*, University of Strathclyde.

94 There is no data yet available on the Seed Enterprise Investment Scheme (SEIS), which encourages investment into new seed stage companies by providing a higher rate of income tax relief

95 HMRC (2012) *Enterprise Investment Scheme Statistics*, December

investments in the UK but only 1.4 per cent of the value of investment. Only Northern Ireland has a worse record than Wales in terms of regional involvement in the EIS. The average Welsh investment via EIS is £157,000 as compared to £286,000 for the UK.

It has been generally acknowledged that the Enterprise Investment Scheme (EIS) has been an important motivator for most business angels, especially in encouraging more private investment in early stage companies. The question is how the Welsh Government can improve on the current offering? Whilst organisations such as the British Business Angels Association⁹⁶ have recommended higher rates of tax relief for high-risk early stage investments in key areas of growth potential to the economy, the Welsh Government, even if wanted to, currently has no fiscal powers to improve tax incentives to investors. However, it could, by offering equity guarantees enhance and improve the environment for private investors. Such guarantees have been discussed in various policy documents in the past⁹⁷ but have never been taken forward by Governments at either a UK or devolved level. There will be further exploration of this potential instrument in the second stage of the review.

Business angel networks have also been shown to be effective as a conduit to financing early stage companies. *xénos* – the Welsh Business Angel network – was established in 1997 to introduce business angels to companies seeking growth funding. *xénos* works closely with investors and businesses to find a suitable introduction, often using its successful investment forums as a way for companies to present their requirements to the angels where necessary and has been compared favourably to other business angel networks elsewhere⁹⁸. In the period 2001-2013, *xénos* has completed deals totalling £19.1 million in 160 companies during the period, at an average investment of £119,000. It works alongside Finance Wales in terms of generating matched funding for investments into SMEs.

In November 2012, a review of *xénos* activities suggested that the current market capacity for Wales based angels is £3m per annum. As *xénos* is attracting over £2million per annum, it could mean that there could be future restrictions on angel funding from Wales which suggests that there may be a requirement to attract informal investors from other parts of the UK to support Welsh SMEs.

Therefore, there is considerable scope to improve informal investment as a source of funding to SMEs in Wales. With research showing that tax incentives such as the EIS have been an important motivator for most business angels, the Welsh Government needs to consider how it could add value to such initiatives, especially as there are different ways in which government can support various such equity finance schemes⁹⁹.

96 BBAA (2010) *Response to Government Green Paper: Financing a Private Sector Recovery*, UK Business Angels Association, 1 October

97 Gavron, R., Cowling, M., Holtham, G. and Westall, A. (1998) *The Entrepreneurial Society*, Institute for Public Policy Research, London

98 Christensen, J.L. (2011) "Should government support business angel networks? The tale of Danish business angels network", *Venture Capital: An International Journal of Entrepreneurial Finance*, Vol. 13, No. 4, pp. 337-356

99 Department for Business Innovation and Skills (2011) *BIS Equity Finance Schemes: Survey of Fund Investors*, BIS, July.

Recommendation

There are currently low levels of informal investment in Wales that could be addressed by (a) raising awareness of equity investment by angels as a viable form of funding amongst growing SMEs and (b) developing an equity guarantee scheme to attract further investment by private individuals into Welsh businesses. These potential interventions, and the role of Welsh Government in supporting them, will be explored in further detail during the second half of the review.

Table 8: xénos investments, 2001-13

	Value of deals completed (ex- leverage)	Private sector leverage	Value of deals completed (including amount leveraged)	Ratio private sector deals	Average value per deal (excluding leverage)	Average value per deal (including amount leveraged)	Number of deals completed	Number of companies supported
2001/02	£323,900	£155,000	£478,900	0.32	£32,390	£47,890	10	6
2002/03	£465,650	£574,500	£1,040,150	0.55	£46,565	£104,015	10	8
2003/04	£205,000	£74,326	£279,326	0.27	£29,286	£39,904	7	4
2004/05	£1,014,000	£78,472	£1,092,472	0.07	£112,667	£121,386	9	8
2005/06	£1,511,678	£109,220	£1,620,898	0.07	£125,973	£135,075	12	10
2006/07	£2,108,173	£924,636	£3,032,809	0.30	£140,545	£202,187	15	12
2007/08	£2,003,250	£830,000	£2,833,250	0.29	£154,096	£217,942	13	13
2008/09	£1,650,000	£1,038,500	£2,688,500	0.39	£82,500	£134,425	20	15
2009/10	£2,699,266	£1,305,165	£4,004,431	0.33	£117,359	£174,106	23	21
2010/11	£2,170,000	£763,000	£2,933,000	0.26	£108,500	£146,650	20	20
2011/12	£2,710,645	£1,281,000	£3,991,645	0.32	£117,854	£173,550	23	23
2012/13	£2,223,000	£1,746,000	£3,969,000	0.44	£111,150	£198,450	20	20
Total	£19,084,562	£8,879,819	£27,964,381	0.32	£104,860	£153,650	182	160

Venture capital

Venture capital is finance provided to companies by specialist financial institutions in the form of equity investments. Whilst it has been estimated that only 1 in 10,000 start-ups actually get access to this type of funding, recent research has found that those companies that do receive this type of funding make considerable contribution to innovation, productivity and competitiveness¹⁰⁰. More importantly, venture capital is seen as the main source of funding for high potential risky startups in key sectors such as ICT and life sciences although research suggests that investment in innovation within the UK has been reducing since 2001¹⁰¹.

The British Venture Capital Association (BVCA) provides data on venture capital investment in the UK annually¹⁰². For 2011, the BVCA noted that:

100 Frontier economics (2013) *Exploring the impact of private equity on economic growth in Europe – a report prepared for the EVCA*, May

101 Sameen, H. (2013) *Two spheres that don't touch: the relationship between British finance and British innovation*, Big Innovation Centre, June

102 BVCA (2012) *Private Equity and Venture Capital Report on Investment Activity 2011*

- 50 Welsh companies received venture capital investment of £58m. This represents an increase on 2010 when only £39 million was invested into 41 companies.
- Whilst this represented 6.2 per cent of all companies, it only accounted for 0.9 per cent of the total amount invested into UK companies.
- In terms of investment stage, £34 million of the amount invested in 2011 went into MBO/MBI, a higher proportion than for the rest of the UK
- The sectors invested into were oil and gas, basic materials and industrials (£24 million), consumer goods (£2 million), health care and consumer services (£22 million) and technology (£10 million)

Although there are venture firms such as Hafren Ventures and Westbridge Capital based in Wales, much of this growth in equity investments is a result of Finance Wales as a number of respondents noted that there is hardly anyone else investing equity into Welsh businesses. Given this, one of the respondents from the venture capital industry suggested that Wales needs to develop programmes that help to grow an strong entrepreneurial ecosystem in terms of the quality of people, number of start-ups, finance equity finance and their clients i.e. large corporates that will buying their products. The Welsh Government has demonstrated the seeds for such a development and how it can, through targeted business support programmes, attract investors to consider funding support for innovative Welsh businesses. Whilst its high potential start-up programme is not specifically aimed at generating additional investments for those firms participating, a consequence of this initiative has been the raising of nearly £6 million of funding for 21 firms through a range of sources. Encouragingly, over 50 per cent of this (£3 million) has come as a result of equity from VCs with another £1.265 million from business angels. Only £308,000 has come through Welsh Government grants or funding from Finance Wales.

Recommendation

Finance Wales has had a positive impact on formal equity investment within the Welsh business community. However, the Welsh Government will need to consider how it builds on this success, especially in terms of having a specific vehicle for equity funding in the future. It also needs to develop programmes that create demand for venture capital not only for new start-up businesses but also growth firms where equity investment is key for further development.

It is also worth noting that a Business Growth Fund (BGF) has been established as an independent investment company with £2.5 billion to invest in fast-growing smaller and medium sized UK businesses that need long-term capital to drive their future success. Funded by five of the UK's main banking groups, BGF can invest off its own balance sheet and act quickly for the right opportunities. In addition to providing investments of £2m to £10m in return for a minority equity stake, BGF will work in partnership with its investee companies. They will benefit from BGF's expertise and guidance on strategic and operational issues plus access to a significant UK-wide network of contacts. BGF will invest in established UK companies (with sales of around £5-£100 million) that have a strong growth trajectory. Its investment can be used as development capital to fund growth that is organic, achieved via acquisition, or both. BGF will not engage in company buy-outs, although an injection of cash from BGF may facilitate some change of ownership, providing the majority of funding is used to generate growth. BGF will work with individual and institutional investors to look at mutually beneficial opportunities

for BGF, partner investors and, most importantly, the investee companies. The first and only investment to date in Wales by the BGF is £5.4m investment of growth capital in Swanbridge Hire and Sales (SHS), a specialist provider of high specification industrial scaffolding services, based in Barry, South Wales¹⁰³ although internal research by BGF shows that the potential Welsh market for their funding is around 85 mid-sized growth firms.

Peer-to-peer lending and crowdfunding

There is increasing attention being placed by SMEs on peer-to-peer (P2P) and crowdfunding lending platforms to raise capital. P2P lends money to unrelated individuals, or “peers”, without going through a traditional financial intermediary such as a bank or other traditional financial institution. Whilst the first P2P platform in the UK was established in 2005, the demand for peer to peer lending has only started to increase in the last couple of years as credit from mainstream funders has dried up. It is currently a small market in the UK, accounting for only £120m of funding annually but according to the innovation agency NESTA¹⁰⁴, it has potential to deliver as much as £12.3 billion in business lending annually. This could equate to 12 per cent of all business lending in Wales. An interview with Funding Circle, the UK’s largest P2P business lending, showed that 1,907 funders had received over £100m since the business was established. In total, 72 businesses in Wales have been supported to raise a total of £3,966,140, below what would have been expected. In the UK, businesses borrowed £35,000 – from 418 people – at an average interest rate of 8.2 per cent, which in terms of the average loan and the cost of borrowing, is lower than the offering for Finance Wales.

More research is needed in terms of crowdfunding i.e. the collective effort of individuals who network and pool their money, usually via the Internet, to support efforts initiated by other people or organisation. There are over 450 crowdfunding platforms available and may have different models e.g. Crowdcube is meant for users to invest small amounts and acquire shares directly in start-up companies whilst Seedrs pools the funds to invest in new businesses, as a nominated agent. However, one remaining concern is that there is a need to consider a new regulatory framework to support this potentially robust and efficient market.

Recommendation

There is a major opportunity for Welsh Government to take the lead in supporting alternative sources of funding such as peer-to-peer lending and crowdfunding, either through partnership or direct funding. It could also raise awareness of both types of funding through its various business support programmes.

103 <http://www.businessgrowthfund.co.uk/inform/news/shs-investment>

104 Pierrakis, Y. and Collins, L. (2013) *Banking on each other – Peer-to-peer lending to business: Evidence from Funding Circle*, Nesta, London, April 2013

Glossary of Abbreviations

ACCA	Association of Chartered Certified Accountants
BBA	British Bankers' Association
BFP	Business Finance Partnership
BGF	Business Growth Fund
BIS	Department for Business, Innovation and Skills
BVCA	British Private Equity and Venture Capital Association
CBI	Confederation of British Industry
CRD	Capital Requirements Directive
ECF	Enterprise Capital Fund
EFG	Enterprise Finance Guarantee
EIS	Enterprise Investment Scheme
FLA	Finance and Leasing Association
FLS	Funding for Lending Scheme
FSB	Federation of Small Businesses
FPB	Forum of Private Business
FW	Finance Wales
GEM	Global Entrepreneurship Monitor
HMRC	HM Revenue and Customs
ICAEW	Institute of Chartered Accountants for England and Wales
IoD	Institute of Directors
LIF	Local Investment Fund
MBI	Management Buy In
MBO	Management Buy Out
NACFB	National Association of Commercial Finance Brokers
ONS	Office of National Statistics
P2P	Peer-to-Peer
SEIS	Seed Enterprise Investment Scheme
SMEs	Small to Medium-Sized Enterprises
UKIIF	UK Innovation Investment Fund
UKSE	UK Steel Enterprise
VCs	venture capitalists
VCT	Venture Capital Trust
WDA	Welsh Development Agency

