National Audit Office

Report
by the Comptroller
and Auditor General

**Department for Business, Innovation & Skills
and HM Treasury**

Improving access to finance for small and medium-sized enterprises

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Department for Business, Innovation & Skills
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Improving access to finance for small and medium-sized enterprises

Report by the Comptroller and Auditor General

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Amyas Morse
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National Audit Office

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Small and medium-sized enterprises (SMEs) are typically defined as businesses that have fewer than 250 employees and an annual turnover of less than £50 million. There are just under 4.8 million SMEs in the UK, employing over 14 million people.

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Contents

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This report can be found on the National Audit Office website at www.nao.org.uk/2013-sme-finance

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Key facts

4.79m

SMEs (firms with fewer than 250 employees and turnover of less than £50 million) in the UK

£22bn

potential gap, by 2017, between the amount of finance available to SMEs and the amount they actually need

38%

of SMEs that are less than five years old and apply for a bank loan have their application rejected

14.1 million	people in the UK are employed in small and medium-sized enterprises
£170 billion	of outstanding lending to small and medium-sized enterprises by UK financial institutions, of which around £17 billion is in the form of overdrafts
£120 million	of funding available to support start-up companies in the form of small loans (typically around £5,000) under the Start-up Loans scheme
£100,000	average loan under the government's Enterprise Finance Guarantee scheme
52 per cent	of small and medium-sized enterprises are aware of the principal bank and government initiatives designed to improve access to finance

Summary

1 Small and medium-sized enterprises (SMEs) are typically defined as businesses with fewer than 250 employees and an annual turnover of less than £50 million. At the start of 2012, there were just under 4.8 million SMEs in the UK, employing over 14 million people. Most SMEs are very small: almost three-quarters are sole traders and partnerships, while there are only around 30,000 SMEs that employ 50 staff or more.

2 SMEs play an important role in job creation. Three-quarters of all new jobs in the UK are created by SMEs. It is therefore important that SMEs with potential are able to obtain the finance they need so that they can grow.

3 Some SMEs face specific problems in obtaining finance. They may struggle to provide potential lenders with the collateral or evidence of a track record that lenders need because of the difficulty in predicting SMEs' likely future performance. There is also evidence that many viable SMEs are deciding not to seek finance. This may result from a more cautious approach to expanding their business, or simply a conviction that they will be unsuccessful in their attempts.

4 The Department for Business, Innovation & Skills (BIS) and HM Treasury published *The Plan for Growth* in March 2011, which cited access to finance as one of the reasons why it is problematic to do business in the UK. BIS's priorities include improving the flow of credit to viable SMEs, and helping to diversify external financing options for all businesses. One of HM Treasury's priorities is to support the development of new routes to finance for SMEs.

5 Under a broadly defined Access to Finance programme, BIS runs six main schemes that address areas of the finance market where there are problems. These schemes, summarised in **Figure 1** overleaf, include finance guarantees, loans, equity support and efforts to diversify financing options beyond the traditional channels of the high street banks.

6 The much larger Funding for Lending scheme is not an Access to Finance initiative in itself but a tool under which the Bank of England provides funding to commercial lenders at cheaper rates, with the price and quantity of funding linked to their performance in lending on to businesses and households. Since April 2013, the scheme has included additional incentives to boost lending to SMEs. The scheme is overseen by a joint Bank-HM Treasury Oversight Board.

Figure 1

The main BIS-led Access to Finance schemes

Nature of scheme	Name of scheme	Aim	Total amount of funding
Loan guarantee to SMEs	Enterprise Finance Guarantee	Facilitate additional lending to viable SMEs lacking the security or proven track record for a commercial loan.	Up to £2 billion of lending may be guaranteed, between 2011-12 and 2014-15
Loans to start a small company	Start-up Loans	Open up finance to those not normally able to access traditional forms of finance because of a lack of track record or assets.	£120 million between 2012-13 and 2014-15
Non-bank channels for small businesses	Business Finance Partnership, SME tranche	Increase non-traditional finance such as peer-to-peer lending, supply chain finance and mezzanine finance for businesses with a turnover below £75 million.	£100 million from 2012-13 to 2014-15
Venture capital fund of funds	UK Innovation Investment Fund	Invest in technology-based businesses in sectors strategically important to the UK including digital technologies, life sciences, clean technology and advanced manufacturing.	£330 million, comprising £150 million government funding and £180 million from private investors
Public-private venture capital funds	Enterprise Capital Funds	Address a market weakness in providing equity finance to SMEs by using government funding alongside private sector investment to provide equity finance to early stage companies.	£200 million from 2011-12 to 2014-15
Co-investment fund	Business Angel Co-investment Fund	Support business angel investments into early stage SMEs with high growth potential.	Initial £50 million in 2011, and an additional £50 million in the March 2013 Budget

Source: National Audit Office analysis of departmental data

7 In September 2012, the government announced plans to create a new Business Bank, which will start operating in 2014. The Bank will incorporate the main BIS-led schemes, and is also likely to devise some new interventions to meet identified funding gaps.

8 This report determines whether BIS and HM Treasury:

- have adequate arrangements in place to manage the programme as a whole; and
- are managing and overseeing individual initiatives effectively.

Key findings

On managing the programme

9 **Preparations for the Business Bank have prompted BIS to undertake extensive work to re-examine the nature of the finance problem.** BIS has commissioned a significant amount of research and analysis into the financing challenges facing SMEs. This research found:

- the flow of new bank term lending to SMEs fell by 23 per cent between 2009 and 2012, but this was partly caused by constrained demand;
- seventy per cent of SMEs whose loan application is rejected get no alternative finance, and younger and smaller firms are worst affected; and
- the ‘funding’ gap (the difference between the funding required by SMEs and the funding available) is £10 billion to £11 billion but, subject to some significant assumptions about the state of the economy, may reach about £22 billion by 2017 (paragraphs 2.3 to 2.5 and Figure 6).

10 **The Departments are able to draw upon an increasingly wide body of data available to inform decision-making.** The data available to the Departments comes from a variety of sources, including: the SME Finance Monitor – a quarterly survey of 5,000 SMEs, introduced in late 2011, focusing on their current borrowing activities and future intentions; Bank of England reports on credit conditions, trends in lending, and SME lending and overdraft volumes; the SME Business Barometer – a twice yearly telephone survey that asks questions about expectations of growth and awareness of government support; and aggregated information from the British Bankers’ Association on loan applications and approvals. While extensive, the data available is heavily focused on bank lending, reflecting its importance to the UK market, with less data available on trends in other sources of finance (paragraphs 2.6 to 2.7).

11 **At present, the ways in which data and research findings are consolidated across Whitehall are fragmented.** There is no formal research programme joining BIS, HM Treasury and other departments that have an interest in SMEs. As a result, emerging insights are not as joined-up as they should be. The Business Bank presents the opportunity to take a more integrated approach (paragraph 2.8 and Figure 5).

12 **To date, BIS and HM Treasury have not clearly articulated what the various schemes are expected to deliver as a programme.** As a result, the Departments cannot be sure about where to direct their resources to achieve the most impact. HM Treasury manages broad interventions which are intended to work at a 'macro' level, while BIS schemes target specific parts of the market, as described in the 2011 *Plan for Growth*. But we found no clear statement of what the initiatives taken together could realistically achieve given the resources available in the medium and longer term. This assessment of what impact might be achieved is particularly important for the BIS schemes where, with limited resources, the support provided is always likely to reach only a small proportion of the SMEs seeking finance at any one time (paragraphs 2.10 and 2.13 to 2.14).

13 **A significant amount of the financial support associated with the schemes involves the banking sector.** By value, the Enterprise Finance Guarantee scheme represents around 70 per cent of the financial support associated with the BIS-led schemes (although BIS's financial exposure is limited to 15 per cent of the amount loaned under the scheme). Its success depends on lenders making use of a loan guarantee facility to increase lending to SMEs who lack security. Funding for Lending depends on the funds provided to banking institutions resulting in improvements in aggregated lending to households and companies. While the scheme includes incentives to increase net lending overall, and since April 2013 has included an additional incentive to increase net lending to SMEs in particular, banks are able to use the funding as they see fit (paragraphs 2.11 to 2.12 and Figure 8).

14 **BIS has taken steps to better explain to SMEs the options available to them in financing their business, using a range of communication channels, but 'branding' the help available to SMEs will be a key challenge for the Business Bank.** Assistance is available to SMEs via a range of communication channels – a telephone helpline, online tools and written guidance. However, these sources of help are not particularly easy to find, and there is some overlap in the online tools which may cause confusion. Around half of SMEs are reported to be aware of the principal initiatives intended to improve their access to finance, although this is largely driven by the relatively high profile of the Funding for Lending scheme (paragraphs 2.18 to 2.21 and Figure 9).

15 **BIS has a programme of independent economic evaluations in place, but there is no rigorous process for making changes to schemes in response to evaluations undertaken.** BIS has made a number of enhancements to existing schemes based on its experiences with earlier similar schemes, but these changes have not been informed by the programme of evaluations or results of formal lessons learned exercises (paragraphs 2.22 to 2.24).

On managing and overseeing individual schemes

16 **The BIS-led schemes provided direct support to around 5,900 firms in 2012-13.** The number of SMEs supported is always likely to be a small proportion of those seeking finance in the market. Research by the *SME Finance Monitor* reported that around 22 per cent of SMEs, or just over a million firms in total, acquired a loan or overdraft, or applied for another form of finance, in 2012 (paragraph 3.6 and Figure 10).

17 **The current BIS-led schemes are generally performing positively in terms of meeting the largely activity-based success measures set for them.** The Start-up Loans scheme and Business Finance Partnership have seen significant amounts of activity in their first year of operation. The Business Angel Co-investment Fund has also exceeded its target performance. By contrast, the number of loans offered under the Enterprise Finance Guarantee scheme has fallen in the last three years, although this reduction in activity is consistent with the general trend towards reduced net lending to SMEs (paragraphs 3.2 to 3.3 and 3.8 to 3.9, and Figures 11 and 12).

18 **The Funding for Lending scheme is intended to lead to an expansion of net lending to the wider economy, and additional incentives to boost lending to SMEs were introduced in April 2013. There are currently no specific data on the loans made to SMEs under the scheme, although the Bank has announced its intention to publish more detailed data in 2014.** Overall, based on figures to the end of June 2013, scheme participants had reduced their net lending by £2.3 billion since the scheme was launched in July 2012 (paragraphs 3.4 to 3.5 and 3.7).

19 **The cost to BIS of operating the Enterprise Finance Guarantee scheme is restricted by the cap on default payments, set at 15 per cent of the lending amount.** At the end of June 2013, 3,706 businesses were in default to their lenders, with outstanding Enterprise Finance Guarantee facilities of approximately £228.6 million. This figure represents the outstanding balances prior to default and before any realisation of assets, and equates to a scheme default rate of 11.9 per cent against total original drawn facilities of £1.93 billion. In April 2012, BIS increased the cap on default payments from 9.75 per cent to 15 per cent to encourage increased use of the scheme. First quarter data for 2013-14 suggest that utilisation has increased, but this lending will come at a greater potential cost to BIS due to the increased claim limit (paragraphs 3.10 to 3.12).

20 **BIS anticipates default rates of around 40 per cent for the Start-up Loans scheme and expects to make a net positive return for each individual lender within the Business Finance Partnership.** BIS is on track to achieve its volume target for funding new businesses under the Start-up Loans scheme, accounting for £42 million in loans to the end of September 2013. Given the rapid rate at which loans are being made under this new scheme, it is important that default rates and other key variables that will affect its success, such as additionality, jobs created, and the survival of new businesses, are closely monitored over the lifetime of the programme (paragraphs 3.13 to 3.14 and Figure 12).

21 **The performance of the equity schemes supported by BIS can only be judged in the longer term but, as we reported in 2009, the earlier funds have in financial terms not recouped the taxpayers' investment.** A report commissioned by BIS in 2010 concluded that "development of a well-functioning early stage venture capital market is a long term project…with positive returns unlikely to be achieved until around year eight following initial investments". The impact of the recession on the value of investments has prompted the expected closure date of a number of the earlier funds to be extended to await better market conditions for exit (paragraphs 3.15 to 3.17 and Figure 13).

22 **An evaluation commissioned by BIS suggests that the Enterprise Finance Guarantee has achieved positive economic impacts, but the basis for evaluation relied heavily on a survey of beneficiaries.** The Enterprise Finance Guarantee has been subject to the most significant evaluation to date. Carried out in early 2013, the study concluded that the scheme had provided a net economic benefit of £1.1 billion and that the cohort of firms who obtained a loan through the scheme in 2009 was responsible for the creation of 6,500 jobs, equivalent to 0.96 additional jobs per business. Evaluations commissioned by BIS, such as this, may be over-reliant on surveys of the businesses that have actually received loans or investment. By measuring the schemes' effectiveness in this way, there is a risk that the wider impacts of the schemes are not considered and put in context (paragraphs 3.22 and 3.26).

23 **Evaluating the impact of equity funds is difficult at this relatively early stage of the funds' development, and BIS cannot yet know the amount of gross value added delivered by each £1 of investment.** A final assessment on the impact of the equity schemes will be carried out only once the funds close, although an interim evaluation is due to be carried out before the end of the 2013-14 financial year. When combined with information from our 2009 report suggesting the possibility of weak financial returns from the earlier funds, the absence of interim economic impact assessments for some equity funds puts value for money in doubt (paragraphs 3.16, 3.21 and 3.25).

Conclusion on value for money

24 A strong body of data is now available on SMEs seeking finance, and there has been a renewed focus on research into SME financing. Many of the individual schemes have been delivering against their individual targets. But BIS and HM Treasury have not managed the range of initiatives sufficiently as a unified programme, and have not clearly articulated what the schemes are intended to achieve as a whole, given the resources available. As a result the departments cannot yet demonstrate that they have a basis for matching their resources against their priorities across the portfolio of schemes to optimise value for money. BIS accepts that looking at the broader impact of the schemes is important, together with a scheme-by-scheme view. We consider that an overall view is necessary to determine whether value is being optimised across the portfolio of interventions, so, at present, value for money has not been demonstrated.

25 There are signs that the Departments have been thinking more systematically about the nature of the problem as part of their preparation for the establishment of the Business Bank. This thinking will need to be carried through into the delivery of a much more coherent programme of interventions with a clear focus on delivering tangible outcomes.

Recommendations

26 The following recommendations are intended to help BIS, HM Treasury and the Business Bank improve their oversight of access to finance initiatives and provide better support to SMEs.

The Departments should:

a take the lead in simplifying responsibility within government for addressing SME finance issues, ensuring that a more integrated approach is taken to analysing data and research and turning this insight into policy interventions;

b articulate the specific impact they want to make through the programme of interventions;

c devise, for all schemes, success measures for the short, medium and longer term that would enable them to demonstrate and justify the merits of the schemes and associated investments;

d introduce a more rigorous process for making changes to schemes in response to evaluations undertaken; and

e develop and make better use of existing data sources. This will allow them to generate better information to be used in evaluations of the relative costs and impact of schemes.

The Business Bank should:

f take a flexible approach, implementing and withdrawing schemes in an agile way to reflect movements in the market;

g align any new interventions with BIS's broader policy priorities, as set out in BIS's Industrial Strategies, based on an understanding of what is working; and

h target SMEs' lack of awareness of issues such as the loan appeals process and alternative sources of funding.

Part One

Background

The importance of small and medium-sized enterprises in the UK business sector

1.1 Small and medium-sized enterprises (SMEs) are commonly defined as businesses with fewer than 250 employees and an annual turnover of less than £50 million. Using this definition, there are just under 4.8 million SMEs in the UK (over 99 per cent of all businesses), providing employment for more than 14 million people. **Figure 2** provides a more detailed breakdown.

Figure 2
The importance of SMEs to UK business

	Businesses (million)	**Employment (million)**	**Turnover (£ trillion)**
All businesses	4.80	23.9	3.1
Of which:			
Large (250+ employees)	0.01	9.8	1.6
SMEs (0–249 employees)	**4.79**	**14.1**	**1.5**
Of which:			
Sole traders and partnerships	3.56	3.9	0.2
1–9 employees	1.02	3.8	0.4
10–49 employees	0.18	3.5	0.5
50–249 employees	0.03	2.9	0.5

Note
1 Figures have been rounded.

Source: Department for Business, Innovation & Skills, *Business population estimates for the UK and regions 2012*, October 2012

1.2 For the purposes of policy and research, SMEs are seen as a distinct subgroup within the business sector. However, there is considerable diversity within the SME sector. As Figure 2 shows, almost 3.6 million businesses (around three-quarters of all SMEs) are sole traders and partnerships. By contrast only around 30,000 SMEs employ 50 staff or more.

1.3 SMEs play an important role in job creation. Research produced by the Department for Business, Innovation & Skills (BIS)[1] suggests that around 76 per cent of new jobs created in the UK result from recruitment by SMEs.

The problems faced by SMEs in obtaining finance

1.4 The outstanding amount of all lending by UK financial institutions to UK SMEs was estimated to be around £170 billion in May 2013.[2] Of this total, around £17 billion was in the form of overdrafts. The stock of lending to SMEs represents around 35 per cent of lending to all UK non-financial businesses.

1.5 Despite the significant volume of lending, SMEs often experience problems in obtaining finance. Lenders like to rely on SMEs' track record and the security provided by their existing asset base, as these factors help them avoid the high transaction costs of conducting detailed due diligence on every SME. However, smaller and newer businesses, as well as innovative, high-growth businesses may find it difficult to give potential lenders this assurance.

1.6 SMEs that are less than five years old have their bank loan applications rejected in around 38 per cent of cases, while the figure for SMEs over five years old is only 19 per cent.[3] Similarly, firms with a turnover of less than £1 million are rejected in 27 per cent of cases, compared with only 16 per cent for firms with a turnover of more than £1 million. Research commissioned by BIS highlights that rejection rates for both overdrafts and term loans have been significantly higher in the period from 2008-09 onwards, which indicates constraints to the supply of credit.[4]

1 Department for Business, Innovation & Skills, *Market failure analysis slide pack*, June 2013.
2 Bank of England, *Trends in Lending*, July 2013, page 7.
3 Business Bank Advisory Group overview paper. Available at: www.gov.uk/government/uploads/system/uploads/attachment_data/file/210925/business-bank-advisory-group-business-bank-advisory-group-overview-paper.pdf
4 National Institute of Economic and Social Research, *Evaluating Changes in Bank Lending to UK SMEs over 2001-12 – Ongoing Tight Credit?*, April 2013.

1.7 **Figure 3** shows the different types of funding used by SMEs in Quarter 2 of 2013. Survey data indicate that SMEs are most likely to turn to their bank when they need external finance. This is particularly the case for those that need finance for working capital.[5] In recent years, the largest five banking groups in the UK have held around 80 per cent of the SME banking market share.[6] Consequently, if banks pull back from the lending market, SMEs can find themselves left without an obvious alternative source of finance.

1.8 Since the economic downturn, regulatory requirements have reduced banks' willingness and ability to lend. This has had a particular impact on SMEs, as lending to smaller enterprises involves capital charges up to five times higher than those of other forms of lending, reflecting the higher risk involved.[7]

1.9 There is evidence that many viable SMEs are deciding not to seek finance. This may be because they have decided to take a more cautious approach to expanding their business, or because they believe that, given difficult economic conditions, their applications will be unsuccessful.[8]

Figure 3

Principal sources of external finance for SMEs

SMEs are most likely to turn to their bank when seeking finance

Source	SMEs likely to use this source (%)
Overdraft	19
Credit cards	17
Bank loan/commercial mortgage	8
Leasing or hire purchase	6
Loans/equity from family and friends	5
Loans/equity from directors	4
Invoice finance	2
Grants	1
Loans from other third parties	1
Any of these	41

Source: BDRC Continental, *SME Finance Monitor*, Quarter 2 2013, August 2013

5 BDRC Continental, *SME Finance Monitor*, Quarter 2 2013, August 2013.
6 Business Bank Advisory Group overview paper. Available at: www.gov.uk/government/uploads/system/uploads/attachment_data/file/210925/business-bank-advisory-group-business-bank-advisory-group-overview-paper.pdf
7 Business Bank Advisory Group overview paper. Available at: www.gov.uk/government/uploads/system/uploads/attachment_data/file/210925/business-bank-advisory-group-business-bank-advisory-group-overview-paper.pdf
8 BDRC Continental, *SME Finance Monitor*, Quarter 2 2013, August 2013.

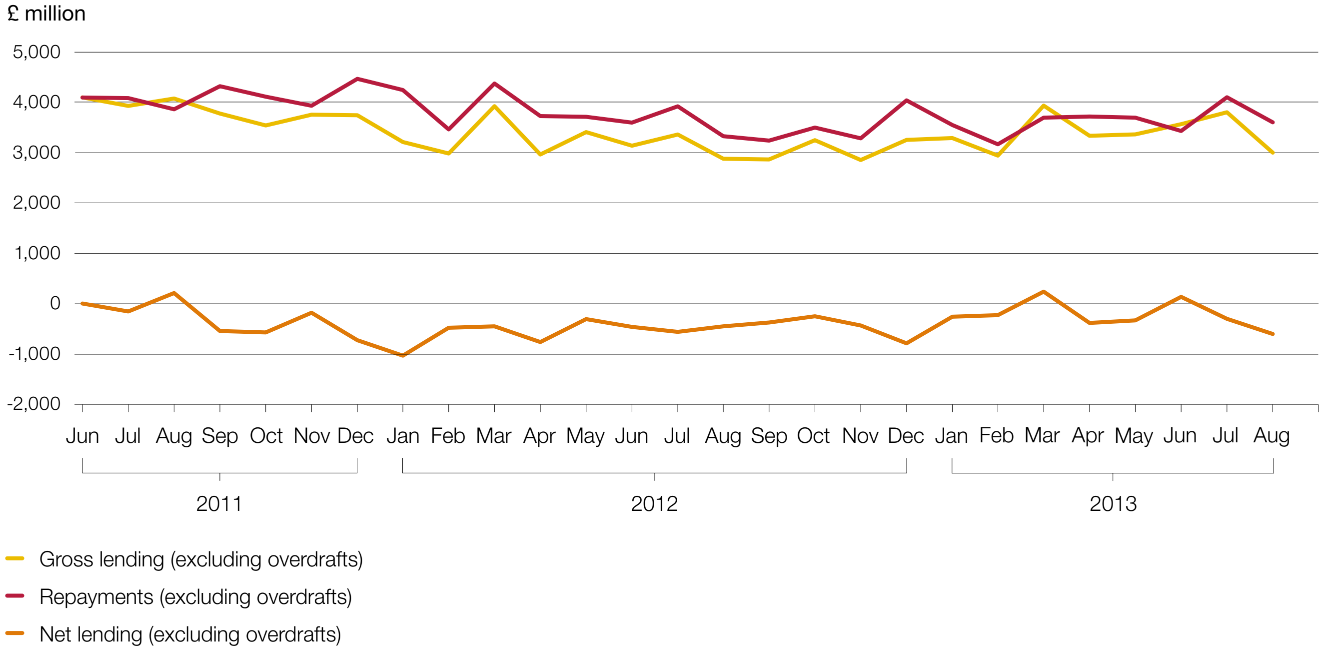
1.10 Because of this combination of factors, net lending to SMEs was negative throughout 2012 (in other words, repayments to lenders outweighed new lending), and this pattern broadly continued into 2013. **Figure 4** shows this trend in more detail.

Government's role in improving SMEs' access to finance

1.11 BIS and HM Treasury published *The Plan for Growth*[9] in March 2011, citing access to finance as one of the reasons why it is "problematic to do business in the UK". In response, BIS's departmental priorities include: to help improve the flow of credit to viable SMEs; and to improve structures of alternative debt markets to diversify external financing options for all businesses. One of HM Treasury's priorities is to support the development of new ways for SMEs to access finance. Its primary means of achieving this priority is supporting BIS in conducting research, producing analysis and engaging with the small business community.

Figure 4
Trends in lending to SMEs

Net lending to SMEs was negative almost every month from June 2011 to August 2013



Source: National Audit Office analysis of Bank of England data

9 Available at: www.gov.uk/government/uploads/system/uploads/attachment_data/file/221514/2011budget_growth.pdf

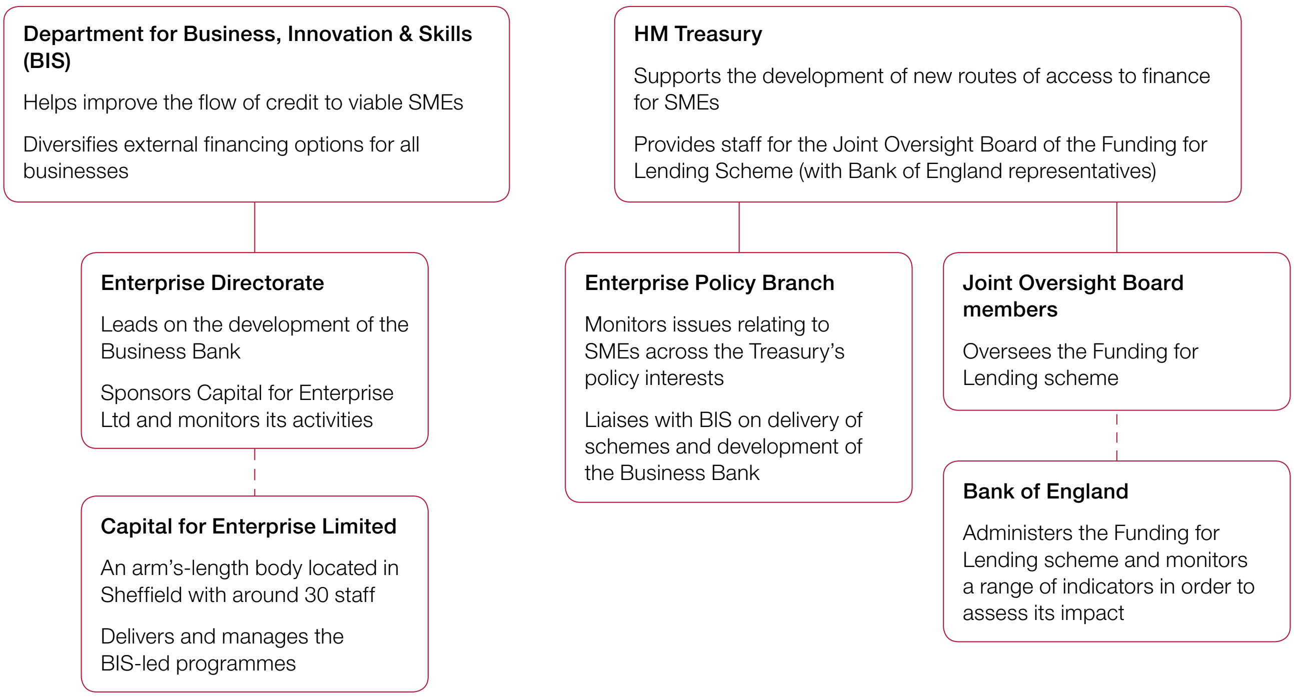
1.12 **Figure 5** shows the main players involved in efforts targeted at improving SMEs' access to finance.

1.13 Under a broadly defined Access to Finance programme, BIS runs six main schemes[10] whose central focus is to help SMEs to acquire funding. These schemes are summarised in Figure 1.

1.14 The Funding for Lending scheme is not an Access to Finance scheme in itself, but is included here because it is intended to have a positive impact on credit conditions, including for SMEs. Under the scheme, the Bank of England makes funds available to commercial lenders at cheaper than market rates, with the price and quantity of funding linked to their performance in lending on to businesses and households. Since April 2013, the scheme has included additional incentives to boost lending to SMEs. The scheme is overseen by a joint Bank-HM Treasury Oversight Board. The Treasury has given no indemnity to the Bank for the scheme.

Figure 5

Responsibilities for improving SMEs' access to finance and monitoring credit conditions



Note

1 At the time of much of our fieldwork, responsibility for Capital for Enterprise Limited sponsorship and access to finance for SMEs sat with BIS's Enterprise Directorate. On 1 April 2013, the Shareholder Executive took over responsibility for this area and for development of the new Business Bank.

Source: National Audit Office

10 A further investment programme was launched in April 2013 but no funding had been made available to lenders at the time of our fieldwork.

1.15 Aside from the BIS-led Access to Finance schemes and Funding for Lending, there are other government activities designed to assist SMEs that are looking for funding. These include:

- the National Loan Guarantee Scheme, launched by HM Treasury in March 2012 to provide businesses with cheaper finance, but now largely superseded by Funding for Lending;
- business advice services (mostly run by BIS);
- schemes to encourage individuals to invest in SMEs by providing tax incentives (run by HM Revenue & Customs); and
- local projects and community finance activities.

1.16 In September 2012, the government announced plans to create a new Business Bank, whose aims would include the improved provision of finance to viable businesses, and especially to SMEs. The Business Bank is likely to start operating in 2014, and will incorporate the main BIS-led Access to Finance schemes. But it is still to be decided whether the Bank will run activities currently led by other departments, and whether it will develop new types of intervention.

Scope of the study

1.17 We limited the scope of this study to the activities carried out by BIS and its main Access to Finance schemes, and its interaction with HM Treasury on matters relating to SMEs. We also considered the Funding for Lending scheme. We did not examine business advice services, or finance schemes provided by other departments.

1.18 We assessed value for money against the following criteria:

- Whether the programme of initiatives is being managed efficiently (Part Two).
- Whether individual schemes are being managed or overseen effectively (Part Three).

1.19 We have also commented on the equity funds that we examined in our 2009 report on *Venture capital support to small businesses*.[11]

11 Comptroller and Auditor General, *Venture capital support to small businesses*, Session 2009-10, HC 23, National Audit Office, December 2009.

Part Two

Managing the programme

2.1 This part examines Department for Business, Innovation & Skills (BIS) and HM Treasury management of the programme. In particular, it looks at:

- efforts to estimate the scale of the challenge;
- targeting the programme of interventions;
- arrangements for measuring the performance and impact of the programme;
- methods of communicating to SMEs the support available to them; and
- learning lessons from the existing interventions.

Estimating the scale of the challenge

2.2 If the programme is to have maximum impact, BIS and HM Treasury need to have a clear idea of the scale and nature of the problems that may cause the market to work suboptimally. These problems may change as the economy moves through the economic cycle. We examined the Departments' efforts to estimate the scale of the problem.

2.3 In the run-up to the Business Bank being established, BIS has taken a more strategic approach to assessing the finance problems facing SMEs. BIS commissioned analysis from Deloitte LLP which included an assessment of available evidence relating to the SME market so that the Department could develop:

- a robust understanding of the current and expected future landscape of business finance for SMEs;
- an initial view on market failures;
- an indication of the expected funding gap; and
- an idea of any additional primary research that would support the economic case for the Business Bank and indicate which finance products it might offer.

2.4 At the time of their report in April 2013, Deloitte found that lending to SMEs was falling faster than lending to larger firms. This is taken to be consistent with the view that the reduction in SME financing had been driven more by restricted supply than by suppressed demand. They noted that addressing issues in the loan market would be the most direct way of enabling SMEs to access the external finance they need for growth. This observation was based on more detailed findings, as set out in **Figure 6**.

2.5 The analysis by Deloitte suggested that a central estimate of the 'funding gap' (the difference between the funding required by SMEs and the funding available) is £10 billion to £11 billion, and by 2017 this figure may rise to about £22 billion. However, uncertainty over future levels of gross domestic product means that it could be as low as £6 billion or as high as £39 billion.[12]

Figure 6
Overview of issues in the SME finance market

Main issue	Supporting evidence
SMEs' use of external finance is relatively low	37 per cent of SMEs use no external finance. More SMEs use credit cards and overdrafts than loans. The UK has a strong reliance on trade credit compared with France and Germany. Loan rejection rates are around twice those of France and Germany.
Demand for finance is constrained	There is uncertainty over future economic conditions. Some SMEs are too pessimistic about getting loans.
SMEs rely on their banks for external finance	70 per cent of SMEs whose loan application is rejected get no alternative finance. This makes SMEs particularly susceptible to possible distortions in their bank's lending decisions. Younger firms and those with turnover below £10 million as well as those with above average risk ratings are worst affected. There appears to be very little demand for equity.
Lending to SMEs has fallen rapidly	The flow of new bank term lending to SMEs fell by 23 per cent between 2009 and 2012. This reflects both falling numbers of applications and increased rejection rates.
Loans are a vital source of funds for growth	Bank finance is the most important source of external finance for SMEs. Overdrafts are used to finance working capital and the running of the business. Over 50 per cent of SMEs would prefer bank loans to other types of finance to realise their growth ambitions.

Source: Based on Deloitte market analysis, April 2013

12 Deloitte noted that these estimates are indicative due to a range of uncertainties in the data and in the market.

2.6 The Departments have been able to draw upon an increasingly wide range of public and private data sources on current finance trends. The principal sources include the following:

- The *SME Finance Monitor*, regarded by many stakeholders we interviewed as the most useful single source of information. It is a survey of 5,000 SMEs,[13] focusing on their current borrowing activities and future intentions. It was commissioned by the Banking Taskforce, in response to the government's 2010 green paper, *Financing a private sector recovery*,[14] and has been published quarterly since November 2011.
- The Bank of England publishes a variety of data. Its main publications relating to SME lending and overdraft volumes are:
  - *Trends in Lending*[15] – a quarterly assessment of the latest trends in lending to the UK economy;
  - *Credit Conditions Survey*[16] – a quarterly picture of lending to SMEs over the past three months and the coming three months;
  - *Agents' Summary of Business Conditions*[17] – a monthly summary of the state of business conditions from companies across all sectors of the economy.
- The *SME Business Barometer*,[18] which began in late 2008, presents the results from a six-monthly telephone survey of SMEs. It covers expectations of growth, the general business environment, access to finance, and awareness of government support.
- The *Small Business Survey*[19] – a large-scale telephone survey among business owners and managers, commissioned by BIS.
- The British Bankers' Association produces a quarterly dataset of applications for finance from SMEs, based on data supplied by the main banks.

2.7 The data routinely considered by BIS and HM Treasury have a strong focus on bank lending, rather than on other forms of funding. This focus is appropriate, as it reflects the importance of the banks to SME finance in the UK. However, as a result, BIS and HM Treasury may not give full consideration to ways in which they can further enhance their data on trends in other sources of finance, such as asset-based financing, peer-to-peer lending, equity finance or the use of personal resources.

13 Available at: www.sme-finance-monitor.co.uk
14 HM Treasury and BIS, *Financing a private sector recovery*, Cm 7923, July 2010. Available at: www.bis.gov.uk/assets/biscore/corporate/docs/f/10-1081-financing-private-sector-recovery.pdf
15 Available at: www.bankofengland.co.uk/publications/Pages/other/monetary/trendsinlending.aspx
16 Available at: www.bankofengland.co.uk/publications/Pages/other/monetary/creditconditions.aspx
17 Available at: www.bankofengland.co.uk/publications/Pages/agentssummary/default.aspx
18 Available at: www.gov.uk/government/publications/sme-business-barometer-february-2013
19 Available at: www.gov.uk/government/organisations/department-for-business-innovation-skills/series/small-business-survey-reports

2.8 While BIS has made good efforts to strengthen its analysis of existing problems before the Business Bank is established, there remain some areas where data sharing and analysis need to be coordinated better. This is borne out by the fact that:

- there is no formal research programme joining the efforts of BIS, HM Treasury and other departments that have an interest in SMEs, such as HM Revenue & Customs; and
- BIS is unable to access some good sources of data that are held elsewhere in government. Tax information, for example, could be used to improve analysis, but such data are subject to confidentiality restrictions.

Targeting the programme

2.9 Each of the existing BIS-led Access to Finance schemes aims to address a known problem in the market, as set out in **Figure 7**.

2.10 The resources available are limited compared with the scale of the problem. The total amount of outstanding lending to SMEs from all financial institutions is estimated to be around £170 billion.[20] By contrast, the BIS-led schemes amount to around £2.85 billion. The Funding for Lending scheme has provided lenders with around £17.6 billion to date, but only part of this comprises lending to SMEs as some will have been used for domestic mortgage lending and lending to larger businesses.

Figure 7

Problems being addressed by the Access to Finance schemes

Type of scheme	Name of scheme	Specific problem being addressed
Debt	Enterprise Finance Guarantee	Lenders take a risk-averse stance towards SMEs who lack security.
Debt	Start-up Loans	New SMEs find it hard to borrow because they do not have a financial track record.
Debt	Business Finance Partnership	SMEs are overly reliant on traditional high street lenders.
Equity	UK Innovation Investment Fund	There is a poor supply of risk capital for new technology companies.
Equity	Enterprise Capital Funds	There is a general lack of equity capital available to SMEs.
Equity	Business Angel Co-investment Fund	Business angels have a reduced capacity to invest in new ventures.

Source: National Audit Office analysis of departmental data

20 Bank of England, *Trends in Lending,* July 2013, page 7.

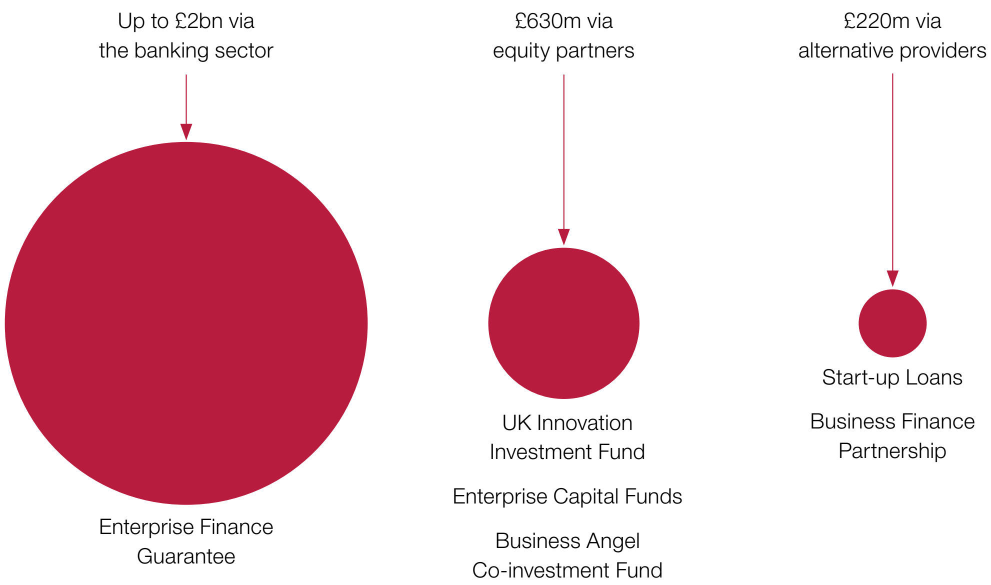
2.11 Around 70 per cent of the financial support associated with the BIS-led schemes is delivered via the banking sector, as shown in **Figure 8**. The Enterprise Finance Guarantee relies on these lenders making use of a loan guarantee facility to increase lending to SMEs who lack security.

2.12 Funding for Lending depends on the funds provided to banking institutions resulting in improvements in aggregated lending to households and companies. While the scheme includes incentives to increase net lending overall, and since April 2013 has included an additional incentive to increase net lending to SMEs in particular, banks are able to use the funding as they see fit.

Figure 8

The delivery mechanisms used by the BIS-led Access to Finance schemes

Around 70 per cent of the financial support associated with the schemes is delivered via the banking sector



Notes

1 The amounts of financial support shown above represent the government's funding commitments for the period 2011-12 to 2014-15, apart from the UK Innovation Investment Fund where monies were committed in 2010.

2 BIS's financial exposure under the Enterprise Finance Guarantee is limited to 15 per cent of the amount loaned under the scheme.

Source: National Audit Office analysis of departmental data

2.13 Given the limited resources available, we would expect the departments to have clearly articulated what the initiatives taken forward by BIS and HM Treasury are meant to achieve. It is clear that HM Treasury manages broad interventions which work at a 'macro' level, while BIS schemes target specific parts of the market, as set out in the 2011 *Plan for Growth*. However, our work suggested that each scheme had been devised on its own merits, rather than as part of an overall strategic approach. It was therefore unclear whether this set of schemes had been sufficiently tested to see if it was the right one, or whether a number of alternative schemes, intended to address different problems faced by SMEs, might represent a more targeted and efficient use of resources.

2.14 There has been no attempt to quantify the intended impact of the programme as a whole, or to set out how this impact might manifest itself in the short, medium and longer term. Without such a statement, the Departments' ability to assess whether the programme as a whole is managing to generate sufficient impact from its resources is weakened. In July 2010, a joint consultation issued by BIS and HM Treasury, *Financing a private sector recovery,*[21] highlighted the central importance of establishing "whether the existing set of government schemes is sufficient to ensure that finance is available to SMEs as confidence recovers and demand revives". The departmental response announced that a range of further initiatives would be taken forward, but there was no accompanying assessment of the desired impact of the programme. Such impacts might take a range of forms, for example, from influencing how SMEs perceive the availability of finance to changing the structure of the finance market.

Measuring the performance and impact of the programme of interventions

2.15 Capital for Enterprise Limited (CfEL) produces appropriate reports on scheme performance for BIS's policy leads. The format and content of the reports vary, but they generally present a sufficient level of detail, including a focus on how the funds distributed or invested are split by region or by sector. The performance of each scheme is reported monthly, except for the UK Innovation Investment Fund and Business Angel Co-Investment Fund whose performance is reported quarterly, and Start-up Loans, whose performance is reported weekly.

2.16 Senior officials and ministers in BIS receive a monthly Business Support Schemes report that provides a summary of the performance of the individual interventions, but does not present an explicit overview of performance across the whole programme. This report is derived from one-page summaries of scheme performance produced by relevant policy leads. The performance of the Funding for Lending scheme is reported quarterly on the Bank of England's website.

21 HM Treasury and BIS, *Financing a private sector recovery*, Cm 7923, July 2010. Available at: www.bis.gov.uk/assets/BISCore/corporate/docs/F/10-1081-financing-private-sector-recovery.pdf

2.17 CfEL is developing an improved management information system that will enable it to measure the economic benefits of its schemes more effectively and analyse how companies have benefited from investment in terms of growth. The new system is also intended to help in the development of counterfactuals to evaluate the additional impact of schemes. The system's reporting tools are still under development, but BIS expects that they will ultimately enhance its capability to produce more detailed data analysis and evaluation. This, in turn, should enable BIS to improve how it presents performance information and demonstrate the impact of its programme of interventions.

Communicating the support available to SMEs

2.18 Evidence suggests that a lack of awareness among SMEs about the types of financial support available may impede business confidence. In August 2013, the *SME Finance Monitor* [22] reported that around half of SMEs knew of any of the principal initiatives designed to improve access to finance, although this level of recognition was driven by the relatively high profile of the Funding for Lending scheme. Around 11 per cent said that a bank had contacted them directly to indicate a willingness to lend, but while such approaches may boost awareness of the schemes they do not appear to encourage applications.

2.19 BIS is using a range of communication channels to better explain to SMEs the options available to them when financing their business. The key communication tools are set out in **Figure 9**.

2.20 The Business Finance and Support Finder can be found quite easily from the main government website, www.gov.uk. However, the other tools are harder to find, and it is likely that an SME would need to know of their existence in order to make use of them. Web pages listed next to the Business Finance and Support Finder, entitled 'Business finance explained' and 'Which finance is right for your business?' lead to a range of other pages, which may make the available support less obvious. In addition, there is some overlap in purpose – for example, it is not immediately clear what differentiates the two online tools, Business Finance and Support Finder, and Business Finance For You.

2.21 In June 2013, the Business Bank Advisory Group recommended that reorganising and rationalising finance advice and other business support activities should be treated as a separate project, but that finance advice should be brought under the umbrella of the Business Bank. BIS is currently considering this recommendation as part of its preparations for the Business Bank.

22 Available at: www.sme-finance-monitor.co.uk

Figure 9

Key communication tools for providing SMEs with guidance on business finance

Communication tool	Nature of interaction with SMEs
Business Link Helpline[1]	Telephone support and advice on financing a business.
Business Finance and Support Finder[2]	An online tool to help businesses find grants, publicly backed finance and loans, business support and funding for SMEs and start-ups.
Business Finance For You[3]	Web pages bringing together a range of finance providers from across the country, including business angels, regional funds, government schemes and bank initiatives.
SME Access to Finance schemes: measures to support SME growth[4]	A guide to the main forms of support and advice available to businesses.
SME Finance: Best Practice Guideline[5]	A guide, produced jointly by the Institute of Chartered Accountants in England and Wales and BIS. It sets out the main financing options and key issues to consider when choosing between options.

Notes

1 Available at: www.gov.uk/business-support-helpline

2 Available at: www.gov.uk/business-finance-support-finder

3 A website managed by the British Bankers' Association, available at: www.businessfinanceforyou.co.uk

4 Available at: www.gov.uk/government/publications/sme-access-to-finance-schemes-measures-to-support-small-and-medium-sized-enterprise-growth

5 Available at: www.icaew.com/~/media/Files/Technical/Corporate-finance/Guidelines/tecpln11488-cff-guideline-58-2-final.pdf

Source: National Audit Office review of online and written guidance

Learning lessons and improving the schemes

2.22 While BIS has a programme of independent economic evaluations in place and broadly adheres to it, we found little evidence of a rigorous process for taking direct action in response to the evaluations undertaken. Such a feedback loop is essential to ensure that resources are put to the best possible use. Our 2009 report *Venture capital support to small businesses*,[23] reported that "the design of funds launched to date has not been informed by the results of formal lessons learned exercises or any assessment of the programme as a whole as it has evolved. A formalised process would provide the Department with more informed decision-making".

23 Comptroller and Auditor General, *Venture capital support to small businesses*, Session 2009-10, HC 23, National Audit Office, December 2009.

2.23 However, BIS has made enhancements to existing schemes as a result of its experiences with earlier schemes. These enhancements include:

- designing new equity schemes which ensure that public investment is not subordinated in favour of private investors but is either on equal terms (Aspire Fund, UK Innovation Investment Fund, Business Angel Co-investment Fund), or shares the risk of losses equally with private investors but takes a prioritised return to cover the cost of capital (Enterprise Capital Funds);
- ensuring venture capital funds have sufficient size and geographical scope to operate more efficiently and with a more diverse portfolio;
- implementing a cap on BIS's liability with regard to loan defaults under the Enterprise Finance Guarantee scheme as compared to the uncapped liability which operated under its predecessor scheme; and
- drawing upon a previous evaluation of a Prince's Trust initiative, to inform expected default rates in the Start-up Loans scheme.

2.24 BIS has also taken steps to develop its new equity schemes to reflect changing market conditions by:

- changing the rate of the prioritised return from Enterprise Capital Funds to reflect changes in the cost of capital as a result of lower gilt yields; and
- seeking European Commission approval to increase the maximum investment permitted in any one company to reflect evidence on the scale of the equity gap affecting SMEs.

2.25 Our 2009 report on *Venture capital support to small businesses*[24] also recommended that BIS could make more information about the funds available publicly. We note that in July 2013, CfEL updated its website with information on the composition of its investments by sector and region, and the overall performance of the funds under its management.[25] A summary of the support provided to sectors and regions is included in Part Three.

24 Comptroller and Auditor General, *Venture Capital Support to small businesses*, Session 2009-10, HC 23, National Audit Office, December 2009. Available at: www.nao.org.uk/wp-content/uploads/2009/12/091023.pdf

25 Available at: www.capitalforenterprise.gov.uk/raa

Part Three

Managing and overseeing individual schemes

3.1 This part examines Department for Business, Innovation & Skills (BIS) and HM Treasury management and oversight of individual schemes. In particular, it examines:

- whether the schemes have appropriate and well-defined objectives and success measures;
- how the schemes have performed against those objectives and success measures, and the extent to which taxpayer funds have been safeguarded;
- the types of SME supported by the schemes; and
- whether there is evidence of positive economic impact.

Scheme objectives and success measures

3.2 The objectives of BIS-led debt schemes are relatively simple – to increase the flow of finance to SMEs that would not have received it otherwise and, in the case of the Business Finance Partnership, to encourage lending from non-bank channels. As such, their success measures are based quite narrowly on the volume of funding generated, supplemented by a broader aim to increase gross value added (GVA). GVA is a widely accepted measure of economic growth but methodologies for measuring the contribution of a scheme in terms of GVA vary.

3.3 The BIS-led equity schemes have common broad objectives: to increase the supply of finance to viable businesses; and to contribute to long-term economic growth through additional output or improvements in productivity. They also have more specific success measures related to attracting private investment. The Business Angel Co-investment Fund originally fell under the aegis of the Regional Growth Fund, and has more specific success measures relating to creating and safeguarding jobs, alongside an objective to achieve a certain level of investment.

3.4 Funding for Lending has a clear objective to incentivise banks and building societies to increase their lending to UK households and businesses. It has a broad success measure of encouraging lenders' overall net lending to be higher than it would have been without the scheme. The Bank of England publishes information on the progress of the scheme in its quarterly inflation reports.[26]

3.5 In April 2013, the scheme was extended in order to:

- allow participants to borrow until January 2015;[27]
- target lending more specifically to SMEs. One of the objectives of the extension is to "increase the incentive for banks to lend to small and medium-sized enterprises both this year and next".[28] For every £1 of net lending to SMEs in 2014, financial institutions will be able to draw down an additional £5 of funding from the scheme during the extension period; and
- include non-bank credit providers.

The performance of Access to Finance schemes

3.6 The *SME Finance Monitor*[29] reported that around 22 per cent of SMEs – just over a million firms in total – acquired a loan or overdraft, or applied for another form of finance, in 2012. Our estimates suggest that in 2012-13 the BIS-led schemes helped just over 5,900 SMEs (**Figure 10**). This analysis excludes SMEs assisted by Funding for Lending, since the lending data currently available do not differentiate between lending to households and lending to businesses.

The Funding for Lending scheme

3.7 Overall, participants in the scheme have reduced their net lending by £2.3 billion since the scheme was launched.[30] HM Treasury and the Bank of England jointly launched the scheme in July 2012. In the quarter ending 30 June 2013, 18 participants made drawdowns of £2 billion, taking the total amount drawn down under the scheme to £17.6 billion. Net lending by participants over the quarter was £1.6 billion. However, this followed two quarters of negative net lending. The Bank currently provides detailed information on the lenders involved in the scheme and their aggregate net lending. The Bank has announced that it intends to publish more detailed data, including disaggregated data on lending to SMEs and larger companies, during the extension of the scheme in 2014.[31]

26 Available at: www.bankofengland.co.uk/publications/Pages/inflationreport/2013/ir1303.aspx
27 Available at: www.bankofengland.co.uk/publications/Pages/news/2013/061.aspx
28 Available at: www.bankofengland.co.uk/publications/Pages/news/2013/061.aspx
29 BDRC Continental, *SME Finance Monitor*, Quarter 4 2012 report, March 2013.
30 Available at: www.bankofengland.co.uk/publications/Pages/fls/q213.aspx
31 Available at: www.bankofengland.co.uk/markets/Documents/marketnotice130424.pdf

Figure 10

The number of SMEs helped by Access to Finance schemes during 2012-13

Scheme	Number of SMEs helped
Enterprise Finance Guarantee	3,296[1]
Start-up Loans	2,419
Business Finance Partnership (small business tranche)	0[2]
UK Innovation Investment Fund	44[3]
Enterprise Capital Funds	149
Business Angel Co-Investment Fund	25
Total	**5,933**

Notes

1 This figure includes some repeat loans to the same SME.

2 First funding not drawn down until April 2013. Around 880 loans had been granted by the end of July 2013.

3 The Fund has invested in 111 SMEs but only 44 of these are based in the UK.

Source: National Audit Office analysis of departmental data

The current BIS-led schemes

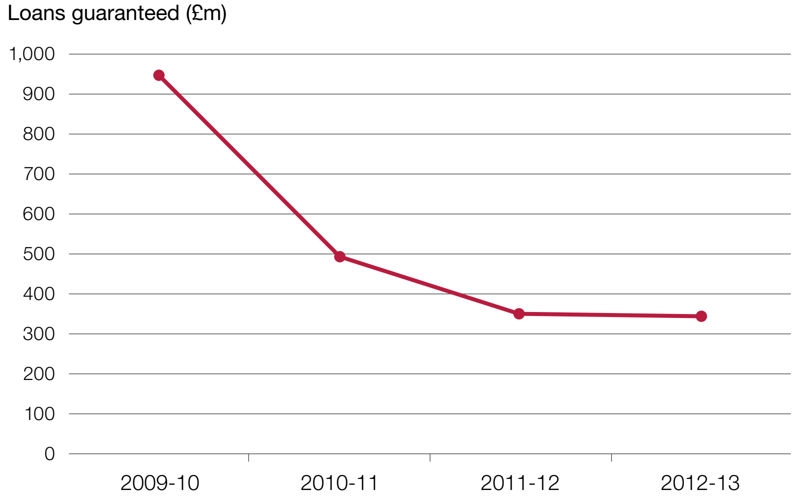
3.8 The Enterprise Finance Guarantee was introduced in January 2009, and aims to increase bank lending to viable businesses that are unable to access commercial lending because they lack security or a financial track record. By the end of 2012-13, almost 21,000 SMEs had been offered loans under the scheme.[32] But the number of loans offered has fallen each year, from around 9,200 in the period to March 2010, to around 3,300 in 2012-13. There has been a similar fall in the total value of loans guaranteed. In 2009-10, around £947 million of loans were guaranteed, but this fell to £350 million in 2012-13 (**Figure 11** overleaf). While there is no specific target for the scheme in terms of the absolute amount of lending, this means that £150 million of the £500 million annual lending facility has been left unused. BIS's analysis of previous years' lending shows that the lending drawn down has typically been around 60 per cent of annual capacity.[33] However, BIS monitors lending as a percentage of gross lending to SMEs, with the aim of ensuring that it remains in the 1–2 per cent range. In relation to the fall in absolute lending under the scheme, most stakeholders in the banking sector that we interviewed believe that this reflects the more general trend towards reduced net lending to SMEs.

32 Capital for Enterprise Limited, *Management Information: CfEL Monthly Report to BIS, Enterprise Finance Guarantee,* March 2013.

33 Capital for Enterprise Limited, *Management Information: CfEL Monthly Report to BIS, Enterprise Finance Guarantee,* June 2013.

Figure 11
Lending under the Enterprise Finance Guarantee scheme

Lending levels have fallen significantly since 2009-10



	2009-10	2010-11	2011-12	2012-13
Loans guaranteed (£m)	946.7	494.1	353.3	349.7

Source: National Audit Office analysis of departmental data

3.9 The BIS-led schemes are generally on track to achieve the largely activity-based success measures described in paragraphs 3.2 and 3.3 previously, as shown in **Figure 12**.

3.10 The main cost of operating the debt-based schemes is meeting the cost of loan defaults. In the event of an SME defaulting, the Enterprise Finance Guarantee scheme provides a 75 per cent guarantee to lenders on the outstanding balance of the loan, with a cap on default payments set at 15 per cent of the total lending amount. Once the cap is exceeded, any further risk falls entirely on lenders.

3.11 At the end of June 2013, 3,706 businesses were in default to their lenders, with outstanding Enterprise Finance Guarantee facilities of approximately £228.6 million. This figure represents the outstanding balances prior to default and before any realisation of assets, and equates to a default rate of 11.9 per cent against total original drawn facilities of £1.93 billion.[34] Default performance across the main lenders ranges between 9 per cent and 14 per cent by value.[35] In April 2012, BIS increased the cap on default payments from 9.75 per cent to 15 per cent in order to encourage utilisation of the scheme by the banks.

34 Capital for Enterprise Limited, *Enterprise Finance Guarantee Quarterly Report*, June 2013.
35 Capital for Enterprise Limited, *Management Information: CfEL Monthly Report to BIS, Enterprise Finance Guarantee*, June 2013.

Figure 12

Summary of the performance of BIS-led schemes against success measures

Scheme and associated success measure	Actual performance	On track?
Enterprise Finance Guarantee: To guarantee annual lending of £500 million subject to demand between 2011-12 and 2014-15.	Financial year 2012-13: 3,296 loans offered with a total value of £350 million – 2,800 loans drawn down, with a total value of £294 million.	While annual lending capacity has not been fully utilised, scheme utilisation consistently represents the 1–2 per cent of gross lending to SMEs that BIS regards as an appropriate level of demand.
Start-up Loans: To use the funding available to support up to 30,000 new businesses between its launch in September 2012 and March 2015.	At the end of September 2013, £42 million had been used to support around 7,500 new businesses. 37 per cent of funding used in the first 12 months. Around a quarter of the target number of businesses supported.	Yes
Business Finance Partnership (small business tranche): For lenders to fully drawdown the £100 million of funding available between its launch in summer 2012 and March 2015.	At 31 July 2013, 882 loans totalling £50 million had been made. The scheme accounted for £12.5 million of the total value of these loans with the remainder provided by private investors. 50 per cent of funding drawn down in the first 12 months.	Yes
UK Innovation Investment Fund: To increase the supply of equity finance to growing technology businesses in strategically important UK sectors. To attract enough private investment to create a £1 billion fund over ten years.	At 31 March 2013, the total value of the underlying fund was just under £2.5 billion.	Yes
Enterprise Capital Funds: To increase the supply of equity finance by establishing a rolling programme of viable funds, attracting at least one third of funding from private sector sources.	At 31 July 2013, the total value of investment was £402.9 million across 12 funds. The government's commitment comprised £237.8 million of the total investment. Funding from private sector sources represented the remaining £165.1 million or 41 per cent.	Yes
Business Angel Co-investment Fund: To use the funding available to create and safeguard jobs. Key performance indicators for Quarter 2, 2013 were to invest £7 million of funds and to create/safeguard 168 jobs.	At 30 June 2013, the fund had exceeded expected performance for Quarter 2, 2013: £12.4 million invested or approved and 347 jobs created/safeguarded.	Yes

Source: National Audit Office analysis of departmental data

3.12 The number and value of loans offered for the quarter ending 30 June 2013 has increased compared with the previous quarter and is the highest by value since the end of 2010. This suggests that utilisation is increasing, but it should be noted that this comes at a greater potential cost to BIS due to the increased claim limit compared to previous financial years.

3.13 BIS initially anticipated default rates under the Start-up Loans scheme of around 40 per cent, based on results from a similar Prince's Trust initiative. The Department is prepared to accept such default rates, and is satisfied with the scheme's current performance. Given the rapid rate at which loans are being made under this new scheme, it is important that default rates and other key variables that will affect the success of the scheme, such as additionality, jobs created, and the survival of new businesses, are closely monitored over the lifetime of the programme.

3.14 Forecast default rates for the Business Finance Partnership vary by individual lender and the relative volume of lending of each lender within the overall programme. BIS expects to make a net positive return (returns less defaults) for each individual lender and across the programme as a whole.

The earlier BIS-led equity schemes

3.15 Venture capital funds are not expected to show significant returns until later in their lifespans. A report commissioned by BIS in 2010 concluded that "the development of a well-functioning early stage venture capital market is a long term project… with positive returns unlikely to be achieved until around year eight following initial investments".[36]

3.16 Four of BIS's earlier venture capital funds which were launched over ten years ago (UK High Technology Fund, Regional Venture Capital Funds, Community Development Venture Funds and Early Growth Funds), and which formed the basis of our 2009 report on *Venture capital support to small businesses,*[37] might be expected to show positive returns by now. All of these earlier funds have completed their active investment periods and are no longer making new investments. Rather, the Department is looking to maximise the value of existing investments and seek viable exits, and has granted Captial for Enterprise Limited (CfEL) approval to extend the closure dates for these funds.

36 SQW Limited, *Improving the coherence, co-ordination and consistency of publicly-backed national and regional venture capital provision*, August 2010.

37 Comptroller and Auditor General, *Venture capital support to small businesses*, Session 2009-10, HC 23, National Audit Office, December 2009.

3.17 While achieving a financial return is not the main priority, as shown in **Figure 13**, the funds established over ten years ago received government commitments of over £140 million but are generally returning sums much smaller than the amounts invested. The exception is the Community Development Venture (Bridges) Funds, which have reported a £6 million gain on the £20 million investment made.

Figure 13
BIS's earlier venture capital funds

Returns from BIS's earlier venture capital funds have been much less than the amounts invested. The Community Development Venture (Bridges) Funds are the exception.

Fund name	Year commenced to expected closure	Commitment	Distributed/expected returns on investment
UK High Technology Fund	2000–2014	£20m	£1.12 million reported as distributed to government but this may be subject to a clawback provision. (The Department subordinated its investment in favour of private investors.)
Regional Venture Capital Funds	2002–2015	£74.4m	£0.82 million reported as expected return out of the £74.4 million invested in the programme. (The Department subordinated its investment in favour of private investors.)
Community Development Venture (Bridges) Funds	2002–2014	£20m	£26.02 million reported as distributed, representing more than £6 million gain on commitment drawn.
Early Growth Funds	2003–2015	£31.5m	£9.55 million reported as the expected return, although significant challenges are expected in achieving this figure.
Aspire Fund	2008, relaunched in 2012	£12.5m	Not reported.
Capital for Enterprise Fund	2009–2015	£50m	Nil – £14.6 million reported loss against the commitment drawn.

Source: Capital for Enterprise Limited, *Equity Monthly Report to BIS*, July 2013

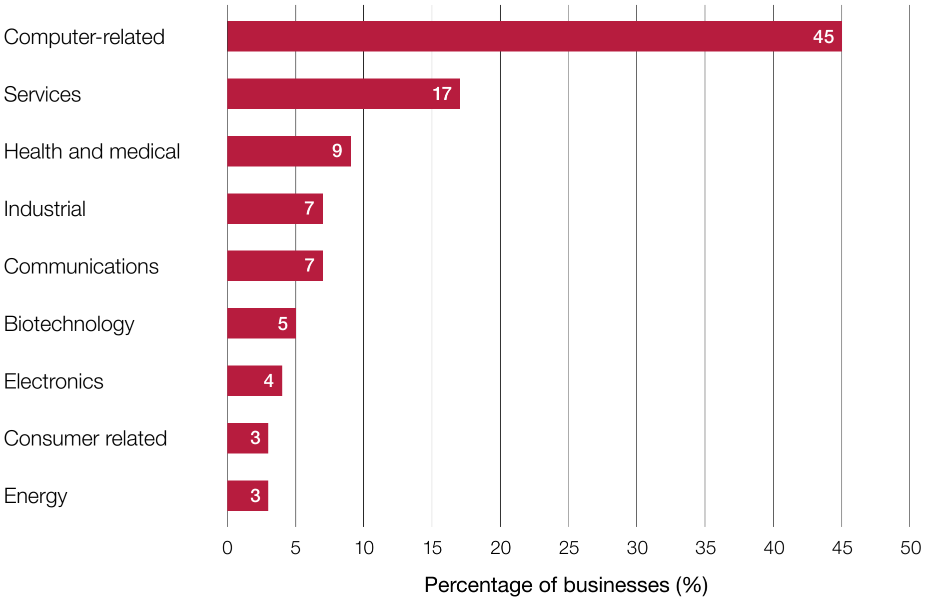
The types of SME supported by the schemes

3.18 With the exception of the UK Innovation Investment Fund, which invests in technology-based businesses, the schemes do not explicitly target SMEs in any specific sector or location. Nevertheless, management information is collected and reported according to sector and region for the majority of schemes. The main beneficiaries of the schemes vary significantly, as illustrated at **Figure 14** on pages 35 to 37 and **Figure 15** on pages 38 to 40.

Figure 14
Beneficiaries of the schemes by sector

Businesses operating in the IT sector (Computer-related, Software and Online Services) are the main beneficiaries of Enterprise Capital Funds and the Business Angel Co-investment Fund

Enterprise Capital Funds



Business Angel Co-investment Fund

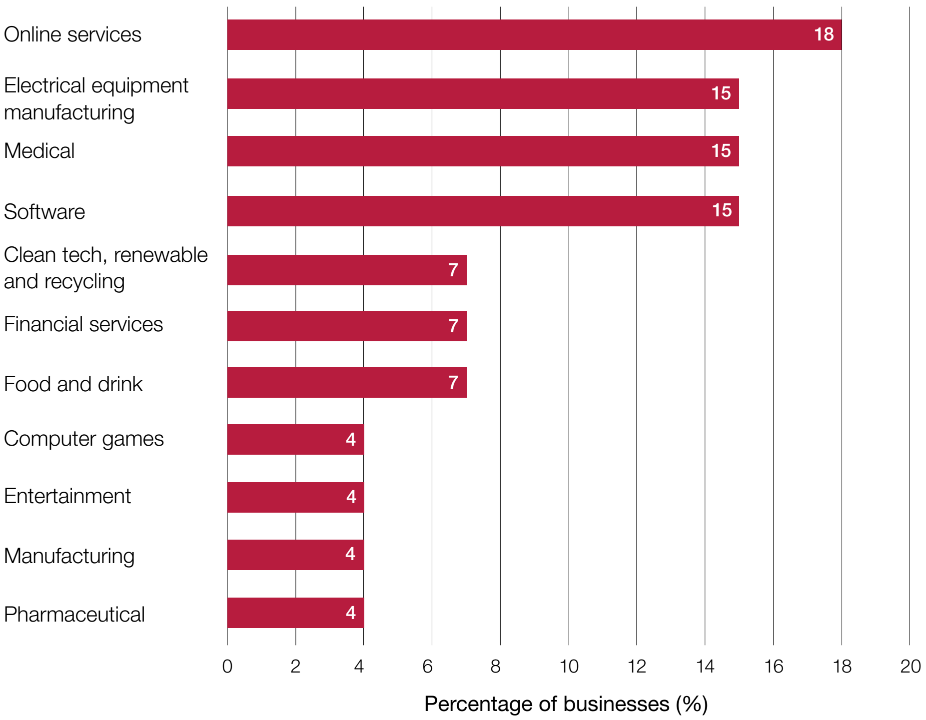


Figure 14 *continued*
Beneficiaries of the schemes by sector

Debt-based schemes such as Enterprise Finance Guarantee and Business Finance Partnership benefit a greater variety of sectors

Enterprise Finance Guarantee

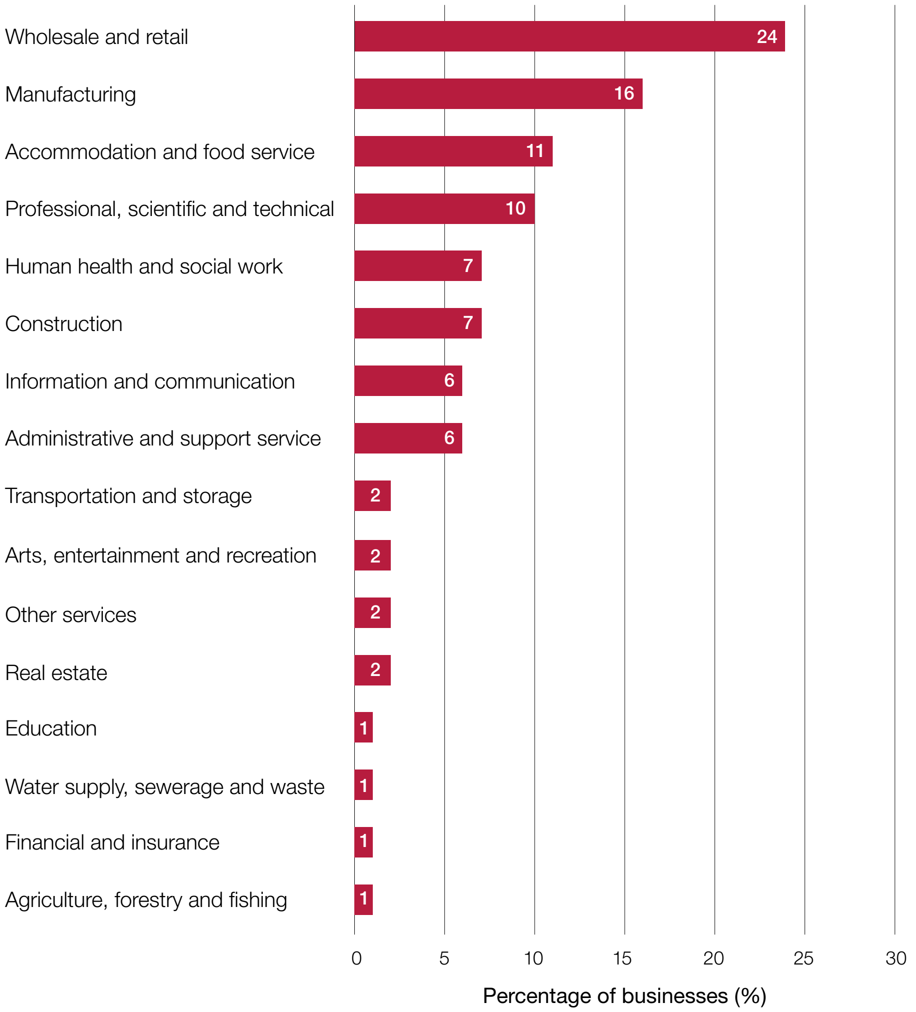
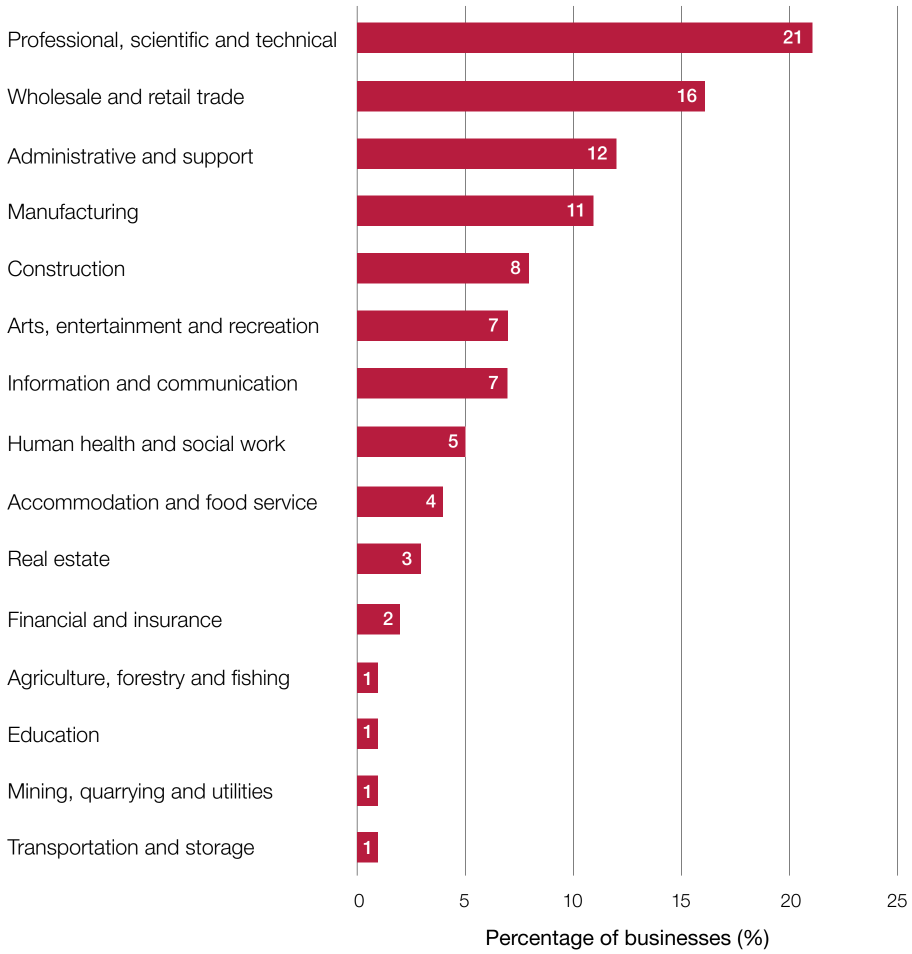


Figure 14 *continued*

Beneficiaries of the schemes by sector

Business Finance Partnership

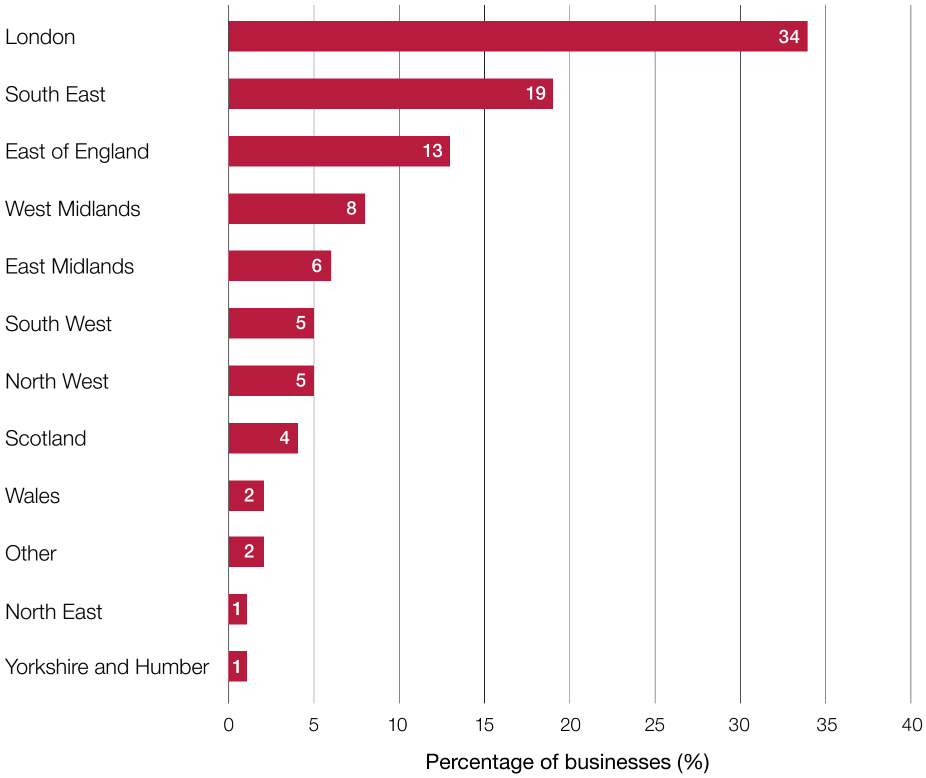


Source: National Audit Office analysis of departmental data

Figure 15
Beneficiaries of the schemes by region

More than half of the support available under the Enterprise Capital Funds and the Business Angel Co-investment Fund benefits businesses in London and the South East

Enterprise Capital Funds



Business Angel Co-investment Fund

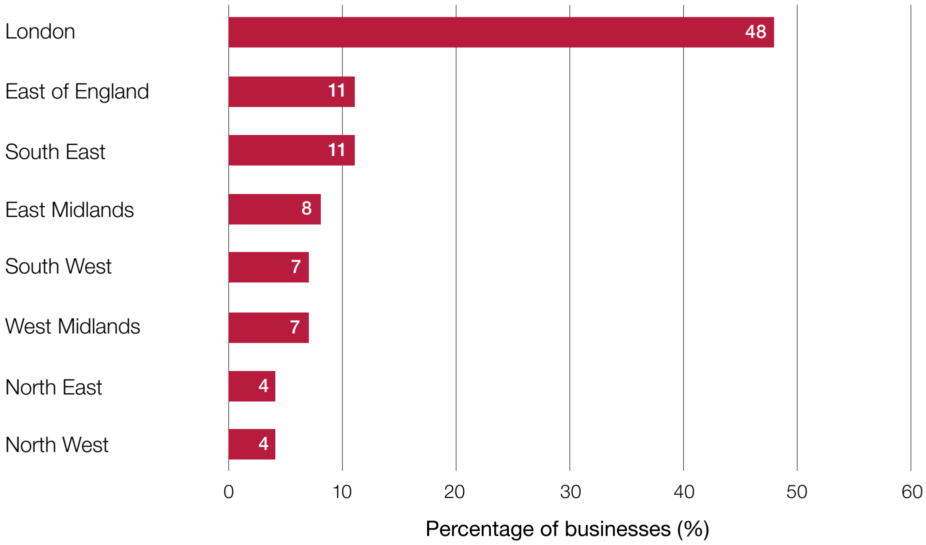


Figure 15 *continued*
Beneficiaries of the schemes by region

Debt-based schemes such as Enterprise Finance Guarantee and Business Finance Partnership benefit a greater proportion of businesses outside London and the South East

Enterprise Finance Guarantee

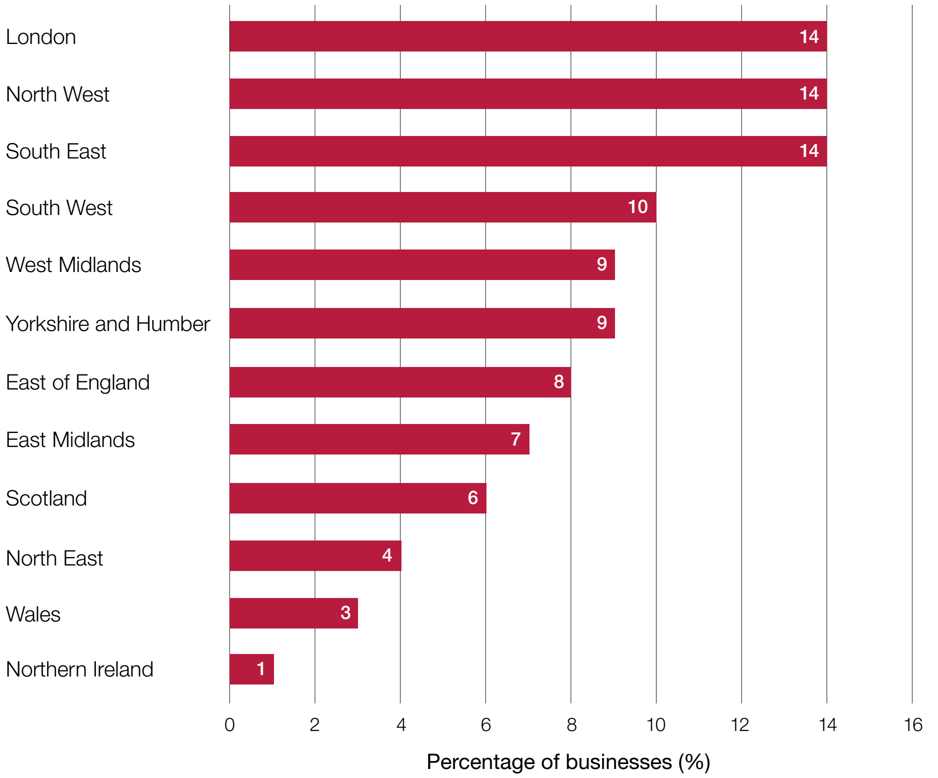
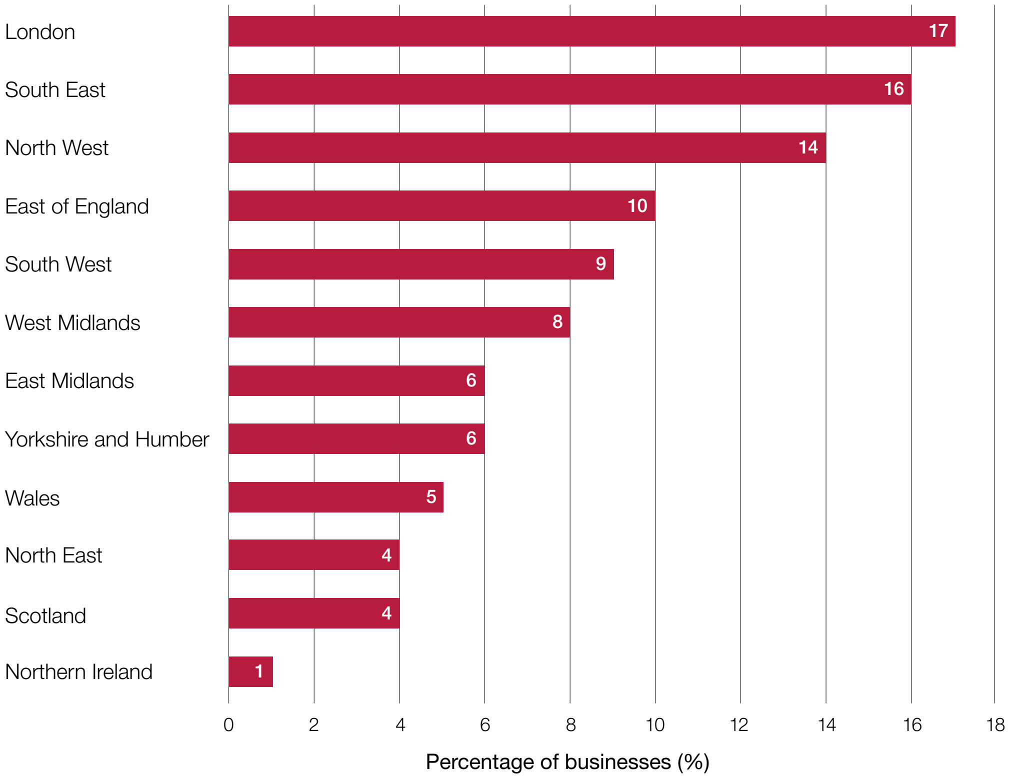


Figure 15 *continued*
Beneficiaries of the schemes by region

Business Finance Partnership



Source: National Audit Office analysis of departmental data

3.19 We would expect SMEs in London and the South East to be significant beneficiaries of support, given that around a third of all SMEs in the UK are based there.[38] As shown in Figure 15, more than half of the support under the Enterprise Capital Funds and Business Angel Co-investment Fund goes to businesses in London and the South East, and businesses operating in the IT sector are the main beneficiaries (Figure 14). The recently published Information Economy Strategy,[39] part of BIS's broader industrial strategy, identified particular finance needs in this sector. It notes that "High-potential tech start-ups and small businesses in the information economy sector can face particular barriers in accessing the finance to grow into medium and large-sized firms".

38 BIS, *Business population estimates for the UK and regions 2012*, October 2012.
39 Available at: www.gov.uk/government/publications/information-economy-strategy

3.20 There is some evidence that the BIS-led debt schemes tend to serve SMEs seeking relatively large amounts of finance. Over the life of the Enterprise Finance Guarantee scheme, the average loan has consistently been around £100,000, while 43 per cent of Business Finance Partnership loans are between £50,000 to £100,000. By contrast, a survey in 2012 indicated that 46 per cent of SMEs that sought finance were pursuing loan amounts of less than £25,000.[40] This suggests that some schemes could be better matched with the needs of businesses at the smaller end of the SME spectrum.

Delivering economic impacts

3.21 The Enterprise and Economic Development Analysis team within BIS has drawn up a comprehensive and well-designed schedule for evaluating the long-term effectiveness of the Department's schemes. Given that the six BIS-led schemes are relatively new, only the Enterprise Finance Guarantee has been subject to a substantive economic evaluation, while early assessments have been conducted on the Enterprise Capital Funds and the UK Innovation Investment Fund.

3.22 The evaluation and assessments have produced a number of positive findings. For example, the Enterprise Finance Guarantee economic evaluation, published in early 2013,[41] concluded that:

- the scheme had provided a net benefit of £1.1 billion and the firms that obtained a loan through the scheme in 2009 were responsible for creating 6,500 jobs, equivalent to 0.96 additional jobs per business;
- most of the borrowing is in addition to any that would have occurred without the scheme; and
- loans used for investment purposes were significantly more likely to be associated with employment and sales growth, compared with loans primarily used for working capital.

3.23 Early assessments of the Enterprise Capital Funds and the UK Innovation Investment Fund, published in July 2010 and May 2012 respectively, concluded that:

- businesses receiving the funding had high growth potential which would lead to economic and non-economic benefits; and
- many firms also perceived qualitative benefits that they had received from investment, including: management advice; being part of a large business support network; sector expertise; improved networking access; and connections with other investors including business angels.

40 BIS, *Small Business Survey: SME Employers*, 2012.
41 Available at: www.gov.uk/government/publications/enterprise-finance-guarantee-efg-scheme-economic-evaluation

3.24 By contrast, the UK Innovation Investment Fund early assessment also identified factors that might inhibit the success of the scheme. One factor relates to the high percentage of overseas businesses within the underlying fund portfolio. The initial objective was to attract private sector investment that matched BIS's £150 million contribution, and this target has been exceeded. However, performance data as at 31 March 2013 show that investment in UK companies comprises just 40 per cent of the total number of investments. While investment in overseas companies is permitted within the guidelines of the scheme, it is apparent that UK companies are not the sole beneficiaries of the Fund, which raises concerns about the extent of additional equity finance made available to UK-based technology businesses.

3.25 Evaluating the impact of equity funds is difficult at this relatively early stage of the funds' development, and BIS cannot yet know the amount of GVA represented by each £1 of investment. An interim evaluation is due before the end of the 2013-14 financial year, but final assessments will be carried out only once the funds close. It will therefore be some time until the effectiveness and success of these equity-based interventions are known.

3.26 We are, however, concerned that evaluations of the debt and equity schemes may be over-reliant on surveys of the businesses that have actually received loans or investment. By measuring the schemes' effectiveness in this way, there is a risk that the wider impacts of the schemes are not considered and put in context. BIS is exploring the potential for using a wider range of comparators in its future evaluation methodologies.

Appendix One

Our audit approach

1 In this study, we examined whether the Department for Business, Innovation & Skills (BIS) and HM Treasury have been successful in improving access to finance for SMEs. We considered whether they are:

- managing the programme of initiatives efficiently; and
- managing or overseeing individual schemes effectively.

2 Our audit approach is summarised in **Figure 16** overleaf. Our evidence base is described in Appendix Two.

Figure 16
Our audit approach

The objective of government

Government's objective is to help improve the flow of finance to viable SMEs, and to improve alternative forms of funding, so that businesses enjoy a wider range of external financing options.

How this will be achieved

By conducting research into the needs of SMEs and the gaps in financing provision.

By engaging with the small business community.

By running specific schemes that aim to make finance more accessible.

Our study

Our study examined whether BIS and HM Treasury are helping improve access to finance for SMEs in an efficient and effective way.

Our evaluative criteria

Are BIS and HM Treasury managing the programme of initiatives efficiently?

Are BIS and HM Treasury managing or overseeing individual schemes effectively?

Our evidence

(see Appendix Two for details)

- Interviews with departmental staff.
- Focus groups of SMEs.
- Discussions with lenders.
- Review of SME surveys.
- Review of research and papers associated with the Business Bank.

- Interviews with departmental staff.
- Discussions with SME representative groups.
- Discussions with lenders.
- Review of scheme documentation, management information and evaluations.

Our conclusions

Research and market data are relatively strong, but the mechanism for coordinating the emerging insights from these sources is fragmented. The approach to the problem is relatively piecemeal, with no overall articulation as to whether the current mix of schemes represents the most efficient and effective use of resources. The development of the Business Bank is a good opportunity to address these issues.

Appendix Two

Our evidence base

1 Our independent conclusions on whether the Department for Business, Innovation & Skills (BIS) and HM Treasury have been successful in facilitating improved access to finance for small and medium-sized enterprises (SMEs) were reached from evidence that we collected between April and July 2013. Appendix One sets out our audit approach.

2 In order to assess whether BIS and HM Treasury are managing the programme of initiatives efficiently, we:

- **assessed** the nature and quality of market data available from different sources;
- **interviewed** key staff within BIS and HM Treasury, including the Senior Responsible Officer for the Business Bank project; the Chair and the Chief Executive of Capital for Enterprise Limited (CfEL);
- **reviewed** the specific pieces of research that have been commissioned by the Departments in the last five years, and particularly those intended to support the establishment of the Business Bank;
- **explored** non-bank lending forms of finance with the Asset Based Finance Association, British Private Equity & Venture Capital Association, and the Finance & Leasing Association;
- **reviewed** sponsorship arrangements and Key Performance Indicators for CfEL;
- **evaluated** the main communications tools used to inform SMEs of the financing options available;
- **visited** the headquarters of CfEL, where we discussed the organisation's role in managing the schemes, and its development of a new management information system; and
- **conducted** focus groups with representatives from SMEs in Bristol, London and Newcastle, with assistance from the Federation of Small Businesses.

3 In order to assess whether BIS and HM Treasury are managing or overseeing individual schemes effectively, we:

- **interviewed** the policy leads for each BIS-led scheme, along with staff in HM Treasury's Enterprise Policy team and Intervention Strategy and Markets team;
- **liaised** with the Bank of England over the Funding for Lending scheme;
- **reviewed** ROAMEF (Rationale, Objectives, Appraisal, Monitoring, Evaluation, Feedback) statements for each BIS-led scheme;
- **evaluated** the management information produced routinely for each scheme;
- **analysed** the scheme evaluations and discussed them with BIS's Enterprise and Economic Development Analysis team;
- **conducted** semi-structured interviews with five of the main high street lenders – Barclays, HSBC, Lloyds Banking Group, RBS and Santander; and
- **discussed** the SME finance market with key representative groups – the Confederation of British Industry, Forum of Private Business, Federation of Small Businesses, and Institute of Chartered Accountants in England and Wales.

Appendix Three

Glossary of terms

Term	Definition
Additionality	The concept of an initiative prompting financial support to a business which would not have occurred if the initiative did not exist.
Asset-based financing	Funding which is secured on an asset belonging to the business – this might be a physical asset, or the promise of future income represented by invoices.
British Bankers' Association (BBA)	Trade association for the banking and financial services sector, representing over 200 bodies.
Business angel	An individual who provides finance for a business start-up, usually in exchange for ownership equity.
Counterfactual	Conditions which would have existed if a particular course of action had not been taken.
Debt finance	Borrowing money from an external source, on the promise of returning the capital and additional interest over a period of time.
Equity finance	Investment in a company, in the anticipation of future income from dividends and capital gains.
Facility	The granting of financial support (usually a loan) by a bank or other type of lender.
Fund of funds	An investment strategy of holding a portfolio of investment funds rather than investing directly in stocks, bonds or other securities.
Gross value added (GVA)	A measure in economics of the value of goods or services produced in an area, industry or sector.
Mezzanine finance	A hybrid form of funding, containing elements of debt and equity.
Net economic benefit	The total benefit of introducing a new scheme or initiative, minus the cost of introducing it.
Net lending (by financial institutions)	The balance, over a fixed period of time, between the value of new loans made and the value of loans repaid.

Term	Definition
Overdraft	The extension of credit by a lending institution, up to a set amount, when the balance on an account reaches zero.
Peer-to-peer lending	Lending to unrelated individuals without going through a traditional intermediary such as a bank.
Sole trader	A business entity owned and run by a single person.
Supply chain finance	Tools that allow a firm to sell invoices to a lender, at a discount, in order to improve cash flow.
Venture capital	Money provided by investors to start-up companies or small firms that appear to have long-term growth potential.
Working capital	The money available for a company's day-to-day operations.

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