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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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.