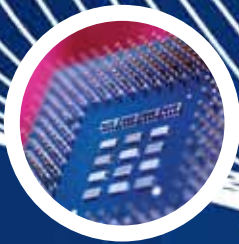
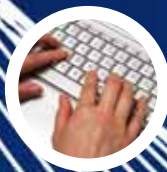


The ERA Foundation



The Sustainability of the UK Economy in an Era of Declining Productive Capability

Access to Finance - The Case for Special Measures for SMEs

6th Report - October 2011

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Introduction

Over the past four years the ERA Foundation has conducted a number of studies under the general heading of "**The Sustainability of the UK Economy in an Era of Declining Productive Capability**". Our first report (published in June 2008) looked at the serious deterioration in the balance of trade over the past decade, in large measure resulting from excessive imports and declining exports of finished manufactured goods. Our second report (published in February 2009) looked at the make-up of the nation's current account and the significance of manufacturing in the UK's balance of trade. Our third report looked at the location of manufacturing capability and the impact of services. In our 4th report (published in February 2010) we looked at those factors which needed to be optimised to ensure productive industry can flourish in the UK. Our 5th report comprised our input to the Government's Growth Framework consultation, which we wished to share with our network of industrialists, funders, investors, academics, and opinion formers. All of these reports are available on our web site www.erafoundation.org.

A consistent theme in our consultations has been the failure of the banks to engage effectively with SMEs, and the loss of confidence of many SMEs in the banks as sources of investment and working capital on other than punitive terms. This issue remains of sufficient concern that we look at the problem in more detail in this report. Although it has become fashionable in some quarters to "bash the bankers", we wish the Financial Services Sector a speedy return to rude health as part of a balanced UK economy. Nevertheless, the strong focus upon what appeared to be more profitable international investment opportunities has undoubtedly led to a serious shortfall in local banking. The banking sector has failed to recognise its role as a "service industry"; providing key services to Industry, and the nation at large rather than merely seeking to optimise its own profitability.

SME's are especially important in the area of manufacturing where they contribute significantly to the balance of trade and provide an essential supporting infrastructure for larger manufacturers. The provision of adequate financing and investment for SME's is clearly a critical requirement for a healthy UK economy. **If the UK is to achieve a substantial growth in productive industry the nation needs special measures to ease access to finance for SMEs.** In recent times the established banks have not demonstrated a commitment to nurturing new businesses and helping them to grow. They may lack the necessary expertise to understand the needs of productive industry and the local knowledge to work effectively with SME's and to identify the good risks from the bad.

The steps taken by the Government to date to encourage the Banks to support productive industry are insufficient to address the national need to unleash a new generation of entrepreneurs, to allow existing small companies to grow to serve the larger companies that remain in the UK and export in their own right. A well-funded, dynamic and expanding SME community is essential if the UK is to maintain and grow its productive capabilities and close the trade gap. To achieve this end a well focussed financing capability, with the technical expertise and local knowledge to be able to identify good risks from bad and to fund them appropriately, is equally essential. If this service is not provided by the established banks it falls to Government to consider how it can best be implemented. A Bank for Industry offers a realistic solution to an obvious problem.

We are grateful to Quotec, Civitas, Oxford Innovation, SMEIA, Simpson Associates and Policy Connect for sharing their knowledge of SME funding with us.



Sir Alan Rudge CBE, FREng, FRS
Chairman, The ERA Foundation

Access to Finance - The Case for Special Measures for SMEs

Introduction

The ERA Foundation has undertaken several studies in recent years relating to the importance of manufacturing in a balanced UK economy. The most recent report, with references to earlier reports, is "The ERA Foundation's 5th Report on the Sustainability of the UK Economy in an Era of Declining Productive Capability" available at http://www.erafoundation.org/docs/ERAF_5thReport_March11.pdf.

These studies have shown that the quality of UK manufacturing is not the primary issue. It is a quantity issue in that there is insufficient manufacturing capability remaining in the UK to sustain national prosperity at its current level. Successive administrations over recent decades have ignored manufacturing and have been overly obsessed with the financial services sector. However, it is clear from the available data that without a substantial manufacturing sector the UK has no prospects of closing the trade gap and effectively earning its living.

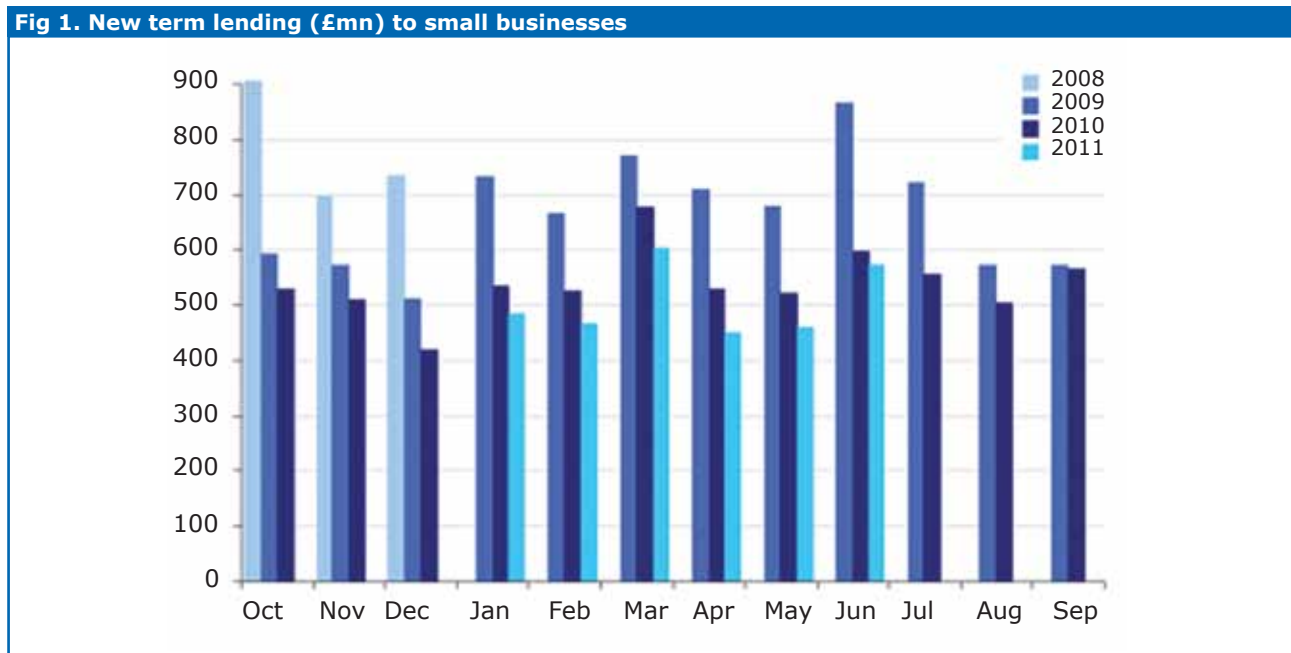
Our 4th and 5th reports, based on evidence from our studies and very wide consultation, highlighted various parameters requiring attention if the decline in UK manufacturing is to be reversed. The ERA Foundation has used the analogy of a greenhouse to illustrate the situation. If just a few plants in the greenhouse die then one questions the health of the plants; but when many of the plants in the greenhouse are withering it is time to examine the greenhouse. The key parameters of our national manufacturing "greenhouse" were identified and the recommendation made that all of these need to be optimised to the greatest degree possible. Access to finance was identified as a key parameter, particularly for start-up companies and SMEs.

UK Bank Behaviour

The banks have neglected the SME sector in recent decades and, as a consequence, have failed to serve the UK's national interest. An excellent analysis of the difficulty faced by SMEs is contained in "SME finance and innovation in the current economic crisis" by Cosh, Hughes, Bullock and Milner of the Centre for Business Research, University of Cambridge available online at http://www.cbr.cam.ac.uk/pdf/CrCr_EconCrisis.pdf. This report examines the findings from a long-running programme of surveys of SMEs. The latest survey for 2008 produced new findings on how SMEs have coped with the credit crunch and recession. The report makes comparisons with earlier periods and, in particular, 2004 and the recession of the early 1990s. It also examines which types of firm have been most affected and the consequences for R&D, capital expenditure, training, and SME policy.

There has been much publicity around the Chancellor's "Project Merlin" agreement with the Banks. The four major UK banks (HSBC, Barclays, Royal Bank of Scotland and Lloyds Banking Group), plus Santander, have committed to making £190bn of credit available to businesses in 2011, up from the £179bn they lent in 2010. Of this lending commitment, £76bn is to be made available to smaller businesses. That represents a proposed increase of £10bn, or 15%, in credit that was available to SMEs in 2010. But based on the experience of recent years, and current practises and structures, there is little confidence in the business community that "Project Merlin" will work – at least for SMEs.

British Banking Association (BBA) data show that lending to SMEs declined in every month during 2010 compared with 2009 (which was in turn down on 2008) – see Figure 1. The first six months of 2011 (the latest data available) show further decline¹, again calling the effectiveness of Project Merlin into question.



Data from the Warwick Business School UK survey of SMEs in late 2008² present a sobering picture. The key findings were that in 2008 (compared to 2004):

- Overdraft rejections increased 3½ times (4.2% to 15.3%).
- Term loan rejections increased 2½ times (6.1% to 16.3%).
- Average size of overdraft facilities loans increased by 30% (£36,500 to £47,500) – but decreased by 75% among 'high risk' firms (£58,000 to £14,500).
- Overdraft margins increased by 83% (2.4% points to 4.4% points over base).
- Overdraft arrangement fees increased by 86% (£237 to £442).
- Term loan margins increased by 68% (2.2% points to 3.7% points over base).
- Term loan arrangement fees increased by 37% (£1,074 to £1,468).
- There was no change in average incidences of collateral – but there was a 78% increase (33.3% to 59.4%) in collateral posted on loans by low risk firms.

¹British Banking Association Small Business Support Statistics

²Small Firms in the Credit Crisis: Evidence from the UK Survey of SME Finances V3 - October 2009

The picture given is of the Banks recapitalising by increasing charges whilst restricting lending.

The results above show that while loan rejection rates increased significantly in 2008, at the same time average loan amounts increased. However lower risk firms, in particular those with collateral, were the main beneficiaries of these increases; higher risk businesses, which would have found it relatively easy to access loans during the credit boom, found their supply of credit substantially reduced. It would therefore seem that banks, to meet lending targets set by the Government, lent larger secured loans to low risk borrowers whilst reducing credit availability to companies perceived as higher risk borrowers and particularly those without collateral.

The funding of SMEs by banks is currently subdued, with net repayments of loans and overdrafts over the last 2 years³. There is a reasonable expectation that funding of SMEs will be severely constrained as demand picks up in the next few years. This financial constraint must inevitably reduce growth.

A major issue has been the move of banks to centralize decision making on lending, which appears to be "formulaic". The loss of local knowledge with the demise of the traditional "local branch manager" means that lending decisions are being made with scant reference to the understanding of individual reputation and competence, beneficial relationships or other local issue – all factors which can maximise the opportunities for success of any small business and distinguish between good and bad risk for the bank or a potential investor.

A brief anecdote illustrates the problem: A Midland's SME supplying to a Japanese car company in the UK was producing components of such quality that it was asked to tender for the provision of the component for the car company world-wide. This dramatic expansion opportunity to a prestigious customer required access to working capital. The response of the SME's bank manager was "*automotive components are not on our central list of allowed investment sectors*"⁴.

An ACCA report "*Improving SME access to equity finance*" (see http://www.accaglobal.com/documents/acca_cga_cpaa.pdf) indicates that 80% of SMEs have now lost confidence in the major banks. New forms of community finance are being tried, but whilst these are to be applauded realistically they can only hope to make an impact at the margins. There are initiatives such as the proposal for the Cambridge Boring Bank⁵ and activities such as the Black Country Re-investment Society⁶ (a mutual), as well as new banks such as Virgin and Metro and a small but growing trend towards crowd-funding⁷ for start-ups and community based financial initiatives (usually in deprived areas)⁸ – see for example <http://www.crowdcube.com/>. These and other innovations (especially around web 2.0 principles) might be expected to offer new models that start to compete with existing banks and established routes to finance (debt and equity). However, the millions that are likely to be loaned, while worthy in themselves, are of small consequence compared to the tens of billions necessary to re-energise the SME base.

³British Banking Association Small Business Support Statistics

⁴Civitas - private communication

⁵Local and national press reports January and February 2010

⁶<http://www.bcrs.org.uk/>

⁷<http://www.fundingcircle.com/>

⁸<http://www.cdfa.org.uk/about-cdfis/>

The plan of the six major banks to set aside a £2.5Bn Business Growth Fund (BGF) could be seen as too little too late and only serves to illuminate the fact that service to UK industry has not been regarded as a core business) - see "Supporting UK business - The report of the Business Finance Taskforce", October 2010 (available online at <http://www.bba.org.uk/media/article/business-finance-taskforce>). The BGF focuses on high-growth potential companies with turnover in the range £10M to £100M pa, so is addressing only a small portion of the industrial landscape – indeed a part of the landscape already well placed to secure equity investment without the help of BGF. One of the original participants, Santander, has decided to withdraw from the BGF agreement since it is now indistinguishable from a conventional Private Equity Fund structure.

Government Initiatives

The various government initiatives (ECF etc.) are of course to be welcomed. The Government's "Financing Business Growth" (Treasury, BIS – October 2010) made many proposals that are to be commended.

- The "Independent Commission on Banking" has addressed the issue of risk associated with the major Banks handling of "high street" and investment functions, through a proposed "ring-fencing" arrangement.
- Regional Growth Fund support for Angel groups investing in local start-ups is a welcome development.
- The continuation of the Enterprise Finance Guarantee scheme until 2014 is excellent news.
- Options are to be explored with major corporates for an expansion of supply-chain financing.
- A commercial scheme is to be explored for access to working capital for firms to fund exports.
- Various steps are being taken to facilitate dialogue between the Banks and the business community (including SME representative bodies).

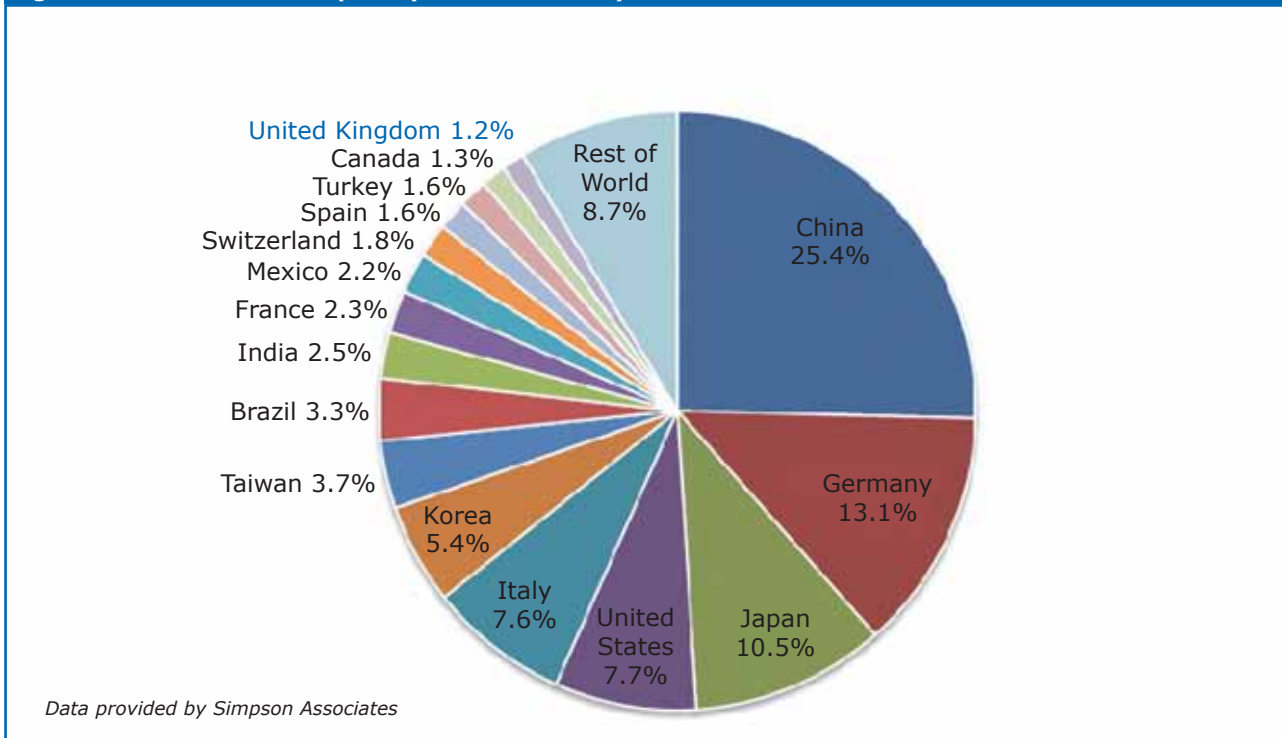
Whilst the first of these bullet points could lead to a fundamental reform, the others, however worthy, can at best be seen as tinkering at the edges. The steps taken so far do not match the commitment made in "Financing Business Growth" –

"The Government wants to make the UK the most attractive developed economy in the world for investment in SMEs ..."

At the September 2011 Conservative Party Conference the Chancellor announced a "credit easing" initiative where the Treasury could buy SME corporate bonds to provide readier access to finance. In the absence of details it is too soon to comment on whether this will provide the much-needed boost to the SME sector.

Investment in capital equipment remains a major issue. The inexplicable decision of the Government to reduce the Annual Investment Allowance for equipment, from £100k to £25k pa, when coupled with the reluctance of the Banks to make capital investments (other than in property) has produced the sorry picture illustrated in the diagram below –

Fig 2. Machine tool consumption (% of world total)



The Government's proposal for a 'Green Bank for Industry' is unnecessarily restrictive and may well direct effort into ultimately non-commercial enterprises. This proposal could sensibly be broadened into an all-product 'Bank for Industry', akin to the Industrial and Commercial Financial Corporation, ICFC. This was an organisation with relevant objectives, until it was transformed into 3i, an organisation concerned primarily with maximising its own short-term profitability.

The ICFC Approach

The history of the ICFC has been recently charted in a Civitas study "The Industrial and Commercial Finance Corporation: Lessons from the past for the Future" (available online at <http://www.civitas.org.uk/pdf/ICFC.pdf>). In this section we draw heavily on this excellent document.

The Industrial and Commercial Finance Corporation (ICFC) was formed in 1945 as a reaction to the findings of the Macmillan Committee's report of 1931 that stated that there is '*no recognised and readily accessible channel, corresponding to the new issue market for larger firms, through which the small industrialist can raise long term funds*'.⁹ The problem became known as the 'Macmillan gap'. The ICFC's prime objective was: '*to provide credit... for industrial and commercial business or enterprises in Great Britain, particularly in cases where the existing facilities provided by banking institutions and the Stock Exchange are not readily or easily available*'¹⁰ – a situation which patently still exists today.

For four decades the ICFC was undoubtedly a success. In 1987 it was renamed "Investors in Industry" (3i) and became a private limited company, with commercial pressures forcing it to focus in large measure on mergers and acquisitions rather than loans. The official history of 3i and the ICFC was written by Richard Coopey, a Fellow at the LSE and Donald Clarke, an ex-director of 3i and, as the latter pointed out, it '*provided a national service at no cost to the taxpayer and a substantial return for its shareholders at minimal cost to them*'¹¹.

The idea of creating a new British industry bank has been mooted in recent times, but if this new institution is going to be successful, it would do well to learn from the experience of the ICFC.

The success of the ICFC was highly reliant on its knowledge of the firms it was supporting. This involved collective expertise in specialised investment from the board of directors downwards, as well as familiarity with local businesses through its regional branches. The ICFC employed its own specialists rather than relying on external advice and in the long term this was highly profitable for the Corporation as its bad debts fell to a level that never endangered profits. New companies with growth potential were given special attention and sought out as clients. A new industry bank would need to adopt the same strategy of amassing a wealth of expertise and local knowledge, allowing it to make profitable investments that would bring confidence to companies.

A Bank for Industry would need articles of association which would not allow it to depart from its commitment to funding of industry (and especially SMEs). The alternative would be a state-owned bank modelled for example on KfW, the German industrial bank. This was set up at the same time as the ICFC, but has stayed true to its original purpose of funding German SMEs

Arguments often made against a Bank for Industry, or some other such special arrangement for SMEs, is that it would only be justified in the event of market failure, and it would also potentially breach EU State-Aid rules. There is ample evidence of market failure – the existing Banks are demonstrably not providing the support needed to rejuvenate UK productive industry. And State-Aid would not be an issue if any special arrangement for SMEs was established on fully commercial grounds without Government subsidy (any initial Government assistance with capitalisation would need to be on appropriate commercial terms). The EU, it seems, has never seen any difficulty in the operation of KfW.

⁹Quoted in: Radcliffe Committee on the working of the Monetary system (para. 937), 1959

¹⁰G.W. Murphy & D. Prusmann, 'The Industrial and Commercial Finance Corporation - A Progress Report', *The Manchester School*, Vol. 36, 3 (September 1968), p.226

¹¹R. Coopey & D. Clarke, *Fifty Years Investing in Industry*, (1995), p. 376

Conclusion

The current UK banking structure is failing to provide the required finance for the UK's SME's. As a consequence of this the sector has become disenchanted with the banks and increasingly dependent upon self-funding, leading to either slow growth or unnecessary extinction. However, without a vibrant and growing SME sector the UK's manufacturing capabilities, including the larger companies will be condemned to a continued decline with massive problems for the nation's balance of trade. This is one of the key weaknesses of the UK's economy and it requires a major and substantial change for it to be corrected.

A Bank for Industry could do much to remedy this obvious weakness. Such an arrangement could also attract investors who are interested in steady growth from local assets rather than the more casino-like products currently on offer. Once through its start-up phase such a new arrangement should not be a cost to the taxpayer and could offer enormous benefits to employment and the national economy in general. It is evident that adequate financing is essential for the development and maintenance of a dynamic SME sector. A Bank for Industry, focussed upon the intelligent and expert provision of finance to the SME sector could, and should be a core component of the UK's industrial strategy.

The ERA Foundation Board



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The ERA Foundation

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