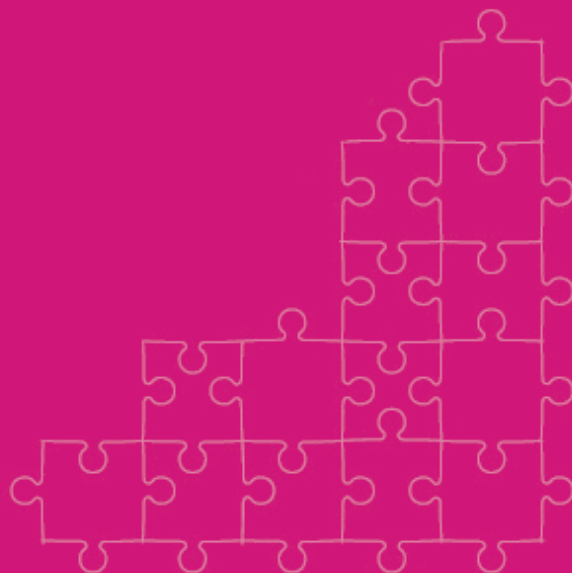


# A Co-operative Approach to Small Business Lending

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## Foreword

Recent reports have shown that lending to SMEs has continued to fall sharply over the course of 2010, especially for smaller SMEs.

Black Country Reinvestment Society has launched this report, “A Co-operative Approach to Small Business Lending” to suggest an alternative to the recently published Business Finance Task Force report, published by a consortium of six leading banks.

We believe that the Business Finance Task Force report misses several opportunities.

Firstly, it is imperative to establish what we mean by a small business. The BFTF report defines a small business as one with a turnover of up to £25 million. The majority of SMEs in the manufacturing heartlands of the Black Country turnover less than £1 million, but are profitable, innovative businesses employing well paid, full time staff.

The BFTF report understates the potential of non-bank financial institutions such as Community Development Finance institutions (CDFIs) and Small Business Loan Funds such as BCRS and the role that they play in SME access to finance.

Little account has been taken as to how SME financing was carried out prior to the credit crunch. The banks have yet to publish their proposed lending principles for small businesses and we believe this reflects the profound difficulties that they have in effectively servicing this sector of the market.

Inventing a whole new proposition on how to grow commerce and enterprise looks attractive at face value, but the lack of start up funding and access to working capital will mean that the majority of small businesses will not be eligible for assistance.

The BFTF report does not recognise the day-to-day needs of running a small business. There is a high degree of risk involved and non-related tangible securities are becoming increasingly scarce. Small businesses need time to accumulate assets and goodwill, to enable them to move up the financial continuum and access for bank funding.

BCRS operate in an area where the commercial banks activity is constrained by their own business model, as well as transaction cost structures which are too high so there is no profit to be made from a small loan. The transaction costs for a £20k loan are similar to a £2m loan.

The BCRS report on lending offers an alternative and wholly co-operative approach based on mutual principles and demonstrates that there is another way to offer a financial model to small businesses. BCRS lending is adapted to meet the needs of these smaller businesses that have scant opportunity to meet bank credit criteria, and the BFTF report does not appear to offer a practicable or commercially viable solution to this problem.

## Background

The 2007-08 Credit Crunch, and its continuing aftermath, has exacerbated and highlighted the deficiencies in the provision of credit to small business within the current institutional framework that is the financial system within England. Much analysis has focussed on the problems that current large financial institutions, primarily banks, have in providing working capital to SMEs, given their own need to replenish capital and de-toxify balance sheets. By their own admission the main banks have recognised that SME lending has contracted sharply, although their analysis of the cause may be at odds with the actual experience of SMEs (see Supporting UK business: the Report of the Business Finance Taskforce, October 2010). Latest available Bank of England (BoE) data, for August 2010, records lending to small businesses contracting by a further 4.5%, with the capital drought becoming more acute the smaller the SME. It is particularly acute for, what the Task Force terms, Micro Businesses, which constitute over 90% of all UK companies. The understandably bank-orientated approach adopted by the Task Force, understates the role, and crucially the potential, of non-bank financial institutions, such as, but not exclusively, CDFIs and Small Business Financing Funds, as can be seen in Table 1.

**Table 1: Use of business finance across different sized firms**

	Turnover	Broad Characteristics	Use of regular finance	Use of specialist finance	Typical Providers
<b>Smallest Micro Businesses</b>	Below £50,000	Cash-based firms, often part-time business; few tangible assets; local operations	Limited mainly to overdraft, loans, & credit cards or personal finance products	Limited. Some asset-backed lending (ABL) – mainly vendor finance	Banks, credit card providers & point of sale (vendor finance).
<b>Micro Business</b>	£50,000 to £1 m	Increasingly fulltime firms with staff, premises, & assets; local activity normally limited to single region; occasional exporting.	Overdraft, loans & credit card	Increasing use of structured ABL. Occasional use of trade finance products	Banks, credit card providers, specialised providers for ABL & trade products
<b>SMEs</b>	£1 m to £25 m	Full-time, larger multi-regional & national firms; increasing export/import activity.	Overdraft, loans	Still some use of ABL, factoring & invoice discounting, export finance & some equity funding.	Banks, credit card providers, specialised providers, business angels, private equity
<b>Mid-sized companies</b>	£25 m to £500 m	Larger national & international firms, often multinational operations	Overdraft (or a revolving credit facility), some loans	Export finance, invoice finance and equity funding.	Banks, venture funds, equity funds & stock market listing

Source: Supporting UK business: the Report of the Business Finance Taskforce, October 2010

Little account, either in the Task Force study or other similar commentaries, appears to have been made of how SME financing was undertaken prior to the crisis and the conditionality and customary tangible sureties that were required. In many, if not the majority of cases pledged assets had little intrinsic relationship to the commercial viability of a specific SME. As a result ventures lacking access to such collateral, and that tend to receive support in other comparable economies, are regularly denied finance and working capital. In a period of accelerating property prices, non-related tangible assets to be secured against working capital were nevertheless relatively easy to obtain and entrepreneurs in an expanding economy were relatively comfortable with such asset pledges. In a period of deflating or stagnating property prices, non-related tangible securities are themselves becoming increasingly scarce. Thus whilst a new business proposition in its own right may have robust prospects for achieving commercial viability and sustainability, the lack of start-up funding and access to medium-term working capital ensures that the proposition will be vetoed. Without formally pledged assets to be secured, banks are unlikely to provide funding, and indeed under current commercial bank criteria would be regarded as imprudent and improvident

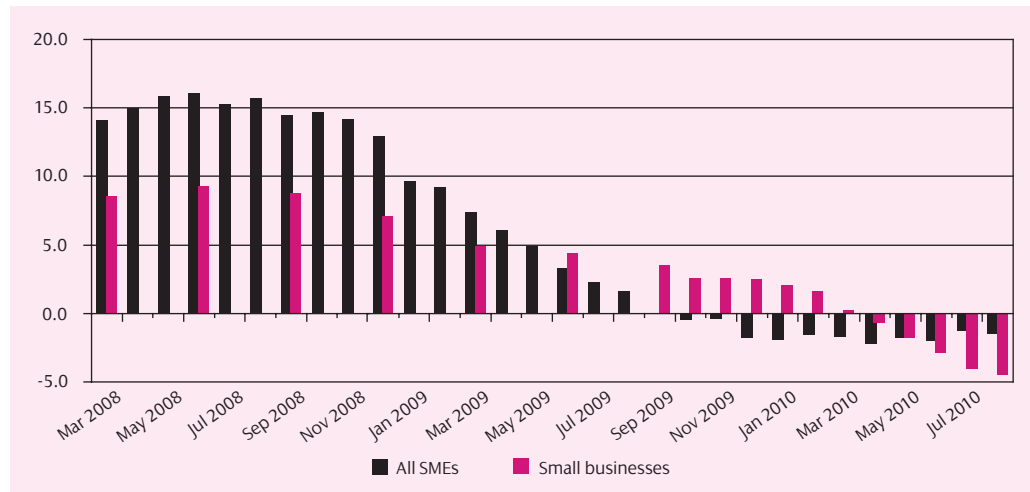
Defining what an SME constitutes, will go some way to clarify what is appropriate to meet lending needs, which the Task Force indeed begin to articulate in Table1. The BoE defines an SME as institution that has an annual turnover of £ 25 million, and while this is useful for statistical purpose, it has limitations for policy delivery. It limits focus on where a significant proportion of growth and innovation is located, that is BCRS would argue in companies with turnovers much less than £1 million per annum.

Large corporates and medium-sized enterprises possess credit histories and company-related tangible assets, accumulated over the course of their commercial life, which enables them to raise finance. Indeed data from the BoE indicates that medium-to-large corporates are continuing to successfully tap capital and credit markets. In terms of business evolution, the smaller SMEs tend to be business start-ups without tangible assets or credit histories, yet this does not preclude the fact that they have the potential to achieve commercial sustainability. In a sense the banks understandable preference for tangible security means they either pick companies that are already winners or companies that have access to assets to provide securities unrelated to the company's operations. Banks fundamentally, given that they should be adopting conservative, risk-mitigated prudential lending approaches, must find it difficult to lend to start-up companies or assess the commercial viability of business proposals in their own right. Yet, the small business sector by its very nature provides a key impetus for economic growth.

## Establishing a viable Small Business funding framework

BCRS would like to invite more wide-ranging consideration of alternative approaches to provide finance, capital and credit to the smaller SMEs. Such an approach needs to recognise the actual needs of these SMEs, both in terms of funding and management, as well as their capacity, or rather lack of it, to provide tangible security. This approach needs to recognise the potential critical role of the main banks but also their real and distinct capacity limitations in providing funding to this sector, as a result of their business models as commercial banks. Moreover, the approach must be based on commercial criteria in the assessment of specific SMEs, but of also consideration by the government of the wider economic rationale for a non-bank but sustainable funding provision for the smaller and start-up SMEs.

### Lending to small business %



Source: Bank of England

The approach needs to be based on a mutual or co-operative model, in which it is seen as in the interests of the fund providers to help foster the expansion and development of the SME provider, through close business support and the acceptance of potential growth and cash flow as security rather than tangible fixed asset pledges.

The funding of a Small Business Loan Fund or CDFI, such as BCRS, should come from as broad and diverse range of sources as practicable, and include the banks, large corporates, high net worth individuals, as well as the Regional Growth Fund, local authority provision and currently available ERDF resources. However, rather than create joint- or club-lending facilities to SMEs, funding would be to BCRS, with then BCRS as the sole-lender to an SME. While the contractual relationships (which would vary according the nature and objectives of the provider) for repayment of funds would be between the providers and BCRS. BCRS would in its own right lend directly to SMEs and would bear the loan repayment risk. The risk to the banks would be that of the credibility of BCRS, they would obviously have to undertake proper due diligence and be satisfied that BCRS has a viable business model, effective credit risk management and be comfortable with the objectives of the Society.

There are a number of benefits to the bank. It provides a risk-reduced method to lend to a sector that it is currently experiencing difficulties in lending to, regardless of whether this is a supply or demand issue. As BCRS is a recognised CDFI, funds placed with it attract CITR which could be used to provide a subsidised interest rate to BCRS and reduce the bank's tax obligations. As BCRS does not intend to open accounts for its borrowers, but rather would prefer accounts to be held at high street banks, it offers the bank introductions to new customers or the ability to offer new facilities to existing customers who do not have a sufficient credit rating to access existing bank facilities. Last but not least, the stated intention of BCRS is to enable its SME customers to grow and move up the financial continuum, developing credit histories, accumulating tangible assets, accessing more formal bank finance, and ultimately issuing equity and commercial paper. As part of this process, BCRS is developing a model in which the average length of a relationship with a client would usually be two loan periods.

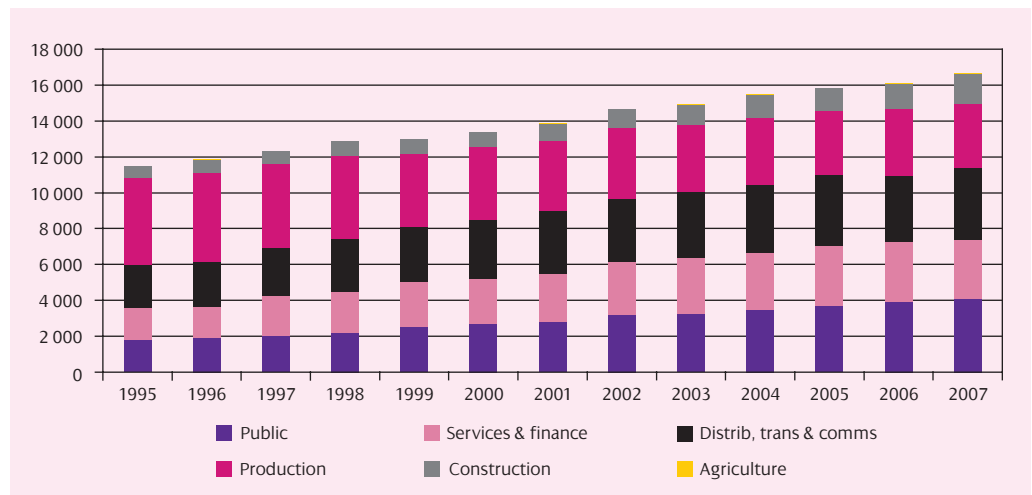
A key weakness of the SME credit sector is the high level of non-performing loans (NPLs), and while these seem high in comparison to the levels in other economies and therefore need to be reduced, it is unlikely that they will ever be anything but significant. There is probably a marked reluctance for junior managers, embarking on a career in a high street bank, to risk their commercial reputation by being anything but extremely cautious and risk adverse in approving loans; and lending to a sector with traditionally high NPLs is probably considered potentially career threatening. In contrast BCRS-type institutions have the capacity to absorb and manage such NPLs and develop a provisioning policy that ensures its commercial viability. As a mutual, and as a financial co-operative the reduction of NPLs is more likely to be the result of effective and focussed customer support relationships. Moreover, BCRS Business Managers adopt a pro-active strategy for tackling NPLs, both to limit their occurrence and effect flexibility in repayment pipelines to accommodate the often volatile or seasonality of client business cycles. The NPL recovery strategy while based on a co-operative ethos, also has a commercial imperative to ensure the sustainability of BCRS institutionally.

Furthermore, the capacity to absorb NPLs is determined by the ability to attract concessional funding from public sources, with which it will be necessary to establish an agreed "haircut" to cover, at least in part, the expected level of NPLs. Similarly, the level of tax write-offs that can be claimed will also support BCRS' capacity to operate. On the positive side however, there is a commercial incentive on the part of BCRS to reduce the level of NPLs and improve its own capital resources. The benefit to the public sector, other than the prospect of increasing the viability of SME taxpayers, is that instead of making grants to SMEs it can create loan funds that are sustainable over the medium-long term, without having to create a costly accounting system as this can be out-sourced to BCRS-type entities. Working in conjunction with BCRS, not only transforms these funds, whether sourced nationally or locally, but also allows these funding resources to be multiplied. By working in conjunction with BCRS, the funds available can usually be expected to be at least three times the size of any specific grant fund. Moreover, the loan funds can be specifically designed to meet

specific geographical or sectoral policy objectives of fund providers. Obviously, there will be some diminution or erosion of the funds, but instead of having to replenish a grant fund every fiscal year, BCRS management of a fund can extend the lifetime of the resources over a period of years, depending on the level of NPLs achieved.

For high net worth individuals the CITR availability offers some incentive, but perhaps more so is the altruistic use of the funds. Similarly for large local corporates, in addition to the CITR benefits, protection of component supplier chains, though providing finance to massage volatility, could be seen as a key issue. The availability of CITR, and similar tax reducers, is crucial and indeed some consideration to adding the flexibility of CITR and its role in attracting funds needs to be considered. The rate and qualifying criteria for CITR have a direct impact on BCRS' performance, and enhancement to the CITR would have a beneficial impact on lending capacity, given the additional funds BCRS would be able attract, and which given the funding model, has a significant multiplier effect – for every £1 of funding sourced as a result of CITR, we can lend a minimum of £3. Given the high-level of NPLs their tax treatment and of associated provisions also has an impact on performance. If it is the Coalition Government's intention to facilitate private sector growth, business start-up and crucially business retention, then an accommodative, telegraphed tax strategy for Small Business Loan Funds, with agreed regimes of maxim and minima for eligibility and application, could stimulate more vigorous growth in the SME sector.

**Black Country sectorial GVA (£mil)**



Source: ONS



## **The Black Country Reinvestment Society: a brief introduction**

BCRS was established in 2002 as an Industrial and Provident Society, initially to provide CDFI-style finance to social enterprises and SMEs in the Black Country. Geographically the Black Country comprises the local authority areas of Dudley, Sandwell, Walsall and Wolverhampton. BCRS has also recently expanded its coverage to Staffordshire. By most social and economic indicators, the Black Country ranks as one of the more impoverished in the country. Furthermore, the structure of the private sector in the area is predominantly composed of SMEs, often very small, especially in the component manufacturing sector.

BCRS currently provides small business loans ranging from £10,000 to £50,000, and continued to provide such facilities through the recent credit crunch - a period when the main high street banks severely tightened their lending criteria or actually exited this segment of the market. As a result, more businesses turned to BCRS for access to finance and in 2009 our last reporting year: we lent £1,368,000, our total loan book exceeded £2 million and cumulatively since our establishment we have issued over £6 million loans. While BCRS has moved from a social enterprise emphasis toward a more SME focussed strategy, both in response to demand and to broaden and diversify our portfolio, BCRS continues to offer the full range of CDFI products.

The success of the strategy is founded on our ability to combine private-sector sourced funding, including that from high net worth individuals, with that drawn from the public sector, both grants and funding, as well as from the co-operative and benevolent sectors. Through leveraging on these funds, BCRS is able to increase the economic impact of that funding. Furthermore, public sector support has been crucial to provide funds to establish provisions, to cover the real risks of lending into this market segment, as well as to attract other fund providers. Current public funding streams are in place to 2011.

Since 2002, BCRS has built up an effective business and credit infrastructure, to enable both the monitoring of the performance and crucially, the risk of the loan portfolio and to provide confidence to funders. As a result of operating at the riskier end of the market, BCRS has sharpened its analytic capabilities, ability to identify potential and innovative commercially-viable borrowers and thus reduce provisioning requirements. The withdrawal of the commercial banking sector from this market has enabled us to service this unmet demand and scale up accordingly.

From the BCRS perspective, the SME sector is, if anything, grossly under-banked with a dearth of effective facilities that could foster expansion. The larger universal and high street banks have historically been reluctant to service a sector that is seen as more volatile despite greater dynamism, more complex although offering greater returns, and requiring relationship-driven, more simple plain vanilla lending products than more exotic, mathematically-satisfying transaction-driven facilities. In other comparable economies, particularly where the private-sector is seen as the principal wealth creator, banks play a still significant but less dominant role in providing capital resources to fund business growth.

This opportunities being provided by the Coalition Government offers the possibility of re-emphasising the strengths of the British financial sector, and complementing these by expanding and intensifying the role of non-bank financial institutions that can provide credit and capital products, facilities and services that have been traditionally shunned by universal banks. CDFI-type structures offer some potential, but the real void in the market is between CDFI-level loans, that are more normally available up to £10,000 and corporate bank products, for which it is generally difficult to find availability below £1,000,000. BCRS currently lends up to £50,000 but for a variety of reasons, both regulatory and capital capacity, has not yet been able to offer amounts that would be credible to the larger SMEs. Realistically, our current estimated potential deal pipeline is considerable, roughly double our current loan portfolio, which we take as indicative of the strength of the demand for working capital and finance, in the Black Country, that is not being met by the high street banks. The average tenor of BCRS loans is 3 years and of funding up to 5 years.





Tel +44 (0)845 313 8410  
Fax: +44 (0)1902 428030  
enquiries@bcrs.org.uk  
www.bcrs.org.uk

Registered Office:  
Technology Centre  
Wolverhampton Science Park  
Glaisher Drive  
Wolverhampton  
WV10 9RU

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