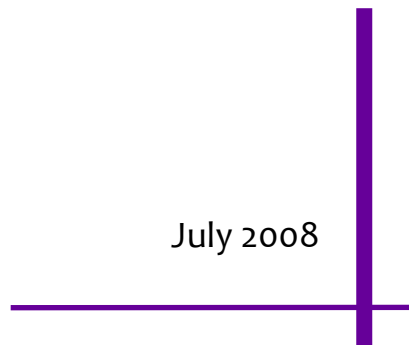


Small Firms Loan Guarantee

Annual Report for Financial Year 2007/08



Executive Summary

This report covers the operation of the Small Firms Loan Guarantee (SFLG) between 1 April 2007 and 31 March 2008. On 1 April 2008 the Department for Business, Enterprise and Regulatory Reform (BERR) transferred responsibility for the operation of SFLG to Capital for Enterprise Limited (CfEL), a newly created Non-Departmental Public Body (NDPB) operating under contract to BERR. In addition to SFLG, CfEL is responsible for managing the Enterprise Capital Funds (ECF) programme and a portfolio of other equity programmes including the Regional Venture Capital Funds (RVCF), Early Growth Funds (EGF) and the UK High Technology Fund (UKHTF).

In 2007 SFLG utilisation declined further to 2,619 loans guaranteed. However, considerable variations in utilisation of lending limits and default performance are now being seen between the key lenders. CfEL now has the information base to enable it to work with lenders to ensure that their use of SFLG demonstrates reach, additionality and cost-effectiveness. Independent auditing of the lenders has confirmed that their use of SFLG is within the eligibility criteria and that the “light touch” oversight envisaged by the Graham Review was justified. However, this must be balanced by the fact that default rates are significantly higher than those for broadly equivalent secured commercial lending.

Six new lenders, representing the banking, factoring and community development finance sectors, joined SFLG during the year. This is in keeping with the intention of making SFLG as accessible as possible to small and medium-sized enterprises (SMEs), irrespective of the type of institution from which they borrow.

The “Five Year” rule has been seen as a significant barrier to use of SFLG and the announcement of its removal in the Enterprise Strategy in March 2008 has been welcomed across the lender and small business communities. Further work with the lenders over the coming year will identify any other barriers to be addressed. In particular, further educational and promotional work to stimulate appropriate demand is considered necessary.

During the year, migration of the legacy (pre-Graham Review) portfolio of loans to the web-based programme management system was completed, enabling economies of scale to be achieved in operational processes and consistent management information to be generated.

The principal recommendations of the Graham Review have now been operative for two full years and CfEL is satisfied that some progress has been made against each success criteria. Following its launch as an NDPB on 1 April 2008, CfEL will now seek to build on the Graham Review to ensure that SFLG operates in the most cost-effective way and adds value to the SME finance markets.

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1

Debt Finance for Small and Medium-sized Enterprises

- 1.1 There are 4.5 million SMEs¹ in the UK, of which around 1.7 million are VAT-registered.² 23% of SMEs sought external finance during 2006.³ 75% were successful on their first attempt but 13% failed to attract any external finance. In almost 70% of the latter cases, insufficient security was cited as the principal factor. While these figures suggest a market gap of 135,000 businesses, it must be borne in mind that almost 80 per cent of SMEs have a turnover of less than £100,000 and the total finance sought in some cases was below the SFLG minimum threshold of £5,000 or required over a period outside the SFLG loan term range of two to ten years. A proportion of these businesses will also have been seeking other forms of finance, such as equity finance, which is not supported by SFLG but is enabled by other measures. Nevertheless, it is essential that SFLG remains appropriately structured to be an effective intervention in this market.
- 1.2 SFLG seeks to address a market failure in the provision of debt finance by providing a Government guarantee to the lender in cases where a business with a viable business plan and apparently able to service borrowing is nevertheless unable to raise finance because they can not offer security for their debt.⁴ SFLG covers up to 75% of qualifying loans of up to £250,000. In return for the guarantee, the borrower pays BERR an annual premium of 2 per cent of the outstanding balance of the loan, assessed and paid quarterly.
- 1.3 Banks advise that the rate at which they have received new SME lending propositions has declined over the last year. The credit crunch and less certain market conditions have made both lenders and borrowers more risk-averse, which may be expected to result in lower SFLG take-up. On the other hand, greater caution in lending, for example the application of lower loan-to-value ratios than previously when property is offered as security, would imply that there is increased need for SFLG in particular situations.
- 1.4 Against this background SFLG lending has declined further to 2,619 loans annually, despite informed feedback from lenders suggesting that, with SFLG being available to enable lending to businesses up to five years old, take-up of around 4,000 loans per annum might be expected.
- 1.5 Use of SFLG is concentrated in the wholesale & retail, hotel & catering, business services and manufacturing & production sectors. 94% of SFLG lending is undertaken by the six leading participating bank lenders⁵, with over 80% by the four main high street banking groups. The remaining 6% of lending is distributed between over 20 smaller lenders, but with 75% of that activity concentrated in seven institutions. Annex A includes a full list of participating lenders.

¹ SME Statistics, 2006 <http://stats.berr.gov.uk/ed/sme/smestats2006-ukspr.pdf>

² Office for National Statistics Inter Departmental Business Register, http://www.statistics.gov.uk/downloads/theme_commerce/PA1003_2007/UK_Business_2007_optimized.pdf

³ The Annual Survey of Small Businesses' Opinions 2006/07, www.berr.gov.uk/files/file42727.doc

⁴ A summary of the principal rules of the scheme is contained in Annex C

⁵ Barclays, HSBC, Lloyds TSB and the Royal Bank of Scotland Group (RBS and NatWest)

SFLG Performance Analysis

Lending Volumes

2.1 In FY 2007/08 2,619 loans (FY 2006/07: 3,019) with a total value of around £207 million (06/07: £236m) were guaranteed. The average loan value was £78,950 (06/07: £78,300).

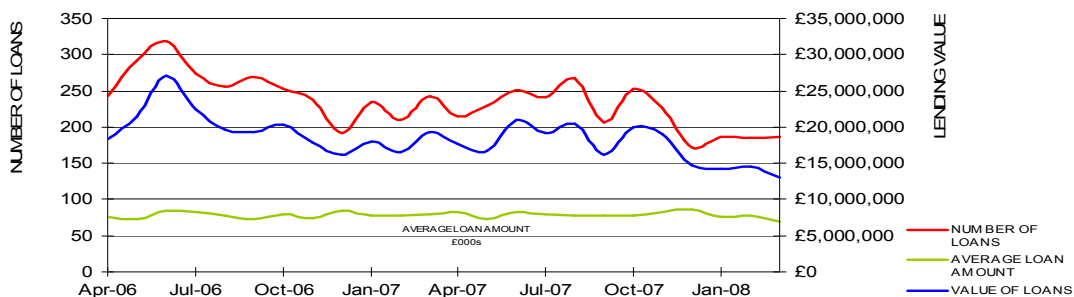


Figure 1: Monthly Lending Characteristics April 2006 to March 2008

2.2 While the market share by value of SFLG lending across the four leading high street banking groups remained almost constant at 83%, significant variation was seen in both supply and demand. The largest lender increased their market share from 33% to 39%, with the majority of that gain being offset by a fall from 17% to 11% in another lender’s participation.

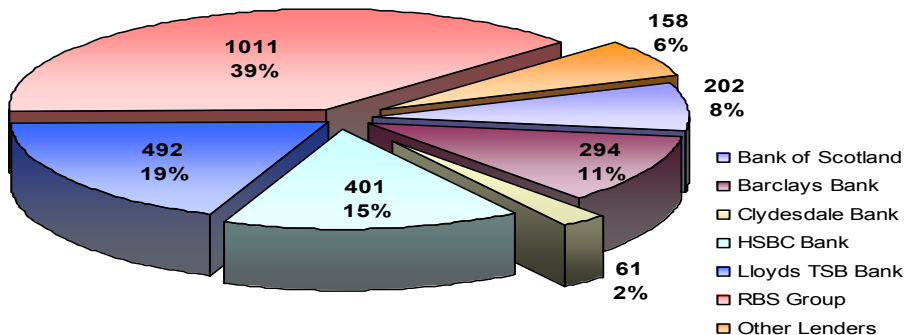


Figure 2: Lender Market Shares by Number of Loans in FY 2007/08

2.3 CfEL continues to see significant variation in SFLG use within lenders. One bank, for example, reported that their SFLG lending in FY 2007/08 was distributed across 61% of their small business teams, down from 70% the previous year. However, use of SFLG nationally is broadly consistent with the geographic distribution of VAT registered businesses. Similarly, lenders’ use of the SFLG capacity allocated to them (“lending limit”), which is allocated on the basis of historic market shares of SFLG lending, ranged between 40% and 86%.

2.4 In terms of business structure and ownership there is a significant difference between the composition of the SME market and the pool of SFLG borrowers. Of the 4.5 million SMEs only 25% are limited companies but 80% by number and 86% by value of SFLG loans are to such companies.

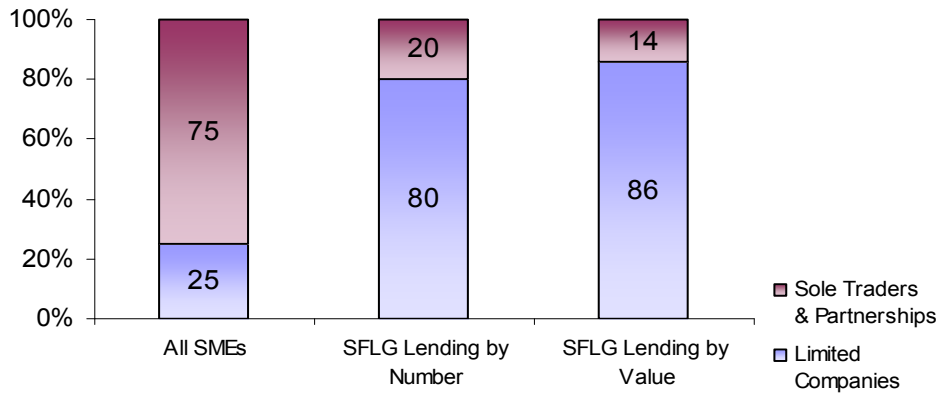


Figure 3: Comparison of SME Stock and SFLG Lending in FY 2007/08 by Business Legal Form

2.5 One potential explanation for this skew in usage is a preference by some entrepreneurs to structure their businesses as limited companies in order to minimise personal exposure. In contrast, it will be noted that sole trader and partnership businesses by definition involve unlimited personal liability for the owner. CfEL intend to investigate this matter further in the coming year.

2.6 As noted above, the average loan value in FY 2007/08 was £78,950 (06/07: £78,300). 77% by number and 51% by value of SFLG loans were of £100,000 or less.

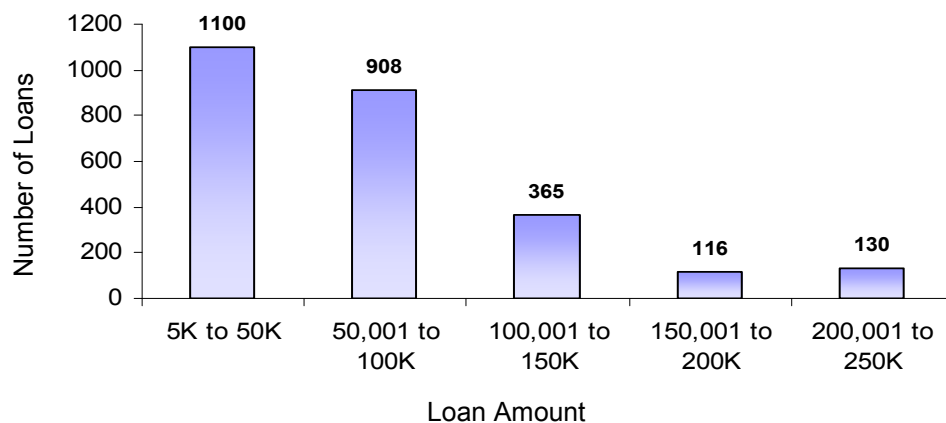


Figure 4: Distribution of SFLG Loans Guaranteed in FY 2007/08 by Loan Value

2.7 The ‘Five Year’ rule applied to all lending agreed in FY 2007/08. In terms of both number and value of loans, SFLG lending is divided almost equally between businesses up to one year old and those older than one year, thus emphasising the relevance of SFLG to start-up businesses.

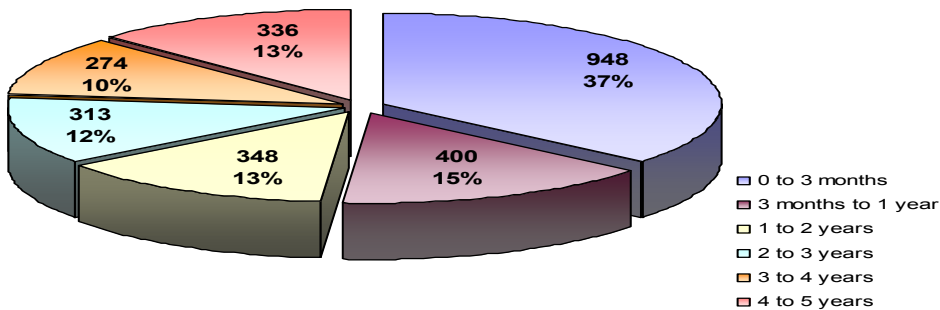


Figure 5: Distribution of SFLG Loans Guaranteed in FY 2007/08 by Age of Borrowing Business

2.8 Almost half of SFLG lending is to businesses in the wholesale & retail and hotel & catering sectors. In relation to the stock of VAT-registered businesses these sectors are over-represented in the use of SFLG.

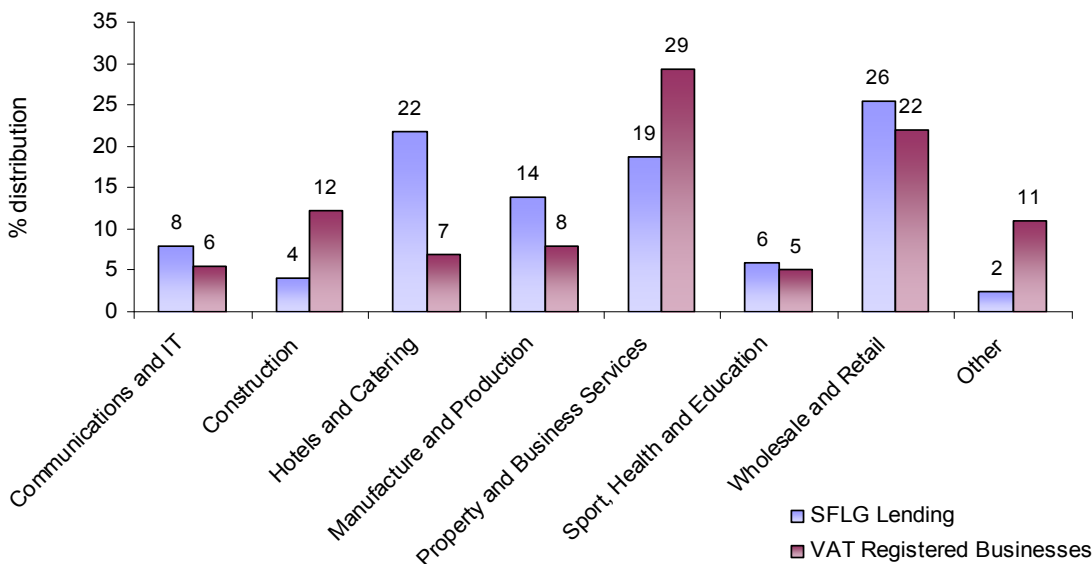


Figure 6: Distribution of SFLG Loans Guaranteed in FY 2007/08 and of VAT Registered Businesses by Sector

Default Performance

- 2.9 The increasing number of loans in the post-Graham portfolio means that more meaningful analysis of changes in default performance is now beginning to be possible. Matched samples of legacy (pre-Graham) and new (post-Graham) loans have been isolated for comparative purposes. While it is still too early to definitively claim that there have been significant or sustained changes, it is apparent that a higher proportion of new loans default within the first six months. This is principally due to improved timeliness of raising demands, but the relative performance of the two samples will continue to be tracked and the underlying reasons for the performance exhibited will be explored during the coming year.

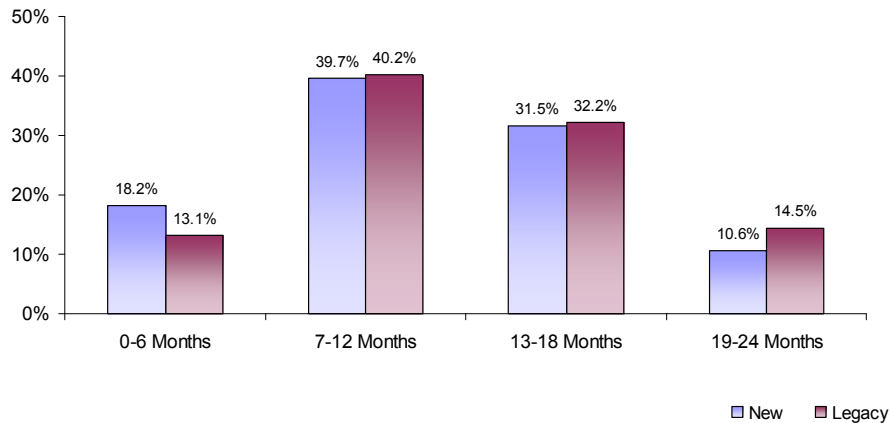


Figure 7: Distribution of Time to Default over First 24 Months for Matched Samples of New and Legacy SFLG Loans

- 2.10 The average default rate for post-Graham loans made by the four leading banking groups, expressed in terms of the proportion (by number of loans in their portfolios) of loans which have defaulted, is currently around 13%. There is, however, considerable variation in individual performances and CfEL is working with each lender bilaterally to understand these differences. This performance nevertheless appears to compare favourably with the proportion of loans defaulting between 1985 and 2000, as reported by the Graham Review⁶, although the portfolio has yet to mature and it is inevitable that there will be some increase from the present levels.

⁶ Graham Review of the Small Firms Loan Guarantee: Recommendations, September 2004 (Chart 4.1, p.34)

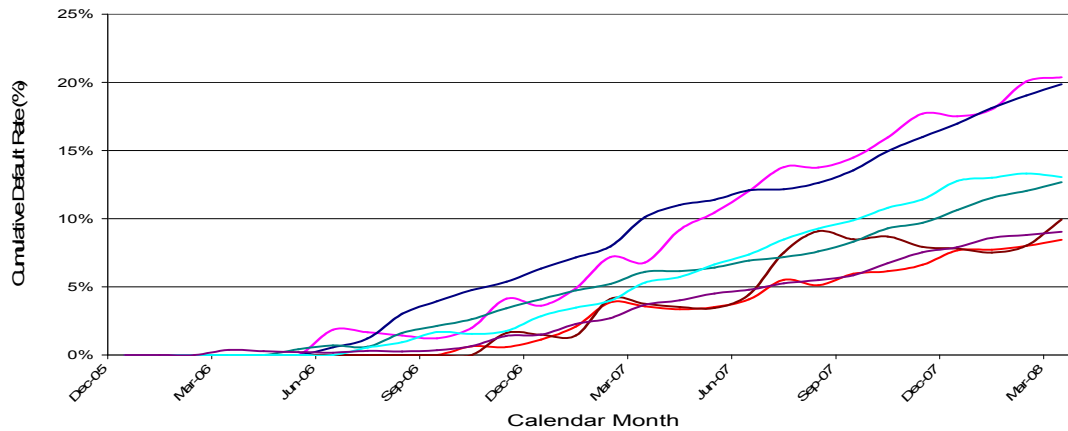


Figure 8: Cumulative Default Performance from December 2005 to March 2008 for Six Leading Lenders and All Other Lenders Combined

- 2.11 There is also evidence that the default performance of SFLG loans is influencing accessibility and supply, as cited by a number of relationship managers from the leading lenders in a recent survey. CfEL plans to further analyse defaults by types of borrowing entity, business sector and other criteria in order to address this issue with the lenders.
- 2.12 The total amount paid out in Demands in the year amounted to £69.3 million arising from 1,759 loans, an average payment of £39,410.

	Number	Total Value (£m)	Average Value (£)
Legacy	1,283	45.166	35,203
New	476	24.157	50,750
TOTAL	1,759	69.323	39,410

Table 1: Number and Value of SFLG Demands Settled in FY 2007/08

- 2.13 Efforts were made during the year to establish the equivalent default rates across lenders' portfolios of comparable lending, as measured by customer characteristics, loan value and loan term. This proved challenging because of the commercial confidentiality which lenders attach to that data and the way in which they segment their data. Interim findings suggest that the extent of the differential remains higher than can be explained solely on the basis of the availability of security. A priority going forward is to quantify what constitutes both an appropriate comparison and an acceptable default rate.
- 2.14 The greatest number of demands arising in FY 2007/08 were from new loans to businesses in the wholesale & retail sector defaulting. Expressed as a proportion of the loans in the portfolio, demands were most prevalent in the construction, manufacturing & production and wholesale & retail sectors.

SFLG Annual Report FY 2007/08

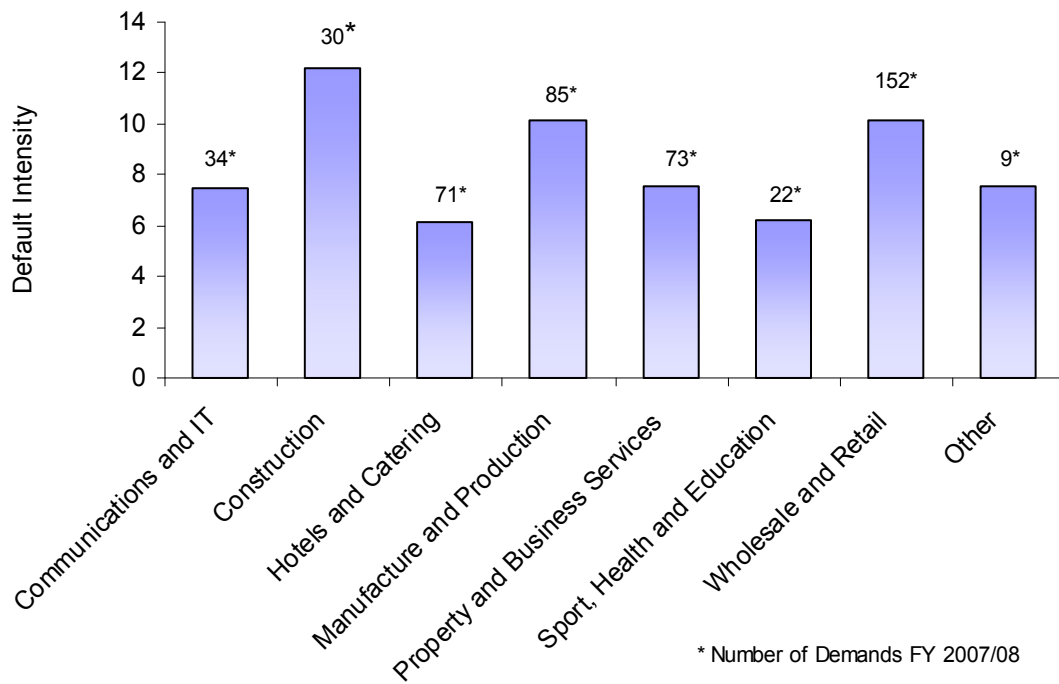


Figure 9: Default Intensity by Sector for Demands Settled in FY 2007/08 Arising From New SFLG Loans

2.15 The age of the business when the loan was originally made has little bearing on the likelihood of a Demand being made, as illustrated by the similarity in the segmentation of Figures 5 and 10, which show that the overall distribution of defaults by age bracket is broadly comparable with that for loans guaranteed.

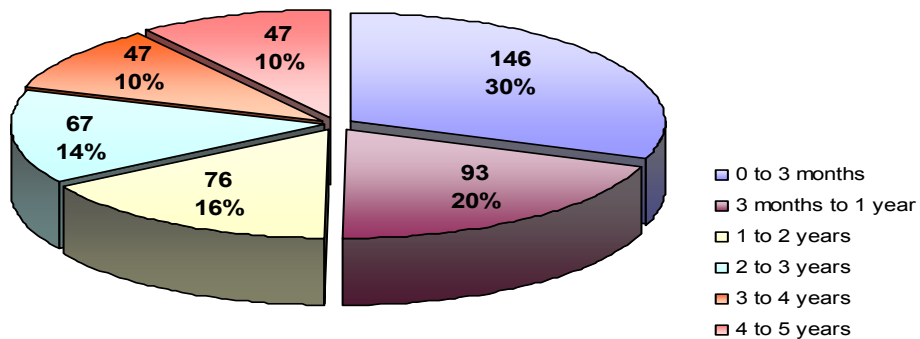


Figure 10: Distribution of SFLG Demands in FY 2007/08 by Age of Borrowing Business at Time of Borrowing

Recoveries

- 2.16 Recoveries arise when a lender's demand against the SFLG guarantee has been settled and the lender subsequently recovers funds from the borrower, such as may occur following liquidation of a business. A standard formula determines how that recovery should be shared with BERR. During FY 2007/08 we have seen recoveries in relation to 163 previous demands with a total value of £1.2 million, or around 2% of the demand settlement payments made in the year. The time elapsed in these cases between a demand being made and a recovery being received ranged from under a month to over ten years, with an average of 322 days.

Conclusion

- 2.17 CfEL continues to work with lenders and business groups to understand the drivers of this performance and to agree plans for improvement. We are committed to ensuring that SFLG is offered in all appropriate circumstances and that taxpayers' funds are used to best effect.

SFLG Performance Measured

Introduction

- 3.1 It is essential that CfEL has clear criteria against which to measure the take-up and performance of SFLG loans. It is now over three years since the Graham Review was published and there have been two full years of lending under the new rules. While the newly-established CfEL is creating its own Business Plan and Objectives, it continues to be relevant to assess performance and identify actions against the criteria set out in the Graham Review. Each of the seven criteria is discussed below.

Increasing appropriate use of SFLG

- 3.2 Take-up of SFLG loans has declined further from FY 2006/07 levels in FY 2007/08. This figure is well below that seen in the two full years prior to the introduction of the Graham Review changes, but direct comparison is inappropriate because of the impact of rule changes made in April 2003 and December 2005. The first round of individual bank audits is now complete and has determined that lending is appropriate.

SFLG has a positive effect on the UK economy

- 3.3 Feedback from lenders and representative bodies confirms that SFLG continues to address an important gap in the market. We continue to seek robust evidence of differential growth and survival rates. Even based on the Legacy portfolio, two thirds of SFLG loans reach maturity, with an average term of seven years, which implies a higher survival rate than for the SME market as a whole.
- 3.4 An economic impact evaluation of SFLG commissioned by BERR is currently underway and will provide further insight on the value for money provided by the programme. CfEL will work with BERR to determine the practical implications of those findings.

Lenders use their SFLG allocations effectively

- 3.5 Allocations were primarily based on historic utilisation and were themselves calculated prior to the introduction of the Graham Review changes. The allocation process has not been a constraint on lenders' ability to use SFLG. The lowest utilisation rate in FY 2007/08 was 40%, while the remaining five of the six leading lenders used between 66% and 86% of their allocations. While we continue to work with Lenders on availability and distribution issues, our audit processes confirm that the lending undertaken is appropriate.

- 3.6 The Graham Review concluded that only lending to businesses under five years old would be appropriate. While lenders have operated within this restriction it has been widely questioned. Analysis of historic SFLG activity suggests that an increase of up to 40% might be expected following the lifting of this restriction as announced in the Enterprise Strategy published alongside the Budget in March 2008. Such an increase in usage would result in lenders operating at close to or above their current allocations, hence the concurrent announcement by Ministers of an uplift of 20% in the overall capacity for lending limit allocations intended to ensure that lenders are not unduly constrained.
- 3.7 The mix of businesses enabled to borrow with the backing of SFLG remains diverse across seven main groupings. However, almost 50% of all lending is in the wholesale & retail and hotel & catering sectors, which were brought within the scope of SFLG in 2003. Use of SFLG in these sectors is proportionately higher than their contribution to the stock of VAT-registered businesses.

Lenders stay within allocations

- 3.8 Only one lender requested additional allocation. This was required in order to provide cover for facilities offered in the final month of the year rather than loans drawn down in the period, and so actual lending remained within the lender's original allocation. Leading lenders all use some form of internal control mechanism to track allocation utilisation and distribution. Therefore early contact with CfEL is triggered if the need arises so that increased allocations can be made in good time and continuity of service to borrowers is maintained.

The number of lending institutions, and individual lenders within institutions, increases

- 3.9 Six further new lenders joined SFLG during FY 2007/08, including a bank, an invoice finance provider and four Community Development Finance Institutions (CDFI).
- Alliance & Leicester Commercial Bank – The business banking arm of Alliance & Leicester Group plc, a major UK bank. Their interest in becoming an SFLG lender was part of a plan to develop their involvement in the SME banking market, including the provision of secured lending, through a network of Business Centres.
 - Cattles Invoice Finance – A major provider of invoice finance to SMEs and part of Cattles plc, a company providing a range of consumer and commercial finance products. Their interest in becoming an SFLG lender was part of a plan to offer a wider range of facilities to SME customers.
 - DSL Business Finance – A CDFI serving Glasgow and West Central Scotland.
 - Enterprise Loan Fund – A CDFI based in Bradford and serving much of West and North Yorkshire.
 - Foundation East – A CDFI based in Suffolk and serving much of the East of England. Foundation East is contracted by the East of England Development Agency to deliver a region-wide CDFI service.
 - South West Investment Group (SWIG) - A CDFI based in Devon and Cornwall and serving much of the South West of England.

- 3.10 The number of participating lending institutions has increased to 29 from 19 at the time of the Graham Review. CfEL continues to process applications from potential new lenders and remains committed to delivering BERR's policy objective of ensuring universal accessibility and offer of SFLG to SMEs in appropriate circumstances. Utilisation profiles within banks continue to indicate a varying propensity to use SFLG.

Default rates decline

- 3.11 Post-Graham lending has yet to reach maturity and volatile trading conditions currently prevail, so it is impossible to be conclusive on changes in default rates. However, some encouraging signs are emerging, with cumulative default rates for at least some of the leading lenders appearing to level out at below historical levels.
- 3.12 In setting this criterion the Graham Review was concerned about historic practice. Our experience indicates increasing confidence among lenders' SFLG Central Teams, leading to more robust and consistent decision-making, as confirmed by our audit processes.
- 3.13 However, of concern to CfEL is the spread of default rates across the six leading lenders and between sectors and business types. Work is underway to understand why this spread is so wide and to determine what action may need to be taken to address any underlying inappropriate practices or behaviours.

Lenders plan for strategic and innovative use

- 3.14 SFLG lending typically accounts for no more than one or two per cent of each major bank's SME lending activity. As a result constant dialogue with the leading lenders is essential to ensure that a focus on communication and innovation is maintained. However, we have seen increasing understanding and believe that the recent audit cycle will also have boosted confidence.
- 3.15 Late in 2007 CfEL received the first proposal for an innovative variation of SFLG. This was still being considered at the end of the period under review but was subsequently approved.

Conclusions and Next Steps

Introduction

- 4.1 As previously indicated, CfEL was launched on 1 April 2008 to manage the Government's interventions in the SME debt and equity markets. Within that remit CfEL manages the operation of SFLG, including improving systems and processes where appropriate.

Operational Priorities for CfEL

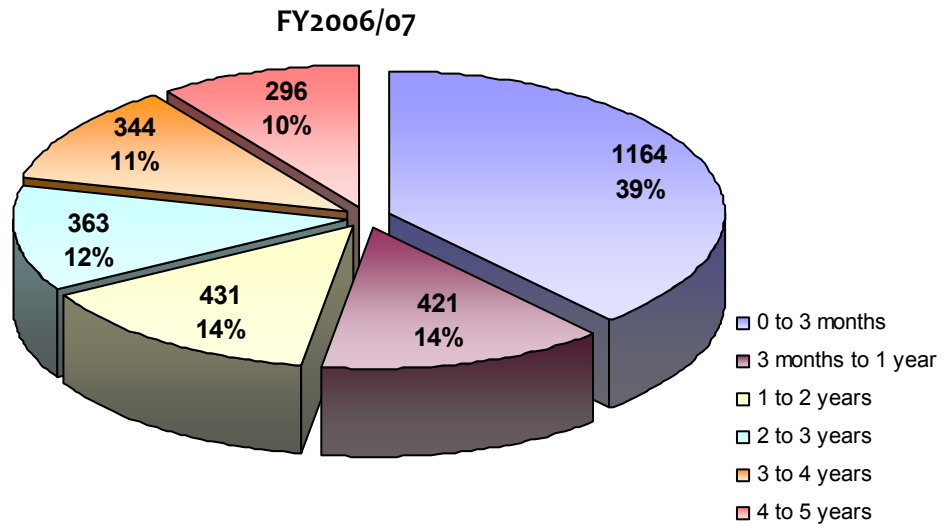
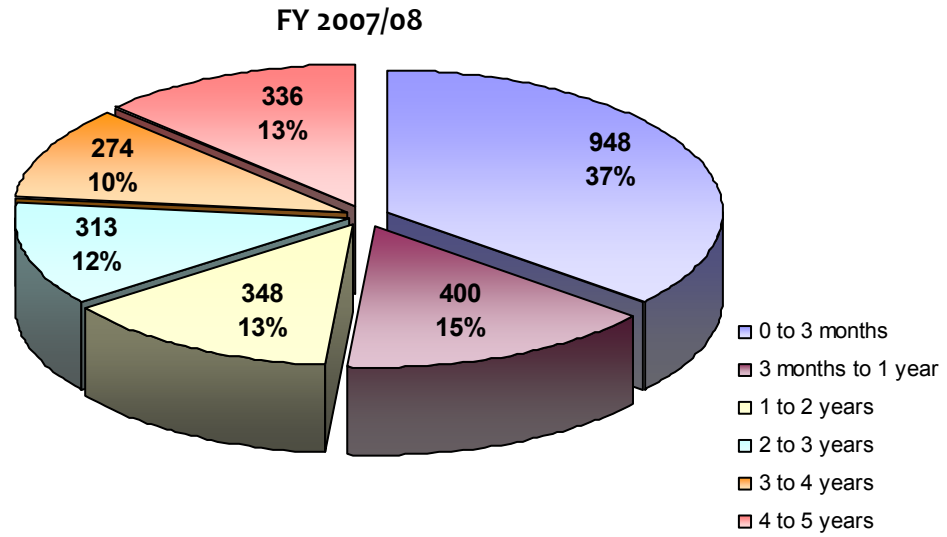
- 4.2 During FY 2008/09 CfEL will:
- receive, analyse and act upon the various research exercises currently underway and the emerging streams of Management Information from both within SFLG and obtained from external sources;
 - make particular efforts to understand the levels of default occurring, including between lenders and sectors, legal forms and ages of borrowing businesses;
 - encourage the supply side (participating lenders) to maintain a consistent understanding of and willingness to use SFLG among the continually changing population of relationship managers and other customer-facing staff;
 - improve the understanding of SFLG among those advising SMEs on finance, through targeted promotional activities;
 - develop, agree and implement an internal operational plan for SFLG which reflects the priorities itemised above.
- 4.3 CfEL's regular interaction with the lenders over the coming year will identify any other barriers to be addressed. In particular, we note that there is interest in CfEL undertaking further educational and promotional work to stimulate appropriate demand and use. CfEL recognises that there is a balance to be struck between ensuring a high level of awareness and understanding among lenders' front line staff and the advisor community while avoiding advertising which encourages inappropriate approaches to lenders by SMEs and their advisors. CfEL intends to make recommendations to BERR during FY 2008/09 following publication of the results of the Relationship Manager survey expected in July 2008.
- 4.4 CfEL continues to follow BERR's Business Support Simplification Programme (BSSP) with interest and remains willing to provide input to the development of the Debt Product informed by SFLG experience when requested.

Annex A - Participating Lenders as at 31 March 2008

Airdrie Savings Bank
Alliance & Leicester Commercial Bank
Bank of Baroda
Bank of Ireland (NI only)
Bank of Scotland
Barclays Bank
Bibby Financial Services
Cattles Invoice Finance
Clydesdale Bank
Doncaster Business Advice Centre (Donbac)
DSL Business Finance
Enterprise Loan Fund (Bradford)
First Trust Bank (NI only)
Foundation East
General Asset Management
HSBC Bank
Lloyds TSB
NatWest
NEL Fund Managers
Northern Bank (NI only)
One London
South West Investment Group
State Securities
The Co-operative Bank
The Enterprise Fund (Manchester)
The Royal Bank of Scotland
Triodos Bank
UK Steel Enterprise
Ulster Bank Ltd (NI only)
Venture Finance
Yorkshire Bank
YFM Group

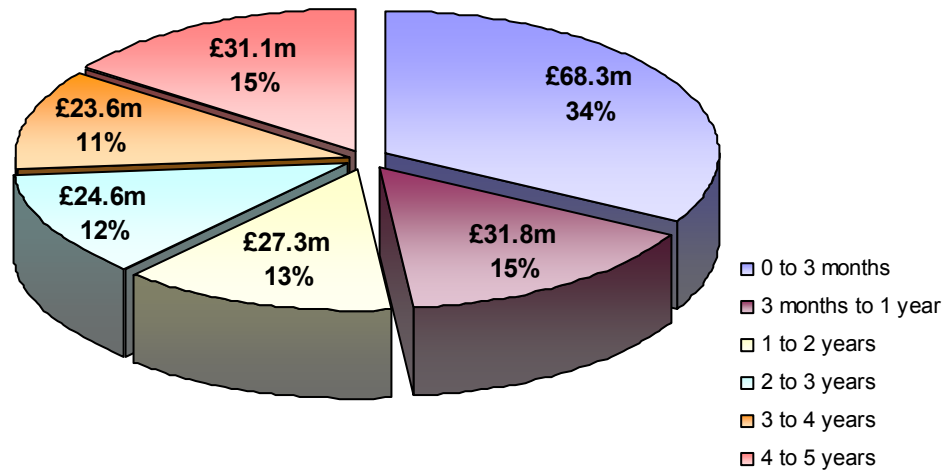
Annex B - Comparison of SFLG Lending Activity FY 2007/08 and FY 2006/07

**Distribution of SFLG Loans Guaranteed by Age of Borrowing Business
(by Number of Loans)**

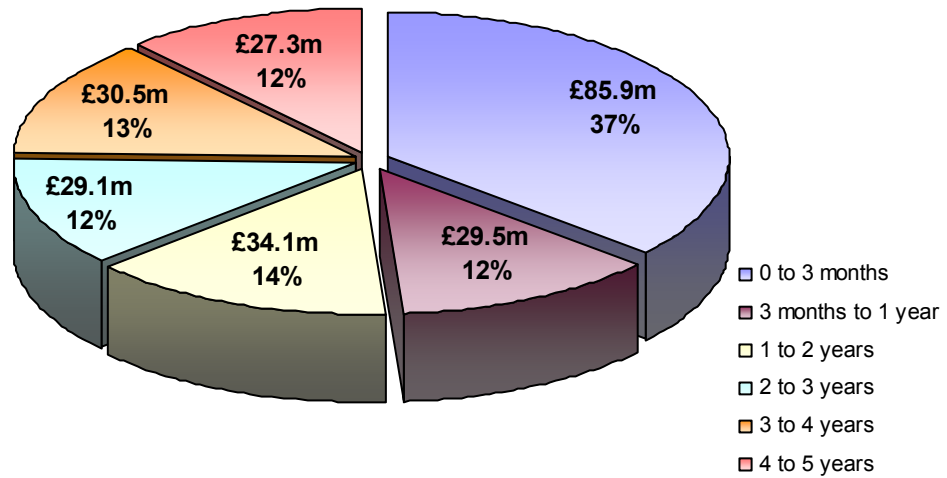


Distribution of SFLG Loans Guaranteed by Age of Borrowing Business
(by Value of Loans)

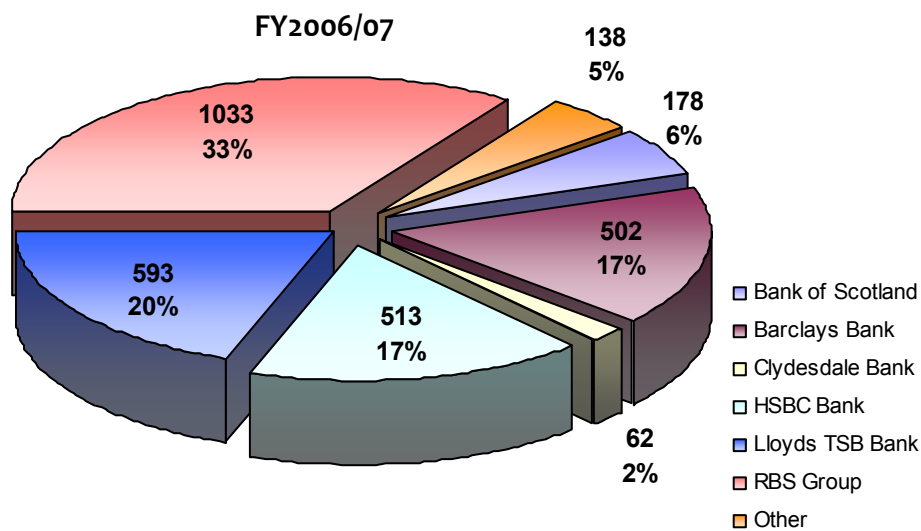
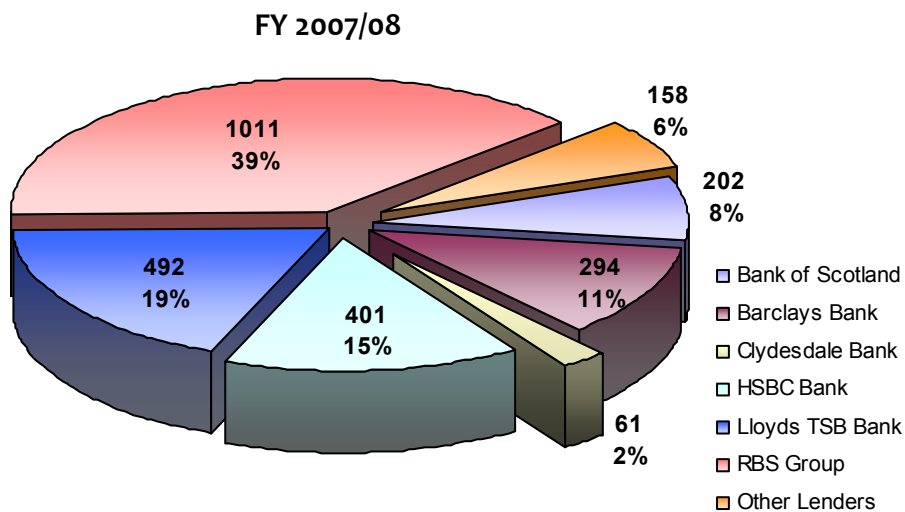
FY 2007/08



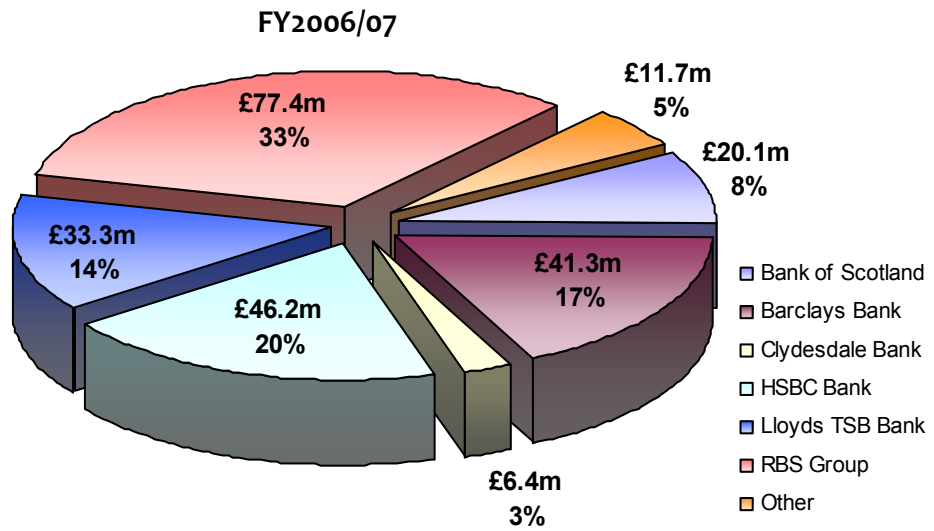
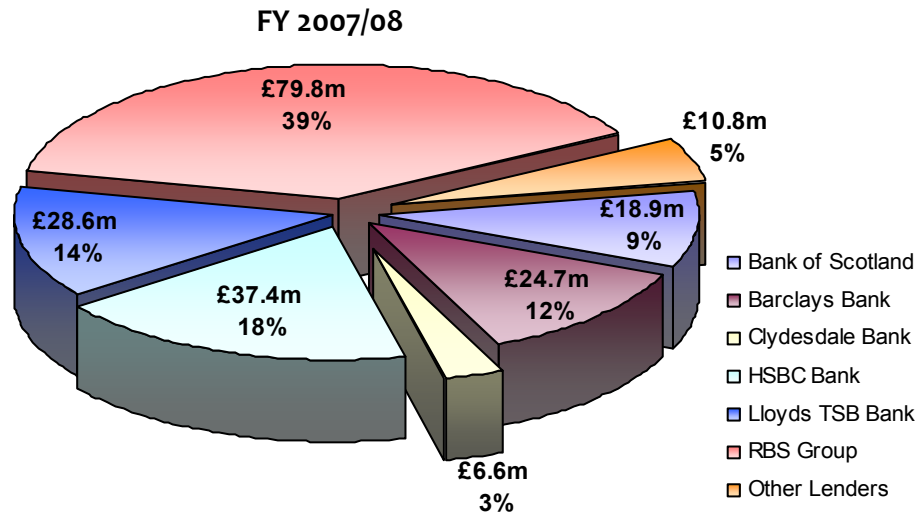
FY2006/07



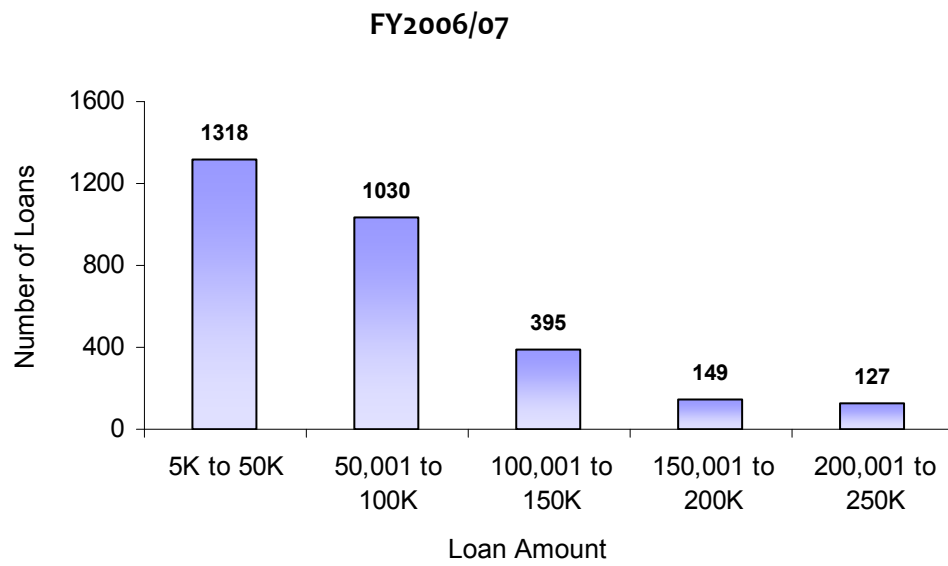
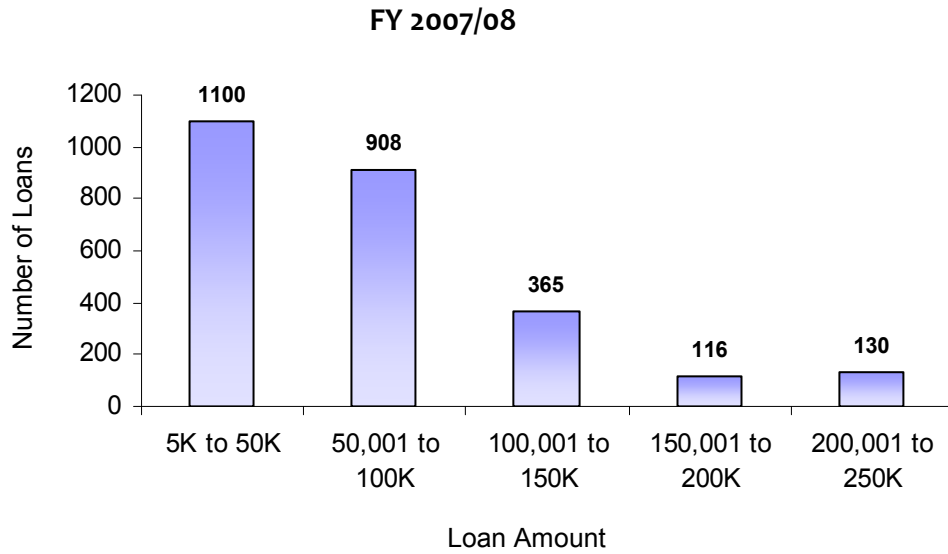
Lender Market Shares by Number of Loans



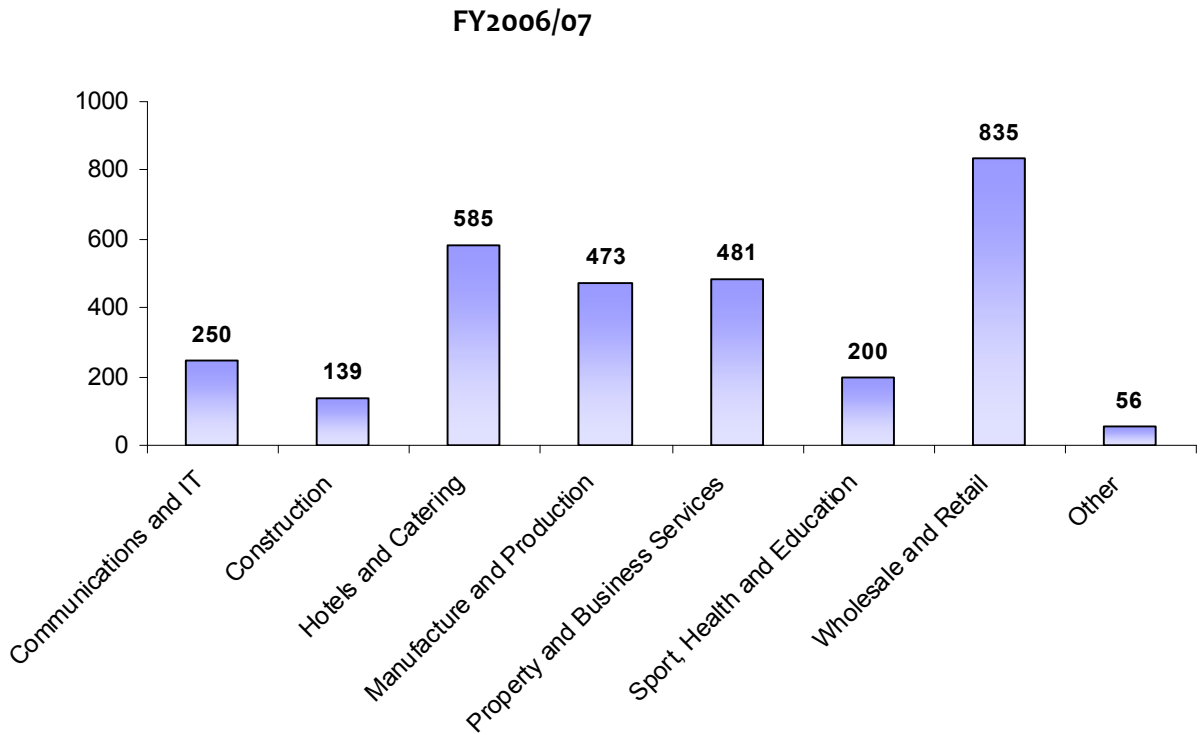
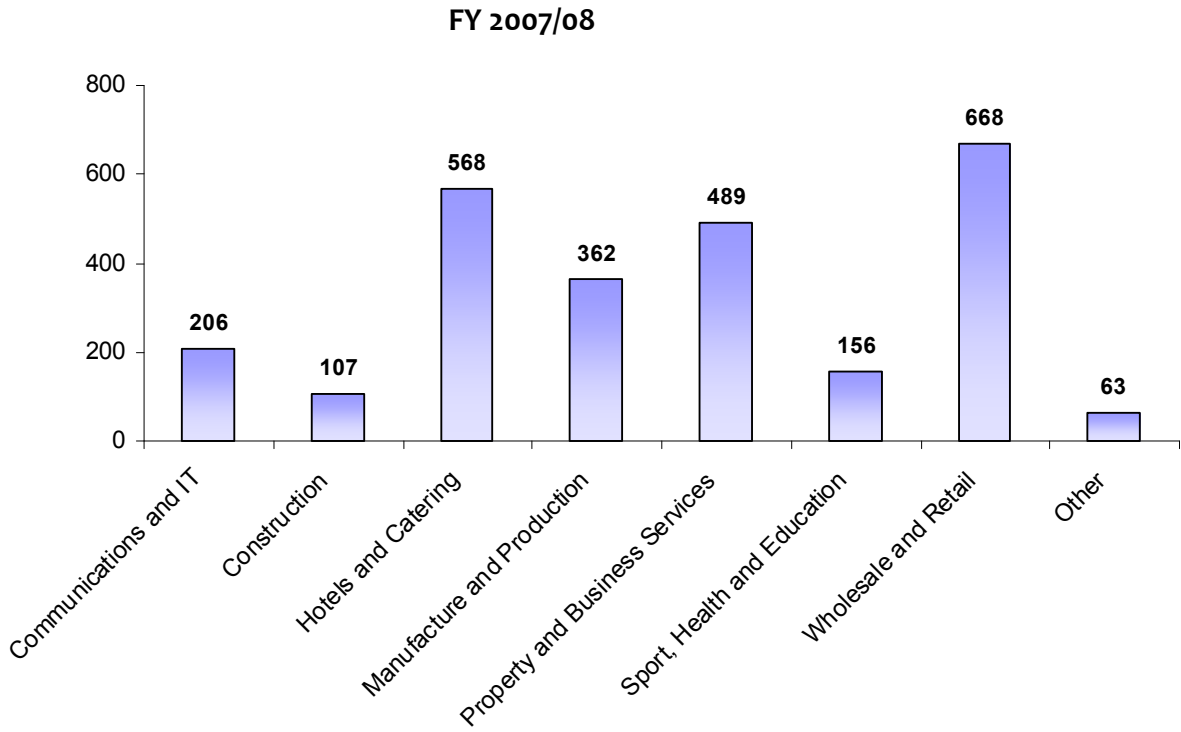
Lender Market Shares by Value of Loans



Distribution of SFLG Loans Guaranteed by Loan Value



Distribution of SFLG Loans Guaranteed by Sector



Annex C - Summary of SFLG Positioning and Eligibility Criteria

Purpose

Intended to facilitate lending by participating lenders to eligible small businesses in cases where the borrower satisfies the lender's normal commercial criteria except for being unable to provide the necessary security.

Delivery Channel

Operates as a tool for the lender to use at their discretion alongside their normal commercial lending practices rather than as a separate scheme for which the business sets out to apply.

Costs and Benefits

Provides the lender with a guarantee covering 75% of the outstanding loan amount plus up to six months' interest in the event of the borrower defaulting.

A 2% annual premium on the outstanding balance of the loan is payable to BERR in quarterly instalments by the borrower, in addition to the capital and interest payments due to the lender.

Eligibility

Available to facilitate lending to most UK businesses with an annual turnover of up to £5.6 million.

Applicable to loans of between £5,000 and £250,000 over terms of between two and ten years.

Available to qualifying UK businesses in most business sectors, subject to exclusions principally in the transport, agriculture, coal and steel sectors.

Guaranteed loans may be used for most business purposes, subject to exclusions principally in relation to the financing of export orders and the replacement of existing finance.

Sectoral and business purpose restrictions arise principally from the need to comply with European State Aid legislation designed to prevent public interventions from distorting the market.