

Finance for Small and Medium-Sized Enterprises

A Report on the 2004 UK Survey of SME Finances

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FOREWORD

This report is unique for three reasons. It is the first in-depth study of all the various forms of finance used by small and medium sized enterprises in the UK and has the depth and range to be a benchmark against which progress can be measured in the future.

Second, it is the result of the coming together for the first time of a consortium of 19 organisations, covering business groups, finance providers and government.

Third, the full results will be made widely available to researchers and policy makers and the full dataset will shortly be deposited at the UK National Data Archive at the University of Essex.

This report can only cover the headline results. There is a wealth of further data analysis available and I hope that researchers will make full use of it in order to help us all to understand how and why SMEs finance themselves, where there are any problem areas and what might be done to address them. It is clear that, in general, SMEs in the UK are well served by the sophistication and flexibility of the UK financial services industry. But there will always be areas for improvement.

I have been honoured to chair the consortium that was responsible for the commissioning and oversight of this survey. I am extremely grateful to them for their financial contributions and for the help and guidance they have provided over the past year. I am particularly pleased that the consortium stuck to one of the key principles on which we all agreed at the outset – we have given Stuart Fraser complete independence to write up the results as he sees fit, warts and all.

Mike Young

Chair of the sponsoring consortium

Small Business Investment Taskforce and formerly Bank of England.

EXECUTIVE SUMMARY

Background to the research

In January 2004, a consortium of 19 public and private sector organizations, led by the Bank of England (see Appendix 2), commissioned Warwick Business School to carry out the UK Survey of SME Finances (SMEF). This is the first representative survey of SMEs in the UK to offer a close analysis of businesses (with fewer than 250 employees), their main owners and access to external finance.

The aims of the study were to:

- Provide benchmarking data on the availability of credit to SMEs and the types of finance used.
- Collect information on the relationship between SMEs and their providers of finance.
- Develop a general purpose micro database for quantitative research on business finance (offering, for example, scope for comparisons with US business finances).

The survey was conducted among a representative sample of 2,500 SMEs, in the private sector, in the UK. The survey fieldwork was carried out by Computer Assisted Telephone Interview (CATI). This was conducted by IFF Research, an independent market research company, at IFF's CATI centre, between 5 August and 18 October 2004.

Structure of the Report

This report constitutes a summary analysis of the results of the survey. The report is divided into three parts. In the first part, we set out some background for the analysis. Specifically, this background is in the form of: a discussion of some key issues affecting SME finances (Section 1); and, an analysis of contextual data, relating to the characteristics of the businesses in the survey and the range of problems experienced in running them (Section 2).

In Section 1, the issues discussed are:

- Potential sources of market failure in SME finance markets – in particular, information asymmetries between lenders and borrowers.
- Underinvestment in financial skills and the impact on access to finance.
- The desire for independence/ high internal locus of control as an internal constraint on access to external finance.
- The lack of competition in markets for SME financial services (principally money transmission and bank debt).

The analysis in Section 2 allows a perspective to be gained on businesses' perceptions of their financing problems relative to other operational issues.

The second part of the report provides a general overview of the data relating to the demand and supply of SME financial products. On the demand-side, we look at:

- The range of financial products currently used by SMEs (Section 3)
- New finances sought in the last 3 years (Section 4).

In Section 5, we look at the extent of *unsatisfied* demand among businesses needing new finance. In this context, we look at the extent of:

- Outright rejection.
- Partial Rejection (i.e., the businesses were offered less than they wanted).
- Discouragement (i.e., the businesses did not apply for new finance because they *believed* they would be rejected).

The second part concludes by examining issues relating to the supply of SME financial services (Section 6). The policy setting for this analysis is public concern about a lack of competition in the supply of financial services to SMEs. These concerns have led the Competition Commission to make a number of recommendations to make it easier for businesses: to compare the prices of banking services; to purchase these services from different suppliers; and to switch banks if desired (Competition Commission, 2002). In this context we look at:

- The market shares of the main providers of financial services to SMEs.
- The number of different providers used.
- The nature of relationships with the main providers, principally
 - The breadth of relationships (number of financial services supplied by the main provider)
 - The length of relationships.
 - The cost of banking.
 - Levels of customer satisfaction.
 - The propensity to switch banks.

This analysis allows us to:

- Examine the extent to which the supply of financial services is concentrated in a single supplier.
- The degree of variation in charges across different providers.
- The willingness of businesses to seek another provider.
- The factors which motivate switching – e.g., dissatisfaction with price or service.

The third part of the report presents analysis of the average and total amounts used of the different forms of finance. The analysis concludes by looking at the relationships between finances to determine which finances could be considered to be in competition with one another. In particular, this analysis gives some indication of which types of finance are potential alternatives to traditional bank debt. Appendices are used throughout to present more extensive tabulations.

Summary of the Results

Section 2: Contextual Data Analysis

The analysis in Section 2 relates to:

- Business and principal owner characteristics.
- Use of external financial advice.
- Self-assessed skills in different aspects of running the business.
- Extent to which financially qualified individuals are running SME finances.
- Extent of problems in different aspects of business operations.

Regarding business characteristics the data show that by size:

- 2,200,000 businesses have no employees (about 61% of SMEs).
- 1,450,000 businesses have an annual turnover of less than £50,000 (about 40% of SMEs).
- 1,350,000 businesses have less than £10,000 worth of assets.

By sector:

- More than a third of SMEs are in Real Estate, Renting and Business Activities (some 1.3 million businesses)
- Only 5% are in manufacturing (around 180,000 businesses).

By region:

- 38% of SMEs are located in London and the South East (1,400,000 businesses).
- 87% of SMEs are located in England (3,150,000 businesses).
- 5% are located in Scotland.
- 5% are located in Wales.
- 3% are located in Northern Ireland.

By legal form:

- Almost 2 in 3 businesses are sole traders (2,400,000 businesses)
- Less than 1 in 4 businesses are limited liability companies (870,000 businesses)
- About 1 in 10 businesses are partnerships (including limited liability partnerships).

By age:

- The majority of businesses (51%) are aged more than 15 years (1,900,000 businesses).
- About 7% of SMEs are start-ups (aged less than 2 years) (250,000 businesses).

By growth rate:

- About 11% of businesses (320,000 businesses) are high growth businesses, having an average turnover growth of 30%, or more, per annum over a period going back up to 3 years.

By ethnicity:

- 93% of businesses are majority white owned (3,400,000 businesses).
- About 7% of businesses are majority owned by individuals from ethnic minority backgrounds (220,000 businesses).

By gender:

- 75% of businesses are majority owned by males (about 2,700,000 businesses).
- 25% of businesses are majority owned by females (just over 900,000 businesses).

Regarding the characteristics of the *principal* owner:

- A woman is the principal owner in 1 in every 5 SMEs.
- 79% of principal owners are aged between 40 and 65.
- In addition, 61% of principal owners have more than 15 years business experience.
- 29% of principal owners have no or, at most, basic (O-levels/GCSE), academic qualifications.
- 23% have a University degree.

Comparing business and principal owner characteristics with those in the US:

- US businesses tend to be larger, on average, than UK businesses.
- US businesses tend to be younger, on average, than UK businesses.
- The proportions of female and ethnic minority businesses, in their respective populations, are similar between the UK and US.
- Owner managers in the US are more likely to have a university degree than their UK counterparts.

Looking at the use of external financial advice in the UK:

- Accountants are used as the main source of financial advice in almost one-third of the SME population.
- Bank managers are the main source of advice for 16% of SMEs.
- Over a third of SMEs use no external advisers.

Also, majority female owned businesses are:

- More likely to use an accountant than majority male-owned businesses.
- Less likely to use no external advice than majority male-owned businesses.

Regarding self-assessed skills in different areas of the business's operations:

- Production is the area of operation in which owner managers have the *highest* degree of self-confidence in their abilities.
- Coping with red-tape is the area with the *lowest* self-confidence.
- Self-confidence in financial operations is intermediate along with sales and staffing issues.

Further analysis in this area shows that:

- The self-confidence levels, in majority female owned businesses, are similar to the average levels, across all aspects of business operations.

- 25% of ethnic minority owned businesses report a lack of self-confidence with finance, which is above the average level (16%).
- 28% of ethnic minority owned businesses report a lack of self-confidence in dealing with red-tape, again above average (22%).
- 16% of start-ups report a lack of self-confidence with sales (versus 10% on average).
- Only 1% of high growth businesses report a lack of self-confidence with sales (versus 10% on average).

Regarding formal financial qualifications:

- Only 16% of sole traders and partnerships have their finances managed by someone with a financial qualification.
- There are *no* significant differences, in the incidence of financially qualified management, comparing: female versus male-owned businesses; ethnic minority versus white-owned businesses; start-ups versus established businesses; or high growth versus non-high growth businesses.

Turning to self-reported business problems:

- Production is the area of business operations with the least reported problems.
- Finance is the second least problem area.
- Staffing and red-tape represent the highest problem areas.

A closer inspection of business problems for different types of business suggests that:

- The problem levels, in majority female owned businesses, are similar to the average levels across all aspects of business operations.
- 20% of ethnic minority owned businesses report problems with production, which is above the average level (9%).
- 23% of ethnic minority owned businesses report problems with finance, again above average (11%).
- However, only 10% of ethnic minority owned businesses report problems in dealing with red-tape, which is below the average level (20%).
- 16% of start-ups report problems with production (versus 9% on average).
- The problem levels, in high growth businesses, are similar to the average levels across all aspects of business operations.

Section 3: Use of External Finance

The analysis in Section 3 relates to the types of financial products used by SMEs in the last 3 years. This analysis indicates that:

- 80% of SMEs have used one or more external sources of finance in the last 3 years.
- Use of external finance increases with the number of employees and turnover. It varies from 75% (no employees) to 98% (50-249 employees).
- There are no significant differences in the likelihood of using external finance between male and female owned businesses or between white and ethnic minority owned businesses.

Regarding the types, and amounts, of finance used:

- Just under 2 million businesses (53% of SMEs) use an overdraft
 - The total amount owed in overdrafts is estimated to be £12 billion.
- A similar number use personal or business credit cards (55%)
 - Businesses spend £450 million per month through personal credit cards
 - Expenditure, through business credit cards, is about £1.4 billion per month.
- Approximately 900,000 businesses use term loans (24%)
 - The total amount outstanding on term loans is about £64 billion.
- A similar number use leasing and/or hire-purchase (asset finance) (27%)
 - Total monthly repayments on leasing/hire-purchase agreements are estimated to be £2 billion.
- Grants are used by just under a quarter of a million businesses (6%)
 - The total amount of grants accessed in the last 3 years is about £7.6 billion.
- Invoice finance is used by about 100,000 businesses (3%)
 - This represents an estimated £8 billion in monthly advances.
- About the same number use equity finance (3%: 100,000 businesses)
 - This represents an estimated £14.3 billion in total investment in the last 3 years.

Estimates of the use of friends and family finance show that:

- About 6% of SMEs report using loans or equity finance from friends and family.
- There are no discernible differences, in the use of friends and family finance, by: gender; ethnicity; business age; or growth rate.

Analysis of current and deposit accounts indicates that:

- 97% of SMEs use a current account.
- 41% of SMEs hold funds on deposit.
 - In value terms, this represents an estimated £92 billion in total deposits.
- Start-ups are significantly less likely to hold funds on deposit compared to established businesses (27% versus 43%).

Comparisons of the use of some basic financial products, between the UK and US, reveal the following:

Table ES.1: Comparisons of Financial Products Used in the UK and US

	US SSBF (1998) ¹	UK SMEF (2004)
Any loan ²	55%	65%
Personal Credit Card	45%	28%
Business Credit Card	33%	34%
Current Account	94%	97%
Deposit Account	22%	41%

Notes:

1. US Survey of Small Business Finance (see e.g., Bitler et al, 2001).

2. For the US, any loan denotes using any of the following: credit lines; mortgages; vehicle loans; equipment loans; or capital leases. For the UK any loan denotes using any one of: overdrafts; term loans; asset finance; or asset-based finance.

- The patterns of usage of financial products are quite similar between the UK and US.
- However, there is some evidence that use of personal credit cards is lower, and use of deposit accounts is higher, in the UK than the US.

Section 4: New Finance Sought in the last 3 years

The analysis in Section 4 relates to *new* finances sought in the last 3 years (not including friends and family finance). This analysis shows that:

- 44% of SMEs (1.6 million businesses) sought new finance in the last 3 years. This percentage varies from 36% (no employees) to 76% (50-249 employees)
- Sole traders are significantly less likely to have sought new finance than either partnerships or companies (37% versus 57%).
- Majority female owned businesses are *no* less likely than majority male owned businesses to have sought new finance.
- However, there is some evidence that ethnic minority owned businesses are *more* likely to have sought new finance than white-owned businesses (61% versus 43%).
- Start-ups are more likely to have sought new finance than established businesses (69% versus 42%).
- Also, 62% of high growth businesses sought new finance versus 41% of slower growing businesses.

Among businesses, which did not seek new finance, 95% report that they did not need new finance. This suggests that a lack of demand, rather than supply side constraints, is the main reason for not seeking new finance.

The amounts of new finance sought are as follows:

- The average amount is just under £82,000 (median=£20,000).
- This amount increases from £29,000 (businesses with no employees) to just over £1 million (50-249 employees).

- Limited companies sought just under £200,000. This amount is significantly higher than the amounts sought by other legal forms of business.
- There are no statistically significant differences in the amounts sought by female-owned versus male-owned businesses.
- However, ethnic-minority owned businesses sought just over £28,000 on average. This is significantly less than the amount sought by white-owned businesses (£85,000).
- There are no significant differences in the amounts of finance sought by age of business or growth rates.

The types of new finance sought are:

- Overdrafts: 32%
- Grants: 15%
- Term loans: 40%
- Asset finance: 39%
- Asset-based finance: 2%
- Equity finance: 7%.

Looking at start-up finance (businesses aged less than 2 years):

- Well over 2 in 3 start-ups used personal savings
- 1 in 8 used a friend or family loan as part of their start-up finance.
- The use of equity finance is very small (1.6%) with investors being mainly family and friends.
- Over 1 in 20 start-ups claimed to have used no finance to establish their business.

As for the *main* source of start-up finance:

- Personal savings were the principal source of finance for 2 in every 3 start-ups.
- 1 in 10 relied mainly on a bank loan.
- Less than 1 in 20 entrepreneurs relied mainly on a mortgage on their home.

The average amount of finance used at start-up is estimated at £71,000; the median amount is just over £15,000.

Section 5: Rejection and Discouragement

In Section 5 we look at experiences of rejection and discouragement in applying for external finances (not including friends and family finance) in the last 3 years. This analysis estimates that:

- 11% were rejected outright (180,000 businesses)
- 19% received less than they wanted (300,000 businesses)
- 8% felt discouraged from applying because they believed they would be rejected (130,000 businesses).

Further analysis shows:

- Businesses with greater assets tend to experience fewer rejections and less discouragement. This is, perhaps, unsurprising since these businesses have more collateral to offer lenders.

- Sole traders are more likely to experience discouragement than partnerships (10% versus 2%).
- Businesses in Northern Ireland have the lowest outright rejection rate (1%) but the second highest discouragement rate (14%).
- Start-ups are less likely to experience outright rejection than established businesses (4% versus 12%). However, this figure does not take into account businesses which did not get started as a result of rejection (since these businesses are not observed in the sample).
- There are *no* significant differences in rejection or discouragement rates by gender, ethnicity or growth rate.
- Similarly, there is *no* evidence that switching banks, or using more than one provider of financial services, increases the likelihood of rejection or discouragement.

Among businesses needing a new overdraft:

- 16% were rejected outright
- Greater than 1 in 3 received less than they wanted
- 7% felt discouraged from applying.

Among businesses needing a new loan:

- 9% were rejected outright
- 6% received less than they wanted
- 9% felt discouraged from applying.

Among businesses needing a new lease/hire-purchase:

- 5% were rejected outright
- 3% received less than they wanted
- 7% felt discouraged from applying.

Looking at businesses' views of the reasons for rejection, denial rates due to no, or insufficient, security are:

- 22% for overdrafts.
- 12% for term loans.

Rejection rates due to a lack of track record (no credit history) are:

- 8% for overdrafts.
- 7% for bank loans.

On the other hand, rejection rates due to a poor credit history are:

- 5% (personal history) and 11% (business history) for overdrafts.
- 4% (personal history) and 4% (business history) for term loans.

A further:

- 5% of overdraft rejections are due to the business having too much existing debt.
- 15% of loan rejections are due to an inadequate business plan.

These results suggest that a sizeable proportion of businesses are rejected due to having no security or track record (30% overdrafts; 19% term loans). These

businesses are *potential* candidates for assistance through the Small Firms Loan Guarantee Scheme (although further analysis would be required to establish their eligibility for the scheme).

Analysis of the impact of (term loan) rejections showed that:

- The project went ahead, with other funding, in 3 out of 5 rejections.
- The plans had to be shelved, for a short time, in just under 30% of rejections.
- The business had to drop its plans completely, or found itself in dire financial straits, in less than 1 in 20 cases of rejection.

We conclude Section 5 by estimating an econometric model relating incidences of rejection to levels of financial skills and other business characteristics (for sole traders and partnerships only). The key findings from this model are:

- Businesses, with qualified financial managers, are 3 percentage points *less* likely to experience rejection, holding other business characteristics constant.
- Low self-confidence in dealing with finances has *no* impact on the likelihood of rejection.
- Also, using no external advice *does not* increase the likelihood of rejection.

Section 6: Providers of Finance

In this section we look at SMEs relationships with providers of finance. In the first analysis we look at the market shares of the main providers of financial services to SMEs. Here we find that:

- The largest four providers account for almost 80% of the market.
- The largest provider is the main provider to 1 in 4 SMEs.
- The two largest providers account for 42% of the market.

Market shares by geographical region are as follows:

- In England and Wales the top four providers supply just over 80% of the market.
- In Scotland the top four providers supply 95% of the market.
- In Northern Ireland the top four providers supply almost 90% of the market.

Analysis of the number of different providers of finance used indicates that:

- The majority of SMEs have only one main provider (59%).
- Less than 1 in 10 businesses have used three or more providers.
- Only 1 in 50 have used four or more providers.
- 71% of businesses, with term loans, have these loans supplied by the same bank which supplies their current account.

Longer financial relationships may help lenders to assess the creditworthiness of businesses and improve businesses' access to finance. In this context, our analysis finds that:

- On average, SMEs have been with their main provider for almost 15 years.
- Larger businesses tend to have had a longer relationship than smaller businesses.
- Majority male-owned businesses have longer financial relationships than majority female owned businesses (15 years versus 12 years).

- Majority white-owned businesses have longer financial relationships than majority ethnic-minority owned businesses (15 years versus 10 years).
- High growth businesses have only half the average relationship of lower growth businesses (8 years versus 16 years).

Looking at bank charges (not including loan interest payments) the survey indicates that:

- SMEs pay, on average, £51 in total monthly bank charges.
- This figure ranges from £25 for businesses with no employees, up to £430 for businesses with 50-249 employees.
- By turnover, charges range from under £15 per month up to £430 per month.
- The amount charged, by bank, varies from £26 to £85 per month.
- There is little variation in the charges of the largest four banks.

The four major clearing groups, Royal Bank of Scotland Group, Barclays; Lloyds TSB and HSBC, were identified, by the Competition Commission (2002), as making excess profits from their SME banking. In order to remove these profits, the 'big four' have undertaken, with the Office of Fair Trading, to pay interest on current accounts or waive charges on money transmission services (since 1st January 2003).

Relating to this issue the survey finds that:

- More businesses report receiving interest on their account than free transactions.
- 2 in every 3 SMEs report receiving free transactions and/or interest on their current account.
- This figure rises to 4 in every 5 SMEs for accounts opened since 2003.

Regarding satisfaction with bank charges:

- The majority of SMEs (61%) are satisfied, to some degree, with their bank charges.
- However a sizeable minority of businesses, almost 1 in 3, report some dissatisfaction with their bank charges.

In respect of other aspects of the services provided by banks:

- Just under two-thirds of businesses are either very, or fairly, satisfied with the availability of finance at their bank.
- However 1 in 4 businesses are unable to say whether they are satisfied or dissatisfied with the availability of finance. This could be because the business has not sought any finance from its bank.
- Almost 90% of businesses are satisfied with the competence of bank staff.
- More than two-thirds are satisfied with their bank's level of understanding of their business.
- However about 15% are unable to say whether they are satisfied or dissatisfied with their bank's level of understanding of their business.

In a competitive environment, one means for businesses to express dissatisfaction with their current bank is to move to another bank. In this context, we look at (ex-post) switching rates and the propensity to switch banks in the future. Here we find that:

- The annual rate of bank switching is just above 2% over all types of business.
- This figure rises to 5% among businesses with a turnover in the range £250,000-£499,999.
- Over 7% of SMEs are currently considering switching to a new provider from their current bank.
- A further 29% of SMEs would consider switching if approached by another bank.

In addition:

- Businesses with qualified financial managers are more likely to switch than businesses without qualified financial managers. This suggests that a lack of financial acumen could be a barrier to switching.
- Start-ups are 3 times less likely to have switched than established businesses (most likely, because they have not been around long enough to make a switch). However, start-ups are twice as likely, as established firms, to be considering switching.
- High growth businesses are 3 times more likely to have switched than slow growing businesses.

Among switchers, the reasons for switching are because:

- The business was attracted by better borrowing terms and/or charges at their current bank (1 in 4 switches).
- The business felt compelled to change banks because they had been refused finance at their previous bank (fewer than 1 in 20 switches).
- The business was offered better services/facilities at their current bank and/or were generally dissatisfied with the service at their previous bank (more than 1 in 2 switches).
- The business was offered lower charges at their current bank (1 in 7 switches).
- The business was offered lower borrowing rates at their current bank (1 in 10 switches).

Switching, it appears, is more sensitive to dissatisfaction with service than charges or borrowing rates.

Regarding the ease of switching, the majority of switchers rate the process as being easy (the median score is 8, on a scale of 1 – extremely difficult – to 10 – extremely easy)

A potentially significant barrier to new suppliers of banking services is if they need to offer customers a local branch network. In this context, we look at the most frequently used method of doing business with the main bank. The results here show that:

- Visiting a branch is the most frequent method of banking among all SMEs, and businesses with fewer than 10 employees.
- Telephone banking is the most frequent method of banking among businesses with 10-249 employees
- Internet banking is used by around 1 in 7 SMEs.

- This figure is higher than 1 in 4 for larger SMEs (50-249 employees) and is more popular than visiting a branch.

Overall these results suggest that technology, facilitating distance banking, could have a beneficial impact on competition for larger SMEs (by circumventing the need for new entrants to provide customers with a local branch network). However, having access to a local branch remains important for smaller businesses.

The key results from the analyses of specific finances (Sections 7-15) are as follows:

Section 7: Deposit Accounts

- The average amount held on deposit by SMEs is £61,000 (\pm £14,000).

The following motives for holding deposits are reported:

- A *transactions* motive (e.g., ‘to meet day to day requirements’ or to ‘fund a specific project’) is reported by more than 1 in 3 businesses holding deposits.
- A *precautionary* motive is reported by almost 1 in 3 businesses holding deposits (‘buffer against a rainy day’).
- An *asset* motive (‘to earn extra interest’) is reported by more than 1 in 4 businesses holding deposits.

Section 8: Term Loans and Overdrafts

- The average amount outstanding on *all* term loans is £88,000 (\pm £20,000).
- The average size, of the largest individual term loan, is just under £100,000.
- Only 38% of largest term loans are secured. These loans have an average size of £148,000.
- 60% of largest term loans are unsecured. These loans have an average size of just under £70,000.
- Start-ups have smaller term loans than established businesses (£61,000 versus £103,000). This result is robust when controlling for other business characteristics.
- There are no significant differences in the size of term loans by gender, ethnicity or growth rate.

The main purposes of the largest term loan are to fund:

- Premises (28% of businesses).
- Working capital (16% of businesses).
- Motor vehicles (15% of businesses).
- Equipment (9% of businesses).

Looking at the analysis of overdrafts:

- The average amount overdrawn is just over £21,000 (\pm £9,000).
- The average secured overdraft limit is £83,000. These overdrafts account for 27% of all overdrafts.
- The average unsecured overdraft limit is just under £20,000. These overdrafts account for 70% of all overdrafts.

- Ethnic minority owned businesses have significantly lower overdraft limits than white owned businesses (£18,000 versus £35,000).
- Start ups have significantly lower overdraft limits than established firms (£7,000 versus £35,000).

The main purposes of having an overdraft facility are:

- To fund working capital (50% of businesses)
- As a safety net (34% of businesses)
- To ease pressure on cash-flow (4% of businesses).

Looking at margins on bank debt, for term loans:

- The median margin is about 2 points over Base.
- The bulk of margins for businesses with no employees lie between 0 and 3 points over Base.
- For businesses with 10-49 employees, most margins lie between 1.5 and 2.5 points over Base.
- There are very few instances of margins exceeding 5 points over Base.

The margin data for overdrafts indicates that:

- The median margin is about 2 points over (Bank of England) Base.
- This figure is closer to 1 point over Base for medium-sized firms (50-249 employees).
- The bulk of margins lie between 0 and 2 points over Base.
- There are very few instances of margins exceeding 5 points over Base.

Comparing margins for different types of business we find that:

- Very long financial relationships tend to reduce margins relative to intermediate relationships.
- Majority female-owned businesses pay significantly *higher* margins on term loans than male-owned businesses (2.9 versus 1.9 percentage points over Base). This result is robust when controlling for business and loan characteristics.
- Ethnic-minority owned businesses pay significantly *lower* margins on term loans than white-owned businesses (1.2 versus 2.3 percentage points over Base). Again, this result is robust when controlling for business and loan characteristics.
- There are no significant differences, in either overdraft or term loan margins, by business age or growth rate.
- Also, switching banks, or using multiple providers, does not appear to increase the cost of borrowing.

An estimated 5% of businesses failed to make one or more of the payments due on their loan in the last 12 months.

Section 9: Asset Finance (Leasing and Hire-Purchase)

Analysis of the types of asset finance used indicates that:

- About 1 in 3 use leasing only.
- 3 in 5 use hire-purchase only.

- Less than 1 in 10 use both leasing and hire-purchase.
- The incidence of using both forms of asset finance increases with firm size: almost 1 in 4 medium-sized firms (50-249 employees), using asset finance, have both forms.

Regarding the amounts of these finances used

- The average monthly repayment on leasing and/or hire-purchase is just over £3,000.
- This represents total monthly repayments of £2 billion.
- Ethnic minority owned businesses make significantly lower monthly repayments than white owned businesses (£709 versus £3,123). This result is robust when controlling for other business characteristics.

Looking at the purposes of asset finance:

- 72% of businesses use it to pay for vehicles.
- 11% of businesses use it to pay for computer equipment.
- 9% of businesses use it to pay for machinery.

About 1.5% of asset finance users failed to make at least one re-payment in the last year.

Section 10: Asset Based Finance (Factoring, Invoice Discounting and Stock Finance)

Analysis of the types of asset based finance used indicates that:

- More than a half use invoice discounting.
- 2 in 5 use factoring.
- 1 in 20 use stock finance.
- Large numbers of businesses 'don't know' the type of asset-based finance being used.

Looking specifically at invoice finance (invoice discounting and factoring):

- The average amount advanced per month is estimated to be £146,000.
- The estimated total advanced is just under £8 billion.

The main purposes of using invoice finance are to:

- Fund working capital (2 in 3 businesses).
- Fund business expansion and acquisition (1 in 4 businesses).

Section 11: Credit Cards

- The average amount charged to personal credit cards is estimated to be £433 per month.
- This represents a total monthly expenditure of £450 million.
- Business credit cards accrue estimated monthly expenditures of over £1,100.
- This amounts to a total of £1.4 billion per month.

Regarding the purposes of credit card expenditures:

- The reasons for using credit cards are very similar across personal and business credit cards.

- In particular, the majority of these expenditures are to fund day to day expenses such as: paying for raw materials (39%); motor (39%) and travel expenses (39%); and sundry expenses (25%).
- However significant numbers use credit cards to pay for fixed capital: about 12% use them to pay for equipment and vehicles; and 5% purchase other fixed assets.

Further analysis of credit card data shows that:

- 21% of business owners never re-imburse themselves for business expenditures on personal credit cards.
- 19% are occasionally re-imbursed for these expenditures.
- 58% are always re-imbursed in full for these expenditures.
- 79% pay-off business expenditures, on *personal* credit cards, *in full* at the end of each month – implying, that 1 in every 5 owners borrow for business purposes on their personal credit cards.
- 95% pay-off business expenditures, on *business* credit cards, in full at the end of each month – about 1 in 20 borrow on business credit cards.

Section 12: Equity Finance

- The average equity investment, in the last 3 years, is estimated at just under £135,000.
- The total raised from all equity investors, in the last 3 years, is just over £14 billion.
- However there is a large degree of uncertainty in these estimates, reflecting the small sample size of equity users.

Regarding the types of investor used (among businesses with equity investments):

- Directors are the most popular, named, source accounting for 1 in 4 equity investments.
- About 1 in 10 of these businesses has received funds from existing shareholders or friends.
- 1 in 50 obtained funding from a venture-capitalist.

Looking at the reasons for using equity supplied by friends, family or directors as opposed to other sources:

- 1 in 5 business-owners cited the following reasons: ‘to maintain control of the business’; or ‘no need for another source’.
- Less than 1 in 20 cited supply-side constraints (‘unable to raise equity from other sources’).

These findings do not appear to support the notion of an ‘equity gap’ in the supply of formal venture capital to SMEs. However, the interpretation of these results requires caution since the sample of equity users is small.

Section 13: Grant Finance

- The value of the average grant awarded, in the last 3 years, is about £33,000.

- The total value of grants awarded to SMEs in the last 3 years is estimated at £7.6 billion.
- The total value of assistance to businesses, with less than 10 employees, is estimated at £6.3 billion, representing over 80% of the total awarded to all SMEs.

The main sources of grant finance reported are:

- Regional Grants (20%).
- Enterprise Grants (12%).
- Agricultural Grants (11%).
- Business Support Scheme (7%)

Section 14: Relationships between Finances

We conclude the report by looking at the relationships between the different forms of finance analyzed individually in previous sections. In particular, the aim here is to investigate:

- The types of finance which are more likely to be used as *alternatives* to each other (substitute finances). These are finances which are in competition with each other, since a rise in the demand for one implies a fall in the demand for the other.
- The types of finances which are more likely to be used in *conjunction* with each other (complementary finances). These finances are not in competition since a rise in the demand for one also implies a rise in the demand for the other.

To achieve this analysis, models are estimated relating the probability of using one source of finance to other sources (controlling for owner, business, regional and industry characteristics).

These results show that:

- There is a strong degree of substitutability between traditional bank debt finances (term loans and overdrafts). In particular, using a term loan reduces the likelihood of having an overdraft facility by almost 80 percentage points (holding firm characteristics constant).
- Asset finance is a potential substitute for term loans. Businesses which use asset finance are 25 percentage points less likely to use term loans, other things being equal.
- Asset-based finance, credit cards, equity finance and grants are also potential substitutes for term loans.
- Interestingly, term loans, asset finance and asset-based finance are strong substitutes for credit cards. Businesses would, most likely, get cheaper finance by replacing credit card borrowing with some other form of debt.
- There is no relationship between overdrafts and asset-based finance. This is, perhaps, surprising since asset-based finance is often viewed as a substitute for overdraft finance.
- Businesses with term loans are more likely to have a grant than those without term loans, suggesting these finances are complements.

These results imply that most finances are in potential competition with each other: most notably, term loans, overdrafts and asset finance. The exception to this finding is the relationship between grants and term loans. Specifically, businesses are more likely to have a grant, *given* they have term loan. This result is unsurprising, since many grants are awarded conditionally on the business matching the grant funding with other sources of finance.

Conclusions

The report concludes by drawing together the various themes which emerge from the analysis. In particular, the general availability of finance is contrasted with specific issues for access to, and the cost of, finance for ethnic minority and female-owned businesses respectively. Further research is planned to enable firmer conclusions, for ethnic minority businesses, to be reached. The low incidence of financially qualified management in SMEs is highlighted as another possible obstacle to obtaining finance.

In the context of competition, the relationship between firm characteristics and bank switching is noted. Specifically, businesses with financially qualified management, and high growth businesses, are more likely to switch banks. This suggests that, on the demand-side, a lack of financial acumen, or absence of dynamism, may contribute to the high level of inertia observed in SME banking relationships. There is no evidence that switching banks is either difficult, hinders access to finance, or raises the cost of borrowing.

INTRODUCTION

Small and medium-size enterprises (SMEs), businesses with less than 250 employees, account for 58% of private sector jobs and 52% of private-sector turnover (Source: SME Statistics for the UK).¹ Between 1999 and 2003, employment in private sector SMEs grew by 4.7%, set against a 4% fall in private sector large firm employment. Further, numerous studies have identified enterprise as leading to higher rates of productivity growth and innovation (Geroski and Pomroy, 1990; Cosh, Hughes and Wood, 1999). The performance of this sector of the economy is therefore integral to the overall performance of the UK economy.

A vital element for entrepreneurship to thrive is the availability of capital for start-ups and growing businesses (HMT/SBS, 2002). However, due to imperfections in capital markets, there have been persistent concerns about the ability of smaller firms to raise sufficient external finance to meet their needs (Bolton, 1971; Wilson, 1979; Graham, 2004). These concerns have led to major government interventions, in both debt and equity markets, such as the Small Firms Loan Guarantee Scheme (SFLG) and, more recently, the Regional Venture Capital Funds (RVCF).

In the last few years, public concern has turned to the lack of competition in the supply of banking services to SMEs (Cruickshank, 2000; Competition Commission, 2002). This has led to the introduction of several measures to increase competition, for example, by easing switching between banks.

In January 2004, a consortium of public and private organizations, led by the Bank of England, commissioned the University of Warwick to carry out an in-depth study of SME finances in the UK. To this end, between August and October 2004, IFF Research Ltd completed 2,500 telephone interviews with SMEs, in a wide range of sectors², across the whole of the UK asking about financial and other information.

This survey, the Survey of SME Finances (SMEF), is the first representative survey of SMEs in the UK to offer a close analysis of businesses, their main owners and access to external finance. In particular, the survey collected data relating to:

- Relationships between small businesses and their finance providers.
- The types of finance used (overdrafts; commercial loans; loans from friends, family, and owners; asset finance; asset-based finance; credit cards; and equity finance)
- Credit terms and conditions.
- Start-up finance.
- Rejection experiences.

¹ www.sbs.gov.uk/content/analytical/statistics/smestats2003.xls.

² Public sector organizations and charities were excluded, together with the Financial Services, Mining and Quarrying, Electricity, Gas and Water Supply sectors. Also, the sample source, Dun and Bradstreet, may lead to under-representation of very small and start-up businesses in the sample. With these sample exclusions, the estimated SME population is 3.6 million versus a figure of 3.8 million reported in the SME Statistics for the UK (2002).

- Income and balance sheet information
- Business owners' human and financial capital.

The general findings of the survey are that:

- Access to (and cost of) finance poses one of the least problems for businesses: coping with red-tape is the biggest problem area.
- 44% of SMEs (1.6 million businesses) sought new finance in the last 3 years.
- The average amount of new finance sought is just under £82,000.
- Among businesses needing new finance, 11% experienced outright rejection (180,000 businesses); but less than 1 in 20 businesses, denied loans, found themselves in dire straits as a result.

Looking at the supply of financial services to SMEs:

- The largest four providers account for almost 80% of the market.
- SME relationships with their main providers are long (15 years on average) and monogamous (60% have only one provider for all their finances).
- The average monthly bank charge is about £50.
- Almost 1 in 3 SMEs report some dissatisfaction with these bank charges.
- However, each year, only 1 in 40 switch banks.
- The majority of these switchers do so because they are dissatisfied with service rather than bank charges.

Analysis of specific financial services yields the following estimates:

- The total held by SMEs on deposit is £92 billion.
- The total amount outstanding on term loans is £64 billion.
- The total monthly business expenditure, on personal credit cards, is £450 million per month.
- Business credit cards accrue total monthly expenditures of £1.4 billion per month.

As these headline figures suggest, the main intention of this report is to provide a wide ranging overview of the data and key results. The tabulations in this report, whilst providing interesting insights into SME finances, are no substitute for rigorous econometric analysis to establish causal relationships. Although, some initial headway is made with this type of analysis, in particular, in the analyses of rejection rates and the relationships between finances, further econometric analysis is left for future research.

The remainder of this report is divided into three parts. In the first part, we set out some background for the analysis. Specifically, this background is in the form of: a discussion of some key issues affecting SME finances (Section 1); and, an analysis of contextual data, relating to the characteristics of the businesses in the survey and the range of problems experienced in running them (Section 2). The latter analysis allows a perspective to be gained on businesses' perceptions of their financing problems relative to other operational issues.

The second part of the report provides a general overview of the data relating to the demand and supply of SME financial services. On the demand-side, we look at:

- The range of financial services currently used by SMEs (Section 3)
- New finances sought in the last 3 years (Section 4).

In section 5, we look at the extent of *unsatisfied* demand among businesses needing new finance. In this context, we look at the extent of:

- Outright rejection.
- Partial Rejection (i.e., the businesses were offered less than they wanted).
- Discouragement (i.e., the businesses did not apply because they *believed* they would be rejected).

The second part concludes by examining issues relating to the supply of SME financial services (Section 6). In this context we look at:

- The market shares of the main providers of financial services to SMEs.
- The number of different providers used.
- The nature of relationships with the main providers, principally
 - The breadth of relationships (number of financial services supplied by the main provider)
 - The length of relationships.
 - The cost of banking.
 - Levels of customer satisfaction.
 - The propensity to switch banks.

From the point of view of competition, this analysis allows us to:

- Examine the extent to which the supply of financial services is concentrated in a single supplier.
- The degree of variation in charges across different providers.
- The willingness of businesses to seek another provider.
- The factors which motivate switching – dissatisfaction with price or service.

The third part of the report presents analysis of the average and total amounts used of the different forms of finance. The analysis concludes by looking at the relationships between finances to determine which finances could be considered to be in competition with one another. In particular, this analysis gives some indication of which types of finance are potential alternatives to traditional bank debt. Appendices are provided at the end of the report to present more extensive tabulations.

Technical preliminaries

A few general technical points about the reporting of results in this document are required before presenting the results. Firstly, an ‘error margin’ is provided, along with the *estimated* percentages/means, in most instances. The estimated figure, plus and minus the error margin, gives a *range* of values which contains the *population* percentage/mean with 95% probability.³ The larger the error margin, relative to the estimated figure, the greater the uncertainty about the population figure. A large error margin could be due to the variable under analysis varying widely in the population, or because the sample size of the cell is small. We can do nothing about the first source of uncertainty. However, regarding the latter source, cells with a sample size

³ Technically, the error margin is 1.96 times the standard-error of the estimate.

of less than 50 observations are not generally reported since they are unlikely to provide informative estimates of the population figure.

Secondly, all the results in this report are population weighted to reflect differences in sampling rates across size bands and sectors. Accordingly, the interpretation of the estimates adheres to the population of SMEs rather than the businesses in the sample. In this context, the notation ' N_p ' is used to denote 'number of businesses in the population': this figure is simply the sum of the population weights for the businesses in the sample to which the estimate relates.⁴ In contrast the notation ' N ' denotes the corresponding number of businesses in the sample.

Finally, all the analysis was conducted using the statistical software package *Stata* (version 7). In particular, the commands implementing code for survey-data analysis were used. This code uses the sampling weights and stratification employed in the survey to ensure that the estimates are consistent with the survey design.

⁴ The population weights are simply the inverse of the probability of selection into the sample due to the survey design.

I. BACKGROUND

1. ISSUES AFFECTING SME FINANCES

1.1 Potential market failure in SME finance markets

Policy-makers have, for a long-time, voiced concern about poor access to external finance, among smaller firms, due to a market failure in credit markets (Bolton, 1971; Wilson, 1979; Graham, 2004). In short, this market failure means that some businesses with viable propositions are unable to access any, or sufficient, external finance.

Analysis of the cause of this market failure has been at the core of financial research for over 20 years. Fundamentally, the problem arises because lenders are imperfectly informed about the characteristics of potential borrowers (asymmetric information). It may be impossible, as a result, for lenders to distinguish ‘good’ borrowers from ‘bad’ ones.⁵ In these circumstances, using the price mechanism to allocate funds does not work since, from the lender’s perspective, it selects the wrong sort of borrower. Indeed, it may be more profitable for the lender to supply fewer loans, at a lower interest rate, than raise the interest rate to clear the market. However, as a consequence, some would-be borrowers, who are willing to pay a market rate of interest, are denied credit. This will impinge on some good borrowers unless, by some fluke, they access all the available funds.

The problem of information asymmetries highlights the importance of relationships between lenders and borrowers. Longer and broader relationships increase the amount and flow of information to lenders, enabling good borrowers to obtain better access to finance over time. Riskier businesses may, on the other hand, prefer shorter relationships in order to hide their true nature.

In the above scenario, some good borrowers, without a transactions history, will go without loans due to the failure of the price mechanism to allocate loans efficiently. However, the terms of a loan contract usually include more than just an interest payment. In reality, lenders can offer a menu of terms; and the terms which the borrower selects reveal the quality of the business (Bester, 1985).⁶ For example, assuming collateral is available, good borrowers could signal their quality by taking-up a secured loan, in return for a lower interest margin. In contrast, poorer businesses would probably prefer to pay a higher margin on an unsecured loan since they know they are likely to fail and hence lose their collateral.

Despite the roles of relationships with lenders and collateral in improving access to finance, it remains a possibility that good borrowers with no transactions history or tangible assets could go unfunded. Indeed, public loan guarantee schemes, such as

⁵ By ‘bad’ we simply mean these businesses have a high likelihood of default on the loan – it does not imply these businesses are morally deficient, anymore than ‘good’ conveys virtue (over and above being able to make re-payments).

⁶ This is known in the economics literature as ‘sorting by private information’. Alternatively, if information asymmetries are not severe, then lenders will require high observed risk borrowers to pledge collateral (‘sorting by observed risk’ – Berger and Udell, 1990)

the SFLG in the UK, are based on the rationale that good businesses may go unfunded due to a lack of security or track-record.⁷

The current state of SME finance markets

In practical terms, it is questionable whether accessing debt finance remains a real concern for most businesses. A recent report by the Institute of Directors found that 71% of businesses did not think it was difficult to access finance (Wilson, 2004). In another report only 1% of small firms reported access to, or the cost of, finance as their main problem (NatWest/SBRT, 2003). Looking ahead to section 2, SMEF also places financial problems far down the pecking order of business problems. In a similar vein, the Small Business Omnibus Surveys shows businesses, reporting access to finance as a barrier to growth, falling from 6% (Summer, 2001) to 1% (Autumn, 2002) (SBS, 2001, 2002). Another study reports that, among businesses which did not seek new finance, 85% had no need for external finance because their internal cashflows were sufficient (Cosh and Hughes, 2003). This suggests that constraints on the supply of debt finance are not a major problem. This array of evidence sets a scene in contrast to the dark days following the recession in the early 1990s. At that time, a combination of poor communications and mistrust between lenders and small businesses led to widespread fears of a credit-crunch (Bank of England, 1994).

In part, the improvement in accessing finance over the last decade may be due to changes in methods of credit assessment which have improved the ability of lenders to determine the risk of prospective borrowers.⁸ Notably these assessments rely less on bank manager's judgments and more on quantitative evaluations of business-owner characteristics and recent cash flows. As a result, most loans below £30,000 are now allocated by credit scoring and do not depend on whether the applicant is able to post security (Graham, 2004).

Nonetheless, the possibility remains that good businesses, without a track record or with nonstandard characteristics, may find themselves with insufficient funds. Indeed, on larger loans, collateral remains a pre-requisite for obtaining funds. The UK government therefore continues to support small business lending, in particular for start-ups and high growth businesses, through the SFLG (Graham, 2004). Also, improving access to finance among 'disadvantaged and under-represented' groups, such as female and ethnic-minority businesses, is squarely on the current policy agenda.

Assessing the evidence for market failure with SMEF data

On the surface, looking at credit denial rates provides a direct indication of the extent of unsatisfied demand. However, since both good and bad types of business may be denied credit, such a figure provides, at best, an upper bound on the extent to which good projects are going unfunded.⁹ Indeed, it is arguable that experienced lenders are

⁷ The problem of information asymmetries will diminish if the business is able to demonstrate objectively its past performance thereby helping the lender to predict future performances.

⁸ For the role of changes in the macroeconomic environment see Bank of England (2004).

⁹ This approach also ignores the contribution from groups of individuals who are discouraged from seeking finance because they anticipate rejection, making it not worth the effort to apply in the first place (Kon and Storey, 2003). In the presence of information asymmetries it is good borrowers who

better informed than inexperienced entrepreneurs about the business' prospects - see e.g., de Meza and Southey (1996) – in which case, most denials would represent bad business propositions.

In SMEF, we are able to examine differences in rejection rates over different business and owner characteristics. This will provide empirical evidence on the types of business which have above/below average chances of credit denial. Also, we can examine what the business saw as the *reasons* for denial which provides some indication of the potential viability of an unfunded venture. For example, businesses denied credit, due to a lack of collateral or track record may represent potentially worthwhile investments. These businesses are, arguably, qualitatively different from businesses denied because of a poor business plan or credit history.

A word of caution is in order about the pitfalls of testing for credit market failure using self-reported rejection experiences. Reports of these experiences may be subject to 'impression management' and other forms of self-serving bias.¹⁰ In contrast, econometric analysis, of the predictions generated by economic models of credit market failure, provide a more objective basis for testing credit rationing (see Evans and Jovanovic, 1989; Berger and Udell, 1992) – this type of in-depth analysis is, however, left to future research with SMEF data.

1.2 Other issues affecting SME finance markets

Market failure in SME credit markets is by no means the only potential constraint on SME finances. Analysis of SMEF data can shed light on some of the following issues:

Skills and advice

Smaller firms are prone to under-invest in skills due to a number of market failures identified in the literature (see e.g., Storey and Westhead, 1997; Fraser, 2003). This may lead to skills deficiencies in key areas of business operations, including finances (SFEDI, 2002). It is possible that, with greater financial skills, smaller businesses could improve their access to finance, by enabling them to write (better) business plans, for example.¹¹ Notably, SMEF data indicates that only 1 in every 2 start-up businesses had a business plan in place before start-up.

In this regard, we look at the extent to which SMEs have financially qualified individuals in charge of finances, and at owner-managers self-assessment of their

are discouraged by the fear of being mistakenly rejected. On the other hand, as lenders become better informed, *bad* borrowers are discouraged by the fear of being spotted correctly (Han, Storey and Fraser, 2004).

¹⁰ The term 'impression management' denotes the tendency for business people to accentuate the positive, and eliminate the negative, aspects of adverse events (Elsbath, 1994; see Fraser et al, 2004 for empirical evidence). In this case respondents may prefer to miss-report the reasons for rejection and place the blame outside the business.

¹¹ Ironically, without funding in the first place, businesses may be unable to make the requisite investments in financial skills to improve access to finance. Government intervention may be an appropriate response to unravel this particular Gordian knot. Indeed, the Small Firms Training Loan Scheme provides subsidized loans for training investments (see e.g., Fraser et al, 2002). However, this scheme has not achieved wide-spread take-up.

skills in handling finances. In addition, SMEF looks at the use of external advice in relation to financial decision making. This allows us to gain some initial insights into the impacts of financial qualifications, self-assessed skills and external advice on access to finance.

Desire for independence/high internal locus of control

A further constraint on small firm finances is the general unwillingness of owners to share control of their business with outside investors. Indeed, one of the principal reasons for starting up in business is a desire for independence, over and above the prospect of financial gain, and the belief that success or failure is down to one's own actions (Blanchflower and Oswald, 1998).

On this point, SMEF data indicates that more than 1 in 3 entrepreneurs started in business, principally, to satisfy a desire for independence. In comparison only 1 in 7 cite making money as their main motivation. This independent streak may lead entrepreneurs to prefer funding from internal sources and from external sources, closer to home, such as friends and family (Cosh and Hughes, 2003). In this context SMEF compares the use of external finances, with 'strings attached' (e.g., secured bank loans or equity), relative to the use of funds provided by friends, family and the owners themselves.

Competition

Another asymmetry, with potentially adverse consequences for SME finances, is the disparity in market power between businesses and the banks supplying their finances. Indeed, in the last few years, public concern has focused on the lack of competition in the provision of financial services to SMEs.¹²

These concerns have led the Competition Commission to make a number of recommendations to make it easier for businesses: to compare the prices of banking services; to purchase these services from different suppliers; and to switch banks if desired (Competition Commission, 2002). The four major clearing groups, Royal Bank of Scotland Group, Barclays, Lloyds TSB and HSBC, were also identified as making excess profits from their SME banking. In order to remove these profits, the 'big four' have undertaken, with the Office of Fair Trading, to pay interest on current accounts or waive charges on money transmission services.

It remains to be seen how much of an impact these recommendations will have on competition. For example, good businesses may be unwilling to switch banks because a long-term financial relationship is important in alleviating information asymmetries, which would otherwise hinder access to finance.¹³ A business considering switching may fear the possibility of losing out on funding by starting-over with a new bank. Indeed, empirically, switching rates are low – around 3-4% per annum (Cruickshank, 2000).

¹² Although the recent report by Graham (2004), on the SFLGS, represents a resurgence of public interest in the issue of access to finance, in particular, among start-ups and high growth businesses.

¹³ Bad businesses, on the other hand, might be happy to switch regularly so that their true nature is not revealed to the bank.

This survey sheds further light on issues relating to competition. We are able to look at: the degree of market concentration in the supply of financial services to SMEs; the extent to which businesses use multiple providers of finance; the extent of switching between banks and the motivation for switching – price or general service; the degree of satisfaction of businesses with their current bank; and the likelihood of switching in the future. The key issue here is whether dissatisfaction, with prices or other aspects of the bank's service, increases the likelihood of switching in the future, or whether the nature of the bank-borrower relationship leads to inertia. This is an important step in understanding how businesses are likely to respond to government interventions designed to increase competition.

2 CONTEXTUAL DATA ANALYSIS

We start the data analysis by setting the context for the subsequent analysis of finances. This context includes business and principal owner characteristics; sources of financial advice; self-reported abilities in various aspects of running the business, including financial abilities; and the problems faced by businesses, including financial problems. Comparisons, with existing data on business characteristics, in the UK (SBS, 2003) and the US (Bitler et al., 2001) are also reported.

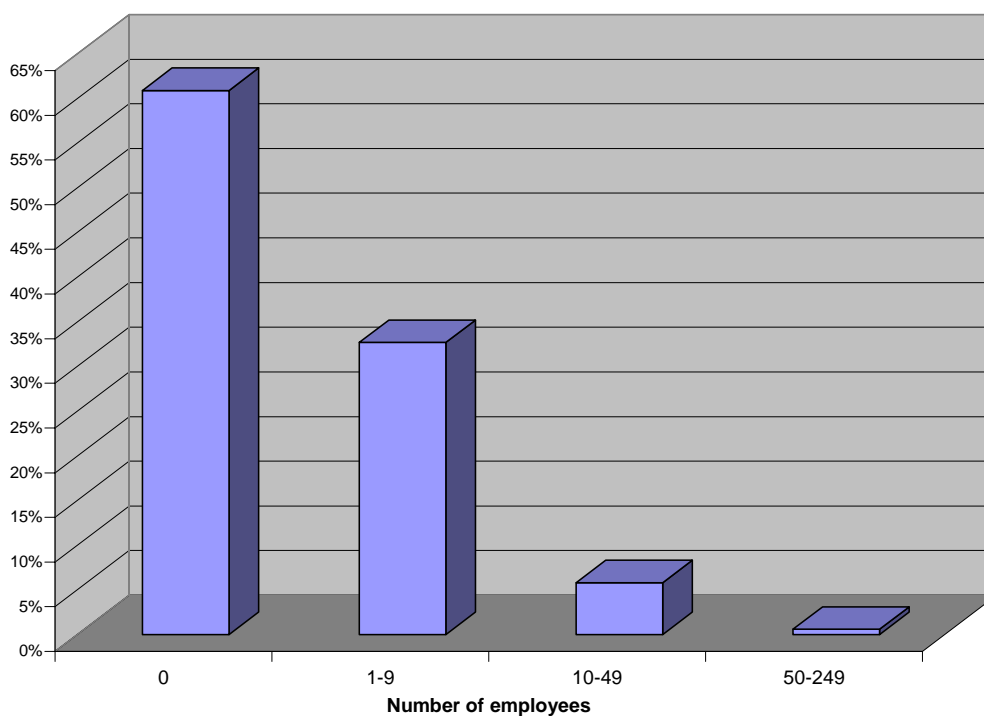
2.1 Business characteristics

We look firstly at the characteristics of the businesses in SMEF. This analysis is started by looking at some general business characteristics before turning to more specific characteristics. A full tabulation of business characteristics is reported in the Appendix to Section 2, Table A2.2.1.

General Business Characteristics

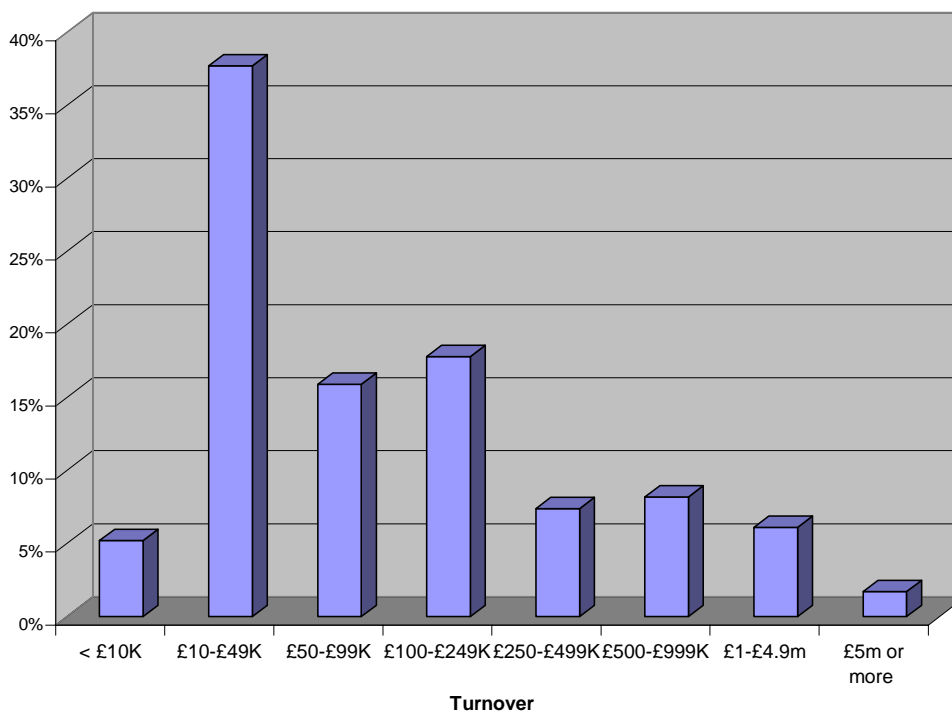
Firstly we look at the size distribution of SMEs using the following measures of size: number of employees; turnover; and assets.

Figure 2.1.1: Business Size Distribution (employees)



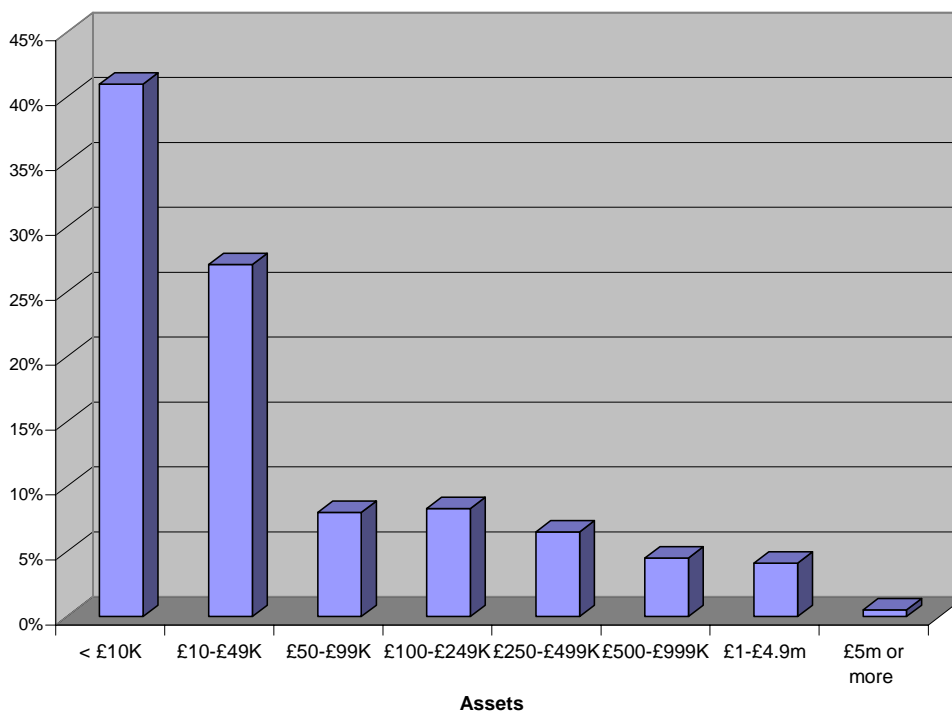
Base: All businesses reporting employment $N_p = 3,625,416$ (Unweighted $N=2,500$)

Figure 2.1.2: Business Size Distribution (turnover)



Base: All businesses reporting turnover $N_p = 3,095,337$ (Unweighted $N=2,253$)

Figure 2.1.3: Business Size Distribution (assets)



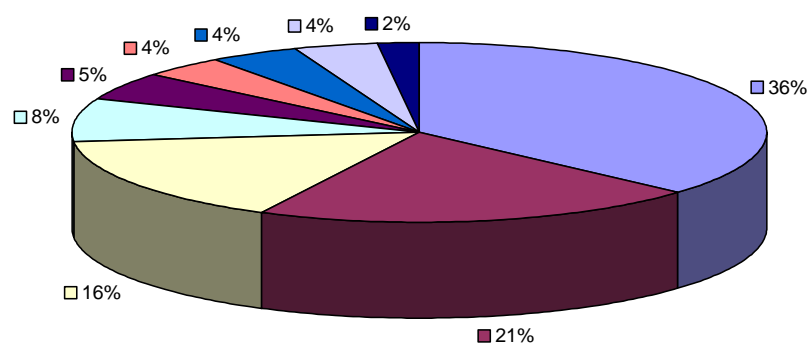
Base: All businesses reporting assets $N_p = 3,270,410$ (Unweighted $N=2,306$)

The preceding graphs repeat some well established results. Principally:

- Smaller businesses are more common than larger ones.
- 2,200,000 businesses have no employees (about 61% of SMEs). SBS (2003) report a figure closer to 70%.
- 1,450,000 businesses have an annual turnover of less than £50,000 (about 40% of SMEs).
- 1,350,000 businesses have less than £10,000 worth of assets.

Next we look at what the businesses do. In this regard the distribution of the businesses by 2-digit Standard Industrial Classifications are reported in the following chart

Figure 2.1.4: Distribution of Businesses by Industry



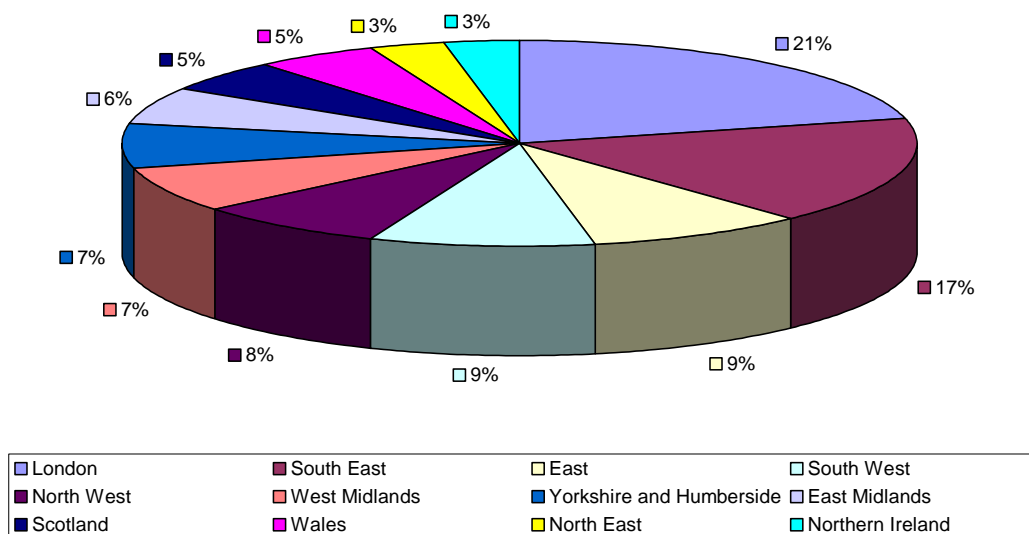
■ K. Real Estate, Renting and Business Activities	■ F. Construction
■ G. Wholesale/Retail	■ O. Other Community, Social and Personal Service Activities
■ D. Manufacturing	■ N. Health and Social Work
■ I. Transport, Storage and Communication	■ AB. Agriculture, Hunting, Forestry and Fishing
■ H. Hotels and Restaurants	

Base: All businesses $N_p = 3,625,416$ (Unweighted $N=2,500$)

- More than a third of SMEs are in Real Estate, Renting and Business Activities (some 1.3 million businesses)
- Only 5% are in manufacturing (around 180,000 businesses).
- This distribution reflects the comparative advantage of SMEs in service-based industries.

The regional distribution of businesses is as follows (businesses are allocated to regions according to the location of its head office).

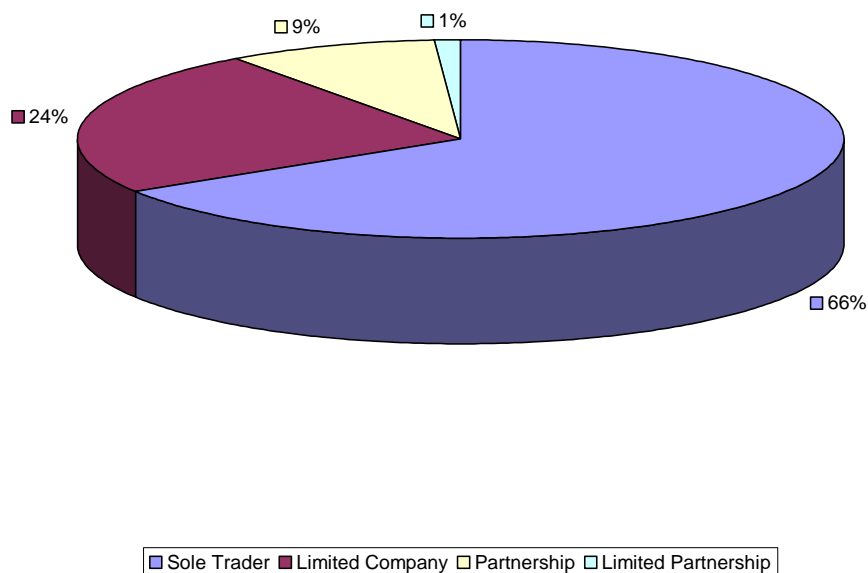
Figure 2.1.5: Distribution of Businesses by Regions



Base: All businesses $N_p = 3,625,416$ (Unweighted $N=2,500$)

- 38% of SMEs are located in London and the South East (1,400,000 businesses)
- 87% of SMEs are located in England (3,150,000 businesses). SBS (2003) report a figure of 86% for businesses with employees.
- 5% are located in Scotland (against 7% reported in SBS, 2003)
- 5% are located in Wales (against 4% reported in SBS, 2003)
- 3% are located in Northern Ireland (same figure in SBS, 2003).

Figure 2.1.6: Distribution of Legal Forms



Base: All businesses $N_p = 3,625,416$ (Unweighted $N=2,500$)

- Almost 2 in 3 businesses are sole traders (2,400,000 businesses)
- Less than 1 in 4 businesses are limited liability companies (870,000 businesses)
- About 1 in 10 businesses are partnerships (including limited liability partnerships).
- Excluding businesses with no employees the proportions are: 29% sole traders; 49% limited liability companies; and 22% partnerships.

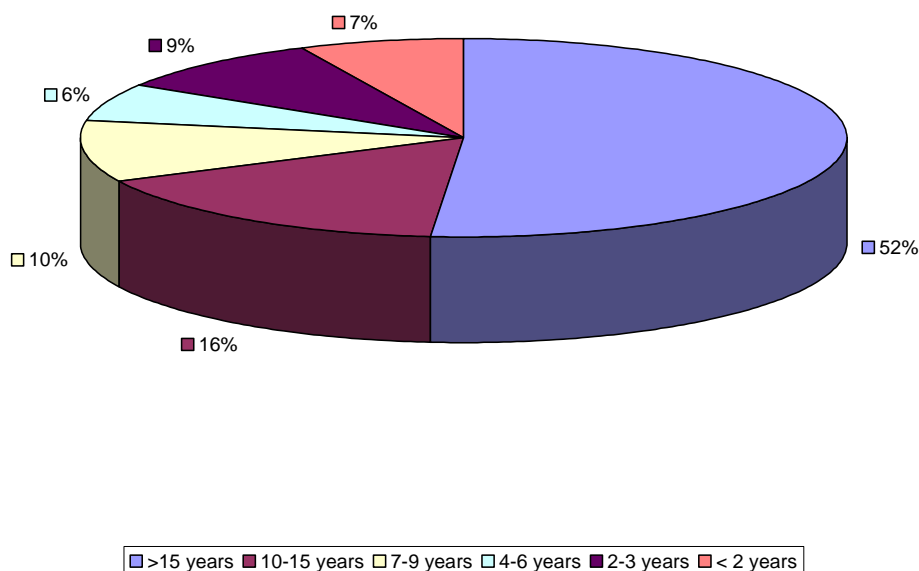
Comment

The preference for sole trading may reflect the entrepreneurs' desire for independence and control over their business. Alternatively, this preference may simply reflect the comparative ease of setting up as a sole trader. Regarding businesses with no employees, compared to SBS (2003) there is a lower proportion of companies and a higher proportion of sole traders (SBS, 2003, reports figures of 59% and 21% respectively)

Start-ups and high growth businesses

The recent Graham (2004) report highlighted ongoing concerns regarding access to capital for start-ups and high growth businesses. From a social viewpoint these businesses are important because they are potentially significant employers. However they may also appear risky to lenders, because they lack a track record or their performance is volatile. Here, we look at the relative importance of these businesses in the business population.

Figure 2.1.7: Business Age Distribution



Base: All businesses $N_p = 3,625,416$ (Unweighted $N=2,500$)

- The majority of businesses (51%) are aged more than 15 years (1,900,000 businesses).
- About 7% of small businesses are start-ups (aged less than 2 years) (250,000 businesses)

The figure for start-ups may under-estimate the true number of start-ups since Dun and Bradstreet records (the sample source) tend to under-represent young businesses.

In this report high growth businesses are defined as having an average turnover growth of 30%, or more, per annum over a period going back up to 3 years. The survey finds that:

- About 11% of businesses fall under the definition of high growth (320,000 businesses).

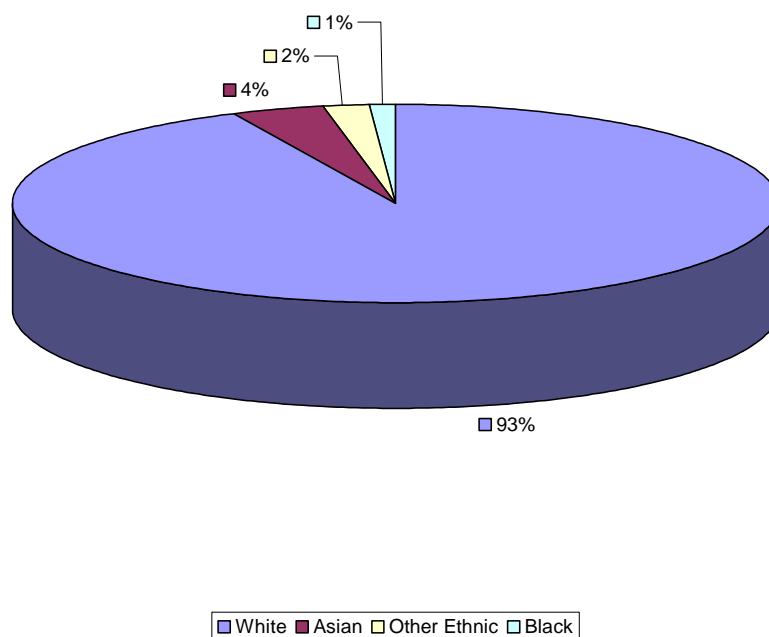
Minority group businesses

Typically rates of entrepreneurial activity are low among certain ethnic minority groups and females. These social groups are therefore a particular focus for enterprise support. The government hopes that, by supporting these groups, the overall rate of entrepreneurship will be increased and problems of social exclusion will be alleviated.

Ethnic minority businesses

The distribution of businesses which are 50% or more ('majority') owned by individuals from white and ethnic minority groups respectively, are reported in the following pie chart.

Figure 2.1.8: Distribution of Ethnic Backgrounds of Majority of Owners



Base: All businesses $N_p = 3,625,416$ (Unweighted $N=2,500$)

- 93% of businesses are majority white owned (3,400,000 businesses).
- About 7% of businesses are majority owned by people from ethnic minority backgrounds (220,000 businesses).¹⁴

¹⁴ Notably, census data give the following breakdown for ethnic minority businesses (see Census 2001: National Report for England and Wales – www.statistics.gov.uk/census2001/ – Table S112)

White British 88.5%
 White Irish 1.4%
 Other White 2.8%

Mixed:
 White and Black Caribbean 0.2%
 White and Black African 0.1%
 White and Asian 0.2%
 Other 0.2%

Asian:
 Indian 2.3%
 Pakistani 1.4%
 Bangladeshi 0.3%
 Other 0.5%

Whilst it appears that our sample is representative of the population of ethnic minority businesses, the small number of these businesses in the sample limits the analysis we can carry out for this group. In particular, our analysis is forced to lump all types of ethnic minority groups together, despite knowing that ethnic minority groups are highly diverse in their use of external finance and business support (Ram et al, 2002). Future work will seek to boost the number of ethnic minority businesses in the sample, allowing analysis by different ethnic minority groups.

Female businesses

Regarding female majority owned businesses the survey finds that:

- 25% of businesses are majority-owned by females (just over 900,000 businesses).
- This figure falls to 15% among medium sized enterprises (50-249 employees)

Comment

SBS (2003) reports that 91% of businesses are majority owned by white individuals. SBS (2003) also reports that 38% of businesses have management teams consisting of 50% or more female *managers*. Our results suggest there are fewer female majority *owned* business than female majority *managed* businesses.

Other business characteristics

The following other business characteristics are noted (see also Table A2.2.1 in Appendix to Section 2)

- The vast majority of SMEs export none of their sales abroad: only 8.5% export up to a half of their sales and the proportion exporting a half or more of their sales is less than 2% (against 4.2% reported in SBS, 2003).
- Less than 1% of businesses are social enterprises i.e., businesses run for a mix of social and commercial objectives. Over 99% of businesses are operated on a solely for profit basis.
- Regarding the origins of the businesses: 82% were established by the current owners; 12% were purchased; and 6% were inherited.
- 60% of businesses are registered for VAT. The high proportion (40%), not VAT registered, reflects the large number of businesses falling below the VAT threshold of £58,000.
- Over three-quarters of SMEs are majority owned by a single family (the proportion is the same considering companies only). Again this highlights the importance to SME owners of maintaining a tight-control over the running of their businesses.

Black:
Black Caribbean 0.6%
Black African 0.4%
Other Black 0.1%

Chinese 0.8%

Other 0.3%

- 47% of SMEs are home based; this figure falls to 21% when businesses with no employees are excluded.
- 36% of SMEs are a member of one or more business organizations (1.3 million businesses).
- 59% of SMEs in this group are members of a trade association.

2.2 Principal owner characteristics

The characteristics of the *individual* with the largest ownership share (principal owner) are reported in the Appendix to Section 2, Table A2.2.2. These results indicate that:

- Females are the principal owners of about 18.5% of small businesses.¹⁵
- 79% of principal owners are aged between 40 and 65.
- In addition, 61% of principal owners have more than 15 years business experience.
- The role of formal academic qualifications is less clear cut. On the one hand, 29% of principal owners have no, or at most very basic (O-levels/GCSE), academic qualifications; on the other hand about 23% have a University degree.

Comment

Regarding the age of principal owners, older and more experienced individuals tend to have accumulated more business know-how which makes their businesses more likely to survive (and, hence, to be observed in the sample).¹⁶ Also, it is likely that the wide variation in formal academic qualifications reflects the diversity of the types of business in the SME sector, and the wide-ranging skills required to run them.

Summary comparisons with other UK and US data sources

The following table provides a summary comparison of the business and owner characteristics in SMEF with those in the:

- United States Survey of Small Business Finances (last conducted in 1998: see Bitler et al, 2001)¹⁷
- United Kingdom Annual Survey of Small Businesses (SBS, 2003)

¹⁵ The previous analysis of female businesses related to *majority* female ownership. Majority ownership is the basis for the analysis of female businesses in the remainder of this report.

¹⁶ Previous studies have highlighted the importance of experience for business survival (Cressy, 1996).

¹⁷ The latest US SSBF was conducted in 2004, but the data are not yet available to the public.

Table 2.1.1: Comparisons of Business and Owner Characteristics in the UK and US

	US SSBF (1998)	UK SMEF (2004)	UK SBS (2003)
<i>Number of Employees</i>			
0	22%	61%	69%
1-9	62%	32%	25%
10-49	14%	6%	5%
50-249	2% (50-499)	1%	1%
<i>Legal Status</i>			<i>(Excluding businesses with no employees)</i>
Sole Trader	49%	66%	21%
Partnership	7%	10%	20%
Company	44%	24%	59%
<i>Industry</i>			
Agriculture	-	4%	3%
Manufacturing	8%	5%	15%
Construction	12%	21%	10%
Wholesale/Retail	26%	16%	-
Service Sectors	54%	54%	72%
<i>Age of business</i>			
Less than 4 years	22%	16%	15%
4-10 years	23%	17%	25%
More than 10 years	55%	67%	60%
<i>Majority Ownership</i>			<i>(Majority Management)</i>
Male	72%	75%	62%
Female	24%	25%	38%
<i>Majority Ownership</i>			<i>(Majority Management)</i>
White	90%	93%	91%
Ethnic Minority	10%	7%	9%
<i>Majority Ownership</i>			
Family	85%	77%	-
Not Family	14%	23%	-
<i>Owner's Age</i>			
Under 21 years	0%	0%	-
21-39 years	17%	14%	
40 years or over	83%	86%	

	US SSBF (1998)	UK SMEF (2004)	UK SBS (2003)
<i>Owner's Experience</i>			
Under a year	0%	0%	-
1-9 years	21%	17%	
10 years or more	79%	83%	
<i>Education</i>			
Trade/vocational qualification	4%	2%	-
Secondary school level qualification	18%	23%	
Undergraduate degree	33%	13%	
Postgraduate degree	19%	10%	

The comparisons in this table suggest that:

- US businesses tend to be larger, on average, than UK businesses.
- US businesses tend to be younger, on average, than UK businesses.
- The proportions of female and ethnic minority businesses, in their respective populations, are similar between the UK and US.
- Owner managers in the US are more likely to have a university degree than their UK counterparts.

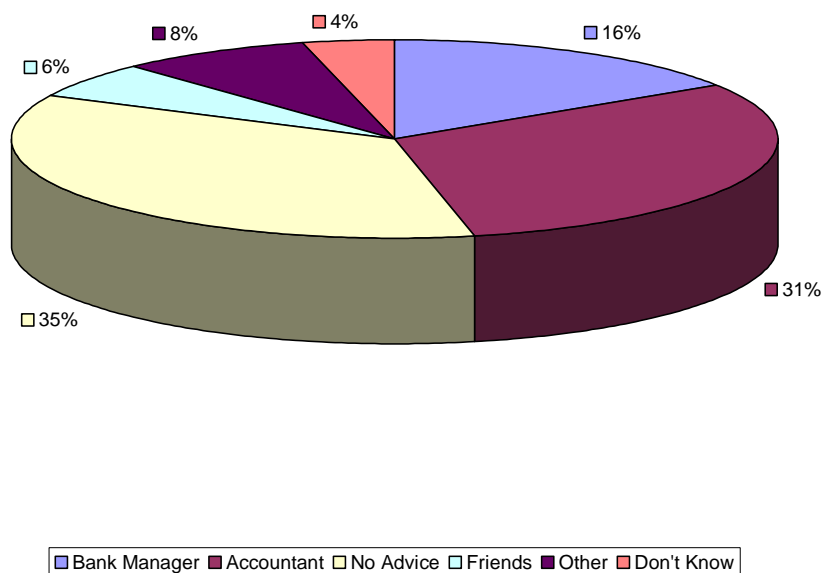
2.3 External financial advice, managerial talents and business problems

The contextual analysis is continued by looking at sources of financial advice, management skills and the problems faced by the business.

External financial advice

The following table presents evidence on the main source of support or advice used in financial decision making.

Figure 2.3.1: Sources of Financial Advice

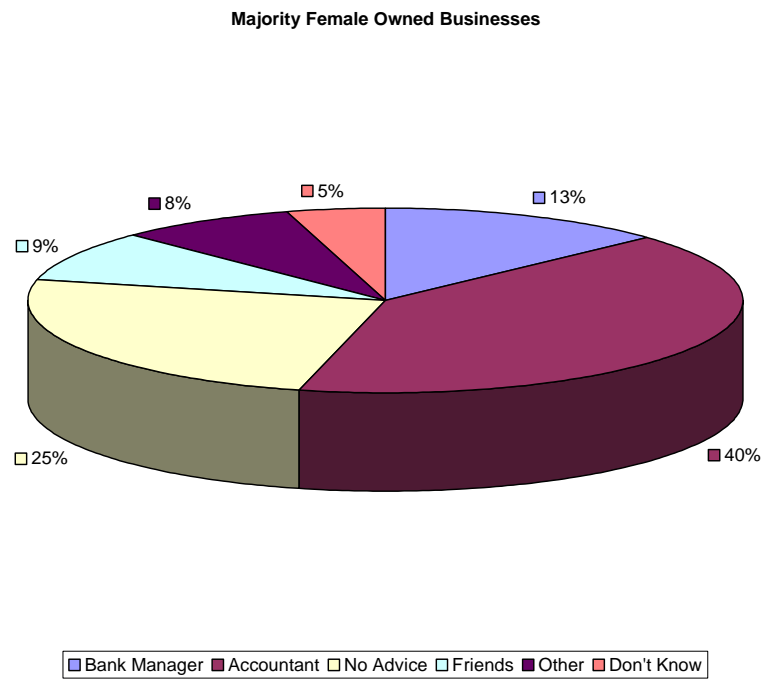


Base: All SMEs $N_p = 3,625,416$ (Unweighted $N=2,500$)

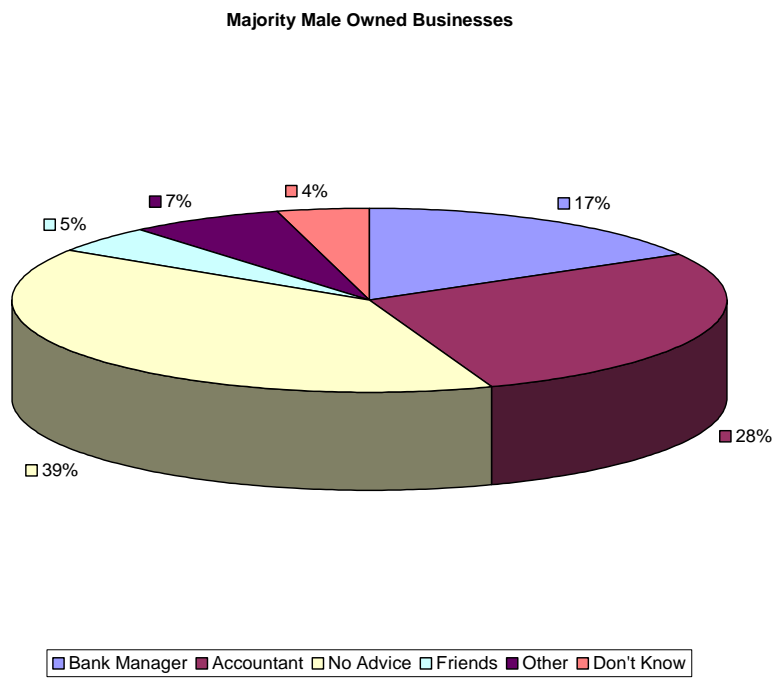
- Accountants are used as the main source of help with financial decisions in almost one-third of the population.
- Bank managers are the main source of advice for 16% of SMEs.
- Over a third of SMEs use no external advisers.

Analysis of the sources of financial advice, by gender and ethnicity are reported in the following charts.

Figure 2.3.1a: Sources of Financial Advice by Gender of Majority of Owners

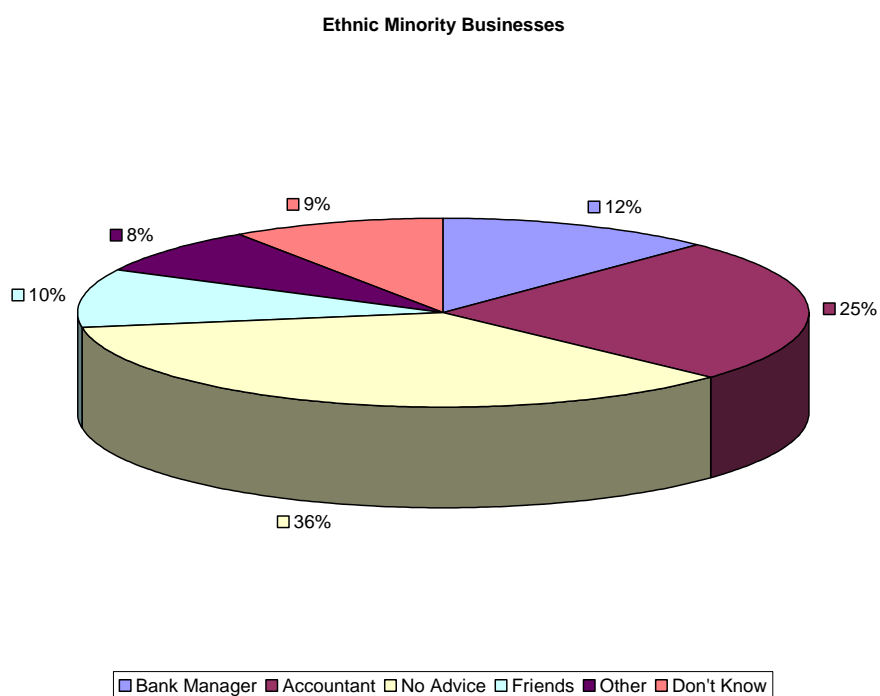


Base: Majority Female Owned SMEs $N_p = 904,532$ (Unweighted $N=713$)

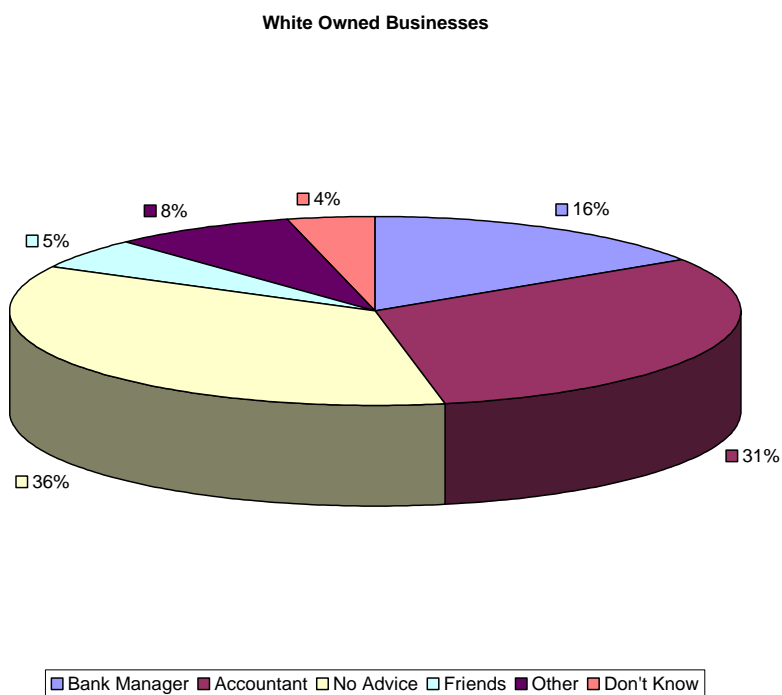


Base: Majority Male Owned SMEs $N_p = 2,719,524$ (Unweighted $N=1784$)

Figure 2.3.1b: Sources of Financial Advice by Ethnicity of Majority of Owners



Base: Ethnic Minority Owned SMEs $N_p = 217,912$ (Unweighted $N=102$)



Base: Ethnic Minority Owned SMEs $N_p = 3,392,927$ (Unweighted $N=2,373$)

These charts show that female owned businesses:

- Are more likely to use an accountant
- And less likely to use no advice than male businesses.

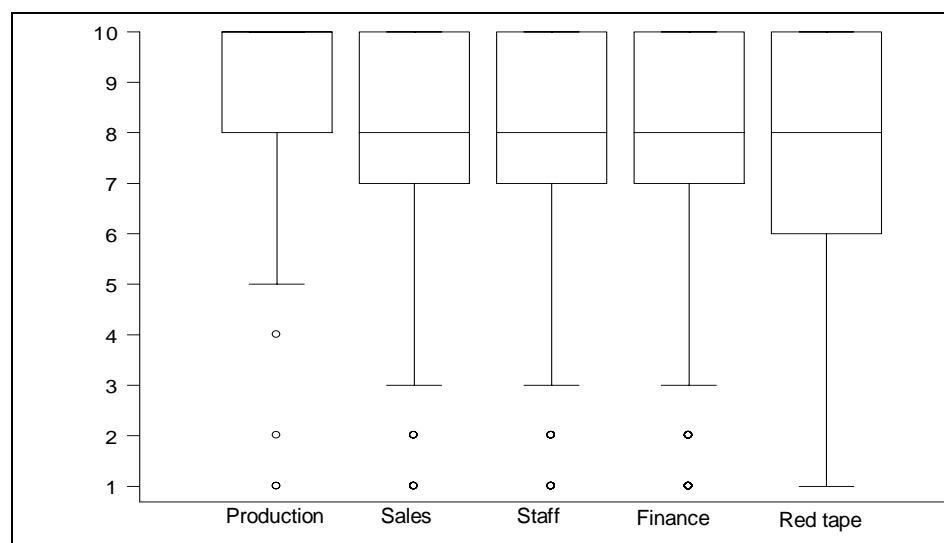
There are only small differences between ethnic minority businesses and white owned businesses. In particular, both groups are equally likely not to use any external advice.

Managerial talents

Next we look at owner-managers self-reported ratings of their abilities in a number of areas of business operations. These areas are: production; sales; staffing; finance; and coping with red-tape. Respondents were asked to rate their abilities in these areas on a scale of 1 (no confidence) to 10 (complete confidence). The caveat in interpreting these data is the susceptibility of respondents to fall prey to self-serving bias and ‘impression management’ (Fraser et al, 2004). This seems to be borne out by the high incidence of reported scores of ‘10’ (see Appendix to Section 2, Table 2.3.2).

The following graphical results on self-reported abilities may be interpreted as follows. The box characterizes where the bulk of the scores lie.¹⁸ The line, usually inside the box, represents the median score (sometimes, however, this median score coincides with one of the box’s edges; in any case, we state the medians explicitly). The ‘whiskers’, extending below the boxes, and individually plotted data-points (circles) give an indication of the extent of reported low scores.¹⁹

Figure 2.3.3 Self-confidence in Own Abilities (box and whisker) (1=no confidence; 10=complete confidence)



Base: Sole traders and partnerships only $N_p = 2,756,979$ (Unweighted $N=1,290$)²⁰

¹⁸ Typically, the box extends from the 25th to the 75th percentile of the distribution. However, in the diagrams below, all the scores, between the 75th and 100th percentiles, equal 10. Accordingly, the boxes characterize 75% of the distribution between the 25th and 100th percentiles (rather than just the 50% between the 25th and 75th percentiles).

¹⁹ These whiskers extend to a distance of 1.5 times the inter-quartile range (i.e., the distance between the 25th and 75th percentile).

²⁰ Companies were not asked about their self-confidence.

The above figure shows that the median self-confidence scores are high. These scores are:

- 10 for production
- 8 for sales, staffing, finance and red-tape

The bulk of scores (within the box) are between:

- 8 and 10 for production.
- 7 and 10 for sales, staff and finance.
- 6 and 10 for red-tape.

The incidence of very low self-confidence scores is characterized by the length of the whisker, extending below the box, and by individually identified data-points (circles) below the whisker.²¹ In this regard we note that all areas of business operations have some instances of low self-confidence: 2% of businesses report a lack of self-confidence (a score of 5 or less) in production; 10% lack self-confidence in sales; 8% lack self-confidence in staffing; 16% lack self-confidence in finance; and 22% lack self-confidence in coping with red-tape (see Table A2.3.2).

In total, these results indicate that:

- Production is the area of operation in which owner managers have the highest degree of self-confidence in their abilities.
- Coping with red-tape is the area with the lowest self-confidence.
- Self-confidence in financial operations is intermediate.

Separate analysis of confidence levels, among majority female owned, ethnic minority, start-up and high-growth businesses, are reported in the Appendix to Section 2 (Tables A2.3.2a-d). This analysis shows that:

- Female owned businesses have similar levels of confidence, across all aspects of business operations, as the average levels.
- 25% of ethnic minority owned businesses report a lack of self-confidence (score of 5 or less) with finance, which is below the average (16%).
- 28% of ethnic minority owned businesses report a lack of self-confidence in dealing with red-tape, which is below the average (22%).
- 16% of start-ups report a lack of self-confidence with sales (versus 10% on average).
- Only 1% of high growth businesses report a lack of self-confidence with sales (versus 10% on average).

Financial qualifications or training

Regarding financial skills, we also asked, sole-traders and partnerships, whether the person in charge of the business' financial management had any financial qualifications or training.

²¹ The whiskers extend out below (resp. above) the box to the smallest (largest) data-point within a distance of 1.5 times the width of the inter-quartile range. Any scores lower than this are plotted individually.

Table 2.3.1 Businesses with Formally Qualified Financial Managers (sole traders and partnerships only)

	PERCENTAGE OF POPULATION	ERROR MARGIN \pm
All $N_p = 2,756,979$ $N = 1,290$	16.0%	3.5%
<i>Number of employees</i>		
0	14.8%	4.5%
1-9	18.5%	5.1%
10-49	25.8%	6.6%
50-249	60.0%	12.8%
<i>Turnover (£)</i>		
Less than 10,000	11.1%	12.0%
10,000-49,999	9.9%	4.5%
50,000-99,999	30.5%	12.2%
100,000-249,999	13.3%	8.4%
250,000-499,999	19.0%	11.4%
500,000-999,999	21.3%	14.5%
1,000,000-4,999,999	28.0%	16.3%
5,000,000 or more	21.1%	17.4%
<i>Gender</i>		
Male	15.2%	4.1%
Female	18.6%	6.8%
<i>Ethnicity</i>		
White	15.1%	3.6%
Non-white	30.0%	17.0%
<i>Age</i>		
Less than 2 years	26.4%	13.9%
2 years or more	15.3%	3.7%
<i>Turnover Growth</i>		
Less than 30%	14.9%	4.0%
30% or more	22.3%	14.8%

The results from this analysis shows that

- 16% of sole traders and partnerships have their finances managed by someone with a financial qualification.
- This percentage tends to increase with firm size.
- There are no significant differences in financial management skills by gender, ethnicity, business age or growth rates.

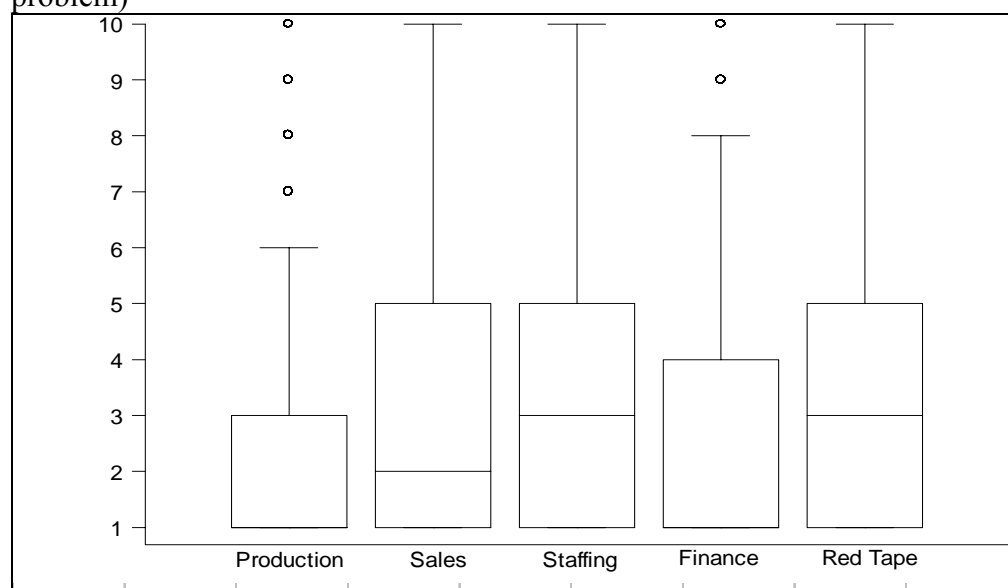
On this evidence, SMEs are unlikely to have a qualified financial manager. It is, therefore, unsurprising that the level of self-confidence in dealing with finances is not high, compared with other aspects of running the business.

Business problems

Having looked at external financial advice and owner-managers' self-confidence in aspects of running the business, this section is concluded by looking at the severity of the problems faced by businesses. The principal aim here is to place financial problems in the context of other aspects of business operations. In this regard, respondents were asked to rate the severity of the problems their business is facing in: production; sales; staffing; finance (cost and access); and coping with red-tape. A severity score of '1' represents no problem, while a '10' indicates the problem is critical.

The chart used here follows the same 'Box and Whisker' format used previously. More detailed tabulations of these results are reported in Appendix to Section 2, Tables A2.3.3-A2.3.3d

Figure 2.3.4: Severity of Problems (box and whisker) (1=no problem; 10=critical problem)



Base: All SMEs $N_p = 3,625,416$ (Unweighted $N=2,500$)

This chart indicates that the median problem scores are:

- 1 for production and finance.
- 2 for sales.
- 3 for staffing and red-tape.

Overall these problem scores are quite low and may be subject to the same issue of impression management discussed earlier. However, it is notable that finance has the lowest median score alongside production.

The bulk of scores (within the box) are between:

- 1 and 3 for production.

- 1 and 4 for finance.
- 1 and 5 for sales, staff and red-tape.²²

The incidence of large problem scores is characterized by the length of the whisker extending *above* the box and by the individually identified data-points above the whisker. In this regard we note that all areas of business operations have instances of large problems.

In total, these results indicate that:

- Production is the aspect of business operations with the least problems.
- Finance is the second least problem area.
- Sales, staffing and red-tape pose the most problems.
- Staffing and red-tape represent the highest problem areas since they have the highest median problem scores.

Analysis of problems among female owned, ethnic minority, start-up and high growth businesses are reported in Tables A2.3.3e-h (Appendix to Section 2). These results show that:

- Female owned businesses have similar levels of problems, across all aspects of business operations, as the average levels.
- 20% of ethnic minority owned businesses report a problem (score of 6 or above) with production, which is above the average level (9%).
- 23% of ethnic minority owned businesses report a problem with finance, which is also above average (11%).
- However, only 10% of ethnic minority owned businesses report a problem in dealing with red-tape, which is below average (20%).
- 16% of start-ups report a problem with production (versus 9% on average).
- High growth businesses have similar levels of problems, across all aspects of business operations, as the average levels.

Comment

Regarding production and red-tape, there is coherence between the reported level of self-confidence in managing these areas (Figure 2.3.3) and the severity of the problems encountered with them.

Also, placing finance in context, these results suggest that red-tape, sales and staffing pose greater problems for businesses than obtaining, or paying for, finance. For comparative purposes, we note that the US Survey of Small Business Finances places staffing at the top of the list of problems whilst problems with finance, as in the UK, are far down the pecking order (Bitler et al, 2001).

The low level of financial skills, found earlier, may be of little concern in the current, pleasant, economic climate. Indeed, businesses themselves place financial problems near the bottom of the pecking-order. However, this lack of skills could bite if the economy were to take a downturn. Later in this report (section 5) we will look at the

²² An implication of these graphs is that all the scores, from the 0th to 25th percentiles, equal 1. Accordingly the box characterizes 75%, of the distribution of problem scores, between the 0th and 75th percentiles.

relationship between financial skills and loan rejections. This analysis will provide an indication of the (detrimental) impact of skills deficiencies on firms' abilities to access finance.

II. ANALYSIS OF THE DEMAND FOR AND SUPPLY OF SME FINANCIAL PRODUCTS

3. USE OF EXTERNAL FINANCIAL PRODUCTS IN THE LAST 3 YEARS

In this section we look at the external financial products used by SMEs in the last 3 years. Here we distinguish between formal sources of financial products, such as banks, and informal providers of finance such as friends and family. However, we have insufficient sample to make this distinction for equity finance: very few businesses used funds from formal investors, such as venture capitalists.²³ Accordingly, we report use of equity finance from all sources.

To begin with, in Table A3.1 (in the Appendix to Section 3), we report the percentage of SMEs which have used at least one of the following external financial products in the last 3 years: overdrafts; term loans (including mortgages); asset finance (leasing and/or hire-purchase); asset-based finance (factoring, invoice discounting or stock finance); credit cards; grants; or equity finance (all sources). Analysis of the use of current and deposit accounts is given separately after this initial analysis.²⁴

The main results from Table A3.1 are that:

- 80% of SMEs have used one or more external financial products (excluding bank accounts) in the last 3 years.
- Use of external finance increases with the number of employees and turnover. It varies from 75% (no employees) to 98% (50-249 employees).
- There are no significant differences in the use of external finance between male and female owned businesses or between white and ethnic minority owned businesses.

In the following bar charts we look at the number of businesses using the different types of financial products in the last 3 years. A detailed tabulation of the results may be found in Table A3.2

²³ Six sample firms raised funds from venture capitalists; one raised funds from another type of private equity firm; and one company was floated publicly. Additionally, four sample firms raised funds from one or more business angels (informal investors). The remaining investments (in about 100 firms) came from friends, family and directors. Regarding formal venture capital, this may be an unattractive investment source to many small business owners due to their reluctance to share control with external investors (see earlier discussion). Also, small businesses may lack the financial skills to make their proposals 'investment ready' – the evidence on skills, in section 2, goes some way toward supporting this view. Equally, on the supply side, venture capitalists tend to view the comparatively small amounts required by small firms as not worthwhile given the high fixed costs of equity investments. This has led to concerns about the existence of a gap in the supply of small-scale equity investments.

²⁴ As we shall see, almost all businesses use a current account. Accordingly, their use would swamp the analysis of other financial products and are, therefore, omitted from this initial analysis.

Figure 3.1: Percentage of Businesses Using Various Types of Financial Products

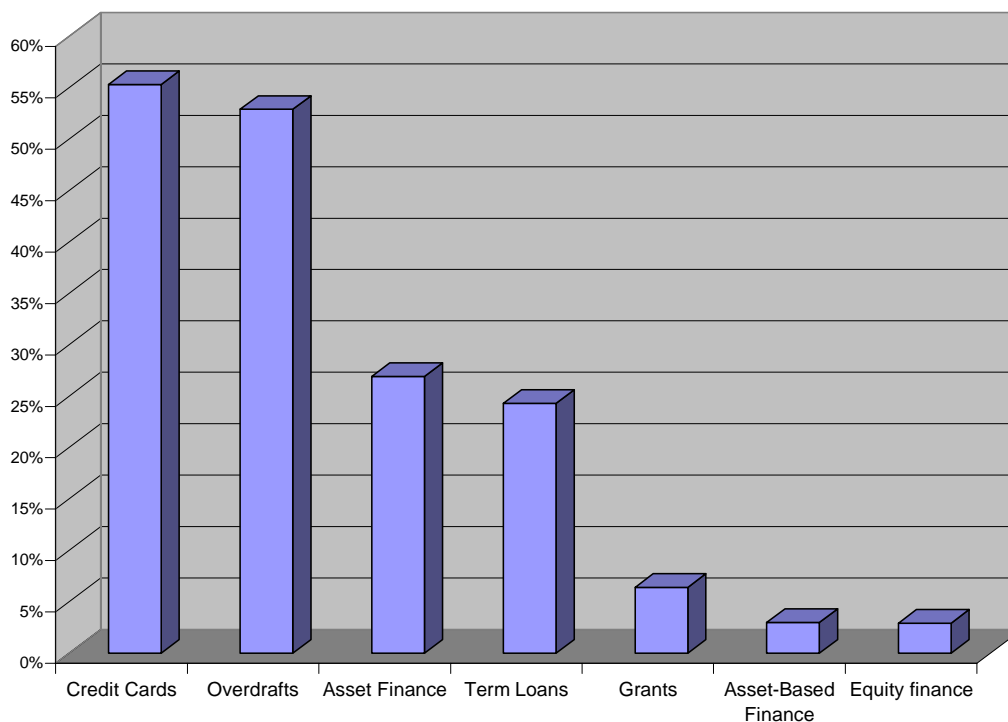


Figure 3.1a: Percentage of Businesses Using Various Types of Financial Products (by turnover)

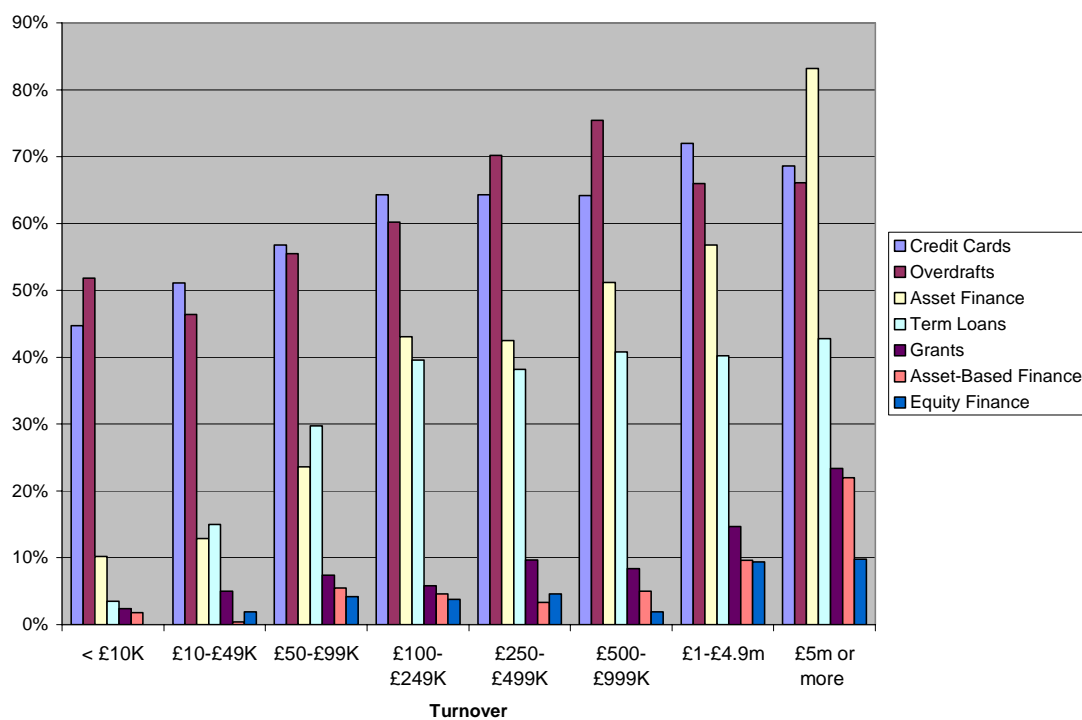


Figure 3.1b: Percentage of Businesses Using Various Types of Financial Products (by number of employees)

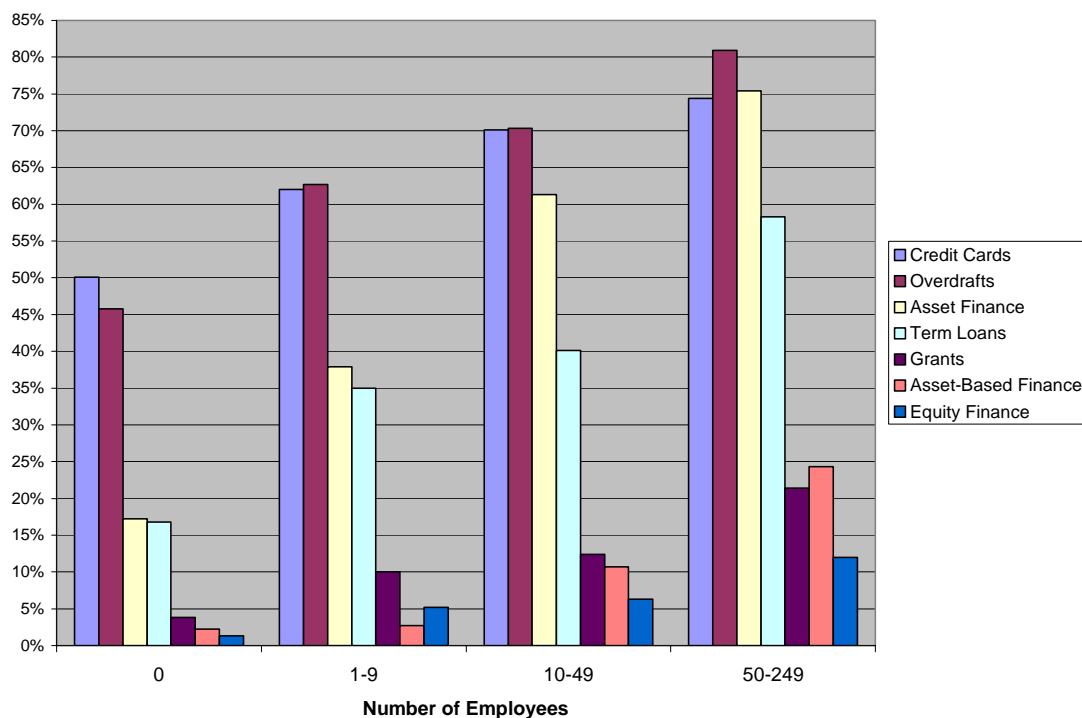


Figure 3.1 shows the following patterns of financial product use (with the amounts used, drawn from later sections of the report, presented to set this use in context):

- Just under 2 million businesses (53% of SMEs) use an overdraft
 - The total amount owed in overdrafts is £12 billion (see Section 8).
- A similar number use personal or business credit cards (55%)
 - Businesses spend £450 million per month on personal credit cards
 - Expenditure on business credit cards is £1.4 billion per month (Section 11).
- About 900,000 businesses use term loans (24%)
 - The total amount outstanding on term loans is £64 billion (Section 8).
- A similar number use leasing and/or hire-purchase (27%)
 - The total monthly repayments on leasing/hire-purchase are £2 billion.²⁵
- Grants are used by just under a quarter of a million businesses (6%)
 - The total amount of grants accessed in the last 3 years is £7.6 billion.
- Invoice finance is used by about 100,000 businesses (3%)
 - This represents £8 billion in monthly advances (see Section 10).
- About the same number use equity finance (3%; 100,000 businesses)
 - This represents £14.3 billion in total investment in the last 3 years (subject to a wide error margin: see Section 12).

²⁵ An important finding of our pilot survey, conducted 2 months before the main fieldwork in June 2004, was that businesses found it difficult to report the amount left to pay on their leasing/hire-purchase agreements. Accordingly, in the main survey, the question on the amount of leasing/hire-purchase used was re-phrased in terms of monthly repayments (a concept that businesses were more familiar with).

Figure 3.1a highlights that

- Credit cards are generally the most popular form of financial product across turnover bands.
- However, for businesses with a turnover of less than £10,000 or between £250,000 and £999,999, overdrafts are the most popular form of financial product.
- Also, asset finance is the most popular financial product among SMEs with a turnover of £5 million or more.
- In general asset finance is used more often than term loans, except for businesses with a turnover between £10,000 and £99,999.

Figure 3.1b shows that

- Overdrafts are the most popular form of financial product across employee size bands (excluding businesses with no employees).
- Asset finance is more widely used than term loans across all employee size bands.
- Use of all forms of financial products increases, steadily, with the number of employees.

Comment

Regarding the heavy usage of credit cards analysis of the purpose, and whether or not balances are paid off in full each month, is deferred until later in the report. In principle, credit cards could be used as a source of finance and/or a method of payment. If used as a source of finance, credit cards are expensive relative to other types of loan.²⁶

For comparison, in the US, 45% of businesses use (personal) credit cards for business purposes (33% use business credit cards; Bitler et al, 2001). Also, in SMEF, we find that majority male-owned businesses are more likely to have used credit cards than majority female-owned businesses (58% versus 45%: see Table A3.2). Similarly, 74% of high growth businesses use credit cards versus 55% of slower growing firms.

Asset finance, such as leasing and hire-purchase, is an increasingly popular means of paying for tangible assets (Cosh and Hughes, 2003). In fact, our figure of 27% is identical to that reported in Cruickshank (2000). Our estimate suggests that asset finance is at least as popular as traditional bank loans. By sector, manufacturing businesses are significantly more likely to use asset finance rather than term loans (32% versus 18%; see Table A3.2). By legal form, the predominance of asset finance over term loans is most notable for limited liability companies (41% versus 28%).

Across sectors, agricultural businesses (SIC AB) are the most likely to be in receipt of a grant (29%; see Table A3.2). Also, firms located in areas traditionally targeted for government support (North of England, Scotland, Northern Ireland and Wales) have

²⁶ Credit cards incur relatively high interest charges if balances are not paid off in full each month or are used to obtain cash advances.

much higher likelihoods of using grants than firms in the South of England (up to 18% in Wales versus 2% in the South-East).

Asset based finance (mainly factoring and invoice discounting) is an alternative to an overdraft for funding short-term working capital. Only 3% have used this form of finance which is similar to previous estimates (e.g., Competition Commission, 2002; Cosh and Hughes, 2003). Medium-sized enterprises (50-249 employees) are the most likely to use this type of finance (24%; see Table A3.2).

Use of current and deposit accounts

We would expect current accounts to be widely used by businesses since they are the main conduit for making and receiving payments (money transmission). Also, businesses may find it difficult to access loans without a history of transactions on a current account

Results from the analysis of current and deposit accounts are reported in Table A3.3. These results show that:

- 97% of SMEs use a current account. This figure is consistently high across different types of SME.
- 41% of SMEs hold funds on deposit.
 - This represents £92 billion in total deposits (see Section 7).
- Use of deposit accounts increases with firm size (number of employees and turnover). This figure ranges from 32% (no employees) to 72% (50-249 employees).
- Start-ups are significantly less likely to hold funds on deposit compared to established businesses (27% versus 43%).

Comment

These results appear to confirm the importance of current accounts in providing access to money transmission. In comparison, 94% of businesses in the 1998 US Survey of Small Business Finance report using a current account (Bitler et al, 2001). Interestingly, over 11% of UK SME current accounts are personal accounts which are used for business purposes (not reported in Table A3.3). This figure rises to over 16% among businesses with no employees.

2 in 5 SMEs hold funds on deposit, which appears to be a relatively small proportion (although, current accounts also have a limited savings function – Cruickshank, 2000). However, we note that this is almost double the figure reported in the 1998 US Survey for use of savings accounts (22%).

Summary comparison with use of financial products in the US

A summary comparison of SMEF data, with financial products used in the US (Bitler et al, 2001), is reported in the following table.

Table 3.1: Comparisons of Financial Products Used in the UK and US

	US SSBF (1998)	UK SMEF (2004)
Any loan ¹	55%	65%
Personal Credit Card	45%	28%
Business Credit Card	33%	34%
Current Account	94%	97%
Deposit Account	22%	41%

Notes:

1. For the US, any loan denotes using any of the following: credit lines; mortgages; vehicle loans; equipment loans; or capital leases. For the UK any loan denotes using any one of: overdrafts; term loans; asset finance; or asset-based finance.

The patterns of usage of financial products are quite similar between the UK and US. However, there is some evidence that use of personal credit cards is lower, and use of deposit accounts is higher, in the UK.

3.1 Friends and family finance

This section concludes by examining the use of informal finance, from friends and family members. Theory suggests that informal lenders may have private information about the borrower, unavailable to banks, thereby overcoming information asymmetries (Casson, 2003). Family members may also be willing to offer loans, for little or no interest, in return for the option to ‘call in the favour’ at a later time (Basu and Parker, 2001)²⁷. Also, as outlined in section 1, small business owners may prefer informal finance to minimize the involvement of strangers in the business. Existing empirical evidence suggests that use of informal finance tends to be among less profitable businesses with higher failure rates (Basu, 1998).

Table A3.1.1 (Appendix to Section 3) examines the use of debt and equity obtained from friends and family. These results indicate that:

- 6% of SMEs report using loans or equity finance from friends and family.
- Small businesses (10-49 employees) report the highest usage (11%).
- There are no discernible differences, in the use of friends and family finance, by: gender; ethnicity; business age; or growth rate.²⁸
- 7% of businesses, which have used formal external finance, also used friends and family finance.
- 1% of businesses with no formal external finance used friends and family finance instead.
- This indicates that users of friends and family finance are more likely, than not, to have other sources of funding.

²⁷ Since entrepreneurship often ‘runs in the family’ it may well be the case that a family lender becomes a family borrower at a later time.

²⁸ The cell sizes are too small in these instances to be able to reach a robust conclusion.

Comment

Interestingly, Bitler et al (2001) also report a figure of 6% for the percentage of firms using friends and family finance in the US.

Previous evidence has suggested that friends and family finance is especially important for ethnic minority businesses (see Curran and Blackburn, 1993; Metcalf, Modood and Virdee, 1996). However, the small sample size for ethnic minority businesses precludes any conclusion that the differences in usage, from white-owned businesses, are statistically significant. This will be tested further in a forthcoming follow-up survey on ethnic minority business finance.

There is little indication that use of friends and family finance is associated with lower growth rates. Also, users of friends and family finance appear to be more likely to use it alongside formal finance rather than on its own.²⁹ Overall, these results do *not* indicate that use of informal finance is confined to disadvantaged or marginal businesses with no alternative sources of funding.

The results show that 1% of businesses, with no formal external finance, used friends and family finance instead (last row of Table A3.1.1). By implication 99% of businesses, with no formal external finance, also did not use friends and family finance. This allows us to estimate that about 20% of SMEs have relied exclusively on internal sources of finance.³⁰

²⁹ In contrast the results in Basu and Parker (2001) suggest that informal finance is used as a substitute for formal finance. It is possible, however, that applying more robust econometric techniques to SMEF data would also show these finances are substitutes (see, for example, the analysis of the relationships between finances in Section 14)

³⁰ The calculation is $(1-0.011) \times (1-0.802)$ where 0.802 is the proportion using formal finances from Table A3.1 and 0.011 is the proportion using informal finance only (Table A3.1.1). Analytically, this calculation is represented by $[1 - \text{Pr ob}(I = 1|F = 0)] \times \text{Pr ob}(F = 0) = \text{Pr ob}(I = 0, F = 0)$ where $I = 1(F = 1)$ indicates use of informal (formal) external finance.

4. NEW FINANCE SOUGHT IN THE LAST 3 YEARS

In the previous section we looked at the *stock* of financial products being used by SMEs in the last 3 years. In this section we look at businesses which have sought *new* finance in the last 3 years. These are businesses which have obtained new finance, or applied for it unsuccessfully, in the last 3 years. This measure gives an indication of the demand for new finance. In this context, the term finance encompasses overdrafts, grants, term loans (including mortgages), asset finance, asset-based finance and equity finance.³¹

In Table A4.1 (Appendix to Section 4) we report the percentage of businesses seeking new finance. The results show that:

- 44% of SMEs sought new finance in the last 3 years. This percentage varies from 36% (no employees) to 76% (50-249 employees)
- 31% of businesses in Health and Social Work (SIC N) sought new finance versus 62% in Hotels and Restaurants (SIC H).
- Sole traders are significantly less likely to have sought new finance than either partnerships or companies (37% versus around 57%).
- Majority female owned businesses are *no* less likely than majority male owned businesses to have sought new finance.
- On the other hand, there is some evidence that ethnic minority owned businesses are *more* likely to have sought new finance than white-owned businesses (61% versus 43%).
- Unsurprisingly, start-ups are more likely to have sought new finance than established businesses (69% versus 42%).
- 62% of high growth businesses sought new finance versus 41% of slower growing businesses.

Comment

SBS (2003) reports that 16% of businesses sought new finance in the previous 12 months. Extrapolating this figure over a three year period gives a similar result to our finding (48%). In addition, the SBS report showed that start-up and high growth businesses had an above average likelihood of seeking finance. In another study, Cosh and Hughes (2003) found that about 40% of businesses in manufacturing and business services had sought new finance in the previous *two* years.

By implication, more than a half of SMEs did not seek new finance. This could reflect constraints on the supply of finance or a lack of demand. If supply is the issue then this suggests that businesses are having problems accessing finance. A lack of demand, on the other hand, suggests that firms' internal resources are sufficient for their growth aspirations.³² In Table A4.2 we report the percentage of businesses which did not seek finance because they had no need for it.

³¹ We are unable to include friends and family finance in this analysis, since we asked whether businesses use this type of finance, but not when it was obtained.

³² This is compatible with the firm having limited growth aspirations where the amount of internal capital is small.

The key result of Table A4.2 is that, among businesses which did not seek new finance:

- 95% report that they did not need new finance.

The percentage reporting lack of demand is consistently high across all types of SME, varying from:

- 88% in businesses with 50-249 employees to 98% in high-growth businesses.

These findings strongly suggest that an absence of demand is the reason for not seeking new finance. Similar findings are reported in Cosh and Hughes (2003). In their sample of manufacturing and business service firms 85% did not seek new finance because their internal cashflows were sufficient.

Amounts of new finance sought

In Table A4.3 (Appendix to Section 4) we report the *amounts* of new finance sought by businesses in the last 3 years. These results show that:

- The average amount of new finance sought is just under £82,000.
- This amount increases from £29,000 (businesses with no employees) to just over £1 million (50-249 employees).
- Limited companies sought just under £200,000. This amount is significantly higher than the amounts sought by other legal forms of business.
- There are no statistically significant differences in the amounts sought by female-owned versus male-owned businesses.
- However, ethnic-minority owned businesses sought just over £28,000 on average. This is significantly less than the amount sought by white-owned businesses (£85,000).³³
- There are no significant differences in the amounts of finance sought by age of business or growth rates.

Types of new finance sought

In the following table we look at the types of new finance sought.

³³ Although part of this difference may be due to differences in other business characteristics, these differences are not the entire explanation for the lower amounts of finance sought by ethnic minority businesses. Indeed, a regression of the amount of finance sought on an indicator for ethnic minority owned businesses, and controls for firm size, industry, region and legal status, still found that ethnic minority businesses sought significantly less (about £55,000 less) than white-owned businesses.

Table 4.2: Types of Finance Sought in the Last 3 Years

TYPE OF FINANCE	NUMBER IN SAMPLE	PERCENTAGE OF POPULATION	ERROR MARGIN \pm
Overdraft	430	32.0%	4.9%
Grant	341	14.5%	2.9%
Term loan/mortgage	620	40.0%	5.7%
Asset finance	708	38.8%	5.5%
Asset-based finance	76	2.1%	1.2%
Equity finance	115	6.8%	2.7%

Base: All businesses who sought finance $N_p = 1,594,619$ (Unweighted $N = 1443$)

Notes:

1. There is no necessity that the reported percentages add up to 100% since some businesses may have sought more than one type of finance.

Comment

As in SBS (2003), term loans are, collectively, the most popular type of new finance. However, our analysis ranks asset finance as the second most popular new finance, with overdrafts third, whereas in SBS (2003) this ranking is reversed. Grants, equity finance and asset-based finance are ranked, in our survey, in the same order of popularity as in SBS (2003).

The average amounts sought, across these types of finance, are reported in the following table. The amount of asset-based finance sought is not reported due to the small samples involved.

Table 4.3: Amounts of Finance Sought in the Last 3 Years by Type of Finance

TYPE OF FINANCE	NUMBER IN SAMPLE	AMOUNT (£)	ERROR MARGIN \pm
Overdraft	430	40,555	21,843
Grant	341	32,681	14,447
Term loan/mortgage	620	75,592	18,838
Asset finance	708	46,363	44,614
Equity finance	112	134,262	116,036

Base: All businesses which sought finance $N_p = 1,594,619$ (Unweighted $N = 1443$)

4.1 Start up finance

It was shown previously that start-ups have an above average chance of having sought finance. This is unsurprising since most new businesses require some type of funding to get up and running. However, start-ups may face particular problems in accessing external finance due to lack of a track record and the absence of tangible assets. This may lead these businesses to rely heavily on personal sources of finance.

To conclude this section, we therefore look at evidence on the sources of start-up finance in the following table

Table 4.1.1: Sources of Finance Used to Establish the Business

	POPULATION PERCENTAGE	ERROR MARGIN±
$N_p = 251,759$		
Personal Savings	69.4%	11.0%
Mortgage on Home	6.5%	5.7%
Credit Card	3.3%	4.7%
Gift from friends/family	0.8%	1.6%
Bank Loan	20.4%	12.0%
Friends/family loan	12.7%	8.4%
Friends/family equity	1.3%	2.5%
Venture Capitalists	0.3%	0.6%
Grant/subsidized loan	3.1%	2.7%
Factoring	0.3%	0.4%
Overdraft	1.6%	2.2%
Other	3.5%	3.5%
None	6.0%	6.5%

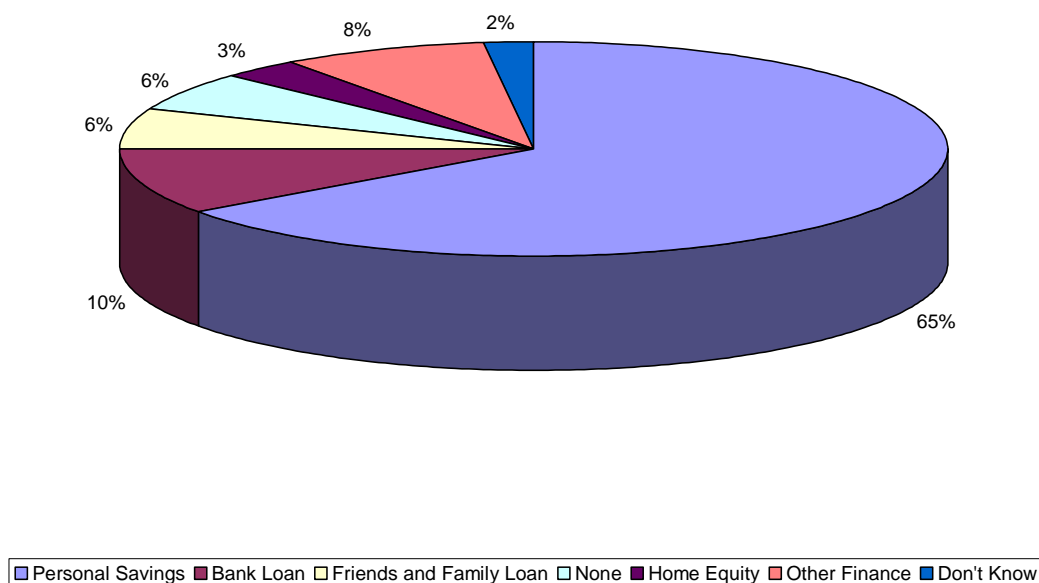
Base: Businesses aged less than 2 years $N_p = 251,759$ (Unweighted $N = 147$)

These results show that:

- Well over 2 in 3 start-ups used personal savings
- 1 in 5 used a bank loan
- 1 in 8 used a loan from friends or family as part of the firm's initial finances.
- The use of equity finance is very small with investors being mainly family and friends.
- Notably over 1 in 20 start-ups claimed to have used no finance to establish their business.

The principal source of start-up finance is reported in the following chart:

Figure 4.1.1: Principal Source of Start-up Finance



Base: Businesses aged less than 2 years $N_p = 251,759$ (Unweighted $N = 147$)

- For almost 2 in 3 entrepreneurs personal savings were the principal source of finance used to establish the business.
- 1 in 10 relied mainly on a bank loan.
- Less than 1 in 20 entrepreneurs relied mainly on equity released from their home.

Amount of finance used at start-up

The average amount of finance used at start-up is estimated at £71,000; the median amount is just over £15,000. Unfortunately the available sample ($N = 128$) is too small to facilitate analysis of these amounts by different types of start-up.

5. REJECTION AND DISCOURAGEMENT

In the previous section we looked at the demand for new finance as measured by businesses which sought funds in the last 3 years. In this section we analyze how many of these businesses were unsuccessful in obtaining funding (outright rejections) or received less than they wanted (partial rejections). Also, some businesses believe it is not worth their while applying in the first place because they expect to be turned down. These are so-called ‘discouraged’ borrowers (Kon and Storey, 2003) which also form part of the analysis in this section.

As argued in Section 1, capital market imperfections may result in some borrowers, with viable business propositions, going unfunded. Both the business, and society as a whole, could be better off if these businesses were able to access funding.³⁴ This is the basis for assisted lending to firms which lack security or a track record (see e.g., Graham, 2004). Therefore, we look at the reasons for rejection, contrasting rejection due to insufficient security or track record with other reasons for rejection. This section continues by analyzing whether businesses denied bank loans or mortgages were able to access finance from alternative sources.

In Section 2 we looked at levels of financial skills and confidence in dealing with finances. To recap, we found that: a large majority of SMEs *do not* have their finances managed by a qualified individual; and confidence in dealing with finances is *not* high compared to other aspects of running the business. We, therefore, conclude this section by looking at the impact of financial skills, confidence, and other business characteristics, on rejection. This will provide an initial indication of the role, if any, of financial skills in improving access to finance.

To begin with, in Table A5.1 (Appendix to Section 5), we report the percentage of businesses, *needing* new finance, which experienced rejection or discouragement in the last 3 years. Businesses ‘needing’ new finance include those which sought finance in the last 3 years (as defined in Section 4) *and* those which felt discouraged from applying.

Table A5.1 shows that, among businesses needing new finance:

- 11% were rejected outright (180,000 businesses)
- 19% received less than they wanted (300,000 businesses)
- 8% experienced discouragement (130,000 businesses).

Further:

- Businesses with greater assets tend to experience fewer rejections and less discouragement. This is, perhaps, unsurprising since these businesses have more collateral to offer lenders.
- Sole traders are more likely to experience discouragement than partnerships (10% versus 2%).
- Businesses in Northern Ireland have the lowest outright rejection rate (1%) but the second highest discouragement rate (14%).

³⁴ The business would be able to proceed with its project, which could lead to the creation of new jobs down the line.

- Start-ups are less likely to experience outright rejection than established businesses (4% versus 12%).
- On the summary evidence, there are *no* significant differences in rejection or discouragement rates by gender, ethnicity or growth rate.
- Similarly, there is *no* evidence that switching banks, or using more than one provider of financial services, increases the likelihood of rejection or discouragement.

Comment

Cruickshank (2000) identifies a rejection rate of 13% for all types of finance. Cosh and Hughes (2003) find a rejection rate of 11%. Results in Wilson (2004) suggest that 15% of company directors have received one or more rejections for funding from a bank. Our results for rejections are within these bounds.

The finding that start-ups have lower rejection rates is surprising (see e.g., Graham, 2004, for contrary evidence). This is probably due to sample selection bias in that we only observe successful start-ups or, at least, those that went ahead with their plans.

In Section 6 we will analyze SMEs relationships with financial providers, including the number of providers used and the tendency to switch between providers. In fact, SMEs tend to use only one provider and switching rates are low. One reason for this is that an established relationship with a single provider may improve access to finance. However, on the evidence in Table A5.1, businesses which use, and stick with, a single provider are no less likely to experience rejection than other types of business.

Regarding discouragement, Levenson and Willard (2000) estimate that 4.2% of the US small business population experienced discouragement. Our estimate, as a proportion of the UK SME population, is a similar 4% corresponding to 130,000 businesses.³⁵

Rejections and discouragement by type of finance

In the following table we look at rejection and discouragement rates for overdrafts, term-loans and asset finance. Unfortunately, the numbers of rejections for asset-based finance and equity finance are too small to be able to report meaningful results for these types of finance.³⁶

³⁵ Whereas the figure of 8% discouragement, reported in Table A5.1, is a percentage of the sub-group of the population which sought new finance or were discouraged from seeking finance.

³⁶ Venture capital is the only type of equity finance for which we attempted to collect rejection and discouragement data.

Table 5.2: Rejections and Discouragement by Type of Finance (overdrafts, term-loans and asset finance only)

	OUTRIGHT REJECTION	<i>ERROR MARGIN</i> ±	PARTIAL REJECTION	<i>ERROR MARGIN</i> ±	DISCOURAGED	<i>ERROR MARGIN</i> ±
<i>Type of Finance</i>						
Overdraft $N_p = 547,717$	16.4%	6.7%	35.7%	8.6%	7.0%	4.1%
Term-Loan $N_p = 702,228$	8.8%	7.3%	6.2%	4.7%	9.1%	5.5%
Asset finance $N_p = 664,033$	5.1%	5.3%	2.7%	4.7%	6.8%	4.7%

This table shows that, among businesses needing a new overdraft:

- 16% were rejected outright
- Greater than 1 in 3 received less than they wanted
- 7% felt discouraged from applying.

Among businesses needing a new loan:

- 9% were rejected outright
- 6% received less than they wanted
- 9% felt discouraged from applying.

Among businesses needing a new lease/hire-purchase:

- 5% were rejected outright
- 3% received less than they wanted
- 7% felt discouraged from applying.

It is somewhat surprising that overdrafts have higher rejection rates than term loans, as the latter tend to be for larger amounts; and overdrafts are, in theory, repayable on demand.

Asset finance has the lowest rejection rates. This may reflect the fact that the finance is secured directly on a specific asset, which can be repossessed.

Reasons for rejection

In the following table we look at the reasons for rejection (outright or partial) reported by businesses rejected for overdrafts and term loans respectively (asset finance being omitted due to insufficient sample). Note that, given the small samples of rejected businesses, it is not feasible to analyze reasons for rejection across firm types.

Table 5.3: Reasons for Outright and Partial Rejections (Population Percentages)³⁷

	OVERDRAFTS	TERM LOAN
	$N_p = 216,160$	$N_p = 83,578$
	$N = 189$	$N = 56$
No Security	4%	0%
Insufficient Security	18%	12%
Poor Personal Credit History	5%	4%
Poor Business Credit History	11%	4%
No Credit History	8%	7%
Applied for too much	7%	11%
Too much existing debt	5%	0%
Inadequate business plan ¹	0%	15%
Industry too risky	2%	7%
No reason given	25%	16%
Other	6%	12%
Don't Know	9%	15%

1. In fact 2 businesses in the sample (corresponding to 0.3% of the population) were denied an overdraft due to an inadequate business plan.

This table shows that rejections rates due to no or insufficient security are:

- 22% for overdrafts.
- 12% for term loans.

Rejection rates due to a lack of track record (no credit history) are:

- 8% for overdrafts.
- 7% for bank loans.

On the other hand, rejection rates due to a poor credit history are:

- 5% (personal history) and 11% (business history) for overdrafts.
- 4% (personal history) and 4% (business history) for term loans.

Also:

- 5% of overdraft rejections are due to the business having too much existing debt.
- 15% of loan rejections are due to an inadequate business plan.

Comment

For businesses denied overdrafts, 30% report being denied due to no/insufficient security or lack of track record. On the other hand, 21% of these businesses were denied due to a poor credit history or too much existing debt.³⁸ Similarly, for term loans, the percentage rejected due to insufficient security or track record (19%) is about the same as the percentage rejected due to a poor credit history or inadequate business plan (23%). These results suggest that a large proportion of businesses are rejected due to lack of security or track record. These businesses are potentially

³⁷ The questions have multi-code responses so the percentages in each column need not add up to 100%.

³⁸ However, these results may be subject to 'impression management', with respondents preferring not to mention a poor credit history.

eligible for assistance under the SFLG, although further analysis of these businesses' characteristics would be required to establish this eligibility.

The high proportion of businesses reporting 'no reason given' for an overdraft rejection is notable (25%). Also, the proportion who 'don't know' the reason for rejection is generally high. These findings are indicative of poor communications between the lender and rejected applicant. We can only speculate about the likely quality of these businesses.

Impact of rejection

Next we look at the impact of rejection on the business. This analysis relates to term loan rejections only.³⁹

Table 5.4: Impact of Term Loan Rejection
($N_p = 83,578$; $N = 56$)⁴⁰

<i>IMPACT</i>	
Not much – got funding from elsewhere	59%
Had to obtain finance from internal sources	3%
Plans deferred – but eventually went ahead	29%
Plans dropped	5%
Business got into serious financial difficulties	4%
Other	5%

The results from this table indicate that:

- The project went ahead, with other funding, in 3 out of 5 rejections.
- The plans had to be shelved, for a short time, in just under 30% of rejections.
- The business had to drop its plans in 1 in 20 cases of rejection.
- The business found itself in dire financial straits in less than 1 in 20 cases of rejection.

In summary, whilst it appears that some potentially viable businesses, with no security or track record, are being denied funds, most businesses denied loans are able to go ahead with their plans using alternative funding. In about 4% of term loan rejections, amounting to just under 3,500 businesses in the population (less than 0.1% of the total SME population), the rejection caused serious financial difficulties. However, this estimate is subject to sample selection bias since we do not observe businesses which went bankrupt as a result of rejection. Future analysis will need to take this issue into account to obtain truer estimates of the consequences of rejection.⁴¹

³⁹ The question on the impact of rejection was only asked in relation to term loans.

⁴⁰ Respondents were able to give multiple responses to this question so that the percentages in this table need not add up to 100%.

⁴¹ This would entail collecting data on businesses which have closed involuntarily. These additional data would enable estimation of the consequences of rejection, controlling for the differences between surviving and defunct businesses.

5.1 Impacts of financial skills, and other business characteristics, on rejections

We conclude this section by assessing the impacts of financial skills, confidence, use of external advice, and other business characteristics, on rejection rates. In this regard, it may be expected that businesses with qualified financial managers could, for example, write better business plans increasing their chances of obtaining funds. Also, individuals who are confident in dealing with finances may present themselves more credibly to lenders, improving their access to finance.

In the following table we report estimates from a model relating the probability of (any) outright rejection to financial skills, confidence, non-use of external advice and other business characteristics. The marginal effects give the impact, in percentage points, of the presence of (or changes in) particular business characteristics on the likelihood of rejection. The sample relates to sole traders and partnerships only since companies were not asked about financial qualifications or their confidence in dealing with finances.

Table 5.1.1: The Impacts of Financial Skills, and Other Business Characteristics, on Loan Rejections. Marginal Effects ($\times 100$) of Independent variables on the Likelihood of Rejection (Population Weighted, Instrumental Variable, Probit Estimation) (Some Estimates of Control Variables Not Reported ¹)

INDEPENDENT VARIABLES	MARGINAL EFFECT (% POINTS ON REJECTION RATE)	P-VALUE ²
Financially qualified ³	-3.200	0.003
Low confidence in dealing with finances ³ (confidence score of 1-5: see section 2)	3.332	0.233
No external advice ³	-1.901	0.248
Female business	-0.201	0.642
Ethnic minority business	2.286	0.052
High-growth business	0.241	0.683
Length of relationship with main bank	-0.073	0.001
Number of financial providers	0.937	0.000
Switched banks in the last 3 years	0.054	0.927
Number of financial products used	0.018	0.913
χ^2 (p-value)		0.000
$N_p = 2,0324,227; N = 1,009$		

Notes:

1. Estimates of additional controls, for firm size, industry and region, are not reported.
2. The p -values denote the exact levels of significance for the tests that the marginal effects are equal to zero. A p -value smaller than 0.05 (0.10) implies the effects are statistically significantly different from zero at the 5% (10%) level.

3. Since financial qualifications, confidence, and non-use of external advice are likely to be endogenous variables (e.g., rejections, financial qualifications, low confidence, and non-use of external advice may all depend on unobserved ability) these binary variables are instrumented. The instruments used are the predicted probabilities of the variables, these predictions being obtained from probit models for financial qualifications, low confidence and non-use of external advice respectively. These probit models included variables for the owner manager's highest academic qualification (11 dummies in total) which are excluded in the probit model for rejections. These exclusions enable identification of the effects of financial qualifications, low confidence, and non-use of external advice, on the likelihood of rejection.

The key findings from these estimates are:

- Having someone, with a financial qualification, in charge of finances *reduces* the likelihood of rejection by over 3 percentage points.
- Having low self-confidence in dealing with finances appears to *increase* the likelihood of rejection by the same amount, but this effect is statistically insignificant ($p\text{-value} > 0.05$).
- Similarly, using no external advice *does not* increase the likelihood of rejection.

We also find that:

- There is some evidence that ethnic minority businesses are more likely to experience rejection than white-owned businesses (the p -value is just above 5% but below 10%). At the moment, we cannot say to which particular ethnic minority groups this result applies.
- However, neither female owned businesses, nor high growth businesses, are any more likely to experience rejection than other types of business.
- Each additional year with the main bank reduces the likelihood of rejection by less than one-tenth of a percentage point.
- Having more than one provider of finances increases the likelihood of rejection (by just below one percentage point for each additional provider).
- Neither switching banks, nor using several financial products, has any effect on the likelihood of rejection.

Comment

Having a suitably qualified individual, in charge of the business's finances, is the single most important factor in reducing the likelihood of rejection. These results provide some indication of the importance of financial skills in improving access to finance.

The results for minority groups are interesting in that they suggest that ethnic minority businesses, but not female-owned businesses, have an above average chance of being denied finance. This adds to our earlier finding that ethnic minority businesses, but not female owned businesses, sought below average amounts of new finance in the last 3 years.

In the next section we will look closely at SMEs relationships with providers of finance. Here we note that longer financial relationships increase the information available to lenders to assess applicants' creditworthiness, reducing the chances of rejection (at least, that is, among creditworthy borrowers: Han et al, 2004). In contrast, using multiple providers of finance reduces the information available to any one lender, which may have a detrimental effect on access to finance. However, there is *no* evidence that switching banks has adverse consequences for businesses.

6. PROVIDERS OF FINANCE

In this section we look at the main providers of financial services to SMEs and the characteristics of the relationship with this provider. Information on the main provider was collected by asking businesses which bank or financial institution they considered to be their main provider of finance.

Firstly, we look at the types of services and finances supplied by this main provider.

Table 6.1: Functions of the Main Provider of Finance

FUNCTION	PERCENTAGE	<i>ERROR MARGIN</i> ±
Provides Current Account $N_p = 3,523,873; N = 2,448$	99.5%	0.4%
Provides Overdraft $N_p = 1,919,574; N = 1,650$	99.2%	0.6%
Provides Deposit Accounts $N_p = 1,500,809; N = 1,410$	90.4%	3.3%
Provides Loans $N_p = 881,947; N = 955$	71.5%	7.4%
Provides Asset Finance $N_p = 975,983; N = 1,193$	21.9%	5.5%
Provides Asset-Based Finance $N_p = 109,418; N = 198$	43.0%	19.6%
Provides Credit Cards $N_p = 2,005,997; N = 1,527$	66.1%	5.3%

Base: All SMEs $N_p = 3,625,416$ (Unweighted $N=2,500$)

This table reveals that the main provider supplies:

- Current accounts to over 99% of SMEs using current accounts.
- Overdrafts to 99% of SMEs using overdrafts.
- Deposit accounts to 90% of SMEs using deposits.
- Loans to 72% of SMEs using loans.
- Asset finance to 22% of SMEs using asset finance.
- Asset-based finance to 43% of SMEs using asset-based finance.
- Credit cards to 66% of SMEs using credit cards.

Comment

These data highlight the three distinct markets which were identified in Competition Commission (2002): liquidity management services (current accounts, overdrafts and short-term deposits); general purpose business loans; and other types of debt. Indeed, the main provider's principal function is the supply of liquidity management services (in 90% or more of cases). There is a sharp drop down to instances where the main provider is the supplier of loans (72%), and a further, distinct, decline to instances

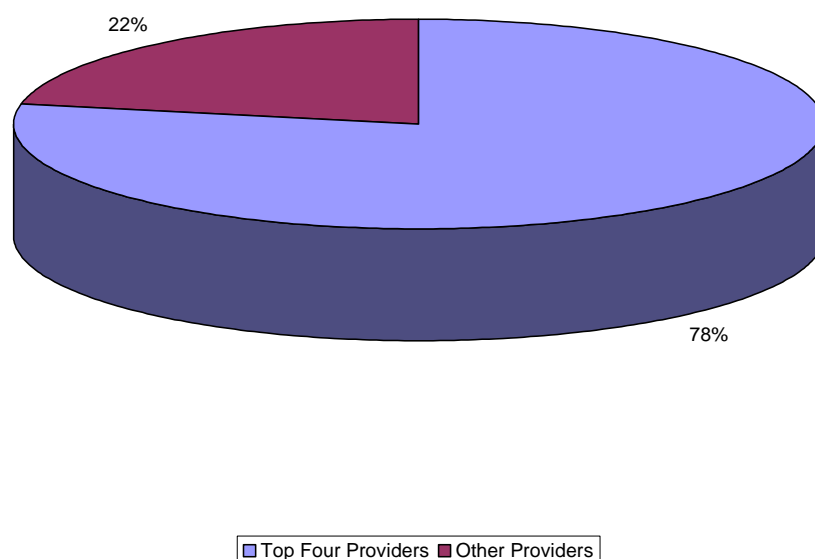
where it supplies other forms of debt. Analysis of the number of different financial products, supplied by the main provider, is given later in this section.

Market shares

Now we turn to an analysis of market shares based on data provided by businesses about their main provider of finance.⁴² In the following charts we report the degree of market concentration among the largest four providers. The previous analysis indicates that the market we are looking at here is, principally, for liquidity management services.

In the following chart we look at the market shares of the top four providers in the UK

Figure 6.1: Market Shares of Largest Four Providers (UK)



Base: All SMEs $N_p = 3,625,416$ (Unweighted $N=2,500$)

This chart indicates that

- The largest four providers account for almost 80% of the market.

In addition (not reported in Figure 6.1)

- The largest provider is the main provider to 1 in 4 SMEs.
- The two largest providers account for 42% of the market.

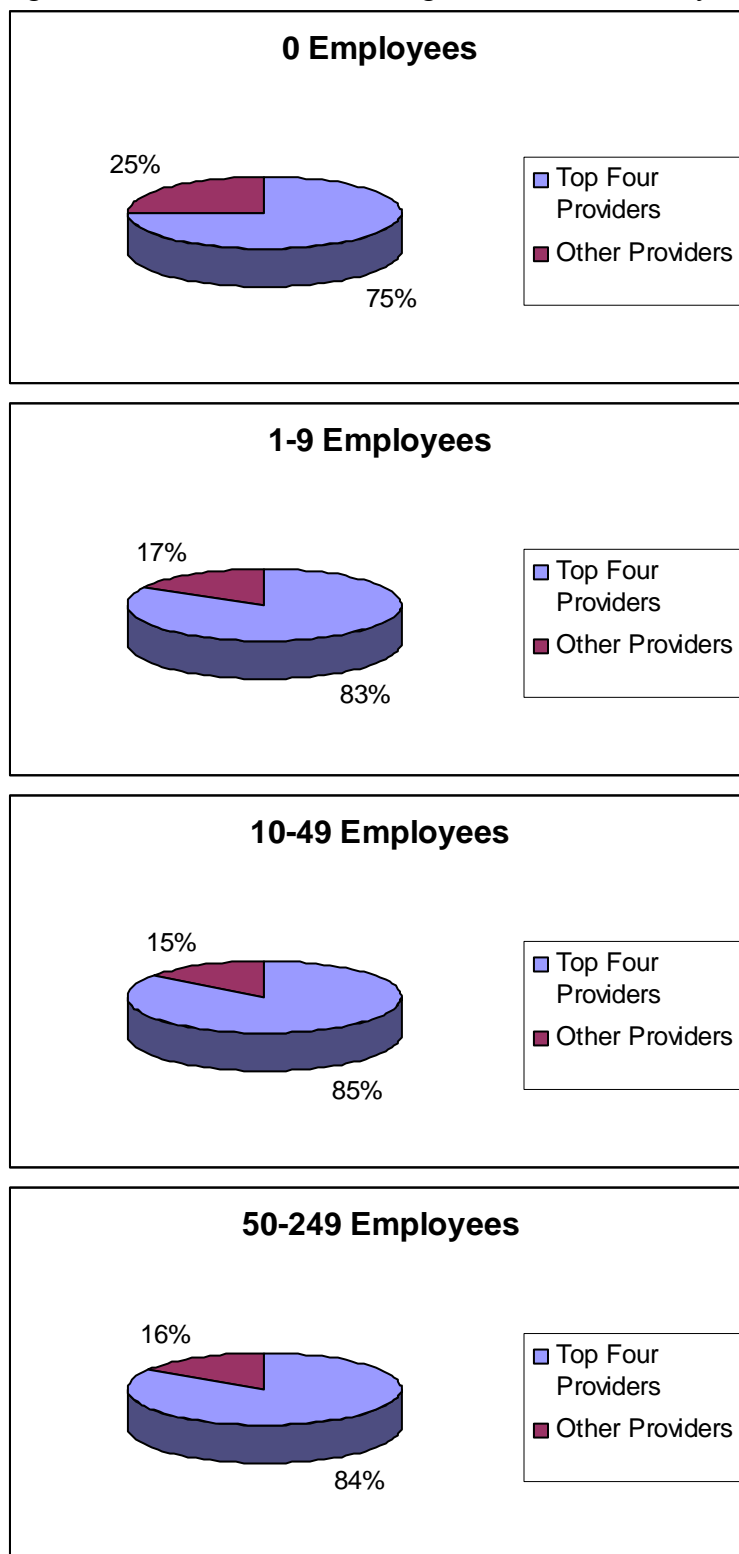
In comparison, Cruickshank (2000), using bank data on the value of loans and overdrafts, estimated that the top four banks account for 83% of the market. Our figure of 78% is indicative of a slight fall in market concentration.⁴³

⁴² In contrast, previous analyses of market share have used bank data (see e.g., Cruickshank, 2000)

⁴³ Whilst our figure is (statistically) significantly smaller than Cruickshank's figure, it would be incorrect to infer that the top four market share has fallen 5 points, due to the different methods of calculating market shares.

Market shares, by number of employees, are reported in Figure 6.2.

Figure 6.2: Market Shares of Largest Four Providers by Number of Employees (UK)



These charts show that

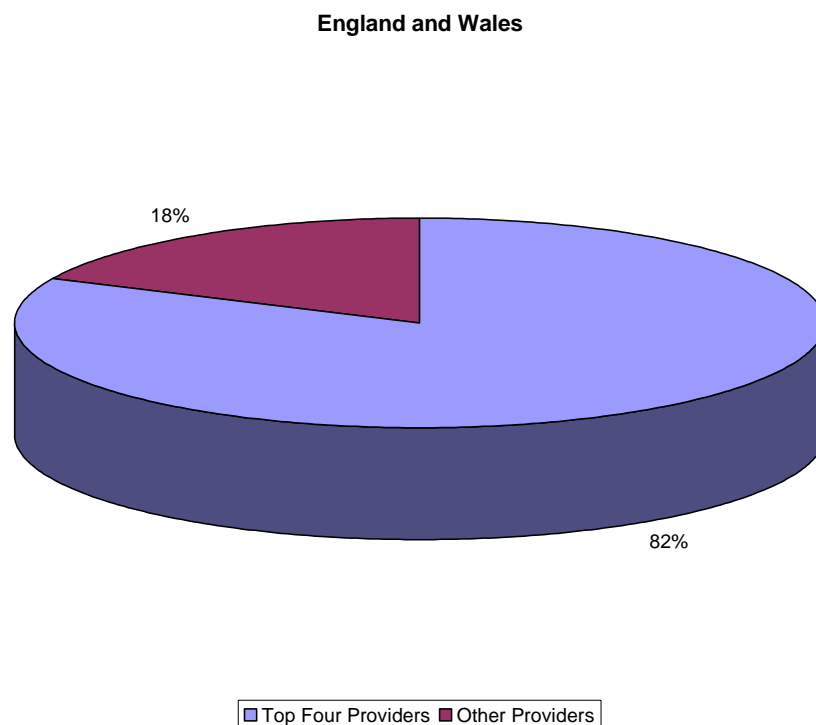
- Market concentration tends to increase with firm size.
- Among businesses with 0 employees the market share of the largest four providers is 75%.
- This figure rises to 85% among businesses with 10-49 employees.

Comment

Cruickshank (2000) reports that the big four providers of *personal* current accounts supply 68% of the market which is lower than the figure for business accounts. Lower market concentration among the smallest businesses is, therefore, likely to reflect the increased usage of personal current accounts for business purposes: 16% of the current accounts used for business purposes, among zero employee businesses, are personal accounts; virtually none of these accounts are personal accounts among businesses with 10 or more employees.

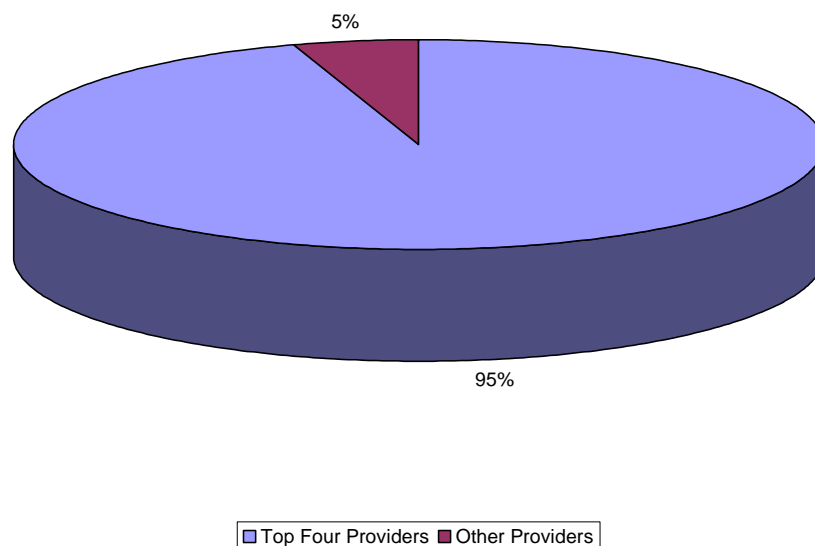
The Competition Commission (2002) identified three separate geographical markets (in England and Wales; Scotland; and Northern Ireland) for liquidity management services and general purpose business loans. Accordingly, further analysis of market shares, is given for these three regions in Figure 6.3

Figure 6.3: Market Shares of Largest Four Providers by Geographical Markets



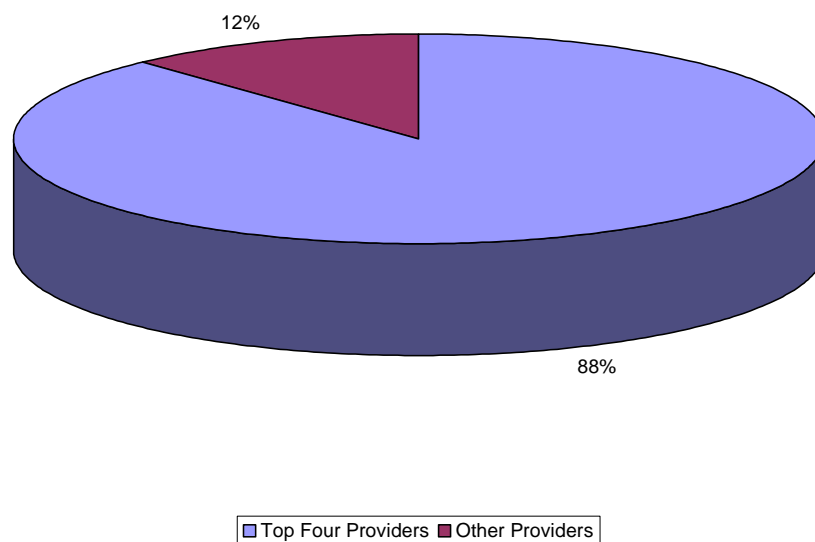
Base: All SMEs in England and Wales $N_p = 3,326,765$ (Unweighted $N = 2,168$)

Scotland



Base: All SMEs in Scotland $N_p = 194,266$ (Unweighted $N = 199$)

Northern Ireland



Base: All SMEs in Northern Ireland $N_p = 104,385$ (Unweighted $N = 133$)

The key results from these figures are as follows:

- In England and Wales the top four providers supply just over 80% of the market.
- In Scotland the top four providers supply 95% of the market.

- In Northern Ireland the top four providers supply almost 90% of the market.

Also, we found that (not reported above)

- England, Wales and Northern Ireland have the same largest supplier; Scotland has a different largest provider from the rest of the UK.
- In Scotland the largest provider accounts for over 50% of the market; the top two providers account for more than three-quarters of the market.
- The banks, comprising the top four, differ across the three geographical markets.

These results indicate that Scotland has the highest degree of market concentration in the UK.

6.1 Breadth of relationship with the main provider

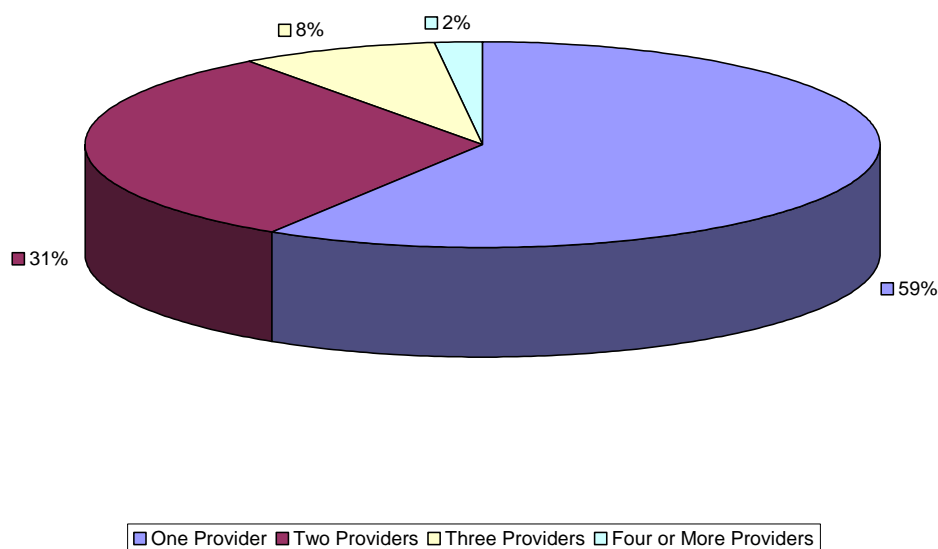
SMEs tend to use one main supplier of external financial services. There are several reasons why this is the case.

- SME finances tend to consist of a limited number of products: e.g., a current account; an overdraft; and, perhaps, a term loan.
- A single relationship, covering all of the firm's financial products, increases the breadth of information, about the business, available to the lender. Good businesses may therefore prefer broader relationships since, through improved information flows, they are able to obtain finance on more favourable terms.
- On the supply side, banks have traditionally bundled products, such as requiring the business to open a current account in order to access a loan. Whilst bundling may help information flows, and increase access to finance, the downside is that it restricts competition.⁴⁴

We begin this analysis by looking at the distribution of the number of separate providers of financial services. A full tabulation of these results, by firm size, are reported in Table A6.1 (Appendix to Section 6)

⁴⁴ In fact, following the recommendations of the Competition Commission (2002), banks have undertaken not to bundle products unless there are legal or technical reasons for doing so.

Figure 6.1.1: Distribution of the Number of Financial Service Providers



Base: All SMEs $N_p = 3,625,416$ (Unweighted $N=2,500$)

This chart shows that:

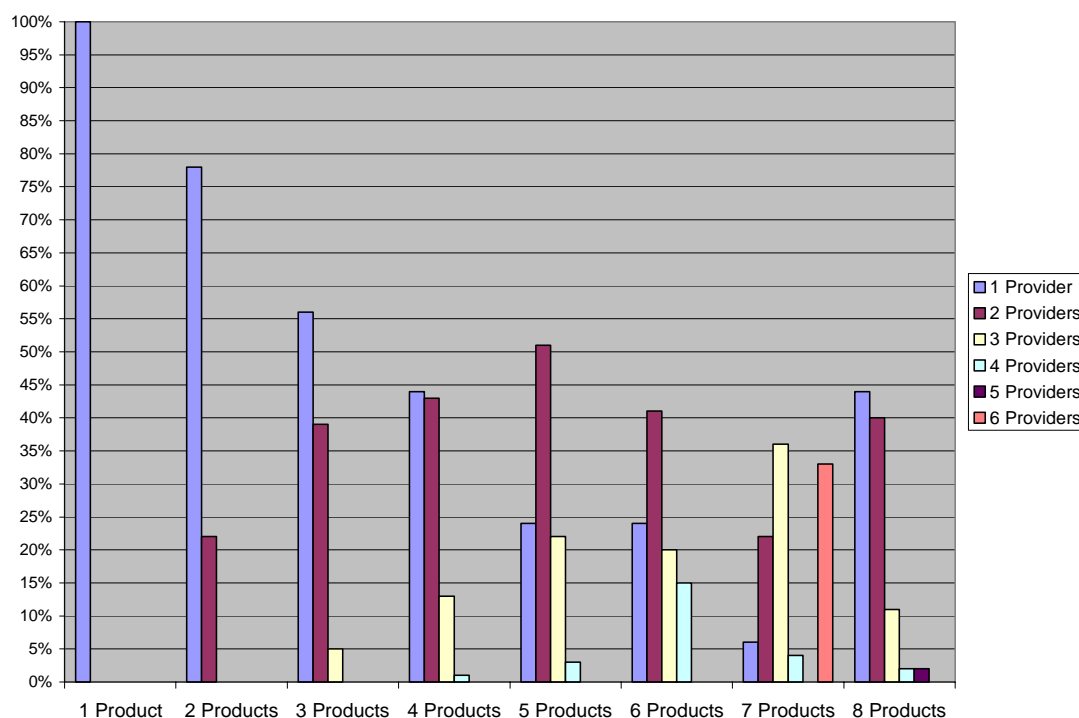
- The majority of SMEs have only one main provider (59%).
- Less than 1 in 10 businesses have accessed three or more (multiple) providers.
- Only 1 in 50 have four or more providers.

Table A6.1 shows that:

- Larger businesses tend to have more finance providers.
- Only 7% of businesses with no employees obtain finance from multiple sources.
- In contrast 25% of medium-sized businesses (50-249 employees) have multiple providers.

In the following charts we look at the relationship between the number of providers and the number of products used (a tabulation of the results is reported in Table A6.2). In particular we look at the evidence for the use of different products with the same provider. This is indicated, in the following charts, by the incidence of using one provider, where more than one financial product is used.

Figure 6.1.2: Distribution of the Number of Financial Service Providers by the Number of Products Used



These charts indicate that:

- Businesses which use more financial products are less likely to use a single provider.
- However, businesses which use between 1 and 4, or 8, different financial products are still *most* likely to have only a single provider.
- For 5 and 6 products, the most probable number of providers is 2.
- Whilst businesses with 7 products tend to have 3 providers.

Comment

These results indicate a preference among SMEs to use, in general, only one or two different providers of finance, regardless of the number of services being used. We are unable to distinguish whether this tendency to bundle services is a result of customer preferences, perhaps to establish good relations with a single provider, or as a result of the requirements of providers. Indeed, the Competition Commission (2002) recommended against the practice whereby banks used to bundle some of their services, for example by requiring businesses to open a current account in order to access a loan. This was implemented in a legal undertaking between the banks and the Office of Fair Trading with effect from 1st January 2003. Despite this regulatory change, it is still the case that the bank providing the current account tends also to be the main provider of loans, as the following table shows

Table 6.1.1: Percentage of Businesses, with Term Loans, for which the Main Provider Supplies Both Current Accounts and Loans

ALL	NO EMPLOYEES	1-9 EMPLOYEES	10-49 EMPLOYEES	50-249 EMPLOYEES
$N_p = 879,441$	$N_p = 368,699$	$N_p = 414,597$	$N_p = 83,951$	$N_p = 12,195$
71%	59%	78%	83%	86%

Base: All SMEs with term loans

This table shows that:

- 71% of businesses with term loans have these loans supplied by same bank which supplies their current account.
- The tendency to shop around for a separate loan provider diminishes with firm size.

Comment

The fact that larger SMEs are more likely than smaller ones to use the same provider for their loans and current accounts seems, on the surface, counter-intuitive, since larger SMEs will have more resources with which to shop around. It may, however, reflect their having more negotiating power with their bankers than smaller businesses and, thus, a greater ability to secure a satisfactory deal.

Interestingly, the incidence of joint supply of current accounts and term loans is *higher* (80%) among businesses whose relationship with their main provider began in 2003 (the year in which the OFT regulations came into force) or 2004.

In summary of the evidence so far, there is an apparent preference among SMEs of all types for a single financial relationship even if a large number of services are used. This preference for a *broader* relationship with the main provider, whilst limiting competition, can help to increase information flows from the business to the bank, which may improve access to finance.

6.2 Length of relationship with main provider

Another important dimension in understanding financial relationships is the *length* of the relationship. Over time, good borrowers will establish a solid track record, helping them to access finance on favourable terms (Petersen and Rajan, 1994; Harhoff and Korting, 1998; Berger and Udell, 1995). Conversely, bad borrowers are more likely to be identified over time and denied finance (see e.g., Han, Storey and Fraser, 2004).

In Table A6.2.1 (Appendix to Section 6) we analyze the length of relationship with the main provider. The key results are that:

- On average, SMEs have been with their main provider for almost 15 years.
- Larger businesses tend to have had a longer relationship than smaller businesses which may be due to the relationship between size and age.⁴⁵

⁴⁵ In the view that entrepreneurship is a learning process, businesses tend to start-up small and increase in size over time as the entrepreneur learns her true efficiency (Jovanovic, 1982). Inefficient

- Also, there are significant variations in relationships by sector, ranging from 28 years (Agriculture) down to 9 years (Transport).
- Majority male-owned businesses have longer financial relationships than majority female owned businesses (15 years versus 12 years).
- Majority white-owned businesses have longer financial relationships than majority ethnic-minority owned businesses (15 years versus 10 years).
- Unsurprisingly, start-ups have much shorter relationships than established businesses (3 years versus 15 years).
- High growth businesses have only half the average relationship of non-high growth businesses (16 years versus 8 years).⁴⁶

Comment

Shorter relationships, among majority female-owned and ethnic-minority businesses, may be expected to have adverse consequences on their access to finance. Earlier evidence in this report suggests this is not the case for majority female-owned businesses but may apply to ethnic minority owned businesses.

Shorter relationships among start-ups are unsurprising. However, their average relationship, at 3 years, indicates the relationship was established prior to start-up (recall, start-ups are aged less than two years).

The much shorter relationships among high-growth businesses are interesting. On the one hand, this may reflect greater dynamism and more willingness to shop-around for better terms. However, since high-growth businesses tend to be riskier, it could also be that they are more likely to switch banks before the lender can establish their true risk-profile. Looking ahead, we note that high growth businesses are, in fact, more likely to switch banks (see Table 6.3.4 below).

6.3 Price, customer satisfaction and the propensity to switch main providers

So far it appears that the supply of finance to SMEs is highly concentrated in 3 or 4 banks. Also, there is little willingness of SMEs to use more than one main provider of finance even where several types of financial product are used. Indeed, a long relationship, with a single main provider, characterizes the financial relationships of the vast majority of SMEs.

These are, by no means, new findings. In fact, concerns about the lack of competition in SME banking (Cruickshank, 2000) have led to several recommendations, made by the Competition Commission, regarding behavioural remedies to promote competition, and the regulation of charges, in the provision of banking services to SMEs. These remedies principally include:

- Limitation on the bundling of banking services.

businesses, on the other hand, decline and fail. The implication is that, by a process of selection, older businesses tend to be larger.

⁴⁶ Controlling for other firm and owner characteristics, high growth businesses have, on average, banking relationships which are about 2 years shorter than non-high growth firms.

- The payment of interest on current accounts (at 2.5 percentage points below the Bank of England Base Rate) by the ‘big four’ clearing groups; or the provision of free money transmission; or a choice between the two options.
- Assistance to fast and error free switching of accounts between banks (Competition Commission, 2002).

In this section we take a fresh look at bank charges and switching, the first issue of bundling having been looked at in Section 6.1. In a broader context, this section seeks to identify:

- The level of businesses’ satisfaction with different aspects of the service from their main bank.
- Whether dissatisfaction, with prices or other aspects of the bank’s service, increases the likelihood of switching in the future.
- The circumstances which induced businesses’, which have made a switch, to change banks - cheaper banking or dissatisfaction with service.

Bank charges

Firstly though, in the following table, we look at monthly bank charges across different firm sizes. These figures do not include interest payments on debt which will be examined separately later in this report.

Table 6.3.1: Average Total Monthly Bank Charges (All businesses with Bank Accounts) (Excluding Interest on Overdrafts or Loans) (Population Weighted)

	MEAN (£)	ERROR MARGIN \pm
All	50.9	8.0
$N_p = 3,239,060$ $N = 2,248$		
<i>Number of employees</i>		
0	24.7	10.4
1-9	64.9	12.3
10-49	201.9	45.1
50-249	431.6	67.0
<i>Turnover (£)</i>		
Less than 10,000	14.6	6.1
10,000-49,999	17.1	3.3
50,000-99,999	25.9	5.3
100,000-249,999	42.0	9.6
250,000-499,999	66.6	16.5
500,000-999,999	149.5	89.8
1,000,000-4,999,999	199.2	58.2
5,000,000 or more	430.2	159.4
<i>Gender</i>		
Male	50.0	9.6
Female	53.7	15.7
<i>Ethnicity</i>		
White	50.4	8.5
Non-white	56.8	25.8
<i>Age</i>		
Less than 2years	32.7	12.6
2 years or more	52.3	8.7
<i>Turnover Growth</i>		
Less than 30%	49.0	6.3
30% or more	100.7	69.7

- SMEs pay, on average, £51 in total monthly bank charges.
- This figure ranges from £25 for businesses with no employees, up to £430 for businesses with 50-249 employees.
- By turnover, charges range from under £15 per month up to £430 per month.

Also (not reported in Table 6.3.1):

- The average amount charged, by bank, varies from £26 to £85 per month.
- There is little variation in the charges of the largest four banks.

Next we look at the percentages of businesses which report that they receive *any* free transactions on their current account, including free money transmission, or receive interest on their current account.

Table 6.3.2: Any Free Transactions, Interest on Current Account or Either (All businesses with Bank Accounts).

	ANY FREE TRANSACTIONS	INTEREST ON CURRENT ACCOUNT	EITHER ¹
All	34%	56%	64%
$N_p = 3,239,060$ $N = 2,248$			
<i>Number of employees</i>			
0	38%	55%	65%
1-9	28%	57%	64%
10-49	26%	53%	61%
50-249	24%	52%	61%
<i>Turnover (£)</i>			
Less than 10,000	49%	51%	63%
10,000-49,999	36%	54%	64%
50,000-99,999	32%	53%	60%
100,000-249,999	29%	57%	63%
250,000-499,999	21%	63%	71%
500,000-999,999	27%	58%	64%
1,000,000-4,999,999	19%	55%	62%
5,000,000 or more	23%	59%	64%

Notes

1. Note that the percentage reporting 'either' is less than the sum of the percentages of 'any free transactions' and 'interest on current account'. This indicates that some businesses are receiving *both* 'any free transactions' and 'interest on current account'.

This table shows that:

- More businesses report receiving interest on their account than any free transactions.
- Businesses with no employees, or turnover below £10,000, have the highest incidence of 'any free transactions'. This may reflect the use of personal accounts in these businesses, which, traditionally, do not incur money transmission charges.
- 2 in every 3 SMEs report receiving free transactions and/or interest on their current account.

- This figure rises to 4 in every 5 SMEs for accounts opened since 2003 (when the banks' undertakings with the Office of Fair Trading came into force).

Note that if a business is in receipt of 'any free transactions' this does not imply that it pays *no* bank charges. We would expect, however, that businesses with any free transactions would pay *lower* bank charges on average. Also, one of the big four banks has pointed out that offering SMEs a choice between receiving interest or *reduced* charges falls within the terms of the big four's undertakings with the Office of Fair Trading.

In the following table we, therefore, look at average bank charges for businesses according to whether or not they receive 'any free transactions' or 'interest on current account'. Our prior expectation here is that businesses in receipt of 'any free transactions' will pay lower average charges than businesses receiving interest.

Table 6.3.3: Average Monthly Bank Charges by Receipt of Any Free Transactions and Interest on Current Account (All businesses with bank accounts)

	MEAN (£)	ERROR MARGIN ±
All		
$N_p = 3,239,060$		
$N = 2,248$		
'Any free transactions':	21.3	4.7
'Interest on current account':	39.6	6.3
'Any free transactions':		
0 Employees	11.0	4.1
1-9 Employees	22.7	9.0
10-49 Employees	132.3	47.8
50-249 Employees	401.7	166.8
'Interest on current account':		
0 Employees	16.3	3.9
1-9 Employees	52.7	11.0
10-49 Employees	188.4	70.4
50-249 Employees	355.0	70.6

These results show that:

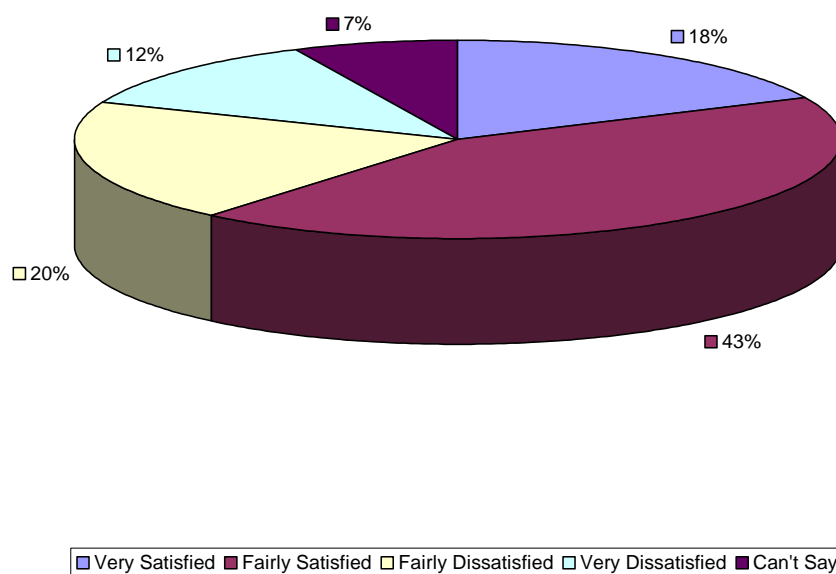
- Businesses with ‘any free transactions’ do, indeed, pay lower charges on average than businesses without any free transactions (£21 versus £69).
- These patterns of bank charges are constant across firm size.

Customer satisfaction

Having obtained an ‘objective’ view of the level of bank charges we turn to the subjective views of businesses regarding these charges. Indeed, regardless of the actual level of charges, a pre-cursor to the decision to switch banks is a *feeling* of dissatisfaction with the current bank and/or the belief that a better deal could be obtained elsewhere.⁴⁷

In the following chart we report the level of SME satisfaction with bank charges (see Table A6.3.1 for a tabulation of the results).

Figure 6.3.1: Satisfaction with Bank Charges (All businesses with current accounts)



Base: All SMEs with current accounts $N_p = 3,239,060$ (Unweighted $N=2,248$)

This chart reveals that:

- The majority of SMEs (61%) are satisfied, to some degree, with their bank charges.
- However a sizeable minority of businesses, almost 1 in 3, report some dissatisfaction with their bank charges.

⁴⁷ As will be seen, feelings of dissatisfaction are not a sufficient condition for switching to occur.

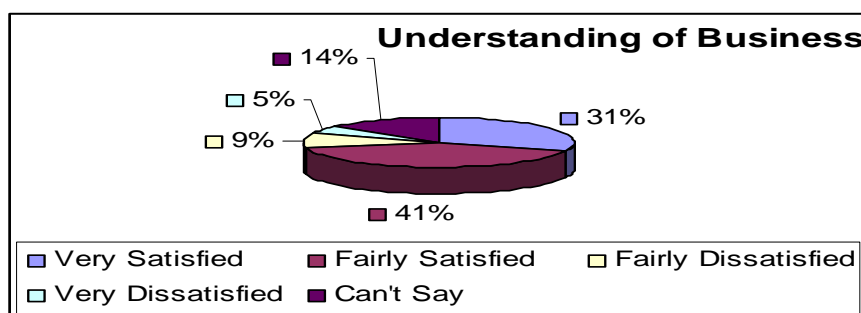
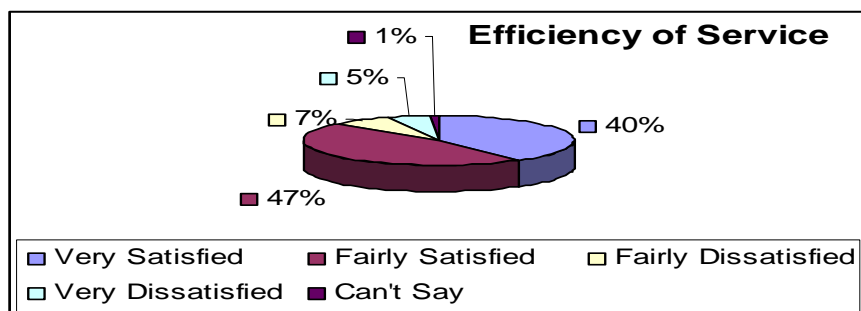
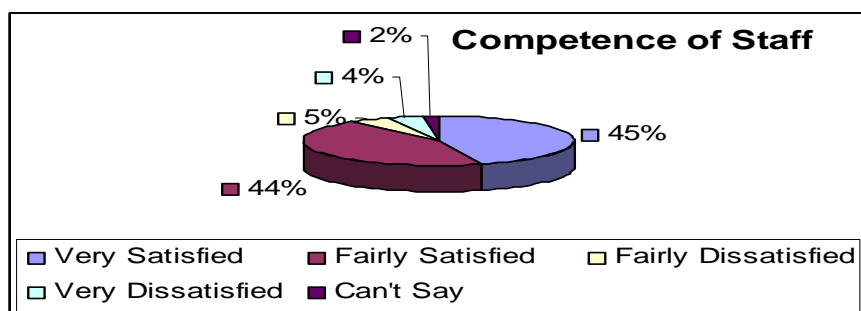
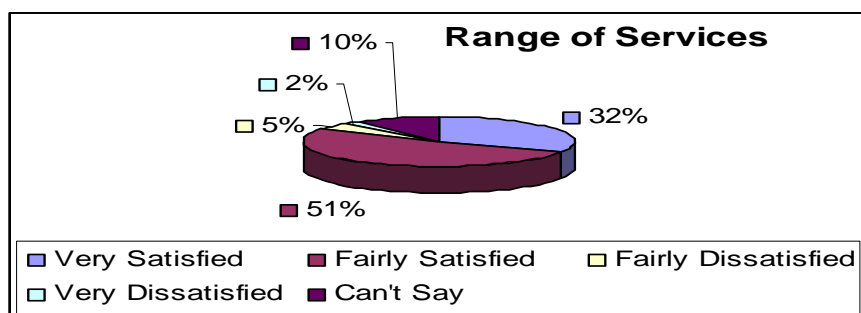
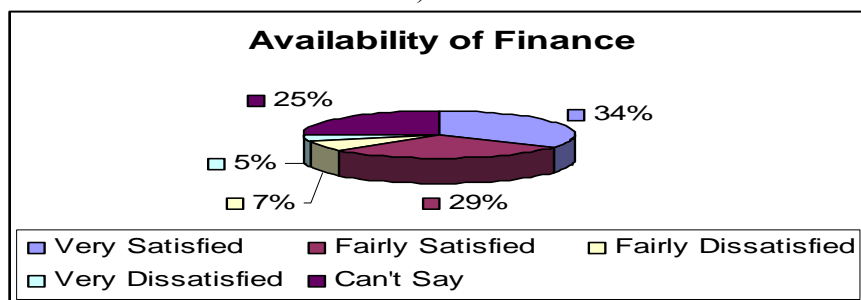
Comment

Micro businesses (1-9 employees) report the most dissatisfaction with bank charges (see Table A6.3.1). We also found that the bank with the highest charges has a dissatisfaction rate of over 40%; this is double the dissatisfaction rate of the lowest charging bank (not reported to preserve individual bank anonymity). This suggests there is a relationship between the actual charges levied and the degrees of self-reported dissatisfaction – in other words, the businesses are not just grumbling about costs for the sake of grumbling.⁴⁸

To complement these subjective views on charges, levels of satisfaction with non-price elements of banking relationships are summarized in the following sequence of charts.

⁴⁸ Regression analysis supported a statistically significant, positive, relationship between the amount of bank charges and the degree of dissatisfaction, controlling for firm size, sector and region.

Figure 6.3.1: Satisfaction with Non-Price elements of Banking Relationships (All businesses with current accounts)



These charts reveal the overall level of satisfaction with non-price elements of the relationship is high compared to satisfaction with charges. In particular:

- Just under two-thirds of businesses are either very, or fairly, satisfied with the availability of finance at their bank.
- However 1 in 4 businesses are unable to say whether they are satisfied or dissatisfied with the availability of finance. This could be because the business has not sought any finance from its bank.
- Almost 90% of businesses are satisfied with the competence of bank staff.
- More than two-thirds are satisfied with their bank's level of understanding of their business.
- However about 15% are unable to say whether they are satisfied or dissatisfied with their bank's level of understanding of their business.

The results so far indicate that a substantial minority of SMEs are dissatisfied with the charges made by their main provider, but most are satisfied with the competence of bank staff. We now turn to the issue of whether this dissatisfaction with bank charges translates into switching, or even contemplation of switching banks.

Switching

In this part, we analyze the percentages of SMEs with current accounts which have switched in the last 3 years (annualized rate), or are considering switching, or would consider switching if approached by another bank.

By adding the percentages of businesses which have switched *to* their current bank recently, with the percentages seriously considering switching *from* it, we can get an informal estimate of the degree of churn in the market. That is, 'churn' is taken to mean the percentage of businesses which have switched to a new bank ('inflows') plus the percentage who are considering switching from their current bank (*potential* 'outflows').

Table 6.3.4: Percentage of SMEs with Current Accounts which have: Switched Main Providers (Annualized Rate); or are Considering Switching; or would Consider Switching if Approached by Another Bank

	SWITCHED (TO CURRENT BANK)	CONSIDERING SWITCHING (FROM CURRENT BANK)	WOULD CONSIDER SWITCHING (FROM CURRENT BANK)
All	2%	7%	29%
$N_p = 3,239,060$ $N = 2,248$			
<i>Number of employees</i>			
0	2%	6%	27%
1-9	2%	8%	31%
10-49	4%	11%	29%
50-249	4%	9%	29%
<i>Turnover (£)</i>			
Less than 10,000	1%	8%	32%
10,000-49,999	2%	7%	26%
50,000-99,999	3%	9%	27%
100,000-249,999	4%	5%	35%
250,000-499,999	5%	8%	32%
500,000-999,999	2%	8%	33%
1,000,000-4,999,999	2%	10%	28%
5,000,000 or more	2%	5%	31%
<i>Financial Qualifications</i>			
Yes	3%	9%	31%
No	2%	6%	27%
<i>Gender</i>			
Male	3%	8%	28%
Female	2%	7%	32%
<i>Ethnicity</i>			
White	2%	7%	29%
Non-white	3%	13%	33%
<i>Age</i>			
Less than 2 years	1%	14%	32%
2 years or more	3%	7%	29%
<i>Turnover Growth</i>			
Less than 30%	2%	8%	29%
30% or more	6%	6%	27%

This table shows that, among SMEs with a current account:

- The annual rate of bank switching is just above 2% over all types of business.
- This figure rises to 5% among businesses with a turnover in the range £250,000-£499,999.
- Over 7% of SMEs are currently considering switching to a new provider from their current bank.
- The implied level of annual churn is just under 10% (representing 344,931 businesses).⁴⁹
- A further 29% of SMEs would consider switching if approached by another bank.

Also:

- Businesses with qualified financial managers (including companies) are more likely to switch than businesses without qualified financial managers. This suggests that a lack of financial acumen could be a barrier to switching.⁵⁰
- Start-ups are 3 times less likely to have switched than established businesses. However, start-ups are twice as likely, as established firms, to be considering switching.
- High growth businesses are 3 times more likely to have switched than slow growing businesses.

Comment

Our figure for switching rates is lower than a figure of 4% reported in FSB (1998). Interestingly, the percentage of businesses considering switching is less than the proportion who feel very dissatisfied with the charges levied by their bank (7% versus 12%, see Table A6.3.1).

Indeed further analysis (not reported) revealed that fewer than 16% of businesses, which are very dissatisfied with bank charges, are considering changing their bank. In contrast, 28% of these very dissatisfied businesses say they are unlikely to change banks in the near future. Perhaps this inertia is due to a fear that, while establishing a relationship with a new provider, they would lose out on accessing new finance. At the very least, it suggests, for these businesses, that the perceived cost of the switch outweighs any benefits.

Switching rates, into the largest four banks, vary narrowly between 1% and 2.7% (not reported in Table 6.3.4). Potential outflows, in the same group of banks, vary between 4.5% and 11.5%. The highest implied level of churn, among the largest four

⁴⁹ This is based on the assumption that businesses, currently considering switching, will act on this consideration. The proportion considering switching is likely to overestimate actual switching in the near future since, if the business makes its intention to switch known, the current provider may be induced to negotiate its tariff downwards, (Competition Commission, 2002)

⁵⁰ Estimation of a limited dependent variable equation for switching (specifically, a probit model) found that businesses, with qualified financial managers, are over 6 percentage points more likely to have switched in the last 3 years than other businesses (controlling for other business and regional characteristics).

banks, is just under 14%. Over all banks, the largest percentage of customer inflows from another bank is 11%. This bank's customers also appear very willing to consider moving on elsewhere: the percentage considering switching is 22%, which is the highest across all banks. The implied degree of churn for this bank represents about a third of its customers.⁵¹

Notably, there is substantial variation, across banks, in the percentage of customers which would consider switching if approached by another bank. These figures vary from 15% to 70%. The implication is that, if all banks launched marketing campaigns designed to attract new customers, some banks would lose less customers than others and possibly gain more new customers. Interestingly, among the largest four banks, the percentages of customers, which would consider switching if approached by another bank, are very similar (around 30%). At least among this group of banks, the aforementioned marketing campaign could amount to a zero-sum game (although the big four might gain/lose customers from/to banks outside the big four).⁵²

Having established that the likelihood of switching is low, we look at the circumstances which actually induce businesses to change their bank. Therefore, in the following table, we report the main reasons for switching, among businesses which have recently changed banks.

Table 6.3.5: Main Reasons for Switching ¹ (Population Percentages; Switchers only)

	FINANCIAL REASONS			NON-FINANCIAL REASONS	
	Current Provider offered lower Charges	Current Provider offered lower interest rates	Previous Bank Refused Finance	Current Bank Offered Better Service/Facilities	Generally Dissatisfied with Service at previous bank
All	15%	9%	4%	18%	37%
$N_p = 258,498$ $N = 236$					
<i>Number of employees</i>					
0	11%	12%	2%	21%	36%
1-9	24%	5%	7%	14%	39%
10-49	9%	6%	9%	11%	30%
50-249	4%	2%	6%	10%	37%

Notes:

1. Only the main financial and non-financial reasons for switching are reported: so the row percentages do not add up to 100%.

⁵¹ Interestingly this bank's average monthly charges are, at just under £40, £10 below the average monthly charge.

⁵² Cruickshank (2000) views, with some skepticism, claims by banks that their low levels of marketing, to attract new customers, is due to a lack of information about the credit risk of firms at other banks. Indeed, banks tend to focus their marketing campaigns on start-ups, about which information problems are most acute.

The figures in this table indicate that:

- Around 1 in 4 businesses switched because they were attracted by better borrowing terms and/or charges at their current bank.
- Fewer than 1 in 20 switchers felt compelled to change banks because they had been refused finance at their previous bank.
- However, more than 1 in 3 businesses switched because they were generally dissatisfied with the service at their previous bank.
- Prices and charges have the least impact on the decision to switch among medium-sized businesses (50-249 employees).

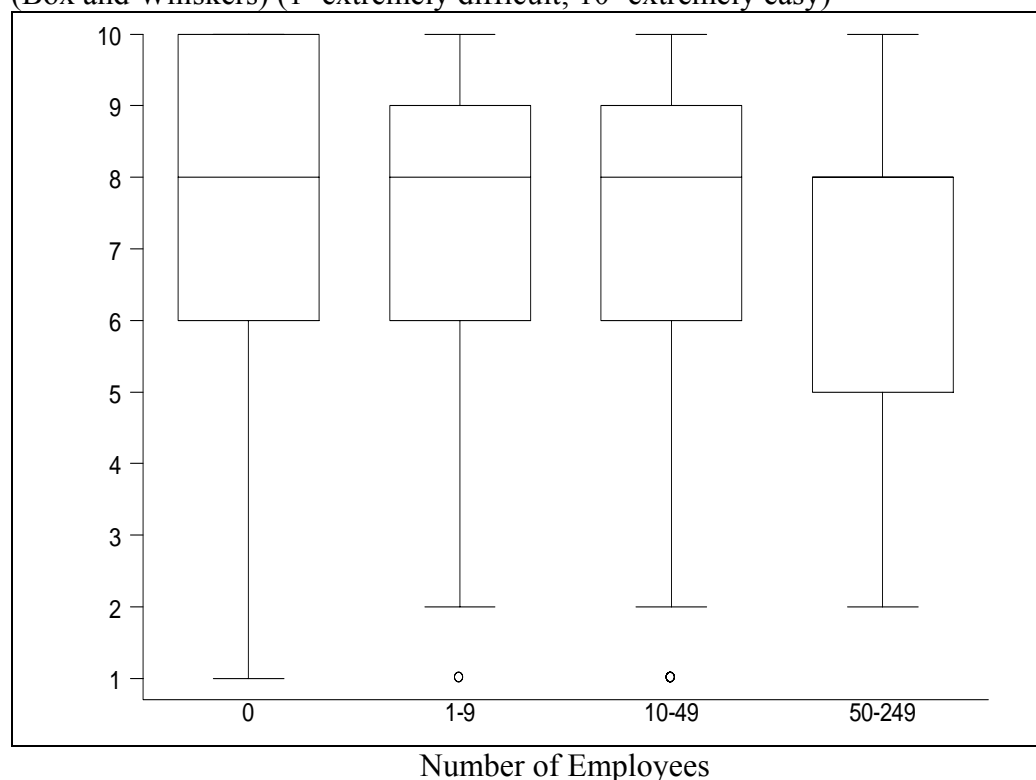
Comment

Switching, it appears, is more sensitive to dissatisfaction with service than prices. Indeed, it was found earlier that overall satisfaction with service is high, which may partly explain why switching rates are so low. A tentative implication of the preceding results is that policies designed to increase price competition may, at best, have a modest affect on switching behaviours, especially regarding larger SMEs. However, since the views of a self-select sample of switching SMEs are probably unrepresentative of the wider population, a large measure of caution needs to be attached to this interpretation. Future analysis of these results will need to take into account this selection issue.

Next we look at how easy switchers found the process of switching. One possibility for the low level of switching is the perceived complexity of the process and the possibility that costly errors could arise.

The following charts summarize the scores, for how easy switchers found the process of switching, on a scale of 1 (extremely difficult) to 10 (extremely easy). These charts follow the same 'box and whisker' format used previously to present results for management skills (see also Table A6.3.3).

Figure 6.3.2: Ease of Switching Banks by Number of Employees (Switchers Only) (Box and Whiskers) (1=extremely difficult; 10=extremely easy)



The above figure shows that the median switching-ease score, at 8, is the same for all sizes of business.

The bulk of businesses (i.e., within the box):

- With 0 employees, report a switching-ease score of between 6 and 10.⁵³
- With 1-9, or 10-49, employees, report a switching-ease score of between 6 and 9.
- With 50-249 employees, report a switching ease score of between 5 and 8

The incidence of difficulties in switching is characterized by the length of the whisker extending below the box and the data points individually identified with a circle. In this regard we note that all business, except those with 50-249 employees, have instances of extremely difficult switches ('1' scores).

Comment

Overall, these results indicate that all sizes of SMEs find switching banks to be relatively easy. If the inertia of non-switchers is indeed due to perceived complexities in the switching process, the above evidence suggests these perceptions are unfounded. There is some evidence that switching-ease diminishes with firm size, presumably, due to the increasing complexity of the business' finances.

⁵³ Note that the diagram indicates that, for 0 employees, all scores, between the 75th and 100th percentile, equal 10. On the other hand, the boxes for larger businesses correspond to the inter-quartile range (between the 25th and 75th percentile).

The caveat with these high ease of switching scores is that we only observe the scores of businesses which have completed switches; some may have found the process so hard that they gave up trying to change banks (self-selection bias). In reality, switching may be harder than reported.

Technology and competition

A potentially significant barrier to entry, into the market for money transmission services, is the perceived need for new entrants to offer their customers a local presence (Cruickshank, 2000). The implication is that new entrants would require a branch network or, at least, some form of agency arrangement, to supply customers with money transmission services. However, with the development of internet and telecommunications technologies, there is increased scope for new entrants to circumvent this barrier and offer distance banking as an alternative to local banking. Accordingly, in the following table, we look at the most frequent method of conducting business with the main bank to see what, if any, scope there is for technological change to improve competition.

Table 6.3.6: Most Frequently Used Method of Doing Business with the Main Bank in the Last 12 Months (Population Percentages)

	ALL $N_p = 3,239,060$ $N = 2,248$	0 EMPLOYEES	1-9 EMPLOYEES	10-49 EMPLOYEES	50-249 EMPLOYEES
Visiting branch	46%	50%	42%	24%	15%
By telephone	30%	26%	34%	47%	48%
By mail	5%	7%	3%	4%	2%
Through a cash machine/ATM	2%	3%	1%	0%	0%
Through the internet	15%	12%	19%	21%	28%
Non internet electronic link	0%	0%	0%	2%	4%
Visit from branch	0%	0%	0%	1%	1%
Other	1%	1%	0%	0%	1%

These results show that:

- Visiting a branch is the most frequent mode of doing business among all SMEs and businesses with fewer than 10 employees.
- Telephone banking is most frequently used in businesses with 10-249 employees
- Internet banking is used most frequently by around 1 in 7 SMEs.
- This figure is higher than 1 in 4 for larger SMEs (50-249 employees) and outstrips visiting a branch.

Overall these results suggest that technology, facilitating distance banking, could have a beneficial impact on competition.⁵⁴ In particular, this is the case for larger SMEs which most commonly use telephone and internet banking in preference to visiting a branch (recall, that market concentration is currently highest for larger SMEs).

Conclusion

In summary, although a sizeable number of SMEs are dissatisfied with their bank's tariffs, the vast majority are unwilling to change providers. From the point of view of businesses that have recently switched, most have done so because of dissatisfaction with the general service rather than prices. Across firm types, high growth businesses and those with qualified financial managers are more likely to switch.

Whilst it would go too far to say that most SME customers are price insensitive, it is apparent that obtaining cheaper banking is not their top priority. This suggests, within the limitations of the current analysis, that policies designed to stimulate price competition may have a limited affect on switching behaviours.

Indeed, high overall levels of satisfaction with the main provider, regarding the availability of finance and understanding of their business, suggest that low switching rates reflect unwillingness on the part of businesses to upset the status quo. Notably, switching rates are significantly higher among dynamic high growth businesses and those with qualified financial managers.

Finally, the analysis provides some insights into the potential impacts of technology in reducing barriers to entry in the market for money transmission services. Whilst visiting a local branch is still the preferred mode of doing business among smaller SMEs, larger SMEs tend to use telephone and internet banking. This suggests that new entrants, providing distance banking, have the potential to attract larger SME customers.

⁵⁴ Whether this explains any of the falls in market shares since Cruickshank (2000), observed in our data, is open to question.

III. SPECIFIC ANALYSES OF FINANCIAL SERVICES

7 DEPOSITS

Analysis of the data on amounts held in deposit accounts revealed the following information:

- The average amount held on deposit by SMEs is £61,000 (\pm £14,000).
- This amounts, on average, to just over 4% of turnover held on deposit.
- In total, SMEs hold about £92 billion on deposit.

(see Table A7.1, Appendix to Section 7; second bullet point not reported in this table)

For comparison with data collected by the British Banker's Association (BBA), we looked at deposits among businesses with a turnover of £1 million or less. These results show that:

- The average amount held on deposit is £33,000.
- In total, these businesses hold about £38 billion on deposit.

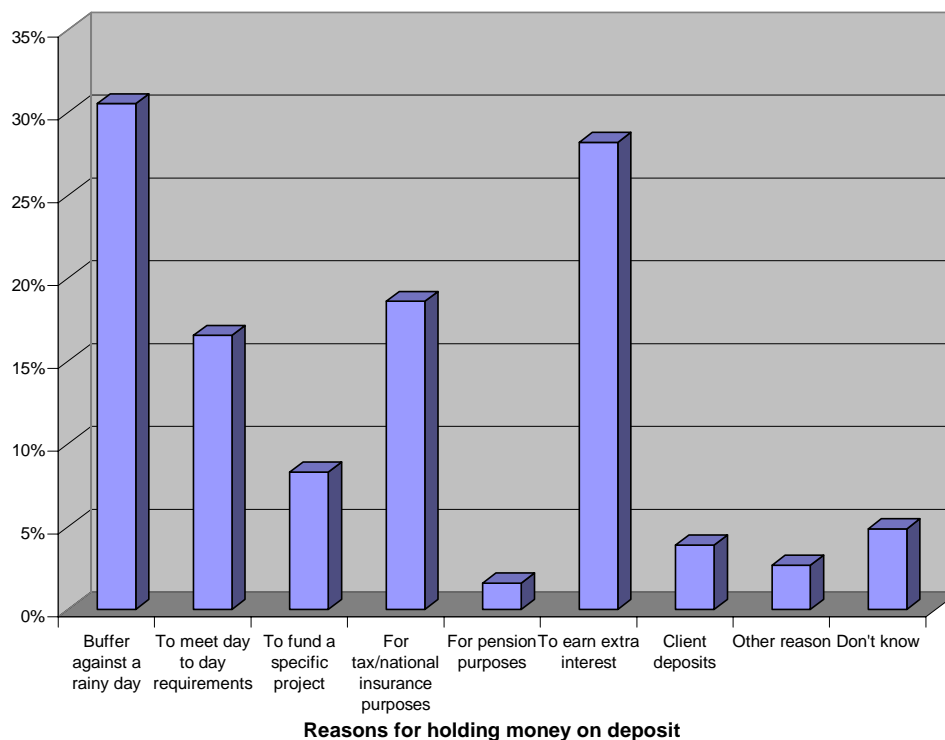
We note that the BBA estimates that businesses, with a turnover of £1 million or less, held about £40 billion on deposit in the last quarter of 2003.

The results in Table A7.1 also show that:

- There are no significant differences in deposits by gender, ethnicity or growth rate.
- However, start-ups hold significantly less on deposit than established firms (£11,000 versus £63,000)

Reasons for holding money on deposit

Figure 7.1 Reasons for Holding Money on Deposit (multi-code response)



Base: All SMEs with deposit accounts $N_p = 1,500,809$ (Unweighted $N = 1,410$)

This figure highlights the following motives for holding money on deposit

- A *transactions* motive (e.g., ‘to meet day to day requirements’ or to ‘fund a specific project’) is reported by more than 1 in 3 businesses holding deposits.
- A *precautionary* motive is reported by almost 1 in 3 businesses holding deposits (‘buffer against a rainy day’).
- An *asset* motive (‘to earn extra interest’) is reported by more than 1 in 4 businesses holding deposits.

8 TERM LOANS AND OVERDRAFTS

Term loans (including mortgages)

Analysis of the data on amounts outstanding on term loans revealed the following information (see Table A8.1 in Appendix to Section 8):

- The average amount outstanding is £88,000 (\pm £20,000).
- In total, SMEs have about £64 billion outstanding on term loans.

For comparison with data collected by the British Banker's Association (BBA), we looked at loans among businesses with a turnover of £1 million or less. These results show that:

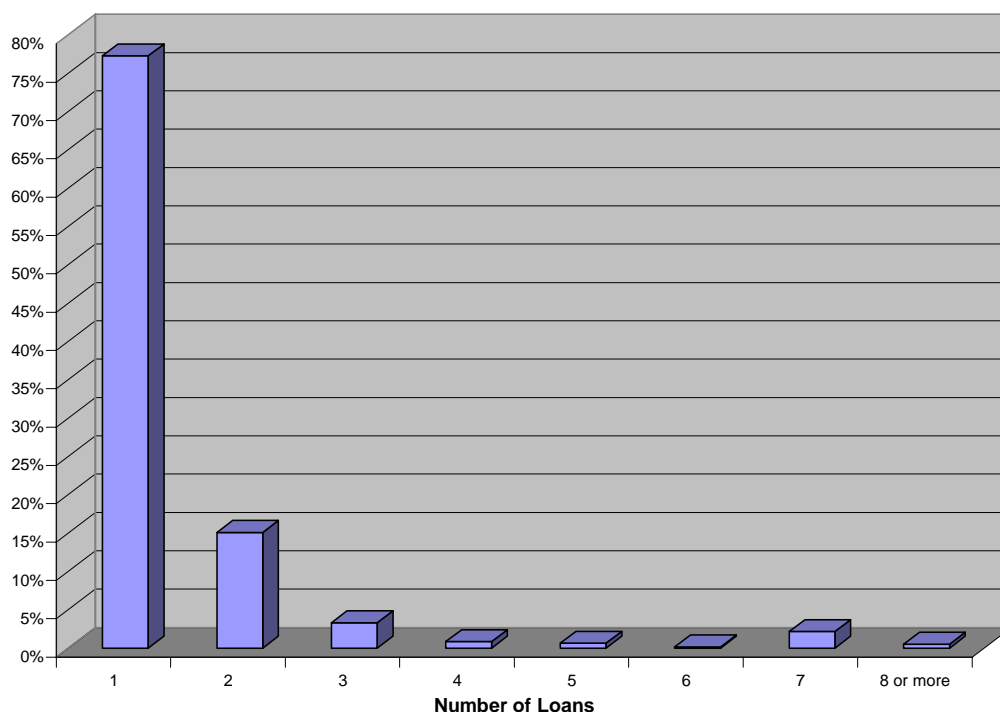
- The average amount outstanding is £59,000.
- In total, these businesses owe about £35 billion in term loans.

The BBA estimates that businesses, with a turnover of £1 million or less, owed about £30 billion on term loans in the last quarter of 2003.⁵⁵

Table A8.1 also shows that there are no significant differences in the amounts outstanding by gender, ethnicity, business age or growth rate.

The distribution of the number of term loans used is reported in the following chart.

Figure 8.1: Number of Term Loans



Base: All SMEs with term loans $N_p = 742,139$ (Unweighted $N = 835$)

⁵⁵ These estimates are based on large samples of small business lending data provided by banks. From December 2002, the data exclude loans to clubs, associations, charities and public sector organizations.

This chart shows that, among businesses with term loans:

- The bulk of (over 3 in 4) have only one term loan.
- Fewer than 1 in 4 have two or more term loans.

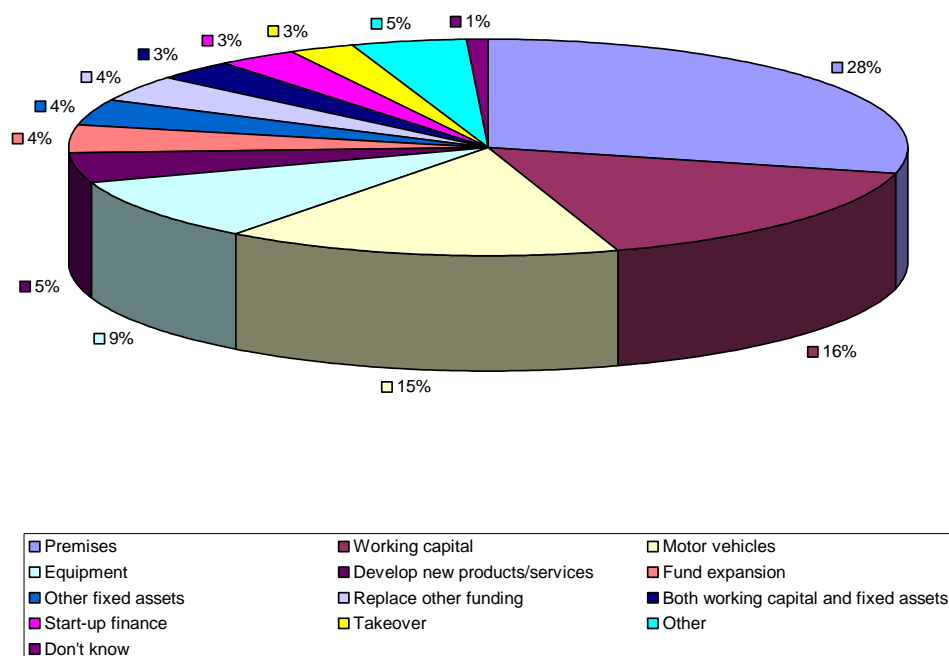
Largest term loan

Table A8.2 (Appendix to Section 8) shows that:

- The average size, of SMEs largest loans, is just under £100,000.
- 38% of largest loans are secured. These loans have an average size of £148,000.
- 60% of largest loans are unsecured. These loans have an average size of just under £70,000.
- Start-ups have access to smaller loans than established businesses (£61,000 versus £103,000). This result is robust when controlling for other business characteristics.⁵⁶
- There are no significant differences in the size of these loans by gender, ethnicity or growth rate.
- Also there is no evidence that switching banks, or using more than one provider, reduces the amount of the largest loan.

⁵⁶ A linear regression of the main loan amount on a start-up indicator, controls for business characteristics and regional dummies, shows that start-ups' main loans are about £55,000 lower than established businesses.

Figure 8.2: Purpose of Largest Loan



Base: All SMEs with term loans $N_p = 742,139$ (Unweighted $N = 835$)

The main purposes of the largest loan are to fund:

- Premises (28% of businesses)
- Working capital (16% of businesses)
- Motor vehicles (15% of businesses)
- Equipment (9% of businesses).

Small Firms Loan Guarantee Scheme (SFLG)

Data were collected on the use of loans obtained under the SFLG. We estimate that all current SFLG loans account for 4% of all term loans.⁵⁷ The average SFLG loan is about £114,000, and the total value of these loans is in the region of £3.2 billion.⁵⁸ Due to the small number of businesses in the sample accessing these loans ($N = 45$), it is not possible to conduct a *robust* analysis of SFLG by sub-groups. However we note, subject to this caveat, that:

- Businesses with 10-49 employees ('small' businesses) have the highest rate of access to SFLG loans across size bands (9%).
- 5% of businesses with assets less than £250,000 accessed SFLG loans versus 3% of businesses with greater assets. This suggests a relationship between (insufficient) collateral and access to SFLG.

⁵⁷ Graham (2004a) reports the number of *new* SFLG loans in 2003-4 was 5,966, which she estimates accounts for 2% of term loans to SMEs.

⁵⁸ Note this is an estimate of the total value of *all* current SFLG loans. In contrast, Graham (2004a) reports a figure of £409 million for *new* lending under the scheme in 2003-4.

- 11% of businesses, rejected for term loans, accessed a SFLG loan versus 3% of businesses with no such rejections.
- 6% of start-ups accessed SFLG loans versus 4% of established firms.

A tentative conclusion from these results is that younger businesses, with fewer assets, and which have been denied other loans, are more likely to access SFLG loans. On this evidence SFLG loans are reaching the types of business for which they are intended.

Overdrafts

Analysis of the data on overdrafts revealed the following information:

- The average amount overdrawn is just over £21,000 (\pm £9,000).
- In total, SMEs owe about £12 billion in overdrafts.

(see Table A8.3)

For comparison with data collected by the British Banker's Association (BBA), we looked at overdrafts among businesses with a turnover of £1 million or less. These results show that:

- The average amount overdrawn is just over £14,000.
- In total, these businesses owe about £7 billion in overdrafts.

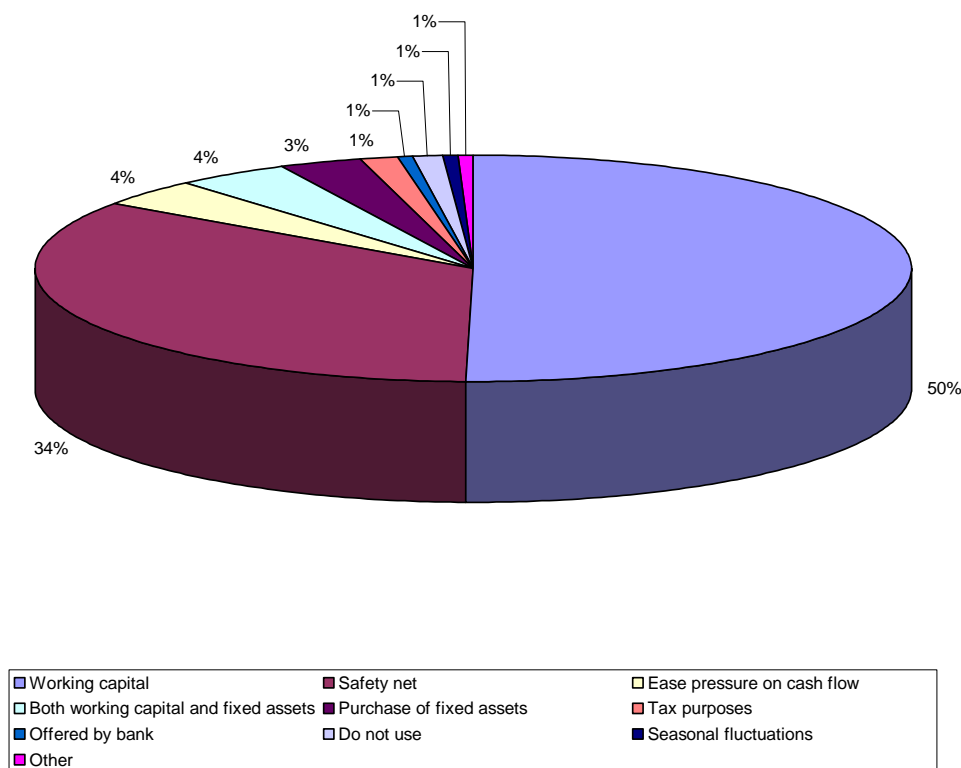
BBA data estimates that businesses, with a turnover of £1 million or less, owed about £9 billion in overdrafts in the last quarter of 2003. SMEF data estimates the total amount outstanding on term loans and overdrafts is about £41.5 billion; the corresponding BBA estimate, for the last quarter of 2003, is £38.9 billion.

Table A8.3 also indicates that:

- The average secured overdraft limit is £83,000. These overdrafts account for 27% of all overdrafts.
- The average unsecured overdraft limit is just under £20,000. These overdrafts account for 70% of all overdrafts.
- Ethnic minority owned businesses have significantly lower overdraft limits than white owned businesses (£18,000 versus £35,000).
- Start ups have significantly lower overdraft limits than established firms (£7,000 versus £35,000).

The following chart shows the main purposes for using an overdraft

Figure 8.3: Main Purpose of Overdraft Facility



Base: All SMEs with overdraft facilities $N_p = 1,919,574$ (Unweighted $N = 1,650$)

The main purposes of having an overdraft facility are:

- To fund working capital (50% of businesses)
- As a safety net (34% of businesses)
- To ease pressure on cash-flow (4% of businesses).

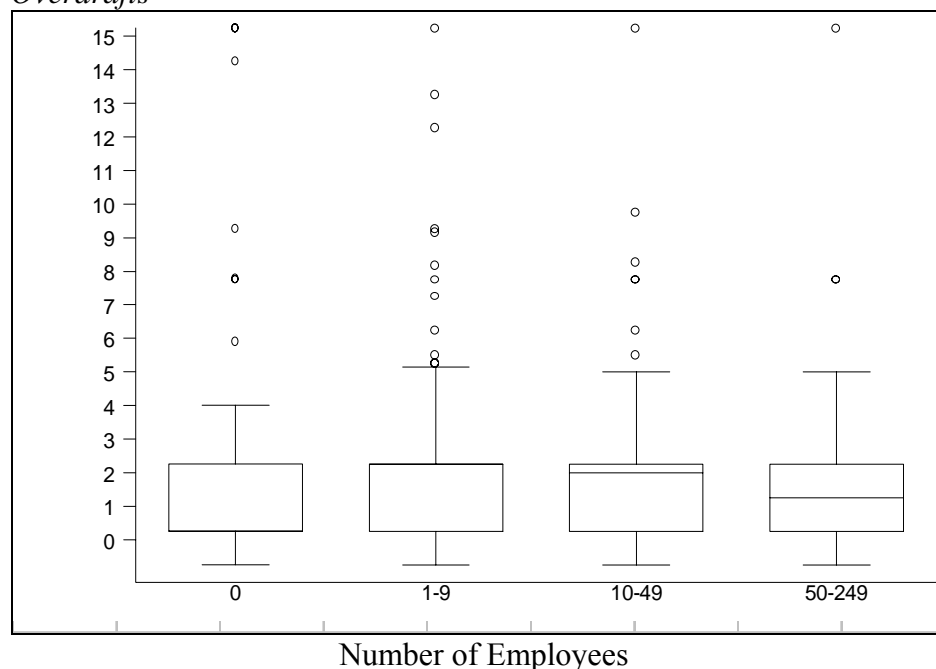
Margins

It was argued in Section 1 that, as a consequence of information asymmetries, the price-mechanism is unable to allocate loans efficiently. In particular, it may be optimal for lenders to hold the cost of borrowing below the market rate since raising interest rates may lead to the selection of riskier borrowers into the loan pool. Accordingly, some authors have argued that ‘stickiness’ in loan margins is evidence of market failure in debt-finance markets (Goldfeld, 1966; Berger and Udell, 1992). Empirically, if this hypothesis is correct, we would expect the distribution of loan margins to be relatively narrow.

In light of these considerations, we conclude this section by looking at variations in loan margins. A useful graphical tool for looking at data variations is the ‘Box and Whisker’ plot used earlier. This analysis is supplemented with a tabulation of the cumulative distributions of loan margins for all SMEs reporting interest payments (see Table A8.3 in Appendix to Section 8).

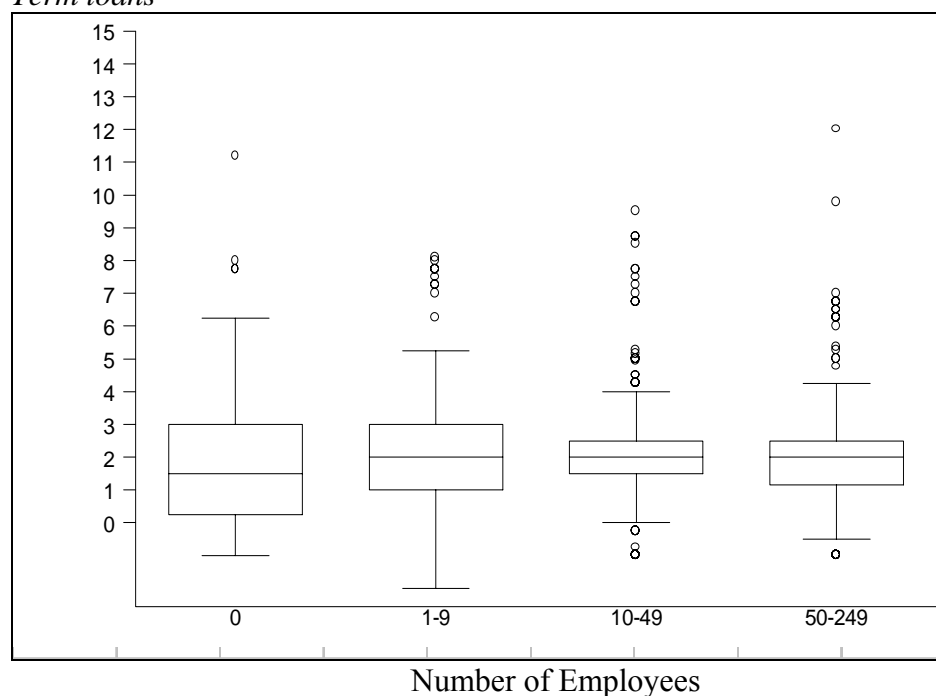
Figure 8.4: Overdraft and Term Loan Margins over Bank of England Base Rate by Number of Employees (Box and Whisker) (All businesses with overdrafts or term loans and reporting interest payments)

Overdrafts



Base: All SMEs with overdrafts reporting interest payments $N_p = 995,039$ (Unweighted $N = 1,080$)

Term loans



Base: All SMEs with term loans reporting interest payments $N_p = 633,574$ (Unweighted $N = 735$)

For overdrafts:

- The median margin is about 2 points over Base.
- This figure is closer to 1 point over Base for medium-sized firms (50-249 employees).
- The bulk of margins (within the box) lie between 0 and 2 points over Base.
- There are very few instances of margins exceeding 4-5 points over Base.

For term loans:

- The median margin is about 2 points over Base.
- The bulk of margins for businesses with no employees lie between 0 and 3 points over Base.
- For businesses with 10-49 employees, most margins lie between 1.5 and 2.5 points over Base.
- There are very few instances of margins exceeding 4-6 points over Base.

Table A8.3 also shows that:

- Less than 1 in 40 overdrafts carry a premium of more than 5.5 points.
- This figure is closer to 1 in 20 for term loans.

Comment

Bank of England (2004) reports an average margin of 2 percentage points at the end of 2003. Also, the narrow spread of margins, in our data, is compatible with evidence on margins reported in Cruickshank (2000).⁵⁹

In the Appendix to Section 8 (Table A8.4) we look at average margins over different types of business. The key results from this table are that:

- Both overdrafts and term loans carry an average margin of 2 percentage points.
- Margins on overdrafts tend to diminish with firm size.
- Very long financial relationships tend to reduce margins relative to intermediate relationships.
- Majority female-owned businesses pay significantly *higher* margins on term loans than male-owned businesses (2.9 versus 1.9 percentage points over Base). This result is robust when controlling for business and loan characteristics.⁶⁰
- Ethnic-minority owned businesses pay significantly *lower* margins on term loans than white-owned businesses (1.2 versus 2.3 percentage points over Base). Again, this result is robust when controlling for business and loan characteristics.

⁵⁹ The Box and Whisker plots indicate that there are a handful of instances, for both term loans and overdrafts, of reported margins in double figures. It is possible that these instances reflect reporting error.

⁶⁰ Regressing loan margins on a loan default indicator, the size of the loan, the length of relationship with the main bank, business, an indicator for variable rate loans, as well as other business and regional characteristics, indicates that female owned businesses pay a 1.1 percentage point premium relative to male owned businesses.

- There are no significant differences, in either overdraft or term loan margins, by business age or growth rate.
- Also, switching banks, or using multiple providers, does not appear to increase the cost of borrowing.

Comment

There is some evidence that longer financial relationships yield borrowers better terms in the form of lower margins. This supports the idea that, with longer relationships, lenders become more informed about borrowers' creditworthiness, allowing them to offer good borrowers better terms.

The results for female-owned and ethnic-minority businesses are interesting, suggesting that only the former group pay more for their borrowing than the respective majority groups. However, recall that there is also evidence that ethnic minority businesses are more likely to be denied finance than otherwise similar white-owned businesses (whereas female-owned businesses are no more likely than male-owned businesses to be denied finance: see Section 5). This suggests that lenders tend to select ethnic minority businesses with below average risk (and female owned businesses with above average risk). This finding raises important issues for policy makers, in both banks and government, to consider. Again, the follow-up survey on ethnic minority business finance may shed more light on these issues.

Failure to make repayments

Businesses were asked how many times they had failed to make any kind of repayment on a term loan in the last 12 months. Analysis of these responses is given in Table A8.5. These results show that, among users of term loans:

- 5% failed to make one or more repayments.
- This rate is apparently higher for smaller businesses and sole traders. However the sample sizes are too small to be confident about this result.
- For similar reasons, we are unable to reach robust conclusions regarding variations by gender, ethnicity, age of business and growth rates.

9 ASSET FINANCE (LEASING AND HIRE-PURCHASE)

We begin this analysis by looking at the types of asset finance used by SMEs.

Table 9.1: Types of Asset Finance Currently Used (Businesses using Asset Finance) (Population Percentages)

	LEASING	HIRE-PURCHASE	BOTH	DON'T KNOW
<i>All businesses</i> $N_p = 679,323$ $N = 938$	33%	58%	8%	1%
<i>Number of employees</i>				
0	26%	72%	2%	1%
1-9	37%	53%	9%	0%
10-49	40%	41%	16%	2%
50-249	28%	48%	24%	0%
<i>Turnover (£)</i>				
Less than 10,000	22%	64%	0%	13%
10,000-49,999	16%	82%	1%	0%
50,000-99,999	43%	49%	8%	0%
100,000-249,999	37%	59%	4%	0%
250,000-499,999	21%	67%	12%	0%
500,000-999,999	43%	47%	8%	1%
1,000,000-4,999,999	41%	38%	21%	0%
5,000,000 or more	34%	54%	11%	1%

This table shows that, among SMEs using asset finance:

- About 1 in 3 use leasing only.
- 3 in 5 use hire-purchase only.
- Less than 1 in 10 use both leasing and hire-purchase.
- The incidence of using both forms of asset finance increases with firm size: almost 1 in 4 medium-sized firms (50-249 employees), using asset finance, have both forms.

In Table A9.1, we report estimates of monthly repayments on asset finance agreements, across different types of business. This table shows that:

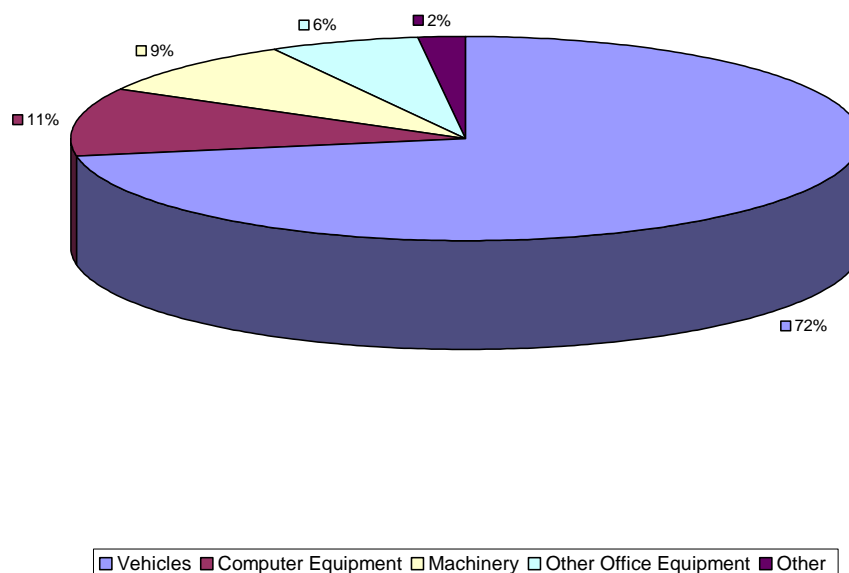
- The average monthly repayment, on asset finance agreements, is just over £3,000.
- This represents total monthly repayments of £2 billion across all businesses with asset finance agreements.

- Repayments among ethnic minority owned businesses are significantly lower than in white owned businesses (£709 versus £3,123). This result is robust when controlling for other business characteristics.⁶¹

Purpose of using asset finance

The types of asset funded, using leasing or hire-purchase, are reported in the following chart:

Figure 9.1: Type of Asset Funded with Asset Finance



Base: All SMEs with overdraft facilities $N_p = 679,323$ (Unweighted $N = 938$)

This chart indicates that:

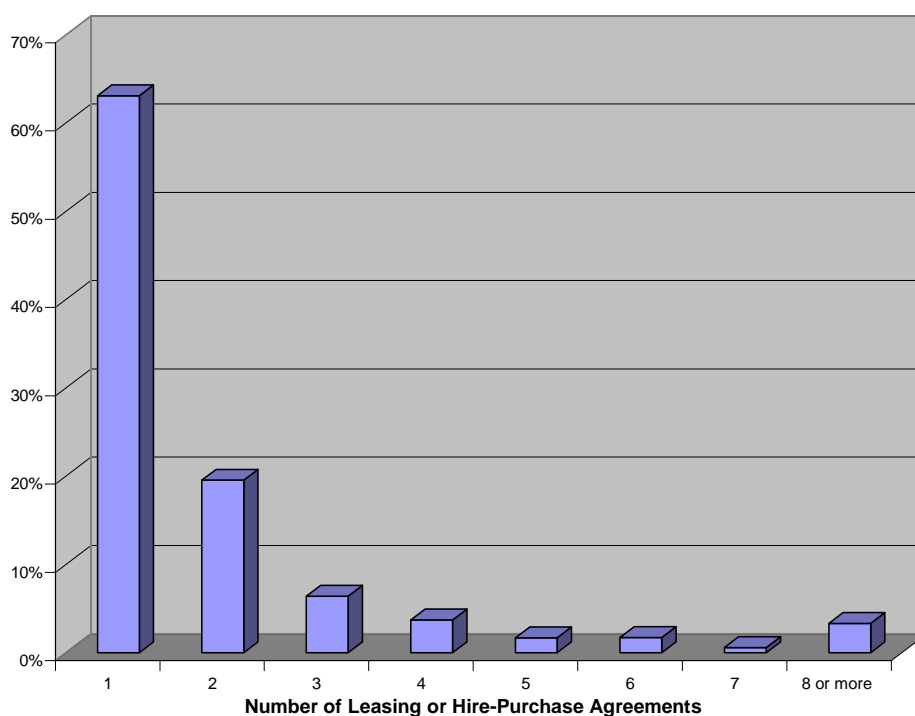
- 72% of businesses use asset finance to pay for vehicles.
- 11% of businesses use asset finance to pay for computer equipment.
- 9% of businesses use asset finance to pay for machinery.

Number of asset finance agreements

The distribution of the number of leasing or hire-purchase agreements used is reported in the following chart

⁶¹ The monthly cost of asset finance was regressed on an indicator for ethnic minority businesses and other business characteristics. These estimates indicate that white owned businesses pay about £3,200 more, than ethnic minority owned businesses, per month on asset finance.

Figure 9.2: Distribution of the Number of Leasing or Hire-Purchase Agreements



Base: All SMEs with Leasing or Hire-Purchase Agreements $N_p = 672,331$
(Unweighted $N = 926$)

This chart shows that, among businesses using asset finance:

- 2 in 3 have one lease or hire-purchase.
- About one-third have more than one leasing or hire-purchase agreements.

Failure to make repayments

Businesses were asked how many times they had failed to make any kind of repayment on an asset finance agreement in the last 12 months. Analysis of these responses is given in Table A9.1. These results show that, among users of asset finance, 1.5% failed to make at least one repayment in the last year.

Tax

Limited companies, using asset finance, were asked whether the availability of accelerated capital allowances influenced their decision to use asset finance rather than purchase the asset outright ($N_p = 280,670$, $N = 633$). 42% of these companies said they were aware of such allowances. Of those companies that were aware of the allowances ($N_p = 116,588$, $N = 336$), 40% said they took them into account when deciding whether to lease or purchase the asset outright.

10 ASSET BASED FINANCE (FACTORING, INVOICE DISCOUNTING AND STOCK FINANCE)

We begin this section by looking at the types of asset-based finance being used by SMEs. Turnover bands are more broadly aggregated, in this section, due to the small number of businesses using this type of finance.

Table 10.1: Types of Asset-Based Finance Currently Used (Population Percentages)

	INVOICE DISCOUNTING	FACTORING	STOCK FINANCE	DON'T KNOW
<i>All businesses</i> $N_p = 66,186$ $N = 158$	49%	36%	7%	6%
<i>Number of employees</i>				
1-9	41%	42%	12%	4%
10-49	53%	35%	3%	9%
50-249	73%	13%	3%	7%
<i>Turnover (£)</i>				
<500,000	64%	46%	1%	13%
500,000-999,999	50%	42%	2%	9%
1,000,000-4,999,999	45%	31%	17%	5%
>5,000,000	52%	45%	0%	2%

These results indicate that, among SMEs using asset-based finance:

- More than a half use invoice discounting.
- 2 in 5 use factoring.
- 1 in 20 use stock finance.
- Large numbers of businesses 'don't know' the type of asset-based finance being used.

Comment

On the basis of 'don't know' responses, the degree of financial 'ignorance' about the type of asset-based finance being used appears to be relatively high (contrast the much lower incidence of 'don't knows', in Table 9.1, relating to asset finance). However, larger firms appear to be better informed.

Next we look at the amounts of asset-based finance being used. The following analysis relates specifically to invoice discounting and factoring (invoice finance).

Table 10.2: Amount of Invoice Finance (% of Unpaid Invoices)

	INVOICE DISCOUNTING		FACTORING	
	Average (%)	Error Margin \pm	Average (%)	Error Margin \pm
<i>All businesses</i>	45.3 [Median=62.5]	11.8	56.3 [Median=77.5]	11.4
$N_p = 66,186$ $N = 158$				
<i>Number of employees</i>				
1-9	24.6	6.1	78.8	2.2
10-49	66.3	9.6	76.5	6.9
50-249	78.8	2.9	61.7	18.8
<i>Turnover (£)</i>				
<500,000	25.2	0.8	41.4	26.9
500,000-999,999	48.2	21.8	76.4	4.9
1,000,000-4,999,999	51.5	24.5	73.6	9.2
>5,000,000	64.3	13.5	80.6	1.4

Table 10.3: Amount of invoice finance in money terms; monthly average and total advances (all types of invoice finance)

	AVERAGE (£)	ERROR MARGIN \pm	TOTAL ADVANCES (BILLIONS £)	ERROR MARGIN \pm
<i>All businesses</i>	145,974	77,200	7.8	4.7
$N_p = 66,186$ $N = 158$				
<i>Number of employees</i>				
1-9	175,245	171,945	3.3	3.7
10-49	224,797	148,625	3.6	2.5
50-249	227,031	69,268	0.9	0.2
<i>Turnover (£)</i>				
<500,000	3,097	3,471	0.1	0.1
500,000-999,999	39,440	30,453	0.4	0.4
1,000,000-4,999,999	229,246	108,086	2.8	2.4
>5,000,000	393,214	187,892	3.2	3.5

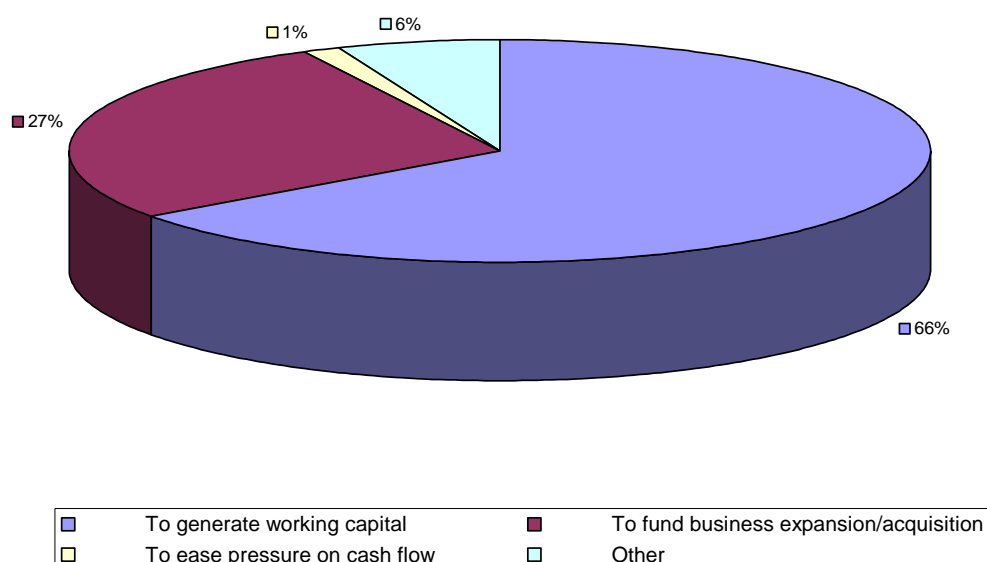
This table shows that, among businesses using invoice finance:

- The average amount advanced per month is about £146,000.
- The corresponding total advanced is just under £8 billion

For comparison, the Factors and Discounters Association (FDA) reported the average advance, at the end of 2003, was £145,000. FDA also report that total advances were £5 billion, among businesses with turnover below £10 million. SMEF data estimates that total advances, based on the same upper threshold, is £5.6 billion (not reported in Table 10.3).

Main purpose of using invoice finance

Figure 10.1: Main Purpose of Using Invoice Finance



Base: All SMEs using Invoice Finance $N_p = 66,186$ (Unweighted $N = 158$)

- 2 in 3 businesses use invoice finance to fund working capital.
- More than 1 in 4 use it to fund business expansion and acquisition.

11 CREDIT CARDS

The analysis in section 3 showed that credit cards are widely used by SMEs. In this section, we examine the significance of this usage by looking at the amounts charged to credit cards and the purposes of these expenditures.

In Table A11.1 (Appendix to Section 11) we report the average and total amounts, charged monthly, to both personal and business credit cards, used for business purposes.

Table A11.1 results show that:

- The average amount charged to personal credit cards is £433.
- This represents a total monthly expenditure of £450 million.
- Business credit cards accrue monthly expenditures of over £1,100.
- This amounts to a total of £1.4 billion per month.

Also,

- Start-ups charge more on personal credit cards, but less on business credit cards, than established businesses. Again, this highlights the importance of personal financial products in the early stages of business (see also Section 4).
- There are no significant differences, in average spending on credit cards, by gender, ethnicity or growth rate.

The purposes of these expenditures are examined in the following table:

Table 11.2: Purposes of Using Personal and Business Credit Cards (Population Percentages)⁶²

PURPOSE	PERSONAL CREDIT CARDS	BUSINESS CREDIT CARDS
Travel and subsistence	39%	36%
Motor Expenses	39%	40%
Rent and rates	3%	1%
Utility bills	4%	4%
Raw materials	39%	42%
Other working capital	6%	7%
Buying equipment/vehicles	13%	12%
Other fixed assets	5%	5%
Client entertaining	2%	3%
Sundry expenses	25%	24%

This table highlights that:

- The patterns of expenditures are very similar across personal and business credit cards.

⁶² Respondents were able to give multiple responses to this question, so the percentages need not sum to 100%.

- The majority of these expenditures are to fund day to day expenses such as: paying for raw materials (39%); motor (39%) and travel expenses (39%); and sundry expenses (25%).
- However significant numbers use credit cards to pay for fixed capital: about 12% use them to pay for equipment and vehicles; and 5% purchase other fixed assets.

Further analysis of credit card data shows that:

- 21% of business owners are never re-imbursed for business expenditures on personal credit cards.
- 19% are occasionally re-imbursed for these expenditures.
- 58% are always re-imbursed in full for these expenditures.
- 79% pay-off business expenditures, on personal credit cards, in full at the end of each month.⁶³
- 95% pay-off business expenditures, on business credit cards, in full at the end of each month.⁶⁴

In particular, the last two points suggest credit cards are more commonly used as a method of payment rather than a source of finance. However, a significant minority of owners (1 in 5) appear to use personal credit cards for business borrowing purposes. A similar number never recoup expenditures on personal credit cards from business funds (see first bullet point).

⁶³ This figure rises to 97% for businesses with 50-249 employees and ethnic minority businesses.

⁶⁴ In this case the figure rises to 99% for businesses with 50-249 employees and ethnic minority businesses.

12 EQUITY FINANCE

The analysis of equity finance is aggregated due to the small numbers, in the sample, using this type of finance (recall that only 3% of SMEs have used equity finance from any source in the last 3 years: see Table A3.2). In particular, we are unable to conduct analysis by separate types of equity finance, such as venture capital.

In the first instance, however, we look at the types of equity investor used recently by SMEs.

Table 12.1: Types of Equity Investor Used in the Last 3 Years (Population Percentages)

$N_p = 106,382$	
$N = 112$	
Business Angels	1%
A Venture Capital Firm	2%
A Private Equity Firm	1%
Family	6%
Friends/Business Associates	10%
Existing Shareholders	12%
Directors	25%
Employees	5%
Other	26%
Don't know	16%

Among businesses, which have used equity finance in the last 3 years:

- Directors are the most popular named source accounting for 1 in 4 equity investments.
- About 1 in 10 of these businesses has received funds from existing shareholders or friends.
- A little over 1 in 50 obtained funding from a venture-capitalist or private equity firm.⁶⁵

Reasons for using informal investors

The main reason for seeking investments from sources 'close to home' (i.e., friends, existing shareholders and directors) are analyzed in the following table. In particular we are interested in assessing the available evidence for constraints in the supply of other, formal, sources of equity finance.

⁶⁵ The term 'private equity' usually encompasses all types of equity investments in unquoted companies. Venture capital is a sub-category of private equity which relates specifically to seed and early stage investments. The term 'private equity' is used separately in this report to denote larger investments e.g., for management buy-outs/buy-ins.

Table 12.2: Main Reason for Raising Equity from Friends, Family and Directors as Opposed to Other Sources (Population Percentages)

Unable to raise equity from other sources	4%
To maintain control of business	20%
Low cost	16%
Least hassle	17%
No need for another source	22%
Other	4%
Don't know	17%

- 1 in 5 business-owners cited ‘to maintain control of the business’ or ‘no need for another source’ as the reason for the choice of investor (cumulatively 40%).
- Less than 1 in 20 cited supply-side constraints (‘unable to raise equity from other sources’) as the reason.

Comment

These results do little to support the notion of an ‘equity gap’ in the supply of formal venture capital to SMEs.⁶⁶ The low take-up of venture capital would appear to be due to a lack of demand, relating to business-owners’ reluctance to share control of the business with outside investors.⁶⁷ In a similar vein, data from the Global Entrepreneurship Monitor in 2003 indicates that about two-thirds of applicants for equity finance are successful.⁶⁸ Of the one-third rejected, the main reason for rejection was the unsuitability of the business for equity finance. Again, this is indicative of constraints lying on the demand-side rather than the supply-side. It should, nonetheless, be emphasized that SMEF is a general survey of SME finances so firm conclusions cannot be drawn about equity gaps (not least, because of the small sample of equity users).

To conclude this section, we look at the average and total amounts of investments from all sources of equity finance combined

⁶⁶ Investors may view the comparatively small amounts required by small firms as not worthwhile given the high fixed costs of equity investments. In particular, regardless of the size of the business, investors must go through extensive checks on the business and its owners before investment (due diligence) and monitoring after investment to ensure the business is being run effectively. Accordingly, there have been concerns about the presence of a gap in the supply of small levels of equity. This has led to recent public interventions, in formal equity markets, such as the Regional Venture Capital Funds.

⁶⁷ Interestingly, among high growth and start-up businesses, the percentage reporting that they could not obtain equity from other sources is only 1-2%. Even allowing for the error in estimation, there is no evidence that these businesses are any more likely to suffer from supply-side constraints than other types of business.

⁶⁸ In 2003, GEM was based on a sample of 22,000 adults across the UK.

Table 12.3: Equity Finance: Average and Total Amounts Invested in the Last 3 Years (£) (Population weighted)

$N_p = 106,382$ $N = 112$	AVERAGE (£)	<i>ERROR</i> <i>MARGIN</i> ±	TOTAL (BILLIONS £)	<i>ERROR</i> <i>MARGIN</i> ±
All sources	134,262	116,036	14.3	12.2

- The average investment is just under £135,000.
- The total raised from all equity investors, in the last 3 years, is just over £14 billion.
- There is wide variation in these estimates, reflecting the small sample size.

13 GRANTS

The following table reports average and total amounts of grant finance accessed in the last 3 years.

Table 13.1: Value of Grants Awarded to Businesses in the Last 3 years (Averages and Totals) (Population Weighted)

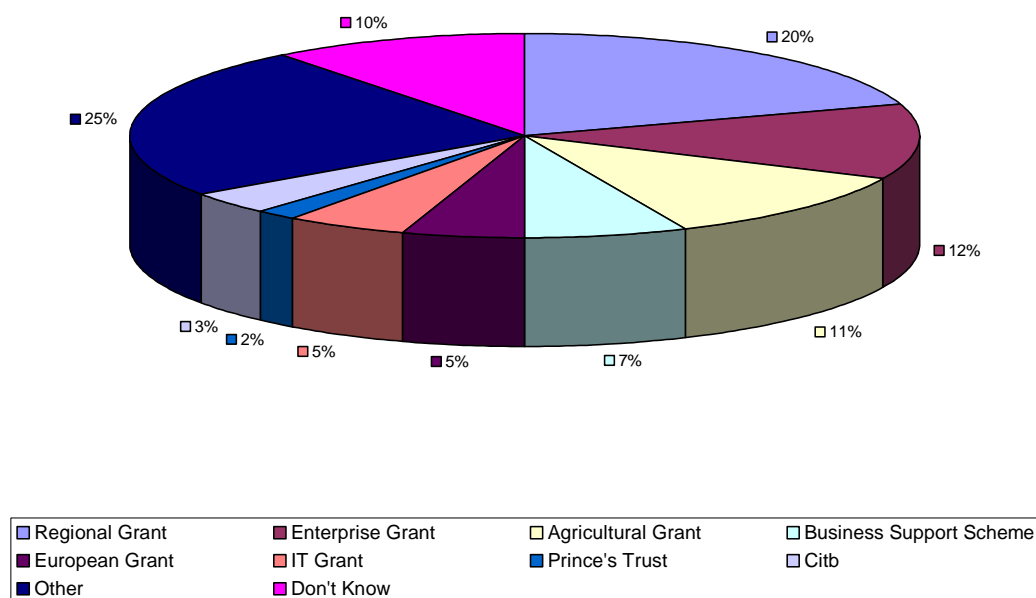
	AVERAGE (£)	ERROR MARGIN \pm	TOTAL (BILLIONS £)	ERROR MARGIN \pm
<i>All businesses</i> $N_p = 231,840$ $N = 341$	32,681	14,447	7.6	3.5
<i>Number of employees</i>				
0	18,928	19,363	1.6	1.6
1-9	39,980	23,561	4.7	3.1
10-49	34,573	16,050	0.9	0.4
50-249	83,380	37,201	0.4	0.2
<i>Turnover (£)</i>				
Less than 10,000	27,587	21,815	0.1	1.6
10,000-49,999	7,828	6,113	0.5	0.4
50,000-99,999	17,878	14,147	0.6	0.6
100,000-249,999	60,765	62,857	1.8	2.5
250,000-499,999	68,371	55,823	1.4	1.4
500,000-999,999	47,591	58,786	0.9	1.2
1,000,000-4,999,999	32,017	26,268	0.9	0.8
5,000,000 or more	94,751	127,786	1.2	1.5

The key results here are that:

- The value of the average grant awarded is about £33,000.
- The total value of grants awarded to SMEs in the last 3 years is £7.6 billion.
- The total value of assistance to businesses with less than 10 employees is £6.3 billion, over 80% of the total awarded to all SMEs.

Grant sources

Figure 13.1: Sources of Grants Accessed in the Last 3 years



Base: All SMEs with grants $N_p = 231,840$ (Unweighted $N = 341$)

The main sources are:

- Regional Grants (20%).
- Enterprise Grants (12%).
- Agricultural Grants (11%).
- Business Support Scheme (7%)

The large number of different grant sources is highlighted by the 25% of businesses naming another, unspecified, source. Also, there is a surprising degree of ignorance as to the actual grant source (10% 'Don't Know').

14. RELATIONSHIPS BETWEEN FINANCES

We conclude the analysis in this report by looking at the relationships between the different forms of finance analyzed individually in previous sections. In particular, the aim here is to investigate:

- The types of finance which are more likely to be used as *alternatives* to each other (substitute finances). These are finances which are in competition with each other, since a rise in the demand for one implies a fall in the demand for the other.
- The types of finances which are more likely to be used in *conjunction* with each other (complementary finances). These finances are not in competition with each other since a rise in the demand for one also implies a rise in the demand for the other.

To achieve this analysis models, relating the probability of using one source of finance to other sources (controlling for owner, business, regional and industry characteristics), are estimated. A positive relationship between finances is indicative that these finances are complements; a negative relationship suggests the finances are possible substitutes for one another.

Cruickshank (2000) reports that only 29% of firms considered alternatives to their main source of finance (usually a term loan or overdraft). The alternative tended to be the other traditional bank debt product from the one chosen, rather than less traditional forms such as asset and asset-based finance. Even fewer firms considered equity finance as an alternative to their main source. Cruickshank took this as evidence that: the market for traditional bank debt is distinct from the market for other debt products; and that competition from other debt products, and equity, have only a limited restraint on traditional bank debt prices.

Estimates of the relationships between finances, based on probit models relating the use of various finances, are reported in the following table. These estimates, by controlling for the influences of business and owner characteristics on the use of finances, represent the underlying relationships between finances.

Table 14.1: The Relationships between Finances. Marginal Effects ($\times 100$) of Different Sources of Finance (Independent variables) on the Likelihood of using other Finances (Dependent variables) (Population Weighted, Instrumental Variable, Probit Estimation) (Estimates of Control Variables Not Reported ¹)

DEPENDENT VARIABLE→	OVERDR AFTS	P-VAL	TERM LOANS	P-VAL	ASSET FINANCE	P-VAL	ASSET-BASED FINANCE	P-VAL
INDEPENDENT VARIABLES↓ ²								
Overdraft			-36	0.02	-42	0.00	0	0.94
Term Loan	-76	0.00			-7	0.59	-1.1	0.12
Asset Finance	-22	0.35	-25	0.00			-0.2	0.62
Asset-based Finance	2	0.94	-13	0.06	-19	0.00		
Credit Cards	-52	0.00	-76	0.00	-68	0.00	-18.2	0.03
Equity Finance	-64	0.00	-14	0.01	-16	0.00	-0.4	0.00
Grant Finance	-20	0.47	-16	0.00	-4	0.82	0	0.98
χ^2 (p-value)	0.00		0.00		0.00		0.00	

Table 14.1 continued

DEPENDENT VARIABLE→	CREDIT CARDS	P-VAL ³	EQUITY FINANCE	P-VAL	GRANTS	P-VAL
INDEPENDENT VARIABLES↓ ²						
Overdraft	-23	0.32	-1.9	0.33	-4	0.20
Term Loan	-77	0.00	3.5	0.48	25	0.07
Asset Finance	-58	0.00	-0.1	0.07	4	0.39
Asset-based Finance	-61	0.00	0	0.00	-2	0.00
Credit Cards			-0.1	0.56	-12	0.11
Equity Finance	6	0.86			0	0.93
Grant Finance	-58	0.00	0.1	0.72		
χ^2 (p-value)	0.00		0.00		0.00	
N	2,175					
N_p	2,960,475					

Notes:

1. The controls are for: firm size (employees, turnover and assets); legal status; dummy variables for majority-owned female and ethnic minority businesses; owner manager personal characteristics (age and experience); financial relationship variables (length of relationship with main provider, numbers of financial providers and products, rejection and discouragement dummies); industry dummies; and regional dummies.

2. The independent variables are instrumented due to the *endogeneity* of finances. In particular firms which use multiple finances are likely to have different (unobserved) characteristics from firms which use few finances. Failure to take these differences into account will result in correlation between the independent variables and the error terms in the models, causing the estimates of financial relationships to be biased and inconsistent. The finance variables are, accordingly, instrumented with their predicted probabilities. These probabilities were obtained from population weighted probit estimates which

included the exogenous variables, listed at note 1, as well as dummy variables for seeking finance in the last 3 years and for the business's main bank. These latter variables are excluded from the models for finance relationships, in order to identify the relationships between the finances.

3. 'p-value' denotes the exact level of significance of the estimates. A value below 0.05 (0.10) indicates significance at the 5% (10%) level.

These results show that:

- There is a strong degree of substitutability between traditional bank debt finances (term loans and overdrafts). In particular, using a term loan reduces the likelihood of having an overdraft facility by almost 80 percentage points (holding firm characteristics constant).
- Asset finance is a potential substitute for term loans. Businesses which use asset finance are 25 percentage points less likely to use term loans, other things being equal.
- Asset-based finance, credit cards, equity finance and grants are also potential substitutes for term loans.
- Interestingly, term loans, asset finance and asset-based finance are strong substitutes for credit cards. Businesses would, most likely, get cheaper finance by replacing credit card borrowing with some other form of debt.⁶⁹
- There is no relationship between overdrafts and asset-based finance. This is surprising since asset-based finance is often viewed as a substitute for overdraft finance.⁷⁰
- The remaining estimates are, in general, indicative of varying degrees of substitutability/competition between finances.
- However, firms with term loans are more likely to use grants (but not vice-versa) suggesting, to some extent, these finances are complements.⁷¹

Comment

Overdrafts and term loans have the strongest degree of substitution, relative to other debt products. This finding supports the view that the market for traditional bank debt is distinct from the market for other debt products (Cruickshank, 2000). The results also indicate that less traditional forms of finance, such as asset and equity finances, could *potentially* be used instead of traditional debt finances. This suggests that competition from other debt products, and equity, could affect the demand for traditional bank debt. However, the final decisions about what finances to use will

⁶⁹ These estimates for credit cards, in showing other forms of finance are substitutes, appears to highlight their function as a source of finance; in contrast, the role of credit cards as a payments mechanism would seem to be complementary to the use of other finances.

⁷⁰ It may be, however, that businesses using asset based finance have lower outstanding overdrafts than otherwise similar businesses which do not use asset based finance. This would indicate that asset based finance is being used as an alternative to overdrafts, but not to the complete exclusion of having an overdraft. We leave the empirical testing of this conjecture to future research.

⁷¹ In fact, the results indicate that the chance of having a grant increases *conditional* on the firm having a loan (grant equation). In contrast, the chance of using a loan decreases conditional on the firm having a grant (term loan equation). The first result is unsurprising since the provision of grants is often conditional on the firm being able to match the amount of grant funding (perhaps, using loan finance). However, regarding the second result, given the firm has a grant it may have less need of a loan.

very much depend on individual firm and owner characteristics, and the nature of the project being funded.⁷²

⁷² We re-iterate that the estimates of financial relationships in Table 14.1 control for both observed and unobserved differences between firms. This, in effect, randomizes the use of finances allowing us to uncover the true relationships between the finances themselves. To take a concrete example, firms with more talented financial managers may be more likely to use *both* debt and equity in their finance portfolios, whereas less skill-endowed businesses may use *neither*. If we failed to take these inter-firm differences into account, our estimates would yield a spurious *positive* relationship between debt and equity finances (this pattern was observed, in practice, for results which did not use instrumental variables). These estimates would, however, only reflect the talent differences between firms and not the true relationships between the finances themselves.

15. CONCLUSIONS

The 2004 UK Survey of SME Finances is the first national, representative survey of SMEs in the UK to offer a close analysis of businesses, their main owners, finance and banking relationships. The aim of this report has been to set out the initial findings from this survey. The length of this report reflects the breadth and detail of the information collected.

The overall impression, gained from the analysis, is that most SMEs are getting the finance they want. In this respect we have found that:

- SMEs report that finance (cost and access) is the second least problem area (after production) in running the business. The biggest reported problems relate to coping with red tape.
- 44% of SMEs sought new (formal) finance in the last 3 years; among those that did not, the overwhelming majority (95%) said that they had no need for new finance.
- 11% of SMEs, which needed new (formal) finance, were rejected outright for debt or equity (180,000 businesses): but, in fewer than 5% of these cases (3,500 businesses), did the rejection have dire financial consequences.
- Only 6% of SMEs report using (informal) loans or equity finance from friends and family.

A closer inspection of the data reveals a wide range of experiences, in accessing finance, across different types of business. For example, preliminary findings for ethnic minority owned businesses, taken as a whole, suggest that these businesses experienced more difficulties in obtaining finance than white-owned businesses. However, the collection of more data, allowing analysis by different ethnic minority groups, is essential before any proper conclusions can be drawn.⁷³

In contrast, regarding female owned businesses, we can reach firmer conclusions on the basis of the current survey. Specifically, we find that:

- Female owned businesses have similar levels of confidence, across all aspects of business operations, as male-owned businesses.
- Female owned businesses have similar levels of problems, across all aspects of business operations, as male-owned businesses.
- Female owned businesses are as likely to have sought, and sought the same amount of, new finance as male-owned businesses.
- Female owned businesses have similar rejection rates as male-owned business.

On the downside, however, female-owned businesses pay significantly *higher* margins on term loans than male-owned businesses (2.9 versus 1.9 percentage points over Base). This result continues to hold after controlling for other business and loan characteristics.

⁷³ Indeed, further research into the finances of ethnic minority businesses will get underway shortly, with funding provided by the Small Business Service.

Start-up businesses are another group to have attracted (renewed) policy interest in recent times. The survey indicates these businesses have mixed experiences with finance. In particular:

- For almost 2 in 3 entrepreneurs, personal savings were the principal source of finance used to establish the business.
- However, if they apply for external finance, they are less likely to experience outright rejection than established businesses (4% versus 12%).
- Regarding the amount of external finance, start-ups have smaller loans than established businesses (£61,000 versus £103,000). This result continues to hold after controlling for other business characteristics.
- Similarly, start ups have significantly lower overdraft limits than established firms (£7,000 versus £35,000).

In the light of low rejection rates, the use of personal savings may reflect a preference to retain maximum control over the business, rather than an indication of constraints on the supply of debt or equity. Of course, this analysis is unable to take into account businesses which were still-born due to a lack of finance. If we were able to add these businesses into our analysis, this overall picture might appear differently.

Another issue, of general concern, is the dearth of financial skills in SMEs. Here, we found that:

- Over a third of SMEs use no external financial advisers.
- In the context of other aspects of business operations (productions, sales, staffing and coping with red tape), self-confidence in dealing with finance is middling (among sole traders and partnerships).
- And only 16% of these businesses have their finances managed by someone with a financial qualification.

The analysis highlighted the positive impact of financial qualifications on access to finance. In particular, businesses (sole traders and partnerships) which have a financially qualified person in charge of finances are over 3 percentage points less likely to experience outright rejection. In an environment of low interest rates, and generally available finance, shortages in financial skills may not be a serious issue (as indicated by the low levels of self-reported problems with finance). However, the analysis suggests that the majority of businesses, which lack skilled financial management, could suffer if the economic climate deteriorated.

The survey has also taken a detailed look at financial relationships and the issue of competition in the supply of financial services. Here we find that financial relationships are:

- Long – 15 years on average.
- Monogamous - The majority of SMEs have only one main provider (59%).
- Mainly happy - 90% of businesses are satisfied with the competence of bank staff.

However, almost 1 in 3 businesses report some dissatisfaction with their bank charges (£50 per month on average). In a competitive market we would expect businesses to act upon this dissatisfaction and switch to another bank. In reality, however:

- SME banking is highly concentrated in a few banks - the largest four banks account for 80% of the market for current accounts and overdrafts.
- And the propensity to switch banks is low - each year, 2.5% of SMEs switch banks.

The reasons for the lack of switching are likely to be complex, involving factors on both the demand- and supply-sides. The data do not allow us to look at supply side causes of inertia directly, although we find that a large minority (29%) of businesses would consider switching if approached by another bank (the implication being that rival banks do not attempt to poach customers). On the demand-side, it is often argued that businesses do not switch banks because it would harm their access to finance, or because the process of switching is difficult. However, in this regard, the survey finds that:

- Switching does not increase the chances of rejection.
- Nor does it increase the cost of borrowing.
- And most businesses, which have switched, report that the process was easy.

On the other hand, switching is influenced by firm characteristics. Notably:

- Businesses with qualified financial managers are more likely to switch than those without.
- High growth businesses are 3 times more likely to have switched than slow growing businesses.

This suggests that a lack of financial acumen and dynamism may be the true (demand-side) causes of inertia, rather than the perceived benefits of established banking relationships. The tendency for most firms *not* to shop-around for alternative financial deals may pose few problems with low interest rates and available finance. In a harsher environment, however, the capacity to search for the best, or any, deal may be crucial. In this regard, financially skilled businesses, once again, have the edge over their competitors.

On a more promising note for competition, there is evidence that new entrants, offering distance banking, could attract market share among larger SMEs. These businesses tend to use telephone or internet banking over visiting a local branch. Also analysis of the relationships between finances shows that traditional bank debt faces potential competition from asset- and equity finance.

In conclusion, the analysis in this report supports some previously held views on SME finances, whilst also offering some new insights. However, this report is only the first stage in analyzing the wealth of data which have been collected. In the future, it is hoped that further analysis will facilitate deeper insights into SME finances.

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APPENDICES

APPENDIX 1: SURVEY METHODOLOGY (WRITTEN BY FIONA McANDREW - IFF RESEARCH LTD)

The survey was conducted among 2,500 small and medium sized enterprises (defined as firms with up to 250 employees) in the private sector in the UK. Public sector and not for profit organisations were excluded, together with the Financial Services, Mining and Quarrying, Electricity, Gas and Water Supply sectors (the latter due to the very small numbers in the population).

The survey fieldwork was conducted by telephone by IFF Research, an independent market research company, at IFF's CATI centre between 5 August and 18 October 2004.

Sample profile

The sample was structured to allow for analysis by size, sector and government standard region. Thus, larger firms and those in sectors and regions with a lower proportion of firms were over sampled. Quotas were also set by turnover and whether the business was a start up (defined as trading for less than 24 months). The following sectors and size bands (by number of employees) were included in the survey, across the whole of the UK.

The achieved sample by size, sector, region and turnover is shown below (2003 SIC definitions for sectors are shown in brackets).

Table A1.1: Sample Profile

NO. OF EMPLOYEES BY SECTOR	TOTAL	0	1-9	10-49	50-249
AB Agriculture, Hunting and Forestry; Fishing (01-05)	192	63	83	38	8
D Manufacturing (15-36)	213	46	51	64	52
F Construction (45)	376	74	158	94	50
G Wholesale / Retail (50-52)	390	56	111	133	90
H Hotels and Restaurants (55)	196	37	42	80	37
I Transport, Storage and Communication (60-64)	210	38	57	78	37
K Real Estate, Renting and Business Activities (70-74)	468	98	127	135	108
N Health and Social Work (85)	187	47	41	72	27
O Other Community, Social and Personal Service Activities (90-93)	268	47	103	79	39
TOTAL	2,500	506	773	773	448

Table A1.1: Sample Profile (continued)

REGION			TURNOVER (LAST FINANCIAL YEAR)	
London	220		Under £100K	600
South East	229		£100K to £999,999	833
South West	233		£1m to £9,999,999	711
East	244		£10m+	109
East Midlands	225		Trading for less than a year	83
North East	179		Figures for this year not available yet	47
North West	224		Don't know / Refused	116
West Midlands	222			
Yorkshire and Humberside	208		START UP	
Scotland	199		Trading for less than 24 months	147
Wales	184		Trading for 24 months or more	2,353
Northern Ireland	133			
TOTAL	2,500			

Approach

The initial intention was to conduct interviews with *all* respondents in two stages, as follows:

- 1) Screening of respondents to check if the firm qualified for the study, identify the most appropriate person to interview (owner / manager for smaller businesses and Finance Director or equivalent for larger ones) and obtain agreement in principle to participate in the study.
- 2) Mail out by email, fax or post of letter providing more information about the survey and datasheet to assist respondents in collating the necessary financial information for the main part of the survey
- 3) Main survey

A questionnaire was only considered complete once both the screener and main survey had been completed. The screener took an average of 6 minutes and the main survey an average of 20-25 minutes.

A pilot of the survey was conducted between 21 June and 6 July, to test the questionnaire and survey approach. One of the key pilot outcomes was that the two stage approach was off putting to some respondents⁷⁴ as they felt it would require too much time to complete the datasheet, which had a negative effect on the response rate

⁷⁴ This was one of the key reasons for refusal, another being concerns over confidentiality in relation to divulging financial information about their company.

(i.e. a large number of businesses dropped out between the screener and main survey). As a result only 21 full interviews could be achieved during the pilot. The ratio of main interviews achieved to recruited was 1:12.

Respondents found the questionnaire to be long and repetitive (reflecting the amount and detail of information being collected). However, those who participated in the study were able to provide the majority of the information requested in the required form. The only section of the questionnaire which caused significant difficulties was the section on leasing / hire purchase financing. This was mainly because some firms had multiple agreements for the same type of asset e.g. cars and thus found it difficult to talk about a single (the largest / most recent) agreement.

As a result of the pilot, substantial changes were made to the approach and questionnaire. The key changes were:

- For firms with fewer than 10 employees, the survey was conducted in one stage. This approach was first adopted for sole traders (0 size band) and then extended to firms with 1-9 employees. These groups had more straightforward financial arrangements and it was therefore easier for the respondent to answer the questions without preparation in advance. Respondents were always given the option to arrange an appointment to be interviewed at the most convenient time to them.
- The 'pack' sent to respondents was significantly reduced to make it look less daunting. The original pack consisted of letters both from the Bank of England and IFF, together with a datasheet and 2-3 pages of further notes to assist firms in completing the datasheet, including details of where in their company accounts / tax return they would find the information and examples of how to complete the datasheet. The final pack consisted of a single letter and simplified datasheet. The notes were not included as most respondents knew where to find the required information and interviewers were able to deal with any queries during the interview.
- The questionnaire was restructured to remove unnecessary repetition and was significantly reduced in length. The section on leasing / hire purchase financing was also reworked to make it easier for firms to provide the required information.

Given the substantial nature of the changes made, the revised approach and questionnaire were retested in a second pilot. In particular, we sought to check the impact on the response rate and interview length and also whether adopting a one stage approach for the smallest firms had any negative impact on the quality of the data obtained. The results of the second pilot indicated that the changes made had succeeded in improving the strike rate and reducing the interview length to an acceptable level. It also indicated that adopting the one stage approach for the smallest firms did not lead to a significant increase in non response to key questions – however a higher proportion opted to use the ranges rather than provide an exact figure, which was felt to be acceptable.

Response rate

The response rate to the screener and main survey of the two stage survey are shown on the following two pages, followed by the response rate to the one stage survey.

The response rate to the screener was 38%, which was quite high, reflecting the fact that the survey only involved a few questions at that stage. Among those re-contacted for the main survey and who were in scope for fieldwork, the response rate was 44%. An overall response rate across the two stages can be calculated, if the number of completed interviews (1,668) in the main survey is divided by the number in scope of fieldwork for the screener (18,297). This gives a much lower response rate of 9%.

By comparison, the response rate for the one stage survey was 18%, reflecting the fact that there was no opportunity for respondents to drop out of the survey between stages.

Table A1.2: Response rate for screener (two stage approach)

	Total	Population in scope of study %	Population in scope of fieldwork %
Total amount of used sample	34,181		
Ineligible	1,115		
Another company owns 50% or more of firm	463		
Business owned by agency of local or national government	96		
Business not run for profit or as social enterprise	394		
Business has 250+ employees	162		
Total in scope of study	33,066	100	
Appointment made for interview with target respondent, but not achieved during fieldwork period	52	<0.5	
Business called several times, but unable to reach target respondent	2,076	6	
Not available in fieldwork period	11	<0.5	
Invalid cases	12,630	38	
Unobtainable number	3,586	11	
Out of quota	9044	27	
Total in scope of fieldwork	18,297	55	100
Interviews achieved	7,012	21	38
Refusals	10,717	32	59
Breakdown during interview	568	2	3
Response rate		21%	38%

Table A1.3: Response rate for main survey (two stage approach)

	Total	Population in scope of study %	Population in scope of fieldwork %
Total amount of used sample ⁷⁵	5,264		
Ineligible	0		
Total in scope of study	5,264	100	
Appointment made for interview with target respondent, but not achieved during fieldwork period	33	<0.5	
Business called several times, but unable to reach target respondent	508	10	
Invalid cases	966	18	
Unobtainable number	0		
Out of quota	966	18	
Total in scope of fieldwork	3,757	71	100
Interviews achieved	1,668	31	44
Refusals	1,555	30	29
Breakdown during interview ⁷⁶	534	10	10
Response rate		31%	44%

⁷⁵ 1,748 businesses were recruited but not called back for the second stage. Of these, 158 had not been sent a datasheet when fieldwork finished. The remaining businesses were cases which had received a datasheet but had not been called when fieldwork ended. Many of these will have been cases where the target for the quota they fitted into had already been reached.

⁷⁶ The reason for interview breakdown was often that the respondent found the interview too long. In cases where respondents had several financial products, the interview could last up to 45 minutes.

Table A1.4: Response rate for one stage approach (0 size band and part of 1-9 size-band)

	Total	Population in scope of study %	Population in scope of fieldwork %
Total amount of used sample	12,119		
Ineligible	67		
Another company owns 50% or more of firm	21		
Business owned by agency of local or national government	18		
Business not run for profit or as social enterprise	24		
Business has 250+ employees	4		
Total in scope of study	11,985	100	
Appointment made for interview with target respondent, but not achieved during fieldwork period	28	<0.5	
Business called several times, but unable to reach target respondent	5,893	49	
Invalid cases	1,630	14	
Unobtainable number	1,505	13	
Out of quota	125	1	
Total in scope of fieldwork	4,501	38	100
Interviews achieved	832	7	18
Refusals	3,100	26	69
Breakdown during interview	569	5	13
Response rate		7%	18%

Weighting

The data were projected by size (number of employees) within sector and by region to the total number of SMEs in the UK in scope of the study. The source of the population figures used for weighting was the Small and Medium Enterprise (SME) Statistics for the UK at the start of 2002⁷⁷ provided by the Small Business Service at the DTI.

The data were weighted up to the population of UK enterprises within the scope of the survey in terms of size and sector: 3,625,415 enterprises in total. Interlocking targets were set for size within sector, but region targets had to be defined separately. Rim weighting was applied to reconcile the size by sector and region targets, to achieve the best fit.

The tables below show the profile of the achieved sample, the profile of the survey data once weighted, and the weighting target (because of the rim weighting, it was not possible to achieve a perfect match with the weighting targets).

⁷⁷ These were the most up to date figures available when the sample structure was defined in May 2004.

Table A1.5: Weighted Sample Profile

SECTOR	SIZE	Sample profile	Weighted survey data	Weighting Target
		%	%	%
A, B Agriculture, Hunting and Forestry; Fishing	0	3	2	3
	1 to 9	3	1	1
	10 to 49	2	1	<0.5
	50 to 249	<0.5	<0.5	<0.5
D Manufacturing	0	2	3	5
	1 to 9	2	1	2
	10 to 49	3	1	1
	50 to 249	2	<0.5	<0.5
F Construction	0	3	15	17
	1 to 9	6	5	3
	10 to 49	4	1	<0.5
	50 to 249	2	<0.5	<0.5
G Wholesale and Retail Trade, Repairs	0	2	6	7
	1 to 9	4	8	6
	10 to 49	5	2	1
	50 to 249	4	<0.5	<0.5
H Hotels and Restaurants	0	1	<0.5	1
	1 to 9	2	1	3
	10 to 49	3	<0.5	<0.5
	50 to 249	1	<0.5	<0.5
I Transport, Storage & Communication	0	2	3	5
	1 to 9	2	1	1
	10 to 49	3	<0.5	<0.5
	50 to 249	1	<0.5	<0.5
K Real Estate, Renting and Business Activities	0	4	23	17
	1 to 9	5	11	7
	10 to 49	5	2	1
	50 to 249	4	<0.5	<0.5

Table A1.5: Weighted Sample Profile (continued)

SECTOR	SIZE	Sample profile	Weighted survey data	Weight-ing Target
		%	%	%
N Health and Social Work	0	2	3	5
	1 to 9	2	1	1
	10 to 49	3	1	<0.5
	50 to 249	1	<0.5	<0.5
O Other Community, Social and Personal Service Activities	0	2	5	9
	1 to 9	4	3	2
	10 to 49	3	<0.5	<0.5
	50 to 249	2	<0.5	<0.5

REGION	Sample profile	Weighted survey data	Weight-ing Target
	%	%	%
London	9	21	18
South East	9	17	17
South West	9	9	9
East	10	10	10
East Midlands	9	6	6
North East	7	3	3
North West	9	8	9
West Midlands	9	7	8
Yorkshire and Humberside	8	7	7
Scotland	8	5	6
Wales	7	5	4
Northern Ireland	5	3	2

APPENDIX 2: CONSORTIUM MEMBERS

This study was sponsored by the following organizations:

- Bank of England
- British Chamber of Commerce
- Confederation of British Industry
- Federation of Small Businesses
- Forum of Private Businesses
- Institute of Directors
- Small Business Service
- HM Treasury
- British Venture Capital Association
- Factors and Discounters Association
- FLA (Finance and Leasing Association)
- Abbey Business Banking
- Bank of Scotland
- Barclays Bank
- HSBC
- Lloyds TSB Group
- National Australia Bank Group
- RBS NatWest Group
- The Co-operative Bank