Micro Finance in the North East – Final Report

Assessment of the demand for micro finance in the North East

Final Report

Commissioned by One NorthEast
on behalf of the Access to Finance Expert Group

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Executive summary

This report presents the findings of a study of the micro finance gap in the North East. Existing activity, likely demand over the next five years and whether existing funds can cope with likely future demand were the three elements of this study. The study utilised desk research, consultations with loan funds and other key players, a survey of clients of business support organisations, and analysis and quantification of supply and demand. The findings were reviewed with the steering group and the Access to Finance Expert Group.

Regional micro-finance: an appraisal
The concepts of micro finance and Community Development Finance Institutions or CDFIs are lynchpins in tackling small firms' access to finance in the North East. Research shows that access to small quantities of finance is often difficult for small businesses – and also that there is lack of awareness of existing CDFIs and concerns about their self-sustainability. The North East, a region that has experienced economic turbulence and that has a policy framework to deal with its problems, has a large number of micro finance providers, some of which have specific geographical, sectoral or group restrictions.

Regional ***demand*** *for micro finance*.
VAT statistics show that numbers of businesses in the North East are increasing slightly because of a failure to raise the firm birth rate well above the UK average – which would have the effect of boosting the enterprise stock in the region. Evidence from the British Bankers' Association suggested that businesses might not have difficulties raising finance. However, new and growing businesses do have such difficulties. We were able to estimate, using BBA data and VAT statistics, that bank lending to SMEs in the North East was £981m.

Our survey of business support agency clients revealed that:

- Existing businesses had an average requirement of £15,000, with £4,000 own resources, £5,000 bank support and a gap of £6,000. Some of these clients clearly did not have bankable propositions. The evidence appears to suggest that those who have a well prepared proposition are able to raise the money that they need from commercial sources.
- Prospective start-ups found it more difficult to secure money from banks; they had an average requirement of £25,000, found £9,000 from own resources, £7,000 from the bank and had a gap of £9,000. The gap increases for those who had talked to the bank – to £10,000.
- With 15,100 new starts in the North East in 2003 with 2,500 seeking support from business support organisations and two thirds of those requiring less than £15,000, the total demand could be around £6m.
- Given over-estimation of requirements by some respondents and business support organisations helping clients to secure more from the bank, the gap is in our estimation £3.75m.

However, there is not much scope for increased demand: the evidence (from the Global Entrepreneurship Monitor and from Barclays for example) suggests that the business birth rate in the region will remain low. Static demand will, therefore, be evident over the next five years unless the Business Birth Rate strategy that may emerge from the Business Support Review is more effective than previous strategies.

*Regional **supply** of micro finance and **gap analysis***
In our survey of the region's CDFIs, a large proportion of lending activity, it emerged that at the end of 2003 the CDFIs had 850 applications, made nearly 600 loans totalling £2.2 million, and a loan book of £2.75m. These figures compare reasonably well to other regions; for example, the West Midlands where a micro finance demand study has also been conducted. With capital of £1.7m, Phoenix Fund monies (£1.1m) and additional resources belonging to other funds, we estimate that there is at least £4m available to be lent. As a result, taken as a whole, the funds could meet the expected demand for a year. Not all funds are prolific lenders and so a gap will emerge but will not be apparent over the next one or two years: there is a disparity between lenders and those who have the capital.

In benchmarking CDFIs, we found wide discrepancy in the cost of running the funds. The study also includes ratios relating to sustainability (how closely a fund covers its costs), deployment (how much of each fund's capital is lent), leverage (the effect that funds have in encouraging others to lend alongside them) and revolution (how many times a fund has revolved its capital). These ratios are most useful to practitioners and policy-makers.

Key issues emerging from this study
Surveys and consultations revealed that:

1. If micro loan funds were 'lenders of last resort', an inevitable consequence could be that many borrowers who could access commercial sources would effectively be barred from non-bank micro finance.
2. There is controversy over the notion of rationalising loan funds, which has merits such as administrative cost savings but potential hazards such as borrowers not having a lender on their 'doorstep'. Loan funds should, however, complement each other – not compete – and should have high quality management systems in place.
3. Promoting loan funds could ratchet up demand, but the capacity of funds both to appraise more applications and to support viable propositions could be tested.
4. Default rates are higher than the banks', and so loan funds should learn 'best practice' from others; but more 'risky' applicants could be squeezed out, defeating the objectives.
5. Lack of awareness of the implications of state aid rules is a problem (collectively – not just for businesses but for One NorthEast and potential borrowers): it also increases paperwork.
6. Cost of finance is not an issue for firms.
7. The jungle of loans means that business advisers might not know what is available.
8. Confusion about what regulatory requirements cover micro loan funds is evident – in relation to the Consumer Credit Act 1974 and the Financial Services Authority.
9. Common reporting systems and effective benchmarking would enable funds to learn best practice from one another and would provide evidence to policy makers.

Recommendations

Based upon the findings of the study, we recommend that One NorthEast:

- Makes provision for closing the capital gap from 2006 onwards, when up to £1m per annum may be required, though the level of lending achieved during 2004 will help to inform on the specific size of the gap;
- Prepares a policy position on the basis that supporting micro-finance is an important component of business support, recognising that CDFIs are unlikely ever to be totally sustainable and that they will require some degree of revenue support;
- Works with all the business support network to increase the level of marketing to encourage more new starts, and to encourage more businesses to make use of the available business support;
- Encourages those providing capital to loan funds to adopt uniform assessment criteria (a sample is provided in Annex 6);
- Considers, with the other RDAs, whether it would be beneficial extending this study to other parts of the UK and implementing an annual CDFI performance review;
- Shares results of this research nationally;
- Commissions the preparation of a simple guide to state aid rules; and,
- Stimulates the creation of a CDFI forum in the North East.

1. Introduction

This document is the final report of a study commissioned by One NorthEast on behalf of the Access to Finance Expert Group; and undertaken by Trends Business Research (TBR) and Irwin Grayson Associates. The overall aim of the study was to examine the micro finance gap in the North East and to quantify the expected level of viable but unmet demand over the next five years. In the context of this study, micro finance is defined as (non-bank) loans under £15,000. The study focuses on all types of business including 'conventional' profit-making enterprises, as well as social enterprises. The study has the following clear objectives:

- Quantify existing and predicted demand over the next five years.
- Quantify current and planned supply over this period.
- Quantify the extent of unmet but viable demand.
- Identify reasons for the gap between supply and demand.
- Identify solutions.
- Identify sources of funding activity to bridge the gap.
- Assess the views of regional and national authorities.

2. Methodology

This study assesses three key elements. First, existing activity. Second, the likely demand over the next five years (based on analysis of the current business base and considered in the light of available forecasts. These include, for example, estimates of likely growth in number of small businesses and any intervention that One NorthEast will implement in order to increase the number). Third, whether existing funds can cope with the likely future demand.

Our methodology comprises several stages that are designed to capture the required information, as follows:

1. Desk research.
2. Consultation with key players within the region (and a small number outwith).
3. Survey of businesses.
4. Analysis and quantification of supply and demand.
5. Review of findings with the steering group.

Three 'steering group' meetings were held during the course of the study: an inception meeting, an interim steering group and a final steering group. In addition, the findings of the study were presented to the Access to Finance Expert Group.

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2.1 Stage 1 – Desk research

As the first part of our desk research stage, we accessed key reports and documents relevant to micro finance generally and to funding issues in the North East in particular. The second stage of this process was to extract a VAT registrations data set to examine the number of businesses, start-ups and growth businesses in each area – augmented by data from Barclays Bank. As a result, we were able to profile the regional 'target businesses' and analyse the target market.

2.2 Stage 2 – Consultation: key players

We consulted with twenty-four key organisations from stakeholder organisations, the bulk of whom were located in the region (see Annex 2). The consultation stage involved the use of a semi-structured interview framework that was built upon the five 'research themes'. Existing loan funds were also consulted about their level of activity, success rates and trends.

2.3 Stage 3 – Survey: businesses

The objective of the business survey was to determine the level of demand and whether there is a gap in provision. To obtain this information, Enterprise Agencies, Business Advice Centres and Business Links distributed to their clients a short questionnaire on access to finance, which they completed whilst waiting for their counselling appointment.

2.4 Stage 4 – Quantification and analysis

These data have been thoroughly analysed, and the key salient points from the consultation were synthesised. We quantified existing and predicted demand and supply based upon the information gathered. Quantification of supply was based on consultation. It was then possible to quantify the extent of the anticipated gap. A critical feature of this analysis was making an assessment of the *viability* of the demand; that is, whether unmet demand would be viable in order to justify funding.

2.5 Stage 5 – Review of findings

Findings have been reviewed with the steering group and also the Access to Finance Expert Group in anticipation of the production of this report.

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3. Background & context

3.1 Micro finance in a global perspective

Micro finance is not new. In the UK it is increasing in prominence but for many years it has been used as an enterprise support and poverty alleviation tool in less developed countries (LDCs). It is now a concept that is widespread in the developed world in recognition of the fact that the banks will not take risks and that many potential borrowers are perceived as too risky – perhaps because they have no money of their own or because they have no collateral. The more deprived parts of the UK, including much of the North East, can benefit from micro finance – a means of facilitating the creation of jobs in existing businesses and providing a route into self-employment for others. Micro finance has key social goals.

3.2 The regional angle

The North East has seen considerable decline in its manufacturing base – with the consequent socio-economic repercussions (such as high concentrations of multiple deprivation, including numerous electoral wards classified as Enterprise Areas: within the 15 per cent most deprived wards in England on the Index of Multiple Deprivation). Industrial decline has been most pronounced from the middle of the 1970s, although signs of economic recovery have been evident since 1993. Job losses in manufacturing (and other traditional industries) have continued, while new forms of employment have emerged: for example, call centres have become important across the region, although there have been concerns about outsourcing of customer contact activities to lower-cost countries.

In a region like the North East where economic conditions are difficult, there is no doubt that one viable and sustainable route to accelerate regional economic recovery is via new business start-ups and by growing existing firms – and resolving their cashflow issues, hence improving survivability. In particular, the Regional Economic Strategy (RES) emphasises innovation, investment and international trade (B1: raising business productivity) – activities that require finance. In addition, B2.2 (increasing new business creation) has a key element on access to finance, viz Regional Venture Capital Fund (Capital NorthEast), North East Regional Investment Fund, Bridges Community Ventures, etc, and on establishing a Micro Loan Fund. A report on small and medium-sized enterprises (SMEs)' access to finance in the region found that:[1]

> "The evidence suggests that small businesses today in the North East are facing difficulties in accessing relatively small amounts of flexible finance as evidenced by the high use of overdrafts, credit cards and non payment to directors. Therefore a flexible regional micro loan fund would provide a short and medium term solution to help address some of the basic needs of SMEs. Flexible finance can incorporate [repayment holidays], shorter-term loans (of say 6 months to meet working capital requirements). Generic business support to accompany the loan fund would be valuable in providing advice on cash flow planning, business planning, and sources of information, training and applications.

[1] Deloitte & Touche (2002) *Regional Access to Finance Expert Group for the North East. Access to Finance: Demand for Financial Engineering Tools in the North East of England*, Deloitte & Touche: Newcastle, pp. 35-36.

> This would help in improving the survival rates of small businesses by helping to resolve basic financial issues that affect businesses' ability to control cash flow. Risk reduction is an essential component of an integrated micro loan package and is required to attract private sector investment as match funding against ERDF finance. This is [a] relatively short and medium term solution to address current needs and should be monitored and evaluated regularly to determine the success and demand for the fund and the applicability of criteria and limits."

Deloitte & Touche's report examined financial engineering tools in the North East – as defined by the European Commission[2] as venture capital, loan funds and guarantee funds for SMEs – and one category that we might consider to include micro finance. The Deloitte & Touche report focused upon two specific types of business: start-ups (<36 months old) and growth businesses (>36 months). As well as issues related to venture capital and other aspects, Deloitte & Touche note that banks are: "very risk averse, high security requirements, inflexible finance packages, start-up finance difficult to obtain, movement towards factoring".[3] These barriers effectively rule out, for example, an unemployed person in Middlesbrough (who is renting a council house) from seeking bank finance in order to become self-employed.

One of Deloitte & Touche's recommendations was a regional micro loan fund – and, indeed, this recommendation has led to the creation of the Micro Finance Loan Fund administered by the Sunderland Business and Innovation Centre (BIC). Another recommendation was for an integrated start-up package with "loans, venture capital, subsidised direct management support and mentoring",[4] in response to the problems faced by lifestyle and high growth start-ups. Returning to their point about banks quoted above,[5] "Small businesses in general face more difficulties in accessing relatively small amounts of finance (less than £20,000) due to the low levels of security, low turnover and the often life style nature of the business." This problem is particular for start-ups and *very small* businesses (micro enterprises). Deloitte & Touche identified the need for a move away from grant dependence and the region's relatively low uptake ("3% of the UK total" until 31 March 2001) of the SFLGS.[6]

3.3 Where do businesses go for finance now?

As might be expected, commercial sources of finance are far more important to small businesses than micro finance. Figure 1 shows estimates of amounts outstanding to small businesses at the end of 2003 from a number of sources, including familiar sources such as bank lending and overdrafts, invoice discounting and asset finance. Factoring[7] and venture capital are less important (particularly for growth businesses[8]) and micro finance is tiny.

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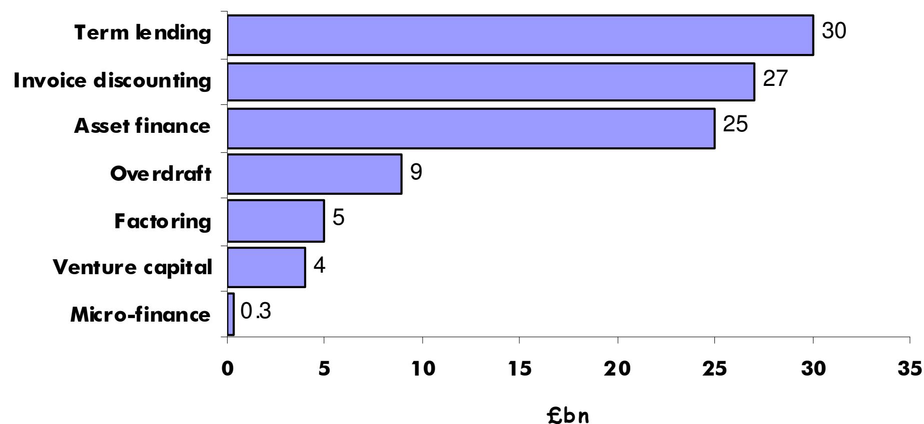
[2] *What Does the EU Commission Mean by "Financial Engineering"?* http://www.localdeveurope.org/
[3] Deloitte & Touche, op. cit, p. 3.
[4] Ibid, p. 4. Also a similar package, minus direct management support, for high growth businesses.
[5] Ibid, p. 30.
[6] Ibid, p. 32.
[7] Soufani found that the client base for factoring was fairly 'exclusive' and that it is not a panacea for specific types of businesses – Soufani, D. (2001) *The Role of Factoring in Financing UK SMEs: A Supply Side Analysis*, Journal of Small Business and Enterprise Development, 8 (1): 37-46
[8] See, for example, Mason, C.M. and Harrison, R.T. (2000) *Informal Venture Capital and the Financing of Emergent Growth Businesses* in Sexton, D. and Landström, H. eds Handbook of Entrepreneurship, Blackwell: Oxford.

Figure 1 Finance for small businesses



Sources: BBA, FDA, FLA, BVCA

Micro finance, however, is more important than it first appears – firstly, because it provides support to businesses that cannot raise all (and, in some cases, any) of what they need from commercial sources and, secondly, because when well managed it can have a substantial leverage effect, encouraging commercial sources to lend to businesses to whom they otherwise would not. It may be appropriate, therefore, to consider whether access to finance is a problem. A recent Natwest Small Business Research Trust (SBRT) Quarterly Survey[9] reports that government regulation and the general economic climate are perceived to be the biggest problems, followed by cash flow, tax burden and competition. These problems are summarised in Figure 2. It should be noted that access to finance (and interest rates) is seen as a problem by just two per cent (up from one per cent in Q4 2003) of respondents, though it should be noted that this survey is of existing businesses. Business size makes little difference. It is possible, however, that people who have not yet started may see access to finance as a bigger problem.

The Bank of England, in its 2003 review of finance for small firms,[10] reported that bank lending to small firms rose in 2002; they did not identify any real evidence of firms having difficulty in accessing bank finance. They noted that the number of loans and overdrafts to small firms in deprived areas increased faster than the national average but that the amount lent fell as a proportion of the national total. The Bank, however, believes that there is some evidence that small firms in deprived areas are, on average, a higher credit risk than elsewhere – though it seems to be unclear about the reasons. The Bank, in its eleventh and *final* report[11] found that small firms (particularly 'early stage businesses') do have difficulties "seeking small amounts of risk capital" but that information and awareness of finance sources etc are now vastly improved since the first report.[12] However, the Bank argued that access to finance was not, in fact, a major constraint for small businesses.

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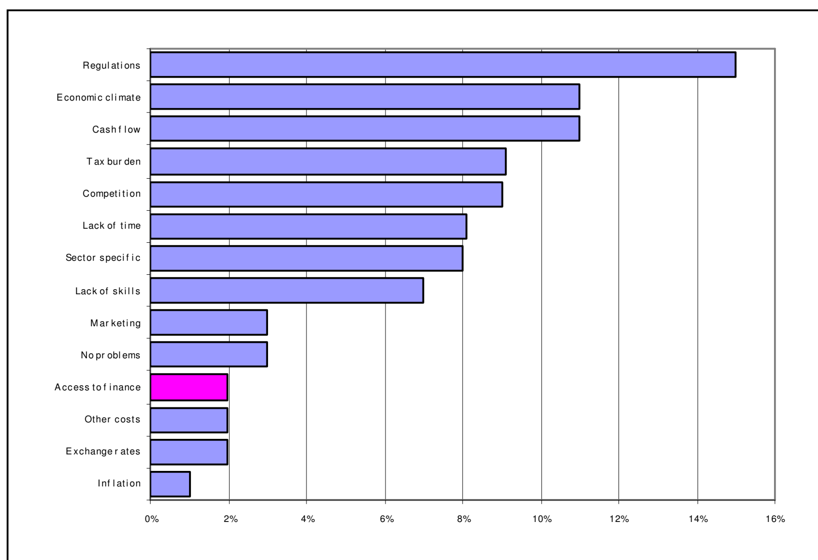
[9] Natwest and SBRT (2004) *Natwest SBRT Quarterly Survey of Small Business in Britain*, Q1.
[10] Bank of England (2003) *Finance for Small Firms – A Tenth Report*, Bank of England: London.
[11] Bank of England (2004) *Finance for Small Firms – An Eleventh Report*, Bank of England: London.
[12] It is of particular interest that in the autumn of 2004 a consortium of 19 organisations, including the Bank, will publish a benchmark survey of external sources of small firm finance.

FIGURE 2 MOST IMPORTANT PROBLEMS FOR SMES



Source: Natwest and Small Business Research Trust (2004 Q1)

A recent report on the UK banking industry[13] notes that:

> "banks are crucial in the provision of finance to SMEs. As businesses grow, they will typically have to seek external sources of finance to complement their internal resources and the main external provider of capital for most firms will probably be a bank."

In addition, the report highlights how Cruickshank's review of UK banking led to an investigation by the Competition Commission of SME banking. The authors are particularly concerned about Government intervention and price controls in the banking market, despite the fact that SMEs do tend to be satisfied with their banks.

Government policy emphasises access to finance for SMEs as key to increasing productivity growth and employment. The recent action plan for small businesses[14] suggests that small business financing has improved, though notes that there are still problems of access to debt finance for some groups – indeed: "There continue to be market imperfections in the provision of small amounts of equity-based risk capital to smaller businesses." Other ways of dealing with the equity gap are being examined, such as Enterprise Capital Fund (ECF), as well as reviewing the Small Firms Loan Guarantee Scheme (SFLGS) and other policy interventions in relation to Venture Capital Trusts, the Enterprise Investment Scheme and a number of actions associated with financial advice.

[13] Lodge, O. and Williams, S. (2004) *A Review of the UK Banking Industry*, Centre for Policy Studies: London, p.11.
[14] Small Business Service (2004) *A Government Action Plan for Small Businesses: Making the UK the Best Place in the World to Do Business*, SBS: London.

3.4 Micro finance

Given the difficulties associated with banks, Community Development Finance Institutions (CDFIs) provide an alternative solution. Firstly, they tend to lend to people who could not otherwise raise the finance that they need, so many more people are helped to start in business. Secondly, they will lend unsecured, or with collateral that is worthless, so they can assist clients who have no resources of their own. If the CDFI is also a business support organisation, it will offer advice and training as well, so the success rate is high – loss rates run at around 5 per cent of outstanding loans per year. Other lenders thus gain confidence in the borrower, so leverage is high – about £3 from other sources for every £1 lent by an agency. And given that the agency takes last place in the queue for repayment if things go wrong, achieving a loss rate of 5 per cent is a remarkable achievement.

Like the banks, micro loan funds are unwilling to take stupid risks. They look for well-prepared propositions and entrepreneurs who have the determination to succeed. Where they differ from the banks is in their willingness to take little or no security and, on occasion, to offer reduced interest rates (though that is less of an issue at present with the bank base rate so low). Lending by micro loan funds is far more extensive in other parts of the world. For example, the UK has a community development finance sector around 40 per cent as large as its American counterpart (adjusted to take account of differences in population size). A snapshot survey by the International Association of Investors in the Social Economy of 86 organisations offering small business loans in the 15 European Union member states showed capital of EUR1.6 billion and a total loan portfolio of EUR640 million.

In the southern hemisphere, as many as 7,000 micro finance institutions have at least US$7 billion in loans outstanding to more than 13 million individuals. Such initiatives have proven that poor and socially excluded people can be profitable customers. The most well-known micro finance institution is the Grameen Bank in Bangladesh. There are many others, though. Accion Internationale, for example, lends extensively throughout Latin America and achieves a default rate of less than one per cent. What is different about these lenders, though, is that they use what are known as 'credit circles' with groups of up to four businesses effectively providing guarantees for each other.

A report, from the UK researchers of an International Labour Organisation (ILO) study of micro finance as a route into self-employment,[15] noted that public sector assistance has concentrated on advice and training. The report argues that the Government should support micro finance because of "economic and social justice considerations" (dealing with market imperfections such as inefficiencies in financial markets and externalities; as well as combating unemployment). The paper also describes the 'double disadvantage' that unemployed people experience – a lack of savings and also problems 'accessing commercial loans'. A key problem identified at the UK level was the multitude of organisations providing micro finance to small numbers of borrowers and thus issues of signposting and lack of knowledge about which organisation to approach.

[15] Metcalf, H. and Benson, R. (2000) *From Unemployment to Self-employment: Developing an Effective Structure of Micro-finance Support*, National Institute of Economic and Social Research Discussion Paper No. 170, NIESR: London. Since this study was conducted over four years ago, we would caution that the study is probably now only *indicative* – and so quote them tentatively.

The European Commission[16] identifies the problem of early-stage financing for many EU firms, and considers loan guarantees as one means to solve this difficulty for borrowers who lack collateral. Micro lending is regarded as another way of enabling such firms to access finance. For example, they emphasise the importance of sustainability of public sector micro loan programmes (i.e. to ensure that the loan funds are revolving in order to enable them to be self-sufficient and thus independent from public support after a period of time). Indeed, the Commission has published a report outlining 'best practice' in micro lending,[17] which they define as loans (including from banks) below €25,000; they note that:

> "The insufficient supply of micro-loans is a major issue, in particular where business creators are unemployed persons, women or form part of ethnic minorities. Supporting micro-loan supply is therefore not only an issue of entrepreneurship and economic growth, but also of social inclusion" (p.1).

Based upon small enterprise surveys, the report (p.6) also identified market gaps because micro loans are: "high risk and low return … due to the important failure rate and the high handling cost." The gap is because of:

> "information asymmetry. For the loan provider, the information regarding the quality of the business and its management is difficult to get and very expensive. The lack of information may lead the credit institution to adverse selection".

The report also recommends, as a key tool to ensuring business survival, that mentoring should be provided. (A justification for the mentoring element in the North East's Micro Finance Loan Fund.)

A report by Deloitte & Touche for the European Commission's DG Budget[18] provides a comprehensive evaluation of SME Financial Assistance Schemes (FAS) and makes a number of key points. The report reminds us, for example, that state aid should focus on 'identified market failures' (Barcelona European Council 2002); and that "The degree to which subsidised loans are effective as a policy tool is controversial … still popular with the SME lobbies … but … discredited by academic research." Their evaluation also raises the issues that loan providers need to improve their 'assessment capacity' and SMEs are confused by the wide range of financial 'products' available.

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[16] Commission of the European Communities (CoECs) (2003a) *Communication from the Commission to the Council and the European Parliament: Access to Finance of Small and Medium-sized Enterprises*, CoECs: Luxembourg.
[17] CoECs (2003b) *Microcredit for Small Businesses and Business Creation: Bridging a Market Gap*, DG Enterprise, CoECs: Luxembourg.
[18] Deloitte & Touche (2003) *Strategic Evaluation of Financial Assistance Schemes to SMEs*, Final Report for DG Budget, Deloitte & Touche: Brussels.

4. Regional micro finance: an appraisal

It is clear from the information on the One NorthEast website that *regional* initiatives are more geared towards loans – whereas national (Regional Selective Assistance), European and local (district and county councils) support is focused on grants, which are beyond the scope of this study. Some of the initiatives on the website fall into the micro finance definition utilised in this study – a maximum loan of £15,000.[19]

The One NorthEast website identifies equity and grants, but also loans – North East Investment Fund (NEIF) 3 (£25,000 – £250,000), Action Energy Loan (£5,000 – £50,000), Micro Loan Funds (maximum £15,000), Community Loan Fund NE (£15,000 – £50,000) and Spirit of Enterprise Fund (£1,000 – £5,000).[20] These sources of loans are broadly *regionally specific*. However, within the region loans are also available from Northern Oak Credit Union (North Tyneside), Darlington Borough Council (Falchion Fund), Project North East, Street UK, the Prince's Trust, Entrust (which only makes a few loans per year), UK Steel Enterprise, Prime, Industrial Common Ownership Fund (ICOF), Tyneside Economic Development Company (TEDCO), and others. Not all of these loans are below £15,000, however. We are also aware of Neighbourhood Renewal Fund start-up loans, including a BME specific loan, in South Tyneside (£500 – £2,000). In addition, a major high street bank is exploring the possibility of establishing a wholesale CDFI fund in partnership with RDAs.

A scan of 'Funding: The Source' in the *Enterprise North East* magazine confirms that the vast majority of the funding sources are **grants**. Loans within the range that are being covered by this study are:

- Barclays Business (£500 +)
- Business Investors Group (£5,000 - £1.5m)
- HSBC Flexible Loan (£10,000 - £250,000) and Small Business (up to £15,000)
- Lloyds TSB – Express Business Loan (£1,000 - £25,000)
- NatWest Business Development Loan (£1,000 - £950,000) and Small Firms Training Loan (£500 - £125,000)
- North Tyneside Business Development Loan (£1,000 - £5,000) managed by North Tyneside Council
- Prelude Ventures Ltd (£10,000 - £4m)
- Prime (up to £5,000 per individual)
- Street UK Micro Finance (£500 up to £10,000)
- TEDCO Start-up Loan Fund (up to £2,000) and Business Development Fund (up to £5,000)
- The Prince's Trust (average of £2,500 – double for partnerships)
- UK Steel Enterprise Ltd (£10,000 – £400,000)
- Yorkshire Bank Business Loan (£300 – £25,000).

There are some major omissions from this list – Micro Finance Loan Fund, Project North East and the Community Loan Fund for the North East are three obvious examples.

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[19] Page 32 of the RES identifies the remit of the Micro Finance Loan Fund as: loans between £3,000 and £15,000 for existing businesses and £3,000 to £5,000 for start-ups.
[20] http://www.onenortheast.co.uk/page/supp_4ii/fin_supp/venture_capital.cfm

4.1 Demand for micro finance in the North East

The Sustainable Cities Research Institute at the University of Northumbria has undertaken various studies on social investment, such as that provided by Credit Unions, with evaluations of Credit Union Development Initiative for Middlesbrough (CUDIM)[21] and Financial Inclusion Newcastle (FIN)[22] amongst others.

Another Sustainable Cities Research Institute report[23] mapped the impact of social investment in Tyne and Wear and found that CDFIs in the area were underdeveloped – although a clear need exists because (commercial) banks tend not to lend to these types of borrowers (especially social and community enterprises) – in fact, the 'third sector' now seems to avoid banks, instead opting for grants or loans tailored to their needs. Affleck and Mellor (2003) characterise the North East's CDFI sector as a: "patchwork of relatively small scale support of which many people were unaware".[24] Benefits from CDFI, therefore, have been 'relatively modest'.

The report also investigates the question of whether there is demand for micro loans. They cite research by the New Economics Foundation (NEF), which identifies a difficulty for 'soft loan funds' finding clients; or "getting money out the door" as NEF puts it.[25] Worse still, NEF estimated that these soft loan funds provided an average of 17 loans per annum! Affleck and Mellor's research suggests that awareness of loan funds is a significant problem. They explain, for example, how Community Loan Fund NE and Street UK, in the region, have endeavoured to publicise their schemes through newspaper advertising, presentations and 'canvassing' in deprived areas. They conclude that there are problems of delivery but also of take up – and argue that: "The commercial sector may not just be failing potential entrepreneurs but whole sections of the population".[26] Conversely, it could be argued that it is not the role of banks to take risks with their money: hence the gap in the market is filled by other sources, such as CDFIs. It is not clear from Affleck and Mellor's research whether there is a gap, or if there is just a lack of knowledge about what is available, or whether there is no more unmet demand for these schemes (given the low uptake).

A major report by NEF and Bert Nicholson[27] examined demand in the West Midlands. While we do not wish to dwell overly on this report, given that it has covered a different region and its authors' definition of CDFI funding (to commercial and social enterprises) has an upper level of £50,000, it is an example of a similar study to ours, the findings of which are nonetheless useful. NEF and Nicholson asserted that there is demand for finance by micro, small and social enterprises, and also that CDFI activity is high in the West Midlands.

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[21] Mellor, M. and Dodds, L. (2003) *Credit Union Development Initiative for Middlesbrough: Evaluation Report*, Sustainable Cities Research Institute, Northumbria University: Newcastle upon Tyne.
[22] Dodds, L. (2003) *Financial Inclusion Newcastle Ltd: Final Report*, Sustainable Cities Research Institute, Northumbria University: Newcastle upon Tyne.
[23] Affleck, A. and Mellor, M. (2003) *Social Investment in the North East of England*, Sustainable Cities Research Institute, Northumbria University: Newcastle upon Tyne.
[24] Ibid, p. 46.
[25] New Economics Foundation (2002) *Who is Who in Supporting Local and Micro Finance*, NEF. See http://www.localdeveurope.org.
[26] Affleck and Mellor, op cit, p. 51.
[27] NEF and Bert Nicholson (2003) *Analysis of the Need and Demand for Development Funding of Community Development Finance Institutions in the West Midlands*, NEF: London.

However, we should not be surprised by NEF and Nicholson's finding that: "Many CDFIs are experiencing problems generating sufficient demand for their existing loan funds"[28] It also emerges that estimation of future demand features 'conservative projections'. The general thrust of NEF and Nicholson's argument is that there is a market out there but demand is just not being created; and, therefore, there may appear *not* to be a gap. It is important that we consider whether this could be the case in the North East.

We have defined the target market for micro finance as businesses that have started in the last two years and have under one employee. (We also considered how many employees the firm had at its inception, or when a business had no paid employees when they started. Also these include people who were sole traders when they started).

To assess demand, we have looked at data from a number of sources:

- Published data which show the level of finance provided by a range of commercial sources;
- A survey undertaken with the business support organisations to explore entrepreneurs' expectations of bank and other lending; and
- Published data showing the rate of growth of start-ups and the business stock in the North East.

Table 1 Support for small businesses

	2002 Q4	2003 Q1	2003 Q2	2003 Q3	2003 Q4
Term lending O/S (£'bn)	26.992	28.227	28.376	28.935	29.804
Term lending change		+4.6%	+0.5%	+2.0%	+3.0%
Overdraft borrowing O/S (£'bn)	9.019	9.451	9.450	9.609	9.067
Overdraft borrowing change		+4.8%	-0.0%	+1.7%	-5.7%
Total deposits O/S (£'bn)	36.793	36.406	38.119	38.200	39.782
Total deposits change		-1.1%	+4.7%	+0.2%	+4.1%
Total no. of current & deposit accounts (millions) O/S	4.341	4.445	4.535	4.453	4.540
Total no. of current & deposit accounts (millions) change		+2.4%	+2.0%	-1.8%	+2.0%

Source: British Bankers' Association

4.1.1 Commercial activity

The British Bankers' Association has recently published data on bank lending to, and deposit taking with, small businesses for 2003.[29] The data suggest that overall bank lending to small firms is rising, though deposits are rising almost as strongly. It is worth noting that:

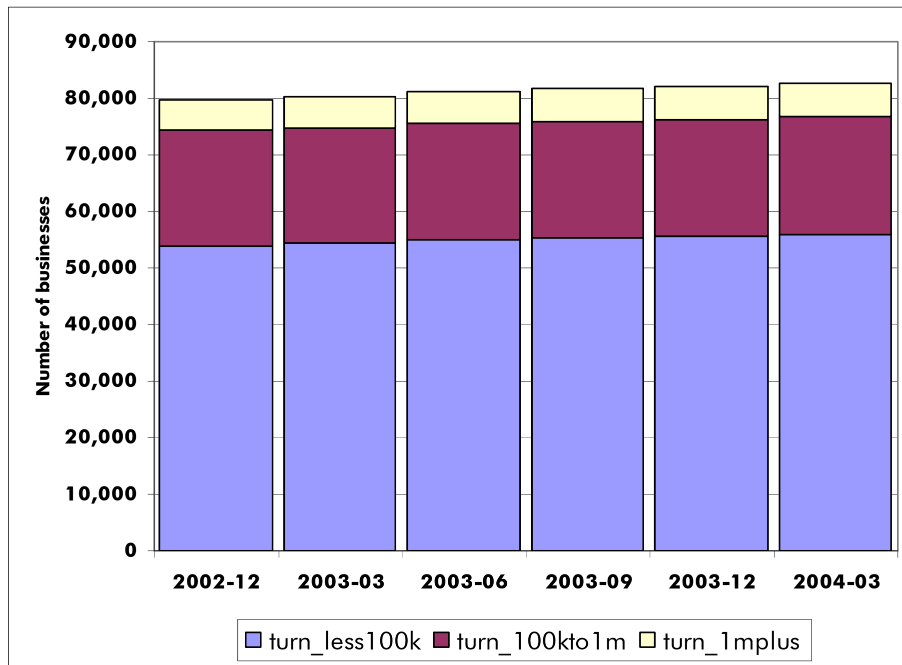
[28] Ibid, p. 39.
[29] British Bankers' Association press release, 29 April 2004

- Term lending rose by £3bn (+10 per cent) over the year, to stand at £30bn;
- Overdraft lending was virtually unchanged (+0.5 per cent), at £9bn;
- Deposits rose by £3bn (+8 per cent) to £40bn; and
- There were 4.5m small business accounts (both current and deposit accounts) in operation at the end of 2003.

On the face of it, these figures would suggest that small businesses do not have any difficulty raising money from the banks. The reality, however, is that many new and growing businesses do find considerable difficulty in raising the finance that they need. The data collected by the BBA are not disaggregated by region. However, working on the basis that there are around 42,000 VAT registered businesses in the North East and a total of 1,664,000 in the UK, this suggests that total bank lending to SMEs in the North East at the end of 2003 was around £981m – compared to somewhat less than £3m from micro finance – so most businesses still rely on the banking sector to meet their financing needs.

It is interesting to look at the profile of businesses in the North East and their borrowing requirements. Figure 3 shows the total number of businesses in the North East by quarter and by turnover. As can be seen, by far the most businesses have a turnover of under £100,000. Very few have a turnover in excess of £1m.

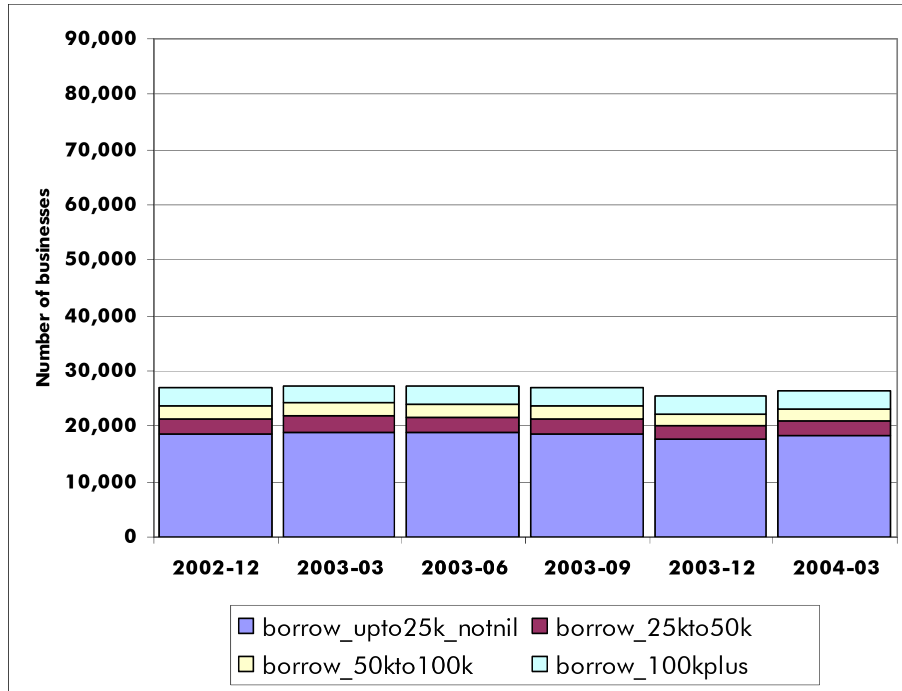
Figure 3 North east businesses by turnover



Source: Barclays Bank

Apparently, no more than a third of those firms borrow money from banks, though they may use other forms of finance. Most businesses borrow less than £25,000, as Figure 4 shows.

Figure 4 Bank borrowing by north east businesses



Source: Barclays Bank

Looking at average (mean) levels of borrowing does not, however, tell the whole picture. Evidence from Barclays suggests that average borrowing (depending on local authority district) varies from £2,700 to £257,000. The median varies from £115 to £6,600, though if all accounts borrowing less than £500 are excluded (effectively excluding the bulk of overdraft facilities), then the median varies from £2,500 to £24,758. It appears, therefore, that most bank borrowers are in the market for loans within the range defined by micro-finance.

4.1.2 Demand for micro finance

To get a better feel for demand, we asked all the business support agencies to participate in a one-week survey by requesting every client waiting for an appointment to complete a very short survey. Seven agencies assisted with this survey and we received 77 responses: 26 from existing businesses, 49 from people still thinking about starting in business and two who did not specify whether they were in business.

We asked respondents to tell us how much finance they needed altogether, how much of this finance they could find from their own resources, whether they had discussed their needs with the bank and, if so, how much the bank was prepared to lend. We also asked where else they expected to find the balance if not from the bank, whether they were confident of raising the money and whether they would contemplate equity.

The results from this survey are interesting: amongst those already in business, there was an average requirement of £15,000 with £4,000 of own resources and expected bank support of £5,000 leaving a need of £6,000. Intuitively, this figure looks slightly suspect, in that one would have expected existing businesses to find it easier to raise bank finance, which suggests that some of these clients may not have bankable propositions. The figures, however, are more revealing when one looks at those who have been offered bank finance. The average requirement of those offered bank finance was £22,000 with the entrepreneurs finding £5,000 and the banks offering £17,000. In one case, the amount of money from the respondent and the bank was more than the stated need. This finding begins to suggest that people in business do not need micro finance at all, or at least can source their requirements from the banks.

The picture changes a little when one looks at all those who have discussed their propositions with the bank, irrespective of whether they were made an offer. The average amount required was about the same at £20,000 and the average resource from the entrepreneur was £5,000. The banks were willing to provide £13,000, leaving an average gap of about £2,000 (actually £1,600, but we have rounded them all to the nearest thousand) – suggesting that the business support agencies are good at helping existing businesses prepare themselves for a discussion with the bank. Of the businesses that had discussed their plans with the bank, 20 per cent received no offer, which represented just 6 per cent of the businesses receiving support. If the business support organisations see 15,000 clients each year,[30] then 900 requiring £1,600 gives a total requirement of £1.4m.

The start-ups figure tells a rather different story. The survey suggested that few businesses were securing finance from the banks, though in reality many will be able to secure finance with backing from the business support organisations. One respondent required in excess of £1m, which we felt skewed the picture, so we have excluded that business from the sample. There was an average need of £25,000 with a personal contribution of £9,000 and an expected bank contribution of £7,000, leaving a gap of £9,000.

However, just over a third of respondents had been to talk to the bank. The average requirement of those offered support was £42,000 but with personal resources of just £5,000 and a bank offer of £32,000 leaving a gap of nearly £5,000. Amongst those who had talked to the bank, irrespective of whether they were made an offer, the average need was £26,000 (fairly well reflecting the total sample) with personal resources averaging £1,000 (somewhat less than the average for the sample) and an expectation of bank borrowing of £15,000, leaving a gap of £10,000.

[30] Figures from the Small Business Service.

Table 2 Demand for finance (one week in May)

	Need	Own resources	Bank lending	Gap
In business				
Total	386,000	93,000	134,000	
Average	15,000	4,000	5,000	6,000
Average (Bank Agreed)	22,000	5,000	17,000	0
Average (Bank Talked)	20,000	5,000	13,000	2,000
Not in business (adj)				
Total	657,000	222,000	195,000	
Average	25,000	9,000	7,000	9,000
Average (Bank Agreed)	42,000	5,000	32,000	5,000
Average (Bank Talked)	26,000	1,000	15,000	10,000
Micro				
Average (Bank Agreed)	9,000	2,000	4,000	3,000
Average (Bank Talked)	8,000	1,000	1,000	6,000

Source: IGA & TBR survey

Our definition of micro finance is distinguished by an upper limit of £15,000.[31] Many of the clients in the sample had a total requirement in excess of £15,000, and many of the businesses needing more than £15,000 may source some of it from a micro loan fund, although many will not find it worthwhile. If we exclude all those businesses whose requirement is greater than £15,000, then the average gap falls to £3,000.

We have calculated the potential demand in two ways. We asked all the business support organisations to participate in our survey. Some 51 of the respondents were looking for finance of no more than £15,000. If this week was typical, it equates to 2,600 clients for the year. Some agencies did not participate in the survey, but most clients will go to the agency more than once. For the purpose of this calculation, we have assumed that those factors roughly cancel each other out. This gives an annual demand of nearly £8m. It is clear, however, that not al the survey returns were from the same week. If we only include the returns that came back immediately after the originally agreed week for the survey, then the number of starts falls to 22 and the demand falls to £3.4m.

We could look at the demand calculation differently. In 2003, there were 15,100 new starts in the North East, of which around 2,500 (which more accurately reflects the higher figure above) seek support from a business support organisation[32] and two thirds of those require less than £15,000. This suggests that the total demand could be around £5m.

If we add an allowance for the needs of existing businesses, we have an estimated top requirement of £6m.

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[31] Although we accept that some loan providers do not restrict their lending to £15,000 maximum, if they do in practice lend below that amount then we can classify them as a provider of micro finance.
[32] According to the Small Business Service, the Business Links and their partners saw 12,953 pre starts last year. Whilst they do not keep records of who subsequently starts, they estimate that about 20 per cent do, which accords with the start rate at Project North East, giving around 2,500 starts.

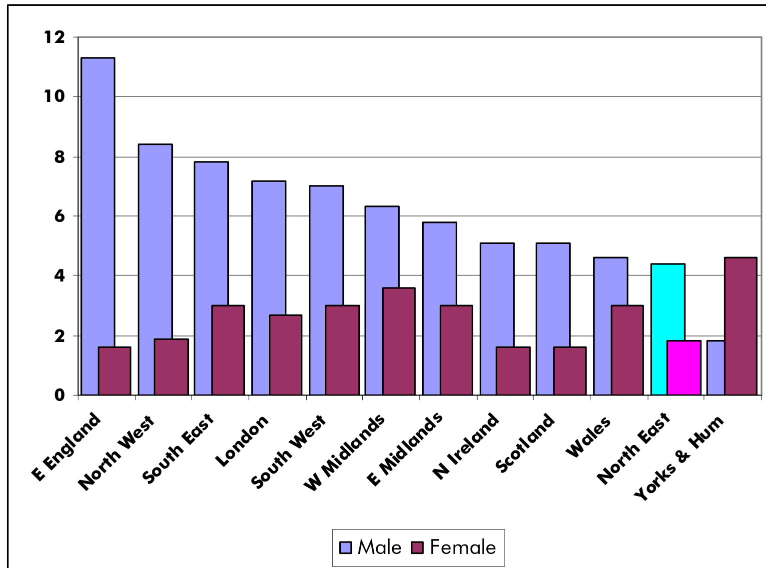
It is likely that many clients are over-estimating their requirements. It is also likely that the business support agencies can help clients secure a rather greater proportion of their need from the banks, particularly if some micro finance is available to encourage the banks to lend more.

It is also worth noting that total lending by CDFIs was £2.23m last year, yet all had sufficient capital to have lent more had they received more viable propositions. It is likely that better promotion of the availability of loan finance would increase the apparent demand, though it is questionable whether it would increase the level of businesses who appear to have a viable proposition but which the banks are unwilling to support. In conclusion, we estimate the annual demand to be £3.6m.

We also need to consider whether the demand will increase over the next few years. Figures from the Global Entrepreneurship Monitor for 2002[33] reveal that the Total Entrepreneurial Activity Index for the North East was 4.4 for men and 1.8 for women (compared to a national average of 6, and a high of 19). In 2003, the UK index went up to 7 but the highest score went up to 29.

Figures from Barclays Bank that look at start-ups for 2003 are even more depressing. Overall, in 2003, new starts were up by 9 per cent, closures were down by 9 per cent and the stock increased by 7 per cent. There were a total of 465,000 new starts, but just 15,000 in the North East, which was about the same as in 2002. Of the 10 worst performing areas outside London, five were in the North East and nowhere in the North East reached the national average.

Figure 5 Global Entrepreneurship Monitor 2002

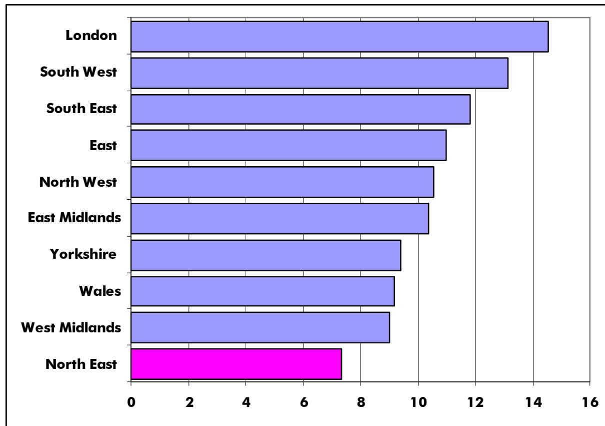


Source: GEM Consortium 2002

[33] Disaggregated data for 2003 are not yet available

Based on these figures, it is hard to argue that the rate of start-up will increase without considerable effort. Indeed, we would argue that increasing the start-up rate is a bigger challenge for the North East than providing more money for micro finance.

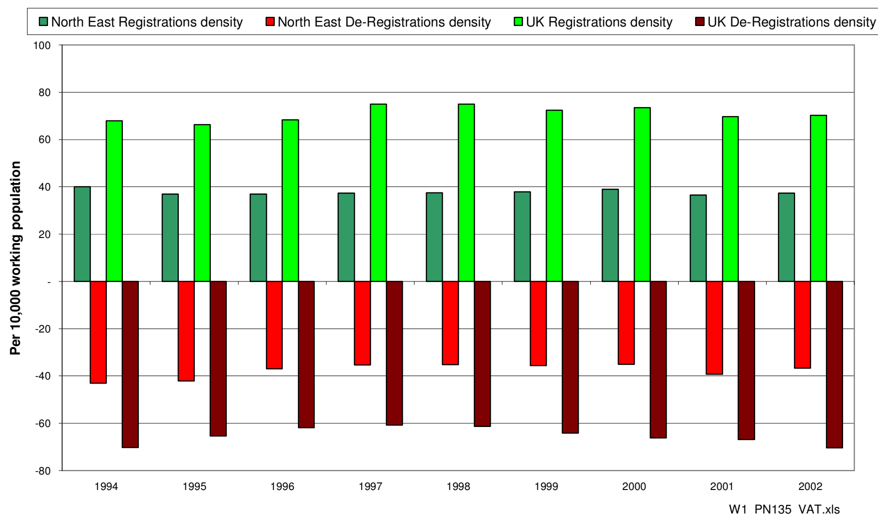
Figure 6 Starts per 1,000 adult population



Source: Barclays Bank

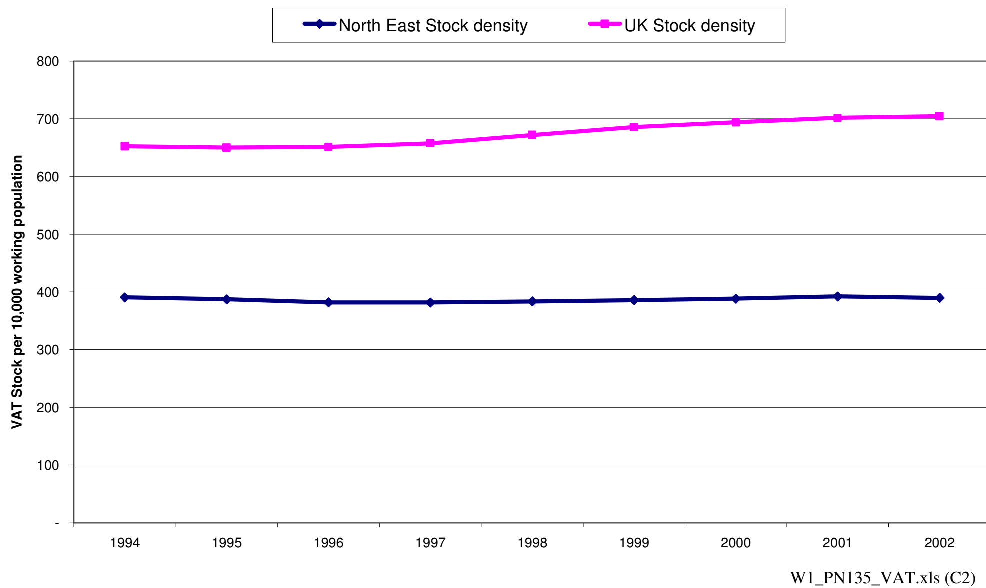
As shown in the charts below, numbers of businesses are increasing slightly – they are not static but the business birth rate is not as high as it should be in order to increase the stock substantially to be anywhere near the better performing regions of the UK.

Figure 7 NE & UK Registrations, Deregistrations and Stock Density (per 10,000 working population), 1994-2002



Source: VAT statistics

FIGURE 8 NE AND UK STOCK DENSITY (PER 10,000 WORKING POPULATION), 1994-2002



Source: VAT statistics

4.1.3 THE GAP BETWEEN SUPPLY AND DEMAND

We have surveyed the CDFIs in the North East and encouraged them to provide us with performance data. The survey covers Project North East, Micro Finance Loan Fund, Street UK, Spirit of Enterprise and Prince's Trust. There are many other lenders in the North East, as shown below.

FIGURE 9 MICRO LENDERS IN THE NORTH EAST

Falchion Fund (Darlington Borough Council)	Prince's Trust business programme
ICOF	SENET
CapitaliSE	Spirit of Enterprise
Micro Finance Loan Fund	Street UK
Northern Oak Credit Union	TEDCO
Project North East loan fund	UK Steel Enterprise
PRIME	

Source: IGA & TBR

Some of these funds either make very few loans, or were unable or unwilling to give us their data. So the figures quoted are based on five CDFIs, though they probably represent a large proportion of micro-lending activity. We also selected a small, unrepresentative group of national exemplars to provide some comparisons outside the region. On the whole, the performance of funds in the North East is not wildly different to funds elsewhere in the country.

Last year the CDFIs in the North East had 850 applications and made nearly 600 loans totalling £2.2m. At the end of the year, they had a loan book of £2.75m.

Table 3 NE micro finance performance indices

	Best	Worst	Region	National
Serious applications	475	33	170	134
Loans approved	83%	39%	65%	39%
Amount lent (during year)	£930k	£34k	£2.2m[1]	
Total outstanding	£1.5m	£90k	£2.75m[1]	£160k
Interest rates	5%	12-26%		
Loan sizes	35,000	500	4,800	14,000
Jobs per loan	15	1	4	6
Default rates	3%	14%	9%	1%

1. Note that this is the total figure and not the average

Source: IGA & TBR

These figures seem to be broadly replicated elsewhere in the country. For example, a review of micro finance in the West Midlands, covering 11 loan funds, revealed that in 2002, collectively, they made 754 loans (averaging 69 loans per CDFI) worth a total of £2.9m (giving an average loan of £3,800). They had a total of 374 loans outstanding (giving an average per CDFI of 42).[34]

At the end of the year, the CDFIs had capital available totalling £1.7m (excluding Prince's Trust which receives capital from its head office as it lends). Five funds have been given support from the Phoenix Fund but currently only one (Project North East) is lending in a serious way, so there is around £1.1 available here. Phoenix Fund money is drawn down as needed quarterly in advance over a two-year period, but several funds have had approval for a year or more and have barely lent anything. The Micro Loan Fund has had £800,000 and PNE has had £200,000 this year from ESF. And the other loan funds all have some resource, so there is probably at least £4m sitting in bank accounts, or easily available, waiting to be lent, plus lending by Prince's Trust.

Table 4 Phoenix Fund Support in the North East

	Revenue	**Capital**	**Total**
Five Lamps	165,000	200,000	365,000
CapitaliSE (NESEP)	297,500	500,000	797,500
Northern Oak Credit Union	20,000	250,000	270,000
Project North East	140,000	300,000	440,000
South East Northumberland Enterprise Trust	90,000	200,000	290,000
	712,500	1,450,000	2,162,500

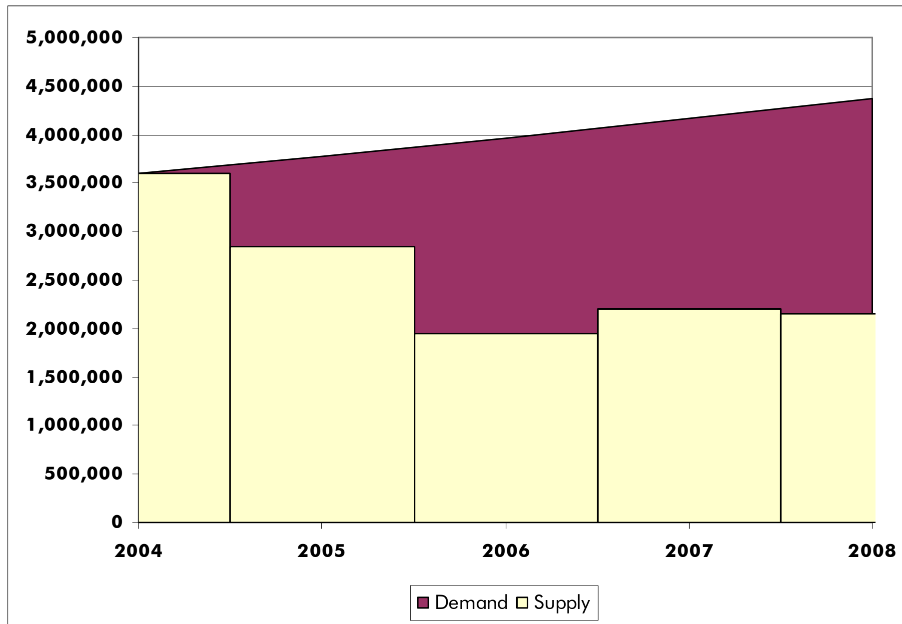
Source: Small Business Service

[34] NEF and Bert Nicholson (2003) *Analysis of the Need and Demand for Development Funding of Community Development Finance Institutions in the West Midlands*, NEF: London.

Taken as a whole, the funds could meet the expected demand for at least a year, even if they did not receive any further loan repayments. However, the funds that are doing the most lending are not necessarily the ones with the most capital sitting idle. We have looked at lending cover – that is, the number of years that funds could keep lending at their present rate, assuming that their repayment pattern stays the same. As can be seen in Table 5, the longest period is more than seven years, though the shortest period is just a couple of months. The regional average is 2.7 years.

We have attempted to estimate the gap between supply and demand. Figure 10 shows the possible size of the gap, though this assumes rapid growth in demand this year and five per cent growth thereafter (see Annex 5 for a detailed explanation). In short, a gap appears from 2005 onwards though this is the worst possible scenario, given that we have estimated the total demand, but recognise that the supply is somewhat higher than shown by our survey.

Figure 10: Gap between supply & demand



Some funds may require more capital in the short term given that there are differences between those with the capital who are not lending and those who are lending but from a limited capital base.

4.1.4 Benchmarks

We compared the performance of CDFIs in the region and also persuaded some national exemplars to share their data with us – to give a broader comparison.

There is a wide discrepancy in the cost of running the funds, with the best spending just 13p for each £1 lent and the worst spending £1.21 for each £1 lent. One might have expected a correlation between low cost of lending and high default rates. However, that is not the case. The fund that spends the most to do its lending also has the highest default rate. The fund with the best default rate has a cost amongst the lowest. However, the figures are collected and reported in such a way that it is difficult to draw sensible conclusions.

One of the funds has a stated intention to become self-sustaining, so we looked at two sustainability indices. The first, the capital sustainability index, is an indication of whether a fund can replenish lost capital with interest charged to borrowers and income on unlent capital. A figure of 1 indicates that it is sustainable. It seems that, on average, funds in the North East do achieve this target, though the variation is substantial.

The second, the total sustainability index, looks at how close a fund is to covering all of its costs, including capital losses, from its income. The best achievement is 0.5 and the worst 0.05. This performance is repeated in the national sample. It seems unlikely that any CDFI is ever going to be sustainable – they simply do not have the economies of scale. However, they provide valuable assistance to many businesses and we would argue that this support alone makes them worth encouraging as part of a total package of business support. It may be appropriate, though, to look at the level of transaction costs when assessing individual funds. It is interesting to look at the transaction costs incurred by Shared Interest. Shared Interest provides trade credit to Fair Trade businesses, mostly operating in developing countries, so one might expect it to have high transaction costs. Last year, its costs were just 5.8p for every pound invested.

We have calculated four other ratios. The deployment ratio is a measure of how much of each fund's capital is lent. The higher the deployment ratio, the lower the amount of money sitting idle. It should be noted, however, that a sudden influx of money, say from ESF, may distort these figures.

Leverage is a measure of the effect that funds have in encouraging others to lend alongside them. A leverage of three, for example, means that for every £1 lent by the CDFI, a further £3 has come from elsewhere. At the moment, this leverage includes all other sources. It would be more useful if it separated other non-commercial funds and commercial funds.

Lending cover, mentioned earlier, is an indication of how long (in years) the funds could keep on lending if they continued to lend and be repaid at their present rate.

Revolution is simply a measure of how many times a fund has revolved its capital.

There are many more ratios that we could have calculated, but these seem to be the ones that are likely to be most useful, both to practitioners wanting to compare their performance with others, and to policy makers.

A summary of all of the performance data is provided in Annex 4.

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Table 5 Key performance indices

	Best	Worst	Region	National
Cost per pound lent	£0.13	£1.21	£0.55	£0.31
Capital sustainability index	2.72	0.18	1.0	4.43
Total sustainability index	0.48	0.05	0.19	0.37
Deployment ratio	76%	25%	52%	91%
Leverage	3.1	0.2		
Lending cover	7.3	0.2	2.7	0.2
Revolution	1.8	0.6	1.0	1.6

Source: IGA & TBR

5. Key issues emerging from this study

The key issues summarised below emerged from the surveys and demand assessment undertaken during the study – as well as from consultations with loan funds, intermediaries and other important players in the North East finance scene.

5.1 'Lender of last resort' only

A viewpoint of one professional, who was not employed by a loan fund (and a policy that is practised by a number of funds), is that micro finance loans could be defined as only 'lender of last resort'. This situation effectively means that those businesses that can borrow from commercial sources, such as banks, would be ruled out of micro finance schemes. Although there are doubts about how 'ethical' this approach might be, it would certainly assist to target those individuals who wish to become self-employed or expand their existing businesses but who cannot obtain loans from other sources. This target market is the normal one for micro finance loans (for example, in the USA the National Community Capital Association (NCCA) lists five categories, one of which is micro enterprise development loan funds[35]). Simply put:

> "A person in Middlesbrough is the sort of person that should be supported by the Micro Loan scheme, even if 20-30% of debts go bad. The micro loan scheme shouldn't support clever, switched-on entrepreneurs, who in my view should go for conventional finance. But it is much easier to demonstrate benefits from clever, switched-on people than someone living in a council estate in South Bank."

Large levels of demand would lead to the need to apply rigorous criteria but thus would exclude many more applicants – which defeats the objective of 'lender of last resort'.

[35] According to NCCA, micro enterprise development loan funds: "[f]oster social and business development through loans and technical assistance to low-income people that [are] involved in very small business or self-employed and [are] unable to access conventional credit". The other four categories are Community Development Banks, Community Development Credit Unions, Community Development Loan Funds and Community Development Venture Capital Funds.
See http://www.communitycapital.org/community_development/index.html

Some consultees believed that the regional Micro Finance Loan Fund did not apply strict enough criteria to potential applicants, and they ascribed the high uptake to the perceived laxity of the criteria. Ultimately, the effectiveness of selection criteria will be measured by the number of businesses that default (see below), although it is inevitable that failures will occur because of the rule of 'lender of last resort'. However, it is still conceivable that true 'duds' can be filtered out at an early stage. The Micro Finance Loan Fund achieves this filtering process via the provision of mentoring – a condition of the loan – which enables advisers to monitor the borrower's business. The Micro Finance Loan Fund also relies upon recommendations from Business Link advisers as to who should be lent money. Its criteria include evidence that there will be growth in employment and/or turnover, or safeguarding of jobs.

In addition to selection criteria as performance measures, it is useful to include the outputs (or outcomes) that the funds generate. The Micro Finance Loan Fund, PNE and Prince's Trust, for example, all report considerable numbers of businesses supported – and, therefore, employment creation. Other loan funds, particularly those that are more localised or sector- or group-specific, show less evidence of achieving significant outcomes. What is particularly difficult about this scenario is that large pots of money remain banked but are not distributed to others (outside the geography, sector, group) who would benefit from the funds. The type of business is also relevant: for example, the Prince's Trust helps predominantly start-ups, whereas the Micro Finance Loan Fund helps few start-ups (and they are mainly existing *companies* – few of its borrowers are unincorporated).

5.2 Sustainability, cost and economies of scale

One NorthEast clearly sees the benefits of rationalising the region's loan funds – by reducing administration costs, efficiency savings can result in more finance being available to the North East's small businesses (and hence more outputs in terms of businesses supported and jobs created). This stance was supported by some of the consultees, but others objected to the notion. The predominant viewpoint from many small loan funds was that they need to look after their own patch and the purpose of their fund was, after all, to promote businesses in their area. Most concern was expressed, for example, in the south of the region where it was considered unlikely that potential borrowers would travel 'all the way to Newcastle' to take out a loan. Other consultees regard amalgamation as essential because of the savings that could be made from having administration undertaken in one place.

Rationalisation is not something that we are recommending because, given the different sources of capital and revenue, it would be impossible to achieve in the short term. The preferable scenario for loan funds in the region, particular those funded by public money, is that they are complementary – not competing. The Prince's Trust, for example, stresses that it complements the Micro Finance Loan Fund and the Arts Council grants.

Another criterion for assessing micro loan funds is quality of leadership. The Prince's Trust performs better than in many other UK regions. Their view, and one that certainly might explain the increased uptake, is that the North East branch of the Trust has thrived because of a growing reputation and track record. As always, the voluntary sector provides important lessons for the public sector. Micro loan funds in the region that do not have decent management and leadership in place should be reassessed in terms of whether they deserve to receive public money. The Business Support Review emphasises that funders should move towards a Brokerage Model in which:[36]

> "There will be an investigation into which backroom services carried out either by funders or the network which do not add value to their business could be centralised or brought together [both to] save cost, but more importantly to allow the organisations to focus on their core business rather than devote resource to operations that do not add to what they do. The core of the 'clearing house' is to provide a mechanism for managing funding and information flows between those involved in the network and also their customers."

Given that the proposed support structure emerging from the Business Support Review is the mechanism by which future business support will be delivered, it is critical that the Review and our recommendations on micro finance are dovetailed – as should be the findings from the Regional Start-up Business Support Review study.

5.3 PROMOTION VERSUS A LIMITED POT

Inevitably, the smaller scale of a regional, publicly-funded loan scheme has a direct impact upon capacity (compared, for example, to a commercial fund that draws down finance for whatever the genuine market demand is). A number of loan funds, such as the regional Micro Finance Loan Fund, made clear that they do not need to advertise or to promote their scheme over-enthusiastically – because the direct result of such publicity would be to increase substantially the number of applicants to the scheme. This scenario appears to be evident most notably with the new Micro Finance Loan Fund, where the trend towards the funds running out has been stemmed by the provision of additional European monies.

It is clear from our research that there is a capacity constraint in micro finance funds in the North East in the sense that there appears to be sufficient demand for some schemes. Were publicity to be increased, it is *conceivable* that the capacity (i.e. the size) of the fund would also have to be increased. This increase might be beyond the realms of possibility for One NorthEast or indeed the European funders and so the issue shifts from publicly-funded monies to commercial sources (i.e. banks willing to provide funds for CDFIs in partnership with the RDA). An alternative might be better signposting to other funds when capital is exhausted in one pot.

It is also important to promote the option of starting in business and the availability of support for rural and new and growing businesses.

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[36] One NorthEast (2003) *The New Business Support Network for the North East*, One NorthEast: Newcastle upon Tyne.

5.4 Default

The proportion of the loan fund lost to bad debt is obviously an important issue for micro loan funds as, in the long term, it affects their ability to be self-sustaining. Funds such as the Micro Finance Loan Fund and PNE's loan funds have had a lower default rate than they expected. However, these when compared to banks are alarmingly high. Given the type of low income, high risk, non collateral loans that these funds are providing it might not be surprising – but it is important that loan funds do learn from other existing, more long-established funds to deal with this problem. It is certainly an issue of how rigorous the selection criteria are applied and is something that might be tightened up on in the rationalisation scenario envisaged by One NorthEast. However, unless capacity is increased or promotion remains virtually non-existent, more 'risky' applicants would likely be squeezed out by the need for more rigorous selection. However, this scenario could defeat the objective of micro finance. These are the very customers that it should support.

5.5 State aid rules and interest rates

State aid rules emerged as a concern in the region – because many representatives of loan funds did not understand the issue at all, and indeed there was considerable confusion. Annex 7 summarises state aid rules, which impinge upon the cost of a loan (in that, in certain circumstances, the interest rate must be above a certain threshold in order to avoid state aid implications). Since state aid rules are complex and perplexing even to professionals in this field, a guidance pack could be produced to provide clarification.

On the whole, we do not believe that the cost of finance is a major issue for borrowers. In the 1980s, when interest rates went through the roof, the banks caused problems by increasing the amount payable each month – it was cash flow that caused a problem, rather than the cost of money. Street UK charges interest rates of 12-26 per cent, partly because they have a wish to become self-sustaining, but also because they perceive the risk of lending to their target group to be high. Unlike the banks, the CDFIs give the impression that they do not price for risks.

5.6 Business adviser knowledge

In some Business Links there was evidence that the jungle of grants being provided was difficult for business advisers to negotiate. This issue need not concern us since grants are beyond the scope of this study. However, there is an emergent finding that indicates that there is also a jungle of loans in the region. Some business advisers may not know where to advise their clients to seek loans (which has to do with the above discussion of publicity). It is also clear that, for example, at Business Link County Durham advisers do not wish to be involved in signposting to certain loan funds. The majority of applications in Durham do come through organisations such as Walker Hall (business advice consultants), not Business Link County Durham, Enterprise Agencies etc. Walker Hall does, however, route its clients through Business Link County Durham, which countersigns the applications, which frees Walker Hall to be the mentor – without this mechanism, there would be a potential conflict of interest.

5.7 Regulatory requirements

There seems to be some confusion about what regulatory requirements cover micro loan funds, and some organisations have been registering with the Office of Fair Trading (in relation to the Consumer Credit Act – CCA) and the Financial Services Authority (FSA) just to cover themselves. In the early days of micro finance, the interest rates offered were generally considerably less than the minimum requirement of the Consumer Credit Act 1974. However, the rates have been changed. Broadly speaking, the position now is that the provision of credit (to individuals, rather than to companies) is only exempt from the provision of the CCA if the interest rate charged is no more than one per cent above the highest of the bank base rates 28 days before the day that the credit is offered. This rule means that any fund offering credit at a rate of more than 4.5 per cent (the current Bank of England repo rate – plus 1 = 5.5%) needs to register under the CCA and to abide by its requirements. It should be noted, however, that the Government is proposing to introduce a new consumer credit act, so the requirements may change.

The requirements of the Financial Services Act seem less clear cut; there seems to be a feeling that funds should register, but no-one seems clear why, or what it is that is being regulated. One loan fund manager admitted that the downside of obtaining ESF and Phoenix Fund money was that bureaucracy has, therefore, increased – hence the need to produce statistics, reports, outputs etc.

5.8 Information that funds should record

In undertaking the loan fund survey, we restricted ourselves to asking for information that we expected to be recorded by and easily available from loan funds. There was much more that we could have asked for, and which is almost certainly recorded, but which would have required far more effort by the funds if they were going to give us the information. However, if funds could be encouraged to set up reporting systems so that they could give far more information which could be used both for benchmarking their performance and also by policy-makers. A suggestion is presented in Annex 6. Our research suggests that no one else has looked at performance in the detail that has been used in this report, so One NorthEast has an opportunity to set a national standard.

5.9 Loan fund best practice

As a result of this study, we believe that there are a number of emergent measures of best practice. As far as clients are concerned, they want a simple, straightforward and prompt service. For the funds, a high level of deployment, means that the funds should have a large proportion of their capital lent – rather than sitting idle in their bank account, particularly important if the latent demand is really higher than current levels of lending. However, funds also have to balance the likely demand on their fund, so that they can meet demand on a continuing basis rather than either being stop-start, or making applicants compete for funds rather than assessing all applicants against objective criteria. Maintaining modest default levels, recognising that CDFIs will take more risk than the banks, and ensuring prompt repayment, will help to ensure that funds can continue to lend, by revolving their capital. A low level of default will also help to ensure that funds are sustainable, at least on a capital basis.

A role of CDFIs is to stimulate more bank lending to businesses that might not be immediately attractive to the banks, and if demand were suddenly to shoot up, the CDFIs would be unable to cope – so CDFIs ability to lever additional support from commercial sources is important. Efficient back office services will keep transaction costs manageable. Lastly, loan funds should be aware of and should meet the regulatory requirements (for example, state aid, CCA, FSA and data protection).

These best practice messages can be used as a basis for discussion amongst loan funds in an informal forum to enable them to improve their performance and move closer to achieving better 'outcomes' for the businesses to whom they lend.[37] We have made a stab, as shown in the box below, at suggesting some measures and targets.

BOX 1: Key measures of loan fund best practice

Deployment	75%
Low level of default	Lower than the interest rate being charged
Leverage	2
Efficient back office services (perhaps using total sustainability index as a proxy)	0.5
awareness of and meeting of regulatory requirements (state aid, CCA, FSA)	All met

6. Recommendations

Based upon the findings of the study, we recommend that One NorthEast:

- Makes provision for closing the capital gap from 2006 onwards, when up to £1m per annum may be required, though the level of lending achieved during 2004 will help to inform on the specific size of the gap;
- Prepares a policy position on the basis that supporting micro-finance is an important component of business support, recognising that CDFIs are unlikely ever to be totally sustainable and that they will require some degree of revenue support;
- Works with all the business support network to increase the level of marketing to encourage more new starts, and to encourage more businesses to make use of the available business support;
- Encourages those providing capital to loan funds to adopt uniform assessment criteria (a sample is provided in the annexes);
- Considers, with the other RDAs, whether it would be beneficial extending this study to other parts of the UK and implementing an annual CDFI performance review;
- Shares results of this research nationally;
- Commissions the preparation of a simple guide to state aid rules; and,
- Stimulates the creation of a CDFI forum in the North East.

[37] Another useful guide to best practice is summarised in Annex 7: CoECs (2003) *Access to Finance of Small and Medium-sized Enterprises*, COM (2003) 713 final, CoECs: Luxembourg.

Whilst not strictly part of our remit, we recommend that such a forum considers:

- Adopting common application requirements for prospective clients (ideally comprising a short application form providing basic information, backed up with a business plan, financial forecasts, previous accounts (for businesses already trading) and a supporting letter from their business adviser);
- How CDFIs can learn from each other and whether there is scope for cost reduction, sharing back office services, etc (and perhaps to learn from others such as Shared Interest);
- Reviews the scope for referring applicants (possibly with appraised propositions) to the under-performing funds to ensure that money is not clawed back and lost to the region;
- Agrees to report against standard requirements so that CDFIs can benchmark their own performance and so that policy makers can learn more about their impact (a suggestion is provided in the annexes).

Annexes

Annex 1: NE micro loan funds

Micro Finance Loan Fund

The Sunderland Business and Innovation Centre (an Enterprise Agency) runs the Micro Finance Loan Fund. The BIC has never had to promote the scheme.[38] In terms of demand, they did not have to promote the Micro Finance Loan Fund outside Business Link; if they promoted the fund, they could increase the demand X 5 and they could displace people who would normally obtain conventional money.

Over a one-year period, they have had 75 loans and in its new contract out of a target of 80 loans they have approved 112. The Micro Finance Loan Fund started in June 2003. BIC had a previous loan fund that commenced in 1995 – the 'Innovation Fund', which the TEC administered at the time, to meet their target of expansion and new jobs. The TECs closed and they stopped the loan fund and the money was returned to central Government: it was flexible, did not require due diligence and was highly risky – but it had few failures.

As the new Business Link formed, there was an ICT Group chaired by Dan Brophy who said that IT clients could benefit from very flexible funding because of volatility in the market. A pilot from One NorthEast was established and the original concept was a 'credit card' with a credit limit (but then many IT companies use credit cards). The practicalities were different, so it became a standard loan fund – 3 years and nine per cent interest open to IT companies in Tyne & Wear. The pilot involved 30 loans, which BIC administered. Business Link then approached the RDA to suggest that it would be a good idea to have a flexible and risky amount of money across the region available to be lent to all types of businesses. The RDA allocated £3m into the Micro Finance Loan Fund. The fund was rolled out in the first 8-9 months with up to *£15,000 for a limited company and £5,000 for a sole trader*. They have not lent as low as £500 as the mentoring element would be impossible; e.g. for £15,000 lent, £3,500 for mentoring is provided. The loan will not be given unless the company allows a mentor (funded separately) to go into the business. This approach is considered to be the best way to transmit professional support and best practice into the company; the mentor's role is not to deliver the plan but to act as a guide.

Prince's Trust Business Programme

The Prince's Trust helps young people, who would not otherwise have the opportunity, to succeed.

It is the UK's leading charity for young people, enabling 14-30 year olds to develop confidence and skills, get into work and start their own businesses. It particularly focuses on those who are unemployed, under-skilled, within or leaving the criminal justice system or leaving care.

[38] They do have brochures that are distributed via the Business Link network but most referrals do come through the network.

The Prince's Trust business programme provides market research grants together with start up loan and grant support to young people ages 18-30. Nationally over 4,000 clients are supported each year and the North East region starts around 420 new clients into business each year. Loan support can be up to £4,000 (£5,000 for partnerships). Grant support of up to £1,500 is available subject to funding.

Average loans in the region are around £2,000.

Mentoring is offered to clients for the 3 year duration of the loan.

Market penetration is higher in the North East than many other regions. They have strong links with Business Links and enterprise agencies and are not in competition with the Micro Finance Loan Fund but rather they compliment it.

Four area offices allow the fund to cover the whole of the region, from Berwick to the North Yorkshire border. Survival rates are above national average. All the young people that they help generally could not raise bank funding initially because they have no capital.

The Prince's Trust loan fund is prepared to take risks. They argue that there is a case for grants in addition to loans as it reduces the debt burden on a financially disadvantaged young person. It helps the young people with the cash flow in the early years of their business, and makes a real difference. In the client's eyes, the Prince's Trust is a supportive organisation: not a moneylender. The interest rate is three percent,(apr 4.98) which can be less competitive when interest rates are low. What they do achieve, though, is to lever their money with bank money – for example they could lend £2,000 and the banks would match it for capable clients with a strong & robust business plan.

Project North East loan fund

PNE is in transition. Its two funds, 'Northern Youth Venture Fund' (under 30s) and the 'Shell Loan Fund' (30 +), provide either a start-up loan of up to £5,000 or an expansion loan of up to £10,000. From 1 April these have become the 'PNE loan fund'. They try to offer their facilities on a regionwide basis, but most enterprise agencies do not have loan funds; but they do have business advisers and PNE can provide business loans to clients. PNE has a limited resource: there is only one person to run the fund. He assesses all the applicants and writes a report, and he represents all applicants on a panel of trustees. He manages the loan fund, chases all debts, and basically does everything. The loan fund has run for 12 years and usually there is a 3-year maximum, and as an organisation they do not want to have commitments for longer than that. If a business is established, it should be able to approach a traditional source of finance after three years. Other loan funds have more HR than they do, but PNE is quite efficient here. Last year they had 125 applications and offered 100 loans, which is a fairly typical percentage. The constraint on numbers is human and monetary: if they had more resources available, they could step up the number of applications. The average amount of loan is £4,000 and the majority are in Tyne & Wear because PNE is based here. Few of their clients are companies – and approximately ninety-eight per cent are unincorporated.

The target market is people who cannot obtain finance from traditional sources, i.e. people from disadvantaged backgrounds who have a viable idea. They could have a degree or could be a non-graduate unemployed for 5 years, and PNE thinks they are worth a chance. PNE takes more risks than a traditional lender, but they achieve good results. The banks have a credit-scoring system that is extremely tight. Over the last 20 years they have lost fifteen per cent of the capital. However, sixty per cent of businesses do continue to trade after 3 years and some do continue trading for 30 months but might write off the debt or pay it off from wages from paid employment.

Falchion Fund (Darlington Borough Council)

As well as grant schemes, the Borough Council's loan scheme is the Falchion Fund, which is a micro loan package up to £10,000 for business start-ups or existing businesses to develop in some way. The fund was started in 1995-96 and it has since been revamped. The Borough Council and HSBC provide it. The fund started with £300,000 – half each from HSBC and DBC – and has recently been topped up by a further £60,000 from HSBC.

The fund is aimed at SMEs in Darlington: eighty per cent of businesses that they help are below 10 employees – most are under 5 and their biggest has less than 50 people. Bigger companies have a better relationship with their bank. The Prince's Trust, Business Link, Darlington Business Ventures, accountants and Darlington Borough Council will signpost their clients to this loan fund. It is discussed and then taken to the bank. They formally turn few away.

The fund is designed to assist businesses where they have a shortfall from High Street banks, which enables them to add some more to what the High Street provides. This loan fund also helps to complement the grants.

Northern Oak Credit Union

Northern Oak Credit Union is a merger of a number of community-based credit unions. It is essentially the legal entity 'North Shields Credit Union' with its name changed; which, they were advised by the FSA, was the best way to set it up, rather than starting a new entity. Credit unions are supposed to be 'friendly societies' but some are less so. It took a long time to establish Northern Oak Credit Union, then they were able to work together – and the slight mistrust was gone. The credit unions had faced volunteer burnout because of FSA compliance and thus there were few remaining volunteers. NOCU has taken compliance away from the credit unions, and an Administrator now runs it from the head office.

Because of internal difficulties, the Phoenix Fund has been passed by – but they accept that they need to develop it. Originally, they had to use the money by March 2004 but they have renegotiated the terms so they can use it by March 2006. They have given out one loan and have £250,000 to spend. That money is to be ringfenced – it can only be lent for business developments and start-ups. They are asked in advance what they expect in the next few months, then they draw it down since it is then their capital. A downside is that the Phoenix Fund money can only be lent to individuals by NOCU because credit unions are not allowed to provide loans to 'businesses'. Instead, they must lend to the directors. Credit union legislation dictates that they can only lend to *private individuals*.

To avoid risk exposure, they will lend a maximum of £2,500 per individual, or a maximum of £10,000 for a business (a number of individuals). The maximum interest rate a credit union can charge is 12.68 per cent per annum, and it is the usual charge to members to cover the overhead costs. However, because of the way that the Phoenix Fund contract was drafted, NOCU's interest rate is 12.68 per cent – the minimum and maximum. They do not know if it is better to have a lower rate than this one – if the applicant cannot obtain money from elsewhere, they can get what they want. It may be easier if the rate were lower.

UK Steel Enterprise

Set up in 1975 by British Steel Corporation, with the objective of regenerating former and current steel areas. Part of this activity involved finance to businesses. Corus have invested a further £10m 3 years ago which is a loan, though effectively it is a grant. The notion is to fill the gap between mainstream VC and small, unsecured loans. The operation is now self-sufficient but this is mainly due to the property aspects and the income they generate. They are a SFLGS technology lender.

Loans or loan/equity deals from £10k to £400k. The average deal is £95k. it is designed to help new businesses to start and existing businesses to grow. Around one quarter of loans go to new businesses, the remainder to existing businesses. The fund is aimed at being a complement to other sources of funding.

The finance they provide falls into the following categories:

Unsecured loans Up to £35k, repayable over 1 to 4 years. Fixed interest rate of 7.5 to 8 per cent (tracks base rate but fixed for period of loan). Provide a capital repayment holiday, but this is not encouraged. The loan may be linked to a share option. No fees.

Secured loans up to £250k on the first round, and £400k total exposure. Terms as unsecured loans. Security taken on business assets but their call on these assets is often subordinated (below the bank, for example). Leverage – 7-8 times over 10 years.

PRIME

PRIME works through a network of local partners – rather than setting up their own infra-structure – which include enterprise agencies, InBiz and other business support organisations. The process, typically, is that someone who is aged 50+ approaches the business support organisation. They are assisted to prepare their business plan and, if eligible, for a PRIME loan, their plan is submitted to a loans panel put together by the partner. This could fit with other activities of the panel – the only requirement is that it is independent. The panel makes the decision and the application is then sent to the PRIME head office for endorsement. As soon as a partner believes that it has a potential PRIME application, it informs PRIME and keeps them apprised of progress – to minimise the chances of PRIME over-ruling the panel decision. Apparently, this situation has happened once – though not for a North Eastern submission, where the applicant wanted to start an employment agency and planned to charge the candidates (which is now illegal) but no-one had advised the client of the illegality until it got to PRIME's head office.

The advantage of this process, apart from keeping down PRIME's transaction costs, is that they have one pot on which a host of partners can draw, rather than having lots of local managers all with money languishing in the bank.

In addition to the local partners, PRIME has been appointing regional managers. The intention is that they should be able to add some value. They link enquirers to partners. They support partners. PRIME has concluded that many business advisers do not make good mentors, so is offering mentoring training (free to the partners). The partners are expected to carry on mentoring the applicant after they are given a loan. To encourage this, PRIME is planning to introduce bonus payments whereby they will pay £500 to the partner towards the cost of providing mentoring support for every applicant who is still in business a year after receiving their loan. PRIME currently charges an interest rate of 9 per cent, though the contact at PRIME asserts that this rate is too low, especially if PRIME is ever to become self-sustainable.

Street UK

Apparently the regions of Street UK are each incorporating separately as companies limited by guarantee. The company in the North East has now been formed. The hope is that this situation will now make it easier to raise money locally to replenish and expand their capital base. Street UK in the North East has £100,000 from the Newcastle Employment Bond (which will eventually have to be repaid) and a loan from Northern Rock.

Their target market is different from everyone else's. Certainly their approach is different, but their market is not so different. The main difference, perhaps, is that they claim to be focusing on identifying people who have been working informally and encouraging them to transfer to the formal market, in order to gain access to loan finance. Other funds will also help such people but do not focus all their efforts on them.

Before they will lend, they require that entrepreneurs find someone who will act as a guarantor. They will lend a maximum of £10,000 though it is far less for a first loan – borrowers have to build up a track record before they can borrow larger amounts. They require people to be in business for at least six months before they will lend, though they regard activity within the informal sector as part (or all) of that time.

To date, they have supported 69 businesses. As far as they know, 50 per cent have never had to call on the guarantor to help. They believe that 11 per cent would not have paid had it not been for the guarantor. They think that the guarantor had an effect in 22 per cent of cases and that in 17 per cent the guarantor made no difference whatsoever. They do expect to call the guarantee if loans go wrong. So far about £17,000 is in delinquency, but they have only actually written off £700 with the rest the subject of negotiation and litigation.

Street UK does not offer cheap money. The interest rate depends on the size of the loan and the term, and varies from 12.4 per cent to 26.8 per cent (and first time borrowers would usually pay interest at that level). Street's objective is for the interest and fees that they charge to cover, at least, any losses on their capital. They still expect, at least in the short term, to have to find all of their revenue costs by way of grant aid, though they would like to be able to contribute towards that from interest on the loans.

Street UK's borrowers are mostly in Newcastle (mainly because of the support that they received from the Newcastle Employment Bond) but they do have clients as far away as Morpeth and Hartlepool.

They see their problems as being marketing (the client group is a hard one to reach) and insufficient capital (despite the high interest rates, they believe that they could easily lend £0.5m if he had the capital available). They could not see the irony in not having enough money and not having enough clients. They believe that ONE NorthEast is keen for them to expand their loan fund regionally.

They do see a big part of what Street is trying do as education. They say that they work closely with the business support organisations and that they would like to work closely with the credit unions. In many ways, Street UK is far closer to the approach of the credit unions than of the enterprise agency loan funds.

Entrust TWELF

Entrust runs Tyne & Wear Enterprise Loan Fund (TWELF), their micro loan fund, which has not been topped up for years. Its interest rate is five per cent, but the money cannot be used for vehicles. Loans can be up to £5k, but typically £2.5k. They do about 6 per year.

The target audience is early-stage or start-up businesses (where they perceive a degree of naivety). The fund is designed to tie in with Entrust's client base. There used to be an arrangement with a local bank that the bank would match the fund, but this diminished because of the low level of activity. They also used to work jointly with PNE and the Shell Enterprise Fund.

Entrust see it as important that, for micro loans, the application process must be simple and the decision made quickly.

Spirit of Enterprise

The fund was started in honour of Peter Goodinson (John Bridge raised a pot of money from sponsorship and this money formed the base of the fund). One NorthEast then provided funding to pay for administration of the fund (for one year) and this was boosted by European money. There is currently approximately £100k in the pot.

There is a high default ratio because the objectives of the fund are based around it being an "intervention" fund. It is used to help businesses develop and start-up. An applicant prepares a business plan, which is then assessed and a decision made. They do not view their fund as a lender of last resort, more as a facilitation of progression of disabled individuals, helping people to move on in their lives. The default rates were higher at the start of the fund – ascribed to the artificial pressure of achieving targets associated with the European elements of the initial funding.

The application process also requires applicants to complete a Regional Micro Loan Fund form, and provide a CV and a letter stating the position relating to their illness or disability.

Their vision is to build the loan fund to include mentoring, which they see as an important complementary business support service. They see that the trust that is built up through their existing relationships could be built upon to good effect.

They approve around 2 out of every 5 applications (forty per cent) but admit that the cost per loan is very high. They approve approximately 15 loans per year, but that they are not scratching the surface (though there is no hard evidence to prove this). Their assessment of the wider demand is based upon the fact that the outputs have restricted the loan fund.

Their target audience is the disabled and those with long-term illness (though the boundaries are not clear, as one might expect). They are not interested in the severity or type of disability. There are many issues associated with helping such people.

Interest rate is 12%, and the term averages at 3 years, though ranges from 1 to 5. They also offer a capital repayment holiday for the first 6 months. There are no restrictions on what the money can be used for (capital, revenue, etc.) They currently offer loans in the range of £1,000 to £10,000, and the average is £3,000. They might submit an application to ESF and Single Programme to increase the pot to allow up to 30 loans per year.

CapitaliSE

The North East Social Enterprise Partnership and Angier Griffin (a social enterprise consultancy started by a former Chief Executive of Traidcraft) are running this CDFI, which is financed through the Phoenix Fund. The Phoenix Fund bid was originally in the name of CashPoint, but due to 'trademark' issues they have had to rename the scheme CapitaliSE (the SE refers to 'social enterprise'). Its aim is: 'To build a vibrant social enterprise sector in the North East, access to finance is one of the essential foundations.' Its first two objectives are to:

- provide an information and signposting service for social enterprises seeking new finance
- train business advisers in the issues around access to finance for social enterprises.

Its themes are to enable people to develop ideas in social enterprises that they can borrow money and work with people who advise social enterprises (the signposting element). The capital amount to set up a commercial loan fund at the early stage is available from the Phoenix fund, and the project commenced in March. They are currently, via consultations with social enterprises, deciding upon the scope and detail of the fund.

They estimate there to be around 400 social enterprises in the region, but this estimate is at the bottom end – there could be as many as 1,000 dependent upon which definition is employed (for example, does the definition include credit unions?). It is clearly a growth area. When they wrote the bid, they said there was a broad target to work with 100 social enterprises to 'interface' with them by providing training and advice; and to provide loans.

They believe that 25-30 per cent will be new social enterprises and 70-75 per cent will be established SEs.

At the first stage (under £10,000), many social enterprises are risk averse but at the second (£10,000 – £30,000) and third stage (£30,000 up to £100,000) they will probably be robust enough to take on a loan. NESEP is trying to build a consortium, to avoid 'competition' with existing initiatives. They anticipate 40 loans at £25,000 each – but there might be a need for lower amounts (so they could conceivably fall into the 'micro finance' definition but not one hundred per cent). SEs that require larger amounts should already be bankable (e.g. mainstream banks, Triodos Bank etc), whereas £5,000 can be obtained in the form of grants, for example, through the Scarman Trust or in the form of start-up loans from the Northern Rock Foundation.

The fund will cover the whole region and CapitaliSE will visit the applicants (although they are aware that much in the region is Tyne & Wear centric, they are themselves based in Teesside.) They recognise the importance of leverage and matching their loans with grants.

North East Seed Capital Fund

The alternative to lending is to seek equity investment. One example is the NESCF administered by Northern Enterprise Ltd. This fund falls slightly into the micro finance category in that its minimum level is £10,000 (although the maximum is £150,000). The following text from the One NorthEast website shows the fund to be an *alternative* to loans.[39] It is, however, beyond the scope of this study to investigate NESCF further – and also it does not cover the deprived groups from 'lender of last resort' loan funds.

> In the North East of England the Universities of Newcastle Durham, Northumbria, Sunderland and Teesside, all demonstrate sustained excellence in Research and Development and successful collaborations with industry. Northern Enterprise (NEL), a Venture Capital Fund Manager, based in the North East, believes that there is great potential to accelerate the pace and scope of technology investment in the region through successful commercialisation of Research and Development in these five Universities.
>
> The Fund is dedicated to the commercialisation of technologies generated in the region's Universities based on or incorporating technology generated in those Universities. Although there are very strong sectors of technology in the region's Research and Development landscape, such as Life Sciences, Informatics and Advanced Engineering, the Fund has no sector bias.
>
> NESCF does not give grants. The Fund makes equity investments, through which it expects to make favourable returns for its investors as a result of the successful commercialisation of the projects it backs. Investments will only be made in projects, which NEL believes have the potential for genuine commercial success, and may be 'milestoned' in accordance with an agreed business plan.
>
> The Fund prefers to invest in private limited companies. However, NEL recognises the need for flexibility; some projects may require pre-commercialisation funding at a time when it is not possible or appropriate to form a company. Investments to back such projects will be in the form of an advance investment for up to £10,000 and are covered under a simple Heads of Agreement.

In all cases projects must as a minimum demonstrate that:

- The technology has significant commercial potential and that a route, or routes, to large, potentially global markets have been identified.
- Further innovation is planned.
- The management and founders are dedicated, capable and have the vision required to commercialise the technology.
- Intellectual property ownership and exploitation is clearly defined i.e. the technology is or can be protected by patent or copyright in the case of software.
- There are opportunities for the Fund to realise the investment, for example, through a licensing arrangement, trade sale, an Initial Public Offering (IPO) or a Corporate Partnering Agreement.

[39] http://www.onenortheast.co.uk/page/supp_4ii/fin_supp/fp_northeastseed.cfm

Annex 2: Organisations consulted

Organisation	Contact
1. Anthony Douglas	Anthony Douglas
2. Barclays	Mark Ford and Sharon Fournier
3. Community Loan Fund for the North East	Rod Jones
4. Darlington Borough Council	Steve Tuffin
5. Entrust	Bob Marris
6. Government Office for the North East	Kay Goodinson
7. Laing & Cruickshank	Sir David Chapman
8. Micro Finance Loan Fund	Jules Preston
9. Micro Finance Loan Fund	David Howell and Alexa Rainsford
10. Northern Enterprise Limited	Barrie Hensby
11. CapitaliSE (North East Social Enterprise Partnership)	Philip Angier and John Probert
12. Northern Oak Credit Union	David Hodgson
13. Northern Pinetree Trust	Michael Heathrol
14. PRIME	Laurie South
15. Prince's Trust	Judith Gill and David Beavis
16. Project North East	Ian Fulthorpe
17. RTC Associates	Abdul Malik
18. South East Northumberland Enterprise Trust	Allan Bell
19. Small Business Service	Grant Peggie, Bob Brennan
20. Street UK	John Hall
21. Teesdale Enterprise Agency	Shaun Stuart
22. Tyneside Economic Development Company Ltd	Neil Plant
23. UK Steel Enterprise	Simon Hamilton
24. unw Chartered Accountants	Neville Bearpark

Annex 3: Micro credit Performance Measures

Quantitative measures	Derived measures	Performance evaluation
Market penetration		
Serious applications (i.e. plans submitted)		
Offers made (by volume & value)		Evidence of quality of proposals being submitted
Impact		Whether intended results are being achieved and whether they remain appropriate
Loans taken up (by volume & value, ideally by sector and post code)		
Businesses supported (to allow for businesses who receive multiple loans)		
Amount levered from elsewhere (ideally split by commercial & non-commercial)		Building relationship of trust and confidence with commercial finance providers
Jobs created or maintained		
Ideally, increase in client turnovers at one, two, three years		Helping businesses with potential or just supporting subsistence businesses
Financial position		
Capital repaid		
Interest paid		
Loans written off (by volume & vale)		
Outstanding loans		
Loans at risk (volume & value)		
Loans written off (volume & value)		
	Loan book value	
	Capital available	
	Average loan size	
	Default rate	
Operating results		Measure of efficiency
Fund running costs	Cost per pound lent	
Capital provided (by grant & loan)		
	Deployment	Fund getting loans out to those who need them…
	Lending cover (years)	…whilst being able to meet demand
Sustainability		Ability of fund to cover its expenditure
	Capital sustainability	
	Total sustainability	

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Annex 4: Detailed benchmarks

	Lower quartile	Median	Upper quartile	Mean		National benchmarks
Calendar 2003						
Applications Considered	107	109	126	170		120
Loans Offered	42	84	100	127		71
Loans Taken Up	42	62	99	118		46
Businesses Helped	22	62	99	114		46
Amount Offered	130,753	394,000	1,010,000	518,751		785,270
Amount Lent	130,753	389,000	744,000	445,551		654,620
Additional Funds Levered	70,000	140,000	175,000	116,667		841,850
Jobs Created/Maintained	59	121	495	325		241
Capital Repaid	39,514	76,552	127,000	146,613		0
Fees/ interest paid	12,000	12,333	12,975	14,862		61,574
Loans Cleared	8	19	85	75		1
Loans Written Off	6	13	30	70		5
Loan Amount Written Off	12,000	43,913	56,000	72,083		38,327
Outstanding Loans	53	59	138	228		814,521
Average loan size	2,480	3,113	3,929	4,790		14,170
Loans approved	45%	77%	79%	65%		62%
Jobs per loan	1.32	1.40	1.50	4.09		6.08
Annual running costs	50,000	110,000	145,525	98,935		200,500
Cost per loan	505	2,390	2,929	1,916		4,334
Cost per pound lent	0.13	0.20	1.11	0.55		0.31
Capital sustainability index	0.30	0.90	0.92	1.00		2.53
Total sustainability index	0.10	0.15	0.20	0.20		0.27
Inception to 2003						
Applications Considered	140	188	1,510	1,399		326
Loans Offered	84	97	871	1,063		159
Loans Taken Up	62	97	760	996		144
Businesses Helped	62	69	656	969		144
Amount Offered	227,253	1,010,000	2,983,725	2,226,196		2,242,877
Amount Lent	227,253	744,000	2,505,000	1,935,251		1,999,175
Additional Funds Levered	522,500	1,000,000	4,331,655	2,902,770		2,576,763
Jobs Created/Maintained	141	929	1,776	1,627		701
Capital Repaid	49,000	128,501	1,724,000	888,203		670,474
Fees/ interest paid	12,975	19,992	170,000	81,393		141,806
Loans Cleared	32	203	772	602		7
Loans Written Off	13	21	243	286		13
Loan Amount Written Off	43,913	57,000	374,000	496,663		146,596
Percentage Write Off	6%	15%	29%	17%		7%
Outstanding Loans	54	59	140	229		1,232,973
Capital raised	346,250	635,000	1,025,000	736,250		1,885,000
Capital outstanding	94,000	407,000	660,573	550,385		1,182,105
Capital available	216,372	244,500	448,750	420,622		536,400
Default rate	9%	13%	14%	12%		5%
Smallest loan	500	500	600	1,420		1,500
Largest loan	10,000	12,000	15,000	15,400		42,500
Income from interest	2.1%	2.3%	2.9%	4.6%		
Apparent average term (years)	3	3	3	5		
Deployment ratio	29%	30%	76%	52%		67%
Leverage	0.0	0.2	0.2	0.7		1.6
Lending cover (years)	0.5	2.7	2.9	2.7		0.9

Annex 5: Estimating the demand

The figures in the table below show the results for 2003, with Prince's Trust lending separated since it does not hold funds locally. We have assumed a rise in demand for 2004 of over 50 per cent, to £3.6m, and then a five per cent per annum increase thereafter. We have assumed that loans are repaid within four years, that interest earned and capital losses balance each other and that Prince's Trust lending goes up at the same rate of five per cent per annum. This shows that the funds can cope with the entire demand this year, but that a gap will appear from 2005.

Figure 11: Analysing the gap

		2003	2004	2005	2006	2007
Additional funds available						
PT		930,000	976,500	1,025,325	1,076,591	1,130,421
Phoenix			1,450,000			
ESF (micro loan fund)			800,000			
ESF (PNE)			200,000			
Total additional funds			3,426,500	1,025,325	1,076,591	1,130,421
Capital brought down			1,682,489	1,821,489	874,625	1,067,610
Capital available			5,108,989	2,846,814	1,951,216	2,198,031
total demand increases to…		3,600,000				
total demand increases by …	5%		3,600,000	3,780,000	3,969,000	4,167,450
Total lending		(2,227,753)	(3,600,000)	(2,846,814)	(1,951,216)	(2,198,031)
Capital Repaid (ex PT) years	4	273,066	312,500	874,625	1,067,610	965,983
Fees/ interest paid	5%	39,308	62,500	174,925	213,522	193,197
Loan Amount Written Off	5%	(120,413)	(62,500)	(174,925)	(213,522)	(193,197)
Capital carried forward		1,682,489	1,821,489	874,625	1,067,610	965,983
loanbook (ex PT)		1,250,000	3,498,500	4,270,439	3,863,932	3,772,362

Annex 6: Criteria for loan fund assessment

The criteria set out here are based on institutional performance standards developed in the USA. They are intended for use by project officers, funders, loan funds and policy makers. The purpose of these principles is to establish common standards for funders to apply in supporting broader access to financial services for micro and small enterprises. They identify the characteristics intermediaries seeking business support should be able to demonstrate, either in current operations or through credible plans.

Institutional Strengths

- Institutional culture, structures, capacities, and operating systems that can support sustained service delivery to a significant and growing number of clients. Requirements include a sound governing structure, freedom from political interference, good fit to local context, competent and stable staff, a strong business plan for expansion and sustainability, and mission and vision which create a sense of purpose, ownership and accountability
- Accurate management information systems that are actively used to make decisions, motivate performance and provide accountability for funds.
- Operations that manage small transactions efficiently, with high productivity, as measured by variables such as loans per staff and operating costs as a percentage of average annual portfolio or of annual loans.
- Meaningful reporting standards with transparent financial reporting that conforms to international standards and allows prospective funders to evaluate performance adequately.

Quality of Services and Outreach

- Focus on people and businesses that cannot raise their funding requirements from commercial source. The focus need not be exclusive, as mainstream institutions such as banks should be encouraged to lend as well.
- Client-appropriate lending. For example, for micro-level clients, institutions should feature quick, simple and convenient access to small, short-term loans, often short-term, that are renewed or increased based on excellent repayments. Use of collateral substitutes (e.g., peer guarantees or repayment incentives) or alternative forms of collateral to motivate repayment. Emphasis on character based lending for smaller loans, with simple cash flow and project appraisal for larger and longer-term loans.
- Growth of Outreach. Making significant progress in expanding client reach and market penetration, demonstrating both strong client response to services offered and competence in service delivery management.

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Financial Performance

- Appropriate pricing policies. Offering loans at rates sufficient eventually to cover the full costs of efficient lending on a sustainable basis (after a reasonable start-up period), recognising that disadvantaged entrepreneurs are able and willing to pay what it costs an efficient lender to provide sustainable financial services. For funds unlikely or unable to do this, there should be a strategy for sustainability in place.
- Ideally, interest charges should be set to cover the costs of capital (at the opportunity cost, including inflation), administration and loan losses though it is recognised that it may not always be possible to cover all the administration costs.
- Portfolio quality. Maintaining a portfolio with arrears low enough that late payments and defaults do not threaten the viability of the institution. For example, organisations with loans in arrears over 30 days below 10 per cent of loans outstanding and annual loan losses under 4 per cent of loans outstanding satisfy this condition.

Legal requirements

- Are registered under the Consumer Credit Act 1974 and the Financial Services Act, if appropriate.

Annex 7: State aid rules

State aid is mentioned by a number of loan funds as a justification for their interest rates of between nine and ten per cent. But the Director of an enterprise agency pointed out that the biggest problem for businesses in his patch was that loans are too expensive: their rates are too high. Darlington Borough Council's Falchion Fund has a very low interest rate and they do not see state aid rules as an issue. Many of the other funds receive European monies, and so these rules may only apply within the agreement period (first 3-5 years), after which the monies are 'clean' and can be lent out under whatever terms are suitable to the fund. It was notable that a number of consultees were unaware of state aid rules. In a nutshell, the state aid rules require that clients are made aware of any state aid issues.

If funds are in receipt of public monies, and are lending secured below a threshold set by the EU (currently 5.68 per cent),[40] then clients must be given a certificate telling them how much state aid they have received. If the interest rate on loans is above the threshold, then there is no state aid provision though some agencies (such as Project North East) are providing certificates explaining that clients have not received any state aid. The state aid rules – which originate from the concept that state aid can distort competition in the single market[41] – also stipulate that (if the loan is unsecured) 400 percentage points must be added, i.e. state aid issues arise if the interest rate is below 9.68 per cent. The rationale behind this distinction is that unsecured loans are considered to have a higher risk. [42] There are various types of state aid: aid to SMEs that are invested in, aid to investors and aid to the fund (or 'other vehicle through which the measure operates'.[43]

It is fair to say that all these rules are adding substantially to the paperwork and red tape and pushing up transaction costs. One suggestion that was put to us was that there should be a guidance pack available which assists loan funds, particularly new ones, to go through all the necessary steps and provides forms etc for their use. This guidance pack could potentially go even further with the provision of appropriate software, which could handle all of the administration and all of the reporting for individual loan funds. The Micro Finance Loan Fund is obliged to have an interest rate of ten per cent, whereas that of the Prince's Trust is 3 per cent (APR 4.98%) and PNE's is 6 per cent.

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[40] See www.europa.eu.int/comm/competition/state_aid/others/reference_rates.html

[41] European Commission (1996) *Commission notice on the de minimis rule for State aid* , *OJ C 68, 6.03.1996* (96/C 68/06). See Annex 6 for the full text.

[42] See also European Commission (2003) *Vademecum: Community Rules on State Aid*.

[43] European Commission (2003) *Small and Medium Enterprise Venture Capital and Loan Fund*, C(2003) 97.