Micro-lending for Enterprise in the UK

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Introduction

This report provides an overview of micro-lending in the UK, covering both the need for micro-finance and the nature of the organisations that have developed to provide it. The first chapter of the report looks at the growth of micro-enterprise in the UK, setting the context for a closer look at needs for financial support among this group. Chapter 2 assesses needs for both start-up and expansion finance among micro-firms in the UK. This is followed, in Chapter 3, by a look at the various sources of funding for micro-enterprise which currently exist in the UK. Chapter 4 looks in detail at commercial finance for micro-entrepreneurs and, in particular provides an analysis of the problems faced by this group in obtaining access to bank finance. The final chapter follows up this theme, by looking at micro-lending initiatives in the UK and the extent to which they meet the needs of micro-entrepreneurs.

1 The growth of micro-enterprise in the UK

Official statistics show a rapid increase in the numbers of both self-employed people and businesses over the 1980's, which was reversed by the effects of the early 1990s recession. At the height - in Spring 1990 - there were more than 3.5 million self-employed people (double the number in 1979) and 3.8 million businesses. The numbers fell quite steeply over the period to the spring of 1993 when 3.2 million people were self-employed and there were 3.5 million businesses. Since then the numbers have picked up somewhat although they are still below the peak of 1990 (Table 1). According to estimates produced by Barclays Bank, the number of business start-ups in 1997 exceeded the number of closures by around 20,000.

Table 1.1 Statistics on self employment and numbers of small businesses

	1990	1991	1992	1993	1994	1995	1996	1997
Self employed ('000)	3,561	3,402	3,227	3,184	3,301	3,355	3,286	3,348
No. with no employees ('000)	2,455	2,363	2,311	2,310	2,443	2,482	2,466	na
No. with employees ('000)	1,106	1,039	916	874	858	873	820	na
No. of businesses ('000)	3,800	3,800	3,600	3,500	3,581	3,706	3,724	na
No. with no employees ('000)	na	na	na	na	2,589	2,486	2,517	na
No. with 1-4 employees ('000)	na	na	na	na	613	812	813	na

Sources: Labour Force Surveys - seasonally adjusted figures for self-employed in the spring of each year
Department of Trade and Industry - figures for numbers of businesses at the start of each year

In spring 1997, 3,348,000 people were estimated from the Labour Force Survey to be self-employed, while the latest Department of Trade and Industry estimates show there were 3,724,000 businesses at the beginning of 1996 - 90 per cent of which (3,330,000 businesses) had up to 4 employees and, therefore, fall within our definition of a micro business There is, however, a much higher turnover than the annual totals in Table 1 would suggest. During 1997, 508,000 new businesses were set up while 489,000 ceased to trade - and, of these, at least nine out of ten might be expected be micro firms with up to four employees (Barclays Bank Bulletin).

Characteristics of micro businesses

Overall, around three quarters of the self-employed and of micro-firms have no employees at all - a figure that has stayed reasonably constant over time (Table 1). The most recent statistics from the Department of Trade and Industry show that, at the beginning of 1996, 84

per cent of UK companies with no employees were sole traders, 15 per cent were partnerships and just 1 per cent were limited companies.

On the whole, their annual turnover was modest, averaging £31,000 across all types of business with no employees. Not unexpectedly, the turnover of partnerships was more than double the figure for sole traders (£58,000 compared with £27,000) while the small number of limited companies averaged £110,000 turnover during the year (Maratos, 1997). In other words, the great majority of micro-firms are sole traders, without employees and an annual turnover that would only bring in a relatively low income for the owner.

The most common type of business was one in the construction industry - accounting for 29 per cent of all companies with no employees - a fact that is unsurprising given the restructuring of the construction industry so that many more workers are now self-employed than used to be the case. The other large groups include 'real estate, renting and business activities' (16 per cent), 'wholesale, retail and repairs' (11 per cent) and 'community, social and personal servicesí (also 11 per cent) (Maratos, 1997).

Characteristics of micro-entrepreneurs

The most recent *Labour Force Survey* shows that, in the summer of 1997, self-employed people were predominantly white males in their 40s and 50s - the very people least likely to encounter difficulties raising finance. It is interesting, therefore, to assess the extent to which groups such as women, young people, ethnic minorities and the former unemployed are represented among people who run micro-firms.

Only a quarter of all self-employed people are women - that is 851,000 compared with 2,394,000 men. As women account for 44 per cent of all people who are economically active, this means they are considerably under-represented the self-employed (Labour Market Trends Dec 1997). Moreover, self-employed women are more likely than men to run very small companies (with up to two employees), and they are also more likely to be working in their business part-time. A survey in the late 1980s showed that three quarters of companies with an owner who worked part-time and 0- 2 employees were run by women (Smeaton, 1992). One possible explanation put forward for the low participation of women in self-employment is discrimination leading to constrained access to finance (Carter and Cannon, 1988).

Likewise, among people of working age, young people aged under 25 are the least likely to be self-employed but when they are, they disproportionately run micro-firms. Survey data showed that 33 per cent of self-employed people with 0-2 employees were aged under 35 (11 per cent of them aged under 26). This is double the rate for self-employed people with either 3-10 or more than 10 employees (Smeaton, 1992).

In contrast, certain ethnic minority groups are over-represented both among the self-employed and among owners of micro-firms. Jones et al (1994) note that:

> *In an age where official emphasis was newly placed on the new and small firm as a central means of economic regeneration, it soon became apparent that the most conspicuously ëentrepreneurialí sections of the population were members of immigrant-origin groups.* (Jones et al, 1994, p246)

Similarly, Curran and Burrows (1988) note the development of entrepreneurship as a ëdistinct occupational specialisationí for some ethnic minority groups.

The most recent *Labour Force Survey* shows that 15 per cent of Britain's ethnic minorities of working age are self-employed, compared with 13 per cent of the white population. This aggregate figure does, however, hide some substantial differences between the different minority ethnic groups. The highest rates of self-employment are to be found among the Asian population and the Pakistani and Bangladeshi ones in particular (where 23 per cent are self-employed). In contrast, self-employment among the Black and African-Caribbean population is, at 7 per cent, well below the national average.

A number of research studies have sought to explain the differences in the extent to which particular ethnic minorities engage in self-employment and, in particular, the ëhighly distinctive entrepreneurial profilesí (Jones et al, 1994) of Asians and African Caribbeans (Basu, 1991; Basu, 1995; Curran and Blackburn, 1993; Ram and Deaconess, 1995; Reeves and Ward, 1988; Wilson and Stanworth, 1988). Most of these explanations focus on the differential cultural backgrounds and historical experiences of these two groups, which have resulted in differing responses to racial disadvantage. Whilst experiences of discrimination appear, in many respects, to have provided a spur to entrepreneurialism among Asians they have resulted in a ëself-perpetuating cycle of unemployment and povertyí (Jones et al, 1994) for many African Caribbeans.

A recurring theme in discussions of the different rates of self-employment among Asians and African-Caribbeans is that former enjoy more access to business resources (Soar, 1991). In particular, strong family, community and cultural networks among Asians are thought to play a significant part in attracting financial and practical assistance, especially in the form of labour. The lack of a co-ethnic market, of firms catering to a community's own needs, is another possible explanation for the low levels of self-employment in the African-Caribbean population, compared with Asians, where such markets are more commonplace. A third explanation is a much lower access to bank finance.

There are also a number of differences in the way in which different ethnic minority groups are represented among the self-employed. African Caribbean business, for example, is extremely likely to be micro-firms. Almost two thirds (61%) are run by sole traders and the same proportion have annual turnovers of less than £50,000. A third of the proprietors of African Caribbean businesses are women, the majority are aged between 26 and 35 and they are located mostly within the service sector (National Westminster Bank plc, 1996).

Asian businesses, on the other hand, are far more likely to involve partnerships than either African Caribbean businesses or the market norm, and to have been trading for longer (National Westminster, 1997).

African-Caribbeans are especially likely to run construction or car repair companies or to be hairdressers; while Asians most commonly run shops, hotel and catering establishments or knitwear and clothing manufacturing companies (Ram and Deaconess, 1995; Wilson and Stanworth, 1988).

There are, in addition, some interesting differences between the specific Asian communities. In general, Bangladeshi and Pakistani entrepreneurs tend to run micro-firms catering to the needs of their own community. Indian entrepreneurs, on the other hand, are more likely to operate 'non-ethnic mainstream businesses' with larger numbers of employees. These differences are most readily explained in terms of human capital such as education, training and work experience.

In general then, the groups most likely to face difficulties gaining access to finance from a bank are under-represented among the self-employed. The exception to this is the Asian communities, where informal finance within the community plays a very significant role. Not only are these groups less likely to be self-employed, but when they are, they tend to be especially concentrated among the micro-entrepreneurs. We return to the problems such groups face getting access to finance in later sections of this report.

Government initiatives to encourage self-employment and micro businesses

Successive British governments have had a range of policies to encourage self-employment and small business development, in recognition of the important part they play in generating economic growth and job creation. Currently, there are two main government programmes which help the self-employed and small businesses to locate an appropriate source of finance. These are the Training and Enterprise Councils (TECs) in England and Wales and Local Enterprise Companies (LECs) in Scotland, and the Business Links scheme, both of which are nation-wide and work together at the local level.

Training and Enterprise Councils (TECs) and Local Enterprise Companies (LECs)

TECs and LECs, were set up by the Government between 1990 and 1991. Their aim was to tackle issues around access to training and to address some of Britainís wider local economic development problems (Bennett et al, 1994). The legislative framework for these organisations is established in two Government White Papers published in 1988. Their purpose was described, by the then Department of Employment as *ëto plan and deliver training and to promote and support the development of small businesses and self-employment within their areaí* (Department of Employment, 1988; p40). The core of TECs/LECs activity is youth training; employment training; business growth training; small firms counselling; and the Enterprise Allowance scheme.

Business Links

Business Links offer a one-stop shop service for small and medium sized businesses and are designed to offer 'a gateway to a comprehensive range of business support opportunities, services and information.

They are run by local partnerships of Training and Enterprise Councils, Chambers of Commerce, Enterprise Agencies, Local Authorities, the Department of Trade and Industry and other providers of business support. Some advice and services are free and many Business Links will offer initial consultations free of charge. Other services incur a fee, which can, in some circumstances be subsidised. One important function of Business Links is to help small and medium sized organisations locate and obtain appropriate sources of finance - grants as well as credit. This can also extend to assistance with the financial management of the business and the development of business plans.

Until recently the service was only available to companies with between five and 200 employees. The new Government has now removed the lower size limit, so that the service does now cover micro firms.

Having established the overall numbers and characteristics of micro-entrepreneurs in the UK, and the statutory initiatives which exist to facilitate them, we can move on to assess their needs for financial support.

2 Micro-entrepreneursí need for finance

Micro-entrepreneurs and start-up finance

A number of studies have established the importance of the availability of finance and decisions to become self-employed. At the macro-economic level, researchers have found a positive relationship between the number of business start-ups and both real net housing wealth (Black, de Meza and Jeffreys, 1992; Robson, 1993; Robson, 1995) and growth in personal sector liquid assets (Robson, 1993; Robson, 1995). The introduction of the Enterprise Allowance scheme also had a significant effect in the long-run self-employment rate (Robson, 1995).

The importance of liquidity constraints has also been identified at the individual level, with studies showing that, all other things being equal, the wealthier people were, the more likely they were to have become entrepreneurs. It was differences in levels of wealth, not age, space *per se*, that explained the low level of self-employment among people aged under 30 (Evans and Jovanovic, 1989; Blanchflower and Oswald, 1991a).

Analysis of the *British Social Attitudes Survey*, found that 50 per cent of people who had seriously considered becoming self-employed but not done so, claimed that capital constraints were the main obstacle (Blanchflower and Oswald 1991b). While research for the Department of Employment identified that almost half (47 per cent) of potential self-employed people were anxious about getting finance to set up a business; and 20 per cent said it was their main anxiety.

Table 2.1 Sources of start-up finance

Source of finance	Owens 1989 (Enterprise Allowance applicants)	Smeaton 1992 (0-2 employees)	Bevan 1988 (self-employed)	Bevan 1988 (potential self-employed)	Rubery 1993 (0-40 employees)		Metcalf 1997 (Asian self-employed)
					Men	Women	
Family or friends	37%	17%	21%	21%	16%	21%	35%
Personal savings	30%	46%	62%	46%	45%	45%	58%
Redundancy payment	10%		11%	7%	7%	9%	
Selling something	5%						
Bank loan/overdraft	30%	31%	23%	48%	32%	34%	36%
Mortgaging/selling home					13%	14%	
Grant	1%	1%		1%			6%
Other	3%		6%	7%			

Note: percentages may add up to more than 100% as some businesses drew on more than one source of finance

Interestingly, though, people who had already set up in self-employment were only half as likely to mention (or recall?) having been concerned about getting finance when they started out on their venture (Bevan et al, 1989). Indeed four out of ten (40 per cent) of the potential self-employed said that the type of help they would most appreciate was assistance with loans or grants. Once again, those who had already set up in self-employment were only half as likely to say that this was the help they would most have appreciated at the time they were starting their businesses (Bevan et al, 1989).

The amounts of money needed to start a micro-business are small. According to a recent survey by Barclays Bank the average UK small business costs around £11,000 to set up (Barclays Bank, 1997). Not surprisingly, the amount depends very much on the size of the business. One survey found that only around one in ten of businesses with no employees required more than £6,000, with women entrepreneurs, on the whole, requiring less than men (Rubery et al, 1993). A qualitative study of 60 women entrepreneurs (with an average of 8 employees) found that only four out of ten of them had needed more than £10,000 to get started (Carter and Cannon, 1988). At the same time, at least a quarter of people who were self-employed had needed no finance at all to set their businesses up (Bevan et al, 1989).

The three most common reasons for self-employed people needing finance were to buy stock or materials (29 per cent of those needing finance) to purchase machinery or equipment (27 per cent) and to finance premises (8 per cent) (Bevan et al, 1989). A more recent Barclays Bank survey of small business start-ups found the same range of reasons for needing external funding: to finance business premises (29 per cent), to buy stock (21 per cent), for working capital (16 per cent) or to buy plant or machinery (15 per cent) (Barclays Bank, 1997).

A large number of studies have explored the sources of finance used by people setting up in business. On the whole, these show that personal savings are the source used most widely, followed by bank loans and overdrafts and then help from family and friends (Bevan et al, 1988; Metcalf et al 1997; Owens, 1989; Ram and Deaconess, 1995; Rubery et al 1993; Smeaton, 1992; Wilson and Stanworth 1988). There are some interesting variations between different ethnic groups. On the whole, help from family and friends was much more commonplace among Asian entrepreneurs than it was for either white entrepreneurs or African-Caribbeans (Wilson and Stanworth, 1988). And among the Asians, Indians made far more use of banks and less use of finance from family and friends than either Pakistanis or Bangladeshis (Basu, 1995; Metcalf et al, 1997). Religious beliefs undoubtedly played a large part in Pakistani reliance on friends and family and avoidance of using banks (Metcalf et al, 1997) (See Table 2.1).

Two-thirds of self-employed people getting a start-up bank loan or overdraft were required to provide security - most commonly this was their home or other property (Bevan et al 1989).

Micro-entrepreneurs' needs for finance to expand

Around one in six self-employed people had needed to raise further finance once they had established their businesses. Most of these had raised the money they needed from a bank (46 per cent got a loan; 37 per cent an overdraft). Savings (6 per cent) and help from family

and friends (6 per cent) were much less important than they had been in setting up the business in the first place (Bevan et al, 1989).

This is in marked contrast to Asian self-employed people, who continued to draw on savings, with only a quarter of them using a bank for further finance (Metcalf et al, 1997). African Caribbean entrepreneurs were more likely to use banks to finance further development of their business than to set their businesses up, but, even so, banks remained a relatively unimportant source of finance (Ram and Deaconess, 1995).

So where do micro-entrepreneurs obtain this finance? The following chapter illustrates the range of sources of finance for micro-enterprises in the UK, both for business start-up and expansion.

3 Sources of finance for micro-enterprise in the UK

Finance for small and micro-enterprises is available from a number of sources in the UK. As we will see, below, banks are the primary source of external finance for setting up or expanding a small business. However, Government interest in and support for the small firm sector has resulted in a proliferation of grants and loans from public bodies at both national and, in particular, local level.

The role played by bank finance

Banks are, undoubtedly, the main source of external finance for small businesses. According to figures published by the British Bankers Association banks' total lending to the small business sector was £34.1bn at the end of June 1997. The six Branch Managers interviewed for this research agreed that applicants for loans from micro-businesses accounted for quite a high proportion of their workload, with numbers ranging from two to ten applications per week. The National Westminster Bank is the major lender to micro-firms.

Table 3.1 Bank lending to small businesses* 1992 - 1997

	Dec 1992	Dec 1993	Dec 1994	Dec 1995	Dec 1996	June 1997
O'drafts	£19.4bn	£16.6bn	£13.9bn	£12.3bn	£11.7bn	£11.7bn
Term loans	£20.1bn	£21.6bn	£22.4bn	£22.9bn	£22.4bn	£22.5bn
Total	£39.5bn	£38.2bn	£36.3bn	£35.2bn	£34.1bn	£34.1bn

Source: *Annual Abstract of Banking Statistics*
* A small business is defined as one with an annual turnover of up to £1m

Over recent years there has, however, been a marked change in the nature of that finance. As recently as 1992, almost half of all bank lending to small businesses was in the form of overdrafts - leading to the concern expressed by the Bank of England in the first of its reports on *Finance for small firms*. By June 1997, there had been a dramatic shift away from overdrafts, which accounted for £11.7 bn, or just over a third, of total bank lending (Table 3.1). In addition, fixed rate term lending has increased in relation to variable lending and in 1997 fixed rate loans accounted for 30 per cent of bank lending.

Most banks are also looking for innovative ways of providing appropriate finance for small firms, with key initiatives outlined in the Bank of England reports. These include the development of a range of equity products and flexible overdraft facilities, as well as involvement in business angel finance (see below).

In 1997, average bank lending margins to small business customers was between 3% and 4% above base rate - a figure that has remained fairly constant over the past five years. Margins do, however, vary between banks and between overdrafts and term loans ranging between 2% and 7% for the majority of authorised lending. Unauthorised overdrafts, in contrast, attract much higher rates of interest.

The most recent Bank of England report also notes that banks claim they are becoming more flexible in their lending criteria for small firms, with less emphasis on the provision of collateral and greater acceptance of business plans and cash flow projections to support loan applications.

The Small Firms Loan Guarantee Scheme

The Small Firms Loan Guarantee Scheme was introduced in 1981 as a joint venture between the Governments' Department of Trade and Industry and commercial lenders to help viable small firms who are unable to raise conventional finance because of lack of security. In essence, the Government acts as a guarantor to encourage banks and other financial institutions to make loans to firms they would not otherwise consider. Borrowers are charged a premium for the guarantee but in all other respects the loan is negotiated and made in the normal way. The borrower approaches his or her bank for a loan and it is the bank that decides whether the application qualifies for assistance under the loan guarantee scheme. The loan agreement is between the bank and borrower and terms of the loan, including the interest rate charged, are determined by the bank not the loan guarantee scheme.

The scheme is available to both new and existing businesses provided they have fewer than 200 employees. It covers sole traders, partnerships, franchises, co-operatives and limited companies but excludes the following types of business: forestry; vehicle repair and servicing; retail; taxi firms; hairdressing and beauty parlours; tied public houses and bars; financial and related services, including insurance; estate agents; commission/intermediary agents; betting and gambling establishments; night clubs; art galleries, museums and libraries; medical and veterinary services; sports organisations and sportsmen; and travel agents.

Guarantees cover loans for developing a project, starting to trade, expanding an existing business or improving efficiency. They do not cover buying a company's shares, buying out members of a partnership, replacing existing loan or overdraft facilities or financing interest payments. The borrower must, in the first instance, apply to their bank for a conventional loan or overdraft; their application can be referred to the scheme if they would have been offered conventional finance but lacked the necessary security. No personal guarantees can be taken as security for the scheme. To qualify a prospective borrower must provide the lender with full details of what loan will be used for, a clear business plan and financial forecasts.

The main terms of the loan guarantee scheme have been revised a number of times since it was established and currently are as follows:

Loan term:	2 to 10 years
Loan size:	£,5,000 to £100,000 (£250,000 for established businesses trading for two or more years). A borrower may have more than one loan up to this ceiling
Guarantee:	70% (85% for established businesses trading for two or more years)
Premium:	1.5% pa (on the whole of the outstanding loan) for variable rate lending; 0.5% for fixed rate lending.

In practice, then, many micro businesses would not qualify for the scheme - either because their type of business is excluded or because they need a loan of less than £5,000.

Table 3.2 Small Firms Loan Guarantee Scheme statistics 1981-82 to 1996-97

	1981/2	1982/3	1983/4	1984/5	1985/6	1986/7	1987/8	1988/9
No of loans Value of guarantees £m	3,351	6,045	4,889	2,081	543	1,042	1,222	2,266

	1989/90	1990/1	1991/2	1992/3	1993/4	1994/5	1995/6	1996/7
No of loans Value of guarantees £m	3,123	3,344 84.6	2,902 69.5	2,273 52.0	3,851 155.0	6,207 246.0	7,484 275.4	6,942 255.8
Percentage of loans... ... to new businesses ... in loans up to £30k					 32% 62%	 30% 66%	 29% 68%	 31% 70%
Percentage of value... ... to new businesses ... in loans up to £30k					 21% 21%	 20% 27%	 21% 30%	 22% 32%

Source: Department of Trade and Industry

The numbers of loans guaranteed per year has varied considerably since the scheme's inception but has increased markedly since the end of the early 1990s recession (Table 3.2). In 1996-97, 6,942 guarantees were issued; 3,866 of which were to 'established businesses'; 2,133 to 'new businesses' and 943 to 'existing businesses'.

The average loan guaranteed in 1996-97 was £36,800, although the great majority of loans (4,866 of the 6942) were for sums up to £30,000. Although available through a wide range of lending institutions, in practice 90 per cent of the loans guaranteed in 1996-97 were made through the four main high street banks - Barclays, National Westminster, Lloyds and Midland.

On average 37 per cent of loans guaranteed since the scheme was established have defaulted, with the level of default fluctuating considerably with the state of the economy. At the height of the 1990s recession it exceeded 50 per cent of loans but has never been lower than 22 per cent - during the boom years of the mid 1980s.

A survey of barriers to business start-up among self-employed people found very low levels of awareness of the Small Firms Loan Guarantee Scheme. Only 2 per cent of the self-employed and potentially self-employed people interviewed spontaneously mentioned the scheme as a source of assistance for people in their position; and only 19 per cent said they were aware of the scheme when specifically asked about it (Bevan et al 1989). These findings do, however, have to be set in context as the survey was carried out when use of the scheme was very low. It has since grown considerably as Table 3.2 shows.

The Small Firms Loan Guarantee Scheme is currently being evaluated, and the results should become available in 1998. This will be the fourth in a series of evaluations since the scheme was set up (Robson Rhodes, 1984; National Economic Research Associates, 1990; National Economic Research Associates, 1992).

Enterprise Allowance and Business Start-Up Schemes

In 1982-83 the, then, Conservative government introduced the Enterprise Allowance Scheme, which provided grants to assist unemployed people to set up as self-employed. To be eligible, would-be entrepreneurs needed be claiming benefit and to have £1,000 to invest in their business themselves.

In 1990-91 responsibility for the scheme transferred to the Training and Enterprise Councils (TECs) and the official name for the programme changed to Business Start-Up (BSU). At the same time, the criteria for assistance changed - with applicants no longer needing either to be claiming benefit or to have £1,000 to invest in their business. There were also important rule changes which introduced greater flexibility into the scheme. TECs can impose their own entry criteria which can include applicants being required to produce a business plan. They can also adjust the level and duration of the phased grant payment to reflect the type and viability of the business being granted-aided.

The number of grants made each year varied quite considerably, reflecting fluctuations in the numbers of business start-ups. It peaked at 106,300 in 1987-88 and then fell steeply in the early 1990s (Table 3.3). These schemes are no longer generally available.

Table 3.3 Number of grants through the Enterprise Allowance and Business Start-Up Schemes

	1982/3	1983/4	1984/5	1985/6	1986/7	1987/8	1988/9	1989/90
Enterprise allowance	2,500	27,600	46,000	60,000	86,800	106,300	98,500	77,900

	1990/1	1991/2	1992/3	1993/4
Business start-up/ Enterprise allowance	60,000	50,400	40,700	40,600

Both the Enterprise Allowance and Business Start-Up have been extensively evaluated (see for example Owens, 1989; IFF Research, 1992; Tremlett, 1993; Tremlett, 1994; Tremlett, 1995). In addition, a survey of self-employed and potentially self-employed people has shown that there was a much higher level of awareness of the Enterprise Allowance than there was of the Small Firms Guarantee Scheme. Four out of ten (42 per cent) of those interviewed spontaneously mentioned the scheme as a source of assistance for people in their position; and 85 per cent said they were aware of the scheme when specifically asked about it (Bevan et al, 1989).

Soft loans schemes

Recent years have seen a rapid growth in small firmsí loan schemes which were initially stimulated by local authorities, and are now frequently operated through TECs and Business Links in conjunction with the private sector. These schemes offer both start-up loans and

loans to established small businesses at interest rates that are lower than commercial loans, and may also require less collateral.

The Small Business Research Centre at Kingston University identified 82 soft loans schemes that were run independently of local authorities in 1994 - 17 more than there had been a year previously.

A more recent survey of local authorities in England and Wales found that 32 (25 per cent) of the 127 authorities responding had loan funds for micro businesses. Some of these funds had restricted access: to firms in a particular sector (eg tourism or manufacturing) or, in one case, to firms that had been trading for at least a year. Many were set up to be the lender of last resort - lending only to people who could not get a commercial loan. The interest rates charged ranged from base rate to 3 per cent above base rate and schemes differed considerably in the collateral required for loans (Lynch and Haidar, 1997).

There does, however, seem to be a fairly rapid turnover of such soft loan schemes. The Small Business Research Centre found that between 1993 and 1994, 28 new schemes had been set up but 11 had closed. Likewise the survey of local authorities identified schemes that were closing either through bad debts or because the funds from the sponsoring body had run out; while other local authorities were actively considering establishing a fund for the first time (Lynch and Haidar 1997).

Other grants

In addition there many organisations which provide and administer grant funding for micro-enterprises. Table 3.4 lists and gives brief details of the grants which are available for small and micro-businesses in one area of the West of England - rural Somerset.

As Table 3.4 illustrates, there are a wide variety of grants available at local level. Most of these grants are targeted at small firms and some, specifically at micro-businesses.

Grants are available at local level for a whole range of purposes, including business start-up and expansion; training and staff development; renovation; marketing and promotion; and recruitment. In fact, some quite small rural areas of Somerset are the focus for a number of different grants and small firms in these areas are likely to be fairly well supported.

However, these grants are not necessarily available to support small business *per se*. Their focus is clearly on vulnerable areas and communities, characterised by disintegration and diminishing work and trading opportunities. While small firms which fulfil the area-based criteria for these grants, potentially have access to quite a wide base of financial support, those with the same needs but based in different areas may have greater difficulty in finding any appropriate form of grant finance.

A greater problem, however, is that many of these grants are available to meet needs, in part rather than in total, providing matched-funding rather than 100% support. For micro-firms, in particular, who lack access to traditional sources of finance, this may present an insurmountable obstacle. Consequently, many of the businesses most in need of financial support in the form of grant finance may be those which are least able to gain access to it.

So, although there is a range of sources of public finance for micro-entrepreneurs, in the form of (soft) loans and grants, bank finance remains the biggest source of business finance in the UK. To what extent can commercial lenders meet the needs of micro-enterprises and what problems have entrepreneurs identified in obtaining finance from this source?

Table 3.4 ñ Grants available for small businesses at local level

Grants	Area eligible/available	Eligible businesses	Details
Training and Development Grants.	Countywide - Rural areas covered by the Communities First programme.	Employers recruiting staff for permanent jobs in specified rural areas.	Cash grant of £750 for training and development of employees 18-60yrs.
Redundant Building Grant ñ Rural Development Areas.	Countywide - Rural businesses.	Rural businesses needing workspace.	Minimum £2,500 and limited to 25% of total cost. For conversion or upgrading of redundant buildings.
Rural Somerset Business Chest - Rural Areas.	Countywide - Rural areas (NOT town centres).	Those demonstrating real need for financial assistance for starting up; or trading for less than 5 yrs, and 0-5 employees.	Up to £500 match funding to help with purchase of piece of equipment or towards cost of a marketing leaflet.
Village Shop Development Scheme.	Countywide - Rural village communities.	Sole existing village shops, in rural communities with a population of under 3000.	
East Mendip Rural Taskforce Marketing Grants.	Must be in a rural area within East Mendip.	Must have less than 5 employees.	Maximum of £400 or 50% of eligible costs, whichever is the lower. To help small rural businesses to promote their goods and services and to encourage local trading
Retail Grant, Frome.	Specific streets within Frome.	New or established retailers of a specialist nature.	50% of eligible costs, up to a maximum of £2,000. For new retailing equipment and conversion works or fitting out.
Shepton Mallet Shopfront Renovation Scheme and Advertising Grants.	Mendip Area - Shepton Mallet town centre.	Shops in Shepton Mallet town centre.	Grants for redecoration, advertising & PR to max of £1,000.
Small Business Grant.	Mendip area.	Businesses in the manufacturing sector or providing a service not commonly found in the local area.	50% of cost of eligible works up to maximum of £2,500.

Grants	Area eligible/available	Eligible businesses	Details
Tourism Marketing Support Scheme.	Mendip area.	Tourism businesses: attractions must receive at least 5,000 visitors a year and accommodation providers must be registered.	25% of total project cost or a maximum of £200 for production of new promotional literature.
Village Shop Grant.	Mendip area.	Independent village shops, with less than 3,000 population, and selling food.	Up to £400 match funding for improvements and adaptations which will lead to an increase in trade.
Communities First in Rural Somerset.	Specified parts of Sedgemoor area.	Businesses in specified areas.	Free advice, assistance with marketing and training for businesses.
Konver - Yeovil Travel to Work Area	South Somerset Area	Companies in (up to the 4th level of) defence supply chain.	Up to 30% project funding for companies with less than 250 employees.
Wincanton, Bruton, Milborne Port, Henstridge & Surrounding Parishes.	South Somerset Area	Those wanting to set up a new shop/business or improve an existing one within the WIRC area.	50% of the cost up to a max of £2,500 available for both shops and businesses.
Taunton Deane Area Retail Grant Scheme	Wellington & Wiveliscombe and surrounding villages.	Those without existing retail premises; new businesses , 0-10 full-time employees; business types not represented in the town.	Up to £1,500 match funding to help fit out retail premises and carry out minor building work.
Shopfront Grant Scheme - Wellington & Wiveliscombe and Surrounding Villages	Taunton Deane Area - Wellington & Wiveliscombe and Surrounding Villages.	Small businesses only - priority to schemes which will improve the built environment.	Up to £1,500 match funding for the renovation or reinstatement of traditional shopfronts.
Greater Exmoor LEADER Project	West Somerset - Greater Exmoor Area.	Only available to groups of businesses working together through a tourist or business association.	Varying from 30-50% businesses
Rural Growth Fund - Objective 5b Area	West Somerset Area	Businesses with less than 25 employees - projects which will create new jobs which can be maintained.	Interest free repayable finance of up to £20,000.

4 Commercial finance for micro-enterprise in the UK

Problems accessing commercial finance

It is clear that a number of, often insurmountable, obstacles exist to obtaining finance for a micro-enterprise in the UK. Bevan et al (1989) found that, altogether, 15 per cent of self-employed people who had approached a bank experienced difficulties. These problems occur at both the initial, start-up stage and later on, when established firms are seeking finance to expand. Established businesses, for example, seem to experience a greater level of difficulty raising finance than they did when they first set up. In a survey carried out by Barclays Bank, 14 per cent of entrepreneurs said that lack of finance was a major constraint on business growth (Barclays Bank, 1997). Around 12 per cent of self-employed people in earlier research said the same (Bevan et al, 1989).

In contrast, it was perceived as much less of a constraint for those who had managed to set up as self-employed. Only 7 per cent of people setting up as self-employed remembered encountering problems raising money when they set up, although it was higher for those who subsequently went out of business (12 per cent) than for those still trading (5 per cent) (Bevan et al, 1989). Not surprisingly, more problems were encountered by those trying to raise finance from banks than by those drawing on savings (Bevan et al, 1989).

In addition, there are suggestions that some groups are disproportionately likely to encounter these obstacles. Cosh and Hughes (1997) identified ethnic businesses as being particularly likely to be affected by problems in obtaining finance. Jones et al (1997), for example, found that 21 per cent of white people who had applied for a bank loan encountered difficulties compared with 29 per cent of Asian applicants and 39 per cent of African Caribbean applicants. Metcalf et al (1997) found that levels of difficulty were somewhat higher among Asian self-employed people, 18 per cent of whom had faced problems raising finance to start their businesses. Indian people were, however, only half as likely to have encountered problems as Pakistanis (10 per cent compared with 19 per cent).

A qualitative study of women entrepreneurs showed that over half of them had had difficulties raising finance (Carter and Cannon, 1988). Finally, Cosh and Hughes (1997) note the existence of specific ëmarket failuresí in relation to high technology firms who, they recognise, may face a more complex set of problems in obtaining finance than firms offering more traditional, and therefore less risky, functions.

Concern over the extent to which obstacles in obtaining access to appropriate financial support are undermining the role of small and micro-enterprises in the UK economy is long-running and well-documented (see, for example, Hughes and Storey, 1994). In particular, it has been the subject of a succession of Government Committees of Inquiry (eg. HMSO, 1971; HMSO, 1979, HMSO, 1991). Evidence of a mis-match between the needs of small and micro enterprises and the range and nature of finance available declined during the self-employment ëboomí of the 1980s, to the extent that one investigation concluded:

> **Small firms in Great Britain currently face few difficulties in raising finance for their innovation and investment proposals in the private sectorÖ the institutional framework for investment finance for small firms is broadly adequate and not in need of further supplementation by public sector initiatives.** ***(HMSO, 1991)***

However, the recession of the early 1990s starkly highlighted the extent to which small enterprises had continued to be heavily reliant on short-term finance from banks (Hughes and Storey, 1994). It also demonstrated, more starkly still, the vulnerability of a small firm sector primarily financed in this way. In addition, during this period it became clear that it was the smallest firms who made the most complaints about their unsatisfactory relationships with the high street banks (Binks et al, 1992).

Mason and Harrison (1997) see the ëgapí in small firm finance as the product of a number of factors. First, the restrictions placed on the borrowing capacity of small firms by banksí requirements for greater security and more equity. Second, the increasingly sensitive risk-price equations which are being used by banks, in which the size of a business is a key element in perceptions of its security. Consequently, the cost of finance for small firms may be disproportionately high. Third, the consistently rising charges for services such as cheque clearing which also add to the costs of finance. Fourth, the limitations placed on small firmsí access to overdraft facilities in the aftermath of the recent recession, which have removed a key source of working capital. They argue that these four factors combine to produce a fifth area of sensitivity:

> *Having recognised the need for greater informationÖ banks are now undertaking much more detailed investigations of their clients. However, the need for more detailed information and the costs of obtaining it, will inevitably result in an increase in bank charges. Ironically, therefore, one consequence of an improvement in the bank-SME relationshipÖ will be a further increase in the cost of bank-provided finance, and a stimulus to a further deterioration in bank-SME relationships on cost, not relationship, grounds (*Mason and Harrison, 1994, p64).

A further element of this debate relates to ëinformation asymmetriesí which exist between banks and small firms, which assume that entrepreneurs have access to better information about the likelihood of success than the bank. Cosh and Hughes (1997) argue:

> *If lenders try to use interest rate increases to allow for their perceptions of riskyness, they are likely to drive out those who believe on their own private information that they are less risky than the bank does, and to attract those who believe they are more riskyÖ In that sense, the good loans drive out the bad* (Cosh and Hughes, 1994, p31).

In these circumstances, they argue, that banks may discard interest rates as a tool to redress the balance between differential risk factors and turn, instead, to ë*credit rationing by refusal to supply loansí* (Cosh and Hughes, 1994, p31). Consequently, some small firms will be completely excluded from access to financial support, even if they are willing to pay high interest rates.

> *As a consequence of all these factors, it is argued, the small firm sector has become over-reliant on short-term finance via loans and overdrafts which has ëinhibited more long-standing relationships between small firms and providers of finance which would be more mutually beneficialí (Hughes and Storey, 1994, preface). It also means that small firms are considerably more vulnerable in times of recession than enterprises with longer-term financial arrangements.*

A measure of Government concern about financing small businesses has been the series of Bank of England reports on *Finance for small firms*. The first of these was published in January 1994 following a series of meetings to discuss improvements to the financing of small firms in the wake of the 1990s recession. (A small business was defined as one with an annual turnover of up to £1m - the definition also widely used by most of the clearing banks.) This report identified seven areas for action by the banks, Government and small businesses themselves:

- Improvements in the provision of appropriate forms of finance by the banks (including a shift from overdrafts to term lending) and in bank staff training.
- Measures to encourage equity investment in small businesses.
- The need for banks to price risk realistically.
- Improvements in the financial and management skills of small businesses.
- The provision of better advice and financial assistance to help small businesses enter the export market.
- The need to monitor the impact on small businesses of legislative and administrative changes.
- A change in business culture towards prompt payment.

Four subsequent reports have monitored developments in these areas, with the content of the reports increasing over time (Bank of England, 1995, 1996, 1997 and 1998). The fifth report, published in January 1998, is now an extensive review of small business finance, some 65 pages long.

Bank Lending and its Limitations

The fact that many micro-enterprises can be disadvantaged in their search for financial support is largely undisputed. However, the exact nature of the problems they face, and the groups most likely to be affected by them are less clear. In many respects, micro-businesses seem to face levels of disadvantage which increase or decrease according to their characteristics. So, some difficulties are apparent, which affect all micro-entrepreneurs, regardless of their race, sex or the type of business they are running. It is also possible, however, to pull out factors which result in an ëamplificationí of these difficulties for some groups.

a) Rigid lending criteria

The difficulties that finance providers face in offering adequate and appropriate financial support to micro-firms centre on their inability to cater to the specific needs and circumstances of this group. As the Small Business Advisor of one high street bank commented, with very small firms ë*each individual case has its own requirementsí*.
In addition, several bank managers felt that micro-firms had greater needs for support and guidance throughout their negotiations for finance and after finance was secured. The size, status and formality of high street banks, the main providers of finance for small firms, makes it very difficult for them to respond to the specificity of those requirements.

The interviews conducted for this research suggest that these problems are less to do with what the banks *offer* to micro-entrepreneurs, than with the difficulty they face in adapting to their circumstances. In fact, bank managers, business advisors, local enterprise agencies and entrepreneurs themselves, indicated wide agreement as to the root causes of most of the difficulties. In essence, they were perceived to be:

- lack of business experience, or a proven track record;
- lack of savings to invest in the business
- lack of assets; and
- an inability to *ëpresent a good caseí* to the bank.

1) Lack of business experience

This is a crucial contributory factor in a bankís assessment of the risk attached to business propositions. It is not unreasonable for banks to consider the presence or absence or a proven track record, either in business or in the type of work which the applicant is proposing to carry out, as a key factor in decision-making. However, it presents a huge stumbling block for some groups of people and, in particular, those who we have identified as being over-represented among micro-entrepreneurs. Young people with little work experience of any kind; women returning to the labour force after caring for a family; and people ëpushedí into self-employment as a result of long-term unemployment or threat of redundancy may find it impossible to prove their ability to run the business they are proposing.

This accounts for the difficulties, noted above, encountered by people trying to raise the finance to start a new business. This is particularly the case for people attempting to set-up unusual or particularly innovative businesses (Bank of England, 1996).

2) Lack of savings

Another key factor which high street banks use in assessing a business loan application is whether the applicant has any money of their own to invest in the business. One bank expects applicants to contribute as much as 50% of the finance needed to set up the business. Others are less concerned by the actual amount of personal investment than by its symbolic significance. An individualís willing and ability to invest his or her own money into a proposed business is a key factor in decreasing the bankís perception of the ëriskynessí of that proposition. It indicates that the applicant is serious in his or her desire to set up a business; it also suggests that the applicant is confident that the business will be successful. Perhaps more significantly, however, is the role of personal investment in spreading risk and reducing the likelihood of an individual acting irresponsibly or, as one bank manager expressed it, *ëwalking away and thinking ì Itís the bankís problemî í*.

Consequently, none of the high street banks investigated as part of this research were comfortable with lending without some degree of personal investment. They would only waive this rule for businesses which did not require heavy initial investment or which could demonstrate a high degree of security prior to set-up.

3) Lack of assets

This issue is very closely related to the lack of funds for personal investment, outlined above. In particular, the availability of assets on which bank finance can be secured becomes a crucial issue for applicants who are not in a position to make a personal investment into their business.

All of the main high street banks in the UK would check the availability of security when considering a loan. Although within most bank branches, the amount and type of security required is open to a certain amount of discretion, only one was prepared to lend without security for business loans under £5,000.

Clearly, the characteristics of some micro-entrepreneurs and their businesses mean that they are likely to be considered too risky to lend to without security. This combined with problems resulting from a lack of savings, contributes to the view, widespread among entrepreneurs with limited resources, that banks are not interested in people without money of their own.

> *Iíll only be able to borrow off banks by proving to them that I donít really need their money. They only lend to people who have a good job and income. For someone like me, who needs a fresh start in life, they wonít even consider the application.* (Pakistani, taxi-driver).

4) Inability to present a good case for funding

Issues raised around this issue, both in existing research and the interviews conducted for the current project, reflect a combination of factors relating both to banksí lending procedures and individual applicants.

The criteria for assessing risk and the likely profitability of a business are, necessarily, quite rigid. A small business advisor in one high street bank, and he is unlikely to be alone, admitted to having daily targets which had to be met. This requires a careful consideration of loan applications according to proven, and defendable, criteria. Applicants for start-up are required to produce a full business plan and cashflow forecast. Applications from existing businesses must be accompanied by detailed accounts information. In addition, applicants have a personal interview with a branch manager or small business advisor.

While it is not unreasonable for banksí to require this amount of detail and supporting evidence both bank personnel and people working in local enterprise agencies recognise a skills gap, particularly in relation to some micro-entrepreneurs, in responding to these requirements. Consequently, for some, presenting a business idea in a way which is sufficient to meet a bankís requirement can be a big obstacle.

One bank manager acknowledged that funds for start-up were ë*not readily availableí*, particularly to people without previous trading experience, and those wanting to set up speculative ventures.

b) Micro-entrepreneursí feelings of fear and alienation

In addition, several commentators, including bankers, local development workers and micro-lenders, note that banks are a very daunting environment for some people, particularly those who are economically disadvantaged. This was perceived to be a key reason why some people do not approach banks for business finance and also why many of those who do are ëfrightened offí by the necessity for formal procedures such as interviews and business plans. One micro-lender also noted that some of the target groups for micro-lending activity, such as young people, those from ethnic minorities and the long-term unemployment, feel very alienated from institutions such as high street banks. Consequently, they *ërefuse to even go near themí*. While this does, to a large degree, represent self-exclusion from mainstream finance, rather than direct access exclusion by the banks themselves, Jones et al (1997) note the complex relationship between self-exclusion and *ëinstitutional rejectioní*.

Clearly, while many of the issues discussed above will relate to many micro-entrepreneurs, regardless of their ethnic origin or other personal characteristics, they will be more acute for some groups. In particular, they are likely to fall disproportionately on some of the more vulnerable groups such as young people, women, people from ethnic minorities and the long-term unemployed.

> *Quite patently, then, membership of a white manís club counts for less than pure economic criteria in determining access to commercial credit. This is a generic factor pertaining to all small businessÖ At the same time, ethnic* ***non****-membership [original emphasis] can be critically disabling, imposing an addition and qualitatively different layer of resistance.* (Jones et al, 1997; p166)

Micro-entrepreneurs from these groups are particularly likely to have low incomes and, consequently, unlikely to have savings and assets they can draw on to start, or support, their business. In addition, people who have been unemployed for long periods of time or who are particularly vulnerable to redundancy, such as people from ethnic minorities, will find it difficult to prove a track record in any form of work, let alone in running a business. Women returning to the labour market after caring for a family will be similarly disadvantaged in this respect.

c) The decision-making process

These problems are perceived, by many commentators, to have worsened as a result of the shift which has occurred in the UK, away from ërelationship bankingí to centralised control and decision-making. A previous investigation of micro-lending in the UK (Lynch and Haidar, 1997) found that staff in both the TEC and Business Links noted greater formality in bank lending decisions. Whereas, perhaps 10 years ago, bank managers exercised their discretion towards customers in whom they had confidence, the strictures that are put on bank managers by central lending departments, constrain their decision-making within specific criteria.
This issue is clouded, however, because bank managers still have the ability to exercise some discretion, but may be less willing and have fewer incentives to do so.

Two of the five banks investigated for the current research operated within highly centralised decision-making structures. The remainder had retained quite a high degree of autonomy over decision-making, not simply at branch level, but also, within branches, at individual level.

This retention of branch level decision-making clearly has advantages. Representatives of all five banks spent around three quarters of an hour talking to business loan customers. Those who had personal responsibility for decision-making, however, supplemented this interview with a personal visit, to obtain a better idea of the personality of individual applicants and *ëmay even include a walk around the area in which theyíre in business or are proposing to set upí*. This gives the banker a comprehensive insight into the individual and their business idea which could not be obtained from a credit score, however complex. This approach is also an important factor in making micro-entrepreneurs feel that their bank is accessible to them and understands their needs.

Interviews with micro-entrepreneurs suggest that the quality of this relationship may even be sufficient to overcome some of the more intractable obstacles to business finance experienced by some. For example, people from ethnic minorities were more likely to feel happy with the service they received from a high street bank if they had a good relationship with the manager.

> *The manager is a personal friend of mine and he suggested that I could get the loan. If I didnít have a personal friendship I would never have got the moneyÖ*

Equally, the frequent changes of personnel which have accompanied the move to centralised decision-making was highlighted as a particular problem for micro-entrepreneurs.

> *Ö in the beginningÖ I knew the manager thereÖ and he wasnít too bad. Then they closed that branch, and they put everything centralisedÖ the one big bank, everything was done from there, and you never saw anyoneÖ Itís very difficult, because you feel restricted all the timeÖ You canít talk on a personal basis at all.*

Some found themselves starved of finance, badly needed for expansion or to smooth cash-flow problems simply because their new bank manager was unaware or unsympathetic to the needs of their business.

However, the two banking representatives in this research who worked in banks with centralised decision-making were at pains to stress that they, too, made a point of building a relationship with applicants as part of their information gather exercise for loan applications. This would enable them to build up a view of the applicant and their proposition, which would be communicated to the decision-makers. They stressed that credit scores were simply *ëone toolí* they used in considering loan applications.

In addition, these branch managers commented that centralised decision-making did not necessarily work to the detriment of micro-entrepreneurs. They argued that central underwriting units were informed by experience developed across the whole of the UK,

rather than simply the local area with which branch managers are familiar. This expertise ensured that decision-making about business loans could be more, rather than less, sensitive. It also reduces inconsistent decision-making between geographical areas, which often results from individual decision-making.
Lynch and Haidar (1997) formed the view that the difference in approach by different banks is not as significant as that between individual bank managers. The fact that the National Westminster Bank combines centralised decision-making with such a high proportion of micro-entrepreneurs as its customers lends some credence to the assertion that this system can work in favour of this group.

d) Allegations of discrimination

Many micro-entrepreneurs are highly critical of the high street banks. People from ethnic minorities have alleged racism, claiming that they are more likely to be refused bank finance than other groups of people. African-Caribbeans feel particularly disadvantaged in this respect and feel that their loan applications are viewed more negatively than those from both white and Asian applicants. Jones et al (1997) cautions that racism, particularly at an institutional level, is rarely proven. However, he also notes evidence that people from ethnic minority backgrounds are more likely to have loan applications refused than white people and, where loans are made, to receive smaller amounts than their white counterparts.

Women accuse banks of being sexist and patronising (Carter and Cannon, 1988). One female micro-entrepreneur explained her experiences of trying to obtain top-up funding from her bank;

> *I was only a woman ñ I felt that was the inference I gotÖ ëWell, tough, youíre a womanÖ youíve got yourself in this messí. That first time we went in to do a cashflowÖ and Iím asking [the bank manager] questions, but he didnít look at me, he looked at [respondentís husband]. And I came out and said ëWas I there?í*

What is also clear, is that some groups of people, and particularly those likely to be over-represented among micro-entrepreneurs, believe that banks do not understand their needs and do not take them seriously. This problem seems to be experienced widely among ethnic minority entrepreneurs. Pakistani and Bangladeshi people, in particular, were critical of high street bank managers' lack of understanding of the business opportunities in their communities. Applications for business finance that had been turned down by the high street banks were subsequently accepted by United Bank who, it was felt, had a better understanding of the type of business proposed and of the potential market and opportunities for growth (Herbert and Kempson 1996).

Language barriers, a particular obstacle for Asian entrepreneurs, and the absence of staff from ethnic minority backgrounds may also contribute to a feeling that high street banks are not equipped to meet the needs of non-white customers. Indeed, a study by National Westminster Bank (1997) found that 15% of their Asian business customers who switched banks, did so because they had found a more ëAsian-friendlyí bank.

Similar criticism were made by African Caribbeans, who had been rejected by banks but managed to raise funds elsewhere. There was a feeling that, whereas the banks see Asians as entrepreneurs, African Caribbeans tend to be typified as 'no-hopers'.

The considerably more favourable experiences of Asian entrepreneurs in recent years are often held up, in defence of the high street banks, as evidence that this cultural gap, if it existed at all, has begun to close. However, Jones et al (1997) notes that, although Asians are experiencing fewer problems in obtaining business finance than has previously been the case, the pattern of business funding among this group is both very selective and highly stereotypical, focussing specifically on the traditional corner shop. In addition, the higher success rates of Asian entrepreneurs in obtaining business finance should also be viewed within the context of striking levels of usage of ëgo-betweensí in arranging finance (Herbert and Kempson,1997).

e) Disincentives to borrow from traditional banks

We said earlier on that the problems micro-entrepreneurs experience in relation to traditional banks are not centred around the services they can offer them. In fact, interviews with representatives of the main high street banks suggest that, to a degree, these institutions are more capable of meeting micro-entrepreneursí needs than we might have anticipated. Nevertheless, issues relating to the high street banksí service provision for micro-entrepreneurs, remain relevant. This is because, in many respects, traditional banks cannot offer business finance in a form which is suitable or acceptable to many entrepreneurs. Consequently, it is important to acknowledge that some micro-entrepreneurs choose not to make use of bank finance, because it does not fulfil their needs.

Four of the five high street banks represented in this research were able to make loans as low as £500, the fifth had a minimum threshold of £1,000. However, they all charged arrangement fees, ranging between 1% and 1.5% , and this can make borrowing from banks an expensive business for micro-entrepreneurs. One branch manager, who had personal autonomy over decision-making on loans up to £15,000 said that he would almost certainly waive the arrangement fee for a loan of £500. Another bank, however, had a minimum arrangement fee charge of £75, which would make a small loans disproportionately expensive.

Moreover, there is some evidence that small firms are charged higher than average interest rates for the money they borrow (Federation of Small Businesses and Pannell Kerr Forster, 1996).

The length of repayment periods were also not viewed, by bank managers, as being a major obstacle to micro-firms. Repayment periods were largely determined by the purpose of the loan ñ loans for equipment or machinery have to be repaid in full within the lifetime of the asset. However, all the high street banks represented in this research believed that they set repayment terms sensitively, to take account of affordability factors. All of them could make business loans over a period of up to five years which, we will see later, is equally, if not more generous, than some UK micro-lending organisations.

Interviews with entrepreneurs indicate the existence of widespread concern about borrowing money from banks and, consequently, some reluctance to do so. This was particularly apparent among people with little experience of the financial services industry.

They were very concerned that high street banks were too inflexible and that once a loan was agreed it would be impossible or, at least, very expensive to alter the terms.
There is, undoubtedly, a recognition within the high street banks of the need to be flexible with regard to micro-firms, which may be particularly prone to cash-flow problems. However, although most are prepared to reschedule loans to reflect changing needs and circumstances, this can be a costly procedure for the bank and, consequently, the customer. In addition, traditional banks have not yet reached the point of offering repayment holidays or other flexible measures to help small firms through tough times.

Moreover, the penalties for failing to keep to the terms and conditions of loans from high street banks can be harsh. Micro-entrepreneurs expressed a clear recognition of, and concern about, this. Again, it is important to stress that the bank personnel interviewed for this research showed a clear willingness to work with businesses which were experiencing difficulties, and recognised the need for support and compromise. However, as with other aspects of their lending service, the extent to which they can be flexible is, often, constrained. As a result, defaulting on a loan from a high street lender can have harsh, and often expensive, consequences. Several micro-entrepreneurs commented on the financial burden of penalties imposed on them by their bank.

> *What I found the biggest problem was with the bankÖ Every week we was getting bills for £27 [for] bounced cheques, and they knew very well that we hadnít got the cashÖ [The manager] gave us an overdraft we didnít ask for, but if we went £5 over the [limit] theyíd send us a bill for £27.50Ö It was putting us further and further behind. There was one monthÖ it was something like £400 weíd been charged on bounced cheques.*

Experiences, first-hand or otherwise, of losing a home as a result of defaulting on a loan secured on it, served only to amplify these concerns and was a strong deterrent to formal borrowing for some people. A Bangladeshi man who had suffered this remarked:

> *I have used credit before and I have lost many things [because of] using it. The bank screwed me and ever since then I have never been to a bank for creditÖ I completely avoid it now. Credit is like a noose ëround your neck, the heavier your burden, the tighter it gets.*

f) Attitudinal factors

Perhaps more pervasive than these experiences are the attitudes which are held by some groups of micro-entrepreneurs.

Among people that we have interviewed, there was a strong perception that traditional banks were untrustworthy. Several people were sceptical of banks that were keen to lend when

their business was prospering, but then completely withdrew support as soon as they hit hard times. A Bangladeshi man was equally suspicious of banks, having had a loan application refused without any explanation in the past, only to find a dramatic improvements in his access to finance once he was running a successful business. While there is a clear logic behind a bankís refusal to lend to somebody unless they can demonstrate an ability to repay, this experience reinforced the manís perception that banks exist only to help themselves and not their customers.

Further, Cosh and Hughes (1997) found evidence that financial decision-making within small firms conforms to a ëpecking order hypothesisí, which means that bank finance is only sought after a number of other avenues have been exhausted. They argue:

> *This structure is, with the exception ofÖ the late 1980s boom, of long-standing. Itís principal characteristics are that small firms are relatively more reliant on short-term loans and overdrafts and less reliant on equity finance. Trade credit also plays a more important role on the liabilities side of their balance sheet, and trade debtors a more important role on the assets side.*

The attraction of this funding structure for many small entrepreneurs is that it ë*minimises external interference and ownership dilution by leaving equity until last after retentions and debt have been exhaustedí* (Hughes and Storey, 1994, p3).

In addition, some Asian entrepreneurs are forbidden to borrow from banks by their religious beliefs. Interviews with several Pakistani and Bangladeshi people illustrates that many are having to forego their religious convictions because they are not compatible with modern British society. However, this factor remains significant in reducing their willingness to borrow from high street banks and many only do so as a last resort.

Consequently there is among many micro-entrepreneurs, but particularly among those of Asian origin, a strong preference for other forms of financing their business. Many use personal savingsí. Others prefer to use facilities such as overdrafts and hire purchase to reduce their reliance on formal borrowing. A recent survey suggests that 17 per cent of small firms were relying on overdrafts to finance long-term business expansion (Federation of Small Businesses and Pannell Kerr Forster, 1996). Other figures indicate that the amount of hire purchase and leasing almost doubled between 1991 and 1995 (Bank of England, 1997). Entrepreneurs from ethnic minorities tended to rely on loans from friends and family which were interest free, flexible and did not have strict repayment terms.

These problems are summarised in Table 2.1 below:

Problems in obtaining commercial finance for micro-enterprises	Identified in the UK
Rigid lending criteria:	
Requirement for savings/collateral	✔
Requirement for business qualifications/experience	✔
Credit checks in which small size is perceived to increase risk	✔
Minimum loans which exceed the amounts micro-entrepreneurs need	✔
Feelings of fear and alienation	
Not used to dealing with financial institutions	✔
Unable to present a ëgood caseí for a loan	✔
Allegations of discrimination	
Sexism	✔
Racism	✔
The disproportionately high costs of small loans	
Charges for facilities eg. cheque clearing	✔
Arrangement fees	✔
High interest rates for small firms	✔
Disincentives to borrow from commercial lenders	
Inflexibility of terms and conditions	✔
Fears of incurring penalties, eg. for overdrawing an account	✔

So what happens to micro-entrepreneurs who cannot access finance via commercial lenders? What are the alternatives to commercial lending in the UK and how do they aim to meet the needs of micro-enterprises?

5 Micro-lending in the UK

Although academic and political interest in micro-lending is relatively new, the activity itself is not. It's origins lie in 19th Century Europe and in the Third World where the Grameen Bank pioneered a successful rural labour programme for Bangladeshi women (Reifner and Evers, 1995). In Europe and the US, micro-lending is perceived as a key solution to problems of unemployment and community disintegration, as well as a means of providing finance to people who have limited access to the mainstream credit market.

Micro-lending has been developing in the UK since the 1970s. The exact nature of the various micro-lending organisations which currently exist is influenced heavily by their *raison díÍtre*. Some are aimed at helping particular client groups, identified by their personal characteristics, for example, women, young people or ethnic minorities. Other schemes focus on particular geographical areas, such as deprived inner cities or isolated rural communities. A few exist purely for the purpose of providing finance for the creation and support of small business enterprises.

According to Lynch and Haidar (1997), micro-lending is distinct from the various soft loan schemes outlined earlier in this report in two key respects. First, they are or, at least, aim to become self-sustainable. Second, they tend to have good relationships with mainstream financial services working closely with the high street banks. In this respect, an important function of micro-lending is to provide people with a platform from which they have access to mainstream credit.

Who are the micro-lenders in the UK?

15 micro-lenders were investigated as part of this study and they are listed in Appendix 1. Although their specific aims and customer base varied they shared a common aim of providing loans to micro-entrepreneurs who would face difficulties raising finance from high street banks.

Initial analysis of the type and nature of micro-lending in the UK indicates four key themes.

- UK micro-lenders operate along a continuum ranging from those which operate on quasi-commercial lines to those which perceive their activities as part of a wider social function. At the furthest point of this continuum, the activities of the very socially-oriented organisations merge fairly closely with those of grant giving bodies with similar aims.
- Many micro-lenders are not focussed specifically on supporting small business *per se*. Rather, they operate as part of wider strategy to address issues of long-term unemployment, poverty and community disintegration. Several, such as the Glasgow Regeneration Fund, the Merseyside Special Investment Fund and Hackney Business Venture grew out of wider urban regeneration initiatives.

- Consequently, many UK micro-lenders have a strong local emphasis and provide quite specific services to a clearly defined target group. Some, such as the Bristol Entrepreneurs Development Fund, operate as part of a larger, local-area network. Very few UK micro-lenders are national organisations. Just two, ICOF and the Princeís Youth Business Trust/Princeís Scottish Youth Business Trust have strong national profiles.
- UK micro-lenders differ as to whether or not they aim to become self-sustainable *organisations*. All, however, are committed to sustainable developments of the *individuals* to whom they lend.
- The UK model of micro-lending often differs in an important respect from that pioneered by the Grameen Bank. Most UK micro-lenders lend to individuals or working partnerships. Only a small number, including WEETU Full Circle Project in Norwich, the Glasgow Womenís Microcredit Project, run by Wellpark Enterprise Centre in Glasgow - operate group-lending schemes. However, others are thinking of expanding into this type of lending because they perceive this model as offering opportunities to make the lending process less labour intensive, without increasing the risk factor associated with loans.

What services do they provide?

Micro-lending for enterprise in the UK fulfils a number of functions; providing finance to help people set up in business or expand an existing business being one of them. However, interviews with representatives of these organisations, suggest that they see their role much more widely than this. While their role as providers of finance cannot be ignored, it must be set within the context of their other objectives. This section gives an outline of the type and nature of the services which micro-lenders provide. The actual process of micro-lending is covered in the next section.

a) The provision of business finance to excluded groups

A key function of UK micro-lending organisation is to provide finance for business start-up or expansion to groups who are excluded from traditional sources of finance. Some, including the Princeís Youth Business Trust/Princeís Scottish Youth Business Trust, specifically target the long-term unemployed. UK micro-lenders often provide several different sources of finance, including small grants and, in a few cases, equity funding. This report focuses on the lending activities of these organisations.

They aim to help people without a proven track record in business or without assets of their own to invest. This also includes people who want to set up the type of low turnover businesses, providing services such as cleaning and home hairdressing, which are not attractive propositions for traditional banks. Micro-lenders can also provide finance for particular types of business, such as workers co-operatives, which banks are often cautious about funding. Some UK micro-lenders also help people with unfavourable credit histories. The Bristol Enterprise Development Fund, for examples, is willing to lend to people who have County Court Judgements against them and to undischarged bankrupts.

b) Providing low-cost flexible loans

UK micro-lending organisations provide a low-cost, flexible financial products, designed to meet the needs of the people they are aiming to help. They are willing to lend small amounts of money - usually starting at £500. One or two will lend smaller amounts - around £200 - but are reluctant to do so because of the disproportionately high administrative costs associated with small loans.
At the other extreme, several micro-lenders in the UK can also lend quite large amounts of money. The Glasgow Regeneration Fund, for example, currently offers a maximum loan of £75,000, although they are considering lowering this ceiling.

Micro-finance in the UK also comes with favourable terms. The majority of micro-lenders in charge interest rates around 2%-4% above base rates. In some organisations, interest rates are fixed for the term of the loan. Repayment terms for micro-loans are also designed to meet a wide range of needs, ranging from 6 months to 10 years, with most organisations preferring loans to be repaid over 3-5 years.

Perhaps most importantly, micro-finance for enterprise in the UK is also largely available without security. None of the micro-lenders included in this research required security in order to be able to make loans, although some do ask for personal and/or bank references.

However, it is important to note that the cost of micro-finance depends, in part, on how commercially the organisation is run. On the whole, the quasi-commercial organisations charge higher interest rates and have greater discretion over the level of interest levied on a loan than those that play a wider social role. For example, loans from the Bristol Enterprise Development Fund have a low rate of interest which remains fixed for the duration of the loan. ICOF Ltd, on the other hand, sets interest rates in relation to the risk factor associated with the each applicant. ICOF also charges an arrangement fee of 1.25% - the same as most high street banks ñ and, although they never take personal security, will take security for loans where assets are available.

c) Offering support and encouragement

Perhaps the most important function of UK micro-lending organisations is that they provide a package of support, for micro-enterprises, of which finance is simply one aspect. This is, in fact, one of the key distinctions between micro-lenders and the traditional banks. It is also widely perceived by micro-lenders, themselves, as the most crucial element of the service they provide. They view their role as offering a means of self-help to disadvantaged people and communities, giving them opportunities to acquire the skills and experience they need to secure a permanent route out of poverty and disadvantage.

Micro-finance also provides people with the support and encouragement they need to overcome some of the obstacles to setting up a business. Consequently, these organisations help their applicants to formulate their business ideas; assist them in producing the necessary supporting documentation; and offer a comprehensive system of post-loan aftercare and support.

Crucially, a central subsidiary aim of micro-finance is to help people gain access to mainstream services by enabling them to acquire work experience and build-up healthy employment and credit histories. In addition, receiving support from a micro-lending organisation often increases the credibility of a micro-business, in the eyes of both the finance industry and the public.

d) Providing a safety-net

In addition, a central element of micro-lendersí wider social role is to provide a safety-net which allows people to make mistakes without suffering severe, long-term consequences. Most give borrowers the flexibility to miss occasional repayments or suspend repayment for a while without incurring financial penalties.

Further, if businesses supported by micro-lenders fail, the owners do not risk the disastrous personal and financial consequences often associated with bank lending that are documented in other research (Whyley, 1998). While all of the micro-lenders who took part in this research aimed to keep debt and default to a minimum, none of them pursued aggressive debt-recovery procedures. Further, as long as debts were perceived to be ëhonourableí ie. not involving fraudulent or illegal activities, it was rare for micro-lenders to take legal action against debtors.

Few micro-lenders view the success of their organisation purely in terms of the number of surviving business on their books. Most, and particularly the less commercial micro-lenders, view their role more in terms of providing a learning environment for people to test out their own capabilities and learn from their mistakes. Even businesses which, ultimately, do not succeed are viewed as having positive outcomes, not least because of the experience that individuals have gained. The Princes Youth Business Trust points out that 60 per cent of their applicants whose businesses do not succeed go on to secure other types of employment. It is not unusual, therefore, particularly for the less commercially-oriented micro-lenders, to view the learning experience of running business as being equally, if not more important, than its success or failure.

This is certainly not a function which the high street banks could provide and it is extremely unlikely that they would ever seek to do so.

The process of micro-lending in the UK

A number of questions arise about how micro-lenders operate and the process by which they make loans for enterprise. This section looks briefly at how UK micro-lending is funded; how they acquire their clients; how they assess and manage risk; and how they deal with default and debt-recovery.

a) Funding

The vast majority of UK micro-lenders are charitable organisations, and some operate as companies limited by guarantee. They finance their activities from a mixture of private and public funds and some, like the Glasgow Regeneration Fund, for example, have obtained funding from the European Regional Development Fund.
Micro-lenders in the UK have, traditionally, received support from the banking sector and the business world. Support received from this source comes in several forms. Several high street banks and other businesses donate money or provide seconded staff to micro-lending organisations in support of the services they provide.

Financial support is also available from private organisations in the form of grants, for which micro-lenders have to submit bids and, often, compete with each other. In addition, a great deal of private sector support for micro-lending in the UK is ëin-kindí help, which comes in the form of donations of equipment, business services and expertise.

There is also a fair amount of public funding available to support UK micro-lending, at both national and local level. The Princeís Youth Business Trust, for example, has secured an agreement from the Employment Department to match, £ for £, the money it raises from private sources. The micro-lenders that operate at local level are all supported by City and County councils. Some also raise further finance by managing regeneration budgets for local authorities, for which they charge a management fee.

The exceptions to this model are Aston Reinvestment Trust (ART) and ICOF Ltd which are industrial and provident societies who fund their activities by selling shares to individuals and organisations. In 1994 ICOF raised, £460,000 in this way and ART has recently raised more than £740,000 both from investments from individuals and organisations, and targeted public sector support.

The majority of micro-lenders represented in this research also finance themselves by providing training and consultancy services.

A crucial element of micro-lendersí funding, is the extent to which their financial arrangements mean that they are, or are working towards becoming, self-sustainable. This was clearly only a goal for those organisations which operated on a quasi-commercial basis. Of the organisations included in this research, just one ñ ICOF - was self-sustainable at the time of the research. This organisation has, in fact, been self-sustainable since the early years of its existence.

Others, such as the Glasgow Regeneration Fund and ART, are aiming to be self-sustainable over the short- to medium-term and have a timetable for achieving this objective. ART anticipates that by 1999 revenue earned on lending and funds held in deposit should be sufficient to cover organisational overheads. The Glasgow Regeneration Fund has also been successful in raising large amounts of money from individual and corporate donation and aims to support this by extending their fund raising activities. However, they have expressed some concern about the likelihood of becoming completely self-supporting as a result of the high risks associated with most of their loans.

Many other micro-lenders, however, particularly those operating at local level and focussing on closely defined client groups, are not anticipating being able to support themselves. In fact, some do not aim to do so. They feel that their target groups present such a high risk, and the process of lending to them is so labour intensive that, as one person explained, they are *ënon starters commercially, because the returns are so smallí*.

b) Client acquisition

Clearly individual organisations have different methods of client acquisition, largely influenced by their target group and the degree to which their activities incorporate a commercial orientation.

The more ëcommercialí organisations tend to pursue their own advertising and marketing strategies. This is also the case for national bodies, like the Princeís Youth Business Trust/Princeís Scottish Youth Business Trust, who have a very high nation-wide profile.

The majority of the micro-lenders included in this research, however, did not actively market or advertise their services. Most could not afford to do so. Rather, they relied on referrals from other organisations, such as high street banks and local enterprise networks. This was a particularly efficient strategy for locally-based micro-lenders who were closely linked with local enterprise networks. In addition, most micro-lenders also found that many of their clients became aware of them via word-of-mouth and via other activities, such as training, which they were involved in.

c) Risk assessment

The way in which micro-lenders are able to offer finance to applicants who would be considered too high a risk by high street banks is of key interest in any analysis of their activities. In many respects, micro-lendersí process of risk assessment is not notably different from that used by traditional banks. Those included in this research all require a business plan and a set of accounts or cash flow forecast before they can make decisions on loan applications. All of them were adamant that support would only be provided for viable businesses. Final decisions about loans are based primarily on this documentation and on assessments of the character and ëdriveí of the applicant.

However, the process of risk assessment for micro-finance is much less formal, more personal and more labour intensive than that employed by the high street banks. Micro-lenders view the application process as more of a ëjoint ventureí between the lender and the applicant, rather than a more straightforward requirement for applicants to prove that they are worthy of receiving a loan. So, applicants for micro-finance will usually have a fairly lengthy personal interview at the start of the application process, where the procedure is explained to them in detail and they are given an opportunity to discuss their business idea in detail. If necessary, applicants are given assistance in refining their idea to something which is both achievable and fundable.

All of the micro-lenders who were interviewed for this research recognised the practical and psychological barriers which many applicants experienced in trying to produce a business plan. This was particularly the case for organisations designed to help people with restricted access to mainstream financial services who are unfamiliar with both the language and the process of loan applications. A representative of the Princeís Youth Business Trust, for example, estimated that around 60 per cent of people who contacted them but did not pursue an application were deterred by the requirement to produce a business plan.
Consequently, providing assistance and support with business plans is a key element in the process of micro-lending. While some micro-lenders provide this support themselves, others are tapped into a local enterprise network which fulfils this function.

A crucial element of risk assessment by micro-lenders is the relationship between the lender and the applicant. Building up a relationship of this kind is essential if lenders are to be able to make accurate assessments of clientsí drive, personality and commitment to the business. If the applicant is lacking in these areas it is unlikely that their business idea will be funded, whatever its potential.
Consequently, lenders place a priority on building a strong relationship with applicants, usually involving several hours of one-to-one contact. Most micro-lenders spend between two and four hours with each applicant. This can include a personal visit to the applicantís home or business as part of this stage, in order to build up a complete picture of his or her life and circumstances.

If this one-to-one relationship is fruitful in producing a clear business plan and the applicant is assessed to ë*have what it takes to run a businessí* the application is put forward for decision-making. In most micro-lending organisations, decisions are taken by panels of specialists and interested parties, including representatives of funding bodies, local banks and experienced business people. In some cases, applicants must go before the panel for an interview of 45-60 minutes, during which they make a presentation on their business idea and answer questions put to them by the panel. Micro-lenders are clear that this interview process is not intended to ë*trip people upí* although they do see it as a test in some respects. These interviews help the panel make judgements on the extent to which the applicant has thought through his or her idea. Their response to the interview situation also illustrates their drive to succeed and their ability to operate under pressure.

The more commercially-oriented organisations, however, are more likely to have devolved responsibility for decision-making to individual level to make the process quicker and more cost effective.

Interviews with the micro-lenders indicate that more, often significantly more, than half of applications are agreed by decision-makers.

d) Risk management

However sensitive and effective micro-lendersí risk assessment strategies may be, the fact remains that their client groups almost always have a higher risk of default than clients of the traditional banks. Consequently, managing and, where possible, reducing risk, is as crucial

an element of micro-lendersí work as risk assessment. It is also an important aspect of the ëpackageí of support which micro-lenders provide and which continues long after loan applications are agreed.

There are several ways in which micro-lenders seek to contain and reduce the risks associated with lending to their target population. First, in some organisations decisions to grant finance may be made with conditions. For example, the Princeís Youth Business Trust may agree to a loan, but only if the applicant agrees that leases for premises or equipment are checked out by experts. This helps many successful loan applicants avoid one of the common pitfalls of running a business.
In addition, all micro-lenders offer a comprehensive and ongoing system of after-care and support. In fact, in many organisations, agreement to participate in monitoring and co-operate with business mentors is written into their contract with the applicant. All micro-lenders place a high premium on regular personal contact with clients, generally on a fairly informal basis. Applicants are also required to provide accounts, usually on a quarterly basis but more frequently for ë*more precariousí* businesses or those experiencing problems.

Micro-lenders can, if necessary, also supply their clients with practical support and specialist help. Most can offer training and many also make services such as photo-copying and computing available. Several micro-lenders have associations with established businesses which provide specialist help such as legal advice or accountancy.

Finally, a central element of risk management among micro-lenders is a willingness to be flexible over repayment arrangements. The Princeís Youth Business Trust, for example, does not require repayments to be made until after the business has been operating for six months. This reduces financial pressures during the crucial early months of running a business. In addition, regular contact and the maintenance of a personal relationship between lender and client means that problems making repayments can often be pre-empted avoiding a build-up of arrears. Micro-lenders are willing to ë*pitch iní* and help solve financial problems in any way they can ñ either by providing support themselves or accessing some specialist help or advice for their clients. If these strategies are unsuccessful, most micro-lending organisations are willing to offer repayment holidays or, where necessary, re-schedule loans to ease financial pressures.

A minority of micro-lenders - including Full Circle and the Glasgow Womení s Microcredit Project offer group loans as a way of reducing levels of default. This is also a key feature of the new organisation that is being proposed along the same lines as Fundusz Mikro - the Polish micro-lender.

e) Coping with default

Despite micro-lendersí commitment to assisting their clients out of financial difficulty, their target populations make problems of default a reality that they have to face. Default rates among the micro-lenders included in this study range between 1% and around 40%, with most experiencing levels of around 20-25%. To a degree these differences are likely to reflect the type of micro-lender involved. For example, the lowest default rate was associated

with ICOF, which is one of the more commercially-oriented organisations. The highest default rates were associated with organisations which perceived themselves to have a very broad social, as well as financial, role and defined success more broadly than simply in terms of business survival rates.

Micro-lenders with low default rates attributed their success to the strength of the personal relationships they built with clients. While close contact between the lender and borrower reduced the likelihood of default *per se*, some micro-lenders spoke candidly of their willingness, where necessary to use these relationships to lever payments out of clients. However, as all the micro-lenders included in this research maintained personal relationships with their clients it cannot be this factor alone which determines default rates.

In fact, the evidence suggests that a key element of low-default rates among some micro-lenders is an ëaffinity groupí feel which promotes a sense of collective responsibility. This significantly reduces the likelihood of default. ICOF, for example, which had one of the lowest default rates, lends primarily to working co-operatives. It is likely that collectives are less inclined to allow problems build up or to decide to close the business than individuals.

In addition, another organisation with a low default rate dealt primarily with young people from black and ethnic minority backgrounds, which also promoted a sense of collectivity rather than individualism. For this reason, group-lending schemes are also likely to be more successful than those which lend to individuals.

Although all of the micro-lenders in this study had established processes of debt recovery, this rarely involved pursuing bad debts after businesses had been closed down. They would clearly do all they could to elicit late payments, usually contacting defaulters several times by letter and in person. Wherever possible, they would provide assistance to overcome the financial problems which were making repayments difficult to manage.

However, none of them, even the most commercially-oriented would take legal action against defaulters, or call in any security they had taken, unless they suspected some kind of illegal activity or fraudulent behaviour. ë*Honourable debtsí* incurred where clients had done their best but been unable to make the business a success, would be written off.

So micro-lending in the UK, as is often the case elsewhere, provides a service for micro-entrepreneurs which goes beyond the issue of access to financial support. Micro-lending organisations offer a package of support to entrepreneurs in order facilitate their business and increase their chances of success.

Summary and conclusions

Issues around the funding of micro-enterprises is clearly very important in the United Kingdom. Although the 1990s saw a dramatic fall in the numbers of new small and micro firms, they still comprise a significant proportion of the economy and recent indications are of renewed growth in this area. It is somewhat difficult to identify ëmicro-entrepreneursí from other self-employed people and small businesses. However, it is important to note that the vast majority of self-employed are sole traders and three quarters of UK businesses have no or fewer than five employees.

Consequently, their annual turnover of these businesses is generally fairly modest, averaging at just £31,000. They are located primarily in the construction industry but they are also prominent in ëreal estate, renting and business activitiesí; ëwholesale, retail and repairs; and ëcommunity, social and personal servicesí.

While the self-employed population consists mostly of white males aged in their 40s and 50s it is possible to identify some people who are disproportionately likely to be running micro-enterprises. There are women, young people aged up to 25 and people from minority ethnic groups, particularly people of Asian origin.

Successive British governments have implemented a range of policies aimed at encouraging and facilitating the development of small and micro-enterprises. These include Training and Enterprise Councils in England and Wales, Local Enterprise Companies in Scotland, and the nationwide Business Links network.

The availability of finance is clearly crucial to decision-making around self-employment. Several studies have noted a link between the availability of wealth or assets and a growth in business start-ups. The amounts of money needed to set up a micro-business in the UK are relatively small ñ around £11,000 although the amounts vary according the type of business. In fact, at least a quarter of self-employed people have been found not to need any finance at all to set up their business. Where start-up funds are needed, the most widely used source in the UK is personal savings, followed by bank loans and help from friends and family. However, these patterns vary, again, between different businesses. Bank funding is the most frequently used source of additional, post-start-up funding.

Finance for micro-enterprises in the UK is available from a number of sources, both private and public. Banks are, undoubtedly, the main source of external finance. However, in recent years the nature of this funding has changed from overdrafts to fixed rate lending. Business loans are generally made at 3%-4% above base rate. The vast majority of these loans require security from the borrower. However, the Small Firms Loan Guarantee Scheme (SFGLS) was introduced by the Government in 1981 to enable viable enterprises without security to borrow from banks. However, many micro-enterprises are excluded from the SFGLS because of its terms and conditions. In addition, awareness of the scheme is extremely low.

Recent years have seen a rapid growth in ësoft loaní schemes for small firms, mostly set-up by local authorities and operating at local level. However research has found a fairly rapid turnover of such schemes, with many closing due to bad debts or loss of funding.

In addition, there are a variety of grants available to encourage or support micro-enterprise. The Enterprise Allowance and Business Start-Up schemes provide grants to assist unemployed people to set up in business. A plethora of grants schemes also operate at local level which are targeted at small or micro-enterprises. However, many of these are the product of area regeneration initiatives, rather than policies to support small business *per se* and few are available to businesses without some other source of ëmatchedí funding.

The problems which micro-entrepreneurs experience in trying to obtain commercial funding, particularly for business start-up are well-documented and have been a source of concern for some time. Many of these problems are the result of the rigid lending criteria employed by banks, requiring a level of business experience and financial security that is impossible for many micro-entrepreneurs to provide. In addition, it is clear that some micro-entrepreneurs feel alienated by mainstream financial institutions and are, therefore, extremely reluctant to use them. These problems have worsened as a result of the recent shift in UK banking away from ërelationship bankingí to centralised control and decision-making. Allegations of discrimination by banks, particularly on the grounds of race, have rarely been proven. Nevertheless, the strength of feeling in this area cannot be dismissed.
All of these factors combine to create a clear set of disincentives for micro-entrepreneurs to borrow from high street banks and, consequently, many look elsewhere for financial support.

Micro-finance is a key alternative source of support for very small businesses and, while it is still a relatively new concept in the UK, it has been an area of fairly rapid growth. Four key themes can be drawn out of an analysis of UK micro-lending:

- They operate along a continuum ranging from quasi-commercial to predominantly social functions.
- It has a strong local emphasis and provides services to a clearly defined target group.
- Not all micro-lenders aim to become self-sustainable as organisations, although there is a wholescale commitment to sustainable development of the *individuals* to whom they lend.
- The emphasis on lending to individuals or partnerships rather than groups is an important departure from the traditional form of micro-lending pioneered by the Grameen Bank.

Micro-lenders in the UK rarely exist simply to provide finance. They generally fulfil a range of functions. They generally offer a whole package of services in conjunction with loans, including a comprehensive system of after-care and support. Crucially, because very few micro-lenders pursue aggressive debt-recovery procedures, borrowers do not risk the disastrous personal and financial consequences which are often associated with defaulting on bank loans.

The majority of micro-lenders in the UK are charitable organisations, They tend to finance their activities via a mixture of private and public funds. Two, however, raised their own funding by selling shares to individuals and organisations. Many others sold their training and consultancy expertise to other organisations. Only one micro-lender was self-sustainable at the time of the research; two others were aiming for this goal in the short- to medium-term. However, many others do not anticipate being able to support themselves at any point in the future and are not aiming for self-sustainability. This is because of the level of risk associated with most of their loans and the high transaction costs of micro-loans.

In many respects, the risk-assessment strategies employed by micro-lending organisations are not notably different from those used by traditional banks. However, it is less formal and involves a great deal more personal contact between lender and client. This relationship is crucial in helping the lender assess the likelihood of a business being successful. Final decisions tend to be taken by committee. In the more commercially-oriented organisations, however, this decision-making process is usually devolved to individual level.

A greater degree of divergence between micro-lenders and traditional banks is apparent, however, in relation to their approach to risk management. All micro-lenders, including the more commercially-oriented, offer a comprehensive and ongoing system of after-care and support. Often an agreement to participate in monitoring and co-operate with a business mentor is written into the conditions of a loan. Some micro-lenders also offer practical support services, such as training and business services and most expressed a willingness to ëpitch iní and help solve any problems which their clients experience. Group loans, which are offered by two UK micro-lenders are a further way of reducing levels of default.

Although their lending and support services are very progressive, the default rates among UK micro-lenders are high. Most have default rates of 20-25%, although the range is from 1%-40%. Lowest default rates are associated with the more commercially-oriented organisations. Those with predominantly social goals tend to have much higher rates. While all the micro-lenders examined for this study had established processes of debt recovery. This rarely involved pursuing debts after a business had closed down.
None of them, even the most commercially oriented, would take legal action against defaulters or call in security, unless they suspected fraudulent activity. In most cases, debts are perceived as ëhonourableí and written off.

What is the status of micro-lending in the UK?

In some respects, micro-finance in the UK presents a fairly positive picture. While UK micro-entrepreneurs may experience greater difficulties in obtaining mainstream business finance than some of their European counterparts, micro-lending has clearly developed as a solution to these problems. This response seems more widespread and subject to faster growth in the UK than elsewhere in Europe. There is currently a continuum of micro-lending activity ranging from the socially-oriented organisations at one end to the quasi-commercial at the other. This response is likely to be due to the high numbers of micro-firms in the UK and the growing awareness of acute finance problems for this sector of the economy over the last decade.

These activities of UK micro-lenders, outlined in this report, could provide an important learning environment for organisations which are developing in other European countries.

What is the competitive edge of micro-lenders over traditional banks?

The key distinction between micro-lenders and traditional banks in the UK relates less to their competitive edge than to their different remits. Micro-lenders rarely, if ever, compete

with banks for clients. Rather, they exist to provide finance for people that the traditional banks are not able to serve.
In fact, the majority of micro-lenders in the UK have predominantly social, rather than business goals. Just one, the most commercially-oriented, perceived itself to be in competition with the high street banks. This did not relate to the provision of start-up finance, but to retaining successful clients after they had built up a sufficient credit history to obtain mainstream finance. In these circumstances, interest rates were set to compete with traditional banks.

In most cases, micro-lenders are simply better able to meet the needs of micro-entrepreneurs because this is the population they were created to serve. Their recognition of the small amounts of money involved; flexibility over lending criteria; and the provision of extensive one-to-one support during the application process are all part of a service which traditional banks do not provide. Likewise, the continued relationship between lender and client and regular contact and monitoring are also crucial in meeting the needs of micro-entrepreneurs.

In short, it is in offering a form of ërelationshipí banking which is no longer available from mainstream financial institutions that micro-lenders excel and it is this which is the key to their success.

What has to be done to support growth in micro-lending in the UK?

Micro-lending in the UK is, already, a fast-growth area, with new organisations being created all the time. Most of these organisations, however, are concentrated at the socially-oriented, rather than the commercially-oriented, end of the continuum. There are clearly some lessons which need to be learned in the UK if micro-lending is to provide an efficient, effective and sustainable response to ëthe finance gapí for small businesses.

Currently, the emphasis in UK micro-lending is not on small businesses *per se* but on regenerating particular areas or facilitating disadvantaged or marginalised groups. Very few organisations currently exist purely to support entrepreneurs for whom lack of access to finance is the key obstacle. While the social goals of many micro-lenders are laudable, their terms may exclude many people whose businesses may otherwise be viable. This is clearly a gap in the micro-lending market in the UK which should be addressed if micro-finance is to be widely available to all micro-entrepreneurs who need it.

Only one micro-lender in the UK is currently self-sustaining, although two others and one new entrant, aim to be in the short-to-medium term. The majority of UK micro-lenders are not looking to this end. While the barriers to self-sustainability in these organisations are clearly apparent, this remains an issue of concern. Without some means of supporting themselves, their activities are constrained by the requirements of their funders and their future is far less secure.

While the need for fairly labour-intensive, one-to-one relationships between micro-lenders and their clients at all stages of the lending process is clear, this does mean that transaction costs are correspondingly high. The fact that micro-lenders, by their very nature, deal with

the kind of ënon-standardí cases that banks reject makes it highly unlikely that their costs in this area will ever be as low as they are in high street banks. In addition, given their role, it would be undesirable for these costs to be reduced to the point where micro-lenders could no longer provide the personal, ërelationshipí banking that micro-entrepreneurs require.

Some organisations, however, were exploring ways of reducing their transaction costs without affecting other areas of their service and, in particular, without increasing default rates. One thought that group lending could be an effective vehicle for achieving these aims. With the entry of a new organisation, based on Fundusz Mikro, into the market it may be possible to test out this hypothesis.

Appendix Micro-lending institutions covered by this research

Aston Reinvestment Trust (ART)

Aston Reinvestment Trust (ART) is a relatively new micro-finance organisation in the UK. The original aim was to address the gaps in funding available to people in Aston, Birmingham, as a result of the withdrawal of mainstream financial services from that area. However, the remit was extended to create the first local social investment society in the UK for the whole of Birmingham but targeting the inner city. They provide loans, at market rates, to micro-firms, small businesses and voluntary organisations. Most of their clients come from a local referral network, consisting of the high street banks and local enterprise agencies. They summarise their activities as *'lending to projects that are viable but not yet bankable'*.

Bristol Enterprise Development Fund (BEDF)

Bristol Enterprise Development Fund (BEDF) is a source of grant and loan finance for small and start-up businesses in the disadvantaged areas of Bristol who have been unable to raise finance from traditional sources. BEDF also provides grants of up to £1000 for sole traders and £2000 for partnerships, limited companies and co-operatives, to be used for market research, professional help in developing a business plan, training, start-up expenses and capital costs, and marketing. Applicants to the Fund are acquired largely via the local network of enterprise agencies although they also advertise in business magazines. BEDF has a sister fund, run along very similar lines in Birmingham, called the Arrow Fund.

Federation of Small Businesses Credit Union

Currently this is a pilot scheme, Lancashire and Cumbria Federation of Small Businesses Credit Union, which began operation in July 1996 as an initiative of the Lancashire and Cumbria region of the Federation of Small Businesses. It is now in the throes of becoming a national scheme and will be extended to the remaining regions, one at a time. Start-up support (staff, equipment etc) has been provided by the Federation although the aim is for the scheme to become self-sustainable. This should be achievable once the scheme has become a national one.

Loans are provided to members of the Federation who have been saving at least £10 a month for six months with the credit union. Start-up loans are not, therefore, available, although the scheme does lend to people who would not be considered for a bank finance. Loans vary in size from £500 to £3,250, although the maximum will increase gradually to £5,000 as the sums of money invested permit. Decisions on loans are made by the Credit Committee, drawn from the members of the credit union. The interest on loans is the standard 12.68% charged by credit unions.

Full Circle

Full Circle has been set up by the Women's Employment, Enterprise and Training Unit (WEETU), based in Norwich. It received financial support from National Westminster Bank, the National Lottery Charities Board, European Social Fund, New Opportunities for Women, Allen Lane Foundation, Caloustie Gulbenkian Foundation, the Tudor Trust, Norwich City Council and North Norfolk District Council.

Since May 1998 it has offered loans to low-income women living in Norfolk who want to become self-employed or to invest in their businesses. Although essentially a micro-credit scheme, it is recognised that participants may also require considerable amounts of training and support before they are in a position to apply to the loan fund. To qualify women have to be unemployed or unwaged; working part-time; in a low-paid job; facing redundancy or claiming state welfare benefits. The scheme is modelled on that operated by the Grameen Bank and is based on individual loans channelled through a peer group collateral system and a programme of complementary business skills development. They self-select between three and five other women to form that circle.

Members of borrowing circles elect a chairperson and, as a group, they decide which member is ready to apply for a loan first. That member must have made several repayments before the next person can have their loan. The average first loan will be £500. When the loan is repaid, participants will have the opportunity to step up to larger loans with a ceiling of £2,000.

Glasgow Regeneration Fund

The Glasgow Regeneration Fund (GRF), operated by Developing Strathclyde Ltd, offers small loans or equity to individuals who want to set up or to expand non-retail business. GRF operates in eight geographical areas in Glasgow, identified as areas of high unemployment and disadvantage, and has set up local funds in four of these. In the past, GRF relied heavily on local enterprise agencies for client referrals. Now, however, they have their own marketing strategy, involving considerable press coverage, targeting of client leaflets and other profile raising activity. GRF has received support from Glasgow City Council, Glasgow Development Agency, Scottish Homes, European Regional Development Fund, Royal Bank of Scotland, Bank of Scotland, Clydesdale Bank, BP, Body Shop and a number of private sector companies.

Hackney Business Venture

Hackney Business Venture has been operating since 1986 and runs five local authority loan funds which offer loans to cover some of the costs of setting up or expanding a business. The exact target group and service provided varies between the different funds. However, most are geographically specific and involve business with less than 25 employees. The majority of their clients are people wanting to set up new businesses. Clients hear about the Fund via word of mouth and as a result of courses that are run by Hackney Business Venture. They are also referred by banks who are unable to provide finance themselves, and local enterprise agencies.

Industrial Common Ownership Fund (ICOF)

The Industrial Common Ownership Fund (ICOF) was set up in 1973, as a limited company, focussing exclusively with worker co-operatives. It developed, however, to manage local authority regeneration funds. Amidst fears that these funds were beginning to dwindle, however, they set up ICOF Plc in 1987, which raised £600,000 from individuals and organisations, by way of redeemable share capital. In 1994, another share issue raised £460,000 and ICOF Community Capital was born, which lent to a wide range of organisations, including community enterprise, the voluntary sector, charities and any business with *'distinct social outcomes'*. ICOF now manages just over £4 million. They acquire clients through some, limited, promotional activity, such as fund-raising. Most of their applicants, however, contact them because they are *'well-known in certain sectors'* such as the co-operative movement.

Lancashire Enterprise

Lancashire Enterprise operates a micro-finance fund called the *Lancashire Rosebud Fund*, established in 1986 and which has, to date, invested more than £2.8 million into small and medium-sized enterprises. The finance that they offer is in the form of loans, equity or a combination of the two. Their focus is on the Lancashire area, in the North West of England, where they offer loans to all small and medium sized enterprises. Finance is available both for start-up and expansion purposes.

Merseyside Special Investment Fund (MSIF)

Merseyside Special Investment Fund (MSIF) was established to help address the lack of support available from traditional sources of finance to small and medium-sized enterprises in the Merseyside area. A range of separate funds have been set up, to provide appropriate finance and management support for all SMEs. These include a venture fund, a mezzanine loan fund and a small firms fund. MSIF's remit is to act as a local provider of additional funds and, in particular, to address gaps in funding for small and medium sized enterprises.

Prince's Youth Business Trust (PYBT)/ Princeís Scottish Youth Business Trust (PSBYT)

The Princes Youth Business Trust/Princeís Scottish Youth Business Trust is one of the best known micro-lending organisations in the UK. It is one of very few national micro-lending organisation and has a very high profile within the UK. It was set up after youth riots in the early 1980s highlighted the socio-economic problems caused by widespread, and growing, youth unemployment. It's aim was to help *'those who have the talents and desire to success, but not the opportunity'*. Originally the scheme was designed to provide grants to young people who could not raise the £1,000 required for access to the Enterprise Allowance scheme. Although grants of up to £1,500 are still available, these are made *very sparingly*. The main emphasis is now on loans.

PYBT/PSBYTís target market is people aged between 18-30, who are either unemployed or underemployed. It has a focus on both people and geographical areas, aiming to help, in particular, people with disabilities, from ethnic minority backgrounds and ex-offenders as well as people living, or planning to start businesses in, deprived areas.

Applicants are attracted by the nationwide advertising and marketing of the Trust. However, the Trust also receives many referrals from enterprise agencies such as the Training and Enterprise Councils and Business Links, as well as from high street banks.

Sustainable Strength

Sustainable Strength was established in February 1996 by the Birmingham Settlement. It ran, first, as a pilot scheme from February to July 1996 and was then evaluated by INLOGOV. I has just been relaunched in June 1998. Like Full Circle, it aims to help women move from 'welfare into economic independence'. The pilot project offered helped two groups of women from the Newtown, South Aston and Ladywood areas of Birmingham, to explore the possibilities of becoming self-employed. The project also worked with local agencies to improve access to financial and other resources and encouraged the women involved to become part of the regeneration process. There are currently around 30 women in the programme, most of them Bengali.

UK Microfinance Institution

Plans are well-advanced for a new, national UK micro-finance organisation, which will be modelled on the successful *Fundusz Mikro* in Poland. This will aim to provide loans to three key groups: people who are self-employed or run registered micro-enterprises, people who are self-employed but in grey (or informal) market activities, and people who are in the throes of setting up as self-employed. A key requirement will be that they lack the collateral for bank finance. The scheme aims, therefore, to offer a service that sits between that provided by banks and those offered by organisations like Full Circle.

Loans will be made on an individual basis although applicants will be encouraged to set up a lending group of up to four people. The encouragement will be in the form of lower interest rates and reduced requirements for loan guarantees.

The project is looking for financial support from mainstream banks, with a view to long-term co-operation with banks. The aim is to become a self-financing organisation within a five to eight year period.

The Glasgow Womenís Microcredit Project

Wellpark Enterprise Centreís Microcredit Project was set up through Glasgow Womenís Enterprise Network. It has set up two pilot schemes to benefit women from the Glasgow area, with preference given to those residing in the cityís regeneration areas. One scheme is aimed at women who are considering self-employment, the other focuses on women seeking to develop an existing enterprise. Both pilot groups had been formed at the time of this research and lending was expected to start early in 1999.

Loans will be available to women organised into ëbusiness credit groupsí consisting of four to six women. The project is supported by Glasgow Regeneration Fund, Glasgow Development Agency, Wellpark Enterprise Centre, Community Enterprise in Strathclyde and the Charities Aid Foundation.

Young Entrepreneurs' Development Loan Fund

The Centre for Employment and Enterprise Development (CEED) acquired funding to set up the Young Entrepreneurs Development Loan Fund in 1994/5, in the face of widespread youth riots, and aimed to help young people out of longterm unemployment by setting up in business. The scheme is targeted specifically at young people living or working in Bristol. Applicants are acquired via the local network of enterprise agencies.

North London Chamber and Enterprise Credit Union

The credit union was set up by the North London Enterprise Club in 1994. The club, in turn, was set up in 1992 by the local Training and Enterprise Council to support micro- and start-up businesses. Since it was established, the common bond of the credit union has been extended to include the North London Enterprise Club and the North London chamber of Commerce, including all the staff of the London Borough of Enfield. It now covers three London Boroughs: Enfield, Barnet and Haringey and has 360 members. There is a current recruitment drive with the goal of reaching a membership of 1,000. In conjunction with the North London Training and Enterprise Council it is operating an ëindividual learning accountí pilot scheme.

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