The performance and transformation of soft-loan funds in the UK

by

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Introduction

This report reviews the performance of soft-loan funds in the UK, and sets out key building blocks for a strategy to transform their performance.

We do not shy away from the fact that the average performance of soft-loan funds has been weak and many have closed down altogether. Nevertheless, there may be over 200 such funds still operating, and many new ones are being created. We estimate that such funds currently control well over £50 million in assets. Transforming them to radically enhance their performance and make them more sustainable is therefore an important undertaking.

This is all the more important for the committed and dynamic managers who run some of the funds. They often face the challenge of operating within a culture of unsustainability. Many promoters and funders of soft-loan funds, especially within the public sector, have not given the funds the independence they need to operate effectively and have funded them out of finite revenue programmes, with little concern for their long-term sustainability. This must change if any transformation strategy is to succeed.

The report is divided into three sections:

Section 1 reports on the performance of soft-loan funds.

Section 2 sets out the building blocks of a transformation strategy

Section 3 provides case-studies of five loan funds we surveyed in greater detail.

Section 1: The performance of soft-loan funds

There may be as many as 250 loan and equity funds in the UK[1], set up primarily to provide last resort lending for small and medium-sized enterprises (SMEs) unable to find finance from conventional sources such as banks. These include community development finance institutions (CDFIs) that aim to operate as institutions sustainable in the long term, while the majority comprise a wide range of local soft-loan funds. In our 1998 report, *Small is Bankable: Community reinvestment in the UK* we argued, largely on the basis of anecdotal evidence, that many local soft-loan funds had 'met with relatively little success and their capital quickly depleted'.

Our main conclusions on the performance of these loan funds, based on detailed research conducted primarily during 2000, are that soft-loan funds have a very high closure rate; the number of loans they make is often low; and their loss rates are high.

Indeed, many promoters and funders of such soft-loan funds, especially within the public sector, have not given them the necessary independence and have funded them out of finite revenue programmes, with little concern for their long-term sustainability. CDFIs – independent, rooted in their communities and delivering against local needs in the long term – are not surprisingly better able to sustain themselves.

While we focused in particular on loan funds, it should be stressed that they are not the primary source of loan finance for SMEs (whether businesses or not-for-profits). Even in disadvantaged areas, banks remain the major source of finance for SMEs (£1.51 billion according to the Bank of England's sample of 5 per cent of UK postcode areas), an entire quantum level of activity greater than the loan funds featured in this report. The one significant loan fund excluded from the data is the Prince's Trust, the largest not-for-profit micro-lender in the UK, and a separate case-study on the Prince's Trust is included in the text (Box 2 below).

At the end of this section we also look briefly at equity-gap venture-capital funds. Because these have not been rooted in their communities through appropriate governance structures, they have often drifted away from their original social or regeneration impetus. Clearly, funds need to sustain both their operations and their mission.

Methodology

We surveyed 148 loan funds, yielding information on 65 funds still in operation today with £41 million in assets, as well as a list of funds that had closed. These 65 funds include some CDFIs, which enabled us to draw out some of the characteristics that distinguish CDFIs from soft-loan funds. This information was supplemented by case studies of five loan funds (see section 3) and five CDFIs surveyed as part of our accompanying work on benchmarking.[2]

The 148 loan funds were identified from two previous studies and from our own research. The two previous studies were the *Directory of Soft Loan Schemes available for Small Businesses in England* put together by the Small Business Research Centre at Kingston University in 1994 and the *Inventory of Schemes for Business Supported by Banks* produced by the British Bankers' Association (BBA) in 1999.

In spite of these two studies, the loan fund sector is not well understood. Neither of them look at the performance and sustainability of the loan funds they cover. With soft-loan funds

[1] Based on provisional figures of the Phoenix Fund. The continuing existence of all 250 funds has not yet been verified.
[2] see NEF's report, *A proposed Performance and Accountability Framework for Community Development Finance in the UK*.

closing and new ones being created, and the ever-changing context of funding programmes and legal structures in which they operate, it is not easy to build up a comprehensive picture of the sector.

Many schemes are dependent on single funding programmes, and changes to these, such as the end of City Challenge funding or the start of Single Regeneration Budget (SRB) programmes, can have a big impact on the sector. Funds in Scotland, Wales and Northern Ireland have to deal with a different funding context. The introduction of the Small Business Service, which is leading to changes in the existing Business Links, and the winding down of the Training and Enterprise Council (TEC) network, will also have an impact on the loan schemes, as these agencies have often been involved in running the funds.

To assess their performance, we therefore sent all the loan funds a detailed questionnaire, which focused on issues such as size and source of investment, the lending commitments and policy, target borrowers and the impact of the fund. Among the loan funds still in operation, we received 24 questionnaires by post, and conducted telephone interviews, based on the questionnaire, with a further 36 of them. An additional five case studies were carried out (as well as five CDFIs covered in the accompanying work on benchmarking community development finance). In the majority of cases the information was obtained from the enterprise agency, business link or TEC involved in administering the scheme, rather than the banks or local authorities involved.

Collecting this information proved to be a time-consuming and problematic process. Key lists of funds are not publicly available, some funds were difficult to track down (see Box 1), and almost no data is available on the many funds that have failed so that little or no learning from these is preserved.

Another problem we encountered was the huge pressures on time faced by those responsible for running the fund. Many were reluctant to give up their time for the survey and talked of the demands on their time when trying to manage the fund in some cases single-handedly. One fund manager admitted that the fund was not greatly publicised as she would not be able to cope with increased demand from local businesses.

In other cases the information we were seeking was not known or measured by those running the scheme. There seemed to be a great variation in the quality of information available, and how such information was used.

Box 1. Lost in Chelmsford

It was not unusual to be directed from Business Link to TEC to local authority and back again before getting in touch with someone who was involved in running the scheme. An example of this is the Chelmsford Soft-loan Scheme. According to the report by the British Bankers' Association (BBA), the scheme is operated by Chelmsford Borough Council and Chelmsford Enterprise Agency. But, when contacted, the Enterprise Agency said it did not run any loan scheme; it recommended any enquiries on loans for small businesses be directed to the Chelmsford Training and Enterprise Council. The TEC does not run any loan schemes, and did not know of any in its area. The Economic Development Department of the Borough Council, however, was able to confirm the existence of the scheme – which it was running in collaboration with Chelmsford Enterprise Agency. The agency was in fact meant to be responsible for dealing with applications to the fund. This perhaps explains why the fund, which has been in operation for over three years, has not been very active. According to the BBA report of 1999, in the fund's first two years of operation it had made loans of £3,000 and the total defaults were £3,000. The fund has not made any new loans since this time, and the future of the scheme is currently under review.

Box 2. The Prince's Trust

The Prince's Trust is the UK's largest micro-loan provider. It was established in 1983 to help young people aged 18 to 30 to contribute to the community through the medium of self-employment. The Trust particularly targets disadvantaged groups including the long-term unemployed, people with disabilities, ex-offenders, minority ethnic communities and lone parents. Young people can receive a whole package of support and are assigned a business mentor who gives on-going support and advice over the first three years. Programmes of marketing support are also available; regional offices of the Trust organise specific marketing events to promote the work of their clients.

The Trust has many informal partnerships with local authorities, enterprise agencies, TECs and business links around the country. It is supported by the European Union and the Department for Education and Employment, as well as a range of private sponsors.

Loans of between £500 and £5,000 are available over three years, at a fixed rate of 3 per cent. In some circumstances the most disadvantaged borrowers may receive a grant of up to £1,500, usually offered as part of a loan/grant package. In its last financial year the Trust supported 7,500 businesses and helped 4,218 people start up their own business. In terms of success rates, 60 per cent of the businesses supported are still in operation after three years.

Over the last 17 years 36,000 people have received loans from the Prince's Trust. To give some idea of the amount of money involved in its operations, as at 31st March 2000, £18.3 million of loans were still outstanding, and £2 million of loans had been written off.

NB. Figures for the lending operations of the Prince's Trust have not been included in the overall calculations in this report as it was felt they would distort the findings. The Prince's Trust operates only in England and Wales, while the Prince's Scottish Youth Business Trust covers Scotland.

Source: Jeff Bowen, jeffbowen@princestrust.org.uk

Closures

Based on our full sample of 148 loan funds, the most striking finding was the number of funds that had ceased to exist: 52 of these funds had been closed, or could not be traced at all, which is 35 per cent of our sample.

We were able to follow up on 49 of the 70 or so schemes that appeared in the BBA's inventory, and among these, 21 (43 per cent) had closed in just two years. We followed up on another 60 separate funds, from the funds featured in the inventory of the Small Business Research Centre, and 27 of them (45 per cent) had closed in the last six years.

The pattern of soft-loan funds and the environment in which they operate is constantly changing. Funds are starting and closing continually. When a fund closes, it is not unusual for all knowledge of the fund to be lost with it. When contacting business support agencies or other bodies that had operated a fund that had closed, it is rare to find anyone with any knowledge of it, or anyone who can even vouch for its former existence. Therefore any learning – of what went well and what went badly - is lost.

Because of this lack of passed-on knowledge, it was difficult to find out why the funds had closed down. The picture is also complicated by the fact that some funds have been renamed, re-launched or absorbed into other funds. Seven funds (13 per cent of closed funds) had been replaced by other schemes. In another five cases (10 per cent), the programme under which the fund was operating had ceased (e.g. City Challenge). Two funds (4 per cent) had run out of funds to lend. Two funds pointed to changing interest rates as the reason for their closure; either it was no longer viable for their partner banks to lend at those rates, so they had withdrawn their funding, or it was no longer advantageous for borrowers to use them. In one case the local authority had decided to support other funds in the area rather than running its own fund. One fund had recently closed due to the legal changes to Training and Enterprise Councils, which meant that running the loan scheme was no longer contractually viable.

In view of such evidence, it is not surprising that longevity is not a strong feature even among the 65 funds we surveyed that are still in operation. Of these, 27 per cent were started before 1990, 39 per cent began between 1990 and 1995 and 33 per cent were set up after 1995. This does not mean that more funds are being set up now than was the case ten years ago, but rather that funds currently in operation are likely to have been set up in more recent years while earlier funds have ceased to exist.

For 36 per cent of the schemes, part or all of their funding will end by 2001. This does not necessarily mean that the fund itself will close, but this may be a further indicator as to why so many funds are closing. A further 12 per cent of funds stated that the future of their funding was currently under review.[3] Some funds seem to be set up to run whilst funding is available and are not always envisioned as long-term ongoing schemes.

We therefore suggest three main reasons for the high closure rate among soft-loan funds:

- *High loan-loss rates.* Average loan-loss rates for different categories of loan funds range from 12 to 19 per cent for surviving funds. However, nearly a quarter of the funds surveyed had loan-loss rates of over 20 per cent per annum and 8 per cent of the sample had loss rates of over 30 per cent. And this excludes the funds that have closed, for which it was not possible to gather data. Clearly, funds with these levels of loan losses are not going to be able to sustain themselves.
- *The end of revenue funding programmes that supported them.* Many of these funds are supported by government and other revenue programmes. When these go, the funds shut down.
- *A lack of will to survive.* Promoters, funders and managers may have little will to ensure the funds stay in existence; some funds see themselves as little more than another funding programme in a stream of funding programmes.

Box 3. Sir Thomas White Loan Charity

Whilst the typical loan fund does not have a long history, the Sir Thomas White Loan Charity is an outstanding exception.

The Leicester-based charity has been in existence for around 450 years. Back in the sixteenth century Sir Thomas White left £1,400 to support young people wishing to start up their own business; the fund size has since increased to £2 million, but the lending criteria has remained the same. The fund supports young people aged 18 to 34 in the city of Leicester with an interest-free loan of up to £10,000 for up to nine years. Around 60 people a year now receive a loan and previous recipients of a loan have included the retailer Curry's.

[3] These figures relate to the total number of funds which responded to a question about when their funding will end. It may be the case, however, that some funds did not respond to this question as it did not apply to them, and there may be a bias towards funding streams which have an end date.

The performance of existing loan funds

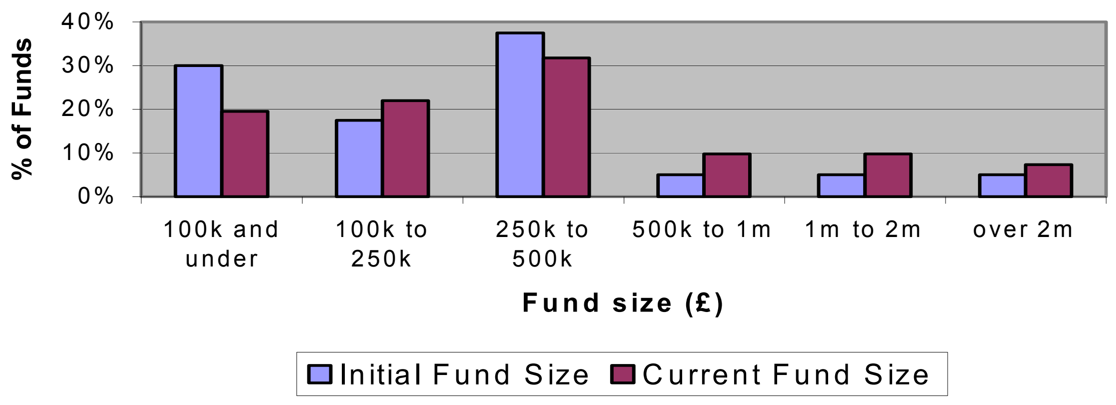
So what is the average loan fund like? We have detailed information on 65 funds that are still in operation, and the rest of this section reports on the performance of these, in addition to their longevity set out above. But, as mentioned previously, not all funds keep records of the same information. The information below is therefore given in percentages and in each case refers to the comparable number of responses in that category, and does not always apply to all 65 funds.

Target borrowers

As Figure 1 suggests, the majority of funds are aimed at small and medium-sized enterprises (SMEs), micro-businesses (usually those businesses employing less than ten people) and at businesses just starting up. Co-operatives and social enterprises are catered for by far fewer funds (17 per cent and 12 per cent respectively). Even fewer funds target the grey market, that is existing 'non-businesses' or unofficial traders.

Three per cent of funds are aimed specifically at businesses run by women and 8 per cent target black and ethnic minority businesses**.** Six per cent of funds target borrowers according to age; these funds are generally aimed at young people but one is specifically for people over 45. 82 per cent of funds target their clients according to geographical area. There is an equal split between funds that serve the whole of their local area, and those which only serve parts of it. Many funds state that applicants must demonstrate the beneficial effects their business will have on the local area.

Figure 1 - Fund Size



Fund size

Fund sizes range from £10,000 to £4 million, but the most common fund size is between £250K and £500K (32 per cent of funds). Figure 2 shows that almost three-quarters of funds (73 per cent) were sized below £500K and only a handful of funds were bigger than £1 million. The figure also includes the size of the funds when they were first set up and shows that the most common size remains between £250K and £500K (38 per cent).

These figures indicate that a sizeable amount of money is located within these funds. We traced the source of almost £25 million (in 41 funds) and Figure 3 shows the source of this finance. It shows the wide range of funding sources which the loan funds draw upon. The largest amount of finance (20 per cent) is supplied by banks, followed by European funding (12 per cent) and then local authority support (11 per cent). These figures are heavily influenced by the small number of very large funds. If we look at the numbers of funds involved rather than the amount of funding, almost half of the funds (49 per cent) receive bank support and 42 per cent receive local authority support.[4]

Figure two - funding source

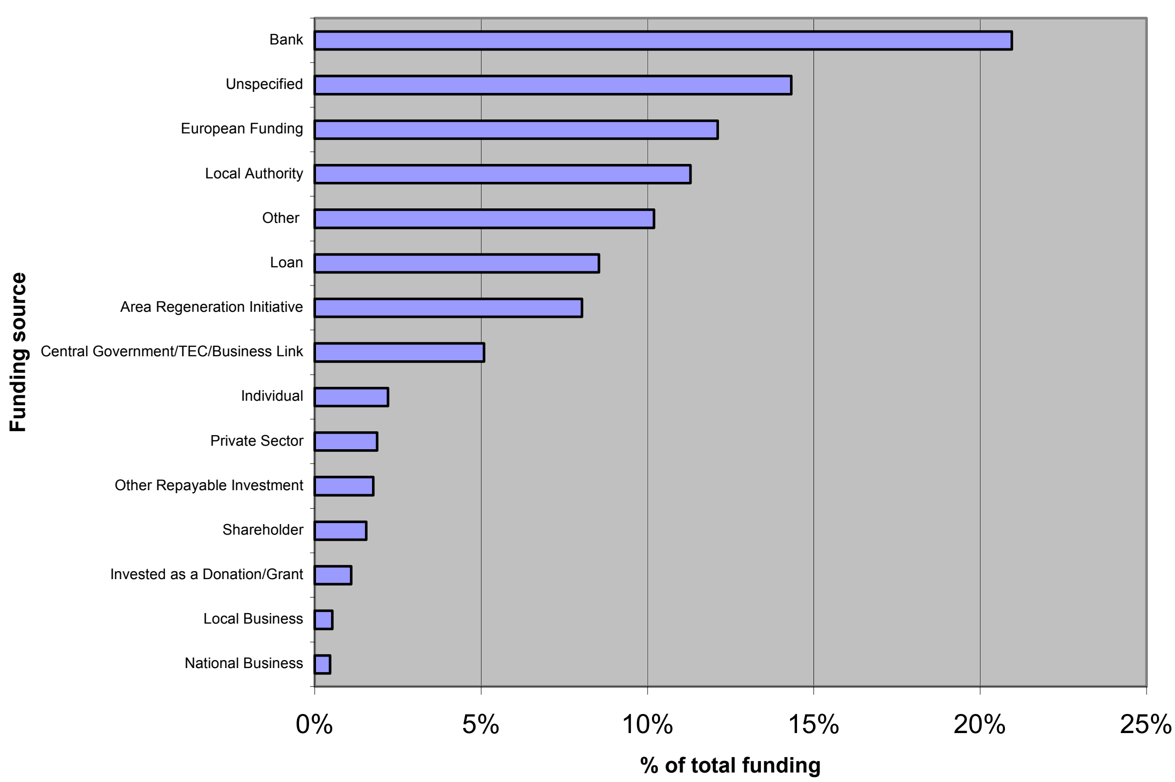
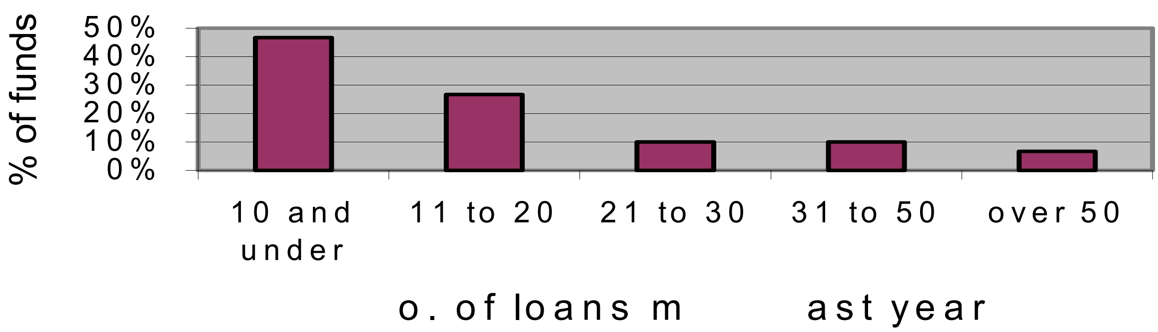


Figure 3: Number of Loans made last year



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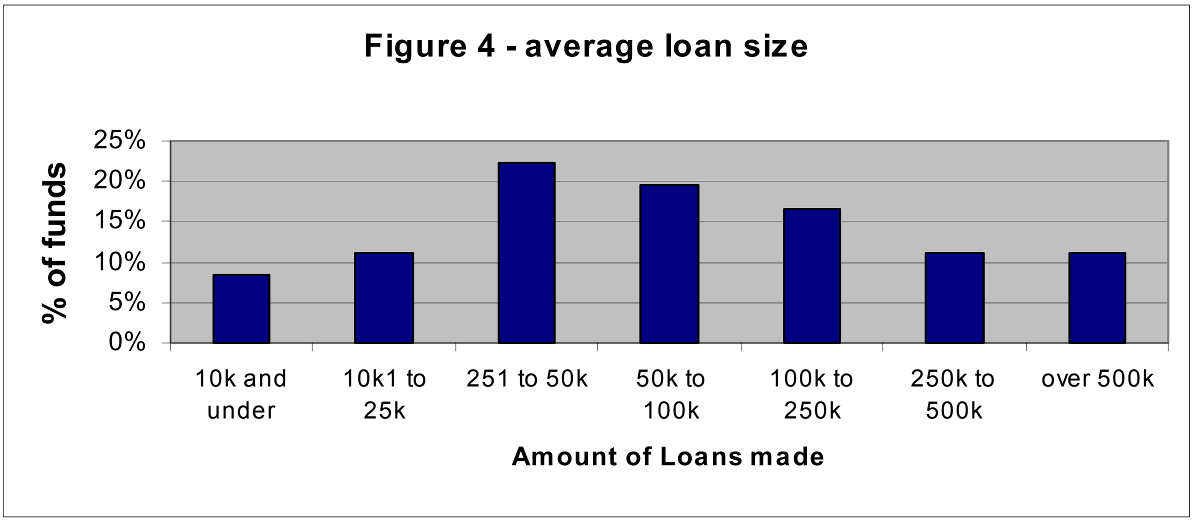
Loans [5]

Figure 4 shows the number of loans made last year by funds, with 47 per cent making ten or fewer loans. The mean number of loans made per year is 17, but this is not a representative figure as there is a huge variety in activity amongst the funds. The number of loans made varies from an average of less than one to 125 per year (made by the British Steel Loan Fund).

Clearly, funds that are making small number of loans per year, where the average loan size is relatively low, are going to have problems sustaining their operations, unless their operation is wholly voluntary.



The data also shows that 95 per cent of the loans made were to new borrowers, and just 5 per cent went to repeat or existing borrowers. There are a number of explanations:

- Firstly, many funds specify that borrowers can only come to them once. A borrower, who has taken one loan already but is still unable to meet bank criteria, is therefore no longer eligible for a further loan from the fund.
- Secondly, a borrower may have made the transition to bankable status, with a proven track record and a sufficient credit-rating.
- Thirdly, the business may simply no longer need to borrow. The initial loan for start-up may have injected sufficient capital into the business for it to continue without further intervention.

However, additional reseach would need to be done to establish which of these three possibilities was most common.

The amount made in loans in a year ranges from nothing to over £860,000. Figure 5 shows the number of loans made by funds in their last financial year. It shows that it is most common for funds to lend between £25,000 and £50,000 in a year (which is the case for 22 per cent of funds).

[5] This section does not include information on the lending of the Prince's Trust, the UK's largest provider of micro-loans, as it was felt that this would distort the data.

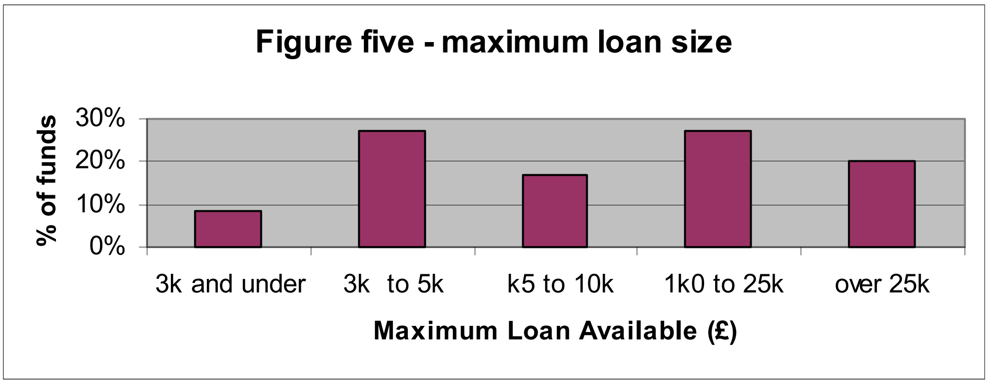


Figure five - maximum loan size

The total amount lent by any fund in its history ranges from £3,000 to over £4 million and so once again there is a vast difference in the scale of activities amongst the funds.

Thirty-seven funds for which we have specific information on committed funds had over £7.3 million of uncommitted funds. To gain a better appreciation of what this actually means, we divided the total amount uncommitted by the total fund size (see Table 1). The most striking result is that 28 per cent of funds still have over 80 per cent of their funds uncommitted. Almost half of the funds (48 per cent) have yet to commit between 21 and 60 per cent of their funds.

There are two caveats to this. Firstly, some of these funds are very new. Secondly, there will always be uncommitted funds held by a loan fund, as a cash reserve to repay investors who may wish to remove their investment or as a result of a programme of raising, where investments are raised in a large block in a relatively short space of time, which will be dispersed gradually with demand. However, even with these caveats, it is clear that some funds are having difficulty getting money out of the door.

Table 1. Uncommitted funds in relation to fund size

Uncommitted funds as a percentage of total fund size	*Percentage of funds*
20% and under	10
21 – 40%	24
41 – 60%	24
61 – 80%	14
81% and over	28

Default rates

The default rates for loans made by the schemes vary enormously - from 0 to 100 per cent. Table 2 shows that the most common default rate is between 11 and 20 per cent and three-quarters of funds have a default rate of 20 per cent or less. However, there are a number of caveats to this data.

Firstly, these figures only include funds which are currently still in operation. As mentioned previously, it proved very difficult to find any information on funds that had closed; this data is therefore biased towards relatively new and successful funds. It is probably true to say, although unverified, that many of the funds with high default rates have already gone out of business.

Secondly, default rates quoted are for loans written off completely. This does not include loans that are not performing in terms of repayment, but are not yet completely written off.

Thirdly, loan funds surveyed were nearly all (with notable exceptions) unable to provide data on their portfolio at risk, or the proportion of their loans not repaying.

On the other hand, some of the CDFIs have guarantee funds to cover for defaults. While the guarantee funds decline with loan losses, they act as a protective barrier for the capital funds of the CDFI, especially useful if there are local private investors to protect.

Table 2. Default rates

Default rates	*Percentage of funds*
10% and under	36
11 to 20%	39
21 to 30%	18
31% and over	6

Lending policy

Two thirds of funds have fixed interest rates, the rest have variable rates. The rates charged vary from below base rate to near market rates. Many of the funds in Northern Ireland have a set rate of 2 per cent below base rate. Other funds charge up to 7 per cent, and some have different rates for start-ups or expanding businesses. The rates are usually designed to be more favourable than conventional lending sources.

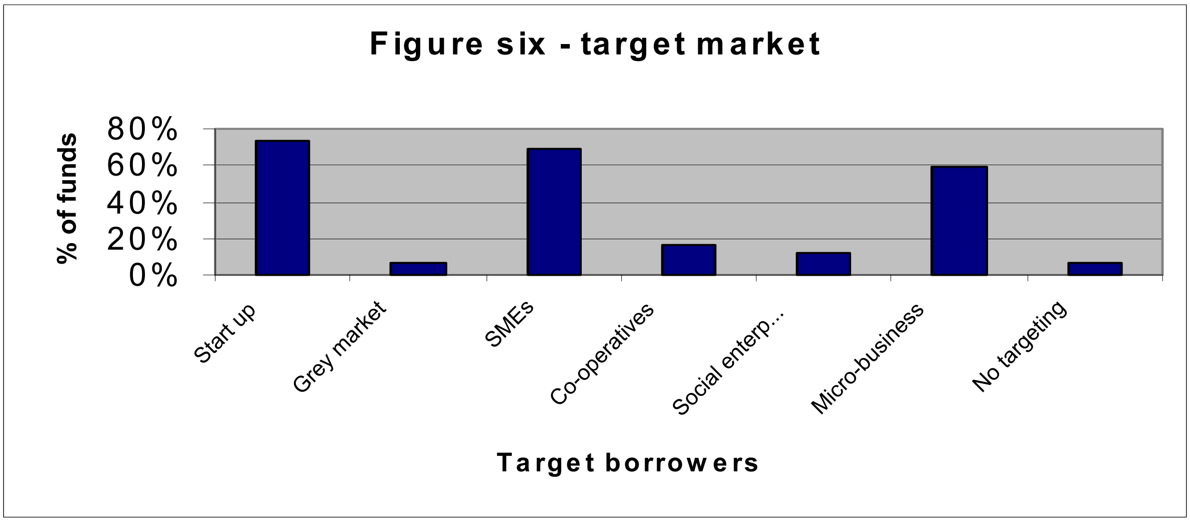
This indicates a perception by those setting up and running these funds that cost is a major problem for their borrowers, rather than access to finance. However, it runs in the face of conventional wisdom in the microfinance sector, that access to finance rather than cost is the primary barrier to accessing SME finance. Additionally, given the Bank of England findings in *Access to Finance in Disadvantaged Areas* (November 2000) that default rates in the most disadvantaged 5 per cent of postcode areas are nearly three times higher than in other areas, operating below market interest rates precludes sustainability for most small business loan funds.

Funds may in reality perceive that both access and cost of finance are a problem. However, if interest rates are kept very low in a situation where loss rates are relatively high, and it is access to finance rather than the cost of finance that is the primary problem, then funds are simply not going to be around in the medium term to meet market demand, thereby failing future businesses in the local area.

In terms of charges other than interest, just over half of the funds (51 per cent) made no lending charges**.** 34 per cent charged a 1 to 2 per cent arrangement fee, while the remainder took approaches that varied from a 10 per cent arrangement fee to a set fee of £50. For 43 per cent of funds, a repayment holiday is available; this is typically 3 to 6 months, but in some cases the terms are negotiable.

The maximum loans available are shown in Figure 6. Again, some funds offer different loan sizes to start-ups and expanding businesses, and repeat borrowers are treated more favourably. Where this is the case, the maximum for start-ups or first-time borrowers was used in the analysis below. The figure shows that the most common maximum is between £3,000 and £5,000 and between £10,000 and £25,000.

Many of the funds set no minimum loan size. Of those that do, a common minimum is £1,000; the largest minimum we came across was £15,000.



Restrictions

The funds can make a variety of restrictions on what their finance can be used for. One of the main restrictions, specified by 58 per cent of funds, is that loans should not be used to refinance existing debt. 15 per cent also stated that they make loans that can only be used for the purchase of fixed assets and working capital. Other common restrictions include specific limits on the size of the business they would support. Some also specify that the business must hold its bank account with the bank supporting the scheme. Many of the schemes were only for start-up businesses, while a few would only support expansions.

Decision to lend

In the vast majority of cases (92 per cent) the lending decisions are made internally. 69 per cent of all the funds had a lending committee and in 8 per cent of cases staff or loan officers made the decision. In another 6 per cent of cases banks made the decision.

Support and monitoring

In 57 per cent of cases, support for clients is provided by an external agency, for 52 per cent by the fund itself and in 7 per cent of cases by the bank. These categories are not mutually exclusive and in some cases there is a package of support available from a variety of agencies. The support can range from pre- and post-loan advice and information, such as help with putting together a business plan and advice on preparing accounts. In a small number of cases a mentor is assigned to the client, while some offer membership of a lending circle or business club for peer support. Where support is provided by an external agency, the loan can sometimes form part of a broader package of business support, such as the business start-up programme in Northern Ireland. 37 per cent of the funds offer training programmes of some sort for their borrowers; this can be run before or after the loan is taken.

The vast majority of funds carry out monitoring visits. Some respondents indicated that their policy was more flexible and visits did not always happen as stated in their policy, either for positive reasons, that the businesses were performing well, or negative, that the fund managers lacked time to visit their clients. Of those funds that carry out monitoring visits, it is most common for them to be quarterly or twice a year (Table 3). In 10 per cent of cases visits are only carried out if there is a problem.

Table 3. Frequency of monitoring visits

Frequency of visit	*% of funds which conduct monitoring visits*
Once a month or more	17
Quarterly	37
Twice a year	24
Annually	7
If there is a problem	10
Other	5

Costs

It was particularly difficult to gather details on the costs involved in running the schemes, or on income earned from lending. We were able to gain statistical information on just ten funds.

In many cases, information on costs is not recorded, as costs are absorbed into the managing organisation's overall running costs, or in some cases costs are seen as in-kind support which was not measured. In one case, for example, all costs were absorbed by the enterprise agency while all income went to the bank involved.

The total operational expenditure per fund (including staff costs, overheads and so on) for the last financial year varied from £5,000 to over £180,000. Figures for the costs of the lending operation (which includes cost estimates for seconded staff that would otherwise have to be employed, for premises provided without cost, and so on) over the same period varied from £12,000 to over £280,000.

In terms of the amount lent, the total operational expenditure for last year was, on average, the equivalent of 47 per cent of the amount made in loans over the same period, and the total cost of the lending operations the equivalent of 53 per cent of the amount lent.[6]

The lack of information on costs and earned income reflects a general lack of concern about sustainability amongst the funds. Many have not measured the costs involved in running the scheme or the income they can earn from it, and have no plans to do so in the future. Those running the funds may not themselves believe that the fund could cover its operating costs from earned income on the fund, and hence have little interest in measuring something they feel they ultimately have little control over.

[6] These figures are based on the results of eight and six funds respectively.

Impact
Impact is poorly measured at present, so that it is true to say that we have little idea if money invested in soft-loan funds is, in general, well spent. If it is measured, the impact of funds is generally considered in terms of jobs created and retained, and the number of enterprises supported.

The average figure for jobs created in the last financial year is 74**.** Again there is a huge variation in the impact of funds, which range from less than ten to almost 400 jobs created in a year. The average figure for jobs retained over the same period is 62, indicating that many funds are aimed at start-up rather than existing businesses. If we compare jobs created with loans made in a year, for the funds that supplied this information, on average one job is created for every £4,402 made in loans. In terms of costs, for every job created there is an average operational cost of £1,591 (or £2,013 if imputed costs are included).[7]

The average number of enterprises supported in the last financial year averages 23. We also looked at the number of enterprises supported surviving after 18 months but found this difficult to measure. Not all funds record this information; some funds measure only their short-term impact (i.e. the number of enterprises that receive a loan, not the survival rates of the enterprises in the years that follow); some can only recount anecdotal evidence.

The information we have for enterprise survival rates is based on a variety of time scales (between one and two years) and is 75 per cent. Other impact measures used include property development such as the number of units refurbished, training places taken up, effect on the turnover of organisations, and, if the borrowers take further loans, the average leverage on loans from the loan fund. A small number of funds have not measured their impact in any way at all.

While 66 per cent conduct regular performance monitoring (quarterly reports, performance against budgets, annual reviews) only 28 per cent of funds (mostly CDFIs) have conducted any in-depth evaluation. In general, there is a lack of interest by most soft-loan funds in actually assessing the impact of their activities, other than where required by funders.

Fund managers
Whilst conducting our research it became apparent that the commitment and drive of fund managers was a crucial part of its success. An individual with the appropriate skills who had the time to promote and administer the fund seemed to make a real difference to the scheme's effectiveness and to the quality of management information systems associated with that fund. The case studies carried out illustrate the kinds of individuals involved in running loan funds, and the energy and enthusiasm they have to work effectively. Their funds show a better performance than the average loan funds in this survey. The fact that we were able to obtain information on these case studies and spend time with a fund manager indicates that they are likely to be more actively marketed and used than some of the other funds featured in the survey.

Governance and transparency
A substantial number of funds (41 per cent) are required to report to their funders. A specific management or advisory committee has been set up for 62 per cent of the funds. Representation on these boards is given in Table 4. These figures imply of course that a third of the funds do not have a management or advisory committee.

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[7] These figures are based on information supplied by a very small number of funds.

Table 4. Representation at board level

Type of representative	*Bank*	*Enterprise agency*	*Local business people*	*Community representative*
Represented on how many funds (%)	55	48	45	38
Average number of members	2	2	4	3

As the table shows, over half of the funds have a bank represented on their management board. (It should also be noted that the personnel running funds are often ex-bankers themselves). Community representatives are the least well represented group at board level, but when present there are typically three representatives.

Information was not generally available on the gender balance or black and ethnic minority representation at board level. The information that was available showed that there were only two cases where there were more women than men on the board, and one of these was for a fund targeted only at women. On average the gender balance is 24 per cent women and 76 per cent men. 17 per cent of boards have representation from black and ethnic minorities – just five funds. Less than half of the funds (45 per cent) produce publicly available reports.

Cross-sectional analysis

We also tried to analyse loan funds by a range of different criteria, for example to see if business support makes a difference to loan loss rates. However, it is here that the difficulties we had in gathering data become very apparent. Of the 65 funds, not all funds provided all the information in the comprehensive survey that we carried out and these gaps make it difficult to analyse data in a statistical fashion. However, the gaps themselves provide information of sorts about the loan funds, and the cross-sectional analysis does reveal some interesting trends (for details see the tables given in Appendix 1).

There is little difference in loss rates across different fund sizes. It is also difficult to comment on the effect of the provision of business support to clients on the loan funds' performance. This was difficult to determine because some funds may provide very useful support as part of the loan negotiation process, without structuring it as a separate non-financial service.

However, cross-sectional analysis did reveal some insights. First, those funds receiving EU funding tend to have lower loss rates and better fund dispersal, although it is difficult to say whether this is because of the EU funding, or because they are large enough and well enough developed to access EU funds.

Banks are major supporters of loan funds, having supported at least one in four of all funds. They have directly provided over 20 per cent of total funding and contributed greatly by providing bank staff and secondees. However, in terms of the performance of these funds, four out of 10 bank-supported funds closed within the last two years and their current average annual loss rate is 18 per cent.

The most important distinction that can be made is between community development finance institutions (CDFIs) and the soft-loan funds. CDFIs have a lower loss rate than other kinds of funds (12 per cent a year, as opposed to as high as 19 per cent for the average enterprise agency fund). Over half of the soft-loan funds in operation in the mid-1990s have ceased operations, whereas only one CDFI from that time has closed. This sustainability is not necessarily only a function of the CDFIs' lower loss rates. It is also a result of their having a greater stakeholder base of people and organisations who contribute, directly or indirectly, to their continued fundraising and re-capitalisation.

CDFIs also have certain characteristics, built into their design, that work to encourage good practice (see Table 5). For example, CDFIs are notably more transparent about their costs and their impact, often commissioning rigorous evaluation. They also tend to have a wider and more diverse governance structure than the other loan funds surveyed.

Table 5. Contrasting CDFIs and soft-loan funds

Characteristic	CDFIs	Soft-loan funds
Time horizon	Are long-term; they aim to be in existence for as long as needed	Are short-term; they are usually linked to a funding programme
Sustainability	Focus strongly on how their operations can be sustained	Are less concerned with sustainability issues
Funding source	Have multiple sources including banks and government sources and also private foundations and individuals	Are funded primarily by government funding programmes and banks
Ownership and control	Are independent organisations; they are often owned and controlled by local people and organisations	Are dependent organisations, often part of a local quasi-state regeneration agency that may pay part or all of their operating costs
Reporting	Make information publicly available Carry out evaluations and make them available	Make little information availabile Carry out little evaluation
Governance	Have diverse local stakeholder involvement	Generally, only have business and regeneration agency involvement

A key lesson from the research is that loan funds need to become more financially sustainable. However, financial sustainability in itself is not an appropriate objective if the fund cannot also sustain its primary purpose of addressing financial exclusion. The experience of venture capital funds (see Box 4) demonstrates how easy it is to lose this focus. The challenge is combining developmental purpose with financial sustainability.

Box 4. Filling the equity gap

Equity-gap regional venture-capital funds in the UK have £463 million under management. Of this, £96 million relates to new Regional Development Authority venture-capital funds that have yet to be approved. Annual equity-gap investment in the UK will therefore represent no more than 1 to 1.5 per cent of overall venture-capital investment.

Many fund managers started as regional public-sector initiatives or public/private partnerships, including Greater London Enterprise, Enterprise plc, Yorkshire Ventures and the Scottish Equity Partnership. Most now operate, however, on a national level and no longer maintain a strong social or regeneration impetus. For example, just one of the eight Enterprise plc funds operates with a 'social' agenda. Greater London Enterprise operates a small 'social inclusion loan fund.' Yorkshire Ventures operates one smaller-end fund, which covers part of South Yorkshire and Humberside. These earlier funds have drifted towards profitable areas, away from a regional focus, and away from smaller deals. What they leave behind is the inclusion gap of potential equity demand in disadvantaged areas and a 'micro-equity' gap more widely.

Conclusions on the performance of soft-loan funds

1. Loan funds vary – in their size and success and in how they measure their performance.

2. There is a high closure rate among soft-loan funds. Consequently, knowledge and learning is lost and it is difficult to find out why funds have shut down after the event. Looking at the closure rate in more detail, the following factors contribute to it:

- High loan loss rates. It is clear from the case study interviews that while all fund managers are concerned with loan loss rates, some see relatively high (25 per cent plus) loan loss rates as acceptable and indeed almost inevitable if needy small businesses are to be targeted. Others, however, do not share this view. A detailed portfolio and business analysis would have to be done to ascertain which viewpoint is correct alongside a close look at business support, training and advice offered. For whatever reason, though, if loan loss rates are high, within three to five years, funds are exhausted.

- It may be that the product offered is not the correct one for the target market. For example, loan sizes may be too large for riskier market areas and need a stepped lending approach instead.

- Contributing to this is a remarkably poor consideration of impact by the soft-loan funds on their target market, or broader community. If relatively high loss rates occurred, but were justified by achievement of social objectives, funds might find it easier to replenish declining capital reserves.

- Soft-loan funds themselves do not see themselves as sustainable initiatives, but linked to particular funding streams.

- In contrast, only one CDFI has ceased operations. Another, Scottish Community Enterprise Fund, merged with Investors in Society (Charities Aid Foundation) and continued its operations. It indicates that there are characteristics of community development finance practice that provides funds with a greater ability to sustain themselves.

3. Almost none of the soft-loan funds lent to the social economy. In contrast, CDFIs like the Aston Reinvestment Trust (ART) and Developing Strathclyde Ltd have special funds to lend to this sector, while national CDFIs, such as ICOF, the Local Investment Fund and CAF's Investors in Society, specialise in these markets. In addition, loan funds of the Co-operative Development Agencies (CDAs) also lend to this sector. It is increasingly difficult to understand why soft-loan funds exclude social enterprise from their activities: these are enterprises that create jobs locally and generate wealth in communities (if not profits). National and international comparisons on loan loss rates in lending to the social economy show losses of typically below 1 per cent of the portfolio written off per annum[8] – this represents a much lower loss rate than typically experienced by soft-loan funds in the SME sector.

4. It is not easy to get information on soft-loan funds. The implications for businesses seeking information from these funds are not good. If a team of professional researchers find it hard to find out information on finance sources, it does not bode well for a business person, focused on her or his activities, to track down the right sources of available local finance.

5. Soft-loan funds do not usually see themselves as long-term or sustainable. As suggested earlier, they are often linked to particular funding programmes or streams, which may be time limited. Thus, rather than seeing the fund as a sustainable, long-term, permanent revolving resource, too often they appear to be seen as one-off funding programmes that need to be 'spent' and then the organisation will move on to the next funding programme. Consequently, little attention is given to sustainability, or growing the fund. Reactions by fund managers instead focus on making a declining resource stretch further and can include not publicising the scheme, adopting a conservative attitude to growth and demand, or a negative view of the funding prospects for expansion. The difference between one fund (with next to no loans and a declining fund-base) and another (with a portfolio busting at the seams) is probably down solely to the quality of the fund manager rather than any formal procedures.

6. Fund outputs in terms of loans per year, and amount lent per year, are small for many soft-loan funds. Careful attention should be paid to these funds and to their costs to establish whether the social outputs that they produce are sufficient to justify their existence.

7. The current pool of capital available is estimated to be £41 million from the 65 funds surveyed (scaled up from available data), and is likely to be over £50 million for all existing loan funds. This is not a large amount relative to likely demand. Nor is it large relative to the amounts lent by banks in deprived areas. However, £50 million is still a significant amount, making strategies to enhance the performance of loan funds worthwhile. We deal with this in the next section.

[8] In riskier sectors losses may be higher, but provisions against a loss of 8 per cent of the portfolio would often be able to cover for lending to not-for-profit organisations that are exceptionally risky.

Section 2. Building blocks for transforming soft-loan funds

The previous section revealed how unsustainable many soft-loan funds have been. Yet we estimate that existing funds control over £50 million in assets. If soft-loan funds could take on the characteristics of CDFIs, they could significantly enhance the capital available in the long term for enterprise investment in disadvantaged areas. This chapter sets out key building blocks needed to transform soft-loan funds, enabling them to perform well and to sustain their operations; the building blocks are equally important for enhancing the performance of CDFIs.

For such an endeavour to succeed, changes in the environment in which many soft-loan funds have been established and now operate are essential. Those who provide funding must give serious attention to how their funding is going to lead to the high performance and long-term sustainability of loan funds, especially beyond the horizon of finite funding streams. Funders must also help existing loan funds to achieve greater sustainability. While such suggestions are not new, it is clear from the continuing poor performance of many soft-loan funds that there is still a long way to go before such suggestions are put into practice.

Proposed or existing funds must, on their part, demonstrate plans for their long-term existence, based around a clearly identified need or a particular finance problem. They need to sustain both their financial operations and the focus on their mission. A loan fund that spends its first year learning the ropes and then disperses and loses the remainder of its funding over the final two years of a three-year funding cycle should become unacceptable. Likewise, a fund that grows rapidly and shifts to easier investments among larger and more established enterprises in less disadvantaged areas should lose its public support.

A cultural shift towards sustainability is therefore needed among both the promoters and managers of soft-loan funds. This is not to say that every fund must deliver extraordinarily low loan losses, but promoters and managers must have an understanding of the need to build institutions that will be there for the long haul, to solve long-term problems. This may involve identifying or negotiating long-term revenue support programmes for funds that are not going to be operationally sustainable, but provide highly valuable social benefits.

In general, however, to become sustainable funds must acquire the discipline of moving towards lower loan-loss rates and towards covering their costs in the long term through earned income, fees and interest. Unless funds get their loss rates under control, playing around with increased income will not address the problem. Likewise, the assumption that low cost credit, rather than access, is essential must be challenged; this can only be determined through detailed analysis of the target market. In some cases these suggestions imply that revenue (although not capital) funding for small loan funds should stop. If they are unable to find ways (as suggested below) of carrying their operating costs they are likely to remain unsustainable, ineffective and inefficient.

The building blocks below suggest how this shift in attitudes and practice towards sustainability can be achieved.

Management, ownership and governance

While conducting our research it became apparent that the commitment and drive of fund managers was a crucial part of success. If a scheme is to be effective, with high-quality management information systems, it needs a social entrepreneur with the appropriate skills and the time to promote and administer the fund.

The fund's ownership and governance structure are also critical to sustaining both its mission and its operations. The most important factor in this is the fund's independence, especially its independence from any form of political interference in its lending operations. In addition, many CDFIs are incorporated as mutual industrial and provident societies, where individual investors are concerned about not losing their investment and local members are determined to ensure that the CDFI continues to serve their community. A more diverse governance structure, and one where members have a strong stake in the local community, is likely to deliver better performance.

One central need which both management and governance must address is the need to promote prudential lending. This is important for funds that aim to operate as sustainable institutions. The key concerns for prudential lending in terms of business conduct will be the quality of accounting, control and reporting systems, and the integrity and competence of management and governance. We address the issue of adequate capital provisions below.

Understanding markets

Loan funds need to understand their target market, including different potential target markets, which can range from fully commercial businesses to community enterprises, and from highly disempowered low-income individuals seeking to become self-employed to established businesses that are not quite bankable. Loan funds should not exclude enterprises because of their legal structure, such as co-operatives or registered charities. Many of the enterprises that can be found in the most under-invested areas of the country are these 'social' enterprises.

Based on this understanding, loan funds need to identify the key problem - is it access, cost or both? Soft-loan funds have tended to 'take a guess' at what interest rate to set. However, a better understanding of the right interest rate is important. If access to finance is the problem, then loan funds can charge interest rates that can more effectively cover their loan losses, as a concessionary interest rate is not necessary. However, if the critical issue is the rate of interest, then soft interest rates may indeed be necessary.

While more detailed work needs to be done on this, international experience strongly suggests that many loan funds could increase their fees and interest charges, and improve their operational sustainability, while still meeting the needs of their target audience. Indeed they could offer a better service as they would have the chance of being there for their clients in the long run.

There also needs to be an understanding of the process and time-scale for borrowers' progression to mainstream banking. Currently, many soft-loan funds have restrictive criteria about the number of repeat loans they can offer their borrowers. The original reason for these restrictions was probably legitimate, in trying to ensure that clients progress to bank services as soon as possible. However, the reality is probably that loan fund clients need more than one or two loans before they reach bankable status and have become creditworthy in the systems of the bank.

Small-scale operations

Small funds can work, but only if they make the leap to true micro-credit approaches such as peer lending, stepped lending or local mutuality, or if they become franchises of national operations carrying few local costs or even using volunteer staff.

There is nothing wrong with being small. However, small funds need a different design. A small fund, making 10 to 15 small loans a year totalling £25,000 to £35,000 on soft rates, is not going to generate enough income to cover its operating costs if it employs full-time staff, and pays for an office and all the processing costs of loan administration. The only way this fund can survive is by working in a radically different way from simply scaled-down bank lending.

For example, peer lending approaches, where the costs of loan appraisal are shifted out of the bank and on to circles of borrowers who appraise and guarantee each other's loans, have been successful internationally in the field of micro-credit. Such lending methodologies can break the cost structure of conventional lending.

Having a central back office to provide financial services which are delivered locally can also significantly reduce costs. This may, however, lead to tension between the back offices' needs for standardisation, and the front offices' needs to be sufficiently flexible to address local demands. One of the critical insights from this research is that funds more rooted in their local community are likely to perform better and be more sustainable.

Adequate capital provisions

Loan-loss provisions are established to build up reserves for loans that fall into arrears. The central idea is that they should correspond to the value at risk in a loan portfolio. Capital adequacy is a basic measure of an institution's financial strength and its ability to absorb losses. It refers to the ratio of capital to assets, with assets weighted according to their risk (see Box 5). The 1988 Basle Capital Accord recommends a minimum eight per cent (risk weighted) capital adequacy ratio. The legal form of a loan fund determines how it is able to hold that capital.

Box 5. Defining capital

Capital equals:

Equity
+ Retained earnings (or unrestricted reserves for charities)
+ Loan loss reserves not ascribed to particular assets
+ Limited amounts of subordinated long-term debt

There are weaknesses in this approach to capital adequacy. The first is that the regulatory definition of capital may not represent an institution's true capacity to absorb unexpected losses; for example, there must also be an adequate provisioning policy. The second is that the way that risk is weighted under the Basle Accord and subsequent amendments may, if not appropriate for the nature of CDFI lending, distort the true level of underlying risk. There may also be a concern about institutions holding adequate capital in liquid form.

Pat Conaty of the New Economics Foundation argues 'as a minimum for capital adequacy, a CDFI should have reserves of at least 7 per cent; if it is doing business lending this should be at least 25 per cent'. He continues, stressing the the need for guarantee funds:

> In the case of mutual industrial and provident societies, reserves will be the CDFI's guarantee funds not its withdrawable share capital. This is a key point, as these reserves are an initial endowment from typically public sector and charitable grants. Beyond the first few years, the reserves need to be

maintained and extended by retaining surpluses from trading (i.e. annual provision policy decisions). Whether the reserves are kept in a separate guarantee company in the group or in the main fund itself, they are reserve funds which are the insurance provision against risk to shareholders and give additional security beyond the security taken with any deal (e.g. asset charges, land charges, personal guarantees and fixed and floating debenture charges). The 25 per cent level need not be maintained indefinitely as it is steep, particularly as the activity of the CDFI widens beyond the first few years, but it depends on the make-up of the underlying portfolio.

Performance

Close attention should be paid to the outputs of the loan funds. To achieve this, and to ensure accountability, funds must do better in recording and reporting their social impacts, particularly in basic areas such as jobs and enterprises created and the progression of clients to mainstream banking. We examine a proposed framework in the accompanying paper, *A proposed Performance and Accountability Framework for Community Development Finance in the* UK.

Box 1. Checklist for an ideal community development loan fund

- Skilled and committed staff and champions; as with any business, the management team is critical.
- Independence, and effective ownership and governance structures to ensure that the fund sustains its mission and its operations.
- Over £500,000 in capital on start-up, plus access to lines of credit: funds need to be at sufficient scale to have some chance of covering their basic operating costs rapidly.
- Funds seeking to survive at a smaller scale must adopt micro-credit methodologies that significantly reduce operational costs.
- Below 10 per cent portfolio losses per annum. Higher loan-loss rates in experimental or start-up phases need not be discouraged, but high on-going loss rates without justified social or economic outputs, or without correspondingly high interest rates to cover for lending to higher risk markets, must be.
- Adequate reserves beyond start-up, with a minimum of seven per cent of capital.
- A range of funding sources including private investors and local individuals and organisations. Having to deal with a range of funders, especially private and local sources, builds discipline into the lending process. The range of funders also enables the fund better to sustain itself and grow.
- Reporting on a range of financial and social performance indicators: unless outputs are measured, value for money and cost-effectiveness cannot be ascertained nor lessons learnt.
- A broad portfolio: local funds should serve all types of small enterprise, including co-operatives and not-for-profit enterprises, but should still retain a clear market focus.

On loss rates, even 10 per cent is high compared to community development loan funds in the US and micro-credit internationally, and reducing losses to 5 per cent over time should be the objective of most funds. Mark Pinsky of the National Community Capital Association (the US CDFI industry's trade association) comments: "In the US, where our CDFI network has default rates of less than 1.5 per cent, much of the riskiest lending in disadvantaged areas is done with the lowest defaults because the strongest organisations are best able to take on the riskiest deals." In other words, default rates may reflect more on the lender and the credit methodology used than on the borrowers.

Conclusions

We have set out the building blocks that could transform the performance of soft-loan funds.

The commitment and drive of fund managers is critical. An effective ownership and governance structure is also essential for sustaining a loan fund's operations and, equally important, its mission. Governance is enhanced by:

- Independence, including from any form of interference in lending operations;
- a diverse governance structure;
- members with a strong stake in the local community.

Loan funds based on a clear understanding of their target market perform better. They identify the key problem: is it access to finance or its cost, or both? If access to finance is the problem, then loan funds can charge higher interest rates to cover more of their costs. Many loan funds unnecessarily exclude social enterprises.

Loan funds need sufficient capital to cover their basic operating costs. Funds that have over £500k in capital to start up with, plus access to credit, perform better. Smaller funds have to use forms of 'micro-credit' (such as 'peer lending', 'stepped lending' or local mutuality) that significantly reduce their operating costs.

Funds with a range of funding sources, including private investors and local individuals and organisations, also perform better. Having a range of funders makes growth and sustainability more likely, in part because dealing with a range of funders also builds in discipline to the lending process.

Effective financial management requires high quality accounting, control and reporting systems as well as adequate reserves against loan losses.

The critical question remains whether transformation can take place. For this it is not sufficient for loan funds only to seek to change their operations. They often face the challenge of operating within a culture of unsustainability. Many promoters and funders of soft-loan funds, especially within the public sector, do not give funds the independence they need to operate effectively and fund them out of finite revenue programmes, with little concern for their long-term sustainability. This is often a waste of public resources, and must change if any transformation strategy is to succeed.

Transformation of existing loan funds is certainly worthwhile if it can ensure the sustainability of £50 million available to enterprises in disadvantaged areas. Associations like the National Federation of Enterprise Agencies can play a major role in such an endeavour.

In addition, if all new funds adopted standards based on good practice in the community development finance sector, the essential provision of financial services to enterprises in disadvantaged areas could grow and be sustained. They would thus support the dynamic entrepreneurs who are often the best hope for local economic renewal.

Section 3. Case study summaries of five loan funds

Case study 1. Sussex Development Fund – a partnership between a local authority and a bank

Background

Sussex Development Fund is a partnership between Sussex Enterprise and HSBC. The size of the fund when it was first set up in 1998 was £1million, a combination of money from Sussex Enterprise and HSBC. It is aimed at small and medium sized businesses (it does not support social enterprises or co-operatives) as a lender of last resort. In its lifetime the fund has lent around £440,000 representing 15-20 loans. Total losses have been 6 – 7 per cent and a further 6-7 per cent of the outstanding loans are classified as looking like potential losses. These losses are split evenly between Sussex Enterprise and HSBC.

The application process

Businesses must have a viable business plan and a cash flow when applying for a loan and these are investigated and credit-checked as part of the vetting process. A committee, made up of a representative of Sussex Enterprise, a representative from HSBC and an independent accountant, decide on whether to lend, and any loans made are supported by directors' guarantees. Personal Business Advisors visit clients six times a year, to provide support and focus for businesses after the loan has been made. Since the beginning of 2000, the fund has started to operate on a more commercial basis than in the past, with interest rates going up.

Conclusions

Sussex is in a part of the country currently growing strongly. Yet it shows that even within an area of relative prosperity, businesses that are viable are not getting appropriate finance. The lack of any coverage of the social economy by the fund is also notable.

Loan loss rates are now below average for the sector; while this may reflect the generally good economic situation in East Sussex, it also reflects the highly qualified staff that Sussex Enterprise have now recruited to manage the fund and a focused approach by the bank involved.

Case study 2. Merton Business Investment Fund

Background

The loan fund was set up in 1998, and had been in operation for 18 months when visited. The fund manager believes Merton Business Investment Fund (MBIF) to be the only Local Authority loan fund in London to administer its fund itself. The scheme is funded by the Single Regeneration Budget, through the Government Office for London. They received £450,000 for 5 years. The funding is due to end in 2001/02. It was originally set up through the Wandle Valley Partnership, which moved its emphasis from grants to loans. The fund manager, Freda Owusu works 3 days a week. Her background is in banking, business information and in running her own business.

The local authority has recently put in £70,000 of its own money. This money has come from section 106 agreements (it should also be noted that all repayments become the fund's own money and do not return to SRB or other funding sources).

Lending criteria

The business must be in Merton. They must be viable with a sound business idea, must create or retain jobs, or enhance commercial floor space. They do not lend for cash flow and will fund up to 50 per cent of tangible capital costs. It helps if the business has a bank loan or other funding – as it shows someone else is interested in the business and indicates it is more sustainable. In their assessment procedure, they look at capital to jobs ratio and see how it compares to the EU standard. MBIF try to give emphasis to poorer areas and lend in accordance with the Council's economic development strategy. MBIF sees itself as a lender of last resort and that its customers are financially excluded – the scheme meets needs going unmet by banks. They do not want to fund businesses that see them as a soft option, as a means of cheap finance when they could get funding from banks.

Loan fund performance

There has so far been one default of £840. (0.3 per cent). However, it is early days yet, to know if this performance will be sustained. In the last financial year the fund made 10 loans and this financial year made 2 loans. MBIF have lent a total of £244,000 (last financial year £189,000). The interest rate is 1 per cent over base.

MBIF report every quarter to the Government Office for London (although this will change with new RDA structures) and must meet performance indicators. This year's target is to fund 10 new businesses. The overall target for the fund is 32 businesses over five years. In terms of jobs, total jobs created is 49 (last year 32) and total jobs retained 83 (last year 77).

The application process

There is a loan panel made up of local bank managers, the chair of the local authority environmental committee, a representative from the chamber of commerce, a representative from AZTEC business link and the director of environmental services.
The loan panel meet as and when necessary. Local banks are represented on the loan panel (bank representatives cannot vote on their own customers). The applicant is not present, to avoid bias towards those who can present themselves well.

The pre-application process is dealt with by enterprise agency-type organisations linked to the chamber of commerce. If funding is approved, a monitoring action plan is developed, with management accounts provided, business counselling arranged if necessary, and visits every quarter (although this is not always carried out in practice)

A standing order is set up for repayment before the loan is issued. The fund manager administers the repayments, and uses the Council's own accounting system to do this. MBIF links in with other council departments, such as business rates, environmental health and planning departments – to ensure there are no existing problems/ties with the business. This joined up thinking also helps businesses e.g. one business was told by the council they had to install fire stairs, and was directed to MBIF who funded this cost.

The gender mix of businesses supported is quite balanced. The fund has recently been targeting a greater ethnic mix. Ethnic minority businesses often lack working capital, relative to other businesses and the Council's £70,000 will be used to fund this. MBIF monitors who their customers are, especially in the light of "Best Value" approaches within the local authority.

Conclusions

The low loss rates probably reflect early days at the fund, alongside a combination of careful selection of businesses lent to and a sound lending policy (a close eye to the ability of businesses to repay). Again, the quality of personnel appears to be critical to the fund performance. The backup of council finance systems undoubtedly helps to make for a slim operations system. It is noteworthy that so much can be done by one part time person.

Case study 3. Coventry and Warwickshire Chamber of Training and Enterprise Business Link Loan Fund

Background

The fund of £260,000 was set up in March/April 1996, using SRB1 money; it is used to guarantee loans from HSBC. The fund is run as a partnership between Coventry City Council, Warwickshire City Council, HSBC Business Link and two other Enterprise Agencies, who are represented on a board.

Characteristics of the local area

Currently, unemployment in Coventry and Warwickshire stands at 9 per cent, which is below the average for the West Midlands. The number of people approaching the Business Link is declining, although the number who go through to start up a business remains constant, perhaps indicating that there are less "involuntary" self employed coming forward. The business link has helped 150 people start in Business – considering that there are 7500 VAT registrations per year in Coventry and Warwickshire, of which perhaps half are new businesses, it indicates that just a small proportion of new business starts are coming via the Business Link route. In particular, it is felt that the better educated / well experienced start ups are not coming to Business Link and are simply getting on with the job.

The product

Loans are last resort, to start up business (defined as new or in business for less than 12 months). Applicants have to live and work in the Coventry or Warwickshire areas (there is some flexibility around the geographical margins). A business plan is needed, hopefully along with contact with a business advisor. An advisor is definitely needed to proceed to the application stage. Loans are up to £5,000 maximum, lent at 1 per cent over base. Up to £1500 is available as a grant (up to the total of £5,000 – so £3500 could be a loan and £1500 as a grant). The loans are a one-off (no repeat loans).

If the loan is paid back within 12 months, the SRB1 fund will pay the interest on the loan (as well as guaranteeing it). This is seen as an incentive to get loans back and revolve the fund. SRB1 programme ends in March 2001, and there is a need to raise additional funds to replace this source.

Co-operatives, and in some cases, women's businesses are referred to the Co-operative Development Agency and the Women's Business Development Agency respectively.

What is in it for the bank?

HSBC gets business accounts, and risk-free loan income, as the SRB1 fund bears all losses.

The loan process

Referrals come through Business Link's own activities, but also through the other partners, enterprise agencies and their business advisors. They put advisors in a local job centre in Coventry town centre, as well as a day a week at the Bangladeshi centre in Highfields and Asian Business Centre in Foleshill (they offer cash support to both these centres).

Loan meetings are held every two weeks, and a maximum of two applications a meeting are considered. The individual applying is invited to the meeting. After the loan, there are SRB funded follow up visits at 1, 3, and 5 months, and the Business Link follows up at 3, 6, and 9 months. The Panel also looks at defaults.

Financial performance
There is a 27 per cent bad debt rate on the fund, as a percentage of the number of loans. The fund has taken out county court judgements against deliberate non re-payers, as there were a number of applications where it was felt that there was no intention of repaying the funds, and this has proved successful in dealing with that particular problem. The fund manager notes the average cost of setting up a business by Business Link is £1900, which compares favourably with a national average of £2600 - £2800.

Finance gaps
There are perceived finance gaps in the £10K-£25K loan requirement range for people who have been in business for 1-2 years, that are not met by existing non-bank providers (the Business Link fund or the Princes Trust schemes), or the banks. In relation to the banks, the risk cover element of the Small Firms Loan Guarantee Scheme was not thought to be well understood across the board. Of the 70 to 80 local bank managers the fund was in touch with, perhaps three were aware of and using the SFLGS appropriately.

Conclusions
There is demand for the loan product offered. Loss rates at 27 per cent are worse than average and the loss rate means the fund is not capable of sustaining itself without periodic topping up. The deal for the bank is an excellent one though, giving them a risk free small business loan product (as the loan made by the bank is 100 per cent guaranteed) as well as new account business.

Case study 4. Falchion Fund, Darlington – a local authority and bank partnership

Background
The fund itself had been set up in 1995 as a partnership between Darlington Borough Council and HSBC Bank. There is also some EU funding. The fund manager took over the fund 12 months or so ago having previously served as a manager at Midland Bank.

It lends only to businesses, start-ups and small businesses, in the Darlington area. It aims to lend to ventures that will benefit Darlington – job creation, self employment, social service/benefit (e.g. a recent loan to fund the establishment of an internet café). These are referred by grant officers (main source) or local banks, accounting firms or Business Link (who are supplied with leaflets on the fund). There is no specific targeting of the fund and in the fund manager's view the number of applications could be increased if the fund was 'promoted properly'. The fund manager intends to concentrate on better promotion in the coming months. Currently banks rarely make referrals.

Lending process
By June 1999 (when the current Fund Manager took over) there had been 82 loans from 253 applications. The Fund Manager felt this 'conversion' rate reflected an over cautious lending policy by the panel (local bankers, representatives of the sponsors, Business Link and local accountants).

There has only been one default (on an £8k loan) to date and late repayment problems are also small. Under his management there have been fewer refusals since he has encouraged more pre-application work on the Business plans. The Fund Manager himself provides pre finance advice and post finance advice and monitoring and is optimistic that a recently established local monitoring (by retired businessmen) network will provide additional support. Business Link is regarded as too expensive to approach for basic advice, but the Fund Manager has referred clients for training and their response has generally been positive.

The Fund Manager discourages applicants (and the panel) from using guarantees (i.e. collateral/e.g. equity in house) and relies on letters of reference and the business plan cash flow projections. Initial capital was £30k (in 1995) and following growth, there is currently around £100k in the fund yet to be lent.

The lending panel meets monthly (if there are applicants) and has possibly been over zealous in its screening (see above). Fund not as well used as ought to be, in the Fund Manager's view – but lent £113k last year (15 loans, each close to the maximum of £8k).

Governance
There is an annual report to the local council. HSBC issues monthly statements to all borrowers and for the fund account (held at HSBC) which is monitored by HSBC.

Lending issues
Overall, The Fund Manager regarded the fund as worthwhile, but under utilised. Even with better utilisation, however, there was no need (at present) to expand scale or scope (he felt it should be confined locally to the Darlington Community).

Conclusions
The loan loss rate, 1.2 per cent as a percentage of loans made, is much better than average. While a picture of the cost was not available, with these high repayment rates, the fund at least has the potential to be sustainable. There is no specific social economy provision in this fund.

Case study 5. Birmingham Enterprise Fund and Creative Advantage Fund

Birmingham Enterprise Fund makes equity investments to enterprises in Birmingham (as defined as the rate paying area). Its initial funding of £500,000 was followed by a further £250k last year provided by the City Council and is almost fully committed.

It was set up in 1986 by the Economic Development Department with City Council money Initially to provide financial support for innovative and pre-production projects. In 1989 it specialised in media & telecommunications and in 1993 was directed towards SMEs in manufacturing and productive services.

Four loans had been made in its initial incarnation as a loan fund and missing out on a share of the profits made by it's first investment (Rag Doll Productions Ltd) had made the Board determined to seek an equity stake in future investments. It was thus felt better to concentrate on equity participation.

The investments are made with a combination of redeemable preference shares and redeemable ordinary shares. The preference shares are redeemable in 3 equal annual instalments (at par) at the end of years 3, 4 & 5. The ordinary shares are redeemed in three annual stages at a six times multiple of average pre tax profits per share at the end of years 5, 6 and 7. The preference shares have are entitled to a dividend of 8 per cent or 10 per cent.

There have been around 14 investments to date, (with the first four as loans) with the objective of promoting economic development and the remainder as equity with the objective of making sufficient profits to make the Fund revolving. Apart from the fact that there is no distribution of profits, the fund adopts strictly commercial venture capital criteria and therefore only businesses with high (turnover/profit) growth potential are appropriate. Direct job creation by the investee companies is regarded as a bonus rather than an objective. The fund aims to recover (over time) funds invested with a profit (resulting from the share in profits) and to re-invest the money in the fund so that it can be reinvested and assist other SME's. Equity participation helps to attract bank funding by strengthening the balance sheet. BEF can invest up to £50,000 in any one business.

In March 2000 the new Creative Advantage (CAF £1.3m) Fund was established with funding from the WM Arts Council, the City Council (£50k), BEF money (£250k) and EC regional development funding (30 per cent of the total). It is a subsidiary of BVC and aims to promote 'creative' businesses. This is now the main focus of Kevin's investment (not monitoring) activity since the BEF is virtually fully invested. CAF provides equity based seed funding up to £20k and also provides larger trances of equity based funding (up to £130k) to growth businesses.

Most of the clients cannot get money elsewhere (lack of assets/collateral, lack of track record, banks are not venture funders). Once funding is promised there is a leverage effect with banks and other financiers often participating. There are few referrals from banks; grant agencies, business links and accountants are much better. The CAF is well promoted by the West Midlands Arts Council through its literature (the BEF was less well promoted).
There are plans to raise more money from several sources for BEF but it will take some time to arrange.

There is potential for the Aston Reinvestment Trust (a local CDFI) to be a good partner for CAF with the two 'CFIs' making cross referrals, entering into co-financing and bringing in banks (sometimes using the SFLGS) to co-finance too. ART sees BEF as getting involved with the 'top end' of its work and BEF /CAF sees ART as a source of additional funding for the smaller of its investments.

Business plans are the key to getting funding from BEF or CAF. When inadequate, but promising plans are submitted, the applicants are urged to take advice from Business Link or an accountant before submission of the plan to the Board. Kevin may provide some feedback himself but prefers to avoid conflicts of interest by referring them to third parties. The quality of Business Link advisors was however regarded as variable, but the cost of the service in Birmingham was 'not too bad'. Kevin takes monitoring of investee companies very seriously and is happy to be called upon to provide advice. He regards this as part of his portfolio (of investments) management duty. Relationship building was important to help protect the equity invested and enhance its value. The role is somewhere between that of a non-executive director and a business mentor.

The Board meets on a six weekly basis to consider applications. There is a need to achieve a rate of approval to two a month (on average) to meet conditions of EC funding which require that the whole £1.3m is invested by Dec 2001, and un-invested funds must be repaid. The new CAF has so far received 35 applications supported by Business Plans, which have been put to the Board. Only one has been rejected outright, but some have gone elsewhere (e.g. to borrow from a bank once they had a well worked business plan). Additionally, some of the business plans had been referred back to the applicants for further work prior to resubmission, and some filtered out before even coming to the Board. In terms of bank lending, the SFLGS had been simplified in recent years so that loan officers could make their own decisions on loans up to £30k, but still the usage was low. In this respect, Kevin suggested that statistics (reported quarterly by banks to the DTI/SFLGS) should be published, outlining the number and amount of SFLGS supported loans, broken down by regional areas, made by each bank. This would encourage competition to make better use of the scheme. Further, the SFLGS should be opened to CDFIs (and the loan size limit for cover lowered) and banks should be encouraged to make better use of it.

Conclusions

Birmingham Enterprise Fund and the Creative Advantage Fund show that there is a market niche for small-scale venture capital finance inner city areas. Given the longer and more blocky payback time scale, it is difficult to assess financial performance at this stage.

APPENDIX 1

Table A. Does the type of organisation managing the fund make a difference?

Fund managed by	Based on no. of responses	Average age (yr.)	Average no. of loans last year	Average amount of loans last year	% of funds uncommitted	Current annual default rate	% of funds which gave info on costs	% of funds which gave info on impact
Enterprise agency	27	7	15	£70,862	58%	15%	11%	21%
Business Link	6	8	34	£570,500				sample too small
TEC	1		Sample too small					
CDFI	8	5	19	£351,983	55%	12%	50%	50%
Local authority	9	8	11	£83,866	sample too small	sample too small	0	22%

Note: figures for info on costs and impact are often based on a very small number of funds.

There are some differences between the different managing agencies, but these are relatively small. Loan loss rates are relatively similar, although better for CDFIs. The total amount of lending is significantly higher for Business Link and CDFI funds, relative to other players. However, enterprise agency funds are making smaller-sized loans. CDFIs are notably more transparent about their costs and their impact.

Table B. Does the size of the fund when it starts matter?

Size of fund on start-up	Based on no. of responses	Average age (yr.)	Average no. of loans last year	Average amount of loans last year	% of funds uncom-mitted	Current annual default rate	% of funds which gave info on costs	% of funds which gave info on impact
over £500k	5 to 6	5	24	£384,200	56%	14% (based on 4 funds)	50%	50%
250k to 500k	13	7	15	£200,533	56%	13%	23%	69%
100k to 250k	7	9	22	£88,944	47%	15%(based on 5 funds)	29%	57%
under 100k	12	7	12	£119,054	71%	24% distorted by one fund with 100% defaults; without it the average is 13%	17%	33%

Table C. Does the funding source make a difference?

Funding source	Based on no. of responses	Average age (yr.)	Average no. of loans last year	Average amount of loans last year	% of funds uncom-mitted	Current annual default rate	% of funds which gave info on costs	% of funds which gave info on impact
Bank supported	27	6	17	£185,155	56	18%	26%	59
LA supported	28	7	17	£137,800	60	17%	25%	39
EU supported	7	5	25	£227,471	34	16%	43%	57
Area regeneration funded	11	6	24	£159,851	33	19%	45%	73

Note: The LA and bank-supported groups are in fact a very similar group of funds. They are not mutually exclusive. Many funds are supported by both.

EU supported and area regeneration supported funds seem to perform better in terms of the number of loans dispersed and in transparency. EU supported funds dispersed the greatest average amounts and with the lowest loss rate. Default rates were broadly similar, although the EU funded funds did slightly better again.

Table D. Does the level of support provided make a difference to loan fund performance?

Support	Based on no. of responses	Average age (yr.)	Average no. of loans last year	Average amount of loans last year	% of funds uncommitted	Current annual default rate	% of funds which gave info on costs	% of funds which gave info on impact (figures for measuring cost and impact are very low, and include funds which we have very little info on anything - not just these sections)	
TRAINING									
Training provided	22	9	15	£75,815	69	17	9	45	
No training provided (includes funds which did not specify if they provide training or not)	41	6	18	£230,260	51	16	20	32	
FREQUENCY OF MONITORING									
Monthly	7	8	12	£54,083	49	13	0	57	Default rate based on 4 responses
Quarterly	14	7	23	£231,369	59	14	36	50	
Twice a year	10	8	13	£106,550	73	31	10	40	Default rate distorted by one 100% fund
Annually	3	4	17	£698,000	67	3	0	33	Loans per year based on 2 funds, uncommitted funds based on 1 fund, default rate based on 2 funds
If there is a problem	4	10	35	£172,675	30	23	50	75	Default based on 2 funds
FUNDING									
Funding ends 2001	6	3	6	£13,433	62	11	17	17	This category is very small – some figures based on 3 responses
"ongoing" funding	6	6	33	£248,698	24	11	33	50	Last 2 figures based on very small number

It is difficult to draw conclusions from these figures. It may be particularly difficult to define what support is. A loan fund that does not offer business support may in fact provide valuable help and advice through its application process, for example.