BACK TO BORROWING? PERSPECTIVES ON THE 'ARC OF DISCOURAGEMENT'

Stuart Fraser

ERC White Paper No.8

March 2014

www.enterpriseresearch.ac.uk

BACK TO BORROWING? PERSPECTIVES ON THE 'ARC OF DISCOURAGEMENT'

Stuart Fraser*
Warwick Business School
Stuart.Fraser@wbs.ac.uk

*The qualitative research in this report was conducted by Shiona Davies and Richard Smith of BDRC Continental. Appendix 2 (case studies) and text/tables relating to the qualitative research presented in the main text were prepared by Shiona and Richard.

This paper is published by the independent Enterprise Research Centre. The Enterprise Research Centre is a partnership between Warwick Business School, Aston Business School, Imperial College Business School, Strathclyde Business School, Birmingham Business School and De Montfort University. ERC is funded by the Economic and Social Research Council (ESRC); the Department for Business, Innovation & Skills (BIS); the Technology Strategy Board (TSB); and, through the British Bankers Association (BBA), by the Royal Bank of Scotland PLC; Bank of Scotland; HSBC Bank PLC; Barclays Bank PLC and Lloyds TSB Bank PLC. The support of the funders is acknowledged. The views expressed are those of the authors and do not necessarily represent the views of the funders.

EXECUTIVE SUMMARY

Why do discouraged borrowers (DBs) matter?

DBs are businesses which would like to borrow but which do not apply for bank finance (loans or overdrafts) because they either: i) felt they would be turned down ('indirectly discouraged'); or ii) they made informal enquiries but did not proceed with their application because the bank seemed reluctant to lend ('directly discouraged'). The report looks at businesses reporting any discouragement whilst noting differences between types of discouragement where apparent.

While the number varies over the economic cycle, estimates indicate there are approximately 173,000 DBs the majority of which, around 115,000, are indirectly discouraged. Although the number of DBs corresponds to less than 4% of the 4.8m SME population, and compares to 3.6m (75%) 'happy non seekers' (businesses which say they have no need for external finance), it is about the same as the number of businesses denied bank finance.

Some DBs will be rightly discouraged because the business is simply not viable. However, to address financial constraints, it may be important to help creditworthy DBs to obtain loans/overdrafts and assist DBs that are viable, but more suitable for non-bank finance, to find alternative finances.

What does a typical DB look like?

DBs tend to be smaller, younger and more risky businesses. The owners of DBs also tend to be less wealthy, have lower levels of education and less business experience. A typical DB in the UK: has sales below £250,000, business assets of £10,000; fewer than 10 employees; is less than 7.5 years old; has an average/above average risk rating; belongs to either the real estate/business services or construction sectors; is located in London, the West Midlands or East of

England; and has an owner aged 31-50 with 15 or fewer years of experience and a personal wealth of around £100,000.

Why are there DBs?

What we already know about DBs is mainly confined to an understanding of the extent of discouragement and the characteristics of DBs. However we know much less about the reasons for discouragement.

In this context, a model is developed to move our understanding of the reasons for discouragement forward. Discouragement occurs when the perceived cost of making a loan application outweighs the perceived chances of the application being successful. The model allows us to disentangle factors that affect the perceived chances of making a successful loan application from factors that affect perceived application costs. This increased understanding of discouragement will help policy makers make more informed decisions about how to assist DBs.

Using a large sample of SMEs, estimates of the model suggest that DBs are especially prone to misperceptions – they significantly under-estimate their actual likelihood of making a successful loan application – and they face higher perceived loan application costs compared to other businesses. Dissatisfaction with banking relationships significantly reduces perceptions that applications will be successful (and hence increases discouragement). Smaller businesses are also less confident that their applications will be successful. On the other hand, awareness of the Lending Code/Principles improves perceptions (lowering discouragement) possibly by raising expectations about minimum service standards. Media coverage of bank lending appears, in this study, to have little impact on perceptions that applications will be successful. Businesses which have poorer credit ratings and/or problems with debt/cash-flow management are more likely to be discouraged because their actual chances of obtaining a loan are lower. Looking at the indirectly/directly discouraged separately did not significantly affect these findings.

Issues with the application process such as perceived security requirements and terms/conditions of borrowing significantly raise perceived application costs (and hence increase discouragement). Similarly, younger businesses find applying for loans more difficult/costly. Conversely proactive banking (approaching businesses about borrowing requirements) helps to lower perceived application costs (lowering discouragement). Also raising awareness of the Appeal Process makes applying seem more worthwhile, since the business is more aware that an initial rejection need not be the end of the story, thereby reducing discouragement. Again, these results are robust to looking at the different types of discouragement separately.

In-depth interviews with 25 DBs offer some deeper insights into the reasons for discouragement and what might help to improve the situation. The basis for discouragement, regardless of type, is the refusal of a loan or overdraft application in the past. However, this refusal tends to be more recent for the directly discouraged. A badly handled decline makes the experience worse increasing feelings of discouragement. In this respect, the belief is that the lending decision is all being done on computer models rather than an actual assessment of the business itself. There were also few examples of the bank offering or signposting to alternatives (apart from invoice discounting) or suggesting ways of being successful next time. Overall improvements in the quality of banking relationships are felt needed to improve perceptions. At the same time, few of the businesses were aware of lending support initiatives such as the Appeals Process. However there is a feeling that business support groups have a role, as a 'trusted voice', in helping businesses become more aware of the help and support available to them.

By how much might discouragement be reduced by addressing bank/business related issues?

Scenario analysis with the model suggests that fully addressing bank issues associated with discouragement (improving satisfaction rates, raising awareness of lending support initiatives and approaching businesses about borrowing requirements) might lower the number of DBs from 173,000 to 50,000.

What proportion of these 123,000 additional prospective applicants are creditworthy? Whilst we do not have access to bank data/credit evaluation models to obtain a direct answer to this question, using the model/data in the report we are able to estimate the number of businesses which might receive a loan or overdraft if they applied. Using this approach we estimate that, if bank issues were fully addressed, about 77,000 (63% of the 123,000 additional prospective applicants in this scenario) might be suitable for bank finance.

Fully addressing business related issues (principally, improving debt/cash-flow management skills) instead might reduce the number of DBs to 110,000. Proportionately more (75%) of the 63,000 prospective additional applicants in this case (corresponding to around 47,000 businesses) might be suitable for bank finance due to the improvements in the quality of applications brought about by addressing debt/cash-flow management issues.

Since the data relates only to bank finance we do not know how (more) suitable any of the businesses examined might be for non-bank finance. This is an area worth investigating further in future research with data involving both bank and non-bank finances. Also, the findings speak mainly to the indirectly discouraged given that they form the bulk of the DBs in the analysis (although, as noted previously, the model is robust to separate analyses of the indirectly/directly discouraged). However, again it would be worth taking a further look in future research at potential differences between the indirectly/directly discouraged in terms of their creditworthiness (perhaps using bank data for the directly discouraged).

What might encourage DBs back to borrowing?

As confidence in the economy returns we would expect perceptions to improve and the number of DBs to fall (although the report highlights ongoing issues with business confidence which may slow this 'self-correction' in discouragement). In terms of taking active steps to encourage more businesses, which are potentially suitable for bank finance, 'back to borrowing' the report indicates that a sensible strategy involves addressing both bank and business issues.

The principal recommendations in the report centre on increasing effort and/or raising awareness in relation to existing policies/measures since the research indicates that these actions could significantly reduce the number of DBs.

To help improve perceptions by increasing businesses' satisfaction with their banking relationships:

R1. Banks should take steps to ensure the Lending Code/Principles are implemented more consistently and effectively.

Due to the beneficial effects of raising awareness of lending support initiatives on perceptions/application costs, given the current low rates of awareness of these initiatives and recognising business support groups can help communications as a 'trusted voice':

R2. Banks, the British Business Bank and business support groups should seek to raise awareness of the Lending Code/Principles.

R3. Banks, the British Business Bank and business support groups should seek to raise awareness of the Appeals Process.

To increase businesses' awareness of their credit health, provide support to help improve credit health and to help businesses that are unsuitable for bank finance to find more appropriate alternative sources of finance:

R4. The British Business Bank, assisted by banks, credit reference agencies, business support groups and alternative finance providers should consider forming a working group to explore how they can: i) enhance businesses awareness of their credit health and the steps they need to take to improve their credit health; and ii) help businesses find alternative providers of finance where this is more appropriate.

To provide extra support for smaller/younger businesses which are less financially confident and find applying for loans more difficult:

R5. The British Business Bank and business support groups should seek to raise awareness/take-up of support from the Start-Up Loans Company.

To encourage more viable businesses which are put off from applying due to a lack of security:

R6. The British Business Bank and business support groups should seek to raise awareness/take-up of the Enterprise Finance Guarantee.

CONTENTS

EXECUTIVE SUMMARY 3

1. INTRODUCTION 10
What do we already know about DBs?..11
Aims and objectives of report...17
Methodology 18
Data..19
UK Survey of SME Finances (UKSMEF) 19
SME Finance Monitor (SMEFM) 19
Structure of report 20
Scope/limitations 21

2. WHY ARE THERE DISCOURAGED BORROWERS?
Insights from the econometric analysis...22

Outline of a model of discouragement 23
Perceived likelihood of making a successful loan application....23
Perceived application costs ('hurdles') 26
Empirical results..31
Perceived and actual probabilities of making a successful loan application..33
Perceived application costs...42
Robustness checks 51
Impacts of addressing bank/business issues on number of DBs...53
Conclusions 58

3. WHY ARE THERE DISCOURAGED BORROWERS?
Insights from in-depth interviews with DBs...59

Key themes from the analysis 60
How larger SMEs differ… 65
The way declines are handled makes a bad situation worse… 66
Awareness of lending support initiatives and perceptions of loan application success rates 69
Conclusions 71

4. BACK TO BORROWING 72
Recommendations..77
Conclusions 84

APPENDIX 1: 'WHO ARE DISCOURAGED BORROWERS?'.................86
Summary analysis of UKSMEF and SMEFM 86
Business characteristics..87
Owner characteristics 97
Conclusions 101

APPENDIX 2: DB CASE STUDIES...103

1. INTRODUCTION

It seems like bank lending to Small and Medium-Sized Enterprises (SMEs) has been constantly in the headlines since Lehman Brothers collapse in September 2008. Who can forget Robert Peston's[1] 'enthusiastic' delivery of news of the latest wave of the financial crisis and the impact on banks' ability to lend? Or not have seen lurid red top headlines about the difficulties facing small businesses seeking loans?[2] With all this attention, the last 5 years have been a boom time for students of SME finance. Times have been harder for those at the sharp end seeking funding for their business. Indeed why bother to look at all given negative publicity about bank lending not to mention actual experiences of problems with lenders?

The recent trends in lending to SMEs have been well documented.[3] The focus of much of the debate has been on the supply side. Success rates for overdraft applications fell from around 89% in 2004 to just below 84% in 2009.[4] In the year ending Q2 2013 these success rates stood at 77%.[5] Success rates for term loan applications decreased from 95% in 2004 to 86% in 2009[6] and dropped further to 69% in the year ending Q2 2013.[7] However, at the same time, demand has also fallen significantly. Overdraft application rates fell from 19% in 2004 to 13% in 2009 and term loan application rates fell from 9% in 2004 to 8% in 2009.[8] Recent data indicate that overdraft and loan applications rates stood at 9% and 5% respectively

[1] BBC Business Editor 2006-2013.
[2] E.g., 'Banks slash their lending to firms by £100billion as experts accuse them of 'sucking the lifeblood out of a business'' Daily Mail 3rd May 2012.
[3] See Trends in Lending, Bank of England, April 2009-; Fraser, S. Bhaumik, S. & Wright, M. (2013), 'What do we know about the relationship between finance and growth?' White Paper No. 4, Enterprise Research Centre.
[4] UK Survey of SME Finances (UKSMEF) 2004-2009, UK Data Archive, http://data-archive.ac.uk/
[5] SME Finance Monitor 2011-2013 http://www.sme-finance-monitor.co.uk/
[6] UKSMEF op. cit.
[7] There are several factors underlying this apparent tightening in the supply of credit since the financial crisis including increased credit risk, increased risk aversion, increased uncertainty and higher bank funding costs. Also, arguably, there was over-lending before the financial crisis.
[8] UKSMEF op. cit.

in the year ending Q2 2013.[9] In aggregate the stock of SME lending has been contracting since late 2009.[10]

Many non-applicants will have chosen not to apply because they simply have no current need for finance. These businesses might be considered as genuine, or 'happy', non-seekers of finance. Currently about 75% of the SME population, corresponding to around 3.6m businesses, fall into this category. However increasingly it is recognised that there is a pool of businesses which would like to borrow but for one reason or another do not proceed with making an application ('would be seekers' of finance). Amongst these businesses are so called **Discouraged Borrowers (DBs)** which are the focus of this report. In particular, DBs are businesses which would like to borrow but which do not apply for bank finance (loans or overdrafts) because they either: i) **felt they would be turned down ('indirectly discouraged')**; or ii) **they made informal enquiries but did not proceed with their application because the bank seemed reluctant to lend ('directly discouraged')**. The report principally looks at businesses reporting any discouragement (either indirectly or directly discouraged) whilst noting differences between types of discouragement where apparent.

What do we already know about DBs?

We know relatively little about DBs compared to what we know about the potential problems facing businesses which seek loans. In this respect, much of the academic and policy focus in SME finance has been on businesses which have sought funding but have been unable to obtain it

[9] SME Finance Monitor op. cit.

[10] See 'Trends in lending – three years on', Trends in Lending, Bank of England, April 2012.

due to a lack of collateral or track record.[11] This situation is a concern for policy makers if it results in financial constraints that limit the ability to start-up and grow businesses.[12]

However, the existence of DBs raises the possibility of financial constraints even where no application for funding has been made. This is worrying because evidence on the potential existence of DBs has been scant.[13] As a consequence DBs have for a long time been hidden from view: we have

[11] In the academic literature, the underlying issue is related to information asymmetries. Banks are assumed to know less about the riskiness of the business than the business itself both before and after the loan is made. This leads to problems of adverse selection and moral hazard that may result in credit being allocated by rationing rather than by the interest rate (Stiglitz, J.E. and Weiss, A. (1981). Credit rationing in markets with imperfect information. *American Economic Review*, 71(3), 393-410). In these circumstances, the ability to signal risk by having a track record or through willingness to offer collateral may increase the chances of obtaining funding (Bester, H. (1985). Screening vs. rationing in credit markets with imperfect information. *American Economic Review*, 75(4), 850-855). On the other hand businesses with insufficient collateral may experience financial constraints which place restrictions on new venture creation and growth. However some academics disagree with this reasoning arguing that information asymmetries may just as likely result in too much lending (de Meza, D., and Webb, D. C. (1987). Too much investment: a problem of asymmetric information. *The Quarterly Journal of Economics*, *102*(2), 281-292).

[12] The issue of financial constraints on the development of small businesses is not new. The MacMillan Committee (1931). *Report on the Committee on Finance and Industry*, Cmnd. 3897, HMSO, London, and Bolton Committee (1971) . *Report of the Committee on Small Firms*, Cmnd. 4811, HMSO, London, identified gaps in the supply of small scale equity investments to small businesses. The Small Firms Loan Guarantee (SFLG) was introduced in 1981 to overcome a perceived gap in credit availability reported in Wilson Committee (1979). *The Financing of Small Firms, Interim Report of the Committee to Review the Functioning of the Financial Institutions*, Cmnd. 7503, HMSO, London. More recently a report by Breedon (2012). Boosting Finance Options for Business, Department for Business Innovation and Skills, has drawn attention to various shortcomings in the provision of financial support for growth businesses.

[13] The earliest studies providing evidence of DBs are by Raturi, M., and Swamy, A. V. (1999). Explaining ethnic differentials in credit market outcomes in Zimbabwe. *Economic Development and Cultural Change*, *47*(3), 585-604; and Levenson, A. R., & Willard, K. L. (2000). Do firms get the financing they want? Measuring credit rationing experienced by small businesses in the US. *Small Business Economics*, *14*(2), 83-94.

only started to systematically collect data about DBs in the UK over the last decade.[14]

What we do know about DBs is mainly confined to an understanding of the extent of discouragement and the characteristics of DBs. Regarding the extent of DBs, some studies have suggested that incidences of discouragement are more prevalent than incidences of loan rejections.[15] The implication is that problems of financial constraints may be greater than originally believed when attention was focused solely on loan seekers.

The following box, 'Trends in Discouragement', provides an indication of the extent of discouragement in the UK over the last decade in comparison to businesses which sought and were denied loans.

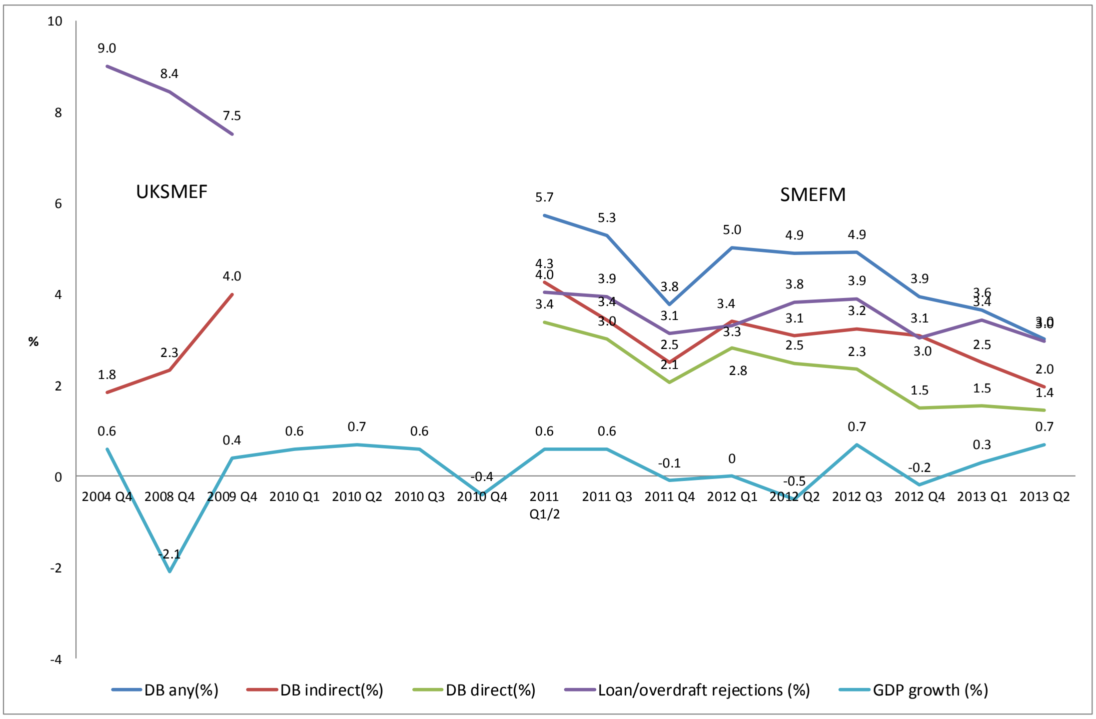
[14] UKSMEF 2004 was the first systematic attempt to study DBs in the UK; in the US the Survey of Small Business Finances (SSBF), which is no longer run, collected data on DBs between in 1993, 1998 and 2003.

[15] Levenson and Willard (2000) op. cit.

Trends in Discouragement

How important are DBs? The following chart looks at trends in discouragement with UK Survey of SME Finances (UKSMEF) and SME Finance Monitor (SMEFM) data between 2004 and 2013. The chart suggests there are almost as many DBs as businesses which have had overdraft/loan applications rejected. Addressing financial constraints may therefore require supporting not only creditworthy businesses denied overdrafts/loans but also creditworthy DBs. In the following chart, overdraft/loan rejections appear to be falling in 2004-2009 because we are looking at rejections relative to all SMEs (and overdraft/loan application rates were falling faster at this time).

Chart A: Trends in discouraged borrowers and overdraft/loan rejections (as a percentage of all SMEs)



Sources: UKSMEF 2004, 2008, 2009 (DB indirect 2004-9); SMEFM 2011Q1/2-2013Q2 (DB any/indirect/direct 2011Q1/2-2013 Q2); ONS (GDP growth rate)

Base: All businesses

- In 2004 there were only around 65,000 DBs (less than 2% of the SME population) based on the indirectly discouraged (the only definition available in UKSMEF).
- Discouragement rates rose in the run up to the 2008 financial crisis (as economic growth declined) and rose even more sharply in the year following the crisis (2008-9). By 2008-9 there were over 180,000 indirect DBs (4% of the population).
- Since the start of 2011 the data suggests that discouragement rates have been on a declining trend.
- Looking across types of discouragement the number of DBs has varied between: 275,000 (5.7%) any discouraged (either indirectly or directly discouraged), and 206,000 (4.3%) indirectly discouraged in Q1/2 2011; falling to 144,000 (3%) any discouraged, and 96,000 (2%) indirectly discouraged, in Q2 2013.
- A change in the definition of 'would be seekers' of finance in Q4 2012 (a group to which DBs belong) may underlie some of the subsequent fall in discouragement.

We also know that discouragement depends on demographic factors relating to the business and its owner(s). In particular DBs tend to be smaller, younger and more risky businesses.[16] The owners of DBs also tend to be less wealthy, have lower levels of education and less business experience.[17] Regarding ethnicity, research in the US[18] and the UK[19] indicates that ethnic minority businesses are significantly more likely to report discouragement than non-minority businesses. A recent study suggests that the role of demographic factors varies internationally depending on the country's level of economic development. In particular discouragement seems to be more sensitive to firm size/age and owner demographics in low income countries.[20] The role of business/owner demographics is discussed in more detail Appendix 1: 'Who are discouraged borrowers?'

Recent research using international data has also found that discouragement depends on the country's growth rate. In particular discouragement is negatively related to economic growth. We have also fairly recently learned that discouragement is affected by banking relationships and competition. In this respect longer banking relationships appear to increase the likelihood of discouragement among higher risk firms and reduce the likelihood of discouragement among low risk firms.[21] This suggests that discouragement may have economic benefits to the extent that as a consequence un-creditworthy businesses choose not to apply for loans. Also the ability of discouragement to 'weed out' high risk businesses from borrowing appears to be greater when there is less

[16] See Cavalluzzo, K. S., Cavalluzzo, L. C., and Wolken, J. D. (2002). Competition, Small Business Financing, and Discrimination: Evidence from a New Survey. *The Journal of Business*, *75*(4), 641-679; Han, L., Fraser, S., and Storey, D. J. (2009). Are good or bad borrowers discouraged from applying for loans? Evidence from US small business credit markets. *Journal of Banking & Finance*, *33*(2), 415-424.
[17] Han et al (2009) op. cit
[18] Cavalluzzo et al, 2002 op. cit; Blanchflower, D. G., Levine, P. B., and Zimmerman, D. J. (2003). Discrimination in the small-business credit market. *Review of Economics and Statistics*, *85*(4), 930-943.
[19] Fraser, S. (2009). Is there ethnic discrimination in the UK market for small business credit? *International Small Business Journal*, *27*(5), 583-607.
[20] Chakravarty, S., & Xiang, M. (2013). The international evidence on discouraged small businesses. *Journal of Empirical Finance*, *20*, 63-82.
[21] Han et al (2009) op. ciot.

competition in the credit market.[22] On the other hand businesses with a greater number of financial providers are less likely to be discouraged possibly because the fixed costs of applying can then be spread across multiple applications with different lenders.[23]

So while we now know a fair amount about the extent of DBs, who DBs are and the role of banking relationships/competition we still have a fairly limited theoretical and empirical understanding of the mechanisms of discouragement.

In essence, discouragement occurs when the perceived cost of making a loan application outweighs the perceived chances of the application being successful. However, there have been very few studies which have looked closely at why discouragement occurs. A leading exception is a study which highlighted the joint role of information asymmetries and application costs in causing discouragement.[24] Viable businesses perceive their chances of making a successful loan application are low when information asymmetries are high (because lenders are more likely to mistakenly assess them as being high risk). Accordingly low risk businesses are more likely to be discouraged when information asymmetries and application costs are high (and when the business has alternative non-bank finance, at a reasonable price, to fall back on).[25]

An earlier, but less well known, study argues that discouragement arises because the business expects to be offered a low credit limit (corresponding to a low perceived probability of making a successful application) and/or the expected costs of applying for credit are high.[26] This study recognises that the business's perceptions of the likely credit

22 Han et al (2009) op. cit. Low risk borrowers are also less likely to be discouraged when there is less banking competition.
23 Han et al (2009) op. cit.; Chakravarty & Xiang (2013) op. cit.
24 Kon, Y., & Storey, D. J. (2003). A theory of discouraged borrowers. *Small Business Economics*. *21*(1), 37-49.
25 Kon and Storey (2003) op. cit. restricted their definition of DBs to *creditworthy* businesses which do not apply for loans because they feel they will be rejected.
26 Diagne, A. (1999). Determinants of household access to and participation in formal and informal credit markets in Malawi. International Food Policy Research Institute Discussion Paper no. 67.

limit on offer and application costs may be wrong leading to 'false discouragement'.

Overall it is fair to say that we barely understand the mechanisms of discouragement. We know nothing about the role of perceptions regarding the likelihood of making a successful application separate from the role of perceived application costs in causing discouragement. Also we know nothing about the extent to which decisions (not) to apply for loans are affected by misperceptions of the chances of making a successful loan application. And, if there are misperceptions, we know nothing about the underlying reasons for this being the case.

Aims and objectives of report

In summary we know quite a lot about the answer to the question 'who are DBs?' but very little about the answer to 'why are there DBs?' In this context the first aim of this report is to:

- Develop our understanding of: 'Why are there DBs?'

This means developing our understanding of the mechanisms of discouragement. This leads to the following specific objectives for the report:

- Develop our understanding of the role of perceptions of the chances of making successful loan applications separate from the role of perceived application costs in explaining discouragement.

- Develop our understanding of whether DBs are affected by misperceptions of the chances of making successful loan applications.

- Develop our understanding of the factors which affect (mis)perceptions.

The second aim of the report is to:

- Develop our understanding of: 'What might encourage DBs back to borrowing?'

Answering this question requires a deep understanding of why DBs exist not just an understanding of who DBs are. The particular objective here is to:

- Provide policy stake-holders in the discouragement debate – banks, the British Business Bank, business support agencies and the businesses themselves – with recommendations as to specific actions that would help to encourage DBs to re-consider applying for loans.

Methodology

The research employs a mixed methodology approach. This provides us with two different perspectives on the aims/objectives of the report:

1. **An econometric perspective**: This involves developing econometric models which allow us: i) to disentangle perceived probabilities of making a successful loan application from perceived application costs; ii) to test for misperceptions in success probabilities; and iii) to analyse the determinants of misperceptions (and of discouragement in general). This aspect of the research allows us to develop a robust answer to the questions of 'why DBs exist?' and 'what might encourage DBs to borrow again?' based on large samples of data (UKSMEF and SME Finance Monitor).

2. **A qualitative perspective**: This involves 25 depth interviews (including 8 case studies) with DBs seeking direct answers to the question of why there are DBs and what might encourage them back to borrowing. This part of the research was conducted by Shiona Davies and Richard Smith of BDRC Continental.

Data

There are 2 data sources used in the econometric analysis:

UK Survey of SME Finances (UKSMEF)

UKSMEF is a series of surveys which have provided detailed information on the characteristics of Small and Medium-Sized Enterprises (SMEs), their owners and experiences of obtaining finance. The surveys are based on large, representative samples of UK businesses with less than 250 employees. UKSMEF was conceived and developed by the Centre for Small and Medium-Sized Enterprises (CSME), Warwick Business School. UKSMEF has provided a wealth of information for policy makers on SME finance issues. The main surveys were carried out in 2004, 2008 and 2009. Together these surveys provide a sample of 5,070 businesses for the analysis.

In UKSMEF, discouraged borrowers are defined as having decided not to apply for finance because they believed they would be turned down (corresponding to indirect discouragement). UKSMEF data has been used previously to study DBs in the context of ethnic minority business finances.[27]

SME Finance Monitor (SMEFM)

SMEFM is a quarterly repeated cross sectional survey of around 5,000 firms per survey (from Q1/2 2011 onwards) conducted by BDRC Continental on behalf the British Bankers Association (BBA). SMEFM was established as one of the initiatives of the Business Finance Taskforce to provide better information on SME finance and promote understanding. The surveys collect detailed information about businesses overdraft/term loan application 'journeys'. In this report we are able to use data relating to 9 waves of SMEFM from Q1/2 2011 to Q2 2013. This provides a sample of 45,183 businesses for the analysis.

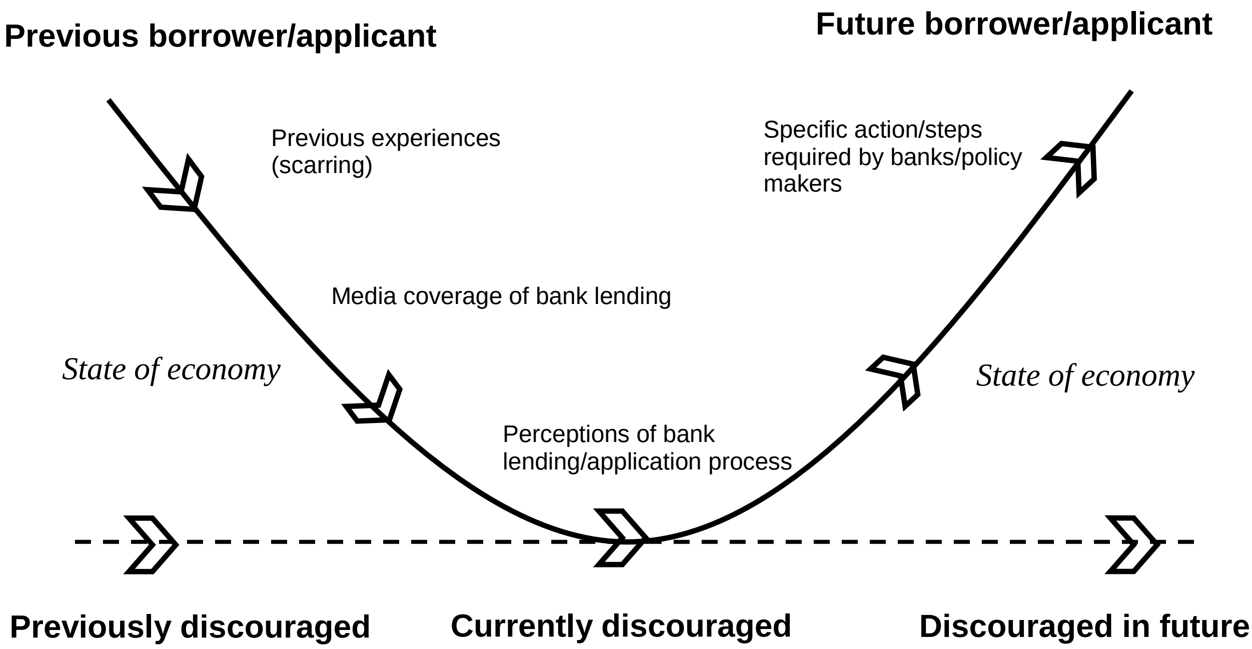
[27] Fraser (2009) op. cit.

The survey collects information on so called 'would be seekers' of finance (i.e., businesses which would have liked an overdraft/term loan but which, for some reason, have not applied). This includes the indirectly and directly discouraged businesses described previously.

Structure of report

The narrative structure of the report is based on the idea of an 'arc of discouragement'. This arc describes the descent into discouragement but looks forward to the possibility that businesses might be encouraged back to borrowing. Accordingly on the descent of the arc we address the question 'why are there DBs?' On the rise of the arc we are concerned with addressing 'what might encourage DBs back to borrowing?'

Figure 1: The 'arc of discouragement'



In section 2 we address the question of 'why are there DBs?' through an econometric analysis of the data. Then in section 3 we provide additional insights into this question obtained from in-depth interviews with DBs. We conclude in section 4 with some suggestions for stakeholders as to 'what might encourage DBs back to borrowing?' Appendix 1 presents the findings of a summary analysis of UKSMEF/SMEFM data pertaining to the question: 'Who are discouraged borrowers?' And Appendix 2 reports 8 case studies of DBs drawn from the in-depth interviews.

Scope/limitations

The focus in this report is on the reasons why businesses with borrowing needs do not apply for bank finance and what steps might be taken to encourage these businesses back to borrowing. In this respect it is largely out-with the scope of this report to consider non-bank sources of finance (although some insights about alternative funding sources being used by DBs are developed through the in-depth interviews).

It is also recognised that there may be some DBs which, whilst viable, are unsuitable for bank finance due to their risk profile. Again, the data used in this report are unable to speak to issues of whether businesses are more suitable for the wide range of non-bank debt, equity finances and grants/government schemes that are available (see https://www.gov.uk/business-finance-support-finder). However, the recommendations made later in this report recognise that some DBs may require help finding more suitable alternative finances.

Also, neither the econometric nor qualitative analysis can tell us whether, in any individual case, a DB would actually have been successful if they had applied for a loan/overdraft. However, through econometric modelling, we are able to predict the chances that DBs might be successful if they went ahead with a loan/overdraft application. This gives an estimate of the proportion of DBs with 'bank finance potential' (i.e., the proportion that might be suitable for bank finance) although it is emphasised that this estimate is obtained using the model/data in this report not bank credit evaluation models/data which are used to make actual lending decisions.

Finally, issues of discouragement and diversity will be addressed in another ERC report.[28]

2. WHY ARE THERE DISCOURAGED BORROWERS?

Insights from the econometric analysis

What factors result in businesses becoming discouraged borrowers? As discussed in the introduction there is a good understanding, from international data, regarding the factors associated with discouragement such as business size, age and risk and the owner's lack of wealth and experience. The importance of these factors is confirmed by the analysis for UK businesses (see Appendix 1).

However, due to a paucity of theoretical models, we have little understanding about the *mechanisms* underlying discouragement. Discouraged borrowers choose not to apply because they believe that they will be turned down; yet we do not know what factors shape these beliefs and whether these beliefs are accurate or inaccurate.

Also, the lack of structure in current empirical modelling of discouragement means it is impossible to separate out the impact of factors relating to the perceived likelihood of the success of loan applications from impacts relating to the perceived costs of applying for finance (recall from the introduction that discouragement occurs when the benefits of applying for finance, i.e., the perceived chance of successfully obtaining finance, are low relative to the costs of applying).

[28] Carter, S. and Mwaura, S. (2014). The Financing of Diverse Enterprises: Evidence from the SME Finance Monitor. Enterprise Research Centre White Paper.

A key part of this discouragement research is therefore to advance our understanding of the mechanisms underlying financial discouragement. In particular a model is developed which:

- Identifies the perceived likelihood of loan application success, the factors which affect these perceptions and whether entrepreneurs under- or over-estimate the actual probability of success.

- Disentangles the perceived likelihood of loan application success from the perceived costs of applying for finance.

This is more than just an academic exercise. From a policy perspective it is important to have a clearer understanding of the distinct role of entrepreneurial perceptions about the chances of obtaining finance compared to the role of application costs. Broadly, the former speaks to a possible need to improve perceptions about the chances of successful applications; the latter a possible need to reduce the perceived costs and hassle encountered in the application process.

The following discussion of the model is non-technical to appeal to a generally interested reader. A full technical exposition will be available in a forthcoming research paper.

Outline of a model of discouragement

Perceived likelihood of making a successful loan application

How do entrepreneurs form their perceptions of whether or not their loan applications will be successful? A 'rational', fully informed entrepreneur would be completely aware of how banks assess the creditworthiness of their loan application. This assessment is based on factors relating to the reliability, or otherwise, of the applicant to repay the loan (as evidenced by events such as CCJs, previous unauthorised overdraft borrowing and missed loan repayments) and whether cash-flows are strong enough to enable the business to keep up with repayments ('affordability'). In addition, in some cases banks may require collateral (see below) and/or expect the entrepreneur to invest some of their own money in the business (to have some ‘skin in the game’). If entrepreneurs were fully aware of assessment procedures there would be no tendency for the perceived likelihood of making a success application to systematically deviate from the actual success probability (as determined by reliability, affordability, collateral and personal stakes)[29].

However, far from the rational ideal, behavioural economics highlights limitations in individual’s ability to process information, especially in situations of uncertainty or stress, which may lead to various shortcuts/heuristics in decision making and the gauging of situations.[30] These shortcuts include making judgements about situations:

- Based on their similarity to comparable situations (representativeness).
- Using information which can be called to mind easily (availability).
- Relying excessively on the first piece of information available (anchoring).[31]

The problem is that these shortcuts may introduce serious errors and biases into our understanding of the world around us. Indeed, these biases are especially likely in situations involving informational overload[32],

---

[29] The 5 C’s of credit analysis emphasise the importance of: character (reliability); capacity (affordability); collateral; capital (personal stakes); and conditions (speaking to the economic/financial context for the lending decision).
[30] Tversky, A. and Kahneman, D. (1974). Judgement under uncertainty: Heuristics and biases. *Science*, 185 (4187), 1124-1131; Kahneman, D., and Tversky, A. (1979). Prospect theory: An analysis of decision under risk. *Econometrica*, 47(2), 263-291.
[31] Tversky and Kahneman, 1974 op. cit.
[32] Gilbert, D.T., McNulty, S.E., Giuliano, T.A., and Benson, J.E. (1992). Blurry words and fuzzy deeds: The attribution of obscure behavior. *Journal of Personality and Social Psychology,* 62(1), 18–25.

novelty/uncertainty[33], high emotions[34] and time pressures[35]. These are precisely the situations which are more often encountered and more intensely experienced by entrepreneurs leading to the inference that they may be especially susceptible to cognitive biases.[36]

In short the evidence from behavioural economics point to the possibility that the perceived probability of making a successful loan application may systematically deviate from the actual success probability. Indeed, based on the idea of heuristics (representativeness, availability and anchoring), we would expect the following factors to be of particular importance in shaping entrepreneurs' perceptions about their chances of making successful loan applications:

- Previous experiences with lenders.
- The borrowing experiences of peers in business.
- Media reports of bank lending.
- Perceptions of a difficult economic climate for borrowing ('economic climate')
- Firm size

These are factors which may cause entrepreneurs' perceptions of success probabilities to systematically deviate from actual success probabilities.[37] In particular negative past borrowing experiences (e.g., rejection) or

[33] Fiske, S.T., and Taylor, S. (1991). *Social Cognition,* 2nd ed. New York: Random House.
[34] Oaksford, M., Moreris, F., Grainger, B., and Wililiams, J.M.G. (1996). Mood, reasoning, and central executive processes. *Journal of Experimental Psychology: Learning, Memory, and Cognition,* 22(3): 476–492.
[35] Wyer, R.S., Jr., and Srull, T.K. (1994). *Handbook of Social Cognition.* Hillsdale, NJ: Erlbaum.
[36] Baron, R.A. (1998). Cognitive mechanisms in entrepreneurship:: Why and when entrepreneurs think differently than other people. *Journal of Business Venturing*, 13(4), 275-294
[37] To emphasise, this list does not relate to the factors which determine *actual* success probabilities only the factors which may *bias* perceptions of actual success probabilities.

(negative) media reports may cause entrepreneurs to under-estimate actual success probabilities. Similarly hearsay about peers' borrowing experiences and general perceptions about the borrowing climate are expected to impact on beliefs about the chances of obtaining a loan. In addition we might also expect firm size to play a role: smaller businesses tend to be less financially confident which may lead to underestimation of actual success probabilities.

Perceived application costs ('hurdles')

If making loan applications was cost free perceptions of whether or not the application is likely to be successful would not matter. If it costs nothing to apply, it would be worthwhile taking a chance with an application even if there were little perceived possibility of it being successful. However, in reality businesses must jump over a number of hurdles for there to be any chance of obtaining finance.

The issue here is that small businesses are notoriously informationally opaque due to a lack of track record and/or audited accounts. This may make conveying information about the creditworthiness of the business costly, if not impossible.[38] These costs relate not only to the financial costs of applying but also the associated psychological hassle of going through a formal application process (a point which is emphasised for the time constrained, multi-tasking owner-manager of a small business).

In addition, due to informational opacity banks may require collateral and/or covenants as a signal of the entrepreneur's creditworthiness and

[38] Credit rationing may arise in situations where finance providers are unable to determine the riskiness of applicants due to a lack of information. In particular, issues related to a lack of information *ex ante* (related to the riskiness of the applicant before the lending decision) may give rise to adverse selection (i.e., raising interest rates to clear excess loan demand would cause low risk borrowers to drop out of the loan pool); and a lack of information *ex post* (related to borrower behaviour after the lending decision) may give rise to moral hazard (i.e., raising interest rates may result in entrepreneurs switching to riskier projects or reducing effort). In both situations credit rationing occurs if raising interest rates to clear the market would result in a fall in finance providers' returns (so that the prevailing interest rate is below the market clearing rate in equilibrium).

commitment to the success of the business. In this respect perceptions that banks will ask for security and/or perceptions about the terms/conditions attached to borrowing represent additional obstacles to obtaining a loan.

On the other hand awareness of business support might help with lowering the perceived obstacles in the way of obtaining finance. In particular awareness of the lending Appeals Process may make applying seem more worthwhile if potential applicants know they have a chance of having an initial decision to turn down their application reviewed and possibly overturned.

Finally the more internal finance is available the less worthwhile it is for the business to have to incur the costs and hassle of applying for external finance. Relatedly an aversion to using external debt may increase preferences for relying on internal finance (i.e., raise the psychological cost of applying for loans).

Accordingly the following factors are expected to be particularly important in affecting perceived loan application costs; these are factors which are expected to raise (+) or lower (–) the various financial and psychological 'hurdles' encountered in applying for loans:

- Firm size (–)
    - Larger firms are less informationally opaque implying lower application costs.
- Firm age (–)
    - Older firms have built up a track record and are therefore less opaque.
- Perceived cost of finance (+).
- Perceived hassle of applying (+)

- Perceptions that the bank will ask for security (+).
- Perceptions of the terms and conditions of borrowing (+).
- Awareness of business support schemes (–).
- Availability of internal finance (+)
- Debt aversion (+)

The following diagram (Figure 2) provides a synopsis of the model. There are two key variables in the model: entrepreneurial productivity ('talent': θ); and entrepreneurial perceptions of the probability of making a successful loan application (ω). A productivity threshold (θ_0) separates businesses with capital demands ($\theta \geq \theta_0$) (i.e., businesses which derive positive net returns from additional borrowing) from those without capital demands ($\theta < \theta_0$). The location of this threshold depends on: the amount of capital already invested[39]; the interest rate[40]; and debt aversion[41]. In a perfect capital market $\theta_0$defines the threshold between 'seekers' (i.e., applicants), whose productivity, and hence capital requirements, are high relative to the threshold ($\theta \geq \theta_0$) and non-seekers of loans ($\theta < \theta_0$). Accordingly, in a perfect capital market, all businesses with capital demands are seekers.

However in imperfect capital markets information issues mean that loan applications are costly. In this context, perceptions of the chances of making a successful loan application matter for the decision of whether or not to apply. A perceived success threshold (ω_0) separates the discouraged, whose perceived chances of success fall below the threshold ($\omega < \omega_0$), from the non-discouraged ($\omega \geq \omega_0$). The location of this threshold depends on perceived application costs: factors which increase

[39] Under diminishing returns the demand for additional capital is decreasing in the amount of capital already invested. In this case greater existing capital will shift the location of $\theta_0$upwards.
[40] A higher interest rate reduces demand for capital shifting the threshold upwards.
[41] Debt aversion raises the psychological costs of borrowing, shifting the threshold upwards

perceived application costs shift the threshold upwards and to the right (thereby increasing the likelihood of discouragement).

The model predicts the existence of 3 known types of business in the context of borrowing decisions:

1. Seekers: businesses which have capital demands ($\theta \geq \theta_0$) and who are not discouraged ($\omega \geq \omega_0$).

2. Non-seekers: businesses without capital demands ($\theta < \theta_0$).

3. Discouraged borrowers: businesses which have capital demands ($\theta \geq \theta_0$) but which do not apply due to discouragement ($\omega < \omega_0$).

In addition the model predicts the existence of a fourth new type of business in the context of borrowing decisions:

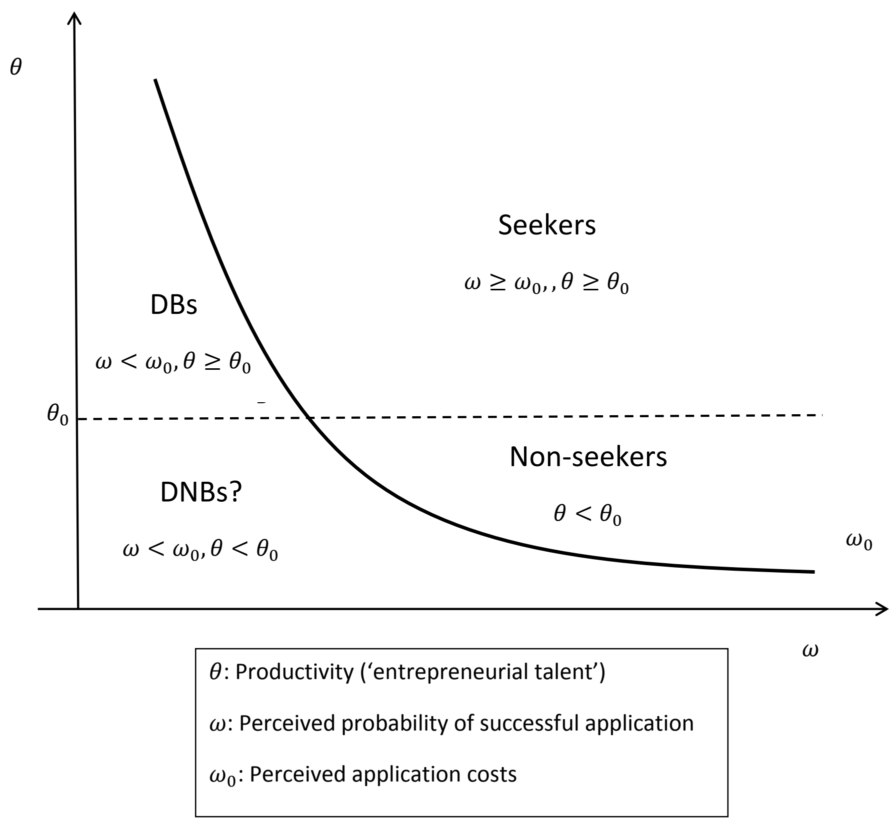
4. Discouraged non-borrowers (DNBs): businesses which (no longer) have capital demands ($\theta < \theta_0$) and which are (or have been) discouraged ($\omega < \omega_0$).

The interpretation of this last group is that these are businesses which may have been seekers in the past, but became discouraged borrowers due, for example, to a bad borrowing experience in the past. This discouragement could have resulted in the business being under-capitalised leading to subsequent falls in productivity and capital demands.[42] Graphically these businesses have sunk from being originally DBs, below the capital demands threshold θ_0, to become DNBs. In a colloquial sense we can identify these as businesses which have simply given up trying to obtain external finance and have decided to get by without it; simple

[42] New capital demands arise when the marginal return on capital exceeds the marginal cost of capital. A fall in productivity will reduce the marginal return on capital leading to a fall in capital demands.

discouragement has become a 'slough of despond'.[43] Whilst there are currently no direct observations of DNBs we are able to estimate their extent indirectly by applying the model to the data. However, it would seem to be an important part of the future discouragement research agenda to seek to verify the existence and extent of DNBs directly.[44]

Figure 2: Model of DBs



[43] Whilst the discouragement model (including the prediction of DNBs) was developed before the qualitative research was conducted, I am still indebted to Shiona Davies/BDRC for the deep insights into the nature of discouragement provided by the qualitative research. In particular, this has helped me to understand the nature of DNBs and the possibility of their existence. Indeed Shiona applied the phrase 'slough of despond' as a description of this situation of entrenched discouragement.

[44] This may be achieved in future finance surveys by asking (current) non-seekers whether they have felt discouraged from applying for external finance in the past.

Empirical results

The discouragement model is able to disentangle the role of perceptions of the likelihood of loan application success from perceived application costs. The perceived likelihood of making a successful application depends on the actual likelihood of success and a component, measuring the difference between the perceived and actual likelihood of success, this latter component relating to cognitive biases in perceptions[45]. Accordingly the following empirical results report estimates relating to:

1. Perceived and actual probabilities of making a successful loan application.

2. The determinants of actual success probabilities (i.e., factors that affect discouragement by impacting on actual risk) and the determinants of gaps between perceived and actual success probabilities (i.e., factors relating to cognitive biases/misperceptions of actual risk).

3. Perceived application costs.

[45] The empirical model is estimated using maximum likelihood. Based on the theoretical model summarized in Figure 2, the probabilities of observing the different borrowing decision groups are given by: $prob(\omega < \omega_0, \theta \geq \theta_0)$ (DBs); $prob(\omega \geq \omega_0, \theta \geq \theta_0)$(seekers); and $prob(\theta < \theta_0)$ (non-seekers) respectively (note we currently have no direct observations of the fourth group, DNBs). Information about the outcome of seekers' loan applications allows us to estimate (the determinants of) actual success probabilities (α, say). Then $\omega = \alpha + \beta$ where β is a cognitive bias term (relating to systematic deviations between perceived and actual success probabilities). α is a function of factors relating to the creditworthiness of the business (e.g., the 5 C's). β depends on a different set of factors relating to previous experiences with lenders, the borrowing experiences of business peers, media reports of bank lending and perceptions of a difficult economic climate for borrowing (see above) – technically, employing a different set of variables to explain β enables identification of ω. Regarding the other equations, θ(productivity) is a function of business/owner characteristics (including human capital) and the capital demands threshold $\theta_0$depends on perceived borrowing costs, debt aversion and whether the business has a need for more capital (as a proxy for the amount of capital already invested). Application costs $\omega_0$depend on the factors discussed previously (e.g., perceived security requirements/terms and conditions). While DNBs are not directly observed, the model allows us to estimate the probability of observing a DNB: $prob(\omega < \omega_0, \theta < \theta_0)$).

4. The determinants of perceived application costs (i.e., factors that affect discouragement by impacting on perceived hurdles in the application process)

5. The net effects of the determinants of actual success probabilities, misperceptions and application costs on the probability of discouragement.

The last set of estimates most closely resembles previously reported estimates obtained from existing models of discouragement. However it is emphasised again that the principal value added of the 'structural' model of discouragement is the ability to see how the various determinants of discouragement impact separately on actual success probabilities, misperceptions of success probabilities and application costs. The net effects of the different factors relating to discouragement are presented alongside their respective impacts on actual success probabilities, misperceptions and application costs (to provide immediate clarity of their actual impacts on discouragement).

The empirical results are reported graphically to aid interpretation. The charts relating to the determinants of actual success probabilities, misperceptions and application costs report point and interval estimates (based on 95% confidence intervals). Interval estimates ('spears') which cross the horizontal axis are statistically insignificant ($p>0.05$); primary interest is accordingly focused on spears which do not cross the horizontal axes as these relate to statistically significant effects ($p<0.05$).

Looking forward to the concluding section on policy implications, messages emerging from the empirical analysis (relating to the effects of different factors on discouragement) are colour coded for the different policy stakeholders as follows:

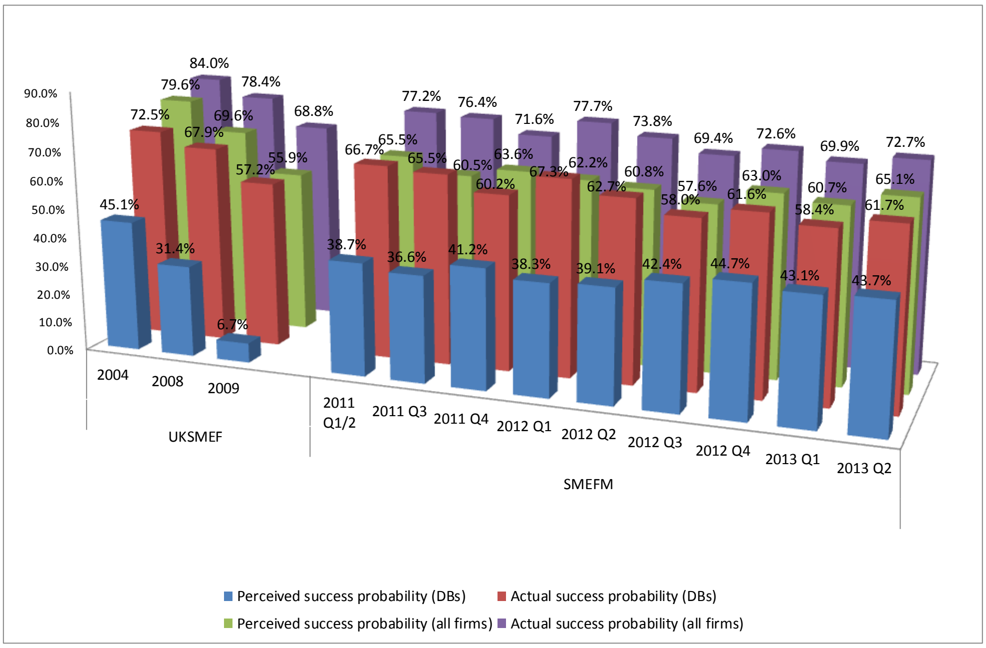
- Banks
- Business support agencies
- Government/British Business Bank
- Businesses

A full discussion of the policy implications of the findings in relation to these different stakeholders will be taken up in the final section.

Perceived and actual probabilities of making a successful loan application

We begin, in the following chart, by looking at estimates of actual and perceived probabilities of making a successful loan application between 2004 and 2013 Q2. These estimates provide an indication of how actual/perceived success probabilities have varied over the economic cycle of the last decade.

Chart 1: Actual and perceived probabilities of making a successful loan application



Sources: UKSMEF 2004, 2008, 2009; SMEFM 2011Q1/2-2013Q2

- Looking at estimates from the UKSMEF data, actual success probabilities fell significantly between 2004 and 2009.

- This is consistent with previous research showing that rejection rates for overdraft/term loan applications increased significantly following the 2008 financial crisis. This was due to increased credit risk on the demand side and tighter lending criteria on the supply side (the latter a result of a range of factors including increased risk aversion, increased uncertainty about risk and higher funding costs/capital requirements). [46,47]

- At the same time the gap between actual and perceived success probabilities increased (in both absolute and relative terms) between 2004 and 2009 suggesting falling business confidence.

- Indeed, looking at actual and perceived success probabilities for all firms, a typical business in 2004 appeared to have an accurate perception of their success probability (the gap between their actual and perceived probabilities is statistically insignificant).

- However by 2009 a typical business believed their chances of success were only slightly above 50/50 when their actual chances of success were closer to 70/30 in favour.

- Actual success probabilities are lower amongst DBs reflecting the riskier profiles of these businesses (recall the evidence from

[46] Fraser, S. (2012), The Impact of the Financial Crisis on Bank Lending to SMEs: Econometric Analysis from the UK Survey of SME Finances, 2012, *Department for Business, Innovation and Skills:* http://www.bis.gov.uk/assets/biscore/enterprise/docs/i/12-949-impact-financial-crisis-on-bank-lending-to-smes
Armstrong, A., Davis, E.P, Liadze, L & Rienzo, C. (2013), Evaluating changes in bank lending to UK SMES over 2001-12 – On-going tight credit? National Institute of Economic and Social Research (NIESR) Discussion Paper No. 408 (February 2013): http://niesr.ac.uk/sites/default/files/publications/dp408.pdf

[47] The other essential point to make in this context is that falling actual success probabilities does not of itself point to 'market failure' – it might simply reflect a return to more prudent lending practices following the financial crisis.

section 2 that DBs are typically smaller, younger and have poorer credit ratings than other businesses).

- However DBs also appear to under-estimate their actual success probabilities to a greater extent than other businesses. This is an interesting result as it provides the first evidence that misperceptions about success probabilities, leading to excessively lower confidence in the outcome of loan applications, is an important ingredient of discouragement.
- Indeed there is a near total collapse in confidence amongst DBs in 2009 with the chances of making a successful a loan application perceived as a long shot (less than 1 in 10). This is despite their actual success probability being similar to other businesses (the actual success probabilities in 2009, for both DBs and all firms, are around 56-57%).
- The SMEFM estimates of actual/perceived success probabilities for all firms and DBs follow a similar pattern: both DBs and other businesses under-estimate actual success probabilities; and DBs under-estimate their actual success probabilities to a greater extent than other businesses.
- Gaps between actual and perceived success probabilities widened at the start of 2012, when there was a (mistaken) belief that the UK economy had entered a double dip recession, again pointing to a fall in business confidence around that time.
- Since the end of 2012 there is some evidence that business confidence has risen (as perceived success probabilities have increased). However this recovery in business confidence is still subject to substantial uncertainty – notably perceived success probabilities dropped again at the start of 2013 (and, indeed, perceived success probabilities throughout the time span of the SMEFM sample are very up and down reflecting ongoing uncertainty in this period).

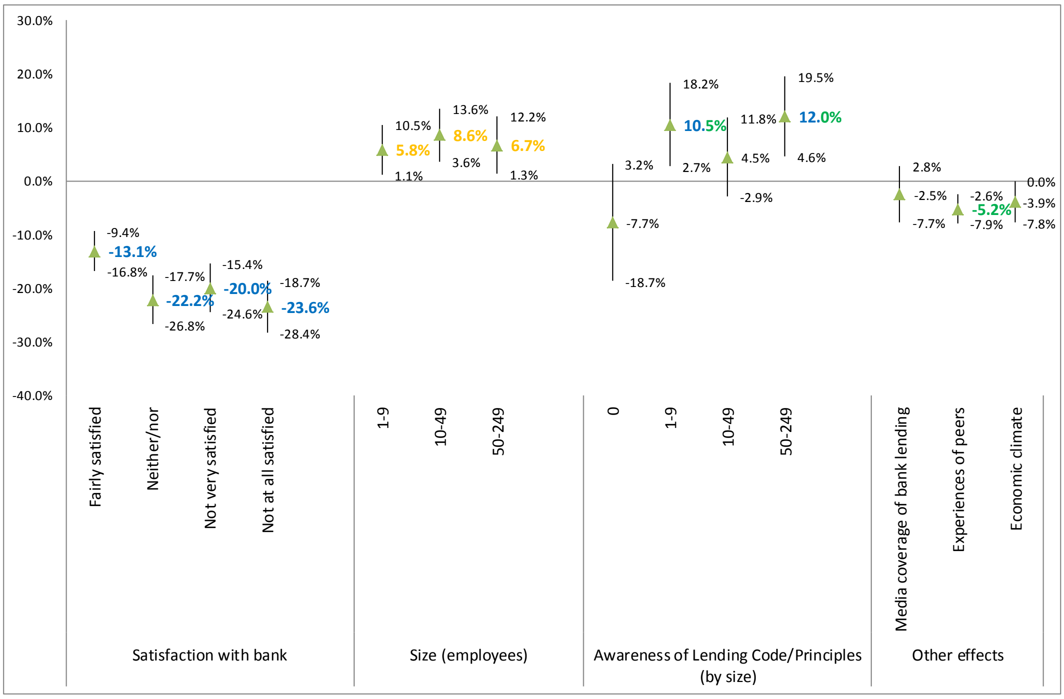
- The situation regarding business confidence will need to be monitored going forward before we can be confident that a recovery has set in.

Information about the viability of a typical DB can be gleaned from the above chart. We know that DBs tend to be riskier than average (smaller, younger, fewer assets, poorer credit ratings etc. – see Appendix 1 ‘Who are discouraged borrowers?’). This is again borne out by comparing the estimated actual success probabilities for the average business versus those for DBs (the latter success probabilities being lower). Nonetheless, looking at the SMEFM data overall, the estimated actual success probabilities for DBs is around 62-63%.

What does this figure mean? It suggests that a little over 3 in every 5 DBs might receive bank finance if they applied i.e., might be suitable for bank finance. The strong caveat here is that we do not have access to bank data/credit evaluation models to obtain a direct answer to the question of whether a business is suitable for bank finance. So our figure of 3/5 DBs which might be suitable for bank finance is only an estimate which depends on the model for application success developed in this report and the available UKSMEF/SMEFM data used to estimate the model, neither of which are the same as the different (proprietary) models/data used by banks for credit evaluation. It nonetheless provides an indication of the extent to which DBs might have ‘bank finance potential’.

What factors lead businesses to become excessively pessimistic about the likely outcome of loan applications? Media coverage of bank lending? Conversations with business friends/associates? Previous experiences with banks? Or a general feeling that the prevailing economic climate is against obtaining a loan? To answer this question we next take a look at the impact of these different explanations on gaps between perceived and actual success probabilities. These estimates, obtained from the econometric model, speak directly to the underlying issues which result in the under-estimation of success probabilities noted previously.

Chart 2: Determinants of gaps between perceived and actual probabilities of making a successful loan application (misperceptions of actual success probabilities) (measured in % points)



Sources: SMEFM 2011Q1/2-2013Q2

- The key result from this chart is that misperceptions about the likely outcome of loan applications are very sensitive to the quality of banking relationships.

- A business which is only fairly satisfied with their bank will under-estimate their actual success probability by 13% points relative to a business which is very satisfied.

- A business which is 'not at all satisfied' with their bank under-estimates their actual success probability by almost 24% points relative to a business which is very satisfied.

- Larger businesses are more confident in their chances of making a successful loan application. Compared to businesses with no employees, the perceived chances of success are: almost 6% points higher for a business with 1-9 employees; between 8-9%

points higher for a business with 10-49 employees; and almost 7% points higher for a business with 50-249 employees.

- Awareness of the Lending Code/Principles (which set minimum standards of service from lenders) also improve businesses' perceived chances of making a successful loan application. These effects, which vary with firm size, indicate that while awareness of the Lending Code does not improve perceptions amongst businesses with 0 employees, awareness of the Lending Code improves perceptions by 10-11% points amongst businesses with 1-9 employees.

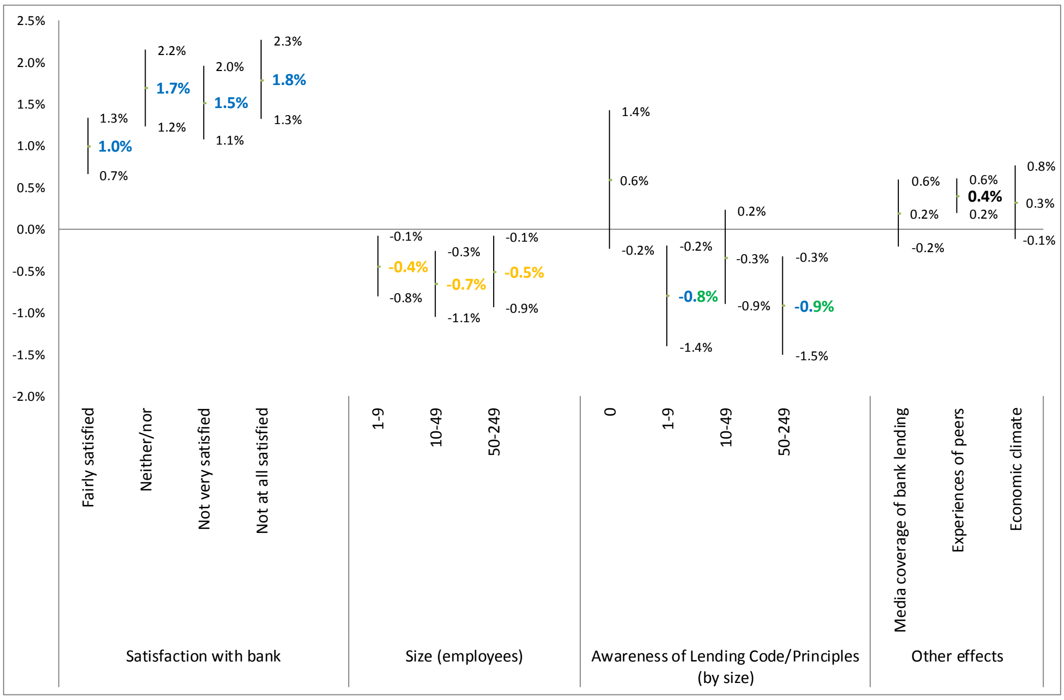
- Awareness of the Lending Principles (which sets minimum service standards for larger businesses) improve the perceived chances of making a successful loan application by 12% points amongst businesses with 50-249 employees.

- Negative borrowing experiences of business peers, and perceptions that the economic climate is against the chances of obtaining a loan, also seem to result in businesses under-estimating their actual success probabilities (by around 5% points and 4% points respectively).

- However media coverage of bank lending does not appear to engender pessimism about the outcome of loan applications (the corresponding 'spear' crosses the horizontal axis suggesting this effect is statistically insignificant).

The corresponding net effects of factors relating to cognitive biases on the probability of discouragement are reported in the following chart.

Chart 3: Net effects of the determinants of misperceptions on the probability of discouragement (measured in % points)

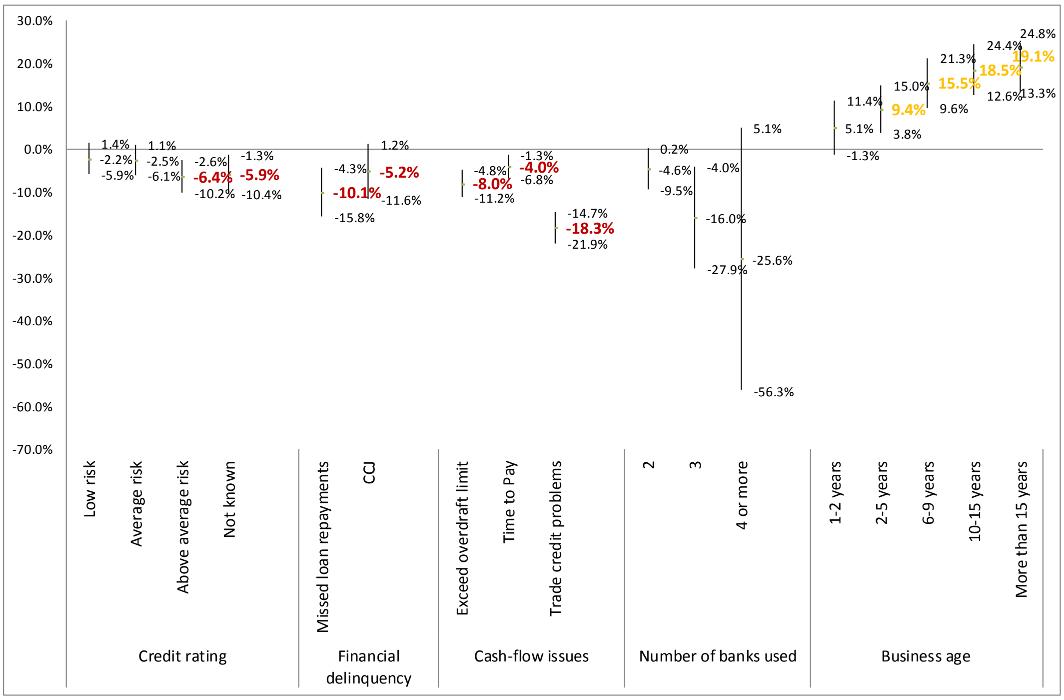


Sources: SMEFM 2011Q1/2-2013Q2

This chart again highlights the important role played by the business feeling dissatisfied with its main bank in increasing discouragement (although from the previous analysis we now understand how dissatisfaction affects misperceptions of application success probabilities). Also awareness of the Lending Code/Principles significantly reduces the likelihood of discouragement amongst businesses with 1-9 and 50-249 employees respectively.

The following chart looks at some key determinants of actual success probabilities. Some of these factors point to issues that businesses might address themselves, possibly with some help from banks and support agencies, to improve their chances of obtaining finance.

Chart 4: Determinants of actual success probabilities (measured in % points)



Sources: SMEFM 2011Q1/2-2013Q2

- Businesses with an above average risk rating are between 6-7% points less likely to have their loan application approved compared to a minimal risk rated business.

- A lack of a credit rating increases uncertainty about risk and reduces the likelihood of a successful application (by almost 6% points).

- Missed loan repayments have a serious detrimental effect on success probabilities lowering them by over 10% points.

- Similarly County Court Judgements lower success probabilities by over 5% points.

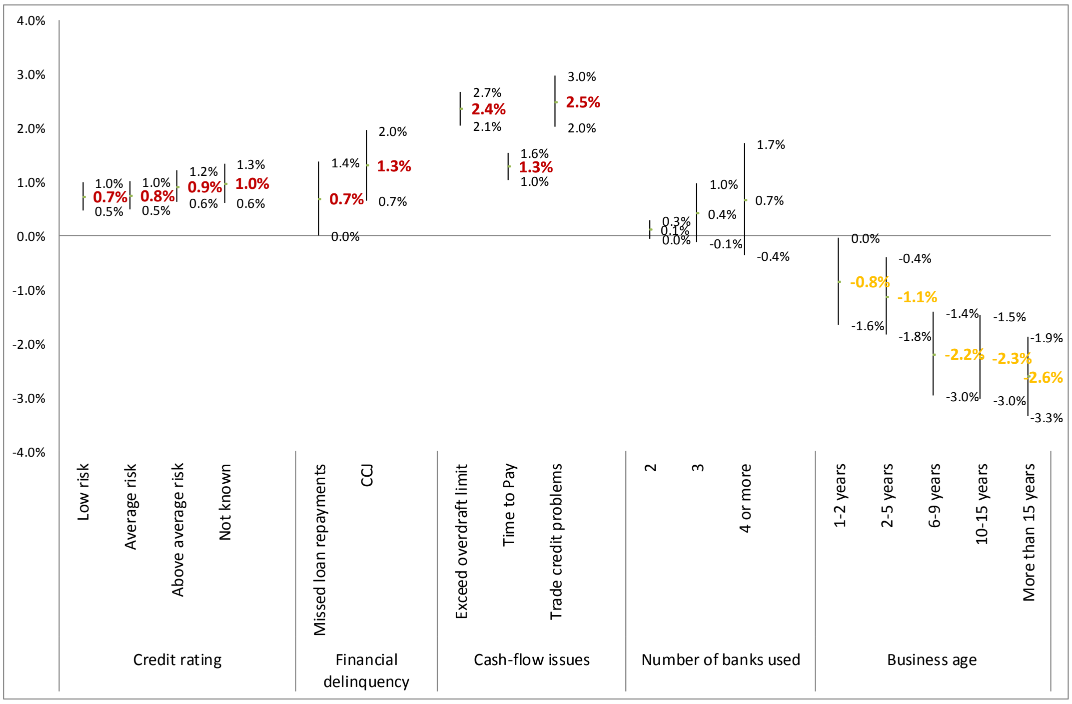
- Regarding cash-flow issues, unauthorised overdraft borrowing reduces the chances of obtaining a loan by 8% points.

- Businesses participating in HMRCs Time to Pay Scheme, which allows businesses experiencing cash-flow problems to pay taxes in instalments, are 4% points less likely to have a loan application approved.

- Businesses that report problems obtaining trade credit (a source of working capital) are over 18% points less likely to have a loan application approved.

Older business (aged 2 or more years) have a higher likelihood of obtaining finance, compared to start-ups, due to having a longer track record.

Chart 5: Net effects of the determinants of actual success probabilities on the probability of discouragement (measured in % points)



Sources: SMEFM 2011Q1/2-2013Q2

Looking at these net effects, the results in this chart highlight the important impacts of increased actual risk through poorer credit ratings, financial delinquency, cash flow issues and shorter track records on discouragement.

The results emphasise the importance of debt and cash-flow management (as well as maintaining a good credit rating) in improving actual chances of obtaining finance and lowering the likelihood of discouragement. These are issues that businesses need to address themselves with support from banks and business support agencies.

Perceived application costs

The other critical component in weighing up whether it is worthwhile applying for a loan are the perceived application costs. Accordingly we now turn to estimates of perceived application costs and their determinants. Perceived application costs are measured in terms of a success probability threshold or 'hurdle': if the perceived success probability lies above this threshold it is worthwhile applying; higher application costs raise the 'hurdle' making it less worthwhile to apply (for a given perceived success probability).

- Looking across the UKSMEF/SMEFM estimates of perceived application costs among all firms, these costs are lower than the corresponding perceived success probabilities reported previously. In other words a typical firm would think it worthwhile applying for a loan if they needed funding (perceived success probability>perceived application cost).

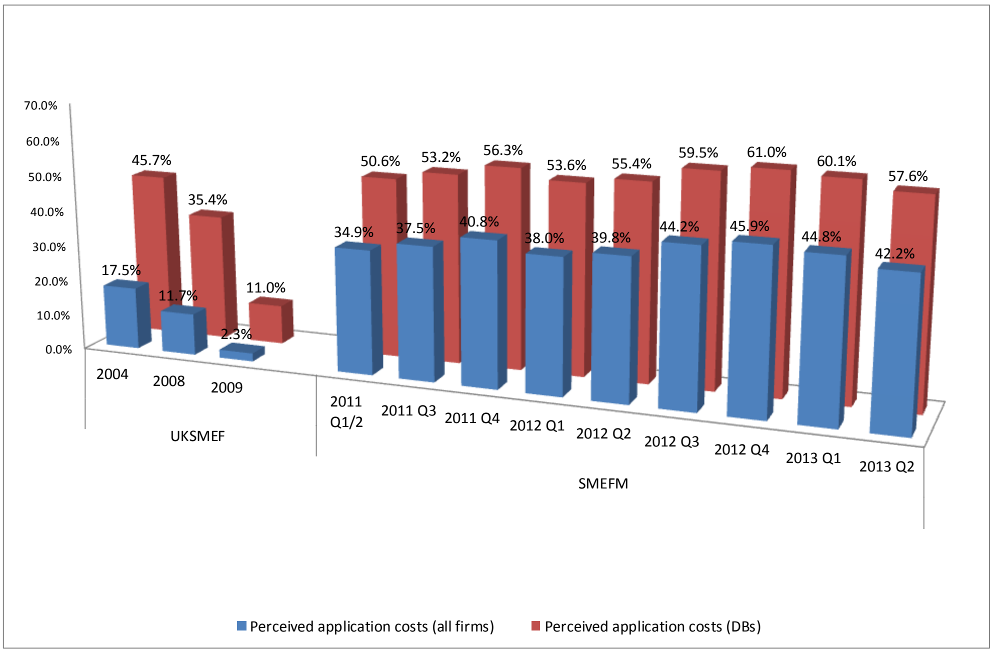
- However, perceived application costs are higher amongst DBs – too high for them to consider it worthwhile applying for a loan (perceived success probability<perceived application cost).

- In particular, looking at the estimates of perceived application costs for DBs overall, a DB would need a perceived success probability of higher than around 50-60% for them to consider it worthwhile applying (whereas the previous estimates suggest perceived success probabilities are typically around 40% for DBs).

- Looking specifically at the UKSMEF estimates, interestingly perceived application costs seem to have fallen during the financial crisis. This is possibly as a result of the introduction of unprecedented levels of government support for SME lending at that time.

- However the key inference from the UKSMEF estimates, in conjunction with the previous estimates of perceived loan application success probabilities, is that the increase in discouragement during the financial crisis was due to a collapse in confidence about the likely outcome of loan applications (as opposed to higher perceived application costs).

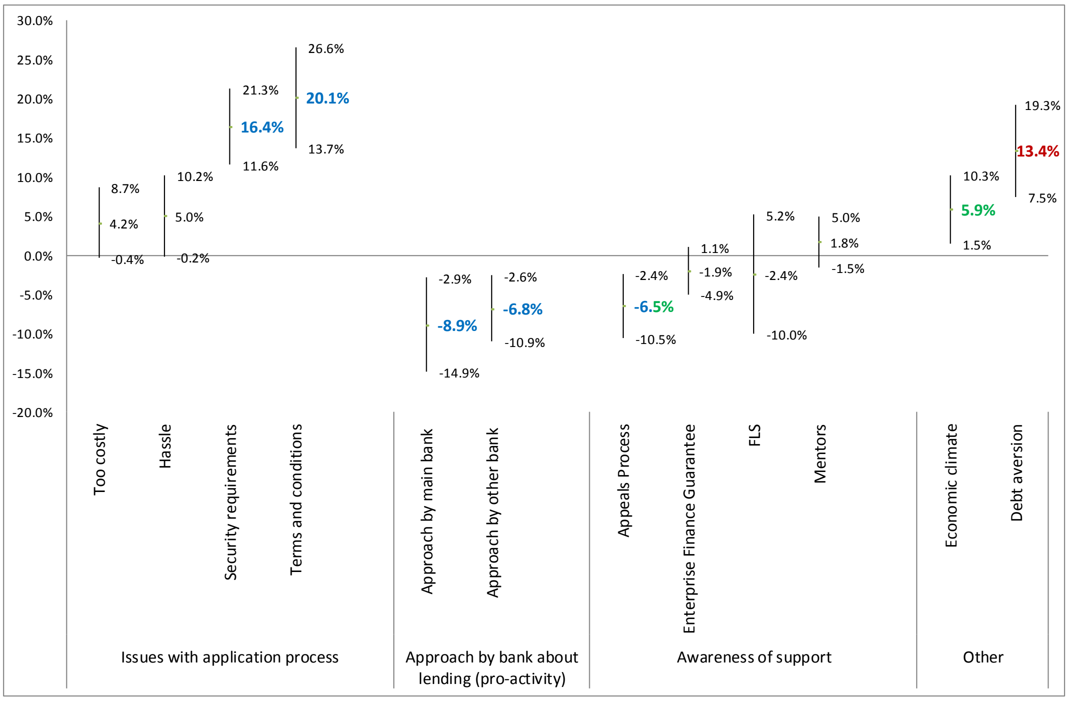
Chart 6: Perceived loan application costs (perceived success probability thresholds)



Sources: UKSMEF 2004, 2008, 2009; SMEFM 2011Q1/2-2013Q2

What factors raise perceived application costs (and thereby increase the likelihood of discouragement)? Perceptions that loans are too costly would seem obvious. However other issues related to loan applications such as perceived security requirements may also create barriers. Or are the barriers simply related to a psychological aversion to debt? What factors might lower perceived application costs? Does business support, or at least awareness of support, help lower the hurdles in the application process? Might a friendly approach by a bank about borrowing requirements make a difference? The following chart provides some answers to these questions.

Chart 7: Determinants of perceived loan application costs (key impacts on perceived success probability thresholds measured in % points)



Sources: SMEFM 2011Q1/2-2013Q2

- Looking at issues with the application process, perceptions that loans are too costly and that the application process is too much hassle raise perceived loan application costs by around 4-5% points (although these effects are on the margins of statistical significance).

- However perceived security requirements and terms/conditions have much larger impacts raising perceived application costs by around 16% points and 20% points respectively.

- On the other hand an approach by the business's main bank about borrowing requirements lowers perceived application costs by almost 9% points.

- An approach by another bank lowers perceived application costs by almost 7% points.

- Awareness of the independently monitored lending Appeals Process lowers perceived application costs by between 6-7% points (awareness of other forms of support seem to have no significant effect on application costs).

- Looking at other key effects perceptions that the economic climate is not right for borrowing increase perceived application costs by almost 6% points.

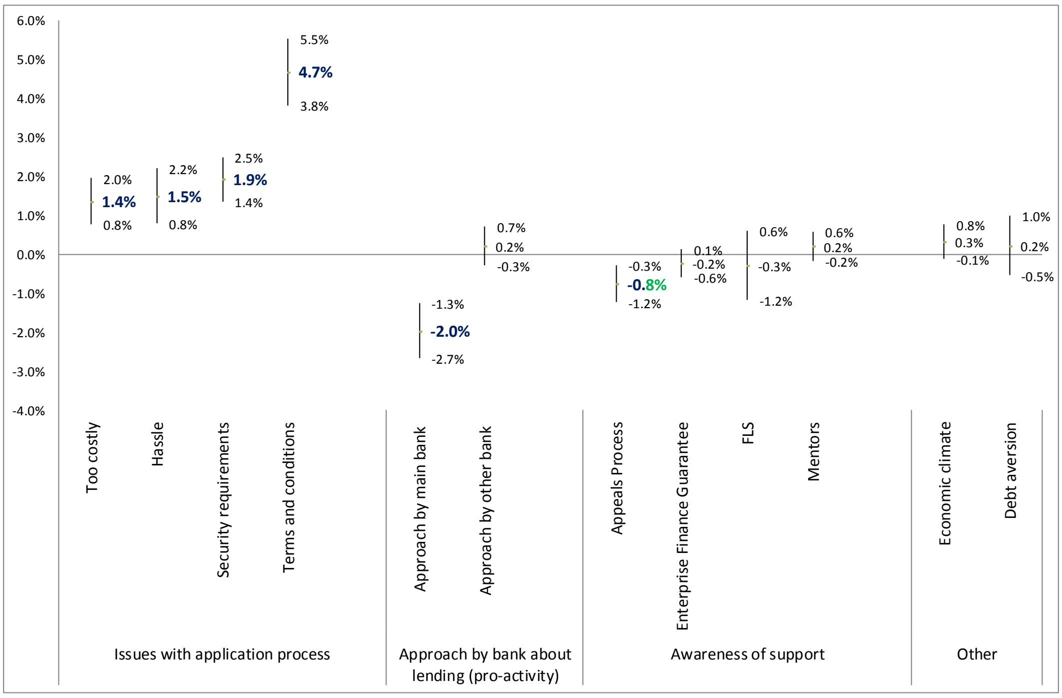
- Also a psychological aversion to debt increases perceived application costs by over 13% points.

In short, it would seem that issues directly related to the application process, perceived security requirements and terms/conditions in particular, have the biggest impact in raising perceived application costs. On the other hand pro-active banking can do a lot to help lower hurdles in the application process. Raising awareness of the Appeals Process also appears to have an important role in lowering perceived application costs –

it would seem more worthwhile applying if an initial decision to deny an application can be appealed and the decision possibly reversed. At the same time, as businesses' perceptions of the economic climate improve we would expect the perceived hurdles in the application process to become lower (thereby reducing discouragement).

The net effects of these key determinants of application costs on discouragement are reported in the following chart:

Chart 8: Net effects of the key determinants of application costs on the probability of discouragement (measured in % points)



Sources: SMEFM 2011Q1/2-2013Q2

We note that the key role played by issues with the application process on application costs is reflected again in their net effects on discouragement. Notably perceived issues with the terms and conditions of borrowing raise the probability of discouragement by almost 5% points. An approach by the business's main bank about its borrowing requirements reduces discouragement by 2% points. Awareness of the Appeals Process lowers discouragement by almost 1% point.

Interestingly, perceptions of the economic climate appear to have no net effect on discouragement (despite the previously reported effects of the economic climate on misperceptions and application costs). This is because the perception that the economic climate is not right for borrowing lowers capital demands which reduce the likelihood of being a DB.[48]

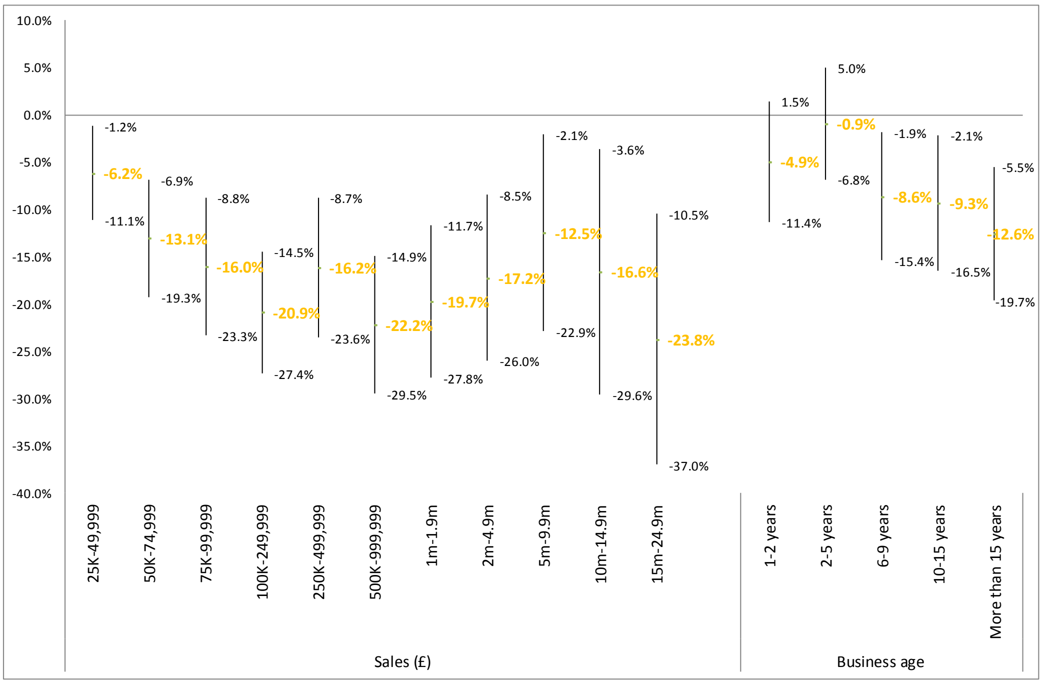
In the following charts we look at other firm and owner related impacts on perceived application costs (along with their net effects on the probability of discouragement).

- Larger firms have significantly lower perceived application costs than smaller firms (the effects of sales are measured relative to firm making sales of less than £25,000 per annum).

- Similarly, established businesses with 6 or more years of trading history have significantly lower perceived application costs relative to firms aged less than one year.

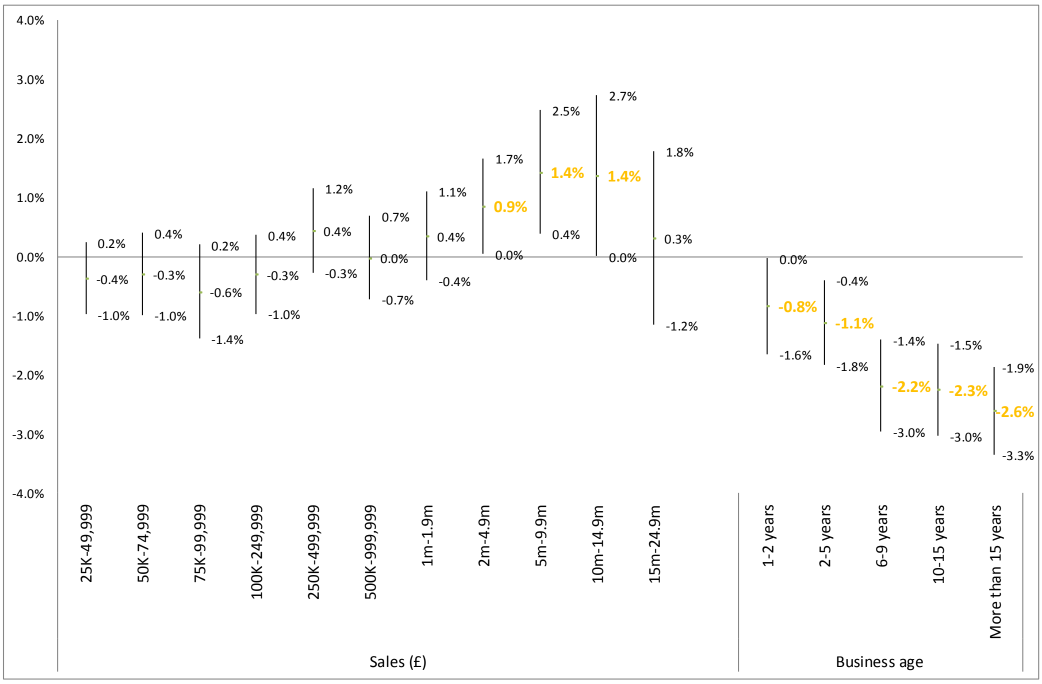
[48] Recall that DBs have both low perceived success probabilities, relative to application costs, and capital demands. The implication is that negative views about the economic climate may be associated with DNBs (who do not have capital demands).

Chart 9: Determinants of perceived loan application costs (firm size/age) (measured in % points)



Sources: SMEFM 2011Q1/2-2013Q2

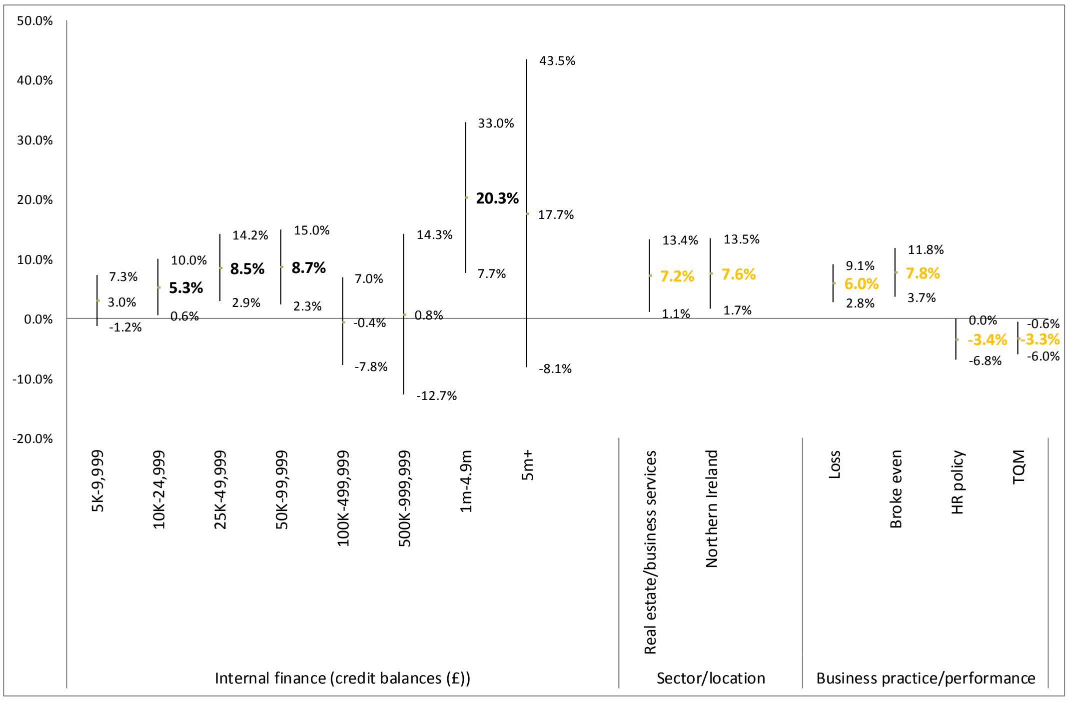
Chart 10: Net effects of firm size/age on the probability of discouragement (measured in % points)



Sources: SMEFM 2011Q1/2-2013Q2

Looking at net effects on discouragement, interestingly lower sales do not appear to be associated with a significant increase in the likelihood of discouragement. Indeed there is a significantly higher likelihood of discouragement amongst businesses in the larger turnover bands (£2m-14.9m). These are businesses which have higher capital demands which increase the likelihood of belonging to the DB group[49]. As noted previously, older businesses are significantly less likely to be DBs.

Chart 11: Determinants of perceived loan application costs (other firm impacts)



Sources: SMEFM 2011Q1/2-2013Q2

[49] So where are the discouraged firms with lower sales (in view of the previously reported higher application costs for these firms)? By implication they lie among the DNBs. We are gradually beginning to build a profile of DNBs (by implication rather than through direct evidence) i.e., they tend to be smaller (in terms of sales) and are pessimistic about the economic climate. While this provides a starting point, we need direct observations on DNBs and their characteristics to move our understanding of this group forward.

- Larger credit balances increase the probability threshold above which it becomes worthwhile applying for a loan. Other things being equal, the availability of internal finance makes it less worthwhile applying for external finance.

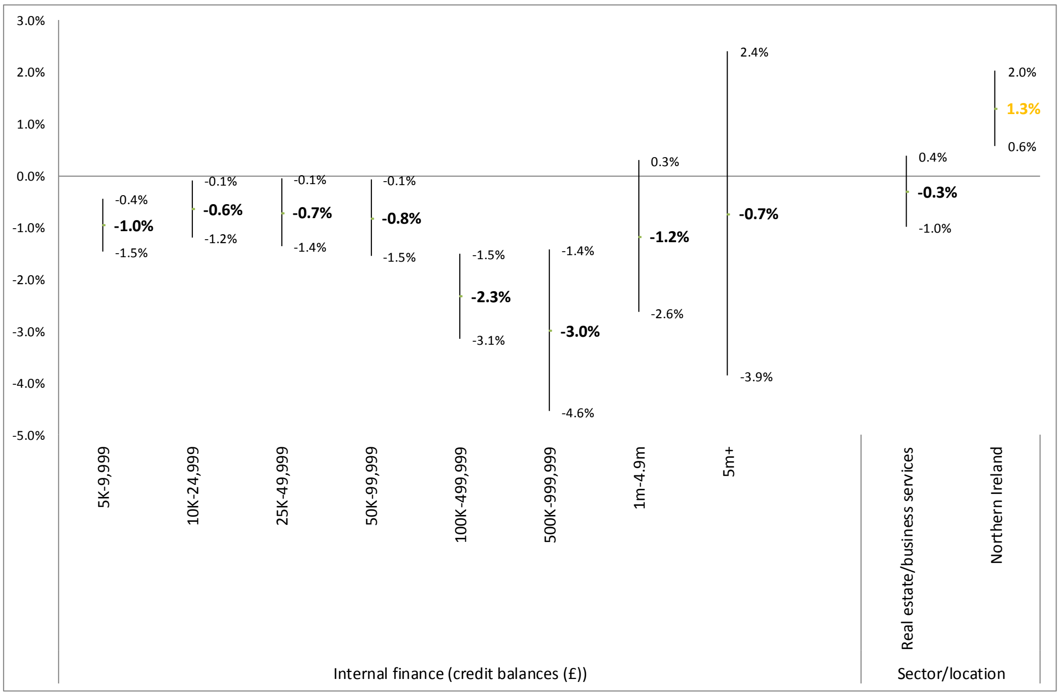
- Real estate/business service sector businesses have higher perceived application costs pointing to higher perceived hurdles in the application process amongst businesses in this sector.

- Similarly perceived application costs are significantly higher for businesses located in Northern Ireland.

- Less profitable firms (experiencing a loss or just breaking even) have higher perceived application costs.

- On the other hand businesses with an HR policy or which practice Total Quality Management perceive lower hurdles in making loan applications.

Chart 12: Net effects of other firm impacts on the probability of discouragement (measured in % points)



Sources: SMEFM 2011Q1/2-2013Q2

The net effects of internal finance on discouragement are negative (greater credit balances reduce external capital demands which reduces the likelihood of being a DB). Interestingly there is no net effect of belonging to the real estate sector on the likelihood of being a DB. Again, in view of the effect of real estate on perceived application costs (which increases discouragement), the implication is that these businesses may be more likely to belong to the DNB group.[50]

Robustness checks[51]

A series of robustness checks were carried out to test the sensitivity of the previous estimates to:

- Inclusion/exclusion of the real estate sector.
- Type of discouragement analysed (indirect/direct).
- Splitting the sample in Q4 2012 (due to a change in definition of 'would be seekers' of finance – a group which contains DBs).
- Segmentation by firm size/age.

Exclusion of the real estate sector from the sample did not significantly affect the results. The conclusion is that the specific problems of real estate businesses are not driving the findings. Similarly the results are not sensitive to particular types of discouragement (the qualitative analysis in the next chapter provides insights into common roots of discouragement).

[50] Whereas real estate sector businesses were more likely to have bank finance demands (relative to other sectors) in the 2004-9 period estimates for the 2011-13 period indicate that they are less likely to have bank finance demands. Whether this means they have lower overall capital demands or whether they have found alternative non-bank sources of finance we cannot answer with these data. Again whether there is an association between the real estate sector and DNBs is a subject for future research with direct observations on DNBs.

[51] The results of the robustness checks are not reported for reasons of conciseness.

Whilst the number of 'would-be seekers' of finance fell following the change in definition in Q4 2012, which may have affected the number of DBs picked up in the survey, estimating models on subsamples with a breakpoint in Q4 2012 did not change the key findings in relation to perceptions/application costs. We conclude from this that the key findings are robust to the change in definition of 'would-be seekers'.[52]

Regarding firm size/age segmentation, the key effects of satisfaction with banking relationships on misperceptions hold across firms of all sizes and ages. Similarly the impacts of awareness of the Appeals Process and perceived terms and conditions of borrowing on application costs are insensitive to the size or age of the firm. Regarding perceived security requirements there is some evidence that this raises perceived application costs more for larger (50-249 employees) and older (aged 10 or more years) businesses. This is perhaps unsurprising since these businesses are more likely to need larger loans which require security. In terms of the impact of an approach by the main bank about borrowing requirements this seems to have a lesser impact in lowering perceived application costs amongst larger (50-249 employees) businesses, who may have more regular discussions with their bank anyway, but has a bigger impact on perceived application costs amongst firms aged less than 1 year (who may be less engaged).

The conclusion from this additional analysis is that any measures taken on issues of perceived security requirements may have more (if not exclusive) impact on larger/older firms whereas there may be a greater return from banks reaching out to smaller/younger businesses. However this does not detract from the general findings that alleviating issues with the application process and increasing pro-activity would help reduce discouragement amongst all businesses.

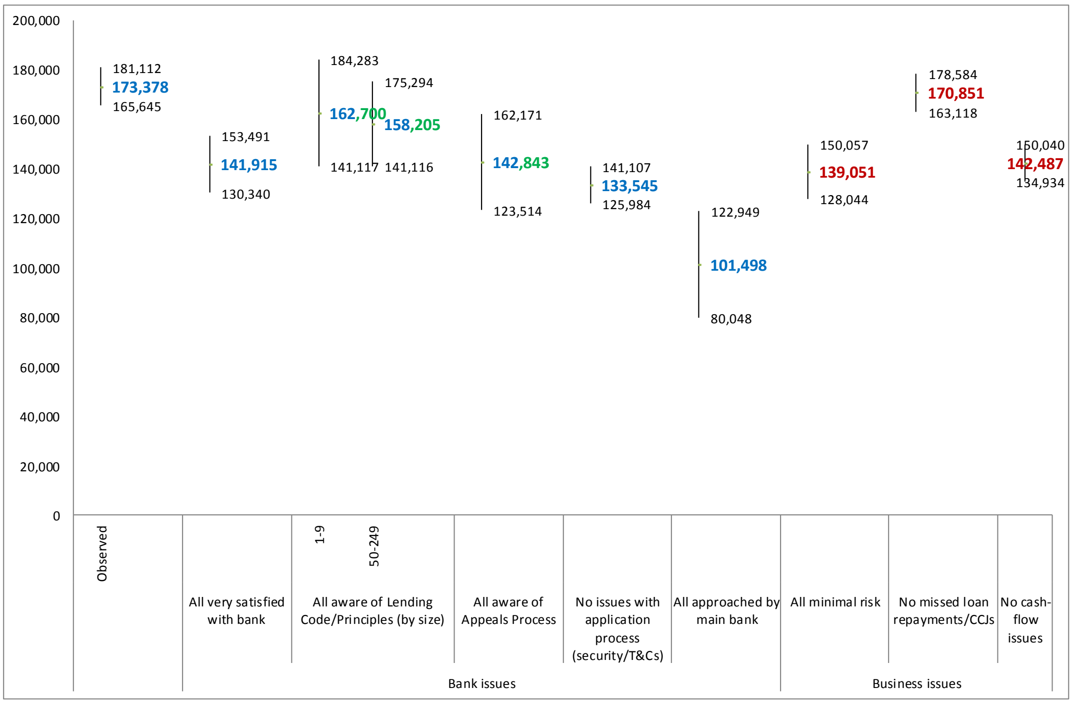
[52] In Q4 2012 the question for 'Would-be seekers' was changed from: 'Would you say that you would like to have an overdraft / loan facility for the business, even though you haven't applied for one?' to 'Has anything stopped you applying for an overdraft / loan, or was it simply that you felt that the business did not need one?'

Impacts of addressing bank/business issues on number of DBs

Addressing the issue of discouragement would seem worthwhile given that the majority (3/5) of DBs might be suitable, or have some potential, for bank finance (subject to the caveat that this estimate is not based on banks’ own credit evaluation models/data). Accordingly, we conclude this chapter by looking at the extent to which the number of DBs might be reduced in different scenarios. In particular the objective is to identify how much discouragement might be reduced by addressing bank issues compared to reductions that might be achieved by addressing business related issues. Bank issues relate to dissatisfaction with service (which increases misperceptions of success probabilities) and issues with the application process e.g., perceived terms and conditions which raise perceived application costs. Awareness of the Lending Code/Principles and Appeals Process is considered a joint issue for banks and the British Business Bank (since raising awareness of support is part of its remit); there may also be a role here for business support groups to help communications (a point taken up in the next section). Business issues relate to factors such as financial delinquency and cash-flow issues which affect actual success probabilities.

In the following chart we look, on the left, at the ‘observed’ number of DBs (predicted by the model given the actual values of the explanatory variables). This provides a baseline for comparison with the different scenarios. To the right are predictions of the number of DBs if (respectively): all businesses are very satisfied with their bank; all businesses (in the 1-9 and 50-249 employee size bands) are aware of the Lending Code/Principles; all businesses are aware of the Appeals Process; no businesses report issues with the application process (perceived security requirements, terms and conditions, hassle and cost); and all businesses are approached by their main bank about borrowing requirements. In terms of business scenarios predictions are reported in instances where: all businesses are minimal risk; no businesses are financially delinquent (no missed loan repayments/CCJs); and no businesses have cash-flow issues (no overdraft excesses, no use of HMRC 'Time to Pay' scheme and no problems obtaining trade credit). These predictions make up 'full-way scenarios' (i.e., if the different bank/business issues are addressed completely).

Chart 13: Number of DBs in different scenarios ('full-way scenarios')



Sources: SMEFM 2011Q1/2-2013Q2
Estimates based on a population of just over 4.8m private sector SMEs.

- In the baseline setting ('real world' scenario) there are around 173,000 DBs.
- If all businesses were to become very satisfied with their main bank the number of DBs might fall to around 142,000.
- Increasing awareness rates of the Lending Code/Principles to 100% (amongst businesses with 1-9 and 50-249 employees respectively) might decrease the number of DBs to around 160,000 in each case.
- Increasing awareness rates of the Appeals Process to 100% would reduce the number of DBs to around 143,000.
- If all businesses were approached by their main bank about

borrowing requirements this would reduce the number of DBs to below 102,000.

- In terms of addressing business issues, if all businesses improved their credit rating to minimal risk the number of DBs would fall to around 139,000.
- Absent financially delinquency (no missed loan repayments/CCJs) there would be about 171,000 DBs.
- Finally, completely addressing cash-flow issues would reduce the number of DBs to about 142,000.

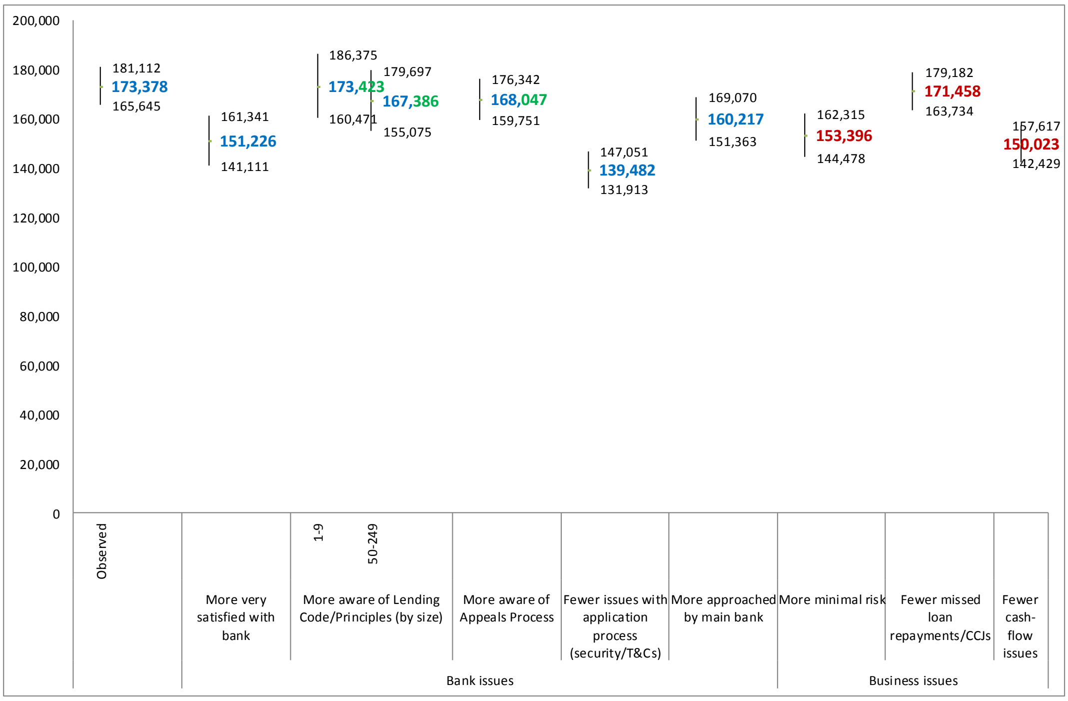
In these full-way scenarios collectively addressing all bank issues might reduce the number of DBs to around 50,000.[53] About 63% of these 123,000 additional applicants (i.e., around 77,000 businesses) might be suitable for bank finance based on an estimate from the model and data used in this report. Collectively addressing the business issues (lowering actual risk) might reduce the number of DBs to around 110,000. An estimated 75% of these 63,000 additional applicants (i.e., around 47,000 businesses) might be suitable for bank finance. The higher proportion of applicants with bank finance potential after addressing business issues reflects improvements in creditworthiness.

We also consider what the number of DBs might be in the following 'partway scenarios'. For bank issues this corresponds to: halving the percentage of less than very satisfied businesses (from 60% to 30%); doubling awareness rates of the Lending Code/Principles (from 13.5% to 27%); doubling awareness rates of the Appeals Process (from 13% to 26%); halving the percentage of businesses reporting issues with the application process; and doubling the percentage of businesses being approached about their borrowing requirements (from 10% to 20%). For business issues the partway scenarios entail: halving the percentage of businesses which have a greater than minimal risk credit rating (from 84%

[53] Note this figure requires a separate calculation because the reduction in the number of DBs in the collective/joint scenarios cannot be obtained by summing the reduction in the number of DBs in each individual scenario (since the variables in each scenario are non-linearly related to the probability of discouragement).

to 42%); halving the percentage of businesses with missed loan repayments/CCJs; and halving the percentage of businesses with cash-flow issues.

Chart 14: Number of DBs in different scenarios ('partway scenarios')



Sources: SMEFM 2011Q1/2-2013Q2

- A partway increase in the percentage of businesses which are very satisfied with their main bank might reduce the number of DBs to around 151,000.
- Doubling rates of awareness of the Lending Principles (among businesses with 50-249 employees) might lower the number of DBs to 167,000.
- Some reduction in businesses perceiving issues with the application process might reduce the number of DBs to 139,000.
- Doubling the number of businesses being approached about their borrowing requirements might lower the number of DBs to 160,000.

- A partway increase in the percentage of minimal risk businesses might lower the number of DBs to 153,000.
- Partly reducing incidences of cash-flow issues might lower the number of DBs to 150,000.

Collectively addressing all of the bank issues in the partway scenarios might lower the number of DBs to 109,000. Around 40,000 (63%) of the 64,000 additional applicants in this scenario might be suitable for bank finance. Similarly, addressing all the business issues in the partway scenarios might reduce the number of DBs to around 130,000 implying 43,000 additional applicants of which about 31,000 might be suitable for bank finance (given an estimated improvement in the application success rate to 73% in this partway scenario).

Since the data relates only to bank finance we do not know how (more) suitable any of the businesses examined might be for non-bank finance. This is an area worth investigating further in future research, with data involving both bank and non-bank finances, since it is important that businesses are being directed towards the most appropriate forms of finance given their circumstances. Also, the findings speak mainly to the indirectly discouraged given that they form the bulk of the DBs in the analysis (although, as noted previously, the model is robust to separate analyses of the indirectly/directly discouraged). However, again it would be worth taking a further look in future research at potential differences between the indirectly/directly discouraged in terms of their creditworthiness (perhaps using bank data for the directly discouraged).

In conclusion actions taken by both banks (including the British Business Bank) and businesses (with support) have the capacity to significantly reduce the number of DBs. Despite the apparently larger number of additional applications due to addressing bank issues, addressing business issues not only encourages more applications but, by improving creditworthiness, potentially improves success rates. A sensible strategy for encouraging businesses which might be suitable for bank finance back to borrowing would therefore seem to involve a balance of both improvements in banking practice as well as supporting debt/cash-flow management issues to improve the actual chances of making a successful application.

Conclusions

We now have a better understanding of the respective roles of perceived chances of loan application success versus perceived application costs underlying discouragement. Businesses (since the 2008 financial crisis) have tended to under-estimate their chances of making a successful application; and a key factor associated with this under-estimation is dissatisfaction with banking relationships. Smaller firms seem to be more overly pessimistic than larger firms about the outcome of loan applications. At the same time awareness of the Lending Code/Principles seems to improve perceptions at least amongst larger businesses. Also there are important business issues relating to debt and cash-flow management which affect discouragement by lowering actual success probabilities.

The key set of factors which increase perceived application costs relate to issues with the application process (e.g., perceived security requirements and terms/conditions of borrowing). On the other hand awareness of the Appeals Process seems to make applying for bank debt more worthwhile (lowering perceived application costs). Similarly an approach by the business's main bank about borrowing requirements encourages loan applications. Younger businesses perceive higher hurdles in the application process and may benefit from additional support in making applications.

Addressing the issue of discouragement may be worthwhile if businesses which are suitable for bank finance feel discouraged from applying for loans. In this respect the analysis shows that, whilst DBs are on average riskier than SMEs as a whole, based on estimates with the model/data in this report a little over 3 in every 5 DBs might be suitable for bank finance (i.e., might receive bank funding if they applied). In terms of addressing discouragement, scenario analysis suggests that fully addressing bank issues associated with discouragement (e.g., improving satisfaction rates, raising awareness of lending support initiatives and approaching businesses about borrowing requirements) might lower the number of DBs from 173,000 to 50,000 – about 77,000 (63%) of these additional prospective applicants might be suitable for bank finance. Fully addressing business related issues (e.g., improving debt/cash-flow management skills) might reduce the number of DBs to 110,000. Proportionately more of the additional prospective applicants in this case (around 75% or 47,000 businesses) might be suitable for bank finance due to the improvements in creditworthiness brought about by addressing debt/cash-flow management issues. A sensible strategy for encouraging more businesses, which are bank finance suitable, back to borrowing needs to address both bank and business issues.

3. WHY ARE THERE DISCOURAGED BORROWERS?

Insights from in-depth interviews with DBs

To provide deeper insights into the causes of discouragement, 25 depth interviews[54] were conducted (phone and face to face) with SMEs who had previously completed the SME Finance Monitor survey in 2013, and who had reported feeling discouraged from applying (8 case studies based on face to face interviews are reported in Appendix 2). The sample was structured by size and type of discouragement, with a mix of respondents by risk rating, sector, region, ethnicity and gender of owner/manager:

- 7 interviews with 0 employee SMEs (1 directly discouraged/3 indirectly discouraged from applying for an overdraft and 3 indirectly discouraged from applying for a loan)

[54] The number of depth interviews was chosen so as to balance the desire for robustness with time/budget constraints.

- 8 interviews with 1-9 employees (2 directly discouraged/3 indirectly discouraged from applying for an overdraft and 3 indirectly discouraged from applying for a loan)

- 10 interviews with 10-249 employees (4 directly discouraged/4 indirectly discouraged from applying for an overdraft and 2 indirectly discouraged from applying for a loan)

- 7 had a worse than average risk rating. 14 had an average or low risk rating (4 did not have a risk rating available).

- 15 were using external finance of some form, while 8 had more than £10,000 in borrowing. 16 held either nothing, or less than £5,000, in credit balances. 18 had a turnover of £500,000 or less.

- 6 SMEs were run by a woman, 2 by an ethnic minority.

The key objectives of the depth interviews were to develop an understanding of:

- Why the businesses are feeling discouraged?

- What could be done to make them feel less discouraged?

Key themes from the analysis

A number of themes emerged from the depth interviews:

Whether directly or indirectly discouraged now, all had an example of being refused lending / put off from applying which formed the basis of their current view of the bank…

Their discouragement is based on an attempt to get funding in the past, sometimes recent, sometimes a few years ago, or the way the bank responded to a short term need for funds (such as when a customer payment was delayed for a few days but the wages needed to be paid). Whilst they could also talk to some extent about their peers, who were experiencing similar issues, these *support* their own direct experiences which are pivotal to driving discouragement.

"*We haven't even attempted it in the last 3 years because I don't think they've got any money to give away. Plus they don't understand our business or our sector so I think they are frightened to get involved. So you give up"*

Case insights: Rejected, dissatisfied and discouraged

S runs a general haulage firm in East Anglia which she bought from the retiring owners 7 years ago. The first 4-5 years were really good, as the market was buoyant, enabling her to upgrade the fleet and pay a loan off. But last year they actually made a slight loss due to the downturn.

When they were going through this sticky patch she sought an overdraft facility. She really didn't think it would be an issue as she'd never defaulted on any of her previous loans plus the value of her house more than covered the facility. But she pretty much got a flat no:

"At the time, I kept on phoning but they wouldn't even agree to meet me. They just asked us to email over our records and said they'd look at it, then they'd email me back with a no, because we'd already got a loan. It was heartbreaking to be honest - we were only asking for £10,000 and have never defaulted on any payments."

It has left her feeling totally underwhelmed by her own banking, and under the impression that it would be pointless to try again:

"I've always been upset with the way I've been treated by the bank. They give you no advice, they never come and see you and all they are after is how much money they can make."

They then also talked about "banks aren't lending" more generally, but did not really identify how they knew this (other than their own direct experience and that of their peers).

The smallest businesses are different…

The very smallest businesses (such as a roofer, or a florist) are typically financially unsophisticated, unaware of the range of options available to them, or indeed of any initiatives that might help them (like mentors). They are focussed on keeping their business going / getting through a difficult trading period, and hoping that things will pick up. They do not have the time or inclination to review their options, many do not have business plans, they are simple operations and they focus on the day to day – running the business day to day comes ahead of sorting out the finances.

These businesses typically only want relatively small amounts of funding, and these were typically for day to day cash-flow or a small amount of improvement to the business. They may well not know how to present their case to the bank in the best way, and some are young businesses with no track record (the group most likely to be declined in the SMEFM data)

"I asked if there was any support or start-up funds, but I got a categorical NO. Because I failed on the credit checks as I had no accounts, they said come back in 12 months. So it was up to me to sink or swim."

"Now they ask too many questions, and do extra checks. If you're not on the electoral roll or your credit score is poor you've had it. They don't really look at how you operate - they could see that the account was fairly healthy, that we had a growing turnover of £200k and were not bouncing any cheques, but we were still turned down because of the credit rating."

There are SMEs who, rightly or wrongly, find it hard to access credit and therefore find themselves in a cycle that is difficult to break out of without some form of help or support: If they cannot get an overdraft initially because they are too new, they struggle to manage their cash flow, go overdrawn and get charged for it, juggle payments to suppliers / HMRC etc so never improve their credit rating, which means it is less likely they will get an overdraft in the future and so the cycle continues.

"Every month I get into problems with cash flow and the banks hit me for charges. It's a double whammy as they don't make the payments and they charge me. I'm fluid again by the end of the month, but then the charges come in and it knocks me over again. You end up working for the bank"

"If I'd had £5,000 more I could have made the shop bigger, and had more stock, which might have meant more traffic coming through. Whereas it was only half-full. If people see a small shop that's half empty, they think it's not worth coming in. I feel they've [the bank] done me up like a kipper - I wouldn't recommend them to anybody, because I think they got me into this mess."

Some of these SMEs probably should be discouraged from applying for borrowing, as the business would not be able to afford it, but for others a small facility would break the cycle and allow them to move forward.

For other SMEs the issue might be a short term one, or they may be more successful at juggling their finances:

- There may be a 'wobble' (late payment from a customer for example) at a particular point, perhaps as they are getting going, which impacts on cash flow and where they need some short term support to help them

- There were a number of examples of these businesses 'managing' the payments they make to suppliers to help their cash flow, and of using trade credit instead of bank finance, or they put the money in themselves, if they can. (For example they might delay paying their rent, put some stock on the credit card or cajole HMRC into allowing them to pay their VAT in instalments.)

- However, none had examples of help or advice that they had received from the bank to help them find the best ways of managing their finances

There were varying degrees of preparedness before approaching the bank. Some had plans, projections etc. others just took themselves. There were several instances where the business talked about ringing up to make an appointment, and going into the branch to discuss their borrowing requirements, and they spoke about this as quite a major 'event' for them –

they were taking this seriously but it seemed the bank less so (see comments on declines below).

Their view of banks is made up not just of any interaction about borrowing, but also their day to day relationship with the bank.

- Many felt that banks were just not interested in businesses of their size because they did not generate enough revenue, and a number of them described 'battles' with the bank on day to day issues (changing signatories on an account) as well as managing their account (a VAT bill that was bounced because the Direct Debit went out at 2am and the transfer to cover it was made at 7am, despite the payment only taking the account £200 over a secured overdraft limit of £25,000).

- There appears to be little contact with the bank unless the bank 'wants something', and no 'relationship' as such. They are often seen as fairly faceless, or pleasant enough but with little local autonomy or understanding of/interest in the business.

- Thus the image of the bank has built up over a longer time frame and from a wide range of events (predominantly things that have happened to them, or their immediate peers, rather than a wider perspective), and has led to a large degree of cynicism.

"I've always been upset with the way I've been treated by the bank. They give you no advice, they never come and see you and all they are after is how much money they can make. Whereas I found Lombard to be really nice (asset finance company)"

"They make a lot of money from me but don't give me anything back for it and when you need their help they are not there"

How larger SMEs differ…

The larger SMEs that BDRC Continental spoke to were typically more financially sophisticated, a bit more aware of the world around them, and typically looking for investment to help them grow and expand the business. They are more aware of options like crowd funding or venture capital.

They had typically approached the bank about their need for finance more positively - a chance to get investment for the business and see it expand and grow. They see themselves as a good risk and so are shaken when the bank either declines, or wants their house as security.

“*The attitude of the bank was that we were very high risk. We thought not, because money is going into the account regularly. They were very negative. It’s not a lot of money (£2,000) but they acted like we wanted £20,000*”

These businesses are more likely to have a Relationship Manager (RM), and some have a very good relationship with them, holding discussions about the business, sharing plans etc., but they are not seen as much help in these situations – the perception is that the RMs do not have the power to make decisions, ‘decision-making’ is all done on numbers and by computer, somewhere remote by someone they cannot talk to.

Getting knocked back for finance puts a dent in that relationship, and damages trust in the bank.

“An overdraft has been discussed several times, but he always says we’re too high risk, and never gives us any support or advice. He always just suggests we put more money in ourselves. Our bank manager used to be brilliant and help us, but since then there’s been lots of change. They have targets to meet, possibly too many clients, and are not friendly. He once said to us ‘You’re like a shop, you get almost instant money, so why do you need it?’”

“They like to pretend they know what’s going on but I don’t think they really understand the pressures. And for relationship mangers, they are not taking a lot of decisions. They seem to have to run backwards and forwards between their risk and lending departments, and not able to do much on their own.”

“We have a great working relationship with a couple of people we deal with on a day to day basis, but it’s always that case that if you ask for something big, these people have got no decision making capabilities at all. If you want anything of any size it gets referred to London and the computer makes a decision based on criteria we don’t necessarily fall into. So I think a lot of us have given up on talking to banks as regards finance for anything other than the basic stuff e.g. invoice discounting.”

For these businesses a decline means having to put plans on hold, turn down a contract, cut their cloth another way, and it is a dispiriting experience. They talk about the lack of customer service from the bank, and the facelessness of it, and compare this to VC or asset finance companies which are perceived as much keener for their business and easier to deal with (even if they are more expensive).

The way declines are handled makes a bad situation worse…

There were a range of examples of the bank not communicating its decision very well, which makes it even more dispiriting for the SME and affects future intentions:

- The small business that made an appointment, explained the sort of finance deal they were looking for over the phone, then when they went in was told that the bank did not offer such deals as a matter of policy (setting up a loan to reduce the overdraft to allow them extra cash flow to add a new product line) – “Why couldn’t they just have told me that over the phone?”
- Another small business went in for an appointment and 30 seconds into the interview ‘the computer says no’ – no explanation, or any suggestions for what to do next.

- A larger business told “we don’t lend to that sector” – a blanket approach when there is a wide range of types of business within the sector, with different levels of risk attached.
- Comments made around the decline that suggest the file has not been read thoroughly (“we don’t lend where the stock is fresh and has a limited life span” - but in fact that element was only 25% of the stock held).
- An overdraft removed overnight due to a change in policy.
- A request to ‘put it in writing’, then a terse rejection email or letter in response, with no chance to ask why the application was rejected or offer to provide further supporting evidence.

The key themes around previous rejections that emerge are:

- The bank not explaining why the decline has happened – it just appears that the ‘tap’ of funding has been switched off.
- The bank taking a very broad brush approach rather than seeming to focus on the specific business and its opportunities, or simply saying “those are the rules”.
- The bank hiding behind the computer or colleagues (“I’d say yes, but head office has said no”).
- The perception that the lending decision is all being done on computer models rather than an actual assessment of that business.
- The bank doing very little to offer alternatives (apart from invoice discounting) or suggest ways of being successful next time
- The bank wanting security – and for that to be a house not just a directors guarantee

“*I ended up pleading with them…. We put a substantial amount of money in and pay £30 a month for the privilege of having our money in there. We’ve given them no cause for concern so it lacks a bit of faith – you don’t feel valued. It feels like you are all chucked in the same bag – they should base their decisions on your track record, not tar you all with the same brush*”

The impression the bank has typically given is that it is not interested, does not care, and cannot be bothered – and it is this, possibly more than the actual decline, that cements the discouragement. If it's been a stressful, embarrassing and potentially humiliating process, why volunteer to go through that again?

Case insight: Issues with the application process

Mr KS runs a hotel and restaurant with 15 bedrooms in Northern Ireland. He has worked in consultancy in the hospitality sector, so has a long industry track record, and experience of dealing with many different banks.

He relates his recent borrowing experiences
"The minute you start talking to them you get asked 'well can we borrow against your house' and all that. So the banks might be saying 'nobody is asking for the money' but that's because they do <u>so much</u> to put you off applying ... The enhanced capital requirements have discouraged lending, and I think they have to replenish their balance sheets."

He also feels there are problems with how they assess applications
"The profiling of the industry is very poor. They don't understand the differences between types of business model, they'll just say 'we're not lending to hospitality.' You all get lumped into one, from fish and chip shops to hotels, which are all totally different. It's just a blanket excuse that comes back."

He's come away from his bank experiences feeling disinclined to go to them to try and borrow again:
"It's left me reluctant. They are now almost a last resort because of their attitude. I feel that you are better doing it on your own, because they give you no inkling that they're interested in lending or helping."

It's both the hassle factor and the slim likelihood of success that has put him off, with his views also being fuelled by the press and colleagues:
"It might be worth the time and hassle if it was likely to come off, but the noises you hear from your peers and the media are that it's very difficult."

Awareness of lending support initiatives and perceptions of loan application success rates

The DBs interviewed also have very low awareness of the initiatives available to support them, and a deep cynicism of the Appeals Process or the current success rates for loan applications:

- There is very limited awareness of the Appeals Process. Once Appeals was explained to the interviewee there were mixed views – some would have taken the opportunity to apply (had they known of its existence), others thought it was all still 'within the bank' so would have made no difference to their decision not to apply. Also there was the feeling that you still would not be able to present your own case – there was still a 'faceless person' looking at it. It would just be another hurdle and then the answer would be no again. When told that 40% of appealed rejections were over-turned, some felt this made applying seem more worthwhile, while others thought that it simply showed the banks were making the wrong decisions in the first place.
- There is also limited awareness of mentoring support (from mentorsme.co.uk supported by Better Business Finance) and the Bank of England's, Funding for Lending Scheme (FLS) – and they were of little real immediate interest to the business anyway. Some did acknowledge that they could do/could have done with some help and advice at various stages in their business. However, they would want this advice to come from someone impartial, who has ideally stood in their shoes and not a 'bank person'.
- Success rates – there was lots of cynicism from the businesses when told actual success rates and a feeling that that banks were 'massaging the stats' to make themselves look good. All had guessed at a lower success rate and where we could convince them the 70% success rate figure was true there was surprise but also a feeling amongst some that this made them feel worse about their own decline.

Table 1: Why are there discouraged borrowers? A summary of insights from the depth interviews

Cause	Comments
The basis for current discouragement (direct or indirect) is often a refusal to lend in the past	Their discouragement is based on an attempt to get funding in the past, sometimes recent, sometimes a few years ago, or the way the bank responded to a short term need for funds (such as when a customer payment was delayed for a few days but the wages needed to be paid).
The way the decline was handled compounded the issue	There were many examples where the way the bank handled the decline made the experience worse, and so caused more discouragement subsequently. Being turned down feel like a personal slight and not something to risk lightly again
A more general "don't care" attitude supports discouragement	If the day to day service, causing niggles and frustration, makes it appear that the bank does not consider then SME to be important, then they will assume that the answer to any future lending would also be no
New businesses found it difficult to access finance	A lack of track record / credit rating and experience make the banks less likely to consider them and not all had business plans / accounts etc. to share with the bank
Many smaller businesses lack financial sophistication	They do not feel very confident in their approach, or understand how to present their case to the bank, or the best type of finance for their needs
Larger businesses felt the bank did not respond to their specific circumstances	Larger businesses are more confident in the deal they want to do, but can be left feeling that the bank had a "one size fits all" approach to a sector that was too broad to reflect their specific situation
Experience of peers supports but does not shape this view	Most had examples of other SMEs that had struggled to get finance, but this supported their existing view rather than creating it
There were few mentions of press/other media	There were some mentions of "banks aren't lending", but generally this group were unaware of specific media coverage

Conclusions

There are strong resonances between the findings of the econometric analysis and in-depth interviews. In particular:

- The under-estimation of success probabilities by DBs.
- The key role of issues relating to the quality of banking relationships in causing discouragement.
- The ancillary role of peers' borrowing experiences in causing discouragement.
- The apparently insignificant role of media coverage of bank lending.
- Issues with the application process including perceived security requirements.
- Lower confidence in applications amongst smaller businesses.
- Higher hurdles for younger businesses.
- The potential for awareness of the Appeals Process to make applying seem more worthwhile.
- The need for some businesses to receive support to improve their debt/cash-flow management skills.

A key additional insight from the depth interviews is that a major cause of dissatisfaction in banking relationships relates to badly handled previous rejections. In addition, consistent with the econometric analysis, is the lack of any clear distinction between the causes of direct/indirect discouragement – both have common roots/characteristics.

4. BACK TO BORROWING

Case insight: Back to Borrowing?

M and her partner S set up their day care and respite business in East Anglia 2 years ago. They support 35 'customers' of ages 19-50, as well as having a respite unit. Previously they worked for the council in nursing, and identified a gap in the market for their services, so the business has taken off and is slowly growing.

Her recent attempts to obtain finance have been unsuccessful. Earlier in the year they wanted to borrow £2,000 to set up an allotment group. There was a lot of 'umming' and 'aahing' from the bank, and eventually an offer, but at a ridiculously high interest rate.

"The attitude of the bank was that we were high risk. We thought not, because money is going into the account regularly. They were very negative. It's not a lot of money, but they acted like we wanted £20,000."

M also he had to go to the bank to ask for £12,000 so that she could pay staff wages because the council were late paying her invoice one month. She'd hoped it would be fairly straightforward as their turnover has increased, they have a good track record, and she only needed the money to tide her over for two days. But again it was a disappointing experience:

"I ended up pleading with them ... We put a substantial amount of money in, and pay £30 a month for the privilege of having our money in there. We've given them no cause for concern so it lacks a bit of faith. You don't feel valued. It feels like you are all chucked in the same bag. They should base their decisions on your track record, not tar you all with the same brush."

The impact of her dealings with the bank is that it's made her reluctant to go back to them for any further needs, as she really didn't like the experience, and they would now prefer to try and do things on their own.

"*I wouldn't try the banks again unless it was the last extreme. It's the fact you have to go and plead your case. It's not a nice thing to have to do – it's like they are doing you a massive favour."*

Our look at the arc of discouragement concludes by considering how DBs might be encouraged back to borrowing. On the evidence of the case insight above, changing current perceptions about bank finance will not be easy. A general perception among the businesses taking part in the depth interviews is that the bank has said no in the past and there is no reason to believe that this situation will have changed if they were to try again.

Having been turned down, businesses are unlikely to have then switched bank – there is a view that if one has said no so will the others, that they are 'all the same' and that you need to have an account for a year before they will consider lending. There was one example from the in-depth interviews where another bank agreed to lend but the cost of breaking the deal with the existing bank was too punitive. That said, if the economy picks up and businesses feel more secure, they might start seeking 'revenge' by moving.

There were a range of responses among the in-depth interviewees to being turned down for funding:

- Struggle on (possibly in the overdraft cycle described above) and hope things get better
- Inject personal funds
- Delay plans for expansion/refurbishment or doing them more slowly as cash-flow allows
- Voting with their feet as soon as they are in a position to move
- Exploring other financial options (asset finance, VC/angel finance, crowd-funding, invoice discounting)

"I think there's angel money about, and these guys have been loving it for the last few years. Because there's no money about from banks etc they can get a much better rate and more equity, because if you want to expand it's the only place to go."

What comes through from almost all of the in-depth interviews is that the businesses do not see the bank as a future source of help/finance – the bank has 'had its chance' and given the attitude they won't willingly go back there again. There is no point, it will take too long, and the answer will still be no, as they are not interested in businesses like theirs.

"I don't want to do that anymore, because you can't get what you want, and the payback is too expensive - getting the money is one thing, but paying it back is another ... There are lots of rules attached. I've given up on the idea."

There was no feeling from the businesses interviewed that they are waiting for the bank to change its attitude so that they can apply again. More the feeling that the bank has all the power, has made its position clear and so there is no point thinking about the bank as an option.

and convincing DBs that things are different is going to be difficult…

Their current view of the bank is built up from:

- Being declined in the past, but also *how* they were declined
- Their on-going relationship (or lack thereof) with the bank
- The day to day service niggles and frustrations that support a general feeling that the bank does not care about them
- The lack of positive advice or support being offered by the bank
- The alternatives that they have accessed
- The way they are doing business now, and the fact that they are managing (some better than others) without bank finance
- And *supported* by the experience of their peers, the lack of involvement of bank staff in local business groups etc.

The banks need to walk the walk, not just talk the talk…

Given the time over which current views of the bank have built up, and the fact that it is based on a range of experiences, not just a single event, it is not going to be easy to change perceptions. An equal barrier is getting the message *seen* by this audience – awareness of existing initiatives is low, even amongst those with an appetite for finance.

A PR campaign (if seen) is unlikely to be successful on its own – it is likely to be seen as the banks presenting figures in a certain way to make themselves look good, and it does not chime with the experiences they have had. Instead, the change in attitude needs to be delivered day to day, on the ground, through the staff and the way they deal with customers, so that they can *see* something different, not just read about it.

"They shouldn't be so distant. You want a friendly face a personal service, to feel valued. The last time our account manager came out, she held the door handle with her coat as if she was going to catch a disease!"

"The relationship managers should be much more positive about their products, coming to us and saying 'What are your expansion plans? Well here's what we can do', i.e. being proactive rather than negative. If I acted like the banks I'd be out of business. If someone came into the bar saying they were thirsty, I'd say 'would you like a drink?' - We're there to serve. I think they've forgotten that. You need to be treated like a customer, not a beggar."

There is also a role for the Business Groups to help SMEs become aware of the help and support available, mentors, the Appeals Process, and how to present the best case to the bank.

"Banks used to be the mainstays of Chambers of Commerce, but now won't pay to be members. It's ridiculous, because that's how local relationships are made. The FSB are quite active and can be a good source of networking too, and a good way to get information out there.

That’s where you get those water cooler moments.”

There is also uncertainty, post financial crisis, about what is the new normal for business lending:

- This uncertainty is compounded by tight conditions, costs rising, no wage increases, the issue of the ‘squeezed middle’ etc.
- *Is* austerity ending? There are mixed signals in the press and from commentators
- The lending ‘tap’ might be back on, but it’s not ‘gushing’ – what are the new lending rules? Do bank staff know, let along customers
- It is likely that more people will decide to manage without finance (and this is a trend seen in the SMEFM data), and while the economic recovery remains uncertain this view is unlikely to change.
- Perhaps there also needs to be a cultural shift about what failure means – in the US it is a sign of someone trying and they will do better next time, but not in the UK:

“Here we are sniffy and jealous about success in others. And in the US, there’s the attitude that if you haven’t failed, you probably haven’t been pushing the envelope, whereas here, if you fail it’s almost impossible to get any further support. They keep talking about encouraging start-ups, but then say ‘God, whatever you do, don’t fail.’”

If the banks could identify those they would be prepared to lend to, then contacted them directly, to have a sensible conversation about the business and its ambitions, this would probably be welcome by businesses as long as the member of staff could convince the customer they were serious.

Where lending is declined, this needs to be handled better, with the staff member taking responsibility for the decision and explaining as

far as they can why it has been declined and what the alternatives are. RMs have gone from a pre-financial crisis climate where they typically said yes, to one where they have typically said no, and they need to be able to do this effectively, and understand what the current rules and policies are.

Table 2: Issues in encouraging DBs back to borrowing. Depth interview evidence

Issue	Comments
It's going to be very difficult to encourage them back to borrowing	Almost all had held their view of the bank for some time, and seen it 'supported' in the way the bank dealt with them day to day, the way their peers were treated etc.
They have found ways round the bank	Many have got themselves into a position now where they don't need bank finance, or can manage without it, and they don't want to go through a difficult and demoralizing process again
Low awareness of initiatives	Very few were aware of any of the initiatives discussed (such as appeals and FLS) and many were cynical about them and the figures quoted (stats can say anything you want them to), although some did "pause for thought"
The wider bank relationship needs work	If the bank appears keen to help and support the SME day to day, then messages around lending have more potential credibility
What is the "new normal" for business lending?	SMEs unsure about the current economic climate, whether the banks are lending, and what the new rules are – uncertainty that will affect appetite for finance
Business groups and other voices	The SMEs need help to become aware of initiatives and support available to them, if they are to start to change their perceptions

Recommendations

What then might be done to encourage creditworthy businesses back to borrowing? The in-depth interviews with DBs highlight the potential difficulties of this task. Standing further back from the problem, the econometric analysis shows that **reducing the number of DBs requires addressing both bank related issues (e.g., improving satisfaction**

rates[55]/handling of rejections and approaching more businesses about their borrowing requirements) and business related issues (improving businesses' creditworthiness so that their applications have a greater chance of success). Whilst addressing bank related issues seems to make a bigger contribution to reducing the number of DBs, addressing business related issues has the double benefit of not only encouraging more applications but improving the quality of applications (so that a greater proportion of applications are likely to be successful).

The principal recommendations of this report centre on increasing effort and/or raising awareness in relation to existing policies/measures since the research indicates that these actions can significantly reduce the number of DBs. Indeed, it would be inefficient to make 'new' recommendations that simply duplicate, or overlap with, existing measures. It is also possible that the number of DBs may fall without any intervention as confidence in the economy returns and perceptions improve. However, in this respect, the report highlights ongoing issues with business confidence that may take a while to resolve so we cannot be certain how quickly, or to what level, the number of DBs would fall if left alone.

Regarding existing initiatives, the Business Finance Taskforce, now operating under the auspices of Better Business Finance, has already undertaken a number of steps in recent years to help re-build trust with customers and improve communications following the financial crisis. Of particular relevance in the context of improving satisfaction in banking relationships is the introduction of measures designed to deliver better service standards to SME customers. This includes:

- A Lending Code for Micro-Enterprises (sales less than €2m and less than 10 employees): This code includes requirements for subscribers to provide businesses with clear feedback, when loan

[55] The vast majority of SMES are either very satisfied (around 40%) or fairly satisfied (around 41%) with their main bank; only around 11% are not very satisfied/not at all satisfied. However among DBs satisfaction rates are lower: around 11% are very satisfied with their main bank; 38% are fairly satisfied; and over 35% are not very satisfied/not at all satisfied (SME Finance Monitor op. cit.)

requests are refused, about the reasons for rejection and providing the business with support in finding alternative sources of funding and advice. Also participating banks are required to deal sympathetically and positively with the customer's financial difficulties.

- Lending Principles for Medium-Sized and Larger Businesses (sales less than £25m but excluding businesses covered by the Lending Code): These principles set out minimum standards of service that businesses can expect when applying for loans. Again this includes providing clear feedback on reasons for rejection, signposting to alternative sources of finance if appropriate and dealing sympathetically with customers in financial difficulties.

However it would seem, on the basis of both the quantitative and qualitative research in this report that more could be done to ensure these measures are being implemented consistently and effectively. For example many of the businesses that took part in the in-depth interviews were unclear as to why they had been rejected and none had examples of help or advice that they had received from the bank to help them subsequently. Therefore to improve satisfaction rates:

R1. Banks should take steps to ensure the Lending Code/Principles are implemented more consistently and effectively.

There are also issues to do with lack of awareness among businesses of the Lending Code/Principles – fewer than 1 in 5 businesses are aware ofthese initiatives[56]. Increased awareness may raise expectations about the standard of service the business is entitled to and consequently improve perceptions. Indeed this view is supported by the econometric analysis which shows that raising awareness of the Lending Code/Principles reduces misperceptions and alleviates discouragement. Business support groups, as a 'trusted voice', also have a role in helping to improve communications with businesses about the available support.

[56] SME Finance Monitor op. cit.

R2. Banks, the British Business Bank and business support groups should seek to raise awareness of the Lending Code/Principles.

The econometric analysis also showed that increased awareness of the Appeals Process significantly reduces perceived application costs thereby encouraging more applications.[57] It seems more worthwhile applying if the business knows that an initial rejection need not be the end of the story:

"It [Appeals Process] gives you a bit of hope and encouragement. Maybe they can give you a bit of advice, because you may have missed things."

However, again the issue is lack of awareness of the scheme. Indeed rates of awareness of the Appeals Process, at around 12% of SMEs[58], are even lower than for other lending support initiatives.

R3. Banks, the British Business Bank and business support groups should seek to raise awareness of the Appeals Process.

Businesses would also benefit from increased awareness of their credit health. This follows from findings of misperceptions and issues, such as low debt/cash-flow management skills, which reduce the actual chances of making a successful application. Raising businesses' awareness of their credit health might be achieved by providing free access to an online credit health check portal. For those diagnosed with credit health issues, the portal could be designed so as to signpost the business towards help depending on the particular issues flagged up by the credit health check. At the same time those identified as being more suitable for non-bank finances might be signposted to alternative sources.

[57] Establishing a transparent appeals process, which allows businesses to make a formal appeal if their loan application is turned down, was another key commitment made by Business Finance Taskforce/Better Business Finance to help improve customer relationships. Since the Appeals Process came into effect in April 2011 over 7,000 businesses have made an appeal and over 2,700 (38.5%) have had the decision to deny their loan application overturned (see Banking Taskforce Appeals Process, Independent External Reviewer, Quarterly Review Period to End September 2013).

[58] SME Finance Monitor op. cit.

Whilst there are already websites run by credit reference agencies which allow businesses to check their credit reports/scores (for a fee), in developing the portal suggested here there would need to be collaboration between the British Business Bank, banks, credit reference agencies, business support groups and alternative finance providers to address issues relating to subsidised access, the underlying credit score model, data requirements and signposting to advice/alternative sources of finance. Also, the portal would need to be designed so that the credit scores for businesses using the portal are not penalised simply for making credit health checks (since the number of credit checks is typically one of the variables used in scoring models):

R4. The British Business Bank, assisted by banks, credit reference agencies, business support groups and alternative finance providers should consider forming a working group to explore how they can: i) enhance businesses awareness of their credit health and provide support for improving credit health; and ii) help businesses find alternative providers of finance where this is more appropriate.

It is well known that smaller and younger businesses experience greater barriers to finance. In part this is due to the riskier nature of businesses which may still be navigating the 'death-valley' of low or negative cash-flows; lack a track record and/or enough collateral to offer banks; and/or which might simply close as quickly as they opened. It would therefore be expected that amongst the businesses receiving support/advice under the previous recommendations there will be a disproportionate number of smaller/younger businesses.

However, over and above issues of increased actual risk, the analysis in this report suggests that smaller businesses are particularly lacking in confidence in their loan applications (they have higher misperceptions about their chances of making a successful application) and that younger businesses find applying for loans more difficult (they have higher perceived application costs). Again many of these issues may be dealt with as part of the support/advice package received under the previous recommendations. Nonetheless there would seem to be a particular role in increasing awareness/take-up of Start-up Loans, which offers both financial assistance (up to £25,000) and mentoring (in particular help with making loan applications/business planning) to smaller/younger businesses.

R5. The British Business Bank and business support groups should seek to raise awareness/take-up of support from the Start-Up Loans Company.

The econometric and qualitative analyses also highlight discouragement due to issues with the application process; in particular issues with perceived security requirements/terms and conditions of borrowing put businesses off applying.

"We are very profitable, but if we need to borrow £300,000-400,000, they'll immediately say 'what can we have as a guarantee against it? But having built up the business by putting any money we've got back in, all of the properties and anything we have is already signed up against other loans, so we have no more capital to sign over."

We are unable to assess whether it was appropriate in this case for the bank to ask for more security. However, the Lending Code makes provision that lenders when asking for security should communicate transparently the reasons why it is needed and what is required in writing. This may be another area where better implementation of the Lending Code might help to reduce discouragement (see R1).

Whilst better communications may help to make security requirements less off-putting where more security is available, what about viable businesses who are put-off applying simply because they lack enough security to offer the bank? It is the role of the Enterprise Finance Guarantee to help encourage creditworthy businesses in these circumstances.

However again a key issue is lack of awareness – fewer than 1 in 4 businesses know about the Enterprise Finance Guarantee[59]:

R6. The British Business Bank and business support groups should seek to raise awareness/take-up of the Enterprise Finance Guarantee.

At the same time a comment made by banks is that businesses which seek loans under the Enterprise Finance Guarantee are often unaware that the bank is permitted to ask for security on these loans including personal guarantees (but excluding a charge over a principal private residence). In this respect, businesses should not see the Enterprise Finance Guarantee as a means of cordoning off personal assets from consideration as security. The British Business Bank should, at the same time as raising awareness of the Enterprise Finance Guarantee, communicate clearly the permissible security requirements under the scheme. This might lead to less surprise and consequently be less off putting for the business when/if the bank does make a request for personal security.

Perhaps surprisingly there has been no mention of a role for the Funding for Lending Scheme (FLS) in alleviating discouragement. It might have been expected that FLS would reduce the perceived costs of borrowing thereby encouraging more businesses to apply for loans. However the evidence from the econometric analysis is that awareness of FLS has no effect on businesses decisions to apply for loans. Rightly or wrongly some businesses have a perception that the scheme will provide them with little benefit:

"I didn't imagine it [FLS] working, because I think the bank would keep the extra money to strengthen their position. Because of the mess they made they are underfunded, so probably want to just build up their reserves."

[59] Whilst, in the econometric model, the effect of awareness of the EFG on perceived application costs falls below conventional levels of statistical significance, this recommendation is based on a joint reading of the findings from the econometric analysis and in-depth interviews regarding the off-putting nature of security requirements.

This view is consistent with FLS's apparent lack of success so far in raising aggregate lending to SMEs. However this situation may change in the future following the Bank of England's decision to refocus FLS to support business lending rather than mortgage lending[60].

Conclusions

What have we learned about DBs in this report? The report has gone beyond a simple understanding of who DBs are (i.e., smaller, younger and riskier businesses) to develop insights into the mechanisms underlying discouragement. That is, we now have a better understanding of the answer to the question: 'why are there DBs?' In this respect we have learned that DBs are especially prone to misperceptions – they significantly under-estimate their actual likelihood of making a successful loan application – and they face higher perceived loan application costs compared to other businesses.

We have also discovered that dissatisfaction with banking relationships, which the in-depth interviews suggest may be due to badly handled previous rejections, is the main reason for businesses under-estimating their chances of obtaining a loan. On the other hand, awareness of the Lending Code/Principles helps to improve perceptions possibly by raising businesses' expectations about the level of service they are entitled to if they apply for a loan. Media coverage of bank lending seems to have little impact on misperceptions.

Regarding application costs, perceived security requirements and terms/conditions of borrowing are seriously off-putting and significantly increase the likelihood of discouragement. On the other hand proactive banking (approaching businesses about borrowing requirements) has a significant positive effect in encouraging businesses to apply for funding. Also awareness of the Appeals Process lowers perceived application costs

[60] See 'Bank of England and HM Treasury re-focus the Funding for Lending Scheme to support business lending in 2014' http://www.bankofengland.co.uk/publications/Pages/news/2013/177.aspx

– it seems more worthwhile applying if the business is aware that an initial rejection need not be the end of the story. Evidence from the in-depth interviews suggests that uncertainty surrounding the new 'norms' for bank lending after the financial crisis represents another significant obstacle back to borrowing.

The report has also made several recommendations regarding actions for stakeholders, principally the banks, British Business Bank and businesses themselves (with support from business groups), that may help encourage more businesses, which are suitable for bank finance, back to borrowing. It is also recognised that some viable DBs, which are unsuitable for bank finance, may require help to find alternative finances.

In this respect, further research is needed into the potential suitability of DBs for non-bank finance; it is important that businesses are being directed to the most appropriate forms of finance given their circumstances. Also it would be worth taking a further look in future research at potential differences between the indirectly/directly discouraged in terms of their creditworthiness (perhaps using bank data for the directly discouraged).

We conclude by noting that DBs may represent only the tip of the discouragement iceberg. The model presented in this report predicts the existence of a new group: 'discouraged non-borrowers (DNBs)'. DNBs may once have had capital demands but have slipped further away from borrowing over time as under-investment causes their productivity to fall. Preliminary estimates suggest there may be several DNBs for each DB we actually observe. However more research is required to directly verify the existence, extent and characteristics of DNBs.

APPENDIX 1: 'WHO ARE DISCOURAGED BORROWERS?'

Summary analysis of UKSMEF and SMEFM

The analysis in this appendix provides a look at the characteristics of discouraged borrowers to gauge the typical profile of these businesses. Discouraged borrowers are examined relative to two other principal groups:

- Businesses that have sought loans/overdrafts ('seekers')
- Businesses that say they have no need for loans/overdrafts ('non-seekers').

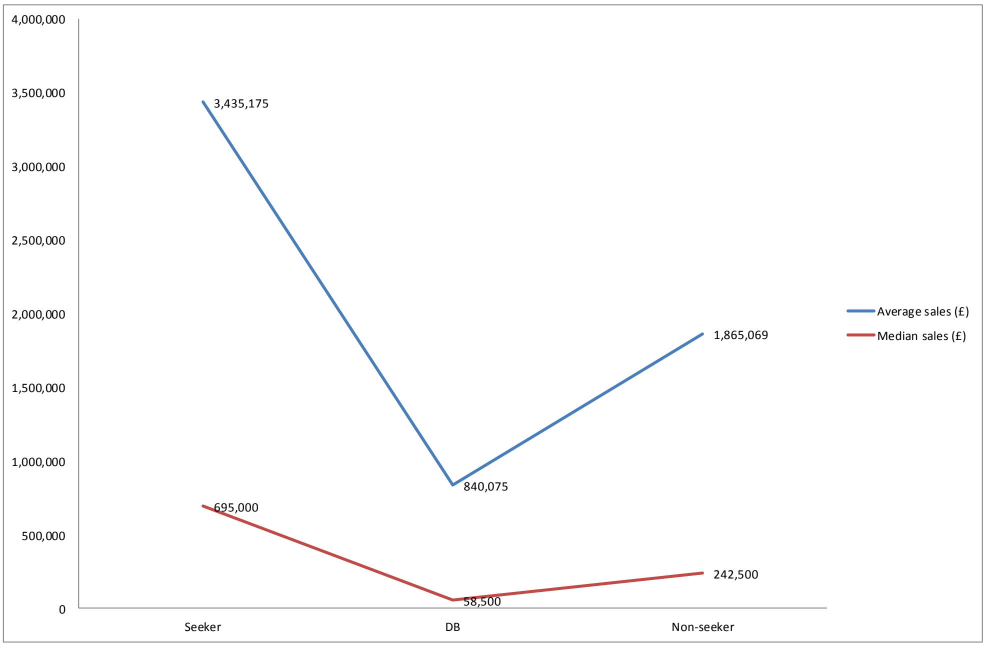
Discouraged borrowers and seekers form a group of businesses which have capital demands, fulfilled or otherwise. Previous research has highlighted there are significant differences in the characteristics of businesses with capital demands on the one hand and those of non-seekers on the other. US data suggests that businesses with capital demands are riskier, younger and have higher growth rates than non-seekers. The owners of businesses with capital demands are also younger and less experienced[61].

However, within businesses with capital demands, there are also significant differences in the profiles of discouraged borrowers relative to seekers. In particular DBs are riskier, younger and smaller businesses compared to seekers. Also the owners of DBs are less experienced, less wealthy and less likely to have a college degree than owners of seekers[62]. This provides the context for seeking to understand the profile of discouraged borrowers relative to other groups of business in the UK.

[61] Han et al 2009 op. cit.
[62] Han et al 2009 op. cit.

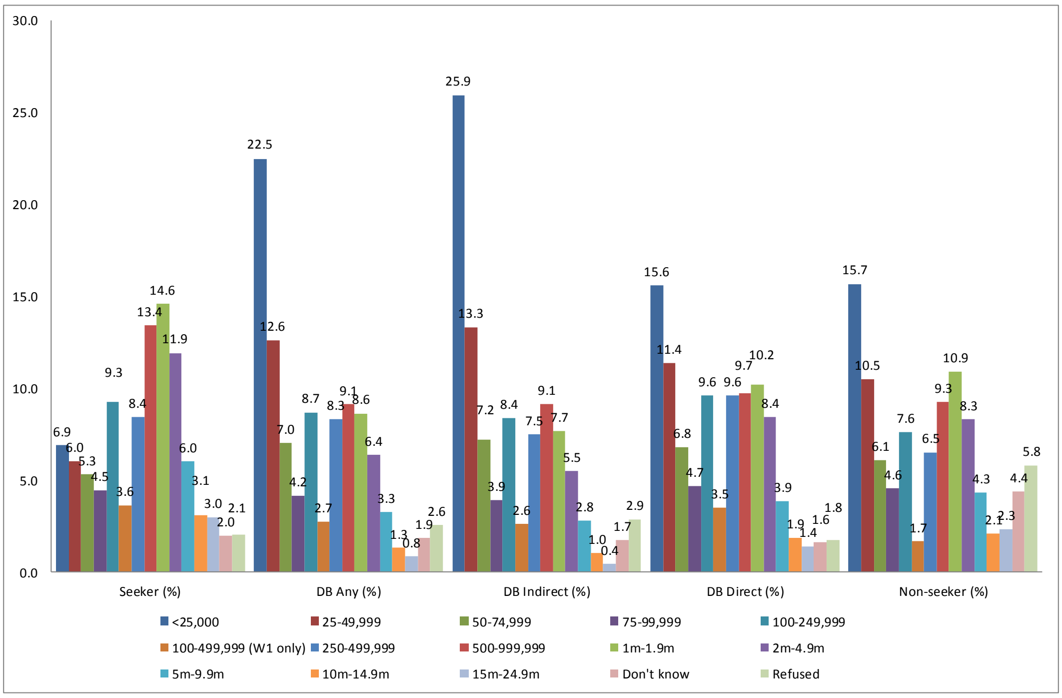
Business characteristics

Chart A1: Sales (£) by business type: UKSMEF



Source: UKSMEF 2004, 2008, 2009
Base: All businesses

Chart A2: Sales by business type: SMEFM



Source: SMEFM 2011Q1/2-2013Q2
Base: All businesses

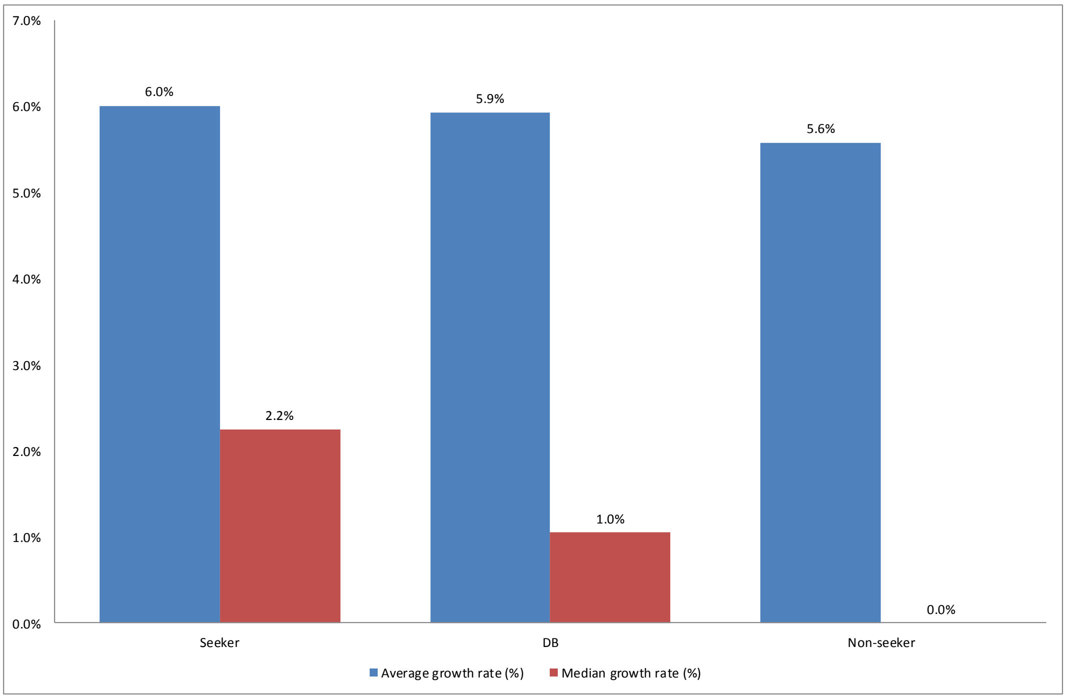
- UKSMEF data indicate that average DB sales are £840,000 which is lower than the average sales of seekers (£3.4m) and non-seekers (£1.9m).

- Significance tests indicate that DBs have significantly lower average sales compared to seekers (p=0.003), while there is no significant difference in the average sales of DBs and non-seekers (p=0.139).

- SMEFM data indicate that the majority (55%) of DBs have sales below £250,000. In contrast only 32% of seekers and 44% of non-seekers have sales below £250,000.

- These data also suggest the indirectly discouraged are smaller than the directly discouraged (59% of indirectly discouraged have sales below £250,000 versus only 48% of the directly discouraged: p=0.001).

Chart A3 Sales growth rate (%) by business type: UKSMEF

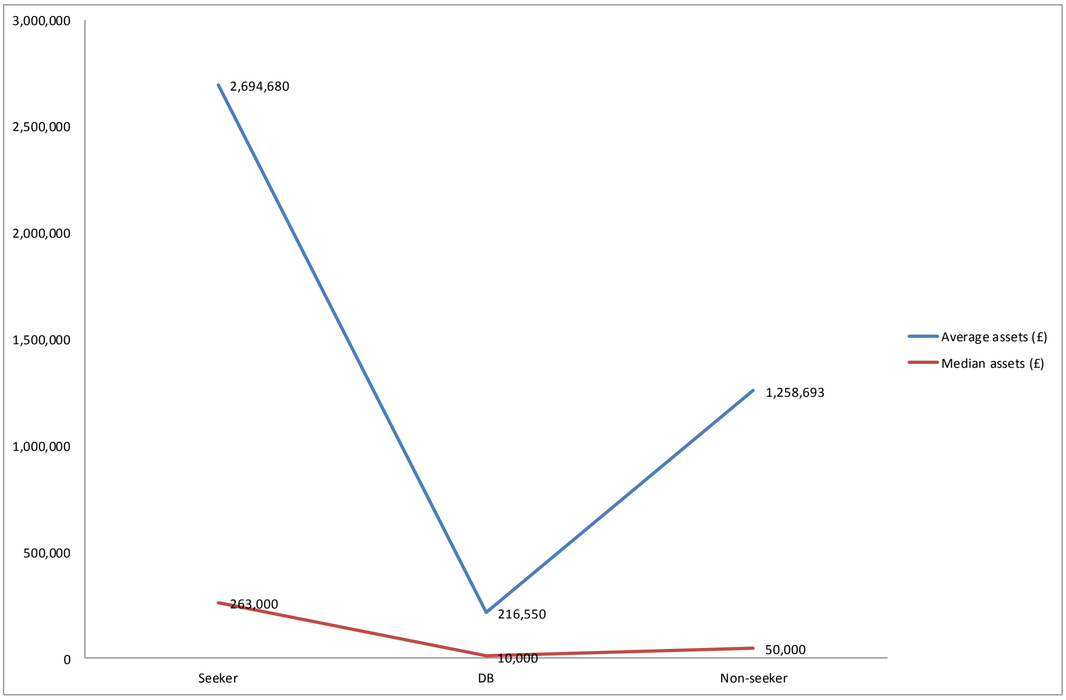


Source: UKSMEF 2004, 2008, 2009
Base: All businesses

- Seekers and DBs (i.e., businesses with capital demands) appear to have higher sales growth rates than non-seekers: around 6% per annum versus 5.6%.

- However these differences are not statistically significant.

Chart A4: Business assets (£) by business type: UKSMEF

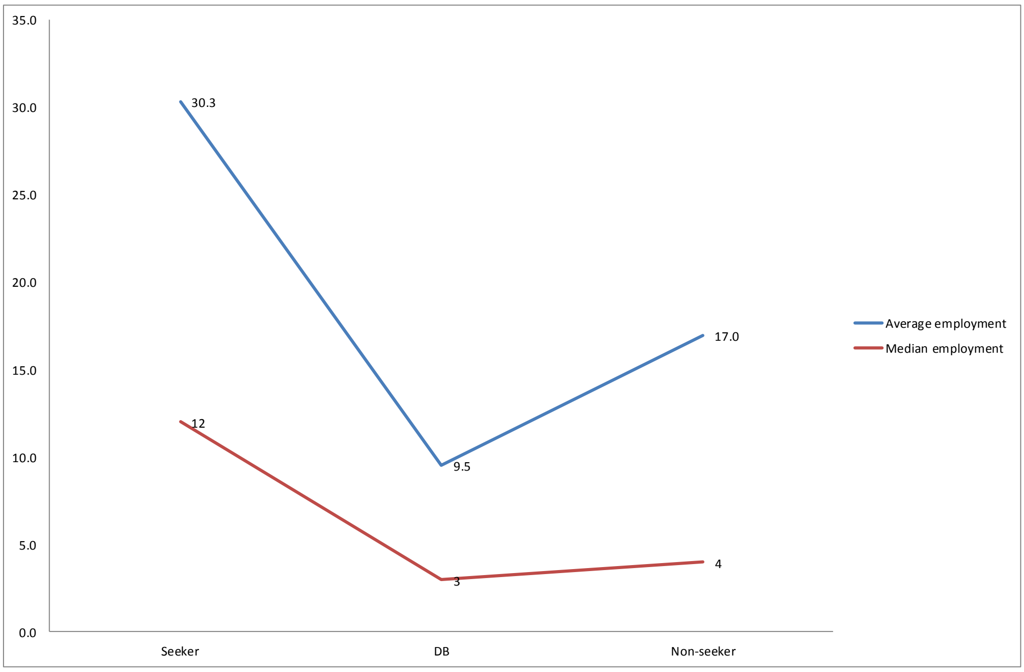


Source: UKSMEF 2004, 2008, 2009
Base: All businesses

- Average DB business assets are almost £217,000 compared with £2.7m (seekers) and £1.3m (non-seekers).

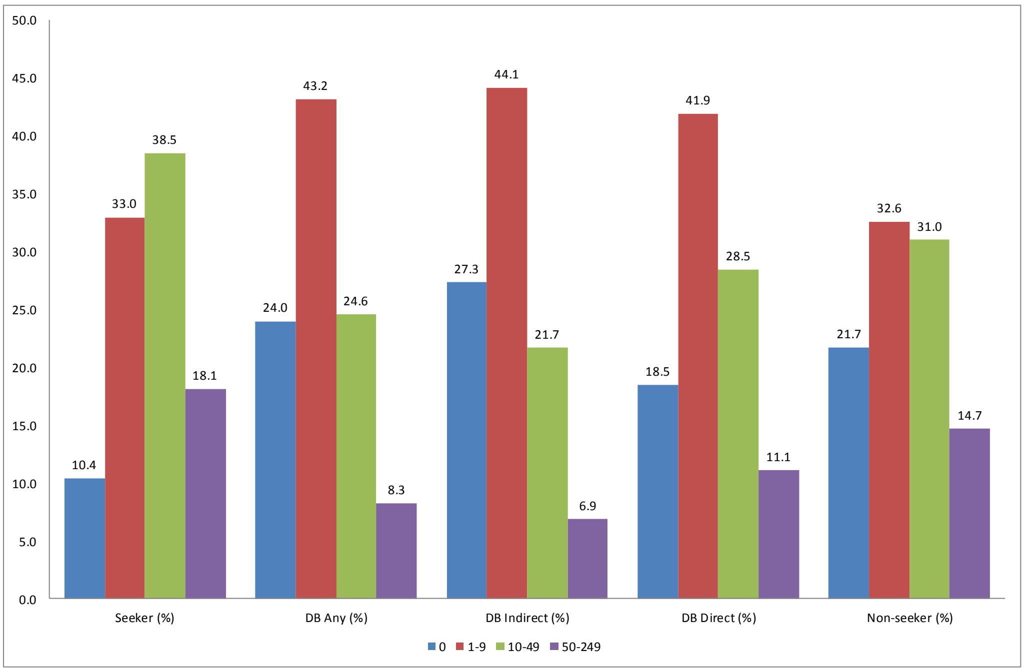
- Significance tests indicate that DBs have significantly lower average assets than seekers (*p*=0.037) while there is no significant difference in the average assets of DBs and non-seekers (*p*=0.303).

Chart A5: Employees by business type: UKSMEF



Source: UKSMEF 2004, 2008, 2009
Base: All businesses

Chart A6: Employees by business type: SMEFM



Source: SMEFM 2011Q1/2-2013Q2
Base: All businesses

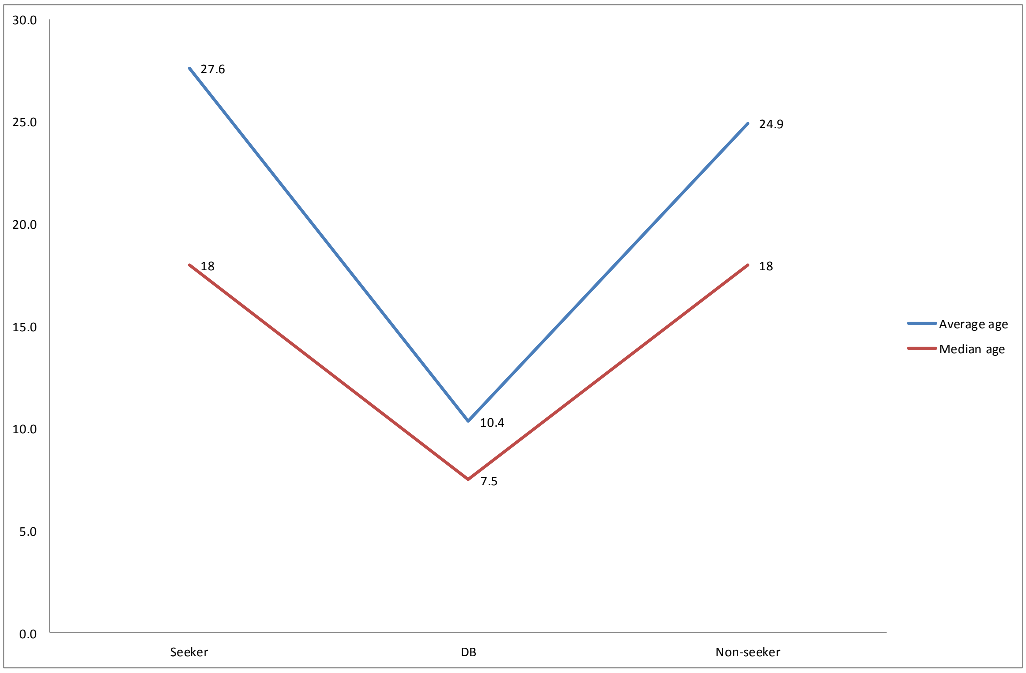
- UKSMEF data indicate average employment of about 10 employees amongst DBs compared with average employment of over 30 for seekers and 17 for non-seekers.

- Further analysis indicates that DBs have significantly fewer employees than both seekers (p=0.000) and non-seekers (p=0.000).

- SMEFM data indicates that two-thirds of DBs have fewer than 10 employees compared with only 44% of seekers and 54% of non-seekers.

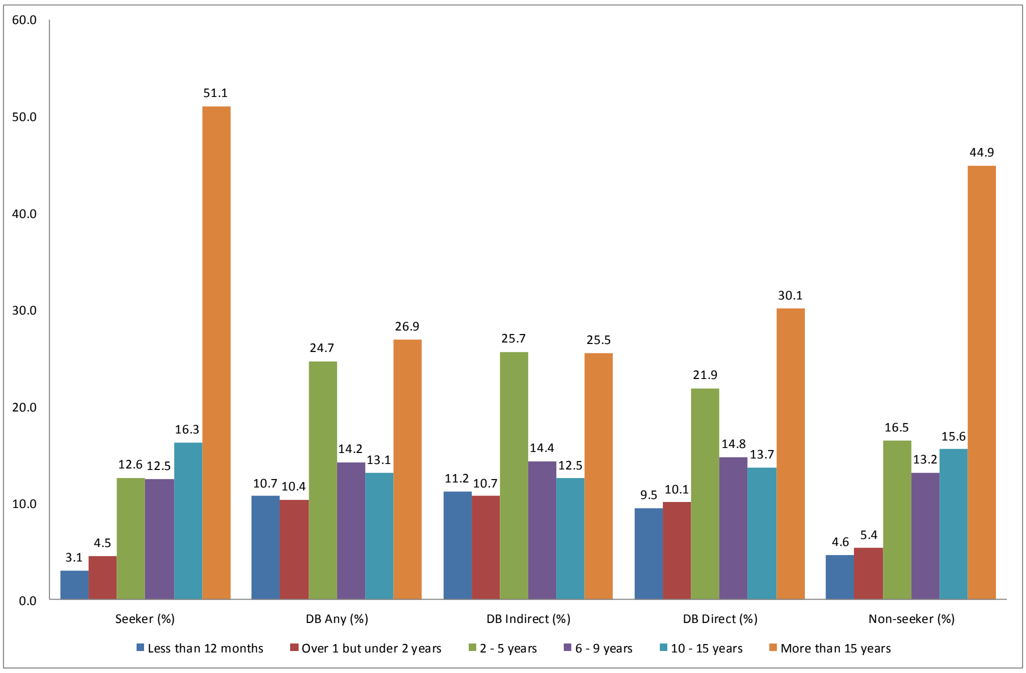
- 71% of the indirectly discouraged have fewer than 10 employees compared with only 60% of the directly discouraged (p=0.000) again suggesting that the indirectly discouraged businesses are smaller than the directly discouraged.

Chart A7: Business age by business type: UKSMEF



Source: UKSMEF 2004, 2008, 2009
Base: All businesses

Chart A8: Business age by business type: SMEFM



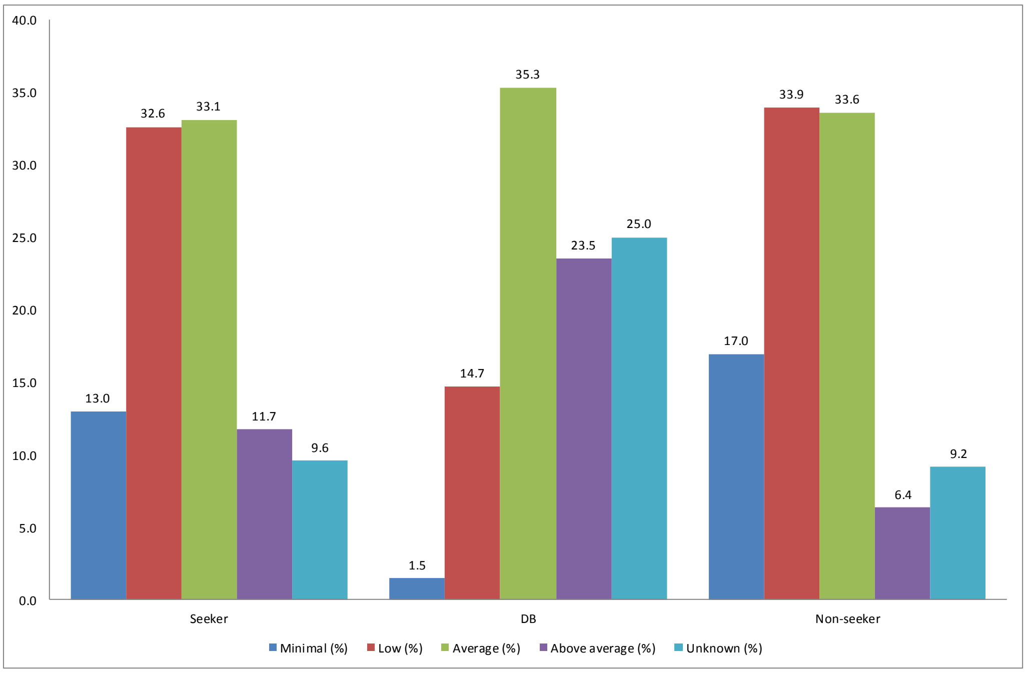
Source: SMEFM 2011Q1/2-2013Q2
Base: All businesses

- The average business age of DBs is just over 10 years. This is significantly lower than average age of seekers 27.6 years (*p*=0.000) and non-seekers 24.9 years (*p*=0.000) respectively.

- SMEFM data also points to the relative youth of DBs: 46% of DBs are aged 5 years or less compared with only 20% of seekers (*p*=0.000) and 26% of non-seekers (*p*=0.000).

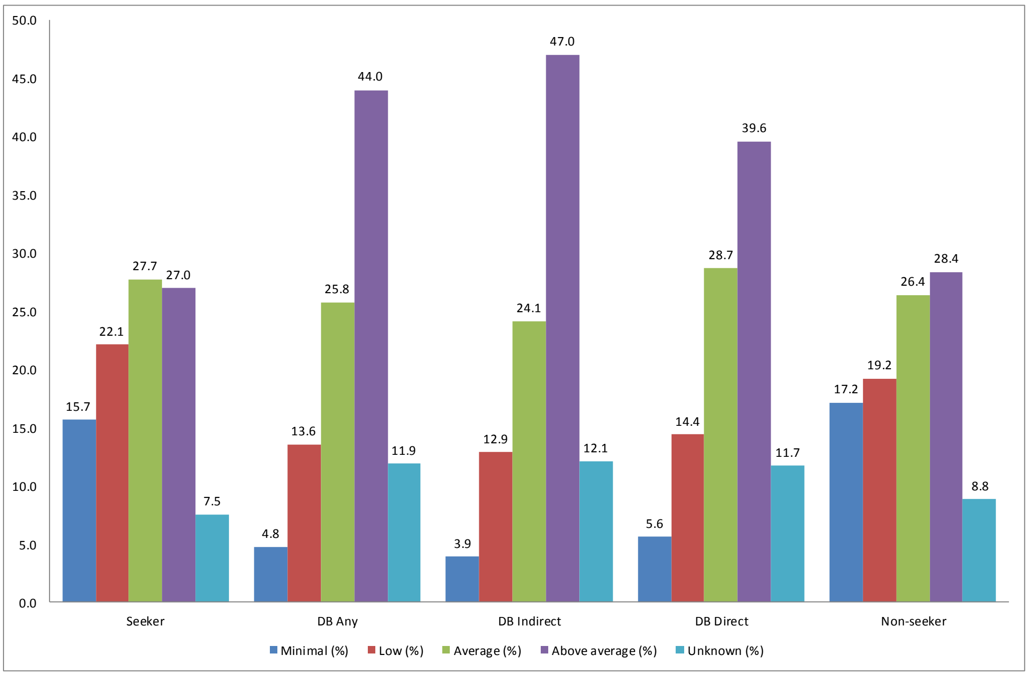
- Also a significantly higher proportion of the indirectly discouraged are aged less than 5 years (48%) compared to the directly discouraged (41%) (*p*=0.006).

Chart A9: Dun and Bradstreet credit ratings by business type: UKSMEF



Source: UKSMEF 2004, 2008, 2009
Base: All businesses

Chart A10: Dun and Bradstreet credit ratings by business type: SMEFM



Source: SMEFM 2011Q1/2-2013Q2
Base: All businesses

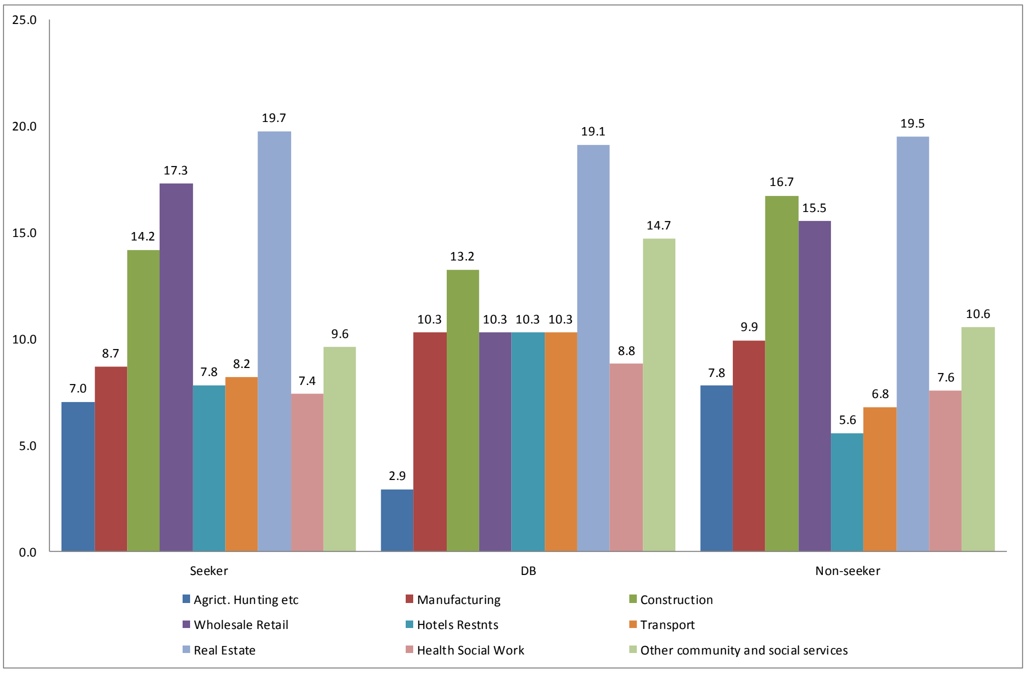
- Looking at UKSMEF data about 16% of DBs have below average (minimal or low) risk ratings.

- This is significantly lower (*p*=0.000) than the percentage of seekers and non-seekers with below average risk ratings (46% and 51% respectively).

- A similar story emerges from the SMEFM data: 18% of DBs have below average risk versus 38% of seekers and 36% of non-seekers (*p*=0.000).

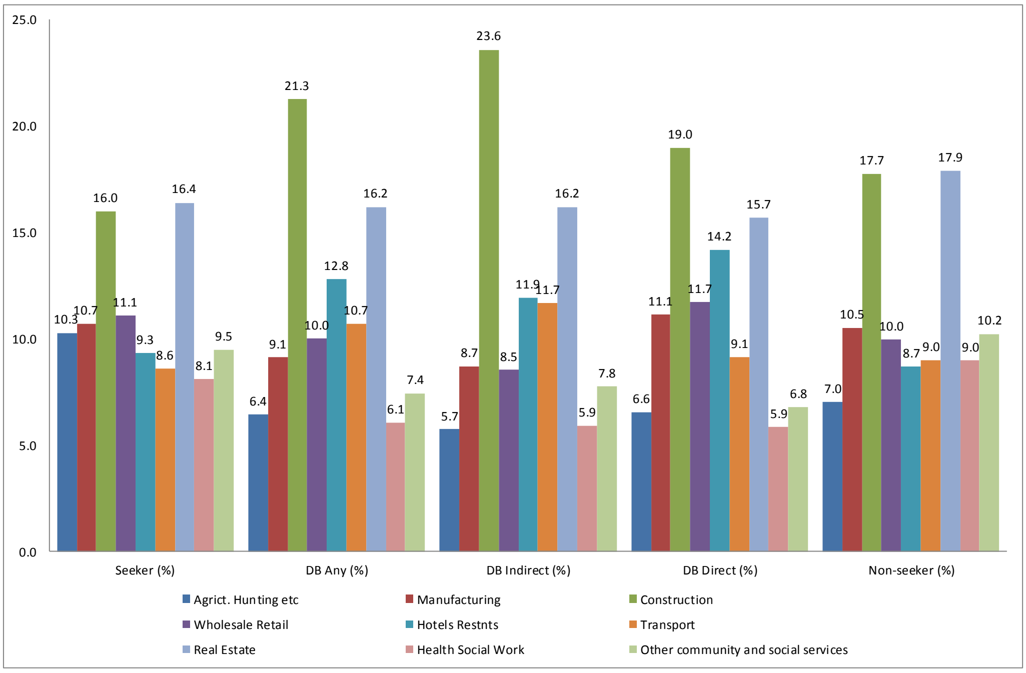
- Also around 17% of the indirectly discouraged have below average risk versus 20% of the directly discouraged (*p*=0.065). This suggests that the indirectly discouraged are slightly more risky.

Chart A11: Sector by business type: UKSMEF



Source: UKSMEF 2004, 2008, 2009
Base: All businesses

Chart A12 Sector by business type: SMEFM



Source: SMEFM 2011Q1/2-2013Q2
Base: All businesses

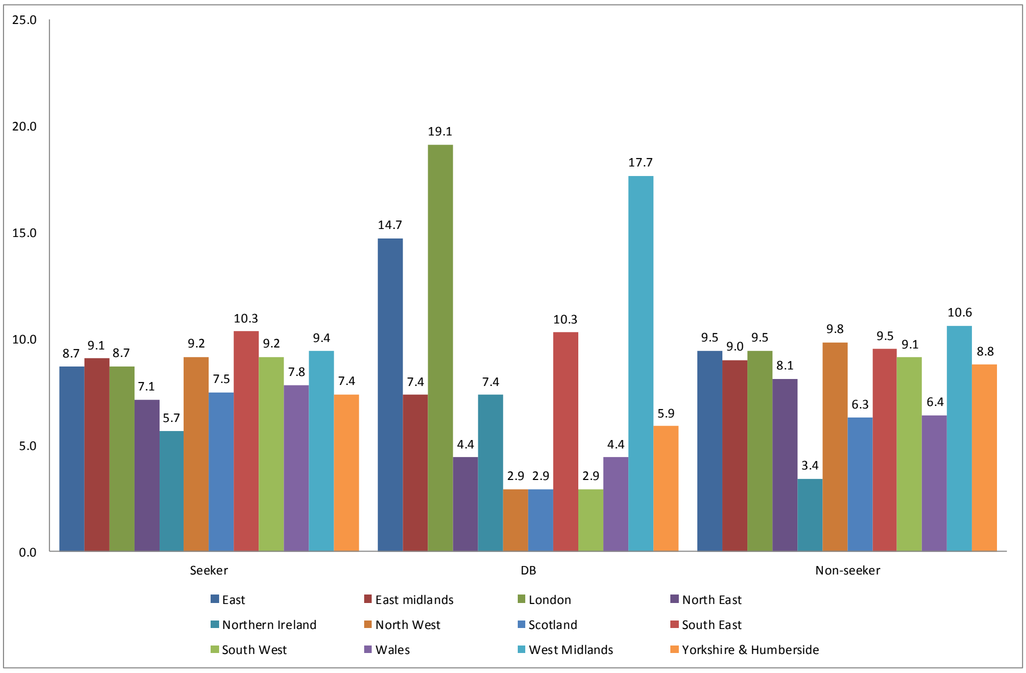
- Charts A11 and A12 look at how sectoral distributions differ across seekers, DBs and non-seekers.

- In the UKSMEF sample, businesses operating in 'real estate/business services' have the highest representation across all 3 groups. Indeed, around 19% of DBs operate in 'real estate/business services' (suggesting a DB would most likely belong to this sector).

- Looking at other sectors notably the proportion of 'other community and social service' businesses is higher amongst DBs compared to their representation amongst seekers and non-seekers. In other words DBs have a higher likelihood of belonging to this sector than seekers/non-seekers.

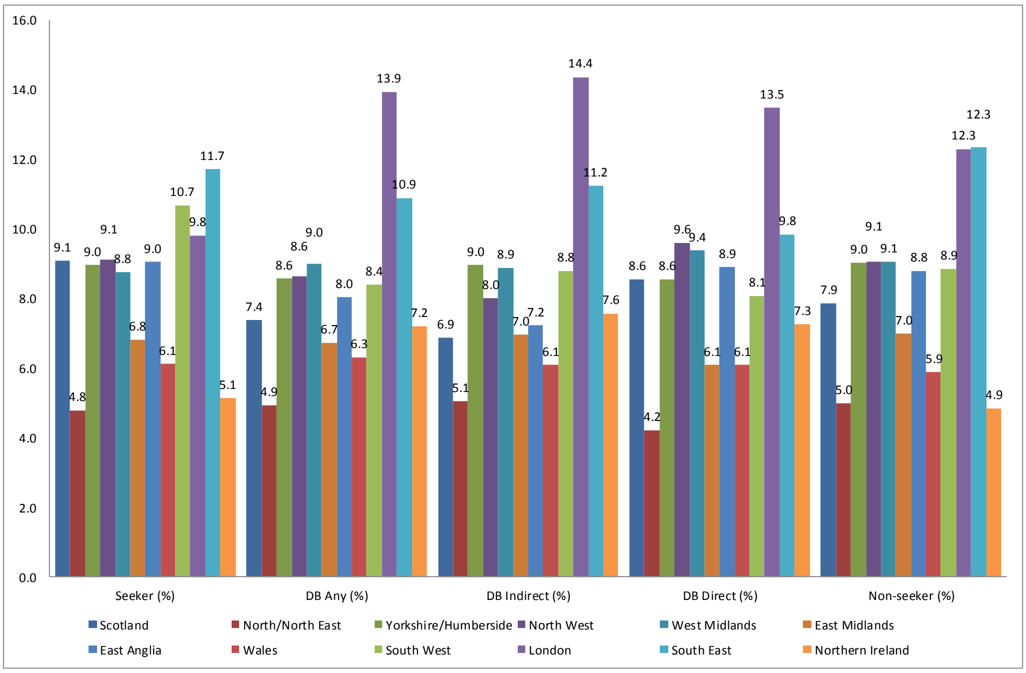
- In the SMEFM sample, construction businesses have the highest representation across the 3 groups. Indeed around 21% of DBs are construction businesses suggesting the typical DB in the SMEFM belong to this sector.

Chart A13: Region by business type: UKSMEF



Source: UKSMEF 2004, 2008, 2009
Base: All businesses

Chart A14: Region by business type: SMEFM

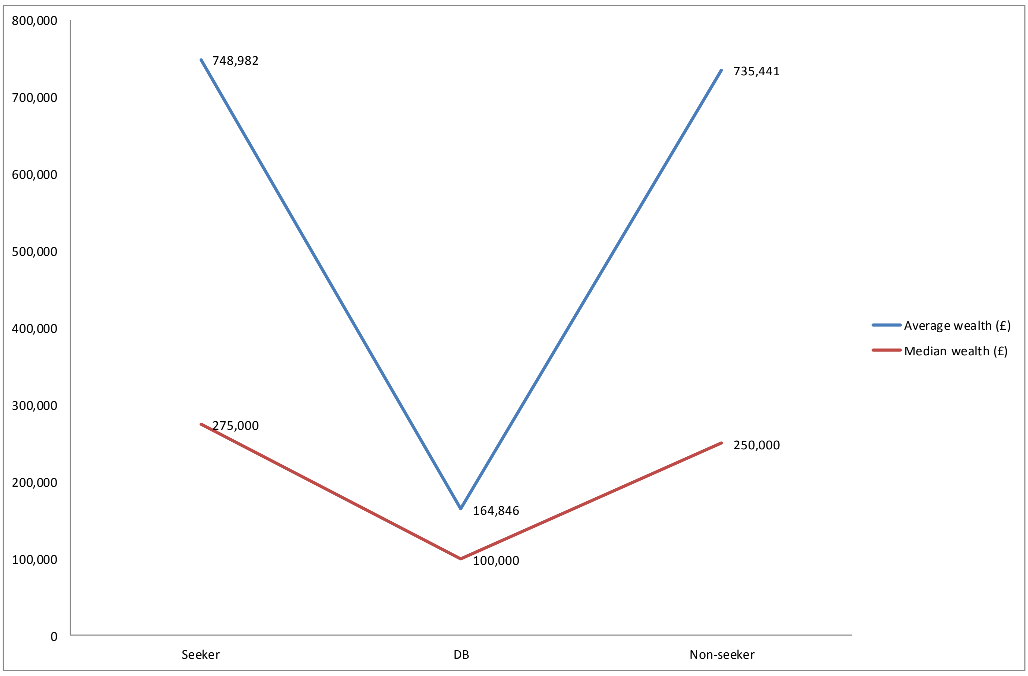


Source: SMEFM 2011Q1/2-2013Q2
Base: All businesses

- Charts A13 and A14 examine how regional distributions vary by seekers, DBs and non-seekers.
- In the UKSMEF sample, the region with the highest representation of DBs is London (around 19% of DBs are located in London).
- The West Midlands and East of England are also the home to a relatively high share of DBs (18% and 15% respectively). DBs have a greater chance of being located in one of these regions compared to seekers/non-seekers.
- In the SMEFM sample, again the typical DB is based in London (this region has the highest share of DBs, around 14%).

Owner characteristics

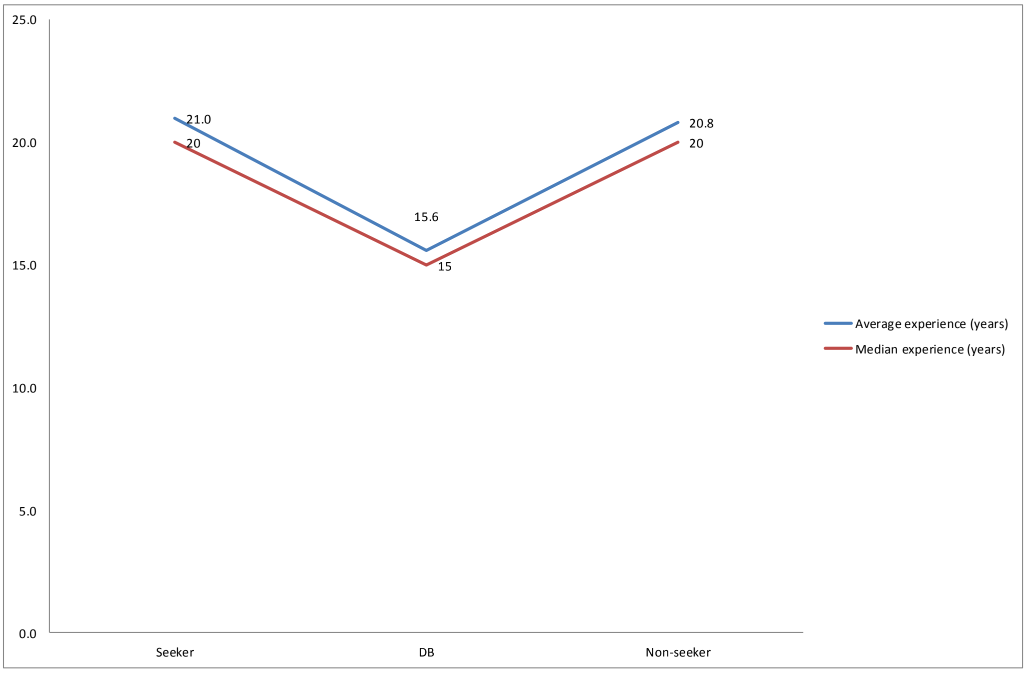
Chart A15: Personal wealth (£) by business type: UKSMEF



Source: UKSMEF 2004, 2008, 2009
Base: All businesses

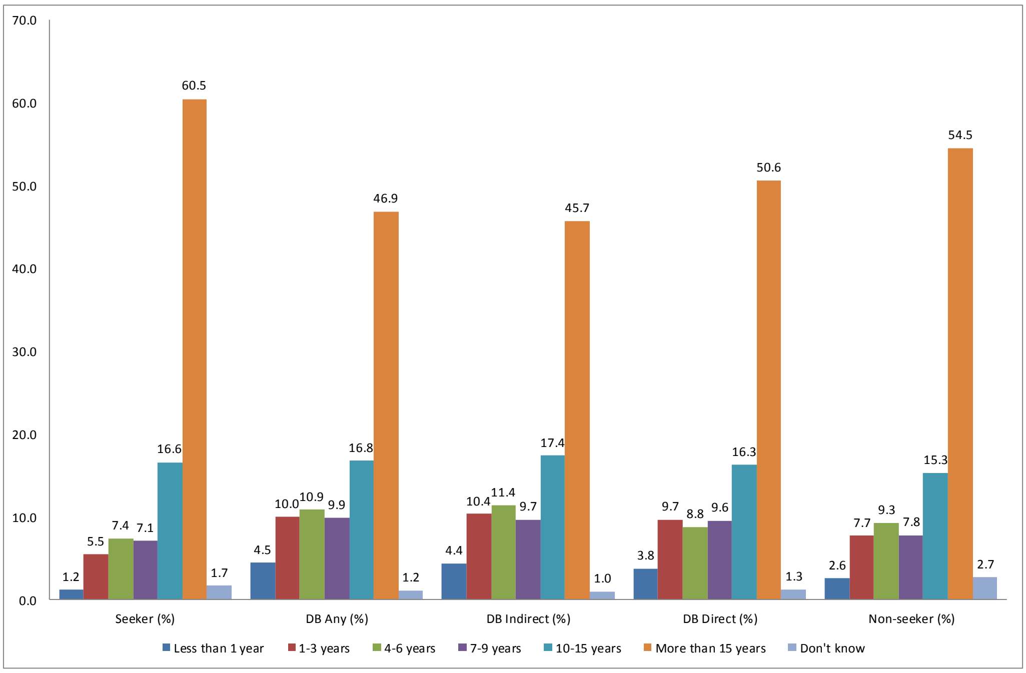
- The average personal wealth of DBs is around £165,000.
- This is significantly lower than the personal wealth of seekers (£735,000; p=0.066) and non-seekers (£749,000; p=0.067).

Chart A16: Business experience (years) by business type: UKSMEF



Source: UKSMEF 2004, 2008, 2009
Base: All businesses

Chart A17: Business experience (years) by business type: SMEFM



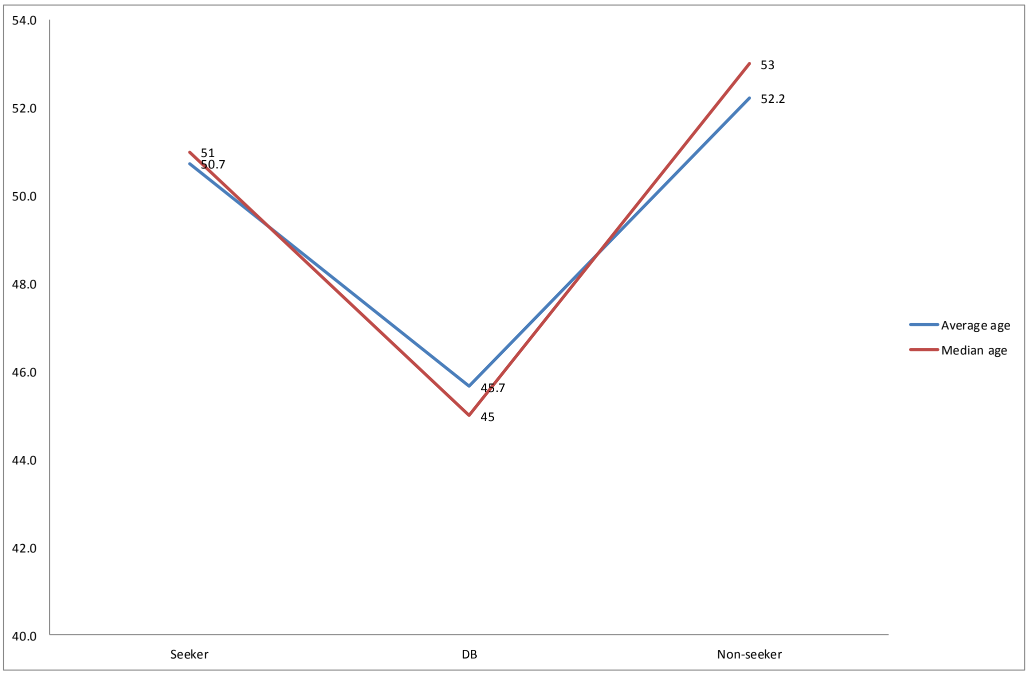
Source: SMEFM 2011Q1/2-2013Q2
Base: All businesses

- UKSMEF data indicate that the average experience of DB owners is 15.6 years, significantly lower than either seekers (21 years; *p*=0.000) or non-seekers (20.8 years; *p*=0.000).

- SMEFM data also indicate that DB owners have less business experience: the majority of their owners (52%) have 15 or fewer years of experience compared to 38% of seekers (*p*=0.000) and 43% of non-seekers (*p*=0.000).

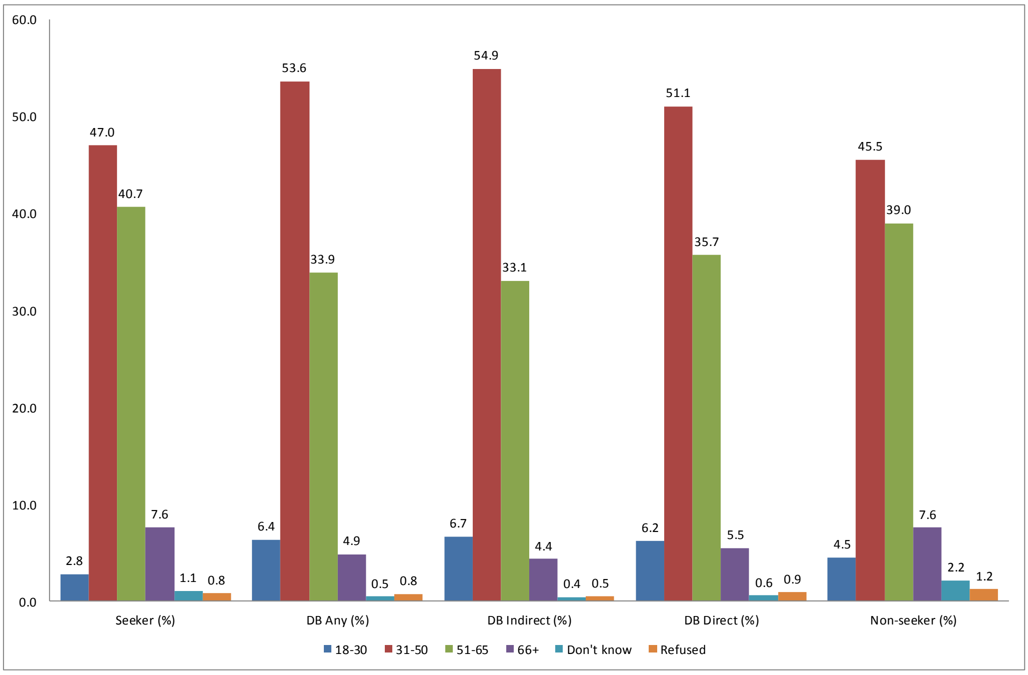
- The indirectly discouraged also appear to have slightly lower experience than the directly discouraged the respective percentages with 15 or fewer years of experience being 53% and 48% (*p*=0.030).

Chart A18: Owner's age (years) by business type: UKSMEF



Source: UKSMEF 2004, 2008, 2009
Base: All businesses

Chart A19: Owner's age (years) by business type: SMEFM



Source: SMEFM 2011Q1/2-2013Q2
Base: All businesses

- In the UKSMEF sample the average age of DB owners is just under 46 years, significantly lower than either seekers (50.7 years; p=0.002) or non-seekers (52.2 years; p=0.000).

- In the SMEFM sample data the majority of DB owners (60%) are aged 50 years old or less, significantly more than the corresponding percentages amongst seekers (49.8% ; p=0.000) and non-seekers (50.1%; p=0.000). Again this points to DB owners being younger than other business owners.

- Indirectly discouraged business owners also appear to be slightly younger than the directly discouraged the respective percentages aged 50 years old or less being 62% and 57% (p=0.049).

Conclusions

A summary analysis of UKSMEF and SMEFM data suggests DBs are:

- Smaller in terms of sales and business assets than seekers if not non-seekers.
- Smaller in terms of the number of employees than both seekers and non-seekers.
- Younger than seekers/non-seekers.
- Riskier than seekers/non-seekers.
- Likely to be a 'real estate/business services' or construction business.
- Likely to be located in London, the West Midlands or East of England.

The owners of DBs are:

- Less wealthy than owners of seeking/non-seeking businesses.
- Less experienced than owners of seeking/non-seeking businesses.
- Younger than owners of seeking/non-seeking businesses.

In answer to the question 'who are discouraged borrowers?'

> *A typical DB: has sales below £250,000, business assets of £10,000; fewer than 10 employees; is aged less than 7.5 years; has an average/above average risk rating; is a 'real estate/business services' or construction business; is located in London, the West Midlands or East of England; and has an owner aged 31-50 with 15 or fewer years of experience and a personal wealth of around £100,000.*

In addition the indirectly discouraged are:

- Smaller than the directly discouraged in terms of sales and employment.
- Slightly younger than the directly discouraged.
- Slightly riskier than the directly discouraged.

And the owners of indirectly discouraged businesses are:

- Slightly less experienced than owners of directly discouraged businesses.
- Slightly younger than owners of directly discouraged businesses.

APPENDIX 2: DB CASE STUDIES

Shiona Davies and Richard Smith

BDRC Continental

CASE STUDY 1: INDIRECT OVERDRAFT DISCOURAGEMENT

Respondent: Mr DM, 250 employees with turnover £12m - Seafood distribution, Average Risk, South West

Business background (type, challenges, plans, responsibilities)

D runs a seafood business with a factory in X (150 staff) and one in Y (100 staff). He was one of five founding members who set up the company 9 years ago. There are now three of them who own the business between them. They sell to retailers and food services businesses in the UK and abroad (e.g. China). He personally looks after sales, but they all have a say in major financial decisions.

Business is buoyant at the moment, they are steadily growing and have a reputation for high quality at a good price, plus can deliver the volumes. They hope to grow further, export more and rebuild the factories, but this requires major investment. This is their key challenge currently, and is proving a major headache, as they are trying to raise finance (see below).

External finance (how financed, history of needing external, types, how long for etc.)

They are currently trying to raise funds for their major building programme. They are seeking a grant via the MMO (Marine Management Organisation - part of Defra, involved with European Fisheries), but this is proving painful, as they are fairly slow and incompetent, and it's a struggle to get any kind of timely decision from them. This has not been helped by the MMO moving up to Newcastle, as many staff didn't relocate, so they've lost a lot of knowledge.

For this project they have secured some funding successfully through Lombard, but MMO are proving so slow it may put their plans in jeopardy completely.

Have also looked to their bank for help. He's found experiences differ markedly depending on how much they've wanted and when, what for etc.

For example, they managed to get a small overdraft from the bank when they'd just started, but this was then taken away at short notice, so they moved to another provider. When they started out it was much more difficult to raise funds as they were an unknown entity, so really struggled to get much support from the banks: *"The vast majority of our funding has come from friends, family and fools as they say, and people within the industry who feel we are doing the right thing and try to support you."*

They have since managed to get <u>some</u> support in the form of invoice discounting/factoring over the last few years, which works well for them (this has not <u>always</u> been through the bank, e.g. they've used Bibby Finance in the past, but they pulled out.) He feels the bank is generally fairly flexible with this kind of thing, as well as being able to cover short term cash requirements for a day or two here and there. But beyond this, for anything large or long term it can be very difficult.

"We have a great working relationship with a couple of people we deal with on a day to day basis, but it's always that case that if you ask for something big, these people have got no decision making capabilities at all. If you want anything of any size it gets referred to London and the computer makes a decision based on criteria we don't necessarily fall into. So I think a lot of us have given up on talking to banks as regards to finance for anything other than the basic stuff e.g. invoice discounting."

In the past they have also managed to get grants from the UKTI, for export initiatives, obtaining 30-40% of costs etc. But this source of funding has also dried up - the rules/selection criteria have become much more difficult and he's got nothing this year. He used to do free talks for the UKTI about exporting, but no longer wants to support that as he's getting nothing in return.

Discouragement & outcome (what happened last time you tried to obtain funding, purpose, amount, type, preparation, who you went to, what shaped your opinions, outcome etc.)

About 18 months ago they managed to secure some funding from their own bank, who were organizing some asset finance, then the week before pressing the button they pulled out, because they felt they'd lost a lot of money in the sector generally so were pulling out. This was a blanket decision rather than a personal one.

They are a very seasonal business, buying crab from May-Dec, but they sell all year round. So they buy 1.4m worth of crab during that period to sell later, therefore ideally they'd have some sort of overdraft or stock loan to cover that. However there's nothing like that available anymore:

"We are very profitable, but if we need to borrow £300-400k, they'll immediately say 'what can we have as a guarantee against it? But having built up the business by putting any money we've got back in, all of the properties and anything we have is already signed up against other loans, so we have no more capital to sign over."

He feels it's not just the banks that make things difficult, it's various rules and regulations, increasing taxes, and fighting against local council stipulations etc. that all seem to take up time and work against the spirit of entrepreneurialism:

"While we are growing, it's harder and harder to make a profit, and that's not driven through customers, but by the added costs of doing business. It gets to a point where you're thinking 'I'm earning less than my staff, why am I taking this risk? Why don't I just work for someone else as the hassle isn't worth it' ... It's almost as if they don't want you to succeed."

He thinks that others within his sector have the same feelings and issues, as do other friends and business associates. These various different experiences leave him feeling deflated and unwilling to keep trying.

Recent experiences (based on response from SME Finance Monitor): Having all done MBAs etc. they are well versed in things like putting together business plans, and continually updating things, so usually have these to hand when talking to the bank and others, so this is not a concern, and has not been a barrier. It's more that in the last year or so they haven't bothered to try and make a formal request because of the perception that it would be futile, given the large amounts they need:

"There's no point when you don't have any capital. You can always find 20 grand, but for example we know we are going to have a shortfall of £250k in February (cash flow reasons cited above), so need to think how we'll fill that, or £1m to rebuild the factory. It's more that sort of thing."

Next steps (what happened since, have you tried again, impact on the business, discussed with others, have they had similar experiences)

They are still waiting on the outcome of their latest attempts to raise funds via the MMO, but ultimately this will have a major impact on the business if it's not successful. It will mean that instead of rebuilding and increasing sales, it will take 2-3 years to get there, by which time they may give up their hopes of expanding:

"By that time we might say forget it, and think about which is best place to run, and shut one down."

Looking forward (what might you do next time, how is that influenced, are banks changing, how do they get that message across, if not them, what should be happening, by whom)

They might look at other sources of finance in the future, given that the perception is that the banks aren't really changing. For example they might look towards crowd funding or business angel investment, although these routes would seem less attractive on the face of it as they charge more:

"I think there's angel money about, and these guys have been loving it for the last few years. Because there's no money about from banks etc. they can get a much better rate and more equity, because if you want to expand it's the only place to go."

But the likelihood is that they'd be less inclined to expand, just grow organically, rather than over-extending themselves through this kind of route. Especially as one of the partners is looking to wind down and retire. So instead of aspirations to grow to a £20m business they will likely reign plans back.

Awareness of initiatives (appeals, mentors, cheaper finance - does it change your views)

Appeals: He's not aware of the appeals process but was very cynical and sceptical that it would make any difference: *"You are still talking about somebody looking at a formula, rather than in the old days when the bank manager had an appreciation for who you are and what you do."*

Was very surprised that so many appeals are successful, and believes that perhaps this relates to very small sums of money, not the realms of his kind of funding needs.

Mentors: Is aware of the general existence of business mentors, and thinks they can be invaluable if you find a good one but thinks they can be hard to find, and that the majority are rubbish. He would prefer to just turn to his accountant or his bank if needing expert advice.

"The people who come from government as advisors, from my experience have not been great, and to me they work in government because they can't do it properly."

The fact that advice might be free doesn't help, as he feels that you should expect to pay for high quality advice, so again this would perpetuate the belief that they probably wouldn't be any good.

Funding for Lending: He was aware of this and thought that actually this sort of scheme might work well for their kind of business, but they were turned down when they enquired. He can't remember why, but thinks it was down to the capital issue again (it was not a formal application). He's also not sure if the rates on offer would be likely to be that much cheaper than those you might get anyway.

He has no idea on the likely level of acceptance for such applications, but feels in any event the figures are likely to be meaningless:

"I'm generally sceptical - I had a book at school called 'How to lie with statistics'. You can make them say whatever you want to."

He's also sceptical as to exactly what such figures mean because it may well be that people have been thoroughly vetted before making an application, so one might hope they'd all get accepted. In which case 7 out of 10 is actually a very poor result! So these sorts of stats are somewhat meaningless.

So overall, despite these initiatives, he doesn't feel the banks have changed their attitudes in the last 5-6 years and are still just as risk averse. He can understand to some extent, given the previous days of more reckless lending, but thinks the barometer has perhaps swung too much the other way. But what is perhaps hampering things further is government policies and attitudes, which he feels have made things harder for business. (In particular he cites his own sector issues about relocating MMO staff to Newcastle, but also general policies about taxing businesses etc.)

In conclusion (summary, what needs to happen, by who, what would encourage you to apply)

To resolve the current problems, he feels potential solutions should include:

- the banks being willing to take more risks
- or being open to considering other forms of finance e.g. mezzanine financing/equity share etc. where you buy the equity back over a period of time e.g.: *“We had a company who came in to talk to us about some form of mezzanine financing the other day, which is very unusual, and revolutionary for a bank to talk about things like that. We don’t necessarily want to give up equity, especially to someone like a bank but we’d look at it, and how expensive the debt is, as ultimately they don’t want to keep the equity and you don’t want them to, so you’d work through it and see if it’s in the realms of reality.”*
- Also in the current climate they obviously don’t want to be paying really high interest rates, so preferential rates of some kind would be good.

So if some of these things could be looked at, it might start to change perceptions and garner more faith.

He also feels that there need to be more positive and supportive messages coming out from government and local councils etc. that business is a good thing:

“More of an attitude like they have in the US of ‘good on you’, rather than it being portrayed as a negative. We need to hear that running or starting a business is not a bad thing. And that without businesses we’re stuffed.”

He’s a member of the FSB and thinks that bodies like that, Chamber of Commerce etc. have a role to play too, but he doesn’t hear a lot coming from them, and maybe they could get more involved.

CASE STUDY 2: DIRECT OVERDRAFT DISCOURAGEMENT

Respondent: Name: JG Size: 34 employees with £1-2m turnover Business: Manufacturing Average Risk, Yorkshire and Humberside

Business background (type, challenges, plans, responsibilities)

This was originally a family owned business started 60 years ago and J’s been involved for 30 years, buying it out when the boss died in ‘94. She is now 68 but not able to slow down yet, as her mortgage doesn’t finish until she’s 70. She makes the final decisions on anything financial but also has a senior management team of 3 Directors (ops/sales/production). They make large colour swatches of fabric and carpet squares for retailers. They used to have a flourishing niche, but with a lot of manufacturing moving to the Far East, business slowed, and they tried to diversify into printing, but this venture went wrong, and it’s been hard to recoup. Plus they changed premises, which swallowed up money in moving etc.

They turned a corner when a Director came in from a competitor, bringing lots of business with him, plus her son came in as a Director, from Yorkshire Bank, so is good on the financial side. They also won a big contract recently. This all helps understand the challenges they face, i.e. keeping their heads above water, trying to ensure they keep on top of bills, have nearly paid off a loan etc., but still struggling with cash flow at times.

External finance (how financed, history of needing external, types, how long for etc.)

How they finance the business (beyond her and her husband regularly propping it up, topping up the mortgage etc.) is in a variety of ways:

- Leasing - they have several bits of factory equipment on lease
- Commercial finance - they’ve just done some asset finance worth £15k against some of their bigger machines
- Peer to peer loans - she has two smallish ones of these through Funding Circle

- Juggling supplier payments, and leaving some as long as possible

- VAT payments - she tries to stay up to date with that but has had the occasional fine. She might call them to discuss rescheduling payments etc. at times, and this usually works, but it depends who she gets on the phone as to how amenable they are

- Credit card (8k limit) - pays bills on time but use of this gives her a few weeks breathing space

- Invoice discounting (via Bank) - they use this and it was helpful at first, but since the recession hit, it’s not been as good (fees etc.)

Discouragement & outcome (what happened last time you tried to obtain funding, purpose, amount, type, preparation, who you went to, what shaped your opinions, outcome etc.)

Her experiences of obtaining funding are based on many interactions with the bank over the years, as well as dealing with asset finance firms, etc. so she can compare and contrast them.

She’s had a very positive experience with the asset finance co:

“The account manager was very helpful, they’ve been fabulous.”

Her experiences with Funding Circle have also been good:

“They were very helpful. They wanted to see the accounts, and we had to guarantee the loan with signatures. They looked at the same things as the banks but were willing to take more risk.”

Conversely, her experiences with the bank tend to be less positive. She’s in regular contact with the account manager, who has visited the premises, is familiar with her accounts and nature of the business etc., but seems disinclined to offer any help when she has requested help or an overdraft.

This is in contrast to the way it used to work with the old 'bank manager' style of relationship:

"An overdraft has been discussed several times, but he always says we're too high risk, and never gives us any support or advice. He always just suggests we put more money in ourselves. Our bank manager used to be brilliant and help us, but since then there's been lots of change. They have targets to meet, possibly too many clients, and are not friendly. He once said to us 'You're like a shop, you get almost instant money, so why do you need it?'"

Next steps (what happened since, have you tried again, impact on the business, discussed with others, have they had similar experiences)

The lack of support from the bank has had an impact as it's meant they can't grow as they'd have liked. For example it's stopped them being able to buy new machinery - there are machines that would make them much more efficient and eliminate manual labour, but they can't buy them.

Having recently won a big job, she has gone back to the bank and the account manager has relented a smidge and allowed a small short term overdraft: *"The manager is not very helpful and won't give us an overdraft. But since this big job, he's now softened a bit and allowed us £5,000 temporarily. But long term he won't budge."*

Despite this small chink of light, it still leaves her with cash flow problems, as even though they've a big contract in, they still have to pay out for labour and material up front, yet can only invoice much further down the line once goods are shipped. So she's still left feeling that the bank are keen to take their money, levy charges etc., but pretty inflexible when it comes to doing much in return.

Looking forward (what might you do next time, how is that influenced, are banks changing, how do they get that message across, if not them, what should be happening, by whom)

At this point they don't think they want to stretch themselves any further, especially as she is nearing retirement, so is unlikely to take out more loans etc. If she was interested, she doesn't think the banks are changing their attitudes and becoming more lenient, so as past comments suggest, feels she'd again have a struggle on her hands.

Awareness of initiatives (appeals, mentors, cheaper finance - does it change your views)

Appeals: She was not aware of the appeals process, and knowing this, it might encourage her to give it a go, as a 40% success rate sounds good, and worth a try. Yet this is still tinged with cynicism:

"I'm sceptical that I might get the same result. Because bank managers have become like clones, with targets to meet, and they just go through the motions."

Mentors: She was not aware of the mentoring scheme, but thinks in principle it could be a good thing, and indeed has paid for consultants and advisors herself in the past. If available free, then great, but the message needs to get out there, through the press etc. She's also a member of the FSB, who are not that active beyond providing legal advice, but it would be a good way of spreading the word.

However, it's very dependent on the track record of the mentor, and she feels it needs to be someone who's been in business. Their own experiences of paying for advice have been mixed - given they are in such a niche and specialist sector, some of the techniques proposed have not always worked.

Funding for Lending: This is something she's never heard of, and feels the government has a role in passing such information down through networks like the FSB, as she believes there's likely to be low take-up if awareness is low. But again she's sceptical about her own likely success:

"I still feel like I might get short shrift. I'm sure my account manager thinks we're a lost cause, although he does say I'm a fighter."

In conclusion (summary, what needs to happen, by who, what would encourage you to apply)

She feels that there should be more of a message spread (by the banks) that if a business is viable, there is some support available, as at the moment there tends to be a lack of information and a lack of willingness to help. And she thinks that the banks should look at the bigger picture rather than just the immediate situation:

"I have two men in their forties who could really make the business grow longer term."

Previously Businesslink used to be a good forum for communicating such messages, but with this shutting down she's sure how else the word could be spread (again, FSB?) There is certainly also a role for bank advertising and written communication, if this is sincere and action-led:

"Sometimes I get letters from the bank offering help, but it's not being translated into practice."

CASE STUDY 3: DIRECT OVERDRAFT DISCOURAGEMENT

Respondent: Name: KS Size: 50+ staff, £1m turnover Business: Hotel/Restaurant Average Risk Northern Ireland

Business background (type, challenges, plans, responsibilities)

K runs a hotel and restaurant with 15 bedrooms in Northern Ireland, which he took on 18 months ago. It's near Belfast (important as many of the key English banks don't feature there, it's Bank of Ireland/Danske/Santander mainly). Prior to this he worked in consultancy in the sector, so has a long industry track record, and experience of dealing with many different banks, helping businesses get finance etc.

Their USP is their great location on the sea front, premium yet quirky local service (I see they get great reviews on Tripadvisor!) It was previously in administration so they are currently concentrating on building it up, running it properly and refurbishing some of the bedrooms, as well as moving to renewable heating to reduce costs. He will be seeking funding/a grant for this last plan.

His biggest challenges are increased costs and the admin/regulatory burden, for example: *"The cost base is going up and margins are getting squeezed, for example staff, food and energy, none of it's going down. And there are always new health and safety regulations coming down the line due to things like the e-coli scare - they want you to have two sets of equipment, one for raw and one for cooked food."*

Another example of the admin burden was having to wade through all the paperwork to set up taking CSA payments for one of his staff - it's all of these sorts of chores that detract from just getting on with more important things like marketing and running the place.

External finance (how financed, history of needing external, types, how long for etc.)

Much of the capital he's raised for the venture has come through private funding, and putting in money himself, so he has very little capital left to inject. He has a small overdraft which he had to negotiate last year, to the tune of approximately £15k, in order to buy some equipment and support a cash flow issue regarding a VAT payment. This was not a major problem as they are turning over £1m, but beyond this it becomes difficult.

Even this required him to put forward quite a lot of information to the local account manager in terms of current trading position, P&L, plans for the future. (He tries to keep them up to date on his plans anyway though.) He banks with one bank for cash and one for credit card processing, and has split the overdraft across the two. By comparison the credit card processer was much easier, he just had to fill in a form online and a couple of days later they agreed it.

The relationship with his bank is generally ok for day to day things, and they were chosen based on his previous experiences, and the fact that they still had a local account manager handling a reasonable number of accounts. But he feels his manager is under increasing pressure to manage more accounts lately, nor does he really understand the business or have a lot of authority:

"They like to pretend they know what's going on but I don't think they really understand the pressures. And for relationship mangers, they are not taking a lot of decisions. They seem to have to run backwards and forwards between their risk and lending departments, and not able to do much on their own."

His opinion of the banks is based on his dealings over some years, and he doesn't think things are getting much better. Possibly they are easing up a little now, but not for the hospitality sector. Plus even though things might be turning a corner, feels the recessionary factors are still there.

Discouragement & outcome (what happened last time you tried to obtain funding, purpose, amount, type, preparation, who you went to, what shaped your opinions, outcome etc.)

He also has more specific personal, recent experiences to base his opinions on, e.g. informally asking about loans or different ways of doing things etc., and discovering it's never straightforward. The manager has to go away and find things out, then needs him to provide all sorts of information, and it becomes a hassle.

A concrete example is even just trying to set up payment to his staff by direct debit. This would have been cheaper, but they were told this would have been viewed like a personal loan, so it would have to go through a personal credit search. So in the end they just stuck with the Faster Payments system, even though it's more expensive. In advance of this he thought this kind of thing would easy, so has been surprised and disappointed at how difficult it can be.

It seems even harder if people want to borrow any significant amount of money:

"The minute you start talking to them you get asked 'well can we borrow against your house' and all that. So the banks might be saying 'nobody is asking for the money' but that's because they do so much to put you off applying ... The enhanced capital requirements have discouraged lending, and I think they have to replenish their balance sheets."

So there's a certain level of cynicism about the hurdles put in the way and the persistence required to overcome objections and be successful with an application. Another problem he feels is that there is a tendency to treat 'hospitality' as a single slightly high risk sector, without looking at the facts case by case:

"The profiling of the industry is very poor. They don't understand the differences between types of business model, they'll just say 'we're not

lending to hospitality.' You all get lumped into one, from fish and chip shops to hotels, which are all totally different. It's just a blanket excuse that comes back."

In order to manage cash flow etc., he does occasionally delay paying his suppliers, but most are paid by direct debit, so this isn't a common tactic. Plus, given the insolvency of the previous business, he's found some suppliers wary of doing business with him, so doesn't want to mess them about and lose the goodwill. In addition, they are largely a cash business, so there's less ability to defer payments etc.

Next steps (what happened since, have you tried again, impact on the business, discussed with others, have they had similar experiences)

He's come away from his bank experiences feeling disinclined to go to them to try and borrow again:

"It's left me reluctant. They are now almost a last resort because of their attitude. I feel that you are better doing it on your own, because they give you no inkling that they're interested in lending or helping."

It's both the hassle factor and the slim likelihood of success that has put him off, with his views also being fuelled by the press and colleagues:

"It might be worth the time and hassle if it was likely to come off, but the noises you hear from your peers and the media are that it's very difficult."

Looking forward (what might you do next time, how is that influenced, are banks changing, how do they get that message across, if not them, what should be happening, by whom)

The experiences he's had in the past mean that in future he might look to alternative ways of raising funds outside of the mainstream banks. For example:

- He knows private investors who understand the sector and are looking to invest, so this could be one avenue to pursue

- He might also look into getting a brewery loan. They have various deals going in return for exclusivity, a levy on the keg price of beer, etc.

- Other forms of loan such as peer-to-peer lending, which he's only recently heard about

- Santander appear to be taking a slightly different attitude to some others, he's heard anecdotally, so may be worth approaching

- A grant or low interest loan through the Carbon Trust - this is something he's seriously looking into as he thinks that they may tick the right boxes to qualify, if they want to change their heating system. The conditions are tight, e.g. it might mean he has to landscape the garden in a certain way to hide the boiler, but might allow him to do two things at once, i.e. get the garden sorted out at the same time. *"You have to think creatively"* (in the absence of the ability to get a straightforward loan.)

Awareness of initiatives (appeals, mentors, cheaper finance - does it change your views)

Appeals: He was aware of this process but immediately cynical about it all: *"It's someone from the bank who reviews it, and the account manager presents it to the risk people, not you. It goes to and fro and you never actually get to meet them. I think the banks have lost the fact that we're the customers. They're arrogant and think they're the boss, and are not giving. They think you should go cap in hand."*

Was also not impressed by the successful appeal rates: *"All that tells me is that the system is flawed because it means they were wrong 4 out of 10 times."*

Mentors: This is something he's aware of and has in fact been a voluntary mentor himself. He feels it's a good idea in principle, but depends very much on who you get, their style and the relationship you build. It's not something he'd rule out, but feels it needs to be someone who has a track record and some credibility, more than it mattering exactly where they come from.

Funding for Lending: He was aware of this through the press but thought it may not be widely known about because of the some of the high street banks not operating widely in Northern Ireland. Again, when told of success rates it provoked a sense of cynicism about the data being skewed:

"They put so many people off that you've probably had to be completely bloody minded and persistent to get through. They do so much to discourage you that I'm not surprised it's a 9/10 success rate."

He also thinks there would be similar hoops and hurdles, the need to provide guarantees and put up assets, etc., so would want to see exactly what the rules and small print were.

He can't remember getting any marketing communication from the bank about any of these things, all they have been sent is information on factoring.

In conclusion (summary, what needs to happen, by who, what would encourage you to apply)

He feels that a key thing that needs to change is the whole mindset of the banks, and the way they communicate, which is currently very negative:

"The relationship managers should be much more positive about their products, coming to us and saying 'What are your expansion plans? Well here's what we can do', i.e. being proactive rather than negative. If I acted like the banks I'd be out of business. If someone came into the bar saying they were thirsty, I'd say 'would you like a drink?' - We're there to serve. I think they've forgotten that. You need to be treated like a customer, not a beggar."

There are a few rays of light evidenced recently, e.g. he's involved with the Chamber of Commerce, and through that he's seen that the Bank of Ireland have had an Enterprise Week, doing roadshows etc., which he thinks is a good way forward:

"Banks used to be the mainstays of Chambers of Commerce, but now won't pay to be members. It's ridiculous, because that's how local relationships are made. The FSB are quite active and can be a good source of networking too, and a good way to get information out there. That's where you get those water cooler moments."

These are the kind of places the banks and others should be using to spread their message, places like the Entrepreneurs Network etc. - *"The angel investors are all over that one."*

He also thinks there needs to be a cultural shift towards that of the US. He feels they are much more positive about people doing well and learning from failure etc., which we could learn from:

"Here we are sniffy and jealous about success in others. And in the US, there's the attitude that if you haven't failed, you probably haven't been pushing the envelope, whereas here, if you fail it's almost impossible to get any further support. They keep talking about encouraging start-ups, but then say 'God, whatever you do, don't fail.'"

And again, it's not just about warm words, whoever's spreading the message needs to be visible in the community, being positive and actually walking the talk.

CASE STUDY 4: DIRECT OD DISCOURAGEMENT

Respondent: Name: SF Size: approx. 10-12 staff, turnover <£50k Business: Transport, Low Risk, East Anglia

Business background (type, challenges, plans, responsibilities)

S runs a general haulage firm, which she bought from the retiring owners 7 years ago. She'd always been good at sales but had no transport experience (by her own admission claims she was a bit naive, especially about financial matters, when she set the firm up. If found her to be a really charming person but perhaps a bit too kind and soft for her own good).

There's a small fleet of 9 flatbed vehicles, transporting fertilizer, some hazardous materials etc. Her partner is experienced in this area but not financially involved - he had a coach firm which ran into money troubles and had to be sold to avoid liquidation, and he now works for the new owners.

The first 4-5 years were really good, as the market was buoyant, enabling her to upgrade the fleet and pay a loan off. But last year they actually made a slight loss due to the downturn. However this year they've turned a corner and found new customers, plus things are picking up. In the next 3 or 4 years she'd like to sell it on and retire (she's 62/hubby 70.)

Keeping all the drivers gainfully employed can be a challenge, but she's good at ringing round touting for work, plus prides herself on offering great customer service, going back to people with quotes quickly etc.

External finance (how financed, history of needing external, types, how long for etc.)

When she started out they needed to put a lot of capital into the business to buy the vehicles etc. They obtained a loan of £80k from bank XXX, secured against their £300k house, and £70k from an asset finance co, secured against the vehicle fleet. She has since paid off the £70k loan completely, and just has 3 more years to run on the other one from the bank.

The bank loan cost £1,800 to set up, plus there's a similar penalty to pay to get out of it, and it was set up on the proviso that they also took on an invoice discounting contract for a minimum of 3 years, which she ended up having for 6 years. She finally managed to extricate herself from this last year:

"I had to fight really hard get out of invoice discounting as it was costing us £500 a month in charges, but of course (bank) try and put every obstacle in your way."

When times are a bit tight she has found other ways to keep the cash flow going and keep their heads above water, as with no overdraft, she can get stung there too if she goes into the red. She will defer paying suppliers a bit if she has to, plus will try and negotiate a bit of leeway with HMRC:

"HMRC will often let me pay the VAT over two months. I always ring and ask them if I can do it like than rather than just not paying. Plus the landlord is quite good if I'm a bit late with the rent. I'd rather defer on these things as I can't not put diesel in the vehicles."

She'll also ring round the drivers to tell them where the cheapest diesel is from week to week.

Discouragement & outcome (what happened last time you tried to obtain funding, purpose, amount, type, preparation, who you went to, what shaped your opinions, outcome etc.)

When they started to go through a bit of a sticky patch last year, she sought an overdraft facility. She really didn't think it would be an issue as she'd never defaulted on the bank loan, had paid the other one off, plus the value of the house is such that it didn't represent a risk in her mind. But she pretty much got a flat no:

"At the time, I kept on phoning but they wouldn't even agree to meet me. They just asked us to email over our records and said they'd look at it, then they'd email me back with a no, because we'd already got a loan. It was heartbreaking to be honest - we were only asking for £10,000 and have never defaulted on any payments."

This had an impact on the business as it made her very stressed about how she was going to pay people, letting them down with late payments etc. It meant constantly being on to their own clients asking to be paid, because terms are now 90 days with a lot of them.

Next steps (what happened since, have you tried again, impact on the business, discussed with others, have they had similar experiences)

As a result, she sought help from a couple of other banks, who were willing to lend, but she found the penalty for leaving and the cost of set up prohibitive, and ended up staying where she was. It has left her feeling totally underwhelmed by her own banking, and under the impression that it would be pointless to try again:

"I've always been upset with the way I've been treated by the bank. They give you no advice, they never come and see you and all they are after is how much money they can make. Whereas I found Lombard to be really nice (finance co.)"

She imagines that others might feel similarly to her (she meets people at networking events and used to find Businesslink and FSB really helpful), though she has no actual evidence of this.

Looking forward (what might you do next time, how is that influenced, are banks changing, how do they get that message across, if not them, what should be happening, by whom)

She hasn't really considered other forms of loan since, for example it had not occurred to her to try the finance company again and she had not heard of peer to peer lending. Plus they are now through the worst of it, so might be inclined to try and do without further loans etc.

Her thoughts now are to potentially downsize the fleet slowly so they don't have the worry of having to constantly generate enough work to keep them on the road. She's certainly not thinking of expanding, given the desire to retire in a few years.

Awareness of initiatives (appeals, mentors, cheaper finance - does it change your views)

Appeals: Was not aware of this, but thinks advisors are unlikely to tell you about it. She feels she was perhaps not pushy enough to insist on some recourse or at least a meeting to explain why she was unsuccessful. The 40% success statistic saddened her because if only they'd known about it, with those odds it might have been worth trying:

"It might have made a difference, and if my partner had known about this he might still be in business now."

The general figure of 7 out of 10 loans/ODs being successful also surprised and disheartened her:

"It's heartbreaking and hard to believe, because it makes you think 'well why weren't we able to get one then?"

Mentors: Again she was not aware of mentors, and feels it might have been worth paying for someone like this in the past, as she'll happily acknowledge that she could have done with a bit of financial advice:

"Nobody has ever sat down with me and told me how to make the best use of cashflow or anything ... Plus I don't think our accountant is very good. So I feel like I'm on my own really."

Mentors should ideally be independent - if attached to the bank for example they'd be likely to have a vested interest.

Funding for lending: Had not heard of this, and certainly the idea of lower interest rates would be of interest, as it might have enabled her to pay the loan off by now, though her perception is that acceptance on these sort of schemes may be difficult, judging by the flat refusal she's had in the past.

In conclusion (summary, what needs to happen, by who, what would encourage you to apply)

She feels that there's a lack of information about the support available to small businesses, especially with the demise of Businesslink, which she found really useful. They used to advise on general topics like health and safety, but not the specifics of your own finances, so any support in this area would be welcome.

She believes the government has a role in facilitating this kind of thing:

"Surely the government want small businesses to survive, and should think: 'If we don't support them we'll only have the likes of Tesco's and Eddie Stobarts.'"

Anything to help small businesses could best be delivered by someone impartial, a bit like an Ofcom or Businesslink, and ideally it would be about some form of personal contact:

"It could be someone calling me to chat about my needs - ideally it needs to be face to face, because that builds trust."

CASE STUDY 5: INDIRECT LOAN DISCOURAGEMENT

Respondent: Name: Mr A Size: 3-4 staff / Turnover £200k Business: Property letting/sales Below Average Risk, West Midlands

Business background (type, challenges, plans, responsibilities)

Mr A runs a property business, letting and selling houses in the Birmingham area. They also deal with maintenance and mortgage referrals (though they are not approved lenders). When he set up 3 years ago, business was quite busy and he had more staff, but in the last couple of years, with the recession biting he has had to lose staff members - now has 3 to 4. He is the sole partner and key decision maker.

They have found that the lettings side has been quite buoyant but that house sales have dropped dramatically. However this does seem to be picking up a little as the banks start to ease up with mortgage lending.

They tend to deal with higher end properties and professional tenants. He feels their USP is the professionalism they show to both tenants and clients.

He has plans to expand the business and introduce foreign investors to the UK property market (from Dubai, where he used to live, acting as property managers for their portfolio etc.). He also wants to reposition the business a bit and harness the internet more as their shop window. But he's found it hard to realize these growth plans in the short term (see below).

External finance (how financed, history of needing external, types, how long for etc.)

When he started three years ago, he injected some personal funds, but also went to the bank for about £10,000 worth of working capital, to get the business going. This was possible with the support of the bank because he had a fairly good track record with them and the sums involved were quite small, so this was sanctioned.

Since then he's found other ways of staying solvent, not so much through putting more money in, but in trying to strip costs out. For example they moved to a cheaper premises, reduced staff overheads and spending etc.

He's not very familiar with other forms of investment (e.g. peer to peer/asset management companies) beyond going back to the bank, but upon explanation thought that peer to peer could be an option worth exploring.

Discouragement & outcome (what happened last time you tried to obtain funding, purpose, amount, type, preparation, who you went to, what shaped your opinions, outcome etc.)

Indeed he has returned to the bank a couple of times to try to raise further funds since the first loan. In one instance he was hoping to raise £20,000 to enable him to take on a second premises, as he'd wanted to expand into another area. Despite posting fairly strong returns, feeling well prepared and confident about his likely chances, he drew a blank. It was more of an informal chat than a proper application, but there didn't appear to be a huge appetite to understand his plans and his business, it was more just a credit check:

"Now they ask too many questions, and do extra checks. If you're not on the electoral roll or your credit score is poor you've had it. They don't really look at how you operate - they could see that the account was fairly healthy, that we had a growing turnover of £200k and were not bouncing any cheques, but we were still turned down because of the credit rating."

He believes he might have been successful in securing a smaller amount, but that wouldn't have been enough to achieve what he needed to. So he has had to put his plans on hold for now, or investigate alternative ways of obtaining funding, for example looking into grants and start-up loans, but it has not proved easy to get information. The broker he deals with recommended one such scheme but it was too late, the scheme had closed down:

"They should market these schemes better. I have tried to see what's available but it seems there's nobody you can meet with, and I couldn't find anything out. The Chamber of Commerce would be a good place for this kind of information and grants - Businesslink used to be good for that."

Next steps (what happened since, have you tried again, impact on the business, discussed with others, have they had similar experiences)

These various experiences have put him off applying to the bank again, and have had an impact on the businesses,

"It means you can't be creative and try other things, or take risks."

It has also made him more self-reliant, and more cautious with money etc. (as witnessed by the office move, staff reductions etc.).

Looking forward (what might you do next time, how is that influenced, are banks changing, how do they get that message across, if not them, what should be happening, by whom)

He feels the banks are changing slightly, and that it's becoming easier for home owners to borrow, there are new schemes coming in to help them etc. But he thinks this is not the case for businesses, judging by feedback he's had:

"From the people we talk to, and our clients, etc., it's just as difficult as it was - they all moan and groan."

If that's not the case, he thinks the banks should be more forthcoming with their advertising, marketing via emails/texts, providing more information on their own websites and personal contact:

"They should be visiting us. They've never once come out to us or go out of their way. It's very much a one way relationship, they are not at all proactive ... You hardly ever see them. I think there's been a reorganisation, and they don't keep in touch."

The only thing he recollects getting any communication on is invoice discounting. As some others have done, he spontaneously mentions that perhaps bigger businesses get better treatment, but that the small guys can be forgotten.

Awareness of initiatives (appeals, mentors, cheaper finance - does it change your views)

Appeals: Not heard of this but thinks it's a good thing to perhaps be able to go over an application in a bit more detail, understand any strengths and weaknesses and learn what might need to be changed in order to be successful. He was also encouraged by the appeal success rate, which may mean it's worth trying again at some point:

"It gives you a bit of hope and encouragement. Maybe they can give you a bit of advice, because you may have missed things."

However, he's still not sure how he'd go about appealing, there's very little information forthcoming.

Mentors: Has a vague notion that Businesslink used to offer this sort of thing, but the Chamber of Commerce haven't advised about anything like this being available. (This is the sort of place where he might expect to find out about such support.) Again he thinks it's a good thing and is less sceptical than some:

"It's a good idea for things like planning, growth, advice, how to use the internet more. It could be a bank person or a government representative, or some sort of consultant there to help."

Funding for Lending:

Again was not aware of this, but in principle liked the idea: *"It might have given us more options."*

However, whether this would have made a difference in practice he's not sure, as he feels it's generally harder to secure such funds than in the past because there are more stipulations and rules these days, e.g. having to offer up your home as security.

In conclusion (summary, what needs to happen, by who, what would encourage you to apply)

As already mentioned, more advertising and communication from the banks is needed to let people know these initiatives are out there, as he might well have pursued them. Having now heard about them, he comes away feeling a little more positive, yet realizing that he might still not fulfil the criteria required (e.g. credit score, ability to offer home as security etc.). He would much prefer just providing a Director's guarantee.

CASE STUDY 6: INDIRECT OVERDRAFT DISCOURAGEMENT

Respondent: Name: Ms MA Size: 10-49 employees Turnover £500k-£1m Business: Transport, Low Risk, Scotland

Business background (type, challenges, plans, responsibilities)

The business has several strands - school buses, taxis and private hire. They've been going since 1997 and M is one of two partners in the business. They both get involved in finance decisions but she has a lot of dealings personally. Times have been tough in the last few years given the recession, people being less inclined to spend on taxis etc., but they are keeping their heads above water. In fact they are trying to grow in areas such as doing school runs, just getting their name out there more etc. Their USP is simply that they are hardworking and very reliable.

External finance (how financed, history of needing external, types, how long for etc.)

They have tried to raise finance from the bank in the past for things like new vehicles, and have had a fairly lukewarm degree of success over time, to a point where they haven't even tried in the last couple of years.

Instead they have tended to fund the business through their own private monies, as well as using a company called Close Asset Finance. They also have factoring in place through another bank.

Discouragement & outcome (what happened last time you tried to obtain funding, purpose, amount, type, preparation, who you went to, what shaped your opinions, outcome etc.)

Moira can compare the typical process she's tended to go through with the banks, vs dealing with the asset finance company.

The banks: She feels they are disinclined to help businesses like theirs. *"We haven't even attempted it in the last three years because I don't think* *they've got any money to give away. Plus they don't understand our business or our sector so I think they are frightened to get involved. So you give up."*

This is based on various dealings she's had with them over time rather than an isolated recent incident (as despite not applying for loans she has fairly regular chats and meetings with the account manager). For example they previously had an overdraft which she preferred as it was cheaper and more flexible than a loan, but the bank insisted they convert it into a loan because they were nervous about the industry.

In addition they've asked several times if they could add on a signatory to the account and it still hasn't happened in over a year. Things like this have brought home to her their unwillingness to take any kind of risk, or provide any support, despite her taking in business plans, going through lots of hoops, having a good track record of not bouncing cheques etc.

M also has second hand experience from her husband who runs his own property business, and he finds things increasingly more difficult (he's also with same bank). He used to have no real issues but now is suffering from the bank being very picky about which projects they will and won't support, so this has confirmed her own opinions of them.

She compares this to dealing with the asset finance firm which appears to be much more straightforward:

"It works much easier. There was nothing really needed beyond a few bank statements, just to see if cheques are bouncing and you've paid on time etc., plus the first time they wanted to see our accounts. They want the business, but the banks don't want to lend and are just disinterested, and offer no help."

She also has experience of factoring, arranged through a bank, and has mixed views on this. It can be useful to help get over a short term hump, but she dislikes the fact that she is now locked in. Again this is the fault of the bank not supporting them:

"It's hard to get away as you're contracted for a period, and can't stop using it for 2 years. It would have been easier if we could have had a short term overdraft."

Next steps (what happened since, have you tried again, impact on the business, discussed with others, have they had similar experiences)

What has happened as a result of all this is that they have not been able to grow at the rate they'd have liked and take up various lucrative opportunities. For example they've had to slow down with recruitment, and had to turn away certain contracts (e.g. those requiring more staff/vehicles):

"Instead we have to save up for everything, for ticket machines, a bigger yard etc."

She feels that the financial crisis of a few years back was very much the fault of the banks due to irresponsible lending, but now they have swung too far the other way, and are stifling growth.

Looking forward (what might you do next time, how is that influenced, are banks changing, how do they get that message across, if not them, what should be happening, by whom)

They don't really wish to get in deeper with the asset management company with more loans than they need, so probably won't go further down that line.

Instead an overdraft would be the more optimum solution. But it's unlikely that she'd turn back to the banks in future as she has a fairly hardened view that they are unhelpful and are, if anything getting worse rather than better. If this is not the case they need to be sending out more positive messages/change their procedures (see ideas below, under conclusions).

Awareness of initiatives (appeals, mentors, cheaper finance - does it change your views)

Appeals: She was not aware of the appeals process and feels that it would not have made any difference to her. This is because of a perception that it would still be too much hassle and there would be too many hurdles:

"You want to get on with your business and paying your way, not badgering the bank. I've got enough to do."

Mentors: This is also something she's not aware of but it would not interest her. She feels they have a fairly simple business model and a tried and tested concept, they know where they want to go, etc., so don't really need advice. She wouldn't rule it out if a free service, but if she were to look into it she thinks it would be better for it to be an independent person, not someone tied to the bank for example, as they are not impartial.

Funding for lending: She was aware of this scheme from what she'd heard on TV, but was again sceptical about it:

"I didn't imagine it working, because I think the bank would keep the extra money to strengthen their position. Because of the mess they made they are underfunded, so probably want to just build up their reserves."

Even when told that a high proportion of applications were successful she wasn't especially impressed and believed that the banks would still make you go through an awful lot of hoops to get there.

In conclusion (summary, what needs to happen, by who, what would encourage you to apply)

She feels that the banks should take a closer look at your history, in terms of things like bouncing cheques etc., and put less hurdles in the way for businesses. *"They should just look back at your history and see that you don't bounce cheques, and cut back on the amount of hoops and meetings* *and forms needed - a forward plan should be enough.”*

The crisis in Cyprus and recent events in America don’t help with confidence in the economy, and she feels that banking should also be made safer by breaking up the banks and separating investment from retail banking.

There are several other solutions which she feels might make a difference:

- Quicker decisions by the lenders:

“When you need to buy a new bus or something you want to do it within two or three days or you are too late, it’s been sold. But it can take weeks.”

- Learn from the asset finance companies and work in the same way, based on your track record - it’s so easy with them by comparison:

“Follow the asset manager’s route. The interest rates are not that high and in any event this is better than having your hands completely tied.”

- Give more autonomy to the banks at a local level:

“They’ve taken all the authority away, so the local managers have their hands tied. I’d have them back and give them more authority.”

- Make it easier to switch banks. She feels there may be better lenders/more amenable ways of doing it etc. but it’s such a major hassle to switch banks that people tend to stay where they are.

CASE STUDY 7: DIRECT LOAN DISCOURAGEMENT

Respondent: Name: MD, Size: 10+ staff, Turnover £500k Business: Day care & respite, Average Risk, East Anglia

Business background (type, challenges, plans, responsibilities)

M and her partner S set up their business 2 years ago. (There are 4 Directors in total, their husbands included, but they make most of the decisions jointly.) They offer day care for adults with learning difficulties, eg activities to give them something to do a few days a week. They support 35 'customers' of ages 19-50, as well as having a respite unit. Previously they worked for the council in nursing, and identified a gap in the market for their services, so the business has taken off and is slowly growing.

For example they recently took on the unit next door at their industrial unit, where they are hoping to expand the respite care side. They are mostly funded by the local council, and the occasional private customer. They believe their USP is being very 'people-centred' and caring.

Beyond the challenges of some difficult customers, it can also be challenging to start and grow a business, because they didn't know what they were doing at the beginning and had to go up a steep learning curve regarding rules and regulations, finance etc.

External finance (how financed, history of needing external, types, how long for etc.)

They got very little help and advice at the beginning, so have learnt as they've gone along. Initially they drew up a business plan, which they took to the bank. The bank loaned them £20,000 over 7 years on the understanding that they also put in £20,000 themselves, which they had to beg, borrow and steal.

In advance of this they thought it might be tough to get funding, given the economic climate, the media etc. It turned out to be a relatively straightforward process, although they had to put their houses up as collateral, and there was no warmth in the transaction, or in their dealings since:

"Decisions are made by others and it's a very distant relationship, with no personal touch. You are just a name and a number. They took no time to understand the business and didn't come out to see us or look at the premises. They just looked at our plans and forecasts."

Beyond this major loan, they have a few other commitments, e.g.: they have a couple of vehicles on monthly HP though others were paid for outright. They don't delay paying suppliers though:

"I try to pay invoices as they soon as come in, so that they don't mount up and I know where I stand."

Discouragement & outcome (what happened last time you tried to obtain funding, purpose, amount, type, preparation, who you went to, what shaped your opinions, outcome etc.)

Her more <u>recent</u> attempts to obtain finance have been less successful. Earlier in the year they wanted to borrow £2,000 to set up an allotment group. There was a lot of umming and aahing from the bank, and eventually an offer, but at a ridiculously high interest rate. They also tried Foundation East, (a charity providing loans for local communities) but got a similar offer of a very high rate.

"The attitude of the bank was that we were high risk. We thought not, because money is going into the account regularly. They were very negative. It's not a lot of money, but they acted like we wanted £20,000."

She's had a further recent brush with the bank when the council changed the way in which they paid suppliers, and were late paying her invoice one month. This meant she had to go to the bank for £12,000, so that she could pay staff wages. She'd hoped it would be fairly straightforward as their turnover has increased, they have a good track record, and she only needed the money to tide her over for two days. But again it was a disappointing experience:

"I ended up pleading with them ... We put a substantial amount of money in, and pay £30 a month for the privilege of having our money in there. We've given them no cause for concern so it lacks a bit of faith. You don't feel valued. It feels like you are all chucked in the same bag. They should base their decisions on your track record, not tar you all with the same brush."

She feels she's not alone with her experiences - going to events and speaking to other business people she finds their opinions to be very similar.

Next steps (what happened since, have you tried again, impact on the business, discussed with others, have they had similar experiences)

The impact of her dealings with the bank is that it's made her reluctant to go back to them for any further needs, as she really didn't like the experience, and they would now prefer to try and do things on their own. For example, she thinks their expansion plans will have to be done by scraping up the money themselves. Part of the problem is a lack of local empowerment:

"Although the response you get can be sympathetic, you get the feeling that there is no sympathy higher up. They'll say 'I'd lend it to you in a jiffy but I've got to go to a higher source.'"

It's also made them very careful with their finances and savvy with what they spend, for example buying furniture on Ebay to kit out the new unit:

"After that we've kept our money very tight, because I couldn't face that hassle again. We now have a bit of a buffer to try and pre-empt this kind of problem happening again" (i.e. the short term bail out required).

Looking forward (what might you do next time, how is that influenced, are banks changing, how do they get that message across, if not them, what should be happening, by whom)

She does get offers from asset management companies, people trying to sell her factoring etc., but doesn't really understand much about them all, so if needing further finance in future would have to look into it all thoroughly and would be somewhat wary, as she doesn't want to overstretch herself. She might use Google for information, or ask advice from friends and contacts.

But what she does know is that the bank would be unlikely to get a look in:

"I wouldn't try the banks again unless it was really the last extreme. It's the fact that you would have to go and plead your case. It's not a nice thing to have to do - it's like they are doing you a massive favour."

Awareness of initiatives (appeals, mentors, cheaper finance - does it change your views)

Appeals: She was not aware of this and wished she'd been told when her overdraft was turned down recently, though she wonders if it would have made any difference. She was surprise to hear of the high appeal success rates, but it immediately begged the question:

"Then why were they turned down in the first place, as they must have had a good case?"

Mentors: Again, unaware of this and feels it's a good idea in principle, but it really depends who's doing the mentoring, and whether they can bring a fresh approach. She feels this kind of service would have been particularly helpful if only she’d known about it at the start of setting up the business, especially to help them with things like navigating their way round HMRC, VAT and tax etc.

Funding for Lending: Was not aware of this, but was again a bit cynical: *“What’s the catch?”*

She was similarly sceptical about the overall success figures for loans and applications:

“I’d think they’d probably doctored the figures. They can say anything can’t they? They’ve probably made those figures look better than they are, so it makes no difference to me.”

In conclusion (summary, what needs to happen, by who, what would encourage you to apply

She feels that any messages need to come from the banks (doesn’t see it coming from the government or elsewhere), but more than this would like to see some concrete actions taken that support small businesses, not just empty promises:

“Show us you mean what you say. Don’t just spout stuff on the telly. Everyone can talk the talk, but match what you’re saying, let’s see the evidence. Don’t just insult our intelligence.”

She has a few further suggestions:

- Make it easier to switch bank accounts - after the service she’s had she might be inclined to move if it was easier
- Visit clients more often to get a feel for the business
- Place more emphasis on personal service:

"They should do more than just give you a free pen. They shouldn't be so distant. You want a friendly face and personal service, to feel valued. The last time our account manager came out, she held the door handle with her coat as if she was going to catch a disease!"

CASE STUDY 8: INDIRECT LOAN/OD DISCOURAGEMENT

Respondent: Size: Sole trader <£50k Name: Mr M Business: Funeral Director, Average Risk, South West

Business background (type, challenges, plans, responsibilities)

Mr M started the business about 12 months ago and has been actively trading since January 2013 (9 months). Meantime he's continuing with a paid job in electronics until the business grows sufficiently for him to switch to full time. They offer eco-friendly funerals, woodland burials etc., which is their USP vs traditional funeral providers. There is a growing interest in this area, plus it works out cheaper for customers, who have so far given excellent feedback. They have only been doing about 1 funeral a month but this is slowly rising. He's the sole decision-maker, just has a receptionist working for him.

One of the biggest challenges is getting started, raising awareness etc., plus they have cashflow issues in their line of work, given that they sometimes have to wait to be paid until after the probate process has been sorted.

External finance (how financed, history of needing external, types, how long for etc.)

Initially he put some finances in himself, borrowing £6k against his house, but that quickly evaporated so he needed to turn to other sources for some funding. This was his first and only real experience of lending, i.e. he's not a sophisticated and experienced business person who knows his way round the system. Having only been going for 9 months he can't really comment on how bank policies etc. have changed over the years either.

He looked at several start-up schemes, funds and grants etc., but there was nothing available in the area. He was also advised to approach the Fredericks Foundation for a start-up loan but decided against that:

"Their interest rates were too high, something like 28%, but they do position themselves as the 'provider of last resort'."

He ended up going to Bank A for funds (only a small amount 5-10k), after being turned down by his own bank and moaning to a friend, who recommended them. He found them completely different culturally - their attitude was extremely open, helpful and supportive. They are local, in the village, and seemed to take an interest in the business, understood his needs etc. It was also quite straightforward, which he found surprising, not too much need for extensive business plans etc.

Discouragement & outcome (what happened last time you tried to obtain funding, purpose, amount, type, preparation, who you went to, what shaped your opinions, outcome etc.)

This is in marked contrast to the treatment he got at his personal bank. He had no trouble getting a business account with them, but when it came to getting any support he was given short shrift. This was despite taking along a comprehensive business plan based on lots of research, and going through it with them:

"I asked if there was any support or startup funds, but I got a categoric NO. Because I failed on the credit checks as I had no accounts, they said come back in 12 months. So it was up to me to sink or swim."

Conversely Bank A couldn't have been more different, and did not ask for capital guarantees:

"They were very positive and responsive, and tried to understand my business. They talked me through how to set it up and asked whether I wanted finance (establishing that an overdraft would be the cheapest way to do it). I just had to sign a Director's guarantee, signing to say I'd personally repay it if the company folded."

Next steps (what happened since, have you tried again, impact on the business, discussed with others, have they had similar experiences)

This overdraft has kept him going and he’s just about breaking even now. He genuinely feels that if he had not been able to switch to Bank A and secure funding, that the business would have folded, as he had no other real sources of injecting capital, unless he could have found some other cash somehow:

“At six months I was in the red. We are relying on clients to pay regularly and on time, but that doesn’t always happen, as it’s a one-off expensive event for people, but I have to pay out a lot of disbursements upfront.”

The experience has made him more financially astute, i.e. keeps a closer eye on cashflow, and he has invested in an accounting package. Plus he has a better appreciation of the liabilities of a limited business.

Another impact on the business of lack of funds is that he hasn’t been able to spend out on things like a decent car, or decent premises. Instead he’s had to sublet, use a very old car etc., and not grow at the rate he might like.

He’s formed his opinions also from talking to other business owners, who he feels have suffered in a similar way and are being held back.

Looking forward (what might you do next time, how is that influenced, are banks changing, how do they get that message across, if not them, what should be happening, by whom)

He would probably go back to Bank A if he needed further support in future. But he might also look to alternative sources like crowd funding, which he thinks is a good idea. However, he feels that he wouldn’t touch his personal bank with a barge pole.

Awareness of initiatives (appeals, mentors, cheaper finance - does it change your views)

Appeals: He's not aware of the ability to appeal, and the bank certainly made no reference to it. In the back of his mind he has a hunch that you can appeal against almost anything, so it's perhaps not surprising, but high interest rates have put him off now anyway. However, was surprised the appeal rate was as high as 40%, though is still left feeling a little cynical.

Mentors: He does have some experience of this scheme, as it was the one thing he took away from the Fredericks Foundation paperwork. He's found it positive, though very slow to get going:

"It's been helpful but not 'transforming', and a bit like running through treacle at times. A local guy made contact then put me in touch with another guy, which took 4-6 weeks. They then put me in touch with a PR agency, which took another 4 weeks."

He'd not been aware of anything like this beforehand and thinks there must be better ways of getting news of this service out into the public domain.

Funding for Lending: This is something he was aware of through the media, but when he enquired about it it seemed that it didn't apply to start-ups, and he was told that there was no chance whatsoever of him getting either a loan or overdraft (from personal bank at least).

Overall he does get the impression from the media etc. that the government are making the right noises about wanting to support small businesses and push through some of these initiatives, but it doesn't appear to be translating into practical implementation:

"In practice, when you ask for help it's hard to come by."

In conclusion (summary, what needs to happen, by who, what would encourage you to apply)

He would like to see the banks being more actively involved with networking groups such as the FSB, which is something he looks to for support (possibly Chamber of Commerce too but he knows less about them.) He feels they could be giving presentations, and communicating out to the business community to offer their support, which is currently lacking:

"From my experience you're on your own, and it's hard to find this sort of information out - you've just got Google."

He feels this is largely the role of the banks, which should be getting their marketing activities aligned and linking up messages to come out in the press, personal communication to customers, networking and offering support via the FSB etc. For example doing more in their marcomms to press home the message of 'we say yes', as seems to be happening with consumer mortgages more lately.

Also it's a question of individual organisations' culture and attitude to risk. The personal bank were very dismissive and he believes this filters down through layers of management and how they interpret the rules locally, which might stifle their ability to make sensible local decisions. Whereas Bank A were more open and receptive, so perhaps other banks need to follow this lead and be more willing to accept things like Directors' guarantees and look at things more closely on a case by case basis, instead of blanket refusals/arbitrary decisions etc.:

"They should be more receptive, look at the data and see that I'd put in £6,000 of my own, which is proof of my own commitment. You might possibly have to pay a higher rate of interest, but at least consider it, rather than an attitude of 'no, don't even come back' ... Other people tell me the same, that they'll happily take your money but are very cautious about unsecured lending."

ERC
Enterprise Research Centre

Centre Manager
Enterprise Research Centre
Warwick Business School
Coventry, CV4 7AL
Enquiries@enterpriseresearch.ac.uk

Centre Manager
Enterprise Research Centre
Aston Business School
Birmingham, B1 7ET
Enquiries@enterpriseresearch.ac.uk

The Enterprise Research Centre is an independent research centre funded by the Economic and Social Research Council (ESRC); the Department for Business, Innovation & Skills (BIS); the Technology Strategy Board (TSB); and, through the British Bankers Association (BBA), by the Royal Bank of Scotland PLC; Bank of Scotland PLC; HSBC Bank PLC; Barclays Bank PLC and Lloyds TSB Bank PLC.