

**The Highland Council**

**Resources Committee**

**27 May 2015**

Agenda Item	<b>27</b>
Report No	<b>RES/54/15</b>

**Scottish Local Authority Business Loan Fund**

**Report by Director of Development and Infrastructure**

**Summary**

This report outlines the proposal for a Scottish local authority's pan-Scotland Business Loan Fund. The Council has an opportunity to invest in the fund and to secure match ERDF and Bank funding for the benefit of Highland businesses.

This opportunity to secure European Union and commercial Bank funding to increase the value of loan funds available, specifically delivers on two Council Administration Commitments:

- the Council will support small businesses and Highland entrepreneurs with advice and finance through Highland Opportunity Ltd and Business Gateway; and
- the Council will work ... to secure maximum benefit for the Highlands from the EU funding programmes for 2014-2020 ...

**1. Background**

- 1.1 The proposed ERDF Programme 2014-2020 has committed £40m to Financial Instruments for the first three years of the 2014-2020 Programme. Activity to be funded includes the recapitalisation of Local Authority loan funds. Due to EU 'scale of activity' requirements, the Scottish Government is actively encouraging a collective effort rather than supporting individual applications from local authorities to recapitalise their own individual loan funds.
- 1.2 The new pan-Scotland Fund will offer gap-funding to small and medium-sized enterprises (SMEs):
- loans up to £100,000;
  - secured by Standard Security, Bond & Floating Charge and / or Personal Guarantee;
  - some loans may be offered on an unsecured basis depending on circumstance; and
  - interest rate fixed (probably at 6% per annum in 2015) with no additional fees or charges.
- 1.3 The value of the pan-Scotland Loan Fund will be in the region of £18m over 3 years. The Highland share of this – **for use by Highland businesses only, will be approximately £1.12m** (see section 3 below). The Fund will be 'evergreen' in that the funds invested will be asset locked in perpetuity and

recycled for the purpose of business loan finance.

- 1.4 All of Scotland's local authorities have been invited to join the fund and at the time of writing this report, 28 of the 32 have agreed to join. The others have yet to make a decision but will be doing so during May 2015.
- 1.5 The Loan Fund, including its governance and management, is modelled on the current West of Scotland Loan Fund and the East of Scotland Investment Fund. As part of this proposal both Funds will cease and transfer to the new pan-Scotland fund.

## **2. Proposal**

- 2.1 The proposed Loan Fund will be a company limited by guarantee, with each of the participating local authorities making up the members of the company. The formal name of the Loan Fund will be Business Loans Scotland Limited. As it will be impractical for each Member authority to be represented on the Board, it is proposed to have three regional (operational) groups across Scotland and for each regional group to nominate three Directors, thereby forming a Board of nine directors. The Highlands and Islands will be one of the regional groups.
- 2.2 Administration of the Fund will be undertaken centrally with the core team located in the west of Scotland (office location currently being sourced) with an outreach officer based in the east of Scotland (office location currently being sourced), and one based in the Highlands (with Inverness an obvious location due to its geographic/travel position).
- 2.3 The Loan Fund is to be financed from local authority funds (30%), a commercial Bank Loan (30%) and ERDF (40%). For the avoidance of doubt, each Local Authority's financial contribution to the Fund will be exclusively ring fenced for investing by that Local Authority solely in their area, i.e. only Highland businesses will be able to draw down loan finance sourced from the Highland Council's match contribution.
- 2.4 Applications will be made online with eligibility checks etc. done centrally before the application is passed to the relevant local authority to appraise and determine the application. If the loan requested is under £50k, then the decision of the local authority is final. If the local authority recommends approval of a loan over £50k, then the loan application and assessment is passed to a regional panel for determination. This regional panel will be made up of representatives from those Highlands and Islands local authorities who are members of the Loan Fund. This is the approach adopted in the current East and West of Scotland loan funds and serves as a useful means to ensure there is a high quality and consistent assessment of loan applications across all local authority areas.
- 2.5 Any bad debt will be managed jointly between the Loan Fund team and the relevant local authority with local contact with the business and local decision making central to any mitigating action pursued. As with any loans there is a possibility that the Council (as is currently the case with Highland Opportunity

Ltd. (HOL) and its loan portfolio) could suffer a loss of capital should recovery action fail.

### **3. Assessment**

3.1 The pan-Scotland Loan Fund is viewed as a further opportunity for local government to demonstrate that it can work collectively to deliver activity in an effective and efficient manner at a national scale and be responsive to local needs and opportunities. It also adds value to other local authority economic development services, for example, Business Gateway, and allows the Council to offer a wider and integrated package of support to growing businesses.

#### **3.2 Match Funding**

3.2.1 The proposed Loan Fund has an indicative allocation for each local authority based on a pro rata share of the Scottish business base. In Highland the following is proposed:

<b>Source</b>	
Highland Council	£337,500
Bank	£337,500
ERDF	£450,000
Total	£1,125,000 (over a three year period)

Taken alongside the existing HOL loan funds (£570k per annum), the total funds available for loan finance per annum would be £945,000 (£2.835m over a three year period).

3.2.2 After liaison with the Finance Service, it has been identified that the source for the Council's match funding could only come from the Council's Balances. If agreed the Council's contribution would be paid in full to the Loan Fund in the first year.

#### **3.3 Demand: (National)**

3.3.1 The Scottish Government has recently produced an ex-ante assessment to establish demand and determine how such a loan fund (and use of ERDF) will at a national level add value and fill gaps in the current supply of loan finance including commercial sources.

3.3.2 The report makes it clear that there are a number of market failures, affecting both the supply and demand of finance to SMEs, which can lead to potentially viable businesses being unable to access the finance they require, and this provides the rationale for government/ERDF intervention. In particular the report found:

- demand for finance by SMEs has been subdued during the recessionary period;
- Bank of England data shows that net lending to SME's has been negative throughout 2013 and 2014;

- rejection rates have remained an issue, particularly in relation to loans;
- Scottish SMEs had slightly more difficulty obtaining finance compared to UK SMEs;
- the main reasons were that Scottish SMEs did not meet the lender's criteria and Scottish SMEs faced more difficulties as a result of their credit history;
- there is clear market failure in the supply of debt finance to SMEs with growth and export potential; and
- the 2012 Royal Society of Edinburgh report on the Financing of Business Innovation in Scotland found that young firms with growth potential are constrained by a lack of access to finance.

3.3.3 The assessment makes a number of recommendations including:

- the Loan Fund should be Scotland-wide, providing loans in the range £20,000 to £100,000 and should be capitalised in the range £15m- £20m (with £6m-£8m ERDF);
- any Scottish wide loan fund should be geared to fill the mid-level gap in investment;
- a national scheme at this level should bring additional benefits including:
  - fund value sufficiently large to make a measureable impact on the debt market for target SMEs;
  - uniformity of coverage;
  - economies of scale in management costs;
  - improved governance procedures;
  - subsidiary in decision making to regional and local levels;
- any national debt scheme should be delivered on a fully commercial basis, with the decisions taken by market-oriented professionals who make lending decisions on a business basis.

#### 3.4 Demand: (Local)

While the above assessment demonstrates that at a national level there is market failure in the supply and demand of finance to SMEs (and a justification for a loan fund with ERDF investment), local commentary on the ability of business to secure business finance has been secured.

##### 3.4.1 Scottish Council for Development and Industry

*Whilst the major banks are opening up once more to business lending there continues to be a concern over that the demands or loan terms they place on lending and the rates offered are unattractive to many businesses.*

*As the banks look to rebalance their lending profile some businesses that have previously had strong ties with a bank can suddenly find that their business sector is not one the bank is looking to invest in any further and as a result are forced to foster new financial relations.*

*Some successful well established businesses have seen their growth stifled through decisions being taken based on a bank's own short term needs, rather than on the long term prospects for that businesses growth and I certainly believe a Loan Fund could be a positive addition to the financing landscape to help meet business demand for lending.*

Fraser Grieve, 23/3/15

#### 3.4.2 Federation of Small Businesses

*I had a chat to my Scottish policy colleagues and was told that small business uptake of public sector financial loan schemes is poorer than it should be.*

*FSB member surveys and conversations with individual members both indicate that access to finance remains one of the key issues impacting on the viability and growth of small businesses, both in the Highlands and right across the UK. The FSB is calling for more competition in the finance market and we support your bid to establish a new Highland Loan Fund.*

*Our one caveat is that the business support network is already a highly confused and confusing landscape for the businesses that need it most - small and micros – so great care should be taken to ensure that the new Loan Fund dovetails with existing offers and that it is marketed as part of a mix of opportunities. I am sure that your Highland Opportunity/Business Gateway staff will take this on board – but so too should HIE and other agencies.*

David Richardson, 27/3/15

#### 3.4.3 Highlands and Islands Enterprise

*HIE can provide loans as part of a package of support for businesses, but we tend to only offer loans over £100k in value, so a product addressing the sub-£100k market would not duplicate or overlap with the support HIE can provide.*

*(Business Gateway) businesses are important to HIE as they represent a potential “pipeline” of growth businesses which may in due course grow to need larger scale support, and be appropriate for HIE to account manage. A local authority loan product appropriate for their needs would therefore be a valuable addition to the funding landscape, and we would view it as helpful in facilitating HIE’s work by supporting potential pipeline businesses to develop.*

*.... aware from contact with banks and other funders as well as from national research that businesses that have little track record of trading, few assets to offer as security or are simply small operations can struggle to secure the finance they seek, being considered either high risk or not necessarily cost effective customers by providers of finance. A lower value loan product from local authorities will therefore be useful in addressing some of this demand, either by providing finance where it is not available from commercial sources, or potentially by sharing the risk and enabling banks to feel comfortable to lend a lower amount.*

HIE, 14/4/15

#### 3.4.4 Highland Opportunity Ltd

The Council, via HOL, provided affordable loan finance in 2013/14 to 25 businesses amounting to £524.5k; a further £27.5k was approved to match fund 9 loans to PTYBS young clients, and £21k of loan assistance to 2 social enterprises. In 2014/15 the total loan finance provided was £520.7k to 20 businesses.

#### 3.4.5 From May 2014, HOL and Business Gateway have been delivery partners for the Start Up Loans Company (SULCo) which provides personal loans for start-

ups within their first 2 years of trading and considers up to £25k per business. £91.3k, representing 10 personal loans to 5 businesses was approved for Highland up to the end of March 2015 with a further 20 applications for £221k in the pipeline. This confirms the market failure in commercial/ bank lending to young businesses with no track record.

3.4.6 Through the Business Growth programme, established with support of ERDF in January 2014, over 60 companies have received Access to Finance advisory support over the 13 month project. HOL's experience in delivering this advice through Business Gateway identified the difficulty many businesses are experiencing in accessing new or enhanced bank or asset finance and, in particular, in managing changed bank behaviour in terms of overdraft facilities.

3.4.7 HOL is of the view that the supply of funding for its loan finance currently meets the demand experienced. Internal measures to free up HOL investment funds has seen the sum available for lending increase to an average of £710k over the last 5 Board meetings in 2014/15 enabling HOL to be more proactive in promoting its loan finance.

### 3.5 Central Administration

In order to resource and staff the new Fund appropriately an assumption has been made that running costs will be 3% of the Fund annually. Pro rata based on each local authority's share of the £18m Fund, this would mean a contribution from Highland Council of £90k for 3 years. No loan interest repayments have been factored in here and the contribution to the management charge could come from the cash at bank figure made up of the ERDF allocation and / or Council's contribution. This is an issue which needs further work but clearly across all local authority partners the aspiration is to keep the management cost as low as possible and proportionate across members.

### 3.6 Assessment/Decision-making costs

The current payment provided for the HOL staff cost of assessing/determining applications for the Start Up Loan Company is a nationally set rate of £400 per application. HOL have indicated that a revised cost of £1000 per loan is required and is a fairer cost reflective of the time required to undertake due diligence of a loan application.

## 4. **Conclusion**

4.1 The proposed Loan Fund offers a chance to access European and commercial bank funding, and to build on the loan finance available to Highland businesses. With an investment of £337,500 over 3 years, this will allow new loan finance to the value of £1,125,000 to be secured and available to Highland businesses. Together with the current HOL finance this would equate to £2.835m over a three year period.

4.2 In doing so it will directly deliver on two Council Programme commitments – to support small businesses and Highland entrepreneurs with finance and secure maximum benefit for the Highlands from the EU funding programmes for 2014-

2020. It also allows the Council to demonstrate that it can, together with its local authority partners, work collectively to deliver activity in an effective and efficient manner at a national scale and be responsive to local business needs and opportunities.

- 4.3 At a national level the demand for such funding exists as it is proven that there are number of market failures, affecting both the supply and demand of finance to SMEs, which can lead to potentially viable businesses not being able to access the finance they require. Comment locally supports these findings and the case to increase the loan finance available to Highland businesses.
- 4.4 Much work has already taken place regarding the set-up of the new Fund and the Council has already offered Legal and Finance Service comments but, if the Council wishes to join the Loan Fund, further due diligence will be required. In addition, work with partner local authorities in the Highlands and Islands will be necessary to determine how best to establish and deliver the required Regional Panel and associated officer support grouping.

## **5. Implications**

### **5.1 Resource**

The Council is being asked to invest £337,500 in the Loan Fund. The Fund is 'evergreen' in that the funds invested will be asset locked in perpetuity and recycled for the purpose of business loan finance. The sum involved will be sourced from the Council's Balances.

- 5.1.1. An annual cost, estimated as up to £30k per annum, will be required as the Council's contribution to the costs of managing the Loan Fund. While efforts will be made to reduce this sum and to bring one of the core Loan Fund teams to Inverness, the sum involved will need to be sourced from the Loan Fund (the Highland ring-fenced fund including loan interest repayments).
- 5.1.2 The Council will also need to contract HOL to undertake loan application assessments. This will be funded from the Development and Infrastructure Service revenue budget.

### **5.2 Legal**

The Loan Fund will be a company limited by guarantee called Business Loans Scotland Limited. If the Council wishes to participate in the Fund it will become a member of the company and will have an opportunity to be a Director of the company. The Council will have the choice as to whether this Director would be an elected Member or a senior officer. As a member of the company the Council would be bound by its Articles of Association and Members Agreement.

### **5.3 Equalities, Rural, Climate Change/Carbon Clever**

Any business loan assessment made and decision taken will be done so on the basis of business need/opportunity and ability to repay the loan. Applications will be positively encouraged from Highland based businesses

including those led by women, businesses located in rural Highland, and businesses in the low carbon and gaelic sectors.

5.4 Risk

As with any loans there is a possibility that the Council (as is currently the case with HOL) could suffer a loss of capital should a business default and recovery action fail. As appropriate, loans may be secured by Standard Security, Bond and Floating Charge, and / or Personal Guarantee to help reduce this risk.

5.4.1 In the event that in the future there is no demand for loan finance from the Fund and a decision is taken by at least 75% of the members of the company to close the Fund, an option will exist for the Highland funds to be transferred to an equivalent organisation (i.e. HOL) or returned for use in Highland business support activities only.

**Recommendation**

Members are asked to:

- agree to become a Member of the Scottish Local Authority Loans Fund (Business Loans Scotland Limited); and
- approve a contribution of £337,500 to the Scottish Local Authority Loans Fund (Business Loans Scotland Limited).

Designation: Director of Development and Infrastructure

Date: 14<sup>th</sup> May 2015

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in liaison with David Robertson, Finance