

# Business Finance

2004

IOD POLICY PAPER

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# 1: Introduction and summary

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## 1.1 Introduction

The United Kingdom (UK) economy continues to outperform many of its principal competitors on a number of key economic criteria. The UK's Gross Domestic Product (GDP) has now grown for 46 consecutive quarters, the longest sustained expansion on record.<sup>1</sup> In 2003 UK GDP grew by 2.3%.<sup>2</sup> By way of contrast, on one recent estimate GDP growth in the 15 European Union (EU) countries (i.e. including the UK) is said to have been just 0.7% in 2003 (and a mere 0.5% in the euro area).<sup>3</sup> The UK's inflation rate when measured on the Harmonised Index of Consumer Prices (HICP) has been amongst the lowest in the EU since 2000.<sup>4</sup> Indeed, the UK's inflation rate for January was just 1.4%, compared to an EU average of 1.8%.<sup>5</sup> With inflation below the Bank of England's target rate of 2% on the Consumer Prices Index (CPI),<sup>6</sup> the Bank of England has been able to keep interest rates relatively low: despite three quarter-point rises, interest rates currently stand at just 4.25%, although further rises are widely expected later this year. Corporate profitability improved throughout 2003, leaving firms with more finance available. The latest overall profitability of UK private non-financial sector companies in the third quarter of 2003 was 12.6%, higher than the previous quarter and the 2002 average of 11.4%.<sup>7</sup> The three-year slump in equity prices ended in March 2003 and since then there has been a recovery, although indices in the UK remain well below their previous highs.<sup>8</sup> Consequently, the value of quoted firms' shares has improved and it should have become easier to raise equity finance. The subdued state of the venture capital market and the business angel market in 2003 has also begun to show signs of improvement.<sup>9</sup> In these circumstances, it probably has not been too difficult for most businesses to gain access to finance. Interest rates remain at historically low levels, banks are reasonably willing to lend and corporate profitability has improved.

Nevertheless, the provision of finance remains an important issue for consideration and is a matter of interest to the Institute of Directors (IoD). Accordingly, we commissioned NOP to conduct a survey of IoD members in order to ascertain their experiences and views on matters connected with business finance. The results of our survey are presented in this research paper.

## 1.2 The profile of respondents to our survey

NOP interviewed 500 IoD members on behalf of the IoD's Policy Unit in December 2003. The sample used and the number of interviews that took place were designed to reflect the composition of the IoD's membership in terms of firm size, economic sector and geographical location. The profile of those IoD members who took part in this survey is shown in Tables 1, 2 and 3.

TABLE 1: PROFILE OF RESPONDENTS BY FIRM SIZE<sup>10</sup>

1-20 employees	36% (180)
21-100 employees	32% (160)
101-200 employees	10% (50)
201 employees plus	22% (110)

TABLE 2: PROFILE OF RESPONDENTS BY INDUSTRY

Business and professional services	32% (160)
Manufacturing	21% (105)
Financial services	13% (65)
Government, education, health and personal services	12% (60)
Distribution	11% (55)
Other (including construction, mining and transport)	11% (55)

TABLE 3: PROFILE OF RESPONDENTS BY GEOGRAPHICAL REGION<sup>11</sup>

North	23% (115)
Midlands	19% (95)
South	58% (290)

Where important differences appear between the answers of IoD members in general and the answers of IoD members from a particular category of firm size, economic sector, or geographical location, these are highlighted.

The IoD Policy Unit previously commissioned NOP to conduct surveys of IoD members on the subject of business finance in December 2000, December 2001 and December 2002. The results were published in the research papers, *Business Finance 2001* (Institute of Directors, March 2001), *Business Finance 2002* (Institute of Directors, January 2002) and *Business Finance 2003* (Institute of Directors, February 2003). Significant differences and similarities in the findings of this research paper and the findings published in the previous research papers are noted at the appropriate points in the text.

### 1.3 Executive summary

#### *Sources of business finance*

48% (231) of directors in our survey had bank overdrafts to finance their business activities. 34% (166) used their own resources and 26% (128) had bank loans. The next most popular sources of

finance were cash flow/money from within the company and retained profits, which were used by 8% (40) and 5% (27) of those surveyed, respectively.

### *Factors determining the choice of external finance*

Unsurprisingly, 95% (291) of those directors in our survey who used external finance said that they regarded cost to be either a very important factor or an important factor when determining their choice of external capital. 93% (285) of directors also considered that the maintenance of business control was either very important or important when selecting external finance.

### *Accessibility of finance*

71% (343) of the directors interviewed in our survey did not think that it was difficult to get access to finance for their business, 23% (112) thought that it was and 6% (29) did not know.

This year's survey results represent a slight improvement on the previous year's findings. In Business Finance 2003, 69% (336) of directors did not think that it was difficult to get access to finance, 25% (123) thought that it was difficult and 6% (29) did not know. Evidently, fewer directors believe that access to finance is a problem in comparison to last year's survey of IoD members.

### *Fixed term bank loans*

26% (125) of the directors in our survey stated that their business had fixed term bank loans.

### *Fixed and variable rate loans*

25% (32) of the IoD members in our survey who had fixed term loans from a bank only possessed loans with a fixed rate of interest, while 36% (46) only had loans with variable rates of interest. 33% (41) used a mixture of fixed term bank loans with fixed and variable rates of interest.

### *Maturity of business loans*

Our survey showed that those IoD members who had fixed term bank loans were borrowing for relatively long periods of time. For 44% (55) of the directors in our survey with fixed term bank loans, the length of maturity of their most recent loan when they originally took it out was between three to five years. For another 22% (28) of directors the length of maturity was between six and ten years and for 14% (18) it was more than ten years. Only 8% (10) of the directors in our survey with fixed term bank loans had loans with a length of maturity of less than three years. Loans with relatively long periods of maturity allow IoD members to plan for the long term.

### *Date of most recent fixed term bank loans*

42% (52) of IoD members with fixed term bank loans took out their most recent loan between 2000 and 2002, while 28% (36) took out their most recent loan in 2003.

### *Bank overdrafts*

48% (231) of the businesses in our survey had a bank overdraft, 48% (235) did not and 4% (19) did not know.

#### **The cost of bank overdrafts**

21% (49) of businesses with a bank overdraft paid between 2-2.9% over base rate for their bank overdrafts, 19% (44) paid between 1-1.9% and 4% (8) paid between 0.1-0.9%.

### *Lending conditions*

60% (138) of IoD members reported that when they last renewed their overdraft facility, the terms that they agreed with their bank were about the same, 21% (49) said that they were more favourable and 9% (20) said that they were less favourable. 10% (23) of members did not know whether the terms of their business's overdraft facility had changed or not.

### *Choice of bank finance*

67% (323) of the directors in our survey believe that, on the basis of their own experience, there is a good choice of bank finance, 26% (125) disagree and 8% (37) are unsure.

In Business Finance 2003, 58% (282) of IoD members considered that there was a good choice of bank finance, 30% (146) took the opposite view and 12% (60) were unsure. Consequently, a significantly larger proportion of respondents in this year's survey believe that there is a good choice of bank finance in comparison to last year's survey. This would seem to indicate that, as far as IoD members are concerned, there is a reasonable degree of competition in the business-banking market.

### *Business banking*

27% (129) of the firms in our survey bank mainly with the Royal Bank of Scotland Group (including the Royal Bank of Scotland, NatWest and Ulster Bank), 23% (110) are with Barclays Bank, 15% (71) use HSBC Bank and 12% (58) have their main account with Lloyds TSB Bank. These figures are virtually the same as those cited in Business Finance 2003 and the relative popularity of the banks in question amongst respondents is unchanged from the previous year.

### *Bank-firm relations*

69% (334) of directors in our survey described their relationship with their bank as good, 22% (109) said it was acceptable and just 5% (23) reported that it was poor. 4% (19) said that they did not know.

In Business Finance 2003, 69% (338) of directors stated that their relationship with their bank was good, 24% (118) said that it was acceptable and just 3% (14) felt that it was poor. Evidently, there has been a slight rise in the proportion of directors regarding their relationship with their bank as poor, despite the greater efforts that the banks now make to have good relations with their business customers, in comparison to the late 1980s. Nevertheless, the overwhelming majority of directors continue to have a good relationship with their bank.

### *Customer loyalty*

44% (211) of businesses in our survey had been with their present bank for more than ten years, while 20% (96) had been with their present bank for between five and ten years.

### *Reasons for not switching*

65% (200) of directors explained that they had not changed their bank in the last five years because they were happy with their existing bank. 12% (38) said that they had not switched because they believed that it was important to have a long term relationship with a bank. 10% (31) rather cynically commented that there was no point changing because all the banks were the same.

### *Switching banks*

15% (22) of businesses who had changed their bank in the previous five years did so because they found another bank offering better terms and services, while another 15% (22) left their last bank because it was providing them with a poor service.

### *Requests for bank finance*

87% (424) of businesses said that they had never had a request for finance turned down by their bank, 7% (34) said that they had and 6% (27) did not know.

### *Reasons for bank rejecting a request for finance*

22% (8) of directors said that the bank had dismissed their request for finance because they lacked sufficient collateral, 17% (6) said that the bank thought that their venture was too risky and 11% (4) said that the bank did not agree with their business plan.

### *Cash deposits*

74% (359) of the IoD members in our survey reported that they had a cash deposit at their bank, 20% (95) did not and 6% (31) did not know.

### *The state of cash deposits*

Of those IoD members with cash deposits, 39% (138) had increased the amount over the last twelve months, 37% (133) kept it at the same level and 17% (61) reduced it. 7% (26) did not know what action their business had taken with respect to its bank cash deposit.

### *Reasons behind the increase in cash deposits*

29% (40) of those directors who increased their cash deposits over the previous twelve months did so because they had managed to increase their profits and more money was coming into the business. 16% (22) built up their cash deposits in case of unforeseen circumstances and to act as a safety reserve. 13% (18) grew their cash deposits in order to finance an investment project. 10% (13) of directors had built up their cash deposits simply because their cash flow had increased.

## 2: Sources of business finance

As a general rule, start up enterprises and small businesses will typically rely on their own resources to finance their operations. In fact, even larger and older businesses will invariably rely to an important extent on internal sources of capital to finance their activities. However, as businesses grow they will usually have to seek external sources of finance to complement their internal revenues, as the latter are unlikely to be sufficient to meet all their needs. In general terms, innovative and growing firms and larger and older businesses are most likely to seek external finance.<sup>12</sup>

In the first instance, the external provider of capital for most firms will probably be a bank. Bank finance in the form of overdrafts and term loans is the most significant form of exogenous finance for small enterprises.<sup>13</sup> Small business owners are typically attracted to using bank finance because they are relatively well informed about how to raise this source of finance in comparison to some of the alternatives. Additionally, for some businessmen the use of bank finance has the added appeal of not diminishing their control over their enterprise, in contrast to the use of equity finance.<sup>14</sup>

Small firms' dependence on external finance diminished during the 1990s.<sup>15</sup> SMEs often prefer to rely on their own resources and the generally strong performance of the UK economy over the last twelve years has made this a realistic option for many businesses. Survey evidence indicates that just 40% of small and medium-sized enterprises (SMEs)<sup>16</sup> used external finance over the period 1997-99, compared with 65% in 1987-90.<sup>17</sup> Within this context, bank finance appears to have become more important, increasing from 48% of the total amount of external finance used by SMEs during the period 1995-97, to 61% in the period 1997-99.<sup>18</sup> Further evidence on the use of external finance by SMEs was provided by a survey of 1,211 firms by BMRB International for the Competition Commission in September 2000. This survey found that 35% (427) of the SMEs surveyed used some variant of external finance. Of those SMEs using external finance in the survey conducted for the Competition Commission, 24% had an overdraft facility and 40% had a loan. However, 44% relied on leasing or Hire Purchase as a form of external funding.<sup>19</sup>

The banks continue to provide the lion's share of funding for SMEs, although traditional forms of bank finance (overdrafts and loans) have declined in importance. Data from the ESRC Centre of Business Research shows that whereas the banks provided 60% of SMEs' sources of external finance in 1991-93, this proportion had fallen to 52% by 2000-02.<sup>20</sup> Conversely, over the same period the proportion of HP-leasing as a source of external finance for SMEs increased from 16% to 25%. However, as the banks or their subsidiaries are major players in the HP-leasing market, this data does not illustrate a decline in the importance of the banks as providers of finance for SMEs.<sup>21</sup>

More recent data suggests that traditional bank lending to small firms is increasing.<sup>22</sup> According to the British Bankers' Association (BBA), bank lending (term lending and overdrafts) to small firms<sup>23</sup> rose by £2.9 billion in 2003 to £38.9 billion.<sup>24</sup> By the end of 2003, overdrafts constituted just 23% of small firm bank borrowing, in contrast to 25% at the end of 2002.<sup>25</sup>

Our research confirms the importance of both internal sources of finance and bank finance to IoD members. 48% (231) of directors in our survey had bank overdrafts to finance their business

activities. 34% (166) used their own resources and 26% (128) had bank loans. The next most popular sources of finance were cash flow/money from within the company and retained profits, which were used by 8% (40) and 5% (27) of those surveyed, respectively (see Table 4).

**TABLE 4: WHAT SOURCES OF FINANCE DO YOU USE TO FINANCE YOUR BUSINESS?  
(INTERVIEWEES COULD GIVE MORE THAN ONE ANSWER).<sup>26</sup>**

Bank overdraft	48% (231)
Self-financing/own money	34% (166)
Bank loan	26% (128)
From our cash flow/money within the company	8% (40)
Retained profits	5% (27)
Shareholders/shareholder loans	5% (22)
Leasing	4% (21)
Parent company	5% (23)
Factoring or invoice discounting	3% (16)
Stock market (equity finance)	3% (15)
Venture capital	3% (15)
Hire purchase	3% (12)
Government/EU grant	2% (9)
Partner investment	1% (7)
Business angel	1% (5)
Family/friends	1% (4)
Small Firms Loan Guarantee Scheme	0% (2)
Others	9% (43)
Refused to answer	1% (7)
No answer	4% (20)
Don't know	2% (9)

### *Size, sectoral and geographic differences*

Smaller enterprises were more likely to be self-financing/use their own money to fund their operations in comparison to larger businesses. Whereas 40% (72) of firms with 1-20 employees and 35% (55) of firms with 21-100 employees were self-financing/use their own money, the equivalent figures for businesses with 101-200 employees and businesses with 201 or more employees were 24% (12) and 27% (27) respectively.

Just 2% (9) of businesses took advantage of Government or EU grants to fund their operations. Interestingly, 33% (3) of these were businesses with 201 or more employees. Larger companies invariably have the management time and the research facilities to find out about the availability of Government and EU grants and they have the knowledge to take advantage of them. Even so, 66% (6) of the businesses who used Government or EU grants to finance their activities were from the smaller categories of firm size in our survey.

IoD members from the North were more likely to have bank loans in comparison to members from other regions. Whereas 39% (44) of directors in the North had bank loans, the figures for directors in the Midlands and in the South were 26% (23) and 22% (61), respectively.

Directors based in the financial services sector were more likely to be self-financing/use their own money than directors from any other sector. Whereas 42% (26) of members involved in financial services were self-financing/used their own money, just 21% (11) of members from the government, education, health and personal services sector did so. At the same time, 41% (21) of members from the government, education, health and personal services sector had bank loans - a higher proportion than members from any other sector. By way of contrast, just 15% (8) members from the construction, mining and transport sector had bank loans.

### 3: Factors determining the choice of external finance

Firms consider a variety of factors when raising external finance: the costs involved, how quickly it can be raised, financial advisers' advice and so on. Unsurprisingly, 95% (291) of those directors in our survey who used external finance said that they regarded cost to be either a very important factor or an important factor when determining their choice of external capital. 93% (285) of directors also considered that the maintenance of business control was either very important or important when selecting external finance (see Table 5).

**TABLE 5: HOW IMPORTANT MIGHT YOU CONSIDER THESE FACTORS WHEN RAISING EXTERNAL FINANCE?<sup>27</sup>**

	Very important	Important	Neither imp't nor unimp't	Not imp't	Not imp't at all	Don't Know
Cost	58% (179)	36% (111)	1% (3)	2% (6)	0% (1)	2% (7)
Maintenance of business control	64% (198)	28% (87)	3% (9)	3% (8)	0% (0)	2% (5)
No requirement for personal collateral	36% (110)	35% (108)	12% (38)	10% (32)	3% (10)	3% (10)
The speed with which finance can be obtained	31% (96)	46% (142)	12% (36)	9% (26)	1% (2)	2% (6)
Previous experience with source of finance	26% (79)	46% (142)	11% (35)	11% (35)	1% (4)	4% (12)
Knowledge of source of finance (how to acquire it, etc)	43% (133)	45% (137)	4% (13)	5% (14)	0% (1)	3% (9)
Advice of bank/accountant/consultant	22% (67)	47% (145)	16% (50)	10% (31)	2% (7)	2% (7)
Length of loan	22% (66)	51% (158)	10% (32)	11% (33)	0% (0)	6% (18)
Availability	41% (126)	45% (139)	7% (21)	3% (9)	1% (2)	4% (11)

*Size, sectoral and geographic differences*

Directors from large businesses place less priority on the speed with which finance can be obtained when raising external finance in comparison to directors from smaller firms. Just 16% (11) of businesses with 201 or more employees regarded speed as a very important factor when raising external finance, compared to 39% (39) of firms with 1-20 employees.

## 4: Accessibility of finance

Generally speaking businesses should not find it too difficult to access capital. True, there have been reports that venture capitalists are shunning start-up enterprises.<sup>28</sup> This is certainly worrying, although relatively few firms look for this form of finance. Nevertheless, corporate profitability is improving, the economy has continued to grow, interest rates are relatively low and the banks appear happy to lend (see Sections 1.1, 2 and 5.14). Consequently, most firms probably do not find it particularly difficult to access finance.<sup>29</sup> This was certainly the view of the majority of directors in our survey. 71% (343) of the directors interviewed in our survey did not think that it was difficult to get access to finance for their business, 23% (112) thought that it was and 6% (29) did not know (see Table 7).

**TABLE 7: DO YOU THINK THAT IT IS DIFFICULT TO GET ACCESS TO FINANCE FOR YOUR BUSINESS?<sup>30</sup>**

Yes	23% (112)
No	71% (343)
Don't know	6% (29)

### *Size, sectoral and geographic differences*

Directors from larger firms were less likely to believe that that it was difficult to obtain finance. Whereas 35% (63) of firms with 1-20 employees thought that it was difficult to get access to finance, this view was held by 23% (36) of firms with 21-100 employees, 12% (6) of firms with 101-200 employees and just 7% (7) of firms with 201 or more employees.

There was also one interesting finding from a sectoral perspective. 30% (19) of businesses involved in financial services believed that it was difficult to get access to finance for their business, compared to just 18% (19) of respondents from manufacturing.

### *Annual change*

This year's survey findings represent a slight improvement on the previous year's results. In Business Finance 2003, 69% (336) of directors thought that it was not difficult to get access to finance, 25% (123) thought that it was and 6% (29) did not know. Evidently, even fewer directors now think that it is difficult to get access to finance than last year.

## 5: Bank finance

### 5.1 Fixed term bank loans

As noted in Section 2, according to data provided by the BBA, term loans now constitute three quarters of bank lending to small businesses (defined as businesses with a turnover of less than £1 million) by value. Our survey does not reveal the value of fixed term bank loans to IoD members. However, it is worth noting that just 26% (125) of the directors who were interviewed in our survey stated that their businesses had bank loans (see Table 8). Moreover, of those IoD members' businesses with a turnover of less than £1 million, only 18% (20) had fixed term bank loans.

**TABLE 8: DOES YOUR BUSINESS HAVE ANY FIXED TERM LOANS FROM A BANK?<sup>31</sup>**

Yes	26% (125)
No	70% (339)
Don't know	4% (21)

#### *Size, sectoral and geographic differences*

In our survey, larger firms had a greater tendency to have some fixed term loans from a bank when compared to smaller firms. 38% (19) of firms with 101-200 employees and 36% (36) of businesses with 201 or more employees had some fixed term loans from a bank, whereas the figures for firms with 1-20 employees and 21-100 employees were just 17% (30) and 26% (40) respectively. As observed in Section 2, businesses that are growing, innovative, larger and older are more likely than any other kind of businesses to look for external finance.

IoD members from the sector embracing government, education, health and personal services were more likely to have fixed term bank loans than any other sector. 40% (20) of organisations from this sector had such loans. Conversely, just 21% (13) of businesses involved in financial services had fixed term loans.

Businesses from the North had a greater propensity to have fixed term loans from a bank in comparison to businesses from other regions. 37% (42) of businesses from the North had fixed terms loans, whereas this was the case with 23% (21) of businesses from the Midlands and 22% (62) of businesses from the South.

### 5.2 Fixed and variable rate loans

A fixed term loan with a fixed rate of interest naturally provides an important element of certainty for a business owner and so it is naturally attractive to many entrepreneurs. However, many business

owners and managers are drawn to taking out fixed term loans with a variable rate of interest because they hope that interest rates will fall, thereby reducing the cost of borrowing to their business. According to the Bank of England, all of the increase in fixed term lending in 2002 was due to variable rate loans, while the use of fixed term loans declined. SMEs clearly did not anticipate significant interest rate rises in 2002.<sup>32</sup>

When businesses take out fixed term bank loans they often have to pay variable rates of interest on the borrowed amount. According to the BBA, 89% of fixed term bank loans are lent at variable margins over base rates (and in parenthesis, almost all overdraft lending is also subject to variable interest rates).<sup>33</sup> Despite the potential uncertainty accompanying the use of variable rate bank loans, many IoD members appear quite relaxed about taking out such loans. In fact, of the IoD members in our survey who had fixed term loans from a bank, 36% (46) only had loans with variable rates of interest. Just 25% (32) of the IoD members in our survey who had fixed term loans from a bank only possessed loans with a fixed rate of interest. 33% (41) used a mixture of fixed term bank loans with fixed and variable rates of interest (see Table 9).

**TABLE 9: DO YOUR FIXED TERM BANK LOANS GENERALLY HAVE VARIABLE OR FIXED RATE INTEREST OR BOTH?<sup>34</sup>**

Fixed rate only	25% (32)
Variable rate only	36% (46)
Both fixed rate and variable rate	33% (41)
Don't know	5% (7)

### *Annual change*

A smaller proportion of IoD members now only have fixed rate bank loans in comparison with the results published in *Business Finance 2003*. In the latter, 35% (48) of members had fixed rate bank loans only, 34% (46) had variable rate bank loans only and 27% (37) had both types of loans. Again, the decline in the proportion of members using just fixed rate bank loans probably reflects the fact that many directors did not anticipate a dramatic increase in interest rates in the course of 2003. They were, of course, totally vindicated in this view.

## **5.3 Maturity of business loans**

Our survey showed that those IoD members who had fixed term bank loans were borrowing for relatively long periods of time. For 44% (55) of the directors in our survey with fixed term bank loans, the length of maturity of their most recent loan when they originally took it out was between three to five years. For another 22% (28) of directors the length of maturity was between six and ten years and for 14% (18) it was more than ten years. Only 8% (10) of the directors in our survey with fixed term bank loans had loans with a length of maturity of less than three years (see Table 10).

**TABLE 10: THINKING ABOUT YOUR MOST RECENT FIXED TERM LOAN, WHAT WAS THE LENGTH OF ITS MATURITY WHEN YOU ORIGINALLY TOOK IT OUT?<sup>35</sup>**

Less than three years	8% (10)
Three to five years	44% (55)
Six to ten years	22% (28)
More than ten years	14% (18)
Don't know	11% (14)

#### 5.4 Date of most recent fixed term bank loans

Most IoD members with fixed term loans negotiated them with their bank after 1997. 16% (20) took out their most recent fixed term loan between 1997 and 1999, 42% (52) did so between 2000-02 and 28% (36) did so in 2003 (see Table 11).

**TABLE 11: WHEN DID YOU TAKE OUT YOUR MOST RECENT FIXED TERM LOAN?<sup>36</sup>**

1988-90	1% (1)
1991-93	1% (1)
1994-96	2% (2)
1997-99	16% (20)
2000-02	42% (52)
2003	28% (36)
Don't know	10% (13)

#### 5.5 Bank overdrafts

Bank overdrafts remain a popular form of finance for many IoD members' businesses. 48% (231) of the businesses in our survey had a bank overdraft, 48% (235) did not and 19% did not know (see Table 12).

**TABLE 12: DOES YOUR BUSINESS HAVE A BANK OVERDRAFT?<sup>37</sup>**

Yes	48% (231)
No	48% (235)
Don't know	4% (19)

### *Size, sectoral and geographic differences*

Firms with 1-20 employees were least likely to have a bank overdraft. 38% (69) of these businesses had a bank overdraft, compared to 55% (86) of businesses with 21-100 employees, 56% (28) of businesses with 101-200 employees and 48% (48) of businesses with 201 or more employees.

Businesses involved in financial services were less likely to have a bank overdraft in comparison with businesses in other sectors. Just 34% (22) of IoD members in the financial services sector had a bank overdraft. By way of contrast, in the sectors most likely to have a bank overdraft - distribution and the sector encompassing construction, mining and transport - the comparable figures were 54% (29) and 54% (30), respectively.

## 5.6 The cost of bank overdrafts

The cost of bank overdrafts is an important matter because it has a bearing on the propensity of businesses to use this source of finance. The average margin on lending to small firms stood at 2.3% at the end of June 2003.<sup>38</sup> Frustratingly, 43% (100) of IoD members in our survey were unable to say what margin over base rate their business paid on a bank overdraft. However, the remainder of directors in our survey who had bank overdrafts generally paid 2.9% or less on top of base rates for this form of finance. 21% (49) of businesses with a bank overdraft paid between 2-2.9% over base rate for their bank overdrafts, 19% (44) paid between 1-1.9% and 4% (8) paid between 0.1-0.9% (see Table 13).

**TABLE 13: IF YOU HAVE A BANK OVERDRAFT, WHAT IS THE MARGIN OVER BASE RATE PAID?<sup>39</sup>**

0.1-0.9%	4% (8)
1-1.9%	19% (44)
2-2.9%	21% (49)
3-3.9%	6% (13)
4% plus	7% (17)
Don't know/refused	43% (100)

### *Size, sectoral and geographical differences*

It is reasonable to believe that larger businesses with a longer track record, a greater range of customers and stronger financial and managerial resources in comparison to SMEs would pay a smaller margin over base rate than these businesses. As with last year's survey, though, the quality of our data was impaired as a consequence of the fact that a disproportionate number of directors from larger businesses did not know what margin they paid over base rate. Whereas 37% (25) of IoD members with 1-20 employees and 35% (30) of members with 21-100 employees did not know the margin over base rate that they paid on bank overdrafts, the figures for directors with 101-200 employees and 201 or more employees were 55% (16) and 59% (29), respectively. This finding can

be explained by the fact that the smaller enterprises in our survey are more likely to be run by an owner or manager or have a small managerial team in comparison to the larger firms. Consequently, the interviewees from smaller enterprises are more likely to know the intricacies of their business's financial arrangements compared to interviewees from larger firms, who may well rely upon a Finance Director for information of this kind.

Our survey did show that whereas 3% (1) of directors with 201 or more employees paid 4% over base rate on bank overdrafts, the corresponding figure for firms with 1-20 employees was 14% (9). However, most businesses with 1-20 employees were paying much smaller margin than this: 3% (2) paid 0.1-0.9% over base rate, 17% (12) paid 1-1.9%, 21% (14) paid 2-2.9% and 9% (6) paid 3-3.9%.

Most businesses with 21-100 employees paid less than 3% over base rates: 4% (3) paid 0.1-0.9%, 21% (18) paid 1-1.9%, 26% (22) paid 2-2.9%, 8% (7) paid 3-3.9% and 7% (6) paid 4% or more.

## 5.7 Lending conditions

The Bank of England raised base rate from a low of 3.5% in 2003 to 4.25% in May 2004. Despite this rise, base rates still remain low from a recent historical perspective. Additionally, British banks have extremely good balance sheets. Consequently, they are well placed to accede to the borrowing requirements of businesses. Moreover, bearing in mind the improvement in businesses' profitability and the steady economic growth of the UK economy (see Section 1.1), it is reasonable to assume that the banks will not have regarded lending to firms as any more of a credit risk in 2003 than they did in 2002.

In these circumstances, it would be surprising to find strong evidence that lending conditions had become decisively more restrictive in 2003. Indeed, 60% (138) of IoD members reported that when they last renewed their overdraft facility, the terms that they agreed with their bank were about the same, while 21% (49) said that they were more favourable. Just 9% (20) said that they were less favourable (see Table 14).

**TABLE 14: WHEN YOU LAST RENEWED YOUR OVERDRAFT FACILITY, WERE THE TERMS YOU AGREED WITH YOUR BANK MORE FAVOURABLE, LESS FAVOURABLE OR ABOUT THE SAME?<sup>40</sup>**

More favourable	21% (49)
Less favourable	9% (20)
About the same	60% (138)
Don't know	10% (23)

### *Size/sectoral/geographical differences*

Our survey showed that the larger the business, the more likely it was to have secured more favourable terms when it last renewed its overdraft facility. Whereas 13% (9) and 21% (18) of firms

with 1-20 and 21-100 employees said that they have achieved better terms when they last renewed their overdraft facility, the figures for firms with 101-200 employees and 201 or more employees were 24% (7) and 32% (15), respectively. Conversely, 7% (5) of firms with 1-20 employees and 13% (11) of firms with 21-100 employees obtained less favourable terms when they last renewed their overdraft facility, compared to 7% (2) and 5% (2) of businesses with 101-200 and 201 or more employees. Once again, a disproportionate number of IoD members from businesses with 201 or more staff - 23% (11) - did not have any information about their overdraft facility. In contrast, just 4% of (3) members from businesses with 1-20 employees did not know what terms were agreed when their organisation last renewed its overdraft facility. As noted earlier, IoD members from smaller firms are more likely to be the business's only director or one of a small team of managers and so they are much more likely to be aware of the financial circumstances of the business. In contrast, IoD members from businesses with 201 or more employees may well be part of a larger management team and unless they hold the position of Finance Director, they are unlikely to know a great deal about their firm's overdraft facility.

### *Annual change*

In Business Finance 2003, 61% (149) of IoD members stated that when they last renewed their overdraft facility, the terms that they agreed with their bank were about the same, 22% (53) said that they were more favourable and only 6% (53) said that they were less favourable. 10% (25) of members did not know whether the terms of their business's overdraft facility had changed or not. Evidently, while there has been a rise in the proportion of directors reporting that the terms concerning their overdraft facility became less favourable in this year's survey, the overall picture is essentially similar to last year's findings.

## 5.8 Choice of bank finance

The majority of employers in our survey believe that, on the basis of their own experience, there is a good choice of bank finance. 67% (323) of the directors in our survey believe that there is a good choice of bank finance, 26% (125) disagree and 8% (37) are unsure (see Table 15).

**TABLE 15: BASED ON YOUR OWN BUSINESS EXPERIENCE,  
DO YOU THINK THAT THERE IS A GOOD CHOICE OF BANK FINANCE?<sup>41</sup>**

Yes	67% (323)
No	26% (125)
Don't know	8% (37)

### *Size, sectoral and geographic differences*

A majority of respondents in each of the four different categories of firm size believed that there was a good choice of bank finance. However, IoD members from the smallest category of firm size in our survey were least likely to take this view. While 54% (96) of firms with 1-20 employees agreed that there was a good choice of bank finance, the figures for firms with 21-100 employees, 101-200 employees and 201 or more employees were 65% (102), 83% (41) and 83% (84) respectively.

A clear majority of respondents from all economic sectors believed that there was a good choice of bank finance, ranging from a low of 59% (32) of respondents from the distribution sector to a high of 71% (35) of respondents from the government, education, health and personal services sector.

### *Annual change*

In Business Finance 2003, 58% (282) of IoD members considered that there was a good choice of bank finance, 30% (146) took the opposite view and 12% (60) were unsure. However, a significantly larger proportion of respondents in this year's survey believe that there is a good choice of bank finance in comparison to last year's survey.

## 5.9 Business banking

27% (129) of the firms in our survey bank mainly with the Royal Bank of Scotland Group (including the Royal Bank of Scotland, NatWest and Ulster Bank), while 23% (110) have their main account with Barclays Bank. 15% (71) use HSBC Bank and 12% (58) have their main account with Lloyds TSB Bank (see Table 16). These figures are virtually the same as those cited in Business Finance 2003 and the relative popularity of the banks in question amongst respondents is unchanged from the previous year.

**TABLE 16: WHO DOES YOUR FIRM MAINLY BANK WITH AT THE MOMENT?<sup>42</sup>**

The Royal Bank of Scotland Group (including RBS, NatWest and Ulster Bank)	27% (129)
Barclays Bank plc	23% (110)
HSBC Bank plc	15% (71)
Lloyds TSB Bank plc	12% (58)
Bank of Scotland	4% (22)
National Australia Bank (including Clydsdale, Northern and Yorkshire)	1% (3)
Bank of Ireland	1% (4)
Nationwide Building Society	0% (2)
Abbey National	0% (1)
The Co-operative Bank plc	0% (2)
Alliance and Leicester plc	0% (2)
AIB (trading as First Trust in Northern Ireland)	0% (2)
Other	8% (41)
Don't know	8% (37)

## 5.10 Bank-firm relations

Banks will never be popular. If they are inefficient (as in Japan) or lose depositors' money (as in Argentina), or go bankrupt (as in the case of the Bank of Credit and Commerce International (BCCI) in the UK in 1991), banks are lambasted. Equally, if banks are profitable they arouse envy and criticism. Perhaps sub-consciously individuals resent being in someone else's debt, both literally and metaphysically.

The UK's banks remain firmly unpopular. In 2000, the Cruickshank Report accused the banks of making excess profits of between £3-5 billion annually from their SME customers.<sup>43</sup> In 2003 the House of Commons Treasury Select Committee criticised the banks for the lack of transparency in the charges on their credit cards.<sup>44</sup> Now the banks are being criticised less for making excess profits at the expense of SMEs (Cruickshank's allegation), but simply for the size of their profits. This is an important and topical debate with important implications for UK businesses. Naturally businesses do not want to be the victim of excessive profits made by the banks. On the other hand, a healthy banking sector is vital for UK firms, especially SMEs.

There is no doubt that the big UK banks do appear to be making significant profits. RBS's annual profits increased by 29% in 2003.<sup>45</sup> Barclays' pre-tax annual profits rose by 20% to £3.84 billion.<sup>46</sup> HSBC made £7.8 billion in pre-tax profits in 2003.<sup>47</sup> The profitability of the UK's banks has not made them popular. The Liberal Democrats' treasury spokesman, Vincent Cable, has attacked both the banks for making huge profits "at the expense of others getting deeper and deeper into debt" and the Government for failing to "curb the huge profits of the banking industry".<sup>48</sup>

In fact, given the size of the UK's big four banks, it would be surprising and disappointing if they were not making big profits. RBS, for example, is the world's fifth largest bank,<sup>49</sup> while HSBC operates in 78 different countries.<sup>50</sup> At the same time, given the strong performance of the UK economy it would be difficult for the banks not to be profitable. As a result of the Bank of England being able to keep interest rates low, more people and businesses have been willing to borrow and keep up with their repayments. This points to the fact that bank profitability is strongly linked to the economic cycle. Were the economy to enter a period of below average economic growth, or were there to be an increase in business failures, then inevitably bank profits would be lower than they are today. However, this would hardly be a welcome state of affairs.

In any case, the UK needs a profitable banking sector. In the first place, the more profits that banks make the more money that they contribute in tax to the Treasury to pay for vital public services, such as defence, transport and education. For example, in 2003, RBS paid £1.9 billion in corporation tax to the Government.<sup>51</sup> If RBS and other banks were not paying such large sums in corporation tax, the Treasury would either have to increase taxation on other businesses and individuals, borrow more or spend less on public services. Additionally, profitable banks are good for shareholders and pensioners, many of whose funds invest in UK banks. For instance, RBS paid out £3.5 billion in dividends to shareholders in 2003 (including pension funds), 55% of whom are UK residents.<sup>52</sup> Moreover, the more profits that banks generate, the better able they are to lend to businesses and the longer they can afford to delay calling in non-performing loans. Banks that are unable to make profits cannot write off bad loans, have to call in outstanding debts and are eventually forced to stop lending. This can cause significant macro-economic damage.<sup>53</sup> The crisis in the Japanese banking

sector has been a major cause of the country's poor economic performance during the 1990s and the first couple of years of the current century. Similarly, the repercussions of the 'Tequila Crisis' that hit Mexico in 1994 continue to plague the country today. The banks have still not completely recovered from the bad loans that were exposed during the crisis. Indeed, "...the subsequent lack of credit and financial services does much to explain the anemic performance of Mexico's domestic economy over the past decade."<sup>54</sup> Consequently, the fact that UK banks make large profits and are amongst the most profitable in Europe should be welcomed.

Significantly, IoD members do not appear to be holding a grudge against their banks. On the contrary, 69% (334) of directors in our survey described their relationship with their bank as good. A further 22% (109) said that their relationship with their bank was acceptable and just 5% (23) reported that it was poor (see Table 17). The generally cordial atmosphere that prevails between businesses and their banks is partly a consequence of the relatively stable economic environment that currently exists, particularly with regards to interest rates. Additionally, bank-firm relations have improved as a result of measures introduced by the banks to address some of the criticisms that were directed at them during the last recession.<sup>55</sup> Finally, small enterprises have become less dependent on bank finance in comparison to the early 1990s and so the potential for a serious collapse in bank-firm relations is unlikely in the near future.<sup>56</sup>

**TABLE 17: HOW WOULD YOU DESCRIBE YOUR FIRM'S RELATIONSHIP WITH YOUR BANK?<sup>57</sup>**

Good	69% (334)
Acceptable	22% (109)
Poor	5% (23)
Don't know	4% (19)

### *Size, sectoral and geographical differences*

A majority of respondents from all four categories of firm size said that they had a good relationship with their bank. 63% (112) of firms with 1-20 employees, 66% (104) of firms with 21-100 employees, 85% (42) of firms with 101-200 employees and 76% (76) of firms with 201 or more employees had a good relationship with their bank.

### *Annual change*

In Business Finance 2003, 69% (338) of directors stated that their relationship with their bank was good, 24% (118) said that it was acceptable and just 3% (14) felt that it was poor. Evidently, there has been a slight rise in the proportion of directors regarding their relationship with their bank as poor, but the overwhelming majority of directors continue to have a good relationship with their bank.

### 5.11 Customer loyalty

A majority of IoD members have well-established relationships with their banks. 44% (211) of businesses in our survey had been with their present bank for more than ten years, while 20% (96) had been with their present bank for between five and ten years (see Table 18).

**TABLE 18: HOW LONG HAVE YOU BANKED WITH YOUR PRESENT BANK?<sup>58</sup>**

Less than three years	14% (70)
Three to five years	16% (75)
Five to ten years	20% (96)
More than ten years	44% (211)
Don't know	7% (32)

### 5.12 Reasons for not switching banks

In 2001 the Competition Commission concluded that it had found a complex monopoly<sup>59</sup> in the supply of banking services to SMEs and it published a list of possible hypothetical remedies.<sup>60</sup> The Government accepted the recommendations of the Competition Commission in March 2002 when it published the Commission's final report on the subject.<sup>61</sup> As a consequence of the Competition Commission's report, from January 1st 2003, the Office of Fair Trading required the big four banks to pay interest on small business's current accounts<sup>62</sup> or alternatively offer small business customers free money transmission.

The Competition Commission concluded that there were significant restraints on SMEs switching from one bank to another, not least because of the lack of competition.<sup>63</sup> Our survey shows that many IoD members have long established relationships with their banks (see Section 5.11). However, this is not necessarily because of a lack of competition in the business-banking market. In fact, 65% (200) of directors explained that they had not changed their bank in the last five years for the simple reason that they were happy with their existing bank. 12% (38) said that they had not switched because they believed that it was important to have a long-term relationship with a bank. However, 10% (31) rather cynically commented that there was no point changing because all the banks were the same (see Table 19).

**TABLE 19: WHY HAVE YOU NOT CHANGED YOUR BANK?  
(INTERVIEWEES COULD GIVE MORE THAN ONE ANSWER.)<sup>64</sup>**

You are happy with your existing bank	65% (200)
You believe that it is better to have a long term relationship with a bank	12% (38)
There is no point because all the banks are the same	10% (31)
It is too difficult	7% (23)
Your bank may not be perfect, but it is not bad enough to make it worth changing	3% (10)
No necessity to do so/not needed/no reason to do so	3% (10)
Haven't got round to it yet/lack of time	3% (8)
The bank that you are with offers better deal/rates	2% (6)
Not my decision to make/accountant or business group decides who to bank with	2% (6)
Group bank/tied into company	2% (6)
I am too lazy/cannot be bothered	1% (5)
We are a new business/we have not been operating long	
Will be changing banks in future	1% (3)
The current bank offers the services that we need	1% (2)
It is too expensive to change banks	1% (2)
Other	3% (10)
Don't know	7% (20)

### 5.13 Reasons for switching banks

Of those directors who did switch their banks over the previous five years, 15% (22) did so because they found another bank offering better terms and services, while another 15% (22) gave the reason that their previous bank offered a poor service. 32% (47) said that they either had not changed their bank in the previous five years (but implicitly had done so earlier than this time frame) or that because their business was less than five years old they had not had the opportunity to change their bank (see Table 20).

**TABLE 20: WHY HAVE YOU CHANGED YOUR BANK?  
(INTERVIEWEES COULD GIVE MORE THAN ONE ANSWER.)<sup>65</sup>**

We have not changed our bank in the last five years/the company is younger than five years old	32% (47)
You found another bank offering better terms and services	15% (22)
Previous bank offered poor service	15% (22)
Change of company ownership resulted in change of bank	10% (15)
Poor relationship with previous bank manager	6% (9)
Previous bank made mistakes	4% (5)
Alternative bank provided better/cheaper rates	3% (5)
Corporate/group requirement to change bank	3% (5)
Alternative bank offered better rate of interest	3% (4)
Previous bank rejected request for loan	2% (3)
Inflexibility on the part of the old bank	2% (3)
Wanted on-line banking and so changed banks	2% (3)
Previous bank had high charges	2% (3)
You were approached by another bank offering better terms or service	2% (3)
Changed because of the result of a regular tendering exercise	1% (1)
Recommendation from a third party (e.g. accountant or friend)	1% (1)
Other	7% (10)
Don't know	7% (10)

### 5.14 Requests for bank finance

87% (424) of businesses said that they had never had a request for finance turned down by their bank, 7% (34) said that they had and 6% (27) did not know (see Table 21). This experience is almost certainly part of the explanation why IoD members tend to believe that access to finance is not a problem (see Section 4).

**TABLE 21: HAS YOUR CURRENT BANK EVER TURNED DOWN  
A REQUEST FOR FINANCE BY YOUR FIRM?<sup>66</sup>**

Yes	7% (34)
No	87% (424)
Don't know	6% (27)

### *Size, sectoral and geographical differences*

IoD members from firms with 1-20 employees were more likely to have had a request for finance turned down in comparison to members from the largest firms in our survey. 11% (20) of firms with 1-20 employees reported that their bank had rejected a request for finance, compared to just 3% (3) of firms with 201 or more employees. Smaller firms may lack a well rounded management team, have limited collateral or possibly a short trading history - all factors that can deter banks from lending. Even so, 87% (155) of firms with 1-20 staff said that their bank had never turned down a request by their firm for finance.

At the same time, 91% (113) of those businesses with fixed term loans and 88% (203) of those businesses with a bank overdraft had never had a request for finance rejected. Evidently, IoD members generally do not have difficulties borrowing money from the banks.

#### **5.15** Reasons for the bank rejecting a request for finance

A bank's decision on whether to lend capital to a firm depends on a variety of factors. The state of the economic cycle and the financial health of the bank itself will be important considerations. Additionally, the bank's willingness to lend will be affected by whether the prospective borrower can offer security for the loan, the competence of the firm's management, the plausibility of the firm's business plan, its market positioning and its financial state, amongst other determinants.

Of those directors who admitted that their business's request for bank finance had been turned down, 22% (8) said that this was because the bank manager believed that they lacked sufficient collateral to justify the loan. 17% (6) of members said that the bank had rejected their application for bank finance because the manager thought that their venture was too risky. 11% (4) of directors said that the bank refused their request for finance because it did not agree with their business plan (see Table 22).

**TABLE 22: WHAT REASONS DID YOUR CURRENT BANK GIVE TO YOU FOR TURNING DOWN A REQUEST FOR FINANCE?<sup>67</sup>**

Lack of collateral	22% (8)
Too high a risk	17% (6)
Bank did not agree with your business plan	11% (4)
Lack of security	11% (4)
Bank did not give a reason	9% (3)
Lack of trading history/too new	8% (3)
Bank did not have confidence in firm's management	6% (2)
Bank doubted that a market existed for the venture in question	4% (1)
Other	18% (6)
Don't know	6% (2)

## 6: Cash deposits

### 6.1 The prevalence of cash deposits

Not only have SMEs reduced their dependence on bank finance in recent years, but since 1992 they have also built up significant deposits at their banks.<sup>68</sup> During 2002, small firms' deposits with banks increased by £2.1 billion to a record £43.9 billion.<sup>69</sup> According to the Bank of England, the value of SMEs' bank deposits has exceeded the total amount of money lent by the banks to SMEs since 1997.<sup>70</sup>

Similar to other businesses in the UK, our survey shows that a large proportion of IoD members has a cash deposit with their bank. 74% (359) of IoD members interviewed reported that they had a cash deposit at the bank (see Table 24).

TABLE 24: HAS YOUR COMPANY GOT A CASH DEPOSIT AT THE BANK?<sup>71</sup>

Yes	74% (359)
No	20% (95)
Don't know	6% (31)

#### *Annual change*

The proportion of directors with a cash deposit at their bank has increased since the previous survey. 67% (327) members in Business Finance 2003 had a cash deposit with their bank, 25% (123) did not and 6% (37) did not know. The increase may in part be a reflection of the strengthening UK economy (see Section 6.3).

### 6.2 The state of cash deposits

Of those IoD members with cash deposits, over the last twelve months 39% (138) increased the amount, 37% (133) kept the amount the same and 17% (61) decreased the amount (see Table 25).

TABLE 25: OVER THE LAST TWELVE MONTHS HAVE YOU:<sup>72</sup>

Increased the amount	39% (138)
Kept the amount the same	37% (133)
Decreased the amount	17% (61)
Don't know	7% (26)

### *Size, sectoral and geographical differences*

Directors from the Midlands had a greater tendency to build up their cash deposits in comparison to directors from the two other geographical areas in our survey. 50% (34) of businesses in the Midlands increased the amount of money that they had in bank deposits over the last twelve months compared to 32% (25) of respondents in the North and 37% (79) of respondents in the South.

### *Annual change*

In contrast to this year's report, Business Finance 2003 revealed that of those IoD members with a cash deposit at the bank, 30% (98) increased the amount, 35% (116) kept the amount the same and 27% (89) decreased the amount. Consequently, a larger proportion of directors increased their deposits at the bank in 2003 in comparison with 2002.

## 6.3 Reasons behind the increase in cash deposits

A variety of reasons appear to be behind directors' inclination to increase their cash deposits. 29% (40) of those directors who increased their cash deposits over the previous twelve months did so because they had managed to increase their profits and more money was coming into the business. 16% (22) built up their cash in deposits in case of unforeseen circumstances and to act as a safety reserve and 13% (18) did so in order to finance an investment project. 10% (13) of directors had built up their cash deposits simply because their cash flow had increased (see Table 26).

**TABLE 26: WHAT WERE THE REASONS FOR INCREASING THE DEPOSIT AMOUNT?  
(INTERVIEWEES COULD GIVE MORE THAN ONE RESPONSE).<sup>73</sup>**

Increased profits/more money coming in	29% (40)
To build up cash in case of unforeseen circumstances	16% (22)
To finance an investment project	13% (18)
Increased cash flow/had lots of cash/generated cash	10% (13)
Build up cash prior to withdrawing it from the business	7% (10)
Built up reserve because there was nothing to spend it on	6% (8)
For future spending	4% (6)
To take advantage of a good financial product (e.g. high interest account)	3% (5)
Sale of assets	2% (3)
For working capital	2% (3)
Surplus funds	2% (3)
Other	7% (10)
Don't know	8% (11)

## 7: Conclusion

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Our research paper revealed three key findings. Firstly, IoD members fund their business operations in two main ways: bank finance (loans and overdrafts) and internal resources (self-financing/own money, cashflow/money within the company and retained profits). This in turn has two major policy implications for the Government - the need to keep the cost of borrowing down and the need to reduce taxation. As noted in Section 2, variable rate debt finance plays an important part in the funding of IoD members and of businesses generally. Accordingly, the aim of policy should be to engender the lowest possible level of interest rates that is compatible with the Bank of England achieving its CPI inflation target of 2% in order to keep the cost of bank borrowing low. This means that with the Bank of England exercising operational control for the setting of interest rates, it is incumbent upon the Government to ensure that fiscal policy is in harmony with monetary policy in order to reduce unnecessary upward pressure on interest rates. At the same time, the Government should aim to reduce the burden of taxation on businesses and individuals because both rely to a crucial extent on their own resources to finance their activities. 60% of start-up enterprises use personal funds as their first source of finance.<sup>74</sup>

Cutting taxes on businesses leaves more money in the hands of owners and managers with which to finance their operations, invest in R&D, develop the skills of their employees and grow their firms. Cutting taxes on individuals leaves more money available for investment in start-up enterprises and creates an incentive for people to become entrepreneurs. Reducing the tax burden on private individuals is important. According to research by Barclays Bank, on average it costs £17,000 to set up a business.<sup>75</sup>

The second principal finding of our research paper is that for the majority of IoD members, access to finance is not a problem. Over two-thirds (71%) of the directors in our survey did not think that it was difficult to get access to finance for their business (see Section 4). This figure represents an improvement on the findings of last year's survey. The fact that most IoD members do not consider access to finance to be problematic does not invalidate the policy prescriptions in the previous paragraph. Although lack of finance is not a problem for the majority of our members, many would still benefit from keeping the cost of borrowing low and from easing the burden of taxation. Both moves would also be generally advantageous for those businesses (both IoD members and non-IoD members) who do face difficulties raising finance.

The third major conclusion is that IoD members typically have a cordial relationship with their banks. Bank-firm relations remain friendly, with 69% (334) of directors in our survey describing their relationship with their bank as good (see Section 5.10). The generally positive nature that characterises the relationship between members and their banks is underpinned partly by the fact that over two-thirds (67%) of members believe that there is a good choice of bank finance (see Section 5.8).<sup>76</sup> The good relations that prevail between members and their banks are further sustained by the fact that requests for finance by the former are rarely turned down by the latter. 91% (113) of IoD members' businesses with fixed term loans and 88% (203) of members with a bank overdraft had never had a request for bank finance rejected (see Section 5.14).

Consequently, because of the strength of the UK economy most IoD members are able to get access to finance to fund their operations and bank-firm relations are good. The Government can help to prolong this relatively benign state of affairs by maintaining a stable macro-economic policy and by lightening the burden of taxation.

## 8: References

1. HM Treasury, Budget 2004. Prudence for a Purpose: a Britain of Stability and Strength (London: The Stationery Office, HC 301, March 2004), p.15.
2. *Ibid*, p.15.
3. European Union, Country Report, March 2004 (Economist Intelligence Unit, 2004), p. 12.
4. National Statistics Online. See the web-page "Inflation falls", <http://www.statistics.gov.uk/cci/nugget.asp?id=19>.
5. *Ibid*.
6. Before December 10th 2003, the CPI was published in the UK as the HICP.
7. National Statistics Online. See the web-page "Corporate profitability 12.6% in Q3 2003", <http://www.statistics.gov.uk/cci/nugget.asp?id=196>.
8. United Kingdom, Country Report, January 2004 (Economist Intelligence Unit, January 2004), pp. 28-9.
9. Finance for Small Firms - An Eleventh Report (Bank of England, April 2004), p. 3 and pp. 19-22.
10. Percentages are rounded throughout this research paper.
11. In this survey, the "North" covers respondents from Scotland, North/North West, Yorkshire & Humberside and Northern Ireland. The "Midlands" covers respondents from the East Midlands, East Anglia, the West Midlands and Wales. The "South" covers respondents from the South East, Greater London and the South West.
12. Andy Cosh and Alan Hughes (eds), *British Enterprise in Transition* (ESRC Centre for Business Research, University of Cambridge, 2000), Chapter 5. For further information on the sources of finance that SME's rely on see David J. Storey, *Understanding the Small Business Sector* (London and New York: Routledge, 1994).
13. Finance for Small Firms. A Seventh Report (Bank of England, 2000), p. 15. See also Finance for Small Firms - An Eighth Report (Bank of England, March 2001), p. 23.
14. Finance for Small Firms. A Seventh Report, p. 43.
15. Finance for Small Firms - An Eighth Report, pp. 23-24.
16. Following the practice of the Department of Trade and Industry, an SME is defined here as a business with 249 or fewer employees.
17. Cosh and Hughes, *British Enterprise in Transition*. The most recent Bank of England report on small business finance now suggests that just 39% of firms in the Cosh and Hughes study sought external finance between 2000 and 2002. See Finance for Small Firms - An Eleventh Report, p. 36.
18. Finance for Small Firms - A Tenth Report (Bank of England, April 2003), p. 11.
19. Cited in *ibid*, p. 11.
20. Cited in Finance for Small Firms - An Eleventh Report, p. 35.
21. Information derived from a conversation with an official from the Bank of England's Domestic Finance Division (May 4th 2004).
22. Cited in Finance for Small Firms - An Eleventh Report, p. 11.
23. Small firms are defined in the BBA's statistics as those businesses with an annual turnover of less than £1 million.
24. Finance for Small Firms - An Eleventh Report, p. 11.
25. *Ibid*, p. 11.
26. There were 485 responses to this question.
27. There were 307 responses to this question.
28. Tom Bawden, Gary Duncan and Elizabeth Judge, "Investment firms shun start-ups", *The Times*, January 16th 2004.
29. For support of this view, see SME Trends Survey (Confederation of British Industry, January 2004) and Small Business Research Trust, NatWest Quarterly Survey of Small Business Customers (December 20003).
30. There were 485 responses to this question.

31. There were 485 responses to this question.
32. Finance for Small Firms - A Tenth Report, p. 12.
33. "Mixed signals in the small business market", British Bankers' Association press release, December 16th 2002.
34. There were 125 responses to this question.
35. There were 125 responses to this question.
36. There were 125 responses to this question.
37. There were 485 responses to this question.
38. Finance for Small Firms - An Eleventh Report, p. 15.
39. There were 231 respondents to this question.
40. There were 231 responses to this question.
41. There were 485 responses to this question.
42. There were 485 responses to this question.
43. Cruickshank, Competition in UK Banking. A Report to the Chancellor of the Exchequer (HM Stationery Office, 2000).
44. House of Commons Treasury Committee, Transparency of Credit Card Charges. First Report of Session 2003-04, Volume 1 (London: The Stationery Office, December 2003, HC 125-1). See also House of Commons Treasury Committee, Responses to the Committee's First Report: Transparency of Credit Card Charges (HC 125), Second Special Report of Session 2003-04 (London: The Stationery Office, March 2004, HC 431).
45. Caroline Merrell, "RBS boss earns £3.45m after profits jump 29%", The Times, March 26th 2004.
46. Charles Pretzlik, "Europe's big banks profit as demand for credit rises", The Financial Times, February 13th 2004, USA Edition 2.
47. "Bank profits: the £7bn question", The Guardian, leading article, March 2nd 2004. Three quarters of HSBC's profits were in fact generated outside of the UK. On the other hand, Abbey, Britain's sixth largest bank, recently reported that full year operating profits were £939 million, 28% lower than the £1.3 billion forecast by the City. See Caroline Merrell, "Abbey slumps after full-year profits warning", The Times, April 23rd 2004.
48. Quoted in The Daily Telegraph, February 20th 2004.
49. Andrew Cave, "Royal Bank refuses to be embarrassed by its £6 billion", The Daily Telegraph, February 20th 2004.
50. "Bank profits: the £7 bn question", leading article, The Guardian, March 2nd 2004.
51. Andrew Cave, "Royal Bank refuses to be embarrassed by its £6 bn", The Daily Telegraph, February 20th 2004.
52. "Bank profits: the £7 bn question", leading article, The Guardian, March 2nd 2004.
53. Jeremy Warner, "Outlook: excessive profits? Up to a point, Lord Copper", Business, February 20th 2004.
54. "Free trade on trial, The Economist, December 30th 2003.
55. Finance for Small Firms. A Seventh Report, p. 24.
56. Ibid, Section Three. See also Finance for Small Firms. A Sixth Report (Bank of England, January 1999) and Finance for Small Firms - An Eighth Report, pp. 36-41.
57. There were 485 responses to this question.
58. There were 485 responses to this question.
59. Supply of Banking Services by Clearing Banks to Small and Medium-Sized Enterprises (SMEs): Statement of Provisional Conclusions on Complex Monopoly (Competition Commission, March 6th 2001).
60. Banking Services by Clearing Banks to Small and Medium-Sized Enterprises (SMEs). Statement of Hypothetical Remedies (Competition Commission, March 21st 2001, news release).
61. The Supply of Banking Services by Clearing Banks to Small and Medium-Sized Enterprises (Competition Commission, Cm 5319, March 14th 2002).
62. The banks are required to pay interest on SMEs' current accounts at the level of at least the Bank of England base rate, minus 2.5%.
63. For a discussion on the extent of competition in the banking market for SMEs, see Finance for Small Firms - An Eleventh Report, pp. 29-32.
64. There were 308 responses to this question.

65. There were 146 responses to this question.
66. There were 485 responses to this question.
67. There were 34 responses to this question.
68. Finance for Small Firms - An Eighth Report, p. 24. See also Finance for Small Firms - A Ninth Report (Bank of England, April 2002), pp. 13-15.
69. Finance for Small Firms - A Tenth Report, p. 13. Following the Bank of England's definition, bank deposits in this context refer to both credit balances in current accounts and balances in deposit and savings accounts.
70. Finance for Small Firms - An Eleventh Report, p. 12.
71. There were 485 responses to this question.
72. There were 359 responses to this question.
73. There were 138 responses to this question.
74. Finance for Small Firms - An Eighth Report, p. 23.
75. Barclays Bank, Research Review - Setting up in Business (February, 1999), cited in Finance for Small Firms - An Eighth Report, p. 23.
76. In fact, this is the highest proportion of IoD members who believe that there is a good choice of bank finance since the IoD first started its annual business finance surveys in 2000.

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