The important role of micro-finance in supporting SMEs

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Contents

ABSTRACT 2

1. INTRODUCTION 3
2. BACKGROUND 3
3. BANK LENDING 6
4. DEMAND FOR MICRO FINANCE 7
5. DEMAND IN THE NORTH EAST 7
6. RESEARCH AMONGST YOUNG ENTREPRENEURS 9
7. REVIEW OF MICRO-LENDERS IN THE NORTH EAST 11
8. HOW MICRO-FINANCE FILLS THE GAP 12
9. CONCLUSIONS 13
10. REFERENCES 14

Abstract

The Community Development Finance Association (CDFA) estimates that CDFIs have a loan and investment portfolio of some £150m which levered a further £160m. This is dwarfed by bank lending to SMEs of some £45bn. The question then is what difference does micro-finance make in the UK? Is it really needed? Or would entrepreneurs find finance from other sources if micro-finance wasn't available.

The results show that micro-finance institutions do make a difference, but also show that they are unsustainable without grant support of some kind, and suggest that they are unlikely ever to become sustainable.

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1. Introduction

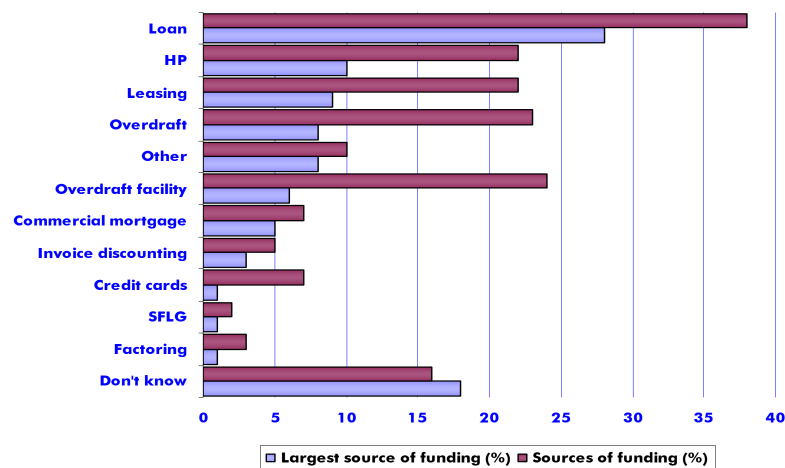
The Community Development Finance Association (CDFA) estimates that there are some 60-70 "community development finance institutions" (CDFIs) in the UK[1], of which perhaps the best known are the Prince's Trust and Triodos Bank. The term was coined by the Chancellor in his budget statement in 2002. Whilst not all CDFIs focus solely on micro-finance, most do and would regard themselves as a micro-finance institution (MFI). An MFI is generally a not for profit organisation that has raised funding by way of grant or loan to provide loans to new and growing businesses who would otherwise be unable to raise the finance that they need. Micro-loans are usually defined as loans of less than £15,000. Many MFIs are part of a business support organisation or else, like the Prince's Trust, have established a network of mentors to provide business advice alongside the finance.

In the UK, the CDFA (Inside Out, 2005) reports that their 55 members have loans and investments of some £150m and have levered a further £160m for their clients. They have some £400m available to invest. However, this is dwarfed by bank lending to SMEs of some £45bn. The question, then, is what difference does micro-finance make? Is it really needed? Or would entrepreneurs find finance from other sources if micro-finance wasn't available?

2. Background

In 1998, the Government's Policy Action Team (PAT 14) articulated the difficulty faced by some businesses in accessing bank finance. Potentially they were viable enterprises, but they did not fulfil the banks' lending criteria. The age, experience, track record or business structure of a potential borrower may make them unattractive to a bank. The Social Investment Task Force's report in 2000 confirmed these conclusions and highlighted the value of developing enterprise within disadvantaged communities. Whilst MFIs had been around for many years, the government provided additional funding, through the DTI's Phoenix Fund, to support CDFIs.

Figure 1: Sources of finance for UK businesses

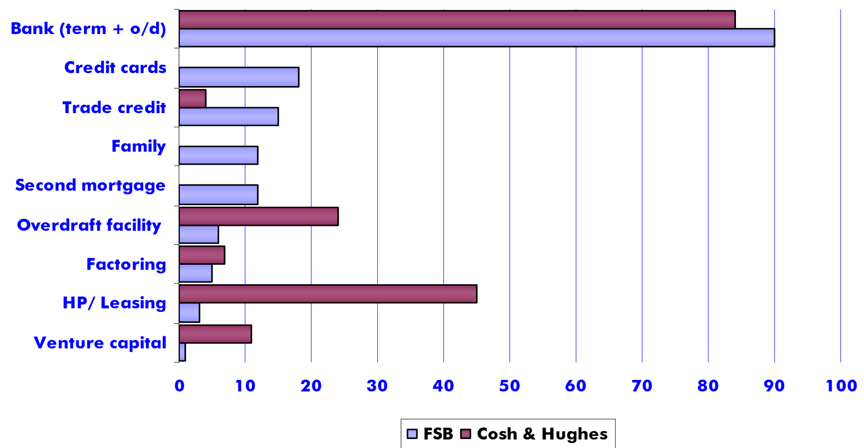


Source: Competition Commission, 2002

As we will see later, for new starts, the most likely sources of finance are savings, family and friends, micro-finance and bank debt, though a few entrepreneurs may persuade an angel to invest. However, once businesses are up and running the banks are the most important source of finance, as can be seen in figure 1.

The importance of bank finance is confirmed by other research. One of the best known analyses is by Cosh and Hughes (2000, 2003). Their analysis is summarised in figure 2 together with the results of research by the Federation of Small Businesses (FSB). The FSB results confirm the importance of credit cards, as identified by the Competition Commission, and the importance of family lending, though curiously these sources do not appear in the Cosh and Hughes analysis.

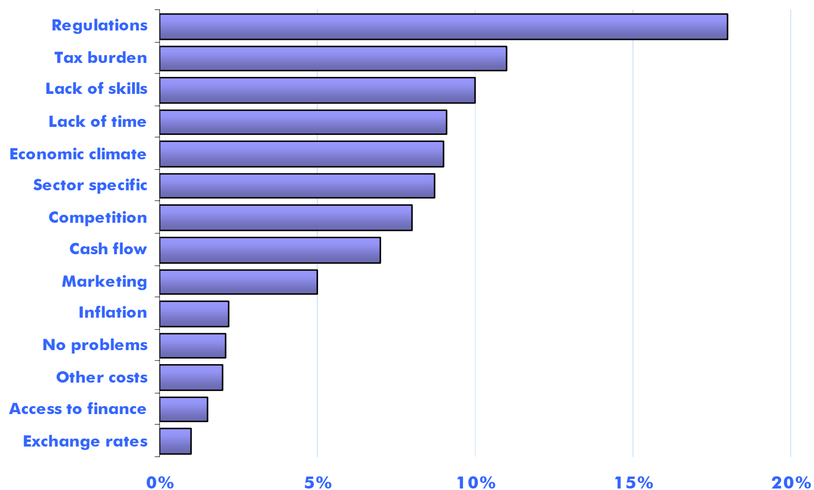
Figure 2: Sources of finance



Source: FSB (2002), Cosh & Hughes (2002)

Once people have started up, however, access to finance is quickly over-shadowed by other problems, with finance cited as a problem by fewer than two per cent of respondents to the SBRTeam's quarterly survey.

Figure 3: Businesses' most important problems (UK)

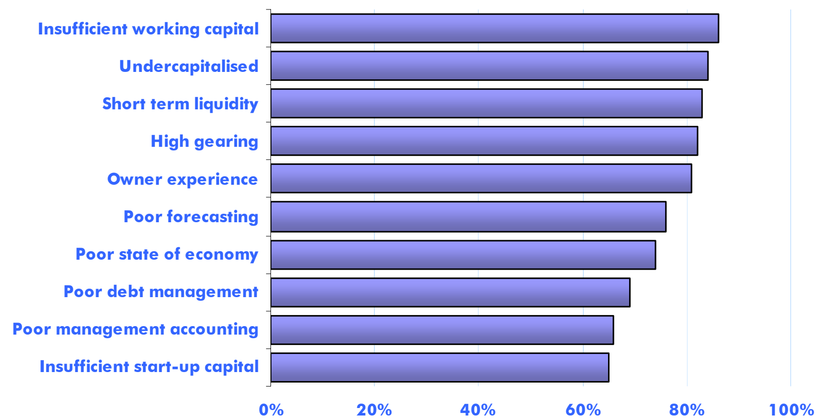


Source: NatWest/SB RTeam Quarterly Survey of Small Business in Britain, 2005, Q1 (UK)

This might be a flaw in the research (SBRTeam uses a panel approach rather than sampling a representative sample – which is good for looking for trends, but may not be able to justify the absolute results). Or, more likely, it might suggest a level of complacency from businesses once they have raised the money they need to start.

Birley and Niktari (1995), in their analysis of the closure of 486 independent owner-managed businesses, interviewed accountants and bank managers about clients that had closed and the importance of 87 possible reasons. (The firms ranged in size from 0 to 300 employees and in age from 6 months to 146 years). The reasons were reduced to 24 common themes, of which the 10 most important are shown in the figure, with the majority identifiable as managerial issues.

Figure 4: Ten most important reasons for failure

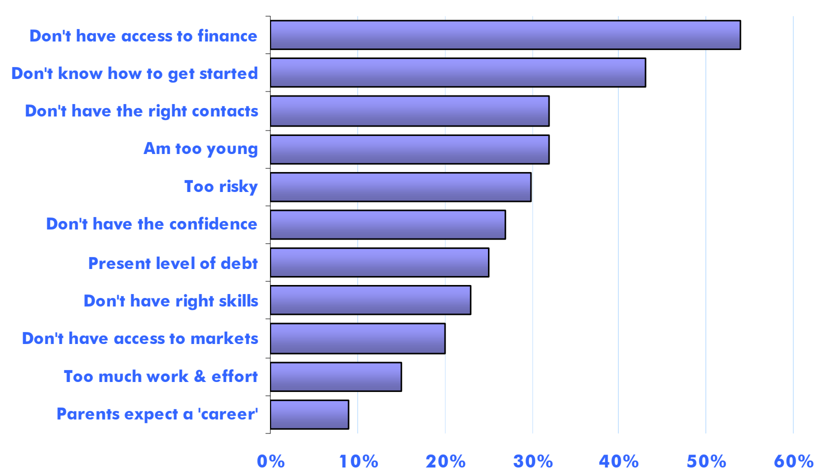


Source: Birley & Niktari, 1995

It is interesting to note how many of these manifest themselves as financial issues. Birley and Niktari report that two thirds of the interviewees believed that failure could have been avoided. This implies a need for more effective support and networking during planning and start up. The results of this research confirm the view of many practitioners – that people starting in business need to learn how to manage their finances effectively. This might also suggest that access to finance is a factor that both inhibits start up and leads to the failure of fledgling businesses.

The Global Entrepreneurship Monitor Finance Report (2004) confirms the view that close family members, friends and neighbours are the biggest sources of informal capital for start-ups. They observe that entrepreneurs typically have to provide two-thirds of the initial capital. Access to finance is seen as the biggest barrier to young people starting in business, at least according to a survey undertaken last year for Enterprise Insight.

Figure 5: Barriers to young people starting in business



Source: NOP Survey for Enterprise Insight, 2004

This pecking order is confirmed by Howorth (2001) (although the theory emerged in other literature): entrepreneurs tend to seek finance first from their own resources, and friends and families, and then from other sources such as banks. Indeed, the money from family and friends is often essential (and often regarded as quasi-equity by the banks) to unlock support from commercial institutions. But that leaves a problem for anyone with a viable proposition but family and friends without any resources to help.

3. Bank lending

The British Bankers' Association regularly publishes data on bank lending to and deposit taking with small businesses. It is particularly worth noting that:

- By the end of 2004, term lending had grown to nearly £35bn (growth of 16 per cent during the year) and overdraft lending had grown to nearly £10bn (growth of 9 per cent during the year);
- Total deposits almost equal borrowing at £41bn;
- There were 4.6m small business accounts (both current and deposit accounts) in operation;
- The BBA has started monitoring new, first time banking relationships and recorded 517,000 new customers.

Dr Stuart Fraser (2005) has recently completed a major study of bank customers which sheds a bit more light on bank lending. He reports that:

- Some 80% of SMEs (2.9m) have used external finance in the last three years;
- Approximately 24% (900,000 businesses) use term loans;
- Some 27% of businesses use asset finance (leasing and hire-purchase);
- Some 1.6m SMEs (42% of established business and 69% of start ups) sought new finance;
- Main sources of finance for start ups are personal savings (65%), bank loan (10%) and friends/family loan (6%); (and fewer than 5% relied mainly on a mortgage on their home);
- The median financial requirement at start-up is £15,000; the median requirement for established businesses is £20,000;
- Obtaining finance is reported as a major problem at start up by some 10% of businesses;

- 11% of businesses needing new finance experienced outright rejection; 19% received less than they wanted; 8% felt discouraged from applying because they expected to be rejected;
- Among SMEs denied a term loan outright: 59% got funding from another source; 5% dropped their plans; 4% fell into serious financial difficulties;
- Start-ups are less likely to experience outright rejection than established businesses (4% v. 12%) although this excludes businesses which did not start as a result of rejection.

Reading the figures from the BBA, or from Fraser's survey, one might think that there is no problem. Businesses are apparently able to raise the finance that they need. These figures, of course, disguise two problems – the businesses that, for whatever reason, are unable to raise finance and, perhaps more importantly, those prospective businesses that never actually start because they are unable to raise the finance. The second of those presents a problem to researchers because they are difficult to find and most likely were turned down for finance because their proposition was poor. But there are some groups, such as the young people who come through the Shell Livewire programme who are easier to identify.

It is perhaps worth noting that around 500,000 new businesses start each year. So, if 10 per cent experience problems, that represents some 50,000 businesses – excluding those who are not captured by the surveys because they fail to start. If 69 per cent of starts seek finance, that represents 350,000 businesses. Around 10 per cent are rejected by the banks but a little over half of those subsequently raise the money elsewhere, representing roughly 5 per cent of the total – still some 25,000 businesses. Whilst they may have been successful, they are most likely under-capitalised, and a further 20 per cent, or 100,000 businesses were offered less than they needed so are even more likely to be under-capitalised. These figures suggest that there is a substantial gap between the need and what the banks are willing to provide

Fraser's research suggests that a sizeable proportion of businesses are rejected due to lack of security or track record (30% overdrafts; 19% term loans) and notes that they may be candidates for the Small Firms Loan Guarantee Scheme, but they might also be candidates for micro-finance.

4. Demand for micro finance

We have attempted to estimate the demand for micro-finance in a couple of ways. Research undertaken originally for ONE NorthEast looked at the needs of businesses in the north east. Shell *Live*WIRE promoted a web based survey amongst regional finalists. In addition, we are doing further research with Barclays Bank who have agreed to undertake a telephone survey of a representative sample of their small business customers.

5. Demand in the north east

We asked business support agencies to participate in a one-week survey by requesting every client waiting for a business advice appointment to complete a short survey. Seven agencies assisted and we received 77 responses: 26 from existing businesses, 49 from people still thinking about starting in business and two who did not specify whether they were in business.

We asked respondents to tell us how much finance they needed altogether, how much of this finance they could find from their own resources, whether they had discussed their needs with the bank and, if so, how much the bank was prepared to lend. We also asked where they expected to find the balance if not from the bank, whether they were confident of raising the money and whether they would contemplate equity.

Amongst those already in business, there was an average requirement of £15,000 with £4,000 of own resources and expected bank support of £5,000

leaving a need of £6,000. Intuitively, this figure looks slightly suspect, in that one would have expected existing businesses to find it easier to raise bank finance, which suggests that some of these clients may not have bankable propositions. The figures, however, are more revealing when one looks at those who have been offered bank finance. The average requirement of those offered bank finance was £22,000 with the entrepreneurs finding £5,000 and the banks offering £17,000. This might suggest that people in business with a sensible request do not need micro finance, or at least can source their requirements from the banks.

The picture changes when one looks at those who have discussed their propositions with the bank, irrespective of whether they were made an offer. The average amount required was around £20,000 and the average resource from the entrepreneur was £5,000. The banks were thought to be willing to provide £13,000, leaving an average gap of about £2,000 – suggesting that the business support agencies are good at helping existing businesses prepare themselves for a discussion with the bank. Of the businesses that had discussed their plans with the bank, 20 per cent received no offer, which represented just 6 per cent of the businesses receiving support. Business Link saw around 157,000 new starts in 2004/5[2] so as many as 9,000 businesses (in England) could be after non-bank finance

The start-ups figure tells a rather different story. The survey suggested that few businesses were securing finance from the banks, though in reality many will be able to secure finance with backing from the business support organisations. There was an average need of £14,000 with a personal contribution of £5,000 and an expected bank contribution of £4,000, leaving a gap of £5,000.

Table 1: Demand for finance (one week in May 2004)

	Need	Own resources	Bank lending	Gap
In business				
Total	386,000	93,000	134,000	
Average	15,000	4,000	5,000	6,000
Average (Bank Agreed)	22,000	5,000	17,000	0
Average (Bank Talked)	20,000	5,000	13,000	2,000
Not in business (adj)				
Total	657,000	222,000	195,000	
Average	14,000	5,000	4,000	5,000
Average (Bank Agreed)	36,000	4,000	28,000	4,000
Average (Bank Talked)	19,000	1,000	11,000	7,000
Micro (not in business)				
Average	5,000	1,600	400	3,000
Average (Bank Agreed)	8,900	5,100	3,500	300
Average (Bank Talked)	8,000	1,000	1,000	6,000

Source: IGA & TBR survey

Our definition of micro finance is distinguished by an upper limit of £15,000.[3] Many of the clients in the sample had a total requirement in excess of £15,000, and many of the businesses needing more than £15,000 may source some of it from a micro loan fund, although many will not find it worthwhile. If we exclude all those businesses whose requirement is greater than £15,000, then the average gap falls to £3,000.

We calculated the potential demand in two ways. We asked all the business support organisations to participate in our survey. Some 51 of the respondents were looking for finance of no more than £15,000. If this week was typical, it equates to 2,600 clients for the year. Some agencies did not participate in the survey, but most clients will go to the agency more than once. For the purpose of this calculation, we have assumed that those factors roughly cancel each other out. This gives an annual demand of nearly £8m. It

is clear, however, that not all the survey returns were from the same week. If we only include the returns that came back immediately after the originally agreed week for the survey, then the number of starts falls to 22 and the demand falls to £3.4m.

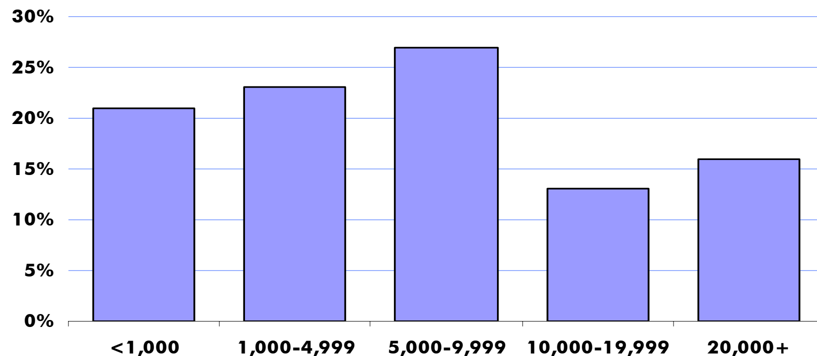
We could look at the demand calculation differently. In 2003, there were 15,100 new starts in the North East, of which around 2,500 (which more accurately reflects the higher figure above) sought support from a business support organisation[4] and two thirds of those required less than £15,000. This suggests that the total demand could be around £5m. If we allow for the needs of existing businesses, we have an estimated requirement, just in the north east, of £6m.

It is likely that many clients are over-estimating their requirements. It is also likely that the business support agencies can help clients secure a rather greater proportion of their need from the banks, particularly if some micro finance is available to encourage the banks to lend more.

6. Research amongst young entrepreneurs

We e-mailed young entrepreneurs[5] asking them to complete a web-based survey. We received 77 responses. Some 12 per cent of respondents were aged 16-19 when they started up, a further 40 per cent were aged 20-24 and 47 per cent were aged 25-30. Not surprisingly, the starting age amongst graduates was a bit higher. Just 4 per cent started up before they were 20, with 47 per cent aged 20-24 and a further 47 per cent aged 25-30. The gender split was 51 per cent male, 49 per cent female.

Figure 6: Finance requirement at start up



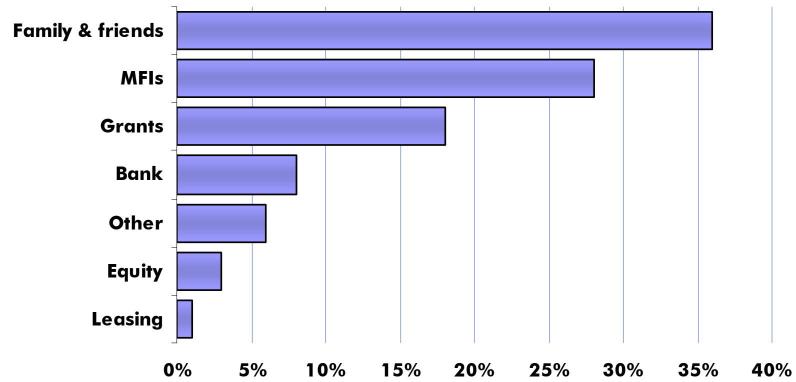
Source: Survey by Shell Livewire on behalf of David Irwin

The spread of finance required was more or less normal with a peak requirement in the range of £5-10,000. Just over a quarter (27 per cent) were able to find all the finance themselves leaving 72 per cent to find finance from other sources. For graduates, the figure was almost identical at 74 per cent. However, it was 79 per cent for those who succeeded in raising money from MFIs – perhaps confirming the view that entrepreneurs without any resources struggle to find it from commercial sources and so need the MFIs if they are to be successful.

The sources of finance is revealing. As might have been predicted, the biggest source of funding was family and friends. But MFIs was the second biggest source. The results were almost the same for graduates only. There may be some element of younger people being able to access specific funds such as the Prince's Trust, though they do claim that they will only help people who

can demonstrate disadvantage. Grants were next with just under 20 per cent of respondents, while bank finance was used by fewer than 10 per cent of respondents.

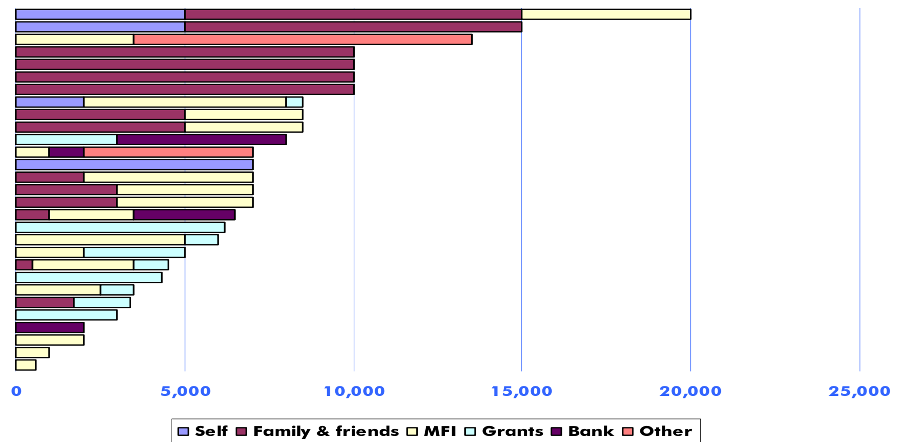
Figure 7: Sources of finance



Source: Survey by Shell Livewire on behalf of David Irwin

The Prince's Trust was by far the most significant provider of micro-finance, but Prince's Scottish Youth Business Trust, Project North East, Arts Council, local authorities, Scotland unLtd and Creativity Works were also cited as sources of finance. A large number of businesses had finance from more than one source.

Figure 8: Sources of finance by respondent



Source: Survey by Shell Livewire on behalf of David Irwin

Figure 8 shows the split of funding by source for each respondent who provided a breakdown (after eliminating those who required more than £15,000, unless micro-finance was part of the total package). This confirms the importance of both family & friends but also of micro-finance in supporting new starts.

En passant, we asked about the impact of student debt on ability to raise finance. Some 71 per cent of the graduates had a student debt. Only 24 per cent said that this was a problem, though as student debt grows it may become a bigger issue.

7. Review of micro-lenders in the north east

There are around 13 micro-finance lenders in the north east of England including regional lenders such as the Prince's Trust and Project North East providing loan finance for people wishing to start in business and the Community Loan Fund North East and North East Social Enterprise Partnership (NESEP) Cashpoint for the not for profit sector. There are also a number of other local funds. For example, the Northern Oak Credit Union has established a small loan fund in North Tyneside. We surveyed all the MFIs in 2004 and again in 2005.

In 2004, the CDFIs in the north east had 900 applications and made 610 loans totalling nearly £2.8m. At the end of the year, they had a loan book of £3.6m and capital available to lend totalling £2.5m (excluding Prince's Trust which receives capital from its head office as it lends).

It is interesting to note that default rates have risen from 2003, when the best was around three per cent and the regional average was 9 per cent. Some of the funds wrote off outstanding bad debts in 2004 which they argue has distorted the figures.

Table 2: North East Micro-finance performance indices

	Highest	Lowest	Mean	Total[1]
Serious applications	475	15	139	
Loans approved	83%	35%	72%[2]	
Amount lent (during year)	£1.2m	£34k	£2.5m[3]	£2.7m
Total outstanding	£1.5m	£27k	£3.5m[3]	£3.7m
Loan sizes	35,000	500	4,500	
Jobs per loan	4	1	1.7[2]	
Default rates[4]	11%[5]	40%	21%[2]	

1. Estimate of totals based on previous research amongst micro-lenders
2. Weighted average
3. Note that this is the total figure and not the average
4. Default is calculated as capital written off during the year as a percentage of the loan book at the end of the year
5. The best default rate is 0%, but the funds that have achieved this have only been lending for a few months

We compared the performance of CDFIs in the region and the key performance indices are shown in the table. These give measures of activity, efficiency and sustainability. The most efficient CDFI has running costs of just 9p for every £1 lent, though it is likely that cost sharing between projects means that the loan fund is not carrying its fair share of overheads. As a benchmark, it is interesting to note that the Providential Finance reports in its annual report a cost of about 16p per £1 lent. None of the funds are sustainable: indeed all but one fails even to replace their capital losses from the interest that they earn.

This raise issues about whether micro-loan funds provide value for money. There is little doubt that micro-finance fills a gap. Furthermore, the best ones achieve an excellent leverage, so they perform a service that is far more important simply than their own level of lending and, in any event, are largely lending to people who would otherwise be unable to borrow the money that they need to start in business. It has been suggested that a cheaper alternative would simply be for the government to provide grants to start ups. That approach, however, is not without transaction costs, would continue to promote a culture of dependence, would not enable entrepreneurs to build up a track record of repaying credit, and would mean that none of the capital

comes back, so would ultimately cost far more. Perhaps the real question, therefore, should be how the funds with the highest administration costs can reduce those costs.

Table 3: Key performance indices

	Best	Worst	Mean	Median
Cost per pound lent	£0.09	£1.05	£0.40	£0.16
Capital sustainability index	1.15[1]	0.18	0.56	0.47
Total sustainability index	0.38	0.17	0.20	0.18
Deployment ratio	95%	11%	59%	48%
Leverage	2.9	0.0	0.8	0.2
Lending cover (years)	7.6	1.0	3.2	2.1
Revolution	2.6	0.1	1.0	0.7

1. The best performing funds have no bad debts yet, but have only been in existence for a short time

The lending cover figures indicate that, on average, MFIs in the north east can continue to meet the demand for micro-finance for around three years with no additional capital.

Table 4: Improvements (medians)

	2003	2004
Capital sustainability index	0.90	0.47
Total sustainability index	0.15	0.18
Deployment ratio	30%	48%
Leverage	0.2	0.2

Although not revealed in this research, an important issue is whether those people who would like to start in business are receiving support of sufficient quality to help them develop their ideas and present a sensible business plan describing a viable proposition to the funders – which would reduce the capital losses of the funds and improve their sustainability.

8. How micro-finance fills the gap

Research by the CDFA (Inside Out, 2005) revealed that, by the end of 2004, CDFIs had a portfolio of £147m invested in 9,500 enterprises and individuals, leading to the protection of 85,000 jobs, the creation of 10,000 additional jobs and leverage of £160m in additional funds. They suggest that the average loan size is £5,200. They observe a variation within interest rates which tend to be high for micro enterprises and individuals and considerably lower for social enterprises and larger businesses.

Our figures would suggest that considerably more people could benefit from micro-finance, yet they all seem to have sufficient resources to cope with the demand. This could suggest that MFIs are not good at, or choose not to, promote themselves – or it could suggest that the greatest demand is actually from the people with the weakest propositions.

Research by the New Economics Foundation (NEF) and Bert Nicholson (2003) in the West Midlands crudely estimated demand for micro-finance[6] based upon numbers of enterprises and micro-enterprises having the greatest difficulties accessing finance. They also identified key business segments that have problems finance: perhaps not surprisingly these are ethnic minorities (especially Afro-Caribbeans and Bangladeshis),[7] women and social enterprises. They noted that CDFIs might enable unemployed people to start up an enterprise particularly in low firm density areas. They noted that whilst "Many CDFIs are experiencing sufficient demand for their existing loan funds" there does not appear to be a gap because demand is not being created by publicity, promotion etc. This begs the question of how many more people

could be helped if more resource was available. NEF estimated that these soft loan funds provided an average of 17 loans per annum!

Research by Affleck and Mellor (2003) confirms that awareness of loan funds is a significant problem. They explain, for example, how Community Loan Fund NE and Street UK, in the region, have endeavoured to publicise their schemes through newspaper advertising, presentations and 'canvassing' in deprived areas. However, it is not clear from Affleck and Mellor's research whether there is a genuine gap or if there is a lack of knowledge about what is available.

9. Conclusions

This paper has drawn upon some key pieces of literature and some recent primary research to consider the importance of micro-finance in supporting small and medium-sized enterprises. We have reached a number of conclusions:

- The literature reflects the importance of micro-finance but until now there has been little coherent effort to measure its demand and supply and the size of the gap;
- Finance from family and friends is particularly important for young people who want to start in business but micro-finance is also essential, not least in levering finance from commercial sources;
- There are a significant number of businesses, and a far higher proportion amongst young people, who would be unable to start in business without being able to secure a loan from an MFI so it would appear that MFIs are indeed filling a gap;
- The survey in the north east would suggest that MFIs are unable to earn enough income to be sustainable, in most cases even to the extent of covering their capital losses – at least without significantly increasing the interest rates that they charge;
- Arguably, however, MFIs provide a social benefit that justifies their need for public sector support;
- There is considerable variation in the running costs of MFIs, though it is not always clear what is the cost of 'managing the loan portfolio' and what are the additional costs of providing mentoring support; nevertheless, it would appear that there is scope for some MFIs to reduce their transaction costs;
- An interesting question to consider is whether MFIs are likely to become sustainable as they grow larger – though in reality sustainability is a function of the number of clients supported by each member of staff rather than absolute size – but this study did not look at the numbers of staff working for each fund;
- MFIs should be encouraged to report against common performance measures which would enable more effective benchmarking;
- More effort needs to be made to promote the availability of micro-finance; and
- It is likely that the real need for a prospective entrepreneur is effective advice and support which will assist in unlocking the necessary financial support so the most effective MFIs, measured by survival and growth of clients, are likely to be those that can provide effective advice and support alongside their loans.

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Endnotes

[1] We estimate that there could be as many as 150 MFIs; we have used CDFA surveys of CDFI performance as a proxy for the micro-finance sector though we recognise that the two are not identical.

[2] Figures from the Small Business Service.

[3] Although we accept that some loan providers do not restrict their lending to £15,000 maximum, if they do in practice lend below that amount then we can classify them as a provider of micro finance.

[4] According to the Small Business Service, Business Link and their partners saw 12,953 pre starts that year. Whilst they do not keep records of who subsequently started, they estimate that about 20 per cent do giving around 2,500 starts.

[5] Shell Livewire e-mailed all the entrants to the 2005 Livewire Awards who had provided an e-mail address, some 474; 207 were opened and 79 responded, a response rate of 16 per cent, thought two responded too late for inclusion.

[6] With an upper level of £50,000 in this case

[7] Research findings show that access to finance, particularly start up finance, varies *within* the 'EMB (ethnic minority business) Community' with 51% Chinese able to access finance compared to 31% of African-Caribbean firms; in other words, there is "more variation between ethnic minority groups than *between EMBs (as a group) and white-owned firms*" (Smallbone *et al* 2001: 9; 18).