What is the potential for a creative industries loan fund:

A report for South of Scotland Creative Enterprise Initiative (SoSCEI)

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1.0 Executive Summary

This report looks at new financing models for arts enterprises in the Scottish Borders. Work was carried out between 22nd November 2012 and 21st December 2012 by Consultants' Niall Alexander and Alistair Grimes.

1.1 What we were asked to do

The main questions dealt with in the report concern:

- The number and scale of creative enterprises in the area;
- The appetite for loans; the size of those loans and the price people are willing to pay;
- The desirability and feasibility of setting up a loan fund to cater for this demand;
- The availability of finance for such a fund; and
- The availability of wider business support for creative enterprises;
- The construction of a number of models and options for such a fund to be sustainable;
- The existence of models of good practice that might be adopted.

1.2 What we did

The report is based on existing data drawn from recent reports by Bop Consulting and EKOS along with a series of interviews with artists, council staff, Creative Scotland, the Scottish Government, loan funds and banks.

We have also constructed a number of funding models based on a range of realistic assumptions.

1.3 Our findings

- The creative industries in the area are a vibrant part of the local economy but consist of, for the main part, small businesses, sole traders or freelancers with a turnover below £20,000 (and in most cases below £10,000).
- They lack both access to finance and, for a significant proportion, a wider range of business skills, including marketing and promotion.

- They are unwilling to borrow money at what they perceive as 'high' interest rates (in this case 10% or more).
- Public agencies want to promote and support creative enterprises in the area. Creative Scotland has intimated that they will invest in a programme to collaborate with local authorities (Place Partnership) and the Scottish Borders Council has recently launched a £300,000 loan fund for SMEs (including creative businesses) at 0% interest with a 5% arrangement fee.
- At least one loan fund (DSL Business Finance – a social enterprise) is interested in investing in this market, provided its risks can be mitigated by other funding and its administration costs covered.
- There is an English pilot scheme between the Arts Council and the Key Fund in Yorkshire which involves matching Key Fund capital of £100,000 with Arts Council monies and payments of £22,500 to cover administration and business support costs. Take up has been slow so far and the pilot will end in February 2013.
- In terms of the anticipated small volumes of likely loans from the Borders area, the level of loans and realistic assumptions about default levels and interest levels, it is hard to see how a sustainable fund can be constructed.
- It is possible, however, to construct a Scottish wide fund, which might be piloted in the Borders and rolled out if demand builds up.
- Such a fund would require £125,000 in capital over five years (and we suggest a number of potential sources) and around £100,000 in running costs over an initial two year period to test out the idea. It would make financial sense to run such a fund as part of an existing portfolio rather than setting up something new.
- A number of arts based agencies, such as WASPS, Out of the Blue and the Edinburgh Sculpture Workshop indicated that they were interested in discussing further their role in promoting such a fund.

1.4 Our conclusions

- There is limited demand in the Borders and this could not sustain a fund.
- There is potential in Scotland, and a Borders pilot to test out demand and delivery mechanisms would have a value. We suggest two years would be an appropriate period of time over which to see if a market can be built.

- There is a need for both finance and business support to make such a scheme work. This would require £125,000 of capital and £100,000 of other support.
- We believe that DSL Business Finance would be willing to ring-fence £100,000 of capital on the assumption that it can cover 15% of any losses through the Enterprise Finance Guarantee Scheme[1] (EFGS) and an additional 15% through another funder agreeing to take on that risk.
- The additional £25,000 of capital and initial running costs of £100,000 over two years would need to be sourced elsewhere. Based on the principles of the Arts Council/Key Fund model in Yorkshire, this could come from a combination of Creative Scotland and Scottish Borders Council, using existing resources (through the Place Partnership model or SB Loan Fund).
- The £100,000 running costs would split roughly 50/50 to cover the costs of both a full time loans officer to promote the scheme, liaise with stakeholders and provide business advice and guidance and the costs (to DSL Business Finance) of administering the loans and organising all relevant paperwork, Direct debit origination, BACS transfers, loan disbursement, EFGS monitoring and collections.
- We have estimated that such a scheme could be expected to generate 42 loans (average £2,500) each year.
- We believe that the scheme should be monitored closely and that if the targets set are not met, it should be stopped after an initial two years, so that the risk of funders and other stakeholders is not open-ended.

1.5 Our recommendations

SOSCEI should:

1. Enter into discussions with DSL Business Finance about managing a Creative Industries loan fund for Scotland; and

[1] The Enterprise Finance Guarantee Scheme (EFGS) is a government backed initiative launched in January 2009 to facilitate additional lending to viable businesses lacking adequate security or proven track record for a standard commercial loan. The Government provides the lender with a guarantee for 75% of each individual loan, subject to a cap set by an Annual Claim Limit. The borrower pays a 2% per annum pro-rata premium to BIS as a contribution towards the cost of providing the Government guarantee. The borrower is responsible for repayment of 100% of the loan, not just the 25% outside the coverage of the Government guarantee. The government cover 15% of the first £1,000,000 of EFGS-backed loans.

2. Clarify the conditions around DSL Business Finance supplying £100,000 of the loan capital required;
3. Open discussions with Creative Scotland to identify the possibilities of them providing the potential revenue support for staffing and administration requirements of a Scotland wide fund;
4. Open discussions with WASPS, Out of the Blue and other similar organisations to discuss their potential role in marketing a discrete fund to the creative industries that rent their workspaces;
5. Open discussions with Business Gateway and the Cultural Enterprise Office to ascertain the package of needs that could be identified to support successful applicants become more business minded and entrepreneurial.

2.0 Introduction: what we were asked to do

Niall Alexander and Alistair Grimes were asked to look at new financing models for arts enterprises in the Scottish Borders. The work was commissioned on 22nd November, with an interim report requested by 21st December and a final report by 31st December 2012.

The brief identified a number of distinct but related questions:

- What is the demand for finance in the Borders and within this, what types of finance?
- What is the cost of money (as opposed to the price of money) that those in the creative industries (and potential providers of loan capital) will bear?
- What level of demand would be required to create a sustainable stand-alone fund, or a fund that could be sustainable if contained within an existing overhead (such as a credit union or Community Development Finance Initiative)?
- How would any such funding arrangement balance the need to generate sufficient volume of loans, keep interest rates low and bad debt rates at an acceptable level?
- Who might public (or other) investors in this area be, including looking at the opportunities provided by crowd funding and similar models?
- What is the direction of travel of the debate on the need for such funds within both the for-profit and not for-profit/social enterprise creative industries?
- Is there any likelihood of support from existing funds?
- Are there examples UK wide of similar funds that might be replicable?
- Are there funders who would take the initial risk in this area to test out the model?

Given the funding available for this work and the tight timescale, our emphasis has been on utilising existing knowledge, desk research and skills developed from existing or past work, in particular the 2011 study '*Creative Financing: feasibility study into financial mechanisms for supporting small-scale creative activity in Scotland*' by Bop Consulting for Shetland Arts with support from Mission Models Money, Creative Scotland and Highlands and Islands Enterprise and the EKOS report on '*Creative industries in the South of Scotland*' commissioned by Scottish Borders Council on behalf of SOSCEI (2012).

We were asked to interview a number of stakeholders in the artistic community, local authorities and Creative Scotland in order to judge the appetite for such funding and to look at UK models in the same area.

Finally, we were asked to produce some models for funding activities, with projections and assumptions on demand, price of funding, default rates and potential investors.

2.1 What we have done

Over the four week period between commissioning and producing this draft report we have carried out the following activities over eight consultancy days.

- We have read the two reports mentioned in the section above '*Creative Financing: feasibility study into financial mechanisms for supporting small-scale creative activity in Scotland*' by Bop Consulting for Shetland Arts with support from Mission Models Money, Creative Scotland and Highlands and Islands Enterprise (2011) and *Creative industries in the South of Scotland* a report undertaken by EKOS for Scottish Borders Council on behalf of SOSCEI (2012).
- We have drawn out information that is relevant to the situation in the Scottish Borders. In particular we have looked at their estimates of demand and their analysis of the types of businesses within the broader category of '*Creative Industries*'. We have also drawn on their views about the nature of the market for these activities in the region and their views on the gaps in knowledge and capacity amongst artists as business people.
- We have investigated the pilot programme being run by the Arts Council in Yorkshire and Humber in partnership with the Key Fund. This has £100,000 of investment from the Arts Council, matched to £100,000 of investment from the Key Fund and offers loans of £5,000 to £25,000 to artists/creative industries that have been rejected by a bank. The Arts Council has put in £9,500 to cover administration costs and £13,500 to fund 12 hours of business support to each successful loan.
- We have talked to staff (both local and national) in Creative Scotland, to understand their activities in this area, including their collaboration with Borders Council on Place Partnerships – a £200,000 one-off investment.

- We have talked to senior staff in the Scottish Government to assess their appetite for funding micro-lending to artists / creative industries as part of their broader financial inclusion and economic development strategies.
- We have talked to Scottish Enterprise staff with responsibility for micro-businesses and social enterprise.
- We have talked to Scottish Borders Council staff with responsibility for economic development and Place Partnerships, and to those managing the recently launched Scottish Borders Loan Fund.
- We have spoken with a small number of artists in their studios in Selkirk, Edinburgh and Glasgow in order to assess their knowledge of finance, their appetite for loans and grants, their business aspirations and business capacity.
- We have talked to the respective Directors / CEOs of WASPS, Edinburgh Sculpture Workshop and Out of the Blue about the relevance of their studio based model for supporting artists and stimulating business activity, and their potential engagement in promoting any discrete fund.
- We have spoken to the Chief Executive of DSL Business Finance about their loans to artists / creative industries and their appetite to lend in the Borders, and / or Scotland more generally, including the possibility of ring-fencing funds for a pilot if a co-investor can be found and if administration costs can be met.
- We have looked at existing loan funds and business support schemes in the Borders and their applicability to creative activities.
- We have modelled two loan funds; one, (SOSCEI Illustration 1: loan book @ 23% interest (25.6% APR) & no running costs) which shows the challenge of pricing, based on realistic assumptions about demand, interest rates and bad debt levels, to illustrate the movement of funds on a sustainable fund before running costs are applied. We have then shown a second, realistic Scotland wide loan fund priced fairly to attract business but still requiring subsidy to become sustainable over the next five years. (SOSCEI Illustration 2.1 loans at 17.3% with potential revenue costs included.)

3.0 The distinctions between the price of money and the cost of money

In the BOP Consulting report mentioned earlier, individuals within the creative industries (who had expressed interest in taking out a loan) were asked what price they would pay for a loan. 84% were interested in a loan at 0% to 5% interest, reducing to 51% who were interested at loan rates of 5% to 10%; only 3% were still interested if told that the loan would be above 10%.

This is partly because people are used to seeing loans, or credit cards, with an interest figure of, say 17.9% APR. 17% seems a big number, and obviously an APR of 100% or, in the case of a currently controversial company such as Wonga, an APR of over 4,000% seems simply astronomical; a rip-off. This is the ***price*** of money.

However, the ***cost*** of money is not the same. For example, the actual difference between borrowing £2,500 over two years at 55% APR, as opposed to 5% APR is only £1.64 per week[2] even though the difference in interest rates seems enormous. We suspect if people in the BOP Consulting survey had been asked about the actual amount of the weekly payment, as opposed to the interest rate, they would have been quite happy with amount needed to cover 10% (or more) in interest rates.

For example, if a friend borrows £30 for a week and repays it by buying a pint of beer which costs £3, the equivalent APR, or the price of money, is a staggering 14,100%. If the pint cost £3.75 the APR for that transaction would be over 45,600%[3]. The cost of money is a much more reasonable £3.00 or £3.75!

Our point here is that we should not focus on headline interest rates, but ask instead '*What could an artist / creative business afford to pay each week/month?*' and build a sustainable model around that figure. The illustrations we use in our models are based on the view that a small business should be able to afford this level of repayment.

[2] Illustration takes £2500 and applies 55% and 5% APR (equivalent to 44.65% and 4.85% interest respectively on a reducing monthly balance repaid over 24 month term)resulting in 24 monthly payments of £159.31 for 55% APR and £109.51 for 5% APR a difference of £49.80 per month or £11.49 per week (on 104 weeks) or £1.64 per day.

[3] Illustration adapted from Provident Financial Group (PFG) CR report (2010)

4.0 Findings: context

Our findings are broadly in agreement with the conclusions from both the 2011 and 2012 reports mentioned earlier. What is highly relevant is their picture of a series of small businesses within the creative industry sector, often sole traders or supplementing their (generally) modest income from other activities with other (often unrelated) work.

The views we gathered were (with some significant exceptions) about a sector that has a prevalence of low earnings, with a more vocational than business focussed attitude, which is sometimes manifest in limited business skills and/or business awareness. Amongst this group the appetite to seek funds to expand is limited.

We also agree with the analysis in the EKOS report that the gaps in business support are not primarily around finance, in the sense of access to loans, but are much more around access to small grants for start-ups and around support on marketing and promotion, basic accountancy / bookkeeping skills and 'routes to market' – places and methods by which goods and services can be sold.

This context may, of course, change. The recession will end and people will have more, in economist's terms 'discretionary spend' with which to buy arts and crafts. The borders railway line which is due to re-open in 2015 may create a new market of better paid workers moving from Edinburgh and commuting who will buy goods (including arts and crafts) locally.

From our limited time assessment we can see there is a vibrant artistic community in the Borders, the EKOS report[4] details 1337 people employed in creative industries across the South of Scotland about 1% of total employment in the region. They also reported just over 300 businesses in the South of Scotland within the creative industry sub headings.

Two out of three businesses were reportedly in the categories of software and electronic publishing, architecture and publishing. The categories containing visual and creative artists,

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[4] EKOS, *"Creative Sector in the South of Scotland"* (May 2012)
Scottish Borders Council on behalf of the South of Scotland Creative Enterprise Initiative

the type of individual who rents workshop spaces from WASPS, Edinburgh Sculpture Workshop and Out of the Blue accounted for just 5% of all businesses suggesting that it was miniscule in size, or, more likely, was under represented and not caught in the data that EKOS reported. Indeed, EKOS acknowledge that creative individuals like visual artists, sculptors, painters, and other sole traders below the VAT turnover threshold, along with similar freelancers are unlikely to appear in official datasets.

Their report attempted to capture the opinions of this grouping through an online survey which resulted in 510 responses the majority of responses 378/510 were from freelancers and sole traders, most of whom would not be captured elsewhere.

Another recent report by Creative Scotland in June 2012[5] identified:

- 800 visual artists;
- 2300 directly employed in crafts related work; and
- 4700 in performing arts, the same number as those employed in design.

The BOP Consulting report[6] interviewed 27 artists in focus groups and through an online survey of 336. Their cohort appears much closer to the 1,100 visual artists, sole traders and freelancers who operate across Scotland, renting space from WASPS, Out of the Blue and ESW.

Their report repeated other findings (subsequently, largely confirmed in our conversations with WASPS, Out of the Blue and ESW) that incomes are invariably low with:

- 64% earning under £10,000 from the art-related work, extending to
- 91% earning under £25,000.

[5] DC Research *"Economic Contribution Study: An approach to the economic assessment of arts and the creative industries in Scotland"* (June 2012) Creative Scotland & Scottish Enterprise
[6] Bop Consulting, *"Creative Financing: feasibility study into financial mechanisms for supporting small-scale creative activity in Scotland"* (Jan 2011) Shetland Arts with support from Mission Models Money, Creative Scotland and Highlands and Islands Enterprise

It should be noted that the spectrum within this "under £25,000" category spanned a £15,000 range from £10,000 to £25,000. It is likely that, given the 64% figure for those earning under £10,000, the likelihood is that there are very few people earning at the top end of the £10,000 to £25,000 range. The emphasis will likely be on the low end; nearer £10,000.

Our discussions with artists in WASPS and ESW studios and with the senior staff within these organisations, and with Out of the Blue further supported a view of their renters as predominantly low income, supplementing their work in some other way. In many cases the artists acknowledged themselves that they were not particularly business focussed, often without a business account, with many reliant on ever diminishing public grant opportunities and even where grants were available, the amounts available were being reduced. The artists were working harder to secure smaller amounts of public support.

We were advised by ESW of a workshop (available for up to 140 artists) on accounting skills for creative industries that attracted just four people, whilst similarly advertised courses by ESW for website development were oversubscribed.

Recent national newspaper coverage has highlighted the continuing withdrawal and diminution of local authority support for arts as Newcastle Council proposed to cut its entire arts budget, following on from the decision previously made by Somerset council to cut their arts budget by 100%. Internationally, themes are similar, the Netherlands government financing for arts programmes has been cut by 25% whilst Portugal has abolished its Ministry of Culture.

The continuing challenge of a reduction in public funds will result in further acceptance of loan finance as a potential route for expansion, development and investment. Demand for finance exists; matching the demand to realistic price points and acceptable risk levels is problematic.

5.0 Findings: Cost of a sustainable loan fund

We recognise the demand for finance to support artistic activity; we have reservations on whether the demand can be realistically met at a price point that is agreeable to the borrower and acceptable to the lender in the context of their likely location within the non-standard unsecured lending market.

As already stated in Chapter 3, the BOP Consulting survey highlighted an acknowledged interest in borrowing; 56% of their 336 interviews said they would consider it. However, those who indicated interest then revealed, in our view, a lack of recognition of the price of money, with **only 3% of those who expressed an interest in borrowing stating that their interest would be maintained if interest rates on any small loans exceeded 10%.**

At the time of writing a search on www.moneysupermarket.com for an unsecured loan of £3,000 for three years (similar to the loans indicated as desired in the 2011 research) returned 13 possible rates from 9.2% to 53.8% APR. The mid-range from household names like *Sainsbury's Bank, The AA, RBS, Clydesdale bank, Tesco Bank, and the Co-op* was around 12.9% APR to 23.9% APR. These loans will only be available to people with good credit histories. We consider that the artists that are being described in previous research and in ours, as seeking small loans are within the non-standard market not the mainstream one.

With subsidy to cover staff and reasonable loan management costs we can project a loan book that is priced at 17.3% APR. Without subsidy, where all expenditure is covered by income from lending, and using the same assumptions of loan volumes and defaults we cannot build a loan book for a price lower that the one identified in the BOP Consulting report of 28% APR.

Only 3% of artists have any acknowledged interest in borrowing at rates above 10%. Our figure of 17.3% APR requires a number of subsidies and underwriting to even ensure that rate can be offered.

In the first illustration (SOSCEI 1) we assume:

- 14 applications per month across the CI sector;
- 3.5 (25%) applications being approved for loans per month;
- an interest rate of 23% on a 24 month reducing balance;
- average loans of £2,500 (with inflation on loan averages of 2% annually);
- a default rate of 14%[7],

SOSCEI Illustration 1: loan book @ 23% interest (25.6% APR) & no running costs

SOSCEI illustration 1	Year 1	Year 2	Year 3	Year 4	Year 5
Funding	£125,000	£0	£0	£0	£0
Loan Capital Issued	-£104,991	-£107,091	-£109,233	-£111,418	-£113,646
Loan Capital Repayments Gross	£28,435	£81,500	£107,190	£109,334	£111,520
Loan Interest Repayments Gross	£7,307	£20,942	£27,543	£28,094	£28,656
Bad Debt Loss Capital	-£14,699	-£14,993	-£15,293	-£15,598	-£15,910
Bad Debt Loss Interest	-£3,777	-£3,853	-£3,930	-£4,008	-£4,088
Loan Admin fees received	£0	£0	£0	£0	£0
Sub total	-£87,725	-£23,495	£6,278	£6,404	£6,532
Salaries	£0	£0	£0	£0	£0
Management Fee	£0	£0	£0	£0	£0
Other revenue costs	£0	£0	£0	£0	£0
Recruitment Costs	£0	£0	£0	£0	£0
Training Costs	£0	£0	£0	£0	£0
Recovered Capital	£0	£0	£0	£0	£0
Net Profit	-£87,725	-£23,495	£6,278	£6,404	£6,532
Annual Cash Movement	£37,275	-£23,495	£6,278	£6,404	£6,532

[7] We selected 14% as this is the known write off of capital issued for new borrowers from Moneyline, the largest (by volume) personal lending CDFI in the UK. Their write off is lower than many business lending CDFI's.

Cash Flow	£37,275	£13,780	£20,058	£26,462	£32,994
Assets	£99,132	£101,229	£109,550	£118,038	£126,695

We have not included any salaries, management fees, or other revenue costs, nor have we included administration fees or any charges on the loan administration nor indeed do we price for the original £125,000 loan capital required.

Even without these overheads, the loan book shows only modest annual profit (£6,532) at year 5 with total assets of the fund at Year 5 (including loan book) is only £1,695 more than the £125,000 it began with. [Note: We ran the same assumptions with a default rate of 2.6%; the default rate alluded to within the SBC loan fund report[8]. The annual profit would increase to £22,817 at Year 5, and the total assets of the fund (including loan book) would increase to £216,956].

An administration fee of about £250 per successful application would normally be proposed covering miscellaneous management costs such as the paperwork involved in processing Enterprise Finance Guarantees (if applicable) or other reasonable costs associated with loan processing such as BACS origination, loan disbursement, collection.

Once reasonable costs to administer the fund are added it is obvious that at 23% interest the fund is not sustainable. Significantly higher interest would need to be applied if the model was to truly cover the expenditure of a loan fund from income from lending. If we assume that income from lending was to cover staff and administration costs (estimated at £247,000 over 5 years) then the loans would need to be priced at 59% interest (77.9% APR). Varying the expected default, loan values, loan volumes and staffing costs would all affect this formula.

[8] Director Of Environment And Infrastructure Executive "*Business Loan Fund Pilot For Small Businesses"* 18 September 2012 (Scottish Borders Council Executive) Risks and mitigations 8.2 (a)

6.0 Findings: A creative industries loan fund

The nature of low-volume, small-sum, higher-risk, unsecured, short-term lending is such that operating a loan fund at the rates called for in previous reports is impossible, unless it is heavily subsidised, or where volumes and values are both substantially higher than projected, or defaults and running costs substantially lower.

There are existing, lower priced, loan funds throughout Scotland where creative industries could, and do, apply. Scottish Borders Council announced on 27/11/2012 a small loans fund for new and existing businesses with loans up to £10,000 at zero per cent interest after an initial payment of a 5% administration fee. A £3,000 loan over 3 years would therefore cost £3,150. The same loan (in our illustration SOSCEI 1) would cost £4,180; a £33 per month difference on loan repayments.

The administration and staffing costs are not revealed within the SBC loan fund, nor is the anticipated default rate (although a rate of 2.6% is alluded to), but these are, presumably, subsumed with Scottish Borders Council Economic Development Department. The fund is intended to support business, it's declared aim is to "*address current problems being experienced by small business in accessing liquidity by providing affordable, interest free lending, initially as part of a 12 month pilot thereby providing an easily accessible lending facility to provide smaller, but essential loans, which may not be available to small businesses through traditional funding sources*"[9].

It is a political decision, laid out in the Scottish Border Council Administration's "*Ambitious for the Borders*" report of May 2012 to set up a business loans fund within six months of taking office to provide appropriate financial support to businesses; but these funds are not explicit in their whole costs and therefore can distort observers understanding of the true cost and price within the lending landscape.

[9] Director Of Environment And Infrastructure Executive "*Business Loan Fund Pilot For Small Businesses*" 18 September 2012 (Scottish Borders Council Executive)

Sustainability is only achievable if realistic costs are established for staff, administration, loan volumes and loan pricing. **We cannot price a sustainable loan book that is anywhere close to the price being offered by Scottish Borders Council (SBC) loan fund because we include substantially higher defaults and transparent costs of delivery**.

Artists indicate that small loans will be required for machinery or materials, exhibitions, transport costs, websites and marketing materials. These are broadly speculative loan purposes, by investing in these items or materials income might be generated to assist in the future repayment. This is high risk lending, and will require a flexible and understanding lender.

DSL Business Finance supplied loan projections within BOP Consulting's report. They indicated an interest of around 28%. As already stated, this doesn't seem at all unrealistic to us, if it includes some costs for consideration (of loans) and delivery; indeed, our projections would be considerably higher, although it is likely that we are projecting higher default rates. Differences in loan values, term, and volume will all dictate price.

The same report recommends credit unions as a potential source of funds. We think it unlikely that credit unions will lend sums of £2,500 unsecured without any savings history. Credit unions tend to specialise in personal loans, they are not business lenders, and there is a significant difference between personal and business loans, including the potential for government safeguards and underwriting, like the Enterprise Finance Guarantee Scheme. In our view, entirely understandably, credit unions will baulk at lending these sums without underwriting or security.

We do not believe there is sufficient demand for a fund within the Scottish Borders or South of Scotland alone at a price that would be sustainable. Indeed, we suspect that - at the price point that we would need to set - there would be only modest interest across Scotland, although we shall offer a view on how such a fund might be subsidised and explored.

BOP Consulting reported 56.5% (178 people) who said they were interested in loan finance, but when they were asked to select a price point that they would still be interested at;

- 84.2% (of those wanting a loan) were very interested at loan rates of zero to 5%
- 50.8% (of those wanting a loan) remained very interested at loan rates of 5% to 10%
- 3.3% (of those wanting a loan) remained very interested at loan rates of 10% to 15%
- 3.4% (of those wanting a loan) remained very interested at loan rates of 15% to 20%

The evidence that is emerging is of an artist living on a low-income not necessarily derived from their art, seeking funds to invest in machinery, materials, exhibition space, travel costs, advertising and website development. Items that may (or may not) result in greater sales and therefore income. There is no obvious free source of loan capital, there are existing funds that theoretically are available to creative industries that are considerably less expensive that any bespoke fund, (e.g. the Scottish Borders Council fund at 0%).

Any loan fund requires:

- Loan capital;
- Loan assessment;
- Loan licencing;
- Loan management (distribution and collection);
- Marketing and promotion.

There is also no obvious source of funds to meet loan management costs. DSL Business Finance have a 23 point checklist that their staff must follow after issuing a loan (someone has to physically be involved, and paid to do this) including processing mandates, scanning and copying documentation, producing, sending and signing loan agreements, processing direct debit mandates, ensuring compliance with any DTI requirements on guarantees schemes and so on.

Notwithstanding the challenges, there is a potential route to market for any fund that could get established, via the range of workshop managed outlets across Scotland from WASPS, Out of the Blue, Edinburgh Sculpture Workshop and other art spaces. There is interest in supporting, promoting and marketing an arts fund that is set at a reasonable price. The potential to promote a discrete arts fund Scotland wide via these arts networks, trade magazines, websites and word of mouth might result in greater knowledge of and demand for loans, and may assist in developing a market.

We conclude that to establish a discrete loan fund offering unsecured small loans to creative industries / artists for a range of purposes requires an initial minimum of £125,000 loan capital and, for a two year pilot, almost £100,000 of revenue support.

We have modelled a number of potential loan book scenarios and have settled on the assumptions in illustrations 2.0 and 2.1 below after discussions with DSL Business Finance on the broad concept of them using a substantial amount of their own capital (subject to certain conditions) to partly establish a Scotland-wide loan fund.

In our conversations with WASPS, Out of the Blue and Edinburgh Sculpture Workshop the concept of advertising and marketing small loans to their renters with built in requirements of business advice and support and some limitations on loan outputs was discussed. They have an interest in growing the market, and would welcome further discussions on the practicalities.

Our dialogue with DSL Business Finance suggests that they might be amenable to providing £100,000 (of the £125,000) loan capital sum. However, for them to risk their own loan capital an arrangement would be required to underwrite loan defaults above the rates that Enterprise Finance Guarantees could cover (currently 15%). Whilst we have estimated a loan default of 14% there remains the possibility that the loan default would be significantly higher, perhaps up to 30%. The loss between 15% and 30% would need to be guaranteed from some source before DSL Business Finance would consider deploying their loan capital.

We recognise the administration and paperwork involved in considering all loan applications. Whilst the process should be relatively straightforward, and free, to artists there is a considerable task for a loan fund manager to consider all applications, look over business plans and make judgements on approval or decline recommendations prior to submitting paperwork for loans panels, dialogue with applicant, verifying income and satisfying anti money laundering (AML) legislation.

A fee for all applications of £100 is reasonable, and is included in our scenarios; and for those applications that are approved, and receive loans additional time is required to submit relevant Enterprise Finance Guarantee paperwork establishing DD's, collection and loan disbursement and monitoring the loans. We believe a fee of £250 for applications that secure approval and receive loan funds is also, therefore, reasonable and required. The question of who meets that cost needs to be addressed.

The income from the loans at 17.3% APR (14% interest + 2% administration fee payable on drawdown) is insufficient to cover costs. Unless the price is raised to the levels identified in previous research (>28% APR) then some other body or organisation with a stake in seeing the loans disbursed will need to meet the revenue cost.

Ideally, it would be desirable for any discrete fund to call upon a loans officer familiar with the work of the likely applicants, able to provide information advice and guidance as well as maintaining contact with the potential routes-to-market providers to maintain a steady flow of good quality applications. Such a post is likely to be full-time and could be accommodated, free of charge, within the existing DSL Business Finance office for a pilot period of two years.

We have assumed a salary and 'on costs' in our calculation and propose that Creative Scotland are approached to fund (possibly using existing commitments to the Borders) both the salary of the loans officer and to meet the application and loans administration costs of fund management (within certain agreed upper limits). We estimate the costs as follows:

Running costs	Y1	Y2	Y3	Y4	Y5	total
Loans Officer	£25,200	£25,704	£26,218	£26,742	£27,277	£131,142
Admin. Costs	£23,100	£23,100	£23,100	£23,100	£23,100	£115,500
Total	£48,300	£48,804	£49,318	£49,842	£50,377	£246,642
Cumulative	£48,300	£97,104	£146,422	£196,264	£246,641	

There is a requirement for an additional £25,000 of loan capital (in addition to DSL Business Finance's £100,000) to ensure the availability of credit. Loan capital is eroded quickly, if the loan term is 24 months or longer, and in our view many loans may be re-scheduled to longer term repayments.

Notwithstanding that there are many assumptions and further discussions to be undertaken we consider that there is sufficient goodwill and interest to pilot a discrete loan fund involving to varying degrees the co-operation and involvement of the following organisations:

- DSL Business Finance;
- Creative Scotland;
- WASPS; Out of the Blue; and Edinburgh Sculpture Workshop;
- SOSCEI;[10]
- Scottish Borders Council.

We recognise from previous research that the loans will be small in value, require flexibility in repayment and may involve significant default levels. We understand that other options for applicants might still be cheaper but loan criteria might also be tighter with other funds.

We believe that the true costs of a sustainable fund are along the lines previously cited in BOP Consulting's research, and income from lending to cover staff and administration cannot be achieved at a cost desired by artists given the likely small loan volumes, low loan values and higher default expectations.

Using our experience of similar loan funds we consider that around 25% of all loan applications will result in a loan offer. We believe it is desirable but perhaps not essential for a specialist loan officer post to be created, funded and established – potentially housed within DSL Business Finance - over a pilot two year period to promote the fund, liaise with route-to-market organisations and consider the business needs and likely support required by applicants.

In developing a loan fund proposal, we have made the following assumptions:

- Loan averages of £2,500 (rising by 2% annually);
- Loan term of 24 months;
- Arrangement fee paid on drawdown of 2% (paid by applicant);

[10] The South of Scotland Creative Enterprise Initiative is a partnership of Dumfries and Galloway Council, Scottish Borders Council and Scottish Enterprise (South Scotland). SOSCEI campaigns to raise the profile of the area and to make sure that South of Scotland's concerns are raised at the highest level of government.

- Interest rate applied of 14% on reducing balance (monthly);
- 17.3% APR typical;
- 14 applications made per month with 3.5 approvals per month;
- All received applications incur a charge of £100;
- All loans disbursed carry additional charge of £150;
- A FT loans officer (salary £22,500 pa) is desirable to promote fund, liaise with partners, and provide support to applicants.
- Loan capital of £125,000 is required (£100,000 possibly provided by DSL Business Finance);
- Default rates anticipated at 14%;
- Marketing and advertising budget (cost unknown);
- WASPS, Out of the Blue, ESW and other similar providers to promote fund.

SOSCEI Illustration 2.0; Loans at 17.3% APR, revenue costs not shown

SOSCEI illustration 2	Year 1	Year 2	Year 3	Year 4	Year 5
Funding	£125,000	£0	£0	£0	£0
Loan Capital Issued	-£104,991	-£107,091	-£109,233	-£111,418	-£113,646
Loan Capital Repayments Gross	£28,435	£81,500	£107,190	£109,334	£111,520
Loan Interest Repayments Gross	£4,331	£12,413	£16,326	£16,653	£16,986
Bad Debt Loss Capital	-£14,699	-£14,993	-£15,293	-£15,598	-£15,910
Bad Debt Loss Interest	-£2,239	-£2,284	-£2,329	-£2,376	-£2,423
Loan Admin fees received	£2,100	£2,142	£2,185	£2,228	£2,273
Sub total	-£87,063	-£28,313	-£1,154	-£1,177	-£1,201
Salaries	£0	£0	£0	£0	£0
Management Fee	£0	£0	£0	£0	£0
Other Running costs	£0	£0	£0	£0	£0
Recruitment Costs	£0	£0	£0	£0	£0
Training Costs	£0	£0	£0	£0	£0
Recovered Capital	£0	£0	£0	£0	£0
Net Profit	-£87,063	-£28,313	-£1,154	-£1,177	-£1,201
Annual Cash Movement	£37,937	-£28,313	-£1,154	-£1,177	-£1,201
Cash Flow	£37,937	£9,624	£8,470	£7,293	£6,092
Balance sheet assets	£99,794	£97,073	£97,962	£98,869	£99,793

The illustration shows the loan fund itself has just £6,092 left in it at the end of year 5. The overall value of the fund is £99,793 encompassing both the cash available to lend, and the value of the outstanding loan book. As money recycles the fund ought to retain sufficient funds on a modest upward trajectory from year six onwards. However, as already stated, these projections illustrated exclude the costs of lending.

Adding in the salary of a loans officer and paying fees to DSL Business Finance (as outlined in the assumptions above) the fund will realistically look like this:

SOSCEI Illustration 2.1 loans at 17.3% with potential revenue costs included.

SOSCEI illustration 2.1	Year 1	Year 2	Year 3	Year 4	Year 5
Funding	£125,000	£0	£0	£0	£0
Loan Capital Issued	-£104,991	-£107,091	-£109,233	-£111,418	-£113,646
Loan Capital Repayments Gross	£28,435	£81,500	£107,190	£109,334	£111,520
Loan Interest Repayments Gross	£4,331	£12,413	£16,326	£16,653	£16,986
Bad Debt Loss Capital	-£14,699	-£14,993	-£15,293	-£15,598	-£15,910
Bad Debt Loss Interest	-£2,239	-£2,284	-£2,329	-£2,376	-£2,423
Loan Admin fees received	£2,100	£2,142	£2,185	£2,228	£2,273
Sub total	-£87,063	-£28,313	-£1,154	-£1,177	-£1,201
Salaries	-£25,200	-£25,704	-£26,218	-£26,742	-£27,277
Management Fees	-£23,098	-£23,098	-£23,098	-£23,098	-£23,098
Other Running costs	£0	£0	£0	£0	£0
Recruitment Costs	£0	£0	£0	£0	£0
Training Costs	£0	£0	£0	£0	£0
Recovered Capital	£0	£0	£0	£0	£0
Net Profit	-£135,361	-£77,115	-£50,470	-£51,018	-£51,576
Annual Cash Movement	-£10,361	-£77,115	-£50,470	-£51,018	-£51,576
Cash Flow	-£10,361	-£87,477	-£137,947	-£188,965	-£240,541
Balance sheet	£51,496	-£28	-£48,455	-£97,389	-£146,840

The fund could not generate income to cover the costs of lending, hence our suggestion that revenue costs will need to be funded from other sources, as the alternatives are loan rates that will be anathema to the majority of borrowers and stakeholders.

7.0 Findings: Standard and non-standard lending

Conventional banks and other standard lenders are not interested in this area of lending because the levels of funding requested are too small, too risky and too unprofitable, even when backed by the Enterprise Finance Guarantee Scheme (EFGS). The average loan value of all Enterprise Finance Guarantee Scheme loans over the past five years from 49 registered lenders was £101,000 (17,291 loans). One of the lenders was DSL Business Finance; their average loan backed by EFGS was £14,000, (110 loans) the second lowest loan value. This is still substantially more than we are projecting but significantly smaller than the averages of the four big banks EFGS averages[11]:

- HSBC £134,000 (1893 loans)
- Barclays £93,000 (2569 loans)
- Lloyds £67,000 (4318 loans)
- RBS £104,000 (6717 loans)

Mainstream lenders are also sceptical about the business skills (see earlier sections) of artists and their capacity to develop a sustainable enterprise.

CDFIs (by which we mean 'not-for-profit' lenders such as DSL Business Finance, Social Investment Scotland and the Key Fund in Yorkshire) are willing to take on small, riskier, loans but the additional costs involved in supporting such loans, and lack of security, would require a higher interest rate.

Credit unions were mentioned in the initial report in 2011 and in the brief. Capital Credit Union is one of the largest and most sustainable in Scotland. Would it be interested in providing micro-loans?

There are a number of issues here. By and large credit unions offer personal lending, but because the money they are lending is the savings of their members, they are rightly cautious and want to ensure a low bad debt level. The implication is that unless it can be secured in some way, lending to artists would be seen as too risky because of the fragile

[11] www.gov.uk/government/publications/number-of-enterprise-finance-guarantee-efg-scheme-loans-drawn

nature of their businesses. In this sense, credit unions are unlikely to represent a cheap supply of capital.

The current Borders loan scheme for SMEs, at a cost of 5% is unsustainable in economic terms and represents an attempt (valuable in its own right) to stimulate demand. What might be possible is blending this, some Creative Scotland 'place' funding and capital from a CDFI to create a small pilot loan fund to test the market place.

8.0 Findings: Sustainable models

Any sustainable model requires a balance of demand, interest rates and default levels. Because overheads require a minimum volume to make them worthwhile, market size is important. The issues in the Borders will be that low levels of demand mean (assuming reasonable default levels) that interest rates will need to be high or at least perceived to be high by borrowers.

An interesting example of trying to make this work is where the Arts Council has set up two pilot projects (running till March 2013) in London and Yorkshire/Humber. In the latter example, the Arts Council has put up £100,000, matched with £100,000 from the Key Fund at an interest rate of 10% for loans of £5,000 to £25,000. In addition, the Arts Council pays £9,500 to the Key Fund for administration costs and insists (and pays for) that each artist has 12 hours of business tuition/support £13,500.

After an initial launch and around 80 expressions of interest, only a small number of applications have come forward and the first loan (£5,000) has just been made.

The moral of the story is that business support is needed as well as finance, interest rates need to be low, and that this means an independent fund will be unsustainable, but there might be a point in bolting such a specialist fund on to an existing CDFI and testing demand.

9.0 Conclusions

We have broken our initial findings down into a number of areas that should help SOSCEI decide on what its priorities, partners and actions might be.

- We do not consider a creative industries / arts loan fund in the Scottish Borders to be either viable or sustainable, particularly when the price of money is distorted by the recently launched Scottish Borders Council loan fund aimed at both new and existing businesses which offers an interest rate of zero[12].

- However, we do believe that there is scope for a discrete fund aimed at creative industries / artists *across Scotland*, which can be promoted through WASPS, Out of the Blue, Edinburgh Sculpture Workshop and other similar creative industry hubs, administered by DSL Business Finance with additional revenue support from Creative Scotland.

- We recognise the value of small loans (around £2,500) to low-income artists to fund largely speculative purchases, or activities that might allow people within the creative industry sector to improve their sales and incomes. This is non-standard lending that would likely fail to secure mainstream funding. We project around 168 people annually might apply for such a loan, with around 25% being approved.

- We believe such a fund could be managed and administered by the Glasgow-based, business lending CDFI, DSL Business Finance; they might be prepared to provide 80% (£100,000) of the loan capital required to pilot such a fund over a two to five year period.

- We think that Creative Scotland - or some other body - would need to support the pilot by providing funds for a full-time loan officer, and meet the reasonable

[12] The Scottish Borders Loan fund offer loans to new and existing small and medium sized businesses, (up to £5,000 for start-ups and up to £10,000 for existing businesses). It is priced at zero per cent interest on loans, after a 5% administration fee is paid.

administrative and management costs per loan application (estimated at 14 per month).

- We further believe that the UK Government's Enterprise Finance Guarantee Scheme (EFGS) might be used to underwrite up to 15% of the potential default value, but an arrangement with Creative Scotland or other body would need to be established to provide a further underwrite / guarantee (if legally possible alongside Enterprise Finance Guarantee Scheme regulations) for any additional default up to 30% of the loan book value.

- We think that the price that would need to be set to create a sustainable fund, (if no funding from Creative Scotland was available, but the same costs needed to be covered), is along the lines proposed in the 2011 report '*Creative Financing: feasibility study into financial mechanisms for supporting small-scale creative activity in Scotland*' by BOP Consulting. Their report identifies a rate exceeding 28%. We agree with this conclusion.

- We do not believe that credit unions will provide unsecured loan capital for arts related business loans, as proposed in the same BOP Consulting report. They have no incentive to do so and the type of lending, for small business purchases, is different to (and much riskier than) their typical loan product.

- We believe that organisations like WASPS, Out of the Blue, Edinburgh Sculpture Workshop and others might be prepared to promote the fund through their normal communication with customers. These three organisations alone rent space to over 1,110 creative artists across Scotland. It is in their interests to see a thriving creative industry sector and potentially, subject to agreement for applicants, rent data could be taken into account as part of the loan application process. A further discussion with these organisations is required to explore potential collaboration.

- We believe some form of business support package, possibly delivered by Business Gateway, or by specialist support (through the Cultural Enterprise Office), should be considered for successful applicants to any fund to improve their business competencies and skills.

10.0 Recommendations

SOSCEI should:

1. Enter into discussions with DSL Business Finance about managing a Creative Industries loan fund for Scotland; and
2. Clarify the conditions around DSL Business Finance supplying £100,000 of the loan capital required;
3. Open discussions with Creative Scotland to identify the possibilities of them providing the potential revenue support for staffing and administration requirements of a Scotland wide fund;
4. Open discussions with WASPS, Out of the Blue, Edinburgh Sculpture Workshop and other similar organisations to discuss their potential role in marketing a discrete fund to the creative industries that rent their workspaces;
5. Open discussions with Business Gateway and the Cultural Enterprise Office to ascertain the package of needs that could be identified to support successful applicants become more business minded and entrepreneurial.

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