Planning Activity

Theme 1

This document provides an example of a plan for one topic within Theme 1. This resource goes into more detail than is required in the specification but it provides some background to the topic and suggested approaches for planning content.

The approach to planning taken in this document was to:

- Identify the specification content and possible links to other topics in the specification
- Identify the knowledge, application, analysis and evaluation relevant to that content
- Identify resources to support delivery – these might include:
  - Support resources including sample assessment materials and Getting Started guide
  - Published resources including textbooks
  - Websites and news stories
- Develop activities and resources – these might include:
  - Practice questions from past papers
  - Worksheets
  - Past and new case studies
  - Practice questions for explain, calculate, assess and evaluate (where appropriate)

Role of banks in the economy

Specification content	1.4.1 Role of banks in the economy a) Channelling savings towards investment b) Role of banks in providing credit c) Interest rates and collateral
Possible specification links	1.2.1 Entrepreneurs have ideas but they do not always have the finance to turn their ideas into a viable business. For this they need credit
	1.2.3 Entrepreneurs need credit to buy factors of production
	1.2.5 Changes in interest rates can affect the cost of credit
	2.1.1 Growth may be financed by credit
	4.5.2 The role of the financial sector

Knowledge, application, analysis and evaluation

Knowledge

Entrepreneurs have ideas but they do not always have the finance to turn their ideas into a viable business. For this they need credit.

Firms produce goods and services by converting inputs into outputs they can sell.

Inputs	**Value is added**	**Output**
Raw material/stock Machinery Labour Premises	→	Goods and/or services for sale
… the input costs	← £	Sale of the output … finances…

The role of credit

The input costs are incurred before the output revenue is received. One role of credit is to finance cash flow (the working capital needed). Overdraft finance is short-term in nature and (relatively) expensive because it is unsecured.

If the business thinks that opportunities for more revenue exist, it may wish to increase output. This will need more factors of production (e.g. premises, machinery) and the firm may invest in new capacity in order to be able to meet the increase in demand. A loan, distinct from an overdraft, finances longer-term investment (e.g. in new capacity) where the loan would be of similar length (maturity) to the life of the asset. The cost of the loan is financed by the return (income) from the asset.

The role of credit is to provide finance for the purchase of new fixed assets which make the increase in productive capacity possible.

The increase in debt has increased the productive capacity of the business (and the economy). The increase in capacity will provide an income to service the debt.

Banks savings and investment

Banks offer a rate of interest to encourage savers to deposit their funds with them.

Banks charge a rate of interest to borrowers wishing to use credit to finance working capital or investment. The spread between the lending and deposit rates is the bank's main source of income (and profit).

The rate of interest charged to borrowers is higher than the rate offered to depositors.

Bank lending does not depend on the level of saving and commercial banks are the main creators of credit in the economy. However, a bank might be 'capital constrained' which means that further increases in its lending would push its capital ratio below the limit set by its regulator. This means the bank is unable to create new credit. Banks may also be risk averse if there is lots of 'bad lending'. In this case, the bank may be able to create credit but unwilling to do so.

Banks, collateral and interest rates

Collateral is sometimes known as security.

A secured loan is when a bank lends money to a business in return for some form of security or guarantee (such as the deeds to property). The security can be transferred to bank ownership if the debt goes bad.

An unsecured loan does not involve security and is usually more expensive as a result.

Interest rates include a charge for credit risk so one would expect riskier unsecured loans with higher credit risk to be made at higher rates of interest than safer secured loans.

The banks' perception of risk may depend on its experience of bad debts. This is sometimes known as its 'loan-loss history'. Some loans are never repaid (if for example the business taking the loan goes bust) and the asset offered as security may not be worth enough to cover the loss made on the loan.

Application

The Bank of England publishes information about the year-on-year percentage change in lending to UK businesses. This fell markedly from 2008 as a result of the Global Financial Crisis.

The Funding for Lending Scheme (FLS) was launched by the Bank of England and Treasury in 2012. The idea was that the FLS would provide banks with funds which banks would then lend to businesses. Banks would be provided with more funds if they lent more. The scheme has since been extended with incentives to increase lending to small firms.

Analysis

Banks and the provision of credit

Banks take differing views on risk and the provision of credit at different times in the economic cycle. Broadly speaking, there is a tendency for banks to lend too much in boom times and too little during recessions.

Economist Hyman Minsky suggested a way of understanding this by describing five different phases in credit provision by banks. This is sometimes called Minsky's Financial Instability Hypothesis. It should be noted that actual credit cycles may or may not follow this pattern. (Note that Minsky is not required in the specification content.)

1. Cautious and risk-averse banks	Banks finance working capital (cash flow) and low risk investments. Firms are also cautious. Credit is tight.
2. Banks become more confident	Because most investments made in phase 1 succeed and debts are easily repaid, banks and firms start to think that they have been too cautious in their evaluation of risk. Firms want to borrow more to buy assets and to finance new investments and banks share the optimism and confidence of the firms. Banks create more credit and asset prices rise. The increase in debt (credit) helps to fund economic growth.
3. Overconfidence (euphoria) takes over	Banks and firms start to think that the future is rosy and that most investments will succeed. Asset prices continue to rise due to growing confidence and firms borrow more and more. Interest rates rise.

4. Growth of speculative finance and an asset bubble	Some firms borrow heavily to buy assets judging that they will be able to repay their debts from selling the assets at an even higher price. This pushes asset prices up still further.
5. The bubble bursts	Some firms are so much in debt that the only way they can pay the interest on their debt is to sell their assets. When sufficient firms do this asset prices fall and banks now find that some of their customers cannot service their debts and that the assets are worth less than the debt still owed. Banks worry about bad debts on their books and raise interest rates and stop lending (a credit crunch). This causes some firms to fold due to cash flow problems. Banks return to their cautious outlook and the cycle returns to phase 1.

Evaluation

Do banks still play a role in providing finance for entrepreneurs? In the recession which followed the Global Financial Crisis many small businesses complained that they could not get access to credit and the resultant cash-flow problems may well have forced some to close.

The reluctance of banks to lend has opened up opportunities for alternative sources of finance such as peer-to-peer lending which by-passes the traditional banking system.

Lending between individuals is more likely to be based on trust and the reputation of both parties. The Prudential Regulation Authority (PRA) is trying to encourage new banks into the UK lending market. These banks are meant to bring new attitudes and practices to the industry so that there is a wider range of options for potential borrowers.

Case study: falling bank lending to small businesses

Small and medium-sized enterprises (SMEs) are an important part of an economy but small firms, especially start-ups, are very risky.

The October *Trends in Lending* report suggests that small firms are still struggling to access cash from the banks. Lending to SMEs through the Government's Funding for Lending Scheme (FLS) was down in the second quarter of this year, contracting by £400m.

The FLS was launched to help banks release loans cheaply, mainly to SMEs.

The most recent *Credit Conditions* survey suggests that demand for credit from small businesses is far outstripping availability.

The Federation of Small Business reports that over 50% of small firms now find the availability of credit 'poor' or 'very poor', with many stating that credit is unaffordable.

As bank lending continues to fall, SMEs are increasingly turning to alternate forms of finance. Flows of peer-to-peer business lending from providers such as Funding Circle increased in the first half of 2014, reaching a total of £300m.

Small firms are increasingly seeking out new forms of finance; the number using only bank loans, overdrafts or credit cards has declined by almost 10% to 20%, according to the most recent SME Finance Monitor.

Samir Desai, founder of Funding Circle commented that "the unprecedented level of demand we are seeing from creditworthy firms at Funding Circle suggests it's not demand for finance that is falling, but instead demand for a traditional bank loan."

Adapted from an article in the Daily Telegraph, 20 Oct 2014

Students can read more about the FLS and look at data on the usage of the FLS on the Bank of England website:

http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/qb120401.pdf

http://www.bankofengland.co.uk/markets/Pages/FLS/extensiondata.aspx

Questions

1. Explain the finance needs of small businesses.
2. Explain the reluctance of banks to lend to small businesses.
3. Research the Funding Circle website.
    a. Describe how it works
    b. Explain a benefit to lenders
    c. Explain a benefit to investors

Case study: sources of finance – crowdfunding

The basic idea of crowdfunding is that investors and customers put up the money to get a product made. Investors are placing their faith in an idea. Customers are pre-ordering a product.

Kickstarter is a site used by creative people in the arts especially for music and film projects. They post a project idea, set a target amount and a deadline. If they raise the target amount by the deadline date, the people who signed up have their credit card charged and the artist can go ahead with the project. The 'investors' are essentially customers who have pre-ordered. If they do not reach the target amount the project does not go ahead. In essence this is combining market research with the raising of finance.

Find out how kickstarter works: http://www.kickstarter.com/hello?ref=homepage

The entrepreneur gets to know that he has a market (i.e. guaranteed orders), has raised the finance from his customers and has avoided either going into debt or giving away a share of his company to raise the money. In other words, free market research and free start-up capital!

Crowdfunding sites to raise money from investors rather than advanced sales from customers have also started to appear:

RocketHub: http://www.rockethub.com/

Crowdfunder: http://www.crowdfunder.co.uk/

Launcht: http://www.launcht.com/

Questions

1. Research **one of the four** sites mentioned above.
    a. Describe one project of interest to you.
    b. What motives might you have for backing the project financially?
2. Summarise in one paragraph, how crowdfunding works.
3. Assess the key benefits to an entrepreneur of this funding model.
4. Assess the limitations of this funding model.