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B/F with PM response.

Caxton House Tothill Street London SW1H 9NF

Telephone Direct Line 01-213 6400

Switchboard 01-213 3000

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
LONDON
SW1

8 May 1985

Dear Nigel

TRAINING LOANS

The purpose of this letter is to bring you and colleagues up to date on the development of our proposals for a pilot Training Loans Scheme in the light of consultations, to outline proposed changes, and to seek agreement to my officials now negotiating a revised package with banks, with a view to starting the pilot scheme from 1st January 1986.

Last November colleagues on E(A) agreed to the issue of a consultation paper outlining a pilot scheme for training loans which proposed, subject to the outcome of consultations, to establish a pilot project costing up to £5m of Exchequer money in 1985/6. Because I had been advised that enabling legislation was required for the Government to act as guarantor, the paper proposed that the banks and Government jointly would make available £10m of loans for vocational training. In the light of responses to the consultation document and advice from the Law Officers that a guarantee scheme is after all feasible, I am now proposing a pilot scheme based on a Government guarantee with funding spread over a longer period but generating much more training than we had previously envisaged.

OUTCOME OF THE CONSULTATIONS

The response of the British Bankers' Association to the scheme in the consultative document was very negative: they expressed doubts about the market, the level of risk, the likely high cost of loans and the administrative complexity. Four of the smaller banks expressed an interest in possible participation but only as a transitional step towards a permanent guarantee scheme. None of the major clearing banks was interested. Other respondents indicated widespread support for the principle of a training loans scheme, but they also suggested that substantial changes would be necessary to

make the scheme attractive to both prospective borrowers and lenders. The consultation document envisaged that a market could be created for training loans on normal commercial terms, but it is now clear that the market for training loans will not grow from its current negligible size unless Government finances some incentives to potential trainees and accepts some of the additional risks which expansion of the market would bring to the banks. A workable cost-free option does not exist and the proposals below are based on the assumptions that cost to the Exchequer is inevitable if the scheme is to succeed but that we must ensure that we get the best value for our expenditure.

PROPOSED CHANGE

The 2 major new features I am proposing are a short "repayment holiday" for trainees (so that they are not liable for interest incurred during the period of training and for up to 3 months shortly after) and a limited portfolio guarantee for the banks. The Law Officers Departments have confirmed that there are powers to operate a loan guarantee scheme under the Employment and Training Act 1973. A summary of my proposals is at Annex A, their rationale is developed at Annex B and possible costs on various assumptions are detailed in Annex C.

A key feature is the idea of offering a <u>limited</u> guarantee to the lenders which, if accepted by the banks, would firmly limit the Government's commitment to a fixed maximum percentage of each banks' portfolio of loans. The level of interest charges which the Government would meet during the 'repayment holiday' would of course remain a potentially volatile element not only because of changes in prevailing interest rates but because of variations in the length of courses, during which the "holiday" would be operative.

These proposals do not contain any element of continuing subsidy to lower the level of interest rates incurred by the borrower after the 'repayment holiday'; while this was suggested by some respondents as a necessary incentive to borrowers, it would mean a significant increase in costs, and would encourage substitution. Nor do they provide for a Government advisory service to borrowers as some respondents and banks suggested. The target group for loans is individuals who are prepared to invest in their own future through acquiring additional skills or qualifications and they will themselves have to raise 20% of the cost of the training. They should be well motivated individuals who are best able to

decide for themselves what training courses are relevant and will improve their earning capacity. Our publicity material will, however, suggest basic questions which potential borrowers will want to satisfy themselves on before committing themselves to a loan.

EXPENDITURE

The actual costs to the Exchequer will of course depend on what terms can be negotiated with the banks, the take-up rate, prevailing interest rates; the average length of training course and the level of bad debt. Annex C (Table 1) illustrates a possible range of Exchequer costs between £5 and £12m. A round of hard bargaining with the banks lies ahead of us; and for negotiating purposes we should of course start off with the banks at the lower end of the ranges illustrated in Annex A, although it would be necessary to retain flexibility and trade-off between individual elements. The banks have made it clear that for the scheme to be worthwhile to them we must have it large enough to repay their investment in staff training and setting up administration procedures and I believe that we should accept that our own commitment must be greater than the £5m single year investment originally envisaged.

The potential benefits of switching to loans from grants are very high. In my view, it is worth increasing our stakes by spending more to generate much more training than originally envisaged and by creating the climate which will allow the pilot to show the way to much more radical ways of funding training - with potentially enormous implications for saving public expenditure. It is important to show sufficient commitment over a reasonable period to persuade the major clearing banks not to hang back but to participate wholeheartedly in the pilots. My proposals, therefore, assume that we increase our investment from £5m in a single year to somewhere between £7 and £10m (with the pilot open for a 3 year period) and that, as a result, we can stimulate loans worth not £10m as originally envisaged but perhaps as much as £36m.

PILOT AREAS AND MARKETING

We have re-considered the best way to test and market a pilot scheme and rather than launch it nationally, it seems sensible to concentrate efforts, at least in the initial year, on banks in a few selected areas. This would help both a concentrated

marketing campaign (in which we would play a major part) and the testing of administration procedures. Concentration on selected areas would not restrict eligibility to applicants and training courses within these areas but in practice most of the take up would come from them. To provide experience of different economic and social characteristics, I propose selecting 4 or 5 areas, one in Scotland, one in the North of England and 1 or 2 in the South and, if Nick Edwards wishes, one in Wales.

NEXT STEPS

I believe that the proposals outlined offer an imaginative and cost effective way of expanding training and increasing the individual's contribution to training costs with the minimum of Government bureaucracy and the maximum involvement of the banks. The importance to our wider training funding objectives of the successful launch of the scheme cannot be overstated. There are advantages in demonstrating that a loans scheme can operate effectively in vocational training. Success will of course depend on how many borrowers we attract and that must be speculative still, but these probably will give us our best chance yet to test the market and begin to change attitudes.

I hope you and colleagues can agree that my officials can now negotiate with the banks on the basis outlined above and within the limits outlined at Annex A and with an overall limit of Government commitment to the scheme of £7-10m. My officials would, of course, keep in close touch with yours and I would come back to colleagues before finalising a deal with the banks. I would hope to do this by July because if the scheme is to be operational by January 1986, the banks have told us that they will need some months for setting up administrative procedures and we will need time to plan an effective marketing campaign. It follows that we should aim to reopen talks with the banks within the next week or two.

I am copying this letter to the Prime Minister, and to members of E(A), to the Secretary of State for Education and Science and to Sir Robert Armstrong.

Lu

Tom

8 MAY 1985

TRAINING LOANS SCHEME **ANNEX A**

SUMMARY OF NEW PROPOSALS

The broad proposals of the consultation document on eligibility, maximum length of course, trainee contribution etc will be retained though a number of minor changes have been agreed with Departments most involved. The following are the proposed major changes.

Trainee Contribution

- Trainees will continue to be required to find 20% of the course costs but will not have to repay capital in full at prevailing commercial rate of interest (at fixed rate as with normal personal loans) until the end of the repayment holiday.

Repayment Holiday

- The Department will meet the cost of interest payments during the period of training, and for a period of up to 3 months after completion of training at the discretion of the banks having regard to nature of training and time taken to find employment using new skills.

- Negotiations with banks to explore ways of minimising "substitution" without imposing detailed Department vetting and/or means testing (e.g. by possible exclusion of certain categories of applicant such as those whose training should be financed in whole or part by their employers).

- Rate of interest payable by the Government during the repayment holiday to be negotiated, within the range of prevailing inter-bank rate and APR (the annualised rate normally charged for personal loans), allowing for factors such as the reduced risk to the banks because of the guarantee on the one hand and greater administrative burdens on the other.

Portfolio Guarantee

- Government guarantee to be based on each banks total portfolio

of loans rather than on individual loans i.e. the Department will agree to meet the costs of bad debts up to a maximum percentage of the banks' annual portfolio.

- Because of the need to encourage the banks into lending in areas which at present they regard as too risky, the level of Departmental guarantee will be negotiated within range of 10-20% of total portfolio less say, 2½% to allow for banks' existing bad debt assumptions.

- Negotiations to explore feasibility within the portfolio concept of maintaining an incentive on banks to pursue recovery of debt even when within the overall default limit.

Managing Agent's Fee

- Government to make payment to banks as a contribution to additiona costs of operating scheme (Government accounting and departmental information requirements etc) and as incentive to banks to handle smaller loans for short courses - which we want to encourage, and which the banks might otherwise regard as uneconomic.

- The level of fee to be negotiated, with aim of achieving an administratively simple flat rate within range of £25-£50 per loan.

Marketing/Evaluation

- Government to offer as its contribution a budget of up to £0.5m over 3 years, designed to complement banks' own marketing efforts and identify/expand market.

- Government to offer some exchange of monitoring/evaluation information to help in assessment and operation of pilot scheme.

Overall Cost and Benefit

- Target of £10m of new loans each year for 3 years generating £36m worth of training (allowing for trainees' 20% share).
- Target cost to Government to be about one-quarter to one-third of value of training i.e. about £7-10m.

Department of Employment
May 1985

PROPOSED INCENTIVES FOR TRAINING LOANS SCHEME ANNEX B

1. The case for introducing and structuring incentives to borrowers and lenders is set out below.

BORROWER INCENTIVES

2. Individuals will generally find it difficult to make repayments whilst they are actually under training. Indeed, those who train full time will have to borrow to cover maintenance as well as course fees. And this difficulty may continue for a period afterwards until they are settled in work. In theory 'roll up' is possible if the banks agree to defer repayment of capital and to add accumulating interest to the debt. In practice banks are reluctant to do this and many potential trainees would be deterred by the prospect of a rising burden of debt. It is not a practicable proposition. A repayment holiday for the period of training and up to 3 months afterwards would be the most useful help which trainees might be given. Under this proposal banks would agree to defer repayment of the principal and Government would pay interest to the banks on behalf of the trainee during the holiday period.

LENDER INCENTIVES

3. The major factor holding back the banking system from offering training loans on a commercial basis is the high degree of risk. So far as personal lending is concerned the single most important criterion which determines an individual's credit rating is whether he has a secure job and is earning enough to cover repayment. An individual proposing to invest in his own training will, however, either not have a job, be giving it up to train, or be contemplating a job

change after completion. In effect, the bank is being asked to finance a speculative investment in an individual's personal skills and competence.

4. There is a strong and unanimous view by the banks that what is needed is a Government guarantee against loan default. Some have made it clear that they will not participate without a guarantee. Others will participate in a pilot scheme but only on the understanding that it is an interim stage towards a guarantee based scheme. A guarantee scheme was originally ruled out for the pilot stage because it was thought the Employment and Training Act 1973 did not give powers although the implication of the consultative document was that if we were able to give a guarantee that would be our preferred option. Legal advice now is that a guarantee is after all possible.

5. The attractiveness of a guarantee scheme is that it permits banks to lend to those who would not be regarded as sufficiently credit-worthy on normal commercial criteria in the knowledge that Government will provide compensation for the additional costs. This will allow an expansion of the market for loans and from the Government's point of view offers the attraction of guaranteeing more loans for a greater level of public investment than a matching loan arrangement. It should also be cheaper and simpler to run. Guarantees do, however, carry the very real risk that banks will regard any guaranteed loan as 'Government money' and become too relaxed in their lending and debt recovery policies. The traditional way of avoiding this, followed for example in USA student loans and with the Department of Industry's Small Business Loan Guarantee Scheme, is to guarantee only a proportion (70-80%) of each loan. This goes some way to reducing the risk and if even lower figures

were adopted it might be reduced further. Even so, experience indicates that default rates would still be high and unpredictable.

6. An alternative approach aimed at limiting commitment to a more acceptable level may be possible although it would require agreement from the banks and has not been put to them. Normal practice in commercial banks is to build a bad debt assumption into the costings of any lending portfolio. For personal lending in the UK, around 2-3% appears to be current practice. Interest rates and other charges are designed to leave a profit with default at that level. Furthermore, standard management information systems are designed to monitor performance and corrective action is taken if ratios fall markedly below (indicating that potentially profitable business is being turned away) or above (indicating laxness). The key to the system is to concentrate management effort on percentages and away from assessment of individual loans. We should build on this approach using the market mechanism and the bank's own management systems to deliver a target bad debt ratio we have set in advance.

7. An agreement with participating banks might:-

(i) Specify a lending limit. We have in mind £10m per year for three years. This would be entirely bank capital.

(ii) Exclude from any guarantee the level of default already assumed in the bank's pricing structure, say the first 2½%.

(iii) Guarantee any default above 2½% up to say 15% or 20%.

(iv) Exclude from the guarantee any defaults above the acceptable limit.

The net effect of this would be to limit Government commitment to a predetermined maximum whilst permitting banks to relax their normal lending criteria thereby expanding significantly the overall market for training loans. So far as the banks are concerned, it need not matter what limit is set but clearly the higher the limit the greater will be the expansion of training which banks would be prepared to finance, and we need to encourage them to take an expansionist view at least in the pilot phase.

MANAGING AGENTS FEE

8. Finally, a modest managing agents fee would compensate banks for the additional paper work involved in handling small loans on Government's behalf. A flat rate fee will encourage banks to lend for the short, relatively low cost courses which we want to encourage and, for that reason may be preferable to a percentage based fee. This will enable banks to handle most of the paper work, keeping Civil Service numbers to a minimum. There may be an element of trade off between this and the rate of interest charged during the repayment period.

DEPARTMENT OF EMPLOYMENT

MAY 1985

Annex C

Cost to Government of Training Loans

1. The target for the pilot scheme would be to make available each year £10m of new loans for a period of 3 years. Assuming repayments would be up to 3 years after starting work the last repayment could be due up to 8 years after the scheme starts.

2. Actual costs will depend critically firstly on what terms can be negotiated with the banks and secondly on the take-up rate; prevailing interest rates; average size of loans; average length of course and level of bad debt.

3. The costs of the scheme as envisaged are attributable to 4 main elements discussed below:

a. Repayment Holiday

The cost of offering a repayment holiday depends on the prevailing rate of interest, the average length of course and the length the permitted 'period of grace' (to allow for trainees finding employment). The formula for agreeing the rate of interest payable to the banks is for negotiation, but costs will inevitably fluctuate over time and no firm ceiling can be put on this element as with the proposed portfolio guarantee limit. Our aim would be to agree with participating banks a common formula and to look for a rate as near as possible to inter-bank rate rather than the prevailing APR normally paid by the individual borrower. Course length is an unknown quantity until we have some experience of operating the scheme. The grace period could be either fixed eg at 3 months or left to the banks' discretion to allow for very short courses of trainees not needing the full period.

b. Portfolio guarantee

The aim is to set an overall limit on the percentage of bad debt (on the annual portfolio of loans) that Government would guarantee, thus putting a firm ceiling on expenditure on this potentially costly element of the scheme. If the maximum level of bad debt to be recovered by the Government were set at, say 15% then after allowing for the fact that banks set their interest rates to allow for 2-3% bad debts, the Government's proposed contribution might be limited to 12½% of the overall value of the loans made. In practice the banks would be likely to proceed cautiously, at least before gaining experience of the expanded market, and the costs could well be lower.

c. Managing Agents Fee

The size of fee would be for negotiation, it might be set at a flat rate or expressed as a percentage of the loan; or alternatively it could be allowed for in the rate of interest paid to the banks during the repayment holiday. The costs of this element of the scheme would of course depend on the number (and size) of loans. A flat rate could be used to encourage banks to handle more small training loans and might be set at between £25 and £50 per loan.

d. Marketing and Evaluation

Effective marketing and evaluation of the new scheme will be essential, and a budgetary allocation to cover costs is considered a vital part of overall investment in the pilot scheme, and a figure of £0.5m is suggested.

4. For the purposes of illustrating the broad order of costs, as set out in the tables below, we have assumed a maximum take-up of loans from the bank of £30m; interest rate 20%; an average loan of £1,000; average course lengths of 3 months plus 1½ months period of grace and 9 months plus grace period of 3 months and permitted levels of default between 10 and 20% of the total annual portfolio less the first 2½%.

5. Table 1 illustrates the lifetime public expenditure costs based on the above range of assumptions and Table 2 illustrates the pattern of public expenditure by FY assuming an even flow of take-up and of default.

PUBLIC EXPENDITURE IMPLICATIONS

Table 1: Illustrative Lifetime Costs of 3 years pilot

	(£m 85/86 prices) Low Estimate	High Estimate	Mean
Repayment Holiday	2.2	5.2	3.7
Portfolio Guarantee	2.2	5.2	3.7
Management Fee	0.7	1.5	1.1
Marketing/Evaluation	0.5	0.5	0.5
TOTAL	5.6	12.4	9.0

Table 2: Illustrative Annual spread of Costs (based on Mean costs of £9m above)

	86/87	87/88	88/89	89/90	90/91	91/92
Repayment Holiday	1.2	1.2	1.2			
Portfolio Guarantee	-	0.4	0.8	1.2	0.8	0.4
Management Fee	0.4	0.4	0.4			
Marketing/Evaluation	0.2	0.2	0.1			
TOTAL	1.8	2.2	2.5	1.2	0.8	0.4

Department of Employment
May 1985

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