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~~B/F with pu comments & in any case of 21/11~~
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The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Great George Street
LONDON
SW1

15 November 1985

Dear Nigel,

TRAINING LOANS

I am writing to let you know the outcome of discussions with banks on setting up a pilot scheme to test the market for training loans. In entering into talks with 10 banks my officials had in mind the proposals set out in Tom King's letter of 8 May and also the objectives advocated by Peter Rees in his letter of 23 May 1985. At the end of a long and difficult round of meetings 3 banks, Barclays, the Co-op and the Clydesdale agreed to participate, subject to working out detailed arrangements for implementation. The main sticking points were the level of guarantee we were prepared to offer and the adverse effect on profitability of the extra cost of running a scheme jointly with Government.

will request if required

Main proposals

I now propose a 3 year pilot scheme with an overall portfolio of £12m. The 2 new incentive features of the scheme - the portfolio guarantee and the repayment holiday - have been accepted. As in the earlier proposals, we will offer participating banks a limited guarantee to set the Government's maximum liability at a fixed percentage of the value of loans issued. It proved impossible to reach an agreement within the target range of 10-15%, and I now propose a tapering guarantee at 40% for the first 18 months and 20% for the second 18 months. A tapered guarantee has 2 advantages: it should encourage the banks to be more adventurous in the critical first 12-18 months of expanding into an unknown area of risk and, without prejudice to any permanent scheme, it enables us during the pilot to assess the impact of different levels of guarantee. For the repayment holiday for borrowers during the period of training and up to

This does not in fact limit the Government's exposure effectively. But Tsy are going along with it.

3 months afterwards we will pay interest to the banks at base rate plus 3% - a much better level than we had thought likely. After 3 months borrowers will pay interest at the banks' normal personal loan rates.

Eligibility

To be eligible for a loan under the scheme, applicants must be over 18, meet DE's criteria - see Annex A - and be assessed as creditworthy by the banks, taking account of the portfolio guarantee. Loans of between £500 and £5,000 could be made available for training fees (less 20% provided by the trainee), living expenses and other related costs.

Expenditure

The actual costs to the Exchequer will depend on factors such as take-up, interest rates and the level of bad debts. Annex B discusses the variables and costs in more detail. For a scheme involving 3 banks and 4 geographical pilot areas I expect to be able to contain the overall costs within the provision for training loans agreed in PES 85, although the funding will need to be spread over a longer period. Our target is to stimulate loans worth £12m. At the end of the pilot with a guarantee at 20% this will produce a gearing of around 1 to 3 in other words we shall get £3 worth of training for every £1 of Government expenditure. This is clearly a cost-effective way of expanding training in areas of known demand where employment prospects are good. My officials and yours are in touch about how to evaluate the scheme.

Pilot Areas

We and the banks think it is best to market the pilot strongly in a few, carefully selected areas. The pilot areas we consider most suitable are Aberdeen, Manchester, Bristol and Reading/Slough. For the pilots access would normally be limited to people living in these areas or taking up a training course there, but the banks expect to interpret these geographical limits fairly flexibly. Visits to the pilot areas have shown an encouraging level of enthusiasm for loans from local training providers and bank managers.

Legal and Community Aspects

The Law Officers have already confirmed that a guarantee scheme is feasible under the Employment and Training Act, and the proposals are considered compatible with our Community obligations. There are 2 other aspects which I should mention. We have recently been advised by DHSS officials that people borrowing money to fund training under the scheme would not normally be regarded as entitled to benefit, as payments depend on the individual being available for work. They take the view that the concession for part-time study (under 21 hours a week) does not apply to vocational training (with the exception of certain MSC funded work preparation courses) and that borrowers would be primarily committed to training not employment. This means of course that the benefit system will effectively deter unemployed people from taking out a loan for training in the same way as with those wanting to undertake MSC 'fees only' courses. This does mean that the scheme will tend to be seen as primarily for the employed.

The loans scheme will come under the Consumer Credit Act, and consultations with banks on its implications indicate considerable difficulties to be overcome in reconciling the Act's provisions with the same novel features of the scheme. My officials are in touch with DTI officials to resolve the problems as a matter of urgency.

Next Steps

The banks that have declared themselves willing to join us see this scheme as a worthwhile experiment of genuine public interest. I share that view. Even a small pilot scheme, operating in 4 areas of Britain with different social and economic characteristics, can demonstrate the potential for operating a loans scheme and harnessing private capital to promote vocational training. It can test and influence the market, by providing impetus for personal investment in training.

I am satisfied that we could not have driven a harder bargain with the banks without them all dropping out and that it is not practicable at this stage to re-open negotiations on this package. I have been in touch personally with the Chairmen of the major clearing banks, but with the exception of Barclays they remain of the view that the scheme is not sufficiently attractive to them.

We have the basis for a worthwhile pilot scheme and now that detailed discussions on implementation are at last underway, I hope that colleagues agree to my pressing ahead with the plans I have outlined with a view to signing agreements with the banks, and to my making a Parliamentary announcement soon (probably by Written Answer).

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

Yours,
David

ANNEX A

DE ELIGIBILITY CRITERIA

For the Scheme:

An applicant will be asked to confirm that:

(1) He or she intends to use the training for employment or self-employment in the UK or elsewhere in the European Community;

(2) the proposed course is appropriate for the intended occupation;

(3) the loan requested is for a minimum of £500 and a maximum of £5,000;

(4) that the course lasts for at least one week but no more than one year;

(5) that the course does not qualify for a mandatory student award;

and (6) that no part of the fees is being financed by an employer nor is the applicant receiving public funds for the course.

For Maintenance:

An applicant will be asked to confirm that:

(1) the loan is needed for day to day living expenses;

(2) he or she works for less than 30 hours per week;

and (3) he or she is training on the course for more than 21 hours per week.

COST ESTIMATES FOR TRAINING LOANS PILOT SCHEME

1. The target for the pilot scheme would be to make available each year £4m of new loans for a period of 3 years. Costs will be attributable to 3 main elements: the repayment holiday, the portfolio guarantee and marketing and evaluation. Actual expenditure will depend on the take-up rate of loans, the level of base rate; the average size of loans; the average length of course and the level of bad debt. At this stage without experience of the public's response and bank managers' attitudes it is only possible to make broad assumptions for estimating purposes.

Repayment Holiday

2. The cost of offering borrowers a repayment holiday depends on the prevailing rate of interest, the average length of course and the length of the 'period of grace' (to allow for trainees finding employment). The formula agreed with the banks for calculating the rate of interest payable by Government is base rate plus 3%, but costs will inevitably fluctuate over time and no firm ceiling can be put on this element as with the portfolio guarantee limit. Courses can be between 1 week and 12 months, and average course length is an unknown quantity until we have some experience of operating the scheme. A figure of 6 months has been assumed for the costing. The grace period, has been set at a maximum of 3 months, with the banks having discretion to fix the period within that limit.

Portfolio Guarantee

3. The aim of offering participating banks a portfolio-based guarantee is to put a firm ceiling on a potentially costly element of a loan guarantee scheme. The Government's financial commitment will be to meet the costs of bad debts (principle plus interest calculated in accordance with an agreed formula) up to a fixed percentage of the value of loans issued by each participating bank. The aim of a 'tapered' guarantee is to provide some additional encouragement to banks to expand the market at a time when experience of the level of extra risk likely to be incurred is being acquired. The maximum level of guarantee to apply during the pilot has been agreed at 40% for 18 months and coming down to 20% for the subsequent 18 months, ie an average of 30% over the period. The expectation is that banks will start off cautiously even with the higher level of guarantee, and that actual claims against the guarantee might be lower than the Government's maximum liability.

Marketing and Evaluation

4. Effective marketing and evaluation of the scheme will be essential, and a budgetary allocation to cover these costs is considered a vital part of the pilot scheme. £0.5m has been allocated.

Projected Costs

5. For the purpose of illustrating the order of costs of the scheme we have made the following assumptions: a total portfolio value of £12m, take up of 100%, interest rate of 15%, repayment holiday of 9 months, and an average default rate of 30%. The total cost is estimated at £5.9m. The table shows these over 6 years, although commitments stemming from the portfolio guarantee will fall during this period, allowing for a 5 year repayment period for larger loans.

TRAINING LOANS: ILLUSTRATIVE LIFETIME COSTS (£m CASH)

	86/87	87/88	88/89	89/90	90/91	91/92	TOTAL
Repayment Holiday	0.5	0.5	0.5	-	-	-	1.5
Portfolio guarantee	0.1	0.5	1.0	1.3	0.8	0.2	3.9
Marketing/ evaluation	0.2	0.2	0.1	-	-	-	0.5
	0.8	1.2	1.6	1.3	0.8	0.2	5.9

<u>Gearing</u>

6. Allowing for the 20% training contribution from individuals the ratio of public to privte expenditure for the period as a whole is 1:2.5. This rises to 1:3.2 once the guarantee level falls to 20%. Both figures assume 100% take up of loans and full take up by the banks of the guarantee facility.

Education March 1981
Student Loans