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cc NO

Prime Minister

Industry Clerk 3/3

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

2 March 1984

The Rt Hon Norman Tebbit MP
Secretary of State for Trade and Industry
Department of Trade and Industry

Dear Norman

REVIEW OF THE LOAN GUARANTEE SCHEME

David Trippier wrote to me on 23 February enclosing a draft passage on the Scheme which I might use in my Budget Speech.

Given the new information we have just received about the scale of the losses the Scheme is incurring, I do not think we should rush into any decision about its future and for that reason I do not now propose to refer to it in the Speech.

Our officials will need to examine carefully the expenditure implications both of the existing Scheme and of any extension we might consider. I suggest that we set this in hand immediately. They can then review the Scheme in the wider context of the finance and management problems of small businesses, as David suggests.

Copies of this letter go to the other recipients of yours.

Yours ever
Nigel

NIGEL LAWSON

10 DOWNING STREET

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Prime Minister

To see Robson Rhodes' conclusions on the Loan Guarantee Scheme.

Even after 2½ years, RR are making rather sharp criticisms of the participants - the borrowers, the banks and the accountants. The failure rate is high and with it the cost to Government.

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A very depressing report.

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From the Parliamentary Under Secretary of State for Industry

Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON SW1

23 February 1984

Dear Nigel,

REVIEW OF THE LOAN GUARANTEE SCHEME

Officials will shortly be submitting a full report on the outcome of the current review of the Loan Guarantee Scheme, which in its present form is due to come to an end on 30 May or when the existing authority of £600m is used up. I expect to be writing to you and colleagues with our recommendations in March.

In case you wish to see them I enclose Robson Rhodes' report on a survey of 150 borrowers and their commentary on a telephone survey done by this Department.

Robson Rhodes' main report has looked very widely into the finance and management problems of small businesses and at the ability of the banks to make loans based on a proper commercial evaluation. Their recommendations therefore go much wider than the present structure of the Loan Guarantee Scheme. I have been receiving a good deal of evidence from other sources to support what Robson Rhodes say and I therefore regard it as essential to consider the future of the Scheme in a wider context.

The Robson Rhodes' reports are a valuable contribution and I see advantage in publishing them in due course so that their conclusions can be debated more widely. I understand that you would not want this to be done before the Budget but it seems inevitable that changes must be made to limit losses on the Scheme as soon as possible.

I also understand that you would like to announce a year's extension of the Small Firms Loan Guarantee Scheme to May 1985. I am having difficulties in financing the losses of the existing Scheme and an extension would add to them. It will be necessary to consider the future financing of the Scheme as a whole and my people will be in touch with yours as soon as we have firmer estimates. But it is clear that I cannot find the money for an extension from my existing estimates and PES provision.

If you are content to announce an extension of the Scheme on this basis I enclose a draft passage for your speech.

I am sending copies of this letter and of the reports to the Prime Minister and to the Secretaries of State for Northern Ireland, Scotland, Wales, the Environment and Employment.

Yours ever

David

DAVID TRIPPIER

Encs.

DRAFT PASSAGE FOR THE CHANCELLOR'S BUDGET STATEMENT

The Loan Guarantee Scheme has played an important part in improving the availability of medium term finance for small businesses throughout the country. The 3 year pilot Scheme which started in 1981 is due to end in May this year. I am glad to be able to announce that it is the Government's intention to maintain the Scheme in being for a further period with broadly the same objectives. The Scheme has been thoroughly reviewed based on a new study by the consultants Robson Rhodes which is to be published. The conclusions from that review are now being considered and will lead to modifications to some of the present features of the Scheme to improve its performance in relation to its objectives. The Government's conclusions on the review will be announced shortly. I am however able to announce today that the Government will continue to provide the funding necessary for the Scheme for a period ahead extending up to the end of the Financial Year 1984/5.

2. CONCLUSIONS

2.1 Nature of our conclusions

Our conclusions are drawn from a combination of analytical study, interview, structured - but subjective - judgement and opinions expressed to us and systematically recorded. Because of the size of the study, and because we visited 86 of the 94 surviving businesses, we have had a better base for our conclusions than for our previous study in 1982. That does not mean that our conclusions are necessarily proven, merely that they are founded on a large sample, thoroughly reviewed.

The banks emphasise, and we accept, that a study of 150 cases of borrowing under the Loan Guarantee Scheme does not necessarily offer ground for any wider comments than on Scheme lending.

2.2 Some general conclusions

2.2.1 The tenor, issues and content of our 1982 report are supported by this further study. We have noticed that our earlier report has been studied quite extensively by the banks - if centrally rather than by individual managers. That report has been useful and it is important that we can now re-affirm its conclusions.

2.2.2 Our study has led us to consider features of the way in which smaller businesses develop. During this study, and the last, we have looked at 198 businesses in depth. The Telephone Surveys have added evidence from a further 278. It is our view that the crucial managerial and financial elements of business growth - a sense of realism, an awareness of finance, determination, some commercial education, a rapport with banks and advisers - are not strong features of our society, which thereby does not foster smaller firms as they could be fostered.

2.2.3 **The small business.** Most of the proprietors of small businesses in our study did not know, when they came to apply for their Scheme loans, how to manage their businesses to the best advantage. They didn't know how best to assess and structure their financial requirements, nor did their bank managers. Business fragility was often compounded by the type of finance.

Once started many were uncertain as to how best to control their businesses, and some of the better ones devised means of their own rather than seek the benefit of external practical advice. Often their bank managers seemed reluctant to monitor regularly what happened to the business. Advisers, predominantly the accountancy profession, either were not asked, or did not offer, to assist; nor did they help anticipate the procedural and administrative problems which small firms encounter. We came across a great number of other people and organisations attempting to do good, but with limited impact.

We drew the broad conclusion that the banks and the professions have a great deal to do in order to assist small businesses constructively.

2.2.4 **The banks.** All the businesses had a very direct relationship with their bank. Equally the banks offer the single most direct route for influencing and contacting smaller businesses.

We met some very able bank managers. Most managers, however, did not see smaller business clients as worthy of the disproportionate attention which they can command. Many managers in the study saw the administration of their branch, and the volume of transactions through their branch, as precluding giving small businesses special attention. Where some of those managers found themselves faced with small businesses wishing to raise risk money, their ideas of how to cope were often limited and they quickly resorted to a Scheme loan.

On balance we think that all banks should have specialists to deal with small businesses, and to appraise the sort of proposals which look to the Loan Guarantee Scheme. We think it will inevitably be some time before the majority of general purpose bank managers will be experienced to assist properly with raising this money.

Many managers in our study were unclear as to how best to make use of the Scheme. We rather doubt that the Scheme has yet brought about as much of the educative process which we hoped for last year.

2.2.5 The borrowers. Setting up a business is somewhat non-conformist and small businessmen are not conformists generally anyway. They need active assistance and they need discipline in their businesses. They need to be assisted in understanding what help they require and what is available to them.

2.2.6 The accountants. Most borrowers had retained professional advisers, usually accountants, at some stage. The evidence is that the accountants usually only respond, they do not initiate. They are uninvolved with their clients. Those cases for which they helped prepare the presentations to the bank did not turn out to have better survival rates.

They do seem to have an increasing influence on choosing the LGS, and a minority saw advantages in the LGS for the wrong motives: a smart, risk-free deal for their clients regardless of need. The consequences of over-gearing did not appear to be considered.

2.2.7 **The market for funds** From this study the evidence is that the importance of the capital structure of a business, even a relatively small business, is not well appreciated by borrowers, their accountants or their bankers. There is still a need for equity, and very long-term capital, to be invested in those sorts of businesses for which the LGS currently provides quasi - equity. It seems to us that the demand in the market for funds is unbalanced and the supply inadequate for the right demand.

2.2.8 **The Scheme** It is our view that the Scheme still suffers from some early disseminated views amongst its users which did not build a sound understanding of its purpose. Those views do not stem from instructions or manuals but seem to relate to opinions prevalent at the time of the Scheme's introduction.

2.3 Borrowers and their proposals

Borrowers under the Scheme are mostly quite unskilled at controlling their businesses - even when they have been running them for some years. Those who were part of this study, and had set up new businesses, by and large lacked some important skill as part of, or available to, their management team. The most frequent need was for financial control and administration. Some managed to acquire that skill in time, others did not recognise the need almost to the day their businesses failed. The most successful, and now well established, survivors achieved their success by great determination and a drive and acumen which was very clear to see. That drive was only evident in a minority of cases.

Proposals for finance were poorly put together. It may be that a higher standard of expectation from banks would discourage borrowers, and their professional accountants, from assembling poorly thought out proposals. Few were competently constructed from a base of likely elements and assumptions. Fewer were a first step in a continuing process of business control: forward view, plan, budget, compare achievement.

The minimum requirement, a cash flow statement (often suspect because it was not based on a budget for trading), was commonly all that was provided. In ten cases we believe even that was not provided. (The rules of the Scheme require a cash flow statement to be prepared). Often we saw little to demonstrate realistic assessment by the borrower of his project or business: proposals were gambits in the one-off exercise of raising money.

2.4 **Banking practice and attitudes**

Bank managers lending in this study were doing so more often than not as if the proposal were one transaction and not part of the development of the business. The considerations of lending to the future of a business are not often recognised. Some bank managers will argue reasonably that their role is not to lend in that fashion anyway. Perhaps only a minority of bank managers are suited to lend at the fringe of commercial prospects where they can only hope to obtain a yield on term money, without the prospect of any capital gain compensating for risk.

Appraisals. We said last year that appraisals for Scheme loans needed to be different from those for normal bank lending because the viability of the business is more important than the security offered. Security never made a bad proposition good, and should never permit weak appraisals. We see poor appraisals lying at the heart of not only many failures but also the problems which struggling businesses suffer when wrongly financed. We concede that, for the banks, this form of appraisal may be a minor activity, and the business of lending for a yield does not create the climate in which the bank is going to prefer managers who can assess risk over those who seek security.

But it is impractical to say that clearing banks should not become involved in lending for the future of risky businesses if it is intended that those businesses should have access to finance. Something like 13,000 loans have been made under the Scheme. Many more thousands of small businesses start on overdrafts or tenuously secured loans backed by further personal security. The venture capital companies could not cope with that volume of business - and most of it is too mundane for them anyway: the prospect of profit, and the size of the proposals, would be insufficient. The funding must lie with the banks.

We have discussed whether, to improve appraisal skills, the banks might like to identify those of their staff specially competent to appraise these types of propositions and concentrate the appraisal of Scheme loans with those managers. The banks do not consider it practical to deal with proposals, and their appraisal, in any other way than the present arrangement of local managers processing the application through area office sanctioning officials.

Most of the lending we studied had initially been appraised fundamentally on an important, but subjective, assessment of character and the apparent credentials of the proprietors, rather than on the viability and prospects of the business.

Bank area offices, on the other hand, tend to make a better job of sifting and appraising proposals. Managers are finding their questioning tougher.

How much, how long? Most small businesses need time to develop. They need better management and more funds, for longer than they originally anticipate. Most of the managers in this study lent the amount suggested in the proposal (or, critically, less) based on the time scale of development set out in that proposal.

Managers' view of the Government guarantee. From our studies we believe that in many cases 80% of the money lent under the Scheme, although lent by the banks, is seen by the managers as 'the Government's money'. The managers seek in their appraisals to feel secure about 'our 20%' rather than to appraise the business for the whole loan. When under pressure on their lending record we believe that many bank managers turn not towards more thorough appraisals, but to more security.

Alternative finance. The banks locally, and their customers, are surprisingly ignorant of the range of different sources of finance for a business and the lending institutions available. Those alternatives might not replace Scheme loans, but would often assist the more demanding cases to be better structured: by using equity, conventional loans and overdrafts, local grants or a combination of the three.

2.5 Choosing the Scheme

There is, inevitably, increased awareness of the Scheme on the part of borrowers and their advisers. For both borrower and banker the Scheme has attractions as a substitute for other finance. The banker, from his side, is partly relieved of his major decision - his concern about security. Nevertheless the Scheme often is the only route for many borrowers.

In institutional lending the Scheme has a role in reducing the institution's risk until that is balanced by their assessment of reward, and sometimes, as a further advantage, it permits the institution to lower its demand for an equity stake until its proposal is acceptable to the borrower.

Additionality. Most bank managers do not understand the concept as it is seen by the Government. Though they, and the public, may never have heard the word, they should have been aware of the idea behind the Government's guarantee - that, by its provision, the Government sought to make happen a volume of lending to viable businesses which would not otherwise have happened. Less than half Scheme loans are now assessed as 'additional' (see our commentary on the Telephone Survey of borrowers). Our analysis of the sample for this study shows a slightly better proportion.

Other lending and guarantees. There remains a not very significant, but very irritating, run of cases in which the borrower has abused the Scheme. More frequently, but still in a small number of cases, the consequence of bank action has been against the spirit of the Scheme allowing the Government to stand in for someone else's previous risk, including the bank's. Section 11 analyses these cases a little further.

2.6 **Business management information**

Management information, so as to be able to run a business, is almost the last thing the borrowers think about. It is woefully lacking even amongst surviving businesses.

2.7 **Features of survival**

The acumen of the proprietors and their practical, immediate control over the business, its operating margins and its cash, are amongst the leading features in our analysis of surviving businesses in Section 13.

This study has brought out examples of the features, illustrated in our last report, of new businesses not only running at losses in their early periods of trading but needing far more cash, as trade increases, than they anticipated. Examples also illustrate the loss of nerve by bankers when more cash is required than they expected.

2.8 **Features of failure**

High break-evens, high gearing and low margins feature in this study as in last year's. We contrast the evidence on survivors and failures which to some extent shows that businesses borrowing under the Scheme are, inevitably, very fragile anyway and usually weak in several respects. However we think the correlations leading to the contrasts set out in Section 14 show pertinent as well as interesting features of failure. Even allowing for the magic of hindsight, the features of failure are very apparent.

2.9 **Monitoring by the banks**

Current account monitoring (setting some limits of behaviour on the current account so that the manager is alerted when they are exceeded) remains the widespread method of customer monitoring. In our two studies we have looked at 198 individual cases which have been selected to be representative of various aspects of the Scheme, and not of bank managers. However it is our opinion that the study indicated that there is a large number of managers who feel uncomfortable with financial and management accounts.

Some regular management information was requested in about half the cases, but only supplied in about one-third of cases. Few managers chased promptly if they didn't receive what they asked for. Only a few managers anticipated failure early enough to try to do something useful. Few managers were in any position to give constructive advice. We are convinced that closer monitoring of small businesses is an area well worth the banks' while trying to improve, in their own interests, if that can be done cost effectively. It would also bring some disiplined routine to some of the borrowers.

2.10 **Advice to businesses**

Constructive, involved advice was rarely found in the cases of this study. We found a virtual absence of marketing help and very few people giving practical, financial accounting and administrative help. The principal role of financial advisers (usually accountants) was firstly to lend credibility to about half the proposals and thereafter to play a reactive and compliance role. Almost all borrowers found an accountant eventually. Less than a quarter said they turned to them for practical advice in their business. Only one in twenty said they had sought and received practical advice from the Small Firms Service: some seemed only hazily aware of that service.

2.11 **Economic benefits**

We formed some brief views of the economic benefits generated by the firms we studied. As it stands the Scheme may be incidentally not too expensive a way of financing jobs (Section 17).

2.12 **Administration**

On the administration of the Scheme, we would not suggest much change because the simplicity of relationships and roles between the Department and the banks works well. We do suggest a development of the declaration signed by the bank manager on each application form. We think the borrower also should make a declaration about himself. We hope our suggestions in Section 18

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will lead to ways in which the declarations will strike home more strongly than do the current paragraphs of the application. That in turn might encourage more rigorous self-regulation.

We think better descriptive guides on the Scheme might help both banks and borrowers: there are some curious impressions at large.

We have discussed during our study the option of a simple straight monthly repayment by the borrower encompassing principal, interest and premium. The banks see disadvantages administratively and in ensuring that premium payments and charges have always been met.

2.13 **Recovery**

Recovery after failure raises two problems. First, overall recovery on debts looks like being less than 15% of outstanding loans, gross of recovery costs, on our sample, and lower still overall. The net proceeds of recovery are shared 80:20 between the Department and the banks. Initiative on recovery must lie with the banks and it just may not be worth the effort and cost of collection to the banks for their 20%. We know of only one institution which has a policy of giving every failure a burial. Secondly, most managers in the sample view the loss in terms of the bank's 20%.

There have been arguments on priority of recovery, treatment of interest and recoveries under personal guarantees, but it would seem that these matters are resolved as they arise.

2.14 **Failure rates**

Our combination of bank statistics indicates a failure rate, so far, on 1981 lending of about 1 in 3 loans. We have compared the trends of our statistics from last year with this year. There are indications of an improvement in 1983. The rates of failure in recent months are not increasing quite so rapidly as in the comparable period last year. Section 20 is devoted to more detail on this topic.

It is important to appreciate how we are expressing these failure rates. We have identified the latest reported numbers of business failures with the months in which each loan was made. We have concluded that after 2½ years in operation one in three of the earliest loans are now proving to have been made to businesses which have since failed. Last year we estimated one in five of initial loans as failures.

This way of expressing failure rates is not as loan failures would be stated in bank reports. There, the amount with the recovery department would be expressed as a proportion of the total loan book and banks would normally report in terms of the bad debts provided as a percentage of the total loan book. So on current evidence one in three would eventually be reported as 5% to 6% of the bank loan books.

We have made our own estimates of the net cost of failure to the Government. At a rate of 1 in 5 we estimate the cost at £17m., or slightly more, per annum. At 1 in 3 we would expect £30m., or slightly more, to be the cost. Perhaps around £25m. per annum might be expected.

The banks have pointed out to us that they consider they are also net losers under the Scheme, on present failure rates - and certainly so if a contribution to staff time is sought.

2.15 **The future: Some specific points**

Since our last report we have noticed heightened central awareness in the banks about some of the difficulties they face in lending under the Scheme, and about some of the points we brought out last year. That same level and detail of awareness had not yet filtered down the line to the majority of managers we met - 145 out of 13,000 or so bank managers 'in the field'. Nevertheless rumours of a 'tightening up' in early 1983 seem to be broadly supported by local comment and discussion.

The opportunity to offer suggestions for guidance on the future of the Scheme is an opportunity to talk about the problems of supporting smaller businesses and the role of the Scheme in that. We think the Scheme has a useful role.

We do not abandon our suggestion, offered for discussion last year, that the guarantee proportion could be 70:30 instead of 80:20. We leave the matter for discussion rather than as a recommendation and some of that discussion is offered in Section 21.

We think that any moves to tighten up on appraisal techniques and the appreciation of viability, sensitivity, and management information systems of small businesses would be generally constructive and helpful to the small business community. Some of the banks are further developing their Business Advisory Services; all are aware of our views but do not agree that developments flowing from the Scheme need be administered by local area office specialists on smaller firms.

Various measures to protect the Government's interests are suggested in Section 21, such as banning reconstruction of loans, even when taken on from another bank, by use of the LGS. We also suggest that the borrowers should sign a declaration reflecting the spirit of the Scheme.

We suggest that the occasion might be opportune for the banks and the Small Firms Division to use their liaison and good working relationships to agree that the banks will seek to encourage managers to obtain better and more appropriate financial information at the time of lending. We suggest some requirements in Section 21.

We also suggest that the Department and the banks could collaborate on improving knowledge of the plethora of organisations now operating to help smaller businesses.

We would very much like to discuss our studies in much greater detail with the banks and see how the experience of this study can be disseminated to the advantage of small business lending nationally.

2.16 **The future: A general point**

The distillation of our findings leads us to appear to criticise. We are critical of all parties involved with smaller businesses, including the businesses themselves, in this report. There is a special skill in nurturing small businesses - managerially, with money or with expertise. That special skill is an attitude as well as a technique. That attitude needs to be fostered throughout our education and our society, not just with the banks and professions whose shortcomings tend to be picked out in this report. We hope this report will be a useful contribution to fostering that attitude.

Prime Minister ②

To note. The wording of the statement correctly keeps all options open, including winding up. — AT 5/10

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From the Parliamentary Under Secretary of State for Industry

Rt Hon Nicholas Ridley MP
Financial Secretary
HM Treasury
Parliament Street
LONDON SW1

5 October 1983

Dear Nicholas,

SMALL BUSINESS LOAN GUARANTEE SCHEME REVIEW

As you know the Loan Guarantee Scheme was introduced on 1 June 1981 as a three year pilot measure with an original allocation of £50m for each of the three years. However, the full £150m was exhausted in the first year and following two earlier reviews of the Scheme it was decided to increase the overall allocation to the current figure of £600m. The experiment is due to be completed in May 1984 and at the present level of demand there should be no difficulty in staying within this ceiling. But clearly before we are going to be in a position to be able to take any decisions on what is to happen when the pilot phase ends, it will be necessary to carry out a further fundamental review of the operation and the impact of the Scheme so far.

I therefore intend to announce in the House shortly after the recess that over the next few months I will be conducting a wide ranging review of the Loan Guarantee Scheme. This will involve analysing all of the available statistical data, including the information on Scheme losses. It remains very difficult to predict with any degree of certainty the extent to which the tightening up by the banks after the last review will have reduced the failure rate for more recent lending. I will want to obtain the views of the banks on this issue and by the end of the year we will have a better data base on which to make judgements. I will also have the benefit of the results of a third sample telephone survey and the outcome of a second, more balanced, study by outside consultants Robson Rhodes into a sample of 150 Scheme borrowers. As before, I envisage that these studies will be published in due course. I will also be meeting bankers, small firms representative organisations and others, as well as taking full account of the many comments and representations I have received from Parliamentary colleagues and elsewhere. I will be announcing the review by way of an arranged Parliamentary Question and a copy of my proposed reply is enclosed.

I expect most of the elements of the review to be completed by the end of this year and of course your officials and those of other interested Departments will be brought into the review and the subsequent discussions as necessary. I hope to be in a position to put forward recommendations to colleagues for the future of the

Scheme by early next year. Clearly at this stage we must keep an open mind about the possible options, but I should like to be able to announce the conclusions to be drawn from the review, and any decision on its future, well before May 1984 if at all possible.

I have copied this letter to the Prime Minister, the Secretaries of State for the Environment and Employment and the Secretaries of State for Scotland, Wales and Northern Ireland.

Yours ever

David

DAVID TRIPPIER

Enc.

DRAFT ARRANGEDPQ ON REVIEW OF THE LOAN GUARANTEE SCHEME

Question: To ask the Secretary of State for Trade and Industry whether he intends to conduct a further review of the Small Business Loan Guarantee Scheme.

Answer: Over the next few months I will be carrying out a fundamental review of the operation of the pilot phase of the Scheme, which is due to end in May 1984. This review will form the basis of any decisions on the future of the Scheme. I shall look closely at a wide range of issues relevant to the Scheme's performance including the extent to which Scheme lending has been genuinely additional to what the banks would have undertaken under conventional terms and the effect of the Scheme on the structure and performance of Scheme borrowers. I will also want to consider the impact of the Scheme on bank lending practices, including the effect of any tightening up by the banks after their early experience, in particular in relation to the personal contribution of Scheme borrowers.

During the review I will want to assess any available statistical information and to examine the results of a further sample telephone survey carried out by my Department. I have also commissioned a second detailed analysis of Scheme borrowers by outside consultants Robson Rhodes, who have been asked to look in depth at 150 Scheme borrowers, 50 of which have been subject to a claim under the guarantee arrangements, and 100 cases where the business is continuing to operate. I will be holding a series of meetings with banks and financial institutions involved in the Scheme, and with the main small firms representative organisations. I will also take full account of the many comments and representations I receive from Hon Members, my Department's Small Firms Service and individual small businesses.