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cc JR

To: MR BURGESS	COPIES TO
FOR ADVICE (AND DRAFT REPLY IF APPROPRIATE)	PS/Mins
PLEASE BY: 9/5/84	PS/Sec I
IF DEADLINE CANNOT BE MET PLEASE PHONE 215 5422	Ms Mueller
	Mr Jardine IT
	Mr Chapman
	Dr Graham SF
	Mr Kemmis SF

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

1 May 1984

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

Dear Norman

REVIEW OF THE LOAN GUARANTEE SCHEME

Thank you for your letter of 29 March. I have also seen the comments from No 10, James Prior, George Younger, and Robin Leigh-Pemberton.

As you know, the main point to emerge from discussion between officials was that there was no way the present scheme could be changed so as to allow a reasonable volume of additional lending to continue while at the same time substantially reducing the likelihood of losses. It follows that extending the scheme would necessarily mean moving further away from one that could be described as trying tomake the market work better, and more firmly in the direction of overt subsidy. Naturally I have very strong reservations about this.

I accept, however, that there are political difficulties in abandoning the scheme. I should, therefore, like to explore how we can best ensure that over time the scheme breaks even in financial terms or, at least, that the losses are kept to a very low level. I am sure that the action you are taking generally to tighten up the administration of the scheme will help in this respect, but believe that changes to its structure are also needed.

To this end, I should like to suggest going rather further than the options you describe. We should certainly try to shift the balance of risk to 70:30 as in your options 3 and 4: perhaps we should go even further to a 60:40 split. That is the way to get banks and other lenders more interested in a realistic evaluation of loan applications. But I think we should combine this with an increase in the premium to 5 per cent (or perhaps 4 per cent if the balance of risk were 60:40), thereby reducing demand from those who could relatively easily get funds from elsewhere. No doubt there would be complaints. But I believe a decision to change the scheme in this way, and so to increase the incentive for companies to raise equity rather than loan finance, would be defensible and could be presented positively.

I suggest our officials might have some further discussion of this suggestion, and, indeed, explore whether there are any better variants - on the understanding, of course, that any losses arising from extending the scheme (like losses from the existing scheme) would fall to be met from within your Department's existing PES provisions.

Copies of this letter go to the Prime Minister, the Secretaries of State for Northern Ireland, Scotland, Wales, the Environment and Employment and to the Governor of the Bank of England.

Yours ever
Nigel

NIGEL LAWSON

Econ M. Smallfirms

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GWYDYR HOUSE
WHITEHALL LONDON SW1A 2ER
Tel. 01-233 3000 (Switsfwrdd)
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Oddi wrth Ysgrifennydd Gwladol Cymru

The Rt Hon Nicholas Edwards MP

WELSH OFFICE
GWYDYR HOUSE
WHITEHALL LONDON SW1A 2ER
Tel. 01-233 3000 (Switchboard)
01-233 6106 (Direct Line)
From The Secretary of State for Wales

2 May 1984

Dear Norman

REVIEW OF THE LOAN GUARANTEE SCHEME

Your letter of 29 March to Nigel Lawson about the Loan Guarantee Scheme sets out a number of possible options in the way to proceed to improve the Scheme and to reduce anticipated losses.

The Loan Guarantee Scheme is one of the better schemes we have produced to help the development of small businesses with its important side benefit of influencing banking attitudes to lending. The evidence is that a good deal is being achieved through it and there is no doubt in my mind that it should continue. I recognise and share the concern that you have about the cost of the Scheme but I am also concerned that the options you have proposed could impair its value.

The solution must lie in effective appraisal of schemes and monitoring by the banks. I am attracted to George Younger's proposal in his letter to you of 11 April, and I would want my officials to take part in any discussion that takes place. A national scheme may not be feasible but I would be prepared to have a pilot scheme, using European Regional Development Fund non-quota monies, in the steel closure areas of Wales. Linked to this the scheme conditions might insist that loan applicants should consult with a Small Firms Service Counsellor before an application is submitted so that the Counsellor could ensure that the proposal was adequately worked up and any business plan submitted of a sufficient standard to allow the banks to carry out an adequate appraisal with the resources at their disposal. An alternative would be to insist that applicants have access to professional advice.

I am copying this letter to the Prime Minister, the Chancellor of the Exchequer, the Secretaries of State for Northern Ireland, Scotland, the Environment and Employment and to the Governor of the Bank of England.

Yours ever
Nick

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

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Small firms
Pt. 4

2 - MAY 1984

CC NO

NORTHERN IRELAND OFFICE
WHITEHALL
LONDON SW1A 2AZ

SECRETARY OF STATE
FOR
NORTHERN IRELAND

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON
SW1P 3AG

n 6pm DMB 19/4

19 April 1984

Dear Nigel

REVIEW OF THE LOAN GUARANTEE SCHEME

Norman Tebbit copied to me his letter of 29 March on the review of the Loan Guarantee Scheme.

I would strongly support Norman's view that the Scheme should be continued. Although the experience of the Scheme in Northern Ireland has differed somewhat from that in other regions I am convinced that it has an important place in our policy towards the support of small businesses and that it has filled a gap in the market.

At the same time I can readily appreciate the concern which arises from the scale of the losses which have been experienced and there is clearly a need to seek some means of reducing the contingent liability on public funds. Fortunately, the loss experience in Northern Ireland has been much happier than in other regions, with a failure rate of only 4.5% compared with the next lowest figure of 9.6%. This is, I believe, due in large part to the stricter approach adopted by the banks in the Province. For this reason I would commend Norman Tebbit's intention to encourage greater prudence by the banks, apart from whatever other action may be agreed.

I am copying this letter to recipients of Norman Tebbit's letter.

Yours

Jim

JLD

Econ Pol: Small Firms Pt 4

cc NO

SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

NBPM
AT 12/4

CONFIDENTIAL

Rt Hon Norman Tebbit MP
Secretary of State for Trade and Industry
Department of Trade and Industry
1-19 Victoria Street
LONDON
SW1H 0ET

11 April 1982

Dear Norman,

REVIEW OF THE SMALL FIRM LOAN GUARANTEE SCHEME

You copied to me your letter of 29 March to Nigel Lawson about the Loan Guarantee Scheme. I should like to offer some comment.

North of the Border, despite indications of a slow initial take-up, evidence now suggests that the Scheme is playing its expected part in fostering new enterprises. For this reason, I would support your view that it should be contined but agree that it should be modified to take account of present weaknesses.

I do not believe, however, that to increase the level of bank liability or the premium rate would be likely to benefit the scheme. Either option could result in reduced usage with the added danger that the latter could lead to a greater failure rate because of the additional repayment burden on borrowers.

I note that adequate assessment and monitoring is seen as a key to reducing the scheme's cost to public funds through meeting guarantee claims, but that resistance is likely from the banks to any suggestion that the burden of monitoring should rest with them. This prompts me to draw to your attention the "Better Business Services" pilot scheme which Allan Stewart and I have introduced, using European Regional development Fund (ERDF) non-quota money in steel and shipbuilding closure areas in Scotland (soon to be extended to textile closure areas). This provides low-cost project appraisal and financial monitoring for small and medium-sized firms, and a national scheme modelled on it might to some extent overcome the weaknesses identified in the Loan Guarantee Scheme.

The costs falling to the business could either be covered as part of the loan itself, or by extension to existing DTI schemes of assistance such as the Manufacturing Advisory Service. Such a scheme would have potential not only to limit the use of public funds but perhaps more importantly to set new and existing small firms on a more secure financial control footing for the future. To reinforce its effect, the banks might be encouraged to promote appraisal and monitoring by our raising the level of bank liability from 20% to 30% in cases where loans were not monitored under an approved system.

I hope that you will find these comments useful; my officials are meanwhile contacting yours to discuss my suggestion in more detail.

I am copying this letter to the Prime Minister, the Chancellor of the Exchequer, the Secretaries of State for Northern Ireland, Wales, the Evironment and Employment; and to the Governor of the Bank of England in view of his interest.

Yours ever,

George

Econ Pol: Small Firms
Pt 4

BF with PU response. AT 29/3

12/4

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JF6152

Secretary of State for Trade and Industry

29 March 1984

CONFIDENTIAL

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON
SW1P 3AG

D Nigel.

REVIEW OF THE LOAN GUARANTEE SCHEME

Your letter of 2 March suggested that officials should now examine carefully the expenditure implications both of the existing Scheme and of any extension we might consider.

2 As you know, David Trippier has been carrying out the review, and he has reported to me his conclusions based on Robson Rhodes and on a full report by officials here, which has also gone to your officials.

3 I am concerned at the serious deficiencies that, as the Review has underlined, exist among both borrowers and bankers. They show that we still have a lot to do in improving the attitudes and techniques of both small businessmen and of bankers. The Scheme has a continuing role to play in both of these respects.

4 I am also of course very concerned at the losses; to the end of January 1984 the net loss was £32 million, and this figure will rise as further businesses fail. Robson Rhodes have estimated that as many as one in three of the earlier loans will fail, although they can see some improvement in the last year.

5 I am, however, impressed by the large number of small businesses that have been helped by the Scheme, about 14,000 to date, and by the number of new jobs that have resulted (although job creation is not the purpose of the Scheme). Up to end January 1984 the Scheme may have directly created 61,000 jobs (or 33,500 if only the strictly additional firms are counted) at a cost per job so far of around £500 (or £950). These costs could rise to £1,000 (or £1,900) per job as the result of future claims on guarantees already issued, but even so they compare well with other job creation schemes.

/6 The ...

6 The key issue now is how the Scheme can best be tightened up. We cannot require the banks to carry out better appraisals or monitoring; they claim that the costs would be too high and could not be recovered. David Trippier will be discussing with them how they can improve their performance, for example by greater use of their own small business units and advisory services. I have asked him to discuss also with them in particular whether the provision by borrowers to the banks of quarterly or monthly profit and loss statements should not be made a condition of our guarantee. He will also pursue with the proposal that borrowers should be required to provide evidence of a contractual arrangement with a professional adviser (the cost of which could be made part of the Scheme loan).

7 Apart from these steps which the banks could take, the main ways in which we can seek to tighten up the Scheme and to reduce our own exposure are by reducing the percentage of the loan under the Department's guarantee - now 80 per cent - and by increasing the Department's premium, now 3 per cent on the amount guarangeed by the Department. Both of these could conflict with the Scheme's objective of encouraging banks to lend to marginal small businesses who cannot obtain conventional finance; bankers will be likely to turn away mmore applicants if they take more of the risk, and a higher premium would raise the financial burden on the small firm. But it is necessary to reduce the cost of the Scheme, if possible without destroying its effectiveness, and I suggest that the main options open to us are those set out below. Option 1 covers a continuation of the existing Scheme as a basis for comparison.

8 I have assumed a continuation of the Scheme for a further three years, from 1 June 1984, and show the - additional costs for each of the four financial years starting with 1984/85; there would also be costs falling in later years. The totals of Scheme lending are based on our estimates of likely take up of the modified Scheme.

Option 1

9 Under the existing Scheme, risk is split 80:20 and the premium is 3 per cent. The failure rate is estimated to fall to one in four as the result of both the further tightening up already undertaken by the banks and the further measures we propose such as new declarations on additionality by both the bankers and borrowers. For a total of £600 million new lending over three years, at the existing level of £200 million per year, the net PES cost would be:

		£million
FY	1984/85	2.2
	1985/86	17.0
	1986/87	23.9
	1987/88	20.6
Total for FY 1984/85 - 1987/88		63.7

Option 2

10 The Scheme would be continued as in Option 1, with the exception that the premium would be raised to either 3.5 per cent or 4 per cent as officials suggested. The failure rate is likely to be unchanged. With a premium of 3.5 per cent, the net PES cost would be:

		£million
FY	1984/85	1.9
	1985/86	16.0
	1986/87	21.5
	1987/88	18.2
Total for FY 1984/85 - 1987/88		57.6

Option 3

11 The balance of risk would be changed to 70:30, the premium remaining at 3 per cent. The banks would however raise the cost of the loans to the borrower in order to maintain their return on Scheme lending. We would expect take up to be reduced sharply, although it might be expected to recover somewhat in time (officials may have been too pessimistic about this in their report). On this basis, £150 million could be adequate, or £450 million over the three years. The failure rate would be likely to improve to one in five. The net PES would then be:

		£million
FY	1984/85	0.9
	1985/86	8.2
	1986/87	11.6
	1987/88	9.8
Total for FY 1984/85 -1987/88		30.5

Option 4

12 The Scheme would be modified as in Option 3, with a 70:30 split, and in addition the premium would be raised to 3.5 per cent. We expect take up and failure rate to remain the same. The net PES would then be:

/£ million

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		£million
FY	1984/85	0.7
	1985/86	7.6
	1986/87	10.7
	1987/88	8.9
Total for FY 1984/85 -1987/88		27.9

13 I have given further thought to Michael Grylls' suggestion for improving the Department's position with regard to recoveries. Basically he has suggested that the banks should not have priority over business assets for any new bank lending advanced at the same time as a Scheme loan. I imagine that he envisages some sort of proportionate sharing. I am not attracted to this idea mainly because it would tend to reduce the amount of conventional lending the banks would be willing to offer as part of a "package" of finance, which is the opposite of our intention. The increase in our recoveries would be small.

14 I suggest that the next step should be for our officials to get together urgently to look in more detail at the implications of these options.

15 I am sending copies to the Prime Minister, the Secretaries of State for Northern Ireland, Scotland, Wales, the Environment and Employment and to the Governor of the Bank of England in view of his interest.

Norman

NORMAN TEBBIT

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Prime Minister

Inty 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
Nigel

NIGEL LAWSON

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