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Secretary of State for Trade and Industry

3 July 1984

Michael Grylls Esq MP
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Thank you for your letter of 27 June. Before you meet the Prime Minister, I feel that I should leave you in no doubt of my views.

Let me say first of all that I do understand your concern, and those of Parliamentary colleagues, over the recent changes to the Loan Guarantee Scheme. However, I should make it clear that the decision to introduce these modifications was taken after detailed consideration by all of the various Departments involved. I cannot accept a construction that the Treasury is in some way to be "blamed" for cutting back the Scheme; the changes are entirely as agreed between colleagues.

As you know, David Trippier carried out a wide ranging review of the pilot phase of the LGS during which he was able to draw on the views of a large number of organisations and individuals. While the review confirmed that in many ways the Scheme had been an extremely worthwhile experiment, it also had to be recognised that the cost, at over £43 million, was unacceptable. In addition, the reports prepared by Robson Rhodes highlighted several important weaknesses in the way that the Scheme had been operating. It was therefore right that we should stand back and learn what we could from our experience so far. Limitations in the appraisal and monitoring by the banks, gaps in the managerial competence of the borrowers, and lack of support provided by professional advisers were all seen by Robson Rhodes as reducing the prospects for survival among what are, by definition, somewhat fragile businesses.

If the LGS is to continue beyond December 1984 we must look for ways of introducing genuine improvements to its impact and operation. The modifications to the Scheme will provide an essential breathing space, during which the immediate cost to the Exchequer will be reduced, and give more time for further discussions with the banks and others. I am particularly keen that we should try to ensure that both the appraisal and the

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"aftercare" carried out by the banks is improved, and if this proves to be possible it could well result in benefits across the whole of the small business sector. One way of tackling these problems might be to make more and better use of outside advisers and expertise, and this will be discussed further with the banks. Progress on these and other issues will determine whether, and in what form, the LGS might continue beyond December 1984.

Yours
Norman

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THE SMALL FIRMS LOAN GUARANTEE SCHEME

Background

* The government set up the loan guarantee scheme (LGS) in 1981 for a three year experimental period in order to stimulate the flow of credit to small firms. By guaranteeing 80 per cent of each loan the LGS enabled the banks to lend where the high level of risk precluded the provision of funds on a conventional basis. Under the original LGS borrowers were charged a premium of 3 per cent on the guaranteed part of loans and the government expressed the wish that the scheme should be self-financing.

* The LGS has proved popular. In the initial three year period almost 15,000 loans to a value approaching £500 million were granted under the scheme, thereby fostering the creation and expansion of a large number of small firms; 54 per cent of LGS loans went to new firms and 46 per cent to existing businesses. However, losses to the government exceeded the premium income by a wide margin. The net cost to the government over the past three years has been in the region of £40 million. Though the lion's share of LGS businesses has been undertaken by the clearing banks, 30 banks have participated in the scheme.

* In May the government announced that the LGS is to be extended until the end of 1984 but with some important changes designed to reduce the public expenditure cost. In particular the premium was raised from 3 to 5 per cent and the guaranteed proportion of loans was cut from 80 to 70 per cent. A further government announcement regarding the future of the LGS is due before the end of the year.

The Banks and the LGS

* The banks are pleased that the government has decided to extend the LGS for a further six months. They believe that the scheme has a useful role to play and they have invested considerable management time and effort to make the scheme work. They welcome the broad conclusion of the study commissioned by the government from Robson Rhodes that they have 'addressed themselves to conducting the scheme in a conscientious way'.

* The level of losses during the first three years is not surprising given that the LGS has extended the risk profile of lending considerably. Had it been possible for the risk frontiers of lending to be expanded on a commercial basis, competition between the banks would already have achieved this. It

is, of course, for the government to decide on the level of public subsidy which is desirable in order to assist small firms and to create new jobs. The increase in the proportion of loans not guaranteed by the government from 20 to 30 per cent, as well as the increase in the premium, will reduce the likely call on the Exchequer. The banks have accepted the consequent increase (50 per cent) in their exposure in order that the scheme may continue.

* The Robson Rhodes Study expressed the view that more detailed appraisal and closer monitoring of LGS loans by the banks would be desirable. In fact, as was agreed with the government in 1981, appraisal and monitoring procedures have been broadly the same as those used by the banks for their conventional lending to small firms; it was agreed in particular that bureaucracy should be kept to a minimum. Nevertheless the banks have been moving in the direction of closer monitoring of their LGS customers and it is intended that this trend should continue.

* Continued support for the LGS is just one element of the banks' commitment to the small firms' sector over recent years. Other initiatives have included the introduction of new term lending schemes, the expansion of business advisory services and growing support for enterprise agencies and similar organisations. Lending under the LGS has probably accounted for around 3 per cent of the growth in the clearing banks' lending facilities for small firms since the scheme's inception.

* All parties involved in the LGS, including the banks, have gained useful experience over the past three years. The banks hope that experience in the next six months will provide further guidance as to the contribution of the LGS and shed some light on how prominently it should figure in future government support for small firms. They will be happy to continue discussing future aspects of the LGS with the government.

If there are any points in this briefing on which you would like further information, please contact James Dreaper or Roger Brown at the above address.