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B/F with Treasury and PU responses AT 22/10

cc NO

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JU398
From the Parliamentary Under Secretary of State for Industry

18 October 1984

CONFIDENTIAL

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London SW1

Prime Minister
Members of EA
Lord Young of Graffham
PS/Sir Brian Hayes
Mr Kemmis
Mr Dell
Mr Jardine
Mr Brown FRM

Dear Nigel,

SMALL BUSINESS LOAN GUARANTEE SCHEME

The seven month extension to the Loan Guarantee Scheme which you agreed to in May will end on 31 December. We must give the participating banks adequate notice of our intentions, and if there were to be any new Scheme it would take two months to clear in Brussels. Therefore decisions need to be taken and announced by the end of this month.

2 Your officials have been informed that the gross cost of the Scheme this year is expected to be £49,996,000, against the £20million provided for in the Estimates. Your officials also have figures for the estimated costs in future years of both the pilot Scheme and the present extension on the same assumption that the failure rate will be 1 in 3.

3 The first consideration, of which you will be aware, is that this Department has no PES provision beyond the end of this year; no applications for guarantees will therefore be received under the Scheme after 31 December 1984.

4 I have discussed the position of the SFLGS with Norman Tebbit. It is his view, and mine, that there are some unhappy lessons that have been learnt from the experience of the LGS. In retrospect it is clear that there are major obstacles in the way of self financing for such a scheme, as other countries have also found out. We were over-optimistic about the ability of the banks to improve the quality of their loan decisions and also about the ability of small firms to achieve their plans. These are of course areas where significant improvements can be looked

for only over a period of time. The ideal solution might have been to stimulate the flow of equity investment in the necessary small amounts into such firms, and the Business Expansion Scheme was intended to achieve this, although it too needs to be developed down market.

5 Norman Tebbit asked me to consider what changes I would propose in the Scheme were we now to be in the position of starting out on a new SFLGS.

6 The pilot Scheme has been valuable in helping small firms, with over 15,000 guarantees issued, and in stimulating employment (81,000 jobs from the two thirds of LGS firms expected to survive). It has formed a significant element in our policies to help small firms. The changed terms for the seven months extension, a 70 per cent guarantee and even more the five per cent premium, have resulted in a major cut back in the numbers of guarantees issued to below one third of the previous level. My recommendations would aim at both reducing the likely cost, and retaining a scheme that will be of interest both to the firms we are seeking to help and to the banks, whose co-operation is essential.

7 I would suggest therefore a scheme in which the premium would be reduced, while at the same time tightening up the other points which we identified in the reviews of the Scheme. The main features of such a scheme would be:

i 70 per cent of loan guaranteed (as now);

ii 3 per cent premium;

iii only those unable, as opposed to unwilling, to provide security for conventional bank lending to be eligible;

iv a minimum requirement for information in a standard form (a business plan) to be provided to the bank for its appraisal, prepared with a qualified accountant; this would be a basic discipline for applicants that would enable their basic assessments to be cross questioned; firms unwilling to provide this would be ruled out;

v minimum requirement for regular quarterly information, agreed by a qualified accountant, to be provided to the bank so that the original plan could be properly monitored; banks and businesses would be expected to use this early warning as a trigger for closer involvement with the business, using other sources of advice and assistance this information would be required for at least the first 2 years;

vi strong encouragement to use other sources of outside advice and technical expertise including the counsellors of our Small Firms Service.

8 It is difficult to predict the take up of such a scheme or likely failure rate. Although some improvement may be achieved with these changes, it is not within our control and the estimated 1 in 3 failure rate of the pilot scheme could continue. Cost estimates for a three year scheme, based on a take up of £100 million per annum and a range of failure rates are:

	1985/6 £m	86/7 £m	87/8 £m
1 in 2½	3.3	14.8	18.8
1 in 3	2.5	11.8	15.0
1 in 5	1.5	6.0	7.7

9 I should say that I have not had a chance, for obvious reasons, to discuss these points with Norman. The position is, however, clear: there is no provision within the DTI programme for an extension to the scheme. But the consequences of ending the Scheme will themselves cause us great difficulty, politically and in terms of our commitment to small firms. That commitment, and the need for it, was amply demonstrated in last Thursday's conference debate. I hope that we may begin therefore to consider whether changes in the Scheme, of the type I have described, make it desirable to proceed with a new scheme for which provision would be made out of the contingency reserve.

10 I am copying this letter to the Prime Minister, other members of E(A), and to Sir Robert Armstrong.

Yours ever,

David

DAVID TRIPPIER