State of the Art Review

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Loan guarantee schemes in the UK: What have we learnt?

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Loan guarantee schemes are the most pervasive and long-standing means of intervening in capital markets to support small business lending in the world. They are popular with small businesses, easy to understand, easy to administer, and allow large numbers of credit constrained small business to access loans that they would have struggled to get. Yet take-up of UK loan guarantees over its 38 year scheme history has varied dramatically. In this review we consider just why, despite its general popularity, the UK scheme has had such a variable past, and show just how sensitive demand for guaranteed loans is to the nuances of the schemes rules.

Background

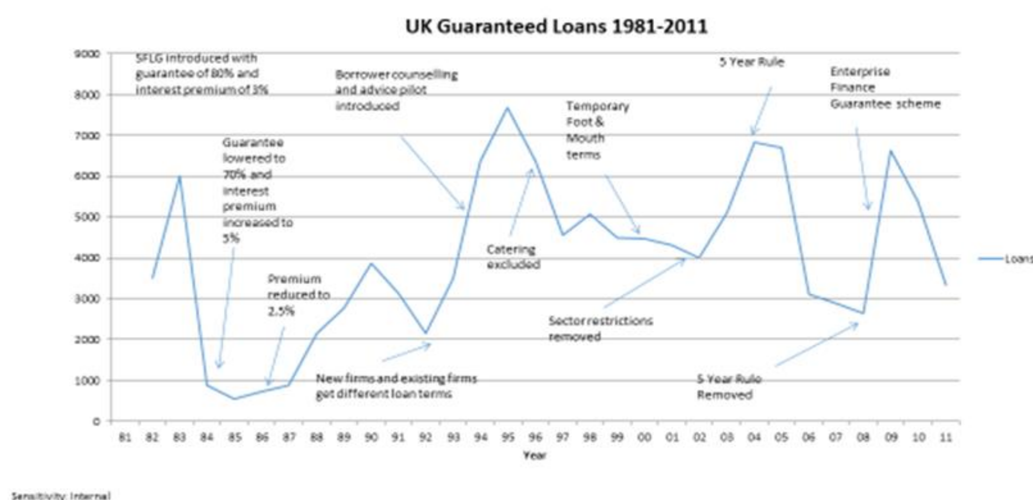
Loan guarantee schemes have existed since 1953 (in the US) and are widely used throughout more than 100 countries in the world to provide financial support to smaller firms by guaranteeing loans from commercial banks, or, in some cases, through direct lending by government agencies. The UK government has been an active supporter of loan guarantees since 1981, and has a long track record of modifying its scheme to reflect changing market conditions and the financing needs of its SME sector. We consider the impact of these changes on the benefits of the scheme and the implications for its future development.

Evidence – loan guarantees designed and re-designed

In the early years of the Loan Guarantee scheme government continually altered the key parameters, the proportion of the loan advanced which is under guarantee, and the interest rate premium it charged for providing the guarantee. It also experimented with offering different levels of guarantee, premium, and maximum loan size to new start-ups and more established firms (Figure 1). It is immediately apparent that changes in the guarantee level (downwards) and the

premium (upwards) had a huge effect on loan take-up, here in a negative way. But the cause of this was driven by two different agents in the lending market (Cowling, 1995; Cowling and Clay, 1995). The lowering of the guarantee clearly acted to discourage banks from using the scheme as it increased their exposure to risk and cash loss in the event of loan default. The premium (or price effect) meant that it became too expensive for small businesses to service the capital and interest rates plus the government premium on a loan. And this negative premium price effect is still clearly evident today as shown in new research (Cowling, Robson, and Yue, 2019). In short, this new research on the sensitivity of loan guarantee take-up by small firms to increases in the premium clearly shows that government has very limited room for manoeuvre.

Figure 1: The history of the UK guarantee scheme



The differentiation of the scheme in terms of offering more favourable terms to more established small business led to a significant expansion in take-up in the early 1990s when the scheme increased its coverage from around 2,000 loans per annum to nearly 8,000. These changes took banks into a segment of the small business market where they were more comfortable and experienced (i.e. dealing with business with a trading record but insufficient collateral). Following on from these major changes, the rest of the 1990s were characterised by softer changes focusing on who was allowed to access the scheme and specialist interventions to support unforeseen circumstance like the foot and mouth outbreak which left many small rural businesses facing significant financial crises.

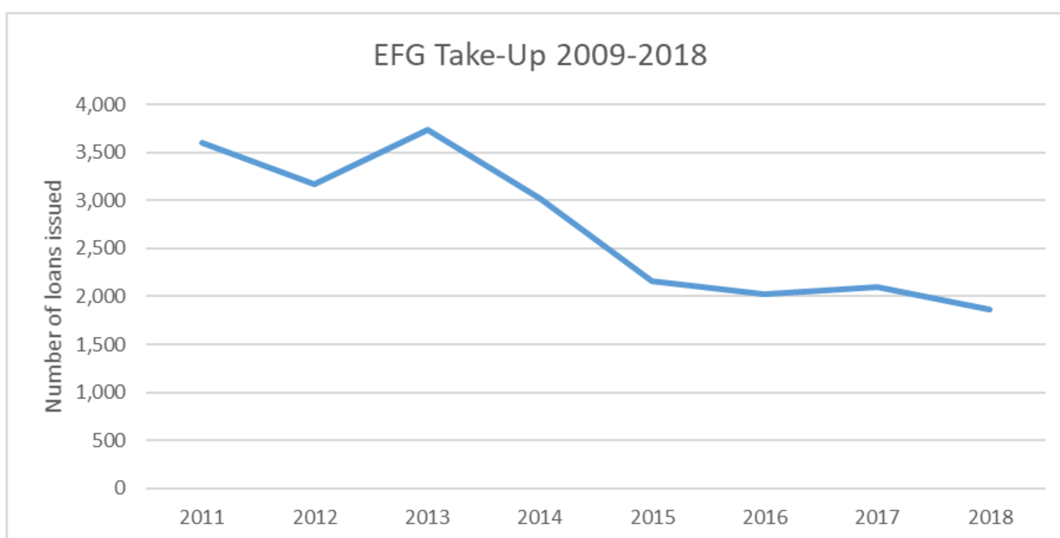
One of the saddest aspects of the history of the UK loan guarantee scheme, which was identified in the 1999 KPMG Evaluation, was that a pilot advice and counselling scheme that ran alongside the loan, was closed down and not rolled out nationally. This pilot was proved to upgrade the management skills of the ownership team and, in doing so, significantly reduced loan default, and importantly, the willingness of banks to lend to small businesses. Again, there was an attempt by government to alter the scheme to reduce high levels of displacement which it believed characterised many low level service sectors, although this strategy was reversed within six years as scheme take-up reduced significantly over the following two years.

The 2000s led to perhaps the most significant changes in the scheme since its first three years of operation. Firstly sector restrictions were removed. This made some sense as banks already included sector driven parameters in their general lending appraisal metrics, but it also captured a slow shift in government thinking around the wider dynamics of creative destruction. In short, the government was shifting its thinking which previously considered all failure to be a bad thing towards a more nuanced approach which would tolerate some failure as a key part of a dynamic entrepreneurial ecosystem where firms compete on a level playing field and the fittest survive. The role of government policy then becomes to ensure that there is a level playing field.

The scheme changes in this respect significantly expanded take-up, that is, until the Graham Review changes that occurred in 2004 when the 5-Year Rule on eligibility was imposed. The review took the view that it was not feasible that an established small business with a track record that extended beyond five years could present a problem that a bank could not deal with through its normal lending processes and procedures. This was solid logic except for the fact that of the two fundamental rationales for the existence of a guarantee scheme, namely that small businesses with good projects were not able to access sufficient lending due to: the lack of track record, and/or, lack of sufficient collateral to secure lending against. Of the two problems, the collateral problem was identified as the key issue for banks, not track record (Cowling, 2010). Essentially, if a small business has collateral the bank wants it before it will lend. Before the 5-Year Rule was removed in 2008, scheme take-up had collapsed from around 7,000 loans per annum to less than 3,000 loans. Take-up of the scheme immediately bounced back to its former levels within 12 months. The sting in the tail was that new research by Cowling, Robson, Stones, and Allinson (2018) showed that the 5-Year Rule was a better policy choice if the desired outcome was more job creation, although it made no difference to other growth metrics.

In 2009 the long-standing Small Firms Loan Guarantee Scheme was replaced by the Enterprise Finance Guarantee Scheme. And, as Figure 2 shows, the scheme has stabilised at what is a very modest level of take-up by historical standards.

Figure 2: Enterprise Finance Guarantee take-up: 2009-18



Implications

We have reviewed a 38 year history charting the evolution and development of the UK loan guarantee scheme. Two things are very clear. Firstly, the UK government has been extremely interventionist in terms of how it operates the scheme and who can access it. Some would even say creative and experimental. Secondly, everything the government has done over the entire history of the scheme has made a difference to the willingness of banks to offer loans under the scheme and to the willingness of small businesses to accept loans under the scheme. Although we restricted our focus here to take-up and use of the scheme, it is also true that everything the government has done has also affected repayment and default. And this has two additional impacts. Firstly, it imposes a higher (lower) cash call on the UK Treasury, and of course tax payers who ultimately bear the costs, as the guarantee in default is a call on the Treasury. Secondly, it impacts on the profitability of banks who lend to small businesses.

In relation to these two key aspects of the whole guaranteed lending market, the evidence is interesting and important. For government, successive full economic and cost-benefit evaluations have concluded that scheme lending makes a very modest, but positive contribution to the overall UK economy (Cowling and Siepel, 2013). On this basis, it is likely to remain as a well-liked, but small part of the whole small business funding landscape, and one which washes it face for tax payers.

For banks, the true picture is very interesting and not well understood by government or the wider research community. It is erroneous to think of a loan made under a loan guarantee scheme in splendid isolation (Cowling and Mitchell, 2003). It is commonly part of a bundle of loans which also includes conventional secured and unsecured loans (Cowling, Ughetto, and Lee, 2018; Ughetto, Scellato, and Cowling, 2017). Thus the lending banks gross exposure to unsecured risk is not 25% of the outstanding loan in default. It is more likely to be a combination of 100% exposure on a conventional unsecured loan of £20,000, zero exposure on a fully secured conventional loan for £50,000, and 25% exposure on a loan guarantee loan of £50,000. The net exposure of the bank is substantially less as very few loans default early in their term, thus the bank receives a stream of interest and capital up until the point a loan defaults, if it does at all. My best estimates on this are that commercial banks make a net profit from their guaranteed lending of between 1.5% and 3.5% per annum plus fees. And for banks, it maintains a relationship with its small business customers (Cowling, Matthews, and Liu, 2017).

Summary and Evidence Gaps

Loan guarantee schemes work in a modest, but important, way and generate positive returns for the UK economy. But everything about a loan guarantee scheme, take-up by small businesses, banks willingness to advance loans through its auspices, default and exposure to risk, are shaped by the operational parameters of the scheme and who is allowed to access it. As we move forward, the lessons from history are very apparent. If government is thinking of changing

something it must clearly assess the implications in respect of banks, small businesses, and Treasury in respect of take-up and default. I am concerned by the EFG and its expansion to support a wider set of UK businesses. It may have been an appropriate response to the immediate aftermath of the GFC but is it still now? And what about the changes in the rules of collateral, particularly around personal assets? Some would argue that the EFG is moving very close to operating like a retail bank. And this is where we need more evidence and thinking. Aside from that, my broad body of research over 30 years on loan guarantees has shown that in terms of the core parameters, the guarantee and premium, the government has little room for manoeuvre if it still wants to provide a credible scheme to UK small businesses.

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