WHERE NEXT FOR COVID BUSINESS LOAN SCHEMES?

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THE CURRENT SCHEMES

In March and May 2020, the government announced two loan guarantee schemes to help cushion SMEs from the impact of Covid-19: the Bounce Back Loan Scheme (BBLS) for lending under £50,000, and the Coronavirus Business Interruption Lending Scheme (CBILS) for loans above that value. The government also launched the Coronavirus Large Business Interruption Lending Scheme (CLBILS) in April for larger businesses.

Following extensions, both SME schemes are due to expire on 31 March. Is there a case to be made for continued government support of SME lending beyond that?

CONTINUED SUPPORT MAKES SENSE

The answer is yes: there are two complementary rationales for the continuation of SME lending guarantees.

The first is that the original rationale – mitigating elevated risk and uncertainty – is still applicable. Even as we enter recovery, economic conditions are likely to remain volatile for some time, and in the absence of guarantees, this climate of risk would suppress SME lending.

The second rationale relates to a longer-term issue: the so-called 'SME lending gap'. There's a long-running debate as to the nature and extent of the gap, but it certainly exists – hence pre-Covid loan guarantee schemes such as the Enterprise Finance Guarantee and similar kinds of support seen in countries like Germany.

These rationales suggest there will be a role for a new, more focused scheme once the existing programmes end. The UK Finance members we interviewed saw a continued, modified scheme potentially underpinning 10–25% of the SME lending market. We estimate that this amounts to between £6 billion and £14 billion of lending supported over the next year – potentially even more, if economic conditions are worse than hoped.

EXEC SUMMARY

Loan guarantee schemes have been one of the key planks of government support for SMEs during the pandemic. But these schemes are set to expire – so what happens next? With the Budget imminent, we may soon see an answer.

In anticipation, we've taken a look at two key questions on SME lending: is there a case for continued government support, and if so, how should the schemes be modified to suit the recovery phase? Our focus is on the economics, and has been informed through interviews with members of UK Finance.

AVOIDING 'CROWDING OUT'

The current schemes are focused on delivering significant and rapid support to SMEs. But achieving those goals has a price.

One of the main downsides is the risk of 'crowding out' commercial lending. If the government is supporting lending that could otherwise take place without its intervention, its money goes to waste and could have done more for the economy elsewhere.

A future scheme, in a changed environment focused on recovery and with a narrower focus, can be designed to avoid this risk of crowding out.

One strategy is administrative: including certain rules and restrictions in the scheme, such as that the lending would not have occurred without the scheme. This seems simple in theory, but it could make the scheme difficult to operate in practice, as with the original implementation of CBILS.

The other, more favourable strategy is to modify the economic incentives involved.

As part of its deal to support lenders, the government charges a fee. For it to be worthwhile for a lender to pay the fee, the fee must be lower than the expected losses that would be covered by the guarantee.

For a term loan, for example, the fee is levied every year on the outstanding balance. A fee of 2% on a three-year loan adds up to around 4% of the original loan. So to be worthwhile to the lender, the value of the guarantee (transfer of expected loses) has to exceed 4%.

Our discussions with UK Finance members suggest that setting a higher fee would be the simplest and most effective way to avoid crowding out. A higher fee would mean, in the current economic climate, that only riskier and less commercial lending would be covered by the scheme.

There's no exact science to determining the right fee level, and some trialling is likely to be important. That said, the broad consensus among UK Finance members is that the fee could be raised to around 1.5–2% for the standard term loan scheme.

At this level, the risk of crowding out commercial, low-risk lending would be much reduced. A simple benchmark: the average price of business lending is around 3%. Lending at this price will mainly reflect highly secured lending to larger businesses. The expected losses on lending at this price will be very low and uneconomic under a scheme charging a fee of 1.5-2%.

OTHER WAYS TO ENSURE VALUE FOR MONEY

A higher fee is the key reform to make. But there are a number of other design changes Government could make to help ensure value for money in a new scheme:

- **Removing the Business Interruption Payment (BIP).** The government currently funds the first year of fees and interest for businesses. This provides valuable cashflow, but the need for it may diminish – and if it does, removing the BIP would substantially reduce the cost of the scheme.
- **Expanding security and personal guarantees.** Security and personal guarantees reduce expected losses for the government, and encourage lending by demonstrating that SMEs are willing to have

‘skin in the game’. But the current design of CBILS only allows for personal guarantees if the loan is above £250,000. Reducing that threshold could reduce costs and encourage lending.

- **Encouraging non-term loans.** Most of the loans currently offered are term loans; far fewer take alternative forms, such as invoice financing (mainly because of extra administrative complexity and less favourable economics).[1] A focus on alternative forms of lending would reduce the risk of a future scheme distorting lending from one form of finance to another. Solutions would likely revolve around simplifying the administrative reporting required, and setting different government fees for different variants to create greater parity between them.

EVOLVING THE SCHEME TO SUPPORT RECOVERY

The current SME lending schemes have been vital for many businesses. In the next economic phase of the pandemic, there will still be a need for support – but evolution of policy will be crucial.

The adaptations we have suggested point toward the use of the existing CBILS scheme, modified to support smaller lending, as a starting template.

Its structure allows for prices to be set to avoid commercial lending being crowded out. Re-consideration of the BIP and personal guarantees could enhance value for money. And design tweaks could be made to ensure a wider range of loan variants are accessible.

By keeping support in place, and adapting it to suit recovery in this way, the government can continue to provide a lifeline to small businesses as they look to an uncertain future.

[1] Government fees are levied on a specified amount covered by the guarantee. For working capital variants like invoice financing, the amount lent will fluctuate over time. This creates a mismatch: fees are levied on a fixed amount (say lending of £10,000), while revenues for the lender will be on lending that may vary from £0 to £10,000.

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