Grylls

29th April, 1982

Study Group on Bank Lending

Thank you so much for your letter of 27th April, with which you enclosed the Notes of the meeting which you had had with Nicholas Ridley on 6th April.

I am only sorry that I was not able to be there myself; it is most helpful for me to have your Notes.

I will do my utmost to get to the Industry Committee on 4th May.

Do please have a word about this, if you would like to do so.

IAN GOW

Michael Grylls, Esq. M.P.
House of Commons

Michael Grylls MP

HOUSE OF COMMONS
LONDON SWIA OAA

Ian Gow Esq TD MP
House of Commons
LONDON SW1

27th April 1982

My Dear Ian,

STUDY GROUP ON BANK LENDING

We were very sorry but, of course, quite understood that you could not get to our meeting with Nicholas Ridley.

I thought you might like to see the enclosed notes of the meeting which have been prepared by the Group.

Yours ever,

Michael

Try and get to the Industry Committee, next week, Tuesday 4th May when the Study Group are giving a progress report to us.

Enc:

"GRYLLS" STUDY GROUP ON BANK LENDING TO INDUSTRY.

NOTES OF MEETING AT THE TREASURY 6th APRIL 1982.

PRESENT:

N Ridley - Financial Secretary to the Treasury.
Mr Middleton (For 5 minutes).
Mr French.

Mr Battishall - IR.

Mr Seebohm.

Michael Grylls MP.
W G Poeton.
B A Baldwin.
G T Edwards.

Ian Stewart MP.

Apologies from Ian Gow - PPS to the Prime Minister.

POINTS MADE BY THE TREASURY.

1. It is agreed that there is a fundamental problem of corporate industrial financing (equity, medium to long-term loan capital, overdraft facility), also that of devising a scheme which would make available medium to long-term loan monies to industrialists on conditions which are attractive to them and encourage investment for modernisation and expansion. In particular, the cost of the money is recognised as a major inhibition.

2. The joint stock banks are not seen to be the appropriate vehicle for the creation/generation of these longer term funds. There are strong economic policy grounds for considering that the general growth of bank lending should be reduced. A much more acceptable source of these funds would be new investment monies provided by pension funds and other institutions.

3. There is concern about the cost of the main Grylls proposal to the Exchequer, albeit in 18 months and further into the future. In addition, it is considered that any scheme should encourage all industrial borrowers and not give preference to wholly or partially tax exhausted companies. There is also the potential problem of "round tripping".

4. The Treasury is more than ready to look at the tax treatment implicit in any proposal, particularly with regard to creating additional incentive for investors to fund medium to long-term industrial investment monies.

5. It would be particularly helpful to the Treasury for information to be gathered from industrialists about the attractiveness of certain facilities - for example:-

(a) 10 year zero bonds (loans with rolled up interest) which result in a larger sum to repay at the end of the term, but accrued tax interest allowable for corporation tax purposes against corporate profits. Tax changes in legislation would be required.

(b) Index linked bond loans with 2½% to 3% real return - capital uplift would be lower than zero bond, but interest would be payable during term of bond.

(c) Deep discount bond resulting in capital profit to investor, but capital loss to borrower. Note: most corporate borrowers might not find "capial loss" availability to be attractive unless capital gains being generated.

GRYLLS STUDY GROUP MEETING AT THE TREASURY - 6th APRIL 1982 Cont...

POINTS MADE BY THE STUDY GROUP.

6. Encouraged by Treasury response to analysis of problem and the need for public debate of it, the Group will continue to develop ideas with industrialists and institutions and report back to the Treasury.

7. Explained the reasons for the concern of many industrialists about "over-exposing" their companies, both public ones and large private ones, to the equity market in the light of the short-term expectations of many risk investors. The danger of and need to avoid over-gearing is recognised.

8. Difficulties of attracting long-term monies from non UK bank sources when UK banks may have obtained not only fixed charges on assets in excess of reasonable security for overdraft and short-term facilities, but also a floating charge on the business as a whole. This creates a lack of industrial confidence as the bank can effectively appoint a receiver over the whole business following a relatively minor default. The impact of a bank's request for a negative pledge was also explained. (The Treasury will review this unique UK problem of the uncertainty created by allowing (legally) the creation of floating charges and the role of receivers appointed under these charges.

9. The need to provide encouragement and incentive to tax exhausted companies to invest - generally such companies are not "clapped out" and are capable of making a significant contribution to the upturn in the economy as it emerges.

10. It might be worth considering the "writing off" of unused tax losses after a number of years if wholly or partially tax exhausted companies are given some particular incentive to reduce the cost of medium to long-term monies.

11. The whole position of floating charges on total assets of companies was discussed. It was agreed to investigate further the dominant influence of senior lenders (99% Clearing Banks), International Comparison of bankruptcy and receivership procedures and other negative effect on long-term industrial investment

Gryls
Ian Gow MP
6/4/82

FINANCIAL SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

Michael Grylls Esq MP
House of Commons
LONDON
SW1A OAA

2 April 1982

Dear Michael

Thank you for your letter of 29 March. I look forward to meeting you and the members of your Study Group at the revised time of 11.30am on Tuesday 6 April. Ian Gow and Ian Stewart both hope to attend together with Douglas French, Peter Middleton, and Tony Battishill.

You suggest in your letter that you would like to have the Treasury's reaction to the Group's letter to Geoffrey Howe of 14 March for the meeting. In a way you have had this in Geoffrey's letter to you on Budget day, and my speech the day after in the House! But I would not like to set out a formalised position at this stage.

Yours ever

Nicholas

NICHOLAS RIDLEY

Michael Grylls MP

HOUSE OF COMMONS

LONDON SWIA OAA

ACTION | PS FST.

previous papers in Chancellor's Registry

The Rt Hon Nicholas Ridley MP
Financial Secretary
Treasury Chambers
LONDON SW1

29th March 1982

Dear Nicholas,

This is to confirm that the members of my Study Group and I will look forward to seeing you on TUESDAY 6th APRIL, at 1600 hours, at the Treasury. I understand that Ian Gow has also asked to be present and that is, of course, very welcome by us.

As you will know, the Study Group sent a considered response to Geoffrey Howe's letter of 9th March although they have not yet had a reply. I would very much like to have the Treasury's reaction to their letter, and if this could be received before our meeting next week, I would suggest it could make the basis for our discussions? I hope you agree that this would be a sensible way to proceed?

Yours ever,

Michael

Encs:

6/4/82

FINANCIAL SECRETARY TO THE TREASURY

CONFIRMATION OF MEETING NOTICE

Date: Tuesday 6 April 1982

Time: 11.30am

Venue: Room 52/2, HMT

Subject: Meeting with the Michael Grylls Study Group

Cast: Financial Secretary
Mr Middleton
Mr French

Mr Battishill - IR

Ian Gow MP

Ian Stewart MP

Michael Grylls MP
W G Poeton
B A Baldwin
G T Edwards

25th March 1982

Proposals on Bank Lending

We have had a word about the proposals which Michael Grylls has submitted to Geoffrey, and I know that Geoffrey has asked you to assume responsibility for this.

You told me that you had in mind to have a further early talk with Michael Grylls.

The purpose of this letter is to ask if I might be present at your forthcoming meeting with Michael.

IAN GOW

The Hon Nicholas Ridley MP

cc. Michael Grylls Esq MP

Michael Grylls MP

HOUSE OF COMMONS
LONDON SWIA OAA

The Rt Hon Nicholas Ridley MP
Financial Secretary
Treasury Chambers
LONDON SW1

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Encs:

c.c. Ian Gow, Esq., T.D., M.P.

THE CHAIRMAN'S OFFICE
A.T. POETON & SON LTD
21 SOUTH TERRACE
SOUTH KENSINGTON
LONDON SW7 2TB
01-589 1945

Dear Sir Geoffrey, March 14th 1982.

BANK LENDING - BRITISH INDUSTRY.

May I thank you, as Convenor of the Study Group which the Conservative Parliamentary Industry Committee established "to examine the terms and conditions of Bank Lending in Britain and its relationship to industry in general", for your most carefully considered letter to Michael Grylls about the Government's proposals.

We are very pleased with your appreciation of our work and findings - particularly the investment problems facing UK industry - our proposals to improve the situation being of secondary importance at this stage.

We listened to Nick Ridley on Thursday night and are briefing Michael with this letter and other notes in case he has an opportunity to contribute to the debate on Monday.

I hope that our detailed consideration of your comments will help towards our common objective ie. "A higher proportion of our national resources devoted to the private sector and a high level of investment in British Industry".

May I begin with your view that the most important thing to do is to get the capital markets moving. Our researches into this matter have convinced us that UK listed companies and large private companies are not attracted to approach the equity market for risk money to fund a substantial modernisation or expansion programme. Too much emphasis is said to be placed by the City and its analysts on the short term prospects for such investment. Advisers to pension funds and other institutions are aware that their results are measured against the market trends and therefore they are often unwilling to support a venture which will show little or no return during a lengthy development and initial production period. Six months is too often the 'norm' in judging performance and not a reasonable two to three year period which many major projects need before they are generating profit and positive cash flow.

The classic UK financing route for these projects is to encourage them to be funded initially by bank overdraft and, after say three years, when the overdraft cost is seen to be too high to be serviced by internally generated resources, to roll up the borrowings into a rights issue. This route is satisfactory and effective for the company provided it is able to keep to the accepted pattern of events during this period up to the rights issue. However, if it fails, for whatever reasons, to achieve the pattern, then it will be in considerable difficulty with a short term borrowing situation which it cannot resolve, and which may well create an overwhelming impact on its cash flow which can be unacceptable to its bankers. Furthermore, we are informed that there is a limit with regard to corporate image to the extent to which a company can return to the equity market in the UK without encouraging undue attention to itself and its performance.

The short term expectations of the equity market do not always make it the attractive source of funds which the City and other believe it to be. Long term loan capital is in many cases the only source of funds which will give the industrialist the confidence to invest in projects with internationally comparable payback periods. However, the high and traditionally fluctuating cost of money can itself erode the confidence to go ahead, and doing nothing can make remarkable commonsense.

The policy which you have initiated and courageously followed for three years, will hopefully, lead to a significant fall in the cost of money. Furthermore, as Government makes less demands on the market interest rates will possibly reach and remain in single figures as inflation is brought under control. Confidence will return, albeit slowly, in the financial system but some special boost is, in our opinion, necessary to encourage an anticipation of that confidence. We believe that boost must of necessity be linked to the cash flow of medium to long term monies.

We have ample evidence, on record, that industry is generally dis-satisfied with the present financial system and that there is, indeed, a lack of confidence in it. The root of the problem is, in our considered view, not the low level of profitability of British Industry, but the high level of profitability required by the risk investors. Industry has to compete for long term funds with pre-existing financial "paper", consumer and property development interests and, more recently, private house purchasers.

As a result, industrialists look primarily for investment projects with a two or three year payback period and those projects with a return of 20% to 25% remain stillborn.

Stimulating Bank Lending.

We agree that there is no particular need for the type of longer term lending which we are seeking to stimulate, to be channelled through the clearing banks. It may well be that the merchant banks and other institutions which the Treasury might approve for this purpose would be willing and able to perform this task.

Despite the publicity material put out by both the CLCB and the FFI to which you refer in your letter, we can assure you that in our discussions with senior officials of the individual clearers and the ICFC we have received a positive response from them. Indeed, as you might well imagine, the clearing banks are particularly enthusiastic about encouraging longer term lending to industry including the moving of hardcore overdraft lending onto a basis which recognises the effective use of the money. At the same time they are well organised to service proposals of this type and have the branch networks and detailed knowledge of their customers to respond quickly and effectively to loan applications as they arise.

Selectivity.

Much progress has been made since our last meeting with your officials on December 4th. Our initial proposal was directed primarily towards the manufacturing sector but, following discussion with the Department of Industry officials, we have recognised the problem of attempting to define precisely the type of project which our researches have shown need support. This problem is particularly acute in relation to multi-active groups of companies. At the same time we are aware that 75%-80% of the private sector GDP comes from the largest 100 corporations and, therefore, we should not seek to exclude them if the proposal is attractive to them.

The revised proposal which we put forward seeks to cover all sectors of industry - manufacturing, construction and services - but with the exclusion of certain, non-priority activities similar to those excluded from the Business Start-up Scheme, for which clauses are already on the Statute Book. Each group of companies (as defined by the Companies Act) would be limited to a maximum of £25m outstanding at any one time so as to create the necessary ceiling on demand.

The funds would be used primarily for modernisation and expansion but also for restructuring an existing situation if the lending institution, which will carry the risk, is satisfied that the business is viable in the medium to longer term. Expansion would not include the purchase of another company by a public company. Borrowing companies in a group would be unable to lend on current or loan account to any other group company during the term of the 'investment' loan. Any taxable non-trading income or gains arising during the loan term would be subject to taxation irrespective of any tax lossed and allowances available from trading activities.

Tax Exhausted Companies.

As you are well aware, the cost of many industrial projects is not simply a matter of purchasing or leasing the plant. There may well be research and development costs, prototype design and testing, the working capital to support an increased level of turnover, the marketing cost of a launch and then the maintenance or expansion of a market share. A positive cash flow position may well not be reached on a major project until some two years after the initial research has shown that a particular idea is worth developing to the prototype stage and hopefully full production.

Whilst companies which pay the full rate of corporation tax on their profits will receive the tax relief on the interest which they pay on loan monies some eighteen months on average after payment, tax exhausted companies receive no such relief as they are not likely to be in a tax paying position in the foreseeable future. We can well understand, viewed from an Exchequer position, that it appears that we are suggesting an additional benefit to tax exhausted companies rather than to all businesses generally. Viewed, however, from industry there is considerable hesitancy by companies which have to bear the full cash cost of the interest charge to proceed with a project unless it shows a substantial short term return. Certainly leasing has provided an exceptionally efficient method of passing the benefit of tax allowances to the user, but in many situations the cost of the 'hardware' which can be leased is not a substantial part of the overall cost. Hence there is often the need for additional borrowings to fund the projects, particularly at present when many efficient British companies are surviving the recession by a significant cutback of activity and reliance on past earnings. Their ability to modernise and expand capacity in anticipation fo the up turn in activity is severely limited unless we are able to give them a significant boost in the form of reducing the cash flow cost of capital to them in the near future.

Our main proposal, which might well also give a short term cash flow advantage to tax-paying businesses (depending on the amount, if any, of the mark-up of the interest rate by the lending institution to cover the carrying cost of the proposed tax credit), would only be available to businesses which are deemed by the lender to be risk worthy and capable of servicing a long term loan, albeit with an initial capital repayment holiday. The risk would remain wholly with the lender and, although many businesses responding to such a boost as the one proposed might well be wholly or partially tax exhausted, it would be necessary for the borrowers to be viable long term and worthy of this type of support. As such it is probable that the stimulation would achieve maximum impact on those efficient business which, at present, despite the success of your economic policy in reducing inflation and interest rates, are unable to borrow funds on terms which are sufficiently attractive to them in the short term as the success of the policy steadily emerges.

Direct cost to the Exchequer of Study Group's Proposal.

Assuming initial lending under the proposal resulted in advances of £3 billion in the first year and £5 billion in the second year, giving an average amount outstanding in Year 1 of £1.5 billion and in Year 2 of £5.5 billion, together with an average interest rate (including any mark-up by the lender above normal rates) of 14% gross and tax deducted at a rate of 50% to cover both large and small companies:-

Year 1 cost (1982/83) payable by Exchequer, say January 1984	£105 million.
Year 2 cost (1983/84) payable by Exchequer, say January 1985	£385 million.

These cost figures are gross and assume no loan repayments in the first two years. They exclude any additional revenue accruing to the Exchequer from full or part tax paying companies, taking advantage of the proposal and so losing the deductibility of the interest paid for corporation tax purposes. It is also possible that there might be a small reduction in the demand for leasing to the benefit of the Exchequer.

At the same time, the steady investment of substantial additional funds in productive schemes would slowly create new wealth and employment, boosting GDP, and over a period increasing personal and indirect tax revenues and reducing benefit payments. It is our considered opinion that, in the light of the time lag inherent in the proposal, the Exchequer would more than offset the direct cost of the proposal in this way. On the other hand, if the proposal is not successful in providing the boost to industrial investment, which we envisage, the direct cost will be reduced proportionately.

We recognise and acknowledge with enthusiasm the efforts which you are making to create space for corporate borrowing in the long term market and hopefully your policy in this direction will bear fruit in the form of cheaper rates. It may well become possible for lending institutions to issue long term industrial bonds to attract pension and life insurance monies, in order to match their own long term lending to industry.

Your Budget measures, including the long overdue reform of capital gains taxation, will generate greater interest by investors in the equity market. However, the problems seen from the viewpoint of the corporate borrower. are deep rooted and will not be resolved quickly.

We are convinced that for the whole of our industry to be in a position to reap the fulfilment of your policies which is vital for the emerging strength of the economy some fundamental boost to their investment confidence is needed which is represented in cash terms now. The core of our main proposal achieves that end and we shall be pleased to continue discussions in order to achieve a detailed proposal which meets the agreed objective and satisfies the concepts of your policies.

Yours sincerely,

W G Poeton (Convenor).
B A Baldwin.
G T Edwards.

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

9th March 1982

Michael Grylls, Esq., M.P.,
House of Commons

Dear Michael

I am writing to you to expand on the comments in my Budget Statement about the proposal recently made by your Study Group in relation to corporate borrowing. Nick Ridley will be developing these points in his wind up speech on Wednesday night.

Let me start by saying how much we admire and value the work of your Group. Your ideas made a valuable contribution to the Business Start-Up Scheme which we introduced last year. The Group's latest proposals represent a substantial piece of work. As you know officials discussed them with Mr. Poeton and his colleagues and I gave their ideas a good deal of thought.

We agree entirely upon the objective. We both want a higher proportion of our national resources devoted to the private sector and a higher level of investment in British industry. What we must do is find the most effective ways of doing this.

I have however several difficulties with the proposals. First the emphasis on stimulating bank lending. You will have seen the recent document from the Banking Information Service "Bank Lending and Industrial Investment", and the earlier publication by FFI "The Capital Structure of Industry in Europe". These show that there is at least room for debate about the extent to which - as George Edwards argues - British industry is currently under-borrowed from the banks. But, however that may be I have considerable reservations about proposals which favour additional bank lending on the assumption that it is superior to other sources of finance. Even higher bank lending - which is running at a rate of over £1 billion a month - must mean higher short term interest rates than otherwise.

And the scheme which the Study Group has proposed is of course very selective. It is selective in favour of bank lending; it is selective in favour of particular parts of industry; and it is selective in favour of tax-exhausted companies.

/I have given

I have given greatest weight to getting the capital markets moving, thus improving the prospects for long-term market finance in general and for equity finance in particular. If we succeed in this it will have the great advantage over schemes for increasing bank lending that it will help bring down short term interest rates.

Perhaps I could expand a little on these points.

There can be no doubt that the proposals would give tax-exhausted companies a positive fiscal advantage in relation to tax-paying ones. As a result, a project which would not be attractive to a company paying tax could be so to one that is not. While I would accept that a tax-exhausted company is not necessarily commercially unprofitable, I am not happy about creating a distortion of this sort. Particularly, as I have just said in the Budget Speech, when consultations are not yet complete on the Corporation Tax Green Paper, which raises big issues about incentives to investment, and when we are still considering how to ensure a proper contribution to tax revenues by the banking sector.

Your scheme also - and perhaps inevitably - envisages selectivity between different kinds of business: with some industries (such as parts of manufacturing) favoured, and others (such as some service industries) excluded. Again, I am not convinced that this would be a desirable feature, since it would add further distortions in the tax system.

The scheme would also involve a considerable cost to the Exchequer. It is not easy to quantify how much but it could be very substantial indeed - even on a selective basis.

I have been searching to find other ways forward. The root of the problem is the combination of the low level of profitability of British industry and the present high level of interest rates. As you know, our economic policy is directed above all to putting this right by restraining public sector borrowing and thus reducing inflation, and by encouraging initiative and enterprise. The benefit of these policies will be felt by all businesses - not just those which are now tax-exhausted, but those which are also earning profits and paying corporation tax. I believe we should continue to focus on these fundamentals.

I am sure you will agree with the emphasis I have placed in my Budget on helping industry. It is most definitely a Budget for industry. I had a limited amount of room for action and I concentrated on those things which I believed offered most help to industry, namely the reduction in NIS, the measures to encourage enterprise and the reductions in capital taxation. I am hopeful that the result on interest rates will be favourable. If I had gone ahead with the Study Group's proposals, I would have had to deny myself some of these important measures.

/I hope the

I hope the Budget will lead to greater use of the equity market following the indexation of capital gains tax. Indeed it may prove that the distortion caused by taxation of paper gains in the past has been the cause of industry's gearing going awry. On long term borrowing, I have tried to clear space for companies at the long term end of the market by the issue of indexed gilts and by continued emphasis on National Savings. We are already moving in this direction. In the last year we issued only £750 million of debt maturing in the next century compared with over £3 billion the previous year. Industry should be able to borrow long term at cheaper rates as these policies bear fruit.

So in both these ways I have sought to achieve our common objective.

I hope you find this helpful. And I hope your Study Group will continue to come forward with proposals to help us achieve these objectives. Certainly we should be ready to discuss them.

GEOFFREY HOWE

Grylls

15th March 1982

MICHAEL GRYLLS

Many thanks for your letter of 10th March, with which you enclosed a copy of a letter of the previous date, which you had sent to Michael Grylls.

I agree entirely.

My purpose is to prevent a meeting between Michael Grylls, and the authors of the pamphlet, with the Prime Minister.

I am sure that further discussions ought to take place with you; indeed, you have already given a great deal of your time to Michael and his colleagues on this subject.

Ian Gow

The Rt Hon Sir Geoffrey Howe QC MP

PERSONAL

COVERING CONFIDENTIAL

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

10 March 1982

Ian Gow, Esq., MP.,
10, Downing Street

Dear Ian

You wrote to me on 1 March about Michael Grylls' letter of 23 February, repeating his request for a meeting with the Prime Minister.

..... We ought now to have a word about this; but before we do, I think that you should see the attached copy of a letter which was delivered to him immediately after my speech yesterday. My instinct is that it would be a mistake to move too quickly in setting up a talk with the Prime Minister. While Michael will be sorry - though hardly surprised - that I did not yesterday announce the adoption of his ideas, what I did announce may have had the effect of taking some of the wind out of his sails. Let's hope so!

Geoffrey

GEOFFREY HOWE

cc: Financial Secretary
Mr. Ryrie
Mr. Quinlan
Mr. Battishill
Mr. Monck
Mr. Turnbull
Mr. Robson
Mr. Gordon
Mr. Middleton
Mr. Ridley
Mr. Isaac - I/R

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

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G—

GEOFFREY HOWE