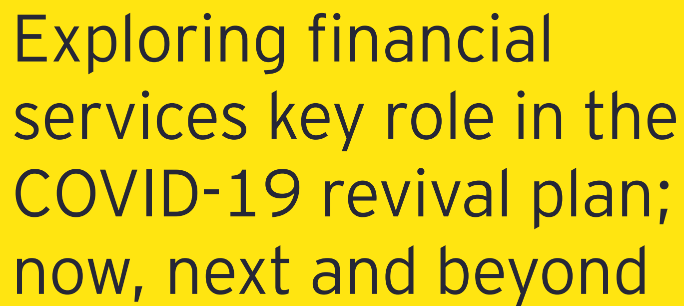

Exploring financial services key role in the COVID-19 revival plan; now, next and beyond

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May 2020

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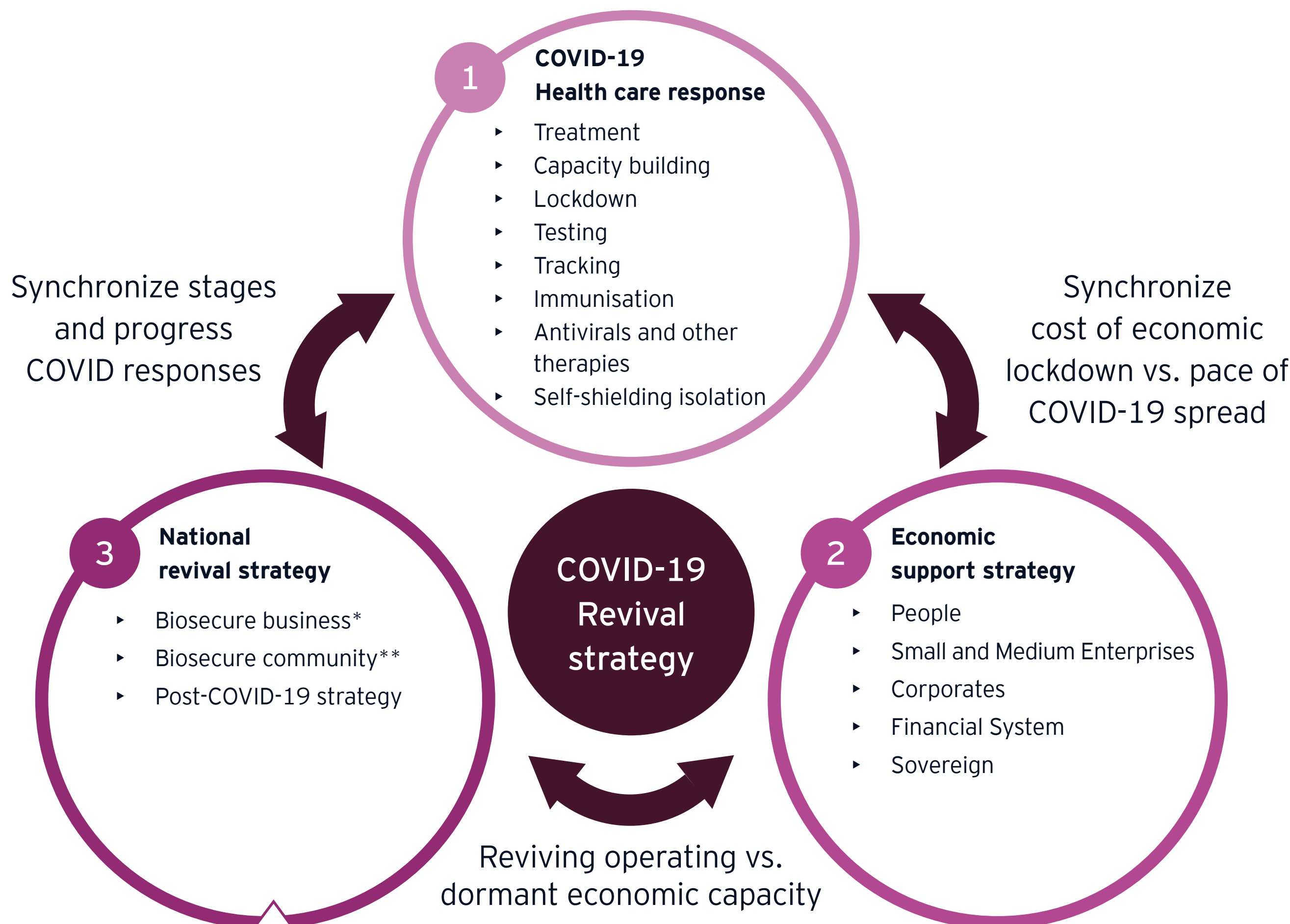
Introduction

We continue to see incredible efforts to combat the COVID-19 pandemic on all fronts. The initial economic impact of the COVID-19 pandemic is starting to be felt as a consequence of countries having to lockdown their economies. Supporting the economy can only be effective if it is considered in a multi-stage revival strategy. A COVID-19 Revival Strategy would be composed of coordinating rapid progress on three dimensions:

1. COVID-19 Health care response
2. Economic support strategy
3. National revival strategy



Including:

- Standard public health design parameters for activities
- Approved protocols at a national and sector by sector level
- Insurance industry funding
- Employers indemnity insurance and H&S liability
- Clear and simple communications

Source: EY
Date: April 2020

***Biosecure business:** Phased protocols to enable restart and scaling of business subject to adherence with biosecurity measures
Biosecurity measures geared to nature of physical activity, health care response capacity and ability to implement distancing, PPE, tracking, testing and treatment; protection of vulnerable groups

****Biosecure community:** Reviving everyday social life within parameters similar to Biosecure business. Importantly business and community likely need to progress in parallel to manage social behaviour

A lead role for financial services

Whilst putting in place a comprehensive framework for revival will take time, businesses need immediate access to liquidity to sustain their operations, maintaining productive capacity until the lockdown measures are eased.

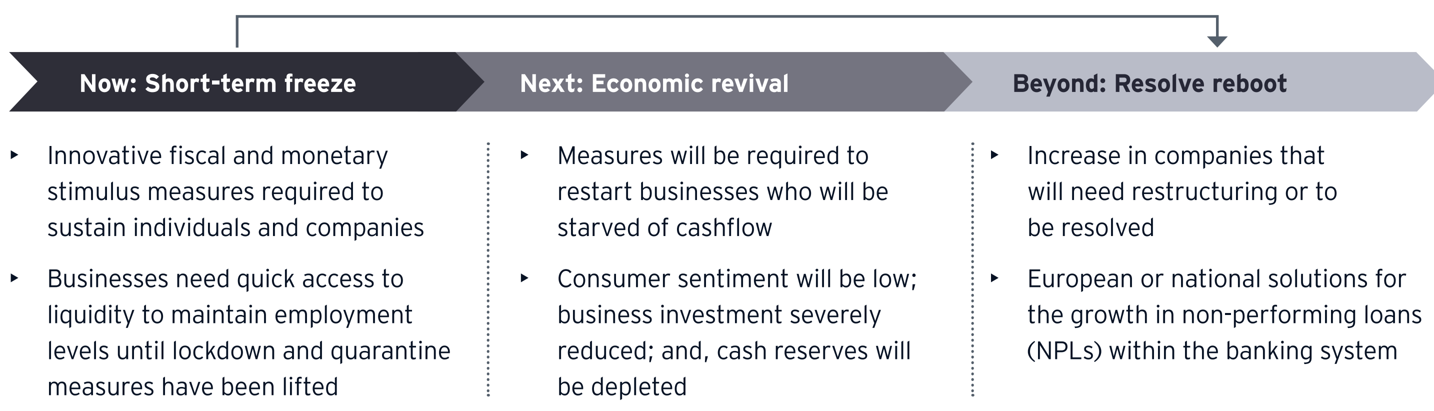
The monetary, fiscal and regulatory changes announced have been designed to ensure there is a wave of "stimulus" that washes over all parts of the economy, from individuals to large corporates. At the heart of turning this stimulus into the real economy is the financial services industry.

In sharp contrast to 2008 the industry is now cast as a key player in helping businesses and individuals get through the next few weeks and months.

This paper is designed to explore how governments, authorities, banks and business leaders can think about doing just that. This requires effective combinations of economic strategy, policy design and operational and technological execution.

Three distinct phases

In developing an appropriate response, we think that it is important to differentiate the response over its different phases and to incentivize private capital to work alongside government interventions. The three phases are set out below encompassing **Now**: Short-term freeze, **Next**: Economic revival and **Beyond**: Resolve reboot.:



Stewardship principles

Consistent with 2008 there is a continued need to rapidly and practically embed responsible stewardship principles and outcomes across all stimulus transition programmes. Critical within this is clarity on what is in the public interest and how a public interest test will be applied. Embedding stewardship principles should be linked to both activities and outcomes.

At the same time, they should be linked to answering the demands of accountability. To shape prioritization and decision making criteria it is critical to use purpose to determine the right strategy to serve the public interest, and establish responsible stewardship linked to outcomes. This should guide lending priorities, broader state support where the right to equity stakes need to be considered, and strategies such as asset protection schemes and asset management companies.

Beyond the initial interventions, an accountability framework needs to be implemented to ensure that the public interest objectives set are met.

We believe that the European response to COVID-19 would be strengthened through the application of a consistent and detailed response framework designed around these three pillars.

Now
Ensuring that scope and size of immediate measures are comprehensive

Authorities and key actors need to work together to size and design programs that maximize participation.

EY teams have mapped out the stimulus transmission mechanism in a framework useful in displaying the key actors and transmission flows. Further, in the paper we summarize the key measures taken at European and national level.

We then go on to explore several options to address the key risks of the most popular schemes currently implemented. At the same time, there is a need to find options that avoid overleveraged companies who would not be able to invest and thrive in a post COVID-19 world.

Next
Restarting the economy using innovative options

Coming out of the lockdown, a different world will await. As economic activity will resume, there will be changes in the structure and level of demand. It will also take some time, before activity may be restored to pre-lockdown levels, if at all in some subsectors.

Under these circumstances, access to funding will become critical (working capital and growth capital). Yet banks and other capital providers may be wary to resume lending and investing, given the level of uncertainty and their immediate focus on balance sheet repair.

Among a range of options, we explore how innovative options can be deployed involving the insurance sector.

Beyond
Building systemic options to address the overhang

It is becoming increasingly likely that there will be significant economic distress in the wake of the crisis, in some sub-sectors even extreme. Whilst the companies impacted early would be in sectors directly affected by lockdowns (e.g., airlines, hospitality, non-grocery retail etc.), the longer the lockdowns last the more the impact will be felt throughout the economy, potentially leading to a wave of defaults and insolvencies.

At the same time, given the need for speed and scope of the stimulus packages, many companies will be able to stay afloat only to find themselves in a different and strategic economic environment post crisis.

The financial sector is at the centre of the stimulus transmission package. A surge in insolvencies and defaults during and post crisis will put severe pressure on the commercial lenders.

EY teams are exploring a range of systemic options to facilitate industrialized restructuring and workouts, as much as possible outside of the banking systems.

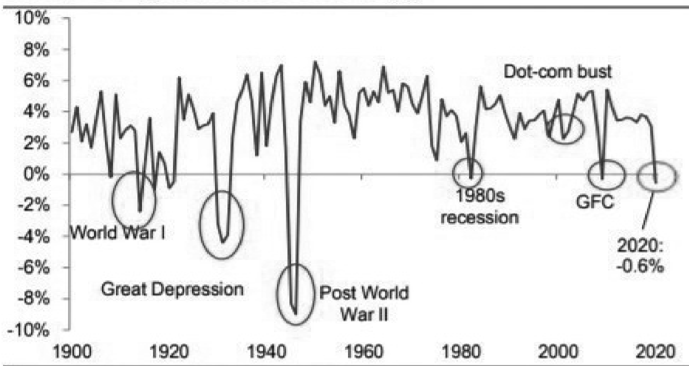
Global GDP growth is slowing to historical levels

Research by Angus Maddison, IMF and Standard Chartered indicates that global GDP growth was already down by -0.6% by March 2020 and could continue to fall. The scale of the recession already appears severe with downside risks based on the length of the lockdown and how restriction measures are eased over time.

Recent economic forecasts show a further deterioration in the global GDP outlook for 2020. The European Commission Spring 2020 ‘European Economic Forecast’ predicts growth in GDP of -7.4% for the EU and -3.5% globally. Similarly, the IMF April World Economic Outlook projects global growth to fall to -3%, due to the ‘Great Lockdown’, a forecast far more severe than the global financial crisis.

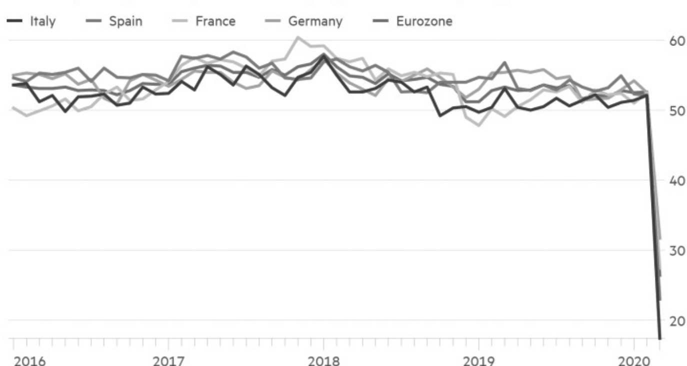
Source: Angus Maddison, IMF and Standard Chartered
http://blogs.ft.com/the-world/liveblogs/2020-04-03/, 3 April 2020
https://www.imf.org/en/Publications/WEO/Issues/2020/04/14/weo-april-2020, April 2020
https://ec.europa.eu/info/sites/info/files/economy-finance/ip125_en.pdf, April 2020

Global GDP growth since 1990, % y/y



Source: Angus Maddison, IMF, Standard Chartered Research
http://blogs.ft.com/the-world/liveblogs/2020-04-03/
Date: 3 April 2020

In line with global GDP movements, European countries have been severely impacted and this has been met with a substantive response by governments, central banks and regulators. Even with the current response we have seen, in March 2020, a record fall in the Purchasing Managers' Index (PMI) for both services and manufacturing in the Eurozone. This is indicative of the level of distress expected throughout the Eurozone's economies.



Source: IHS Markit
https://www.ft.com/content/f8e58c8a-de5e-44ac-84c4-dac767e6cfca
Date: 3 April 2020
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The country-by-country data has underlined the enormous economic cost of the lockdowns in Europe, as business activity tumbled across the region:

- Italy's services activity crashed to an all-time low of 17.4
- France's fell to 27.4, the sharpest contraction in that survey's history
- Spain's reading of 23 was also the lowest recorded in that country
- The German services industry fared little better, as its PMI reading fell to 31.7

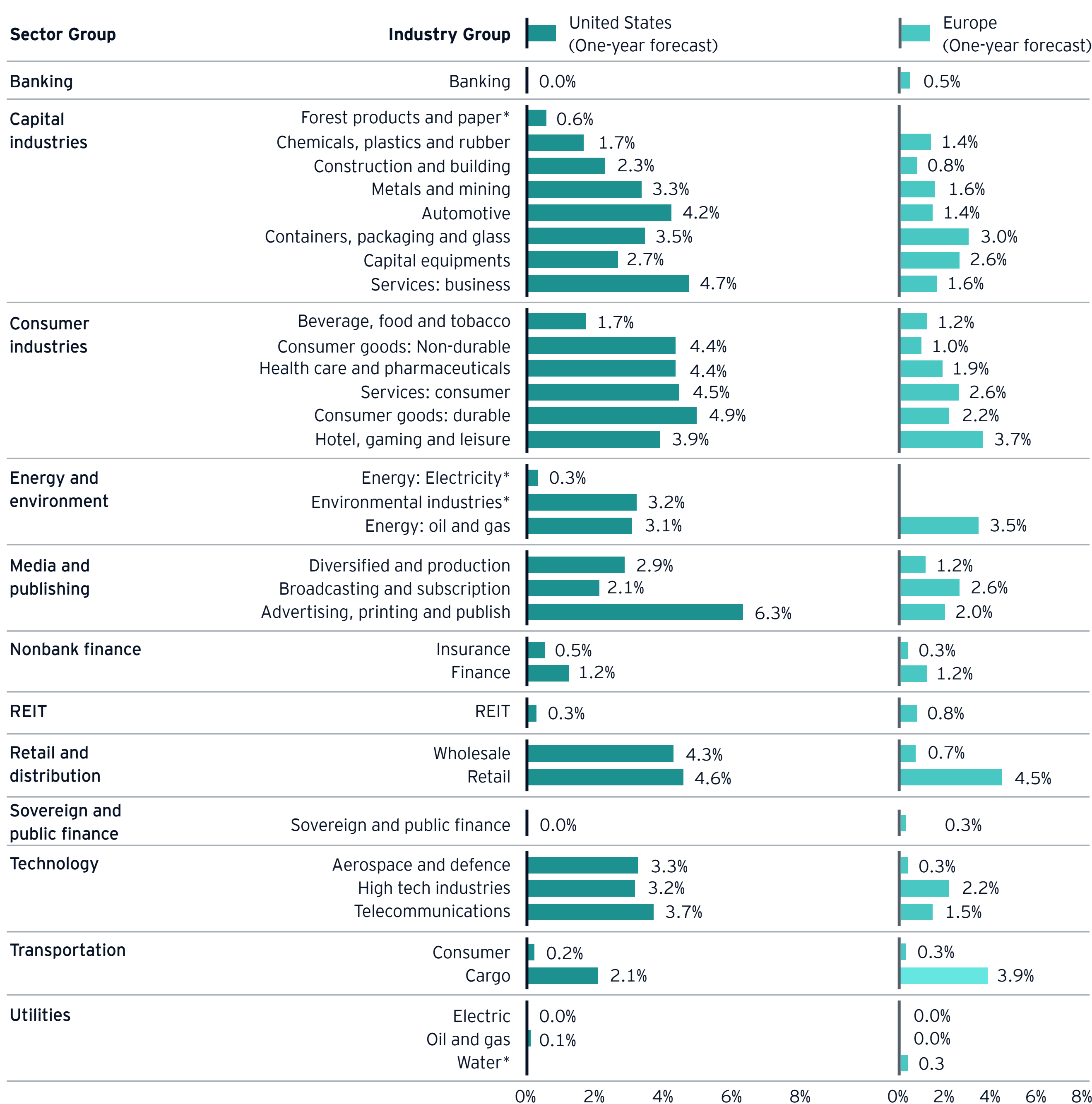
Whilst the services sector has suffered a stronger decline, manufacturing PMI has experienced the sharpest fall since 2009.

There is a strong desire to avoid this translating into large corporate defaults, recognizing that not all will survive. The most impacted industries are expected to be transportation (in particular airlines and shipping), retail and distribution, consumer industries (hotels, gaming and leisure), consumer services, energy, oil and gas, and capital industries such capital equipment and packaging. However, shoring or near shoring of operations (manufacturing or services) will provide growth opportunities, as will the emergence of new "biosecure" products and services, and health care device demand.

Much of the stimulus measures reflect the authorities' desire to get large corporates on a stable footing and operating effectively. A robust corporate sector response will not only help its employees directly, but also assist suppliers who are likely to be other corporates and SMEs. Central banks and politicians will also be keen to avoid the symbolic importance of large corporates failing.

Speculative grade companies are expected to experience an increase in defaults by an order of magnitude of 10x or even 15x in a very severe recession scenario. This is particularly relevant given the increasingly leveraged corporates who have benefitted from a decade of historical low interest rate.

One-year default rate forecasts by industry



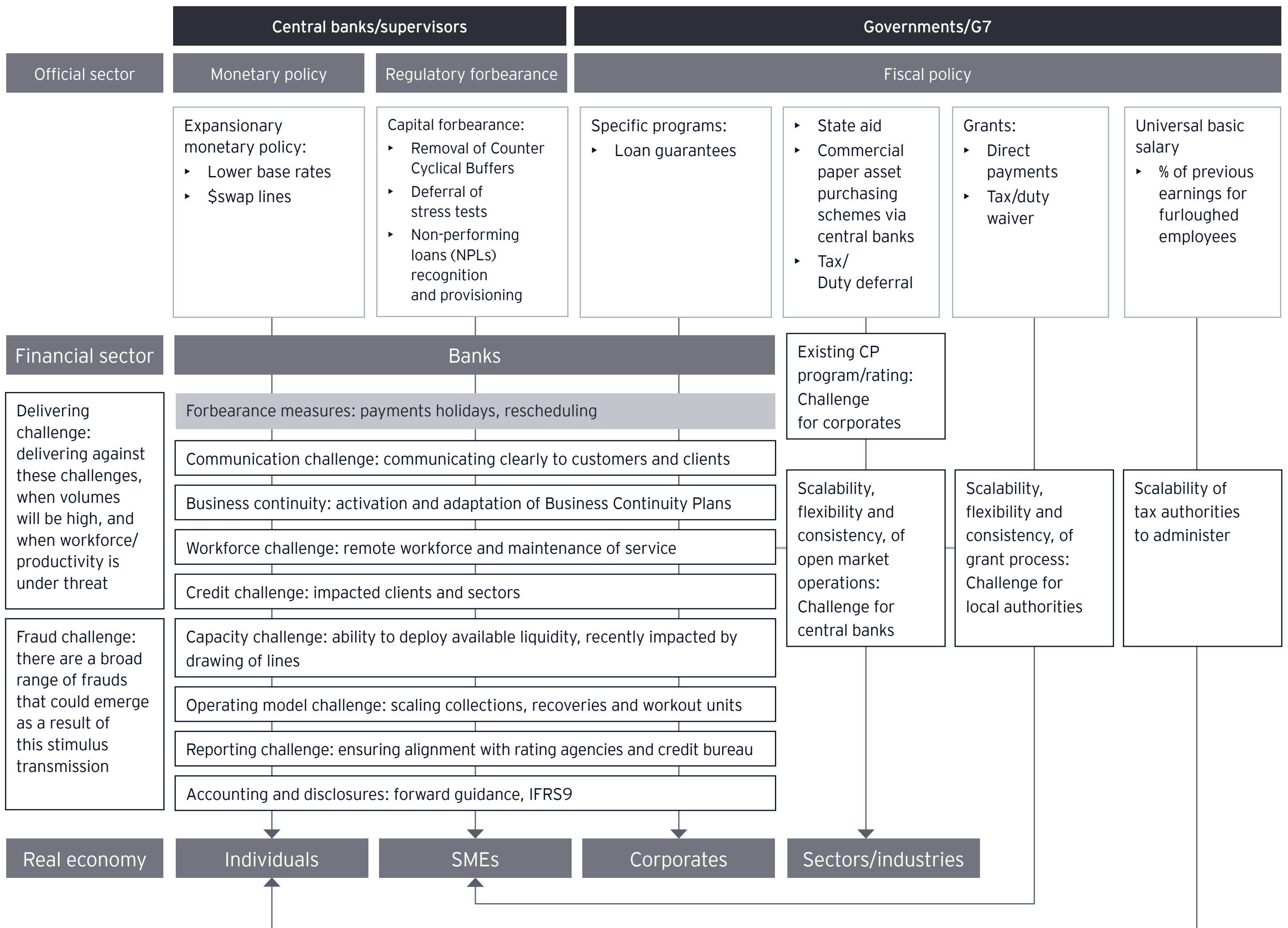
Source: https://www.moodys.com/research/Default-Trends-Global-March-2020-Default-Report--PBC_1199583
Date: 9 April 2020

*Default rate forecasts are not reported in these sectors in Europe or in the US owing to small sample size (fewer than 10 issuers).

The stimulus transmission challenge

On the following page a framework is set out that considers the breadth of stimulus measures, and their transmission mechanisms to the real economy. In doing so some of the impediments to smooth, effective and fast transmission are identified.

The measures encompass monetary and fiscal stimulus transmitted to the economy both directly and through the banking system via a combination of loans, grants, tax forbearance and other schemes. Most countries have used a combination of these measures, but the efficacy in terms of availability, quantum, and execution vary significantly.



Source: EY research, April 2020

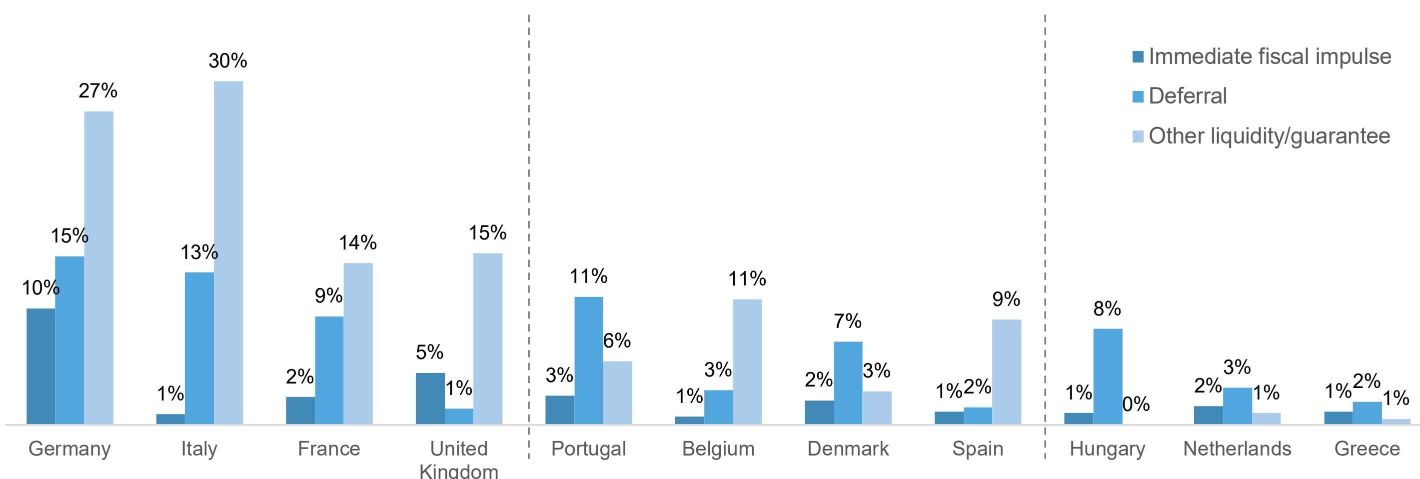
Stimulus measures in Europe

Governments across Europe have taken unprecedented measures to support their economies. We have seen central authorities use a combination of fiscal, monetary and regulatory policies including the provision of grants. Measures have been sized to weather a very significant shock.

The level of economic stimulus as % of GDP varies significantly across Europe. As a general rule, larger European countries have committed the highest amounts (fiscal packages and bank guarantees) with respect to their GDPs.

The table below highlights that the scale of the stimulus measures announced by each European country vary considerably and are not proportionate to the level of COVID-19 transmission in each country.

Economic stimulus packages (% of GDP)*



Debt as % of GDP**

Germany	Italy	France	United Kingdom	Portugal	Belgium	Denmark	Spain	Hungary	Netherlands	Greece
57	133	99	86	120	100	34	96	67	52	174

Cases per 1 million people**

Germany	Italy	France	United Kingdom	Portugal	Belgium	Denmark	Spain	Hungary	Netherlands	Greece
2,022	3,560	2,045	3,027	2,548	4,462	1,732	4,702	322	2,368	248

Stimulus Definitions

Immediate fiscal impulse: measures that will increase the budget deficit in 2020.

Deferrals include two main types:

- Deferral of tax and social security contributions, which in most cases allow to pay these duties a few months later, so these will not increase the budget deficit.
- Deferral of obligations to private entities, such as loans, rents and utilities. These measures indirectly impact the budget deficit by lowering the profit of providers, and thereby their tax obligations.

Other liquidity and guarantees: various loans by public banks and guarantees for loans provided by private banks. Loans should be paid back and therefore it is highly uncertain how much of the guarantees will be actually called.

* Source: https://www.bruegel.org/publications/datasets/covid-national-dataset/, 6 May 2020
**Source: https://news.google.com/covid19/map?hl=en-GB&gl=GB&ceid=GB:en, 6 May 2020

Common measures

Country	Debt as % of GDP	Guarantee % of loan	Headline Policies	Corporate Grants	Salary Support	State Loan Guarantees	Tax Deferrals	Social Security Deferrals	Debt Repayment Holidays
France	99%	Between 70%-90%	€315bn of government backing for loans. Fiscal stimulus for workers and business worth €110bn.	✓	✓	✓	✓	✓	✗
Germany	57%	Between 80%-100%	Supplementary budget of €156bn. Economic stabilisation fund (WSF) created. KfW loans up to 100% guaranteed.	✓	✓	✓	✓	✓	✓
United Kingdom	86%	Between 80%-100%	£330bn of government backed loans to SMEs. Will pay 80% of salary for furloughed workers. Bounceback loan scheme for 100% guaranteed loans up to £50k. Deferral of VAT payments.	✓	✓	✓	✓	✓	✓
Italy	133%	Up to 100%	€400bn fiscal rescue package. Substantial worker support package including support for laid off and self employed workers. Committed to help Alitalia.	✓	✓	✓	✓	✓	✓
Spain	96%	Between 70%-80%	€100bn of state loan guarantees aimed at SMEs. €19bn of other fiscal commitments and further support in the form of tax deferrals.	✗	✓	✓	✓	✓	✓
Greece	174%	N/A	€7bn of support measures. Financial support to employees. Health spending increases. Grants to vulnerable individuals. Liquidity support to businesses through subsidized loans.	✗	✓	✓	✓	✓	✓

Source: EY research, 6 May 2020

As these measures are being implemented it becomes apparent that some segments are better addressed whilst others may struggle. For example, many of the mid-sized corporates that do not have investment grade ratings may find that they do not automatically qualify for any of the schemes. The so called "squeezed middle" issue is very common across Europe.

Loan scheme case studies

Germany

KfW Entrepreneur Loan

- Company has been active on the market for at least five years
- Apply through commercial banks
- 80% KfW guarantee for large companies, up to 90% KfW guarantee for SMEs
- Loan size up to EUR 1 billion per company group

Direct participation for syndicate financing

- For medium-sized enterprises and large companies
- KfW assumes up to 80% of the risk, but no more than 50% of the total debt
- The KfW risk share amounts to at least EUR 25 million and is limited to 1). 25% of the annual turnover in 2019 or 2). double the wage costs in 2019 or 3). the current financing requirements for the next 12 months

ERP Start-Up Loan — Universal

- Company has been active on the market for at least three years or has two annual financial statements
- 80% KfW guarantee for large companies, up to 90% KfW guarantee for SMEs
- Up to EUR 1 billion per company group

KfW instant loan

- Showed profits in 2019 or on average over the last three years
- The company has more than ten employees and have been active on the market since 01/01/2019
- The credit volume per company is up to 3 monthly turnovers, with a maximum of EUR 800,000 for companies with more than 50 employees, and a maximum of EUR 500,000 euros for companies with staffs of up to 50 people
- The company is not under financial difficulties before 31 December 2019 and is required to demonstrate that its financial condition was in order at that point in time
- A current interest rate of 3 per cent with a term of ten years
- 100% guarantee from the German Federal Government
- No additional credit risk assessment by the bank or KfW

Switzerland

Large companies with a turnover of more than CHF 500 million are not covered in Swiss loan schemes

Swiss Federal Council

- Affected companies can apply to their banks for bridging credit facilities representing a maximum of 10% of their annual turnover and no more than CHF 20 million. Certain minimum criteria must be met.
- The company must declare that it is suffering substantial reductions in turnover because of the COVID-19 pandemic.
- Credits of up to CHF 500,000 will be 100% guaranteed by the Confederation, and will be paid out quickly and with the minimum of bureaucracy. Zero interest will be charged.
- Bridging credits that exceed CHF 500,000 will be guaranteed by the Confederation to 85% of their value; the lending bank will secure the remaining 15%.
- Each company can obtain a credit of this type for up to CHF 20 million, which means a more rigorous bank review will be required.
- The interest rate on these credits is currently 0.5% on the loan secured by the Confederation.
- Companies with a turnover of more than CHF 500 million are not covered by this programme.

United Kingdom

Bounceback Loans

- Designed to enable small businesses to apply for quick and easy-to-access loans
- Businesses will be able to borrow between £2,000 and £50,000 with the cash arriving within days
- The government will provide lenders with a 100% guarantee and cover the cost of any fees and interest for the borrower for the first 12 months
- No repayments due within the first 12 months
- The government has also agreed with lenders that a flat rate of 2.5% interest will be charged on these loans

Source: EY Research, April 2020

Key challenges preventing a broader reach

From the analysis of the existing schemes in place against the framework we mapped out, we have identified several challenges in reaching out to a broader segment.

1

Squeezed middle

There has been a significant effort to cover very large corporate and SMEs. However, the criteria for applying these schemes can result in delays in the access to finance. In some countries there is a gap in coverage such that mid-sized and larger corporates are not eligible for these schemes. Non-bank finance companies do not have access to finance and their structures mean that they have financing strain.

Current schemes may need to be assessed and expanded or streamlined in order to cover all relevant segments and expedite the transmission of stimulus. Measures may need to be tiered to address the specific trade-offs between speed and volume and credit quality.

2

Provision of finance

The level of Government guarantee varies but is usually between 80%-100%, still leaving substantial credit risk and decision making with the administering banks.

Business owners usually have to "exercise all available options" before any government backed loans are forthcoming, including deferment of supplier payments, laying off staff and other credit.

3

Complex processes

The operational success of schemes can be seen to be related to the a combination of

- Policy design
- Operational process
- Technology platform coupled with the availability of sufficient staff capacity to process at speed.

Also to be considered is the avoidance of reliance on external, sometimes slow databases for KYC, AML and fraud checking or external payment gateways. Some schemes have initially required new systems to be built. Schemes that appear to work fastest and most effectively have very high or 100% guarantees, minimal underwriting questions and rely on existing highly or fully automated platforms, existing KYC reviews and simple fraud checks (coupled with very significant penalties for fraudulent applications).

Government grants to businesses usually require owners to explore payment holidays from commercial banks, adding process time and delaying cash receipt by businesses.

4

Eligibility

Conditions of the stimulus packages may be strict and hard to understand, the details are yet to be fully revealed.

Some loan schemes require "all available security must be explored first", which adds complexity to the process, discourages businesses who don't want to collateralise their assets, and excludes businesses without available assets.

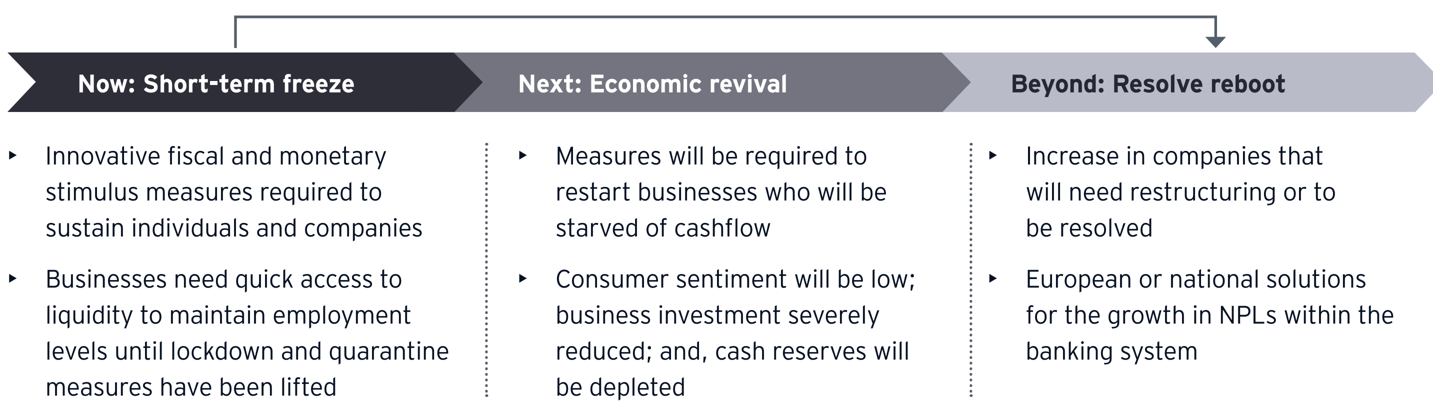
Strengthening the response to COVID-19; now, next and beyond

Whilst the focus is currently on ensuring adequate and proportional coverage is provided for the economy, as the crisis peaks there will be a need to adjust policies to the post-crisis environment.

Companies which will have seen both their resources depleted and their business models unravelled will require access to funding to resume trading. In such a liquidity scarce environment they will require additional support to facilitate access to funding. At the same time, many of the measures in place will have a significant impact on the financial sector, as large segments of the economy may not be able to adapt to the new conditions.

The diverse scale of the impact as well as the pre-crisis economic fundamentals, different from one country to the other, may lead to an inconsistent response post-crisis and endorse a divergent agenda which will only delay recovery. We believe that a detailed European framework may provide the platform for a coherent response.

Now, next and beyond: a European stimulus transmission framework



Now - Ensuring scope and size of immediate measures are adequate

The focus of the immediate measures taken so far has been to keep the economies afloat. These measures involve innovative fiscal and monetary stimulus measures required to sustain individuals and companies.

Amongst the most popular measures utilized we have seen:

- Commercial finance paper schemes
- Loan guarantee schemes

Commercial finance paper schemes

On 18 March 2020, the European Central Bank (ECB) announced the launch of a Pandemic Emergency Purchase Program (PEPP), covering both private and public sector securities.

The ECB intends to purchase bonds issued by corporates and countries within the Eurozone without limiting eligibility to specific corporate entities or member states.

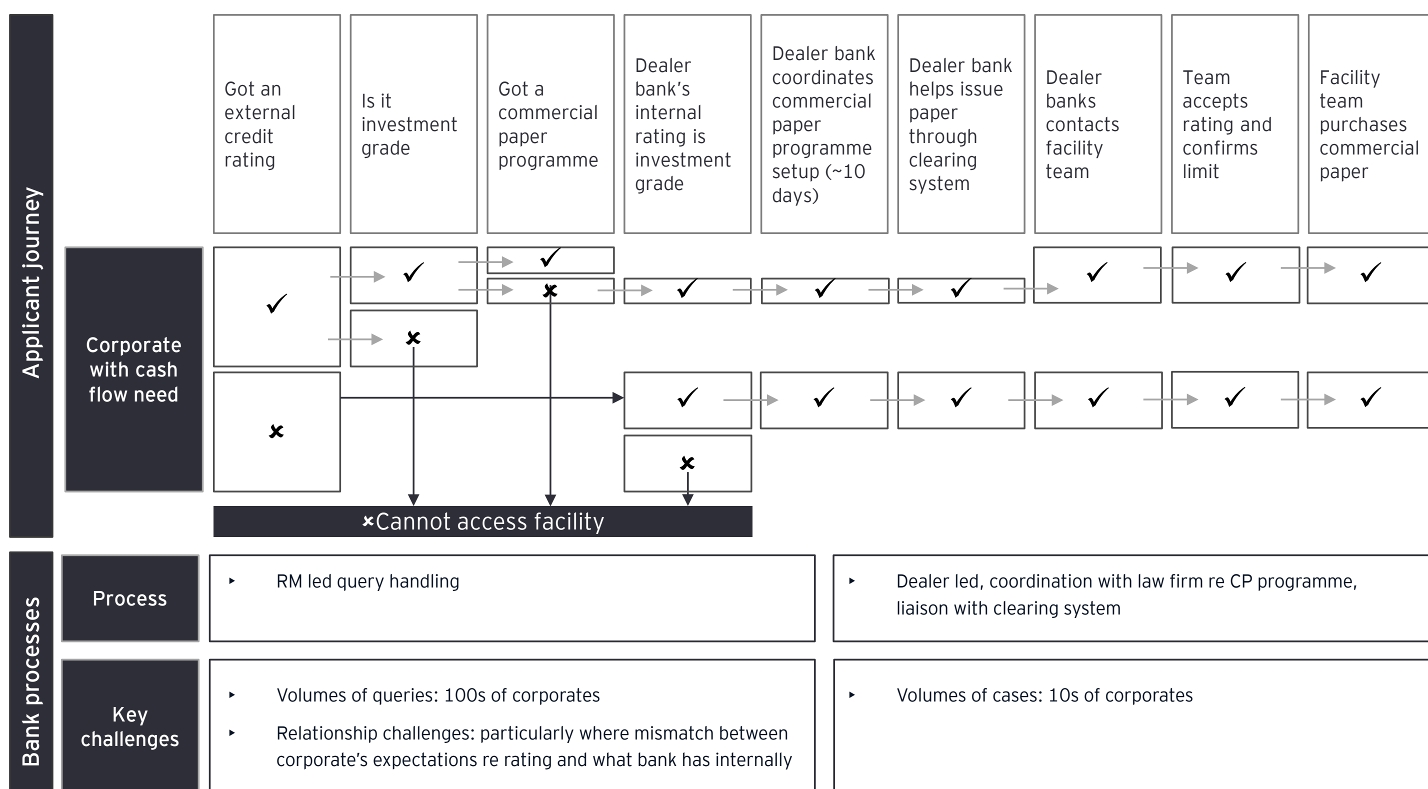
The PEPP has an overall envelope of €750b. The ECB has the power to terminate the PEPP once its Governing Council considers that the current crisis phase of the epidemic is over.

On 7 April 2020, the ECB announced that it will accept a wider range of loans and other assets, including Greek Government Debt, as security for funding. It also reduced the "haircuts" it applies to the value of collateral it accepts, so banks can get more funds with the same amount of assets.

A similar measure has been implemented in the UK as well with HM Treasury and the Bank of England launching the COVID-19 Corporate Financing Facility ("CCFF") on 23 March 2020. The CCFF will be available to non-financial firms that make a material contribution to economic activity in the UK and that had an investment grade credit rating or equivalent on 1 March 2020.

Commercial paper financing facility: applicant journey and bank process flow

This chart below displays the applicant journey and bank process flow for a Commercial Paper Financing Facility, highlighting the factors that would prevent an applicant from accessing the facility.



Scheme restrictions

The current schemes we have seen implemented appear to have a narrow scope as Commercial Paper (“CP”) programs are serving almost exclusively investment grade corporates.

At the same time, many sub-investment grade corporates also have significant cash flow challenges arising from the onset of COVID-19.

Many investment grade corporates without CP programs are now attempting to put programs in place at pace. Critical businesses, e.g., ports, airports, water companies and electricity companies do not have a funding pattern that enables them to issue CP, and/or are not structured as companies.

Potential ways to expand the scope of commercial finance paper schemes

There are two ways that access could be expanded to commercial finance paper schemes:

- Increasing availability of scheme, allow alternative rating systems, consider certain access for non-bank financial institutions
- Increase the cap for the maximum amount of a single issue that can be purchased, e.g., 70% cap for ECB

Expanding the scope of entity type would be a simple way to extend access without altering other terms.

Providing access to non-bank lenders would help credit transmission to the SME sector (Approx. 30% of SME financing is through non-bank lenders).

Accepting NAIC (or equivalent) designation as a proxy for rating or allowing credit references from the existing relationship banks can enable access for a wider community of corporates.

Business loan guarantee schemes

Many European countries have implemented loan guarantee schemes. However, there has been some challenges in implementing schemes and ensuring speedy transmission of stimulus.

Key parameters of existing schemes

Eligibility

- Local businesses
- Annual turnover cap
- Have a borrowing proposal which the lender considers viable, were it not for COVID-19

Application process

- Apply through participating lenders
- Personal guarantees will be capped at 20%, the government is providing the remaining 80%
- Final decision lies with the lender

Mechanics

- The government may cover initial interest and any lender-levied fees
- The scheme is available for a limited period of time

Examples of announced schemes

Country/Body	Guarantee %	Scheme Overview
Switzerland	85%-100%	On 25 March 2020, the Swiss Federal Council announced a government guaranteed CHF 20b financial aid package for SMEs, allowing for immediate bridging finance.
Italy	90%	The state will provide a guarantee for 90% of the credit lines provided by the banks for performing loans over a 1 year period. Any new loan losses generated from this will therefore be partially shared with the state.
France	70%-90%	French President, Emmanuel Macron, announced the government would guarantee bank loans of up to €300 billion for businesses in need of financial support. Additionally, Bruno Le Maire, the French Finance minster, has promised to provide an additional €45 billion in aid for business and employees impacted by the COVID-19.
Germany	80%-100%	The government has made up to €500 billion in loans available to companies hit by the COVID-19, most of which will be provided by the state development bank, KfW.
Austria	80%	Announced a €38b package to support companies and workers. The AWS also announced credit guarantees for SMEs.
UK	80%-100%	Coronavirus Business Interruption Loan scheme (CBILs) announced on 17 March whereby the government would provide £330b worth of government backed loans and guarantees to small and large businesses, which amounts to c. 15% of the economy's GDP.
Spain	70%-80%	Prime Minister, Pedro Sanchez, also announced that €100 billion would be made available to businesses in the form of public guarantees.
EIB	Varies	On the 16 March, it was announced that potential financing of up to €40b can be mobilized at short notice, backed up by guarantees from the European Investment Bank Group and the European Union budget.

In some cases business owners have to "exercise all available options" (including deferment of supplier payments, laying off staff and other credit). Preparation and self assessment prior to applying for any loans can materially ease the process.

Potential ways to expand the scope of loan guarantee schemes

Extending the criteria for access to bank loan guarantee schemes

- Increase turnover thresholds and max loan size in order to minimize "gap" between the two types of scheme
- Remove requirements for banks to underwrite for a bank loan first
- Extend access to non-bank financial companies
- Increase use of automation and AI for underwriting of simpler cases

Adjusting the conditions

- Consider increasing guarantees for companies based on underwriting criteria, up to 100%
- The maximum term of loans should be increased to 6–10 years
- Consider prioritizing loans to harder hit sectors (construction, tourism, hospitality, etc.)

Next - Restarting the economy

Companies emerging from the lockdown will require access to funding to resume trading. Measures will be required to restart businesses who will need cashflow as many will have used reserves. Recapitalisation could take different forms from conversion of debt to the injection of new funds based on the individual circumstances.

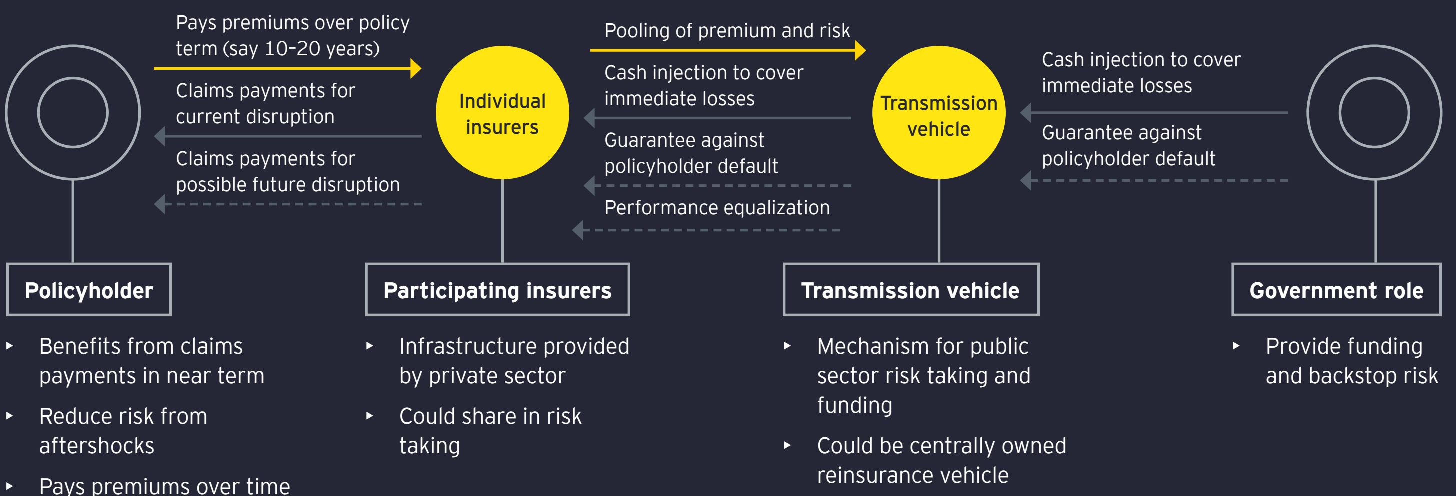
Alongside the banks we think that private sources of capital need to be incentivised to support businesses in parallel with government. This could range from investment funds, private equity and insurance firms.

An illustrative insurance concept

A long-term insurance product which covers pandemic business interruption – including the current COVID-19 pandemic, could be an efficient mechanism to provide relief to enterprises with limited borrowing capacity.

The contract would likely be loss making in the first year. But it would have either a multi-year duration or compulsory renewal with adjustable premiums based on a claims experience related formula. This would mean that insurers could recover their position. This would have the benefit of cover now as well as protection for risks during and after recovery. This product would suffer from credit risk impacting lapses and so would need to be backstopped by the government to be economic for insurers. However the backstop help would emerge over the next 10 to 20 years rather than up front on a cash basis.

Insurance solution – illustrative model



Policyholder

- Benefits from claims payments in near term
- Reduce risk from aftershocks
- Pays premiums over time

Participating insurers

- Infrastructure provided by private sector
- Could share in risk taking

Transmission vehicle

- Mechanism for public sector risk taking and funding
- Could be centrally owned reinsurance vehicle

Government role

- Provide funding and backstop risk

To maintain stability of the insurance industry – and to protect against further economic damage which could be caused by its failure – some of these activities could only be delivered in partnership with government. Careful consideration is needed as to whether some aspects are better addressed by other mechanisms e.g., tax or banking system.

Beyond - Building systemic options to address the overhang

Systemic options are required to address the expected severe overhang. In the aftermath authorities will have to deal with large-scale defaults and insolvencies. There will be a stark increase in companies that will need restructuring or to be resolved. European or national solutions will be needed for the growth in NPLs within the banking system.

Amongst the tools that may be utilized to build systemic support:

- Lender of last resort scheme
- Asset management companies
- Asset protection schemes

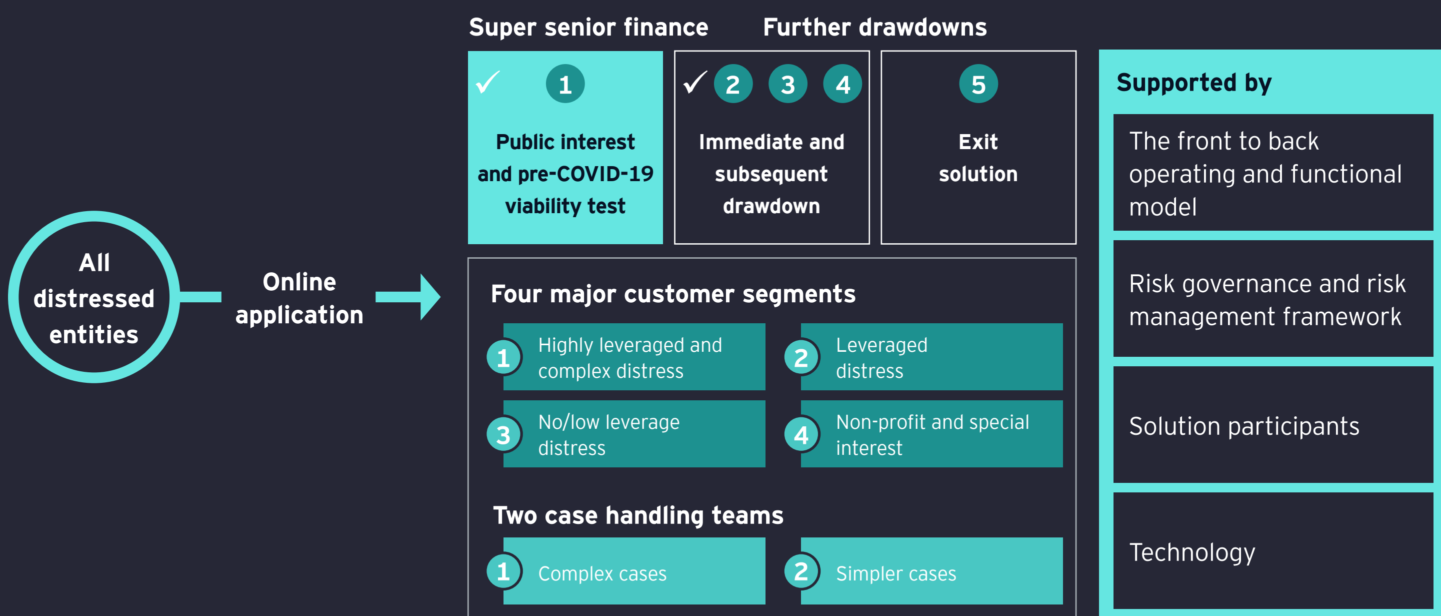
Lender of last resort scheme

Insolvency frameworks around Europe are not uniformly facilitative of the provision of rescue financing. Consideration should be given to the facilitation of a form of 'debtor in possession' financing.

The process would need to be customized for segmented handling, underwriting and restructuring.

The key segments would be:

1. Highly leveraged and complex distress
2. Leveraged distress
3. No/low leverage distress
4. Non-profit and special interest



Both initial and subsequent drawdowns would need to be purpose built and could be tailored to the level of business size and complexity.

For the initial drawdowns, the loans would need to be ranked super senior. In terms of maturity, they should be very short-term, up to 4–12 weeks, subject to risk and operational flow smoothing.

All debt and debt like claims would be subordinated. The sizing of the loan would be based on net cash flow needs, excluding debt and debt like claims. Other conditions will include taking of security over all relevant entities, accepting stewardship terms and sanctions. Warrants are triggered at default.

Subsequent drawdowns would also super senior. In terms of maturity they would be extended for a slightly longer term, up to 6–12 months.

As part of the structure, there would be an interest incentive for early repayment in the form of reduction on amount.

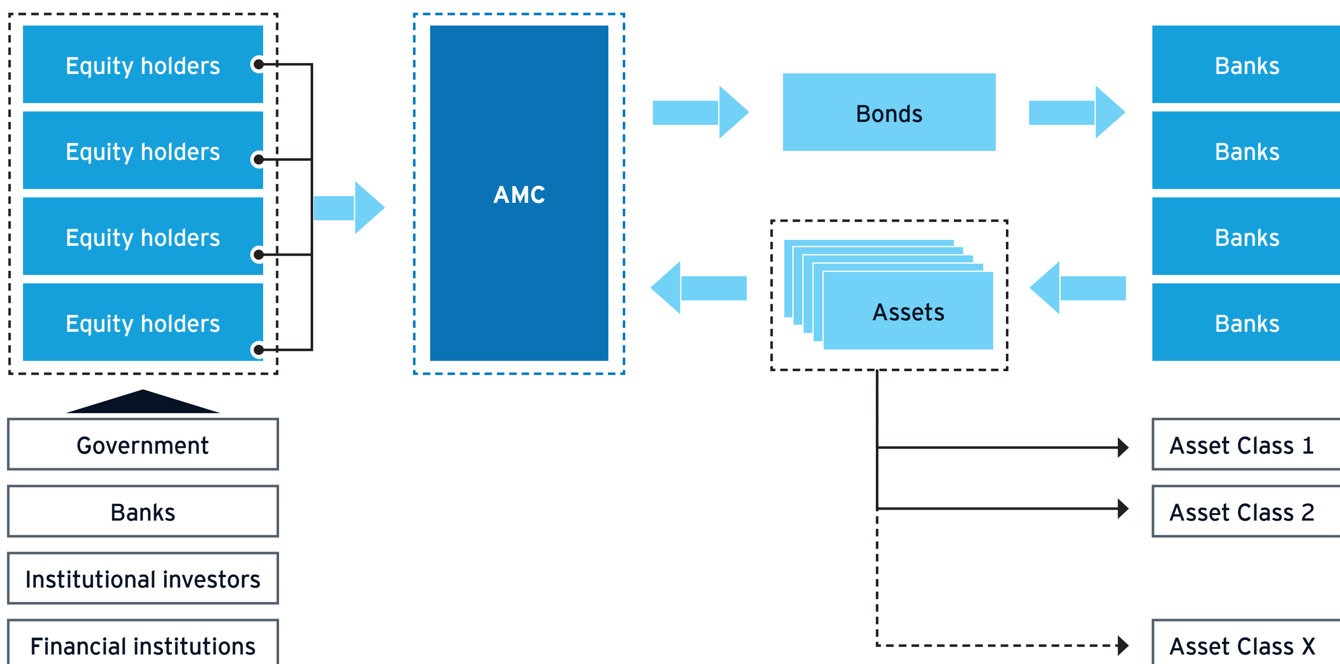
Asset management companies

Following the crisis there will be a surge of non-performing exposures in the bank's balance sheets. Banks would need to have available options with sufficient government support to swiftly dispose of NPLs and resume their lending.

A government owned Asset Management Company (AMC) can take the role of freeing banks from NPLs and with sufficient state support can provide adequate solutions to the underlying borrowers.

The AMC will be more complex than historical examples - the exposures will include not only real estate backed loans but a range of different loans, and potentially on a much larger scale.

The specific type of AMC needed in this case is likely to cover classes of operating businesses, requiring specific operating model, governance and funding.



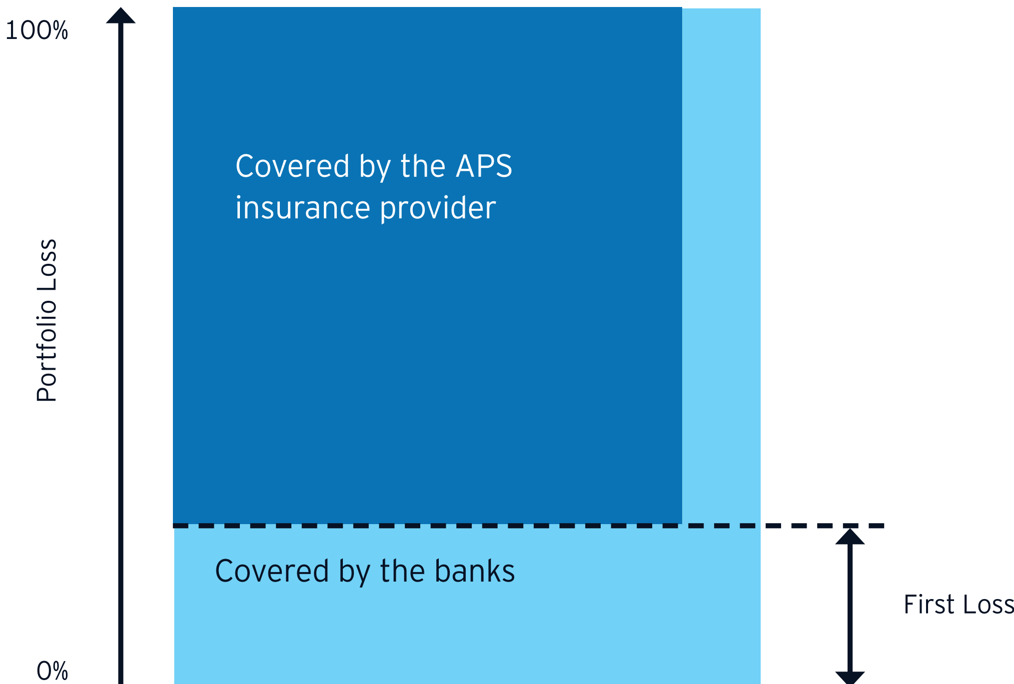
Asset protection schemes

Banks will face an increase in NPLs while at the same time they will be under pressure to increase the provision of credit into the economy.

Asset protection schemes (APS) could be another instrument that could become useful in stabilizing the financial sector and supporting the banks in resuming lending. These have also proven useful in the 2008–2009 financial crisis, yet they come along with certain costs and a need to protect the public interest.

In essence, an APS is a risk sharing scheme, through which the government provides the banks with protection against losses on a pool of assets deemed eligible. The structuring is usually designed to include a first loss retention by the banks participating, with no compensation being paid for the losses up to the first percentage of the agreed value of the loan pool. Once the first loss level is reached, further losses are effectively insured for the rest of the value on the entire asset pool. However, in order to continue the diligent management of the loan portfolio, after the first loss threshold is exceeded, the banks should still cover a fraction of further losses for appropriate incentive alignment.

The assets continue to be managed by the bank and remain on the banks' balance sheets. However this is subject to certain controls and restrictions, even possibly having an independent manager appointed. Additionally banks may be asked to provide commitments to increasing funding to the rest of the economy.



Conclusion

Governments, central banks, regulators and supervisors have introduced a huge amount of stimulus to provide liquidity for companies and individuals impacted by COVID-19. Speed is of the essence with Government, banks, and industry working hard to translate these commitments into action. As restrictions around the world are eased focus is turning to the next phase where there is a need to restart businesses and revitalise economies. This will need new schemes which provide rescue financing involving a combination of debt and equity financing that provide time and space for companies to rehabilitate, preserving jobs and supporting the recovery. Moving beyond these immediate needs longer-term options will be required to deal with the growth of non-performing loans and debt overhang.

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