Floating Britannia Through COVID-19: What Could the Treasury's March 2020 Announcements Help Achieve for British Business?

In the week commencing 16 March 2020, in anticipation of increased social distancing and isolation measures which have since been announced by the Prime Minister of the United Kingdom in the face of sharp increases in COVID-19 positive cases and related deaths, the Treasury and Bank of England jointly announced a raft of measures aimed at alleviating the short to medium term pain to be felt by British business and workers and looking to limit any long term negative macro-economic impact.

Purpose

In this note, we focus mainly on what would appear to be the reasoning behind the two main business funding schemes announced, the details of which have emerged in the week commencing 23 March 2020 – the Covid Corporate Financing Facility (CCFF) and Coronavirus Business Interruption Loan Scheme (CBILS) – as well as touching on other business reliefs and measures for individuals.

Background and Comparisons With the Credit Crunch of 2007/8

In trying to understand the Treasury's and Bank of England's (BoE) collective reasoning, it is perhaps helpful to look at some of the parallels and distinctions between the onset of the credit crunch in 2007/8 and now, and lessons that have been learnt in the intervening period. Certainly, in both circumstances, the result was and today will be increasingly unprecedented levels of business paralysis. However, there are a number of key differences. In 2007/8 the markets were overvalued, debt was exceptionally cheap, covenants were relaxed to a level never before seen, banks were significantly overstretched and, most importantly, the proliferation of complex financial instruments involving certain types of securitisation meant that huge swathes of investors, financial institutions and insurers had no idea what the underlying credits were that they were investing in or insuring against. Hence, financial institutions found it almost (if not completely) impossible to mark to market their investment holdings, trust disappeared to be replaced by fear and suspicion and credit markets began to dry up at a time when the only credit that had been available came from banks, some large and sophisticated insurance and pension companies, and (certainly in Europe) a minority share debt capital market and securitisation market. The LIBOR market spiked with lenders refusing to lend to each other and before alternative funders (both regulated and unregulated) emerged en masse to try to fill the funding gap in an increasingly regulated financial institution market. Liquidity dried up, almost overnight.

On 1 February 2020 markets were generally considered not to have been massively overvalued, debt was overall less cheap than immediately before the 2007/8 crash, far more regulation surrounded the securitisation markets, requiring greater reporting, disclosure and investor due diligence and meaning that the levels of transparency were far greater than in the credit crisis and, generally, the financial institutions are in decent health judging by the recent stress test results and careful management by the Bank of England through the Prudential Regulation Authority and Financial Conduct Authority since the credit crunch. Crucially, the threat posed by a pandemic such as COVID-19 is one that is finite – a vaccination will be found that is effective and medicine developed to alleviate symptoms so that fewer sufferers require intensive care. However, in the meantime, stringent measures need to be taken by government to try to "flatten the curve", which results in a lockdown of people and a significant proportion of business.

Treasury and BoE Purpose in Introducing Economic Stimulus

Quite simply, the purpose of the unprecedented stimulus package announced is to keep Britain afloat (or, if you prefer a motoring analogy, to keep the British motor running) for the finite period referred to above and to try to ensure that a large proportion of the economy can tread water until the curve has been flattened. If companies, rather than going bankrupt and making their employees redundant, remain in being with their employees ready to go, they can self-evidently resume economic activity much more quickly. If successful, this will mean that, rather than another stuttering economic recovery of 10 or more years akin to that experienced following the credit crunch, requiring very challenging austerity measures, the economy can kickstart with a flourish, with businesses strategically poised to resume and grow quickly, providing some of the tax receipts that will be necessary to help pay off the massively increased debt.

Covid Corporate Financing Facility (CCFF)

The CCFF, further details of which were published on 23 March 2020, is the main driver to maintain liquidity for large, strategically important (non-financial institution) companies that are "fundamentally strong" and make a "material contribution to the economy" of the UK. In essence, the BoE will purchase short dated unsecured commercial paper debt (CP) issued by such companies, provided they are "investment grade" (with short term ratings of at least A3/P3/F-3/R3 from any of the main credit rating agencies of Standard & Poor's/Moody's/Fitch/DBRS Morningstar) as of 1 March 2020, at a rate and on terms reflective of rates available prior to the COVID-19 outbreak.

The reasoning behind this intervention is clear. Some of the largest FTSE100 and FTSE250 companies will suffer and their credit ratings will dip (possibly significantly) over the coming weeks and months. Provided they were fundamentally strong pre-crisis, these companies' long term stability and viability remain integral to the UK economy as employers, taxpayers and suppliers/buyers in numerous intricate and integrated supply chains and the Treasury should merely be replacing existing debt that might be defaulted against through breach of covenants due to the crisis with the same amount of debt, but not at elevated margins. The hope is that, as the crisis starts to diminish, these companies can revert to private debt sources (whether through publicly traded CP markets or financial institution debt) to refinance the BoE CP purchases in full without having been crippled by distressed levels of debt servicing or restructuring.

Sensibly, the Treasury and BoE have stated that companies should approach named contacts at the main banks providing CP facilities. Although not impossible, it will be more difficult for a company that does not already have a CP issuance programme to access this facility, as they will need to secure a backward looking rating, as at 1 March 2020, of at least investment grade and the BoE has not published any standard documentation to issue directly. A fully cleared (through clearing systems) rated programme will need to be established, with attendant time and cost implications. However, it is possible that fundamentally strong companies with existing syndicate bank revolving credit facilities of sufficient size would be able to set up such a facility in the event of covenant breaches outside of their control, likely in conjunction with the bank syndicate to ensure a smooth temporary transition. This is particularly true if the relevant bank lenders have assigned internal ratings to such companies' debt equivalent to investment grade under an internal ratings-based (IRB) approach to risk weighted capital requirements. In that vein, it is helpful that the International Capital Market Association has made European CP materials available to non-members and announced a suspension of certain reporting requirements.

Coronavirus Business Interruption Loan Scheme (CBILS)

This scheme is aimed at SMEs with a borrowing proposal that would have been considered viable for a fully commercial loan with the relevant lender, but for COVID-19, that represent the fastest potential growth in terms of employees and income (and, therefore, tax receipts from both) in the UK economy and is designed to enable financial institution lenders to have greater confidence in providing finance to small businesses. The key difference between CBILS and the CCFF is that the loans will be made available by an accredited lender and partner of the British Business Bank and applications need to be made through one of them. The Treasury will cover the first 12 months of interest of a maximum £5 million loan, making this period interest free to the borrower, and will also guarantee 80% of the principal of each loan. Amongst eligibility criteria, the company needs to have less than £45 million annual turnover and to generate at least 50% of its turnover from trading activity. The CBILS covers a range of finance products, including term facilities, overdrafts, invoice finance facilities and asset finance facilities. Again, the aim is to ensure liquidity to this end of the market, but also a degree of credit support through the guarantee.

Additional Business Support

The Treasury and BoE have also announced other measures, including (amongst others) grant relief from business rates for small businesses, relief from business rates for retail, hospitality and leisure businesses (including shops, restaurants, cafes, drinking establishments, cinemas, live music venues, properties for assembly and leisure, hotels, guest and boarding premises and self-catering accommodation) and support with statutory sick pay and some business tax liability relief for SMEs, and individuals in financial distress.

In addition, the VAT deferral and job retention schemes (the latter gaining most headlines with its promise to pay employees 80% of their wages to a maximum ceiling to keep them employed if they would only be being made redundant due to the crisis) are due to come into force in the coming weeks. There is also discussion (although by no means certain) of corporate tax deferral and deferral or waiver of PAYE and National Insurance in the future, if necessary. However, it must be remembered that the Treasury's purpose in bringing into force these measures is to mitigate against the negative impact to companies' and individuals' financial viability brought about directly in response to COVID-19. It is not intended to be an opportunity for companies to derive additional benefit, rather, that sound companies which would otherwise have found it hard to continue will weather the crisis and resume their activities quickly.

The "Gap" Issue

A number of commentators and many of our clients are questioning the "gap" between what is available for the large rated UK corporates under the CCFF and what is available for SMEs pursuant to the CIBLS. This may lead to the Treasury looking again at measures to mitigate. It is also possible that the CCFF may be relaxed, although the intention of that scheme seems very much one of providing liquidity, rather than credit support. The Treasury will also point to the raft of measures (some of which are touched upon in the section above). It is certainly the case that retaining liquidity for the larger companies should have a positive knock-on effect in terms of supply chains, with benefits particularly into mid-tier companies. Also, when the worker retention scheme comes into force, it should alleviate some of the cash flow issues, particularly as payments will be backdated to 1 March 2020.

There is also growing concern for many self-employed workers, who will not benefit from the worker retention scheme. The Treasury has pointed out that extending the worker retention scheme to those individuals as it stands would not work, as under the announced scheme it is companies that will be reimbursed for 80% of furloughed employee salary costs (up to the cap) and it is much more difficult to verify the direct impact of COVID-19 on their income, but it seems likely that some measures will be introduced over the coming weeks to at least partially alleviate those suffering most.

It also seems likely that other businesses forced to shut, such as dentists, hair salons, etc., will need to be included in the grant relief from business rates in the future.

Conclusion

The UK's financial institutions are generally in sound financial health, able to withstand stress testing in the short to medium term, and there is no systemic lack of trust in those institutions' financial viability. The new governor of the BoE is widely regarded as the ideal person at the helm of the BoE at a time of crisis such as this. The Treasury and BoE appear to be very sensibly "joined up". Lessons have been learnt from the credit crunch of 2007/8 and its aftermath. The Chancellor of the Exchequer has made it clear that not all businesses will survive and the Treasury cannot protect against all losses. However, the fiscal stimulus package announced is unprecedented and aimed to keep a significant proportion of the economy, businesses and individuals afloat for a finite period. Let us all hope it does just that.

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