SQUIRE PATTON BOGGS

Mind the Gap – Watching Out for the Squeezed Middle:

Will the 3 April 2020 Treasury Announcements Be Enough to Unlock Funding for British Business?

In our article published on 25 March 2020 ("Floating Britannia through COVID-19"), we compared the current crisis with the credit crunch and aftermath of 2007/8 to look at the purpose behind the COVID Corporate Financing Facility (CCFF) and Coronavirus Business Interruption Loan Scheme (CBILS), both launched on 23 March 2020. We also touched on certain other announced fiscal stimulus measures to keep the British motor running through the economic crisis caused by the COVID-19 pandemic.

Just over a week on, have these measures been successful? And what of the "gap" issue – those companies that are not (or not deemed to be) investment grade and therefore not strong enough to benefit from the CCFF, and yet have annual turnover above the £45 million limit for CBILS loans?

The 3 April 2020 announcement attempts to address both questions.

Successes and Failures of the CCFF to Date

The Chancellor announced on 3 April 2020 that £1.9 billion of funding had already been provided to firms and a further £1.6 billion had been committed, which is a good start given resources available. The majority of that has, we understand, been provided and committed to businesses with existing investment grade commercial paper (CP) programmes, which can be easily refinanced through the CCFF.

The situation is rather different, however, for those companies without formal investment grade debt (whether through CP or syndicated lending). Relationship banks have (to a greater or lesser degree) been helpful in providing letters in support of applications confirming that they treated the debt of a company prior to 1 March 2020 as investment grade for the purposes of their internal ratings-based approach to risk weighted requirements.

However, one of the stipulations of the CCFF is that the debt must form *unsecured and unsubordinated obligations* of the issuer, ranking at least *pari passu* with any other existing unsecured debt. What is unclear is how this is designed to work where companies have existing bank facilities that are secured and whether the lenders under those facilities are assigning an investment grade to the company on the basis of the security or otherwise.

In addition, there are a number of companies that have existing asset-backed CP (ABCP) funding through bank conduits. Whilst the CCFF terms jointly published on 23 March 2020 by the Treasury and Bank of England made clear that refinancing a bank's own CP programmes is excluded from the CCFF, it is still unclear whether such companies will be able to refinance CP issued in such a way through the CCFF in the absence of general market liquidity. Arguably, this should be attractive to the Treasury, as there is already built in credit enhancement to such programmes.

Further, there are some companies that would seem to be able to qualify for CCFF, but which have divisions incidental to their business which provide extended credit terms for purchasing goods or services sold by them. It is, as yet, unclear whether such businesses should be excluded as financial companies or not.

Successes and Failures of the CBILS to Date

Implementation of the CBILS has attracted greater criticism. Many supposedly eligible businesses have failed to access the support. Only £90 million of loans had been approved for 983 businesses as at 3 April 2020, against a reported 130,000 applications. The reasons for this are varied and we address some of the main ones below.

First, the initial purpose of both the CCFF and the CBILS (particularly the CCFF) was to provide liquidity to British business for a finite period until debt markets went back to trading normally. Their purpose is not credit enhancement. The government clearly hopes to recover any capital outlay in the medium term. This is quite distinct from measures such as furloughing of employees through the job retention scheme. These comprise direct grants that will need to be recouped through growth and/or taxes in the future.

It also seems that the Treasury and the Bank of England expect the banks that had been saved through the credit crunch of 2007/8, and then regulated to a position of greater strength and resilience to future crises, to step up and make these loans available. However, this is asking those banks, notably their credit and risk departments, to override the very processes that have been painstakingly introduced, modified and finessed over the last 10 years – all in one week!

Second, it was a condition of the CBILS that SMEs would first have to show that they could not secure regular commercial financing (rates for which have understandably increased in recent weeks) before they could access the scheme.

Third, as matters stand, lenders are aggregating the turnover of private equity portfolio companies under common ownership and control. (This is similar to the approach taken under the Coronavirus Aid Relief and Economic Security (CARES) Act in the US which imports the Small Business Administration's affiliation rules.) This applies regardless of the diversity and lack of synergies within the portfolio. The effect is that, in all but the most exceptional cases, private equity portfolio companies will exceed the £45 million turnover threshold and, therefore, be ineligible for CBILS support. Lenders have sought clarification on this approach from the government.

Finally, there is a question of resources available to approve and process given the unprecedented volume of applications and the difficulty for some SMEs to contact their relationship banks, which themselves are struggling with forced alternative working arrangements and other issues related to the economic fallout from this pandemic. This was initially compounded by the comparatively small number of lenders accredited for CBILS.

What Has Been Announced in Relation to the CCFF, the CBILS and the "Squeezed Middle" on 3 April 2020?

Announcements in Relation to the CCFF

The government has suggested that it is evaluating the CCFF. We assume that the ability of companies without existing CP programmes or official credit ratings to access the scheme will be part of that evaluation.

We are expecting further announcements on the CCFF in the week commencing 6 April 2020. Hopefully, these will address some of the issues raised above.

Announcements in Relation to the CBILS

The 3 April 2020 announcement has removed the requirement for companies to show they are unable to secure regular commercial financing due to having insufficient security headroom. CBILS is now ostensibly open to "all viable businesses affected by COVID-19". Lenders may, therefore, take security in relation to a CBILS loan.

The Treasury also suggested they would be "making operational changes to speed up lending approvals", although it is unclear what these will entail at present.

There was no comment on the private equity portfolio company issue referred to above. It seems that sponsors are being asked to inject liquidity themselves. However, many sponsors are not configured for this. Notably, they are funded through capital raises that are closed after an initial period. This makes their ability to provide short-term liquidity funding less straightforward than it would be for a bank.

Announcements in Relation to the "Squeezed Middle"

Following intense lobbying from business, the Treasury announced the introduction of a new Coronavirus Large Business Interruption Loan Scheme (CLBILS) for businesses with an annual turnover of between £45 million and £500 million and for loans up to £25 million.

In common with the CBILS, the government will provide a guarantee of 80% of the amount lent. The Treasury stated that "loans backed by a guarantee under CLBILS will be offered at commercial rates of interest" and that "further details of the scheme will be announced later this month". Market expectations are that the terms and conditions of this new scheme will be similar to CBILS.

Whilst undoubtedly welcome, again the efficacy of the CLBILS will determined by how quickly desperate businesses, who have already availed themselves of all the other support measures available to them, including (where relevant) furloughing of employees through the job retention scheme, deferral of business rates, PAYE, National Insurance, corporation tax and VAT, are able to access these loans.

Another consideration will be how such loans will fit with existing debt of those businesses, both secured and unsecured. As more sizeable businesses, CLBILS borrowers are likely to have more complex capital structures. Inserting additional debt into such structures may well necessitate intercreditor negotiations with other creditors.

The further down the capital stack the CLBILS loans are, the more that they will look like riskier credit enhancement loans, which would attract higher "commercial rates of interest". Yet what is the incentive for existing secured lenders to accept increased debt ranking alongside them on a *pari passu* basis? Will certain larger corporates who have already initiated applications under the CCFF be pushed into the CLBILS, with attendant potentially much higher debt service coverage costs?

Given these negotiations may take time, the government should publish the full eligibility criteria as soon as possible so potential borrowers can commence discussions.

Conclusion

There has obviously been mixed initial success for the government's aim of keeping British businesses afloat through a combination of financial support measures, including the CCFF and CBILS.

We have been in discussions with many clients on these schemes. We are constantly receiving feedback from them on both schemes. Along with them, we await further announcements in relation to the CCFF in the week commencing 6 April 2020, when we hope that some of those questions will be addressed.

In relation to the CBILS, we hope that the clarifications announced on 3 April 2020 (along with operational changes) will help to speed up the deployment of monies to desperate SMEs, especially given the numerous applications from alternative lenders to be accredited to provide loans under the CBILS which are being processed in order to take the strain off the other named institutions. However, the government has continued to stress to lenders that loans under the scheme should only be on the basis of need. That said, lenders are open to arranging CBILS loans for borrowers with cash reserves, but on condition that those reserves are used first.

In relation to the CLBILS, further details of the scheme are needed quickly, although the announcement itself is welcome news.

Trying to ask banks that have kept to stringent laws and regulations for the last decade to change their risk decision making processes overnight, and yet avoid becoming casualties of this crisis themselves, is not straightforward, and it is not surprising that the number of successful applications to date (particularly for the CBILS) has not been greater. But these new measures, combined with the government's evident determination to get cash into the economy on an unprecedented scale will certainly provide some more impetus.

What is clear is that the CBILS, the CLBILS and even, potentially, the CCFF are not just needed to plug the liquidity gap left by the economic shock of the pandemic and measures to fight it, as well as the increasing unavailability of refinancing of short term CP in public markets, but also as credit enhancement for British business and the private UK economy as a whole.

It is highly possible that direct losses under the 80% Treasury guarantees in relation to the CBILS and CLBILS will be greater than initially thought, with the attendant long-term issues for the economy that brings. However, the hope remains that, if businesses can stay afloat through all these measures, when growth restarts it will be on a steep upward trajectory to mitigate against these losses and enable companies that would have faced insolvency to grow quickly and continue to employ staff and pay deferred taxes.

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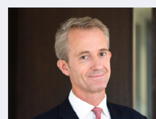

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