The Treasury

Business Finance Guarantee Scheme Information Release

January 2021

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TE TAI ŌHANGA
THE TREASURY

Treasury Report: BFGS: Restricting the use of Personal Guarantees

Date:	28 May 2020	**Report No:**	T2020/1678
		File Number:	SH-1-6-1-3-5-2-1-1 (Final Treasury Reports and Cabinet Papers)

Action sought

	Action sought	Deadline
Hon Grant Robertson **Minister of Finance**	**Indicate** your preference for the personal guarantee options that officials will investigate and report back to you in mid-June. **Agree** to discuss your objectives and preferences, regarding personal guarantees, with officials.	3 June 2020

Contact for telephone discussion (if required)

Name	Position	Telephone	1st Contact
Anthony Powell	Senior Analyst, BFGS	[39] [35]	
Kate Le Quesne	Manager, BFGS		✓

Minister's Office actions (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report	

Enclosure: No

Treasury Report: BFGS: Restricting the use of Personal Guarantees

Executive Summary

You recently asked Treasury to report back on options to restrict or prohibit personal guarantees for Business Finance Guarantee Scheme (BFGS) loans (T2020/1239 refers). In the previous report, Treasury had recommended against either prohibiting or restricting the use of personal guarantees by banks on the basis that it would be likely to reduce the provision of credit to businesses where it would be standard practice to use a personal guarantee to support the loan. We also highlighted there was likely to be a high level of legal and administrative complexity in the implementation of this option.

This report provides you with some further advice on personal guarantees. Any option you wish to consider will need to be discussed and agreed with banks and effected through an amendment to the Deed of Indemnity.

We recommend that you consider all changes to the scheme as a single package when we report back to you with a scheme settings review in June. Considering this issue in isolation is difficult because of the links with other parts of the scheme. As a part of the upcoming review we will provide some advice around the current repayment waterfall (described below) which will help to further inform your choices around personal guarantees. A change, for example isolating the supported loans away from non-supported loans, may also be effective in limiting the use of personal guarantees.

The purpose of the BFGS is to provide a credit cushion to encourage banks to support otherwise viable firms temporarily impacted by COVID-19. We understand your concerns to be around the fairness of relying on personal guarantees, particularly those supported by mortgages over a business owner's home, given the Crown is covering 80% of the risk under the loans.

Since you requested further advice on this issue, you have announced the Small Business Cashflow Scheme (SBCS). The SBCS has provided another avenue, particularly for smaller SMEs, to receive credit. It is unsecured and does not place any reliance on personal guarantees. If you wish to make further unsecured credit available to businesses, a change to the SBCS would be more effective as you have direct control over scheme settings.

Treasury has recently provided advice that the SBCS be extended for a further 6 weeks until 24 July, and that we will report back on possible changes to scheme settings if it is further extended beyond 24 July (T2020/1621 refers).

The BFGS is a loss sharing arrangement. Under the current terms of the BFGS, the amount of the loss (which is shared between the bank and the Crown) is arrived at by applying repayments (whether from the primary borrower, or from guarantors), to repay:

- first, the bank's costs and expenses
- second, to the borrower's non-supported loans with the bank, and
- third, to the borrower's supported loan.

This is referred to as the repayment waterfall. The amount of the supported loan that is still outstanding after payments have been applied in accordance with the repayment waterfall is the loss. Under the Deed of Indemnity, the Crown pays 80% of the loss to the bank, and the bank bears the other 20% of the loss.

In considering your options around personal guarantees it is important to consider the structure of the waterfall and your objectives under the loss share arrangement. If a borrower has insufficient proceeds from other assets to repay non-supported loans, and the bank holds a personal guarantee, a bank is likely to call the personal guarantee to repay non-supported loans, as these must be repaid first prior to supported loans.

There are two broad options if you wish to restrict or prohibit the use of personal guarantees. There are other options if you wish to reduce the risk that a bank calls upon a personal guarantee.

Option 1: Restrict the use of personal guarantees on supported loans

This option would restrict the amount of proceeds under a personal guarantee that would be applied to repay the supported loan. This has the effect of reducing the security available to banks and the Crown.

Our view remains that restricting or prohibiting the use of personal guarantees is likely to reduce the provision of credit through the scheme, particularly to smaller SMEs whose banks would normally rely on the use of a personal guarantee.

You may still be interested in pursuing this option on the basis that the SBCS scheme provides support to smaller SMEs. One sub-option for you to consider would be to limit this restriction to loans of a certain size, say, $25,000 or less.

The equivalent UK scheme has implemented a permutation of this option. At this stage we do not have insights into precisely how this operates or how effective it has been. We are investigating this further and it will inform future advice.

Option 2: Reduce or limit the use of personal guarantees with respect to the Crown's share of risk

If your objectives relate to restricting the Crown from receiving proceeds of personal guarantees, you could seek to allow banks to apply the proceeds of personal guarantees to their share of the risk of supported loans, whilst the Crown, for example, could bear the loss in the event of default, unsupported by any guarantee arrangements sought by banks.

This approach would be consistent with the objectives of the BFGS, and would support the provision of credit by allowing banks to manage their risks consistent with standard practice.

In effect this approach changes the repayment waterfall, and in most scenarios, would effectively result in a 100% Crown risk share. As such, the policy, commercial and legal considerations would need to be carefully worked through.

Other Options:

The most straightforward way to limit the use of personal guarantees would be for the Crown to increase risk-share on supported loans (likely to 100%). This would come with higher fiscal cost and reduce incentives on banks based on their risk share.

There are also options within the Deed to make more explicit the Crown's desire to not rely on the proceeds of personal guarantees. This could involve being more explicit that a settlement (rather than enforcement) of a loan is acceptable to the Crown and losses will be covered (albeit this is already a feature of the agreement).

To make this effective, you may wish to simultaneously consider isolating supported loans from non-supported loans. That is, if a borrower failed to make a repayment defaulted, on a supported loan, banks would not automatically have to enforce their securities and seek repayment for all loans outstanding, meaning a personal guarantee is less likely to be called upon. Again, this represents a material structural commercial and legal change to the document and needs to be carefully considered in conjunction with all other changes.

All options require further investigation and need to be tested with the banks

Imposing restrictions on personal guarantees would materially increase administrative and credit assessment complexity for the banks. This is because the default position under standard bank lending documents is that all of the bank's lending to a particular borrower has the benefit of all security granted in respect of that borrower's debt (including security granted under personal guarantees). Increasing the administrative complexity of the scheme greatly could have the effect of banks abandoning use of the scheme.

Bank systems are not set up to assess creditworthiness and make lending decisions on the basis that some lending may not have the full benefit of new or existing personal guarantees.

Some of the changes described above represent a material departure from the original scheme design and need to be fully commercially and legally tested in conjunction with other proposed changes.

Next steps

We seek an indication on your preferred approach and objectives with respect to personal guarantees. However, due to the potentially substantive changes to the scheme that may be required as a result of your preferred approach, we recommend waiting until you consider broader changes to the scheme in June before making a firm decision on this issue.

We prepared this advice with some urgency so the RBNZ has had limited time to provide substantive feedback. We will continue to work closely with RBNZ in developing BFGS related proposals and will ensure their views are reflected in final recommendations regarding scheme changes

Recommended Action

We recommend that you:

a **indicate** your preference for the options that officials will investigate and report back to you in mid-June based on your objectives to (please circle):

i. Seek to restrict the use of proceeds of personal guarantees on supported loans. This would restrict both the Crown and the banks reliance on proceeds of personal guarantees with respect to supported loans.

ii. Seek to reduce or limit the use of proceeds of personal guarantees with respect to the Crown's share of risk. This may involve changing the payment waterfall or the Crown's risk share.

iii. Seek to reduce the risk that a bank calls upon a personal guarantee by considering other options, which may include isolating supported loans from non-supported loans.

b **agree** to discuss your objectives and preferences, regarding personal guarantees with officials.

Agree/Disagree

c **note** officials will report back on options around the use of personal guarantees, based on your preferences and objectives, in conjunction with other setting changes in June.

Kate Le Quesne
Manager, BFGS

Hon Grant Robertson
Minister of Finance

Treasury Report: BFGS: Restricting the use of Personal Guarantees

Purpose of Report

1. We previously provided brief advice on the possibility of prohibiting or restricting banks from taking personal guarantees for BFGS supported loans as part of a recent report that resulted in various changes to the scheme aimed at increasing its uptake and better supporting businesses (refer T2020/1239: BFGS: Progress Update and Options for Enhancement).

2. You requested further advice on options to prohibit or restrict banks from taking personal guarantees for BFGS supported loans. We understand that you are primarily concerned with the standard banking practice of using guarantees to link the personal assets of business owners to the debts of their businesses, and whether this is equitable for supported loans given the Government is underwriting 80% of any bank credit losses arising from them.

3. This report provides advice on:

    - the role and use of personal guarantees in SME borrowings, and
    - options to reduce or restrict the use of personal guarantees for BFGS supported loans.

Background

4. The primary objective of the BFGS is to facilitate the provision of credit to meet the liquidity and bridging finance requirements of businesses while they deal with the disruption caused by COVID-19. The BFGS seeks to allow participating lenders to look through the economic cycle, and take account of the current uncertainty, when deciding to support new business lending.

5. Participation as a BFGS lender was initially limited to banks and then extended to Non-bank deposit takers (NBDT's). We are currently progressing the on-boarding of the Nelson [25]

6. [33]

7. [33]

8. As at 25 May, 376 BFGS loans had been approved by participating lenders with a total value of $60 million and an average loan size of approximately $160,000.

The Role and Types of Guarantees in SME borrowings

9. Banks use guarantees to improve their risk position, by obtaining from someone other than the borrower, a secondary commitment to repay the debt owed to the bank by the primary borrower.

10. Banks take guarantees from various parties who have some relationship with the borrower. Guarantees given by the individuals who own a business are commonly referred to as "personal guarantees", these are often given by related individuals or entities (such as spouses, parents, and/or the trustees of a family trust).

11. The most common context in which banks require a guarantee is where the borrower is a limited liability company. Although most shareholders create limited liability companies precisely because they wish to limit their personal liability to creditors, banks are typically not content to rely solely on the company's obligation to repay (even if this is supported by security over the company's assets, called a General Security Agreement (GSA)).

12. Banks use personal guarantees from the owners of a business for two key purposes:

    - to increase the incentives on the owners of a business to ensure that it succeeds (or at least services and then repays its debt to bank), and

    - to expand the pool of assets available to the bank in the event that the business fails to repay the bank debt.

Personal guarantees to enhance owner incentives

13. Guarantees to enhance owner incentives are given by the owners of the business (who, in the context of smaller SMEs, are usually the directors as well). These guarantees are not supported by security (for example, a mortgage over the owners' home). Although guarantees of this type theoretically give banks access to the owners' personal assets, in the absence of security, they primarily operate in practice to ensure the owners' commitment to the business.

14. Personal guarantees which are not supported by security over the guarantor's assets are primarily used in the context of bank lending to very small businesses where the level of lending is modest.

Personal guarantees to increase the pool of assets available to the bank

15. More commonly, personal guarantees are taken to increase the pool of assets available to the bank, in the event that the business defaults. In some cases, in the absence of third-party support, the borrower does not have the assets to enable the bank to justify lending at all, or at the level required by the business.

16. In this context, secured personal guarantees are critical to enable borrowers to have access to debt funding. In addition, secured personal guarantees provide important protection for the bank in the event that the primary borrower fails to repay. Secured personal guarantees may be given by the owners of the business, or related individuals or entities (such as spouses, parents, and/or the trustees of a family trust).

17. The purpose of a personal guarantee in this context is to create the repayment obligation which is then secured by a mortgage over land owned by the guarantor (or security over the guarantor's other assets, if relevant).

18. By making these additional assets, which are not owned by the primary borrower, available to the bank, the bank's overall risk position is lowered, which:

    - improves the bank's willingness to lend

    - increases the amount the bank is willing to lend, and

    - reduces the risk-based interest rate the bank charges.

Personal guarantee prevalence and BFGS loans

19. We set out below a high-level description of the prevalence of personal guarantees in the context of businesses that would be eligible for loans under the BFGS. This information is based on advice and observations from PwC (a professional services firm) and Minter Ellison (a law firm).

Annual Revenue	Less than $10 million	$10 to $50 million	$50 to 80 million
Unsupported personal guarantees	Common	Relatively rare	Relatively rare
Secured personal guarantees	Very common	Relatively common	Rare

20. The New Zealand banks have remained open for business but have been most supportive of their ‘good’ customers, being businesses that have an established relationship, existing lending and a history of profitable trading.

21. Banks have been more cautious in entering into new customer relationships, and in extending credit to existing customers who have not previously been secured borrowers.

22. Given these observations and that the maximum loan amount under the BFGS is $500,000, we expect that most borrowers under the BFGS will fall into the category of businesses with annual revenue of less than $20 million, meaning that it is very likely that banks will already have taken a personal guarantee (more than likely supported by a mortgage over the business owner(s) residential property) for the majority of potential BFGS borrowers.

23. This analysis consistent with RBNZ statistics that of the $113.19 billion of total bank lending to all firms, **at least $45 billion (40%)** is directly or indirectly secured by residential or commercial property. The percentage of bank debt that is secured is likely much greater for firms with lower turnover. It may also be useful to note that approximately 87% of firms in New Zealand have turnover of less than $1 million but these firms only account for 12% of total bank debt.

Overseas Schemes and use of Guarantees

24. We primarily looked at the details of the Australian Coronavirus SME Guarantee Scheme and the and the United Kingdom’s Coronavirus Business Interruption Loan Scheme (CBILS) in developing options to prohibit or restrict the use of guarantees for BFGS supported loans.

25. The design of the SME Guarantee Scheme and the UK’s CBILS reflect the greater sizes of their economies relative to New Zealand, and the broader and more diverse nature of both their industry structures and their bank and non-bank lending sectors. For example, the SME Guarantee Scheme has 41 participating lenders and the UK’s CBILS has 76 participating lenders

26. The SME Guarantee Scheme has a 50:50 risk share, supports SME’s with a turnover of up to AUD 50 million, has a maximum loan size of AUD 250,000 per borrower and an up to three year repayment term. The SME Guarantee Scheme is open until the 30 September 2020.

27. The SME Guarantee Scheme **only allows lenders to take personal guarantees** and excludes lenders from relying on any other securities (including over the business itself) in the repayment of the supported loans (including for the lenders 50% share).

This has the effect of making the supported loans unsecured except for reliance on personal guarantees. We understand that this feature has been implemented to ensure competitive neutrality between the variety of bank, deposit taking and non-deposit taking lenders that participate in the Australian scheme.

United Kingdom's Coronavirus Business Interruption Loan Scheme

28. The CBILS has a 80:20 risk share, supports SME's with a turnover of up to less than £45 million, has a maximum loan size of £5 million per borrower and an up to six year repayment term. The CBILS also has a 12 month interest free period funded by the UK government.

29. Under the CBILS, the UK Government has imposed restrictions on lenders taking **new personal guarantees or enforcing existing personal guarantees**, and taking security over residential property, as below.

30. For CBILS facilities below £250,000:

- no new personal guarantees can be taken, and
- existing personal guarantees cannot be enforced and the proceeds from any guarantees cannot be applied in repayment to the CBILS facility.

31. For CBILS facilities above £250,000 personal guarantees may still be taken by a lender, at the lender's discretion. If a personal guarantee is used in relation to a CBILS facility:

- a lender must only make demand on a personal guarantee once it has realised all other collateral that is available to support the CBILS facility. This includes collateral that is available to both the CBILS facility and other facilities
- recoveries under these are capped at a maximum of 20% of the outstanding balance of the CBILS facility after the proceeds of all other available collateral have been applied, and
- in addition, neither a borrower's nor a guarantor's principal private residence can be taken as security to support a personal guarantee or as direct security for a CBILS facility.

32. The effect of these provisions is to increase overall loss under a CBILS facility, which is borne by both banks and the UK Government under CBILS's 80:20 risk share. Because this overall loss is higher than it would otherwise be, even though the bank only bears 20% of the loss, its 20% share is a larger number than it would be if the bank's access to personal guarantees was unrestricted.

33. At this stage we do not have insights into precisely how the CBILS operates or how effective the personal guarantee restriction has been. We do note however that it has other unique features, such as a subsidy from the UK government to lenders for the first 12 months interest payments. We are investigating this further and it will inform future advice.

How a loss arises under the BFGS

34. The BFGS is a loss sharing arrangement. Under the current terms of the BFGS, the amount of the loss (which is shared between the bank and the Crown) is arrived at by applying repayments (whether from the primary borrower, or from guarantors), to repay:
    - first, the bank's costs and expenses
    - second, to the borrower's non-supported loans with the bank, and
    - third, to the borrower's supported loan.
35. This is referred to as the repayment waterfall. The amount of the supported loan that is still outstanding after payments have been applied in accordance with the repayment waterfall is the loss. Under the Deed of Indemnity, the Crown pays 80% of the loss to the bank, and the bank bears the other 20% of the loss.
36. The application of the repayment waterfall, and therefore the loss arising from the enforcement of any securities, has important implications for the range of options available to prohibit or restrict the use of guarantees for BFGS supported loans.
37. The application of the repayment waterfall also complicates how a loss arises, and indeed whether a loss arises for the bank, if the use of guarantees is prohibited or restricted.
38. If you decide to attempt to restrict or reduce the use of guarantees for BFGS supported loans, there are a number of potential alternatives available. These are discussed below.

Option 1: Restrict the use of personal guarantees on supported loans

39. This option would restrict the amount of proceeds under a personal guarantee that would be applied to repay the supported loan. This has the effect of reducing the security available to banks and the Crown.
40. Our view remains that restricting or prohibiting the use of personal guarantees is likely to reduce the provision of credit through the scheme, particularly to smaller SMEs whose banks would normally rely on the use of a personal guarantee.
41. You may still be interested in pursuing this option on the basis that the SBCS scheme provides support to smaller SMEs. One sub-option for you to consider would be to limit this restriction to loans of a certain size, say, $25,000 or less.

Option 2: Reduce or limit the use of personal guarantees with respect to the Crown's share of risk

42. If your objectives relate to restricting the Crown from receiving proceeds of personal guarantees, you could seek to allow banks to apply the proceeds of personal guarantees to their share of the risk of supported loans, whilst the Crown, for example, could bear the loss in the event of default, unsupported by any guarantee arrangements sought by banks.

43. This approach would be consistent with the objectives of the BFGS, and would support the provision of credit by allowing banks to manage their risks consistent with standard practice.

44. In effect this approach changes the repayment waterfall, and in most scenarios, would effectively result in a 100% Crown risk share. As such, the policy, commercial and legal considerations would need to be carefully worked through.

Other Options:

45. The most straightforward way to limit the use of personal guarantees would be for the Crown to increase risk-share on supported loans (likely to 100%). This would come with higher fiscal cost and reduce incentives on banks based on their risk share.

46. There are also options within the Deed to make more explicit the Crown's desire to not rely on the proceeds of personal guarantees. This could involve being more explicit that a settlement (rather than enforcement) of a loan is acceptable to the Crown and losses will be covered (albeit this is already a feature of the agreement).

47. To make this effective, you may wish to simultaneously consider isolating supported loans from non-supported loans. That is, if a borrower failed to make a repayment defaulted, on a supported loan, banks would not automatically have to enforce their securities and seek repayment for all loans outstanding. This would reduce the likelihood that a bank would call on a personal guarantee. Again, this represents a material structural commercial and legal change to the document and needs to be carefully considered in conjunction with all other changes.

All options require further investigation and need to be tested with the banks

48. Imposing restrictions on personal guarantees would materially increase administrative and credit assessment complexity for the banks. This is because the default position under standard bank lending documents is that all of the bank's lending to a particular borrower has the benefit of all security granted in respect of that borrower's debt (including security granted under personal guarantees). Increasing the administrative complexity of the scheme greatly could have the effect of banks abandoning use of the scheme.

49. Bank systems are not set up to assess creditworthiness and make lending decisions on the basis that some lending may not have the full benefit of new or existing personal guarantees.

50. Some of the changes described above represent a material departure from the original scheme design and need to be fully commercially and legally tested in conjunction with other proposed changes.

Risks

51. Changes to scheme settings that would restrict or prohibit the use of personal guarantees as a routine part of the credit management relationship between the bank and its customers is likely to reduce banks' willingness to make loans under the Scheme. Even if the Crown was to absorb the incremental cost of unsecured losses, the complexity of the arrangements may make it too hard for the banks to bother with continuing to offer the scheme to customers.

52. Once any changes are implemented, the scheme will have been operating for at least two months. There will be a risk that existing borrowers under the scheme feel that they are put at a disadvantage, relative to new borrowers, and it would be very difficult to apply any changes retrospectively.

53. Implementation of any changes, from reviewing scheme's settings, will be a commercial negotiation between the Crown and the Banks.

54. A restriction on how the proceeds of personal guarantees can be applied to the Crown's risk share will increase the financial losses incurred by the Crown.

Next Steps

55. Once we have received your feedback on the scheme settings review, we intend to engage with the banks on your preferred changes. As part of that process, we can discuss those options in relation to the treatment of personal guarantees that you wish to pursue.

56. We prepared this advice with some urgency so the RBNZ has had limited time to provide substantive feedback. We will continue to work closely with RBNZ in developing BFGS related proposals and will ensure their views are reflected in final recommendations regarding scheme changes.