The Treasury

Business Finance Guarantee Scheme Information Release

January 2021

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TE TAI ŌHANGA
THE TREASURY

Treasury Report: BFGS Settings Review

Date:	11 June 2020	Report No:	T2020/1811
		File Number:	SH-1-6-1-3-5-2-1-1

Action sought

	Action sought	Deadline
Hon Grant Robertson **Minister of Finance**	**Agree** in principle to parameters for officials to discuss with banks.	19 June 2020

Contact for telephone discussion (if required)

Name	Position		Telephone	1st Contact
Anthony Powell	Senior Analyst, BFGS	[39]	[35]	
Dr Brian McCulloch	Consultant, BFGS			
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

Executive Summary

The Business Finance Guarantee Scheme (BFGS) was announced in late March on the day before the alert level 4 lockdown started, and it was implemented at pace by mid-April. The COVID situation has evolved significantly since then, and additional government initiatives to support small businesses have also been put in place.

When you announced some enhancements to the Scheme on 1 May 2020, you signalled your intention to make some future changes, with the banks' agreement, to support the operation of the BFGS.

BFGS objectives and the landscape of firm support

Our recent advice, *Next phase of CRRF Funding* (T2020/1569 refers), set out the need to transition from measures that aim to retain existing firms and jobs, to measures that support demand and assist businesses to invest and hire, to support the economic recovery. It noted that weak and uncertain demand is the critical factor for many firms and that an overall resumption of economic growth is critical to any firm support measure effectiveness.

Within this backdrop we consider that credit channel interventions (BFGS and Small Business Cashflow Loan Scheme (SBCS)) are consistent with this strategy as they provide support to viable and marginally viable firms (ie, those in a position to take on and repay debt) to invest and employ, and supplement existing channels of finance for firms. Some of the changes we recommend in this report are designed to allow the BFGS to further support the recovery.

Uptake of the BFGS has been low to date. The Scheme is nonetheless useful as a backstop in case of a severe contraction in bank lending. In addition, the BFGS could be more focussed toward enabling banks to lend to marginally viable firms. However, there are inherent limitations of a bank-administered, debt-based scheme in supporting marginally viable firms.

The parameter settings below, on which we seek your guidance, comprise changes that remove unnecessary barriers to banks' use of the Scheme, and changes that at the margin should further incentivise banks to lend to marginally viable firms.

The last few months have been fast-paced with many moving parts and schemes introduced quickly to support business through the COVID response. You are receiving advice now on changes to the BFGS and you have agreed in-principle to support an extension to the SBCS. The adjustments to these schemes' settings are important to ensure they are operating as well as possible now and for the upcoming months. Shortly you will receive a paper on the business support landscape and potential next steps, which aims to take stock, and consider what else may be needed for the future.

Parameter settings

Potential enhancements to the BFGS fall into two categories: parameter settings that are largely for you to decide (with the exception of personal guarantees) and operational settings that will require agreement with the banks (but are beneficial to banks and borrowers). The Treasury has commissioned an independent report from TDB Advisory, which helped inform this settings review.

The proposed changes to both the parameter and operational settings will benefit from engagement and consultation with the banks, to enable them to be further refined. We seek your agreement in principle to the recommendations outlined below to provide a basis for officials to work with the banks to arrive at final agreed proposals for change.

The key parameter settings, and our recommendations, are:

- Risk share (currently 80/20): No change for Supported Loans not subject to guarantee restrictions (if adopted). The existing 80/20 risk share for can be revisited later, eg, if any changes made to the Scheme do not result in higher uptake or if the objectives of the Scheme change.

- Availability period (currently 30 September 2020): Extend to 31 December 2020 so that banks can continue to lend under the BFGS for a further three months.

- Maximum borrower revenue (currently $80 million): Increase the size of businesses eligible for the BFGS to $200 million annual revenue.

- Supported loan limit (currently $500,000): Increase the maximum Supported Loan to $5 million.

- Loan term (currently 3 years): Increase the maximum Supported Loan term to five years.

- Capital investment: Remove the restriction on using funds for capital investment. It is currently restricted to business-as-usual capital expenditure that does not exceed 5% of the supported loan.

- Property development or investment: Remove the exclusion of property developers and investors; or remove the exclusion for property investors only.

- Watchlist: Revise or remove the exclusion of borrowers who were on the bank's watchlist as at 31 January 2020.

- Refinancing: Relax the restriction to permit banks to refinance up to 20% of existing customer facility limits.

- Personal Guarantees: We will engage with representatives of the business community to understand how much of an impediment personal guarantees are to accessing finance from banks.

  If personal guarantees are to be restricted, a possible outcome from our negotiations with banks is that the Crown will have to accept a 100% risk share for Supported Loans below $25,000, which would come with risks.

  We suggest final decisions on this are taken in conjunction with advice on any changes to, and further extension of, the SBCS beyond 24 July 2020.

- Payment waterfall and isolation: No change, issues to be dealt with in operational settings, that is, enforcement flexibility (below).

- Liability cap (currently $5 billion): No change. This can be revisited later, if necessary.

Operational settings

The other operational settings, and our recommended approaches, are:

- Reliance on borrower certification: Further relax the banks' obligations in respect of borrower certification.

- Enforcement flexibility: Clarify the requirements around enforcement of defaulted Supported Loans to ensure they operate as intended and that banks can reach compromises and settlements with affected borrowers, and still claim under the Scheme.

- Supported Loans Policies, Practices and Processes (SLPPPs): Relax and revisit the SLPPP requirements where they may have the unintended consequence of inhibiting banks from supporting marginally viable customers.

- Reporting: Update the specification of Notices of Claim.

- Crown rights of investigation: Limit the Crown's rights under the Deed, as already signalled, and explore other practical refinements alongside relaxing the SLPPP requirements.

- Agreed-upon procedures engagement: No further change. A Notice of Amendment was agreed recently with the banks to confirm that this process will not be required for the audit of this year's Financial Statements of the Government.

Key themes and trade-offs

A number of changes widen the purposes and targeting of the Scheme. Extending the Scheme Availability Period, increasing the Supported Loan limit and revenue requirement are aimed at assisting more firms to access working capital to **respond** to COVID-19.

These changes, and the inclusion of capital expenditure, are also aimed at assisting firms to **recover** from COVID-19. In particular they do so by encouraging investment in fixed assets, and providing for the expansion of the Scheme to larger firms and accompanying increase in Supported Loan limits, is particularly relevant here.

Larger firms are generally more financially resilient and are expected to begin to invest to support their post COVID-19 operations, once rationalisation activities are completed, sooner than SME's. The inclusion of capital expenditure will also allow SME's to re-tool and adapt to the new normal post the domestic COVID-19 restrictions.

Other changes relate to the trade-off between the policy effectiveness and fiscal risk/cost of the Scheme. For example, refinancing existing debt, relaxing the watchlist requirements, extending the repayment term and potentially increasing the risk-share to enable personal guarantees to be restricted (for Supported Loans below $25,000).

Allowing banks to refinance some existing customer indebtedness, along with relaxing the watchlist requirements, will encourage banks to support marginally viable businesses and may decrease borrower debt servicing costs. The Treasury's preference is for a relaxation to 20%, this is consistent with the equivalent UK schemes.

Feedback from banks and the business community is that firms need a longer repayment period, first to get through the COVID situation, and then to be in a position to repay the loans. A five year repayment term is consistent with the SBCS.

The RBNZ's Term Lending Facility (TLF), which was introduced to support the BFGS, has a three-year tenor currently. The RBNZ requested that we insert the below comment regarding whether the TLF is also extended to a five year duration:

"If the Minister decides that the effectiveness of the BFGS will be improved by extending its duration to five years, the RBNZ is willing to support this by extending the duration of its Term Lending Facility (TFL) to five years. However, this will potentially have significant implications on the RBNZ's reported earnings given the TLF provides below-market interest rates on funding to commercial banks (fixed at the Offfical Cash Rate). The RBNZ will be required to hold additional capital for higher duration risk and this may impact future dividends."

If it is necessary to restrict banks from taking personal guarantees by moving to a 100% risk share for Supported Loans less than $25,000, this is likely to increase fiscal risk to the Crown and remove the incentives created by the banks' 20% risk share.

Depending on the mix of changes agreed to in this report we will re-estimate expected Scheme uptake and fiscal costs to the Crown. For most of the Scheme changes contemplated we think it is unlikely that the fiscal costs to the Crown will exceed our initial estimate of credit losses of $525 million. There is much greater uncertainty as to the fiscal costs around potentially increasing the risk-share to enable personal guarantees to be restricted (for Supported Loans below $25,000).

Measures to support bank and firm behaviours

We have heard that banks are finding it difficult to reconcile their requirement to be responsible lenders with the Crown's desire that they make more courageous decisions to support marginally viable firms, as they benefit from the 80% Crown guarantee.

For lending under the Scheme it is not a requirement that banks be 'responsible' lenders in terms of the Credit Contracts and Consumer Finance Act 2003, which doesn't apply to business lending. However, where requests for business credit rely on mortgages of residential properties as security, banks take a necessarily conservative approach.

Behavioural issues, such the responsible lending ‘requirements’, are likely to persist even if changes are made to the Scheme.

Given the Treasury has not had substantive institutional, or contractual, relationships with banks since the Global Financial Crisis, it takes time to build trust and encourage banks to rely on the ‘reasonableness’ of the Crown’s approach rather than their worst-case legal interpretation of how the Crown will exercise its rights under the Deed, and for what purpose.

We think the operational changes to enhance reliance on borrower self-certification and relax the requirement and reporting of Supported Loans Policies, Practices and Processes (SLPPPs) will usefully demonstrate the Crown’s confidence in banks and build the trust required for a more effective Scheme. We will continue to monitor this relationship, and if further measures are needed, will bring forward other recommendations to you to assist in building this relationship to ensure the Scheme operates as intended.

In conjunction with any settings changes ultimately agreed between the Crown and banks, we think it would be worthwhile producing some clarifying material for publication around the Scheme, how it is intended to work and be used, and who is eligible, over and above what is published on the business.govt.nz website. This will help inform the business community who are the target of the Scheme, and provide independent information over and above what is available to them through banks.

Process from here

Once you have agreed in principle to the changes in settings, officials will work with the banks to arrive at final agreed proposals for change. These would be worked into an amended Crown Deed of Indemnity for your final decision, and to formalise agreement between the Crown and the participating banks. In making your final decisions on any changes to the Crown Deeds of Indemnity, you will need to be satisfied at that time that the indemnities given by Deeds, as amended, are “necessary or expedient in the public interest” (S65ZD, Public Finance Act 1989).Prior to the BFGS being established, the Ministers with power to act on COVID-19 matters authorised you to make final decisions on Scheme design (CAB-20-MIN-0130). Once we have discussed the proposed changes with the banks and arrived at final proposals, you may wish to advise Cabinet of these further changes in Scheme design.

Recommended Action

We recommend that you:

a **note** that you have signalled to banks your intention to make further changes to the BFGS;

b **agree** in principle to the following parameters for officials to discuss with banks:

i.	Risk share: No change for Supported Loans at this time;	*Agree/disagree*
ii.	Availability period: Extend to 31 December 2020;	*Agree/disagree*
iii.	Maximum borrower revenue: Increase the size of businesses eligible for the BFGS to $200 million annual revenue;	*Agree/disagree*
iv.	Supported Loan limit: Increase the maximum Supported Loan to $5 million;	*Agree/disagree*
v.	Loan term: Increase the maximum Supported Loan term to five years;	*Agree/disagree*
vi.	Capital investment: Remove the restriction on using funds for capital investment;	*Agree/disagree*
vii.	Property investment and development: Remove the exclusion of property development and investment; or	*Agree/disagree*
viii.	Remove the exclusion of property investment only (ie, exclude developers);	*Agree/disagree*
ix.	Watchlist: Revise or remove the exclusion of borrowers who were on the bank's watchlist as at 31 January 2020;	*Agree/disagree*
x.	Refinancing: Relax the restriction to permit bank to refinance up to 20% of existing customer facility limits;	*Agree/disagree*
xi.	Personal Guarantees: We will report back for final decisions once we have undertaken engagement with the business community, and tested options to restrict personal guarantee with the banks;	*Agree/disagree*
xii.	Payment waterfall and isolation: No change;	*Agree/disagree*
xiii.	Liability cap: No change;	*Agree/disagree*
xiv.	Reliance on borrower certification: Further relax the banks' obligations in respect of borrower certification;	*Agree/disagree*
xv.	Enforcement flexibility: Clarify the requirements around enforcement of defaulted Supported Loans to ensure they operate as intended and that banks can reach compromises and settlements with affected borrowers, and still claim under the Scheme;	*Agree/disagree*

xvi. Supported Loans Policies, Practices and Processes (SLPPPs): Relax and revisit the SLPPP requirements where they may have the unintended consequence of inhibiting lending; *Agree/disagree*

xvii. Reporting: Update the specification of Notices of Claim; *Agree/disagree*

xviii. Crown rights of investigation: Limit the Crown's rights under the Deed, as already signalled, and explore other practical refinements alongside relaxing the SLPPP requirements; *Agree/disagree*

xix. Agreed-upon procedures engagement: No further change; *Agree/disagree*

c **note** that Treasury will report back with final proposals for revision to the Crown Deeds of Indemnity following discussions with the banks;

d **indicate** if you require a Cabinet paper to be prepared to advise Cabinet of your final decisions on scheme changes;

Yes / No

Kate Le Quesne
Acting Manager, Business Finance Guarantee Scheme

Hon Grant Robertson
Minister of Finance

Treasury Report: BFGS Settings Review

Purpose of Report

1. This report seeks your agreement in principle to parameters for review of the Business Finance Guarantee Scheme (BFGS) to provide a basis for officials to work with the banks to arrive at final agreed proposals for change.

Analysis

2. The BFGS was announced in late March on the day before the Alert Level 4 lockdown started, and it was implemented at pace by mid-April. The COVID situation has evolved significantly since then, and additional government initiatives to support small businesses have also been put in place. When you announced some enhancements to the Scheme on 1 May 2020, you signalled your intention to make some future changes, with the banks' agreement, to support the operation of the BFGS.

BFGS objectives and the landscape of firm support

3. Our recent advice, *Next phase of CRRF Funding* (T2020/1569 refers), set out the need to transition from measures that aim to retain existing firms and jobs, to measures that support demand and assist businesses to invest and hire, to support the economic recovery. It noted that weak and uncertain demand is the critical factor for many firms and that an overall resumption of economic growth is critical to any firm support measure effectiveness.

4. Within this backdrop, we consider that credit channel interventions (BFGS and Small Business Cashflow Loan Scheme (SBCS)) are consistent with this strategy as they provide support to viable and marginally viable firms (ie, those in a position to take on and repay debt) to invest and employ, and supplement existing channels of finance for firms. Some of the changes we recommend in this report are designed to allow the BFGS to further support the recovery.

5. The primary objective for the BFGS is (T2020/707 refers):

   "to facilitate the provision of short-term credit to cushion the impact on solvent firms with viable business models that may arise from a temporary delay [or decline] in receipts arising directly or indirectly from the COVID 19 virus."

6. Given the speed at which the Scheme was put in place, how the economic shock has developed and been managed, and the market response to the Scheme, it is worthwhile to unpick this objective to see if the underlying problems are being addressed.

7. There are two different underlying problems behind why the government should facilitate the provision of short term credit by the banks to firms:

   - ***Problem A: Risk of bank credit drying up***: Banks may become worried about their own financial viability, and become extremely risk-averse, to the extent that bank credit dries up. This could lead to market failure that would exacerbate the crisis as, while each bank may restrict lending out of prudence, the cumulative effect will be excess credit rationing. This in turn could worsen the prospects of recovery.

- ***Problem B: Risk of banks not lending to marginally viable firms:*** Banks are not likely to be willing to lend to all the firms the government would like to see supported. This is particularly the case where the firm's prospects are too uncertain for a bank to be prepared to lend on commercial terms. The government may want to see more firms supported than the banks are likely to and the government wants to reduce economic scarring which produce wider costs for the economy, while a bank is focused more on the ability of an individual firm to repay its debt to the bank.

Is the BFGS addressing problem A: Risk of bank credit drying up?

8. To date, banks have generally been extending credit, and with the move to Alert Level 1, the economic outlook does not suggest banks have concerns about their own strength at this point in time.

9. The BFGS has not been needed in terms of this problem. However, it was a sensible step to take at the time, and while the financial system remains sound for now, loan losses are expected to rise as unemployment increases and house prices fall. There is a risk that over time, this could lead to a sharp contraction in lending which would exacerbate the economic recession. The BFGS therefore remains an important "insurance policy".

10. The current low uptake of the Scheme does not necessarily reflect the effectiveness of the Scheme at meeting this objective as credit seems to have continued. However, it does make sense to take this opportunity to look at removing any unnecessary barriers that may restrict the use of the BFG by banks in the future for this purpose.

Is the BFGS addressing problem B: Risk of banks not lending to marginally viable firms?

11. The low uptake of the BFGS to date indicates that the Scheme has likely not been overly effective at encouraging banks to lend to relatively less viable firms. Also, other initiatives the government has taken to support firms, such as the wage subsidy and changes to the tax system, would have, at least to date, greatly reduced the need for firms to draw down more credit from banks.

12. We are recommending some changes to the Scheme that, at the margin, should encourage banks to lend to marginally viable firms. However, if we make changes that improve uptake of the Scheme, our ability to target these marginally viable firms may be limited. It is likely that most of the uptake of the Scheme will be to firms that banks would have lent to anyway. This is primarily because of the inherent limitations of a bank-administered, debt-based scheme, which is largely only effective for supporting marginal firms with short-term liquidity issues.

13. Banks are naturally conservative, and due to the difficulties of undertaking in-depth credit assessment at scale, credit assessment tends to be a "numbers game", simplified down so that credit decisions can be made quickly at branch level. Banks also tend not to lend to smaller firms (other than lending against the family home) due to the cost/benefit of carrying out credit assessments for relatively small loan amounts, to inherently risky firms (due to their size).

14. Notwithstanding these difficulties, the proposed changes to the BFGS settings should further enhance the incentives on banks to lend to marginally viable firms at the margin and remove obvious unnecessary barriers to banks using the Scheme.

15. There still might be a gap in the support the government wants to offer to firms that have reached the limit of banks credit appetite (even with the BFGS), but that will be too small to access the potential debt hybrid instrument, and too big to access the SBCS (noting that the SBCS is also being reviewed).

16. The last few months have been fast-paced with many moving parts and schemes introduced quickly to support business through the COVID response. The BFG is one of a number of tools for business support. You are receiving advice now on changes and extensions to the SBCS strategy and to the BFGS because it is important that both schemes are operating as well as possible now and for the next months. Shortly you will receive a paper on the business support landscape and potential next steps, which aims to take stock, and consider what else may be needed for the future.

Scheme Uptake

17. As at 8 June 2020, banks have lent under the BFGS to 514 customers with approved (and partially drawn) facilities of $91 million[1]. Broadly, uptake is determined by bank behaviour in making Scheme loans available to eligible customers, Scheme settings and customer demand.

18. As described above banks appear to be generally extending credit to their viable customers.

19. We have previously reported to you (T2020/1257 refers) that banks have indicated that businesses are taking a cautious approach to taking on additional debt in an uncertain operating environment caused by COVID-19. Other support measures such as the Wage Subsidy Scheme, tax measures, mortgage deferrals and more recently the SBCS loans have been used in preference to BFGS loans to help cushion the impacts of COVID-19.

20. Demand for BFGS is likely to increase over time as other support measures such as the Wage Subsidy Scheme roll off and businesses have greater certainty about their future as we move down alert levels.

21. Nonetheless, we think it is worthwhile considering changing some of the Scheme settings to ensure that any unnecessary barriers that may restrict BFGS usage by banks are removed to be best aligned to both objectives above.

22. We would note that settings changes in isolation are unlikely to result in dramatically higher uptake. This is only likely to be the case should customer demand for credit increase once other measures roll off, combined with an increase in banks credit risk appetite.

23. In conjunction with any settings changes ultimately agreed between the Crown and banks, we think it would be worthwhile producing some clarifying material for publication around the Scheme, how it is intended to work and be used, and who is eligible, over and above what is published on the business.govt.nz website.

[1] Based on fortnightly data provided to the Treasury

24. We would also note that bank behavioural issues, such the responsible lending ‘requirements’ that may be constraining bank appetite to provide BFGS loans, are likely to persist even if changes are made to the Scheme.

25. It takes time to build trust and encourage banks to rely on the ‘reasonableness’ of the Crown’s approach and influence the banks perception of the Crown’s willingness to pay the claims that will inevitably arise under the Scheme.

26. We think the operational changes to enhance reliance on borrower self-certification and relax the requirement and reporting of Supported Loans Policies, Practices and Processes (SLPPPs) will usefully demonstrate the Crown’s confidence in banks and build the trust required for a more effective Scheme.

External Review

27. The Treasury commissioned external consultants TDB Advisory to conduct a review of the BFGS settings against its objectives. The findings of the report suggested a range of changes to settings to ensure the BFGS is most suited to meeting its objectives. These have been used to inform the analysis in this report. The review highlights that changes to the settings may remove some impediments for the banks to use the Scheme but may not lead to a major increase in uptake of the Scheme given it is entirely dependent on the economic and future credit environment.

Parameters for review

28. Potential enhancements to the BFGS fall into two categories:

- Scheme parameter settings that are largely for you to decide (with the exception of personal guarantees). However, the majority of the proposed changes will benefit from engagement and consultation with the banks, and
- Operational settings that will require agreement with the banks (but that are beneficial to them and borrowers).

29. We seek your agreement in principle to the recommendations outlined below to provide a basis for officials to work with the banks to arrive at final agreed proposals for change.

Scheme parameter settings

30. Scheme parameter settings are the overall elements of the Crown Deeds of Indemnity that determine the scope of the Scheme and the Crown’s financial exposure. The following Scheme parameter settings are recommended for inclusion in the review, and are discussed further below:

- Risk share (currently 80/20)
- Availability period (currently 30 September 2020)
- Maximum borrower revenue (currently $80 million)
- Supported Loan limit (currently $500,000)
- Supported Loan term (currently 3 years)

- Capital investment
- Property development or investment
- Refinancing
- Personal Guarantees
- Payment waterfall and isolation, and
- Liability cap (currently $5 billion).

Risk share

31. The liability cap of $5 billion enables banks to issue Supported Loans of up to $6.25 billion, and the Crown meets 80% of the shortfall on each Supported Loan that defaults and goes through the bank's arrears management and enforcement processes (that is, an 80/20 risk share).

32. The comparable Australian scheme offers a 50/50 risk share, and the comparable UK scheme offers 80/20.

33. There has been no particular call to change the risk share, and there has been no indication from banks that it is inhibiting lending. Having a portion of risk shared by the banks is important to maintain sound commercial practices and care in assessing customer credit. In addition, changing the risk share at this stage could raise consistency issues between existing and new Supported Loans.

34. The existing 80/20 risk share can be revisited later, eg, if any changes made to the Scheme do not result in higher uptake or if the objectives of the Scheme change.

35. If you wish to pursue the personal guarantee restriction to meet the Minister's objectives, the restriction will need to be discussed with the banks. The banks may require that the Crown move a higher, possibly 100%, risk share. If implemented, the Crown is fully accepting the risk on those Supported Loans, which is likely to increase fiscal risk to the Crown and remove the incentives created by the banks 20% risk share. This represents a material change to the current Scheme operations. This is discussed further below.

36. **Recommendation: No change for Supported Loans at this time.**

Availability Period

37. The Scheme requires Supported Loans to be entered into during the Availability Period, which goes until 30 September 2020. Currently, Supported Loans must be repaid in full within 3 years from the date of the Supported Loan was entered into.

38. The public commentary from banks and others over the last few weeks is that many SMEs are taking their time to assess how the COVID uncertainties will play out, and the merits of the various (and broadening) government support options that are available to them, before they resort to bank debt. It is therefore reasonable to expect increased use of the Scheme over the remainder of the Availability Period.

39. The COVID situation has evolved since the Scheme was established, and it is now expected to take longer for business conditions to return to “normal” for many firms. As a result, this Scheme may be of most use as firms have more certainty about the economic situation to accurately assess their business prospects and adjust their finances accordingly. For many firms, it could now be beyond 30 September 2020 before they are in that position.

40. Usage of the Scheme is likely to continue to increase only modestly in the next few months, as the temporary facilities provided by banks since March 2020 begin to expire. Uptake may also increase once other support measures, eg, the Extended wage subsidy scheme, expire.

41. It will also take some time for firms to reformulate their plans for operating in a very different economic environment, and to determine what investment financing is required to support this.

42. We therefore recommend that the Scheme is extended to 31 December 2020 in the first instance. This would also allow the Scheme to support the ‘seasonal’ working capital requirements of the retail sector ahead of Christmas trading.

43. Depending on the economic situation towards the end of the year, and the effect of any Scheme changes made as a result of this report, Ministers could consider extending the Scheme further in November 2020.

44. Extending the Availability Period requires the RBNZ to extend its Term Loan Facility (TLF). RBNZ has made a decision that it is willing to do so.

45. The RBNZ also notes that it has already signalled to the banks it would look favourably at extending the TLF past the Availability Period to take account of the distinction between banks approving Supported Loan facilities and the actual subsequent drawdown of the Supported Loans by borrowers.

46. **Recommendation: Extend the availability period to 31 December 2020.**

Supported Loan limit and maximum revenue requirement

47. The Scheme is currently available to businesses with revenue up to $80 million, and the facility of each Supported Loan is limited to $500,000.

48. We have previously advised that the introduction of the SBCS will provide support for small businesses where they do not wish to apply, or may not be eligible, for a Supported Loan under the BFGS, and to ensure consistency between the two schemes, the BFGS could be expanded to include larger business, which do not currently receive support from any government guarantee or direct lending products (T2020/1239 refers).

49. You have also agreed in principle to create the bespoke Hybrid Debt Support and the Coronavirus Loan Guarantee (CLG) products and market soundings on the merits of these products, and key stakeholder interest in them, is currently under way. This market sounding is also testing the merits of extending the Scheme to firms with larger turnovers to complement the introduction of these additional bespoke products.

50. The Hybrid Debt Support and CLG products are intended to target firms that would remain viable with additional debt financing but are unable to access this debt from market sources (including from participating BFGS banks). A 'larger' Scheme is a means to provide broader, market-led support to businesses with higher turnover alongside these bespoke products, and the market testing undertaken to date supports an expansion of the Scheme (relative to the other options).

51. Currently approximately 36% of total business debt is borrowed by firms who are not eligible for this Scheme. In addition, these larger more financially resilient firms are expected to begin to invest to support their post COVID-19 operations sooner than SME's. As such there is a strong rationale to extend the Scheme to these businesses.

52. Firms with greater than $200m in revenue have more diverse funding sources than bank debt, equity and debt capital markets, so we propose to increase the maximum revenue to $200m.

53. Larger firms will generally require larger facilities, particularly if capital expenditure is included in the Scheme. The table below shows the average bank debt of firms with turnover of between $50 and $100 million is $5.1 million, and of greater than $100 million is $10.7 million. Firms in different industries will also have different levels of bank debt. For example, firms in labour intensive industries like tourism and hospitality will generally have less bank debt than those in more capital intensive industries like manufacturing.

54. To allow for a meaningful increase in the debt of firms with turnover up to $200 million we propose increasing the Supported Loan limit to $5 million.

55. The below table is a very approximate estimate, based on data from Statistics NZ, Inland Revenue and the Reserve Bank, of the distribution of bank borrowing across firms of different sizes.

<table>
<tr><th>Firm size by sales band</th><th>Firm count</th><th>Percentage</th><th>Average bank debt</th><th>Total bank business debt (billions)</th><th>Total bank business debt (%)</th></tr>
<tr><td>Zero</td><td>18,930</td><td>4%</td><td>-</td><td>-</td><td>-</td></tr>
<tr><td>>0 to $100k</td><td>177,867</td><td>38%</td><td rowspan="3">$75,000</td><td rowspan="3">$13.04</td><td rowspan="3">12%</td></tr>
<tr><td>$100k to $250k</td><td>106,890</td><td>23%</td></tr>
<tr><td>$250k to $1m</td><td>103,023</td><td>22%</td></tr>
<tr><td>$1m to $5m</td><td>45,363</td><td>10%</td><td rowspan="4">$1,140,00</td><td rowspan="4">$59.18</td><td rowspan="4">52%</td></tr>
<tr><td>$5m to $10m</td><td>5,745</td><td>1%</td></tr>
<tr><td>$10m to $20m</td><td>2,865</td><td>0.62%</td></tr>
<tr><td>$20m to $50m</td><td>1,956</td><td>0.42%</td></tr>
<tr><td>$50m to $80m</td><td>516</td><td>0.11%</td><td rowspan="2">$5,057,000</td><td rowspan="4">$40.97</td><td rowspan="4">36%</td></tr>
<tr><td>$80m to $100m</td><td>159</td><td>0.03%</td></tr>
<tr><td>$100m to $200m</td><td>330</td><td>0.07%</td><td rowspan="2">$10,701,000</td></tr>
<tr><td>above $200m</td><td>264</td><td>0.06%</td></tr>
<tr><td>Total</td><td></td><td></td><td></td><td>$113.19</td><td></td></tr>
</table>

56. **Recommendation: Increase the maximum revenue for eligible borrowers to $200 million.**

57. **Recommendation: Increase the loan limit to $5 million.**

Supported Loan term

58. The Scheme requires Supported Loans to be repaid in full at the end of three years.

59. While banks are free to refinance loans into regular bank financing as they expire, feedback from banks is that the evolving COVID situation is indicating a significant number of 'otherwise viable' customers may still not be independently bankable after three years, and really need a longer period. First to get through the COVID situation, and then to be in a position to repay the Supported Loan. Consistent with this feedback, the SBCS, which was established after the BFGS, has a five-year repayment period.

60. The RBNZ's Term Lending Facility (TLF), which was introduced to support the BFGS, has a three-year tenor currently. The RBNZ requested that we insert the below comment regarding whether the TLF is also extended to a five year duration.

    "If the Minister decides that the effectiveness of the BFGS will be improved by extending its duration to five years, the RBNZ is willing to support this by extending the duration of its Term Lending Facility (TLF) to five years. However, this will potentially have significant implications on the RBNZ's reported earnings given the TLF provides below-market interest rates on funding to commercial banks (fixed at the Offfical Cash Rate). The RBNZ will be required to hold additional capital for higher duration risk and this may impact future dividends."

61. **Recommendation: Extend the term over which Supported Loans must be repaid to five years.**

Capital investment

62. Loans under the Scheme cannot be used to fund capital assets or projects, other than business-as-usual expenditure that does not exceed 5% of the loan facility.

63. Now that other immediate government initiatives are in place, the focus of the Scheme can be widened to assist otherwise-viable firms as they move out of the response phase and into a recovery phase. For many firms, the recovery phase is likely to require more than 'business-as-usual' capital expenditure as they rebuild their businesses.

64. The banks have suggested allowing COVID-related capital expenditure. However, there would be some difficulty in determining whether a particular expenditure is specifically COVID-related, especially as businesses repurpose into the post-COVID era. We therefore recommend removing the restriction altogether, even though this may mean that some Supported Loans go to support non-COVID projects.

65. The benefit of allowing capital investment is that businesses can invest in assets required for the recovery phase at a lower interest rate than the banks might otherwise offer to them. The risk is that there is significantly higher uptake by businesses that would have invested in capital assets anyway, exposing more loans to the Crown's risk share than expected.

66. Even if the uptake is higher, the costs to the Crown are expected to fall within the $525 million credit loss estimate previously advised (and the Crown's risk share is capped at $5 billion).

67. **Recommendation: Remove the restriction on funding capital expenditure.**

Property investment and development

68. Supported Loans cannot be made to residential or commercial property investors or developers. We have previously recommended removing this exclusion (T2020/1239 refers). The original rationale for the exclusion of these type of firms is that they would be able to draw on existing lending facilities that are typically secured against land and buildings.

69. Commercial property – especially accommodation, hospitality, retail, and some office properties – was immediately affected by international travel restrictions and the Alert Level 4 measures.

70. Some property owners have proactively offered rent reductions to support tenants during the downturn. For those landlords that haven't already offered rent relief, they are now required too, where their tenant is a business with 20 or fewer full-time equivalent staff.

71. Banks' total lending to the commercial property sector is around $40 billion, representing 35% of total bank business lending, with around $5 billion of this related to property development. Commercial property has historically been a source of significant credit losses for NZ banks.

72. Therefore, allowing commercial property investors and developers into the Scheme will likely increase the Crown's risk, and is also relevant to the consideration to allow banks to refinance existing debt into the Scheme. The risk is that too much of the Scheme funding envelope is used up on commercial property refinancing leaving less available for other businesses, or property investors and developers use Supported Loans for speculative purposes.

73. Given the economic outlook, and the likely further tightening of bank credit risk appetite for this sector, we think the use of Supported Loans for speculative purposes will be limited.

74. RBNZ observes that in recent years that banks have tightened lending standards to both commercial property investor and developers, given this, and the Government's recent introduction of a COVID-19 rent relief clause into some commercial leases, we recommend removing this exclusion.

75. Removing this exclusion is also consistent with the objective of making the Scheme as broad based as possible. An alternative approach is to relax the restriction to include property investors, but not developers, in the Scheme.

76. Loans to property developers generally have a higher risk of default, however, excluding developers may not be consistent with the Governments objective of increasing housing supply and affordability.

77. Relaxing the restriction to include property investors, but not developers, in the Scheme will have some operational complexity, but we will be able to address this in conjunction with the banks.

78. **Recommendation: Remove this exclusion altogether, or relax the exclusion to include property investors but not developers, in the Scheme.**

Watchlist

79. The Scheme only accepts borrowers who were not on the bankwatchlists[2] as at 31 January 2020.

80. The purpose of this clause is to provide the banks with an objective means of helping to determine which customers were 'otherwise viable' at the outset of the COVID situation, by limiting the inclusion of customers the bank had already determined were not credit worthy pre-COVID.

81. In the original Deed, the date was set at 28 February 2020. Feedback from banks was that forestry sector customers had experienced COVID difficulties before that date. This, along with the inclusion of farm lending, which was likely to be in a similar situation, led to the date being adjusted back to 31 January 2020, through the Scheme Notice that was issued on 1 May 2020.

82. Further feedback from banks is that many 'otherwise viable' customers stretch their cashflows over the Christmas/New Year period and end up on the January watchlist for a short time, so this date is not necessarily ideal either.

83. No specific date is going to be a perfect indicator of 'otherwise viable' businesses, and any hard rule will mean that some 'otherwise viable' businesses will be deemed ineligible.

84. Currently banks can make Supported Loans to businesses who subsequently moved onto their watchlists after the 31 January 2020. In addition, how some banks identify watchlisted customers may be excluding some businesses from the Scheme that it was intended to support. For example, one large banks definition of a watchlisted customer is those that have a credit rating equivalent to B- or below.

85. A credit rating of B- indicates that the borrower *currently has the capacity to meet its financial commitments* but adverse business, financial, or economic conditions (like those related to COVID-19) will likely impair the borrower's capacity or willingness to meet its financial commitments.

86. Banks will assess the viability of businesses under their credit policies and apply their commercial discretion. This will likely include an assessment of the impact of whether the business is or has been on their watchlist, for how long and how often, applying different criteria for different sectors and types of business. Relying on this process may be better than a hard-wired requirement in the Deed, but any change would need to take into account the proposed relaxation on the restriction on refinancing existing debt.

87. An alternative definition could potentially developed to identify businesses that were not 'otherwise viable' at the outset of the COVID situation, or the loan size to borrowers on watchlists as at 31 January 2020 could be restricted.

88. Our preference, and the RBNZ's strong preference, is to revise rather than remove the watchlist requirement.

89. **Recommendation: To discuss with banks, and either revise or remove the watchlist requirement.**

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[2] A bank's "watchlist" is defined as its list of customers who are 30 or more days in arrears, or who are being managed by the bank's distress business management unit, or the banks had determined were at heightened risk of default.

Refinancing

90. Supported Loans cannot be used to refinance existing debt. There are exceptions to this to allow debt maturing during the Availability Period to be refinanced, and to allow eligible debt advanced from 16 March 2020 to be refinanced into the Scheme. In addition, the Scheme Notice issued on 1 May 2020 dropped the requirement for existing facilities to be fully drawn before taking a Supported Loan.

91. Banks have suggested allowing existing debt to be refinanced more generally, and an inability to refinance existing appears to create some practical problems for revolving credit facilities.

92. The benefit to the customer would be from receiving a concessionary interest rate on the Supported Loan to the extent that this is less than the interest rate on their existing borrowing.

93. Allowing existing debt to be refinanced more generally would have the effect of shifting risks that the banks currently fully (100%) bear onto the Crown bearing 80% and the banks only 20%. Although, as Supported Loans are not likely to be as profitable for banks this provides some constraints on this behaviour.

94. Any change to the refinancing restrictions needs to take into account the combined effects of such a relaxation, the removal or amendment of the watchlist restrictions, the inclusion of property investors and developers, the increased maximum revenue limit and the increased Supported Loan size.

95. On balance we recommend that banks be permitted to refinance existing debt, subject to some constraint on their ability to do so. We recommend that banks be permitted to refinance existing debt of up to 20% of existing customer facility limits. Introducing a percentage limit will have some operational complexity, but we will be able to address this in conjunction with the banks.

96. **Recommendation: Relax the restriction to permit banks to refinance up to 20% of existing customer facility limits.**

Personal Guarantees

97. The Scheme has no requirements in respect of personal guarantees to a bank from its customer. Given equity concerns of relying on personal guarantees, in light of the risk share the Crown accepts under the Scheme, you indicated your preference to negotiate with banks to restrict the use of personal guarantees (T2020/1678 refers).

98. We will engage with representatives of the business community to understand how much of an impediment personal guarantees are to accessing finance from banks.

99. You could attempt to prohibit banks from taking new personal guarantees in relation to Supported Loans below $25,000.

100. We are also investigating whether an additional prohibition is required to cover the interaction with existing any personal guarantees. That is, if a bank advances a Supported Loan of less than $25,000 and benefits from an existing (or future) personal guarantee, then the bank cannot make demand or otherwise enforce any such a guarantee for any amounts due under the Supported Loan or apply any proceeds from the guarantee to the Supported Loan.

101. 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). As a result, banks will likely seek a higher risk share (likely 100%) for Supported Loans that are subject to the personal guarantee restrictions. This represents a material departure from the existing operation of the scheme.

102. The SBCS already takes 100% risk, through a direct lending rather than agency channel, on loans to very small SME's.

103. The largest number of SBCS applications (45%) have come from individuals and sole traders. The next largest group is businesses with 2-5 employees (33%). The rate of uptake declines as firm size increases (given the relatively low loan amounts on offer). The average loan size is approximately $17,000.

104. For individuals and sole traders, personal guarantees are not usually relevant as they are already personally liable for any debts and banks are reticent to lend to them unless the debt is backed by a mortgage over land and buildings.

105. The decision on personal guarantee restrictions, and the appropriate Supported Loan amount (currently recommended at $25,000), is best considered in conjunction with any changes to, and further extension of, the SBCS beyond 24 July 2020.

106. The BFGS with personal guarantee restrictions and 100% risk for very small SME's then becomes a very similar product to the SBCS, but without the concessional repayment features and delivered through the bank channel. Direct lending through Inland Revenue, by increasing the SBCS loan amount, is likely to be more effective as a delivery model.

107. Prohibiting banks from taking personal guarantees in relation to Supported Loans below $25,000, with a higher (possibly 100%) risk share, will also raise the expectations of the small business community that the Supported Loans will be readily available without any credit criteria from banks, which will not be the case, as banks will follow their standard assessment processes.

108. If it is necessary to restrict banks from taking personal guarantees by moving to a higher (possibly 100%) risk share for Supported Loans less than $25,000, this is likely to increase fiscal risk to the Crown and remove the incentives created by the banks 20% risk share. This needs to be thought through carefully.

109. **Action: We will engage with representatives of the business community to understand how much of an impediment personal guarantees are to accessing finance from banks.**

110. **If personal guarantees are to be restricted, a possible outcome is that the Crown will have to accept a higher, possibly 100%, risk share for Supported Loans below $25,000. This represents a substantial change away from the current operations of the scheme, and will increase fiscal and other risks to the Crown.**

111. **We suggest final decisions on this are taken in conjunction with advice on any changes to, and further extension of, the SBCS beyond 24 July 2020.**

Payment waterfall and isolation

112. 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
- Finally, to the borrower's Supported Loan under the Scheme.

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

114. Under the payment waterfall a bank can only make a claim after first implementing their Supported Loan arrears management and enforcement processes to a point where no further recoveries are ***reasonably expected***.

115. Under the equivalent Australian scheme, the SME Guarantee Scheme, banks may claim (for their 50% risk share) ***before*** taking enforcement action against a borrower.

116. However, under the SME Guarantee Scheme rules each bank must undertake an accounting exercise which takes into account any subsequent enforcement action against any borrower.

117. This accounting exercise (or wash-up) reflects the fact that the bank's claim is based on an estimate of its loss (not actual loss) and that its ultimate loss may be greater or lesser than that estimate.

118. Under the wash-up, the bank may be required to make payment to the Australian government (if the bank recovers more than expected) or the Australian government may be required to make an additional payment to the bank (if the bank recovers less than expected).

119. We think New Zealand banks will resist the move to a wash-up regime because of its administrative complexity. It is also not clear that such a change would introduce strong incentives on banks to delay enforcement action in respect of a Supported Loan.

120. As the ability for banks to make a claim under the BFGS before taking enforcement action is already partly in place under the existing Deed, we recommend these features are further clarified rather than changing the payment waterfall. This is discussed further below in the enforcement flexibility section (see paragraphs 141 to 143).

121. Another reason we discounted adopting the SME Guarantee Scheme 'wash-up' approach are the perverse incentives it would create in conjunction with the other changes contemplated in this report.

122. Depending on the final 'watchlist' definition, or its removal, banks may be able submit claims as soon as any changes were enacted. This 'risk' is increased with the possibility of relaxing or removing the refinancing restriction. That is, there is potential for such a change to move existing impaired lending from full bank risk to a 80% Crown

guaranteed exposure, which creates a significant opportunity for banks to 'game' the Scheme, and increase costs to Crown with little benefit to borrowers.

123. We have also considered whether BFGS Supported Loans should, and could, be partially isolated from the borrower's other non-Supported Loans. This idea arose from the recent external 'settings' review of the BFGS by TDB Advisory.

124. We took legal and commercial advice on this idea; as it would require banks making changes to both Supported Loan and standard non-Supported Loan documentation, we concluded it would not be feasible for legal, commercial or operational efficiency reasons

125. We also assessed that clarifying that the banks have the ability to take flexible and commercially reasonable approaches in their enforcement actions would be simpler.

126. **Recommendation: No change to payment waterfall but increase 'enforcement flexibility' (see below).**

Liability cap

127. The Crown's maximum liability under the Scheme is $5 billion. This enables banks to issue up to $6.25 billion of Supported Loans. This amount was allocated among the banks according to their relative market shares. The initial allocations held some money aside to ensure there was there was sufficient to enable further banks to join as the Scheme evolved. Following the recent entry to the Scheme by Bank of China, $4.83 billion has been allocated to banks, leaving a buffer of $170 million still unallocated, in case further banks seek to join the Scheme.

128. Up to 8 June 2020 (eight weeks into the Scheme), banks had established facilities of up to $91 million under the Scheme. This represents about 1.5% of the potential supported lending under the Scheme.

129. Some of the other recommended changes (for example, extending the Availability Period, allowing funds to be used more for capital expenditure, or increasing the maximum revenue) might encourage further banks (in particular, [25]) to join the Scheme. It might also create a case for revisiting the methodology for allocating the liability cap amongst the banks, or for increasing the liability cap as a whole. If further banks seek to join the Scheme case we will provide you with further advice.

130. If the liability cap appeared to be heading toward being fully utilised toward the end of the Availability Period, you could decide at that time to expand it, depending on other government priorities. We do not believe that this is necessary at this stage.

131. **Recommendation: Leave the liability cap at its current level of $5 billion.**

Operational settings

132. Operational settings are the elements of the Crown Deeds of Indemnity that set the detail of how the Scheme will operate. The following operational settings are recommended for inclusion in the review, and are discussed further below:

- Reliance on borrower certification
- Enforcement flexibility
- Supported Loans Policies, Practices and Processes (SLPPPs)
- Reporting
- Crown rights of investigation, and
- Agreed-upon procedures engagement.

Reliance on borrower certification

133. The Deed provides that a bank may rely on a certification or confirmation made by a borrower, relating to their eligibility and to the intended use of the funds. This includes that the business: is New Zealand-based, meets the revenue criteria, does not involve an “excluded activity”, does not already have a Supported Loan from another bank, is not a local authority; and that the loan: meets the purpose of the Scheme, and will not be used to fund non-Scheme activities (capital expenditure, dividends, on-lending, refinancing existing debt, “excluded activities”, and property development and investment).

134. The Deed also provides that:

- A loan will not cease to be a Supported Loan merely because of the borrower’s certification being untrue or incorrect, and
- The bank has no obligation to monitor or verify how the proceeds of a Supported Loan are used.

135. The effect of these provisions is that:

- The bank does not need to undertake the due diligence on its customers that its standard credit processes might normally require, and
- On default, the Crown will be obliged to meet its 80% share of any shortfall, regardless of the truth or correctness of the borrower’s certification.

136. Irrespective of these provision the banks 20% risk share means that they are appropriately incentivised to assess credit risk.

137. There is an exception to the bank’s ability to rely on the borrower’s confirmation if, “at the time of the confirmation, the bank had actual knowledge or, based on the information available to the bank at that time, ought reasonably to have had knowledge to the contrary of [the statements in the borrower’s certification]”.

138. Banks have proposed that the exception related to what banks already know, or ought reasonably to have known, should be removed. It is apparently a source of significant

concern that the Crown might try to use this exclusion to avoid meeting its obligations under the Scheme.

139. In our view, the language could be softened and still achieve largely the same intent, along the lines of "… at the time of the confirmation, the bank had actual knowledge ~~or, based on the information available to the bank at that time, ought reasonably to have had knowledge~~ to the contrary of [the statements in the borrower's certification]".

140. **Recommendation: To discuss with banks, with a view to relaxing requirements.**

Enforcement flexibility

141. The ability for banks to make a claim under the BFGS before taking enforcement action against a borrower is already partly in place under the existing Deed. Neither the payment waterfall nor the Deed generally requires banks to take enforcement action in respect of non-Supported Loans before they can claim for losses in respect of a Supported Loan. All that is required is enforcement action in respect of the Supported Loan (and enforcement action in this context can include a settlement or compromise).

142. However, we have heard anecdotally that the banks' understanding of the Deed is that they can only claim once they have taken enforcement action in respect of non-Supported Loans. Because of this, banks are less likely to adjust their standard lending criteria and make Supported Loans in the first place.

143. This issue could be simply addressed by an amendment to the Deed to:

- Clarify that banks need not take enforcement action in relation to non-Supported Loans before they are able to claim in respect of a Supported Loan, and

- Further clarify that banks may reach a settlement or compromise with a borrower in respect of Supported Loans and non-Supported Loans and the shortfall (as calculated in accordance with the payment waterfall) will be covered by the Scheme.

144. **Recommendation: provide clarity as to the enforcement approaches banks can take**

Supported Loans Policies, Practices and Processes (SLPPPs)

145. For the purposes of the Scheme, a bank's SLPPPs are its:

> *"… credit assessment, lending, administration, arrears management acceleration and enforcement policies, practices and processes applicable to Supported Loans from time to time, as determined commercially by the bank, which must generally reflect the bank's standard policies, practices and processes, as modified to allow the bank to give effect to the [Scheme] and to allow the bank to look through the economic cycle to sensibly take account of the uncertainty of the current economic conditions caused by COVID-19."*

146. The Scheme requires banks to approve, administer and service each Supported Loan in accordance with the SLPPPs. The Scheme also requires banks to:

- Complete its arrears management and enforcement processes in accordance with the SLPPPs
- Make recoveries according to the SLPPPs (but only to the extent that this is "commercially reasonable")
- Certify by senior management that Defaulted Supported Loans being claimed against for the Crown's share of the shortfall have been subject arrears management and enforcement in accordance with the SLPPPs, and
- Provide to the Crown a summary of its SLPPPs (as a condition precedent to joining the Scheme), and of any material amendments to them.

147. The Deed provides that the SLPPPs are to be commercially determined by the bank, and there is no provision for the Crown to approve the SLPPPs, assess their adequacy, or require any amendments to the SLPPPs. Claims cannot be declined for payment on the basis that the bank's SLPPPs have not been followed.

148. In summary, banks set (and can amend) their own SLPPPs on a commercial basis, without any requirement for Crown approval, and only face consequences if they are found to have breached those SLPPPs in a way that is likely to materially increase the Crown's liability.

149. The banks have indicated concerns around the application of the Deed's requirements in respect of SLPPPs and that this may be inhibiting lending, without being specific about exactly what is the problem. We propose to discuss this further with the banks, with a view to clarifying or removing provisions that may be giving rise to unintended constraints on bank lending under the Scheme.

150. For example, the "… in accordance with…" requirements (as listed above) could be relaxed to include "… or otherwise at the bank's sole discretion, acting reasonably …", and the requirement to provide to the Crown updates to their SLPPPs could be removed. Another option is to separate out the credit assessment, lending, and administration aspects of the SLPPP's from the arrears management, acceleration and enforcement features.

151. This is likely to provide more certainty to the banks and address what we currently understand to be their main concerns regarding the SLPPPs. Both banks and the Crown need some degree of certainty regarding the actions that need to be taken (even if only generally described) when borrowers start to experience difficulty in

meeting their Supported Loan obligations and subsequently default. The SLPPPs usefully provide for this by describing arrears management, acceleration and enforcement features. Their merits can be explored further with the banks.

152. However, as the intent of the Scheme is to rely on the banks 20% risk share to incentivise banks to make reasonable commercial decisions, and by design they can use their discretion to approve loans within the terms of the Deed as they see fit, we will explore with banks whether credit assessment, lending, and administration can be deleted.

153. **Recommendation: To discuss further with banks, with a view to relaxing SLPPP requirements or removing the credit assessment, lending, and administration aspects, and revisiting other aspects.**

Reporting

Monthly portfolio reporting

154. Banks are required to report monthly on their Supported Loans. This is aggregated portfolio-level reporting, centred on expected credit losses and characteristics of the Supported Loan book.

155. This reporting is required to enable the Crown to meet its financial reporting and financial management obligations. Detailed loan-by-loan reporting, as is required under the comparable Australian Scheme, is not required. The only quality assurance that surrounds the monthly reporting is a certificate provided by the bank that appropriate controls are in place and have worked effectively, and that the reporting is complete and accurate in all material respects.

Notice of Claim

156. Banks also submit a monthly Notice of Claim in order to demand the Crown's 80% share of the shortfall on valid defaulted claims. This is also required to be accompanied by a management certificate. The Crown is obliged to pay within 20 working days. So long as the Notice of Claim is duly completed (and there are some exclusions that banks are expected to honour), there is no provision to challenge the claim, or to deny payment.

157. The electronic templates and specifications that have been developed to facilitate submission of Notices of Claim by the banks vary slightly from the specification in the Deed, so this should be updated.

Conclusion re compliance provisions

158. Banks have raised a concern that compliance requirements are onerous. These requirements are the minimum that is necessary to meet the Crown's financial reporting and financial management obligations. However, we propose to discuss this further with the banks to ensure that any concerns can be allayed.

159. **Recommendation: Update the specification of Notices of Claim.**

Crown rights of investigation

160. The Deed provides for a process termed “Crown rights of investigation”. Crown’s rights of investigation are not tied to the monthly claims process, and an “investigation” can occur no more than annually over the course of the Scheme (that is, at most 3 times), and not at all during the Availability Period.

161. The Deed sets out the limited range of issues an “investigation” can cover. These include that loans meet the definition of a Supported Loan, the Supported Loans are being administered in accordance with the bank’s SLPPPs, and a commercially reasonable default and workout process is being followed.

162. The rights of investigation do not extend to challenging the SLPPPs established by the banks, nor to second-guessing the bank’s credit decisions. In addition, there are procedural provisions to allay an initial concern the banks had that it could be used as a backdoor for regulatory investigation. Unless material deficiencies are identified, the Crown bears the costs.

163. There are two possible consequences of an investigation:

- Payments made by the Crown in respect of claims that are found not to have been valid Supported Loans under the Scheme can be required to be refunded by the bank.
- If material issues arise, there is an “Event of Review” that, if not satisfactorily resolved, could lead to termination of the Deed. However, the existing Supported Loans remain supported, and an investigation would not take place during the Availability Period, so termination would not affect new lending.

164. These limited rights of investigation are an important back stop to retain, especially as the Scheme involves a significant amount of public money being at risk. Their relatively ‘light touch’ reflects the ‘high trust’ approach that has been adopted for this Scheme.

165. Banks have raised a concern that the existing review powers under the Deed are potentially overbearing. We plan to discuss this further with the banks. We think that the proposals discussed above in respect of relaxing the SLPPP requirements, along with limiting the “investigation” powers to no more than annually, and not at all during the Availability Period, should address those concerns. You have already confirmed to banks that you intended to make these changes in your letter of 1 May 2020 (T2020/1239 refers). There may also be other practical refinements that could be made to the Deed to ensure that any remaining concerns can be allayed.

166. **Recommendation: Amend the Deed to limit Crown rights of investigation as already signalled, and explore with banks any other practical refinements alongside relaxing SLPPP requirements.**

Agreed-upon procedures engagement

167. To enable the Crown to meet its obligations in respect of preparation of the audited annual Financial Statements of the Government in accordance with generally accepted accounting practice, it may be necessary for independent assurance to be gained around the accuracy of the information about the Scheme provided by banks.

168. The Deed therefore allows for the bank's own independent external auditors to be engaged to undertake an "agreed-upon procedures engagement" (with the details of the required work to be agreed between the bank and the Crown) and report the findings to the Treasury and the Crown's auditors. This is a relatively standard auditing approach for an outsourced process, such as this Scheme, and it follows established auditing standards.

169. While an agreed-upon procedures engagement might possibly happen to identify an invalid shortfall claim on a Supported Loan, this is not the purpose of the engagement.

170. For the 30 June 2020 audited financial statements, it has been agreed with the banks that an agreed-upon procedures engagement will not be required because of the early stage of the Scheme.

171. **Recommendation: No further change.**

Surrounding policies

Non-deposit-taking lenders (NDTLs)

172. [33]

173. We have recommended that the Scheme's Availability Period is extended, and that Supported Loan be permitted for capital expenditure. [33]

174. [33]

175. The Treasury financial markets team will provide further advice on [33] to the Scheme with support from the BFGS team.

176. In respect of interest from the Non-bank deposit taking sector (you previously agreed to their inclusion (T2020/1035 refers)), [25] Nelson Building Society (NBS) were interested and we had substantially progressed deed drafting.

177. [25] recently advised that its customers are well supported by the SBCS and that they may enter the Scheme later in the year. NBS are awaiting the outcome of this report and whether any resulting Scheme changes are appropriate to them. Both [25] and NBS were appreciative of the opportunity given to them to join the Scheme and we will re-engage with them later in June 2020.

Consultation and Communications

178. The RBNZ were consulted on this report.

179. Based on what you agree to in this report, we will work with participating banks to agree a final proposed set of changes and will present them to you for final decisions.

180. In conjunction with any settings changes ultimately agreed between the Crown and banks we think it would be worthwhile producing some clarifying material for publication around the BFGS, how it is intended to work and be used, and who is eligible, over and above what is published on the business.govt.nz website. This will help inform the business community who are the target of the scheme, and provide independent information over and above what is available to them through banks.

Fiscal implications

181. The Treasury applied a cost approach to derive its $583 million estimate of expenses related to the BFGS, which are recognised upfront. The required view to be taken of the three components of a guarantee:

- Expected credit losses ($525 million)
- Expected admin costs ($13 million), and
- Expected return on capital ($45 million).

182. The hardest of these to assess was the expected credit losses. The following assumptions were used in the original estimate: the Scheme would be fully taken up ($5 billion for the Crown), COVID-19 and the intent of the Scheme (to encourage banks to support marginally viable firms) would lead to high loan default rates, repayment of the Supported Loans over the 3 year term would be slow and when Supported Loans defaulted recoveries to the Crown would be low (because it is last in line for repayment).

183. This led to a total estimated initial liability and expense of $583 million at the point the Deeds were signed in April, and a view that over the life of the Scheme the impact on net debt would be $538 million (i.e. $525 million of pay-outs and $13 million of administrative costs). Our expectation was also that credit losses would not emerge in the first few months of the Scheme, and that during the period up to 30 June 2020, the liability would be amortised (reduce) to $543 million.

184. We re-estimated the expected credit losses at the end of May 2020 and given how the Scheme had operated in its first eight weeks, we considered the original assumptions were too conservative.

185. Under the current settings, and at the end of May 2020, we expected a much lower uptake of the Scheme (approximately $500 million), a somewhat quicker repayment of the Supported Loans and much lower default rates (given banks were taking much less risk under the Scheme that we initially expected).

186. We estimated that the expected credit losses could be as low as $4 million but given the uncertainty, and the relative immateriality of this item, the amount was not recorded in the Crown's financial statements for April 2020.

187. It should be noted the Treasury's methodology for estimating expected credit losses, which is still being developed, is based on a number of assumptions for which there is currently limited external data available to validate. We are currently in the process of gathering information from banks to assist us with our expected credit loss estimates.

188. Depending on the mix of changes agreed to in this report we will re-estimate expected uptake and credit losses. Whatever changes are made we think it is unlikely that the expected credit losses will exceed our initial estimate of $525 million.

Risks

189. We have described the fiscal risks and the key trade-offs throughput this report. As with any agency arrangement that relies on delivery through private sector actors, with incentives not fully aligned to those of the Crown, there is a risk of unintended consequences irrespective of how robust the accountability mechanisms are.

190. We think the key trade-offs reflected in the recommendations in the report strike an appropriate balance between the increasing policy effectiveness while managing the fiscal risk/cost of the Scheme and ensuring the Crown's probity requirements in respect of the management of public money are met.

Next Steps

191. Once you have agreed in principle to the changes in settings, officials will work with the banks to arrive at final agreed proposals for change. These would be worked into an amended Crown Deed of Indemnity for your final decision, and to formalise agreement between the Crown and the participating banks.

192. In making your final decisions on any changes to the Crown Deeds of Indemnity, you will need to be satisfied at that time that the indemnities given by Deeds, as amended, are "necessary or expedient in the public interest" (S65ZD, Public Finance Act 1989).

193. Prior to the BFGS being established, the Ministers with power to act on COVID-19 matters authorised you to make final decisions on Scheme design (CAB-20-MIN-0130). Once we have discussed the proposed changes with the banks and arrived at final proposals, you may wish to advise Cabinet of these further changes in Scheme design.