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The ABC and DE of Emergency Liquidity Solutions

Setting aside, if one has the luxury, the wave of personal tragedy resulting from the global spread of COVID-19, there is no doubt that important measures for the public good to contain and slow the epidemic will have an acute and significant economic impact. Few businesses, big or small, will be immune from demand shocks, disruption to supply chains, labor shortages or all three. The resulting impact on their cash flow could potentially cause irreparable and unnecessary damage to firms with otherwise perfectly viable longer term prospects. Responsible lenders that value client relationships and that want to avoid the domino effect of multiple defaults will need to engage constructively with borrowers to nurse them through impending liquidity crises. Banks will also need to act fast and in a concerted manner.

In Italy, the European nation currently feeling the worst effects of the coronavirus epidemic, politicians are discussing how a government that is asking its citizens to make sacrifices to defend civil society should share costs across the economy and spread them over time. Primary financial healthcare is offered predominantly by banks and other centralised lenders. By the same token, if lenders are to recover the cost of short term bailouts from their respective tax authorities, then they would be best advised to ensure that the liquidity solutions they dispense are simple, transparent and standardised and so easily accounted for.

In this article, we look briefly at the most essential items for discussion between business borrowers and lenders dusting off their finance agreements with a view, in both of their respective interest, swiftly to avoid a liquidity crunch and cascading defaults.

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A first question to ask is what sort of payment holiday the borrower reasonably needs: Lenders and customers usually begin with repayments of principal, but it's obviously less straightforward than simply making a loan 'interest only': Will the repayments forgone be treated as made for the purposes of calculating interest, or merely deferred as further borrowed money? Will suspended payments be added to the next scheduled repayment, to a 'balloon' amount repayable only at maturity or spread over the life of the loan? There are obviously very different implications for lender and borrower over time.

Borrowers may be equally or more concerned with meeting their interest bill: When bank customers remain obliged to pay for wages and utilities, a reprieve from monthly or quarterly interest charges could result in a business having enough cash flow to keep its head above water. Again, questions arise around whether interest payments are simply forgiven (unlikely, unless the lender may reclaim the benefit forgone from government, whether by tax allowances or otherwise) or if capitalized and borrowed as principal, in what manner. Separately, monetary authorities across the world have started to cut base rates to loosen money supply and reassure markets in the face of the current emergency. The question arises whether government policy will also intervene to oblige lenders to pass on the benefit of those cuts to borrowers. Similarly, lenders may be forced to apply discounted margins on loans to borrowers most starved of short term liquidity, small and medium sized enterprises as employers of 66% of the EU's workforce or those considered essential or central to the economy.

Covenants in existing borrowing arrangements will need to be examined carefully: Many credit agreements restrict the ability of borrowers to negotiate with creditors and suppliers, suspend payments, dispose of assets, make changes to their business and the like. Others also contain financial covenants such as those limiting indebtedness and requiring the borrower to generate enough free cash to cover loan interest and other costs. Clearly, where one or more lenders is extending liquidity to a borrower, many or all of those covenants will need to be relaxed or waived. At the same time, lenders would be wise to avoid anything like a blanket waiver: Negotiations should neither leave the door open to reckless borrower behaviour, nor allow them to sweep more fundamental problems under the carpet. Careful drafting should make carve-outs and waivers time sensitive and conditional. And as referenced above, banks will need to keep a weather eye on government policy, since the introduction of an automatic stay on lenders accelerating or enforcing debt during the crisis, could mean it is safer for them to leave certain protections in credit agreements unaltered.

Documents covering matters outside the borrower's principal banking relationship should not go ignored either: Other financial arrangements such as interest rate or foreign exchange hedging agreements could contain cross-default provisions whether the customer's main bank has waived them or not. There may well be analogous provisions in supply contracts (especially IT licences) and lease agreements requiring at least a discussion with suppliers, service providers and landlords. Plenty of good work by the parties to a company's main credit agreement could be undone if third party creditors and counterparties become difficult as a result of being left out in the cold.

In an ideal world, the industry would at a local or preferably international level, sponsor the development of short-form liquidity support documentation for businesses that is sanctioned by regulators and government. The provisions could not only be imposed automatically on the borrower's other lenders and extraneous creditors, but also streamline the process for the liquidity facility provider to recover some or all of its costs and losses from the public purse. Similarly, if there is time (although perhaps there isn't), we could consider giving emergency liquidity providers enhanced priority relative to other creditors and / or a privilege over the borrower's floating assets to compensate them for the additional risk they are taking for no immediate reward.

Events are moving so rapidly at present, that one of the most difficult questions for Europe's financial services industry is determining to what extent lenders and borrowers will be required to adjust their relationships privately, or alternatively move in lockstep with ad hoc legislation. We hope that there is a move towards the latter, but in the midst of this ongoing challenge, businesses and their advisors will need to be nimble and anticipatory in the face of changes in the need for and supply of short term credit.

Should you have any queries in relation to the issues raise in this bulletin, please contact the authors or your usual Dillon Eustace contact for further information.

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