Revenue Contingent Loans for COVID-19 Economic Recovery

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1. The Problem – unprecedented uncertainty chokes credit supply

1.1 Background: the economics of crisis, uncertainty, and credit

We are now enmeshed in the worst combined health and economic crisis in Australian recorded history. The economy is clearly in serious trouble (and will be for the foreseeable future), and there are no simple solutions for government policy. While it is clear that major injections of outlays in various forms are critical to mitigating the risk of a very deep and prolonged recession, it is also the case that extremely high levels of public debt have the potential to severely constrain future budget flexibility.

One of the salient features of the crisis is the extraordinary levels of uncertainty, impacting on business decisions with respect to borrowing to help replace falls in revenue. In such an unparalleled risk circumstance it is completely predictable that business, especially small business, will be very cautious with respect to extensions of credit obligations.

This uncertainty must be a critical issue on the credit lender side as well, with banks now in an unprecedented environment in which sensible calibrations of repayment risk are not possible. In short, it is a terrible time to borrow, just when the need for financial buoyancy for business is at its greatest.

1.2 The government's loan guarantee response and take-up

The Australian Government has recognised the need for funding to small business and committed $40 billion dollars to the Coronavirus SME Guarantee Scheme from April 2020 to June 2021. The scheme design explicitly recognises the uncertainties for banks through the Government guaranteeing 50% of loans. Loans are up to $250,000 for 3 years with no interest payable in the first 6 months and are unsecured. Details are available on the Australian Treasury website.

But, and completely consistent with the characterisation expressed above of the current wariness enveloping both lenders and borrowers, a third of the way into the scheme's availability, only about 4.5% of funds have so far been provided to some 16,000 out of a potential pool of around 2.5 million Australian businesses.

This expectation is not being fulfilled. The combination of COVID-19 uncertainty, a post-Royal Commission into the Banking environment, and regulations put in play after the global financial crisis, including the Australian Financial Complaints Authority, have meant that even with both a relaxation of responsible lending obligations and a guarantee by the Government to cover 50% of defaults, small businesses are obviously finding it difficult to access funds.

1.3 Time for a change?

A critical point for small business borrowing with the current loan approach relates to the nature of repayment of normal debts, which is on the basis time. This means that since loan obligations require repayments of a constant amount per period, business will necessarily normally be at least partially averse to taking such loans through concerns with future repayment hardships. With the current levels of unprecedented uncertainty these familiar borrowing concerns must now be accompanied by the heightened prospects of default and bankruptcy with any the further use of commercial credit.

In this context a pertinent question is: is there a different type of debt that might help overcome our contemporary loan repayment hazards for small business? What follows explains that in concept, and with enough due design diligence, also in practice, there is such an instrument and it is known as a "revenue-contingent loan" (RCL).

2. The Solution: Revenue-Contingent Loans

2.1 What is an RCL?

An RCLs for business is a financial instrument in which money is provided to eligible firms in the form of a loan. However, the loan has a critical feature which is quite different to normal commercial lending, including the Government's SME loan guarantee. This is that with an RCL repayments of the debt are required if and only when the firm has a comfortable capacity to repay; RCL is a subset of is what economists call a "contingent debt".

In concept the idea is similar to the Higher Education Contribution Scheme (HECS), in which students are provided with a benefit, in the form of not having to pay tuition on enrolment for a university degree, which is then paid when graduates are able to afford to do so depending on their future incomes. This provides to university debtors insurance in the form of not having to repay the loan in financially adverse periods.

An RCL would also provide insurance to a small business debtor, and in this way HECS and an RCL have in common protection against the consequences of loan repayments when financial circumstances are adverse. However, RCL operate quite differently to HECS in practice, an issue explained below.

2.2 How would an RCL work in principle?

The first operational point of an RCL is to distinguish this type of loan from the income contingent loan (ICL) which defines HECS. This is because HECS uses individual income as the basis for repayment of the debt, which is completely appropriate for a system targeted in the main on wage and salary earners. However, the way forward for a COVID-19 RCL must be related to the economic well-being of a small business and not personal incomes.

Botterill, Chapman and Egan (2004) examines the most efficient basis for collection of an RCL for farmers in the time of drought, and it is concluded that the use of farm property revenue is the best way to ensure the instrument would be effective; the use of profits as an alternative is rejected, given how open profit reporting can be to the gaming of an RCL system.

Since most farms are simply a subset of Australian small business, the collection issues are highly pertinent to how an RCL would work for all small business. The key debt collection administration principles are that:

- The reporting of revenue is a legal requirement of all business, through the Business Activity Statement (BAS);
- The debt would be tied to the firm's unique Australian Business Number (and, in future, the Director Identification Number);
- Debts would be capped and linked to a proportion of a firm's previous revenue (say, the most recent three year) history, data easily available from the Australian Taxation Office (ATO); and

- To minimise administrative complexities the periodic repayment requirement would involve no first revenue threshold and would simply be a fixed low proportion (for example, 5% or less) of annual revenue.

2.3. Practical example

Here is how it could work. A qualifying business, with eligibility determined by the government (discussed further below), would apply for a COVID19 RCL. The maximum amount able to be accessed would be capped (like the currently undersubscribed Coronavirus SME Loan Guarantee scheme.) To ensure substantial repayments, this amount needs to be set at a maximum depending on a firm's past annual revenue experience. The cap could be something like not more than 50 percent of the average annual revenue of the past 2-3 years of the company, with a maximum set at, say, $200,000 per firm.

It is envisaged that the government would provide the loan (although creative thinking might lead to a partnership with the banks) to the business and the debt would be recorded with the ATO. Every month the revenue reported with the firm's BAS would activate some debt collection, with the amount set at a given (low) percentage of annual revenue, for example, as suggested above, of 5% or less.

This means that if a firm borrowed $50,000 and in the first year after the loan became available the firm's annual recorded revenue was $80,000, the arrangement would require a repayment of 5% which is $4,000. If revenue in the second year turned out to be $200,000, the repayment obligation would be $10,000 in that year. If this experience were replicated in each of the ensuing 5 years, the RCL would be repaid in under 6 years.

Some simple modelling results (using different scenarios of debt levels, interest rates, debt surcharges and collection parameters) are available with respect to both a farm RCL Chapman and Dunk (2020) and business generally (Chapman and Piggott, 2020a). All these exercises come to the same conclusion: repayments are completed within less than 6 years, although this requires the assumption that the establishments continue to exist for the repayment period, which is a critical issue for the policy debate (more on this below).

2.4 Advantages and disadvantages of an RCL

As emphasised, RCLs are quite different to typical loans, because very low or no repayments of the debt are required when the financial circumstances of the borrower are poor. This is a particularly important feature in Australia's contemporary economic environment where uncertainty with respect to the financial well-being and future of small business is extreme. What an RCL means is that firms will be able to access finances with significantly diminished concerns or anxieties associated with repayment difficulties and concomitant potential default and bankruptcy.

Even so, RCL pose critical challenges related to the repayment amounts received by the government. This is a key concern with a prospective COVID-19 RCL and is the subject now addressed.

3. Objections and Options

3.1 The temporary nature of a COVID-19 RCL

A first major point is that a COVID-19 RCL is an instrument designed for today's unique financial circumstances, and not as a radical departure for government with respect to the public sector's role in commercial financing. The extraordinary adverse economic situation that is today's economic reality is the rationale for our suggestion with this different approach to credit not seen to be a more than a temporary re-balancing of the financial landscape.

Second, if government is to provide the basis of the finances required for a COVID-19 RCL, there is an over-riding question: what mechanisms can be put in place to ensure that the vast majority of taxpayer provided RCLs will be recovered?

It is useful to distinguish the ways in which a small business RCL borrower might end up not repaying the full amount, with the first being through them taking active steps to avoid the obligation, which can be labelled "moral hazard". The second does not involve unethical behaviour but can be traced instead to the market vicissitudes beyond the control of most small business. We now explain these concerns and offer some potential ways to minimise their impact.

3.2 RCL repayment avoidance: phoenix-type firm behaviour

As with all lending, a COVID-19 RCL has the potential for "phoenix-type behaviour" (dissolving a business in order for a firm borrower to avoid credit obligations) and also for attracting the "wrong" type of credit profile/customer. There is also potential for businesses splitting revenue sources into different entities (such as the way some do to avoid payroll tax thresholds), although if the collection basis is as a percentage of revenue as suggested this may not matter operationally.

It is useful to note that this avoidance behaviour already exists and there are laws against it. These must also apply to any RCL context.

Even though there are legal impediments to this type of behaviour with respect to an RCL, the importance of potential adverse outcomes for debt recovery require some additional careful thinking and the application of definitive parameters for eligibility. Consideration needs to be given to disqualifying RCL entitlement to firms with:

- a short history; and/or
- unsatisfactory indicators of previous credit conduct.

Further, it is critical that ways are found to share the risks of less-than-full repayment with borrowers, and this raises the important prospect of there being personal repayment liabilities of directors in the event of a firm's dissolution. The details are critical and need to be considered further.

3.3 RCL repayment efficiency

It is possible that the use of the current BAS arrangements are not completely suitable for the collection of a COVID-19 RCL. This is because business elect reporting periods, one, three or 12 months and can be lodged months after the reported period has ended, meaning the

information can be out of date when an RCL repayment obligation is enacted. While this is unlikely to constitute a major problem if the rate of collection from revenue is as lower than 5% or less, there still might be more efficient repayment arrangements.

One way to help ensure that the process works well would be to require RCL debtors to report revenue monthly, and to repay the required loan amount within a very short period, for example, one week.

A more fundamental response would be to have the means of repayment linked direct to the borrower's bank account in which a small set percentage of every (sales) deposit was diverted to reduce the RCL loan balance.

3.4 An RCL Loan Surcharge

Even if all goes smoothly, it is inevitable that there will be some repayment leakage with a COVID-19 RCL. To minimise the total financial impost that this implies, a surcharge should be added to each loan obligation, and this could be of the order of 10% of the debt. This would mean that loan collections to the government from those repaying in full would constitute a surplus to the budget and, if non-repayment leakages from other RCL borrowers are sufficiently small, imply the possibility of revenue neutrality from the system.

3.5 Security and deposits

As noted, while the intention of an RCL scheme is to minimise to a firm the default risk associated with borrowing, it is still the case that some security is required for the lender. The Government's SME Guarantee loan currently does not require security against personal assets. If a business decides to close, the loan would be treated as a debt with respect to all other creditors, subject to insolvency or administration arrangements. In contradistinction it would seem desirable that the RCL eligibility would be the same as other loan instruments in regard to security and deposits, being secured by assets (business or personal) and if being used to buy property or assets being a percentage of the overall purchase cost

3.6 The borrower and lending criteria

RCLs are designed to provide credit to businesses that currently are unable to access finance due to uncertainty. With an RCL, basic eligibility criteria, including importantly the viability of, previous trading history and credit rating of the business, the character of the borrower and their capacity to repay, would all still be considered in the lending criteria. In many ways, RCLs would look like a normal loan.

3.7 The Lender

The banks have shown little appetite for small business lending in the current unprecedented uncertainty, and it appears as if small business borrowers have the same reservations with respect to borrowing. The Australian Government has already thrown $40B in the kitty with a 50% guarantee SME Coronavirus Loan Scheme, implying that the Government is keen to underwrite economic recovery. In these circumstances, and likely without significant budget implications it appears considerable funds could be diverted into an RCL scheme or pilot.

The RCL scheme could be initially introduced and administered over a short term and its performance gauged quickly. The long-term view would be to provide information concerning the viability of an RCL, and to then consider how it could proceed, with an

important question being the potential and nature of finance sector involvement conditional on the scheme establishing its value beyond its initial application to the current COVID-19 circumstances. This provides low risk entry, time, and information regarding performance for banks and other lenders, to reimagine emerging financial products.

It is not unusual for Governments to underwrite policy direction with an aim of creating a commercial market for the future, taking up the challenge in the first instance, in a small, defined, and controlled manner that mitigates risk. Governments often fund innovative manufacturing and research, so why not a financial product?

Another reason for proposing the initial lender for an RCL product be Government, is the issue of the urgency and seriousness of our contemporary financial trauma. It takes time for banks to create new product, offerings and to change their established structures and culture around risk and borrowing. The Government, and its servants, especially during COVID-19 have shown capacity to imagine and enact new policy and legislation.

This is new territory; however, these are unprecedented times. Credit is critical to restarting the economy and exploring RCL potential could lead to a way in which capital begins flowing to the many small businesses that can drive economic recovery.

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Summary RCL

- ☒ The problem is uncertainty, banks are not lending, and businesses are not borrowing.
- ☒ Without free-flowing capital, businesses cannot rebuild and recover.
- ☒ This problem is impacting nearly a million business (who have experienced a >30% revenue decline) and this impacts over half the Australian workforce, so while it is mainly a small business problem, it is a BIG problem.

- ✓ The solution is a loan that can cope with uncertainty.
- ✓ Such a loan exists in principle and has been used successfully for student loans for over 30 years. It is known as the Higher Education Contribution (HECS) scheme.
- ✓ This idea could be changed to become a Revenue Contingent Loan (RCL) for small businesses.
- ✓ RCL removes time as a determinant of the loan repayment obligation because loan repayment obligations are contingent on revenue.
- ✓ If a business can get some flexibility around repayments, a lot of the risks associated with uncertainty are minimised.

How it works

- An RCL is repaid based on the business revenue at a low rate, say <5% of annual revenue.
- RCLs would be small loans, capped at say <$200,000 and tied to the businesses' past trading.
- A small surcharge of say <10% would be charged to cover the costs, including the risk of less-than-full repayment of the RCL from some proportion of borrowers, of running the scheme.
- The Government would initially administer the scheme, having the associated legislative and administrative capacity.
- There is about $38B in unused funds that could be diverted from the undersubscribed SME Coronavirus Government Guaranteed scheme to an RCL trial.
- The Government can use existing revenue reporting facilities, like a Business Activity Statement (BAS) to collect repayments.
- Just like a normal loan, business applicants to be eligible must establish their trading and credit histories, repayment capability and good character. If the purpose is to buy major assets the borrowing will be a % of the total cost (they will need a deposit) and security against business or personal assets.
- The Government is not competing with the banks, as the banks are not lending to small business.
- The scheme would be limited to a COVID-19 response and assessed for its useability in future contingent on outcomes.

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