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COVID–19: Providing access to finance for firms

The COVID-19 pandemic has severely affected firms through the direct impact of the lockdown, falling demand, reduced input supply, the tightening of credit and liquidity conditions, and rising uncertainty.

One way to help businesses through a crisis of this nature is to give them access to finance to tide them over until the economy improves. To this end, the UK government quickly introduced loan guarantee schemes. The Bounce Back Loan Scheme (BBLS) and the Coronavirus Business Interruption Loan Scheme (CBILS) provide financial support to businesses across the UK that are losing revenue and seeing their cashflow disrupted. These programmes are intended to have direct effects (e.g. easing credit constraints), which then feed through to improved firm performance (e.g. survival and employment).

Debate continues about how these schemes might be developed as the crisis continues and whether other interventions should be considered. For example, should the loan guarantee be more generous? Should an additional equity-based scheme be developed to complement the debt-based scheme? Local areas, and umbrella organisations, are discussing and proposing alterations or alternatives.

To inform this debate, this rapid evidence review provides a summary of the evaluation evidence on the impact of government access to finance schemes and some general guidelines on designing effective policy responses drawing on the broader economics literature. Our aim is not to offer a comprehensive discussion of the current crisis, but to provide a concise summary of relevant evidence that tells us what has worked in the past and any lessons this holds for current policy.

Evidence on the performance of loan guarantee schemes[1]

Loan guarantee schemes (LGS) provide loans through private banks either partially or fully guaranteed by public sector organisations. LGS are one of the most widely used mechanisms to support SME access to debt finance. Similar schemes are in effect in the UK, US, Canada, Japan, Korea, and Germany, and many other countries.

The available evaluations, mostly from growth periods, suggest LGS have a positive effect on firm access to debt finance either in terms of the availability of credit or the cost of borrowing (or both).

The evidence on firm survival is mixed; there are only two evaluations of LGS that consider this outcome, with one finding positive effects and the other no effect. Moreover, there is some evidence that loan guarantees may increase default risk and that schemes introduced in response to economic crisis perform somewhat worse than long-term development schemes.

Developing the Loan Guarantee Scheme: Things to consider

- Emergency policy responses needed to be implemented quickly; on the other hand, the need to act quickly must be balanced with making sure that money is spent wisely, which takes time.
- Developing the policy response should include identifying gaps in provision where otherwise viable firms are not being supported.
- Programmes should avoid using public resources to support firms that i) would have not survived under normal circumstances; and ii) are able to access finance but at a higher cost.
- Risk sharing between banks, governments and the private sector plays a key role in providing the correct incentives to both lenders and borrowers.
- Larger guarantees encourage banks to lend more because they place less weight on the viability of borrowers (as government guarantees the loan). Proposals to change the size of the guarantee need to recognise this trade-off.
- While guarantees mostly affect the behaviour of lenders, grants change the behaviour of borrowers. They will provide some support for otherwise viable firms for whom increased debt is not an attractive option (e.g. because they become non-viable when they must repay increased debt). However, they will encourage otherwise non-viable firms to seek support (as they do not have to pay back the loan). Again, proposals to provide grants need to recognise this trade-off.
- More generous support also increases the direct cost to government.

Equity type schemes

A key concern associated with the uncertainty of the COVID-19 crisis is that providing access to finance through LGS in the emergency response phase could lead to high indebtedness and debt overhang (i.e. prevent future borrowing), and therefore hinder future investments and growth.

This has led to suggestions that the development of the access to finance response should involve some type of equity scheme which would provide additional support to firms and also help mitigate the debt overhang problem.

1 Based on our evidence review on Access to Finance

Developing Equity Schemes: Things to consider

- Alternatives should be assessed on the basis of both short and long-term objectives; addressing liquidity issues and implications for future risk, debt levels and growth.
- Equity schemes will need to price equity in a way that correctly assesses risks and returns and will involve complex negotiations and legal agreements. It is unclear that many local areas would have the capacity to implement such a scheme.
- Effective risk management also requires a large pool of firms which may also be a problem for local schemes.
- Most SMEs are funded through debt (see annex) and will be unwilling or unable to accept the external ownership that would be required to participate in an equity scheme. This suggests such schemes might only be appropriate for larger firms.
- Equity-like schemes are possible if government can offer support to a firm in exchange for a share of future profits recouped through the taxation system. Government absorbs the loss in case of a poor future performance of the firm but shares the benefits of improved performance.
- Because repayment to equity-like schemes is through corporate taxes, such schemes must solve problems raised by firms' abilities to manipulate profits (e.g. through legal accounting practices). They also have implications for future tax revenues.
- While local governments may have some informational advantages in running equity-like schemes this is offset by the need to pool risks, avoid rent-seeking and consider effects that occur outside the immediate area – e.g. through supply chains. In the UK, as the local tax base is limited, it is also unclear what tax revenues could be used to implement such a scheme.

Annex

The case for government intervention[2]

Financial markets play an important role in the efficiency and growth of the economy. They mobilise savings, pool capital, select projects, monitor and enforce contracts, and manage risks. Obtaining, processing and managing information is fundamental to well-functioning financial markets. Information problems in credit markets can result in credit rationing. Evidence from the 2008-09 international financial crisis suggests that greater uncertainty during business cycle downturns has the potential to exacerbate credit rationing. Smaller firms are also more likely to be more affected by liquidity constraints, even when collateral is available.

Governments have always played a role in financial markets. Most obviously, the state steps in during financial crises. Even in the absence of crisis, market failures provide a rationale for government intervention in firm finance markets. These market failures mainly relate to imperfect or asymmetric information. These information problems are exacerbated during sharp economic downturns. When future profitability is hard to predict it may be difficult to distinguish between good and bad prospects. Those firms most keen to borrow may be least likely to default and therefore not pay back.

Financial markets also typically disregard social returns. Banks and other lenders fund projects with the highest private returns. But society may benefit from other projects being funded. These factors are particularly important during an economic crisis as sustaining firm viability and preventing job losses is important for preventing negative spillovers across the economy.

Sources of finances by type of firm

Under normal circumstances, lenders tend to struggle when assessing the viability of a loan for SMEs (Table 1). Governments often use loan guarantee schemes to address this issue. Equity finance is rare for SMEs due to the large and fixed costs of accessing equity markets. This creates an equity gap for SMEs seeking between £250,000 and £5 million of financing. For this reason, the UK's government launched the Enterprise Capital Fund (ECF), which provides equity finance to innovative small businesses with high growth potential.[3] Mid-sized businesses tend to rely on a combination of bank lending and equity markets to raise capital. Large viable firms do not generally have problems accessing finance, at least in normal market conditions.

Table 1: Common financing alternatives by size of the firm

Type of firm	Bank lending	Equity market	Private placements	Bond markets
SMEs	Yes	Limited	No	No
Mid-size companies	Yes	Limited	Limited	No
Large companies	Yes	Yes	Yes	Yes

2 Adapted from our evidence review on Access to Finance
3 ECF has not been evaluated with a robust methodology or the evaluation is not publicly available.

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