Crisis Working Group Report

Communiqué

May 7, 2020

COVID-19 Crisis Working Group: Monetary and Financial Measures

Communique #5: Viable Businesses Need Access to Capital

The C.D. Howe Institute has initiated a special project to provide rapid expert insights to help Canadians and Canadian policymakers navigate the COVID-19 crisis. Its Working Group on Monetary and Financial Measures is co-chaired by David Dodge, former Governor of the Bank of Canada, and Mark Zelmer, former Deputy Superintendent, OSFI, and supported by a group of financial market experts and economists. The group's fifth meeting was held on Monday, May 4th, 2020.

The group's focus at the meeting was on the recovery phase and how to ensure companies with viable business models can make the types of investments needed to adapt to the changing structure of the economy, avoid unsustainable debt, and replenish their working capital. Traditional risk metrics are likely to show that potential borrowers are riskier than they were pre-pandemic. Private lenders might be unable or unwilling to take on the associated risk in this highly uncertain environment. The primary question then is whether there are steps governments can take to facilitate business access to both short-term working capital and new sources of patient capital without propping up businesses that would have failed anyway, or whose models will not work post-pandemic.

Members agreed that one of the major impediments to private-lender capital provision is high uncertainty about how the economy and public policy will evolve in the recovery. Anything that governments at all levels, as well as the central bank and regulators, can do to provide forward guidance and reduce uncertainty about how public policy and regulation will unfold as the economy recovers will help ensure private lenders and borrowers can match up as the recovery takes hold.

Members felt that the underlying issue of replenishing business working capital is one of liquidity. On this front, the Bank of Canada has supported financial institutions with plenty of liquidity through the pandemic. Therefore, as long as companies have viable business models, financial institutions should be there to help companies restore their working capital.

INSTITUT C.D. HOWE INSTITUTE
Trusted Policy Intelligence | Conseils de politiques dignes de confiance

The focus then turned to the other two concerns, namely the ability for businesses to invest in the new economy, and restructuring their balance sheet in order to do so.

Members began by pointing to the three different types of companies that will emerge from this crisis. First, there are companies that no longer have a viable business model despite the liquidity support they have received. Second, companies that do have viable business models, but need to restructure their finances and obtain new sources of capital to invest. And, third, companies that are going to have to do a deeper restructuring, and will likely have to shrink in a post-pandemic world.

The group felt that focusing on how to support these last two buckets – those needing to restructure their finances, and those needing to restructure in more depth – would be critical for the success of the recovery.

On those companies needing to restructure their finances, the group discussed regulatory impediments that might restrict the type of necessary patient capital flows in an environment where traditional risk metrics may not tell a company's true story. One such impediment highlighted by the group was life insurance company capital requirements. In particular, life insurer regulations assign the same capital charge to all unrated debt investments regardless of the inherent credit risk of the investment. This effectively dis-incents investments in lower risk investments like many infrastructure projects. Members advocated allowing major life insurance companies to use their own risk models to measure and capitalize the risk for those projects in the same way regulations allow major banks to use their own risk models to measure and capitalize the risk in their lending activities. That would help facilitate greater institutional investor supply of capital for infrastructure projects and to unrated companies more generally.

For companies that need to restructure their operations, the two main federal insolvency statutes are the *Bankruptcy and Insolvency Act* and the *Companies' Creditors Arrangement Act*. This bankruptcy system allows companies to reorganize and develop a restructuring plan in negotiations with creditors with protection from liquidation, effectively giving businesses a second chance. Members felt that governments should encourage companies to take advantage of the system, removing any stigma attached and assessing whether there are ways to streamline the process.

Members did feel, however, that some companies are likely too systemically important, as judged by their knock-on effects in the rest of the economy, to be able to go through the bankruptcy and insolvency process. The challenge is determining which companies are truly systemically important. Governments need to be clear on the criteria they will use to make this determination. And once these criteria have been laid out, the question is what role should government play. Alternatively, members pointed to an approach used in other jurisdictions whereby companies are encouraged to look to

employees and other stakeholders first for capital. Members acknowledged, however, that this was a longer-term approach and actual government intervention might be necessary in the more immediate term.

One option for government intervention involves incentivized loans, where government provides favourable terms to companies in exchange for them making specific investments. Members were wary of this option, with governments directing investments. Members pointed to other options such as government or Crown lenders taking a mezzanine debt or preferred equity position, which would allow companies themselves to determine the appropriate investment. One potential concern here is that this type of investment puts the government, and by extension the taxpayer, lower in the creditor stack, i.e., behind secured debt holders. While no perfect option exists, members did favour the preferred equity approach. The group did not discuss tax issues but noted that the government might want to consider tax measures that facilitate the flow of patient equity capital.

In summary, the group felt that policymakers and regulators should take the following steps to ensure capital is flowing efficiently to businesses best placed to drive economic growth during the recovery:

- Reduce uncertainty about the future course of public policy and regulation by continuing to be transparent in communication with the public;
- Reduce regulatory impediments to capital flow, through, for example, allowing life insurance companies to use their own internal risk models, thereby incenting more investment in companies and infrastructure projects that do not have public credit ratings;
- Encourage companies to take advantage of Canada's bankruptcy and insolvency programs, which in effect, give companies with viable business models a second chance through negotiations with creditors; and
- Be upfront about the criteria that will determine systemically important Canadian businesses, and if forced to invest, lean towards preferred equity.

The next meeting of the Monetary and Financial Measures Working Group will be on Wednesday, May 20th, 2020 at 3pm. The group will continue to monitor events and policy actions in determining the most relevant topics for that meeting.

Monetary and Financial Measures Working Group Members include:

David Dodge, Co-Chair, former Governor of the Bank of Canada

Mark Zelmer, Co-Chair, former¬ Deputy Superintendent, OSFI

Riaz Ahmed, TD Bank

Steve Ambler, Universite du Quebec a Montreal

Dwight Duncan, McMillan LLP

Paul Jenkins, Former Senior Deputy Government, Bank of Canada

Phil Howell, Former Superintendent, FSCO

Thor Koeppl, Queen's University

Andrew Moor, Equitable Bank

Tamara Vrooman, VanCity

Jeremy Kronick, C.D. Howe Institute

Duncan Munn, C.D. Howe Institute