Crisis Working Group Report

COMMUNIQUÉ

June 22, 2020

COVID-19 Crisis Working Group: Monetary and Financial Measures

Communiqué #7: Guidelines and Creativity Key to Restoring Financial Confidence

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 seventh meeting was held on Monday, June 1st, 2020, and its eighth meeting on Monday Jun 15th, 2020. This communiqué reflects the conversations at both.

Governments have stepped in with unprecedented stimulus to shepherd businesses and households through the crisis. In many cases, this has been through specific lending programs in partnership with financial institutions. On the business side, these lending programs include the Business Credit Availability Program, the Canadian Emergency Business Account, and the Large Employer Emergency Financing Facility.

As we move from the crisis to the recovery phase, these programs need winding down or modification to reflect the changing economic circumstances. Members noted, however, that traditional risk metrics are likely going to make even healthy businesses appear unhealthy until the recovery is well underway and economic uncertainty has eased. Members agreed we do not want to support zombie firms, but we also want to make sure healthy firms with viable business models do not disappear. Therefore, in the view of members, some continued government involvement is likely warranted. With uptake of certain support programs underwhelming so far, certain big questions arise: why this lack of uptake is the case? what modifications are necessary? and what principles should guide any future government involvement?

Members pointed out at the outset that the last question of principles assumes a degree of certainty about the path of the recovery and the kind of government support required. The current high degree of uncertainty regarding both the future course of the pandemic and how policymakers will respond

and ultimately fund the support provided, makes it much more difficult for lenders, investors and even business owners to assess the prospects of even healthy businesses. This high uncertainty matters both for lenders and investors considering taking an equity stake and for businesses deciding what form of support would be most useful for them. Members thought that the programs to date have focused on (i) helping borrower creditworthiness and (ii) supporting financial institutions in bridging the initial mandated restrictions on business activity. But the bigger challenge going forward will be to assess business prospects during a recovery that is uncertain, reflecting in part the uncertainty surrounding future government regulatory policies and fiscal support measures.

As much as possible, then, governments should look to reduce the uncertainty within their control, noted members. They felt that governments rightly prioritized health outcomes at the outset of the COVID-19 crisis. However, as physical distancing measures are relaxed and economic activity recovers, reducing uncertainty for businesses involves taking a more holistic approach; one that focuses on the intersection of health and economic outcomes. Members agreed that governments could provide more clarity on how they will approach a second wave, and expressed support for a more a targeted, regional approach. In addition, more clarity is needed on how the existing support measures will evolve during the recovery and on how the government plans to restore fiscal sustainability over the medium term. Such clarity would help to tangibly reduce the uncertainty that is currently hindering business planning and associated investment and lending decisions. A coherent, credible story will increase confidence for households and businesses, members noted.

Assuming forward guidance helps reduce some of the uncertainty, members agreed that a broad creative approach to capital allocation was necessary, one that looks at both credit, as well as equity and equity-like investments.

Some members raised the possibility of a sandbox of sorts, allowing for some experimentation and creativity on the design and execution of traditional credit facilities and investment arrangements. We need to create an environment where there is enough confidence for lenders and investors to engage with businesses. Different businesses might need different types of support, making one-size-fits-all programs less appropriate. The approach needs to find ways to create custom-designed solutions.

Members agreed that some of the low uptake of certain government support loan programs stems from the demand side: a result of both economic uncertainty and the concerns of businesses over saddling themselves with even more debt than they had coming into the crisis. As an example, while it is early days in the recovery, only a small fraction of earmarked funds for the Business Development Bank of

Canada (BDC) co-lending program have been used. While the Canada Emergency Business Account has seen greater uptake, at $26.6 billion it is still far below the $55 billion earmarked for the program.

Members felt that should governments succeed in reducing some of the uncertainty through forward guidance, some demand for current programs might pick up as the recovery gathers strength. However, members agreed that the issue of debt fatigue is significant and governments need to look at ways to unlock more capital to take equity and equity-like investments, through the sandbox or otherwise. Governments and regulators need to ask themselves how they can motivate more interest from investors in supplying equity and/or equity-like capital to businesses looking to build capacity during the re-opening. Members raised the idea of making sure regulatory requirements do not unnecessarily impair investment by domestic and foreign institutional investors like pension funds and life insurance companies. They also favoured looking for ways to facilitate the tapping of large saving pools among retail investors, possibly through various types of collective investment schemes – or investment funds – such as mutual funds, which bring a number of investors together with the intention of sharing in any profit from the investment, and benefiting from, among other things, the economies of scale of investing together.

To the extent that lending programs continue, members pointed to a set of principles that should guide government support. Members felt that the first principle is to ensure that the decisions on who to lend to rests with the financial institutions with the necessary expertise.

Moreover, the market should be competitive and encompass as many financial institutions as possible, and governments should be clear about who qualifies for access to the support programs and who does not; and the reasons behind any exclusions.

Furthermore, clarity is needed on how these programs of support will evolve over time. Financial markets have continued to be supportive – in the form of low borrowing costs – of the monetary and fiscal support offered as a crisis response to the global pandemic. However, they will only continue to do so as long as they remain confident that governments have a plan to restore fiscal sustainability over the medium term. Governments are reacting in real time to an evolving pandemic, but clarity – through, among other things, fiscal updates and formal budgets – on how support programs will be wound down and eventually exited will go a long way to maintaining market confidence. Some members felt that should the existing programs not lead to sufficient aggregate demand amongst borrowers, governments may have to turn to more traditional countercyclical fiscal stimulus such as lower taxes or job-creating government spending, e.g. infrastructure spending, but again, with an eye towards maintaining investor confidence.

In summary, members of the Monetary and Financial Measures Working Group recommended the following:

- On the issue of uncertainty, governments should provide a clear state-contingent roadmap for how they will react to the evolution of the pandemic from an integrated health and economic standpoint;
- In addition, governments should provide clarity on the medium-run plan for a return to fiscal sustainability;
- Governments and regulators should set guidelines for a sandbox that allows for experimentation between businesses looking for capital and lenders and investors looking to provide it. Equity and equity-like investment should be prioritized;
- As part of these guidelines, policymakers should ensure rules and regulations do not impair domestic and foreign institutional investment;
- They should also look for ways to tap into retail investor savings pools through, for example, collective investment schemes;
- To the extent that credit programs continue, they should be guided by the following principles:
    - Any credit decisions on who to lend to should rest with the lender not the government;
    - Any facility should be a facility of last resort for borrowers, i.e., the incentive should exist for borrowers and lenders to negotiate on commercial terms first;
    - Any government support, be it through a guarantee or as a co-lender, should provide a return for taxpayer commensurate with the risk being taken by the government, plus provide incentives to encourage lenders to conduct proper and complete credit assessments and structure lending on proper commercial terms;
    - Programs should recognize that longer repayment terms may be appropriate for some borrowers but that longer terms for repayment should compensate the taxpayer for the associated additional risk;
    - The taxpayer, through the government, should rank on equal footing with other senior unsecured creditors in the creditor stack or should be compensated accordingly for supporting more subordinated exposures;
    - Government should consider the broad range of financial institutions that might appropriately have access to these facilities and make clear the rationale for including or excluding any type of institution for a particular type of facility; and
    - Government should make clear its plan for modifying programs over time related to objective indicators of economic conditions.

Monetary and Financial Measures Working Group Members Include:

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