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# Changes to the Business Finance Guarantee Scheme: Abnormal Lending on Normal Terms

*By Bill Gambrill - 6 May 2020*

On Friday, 1 May 2020, the Government announced changes to the operation of the [Business Finance Guarantee Scheme \(BFGS\)](#). As readers might recall, the BFGS was introduced as part of its initial economic approach to the COVID-19 response. The specific change announced was that it would no longer be a Government requirement that a bank which was making a loan of more than \$50,000 under the scheme would have to take security against the debtor's default by way of a General Security Agreement (security over all of the assets of a debtor in the event of a loan default) - although [a bank is still entitled to ask for security if it wishes to do so](#).

At the same time, the Government announced the Small Business Cashflow Loan Scheme, to provide reduced-rate loans of up to \$100,000 to firms employing 50 or fewer full time equivalent employees, to be administered through the Inland Revenue Department. The Government's announcement expressed the view that the [support available currently through banks was not meeting the needs of small and medium business](#) or the expectations of the Government.

The BFGS was [announced by the Government](#) in the early days of Level Four. The BFGS's premise was that the Government would support new loans of up to \$500,000 to eligible businesses which had a turnover of less than \$80 million per annum. Government funds of \$6.25 billion were to be available under the BFGS. The loans would be made by through the banks to business customers (including new customers) on the basis of normal lending processes and

assessments. The Government was to assume 80% of the risk of the loans under the BFGS, with the lending bank assuming the remaining 20%.

Making Government money available to business through the banks under the BFGS no doubt reflected the (not unrealistic) expectation that the banks would be better placed than the Government to do what needed to be done, practically, in order to assess a borrower's eligibility and to make loans. However, one suspects that the reason why the BFGS does not appear to have functioned as the Government had hoped is that, essentially, there would be challenges for both lenders and borrowers in making assessments and decisions regarding financing in a "normal" way (as was required under the BFGS) in the face of the current, abnormal, circumstances.

#### Provision of Security by Borrowers

It is inherent in any responsible lending process that the lender obtain adequate security over some asset as collateral, to ensure repayment in the event of the debtor's default. In most business lending, that collateral will be the assets of the business. The value of the assets of the business will be closely tied to the value of the business itself.

However, a business seeking emergency finance will almost always find it difficult to demonstrate to a lender that it has adequate collateral for any loan, if strictly "normal" criteria were to be applied to valuation of the collateral available - the business needs the loan because of what is, fundamentally, a depreciation in the value of the business. Furthermore, even if other collateral were available - typically, a mortgage over residential property owned by the business-owner - any uncertainty in the housing market or wider economy would affect whether the value of that collateral is sufficient to allow the bank to make loans applying "normal" criteria.

Whether there has been a reluctance by some businesses to seek to borrow on "normal" terms, or businesses have not been able to demonstrate to the banks that any such loans would satisfy "normal" criteria, it is perhaps no surprise that the BFGS has not proved to be as effective as the Government might have wished; it will have to be seen if the change in policy results in more loans being made.

#### Potential Consequences of General Security Agreements under BFGS

However, there might also yet be an unintended consequence of providing emergency business finance through the banks. Notwithstanding the proposed change in policy, banks may still require security for BFGS loans. Generally, secured creditors' rights to enforce against an asset subject to a security are not affected by the debtor's insolvency. If the business ultimately fails and goes into a formal insolvency process, the assets available to unsecured creditors will not include those subject to any security - including, potentially, those assets which are security for any loans made under the BFGS. Any increase in a business's exposure to its bank (as a

secured creditor) might well cause that business's suppliers to hesitate in providing any unsecured trade credit.

Any change in approach by trade creditors could be compounded by the [proposed changes to the insolvency regime](#). In response to the COVID-19 situation, the Government wishes to create a mechanism for a moratorium on enforcement of business debts, which is described as "Business Debt Hibernation". The bill to give effect to these changes was introduced to Parliament on 5 May 2020. Under the proposed legislation, those holding a General Security Agreement would not be bound by a moratorium in the way that other creditors would be. (For more on this see clause 20, Schedule 4 of the [COVID-19 Response \(Further Management Measures\) Legislation Bill](#).) A scenario could arise in which those holding General Security Agreements (including for loans under the BFGS) could still retain significant rights to enforce security when a debtor is in "hibernation", while all of the debtor's pre-existing obligations to its unsecured creditors were subject to a moratorium.

All of this illustrates the practical challenges faced in making public money available quickly through the conventional mechanisms of finance. It is perhaps no surprise that the Government has not ruled out unconventional approaches to getting money into the economy, including ["helicopter money"](#).

Corporal O'Reilly, a character in the 1970s television series *M\*A\*S\*H*, was given the nickname "Radar" because he could sense that helicopters were coming before they were audible; one wonders what Radar is thinking now.

*This article is of a general nature and is not intended to be relied upon as legal advice. Please contact Andrew Skinner at Martelli McKegg if you wish to discuss (09 300 7622).*

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