

# SUPPORTING UK ECONOMIC RECOVERY

RECAPITALISING BUSINESSES POST COVID-19

## About TheCityUK

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TheCityUK is the industry-led body representing UK-based financial and related professional services. In the UK, across Europe and globally, we promote policies that drive competitiveness, support job creation and ensure long-term economic growth. The industry contributes nearly 10% of the UK's total economic output and employs over 2.3 million people, with two thirds of these jobs outside London. It is the largest tax payer, the biggest exporting industry and generates a trade surplus greater than all other net exporting industries combined.

# FOREWORD

The scale and complexity of Covid-19 has brought about some of the most challenging economic conditions the country has ever encountered. It has also placed immense stress on UK business of all sizes and across all sectors.

The UK Government responded quickly in the early stages of the pandemic with huge and far-reaching stimulus measures, with many businesses taking advantage of the available schemes to keep them afloat and protect jobs. The job retention bonus and VAT relief announced by the Chancellor in the Summer Statement continue this support to provide much needed short-term liquidity to businesses and incentives to protect jobs.

While the Government's actions have provided essential immediate-term relief, over the medium-to-long term, trading conditions are forecast to become tougher, as businesses need to start repaying the extra debt they have taken on as well as tax deferred.

At the encouragement of the Bank of England, TheCityUK convened a group of senior practitioners from across the financial and related professional services industry to think creatively about how industry and Government could work together to address this challenge and support the recapitalisation of businesses.

The scale of this work has been as unprecedented as the challenge it sought to address, with over 200 individuals from over 50 firms volunteering their time and expertise. With invaluable support from EY, the Recapitalisation Group (RCG) has produced innovative outputs that are grounded in technical analysis and represent a broad consensus of expert views representing every element of the financial services industry. Our recommendations have been developed through extensive consultation with businesses, regulators, Government across the UK and the Bank of England.

While there are no easy options, quick wins or a one-size-fits-all solution, what the RCG has put forward is, we believe, the best range of options for recapitalising businesses across the country and saving taxpayer money. We hope they provide a useful basis from which to support UK businesses, protect jobs and underpin the wider economic recovery.

I am hugely grateful to everyone who has given up so much of their time, energy and resources to contribute to this work, it has been a Herculean effort. I would particularly like to thank Omar Ali, Managing Partner for Financial Services at EY, and his team for their significant contributions. We commend these options to Government and stand ready to continue our conversations with Government, the Bank of England, businesses and other key stakeholders to take them forward.

## **Sir Adrian Montague**

Chairman of Leadership Council, TheCityUK

# STATEMENT FROM THE RCG SENIOR STEERING GROUP

The Government acted quickly and decisively at the onset of the crisis to ensure that Small and Medium-sized Enterprises (SMEs) were protected from the initial shock, safeguarding millions of jobs and putting the UK economy in the best position to recover. However, the numbers in this report are a stark reminder of the challenge that is still in front of us, with tens of thousands of businesses across the UK facing into an unsustainable level of debt and taxes deferred.

To date, the Government has guaranteed a total of c.£43bn of lending to businesses through the Bounce Back Loan Scheme (BBLs), Coronavirus Business Interruption Loan Scheme (CBILs) and Coronavirus Large Business Interruption Loan Scheme (CLBILs) loan schemes, and deferred more than £30bn in VAT, in addition to other taxes deferred. The financial services sector facilitated this initial lending, providing the infrastructure for businesses to access funding, and provided significant additional assistance to businesses and consumers through repayment holidays.

The challenge now is to ensure this initial effort does not go to waste and find manageable ways to help businesses repay their additional debt, and, perhaps more importantly, enable businesses to grow again and play their part in the UK's economic recovery.

In addressing this challenge, our aim is to find solutions that minimise the impact on the taxpayer of the potential tide of insolvencies arising from SMEs over the next 12-18 months. Where businesses do ultimately fail, the loan guarantees will crystallise as obligations of the Government. This work is aimed at finding solutions that contain that cost to Government, while at the same time ensuring that every business that can survive has a chance to do so.

In principle, there are substantial pools of private sector capital that may be available to meet the demand for recapitalisation, including capital held by insurers, pension funds, private equity / venture capital, private debt and retail investors. However, it is clear from the detailed analysis in our report that even with the innovative application of private capital to the problem, there is a fundamental mismatch between the scale of the problem and the quantum of capital that is plausibly likely to be found from private sector sources.

In addition, where the debt was issued with a Government guarantee, it cannot be replaced with private finance if that loses the guarantee protection – the guarantee must be resolved first. There are also important operational and regulatory barriers that will need to be addressed if we are to unlock these private capital pools.

We believe this can best be achieved by introducing new solutions for businesses to use, which are managed by a new entity, the UK Recovery Corporation, that would issue funding on new, more manageable terms for business and establish a vehicle that the private sector can invest in over time to start to clear the Government's existing commitments. There are precedents in the UK and overseas for governments seeding new institutions to support economic recovery, as well as facilitating private sector support. 3i (in its original form as ICFC), UK Asset Resolution and KfW are but three, and we believe a new UK Recovery Corporation with these objectives could put the UK in the best possible position to recover quickly and confidently from the damage Covid-19 is causing to the economy.

Listening to the feedback from businesses and their representatives, we understand that thinking about new forms of finance is not something all businesses are comfortable with. We believe a Government-backed system, with options for repayment plans through the tax system for smaller players, and simple, easy to manage options for others, would be best suited to SMEs. We have outlined our thinking on these options in this report for further discussion.

To take these ideas forward, there are some important elements that would need further development, including:

- clear criteria to agree when the Government guarantee can be called to enable a business's recapitalisation
- an industrial scale process to handle small business failures quickly and fairly, and
- a simple, agreed oversight process to reduce conduct risks and avoid disputed cases.

The architecture of the proposed UK Recovery Corporation and its associated solutions would also be dependent on significant policy decisions. Balancing employment, business viability, the potential cost to the national balance sheet, and longer-term policy aims such as sustainability, correcting regional imbalances and promoting international trade and UK competitiveness, are just a few of the important factors Government would need to consider.

We and TheCityUK look forward to engaging further with Government, Parliament, Regulators and Business to take this work forward.

**Senior Steering Group members:**

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# CHAIR OF THE RCG TECHNICAL WORKING GROUP

It has been an honour to lead the work on behalf of Sir Adrian Montague, the Senior Steering Group and TheCityUK.

Ensuring that businesses across the UK have access to the financing options they need to survive and return to growth, whilst limiting the immediate impact on the public purse and the taxpayer is a complex problem and one that will affect us all professionally and personally.

To have most impact, recapitalisation solutions will need to be ready much sooner than when the Government-backed schemes become repayable in March 2021. Our analysis suggests that the drop in revenues experienced during the pandemic, combined with future challenging economic and trading conditions, mean some sectors may come into difficulty as early as Q4 this year. As such, the options in this report have been developed to be taken quickly into detailed design and then into implementation.

However, the work of the RCG also takes on board learnings from other markets and history, and we hope the proposed options will have a lasting impact, laying the foundations for better funding for SMEs in the UK in the long-term as well as in the immediate aftermath of the pandemic.

The RCG epitomises what TheCityUK was set up to do – bring the financial services industry together to speak as one voice on the most important issues of the day. The work reflects the efforts of c.200 people from more than 50 firms across the Financial Services industry to address a major challenge for the UK economy.

In particular I would like to thank the leaders of Technical Working Group; **Sandy Bhogal**, Gibson, Dunn & Crutcher; **Jonathan Blake**, Herbert Smith Freehills; **Louise Brett**, Deloitte; **James Chew**, HSBC; **David Chubb**, Chubb Advisory Limited; **Ed Cook**, BlackRock; **Charlotte Crosswell**, Innovate Finance; **Ben Davey**, Barclays Ventures; **John Godfrey**, Legal & General; **Irene Graham**, ScaleUp Institute; **Jan Hunter**, Linklaters; **Andrew Kail**, PwC; **Gareth Lambert**, EY; **John Liver**, EY; **Marco Schwartz**, KPMG; **David Soden**, Deloitte; **Dr Kay Swinburne**, KPMG; and **Adam Young**, Rothschilds & Co.

It was truly inspiring to see the level of commitment, the openness to sharing ideas and information across the industry, and the resulting innovation. I'm incredibly proud that EY has been a part of it – thank you to all of you who gave your time, ideas and data. We hope this work provides a helpful foundation for the Government's next phase of support for business, jobs and the economy in the face of Covid-19.

## **Omar Ali**

Managing Partner for UK Financial Services, EY

**Bim Afolami MP** (Chair, APPG Financial Marketing and Services)

“In the wake of Covid-19, we must focus on driving forward economic recovery right across the country. Recapitalising SME businesses – the backbone of the UK economy – will be a key piece in the puzzle to getting communities in all parts of the UK back on their feet. The financial and related professional services industry can play an important role in this challenge and this report from TheCityUK and EY is a great contribution to building back better and helping the nation thrive into the future.”

**Kevin Hollinrake MP** (Co-Chair, APPG Fair Business Banking)

“The work of The Recapitalisation Group demonstrates the leadership role that finance can take in both protecting jobs and businesses and supporting the economic recovery post-Covid. The scale of the challenge facing our country is immense – it is only with collaborative and innovative initiatives like this that we will be able to not only recover but reshape our economy for the better. I very much welcome this initial report. As the Group enters into the next phase of work, I would encourage it to think about how Environmental and Social Governance can be built into the recovery process, and how certain sectors that are not profit driven but that have immense social value can be supported. I would also encourage thinking about what mechanisms can be introduced to align funds and structures to the UK’s 2050 Net Zero ambition. We have a significant opportunity to reset the relationship between finance, business and the wider economy. The financial world has the opportunity to demonstrate that the banking industry is committed to becoming more than just a platform for disbursement of funds, but a force for good and an integral and proactive part of the short, medium and long term solutions that drive us to a more sustainable future. As with all initiatives, the devil will be in the detail and success relies upon the execution. The APPG on Fair Business Banking looks forward to being part of the next stage of the process and working with the Group moving forward.”

**Adam Marshall** (Director General, BCC)

“With many firms concerned about repaying the loans they have accumulated during the pandemic, this report is an important contribution in identifying some of the bold solutions that will be needed to prevent thousands of businesses from falling into a spiral of unsustainable debt. A number of the measures proposed in the report warrant close consideration, including the student loan style ‘Business repayment plan’ which could provide eligible firms with much needed headroom to return to a much firmer financial footing before starting to repay their loan. Government, regulators and the banking sector must now work together with business communities to find solutions that help viable businesses recover and invest as they emerge from this crisis.”

**Carolyn Fairbairn** (Director General, CBI)

“The financial services sector continues to play its part in providing a critical lifeline to businesses through this crisis. Looking ahead, it is crucial to consider a range of options to get the economy back on its feet. This report offers a welcome overview of possible solutions to provide a platform for future growth.”

**Martin McTague** (Chairman, Policy & Advocacy, FSB)

“FSB is pleased to have played a part in this report, which sets out starkly the urgent need to agree future recapitalisation of the huge number of SMEs, whose debt will reach unsustainable levels due to the ongoing economic impact of the Coronavirus crisis. We particularly welcome the proposal of a Business Recovery Plan that should enable small firms to repay debt based on taxable profits via the tax system. To overcome challenges of such a new approach, FSB is keen to work with all actors to develop a system that small businesses have confidence in and which encourages rather than stifles future growth – to enable small businesses to spearhead the economic recovery.”

**Edwin Morgan** (Director of Policy, Institute of Directors)

“To deal with the challenges presented by coronavirus, we need innovative thinking. The debt pile companies have built up during lockdown is a threat to the recovery, not just for the businesses themselves, but for the economy as a whole. This report presents a vital toolbox for policymakers to overcome this obstacle and minimise the lingering effects of the pandemic on UK investment and growth.”

**Stephen Phipson** (Chief Executive, MakeUK)

“The economy will emerge from this pandemic and, as it has shown during the crisis, manufacturing will be the sector which will play a critical role in driving the recovery and growth in the future. To do this companies will need to access both growth capital and finance to service the level of debt incurred during the crisis. The recommendations for recapitalisation are an important first step in developing public policy and initiatives to support an industrial sector fit for the future and they are proposals Industry fully supports.”

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# CHAPTER 1

# EXECUTIVE SUMMARY

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1. The Government has made an unprecedented, and necessary, investment in guarantees, grants, furlough, job retention bonuses, tax deferrals and VAT cuts, to protect Small and Medium Enterprises (SMEs) from the initial economic shock of the pandemic. This has helped to safeguard millions of jobs and put the UK economy in the best position to recover.
2. To date, the Government has guaranteed c.£43bn of lending via the Business Interruption Loan Scheme (CBILS), the Large Business Interruption Loan Scheme (CLBILS) and the Bounce Back Loan Scheme (BBLs) and deferred more than £30bn in VAT to support businesses through the crisis. Without further action, however, many of these businesses will struggle to repay the debt which has been guaranteed by the Government and pay taxes deferred.
3. By the end of March 2021, our analysis estimates that there could be c.£100bn of unsustainable debt held by UK businesses, of which c.£35bn would stem from Government loan schemes.<sup>1</sup> But as early as Q4 this year, some sectors may come under increasing strain given challenging trading conditions, accumulating operating losses and the tapering of government stimulus such as the furlough scheme.
4. To look at this another way, we estimate that c.2.3 million businesses will have a CBILS or BBLs loan by the end of March 2021. Roughly a third of these businesses could struggle to repay these government loans and are at risk of failing if left without a mechanism for recapitalisation. Indicatively, we estimate that these loans represent businesses which employ a total of c.3 million people.<sup>2</sup>
5. We note that our estimates of the level of unsustainable debt are as previously published in the Interim Report dated 8 June 2020, reflecting economic assumptions as of early June 2020 and utilisation of Government lending schemes as of 24 May 2020. We recognise that since publication of the Interim Report there have been several developments and data updates that may change the outlook for the pace of economic recovery, the take-up of Government lending and the support available to businesses through policy stimulus. In light of this, we propose to review and revise our estimates in August 2020, following the release of the Bank of England's Financial Stability Report.
6. Difficulties repaying debt will affect businesses across the UK and make regional imbalances more pronounced. Nearly three-quarters of the c.£100bn of unsustainable debt (c.£75bn) is held by businesses outside of London. Of the total c.£35bn in unsustainable debt from Government loans, we estimate that £25bn, or three-quarters, is held outside of London.
7. Simply delaying repayment obligations for these businesses, even for another year, will be insufficient to meet their needs. Approximately one in five businesses are estimated to have less than one month of cash reserves left and this increases to one in three businesses for those that have been accepted for Government-backed schemes.<sup>3</sup> Beyond liquidity, businesses need growth capital to relaunch and currently c.60% of businesses do not expect to return to growth anytime soon, notably slowing the UK's potential economic recovery.<sup>4</sup>
8. Where businesses do ultimately fail, the loan guarantees will crystallise as obligations of the Government. This work is aimed at finding solutions that contain that cost to Government while at the same time ensuring that every business that can survive has a chance to do so.
9. This report presents a toolbox of options that could provide a platform for businesses to repair their balance sheets by reducing their leverage and to repay government guaranteed debt in a more sustainable way. In doing so, the options will support SMEs and help preserve jobs and growth, while protecting the taxpayer. Our solutions focus on loans provided through the Government's Covid-19 lending schemes, in particular BBLs and CBILS.

1 Government loan schemes refers to the Bounce Back Loan Scheme (BBLs), Business Interruption Loan Scheme (CBILS) and the Large Business Interruption Loan Scheme (CLBILS). The £100bn in unsustainable debt compares with current total outstanding lending balances held by UK private non-financial corporations of c.£1trn as of Q4 2019 (ONS; representative of total short-term and long-term loans excluding inward and outward direct investment loans).

2 This illustrative estimate assumes that the average turnover for a BBLs and CBILS borrower is £0.2m and £4.8m respectively and the corresponding FTE for a BBLs and CBILS borrower is 1.6 and 29 FTE respectively.

3 UK Finance: Covid-19 loan schemes reaching firms in most financial difficulty (June 2020).

4 UK Finance: Covid-19 loan schemes reaching firms in most financial difficulty (June 2020).

10. The RCG has developed options to support recapitalisation:

#### **The UK Recovery Corporation**

A new entity to administer, or issue and hold, the options listed below. This will focus primarily on unsustainable debt but could supply growth funding in the future. The RCG looked at existing infrastructure and believes it has an important role to play but does not have all the capabilities necessary to handle the forecast volume of recapitalisation.

#### **Business Repayment Plan (BRP)**

Converts BBLs and small CBILs into a tax obligation, administered by HMRC with the operational support of the UK Recovery Corporation and repaid through the tax system. This would be means-tested, ensuring businesses only pay what they can afford, which could be calculated based on taxable profits or another measure of business recovery. Anti-avoidance measures have been considered.

#### **Business Recovery Capital (BRC)**

Converts Government-guaranteed loans into subordinated debt (an unsecured loan that ranks below others) or preferred share capital (that provides fixed dividends ahead of ordinary shareholders).

These are non-voting instruments and, whilst there may be restrictions on businesses, they will not lead to a business owner or founder losing control of their business.

#### **Growth Shares for Business (GSB)**

A mix of instruments, including preference shares, to provide growth capital to rebuild cash reserves, invest in working capital and relaunch after the crisis.

11. In addition to these options, lenders have a range of forbearance and restructuring options that businesses can continue to utilise. Due to the anticipated volumes of businesses that may face difficulty, we recognise that lenders will face difficulties in delivering bespoke solutions to all businesses. We have therefore outlined two potential forbearance options that could be adopted by the lenders to meet this volume challenge. Through these, businesses may be able to extend the terms of their debt (be it a Government scheme loan or a loan not acquired through a Government scheme) or be given a capital repayment holiday.
12. We believe that converting the currently unsustainable debt into longer-term repayment options for business, accounted for in a manner that reduces their debt burden, will create the conditions needed for the private sector to invest, not least due to the greater certainty and clarity of information for savers and investors. From the outset, the management of the UK Recovery Corporation should be tasked with developing plans to involve the private sector as soon as possible. We also believe that the management of the UK Recovery Corporation should investigate the potential to attract private capital to fund SME growth directly via ordinary equity.
13. Whilst we propose that the UK Recovery Corporation issues and holds BRC and oversees/manages the BRP in conjunction with HMRC, we note that the operational requirements of the solutions are different. The main challenge in delivering the BRP is likely to be the scale of operations, and the solution could potentially be delivered by providing additional operational capacity to existing entities such as HMRC. However, BRC presents more sophisticated instruments and therefore primary enabling legislation is proposed to facilitate its delivery via a rules-based mechanism. Both the BRC and BRP are likely, at least in the short term, to need to leverage existing infrastructure and operational capabilities of the accredited lenders of CBILs and BBLs.
14. We recognise that certain protections may be necessary to reduce the risk that companies avoid their repayment obligations under the proposed options. We have therefore suggested that the BRP is limited to smaller loans (under £250,000) which are likely to have been advanced to companies for which tax planning is less prevalent and have also suggested a number of proposed restrictions on dividends and salary increases. We would look to engage further on this topic with HMRC and Government.

15. The RCG has consulted throughout with the Bank of England, HM Treasury (HMT) and the Financial Conduct Authority (FCA), and business – through 15 business trade associations and many of their members. Their feedback has played a key role in shaping these options.
16. We must act quickly for these options to have the most impact. Businesses currently need to start repaying Government Covid-19 loans in March 2021. But before March, many strong, well-managed UK businesses may come under immense pressure, as the Government furlough scheme starts to taper off, rent deferrals come to an end, VAT payments deferred are due in full by 31 March 2021 and operating losses continue to accumulate. The ongoing sustainability of these businesses not only requires liquidity but also adequate recapitalisation.
17. There is a clear need to act now to avoid a wave of insolvencies and the resulting consequences of increasing unemployment, loss of tax revenues and the loss of UK economic growth.

**We are using the BEIS definitions of SMEs which classifies them as businesses with 250 employees or less. SMEs account for 99.9% of the business population.**

At the start of 2019 (BEIS, 2019):

- There were estimated to be 5.9 million UK private sector businesses.
- 1.4 million of these had employees and 4.5 million had no employees.
- 76% of businesses did not employ anyone aside from the owner(s).
- There were 5.8 million small businesses (with 0 to 49 employees), 99.3% of the total business population.
- There were 35,600 medium-sized businesses (with 50 to 249 employees), 0.6% of the total business population.

18. Key findings from each chapter in this report are summarised below.

### Chapter 3: The UK Recapitalisation Challenge – Key findings

- Our estimates indicate that c.£100 billion could arise in unsustainable debt by the end of March 2021.
- By the end of March 2021, it is estimated that c.£32-36 billion of lending provided through Government lending schemes could become unsustainable with borrowers struggling to repay these loans.
- SMEs (with FTE < 250 employees) are estimated to incur around half of the total unsustainable debt, amounting to c.£50-56 billion by the end of March 2021.
- Regions outside of London could be particularly hard-hit, given that nearly c.75% of unsustainable debt is estimated to be held outside of London and that regional SMEs have reduced access to equity finance on favourable terms.
- The unsustainable debt challenge poses a real threat to UK jobs. We estimate that c.2.3 million businesses will have a CBILS or BBLS loan by the end of March 2021 and that roughly a third of these businesses could struggle to repay their government loans, putting them at risk of failing. Indicatively, we estimate these businesses employ a total of c.3 million people.
- In contrast to the scale of demand for recapitalisation, the volume of SME equity finance is low, at under £10bn per annum. Only a very small fragment of UK SME equity investment is allocated to rescue/turnaround (c.2% in 2019) with the majority focused on growth capital.
- There are also large differences in equity investment levels across UK regions with c.75% of SME equity investment (and half of all equity deals) skewed to London.
- In addition to capital to address the unsustainable debt challenge, UK SMEs have faced long-standing challenges in attracting growth capital. This will only become more pronounced as a result of Covid-19.
- There is a need to act quickly. Businesses need to start repaying Government Covid-19 loans in March 2021. However, before this, Government stimulus and forbearance support including the furlough scheme starts to taper off and VAT and PAYE tax deferrals fall due.
- Ahead of this, the Chancellor's Summer Statement has provided additional and welcomed stimulus including the Job Retention Bonus, the Kickstart Jobs Scheme, the trainee scheme and VAT reductions targeted for tourism, accommodation and attractions sectors.
- Nonetheless, before March 2021 and as early as Q4 this year, several sectors are expected to come under strain given challenging trading conditions, accumulating operating losses and the tapering of government stimulus including the furlough scheme.

#### Chapter 4: Options to help address the recapitalisation challenge – Key findings

- Our options focus on a path to recovery for unlisted SMEs that have received a Covid-19 Government loan that they are likely to struggle to repay.
- A range of policy considerations have influenced our options including the need to manage Government's exposure, conduct considerations, timing, European Commission State aid Rules and implementation goals. The design of options has also been guided by feedback received from end-users and trade associations.
- We have sought to apply the lessons of schemes deployed in the UK and globally in determining the design criteria for our options.
- Guided by these criteria, we have segmented the lending schemes and propose a range of new instruments which could offer a path to recovery for different types of businesses, based on their size, their type of Government Covid-19 loan and the type of capital they need.
- For small businesses with a BBLs or small CBILs loan we propose the BRP which would convert the outstanding loan balance into a means-tested tax obligation, for businesses to repay through the tax system. Appropriate repayment incentives will need to be put in place to encourage repayment, which should be decided upon in conjunction with HMRC and HMT.
- For SMEs with a CBILs loan, we propose the BRC which would help businesses convert their Government guaranteed loans into longer term subordinated debt or preferred share capital.
- We propose that the above options should be accounted for in a manner that does not create a new debt obligation and therefore businesses will be able to improve their balance sheets through these options.
- We propose the creation of the GSB for businesses that have viable growth prospects, but find their growth constrained by a lack of available funding.
- We believe the best approach is to create a new entity, the "UK Recovery Corporation", dedicated to the recapitalisation process. We propose that the BRC is issued and held in this entity and that the BRP, as a tax obligation, is overseen and/or managed by the entity in conjunction with HMRC.
- Business access to the options would be voluntary and, critically, before default on obligations or insolvency. It would be subject to eligibility criteria agreed between Government and lenders.
- In addition to these solutions, lenders have a range of forbearance and restructuring options that SMEs can continue to utilise. We propose two forbearance options that could be adopted by lenders: a term extension or a capital repayment holiday.
- There are potential future extensions to the BRP and BRC that could enable it to support a larger range of businesses and/or capital needs.
- A mechanism will be designed, to examine the application of the eligibility trigger and facilitate complaints handling.
- There is an opportunity for Government to advance policy objectives by attaching well-designed incentives and conditions. This could include conditions related to net zero emissions, employment practices, diversity and inclusion goals, tax transparency and responsibility, the levelling up agenda, and productivity improvements.

### Chapter 5: Enablement considerations – Key findings

- We believe enabling the new instruments necessitates the establishment of a new entity the UK Recovery Corporation, in order to provide the flexibility, efficiency and governance required to oversee the management of new schemes.
- A series of key design principles have been established to create three potential operating models for further consideration:
  - **Lite:** A near virtual organisation sourced from third-party providers to provide a minimum amount of in-house functionality
  - **Hybrid:** An organisation comprised of analytical capabilities as well as some risk management abilities in-house to fulfil necessary governance obligations to act as an interim fiduciary
  - **Full Stack:** A full-fledged organisation that can handle complexity and provide an integrated solution for addressing the large asset pools and have the analytical capabilities to make underwriting decisions. Predominantly an in-house service provision model.
- To fast-track time to market and enable the UK Recovery Corporation (UKRC), accredited lenders would continue to play a key role. It is likely that, at least in the beginning, their existing infrastructure, resources and lending systems would need to be leveraged.
- As a result, the optimal operating model may evolve through the implementation process, starting as a Lite/Hybrid operating model in the first instance to meet specific goals and over time transitioning to a Full Stack model based upon policy development and clarity on future strategy.
- Components of operational delivery could be sourced from existing organisations or outsourced to third parties with proven capabilities. The Lite model utilises third parties to provide the majority of functionality which, negates the need to establish new operating structures and allows for an accelerated set up phase.
- Notwithstanding the operating model selection, the UK Recovery Corporation will require its own resources to oversee third party providers and provide appropriate governance and controls. The construct of an Arm's Length Body (ALB) could be instrumental to achieving this.

### Chapter 6: Funding of the options – Key findings

- Given the scale of the challenge and the level of uncertainty about performance, it is unlikely that private sector investors will be able to finance the UK Recovery Corporation initially.
- Converting the currently unsustainable debt into stable longer-term repayment options for business should create the conditions needed for the private sector to be able to invest, once there is greater certainty and clarity of information for savers and investors and key constraints are addressed.
- From the outset, the management of the UK Recovery Corporation should be tasked with developing plans and mechanisms to involve the private sector as soon as possible. Creating a fund structure to attract private investors in this subsequent phase is also critical.
- Private Equity (PE) and Venture Capital (VC) funds will continue to invest directly in SMEs on a selective basis, rather than participate in a pooled asset solution, providing distress and growth capital where Internal Rates of Return (IRRs) of 15%-25% are achievable.
- Private Debt funds have a flexible investment approach and can provide capital both directly as well as to a fund like the UK Recovery Corporation. Private debt funds look for return rates of 7%-15% per year.
- For insurers and defined benefit pension funds, unlocking capital through a long-term debt solution is possible if some form of credit enhancement can be provided and return rates are close to private placement.
- Retail investors could potentially provide additional private capital at a later stage if a carefully designed retail investment product was launched.
- For a growth capital fund, private sector investors can be expected to play an important role from the outset with insurers, pension funds and Sovereign Wealth Funds (SWFs) looking to invest growth capital where this meets their risk and return requirements.
- We also believe that the management of the UK Recovery Corporation should investigate the potential to attract private capital to fund SME growth via ordinary equity.
- In addition to providing capital, private sector investors offer a range of capabilities and infrastructure that could be leveraged by the UK Recovery Corporation and/or a growth fund.



### Chapter 7: End user feedback – Key findings

- UK Finance formed an end user group to secure feedback from across 15 business representative organisations and their members. The businesses and trade associations consulted broadly agreed that:
  - The scale of unsustainable debt was likely to be substantial and there was broad support for the consideration of innovative recapitalisation solutions.
  - It would be desirable to have a range of tools and solutions adapted to different sizes and sophistication levels of business, including smaller or micro businesses.
  - The point of default was too late a trigger point for recapitalisation.
  - Using existing infrastructure could be beneficial but that it was currently stretched as a result of the initial Covid-19 response.
  - Simple criteria should be defined, that will be easy to apply and implement.
  - They were supportive of a solution for smaller entities that sought repayment through the tax system and supportive of a preference share like scheme for larger SMEs.
- A survey of SMEs themselves was conducted which confirmed that:
  - Of those firms that had taken on additional debt over the coronavirus period, over half had borrowed less than £50,000 through BBLs and many had tax deferred.
  - Their biggest concerns for repaying debt are reduced income and cash flow timing issues.
  - Whilst firms had considered equity investment, relatively few had ever taken on equity investment before, with half still not willing to consider equity investment regardless of where it came from.
  - Over half the respondents use their accountant as a key source of advice. Business mentors and self-education were also cited as ways businesses navigate their external finance options.

### Chapter 8: Next steps – Key findings

- There is a need to move quickly. The Chancellor’s Summer Statement provides welcome stimulus to ease the transition as the furlough other support schemes unwind. Nonetheless we estimate that the need for the proposed options is likely to start to crystallise in late autumn 2020 and increase in early 2021.
- There are some key policy considerations to address. This includes balancing factors such as employment, business viability, the cost to the national balance sheet, and longer-term policy aims such as sustainability, correcting regional imbalances and promoting UK competitiveness.
- The focus of work then needs to move rapidly to detailed design, infrastructure integration and build and launch to the market. We propose a four-phase approach to implementation including:
  - validation and mobilisation
  - detailed design and build
  - transition and pilot with initial borrowers
  - operate with transition to full capacity.
- The options proposed by the RCG aim to lay the foundations for SME access to finance in the UK in the long-term. We are aware of a number of pieces of work in this arena that these options should look to complement and are committed to working with the business community, financial services industry, and all levels of Government to take these next steps together.

# CHAPTER 2

# INTRODUCTION

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19. The Covid-19 global pandemic has placed immense stress on UK businesses of all sizes and across all sectors. The long-term effects on society of the Covid-19 pandemic have not yet emerged, but they will be far-reaching, and business will be seriously affected. In the short-term the financial impact on businesses, large and small, is serious and profound.
20. The UK Government has responded quickly to this challenge with far-reaching stimulus measures including business funding packages, tax relief, support for UK workers and the self-employed. Significant numbers of UK businesses are using these schemes to provide liquidity and protect jobs. The job retention bonus and VAT relief announced by the Chancellor in the Summer Statement continue this support to provide much needed short-term liquidity to businesses and incentives to save jobs. The Corporate Insolvency and Governance Act, which came into effect at the end of June, will also provide much needed breathing space.
21. But economic forecasts suggest that, over the next 12 to 18 months, these businesses will face tougher trading conditions than before Covid-19, making it harder to service both existing debt and any additional debt taken to weather the crisis or restart their business.
22. The demands of this debt are likely to compromise the growth and viability of many UK businesses and, as a result, the UK economy.
23. At the encouragement of the Bank of England, TheCityUK has brought together member firms, industry practitioners and other stakeholders to form the RCG to help consider the post Covid-19 recapitalisation challenge.
24. The work of the RCG has been driven by senior industry figures, led by Sir Adrian Montague, TheCityUK's Leadership Council Chairman, Miles Celic, CEO of TheCityUK, and Omar Ali, Managing Partner for Financial Services at EY. It is governed by a Senior Steering Group and delivered by a Technical Working Group. In total, 200 people across more than 50 organisations from across the UK's financial and professional services sectors have given their time and resources pro-bono over the past three months.
25. The financial services businesses of the United Kingdom exist to serve not just the interests of the financial sector but rather those of the consumer and society as a whole, and the member firms of TheCityUK are resolved to play a full part in driving the UK's economic recovery for the benefit of society.
26. This report is our third and final report, setting out the details of a toolkit of options and mechanisms that we believe could support recapitalisation of both unsustainable debt, as well as options for growth capital. These options are for industry, Government and regulators to consider – we believe all will need to work together given the unprecedented nature of this challenge.

## Scope and objectives

27. Recapitalising businesses of all shapes and sizes is an enormous challenge. Given the urgency with which we believe recapitalisation may be required in certain areas of the economy, we have focused our work on businesses that we believe will require the most significant support. These are unlisted SMEs, eligible for Government Covid-19 CBILS and BBLS loan schemes, which employ well over 16 million people across the UK and turnover more than £2trn.<sup>5</sup>
28. Listed firms will also require additional capital but, in principle, listing brings potential access to capital. Rights issues and placings provide established pathways to raising capital and, to date, the market is deep and liquid, at least for the larger firms. Other Government interventions have also been trailed here.
29. Small unlisted businesses (including micro firms, family-owned businesses and sole traders) have different requirements. Many are financed by closely held equity and bank lending; they have little or no contact with professional investors; and yet their resilience and prosperity is vital to local employment and to the health of the economy.
30. By March 2021, when interest becomes payable on the Government's CBILS and BBLS loan schemes, we estimate that £35bn of lending through these schemes may be unsustainable. These loans are fully or partially guaranteed by the Government.

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<sup>5</sup> BEIS (2019).

31. The aim of the RCG is to find solutions to help address the unsustainable debt burden facing UK SMEs as a result of the Covid-19 pandemic, and in doing so avoid the prospect of calling on the Government guarantees and adding considerable strain to public finances.
32. In addition, UK SMEs, including those not struggling to repay their debt, have a need for growth capital, in varying forms, to rebuild and relaunch following the crisis. We have proposed solutions to help meet the demand for growth capital, but our primary focus is on the immediate need to resolve the unsustainable debt challenge, which will also have the benefit of laying the foundation for more private sector lending, employment and, ultimately, growth.
33. As such, we have focused initially on solutions for Government guaranteed lending schemes, but the options developed in our work have the potential to be extended to larger businesses and non-Government scheme debt and incorporated into further work to address the UK's growth and patient capital needs.

## Approach

34. Our approach to this work has been built on five pillars. These are:
  - **The challenge:** Identifying the scale of recapitalisation of unsustainable debt required
  - **Demand:** Identifying the nature and size of the demand for recapitalisation by UK businesses. This has included extensive consultation with business trade associations and their members
  - **Supply:** Identifying the pools of private sector capital available that could be deployed and any shortfall in capacity
  - **Solutions and infrastructure:** Devising solutions and infrastructure that can support the necessary volume of recapitalisation for the unsustainable debt held by businesses as a result of the pandemic. This has considered both private sector capacity and the potential need for public intervention in the event of a clear market failure
  - **Growth capital:** Reviewing the need of companies that may also require equity funding for growth capital. The use case for growth capital is different to that of capital for the recapitalisation of unsustainable debt, and we have undertaken an initial study into the design and structure of growth capital solutions that will require further consideration.

## Engagement

35. Throughout this work, the RCG has consulted with HM Treasury, the Bank of England and the Financial Conduct Authority, as well as officials and Members of Parliament including the All-Party Parliamentary Group on Fair Business Banking and Financial Markets and Services. In addition, the RCG is grateful for the engagement of more than fifteen business trade associations, both within and outside of financial services, and many of their members, through surveys, bilateral conversations, roundtables and formal responses to our interim update. This consultation has helped to shape the options set out in this document.



# CHAPTER 3

# THE UK RECAPITALISATION CHALLENGE

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## SUMMARY FINDINGS

36. The Covid-19 pandemic has affected UK businesses of all sizes, in all parts of the country and across all sectors.
37. The Government has made a huge and necessary investment in government guaranteed lending, grants, furlough support and tax deferrals to ensure that SMEs were protected from the initial shock. Businesses have used the wide range of measures available which has helped to safeguard millions of jobs and put the UK economy in the best position to recover. Further measures announced in the Chancellor's Summer Statement continue this support, providing much needed support to businesses and workers as the furlough scheme and other emergency stimulus unwind.
38. However, weaker trading conditions combined with the additional debt taken by many, may result in tens of thousands of businesses struggling to repay their loans. We estimate that, by the end of March 2021, there could be c.£100bn of debt held by UK businesses that they will struggle to repay under existing terms. Of this total, c.£35bn is estimated to stem from Government loans provided to UK businesses by the end of March 2021, through the CBILS, BBLs and CLBILS Covid-19 loan schemes.
39. These estimates of what we term unsustainable debt do not include tax payments that have been deferred over 2020, a portion of which UK businesses may also struggle to repay when due. VAT deferrals to June 2020 must be repaid by the end of March 2021 and are estimated to be over £30bn by the end of June 2020.<sup>6</sup> This does not include other payment relief that HMRC has provided, such as PAYE and income tax self-assessment deferrals.<sup>7</sup>
40. Difficulties repaying debt will affect businesses across the UK and make regional imbalances more pronounced. Nearly three-quarters of the c.£100bn of unsustainable debt (c.£75bn) is held by businesses outside of London.
41. Of the c.£100bn of unsustainable debt, over half, c.£55bn, is held by UK SMEs. UK SMEs account for c.99% of all UK businesses, over half of total turnover and c.60% of all UK jobs. The challenge for SMEs will be particularly acute, and more challenging than for larger businesses, given the low volume of equity finance raised by SMEs and their limited access to professional investors. Equity finance raised by UK SMEs remains under £10bn per annum, with less than 5% of this flowing to rescue/distress equity.<sup>8</sup> This falls significantly short of the potential demand for capital.

### There is a need for urgent action

42. Businesses need to start repaying Government Covid-19 loans in March 2021. But well before March, many strong, well-managed UK businesses will come under pressure, as the Government furlough scheme starts to taper off (albeit cushioned somewhat by the newly announced Job Retention Bonus), rent deferrals come to an end, VAT payments deferred are due in full by 31 March 2021 and operating losses continue to accumulate. The ongoing sustainability of these businesses not only requires liquidity but also adequate long-term recapitalisation.
43. Most larger businesses with more developed routes to external finance have been able, and are expected to continue, to find their way to recapitalisation. Project Birch has been highlighted as another initiative to further support these companies. Smaller businesses, which account for most UK jobs, do not have these developed routes to equity or equity type capital. There do not exist, at scale, equity-type solutions for SMEs in distress.
44. The Government has fully or partially guaranteed the loans made under the Covid-19 business lending schemes and has provided financing to businesses through tax deferrals. Businesses which cannot repay these Government loans will add further pressure to public finances already under strain. Unsustainable debt related to loans only partially guaranteed, as well as loans taken out prior to Covid-19, may also impact the ability of UK lenders to undertake further lending and support the UK's financial recovery.

<sup>6</sup> HMRC Coronavirus (Covid-19) data shows that the cumulative amount of VAT payments deferred total to £27.5bn based on taxpayers with outstanding return liabilities as at 12 June 2020.

<sup>7</sup> HMT estimate a 2020-2021 cost estimate of VAT and income tax self-assessment deferrals of £50bn (A Plan for Jobs 2020: 8 July).

<sup>8</sup> Total SME equity financed is sourced from the BBB (data for 2019) and the proportion of rescue equity is sourced from the BVCA (data for 2018).



45. Our analysis has identified four market distortions that our options seek to solve:
- The volume of equity capital directed at SMEs in distress is insufficient to meet the recapitalisation need.
  - The operational capacity to distribute capital is currently sub scale.
  - Any capital that is deployed currently exacerbates the regional imbalances in the country.
  - In practice, where debt is covered by government guarantees, it cannot realistically be refinanced if refinancing triggers the loss of guarantee protection (which repays the debt at face value in default).
46. Given these market distortions, there is a clear need to act now to avoid a wave of insolvencies and the resulting consequences of increasing unemployment, loss of tax revenues and the loss of UK economic growth. We estimate that c.2.3 million businesses will have a CBILS or BBLs loan by the end of March 2021. Roughly a third of these businesses could struggle to repay these Government loans and are at risk of failing if left without a mechanism for recapitalisation. Indicatively, we estimate that these loans represent businesses that employ a total of c.3 million people.
47. Delaying repayment obligations for these businesses, even for another year, will be insufficient to meet their needs. Approximately one in five businesses are estimated to have less than one month of cash reserves left and this increases to one in three businesses for those that have been accepted for Government-backed schemes.<sup>9</sup> Beyond liquidity, businesses need growth capital to relaunch and currently c.60% of businesses do not expect to return to growth anytime soon, notably slowing the UK's potential economic recovery.<sup>10</sup>
48. UK regions could be particularly hard-hit. Regions outside of London are estimated to account for nearly 75% of the total amount lent through Government schemes by the end of March 2021. Yet regions outside of London account for only c.25% of total SME equity finance. Should the current situation be left to resolve itself, and regional SMEs be required to find their own route to external finance, the UK will take a step back in its objective of levelling up regional imbalances.

### The inflection point is approaching

49. The Government has taken vigorous and effective action to preserve business through the pandemic. As set out by the Chancellor in the Summer Statement, the next phase is to stabilise business, protect jobs and allow it to rebuild now that the immediate threat from the pandemic appears to be receding. Many other Government objectives, including a strong investment-led recovery and an enhanced focus on the regions will be imperilled if this cannot be done.
50. The immediate priority is to avert widespread job losses and calls on the guarantees that Government has given lenders under the Covid-lending schemes, as that would jeopardize the continued existence of many businesses essential to the recovery. Beyond that, we must look to augment the sources of growth capital beyond debt capital to fuel business contribution to a resumption of growth.
51. We believe the priority must be to transfer the unsustainable debt backed by Government guarantees into structures that are sustainable for SMEs to service. This is the essential precursor to the resumption of stable investment conditions and the flow of growth capital from private investors to SMEs. In order to build a bridge to more normal conditions, these solutions must address this unique challenge and provide a foundation to then secure the greatest possible opportunity to channel private capital into SME businesses emerging from the pandemic.

<sup>9</sup> UK Finance: Covid-19 loan schemes reaching firms in most financial difficulty (June 2020).

<sup>10</sup> UK Finance: Covid-19 loan schemes reaching firms in most financial difficulty (June 2020).

## FURTHER DETAIL

### OUR ESTIMATES INDICATE THAT C.£100 BILLION COULD ARISE IN UNSUSTAINABLE DEBT BY THE END OF MARCH 2021

#### Overview of results

52. The RCG estimated that the value of unsustainable debt could reach c.£100 billion by the end of March 2021 (as published in its Interim Report dated 8 June 2020). This represents lending volumes which UK companies may struggle to service given economic shocks arising from the Covid-19 pandemic. This level of unsustainable debt compares with current total outstanding lending balances held by UK private non-financial corporations of c.£1 trillion (as of Q4 2019).<sup>11</sup>
53. Unsustainable debt volumes are expected to arise from both existing lending balances and new lending volumes provided through the period from March 31 2020 to March 31 2021. The former is expected to account for c.£83-91 billion in estimated unsustainable debt and the latter c.£43-49 billion (Figure 1). However, we estimate that offsets from operational cost reductions and supportive policy measures could alleviate unsustainable volumes by c.£29-33 billion. We note that the estimated effect of offsets from supportive policy measures do not include recent initiatives announced as part of the Chancellor's Summer Statement which provides stimulus to sectors hard hit by the crisis (such as hospitality and tourism) and helps to ease the transition as the furlough scheme unwinds.
54. Separate to potential recapitalisation requirements arising from unsustainable debt, businesses may also incur cash replenishment needs resulting from depletion of existing cash balances (available cash balances estimated at c.£85 billion)<sup>12</sup>, used to finance deficits and cover future incremental lending. The long-standing growth capital gap in the UK is likely to have widened as a result of Covid-19. Notwithstanding increasing demand for growth capital, recent analysis by the ScaleUp Institute and Innovate Finance indicates that the supply of growth capital will contract by the end of 2020 (the ScaleUp Institute and Innovate Finance working with Business Action Council will be issuing a report in the coming weeks with more details on UK growth capital requirements).
55. These estimates of unsustainable debt do not include tax payments that have been deferred over 2020 (e.g. VAT, PAYE and income tax self-assessment deferrals), a portion of which UK businesses may also struggle to repay when due. VAT deferrals to June 2020 are estimated to be over £30bn and must be repaid by the end of March 2021 (HMRC has provided other payment relief in addition to VAT deferrals). Businesses in retail and wholesale trade and accommodation and food services which typically account for a large proportion of VAT payments (c.35%; 2018-19)<sup>13</sup> may be particularly affected given expected revenue shocks incurred. Businesses in these sectors account for c.25% of the total estimated unsustainable debt by March 2021.

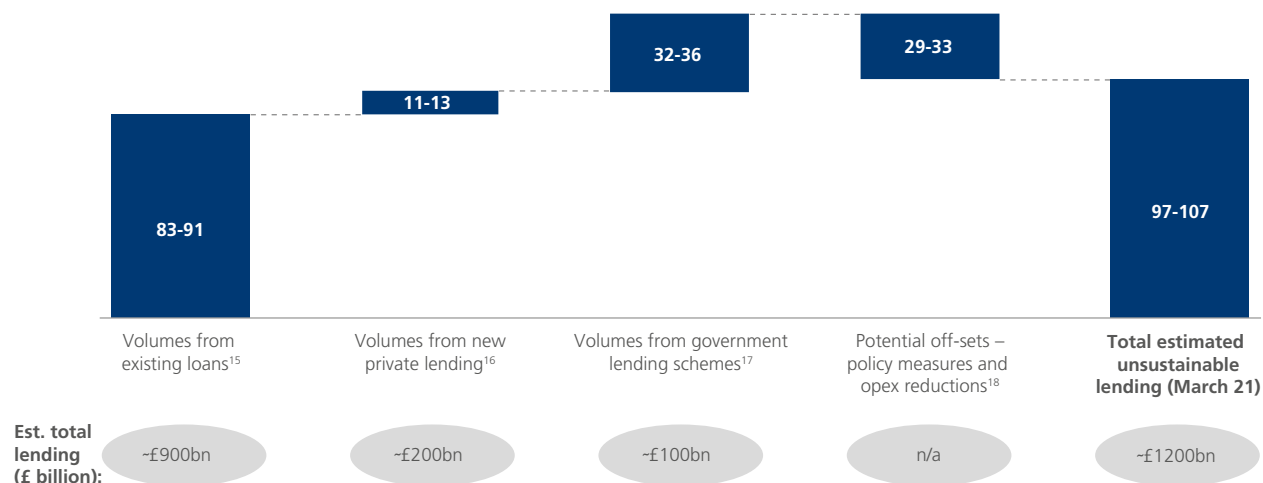
<sup>11</sup> ONS; Representative of total short-term and long-term loans excluding inward and outward direct investment loans.

<sup>12</sup> Bank of England: Interim Financial Stability Report (May).

<sup>13</sup> HMRC; representative of proportion of contribution to Net Home VAT liabilities from the Retail and Wholesale sector for 2018-19.

**Figure 1:** Estimated amount of unsustainable debt, March 2021 £bn<sup>14</sup>

Source: EY Analysis; ONS; BoE; HM Treasury



## Scope and approach

56. The scope of our analysis is limited to the assessment of non-financial service companies, i.e. it excludes consideration of lending volumes provided to the financial services sector. As such any references to lending volumes and associated unsustainable debt amounts relate to non-financial service companies only.
57. Estimates of unsustainable debt consider both the existing stock of lending balances and new lending volumes that could arise by 31 March 2021. Incremental lending from recently established Government lending schemes were considered. These include: The Business Interruption Loan Scheme (CBILS), the Large Business Interruption Loan Scheme (LBILS) and the Bounce Back Loan Scheme (BBLs).
58. Estimates of unsustainable debt were further informed by the potential impact of sectoral revenue shocks and potential offsets arising from operational cost reduction and supportive policy measures. These were based on projected forecast change in sector revenues by March Quarter 2021 relative to a December Quarter 2019 reference period.

## Limitations and future revisions

59. It should be noted that estimates included in this report were previously published as part of the RCG's Interim Report (dated 8 June 2020) and reflect economic assumptions as of early June 2020 (based on EY ITEM Club) and utilisation of Government lending schemes as of 24 May 2020. These estimates are based on high-level suppositions and assumptions which may deviate from the actual outturn given the rapidly changing dynamics in economic, business and policy environments.
60. It should also be noted that the RCG's analysis of unsustainable debt is based on a point-in-time assessment of sectoral revenue shocks and relevant offsets (comparing March Quarter 2021 relative to a December Quarter 2019 reference period). As such, it does not explicitly consider the net impact of VAT deferrals where the benefit of these deferrals accrues in preceding periods.

<sup>14</sup> All estimates for unsustainable debt volumes relate to private non-financial corporations (PNFCs).

<sup>15</sup> Existing lending and associated unsustainable loan balances representative of / correspond to balances as of 2019 y/e; estimates of loan balances reflective of lending volumes net of insolvencies under a steady-state (assumed at circa 1.5% of lending balances pre-insolvencies).

<sup>16</sup> New private lending relates to provision of lending volumes from the private sector, i.e. excluding government business lending schemes.

<sup>17</sup> Government lending schemes include analysis of CBILS, CLBILS and BBLs. Commercial paper volumes from the Covid-19 Corporate Finance Facility (CCFF) program have not been included as part of this analysis.

<sup>18</sup> Policy off-sets and operating cost off-sets include estimated reduction in labour / net employment and non-labour variable costs in response to revenue shocks and business rate reliefs.

61. The RCG acknowledges that since publication of its Interim Report, the UK has embarked on a path of gradual relaxation of lock-down restrictions. In addition, recent disclosures in utilisation of Government lending schemes for the month of June, also indicate a general decline in application volumes, particularly in BBLs and CBILS lending.
62. The Chancellor's Summer Statement also included c.£30 billion in measures including a range of initiatives to support businesses such as the Job Retention Bonus, the Kickstart Jobs Scheme, the apprenticeship scheme and targeted VAT reductions. These measures provide stimulus to particularly hard-hit sectors such as hospitality and tourism and help to ease the transition as the furlough scheme and other support mechanisms unwind. These developments may improve the pace of economic recovery, reduce the take-up of Government lending and the estimated level of unsustainable debt (by potentially increasing the level of offset from supportive policy measures and providing businesses with more breathing space).
63. The RCG proposes to review and revise its estimates in August 2020 following the release of the Bank of England's Financial Stability Report, factoring in recent developments, latest data on Government lending schemes and emerging trends in economic, policy and business environments.

## IT IS ESTIMATED THAT C.£32-36BN OF LENDING PROVIDED THROUGH GOVERNMENT LENDING SCHEMES COULD BECOME UNSUSTAINABLE

64. The UK Government established three business lending schemes in response to Covid-19 to enhance business access to financing: the CBILS, CLBILS and BBLs loan schemes. The Bank of England also launched the Covid Corporate Financing Facility (CCFF) program which provides liquidity to larger businesses in the form of commercial paper; this has not been included as part of our analysis.
65. Each of these schemes focuses on different segments of the UK's business community. The BBLs focuses on micro and small businesses, offering facilities of up to c.£50k; CBILS focuses on both small and medium sized businesses, offering facilities of up to c.£5m; and CLBILS focuses on larger businesses offering facilities of up to £200m (increased from £50m).
66. By the end of March 2021, we estimate that total lending volumes provided from Government schemes will reach c.£111-£123bn provided to c.2.3 million businesses.<sup>19</sup> A proportion of these loans will be potentially unsustainable due to ongoing economic challenges. This proportion is estimated to total £32-36bn (Figure 2).<sup>20</sup> We estimate that this accounts for roughly a third of Government lending scheme borrowers that may struggle to repay these loans and that together these businesses employ c.3 million people.<sup>21</sup>
67. It should be noted that estimates of lending volumes and unsustainable debt volumes outlined in this report are as per the RCG's Interim Report (dated 8 June 2020) and reflect economic assumptions as of early June 2020 (based on EY ITEM Club) and utilisation of Government lending schemes as of 24 May 2020 (Figure 3). The RCG proposes refreshing these estimates in August 2020 following the release of the Bank of England's Financial Stability Report factoring in latest emerging trends in economic, policy and business environments.

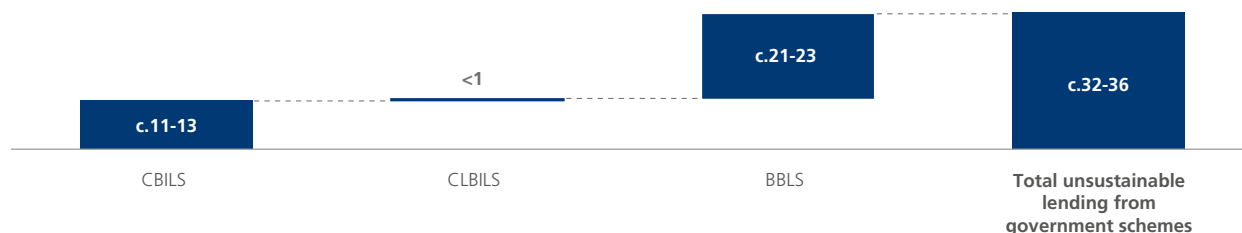
<sup>19</sup> Estimates of government lending assume that the BBLs closes for applications on the 4th November and that CBILS is renewed beyond its initial six-month term and runs for the duration of the forecast period (i.e. to end of March 2021). The RCG proposes to review / revise its estimates in August following the publication of the Bank of England's Financial Stability Report by which time further communication may be provided on scheme continuation and closures.

<sup>20</sup> The proportion of unsustainable debt from government scheme lending is assumed higher than other sources (i.e. existing lending or private new lending). This is assumed to reflect potential higher rates of distress from applicants and the reliance of certain schemes on self-certification (i.e. BBLs).

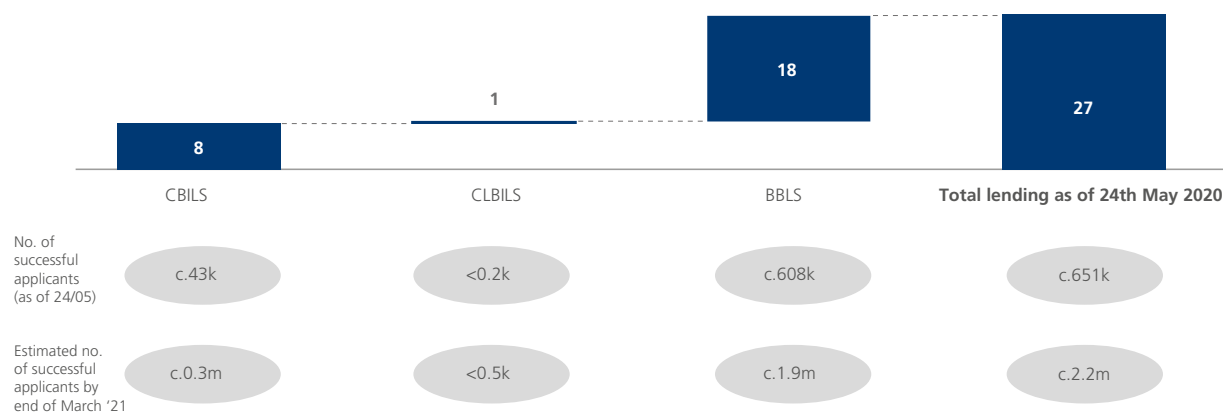
<sup>21</sup> This illustrative estimate assumes that the average turnover for a BBLs and CBILS borrower is £0.2m and £4.8m respectively and the corresponding FTE for a BBLs and CBILS borrower is 1.6 and 29 FTE respectively.

**Figure 2:** Estimated amount of unsustainable debt from Government lending schemes, March 2021 £bn

Source: EY Analysis; HM Treasury

**Figure 3:** Total lending from Government lending schemes as of 24th May 2020, £bn

Source: HM Treasury



## SMES ARE ESTIMATED TO INCUR AROUND HALF OF TOTAL UNSUSTAINABLE DEBT AMOUNTING TO C.£50-56BN

68. The UK has a total business population of c.5.9m (as of 2019) of which the vast majority (c.99%) comprises of SMEs defined as businesses with up to 249 employees.<sup>22</sup> In 2019, SMEs comprised c.52% of UK turnover and c.60% of UK employment; larger businesses, defined as those with 250 employees and above, account for c.48% of UK turnover and c.40% of UK employment.<sup>23</sup>
69. We estimate the amount of unsustainable debt volumes to be evenly split between SMEs and large businesses, with SMEs accounting for c.£50-56bn in potential unsustainable debt volumes and large businesses c.£47-51bn (Figure 4).
70. Recent surveys on the business impact from Covid-19 (ONS) indicate that c.30% of SMEs are unsure if they have enough financial resources to continue operating throughout the coronavirus outbreak. For larger businesses, c.23% of respondents responded similarly.<sup>24</sup>
71. Further surveys of SMEs indicate that a notable proportion of SME borrowers may struggle to repay their Government scheme loans.

22 Department for Business, Energy & Industrial Strategy (BEIS) [NB. Business segment definitions per BEIS].

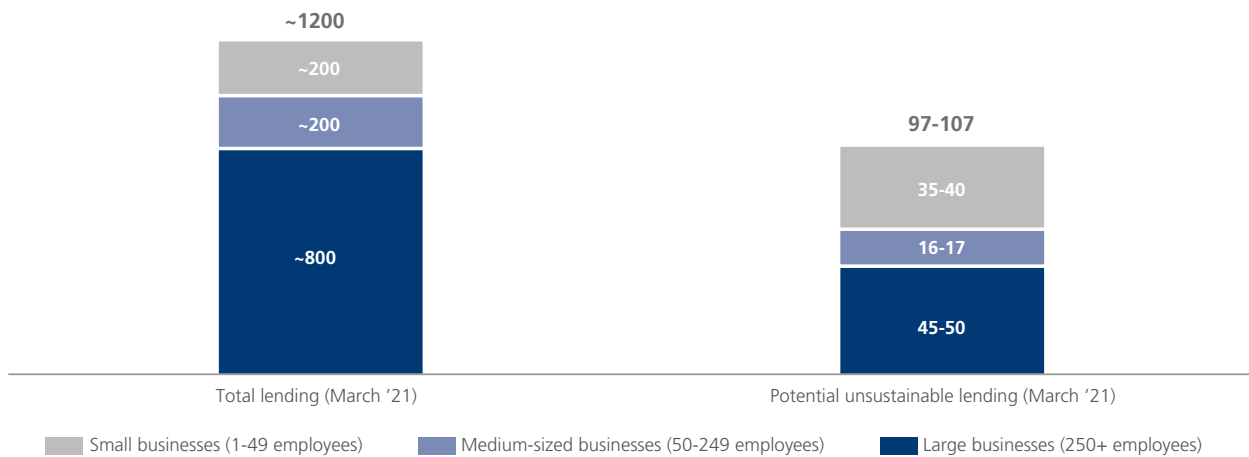
23 Ibid.

24 ONS Business Impact of Covid-19 Survey (BICS) results (May 2020).

- A survey conducted by Funding Xchange indicates that c.63% of businesses currently have insufficient monthly free cash to service a BBLS facility once the repayment holiday ends at month 13, assuming no major change to free cash in the next 12 months.<sup>25</sup>
- A survey by the BBRS indicates that c.45% of respondents who have taken out a loan from a Government business lending scheme may not repay them.<sup>26</sup>
- Approximately one in five businesses are also estimated to have less than one month of cash reserves left, this increases to one in three businesses for those that have been accepted for Government-backed schemes (UK Finance).<sup>27</sup>

**Figure 4:** Scenario projections of estimated unsustainable debt and total lending by business size, March 2021 £bn<sup>28</sup>

Source: EY Analysis; HM Treasury; ONS; Bank of England; UK Finance



## AN ESTIMATED C.70-75% OF UNSUSTAINABLE DEBT IS HELD IN UK REGIONS OUTSIDE OF LONDON

72. Unsurprisingly, our analysis indicates that regions most likely to experience higher levels of unsustainable debt are those with higher levels of estimated borrowing.
- London is expected to account for c.28% of estimated unsustainable debt and c.30% of total estimated lending (Figure 5). This falls to c.24% and c.25% respectively when discounting for the property sector (where there is more activity in London).
  - Regions outside of London are expected to account for c.72% of estimated unsustainable debt and c.70% of total estimated lending. This rises to c.76% and c.75% when discounting for the property sector.
  - Outside of London, the South East, the East of England and the North West represent regions that could be more affected by unsustainable loans:
    - The South East is estimated to account for c.14% of unsustainable debt and c.15% of total estimated lending
    - The East of England is estimated to account for c.11% of unsustainable debt and c.10% of total estimated lending
    - The North West is estimated to account for c.8% of unsustainable debt and c.8% of total estimated lending

25 Funding Xchange SME Lending Monitor 2020 Q2.

26 BBRS (Business Banking Resolution Service): The impact of Covid-19 loan schemes on business banking dispute resolution (May 2020). The survey indicates that 43% of those who have taken out Government-backed loans do not expect to repay them, either because they do not think they will be able to (c.16%) or because they do not think that the Government will pursue the debt (c.27%).

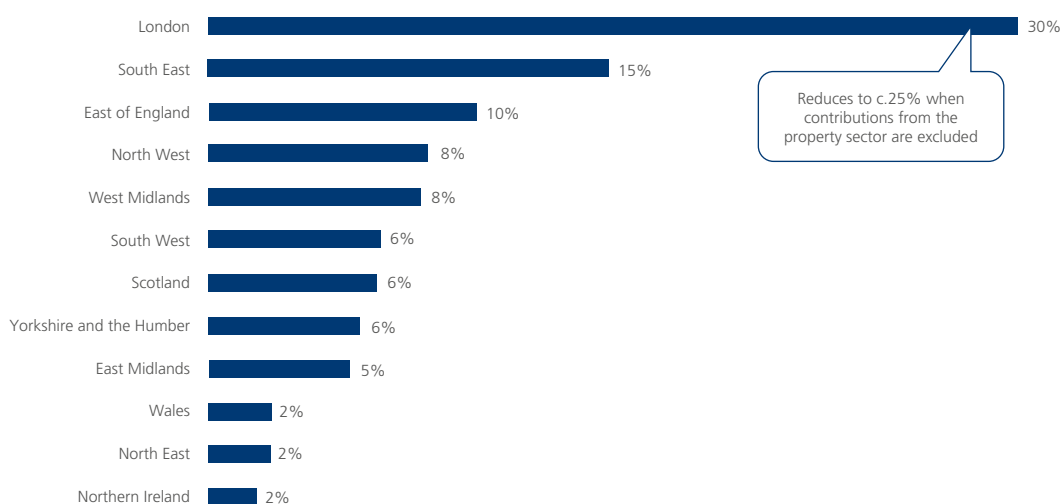
27 UK Finance: Covid-19 loan schemes reaching firms in most financial difficulty (June 2020).

28 This analysis is based on a number of key suppositions and assumptions including top-down interrogation of high level data. Estimates may be reviewed and refined over time on further availability of data sources.

73. It should be noted that should unsustainable debt volumes need to be recapitalised, regions outside of London may face greater difficulties in accessing equity finance. There is a notable skew in the provision of equity finance to London relative to other regions, particularly amongst SMEs. It indicates that, if left to resolve the challenge on their own, regional SMEs with unsustainable debt are less likely to find their own route to recapitalisation on favourable terms. This is further expanded on page 34 below.

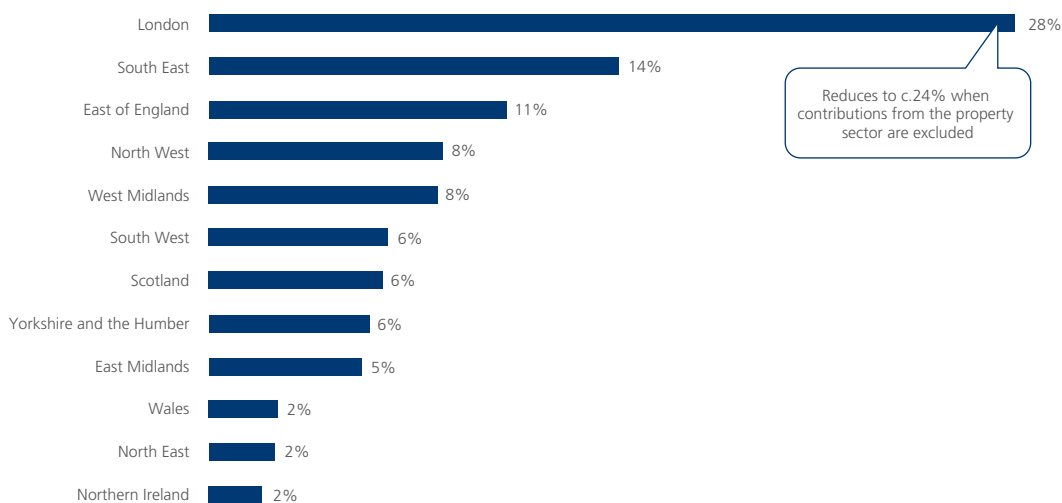
**Figure 5:** Estimated proportion of total estimated lending by region, March 2021, %

Source: EY Analysis; HM Treasury; ONS; Bank of England; UK Finance



**Figure 6:** Estimated proportion of estimated unsustainable debt by region, March 2021, %

Source: EY Analysis; HM Treasury; ONS; Bank of England; UK Finance



## THE VOLUME OF SME EQUITY FINANCE IS LOW AND WITH LIMITED FOCUS ON RESCUE / TURNAROUND

### Access to equity finance for large and listed businesses

74. Access to equity investment varies by size and type of business. Whilst larger firms, both public and private, will also require additional finance, these businesses are likely to have more developed routes to capital and are better equipped to refinance themselves with support from existing creditors and shareholders. In contrast, many unlisted SMEs are financed by closely held equity and branch bank lending, with little or no contact with professional investors. Where their recapitalisation needs are urgent and immediate, their ability to access a more differentiated capital base becomes critical.
75. Large UK corporates are more likely to already have more developed routes to capital and are better able to leverage existing relationships with both current and new potential investors to raise equity finance. By contrast, smaller companies have limited experience with professional investors and often rely on private debt finance from lenders.
76. Through the Covid-19 crisis, UK listed businesses have shown a continued ability to access fresh equity capital through public markets. Since the onset of Covid-19, between February to the end of June 2020, a total of c.£13.8 billion of equity capital has been raised by c.240 businesses on the London Stock Exchange markets, across the main market and AIM (Figure 7).<sup>29</sup> This compares to c.£10 billion raised by c.220 businesses in the comparable period in 2019. Of the total amount raised from February to June 2020, c.15% (or £2.2 billion), has been raised by c.170 companies through the AIM market (a sub-market of the London Stock Exchange designed to help small to mid-sized companies access capital). Most of the amount raised in 2020 has been secondary issues as opposed to new issues and IPOs (which account for a noticeably lower share of raisings since the onset of the crisis).

**Figure 7:** New and secondary issues on the London Stock Exchange during Covid-19 (Feb-June 2020), £ billion and number of companies that have raised<sup>30</sup>

Source: London Stock Exchange

		2019 (1 February to 30 June)				2020 1 February to 30 June			
Deal type		Amount raised (£bn)		Number of companies		Amount raised (£bn)		Number of companies	
LSE Main Exchange	New issues	2.6	30%	13	19%	2.0	17%	7	10%
	Secondary issues	6.0	70%	56	81%	9.6	83%	60	90%
	<b>Subtotal</b>	<b>8.5</b>		<b>69</b>		<b>11.6</b>		<b>67</b>	
LSE AIM	New issues	0.1	9%	5	3%	0.0	2%	2	1%
	Secondary issues	1.3	91%	145	97%	2.1	98%	167	99%
	<b>Subtotal</b>	<b>1.4</b>		<b>150</b>		<b>2.2</b>		<b>169</b>	
<b>Total (Main + AIM)</b>	<b>Total</b>	<b>10.0</b>		<b>219</b>		<b>13.8</b>		<b>236</b>	

### Access to equity finance for SMEs

77. UK SME access to equity finance falls significantly short of the potential demand for capital. While equity finance raised by UK SMEs has doubled since 2016, it remains under £10bn per annum (Figure 8).

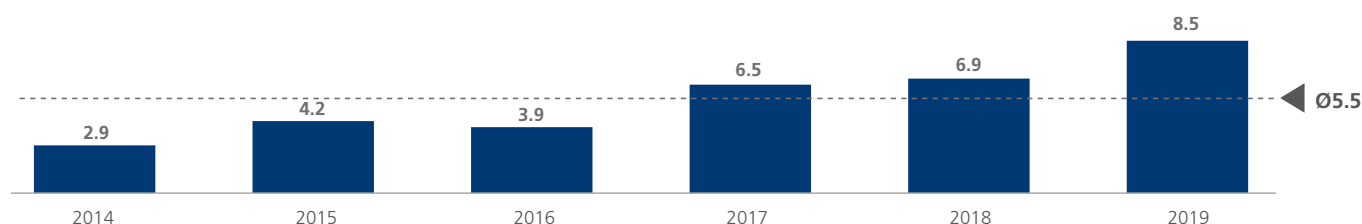
<sup>29</sup> Data sourced from the London Stock Exchange, raisings from 1 February 2020 to 30 June 2020.

<sup>30</sup> Data sourced from the London Stock Exchange, raisings from 1 February 2020 to 30 June 2020. New issues includes 'IPO' only and secondary issues includes 'placing for cash' and 'further issues'. Categories excluded include Closed End Investments, Open End Miscellaneous Investment Vehicles and Real Estate. Due to rounding, numbers presented may not add up precisely to the subtotals provided.



**Figure 8:** Total equity finance into UK Smaller Businesses, £ billion<sup>31</sup>

Source: British Business Bank



78. There are a range of challenges which currently impede SME access to equity markets:

- The relatively high cost and time of target scanning, fundraising (6-9 months on average for VC, according to the BBB) and completing due diligence in relation to deal size. This makes it challenging for investors to achieve the desired rates of return on SME investments.
- VC specific funding is typically focused on high growth entities, which therefore limits the breadth of businesses potentially targeted. 80% of investments made through Venture Capital Trusts (VCTs) must meet qualifying criteria which are strict and exclude a large number of SMEs.
- PE backed funding will typically be highly geared and targeted at large and larger-midmarket companies rather than SMEs.
- Issues faced in agreeing terms around valuation, control, governance and dilution.
- Fund managers such as PE and VC firms look to actively manage businesses invested in, leading to difficulties deploying capital at scale (as funds can only manage a small number of businesses at any given time).
- Reduced SME demand, partly due to lack of awareness and equity raising experience.

### Access to equity finance for SMEs requiring rescue and distress capital

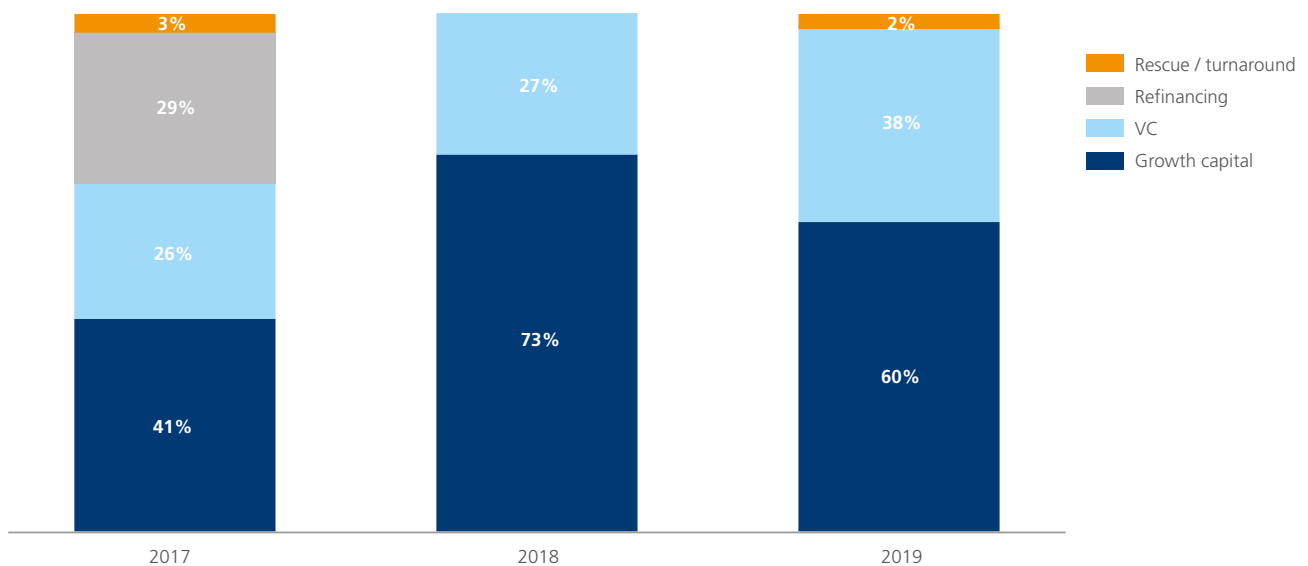
79. Where SMEs can obtain equity finance, only a small fragment of this investment is provided for the purposes of rescue, distress or turnaround assets (i.e. the pool of capital most akin to post-Covid SME recapitalisation). In 2019, capital for rescue/turnaround accounted for c.2% of UK SME investment flows, versus 60% for growth capital (Figure 9).<sup>32</sup>
80. While investment into rescue/distressed opportunities may increase as a result of the pandemic, this is unlikely to focus on smaller businesses requiring distress capital. It is instead likely to skew towards large corporates and larger mid-market businesses which tend to be the focus of large private equity funds and niche investors with a mandate to invest in rescue or distressed businesses.

<sup>31</sup> Data for 2016-19 sourced from BBB's Small Business Equity Tracker (2019/2020) representative of "equity finance invested into UK SMEs"; data for 2014-2015 sourced from BBB's Small Business Finance Markets Report (2019-20) representative of "SME Finance - private external equity investments".

<sup>32</sup> The share of SME equity finance attributable to rescue/turnaround (2%) versus growth (60%) purposes are sourced from the BVCA. Applying these percentages to the total SME equity investment figure reported by the BBB (c.£8.5b) suggests that c.£170m of UK SME equity investment is focused on rescue/turnaround. We note that BVCA data is based on the SME portfolio investments of its member funds and that these investments may be in UK and overseas businesses.

**Figure 9:** Investments of UK funds into SMEs, share by stage/focus area (%)<sup>33</sup>

Source: BVCA (2019 data is provisional). Percentages may not add to 100% due to rounding.



## There are large differences in the equity investment levels across UK regions

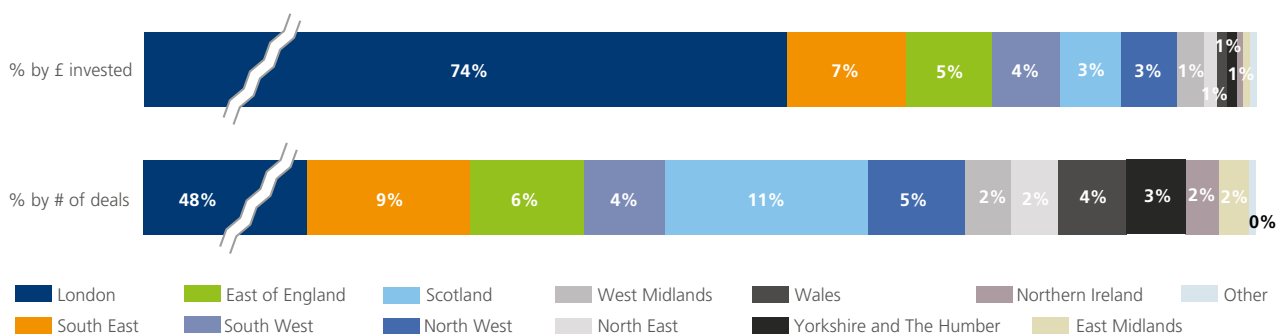
81. There is an imbalance in the distribution of UK SME equity investment across regions in the UK, with equity investment heavily skewed towards London. This imbalance is even more pronounced when considering that the SME unsustainable debt burden (estimated above) is heavily skewed to UK regions outside of London.
82. London is the largest market in terms of the amount of equity invested and the number of investments, accounting for c.75% of all pounds invested and around half of all equity deals (Figure 10). London is followed by the South East and the East of England, accounting for c.7% and c.5% of total equity invested respectively.
83. London represents a popular destination for global and institutional investors, which are more likely to participate in larger, late-stage deals. In 2019, London accounted for around two-thirds of 'megadeals' and c.80% of megadeals involved participation from one or more foreign investors.<sup>34</sup>
84. While equity investment is skewed towards London, the vast majority (nearly 75%) of estimated unsustainable debt that could arise by end of March 2021 is expected to derive from regions outside of London (Figure 11). This is true of both total unsustainable debt and the share of unsustainable debt from Government lending schemes (i.e. BBLs, CBILs, CLBILs), where we estimate that c.£25bn, or three-quarters, could derive from regions outside of London. This illustrates that the current debt challenge may only amplify regional imbalances and set the Government back in its objectives of levelling up.

<sup>33</sup> Sourced from the BVCA; based on the investments of UK funds (noting that some investments may be in overseas businesses and in non-SME businesses); Rescue/Turnaround are funds investing equity in companies that are in financial distress with the view to restoring the company to profitability. Total equity investment amounts are reported by BVCA members and may not include all investment into rescue/turnaround and growth capital.

<sup>34</sup> Beauhurst; includes equity investment data for ~20k companies that raised a total £12b, of which SME accounts for ~19.7k companies and £10.3b of equity raised.

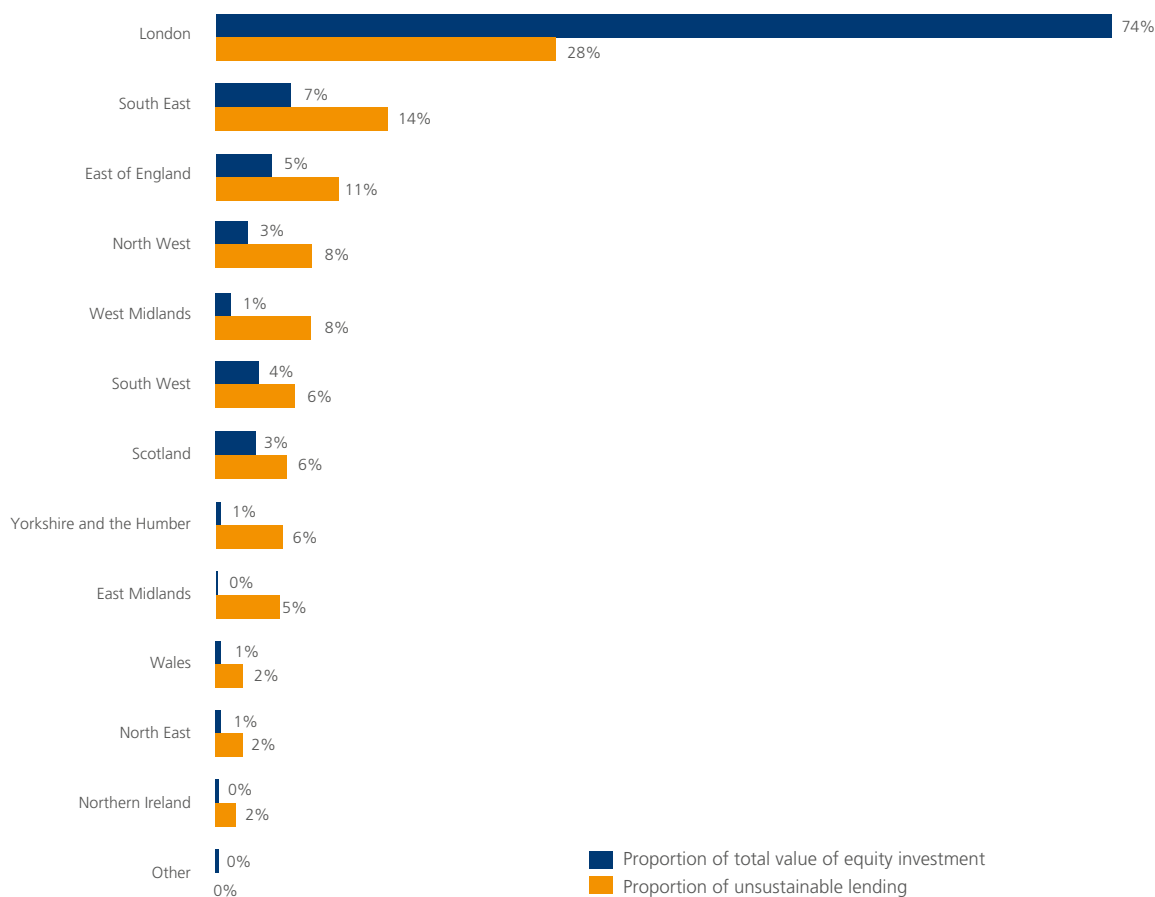
**Figure 10:** Proportion of UK SME equity investment by region, 2019, (%)

Source: Beauhurst



**Figure 11:** Proportion of equity investment (2019) versus proportion of estimated unsustainable debt (March 2021), by region (%)

Source: EY analysis, Beauhurst



## UK SMES HAVE FACED LONG-STANDING CHALLENGES IN ATTRACTING GROWTH CAPITAL, WHICH WILL ONLY BECOME MORE PRONOUNCED AS A RESULT OF COVID-19

85. In addition to the need for distress capital to help address unsustainable debt, the UK faces an intensifying SME growth capital challenge.
86. The success and growth of new businesses and products is vital to the long-term health of the UK economy. The UK has a vibrant SME and entrepreneurial community across sectors and geographies, but also has well-established challenges when it comes to scaling them up<sup>35</sup>. Even before the Covid-19 crisis the UK struggled to increase the number of high-growth companies and thereby deliver new jobs and value-add to the economy. Supporting scale-up companies<sup>36</sup> is therefore a key focal point for the funding of infrastructures that the UK requires to meet future economic needs, including the flexibility to deal with economic shocks and emerging opportunities.
87. As we approach economic recovery, addressing the needs of businesses which are indebted must work in tandem with the need to ensure our growth businesses are able to access the capital required to further fuel their scaling at home and abroad.<sup>37</sup>
88. Work is currently underway by the ScaleUp Institute and Innovate Finance, under the banner of 'the Future of Finance' and the auspices of the Business Action Council and Recapitalisation Growth team to develop options to meet the UK's growth capital gap.

### The scale of the UK growth capital gap

89. In assessing the UK growth capital gap ScaleUp Institute and Innovate Finance acknowledge that a range of pre-existing weaknesses have challenged the UK in its scale and depth of such growth capital. These cut across structural and regulatory barriers, sector and regional barriers, asset class constraints and market dislocation / asymmetry. The Covid-19 crisis has further affected many viable businesses across sectors and geographies. Though the recent steps by Government to provide enhanced grants, subsidised debt products and the creation of the Future Fund to deal with immediate needs (including recent adjustments) in the face of Covid-19 are welcomed, they have not been designed with the intention of overcoming the long standing structural gaps necessary to fuel a robust recovery.
90. The effects of the Covid-19 pandemic could add further pressures to the long-standing UK growth capital gap (i.e. the mismatch between the need or demand for growth capital by high-growth SMEs and the provision of growth capital).
91. The growth capital gap was most recently assessed by the Industry Panel reporting to the Patient Capital Review in 2017, which estimated the annual UK flow gap as between £3-6bn. This pre-existing growth gap, which includes vital follow-on capital, could well be greater than this estimate due to missed opportunities for growth and spans asset classes. In 2019, a further lens was brought to bear with the Government-commissioned Rose Review and through work completed by the British Business Bank, which highlighted that all female founder teams receive less than 1% of VC funding and mixed teams receive only 10%.
92. The pre-existing growth capital gap is now further weakened by the Covid-19 pandemic.
93. UK SMEs need growth capital, in varying forms, to invest for the future whether that be for investing in equipment, expansion and /or bolstering working capital. By way of indication, in recent analysis by ScaleUp Institute, demand for finance from scaling businesses has increased from 26% of scale-ups, in 2019, to 43% in the three months to May 2020. This is almost double the number of scale-ups looking for finance seen in recent years<sup>38</sup> and coincides with such businesses also having heightened concern over the challenge to access suitable patient funds. Cash runway is also a concern in some of our most innovative firms. This was highlighted by a recent survey of FinTech companies by Innovate Finance reporting that nearly 70% of smaller UK FinTech companies have a cash runway of six months or less.<sup>39</sup>

<sup>35</sup> The UK has been ranked third in the world for starting a business, but only 13th when it comes to scaling them up. See Building Our Industrial Strategy – Green Paper, January 2017 (p18).

<sup>36</sup> An enterprise with average annual growth in employees or turnover greater than 20% per annum over a three-year period, and with more than 10 employees at the beginning of the period - this correlates to the OECD definition of a high growth business.

<sup>37</sup> BoE Interim Financial Stability Report, May 2020 emphasises the need for 'productive capital' to drive productivity growth.

<sup>38</sup> ScaleUp Sentiment Insight, June 2020.

<sup>39</sup> Innovate Finance, UK FinTech Covid-19 Impact Survey, June 2020.

94. In parallel, in the initial assessment that the ScaleUp Institute and Innovate Finance are undertaking with industry and business, there are clear indications that supply of growth capital is estimated to have reduced significantly, with one estimate of a 30-40% reduction in capital availability in the last two months,<sup>40</sup> although the views of many market participants suggest an even larger decline in investor confidence. The analysis already reflects a £500m of funding loss in the June Quarter of 2020, which is expected again in the September Quarter. This work therefore already reflects an anticipated compound funding loss by the end of 2020. This comes also at a time when access to EU funds, such as, the European Regional Development Fund (ERDF) and European Investment Bank / Fund (EIB / EIF) is changing.
95. Further work to size the UK's growth capital gap is ongoing, co-led by the ScaleUp Institute and Innovate Finance, under the auspices of the Business Action Council and Recapitalisation Growth team. Full findings are expected to be published in July 2020.

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40 OECD Policy Responses to Coronavirus (Covid-19), 19 May 2020.

### Chapter 3: The UK Recapitalisation Challenge – Key findings

- Our estimates indicate that c.£100bn could arise in unsustainable debt by the end of March 2021.
- By the end of March 2021, it is estimated that c.£32-36bn of lending provided through Government lending schemes could become unsustainable with borrowers struggling to repay these loans.
- SMEs (with FTE < 250 employees) are estimated to incur around half of the total unsustainable debt, amounting to c.£50-56bn by the end of March 2021.
- Regions outside of London could be particularly hard-hit, given that nearly c.75% of unsustainable debt is estimated to be held outside of London and that regional SMEs have reduced access to equity finance on favourable terms.
- The unsustainable debt challenge poses a real threat to UK jobs. We estimate that c.2.3 million businesses will have a CBILS or BBLs loan by the end of March 2021 and that roughly a third of these businesses could struggle to repay their government loans, putting them at risk of failing. Indicatively, we estimate these businesses employ a total of c.3 million people.
- In contrast to the scale of demand for recapitalisation, the volume of SME equity finance is low, at under £10bn per annum. Only a very small fragment of UK SME equity investment is allocated to rescue / turnaround (c.2% in 2019) with the majority focused on growth capital.
- There are also large differences in equity investment levels across UK regions with c.75% of SME equity investment (and half of all equity deals) skewed to London.
- In addition to capital to address the unsustainable debt challenge, UK SMEs have faced long-standing challenges in attracting growth capital. This will only become more pronounced as a result of Covid-19.
- There is a need to act quickly. Businesses need to start repaying Government Covid-19 loans in March 2021. However, before this, Government stimulus and forbearance support including the furlough scheme starts to taper off and VAT and PAYE tax deferrals fall due.
- Ahead of this, the Chancellor's Summer Statement has provided additional and welcomed stimulus including the Job Retention Bonus, the Kickstart Jobs Scheme, the Trainee Scheme and VAT reductions targeted for tourism, accommodation and attractions sectors.
- Nonetheless, before March 2021 and as early as Q4 this year, several sectors are expected to come under strain given challenging trading conditions, accumulating operating losses and the tapering of government stimulus including the furlough scheme.



## SUMMARY FINDINGS

96. In our interim report, dated 8 June 2020, the RCG presented a broad range of tools that could help to address recapitalisation needs, including common equity and warrants, preferred shares, contingent tax liabilities, profit participating debt and forbearance schemes (as detailed in the table below).

**Figure 12:** Potential recapitalisation options considered in our interim report

<b>Common equity and warrants</b>	<ul style="list-style-type: none"> <li>• Combination of ordinary shares and equity warrants which could provide an incentive for existing shareholders to participate to mitigate dilution.</li> <li>• Warrants provide equity upside and reduce appeal versus other private forms of capital.</li> </ul>
<b>Preferred shares</b>	<ul style="list-style-type: none"> <li>• Preferred Shares subordinate to all existing debt but ahead of existing shareholder loans and common equity.</li> <li>• Annual dividend payments but means tested with ability of issuer to roll-up dividend if needed reflecting business growth needs /operating requirements etc.</li> <li>• Potential to be used as 'growth' instrument as well as a restructuring instrument.</li> </ul>
<b>Contingent Tax Liability (CTL)</b>	<ul style="list-style-type: none"> <li>• A CTL could be used as a restructuring tool as a means tested obligation to the Government repayable alongside taxes.</li> <li>• Possibly perpetual, calculated as a set percentage of taxable profits (or other simple calculation) paid after corporate tax charges and NIC etc.</li> </ul>
<b>Profit participating debt</b>	<ul style="list-style-type: none"> <li>• Linked to specified profitability metric(s), interest rate ratcheted to reduce in times of reduced profitability.</li> <li>• Provides high incentive to refinance and redeem instrument as well as downside protection that protects the against duration of investment.</li> </ul>
<b>Forbearance schemes</b>	<ul style="list-style-type: none"> <li>• Schemes include restructuring tools such as extension of term loan, extension of moratorium and capital holidays.</li> <li>• These can be applied individually or consecutively, with re-assessment of suitability and effectiveness performed periodically, with a view to eventually getting the loan to re-perform.</li> </ul>
<b>Conversion to grant</b>	<ul style="list-style-type: none"> <li>• At the extreme end – consideration may need to be given to grants offered by the Government to meet solvency or liquidity requirement and maintain operation through the crisis.</li> </ul>

97. In the interim report, we also set out wider design principles to be considered in designing the options, including the need for scale, simplicity, transparency, speed and the need to build in fairness and conduct considerations. It was also critical that the options are designed in a way that allowed private sector investors to contribute and play an increasing role in the financing of any solutions as soon as practically possible.
98. Based on these design principles and feedback received from businesses, Trade Associations that represent businesses and participants from across the financial services ecosystem, we have alighted on the options set out below.
99. Our objective in designing options was to find solutions that would afford businesses more flexibility thereby minimising the impact on the taxpayer of the potential tide of insolvencies arising from SMEs over the next 18 months. Where businesses do ultimately fail, the loan guarantees will crystallise as obligations of the Government. This work is aimed at finding solutions that contain that cost to Government, while at the same time ensuring that businesses that can survive have a chance to



do so. The suggested options should mitigate losses to Government under its guarantees, as we anticipate that allowing companies the time to recover and grow will result in a better return under the new options than the alternative of enforcing on guaranteed loans at the point of default.

### Our options for Government lending scheme debt and non-scheme debt

100. Our work has primarily focused on unsustainable debt related to Government scheme lending, with the primary aim of avoiding the prospect of calling on the government guarantees through enforcement on one hand, or the prospect of mass conversion of these loans to grants on the other. We have concentrated our ideas on mechanisms to recover the lending guaranteed by Government by providing businesses with more flexibility and time to recover.
101. Even if the c.£35bn of unsustainable debt under the Government Scheme is recapitalised via the tools we propose, UK lenders continue to provide debt to the businesses holding the remaining two thirds of the estimated unsustainable debt (equal to c.£65bn) that originated from pre-Covid-19 lending.
102. Lenders can continue to apply a range of forbearance and restructuring options to lending not covered by government guarantees. Due to the anticipated volumes of businesses that may face difficulty, and the time and skill normally required to restructure debt, we recognise however that lenders may face difficulties in delivering bespoke solutions to all borrowers. We have therefore proposed the use of two forbearance options that could be adopted by lenders to meet this challenge (a term extension and capital holiday).

### The need for a new entity: The UK Recovery Corporation

103. Given the unique demands of the current situation and the scale of the UK recapitalisation challenge, we believe the best approach is to create a new entity (the UK Recovery Corporation) dedicated to the recapitalisation process. This entity would administer the new obligations created through the conversion of the Government guarantee on BBLs loans and would issue, hold and administer the new instruments created through the conversion of the guarantee on CBILs loans. In doing so, the entity will need to take on the obligations on behalf of the Government of its loan guarantees.
104. Delivery of the proposed recapitalisation solutions (detailed below) will have several complex requirements. The entry point for businesses looking to utilise these instruments should provide procedural simplicity and be rules-based. However, the delivery entity will also need to be sufficiently flexible to manage specific instruments through the lifecycle, from onboarding to exit. The entity will require clear governance, robust controls and a level of technology enablement appropriate to the scale and nature of the operations it conducts.
105. These complex requirements necessitate a new entity to be created, likely combining both existing infrastructure across multiple providers and the development of new operational capabilities. We do not believe there is an existing entity with the capacity to pivot and scale up at speed to deliver all the required operational capabilities.
106. The factors influencing this conclusion include:
  - **Purpose built:** A new entity offers the advantage of single purpose, ease of design and construction to integrate and leverage existing infrastructure without the restrictions of existing legacy operations and systems.
  - **Speed to scale:** Operations will need to be established quickly, scaling up at a rapid pace, overcoming the capacity constraints of existing providers.
  - **Financing:** An entity is necessary to own the Government interest in the receivables and issue financing as the interest is sold down to private investors over time.
  - **Flexibility:** A new entity is better able to flex operational capabilities as likely needed to meet private sector investor requirements and scale up and scale down operations, adjusting in line with demand patterns and the evolving economic environment.

- **Governance and controls:** A new entity offers distinct oversight of the new instruments and the Government's interest, with clear decision making, accountability, audit trail and controls.
  - **Separability:** A new entity is more easily identified, defined and communicated to stakeholders and able to evolve into a future organisation or run-off to closure should requirements change.
  - **Public perception:** A new entity provides clarity to borrowers and the public more generally over the specific nature of the instruments and the longevity of support provided to UK businesses.
  - **Simplicity and transparency in borrower experience:** Focused entirely on the recapitalisation instruments initially, the new entity offers borrowers a dedicated, standardised, high quality and efficient client journey helping to mitigate conduct risk and reduce complaints.
  - **Cost effectiveness:** The rapid establishment of a largely virtual organisation offers low cost build and operations, leveraging modern technology and best of breed existing infrastructure.
107. There are a range of existing organisations that could plausibly offer potential infrastructure and operational components necessary to deliver this operating structure, including the British Business Bank (BBB), UK Government Investments (UKGI) and Local Enterprise Partnerships (LEPs), although none of these organisations appear to meet all the requirements. Nonetheless, they have important capabilities that might support a dedicated new entity, at least in its formative stages.<sup>41</sup>

### The proposed solutions available to businesses

108. As outlined in our interim report, we have sought to apply the lessons of schemes deployed in the UK and globally in determining the design criteria for the options. This includes:
- **Scale and speed:** How to recapitalise tens of thousands of companies quickly?
  - **Economic criteria:** How to rapidly identify which companies should receive support on an economic basis?
  - **Government guarantee:** Any solution should preserve the intent of the guarantee that was provided by Government on the stimulus loans that have been issued to borrowers.
  - **Guarantee criteria:** How to set clear criteria that lenders can follow to recognise recoveries under the existing guarantees when a borrower chooses to apply for a solution?
  - **Policy criteria:** Could support be linked to broader public policy or long-term value issues, such as sustainability, levelling up, industrial strategy, diversity, or employment, to create a lasting economic legacy?
  - **Legal requirements:** Any solution should meet all necessary legal requirements including the European Commission's State Aid rules and updated UK insolvency laws.
  - **Publicity:** How best to engage with businesses on the options available to them?
  - **Conduct:** How to ensure that businesses are treated fairly, in accordance with applicable regulatory standards and that existing shareholder interests are appropriately respected?
  - **Governance:** How to ensure the process is clear, standardised, transparent, respected and accountable?
  - **Sustainable:** How to provide an exit route for Government, investors and businesses?
109. Guided by these criteria, we have segmented the lending schemes and propose a range of options which could offer a path to recovery for different types of businesses, based on their size, the type of Government Covid-19 loan they have taken and the type of capital they need. This is set out in Figure 13.

<sup>41</sup> A more detailed assessment is required to evaluate the ability of existing organisations to scale functionality and capacity and evaluate how the recapitalisation tools align to their existing mandates, business models and capabilities.

110. **Businesses that were not viable pre-Covid:** There will be some UK businesses which were not viable before Covid-19, for which enhanced insolvency frameworks may be required. The UK Government has announced changes to insolvency laws to support these businesses. Our solutions for extra support do not extend to these businesses.
111. **Viable businesses that need capital to repay unsustainable debt:** For businesses which were viable prior to Covid-19 but are now unable to repay their Government-backed loans we propose a range of recapitalisation solutions or options based on the size of the business.
- I. This includes:
    - **Small businesses with a BBLs or small CBILS loan:** For these businesses, we propose the **Business Repayment Plan (BRP)** which would convert the outstanding loan balance into a means-tested tax obligation, for businesses to repay through the tax system. Repayment could be based on taxable profits or some other measure of business recovery, and there may be certain restrictions on the borrower (such as the ability to pay dividends, dispose of assets and restrictions on salaries or partnership drawings) to ensure that tax obligations are repaid (refer to Figure 14).<sup>42</sup>
    - **Small and Medium-sized businesses with a CBILS loan:** For these businesses, we propose the **Business Recovery Capital (BRC)** which would help businesses convert their Government guaranteed loans into longer term subordinated debt or preferred share capital that provides the borrower with breathing space and discretion in the short term in relation to their payment obligations under the solution.<sup>43</sup>

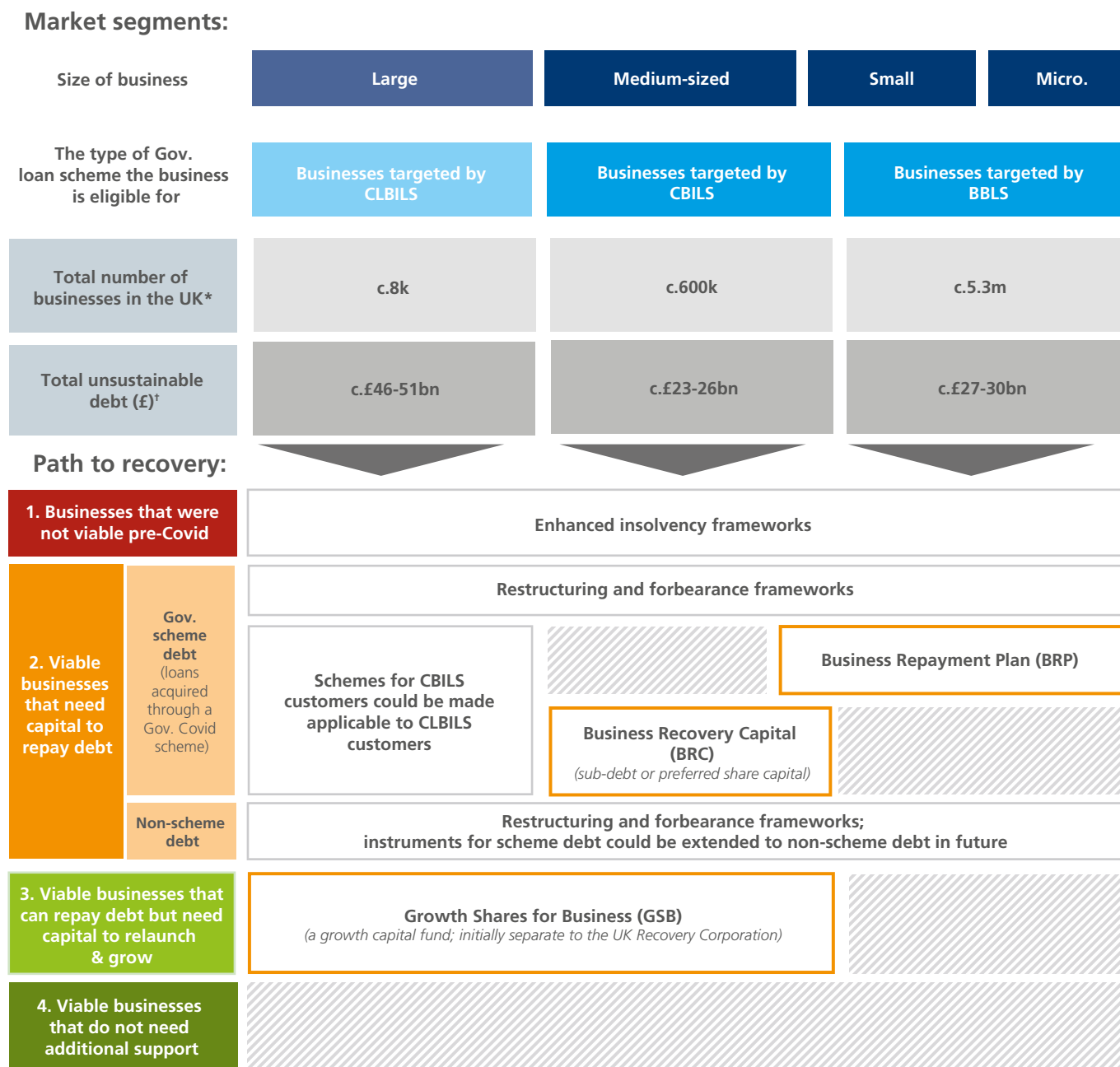
We propose that the BRC could be structured in one of two ways. The first option is a **longer-term (subordinated) debt** agreement. The second option would enable the borrower to convert their Government guaranteed loan into senior equity in the form of **preferred share capital**, or **preferred partnership capital** in the case of partnerships and sole traders. Conversion to preferred share capital would be available to companies with CBILS loans of up to £1,000,000 in value (for loans above this threshold, the conversion of HMT's guaranteed portion into preferred share capital will typically trigger various additional conditions and obligations under European Commission State Aid rules). Under this second option, loans over £1,000,000 would be converted into subordinated debt.
    - **Larger businesses:** Most of these businesses are more likely to be able to refinance themselves with the support of existing creditors and shareholders. Nonetheless, where larger businesses have Government guaranteed debt, that debt will need to be resolved first.
  - II. In those cases, the above options for CBILS borrowers could be modified and made applicable to CLBILS borrowers. Listed businesses are assumed to continue to be likely to have access to fresh capital through public markets.
  - III. We are proposing the BRP is targeted at smaller borrowers that capture all BBLs loans and the lower end of CBILS loans. Whilst the BRP could be rolled out to larger borrowers, the view is that larger loans should follow more structured repayments to avoid risks of non-payment, which is likely to be more pertinent when the size of the loan is higher and the risk of profits being diverted overseas is greater with larger businesses. However, it is possible that the BRP can be used as a single solution up until the point at which a bespoke restructuring would be more suitable. The level of threshold, or indeed the need for a capital solution, is therefore a policy issue to be discussed with the Government.
  - IV. The BRP and the BRC are new solutions, which we propose are created by the UK Government to support the UK's economic recovery. Given the need for urgent action, these solutions will require primary legislation in order to avoid complex terms and implementation.
  - V. We propose that the BRC is issued and held in the UK Recovery Corporation and that the BRP, as a tax obligation, is overseen and / or managed by the UK Recovery Corporation in conjunction with HMRC. However, the infrastructure and operational requirements of the BRP is likely to differ from the BRC. Whilst delivering the BRP requires scale of operations, the solution could be delivered by providing additional operational capacity to existing entities such as HMRC or UK Asset Resolution. However, BRC, presents more sophisticated options, and therefore the proposal to implement via primary enabling legislation is intended to facilitate the delivery of the instrument without the need for tailoring to suit the differences in borrowers' capital structures and articles.

<sup>42</sup> For partnerships and sole traders with a BBLs or small CBILS loan, the BRP would convert the outstanding loan balance to a future tax obligation under income tax (rather than corporation tax).

<sup>43</sup> Partnerships and sole traders with a CBILS loan that are not eligible for a BRP would be deemed to be eligible for Business Recovery Capital of a statutory partnership, i.e. new partnership capital.

- VI. In addition to these solutions, lenders have a range of forbearance and restructuring options that businesses can continue to utilise. Due to the anticipated volumes of businesses that may face difficulty, and the time and skill normally required to restructure debt, we recognise that lenders may face difficulties in delivering bespoke solutions to all businesses.
  - VII. We have therefore outlined two potential forbearance options that could be adopted by the lenders to meet this volume challenge. Through these, businesses may be able to extend the terms of their debt or be given a capital repayment holiday.
  - VIII. We propose that the BRP and BRC are available to all businesses that currently hold BBLS and CBILS loans and are facing difficulties in repaying this debt. This means that there is a clear and simple statement of eligibility that can be communicated to businesses. The options therefore offer a path to recovery for all businesses that have a Government BBLS or CBILS loan.
  - IX. We do not propose that businesses are refused these solutions by virtue of their financial positions having deteriorated further during the pandemic. The only eligibility assessment that would take place upon borrower application would be a simple rules-based assessment to confirm the borrower's statement that they face difficulty in repaying their BBLS or CBILS debt.
  - X. Critically, businesses should be able to access these solutions before they default on their debt obligations. In doing so, we are seeking to address distress early enough to give businesses the best chance of survival.
112. **Viable businesses that need growth capital:** There are businesses which have either not taken out debt or are able to repay their debt but nonetheless need growth capital in varying forms to rebuild cash reserves, invest in working capital and relaunch after the crisis. We propose the creation of **Growth Shares for Business (GSB)** for these businesses. This growth capital could help support the regeneration of local and regional economies to drive the long-term recovery of communities across the UK.
113. Several solutions could be used as part of the GSB to attract growth and patient capital, including preferred share capital. We comment further on the GSB below, but detailed analysis and options for growth capital were not in our initial scope of work. We have, however, been collaborating with the ScaleUp Institute and Innovate Finance, who will be issuing a report in the coming weeks outlining options for a growth capital scheme.
114. **Viable businesses that do not require additional support:** The options do not extend to these businesses which are able to access private capital and do not require additional support.

**Figure 13:** Market segments and recommendations: schematic



\* Representative of the total business population (2019; BEIS) segmented by their broad alignment to government lending schemes. Illustrative estimates assumes that: (i) the majority of small businesses with 0-49 employees align to BBLS (c.90%) with a small proportion of these businesses aligning to CBILS (c.10%); (ii) medium sized businesses with 50-250 employees entirely align to CBILS and (iii) large businesses with 250+ employees (per BEIS definitions) entirely align to CLBILS.

† Representative of total estimated unsustainable lending that could arise by end of March 2021 residing across the business population.

Figure 14: Outline of the options

Scheme	Description	Target businesses	Illustrative attributes
<b>Business Repayment Plan (BRP)</b>	<ul style="list-style-type: none"> <li>Government loan (BBLS or CBILS) is converted to a tax obligation that the business repays out of taxable profits or some other measure of business recovery, alongside its tax payments.</li> <li>The business has a more manageable repayment schedule and repays the loan only when it can afford to do so.</li> <li>The Government guaranteed portion of the loan is fully converted.</li> <li>Where the borrower has a CBILS loan, the lender's unguaranteed portion would be converted into an equivalent economic interest ranked alongside Government's guarantee obligation.</li> </ul>	<ul style="list-style-type: none"> <li>UK businesses with BBLS loans and CBILS loans up to £[250,000] in value (threshold loan values for solution eligibility to consider any regional differences in the size of Gov loans).<sup>44</sup></li> </ul>	<ul style="list-style-type: none"> <li><b>Term:</b> Liability continues until the tax obligation is paid off (or the company/business is liquidated / dissolved).</li> <li><b>Coupon / dividend:</b> Fixed annual coupon payment with a step up over time.</li> <li><b>Repayments:</b> Repayable in annual amounts equal to a portion of taxable profits or some other measure of business recovery.</li> <li><b>Delivery:</b> Potentially integrated with HMRC systems to facilitate collection of repayments.</li> <li><b>Restrictions:</b> The instrument would impose certain restrictions on the borrower's ability to pay dividends, increase salaries of shareholder employees, limit partnership drawings or dispose of assets to ensure that tax obligations are repaid.</li> </ul>
<b>Business Recovery Capital (BRC)</b> <sup>45</sup> <ul style="list-style-type: none"> <li>Sub-ordinated debt agreements;</li> <li>or</li> <li>Preferred share capital</li> </ul>	<ul style="list-style-type: none"> <li>Government CBILS loan is converted to subordinated debt or preference shares, with a longer fixed term.</li> <li>The business has a more manageable and predictable repayment schedule.</li> <li>The guaranteed portion of the loan (80%) is fully converted. For the remaining exposure (20%), the lender receives subordinated debt or preference shares or an equivalent economic interest.</li> <li>There is no need for complex valuations upon conversion of CBILS loans into subordinated debt or preference shares.</li> </ul>	<ul style="list-style-type: none"> <li>UK companies limited by shares, or partnerships and sole traders<sup>46</sup> with CBILS loans over £[250,000].</li> </ul>	<ul style="list-style-type: none"> <li><b>Term:</b> Longer fixed term (e.g. eight to ten years).</li> <li><b>Coupon / dividend:</b> Fixed annual coupon payment with a step up over time.</li> <li><b>Repayments:</b> Equivalent to the amount of the CBILS loan converted, plus any unpaid coupon.</li> <li><b>Restrictions:</b> The instrument would impose certain restrictions on the borrower's ability to pay dividends, increase salaries of shareholder employees, limit partnership drawings or dispose of assets to ensure that dividends are paid once the company returns to profitability.</li> </ul>
<b>Growth Shares for Business (GSB)</b>	<ul style="list-style-type: none"> <li>Equity investment into Small and Medium-sized UK businesses in the form of patient or growth capital.</li> </ul>	<ul style="list-style-type: none"> <li>Small, Medium-sized and Large UK businesses requiring growth capital.</li> </ul>	<ul style="list-style-type: none"> <li>Longer term growth and patient capital.</li> <li>Several solutions could be used including a preference share solution supplemented by other solutions.</li> <li>Further detail forthcoming in ScaleUp Institute and Innovate Finance report due July 2020.</li> </ul>

<sup>44</sup> Threshold loan values for instrument eligibility should consider any regional differences in the average value of Government loans. We also note that the limit of £250,000 for BRP has been provided for illustrative purposes. This threshold is to be determined by UK Government following a more detailed assessment and could be adjusted.

<sup>45</sup> Consideration should be given to changes to accounting treatment in order that the BRC relevant instrument qualifies for equity treatment and facilitates balance sheet repair.

<sup>46</sup> Partnerships and sole traders with a CBILS loan that are not eligible for a BRP would be deemed to be eligible for Business Recovery Capital of a statutory partnership, i.e. new partnership capital.

## The triage process

115. We propose that the use of recapitalisation tools would require the consent of both the borrower and the relevant lender and that either the borrower or the lender could initiate this process.
116. A framework would need to be independently developed and agreed between the Government, Regulators and lenders on the application of the various solutions proposed. This includes the detailed processes by which businesses are offered the proposed solutions, the assessment of businesses as eligible for the option, and the process for triggering Government loan guarantees.
117. It is critical that there are clear and operable criteria for when a borrower can access these new arrangements and that they are triggered at an early enough stage to enable viable businesses to be supported, whilst maintaining lenders' obligation to manage loans effectively before loans are converted. Independent oversight of the triage process and mechanisms developed is key to ensure that decisions are made fairly and that conduct risk is minimised.

## Proposed fund structure for the options

118. The potential fund structure of the UK Recovery Corporation, and a potential growth capital fund, should be designed with a view to attracting private sector investors.
119. In its launch and initial phase, the primary options for the structure of the UK Recovery Corporation are likely to be either a limited partnership or a private limited company, both of which could be set up on an expedited timeframe. A further advantage of a limited partnership structure would be its tax transparency. Whilst the benefits of a private limited company would be that if the fund structure in the subsequent phase was intended to be an investment trust (as detailed below), the private limited company could be listed and become an investment trust without a new structure being needed.
120. In the subsequent phase, the choice of fund structure should be driven by the needs of the investors that are likely to be introduced into the structure (we consider the applicability of various investor types in Chapter 6). This may mean that the fund structure remains as a limited partnership or private limited company or that the structure moves to an investment trust structure or private fund limited partnership structure. For example, an investment trust structure in this subsequent phase could be attractive to retail investors, offering both robust governance arrangements and taxation benefits and being a familiar model amongst the investor base.
121. A comparison of the relevant fund structures and their policy considerations are presented in the Appendix.
122. Irrespective of fund structure, private sector investors will require the UK Recovery Corporation to undertake a detailed valuation exercise in order to invest in the fund. As the fund moves into this subsequent phase, assets will need to be segmented and valued by key variables and characteristics such as borrower type, risk category, sector, duration and performance.

## Policy conditionality for users of the options

123. Across the options (BRP, BRC and GSB), supporting businesses through public intervention presents a question for the Government as to whether it wishes to advance policy objectives by incorporating well-designed incentives and conditions. While the calibration of any such conditionality is not within our terms of reference, we note this is an area that Government may wish to consider in any further development of these options.
124. Conditions imposed by Government on businesses adopting the new instruments, might encourage positive behaviours, including net zero emissions, good employment and business management practices, diversity and inclusion goals, tax transparency and responsibility, the levelling up agenda, and productivity improvements. We have also heard from investors that promotion of certain public policy objectives can increase the attractiveness of businesses to private capital, particularly where they align with investors' Environmental, Social, and Governance (ESG) considerations.
125. However, conditionality would apply an additional operational and potential economic complexity burden that also needs to be considered.
126. Options need to remain available to businesses, simple to use, quick and accessible. Any design criteria should also consider whether the capital is for growth or recovery purposes, the type of instrument used, and the businesses targeted.

## FURTHER DETAIL

### THE OPTIONS FOCUS ON A PATH TO RECOVERY FOR UNLISTED SMES WHICH HAVE RECEIVED A COVID-19 GOVERNMENT LOAN THAT THEY ARE LIKELY TO STRUGGLE TO REPAY

127. Our focus has been on the primary problem statement of addressing the need to recapitalise UK SME companies, partnerships and sole traders with an unsustainable debt burden, ensuring that additional measures can be put in place to support these businesses.
128. The expectation is that listed businesses and unlisted large corporates will be better able to access capital markets, bank financing and existing proposed restructuring tools, whereas SMEs have less alternatives or tools available to them. Many SMEs will come under immense pressure in the coming months, as the Government furlough scheme starts to taper off, rent deferrals come to an end, VAT payments deferred are due in full by 31 March 2021 and operating losses continue to accumulate. Their resilience and prosperity are vital to local employment and to the health of the economy as a whole, and therefore the options focus on this group of borrowers, given their needs are urgent and immediate. .

#### Scope: A primary focus on the Government scheme unsustainable debt

129. Government has fully or partially guaranteed the loans made under the Covid-19 business lending schemes and provided financing to companies through tax deferrals. If we are to avoid the prospect of calling on those guarantees through enforcement on one hand, or the prospect of mass conversion of these loans to grants on the other, then a mechanism to deal with these exposures must be found. The options are aimed at providing such a mechanism.
130. Businesses which cannot repay will add further pressure to public finances already under strain. If this problem is left to resolve itself, there are likely to be more UK businesses which fail, particularly in regions outside of London. This will set the UK back in its objective of “levelling up”. In cases where the guarantee from Government is only partial, and / or where the businesses affected have taken out loans prior to Covid-19, UK lenders could suffer large losses if businesses cannot repay their debt which would reduce the ability of UK lenders to lend and power the UK recovery.
131. The need for both simplicity and tackling the unsustainability problem early, gives rise to issues of moral hazard and fairness that need to be balanced within scheme design. Acknowledging that whilst schemes need to be supportive, they need to be suitably restricted so that they are only provided to those that need it.
132. Specific consideration has also been given to:
- The terms of each of the options, e.g. structure of the rates, as we believe this is critical to ensure that appropriate incentivisation for repayment is created; and
  - The explanation of the presentation of the schemes.
133. These are choices for the Government to make, rather than the borrowers themselves.
134. Solutions to deal with SME unsustainable debt quickly are essential. Leaving the market to resolve the challenge has the potential to fail, and would lead to wide-spread negative economic and social consequences. The aim of the schemes being proposed is to avoid company insolvencies and thereby protect jobs, by attempting to provide support to companies prior to them entering default. In doing so, we are seeking to address distress early enough to give businesses the best chance of survival. It is important to balance the protection of taxpayers and preservation of moral hazard with the benefits that would be achieved by recapitalising small businesses (on terms not available in the market) to preserve jobs, economic activity and tax base.
135. Our options are designed to assist those businesses which are facing the need for longer term assistance, as a result of the fall out of Covid-19. For those entities that need lighter touch / shorter term assistance we acknowledge that lenders have a range of forbearance and restructuring options currently being offered as part of usual business practices that businesses of all



sizes can continue to utilise. For example, a lender may allow a business to extend the terms of their debt or be given a capital repayment holiday. To this end, we have included two potential forbearance options for consideration for use by lenders below (see page 65).

136. Within unsustainable debt, we have focused our options on recapitalisation solutions for borrowers under the BBLS and CBILS Government loan schemes. Our solutions offer a path to recovery for all businesses that currently hold BBLS and CBILS loans and are facing difficulties in repaying this debt. We do not propose that businesses are refused these solutions by virtue of their financial positions having deteriorated further during the pandemic.
137. Whilst noting the parameters of our scope, the options developed in our work have the potential to be extended to address broader needs. This includes:
138. **Non-scheme debt:** The remit of this report is to explore the future support that could be provided to businesses that have already received support under the Government's existing business support loans. However, we believe that, should Government wish to extend the application of our recommendations, the schemes proposed provide enough flexibility so that they can be modified and targeted to borrowers with debt other than that taken on through the BBLS or CBILS schemes. Please see details on the next page for further discussion of the potential future extensions of the options.
139. **Growth capital needs:** We recognise that there are other businesses which can repay their debt, or those which may not have taken debt through the crisis period, but nonetheless need growth capital support. Please see page 63 for further discussion of growth capital.

### Scope: A primary focus on unlisted SMEs

140. We recognise that larger corporates across the UK are also facing varying levels of financial distress as a result of Covid-19. Market experience suggests that most larger businesses are more likely to be able to refinance themselves with the support of existing creditors and shareholders.
141. Larger listed businesses continue to have access to fresh capital through the public markets. Nonetheless, there may be further adjustments that could be made to speed up the process of capital raising for listed businesses; however, we note that we have not dealt with enhancements to public markets thus far.
142. We note that whilst large businesses were not the focus of our work, the options for CBILS borrowers could be modified and made applicable to CLBILS borrowers.
143. Given our area of focus, our consultation with SMEs and trade associations has helped inform the development of the options. In response to the interim report, they told us that:
  - It would be desirable to have a range of tools and solutions adapted to different sizes and sophistication levels of business.
  - A solution that would work for microbusinesses should be a priority.
  - The point of default was felt to be too late to be a trigger point for recapitalisation.
  - Using existing infrastructure should be considered where possible, noting that existing infrastructure was currently stretched as a result of the initial Covid-19 response.
  - They were supportive of a solution for smaller entities that sought repayment through the tax system and supportive of a preference share like scheme for larger SMEs.

## Potential scope extensions: The BRP and BRC could be extended to support a larger range of businesses and/or capital needs

144. While the remit of this report is to explore the future support that could be provided to businesses that have already received support under the Government's existing business support loans, there are number of areas where the options provided could be extended to a wider range of businesses. The key question underpinning the choices relating to Government extending its support beyond its existing guarantee exposures outlined below, is how it would assess the value it should pay existing Third-Party Debt holders, or non-indebted owners, to support the relevant borrower's business. The potential extensions to the proposed support mechanisms suggested are set out below.

### Extension to borrowers with non-scheme debt

145. We have focussed our recommendations on unlisted SMEs, which have taken out Government loans through the CBILS and BBLs schemes. However, we believe that, should Government wish to extend the application of our recommendations, the schemes proposed provide enough flexibility so that they can be modified and targeted to borrowers with debt other than that taken on through the BBLs or CBILS schemes. We recognise that to do so gives rise to material policy considerations regarding the type of such debt that might be converted, how to deal with relative priorities and inter-creditor agreements and also of where the cost of such intervention should be borne.
146. Should the BRP and BRC schemes only be available to borrowers which have applied for BBLs/CBILS, there is the potential for a surge of refinancing of other borrowings through BBLs and CBILS, prior to the enablement of the options set out in this report.
147. Therefore to support these businesses the options provided in this report could be extended, enabling non-scheme debt to be converted into either BRP or BRC at the agreement of both the lender and the borrower, following an assessment of the quantum/proportion of non-scheme debt that would be required to be converted to facilitate on-going sustainability of the business. In such a situation both the trigger event and terms offered would likely be the same as for CBILS debt.
148. Conversion of the debt could be at face value and the new instrument then transferred to a management company (potentially the UK Recovery Corporation) at fair value, perhaps on a portfolio basis. (EU State Aid rules, while they apply, are likely to require that such sales are demonstrably at fair (market) value). Simultaneously the instrument could be transferred to the asset management company to manage economics and cashflows and then private capital funding or securitisations could be introduced over time.
149. An alternative solution to provide support for businesses which have non-scheme debt could be to offer a more permanent guarantee scheme, likely on more prescriptive terms than provided for CBILS. This could in turn be managed through the institution created to manage the recapitalisation scheme.

### Extension to non-borrowers that are now under stress

150. Support could also be extended to companies (or sole traders / partnerships) which have not previously borrowed but which are now under stress and are looking for access to funding to help avoid closure or significant cutbacks.
151. If help is not extended, it could be argued that these businesses are being penalised for their prudence in not taking on debt originally. There are complexities with respect to implementing the additional support for them, that would need to be addressed for example there is no existing lender involvement to assess the credit exposure of the business.
152. Given that these businesses currently do not have debt, and therefore by definition they don't have unsustainable debt, it may be more reasonable that they are covered by the GSB (see below).
153. In such situations it could however be possible to offer a small tranche of equity (possibly slightly less than would have been available to those with Government debt) to provide share capital to the prudent borrowers without creating a debt obligation, but that would meet the same recapitalisation needs.

154. In addition, while further work is required to explore additional options, it might also be possible to provide a 'rebate' of tax paid in one or more prior tax years that would then be recoverable through a BRP-like solution operated by HMRC. Only rebating to the extent of tax paid implicitly gives some assurance around the pre-Covid substance and viability of the business. This approach could also work equally well for small companies, partnerships or sole traders.

## A RANGE OF POLICY CONSIDERATIONS HAVE INFLUENCED THE OPTIONS

155. In addition to the design criteria set out on page 42, the below policy considerations shaped the detailed design of the options. These considerations are further detailed below.

### Timing and prioritisation

156. There is a need for some haste given our expectation that some businesses will need to consider recapitalisation options imminently, particularly given the need to have a workable plan in place in advance of a loan potentially defaulting. Implementation timeframes will need to give due consideration to the adjustment of existing and any additional Government support mechanisms as well as the evolving economic environment.
157. Critically, businesses should be able to access these solutions before directors believe the company is insolvent or they default on their debt obligations. In doing so, we are seeking to address distress early enough to give businesses the best chance of survival. Insolvency will arise long before repayment dates for many businesses.

### European Commission State Aid Rules

158. While the UK may be operating under a revised State Aid framework from 1 January 2021, our recommendations are designed to operate with the current State Aid frameworks. There could however be a case for adjusting the options to ensure they consider future revisions that are made.
159. The Commission's Temporary Framework and the related decision of the Commission to clear a UK aid scheme under that framework<sup>47</sup>, contemplate that limited equity investments by the Government of up to EUR800,000 per business (or EUR1,000,000 if aggregated with de minimis aid) can be made, without needing to be cleared in advance by the Commission and without needing to comply with the various conditions and obligations that apply for equity investments above that threshold (such as minimum levels of remuneration, restrictions on the competitive conduct of the company and the submission of a restructuring plan to the European Commission in certain circumstances). These rules have been key to informing the solutions we have proposed.

### Implementation goals

160. The UK's existing public and private infrastructure will need additional support in implementing these options at the necessary speed and scale given the size of the challenge. The option to establish a UK Recovery Corporation is aimed at meeting this need.
161. While in the short term the focus will be on meeting the challenge of resolving the unsustainable debt burden of UK SMEs, consideration will need to be given to how long these schemes should be deployed for and whether they are incorporated into more permanent infrastructure. For example, they could be incorporated into a UK development bank that could support long term public policy, as well as be available to respond to any subsequent economic crises.
162. UK precedents to consider include the loans work-out unit in UKFI; ICFC (3i) and its equity investments in SMEs; the Green Investment Bank and its approach of mandating private sectors managers; British Business Bank, Student Loans Company and UK Asset Resolution. There are a number of existing BPO and collections companies that will be well positioned to support and as we turn to the goal of delivering growth capital, existing mid-market PE firms may have a role to play. There may also be policy rationale for a regional network to support growth across the country, or for elements to be devolved regionally.

<sup>47</sup> State Aid SA.56841 (2020/N) - Temporary Framework for UK authorities, Commission decision of 6 April 2020, as amended by State Aid SA.57078 (2020/N), Commission decision of 23 April 2020.

## Primary legislation

163. It is proposed that the new tax establishing the BRP, and the new solutions for the BRC, would need to be created by primary legislation. This would help to maximise effective implementation of the policy goals, as well as to enable rapid roll-out by SMEs, cutting through the processes of constitutional change and resultant delays that would otherwise potentially apply. Primary legislation would also support appropriate UK GAAP accounting treatment, as well as reinforcing desired solvency outcomes and facilitating the ability to repay the BRC when the business can afford to do so.
164. Absent primary legislation, the Government could adopt measures to aid recapitalisation, but they will be far less effective in recapitalising borrowers, in doing so at scale and simply, and in facilitating appropriate returns to Government and taxpayers.

## BUSINESSES WOULD ACCESS THE SCHEMES VOLUNTARILY VIA APPLICATION TO THEIR EXISTING LENDER

165. The options presented would be made known to borrowers through client communication campaigns but are intended to be accessed by businesses on a voluntary basis through self-certification by the borrower.
166. When a borrower has ascertained that additional financial support is required, the borrower / lender would determine which of the two schemes proposed is appropriate, based on the size of borrowings (see Figure 14).
167. For borrowers with loans less than £[250,000] (which covers BBLs and smaller CBILs), BRP would be available. Given the simplicity of the scheme and the relative ease with which it could be operationalised, we believe it would be suitable for the large quantum of loans extended under this threshold.
168. For borrowers with CBILs loans greater than £[250,000], it is proposed they would be eligible to enter the BRC scheme and either issue preferred shares (up to the value of £1,000,000) or convert the debt to subordinated loan notes.
169. We are proposing the BRP is targeted at smaller borrowers that have loans of up to £250,000, which would capture all BBLs loans and the lower end of CBILs loans. Whilst the BRP could be rolled out to larger borrowers, the view is that larger loans should follow more structured repayments to avoid risks of non-payment, which is likely to be more pertinent when the size of the loan is higher and the risk of profits being diverted overseas is greater with larger businesses. The threshold of £250,000 has been selected as a proposed threshold, however, the BRP could be used as a single solution up until the point at which a bespoke restructuring would be more suitable. The level of threshold, or indeed the need for a capital solution, is therefore a policy issue to be discussed with the Government.
170. It is proposed that these schemes are made available to all borrowers which have previously taken out Government business support (albeit for larger businesses / loans, bespoke restructuring solutions may be more suitable). The application to these schemes could be supported by simple financial information (such as forecast cash flows or financial statements), evidencing difficulty a borrower was having in making repayments, enabling the lender to validate eligibility by way of a review of documentation provided. It is further proposed, that for smaller loans it may be possible to simplify this process further, removing the need for supporting documentation.
171. Several mechanisms would need to be developed and agreed between the Government, Regulators and lenders on the application of the various solutions proposed which, to the extent possible, should be transparent, standardised, programmatic and be supported by strong governance. This includes mechanisms for triaging businesses according to their needs and triggering loan guarantees.
172. It is critical that there are clear and operable criteria for when a lender is able to transfer a loan into these new arrangements and call on the Government guarantee at an early enough stage to enable viable businesses to be saved, while maintaining their obligation to manage loans effectively before the guarantee is called.

## DETAILED DESIGN OF MECHANISMS AFFECTING BORROWER ACCESS, PROCESS AND OUTCOMES MUST BE GUIDED BY CONDUCT CONSIDERATIONS

173. It will be crucial that the recapitalisation programme is, and is seen as, fair and delivering appropriate outcomes by all stakeholders. Risks could arise from conflicting financial incentives of the parties, poor processes leading to unfair treatment, or lack of transparency. Significant work will be required both within individual firms and across the broader financial and policy system to mitigate these risks.

### Process

174. The programme will need to enable all lenders and other parties involved to deliver the desired outcomes to stakeholders at pace and scale. Decisions will need to be made rapidly, to give fundamentally viable businesses the best chance to survive. Policy and operational processes, including for independent advice, will need to deliver consistent outcomes so that borrowers can be confident that similar businesses will receive similar treatment. Appropriate mechanisms need to be in place to enable disputes to be resolved.

### Simplicity and practicality

175. For smaller borrowers, lenders have little information and lending decisions under Government schemes have been made largely on the basis of borrower summaries. Tests to determine eligibility for new solutions including the Potential Default conclusion trigger, use of fund restrictions and monitoring / MI requirements need to recognise these practical limitations. Lenders will be the point of initial contact for most borrowers seeking to access refinancing options. They will need to develop automation and decision tree-type processes to achieve consistency across different channels and the breadth of their branch networks, and to serve the volume of impacted borrowers at pace. These processes will also need to allow for appropriate consideration of individual borrower circumstances to deliver fair outcomes. This will also be an important time to identify and address lending made on the basis of fraudulent information. Lender judgements, for example about borrower eligibility or triggers for solutions, will need to be based on objective criteria to mitigate risks of inconsistent treatment or misunderstanding that could lead to unnecessary dispute.

### Training, systems and other capabilities

176. High quality and efficient processes take time to build. The volumes of client contact and other work involved in refinancing will necessitate robust processes and the development of increasingly smart processes will evolve over a period of several months. Significant human intervention will be needed throughout but this is likely to dominate in the early days. Firms will need to build, scale and train client teams rapidly and to put in place supervision, control processes and management information that will help them rapidly to identify and rectify problems. Different challenges will be faced by large firms with widespread presence, and the many smaller lenders which are now accredited under the Government-supported schemes.

### Clarity on decision authorities and processes to enable good choices

177. It needs to be clear which party has decision authority to trigger solutions, and the level of input sought from other stakeholders. Where applications are envisaged to be made jointly, the process for reaching agreement, or dealing with disagreement between the applicants, will need to be specified. To the extent that multiple options are available to borrowers, this could cause risk of confusion or poor choices, and the potential consequences of each option – whether in terms of conditions, costs, or possible control dilution, need to be made clear upfront.

178. Smaller borrowers should be strongly encouraged to take affordable independent advice, and perhaps required to do so for the preference share / subordinated debt options. Lenders may not be perceived as independent and may not have information on the borrower, or skilled resources to provide the advice needed. Borrowers will need to know to whom they should turn and be able to have confidence that they will receive consistent good outcomes. Research highlights how the majority of SMEs rely on their local accountants and they or new or existing advice bodies or professional advisers will need to be trained to provide the support that will be demanded. Consideration may also be required as to the cost and availability of such professionals.

### Complaint handling

179. Unfortunately, high numbers of borrowers may ultimately prove to be non-viable and they will not recover from the crisis. Others may not meet the scheme's eligibility criteria, or only on terms they find unacceptable, whether because of Government policy decisions, lender risk appetite or other reasons; or may feel otherwise that they have been badly treated by their lender. Refinancing efforts will need to recognise that borrowers or others may be dissatisfied with the outcomes they receive. Consideration is needed of the right mechanism to resolve complaints and disputes, and of any routes for independent assessment of complaints if a borrower remains dissatisfied with the result of internal lender or Government complaint-handling processes.
180. The current scope of the Financial Ombudsman Service (FOS) is limited to small businesses (<£6,500,000 turnover and other conditions). The newly establishing Business Banking Resolution Service (BBRS) will extend the availability of an independent dispute resolution mechanism for clients of seven banks up to £10,000,000 turnover. Depending upon the final design of the entry process to our options, even with no change to their mandates, these bodies will need to build trained resource and operational scale for increased demand. Over 100 lenders are involved in current scheme lending; and existing lenders and other parties will be involved in the solutions proposed. Decisions are needed as to whether to extend either of the existing mechanisms, and if so, to determine whether scope should be confined to lending solutions or to the broader solution set such as subordinated debt and preference shares. If changes are required, the nature of the work to be undertaken by dispute resolution mechanisms will also need to be determined – it could involve a full (but probably relatively expensive and time-consuming) holistic case assessment or some lower cost and faster intermediate arbitration process. Speed will be important for borrowers under pressure.

### Transparency

181. Sound processes that can be executed at scale and at pace will need to be underpinned by clear policy to mitigate risks of inconsistent treatment and misunderstanding, and to enable decisions to be made on a properly informed basis.

### Terms and features of solutions

182. Advice given and decisions made, whether by advisers, borrowers, lenders, or new providers of finance, will need to be properly informed by an understanding of the terms of features of solutions and of new instruments that may be created. Communications including descriptions of product features, risks and costs, including for example the potential for varying repayment costs over time or for payment in kind for a period, will need to be clear, fair and not misleading.
183. Existing regulatory requirements regarding prospectuses and product disclosures aim to ensure appropriate information is provided to potential investors; guidance may be needed to allow for the types of solutions, transfer and sales processes envisaged.

### Regulatory status

184. Lending to business typically sits outside the regulatory perimeter but certain types of lending for some smaller businesses are regulated by the FCA. The Lending Standards Board's Standards of Lending Practice for business clients, which were recognised

by the FCA in February 2020 as tending to indicate adherence to proper standards of market conduct for unregulated activities, apply for some larger scale borrowers. Reliefs have been incorporated into both FCA rules and the Lending Standards Board's Standards to facilitate CBILS and BBLS lending. It will be important to clarify the regulatory status of new solutions under the programme so that lenders and new providers of finance can develop properly compliant processes.

## Policy resolution

185. A number of the matters raised in this section, including those on complaints, regulatory status, and further conditions for support, will require policy decisions by Government and regulators as well as actions by the private sector. Government and regulatory policy needs to be clear and not open to interpretation as it will lead to inconsistent outcomes, confusion and disputes.

## BUSINESS REPAYMENT PLAN (BRP): FURTHER DETAIL

### Description:

186. The BRP would convert the outstanding loan balance into a means-tested tax obligation payable to the Government. It is proposed that this obligation would then be repayable alongside taxes and could be calculated as a surcharge on profits or other measure of business recovery and be payable through the tax system. The benefit of this scheme is that it provides the holders of BBLS and smaller CBILS loans (borrowings up to [£250,000])<sup>48</sup> the option to convert their scheme debt into a flexible repayment plan, with the consent of the relevant lender and enable repayment as and when profits are made.
187. We propose that the BRP payment could be calculated as a set percentage of profits (for example between 10-25%) or another measure of business recovery and be collected by HMRC in respect of the borrower (and where applicable, its subsidiary undertakings), and repaid every year.
188. As a result of the conversion to a tax obligation, rather than debt to a lender, a business that isn't making a profit would not make repayments but would instead accrue an increasing obligation to pay as and when profits recover. A business that returns to healthy profit would pay down the BRP rapidly and return to normal course, with no other exit mechanism required.
189. Upon conversion of the BBLS or CBILS debt into the BRP, the lender is paid out in full for the Government guaranteed portion of the loan (i.e. 100% for BBLS and 80% for CBILS). For the remaining 20% of the CBILS loan, the Government issues an interest to the lender and pays the lender the equivalent of 20% of the proceeds for the BRP to the extent it is received.
190. As detailed previously, we are proposing the BRP is targeted at smaller borrowers that have loans of up to £250,000. However, the ultimate decision on the most appropriate threshold is a policy decision for Government.
191. Further, whilst we have highlighted that profit may be appropriate as the mechanism to measure business recovery, this may not be suitable to all borrowers. Therefore, a policy determination is required to assess the most suitable repayment basis when considering borrower affordability.
192. A summary of the key terms is set out below. A full indicative term sheet, and an evaluation of the key technical perspectives of the BRP, can be found in the Appendix.

### Duration:

193. The BRP would be perpetual in nature i.e. the liability continues until the tax obligation is paid off (or the company/ business is liquidated/dissolved).

<sup>48</sup> As noted previously, the cap would be subject to policy choice by HM Government and could be adjusted.

**Terms and rates:**

194. The proposed coupon (interest) rates post conversion would be a fixed annual coupon with an agreed step up over time.

**Exit / Repayment:**

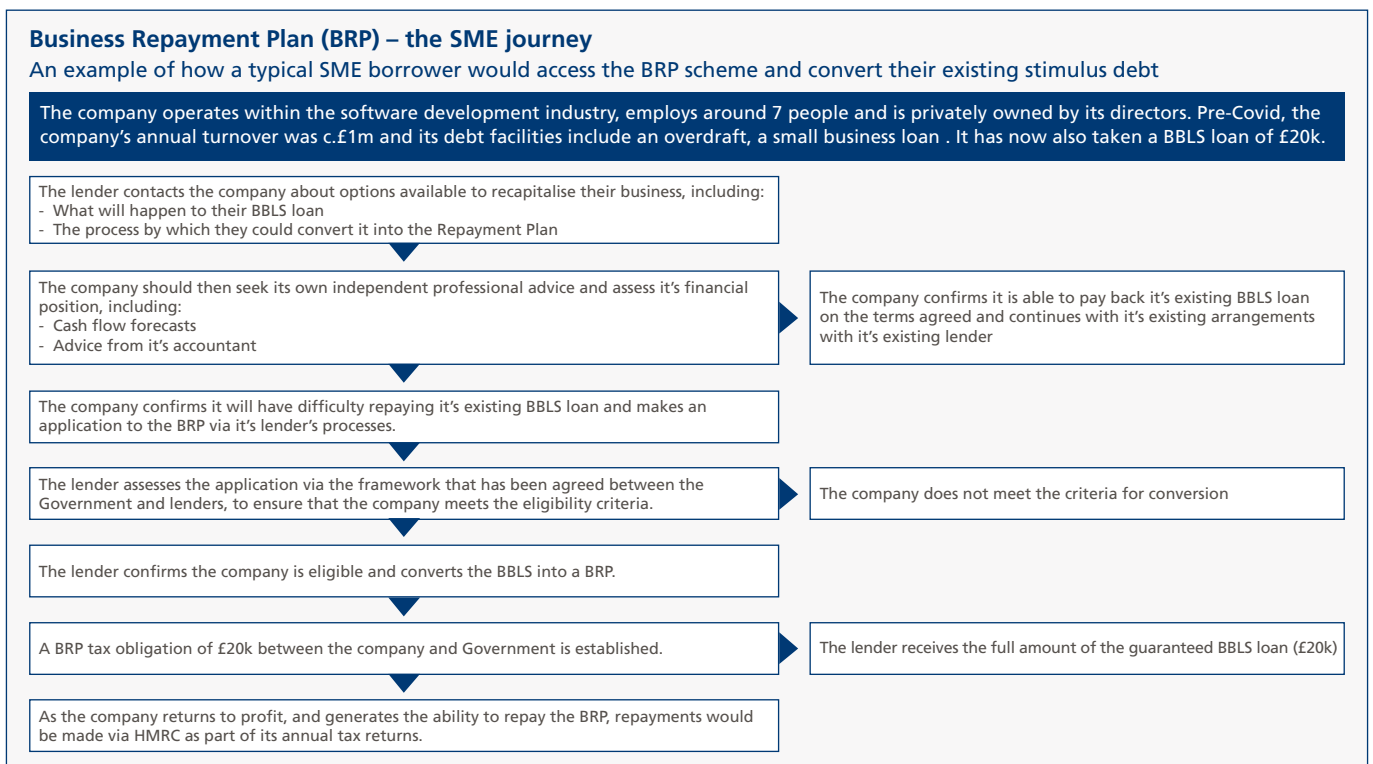
- 195. There would be annual payments made towards the outstanding liability, which could be in line with a percentage of profits that are chargeable to tax, or another measure of business recovery.
- 196. It is proposed that there is an option available to the borrower at all times to repay in full, overpay or accelerate payments, should they so wish.
- 197. The underlying economic benefit of the BRP is capable of being economically assigned / economically transferred to third parties by HMT as required.
- 198. If a borrower fails to make repayments as they fall due, the debt is treated and ranked in the same way as failure to pay corporate taxes.

**Illustrative use case:**

199. Below we have provided an example of how a typical SME borrower would access the BRP scheme and convert their existing stimulus debt.

**Example company profile:**

200. The company operates within the software development industry, employs around seven people and is privately owned by its directors. Pre-Covid, the company's annual turnover was c.£1,000,000 and its debt facilities include an overdraft, and a small business loan. It has now also taken a BBLs loan of £20,000.





### Eligibility criteria and business coverage:

201. The underlying aim of the BRP is to avoid complexity for the smallest borrowers under the schemes while providing them with additional support that avoids leaving or creating debts that would affect solvency.
202. The BRP is therefore targeted at UK taxpaying businesses, partnerships and sole traders, which accessed the following UK Government business support schemes:
- BBLs borrowers; or,
  - CBILs borrowers with borrowings up to £[250,000] or other maximum threshold to be agreed.
203. It is proposed that conversion to the instrument would primarily be triggered by the submission of an application, by the scheme holder, to the lender it holds its existing scheme debt with. However, a lender could approach its client to provide this option should it become aware of its client suffering financial stress.

### Borrower access:

204. Access to the scheme would be granted following consent of both the borrower and the relevant lender, and the borrower providing documents evidencing the support they require. Further details are provided on page 52. There would be no obligation on either the borrower or the lender to approve access, subject in the lender's case to terms of eligibility agreed with Government.

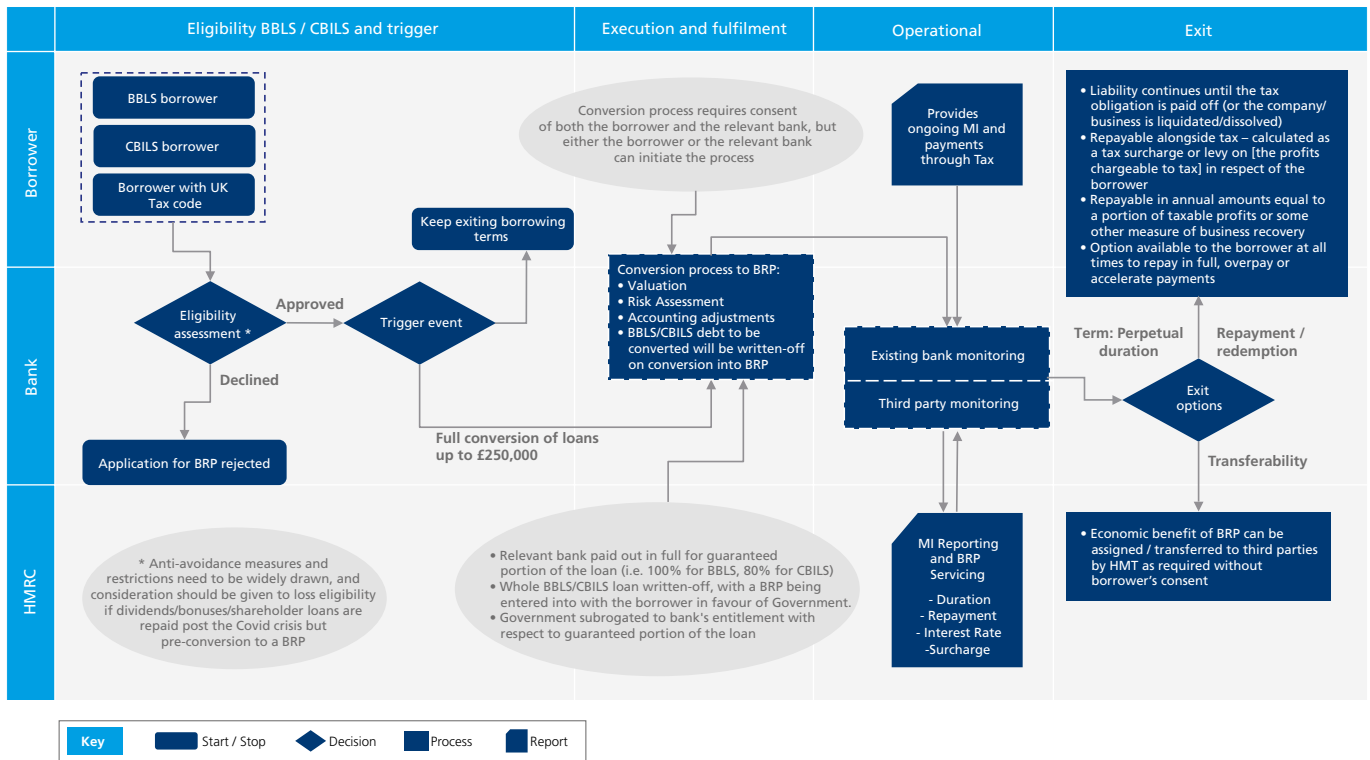
### Anti-avoidance measures:

205. Due to the BRP being a tax obligation, it is recognised that there may be risk of non-payment by some businesses. Therefore, anti-avoidance measures and restrictions may need to be widely drawn, and consideration should be given to loss of eligibility if dividends, bonuses or shareholder loans are repaid post the Covid crisis but pre-conversion to a BRP. Appropriate repayment incentives need to be put in place to encourage repayment of the instrument, which should be decided upon in conjunction with HMRC and HMT. Examples of a number of restrictions have been outlined below.
- Restrictions on dividends, shareholder loan payments, buybacks or other capital distributions until the BRP is fully repaid;
  - Targeted salary restrictions for equity holders, where also employees of the company; certain executives and senior staff members and their connected persons were also an employee of the company, until BRP is fully repaid;
  - Share transfers and disposals would be restricted;
  - Transfers of business assets or property would be restricted; and
  - A failure to make repayments as and when they fall due would be classified and treated in the same way as failure to pay corporate taxes.

### Enablement and delivery:

206. Enablement and delivery of the BRP should be read in the context of broader enablement considerations set out in Chapter 5. Further considerations specific to BRP are set out below.
207. The following key design principles have been used to create the proposed outline structures for the BRP solution and should be considered for the more detailed future phase design activities:
- A consistent set of parameters will be used for eligibility and trigger criteria.
  - Economic benefit of BRP is capable of being assigned / transferred to third parties by HMT as required.
  - Collection of repayments by HMRC through the tax system.
  - A central entity (perhaps through operational capacity to be provided by the UK Recovery Corporation) will be required to monitor SMEs which opt for the BRP recapitalisation solution (like the Student Loan Company).
  - Full BBLs loans are to be converted to BRP.

Figure 15: Business Repayment Plan (BRP) borrowers process flow



Technology considerations:

208. Further assessment should be undertaken of existing taxation calculation and collection capabilities through direct engagement with HMRC. The focus would be to evaluate the existing infrastructure of HMRC, with a emphasis on data quality, the timeliness of data and the standardisation and monitoring requirements of payments. These are all important factors in potentially automating the due diligence process and creating a robust, consolidated view of businesses for stakeholders and investors.
209. Specific consideration is also required of:
- HMRC infrastructure capacity: An assessment of HMRC's technology to determine the extent to which the existing infrastructure can be leveraged in the envisaged timeframe and scaled to meet the current BRP solution specification, criteria, controls and anti-avoidance measures.
  - BRP management entity: While calculations and payments may be facilitated by HMRC, a central entity may also be required to manage and monitor businesses that convert to the BRP solution (with potential similarities to the existing Student Loans Company).

Policy and design considerations:

210. There are a number of open policy considerations relevant to all schemes being proposed as described on page 51. These notably relate to the extent to which these products can be extended to non-scheme debt or current non-borrowers. In addition, there are several specific policy and design related questions pertaining to the BRP scheme, as follows:
- There is the potential to broaden the application of the BRP to cover all businesses with unsustainable debts, which would in turn provide a more comprehensive market solution, however this raises policy choices for the Government.

- Interest rates and caps will have to be utilised to balance moral hazard, generate incentives to repay while still ensuring affordability and enable the potential to introduce private sector capital.
- Whilst considering borrower affordability, a policy determination is required as to what is the most suitable repayment metric for borrowers and what annual percentage repayment is most appropriate.
- Any restrictions need to be reasonably enforceable taking account of target beneficiaries and not unduly constraining to growth (notably for SMEs and Micro businesses).
- Consideration must be given to the attractiveness of the terms of the BRP, so that they do not distort competition or disadvantage those that have not borrowed.
- BRP will not work for non-tax residents' borrowers, however a BRC could be offered to them if they meet the eligibility criteria for that option.

## BUSINESS RECOVERY CAPITAL (BRC): FURTHER DETAIL

### Description:

211. The key principle of the BRC scheme is to lower the cost of capital of the private sector and deploy new investment into the UK economy. The scheme is aimed at helping small and mid-market businesses and could be facilitated by one of two underlying financial instruments, both of which would require primary legislation to help ensure they met the needs of the borrowers. One potential solution would be for the underlying instrument to be longer term (subordinated) debt agreements, while the second option could see conversion of the loan into preference shares.
212. The key advantage of the subordinated debt facility, as the underlying instrument, is that it would benefit from existing rules on tax deductibility. However, it may be harder to legislate for classification as 'equity like' from a solvency and UK GAAP perspective. In addition, rules on tax deductibility, could be changed to benefit all forms of BRC.
213. The key advantage of the preferred shares instrument is that it is potentially easier to legislate as 'equity like' in nature, from a solvency and UK GAAP perspective, however it would only be available to UK limited companies. Partnerships and sole traders could potentially be offered a similar instrument via preferred partnership capital. In addition, such an instrument could only be extended for loans up to £1,000,000, without triggering additional conditions and obligations under the State Aid rules.
214. Under either option, upon conversion of the borrower's debt into the BRC, the relevant lender would be able to claim in full for their guaranteed portion of the loan (80%), while for the remaining exposure (20%), the lender would receive either an equivalent economic interest to the sub-debt or preference shares, depending on the underlying instrument chosen by the Government.
215. The BRC is aimed at supporting businesses which have previously accessed CBILS loans, the value of which exceeds [£250,000].<sup>49</sup> While there would be no strict cut off limit at the higher end of loan value, it is envisaged that for loans that are significantly above the £1,000,000-mark, bespoke restructuring may be more suitable.
216. Upon request by the borrower and the relevant lender, the CBILS loan would be written off and replaced with a BRC solution with the Government, equivalent to the gross amount outstanding under the CBILS loan.
217. It is proposed there would be a requirement to make annual payments under the BRC obligation. However, based on the growth needs or operating requirements of the business, there would be an option for the borrower to make a Payment in Kind as opposed to interest payments in the first two years. The BRC solution would be subordinate to all existing debt but rank ahead of existing shareholder loans and common equity, with no voting rights (if the underlying solution was the preferred shares).
218. Potential key terms for both the BRC preference shares and BRC loan are largely aligned and are set out below. Indicative examples of full-term sheets for both solutions, as well as an evaluation of the key technical perspectives of the BRC, can be found in the Appendix.

<sup>49</sup> The minimum threshold for the BRC scheme would be aligned to match the maximum threshold for BRP such that the two schemes do not overlap.

### Duration:

219. The BRC would be a long-term fixed return of between [eight to ten] years, but like a preference share or deeply subordinated debt instrument, can only be repaid at term if the borrower is solvent after doing so out of relevant financial resources.

### Rate:

220. The proposed coupon (equivalent to interest) rates post conversion would be a fixed annual coupon with an agreed step up over time.

221. In addition, with respect to the 20% of non-guaranteed borrowing, it is proposed that the Government would continue to pay the interest payments during the Business Interruption Payment (BIP) period, being the first 12-month period of the CBILS loan. Further, within the first [two] years, the lender may also opt to receive Payment in Kind and waive dividend payments.

### Restrictions:

222. Upon conversion of the loan, certain restrictions should be considered in order to protect the interests and rights of the holders of the BRC, for example:

- No payments of dividends, non-mandatory coupons or share buy-backs.
- Restrictions on remuneration of management.
- Anti-avoidance and fraud protection measures.

### Exit / Repayment:

223. The BRC would result in a repayment of the amount equivalent to the CBILS loan, which was written off, plus any unpaid dividends or interest. The borrower may choose to opt to defer repayment until the expiry of the BRC.

224. It is recommended that distributable reserves and capital rules are adjusted for the BRC by primary legislation to simplify processes and facilitate repayments out of available resources.

225. The underlying economic benefit of BRC is that it is capable of being assigned / transferred to third parties by HMT as required.

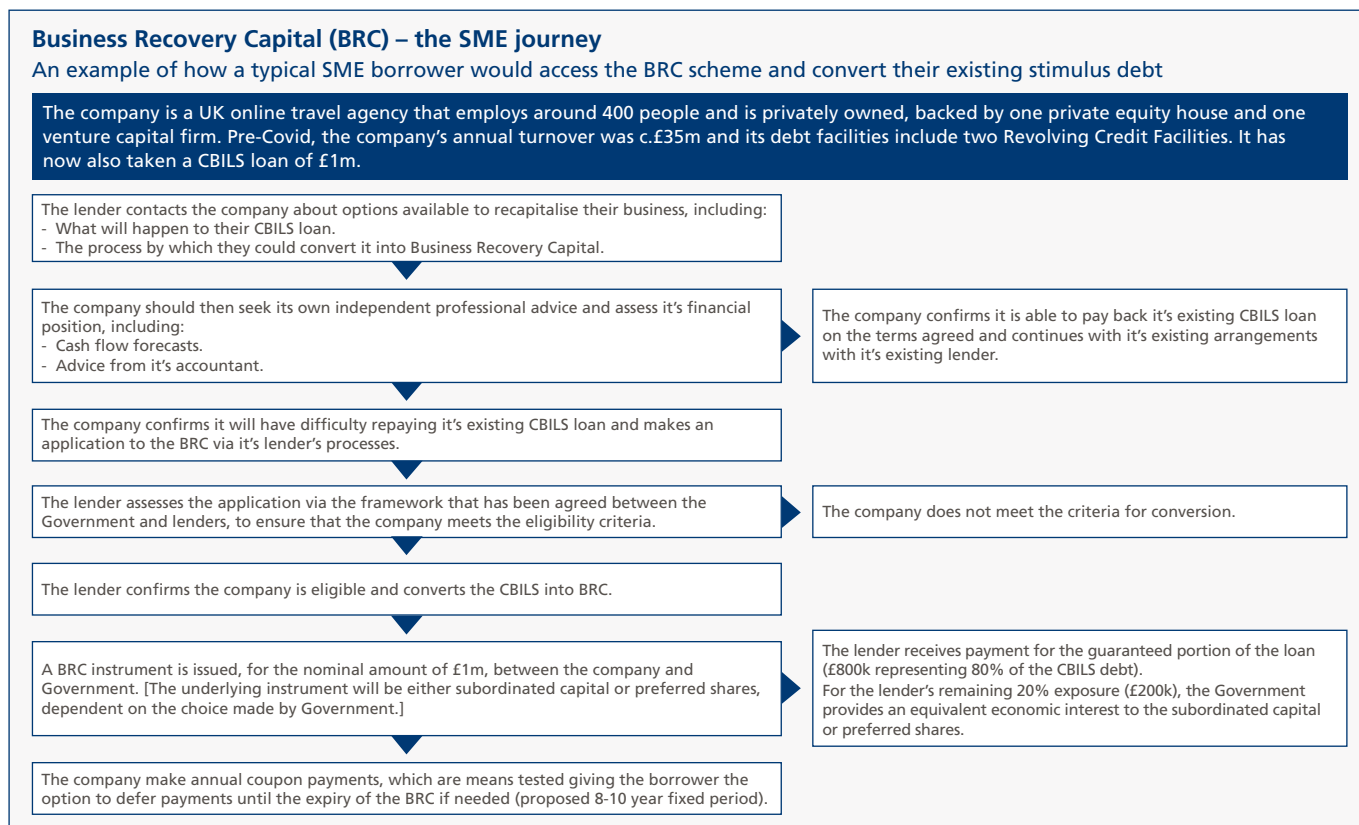
226. In an event of default, it is proposed that the default conditions would be in line with those of the current CBILS scheme i.e. a default would trigger an option for the Government to recall repayment in full of the borrower's outstanding balance.

### Illustrative use case:

227. Below we have provided an example of how a typical SME borrower would access the BRC scheme and convert their existing stimulus debt.

### Example company profile:

228. The company is a UK online travel agency, employs around 400 people and is privately owned, backed by one private equity house and one venture capital firm. Pre-Covid, the company's annual turnover was c.£35,000,000 and its debt facilities include two Revolving Credit Facilities. It has now also taken a CBILS loan of £1,000,000.



### Eligibility criteria and business coverage:

229. The scheme is targeted towards small and medium-sized businesses with CBILS borrowings. The BRC preference shares specifically cater for CBILS borrowers that are UK companies limited by shares. For borrowers that are sole traders or partnerships, and hence are not able to issue preference shares, preferred partnership capital (or subordinated debt) would be required.
230. It is proposed that the process to convert to the instrument would be commenced by the submission of an application, by the scheme holder, to the lender it holds its existing scheme debt with, however, a lender could approach its client to provide this option should it become aware of its client suffering financial stress. It will then be subject to the process and criteria for eligibility agreed between Government and the lender.

### Borrower access:

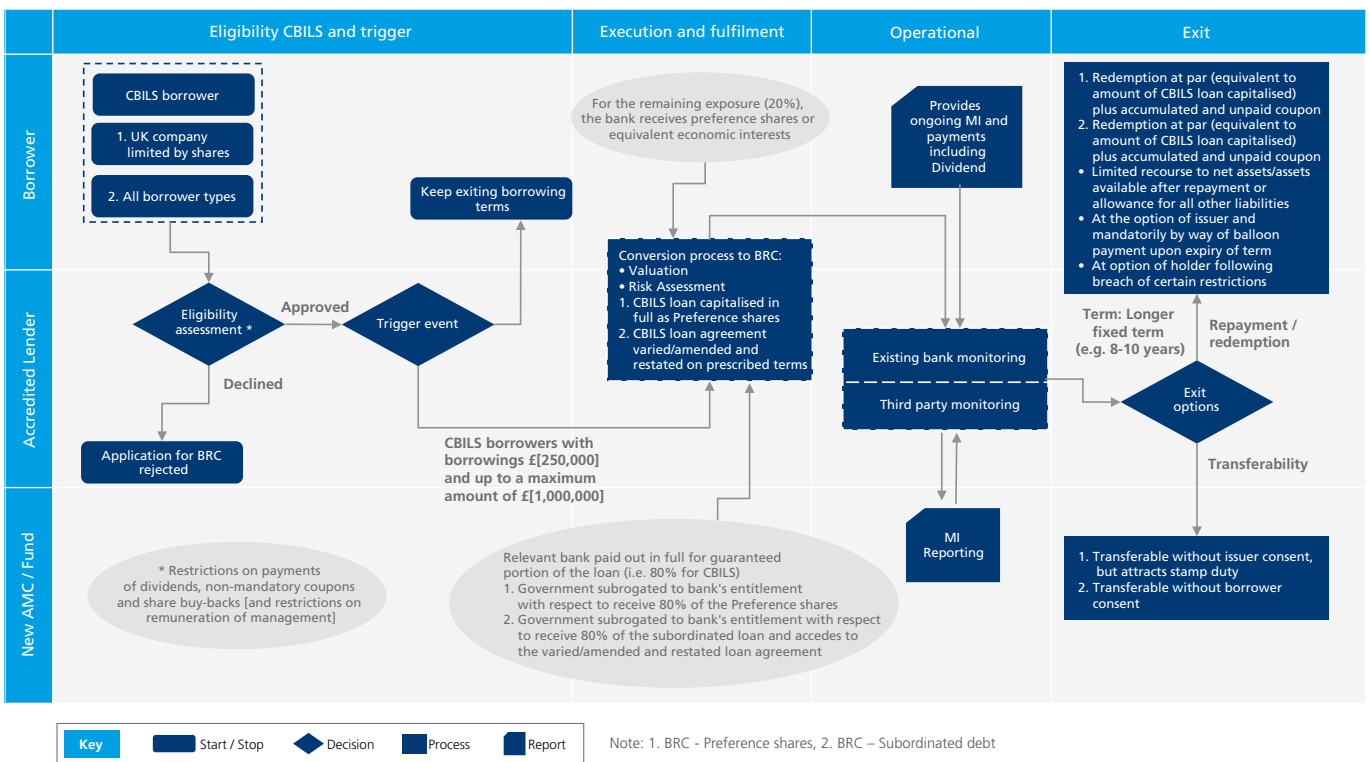
231. Access to the scheme would be granted following consent of both the borrower and the relevant lender, and the borrower providing documents evidencing the support they require, which satisfy the criteria agreed between the lender and Government. Further details of which are noted on page 52.

### Enablement and delivery:

232. Enablement and delivery of the BRC should be read in the context of broader enablement considerations set out in Chapter 5. Further considerations specific to BRC are set out below.
233. The following key design principles have been used to create the proposed outline structures for the BRC solution and should be considered for the more detailed future phase design activities:
- Strong governance and control frameworks.
  - A consistent set of parameters will be used for eligibility and trigger criteria.

- On conversion of CBILS into Sub-debt or Preferred Shares the relevant lender will be paid-out in full for its guarantee portion.
- Interoperability across existing operational and technological platforms.
- The Preferred Shares will be issued to a form of Government owned entity (UK Recovery Corporation).
- Automatic conversion of de minimis amounts could occur following the borrower’s submission of an application to the scheme and then meeting the eligibility criteria agreed between Government and the lender.
- The viability threshold will be set at a level to maximise the number of suitable applications.
- A consistent set of governance and operational procedures to manage private investments.

**Figure 16:** Business Recovery Capital (BRC) borrowers process flow



**Technology considerations:**

234. There are a range of existing and new technologies in the market which could be used to digitise the new recapitalisation process. Those solutions could support activities such as providing a consistent user journey for SMEs, automated due diligence, leveraging open banking to improve credit scoring and BRC eligibility monitoring, automating data flows and creating the transparency private investors generally expect and accelerating UK Fintech strategy.
235. However, in a scenario requiring a more rapid build, it may be helpful to leverage existing accredited lenders’ infrastructure, which may require additional resources, support and technology investment to support the lite operating model option.
236. Further assessment should be undertaken to evaluate the attractiveness of deploying new technologies or of leveraging the existing infrastructure of accredited lenders for each operating model scenario. That assessment needs to consider both current capabilities and their need to evolve to support the BRC over its whole lifespan, in particular covering data requirements, transparency standards, user journey etc.

### Policy and design considerations:

237. There are a number of open policy considerations relevant to all schemes being proposed as described on page 51. These notably relate to the extent to which these products could, if desired be extended to non-scheme debt or current non-borrowers. In addition, there are several specific policy and design related questions pertaining to the BRC scheme, as follows:
- The proposed dividend and interest rates imposed on borrowers need to strike an appropriate balance between; a) cashflow recovery and affordability; b) an appropriate incentive to repay quickly; and c) the ability, at a later date, to create value for the UK Recovery Corporation if such instruments were transferred or securitised to private market investors.
  - Mechanisms need to be put in place to ensure continued fair treatment of the borrower despite multiparty participation. Clarity over the rate and requirement to pay and the potential impact on other creditors, needs to be well understood to avoid misunderstandings and disputes. In general of course recapitalisation is aimed at sustaining businesses, so should help other creditors.
  - Consideration should also be given to the possibility of business owners being able to buy back shares from equity investors who have invested as a result of the current crisis once certain criteria have been met. From a policy perspective, this would be helpful to ensure that there is not a significant transfer of value from current business owners to passive providers of capital.
  - There is a need for Government participation to clearly articulate any conditionality e.g., Environmental, Social and Corporate Governance requirements.
  - There is a risk that many small companies and sole traders may opt for pre-pack administrations which would lead to the creation of phoenix companies i.e. where the assets of the insolvent business are purchased by the previous business owners and the new business operates in the same way as the old one. As such, the Government could consider what restrictions may be put in place to limit these.

## GROWTH SHARES FOR BUSINESS (GSB): FURTHER DETAIL

238. We recognise that outside of the demand for rescue/distress capital, UK SMEs have growth capital needs. Even before the Covid-19 crisis, the UK faced a 'scale-up challenge', to increase the number of high-growth companies in the UK, and thereby deliver new jobs and value-add to the economy.
239. GSB is an opportunity to focus on those SMEs, which, despite participating in Covid debt schemes, remain without stress. However, these SMEs now find their growth constrained by a lack of available funding.
240. As stated above, we also note that the Government could consider advancing broader economic and social policy objectives through attaching certain incentives or conditions to any scheme proposed. For example, this could include conditions related to the environment (such as net zero emissions), regional growth and diversity and inclusion, but these need to be weighed against the complexity and burdens of rolling out and organising such requirements at scale for small businesses and micro businesses

### The UK growth and patient capital gap

241. The long-term pre-existing UK growth and patient capital gap is one that continues to need to be addressed.
242. Patient productive finance will be an essential foundation as we galvanise recovery. Work to size this gap is a collaboration across the finance, business and investor community under the auspices of the Business Action Council (BAC) and Recapitalisation Growth team, co-led by Innovate Finance and the ScaleUp Institute, supported by Deloitte.<sup>50</sup> Under the banner of 'The Future of Finance' this Group will report on its full findings in the coming month. This review will seek to size the quantum of the Growth Gap issue as well as the opportunity for businesses across their growth cycle and will provide a menu of options for policy makers to consider.

<sup>50</sup> The UK's leading entrepreneurship organisations have united to establish the BAC to address the concerns of businesses in an emergency response to the Covid-19 pandemic to meet the needs of over 500K businesses across every sector and region in the UK, providing the government with well-evidenced advice and policy proposals to meet the demands of a wide range of businesses to build resilience and restore confidence in businesses. Its founding members include organisations such as the Confederation of British Industry (CBI), the Institute of Directors (IoD), the Federation of Small Businesses (FSB), the British Chambers of Commerce (BCC), the ScaleUp Institute (SUI) and Innovate Finance.

243. As ScaleUp Institute 2019 annual review reflects, turning the UK into the best place to start a business that can scale will require deep pools of connected capital available through the lifecycle of a business. Reaching global scale with sustained growth and longevity also require a focus on the talent, skills, market access, and infrastructure. Having the right, dynamic regulatory and tax environment is also vital to instil confidence to invest.
244. The forthcoming work will look not just at immediate challenges, but to the long term and what financial solutions are needed to ensure the UK can embed an innovative, export rich economic global future.
245. At a national level the UK has a set of core strengths including a world class higher education system, broadly supportive of regulatory structures and a complex, knowledge rich economy. However, local and regional disparities remain, as does access to appropriate patient capital to fuel long term businesses growth.
246. The need to address the issue of long-term patient' capital within the UK is not new and has been tackled in successive reviews from Cruickshank, to Rowlands to the Breendon Review, the ScaleUp Report on Economic Growth with successive reports, and the Patient Capital Review.
247. In the last eight years, inroads have been made in how we evolve our public infrastructure for our future economic needs, with the creation of the British Business Bank (BBB) and more recently British Patient Capital as well as the formation of Innovate UK (IUK) and Big Society Capital (BSC). These are key steps in dealing with the long-term market failure the UK has faced in unlocking institutional patient capital and innovation finance.
248. While these are collective foundations upon which we can build, the current crisis brings into focus what more needs to be undertaken to ensure the UK has a long-term vision for its funding infrastructures. These must have a resilience and flexibility to deal with economic shocks, cyclical downturns, and emerging opportunities. The impact of Covid-19 will have far reaching consequences and may change risk appetite across a range of institutions and investors, both within the UK and globally. This situation is also not occurring in isolation - the UK in 2020 needs to assess what is required in its infrastructural frameworks in a post-Brexit era as part of the suite of recovery policies that are developed.
249. In a dynamic global landscape, which is not standing still, many countries and regions such as Brazil, Canada, Singapore, Europe, are turning their attention to scale-ups as a means of economic renewal. Ensuring high growth industries have the capital they require to succeed is not only important for rekindling economic growth but also because our scaling businesses are our sources of innovation and technology that will help us address the current and future public health crises. This is especially true for life sciences, which the Patient Capital Review identified as being affected by a particularly acute growth capital gap.
250. If the UK does not align its resourcing effectively to scaling high potential growth businesses, we run the risk of falling further behind. This means accurately sizing and acting to close the growth capital gap that we face.
251. Flexibility alongside investment scale will be key, as will instilling confidence in the future to invest both at a business and investor level. In order to create a robust economic response, we will need to ensure, at its core, that local economies are enabled to grow and that businesses are supported across their growth cycle.

## THE NEXT PHASE OF THE SCALEUP INSTITUTE AND INNOVATE FINANCE WORK: THE NEED FOR OPTIMISATION, EXPANSION AND INNOVATION

252. History tells us that there will be no silver bullet that can solve the challenge. Instead, a blend of different and complementary initiatives will need to be adopted and adapted in a timely manner. Resources will likely need to be focused on a number of interventions across a number of different programmes.
253. The guiding principles of the ensuing growth capital analysis being undertaken by the ScaleUp Institute and Innovate Finance and evaluation of options available is being assessed under the framework of:
- **Accelerate** the pillars that are already underway
  - **Expand** what works to address the regional development and diversity the levelling-up agenda, and address existing systemic imbalances in the investment ecosystem



- **Create** long term infrastructure to drive growth, social impact and the Green Economy, such as supporting inward investment into UK growth capital
  - **Redirect** and align in response to the changing opportunities post-Covid, assessing if there could be clear benefits from redirecting from x to y.
254. Flexibility alongside investment scale will be key, as will collaborative engagement across Regulators, business, senior Finance Industry leaders and Government.
255. In order to encourage rapid and sustainable growth it is important to take note of best practice that are deployed in similar economies to the UK and platforms that in the past have proven successful in the UK.
256. The UK remains one of the few OECD countries which has not yet embedded a Sovereign (Wealth) Fund or Development Bank Agency (such as KfW, albeit the British Business Bank is to an extent playing such a role) with long term scaled funding that focuses on the domestic and international agenda. As we approach consideration of what tools will be needed to close the growth capital gap, we must not only consider international mechanisms but also UK regional examples that have had an impact such as Industrial and Commercial Finance Corporation (ICFC) and how this may evolve within current UK structures.
257. Now is the time to take concrete and bold action to maintain the UK as a top destination for capital investment and to set the foundations for robust future growth. In this next phase of work being done by the ScaleUp Institute and Innovate Finance, they will be looking in further detail at the growth capital landscape, including products, segmented solutions and distribution channels. This will be detailed in their report which is due in July 2020.

## LENDERS HAVE A RANGE OF FORBEARANCE AND RESTRUCTURING OPTIONS THAT SMES CAN CONTINUE TO UTILISE

258. Due to the anticipated volumes of businesses that may face difficulty, and the time and skill normally required to restructure debt, we recognise that lenders may face difficulties in delivering bespoke solutions to all borrowers. Therefore, we have outlined in the Appendix to this document, potential term sheets of two potential forbearance options that could be adopted by the lenders to meet this volume challenge:
- **Term extension:** Where the borrower is provided with additional time in which to repay the loan through an extension of the loan term (a 'Loan Term Extension'). Capital repayments would continue but would be amortised over an extended period, with a commensurate reduction in the regular monthly repayments.
  - **Capital holiday:** Where the borrower is granted a 6-month capital repayment holiday, during which interest only payments are due (a Capital Repayment Holiday) and repayments of the principal loan balance are suspended.
259. Through these options businesses may be able to extend the terms of their debt or be given a short repayment holiday to re-establish their ability to repay. These options would however require support from the Government to allow lenders to extend forbearance on existing CBILS and BBLs loans.
260. Lenders will wish to ensure that their business models do not incentivise behaviours that could act contrary to borrower interests. Financial return targets for restructuring activities, and remuneration incentives for senior staff, will need to align with the fair treatment of borrowers. Business relationships with advisers or other parties which may be involved in the process should not create conflicts of interest that result in poor outcomes.
261. Solutions may be provided on different terms from existing lending, depending on lender assessment of credit worthiness, continued Government policy on subsidised funding and guarantee levels, and any other support criteria to achieve broader policy objectives such as environmental performance considerations or sectoral or regional prioritisation. Solutions could also encompass other lending beyond that incurred under the Government support packages. Changes to pricing will need to be clearly communicated to and appropriate for borrowers. Even the most straightforward payment moratorium or lending extension solutions will have implications for the overall costs that borrowers will pay.

#### Chapter 4: Options to help address the recapitalisation challenge – Key findings

- Our options focus on a path to recovery for unlisted SMEs that have received a Covid-19 Government loan that they are likely to struggle to repay
- A range of policy considerations have influenced our options including the need to manage Government's exposure, conduct considerations, timing, European Commission State aid Rules and implementation goals. The design of options has also been guided by feedback received from end-users and trade associations.
- We have sought to apply the lessons of schemes deployed in the UK and globally in determining the design criteria for our options.
- Guided by these criteria, we have segmented the lending schemes and propose a range of instruments which could offer a path to recovery for different types of businesses, based on their size, their type of Government Covid-19 loan and the type of capital they need.
- For small businesses with a BBLS or small CBILS loan we propose the BRP which would convert the outstanding loan balance into a means-tested tax obligation, for businesses to repay through the tax system. Appropriate repayment incentives will need to be put in place to encourage repayment, which should be decided upon in conjunction with HMRC and HMT.
- For SMEs with a CBILS loan, we propose the BRC which would help businesses convert their Government guaranteed loans into longer term subordinated debt or preferred share capital.
- We propose that the above options should be accounted for in a manner that does not create a new debt obligation and therefore businesses will be able to improve their balance sheets through these options.
- We propose the creation of the GSB for businesses that have viable growth prospects, but find their growth constrained by a lack of available funding.
- We believe the best approach is to create a new entity, the 'UK Recovery Corporation', dedicated to the recapitalisation process. We propose that the BRC is issued and held in this entity and that the BRP, as a tax obligation, is overseen and/or managed by the entity in conjunction with HMRC.
- Business access to the options would be voluntary and, critically, before default on obligations or insolvency. It would be subject to eligibility criteria agreed between Government and lenders.
- In addition to these solutions, lenders have a range of forbearance and restructuring options that SMEs can continue to utilise. We propose two forbearance options that could be adopted by lenders: a term extension or a capital repayment holiday.
- There are potential future extensions to the BRP and BRC that could enable it to support a larger range of businesses and/or capital needs.
- A mechanism will be designed, to examine the application of the eligibility trigger and facilitate complaints handling.
- There is an opportunity for Government to advance policy objectives by attaching well-designed incentives and conditions. This could include conditions related to net zero emissions, employment practices, diversity and inclusion goals, tax transparency and responsibility, the levelling up agenda, and productivity improvements.



## SUMMARY FINDINGS

### ENABLING THE UK RECOVERY CORPORATION

262. The UK Recovery Corporation would be the delivery mechanism for the proposed solutions available to businesses. It would administer the new obligations created through the conversion of the Government guarantee on BBLs loans and would issue, hold and administer the new instruments created through the conversion of the guarantee on CBILs loans. In doing so, the entity will need to take on the obligations of the Government loan guarantees.
263. The operating model of the new entity requires further consideration. It might seek to build up its own operating staff by direct recruitment; alternatively, and preferably in the interests of rapid mobilisation, it could appoint third-party Manager(s) to oversee its portfolio on a day-to-day basis and provide ongoing servicing. The operating model and delivery strategies of the entity will evolve as it reaches full maturity. Its direction of travel will primarily depend on the Managers' role, the timeline to market launch, the extent of process outsourcing, the degree of complexity and planned longevity of the entity.
264. Given the need to move at speed and to establish this new entity quickly, a relatively light, centrally operated infrastructure should be considered. Components of operational delivery could be sourced from existing organisations or outsourced to third parties with current, proven capabilities.
265. Expert leadership will be crucial. Such a structure will require its own resources to oversee third party providers, provide appropriate governance and controls, and ensure that the UK Recovery Corporation is being operated in line with policy and guidelines set by Government.
266. Establishing the UK Recovery Corporation as an Arm's Length Body (ALB) is one mechanism that could be used. This is an established deployment model where technical expertise and capabilities are required to manage complex outcomes and interactions with the private sector.<sup>51</sup> The shareholder function is central to ensuring the success of any ALB. We note that UKGI has bespoke UK Government shareholder expertise and could be used in this role to help realise clear separation between policy sponsor and shareholder interests.
267. To accelerate time to market and enable the UK Recovery Corporation, lenders would continue to play a key role. It is likely that, at least in the beginning, the accredited lenders' existing infrastructure, resources and lending systems would need to be leveraged. Lenders would also continue to provide a range of forbearance options to their borrowers as part of their operations.

### Oversight and review of the recapitalisation process

268. To the extent possible, these mechanisms and criteria should be transparent, standardised and programmatic, and be supported by strong governance. We envisage a strong regional dimension to these mechanisms, to promote on the ground decision-making, and the involvement of businesspeople from the local SME community. This will help to ensure that mechanisms sufficiently reflect the varying economic and business circumstances of different regions in the UK. The proposed use of an ALB should help to manage these complex interactions with the private sector and provide the strong governance and protections this requires.

### Growth capital: Delivery of the Growth Shares for Business (GSB)

269. The GSB is aimed at businesses with growth capital needs as opposed to businesses that require rescue capital to address unsustainable debt. The GSB will help to address the long-standing need for patient capital evenly spread across the UK.
270. We propose that the GSB is delivered through a growth capital fund. Over time, the scope of the UK Recovery Corporation could transition to include a greater focus on growth capital, with its operating model, centralised decision-making and governance frameworks making it a suitable entity to deliver the GSB in the future.

<sup>51</sup> The term Arm's Length Body (ALB) is commonly used to refer to a wide range of public bodies, including non-ministerial departments, executive agencies, and non-departmental public bodies, but also other bodies such as public corporations, regulators and tribunals. See UK Government Investments (January 2020).

271. The GSB could be delivered at the outset either through a new growth capital fund or through the scaling up of an existing fund (or funds) focused on growth and patient capital. The growth capital fund could take a similar approach to that used by the Industrial and Commercial Finance Corporation (ICFC) to provide patient capital across a widespread portfolio of companies and in regions across the UK. This approach may require a public private venture to be created which would help establish momentum with private sector investors.
272. In contrast to the market for distressed equity, which is very thin, there are several significant existing players providing growth capital. It will be necessary to consider how GSB can complement rather than compete with these providers of growth capital.
273. Detailed options for delivering a growth capital scheme were outside the scope of our work and will be assessed in the work underway by the ScaleUp Institute and Innovate Finance.

## FURTHER DETAIL

### THREE POTENTIAL OPERATING MODEL STRUCTURES HAVE BEEN ASSESSED

274. To be set up for success, the UK Recovery Corporation must have the flexibility to manage each of the schemes outlined and the capacity to both onboard and service effectively and efficiently.
275. Three potential operating model structures have been assessed:
- **Lite:** A near virtual organisation sourced from third-party providers to provide a minimum amount of in-house functionality, with the operational flexibility to up or down scale operations quickly and with limited set up and operate costs.
  - **Hybrid:** An organisation comprised of analytical capabilities as well as some risk management abilities in-house to fulfil necessary governance obligations to act as an interim fiduciary. Comprised of both internal and third-party sourced solutions, providing additional longevity and sustainability in operating model.
  - **Full Stack:** A full-fledged organisation that can handle complexity and provide an integrated solution for addressing the large asset pools and have the analytical capabilities to make underwriting decisions. Predominantly an in-house service provision model.

#### Design principles for the operating model

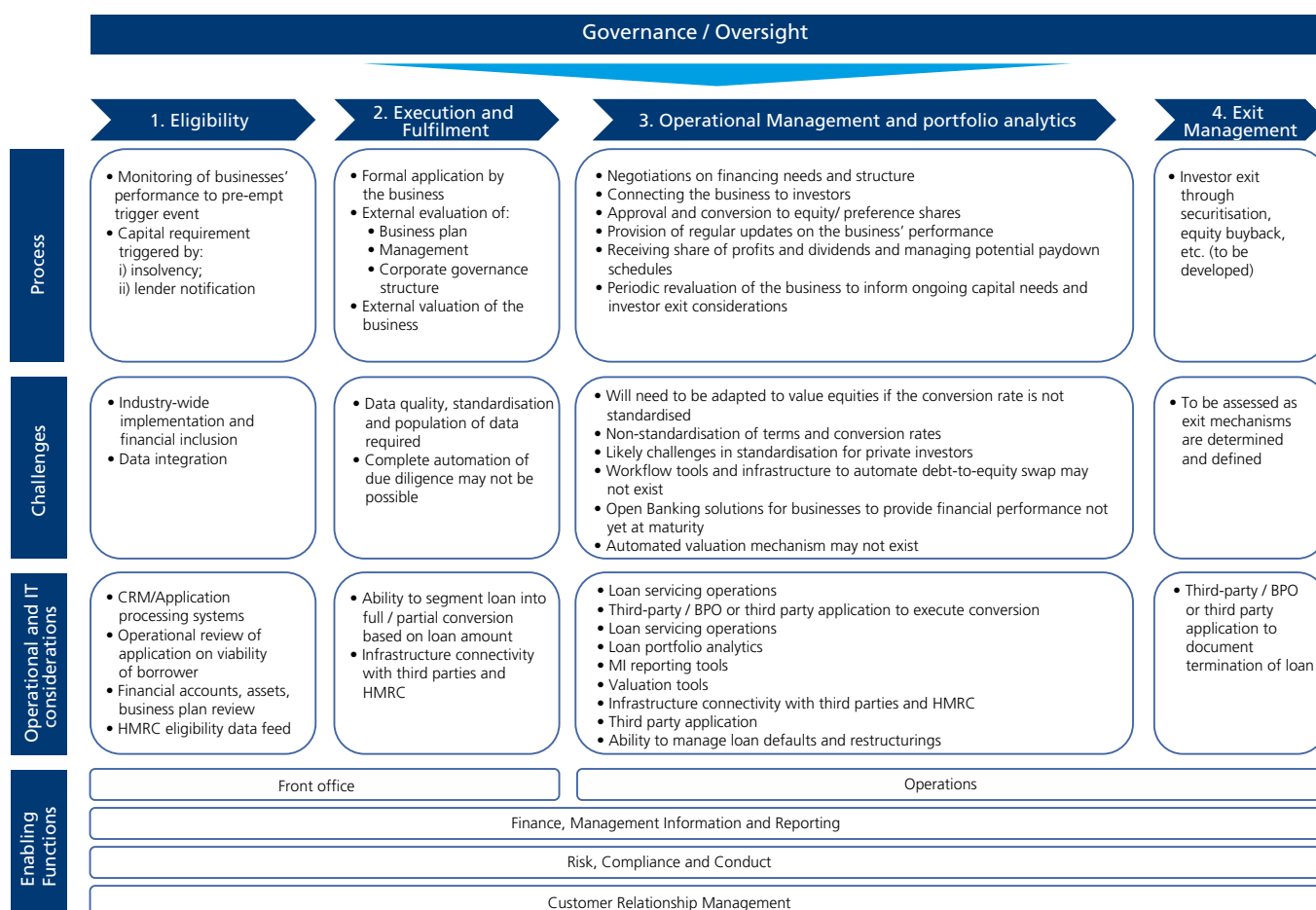
276. The following key design principles have been used to create the proposed outline structures and should be considered further through more detailed future phase design activities:
- Straightforward end to end operations to maximise adoption and speed to market.
  - Cost effective, value for money solution.
  - Implementation able to be delivered initially through interim solutions or transition state solutions to accelerate speed to market.
  - Scalable and sustainable solution to meet significant demand fluctuations over short periods of time.
  - Transparent client proposition and journey.
  - Simple take on process to minimise end user support, education and training to on-board businesses and mitigate conduct risk.
  - Strong governance and control frameworks.
  - Reuse of industrial strength solutions and existing market capabilities.
  - Simplified integration with private sector funding operating models.
  - Standardised application / conversion processing wherever possible (e.g. a rules-based asset management framework).

- Capabilities to aggregate source data from different accredited lenders.
  - Data rich environment to enable robust decisioning, monitoring and reporting, with clear audit trails.
  - Interoperability across existing operational and technological platforms.
  - Resilient and sustainable operating model and underlying technology and processes.
  - Fulfilment where possible by documentation, minimising funds transfer flows.
  - Clarity of governance required throughout the end to end process including transition, onboarding, operations and exit.
  - Optimise accredited lenders existing policies and procedures where appropriate to minimise delivery/execution risk.
277. The optimal operational solution may evolve through the implementation process, starting as a Lite / Hybrid operating model in the first instance to meet specific goals such as accelerated build, ability to scale to increased volume and cost, and over time transitioning to a Full Stack model based upon policy development and clarity on future strategy.

## THE LOGICAL MODEL REPRESENTS THE CAPABILITIES REQUIRED

278. Based on the design principles and operating model concepts, a logical model has been formulated as illustrated in Figure 17 to highlight the end to end capabilities required within the New Fund / AMC and Third-Party Operators / ServiceCo.
279. This shows the process flow of the asset / business from onboarding, to revised contractual agreement, operational management and exit. Each stage of the process is expected to have a decisive handoff, transparency of ownership and leverage existing infrastructure for procedures and arrangements. Governance frameworks are required across the process flow and at each phase of the process to meet compliance procedures.

Figure 17: Logical model

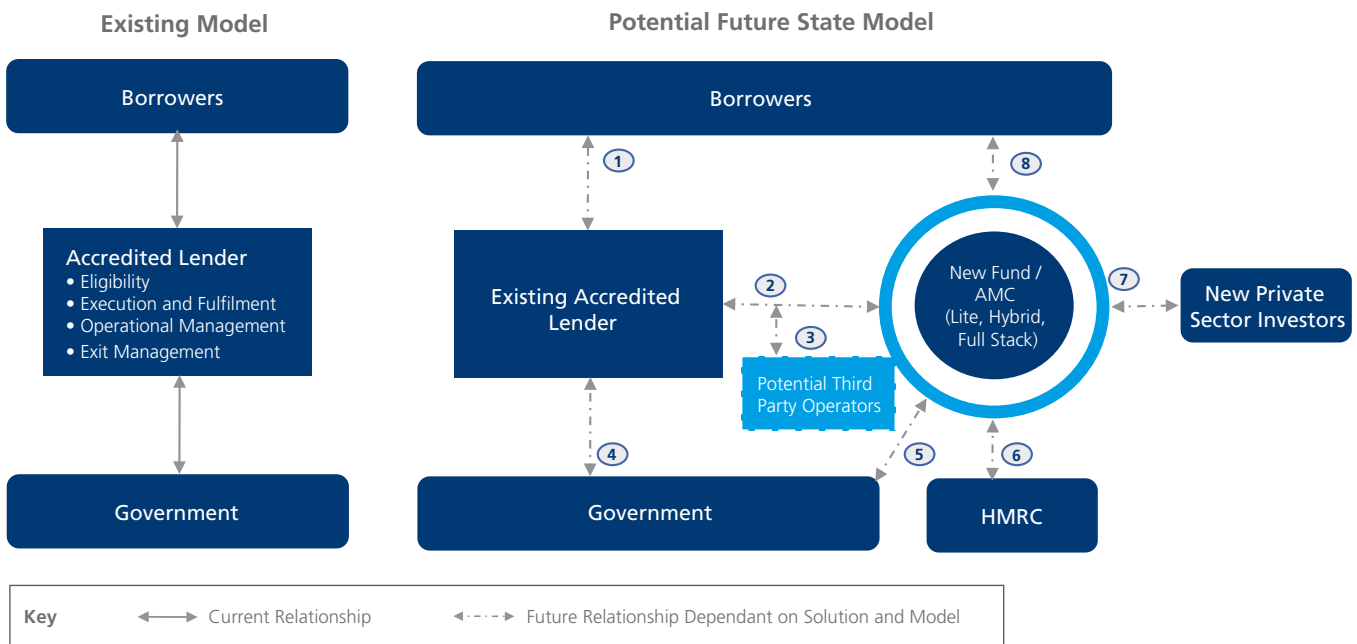


## THE ENABLEMENT MODEL ILLUSTRATES THE EXISTING AND POTENTIAL FUTURE STATE MODEL

280. The existing model illustrates the current relationship between the Borrower, Accredited Lender and Government to support the CBILs, the CLBILs and the BBLs. The relationship is established primarily between the Borrower and the Accredited Lender through with the British Business Bank has provided lending. The structure was created to leverage existing infrastructure across the Accredited Lenders and Government to provide timely access to loans.

281. In contrast, the potential future state model to fulfil the solutions require more complexity, stakeholders and processing/sharing of data. The creation of a New Fund / AMC will require new relationships with Borrowers, the existing Accredited Lender, Government, HMRC, Third-Parties and Investors. Depending on whether the Lite, Hybrid or Full Stack operating model is adopted (potentially all three in an interim / phased approach), a variety of operational and IT capabilities will need to be built and/or assembled to manage the end to end process including processing, valuation, loan servicing, monitoring, analytics and termination.

**Figure 18:** Existing and potential future state model comparison



### Future state relationships and flow options

282. There could be varying degrees of relationships, interactions, and process flows between stakeholders as illustrated in Figure 18. The following process flows describe each of these relationships based on the potential future state model.

1. Borrowers may maintain a direct relationship with the Accredited Lender for non-converted loans or if the Accredited Lender undertakes processing activities for the New Fund / AMC.
2. New Fund / AMC may contract with the Existing Accredited Lender to support ongoing operational management and reporting of a converted product.
3. It may be beneficial for a ServiceCo (rather than existing Accredited Lender) to undertake some or all operational administration. There are different options for the operating model that UK Recovery Corporation could take depending on



the role the ServiceCo would take, the extent to which processes are outsourced and the degree of complexity. For example, this New Fund / AMC could be a nearly virtual organisation sourced from third party providers and providing minimal functionality or, alternatively, it could be a full-stack organisation that can handle complexity and provides an integrated solution. In addition, third parties may also be involved with other parties and the New Fund / AMC in some instances.

4. As appropriate the Accredited Lender may receive a conversion true-up payment on conversion based on the existing Government Guarantee.
5. New Fund / AMC may have a future relationship with Government depending on ownership and any future financial links.
6. New Fund / AMC would have a relationship with HMRC in relation to the BRP solution.
7. New private sector investors would have a financial interest in terms of funding and associate payments from the New Fund / AMC.
8. The New Fund / AMC would have the financial ownership and associated relationship with the borrower for converted solutions.

## THE ROLE OF STAKEHOLDERS MAY EVOLVE IN THE POTENTIAL FUTURE STATE MODELS

283. The table below (Figure 19) describes each of the stakeholders and their current role in the existing model compared to the potential future state model illustrated in Figure 18. The role and responsibilities of each stakeholder could evolve based on the operating model requirements.

**Figure 19:** Stakeholders, current roles and future expectations

Stakeholder	Current Role	Future Expectation
<b>Borrowers</b>	<ul style="list-style-type: none"> <li>Businesses that have taken (or are eligible to take) the stimulus packages offered by the Government. The borrower is 100% liable for the debt.</li> </ul>	<ul style="list-style-type: none"> <li>Liaise with the relevant organisation to agree the terms of recapitalisation and/or restructuring.</li> </ul>
<b>Accredited Lender</b>	<ul style="list-style-type: none"> <li>Accredited Lender processes the CBILS/BBLS loan application from the borrower and provides the CBILS/BBLS loan to the borrower.</li> </ul>	<ul style="list-style-type: none"> <li>Accredited Lender processes the application from the borrower and supports the execution of the conversion.</li> </ul>
<b>Government</b>	<ul style="list-style-type: none"> <li>Provides the accredited lender with a government-backed guarantee against the outstanding balance of the finance. The Government will make a Business Interruption Payment (BIP) to cover the first 12 months of interest payments</li> </ul>	<ul style="list-style-type: none"> <li>The role of Government is expected to evolve as private sector investment is introduced.</li> </ul>
<b>HMRC</b>	<ul style="list-style-type: none"> <li>Responsible for all tax considerations in relation to stimulus packages.</li> </ul>	<ul style="list-style-type: none"> <li>Responsible for all tax considerations in relation to the recapitalisation arrangement.</li> <li>Potential service provider under BRP solution.</li> </ul>
<b>Private Sector Investors</b>	<ul style="list-style-type: none"> <li>Potential private investors include institutional investors (Insurers, Pension Funds, PE, VC &amp; Private Debt markets).</li> </ul>	<ul style="list-style-type: none"> <li>Provides investment into the New Fund / AMC vehicles.</li> </ul>
<b>New Fund/ AMC</b>	<ul style="list-style-type: none"> <li>Not applicable</li> </ul>	<ul style="list-style-type: none"> <li>Manage the recapitalisation of debt, role dependent on operating model leveraged (Lite, Hybrid and Full Stack).</li> <li>Connectivity between the accredited lender, Borrower, Private Sector Investors and Government.</li> </ul>
<b>Third Party Operators</b>	<ul style="list-style-type: none"> <li>Not applicable</li> </ul>	<ul style="list-style-type: none"> <li>Operational support to the New Fund / AMC.</li> </ul>

## THE CHARACTERISTICS OF THE OPERATING MODELS VARY

284. The potential operating model structures; Lite, Hybrid and Full Stack, each have their advantages, limitations and differing impacts on implementation timelines and costs. For example, a Lite model may be quick to set up and incur a lower setup cost but may not provide the same level of capability and flexibility as the Full Stack model for a longer-term strategy. The table below considers the characteristics of each deployment model.

**Figure 20:** Operating models and their characteristics

Operating Model	Lite	Hybrid	Full Stack
<b>Outline Description</b>			
<b>Summary</b>	A near virtual organisation sourced from third-party providers to provide a minimum amount of in-house functionality, with the operational flexibility to up or down scale operations quickly and with limited set up and operate costs.	An organisation comprised of analytical capabilities as well as some risk management abilities in-house to fulfil necessary governance obligations to act as an interim fiduciary. Comprised of both internal and third-party sourced solutions, providing additional longevity and sustainability in operating model.	A full-fledged organisation that can handle complexity and provide an integrated solution for addressing the large asset pools and have the analytical capabilities to make underwriting decisions. Predominantly an in-house service provision model.
<b>Characteristics</b>			
Speed			
Ease to setup			
Scalability			
Setup cost			
Initial operational cost			
Ongoing operational costs			
Operational flexibility			
Operational simplicity			
Ease to disband			
Run-off applicability			
Strategic longevity			

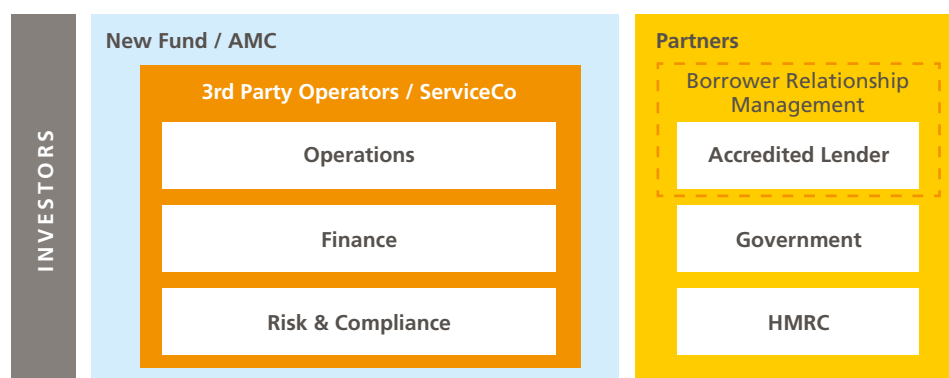
Limited applicability      Highly applicable

## WE PRESENT A STYLISTIC OVERVIEW OF THE LITE, HYBRID AND FULL-STACK OPERATING MODEL DESIGNS

285. The operating model designs below provide an illustration of the potential way in which the New Fund / AMC may function in each of the three alternative models. These are stylistic operating models for illustration and do not include all the corporate functions required (e.g. the Full Stack model would also require support functions such as a Human Resource function).

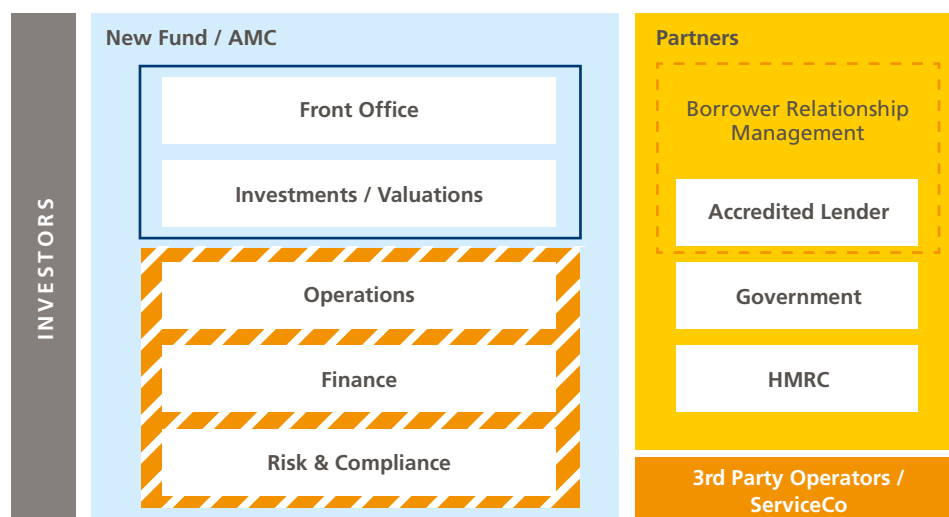
### 286. Lite Model

A virtual organisation with the Accredited Lender having full ownership of the Borrower relationship. Third-Party Operators / ServiceCo provide the majority of functionality in conjunction with the Accredited Lender operational capabilities. The Accredited Lender coordinates the relationship with the Government and Investors.



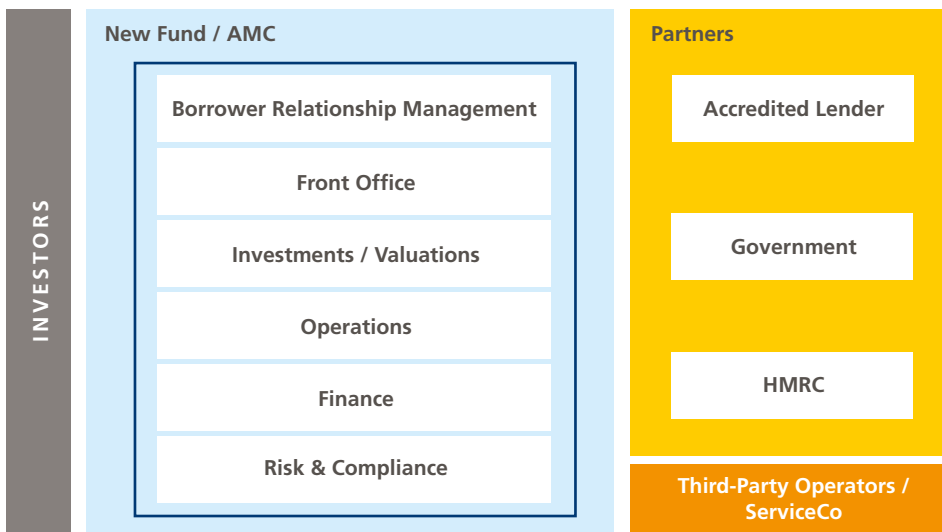
### 287. Hybrid Model

The New Fund / AMC provides analytics from the Investments team and manages the relationship with Investors. The Accredited Lender is responsible for managing the Borrower relationship. Third-Party Operators / ServiceCo manage key processes as appropriate, balanced with in-house capabilities.



288. **Full Stack Model**

The New Fund / AMC provides an integrated solution to managing the solutions. Third-Party Operators / ServiceCo have a minimum input into operations. The New Fund / AMC operates the end processes and Borrower relationships interfacing with the Accredited Lender, Government and Investors.



**OPERATING MODELS VARY IN THEIR APPLICABILITY TO EACH OPTION**

289. For each of the operating models, the table below (Figure 21) illustrates their applicability in relation to the proposed options.

- **Lite** – The Lite operating model is applicable for both the BRC and BRP, due to the extensive dependency of existing accredited lenders infrastructure and operations. A primary consideration for this model is the existing capability of the accredited lender to segregate borrower data and perform monitoring and reporting to a third party. It should be expected that there is significant variation in operational, analytical and management information reporting capabilities across the current pool of accredited lenders.
- **Hybrid** – The Hybrid model will be highly relevant for all options except for Restructuring which will remain on the accredited lenders infrastructure and managed accordingly. A primary consideration for this model is the existing capability of the accredited lender to segregate borrower data and perform monitoring and reporting to a third party.
- **Full Stack** – The Full Stack model will be highly applicable for the BRC instrument with most operational activities processed in-house within the New Fund / AMC.

290. The Lite and Hybrid models rely upon infrastructure within existing accredited lenders. In addition, the infrastructure needed to deliver this structure, may already be available elsewhere such as within the British Business Bank (BBB) and Local Enterprise Partnerships (LEPs).

**Figure 21:** Applicability of operating models to recapitalisation solutions

Recapitalisation solutions	Lite	Hybrid	Full Stack
Business Recovery Capital (BRC)	●	◐	◐
Business Repayment Plan (BRP)	●	◐	○

○ Limited applicability      ● Highly applicable

### Chapter 5: Enablement considerations – Key findings

- We believe enabling the new instruments necessitates the establishment of a new entity the ‘UK Recovery Corporation’ in order to provide the flexibility, efficiency and governance required to oversee the management of new schemes.
- A series of key design principles have been established to create three potential operating models for further consideration:
  - **Lite:** A near virtual organisation sourced from third-party providers to provide a minimum amount of in-house functionality.
  - **Hybrid:** An organisation comprised of analytical capabilities as well as some risk management abilities in-house to fulfil necessary governance obligations to act as an interim fiduciary.
  - **Full Stack:** A fully-fledged organisation that can handle complexity and provide an integrated solution for addressing the large asset pools and have the analytical capabilities to make underwriting decisions. Predominantly an in-house service provision model.
- To fast-track time to market and enable the UK Recovery Corporation, accredited lenders would continue to play a key role. It is likely that, at least in the beginning, their existing infrastructure, resources and lending systems would need to be leveraged.
- As a result, the optimal operating model may evolve through the implementation process, starting as a Lite/Hybrid operating model in the first instance to meet specific goals and over time transitioning to a Full Stack model based upon policy development and clarity on future strategy.
- Components of operational delivery could be sourced from existing organisations or outsourced to third-parties with proven capabilities. The Lite model utilises third-parties to provide the majority of functionality which, negates the need to establish new operating structures and allows for an accelerated set up phase.
- Notwithstanding the operating model selection, the UK Recovery Corporation will require its own resources to oversee third-party providers and provide appropriate governance and controls. The construct of an Arm’s Length Body (ALB) could be instrumental to achieving this.

# CHAPTER 6

# FUNDING OF THE OPTIONS

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## SUMMARY FINDINGS

291. The attractiveness of the UK as an investment destination means that there are substantial, well-established pools of third-party capital<sup>52</sup> from the UK and overseas that may be available to meet the demand for recapitalisation. This includes capital held by insurers, pension funds, sovereign wealth funds (SWFs), private equity funds (PE), venture capital funds (VC), private debt funds (PD) and retail investors. Whilst these cannot initially replace Government obligations on debt issued under Government guarantees, they may be able to supplement Government funding. To draw in private sector capital, Government support in the form of guarantees and credit enhancements may be helpful.
292. The analysis and primary research undertaken for this report suggests that even with the innovative application of private capital to the problem, there is currently a fundamental mismatch between the scale of the challenge and both the amount of capital that can plausibly be found from private sector sources and the lack of delivery mechanisms of sufficient scale to deliver this at pace. The availability of private sector capital to address the need for SME recapitalisation illustrates the market distortions that the options in this report seek to solve.
293. Private sector investors have certain risk and return requirements and will need to ensure the commercial terms of their investment can be shown to be in the best interests of their shareholders and end-policyholders (recognising investors' fiduciary duties to people's pensions and life savings).
294. It is important to distinguish between the ability of private sector investors to provide capital for SME rescue investment with their ability to invest in growth capital.
295. With respect to providing capital to SMEs with unsustainable debt, it is challenging to align the risk and return requirements of private sector investors with the debt restructuring solutions proposed, particularly given the current level of uncertainty around the performance of the underlying SME assets. For private capital to evaluate these pools of assets against their risk and return expectations, a period of time is required to establish a track record for that assessment to be made. Private sector investors also face a range of operational and regulatory constraints to investing in SME distress assets which may take time to address.
296. Therefore, private sector investment in these options to recapitalise SME unsustainable debt is more likely in a subsequent phase as more information becomes available to investors and key constraints are addressed (refer to Figure 22). From the outset, management of the UK Recovery Corporation should be tasked with developing plans and identifying mechanisms (for example, the use of guarantees and credit enhancements) to introduce the private sector as early as possible.
297. With respect to a growth capital fund, private sector investors can be expected to play an important role from the outset (if their required terms are met), particularly if the proposed growth capital fund is supported by a public-private venture. As this fund provides capital to SMEs that require growth capital (rather than capital to support unsustainable debt), there is inherently more certainty about the underlying exposures and the risk-return dynamics.

### Approach to our analysis

298. In our interim report, we set out the broad and interconnected ecosystem of investors in the UK, the ability of different investor groups to (re-)allocate capital to UK SMEs and the significant regulatory and operational impediments which would need to be addressed.
299. To build on this work and better understand what private sector investors would require to unlock capital we conducted discussions with a wide range of private investor groups and trade bodies. This included active investors that invest directly in the equity of SMEs such as private equity funds (spanning from global large cap funds to small local specialist funds), venture capital funds and Enterprise Investment Scheme (EIS) fund managers, as well as passive institutional investors such as insurers and pension funds. We also considered the requirements of retail investors via discussions with the relevant investor groups outlined above.

<sup>52</sup> Third party capital includes private sector investors, such as those mentioned above, as well as other investors which may be considered more public sector in nature, such as sovereign wealth funds and endowments. For simplicity, we have referred to all potential third party capital providers as 'private sector' hereafter.



300. In total we have held conversations with over 30 different private investor organisations that invest in a range of different sectors, asset classes, geographies, solution types and business sizes.
301. This report discusses options for involving sources of private sector capital by reference to their typical risk profiles, appetites and mandates. Government might also consider other financial or legislative levers beyond those considered here, to achieve any specific policy objectives.

### Funding of the UK Recovery Corporation

302. Our discussions with investors suggest that the principal investor supplying seed funding for the UK Recovery Corporation at launch is most likely to be the UK Government. The UK Recovery Corporation's initial funding would be through the contribution of the Government's guarantee exposures converted into BRC. It would initially also administer the Government's entitlements under the BRP.
303. The initial size of the fund will depend on the take-up of proposed solutions (BRP and BRC) and the phasing of when loans will convert into these solutions (which is likely to take place over time, with a need initially arising well before March 2021). We have not assessed the expected take-up of solutions by businesses or the timing for conversion in our work and therefore have not estimated the initial size of the fund. However, the fund will represent a conversion of the Government's existing guarantee commitments on CBILS and BBLs lending, as opposed to a further or new commitment.
304. Initially, it is unlikely that private sector investors will be able to finance the UK Recovery Corporation, given the scale of the challenge and the level of uncertainty about the fund's performance.
305. Once viability of the underlying businesses becomes clearer and repayment ability is better understood, private investors could be introduced to provide finance to the UK Recovery Corporation, perhaps through securitisation or by acquiring portfolios of solutions that best meet their investment criteria. Creating a fund structure to allow this is critical and there is precedent in the UK.
306. The ability to attract private sector capital in the future will partly depend on the UK Recovery Corporation's performance, the type of solution and the investor's need for liquidity. Investors are increasingly accounting for ESG considerations in making investment decisions and urging businesses, of all sizes, to build these considerations into their strategy. Therefore, attracting private sector capital could be enhanced by aligning the UK Recovery Corporation's ESG objectives or any conditionality that is attached to instruments with that of their investors.
307. Institutional investors (particularly insurers and pension funds) appear the most likely to invest via a fund or AMC structure that holds SME recapitalisation assets, albeit in a subsequent phase once information on the performance of the fund is better understood.
308. For insurers and defined benefit pension funds, unlocking capital through a long-term debt solution is possible, although this would require the meeting of several criteria:
- A long-term investment horizon (durations of seven - fifteen years).
  - Some form of credit rating, or as a minimum, a form of Government guarantee or wrapper in order to remove the need to underwrite the individual loans and meet an investment grade requirement. Insurers require high quality credits, and whilst defined benefit pension funds also favour high quality credits, they will likely have less constraints on their investments and would consider credit across the quality spectrum if priced at an appropriate yield.
  - To be within their risk appetite investors are likely to want to see an appropriate mechanism in place to deal with non-payment. Insurers note there is a delicate balance to be struck between enforcement, to ensure incentives to repay, whilst also ensuring that there is no undue pressure put on SMEs.
  - Return rates that are close to private placement being around 50 to 100 basis points above the equivalent corporate bond yield (see Figure 23). For lower quality credits (such as sub-investment grade) pension schemes would typically require a yield (net of defaults and fees) in the region of 6%-7% p.a. given the other opportunities currently available to them.
  - Amending of potential regulatory constraints, including those related to Solvency II for insurers.

- Specific investment and performance criteria and monitoring in relation to ESG considerations, to support investors, satisfy their investment mandates and their ESG objectives.
309. Private credit funds could also provide debt capital through a fund structure in a subsequent phase, although this would likely need to be at higher rates of return of c.7%-15% in line with their current risk return appetite.
310. Retail investors could in principle invest in a fund holding unlisted SME loans, although there is little precedent for this, and the likely closed nature of the structure may not be appealing or suitable for a large proportion of retail investors. A retail solution could be considered once proven with institutional investors, given that, historically, retail investors tend to follow the investment trends of institutional investors on an advised and non-advised basis, on a lagged timeline.
311. Given the high regulatory bar for demonstrating that investments are suitable for retail investors, with an appropriate risk and return profile, any retail product would need to be carefully designed and may require some form of Government guarantee, particularly given highly publicised recent fund collapses.
312. Further, any promotion of an alternative SME growth fund for retail investors should be introduced in a way that does not undermine the existing tax efficient Venture Capital Trust (VCT) and EIS initiatives that exists for investment into SMEs. It may be preferable to instead amend these existing solutions in order to attract more retail capital and allow fund managers to invest in a wider range of small businesses.

### Funding of a growth capital fund

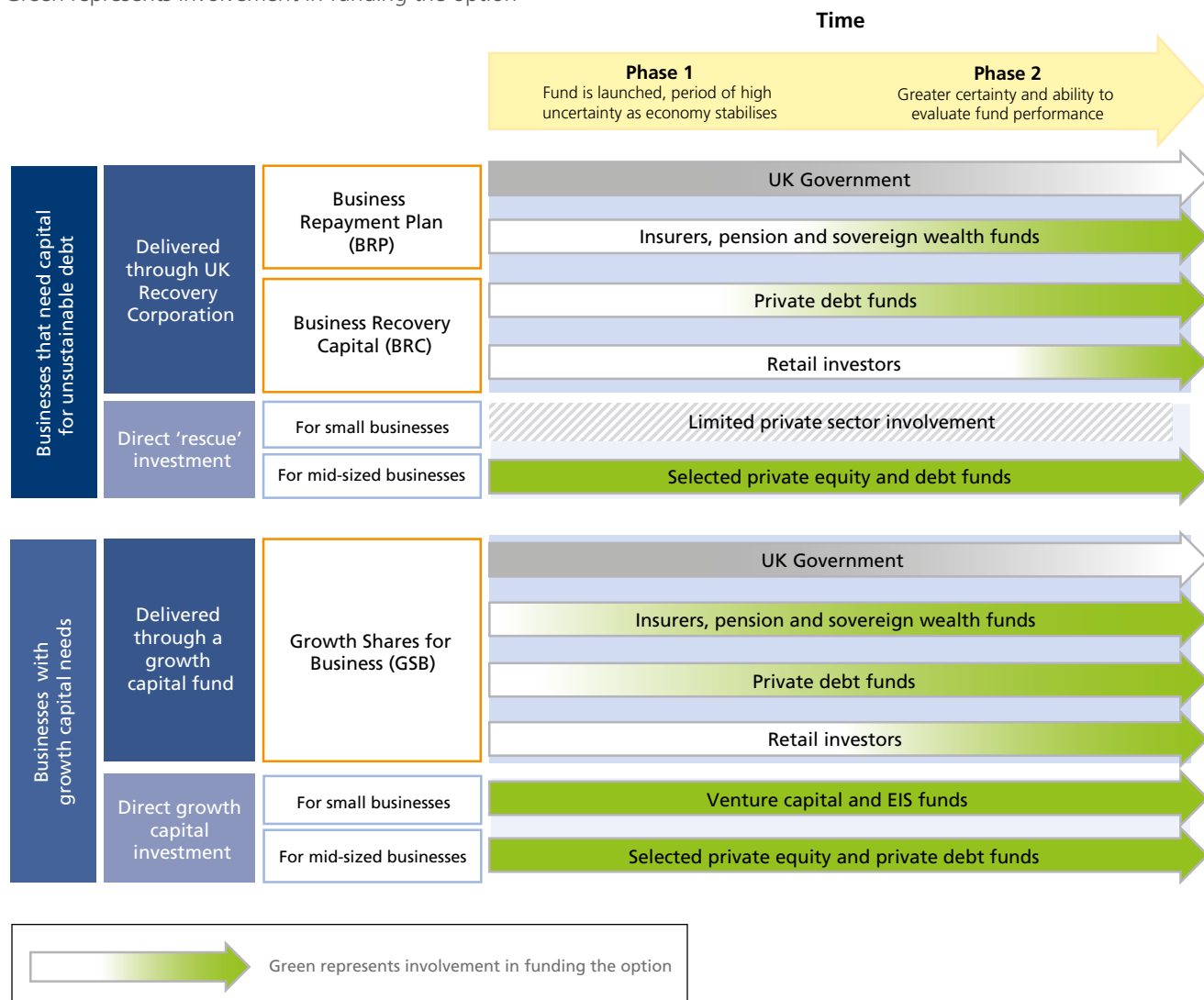
313. Many types of UK and international institutional investors including insurers, pension funds and sovereign wealth funds look to invest in growth capital funds. These investors can be expected to invest in the proposed growth capital fund where, relative to the UK Recovery Corporation, there is inherently more certainty from the outset about fund performance. The proposed growth fund would still need to meet investors' risk and return requirements. Indicatively, institutional investors typically target returns of 10%-15% per year via investments in UK private equity mid-market funds.

### Direct equity investments into UK SMEs

314. Investment intermediaries such as private equity and venture capital funds would not look to capitalise businesses through a fund or AMC structure. Rather, these investors make direct equity investments in businesses looking for equity investment, and typically take an active role in the management of these businesses.
315. A number of these funds already have a focus on rescue/turnaround and/or growth capital, including in small and medium-sized businesses (although this accounts for a relatively small share of overall private equity activity).
316. Given the large amount of undeployed capital available, these investors can be expected to contribute to the UK SME recapitalisation effort. This will be through direct investments in UK businesses that are looking for equity investment and that meet their investment criteria, with PE and VC funds targeting return rates of 15%-25% per year on individual investment opportunities. Direct investments however are unlikely to occur on the scale required, given the number of UK SMEs likely to need equity recapitalisation.

**Figure 22:** The phasing of private sector involvement: schematic

Green represents involvement in funding the option



**Figure 23:** Indicative investment appetite by capital pool

Source: EY Analysis

		PE	VC	PD	Insurers	Pension Funds	Retail
<b>Indicative investment return requirement by asset pool</b>		15% – 20%	20% – 25%	7% – 15%	Corporate rate + 50 -100bps	6% – 7%	3% – 8%
<b>Capital for unsustainable debt</b>	Via a fund / AMC						
	Direct Investment						
<b>Growth capital</b>	Via a fund / AMC						
	Direct investment						

Limited applicability      Highly applicable

**Private investor expertise and infrastructure**

- 317. At present the operational servicing capability does not readily exist in the UK on the scale required for the volume of unsustainable SME debt expected to soon materialise.
- 318. However, in addition to capital, private sector investors offer a range of capabilities and infrastructure that could be leveraged by the UK Recovery Corporation and/or a growth fund. Deploying capital at scale and at pace requires a segmented approach. It requires expertise to identify key parameters to triage investments, undertake valuation, manage risk and provide intervention where necessary.
- 319. Loan servicers, FinTechs, conventional asset managers and private equity, venture capital and private debt funds have access to experts, scalable technology systems, investment models and methodologies and often a regional deployment model that could be utilised to deliver capital across the UK at pace.

## FURTHER DETAILS

### THERE IS AN INTERCONNECTED ECOSYSTEM OF INVESTORS IN THE UK ABLE TO INVEST IN UK SMES VIA A FUND OR DIRECTLY, AS CONDITIONS STABILISE AND RISK AND RETURN DYNAMICS BECOME MORE CERTAIN

320. In the remainder of this chapter, we assess three categories of investors that make up the broad and interconnected ecosystem of investors in the UK:

- **Private Equity (PE), Venture Capital (VC) and Private Debt (PD) markets:** These firms raise funds from capital providers such as institutional investors. Undeployed capital exists in these markets including c.£157bn of undeployed capital in PE (inclusive of VC) in 2019 and c.£35bn in PD.
- **Institutional investors including insurers, pension funds and SWFs:** These firms invest in equity and debt both directly and indirectly (a significant amount of PE/PD dry powder is from global insurers and pension funds). UK insurers and pension funds together accounted for £3.6trn in assets in 2019.
- **Retail markets:** Retail investors accounted for c.£1.4trn in assets in May 2020. While there is limited undeployed capital among retail investors, carefully designed new investment products could potentially be issued with appropriate consideration of investor protections and suitability.

321. For each category of investor, we assess:

- The typical return requirements of the investor type.
- The appetite and ability of the investor type to provide distress capital (i.e. invest in assets requiring capital for unsustainable debt) and/or growth capital.
- Whether the investor type is likely to invest through a fund structure or invest directly in SMEs.
- We present a summary of the preferences of each investor group through these lenses below.

### PRIVATE EQUITY AND VENTURE CAPITAL FUNDS WILL CONTINUE TO INVEST DIRECTLY IN SMES ON A SELECTIVE BASIS RATHER THAN PARTICIPATE IN A POOLED ASSET SOLUTION

322. PE and VC firms take equity stakes in businesses across the UK and across a wide range of sectors. Their investee businesses are typically unquoted and PE/VC funds seek to make a return on their investment by growing and improving the investee company using financial engineering, their commercial expertise, as well as, increasingly, value creation techniques.

323. There are several smaller PE funds which allocate capital to UK mid-market businesses and some which allocate to rescue/distressed assets. While investment in rescue/turnaround situations historically accounts for a small share of PE activity (relative to growth capital), the focus on rescue/distress may increase following the crisis if the risk-return dynamics are sufficiently attractive. VC funds have a focus on start-ups and SME businesses with strong growth potential. These investments are generally fast growth, high risk, high return opportunities and necessarily have very specific characteristics.

324. The VC market is considerably smaller than the PE market (VCs in the UK had c.£7bn undeployed capital in 2019, whereas PE had £150bn).<sup>53</sup> While these investors have a large pool of existing dry powder, there are significant fundamental challenges to unlocking this for the purposes of recapitalisation of UK SMEs on a large scale. The existing stock of undeployed capital is predominantly focused on the buyout of larger companies and is held in funds with investment mandates that could prohibit its deployment towards UK SME recapitalisation due to the required size and sector of the investments. PE and VC firms run small investment teams and by nature take an active role in the management of investee companies, which limits their ability to recapitalise SMEs at scale.

53 Preqin; figure represents dry powder held by UK based funds who may deploy capital into non-UK regions.

- 325. If a pooled investment vehicle was set up to solve the scale and investment size challenge, they would not be able to invest as their investment mandates do not allow them to invest in a fund; they can only invest directly in individual companies themselves. Additionally, most PE funds (and all VC funds) focus predominantly on growth investments (rather than turnaround or special situations). Please refer to Figure 24 for a summary of how and where PE and VC funds may be able to invest. They are unlikely to be attracted by companies struggling with non-viable debt so whilst their dry powder is additive to the broader UK economy, it unlikely to address the non-viable debt problem. Inversely, it is notable that many businesses may not be aware of the option to undertake equity investment, and those that do may not see raising equity as an attractive option compared to debt refinancing. Additional education of businesses regarding equity investment may be required.
- 326. PE and VC investors will continue to play a role in selectively supporting the recapitalisation of a small number of UK corporates as they will continue to seek investment selective opportunities that conform to their investment mandates and return requirements. Despite some fundamental impediments to their ability to use existing capital to recapitalise UK SMEs on a large scale, there are some incentives that could be used to unlock a portion of currently undeployed PE capital, such as changes to the structure of Government loan guarantees, alteration of tax incentives and VCT investment qualifying criteria, and amending competition rules.
- 327. As part of our research we have also considered the potential for unlocking capital from SWFs. SWFs are well-established, major investors globally and could be a large potential investor in UK SMEs, alongside Government funding. These investors have investment characteristics similar to a pension fund and provide long term, patient capital to growth opportunities and typically take a passive approach to management with indicative minimum investment sizes of ~£0.5bn. Given this, there are two routes to attracting their capital: firstly, they could set up an investment fund in the UK, some of which could be invested in a UK SME recapitalisation fund. Secondly, they could co-invest in such a fund alongside other institutional investors. Although SWFs are currently looking for new investment opportunities and have capital to deploy, they are generally slow moving and favour particular sectors such as technology, real estate, infrastructure and energy, suggesting that on balance other institutional investors may be more likely to invest in the widescale recapitalisation of UK SMEs.





**Figure 24:** Private Equity and Venture Capital investment feasibility assessment and incentives

Indicative feasibility of PE:

		Applicability	Feasibility assessment and required incentives
Capital for unsustainable debt	Via a fund / AMC		<ul style="list-style-type: none"> <li>• Unable to invest in funds as this is restricted by PE investment mandates.</li> </ul>
	Direct investment		<ul style="list-style-type: none"> <li>• Ability to make direct investments through the business as usual processes of PE houses with special situations and restructuring funds.</li> <li>• Potential to unlock additional capital via incentives such as changes to competition rules, tax incentives and Government guarantees.</li> </ul>
Growth Capital	Via a fund / AMC		<ul style="list-style-type: none"> <li>• Unable to invest in funds as this is restricted by PE investment mandates.</li> </ul>
	Direct investment		<ul style="list-style-type: none"> <li>• Ability to invest directly in SMEs, most likely towards the larger end of the SME market and very selectively.</li> <li>• Potential to unlock additional capital via incentives such as changes to qualifying investment criteria, tax incentives and Government guarantees.</li> </ul>

Limited applicability      Highly applicable

Indicative feasibility of VC:

		Applicability	Feasibility assessment and required incentives
Capital for unsustainable debt	Via a fund / AMC		<ul style="list-style-type: none"> <li>Unable to invest in funds as this is restricted by VC investment mandates.</li> </ul>
	Direct investment		<ul style="list-style-type: none"> <li>Although able to make direct investments, VC funds are unlikely to make direct investments into SMEs requiring recapitalisation since they typically focus on high growth businesses.</li> </ul>
Growth Capital	Via a fund / AMC		<ul style="list-style-type: none"> <li>Unable to invest in funds as this is restricted by VC investment mandates.</li> </ul>
	Direct investment		<ul style="list-style-type: none"> <li>Ability to make direct investments through the business as usual processes of VC funds looking for growth opportunities (albeit very selectively).</li> <li>Potential to unlock additional capital via incentives such as changes to qualifying investment criteria, tax incentives and Government guarantees.</li> </ul>

 Limited applicability       Highly applicable

## PRIVATE DEBT FUNDS HAVE A FLEXIBLE INVESTMENT APPROACH AND CAN PROVIDE CAPITAL BOTH DIRECTLY AS WELL AS THROUGH A FUND, HOWEVER THEIR RETURN REQUIREMENTS ARE HIGH

328. Private debt (PD) funds (also known as debt funds or direct lending funds) have become an increasingly important source of private capital in recent years. They have filled the gaps in the market that were created post the financial crisis where commercial banks pulled back from lending to segments such as PE-backed businesses and SMEs due to the perceived risk and cost of lending.
329. Debt funds have a wider mandate than PE and VC funds for generating returns and provide funding to companies of all sizes and sectors. Funding is given both directly (i.e. term loans or Revolving Credit Facilities), as well as through other means such as bonds that are traded on public markets, securitisation structures, or co-investment alongside other funding providers.
330. Most debt fund activity is single-asset investing in established businesses, that are often PE-backed. There is some restructuring-type turnaround single-asset investing but this tends to be for relatively large businesses. Both investment styles are typically actively managed in order to unlock assets that are undervalued. The third type of credit fund investing is into a fund of pooled assets such as NPLs. This investment style is more passive in style due to the volume of underlying exposures. Fund investing requires an experienced and high-quality servicer to manage the loans, as outlined below. Please refer to Figure 25 for a summary of how and where Private Debt funds may be able to invest.
331. Debt funds could play a significant part in recapitalising UK SMEs, as well as providing growth capital, and there is a large amount of capital that is currently undeployed (£35bn in 2019). That said, as with other investors, PD investors have risk and return requirements (7%-8% on performing loans and 15%+ on NPLs). They require high quality data on the businesses that they are funding in order to perform their due diligence as well as strong corporate governance structures. For PD investors to fund the UK Recovery Corporation at an early stage, some form of Government guarantee may be required.
332. Additionally, for portfolio type loans, they will require a third-party servicer to manage, service and collect the debts. At present this operational servicing capability does not exist in the UK on the scale required for the volume of unsustainable SME debt that is expected to materialise in the coming years. The UK consumer debt collection market is mature and well established,

having grown significantly since the global financial crisis, however these businesses largely focus on unsecured consumer debt. Collection and servicing of SME debt requires a different approach as there is no one-size-fits-all approach as with consumer debts. That said, a lot of the existing unsecured consumer expertise of these companies would be transferable to the micro end of SME (BBLs businesses, for example) and could solve part of the operational challenge.

**Figure 25:** Private Debt investment feasibility assessment and incentives

		Applicability	Feasibility assessment and required incentives
Capital for unsustainable debt	Via a fund / AMC		<ul style="list-style-type: none"> <li>Some special situations and restructuring debt funds are able to invest in a pooled asset fund structure.</li> <li>Co-investment structure is possible, but funds require appropriate loan segmentation, high quality data, and a servicing capability.</li> </ul>
	Direct investment		<ul style="list-style-type: none"> <li>Special Situations and restructuring debt funds can provide debt funding directly to struggling SMEs through business as usual processes.</li> </ul>
Growth Capital	Via a fund / AMC		<ul style="list-style-type: none"> <li>Some funds are able to invest in a pooled asset fund structure.</li> <li>Co-investment structure is possible, but funds require appropriate loan segmentation, high quality data, and a servicing capability.</li> <li>Lower return hurdles than for investing in unsustainable debt.</li> </ul>
	Direct investment		<ul style="list-style-type: none"> <li>Able to provide debt funding directly to SMEs through business as usual processes.</li> </ul>

Limited applicability      Highly applicable

## INSURERS CAN HELP FUND THE UK RECOVERY CORPORATION, BUT ANY INVESTMENT PRODUCT MUST BE DESIGNED TO MEET THEIR CRITERIA

333. Insurers manage a large pool of assets in the UK (c.£2trn in 2019),<sup>54</sup> of which over half are partly or entirely invested at the discretion of management. These assets are typically held and invested in three main fund types each with varying asset allocation and strategies:

- Annuity funds (total £400bn of insurers’ AUM with £40bn of new premium in 2019)<sup>55</sup> pay guaranteed benefits in the form of pensions payments to policy holders. This pool of assets is typically invested in investment grade debt instruments with a fixed repayment schedule that are diversified across sectors, with long-term durations matched to the expected duration of annuities payments.
- With-profits funds are asset pools used to pay guaranteed benefits, as well as additional bonuses to policyholders. These funds are typically more diversified than annuity funds, since they have exposure to debt, equities, as well as other asset classes.
- Unit-linked funds are asset pools used to pay benefits to policy holders linked to the performance of the underlying assets, which can be fixed income, equities or both.

334. Each of the fund types vary in the level of discretion over assets. With-profit and unit-linked funds are typically tied to allocation ranges, and therefore have limited discretion and are unlikely to be able to re-allocate material amounts to new asset

<sup>54</sup> European Insurance and Occupational Pensions Authority.

<sup>55</sup> European Insurance and Occupational Pensions Authority, EY Analysis.



classes, such as SME debt or equities, within existing funds. As such, any investment in SME recapitalisation from these capital sources (and towards equities) would more likely be from new investment flows and over a longer time horizon.

- 335. In contrast, annuity fund managers have significantly more discretion over asset allocation and are therefore more likely to invest in new asset classes such as SME recapitalisation, and could do so at scale and within a more immediate timeframe. A debt solution which allows the fund manager to underwrite the pooled SME exposures, without having to look through to the underlying assets, would be required.
- 336. Unlocking capital from this group of insurers requires meeting of return requirements (in the region of around 50 to 100 basis points above the equivalent corporate bond yield), as well as some other challenges to be met. Insurers look for investment products with long durations (7-15 years). They require some form of external credit rating, or as an alternative, a form of Government guarantee or wrapper in order to remove the need to underwrite the individual loans and still meet an investment grade rating requirement. Lastly, ensuring appropriate application of regulation including the Solvency II Prudent Person Principle would help to attract capital. Please refer to Figure 26 for a summary of how and where insurers may be able to invest.

**Figure 26:** Insurance investment feasibility assessment and incentives

		Applicability	Feasibility assessment and required incentives
Capital for unsustainable debt	Via a fund / AMC		<ul style="list-style-type: none"> <li>• Ability to invest in debt issued by fund, if debt can be structured to be 'matching adjustment' compliant, see parameters above.</li> </ul>
	Direct investment		<ul style="list-style-type: none"> <li>• Insurers don't have underwriting capability to take on direct stakes in large numbers of SMEs.</li> </ul>
Growth Capital	Via a fund / AMC		<ul style="list-style-type: none"> <li>• A smaller amount of equity investment may be attractive to certain With-Profit and Unit-Linked funds, but much less scale than the debt investments for annuity funds.</li> </ul>
	Direct investment		<ul style="list-style-type: none"> <li>• Insurers don't have underwriting capability and coupled with smaller potential scale of investment, are unlikely to have an interest.</li> </ul>

Limited applicability      Highly applicable

## PENSION FUNDS (DC AND DB) ARE LIKELY TO BE ABLE TO INVEST ON A SIMILAR BASIS TO INSURERS SO THEIR SPECIFIC REQUIREMENTS MUST BE CONSIDERED

- 337. Both Defined Benefit (DB) and Defined Contribution (DC) schemes have significant pools of capital. Total invested assets of private sector DB schemes are c.£1.6trn while those in DC schemes are c.£680bn<sup>56</sup>, with DC schemes growing rapidly following the introduction of auto-enrolment. Existing capital is largely already deployed and new contributions into pension schemes, in particular DC schemes, are invested in a pre-agreed manner (such as in the default fund).
- 338. Pension schemes have wide discretion on the types of investments they are permitted to invest in, and invest across the full spectrum of asset classes across the globe: debt, equity, listed, unlisted and securitisations etc. They have long term investment horizons and prefer for long duration products (often >10 years) with visible and regular cashflows that can match the duration of their liabilities.

56 EY Analysis.

- 339. Except for large DB pension schemes, pension funds generally do not seek to be actively involved with their underlying investee companies. They do not typically invest directly in businesses and will require any solution to be on an aggregated basis to ensure a diversified pool of SME exposure. Please refer to Figure 27 for a summary of how and where pension funds may be able to invest.
- 340. DB schemes typically seek to generate a return of between + 3%-5% p.a. on their growth assets over the medium to long-term. DC default funds would typically try to out-perform inflation by 1%-3% p.a. over the medium to long-term.
- 341. In order to attract pension capital, some fundamental challenges will need to be overcome, and incentives considered. The underlying pooled assets must have some form of credit rating, or as a minimum, a form of Government guarantee or wrapper in order to remove the need to underwrite the individual loans and to enhance the credit rating overall. Pension funds need to understand the risks, sectors, business types and performance of the loans in the fund, which will require the creation of an administration company to manage and administer the portfolio. The new entity will need to administer, service, monitor and report on the underlying loans.

**Figure 27:** Pensions investment feasibility assessment and incentives

		Applicability	Feasibility assessment and required incentives
Capital for unsustainable debt	Via a fund / AMC		<ul style="list-style-type: none"> <li>• DB schemes have appetite to invest in SME debt instruments, subject to suitable terms and risk characteristics.</li> <li>• Appetite from DC schemes in the short to medium term is likely to be limited unless operational and regulatory challenges are removed.</li> </ul>
	Direct investment		<ul style="list-style-type: none"> <li>• Very limited appetite from DB or DC schemes.</li> </ul>
Growth Capital	Via a fund / AMC		<ul style="list-style-type: none"> <li>• DB schemes have appetite to invest in SME debt instruments, subject to suitable terms and risk characteristics. There is a lower appetite for equity as DB schemes de-risk as well as the continued trend towards more global equity allocations that are less UK centric.</li> <li>• Appetite from DC schemes in the short to medium term is likely to be limited unless operational and regulatory challenges are removed.</li> </ul>
	Direct investment		<ul style="list-style-type: none"> <li>• Very limited appetite from DB or DC schemes.</li> </ul>

Limited applicability      Highly applicable

## RETAIL INVESTORS COULD POTENTIALLY PROVIDE ADDITIONAL PRIVATE CAPITAL AT A LATER STAGE IF A CAREFULLY DESIGNED RETAIL INVESTMENT PRODUCT WAS LAUNCHED

342. There is c.£1.4trn<sup>57</sup> of UK retail investment assets in the UK. These assets are held in a combination of bonds, equities, property and managed cash Unit Trusts and OEICs. As at the 5th April 2019 there was £584bn invested in ISAs.<sup>58</sup>
343. Discussions with wealth industry participants suggest a strong investor interest in supporting UK businesses, particularly if this can be linked to a local theme and consistent with a growing interest in Socially Responsible Investing. The question is more whether retail investors should be allowed to invest given the risk and illiquidity associated with the underlying companies which may result in significant capital losses.
344. Any investment product aimed at the retail market would need to be simple, transparent and carry reasonable charges. In order to access a mass retail market, a Government guarantee over the principle invested is likely to be necessary.
345. A Government guarantee within a fund structure is likely to appeal to the retail market broadly. However, for advised and discretionary clients to access this it will have to be signed off by Investment Committees.
346. A closed recapitalisation and/or growth fund that does not have a guarantee may still be attractive to discretionary fund managers (DFMs) who manage assets on behalf of retail advised clients. This asset is likely to be classified as an alternative product and would not be suitable for all clients; it would also be unlikely to form a substantial part of a client's portfolio. In 2018, DFMs managed £600bn on behalf of clients.<sup>59</sup> We therefore estimate there could be a pool of capital in excess of £5bn that may be able to invest in these funds subject to a suitability assessment.
347. The closest existing products to the proposed BRC and GSB contemplated in this report are peer to peer lending which has similar characteristics in terms of lack of transparency of the underlying companies, EIS (£1.9 billion raised in 2018) and VCTs (c.£0.7 billion raised in 2018)<sup>60</sup> which are typically only considered suitable, for high net worth, experienced investors and in the case of EIS/VCT have significant tax benefits as well as professional managers selecting underlying companies. Many participants interviewed suggested that it is likely similar tax benefits to EIS/VCTs would be required to attract investors to the proposed investment solutions. It is notable that many financial advisers are reluctant to recommend these products (due to risk and lack of PI cover) and most are acquired directly.
348. Historically, retail investors tend to follow the investment trends of institutional assets on an advised and non-advised basis, on a lagged timeline. Therefore, any retail solution could be considered once proven with institutional investors. However, given the high regulatory bar for demonstrating that investments are suitable for retail investors, with an appropriate risk and return profile, any retail product would need to be carefully designed and may require some form of Government guarantee, particularly in light of highly publicised fund collapses and closures. Please refer to Figure 28 for a summary of how and where retail investors may be able to invest.
349. **Covid ISA:** The idea of a Covid-19 ISA wrapper around a carefully designed retail product has been discussed with several industry participants. It is generally felt that there is already a proliferation of products in this area that have been received and utilised with limited degrees of success by retail investors. It was not felt that an ISA would be particularly appealing or structured in any way that would allow for the short or even medium-term deployment of retail assets to aid recapitalisation. Industry participants felt that having an investment that was free of inheritance tax (IHT) was potentially appealing if you could prove the stability of the underlying portfolio. An investor might take a lower than expected return if he/she was allowed to pass that asset down with no IHT.





57 Investment Management Association, collective sector: Unit Trusts, OEICs as of May 2020.

58 UK government website, Individual Savings Accounts (ISA) Statistics, June 2020.

59 Private Asset Manager (PAM); Compeer UK Wealth Management Industry Report.

60 Alternative Investment Report 19/20 EIS Industry Report, HMRC Venture Capital Trusts Statistics Commentary.

**Figure 28:** Retail investment feasibility assessment and incentives

		Applicability	Feasibility assessment and required incentives
Capital for unsustainable debt	Via a fund / AMC		<ul style="list-style-type: none"> <li>High risk and complex nature of the underlying assets or vehicle introduced to ensure risk mitigation is unlikely to be suitable for most retail investors. Closed nature of the fund is also unlikely to appeal or be appropriate for most retail investors.</li> <li>It may be possible to attract a tranche of HNW, experienced investor and Discretionary Fund Manager assets with appropriate tax incentives.</li> </ul>
	Direct investment		<ul style="list-style-type: none"> <li>Very limited appetite owing to complexity of instruments and holding direct.</li> </ul>
Growth Capital	Via a fund / AMC		<ul style="list-style-type: none"> <li>Closed nature of the fund may make it less appealing to retail investors, however, the focus on growth in a fund structure may appeal to HNW, experienced investors and Discretionary Fund Managers (DFM) with a medium to long term investment horizon.</li> <li>However, HNW, experienced investors can access this market through VCT's, EIS's and SEIS's. The positioning of a new fund alongside the existing schemes that can be utilised would need to be considered.</li> <li>A clearly supported risk return profile would likely be needed for retail investors accessing a closed-ended growth fund either directly or via a DFM.</li> </ul>
	Direct investment		<ul style="list-style-type: none"> <li>As per the above there are already structures to allow HNW and experienced investors access to these SMEs and these structures have tax relief factored in. Holding equity direct is therefore likely to be less appropriate/appealing and is unlikely to be attractive to the majority of retail investors owing to the risk associated with holding a single asset directly.</li> </ul>

 Limited applicability       Highly applicable

### Chapter 6: Funding of the options – Key findings

- Given the scale of the challenge and the level of uncertainty about performance, it is unlikely that private sector investors will be able to finance the UK Recovery Corporation initially.
- Converting the currently unsustainable debt into stable longer-term repayment options for businesses should create the conditions needed for the private sector to be able to invest, once there is greater certainty and clarity of information for savers and investors and key constraints are addressed.
- From the outset, the management of the UK Recovery Corporation should be tasked with developing plans and mechanisms to involve the private sector as soon as possible. Creating a fund structure to attract private investors in this subsequent phase is also critical.
- PE and VC funds will continue to invest directly in SMEs on a selective basis, rather than participate in a pooled asset solution, providing distress and growth capital where IRRs of 15-25% are achievable.
- Private Debt funds have a flexible investment approach and can provide capital both directly as well as to a fund like the UK Recovery Corporation. Private debt funds look for return rates of 7% - 15% per year.
- For insurers and defined benefit pension funds, unlocking capital through a long-term debt solution is possible if some form of credit enhancement can be provided and return rates are close to private placement.
- Retail investors could potentially provide additional private capital at a later stage if a carefully designed retail investment product was launched.
- For a growth capital fund, private sector investors can be expected to play an important role from the outset with insurers, pension funds and SWFs looking to invest growth capital where this meets their risk and return requirements.
- We also believe that the management of the UK Recovery Corporation should investigate the potential to attract private capital to fund SME growth via ordinary equity.
- In addition to providing capital, private sector investors offer a range of capabilities and infrastructure that could be leveraged by the UK Recovery Corporation and/or a growth fund.



# CHAPTER 7

# END USER FEEDBACK

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## **BUSINESSES AND THEIR REPRESENTATIVES RECOGNISE THE CHALLENGES RELATING TO UNSUSTAINABLE DEBT POST COVID-19 AND THERE IS BROAD SUPPORT FOR THE CONSIDERATION OF INNOVATIVE RECAPITALISATION SOLUTIONS**

350. It was agreed at the outset that the RCG would consult and seek input from the businesses that are the end users of any proposed options. UK Finance led this work and secured feedback from across general and sector specific business representative organisations, stakeholders with expertise in SME perspectives, key intermediaries and representatives of suppliers of professional services such as accountancy bodies.
351. An end user group was brought together to facilitate collective engagement, accompanied by bilateral conversations with trade associations, and roundtables with relevant groups of trade association members. A survey of SMEs was conducted, and written input received from several end user groups was collated. Extensive use was also made of other relevant sources of data, including attitudinal insight from individual trade associations surveys and the independent SME Finance Monitor.
352. The key themes raised through engagement with end user groups included, but were not limited to, the areas outlined below.

### **Scale of the challenge**

353. Overall, the businesses and trade associations consulted agreed the scale of unsustainable debt was likely to be substantial and they agreed with the basis of analysis performed in the interim report.
354. They requested that the definition of unsustainable debt should be clear and that there should be criteria defined with the business audience in mind, that will be easy to apply and implement, if there are options to consider.

### **Segmentation and scope**

355. Given the diversity of the business population, there was broad recognition that there are unlikely to be 'one size fits all' solutions.
356. While understanding that larger SMEs were the core focus of this work, many consultees were equally concerned with smaller businesses' post-crisis debt burden. End user groups agreed that a range of tools and solutions adapted to different sizes and sophistication levels of business, ranging from simple ones to more bespoke solutions for larger businesses, would be desirable.
357. Consideration of pre-crisis debt and debt taken on during the crisis on commercial terms was just as important as debt taken on under the Government schemes, both for practical reasons and to address 'moral hazard' concerns. Many businesses across all segments and sectors have experienced a fall in market demand or have weaker business models because of the Covid-19 crisis. Nevertheless, the role of growth finance was cited by almost all as a critical part of the recovery phase, though this is not covered directly in this overview.

### **Risks**

358. Business size and sophistication is also associated with potential conduct risk for holders of debt and/or equity, depending on who was making decisions around options with a direct impact on the business.
359. Many of those consulted remarked on the relative regional disparity in the distribution of equity investment in UK SMEs seen before the crisis. The recovery phase was seen as an opportunity to seek to address this. They raised the risk that businesses in already economically deprived areas could be excluded, especially if the focus of any recapitalisation measures favour regions and sectors of economic activity which are already beneficiaries of equity support.
360. Ensuring that businesses are incentivised to 'do the right' thing was cited. Solutions should be mindful of incentives and motivations of SMEs around continuing to trade and keep employment going, with a need to avoid creating zombie companies but to support businesses that are genuinely sustainable and have prospects for growth.



361. There was agreement that the UK had to be seen to be a competitive location to 'recapitalise' SMEs in what is likely to be a global challenge. There were some concerns that international, including European, investors may be reluctant to invest in UK-focussed funds or smaller funds in the coming years, with uncertainty relating to the UK's long-term trading arrangement with the European Union being exacerbated by the Covid-19 crisis.

## Solutions

362. The two potential options explored in the interim report which got most substantive feedback were a contingent tax liability and conversion to preferred equity. The substantive detail on these options is covered on pages 58-72.

## Business Repayment Plan (BRP)

363. The BRP was seen as a relatively attractive solution for smaller levels of indebtedness, with a view that linking it to taxable profit may avoid complexity. Views were that it may need to be time-bound, should not cover debt for working capital purposes, and should have scope to allow full repayment at any time.
364. There were some questions around HMRC's capacity and interest in administering such an option, as well as whether this would be subject to ongoing political debates about the way it would work.
365. A number commented that it would need to be understandable for business and their advisors, such as whether it was tax liability or a loan, and terminology was critical. If the liability was to be sold onto a third party, as student loans had been, this may also be controversial with business borrowers.
366. The link between this solution and the proposed reintroduction of secondary preferential creditor status for certain tax liabilities in December 2020 was raised, and we note that business groups are making ongoing representations to Government to reconsider it. The potential impact of the prioritisation of further tax liabilities (effectively incurred from lending) and its impact on the provision of all other types of secured finance was emphasised by some stakeholders as a serious concern.

## Business Recovery Capital

367. The Business Recovery Capital (BRC) was bringing many benefits for mid-market companies, though this was seen as a solution that lends itself to larger SMEs with greater financial sophistication. Whether this would be solely an option for Government lending schemes was a question raised by several groups, as well as the State Aid implications of this option. Many broader areas considered elsewhere in this report were referenced such as the potential need for legislative support, Government scheme rule changes and what level of external guidance would be required for this option to be viable or responsible for SMEs to consider. Anti-avoidance measures to make sure this was used appropriately by business were also seen as important.

## Implementation and leveraging existing infrastructure

368. Trade Associations and the representatives of suppliers of professional services to SMEs said that the attitudes of business would be an important factor to consider. In particular, the long-standing aversion to taking on equity finance would impact demand for certain options. It was acknowledged that many businesses would need access to business education, mentoring and advice as appropriate.
369. The point of default was felt to be too late to be a trigger point for recapitalisation and so businesses and their representatives recognised that other verifiable KPIs may need to be used. Consistency between providers of this, particularly under the Government loan schemes, was cited as being desirable.
370. While it was acknowledged that the scale of the recapitalisation challenge for the UK was unprecedented, there was consensus that existing infrastructure should be leveraged where possible. The role of angel investors, both as sources of funds but also expertise was one such example. Many cited the role of the British Business Bank (BBB) and how to leverage the

Future Fund, including the potential to improve compatibility with EIS / SEIS investment. Several stakeholders commented that the BBB has a proven and capable distribution mechanism and has been adaptable, including British Patient Capital funding. Similarly having a regional and devolved nations network was an important distribution structure, at least for growth finance.

371. The regional and devolved nation dynamic was important more generally. It was important not to lose sight of the role the Scottish National Investment Bank, Scottish Enterprise Co-investment Fund, the BBB's Northern Powerhouse Fund as well as the Cornwall and Isles of Scilly Fund could play.
372. Some of this infrastructure was already being stretched with, for instance, the angel investment community having used up considerable sums of their set-aside 2020 financial capacity to support existing portfolio business, bringing forward investment rounds to address Covid-19 related needs. It was acknowledged that co-investment models to supplement capacity may be necessary.

### Timing

373. End users stressed the importance of considering recapitalisation options for business at an early stage of the crisis to provide confidence to businesses and facilitate growth post crisis. Several end user groups were keen to get a sense from Government how the work of the RCG would be taken forward by officials.

### Broader policy measures

374. A number of end user groups talked about the need to consider the role of broader policy measures and observed that recapitalisation was not a challenge that could be considered in isolation. We did not seek to achieve consensus around these, but examples cited included employers' National Insurance payment holidays, acceleration of Research and Development credit payments and shorter claim periods. Tax incentives such as EIS / SEIS tax breaks were felt to be very valuable post the financial crisis. In 2012, tax relief on EIS was raised to 30% (from 20%) and SEIS was introduced offering 50% relief. Over £2bn was invested in over 4,000 businesses via EIS and SEIS in the past tax year. Building on this to attract more private investors, especially to address thin capital available in the regions could make a significant contribution.

## KEY RESULTS FROM THE THECITYUK / UK FINANCE SURVEY

375. As noted above, one of the end user engagement activities was a survey of businesses, which received 41 responses, mainly from SMEs. 37% had not yet taken on additional debt to get through the crisis. This echoed one of the points from end user groups around balancing recapitalisation options with not providing incentives simply to take on debt which would exclude non-borrowers.
376. Of those firms which had taken on additional debt over the coronavirus period, over half had borrowed less than £50,000. The biggest concerns for repaying debt are reduced income and cash flow timing issues.
377. The most popular option amongst those which have taken on additional debt is the BBLs.
378. Many noted they had taken on tax deferrals – the timing of the resumption of these is critical interdependency with finance needs. Over half said they would convert to a contingent tax liability type solution if offered.
379. Aligning to broader and longer-term research under the SME Finance Monitor, whilst firms had considered equity investment, relatively few had ever taken on equity investment before, with half still not willing to consider 'equity investment' regardless of where it came from. The top four (largely equally weighted) reasons why equity investment was not considered a good option were: 1. Price/cost 2. Valuations/Impact on existing shareholder's stakes 3. Conditions that accompany the investment 4. Impact on existing shareholder control.
380. Over half the respondents use their accountant as a key source of advice. Business mentors and self-education were also cited as ways businesses navigate their external finance options.

## NEXT STEPS FROM THE END USER PERSPECTIVE

381. There was a clear recognition of the importance of recapitalisation for the UK economy and a recognition that this would have to be done in an innovative way. There was recognition that a broad public policy consultation would be needed to balance the conflicting financial interests. With various stakeholder groups proposing a range of sometimes overlapping approaches to these challenges, and the uncertainty of how business conditions will evolve, the importance of ongoing consultation with businesses going forward was evident, including by region, segment and sector bases, to reflect the diversity of SMEs.

### Contributors

382. As well as the firms which took part in the survey, written submissions were received from the CBI, BVCA, ICAEW, and UKBAA, and we held a series of meetings with the following trade associations:

- ACCA
- British Chambers of Commerce
- British Retail Consortium
- BVCA
- CBI
- Federation of Small Businesses
- Freight Transport Association
- ICAEW
- IOD
- MakeUK
- PIMFA
- R3
- ScaleUp Institute
- SMMT
- UKBAA

### Chapter 7: End user feedback – Key findings

- UK Finance formed an end user group to secure feedback from across 15 business representative organisations and their members. The businesses and trade associations consulted broadly agreed that:
  - The scale of unsustainable debt was likely to be substantial and there was broad support for the consideration of innovative recapitalisation solutions.
  - It would be desirable to have a range of tools and solutions adapted to different sizes and sophistication levels of business, including smaller or micro businesses.
  - The point of default was too late a trigger point for recapitalisation.
  - Using existing infrastructure could be beneficial but it was currently stretched as a result of the initial Covid-19 response.
  - Simple criteria should be defined that will be easy to apply and implement.
  - They were supportive of a solution for smaller entities that sought repayment through the tax system and supportive of a preference share like scheme for larger SMEs.
- A survey of SMEs themselves was conducted which confirmed that:
  - Of those firms that had taken on additional debt over the coronavirus period, over half had borrowed less than £50,000 through BBLs and many had tax deferred.
  - Their biggest concerns for repaying debt are reduced income and cash flow timing issues.
  - Whilst firms had considered equity investment, relatively few had ever taken on equity investment before, with half still not willing to consider 'equity investment' regardless of where it came from.
  - Over half the respondents use their accountant as a key source of advice. Business mentors and self-education were also cited as ways businesses navigate their external finance options.

# CHAPTER 8

# NEXT STEPS

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383. The work of the RCG has established a view of the size of the potential recapitalisation challenge, developed a toolbox of options and presented initial thinking on potential delivery mechanisms that together will help put the Government, businesses and the Financial Services industry in a better position to support the economic recovery post-Covid-19. Whilst businesses do not need to start repaying Government Covid-19 loans until March 2021, our work shows that many previously viable businesses will need recapitalisation well before March.
384. We estimate that the need for the solutions is likely to start to crystallise in late autumn 2020, and increase in early 2021, necessitating a near term implementation solution.
385. We will need to continue to move quickly.
386. To achieve this, decisive action is now required to conclude the solution design and quickly move towards a market launch of the solutions.
387. Whilst significant work has been undertaken over recent months on the potential options and enabling operating models, work now needs to move rapidly to detailed design, infrastructure integration and build and launch to the market.
388. Despite several unknowns and assumptions yet to be fully validated, we remain confident that with prompt decision making alongside continued Government and industry sponsorship, operational solutions are available and that a timely market launch is realistic and viable.
389. A four-phase approach to implementation is proposed and summarised below:

**Phase 1: Validation and Mobilisation**

- Agreement on primary policy decisions.
- Confirmation of governance, entity model, business case and funding provision.
- Assimilation of product roadmap, including the verification of solution characteristics, eligibility and conversion triggers.
- Finalisation of borrower product proposition.
- Confirmation of launch target date and primary transition stages.
- Mobilise design and build teams.
- Engagement with Accredited Lenders, HMRC and existing infrastructure providers as potential service suppliers.
- Development of detailed operational delivery route map.
- Determine consolidated technology and business infrastructure requirements.
- Engagement with private sector investors as appropriate.

**Phase 2: Detailed design and build**

- Finalise solution configuration.
- Finalise operating model design and entity structure.
- Design end to end process and procedure model.
- Development of client journey / experience.
- Preparation of launch plans.
- Develop third party contracting framework with associated SLAs/OLAs.

### Phase 3: Transition and pilot with initial borrowers

- Stand up full infrastructure.
- Detailed capacity and resilience testing.
- Development of client and communications materials.
- Soft launch of operational capability.
- Initial transition of borrower cohorts to new solutions.

### Phase 4: Operate with transition to full capacity

- Refine based on outcomes learnt from pilot lessons.
- Transition to full operational capacity / delivery.
- Monitoring of operational performance and full reporting.
- Post implementation review.
- Implement any required / desired efficiency improvement.

390. Before the work outlined above can be progressed, there are some key policy considerations to address. Balancing employment, business viability, and the potential cost to the national balance sheet, as well as longer term policy aims such as sustainability, correcting regional imbalances and promoting international trade and UK competitiveness, are just a few of the important factors the Government will want to consider.
391. In addition, there are some important mechanisms that would need to be developed in collaboration with the Government and regulators, including: how a business's recapitalisation would interact with the Government guarantee; a process to handle business failures; and robust governance and appeal processes.
392. As well as addressing the immediate challenges, the options proposed by the RCG aim to lay the foundations for better funding for SMEs in the UK in the long-term. We are aware of a number of pieces of work in this space that these options should look to complement, including those from the Government (such as Project Birch and the Department for Business, Energy and Industrial Strategy's Economic Recovery Roundtables) and other proposals such as those from the Social Market Foundation should also be considered.
393. There is much to be proud of in the economic response to Covid-19 to date. The initial Government reaction to protect the economy from the impact of Covid-19 has been momentous. It has provided SMEs the lifelines they have needed by way of grants, tax relief, the furlough scheme and access to short-term funds.
394. The Financial Services industry has equally mounted an unprecedented effort, standing up the operations to facilitate the government lending schemes overnight and providing the repayments holidays and waived fees that consumers and businesses have needed to see them through lockdown.
395. Businesses across Britain have shown amazing resilience and innovation to keep both themselves and their communities going in the face of incredibly testing and uncertain times.
396. Now, as we look forward, the onus is on business, government, and financial services to work together to find innovative ways to ensure the well run businesses that are the engine of the UK's growth not only survive but have the opportunity to grow, and help our economy recover.
397. We believe the unsustainable debt challenge calls for capital to be deployed into distressed firms on an industrial scale. This will need a simple rules-based eligibility system to convert into new solutions, an independent review process and an entity that can provide the delivery vehicle. We have examined prior examples in the UK and abroad and, if we proceed soon and with alacrity, there is enough time to establish such an entity.

398. TheCityUK, and the financial and related professional services industry, are committed to working with all parties within the business community, financial services industry, and all levels of Government including the devolved administrations and the supervisory authorities, to move forward to a workable solution together.

### Chapter 8: Next steps – Key findings

- There is a need to move quickly. The Chancellor’s Summer Statement provides welcome stimulus to ease the transition as the furlough and other support schemes unwind. Nonetheless, we estimate that the need for the proposed options is likely to start to crystallise in late autumn 2020 and increase in early 2021.
- There are some key policy considerations to address. This includes balancing factors such as employment, business viability, the cost to the national balance sheet, and longer-term policy aims such as sustainability, correcting regional imbalances and promoting UK competitiveness.
- The focus of work then needs to move rapidly to detailed design, infrastructure integration and build and launch to the market. We propose a four-phase approach to implementation including:
  - Validation and Mobilisation
  - Detailed design and build
  - Transition and pilot with initial borrowers
  - Operate with transition to full capacity
- The options proposed by the RCG aim to lay the foundations for SME access to finance in the UK in the long-term. We are aware of a number of pieces of work in this arena that these options should look to complement and are committed to working with the business community, financial services industry, and all levels of Government to take these next steps together.



# APPENDICES

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## APPENDIX A: THE UK RECAPITALISATION CHALLENGE: DETAILED ANALYSIS

### Key economic assumptions

399. Estimates for unsustainable debt presented in both this report and the prior Interim Report (released by the RCG, dated 8 June 2020) take into account revenue shocks projected at a sectoral level. These were based on macroeconomic assumptions which are representative of EY ITEM Club Forecasts (June 2020) with the following significant assumptions:
400. The lockdown measures put in place to suppress transmission of coronavirus will be fully lifted by the end of Q3 2020 and a second wave of Covid-19 does not occur.
401. The UK and the EU agree a trade agreement to take effect from 1 January 2021.
402. The GDP estimates in the EY ITEM Club forecasts have been adjusted to reflect EY's analysis of sector supply and demand conditions to provide the basis for the revenue shock estimates used in this report.

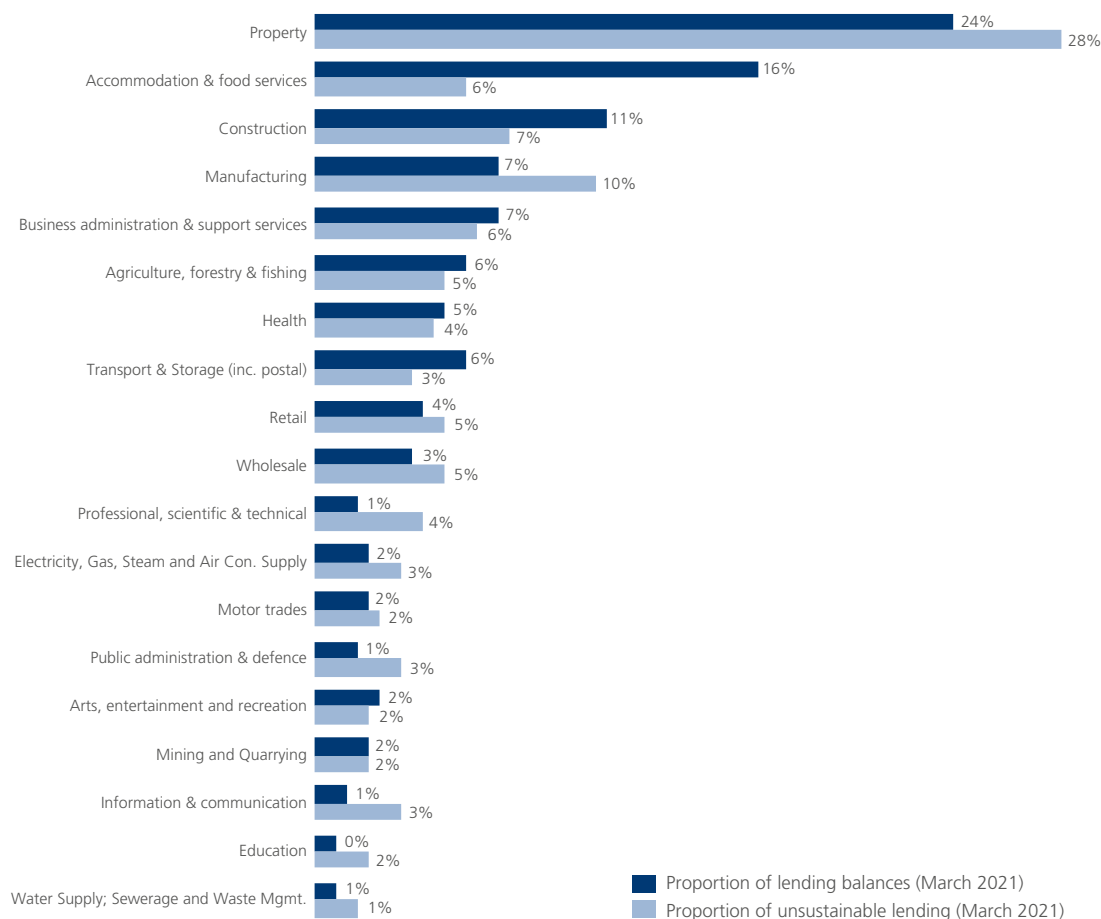
Projections for macroeconomic aggregates					
	2020 Q1	2020 Q2	2020 Q3	2020 Q4	2021 Q1
GDP (2019 Q4 = 100) used for Revenue Shock	98.0	80.0	82.6	87.0	90.4
Unemployment rate (ILO)	3.9%	7.0%	7.7%	6.8%	6.1%
Bank rate (period average)	0.6%	0.1%	0.1%	0.1%	0.2%

Projections for sector groups, GVA at 2021 Q1 (where Q4 2019 = 100)			
Agriculture, Forestry and Fishing	99.5	Financial and Insurance Activities	96.7
Mining and Quarrying	85.9	Real Estate Activities	93.3
Manufacturing	91.9	Professional, Scientific and Technical Activities	98.8
Electricity, Gas, Steam, and Air Conditioning Supply	91.9	Administrative and Support Service Activities	89.7
Water Supply; Sewerage, Waste Management and Remediation Activities	94.0	Public Administration and Deference; Compulsory Social Security	96.3
Construction	87.4	Education	84.5
Wholesale and Retail Trade; Repair of Motor Vehicles and Motorcycles	89.3	Human Health and Social Work Activities	94.3
Transportation and Storage	80.3	Arts, Entertainment and Recreation	88.6
Accommodation and Food Services Activities	63.7	Other Service Activities	80.1
Information and Communication	98.2		

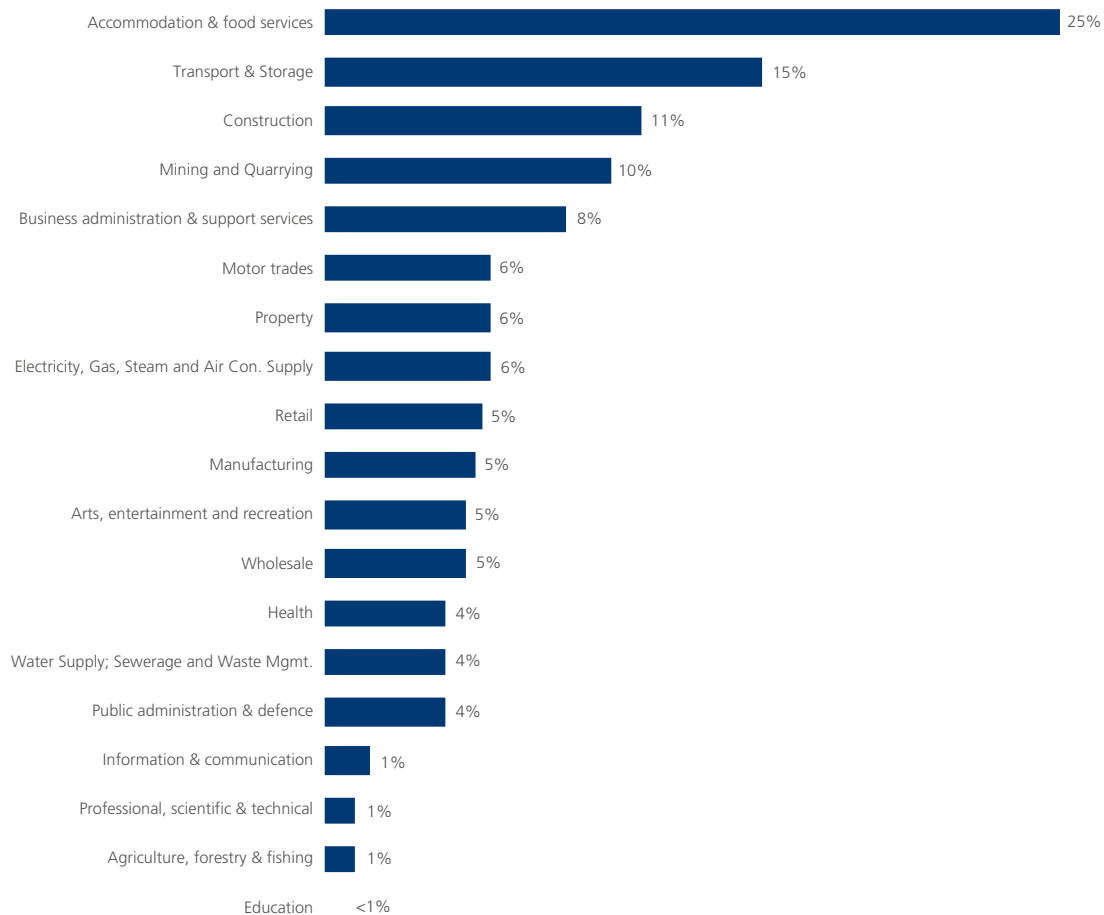
## Supplementary analysis: Estimates of unsustainable debt by sector

403. Our analysis indicates that the sectors most likely to experience higher levels of unsustainable debt are those with higher initial levels of borrowing which also suffer from larger net shocks on revenues resulting from the Covid-19 pandemic.
404. We estimate that the top three sectors which could be affected by unsustainable loans are 1) property, 2) accommodation and food services and 3) construction which collectively comprise c.50% of total volumes. These sectors also comprise c.40% of total estimated lending balances (with the property sector alone accounting for c.28%).
405. Sector net shocks as a consequence of the Covid-19 pandemic have been projected based on a forecast change in revenues by end of Q121 (vs. a Q419 reference period) and estimates of potential offsets arising from operational cost reductions and supportive policy measures (which are expected to conclude after the forecast period). We estimate the top three impacted sectors to comprise accommodation and food services, transport and storage, and construction which range in impact between 11-25%.
406. It should be noted that estimates of lending volumes and unsustainable debt volumes outlined in this report are as per the RCG's Interim Reported (dated 8 June 2020) and reflect economic assumptions as of early June 2020 (based on EY ITEM Club) and utilisation of Government lending schemes as of 24 May 2020.

**Figure 29:** Estimated proportion of total unsustainable debt and total lending balances by sector, March 2021, %<sup>61</sup>



<sup>61</sup> Estimated proportions of unsustainable lending (or lending balance) represent each sectors proportion as a percentage of the total.

**Figure 30:** Estimated net shock on revenues by sector, % (Q121 vs. Q419)<sup>62</sup>

### Supplementary analysis: Evaluation of interest coverage ratios by sector

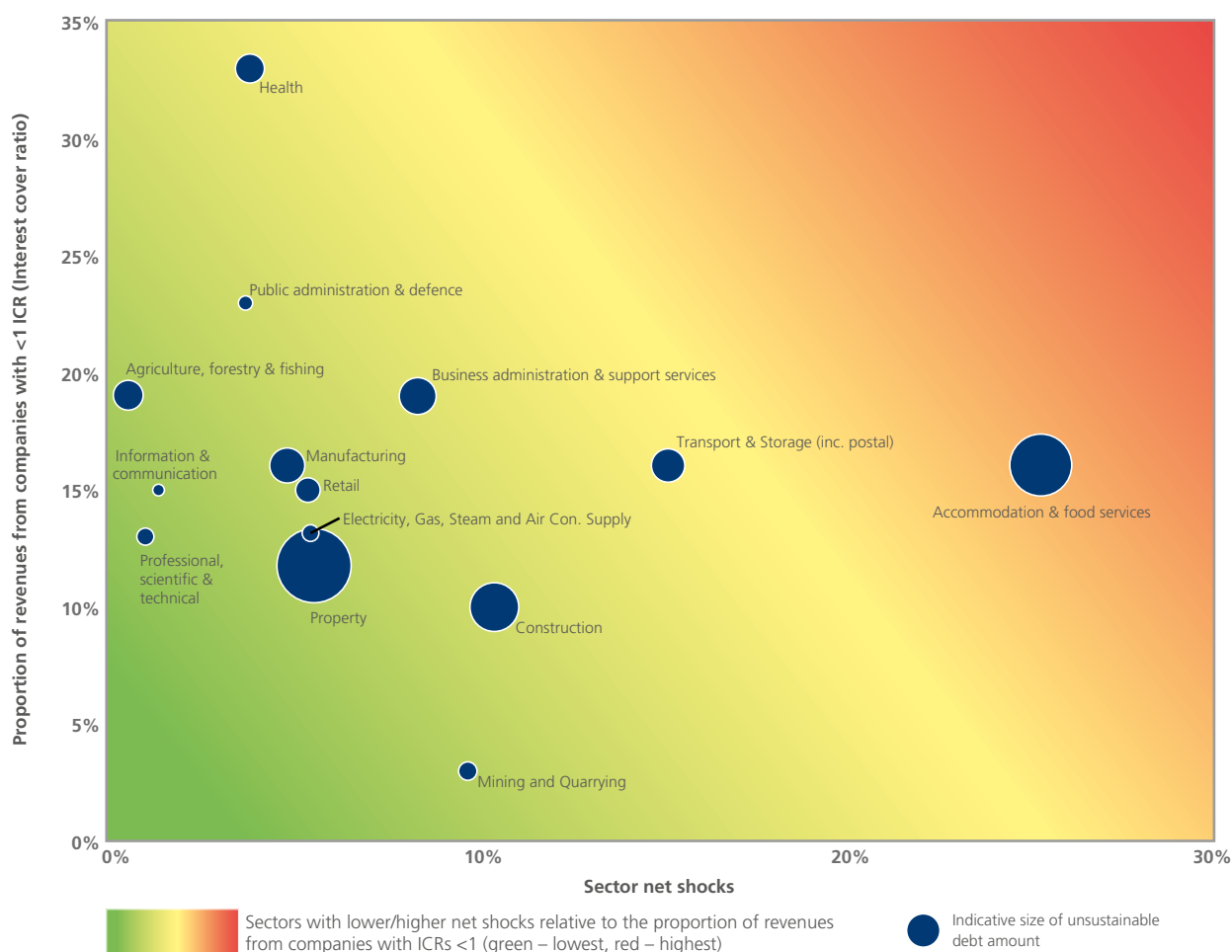
407. Sectors' ability to absorb net shocks on revenues in the near-term (as defined as revenue downturn partially mitigated by cost reductions and policy measures – the x axis in Figure 31) arising from the Covid-19 pandemic will in part be influenced by their ability to cover their existing financing costs.
408. As an indicator of a sector's ability to absorb these net shocks, we assess the proportion of each sectors' revenues deriving from companies with limited means to meet their financing costs (i.e. companies with Interest Coverage Ratios (ICR) of < 1; the y axis in Figure 31).<sup>63</sup>
409. Based on these metrics, accommodation and food services, transport and storage, construction and business admin and support service sectors all appear to represent sectors facing both higher net shocks (sectors where turnover shocks less offsets range between c.10-25%) and a lesser ability to immediately absorb these shocks (sectors where over 10% of revenue is derived from companies with an ICR <1).

<sup>62</sup> Sector net shocks on revenues based on forecast change in sector revenues, and estimates of operational cost reductions and policy off-sets.

<sup>63</sup> Interest coverage ratio is defined as earnings before interest and tax as a share of interest paid and interest capitalised; ICR less than 1 includes those companies that are unprofitable and have interest expenses; interest capitalised is only available for listed companies.

**Figure 31:** Heat-map of estimated sector net shocks vs. proportion of sector revenues from companies with Interest Coverage Ratios (ICR) < 1 (%)<sup>64, 65</sup>

Source: EY Analysis; Bureau van Dijk; S&P Capital IQ



**Detailed analysis: Estimated composition of unsustainable debt across regions**

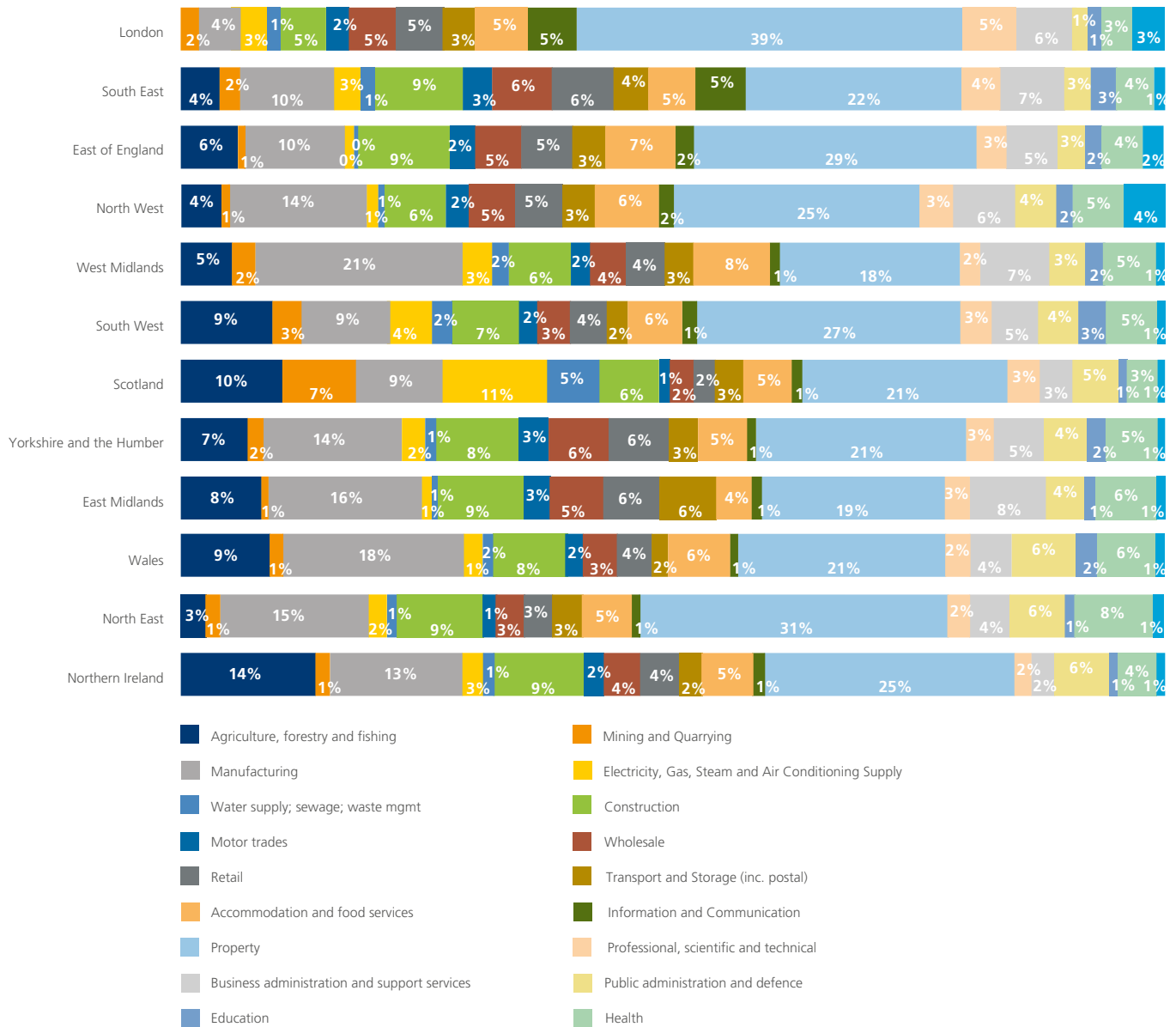
- 410. Estimates of unsustainable debt across regions have been based on each region’s revenue composition across sectors and a high-level consideration of how economic shocks and potential offsets (e.g. operational cost reductions and supportive policy measures) could affect each region.
- 411. The below figures outline our estimates of sectoral composition for both unsustainable debt and total lending that could arise across each region by the end of March 2021.

64 Interest coverage ratio is defined as earnings before interest and tax as a share of interest paid and interest capitalised; ICR less than 1 includes those companies that are unprofitable and have interest expenses; interest capitalised is only available for listed companies.

65 Sector net shocks based on forecast change in sector revenues (forecast change in revenue by Q2/21 vs. a Q4/19 reference period) and estimates of operational cost reductions and policy off-sets.

**Figure 32:** Indicative estimates of sectoral composition of total lending by region, March 2021, %<sup>66</sup>

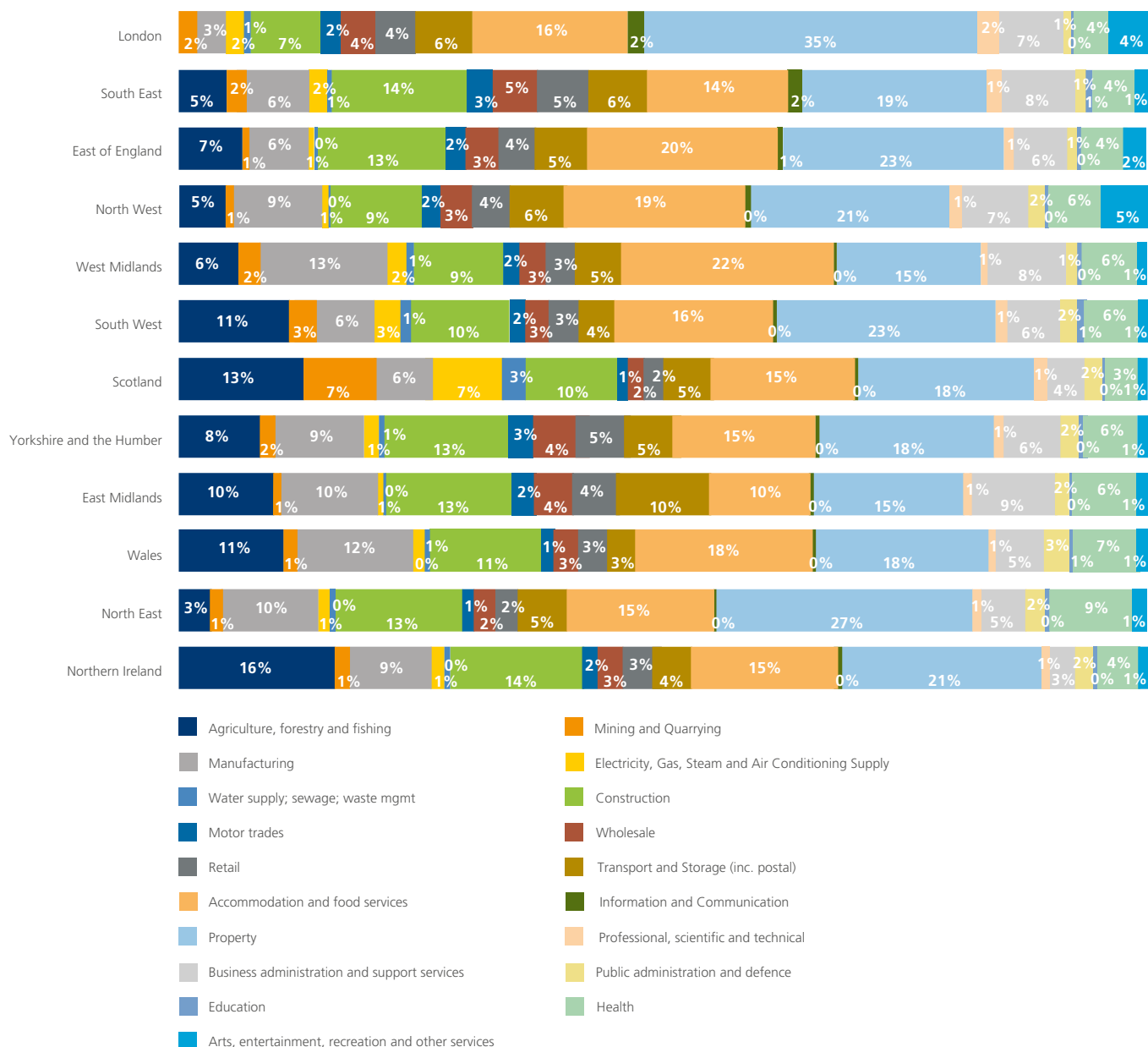
Source: EY Analysis; HM Treasury; ONS; BoE



66 Indicative estimates of regional lending volumes approximated from available data on composition of sectoral revenues across regions per ONS (start of 2019). Relative proportions of sector revenues across regions assumed indicative of distribution of sector lending volumes across regions.

**Figure 33:** Indicative estimates of sectoral composition of unsustainable debt by region, March 2021, %<sup>67</sup>

Source: EY Analysis; HM Treasury; ONS; BoE



67 Indicative estimates of unsustainable debt across regions based on assumed regional lending volumes as of March '21. Assumed regional lending volumes approximated from available data on composition of sectoral revenues across regions per ONS (start of 2019).

## APPENDIX B: OPTIONS: INDICATIVE SCHEME TERM SHEETS

### Business Repayment Plan

#### Evaluation of BRP from key technical perspectives

412. In developing our options, we have consulted with a wide-ranging group of technical experts who have assessed the key technical considerations for the BRP and which are summarised below.

#### Legal & State Aid considerations

413. Primary legislation will be needed to implement the scheme quickly and successfully and appropriately manage several important consequential considerations e.g. solvency tests and UK GAAP in relation to the BRP, and how restrictions are imposed as a result of the classification of the instrument as a tax obligation rather than as a contractual instrument.

414. The instrument as designed should fall within the State Aid de-minimis threshold and hence not trigger the need for State Aid clearance by the European Commission.

#### Accounting & regulatory considerations

415. From an accounting perspective, UK SMEs tend to adopt UK GAAP. Different considerations apply for IFRS borrowers. The proposals envisage the primary legislation creating the BRP being clear that the BRP will not be treated as liabilities until the trigger conditions for payment arise, like corporation or income tax.

416. If profit is considered to be the suitable trigger event, an assessment should be undertaken to ensure that the profit has been considered in an appropriate manner, given a lot of companies with BBLs are able to get an audit exemption.

417. The capital and regulatory treatment of any instrument that would be issued back to the lender to reflect their 20% retained interest in converted CBILs loans, would need to be agreed by relevant regulatory bodies.

#### Conduct considerations

418. As noted previously, there are multiple conduct related issues that must be considered across all schemes being presented. Specifically, for the BRP, care must be taken for the application to SMEs to ensure communication is clear, choice is deemed fair and borrowers should be encouraged to take advice. Consideration must also be given to what impact triggering the BRP would have on credit data.

#### Tax considerations

419. From a legal perspective, there is sufficient flexibility under current law such that the BRP can be a tax or a levy, notwithstanding that it may not fulfil the typical criteria for these. For example, if there is a preference or requirement for the BRP to be a levy for accounting purposes, this should be feasible from a legal perspective by designating it as such under statute.

420. Any conversion mechanics would require legislation (either on principles basis or prescriptive basis) to ensure neutrality for borrower entities. However, in order to avoid complexity, scope for avoidance, risks to the revenue stream and other legitimate objections, the BRP rules should be ring-fenced. Anti-avoidance measures and restrictions may need to be widely drawn, and consideration should be given to loss eligibility if dividends/bonuses/shareholder loans are repaid post the Covid crisis but pre-conversion to a BRP.



421. Where the borrower's business sits within a wider group structure, consideration must be given as to where liabilities sit within a group. For example, the underlying borrowing might have been at an operating subsidiary level, but what might be repayable by that company might not be at a parent company level, because of underperforming sister companies. Moreover, it may well only be the group holding company that offers any particular clarity as to its potential tax liability.

#### 422. Illustrative term sheet: BRP

	Details
<b>Market segmentation: eligibility requirement</b>	<ul style="list-style-type: none"> <li>Available to:               <ul style="list-style-type: none"> <li>BBLs borrowers, OR CBILs borrowers with borrowings up to £[250,000] (including costs of conversion), and</li> <li>Borrowers with a UK tax code.</li> </ul> </li> </ul>
<b>Trigger event</b>	<p><b>Trigger event:</b> Conversion is triggered by:</p> <ul style="list-style-type: none"> <li>Application to the relevant lender by the Borrower</li> <li>AND</li> <li>Request by the relevant lender following a Potential Default Conclusion (as defined below).</li> </ul> <p><i>Potential Default Conclusion</i> means the conclusion reached by the relevant lender, based on a simple assessment carried out by it using its Internal Watchlist / Monitoring Process at the relevant time, that it is reasonably likely that in the medium or long term the borrower may not be able to service the BBLs/CBILs debt, or other appropriate high-level test to protect Government to be included.</p>
<b>Conversion process</b>	<ul style="list-style-type: none"> <li>Gross amount of BBLs loan and CBILs loan converts in full to BRP with a value equivalent to the gross amount outstanding under the relevant loan.</li> <li>Only full conversion of BBLs/CBILs loans up to £[250,000] permitted (i.e. no partial conversion).</li> <li>Completion of the conversion process requires consent of both the borrower and the relevant lender (as per Trigger event above), but either the borrower or the relevant lender can initiate the process.</li> <li>BBLs/CBILs debt to be converted will be written-off on conversion into BRP.</li> </ul>
<b>Treatment of lender's guaranteed portion</b>	<ul style="list-style-type: none"> <li>Relevant lender paid out in full for guaranteed portion of the loan (i.e. 100% for BBLs, 80% for CBILs).</li> <li>Whole BBLs/CBILs loan written-off, with a BRP being entered into with the borrower in favour of Government.</li> <li>Government subrogated to lender's entitlement with respect to guaranteed portion of the loan.</li> </ul>
<b>Treatment of lender's portion not guaranteed</b>	<ul style="list-style-type: none"> <li>Relevant lender's portion of CBILs written-off as part of whole as described above and Government undertakes to pay amounts to the relevant lender equal to 20% of the proceeds of the BRP as and when and to the extent received by Government.</li> <li>Government could have an option to acquire for fair market value the lender's right to 20% of BRP proceeds.</li> </ul>
<b>Legal status</b>	<ul style="list-style-type: none"> <li>BRP is a tax obligation under primary legislation – specifically not a capital instrument on the borrower's balance sheet.</li> <li>BBLs/CBILs debt will be written-off on conversion into BRP.</li> <li>BRP has no positive / negative value on the borrower's balance sheet and repayment is contingent on future profits chargeable to tax in respect of the borrower (and where applicable, its subsidiary undertakings), and such profits chargeable to tax will rank <i>pari passu</i>, but otherwise would not be proveable in insolvency.</li> <li>Any third party consent requirement and cross-default are overridden by primary legislation.</li> </ul>
<b>Ranking</b>	<ul style="list-style-type: none"> <li>Obligations under BRP to rank in the same manner as a tax liability and <i>pari passu</i> with any obligations to pay tax.</li> </ul>
<b>Duration</b>	<ul style="list-style-type: none"> <li>Perpetual – liability continues until BRP is paid off or the company / business is liquidated / dissolved.</li> </ul>

<p><b>Interest rate</b></p>	<ul style="list-style-type: none"> <li>• Post conversion and only in relation to the 20% of non-guaranteed borrowing under CBILS, interest continues to be paid during the Business Interruption Payment period (the BIP Period), being the first 12 month period of the CBILS loan, during which the Government is contracted to pay the BIP to cover the interest payments and any lender-levied charges in that period</li> <li>• Note it is assumed for now that HMG will not want to continue the mechanics of paying the BIP in relation to the BBLs and portion of CBILS held by HMG post-conversion</li> <li>• Both BBLs and CBILS borrowers therefore pay no interest themselves for the duration of the BIP Period</li> <li>• [ ] for the first year following the expiry of the BIP Period, which rate would then:             <ul style="list-style-type: none"> <li>- On each subsequent anniversary for four years, increase by [ ]%, such that for the second year following expiry of the BIP Period, the interest rate will be [ ]%, third year [ ]%, fourth year [ ]% and the fifth year [ ]%</li> <li>- From sixth year following expiry of the BIP Period and on each subsequent anniversary, increase by [ ]%, such that for sixth year following expiry of the BIP Period the interest rate will be [ ]%, seventh year [ ]%, eighth year [ ]%, ninth year [ ]% and tenth year [ ]%</li> </ul> </li> </ul>
<p><b>Repayment / redemption</b></p>	<ul style="list-style-type: none"> <li>• Repayable alongside tax – calculated as a tax surcharge or levy on the profits chargeable to tax in respect of the borrower (and where applicable, its subsidiary undertakings)</li> <li>• Repayable in annual amounts to [10-25%] of yearly profits chargeable to tax in respect of the borrower (and where applicable, its subsidiary undertakings)</li> <li>• Option available to the borrower at all times to repay in full, overpay or accelerate payments</li> <li>• Failure to pay repayments when due ranks alongside and is treated in the same way as failure to pay corporate taxes</li> </ul>
<p><b>Transferability</b></p>	<ul style="list-style-type: none"> <li>• Economic benefit of BRP can be assigned / transferred to third parties by HMG as required without borrower's consent</li> </ul>
<p><b>Conditions on the beneficiary</b></p>	<ul style="list-style-type: none"> <li>• No dividends, shareholder loan payments, buybacks or other capital distributions permitted until the CBRP is fully repaid</li> <li>• Targeted salary restrictions for existing equity owners and for certain executives / senior staff members and their connected person until the BRP is fully repaid</li> <li>• Any share capital of the borrower cannot be transferred or otherwise disposed of to any third party, other than: a) on death of the shareholder (right to interest will pass to whoever inherits under a will or intestacy); b) foreclosure by an independent secured lender enforcing its security until fully repaid; c) with the prior consent of the relevant BRP manager, whose consent shall be based on certain specific parameters (to be defined)</li> <li>• Any transaction designed to avoid payment in respect of the BRP shall be prohibited. The borrower cannot transfer all or substantially all of the assets / property of the business to extract value for the shareholders / managers</li> <li>• The conditions set out above shall apply to the borrower and as appropriate, its subsidiary undertakings</li> </ul>

## Business Recovery Capital

### Evaluation of BRC from key technical perspectives:

423. In developing our options, we have consulted with a wide-ranging group of technical experts who have assessed the key technical considerations for the BRC and which are summarised below:

#### Legal & State Aid considerations

424. Under State Aid rules and the existing Temporary Framework, loans with amounts outstanding of less than £1,000,000 would not trigger additional conditions and obligations under the State Aid rules, which is expected to capture the vast number of borrowers. For borrowers with loans over £1,000,000, a combination of the BRC preference shares and BRC loan would mean that that additional State Aid conditions and obligations would not be triggered, provided the BRC loan does not exceed certain thresholds, although European Commission State Aid clearance would be required for such BRC loans.
425. There is potential for a requirement for corporate approvals to be sought by the borrower which may impact third party rights. This can be addressed through primary legislation.

#### Conduct considerations

426. As noted previously, there are multiple conduct-related issues that must be considered across all schemes being presented. Specifically, for the BRC, care must be taken to ensure borrower understanding of the implications of the full extent of proposed restrictions on dividends, remuneration etc.

#### Tax considerations

427. Current debt and equity conversion tax rules are significantly complex and would need to be made easily understandable for borrowers. There are also currently restrictions on tax deductions for interest / dividend on preference shares, however primary legislation could address this.
428. Further development of appropriate anti-avoidance and fraud protection measures should be widely drawn, and should be catered for in primary legislation.
429. It is noted that recapitalisation may form part of wider restructuring transactions undertaken by businesses. These tend to be bespoke transactions, and given the complexity of the tax system are known to raise a host of technical tax hurdles. Therefore, consideration may need to be given to legislating for wider tax neutral restructuring in the context of the current crisis, on a principles based approach or otherwise.
430. Further, specific primary legislation is likely to be required from a tax perspective to cover the following:
- i. An exemption from Stamp Duty on transfers of preference shares.
  - ii. Deeming the preference shares to continue to be treated for all tax purposes as if they represent the original debt. irrespective of the fact that conversion has taken place.
  - iii. A principal based exemption, to ensure tax neutrality of the conversion, holding and transfer of preference shares.
  - iv. To avoid the risk of impacting group analysis, the exemption of the conversion and holding of the preference shares for the purposes of all such grouping, related, close company and control relationships/tests.
  - v. Exemption from any tax charge arising on conversion of the CBILS loan to the BRC instrument.

## 431. Illustrative term sheet: BRC - Preference shares

	Details
<b>Market segmentation: eligibility requirement</b>	<ul style="list-style-type: none"> <li>Available to: <ul style="list-style-type: none"> <li>CBILS borrowers with borrowings over £[250,000] and up to a maximum amount of £[1,000,000], and</li> <li>UK company limited by shares</li> </ul> </li> </ul>
<b>Trigger event</b>	<p><b>Trigger event:</b> Conversion is triggered by:</p> <ul style="list-style-type: none"> <li>Application to the relevant lender by the Borrower</li> </ul> <p>AND</p> <ul style="list-style-type: none"> <li>Request by the relevant lender following a Potential Default Conclusion (as defined below)</li> </ul> <p><i>Potential Default Conclusion</i> means the conclusion reached by the relevant lender, based on a simple assessment carried out by it using its Internal Watchlist / Monitoring Process at the relevant time, that it is reasonably likely that in the medium or long term the borrower may not be able to service the CBILS debt, or other appropriate high-level test to protect Government to be included.</p>
<b>Conversion process</b>	<ul style="list-style-type: none"> <li>CBILS loan capitalised in full as Preference shares with an aggregate par/redemption value equivalent to the gross amount outstanding under the CBILS loan</li> </ul>
<b>Treatment of lender's guaranteed portion</b>	<ul style="list-style-type: none"> <li>Relevant lender paid out in full for guaranteed portion of the loan (i.e. 80% for CBILS)</li> <li>Government subrogated to lender's entitlement with respect to receive 80% of the Preference shares</li> </ul>
<b>Treatment of lender's portion not guaranteed</b>	<ul style="list-style-type: none"> <li>Relevant lender receives Preference shares in respect of its 20% portion which will rank pari passu with the Government's Preference shares</li> <li>Government could have an option to acquire lender stake for fair market value</li> </ul>
<b>Legal status &amp; voting rights</b>	<ul style="list-style-type: none"> <li>Preference share capital (but accounted for as debt absent change of accounting practice/law)</li> <li>Non-voting except as regards variation of class rights</li> </ul>
<b>Ranking</b>	<ul style="list-style-type: none"> <li>Ahead of all issued and to be issued ordinary and preference/preferred share capital, likely ahead of shareholder loans and behind all other debt</li> </ul>
<b>Duration</b>	<ul style="list-style-type: none"> <li>[Fixed: [eight to 10] years]</li> </ul>
<b>Interest rate</b>	<ul style="list-style-type: none"> <li>Post conversion and only in relation to the 20% of non-guaranteed borrowing under CBILS, interest continues to be paid during the Business Interruption Payment period (the BIP Period), being the first 12 month period of the CBILS loan, during which the Government is contracted to pay the BIP to cover the interest payments and any lender-levied charges in that period</li> <li>Note it is assumed for now that HMG will not want to continue the mechanics of paying the BIP in relation to the portion of CBILS held by HMG post-conversion</li> <li>CBILS borrowers therefore pay no interest themselves for the duration of the BIP Period</li> <li>[ ]% for the first year following the expiry of the BIP Period, which rate would then: <ul style="list-style-type: none"> <li>On each subsequent anniversary for four years, increase by [ ]%, such that for the second year following expiry of the BIP Period, the interest rate will be [ ]%, third year [ ]%, fourth year [ ]% and the fifth year [ ]%</li> <li>From sixth year following expiry of the BIP Period and on each subsequent anniversary, increase by [ ]%, such that for sixth year following expiry of the BIP Period the interest rate will be [ ]%, seventh year [ ]%, eighth year [ ]%, ninth year [ ]% and tenth year [ ]%</li> </ul> </li> <li>Beneficiary may elect to PIK during first [2] years</li> </ul>
<b>Repayment / redemption</b>	<ul style="list-style-type: none"> <li>Redemption at par (equivalent to amount of CBILS loan capitalised) plus accumulated and unpaid coupon</li> <li>Limited recourse to net assets/assets available after repayment or allowance for all other liabilities</li> <li>At the option of issuer and mandatorily by way of balloon payment upon expiry of term</li> <li>At option of holder following breach of certain restrictions.</li> </ul>
<b>Transferability</b>	<ul style="list-style-type: none"> <li>Transferable without issuer consent, but attracts stamp duty</li> </ul>

<b>Conditions on the beneficiary</b>	<ul style="list-style-type: none"> <li>• Restrictions on payments of dividends, non-mandatory coupons and share buy-backs [and restrictions on remuneration of management]</li> <li>• [Further anti-avoidance and fraud protections to be developed]</li> <li>• The conditions set out above shall apply to the borrower and as appropriate, its subsidiary undertakings</li> </ul>
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### 432. Illustrative term sheet: BRC – Subordinated debt

	Details
<b>Market segmentation: eligibility requirement</b>	<ul style="list-style-type: none"> <li>• Available to: <ul style="list-style-type: none"> <li>- CBILS borrowers with borrowings over £[250,000] and up to a maximum amount of £[1,000,000], and</li> <li>- All borrower types</li> </ul> </li> </ul>
<b>Trigger event</b>	<p><b>Trigger event:</b> Conversion is triggered by:</p> <ul style="list-style-type: none"> <li>• Application to the relevant lender by the Borrower</li> </ul> <p>AND</p> <ul style="list-style-type: none"> <li>• Request by the relevant lender following a Potential Default Conclusion (as defined below)</li> </ul> <p><i>Potential Default Conclusion</i> means the conclusion reached by the relevant lender, based on a simple assessment carried out by it using its Internal Watchlist / Monitoring Process at the relevant time, that it is reasonably likely that in the medium or long term the borrower may not be able to service the CBILS debt, or other appropriate high-level test to protect Government to be included.</p>
<b>Conversion process</b>	<ul style="list-style-type: none"> <li>• CBILS loan agreement varied/amended and restated on prescribed terms</li> </ul>
<b>Treatment of lender's guaranteed portion</b>	<ul style="list-style-type: none"> <li>• Relevant lender paid out in full for guaranteed portion of the loan (i.e. 80% for CBILS)</li> <li>• Government subrogated to lender's entitlement with respect to receive 80% of the subordinated loan and accedes to the varied/amended and restated loan agreement</li> </ul>
<b>Treatment of lender's portion not guaranteed</b>	<ul style="list-style-type: none"> <li>• Relevant lender continues to hold 20% of loan on new subordinated terms pari passu with the Government</li> <li>• Government could have an option to acquire lender stake for fair market value</li> </ul>
<b>Legal status</b>	<ul style="list-style-type: none"> <li>• Debt (but PIK and limited recourse features as noted below)</li> </ul>
<b>Ranking</b>	<ul style="list-style-type: none"> <li>• Ahead of all issued and to be issued ordinary and preference/preferred share capital, likely ahead of shareholder loans and behind all other debt</li> </ul>
<b>Duration</b>	<ul style="list-style-type: none"> <li>• [Fixed: [eight to ten] years]</li> </ul>
<b>Interest rate</b>	<ul style="list-style-type: none"> <li>• Post conversion and only in relation to the 20% of non-guaranteed borrowing under CBILS, interest continues to be paid during the Business Interruption Payment period (the BIP Period), being the first 12 month period of the CBILS loan, during which the Government is contracted to pay the BIP to cover the interest payments and any lender-levied charges in that period</li> <li>• Note it is assumed for now that HMG will not want to continue the mechanics of paying the BIP in relation to the portion of CBILS held by HMG post-conversion</li> <li>• CBILS borrowers therefore pay no interest themselves for the duration of the BIP Period</li> <li>• [ ]% for the first year following the expiry of the BIP Period, which rate would then: <ul style="list-style-type: none"> <li>- On each subsequent anniversary for four years, increase by [ ]%, such that for the second year following expiry of the BIP Period, the interest rate will be [ ]%, third year [ ]%, fourth year [ ]% and the fifth year [ ]%</li> <li>- From sixth year following expiry of the BIP Period and on each subsequent anniversary, increase by [ ]%, such that for sixth year following expiry of the BIP Period the interest rate will be [ ]%, seventh year [ ]%, eighth year [ ]%, ninth year [ ]% and tenth year [ ]%</li> </ul> </li> <li>• Beneficiary may elect to PIK during first [2] years.</li> </ul>

<b>Repayment / redemption</b>	<ul style="list-style-type: none"> <li>• Redemption at par (equivalent to amount of CBILS loan capitalised) plus accumulated and unpaid coupon</li> <li>• Limited recourse to net assets/assets available after repayment or allowance for all other liabilities</li> <li>• At option of borrower and mandatorily by way of balloon payment upon expiry of term</li> <li>• At option of lender following event of default</li> </ul>
<b>Transferability</b>	<ul style="list-style-type: none"> <li>• Transferable without borrower consent</li> </ul>
<b>Conditions on the beneficiary</b>	<ul style="list-style-type: none"> <li>• Restrictions on payments of dividends, non-mandatory coupons and share buy-backs [and restrictions on remuneration of management]</li> <li>• [Further anti-avoidance and fraud protections to be developed]</li> <li>• The conditions set out above shall apply to the borrower and as appropriate, its subsidiary undertakings</li> </ul>

### Indicative term sheets for restructuring scheme

433. The Restructuring-Led Recapitalisation Solution envisaged in this Term Sheet requires the consent of the Debtor, each CBILS/BBLs Lender and the UK Government.

434. We envisage the participation any Third-Party Financial Creditor should also be required in order that their debt is treated in the same way as scheme debt, thereby avoiding the so-called free-rider problem.

Parties	
<b>Debtor</b>	SME borrowers under the CBILS or BBLs
<b>CBILS/BBLs Lender</b>	<p>Lenders under CBILS or BBLs, whether secured or unsecured and whether or not the CBILS/BBLs facility (each a Facility) benefits from a (non-Government) guarantee</p> <p><b>Operating assumption:</b> Each accredited lender under CBILS and BBLs, and the UK Government, would need to sign up to the terms of the Restructuring-Led Recapitalisation Solution, agreeing changes to the standard form legal agreement (including guarantee) between the UK Government and each accredited lender</p> <p><b>Feasibility:</b></p> <ul style="list-style-type: none"> <li>• We note that BBLs loans are 100%-Government-backed, whilst CBILS loans are 80% Government-backed</li> <li>• Accordingly, it ought to be more straightforward to obtain the consent of BBLs lenders to the Restructuring-Led Recapitalisation Solution</li> <li>• Obtaining consent of CBILS lenders (who are at risk on the 20% stub not guaranteed by the Government) may be more challenging, and may in practice necessitate amending terms of CBIL guarantee</li> </ul>
<b>Third-Party Financial Creditor (where relevant)</b>	<ul style="list-style-type: none"> <li>• Any third-party financial creditor (TPFC) of the debtor</li> <li>• Excludes non-financial institutions</li> <li>• <b>Operating assumption:</b> Debtor's directors to inform the TPFC(s) of the Debtor's plan to pursue the Restructuring-Led Recapitalisation Solution and (if pursuing Options 1 or 2) seek the TPFC's consent to its terms.<sup>68</sup> If the TPFC does not consent, the Restructuring-Led Recapitalisation Solution will not proceed</li> </ul>
Overview of Recapitalisation Options - at Debtor's election (subject to eligibility)	
<b>Option 1: Extension</b>	Extension, with commensurate reduction in monthly repayments
<b>Option 2: Capital repayment deferral</b>	Capital repayment deferral (the <b>Deferral</b> ) for a period of six months (the <b>Deferral Period</b> )

68 It is unlikely that Option A would require the TPFC's consent, but directors should be encouraged to check their agreement with the TPFC.

Option 1: Extension	
<b>Availability period</b>	<ul style="list-style-type: none"> <li>• A Debtor may, by delivering a duly completed request (an Extension Request) to the relevant CBILS/BBLS Lender at any time within the period commencing six months after the first principal repayment of the relevant Facility and ending on the last day of the original maturity period of the relevant Facility (the Final Maturity Date) request an extension to the Final Maturity Date (an Extension) of all or part of the amount outstanding under the Facility as at the date of the Extension Request (the Outstanding Amount and the amount which is the subject of the Extension Request being the Extension Amount).</li> <li>• An Extension shall be limited to twice the length of time remaining from the date of the Extension Request to the Final Maturity Date.</li> </ul>
<b>Evidence of Debtor's financial condition</b>	<p>Each Extension Request shall be accompanied by:</p> <p>a cashflow forecast from the relevant Debtor reviewed and approved by a qualified accountant (a Cashflow Forecast);</p> <p>a certificate (the Confirmation Certificate) comprising a sworn statement from the directors that:</p> <ol style="list-style-type: none"> <li>the Cashflow Forecast was produced after careful consideration and has been prepared in good faith on the basis of recent historical information and on the basis of assumptions which were reasonable as at the date on which the Cashflow Forecast was prepared;</li> <li>the Debtor has encountered, or is likely to encounter, financial difficulties that are affecting, or will or may affect, its ability to carry on business as a going concern;</li> <li>the purpose of the proposed action is to eliminate, reduce, prevent, or mitigate the effect of, any such financial difficulties,</li> </ol> <p>((i) - (iii) together, the Relevant Confirmations), and, in addition:</p> <ol style="list-style-type: none"> <li>the Debtor has paid all capital repayments falling due under the relevant Facility in the first six months on time; and</li> </ol> <p>c) if the original amount of the relevant Facility was equal to or greater than £750,000, a statement from an independent and certified accounting / finance professional reviewing and commenting on the Cashflow Forecast (the Cashflow Review).</p>
<b>Trigger</b>	Delivery of a duly completed Extension Request with a Cashflow Forecast, Confirmation Certificate and, if necessary, Cashflow Review. The Extension shall take effect five Business Days after the date of the Extension Request (the Extension Date).
<b>Key terms</b>	<ul style="list-style-type: none"> <li>• Interest on the Extension Amount to accrue at [ ] (and be otherwise payable on the same terms) as prior to the Extension Request.</li> <li>• Each guarantor and security provider (if different) to provide standard guarantee/security confirmation of their agreement to the Extension.</li> <li>• With effect from the Extension Date, each subsequent amortisation payment shall be reduced on a pro rata basis to reflect the Extension.</li> <li>• Until the Outstanding Amount is less than 50% of the original amount lent under the relevant Facility:             <ol style="list-style-type: none"> <li>the aggregate of (i) any increases in the amounts paid to directors and (ii) dividend payments, shall not exceed an amount equal to three times the percentage increase in tax paid (when compared to the most recent financial year of the Debtor ending on or before 1 March 2020) with a cap of 30%.</li> <li>no payments to directors or shareholders (including, without limitation, in respect of loans, bonuses or dividends) are permitted.</li> </ol> </li> <li>• All other terms of the Facility shall continue to apply during the Extension.</li> </ul>
<b>Conditions precedent</b>	[Appropriate conditions to be developed]
<b>Third Party Financial Creditor</b>	<ul style="list-style-type: none"> <li>• Equivalent extension of TPFC unsecured debt: absent specific legislation, requires consent of the TPFC; or</li> <li>• CBILS converts to preferential status: likely to require consent of the TPFC; consent especially unlikely to be granted/appropriate where the TPFC is secured</li> <li>• Prohibition on voluntary repayments of TPFC debt (only scheduled payments permitted)</li> </ul>
<b>Documentation required</b>	Extension Request, Cashflow Forecast, Confirmation Certificate and, if applicable, Cashflow Review Guarantee / security confirmations

Option 2: Capital repayment deferral	
<b>Availability period</b>	As per Option 1, only one Deferral Period is permitted in respect of each Facility.
<b>Evidence of Debtor's financial condition</b>	A Confirmation Certificate comprising a Cashflow Forecast and the sworn Relevant Confirmations from the directors, and if the original amount of the relevant Facility was equal to or greater than GBP750,000, the Cashflow Review.
<b>Trigger</b>	Deferral notice provided by the Debtor to the relevant CBILS/BBLs Lender not less than [30] days prior to the start of the proposed Deferral Period
<b>Key terms</b>	<ul style="list-style-type: none"> <li>• Deferral of any principal amount due to be repaid within the Deferral Period (the Deferred Amount) with the Deferred Amount added to the amount payable on the Final Maturity Date of the relevant Facility / split between each subsequent principal repayment so that the amount of each subsequent principal repayment is increased on a pro rata basis.</li> <li>• Interest on the Deferred Amount to be paid in accordance with the terms of the relevant Facility during the Deferral Period.</li> <li>• During the Deferral Period, the aggregate of (i) any increases in the amounts paid to directors and (ii) dividend payments shall not exceed an amount equal to two times the percentage increase in tax paid (when compared to the most recent financial year of the Debtor ending on or before 1st March 2020) with a cap of 20%.</li> <li>• During the Deferral Period and for the period of six months after the end of the Deferral Period (or, if longer, for as long as there are interest and/or capital repayments under the relevant Facility outstanding), payments to directors to be limited to ordinary course salary entitlements and no other payments to directors or shareholders including, without limitation, in respect of loans, bonuses or dividends.</li> </ul>
<b>Conditions precedent</b>	Automatic other than delivery of requisite documentation (see below). <sup>69</sup>
<b>Third Party Financial Creditor</b>	Informed, but no requirement for consent <sup>70</sup>
<b>Documentation required</b>	Deferral notice, Cashflow Forecast, Confirmation Certificate and, if applicable, Cashflow Review

<sup>69</sup> Note that this is on the basis of the Operating Assumption above.

<sup>70</sup> Note that this is on the basis of the Operating Assumption above.



## APPENDIX C: RELEVANT POLICY CONSIDERATIONS ACROSS FUND STRUCTURE OPTIONS

OPTIONS FOR FUND STRUCTURES: MAPPING OF RELEVANT POLICY CONSIDERATIONS					
	Types of fund structures				
	Private Funds (PF)	Investment Trusts (IT)	Long-Term Asset Funds (LTAF)	Non-UCITS Retail Scheme (NURS)	Undertakings for Collective Investment in Transferable Securities (UCITS)
Degree of regulation – regulatory footprint of the structure should be minimal, in order to provide greater flexibility	Fund structure itself is unregulated Limited regulatory requirements applicable to marketing activities	Fund structure itself is unregulated Listing-related regulatory requirements are not onerous Limited regulatory requirements applicable to marketing activities	Fund structure will be regulated Expected to be lighter than NURS or UCITS	Fund structure is subject to extensive regulation	Fund structure is subject to extensive regulation
	✓	✓	●	✗	✗
Extensive portfolio diversification requirements would be unhelpful	No limits – purely contractual	No more than 25% of GAV may be invested in any single investment	Expected to be more flexible than UCITS or NURS, but not as much as ITs or PFs	Extensive portfolio diversification requirements apply	Extensive portfolio diversification requirements apply
	✓	✓	●	✗	✗
Prescriptive eligibility requirements for investments would be unhelpful	No eligibility requirements	No eligibility requirements	Expected to be subject to less prescriptive eligibility requirements than UCITS or NURS	Prescriptive eligibility requirements apply, including a 20% limit on unlisted investments (would require legislative amendment to increase)	Prescriptive eligibility requirements apply, including a 10% limit on unlisted investments (would require legislative amendment to increase)
	✓	✓	●	✗	✗
Investors' right to regular redemption will result in a tension with illiquidity of portfolio	Typically no such redemption right	Typically no such redemption right	Expected to have redemption rights but less regular than UCITS or NURS	Fortnightly dealing requirement	Fortnightly dealing requirement
	✓	✓	●	✗	✗

<p><b>In the absence of regular redemption rights, the existence of some liquidity mechanism would make the structure more attractive to investors</b></p>	<p>Typically has limited liquidity, though liquidity mechanisms can be contractually provided</p>	<p>Liquidity provided by secondary market trading if listed</p> <p>Regular buybacks / tender offers can also be built in as additional sources of liquidity</p>	<p>Redemption right is the primary source of liquidity</p>	<p>Redemption right is the primary source of liquidity</p>	<p>Redemption right is the primary source of liquidity</p>
	●	✓	●	✓	✓
<p><b>Fixed life would be inconsistent with the uncertain duration of the underlying investments</b></p>	<p>Very long life possible but investors typically expect a final realisation date</p>	<p>Evergreen</p>	<p>Evergreen</p>	<p>Evergreen</p>	<p>Evergreen</p>
	●	✓	✓	✓	✓
<p><b>Fund structure should be tax neutral</b></p>	<p>Tax transparent</p>	<p>Dividends<sup>71</sup> and interest paid on efficiently – no double charge</p> <p>The IT mustn't retain more than 15% of its gross income in any accounting period, distributions may be made out of distributable capital reserves</p>	<p>This is a potential new vehicle and there is an expectation of efficiency. We will be in a position to confirm once we have confirmation of the vehicle</p>	<p>Dividends and interest paid on efficiently – no double charge<sup>72</sup></p>	<p>Dividends and interest paid on efficiently – no double charge<sup>73</sup></p>
	✓	✓	✓	✓	✓

71 In this row, reference to dividends means dividends for which no deduction is given to the paying company and which fall within one of the exempt classes for purposes of the exemption from corporation tax for company distributions.

72 We assume that the UCITS will be established as an OEIC or an authorised unit trust.

73 We assume that the NURS will be established as an OEIC or an authorised unit trust.

<p><b>Potential tax incentives at fund-level (in addition to any at investment-level) would make it more attractive to investors</b></p>	<p>Tax transparent, so tax incentives could flow to investors through the fund structure</p>	<p>ISA and other individual incentives Tax incentives may be provided for secondary trading on listed markets For a bespoke IT investing in Covid-19 additional EIS and SEID incentives may be provided Variants of VCT incentives may be considered</p>	<p>For a bespoke LTAF investing in Covid-19 capital additional EIS and SEID incentives may be provided</p>	<p>ISA and other individual incentives</p>	<p>ISA and other individual incentives</p>
	✓	✓	✓	✓	✓
<p><b>Familiarity among, and greater access to, the investor-base would increase the potential for private sector investment</b></p>	<p>Familiar among professional and institutional investors, less so among retail investors</p>	<p>Familiar among all types of active, sophisticated investors, less so among occasional retail investors</p>	<p>Investor education required but should be manageable</p>	<p>Prior to UCITS, the most widely held retail investment vehicle</p>	<p>On a pan-European basis the most widely held retail vehicle</p>
	●	✓	●	✓	✓
<p><b>Minimal set up costs and expedited timeframe would be helpful</b></p>	<p>Can be relatively inexpensive to set up (unless extensive negotiations with multiple investors are required) Expected timeframe of 1-2 months</p>	<p>Can be relatively expensive to set up and getting FCA/LSE approvals for the Prospectus can extend timetable Expected timeframe of 4-5 months</p>	<p>Likely to be similar to UCITS or NURS</p>	<p>Less expensive than an IT Potentially shorter timetable than for an IT Expected timeframe of 3-4 months</p>	<p>Less expensive than an IT Potentially shorter timetable than for an IT Expected timeframe of 3-4 months</p>
	✓	✗	✓	✓	✓
<p><b>Given uncertainties over requirements in the future, ease of restructuring would be a useful feature</b></p>	<p>Entirely contractual – easy to restructure</p>	<p>As an English company, reasonably flexible for restructuring although there would be some limitations</p>	<p>Likely difficult due to regulatory framework</p>	<p>Likely difficult due to regulatory framework</p>	<p>Likely difficult due to regulatory framework</p>
	✓	●	✗	✗	✗

<p><b>Robust governance arrangements independent of the manager would be politically and commercially attractive</b></p>	<p>Manager has significant influence, although possible to put in place contractual and structural governance mechanisms</p>	<p>Existence of an independent Board and rules applicable due to listing provide robust governance</p>	<p>Expected to be similar to UCITS and NURS</p>	<p>Governance arrangements are typically not independent of the manager and rely on the regulated status of the manager and the entity</p>	<p>Governance arrangements are typically not independent of the manager and rely on the regulated status of the manager and the entity</p>
	<p>●</p>	<p>✓</p>	<p>✗</p>	<p>✗</p>	<p>✗</p>

## APPENDIX D: FUNDING OF THE OPTIONS: DETAILED ANALYSIS

### 435. Private Equity and Venture Capital funds

#### Investor preferences: PE and VC

<b>Investment style</b>	<ul style="list-style-type: none"> <li>• Some private equity firms deal in distressed and special situations, however the majority of funds focus predominantly on mature and growth investments. All VC funds focus on growth opportunities.</li> <li>• Investment mandates for PE funds allow for equity investments in companies of anywhere from &lt;£1m to over £1billion, with funds of all sizes covering all parts of the market in between.</li> <li>• There are strict criteria regarding how VCTs can invest their funds such that their investors can obtain the tax relief associated with VCTs. At least 80% of investments must be in 'qualifying investments' i.e. satisfy the criteria. The remaining 20% of a VCT's money is usually invested in cash and other investments such as listed equities and large company debt instruments. Funds must be invested in companies within three years of raising new money. VC funds can make equity investments of up to £5m per investee company.</li> <li>• Some of the main criteria for VCT investee companies are as follows:             <ul style="list-style-type: none"> <li>- Maximum of £15m of assets</li> <li>- Unquoted or listed on AIM</li> <li>- Less than seven years old</li> <li>- Less than 250 employees (500 if a knowledge intensive company)</li> <li>- Raise no more than £5m per year per group from a combination of the EIS, SEIS and VCT schemes</li> <li>- Must have a permanent establishment in the UK</li> <li>- Must carry out a 'qualifying trade'. This excludes sectors such as land dealing, financial activities, forestry, farming, running hotels and energy generation.</li> </ul> </li> <li>• PE and VC funds take an active role in management of the portfolio business as this is one of the main methods for creating value. In order to do this, typically they will take a controlling stake, although this is not always the case. Many of the companies that we interviewed for the purposes of this report do minority equity investments or would at least consider them in some situations.</li> <li>• Visibility of an exit route is crucial for PE and VC investors, and holding periods are typically in the region of three to five years to hit IRR targets. Exit routes tend to be through a trade sale, a secondary buy-out or an IPO.</li> </ul>
<b>Asset class</b>	<ul style="list-style-type: none"> <li>• Mid-market PE firms and VC funds will continue to play a role in providing equity capital to UK SMEs in a range of sectors in a selective manner subject to hitting high IRR return hurdles</li> </ul>
<b>Target return range</b>	<ul style="list-style-type: none"> <li>• Target returns differ from fund to fund and are ultimately driven by risk appetite. This in turn is impacted by variables such as:             <ul style="list-style-type: none"> <li>- Sector</li> <li>- Minority/majority/control considerations</li> <li>- Point in the economic cycle</li> <li>- Availability of capital</li> <li>- Investor return requirements/guarantees</li> </ul> </li> <li>• Based on discussions with a range of investors, annual return targets are typically in the region of 15%-20% IRRs for PE funds and 25%+ IRRs for VC funds</li> </ul>

## Incentive toolkit: PE and VC

Through discussions with PE and VC contributors to this Report, we have identified some incentives that could be used to attract capital to recapitalise and grow UK SMEs.

<p><b>Triaging of distressed scheme companies by size and status</b></p>	<p>Most companies that have unsustainable levels of scheme debt (and/or non-scheme debt) will be too small to attract private equity capital due to the investment mandates and thresholds, even for PE firms that operate at the small end of the market. However, businesses towards the top end of CBILS scheme (&lt;£45m turnover) and those that are CLBILS eligible (&gt;£45m turnover) are likely to be large enough for PE to consider investing.</p> <p>In order to unlock PE capital that could directly invest in these businesses, a triaging process needs to occur so that distressed businesses can be categorised by size, sector and status (i.e. growth potential, requires restructuring capital, defaulted, insolvent etc). This would then allow PE and other investors to identify potential investment opportunities more easily.</p> <p>A potential mechanism for doing this could be to set up an intermediary company in the style of a VC fund that could analyse the prospects of the distressed companies in the schemes.</p>
<p><b>Amendments to competition rules</b></p>	<p>One often-used strategy by PE firms is a buy and build strategy. After acquiring (or investing in) a business, they look for complementary businesses that can be bolted-on to the portfolio company in order to create scale and other synergies in order to create value.</p> <p>PE firms that have contributed to this report have suggested that they have declined investment opportunities in recent times due to the risk that they would not satisfy CMA requirements. Additionally, planned and agreed investments in SMEs have been cancelled following CMA review.</p> <p>A relaxation of CMA rules would encourage PE investors to increasingly adopt buy and build strategies in order to roll-up businesses within particular sectors, thereby unlocking some of the currently undeployed PE capital.</p>
<p><b>Changes to the VCT scheme capital deployment rules</b></p>	<p>Venture Capital Trusts (VCT) attract tax relief for retail investors in the form of a 30% tax credit against the amount invested. A VCT fund manager then invests this money in small, high risk businesses that qualify for VCT funding.</p> <p>A historical tightening of the criteria and rules around how VCT fund can deploy capital has created a significant amount of dry powder which VCT fund managers have struggled to deploy as there are not enough qualifying opportunities that meet all the requirements, as well as return requirements.</p> <p>VC funds in the UK had c.£7bn undeployed capital in 2019. A relaxation of the rules around businesses that qualify for VCT funding as well as what the money can be used for, would help unlock a large proportion of this dry powder.</p> <p>The VCT fund management industry is well established, experienced and ready to deploy existing (and any new) capital into small businesses, many of whom will be those that are in scope for consideration in this Report.</p>

## Challenges and impediments to consider: PE and VC

<b>Risk and return dynamics</b>	<ul style="list-style-type: none"> <li>• <b>Active vs passive investment:</b> PE and VC funds actively manage their investment portfolio businesses. The recapitalisation problem we are seeking to address through this Report is extremely large and will therefore necessarily require investment in SMEs at scale. As such a passive investment style will be required due to the large numbers of SME businesses requiring funding. A passive style will limit control for investors and reduce the opportunities for value creation, thereby compromising the ability to generate a differentiated risk-return profile.</li> <li>• <b>Return requirements:</b> PE and VC firms typically have a high return requirement. It varies from firm to firm, however our research suggests that return hurdles are in the region of 15%-25% IRRs, and/or money-on-money multiples of ~3x.</li> </ul>
<b>Governance</b>	<ul style="list-style-type: none"> <li>• <b>Investment mandates:</b> Investments will need to be made in accordance with investment mandates, which may inhibit the deployment of PE and VC capital to recapitalise UK SMEs. There may be restrictions related to minimum ticket size (particularly for larger funds), sector, geographical concentration and ESG considerations.</li> <li>• <b>Growth investment opportunities:</b> VC funds invest in small businesses with high growth prospects. They do not provide capital that will be used for recapitalisation purposes.</li> </ul>
<b>Operational challenges</b>	<ul style="list-style-type: none"> <li>• <b>Deployment:</b> There is considerable time and cost associated with raising funds and deploying capital (including finding potential businesses and conducting due diligence). This means that investment in SMEs at scale is likely to require the pooling of assets. This is more likely to be achieved through the creation of a new fund (or fund of funds) rather than the deployment of capital within existing fund structures.</li> </ul>
<b>Regulatory impediments</b>	<ul style="list-style-type: none"> <li>• <b>Competition rules:</b> One often-used strategy by PE firms is a buy and build approach. After acquiring (or investing in) a business, they look for complementary businesses that can be bolted-on to the portfolio company in order to create scale and other synergies in order to create value. Competition rules in their current form can inhibit this strategy.</li> <li>• <b>Qualifying investment criteria:</b> As mentioned, there are strict criteria for VCT investments to qualify such that investors in the funds can obtain the tax benefits.</li> </ul>
<b>Duration</b>	<ul style="list-style-type: none"> <li>• <b>Investment life cycle:</b> PE investments tend to last between four and seven years due to the constraints of the life cycle of their underlying funds (which typically have an eight to ten year life). As such, any investment opportunity will need to provide a return to the PE investor within three to five years.</li> </ul>

## 436. Private Debt

## Investor preferences: Private Debt

<b>Investment style</b>	<ul style="list-style-type: none"> <li>• Investment mandates for PD funds allow for investments in companies of all sizes, with funds covering all parts of the market.</li> <li>• Debt funds generally take an active approach to their investments (unless they have invested in a pool of assets via a fund structure) as they are unlikely to have control of the investee company via debt instruments.</li> <li>• Different funds specialise in different types of debt in terms of term, repayment profile, listed/unlisted, sector, collateral/security etc.</li> <li>• For a portfolio of NPLs, exit routes are generally either collecting out the debt; or a secondary sale to another investor (or back to the originator).</li> </ul>
<b>Asset class</b>	<ul style="list-style-type: none"> <li>• PD investors invest in a wide range of credit products, however the exact assets classes depend on the investment mandate of the individual debt fund. Investment mandates will dictate criteria around asset class such as:             <ul style="list-style-type: none"> <li>- Listed / unlisted debt</li> <li>- Duration</li> <li>- Floating / fixed rate instruments</li> <li>- Securitisation structures</li> </ul> </li> </ul>
<b>Target return range</b>	<ul style="list-style-type: none"> <li>• Credit fund return targets are typically in the range of 7%-15%, depending on factors such as:             <ul style="list-style-type: none"> <li>- Sector</li> <li>- Point in the economic cycle</li> <li>- Availability of capital</li> <li>- Security/collateral</li> <li>- Use of funds</li> <li>- Performing / non-performing</li> <li>- Credit score (if relevant)</li> <li>- Geographical location</li> <li>- Availability of data for underwriting</li> <li>- Quality of servicing available</li> <li>- Ability to actively influence performance</li> <li>- Position in the debt stack</li> </ul> </li> <li>• Return hurdles are still high but typically lower than private equity because they invest in debt products (which have a lower risk premium than equity). Furthermore, they have reduced management costs of each investment and absence of the use of financial engineering to increase returns.</li> </ul>



## Incentive toolkit: Private Debt

<b>Debt servicer</b>	<ul style="list-style-type: none"> <li>• Whether debt funds invest in SME debt directly or through a fund structure, they (along with other institutional investors) will require the services of a debt servicing company that can service, monitor, report, collect and administer all the performing and non-performing loans in the portfolio. Without this, institutional investors will not be able to invest in a fund structure. No such entity currently exists to manage SME on this scale at present in the UK. There are three main options for this challenge. Firstly, a new business could be created, although this would be very complex and time consuming given the specialist nature and scale of the operations required. Secondly, an existing operation could be carved-out from a bank, because this is where SME debt is typically serviced from at present. Lastly, an existing consumer debt servicer (or a few them) could to be scaled-up and converted into a large-scale SME debt servicer. The debt purchase and collection industry in the UK is mature and well developed, however it largely focuses on consumer debt. These companies could probably be persuaded with the right incentives to service debt at the small end of the SME spectrum because it behaves broadly like consumer debt, however a new approach would be required for medium businesses.</li> </ul>
<b>Government guarantee</b>	<ul style="list-style-type: none"> <li>• In order to meet return requirements of debt funds, a Government guarantee may be needed to give some downside protection to debt investors. This would reduce their risk exposure and therefore reduce return hurdles.</li> </ul>

## Challenges and impediments to consider: Private Debt

<b>Risk and return dynamics</b>	<ul style="list-style-type: none"> <li>• <b>Return requirements:</b> PD firms typically have a high return requirement. It varies from firm to firm, however our research suggests that return hurdles are typically in the range of 7%-15% per year, depending on various factors.</li> </ul>
<b>Governance</b>	<ul style="list-style-type: none"> <li>• <b>Investment mandates:</b> PD investments will need to be made in accordance with investment mandates, which may inhibit the deployment of capital to recapitalise UK SMEs. There may be restrictions related to minimum ticket size (particularly for larger funds), sector, listed vs. unlisted debt, geographical concentration, debt instrument type and Environmental, Social and Governance (ESG) considerations.</li> </ul>
<b>Operational challenges</b>	<ul style="list-style-type: none"> <li>• <b>Debt servicer:</b> Servicing of UK SME debt has historically never been carried out at scale outside of originating banks. The required servicing capability does not currently exist so a new servicer would be required.</li> <li>• <b>Deployment:</b> There is considerable time and cost associated with raising credit funds and deploying capital (including finding potential businesses and conducting due diligence).</li> <li>• <b>Quality of data:</b> In order to conduct due diligence, debt investors will require a detailed data tape for the businesses that they are providing funding to, such that they can re-underwrite the loans. This is something that may be difficult given that some loans (especially BBLs loans) were not underwritten in the first place and given that some of these businesses may have been new to banks and therefore no payment history is available.</li> </ul>
<b>Regulatory impediments</b>	<ul style="list-style-type: none"> <li>• <b>FCA debt collection regulations:</b> The FCA has developed its guidelines and rules for debt collection in recent years. This largely applies to consumer debt, however given that many BBLs loans were given to sole traders and small partnerships, similar consideration will be important for the businesses in scope for this Report. The servicer of the debt funded by credit funds will need to comply with these regulations.</li> </ul>
<b>Political and social considerations</b>	<ul style="list-style-type: none"> <li>• <b>Mass collection of SME debt:</b> Collecting defaulted SME debt on the scale anticipated has never been done in the UK historically. In current environment, the political and social impacts of this should be carefully considered. There are extensive FCA regulations regarding consumer debt collection, however this is less robust of SME debt collection. Very clear rules and guidelines on acceptable collection practices will be required.</li> </ul>

## 437. Insurance

### Investor preferences: Insurance

The largest relevant pool is made up of assets backing annuities. This pool is investment grade, long term debt with fixed repayment schedule.

<b>Investment style</b>	<ul style="list-style-type: none"> <li>• Insurers control three main pools of money, each of which has their own style.</li> <li>• Asset backing annuity products are invariably backed by debt instruments with durations matched to expected duration of payments to the annuitants. This represents c.£400bn of the investable universe with new premiums of £40bn in 2019. This represents the most feasible pool to consider.</li> <li>• Assets backing with-profit funds are more varied, with exposure to equity as well as debt and other asset classes. Asset allocation ranges are published and there is complex governance with With-Profits Committees and a regulatory role, the With-Profits Actuary, being involved in asset allocation decisions. Funds tend to be managed conservatively as many with-profit funds are effectively closed to new business and declining in size, so matching by duration is more common.</li> <li>• Assets backing unit-linked funds can be very varied, clearly a fund might be labelled 'Japanese Equity' or 'European Corporate Bonds' with obvious investment guidelines to match. However, much of the money is invested in 'default funds' which are broad-based managed funds investing in listed debt and equity. But investment allocation ranges are published and are not changed often, thus the amount of truly discretionary money that can be invested in a new asset class is relatively small.</li> <li>• Narrowing the universe just to the annuity business, the investment style is: <ul style="list-style-type: none"> <li>- Long term</li> <li>- Fixed coupons, no prepayments (or Spens clause protection)</li> <li>- Diversified across sector</li> </ul> </li> </ul>
<b>Asset class</b>	<ul style="list-style-type: none"> <li>• As noted above, the largest capital pool where insurance managers have the greatest discretion, assets backing annuities, will almost invariably require a fixed rate debt security.</li> <li>• There is demand for sectoral diversification. Insurers are generally overweight financial services at the long end which would make SMEs appealing from a diversification perspective.</li> </ul>
<b>Target return range</b>	<ul style="list-style-type: none"> <li>• Returns are likely to be required to be close to private placement, so in current conditions, around 50 to 100 basis points above an equivalent corporate bond yield.</li> </ul>
<b>Risk tolerance</b>	<ul style="list-style-type: none"> <li>• Insurers' appetite for risk is low, and any investment in debt securities will be required to be investment grade.</li> </ul>

### Incentive toolkit: Insurance

Insurers will require a commercially attractive debt instrument which is restructured to make it longer term, investment grade and with a clear method of applying a rating.

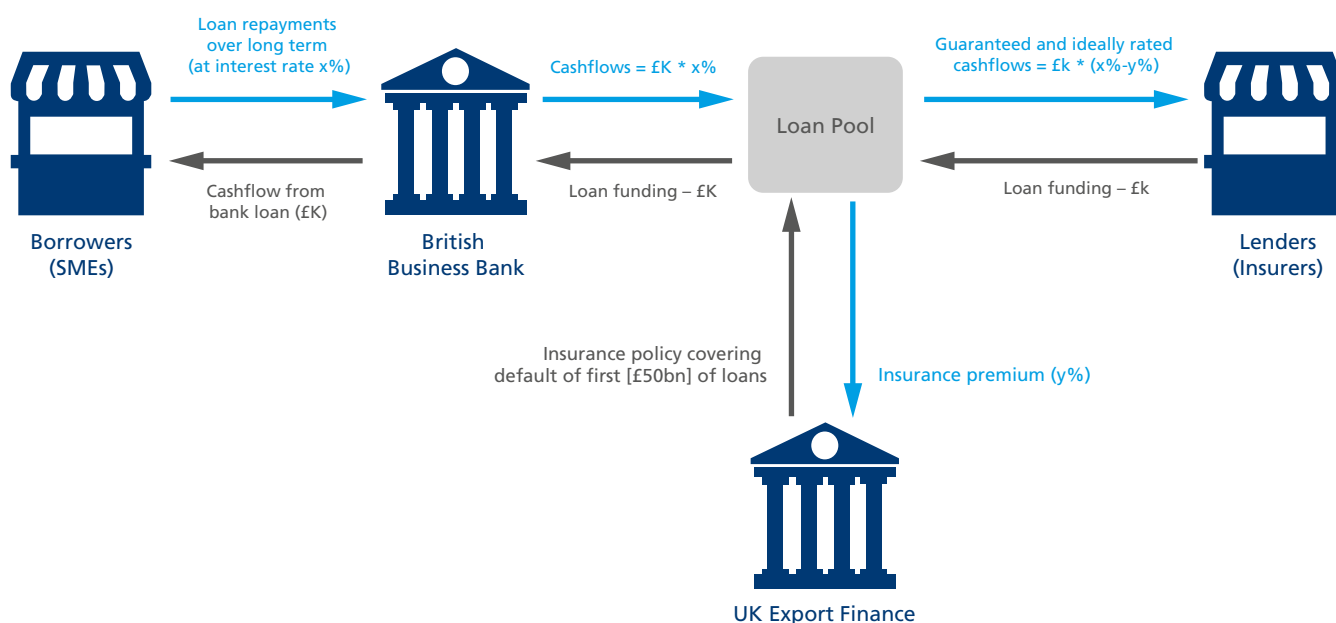
<b>Commercial returns</b>	<ul style="list-style-type: none"> <li>To make any debt securities attractive, the return must be commensurate with that on other similar debt instruments. Considering yields on private placements, a gross yield of between 50 basis points and 100 basis points above typical corporate bond yields for similar rated debt is likely to be required.</li> </ul>
<b>Credit enhancement</b>	<ul style="list-style-type: none"> <li>Insurers don't have the capability to underwrite many smaller SME loans, and would have difficulty in assessing credit worthiness of a package of such loans. Equally, SME loans will not meet the required credit worthiness of a typical investment for an insurer.</li> <li>Providing a credit wrap from the Government is likely to be required in order to leverage the Government's rating, removing the need to underwrite the individual loans and to enhance the credit rating overall.</li> </ul>
<b>Duration restructuring</b>	<ul style="list-style-type: none"> <li>An appropriate duration will be required for any debt securities to be attractive to insurers. Thus, restructuring the original loans to SMEs which are more likely to be short-term, into loans of durations expected to be more attractive to insurers, e.g. between seven and fifteen years, will be required.</li> </ul>
<b>Rating clarity</b>	<ul style="list-style-type: none"> <li>Insurers will not have the ability to individually credit rate the investment. Therefore, the investment will likely have to either:                     <ul style="list-style-type: none"> <li>- Be externally rated.</li> <li>- Be able to clearly leverage the government rating or the rating of the credit wrapper.</li> <li>- Have a regulatory approved internal rating approach defined in the offering memorandum.</li> </ul> </li> </ul>

### Potential execution options and structures: Insurance

A structure leveraging existing mechanisms such as UK Export Finance could be utilised to meet the incentives set out in this section.

**Figure 34:** Illustrative execution structure to attract capital from insurers

Source: EY analysis; April 2020.



<p><b>Key underlying assumptions</b></p>	<ul style="list-style-type: none"> <li>• Restructuring of original SME debt will need to take place to transfer duration of debt to something acceptable for insurers. Note that is also likely to be required to transform debt into something that is sustainable for original SME borrowers.</li> <li>• Criterion for performing the transformation will need to be published and data about ongoing performance of the loan pool should be made available to investors.</li> <li>• Some form of credit wrap, of the form typically provided by UK Export Finance, will be required to ensure cash-flows can be rated at least investment grade.</li> <li>• The return assumption is 50 to 100 basis points above the typical return for an equivalent rated corporate bond.</li> </ul>
<p><b>Timing considerations</b></p>	<ul style="list-style-type: none"> <li>• The main items on the critical path are developing the methodology for restructuring the original SME bonds, negotiating with individual SME borrowers and underwriting the acceptance of the restructured bonds into the loan pool. This needs to be done in such a way that the expected losses less any form of credit granted by the Government are consistent with the credit rating ascribed to the debt issued by the loan pool, which will need to be at least investment grade to be attractive to insurers.</li> <li>• In parallel, Government will need to get comfortable about expected and stress costs to them of offering the credit wrap, with all parties iterating to a solution that works for all.</li> <li>• This initial phase is expected to take six to fifteen months, during which time the setting up of the administration and control processes within the loan pool and the pre-marketing of the debt security to the insurance community can take place, together with conversations with the regulator about indicative treatments for Solvency II capital treatment.</li> </ul>

**Challenges and impediments to consider: Insurance**

<p><b>Risk and return dynamics</b></p>	<ul style="list-style-type: none"> <li>• <b>Interaction between return and defaults in underlying:</b> Insurers will require a minimum expected return, net of defaults, Government will wish to keep any payments due to credit wrapping to a minimum, while SMEs will wish to minimise loan terms on restructured loans. Multiple iterations and negotiations may be necessary, adding to timelines.</li> </ul>
<p><b>Operational challenges</b></p>	<ul style="list-style-type: none"> <li>• <b>Initial restructuring:</b> There will be significant negotiation with individual SME borrowers over terms and access to the loan pool. Material banking expertise will be required to finalise revised loan terms</li> <li>• <b>Loan pool administration:</b> After initial underwriting, negotiation of terms and access to loan pool, the loans will need to be administered, with arrangements put in place.</li> <li>• <b>Administration processes with insurance funders:</b> Data collection and MI processes will need to be put in place with funders, allowing for ‘look-through’ information to be supplied to insurers.</li> </ul>
<p><b>Regulatory considerations – Solvency II</b></p>	<ul style="list-style-type: none"> <li>• Insurers will want to invest in a pool of loans that is structured in a way that allows insurers to meet existing regulatory requirements, but at the same time insurers require an approach from the PRA in the application of rules and ongoing supervision that enables this investment.</li> <li>• <b>Solvency II - matching adjustment:</b> If insurers are to invest in SMEs’ long-term debt at scale, it is likely to be held by insurers in their Matching Adjustment portfolios, provided the eligibility conditions are met. Matching Adjustment is a key feature of the Solvency II regime that enables firms to match long-term illiquid assets with long-term liabilities and discount these liabilities at a higher rate. While the Matching Adjustment is essential for UK firms, the criteria for Matching Adjustment assets and rules on cashflow matching are more rigid than necessary and less principles-based than the illiquidity premium used under the previous ICAS regime prior to 2016. More widely, the PRA’s approach to matching tests, asset eligibility, MA breaches and re-applications are onerous. To address this barrier to investment, the PRA should recognise that bespoke SPV structures will not be feasible in relation to the pool of Government-backed debt and so an off the shelf asset structure at a suitable level of credit quality and fixity of cashflows should be considered Matching Adjustment eligible.</li> <li>• <b>Solvency II - capital treatment:</b> The ‘risk based’ capital treatment for insurers operating under their ‘internal model’ need to be approved by the PRA. This determines the IRR / ROC, a key metric used by insurers to determine profitability of investments, so achieving an appropriate capital treatment is vital.</li> <li>• <b>Solvency II - credit rating:</b> Insurers’ investments are also governed by the Solvency II Prudent Person Principle (PPP) which will often require firms to undertake due diligence on each underlying counterparty. We note the recent change in PPP rules making it clearer that pools of loans can be considered in some circumstances. Clearly, to enable insurers to invest in SME debt, PPP compliance will need to be demonstrated on an aggregate basis for the pool of loans rather than on an individual basis for potentially hundreds of thousands of counterparties. Similarly, insurers will need reassurance that they can apply a single credit rating to their investment in the loan pool, rather than a rating for each counterparty.</li> </ul>

## 438. Pensions

### Investor preferences: Pensions

The UK pension scheme market is fragmented with over 5,400 private DB schemes and over 30,000 trust-based DC schemes (contract-based arrangements will increase this number further). This leads itself to a range of different investor preferences.

Within the DB sector, investment preferences will differ for a variety of reasons including the scheme's long-term objective (e.g. whether the scheme is seeking to move liabilities into an insured scheme via a buyout), the time horizon for achieving the scheme objectives, the strength of their sponsors' covenant, the scheme's maturity (and cashflow needs), the prevailing funding level and whether the scheme is open or closed to new members or accrual. These variables lead to a diverse range of investment preferences.

DC schemes tend to be more homogeneous in their investment preferences. This is primarily a function of many DC schemes being in a similar situation of having a long investment time horizon, with the likelihood being that they will increase in size as DC has become the pensions saving vehicle of choice.

Trust-based pension schemes are required to take investment advice prior to investing. Therefore, investment advisers play a crucial role in investor preferences.

<b>Investment style</b>	<ul style="list-style-type: none"> <li>• Pension schemes, both DB and DC, primarily invest through funds offered by asset managers. Some large DB schemes have their own in-house investment teams who will invest in deals directly, however the ticket size of these deals must be of a certain size to make the due diligence and ongoing governance worthwhile.</li> <li>• With the exception of large DB pension schemes, schemes have generally not sought to be actively involved with their underlying investee companies. However, engagement with underlying investee companies has increased as responsible stewardship of assets has become an increasingly important consideration for trustees. Regulations have been clarified and enhanced in this area.</li> <li>• For DB schemes, many of which are now maturing, long duration sterling denominated fixed income assets are attractive as are investments with a direct inflation-link as such assets match against expected pension liability cash outflows.</li> <li>• Illiquidity can be tolerated by many DB schemes, however this is dependent on their cashflow requirements and how close they are to their long-term objective. For example, if a scheme is looking to buyout over the medium term investing in illiquid assets may be unattractive.</li> <li>• Whilst DC schemes have very long-term investment time horizons, illiquid assets have not typically been held in any large proportion.</li> </ul>
<b>Asset class</b>	<ul style="list-style-type: none"> <li>• DB schemes will invest across the full spectrum of asset classes across the globe. They will also invest in both listed and private securities, however most of the equity and bonds investments tend to be listed.</li> <li>• DB schemes will invest into debt securitisations, typically via specialist teams within asset managers. This enables pension schemes to gain access to debt instruments with characteristics that meet their overall risk profile (typically fixed interest, sterling denominated). Similar characteristics apply to several instruments including first loss pools passing tranches of loans from bank balance sheets to pension funds and other investors.</li> <li>• DC schemes primarily invest across a range of traditional asset classes such as equity, Government bonds, corporate bonds and property. Default funds may include small allocations to other asset classes, however these tend to be equity heavy. There is currently limited investment in illiquid assets.</li> </ul>
<b>Target return range</b>	<ul style="list-style-type: none"> <li>• DB schemes typically seek to generate a return of between cash + 3-5% p.a. on their growth assets over the medium to long-term. Within their allocation to growth assets, different asset classes will have different expected return targets (and risk profiles).</li> <li>• DC default funds would typically try to out-perform inflation by 1-3% p.a. over the medium to long-term.</li> <li>• For an investment in a distressed debt like asset the expected returns would be at the top end of, or above, these ranges. For example, DB would typically require a net return (net of both fees and defaults) of approximately 6 - 6.5% on mid-market senior lending.</li> </ul>

<b>Risk tolerance</b>	<ul style="list-style-type: none"> <li>• The risk tolerance of a DB scheme will be dependent on the factors set out in the introduction of this chapter. In addition, the fiduciary responsibilities of both DB and DC pension scheme trustees require them to assess the characteristics of any potential investment. With finite governance bandwidth, decision makers tend to favour simplicity over complexity.</li> <li>• DC schemes have a long investment time horizon and can weather market volatility. However, members may need liquidity, for example, to enable retirement or to transfer between schemes so liquidity risk is a factor.</li> <li>• Diversification of assets is important for both DB and DC pension schemes. To consider supporting SMEs, pension schemes will expect any solution to aggregate the loans to / equity of SMEs to ensure a diversified pool of exposure.</li> </ul>
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### Incentive toolkit: Pensions

<b>Government support</b>	<ul style="list-style-type: none"> <li>• A Government underpin, whether partial or complete, would increase the attractiveness of this investment.</li> <li>• This could operate in several ways such as:             <ul style="list-style-type: none"> <li>- The Government could guarantee the yield on investment at the prevailing gilt yield (at the relevant term). This gives pension scheme investors (who hold significant allocations to gilts) a potential upside with a capped downside whilst encouraging them to potentially redeploy existing assets already committed to gilts.</li> <li>- The Government absorb the first tranche of losses on these investments with private investors only participating below the Governments buffer.</li> <li>- The Government could absorb a proportion of losses, such as 50%, with private investors having to absorb the residual.</li> </ul> </li> </ul>
<b>Structuring the assets</b>	<ul style="list-style-type: none"> <li>• As discussed, pension scheme investor appetite varies considerably. For these assets to appeal to the widest set of pension scheme investors the assets could be restructured in a Special Purpose Vehicle (SPV). The SPV could then issue tranches of debt with various credit quality with the residual exposure being the equity tranche. This has the dual benefit of making these assets appeal to a wide range of investors, but also provides pension scheme investors with a range of debt instruments applicable to differing risk / duration requirements.</li> </ul>
<b>Investment Trust</b>	<ul style="list-style-type: none"> <li>• Launch an investment trust to hold these assets. This investment trust could be made available on investment platforms managing pension scheme monies.</li> <li>• Investment trusts are a familiar concept to investors and reduce some of the complexities of alternative structures.</li> </ul>
<b>Tax relief</b>	<ul style="list-style-type: none"> <li>• Pension contributions already receive tax relief, either at source or net pay. If enhanced tax relief was given on investments made to the SMEs, this may incentivise pension schemes, or DC members, to deploy their pension capital towards this investment opportunity.</li> <li>• Ultimately additional tax relief is a Government subsidy but through a less explicit route.</li> </ul>
<b>Charge cap carve out</b>	<ul style="list-style-type: none"> <li>• Trust based DC schemes are subject to a charge cap on their default funds. This cap applies across the default fund and not at an underlying asset/fund level.</li> <li>• Given this type of asset it is likely the fees will be higher than many of the investments currently held and a decision will need to be made on whether the higher fee is compatible within the charge cap.</li> <li>• It is possible that this investment opportunity could be agreed to not be eligible for assessment against the charge cap. However, making the investment non-eligible is not well aligned to the premise behind the introduction of the charge cap.</li> </ul>

## Challenges and impediments to consider: Pensions

<p><b>Risk and return dynamics</b></p>	<ul style="list-style-type: none"> <li>• <b>Weak covenants/poor funding:</b> DB schemes with weak sponsor covenants (which are perhaps UK-centric and impacted by Covid-19) and/or poorly funded DB schemes may not find this an attractive asset class from a risk perspective given their limited ability to absorb losses.</li> <li>• <b>Time horizons:</b> This investment opportunity will only make up a small proportion of a scheme's overall asset allocation. If the asset has a short opportunity time horizon then schemes will need to consider whether given the size of allocation and time horizon is the opportunity attractive from a risk and return perspective to commit to the initial training, due diligence and ongoing monitoring. This consideration may be less applicable for any Growth Fund that is launched if the intention is to maintain this as a long-term venture.</li> <li>• <b>Visibility of risks:</b> Prior to making any investment, pension schemes will need to understand risks, sectors, business types they are exposed to. Clear risk analysis and communication on the underwriting on the loans and business and expected defaults will be key in allowing investors to assess the risk and return potential of these investments. Whilst exposure to a range of SMEs will provide diversification, there may be systemic risks that may run throughout the underlying companies.</li> <li>• <b>Illiquidity of investments:</b> As the investments are not liquid this may pose issues, in particular for DC investors (though this could be overcome to some extent through how the investment is structured). Underlying members may need to invest new monies, or disinvest to enable a transfer out or retirement, for example. The illiquidity risks may be exacerbated in times of market stress as some DC pension schemes have found in relation to some UK property funds being gated. Some asset managers have set up funds that hold illiquid instruments alongside more liquid assets to address liquidity risks, though this ultimately dilutes the exposure to illiquid assets.</li> </ul>
<p><b>Operational challenges</b></p>	<ul style="list-style-type: none"> <li>• <b>Daily dealing of DC funds:</b> Platforms have traditionally offered daily dealing as the market standard to DC investors. Furthermore, this commitment may be explicitly set out in legal agreements between providers and investors. Given these types of assets to not lend themselves to daily dealing, there may be restrictions offering them on certain platforms or to certain investors.</li> <li>• <b>Aggregation of underlying exposures:</b> Any structure would need to offer investors a diversified exposure to underlying borrowers. This will require some sort of pooling or structuring of the loans.</li> <li>• <b>Eligibility:</b> Pension schemes primarily invest through funds and they will have existing investment manager agreements in place with their existing managers. The recapitalisation opportunity may not be an eligible asset within current investment guidelines if there is a desire to access this asset through their existing investment arrangements and structure.</li> <li>• <b>Fragmented market:</b> As noted pensions are a fragmented market. It is likely only schemes, or advisors, of a certain scale will be able to invest/recommend investment into such an opportunity. Consolidation of the pensions market would help overcome some of these issues.</li> </ul>
<p><b>Regulatory impediments</b></p>	<ul style="list-style-type: none"> <li>• <b>DC Charge cap:</b> The majority of DC trust-based assets are invested in default funds and a charge cap applies on these funds. Whilst the charge cap applies at an overall default fund level, if the fees of investing in this opportunity are high then this may be prohibitive or lead to only minimal allocations being possible (which then introduces questions on whether from a governance perspective it is a worthwhile investment).</li> <li>• <b>Permitted links:</b> These rules apply to DC assets that are held in an insurance wrapper. Under the regulations, only some assets are permitted to be held to back these investments. One criterion is that the investment must be realisable in the short term. Whether these opportunities would satisfy this requirement would depend upon how the opportunity is structured.</li> <li>• <b>Fiduciary duties:</b> Trustees of pension schemes have fiduciary duties to their scheme members. Trustees are expected to act as a prudent person. While this has not prohibited investment into similar asset classes, the fiduciary duty of trustees will core in their decision making.</li> </ul>

## 439. Retail

## Investor preferences: Retail

<b>Investment style</b>	<ul style="list-style-type: none"> <li>• Retail investors, DFMs and HNW experienced investors through pooled structures, invest on both an active and passive basis.</li> <li>• Retail investors tend to invest on a medium to long term horizon and predominantly invest through open-ended, daily traded structures available direct and through advised and execution only platforms. These funds can be held directly or in tax wrappers such as pensions and ISAs.</li> <li>• EIS, SEIS and VCT schemes are available to HNW, experienced investors with a focus on allocating funding to SMEs. These vehicles already have professional managers and significant tax incentives however, these are specialist vehicles and unlikely to be needed or used by most retail investors.</li> <li>• The closest existing products to the proposed Covid Recovery Capital and Covid Growth Capital contemplated in this report are peer to peer lending (£17bn Loans outstanding with £0.6bn issued from April – June 2020<sup>74</sup>) which has similar characteristics in terms of lack of transparency of the underlying companies.</li> <li>• Retail investors tend to be more fragmented than institutional investors and it is unlikely a small to medium SME would want or be able to administratively deal with having a large number of individual equity or debt retail investors, this further cements the need to arrange SME debt or equity into a pooled instrument to attract and manage retail investment.</li> </ul>
<b>Asset class</b>	<ul style="list-style-type: none"> <li>• Retail investors tend to hold a variety of asset classes either directly or through advised/discretionary portfolios.</li> <li>• Generally, EIS, SIES, and VCTs are marketed directly to HNW experienced investors.</li> <li>• The 2018/2019 IMA Investment survey found that the UK retail funds market has grown significantly over the last 10 years and that there has been an increased demand for outcome-oriented funds by retail investors. Any fund structured for SME recapitalisation or growth that aims to attract retail investors may need to target either a particular risk category or certain level of return to attract investors. There is strong investor interest in socially responsible investing (SRI) with corresponding ESG measures. Structuring a Covid recapitalisation and/or growth fund to align to this could be advantageous in attracting flows.</li> <li>• However, as these funds are likely to be classified as an ‘alternative’ it is unlikely that financial advisers or discretionary fund managers would allocate a significant percentage of client’s portfolios to these funds therefore there may be structural barriers to attracting flows, immediately or in the long term to these funds.</li> </ul>
<b>Target return range</b>	<ul style="list-style-type: none"> <li>• Target returns differ from asset class to asset class and fund to fund. Advised and discretionary clients’ portfolios are selected based on the clients’ investment need, appetite for risk and capacity for loss.</li> <li>• There are also wide range of investment objectives e.g. income, growth, passing on assets to next generation which will drive a different risk /return appetite for retail clients.</li> </ul>
<b>Risk tolerance</b>	<ul style="list-style-type: none"> <li>• The retail investment sector is heavily regulated and there is heightened emphasis on the suitability assessments and reduction in the risk of mis-selling by the FCA. Therefore, any investment that is targeting retail investors would need to be deemed suitable, with clearly documented fund objectives and a risk and return profile. The structures would have to be transparent and have a fair and clear charging structure. There will be significant focus on the risk of the underlying investments and the fund’s ability to realise these investments.</li> <li>• In addition to regulatory approval there are many stakeholders connected with retail investors (e.g. advisers, DFMs and platforms) all of whom have risk aware compliance teams and product governance committees that would heavily scrutinise any product before being willing to make this available for retail investors.</li> </ul>

Therefore, while there may be interest from retail investors in Covid recapitalisation and growth funds there are also significant barriers to retail assets being able to flow to these.



## Incentive toolkit: Retail

Through discussions with Retail contributors we have identified some incentives that could be used to attract retail investor capital to recapitalise and grow UK SMEs. There are several fundamental challenges that may lead to other pools of capital being prioritised to help rebuild and grow the SME sector. The incentives detailed below are likely to be expensive and create long-term financial commitments for this and subsequent governments.

<b>Government/state backed guarantee of return on pooled investments</b>	<ul style="list-style-type: none"> <li>• As aforementioned, assuming a pooled structure is adopted, and a third-party manager selected for the management of the recapitalisation debt and growth equity a further incentive which may lead to increased retail flows into the product would be a Government guaranteed minimum investment return.</li> <li>• An investment guarantee against the backdrop of a volatile economic environment could be attractive from a risk and return diversification perspective for a retail investor (either direct or on an advisory basis).</li> <li>• The guarantee is likely to require a minimum period of participation from the investor and a closed, long term asset structure may be appropriate to facilitate the guarantee. This may not be attractive to retail investors approaching retirement or with a shorter-term investment horizon however, it may be attractive to medium to longer term retail investors.</li> <li>• Any retail instrument set-up and marketed to investors on a Covid-19 recovery basis may benefit from the current national sentiment to want to actively participate in the recovery of UK businesses.</li> </ul>
<b>Government issued Covid-19 Investment product with enhanced tax benefits</b>	<ul style="list-style-type: none"> <li>• A standalone investment product such as a Covid-19 ISA or bond may be marketed directly to retail investors to recapitalise and/or grow the SME market. As with the incentive above, if this product is marketed to investors with a specific recapitalisation/growth agenda linked to Covid-19 it may benefit from the current national sentiment to want to assist with the UK recovery.</li> <li>• If, however there was no Government guarantee with these assets to mitigate the risk more generous tax incentives akin to EIS/VCTs may be needed. As mentioned earlier the addition of another tax incentivised product in this area may negatively disrupt the SNE funding system that already exists for certain high net worth, professional investors.</li> <li>• Industry experts interviewed for this report did not believe that the creation of a Covid-19 ISA would be particularly successful given the proliferation of products in this area that have been received and utilised with limited degrees of success by retail investors. It was not felt that an ISA would be particularly appealing or structured in any way that would allow for the short or even medium-term deployment of retail assets to aid recapitalisation.</li> </ul>

## Challenges and impediments to consider: Retail

<b>Risk and return dynamics</b>	<ul style="list-style-type: none"> <li>• <b>Structure:</b> Retail funds, such as Unit Trusts and OEICs tend to be open-ended, pool assets and price and trade assets daily, they tend to be more liquid but post lower returns than close-ended funds such as Investment Trusts. As open-ended structures tend to invest in more liquid, listed assets these funds would not be suitable for SME recapitalisation. The use of close-ended funds or the set-up of new long-term asset funds may be attractive to DFMs and could therefore attract some retail flows although this is not likely to be significant.</li> <li>• <b>Suitability:</b> In addition to the structure of these assets being important to attract retail investors the risk/return profile will have to be calculated and disclosed in order for investors, Financial Advisors and DFMs to be able to assess suitability as aligned to an individual's appetite for risk and capacity for loss.</li> </ul>
<b>Operational challenges</b>	<ul style="list-style-type: none"> <li>• <b>Structure:</b> Attracting and retaining retail assets is likely to require the set-up and management of fund structures with third party managers selecting and actively managing the underlying assets (be that SME debt or equity). These funds would then have to be made available for both direct and platform (advised and execution only) investment. As mentioned above there are existing, tax attractive structures available for HNW, experienced investors to fund the growth of SMEs.</li> <li>• <b>Access:</b> Depending on the structures utilised reporting and trading will need to be facilitated in order to make these assets attractive to individual investors, DFMs and financial advisors. As mentioned above any new assets will also be heavily scrutinised by product governance committees within platforms, DFMs and financial advisory firms.</li> </ul>
<b>Regulatory impediments</b>	<ul style="list-style-type: none"> <li>• <b>Investor protection:</b> The retail investment sector is heavily regulated and there is heightened emphasis on the suitability assessments and reduction in the risk of mis-selling by the FCA. Therefore, any new funds with underlying esoteric investments that are marketed directly to retail investors are likely to attract a high degree of scrutiny through the authorisation process. How these funds are structured will determine their classification and may limit the ability to attract retail flows directly.</li> </ul>

## APPENDIX E: ACKNOWLEDGEMENTS

TheCityUK would like to thank a number of participants who were involved in shaping this report. Contributors fell under three main categories: those in the Senior Steering Group, those in the Technical Working Group, and those who were interviewed and contributed their time and expertise outside of the Technical Working Group.

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<b>Saleem Malik</b>	<i>Partner, Strategy &amp; Transactions</i>	EY
<b>Dr Adam Marshall</b>	<i>Director General</i>	British Chambers of Commerce
<b>Lee Marshall</b>	<i>Partner, Financial Services</i>	EY
<b>David Mathers</b>	<i>CFO</i>	Credit Suisse
<b>Sir Charlie Mayfield</b>	<i>Chairman</i>	Be the Business
<b>Alex McFarlane</b>	<i>Digital Marketing Executive</i>	TheCityUK
<b>Martin McTague</b>	<i>National Vice Chair Policy and Advocacy</i>	Federation of Small Businesses
<b>Gareth Mee</b>	<i>Partner, Financial Services</i>	EY
<b>Andrew Menzies</b>	<i>Global Head of Debt Corporate Markets</i>	Societe Generale
<b>Michael Moore</b>	<i>Director General</i>	British Private Equity & Venture Capital Association
<b>Edwin Morgan</b>	<i>Director of Policy</i>	Institute of Directors
<b>Dan New</b>	<i>Consultant</i>	EY
<b>Ndidi Njoku</b>	<i>Principal Management Consultant, Public Affairs, Policy and Research</i>	TheCityUK
<b>Lord O'Neill</b>	<i>Vice Chair</i>	Northern Powerhouse Partnership
<b>Niall O'Sullivan</b>	<i>Chief Investment Officer, Europe</i>	Mercer Global Investments
<b>Kevin Parry OBE</b>	<i>Chairman</i>	Royal London
<b>William Parry</b>	<i>Principal</i>	Aon
<b>Stephen Phipson</b>	<i>CEO</i>	Make UK
<b>Andrew Pilgrim</b>	<i>Partner, UK Government and Financial Services Leader</i>	EY
<b>James Ramsey</b>	<i>Managing Director</i>	Kuber Ventures
<b>Ajay Rawal</b>	<i>Partner, Financial Services</i>	EY
<b>Hayley Rees</b>	<i>Head of Investment Strategy</i>	Pension Insurance Corporation
<b>Sacha Sadan</b>	<i>Director of Investor Stewardship</i>	Legal & General Investment Management
<b>Marcus Scott</b>	<i>COO</i>	TheCityUK
<b>Shalini Shan</b>	<i>Director, Financial Services</i>	EY
<b>Siddhartha Shukla</b>	<i>Senior Associate</i>	Herbert Smith Freehills
<b>Balaji Srimoolanathan</b>	<i>Programme Director</i>	Aerospace Growth Partnership
<b>Richard Swann</b>	<i>Partner</i>	Inflexion
<b>Tom Sweet-Escott</b>	<i>Partner</i>	Exponent
<b>Catherine Thirlaway</b>	<i>Senior Manager</i>	EY

<b>Jenny Tooth OBE</b>	<i>Chief Executive</i>	UK Business Angels Association
<b>Mark Tucker</b>	<i>Group Chairman</i>	HSBC
<b>Matthew Tucker</b>	<i>Partner, Financial Services</i>	EY
<b>Ben Walwyn-James</b>	<i>Director, Strategy &amp; Transactions</i>	EY
<b>David Wells</b>	<i>CEO</i>	Freight Transport Association
<b>Chris Wilford</b>	<i>Head of Financial Services Policy</i>	CBI
<b>Garry Wilson</b>	<i>Founding Partner</i>	Endless LLP
<b>Andrew Wollaston</b>	<i>Partner, Financial Services</i>	EY
<b>Gordon Wood</b>	<i>Executive Director</i>	EY
<b>Ian Wright</b>	<i>CEO</i>	Food and Drink Federation
<b>Steve Wynn</b>	<i>Director, Financial Services</i>	EY
<b>Phil Young</b>	<i>Executive Chairman</i>	Sense Network
<b>James Zuurbier</b>	<i>Associate Director, Strategy &amp; Transactions</i>	EY









TheCityUK | THE FIRST 10 YEARS

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## MEMBERSHIP

To find out more about TheCityUK and the benefits of membership visit  
[www.thecityuk.com](http://www.thecityuk.com) or email us at [membership@thecityuk.com](mailto:membership@thecityuk.com)

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