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Breaking the emergency glass: government liquidity support in the time of COVID-19

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As the COVID scourge continues its march across the lives and livelihoods of Canadian individuals and businesses, the federal government has broken the glass and deployed into the economy a historically unprecedented amount of emergency funding in an effort to provide a financial bridge through the crisis to affected enterprises.

This bulletin focuses on the government liquidity programs that are currently available to Canadian small and medium size businesses (SMEs), with relevance by extension to private equity sponsors, venture capital firms, and other institutional investors that are stakeholders in SMEs.

As of the date of writing, liquidity support programs announced by the federal government for Canadian businesses have been for SMEs and not-for-profits. However, the government has acknowledged the need for additional support for large businesses as well. More details are expected in the coming days and weeks.

Business Credit Availability Program

In mid-March, the government announced the redeployment of the Business Credit Availability Program (BCAP) (initially established in 2009 following the financial crisis) to help Canadian businesses obtain financing during this current period of significant disruption and uncertainty. This program will help to fill gaps in market access and leverage additional lending by partnering with private sector institutions.

The federal government is implementing the BCAP program through Export Development Canada (EDC) and the Business Development Bank of Canada (BDC). Together, EDC and BDC will provide more than $65 billion of funding through direct lending, loan guarantees and other types of financial support to SMEs whose access to financing would otherwise be restricted or insufficient to support the SME through this crisis period. Included under the BCAP are the Canada Emergency Business Account (CEBA) and the SME Loan and Guarantee Program. A discussion of the CEBA program (which provides no-interest $40,000 loans to small businesses) is beyond the scope of this bulletin as it is only available to businesses with less than $1 million in total payroll[1].

SME Loan and Guarantee Program

The Small and Medium-sized Business Loan and Guarantee program is designed to be implemented in partnership with Canada's financial institutions to provide additional credit and liquidity options, backed by BDC and EDC, to eligible SMEs whose businesses have been impacted by COVID-19.

1. EDC BCAP guarantee. EDC will provide guarantees to financial institutions backstopping 80% of new operating credit and cash-flow term loans to eligible SMEs of up to $6.25 million. Because EDC is a Crown corporation backed by the full faith and credit of the Canadian Government, the guaranteed portion of the loan will benefit from "AAA" credit enhancement, significantly improving the risk profile of loan exposure from the perspective of the financial institutions making the loans. As of the date of writing, the program cap for the guarantee program is a total of $20 billion for the export sector and domestic companies.

2. BDC co-lending. Through the co-lending platform, eligible businesses may obtain incremental financing to help meet operational cash flow requirements, 80% of which would be advanced by BDC, with the remaining 20% to be funded by the partnering financial institution. The maximum amount of available funding is segmented into three tiers based on annual revenues of the business, with loans of up to:
   - $312,500 to businesses with revenues of less than $1 million
   - $3.125 million for businesses with revenues between $1 million and $50 million
   - $6.25 million for businesses with revenues in excess of $50 million

Eligibility

While the federal guidance published to date has indicated that the SME Loan and Guarantee Program will be geared towards providing liquidity to small and medium sized Canadian businesses, specific criteria as to which entities will be considered eligible is not yet publicly available beyond the requirement that applicants must be credit-worthy with viable business models and whose activities fall within the mandate of either BDC and/or EDC. BCAP is available to eligible businesses across Canada in all industries.

The programs are intended to support viable Canadian businesses so an applicant business must be able to demonstrate that it was directly or indirectly affected by the COVID-19 crisis and was otherwise financially viable prior to its impact.

The requirement to fall within the mandate of either EDC or BDC has been made easier due to the recent legislative amendments passed in March. As Canada's export credit agency, EDC has a mandate to provide financing, insurance and risk management products to help Canadian exporters and investors expand their international business. However, in response to the COVID-19 pandemic the Government of Canada has expanded EDC's mandate to include the support and development of domestic business for a period to be determined by the applicable Ministers. Specifically, EDC has been enabled to facilitate emergency liquidity by providing credit enhancement for financing products available from Canadian financial institutions and private credit insurers. BDC's mandate is to foster and develop strong Canadian businesses by providing capital, financing and advisory services, with a focus on entrepreneurial SMEs across all industries.

Terms

Loans provided under the EDC Guarantee program and the BDC co-lending program are in the form of term loans, rather than revolving loans, and, in each case, are intended to fund operating expenses of the borrower. Loans under the EDC Guarantee program may not be used to benefit the shareholders of the borrower by way of dividend payment or shareholder loan, or to pay bonuses or increases in executive compensation, or to finance a share buy-back or option issuances. A borrower can expect strict compliance provisions to this effect in the loan documentation. In addition, loans issued under the EDC Guarantee program are not to be used for the repayment or refinancing of existing debt of the business. This program is intended to help Canadian businesses survive this period of economic lock-down and not benefit existing creditors. However, recent guidance from Canada has indicated that interest payments on existing debt are considered to be an operating expense for which the loans made under the BDC co-lending program could be used.

In contrast to the no-interest loans being offered under the CEBA program, the loans facilitated by EDC and BDC will accrue interest at "market rates", implying a standard benchmark rate such as a prime rate plus a margin based on the credit risk profile of the enterprise seeking funding. Loans under the BDC program are interest-only for the first 12 months and are then subject to a 10-year repayment period. Loans that are guaranteed under the EDC Guarantee program must be repaid within one year.

Eligible companies may apply for financial assistance under either or both of the EDC and BDC platforms, so medium-size companies with revenues in excess of $50 million could obtain up to $12.5 million through the two streams.

How to access

Businesses seeking support through BCAP should contact the financial institutions with which they have a pre-existing relationship, so that the financial institutions may assess the client's financial request. If the needs of the client exceed the level of support the financial institution is able to provide, the financial institution will work alongside BDC or EDC to access the additional resources the federal government has made available under BCAP. Participating financial institutions will conduct the underwriting and manage the interface with their customers. This program is not intended to supplant available private credit, but to support the ability of Canadian businesses to receive, and financial institutions to provide, the liquidity support required to weather this unexpected financial storm.

Business and legal implications

From the perspective of an SME, or a private equity sponsor with SME portfolio companies, there are a number of legal and strategic considerations implicated by accessing, or choosing not to access, emergency COVID-19 government funding.

One interesting and open question relates to how SME companies with private equity ownership or institutional backing will be viewed in terms of applying for government funding. On the one hand, a PE sponsor with the ability to step-in to provide financial or other support to the SME—for instance, by injecting equity for liquidity or financial covenant compliance purposes—would be considered favourably from a credit profile perspective, and accordingly, a more attractive candidate to receive the government support. On the other hand, SMEs with private equity support may be considered to have less need for BCAP funding which could score against them in terms of their eligibility. It bears repeating that the government's objective is to support access to private funding rather than supplant it. In that regard, to the extent that a bank would be willing to lend to an SME supported by a PE sponsor, then the presumption will be that the SME does not need to access to BCAP—it is intended for those cases where the bank would not otherwise be prepared to take the credit risk of extending additional financing.

For SMEs that do choose to avail themselves of one or more BCAP financing programs, they will need to consider the same third-party creditor implications they would face in the ordinary course; the loans made and guaranteed under the BCAP program do not have any special legal or legislative status that would remove such loans from such considerations. For instance, do their existing credit facilities permit additional third-party debt? Can post-COVID-19 forecasted revenues support the additional BCAP debt? Will amendments to existing credit facilities be needed to permit the new BCAP debt? Will financial covenants need to be adjusted to take into account the increased leverage due to the BCAP funding?

Experience has shown that, in times of financial distress, relationships matter most. Those SMEs, private equity sponsors, VC funds, and other stakeholders that have an established track-record and trusted relationship with their banks will be well positioned to secure the requisite amendments necessary to access the additional BCAP financing. Conversely, it may be a possible challenge for SMEs that do not have established relationships with banks, finding themselves at a relative disadvantage to PE-sponsored SMEs that do.

From the lender perspective, the BCAP financing platforms will provide an opportunity to deepen existing relationships at a critical time when SME customers (and their financial sponsors) will remember who was there with available capital when they needed it most.

OSFI measures

The Office of the Superintendent of Financial Institutions (OSFI) is taking measures to indirectly release financing capacity into the economy by relaxing certain capital adequacy requirements (CAR) applicable to Canadian financial institutions. Capital adequacy guidelines issued by OSFI generally require that regulated financial institutions hold regulatory capital (such as common shares and retained earnings) as a percentage of the institution's risk-weighted assets; this regulatory capital is intended to absorb potential losses on the institution's assets (such as it loans to consumers and businesses) and shelter depositors and other creditors from losses.

On March 13, 2020, OSFI announced it would lower the Domestic Stability Buffer (DSB) of risk-weighted assets by 1.25%, effective immediately. The DSB is intended as an additional capital safeguard to protect against key vulnerabilities and systemic risks. Lowering the DSB has allowed Canada's "Big Six" banks to release up to $300 billion of additional lending liquidity into the economy. In conjunction with that directive, OSFI has advised that it will be incumbent upon those banks to use the additional lending capacity to support Canadian businesses and households, rather than, for instance, using the released capital to increase shareholder distributions or to undertake share buybacks[2].

On March 30, 2020, OSFI released a direction mandating how financial institutions should treat new capital made available to SMEs through the government programs described above[3]. With respect to the EDC BCAP Guarantees, the guaranteed portion of the loans from EDC can be treated as an exposure to the Government of Canada (being a Crown corporation), thereby benefiting from a "AAA" credit rating and a 0% risk-weighting under the CAR Guidelines. The remaining portion of the loan would be treated as an exposure to the borrower. This has the effect of elevating the credit-worthiness of the guaranteed portion of the loan, thereby decreasing the amount of regulatory capital that the institution needs to hold with respect to the loan and making it more likely for the loan to receive credit approval from the lender and improving the terms and pricing of the loan.

Under the BDC co-lending program, only the portion of the loan made by the financial institution will receive the risk weight attributable to the exposure of the borrower. In calculating OSFI's leverage ratios that each financial institution is required to maintain, the BDC portion of the loan will be excluded from the leverage ratio[4]. Both measures result in more favourable capital treatment of the underlying credit exposure for the partnering financial institutions, and accordingly are designed to incentivize the assistance of the financial institutions in the deployment of additional liquidity to Canadian businesses.

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[1] https://www.canada.ca/en/department-finance/news/2020/03/additional-support-for-canadian-businesses-from-the-economic-impact-of-covid-19.html

[2] https://www.osfi-bsif.gc.ca/Eng/osfi-bsif/med/Pages/nr_20200313.aspx

[3] http://www.osfi-bsif.gc.ca/Eng/fi-if/in-ai/Pages/DTI20200330_let.aspx

[4] https://www.osfi-bsif.gc.ca/Eng/fi-if/in-ai/Pages/DTI20200330_let.aspx

Read all our coronavirus-related updates on our COVID-19 guidance for organizations resource page.

To discuss these issues, please contact the author(s).