Tick, tick . . . race to defuse the £107bn coronavirus debt timebomb

City grandees are mobilising amid fears the huge borrowings needed to get firms through the crisis could bring the economy crashing down

Peter Evans | Emma Dunkley | Jill Treanor
Sunday June 07 2020, 12.01am, The Sunday Times

Emma James, second left, with staff at her physiotherapy practice. She worries another lockdown would leave her unable to pay off her loans

Emma James has kept her physiotherapy practice running throughout lockdown. The 43-year-old, who has a clinic in Berkhamstead, Hertfordshire, and runs ergonomics training courses for the Foreign Office, has managed to conduct virtual sessions and plans to restart treatments that require minimal contact, such as acupuncture.

Still, the financial strain of the past three months has been severe. To support the business, James borrowed £150,000 using the bounce back loan scheme (BBLS), which provides a full government guarantee for lending of up to £50,000. She has three companies and borrowed the maximum for each one.

While James is confident she can repay the debts and believes her business will return to growth, there is a nagging doubt: “Another lockdown would kill the business and I would not be able to pay back the loans,” she admitted.

This is the nightmare facing the economy just as signs of life begin to stir. A vast wall of debt and other liabilities has built up since the pandemic started, mainly through the government's emergency loan schemes, but also from payment holidays on existing loans, overdraft extensions, delayed rent payments and temporary tax exemptions.

The measures were essential to help companies survive but could now represent the greatest obstacle to recovery. Research submitted to the Bank of England, to be published tomorrow, puts the scale of "unsustainable debt" in the system, including loans taken out before the coronavirus struck, at as much as £107bn by March next year — the end of the interest rate-free period on Covid-19 emergency loans.

In March, private-sector companies raised £31.6bn from banks and markets — more than the previous six months combined. That fell to £16.3bn in April but does not include the BBLS, which launched at the start of last month and lent more than £21bn in the first four weeks.

The assumption is that businesses will start trading again around the time that many of these liabilities fall due, allowing the economy to return to growth as banks and the exchequer are repaid.

That looks like a gigantic gamble. Company bosses, senior bankers and economists all agree: another setback would be terminal for thousands of businesses and stifle any hopes of economic recovery.

Insolvency practitioners say a "phony war" has broken out, where few businesses have actually gone under thanks to rescue loans. The real test will come as consumer demand rebounds — but businesses are incapable of meeting orders because of debt repayments.

"It is the classic symptom of overtrading," said Duncan Swift, a recent president of the insolvency trade body R3. "If there is a significant uptake in orders but a weakened working capital base, that is when insolvencies will spike. The feeling is that it is three months off."

Three months coincides with the end of the job retention scheme, which has seen employers rely on the state to help pay the wages of 8.7 million workers. Many are expected to be made redundant and the unemployment rate is forecast to hit 10%, or 3.5 million. Redundancy costs will add another short-term liability for bosses to worry about.

Even without a second wave of disease, the mountain of corporate debt poses a significant problem. Bank bosses believe many loans will not be repaid. Last weekend, Sir Howard Davies, chairman of Royal Bank of Scotland, said he thought that a toxic clean-up fund should be created to work out soured debt from the BBLS and the coronavirus business interruption loan scheme (CBILS).

Privately, bankers believe that the government's backing of loans will not automatically kick in if defaults occur. "We view BBLS and CBILS as unsecured because, if something goes wrong, the government will not say 'We'll pay you off' — it will come up with all sorts of reasons why it can't," one said.

The spectre of unpaid debt risks strangling the ability of companies to recover. Senior politicians and business leaders fear a generation of zombie companies, with bosses unable to invest in growth or innovation because everything is geared towards servicing loans. A report last week by the Institute of Directors (IoD) found that more than half the businesses that have taken on debt during the crisis said it would have a negative impact on their recovery without further assistance.

Defusing the debt timebomb is seen as an essential next step in salvaging the economy. Several groups of City figures have come up with plans to inject equity, rather than more debt, into companies with a shot at survival. Others, such as former chancellor George Osborne, recommend the government write off some loans. All agree that a strategy is essential.

“To be designing something at five minutes to midnight before launching the next day makes no sense when we can see what is going to happen starting in the autumn,” said Stephen Welton of the Business Growth Fund (BGF), Britain’s biggest investor in small businesses.

The BGF has proposed a £15bn fund, with up to half put up by the state, to invest and kick-start growth. Welton said: “There is a growing acceptance that [equity] investment has to be part of the solution. Then you get into who is going to pay for it — and how.”

The most prominent faction to address funding the recovery is the so-called recapitalisation group, chaired by Aviva’s Sir Adrian Montague under the auspices of TheCityUK. Its research indicates that a third of all funding through the emergency loan schemes will not be repaid — about £36bn of toxic debt.

The group’s interim report, published tomorrow, focuses on 250,000 small and medium-sized businesses that face “unsustainable debt”, leaving them unable to grow. Its ideas include creating a pool of problem loans, and two potential vehicles. The first, a development body funded by the government, could take minority stakes in small companies and also absorb the big, strategic investments being examined by Project Birch, the scheme through which the Treasury is expected to bail out airlines, car-makers and other giants. The second, an asset management company or asset protection scheme, would underwrite the loans.

The report outlines the use of instruments such as preference shares or contingent tax liabilities to relieve the debt burden, and appears to acknowledge that the private sector is unlikely to come up with enough equity funding. If debt-laden firms collapse, it could force banks to call on government guarantees — and create a second wave of financial problems.

Bank chief executives were instructed by chancellor Rishi Sunak to distribute the loans as quickly as possible — but debt collection still falls upon the banks, and it is already weighing on their minds.

Many bank chiefs are rightly worried about demanding loan repayments from small businesses a decade after the global financial crisis, when thousands of struggling companies were mistreated by banks such as RBS. Sources say a row with the Treasury is likely. “This will be a massive area of contention,” a former banker said. “Did the banks try hard enough to collect the debts?”

Foreign groups and tax avoiders snaffle bank cash
Mid-sized companies are still struggling to access emergency loans from the Bank of England nearly three months after the scheme was launched, and are being forced to borrow from banks at much higher rates.

The Covid Corporate Financing Facility (CCFF), announced on March 17, allows companies to sell debt directly to the Bank at low rates, rather than via the financial markets.

It was designed to offer a lifeline to companies needing bigger loans than offered by programmes such as the coronavirus business interruption loan scheme (CBILS).

However, the requirement to have a commercial credit rating and the complexity of the application process appears to have favoured the largest companies. Figures released last week showed that German chemicals giant BASF had borrowed £1bn, while easyJet, InterContinental Hotels and luxury brand Chanel took £600m each.

In total, £16.2bn has been taken from the CCFF, but many companies have been rejected, or been asked to resubmit applications.

The CCFF has been criticised for channelling taxpayers' cash into foreign companies, including two that paid no corporation tax last year — BASF and CNH, owner of lorry-maker Iveco, which borrowed £600m.