

A Simple Proposal to Support Indebted Small Businesses (SMEs) during COVID-19:

Allow Debt Extension, Keep Financial Sector Liquid, and Preserve Bank Capital

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The proposal consists of three steps to provide *temporary* debt relief to SMEs, effectively *postponing adverse asset-quality recognition and bankruptcy filings*, while *safeguarding financial stability*:

- 1) **Allow SME debt extension without bank capital charges:** Increase the maximum grace period on loan payments of “standard” (not already in default) *eligible* SMEs that are due between 24th March 2020 and 30th June 2020 from 90 days to 180 days for asset classification by banks as a non-performing asset (NPA). Example: For a payment due March 31st, the SME would not be classified by its bank as NPA (which usually hinders future credit) as long as the payment is made by 30th Sep.
 - a. Eligibility is a regulatory design choice between Comprehensive versus Targeted (which limits unintended consequences): All standard loans or only above a threshold rating and below a threshold asset size or turnover? All SME sectors or only the most-affected ones? Exclude federal aid recipients? Reduce eligible debt by the amount of federal aid received?
 - b. Eligible SMEs would avail of the option at their discretion to delay repayment up to 180 days delay. Healthier SMEs not facing headwinds may repay on time to access extra credit.
 - c. Banks would not have to undertake write-offs and suffer capital erosion on such delayed repayments during the 180-day grace period on eligible SME loans.
 - d. Banks, and also non-bank lenders, should not be allowed to file eligible SMEs for bankruptcy for delayed payments until the 180-day grace period is over.²
- 2) **Keep the financial sector liquid** through central bank’s lender-of-last-resort (LOLR) operations:
 - a. Delaying loan payments does not alter aggregate liquidity but affects only its distribution within the banking system. Hence, banks exposed more to the eligible SME sectors may need greater LOLR access if inter-bank markets fail to reshuffle liquidity efficiently.
 - b. The central bank can increase aggregate liquidity injection to assuage liquidity concerns of such banks by increasing the pool of eligible collateral or lowering haircuts and lending rates.
- 3) **Preserve bank capital** by restricting all banks with immediacy from any dividend payouts or share buybacks over the next 12 months:
 - a. Due to moral hazard on part of some eligible SMEs and/or if economic stress worsens, banks may incur greater loss than presently anticipated. Banks should be prepared for this outcome with preservation of existing capital; hence, no dividends or buybacks.
 - b. Any excess bank capital can be countercyclically relaxed to support new credit creation.

Sunset clause: This is not meant to be a permanent relief, so a sunset clause such as eligibility of payments due only up to 30th June 2020 is desirable; the objective is temporary debt relief for employees and owners of SMEs, not to “extend and pretend” bank loan defaults or to provide banks capital relief.

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² Many countries have already adopted temporary moratorium on bankruptcy filings for small businesses.