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Ideas Forum: Can revenue contingent loans support the small business recovery

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Introduction

As the COVID-19 pandemic arrived in Australia, the Prime Minister Scott Morrison MP announced a financial package to support businesses including the "Coronavirus SME Guarantee Scheme".

The scheme is one of the largest pandemic support measures, only dwarfed by JobKeeper. It would support $40 billion of lending to Small and Medium Enterprises (SME) by guaranteeing 50 per cent of the loan with participating financial institutions.

Low take up led to an expansion of the scheme in March 2021 which would now guarantee 80 per cent of the eligible loans up to $5 million.

As of 31 August 2021, only 17 per cent ($6.8 billion) of the $40 billion of loans have been issued.

The NSW and Victorian economies are expected to begin easing restrictions from October 2021. Other states are expected to take steps towards normal reopening before Christmas as the number of vaccinated Australians reaches 80 per cent.

While these developments may be welcome relief for small businesses, in many cases they will also require the beginning of repayments of deferred rent and other expenses.

Many of these small businesses continue to fall within a gap of available credit. In their 30 September 2021 paper "Small Business Access to finance", the Productivity Commission stated:

> *"While the SME market is well covered by various lenders and products, there appears to be a gap for unsecured finance between $250 000 and $5 million, with few lenders willing to offer these loans."*

Uncertainty will undoubtedly be impacting on business decisions with respect to commercial borrowing to help replace recession-induced falls in revenue. In such an unparalleled risk circumstance it is predictable that business, small business in particular, will be very cautious with respect to extensions of credit obligations.

A pertinent question is: Is there a different type of a loan instrument that overcomes these repayment concerns for borrowers? What follows explains that in concept there is such an instrument and it is known as a "revenue-contingent loan" (RCL).

What is a revenue contingent loan?

RCLs for business are a financial instrument in which money is provided to eligible firms in the form of a loan. However, the loan has a critical feature which is quite different to normal commercial and the government's concessional loans. This is that with an RCL repayments of the debt are required if and only when the firm has the capacity to repay; this is what economists call a "contingent debt".

In concept the idea is similar to the Higher Education Contribution Scheme (HECS), in which students are provided with a benefit, in the form of not having to pay tuition on enrolment for a university degree, which is then paid when graduates are able to afford to do so depending on their future incomes. This provides to university debtors insurance in the form of not having to repay in periods when they can't afford to. An RCL would also provide insurance to a small business debtor, and in this way HECS and an RCL have in common protection against the consequences of loan repayments when financial circumstances are adverse. However, RCL operate quite differently to HECS in practice, an issue explained below.

What are the benefits for borrowers?

As noted, RCLs are quite different to typical loans, because no or only very low repayments of the debt are required when the financial circumstances of the borrower are poor. This is a particularly important feature in Australia's contemporary economic environment where uncertainty and high variance with respect to the financial well-being of small business are very high. What an RCL means is that firms will be able to access a loan without major concerns or anxieties associated with repayment difficulties, and this also implies that even with very poor financial circumstances the potential costs of bankruptcy from an incapacity to repay a loan are avoided.

This does not mean that RCL should be promoted as a major replacement of bank loans - it is not after all a function of government to organise and control commercial credit - and there might be good reasons why different financial instruments could be available simultaneously to suit the particular and idiosyncratic circumstances of business. In the contemporary crisis RCL should be seen as a complement to normal loans, and having this facility available to business could well mitigate the substantial risks faced by banks in on-going loan recovery. While this is beyond our discussion, it should be recognised that the suggestion of RCL is at this time because of the uniquely poor economic circumstances that is today's economic reality.

How would it work?

The first operational point of an RCL is to distinguish this type of loan from the income-contingent loan variety which defines HECS. This is because HECS uses individual income as the basis for repayment of the debt, which is completely appropriate for a system targeted in the main on wage and salary earners. However, the way forward for a business-oriented contingent debt can't be personal income; this is because the collection contingency has to to be related to the economic well-being of a small business and not personal incomes.

In Botterill, Chapman and Egan (2004), we examined what might be the most efficient basis for collection of a contingent debt for farmers provided loans in the time of drought, and it became clear that farm property revenue is the best way to ensure the instrument would be effective. Since most farms are simply a subset of Australian small business, the collection issues we developed and resolved are very pertinent to how an RCL would work for all small business. Our analysis suggested quite clearly that revenue, not profits, is the best forward, now explained.

The key debt collection administrative points with respect to an RCL for small business are that:

(i) The reporting of revenue is a legal quarterly requirement of all business, through the Business Activity Statement;

(ii) The debt would be tied to the firm's unique Australian Business Number; and

(iii) Unlike what the situation would be for the use of profits, revenue cannot legally be manipulated to suit the timing of repayments for an enterprise.

Here's how an RCL would work. A qualifying business, with eligibility determined by the government, would apply for an RCL. The maximum amount able to be accessed would be capped, and in order that substantial repayments would ensue, this amount needs to be set at a maximum depending on a firm's past annual revenue experience; this information is easily available from the Australian Taxation Office (ATO). The cap could be something like not more than 50 percent of the average annual revenue of the past 2-3 years of the company, with a maximum set at, say, $200,000 per firm.

The government would provide the loan (which could come from a bank if that mattered for the budget) to the business and the debt would be recorded with the ATO. Every quarter the revenue reported with the firm's Business Activity Statement would activate some debt collection, with the amount set at a given (low) percentage of revenue, for example 5 percent.

This means that, with a 5 per cent of revenue repayment requirement, if a firm borrowed $50,000 and in the first year after the loan became available the firm's recorded revenue was $80,000, the RCL in that year would require a repayment of 5 percent of this, which is $4,000. If revenue in the second year turned out to be $200,000, the repayment obligation would be $10,000 in that year. If this experience was replicated in the ensuing 5 years, the RCL would be completely repaid in under 6 years.

With colleagues, I have done some simple modelling using different scenarios of debt levels, interest rates, and collection parameters, and they all come to the same result. This is that RCL organised for both farms Chapman and Dunk (2020) and business generally (Chapman and Piggott, 2020a) in the way described would lead to 100 per cent of repayments within less than 6 years, so long as the establishments exist in the future and are thus able to repay (more on this below).

Of course, there is a very large number of possible collection parameters for an RCL, such as making the proportion of revenue required for repayments progressive depending on revenue (as happens with HECS with respect to personal incomes). Our modelling is illustrative only and we have kept it very simple.

What is the fine print?

There is little doubt that an RCL would be strongly favoured by small business; after all, the policy minimises the risks to firms of borrowing. If designed well there is no prospect of a firm having repayment hardships with respect to such a loan, and this type of financing cannot add to default risk. But what about the lender, the government? What might be the issues for government from this type of public policy financial intervention?

For the public sector, a principal concern of the suggested policy instrument would come down down to the prospect that repayments of an RCL are low, meaning that the taxpayer subsidies could be considered to be excessive. It is important that the design of an RCL for small business tackles this concern.

There are several design questions that need to be addressed to minimize the extent of RCL non-repayment for small business and among others these would include:

(i) Eligibility criteria: Making RCL available only to business which have been in existence for a set amount of time (eg 3 years);

(ii) A sharing of the risk such the managers/owners of a small business have some personal responsibility of unpaid RCL obligations in the event of a bankruptcy;

(iii) Considering the possibility that, in the event of a bankruptcy, unpaid RCL debts have a major priority to be repaid out of the sale of assets; and

(i) To cover some part of the non-repayment of an RCL by some firms, there could be a surcharge of say 10 per cent on the debt, such that a business borrowing for example $50,000 would be required to repay $55,000.

Finally, when governments are not quite sure how policy reform might work in practice, but there are compelling arguments for such a reform if it can be shown to work, a sensible response is to gather evidence on the likely effects. This is the basic rationale for an RCL pilot, and the issue is promoted in Chapman and Piggott (2020b). But given the urgency of the situation this would be a very long way from the best current approach.

References

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