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COVID-19 Considerations For UK Asset-Based Lenders

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As the global crisis develops with bewildering speed, lenders of all kinds find themselves caught, increasingly, between the demands of government to support business and jobs on the one hand, and the increasing risk of borrower default on the other.

Regulated lenders are subject to specific requirements laid down by their supervising authorities. The following is intended to provide pointers to nonbank lenders, specifically those operating in the receivables finance and asset-based lending sectors, which may not be receiving guidance from regulatory bodies.

A number of lenders for which we act, particularly those with small-and-medium-enterprise lending businesses, are experiencing material week-on-week decreases in receivables turnover. Those with exposures in the larger enterprise market have been witnessing almost the opposite, largely as a consequence of stockpiling by purchasing managers.

Stockpiling drives short-term demand. Meeting that demand is a societal good and may make sound business sense by generating increased revenues now which may strengthen the client's ability to weather leaner economic times ahead. However, ramping up production may be more than the client's current cash position can permit. They will need additional finance to meet increased demand.

On the supply side, clients that are stockpiling need increased inventory finance availability.

But as we noted at the outset, clients operate in other sectors are already suffering sharp falls in demand. Business services and travel-related businesses are prime examples. This group are at increased risk of covenant breaches and payment defaults.

In these and other situations, receivables financiers and asset-based lenders are well-placed to, and may wish to, provide increased financial support to valued clients. But with clients themselves experiencing disruption and calling for urgent support, the lender's desire to help must be balanced by careful risk management and realized by efficient service delivery.

Plan

Lenders need to make contingency plans now to cope with a high volume of covenant breaches, forbearance requests and requests for limit increases. This extends to assessing the robustness of management. Do you have multiple redundancy built in to your senior management structure, so that decisions can still be made if and when managers become unwell or are compelled to self-isolate?

Huge numbers of staff have been transferred to homeworking, yet there are still people performing tasks in lenders' offices that cannot so easily be handled remotely. It's time consider to how and to what extent these remaining tasks are capable of being dealt with on a remote basis. For example, can payments to clients be authorized and actioned remotely each day?

All staff, but remote workers in particular, may be coping with significant personal demands. They may be infected themselves or may be living with partners or children who are showing symptoms of illness. In such circumstances, they may be operating under significant stress, without the usual support systems on which they could rely at work, while having to make important credit or portfolio decisions alongside caring for relatives.

Ensuring that they are provided with support not only falls firmly within your duties as an employer but also may help to reduce poor or rushed decisions which might lead to problematic or even damaging credit exposures.

Consider the extent to which credit or portfolio decisions could, in the first instance, be standardized — in essence, a system to triage client forbearance or increased limit requests — which enables low-risk requests to be handled on a simplified basis, while separating more difficult decisions to be dealt with in a more bespoke manner.

U.K. lenders participating in the Coronavirus Business Interruption Loan Scheme will already be having to deal with a significant number of applications for finance, but they are going to be far from alone. All lenders are going to come under pressure and setting up decision-making processes now will make matters easier — or as easy as they can be — later.

Lenders should recall that they have professional suppliers — including accountants, valuers, lawyers and insolvency practitioners —who may be in a position to provide enhanced support. Consider whether more tasks could or should be outsourced to them in order to relieve pressure on your own resources. At the same time, be alert to their service delivery and ensure that you are aware of the extent to which they may or may not be affected by coronavirus-related disruptions.

Legal Risk

Straightforward limit increases and waivers may not require much, if any, legal documentation. In many cases, a simple letter will suffice.

However, thought should be given to the existing legal package. It may have been negotiated at a time when the client was in a stronger financial position. As a result, the coverage provided by the documents may not be sufficient to provide the best protection for increased risk or exposure.

An example that we commonly encounter occurs in group lending situations where, at the outset, the parties agreed that certain members of the group would not need to provide guarantees or collateral. In such cases, ring-fencing arrangements should be checked to ensure that cash leakage to members of the group that have not given security is restricted.

Even where ring-fencing is adequate, consider whether previously excluded members of the group could now provide additional collateral to support an increased exposure.

For higher-risk clients or larger exposures, consider whether a security review may be appropriate. Clients may experience increased payment periods and/or defaults among their own customers. Lenders should be alert to changes in debt turn performance which may indicate, together with any available data indicating increasing creditor stretch, that debtor ledgers are becoming unreliable.

Lenders offering recourse facilities will almost certainly experience greater demand for accommodations from their clients. Those offering nonrecourse or credit-insured facilities will face a greater load on their credit collections departments and will have to deal with increasingly stretched insurers and brokers. This is another area in which outsourcing can be effective, by the use of external collection agencies (or, in more complex or larger cases, external litigation counsel) as part of a wider debt recovery strategy.

Grounds for nonpayment of receivables are likely to become more complex, due to the impact of coronavirus on debtor businesses. Contractual grounds for nonpayment that may become relevant include frustration, material adverse change and force majeure, which are not typically encountered in debt recovery situations.

Lenders should ensure they have access to specialist legal advice to assist in dealing with these more difficult disputes. It should be noted, in passing, that there may be situations in which the client itself has failed to perform and those lenders financing contractual debts will need to consider the whole of the supply relationship, over a period of time, determine to what extent nonpayment is justified.

Financial stress connected with coronavirus may also lead to an increase in fraud cases. Always an issue for invoice financiers, incidences of fraud tend to increase in recessionary downturns, particularly (but not exclusively) in owner-managed businesses lacking internal controls. Consideration should be given to taking fraud indemnities in a wider range of cases than is currently market practice.

We have advised clients repeatedly that, even where the indemnifier does not have sufficient assets to meet an indemnity claim, the mere existence of a fraud indemnity is a major incentive to business owners to cooperate with their lenders when events start to spin out of control. In such circumstances, they will be anxious to preserve even limited assets such as the family home which might otherwise be at risk.

In all cases, it will become important to try and get ahead of events as they unfold. This means more proactively intervening where cases of client stress emerge and making rapid decisions on the best approach on a case-by-case basis. Although it is reasonable to expect that lenders will treat client insolvency as a last resort, this may not be avoidable in some situations and in any case, external events may lead to insolvencies even where lenders themselves would be inclined to provide financial support.

Lenders should be taking steps now to ensure that they have sufficient personnel allocated to deal with clients under stress and that clear procedures are in place to empower their staff to achieve rapid resolutions.

Receivables finance and asset-based lending are to some extent counter cyclical and previous downturns have shown that the sector is remarkably resilient in periods when other types of lender may be pulling in their horns. It is quite possible that lenders will receive a higher-than-normal number of inquiries from prospective clients, including those that are not receiving the support they need from their current lenders.

While this represents both a growth opportunity for the sector and a chance to help the wider business community, it will be important to maintain lending discipline, to ensure that facilities are properly documented with robust legal documentation and that lending criteria are adhered to as closely as possible.

Experience of previous downturns indicates that, early on in the recessionary period, sales prerogatives can sometimes outweigh credit and risk considerations, with discipline only reestablishing itself once early mistakes start to come home to roost.

Silver Linings

Recent developments may encourage lenders to provide increased support to clients that are under financial pressure.

First, on March 11, the U.K. Budget announced that the government would delay its plans to make Her Majesty's Revenue and Customs a secondary preferential creditor in insolvency for debts related to specific taxes payable for customers and employees. This will now apply only insolvencies commencing on or after Dec. 1, as opposed to the start of the new tax year on April 6.

The delay in implementing the measure has given rise to some hope that this much-opposed change to the status of HMRC may be abandoned altogether. Regardless of that, the importance of the delay for lenders in the current circumstances is that it will be one less thing for them to worry about, should they decide to defer taking enforcement steps in respect of problem credits while the coronavirus crisis persists.

Second, new legislation increasing the upper limit of the prescribed part (the ring fenced amount of floating charge recoveries that is reserved for unsecured creditors) from £600,000 to £800,000 will now only take effect where the relevant floating charge was created on or after April 6.

Importantly, lenders relying on existing floating charges will not be affected by this increase and there are still two to three weeks remaining in which supplemental floating charges can be taken without being affected by the increase, should lenders choose to provide greater financial support to clients on the basis of additional collateral.

Finally, at the time of writing, the U.K. government is consulting on significant short-term reforms to insolvency and related laws to help protect struggling businesses — many of which would be entirely viable but for the impact of the current crisis — and protect jobs. These are still subject to consultation but may include protection against creditor winding-up petitions and extended moratoria against creditor enforcement action.

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