Are additional crisis measures needed for supply chain finance?

The government has introduced a vast arsenal of fiscal and financial responses to mitigate the effects of the crisis on households, business and the economy. The financial responses are largely focused on the "formal" financial sector, with the objective of enabling banks and others to support businesses and households via continued lending and easing cash flow pressures from existing debts.

These are welcome, but the complexity and interdependence of our economy means that there is another source of financial stress that needs to be addressed. This is what might be called "informal finance" associated with the usual practice of payment for goods and services lagging behind their delivery.

Trade credit is one element. Another is the implicit financing of employers by their employees via accrued entitlements, such as holiday leave.

Trade credit financing is vitally important to the smooth functioning of our economy. Trade debtors, reflecting credit granted from sale of goods, together with other receivables can be quite large relative to bank financing for many businesses.

Typically the business will also be a recipient of trade credit resulting from its purchases of inputs, meeting those obligations as it receives cash from its trade debtors. Disruptions to that cash flow due to delays or (worse) default on payment can thus cascade through to other businesses.

Likewise, employee entitlements which could be met as they are gradually called upon over time can create liquidity and solvency problems if suddenly triggered by mass layoffs. Fire sales of assets in an attempt to meet these obligations can worsen financial distress.

The current shuttering of many businesses and reduced demand being experienced by others brings these problems to the fore, and highlights a need for further government attention.

Consider first the case where the crisis means that what appeared to be a previously viable firm will fail (perhaps because its trade debtors default or reduced cash inflow makes it unable to meet unavoidable fixed costs such as rent). In these cases it is important that insolvency and liquidation practices are efficient and fair – not something which past experience provides confidence about.

Luckily, unpaid employee entitlements will be met via the government operated Fair Entitlements Guarantee (FEG) scheme. But a firm's default on trade debits and other payables, means other firms to which it owes money will be put under stress.

While some of those businesses will have taken out trade credit insurance to hedge this type of default risk, not all will have done so. The government's CoronaVirus SME Guarantee Scheme, which provides a 50 per cent guarantee of new bank loans to SMEs, may warrant amendment to deal with this problem for uninsured firms.

Banks, or other financiers, will be reluctant to purchase existing trade credit receivables from viable SMEs (at anything other than a low price) because of the risk of default of the debtor firm. Extending the Guarantee Scheme to cover such purchases (admittedly not a simple thing to design and implement efficiently and fairly) would facilitate such SMEs remaining liquid and solvent.

There may also be some otherwise viable firms where employee layoffs trigger the immediate demand for payment of employee entitlements, which reduced cash inflows mean they are not able to meet. Such firms may be able to get working capital loans from banks which utilise the RBA's Term Funding facility, enabling them to meet those employee entitlement payments.

Arguably, there is a case for generous terms for such targeted loans since, if the business otherwise failed and could not make the entitlement payments, the government would bear the cost via the call on the FEG Scheme.

A further concern is that the increased risks, claims, and uncertainty in the current crisis will likely put trade credit insurers under pressure and lead to increased premiums and reduced availability of cover. This was the experience after the GFC in the UK where the government introduced a (not obviously effective) trade credit insurance scheme to enable firms facing diminished private insurer cover to obtain "top-up" insurance via the government scheme.

To the extent that the availability of trade credit dries up, or its cost increases, economic recovery and business continuity will be threatened. We saw, last year before the crisis, that there were many problems in the trade credit market, enabling larger firms to impose significant costs on smaller counterparties.

Avoiding a trade credit "meltdown" should be an important focus of current policy.

Kevin Davis
Professor of Finance
The University of Melbourne
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