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PERSPECTIVES

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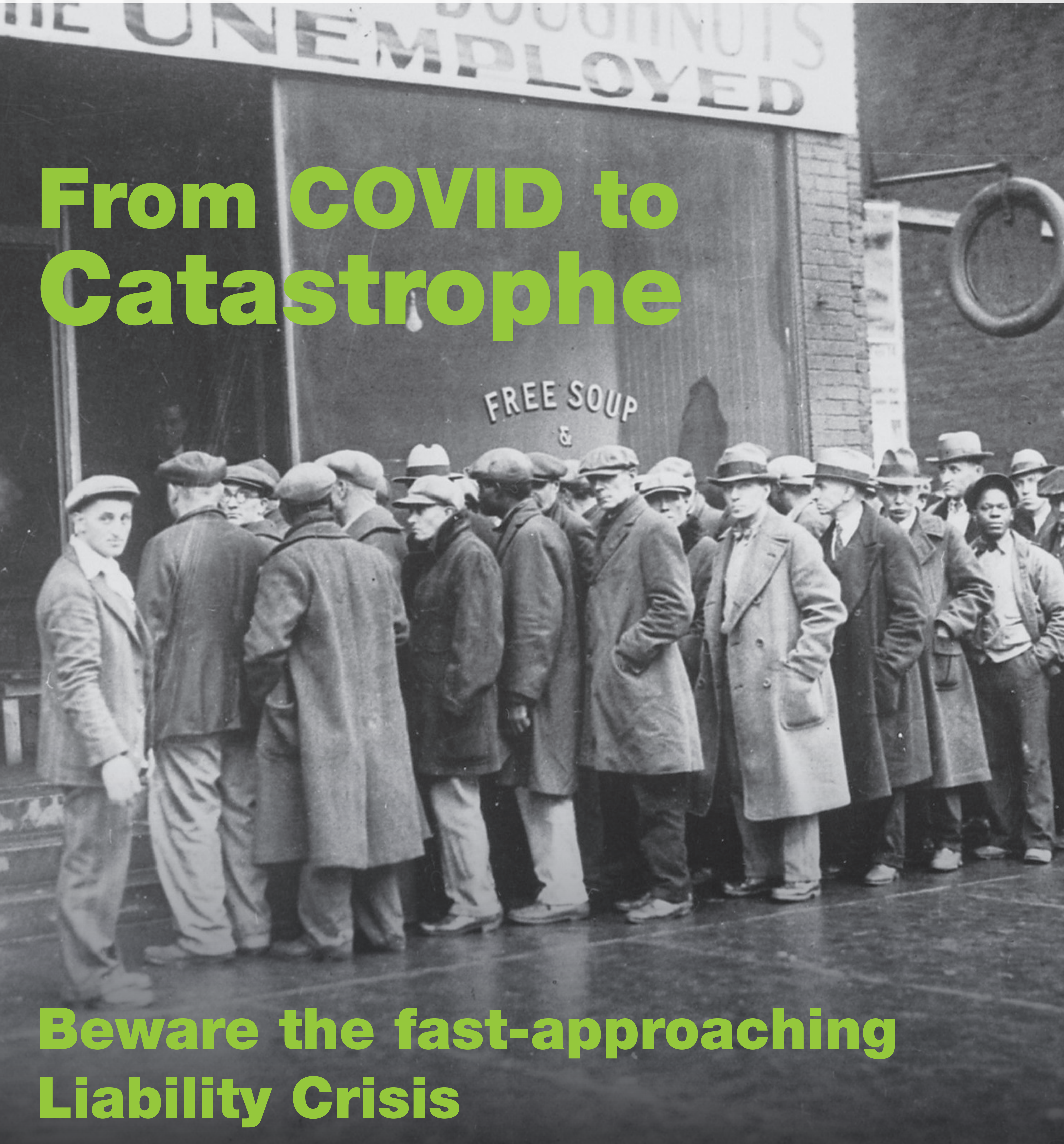
From COVID to Catastrophe



Beware the fast-approaching Liability Crisis

Chicago Soup Kitchen During the Great Depression - National Archives at College Park / Public domain

Too much attention has been focused on filling the income gap that many people and companies now face and too little on reducing expenses and liabilities. As a result, there is a growing risk that the current health crisis and economic downturn turns into a massive liability crisis, triggering a Second Great Depression in many developed economies.

Let me explain.

Most importantly, many government policy responses to the economic downturn triggered by the COVID Crisis appear to overlook two critical facts:

- First, providing people or businesses with access to additional *debt* does not address their *income* problem – it merely kicks it down the road and adds to financial stress. For individuals, the added financial risk should logically drive *reduced* spending, the last thing governments want right now. For company directors, borrowing in the face of operating losses will simply increase risk of trading whilst insolvent, opening up a can of personal liability worms. Many will prefer to seek Chapter 11 protections/ administration proceedings.

- Second, interest rates are close to or below zero in most developed countries. This means that financial institutions can defer principal repayments with no associated holding cost. In contrast, if institutions trigger default clauses and call in loans at a low point in the financial cycle, they will incur additional credit recovery costs and are much more likely to crystalise credit losses too, damaging their capital base. This will, in turn, rapidly restrict their ability to make new loans to healthy companies, both now and into 2021 when capital will be required to support rebuilding economies.

The above scenario is well understood – it is precisely what Japan has navigated over the last thirty years, as I witnessed first-hand during my time there in the late 1990s and early 2000s.

To avoid the fast approaching liability crisis, governments must act to address the largest major fixed expense and liability faced by most households and many businesses, namely rent and/or mortgage costs. The solution here is straightforward.

1. First, **all principal payments should be deferred** on mortgage liabilities, corporate borrowings and other similar loans for twelve months, with loan terms extended by the same period.

2. Second, **borrowers should be required to meet interest payments** and, as long as they do so, covenant defaults must be automatically waived by the banks.

3. Third, **all rents should be automatically reduced by at least 60%**, reflecting the reduced cash cost to landlords of servicing their debts during this period.

Some adjustments will need to be made to relevant legislation to make the above

workable. This may include establishing precedence in any subsequent insolvencies based on debts as at the debt the above legislation is introduced, as well as safe harbours from insolvent trading actions for directors that choose to keep businesses alive during this period. Moreover consideration must also be given to other forms of consumer borrowing, particularly unsecured loans and credit card debt, which typically attract extraordinarily high interest rates.

The above approach will have several important advantages over current measures.

- A key fixed cost for consumers and companies will fall dramatically, reducing defaults and lease cancellations by tenants, as well as the massive associated stress felt by many people at this time.

- Fast-approaching pressure on the property sector as a whole will also be significantly reduced, thus reducing defaults by mortgagees and other borrowers and benefiting the financial system as a whole.

- The amount of financial support that governments need to provide to limit the near-term economic downside from the COVID Crisis will reduce significantly due to the reduction in consumers' living costs.

- Finally, a nationwide systematic approach will avoid massive operational complexity for the property and banking sectors, and contribute positively to our collective mental health.

Failure to adopt this approach will have dire consequences. Many companies have already begun to downsize work forces and take other measures to cut payroll costs, as this is the largest variable cost that most face. 3,283,000 Americans filed unemployment claims last week alone, beating the previous record of 695,000 by a factor of almost five. Significant further job losses are likely.

In the week ahead, both companies and individuals will turn their attention to lease costs and will begin to terminate leases or place underlying operating companies into administration. If this happens, the significant downturn predicted by many economists will be further amplified by systemic pressure on the banking system. And don't forget that banks are very highly leveraged, with only a dollar or so of capital for every ten dollars of loans. Even a modest uptick in default rates can eat into reserves rapidly, undermining their ability to provide new loans to health companies in the months ahead.

Many governments have already implemented significant measures to support their economies. These are welcome, but broader and deeper measures driving by long-term thinking will be needed. I see four key principles that should drive government support packages, and five areas in which policy initiatives are important - acting to address the liability crisis is just one.

For more on the above, please visit https://www.pottinger.com/covid/government-policy-rebuilding-a-better-future.

The clock is ticking on the liability time bomb. Governments must act rapidly, or the property sector will begin to crumble and banks will face a new financial Armageddon. P

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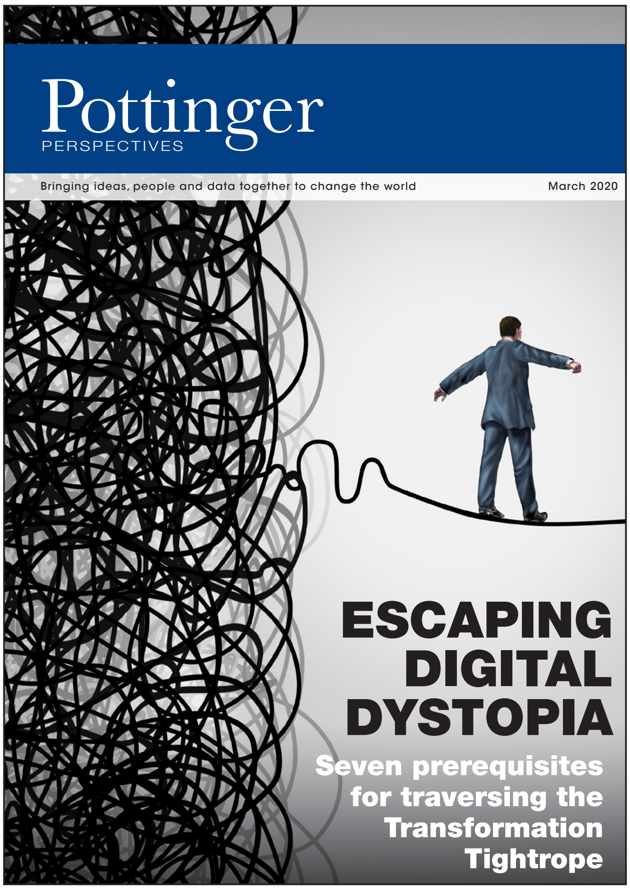

Seven steps to Escape Digital Dystopia
Since Y2K, agile blackbelt big data devops scrums onboarded scale cloud deployment stacks, gamifying paradigm shifts in legacy siloed cyber architecture. A digital transformation. But you knew this already.

The tech industry owns jargon like it claims to own innovation. Business used to be enabled by technology. Today, technology drives business, though not always in a successful direction. So, if you are fundamentally reshaping your business, there are seven things you must watch to ensure that you do not become a prisoner of the technology you adopt

By Andrew Paddon & Nigel Lake

https://www.pottinger.com/uploads/1/9/5/1/19512909/pottinger_perspective_-_escaping_digital_dystopia.pdf

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Pottinger helps organisations to adapt, innovate and transform, by providing insight and advice on strategy and public policy matters, as well as the negotiation and execution of M&A and financing transactions. Our combination of strategic thinking, M&A advice and financing capabilities allow us to find innovative solutions to the challenges arising in industries facing dynamic change and disruption.

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- Capital optimisation and financing advice for large enterprises, together with advice on commercialisation planning, capital strategy and capital raising for emerging companies;
- Specialist input in relation to the design, formation, restructuring, sale and dissolution of large scale joint ventures and partnerships; and
- Identification and quantification of risk, by applying advanced statistical techniques to relevant data pools, thus simplifying decisions impacted by significant uncertainty.

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