Introducing the liquidity-facility

Responding to Corona-fallouts while maintaining responsibility

In the short run, small and medium-sized enterprises (SMEs) will face a severe decline of gross sales. This leads to a liquidity squeeze, which in turn can bankrupt even solid firms. Providing liquidity to these companies is the most fiscally responsible countermeasure right now. As immediate response, it is a proactive way of alleviating the effects of the actual situation on the economy as a whole.

Let’s face the facts: SMEs are the backbone of the European economies. Over 99% of all firms are SMEs with 250 or less employees. Europe’s almost 30 million SMEs account for nearly two-thirds of net new private sector jobs in recent decades. However, it is also a fact that these enterprises operate with little liquidity. The lack of the companies’ liquidity is by far the most important risk that the European private sector is facing in these times.

The situation

At its core, the liquidity assesses a business’ ability to pay its bills when they are due. Every day’s business runs on the flow of incoming and outgoing cash and near-cash transactions. A company may be very profitable, but if it has no money to cover salaries, rent, electricity and other bills, it is at risk of failing. The same applies to solidly financed firms. They may have a lot of assets, but if these assets are locked down in long-term investments, they cannot serve current needs. In short, without liquidity there is no short-term operation of any firm.

Now comes the bad news. SMEs operate without much liquidity. They only show a thin ratio of current assets to current debt. This ratio is also called the working capital ratio. According to baking data, this ratio has been declining steadily over the last decades. Companies have little or no liquidity reserves. This means that most SMEs will have difficulty servicing their current debts if inflows of cash cease or diminish. And this is exactly what is going to happen in the next weeks.

Without or with fewer inflows of cash, SMEs will have trouble maintaining their day-to-day operations, paying their bills and salaries to their employees. Bridging the lack of liquidity is one of the most pressing actions to be taken by governments – on the federal and state-level.

The nuts and bolts of the facility

The liquidity facility bridges the short-term liquidity needs of SMEs. By providing a quickly approved no-interest loan to affected firms, the facility allows companies to maintain their day-to-day operations. The amount of money to lend is determined by the working capital ratio of the individual company accessing the facility. Here are the nuts and bolts:

- On the front end, a company accesses the facility via a webpage or an app. It completes a questionnaire about its financial situation, especially responding to questions on current debt, wages to pay, debt level, as well as on the firm’s legal situation. It also uploads the most recent income statement and balance sheet.
- Mid-level, an algorithm goes through the information provided by the firm assessing knock-outs – firms under chapter 7 or 11 as well as overleveraged firms cannot qualify for the loan. The algorithm determines the need for liquidity basing on a modified working capital ratio.
The need is twice the value of current assets in relation to current debt, including salaries to be paid. For a more technical explanation, refer to the endnote.¹

- On the back end, governments or government-backed agencies, for example extend loans to the company that accessed the facility and passed the algorithm’s assessment. The value of the loan is the amount determined by the algorithm using the modified formula. The loan itself carries zero interest rate and has to be repaid by the recipient within 5 years.
- Two final remarks about these nuts and bolts: First, the liquidity facility can only bridge the liquidity-needs of a company for a maximum of three months. Second, the whole process from the front-end to the back end and back should not take more than three days. Liquidity is an urgent matter.

Pros and Cons

Once the actual situation – marked by a decline of business activity because of the spread of the Coronavirus and the subsequent measures installed to abate it – ends, the economy needs to rebound. The more SMEs still operate, the speedier can the economy recover, and the quicker new jobs can be offered. The liquidity facility helps keeping firms that are otherwise solidly financed and productive in the market by bridging short-term liquidity squeezes. In addressing the needs of SMEs, the facility focusses on the backbone of the European economy.

Also, on the plus side, the facility is fiscally responsible since it is conceived as a provider of loans. Even in the medium term, it does not impact public spending and it does not lead to new taxes because the loans are paid back. By the way, this is the reason for firms already suffering from liquidity shortage, companies in liquidation, and overleveraged entities being excluded from the access the facility. They are not solidly financed.

A final advantage of the facility is its relying on the responsibility of entrepreneurs. It neither bails out nor provides helicopter money. It is a loan that must be repaid. Businesses will add the loan to their amount of debt which in turn impacts their business decisions and interactions with partners.

Classical liberals and fiscal conservatives may object to the liquidity facility as such. Under normal circumstances they should. However, the current business environment is not normal. Also, never forget: Politicians have the incentive to intervene – especially in times of “crisis”. Taking the political factor into account and accepting that intervention is the most likely course of events, it lies within the limits of classical liberalism and fiscal conservatism to develop proportionate interventions. The liquidity facility is such. It not only maintains fiscal discipline but also holds the recipient of government money accountable.

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Endnote
Business and management literature recommends the normal working capital ratio – current assets divided by current debt – to be between 140 to 200%. The formula and the recommendation can be expressed as:

\[
\text{working capital ratio} = \frac{\text{current assets}}{\text{current debt}} = 140\% \text{ to } 200\%
\]

The modified formula builds on this general recommendation adding the wages to be paid to the short term debt. The thinking is: In the short term, firms have to plan for paying wages, i.e. they need the liquidity for doing so. The modified formula for the ratio is, then:

\[
2 = \frac{\text{current assets}}{\text{current debt + wages}}
\]

Taking the current assets as the liquidity to be provided by the facility to the firm, the formula becomes:

\[
\text{liquidity to be provided} = 2 \times (\text{current debt + wages})
\]

Correcting the value of liquidity to be provided by the liquidity that the firms already has leads to the final version of the formula:

\[
\text{liquidity to be provided} = 2 \times [(\text{current debt + wages}) - \text{current assets}]
\]