# BEYOND BAILOUTS

DISCUSSION PAPER

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## ABOUT THIS PAPER

The global COVID-19 pandemic has required unprecedented government action at an unprecedented pace. It is vital that policymakers act to slow the spread of the virus, protect people's livelihoods and ensure the economic recovery delivers both prosperity and justice for the long term.

This discussion paper has been commissioned to provide rapid analysis and expertise to the UK government with this goal in mind and will be followed by further analysis and recommendations from IPPR.

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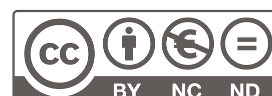

## OBJECTIVES

The survival of large parts of our capital base will now depend on significant government support. This short paper outlines how this can be delivered. Currently we have in mind a large government intervention in the airline industry, which has experienced a collapse of revenues to close to zero; if such low revenues persist for more than several months, it is likely the sector will fail. The model of support we outline below does not just pertain to airlines; it could be rolled out across the travel and leisure sector, or more broadly across the economy, including the retail and manufacturing sectors.

Any support package should be consistent with the following objectives:

1. The immediate provision of support. Many businesses are on the brink of collapse, jobs are being lost, and defaults on trade and financial creditors will also risk a broader round of corporate failure and threaten the banking system. A system of support has to be as simple as possible, and implemented rapidly.
2. Maintaining jobs. Support, as far as is possible, must meet the short term goal of maintaining employment levels and preventing a spiralling of defaults.
3. The hindsight test. When we look back on this phase we want to ensure that the state has been compensated for the support it has provided and shares in the gains from recovery; that the equity gains which are likely are distributed fairly; and that changes in corporate governance and behaviour are consistent with our collective longer-term environmental and ethical goals.

## BACKGROUND

It is helpful to have some historical context - particularly drawing on lessons from 2008. It is also useful to have an understanding of the cyclical differences in the cost of capital to the government and the private sector, which means that far from putting long-term pressure on the state's balance sheet, as some fear, this intervention – if priced correctly – should create very significant value for the state.

The term 'bailout' is, in this context, a misnomer. Sustaining the operations of good businesses, and supporting employment, is in our collective interests. Shareholders in most industries have already experienced large losses. The stock prices of airlines, for example, have already fallen by more than 50 per cent (as of 23 March 2020).

The price of government bonds, by contrast, has soared in recent years, dramatically reducing the cost of capital to the government. Currently, the UK government can issue 10-year bonds at a yield of 0.5 per cent, or -1.5 per cent after inflation. Simple financial arithmetic implies that if the government can buy assets – for example, by taking equity stakes – at positive real expected rates of return, the state will emerge from this crisis with a stronger, not a weaker, balance sheet. This is a very different calculus to the government issuing debt to finance current expenditure. By issuing debt when interest rates are so low and, in effect, buying assets at very cheap prices, in the medium-term, the state will simultaneously ensure businesses survive, workers keep their jobs, and the state emerges an owner of significant assets.

It is not widely known that the US government's intervention in the US financial sector under the Troubled Assets Relief Programme (TARP), and particularly the equity injections orchestrated by then Treasury secretary Tim Geithner, generated a very significant return to the US treasury overall (Treasury 2016). That is despite the fact that many 'toxic' financial assets never recovered their values. In stark contrast to the financial crisis, there is no reason to believe that the value of the UK's capital stock which is in need of support will be permanently impaired. If strict lockdown is enforced and complied with, along the lines we have seen in China, the economy could be returning towards normal in approximately 40 days.

In summary, the requirement for public support is very different to the 'bailing out' of a failing industry or business. Instead, it is an opportunity for the state, with a negative real cost of capital, to provide loans and obtain equity stakes in fundamentally very strong businesses whose short-term operations have temporarily ground to a halt due to a health emergency.

## THE MODEL

How should the government support industries such as airlines? In contrast to the American airline industry, the major UK airlines have been run on a financially prudent basis, so their debt levels are relatively modest, and would be entirely manageable in a 'normal' recession. The government should do three things:

1. Refinance existing credit facilities at zero interest for six months.
2. Offer new credit facilities up to a maximum equivalent to 3 months' revenue, if necessary. These would also be priced at zero interest rates, also for six months.
3. Take equity stakes of 30 per cent in each of the major airlines. These stakes will be priced using the average share price holding over the prior 30 days.
4. The 'price' for the loan guarantees and zero interest credit facilities which the government is making should come in the form of five year warrants - ie granting the government the right to buy equity in the businesses up to an additional 10 per cent at the same price at which it has injected the equity at any point in the next five years. All dividends, buybacks, and executive bonuses are suspended until all public loans and guarantees have expired (Nasdaq 2013).
5. The sole conditionality at this juncture is to require that the companies in receipt of this support maintain all of their current employees, regardless of their contract type, not least because they can now avail of the Coronavirus Job Retention Scheme announced by the Chancellor (HM Government 2020).

This model is designed to fulfil our objectives. It is relatively simple and can be implemented very rapidly. It preserves high quality essential businesses, protects employees, and limits multiplier effects through the economy and financial system. It is also fair. The government is likely to generate very high returns on its equity investments – as much as three times its investment, over a decade, if not a lot more. At the same time, existing owners are being treated fairly, as these businesses would otherwise face complete failure.

The financial structure of the support is very specifically designed to minimise any current cash flow needs of these businesses whilst ensuring a fair, high, return to the public in the medium-term. This is precisely why the government should provide credit at zero interest rates, with no capital repayment due for at least six months. The state should be remunerated through a long-term return on equity.

## THE HINDSIGHT TEST

How will we view this support programme with the benefit of hindsight – in 12 months and in five years? And how can we add to current design and planning to ensure perceived success?

The evidence from China is that if we pursue a well-enforced lock-down combined with widespread testing, we should expect our economies to begin to normalise within two months. There is absolutely no need for this health emergency to morph into a sustained economic depression. The state is absolutely well placed to guarantee all short-term liabilities.

Within twelve months we should expect airlines and related industries to have recovered most of their activity and value. Based on their prior market capitalisations - which were based on very reasonable equity valuations - we would expect the value of the publicly owned equity stakes to have risen by at least three times the initial investment. In addition, the loan facilities will either be refinanced with commercial alternatives or repaid. Depending on share price performance, the value of the government's warrants should have more than amply compensated for the credit risk.

## THE RIGHT TIME FOR A NATIONAL WEALTH FUND

There are three further challenges which we think we can address without an impact on efficacy or speed of the rescue programme outlined above:

1. How to improve corporate governance in the medium-term. There has been too much neglect of governance issues, such as executive remuneration of publicly listed companies, and an excessively myopic focus on short-term share price performance.
2. How to accelerate the trend towards long-term sustainability and ESG compliance in the private sector.
3. How to positively affect the distribution of asset ownership in the economy. Too many in our society do not have the safety net provided by asset ownership and savings.

IPPR and a number of economists have been advocating for some years the case for setting up a national wealth fund (Roberts and Lawrence 2018; Farmer 2017). Lonergan and Blyth have suggested that given the negative real cost of capital the government now has the luxury of availing of, such a fund could substantially be funded by debt. We did not anticipate that this would happen by necessity Blyth & Lonergan (2015).

Public sector debt-financed acquisition of assets should be a standard counter-cyclical tool in the public policy armoury (Blyth & Lonergan, forthcoming). The purely economic and financial case for this hinges on the simple observation that in a world of low inflation the government's cost of capital is counter-cyclical and the private sector's is pro-cyclical. We have seen this again in the current recession: government bond prices have risen dramatically, sending yields to extremely low levels. By contrast, equity prices have collapsed and credit spreads for the private sector have widened dramatically.

Our firm belief is that in contrast to the financial crisis, the government should not look to offload the equity stakes it has acquired during this emergency at the earliest possible point. Rather, these assets should form the basis of a National Wealth Fund (NWF).

To be absolutely clear, the establishment of a NWF is entirely complementary to the programme of support we have outlined. There is no need for it to be designed or set up prior to the disbursement of funds, or in any way that delays the rescue. In due course, however, this is absolutely how the state and public should think of using these assets.

Many industries – including aviation - have emissions and sustainability challenges. This is both a risk and an opportunity. The risk to the state from taking on equity in these industries is some loss of economic value, but the opportunity is to create a new stakeholder which enforces ESG and sustainability at the heart of corporate behaviour. A NWF enables conditionality to work retrospectively, rather than imposing complex conditions at odds with the urgency of the need for support.

Over the next twelve months, the UK government should convert the management of the many assets it is in the process of acquiring to a new NWF, with an independent supervisory board, and a very clear mandate to pursue the highest standards of corporate governance and ESG compliance. In the medium-term we should look at this not only as a case of hugely effective public intervention, but also as a turning point in corporate governance and sustainability. Finally, there is no reason why ownership of the NWF cannot be distributed through time to those in our society who have no assets. The current crisis is a huge opportunity to transform and improve the structure of our capitalism.

## CONCLUSIONS

One of the challenges facing the state currently is how to provide immediate assistance to viable businesses which have been devasted by this health emergency while at the same time, protecting employment, ensuring a fair price for the provision of capital, and acting quickly without sacrificing long-term goals. We have set out how to do this. We are recommending that the government limits conditionality currently to employment protection. We have outlined how the state will share in the considerable returns generated by a normalisation of economic activity. But we also have a framework for ensuring through the creation of a National Wealth Fund that our long-term goals of better corporate governance, ESG compliance, and distributional equity can be met (see for example Common Wealth 2020).

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