

## **New Zealand debates the merits of a bank equity fund**

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One of the bolder proposals coming out of the Jobs Summit was the proposal for a bank equity fund to rescue large companies in temporary financial stress. The major trading banks proposed to commit up to one billion dollars in equity funding, on the proviso this would be matched by a similar level of government funding.

The aim of the bank equity fund is to create a mechanism whereby banks may replace debt financing with equity financing (i.e. the bank buys shares in the company). By taking equity stakes in companies the banks are able to adopt a longer term interest in their growth prospects. The banks want to get their capital back – thus creating an incentive for the banks to take equity in companies they believe have the best prospects to reorganise their affairs and move to a stronger medium term position.

The genius of this proposal is that it solves some of the problems inherent in making government officials the arbiters of how government equity might be allocated. The Government should be a silent partner in this endeavour, with the fund managed by a well respected and experienced fund manager supported by representatives of each of the banks contributing to the fund. Checks and balances should ensure that decisions on equity investments in the customers of one bank are made by the independent fund manager and representatives of the other banks, so that decisions are not affected by the self-interest of a particular party.

The stakes are high. The target of the fund will be companies on the brink of collapse because they have breached their bank debt covenants. The recent slump in earnings of New Zealand companies exposed to the fast imploding markets in the U.S, Europe and South East Asia heightens the risk that companies will breach the narrow terms of their bank debt covenants (these agreements usually contain ratios of cash flow to debt levels constructed prior to the unanticipated meltdown in foreign markets). The potential impact on employment relates to the way employment is concentrated in New Zealand's larger companies (46% of New Zealand employees work in large companies employing 100 employees or more.)

Given the current state of equity markets, there is no option for a company that breaches its debt covenant to replace debt financing with equity finance through the normal route of share offerings. Without financing to honour short term obligations the company declares itself insolvent. Debt financing has short time horizons – obligations must be honoured now or all bets are off.

The bank equity fund proposal appears to have been met with an equal degree of scepticism from both the left and the right of the political spectrum, although it appears people are rushing to judgement without fully investigating the purpose and likely structure of the fund. In fact, the reaction has been reasonably united in its concerns with using 'corporate welfare' to bail-out companies, raising the spectre of a slippery slope to the bad old days of Muldoonist state intervention.

Critics would be right to be concerned with the Government randomly choosing 'iconic' companies to support as this would recreate a lobbying industry that distributes government support on the basis of political favour and hand-outs. Fortunately no-one is currently proposing such an approach. Indeed, the bank equity scheme would help the Government to avoid such an outcome.

A serious review of the proposal needs to look at the alternatives in the light of the extraordinary circumstances of the global financial crisis. One option is for the Government to do nothing, and to accept whatever eventuates even if this leads to a wholesale hollowing out of the New Zealand economy. A more probable alternative is that the Government reacts to each threatened closure with emergency, ill-thought out measures informed by political judgement, while officials scramble to advise in commercial spheres where they lack the requisite experience to make balanced assessments of which company does and does not merit support.

The bank equity scheme provides a mechanism to support companies using the independent assessment of commercial funds managers, aligned with private sector incentives to choose companies with the most chance of surviving and prospering medium term. This protects the interests of tax-payers, while the process of taking equity shares dilutes the rewards of existing owners (equity holders) ensuring they pay a price for the benefit of tax-payer support.

Several countries have adopted a similar equity fund approach to supporting companies since the crisis began. For example, France has established a 20 billion Euro strategic investment fund in partnership with a state owned investment bank. The Fund is taking equity stakes in major French companies that are having difficulty accessing loans from the banks or that are vulnerable to takeovers because of falling stock prices. The Fund's Investment Committee is headed by a senior executive from the French private sector.

The preoccupation of many New Zealand commentators with the sins of New Zealand's interventionist past is in danger of paralysing the body politic just when it is most in need of an injection of pragmatic realism. For the bank equity fund to be useful, I suspect it needs to be up and running by the end of April. This will be a real test to see if government policy processes move quickly enough to serve the present needs of the New Zealand economy. This is not Muldoonist state intervention, but simply the best amongst a range of alternatives. It certainly should be debated in that light.