



## COVERSHEET

<b>Minister</b>	Hon Dr Megan Woods	<b>Portfolio</b>	Research, Science and Innovation
<b>Title of Cabinet paper</b>	<b>Research and Development Loan Scheme: Implementation Matters</b>	<b>Date to be published</b>	21 September 2020

### List of documents that have been proactively released

<b>Date</b>	<b>Title</b>	<b>Author</b>
5 August 2020	<i>Research and Development Loan Scheme: Implementation Matters</i>	<i>Office of the Minister of Research, Science and Innovation</i>
5 August 2020	<i>Cabinet minute DEV-20-MIN-0161</i>	<i>Cabinet Office</i>
17 July 2020	<i>R&amp;D loan scheme implementation and draft Cabinet paper</i>	<i>MBIE</i>

### Information redacted

### YES / NO

Any information redacted in this document is redacted in accordance with MBIE's policy on Proactive Release and is labelled with the reason for redaction. This may include information that would be redacted if this information was requested under Official Information Act 1982. Where this is the case, the reasons for withholding information are listed below. Where information has been withheld, no public interest has been identified that would outweigh the reasons for withholding it.

Some information has been withheld for the reasons of:

- Privacy of natural persons
- Free and frank advice

## In Confidence

Office of the Minister of Research, Science and Innovation

Cabinet Economic Development Committee

## Research & Development loan scheme implementation matters

### Proposal

- 1 This paper seeks your agreement to make changes to the appropriation(s) for the Government's R&D loan scheme in line with recently received accounting advice. It also seeks approval to reallocate existing baseline funding to meet an upward adjustment in the costs of implementing the loan scheme.

### Relation to government priorities

- 2 The proposals are consequential adjustments required to implement the policy intent of the R&D loan scheme and require Cabinet approval.

### Executive Summary

- 3 On 8 June 2020, Cabinet agreed to introduce an R&D loan scheme to assist R&D performing businesses impacted by COVID-19 [DEV-20-MIN-0095 refers]. While Callaghan Innovation has been tasked with implementing and administering the R&D loan scheme, Cabinet's intention was that the financial risk of the scheme sits with the Crown, rather than with Callaghan Innovation. To ensure that the accounting treatment of the loan scheme is consistent with Cabinet's intent, I propose the following adjustments (with no change to the policy, and no impact on the government's net debt position):
  - 3.1 establish a new appropriation to record the initial fair value write-down of the R&D loans;
  - 3.2 establish a new appropriation to record any subsequent impairment of the loans;
  - 3.3 amend the scope of the existing capital appropriation to reflect the intended nature of the funding provided for the loan scheme; and
  - 3.4 reallocate \$1 million of Callaghan Innovation's COVID Response and Recovery Fund cost pressure funding for 2020/21 to meet the costs of administering the R&D loan scheme for the 2020/21 year.
- 4 Applications for the R&D loan scheme opened on 6 July. The updated appropriations are required to be in place before Callaghan Innovation can begin to disburse the loans.

### Background

- 5 The R&D loan scheme was established to assist R&D performing businesses impacted by COVID-19. The loans will provide an immediate source of finance to R&D-performing businesses to enable them to maintain their R&D programmes and secure the highly skilled jobs associated with these programmes.

**I N C O N F I D E N C E**

- 6 On 11 May Cabinet approved \$150 million in funding to establish the R&D loan scheme [CAB-20-MIN-0219 refers]. This was comprised of operating funding of \$1 million to set up and administer the scheme, and \$149 million in capital to provide the loans.
- 7 On 3 June 2020 the Cabinet Economic Development Committee (DEV) agreed to introduce the R&D loan scheme and the broad design parameters for the scheme [DEV-20-MIN-0095 refers]. That decision was affirmed by Cabinet on 8 June 2020.
- 8 In making decisions on the design parameters of the loan scheme, DEV –
  - 8.1 agreed to concessionary<sup>1</sup> terms for the loans including setting the interest rate at 3% and making the loans interest free if repaid within the first year.
  - 8.2 noted that the estimated ultimate fiscal cost of the scheme was around \$38 million based on the best available estimates of R&D spending and likely take-up and default rates; and
  - 8.3 noted the prior Cabinet decision that the funds recovered from businesses, and any funds not distributed, will be repaid by Callaghan Innovation to the Crown [CAB-20-MIN-0219];
- 9 While Callaghan Innovation has been tasked with implementing the R&D loan scheme, Cabinet’s intention was that the financial risk of the scheme sits with the Crown. This paper seeks agreement to update the relevant appropriation arrangements to ensure that intent is appropriately reflected.
- 10 The paper also seeks agreement to reallocate funds to ensure that Callaghan Innovation can meet the costs of administering the scheme.

**The proposed appropriation changes more accurately reflect Callaghan Innovation’s role to administer the R&D Loan Scheme on behalf of the Crown**

- 11 It was originally envisaged that Callaghan Innovation would record the loan book on its accounts because it is administering the scheme. However, recently received advice is that the appropriate accounting treatment, consistent with the policy intent for the R&D loan scheme, is to treat Callaghan Innovation as an agent.<sup>2</sup> This means that, for financial reporting purposes, Callaghan Innovation record only revenue and expenses related to their loan administration activity. As a result, MBIE, acting on behalf of the Crown, should record the actual lending transactions associated with the loan scheme within its non-departmental accounts.

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<sup>1</sup> Concessionary loans are loans that offer more generous terms than market rate loans e.g. lower interest rates or longer payback periods.

<sup>2</sup> While officials are comfortable that the accounting proposals represents the substance of the scheme, the agent/principal accounting treatment is still subject to auditor confirmation as treating Callaghan Innovation as an agent for financial reporting purposes is a judgment made under accounting standards.

12 In order for the loan to sit in MBIE’s non-departmental accounts the following changes are required:

- 12.1 a new appropriation for the initial fair value write-down; and
- 12.2 a new appropriation for any subsequent impairment of the loans.
- 12.3 amending the scope statement of the existing capital appropriation

*Establishing a new category in the appropriations to record the fair value write-down*

13 The R&D loan scheme will be recorded in MBIE’s (the Crown’s) accounts as a loan asset, but that asset will not be valued at the amount of capital lent. Instead, accounting rules require that the loan asset is measured at fair value at the point when the loan contracts are entered into and the cash is advanced to the borrower (initial recognition). The difference between the capital amount lent (which could be up to \$149 million depending on uptake) and the fair value of the loan on initial recognition is the fair value write-down expense. A new category in the multi-category appropriation is required to incur the initial fair value write-down expense. This expense does not affect cash (and therefore does not impact net debt) but it does impact the Operating Balance Before Gains and Losses (OBEGAL).

14 The table below outlines how the transactions from the R&D loan scheme will have different impacts on the Government’s key fiscal indicators:

	<b>OBEGAL</b>	<b>Net Debt (Cash)</b>
Amount lent	No	Yes
Fair value write-down	Yes	No
Repayments	No	Yes
Interest unwind	Yes	No

15 Officials estimate the fair value write-down to be approximately \$90 million (rounding up the value of the following estimates) based on all of the \$149 million being lent. Using a conservative estimate is recommended given the uncertainty surrounding the data that has informed the assumptions. This estimate is made up of -

- 15.1 *Expected credit-losses* (the estimated value of the loans that are defaulted on). Based on the initial modelling completed to establish the scheme officials estimate the value of this to be around \$38 million over the life of the loans. This is based on initial assumptions on both the uptake and default rates that are very uncertain currently. In particular, the risk of default will become clearer once we know which companies loans are being made to.

15.2 *The concessionary expense*<sup>3</sup> (the difference between the market interest rate and the interest rate of 3% set for the R&D loan scheme). This is recorded as an estimated total for the life of the scheme upfront and then is unwound over time. The interest concession has been calculated based on an assumed market interest rate of 15% for R&D firms and a repayment rate of 20% in the first year and 9% per annum thereafter. The total estimated concessionary expense is around \$51 million.

15.3 Any other associated fair value write-downs.

*Establishing an appropriation for any subsequent impairment*

16 A new appropriation is also required for any subsequent impairment expense.<sup>4</sup> The value of loan assets on the Crown's balance sheet, having been written down to fair value when initially recognised, are regularly (at least annually) reviewed and assessed for impairment over the life of the loan. If a loan needs to be further impaired, an impairment expense is incurred. This covers a situation where the subsequent revaluation of the loan portfolio results in a devaluation beyond what was anticipated in calculating the initial fair value write-down. This can arise because the initial fair value is generally calculated based on projecting forward repayments that are unknown at the time of the initial loan, and actual repayments and defaults may differ from what was initially assumed.

17 Officials recommend establishing an upper limit of \$20 million in this appropriation, essentially as a buffer. There is no fiscal cost forecast in establishing this subsequent impairment amount now, but if a subsequent impairment arises, and the appropriation amount is not established, it will result in a breach because MBIE will have exceeded its appropriation.

18 Because the estimates above are uncertain I propose that Cabinet delegate authority to the Minister of Finance and myself to increase the value of the appropriations for the initial fair value write-down and any subsequent impairment of the loans if required. Furthermore, as the accounting treatment of government concessionary loans is complex and it is possible that further technical issues may arise over time as the scheme is implemented, I am also seeking delegated authority for joint Ministers to approve the establishment of further fair value write-down appropriations if required.

*Amending the scope statement of the existing capital appropriation*

19 Cabinet established the following Non-Departmental Capital Expenditure appropriation for the funds intended to be distributed as loans [CAB-20-MIN-0219.04]:

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<sup>3</sup> The loans are considered to be concessionary in nature as the loan interest rate offered is lower than the rate that would be offered in an open market, the loan is interest free if borrowers repay within a year and repayment obligations only begin in year three (although borrowers can make voluntary repayments before then). The Crown will incur an economic sacrifice for the interest revenue it has foregone.

<sup>4</sup> A loan is considered to be impaired when it is probable that not all of the related principal and interest payments will be collected.

Name	Period	Type	Category Name	Scope
Research, Science and Innovation: Callaghan Innovation – Operations MCA	Annual	Multi-Category Expenses and Capital Expenditure	Short-term Research and Development Loan Scheme	This category is limited to loans to Callaghan Innovation to provide temporary financial assistance by way of short-term loans to businesses undertaking research and development.

- 20 The scope statement refers to the funding as “loans to Callaghan Innovation”. I am seeking agreement to change the scope statement to more accurately reflect the nature of the transaction between the Crown and Callaghan as follows: *“This category is limited to the Crown’s investment to support a short-term scheme that provides financial assistance by way of loans to businesses undertaking research and development.”*

**Reprioritising funds to meet the costs of administering the R&D Loan Scheme**

- 21 As I signalled in the Cabinet Paper seeking agreement to the R&D Loan Scheme policy, Callaghan Innovation will require additional resources to meet the costs of administering the loan scheme [DEV-20-MIN-0095 refers]. When funding for the scheme was allocated, \$1 million in operating funding was provided to meet the costs of administering the scheme. At the time the design and implementation requirements of the scheme had not been developed.
- 22 Callaghan Innovation have now provided an updated estimate of the costs to implement the scheme over the 10 year life of the loan scheme of \$4.9 million (\$3.9 million in addition to the funding already provided). This includes the costs of expert advice (financial and legal) on the set up of the scheme, personnel costs for process design and application assessment, and operating a compliance and audit function. MBIE officials have reviewed the estimate and consider it reasonable at the current time, but expect better information will be available as implementation proceeds.
- 23 Callaghan Innovation were allocated \$6.3 million for 2020/21 from the COVID Response and Recovery Fund (CRRF) to meet cost pressures resulting from an anticipated COVID-related drop in commercial revenue. Updated forecasts from Callaghan Innovation indicate that the full funding allocated for 2020/21 will not be required for this purpose as commercial revenue has not been as badly affected as anticipated. As such, I am seeking agreement to reallocate \$1 million Callaghan Innovation’s CRRF cost pressure funding for 2020/21 to meet the costs of administering the R&D loan scheme.
- 24 I note that CRRF underspends are required to be returned to the Crown, but consider that the reallocation is appropriate because it is transferring funds from one CRRF initiative to another.

- 25 Callaghan Innovation estimates that a further ~ \$2.9 million of funding will be required to meet future costs of administering the scheme. Officials will report back to me on firming up the cost estimates and options for meeting these costs, including from existing resources. I am seeking delegated authority to the Minister of Finance and myself to approve further transfers from Callaghan Innovation's CRRF funding to provide for the costs of administering the R&D loan scheme if needed.

#### **Financial Implications**

- 26 The new appropriations for the fair value write-down and the subsequent impairment expense do not affect cash (and therefore do not impact net debt) but do impact the Operating Balance Before Gains and Losses (OBEGAL).
- 27 The proposed change to the scope statement of the existing capital appropriation does not have any financial implications.
- 28 The proposed reallocation of \$1 million of Callaghan Innovation's CRRF cost pressure funding is a fiscally neutral adjustment.

#### **Legislative Implications**

- 29 There are no legislative implications.

#### **Impact Analysis**

##### **Regulatory Impact Statement**

- 30 Cabinet's impact analysis requirements do not apply.

##### **Climate Implications of Policy Assessment**

- 31 A Climate Implications of Policy Assessment (CIPA) is not required.

#### **Population Implications**

- 32 No impacts are expected on population groups.

#### **Human Rights**

- 33 This paper does not have any implications for human rights.

#### **Consultation**

- 34 The Treasury, The Department of Prime Minister and Cabinet, and Callaghan Innovation have been consulted in the preparation of this paper

#### **Proactive Release**

35 I intend to release this Cabinet paper and associated minutes, with redactions as appropriate under the Official Information Act 1982.

**Recommendations**

The Minister of Research, Science and Innovation recommends that the Committee:

- 1 **note** that on May Cabinet approved \$150 million in funding to establish the R&D loan scheme [CAB-20-MIN-0219 refers];
- 2 **note** that on 3 June 2020 the Cabinet Economic Development Committee (DEV) agreed to introduce the R&D loan scheme and the broad design parameters for the scheme [DEV-20-MIN-0095 refers];

**New appropriations for the initial fair value write-down and subsequent impairment of the loans**

- 3 **note** that officials have determined that the appropriate accounting treatment, consistent with the policy intent for the R&D loan scheme, is that Callaghan Innovation is acting as an agent and therefore, for financial reporting purposes they record only revenue and expenses related to their administration activity;
- 4 **note** that, as a result of recommendation 3 above MBIE, acting on behalf of the Crown, will record the actual lending transactions associated with the loan scheme within its non-departmental accounts;
- 5 **note** a new appropriation is needed to record the initial fair value write-down of loans granted through the R&D loan scheme;
- 6 **note** that the Minister of Finance and the Minister of Research, Science and Innovation have agreed to add the following category to the multi-category appropriation “Research, Science and Innovation: Callaghan Innovation - Operations MCA”:

Title	Type	Scope
R&D short term loan scheme initial fair value write-down	Non-departmental Other Expense	This category is limited to the initial fair value write-down of loans granted through the short-term research and development (R&D) loan scheme.

- 7 **approve** the following changes to appropriations to provide for the R&D loan scheme fair value write-down, with a corresponding impact on the operating balance, noting it will have no impact on core Crown debt:

	(\$m) – increase/(decrease)				
<b>Vote Business Science and Innovation</b>	<b>2020/21</b>	<b>2021/22</b>	<b>2022/23</b>	<b>2023/24</b>	<b>2024/25 &amp; Outyears</b>
	<b>1</b>		<b>3</b>		



**IN CONFIDENCE**

<b>Minister of Research, Science and Innovation</b>					
Multi-Category Expenses and Capital Expenditure: Research, Science and Innovation: Callaghan Innovation - Operations MCA Non-departmental Other Expense: R&D short term loan scheme initial fair value write-down	90.000	-	-	-	-
<b>Total</b>	<b>90.000</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>

8 **note** a new appropriation is needed to incur expenses for any subsequent impairment of loans granted through the R&D loan scheme;

9 **note** that the Minister of Finance and the Minister of Research, Science and Innovation have agreed to add the following category to the multi-category appropriation “Research, Science and Innovation: Callaghan Innovation - Operations MCA”:

<b>Title</b>	<b>Type</b>	<b>Scope</b>
R&D short term loan scheme subsequent impairment of loans	Non-departmental Other Expense	This category is limited to the subsequent impairment of loans granted through the short-term research and development (R&D) loan scheme, including write-downs and write-offs.

10 **approve** the following changes to appropriations to provide for the R&D loan scheme subsequent impairment of loans, with a corresponding impact on the operating balance, noting it will have no impact on core Crown debt:

	(\$m) – increase/(decrease)				
<b>Vote Business Science and Innovation Minister of Research, Science and Innovation</b>	<b>2020/21</b>	<b>2021/22</b>	<b>2022/23</b>	<b>2023/24</b>	<b>2024/25 &amp; Outyears</b>
Multi-Category Expenses					

**IN CONFIDENCE**

and Capital Expenditure: Research, Science and Innovation: Callaghan Innovation Operations – MCA					
Non-departmental Other Expense: R&D short term loan scheme subsequent impairment of loans	20.000	-	-	-	-
<b>Total</b>	<b>20.000</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>

**Change to existing capital appropriation scope statement**

- 11 **note** that the scope statement for the existing capital appropriation named “Research, Science and Innovation: Callaghan Innovation – Operations MCA: Short-term Research and Development Loan Scheme”, contains an error describing the capital to be disbursed as loans as “loans to Callaghan Innovation”.
- 12 **agree** to amend the scope statement to the following “This category is limited to the Crowns investment to support a short-term scheme that provides financial assistance by way of loans to businesses undertaking research and development.”

**Transfer to provide for the costs of administering the R&D loan scheme**

- 13 **approve** the following fiscally neutral adjustment to provide for the operating costs of the R&D loan scheme, with no impact on the operating balance and/or net core Crown debt:

	\$m – increase / (decrease)				
	2020/21	2021/22	2022/23	2023/24	2024/25 & Outyears
<b>Vote Business Science and Innovation Minister of Research, Science and Innovation</b>					
Multi-Category Expenses and Capital Expenditure: Research, Science and Innovation: Callaghan Innovation - Operations MCA Non – departmental Output Expense: Research and	(1.000)	-	-	-	-

I N C O N F I D E N C E

Development Services and Facilities for Business and Industry Research, Science and Innovation: Callaghan Innovation - Operations MCA Non – departmental Output Expense: Building Business Innovation	1.000	-	-	-	-
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- 14 **agree** that the proposed change to appropriations above at recommendations 7, 10, 12 and 13 be included in the 2020/21 Supplementary Estimates and that, in the interim, the increase be met from Imprest Supply;
- 15 **agree** that the expenses incurred under recommendations 7, 10 and 13 above be charged against the COVID Response and Recovery Fund established as part of Budget 2020;
- 16 **agree** to delegate to the Minister of Finance and the Minister of Research, Science and Innovation the ability to approve further transfers from Callaghan Innovation’s CRRF funding to provide for the costs of administering the R&D loan scheme if needed;
- 17 **agree** to delegate authority to the Minister of Finance and the Minister of Research, Science and Innovation to increase the appropriation for the *R&D short term loan scheme initial fair value write-down* and the *R&D short term loan scheme subsequent impairment of loans* categories within the *Research, Science and Innovation: Callaghan - Operations MCA*; and
- 18 **agree** to delegate to Minister of Finance and Minister of Research, Science and Innovation the ability to set up subsequent appropriations for fair value adjustments if needed.

Authorised for lodgement

Hon Dr Megan Woods

Minister of Research, Science and Innovation