# Prevention and management of a large number of corporate insolvencies

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# Contents

# 1 Introduction

**The coronavirus (COVID-19) pandemic has not triggered a "normal" recession,** when an initial shock spreads through the economy and corporate insolvencies cause further losses to other firms, reducing employment and consumer spending, which in turn causes further business failures. In a "normal" recession, losses quickly reach the financial system through credit defaults and falling asset prices, impairing the ability of banks to provide credit to the economy. Automatic stabilisers and discretionary fiscal and monetary policies eventually halt this process, but not before major scars have been left on the economic fabric.

**During the COVID-19 crisis, GDP has fallen because economic activity has been constrained as a result of lockdowns and changes in behaviour to minimise the risk of infection.** The specific nature of the COVID-19 shock, i.e. a suppression of supply and demand, could imply that the economy bounces back as soon as the pandemic has been brought under control, social distancing and travel restrictions are no longer required, and supply chains can resume operating normally. Even without the Recovery and Resilience Facility (RRF) – the European Union's recovery instrument – the European Commission (2021a) estimates that EU economies will grow on average by 3.7% in 2021 and should return to their pre-crisis levels of output by mid-2022. Robust economic growth could help viable companies grow their way out of debt, as interest rates on debt instruments issued during the COVID-19 crisis have generally been rather low. However, uncertainty and risks surrounding the baseline forecast remain elevated, and ongoing challenges with the vaccination rollout in Europe and the possible emergence of another wave of the pandemic, with more contagious and/or vaccine resistant variants, could stall or even reverse the recovery.

**The financial sector has not contributed to the economic crisis and has helped to mitigate the impact on households and corporates.** Apart from the market turmoil in March 2020, when it had become clear that COVID-19 was a global pandemic, financial systems around the world have been remarkably stable in what became the biggest contraction in economic activity since the Great Depression of the 1930s. The financial sector seems to have been shielded so far from the revenue losses suffered by many corporates due to lockdowns and social distancing in several EU Member States. Banks have helped keep many corporates afloat by continuing to provide credit to the real economy. This stabilising role was partly due to the more resilient balance sheets and capital buffers that banks had built up since the last crisis, accommodative monetary policy, and regulatory and supervisory leniency. Moreover, the substantial support that households and corporates have received from fiscal authorities and through loan moratoria has, so far, protected banks to a large extent from credit losses.

**The rise in insolvencies that normally accompanies a contraction in economic activity has so far not materialised.** In fact, the number of insolvencies in 2020 was significantly lower than in previous years. This is a reflection of the numerous policy measures that have been taken to soften the impact of the COVID-19 crisis on the economy, such as maintaining accommodative financial conditions, providing direct support to companies and, in some Member States, temporarily suspending filing for bankruptcy. Moreover, European companies entered the pandemic in a stronger financial position compared with at the start of the global financial crisis more than a decade ago (Ebeke at al., 2021), allowing them to absorb initial losses arising from the economic shock, although there is significant heterogeneity across countries.

**A major wave of insolvencies may yet happen if crisis management measures are withdrawn too quickly, and the macro-financial amplification dynamics of a "normal" recession may yet set in.** If insolvencies of fundamentally viable firms can be avoided and if insolvencies of fundamentally unviable firms can be dealt with efficiently, the damaging economic effects of the COVID-19 shock should be minimised and a robust recovery of the economy might be expected once the pandemic has been brought under control. However, many crisis management measures that focus on the provision of liquidity support to companies could be simply delaying insolvencies and possibly also structural change.

**This note[1] seeks to assess the risk of a rise in insolvencies over the next year or two, as well as the possible implications that this may have for the economic recovery and financial stability.** It also discusses how a steep rise in insolvencies could be prevented and how insolvency frameworks can mitigate the disruptive impact of a large number of simultaneous corporate insolvencies, notably through the swift identification of fundamentally viable firms and their restructuring. Finally, it looks at some evidence, including the results of a survey among ESRB members, on how well countries are prepared for a possible wave of insolvencies and what policies would be required to enable all countries to avert, or cope with, a possible wave of insolvencies. This is crucial to avoid disparities within the European Union, which could generate economic and political tensions that could spill over and jeopardise financial stability across the Union as a whole.

**The note suggests that, as current support measures are withdrawn, governments should have strategies in place to address solvency issues, enabling fundamentally viable companies to thrive again once the COVID-19 pandemic is over.** Governments and banks should start planning for the end of the pandemic and design a smooth phasing out of the support measures. Improved restructuring frameworks are particularly important in the current crisis to the extent that a rise in insolvencies has been forestalled by allowing corporate debt to rise. Debt relief or equity injections facilitated by the public sector would keep viable companies in business, reducing economic losses and lowering the ultimate losses borne by the state and the financial sector. For those companies that are found to be unviable in the post-COVID-19 economy, efficient insolvency procedures should be developed to facilitate the swift redeployment of resources to more efficient uses.

[1] This note was prepared at the request of the General Board of the ESRB. The drafting team was chaired by Martin Oehmke (London School of Economics) and Ralf Jacob (European Commission), with contributions from the European Banking Authority (Samuel Da Rocha Lopes), European Central Bank (Benjamin Hartung), European Systemic Risk Board (Francesco Mazzaferro, Barbara-Jeanne Attinger and Tuomas Peltonen), European Commission (Miriam Parmentier and Vincent O'Sullivan), Deutsche Bundesbank (Ingrid Stein), Goethe University Frankfurt (Loriana Pelizzon), Banque de France (Vincent Jamet), Central Bank of Ireland (Niall McGeever), Banca d'Italia (Francesco Columba and Tommaso Orlando), National Bank of Romania (Amalia Stamate), Sveriges Riksbank (Martin Regner) and De Nederlandsche Bank (Sander van de Laar).

# 2 Assessing insolvencies as a threat to economic and financial stability

**The sharp contraction in economic activity linked to COVID-19 has not been accompanied by large-scale corporate insolvencies.** In fact, the level of insolvencies remains well below historical norms. Incomplete data for the European Union suggest that there was a slight increase in bankruptcy declarations in the third quarter of 2020 as courts reopened following the lockdown [Chart 1]. The median expected default frequency for European firms in September 2020 was only slightly above levels at the end of 2019 (IMF 2020). The survey of ESRB members revealed that most respondents believe that bankruptcies are likely to remain subdued for the next few years (see Annex I). This differs from previous cases of economic contractions, like the 2008 financial crisis and the sovereign debt crisis a few years later, where a large uptick in corporate insolvencies was an important element of the recession dynamics [Chart 2].

## 2.1 How big a wave of insolvencies should we expect?

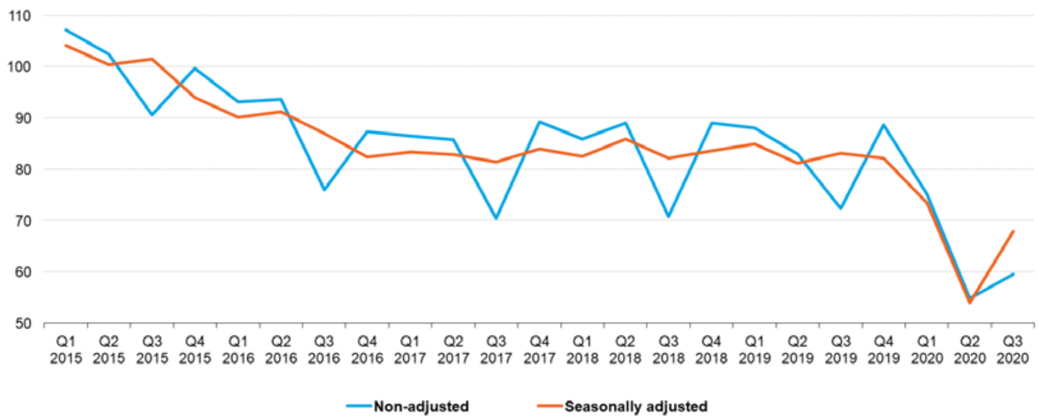
**It is important that policymakers do not consider the low number of insolvency filings in Europe as a sign of corporate health.** Many corporates came under enormous financial strain in 2020. This crisis is different insofar as we did not see the self-reinforcing chain reaction of corporate insolvencies that occurs in “normal” recessions, where creditors cannot absorb the losses following the insolvency of corporates and are themselves pushed into financial distress and, in some cases, insolvency. This could have happened, but a swift response by policymakers has so far helped businesses bridge the short-term liquidity shortfalls due to the economic contraction, avoiding immediate and widespread insolvency crises (Demmou et al. 2020; Demmou et al. 2021). Moreover, insolvency proceedings were deferred and the obligation to file for bankruptcy was suspended in some countries, which artificially reduced the number of insolvencies.

**Once support measures are withdrawn, corporate insolvencies may rise.** The ECB (2020) estimates that corporate insolvencies are likely to increase as support measures are withdrawn and liquidity constraints morph into solvency issues. According to private sector research (Allianz Research and Euler Hermes 2020), in 2021 there could be a rise in insolvencies of about 32% in western Europe and 34% in central and eastern Europe from 2019 levels, following the gradual ending and phasing out of fiscal support measures. This would be exacerbated by the catch-up effect from non-COVID-related insolvencies which were held at bay by some of the crisis measures.

Chart 1

**Europe (available countries), declarations of bankruptcies**

*(2015 = 100)*

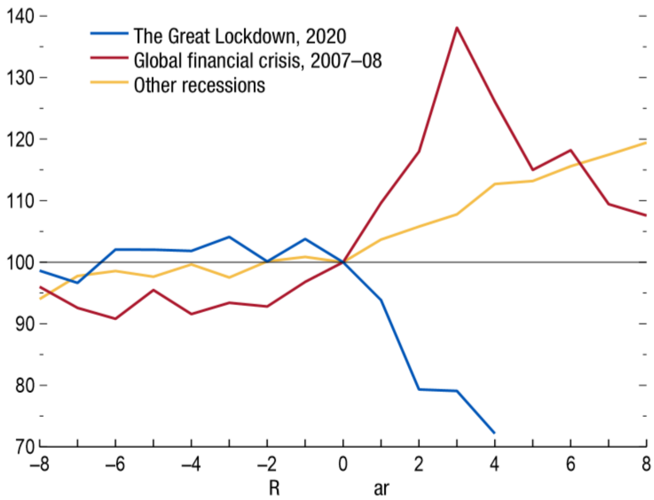



*Source: Eurostat (2021).*
*Note: Includes the following EU countries: Belgium, Bulgaria, Denmark, Estonia, France, Germany, Hungary, Iceland, Italy, Lithuania, Norway, Poland, Portugal, Romania and Spain.*

Chart 2

**Bankruptcies in 13 advanced economies**

*(last pre-recession quarter for each crisis = 100)*




*Source: IMF (2021).*
*Note: Data are from 13 advanced economies, including Canada, France, Germany, Italy, Japan, Spain, the United States and the UK.*

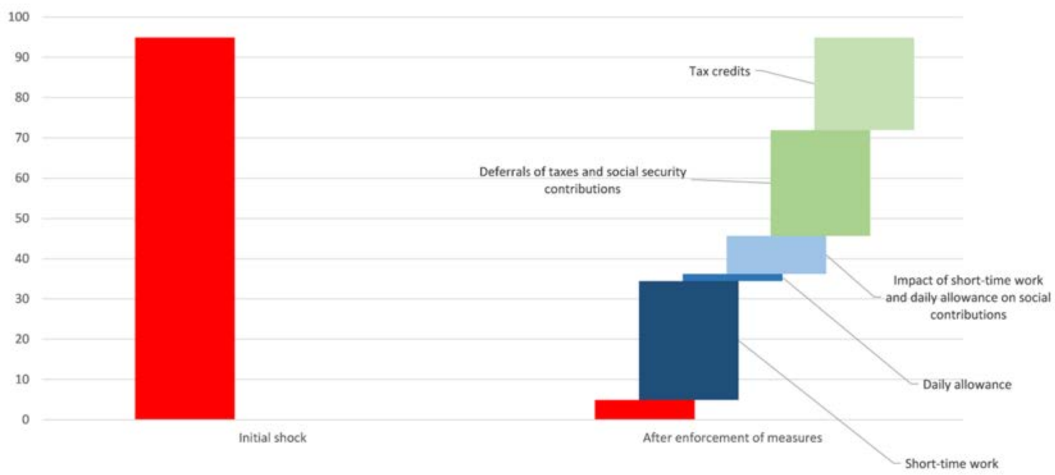
**Through their support measures, governments have absorbed much of the losses experienced by corporates (and households) as a result of COVID-19.** A study by the French Treasury (2020) estimates that public support could have absorbed around 95% of the immediate shock suffered by French firms, for a total of €95 billion in lost value added[2] [Chart 3]. Similarly, in Belgium the NBB (2021) estimates that approximately 85% of the loss in income across all sectors in 2020 was borne by the government [Chart 4]. The timely and decisive action taken by many Member States has kept a lid on overall debt levels at corporates.

**Corporate debt levels rose by a few percentage points relative to 2019 GDP in most Member States.** However, this aggregate picture may mask considerable differences across sectors. Moreover, the percentage increase in corporate debt is significantly higher when calculated relative to 2020 GDP. [Chart 5] compares 2019 and 2020 debt levels both as a percentage of the 2019 GDP level – arguably the relevant metric if we expect a quick V-shaped recovery – and as a percentage of 2020 GDP – which would be the appropriate metric if the economy takes longer to rebound.

Chart 3

**Impact of support measures on corporate cash flow in France, March to May 2020**

*(EUR billions)*

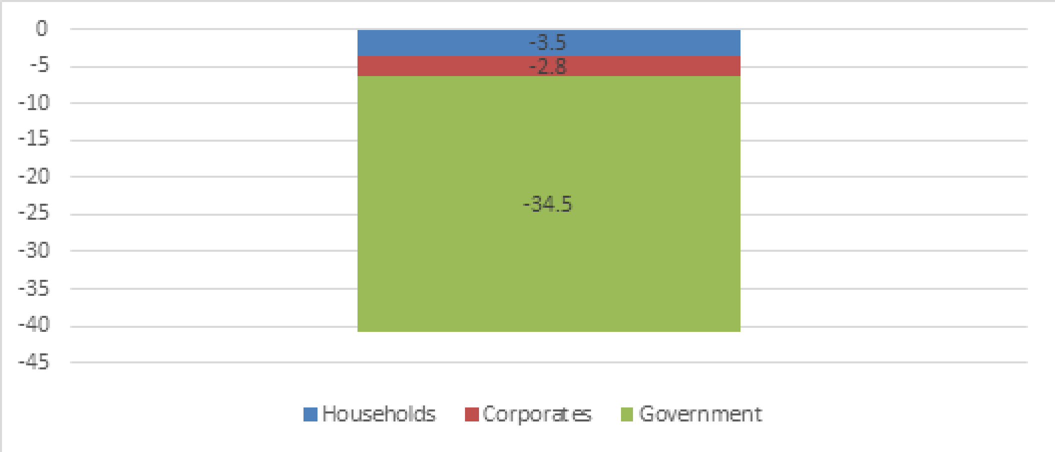



*Source: French Treasury (2020).*

2 This amount includes deferrals of taxes and social insurance contributions which would postpone the impact of Covid-19 on corporate incomes.

Chart 4
**Change in income in the Belgian economy in 2020**

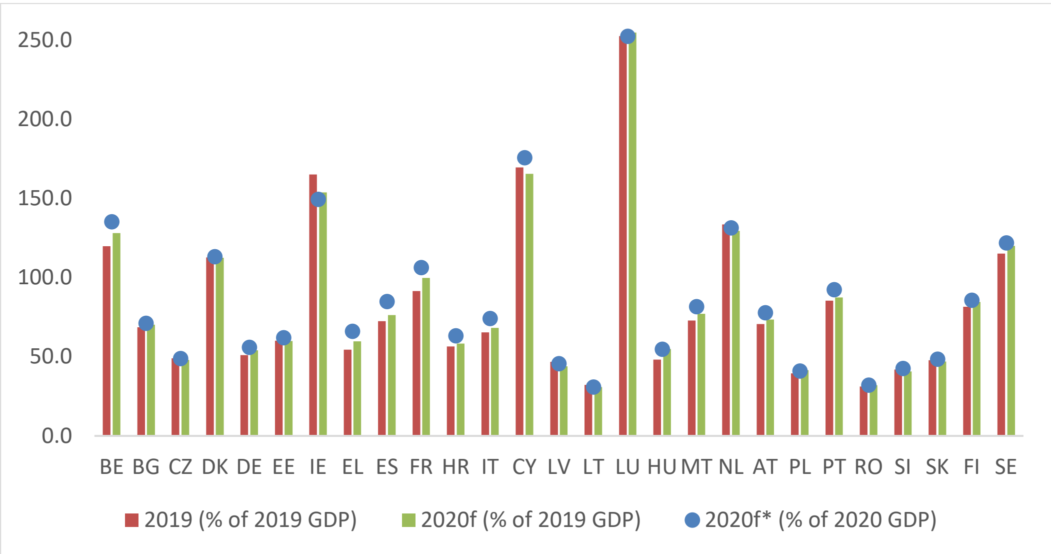
*(EUR billions)*




*Source: NBB (2021).*
*Note: Compared to projections made by the NBB in autumn 2019.*

Chart 5
**Non-financial corporation sector debt, consolidated**

*(% GDP)*



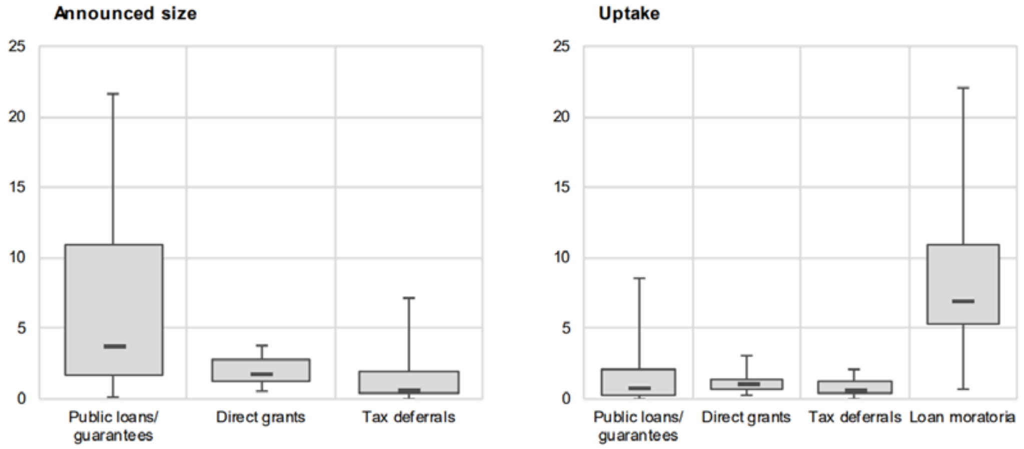

*Sources: European Commission, Eurostat and AMECO. For methodology see European Commission (2021b).*
*Note: NFC debt levels are expressed as a percentage of 2019 GDP apart from 2020f* which uses 2020 GDP as the denominator.*

**Governments have provided support through more than 600 measures taken by the 31 ESRB Member States (ESRB 2021).** [Chart 6] illustrates the heterogeneity in the scale and scope of the measures across countries. The types of measures most common are public loan guarantees (which are used by all Member States), direct grants to corporates (used by 30 countries), tax deferrals (29) and loan moratoria (23). In terms of total uptake, moratoria are most extensively used, followed by public loan guarantees and direct grants [Table 1]. At the EU level, the use of the general escape clause of the EU fiscal framework, the swift adoption of the Temporary State Aid Framework[3], and the prospect of support from the RRF helped countries deploy much needed support to companies (Ebeke et al. 2021). Central banks in Europe also reacted promptly and forcefully to the crisis. They have adopted a range of tools to improve funding conditions for the real economy, such as cutting policy rates, expanding the purchase of additional assets through commercial paper and corporate bond purchase programmes and extending collateral eligibility to a wider class of assets (Cavallino and De Fiore 2020).

Chart 6

**Heterogeneity in the announced size and uptake of support measures**

*(percentages)*




*Sources: ESRB (2021), Recommendation ESRB/2020/08 of 31 October 2020 (reference date 30 September 2020), ECB (MNA).*

*Notes: Announced size (field 1.1.01) and uptake (field 2.2.10) as a percentage of 2019 GDP. The box plot shows the median, 25th and 75th percentiles (grey box), as well as the maxima and minima across countries for selected programmes. Announced size is not available for loan moratoria. Based on EU Member States (IS, LI and NO are excluded).*

[3] The various amendments of the Temporary State Aid Framework can be found **here**.

Table 1

**Announced size and uptake of support measure**

| | Total uptake (€ bn) | Total size announced (€ bn) | Total uptake (% GDP) | Total size announced (% GDP) | Total uptake (% total loans) | Total size announced (% total loans) |
|---|---|---|---|---|---|---|
| **Moratoria** | 838 | | 5.0% | | 5.4% | |
| **Public loan guarantees** | 435 | 1,580 | 2.6% | 9.5% | 2.8% | 10.2% |
| **Public loans** | 66 | 57 | 0.4% | 0.3% | 0.4% | 0.4% |
| **Direct grants** | 112 | 327 | 0.7% | 2.0% | | |
| **Tax deferrals** | 77 | 170 | 0.5% | 1.0% | | |
| **Tax reliefs** | 13 | 75 | 0.1% | 0.4% | | |
| **Public support for credit insurance** | | 227 | | 1.4% | | |
| **Total** | 1,541 | | 9.2% | | | |
| **Total w/o moratoria** | **704** | **2,436** | **4.2%** | **14.6%** | | |

*Source: ESRB (2021).*

*Note: There are gaps in the data reported and results should be interpreted with caution, especially for the uptake of direct grants, tax measures and credit insurance guarantees.*

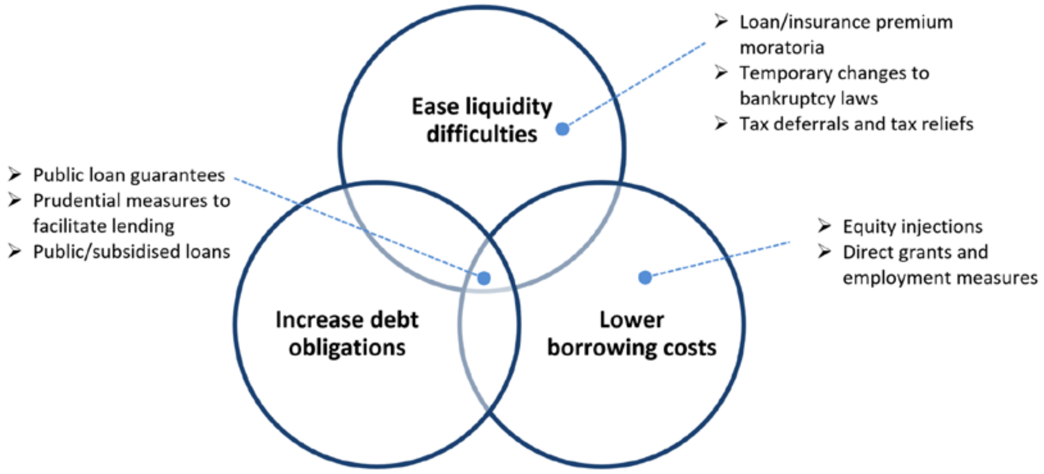
**Fiscal measures and loan moratoria are not the only policy interventions which have dampened the levels of insolvencies.** Obligations to file for bankruptcy were temporarily suspended, and regulatory relief for banks, often in combination with loan guarantees, made it easier for banks to continue providing credit rather than recalling loans. Moreover, monetary policy provided for exceptionally favourable conditions for borrowers on corporate bond markets.

**A key question is the extent to which support measures in this crisis have had the effect of merely postponing or durably preventing a large wave of corporate insolvencies.** In a worst-case scenario, the postponed insolvencies would suddenly materialise and trigger a recessionary dynamic, potentially causing further insolvencies. The current low rate of insolvencies would then be similar to the sea retreating before a tsunami. Prevention would imply that companies (i) do not emerge from the crisis with a debt burden that causes them to fail and (ii) are enabled to adapt to lasting structural change in the wake of the crisis (by scaling down unviable activities and/or shifting towards viable activities).

**Prevention presupposes a stronger emphasis on solvency in the support measures (Figure 1)** sets out how different measures impact the liquidity and solvency of corporates. As soon as the current liquidity support measures are lifted, access to affordable credit for companies from banks or financial markets will depend more heavily on creditworthiness, which reflects the worsened solvency position and the repayment capacity as determined by prospective turnover (Ebeke et al. 2021).

Figure 1

**Implications of support measures for companies**




**The support measures with a strong positive impact on corporate liquidity were implemented and administered quickly.** As of the third quarter of 2020, loans under moratoria across the European Union amounted to €587 billion; corporate loans represented 60% of that amount. Moreover, €289 billion in loans were subject to public loan guarantee schemes, with guarantees covering nearly 70% for these exposures (EBA 2020a). According to the EC (2021c), without these government support measures (with the exception of short-time work/wage compensation schemes), or new borrowing, 23% of EU companies would have experienced liquidity distress by the end of 2020 after exhausting their working capital buffers.

**In most euro area countries, bank credit to NFCs increased significantly in 2020** [**Chart 7**], marking a reversal of a trend towards deleveraging in small and medium-sized enterprises (SMEs)[4]. Some of the heterogeneity in [**Chart 7**] can be partly explained by differences in the scale and scope of solvency and liquidity support measures across countries, which affected overall demand for loans. On the other hand, the ECB's (2021) Bank Lending Survey in January found that lending conditions are tightening, suggesting that it will become increasingly difficult for companies to keep borrowing [**Chart 8**]. If conditions were to deteriorate significantly, further government intervention to support credit growth may be required.

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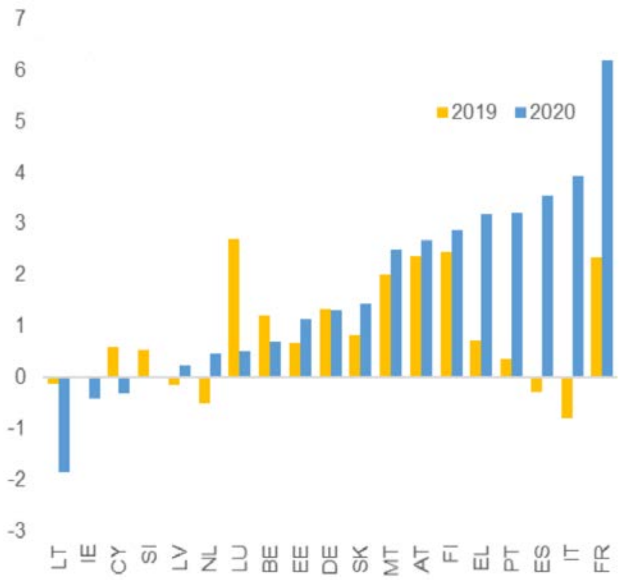
4 According to the survey on the access to finance of enterprises (SAFE) in November 2020, SMEs' debt-to-assets ratio rose to 8% over Apr-Sep 2020 (from -4% during Sep 2019-Apr 2020).

Chart 7

**Annual change in bank credit to NFCs (loans and debt securities)**

*(% 2019 GDP)*

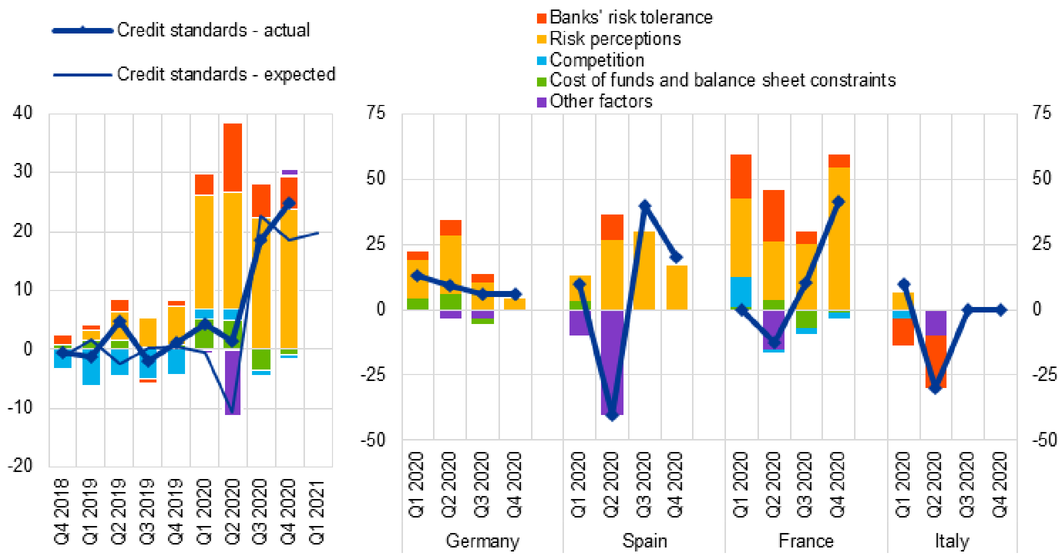



*Source: EC (2021b).*
*Note: For 2020, the projection corresponds to 12 times the monthly average (monthly data available until November 2020).*

Chart 8

**Changes in credit standards for loans or credit lines to enterprises and contributing factors**

*(percentages)*




*Source: EC (2021b).*
*Note: Net percentages are defined as the difference between the sum of the percentages of banks responding "tightened considerably" and "tightened somewhat" and the sum of the percentages of banks responding "eased somewhat" and "eased considerably".*

**IMF simulations[5] estimate that fiscal measures have been more effective in lowering liquidity risks than in reducing solvency risks (Ebeke et al. 2021).** Liquidity support measures could reduce the COVID-19 liquidity gap by 60% across European economies – rising to four-fifths in advanced European economies[6]. In comparison, public support could cover only 30% of the rise in the equity gap generated by the pandemic. As a result, the share of insolvent firms could increase by 6 percentage points to 17% in advanced economies and by 5 percentage points to 24% in emerging economies[7] even with the policies implemented as announced.

**Critically, the economic impact of the pandemic varies greatly across sectors.** Therefore, financial vulnerabilities may be far more severe in certain sectors than the average. Firms in leisure, tourism and contact-intensive services have seen the largest losses in turnover and profit (EC 2021c), with accommodation and food services, transport and car manufacturing closely behind.

## 2.2 The impact of insolvencies on the banking sector

**A significant rise in corporate insolvencies would translate into higher non-performing loans (NPLs) and impair the banking sector's ability to finance the economic recovery.** Higher NPLs can weaken the banking system and its ability to provide credit to the real economy through three channels (Huljak et al., 2020). First, higher NPLs reduce profits due to the increase in loan-loss provisions and compliance costs, lower interest income and increased funding costs as investors require greater returns to lend to companies with a lower credit quality. Second, NPLs results in higher risk weights for banks, and hence higher capital requirements which may force banks to deleverage to maintain or increase capital adequacy. Finally, the management of NPLs can divert management resources away from core and more profitable activities that would support the economic recovery.

**Due to the government support measures, loan moratoria and prudential flexibility granted to banks by supervisors, the pandemic has not yet translated into higher NPL ratios.** NPL ratios for NFCs have stabilised at about 5.3% since early 2020 [**Chart 9**]. At the same time, performing forborne loans, which include restructured loans on which banks have offered a concession to the debtor, increased from 1.2% to 1.7% of total corporate loans between end-2019 and September 2020, heralding an asset quality deterioration expected by the ECB.

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5 These simulations estimate the near-term effect of the pandemic on more than four million non-financial corporations across 26 European countries using firm-level data on balance sheet and income statements from Orbis.

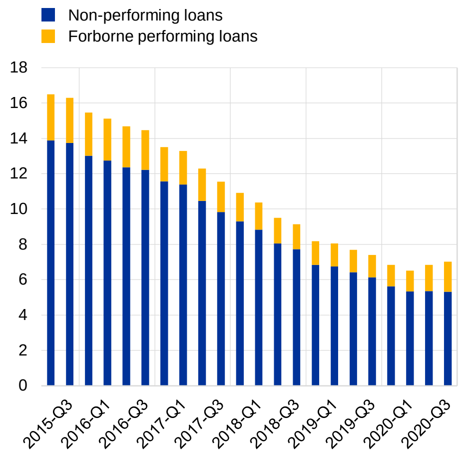
6 Advanced economies are Austria, Belgium, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Iceland, Ireland, Israel, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Norway, Portugal, Slovak Republic, San Marino, Slovenia, Spain, Sweden, Switzerland and United Kingdom.

7 Emerging economies are Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, Kosovo, Moldova, Montenegro, North Macedonia, Poland, Romania, Russia, Ukraine, Serbia and Turkey.

Chart 9

**Corporate non-performing and performing forborne loans**

*(percentages)*




*Source: ECB calculations based on ECB supervisory data.*

**Large-scale government support in the form of loan guarantees have increased contingent liabilities and made the sustainability of public finances more dependent on the recovery of the corporate sector.** A surge in corporate insolvencies would result in an additional burden on public budgets on top of the well-known impact of automatic stabilisers during a recession. In its November 2020 Financial Stability Review, the ECB highlighted the medium-term risk of a potential adverse feedback loop stemming from a sovereign-corporate-bank nexus (ECB 2020). Nevertheless, loan guarantees may still prove a cost-effective way of preventing insolvencies: solvency support in the form of grants or debt relief could be targeted at fundamentally viable companies as soon as the call of a loan guarantee becomes likely. Any viable company that is saved from bankruptcy could reduce losses for banks, governments and other private creditors and thus help break the adverse sovereign-corporate-bank feedback loop. Recent changes to the European Commission's State Aid Temporary Framework allow governments to convert public loans and guarantees into grants up to a certain ceiling to help companies weather the COVID-19 crisis, which some European countries are now actively considering.

# 3 Managing corporate insolvencies: four lines of defence against economic and financial instability

**Preventing insolvencies of distressed but fundamentally viable companies is crucial for preserving economic and financial stability.** A year into the crisis, public authorities have managed to avoid a wave of insolvencies that would deepen and prolong the recession, including by saddling banks with bad loans and curtailing their ability to fund the economic recovery. However, some of the tools that were applied as an immediate reaction to the COVID-19 crisis focused primarily on maintaining liquidity in the corporate sector and were not sufficient to cushion the impact of COVID-19 on corporate balance sheets. The resulting debt overhang increases the risk of a major wave of insolvencies and subdued growth.

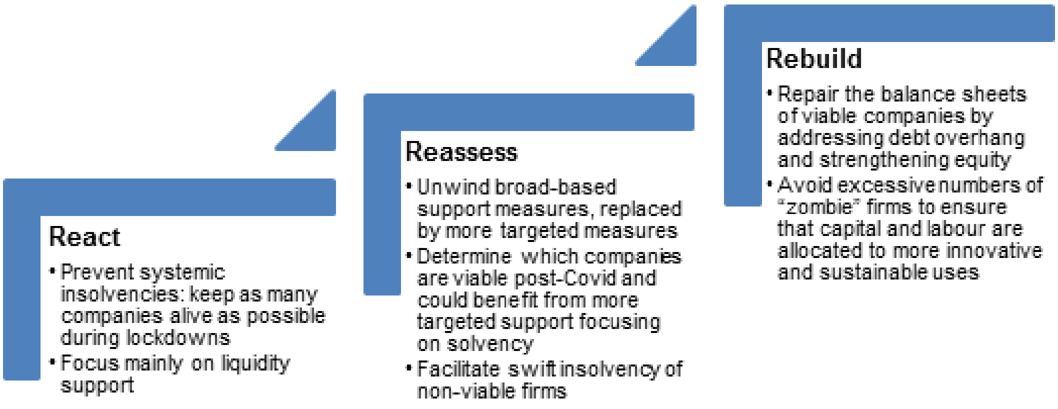
**The policy mix needs to evolve from addressing liquidity needs towards more solvency support to viable firms in order to prevent a potentially systemic crisis.** Three phases of the current crisis can be distinguished [**Figure 2**]. In the first phase, policies had to **react** to the immediate public health and economic and social emergency, a need that continues as we experience a second or even third wave of the pandemic with new variants of the virus and the slow rollout of vaccines.

**As the public health emergency subsides, policies must reassess the measures that have been deployed and phase them out with the least possible damage to the economy.** Many companies, particularly in some sectors, may need solvency support, which strengthens corporate balance sheets and prepares businesses for economic recovery. However, this also requires a more targeted approach based on an assessment of the viability of firms (as outlined in Becker and Oehmke 2021; G30 2020). Policymakers should aim to preserve the going-concern value of fundamentally viable firms, while allowing non-viable firms to be resolved in an orderly and cost-efficient fashion.

**Finally, policies must be geared towards rebuilding the economy, fostering adaptation to structural change,** rather than trying to preserve, or return to, the pre-pandemic economy. Avoiding excessive numbers of “zombie” firms is important to ensure that capital and labour are allocated to more innovative and sustainable uses (See Annex II).

**The boundaries between the stages are fuzzy,** with the challenges and policy needs of each stage blending into each other. Moreover, the progression through the stages is not linear and may circle back to a previous stage depending on the prevailing health and economic conditions.

Figure 2
**Phased approach to crisis management**




**There are four lines of defence that policymakers can use to mitigate the destabilising impact of corporate insolvencies and to support a swift and sustainable economic recovery:**

1. emergency liquidity support schemes during lockdowns (system-wide);
2. solvency support schemes to compensate for losses (more targeted, e.g. sector-wide);
3. debt restructuring and/or equity injections to repair balance sheets of companies with viable business models (individual companies);
4. efficient insolvency procedures to ensure that non-viable firms are swiftly wound down and resources can be reallocated to productive uses (individual companies).

## 3.1 Broad-based liquidity support

**Emergency liquidity support schemes during lockdowns can be quickly deployed system-wide.** Liquidity support can be provided by stopping the cash drain (moratoria, tax deferrals, short-time work subsidies) or by ensuring access to sources of finance (loan guarantees, public loans). The liquidity support needs to be maintained as long as justified by lockdowns, social distancing and prevailing macroeconomic conditions. This will prevent systemic bankruptcies across sectors (such as tourism and hospitality), where a flood of insolvencies could trigger fire sales and a collapse in asset prices (and subsequent financial stability risks). It is important to use liquidity relief measures where possible to prevent viable firms from being forced prematurely into insolvency.

**Liquidity support measures were well suited to deal with a short suppression of economic activity that we experienced last year – a short and sharp lockdown which was expected to be followed by a swift return to normal.** However, the longer companies have to rely on these liquidity support measures, the greater their solvency problems become. Liquidity support may delay or prevent insolvencies, but it also saddles companies with debt, increasing the risk of insolvencies later on.

**As more parts of the economy start to reopen, policymakers will have to phase out liquidity measures, exposing the increased vulnerability of corporates due to the high levels of debt they have accumulated.** As soon as the lifting of restrictions to fight the pandemic can be anticipated, governments should announce a clear schedule for phasing out support measures, particularly those measures that are masking or delaying the recognition of loan losses.

**The phasing out of liquidity measures will restore the transparency of bank balance sheets and oblige banks to recognise borrowers' long-term payment difficulties (ESRB 2021).** During 2020, banks have already booked significant provisions on performing loans, resulting in a material increase in cost of risk and loans classified under IFRS 9 stage 2, and forborne exposures have increased markedly. The phasing out of measures such as moratoria on loan repayments and public guarantees can therefore be expected to affect asset quality (EBA 2021). However, there is wide variation in NPL levels across countries and in how banks book provisions for potential future losses for these bad loans. Increased provisioning for loan losses may reduce banks' ability to provide liquidity support to companies, which in turn could result in a rise in insolvencies. This further underlines the importance of shifting to solvency support.

## 3.2 Solvency support schemes

**Various fiscal support measures taken in response to the COVID-19 shock provided solvency support to corporates.** Such measures in the form of grants, tax relief, employment support (short-time work) and compensation for reduced revenues or costs stemming from COVID-19 were also widely used, albeit to varying degrees across Member States, reflecting in particular, differences in fiscal space.

**The extent to which solvency support has been provided to corporates is a key determinant of the debt overhang that firms will carry when they emerge from the pandemic.** As the COVID-19 crisis becomes more protracted, liquidity support alone will become increasingly ineffective in ensuring the survival of businesses. A gradual shift from liquidity to solvency support is essential, but also implies higher costs to public budgets. Solvency support therefore needs to be more targeted than liquidity support measures, for instance by designing support measures for the hardest-hit sectors and by using stricter eligibility criteria, subject to state aid controls.

**Governments will need to plan carefully the phasing out of the first two lines of defence against insolvencies, i.e. liquidity and solvency support measures.** Broad-based liquidity and solvency support measures (targeting groups/categories of corporates rather than individual firms) may have to be maintained beyond the moment when all COVID-related restrictions on economic activity can be lifted. When these measures are finally withdrawn, debt-related vulnerabilities in the corporate sector will become manifest. At that point, it will be crucial to have built the third and fourth lines of defence, and thus a capacity to deal with individual firms, based on an assessment of their viability in the post-COVID economy [Box 1].

Box 1

## Viability assessment – this time is different

**A key challenge will be distinguishing between viable and non-viable firms as emergency measures are being unwound.** For many companies and sectors, the COVID-19 shock is mostly, perhaps entirely, temporary. When normal life returns, these companies will have a viable business model. Yet, despite their viable business model, some of these companies may be close to insolvency. Policy interventions should ensure that the debt of such viable companies can be restructured.

**The separation of viable and non-viable firms cannot realistically be performed on the required massive scale by public administrations or courts.** While public, quantitative and easily comparable information (such as financial indicators) may be appropriate in defining distress levels, it may not be enough to guarantee a sufficiently reliable appraisal of viability. At the same time, the costs of carrying out such screening activity on a case-by-case basis would be too large, should a sharp increase in insolvencies occur.[8]

**The uncertainty of what exactly the post-pandemic economy will look like only increases the difficulties of viability assessment.** For example, identifying "zombie" firms based on accounting information, such as a persistently low interest coverage ratio, is prone to lead to significant errors in both directions. Therefore, distinguishing between viable and non-viable companies will likely require drawing on information and expertise held by informed lenders, such as banks and other investors. It also requires providing single or multiple creditors with the right incentives to choose restructuring over liquidation whenever the survival of a corporate is socially and economically optimal.

**The issue of assessing viability is not a new requirement linked to COVID-19, it is an element of all insolvency systems.** The specificity of the COVID-19 crisis is that it changed the relationship between distress and viability. In "normal" times (including in "normal" recessions) a certain distribution of viability exists within the pool of distressed firms. COVID-19 tilted this distribution: the share of distressed firms that are in fact viable may be much larger in the current situation than in previous recessions. Moreover, quantitative and qualitative parameters used to assess viability in the past may no longer be appropriate, due to the exceptional nature of this crisis.

**Three actors usually contribute to the viability screening: public authorities, creditors and firms themselves (and, in addition, providers of specialised information and financial accounts).** When and how they act largely depends on national insolvency rules. For instance, courts or other specialised boards can decide whether or not to declare insolvency, or approve a restructuring plan. Creditors can usually decide whether or not to take individual action against the insolvent debtor, file for insolvency, or participate in a restructuring agreement. Firms can decide (under several constraints) whether to attempt restructuring, what measures to activate to reach a

8 For instance, the forthcoming Italian "early-warning system" combines quantitative criteria to identify distressed firms with an ad hoc evaluation by a board of experts. Even though only larger firms are typically subject to this system, there are fears that an extraordinary inflow of distressed firms due to Covid-19 may hugely increase these boards' workload and negatively impact their ability to assess viability.

restructuring agreement (such as raising capital, reorganising their business, negotiating for debt delays or write-offs).

**Normal mechanisms for determining viability might not work as properly now as in the past, due to the combination of a larger pool of distressed firms and a different distribution of viability within it.** For instance, public authorities might suffer congestion due to a larger inflow of insolvencies, which would hinder their ability to provide reliable viability assessments, or cause delays in this activity. High uncertainty about economic prospects at the micro and macro level may dissuade creditors from participating in restructuring plans, leading to the liquidation of viable firms. Furthermore, creditors' private evaluation of the firm may be lower than its social value (e.g. if the firm is an important node in a network: see Blanchard et al., 2020).

**Public authorities have acquired a significantly larger stake in companies in this recession.** Through public loans, loan guarantees and possibly equity participation, the public sector has become a more dominant stakeholder in non-financial corporates. Yet, the public sector's ability to manage its stakes in NFCs and to maximise the value of these stakes has certainly not grown to the same extent. The public sector will therefore have to rely on the financial sector for an optimal management of these stakes, including viability assessments, but needs to provide the right incentives to ensure that interests are aligned.

## 3.3 Restructuring: fast and fair

**Improved debt restructuring will be needed to repair balance sheets of corporates with viable business models.** The liquidity and solvency support measures put in place in response to the COVID-19 crisis may not be sufficient to prevent a significant increase in insolvencies in all Member States and sectors. Despite the current favourable financing conditions – low interest rates and flat yield curves – some companies will require debt relief. However, excessively complex and lengthy restructuring proceedings as well as misaligned incentives may prevent restructuring even where it is economically desirable, to the detriment of small firms in particular.

**The next line of defence should be to facilitate debt restructuring to avoid viable businesses facing bankruptcy.** Debt restructuring can help preserve going-concern value, avoid lengthy and costly court procedures and reduce potential congestion of insolvency courts. Many companies will have become insolvent only due to the debt overhang accumulated during the COVID-19 crisis but are otherwise viable. Debt relief or equity injections, potentially facilitated by the public sector, would keep viable companies in business, reducing economic losses and costs to public budgets and the financial sector, and may lower the ultimate losses borne by the state, given externalities and coordination failures.

**Member States are required to put in place preventive restructuring frameworks in accordance with the EU Restructuring and Insolvency Directive of 2019 (see Annex III).** A swift recovery is more likely if financial restructuring is available to all companies with viable business models that had to increase debt levels due to COVID-19 and are facing temporary problems. By contrast, facilitating debt restructuring for companies whose business models were already under pressure before COVID-19 could be counterproductive and slow down necessary structural change, unless such financial restructuring is accompanied by operational restructuring measures.

**Directive 2019/1023 on preventive restructuring aims at preserving businesses whose insolvency is likely, but has not technically set in**, so before the business would be subject to bankruptcy proceedings that often lead to a piecemeal liquidation. To support the negotiation of the restructuring plan, a stay on individual enforcement actions (Article 6) is foreseen, with the effect that individual creditors' enforcement actions concerning their claims against the debtors, or acceleration of certain contracts, are suspended. Moreover, the debtor is temporarily relieved from a possible obligation to file, and creditors are temporarily prevented from filing for the debtor's bankruptcy. Proceedings which would lead to the piecemeal sale of assets are halted for the duration of the stay. [Box 2] illustrates how preventive restructuring has been introduced in the Netherlands and also provides a French example of debt remediation with support by public authorities.

## Box 2
## Restructuring and credit mediation – lessons from Member States

1. New restructuring regime in the Netherlands

**Since 1 January 2021, a new corporate restructuring framework has been in force in the Netherlands, the Act on confirmation of private restructuring plans (Wet homologatie onderhands akkoord, WHOA).**[9] The WHOA aims to improve effective debt restructuring for financially distressed, but viable businesses.[10] While the introduction of this new pre-insolvency tool is very timely with a view to the COVID-19 crisis, it has been in preparation for seven years and is therefore not directly related to COVID-19.

**In line with the Restructuring Directive and inspired by the United States Chapter 11 procedure and the English Scheme of Arrangement[11], the WHOA introduces (i) the possibility for the debtor in financial distress to propose a restructuring plan to prevent the debtor from going insolvent and (ii) the possibility for the debtor in financial distress, its shareholders, creditors or works council (if established) to request the court to appoint a restructuring expert to prepare a restructuring plan on the debtor's behalf.**

**After preparation of a draft restructuring plan, the debtor's shareholders and creditors are divided into classes based on their rights. Subsequently, every class will cast its vote on the draft restructuring plan.** A two-thirds majority of the votes cast in value of the claims of the creditors or of the issued capital of shareholders is required for a particular class to consent to the restructuring plan. Note that for the calculation of the required majority (i) only votes cast are counted and (ii) neither the number of claims/shares nor the number of creditors/shareholders are

9 Act of 7 October 2020, amending the Bankruptcy Act in connection with the introduction of the Act on confirmation of private restructuring plans (Wet homologatie onderhands akkoord), Dutch Official Journal 2020, 414 (Dutch only).

10 Banks and insurance companies are excluded as these entities are covered by specific legislation.

11 Parliamentary documentation, 2018/19, 35249, no. 3, Amendment of the Bankruptcy Act in connection with the introduction of the Act on confirmation of private restructuring plans (Wet homologatie onderhands akkoord) (Explanatory memorandum) (Dutch only).

taken into account (i.e. no vote by headcount). The draft restructuring plan may be submitted to the court for confirmation if all classes have voted in favour of the plan, but also if only one class, that would in the event of the bankruptcy of the debtor expect to receive a (partial) return on its claim, has voted in favour of the plan. Upon confirmation by the court, the restructuring plan becomes binding on the debtor and all creditors and shareholders who were entitled to vote. The restructuring plan may lead to an amendment of the rights of any creditor or shareholder, with the exception of rights of employees. Creditors and shareholders who have voted against the restructuring plan can be bound by the restructuring plan against their will.

**As the WHOA has been introduced at the beginning of 2021, it is too early to comment on its effectiveness.** So far, only the very first restructurings have taken place based on the new framework and many of its core aspects still need to take shape. While it was expected that large firms would in particular use the WHOA to restructure their debts, the WHOA was first applied by SMEs.

2. The credit mediation scheme in France: mediating between banking institutions and viable NFCs

**The credit mediation scheme ("Médiation du crédit") was set up by the French government in November 2008 in the wake of the global financial crisis to help companies – particularly SMEs – experiencing financing difficulties.** The scheme aims at facilitating access to loans and easing cash flow problems through a voluntary conciliation process with financial institutions to find appropriate solutions (including moratoria, debt refinancing or renewal of credit lines). However, the scheme is not meant to support non-viable corporates.

**After the Banque de France provided the backbone of the mediation since its early days, and took over the whole scheme in 2018, the credit mediation scheme has been implemented by the Banque de France by making full use of its expertise in local businesses and economic issues, its network of third parties that can advise companies prior to and during mediation, and its geographical footprint across the country.** At the national level, a credit ombudsman is proposed by the Banque de France and is appointed by the government and assisted by two deputies and a small team in charge of the coordination of the network and the most complicated cases, but almost all applications are managed at local level (105 local offices overall, including in French overseas territories).

**Such a mechanism appeared particularly helpful during the initial phase of the crisis: it is a fast-track procedure (a response from credit mediation within two business days and a five-day period for financial institutions to reconsider their position), cost-free for the borrower, confidential and easily adaptable to the characteristics of a specific company.** The mediation is conditional on an evaluation of the degree of viability of the company. During 2020, in the COVID-19 context, 14,147 companies, mostly very small businesses (84.1 per cent), benefited from credit mediation (14 times more than in 2019), with a success rate of 51.4 per cent, representing 2.3% of the French State Guaranteed Loan programme (€3 billion).

**Improved preventive restructuring frameworks are particularly important in the current crisis to the extent that a rise in insolvencies has been forestalled by allowing corporate**

**debt to rise.** Conventional insolvency procedures to deal with debt overhangs are often characterised by elevated costs and incentive misalignments: this hinders their suitability especially for smaller firms, which are those mostly hit by the COVID-19 shock. Specific attention should therefore be paid to ensure that small firms can access (both preventive and non-preventive) restructuring solutions, as this will be a central challenge in the post-COVID recovery.

**The role of banks during debt restructuring is critical, and incentives for banks to play a supportive role need to be considered.** Banks have thus far avoided restructuring debt of distressed corporates, as shown by the low percentage of loans with forbearance [**Chart 9**]. This wait-and-see approach is appropriate given the support measures offered to corporates and the uncertainty surrounding future economic conditions, including the phasing out of support measures. However, as support measures are withdrawn, involving banks in debt restructuring and reduction will become critical for the survival of viable companies.

**Governments have been given greater discretion in supporting firms through grants and equity injections.** The European Commission's State Aid Temporary Framework sets out the wide range of options that Member States have at their disposal for supporting corporates. The fifth amendment of the Framework, adopted on 28 January 2021, contains the following provisions.

- It extends the Temporary Framework until 31 December 2021.
- It increases the aid ceilings for limited amounts of aid and support for uncovered fixed costs.
- It enables Member States to convert repayable instruments (e.g. guarantees, loans, repayable advances) into grants and other forms of aid until 31 December 2022. The second amendment of the Temporary Framework on 8 May 2020 had already introduced the possibility for Member States to provide subordinated debt to distressed corporates on favourable terms subject to conditions[12]. The fifth version introduced the possibility to grant guarantees on newly issued subordinated debt instruments (again, subject to conditions).

**The possibility to convert repayable instruments into grants (up to a ceiling) could become a key tool for preventing insolvencies of distressed but fundamentally viable corporates.** While this would imply additional public spending in the short run, it could reduce deficits and debt in the medium term by speeding up the recovery, as well as by avoiding a steeper rise in NPLs, which would constrain the banking sector's ability to finance the recovery. This conversion of repayable instruments offers the possibility of engineering a smooth phasing out of the current support measures. Once we are confident that restrictions can be durably lifted and "normal" economic activity can resume, it will be easier to assess the viability of corporates and to design appropriate restructuring measures for individual firms or groups of firms in similar situations.

**Public authorities need to work with financial institutions to address debt overhang.** Public authorities need the expertise of financial institutions to assess the post-COVID financial viability of corporates and how much capital they need to mitigate sufficiently the risk of insolvency and to overcome any impediments to business expansion that may be caused by the COVID-related debt

12 Subordinated debt increases the ability of corporates to take on senior debt in a manner similar to capital support. This type of debt cannot be converted into equity whilst the company is a going concern, and the State assumes less risk.

overhang. It is important to ensure that the interests of public authorities and financial institutions are aligned when debt is restructured and that corporates are put on a sound financial footing for the recovery after COVID-19. This would imply requiring financial institutions to bear some of the restructuring costs and downside risks going forward. Moreover, under the State Aid Temporary Framework (point 31) banks should “to the largest extent possible” pass on the advantages of the public guarantee of subsidised interest rates to the borrower. This can be in the form of higher volumes of financing, riskier portfolios, lower collateral requirements, lower guarantee premiums or lower interest rates than would have been available without public support. [Table 2] provides a non-exhaustive list of the measures that could be considered for different viability categories – although the set of measures will largely depend on national specificities, including the support measures that have been taken already, and would be subject to state aid discipline.

Table 2

**Targeted restructuring, role of government and banks**

| Corporate viability category | Government support to be considered | Bank/lender involvement | Obstacles that may need to be removed |
|---|---|---|---|
| **Debtors without problems and good growth potential (e.g. companies that benefited from COVID-19)** | No intervention | Banks decide freely, subject to the regulatory framework | None |
| **Debtors without problems, but possibly diminished investment and growth potential due to COVID-19** | Partial debt relief in compensation for COVID-related losses | Banks could refinance loans on better conditions | None – negotiation may be required |
| | Loan guarantees | Banks could refinance loans on better conditions;<br>banks to provide additional loans and bear some of the risk | None – negotiation may be required<br>(coordination failure needs to be avoided: banks need to price in the beneficial effect of the government support) |
| | Direct investment through loans and equity | Design of financial instruments; “skin in the game” | Lack of appropriate financial instruments and public bodies empowered and able to manage equity stakes |

| Corporate viability category | Government support to be considered | Bank/lender involvement | Obstacles that may need to be removed |
|---|---|---|---|
| **Debtors with unsustainable debt due to an increase in debt burdens linked to COVID-19, but with a viable business model in the absence of this higher debt burden** | Grants to compensate for COVID-related losses | Banks to help determine losses and to bear some of the losses | Loans may have to be classified as NPLs |
| | Pre-emptive activation of loan guarantees | Banks to help identify cases where loan guarantees are likely to be needed and to bear partial loss on the guaranteed loan | Loans may have to be classified as NPLs |
| | New loan guarantees or public loans to lower debt costs | Banks to provide loans at lower costs and to bear some of the risk | |
| | Equity participation | Design of financial instruments; “skin in the game” | Lack of appropriate financial instruments and public bodies empowered and able to manage equity stakes |
| | If already in bankruptcy: grant debtor discharge to honest bankrupt individuals, including for personal guarantees granted for a business | Banks to help determine whether honest debtor discharge is justified | Legislation may need to change and courts may have to determine whether honest debtor discharge is justified |
| **Debtors with unsustainable debt due to an increase in debt or debt servicing costs linked to COVID-19 and with diminished earnings potentials post-COVID due to structural change** | Reduction of liquidity and solvency support for unsustainable activities (e.g. short-time working schemes); retraining of redundant employees (operationally restructured business could then be treated as under category 3) | Banks to help slim down the business;<br>private equity/business turn-around funds could step in | Social tensions, political interference (notably at local /regional level) |
| | If already in bankruptcy: grant a swift honest debtor discharge | Banks to help determine whether honest debtor discharge is justified | Legislation may need to change and courts may have to determine whether honest debtor discharge is justified |
| **Debtors with unsustainable debt even in the absence of COVID-19 effects and no viable business model** | Provide incentives for involvement of business turn-around specialists | Banks to bear their credit losses in full | |
| | Swift liquidation under normal bankruptcy rules | | Limited capacity of insolvency courts, lengthy and inefficient procedures delaying the disposal of assets |
| **Debtors in formal insolvency procedures** | Fast-track insolvency procedures particularly for small enterprises | | Legal obstacles, lack of expertise |

**There are a number of innovative restructuring proposals that are currently being discussed in the literature in response to the COVID-19 economic shock.** Greenwood and Thesmar (2020) propose that tax credits could be used to induce restructuring of debt and other liabilities, such as rent, which could be aimed at SMEs. To bridge cash flow shortfalls, Boot, Carletti et al. (2020) propose trading an initial cash flow injection into the company by public authorities against a proportionate participation in future gross earnings (“value added”) or net earnings (“profits”). Therefore, a temporary increase in future tax receipts from the surviving companies would be used to repay (part of) the solvency aid they received during the crisis. Blanchard et al. (2020) suggest a scheme in which governments match private sector haircuts by forgiving an equal amount of deferred tax or guaranteed loans. For medium to large firms, Gobbi et al. (2020) argue for the creation of a special purpose vehicle, funded with public equity and long-term debt placed with the ECB, that purchases and restructures COVID-loans from banks. They also propose that tax credits could be used to generate incentives for the private sector to inject equity to recapitalise indebted firms. All of these options could be considered so long as they are compatible with the state aid framework.

## 3.4 Efficient insolvency procedures

**Efficient insolvency procedures are the last line of defence against the economic costs arising from insolvencies.** They must ensure that firms without prospects of becoming viable again are swiftly wound down and that resources can be reallocated to productive uses. This should concern businesses in categories 4 and 5 of [Table 2], i.e. corporates that were already unviable before the COVID-19 crisis or that are confronted with long-lasting or even permanent changes in the business environment due to COVID-19. These corporates are economically unviable even when normal life returns. For these corporates, policy interventions could seek to promote operational restructuring (e.g. by private equity/business turn-around funds) and, in case of their liquidation, a smooth reallocation of resources to more productive uses. This may involve, among other things, reducing deadweight losses during liquidations, easing bottlenecks in reallocation and preventing fire-sale externalities. Importantly, policy interventions should avoid supporting “zombie firms” as this could significantly slow down the post-COVID recovery.

**Most European countries still have significant scope for improvement along the lines of the best practice principles on effective insolvency frameworks [Box 3].** It is crucial to ensure that courts have the capacity to deal swiftly and efficiently with an increased number of insolvencies. Yet, the efficiency of court systems is very disparate across EU Member States, and courts are often close to capacity even under normal circumstances. The World Bank’s Doing Business indicators provide an overall score for the efficiency of corporate insolvency [Table 3]. The EBA (2020b) also provides information on recovery rates and time-to-recover indicators based on data on insolvency outcomes [Chart 10]. Both the EBA and World Bank datasets point to significant variation across countries in terms of the efficiency of insolvency frameworks and thus room for improvement in many countries. Similarly, while not including all ESRB member countries, OECD data point to wide cross-country differences in the design of insolvency regimes, in particular with regard to the following features: personal cost to failed entrepreneurs, lack of prevention and streamlining, and barriers to restructuring [Chart 11].

Table 3

### Efficiency of insolvency regimes across ESRB members

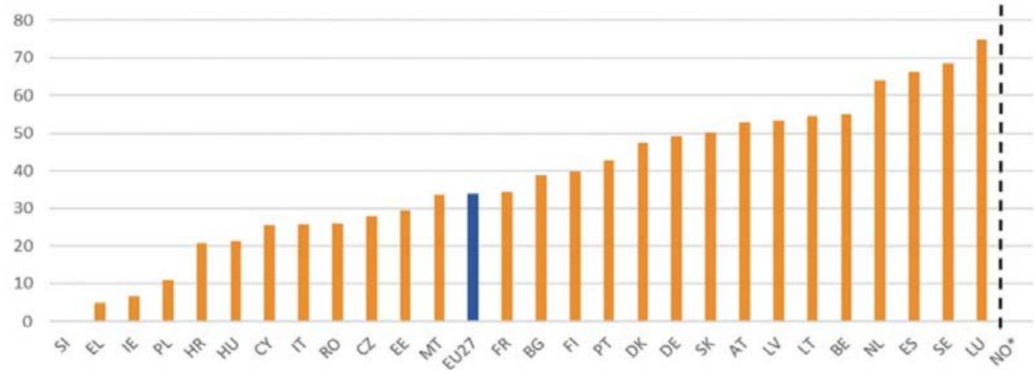
| Location | Resolving Insolvency rank(global) | Resolving Insolvency score | Recovery rate (cents/ dollar) | Time (years) | Cost (% of estate) |
|---|---|---|---|---|---|
| **Finland** | 1 | 92.7 | 88.0 | 0.9 | 3.5 |
| **Germany** | 4 | 89.8 | 79.8 | 1.2 | 8.0 |
| **Norway** | 5 | 85.4 | 91.9 | 0.9 | 1.0 |
| **Denmark** | 6 | 85.1 | 88.5 | 1.0 | 4.0 |
| **Netherlands** | 7 | 84.4 | 90.1 | 1.1 | 3.5 |
| **Slovenia** | 8 | 84.4 | 90.0 | 0.8 | 4.0 |
| **Belgium** | 9 | 84.1 | 89.4 | 0.9 | 3.5 |
| **Iceland** | 12 | 82.0 | 85.5 | 1.0 | 3.5 |
| **Portugal** | 15 | 80.2 | 64.8 | 3.0 | 9.0 |
| **Czech Republic** | 16 | 80.1 | 67.5 | 2.1 | 17.0 |
| **Sweden** | 17 | 79.5 | 78.1 | 2.0 | 9.0 |
| **Ireland** | 19 | 79.2 | 86.1 | 0.4 | 9.0 |
| **Spain** | 18 | 79.2 | 77.5 | 1.5 | 11.0 |
| **Italy** | 21 | 77.5 | 65.6 | 1.8 | 22.0 |
| **Austria** | 22 | 77.4 | 79.9 | 1.1 | 10.0 |
| **Poland** | 25 | 76.5 | 60.9 | 3.0 | 15.0 |
| **France** | 26 | 74.6 | 74.8 | 1.9 | 9.0 |
| **Cyprus** | 31 | 72.5 | 73.8 | 1.5 | 14.5 |
| **Slovak Republic** | 46 | 65.5 | 46.1 | 4.0 | 18.0 |
| **Estonia** | 54 | 60.1 | 36.1 | 3.0 | 9.0 |
| **Latvia** | 55 | 59.8 | 41.4 | 1.5 | 10.0 |
| **Romania** | 56 | 59.1 | 34.4 | 3.3 | 10.5 |
| **Bulgaria** | 61 | 57.8 | 37.7 | 3.3 | 9.0 |
| **Croatia** | 63 | 56.5 | 35.2 | 3.1 | 14.5 |
| **Hungary** | 66 | 55.0 | 44.2 | 2.0 | 14.5 |
| **Greece** | 72 | 53.1 | 32.0 | 3.5 | 9.0 |
| **Lithuania** | 89 | 46.7 | 40.3 | 2.3 | 15.0 |
| **Luxembourg** | 93 | 45.5 | 43.9 | 2.0 | 14.5 |
| **Malta** | 121 | 38.3 | 39.2 | 3.0 | 10.0 |
| **Liechtenstein*** | NA | 41.3 | 47.7 | 1.5 | 12.7 |

*Source: World Bank (2020).*
*Notes: *= rank not provided. The indicators measure the time, cost and outcome of insolvency proceedings involving domestic legal entities. These variables are used to calculate the recovery rate, which is recorded as cents on the dollar recovered by secured creditors through reorganisation, liquidation or debt enforcement (foreclosure or receivership) proceedings. The most recent round of data collection for the project was completed in May 2019. Data are derived from questionnaire responses by local insolvency practitioners, based on a specific case study (i.e. the insolvency of a hotel). Results should therefore be used cautiously for policy advice on general insolvency proceedings.*

Chart 10

**EU benchmark, gross recovery rate (%), simple average – SMEs**

*(percentages)*

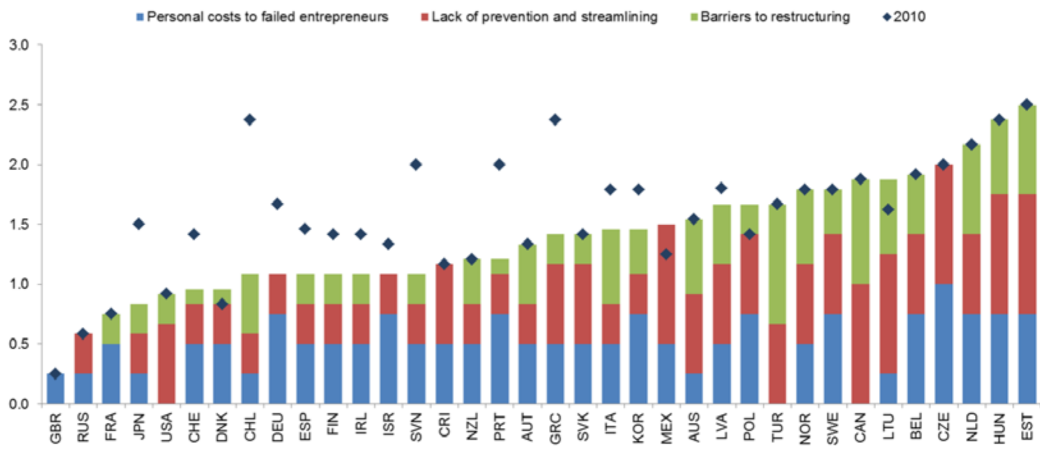



*Source: EBA (2020a).*
*Notes: The asterisk (*) indicates that the value is not shown because the number of observations is less than five. The EU27 figures include observations that are not shown.*

Chart 11

**Indicators of insolvency regimes, OECD countries**

*(OECD solvency indicators)*




*Source: McGowan and Andrews (2018).*
*Notes: Data are based on OECD questionnaire. The stacked bars correspond to three subcomponents of the insolvency indicator in 2016. The diamond corresponds to the value of the aggregate insolvency indicator based on these three subcomponents in 2010. Only countries for which data are available for the three subcomponents in 2016 are included.*

Box 3

## Effective insolvency frameworks

There is no blueprint for an ideal framework for effective insolvency but several best practice principles have emerged which also include a number of flanking policies that are needed to ensure the proper functioning of institutions implementing insolvency procedures (Bricongne et al. 2016; EC 2016a, b), including:

*Early identification of debt distress*: Detection and resolution of distress at an early stage helps preserve the value that can be recovered by creditors while minimising overall deadweight costs to the economy. In this respect, early warning tools enable debtors, notably SMEs, to test their financial soundness regularly and to resort in timely fashion to adequate instruments to deal with debt distress.

*Availability of early restructuring procedures*: For viable businesses, debt restructuring coupled with the reorganisation of corporate operations as a going concern is preferable to servicing debt via the piecemeal liquidation of assets. Preventive restructuring procedures with limited court involvement help in carrying out restructuring measures in a timely fashion while reducing uncertainty on outcomes.

*Availability, accessibility and affordability of insolvency procedures*: A variety of well-suited insolvency procedures covering different types of debt distress needs to be available to corporations, entrepreneurs and individuals. Insolvency procedures should be easy to start for both debtors and creditors, on the basis of clear criteria.

*Effective enforcement of creditor claims in secured lending*: This provides incentives for responsible borrowing. In situations where liquidation becomes necessary, it contributes to the efficiency of insolvency frameworks by reducing deadweight losses and makes outcomes more equitable.

*Allowing distressed debtors a genuine fresh start*: The adverse consequences of insolvency on the incentives to work and invest for distressed debtors, namely entrepreneurs or households, can be reduced by granting honest debtors discharge after a reasonably short period of time and repayment programmes compatible with repayment capacity. Such mechanisms need to be structured in a way that incentivises responsible borrowing and debt management upfront. For entrepreneurs who clearly failed due to the COVID-19 pandemic, discharges could be granted automatically.

*Clear rules on cross-border insolvency*: This is required for a speedy and cost-effective workout of international corporate insolvency, including with a view to not discouraging cross-border investment. Activities of firms that span national borders, and in particular cross-border groups of companies, can be subject to different jurisdictions. Clarity in the way cross-border insolvency cases are handled helps to ensure a quick and efficient resolution in the event of bankruptcy.

*An effective justice system is key to improving the implementing framework*. This includes several aspects such as judicial independence and transparency; the training of judges and practitioners; the creation of specialised courts; and alternative dispute resolution procedures, for instance through the appointment of mediators to assist the debtor and creditors while negotiating a restructuring plan (EC 2016a, b).

*Measures to improve the quality of information* available on the debtor's liability and assets, for example via credit registries, can foster faster handling of insolvency procedures. In times of large-scale debt distress, measures contributing to the offloading of non-performing debt from the banking system may be needed in order to reduce the impact on credit supply and provide incentives against the "evergreening" of NPLs.

**According to the survey among ESRB members, most countries have bottlenecks in their insolvency regimes which might be exposed if a large wave of insolvencies materialises.** A lack of effective informal out-of-court or hybrid workout frameworks, judicial inefficiency, limited capacity of the judiciary system and a lack of efficient restructuring procedures are reported as the most common bottlenecks associated with effective and efficient corporate insolvencies. Weaknesses in institutional settings that affect the implementation of insolvency procedures need to be addressed, including the functioning of and the availability of resources to courts as well as the availability and quality of insolvency practitioners. The quality and availability of information about debtors can also be improved by means of credit registries and interconnectivity among different registries.

**The majority of countries do not have specific corporate insolvency provisions for SMEs, such as simplified court proceedings.** COVID-19 has particularly impacted sectors with large numbers of SMEs. Countries will have to pay particular attention to possible improvements of their insolvency frameworks to assist SMEs (e.g. simplified procedures), which should also provide for swift honest debtor discharges and thus facilitate a fresh start for entrepreneurs whose businesses failed due to the COVID-19 crisis.

**While making far-reaching changes to insolvency regimes may not be feasible as an immediate response to the COVID-19 pandemic, there are a number of tools at the disposal of governments to support companies and their employees during the insolvency process.** As per the European Commission's (2014) Guidelines on State aid for rescuing and restructuring non-financial undertakings in difficulty, Member States may grant rescue aid to keep an ailing undertaking afloat for a short period of time needed to work out a liquidation plan. The liquidation plan must be set out in a substantiated way, with steps leading to the liquidation of the beneficiary within a reasonable time frame without further aid.

# 4 Policy conclusions

**Any prediction of insolvency rates is challenging given the multiple uncertainties about the vaccination rollout and the future course of the COVID-19 pandemic,** as well as the continuation of fiscal, monetary and other support measures. Governments and the financial system need to be ready to deal with a potential wave of corporate insolvencies.

**Preventing large-scale liquidations of fundamentally viable businesses will be key to preserving economic and financial stability and to fostering a swift recovery after the pandemic has been brought under control.** So far, policies have "cast the net wide" and have been successful in achieving this goal, but the first two lines of defence against insolvencies, namely broad-based liquidity and solvency support measures, will be gradually adjusted and end when the pandemic-related crisis subsides.

**Governments and banks should start planning for the end of the pandemic and a smooth phasing out of the support measures with the aim of preserving productive capacity in fundamentally viable firms or facilitating its swift redeployment from non-viable firms to more efficient uses.**

**Member States now have to take additional measures to bolster the lines of defence against the destabilising impact of insolvencies.** Such measures should deal with the debt overhang that many corporates will be saddled with after more than a year of restrictions on economic activity. Many of these businesses would be viable without the debt increase caused by the COVID-19 pandemic; they should be allowed to survive and enabled to contribute to the recovery, while unviable businesses should be swiftly liquidated.

**The first priority for Member States must be to create the right conditions for successful debt restructuring.** Through public loans and loan guarantee schemes, the public sector has acquired a significantly larger stake in the corporate sector. Sound public finances in the medium term depend on successful debt restructuring for a large number of firms. Under the State Aid Temporary Framework, governments are allowed to convert repayable liquidity support into grants and other forms of aid (up to certain ceilings). Governments can use such measures to contribute to debt restructuring while providing restructuring incentives to private creditors, and banks in particular, to put viable businesses on a sound financial footing for the recovery phase, harnessing the expertise of the financial sector in assessing business viability. In addition to providing financial incentives for debt restructuring, Member States can also amend the rules by developing restructuring frameworks that are more conducive to positive outcomes, in line with the 2019 Directive on preventive restructuring.

**For those companies that are found to be unviable in the post-COVID economy, efficient insolvency procedures should be developed.** While avoiding fire sales and bottlenecks, a swift liquidation of assets when businesses have to be wound up contributes to the recovery by allowing resources to be reallocated to more productive uses and by mitigating the impact of higher NPL ratios on banks' lending capacity.

**The ability of Member States to prevent and manage insolvencies should be seen as a matter of common concern in the European Union.** Countries entered the crisis in heterogeneous positions (e.g. strength of public finances, sectoral structural weaknesses, insolvency frameworks, sectoral NPL levels and economic cycle), have been affected differently by the economic shock and have different policy tools and varying levels of fiscal space at their disposal to support their economies. Some countries may emerge from the pandemic without a major increase in insolvencies, while others face a steep increase. However, financial stability in the European Union will be affected even if only a few countries are negatively affected by a post-COVID insolvency wave.

**Threats to financial stability can also arise from increasing disparities across Member States linked to insolvencies.** If rising insolvencies undermine the capacity of some Member States to recover from the COVID-19 shock and lead to a deterioration in the asset quality of the countries' banking sectors, it may result in political and economic instability which could spill over to the rest of the European Union. The Union's long-term budget, coupled with NextGenerationEU, will help repair the immediate economic and social damage brought about by the coronavirus pandemic and reduce disparities across countries.

**Cooperation at the EU level should support the efforts of national authorities in tackling the economic and financial stability risks stemming from corporate insolvencies.** This should include information sharing on expected insolvency developments and on the development of policies to prevent and deal with insolvencies. Such cooperation would allow the early identification of spillover risks and facilitate mutual learning. Policy recommendations addressed to individual Member States through the European Semester process may support national authorities.

**The ESRB is already committed to monitoring the financial stability implications of fiscal measures to protect the real economy from the COVID-19 pandemic.** Future insolvency developments in the European Union will depend, to a large extent, on the measures that have been taken and on how they will be phased out. As argued in this note, the phasing out of support measures should be accompanied by the deployment of preventive debt restructuring strategies and the build-up of capacity to deal with insolvencies in an efficient manner. These aspects should be included in the scope of the ESRB's monitoring of fiscal support measures.

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# Annex I: Key findings from the survey

**A survey of ATC members was conducted in December 2020** to examine the practices, experiences and lessons among members on corporate insolvency frameworks in response to COVID-19, and implications for financial stability. There were 28 responses.

**The survey found that there were low rates of corporate insolvency across members in 2020** compared to previous years and historical norms despite the COVID-19 pandemic and deteriorating macroeconomic conditions. This was explained by a number of factors:

- fiscal and monetary policy support measures taken by authorities to assist firms impacted by COVID-19 (e.g. moratoria on loan repayments, taxes, social contributions, job retention schemes, state participation in a few cases);
- the lockdown which closed commercial courts for a number of months;
- moratoria/restrictions on the obligation to file for bankruptcy;
- lag between financial distress and the time it takes for corporate insolvencies to the filed.

**Most of the companies which filed for bankruptcy in 2020 were already vulnerable before entering the crisis** due to low profitability, high leverage and poor liquidity, according to respondents. These companies were most likely unable to benefit from fiscal support, and at the same time, could not access other sources of financing.

**The worst-hit sectors have seen substantial deterioration in their financial position since the pandemic.** Profits have significantly deteriorated, own equity has decreased, and debt levels have risen in the most heavily impacted sectors (e.g. food and accommodation, arts and entertainment). The financial soundness of these companies has overall not considerably improved in the third/fourth quarter of 2020 – which could point to significant challenges in the near future.

**The number of insolvency cases will be higher in the next few years**, assuming a gradual phasing out of fiscal and monetary support measures which limits cliff edge effects. Most countries expect the pick-up in corporate insolvencies to be modest, as the lasting impact of fiscal support measures in 2020 outweighs the medium-term economic repercussions of the pandemic.

**However, any prediction of insolvency rates is challenging given the range of uncertainties** (e.g. vaccine rollout, new strains of the virus). The potentially beneficial effects of vaccinations weighed against the potential for further adverse economic effects makes it difficult to provide an expectation in relation to the number of insolvencies.

**The financial stability risks associated with corporate insolvencies for banks are manageable.** As long as insolvencies develop according to the baseline scenario, the resulting losses and loss allowances should be manageable for European banks which entered the crisis in a relatively strong position. Risks to the banking system are limited to the sectors which are most affected by COVID-19 – which account for approximately 5-15% of total non-financial corporation loans across most countries (although there is considerable variability across countries).

**Non-banks can play an important stabilising role in the recovery phase.** Due to the overall good capitalisation of insurers and their long-term business model, they can play a stabilising role in supporting an economic recovery. For investment funds, portfolio losses resulting from downgrades of corporate bonds or bankruptcies have an immediate adverse effect on the fund's performance and have the potential to put them under severe strain. However, EU capital markets can help play an important role in providing financing to distressed firms and support in their restructuring.

**A rise in insolvencies would have a negative impact on public finances,** especially in the event of a deterioration in economic activity concomitantly with an increase in losses linked to guaranteed loans. A feedback loop could emerge in which the downgrade of the sovereign's rating would elevate risks to the banking system, which would in turn, increase risks to the sovereign.

**Members have initiated a number of measures within their restructuring frameworks that have the effect of delaying corporate insolvencies,** including temporary stays on all activities related to insolvency proceedings and deferral of payments to credit institutions.

**Countries have adopted measures to buffer early warning tools and preventive restructuring frameworks since the start of the COVID-19 pandemic,** including:

- interactive tools (such as an insolvency dashboard), which will provide information on a weekly basis about the frequency of insolvencies against previous years;
- new early warning tools, which impose a requirement on debtors to take action to tackle distress situations before insolvency occurs;
- credit register, which documents the loan performance of companies with credit agreements over a low nominal amount;
- notifications, for communication to companies that may be facing problems that can lead to insolvency, by governmental departments (i.e. tax departments);
- multi-factor approaches, comprising data on newly filed insolvency cases involving corporations from the primary source of bankruptcies, combined with data on impairments and securities at bank level.

**Members' ability to assess viability of corporates is mixed.** It varies considerably across countries and in many cases there is no framework in place. However, the most popular methods used include credit assessment models, when evaluating corporate debt servicing capacity or loan portfolios; solvency and liquidity measures at the company level, to evaluate viable and non-viable corporates; and stress tests.

**The majority of countries do not have specific corporate insolvency provisions for SMEs** such as simplified court proceedings or the option of instalments in the payment of administrative expenses related to the insolvency proceedings.

**There are several bottlenecks to insolvency that are experienced by most countries.** A lack of effective informal out-of-court or hybrid workout frameworks, judicial inefficiency and limited capacity of the judiciary system, and a lack of efficient restructuring procedures are the most common bottlenecks associated with effective and efficient corporate insolvencies.

# Annex II: Dealing with zombification

For several years, and especially since the pandemic, numerous studies have drawn attention to the increase in the share of "zombie" companies in advanced countries, based on a variety of definitions. For example, Banerjee and Hofmann, 2020, using firm-level data on listed non-financial companies in 14 advanced economies, document a rise in the share of zombie firms from 4% in the late 1980s to 15% in 2017. These companies, which are sometimes less profitable, less productive and invest less, can certainly hold back the recovery as a symptom of a misallocation of resources.

From this point of view, it seems relevant to minimise the share of these zombie companies, in particular by promoting the efficiency of insolvency proceedings, which is without a doubt the key to success. For instance, the proportion of distressed corporates in France is very close to the OECD average (between 3.9 and 4.6% versus 5 to 6% from 2013 to 2016), while the business failure rate is higher than in other countries (between 1.1 and 1.3% from 2013 to 2016, which corresponds more or less to the German situation; conversely, in Spain and Italy this rate was lower, between 0.1 and 0.3 per cent). This is probably explained by the effectiveness of insolvency proceedings, taking into consideration the fact that the most inefficient companies have the highest probability of defaulting. For example, a government study (Hassine et al. 2019) carried out over the period 2008–2015, shows that between 20% and 30% of failing companies in a given year were not zombies one year prior to their failure, with this rising to between 52% and 60% two years prior to failure. Therefore, based on these pre-pandemic findings, it is possible to anticipate that only a very small proportion of non-viable businesses could continue to operate in 2021 after insolvency proceedings. On the other hand, considering the massive impact of the exceptional measures adopted in order to adapt the insolvency and restructuring legal framework to the magnitude of the crisis, a catch-up effect might be observed, depending on the phasing out process, in particular for those of the companies which are structurally non-viable.

However, at the same time, it is essential not to exaggerate the fear of a massive "zombification" of European economies due, on the one hand, to the excess debt resulting from the crisis and, on the other hand, to the masking effect of the massive and undifferentiated crisis liquidity support from public authorities during the past year. To be sure, timely liquidity support can help avoid the emergence of solvency problems. For example, a study (Bénassy-Quéré 2021) by the French Treasury clearly shows that public support measures have made it possible to drastically reduce the number of companies at risk of insolvency, without selecting the most productive or the least productive. This study shows the neutrality of the support mechanisms deployed in 2020 and tempers the alleged "zombification" of the economy.

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# Annex III: EU Restructuring and Insolvency Directive of 2019 – benefits and challenges

Several respondents to the survey (see Section 1) named a lack of efficient restructuring procedures as a major bottleneck in dealing with a potential increase in corporate insolvencies post-COVID19. The EU Restructuring and Insolvency Directive (Directive (EU) of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency)) was adopted in 2019 (the "Directive").

### Preventive restructuring

A significant tool with regard to post-crisis recovery is the preventive restructuring framework which Member States will be required to put in place pursuant to the Directive (Title II). Preventive restructuring aims to prevent the insolvency and ensure the viability of debtors in financial difficulties when there is a likelihood of insolvency (Article 1 (1) a). Restructuring is defined in the Directive (Article 2 (1) 1)) to mean "measures aimed at restructuring the debtor's business that include changing the composition, conditions or structure of a debtor's assets and liabilities or any other part of the debtor's capital structure, such as sales of assets or parts of the business and where so provided under national law, the sale of the business as a going concern, as well as any necessary operational changes, or a combination of those elements". The preventive restructuring framework thus focuses on financial restructuring measures, particularly capital measures, but also includes performance-related restructuring measures (operational changes). The need for financial restructuring is especially valid for companies with healthy business models that have had to increase debt levels due to COVID-19 and are facing temporary problems, rather than companies whose business models were under pressure before COVID-19 and that require operational restructuring measures.

The Directive requires Member States to have in place preventive restructuring frameworks, that is, rules that allow for a restructuring before insolvency sets in. While restructuring by way of agreement with (some) creditors is and remains possible at any point in time, it may not always be an option because not all creditors necessarily agree, including for collective action problems. Preventive restructuring as provided for in the Directive allows for the adoption of a restructuring plan that impacts the rights of all or some creditors even against their agreement, but with a view to rescuing the business as a going concern. The Directive aims at preserving the business whose insolvency is likely, but has not technically set in, so before the business would be subject to bankruptcy proceedings that often lead to a piecemeal liquidation. In that context, the Directive provides minimum harmonisation of certain elements of the restructuring plan, to be adopted by the debtor and other affected parties. The plan is to be adopted by majority voting; however, Member States can exclude certain stakeholder groups from voting on the plan. National provisions transposing the Directive will have to ensure that a court or administrative authority may, under certain conditions, confirm the plan in order for it to become binding also on the dissenting creditors or on entire dissenting creditor classes (cross-class cram-down, Article 11).

To support the negotiation of the restructuring plan, a stay on individual enforcement actions (Article 6) is foreseen, with the effect that individual creditors' enforcement actions concerning their claims against the debtors, or acceleration of certain contracts, are suspended. Moreover, the debtor is temporarily relieved from a possible obligation to file, and creditors are temporarily prevented from filing, for bankruptcy so proceedings which would lead to the piecemeal sale of assets are halted for the duration of the stay.

The Directive also provides for the protection of new or interim financing in the case of a restructuring plan and gives a direction of travel for directors' duties where there is a likelihood of insolvency.

At the Member States' discretion, they may introduce a viability test in order to allow only those debtors which "have a prospect of viability" to enter preventive restructuring (Article 4 (3)).

### Debt discharge

For insolvent entrepreneurs, the Directive (Title III) requires Member States to put in place rules for a debt discharge. While these rules are designed to play an important role in ensuring that entrepreneurs personally are not caught in a debt trap following a crisis (be it COVID-19 induced or otherwise), they do not concern the survival of the business. Rather, Article 20 (1), sentence 2 of the Directive allows Member States to require that the entrepreneur cease the business activity in which the debt was accumulated. Also, the discharge can require up to three years, therefore it does not lend itself to an immediate restart of economic activity during the post-crisis recovery.

### Increase in efficiency

The Directive further provides for measures to increase the efficiency of restructuring, core insolvency and discharge procedures (Title IV). Some of them can be expected to also help in procedures during the post-COVID recovery. However, specifically the requirement to allow for certain procedural steps to be carried out electronically (Article 28) will only apply from 17 July 2024 (Article 34 (2)). Others are either difficult to measure and may take some time to show their full beneficial effects across the board (e.g. judges' training; e.g. transparent and fair process for the appointment of practitioners). This being said, those measure might not have an immediate positive impact on the post-COVID recovery, but rather a systemic and gradual one. Similarly, the provisions on the monitoring of procedures (Title V) are only likely to allow for conclusions once a picture has been obtained over time.

Rules on early warning tools (Article 3) are important in normal times because an early grasp of the situation increases the efficiency of the tools provided by the Directive. These rules, once transposed in national legislation, will also be important in the post-COVID recovery phase in particular to detect any cascading insolvencies, e.g. insolvencies deriving from bankrupt suppliers or contractors.

### Transposition

Member States are supposed to transpose the Directive into national law by 17 July 2021 (Article 34 (1) Restructuring and Insolvency Directive). However, by the deadline of 17 January 2021, 23 out of 27 Member States had notified the Commission that they encountered particular difficulties in implementing this Directive and opted for the extension of the implementation period by one year (Article 34(2) of the Directive)[13]. In many Member States, the new rules may therefore not stand ready from the outset to help the post-crisis recovery. Since preventive restructuring is an option, it would, moreover, have been beneficial if the market could have tested the new rules in a non-crisis environment to foster confidence.

Nevertheless, preventive restructuring is an important tool if used at the appropriate moment in time. When temporary crisis measures lapse, such as when moratoria on the obligation to file for bankruptcy proceedings are lifted, preventive restructuring could be a means to carry viable companies over until earnings pick up. For preventive restructuring to be used responsibly, it would be useful to apply or introduce a viability test that would take into account changes resulting from a permanent shift in customer behaviour or changes due to fear, regulation or a shift in values.

[13] Austria, France, Greece and Portugal will not use the extension.

# Annex IV: Glossary of key terms

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| **Corporation/corporate entity** | A legal entity that has a separate legal personality from its owners and/or managers, where the liability for debts incurred in the course of the business is limited to the legal entity (absent contractual assumption of liability by another party, e.g. the majority shareholder). Examples are joint stock corporations, limited liability companies and partnerships limited by shares. This definition applies irrespective of the size of the business and thus encompasses both large corporates and SMEs. |
| **Insolvency/insolvent** | A situation of financial distress that cannot be overcome without current creditors not receiving their expected payments or a third party stepping in to cover losses. |
| **Insolvency proceedings** | Collective insolvency proceedings that, in their normal course, entail a total divestment of the debtor and the appointment of a liquidator. |
| **Restructuring and preventive restructuring** | Restructuring, a process that involves measures aimed at restructuring the debtor's business that might include changing the composition, conditions or structure of a debtor's assets and liabilities or any other part of the debtor's capital structure, such as sales of assets or parts of the business and, where provided for under national law, the sale of the business as a going concern, as well as any necessary operational changes, or a combination of these elements.<br>Preventive restructuring, a process that involves frameworks available for debtors in financial difficulties when there is a likelihood of insolvency, with a view to preventing insolvency proceedings and ensuring the viability of the debtor. |
| **SME** | An enterprise that employs fewer than 250 persons and has an annual turnover not exceeding €50 million, and/or an annual balance sheet total not exceeding €43 million. |
| **Viable/non-viable firm** | A corporation is deemed to be viable if it can expect, for the foreseeable future, to obtain the funds it needs to continue its business without public support. A non-viable corporation is often referred to as a zombie firm (see below) if it remains in business beyond the point at which it becomes clear that the firm is unlikely to become profitable again. |
| **Zombie firm** | A firm that is not expected to be profitable in the longer run and whose economic survival depends on the forbearance of its creditors or public support. Different indicators are used to determine whether a firm should be labelled as a zombie firm (interest coverage ratio <1, negative or very low return on assets, negative net investment, EBITDA below 5% of debt). Accurately determining whether a firm is a zombie firm can be challenging. |

# Imprint



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For specific terminology please refer to the **ESRB glossary** (available in English only).

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