Covid-19 and the Bazooka of the Belgian Financial Sector: Where Did It Go Wrong?

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ABSTRACT

Covid-19 has hit health systems and economies all over the world. To weather this crisis, the financial sector encompassing Febelfin, the National Bank of Belgium and the minister of finance installed a financial bazooka of €50 billion on March 22, 2020. In contrast to some other countries such as Switzerland, this bazooka did not work out as expected. In this short note, we make an evaluation and go deeper into potential drivers behind this failure. We conclude by making some alternative suggestions.

1. Introduction

Economies all over the world have been surprised by Covid-19. Initially, when the pandemic hit, there was widespread hope that economies would be able to reopen after a couple of months of lockdown. Firms would be put under a coma, stay intact over the lockdown period, and start production quickly when Covid-19 was over. These expectations, however, quickly turned out to be dramatically wrong. With this in mind, the Belgian financial sector (Febelfin, the National Bank of Belgium, and the Minister of Finance) agreed towards a "coordinated debt rescheduling" of outstanding mortgage and business loans (on the request of an individual household or firm). Furthermore, Belgian banks committed to make €50 billion available by relying upon a loan guarantee scheme provided by the Belgian government. The design of this scheme puts the systemic risk with the Belgian government but keeps the idiosyncratic risk with each bank. The idea was to help solvent but illiquid firms over this crisis by making short term loans up to one year

available. Solvency here being defined as pre-corona crisis solvency – assuming that the post-corona world would be a simple copy paste from the pre-corona one.

2. Evaluation of the Bazooka

Let us evaluate what has happened with the bazooka. It seems that the "coordinated debt rescheduling" gained traction: on May 15, about €19 billion of business loans employed the rescheduling option. This is about 12.5% of total business loans outstanding, or about half of loans with maturity less than one year (based upon data from the NBB). These are substantial and should relax credit constraints faced by firms. The second part of the Bazooka, however, seems by far much less successful. While official numbers are lacking to date (to my knowledge, neither Febelfin nor the NBB do reveal details about the usage of the bazooka), De Standaard reports on May 15, 2020 that "KBC initiated during the first quarter of 2020 about €4 billion in loans to business but only a couple of millions fall under the bazooka (my translation)".

Admittedly from an ex-post view, the design of the Belgian bazooka did not lead to the expected injection of loans to firms. While Belgium is definitely not the only country where the bazooka did not work out as expected, in some other countries (e.g., Switzerland) it did quickly, smoothly and efficiently (see IMF, 2020, for an overview of Covid-19 measures for different countries). Switzerland unveiled its CHF20 billion package of emergency loans to support small businesses on March 25. In its first week of operating, it disbursed more than CHF15 billion to 76,034 businesses. Where does this substantial difference in success come from?

3. Where Did It Go Wrong?

The decision to delegate credit decisions to banks in a bank-based economy such as Belgium seems the right one for at least three reasons. First, banks build long-term relationships with firms and should be able to make informed decisions about the allocation of credit (e.g., Rajan, 1992; Petersen and Rajan, 1994). About 85% of Belgian firms has a single lending relationship allowing each bank to largely internalize its decision regarding lending to a firm without important coordination problems (Degryse et al., 2019). Second, Belgian banks are well-capitalized compared to their European peers, and with the advent of the pandemic, regulators have been flexible regarding capital requirements and loan loss provisioning. In particular, the European Central Bank (ECB) announced on March 12, 2020 to allow for temporarily lower capital requirements in the

bank-specific capital buffer (Pillar 2 guidance), the capital conservation buffer, and the contra-cyclical capital buffer. The ECB announced flexibility regarding loan-loss provisioning given the current crisis. Also, the supervisor called for restrictions on share buybacks and dividend payments. Third, delegating the implementation to banks also reduces the risk that hard-shouting lobby groups and politicians get involved. This should avoid or reduce favoritism and related lending. So the environment seems such that the bazooka is credible. So why did it not work? Where did it go wrong?

Unattractive for Banks and Firms

The terms of the bazooka may be too unattractive both from a bank's perspective and from a firm's perspective. Let me start from a *bank's perspective* and mention two reasons. First, the design of the bazooka is subject to EU state aid law requiring a fee of up to 50 basis points, to be transferred by the bank to the Belgian government. Further, it limits the maximum interest rate to 1.25%. From the ECB's statistical warehouse, we learn that the average interest rate for new short-term loans granted in Belgium in March 2020 was 1.57%. This implies that it may be quite unattractive for banks to call upon the guarantee as the loan rate they receive is below the market rate and the fee they could charge actually goes to the government.

Second and probably more important, the design of the bazooka leaves idiosyncratic firm risk with the bank, making it largely unattractive. In particular, each bank needs to bring all new short-term loans with a maturity of less than one year under this guarantee and can "deselect" 15% of these new loans for which they do not ask the guarantee (and do not pay the fee). As long as a bank's entire portfolio does not incur more than 3% credit losses, the guarantee does not kick in. The guarantee thus only works at a bank's portfolio level: decisions at loan level may not at all reflect the government guarantee while they have to pay the insurance premium. Put differently, a bank will only start recognizing the presence of a government guarantee at loan level whenever the outcomes on previously initiated loans turn sufficiently sour. Banks may prevent paying the insurance premium by either not supplying short-term loans or supplying loans that are outside the scope of the bazooka. Banks could have incentives to include in the bazooka truly bad risks, where new loans may help them recover outstanding loans, i.e., encouraging zombie lending. That is, banks supply loans outside the scope of the law and put bad risks in the "bazooka portfolio".

Also, from a *firm's perspective*, such loans may not be the most desirable ones as they are short-maturity only and call for repayment within a year. Firms liquidity needs may be more persistent and have a longer time horizon. So, there may be a mismatch between demand and supply as the crisis unfolded.

Too Short

The bazooka only considers additional loans within the bank-firm pair with a maturity less than one year. This design clearly started from the premise that the pandemic would induce a short-term coma without spillovers across the entire supply chain as well as international spillovers which are so important in our export-oriented economy. This implies that firms may require loans with a much longer maturity, as also evidenced in De Standaard of May 15, where it is mentioned that “KBC received loan application from many firms for loans with a maturity of 36 to 48 months”. The motivation is clear: supply chain disruptions, demand disruptions, negative demand shocks in other countries, and proving a credible financial structure imply that even healthy firms will require financing with longer maturity. Here the regional governments play a role, but their firing power is limited. For example, the bazooka of the Flemish government is limited to €3.4 billion of which only €400 million for smaller deals.

Too Fragmented

The Covid-19 crisis required action from the government, but the efforts have been fragmented and uncoordinated across several levels – Europe, Belgium, regions, province, …. At the European level, apart from the ECB, actions have been shamelessly slow, small, and almost inexistent. This does not only apply in terms of firing power but also in terms of coordination efforts regarding the health crisis and economic efforts. European economies, and in particularly export-oriented ones depend on a strong coordinated supporting set of policy actions.

At the level of Belgium, there is also considerable fragmentation with politicians showcasing with individual measures such that you almost need a PhD in finance to find your way in the entire patchwork of (possibly well-intended) policy actions. Small firms most in need may lack such information and therefore be disproportionally hurt.

Too Slow

While the bazooka of the Belgian financial sector was agreed quite quickly (March 22), its actual implementation took quite long as details on how to interpret and implement it only got available mid-April. Loan officers and relationship managers deciding on firms’ requests thus faced uncertainty during a considerable time window, hindering the timely implementation of the bazooka.

4. Concluding Remarks and Some Suggestions

While well-intended, the bazooka of the Belgian financial sector has turned out to be a water pistol. The bazooka's upside is that a vast group of (hopefully viable) firms have been able to reschedule their debt employing the room created by the bazooka and the financial regulators. From an ex-post view, the downside is that the €50 billion bazooka was badly designed due to incentive problems for banks, the crisis not being a simple coma, and the supply chain linkages between firms at national and international level.

While it is late, it is never too late to make up our mind and adjust the bazooka. Let me give some suggestions:

- Increase the maturity of loans included in the deal up to 5 years, in line with what firms require.
- Apply the guarantee scheme at bank-firm level (as was the case in Switzerland), not at bank-portfolio level. At loan level, the government guarantee can be substantially lower (say 50%).
- Reduce the patchwork and fragmentation across different levels.
- Covid-19 is not a simple coma. Decisions should be forward looking and take into account that some industries might have worse prospects after Covid-19. Examples include airlines, retail shops, restaurants, pubs, …. However, do take into account that renegotiation with other stakeholders also allows to absorb shocks and may create a viable business model for these industries. For example, lease contracts with aircraft lessors can be renegotiated, or rents of pubs can be lowered.
- Pay attention to the possible building up of zombie firms (i.e., non-viable firms) and zombie banks, and let these two not tango. Give banks incentives to recognize losses and pull the plug on firms. Avoid debt overhang problems. Impose recapitalization of banks when needed. Close scrutiny from the financial supervisor is required once the dust gets settled (e.g., Bonfim et al., 2020). Creative destruction is part of a sound economy.
- A lot of policy attention has gone to debt. The aggressive monetary policy of central banks around the world has favored debt over equity. However, we should not forget that equity is another important part of a firm's capital structure. Transforming part of our savings deposits into equity supporting in particular small and medium sized firms is desirable.

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