

Weathering the COVID-19 storm: liquidity and solvency of Belgian firms¹



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ABSTRACT

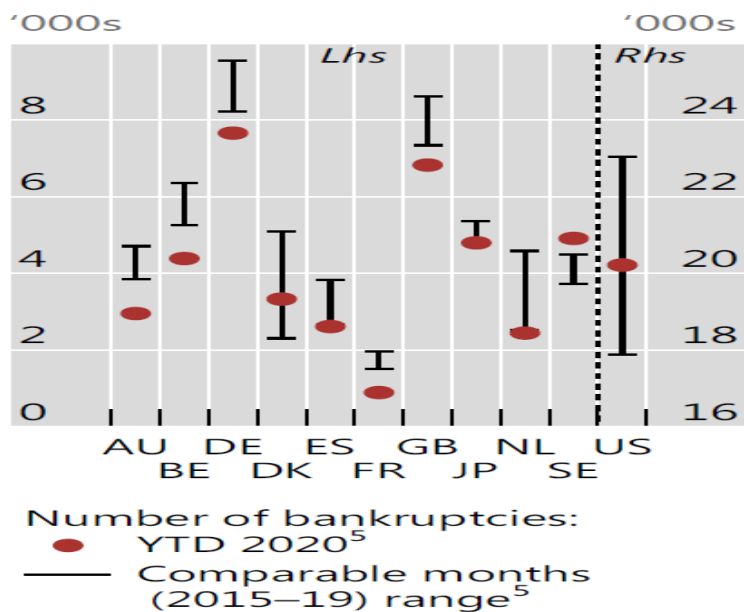
COVID-19 puts firms under severe strain in countries where the pandemic continues to hit. The initial reaction was to provide outright transfers and liquidity support to weather this perfect storm. We argue that a focus on the solvency of firms and sectors is needed. We discuss several avenues on how to improve firm solvency such as conditional transfers and a pandemic equity fund. We further argue that support policies should avoid a further zombification of the economy: preserve firms (and jobs) that have a post-COVID-19 viable business model. Redirecting resources to the future engines of growth is desirable. Banks, policy makers and businesses face a balancing act to keep firms and sectors with “post-corona viable business models” liquid and solvent. At the same time, policymakers should avoid zombification and allow for creative destruction such that firms with “post-corona non-viable business models” are reorganized or liquidated.

¹ This article is partially based upon my contribution to the NBB-Febelfin Webinar on “Les mesures corona visant a soutenir l’économie et les affaires”, which can be viewed over here <https://www.nbb.be/nl/evenementen/webinar-de-coronamaatregelen-ter-ondersteuning-van-de-economie-en-van-het-bedrijfsleven>

1. Introduction

COVID-19 has hit the business sector in an unprecedented way. The initial hope for a V-shaped recovery quickly faded and is replaced by a pessimistic and uncertain outlook. We still have no answer on when and whether we go back to normal and how this “new normal” will be defined. Firms have to evolve their business models amid the pandemic. Despite the dramatic economic downturn, recent data show that firm bankruptcies are lower year-to-date (YTD) than in the previous five years (as reported in the BIS (2020) and shown in Figure 1 below). Firm bankruptcies have been prevented or postponed by unprecedented blanket support measures by governments and debt moratoria by banks (as approved by their supervisors).

Figure 1: Bankruptcies in Advanced Economies



Note: 5 Year to date (YTD): latest data available, July 2020. For Australia (AU), Spain (ES) and Great Britain (GB), June 2020. For Germany (DE) and France (FR), May 2020. For ES and GB, quarterly data. The comparable month range is calculated for the period 2015–19 on the same months as the YTD figures.

Source: BIS (2020), part of their Graph 1

The Belgian financial sector (Febelfin, the National Bank of Belgium, and the Minister of Finance) initiated two bazookas (in March and July 2020, respectively) to ensure liquidity provision to firms and households. These bazookas encompassed a coordinated debt



moratorium on outstanding mortgage and business loans, as well as a commitment of €50 billion on short-term loans (with maturity up to one year) to pre-COVID-19 healthy firms. The second bazooka focused on small and medium sized enterprises and converted €10 billion of the first bazooka (i.e., taken out of the previous €50 billion) for loans with maturities from one to three years.

We argue that the focus gradually needs to turn to firm solvency, i.e., the question whether a firm can meet its long-term obligations and continue to run its current operations long into the future. What will happen when the current moratoria on debt service and the outright transfers end? When a firm's revenues decline and costs do not drop accordingly (or support measures do not cover this completely), servicing of debt becomes more difficult. At this point in time, due to the unprecedented support measures, the dust is not settled yet but a wave of loan defaults, insolvencies and ultimately firm bankruptcies is expected. Policy makers therefore need to provide a policy mix that supports economically viable firms but cuts short on non-viable ones and reallocates resources towards sectors with post-COVID-19 viable business models. We will discuss potential paths to improve solvency of viable businesses.

The remainder of the text is organized as follows. In Section 2, we start with a brief evaluation of the liquidity provision by banks around the first COVID-19 wave and discuss the solvency situation of firms. In the third section, we discuss a few paths to enhance firms' solvency. The final section concludes.

2. From liquidity to solvency

Liquidity provision around the first COVID-19 wave

Many countries exposed to the COVID-19 pandemic have provided different types of support to their households and firms. Information on support measures for several countries is presented in Breugel (2020).² This allows to compare the Belgian support relative to other countries. Next to the immediate fiscal response (such as the cancellation of some social security contributions) and deferrals (taxes and social security contributions that should be paid later), the Belgian financial sector has provided 21.3% of GDP as liquidity support to households and businesses. This support encompasses both a coordinated debt rescheduling of mortgages and business loans as well as the provision of

² More information can be found on <https://www.bruegel.org/publications/datasets/covid-national-dataset/>

new bank loans to firms with a pre-COVID-19 viable business model. While the coordinated debt rescheduling proved to be a success, the provision of additional liquidity to firms in sectors harmed most by COVID-19 did not take off. This stems partially from a poorly designed government guarantee as it kicks in at the portfolio level but not at the level of the individual loan (see Degryse (2020) for an earlier critical assessment). As a consequence, the financial sector in cooperation with the government decided to improve the bazooka for SMEs and support longer maturity loans (in between 1 and 3 years) with government guarantees at the loan level.³ It is not clear at this stage whether this second bazooka was effective.

Solvency: how to avoid the further zombification of the economy?

The COVID-19 crisis has not only a major impact on the liquidity position of firms but also on their equity positions. Solvency concerns arise in particular for the sectors most affected by COVID-19. Solvency support therefore may be necessary to allow firms to stay in business and resume investments and employment growth when the recovery kicks in. Several direct support measures should dampen the negative impact on firms' solvency.

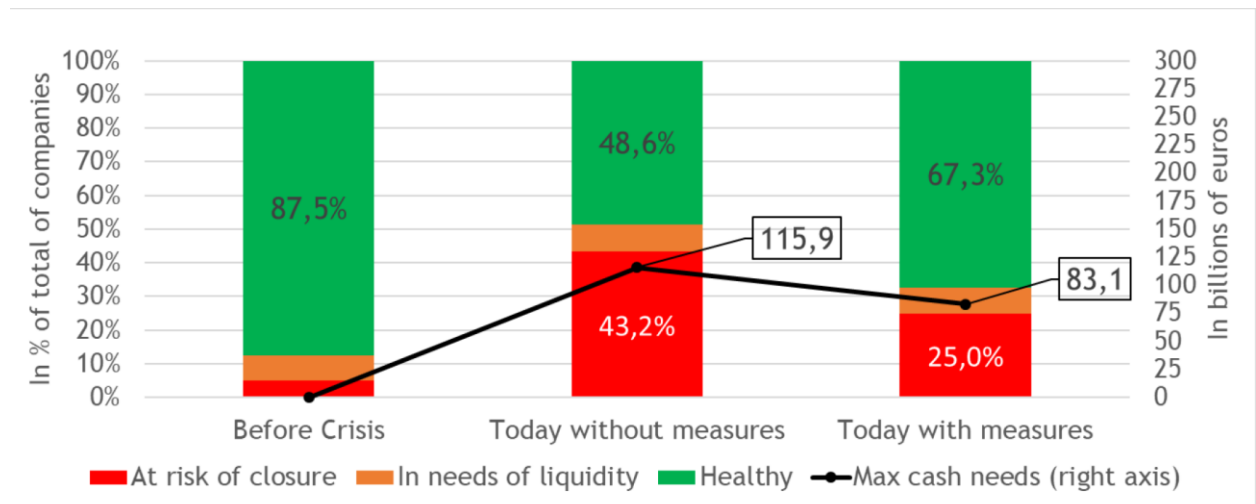
The European Commission (2020) in its investigation at the end of May 2020 analyzes the degree of equity injection required to keep firms balance sheets healthy in the European Union. In particular, the report states that “while is a difficult to precisely quantify equity repair needs given the many modelling assumptions involved, simulations using firm-level data suggest that these needs could be around €720bn in 2020 ... these needs would be significantly higher in case the lockdown measures stay in place longer than assumed in the baseline scenario of the Spring Forecast. In the longer-lasting confinement scenario presented in chapter 3 of the Spring Forecast, the damage to corporate equity in the EU could be as big as €1.2trn”. Given the ongoing second wave in many countries, firms' solvency should be top priority for policy makers.

This situation also occurs in Belgium. Recent numbers in VBO and Graydon (2020) show that despite the support measures by the various governments around a quarter of the firms is at risk of closure (see Figure 2 below). (Without support measures, this would have been around 43%). Policymakers have to turn to targeted support measures to keep viable firms that encompass post-corona business models alive, but also reorganize the firms

³ Belgium was not the only country where the Bazooka was not successful. According to the De Nederlandsche Bank, SMEs in the Netherlands also made limited use of government guarantees due to the high insurance premium and the guarantee being too low to make it attractive to banks to apply for it, see De Nederlandsche Bank (2020).

without such models to avoid a further zombification of the economy and fuel the new engines of potential growth when the sky clears up.

Figure 2: Solvency of Belgian firms



Sources : Graydon and FEB.

3. Improving Solvency

To improve the solvency and the long-term potential of firms' operations, policy makers can work on several dimensions.

From blanket support to targeted support

First, providing direct support to firms covering (partially) their costs allows them to limit drawing down their own equity. The novel *conditional/ targeted* support measures are a reasonable approach: firms which face a sales drop of more than 60% compared to sales in a similar period the year before receive direct support. At the same time, a few problems pop up. First, this gives firms incentives to fail miserably or to start shifting around with sales during particular periods. Second, you support firms that most likely are the ones with a business model that is not adjusting towards the new normal after the corona virus. So additional conditionality might be needed. To give an example, we should probably not support firms in the catering industry (i.e., restaurants, pubs, ...) that do not encompass takeaway and do not have an official cash register system (the so-called "*witte kassa*").

Second, renegotiations with other fixed claimholders (such as rental costs) could be part of the game. Otherwise the targeted support is a hidden bailout of the real estate industry or banks.

Expansion of Notional Interest Deduction

The current framework of “notional interest deduction, NID” could be reinforced. The NID enables companies subject to Belgian corporate tax to deduct from their taxable income a fictitious interest calculated on the basis of their shareholder’s equity. This is more attractive for firms with greater solvency. The tax deductibility could be tailored such that it is larger for (i) firms injecting additional capital, (ii) small and medium sized enterprises, or (iii) firms that have business plans anchored in the “new normal”.

Pandemic Equity Fund

Firms that become weakly capitalized but with promising business models could benefit from equity-like instruments through a Pandemic Equity Fund. Boot et al., (2020) call for a *European* Pandemic Equity Fund that could reduce firms’ over-indebtedness and create a fair level playing field in the internal market. Unfortunately, this idea did not make it to the European recovery plan and the multiannual financial framework for 2021-2027.

The equity-like instruments are financial contracts that imply loss absorption in case of poor future firm performance but reward participation otherwise. The following characteristics could prevail for injecting the equity-like instrument into firms:

- Equity-like instruments in exchange for a proportionate participation in future gross earnings (“value added”) or net earnings (“profits”);
- Equity-like instruments are in contrast to fully-fledged equity investments as they avoid dilution of control by existing owners;
- Firms having received equity-like capital injections have the right to buy out the pandemic equity fund in the future using a ‘termination option’.

Notice that equity-like instruments are different from blanket transfers and targeted transfers as the latter do not reward participation in case of good performance (except for the usual tax receipts when firms survive). Equity-like financing thus has the advantage for the government that there is an additional upside from sharing in the profits by the pandemic equity fund.

Equity-like instruments are also different from bank loans or other types of debt as firm leverage does not increase and the probability of firm default should drop due to the absence of a fixed payment obligation (in contrast to bank loans or other types of debt).



As mentioned above, Boot et al., (2020) propose a *European* Pandemic Equity Fund which would allow for risk-sharing across countries and sectors. The European Commission however decided not to include this design in its European recovery mechanism. This is unfortunate as such a fund holds the middle between loans on the one hand and targeted or blanket transfers on the other hand. Nevertheless, Belgium could still resort to such a pandemic equity fund. A further possibility is to involve Belgian households in a way to transform part of the savings deposits of Belgian citizens.

4. Concluding remarks

The ongoing COVID-19 pandemic puts pressure on the liquidity and solvency positions of firms. In this paper, we call to focus on the solvency positions of Belgian firms as about a quarter of them are subject to severe solvency stress. While the initial policy mix was unconditional and provided support to all business that temporarily closed, the new policy mix focuses on sectors and firms with severe drops in sales. While such policies are a possible step in the right direction, two problems remain. The first one is that targeted support might be given to firms with business models that are not sustainable after COVID-19. A second problem is that the targeted policies are transfers that are not providing upside potential (except for firm survivorship and contribution through future tax receipts). We make the case for an intermediate solution stemming from a pandemic equity fund (as in Boot et al., 2020). This fund provides equity-like injections in exchange for future profit participation, without diluting existing shareholders.

An important concern in many advanced economies is the zombification of firms. The pandemic debt binge will have further stimulated the fraction of firms that has no viable business model. Policy makers also need to allow for creative destruction and stimulate an entrepreneurial environment. Hombert et al., (2020) for example show that lowering barriers to entry through unemployment insurance for self-employed, spurs entrepreneurial activity. Incentives to stimulate business dynamism are key to unlock our future potential.

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