

# Will corporate debt choke the post-COVID-19 recovery?

**Frederico Mollet**  
Policy Analyst  
European Policy Centre

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## BACKGROUND

Over the past year, European firms have been forced to take on significant debts to survive the COVID-19 crisis, and will be forced to continue to do so well into 2021. Even as vaccines roll out, Europe faces the prospect of a prolonged retrenchment as indebted firms pull back investments and repair their balance sheets, hampering the economic recovery. Europe's green and digital ambitions, which require significant private investment, are also in danger. Furthermore, a dearth of private investment will force fiscal authorities to take on greater debt burdens to stimulate the recovery, and widen economic divergences between member states. This will further aggravate the Union's fractious fiscal politics. Resolving the COVID-19 debt overhang is critical.

Many solutions have been proposed to address the debt overhang and accompanying rise in non-performing loans (NPLs). However, surprisingly little attention has been paid to the opportunities created by the 2019 Directive 2019/1023 on restructuring and insolvency (DRI), given that insolvency regimes are the critical determinant of whether debt overhangs inflict long-term damage. Europe has long struggled with slow and inefficient insolvency regimes which aggravate debt overhangs by liquidating insolvent but viable businesses. In contrast, the US's Chapter 11 bankruptcy system has allowed viable businesses to swiftly restructure. While member states have undertaken a series of reforms over the past decade, many still lack crucial legal tools. The DRI resolves many of these issues.

The mere existence of the legal framework is not enough, however. Member states still struggle with slow procedures and inadequately resourced judicial systems. Even the best-resourced systems will be under extraordinary strain, given the scale of the restructuring necessary.

Historical experience, such as South Korea's resolution to the 1997 Asian financial crisis, also shows that the public sector must proactively provide the necessary incentives and coordination between creditors and debtors in times of crisis. Given the unprecedented scale of the COVID-19 shock and the role of public guarantees behind much of the debt, the imperative for an active government response is even greater. The European Commission and member states need a clear joint action plan to take full advantage of their reformed toolkit and push through the necessary restructuring before it is too late.

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## STATE OF PLAY

### *Increasing corporate leverage and insolvency risk*

Despite extraordinary fiscal action to shield the economy from the pandemic, European firms' debt-to-GDP ratio jumped 9.1% by Q3 2020,<sup>1</sup> and as Figure 1 shows, their leverage ratio jumped almost 20%.<sup>2</sup> The situation will have deteriorated further over Q4 2020 and Q1 2021. As activity recovers with the vaccine roll-out, the debt overhang will significantly constrain investment<sup>3</sup> and NPLs will spike. A wave of insolvencies is a real risk.<sup>4</sup>

Unlike past crises, firms have not taken part in a credit bubble and built unsustainable business models requiring liquidation and resource reallocation. While the pandemic will have altered some markets permanently, perfectly sound business models will be pushed over the edge. Therefore, liquidation is more likely to be economically inefficient and damaging, even beyond the immediate macroeconomic damage.<sup>5</sup>

### *Other proposed solutions*

Much of the policy discussion so far concerns NPLs and the importance of freeing up bank balance sheets for new lending.<sup>6</sup> Proposed solutions range from creating a network of asset management companies (AMCs) to relying on banks' strengthened capital buffers and encouraging the sale of NPLs on secondary markets. These are all feasible solutions, but the focus on banks and their balance sheets – a systemic risk that a decade of regulation has sought to address – obscures the wider macroeconomic impact of debt overhangs.

The lack of real estate or other collateral built up during a boom also reduces the effectiveness of AMC solutions. Holding easily valued and disposable assets to avoid fire sales are one of AMCs' main advantages.<sup>7</sup> Nevertheless,

we now face a diverse set of businesses, including a large proportion of small and medium-sized enterprises (SMEs), with no pre-existing collateral build-up. Even if banks can dispose of NPLs through AMCs, capital write-offs or the secondary market, whether NPLs are ultimately resolved through restructuring or the drawn-out liquidation of viable firms remains critical.

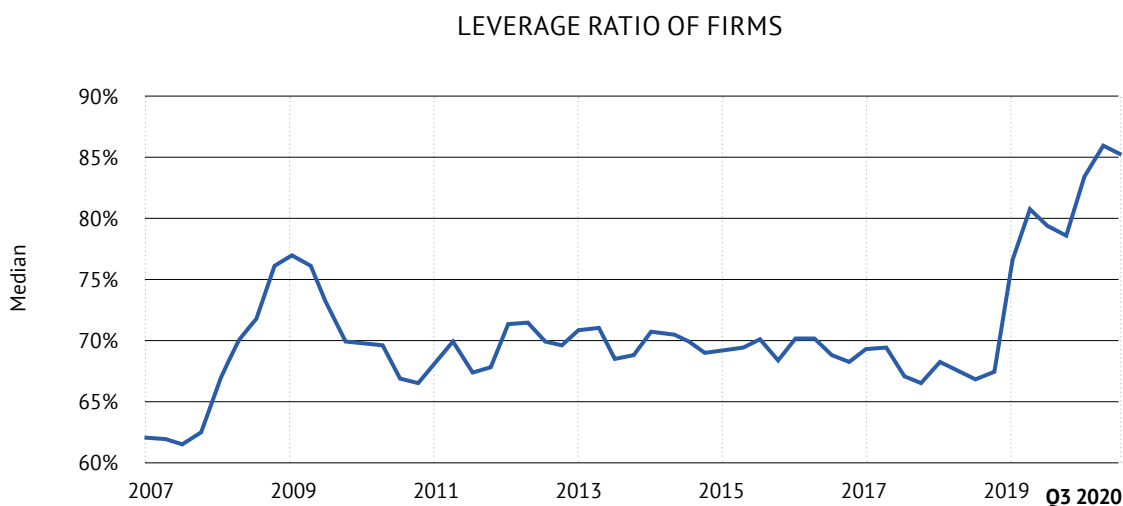
Furthermore, NPLs are not the only challenge. Solvent and viable firms can and will continue to service their loans but reduce investment in the face of a high debt burden and an uncertain economic recovery, even if bank balance sheets remain unaffected.

Public equity injections have been proposed but would be difficult to muster political agreement. The European Council already rejected a 'Solvency Support Instrument' in its NextGenEU agreement. Not only is there weak political will, but governments have already borne significant fiscal costs to weather the pandemic. Some of the costs should be allocated to those sections of the private sector that can bear them best while minimising the economic impact. While some public equity injections will likely be necessary, encouraging private solutions would reduce costs and create better incentives for economically efficient outcomes.

### *European insolvency regime reform*

Although restructuring viable firms is theoretically the optimal solution for private creditors, restructurings are often plagued by short-sighted or uncooperative behaviour as creditors seek to maximise their claims over others, pushing firms into bankruptcy.<sup>8</sup> In the US Chapter 11 proceedings prevent such behaviours, considered a key reason for faster recoveries than in Europe.<sup>9</sup> Recent evidence suggests that these institutional factors are the leading determinant of whether a corporate debt overhang impacts economic recovery.<sup>10</sup> Out-of-court negotiated restructurings, less cumbersome than court proceedings, are considered particularly effective.<sup>11</sup>

Fig. 1



Source: Lane (2020)<sup>12</sup>

Europe has long struggled with insolvency regimes that encourage drawn-out liquidation, although this varies significantly between member states.<sup>13</sup> Over the past decade, states have undertaken a raft of reforms, but many key features are still missing. For example, many do not have cross-class cramdown mechanisms for forcing dissenting creditors to accept restructuring plans.<sup>14</sup> Insolvency systems also struggle with poor resourcing and drawn-out processes.<sup>15</sup> Even though the use of preventative out-of-court restructurings is increasing, formal proceedings often result in liquidation.<sup>16</sup>

The DRI<sup>17</sup> addresses many of the gaps in member states' regimes by introducing key requirements for preventative out-of-court restructurings. These include cross-class cramdown mechanisms, creditor classes to facilitate negotiations, and preventing actions by creditors that would otherwise force a firm into insolvency.

## PROSPECTS

### *Government action is necessary*

The mechanisms contained in the DRI played a critical role in resolving episodes of debt overhang elsewhere. However, international experiences show that in a crisis, the state must also take an active role in coordinating restructurings.<sup>18</sup> For example, in the aftermath of the Asian financial crisis, the South Korean financial supervisor pushed the largest companies to enter into binding corporate restructuring negotiations, and set up a Corporate Restructuring Co-ordination Committee to oversee them.<sup>19</sup>

Given the scale of the crisis, a comprehensive European strategy is necessary to take full advantage of the new legal regime. A joint action plan should be agreed between the Commission and member states to accelerate the necessary restructuring before firms are forced into insolvency and protect the level playing field (LPF).

There are four main areas which a restructuring strategy should address:

1. **Implementing the DRI:** Any member state which has not yet implemented the DRI should prioritise transposition immediately.
2. **Pushing firms to restructure:** Companies should exercise the option to use out-of-court proceedings before they are pushed into formal insolvency. The strategy should educate companies about the options available, particularly SMEs, and provide incentives to restructure early. EU institutions like the European Investment Bank could play a role here.
3. **Ensuring sufficient resources:** Well-staffed and dedicated bodies are required to oversee restructurings<sup>20</sup> and the scale of the crisis requires the temporary hiring of large numbers of restructuring professionals to facilitate negotiations – a DRI requirement.

As discussed, many member states' insolvency systems struggle with a lack of resources, and they should commit to swiftly resolving the issue. There is also a strong case for a Regulation that would authorise a network of EU-level bodies to oversee out-of-court restructurings, to supplement national efforts. The Commission could also create a pool of restructuring professionals for member states to draw on, given the lack of qualified professionals in some systems.

4. **State guidance of outcomes:** Beyond administrative resources, the state has considerable ability to influence creditors' acceptance of restructuring plans. For example, the French Treasury has long made use of its Comité Interministériel de Restructuration Industrielle to arbitrate economically important negotiations.<sup>21</sup>

There are a range of supervisory and financial incentives to nudge creditors to negotiate and accept plans. For instance, state guarantees underpinning the loans could be used as leverage to force compromises. The DRI also creates significant leeway for overseeing authorities to approve restructuring plans despite dissenting creditors.

Given the scale of the emergency, such actions will be necessary to ensure a comprehensive economy-wide restructuring that protects the European recovery.<sup>22</sup> However, given the potential for diverging treatment of creditors and debtors and the implications for the LPF, there should be clear principles guiding these tools.

### *Key issues of a common approach*

If governments are to implement a comprehensive restructuring strategy, several key issues would benefit from common European **guidelines and criteria**. Not only are there key policy decisions to take that would determine the outcome of any restructuring strategy, but a common approach would also protect the LPF.

1. **Criteria of viability:** Only viable companies should be restructured since propping up unsustainable businesses distorts competition and misallocates resources. However, it is unclear how the structural changes accelerated by the pandemic, such as greater homeworking, will impact firms' viability. Viability will be difficult to assess over the 12 months, and unnecessary liquidation should be avoided. Common guidelines can ensure that temporary forbearance does not mask support for unsustainable businesses at the expense of new business models. For example, it could be decided that after a year, it is no longer possible to assume that pre-COVID-19 market conditions will return.
2. **Treatment of SMEs:** SMEs pose a particular challenge, given fixed restructuring costs, size, capital structures, and diversity.<sup>23</sup> In past episodes, SMEs have borne the brunt of liquidations while larger firms

were restructured. The diversity of SMEs impacted by COVID-19 complicates the matter further. The Commission and member states should explore simple restructuring packages that can be applied wholesale, potentially encouraged by government incentives. It may turn out that one-off debt write-offs, including tax and social security liabilities, are inevitable, with accompanying state aid implications to be resolved.

3. **COVID-19 versus non-COVID-19 debt:** Debt incurred during the pandemic is unlikely to create moral hazard. However, pre-COVID-19 debt will also need restructuring to guarantee sustainability. While private negotiations should produce solutions that guard against moral hazard, guidelines for the treatment of non-COVID-19 debt may be necessary to guide authorities' treatment of restructuring plans.
4. **Encouraging debt for equity solutions:** Encouraging greater use of equity is a key objective of the Capital Markets Union,<sup>23</sup> and restructuring presents an opportunity to deepen equity markets by encouraging debt-for-equity solutions. The Commission could provide guidance on how and whether this goal should be pursued, and how it should be balanced with fair treatment for creditors. This is one area where European AMCs could act as temporary holders of equity, following a debt-for-equity swap, if the original lenders are not comfortable with holding equity on their balance sheets. This could then be sold off into private secondary markets or retained in a public wealth fund.

## CONCLUSION

Europe's economic recovery depends on resolving the corporate debt overhang created by the pandemic. Insolvency procedures have gradually improved over the past decade, but decisive and swift public action is needed to take advantage of these reforms. Member states and the Commission must step in to provide the resources, guidance and coordination necessary to push through the necessary monumental restructuring. Otherwise, Europe risks a piecemeal approach, resulting in a drawn-out restructuring process that pushes too many viable firms into liquidation and permanently hampers the economic recovery. An approach centred on private restructurings would also minimise the use of public funds at a time when governments face multiple competing fiscal pressures.

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<sup>11</sup> Laryea (2010), *op.cit.*

<sup>12</sup> Lane (2020), *op.cit.*

<sup>13</sup> Bricongne *et al.* (2016), *op.cit.*

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<sup>17</sup> The transposition deadline is 17 July 2021.

<sup>18</sup> Laryea (2010), *op.cit.* Bergthaler, Wolfgang; Kenneth Kang; Yan Liu; and Dermot Monaghan (2015), "[Tackling Small and Medium Sized Enterprise Problem Loans in Europe](#)", International Monetary Fund.

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<sup>20</sup> *Ibid.*

<sup>21</sup> Keohane, David and Leila Abboud, "[French economy and the pandemic: 'It's the calm before the storm'](#)", *Financial Times*, 09 December 2020.

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