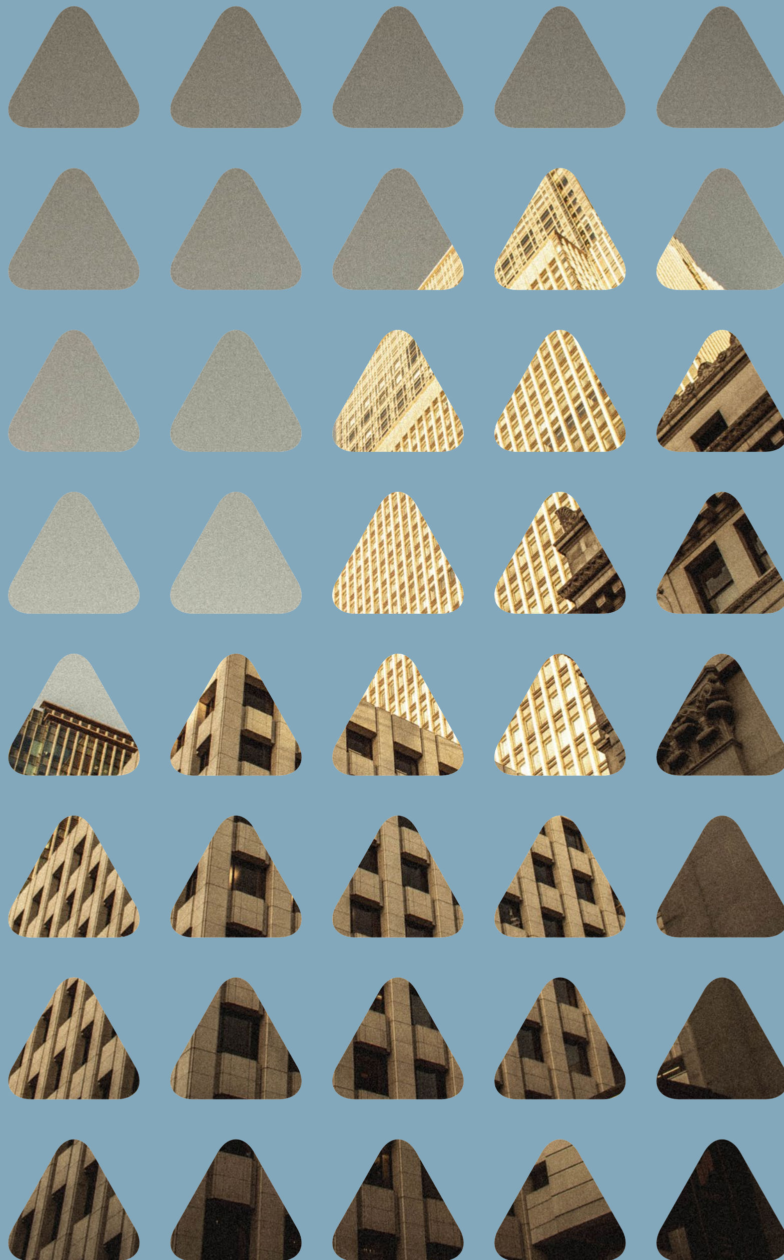

FINANCE AND ACCOUNTING

PLANNING FOR DEBT RESTRUCTURING AFTER COVID-19

FINANCIAL POLICY MAKERS NEED TO START PLANNING FOR HOW TO HANDLE RECORD-HIGH CORPORATE DEBT BURDENS

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Apart from the important threat to human health posed by COVID-19, there are significant economic risks. China's economy plunged in January and February of 2020 for the first time in many decades, with a 13.5% contraction of manufacturing output. As other countries move into lockdown, they may experience a similar fall in economic activity, and macroeconomic forecasts of the impact of the COVID-19 pandemic, at the time of writing (March 2020), include a global recession. It seems increasingly plausible that the COVID-19 crisis will not only trigger a steep contraction but also a protracted one, as public health policies will backload the time when the peak of the epidemiological curve will be reached. Financial markets around the world point to a severe economic impact. Travel, hospitality, leisure, and some manufacturing firms have already experienced considerable revenue deteriorations; other sectors are likely to follow.

To mitigate the economic impact of the pandemic, governments are putting ambitious support programmes in place for both households and firms. Many countries, including Germany, France, Sweden, and Denmark are extending unemployment and short-time work benefits. Meanwhile, the US is considering direct transfers to households. Emmanuel Macron has announced that "no company, whatever its size, will have to face the risk of bankruptcy". Other countries act similarly. Policy responses outlined so far largely aim to be broad and fast. Germany has announced "unlimited loan support" via KfW, its public development bank. France and Spain are offering loan guarantees of up to €300 billion and €100 billion for companies, respectively. Italy and others are also putting in place massive business support programmes. Several countries plan to offer tax deferral programmes. Central banks use various policies to encourage banks to lend to affected firms, by releasing countercyclical capital buffers or extended facilities to purchase government and corporate debt. These include the ECB's targeted longer-term refinancing operations (TLTROs) and Pandemic Emergency Purchase Programme (PEPP), the Fed's revival of the Primary Dealer

Credit Facility, and the Bank of England's unlimited commercial paper facility.

Much of the hundreds of billions of emergency aid packages for companies will come in the form of credit or credit guarantees. This makes sense for two reasons.

First, many sovereigns go into this crisis with high levels of government debt, largely due to policies adopted in response to the Global Crisis. Sovereign spreads in the euro area, for Italy in particular, are already widening, indicating that there could be more trouble ahead for the credibility and solvency of sovereign borrowers. Sovereigns now need to preserve their fiscal resources, and gifts are more demanding than loans and guarantees. Second, the economic effects of the pandemic are likely to be very different across sectors, and there is little time to fully understand this heterogeneity. In short, the heterogeneous impact of the health crisis and lockdowns, large uncertainty about the course of the health crisis, the need to use sovereign resources wisely, and a great urgency to respond, all favour using credit to support the private sector.

However, the COVID-19 crisis arrives against a backdrop of private sector indebtedness. Corporate and household balance sheets in Europe are extended – neither firms nor households deleveraged substantially since the Global Crisis and the European sovereign debt crisis. On the contrary, low monetary policy rates and low credit spreads lured them into complacency about debt levels. Corporate leverage is at an all-time high (IIF 2020, Graham et al. 2015). A large fraction of corporate debt is now rated BBB, the lowest investment grade rating, while corporate debt rated below investment grade is at an all-time high. For example, almost half of all US corporate bonds maturing in the next five years are below investment grade.

Current policies will inevitably leave parts of the corporate sector with even larger debt burdens. These will delay a recovery – distressed firms tend to implement labour reductions, sell assets, reduce invest-

ments and employment, and shrink their business, and they become reluctant to raise new capital. Additionally, banks and other lenders stuck with underperforming loans may restrain lending (Becker and Ivashina 2014) and misdirect it to 'zombie firms' (Caballero et al. 2008). If one firm is affected, its customers, suppliers and employees are affected in turn. All of this can turn a temporary economic shock into a long-term balance-sheet driven dislocation. One policy lesson of the big financial crises in the developed world, starting with Japan in the early 1990s, is that the effects of simmering corporate debt overhang are multiple and nefarious (Koo 2003).

To manage the looming corporate debt strains and keeping the likely precarious situation of sovereign finances in mind, we see three broad policy areas that require addressing.

First, public credit packages such as loan guarantee programmes should be designed with the looming debt overhang problem and the future need for debt restructuring in mind. Conflicts of interest become important when companies have multiple creditors (Gertner and Scharfstein 1991, Hege and Mella-Barral 2019), and bailouts create new creditors, making restructuring more complicated, as the bank bailouts after the Global Crisis demonstrated. Programmes must also ensure that bailout funds are used as intended to ensure business continuity, and not to benefit existing debt holders or shareholders. Policy should also have an eye to future crises. One important difference between the COVID-19 crisis response and bank bailouts after the Global Crisis is the extent of moral hazard. This time, bank risk-taking did not trigger the crisis and this means moral hazard concerns are weaker. They are not absent, however, since banks may infer from current policy choices what taxpayer support will be available in other types of crises. Therefore, bailouts should be designed to avoid benefitting existing creditors and shareholders, when possible. Given all these concerns, bailouts should contain provisions that limit the scope to which investors benefit from support. We recommend banning dividend payments and most debt reductions for all recipients of support. We also recommend that any taxpayer-funded credits be senior in the event of future restructurings. It may also make sense to attach options to the bailout funds in the form of stock warrants or convertibles that can ensure that the public benefits from future gains in corporate valuations made possible by public money, especially for publicly listed companies.

Second, European systems for handling insolvency in court are not good at protecting viable businesses with unsustainable capital structures. Businesses are too often liquidated, generating poor returns for bankruptcy claims, and processes can be slow. These inefficient in-court proceedings hold back credit market development even in good times (Becker and Josephson 2016). In a recession or crisis, it slows down returning productive assets to the economy and may destroy valuable businesses (Gilson 2012). Any reforms that can simplify and speed up in-court processes should be considered. Such reforms would need to be exceptionally quick to impact short-run developments, but they can help support a vigorous recovery. Current EU initiatives for better resolution of corporate insolvency should be accelerated.

Third, given the inefficiencies of court-supervised bankruptcy procedures, government agencies must be prepared to be a leader in debt restructuring for the companies that receive bailouts. They should prioritize out-of-court renegotiations whenever possible. They have proven to be a successful tool after the Global Crisis (Bernstein et al. 2019, Hotchkiss et al. 2014). This can include temporary nationalisations where needed, with tough conditions for existing shareholders to avoid distortions. Public agencies such as public development banks in charge of loan guarantees may not be the best placed to oversee debt restructuring – with their own balance sheets exposed, they may be inclined to 'extend-and-pretend' distortions in their actions (Sapienza 2004, Bertay et al. 2015). So, it is worth thinking about an independent organisation of government leadership in debt restructuring.

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