Insolvency and Debt Overhang Following the COVID-19 Outbreak: Assessment of Risks and Policy Responses

By Lilas Demmou, Sara Calligaris, Guido Franco, Dennis Dlugosch, Müge Adalet McGowan and Sahra Sakha, OECD Economics Department

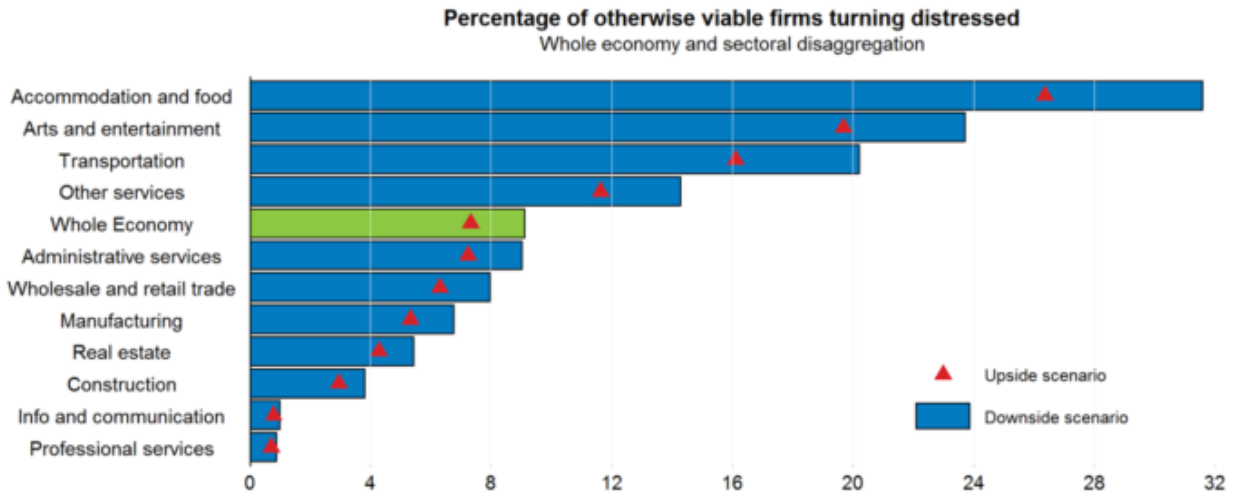
A swift response of policy makers across OECD countries has helped businesses to bridge the short-term liquidity shortfalls due to the economic shock following the COVID-19 outbreak (Demmou et al., 2021a). However, many countries have entered a second phase of the crisis and the shock is translating into an enduring risk of a wave of corporate insolvencies as well as in a significant increase in leverage, depressing investment and job creation for long. A recent OECD working paper (Demmou et al., 2021b) investigates the extent of these risks and outlines policy options to address them.

A large portion of firms are predicted to become distressed and will find it hard to service debt, with negative consequences on future investment

Using a simple accounting exercise, we evaluate quantitatively the impact of the COVID-19 pandemic on firms' long-term

viability under an “upside” and a “downside” scenario. According to our estimates, around 7% (9%) of otherwise viable companies are likely to become distressed (i.e. their net equity is predicted to be negative) in the upside (downside) scenario (Figure 1), and between 30% and 36% of firms would no more be profitable enough to cover their interest expenses. However, these percentages are heterogeneous across sectors and type of firms. Firms in industries that use intangible assets (such as intellectual property, data or software) intensively are significantly impacted but better positioned to bridge the crisis, while the Hospitality, Entertainment and Transport sectors are the most severely hit. Young, small and low productivity firms are predicted to suffer more compared to their old, large and high productivity counterparts.

Figure 1: A substantial portion of otherwise viable firms is predicted to become distressed

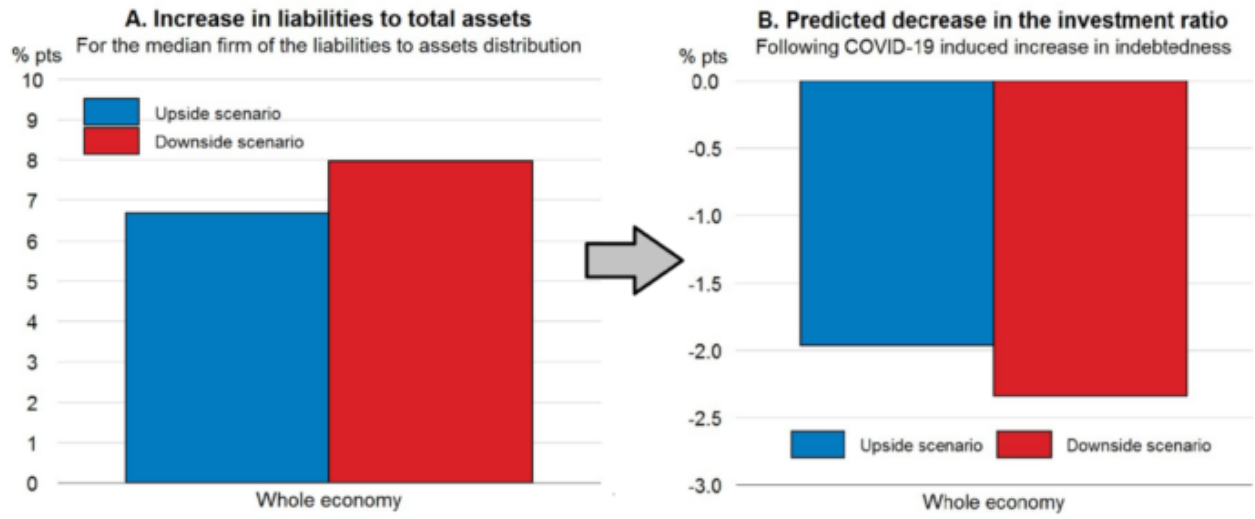


Note: The figure shows the percentage of distressed firms in the upside (triangles) and downside (bars) scenarios for the whole economy (green bar) and by 1-Digit Nace Rev.2 sectoral classification (blue bars). Firms are defined as distressed if their book value of equity is predicted to be negative one year after the implementation of confinement measures. The sample is restricted ex-ante to firms having both positive profits and book value of equity in the 2018 reference year.
Source: OECD calculations based on Orbis® data.

The reduction in equity relative to a business-as-usual scenario has immediate consequences on firms’ leverage ratios: the ratio of total liabilities to total assets would increase by 6.7 p.p. in the upside scenario and 8 p.p. in the downside scenario for the median firm in the sample (Figure 2, Panel A). In turn, the increase in the level of indebtedness can push firms towards the so-called “debt overhang” risk. Based

on an empirical investigation of the historical relationship between indebtedness and investment, our findings suggest that an increase in the debt to total assets ratio comparable to the one predicted by our accounting model could imply a decline of the ratio of investments to fixed assets by 2 p.p. (2.3 p.p.) in the upside (downside) scenario (Figure 2, Panel B).

Figure 2: Leverage ratios are predicted to increase, potentially acting as a drag on investment



Note: Panel A shows the percentage points increase in the liabilities to total assets ratio for the median firm of the leverage distribution following the COVID-19 outbreak in the upside (blue bars) and downside (red bars) scenarios. Panel B shows the predicted decrease in the investment to fixed assets ratios under the hypothetical increase in the debt over total asset ratios shown in Panel A for the median firm.
Source: OECD calculations based on Orbis® data.

Policies to support the corporate sector's ability to weather the crisis and recover fast

Distress and debt overhang of non-financial corporations could threaten the recovery by compromising firms' ability to invest, suggesting that governments should carefully design support packages in order to limit the increase in corporate indebtedness. Moreover, given the difficulty to screen ex-ante firm performances, policy makers face the additional challenge of finding the right balance between the risk of supporting potentially non-viable firms against the risk of forcing viable and productive firms into premature liquidation. In the current circumstances, the balance of risks should be tilted in favour of the former, as the risk to push-out of the market many viable firms is particularly high. To this end,

governments may adopt the following cascading approach, regularly re-assessing and adapting support as the economic situation evolves:

- Support measures should first aim at “flattening the curve of insolvencies” by ensuring that distressed firms have access to additional resources but avoiding the increase in debt that follows debt-based support. To mitigate debt overhang concerns, measures should increasingly include complementary non-debt financing instruments to recapitalise firms: a) equity and quasi-equity injections (e.g., preferred stocks, convertible loans); b) phasing in an allowance for corporate equity; c) debt-equity swaps to provide firms with the required liquidity, without increasing their leverage; d) state-contingent loan repayment (e.g. linked to business returns) in the form of future taxes; e) convert loans into grants.
- If this strategy proves insufficient, policy makers could encourage timely debt restructuring to allow distressed firms to continue operating smoothly. This would help to coordinate creditors’ claims in a manner that is consistent with preserving the viability of the firm and its capacity to invest going forward. Relevant measures include establishing legal conditions favouring new financing for distressed firms, reforms to insolvency regimes including promoting pre-insolvency frameworks and specific procedures to facilitate the restructuring of SMEs.
- These two steps aim to reduce the number of viable firms that would otherwise be liquidated. To deal with firms that would still be non-viable despite public support and debt restructuring, governments could improve the efficiency of liquidation procedures to unlock potentially productive resources. Providing the institutional conditions for a fresh start by removing barriers that might push debtors to delay liquidation,

in particular by reforming the personal insolvency regime, remains a key challenge in several countries.

Further reading

Demmou L., G. Franco, S. Calligaris and D. Dlugosch, (2021a), “Liquidity shortfalls during the COVID-19 outbreak: assessment of risks and policy responses”, *OECD Economics Department Working Papers,* No 1647, OECD Publishing.

Demmou L., S. Calligaris, G. Franco, D. Dlugosch, M. Adalet McGowan and S. Sakha, (2021b), “Insolvency and debt overhang following the COVID-19 outbreak: assessment of risks and policy responses”, *OECD Economics Department Working Papers,* No 1651, OECD Publishing.

http://www.oecd.org/economy/financial-fragilities-during-COVID-19/