ESRB
European Systemic Risk Board
European System of Financial Supervision

Press release

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Preventing and managing a large number of corporate insolvencies

More than a year of restrictions on economic activity has so far not resulted in financial instability. However, the threat of a wave of insolvencies looms large, unless Member States manage a smooth transition from liquidity support towards more targeted solvency support and successful corporate debt restructuring for viable firms. This is the key message of today's ESRB report, which reviews the risks to economic and financial stability of a potential large wave of insolvencies and the possibilities for mitigating these risks.

Non-financial corporations are under enormous financial strain due to the coronavirus (COVID-19) crisis. A swift and decisive response by policymakers has so far prevented a large wave of corporate insolvencies. However, the longer non-financial corporations have to rely on liquidity support measures such as debt moratoria, loan guarantees and public loans, the greater their solvency problems might become as their debt accumulates.

In fact, in most Member States corporate debt levels have already risen by several percentage points relative to pre-COVID GDP levels. This debt overhang increases the risk of a large wave of insolvencies and a protracted, slow recovery.

The policy mix therefore needs to evolve from addressing immediate liquidity needs towards providing more solvency support to viable firms. At the same time, the shift from liquidity to solvency support implies higher costs to public budgets. Solvency support measures therefore need to be more targeted[1] than liquidity support measures, for instance by focusing on the hardest-hit sectors and by using stricter eligibility criteria, subject to State aid controls.

Governments now have to strengthen their additional lines of defence against the destabilising impact of insolvencies.

The first priority for Member States must be to create the right conditions for successful debt restructuring. Through public loans and loan guarantee schemes, the public sector has acquired a significantly larger stake in the non-financial corporate sector than it had before the pandemic.

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[1] See also ESRB (2021), *Financial stability implications of support measures to protect the real economy from the COVID-19 pandemic*, February.

Successful debt restructuring for the large number of firms that benefited from such schemes is likely to be key to sound public finances in the medium term. Recent changes to the European Commission's Temporary State Aid Framework[2] allow governments to convert public loans and guarantees into grants (up to a certain ceiling) to help companies weather the COVID-19 crisis. Some European countries are now actively considering taking advantage of this new possibility. Governments can use such measures to contribute to debt restructuring while at the same time providing restructuring incentives to private creditors, and banks in particular, to put viable businesses on a sound financial footing for the recovery phase by harnessing the expertise of the financial sector in assessing business viability.

To avoid moral hazard, it is important to ensure that the interests of public authorities and banks are aligned when debt is restructured to put companies on a sound financial footing for the recovery after COVID-19. This will require banks to bear some of the restructuring costs and downside risks.

Efficient insolvency procedures should be used or, if unavailable, developed for companies that are found to be unviable in the post-COVID economy. By eliminating judicial bottlenecks, assets of businesses that have to be wound up can be reallocated swiftly to more productive uses, thereby contributing to economic recovery and mitigating the impact of non-performing loan ratios on banks' lending capacity.

Finally, policies must be geared towards rebuilding the economy and fostering adaptation to structural change, rather than towards trying to preserve, or return to, the pre-pandemic economy. It will be important to ensure that capital and labour are allocated to more innovative and sustainable uses.

The ESRB's work on the financial stability implications of the national support measures **has informed this report.** We are now expanding our reporting framework to include information on how the national authorities plan to address solvency pressures in the non-financial corporate sector, including by adjusting the support measures and encouraging debt restructuring processes.

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[2] The various amendments to the Temporary State Aid Framework can be found on the European Commission's website.