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Post COVID-19 recovery: hold up viable businesses but let zombies go to rest

Key takeaways

- Corporate bankruptcies fell sharply in 2020, owning to extensive government support measures.
- However, bankruptcies are bound to rise above-trend, in particular among SMEs, as the end of the crisis draws nearer, and support measures eventually expire.
- Governments should target support at companies that are viable in the long run and at the same time allow unproductive companies to restructure.
- The establishment of "bad banks" or specially designed asset management firms could help alleviate the burden of non-performing loans.

About Economic Insights
Analysis of key economic developments and their implications for the global re/insurance industry.

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In a nutshell

Insolvencies have fallen sharply during the pandemic due to extensive government support measures. Still, financial stress is real, and we expect bankruptcies to rise, notably among SMEs, once support measures are withdrawn. For a sustainable economic recovery, policy should support businesses that are viable in the long run and facilitate the orderly restructuring of non-viable firms such as zombie companies.

During economic crises, insolvencies typically rise as the demand for products and services falls and firms struggle.[1] The reverse has happened during the COVID-19 pandemic-induced economic slump, with a sharp decline in bankruptcies in several countries. In the fourth quarter of 2020, US insolvencies were at the lowest level since mid-2006, and down by 5% over the whole year. In Europe, insolvencies fell by 27% in the UK, by 16% in Germany and by 40% in France last year (see Figure 1). These figures do not, however, indicate absence of financial stress: the simultaneous increase in capital market debt defaults tells another story. With the rebound in economic activity this year, we expect governments to reduce the level of private sector support. At this time, many firms, particularly small and medium-sized enterprises (SME) may struggle to balance their books, and we expect an increase in the number of bankruptcies.

The fall in bankruptcies despite last year's sharp economic downturn, can be explained by the extensive government measures to support businesses during the crisis: credit guarantee schemes, liquidity relief, grants, moratoria on loans and rent payments, tax deferrals, government financed short term schemes and temporary amendments to bankruptcy rules. Additionally, central banks around the world turned to accommodative monetary policy, providing cheaper financing conditions for companies. The measures have helped many firms avoid bankruptcy. The IMF estimates that without policy support, the share of insolvent firms would have roughly doubled relative to pre-pandemic levels by the of end-2020.[2]

At the same time, the support measures have led to a notable increase in corporate indebtedness, accompanied by a rise in loan forbearance, and capital market debt restructuring or defaults.[3] Alarmingly, the global speculative-grade default rate rose to 5.5% in 2020, the highest level since the global financial crisis (GFC), with defaults higher in the US (6.6%) than in

[1] For example, during the global financial crisis (GFC), bankruptcies in the US jumped by 52% in 2008, according to data published by the Administrative Office of US Courts
[2] *Corporate Liquidity and Solvency in Europe during COVID-19: The Role of Policies*, IMF, 2021
[3] A company can restructure its financial markets debt without going bankrupt, leading to a rise in the default rate but not in the bankruptcy count. Similarly, the bankruptcy of a company does not automatically lead to a rise in the default rate, as not all firms issue debt in financial markets.

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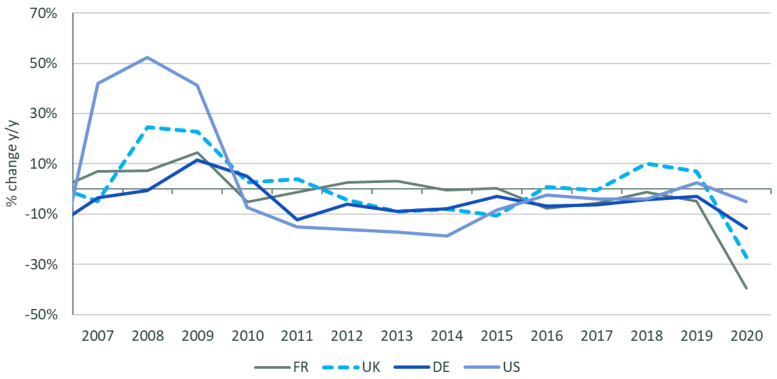
Europe (5.3%).[4] However, there are signs of easing financial stress. Credit deterioration peaked in 2Q20, something that usually happens three quarters ahead of the peak in credit defaults. In line with this, rating agencies project a decline in the global speculative grade default rate over the next two years.

Figure 1
Registered company insolvencies, annual growth rate



Source: Swiss Re Institute, Bloomberg

Outside the financial markets, the real economy has yet to stand the test of time of a post-COVID era. We expect an above-trend rise in bankruptcies as support measures expire, especially among SMEs, which typically have fewer financing options than large companies, with greater reliance on banks. In southern Europe in particular, where banks have a relatively large exposure to the SME sector, stress in the corporate sector in the form of a sharp rise in loan losses, could easily put pressure on the banking system.[5]

To mitigate rising insolvencies, governments should be wary of withdrawing support prematurely and ensure that it is carefully targeted at companies that are viable in the long run, avoiding the creation of unproductive zombie companies.[6] Businesses that are not viable, should be allowed to restructure, to alleviate the long-term burden of non-performing loans on a sustainable recovery. To this end, insolvency law reforms, in particular in Europe, and the establishment of well-managed bankruptcy procedures could facilitate the orderly restructuring of unproductive firms and make the system more sustainable in the long run. Additionally, "bad bank" structures or specially designed asset management companies could be established to take on non-performing assets and minimize the costs of restructurings.[7]

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[4] *Default, Transition, and Recovery: 2020 Annual Global Corporate Default and Rating Transition Study*, S&P Global Ratings, 2021.
[5] *European banks face rising losses from consumer and SME loans, Moody's, 21 July 2020.*
[6] *Zombie firms are defined as firms aged ≥5-10 years and with an interest coverage ratio below one over three consecutive years.*
[7] *Reviving and Restructuring the Corporate Sector Post-Covid*, G30 report, December 2020.