RESEARCH

Insolvency Prospects Among SMEs in Advanced Economies: Assessment and Policy Options

Federico J. Díez, Romain Duval, Jose Garrido, Sebnem Kalemli-Ozcan, Chiara Maggi, Soledad Martinez-Peria, and Nicola Pierri

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Background and motivation

SMEs hit disproportionately hard by outbreak/lockdowns,

- Thinner cushions; most prevalent in contact-intensive sectors
- Government actions have contained liquidity risks, but solvency risks are building up
- Could drag the recovery: debt overhang problem; SMEs account for majority of jobs

This paper

- **Quantify SME insolvency risks in AEs**, and implications for jobs at risk and financial stability
- **Assess policy options—with focus on (quasi) equity injections**—to dampen the wave of insolvencies
- **Discuss SME insolvency procedures** to cope with the wave of insolvencies

Firm balance sheet projections and quantification of SME risks

Theoretical framework (Gourinchas et al., 2020)

- **Cost minimization problem** of firm under
  - **Aggregate shock:** drop in country-level aggregate demand
  - **Sectoral shocks:**
    - Supply: lockdowns, impact varies across sectors depending on teleworkability
    - Demand: pandemic-induced change in consumption patterns, depending on reliance on face-to-face with customers

Strengths

- Closed-form solutions ➔ direct mapping of model variables to actual firm balance sheet data
- Firm optimization ⋟ ad hoc assumptions adjustments ➔ more realistic projections?
- Rich set of well-specified shocks

Limitations

- Partial equilibrium & fixed prices; no input-output linkages
- No *direct* account for policy support in general, and to firms in particular

Taking the framework to the data

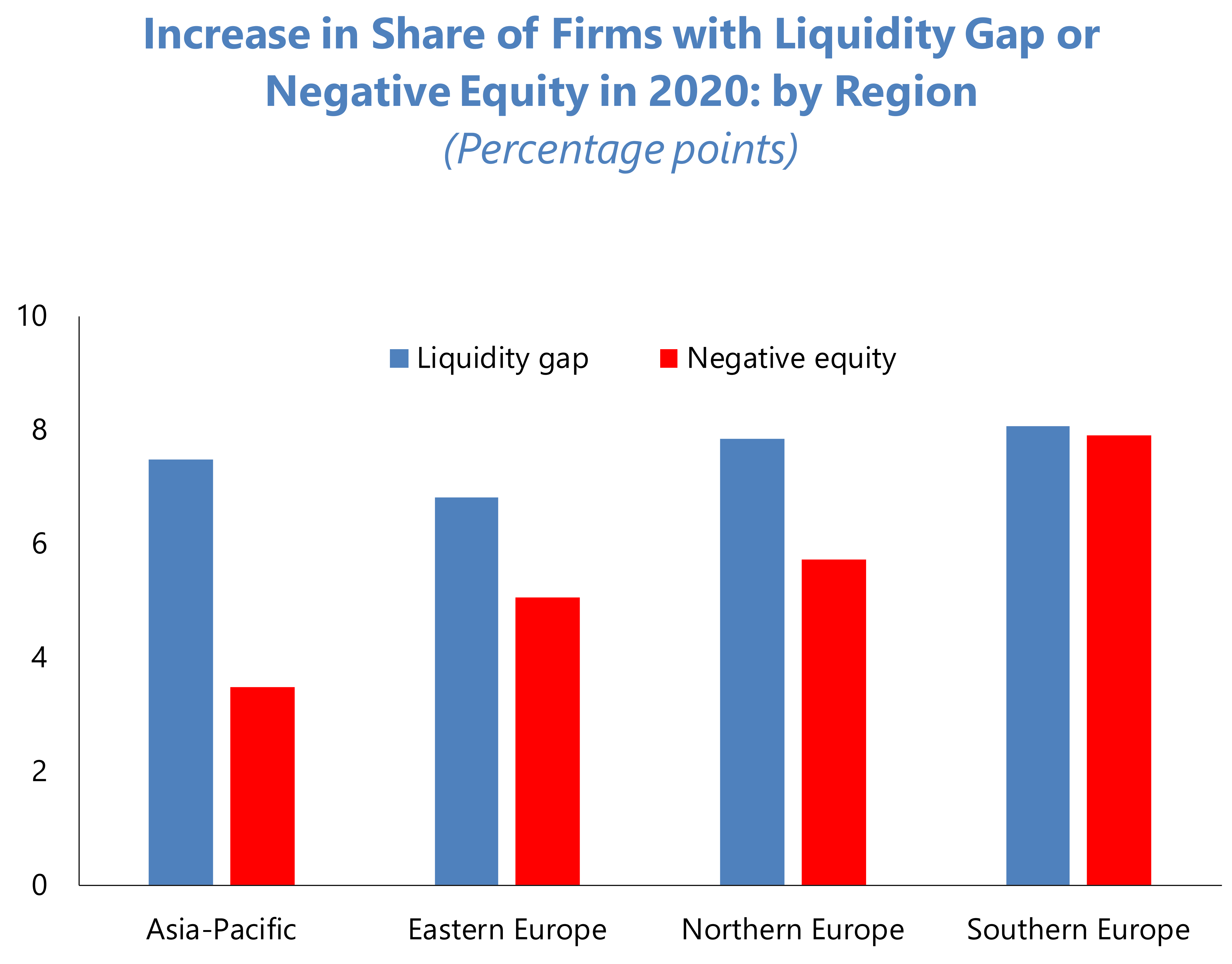
- ORBIS for 20 countries—EU and Asia-Pacific
- Focus on SMEs (defined as employment < 250 employees)
- Firm balance sheets projected based on aggregate demand (WEO) and sectoral projections that factor in the greater impact of Covid-19 in some industries (teleworkability, face-to-face interactions)

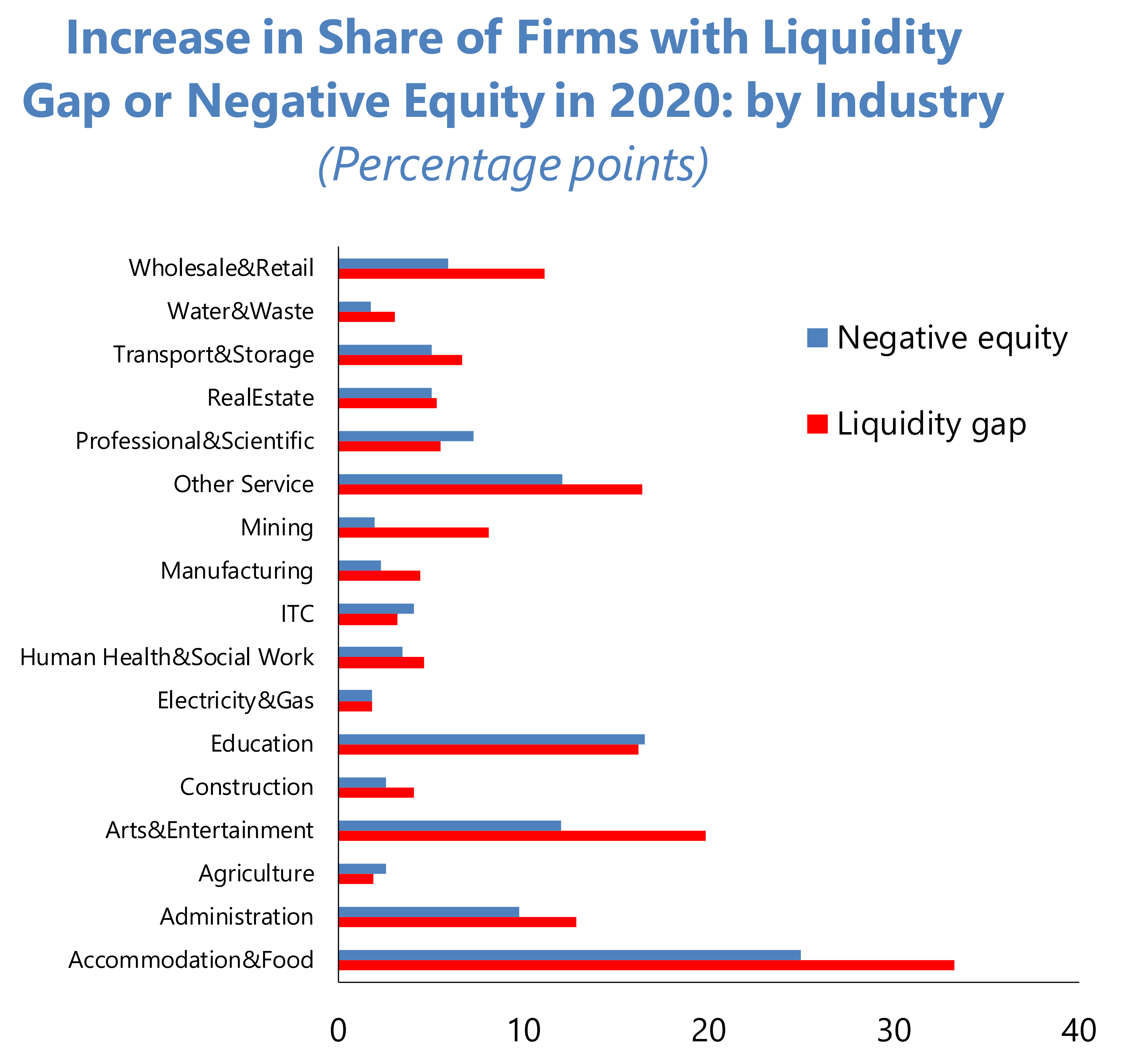
Some definitions:

- $$Liquidity_t = CashStock_{t-1} + \underbrace{OpCashFlow_t}_{\text{Model-based outcome}} - Financial\ expensest + \underbrace{PolicySupport_t}_{\substack{\text{Alternative Policy Counterfactuals} \\ \text{(government loans or (quasi) equity injection)}}}$$

- $$Equity_t = Equity_{t-1} + \underbrace{NetIncome_t}_{\text{Model-based outcome}} + \underbrace{PolicySupport_t}_{\text{(Quasi) equity injection only}}$$

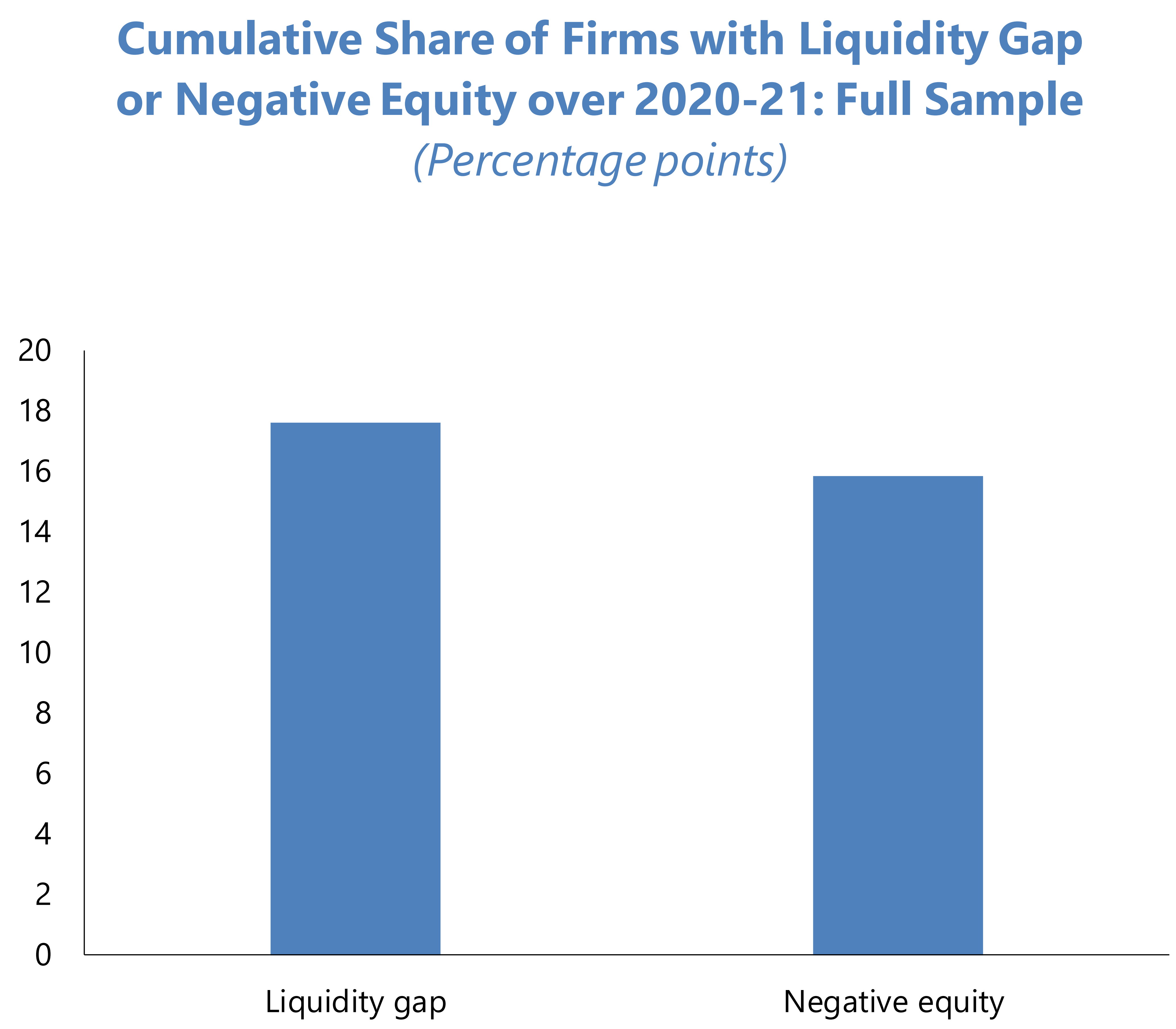
Sharp rise in share of firms with liquidity and insolvency risks in 2020

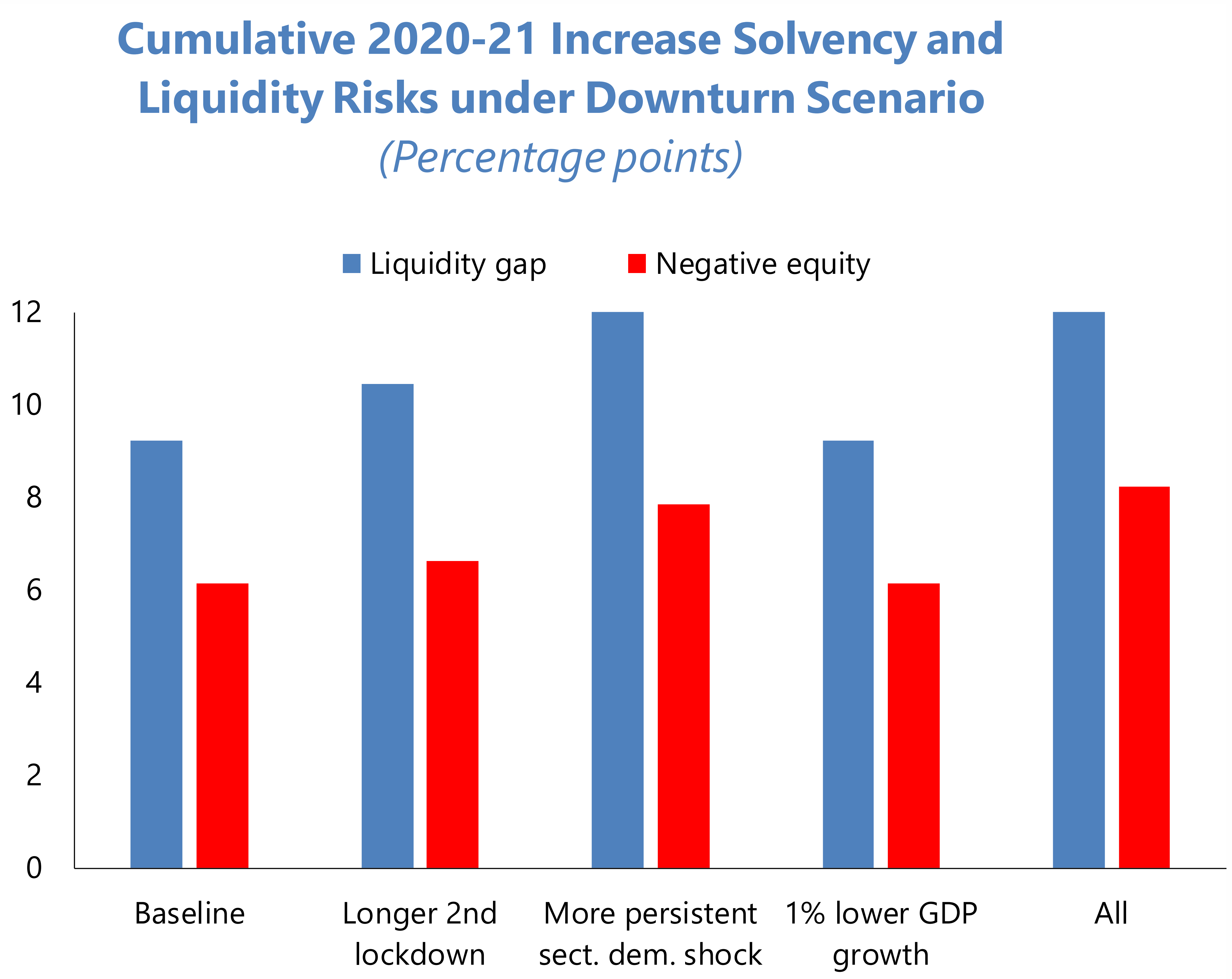




Note: increases computed with respect to a no-Covid scenario.

Sizeable projected increases in risks over 2020-21





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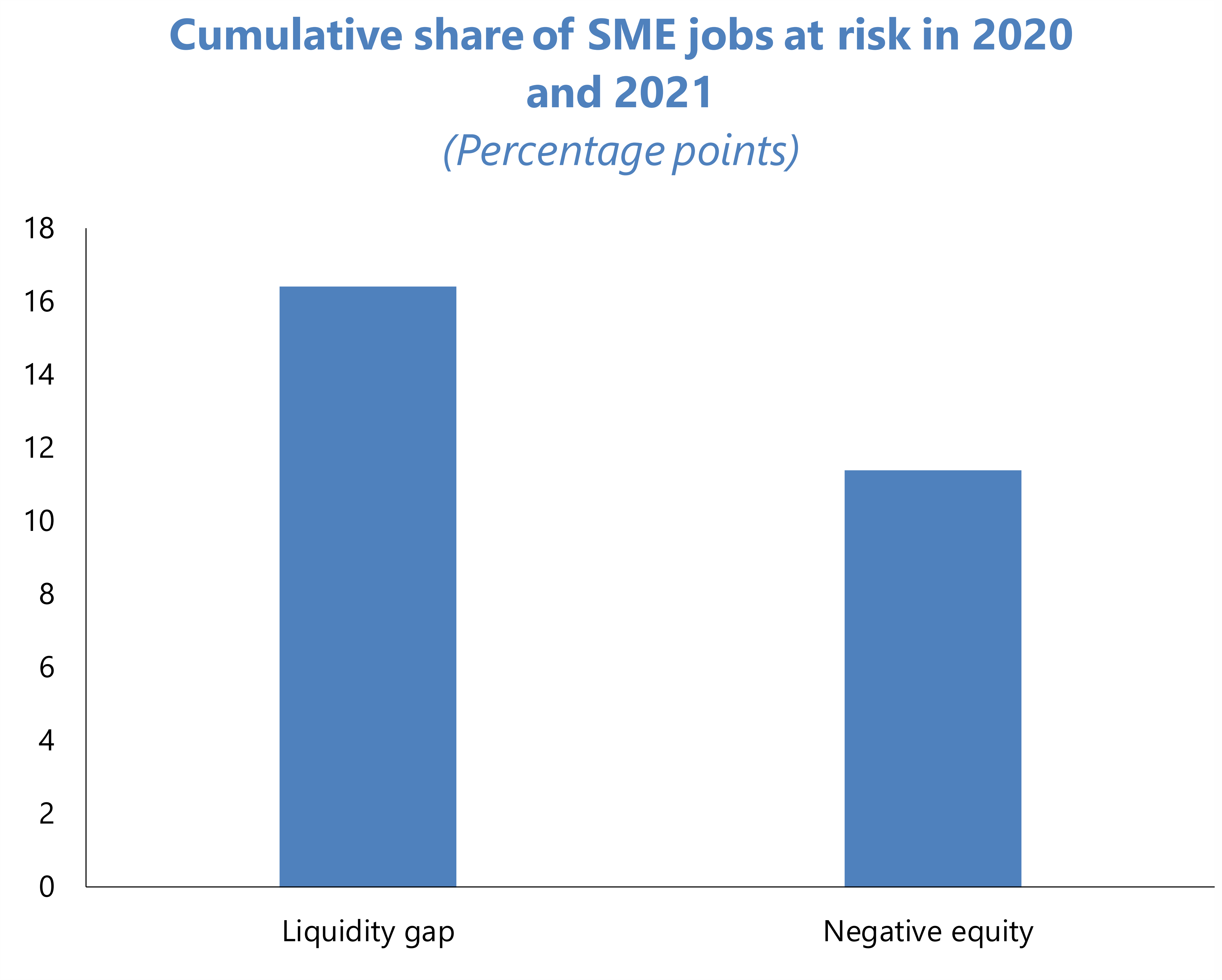
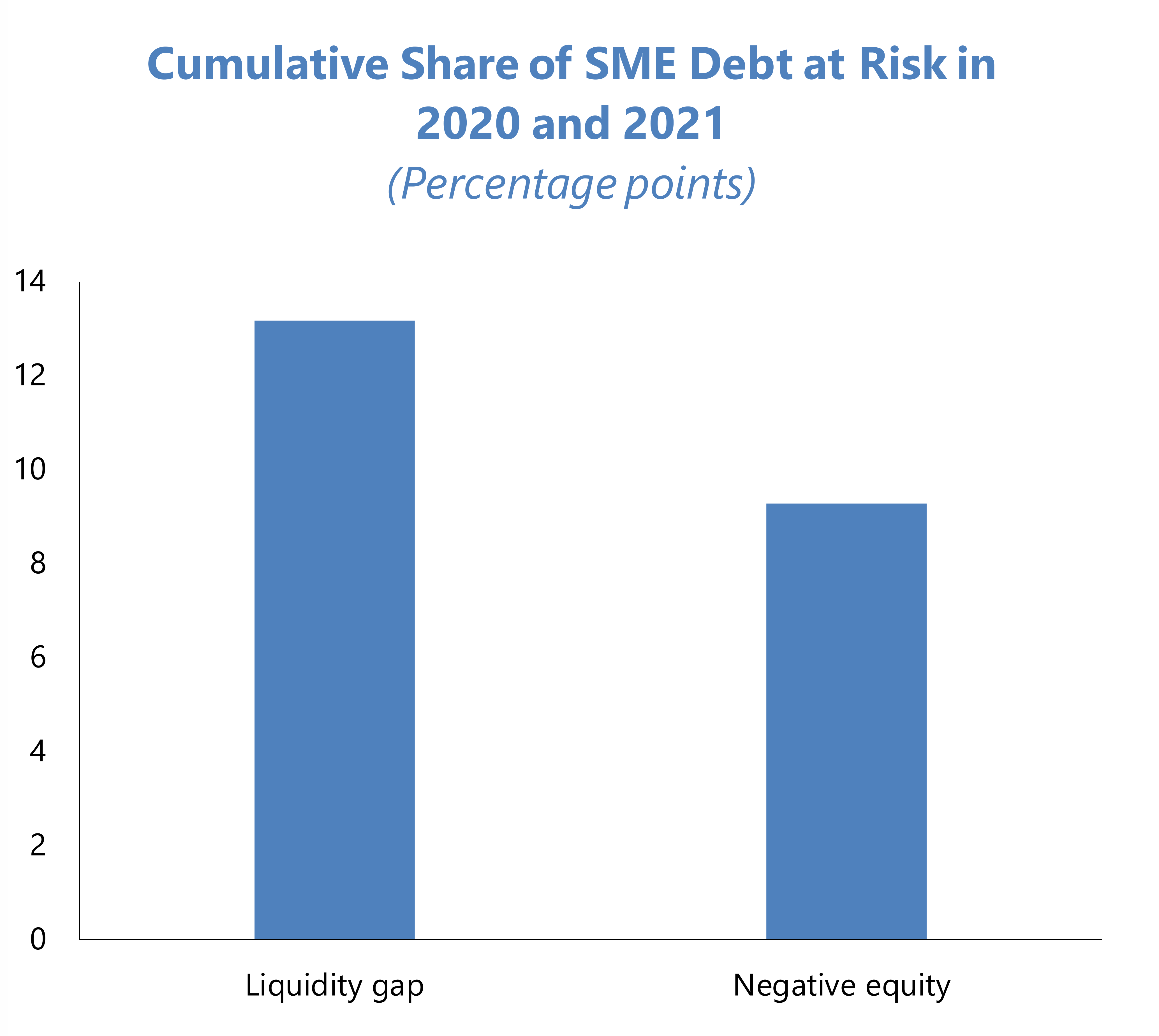
Implications for labor markets and financial stability





Policy options to dampen the wave of SME insolvencies

Solvency support for SMEs: key considerations

Conventional advice: provide liquidity to illiquid but solvent firms; restrict any solvency support to (typically large) systemic or strategic firms

This time may be different—larger wedge between social and private cost of letting firms fail:

- Crisis magnitude
- Bankruptcy court congestion
- Mass uncertainty

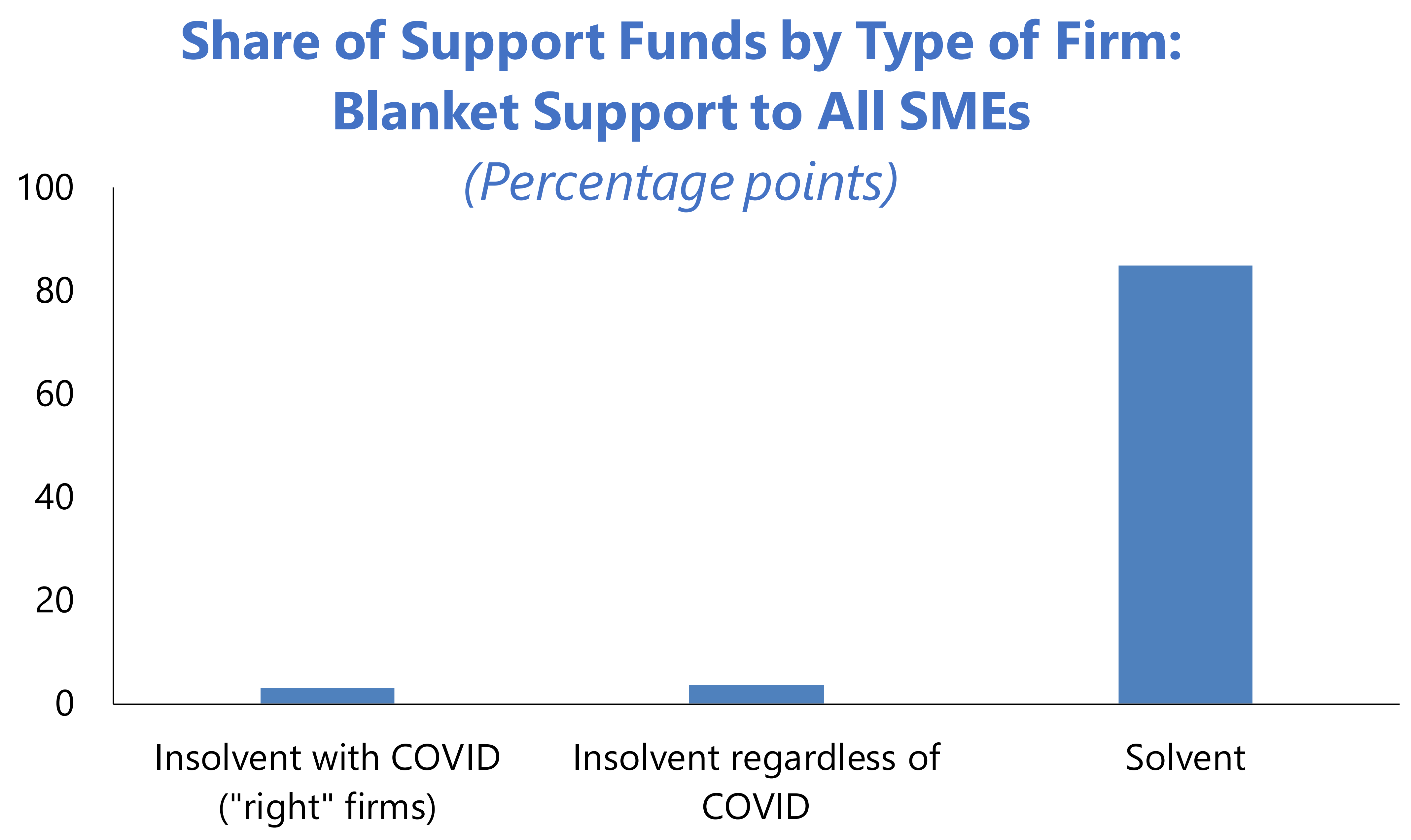
Need to tailor to country-specific circumstances, and address major design challenges

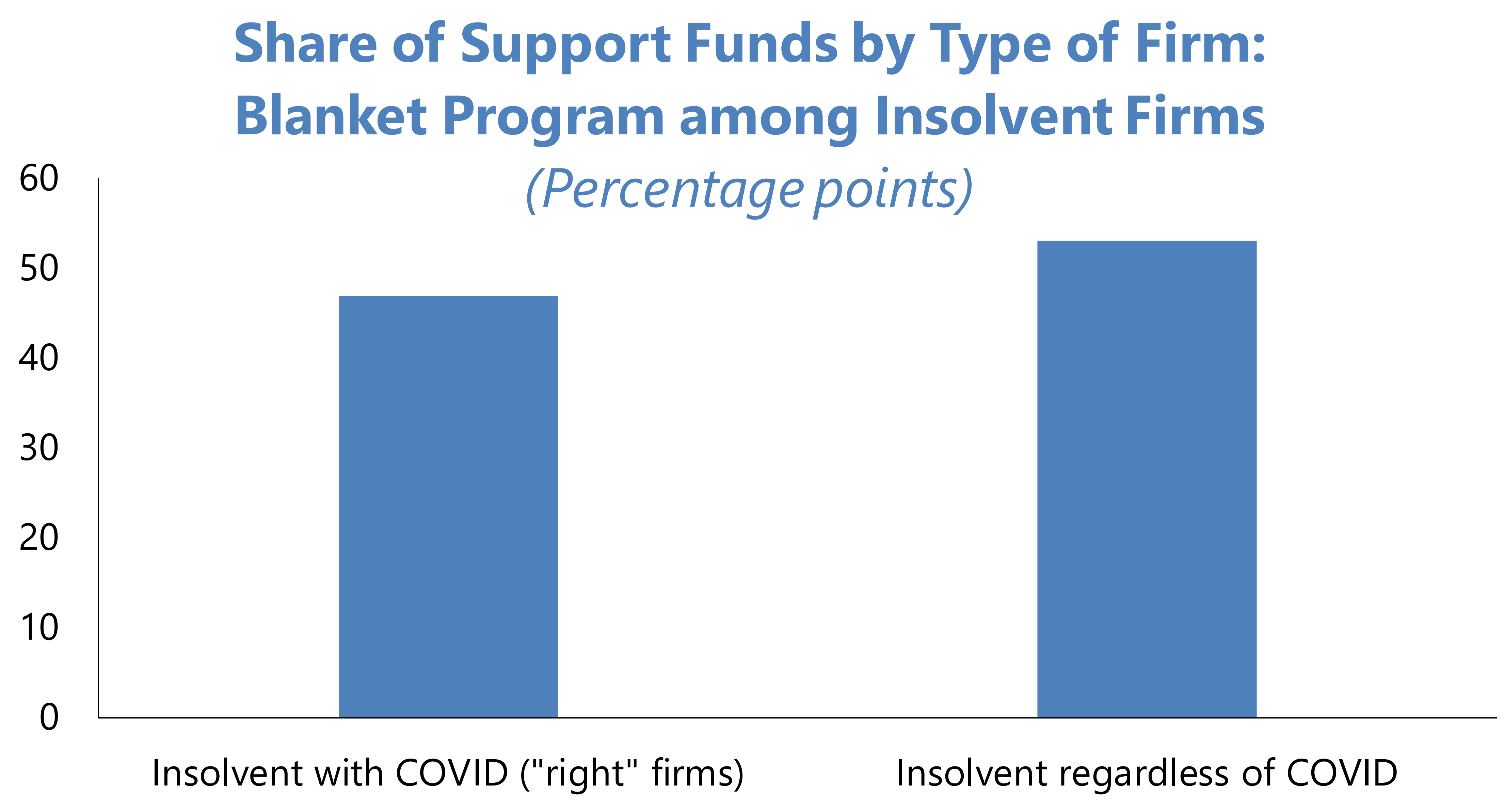
- Fiscal space, quality of governance, transparency, accountability, admin capacity
- Major uncertainty surrounding post-COVID prospects makes it more difficult to target the *right* firms—*viable* firms that find themselves insolvent only due to COVID
- Some options: (i) hybrid instruments that bolster equity (participation loans); (ii) grants paired with higher future profit taxes; (iii) condition support on equity injections by private sector and provide quasi-equity at a premium

Still, sharp trade offs: bankruptcy vs fiscal risks; firms/jobs preservation vs reallocation

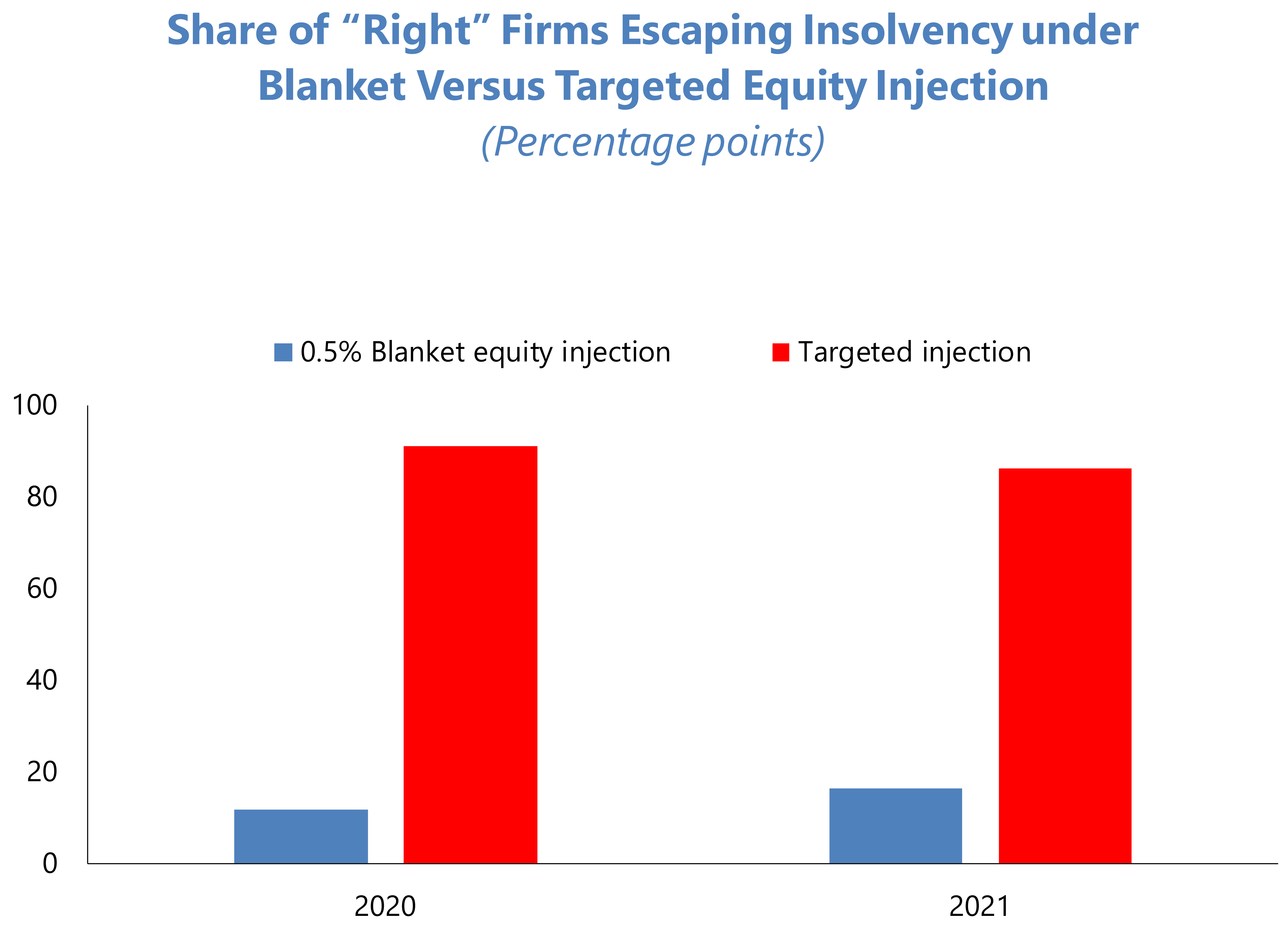
"Blanket" solvency support would be wasteful

Illustration: consider a support scheme allocating 0.5 percent of the overall SME revenue in the form of an equity injection





Targeting large efficiency gains ("right" firms saved per dollar spent)



Concluding Remarks

Sizable increase in insolvency risks for SMEs—even under economic recovery baseline

- Social costs of letting SMEs fail > private costs

(Quasi) Equity injections could dampen the wave

- Insolvency not addressed by credit (liquidity) provision

Two main challenges from (quasi) equity injections for policymakers

- Technically challenging for SMEs
- Can be quite costly (blanket vs targeted) and risky (bet on recovery)

Three-pronged policy response:

- Continued liquidity support
- (Quasi) Equity injections where appropriate. Design is key—large efficiency gains from targeting, need to incentivize private investors
- Strong(er) SME insolvency procedures and debt restructuring mechanisms