CompNet - ProdTalks 10

“Insolvency Prospects Among Small-and-Medium-Sized Enterprises in Advanced Economies: Assessment and Policy Options”

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CompNet and IMF

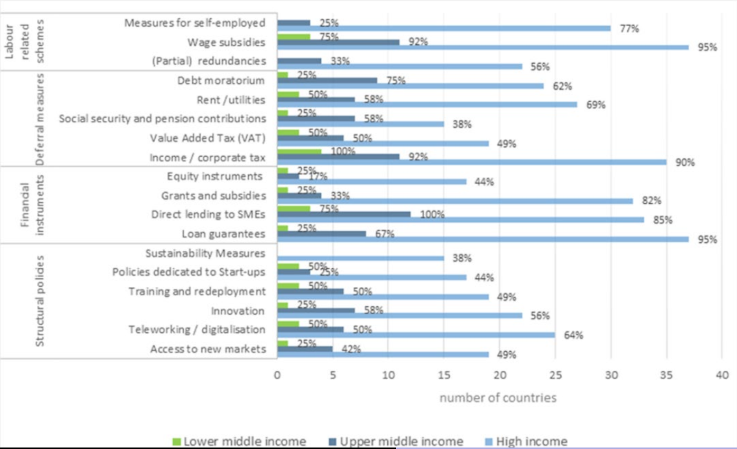
Summary

- SMEs are the backbone of the productive fabric in Europe (more than 70% of employment in most EU28 countries) and have been particularly negatively affected by the Covid-19 crisis.
- Governments have tried to mitigate the negative effects with ample support policies directed to SMEs (OECD figure).

SME response measures to Covid-19

- One year of SME and entrepreneurship policy responses to COVID-19: Lessons learned to "build back better", OECD, April 2021.

Figure 1. **SME support measures introduced as a response to the COVID-19 crisis by group of countries according to their income levels (February 2020 - February 2021)**



Summary

- SMEs are the backbone of the productive fabric in Europe (more than 70% of employment in most EU28 countries) and have been particularly negatively affected by the Covid-19 crisis.
- Governments have tried to mitigate the negative effects with ample support policies directed to SMEs (OECD figure).
- The study highlights the potential solvency risks associated to such policies. Most government assistance programmes have relied on some form of debt financing which increases firm leverage and therefore, can negatively influence the risk of default.
- Findings: the share of insolvent SMEs may rise by 6 percentage points in 2020-21, threatening up to 1 in 10 SME jobs.
- Second step: policy evaluation of the "right" instrument (equity vs debt) and targeted vs indiscretionary policies. Quasi-equity injections can be over four times more effective if directly **only** to firms in need.

Summary

- Very policy relevant and needed exercise. Highly difficult since no data and high uncertainty.
- Firm level balance sheet data from Orbis: 20 European countries plus Australia, Japan and Korea. Over 1.25 million firms. Latest available financial information year, 2017.
- Use the model by Gourinchas et al. (2020) (that incorporates an aggregate demand shock, an industry supply shock, a sector demand shock and a sector productivity shock) to predict the corresponding solvency and liquidity indicators for 2020 and 2021. Based on these shocks, the model predicts changes in firm level cash flows (CF) that are then used to compute solvency and liquidity indicators.
- A firm is projected to have a negative stock of cash (illiquid) whenever:

$$cashstock_{i,s,t-1} + \widehat{CF}_{i,s,t} - InterestPayment_{i,s,t-1} < 0$$

- A firm is projected to have negative equity (insolvent) whenever:

$$Equity_{i,s,t-1} + \widehat{NetIncome}_{i,s,t} < 0$$

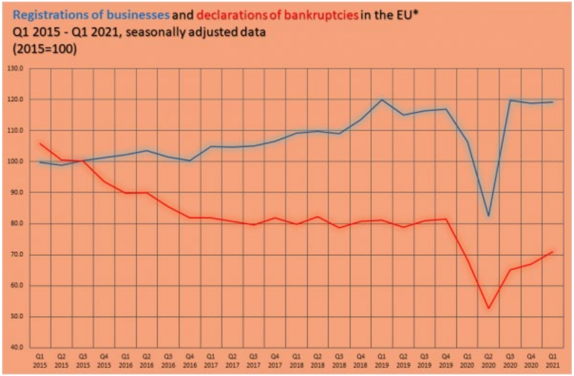
Comments

1. Measurement and prediction of illiquid and insolvent firms.
2. Indirect effects in the real economy through network effects.
3. The challenge of equity-like instruments for SMEs.
4. DG Competition State Aid

- Soundness of exercise relies on predicting insolvent and illiquid firms. How do the estimates compare to early release data on bankruptcies (although provisional)? or countries with financial information for 2020?

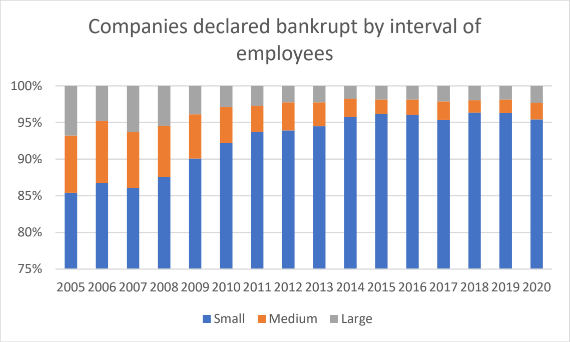
Comment #1: Bankruptcy Evidence - EU

- Eurostat: Quarterly registrations of new businesses and declarations of bankruptcies - statistics.
  - The data transmitted for the first quarter of 2021, is the first legally-binding requirement for the variables: registrations of businesses and declarations of bankruptcies under the European Business Statistics (EBS) Regulation.
  - Up to the fourth quarter of 2020, the statistics were classified as experimental statistics and based on voluntary data collection.



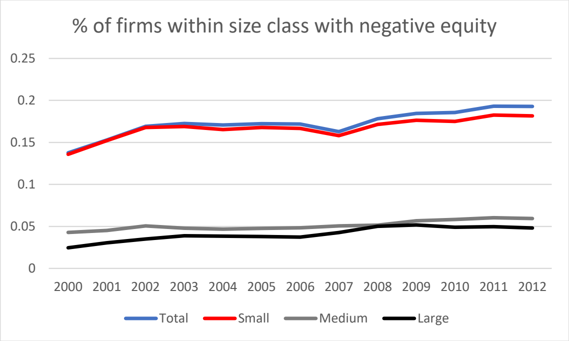
Comment #1: Bankruptcy Evidence - Spain & Size

- Spain INE: Quarterly declarations of bankruptcies - statistics (forth quarter of 2020 preliminary).



Comment #1: Insolvency Evolution - Spain

- Orbis information (2000-2012)
- More descriptive statistics on the evolution of solvency and illiquidity during "normal" times and after the GFC.
- Most of the action within Small firms (not Medium). Relevant from a policy view point since Small firms harder to reach. Misreporting - tax considerations?



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- Soundness of exercise relies on predicting insolvent and illiquid firms. How do the estimates compare to early release data on bankruptcies (although provisional)? or countries with financial information for 2020?
- Insolvency and Illiquidity are treated separately for the most part. Consider jointly and dynamic effects: firms that become illiquid because they are insolvent.
- Percentage of the insolvent firms that are zombie ($ICR < 1$)?
- Challenge of traditional metrics: firms may be illiquid or even insolvent according to traditional measures, but still viable, whereas in other cases firms may appear viable but have structurally unsound or unsustainable business models.

Comment #2: Indirect Effects through Customer - Supplier Linkages

- SMEs have a limited number of suppliers making them more vulnerable to disruptions.
- SMEs have less bargaining power to enforce attractive payment conditions. OECD:
  - According to a large-scale survey among European SMEs conducted between February and May 2020, 51% of respondents reported that late payments squeezed their liquidity during the COVID-19 crisis, compared to 39% in 2019.
  - In addition, there was a noticeable increase in the percentage of SMEs that had to accept longer payment terms than they were comfortable with.
- Trade credit an important share of SMEs liabilities.

Comment #3: Equity-like Instruments

- Relative consensus: The phasing out of credit guarantees could be usefully complemented with measures that promote the use of equity (or equity-like) instruments to reduce the excessive reliance on debt-based instruments.
- Proposed measure in this study: "profit participation" loans. Still debt but given the advantageous conditions (repayment flexibility) in accounting terms may not contribute to indicators of higher indebtness.
- Evaluation and comparison of alternative proposed measures (probably country heterogeneity):
  1. Grant support
  2. Convertible Loans
  3. Loans eligible for forgiveness
  4. Equity funds/convertible bonds
  5. Equity crowdfunding
  6. Tax profits to strengthen SMEs equity
  7. Cash against tax surchages (Boot et al. (2020))

Comment #3: Equity-like Instruments

- How to select the right firms? Proposal: based on private sector participation/involvement.
  - Moral hazard: banks with higher exposure higher incentive to signal participation even if no viable firm.
  - Potential solution: based on participation by banks with lower exposures among the banking pool or new banks willing to lend.

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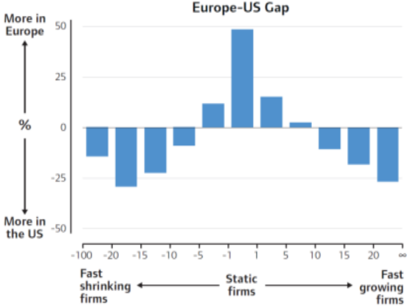
- Implementation (which government agency?)
- Take-up rate (SMEs particularly reluctant to take on equity-base instruments, or unfamiliar with the process, especially relevant for Small firms).

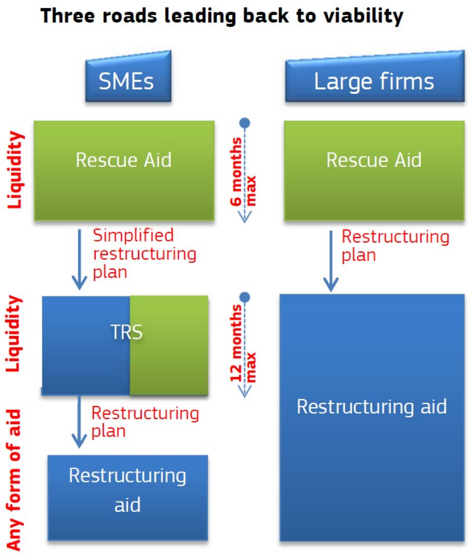
Comment #4: EU - DG Competition

- At the European level there are rules on rescue and restructuring aid for industries that were amended in 2014 and again in the face of the Covid-19 crisis.
- Pre-Covid the concern: Comparing the churn processes in Europe and the US shows a much more dynamic picture in the US, with more firms either growing or declining quickly, while more European firms remain static.



- To help close the productivity gap with the US, the churn process in Europe needs to be encouraged and interventions that interfere with that process, such as rescue and restructuring aid, should be subject to strict control (Occasional papers by the Competition Directorate-General, Issue 9, 2014).

- Viability Plan (Occasional papers by the Competition Directorate-General, Issue 9, 2014):



Comments

- Sound framework to analyze solvency risk among SMEs in Europe.
- Major contribution: quantify effects of insolvency risk under different scenarios.
- Once we settle for equity-based instruments, comparison across different options and evaluation of implementation procedures.
- Bear in mind limitations to state aid in the European context, EU-wide solution?

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