Working Session 2 - Preparing for the challenges ahead: how to ensure a virtuous cycle between the financial and non-financial sectors

Ministers and Governors are invited to discuss strategies to avoid, on the one hand, the cliff-effects associated to the withdrawal of the support measures, and, on the other hand, the building up of imbalances. Special attention is given to (i) a targeted policy approach focusing on financially stressed companies in the most affected sectors with viable business models that need further support to ensure solvency; and (ii) the way the crisis impacts banks and the effectiveness of the tools available at the EU and Member State levels to avoid negative spillovers between the real economy and the financial system.

The interlinkages between the financial and non-financial sectors

The COVID-19 crisis has led to unprecedented coordinated and decisive action in Europe. Policy response was timely, comprehensive and forceful at different levels. Both monetary and fiscal policies played a crucial role. Monetary policy intervention was essential to keep financing costs low and to mitigate the risks of financial fragmentation, while fiscal support measures helped households and firms facing significant liquidity shortfalls. These policies contributed to mitigate the economic and social costs of the crisis, including the short-term impact on banks' balance sheets. Loan moratoria and public guarantee schemes played a fundamental role both in securing the financing of the economy and preserving financial stability. At the same time, these policies have intensified the interlinkages between sovereigns and the financial and non-financial sectors.

Against this backdrop, finding the correct timing for phasing-out the current set of measures is key. Especially so, considering the high level of uncertainty regarding both the asymmetric pace of recovery and possible economic scars. Liquidity problems in firms that have been more severely affected, notably those in the most vulnerable economic sectors, that can differ across countries, may turn into solvency problems, due to excessive indebtedness and negative prospect in terms of cash-flow generation. The premature withdrawal of policies could act as a trigger for the materialization of these bankruptcies which would strongly impair bank asset quality and might even constraint the banking sector's capacity to finance our economies. In addition, some viable firms that are under significant financial distress might also go out of business, which would only deepen and protract the costs of the crisis. The interlinkages between banks, sovereigns and corporates, which were crucial for stabilising the economic and financial situation during the pandemic, could turn into a vicious circle giving rise to destabilising feedback loops.

However, maintaining a too broad-based support for too long is also risky as it may delay economic restructuring and prevent unviable firms from exiting the market, ultimately leading to the misallocation of resources and suppressing growth and innovation. Furthermore, some of the measures in place can lead to the building up of imbalances.

Authorities face a trade-off associated with their choices: while an accommodative policy stance is appropriate to ease financial conditions and stimulate aggregate demand, extending policy support for too long may amplify the existing leverage vulnerabilities. In its turn, high corporate indebtedness results in pressures on corporate solvency. Thus, pursuing the right balance between the need to mitigate cliff effects and the need to avoid keeping a too broad set of measures for too long and delaying economic restructuring is of the essence.

A more targeted policy support approach

A consensus is emerging that a more targeted policy support approach is needed, notably to support the solvency of viable but financially distressed firms within the most affected sectors. Although some liquidity measures could be maintained, the priority should evolve from liquidity to solvency support and from broad support to a more targeted approach focused on the aforementioned firms, such as equity injections into SMEs to mitigate their solvency risks.

According to a recent IMF Staff Discussion Note, even if a solid economic recovery materializes, solvency risks are projected to rise significantly among SMEs and, if the economic recovery is slower than expected, particularly in the sectors more affected by the crisis, the rise in SME solvency risks would be larger and exceed its cumulative post-Global Financial Crisis increase.[1] This paper also argues that equity injections into SMEs could mitigate their solvency risks, but a targeted equity injection will be far more efficient than across-the-board injections, as the latter would benefit (i) firms that do not need this support, as they are solvent even with COVID-19, and (ii) firms that would have been insolvent even without COVID-19. While a gradual shift from liquidity to solvency support might be warranted, it may also imply higher costs for public budgets. Designing support measures for the hardest-hit sectors and using stricter eligibility criteria, subject to state aid controls would be well-advised. The involvement of the private sector and the role of current firms' shareholders could be promoted in this recapitalization effort.

Against this background the following issues would be key for the success of this approach and, consequently, for economic recovery:

- **The need to have in place an effective framework to distinguish viable from non-viable firms**. To guarantee an adequate allocation of resources in this new phase of the crisis, a more detailed analysis, on a firm-by-firm basis and grounded on what we expect to be the new normal is needed. Indeed, an easy-to-verify approach would be to rely on pre-pandemic financial indicators; however, this approach might be impaired by the structural changes accelerated by the pandemic. The analysis should be based on a broad set of indicators and on firms' expected future cash-flows, and include the necessary flexibility to be applied by each Member State. The large scale and level of detail of this task warrant a discussion on the role of the private sector (e.g. banks, auditors and liquidators).
- **The need to design equity or quasi-equity instruments**, that may be applicable to a significant number of SMEs. Some EU Member States have already announced and are now implementing some measures aimed at increasing the level of capitalisation of non-financial corporations, under the European Commission's Temporary Framework for State aid. These measures include not only direct grants, but also targeted recapitalisation aid to non-financial companies and support for uncovered fixed costs. The conversion of public guaranteed loans into

[1] Insolvency Prospects Among Small-and-Medium-Sized Enterprises in Advanced Economies: Assessment and Policy Options (imf.org).

equity or quasi-equity instruments can also be considered during the recovery phase. The role of the private sector, notably of the current firms' owners and of potential new investors, should also be explored in the solutions to be set.

- **The need to have in place an efficient and effective firms' restructuring and insolvency framework**, to minimise losses and promote economic recovery. It is expected that, even with the recovery underway, a significant number of firms will need to go through a deep restructuring process to guarantee their viability. An effective and swift procedure to deal with the insolvency/liquidation of unviable firms will be very relevant. Despite the important developments that have recently taken place in some Member States, the existing national frameworks may not be prepared to deal with a significant number of firms requiring restructuring or liquidation in the aftermath of the crisis. The need and feasibility to set up mechanisms for standardized debt restructuring solutions and further development of out-of-court procedures may need to be further explored, alongside structural measures to avoid courts' congestion. Available flexibility in the scope of existing frameworks should be used to the extent possible, as progress in changing insolvency frameworks may be too slow to deal with the current situation.

The banking sector side

Banks entered the crisis in a significantly stronger position compared to the last financial crisis. In fact, the banking sector has shown, so far, a significant level of resilience and has been playing an important role in financing the non-financial sector. This is the result not only of the work done since the previous crisis, notably in terms of solvency, liquidity, financing structure, asset quality and cost reduction, but also of the aforementioned economic policy measures that were implemented in a timely manner in the aftermath of the pandemic outbreak. Indeed, public moratoria and guarantee schemes and the measures taken at supervisory and regulatory levels played an important role in preserving the financial sector's financing capacity.

The impact of the pandemic on economic activity has not yet led to an increase in the non-performing loans (NPLs). According to the EBA, the NPL ratio decreased by 20bps (q-o-q) to 2.6% in the fourth quarter of 2020 and the decline was due to a contraction in NPLs, which exceeded the decrease in loans and advances. However, the EBA has also highlighted that while the NPL ratio improved for most economic sectors it increased for some of the sectors more affected by the crisis. Furthermore, the share of stage 2 (i.e. exposures that, even though not impaired, suffered an increase in credit risk) loans rose in the last quarter of 2020, with this increase being particularly pronounced for loans still under moratoria.

In the coming quarters further deterioration in the asset quality of banks' balance sheets may occur, notably when credit moratoria and the grace period on public guaranteed loans expire. **Authorities need to continue monitoring the risks to financial stability very closely and are committed to take further action, if needed, in a coordinated way**. Banks' balance sheets need to reflect, in an accurate and transparent way, borrowers' credit risk. Initiatives like those taken by the ECB on the need for banks to set up operational capacity to deal with distressed debtors and on prompt identification and measurement of credit risk in the context of the pandemic are important.

Banks should also continue to benefit from the flexibility provided by authorities to temporarily use capital and liquidity buffers to absorb losses and continue financing our economies. This flexibility should not be offset by conflicting requirements that could lead to a sudden halt on credit supply and magnify bank losses.

Furthermore, the regulatory and supervisory framework should not preclude an effective restructuring process for firms. This means that any flexibility should be extended only to the restructuring of firms that are considered viable in the post-pandemic context and no complacency should be provided to banks that intend to 'extend-and-pretend', resulting in zombie lending.

Questions for discussion

1. How can we move from broad-based to more targeted support? How can instruments, such as public guarantee schemes, be rethought for the upcoming recovery phase? What should be the design of these instruments both in terms of eligibility criteria for viable firms and the creation of appropriate incentives?

2. Taking into account the still high level of uncertainty, how can we ensure that financial institutions, notably banks, continue to play an important role in the next phase of the crisis, in which a significant number of firms might need to be restructured?