

BUSINESS SOLVENCY SUPPORT MEASURES

The economic literature highlights the fact that high corporate indebtedness can weigh down on investment, generating adverse effects on productivity and economic growth.¹ High indebtedness also entails a risk to financial stability. The COVID-19 crisis has given rise to an increase in corporate indebtedness which, against the backdrop of a still-uncertain outlook, may ultimately generate solvency problems in specific company segments.

Against this background, Royal Decree-Law 5/2021² envisages a series of extraordinary measures aimed at supporting business viability: (1) a specific-purpose direct aid fund totalling €7 billion,³ (2) a range of tools to facilitate the restructuring processes of loans with a public guarantee to firms and the self-employed who should need it, including a facility worth €3 billion, (3) a recapitalisation fund of €1 billion for pandemic-affected companies and (4) the extension until end-2021 of the suspension of the obligation for insolvent debtors to initiate bankruptcy proceedings.

Regarding the direct aid, it poses at least two fundamental design challenges: (i) selection of aid recipient firms and (ii) incentives structure for participating firms. Not having an appropriate selection criterion could give rise to a poor redistribution of productive resources, keeping low-productivity firms going or providing support to companies that do not need it to reduce their debt level. Conversely, an unsuitable design could leave out companies that are viable but facing solvency problems. The heterogeneity of the distribution of business productivity, profitability and the debt ratio prior to the COVID-19 crisis (see Charts 1 and 2) points to a very different potential impact of the programme depending on the firms that are the ultimate recipients.

The introduction of sector-based eligibility criteria, by firm size and with regional compartmentalisation elements, in Royal Decree-Law 5/2021 is related to some extent to

these optimal selection criteria; but their implementation will determine to what extent the criteria are ultimately observed, given that the level of indebtedness is not explicitly taken into account. This is a key measure for assessing business solvency. Further, it cannot be ruled out that there are viable companies with solvency problems arising from the crisis that are operating in sectors not among those most affected by the crisis and which could, therefore, remain outside the aid-eligible set. However, the subsequent amendment of the aid programme, empowering regional governments to extend the granting of aid to other sectors not initially envisaged in Royal Decree-Law 5/2021, limits this possibility.⁴

Furthermore, the direct aid fund is intended for solvent companies and individual entrepreneurs (in accordance with the criterion of not having filed negative personal or corporate income tax bases in 2019), under a commitment to maintain activity. This requirement of a positive tax base in 2019 correlates to productivity, but it is a backward-looking and partial measure that could leave out young firms or companies that were to undertake major investment projects that year.⁵

The swift and uniform implementation of this aid is particularly significant in this setting, and the distribution mechanisms should be adjusted to selectively target the aid precisely on companies that are viable but have solvency problems. Flexibility in the volume and use of the committed funds is also necessary, to adapt them to the course the pandemic is following and to any future materialisation of risks.

The second course of action, namely the restructuring of bank debt backed by the ICO, seeks to alleviate the financial burden on viable firms with specific solvency problems. It does this, first, by extending the term of the guaranteed loan, converting it into a participating loan,⁶

1 See Myers, S. C., 1977, *Determinants of Corporate Borrowing*, Journal of Financial Economics, Vol. 5, Issue 2, pp. 147-175.

2 See publication in BOE of *Real Decreto-ley 5/2021*.

3 This fund would provide for the coverage of overheads (utilities, suppliers, etc.) and, should anything be left over after covering these expenses, also for new debt commitments entered into after March 2020.

4 The announcement on 20 April 2021 of the *Resolution of the Council of Ministers* authorises the regional governments and the city-enclaves of Ceuta and Melilla to grant aid to companies in sectors other than the 95 initially established under Royal Decree-Law 5/2021 on the basis of the percentage of employment in such sectors under furlough schemes, and of the persistence of the use of furlough schemes since the start of the pandemic.

5 The announcement on 20 April 2021 of the *Resolution of the Council of Ministers* has subsequently authorised the granting of aid, exceptionally, to companies with negative tax bases in 2019.

6 A participating loan is a financial instrument mid-way between a debt instrument and a capital instrument. Some of its advantageous characteristics for the borrower include: (1) consideration as equity for the purposes of mercantile legislation, which will help in avoiding or delaying the winding up of the company, (2) in the case of winding up, its seniority in terms of payment is behind that of ordinary creditors and (3) accrued interest, fixed and variable alike, is generally deductible for corporate income tax purposes.

BUSINESS SOLVENCY SUPPORT MEASURES (cont'd)

Chart 1
DISTRIBUTION OF THE PRE-PANDEMIC PRODUCTIVITY OF NON-FINANCIAL CORPORATIONS (a)

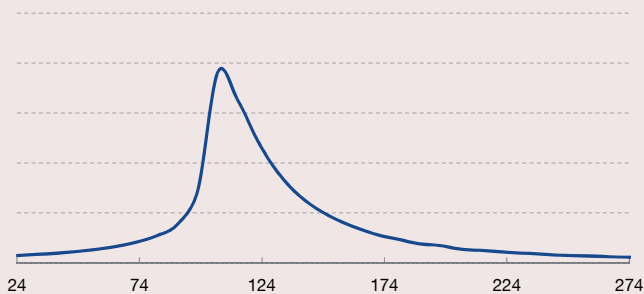
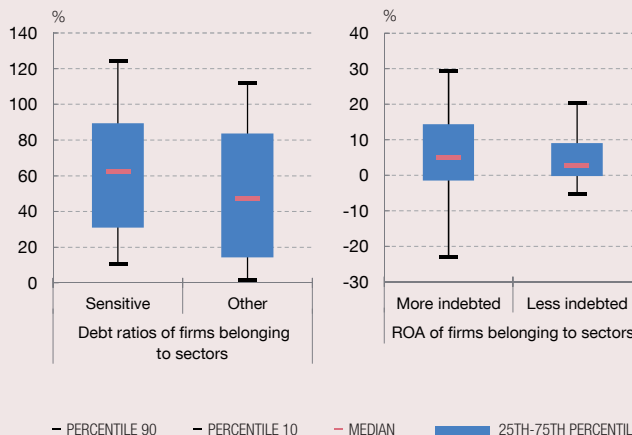


Chart 2
DISTRIBUTION OF NON-FINANCIAL CORPORATIONS' PRE-PANDEMIC DEBT AND PROFITABILITY RATIOS (b)



SOURCES: CBB Database, CCR and Banco de España.

- a Productivity is measured as the ratio of gross value added to personnel costs (as a percentage). The data are for 2018, the latest year for which a representative sample is available in the CBB Database. The density function is proxied using a kernel estimator, which provides for a continuous and smoothed representation.
- b The debt ratio shown corresponds to the sum of current and non-current liabilities over total assets. The sectors most sensitive to the COVID-19 crisis belong to manufacturing activities (excluding the food, beverages and tobacco industries), transport and storage, hospitality, wholesale and retail trade, and vehicle repair and other services (artistic, recreational and entertainment activities). The most (least) indebted sectors are those that have a debt ratio higher (lower) than the 75th (25th) percentile of the distribution of sectors according to the two-digit CNAE classification.

and, exceptionally, through the reduction of its principal. The facility set aside for this purpose, in coordination with the lender institutions, is subject to the lenders assuming their proportional share and to subscription of a code of good practices. The code of good practices should retain the capacity banks have to use the greater information they have on their borrowers.

The third component of the decree, the recapitalisation fund, complements the actions of the SEPI-managed fund for strategic firms in the sphere of medium-sized firms.

In short, these measures have the potential to contribute to preserving the productive system; but their implementation is complex and their impact will hinge on a correct selection of the participating companies. Moreover, the quicker their implementation is, the greater their effectiveness will be. In this regard, the relatively simple selection mechanism in the measures adopted would have the potential virtue of facilitating their quick implementation. Finally, it should be borne in mind that, if the macroeconomic situation proves worse than expected, it might be necessary to recalibrate their size and the selection criteria.