AFME Speech: “Addressing the SME Solvency Crisis”

Wednesday 24 February, 14h15 CET (13h15 GMT)

Good afternoon to all of you,

Thank you to the Association for Financial Markets in Europe for inviting me to this event. It is a great honor to be here today.

I would like to take the opportunity of this tribune to raise awareness on the issues being faced by small and medium enterprises in Spain.

As you all may know, SMEs represent more than 99% of companies in Spain, around 75% of employment and close to two thirds of economic value added. However, given their economic structure, their limited buffers to absorb shocks, and the lack of diversified funding sources, those companies have been particularly vulnerable to the Covid crisis. If a large number of SMEs were forced to step down following the crisis, the impact on employment and economic production could be of unprecedented magnitudes. A social and economic catastrophe could take place, and it will take a large number of years to recover.

It is also essential to keep in mind that the closure of SMEs will not solve the problem of company’s insolvency by itself, it will just transfer the solvency issue to banks, that will face a surge in the number of non-performing loans, potentially transforming the problem into a banking crisis with uncertain consequences for the overall economy and public finances.

Rather than allowing the solvency crisis of SMEs to snowball into a systemic economic crisis, we should address the root of the problem: help insolvent but viable SMEs survive.

During this keynote speech, I will try to give a sense of the magnitude of the problem, and the different instruments that should be mobilized to help address this challenge – especially what Europe can do to help address this problem.

Diagnostic: so, what is the magnitude of the challenge?

Last week, the Bank of Spain published an analysis on the impact of the Covid-19 on the financial situation of Spanish SMEs.

The crisis has increased companies’ solvency risks due to both increasing indebtedness levels and declining profits.

According to the study, the share of vulnerable of SMEs has increased from a pre-covid level of 20% to over 35% (a 75% increase). However, the percentage of vulnerable companies reaches up to 70% for the sectors most impacted by the pandemic and its associated restrictions, such as hotels, restaurants and leisure activities.

As a result, the number of insolvent SMEs could reach 20%, that is one in five companies being insolvent. Among sectors most affected by the pandemic, such as hotels, restaurant and leisure activities, the percentage of insolvent companies could go over 30%, that is one in every three companies facing insolvency.
It is therefore essential to act soon. Otherwise, we could face a great chaos that could translate in amplified problems. If those problems remain unaddressed, in the coming months we will be witnessing an unprecedented increase in the number of saturated mercantile courts, a proliferations of zombie loans and a surge in bankrupt SMEs.

This would be a tragic equilibrium for everyone.

- For entrepreneurs, who would see a life project vanish and would enter a complicated liquidation process.
- Tragic for all the workers that would lose their jobs.
- Tragic for the economic value chains, which would lose customers and suppliers.
- Tragic for the state, that would witness a further decrease in tax income, while social benefits such as unemployment would keep increasing, exacerbating the deficit hole.
- And finally, tragic for the banking sector, that would witness a significant increase of non-performing loans, potentially leading to banking crisis.

For all this, Spain – and Europe – must act now to face the crisis of solvency of the entrepreneurs and small companies. Otherwise, you will have to face higher costs in the future, in a deteriorated economic environment and with an unpopular and undesirable tool: bank bailouts.

Solutions – How Europe can help SMEs face those problems?

Solving these problems will require a combination of several elements. I believe that three key pillars are essential. In all those pillars Europe can help countries guide their efforts:

- First, to improve the insolvency frameworks for small and medium companies
- Second, to improve the debt restructurings proceedings, including public creditors
- Third, to encourage the implementation of direct aids under the State Aids

Let's go one by one.

1. First priority: to improve the functioning of judicial procedures and extrajudicial insolvencies

For our small businesses, what started as a liquidity problem has turned into a debt overhang. Many relied on the announcements that the pandemic would be a short-term shock and contracted a large number of debts to absorb it (ICO credits, as well as other credit lines or existing savings to meet fixed expenses). This debt, which in principle had to cover one or two months of activity, are now equivalent in many cases to one year of activity and place these companies in a situation of insolvency.

We are approaching the brink of corporate insolvencies. As Mario Draghi recently mentioned, "the problem is worse than it seems." It is true that so far, the bankruptcy moratorium has allowed to keep companies in a "hibernation mode" – there has actually been a 15% decrease in the number of companies that have filed for insolvency in 2020 compared to the previous year.

In that regard, it seems that the measures to support the economy have resulted helped prevent the destruction of companies and have induced the economy into a coma. We need now to ensure that we have the good anesthetist responsible for waking up the business fabric from this coma.

That anesthetist is a well-functioning the insolvency framework. Indeed, pre-insolvency and bankruptcy procedures perform fundamental functions for business activity, since they allow differentiating between highly indebted viable companies (temporarily insolvent, but with good business opportunities), whose debt has to be restructured, and non-viable companies (insolvent indefinitely), which have to be liquidated.

However, the Spanish insolvency framework is inefficient. It is not prepared to manage such an increase in insolvency applications. According to the Bank of Spain, in 2019 there were 13 tenders for every 10,000 companies; the same ratio amounts to 108 in France and 76 in England, this is between 6 and 8 times more! The use of pre-insolvency mechanisms for freelancers and small companies, key to address solvency problems before it is too late, is even scarcer: there have only been 93 Extrajudicial Payment Agreements between 2015 and 2020. Think about it: if we have only been capable of 93 deals in 5 years (an average of 18 per year), how many restructuring deals will we get in 2021?

We urgently need a fast, agile and less expensive insolvency process to manage the coming tsunami of insolvency proceedings. A more efficient and agile system will allow more companies to continue operating.

In that regard, the European Directive on preventive restructuring frameworks and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, to be transposed before mid-July 2021, is an excellent opportunity to improve the existing framework. Taking into account the urgency to transpose the directive, and the economic urgency, this may be an opportunity to adapt the insolvency processes and minimize the impact of the crisis on the business fabric.

This reform could also be a reform to be considered under the reforms to be implemented in the framework of the RRF. It should therefore be strongly promoted by EU institutions.

Time is of the essence. It is essential to modify the existing framework before the bankruptcy moratorium expires.

2. Second pillar: incentivize debt restructurings, in particular involving public creditors in the restructuring

In order to incentivize the restructuring of SMEs' debt, it is important to involve public creditors in those restructurings. The idea is simple. Small businesses have two main types of creditors: banks (to which they owe loans) and government (to which they owe taxes, fees, and social security payments). However, until now, debt owe to public creditors cannot be renegotiated in bankruptcy or pre-bankruptcy proceedings. Consequently, these mechanisms lose a significant share of their potential attractiveness to small entrepreneurs, for whom public credit represents an important part of their debts.

The idea proposed by experts such as Olivier Blanchard consists in that public creditors (including the Treasury and Social Security) get involved and encourage debt restructurings, accepting equal or even greater haircuts than private creditors. In return, banks must also accept some restructuring to allow the company to survive. This should be done under strict and transparent rules, so that governments can prevent or not save certain companies for non-economic reasons, and that any perverse incentive for banks can also be created.

There is an economic rationale for asking public entities to accept a higher haircut than private creditors. This is the difference between the social and the private value of the firm. This scheme also allows the bank to take the optimal decision. The bank takes into account that, if it restructures the firm instead of closing it, it will benefit from a more generous haircut from the government.

However, in that regard, it is also essential that private creditors are involved in the process. The government, as one of the creditors, has neither the information nor the administrative capacity to implement efficient restructuring by itself. It must work with private creditors (typically banks in the case of SMEs) that have more granular information and a better capacity to use it. In order to set the right incentives for the banks to differentiate between viable and non-viable companies, then banks should have some "skin in the game" in the process, that means that they should also assume some level of haircut.

In Spain, there is currently an ongoing debate concerning the potential haircuts to the credit lines that had the public guarantee of the ICO. My position in that debate, in a nutshell, is that:

- First, a generalized haircut based on some solvency metric would be counterproductive and potentially lead to a misallocation of capital. Restructuring and haircuts need to be defined on a case-by-case approach, using the ground knowledge of banks.
- Second, aid to improve the solvency of the self-employed and SMEs cannot be limited to the "ICO loans". Restructuring proceedings need to have a broader approach and potentially consider social security payments or taxes, in order to potentially support SMEs that require that support but that do not have an ICO credit line.
- In any restructuring, for the design to be efficient, it will need to involve banks participation and also banks assuming part of the haircut.

At European level, the modification of restructuring proceedings to include public creditors could be considered a key reform under the RRF and the insolvency proceedings directive.

3. Third pillar: direct aids can mean an effective and efficient financial support

Finally, in order to keep supporting small companies and incentivizing bank restructurings, the two measures above should be accompanied by the introduction of direct aids. Those can represent an efficient economic support, much needed by the sectors most affected by the pandemic.

In that regard, I welcome today's announcement from Spain's Prime Minister concerning the application of direct aid measures, as other European countries have already done.

As publishes by the European Commission, the extension of the Spanish "umbrella" scheme now includes the direct aids to help companies affected by the pandemic to cover their fixed costs within the State Aids Temporary Framework.

According to the Commission information:

- The public could take the form of direct grants, tax and payment advantages, repayable advances, guarantees, loans and equity.

- The measure's objective would be to provide liquidity to companies that are still experiencing a decline in turnover of at least 30% because of the coronavirus outbreak.

- The support should be to cover fixed costs, not exceeding €10 million per company, and should be granted before the end of the current year.

I can only encourage the implementation of direct aids to most affected companies – as my political party has already requested to the government.

In order to support entrepreneurs and small & medium companies' efforts to stay alive, now that we start seeing the light at the end of the tunnel, it is vital to give this kind of support. Public help cannot keep coming in the form of debt, as this would further deteriorate the solvency position of an already "damaged" company.

In addition, the introduction of direct aids will help reinforce the viability position of companies that receive that aid, strengthening their business case for a viable restructuring agreement with their creditors.

This is why I believe that the combination of the three measures – improved insolvency proceedings, more attractive debt restructurings including public and private creditors, and the implementation of direct aids – is essential to minimize the economic consequences of the pandemic.

To conclude, I just want to mention that the challenges ahead of us are indeed numerous, and that I could have also focused on other pressing challenges such the development of asset protection schemes, the securitization of non-performing loans in the times of a pandemic, the importance of SMEs financing, etc. I just wanted to stress the importance of addressing SMEs insolvency issues given the spillovers that their solvency issues could have for the overall economy, and in particular the banking and capital markets sector.

I hope you will enjoy the panels organized by the Association for Financial Markets in Europe.

Thank you for listening. I am happy to try to respond to your questions.