WORLD BANK GROUP

Research & Policy Briefs

From the World Bank Chile Center and Malaysia Hub

No. 30 April 13, 2020

Financing Firms in Hibernation during the COVID-19 Pandemic

Tatiana Didier, Federico Huneeus, Mauricio Larrain, and Sergio L. Schmukler

The coronavirus (COVID-19) pandemic has imposed a heavy toll on economies worldwide, nearly halting economic activity. Although most firms should be viable when economic activity resumes, cash flows have collapsed, possibly triggering inefficient bankruptcies with long-term detrimental effects. Firms' valuable relationships with workers, suppliers, customers, governments, and creditors could be broken. Hibernation could slow the economy until the pandemic is brought under control and preserve those vital relationships for a quicker recovery. If all stakeholders share the burden of economic inactivity, firms are more likely to survive. Financing could help cover firms' reduced operational costs until the pandemic subdues. But financial systems are not well equipped to handle this type of exogenous and synchronized systemic shock. Governments could work with the financial sector to keep firms afloat, enabling forbearance as needed and absorbing part of the firms' increased credit risk, by implementing policies with proper incentives to keep firms viable.

Sergio Schmukler

Maintaining Finance for Firms Impacted by COVID-19: Perspectives for East Asia

Malaysia Knowledge and Research Hub, FCI, and DEC

May 4, 2020

Background

- COVID-19 pandemic profound effect on firms
  - Heterogeneity across industries and across firms
  - Two extremes
    - Some firms completely shut down
    - Others doing fine, or in the middle
  - Large mass of firms are hurting

- Policy debate
  - Need to salvage firms, in addition to households
  - Many proposals to do so

This policy brief

- Unified framework
  - Organize policy debate related to firm financing during pandemic
- Discuss policy choices given challenges
- Discuss trade-offs when trying to save firms

This policy brief

1. Different type of crisis
   - COVID-19: health crisis with economic effects
   - Transmission channel and resolution
2. Firm relationships
   - Stress on firm relationships with stakeholders
3. “Hibernation”
   - Hibernation way forward, but credit needed
4. Policy action on financial side
   - Existing infrastructure ill-equipped for a pandemic
   - Could make crisis worse
   - Need to innovate on policy front

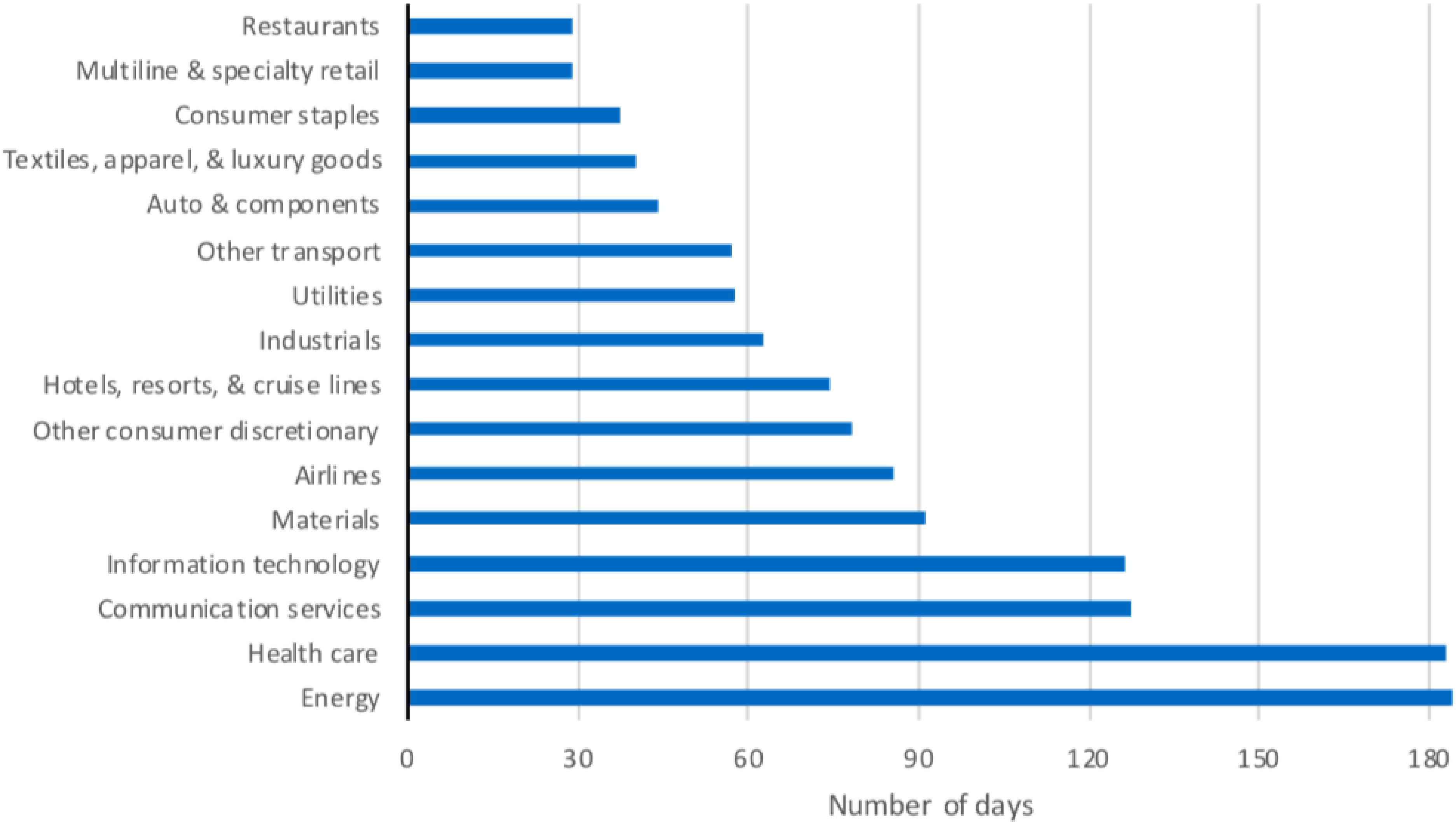
1. Typical crisis

- Past crises originated in financial sector
  - E.g., 1980s debt crisis, 1998-98 Asian crisis, 2008-09 global financial crisis (GFC)
- Banks (market participants) behave irresponsibly (take excessive risk) due to ex-ante moral hazard
- Bank (market) liquidity problem
  - Banks suffer runs, unable to rollover their liabilities
  - Banks stop lending to the real sector
  - Shock transmitted to real economy

1. Coronavirus crisis

- Root of problem lies outside financial sector
  - A health issue (highly contagious virus)
- Social distancing measures hit real economic sectors
  - Supply shock (employees cannot go to work)
  - Demand shock (cannot buy certain goods, services)
- Cash flows collapsed to unprecedented levels
  - Firms struggle to survive
- Affects financial sector

1. Days of cash-in-hand across industries



1. Coronavirus crisis

- Transitory health shock
  - Crisis will get resolved eventually (immunity attained)
  - As long as shock does not persist for too long, most firms could remain solvent
- Credit risk problem
  - Most industries as a whole will exist
  - But not all firms likely to survive the lockdown
  - Banks face problems with assets (not liabilities)
  - Do not know who to lend
  - Might push firms into bankruptcy

2. Economy as a set of relationships

- Transitory shock would make bankruptcies inefficient
- Firms depend on key relationships with stakeholders
  - Workers, suppliers, customers, creditors, (government)
- Relationships
  - Costly to build, maintain, and adjust
  - Intangible asset of firms
  - Organizational capital
- If relationships are destroyed, they must be recreated, leading to hysteresis effects

3. Hibernation during pandemic

- “Hibernation”
  - Firms operate at minimum capacity, if needed
  - Burn some cash to withstand pandemic
- Hibernation vs. “freezing”
- Relationships (not firms) are frozen, but not destroyed
  - They all absorb part of the shock
  - Avoid creating “zombie” firms, debt overhang
- Hibernating firms still need financing to survive

4. Existing policy framework

- Framework designed to avoid and resolve crises
  - Identify and remove “bad apples”
  - Avoid moral hazard
  - Avoid contamination to the rest of financial system
  - Basel III regulation, deposit insurance, LOLR
- Timing: act fast to resolve crisis
  - Once main problems in financial sector addressed, lending to real sector resumes and economy recovers
- Framework not designed for COVID-19 type of shock
  - Punishing firms in trouble now not a good option
  - Evolution depends on external factors

4. Policies to sustain financing

- Ensure that credit flows rapidly to firms, refinancing existing debt, and extending new financing
  - Avoid bankruptcy and liquidation

- Absorb/redistribute remaining and increased credit risk

- Policies in two categories
  i. Adapt the institutional framework
  ii. Provide credit to firms
     a. Liquidity to intermediaries (banks)
     b. Direct credit exposure by government

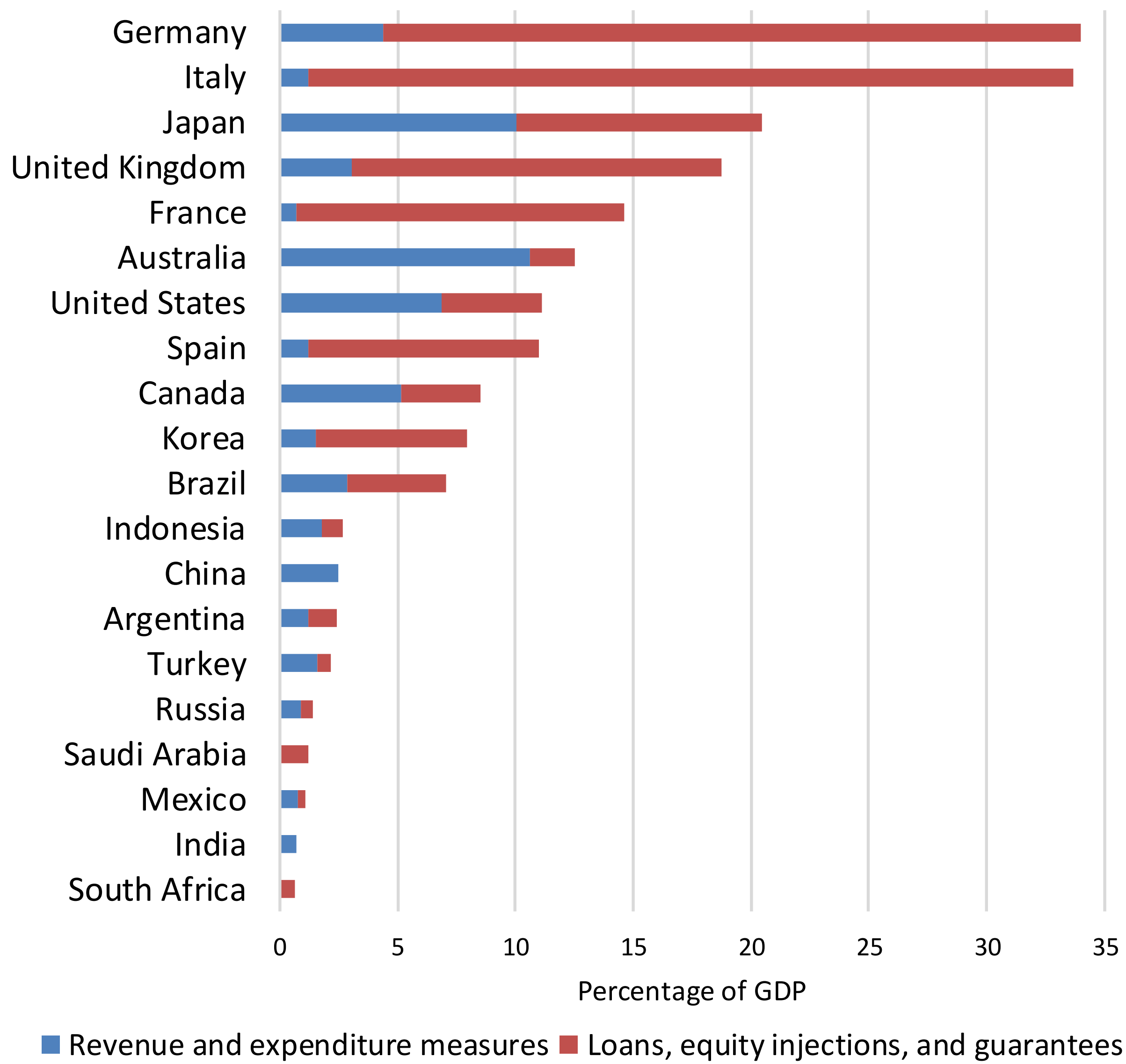
4. Adapting institutional framework

- Existing framework
  - If firm doesn’t pay, banks must increase provisions
  - Credit score is reduced
- Forbearance
  - Payment postponements
  - Regulatory freeze bank provisions for renegotiations
  - Freeze credit classification of firm
- Work with different branches of government
- Trade-off
  - Rapid assistance vs. (ex-ante and ex-post) moral hazard and redistribution

4. Liquidity to intermediaries

- Reductions in monetary policy rates
- Extensions of central bank liquidity lines to banks
- Reductions in Basel III capital requirements
- Ensure that banks pass loans to corporation
  - Incentives might not be enough
- Trade-off
  - Rapid implementation vs. effectiveness and stability

4. Credit risk to government



4. Credit risk to government: SMEs

- Instruments
  - Capitalization of state-owned banks
  - Scale up public credit guarantee programs
  - Large-scale purchases of portfolios of SME loans
- Design features
  - Creditors must retain skin in the game
  - Scale to allow for risk diversification
- Trade-off
  - Access to credit vs. government balance sheet

4.Credit risk to government: large firms

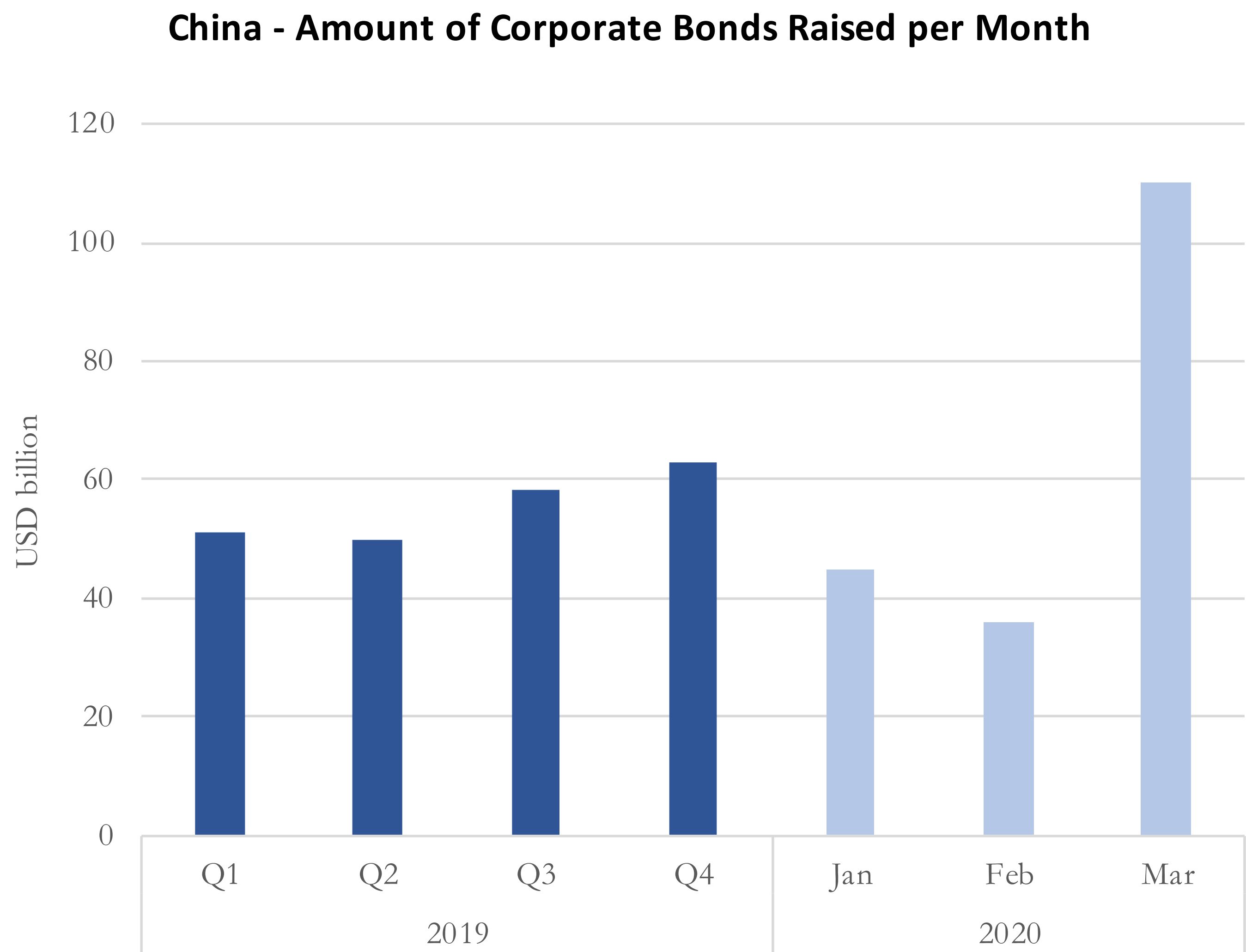
- Large firms have access to capital markets and bank
  - Capital mkt finance can avoid crowding out

- Government purchases of newly issued preferred equity or convertible bonds

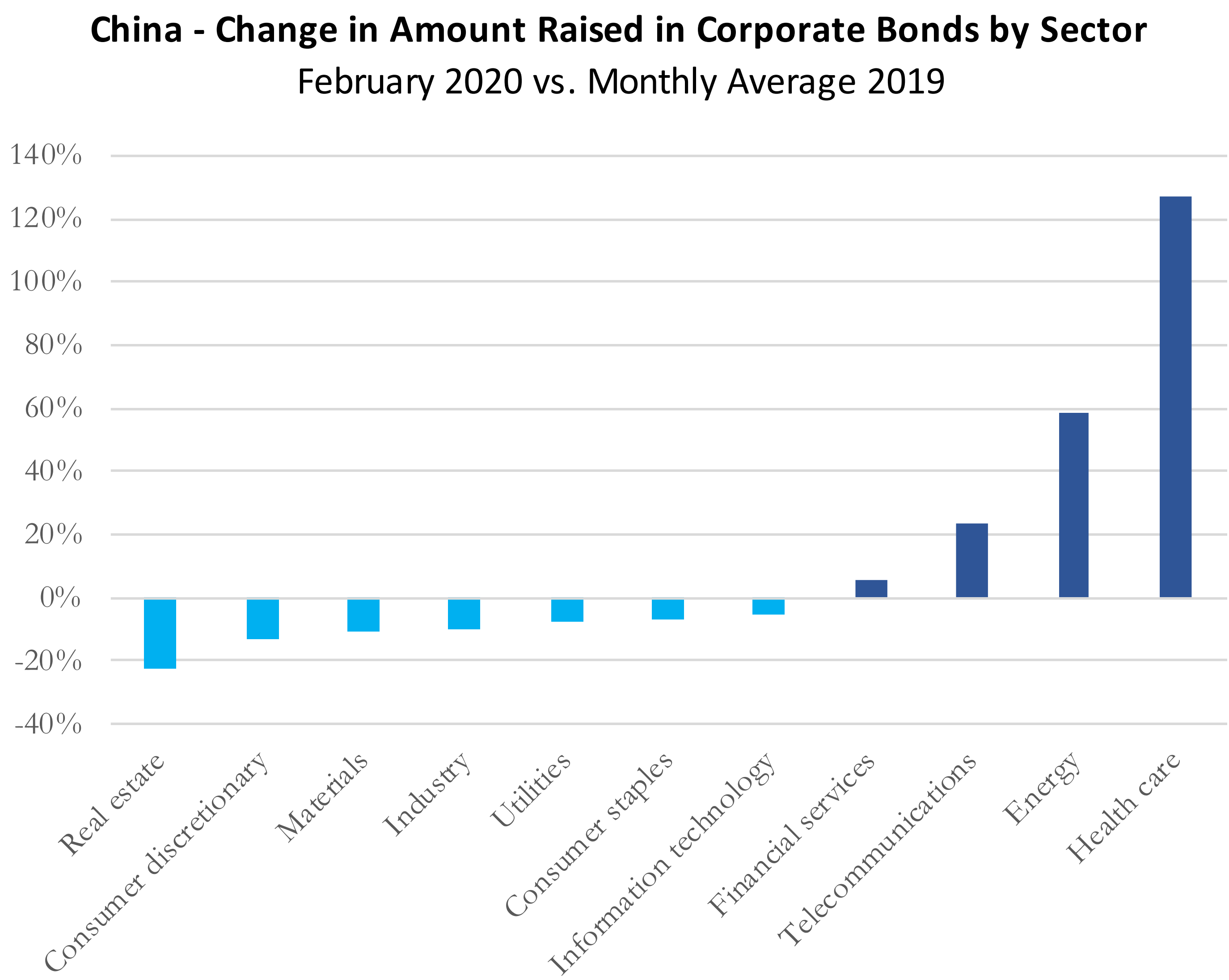
- Public credit guarantees (exchange for warrants)

- Trade-off
  - Access to credit vs. government balance sheet

4.Credit risk to government: large firms



4.Credit risk to government: large firms



Conclusions

- Need to prioritize policies and evaluate trade-offs
  - Large firms vs. SMEs
  - Firms w/different relationships, essential industries
  - Conditional on keeping certain relationships
- Allocating resources over time
  - Hibernation vs. jump-start
- Country differences: initial conditions matter
  - Developed vs. developing countries
  - Among each group
- Intergenerational transfers

Thank you!