Date

SDN/XX/XX

IMF STAFF DISCUSSION NOTE

Insolvency Prospects Among Small and Medium Enterprises in Advanced Economies: Assessment and Policy Options

Federico J. Díez, Romain Duval, Jiayue Fan, José Garrido, Sebnem Kalemli-Özcan, Chiara Maggi, Soledad Martinez-Peria, and Nicola Pierri

Insolvency Prospects Among Small and Medium Enterprises in Advanced Economies: Assessment and Policy Options

Prepared by Federico J. Díez, Romain Duval, Jiayue Fan, José Garrido, Sebnem Kalemli-Özcan, Chiara Maggi, Soledad Martinez-Peria, and Nicola Pierri

Authorized for distribution by Gita Gopinath and Rhoda Weeks-Brown

JEL Classification Numbers:	E65, G33, G38
Keywords:	Insolvency, Bankruptcy, "Quasi" Equity Injections, Small- and medium-size enterprises, COVID-19
Authors' E-mail Address:	fdiez@imf.org, rduval@imf.org, jfan@imf.org, jgarrido@imf.org, kalemli@umd.edu, cmaggi@imf.org, mmartinezperia@imf.org, npierri@imf.org

CONTENTS

TABLES

EXECUTIVE SUMMARY

The COVID-19 pandemic has increased insolvency risks, especially among small and medium enterprises (SMEs), which are vastly overrepresented in hard-hit sectors. Without government intervention, even firms that are viable a priori could end up being liquidated—particularly in sectors characterized by labor-intensive technologies, threatening both macroeconomic and social stability.

This staff discussion note assesses the impact of the pandemic on SME insolvency risks and policy options to address them. It quantifies the impact of weaker aggregate demand, changes in sectoral consumption patterns, and lockdowns on firm balance sheets and estimates the impact of a range of policy options, for a large sample of SMEs in (mostly) advanced economies.

Under current IMF projections, the note finds that the share of SMEs with negative equity—one definition of insolvency—may rise by 6 percentage points in 2020–21, threatening up to 1 in 10 SME jobs, or a number of jobs comparable to the total number of unemployed. This increase is similar to that seen in the five years after the global financial crisis, but it would occur over a much shorter period. In a downside scenario with extended lockdowns and persistently weaker demand, the share of insolvent SMEs would rise by 8 percentage points.

Rising SME insolvencies could reduce average banking systems' capital Tier 1 ratios by less than 1 percentage point. However, the fall in capital could be twice as large in hard-hit countries where SMEs are predominant, and a quarter of small banks could experience a drop of at least 3 percentage points. In a downside scenario, average banking systems' capital Tier 1 ratios could decline by an additional one-third to two-thirds relative to the baseline.

"Quasi"equity injections could address rising insolvency risks, conditional on adequate fiscal space, accountability, governance, and the capacity to reach the intended firms. Although technically challenging, these could take several forms, including (junior) "profit participation" loans—through either fresh loans or conversion of existing government loans. Governments may consider providing such quasi equity on generous terms, conditional on private investors injecting equity.

Policy simulations also illustrate the large efficiency gains, in terms of viable SMEs saved per dollar spent, from targeting solvency support—"quasi" equity injections can be over four times more effective if neither those firms that are solvent even with COVID-19, nor those that would also be insolvent even without COVID-19, receive support. Targeting will also contain the fiscal costs that could emerge, particularly if the economic recovery disappointed.

Solvency support should be complemented by an effective set of insolvency and debt restructuring tools, including dedicated out-of-court restructuring mechanisms, hybrid restructuring, and stronger insolvency procedures—including simplified reorganization for smaller firms, to raise the system's capacity. Because liquidations of a priori viable firms may occur even under adequate insolvency procedures, government incentives could be considered to tilt the balance toward restructuring.