A Restart Procedure to Deal with Covid-19[1]

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Governments around the world are assisting firms to deal with the adverse effects of Covid-19. Most forms of government assistance provided so far reduce firms' operating costs. Firms' debts keep accumulating, however, and the resulting debt overhang will be a drag on economic recovery. In this chapter we argue that policies are needed to restructure the debt of a large number of firms throughout the economy. We propose one such policy, which includes an extended bankruptcy stay, followed by a write-down of government claims on a firm conditionally on a comparable write-down agreed by the firm's private creditors. Our procedure makes efficient use of fiscal resources, discourages healthy firms from claiming to be distressed, and can be combined with debt-equity swaps for large firms.

1. Financial distress caused by Covid-19

Covid-19 has generated paralysis in some sectors of the economy. Firms in these sectors face collapsed revenue, while still having to pay for costs such as salaries, rents, and debt service. Not surprisingly, firms are running out of cash. In the United States, firms have cash reserves to last anywhere between three weeks and six months. Restaurants, for example, have less than a month of cash on hand (Didier et al., 2020). Analysis of twelve high- and middle-income economies across Africa, Central Asia, Europe, Latin America, and the Middle East shows that firms could rapidly run out of cash during a continued lockdown. In a hypothetical scenario where firms have no revenues, but where the government fully subsidises wages, the median firm in Colombia, Greece, Italy, Jordan, Kazakhstan, Kenya, Morocco, Peru, Portugal, Russia, Turkey, and Ukraine has retained earnings and other sources of financing to last eight (in retail) to 19 weeks (in other manufacturing). Once reduced export demand is taken into account (Baldwin 2020), the median survival time falls to within eight to 14 weeks (Bosio et al. 2020a).

Governments around the world are searching for ways to abate the sudden economic shock. The International Monetary Fund projects an annual decline in GDP in developing economies for the first time in three decades. Relief policies for firms are being implemented to minimise permanent job losses, expand the social safety net for workers whose jobs are in peril, and keep essential sectors in operation (Baldwin and Tomiura, 2020). As the crisis persists, the costs and complexity of this challenge both rise.

Government assistance allows firms to cover some of their operating costs, and hence slows down the increase in their debt obligations. Debt keeps accumulating, however, and will be a drag on economic recovery. In this chapter we argue that policies are needed to restructure debt across a large number of firms throughout the economy. We propose one such policy, which includes an automatic write-down on government claims in a firm in exchange for write-downs

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by the firm's private creditors. We also discuss the challenges in implementing such a policy in developing economies.

2. The current measures

Government assistance to firms has taken four main forms so far: tax deferrals or cuts, job retention schemes and expanded unemployment protection, speeding payments on government procurement, and loan guarantees. We discuss each in turn.

a. Tax Deferrals or Cuts

Over eighty governments have deferred or waived taxes to provide liquidity for struggling businesses. Norway, for example, has implemented automatic deferral of value-added tax (VAT) and corporate income tax for six months. Benin has extended the submission of the corporate income tax until the autumn. A group of countries have instituted measures that allow for quicker tax refunds, especially for VAT input credits. Niger reimburses excess input VAT refund claims within 30 days and allows excess input VAT credits that have been carried forward from previous periods.

Some countries have implemented cuts to the employer's share of social security contributions. Malaysia exempted employers in all sectors from the Human Resources Development Fund levy for a period of six months effective from April 2020 (Djankov and Nasr 2020).

b. Job retention schemes and expanded unemployment protection.

The United States is providing loans to small firms via banks, which firms will not have to repay if they do not fire their workers during the shutdown. The objective is to cover firms' costs during the shutdown. Broadly similar approaches are being followed in many developing economies, albeit at smaller scale. For example, Senegal covers in part the wages of workers in danger of being laid off and vulnerable workers such as the self-employed (Djankov and Georgieva 2020).

A few developing economies have enhanced unemployment protection. Nepal introduced a contribution-based social security program in the wake of the Covid-19 crisis. The program includes medical, health, accidental and other benefits, and is made available to workers in the formal sector. In Sub-Saharan Africa, three other economies – Cabo Verde, Mauritius, and South Africa – offer expanded unemployment protection. A number of developing economies – for example Benin and some states in India - are contemplating various forms of unemployment-related cash transfers for workers in informal businesses. In places where cash transfer programs are already in place, the same can be topped-up to ensure additional resources reach idled informal workers.

c. Speeding Payments on Government Procurement

Some governments wondering how to expediently put money in the hands of firms struggling in the Covid-19 crisis have found another solution by paying their bills on time. New Zealand's Prime Minister ordered all government agencies to pay their bills to the private sector within ten days of the completion of works or services. The positive effect on liquidity is instantaneous. Barrot and Nanda (2019) show that the Quickpay reform of 2011 in the US that accelerated $70 billion in annual contract value, by cutting from 30 to 15 days the time taken between invoice approval and payment, causally increased employment growth in small business contractors.

The impact of similar reforms in developing countries could be staggering. If developing countries' governments paid all receipts due to their contractors, several hundred billion in fresh liquidity would enter the private sector. Data from the World Bank show that procuring entities take on average 14 weeks (about 100 days) to process the final payment for public works contracts (Bosio et al 2020b). Delays vary broadly across countries, from 48 days in Azerbaijan to 760 days in São Tomé and Príncipe. Only about 28% of countries pay contractors within 45 days from the completion of works. Many companies, their contractors, and employees are struggling without work during the lockdown while waiting for the government to release payments for the work they have already done.

d. Loan Guarantees

Much of the government assistance for firms during Covid-19 is coming in the form of loan guarantees that increase firms' access to credit as a way to loosen liquidity constraints. For example, the Mexican government unveiled a scheme for loan guarantees – equivalent to 3% of GDP – to provide businesses with cash to pay wages and other expenses. Mongolia introduced credit guarantees to small businesses and subsidised loans to cashmere producers amounting to one percent of GDP.

Using loan guarantees makes sense because these can impose much lower fiscal costs than cash transfers (Gonzalez-Uribe and Wang, 2020). However, the concern is that the streamlined guarantees implemented by governments during Covid-19 can increase risk-taking by banks and borrowers, especially since the pandemic arrived against the backdrop of high corporate indebtedness (IMF, 2019). For example, the one-year coverage of lenders' charges by the UK government for the guaranteed loans in Covid-19 will likely increase opportunistic behavior by borrowers. Likewise, the 100% guarantee for most of the UK guaranteed loans in Covid-19, will likely lead banks to distribute cash without worrying about the creditworthiness of borrowers. Another concern is that guarantees can also create new creditors (Mullins and Toro, 2018), which in good times can be good news for firms, but in bad times can make potential restructuring more complicated.

3. Measures Come at a High Fiscal Cost

Government assistance has its limits. Debt burdens are high in many advanced economies, largely due to the fiscal cost of policies in response to the Great Recession, and further debt issuance may be hard to finance, especially when the economy is contracting. Even in countries that have more flexibility to issue debt (e.g., US), the costs of government assistance will ramp up quickly if the shutdown and stringent social distancing measures last for more than 3-4 months. In the US, the first $350bn rescue fund for small businesses ran out of cash in just 12 days.

Fiscal considerations are even more important in developing economies. While governments in some advanced economies can finance their debt at near-zero interest rates, governments in many developing economies face high interest rates. A number of developing countries, such as Somalia, Sudan, and Zimbabwe, were already in arrears to international institutions before the crisis started. Others, such as Ecuador and Lebanon, have defaulted on international debt since the start of the crisis. Sovereign spreads in emerging economies have already widened, indicating that there is likely more trouble ahead for the credibility and solvency of these countries.

Government assistance, in the forms described above, allows firms to cover some of their operating costs, and hence slows down the accumulation of their debt obligations. It does not prevent the accumulation of debt, however, nor does it address the resulting debt overhang. Since, in addition, government assistance cannot continue forever, it is urgent to design policies that can address debt overhang and financial distress throughout the economy.

4. Dealing with Financial Distress

Financial distress is usually addressed through liquidation or through reorganization. Firms that cannot operate profitably, and whose assets can be put to better use elsewhere, are liquidated, and the liquidation proceeds go to creditors according to a pre-specified priority. Firms that can instead operate profitably, and whose assets have greater value inside the firm, seek to reorganize their obligations. A reorganization plan must be agreed with the creditors and involves a reduction in firms' obligations to them. In the U.S., liquidation takes place via procedures specified in Chapter 7 of the bankruptcy code, and reorganization takes place via Chapter 11.

For some firms, the financial distress caused by the Covid-19 crisis must be addressed through liquidation. For example, some airlines will not be able to operate profitably even after the lockdown is lifted because of the reduced demand for travel. The same is true for many restaurants and bars because of social distancing. For the majority of the firms in the economy, however, the financial distress caused by Covid-19 should be addressed through reorganization. Indeed, since most economic activity will resume after the pandemic subsides, the crisis for the majority of the firms is primarily a negative shock to their current revenue. The firms' future revenue may be affected, but less so.

The challenge in addressing the Covid-19 financial distress is two-fold. First, distress is occurring throughout the economy at a massive scale, which can lead to bottlenecks in court-supervised bankruptcy procedures. Second, Chapter 11-type procedures are complex and typically accessible in practice only by the largest firms. Increased uncertainty about firms' prospects further complicates reorganization during Covid-19, as it is hard to value a firm with highly uncertain cash flows.

Chapter 11-type procedures are complex because they involve the preparation and the assessment of a reorganization plan. Firm managers must prepare a plan to return the firm to profitability. They must then negotiate the plan with multiple creditors in a short period of time and have it approved by a judge. Formulating such a reorganization plan is challenging and time-consuming. Firm managers often turn to specialized professionals who have expertise in drafting reorganization plans. However, this approach is expensive, making reorganization procedures accessible to only a small number of debtors, typically the largest firms. In 2016, for example, Kenya introduced reorganization procedures for companies as an alternative to the previously available involuntary winding-up. Four years on, companies and legal professionals are still learning how to use the new procedure.

Because of the complexities of reorganization, liquidation is the main method used to deal with financial distress. Many developing economies do not have reorganization procedures in their bankruptcy laws. In other developing economies, bankruptcy laws trigger foreclosure or receivership procedures after just weeks of illiquidity. These include a diverse range of countries from Albania to Zambia (Djankov et al. 2008).

The cost of reorganization procedures can substantially be lowered if alternative dispute resolution (ADR) could be used. This option may be tempting for businesses with few creditors. Still, the normal ADR process requires intensive face-to-face negotiation. Presumably the process can be adjusted to benefit from online technology. However, as thousands of businesses will be undergoing the process simultaneously, countries will quickly run short of mediators. Some measure of automaticity is required.

Our proposed restart procedure is a Chapter 11-type one as it involves a write-down of firms' obligations. It strips away some of the complexity of Chapter 11 by making the write-down of government claims automatic and conditional on the write-down of creditors' claims, thus incentivizing creditors' write-downs to start with. Automaticity is important given the massive scale of debt restructuring that is needed throughout the economy. Conditionality is important to avoid opportunistic behavior.

5. A restart procedure

Our proposed restart procedure consists of two steps: (a) an extended bankruptcy stay for firms, and (b) a negotiated write-down of firms' obligations to their private creditors, incentivized by a write-down on government claims. We describe and motivate each of these steps in turn.

a. Bankruptcy Stay

Firms that are unable to cover their obligations can elect to enter into an extended bankruptcy stay. A bankruptcy stay allows the firms to operate and protects them against asset seizures or judicial actions by their creditors.

Bankruptcy stay is a feature of bankruptcy systems in many countries, as part of their Chapter 11-type procedures. It typically lasts for a few weeks or months. In some countries, firms are required to make tax and social security payments corresponding to a small fraction of their obligations during a stay.

Our restart procedure is a Chapter 11-type one, and as such includes a bankruptcy stay. We propose that the bankruptcy stay is for a period of about a year, so longer than the typical one. This is because of the large uncertainty that is involved. In fact, some countries that allow for bankruptcy stay – for example, France, Germany and Spain among advanced economies; Russia and Turkey among emerging markets - have extended the stay to a year.[2] Some countries do not have bankruptcy stay. We propose that they introduce one as an emergency measure, for a comparably long period of time.

b. Write-Down

The bankruptcy stay must be followed by a write-down of the firms' obligations, to their creditors, landlords, suppliers, etc. Such a write-down should have some automatic features that use the claims that the government holds in firms to facilitate concessions by firms' other claimholders.

The claims that the government holds in firms include unpaid taxes and social security contributions, as well as loans made by government entities. In many countries, for example Canada, Indonesia and the 17 African economies in the OHADA initiative, these claims are senior to those of other claimholders, i.e., the government must be paid first, before everyone else. We propose that the seniority structure is made more symmetric, and in particular that reductions to private claims are accompanied by reductions to claims by the government. Private claimholders will be more willing to write down their claims if they know that such write-downs will be accompanied automatically by a write-down of government claims.

The write-down of government claims to firms has obviously a fiscal cost. That cost is countered by two benefits. First, because the claims are smaller, firms' financial viability improves. This benefit is comparable to the benefits that current government assistance confers, and imposes a lower upfront cost for governments than cash transfers. Second, there is a multiplier effect because private claims to firms also become smaller. The multiplier effect is the key advantage of the restart procedure.

c. *Other issues*

To further counter the fiscal cost, debt-to-equity swaps for larger firms could also be considered, whereby the government turns its debt-like claims into equity-like claims, and allows the taxpayers to share in the upside following the recovery. For smaller firms, debt-to-equity swaps are less relevant.[3]

If the government does end up owning equity in many companies, issues arise with respect to governance and eventual sale of such equity positions. The government should have limited corporate governance rights as shareholder. The assets could be centrally managed through an

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[2] Other countries have suspended particular sections of the insolvency law. In Colombia, for example, three provisions that trigger insolvency are suspended for 24 months: (i) imminent inability to pay for insolvency proceedings; (ii) new judicial liquidation processes by adjudication; and (iii) the cause of dissolution by losses. Furthermore, the obligation to report the cessation of payments is suspended until December 31, 2020 whenever such cessation is triggered by the Covid-19 crisis.

[3] Government loans to distressed firms sometimes have features that allow debt to be converted to equity. For example, in providing assistance to large firms, Canada requires warrants with the option to purchase common shares totaling 15 percent of the principal amount being lent to the firm, in addition to interest payments. Hanson and others (2020) also propose equity-like instruments be provided to U.S. firms.

asset management company (AMC) that is independent of the public agencies in charge of loan guarantees, to avoid incentive conflicts that can arise from these agencies' exposed balance sheets. Historical cases of management and governance structures that facilitate this exist (e.g. Dyck 1997; Calomiris, Klingebiel, and Laeven 2012).

The restart procedure should be designed to counter adverse incentive effects. The conditional government write-down mitigates the opportunistic use of the procedure by healthy firms to reduce debts that they can service. Borrowers will anticipate that private creditors would not agree to write down their claims if they know that the firms can service them, even if such a write-down is accompanied by a write-down of government claims. Hence, our proposed procedure has built-in disincentives against abuse.[4]

A generalized write down of claims could have knock-on effects throughout the economy, and especially in the financial sector, which holds many of the debt claims. To somewhat counter these effects, the restart procedure could be used in conjunction with some form of government assistance towards banks, especially if the assistance is tied to banks' collaboration in the debt write-downs.[5]

Finally, there may be some desire to prioritize specific sectors, however, this should be done with caution. There are risks to having the government select industries for support, including the risk for corruption and misallocation. It may be difficult to prioritize industries according to specific criteria that reflect the impact of the crisis and shifting consumption patterns on their revenues, the specificity of their labor and capital, and their centrality in production networks. There are advantages to having simpler procedures that require less detailed information, if they are to be applied broadly to a large number of firms.

Even though the restart procedure has some automaticity built in, it is still a Chapter 11-type procedure and as such it involves a reorganization plan. User support should be considered especially in places where the expertise in drafting renegotiation plans is lacking, either because reorganization procedures are unavailable or are not commonly used. This support can be especially important for small businesses, which can be less savvy than large firms in navigating the bail-out bureaucracy (Granja and others 2020). In the US, the Small Business Reorganization Act (SBRA) was recently introduced to afford small firms a less administratively burdensome alternative to the traditional Chapter 11 procedure.

Importantly, government assistance to firms in developing economies is more difficult because of the large share of informality. Informality is sizable in emerging markets and developing economies, accounting for between 13 per cent of employment in Mongolia and 98 percent in

[4] Conditionality may not eliminate ex-ante incentive effects on borrowers and creditors (for example, Agrawal, Gonzalez-Uribe and Martinez-Correa, 2020). For example, banks may offer solvent firms less credit and at a higher cost, if they worry that the possibility of write-downs will exacerbate opportunistic behavior by borrowers before they file for the restart procedure. Likewise, the restart procedure can affect creditor coordination, and through this channel impact the cost of debt for solvent firms (Rodano, Serrano-Velarde and Tarantino, 2016).

[5] This could potentially take the form of either central bank refinancing or providing flexibility on accounting for the impact of Covid-related loan losses on regulatory capital.

Honduras and Mali.[6] Governments cannot use the tax system or the banking sector to finance informal firms. In countries with a preponderance of informal businesses, the restart scheme we describe in this section will work only for the formal sector.

6. Conclusions

Developing economies are experiencing significant disruptions to their economies due to the pandemic. The projected economic decline is highest in Eastern Europe and Latin America, though the latest figures from Africa paint an even more difficult picture due to limited fiscal space and inability to reach large parts of the population with crisis response measures.

The health crisis is still the primary focus, yet governments are turning to international institutions for assistance on restarting the economy. A major part of this restart will be ensuring that the business sector can stand on its feet. This process will take time, will be different across sectors, and will likely necessitate an innovative procedure over and above standard insolvency procedures. The proposal here is a step in this direction.

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[6] The data are from the World Bank's JOIN survey, which provides analysis on social protection for workers.

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