Covid-19 and SME ABS: liquidity crunch or fundamental decline?

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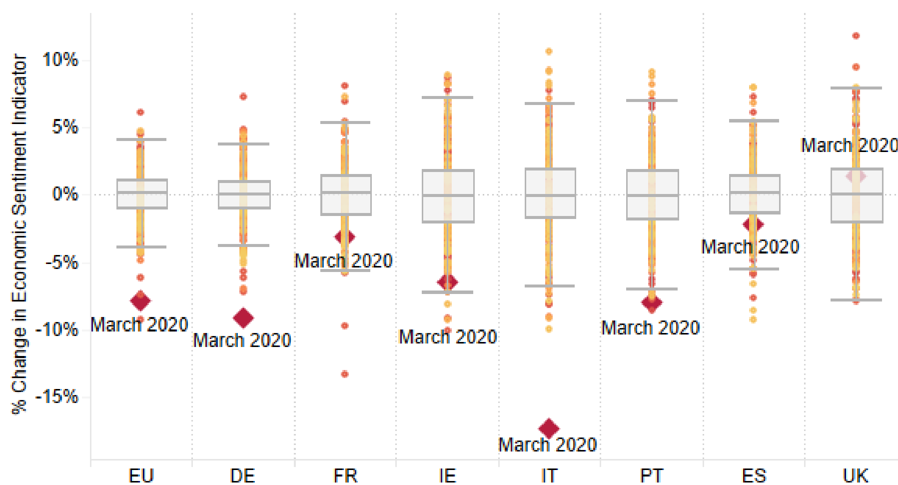
Covid-19 is likely to lead to the sharpest global recession in modern history, as businesses struggle to cope with prolonged lockdowns and consequent drops in economic activity. Given the uncertainties, any credit impact on SME ABS will be conditional on the duration of shutdowns and the efficacy of fiscal and monetary measures in providing businesses with a cushion against financial distress.

Executive Summary

Unlike the Global Financial Crisis (GFC) of 2008-2009, the COVID-19 crisis arises from an exogenous shock to the real economy, leading to some of the sharpest declines in business sentiment across Europe (**Figure 1**). The twin blow to both the supply and demand side will likely result in significant economic contraction, accompanied by a severe increase in corporate and individual defaults.

Figure 1: Economic sentiment declines across Europe among the sharpest ever[1]



Source: European Commission, Scope Ratings.

However, measures taken by State, national and supranational authorities should ensure that the liquidity transmission functions of the financial sector are maintained, and that funds are delivered to otherwise healthy businesses in a timely manner. We also believe that European banks are better capitalised to face this crisis than the last one, which, together with the liquidity support on offer, should help the sector nurse the real economy back to health. Moreover, if China recovers from the pandemic before the rest of the world, the globalised nature of trade may cause its recovery to ripple through to Europe, as market participants have the incentives to safeguard productive, long-term relationships.

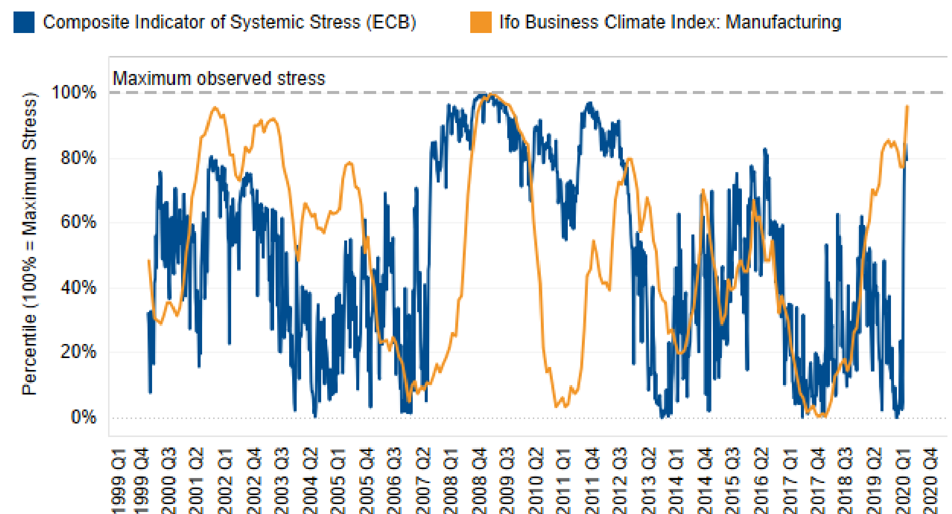
In this report, we map the current situation relative to past periods of financial distress and provide an overview of the evolution of corporate defaults during such downturns. Our analysis shows that contractions similar in magnitude to Scope's latest forecasts of between a 6-16% drop in Eurozone's real GDP have led to near doubling in bankruptcies in the past. We discuss how this impacts our forward-looking view for SME ABS, which, given the uncertainty, is conditional on the duration of ongoing shutdowns and the effectiveness of fiscal and monetary measures.

[1] This box plot illustrates the distribution of month-over-month change in European Commission's Economic Sentiment Indicator for eight jurisdictions between 1990 and 2020.

Provenance matters: Covid-19 not a credit event

While some have drawn parallels between the ongoing crisis and the GFC, it is important to note that by contrast with the GFC, the Covid-19 crisis did not originate from a financial event. In fact, at the outset, European banks were well capitalised to absorb financial shocks[2]. This is not to say that the current crisis is less significant in its scope than the prior one, however. As measured by the ECB's Composite Indicator of Systemic Stress, financial conditions have deteriorated sharply and materially in the euro area (see **Figure 2**).

Figure 2: Deterioration of financial conditions arise from a shock to real economy



Source: European Central Bank, Haver Analytics, Scope Ratings.

Drop in business confidence highlights dislocations in real economy

This time the problems originate from an exogenous drop in return on factors of production, rather than structural supply or demand issues. Prolonged and forced shutdowns have led to elevated liquidity and solvency risks for most companies, irrespective of their ex ante financial position. This is an important detail for two reasons:

1. To clearly identify the most susceptible businesses. Those worst affected by forced shutdowns include consumer-driven and labour-intensive sectors, like manufacturing in Germany, which employs 17% of the country's labour force[3] and which in March 2020 saw its worst business climate since the GFC, ahead of significant deterioration in financial conditions (see **Figure 2**).
2. It is crucial to trace the fiscal costs of the crisis back to the containment of the SARS-Cov-2 virus, which may help alleviate political or social resistance and any hesitancy to act now. This is important, as politically inexpensive monetary responses to this crisis in the real economy can treat the symptoms, not necessarily the cause.

Another key difference between now and 2008-2009 is that today, the world is significantly more connected. The OECD reports that foreign countries' value-added in euro area exports grew by 20% between 2007-2015, from USD 384bn to USD 462bn[4]. Much of this value is added within the confines of the European Union. For instance, 50% of foreign value-added in German exports was from countries within the EU. At the other end of the value chain, a significant share of final demand for manufactured goods is more international, especially within Europe, where free movement of goods has allowed

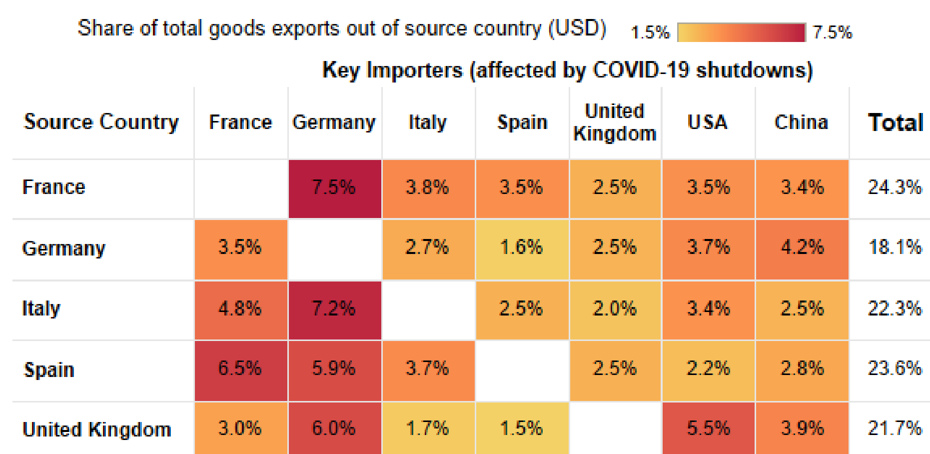
[2] Covid-19 impacts on European banks: pre-existing financial health condition matters, Scope Ratings.
[3] EUROSTAT.
[4] Trade in Value Added (TiVA) Database 2018, OECD.

large volumes of cross-border trade. This adds a dimension of risk from disruption to such complex value chains to which there are no historic parallels.

Countries in later stages of the pandemic could support global recovery

However, this may also be a source of resilience through the crisis. For instance, as shown in **Figure 3**, Germany is an important European link to global trading networks, which generates significant demand for French, Spanish and Italian goods, and exports a significant volume of goods to China. While the German consumer will be the most important domestic driver of Germany's economic recovery, it is important to note that the country relies significantly on its exports to China, where the pandemic is in a more advanced stage. As manufacturers in China come back online and Chinese demand leads a global recovery, exporters and consumers in Germany and then those in the rest of Europe's economic engine may see a quicker recovery than they would otherwise. In that sense, globalisation may yet offer a benefit from geographic diversification against a global pandemic.

Figure 3: Recovery of international goods trade may be key to broader recovery



Share of total goods exports out of source country (USD) 1.5% 7.5%

Source Country	Key Importers (affected by COVID-19 shutdowns)							Total
	France	Germany	Italy	Spain	United Kingdom	USA	China	
France		7.5%	3.8%	3.5%	2.5%	3.5%	3.4%	24.3%
Germany	3.5%		2.7%	1.6%	2.5%	3.7%	4.2%	18.1%
Italy	4.8%	7.2%		2.5%	2.0%	3.4%	2.5%	22.3%
Spain	6.5%	5.9%	3.7%		2.5%	2.2%	2.8%	23.6%
United Kingdom	3.0%	6.0%	1.7%	1.5%		5.5%	3.9%	21.7%

Source: UN Comtrade Database (2018), Scope Ratings.

Businesses display unparalleled pessimism

The here and now – pessimism

Germany and Italy see sharpest drop in economic sentiment in three decades

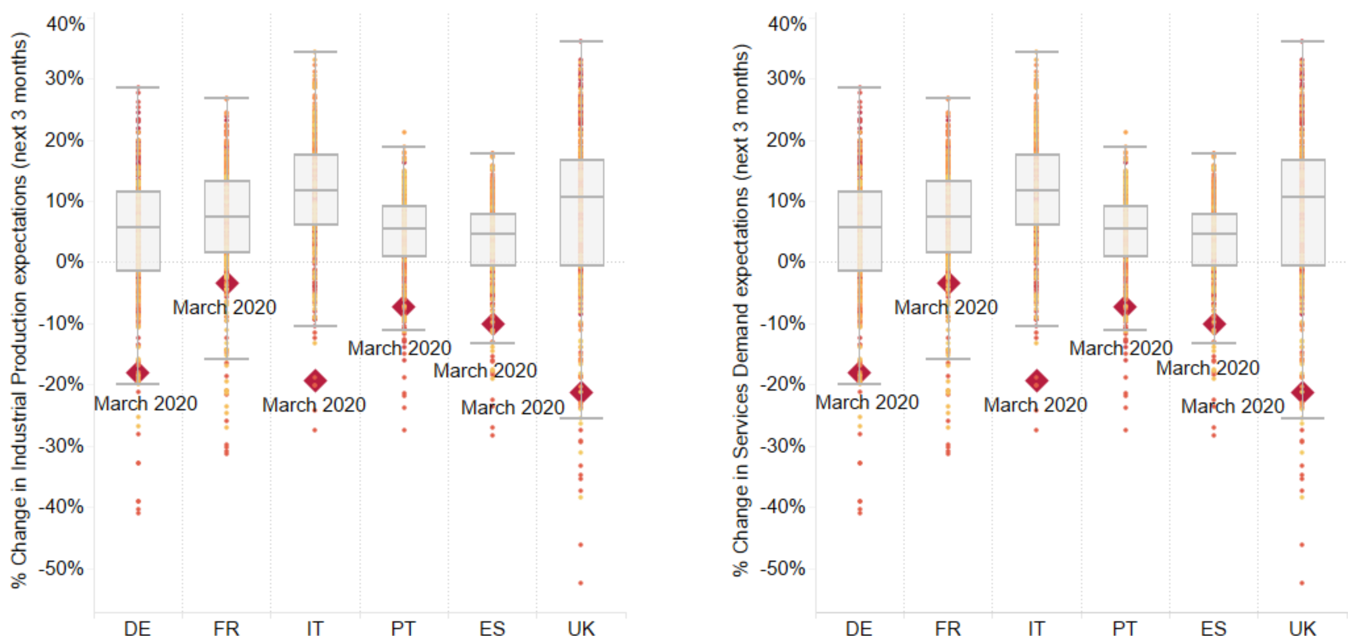
As of month-end March, data from Eurostat paints a bleak picture across all major sectors and countries in Europe. Business and economic sentiment has experienced its biggest month-over-month declines in Germany and Italy in 30 years – larger than any recorded single-month drop during the GFC and the euro area sovereign debt crisis (see **Figure 1**). Germany witnessed its biggest monthly drop in confidence in the construction, industrial, service and retail sectors. The same for Italy in its industrial and service sectors, as well as for its consumers. The data is very clear that the initial impact has been indiscriminate towards any sector or region in Europe, and that the psychological impact on industry decision-makers is acute.

Three months into the future – pessimism

When we peek ahead three months the outlook is equally grim, based on Eurostat expectation survey data. Demand and price expectations have both seen near record month-over-month drops. Arguably more worrying are the record drops in employment expectations across industries and geographies. Unemployment is a more complicated, fundamental problem to work out from a policy perspective, when compared to demand and pricing deterioration – not to mention more prolonged. Historically, unemployment levels are in step with the performance of SMEs, so a realisation of expectations is a troubling prospect.

Here again, impacts in Germany and Italy are pronounced, with industrial production expectations rapidly moving closer to all-time lows, and the month-over-month rate of change easily surpassing any change on record since 2000. Pessimism also prevails in the services sector, with demand expectations closing in on records lows for Germany, Ireland and Italy. The employment outlook for services in Ireland and Italy also experienced its largest month-over-month drops going back to 2000, while Italy in particular is inching closer to an all-time low employment expectation for the services sector.

Figure 4: Severe decline in industrial production and services demand expectations for the next three months



Source: Haver Analytics, Scope Ratings.

The future and beyond – an impossible moving target

However, attempts at predicting the business outlook for SMEs beyond the near-term are futile, given the uncertainties around solutions for a vaccination, symptom mitigation, virus testing, and population immunity; as well the sustainability of policy responses. A widespread vaccine is likely not a reality until early 2021, and the fiscal measures taken thus far cannot sustain economies for years to come. By most accounts, the current short-term economic shock is a manageable liquidity crisis, albeit sharp and deep. Anything beyond that raises more fundamental questions. Governments will have to strike a delicate balance between maintaining the health of their economic drivers – SMEs – and the health of the irreplaceable inputs to those SMEs – people.

European and national responses to the crisis

Governments pull out all the stops with large relief packages

Indeed, in an acknowledgement of this trade-off, governments across the world have taken unprecedented steps to contain the economic fallout from the Covid-19 pandemic. France, Germany and Italy have announced the largest public loan guarantee programmes for businesses (relative to their GDP), with notional caps at 12%, 18% and 20% of annual GDP, respectively. Smaller economies like Portugal have unveiled programmes to the tune of several billion euros. Most notably, the scale of some of these initiatives already exceeds the sum total of those implemented during the entirety of the GFC.

At the European level, both the European Commission and the ECB have responded in due measure, adopting extraordinary programmes such as the temporary framework for State aid and the EUR 750bn Pandemic Emergency Purchase Programme (PEPP), with the central bank further stressing that it remains ready to use other tools at its disposal. Under the European Stability Mechanism (ESM), EUR 240bn in credit lines have also been made available for especially hard-hit periphery economies, even as controversial "coronabond" proposals face obstacles. For more details on these national and European initiatives, please refer to Scope's Q2 2020 Sovereign Update.

The nature of the crisis requires a European response

Across Europe, as in the rest of the world, there is a broad spectrum of counter-measures, ranging from localised solutions aimed at supporting the worst affected small and medium-sized enterprises, to whatever-it-takes supranational/federal programmes aimed at supplying much-needed liquidity to the broader corporate sector and the financial system supporting it. The scale of this crisis may warrant both, but as illustrated by the pandemic, the inherent inter-connectedness of Europe warrants a coherent and co-ordinated European response.

European banks to deliver the cure, but with a tinge of bitterness

European banks are expected to play an important role in mitigating the economic effects of the crisis[5] and delivery of the programmes described above, as opposed to having been perceived as a problem as was the case in 2008. For context, European banks are better capitalised than their US counterparts and play a much more important role in financing their domestic non-financial private sector. Data from the Bank for International Settlements (BIS) shows that as of 2018, bank debt to the non-financial private sector stood at 89% of GDP in the euro area, as opposed to 51% in the US, even as non-financial sectors in both jurisdictions are similarly leveraged relative to GDP.

Bankers may finally rid of zombie firms

However, the depth of the crisis also means that banks will be forced to trim some fat, potentially with positive long-term effects. Consider zombie firms – companies that would either restructure or exit in competitive markets – for instance, which have plagued the European financial system for years, forming a part of the productivity puzzle. An ECB working paper[6] found credit lines to these firms to be more likely to be from banks that were weak themselves.

Depending on the implementation of State loan guarantees, i.e. refinancing possibilities for such firms in this hostile environment, the current crisis could lead to a clean-up of such accounts. At the risk of being cautiously optimistic at such desperate times: if the congestion theory[6] holds, this may ultimately lead to a de-crowding of credit pathways to the benefit of healthier firms with viable business models.

Scope's outlook for European SME ABS

A range of scenarios remain possible

Scope forecasts a recession leading to a rise in defaults

As for all asset classes, a severe economic downturn is expected to have significant impact on structured finance instruments, especially non-performing loan securitisations, as discussed in a recent publication by Scope. For securitisations of performing credit, particularly SME ABS, a potential wave of bankruptcies remains a key downside risk. The pace as well as the extent of such a phenomenon depends on the as-yet uncertain impact of fiscal and monetary measures. Regardless, as highlighted in previous sections, there are several other factors, starting from the extent to which economic activity will have receded due to the events of past weeks.

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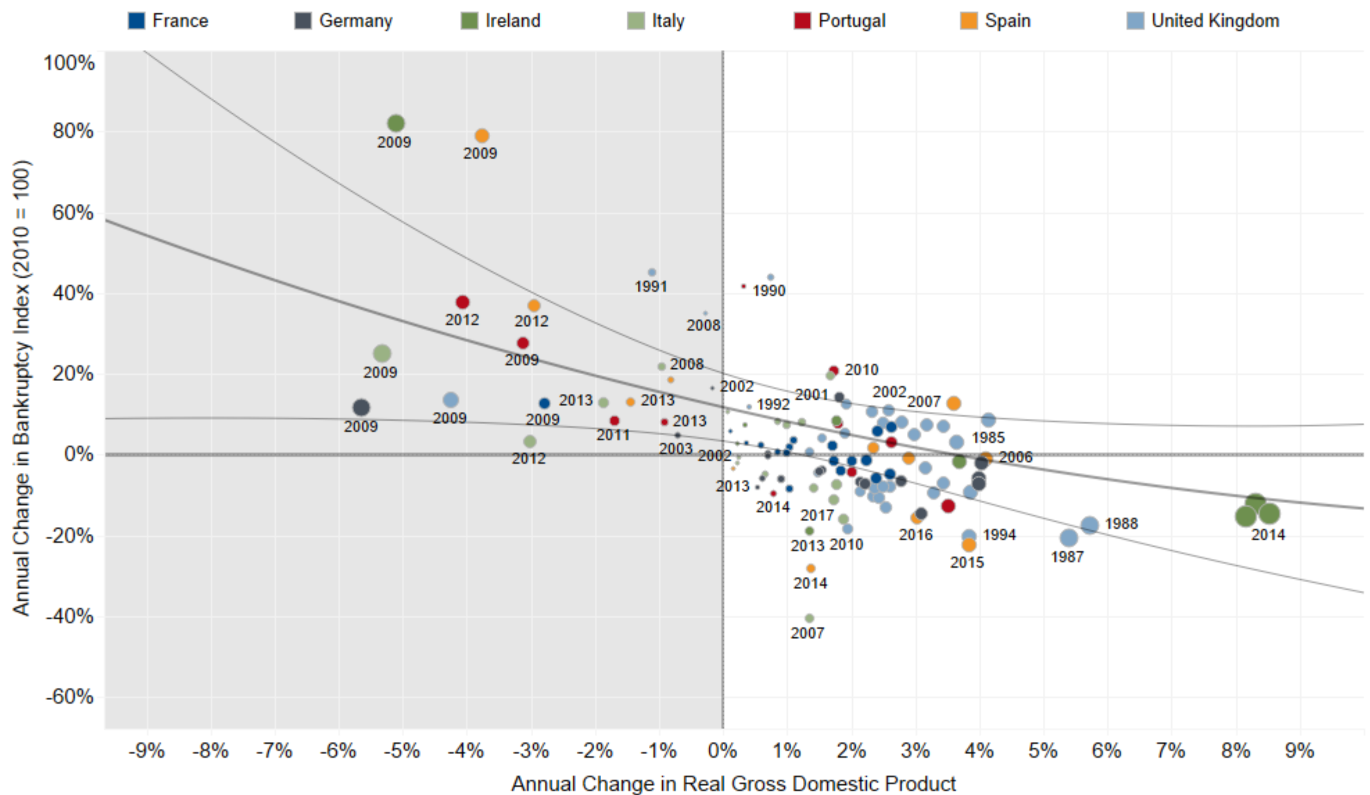
[5] Covid-19 economic crisis: banks emerge as part of policy solution, Scope Ratings.
[6] Andrews and Petroulakis (2019), Breaking the shackles: Zombie firms, weak banks and depressed restructuring in Europe, ECB Working Papers (No 2240).

Figure 5: Relationship between real GDP growth rate and annual change in new bankruptcy filings[7]



Source: National Government Sources, Haver Analytics, Scope Ratings.

In previous recessions, defaults have risen by up to 80%

Scope currently forecasts between a 6% (baseline) to 16% (prolonged recession) drop in euro area real GDP in 2020[8]. Historically, crises of such magnitude have led to up to an 80% rise in bankruptcies. However, as shown in **Figure 5**, there has been significant divergence between jurisdictions. Large, diversified and less volatile European economies including France, Germany and the United Kingdom saw new filings jump by a maximum of around 12%-13%, with the exception of the currency crisis in the UK in early 1990s, which saw bankruptcies go up by more than 40%.

At the other end of the spectrum, more volatile economies like Ireland and Spain saw insolvencies go up by more than 80% during the GFC. Scope believes that the current uncertainty as well as a broad range of outcomes in historical data warrants caution and is best addressed by factoring in a range of scenarios in our default-rate assumptions. It is also important to note that we factor in scenarios relative to the current level, so as to incorporate our pre-crisis view on the credit cycle.

Baseline scenario

In our baseline scenario, we assume a slowing of the pandemic by the end of Q2 2020 in Europe and US, followed by a gradual withdrawal of containment measures. In this scenario, the approach in Europe would echo 'the hammer and the dance' tactic adopted by Chinese authorities, accompanied by a phased pivot from antigen (diagnostic) to antibody (immunity) tests for SARS-CoV-2 as proposed in France and Germany[9] – which will allow segments of the population to go back to work.

[7] Data for 'United Kingdom' is compiled by the UK's Insolvency Service for England and Wales.
[8] Q2 2020 Sovereign Update, Scope Ratings.
[9] Antibody tests key to end lockdown, France 24.

Even if activity picks up by Q2 2020, defaults to rise by 10%-25%

However, even with such measures in place, the euro area economy will shrink by 6%[8], and we expect a significant rise in defaults, ranging from 10% to 25% across jurisdictions. We expect the effects to be more severe in historically volatile and structurally weaker economies, like Spain and Ireland, based on the historical increase in bankruptcies given economic contractions of similar scale. The downside is expected to be driven by a sudden drop in corporate revenues, as well as the risk of being cut off by banks.

It is also important to note that this scenario assumes that the European and national programmes injecting unprecedented amounts of liquidity into the system and supporting the solvency of enterprises will allow banks to maintain long-term relationships with stable and profitable businesses and avoid the distortionary elimination of viable business models due to a prolonged liquidity crunch. Depending on where beneficiaries lie across the cross-section of European firms in terms of their size and sector of activity, the impact could vary dramatically. For instance, the ECB's public market purchase programmes will not directly supply liquidity to European SMEs, less than 1% of which reported using debt securities for financing in the central bank's latest Survey on the Access to Finance of Enterprises (SAFE).

Highly stressed scenario

The scenario described above is subject to several downside risks, which include:

1. Extension of containment measures, leading to more permanent business closures;
2. A more pronounced recession in the United States;
3. Inadequate or inefficient implementation of government relief packages; or
4. Re-emergence of an epidemic in China.

During the great depression, default rates tripled

If one or several of these events were to occur, we expect especially severe depressions in the euro area periphery. The only reference point for such an extreme scenario would be the Great Depression, even though it was primarily a credit crisis and the systemic backstops were vastly inferior at the time. At the peak of that crisis, global default rates reached more than 200% of the global unconditional average[10], while the corporate bond market saw defaults rise by 300%[11].

In Scope's highly stressed scenario, defaults may double

While bond markets at the time were not as deep and diversified as today, in our view, bankruptcies may yet rise by up to 100% if the risks listed above were to materialise. However, just as the baseline scenario, the impact of such a deep shock would vary by the sector of activity and the size of companies, where large companies in sectors benefiting directly from monetary or fiscal programmes would likely experience lower stress.

It is crucial to note, however, that such a climate would mark uncharted waters for the European corporate sector, and historical analyses may only serve as loose guidelines – in the best case.

[10] See Chapter V, "Historical Statistics of the United States, Colonial Times to 1970" for business failure rates dating back to 1901.
[11] Giesecke et al. (2010), Corporate bond default risk: A 150-year perspective, Journal of Financial Economics, 2011, Vol. 102.

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