The vulnerabilities of corporate debt in the face of a historic shock

- **The paralysis of economic activity will lead to a fall in global GDP not seen since 1930. Are there latent financial fragilities that could amplify this decline?**
- **In a more demanding financial environment, the high levels of debt will be put to the test, its quality will deteriorate and mechanisms that amplify economic stress could be activated due to the interconnections that exist between different assets.**
- **In the face of these risks, economic policy has reacted quickly and decisively, especially on the part of the central banks, which may still need to redouble their efforts.**

The impact of the COVID-19 outbreak on the economy is one of historic proportions and the IMF has predicted that the fall in GDP growth this year will be the biggest recorded since the Great Depression. Whilst – unlike the recession of 2008 – excessive risk-taking and a credit boom are not the cause of this crisis, the paralysis of economic activity will put stress on many companies' financial health. Furthermore, the market turmoil (with historic falls in the stock markets) and the widespread tightening of financial conditions could activate latent vulnerabilities that may amplify the initial shock. In this environment, how will the COVID-19 outbreak affect corporate balance sheets? Which financial vulnerabilities should we be concerned about? And what protection does the response from economic policy offer?

The COVID-19 economic crisis is affecting firms' liquidity in particular, but their solvency could also suffer

The paralysis of economic activity is reducing many businesses' ability to generate income. However, firms' costs have not reduced by the same amount, since some of them are not directly linked to production, which leads to short-term liquidity problems. This is illustrated by the 25% and 20% reductions in the 2020 business profit expectations of the Eurostoxx 600 and the S&P 500, respectively. In addition, the COVID-19 outbreak has led to a widespread tightening of financial conditions, which could hinder firms' access to their sources of liquidity. As we can see in the second chart, firms' ability to access liquidity in the wholesale markets has been somewhat mixed: in March, higher-grade debt issues were the highest since 2019, whilst the lower-grade debt market dried up. For this reason, many of the measures offered by the various advanced economy governments have been aimed at providing companies with liquidity (for instance, with public credit lines and guarantees or tax payment deferrals) and **ensuring that those which were solvent prior to the economy's stagnation remain so when it is reactivated**.

However, the change of environment could also affect some companies' solvency in the medium term. Despite the central banks' efforts to maintain an accommodative environment, the cost of financing for the most vulnerable companies is likely to increase, which will put even more strain on their balance sheets. There are also significant differences between sectors. Most notably, all the indicators suggest that the normalisation of economic activity will be more gradual in sectors such as leisure and tourism. The energy sector is also suffering heavily due to the collapse in the oil price.

US: financial conditions
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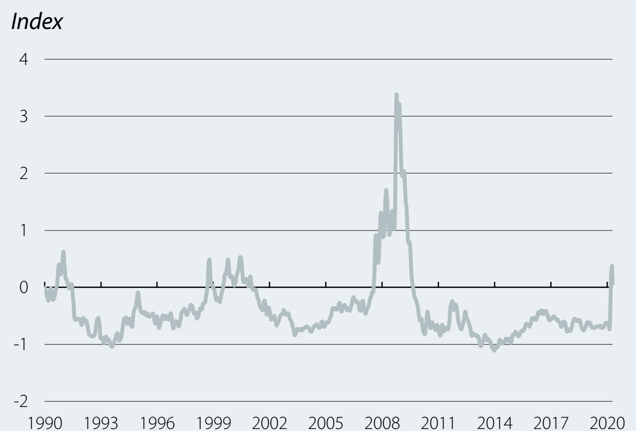
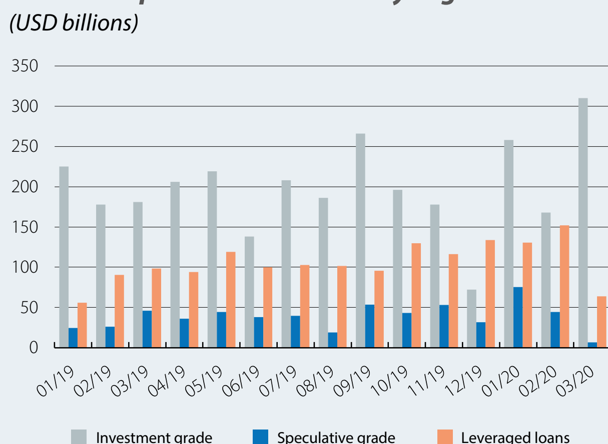


Source: *CaixaBank Research, based on data from the Federal Reserve Bank of Chicago.*

World: corporate debt issues by segment
(USD billions)



Source: *CaixaBank Research, based on data from the IMF.*

The vulnerabilities of corporate debt: quantity, quality and interconnections

These liquidity and solvency difficulties could once again expose the various vulnerabilities that exist in non-financial corporate debt. On the one hand, **the amount of corporate debt is at historically high levels**. According to data from the BIS, corporate debt in the US stands at an all-time high of 75% of GDP, while in the euro area it stands at 107%, slightly below its all-time peak of 111%.

The quality of this debt in some segments is also a source of concern. One of the main vulnerabilities is the risk of so-called fallen angels – companies whose debt, while currently rated as investment grade, could be slashed to high yield with only a small reduction in their credit rating. Given that many funds have limits on the level of high-yield assets they can hold in their portfolio, when an angel falls, this usually triggers fire sales, which drive the price down even further. In addition, this situation increases the supply of assets of this segment and increases the cost of financing and refinancing, both for the fallen angels themselves and for all other companies with high-yield debt. In the third chart we can see the volume of corporate debt in Europe and the US that is currently at risk of becoming a fallen angel (i.e. debt currently lying on the bottom rungs of investment grade, namely BBB and BBB–/Baa2 and Baa3). The magnitude of the potential new fallen angels is particularly worrying given that, in past episodes of financial stress, between 2% and 4% of the total investment-grade debt was downgraded to high yield. At current levels, this would amount to 160 billion euros in Europe and 230 billion dollars in the US. However, today this fraction could be even bigger, because there is a higher concentration of debt in the lower rungs of investment grade.

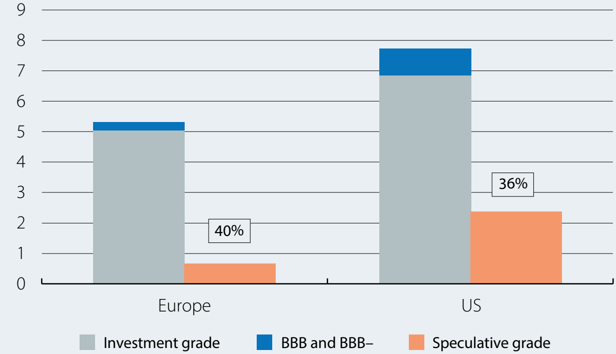
Another vulnerability related to the quality of corporate debt lies in new lending to highly-indebted companies (known as leveraged loans). This type of credit accounts for some 1.2 trillion dollars in the US and around 0.2 trillion euros in the EU (or approximately 8% of all corporate debt in advanced economies).[1] The primary risk related to this segment of corporate debt is that, in situations of financial stress, it tends to suffer more cases of rating downgrades, forced deleveraging and higher defaults. So far, the drop in the price of these assets has been approximately half that registered during the Great Recession (see fourth chart).

Most of this debt lies on the balance sheet of the banking sector, but the fifth chart shows how a not so insignificant portion lies in the hands of less capitalised financial institutions or is packaged into collateralised loan

1. Financial Stability Board (2019). «Vulnerabilities Associated with Leveraged Loans and Collateralised Loan Obligations».

Europe and the US: corporate debt

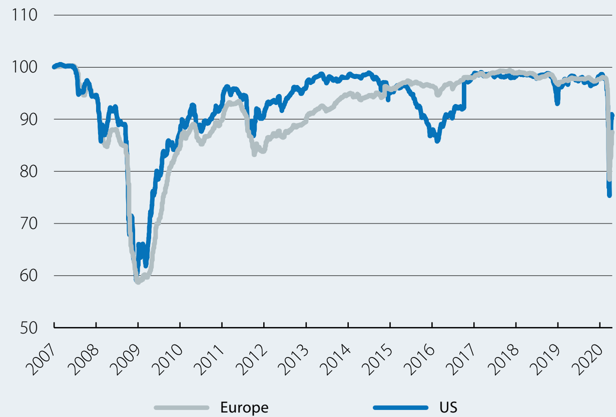
(EUR and USD trillions)



Note: *In the boxes we show the percentage of debt with a rating of BBB or BBB- relative to the total market for speculative grade debt.*
Source: *CaixaBank Research, based on data from Bloomberg.*

Europe and the US: price of leveraged loans

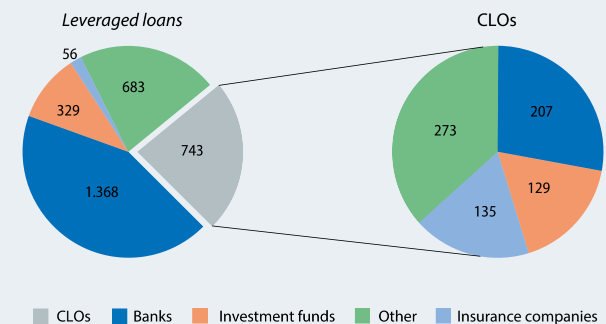
Index (100 = January 2017)



Source: *CaixaBank Research, based on data from Bloomberg.*

Holders of leveraged loans and CLOs

(USD billions)



Source: *CaixaBank Research, based on data from the Financial Stability Board.*

obligations (CLOs), which are made up of sets of other assets with differing levels of risk (public debt, high-rating corporate debt, leveraged loans and even equities). This process involving the securitisation of leveraged loans generates a complex system of interconnections in the financial system (between the

originators of each underlying asset, the originators of each CLO, buyers of CLOs, etc.). In this regard, the poor quality of the underlying assets that comprise CLOs is of particular concern (the vast majority are below investment grade), as is the significant growth of the CLO market in the last decade (it has more than doubled). However, there are technical elements which make CLOs less sensitive to changes in market sentiment than other instruments which amplified episodes of financial turbulence in the past.[2] In addition, as a whole, the market for securitised assets is barely half the size that it reached in the quarters leading up to the financial crisis of 2008.

The response from economic policy is on the right path, but is it enough?

In order to ensure that these risk elements do not to become amplifiers of the shock, **it is important that the corporate sector continues to have favourable access to stable sources of financing**. Both governments and the major central banks have taken action in this regard, although the scope of the measures differs between regions. As an example, the direct fiscal measures announced in the US and Germany[3] represent 8.6% and 4.8% of GDP, respectively, while in economies with less fiscal space, such as Italy or Spain, the bulk of the stimulus has focused on aspects such as public guarantees. In the US, the Fed and the Treasury have also coordinated to facilitate the flow of credit and the proper functioning of the markets.[4]

The central banks, meanwhile, have taken a particularly aggressive stance in order to contain financial stress, ensure the proper functioning of the markets and guarantee that credit continues to flow in favourable conditions.[5] As for corporate debt, the programmes announced to date could lead to the ECB and the Fed acquiring around 2% and 7%[6] of the corporate debt that exists in their respective markets during 2020. Moreover, both the Fed and the ECB have helped to ease tensions in the market of fallen angels by announcing that they will accept debt that was investment grade at the beginning of the health crisis as collateral, even if it falls to speculative grade (provided that, at the time of purchase, the rating is not below BB– and BB, respectively).

All in all, the bulk of the measures is limited to investment grade debt. However, as we have seen, there are significant vulnerabilities in lower-grade debt, and this is a segment which registered default rates of 9.6% and 13.4% in 2001 and 2008 recessions, respectively, and which is unlikely to be immune to the COVID-19 outbreak.

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2. For example, CLOs do not allow early repayments, and the flow of their payments is not dependent on sources with refinancing needs with shorter maturities than those of the underlying assets.
3. Which include furlough schemes similar to Spain's «ERTEs», or subsidies to small and medium-sized enterprises.
4. See the article «Economic policies in the face of COVID-19: will the boundaries of the impossible be broken?» in the Dossier of this same *Monthly Report* for more details on the coordination of monetary and fiscal policy in the euro area.
5. The measures taken include slashing interest rates to minimum levels, injecting liquidity into the financial system, promoting the use of capital buffers accumulated in recent years to absorb new costs, and large-scale purchases of public and corporate debt.
6. For the ECB, we assume that its allocation to corporate debt represents a similar percentage in the current programmes to the portion allocated in the past (20 billion per month plus the 120 and 750 billion announced in March). In the US, we focus on the Primary and Secondary Market Corporate Credit Facility (500 and 250 billion dollars, respectively).