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Fergal McCann and Niall McGeever

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Fergal McCann and Niall McGeever[1]

Central Bank of Ireland

Abstract

The unwinding of COVID-19 pandemic supports and the effects of renewed inflationary pressures have the potential to expose latent distress among a cohort of Irish businesses. In this *Note*, we discuss the options available to policymakers to address a potentially large volume of business distress that may emerge if these risks were to crystallise. We argue that an effective policy response will require a trade-off between the targeting of restructuring options at viable firms and the scalability of policy action in the short term. The introduction of the Small Company Administrative Rescue Process (SCARP) is a positive development and provides a useful restructuring tool for many small companies. However, we flag some potential risks associated with the rollout of SCARP and we consider potential policy actions to mitigate these risks. We also discuss contingency options in the event that formal insolvency channels have difficulty processing a large number of cases, were they to emerge.

1 Introduction

The COVID-19 pandemic resulted in a substantial hit to the trading performance of Irish businesses and necessitated a major policy response (Kren et al., 2021). Government support primarily took the form of cash grants (such as wage subsidies) and tax deferals (Durante and McGeever, 2022). These measures boosted firm liquidity and mitigated some of the balance sheet damage that could otherwise have resulted.[2] Central Bank analysis estimates that 12 per cent of Irish SMEs were financially distressed in 2020 and that this rate would have reached 30 per cent in the absence of supports (McCann et al., 2021). Traditional measures of distress – such as corporate insolvency filings – have remained unusually low as a result of both direct fiscal support and widespread creditor forbearance (McGeever et al., 2020; FSR 2022-I). However, the unwinding of pandemic supports and the onset of inflationary pressures are likely to expose the full level of latent distress in the economy, with inidicative evidence that insolvency rates are indeed beginning to rise from their extraordinarily low level.[3]

The level of latent distress yet to crystallise is potentially large. The government began unwinding pandemic-related supports in January 2022 and the main support schemes ceased by May 2022. A large cohort of businesses continued to utilise government supports well into 2022. Over 20,000 enterprises were still in receipt of wage subsidy payments in April 2022 (its final month of widespread operation). This scheme provided non-repayable grants for businesses with depressed turnover and was the support with the highest level of utilisation by far during the pandemic (Durante and McGeever, 2022). An extensive tax deferral scheme ceased in December 2021 for

[1] We thank Mark Cassidy, David Duignan, Vasileios Madouros, Aisling Menton, and seminar participants for helpful comments. The views expressed in this Note are those of the authors and do not necessarily represent the views of the Central Bank of Ireland.
Email: fergal.mccann@centralbank.ie; niall.mcgeever@centralbank.ie

[2] See Central Bank of Ireland Financial Stability Review 2022-I.

[3] See 2022Q3 insolvency filing figures compiled by Deloitte and rising projections by insolvency practitioners.

most businesses, but ran until April 2022 for sectors most affected by the pandemic. The COVID-19 Credit Guarantee Scheme (CGS) – a €2bn partial guarantee loan scheme – ceased in June 2022 and was replaced by a €330m COVID Loan Scheme (CLS).

Through the removal of these schemes and other ancillary supports, firms that remain financially weak despite the reopening of the economy will no longer be able to maintain their liquidity through cash grants and government-supported access to finance. They are now likely to be encountering payment demands on trade credit, rental arrears, current tax liabilities, and from 2023, deferred tax liabilities. The strong trading recovery experienced in the first half of 2022 by the most acute pandemic-affected sectors, such as Accommodation & Food, will help ease this transition.[4] However, the accumulated liabilities that businesses built up throughout the pandemic will still need to be addressed. In this context, insolvency rates, and the need for restructuring of liabilities for potentially viable businesses, are likely to rise (ESRB, 2021), even before the effects of the current inflationary shock are factored in.

Previous work involving the authors suggests that about 2 per cent of Irish businesses are likely financially distressed and without a viable trading future as a result of the pandemic, while another 2 per cent are in financial distress but may have a viable trading future under the economic recovery expect as of early 2022 (McCann et al, 2021). In total, an estimated 4 per cent of active Irish businesses represents something in the region of ten thousand firms that may require restructuring, liquidation, or some form of company dissolution. For context, but not directly comparable to the estimate of the number of distressed firms, approximately 6,000-7,000 companies are dissolved through either insolvent liquidation or involuntary strike-off in an ordinary year (McGeever et al., 2020).

Inflation is generating further challenges for Irish businesses recovering from the pandemic. Rising costs will squeeze profit margins if businesses cannot adjust their cost base or raise prices. Central Bank analysis using Irish survey data shows that cost pressures of the magnitude observed in early 2022 would reduce profitability and/or strongly incentivise price rises.[5] Euro area survey data up to March 2022 also demonstrates that rising costs are indeed acting as a drag on business profitability.[6] Higher prices may depress demand among consumers, hitting sales, and has significantly raised expectations of interest rate rises that will raise debt service costs.[7]

In this *Note*, we consider the options open to policymakers to manage a potentially large volume of business distress if it were to emerge over the coming months and into 2023. We argue that policymakers will need to strike a balance between targeting restructuring opportunities at viable businesses and ensuring that policy action is scalable enough to manage a potentially large volume of cases. In addition to this, some policy options may be viewed as inequitable and so may be considered inappropriate.[8]

The introduction of the Small Company Administrative Rescue Process (SCARP) provides small companies with an alternative to the in-court examinership restructuring procedure.[9] The process

[4] See the March 2022 wave of the Department of Finance Credit Demand Survey.
[5] See the Central Bank of Ireland Financial Stability Review 2022-I.
[6] See the March 2022 wave of the ECB Survey on the Access to Finance of Enterprises (SAFE).
[7] A new policy – the Temporary Business Energy Support Scheme – will seek to lower energy costs for eligible businesses.
[8] See the remarks of Central Bank of Ireland Governor Makhlouf in March 2022.
[9] Examinership in Ireland is akin to Chapter 11 bankruptcy in the United States and Administration in the United Kingdom. See further details here.

has many attractive attributes. It is designed to meet the needs of small companies and, where possible, to keep legal and professional costs low.[10] In principle, SCARP can provide a low cost method of restructuring liabilities and crucially a mechanism for dealing with creditors jointly in a co-ordinated manner. This has the potential to increase the number of companies that can access formal restructuring tools and speed up the resolution of company distress. However, we highlight risks that warrant consideration relating to the potential need for widespread and rapid adoption of SCARP. These include the possibility that creditors may challenge proposals in court and difficulties very small companies may face in funding even modest professional fees associated with restructuring.

Policymakers may wish to consider contingency plans in the event that SCARP is unable to address a large volume of business distress. We thus further discuss the role of bilateral restructuring negotiations between debtors and creditors. Examples include banks restructuring loans on a bilateral basis with a debtor business. We review the practical difficulties of such action and argue that bilateral restructuring is an inferior option relative to SCARP or examinership. Separately, we argue that outright forgiveness of deferred tax liabilities is likely to be untargeted and costly, as well as being perceived as inequitable. The provision of equity-like support to distressed businesses is another policy option with some positive attributes. Equity instruments or inventive profit sur-tax solutions could provide the State with some upside returns in the event that businesses return to profitability. Difficulties with such proposals include valuation issues for small and opaque companies, securing the state's investment in circumstances of potentially imperfect corporate governance, and the difficulty of implementing such a policy swiftly. Lastly, we discuss the merits of rental arrears arbitration.

The remainder of this Note is structured as follows. In Section 2, we consider the potential scale of business distress in the economy. In Section 3, we describe our framework for considering policies. In Section 4, we describe the relative merits of different policy options. We conclude in Section 5.

2 How much business distress is out there?

In this section, we try to characterise the potential scale of business distress in the Irish economy.

Wage subsidies were the primary method by which the Irish government provided pandemic support to business (Durante and McGeever, 2022; Lambert et al., 2022). This was a grant-like payment provided to businesses which could demonstrate a decline of 25 to 30 per cent or more in their turnover relative to a suitable benchmark. Wage subsidy payments were tapered from January 2022 and withdrawn completely in May 2022. The continued eligibility of many businesses for the subsidy into the second quarter of 2022 is a strong indication of persistent depressed turnover for these firms prior to the full reopening of the economy in spring 2022. That said, the strength of the general economy since then is evidenced by very strong employment numbers and suggests that the trading performance of many of these firms will have improved markedly.

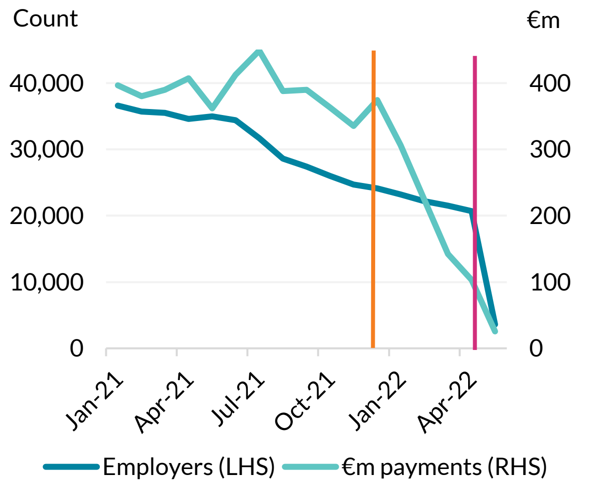
The unwinding of the wage subsidy has removed an income flow for 20,000 (or approximately one-in-twelve) businesses in respect of 252,200 employees (or 10 per cent of the labour force).[11] Where firms have enjoyed a return to good trade, they will still have to repay the liabilities they accumulated during periods of closure. The most vulnerable of these businesses will not be able to meet a full wage bill as well as other existing outgoings on an ongoing basis. In response they will ultimately have to consider further cost cutting measures, employee layoffs, the restructuring of liabilities, or closure. If even a modest fraction of these firms seek to restructure their liabilities or

[10] Greenwood et al. (2020) discuss the difficulties small businesses face in accessing restructuring options.
[11] See Lambert et al. (2022).

dissolve, then this would generate a very sizeable caseload for the insolvency and SCARP system to work through.

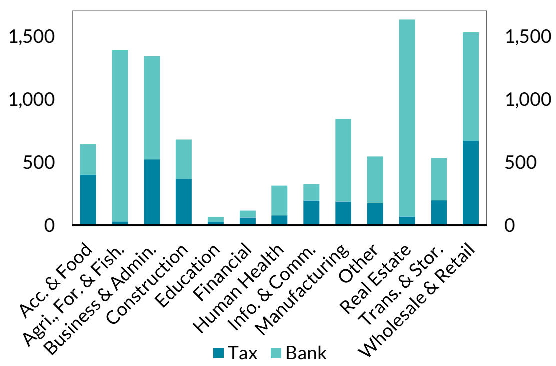
In addition to wage subsidies and other grants, the state provided debt-like support to businesses through an extensive tax deferral ("warehousing") programme. This scheme ceased in December 2021 for some firms and in April 2022 for sectors heavily affected by public health measures. Utilisation of this scheme was high relative to publicly guaranteed loans channelled through the banking sector (Durante and McGeever, 2022). 105,000 businesses had deferred tax liabilities of a total of €3.2bn as of January 2022.[12] Chart 2 provides a breakdown of sectoral utilisation of the scheme and compares this to new bank lending over the pandemic. Accommodation & Food is an example of a sector with high utilisation of tax deferrals relative to bank lending (with or without a guarantee). A repayment schedule for deferred tax liabilities must be agreed in 2022 between businesses and the Revenue Commissioners, and repayments are to begin in most cases in 2023. This could generate pressure for vulnerable firms who may find it difficult to keep up current tax payments and repay deferred liabilities, risking fines, penalties, and court petitions to be liquidated.

Chart 1: A large number of employers claimed the wage subsidy until the end of the scheme



Source: Revenue Commissioners
Notes: Number of employers in receipt of the wage subsidy and the euro value of payments made per month. The two vertical lines show when payment rate tapering began and when eligbility for the scheme was removed for all but Accommodation & Food employers, respectively.

Chart 2: Some sectors have a lot of warehoused tax liabilities to repay



Source: Central Bank of Ireland; Revenue Commissioners
Notes: Gross new bank lending and tax liabilities warehoused between April 2020 and December 2021 by sector.

At the same time as grant aid was provided and tax liabilities deferred, a wider system of bilateral forbearance arrangements has emerged in the economy during the pandemic. Businesses have deferred payments on liabilities such as bank loans, trade credit obligations, and commercial rents.

The difficulty borrowers face in repaying their bank loans is another gauge of the scale of business distress. Half of Irish SMEs report having no bank debt (Central Bank of Ireland FSR 2020-I). An extensive payment break scheme resulted in approximately 22 per cent of Irish SME balances temporarily reducing their repayments in the early stages of the pandemic (Duignan and McGeever, 2020). Since then, a significant minority of borrowers have continued to rely on forbearance.

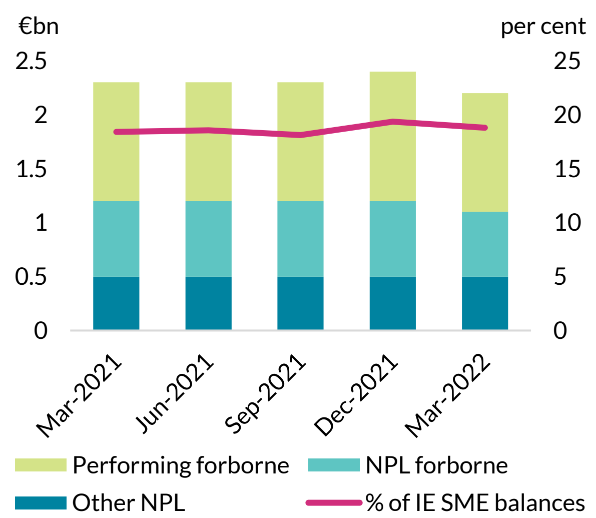
Chart 3 shows that, as of March 2022, €2.2bn (or 18 per cent) of Irish-resident SME balances owed to Irish retail banks were either forborne, non-performing, or both. Forborne loans in these cases were associated with a mix of term extensions, covenant adjustments, interest-only periods, and

[12] See tax deferral statistics from the Revenue Commissioners.

payment moratoria. The volume and share of forborne and NPL balances has been quite consistent between 2021Q1 and 2022Q1. Table 1 provides a sectoral breakdown using loan-level data as at December 2021. Accommodation & Food and Arts, Entertainment & Recreation stand out as sectors with high levels of forborne exposures. Almost all forborne balances relate to term loans, so we also present a separate breakdown for this product group. From an operational viewpoint, we note that the potential caseload of forborne loans at Irish retail banks is close to 7,000.[13]

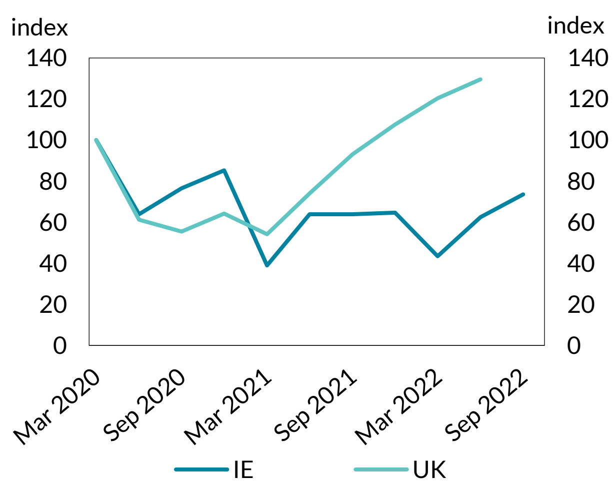
Central Bank modelling suggests that the majority of Irish SMEs currently in financial distress due to the pandemic have a viable trading future under a baseline macroeconomic scenario; however, some of these businesses will run losses in 2022 and even into 2023 and will still require some external finance to "bridge" their way to a viable future. These models estimate that 3-4 per cent of SMEs were financially distressed as a result of the pandemic at end-2021, of whom 2 per cent are likely to still be distressed even under a baseline macroeconomic recovery out to 2024. In magnitude terms, this 2 per cent would represent an estimated five thousand businesses that are currently in operation, in financial distress, and unlikely to recover, while another estimate five thousand businesses are in financial distress and likely viable, if appropriate restructuring of liabilities can be achieved.[14] Not all of these businesses will necessarily require contact with a formal element of the insolvency system, due to the potential for own-funds not visible to the models used by the Central Bank to form part of a restructuring, and particularly given the prevalence of "informal" restructuring arrangements in Ireland, where businesses close but assets are purchased into new companies by previous owners. Nonetheless, the estimate of close to ten thousand potentially distressed businesses appears large, even if only a portion are to formally liquidate or restructure in the coming years. For context, approximately 6,000-7,000 companies are dissolved through either insolvent liquidation or involuntary strike-off in an ordinary year (McGeever et al., 2020) and approximately 14,000 companies either entered insolvency or were otherwise dissolved at the trough of the post-financial crisis recession in 2012.[15]

Chart 3: Loan forbearance is still playing a significant role in supporting SMEs



Source: Central Bank of Ireland
Notes: The sum of forborne SME loan balances and non-forborne non-performing loan (NPL) balances at the three largest Irish retail bank lenders to SMEs in euro and as a share of all Irish SME loans balances.

Chart 4: Corporate insolvencies are likely to rise in the coming months



Source: Companies Registration Office; CRIF Vision-Net; UK Insolvency Service
Notes: The number of creditors' voluntary and court-ordered/official liquidations in Ireland the UK, indexed to 2019 levels.

[13] See Sweeney and Kearns (2021) for further analysis of business loan forbearance.
[14] We base this calculation on the number of active enterprises in Ireland in 2019 provided by the CSO's Business Demography release.
[15] See the CRO's annual reports.

The Central Statistics Office (CSO) have separately examined administrative data sources and used these to estimate levels of business vulnerability across sectors.[16] They look at enterprises that were active in 2019, follow them through the pandemic, and assess their status at end-2021. They find that 6 per cent of enterprises appear to have ceased trading and a further 10 per cent are at risk of closure. This latter figure is higher in the Accommodation & Food, Construction, and Other Service sectors at 14 to 18 per cent.

The recovery of affected firms will depend on general economic conditions and on the scale of structural change in the post-pandemic economy. It remains to be seen how large the impact of greater remote working, changed international travel patterns, and altered consumer behaviour will be. This medium-term uncertainty underpins the difficulties in designing an appropriate policy response in 2022 to businesses who are unable to meet their short-term liabilities in the absence of wage subsidies and other grants. In particular, the assessment of viability, whether by an individual creditor or in the context of SCARP or examinership, will be fraught with uncertainty. The onset of higher inflation and the potential knock-on effects on SMEs' profit margins will render further challenges to the assessment of financial distress cases.

Table 1: Forbearance rates on IE SME loans at end-December 2021 by sector and product

	All loans				Non-revolving loans only			
	Count	%	€m	%	Count	%	€m	%
Accommodation & Food	1,350	10.3	1,074	55.5	1,200	16.1	1,073	56.0
Administrative & Support	1,184	1.6	98	8.0	1,055	3.6	97	8.6
Agriculture, Forestry, Fishing	1,347	1.6	124	4.9	1,287	2.7	123	5.2
Arts, Entertainment & Recreation	176	6.2	141	56.4	156	17.5	139	56.9
Construction	486	1.9	12.8	3.0	447	3.0	13	3.4
Education	34	1.9	9	8.8	29	4.6	9	8.9
Human Health	105	1.5	44	5.3	91	2.9	44	5.5
Information & Communication	59	1.8	2	0.9	59	5.1	2	1.1
Manufacturing	400	2.0	60	5.2	344	3.0	54	5.6
Other Industry	24	1.4	6	2.3	20	2.0	5	2.4
Other Services	802	5.0	74	15.3	790	9.8	74	16.6
Professional, Technical, Scientific	269	2.7	51	14.5	208	7.5	47	17.5
Transport & Storage	425	2.8	39	6.4	409	3.8	38	6.8
Wholesale & Retail	1,073	2.6	188	9.2	935	4.8	181	10.9
	7,734	2.5	1,922	15.4	7,030	4.4	1,899	16.8

Notes: We use loan-level data as of end-December 2021 from the three main Irish retail bank lenders to SMEs. We exclude real estate loans. We define "Other Industry" as all borrowers in NACE sectors B, D, and E. "Count" refers to the number of loans that are forborne, while % relates the Count to the number of loans in each sector.

Corporate insolvencies are likely to rise in the coming months. Chart 4 shows insolvency rates in Ireland and the UK over recent months, indexed to 2019 levels. The number of insolvencies in Ireland has been significantly below pre-pandemic levels since March 2020 and has yet to rise to normal levels thus far in 2022. Separate to the negative pandemic impact on firms, survey evidence suggests that there is a cohort of perhaps 5 per cent of firms that were unprofitable prior to the pandemic and which are less likely to be viable going forward (McCann et al, 2021). We should thus be expecting something of a catch-up effect in insolvency filing levels, on top of any pandemic impact. The UK has interestingly seen a large and consistent rise in insolvency filings co-inciding with the withdrawal of government COVID-19 supports to businesses in September 2021.

[16] See the Business Signs of Life statistical release.

3 Desirable policy characteristics

The most desirable policy for managing business distress will be targeted, scalable, and equitable.

The targeting of restructuring opportunities towards firms with a viable economic future is a key consideration at this point in the recovery. The continued provision of support to unviable firms is a costly exercise for the exchequer where public funds are utilised, while the assets and labour tied up in unviable firms could be better utilised elsewhere in the economy. Public perception of a poor allocation of scarce resources, whether that is providing support to businesses with no reasonable prospect of recovery or to those which no longer require assistance, is also undesirable.[17]

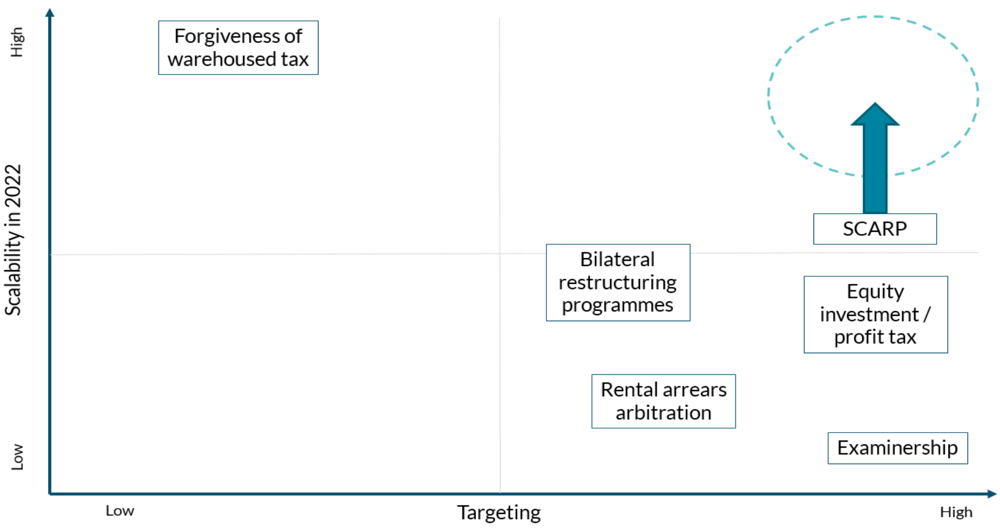
Scalability is a second key consideration. Any policy initiatives must be capable of dealing with the risk of a large volume of distress over the coming months, should it crystalise, most likely using existing policy levers. Novel proposals that require lengthy consideration or primary legislation are not scalable in the short term. In addition, desirable policies will be able to overcome the strong incentives for individual creditors to stall and hope that someone else (e.g., a public creditor) will carry more of the burden. Policy tools that allow for a centralised and co-ordinated restructuring of liabilities (and, where necessary, the imposition of losses on some creditors) will help ease this problem and result in more swift resolution of distress. Ultimately, the optimal policy mix should be able to provide a satisfactory trade-off between targeting and scalability.

A final consideration is whether a policy option is perceived as equitable or not. This may rule out options that are perceived to be unfair, even if they meet immediate policy objectives. For example, the forgiveness of deferred tax liabilities may be considered objectionable by those who paid tax throughout the pandemic, and by many in the public at large, if it leaves those companies who paid their taxes on time at a relative disadvantage.

4 Policy options

Figure 1 lays out a set of policy options for addressing a large volume of business distress, should it materialise in the coming months. The options are placed ranked by their level of targeting towards viable firms and their short-run scalability.

Figure 1: Policy options are a trade-off of targeting and scalability



[17] Lambert et al. (2022) show that long-term wage subsidy claimants had relatively high pre-pandemic leverage, suggesting that some companies dependent on supports were already weak prior to the shock.

4.1 Small Company Administrative Rescue Process (SCARP)

In 2021, the government introduced a new corporate restructuring process dedicated to small companies. The Small Company Adminsitrative Rescue Process (SCARP) aims to provide a primarily out-of-court, lower cost alternative to the pre-existing in-court examinership process. Small companies can use SCARP to appoint an insolvency practitioner who will prepare a rescue plan and seek to restructure liabilities in a coherent and timely manner.

SCARP has a number of desirable characteristics and is a welcome development for the corporate restructuring toolkit. In principle, an SME encountering solvency issues after the roll-off of pandemic support schemes can have their liabilities restructured in a coordinated fashion through the SCARP process. Economically, this is the optimal outcome, if it can be achieved operationally and if the cost and complexity of the scheme leaves it usable and attractive to a wide enough range of firms. Other policy options generally involve independent action being taken by a single creditor and come with costs relative to a coordinated system like SCARP. Experience in Ireland with personal insolvency legislation in the last decade suggests that there are potential risks, both on the creditor and the applicant side, associated with a reliance on SCARP as the primary mechanism to resolve business distress.[18] We highlight five risks associated with a widespread and rapid adoption of SCARP:

i. Creditors may generate significant uncertainty and delay if they challenge aspects of the legislation itself or even challenge a modest number of cases. Similarly, secured creditors could potentially undermine rescue attempts if they were to appoint a receiver.
ii. The need for court approval for lease repudiation proposals (and the likely implementation of tough qualifying criteria in any case) may limit the benefit of SCARP for some businesses.
iii. The Revenue Commissioners have the ability to opt-out of SCARP cases. This aspect of the legislation is intended to safeguard the interests of the state and ensures that taxpayers with a history of non-compliance are not given outsized negotiating power. As insolvent companies are very likely to have tax debts, and perhaps quite large tax debts in the context of the pandemic, the stance the Revenue Commissioners take regarding their opt-out could have a major influence on the outcome of SCARP cases. While the Revenue Commissioners have made public communications on their constructive engagement with the SCARP process, the opt-out clause leaves open an element of risk, with the possibility that perceptions among other creditors relating to the approach of the Revenue Commissioners could lead in an adverse case to a weakening of their engagement with the process.
iv. Unfamiliarity with or suspicion of corporate restructuring may lead company directors to delay restructuring efforts, resulting in more distress and weaker arguments for viability.
v. All SCARP applicants will have to find some way of financing the cost of the process and potentially a fresh cash injection into the company. Upfront professional fees, even if lower relative to examinership, may still be too much for the smallest and most distressed enterprises. These cost pressures may lead directors to opt for dissolution instead or to attempt backdoor restructuring attempts such as re-purchasing assets out of a liquidation.

[18] During the first years after PIA was introduced as a personal insolvency option, there were numerous examples of creditors exerting veto rights, challenging and delaying cases, which contributed to slow take-up of PIAs as an option to resolve borrower distress. Even a decade after implementation, and following policy and legal reforms, there remains variation in the speed with, and way in which creditors engage with the PIA process. Borrower awareness and willingness to participate in the scheme has progressed, albeit slowly, in the decade since implementation. See the recent IMF FSAP report on insolvency and creditor rights in Ireland.

The scalability of SCARP will be crucial in order to maximise the benefits it can bring for distressed small companies. Here we highlight a number of steps that may help in improving scalability.

- Policymakers should continue to monitor the rollout of SCARP and be prepared to make adjustments where necessary to ensure that as many small companies as possible have access to a formal restructuring tool.
- To date, the Revenue Commissioners have participated in 9 of the 10 SCARP cases that have been processed.[19] The continued participation of state creditors in restructuring arragements is an important driver of process success. Greenwood et al. (2020) demonstrate the key role that the State can take in coordinating creditors in the context of corporate rescue. While there may be an element of cost to the State in accepting haircuts or offering additional payment flexibility, this may be preferable to an alternative outcome of disorderly liquidations of viable companies, and would very likely represent a higher return to the state than widespread write-down of warehoused tax liabilities. In light of this, continued clarity and direct communications from the Revenue Commissioners regarding their broad stance towards SCARP cases will play a role in minimising risks related to the participation of other creditors.
- The promotion of SCARP in the near term as a scheme whose primary purpose is to facilitate recovery and resolution following the COVID-19 pandemic may lessen any potential for stigma associated with utilisation. If seen as a tool for repairing extraordinary balance sheet damage which occurred during the pandemic, the scheme may be deemed more attractive to businesses.

Contingency plans may also be warranted in the event that SCARP encounters teething difficulties or is unable to deal with a large volume of cases, putting large numbers of potentially viable businesses at risk of liquidation. The highlighting of this risk has empirical grounding: research from the United States has shown that the weaker capacity of smaller firms to restructure through the legal system (for cost and capacity reasons) typically leads to a sub-optimal level of liquidations among possibly viable prospects relative to larger businesses (Greenwood et al., 2020). We next highlight a number of initiatives which may help to avoid unnecessary liquidations in the event that SCARP does not prove a panacea.

Examinership also remains an option for larger distressed companies with sufficient financial resources to navigate the process. This in-court corporate restructuring tool is well targeted, as companies must demonstrate to a judge that they have a "reasonable prospect of survival". Historically, though, the number of companies making use of examinership has been quite low. In fact, one of the primary motivations for the introduction of SCARP was the high cost burden associated with examinership. It is thus unlikely that examinership will be able to facilitate the restructuring of distressed companies at a large scale.

4.2 Bilateral restructuring programmes

Bilateral debt restructuring is an alternative option for providing relief to firms, though one that is sub-optimal relative to either SCARP or examinership. A central issue with bilateral negotiation is co-ordination. If a single creditor engages in a bilateral restructuring arrangement with a debtor, then this may place them at a disadvantage relative to other creditors in the event that the company returns to healthy trading or indeed ends up in liquidation. This is a classic example of "coordination failures" in economics, where anticipation that some other creditor will be first to accept a haircut may initially discourage all creditors from accepting write-downs. Generally speaking, the smaller the number of creditors, the more feasible is a coordinated bilateral restructuring program. For this reason, if bilateral programmes were to be introduced, two forms of liability are worth particular consideration: tax liabilities, where the Revenue Commissioners are a single creditor, and bank debt restructuring, where three lenders dominate the market. We review both cases below. Liabilities

[19] Private correspondence with the Revenue Commissioners.

such as trade creditors or unpaid rents are more complex, with a wide array of smaller creditors across the system, making coordination more challenging in the absence of legislation.

First, tax liabilities could in theory receive a uniform level of either forgiveness or restructuring into long-term debts. Interest-only payments, flexibility on payment of capital and interest, or outright moratoria in 2023 and 2024 would provide further relief. The attraction of this policy is its lack of coordination costs: such a policy could be implemented immediately upon decision by a single creditor. The cost of such policy relates to poor targeting: in achieving speed of implementation, many healthy businesses would receive the benefit. We go into this problem in more detail in Section 4.3.

Second, policy could be enacted around bank debts, which are a major component of distressed business liabilities. In this instance, government policy can play less of a role. As outlined in Gaffney et al. (2021), blanket approaches with minimal or non-targeted eligibility criteria such as the 2020 COVID-19 payment moratoria are best suited for rapid onset crises where case-by-case assessments would simply not be scalable within the appropriate timeframe. At this point in time, however, we are in a different situation: the volume of pandemic-distressed bank debt is now at a small enough scale that case-by-case assessment by the lenders' arrears support units is feabile and desirable. Where case-by-case assessment can be carried out within a reasonable timeframe, this approach will lead to a better-targeted outcome than any more widespread or blanket type of bank debt restructuring for businesses.

4.3 Flexibility or forgiveness of warehoused tax liabilities

The forgiveness of warehoused tax liabilities has been raised in the public debate as one option to provide relief to distressed businesses. A policy of partial or full forgiveness would be scalable, but extremely untargetted. Access to the tax warehousing scheme during the pandemic was automatic for smaller companies and its flexible terms may well have even led healthy businesses to use the scheme. Other businesses with warehoused liabilities may have been badly affected by the pandemic, but have since recovered strongly. In this way, indiscrimate forgiveness of these liabilities would not be well targeted. An alternative option is to provide some form of flexibility similar to a restructuring of bank debt, which is applied in a uniform way to all remaining tax warehouse debtors. This would have the desirable feature of avoiding blanket forgiveness while managing to smooth the potentially large shock from energy prices that is following the pandemic. However, again, this would come with costs as it would involve the tax authority foregoing receipt of liabilities in a non-targeted way.

Separately, there is a question of whether such forgiveness is equitable, or would be perceived to be so. Those companies which opted to pay their tax liabilities on time would be placed at a relative disadvantage compared with those that made use of the scheme. This might prompt concern about the fairness of the tax system and hinder tax officials in future collection efforts.

The restructuring of tax liabilities, whether warehoused or not, is likely more suited to a formal legal process or a structured bilateral negotiation. SCARP and examinership require that companies pass a viability test for eligibility and both allow for a co-ordinated approach to the writedown of liabilities. Disclosure requirements to creditors and public registries also provide a layer of accountability where there is a loss borne public creditors. These features mean that, where the system can process the level of cases adequately, it remains desirable for tax warehouses to be treated within formal, coordinated structures rather than through the issuance of blanket forgiveness or restructuring.

4.4 Equity investment / profit tax

Equity investment has some attractive features for distressed businesses, given that there is no fixed repayment schedule. For unsecured creditors, an equity stake may be preferable to a severe write-down arising from a liquidation or restructuring scheme, given the potential upside involved in the event of business recovery. An equity investment held by the State can be thought of as similar to a profit sur-tax for companies. If the company regains profitability, then the government has some upside potential in their share of the profits.[20]

Government funding could in theory be used to purchase debt and convert into equity, in order to recapitalize the most at-risk businesses that have a viable future. However, one would question whether this was the best use of public money, when those liabilities may possibly be written down during restructuring, as is likely the case in the SCARP process.

There are other complications regarding equity investment by the state in smaller businesses. These include valuation difficulties when businesses are generally quite opaque. The protection of minority shareholder interests may be difficult if governance standards are imperfect. It may be particularly difficult to monitor the interaction of the corporate balance sheet and personal finances of the incumbent directors. Furthermore, it may be difficult to protect the state's claim on company assets in the event of dissolution. Scalability in the near term may be very challenging, but the government may wish to consider how equity-like options could feature in future.

Another mechanism may be to offer up-front equity-like support to businesses in the form of a direct recapitalization grant (or by purchasing loan liabilities), in exchange for a commitment to a corporate tax sur-charge over a medium term horizon. This would avoid complexities relating to ownership and valuation, while having desirable equity-like properties in that businesses only face a liability in the event of a return to profitability, while the taxpayer benefits from upside potential among successful supported businesses. A key challenge relating to this mechanism, however, is the need for policymakers with responsibility over additional direct government financial outlays to decide on which businesses are sufficiently viable as to warrant inclusion within such a scheme.

4.5 Rental arrears arbitration

The scale of commercial rental arrears remains difficult to observe, given the private bilateral nature of landlord-tenant relationships. Survey evidence from October 2020 showed that 7 per cent of Irish SMEs had built up rental arrears since the start of the pandemic.[21] In late 2021, the commercial landlord Hammerson claimed that 29 per cent of its retail tenants were in arrears. Their rental collection rate, mainly from retail units in the Greater Dublin Area, was in the region of 33 per cent in mid-2020 and 75 per cent in 2022Q1.[22]

The strategic interests of landlords may vary depending on the type of property involved and especially its location. Prime units may be easy to re-let and less likely to suffer rental discounts due to excessive local vacancy. Landlords in other cases may find it wise to bear some of the cost of the pandemic by waiving a proportion of rental arrears. There may also be substantial discrepancies in the attitude of landlords to rental arrears depending on investor type (institutional fund versus individual local owner, for example).

The need for court involvement and the likely use of tough qualifying criteria make lease repudiation a very difficult prospect for small businesses in need of restructuring. A streamlined system for processing rental arrears disputes, even if only to inform a court supervised process, would provide some benefit.

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[20] See Boot et al. (2020).
[21] See Kren et al. (2021).
[22] See Hammerson's 2021Q1 update.

5 Conclusion

In this *Note*, we discuss policy options for dealing with a potentially large volume of latent business distress, were it to emerge over the coming months. We summarise a range of indicators of distress and try to scale the problem. We report that a little over 20,000 companies were still claiming wage subsidy payments as late as April 2022. Other indicators of potential distress, such as bank loan forbearance, remain elevated as of March 2022. The scale of these figures is large relative to the number of company dissolutions in a typical year. If enterprises were to fail in relatively large numbers, then policy tools would need to distinguish between viable firms that might be directed towards restructuring opportunities and unviable firms towards liquidation.

We argue that a desirable policy response to a wave of business distress is a trade-off between the targeting of restructuring opportunities at viable firms and the scalability of policy to deal with a high number of cases. Blanket policies that are not targeted at viable firms will be costly to the exchequer and prevent assets and labour from moving toward more productive uses. Separate to targeting and scalability, the question of equity is also important. The implementation of policies that are viewed as unfair may have undesirable second-order effects, such as possibly undermining confidence in tax collection procedures.

SCARP represents a welcome development in the corporate restructuring landscape in Ireland. It is a streamlined out-of-court process for small companies and has the potential to lower restructuring costs significantly relative to examinership. Notwithstanding these positives, there are risks to relying heavily on this new procedure. We highlight risks associated with the widespread rollout and adoption of SCARP. These include the possibility that creditors may challenge proposals in court and difficulties very small companies may face in funding even modest professional fees associated with restructuring.

We discuss alternative contingency options in the event that SCARP encounters difficulties in its rollout. First, we consider bilateral restructuring negotiations between debtors and creditors. We argue that such negotiations are subject to a major co-ordination problem. Individual creditors will generally have a strong incentive to wait and see how the debtor performs over time or to wait for another creditor to take on more of the restructuring burden first. In cases where the number of creditors is small, co-ordination may be possible. Nonetheless, these options are sub-optimal and less appealing than a centralised process like SCARP or examinership. We further discuss other policy alternatives, such as equity-like supports and rent arrears arbitration. We view these as positive in theory, but potentially problematic in terms of scalability in the short term.

Ultimately, the restructuring of business liabilities at scale brings with it macro-financial risks. If banks and other lenders experience meaningful losses and capital depletion due to writedowns, there is a potential for credit risk retrenchment and a drop in credit supply during the recovery. This may be particularly important in the current context as Central Bank research has estimated that a 20% cut in the availability of liquidity finance for distressed firms could result in an increase in the medium-term SME distress rate from 7% to 13%.[23] Furthermore, the pressures that will be experienced by ongoing inflationary challenges may bring additional difficulty to businesses continuing to struggle with the after-effects of the pandemic. Nonetheless, the Central Bank's current assessment is that the banking sector has adequate capital to absorb losses stemming from the restructure or liquidation of distressed businesses. The results of the 2021 EBA Stress Test highlighted the continued capital resilience of Irish and EU banks, reiterating the findings of the Bank's own resilience assessment in FSR 2020-II.[24]

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[23] See McCann, McGeever, and Yao (2021).
[24] See Box D of the 2020-II Financial Stability Review published by the Central Bank of Ireland.

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T: +353 (0)1 224 6000
www.centralbank.ie
publications@centralbank.ie
Bosca PO 559, Baile Átha Cliath 1, Éire
PO Box 559, Dublin 1, Ireland

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