

Awash in Liquidity: Stress-testing Corporate Balance Sheets

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Research Note

The next stage of the recovery may put increased stress on some sectors and many firms, but an analysis of corporate balance sheets in Europe and the United States reveals that a systemic liquidity crunch triggering a financial crisis, bankruptcy waves and recessions is very unlikely. Euro area balance sheets are as liquid as they have been since the euro's inception. A combination of increasing cash buffers and lengthening of funding maturities has taken place since 2012, so that, thanks also to the unprecedented policy support, euro area firms were able to weather the March liquidity crunch and today possess a much bigger liquidity buffer than the one they had at the onset of the 2008 crisis. U.S. corporates increased their liquidity buffers much less, by comparison, but they still appear in a very strong position to be able to manage a severe liquidity shock, especially given their ability to liquidate their financial assets easily if required.

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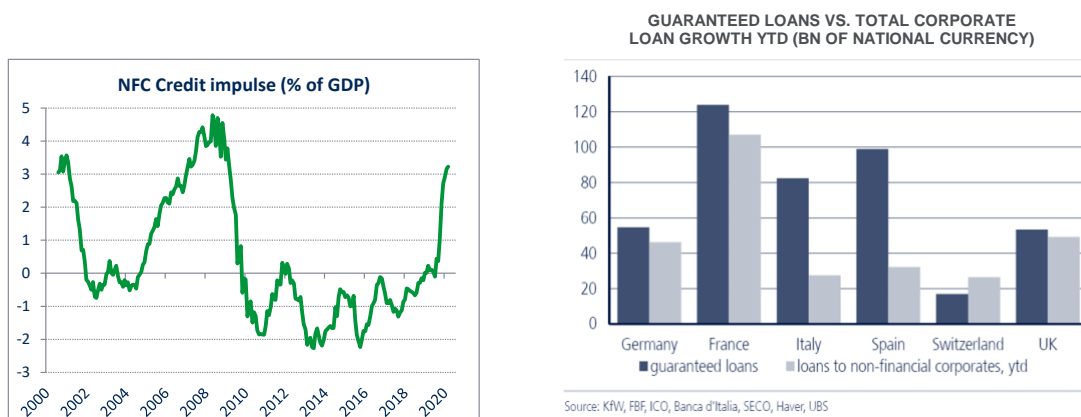
The COVID shock has raised worries about the health of non-financial corporations in the euro area and the U.S. and thus the possibility of a wave of bankruptcies and labor shedding similar to what happened after 2008. While the root causes of corporate financial distress are always different, the trigger tends to be the same: the evaporation of liquidity that makes firms unable to pay back maturing commitments. Data on corporate balance sheets¹ aggregated by the European Commission and the Federal Reserve offer reasons for optimism.

2020: COVID, the liquidity wall and firms stashing cash

The fast deployment of loan guarantee schemes and ultra-subsidized bank liquidity through the ECB's operations have kept credit provision easy for European corporates, supporting their cash inflows as revenues dwindled. The introduction of furlough schemes, as well as the suspension of mortgage and loans payments, have limited their cash outflows.

¹ Financial accounts of all incorporated business taken from the 'Flow of Funds' databases.

This joint policy support made the Loan Guarantee Schemes² (LGS) launched across Europe a success. Unusually for a recessionary and uncertain period, credit to corporates accelerated sharply (see left panel chart³) and all of the new loans YTD have been financed by the LGS (right panel)⁴.



Source: (LHS) Bloomberg. Haver. November 30, 2020.

(RHS) KfW. FBF, Banca d'Italia. SECO. Haver. UBS. November 30, 2020.

Importantly, three quarters of the new credit obtained by firms have been used to shore up their liquidity: in the euro area Big Four countries,⁵ LGS loans amount to €360 billion, outstanding securities increased by €120 billion and euro area corporate overnight deposits increased €330 billion. It is no surprise that bankruptcies are at record lows.

The story was similar in the U.S., as companies were able to tap both the bank loan market and capital markets for precautionary funding, heavily aided by the Federal Reserve's alphabet soup of programs that stabilized capital markets and the Treasury's subsidized lending programs, such as the Paycheck Protection Program. The "dash for cash" liquidity dry-up was thus short lived, and cash and short-term liquidity spiked from nine-times short-term liabilities pre-crisis to 15-times short-term liabilities in 2Q20.

A decade of liquidity shoring-up in the euro area, not so much in the U.S.

The increasing liquidity of corporate balance sheets is not a recent phenomenon in the euro area. For the last 20 years, euro area firms have been increasing coverage of their short-term (ST) liabilities⁶ with ST assets. The difference between ST financial assets and ST financial liabilities in their balance sheets has increased four-fold since 2008 to reach €1.5 trillion, and ST assets now cover 120% of ST liabilities, up from 105% in 2008.

The increase in corporate assets in the euro area has been almost entirely in bank deposits, the most liquid of all assets. After a 20-year uninterrupted rise, deposits jumped 14% in the last six months. As a result,

² Loan guarantee schemes are facilities for encouraging banks to provide loans to firms who, because of the high risk involved or lack of collateral, would be unable to obtain conventional loans. Under the scheme, the ministry of finance typically guarantees repayment to the bank of a percentage of the loan on default. Such schemes were launched in all major EU jurisdictions at the onset of the pandemic.

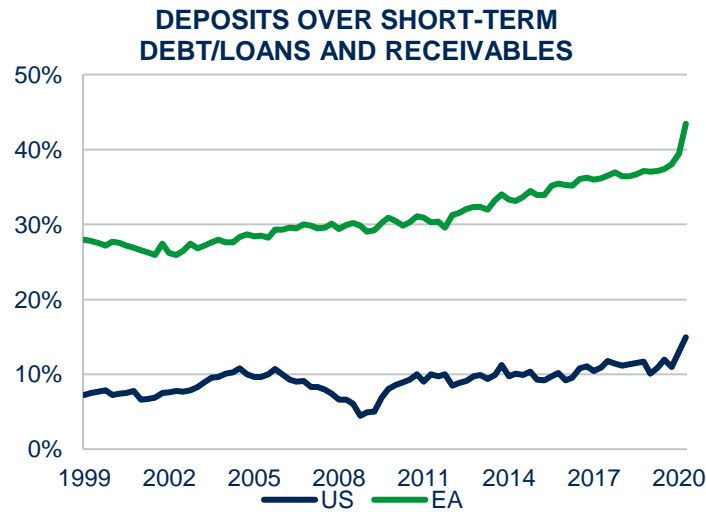
³ The charts show the credit impulse, i.e. the increase in debt issuance and loans provision to NFCs as % GDP over one year.

⁴ Loans provided by LGS were actually a multiple than new loans YTD, suggesting that banks are shifting many pre-existing loans to the guaranteed ones. This has been particularly pronounced in Italy and Spain, where LGS loans are three- to four-times the total amount of new loans.

⁵ Germany, France, Italy and Spain, accounting for more than 80% of EA GDP.

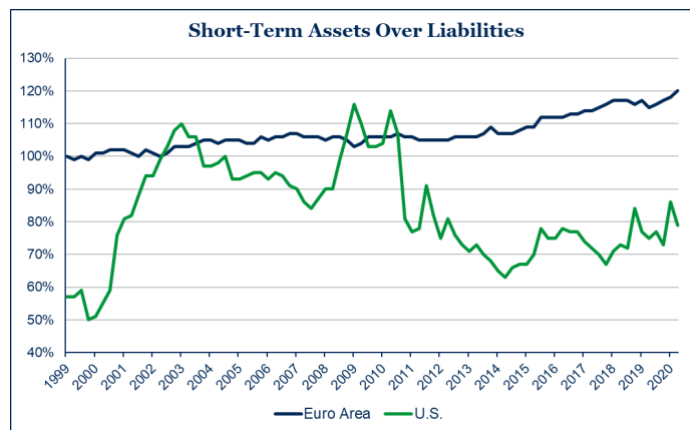
⁶ Defined as debt and loans with maturity shorter than one year + other receivables

firms' immediate liquid availability of cash from deposits now covers 45% of potential immediate liquidity needs (i.e. short-term debt, loans, trade payables and derivatives)⁷ as illustrated in the chart below.



Source: Bloomberg. Haver. November 30, 2020

The picture in the U.S. looks very different, as liquidity coverage trended sideways leading up to the COVID crisis. A possible explanation for this difference is that, in the low-rate environment with deep capital markets, U.S. corporates were not incentivized to increase their liquidity coverage as much as EU corporates were post-Global Financial Crisis. Broadening the look to consider all ST assets (i.e. adding ST loans, securities and derivative assets), in the U.S., ST assets now cover 79% of ST liabilities—much less than in the euro area (see chart below). It seems that U.S. firms operate with a structurally smaller buffer of ST assets to cover for potential outflows in times of crisis.



Source: Bloomberg. Haver. November 30, 2020

It would seem that U.S. firms are much more exposed to liquidity risks than their euro area counterparts. However, U.S. firms appear to be better able to cover such reversals liquidating their assets. In 2008, the

⁷ Excluding loans whose maturing instalments have been suspended for the time being in most of the EA, deposits cover 70% of ST liabilities in the EA.

U.S. corporate sector switched from being a net lender to a net borrower as the Lehman shock hit. So, when U.S. firms had to repay debt, as this was not rolled over, they managed to do so selling financial assets. In contrast, euro area firms were unable (or unwilling) to cover the debt repayments by selling assets, so they had to produce massive savings to cover the repayments. In an environment of steeply falling revenues, this was only possible by cutting costs and investing brutally, with very negative impact on growth and employment. It is probably for this reason that euro area firms spent the following decade amassing the liquidity “war chest” they now possess. Needless to say, the war chest comes at a cost, which is to hold vast amounts of zero-yielding cash instead of investing it in yielding assets or business expansion.

Lengthening debt maturities

The maturity of liabilities has also increased in both the euro area and U.S. Long-term debt represents 92% of nonfinancial corporations’ (NFCs) debt liabilities in the euro area today, up from the low of 83% in 2008. Since the crisis, ST bank loans have seen virtually no growth, while longer maturities have recovered (see left-hand chart taken from [this ECB report](#)). This trend has persisted in 2020, even if the amounts lent has jumped. In H1 2020, 93% of all new bank loans to NFCs in the euro area have been long-term.⁸ So, for a decade corporates have increasingly borrowed at long maturities and parked the funds in bank deposits. Similar developments can be seen in the U.S., where the Investment Grade Corporate Aggregate Index average maturity index rose from about 9.5 years in 2004 to more than 12 years today.



Source: (LHS) ECB Notes: Breakdown by maturity based on unadjusted loans. The latest observation is for November 2019. (RHS) Bloomberg. As of December 3, 2020.

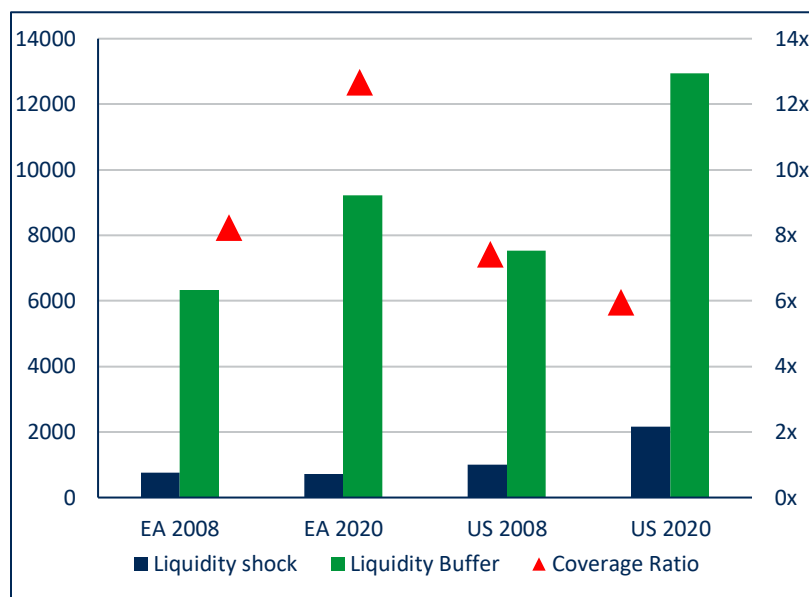
Why a liquidity crisis looks so unlikely

Corporates on both sides of the Atlantic seem to be in a strong position to fend off a liquidity shock. But how long a credit crunch could they survive before their liquidity buffer is depleted? The March “dash for cash” episode was so short-lived that one cannot analyze it with the available quarterly data on balance sheet. For this reason, we look back at 2008, when the liquidity shock hitting the euro area and U.S. was big and protracted. In the year following the 2008 crisis, euro area corporates lost €770 billion, or 93%, of their net liabilities inflows (see blue columns in the chart below). To cover such losses, they had a liquidity buffer of

⁸ See ECB table 2.1.1 - Loans to households and non-financial corporations. Available at: <https://sdw.ecb.europa.eu/reports.do?node=1000005718>

ST assets⁹ equalling roughly €6 trillion (green columns). The buffer was then eight-times the shock (read triangles). Simulating a similar liquidity shock today¹⁰, we find that euro area NFC buffer would cover more than 12-times the shock. At the aggregate level, corporates should thus be able to withstand a liquidity shock considerably larger than that in 2008 without running out of liquidity.

U.S. firms have also considerably increased their liquidity buffer (from \$7.5 trillion in 2008 to almost \$13 trillion today). However, their liabilities inflows also doubled, so that the liquidity shock in a 2008-type scenario would be double this time around (see blue columns). As a consequence, the coverage provided by the liquidity buffer decreases from seven-times to six.



Source: Bloomberg. Haver. November 30, 2020.

Conclusions

This aggregate analysis cannot identify pockets of illiquidity that may be present in certain sectors, countries and single firms. So, while at the aggregate level the picture is reassuring, it does not imply that all firms, sectors or countries are liquid. Also important, while this analysis suggests a systemic liquidity crunch is unlikely to develop, firm topline and their profitability will remain under pressure for some time to come. We see this as a limit to downside risks, rather than an upside risk on firms' profitability.

With these caveats in mind, we can conclude that corporates in the euro area are in a much stronger position today than during earlier crisis episodes. U.S. corporates' war chest against liquidity evaporation is similar to those seen during previous crises, but they have shown in times of crisis that they manage to liquidate their assets with more ease.

⁹ I.e. ST loans, securities, derivative assets and trade receivables

¹⁰ I.e. the same proportional drop of liabilities inflows (-93%).

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