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Covid-19 loans in Switzerland – a success story?

Current interest rate environment & monetary policies

After an additional interest rate hike of 25 basis points, the US Federal Reserve (Fed) has probably reached its peak key interest rate with a federal funds rate of 5.25 to 5.5%. Within three months, core inflation fell slightly from 5.5% in April 2023 to 4.7% in July 2023, while the labour market cooled off in certain areas. It is still far too early to declare victory over inflation in the US, as second-round effects can still be expected in the short and medium term. The next few months will show whether the US achieves a soft landing (which is historically the exception rather than the rule) and what impact the resumption of interest payments and repayments of student loans (from September and October 2023 respectively) will have on the US economy. According to Moody's Analytics, payments of around USD 1.4 billion per month are due. Widespread expectations that US interest rates are likely to remain higher for an extended period of time, coupled with Fitch's downgrading of the US credit rating from AAA to AA+ in early August 2023, pushed the US 10-year Treasury yield to 4.2%, the highest level since 2008. Over time, the higher interest rates will have a negative impact on corporate earnings and private consumption and put a question mark behind the high stock market valuations, not only in the US, since the discount rates will have to be adjusted upwards if interest rates stay elevated in the medium term.

In the eurozone, inflation has been moving sideways at high levels and with core inflation stubbornly at 5.5% at the end of July 2023, the European Central Bank (ECB) is still a long way from its medium-term inflation target of 2.0%, despite having raised interest rates twice by 0.25% to currently 4.25% in the past three months. Perceived inflation was 8.0% (median) as of June 2023, well above core inflation, particularly as food prices continue to rise at over 10%. At the same time, according to the bank lending survey, corporate demand for loans in the eurozone has fallen significantly (particularly for investments in fixed assets), while the rejection rate of loan requests by SMEs has continued to rise. As a result, the ECB is still struggling with the dilemma of further weakening the faltering economy in the eurozone by resolutely fighting inflation.

The Swiss National Bank (SNB) is in a much more comfortable position. Following the 0.25% rate hike to 1.75% in June 2023, core inflation fell to 1.7% in July 2023, supported by a 0.6% decrease in import prices. Due to the increase in the reference interest rate from 1.25% to 1.5%, widespread increases in residential rents of 3 – 4% are expected starting in October 2023, which flow into the Swiss consumer price index with a weight of 19%. As a result, the SNB expects inflation rates of slightly above 2.0% in its conditional inflation forecast for 2024. However, this does not necessarily lead to a further tightening of the Swiss monetary policy on 21 September 2023, since the SNB's considerations will be influenced by the interest rate decision of the ECB the week before and by various leading economic indicators such as the purchasing managers' index for the Swiss industry, which recently showed a sharp decline in production and incoming orders, as well as the development of the exchange rates.

Covid-19 loans in Switzerland

The interest rate hikes by the SNB also had an impact on Covid-19 loans, whose interest rates were raised from 0.0% for loans up to CHF 500,000 and 0.5% for loans with larger amounts to 1.5% and 2.0% respectively as of April 2023. The higher interest rates are intended to create an incentive not to hold on to Covid-19 loans longer than necessary. While the interest rate adjustment seems justified in the current market environment and the conditions are still significantly better than the market conditions in most cases, the lead time of less than a week was unreasonably short.

What are Covid-19 bridging loans as they are officially called? The largest economic aid program in Swiss history was launched within two weeks at the beginning of the Covid-19 pandemic in March 2020 and benefitted from a maximum credit guarantee of CHF 40 billion from the federal government to provide in a swift and unbureaucratic manner loans to bridge corona-related liquidity bottlenecks, via 125 participating banks. Companies were entitled to a loan of 10% of sales in 2019 or 2018 (max. CHF 20 million). Up to a loan amount of CHF 500,000, the federal government issued a full credit guarantee, while 85% of the risks of Covid-19-credit-plus (with an amount between CHF 500,000 and CHF 20 million) are borne by the federal government and the remainder by the financing bank. The term of a Covid-19 loan is normally 8 years and can be extended to up to 10 years in cases of hardship.

Within around four months, i.e. by the end of July 2020, 137,870 Covid-19 loans totalling CHF 16.9 billion were granted, the vast majority of them with amounts of up to CHF 500,000 (the average was CHF 101,777), where the issuing banks had no risk to bear. Only 1,133 Covid-19-Plus loans were granted, but these had a significantly higher average loan amount of CHF 2.65 million. By mid-August 2023, CHF 7.5 billion in Covid-19 loans had already been repaid in full, and CHF 1.8 billion had been amortised by the end of March 2023. Currently, the open Covid-19 loans amount to approx. CHF 6.1 billion, i.e. a little more than a third of the loan amount originally granted.

It was to be expected that there would be isolated cases of abuse due to the self-declaration when applying for Covid-19 loans and due to the uncertain economic situation, but these cases are being pursued consistently and are insignificant in terms of the amount of the abuse: CHF 342 million as of mid-August 2023 for open and closed cases in which criminal complaints have been filed (whereby the amounts shown correspond to the volume of the loans at the time they were granted, but not to the actual losses incurred). The main complaints were about unauthorized use of loans and incorrectly declared revenues figures.

Using revenues as a base for calculating the loan amounts was in particular questionable for low-margin sectors (e.g. gastronomy, retail / trade, construction) and to an unjustified extent also supported companies that already had been in difficulties before the Covid-19 pandemic, delaying structural change. In our view, EBITDA would have been a more suitable basis for granting the Covid-19 loans.

The ban on dividends posed a major challenge for companies with financing at holding level, which could have been countered with a more sophisticated drafting of the law. From our point of view, a more serious issue is that the law stipulates that Covid-19 loans do not have to be considered as debt for the calculation of over-indebtedness. This regulation made sense during the Covid-19 pandemic, but now delays the timely initiation of restructuring measures and leads to numerous situations that can no longer be solved without drastic measures, because the other lenders naturally regard Covid-19 loans as debt, which they actually are.

Overall, the best possible outcome of the Covid-19 loans was achieved, which could be reasonably expected when setting up the program in only two weeks, and together with other instruments such as hardship programs and short-time work, numerous company bankruptcies were avoided in the short term and many jobs were secured, at low economic costs, as studies confirm.

By the end of 2022, federal guarantees in the amount of CHF 644 million were drawn down by the banks granting the Covid-19 loans (current status mid-August 2023: CHF 850 million). While many cases are still open, the loss rate for closed cases is high with 84%. Together with the federal provisions for future drawdowns of CHF 1.1 billion at the end of 2022, the expected losses amount to around CHF 1.6 billion or approx. 10% of the granted credit volume of the Covid-19 loans. However, we assume that the losses given default will reach a higher amount. Even though the

Covid-19 loans are not formally subordinated, due to the long maturities they are structurally subordinated, i.e. other financial liabilities will be repaid first, apart from the contractually agreed amortizations on the Covid-19 loans. In addition, Covid-19 loans are generally unsecured, so in the event of bankruptcy, lenders with collaterals are serviced first, which increases the expected loss given default for Covid-19 loans. With the ban on dividends during the term of the loans, there is also a strong incentive for profitable companies to early refinance Covid-19 loans, even if the interest costs are slightly higher. Due to the negative selection, the higher credit risks remain in the Covid-19 loans, what we are increasingly noticing in our daily work. In difficult situations, the Covid-19 loans are generally retained, as they represent subordinated debt financings on terms that are well below market conditions.

We estimate losses given default on the Covid-19 loans, which the federal government will have to bear, totalling CHF 2.1 to 2.5 billion. Nevertheless, we would describe the instrument as a Swiss success story, which made a significant contribution to Switzerland being able to weather the Covid-19 pandemic well from an economic point of view.

About Fincerta

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