

Agenda

Advancing economics in business

Throwing good money after bad? EU rescue and restructuring aid guidelines

As part of its state aid modernisation initiative, the European Commission is revising its guidelines for rescue and restructuring (R&R) aid. Oxera's 2009 report on restructuring aid provided evidence on the indicators and impact of financial difficulty, to inform the Commission's decision criteria. The Commission's proposed revisions to the guidelines now emphasise a role for objective economic analysis—such as financial ratios and counterfactual economic scenarios—in assessing whether to allow R&R aid

In the context of EU state aid policy, R&R aid refers to the use of public funds to rescue and restructure firms that are in difficulty. For example, in July 2013 the European Commission approved financial support given by France to the car manufacturer, PSA Peugeot Citroën, to enable it to restructure itself following a period of financial difficulty.¹

The Commission has launched a review of its 2004 R&R guidelines² and is planning to adopt a revised framework in the first half of 2014.³ This revision of the guidelines is timely as it will allow the Commission to revise state aid rules in light of lessons learned from the recent financial and economic crisis, to ensure that aid measures are well-targeted and least-distortive. As noted by Joaquín Almunia, Commission Vice-President in charge of competition policy:⁴

While keeping inefficient firms artificially alive is a waste of taxpayers' money which harms competition and hinders economic growth, the jobs and know-how of companies that are viable if they restructure can be preserved through well-targeted support. Our [R&R] guidelines on state aid for firms in difficulty aim to preserve this fine balance.

This article comments on the Commission's proposed overhaul of the R&R framework, with a focus on the following.

- **A sectoral dimension to a horizontal framework**—the Commission has indicated a departure from the horizontal nature of the 2004 R&R framework by proposing R&R rules for the financial sector separate to those for non-financial undertakings.⁵
- **A new 'T' in the R&R framework: temporary aid**—in addition to the original categories of rescue aid (i.e.

short-term) and restructuring aid (i.e. long-term), the Commission is now proposing an intermediate category of 'temporary restructuring aid', which is envisaged as a form of liquidity assistance for small and medium-sized enterprises (SMEs) for around 12–18 months.

- **Burden-sharing**—owing to a lesson learned from the recent economic crisis, the Commission is proposing more narrowly defined rules on 'burden-sharing'—i.e. the contribution that the aided firm and its investors make towards restructuring costs.
- **Financial ratio analysis**—the Commission now requires a higher degree of sophistication in conducting financial ratio analysis to demonstrate that a firm is 'in difficulty' and is therefore a candidate to receive R&R aid.
- **Counterfactual analysis**—as a criterion for allowing R&R aid, the Commission now requires more economic analysis in order to understand what would happen if a failing firm did not receive aid.

This article comments on each of these points in turn.

A sectoral dimension to a horizontal framework

The 2004 R&R guidelines applied to both financial institutions and non-financial undertakings. As the financial and economic crisis which began in 2007 evolved, however, the Commission developed an increasingly elaborate set of temporary sector-specific rules for state aid to financial institutions. These rules were set out in a series of crisis-related Communications for the financial sector from 2008 onwards.⁶

The post-2008 financial sector Communications were underpinned by principles that were in common with the 2004 R&R framework, including the restoration of long-term viability, limiting aid to the minimum amount necessary, and avoiding undue distortions to competition. However, the crisis-related Communications were more sector-specific and detailed than the R&R guidelines, as they sought to address novel issues in the financial sector following the crisis, such as the appropriate design of national schemes for insuring impaired assets.

In revising the R&R framework for 2014, the Commission has stated that the new guidelines will apply only to non-financial undertakings. Financial undertakings will continue to be subject to sector-specific rules. This is an important legacy of the crisis: with a flurry of ongoing change to the regulatory architecture dealing with the winding-down and resolution of banks, it is no longer practical to deal with financial undertakings through a generic set of R&R guidelines. The sectoral stratification within a hitherto horizontal framework acknowledges that market failures and state aid measures to address these failures may differ in the financial sector relative to the rest of the economy.

A new ‘T’ in the R&R framework: temporary aid

As another legacy of the economic and financial crisis, the Commission has shown signs of moving away from its clear distinction between short-term ‘rescue’ and long-term ‘restructuring’ aid. In the proposed R&R guidelines for 2014 onwards, the Commission has introduced a new category of liquidity aid: ‘temporary restructuring aid’. Specifically, under the new rules, three forms of potential assistance to failing institutions are considered:⁷

- **rescue aid:** this is temporary assistance that is given for a period of no more than six months—meaning, for example, that any loan must be repaid or any guarantee withdrawn within six months. The primary objective of rescue aid is to keep an ailing firm afloat for long enough to work out a restructuring or liquidation plan. Rescue aid is commonly followed by restructuring aid;
- **restructuring aid:** this is long-term aid designed to restore the long-term viability of the beneficiary on the basis of a ‘feasible, coherent and far-reaching restructuring plan’;
- **temporary restructuring support:** in common with rescue aid, temporary restructuring support can only take the form of liquidity assistance that is limited in both amount and duration. However, this contribution is designed to support an entire restructuring process, rather than as a preface to receiving restructuring support. Temporary restructuring support may not be followed by further rescue or restructuring aid. The Commission is considering limiting the maximum

duration of temporary restructuring support to 12 or 18 months. In addition, it envisages that this form of support may be granted to SMEs only.

This new category of temporary restructuring support is interesting for a number of reasons:

- in limiting this form of aid to SMEs, the Commission is acknowledging that smaller undertakings suffer disproportionately in crisis conditions;
- in recognising the importance of medium-term access to liquidity, the Commission has learned a lesson from the liquidity crisis that accompanied the start of the financial crisis in 2007;
- the temporal dimension means that it will be easier for an SME to access temporary restructuring aid, but the undertaking must be confident that it can restructure itself within 12 to 18 months without requiring longer-term support measures.

Burden-sharing

The Commission is proposing more narrowly defined rules on how much of the costs of restructuring are to be supplied from a failing firm’s own resources as a condition for receiving aid. As part of the 2004 guidelines, the Commission specified that it would require firms to meet around 25–50% of their restructuring costs, by selling assets or raising external capital.⁸

Under the revised proposals, there is a greater burden-sharing requirement.

- The Commission now requires ‘bail-in’ from debt and equity investors, before a failing firm is eligible to receive a ‘bail-out’. For example, the Commission proposes that debt-holders be required to take a haircut on some loans in the event that a failing firm faces a shortage of capital.⁹

Where the beneficiary’s difficulties relate to a shortage of equity capital, that contribution should include measures such as raising fresh equity from incumbent shareholders, the write-down of existing debt and capital notes or the conversion of existing debt to equity, the raising of new private external equity or the sale of assets that are not essential to the beneficiary’s survival

- Also, the amount of own investment should be equivalent to the whole aid amount, or to 50% of the restructuring cost, which is higher than the 25–50% threshold specified in the 2004 guidelines.

The higher burden-sharing measures are designed to curb excessive risk-taking by aid recipients, by ensuring that private capital will also bear the risks inherent in reshaping a failing firm to restore viability.

Financial ratio analysis

The 2004 guidelines provided advice on the interpretation of a firm 'in difficulty'. A firm was deemed to be in difficulty if more than half of its registered capital had 'disappeared', or if it was subject to collective insolvency proceedings.¹⁰ In Oxera's report for the Commission on restructuring aid, empirical analysis of the indicators of financial distress showed that firms in difficulty exhibit a marked deterioration in financial performance in the three years leading up to the distress. The Commission has incorporated this finding in specifying additional, more objective, decision criteria for assessing whether a firm is in difficulty:¹¹

Where the undertaking is rated the equivalent of CCC+ ('payment capacity is dependent upon sustained favourable conditions') or below by at least one registered credit rating agency.

Where: (1) the undertaking's book debt to equity ratio is greater than [7.5] [and]/[or] (2) the undertaking's [EBIT]/[EBITDA] interest coverage ratio has been below [1.0] for the past [two] years.

The Commission therefore requires evidence on a firm's gearing and interest coverage ratios over the past two years to substantiate whether the undertaking is in difficulty. This is in line with the empirical analysis conducted for the Commission by Oxera.

To provide greater clarity for member states, the Commission may consider providing more detailed guidance on ratios and thresholds. For example, it has recommended that, to substantiate that a firm is in difficulty, the EBIT/EBITDA interest coverage ratios should be below 1. There can be a significant difference between EBIT and EBITDA measures of operating profitability, so the Commission may consider whether it would be appropriate to apply a similar threshold to both ratios.

Counterfactual analysis

The 2004 guidelines reflected a policy presumption that the provision of restructuring aid saves a 'considerable amount of jobs and activities which would otherwise disappear', but with limited evidence or quantification underpinning this assumption.¹² In its study for the Commission, Oxera assessed the impact of financial difficulty and distress on firms' output and employment. It was found that the impact of a firm's financial distress on regional output and employment was more likely to be severe under certain conditions—for example, where there are high levels of unemployment in the local region, where there is no training available for displaced workers, where the firm owns assets that are not easily transferable, and where the firm is systemically important.¹³

In line with the evidence examined by Oxera, in the revised R&R guidelines the Commission envisages that member

states would have to robustly demonstrate that 'the failure of the beneficiary would be likely to involve serious social hardship or severe market failure.'¹⁴ The Commission points to the use of various economic tools for assessing the impact of failure on competition and market dynamics—for example, the Commission requires firms to demonstrate that failure would lead to eventualities such as:¹⁵

- difficulty in creating new employment in a region which already exhibits persistently higher unemployment than the EU or national average;
- the risk of disruption to an important service which is hard to replicate and where it would be difficult for any competitor to easily step in;
- the exit of an undertaking with an important systemic role in a region or sector;
- an irremediable loss of important technical knowledge or expertise.

At the same time, the Commission requires an assessment of counterfactual scenarios—i.e. credible alternative scenarios not involving state aid that demonstrate what would happen if aid were not granted, and how this would jeopardise the development objectives of the sector or region. The Commission suggests that counterfactual scenarios could include debt reorganisation, asset disposal, private capital-raising, and sale to a competitor or break-up. This requirement for a substantive counterfactual assessment is a new addition to the R&R guidelines which should increase the objectivity of the Commission's decision-making criteria in allowing R&R aid.

However, the proposed guidelines do not provide sufficient detail on how the counterfactual assessments will be conducted. The present wording of the criteria may be too vague to be meaningful—for instance, how should a member state substantiate 'risk of disruption to an important service which is hard to replicate and where it would be difficult for any competitor to easily step in'? For example, if an airline faces financial distress, it could be asserted that there is a risk of disruption to an important service and that competitors will not be able to replace the failing airline's routes. However, in this case a member state would have to prove why other airlines would fail to enter profitable routes. (Presumably the unprofitable routes would close whether or not aid is given, since a restructuring plan for viability should not be based on a scenario where the aided airline continues to run unprofitable parts of its network.)

Role of counterfactual analysis in designing compensatory measures

The requirement for a robust counterfactual assessment goes to the heart of the Commission's policy objective that aid should be well-targeted. However, the draft R&R guidelines do not refer to a role for counterfactual analysis

in calibrating any remedial measures—to ensure that moral hazard¹⁶ and any competitive distortions are minimised—after a decision has been taken to allow aid. There is a potentially useful role for counterfactual scenario analysis in calibrating the design of any such compensatory measures.

- If counterfactual analysis shows that a firm would exit the market absent aid, and that few of the firm's assets could be redeployed in the economy, then keeping it alive with aid would imply a significant distortion to competition. In this case, it may be appropriate to introduce strong compensatory measures as a condition in allowing aid.
- If counterfactual analysis shows that a firm is fundamentally viable, and that its assets can be substantially reused by a different management team, then providing aid (e.g. to restructure short-term liabilities) can be considered as a soft form of a bankruptcy proceeding. The firm is likely to require minimal intervention to keep it alive. In this case, it is likely that the distortion to competition would be limited, and it may be appropriate to impose limited compensatory measures as a condition in allowing aid.

Counterfactual analysis can therefore be used to design compensatory measures which are oriented to the market outcome. This would allow competitive distortions which

arise with R&R aid to be minimised. It would also incentivise member states to keep the aid given to the minimum necessary, in the knowledge that granting more distortive aid measures will lead to the Commission imposing stricter compensatory measures on the beneficiary firm.

Are the proposed guidelines appropriate?

Given that R&R aid has the potential to be highly disruptive to well-functioning competitive markets, it is important to ensure effective controls in allowing it. The Commission is proposing to tighten the R&R guidelines from mid-2014 onwards, and has emphasised a role for robust economic analysis—including financial ratio analysis and counterfactual economic scenarios—as a criterion in assessing whether to allow R&R aid. While clearer guidance on appropriate financial metrics and counterfactual scenarios would be welcome, in general this move to using financial ratio indicators and conducting counterfactual analysis should provide a more objective assessment of whether a firm is in difficulty, and what market failures are likely to arise if support is not given. As such, the R&R reform is compatible with the Commission's objective to promote 'good aid': aid that is well-designed, targeted at identified market failures, and least-distortive.¹⁷

¹ European Commission (2013), 'State aid: the Commission approves the restructuring plan for the PSA Peugeot Citroën group', press release, 30 July.

² European Commission (2004), 'Communication from the Commission, Community Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty', 2004/C 244/02, *Official Journal of the European Union*, 1 October, paras 43–4.

³ European Commission (2013), 'State aid: Commission consults on draft guidelines for supporting firms in difficulty', press release, 5 November.

⁴ European Commission (2013), 'State aid: Commission consults on draft guidelines for supporting firms in difficulty', press release, 5 November.

⁵ 'Horizontal' measures are aimed at solving problems that may arise in any industry and country, while 'sector-specific' rules are geared towards addressing problems in a particular industry.

⁶ Including the Banking Communication, the Recapitalisation Communication, the Impaired Assets Communication, the Restructuring Communication and the Prolongation Communication. See http://ec.europa.eu/competition/state_aid/legislation/temporary.html.

⁷ European Commission (2013), 'Communication from the Commission, Guidelines on State aid for rescuing and restructuring non-financial undertakings in Difficulty', draft, 5 November.

⁸ European Commission (2004), 'Communication from the Commission, Community Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty', 2004/C 244/02, *Official Journal of the European Union*, 1 October, paras 43–4.

⁹ European Commission (2013), 'Communication from the Commission, Guidelines on State aid for rescuing and restructuring non-financial undertakings in Difficulty', draft, 5 November, para. 64.

¹⁰ See European Commission (2004), 'Communication from the Commission, Community Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty', 2004/C 244/02, *Official Journal of the European Union*, 1 October, para. 10. In the proposed revisions to the guidelines, the Commission is more explicit about the meaning of 'disappearing' capital—it explains that, in the case of a limited liability company, the company will be considered to be in difficulty if more than half of its subscribed share capital has disappeared as a result of accumulated losses. This occurs when the deduction of accumulated losses from reserves (and all other elements generally considered part of the company's own funds) leads to a negative result that exceeds half of the company's subscribed share capital.

¹¹ European Commission (2013), 'Communication from the Commission, Guidelines on State aid for rescuing and restructuring non-financial undertakings in Difficulty', draft, 5 November, para. 21. EBIT, earnings before interest and taxes. EBITDA, earnings before interest, taxes, depreciation and amortisation. Square brackets are in the original draft text.

¹² European Commission (2008), 'Specifications to invitation to tender COMP/2008/A3/015', July.

¹³ Oxera (2009), 'Should aid be granted to firms in difficulty? A study on counterfactual scenarios to restructuring state aid', prepared for the European Commission, December, section 8.

¹⁴ European Commission (2013), 'Communication from the Commission, Guidelines on State aid for rescuing and restructuring non-financial undertakings in Difficulty', draft, 5 November, para. 45.

¹⁵ See European Commission (2013), 'Communication from the Commission, Guidelines on State aid for rescuing and restructuring non-financial undertakings in Difficulty', draft, 5 November, para. 45.

¹⁶ 'Moral hazard' refers to a situation where an aid beneficiary may be incentivised to take excessive risk because it believed that the costs of the risky activity would be borne by another party. For example, banks may have an incentive to engage in high-risk lending if they believe they will be bailed out by taxpayer support in the event of financial distress.

¹⁷ European Commission (2012), 'EU State Aid Modernisation (SAM)', Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, 8 May, para. 12.