European Association of Public Banks
European Association of Public Banks and Funding Agencies AISBL

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EAPB position on public consultation on rescue and restructuring guidelines

European promotional banks carry out targeted promotional measures on behalf of their owners – central and regional governments and municipalities. National, regional, and often additional European funding is used for this purpose.

European state aid rules are of essential importance in this context. Against this background, we would like to make a few suggestions and point out some significant shortcomings in the context of the consultation on the revision of the rescue and restructuring guidelines for companies in difficulty. Our primary concern is the definition of undertakings in difficulty (UiD), which should reflect economic reality and be simplified.

Key demands:

→ 1. Mezzanine capital should be recognized as part of own funds when assessing whether a company should be classified as an UiD.

→ 2. For small and medium-sized enterprises (SMEs), only the existence of grounds for insolvency under national law should justify UiD status.

→ 3. Exclusion of UiD for risk sharing aid

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1. Recognition of mezzanine capital as part of own funds

According to paragraph 20 of the Guidelines on State aid for rescuing and restructuring non-financial undertakings in difficulty (Rescue and Restructuring Guidelines), an undertaking is considered to be in difficulty if it is virtually certain that it will be forced to cease trading in the short or medium term unless the State intervenes. The definition is thus intended to reflect the actual economic circumstances of an undertaking.

Both the R&R Guidelines (paragraph 20(a) and (b)) and the General Block Exemption Regulation (GBER) (Article 2(18)(a) and (b)) refer to the capital depletion criterion. According to this criterion, a company is classified as in difficulty if more than half of its subscribed share capital or own funds have been lost.

According to the Commission's current interpretation of the term “own funds,” only funds that are classified as equity under IFRS accounting rules are considered own funds. However, mezzanine capital such as subordinated loans or typical silent partnerships is not recognized as equity in the balance sheet.

There is no clear regulation as to which balance sheet items may be recognized as own funds. In our opinion, the terms “other elements generally classified as own funds” and “own funds” cannot be equated with the term “equity capital” and therefore cannot be understood exclusively in accounting terms. Own funds must be viewed from a business perspective. This is also in line with standard business practice in the financial sector. In their balance sheet analyses and rating systems, commercial banks classify mezzanine financing as economic equity under certain conditions. Accordingly, banks take these financial instruments into account as economic equity capital when making credit decisions and thus when assessing whether a company can be expected to repay the loan with sufficient certainty. No other approach should be used when assessing whether a UiD exists.

In order for mezzanine financing to be recognized as economic equity by banks, it should be sustainable and subject to qualified subordination.

• Sustainability/long-term nature

The funds must be made available to the company on a long-term basis. In accordance with rating practice, this can be assumed if the financing is unlimited or has a term of at least five years. The financing may not provide for any repayment obligations during this period.

• Qualified subordination with pre-insolvency enforcement ban

In many cases where funding is provided by promotional banks, national law foresees a qualified subordination (see for example section 19 (2), section 39.(2) and section 39 (1) nos. 1 to 5) of the German Insolvency law (Insolvenzverordnung (InsO). In accordance with such rules, the creditor and debtor agree

that a claim will be subordinated in insolvency proceedings to the claims specified. Such a subordination agreement means that the claim in question is not taken into account in the debtor's over-indebtedness balance sheet. Forms of financing with qualified subordination therefore stabilize the company in the continuation of its business operations. The economic risk for the lender is equivalent to that of equity financing. Due to this equity-like financing and liability function, forms of financing with qualified subordination have the character of an entrepreneurial investment.

According to the economic fiction of the UiD definition, mezzanine financing under the conditions mentioned is suitable for mitigating or ending threatening situations for companies. Its exclusion as equity for purely formal accounting reasons is unjustified and leads to companies being unjustifiably classified as UiD. Against this background, the UiD definition should be supplemented by an own funds definition that includes mezzanine capital. We propose the following definition for this purpose:

“The own funds of an undertaking comprise the balance sheet equity capital and other funds that are similar to equity from an economic perspective.”

2. For small and medium-sized enterprises (SMEs), only the existence of grounds for insolvency under national law should justify the UiD status.

For reasons of practicability and in view of the experience gained from the COVID crisis, we propose that only the insolvency criterion (margin note 20(c) of the RuU guidelines, Art. 2(18)(c) of the AGVO) should be applied to small and medium-sized enterprises.

The Commission itself proposes not to apply all quantitative criteria of the UiD definition to start-ups and scale-ups, as companies may meet the currently applicable criteria for UiD at certain stages of their life cycle even though they are not actually in difficulty. As a result, these companies are excluded from access to State aid support programs. In our opinion, there are also periods of particularly intensive growth or short-term investment needs in later stages of a company's life cycle – not only for start-ups and scale-ups, but for all SMEs. Against this background, the capital consumption criterion should no longer play a role in the definition of UiD for all SMEs, regardless of their age. The only decisive factor for the UiD classification of SMEs should be the insolvency criterion, i.e., “the company is subject to insolvency proceedings or meets the conditions laid down in national law for the opening of insolvency proceedings at the request of its creditors.”

This would provide a clear assessment criterion that does not disadvantage or favor any particular corporate legal form, as not all companies are required to prepare a balance sheet due to the different corporate legal forms. In the case of companies that are not required to prepare balance sheets, it is not even possible to determine whether more than half of their own funds have been lost as a result of accumulated losses, given the mere existence of an annual income surplus statement.

The basic idea of privileging SMEs runs through the entire EU State aid law, as can be seen in numerous regulations. It is therefore only logical to include such privileges in the UiD criteria as well. With the exception of the additional criterion of debt ratio/interest coverage ratio, which only applies to large companies, the same strict criteria apply to SMEs as to large companies. However, SMEs often face different challenges, a different financial structure, and different risks. Apart from the insolvency criterion, i.e., pending insolvency proceedings or imminent insolvency, no further criteria are required for SMEs.

This would have the advantage of greater transparency and legal certainty for users and companies, as well as less bureaucracy. For SMEs, reliance solely on the insolvency criterion should apply as an alternative, at least in the first ten years after they commence business activities. The capital consumption criteria should not constitute grounds for insolvency during this period. In addition, the condition from the 2004 guidelines that more than half of the lost funds must have been lost in the last twelve months should be reinstated for the capital consumption criterion.

3. Exclusion from UiD status for companies receiving risk sharing aid

We agree that State aid should not be granted to undertakings lacking market viability, as such support can hinder the development of more deserving businesses. While the assessment of an undertaking's market viability should theoretically concern its future business. we agree with the need to have a general definition of a UiD, and that this definition must be formal, easily applicable and therefore based on historical financial statement data, which in most cases is the only way to provide certainty from a legal point of view.

However, we believe that when an undertaking receives State aid through a financial product and when a financial intermediary assumes a higher and relevant risk on MEOPs capital than previously (on their own books in the case of commercial banks or on capital of genuine private independent investors in other cases), it should never be considered a UiD. In this case, the decision by private and experienced entities, such as banks and professional investors, to invest their new MEOP capital serves as a more reliable indicator of a company's market viability than the formal definition of a UiD, reliably assessing the undertaking's future business, beyond historical financial data alone, which may be negative even due to temporary challenges. The current R&R aid guidelines, with greater emphasis than the previous ones, already indicate "burden sharing" (the sharing of the risks of loss between state resources and MEOPs capital) as a fundamental element for the compatibility of the aid to restructuring plan.

We propose that an undertaking receiving State aid through a financial product and from a financial intermediary which assumes a higher and relevant risk on MEOPs own capital than previously, be not considered a UiD even under the GBER definition, if necessary at least for aid schemes and excluding ad hoc aid.

The relevant share of new risk assumed by MEOPs capital for excluding that the beneficiary company is a UiD should be the same as already foreseen in the case of public guarantees on loans (20%) and in the case of equity investments (30% or the lower shares foreseen by art. 21 (12) of the GBER when applicable.

If anything, safeguards should be provided to ensure that this risk take from MEOPs capital is a "genuine new risk", i.e., not offset by a reduction in risks assumed by the same financial intermediary (e.g., early repayment of pre-existing loans, replacement of lower collateral, etc.), also considering this at group level.

We believe that all public-private equity co-investments should be exempted from the UiDs rule, even in the form of risk financing aid under Article 21 GBER, because they have already to involve significant new risk-taking by MEOPs capital and profit oriented investments decision to be compliant with State aid rules. These rules appear sufficient to ensure that public support is directed exclusively to undertakings with a market viability, irrespective of their age, and so promote investments also in more deep and disruptive technologies that require extended periods to achieve profitability.

The European Association of Public Banks (EAPB) gathers over 30 member organisations which include promotional banks such as national or regional public development banks and local funding agencies, public financial institutions, associations of public banks and banks with similar interests from 17 European Member States and countries, representing directly and indirectly the interests of over 90 financial institutions towards the EU and other European stakeholders.

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