European Economic and Social Committee

OPINION

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Recapitalising EU companies – An innovative way towards sustained and inclusive recovery

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Recapitalising EU companies – An innovative way towards sustained and inclusive recovery
(Own-initiative opinion)

ECO/582

Rapporteur: **Antonio GARCÍA DEL RIEGO**

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	Own-initiative opinion
Section responsible	Economic and Monetary Union and Economic and Social Cohesion
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(for/against/abstentions)	186/0/2

1. **Conclusions and recommendations**

1.1 Recent evidence estimates an equity and hybrid capital shortfall of EUR 450-600 billion. This puts many companies at risk, especially considering that new economic tensions are arising and that EU companies are over-indebted. EU companies rely mainly on banking financing, and other sources of funding should therefore be encouraged. This requires involving actors such as asset managers, insurance companies and pension funds.

1.2 In this context, the EESC recommends the development of a framework that enhances hybrid financial instruments, so that they are easy to implement, reinforce firms' balance sheets and allow companies to maintain their level of investment without increasing their indebtedness. This would allow them to remain competitive and to be able to adapt to the future, by boosting their green and digital transformations.

1.3 Highly subordinated instruments are the best possible alternative for several reasons:

i) They already exist and are regulated in different European countries, making them a secure instrument for Micro, Small and Medium-Sized Enterprises (MSMEs);
ii) They are an agile long-term solution, easy to implement, for firms of all sizes, compared to more sophisticated alternatives such as bonds or shares;
iii) They are a product compatible with family businesses, which account for 60% of EU firms, as usually these families wish to retain control of their company.

1.4 To be an effective solution, these instruments should have a quasi-equity status, so as to not account as debt in balance sheets, ranking just before equity in waterfall payments in the event that a company is liquidated.

1.5 To have a large impact, reaching companies of all sizes, the best option is a scheme where there is collaboration between private and public institutions, including banks, asset managers, public sector, and institutional investors (insurers and pension funds).

1.6 This recommendation serves a long-term goal with a solution that can be implemented in the short term, and would support the Capital Markets Union (CMU). An EU-wide instrument model could benefit from the visibility, liquidity and scale of the single market and generate broad appeal among institutional investors seeking debt and hybrid-type risk profiles but with higher returns, while catering to the needs of smaller companies. With sufficient EU-wide scale, a successful framework could develop into a well-defined asset class, encouraging investment and EU integration.

2. **Background**

2.1 Small and medium-sized companies are the heart of the economy: in the EU-27, they represent 99.8% of all firms, almost two thirds (65%) of employment and more than half (53%) of the value added generated by the non-financial business sector (NFBS)[1]. They are the real economy and the main factor for social cohesion in many European regions. There were over 22.5 million

1 Annual Report on European SMEs 2020/2021, European Commission, July 2021.

SMEs in 2020. There are just under 200 000 medium-sized SMEs, but they account for 17.3% of value added and 16% of employment[2].

COVID-19 hit the economy hard throughout 2020 and for part of 2021, but the rapid response of governments with temporary public measures prevented a widespread wave of COVID-19-related bankruptcies, mainly through solutions to address liquidity and short-term issues that have resulted in over-indebtedness among EU companies.

The end of most public support measures already granted coincides with new tensions affecting the global and European economies, such as energy crisis, inflation, the end of the ECB's
2.2 accommodative monetary stance, the widening of risk premia, the increased cost of financing, problems in supply chains and Russia's invasion of Ukraine.

Europe's position as the leader of the green transition will require large investments from public and private agents. SMEs' weakened position could make it difficult for them to adapt to new
2.3 standards and cause them to lag behind large corporations or mid-sized companies from other parts of the world.

Given that a high proportion of companies are overindebted[3] and at the same time need long-term resources to face upcoming challenges, new solutions that reinforce the capital of MSMEs
2.4 and small midcaps are needed. Existing initiatives at European level, such as EIB's ESCALAR programme, usually target high-growth corporates that are considered scale-ups or companies in their early stages that are financed by venture capital funds. New solutions should complement those currently in place and focus on existing and established MSMEs and small midcaps, which make up the majority of European firms.

2.5

Some countries have launched selective measures to reinforce the investment capacity of companies, while avoiding the risk of "zombification". In Spain and France, these programmes represent more than EUR 30 billion for 15 000 companies[4], using deeply subordinated loans as the main instrument and credit rating as a selection criterion to ensure recipients are viable firms.

3. General observations

2.6

The over-indebtedness of European companies demands some sort of recapitalisation instrument that allows them to keep or increase their investment effort. Public markets have supported existing listed companies reasonably well to date, but private ones lack the depth to support smaller companies. The equity and hybrid capital gap that the EU could face because of the pandemic and the reduction of state support measures is estimated at EUR 450-600 billion[5].

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2 Annual Report on European SMEs 2020/2021, European Commission, July 2021.

3 The debt ratio increased by 18.8 percentage points between the end of 2019 and early 2021, peaking at 164.4%. ECB Economic Bulletin, Issue 2/2022.

4 Ministry of Economy of France, COFIDES, SEPIDES, Instituto Valenciano de Finanzas.

5 Recapitalising EU businesses post COVID-19, AFME and PwC.

MSMEs and small mid-caps generally report that they find it more difficult to access finance than large companies, especially long-term financing:

When applying for a loan, a larger proportion claims that they face obstacles (7% of SMEs compared with 4% of large companies), they have lower success rates (72% vs 85%) and higher rejection rates (6% vs 2%) as well as worse conditions, according to the SAFE survey[6].

3.2 Family businesses represent more than 60% of all European companies (with the figures rising to 85% in Spain and 75% in Italy, France and Germany[7]). These companies are less likely to seek equity alternatives for long-term financing that require giving up control of the company.

3.2.1

On top of this, SMEs tend to have a less diversified portfolio of external financial instruments, often bank-based and geared towards short-term uses.

i) SMEs' dependency on banks remains high in the Eurozone, with 70% of external financing
3.2.2 being reliant on banks, against 40% in the US[8].
ii) 63% of large firms report using funds for fixed investment, compared with 38% of SMEs, and only 28% of micro firms[9].

3.3 This own-initiative opinion therefore recommends developing a common framework for highly subordinated financial instruments that boosts the recapitalisation of EU companies. This framework should ensure that these instruments have a quasi-equity consideration, so it does not affect the debt ratio of companies and their corporate rating.

This opinion calls the EU to take action collectively to properly develop this common framework in line with the principles of subsidiarity and proportionality, authorising
3.4 intervention by the Union when the objectives of an action can be better achieved at Union level by reason of scale and effects of the proposed action.

This framework for highly subordinated instruments should:

i) Close the aforementioned financing shortfall in long-term financing to reinforce balance
3.4.1 sheets and support investment;
ii) Provide family businesses with an instrument to boost their long-term investments without giving up control of their firm, as studies show that they are willing to distribute a share of profits and/or issue hybrid instruments[10];
iii) Be compatible with the practices of the main financial providers (commercial banks, asset
3.4.2 managers, the public sector) so it can reach a majority of companies;
iv) Help to attract institutional investors, such as insurance companies and pension funds, subject to the PRIIPs regulation, who manage savings and are a key player for channelling more assets to the real economy.

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6 Survey on the access to finance of enterprises (SAFE), European Commission, November 2021.

7 European Family Businesses, EFB.

8 European SMEs Financing Gap, Euler Hermes.

9 Survey on the access to finance of enterprises (SAFE), European Commission, November 2021.

10 Recapitalising EU businesses post COVID-19, AFME and PwC.

There are different highly subordinated instruments that could be used to reinforce SMEs and midcaps balance sheets, such as bonds, convertible bonds, dual-share schemes, and hybrid loans (such as participative loans):

3.5

i) Bond issuance is mainly used by large caps and for large emissions. They are complex and expensive. For example, even if the use of corporate bonds has grown considerably in recent years, there are only 2 000 active issuers in total, mainly larger companies[11];

ii) Private Convertible bonds have the main advantage of being extremely flexible in terms of structure, as they are a private contract. However, that also implies a low level of security for smaller companies, usually with less financial literacy, and a high transaction cost. They are mainly used by sophisticated venture capital providers;

iii) Dual share schemes refer to the issuance of two classes of shares, one of which usually has limited or no voting rights, while providing equity. Although in some Member States this instrument is allowed[12] (such as the Nordic countries, Poland, Portugal and Italy), in many others (such as Germany, France and Spain) it is not, and a large-scale deployment seems tougher to achieve, since it would require a high degree of adaptation to the company issuing shares;

iv) Hybrid loans are debt instruments that are deeply subordinated and oriented towards the long term (usually including grace periods). This is an instrument that is regulated in many jurisdictions, giving companies more security, and making the process more agile, since the product is not created in each operation. On top of this, it does not penalise companies in terms of indebtedness, as it ranks last in the repayment order, before equity.

	Deployment	Feasibility	Track Record	Company protection	Investor protection
Bonds	Low	High	Low	Medium	High
Convertible bonds	Medium	Medium	Low	Low	High
Dual shares	Low	Medium	Medium	High	Medium
Hybrid loans	High	High	Medium-High	High	Medium

Source: Inbonis Rating.

A hybrid loan instrument is the best alternative for several reasons:

i) They represent a long-term solution that is easy to implement and provides greater protection to companies, when compared with bonds or shares;

ii) For MSMEs, it ensures that there is no dilution or loss of control, while having cost-related advantages, such as tax deductibility or lower issuance costs);

iii) For lenders, it offers an attractive return, with no need to involve holders in corporate decisions;

3.6 iv) Participative loans, a type of hybrid loan, already exist and are regulated in many European countries, such as Spain (*préstamos participativos*), France, (*prêts participatifs*), Germany (*Partiarisches Darlehen*) or recently Portugal (*empréstimos participativos*)[13].

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11 The rise of non-bank finance and its implications for monetary policy transmission, 2021, ECB.

12 Study on minority shareholders protection, final report, European Commission.

13 Legal framework of participative loans approved by Decree Law 11/2022 of January 12.

Hybrid loans are the chosen instrument for different public and private initiatives to address the lack of capital funding across the EU: at least six programmes in three Member States, as well as some European Investment Fund programmes, use this hybrid participative loan:

i) France has the *Relance* Programme, an EUR 12.7 billion government-supported subordinated debt programme, targeted at 10 000 firms, mainly SMEs, using participative loans and subordinated bonds. This programme is being distributed by banks and is financed by institutional investors;

3.6.1 ii) In Spain, the EUR 1 billion Fund for the Recapitalisation of Covid-Affected Firms, for SMEs and midcaps that have solvency issues but are viable, using participating loans;

iii) Also in Spain, a 15-year, EUR 9 billion total Support Fund for the Productive Industrial Investment (EUR 600 million a year), public financed, using regular debt, participative loans and equity, targeted at companies with industrial investment projects;

iv) In Valencia, the regional development bank, Instituto Valenciano de Finanzas, has launched several financing programmes that use a participative loan to support SMEs and strategic Midcaps with an investment project, totalling EUR 400 million a year;

v) The Netherlands launched an EUR 400 million SME subordinated loan support programme.

To ensure effective deployment that reaches all MSMEs and has the maximum impact, the best operational scheme is one where there are multiple public and private originators and distributors, who might not be the same. Originators include banks, asset managers as well as the public sector, whereas the investors can be the own banks, the public-sector or institutional investors (insurers and pension funds). This framework refers to newly originated transactions, not the securitisation of existing ones. This is, for example, what was done in France, with its *Relance* programme[14].

3.7

Mitigation of potentially perceived risks of a hybrid loan scheme being distributed at scale across Europe:

Perceived risk	**Solution**
Supervising shadow banking	Including tools to manage risk, such as the credit rating, would remove the risk of shadow banking.
3.8 Crowding out banks	A hybrid loan instrument would restore the solvency of companies and banks would therefore be willing to keep lending to them.
Compatibility with Debt Equity Bias Reduction Allowance (DEBRA) initiative	This initiative also seeks to avoid the over-indebtedness of companies, so it is compatible with the main objective of the DEBRA initiative.
Restoring solvency of non-viable companies	Introducing market standards such as the credit rating would prevent non-viable companies from accessing these instruments. Many public programmes using participative loans have included this requirement.

14 *Dispositif de garantie aux fonds de prêts participatifs et d'obligations subordonnées* [French State Guarantee scheme for participative loan and subordinated bond funds], European Commission.

4. **Specific observations**

The proposed framework for hybrid loans should meet certain standards that make it attractive to all stakeholders: companies, financial providers acting as distributors and institutional investors.

It is essential that the framework ensures an equity consideration for this type of hybrid loan with the following effects:

4.1 i) For the calculation of the debt capital ratio, so it does not add to existing indebtedness or does not have an excessive impact on the debt-to-capital ratio. For example, in France Article 313-14 of the *Code monétaire et financier* [Monetary and Financial Code] establishes that "participative loans are, for the purposes of assessing the financial situation of the
4.2 companies receiving them, treated as equity capital";

ii) For the purposes of capital reduction. This is the case, for example, of the Spanish regulation, which states that participative loans are included in the calculation of equity for the purposes of capital reduction and dissolution of companies, and that early repayment or amortization of participative loans can only happen if it is followed by a capital increase of the same amount[15];

iii) In the event of insolvency, this hybrid loan should have a subordinated status, ranking behind ordinary debts or common creditors, and before shareholders. Failure to construct the debt in this way would likely undermine firms' ability to raise debt from traditional sources. One of the aims of the CMU Action Plan is to achieve greater convergence among the different insolvency regimes across EU Member States.

There are cases in which hybrid loans have an equity consideration according to International Financial Reporting Standards (IFRS) and Basel II. For example, when a hybrid loan has perpetual maturity, it qualifies as equity under IFRS rules due to its deeply subordinated status[16]. In general, hybrid instruments can be considered as equity if they are unguaranteed, subordinated and fully disbursed, if they are not redeemable at the initiative of the holder, if they can be used to cover losses and if the obligation to pay interests can be postponed[17].

4.2.1 The EESC recommends modifying the Accounting Directive 2013/34/EU so that the accounting procedure is harmonised for hybrid loans or other types of debt that have a maturity longer than eight years[18] with a grace period of at least three and with a variable interest rate, part of it linked to "success" defined at discretion (e.g., on growth, on profitability…). This modification will facilitate the computation of hybrid loans as equity when calculating the net worth of a company for commercial law purposes and treated as equity or own funds for accounting purposes.

4.2.2

15 Resolution of December 20, 1996, of the Instituto de Contabilidad y Auditoría de Cuentas (Accounting and Auditing Institute).

16 Decision of the Commission SA.60113 (2021/N) – Finland – COVID-19 aid to Finnair.

17 Basel II. 4. Hybrid debt/capital instruments, Annex 1a. Definition of capital. (d) Hybrid debt/capital instruments.

18 It has to be remembered that the average life of a company is around that number, and for private equity is even lower (five years).

To avoid uncertainty, the instrument should keep its debt consideration for other purposes (i.e., tax and legal), therefore the issuance of an equity-like instrument should not involve loss of voting control for companies.

Another important point for companies and investors alike is that the periodic interest paid on the subordinated debt instrument must not be subject to any tax withholding or deduction at source, so that the pool receives the interest income on a gross basis.

4.3

Regarding the investment side, a quasi-equity instrument such as the one proposed would qualify as an eligible instrument for European Long-Term Investment Funds (ELTIFs), according to Article 10 of the ELTIF Regulation, enabling it instantly to become part of the
4.3.1 financial ecosystem.

The ELTIFs could later be marketed in the EU by publishing a prospectus or a Key Information Document (KID) that complies with the requirement of the Prospectus Directive or the
4.4 Packaged retail and insurance-based investment products Regulation, respectively. This would help integrate retail investors into private debt and the real economy, something that has not yet been achieved with the crowdlending initiatives.

Ideally, the instrument should incorporate market standards such as credit ratings by ESMA-
4.4.1 registered agencies or Environmental, Social and Governance indicators assessments, to enhance the investor base.

Lastly, this initiative would support the CMU. An EU-wide approach, a common European instrument model, could benefit from the visibility, liquidity and scale of the single market and generate broad appeal amongst institutional investors seeking debt and hybrid-type risk profiles
4.4.2 but with better returns, while catering to the needs of smaller companies. With sufficient EU-wide scale, a successful framework could develop into a well-defined asset class encouraging investment and EU integration.

4.5 Brussels, 26 October 2022

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