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Competition *policy brief*

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New rules on rescue and restructuring aid for industry: the right incentives for innovation and growth

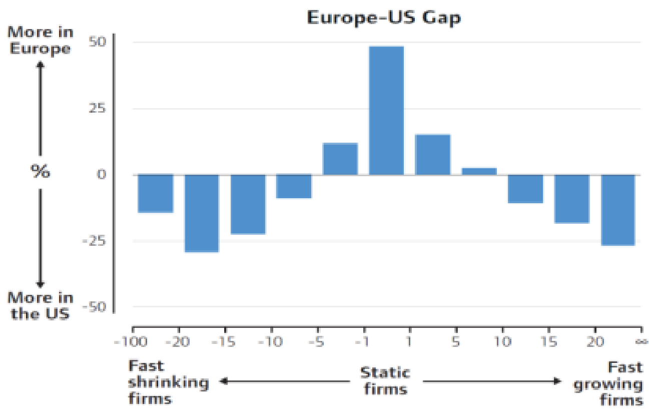
1. State aid control 2.0

The Commission is conducting a complete overhaul of its State aid rules. Following the principle of "trust and verify", the new rules massively cut red tape for less distortive aid measures thanks to more exemptions from prior notification to the Commission. At the same time, measures that may seriously harm competition or fragment the EU internal market will be subject to more careful scrutiny, monitoring and evaluation. This will allow the Member States and the Commission to promote "good aid" that fosters economic growth and other objectives of common interest, and to focus their scrutiny on the cases that matter. The new guidelines on rescue and restructuring aid for undertakings in difficulty, applicable to industry and services except the financial sector, play a key role in that effort.

2. Introduction

Why impose strict conditions on rescue and restructuring aid?

Financial distress at company level plays a signalling role in an economy, indicating that a firm is not making optimal use of its resources. If it does not manage to remedy this suboptimal use



of resources, the firm will disappear from the market.

The so-called churn process, that is to say the exit of firms and their replacement by others, is an important driver of productivity growth.

Comparing the churn processes in Europe and the US shows a much more dynamic picture in the US, with more firms either growing or declining quickly, while more European firms remain static. To help close the productivity gap with the US, the churn process in Europe needs to be encouraged and interventions that interfere with that process, such as rescue and restructuring aid, should be subject to strict control.

Aid to firms facing financial distress can also undermine the single market, by protecting national firms at the expense of their competitors in other countries. This not only shifts the burden of the necessary structural adjustment to other countries that may not have the budgetary resources to compete in a subsidy race. It also contributes to keeping markets divided along national boundaries, rebuilding with State aid the trade barriers that the single market has brought down.

Furthermore, when troubled firms receive aid, their more efficient and more innovative peers see the rewards for their efforts disappear. The result of this is a loss of incentive to invest and grow, and thus a loss of opportunities to raise productivity and create jobs across the EU.

Aid granted to firms in distress can therefore delay adjustments and ultimately waste public money. That is why this type of aid is

In a nutshell

In the current economic and social landscape, it is more important than ever that the challenges of the crisis be turned into opportunities to create sustainable growth and jobs. The new rules do that by providing incentives for rapid and effective restructuring; by targeting aid where it serves a real public interest; and by ensuring that investors, particularly shareholders, make a fair contribution to the costs of restructuring.

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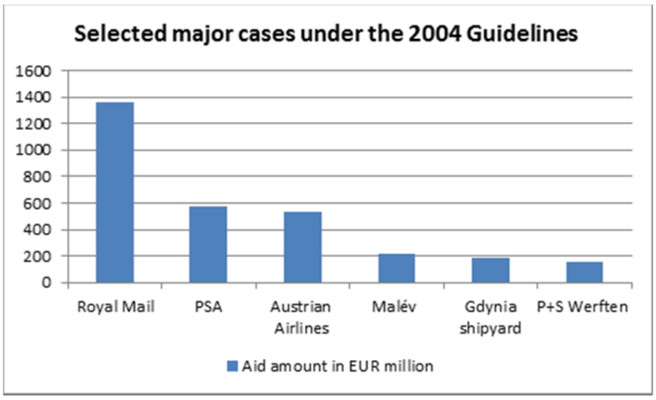
particularly distortive and requires close scrutiny and strict conditionality.

The rescue and restructuring guidelines in practice

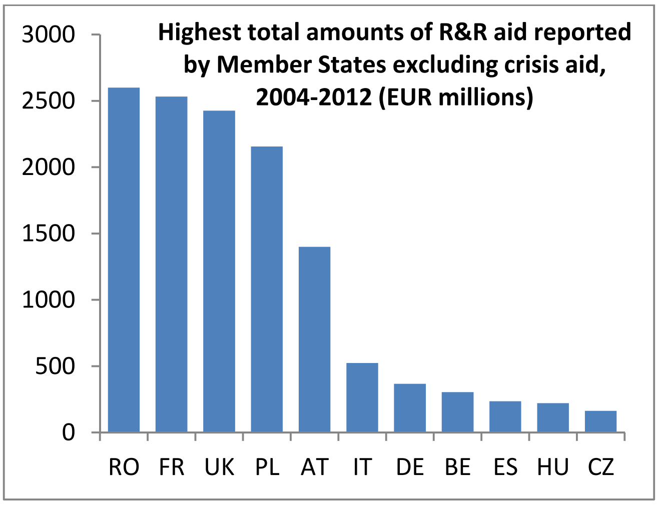
The new rescue and restructuring aid guidelines replace existing guidelines dating from 2004. The 2004 guidelines were the basis for almost 200 individual rescue and restructuring cases over the nearly ten years they were in force, including restructuring of the PSA group (manufacturer of Peugeot and Citroën), Royal Mail and TV2, of airlines in Austria, Italy, Malta, Cyprus and the Czech Republic, shipyards in Poland and Croatia, and rail operators in Bulgaria, Greece and the United Kingdom.

Between 2004 and 2012, and without counting aid granted under special crisis regimes, Member States together granted just under EUR 22 billion in rescue and restructuring aid.



The context in which the new guidelines have been adopted makes the issues at stake all the more pressing. While the European economy is showing signs of improvement, many firms still face difficulties and the threat of insolvency. Yet an expansion of rescue and restructuring aid, with the serious risks that would pose to growth prospects in the longer term, would not be the answer, even if governments had the resources available to pay for it. Instead, the rules need to be tailored to ensure that the current level of resources can be used more efficiently and with fewer market distortions.

Three reforms in particular are critical for the achievement of those goals: (1) better filters, to ensure that state aid is targeted at cases where it is really needed, (2) a new concept of temporary restructuring support, to simplify the granting of aid for restructuring SMEs while reducing competition distortions, and (3) new requirements for burden sharing, to ensure that a company's investors make a fair contribution to the costs of its restructuring.



3. The basics of the current rules

Rescue aid and restructuring aid

The 2004 guidelines distinguish between rescue aid and restructuring aid. Rescue aid is designed to allow firms that are facing imminent collapse to stay in business for long enough to prepare a restructuring plan. It must be in the form of liquidity support (loans or guarantees) and has a maximum duration of six months. If further public support is needed after that, it must be in the form of restructuring aid. Restructuring aid aims at supporting a firm's restructuring and its return to long-term viability. It can be granted for a longer period, but must be accompanied by a detailed restructuring plan that meets a number of conditions.

> Example:
> The economic crisis took its toll not only on banks but also on a number of firms operating in the real economy. PSA, manufacturer of Peugeot and Citroën, experienced large losses and a sharp decrease in sales in 2011 and 2012. As a result, Banque PSA Finance, which finances the commercial activities of the PSA group, found it impossible to refinance itself adequately on the markets, and, following a downgrade by rating agencies, faced an acute liquidity shortage. This, in turn, put the entire group at risk. The Commission thus initially approved a EUR 1.2 billion guarantee covering its market issues as rescue aid.
> Following the submission of a restructuring plan, the Commission launched an in-depth investigation, which it concluded in July 2013 with the approval of a package of restructuring aid, including a guarantee covering bond issues by Banque PSA Finance up to a maximum of EUR 7 billion and a repayable advance of EUR 85.9 million for the implementation of an R&D project.

The restructuring plan

To approve restructuring aid, the Commission needs to be satisfied that:

- the restructuring plan can be expected to bring the firm back to long-term viability without further public support,
- the firm will bear a sufficient proportion of the cost of its restructuring, and
- the plan provides for adequate measures, such as asset sales or capacity reductions, to keep the competition distortions caused by the aid to a minimum.

> Example:
> The restructuring of PSA illustrates well the significance of those three criteria in practice.
> To return to long-term viability, the PSA group reoriented its activity, reducing production capacity in some segments and increasing the specialisation of its production sites, while also investing in new diesel hybrid technology. A EUR 2 billion asset sale programme ensured that the firm bore a sufficient proportion of the restructuring costs. Finally, distortions of competition were reduced through an acquisition ban and a dynamic pricing mechanism for the guarantee that prevented the aid being used to increase the PSA group's sales artificially and harm its competitors.

Experience from the financial crisis

At the onset of the financial crisis, the Commission devised special rules for aid to banks, which are still in force, and (from 2008 to 2010) a temporary regime for aid to other firms. Once the most acute phase of crisis was over, the rescue and restructuring aid guidelines provided the basis for the assessment of aid to firms in difficulty in various sectors and across all Member States.

The experience of the crisis revealed a number of important lessons, such as the need for a more targeted and effective use of rescue and restructuring aid, the scope for reducing competition distortions by encouraging the use of liquidity over more distortive forms of aid and the importance of effective burden sharing to prevent losses being transferred from shareholders to taxpayers.

> Example:
> During the crisis, the Commission refined its distinction between temporary liquidity support and more structural measures such as recapitalisation. Following the collapse of interbank lending in autumn 2008, for some time a great number of banks could only refinance themselves with the backing of State guarantees. This aid was granted without further strings attached, and allowed some banks to implement internal restructuring without using more structural forms of aid. On the other hand, banks in need of capital support were required to submit restructuring plans, including measures to limit distortions of competition and burden sharing.
> The different consequences resulting from the granting of liquidity or capital support constituted a valuable incentive for banks to seek more distortive types of aid only as a last resort.

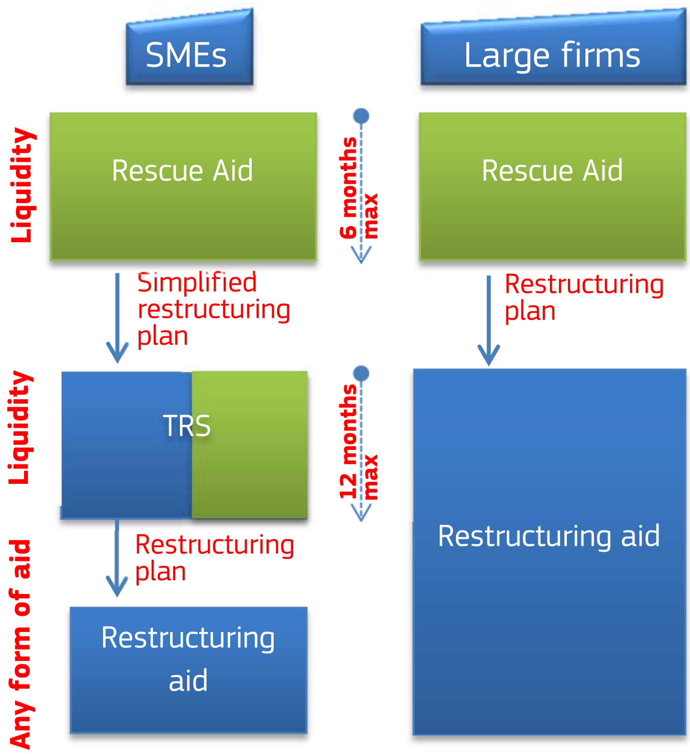
4. Key novelties introduced in the new guidelines

Better targeting of aid

The 2004 guidelines focused mainly on ensuring that when aid was granted, measures were taken to minimise competition distortions.

They said relatively little about whether it was necessary to grant the aid.

Three roads leading back to viability



In line with the goal of making more efficient use of state aid, the new draft guidelines include “filters” designed to check that aid is truly in the public interest in a given case.

First, it must be shown that the aid pursues an objective of common interest, in the sense that saving the undertaking would prevent social hardship or address market failures. The draft guidelines set out a non-exhaustive list of situations in which aid would be justified under this provision, for example where the unemployment rate in the region is particularly high or where the failure of the firm would lead to irremediable loss of technical know-how.

Aid will also only be in the public interest if it can make a difference to the situation that would prevail without aid. The guidelines therefore require Member States to present a comparison with a credible alternative scenario not involving State aid. For reasons of simplification, this requirement does not apply to rescue aid or temporary restructuring support.

Example:
In practice, this would mean that a State could, for example, provide restructuring aid to an important employer in a structurally weak region if not granting the aid would lead to disappearance of the jobs. However, it will need to consider whether the aid would really make a difference – whether, for example, the firm's viability could be ensured and the jobs preserved through restructuring supported by private investors rather than by the State.

Temporary restructuring support for SMEs

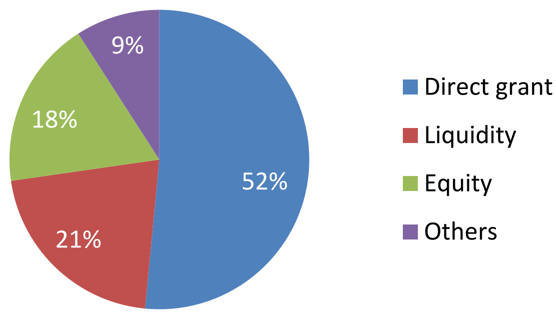
The 2004 guidelines treated all forms of restructuring aid alike: loans, guarantees, capital injections, debt waivers and even outright cash grants. However, liquidity assistance that is limited in both amount and duration is less distortive than other forms of aid, since it does not go beyond what is needed to address the liquidity problems that are commonly the main obstacle to restructuring, and since it must be repaid with interest. Despite that, liquidity assistance is used in only a minority of restructuring cases.

To simplify the provision of aid for restructuring, while also reducing distortions of competition, the guidelines include a new concept of temporary restructuring support for SMEs.

In future, SMEs that need only liquidity support from the State to carry out restructuring will be able to obtain that support on simplified conditions for up to 18 months. Up to six months of that can be in the form of rescue aid, which simply needs to meet certain basic conditions concerning, for example, the minimum interest rate.

To continue to receive temporary restructuring support after the end of the six-month rescue period, the recipient of such support will need to submit a simplified restructuring plan, explaining how it intends to use the aid to restore its long-term viability, but will not have to provide a detailed restructuring plan containing own contribution and measures to limit distortions of competition.

Form of aid in restructuring cases decided in 2012

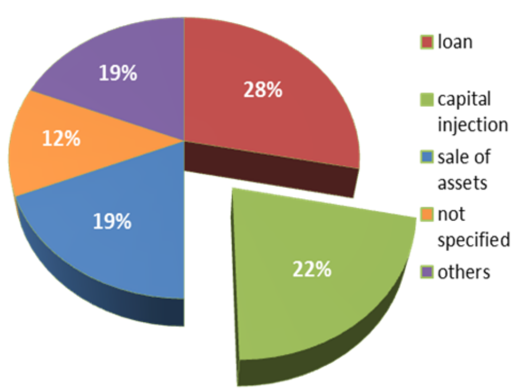


Burden sharing and own contribution

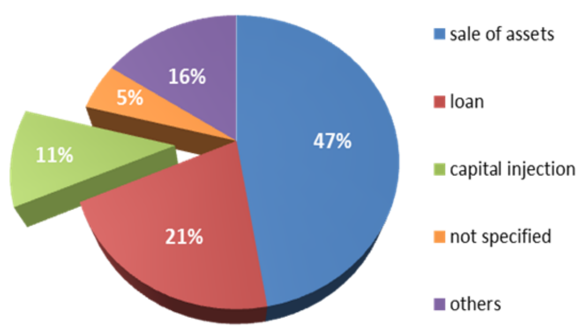
It is reasonable to expect investors in a troubled firm – particularly shareholders, who receive the highest returns when a firm is performing well – to bear a fair share of the cost of restructuring. Under the 2004 guidelines, firms being restructured had to make a contribution to the restructuring costs from their

Type of own contribution for aid granted in structural forms

Aid in form of direct grant



Aid in form of equity injection



own resources. That helped to reduce the amount of aid provided by the State, but it did not necessarily ensure that investors in the firm bore a fair share of the costs of and the risks relating to the restructuring.

The graph illustrates this problem: in cases where aid has been provided in the form of grants or equity injections, which absorbed losses and/or directly increased the recipients' capital base, this has rarely been matched by own contribution of similar effect and riskiness. Only 22% of cases involving aid in the form of direct grants, and 11% of cases where it was in the form of an equity injection, saw matching equity injections by new or existing shareholders. In the remaining cases, shareholders were bailed out, and no commitment from investors to the future of the firm was obtained. Such an outcome can create moral hazard and incentivise risky behaviour at the expense of more prudent firms.

Over the course of the crisis, the Commission has dealt with this issue in relation to aid for troubled banks by developing and refining the concept of "burden sharing", which helped bring about a significant reduction of the aid necessary for restructuring.

This concept has now been adopted in the new rules for restructuring aid to non-financial firms. To ensure that investors in troubled firms bear a fair share of the burden of the restructuring, losses that the firm has accumulated in the past must be allocated to them before any State aid can be granted. Moreover, the new regime requires that the State receive a fair share of the upside, meaning that if the restructuring plan succeeds, taxpayers will also benefit.

This new regime will have an important disciplining effect, reducing the incentive for investors to hold out for a public bailout and encouraging them to address the firm's problems as early as possible, in the knowledge that if the State does intervene, it will not do so in a way that protects shareholders' investments.

The new guidelines now also require that the nature of the company's own contribution to the costs of restructuring be similar to that of the aid (for example, through an equity injection if the State also grants capital). This will not only reduce the cost to taxpayers, but can also produce better outcomes for the firm itself, by ensuring that private investors are committed to its future and share the risks associated with the restructuring with the State that has come to the rescue.

Example:

The significance of the burden sharing instrument is best illustrated by the restructuring of the Spanish banking sector, which the Commission approved in autumn 2012. This aid was not subject to the rescue & restructuring guidelines, which apply only to non-financial firms, but to the specific rules on State aid to banks during the crisis. The approval of eight restructuring and resolution plans was based on Spain's commitment to allocate losses to existing shareholders and subordinated debtholders, before injecting fresh capital. This reduced the ex ante cost of the programme by approximately EUR 12 billion. In addition, the burden sharing regime provides Spain with a fair share of the upside. If the restructured banks continue to perform well, Spain will receive dividend payments and will eventually be able to sell its stake at a profit, further reducing the cost to the taxpayer of rescuing the banks.

A fair share for taxpayers

To illustrate what difference the new rules could make, we can look at a recent case that the Commission dealt with.

FagorBrandt, a manufacturer of household appliances, received a State contribution of EUR 31 million for restructuring in the form of a direct grant. Own contribution was provided by means of external loans of between EUR 20 and 40 million and by a contribution of EUR 27 million from incumbent shareholders.

The contribution from shareholders was a positive element, which meant that a substantial proportion of the own contribution was, like the aid, equity-enhancing. However, because the aid was in the form of a direct grant, the State did not obtain any return on its investment of EUR 31 million. Shareholders, who contributed EUR 27 million, received the benefit of the full EUR 58 million in equity-enhancing contributions.

Under the new rules, the State would need to obtain a fair share of the upside in a situation such as this. This could have been done, for example, by converting part of the EUR 31 million grant into an injection of shares at an appropriate price, or by agreeing a claw-back mechanism that would return part of any future gains to the taxpayer.