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Policy Paper

Taking a closer look:

How to improve the design of the Solvency Support Instrument

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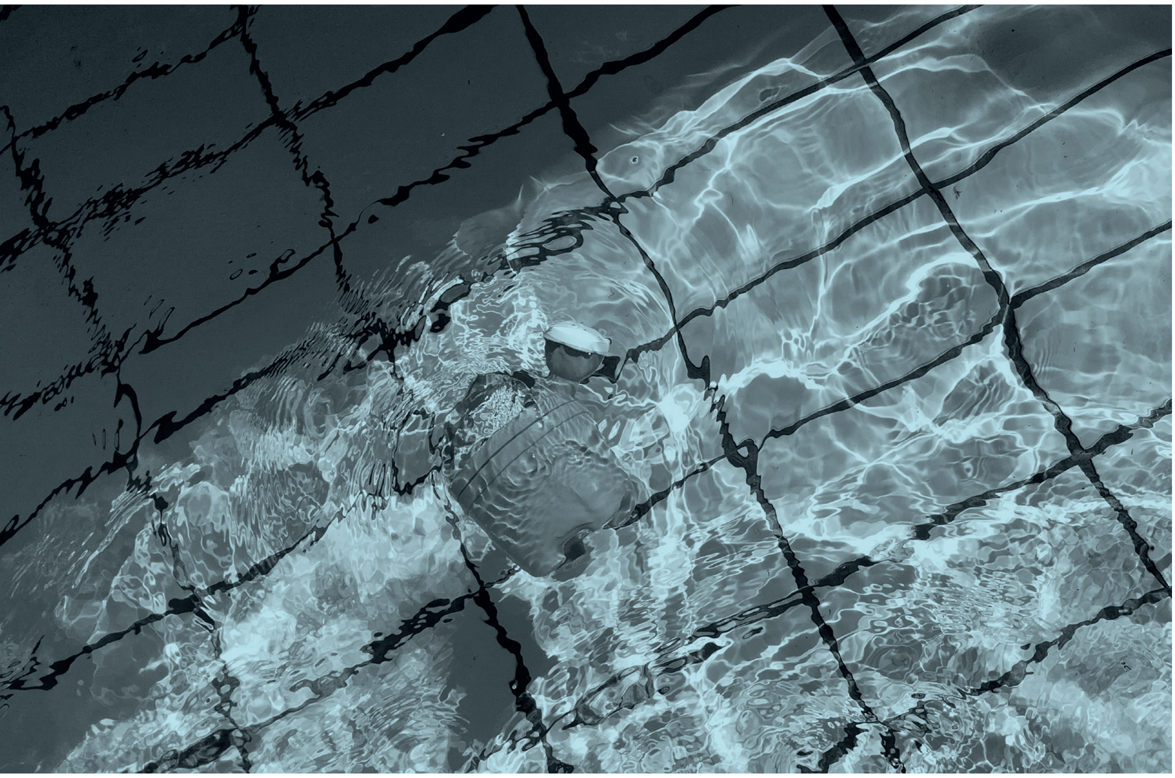
#Corona
#Recovery
#EquitySupport



The Solvency Support Instrument (SSI) is central to the European Commission's proposal to mitigate economic damage of the pandemic. It would use part of the money raised under the Recovery Instrument to provide equity support to struggling firms. It could become a powerful tool for the recovery. However, in its current form, the instrument risks providing free lunch bailouts for owners and private investors without ensuring that public support secures jobs, avoids market concentration, and puts firms on a growth path more conducive with the EU's broader industrial policy goals. To remedy these shortcomings, the instrument needs clear political criteria for equity support and better political control.

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Introduction

Negotiations on the European Recovery Instrument are in full swing. A central pillar of the European Commission's (EC) proposal to mitigate the pandemic's economic damage is the Solvency Support Instrument (SSI). This program aims at helping struggling firms across the European Union (EU) by using €31bn of borrowings under the Recovery Instrument to provide a new guarantee to the European Investment Bank (EIB). This is then supposed to mobilise about €300bn in private resources for capital injections in companies that are economically viable but run into funding issues because of the crisis.

The SSI could become a powerful tool for the recovery: it provides fresh liquidity in the form of equity support for firms hit by the pandemic and can, thus, help companies and workers through the crisis without the negative side effects of increasing corporate indebtedness. By targeting support for firms in those member states in which national solvency aid, so far, has been more limited, it could also be an important step towards securing a more symmetric recovery.

In its current form, however, the proposal lacks political guidance and control. Selecting what firms will benefit under what conditions comes with difficult trade-offs and will have profound distributional effects on jobs, growth and the economic fabric of member states (MS). By leaving these decisions largely to technocratic processes within the EIB and to market actors and attaching few if any conditions to the support, the SSI fails to make sure that European resources are spent in genuine European interests. It, therefore, **risks providing free lunch bailouts for owners and private investors** without ensuring that public support cements jobs, avoids market concentration, and puts firms on a growth path more conducive with the EU's broader industrial policy goals.

"In its current form, SSI fails to make sure that European resources are spent in genuine European Interests."

To remedy these shortcomings, we propose three major changes to the SSI:

1. The instrument needs to include **clear political goals** on geographical distribution, sectoral composition and size of firms targeted under the program with support linked to binding environmental and social conditions.

2. Final beneficiaries should be selected by institutions that are well-versed in aligning market-based assessments with broader policy goals. National promotional banks and institutions **(NPBIs) banks should, therefore, be put in the lead.**

3. The instrument needs **better political control.** Larger suboperations exceeding €100M of European exposure should, therefore, be approved by a new Equity Supervision Board made up of representatives from the Council, the European Parliament, and the Commission.

1 Why do we need European equity support?

The pandemic is hitting companies across Europe. Depending on the data and underlying assumptions, studies have estimated that after three months of lockdown, between 25% and more than 50% of all EU firms could face liquidity shortfalls.[1] The EC's own projections put the lower end of potential equity losses across the Union at about €720bn.[2] Crucially, these losses are concentrated amongst firms in a handful of major sectors, including accommodation and food services, transport, wholesale and retail trade as well as some areas of manufacturing and they are especially prevalent amongst small- and medium-sized enterprises (SMEs).[3]

Left unattended, these liquidity shortfalls could quickly turn into solvency issues for firms and may permanently scar European economies. Counter-vailing policies so far have mainly focused on loans and credit guarantees.[4] While such measures can provide important short-term support, they may also lead to a massive increase in corporate indebtedness, raise the risk of future defaults and leave firms with little room for growth and investment once economic growth picks up again.[5]

Equity support can circumvent this problem. Put simply, equity-based programs provide firms with fresh liquidity by using public money to buy shares or take on other forms of equity stakes in private companies. This injects capital without raising firms' leverage and, at the same time, allows taxpayers to participate in future profits. Against this background, some MS have already started to provide their firms with national equity support. However, national fiscal capacity to set up such schemes differs widely and, **without European coordination, corporate over-indebtedness in some weaker economies could easily produce systemic risks for the entire Union.**

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To avoid this and to make sure that European companies, no matter what their home country is, have the chance to survive the crisis, a joint European equity support scheme is indeed warranted. However, the use of public money for equity support also comes with severe risks and massive distributional implications: **deciding who is supported and who is not will have a huge impact on job losses, capital gains and Europe's post-recovery economic structure.** Getting this right is, therefore, important and we suggest it should be guided by the following principles.

[1] Revoltella et al. (2020): *"EU firms in the post-COVID-19 environment: Investment-debt trade-offs and the optimal sequencing of policy responses"*, VoxEU.org, 23 June; Demmou et al. (2020), *"Corporate sector vulnerabilities during the COVID-19 outbreak: Assessment and policy responses"*, VoxEU.org, 23 May; Banerjee et al. (2020), *"COVID-19 and corporate sector liquidity"*, BIS Bulletin No. 10, 28 April.

[2] EC (2020), *"Identifying Europe's recovery needs"*, Commission Staff working document, 27 May.

[3] Carletti et al. (2020): *The equity shortfall of Italian firms in the COVID crisis: A first assessment*. VoxEU.org, 19 June.

[4] Redeker & Hainbach (2020): *"Flattening the Recession Curve: Fiscal Responses to the Corona Crisis"*, Delors Centre Policy Paper, April 2020.

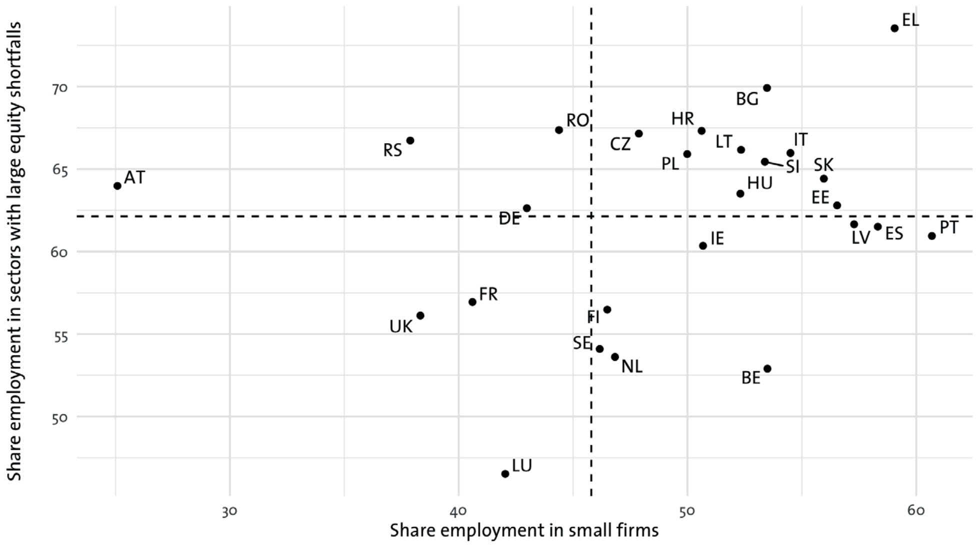
[5] Boot et al (2020): *"Coronavirus and financial stability 3.0: Try equity – risk sharing for companies, large and small"*, VoxEU.org, 3 April.

1.1 Help firms in countries with limited room for national support

The central aim of European equity support should be to support struggling firms in those MS where liquidity shortfalls are especially pronounced and national support schemes remain more limited. Given the concentration of liquidity shortfalls in some key sectors as well as amongst small firms, the need for equity support is likely to be especially large in countries like Greece, Italy and a number of Eastern European countries (see Figure 1). Many of these, so far, have provided comparably little national liquidity support. To reduce the risk of persistent economic damage and ensure that viable businesses can survive the crisis, European equity **support should be concentrated in severely impacted but fiscally constrained MS.**

Figure 1: MS vulnerability to equity losses

Sectors with large equity shortfalls are defined as NACE sectors I, H, G and C. Small firms include companies with less than 50 employees.



Data: Eurostat.

1.2 Lean against market concentration

Already before the corona crisis, European market concentration was on the rise.[6] The pandemic will further accelerate this trend. On the one hand, big firms with higher margins and larger cash buffers are less likely to run into liquidity issues.[7] On the other hand, firms in stronger positions are likely to exploit the rise in asset erosion and forced exits amongst competitors for mergers and acquisitions to further consolidate their dominance.[8] Bucking this trend and preserving competitive product- and deep labor markets will be key to safeguarding European productivity and avoiding even greater inequality. **Equity support, therefore, needs to be designed in ways that avoid market concentration.**

[6] IMF (2019): *World Economic Outlook – Growth Slowdown and Precarious Recovery.*
[7] Revoltella et al. (2020): *"EU firms in the post-COVID-19 environment: Investment-debt trade-offs and the optimal sequencing of policy responses"*, VoxEU.org, 23 June;
[8] OECD (2020): *Merger control in the time of COVID-19.*

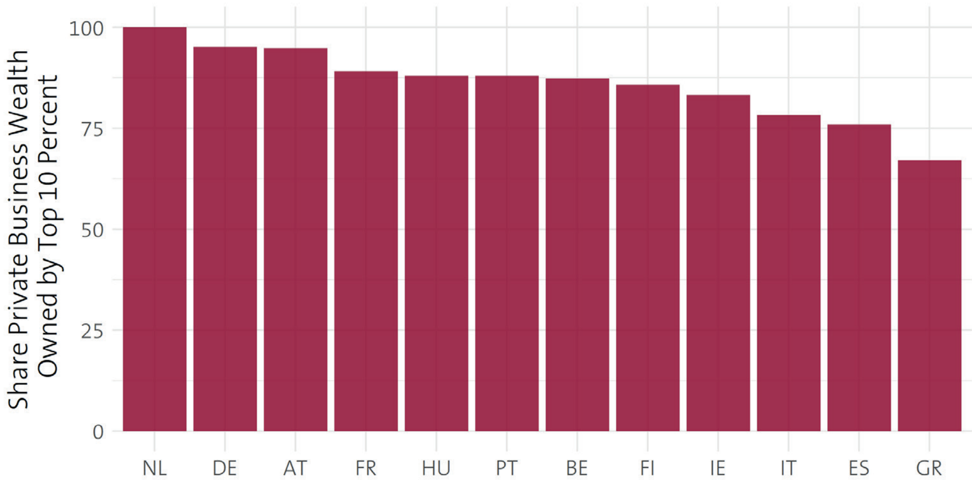
1.3 Prioritise jobs over owners

Supporting viable businesses through the crisis is crucial to avoid any negative economic downward spirals. However, any form of European equity support implies significant socialization of private risks and constitutes direct public help for business owners. As private business ownership is heavily concentrated at the top of the income distribution in all member states (see Figure 2) **equity support will directly benefit very wealthy households in particular.** To ensure that the gains of equity support are widely shared instead, a European instrument should make saving jobs and creating new ones the key priority. At the same time, it should minimise the risk of moral hazard, make sure that internal resources stay within supported companies and prevent insiders from extracting wealth.

1.4 Align equity support with the EU's broader industrial policy agenda

To maximise the public value of solvency support, **European resources should be used to advance longer-term policy goals** such as the transition towards less carbon-intensive and more digitialised modes of production. Some have, therefore, suggested providing companies in specific sectors such as green technology with privileged access to equity support. However, such an approach could directly conflict with the principle goal of limiting long-run economic damage by safeguarding firms and jobs in those sectors most affected by the crisis. Instead, solvency support should be broadly available to all ailing firms but come with clear conditions that incentivise ecological and digital transition within them.

Figure 2: Share of private business wealth owned by the Top 10 Percent in selected MS



HFCS data based on Dao (2020)

2 The Commission's Proposal: Solvency Support Instrument

To answer the calls for a new tool for equity support at European level, the Commission has proposed a Solvency Support Instrument (SSI) as part of its overall Recovery Instrument. The SSI would serve as a temporary third window under the extant European Fund for Strategic Investment (EFSI) and should be up and running by no later than October 2020.

The central idea behind this new tool is to use part of the money that the EU will jointly raise on financial markets under the Recovery Instrument to increase its guarantee to the European Investment Bank (EIB) under EFSI. According to the EC, this guarantee should be raised by €66bn, which, given a provision rate of 50%, would require EU budget resources of about €33bn. It is important to note that the EIB would not use this new guarantee to acquire stakes in struggling firms. Instead it would pass the guarantee on to financial intermediaries in member states, thereby crowding-in additional capital by decreasing the risk of private investors. In doing so, **the Commission hopes to mobilise an overall sum of €300bn in fresh equity support for European firms.** However, the new proposal by European Council President Charles Michel has already cut the proposed budget resources for the SSI to €26bn, which would significantly reduce the instrument's reach. In any case, the program is supposed to run until the end of 2024 with 60% of operations approved by the end of 2022.

Figure 3: The proposed Solvency Support Instrument

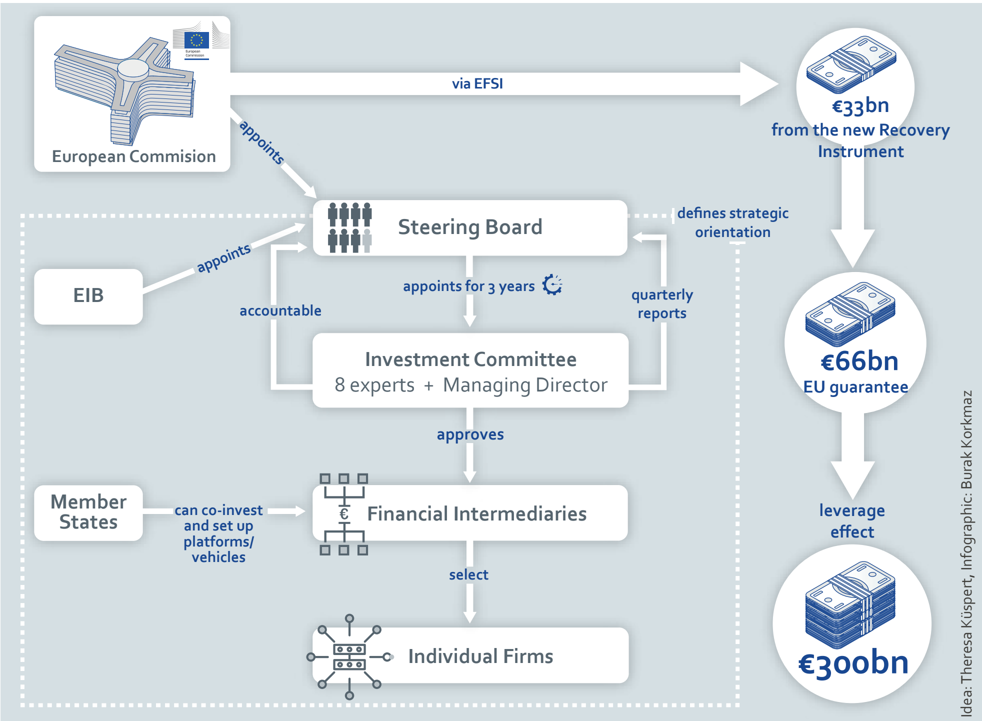


Figure 3 above shows how this would work in practice. The EU would mobilise equity support by reducing risks for private investors through channeling guarantees towards, investing in or funding financial intermediaries. Decisions about which financial intermediaries should benefit from the EU guarantee will be made by EIB staff. Under the EFSI framework, these decisions need the approval of an Investment Committee, which is composed of eight financial sector experts and headed by the EFSI Managing Director. At the top of the governance structure sits the Steering Board consisting of three representatives from the Commission, one EIB official and an observer from the European Parliament. This board sets overall investment guidelines, reviews the SSI's functioning on a quarterly basis and appoints the Investment Committee.

The SSI's current structure would mean that **neither Commission nor EIB is involved in making the final call on what companies on the ground will benefit from the money provided by European taxpayers.** This decision will be taken exclusively by financial intermediaries and independent, commercially-run fund managers. To crowd in private capital, such intermediaries could include not only National promotional banks and institutions (NPBIs) but also private equity funds, special purpose vehicles and investment platforms. In exceptional cases, the EIB might also invest directly.

In selecting the companies to invest in, financial intermediaries would have relatively free rein. Companies that receive support would only need to prove that they were not in financial difficulties at the end of 2019. While the proposed regulation does not include any geographical quotas, it stipulates that the Steering Board should establish geographical concentration limits to ensure that the bulk of the EU guarantee supports eligible companies in member states severely impacted by the crisis and where national solvency support is more limited. However, the proposal does not include targets on sectoral composition or size of companies to be supported under the SSI.

"In selecting the companies to invest in, financial intermediaries would have relatively free rein."

For beneficiary firms, equity support would come with few strings attached. Firms targeted by financial intermediaries "shall be encouraged to comply, to the extent possible, with minimum high level social and environmental safeguards". and companies that engage in ecologically especially harmful activity "shall be encouraged to put in place, in the future, green transition plans." No other environmental or social provisions are included and the terms of updated State Aid rules – such as a ban on dividends, bonus payments and share buybacks – would only apply to support provided on non-commercial terms.

3 What does the Commission's proposal amount to?

How does this proposal hold up against the principles outlined above? In line with the first principle, establishing geographical concentration limits could help ensure that EU equity support predominantly helps firms in weaker member states. Otherwise, however, the **proposal provides little in terms of avoiding market concentration, safeguarding employment, or aligning equity support with broader industrial policy goals.**

Instead, the proposal addresses the goal of rolling out a huge amount of money across many member states and thousands of firms in a very short period of time by building on existing, market-driven instruments and maximizing flexibility. There is little political guidance on the distribution of the funds; EIB personnel have significant discretion in selecting any public or private financial intermediaries they see fit for the purpose of delivering equity support; it delegates the task of selecting beneficiary companies to financial intermediaries and it attaches minimal conditions to the provision of equity aid at the firm level.

From an EIB/EC perspective this is a comprehensible approach. However, the combination of severe time-pressure and considerable discretion for technocratic staff and market actors leaves little room for any political guidance. This is problematic. First, the issue of who benefits from the instrument will have profound distributional implications across and within member states and will shape Europe's economic structures for decades to come. Relying almost exclusively on technocratic, market-driven processes in making these decisions **runs the risk that European funds are employed in ways that maximise profits for private investors** rather than prioritise competitive labor and product markets, safeguard employment and align support with EU industrial policy goals. Second, the new EIB guarantee is based on a large amount of new and jointly borrowed money that will be used to invest in highly risky portfolios. Ensuring proper political control is, therefore, key to safeguarding the program's legitimacy and to make sure that public resources are used with clear regard to public interests. The SSI design, therefore, needs a serious rethink.

4 Aligning Public Equity Support with the Public Interest

Without proper political guidance and oversight, the proposed SSI runs the risk of turning into a subsidy program for private intermediaries providing free-lunch bailouts for European company owners. To remedy these shortcomings, we propose three major changes.

- First, the instrument needs clearer political guidelines and conditions on which companies should be supported and under what conditions.
- Second, financial institutions with a clear public mission need to be put in the driver's seat of selecting final beneficiaries.
- And third, political control needs to be strengthened, especially when it comes to large projects.

4.1 Determine Clear Criteria for Equity Support

Evaluating which companies are viable over the longer run is a tricky business. The SSI starts from the reasonable premise that politicians should not take the lead in making that decision. However, this makes it all the more important to **equip the instrument with clear guidelines on what companies should be supported and under what conditions.**

First, the current proposal provides too little guidance on what companies should be targeted. Besides leaving it to the Steering Board to define geographical concentration limits, the proposed regulation merely states that most of the EU guarantees should support eligible companies in member states and sectors most affected by the crisis. This leaves too much room for interpretation. Clear goals are needed to ensure that **the lion's share of support goes to those sectors and companies most in need.**

Besides defining vulnerable sectors, selection criteria need to be specified on two other fronts. To make sure that equity support only goes to companies that do not vitiate Europe's green transition, the regulation should **clearly state that economic activities that undermine the attainment of Europe's climate targets, such as fossil fuel projects, cannot be supported.** To avoid market concentration, the regulation also needs to do more to specifically steer equity support towards SMEs. Providing equity support for smaller, non-listed firms whose economic value is more difficult to determine is complex. It is, therefore, helpful that the proposal is open to quasi-equity support such as hybrid debt and preferred stock. However, given that the provision of equity-like investments in SMEs is more difficult and that the instrument will operate under strict time constraints, it still remains likely that larger firms in more dominant market positions will get privileged access. The instrument, therefore, **needs a clear quantitative target on how much of the guarantee should be earmarked for supporting SMEs.**

"The regulation should clearly state that economic activities that undermine the attainment of Europe's climate targets cannot be supported."

Clearer criteria are not just required for the selection of companies but also for the conditions that companies must meet to receive European equity support. The SSI as it stands entails no binding conditionality. To avoid free lunch bailouts and align the instrument with Europe's industrial policy goals this must change. First, it needs to set out **clear goals on the extent to which supported firms should cut their carbon emissions.** Targets should differ depending on sector and corporate size but need to be specific enough to allow company owners to be held accountable. Failures to abide by these targets should bring an immediate loss of funding.

Second, providing equity support should be linked to securing jobs. One might argue that equity support confronts a trade-off between preserving productive company-employee relations and facilitating the reallocation of workers to sectors more viable in the long term.[9] However, whether the crisis will result in a permanent restructuring of economic activity remains far from clear.[10] If limited public resources are used to provide equity support to private owners, this **should be reserved for business models that remain viable without the need to shed large swaths of their workforce.** The SSI, therefore, needs clear goals on the aggregate share of employment retained or created in the firms enjoying EU equity support.

Finally, in line with the EC's updated state aid rules, beneficiaries should curb executive remuneration and refrain from extracting capital through dividends, payouts and share buybacks. The current proposal mandates such measures only if equity support is given on non-commercial terms. However, determining whether this is the case is difficult in the midst of a deep downturn, leaving financial intermediaries with considerable discretion in categorizing the nature of their support. To circumvent possible conflicts of interest, these specific rules should, therefore, apply to all equity support provided under the SSI.

9 Barrero et al. (2020): *"Covid-19 is also a reallocation shock"*. NBER Working Paper 27137.
10 Pagano et al. (2020): "COVID-19, asset prices, and the Great Reallocation." VoxEU.org, 11 June; Fujita et al. (2020): *"The labour market policy response to COVID-19 must save aggregate matching capital"*, VoxEU.org, 30 March.

4.2 Put public institutions in the lead of the rollout

Even with clear political guidelines, investment decisions on the ground will still need to resolve major trade-offs. This includes, for example, whether limited resources should be channeled towards labor-intensive industries with weaker balance-sheets in which corporate liquidation would have a bigger impact on overall employment or be used for sectors with greater prospects for growth. Similarly, one needs to know whether equity support should go to risky firms in key sectors or be reserved for more conservative investments in bigger companies enjoying strong market positions. In contrast to the some of the ideas discussed prominently earlier in the crisis,[11] the SSI does not create a new independent European institution to make these judgement calls but delegates it to a range of possible financial intermediaries including private funds.

Being flexible about possible intermediaries and relying on private funds may help leverage and increase efficiency on paper. However, **when looking at the trade-offs lined out above, the interest of private investors and the European public as a whole are unlikely to be constantly aligned.** Moreover, organizing equity support by de-risking the portfolios of private equity funds would imply using taxpayer money to subsidise the incomes of financial actors that already sit on a huge amount of dry powder from soaring profits in the run-up to the crisis.[12] To avoid these problems, calling the shots on final investment decisions should be left to public institutions that are able to align market-based assessments with national and European policy goals.

In the short term, this **means providing NPBIs which in most cases are already deeply involved in national crisis policies[13] with exclusive rights to select eligible companies.** To ensure a quick rollout across the EU, public institutions in smaller member states may seek the support of promotional and investment banks in other MS international institutions or buy in external expertise. Critically, these banks would still work closely with other investors and crowd-in private capital. However, it would be ensured that that decisions on public money are taken by institutions with a clear public mission.

In the medium term, **the EIB should get resources to hire more staff that is able to carry out business valuations in member states.** This would enable Europe's largest promotional bank to undertake equity support without relying on financial intermediaries provided. This may also include working on an independent public European equity fund that is led by public officials and tailored specifically to the needs of SMEs such as proposed by Boot et al. (2020).

[11] Boot et al (2020): *"Coronavirus and financial stability 3.0: Try equity – risk sharing for companies, large and small"*, VoxEU.org, 3 April.
[12] PWC (2019): *„Private Equity Trend Report – Powering Through Uncertainty"*
[13] ELIT (2020): *"Overview of measures against the economic impact of the Coronavirus (COVID-19) outbreak"*

4.3 Ensure proper political control

Besides providing clear political guidelines for equity support and a strong role for public intermediaries in delivering it, the SSI also needs better political control. In its current form, decisions on passing EU guarantees on to financial intermediaries is largely taken by EIB staff and only subject to the approval of an Investment Committee composed of financial sector experts. Given the profound distributional implications that the instrument is going to have on corporate survival, employment, and the industrial structure of member states in the recovery, this technocratic oversight is insufficient.

This must change. We propose setting up a **new political control board under the EFSI as part of the SSI** which could be labelled an Equity Support Board. Given that the SSI will be funded directly by fresh borrowings under the Recovery Instrument, this new board should consist of an equal number of representatives from the European Commission, the European Parliament and the Council as the three institutions in charge of the EU Budget.

Its purpose would be to approve large-scale suboperations of financial intermediaries. If a national promotional bank decided to make an equity investment in which the share of European resources put at risk exceeds €100M, the Equity Support Board would need to assess whether this substantial support is warranted by common European interest and ensure that it goes hand in hand with high environmental and social provisions. **If this is not the case, a majority of board members could decline support under the SSI.** Any suboperations below the threshold of €100M would follow the normal procedure and not require additional approval.

"If this is not the case, a majority of board members could decline support under the SSI."

An institution along these lines could easily be installed as part of the current EFIS set-up. Doing so would substantially improve political control of large-scale equity support measures, make sure that due diligence is carried out with regard to common European interest and improve the longer-term legitimacy of equity support decisions. At the same time, limiting the need for Equity Support Board approval to larger sub-operations would not hamper the speedy provision of equity support, especially when it comes to smaller operations and SMEs.

Conclusion

The SSI constitutes a promising tool with huge potential to help struggling companies through the crisis, accelerate the recovery and mitigate some of the asymmetric effects of the pandemic across the EU. To realise this potential and make sure that equity provisions help ailing member states, curb the rise of market concentration, secure employment and foster the EU's broader policy goals, the current proposal, however, needs a serious rethink. It needs clearer criteria for equity support, a stronger role for public institutions and tighter political oversight. Delivering on these goals will make the instrument both more effective and legitimate and ensure that the fruits of public corporate support are shared widely.

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