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Coronavirus and financial stability 3.0: Try equity – risk sharing for companies, large and small

Arnoud Boot, Elena Carletti, Hans-Helmut Kotz, Jan Pieter Krahnen, Loriana Pelizzon, Marti Subrahmanyam 03 April 2020

COVID-19 is a disaster for many firms – especially small and medium-sized ones. This column proposes a scheme that could bring funding to firms quickly without increasing their leverage or default risk. The plan combines outright cash transfers with a temporary, elevated corporate profit tax at the firm level as a form of conditional payback. The implied equity-like payment structure has positive risk-sharing features for firms, without impinging on ownership structures. The proposal should be implemented at the European level to strengthen euro area resilience.

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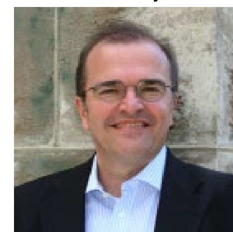

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This column builds on our earlier work on the coronavirus and financial stability and adds to the current debate about effective policy responses to mitigate the COVID-19 economic crisis (e.g. Bénassy-Quéré et al. 2020, Brunnermeier et al. 2020, Giavazzi and Tabellini 2020). In our earlier note (Boot et al. 2020), we discussed the potential consequences of the current broad-based interruption of economic activity in a number of countries around the world. Imminent liquidity problems and the ensuing solvency concerns need to be addressed swiftly and through vigorous government programmes, as is already happening in most countries. While warranted as an immediate response, we emphasised the problematic longer-term consequences of some of these measures, in particular due to their uncoordinated, national scope, particularly in the European context. Upcoming problems may relate to 1) rising corporate leverage, 2) increasing bank risk exposure, 3) growing sovereign exposures, and 4) emerging cross-country distortions to competition in product and capital markets.

The current substantial policy measures in the EU are characterised by a broad similarity in goals and structures. However, they are divergent in size and fall short on one important dimension – effective risk sharing across firms and countries in Europe. Our proposal is not a cure-all solution but suggests a pan-European risk- and reward-sharing mechanism for firms, while providing crucial funding at the firm level. Most European firms are small or medium-sized and privately owned with no access to capital markets, generally relying on bank loans for their funding needs. Therefore, it is imperative that the choice of policy instruments properly reflects these initial conditions.

Most government assistance programmes in Europe during the coronavirus crisis, thus far, rely on some form of debt financing, which increases firm leverage even if there is some sort of a guarantee

attached. Rising corporate debt levels have a negative impact on firms' default risk. Moreover, they may, sooner or later, overwhelm the fiscal capacity of at least some guarantors. The incremental rise in corporate leverage due to the coronavirus crisis can, however, be limited by relying more on equity-like instruments, i.e. financial contracts that imply loss absorption in case of poor future firm performance and reward participation otherwise. If implemented on a European level with a European Pandemic Equity Fund (EPEF), all citizens would participate in the common risks and potential rewards of a broad-based participation in Europe's industry post-crisis. This would be akin to a pan-European sovereign wealth fund of -hopefully- substantial proportions.

The major characteristics of equity-like financing provided by a government-backed pan-European fund are as follows:

1. Initial payments (from the fund to firms) carry no direct repayment obligation, although they are not outright transfers either (see 4).

2. Firm leverage (and thus, firm default risk) does not rise as a result of the financing operation.

3. The risk of a future loss of the initial payment is assumed by the investor, the EPEF.

4. In the same way, future profits are also shared by the EPEF, with repayments to the fund being conditional on positive firm performance.

The mechanism and structure of the EPEF we propose would strengthen euro area stability in conjunction with financial stability in the European Union. The equity fund would strengthen the resilience of businesses (reduces debt build-up and creates risk absorbing capacity), strengthening local conditions, and together with the strong, pan-European backing, would provide for direct sharing of firm risks (losses and rewards) across member states. This would augment the resilience of the euro area and ultimately ensures the stability of the European Union. Moreover, the reduced leverage at the firm level would reduce the risk to the banking system (lower loan losses) and, thus, strengthen financial stability. This in turn, would mitigate the doom loop between local banks and governments, further strengthening the resilience of the euro area, in a virtuous cycle.

Our approach

In this section, we focus on the design of the EPEF's equity-like participation scheme. Its elements are novel, given that most firms do not have direct access to capital markets. Of course, the scheme would also work for larger firms, which have easier access to capital markets.

The difficulty of reaching firms through equity-like financing differs between large firms and small and medium-sized firms, along several dimensions. For the first group, a set of financing instruments, typically with conditions attached, are well known, and can be used for the purpose at hand. One way is to use non-voting stocks, which differ from common equity in terms of dividend payouts, voting rights, and potentially further restrictions or conditions. Thus, the EPEF could offer to take an equity-like claim, offering cash to the firm, in exchange for a fair share of future profits.

The second group consists of small and medium-sized enterprises (SMEs), typically without direct access to capital markets. Reaching these firms with an investment in their equity is notoriously difficult, because entrepreneurs from family businesses tend to dislike external ownership of the firm, particularly when accompanied with voting rights. This is often why such firms stay away from the capital market in the first place and rely on bank financing instead. Since these SMEs are the backbone of continental Europe's economies, it is important to find an equity-like access route to such smaller, unlisted firms.

Our proposal meets this requirement: it is applicable even to sole proprietors of 'mom and pop businesses'. The basic idea is simple: the EPEF offers cash to firms in exchange for a temporary increase in the future corporate profit tax rate post-crisis. In the case of sole proprietors, a temporary rise in their personal income tax rate is the equivalent formula. The additional tax income raised in that way is channelled back to the fund in the future, representing the return to the cash investment made by the fund.

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Note that our cash-for-tax scheme is intended to be an offer to firms of all sizes, in all industries and across all countries in Europe. Its conditions, like the basic initial investment amount, tax surcharge, duration, as well as specific conditionalities (covenants) on corporate actions, are set up in a non-discriminatory way.

To reach out to firms, small and large, throughout the economy, we propose to rely on existing networks of national entities, such as development banks, tax authorities or other such institutions. These agencies should be able to channel cash directly to firms through their existing networks. The firms in each country would, in exchange for accepting a cash transfer of a defined size, accept henceforth a surcharge on their corporate profit tax rate for a defined number of years. By relying on existing networks and direct cash transfers, the programme would facilitate quick assistance to firms in need. Specific criteria and terms of the investments would be decided at the European level but implemented at the national level through designated entities.

What does an outright transfer of cash tied to a temporary increase in profit tax have to do with equity financing? Actually, a lot. The cash flows emanating from firms under our scheme are identical to those associated with an equity stake in that firm. In both cases, an investor hands over cash to the firm in the initial year. Every year thereafter, conditional on the firm making profits, a defined share of profits flows back to the investor; else, the investor shares in the losses. The properties of our scheme are similar to those described above: the investor participates proportionally in gains and losses. An additional advantage of our scheme, in the eyes of the investee (the SME), is the limited number of years that the fund participates in the firms' profits. This aspect may be of great relevance if family enterprises are to be included in the programme, which is doubtless intended essential throughout Europe.

The fine-tuning of our scheme involves additional considerations, as there may be opportunistic behaviour by some firms to lower or even avoid payments in good states (i.e. if the firm does well after the crisis years). In that case, the firm may try to delay tax payments, for example by overinvesting in long-term assets, or by relocating parts of their activities in countries without tax surcharges. Firms may also be in a position to partially affect their tax base, by splitting the firm or by paying out excessive wages to themselves. These are, however, technical details that need to be worked out, particularly since the scheme is of a pan-European nature. Those issues have been dealt with successfully in the past in cases of state involvement in corporate restructurings, and we believe firmly that it can be done again.

As already alluded to, there are several implementation options, the national execution may occur via the national tax authorities or other entities expressly set up for this purpose. Similarly, whether the repayment in good times is via a tax surcharge or via a separately arranged profit sharing agreement is not central for our idea either. Key, however, is the equity-like payment pattern that we envisage with its beneficial impact on firm leverage and its benign effect for banking stability.

Discussion

The suggested scheme of an equity-like funding mechanism fits well into several programs announced recently, in the midst of the Coronavirus crisis. For example, the German government in its latest fiscal 'bazooka' programme, presented on 25 March, has introduced a €600 billion Economic Stabilization Fund (*Wirtschaftsstabilisierungsfonds*, or WSFs) with €400 billion for guarantees, €100 billion for credit lines and another €100 billion for facilities to recapitalize, i.e. to take direct stakes in companies (although it has not yet specified what channel or instrument it will use). Similarly, as was announced on 28 March, the US government is considering taking equity stakes in large firms, including airlines, in exchange for rescue money. The distinguishing feature of our proposal is that it generalizes the equity approach to rescue measures by opening a path to reach smaller and medium-sized firms.

An issue we have left intentionally untouched in this column is the question of funding. What European fiscal scheme will provide the funds needed for a sizable equity-like funding spree in

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Europe? Since there is a large literature on how such funding instruments could be set up – ranging from public private partnerships, to 'Coronabonds', to less ambitious, national solutions – we wanted to avoid losing focus in this column and instead concentrated on the important and original idea of how to use it.

We focus on the concept of the financing arrangement here and also defer to our next policy note the important question of how to design the governance of the proposed fund – in particular, the connections of the EPEF with the national fiscal authorities and the supranational financial institutions (EIB, ESM) to ensure that the various demands of fiscally stronger and fiscally weaker countries, north and south, are met simultaneously. We also leave to the next note the question of whether our proposed scheme is complimentary to existing national programmes, or rather a substitution for some of them.

However, we reiterate our belief that any effective solution to the current economic problems must eventually entail a coordinated European approach, and it is more efficient to do this right now in a consciously designed, structured manner, rather than kicking the can down the road until some broken pieces of the European financial system, especially in the euro area, have to be realigned and reassembled.

We conclude on a bright and positive note: by designing a broad-based European equity-like participation scheme, funded with resources from all countries in the EU, we will not only help to create a common perception of shared responsibility and solidarity across Europe, but also – equally important – a strong perception of shared success. In that latter sense, a European Pandemic Equity Fund fits perfectly into the narrative of an emerging European capital markets union and may indeed be one of its defining moments. In the words of Jean Monnet, one of the founding fathers of the European Union: "Make men [and women] work together, show them that beyond their differences and geographical boundaries there lies a common interest."

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