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Restructuring State-Guaranteed Loans Granted During the Covid Pandemic: Lessons Learned From the French Case Study

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State-Guaranteed Loans: The Right Solution During the Pandemic (1)

- Specific economic issues during the pandemic: (i) operating cash-flow affected; (ii) uncertainty other post-pandemic conditions, (iii) temporary productivity and demand shocks.
- State intervention justified by specific market failures:
  - Informational problems: adverse selection by lenders and potential breakdown of the lending market
  - Other potential negative externalities: sub-optimal failures of viable companies, labour market effects, distress spreading to trade / financial partners
- Multiple complementary policies used:
  - Direct financial support to change private incentives towards socially optimal behaviour (eg furlough schemes, extensions of tax / social liabilities, direct lending, etc.)
  - Indirectly increasing availability of credit by targeting the private incentives of financiers: temporary ECB measures to facilitate moratoriums, State guaranteed loans (SGLs), etc.

State-Guaranteed Loans: The Right Solution During the Pandemic (2)

- SGLs have a long history as a tool to facilitate financing of SMEs: but during the pandemic the tool was used to preserve viable companies.
- SGLs were the right tool to ensure emergency access to liquidity…
  - Subsidiarity of State intervention in a market economy + preservation of public funds
  - SGLs preserve the real option of resource reallocation: where viability is uncertain, guarantees lower lender's adverse selection and push the reallocation / continuation decision for later, with more information about the post-pandemic economy and the situation of the specific company
  - Banks retain a fraction of the risk to harness (i) their informational advantage in the lending decision; (ii) the effects of their self-interested behaviour in controlling and enforcing their rights against the borrower; as well as to (iii) control moral hazard
- … but now they may need to be restructured (jurisdictional differences).

Main Features of State-Guaranteed Loans

- Constrained by EU state aid regulations — the Temporary Framework provides 'safe harbour' for specific types of SGLs.
- Implemented in France through the public finance 2020 law, various ministerial decrees, the contract passed with Bpifrance, an interpretative FAQ, some (emerging) informal principles. Economic functioning closer to insurance than guarantee.
- Loans of up to 6 years and up to 25% of the 2019 turnover. Guarantee covering 90% (80%-70% for some larger companies).
- SGLs address the market failure precluding financing of viable firms, with some conditions limiting the risks of (i) unviable/zombie financing (e.g. risk retention), (ii) risk substitution by the lenders (e.g. maintaining levels of exposure), (iii) bad loans being given to gain market share (e.g. risk retention, informal agreements).
- Some characteristics aim to limit the scope of moral hazard from borrowers by increasing self-screening: premiums, limitations on use of proceeds (but outsourced to lenders), (limited) upstreaming restrictions—but perhaps insufficient.
- Empirical studies seem to show that SGLs didn't increase the level of zombie firms and didn't result in high levels of risk substitution, while preserving social value.

Various Reasons to Restructure State-Guaranteed Loans

- At the moment, economic studies vary in anticipations of default between jurisdictions—expected to be low in France. But forecasts could change due to new economic situation + restructuring could be useful even where default isn't looming.
- **Cash-flow shortages**: for companies with limited margins, the repayment of loans covering 3 months of lost turnover over 6 years could be difficult. But some companies might also be simply non-viable, so bland rescheduling might not be justified.
- **Debt overhang**: fixed payment liabilities undermine the capacity of companies to finance new positive NPV projects.
- **Holistic restructuring**: some borrowers are viable but adversely affected by the shock and might need to right-size their capital structure to adjust for new economic realities—existing SGLs cannot be left aside.

Specific Issues in Restructuring of State-Guaranteed Loans

- The State *would like* SGL restructurings to be conducted so that (only) viable companies survive and are adequately reorganised, at a minimal cost for taxpayers, and preserving banks' lending capacity (NPLs issues).
- But the State (principal) relies on actions taken by the lender (agent) that affect its welfare (i.e. **agency problems**), which could lead to unnecessary costs to taxpayer (externalities). These problems are *in addition* to potential multi-party PDs / collective-action problems that traditionally justify R&I procedures. Note that SGL restructurings might raise problems *even in the absence* of collective-action problems (e.g. single lender).
- (Partial) **Risk retention** by lenders is a solution to align principal / agent interests and avoid disinterest / incompetence in SGL enforcement. But it still leaves room for **strategic action**: conflicted behaviour (e.g. the lender 'sacrificing' the SGL to preserve other exposures), debtor/lender collusions, etc.
- The principal (State) can use two main types of (legal) strategies:
  - **Governance strategies**: controlling lender's behaviour, i.e. direct involvement of State / third-parties on its behalf to supervise the restructuring of SGLs.
  - **Regulatory strategies**: prescribing the substantive terms / constraints on admissible restructuring measures involving SGLs.

Specific Objectives in Restructuring of State-Guaranteed Loans

- Traditional (economic) objectives of restructuring procedures should apply, but adapted to the specific issues discussed above:
  1. **maximise ex-ante availability of credit**, i.e. create incentives for creditors to extend SGLs *and* other types of credit in anticipation of the treatment in restructuring (including in future crises).
  2. **maximise the available value in case of distress**, i.e. (i) *minimise* all distortions to the usual restructuring process / viability assessments stemming from the guarantee; (ii) minimise additional direct costs of the procedure (e.g. information & administrative costs of State involvement).
  3. **minimise additional negative externalities**, including costs for taxpayers, i.e. control the new agency costs and limit the scope for opportunistic behaviour from lenders and/or borrowers.
- **Tentative guideline**: adapt the SGL restructuring process to harnesses the private information and self-interested incentives of private lenders and minimise the additional costs of State involvement for the protection of public interest.

General Themes of SGL Restructuring (in France) (1)

- **Recovery of guarantee payment**: the objective of encouraging *ex-ante* lending requires that the guarantee payment be predictable and quick. But this increases agency costs and creates potential costs for the taxpayer. Several solutions:
  - Subrogation: possible immediate payment and subrogation into creditor's rights (usual for guarantees). But this implies high information / administrative costs for the State in managing the exposure + the State itself could drive borrowers insolvent upon enforcement (political issue). Solutions could be allowance for delays of payments until a more suitable time or generalised conversions into quasi-equity / fiscal equity (see below).
  - **No subrogation**: the French system *seems* to operate under the assumption of no subrogation.
    - But in most cases it relies on a (almost) functional equivalent structure in most cases: large preliminary payment (e.g. 90% of coverage); the lender retains risk and manages the restructuring going forward; the State shares in the payments under the restructured SGL (if the loan still exists); final settlement after the lender took all enforcement steps it deemed necessary and the final instalment under the restructured loan is paid.
    - So, risks of creditors not taking the appropriate steps can be expected to be off-set by retention of risk and lower information / administrative costs, i.e. guarantee payment recovery outsourced to banks. For banks, this means lower immediate payment + enforcement costs.

General Themes of SGL Restructuring (in France) (2)

- **Relative treatment of the SGL**: SGLs are senior unsecured loans, and the issue of their relative treatment could be left for the general / typical rules of restructuring. But high agency costs justify additional constraints.
  - Insulation / better treatment of SGL: anecdotal evidence suggests this was the informal principle in France at the beginning. But likely to cause a liquidation bias in many small companies, and unjustified if the guarantee was paid for by borrowers
  - Higher haircut as countercyclical measure: under some circumstances of economic recession (excessive unemployment), the social value of the firm can be greater than the private value, so there might be privately optimal but socially sub-optimal liquidations. In this case, the State might concede a higher haircut in restructuring to incentivise creditors to opt for it, without the State needing to know the social / private value of the firm. If the costs of the measure are an issue (also state aid constraints), the higher haircut can be coupled with 'better fortune' / fiscal equity (see below). But principle of subsidiarity applies: the premises don't seem to be satisfied now.
  - ***Pari passu* (at least)**: to piggyback on private information and incentives of lenders while saving information / administrative costs of State involvement.
    - Currently in France applies as regulatory principle in credit mediation, but only emerging as informal principle in other cases: requires State involvement for enforcement, and leaves room for bargaining for exceptions. Suggestion: enshrine into law as condition for call of guarantee (regulatory strategy).
    - But the principle is incomplete. Question: **what other way to harness private incentive in the absence of similar liabilities?**

General Themes of SGL Restructuring (in France) (3)

- **'Better fortune' / option preservation**: where borrowers are viable but insolvent / debt overhang, one solution is to convert the fixed claim into a contingent / option claim, from which the State would benefit to recoup the guarantee payment.
  - Where there is subrogation: operates through systematic gavage options or fiscal equity (but subject to potential state aid constraints).
  - Without subrogation: in France there is an incentive for lenders to accept conversions / write-offs against contingent claims: such rights / instruments are not valued at the final settlement, so payment as if they didn't exist. Following the payment, all proceeds of such rights / instruments are shared by the State and the lenders:
    - Pierre & Vacances (2022) restructuring: publicly traded company; SGL converted into shares together with other unsecured liabilities (with exceptions), and shares transferred into a trust (not to be on banks' balance sheet and their management). The shares will be sold on the market and proceeds used to repay the State and lenders.
    - Private (smaller) companies: in some ongoing (confidential) cases, lenders concede partial write-offs of loans including SGLs in exchange for contractual 'better fortune' clauses: beyond some thresholds, a percentage of free cash-flow used to repay the lenders (and indirectly the State).
- Question: **should better fortune structures be generalised** (i.e. regulatory strategy to protect against strategic haircuts)? Seems justified only if the State consents to systematically higher haircuts.

General Themes of SGL Restructuring (in France) (4)

- **Transfer restrictions**: currently in France, the SGL cannot be transferred together with the guarantee (except in limited circumstances). The restriction targets risks (additional costs for taxpayer) from strategic action by buyers. But is likely also justified by the risk of weaking the control of agency costs through informal norms / arrangements between State and banks.
  - But the *general* restriction is not justified, hence contrary to 'no distortion' objective above:
    - Limited risk: transfers should be possible to other institutions eligible to give SGLs (but *not* other types of investors), with limited risk of additional costs for taxpayers: business model based on restructuring facilitation / DIP financing / subsequent commercial banking + guarantee limited at the cost of acquisition.
    - Lower bargaining frictions: offers exit route to impatient/hostile banks that no longer wish to maintain commercial relations with borrower and entry route for new bank partners interested in value preservation.
    - NPL: facilitates offloading of NPLs by banks and increases their subsequent lending capacity.

French Procedures for SGL Restructuring (1)

- **Procedural gradation**: the general themes above seem to show that the French system relies more on governance rather than regulatory strategies to handle agency problems in SGL restructurings. But the State isn't (and cannot be) involved in *all* cases. Hence, there is a gradation of how easy the restructuring is depending on trustworthiness of bargain supervisors / mediators.
- **Private workouts** are always possible, but the system seems to be crafted to discourage taking measures where scope for opportunism is high:
  - If novation / waiver / conversion / rescheduling bringing total term to 6+ years: the guarantee terminates (for this portion) and compensation is equal to the 'actuarial loss' at that date. The value of all received instruments taken into account.
  - If rescheduling within the 6-year limit: the guarantee is automatically extended (for this portion), but the borrower has to pay a new guarantee premium for the additional period.

French Procedures for SGL Restructuring (2)

- **Credit mediation**: service created by the BdF and only dealing with bank loans (SGLs and others), typically for smaller borrowers encountering liquidity issues (i.e. not debt overhang). The court / court-officers not involved.
  - Measures are limited to consensual debt rescheduling (up to 10 years) and the *pari passu* principle is respected: constraints meant to limit agency costs considering that the State is not involved. In exchange, the borrower is not liable for additional guarantee premia.
  - Suggestion: justification for limit on types of measures unclear if allowed in private workouts-–allow waivers / debt conversions if necessary but only *pari passu*.
- **CIRI**: for larger cases, negotiations are typically supervised by the CIRI on behalf of the State—*not specific to SGLs*.
  - Traditionally influence of the mediator through informal channels + proposals being acceptable (no legal coercive power). CIRI is generally able to ensure the respect of the *informal* principles, but also subject to political pressures / demands for concessions. Role changing with the post-Restructuring Directive procedures.
  - Suggestion: protect from bargains for exceptions by enshrining some principles (e.g. *pari passu*) in the law.

French Procedures for SGL Restructuring (3)

- **Conciliation**: negotiations brokered by a court-appointed officer (i.e. RP). All types of restructuring measures are admitted. Presumably, agency costs controlled through reputation mechanisms of repeat-player RPs.
- **Formal proceedings**: all types of measures allowed
  - Presumption that the involvement of the court and the court-appointed officer are sufficient to police strategic actions detrimental to the State.
  - In the larger cases, SGLs are in a separate class and could conceivably be treated differently from similarly ranking liabilities. But the State is often direct privileged creditor and can credibly threaten to impose a plan through cross-class cramdown with the ascent of repeat-player RPs.
- **In both cases**:
  - Extended and converted/waived fractions of the SGL treated separately.
  - Possible to reschedule the SGL beyond the 6 years limit: the final settlement of the guarantee is at maturity and the value of other instruments not considered (but count for the 'better fortune' structure).
  - In case of waiver or conversion into shares/warrants: immediate final settlement for this portion, without taking into account the value of received instruments (but count for the 'better fortune' structure).
  - In case of novation: immediate final settlement for this portion, but the compensation is only of the 'actuarial loss' (i.e. the difference in value of the repayment flows before and after the restructuring).

THANK YOU!