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State-aid framework under Covid: what impact on credit markets?

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- Through the great financial crisis, taxpayers had to bail-out companies - mostly in the financial sector - with creditors ending up largely unscathed. To prevent a repeat of such situation, bail-in mechanism were put into place both by financial regulators and the European Commission (EC) via the competition framework both for financial and non-financial companies.
- Containing economic destruction has been a key priority of public authorities since the start of the Covid-19 crisis, to protect the chance of a post-lockdown recovery. State aid rules have been eased to simplify government support.
- Credit markets have mostly benefited for this temporary framework, as the burden sharing principle is mostly suspended – clearly a positive for markets. However coupons restrictions on corporate hybrids may arise for companies applying for long-term aid like Lufthansa. We nonetheless keep our positive stance on corporate hybrid.

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Through the great financial crisis (GFC), taxpayers had to bail-out companies with creditors ending up largely unscathed, mostly in the financial sector. Indeed even subordinated creditors of banks that requested public support weren't touched, even though the higher yield received on such securities was supposed to reflect a higher level of risk. But as we found out then, banks are too big to fail and the probability of a large bank going bankrupt is near zero, as governments would intervene beforehand.

Bail-out during the GFC has fueled populism

Not every citizen knows about additional Tier 1 but it is clear that often populists are advancing the idea that taxpayers have been absorbing the losses during the GFC while the gains remained privatised, which is partly true. Hence, in an attempt to build a fairer system, bail-in mechanisms have been put into place by financial regulators and the European Commission (EC) via the competition framework both for financial and non-financial companies.

Regulatory efforts have been made mostly in the financial sector: instruments like Additional Tier 1 (AT1) have been created for banks to absorb losses in a going concern way, i.e. before the bank reaches the point of non-viability.

Also under the rules of competition governed by the Directorate-General (DG) for Competition of the European Commission (EC), both financial and non-financial companies have gradually become subject to the **burden-sharing principle**, meaning that shareholders, subordinated creditors and possibly senior creditors must absorb losses before governments can decide to grant state-aids to support a company in difficulty.

A Covid-19 New bail-in framework

That being said, the Covid crisis had reshuffled the cards. Economic preservation is now the name of the game for public authorities in Europe, on both the fiscal and monetary fronts. The ECB is taking its share with an unprecedented level of corporate bonds purchases of non-financial companies (CSPP, PEPP), coupled with very attractive liquidity measures for banks (TLTROs, PELTROs). But the EU Commission has also taken action to preserve the continuity of economic activity during and after the COVID-19 outbreak, allowing member states to use the fiscal leeway to help their respective business sectors.

Indeed the main fiscal response to the Coronavirus will come from Member States' national budgets, and the EU State aid rules have been amended to enable Member States to take swift and effective action to support citizens and companies, in particular SMEs, facing economic difficulties due to the COVID-19 outbreak.

On 19 March 2020, the Commission adopted the Communication on the **Temporary Framework for State Aid** measures to support the economy in the current COVID-19 outbreak (TF COVID-19) which has been amended twice afterwards (on 3 April 2020 and 8 May 2020).

The support to the economy can take various forms, such as wage subsidies, suspension of payments of corporate and value-added taxes or social contributions. Besides, Member States can grant financial support directly to consumers, for example for cancelled services or tickets that are not reimbursed by the operators. Also, EU State aid rules enable Member States to help companies cope with liquidity shortages and needing urgent rescue aid.

For longer-term aids, the second amendment to the temporary framework is also introducing, beyond the usual capital injection, the possibility for Member States to support their industries via subordinated loans, the latter being seen as less competition-distortive than the former by the DG Comp.

Banks are well protected by the Covid framework

To preserve the credit channel via bank lending the EC via the DG Comp has eased rules for governments to support troubled banks. The first version of the temporary framework has offered a very strong support for banks as it clearly states that the burden-sharing principle is suspended provided the losses are related to Covid-19.

> ***Temporary framework Art7. (link)***
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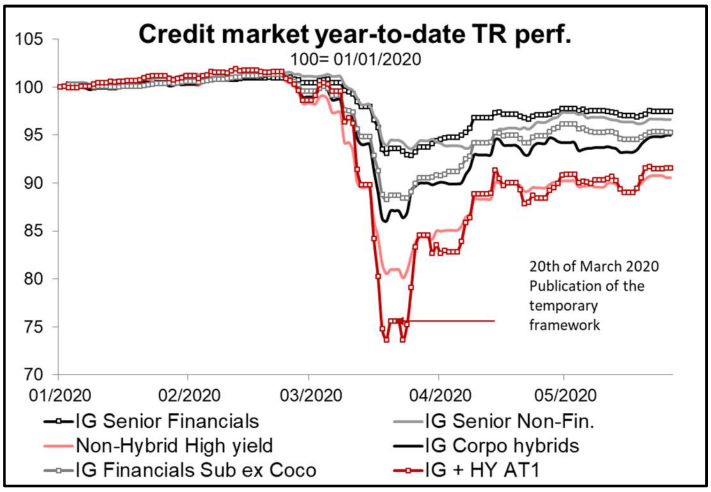
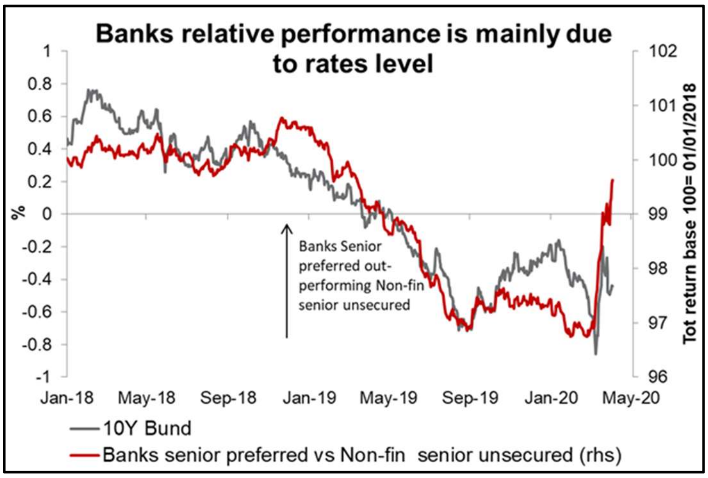
> *If due to the COVID-19 outbreak, banks would need direct support in the form of liquidity recapitalisation or impaired asset measure, it will have to be assessed whether the measure meets the conditions of Article 32(4)(d) (i), (ii) or (iii) of the BRRD. Where the latter conditions were to be fulfilled, the bank receiving such direct support would not be deemed to be failing-or-likely-to-fail. To the extent such measures address problems linked to the COVID-19 outbreak, they would be deemed to fall under point 45 of the 2013 Banking Communication ([6]), which sets out an exception to the requirement of burden-sharing by shareholders and subordinated creditors.*

As banks capital positions are much stronger compared to their pre-GFC crises, we do not see immediate candidates for state support application within the banking sector. This is even more the case since the ECB has strongly encouraged banks to suspend their dividend distribution. We see this as a mitigant to the mild deterioration of capital position attributable to a higher cost of risk triggered by a sharp expected increase of non-performing loans in the context of Covid. Hence, overall we have seen great attention paid by public authorities to banks, and a clear preference has been made to creditors over shareholders.



The **suspension of the burden-sharing principles for subordinated creditors is a relief for bank creditors**. If the new state-aid rules are undeniably positive for subordinated bonds (Tier2 and AT1) even senior preferred bonds have largely benefitted from the new framework.



Looking ahead, we are rather confident on AT1 coupons given the encouraging tone of regulators that do not seem to have any plan to ask for a global coupons skip. As Andrea Enria Chair of the European Central Bank's Supervisory Board said recently: "restrictions on payments of these instruments will be automatically triggered only if banks hit certain capital levels set out in the legislation – but as of today, banks still have significant buffers to use before reaching that point." Hence we expect a convergence in terms of coupon risk between AT1 and corporate hybrids that are not subject to an automatic trigger-based suspension but remain exposed to a suspension in case of bail-in.

Non-financials remain more exposed

However, the second amendment to the temporary framework is making clear that, unlike in the financial sector, **may-pay coupons and dividends will have to be suspended** until the state-aid has been fully repaid in the non-financial sector

> ***Seond amendment to the temporary framework Art. 77 (link)***
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> *As long as the COVID-19 recapitalisation measures have not been fully redeemed, beneficiaries cannot make dividend payments, nor non-mandatory coupon payments, nor buy back shares, other than in relation to the State.*

However we don't expect corporate hybrids to suffer from this news for the following reasons:

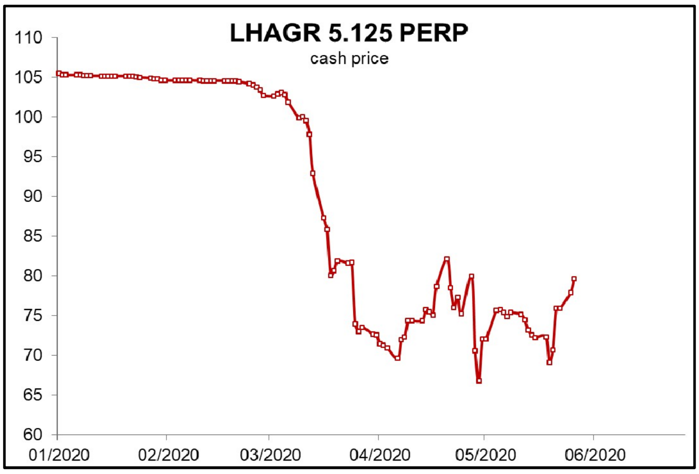
- First, the question of the competition distortion between the financial and the non-financial sector may arise in the near term, because tax-issues on AT1 in the Netherland and in Denmark have taught us that the DG comp pays usually much attention to fair completion between sectors on subordinated bond matters. Hence we can't rule out that the EC may align the treatment of the coupon on non-financials to the one of financials.

- Second, to be eligible for state aid, the company should be in such financial distress that it could not survive without it. It is not just a matter of avoiding a downgrade to HY. Consequently, we see a limited number of corporate bond issuers currently matching this definition at this point of the crisis. Of course, any material second wave of Covid-19 contagion could challenge this view.

Seniority of "debt" state-aid vis a vis corporate hybrids is not clarified in the temporary framework

Some issuers that will request state-support in the near future have already subordinated debt outstanding. And in the case where the aid would be granted in the form of subordinated debt, the temporary framework is silent regarding the payment rank of the "public hybrid" vis a vis the subordinated debt previously sold to private investors.

Lufthansa's rescue package (suspended for now) is the first example of such a situation. The plan has not yet been approved by Brussels, but from the preliminary communication of the company, we understand that part of the aid granted by the German government to the airline company, will be done in the form of subordinated debt convertible into equity. The company is so far reluctant to make any comment on the hybrid situation, which is likely to be a bone of contention with Brussels and despite the above-mentioned Article 77 theoretically pointing to a coupon suspension, the "private corporate hybrid" of Lufthansa has been rising on the news of the agreement between the company and the German state.



State aid will not necessarily deteriorate credit metrics

We understand that state aid in the form of subordinated debt structure can be accommodated to better suit company needs. Indeed only the remuneration is specified in the framework. Hence we expect those bond have no maturity date because they would then as 100% equity under IFRS and not deteriorate the companies credit metrics. Depending on the subordination versus other outstanding subordinated debt we also understand that rating agencies could retain an equity treatment up to 100% at S&P and 50% at Moody's.

Of course, the state-aids are intended to be repaid and are thus adding to the overall leverage of corporates, already elevated before the crisis. But they should not be a catalyst for faster downgrades from rating agencies if not the opposite since the sovereign support can be mitigating the deterioration of the credit in some cases.

Strategic companies can still be helped outside the temporary framework

Strategic issuers that receive a capital injection or subordinated loan from their respective state at market price or an investment pari passu with private shareholders will not necessarily qualify as state aid. Therefore, it implies that the subordinated bonds of these issuers will not be affected by state aid-related risks (burden sharing, coupon deferral). Interestingly there is no definition of 'strategic'. EDF is among the companies that can be considered at risk from a state support standpoint, but despite all the issues the company is facing it is far from being near default. Consequently, should EDF receive a subordinated loan (never mentioned by the company but not to be excluded), we expect it to fall under this category of strategic issuers support, not implying any forced coupon deferral.

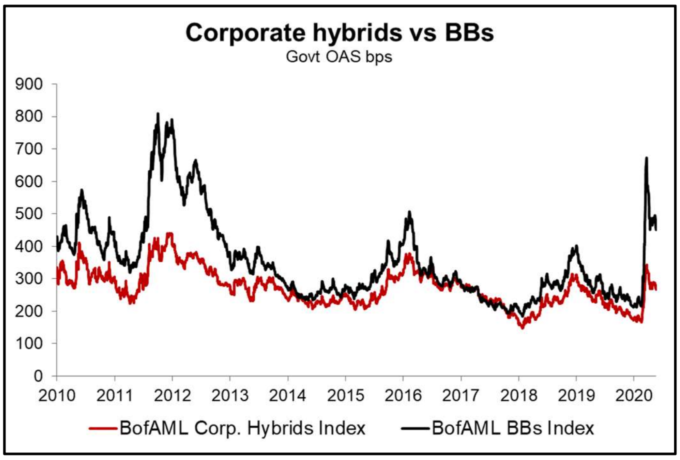
Second amendment to the temporary framework Art. 10 (link)

The Commission also recalls that there are a number of additional tools to deal with acquisitions of strategic companies. In its Communication issued on 25 March 2020 (4), the Commission called upon Member States that already have an existing foreign direct investment screening mechanism in place to make full use of such tools to prevent capital flows from non-EU countries that could undermine EU's security or public order. (…)

Corporate hybrids can live with article 77 for now

Since the coupons are not protected on the non-financial side, the corporate hybrid segment is the most vulnerable one since the coupons are paid on a discretionary basis. However, we see several reasons for not turning negative on corporate hybrids despite the threat on the coupon for companies that will be helped.

- Hybrid issuers are mostly IG rated, hence very few companies are matching the "near-default" criteria: the airlines are probably the only ones at this stage. Of course, should the scenario of a severe second lockdown materialize, more companies might join the list. But we are already taking into account a medium stress scenario when considering the likely candidates for state aid within the relevant universe.
- A significant share of hybrid issuers are strategic as the universe is mostly made of Telcos and Utilities. Several state-related entities have faced strong volatility on the back of the second amendment to the temporary framework after its publication, e.g. Deutsche Bahn hybrids lost several points. But they have been retracing most of their widening on the perception that they should fall under the strategic issuer definition, which does not threaten the payment of the coupon.



As a conclusion, we can say that the Covid-19 related framework has been a support for credit markets in general and Banks in particular. AT1 and Tier 2 are perceived as less risky now, which is improving banks funding profile allowing them to access the market for subordinated issuances. The most vulnerable segment would be in our view corporate hybrids, but assuming the impacted companies will be limited to the airline sector, it is not altering our positive stance on the asset class : we continue to like the defensive composition bias of the universe (Utilities, Telcos). We continue to see extension risk as limited and it remains almost immune to default risk (unlike high yield) since most issuers are rated investment grade.

Imprint

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