KNOW-HOW

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BANKING AND FINANCE

RESCUE BY KFW LOANS IN THE COVID-19 PANDEMIC?

The measures for stemming the COVID-19 pandemic have serious consequences for the economy. The travel restrictions and closure of businesses are threatening the very existence of the tourism, retail trade and food service sectors in particular. Other companies are also experiencing a drastic drop in their turnovers due to the crisis; numerous companies have had to correct or completely withdraw their forecasts for the current financial year. The Federal Government has promised to provide speedy and non-bureaucratic aid to the affected companies and taken a number of different support measures, including liquidity assistance. A large number of companies have already filed applications for immediate aid.

The European Commission has assumed a large portion of the aid package planned by the Federal Government, in particular the liquidity assistance and the provision of guarantees already at the end of March 2020.

I. KfW special programmes

The Federal Government provides liquidity assistance through the Reconstruction Loan Bank (Kreditanstalt für Wiederaufbau zur Verfügung – KfW). To this end, KfW introduced its new special programme on 23 March 2020, which consists of two main elements – "Entrepreneur Loan (037)" and "Syndicate Financing (855)".

a) "Entrepreneur Loan (037)"

Under this programme, KfW covers up to 80% of the default risk of the regular bank for loans to large companies and up to 90% for loans to small and medium-sized companies.

This is available to companies that have been on the market for at least five years.

The beneficiaries can obtain up to EUR 1 billion euro in the form of a loan. However, the amount of the loan is limited per group of companies to a maximum of (i) 25% of the annual turnover for 2019, (ii) double the amount of the wage costs for 2019 or (iii) the current financing needs for the next 12 months for large companies (or 18 months for small and medium sized companies).

Moreover, for loans of more than EUR 25 million, the amount of the loan may not exceed an upper limit of 50% of the company's overall debt. The loans will be granted for a period of up to five years, with the possibility of a one-year grace period. The terms provide for a reduced interest rate of a maximum of 2% and a fixed interest rate for the entire period.

b) "Syndicated lending (855)"

Within the scope of this programme, KfW provides larger loans in a consortium with other banks, whereby KfW will assume 80% of the loan default risk, but not more than 50% of the company's overall debt.

The restrictions stipulated in the "Entrepreneur Loan (037)" on the amount of the loan apply analogously for KfW's part of a syndicated loan.

For companies that have been on the market for at least three years, but less than five years, KfW has set up a separate programme – "ERP Start-up Loan – Universal (073/074/075/076)" – which largely stipulates the same conditions for assistance as the programme for companies which are already established.

Detailed information and exclusion criteria can be found on the KfW website.

II. Provision of guarantees

Additionally, in order to implement the approved provision of guarantees, the Federal Republic of Germany enacted the "Regulation on the temporary provision of guarantees, counter-guarantees within the territory of the Federal Republic of Germany in relation to the outbreak of COVID-19 – Federal Guarantee Regulation 2020" *(Regelung zur vorübergehenden Gewährung von Bürgschaften, Rückbürgschaften und Garantien im Geltungsbereich der Bundesrepublik Deutschland im Zusammenhang mit dem Ausbruch von COVID-19 – Bundesregelung Bürgschaften 2020)*.

This enables the Federal Government and the Federal States – acting through their corresponding state aid granting authorities – to assume guarantees and counter-guarantees at fixed terms and for a period of no more than six years.

Subject to the prerequisite that the guaranteed capital must decrease proportionally to the unguaranteed capital, the maximum guarantee rate will be:

- 90% of the guaranteed loan if losses are borne by the credit institution and the state guarantor pro rata and at the same terms; or
- 35% of the guaranteed loan if the losses are first attributed to the state guarantor and only then to the credit institution ("first loss guarantee").

The upper limit for the guarantees is the same as that for the KfW loans and may not be higher than (i) 25% of the annual turnover for 2019, (ii) double the amount of the wage costs for 2019 or (iii) the current financing needs for the next 12 months.

Additionally, numerous guarantee programmes have been established by the state development banks *(Landesförderbanken)*, such as NRW.Bank, L-Bank, WIBank, NBank and IBB.

III. Economic stabilisation fund

As a further measure to strengthen the economy, the Federal Government established the economic stabilisation fund with the Economic Stabilisation Fund Act *(Wirtschaftsstabilisierungsfondsgesetz - WStFG)* which entered into force on 27 March 2020. This fund is authorised to assume guarantees of up to EUR 400 billion for debt instruments and liabilities incurred by companies between 28 March 2020 and 31 December 2021, e.g. bonds or issues, in order to prevent liquidity bottlenecks. Additionally, the economic stabilisation fund can take recapitalisation measures for companies which need to strengthen their equity capital base, i.e. make genuine equity participations or subordinated capital (dormant equity holdings) available to companies. The Economic Stabilisation Fund Act is still subject to the approval of the European Commission. It is to be expected that once this approval has been granted, the individual applications will have to once again be approved by the Commission (reservation of individual notification).

IV. Implementation of the assistance measures in practice

Even if the state measures to secure the liquidity assistance are substantial and will certainly reach many companies, some of the provisions will run into problems when applied in practice.

1. Assistance for restructuring cases

The framework adopted by the Federal Government is generally meant to assist healthy companies that have run into financial difficulties due solely to the corona crisis. For this reason, all of the mechanisms established by the Federal Government – the KfW loans, the guarantees and the recapitalisation by the Economic Stabilisation Fund – will only be available to companies which were not in difficulty on 31 December 2019 (decisive for determining this is the definition of "undertakings in difficulty" under EU State aid law), but only began to experience financial problem needs thereafter due to the spread of COVID-19. Moreover, access to a KfW financing or guarantee from the economic stabilisation fund is contingent on the prospect that it will be possible to continue the company once the pandemic will have been overcome.

These limitations of access to the liquidity assistance are of great importance in practice. Some companies that were in the process of restructuring at the end of 2019 will not be able to profit from this support even though they are no less likely to have been affected by the consequences of the COVID-19 pandemic than other companies – some of them, in fact, much more seriously.

According to the (established) "Rescue and Restructuring Guidelines", the granting of state aid would come into consideration for companies with structural problems. With such rescue aids, short-term financial support (up to six months) is available in the form of guarantees or loans. It is also generally possible to receive restructuring support (typically capital injections).

However, at present it would appear doubtful whether a short-term rescue aid would be able to give the affected companies enough time to make up for the negative influence of the corona crisis. On the contrary, the stipulated period of the KfW promotional loans of up to five years strengthen the expectation that the consequences of this crisis will be troubling to even healthy companies for some time to come. Restructuring aid, on the other hand, must be kept to a minimum and can only be granted subject to the stringent prerequisites that a comprehensive restructuring plan must exist. The beneficiary must make an "own contribution" and distortions of competition must be "offset" by counter-performances (sale and reduction of business units, closure of sites, etc.).

In both cases, the granting of state aid on the basis of the "Rescue and Restructuring Guidelines" represents a burdensome and time-consuming process for the applicant. Moreover, a public authority must indicate that it is willing to provide such aid in the first place.

2. Participation quota of the regular bank and other financers (20% and 10%, respectively)

Another aspect is the fact that the KfW loans are extended within the scope of the special programmes by way of the regular bank or a consortium of banks. KfW assumes up to 80% of the default risk of loans to large companies (up to 90% for smaller and medium-sized companies 90%). In practice, given the current difficult market environment, it will most likely not be an easy task for borrowers to find a financing partner that is willing to assume a financing share of 20% or 10% itself. Since it is impossible to predict the precise extent of the corona crisis for the economy presently, it is to be expected that the normal financing partners, which are already "at risk", will be reluctant to extend yet further loan participations. It will also probably not be easy for borrowers to win new loan financers that do not know the borrower or its corporate group, since in view of the complete uncertainty regarding the course the crisis will take, hardly any company is in a position to present a reliable budget plan. However, that would be indispensable for the performance of a credit check by a potential lender.

For this reason, it seems unfortunate that the special programme of the KfW limits itself to a risk rate of 80% or 90% instead of availing itself of the possibility of granting a loan for 100% of the liquidity needed, as would be permissible from the standpoint of EU law.

3. Rescheduling of debts from existing financing

Moreover, a rescheduling of loans that were granted up to 12 March 2020, as well as supplementary financing, follow-up financing and extensions of credits, cannot be financed by a KfW loan. This rule will most likely also prove to be impracticable for some companies. The vast majority of companies most likely have existing financing. If such financing cannot be drawn upon, e.g. due to a failure to comply with financial covenants or due to other grounds for termination – as a result of the COVID-19 pandemic – or, in the case of revolving facilities, if the loans that have already been paid out cannot be extended, the borrower could quickly run into liquidity difficulties. On the other hand, the restrictions that are normal for such financing, and in particular the prohibition of taking on financial liabilities elsewhere, will continue to apply, and thus may not permit a KfW loan to be taken out, since it is to be expected that the KfW financing would exceed the existing baskets under the existing financing of most companies.

However, this predicament for borrowers could in fact be prevented by opening up the KfW financing for rescheduling or extensions as well, since it is to be assumed that many of the financing partners will deal more generously with consent and extension inquiries if only a reduced default risk is to be feared.

The situation is similar with regard to the guarantees provided by the economic stabilisation fund – they can only be used for liabilities and debt instruments which were incurred or issued in the period from 28 March 2020 to 31 December 2021. For old financings that might turn into restructuring cases, the economic stabilisation fund does not offer very much help.

4. Loans backed by normal bank security

The requirement under the KfW programme that the loan be secured with normal bank security could present an insurmountable hurdle for many companies in practice. On the one hand, the security available for existing financing agreements (which in the current situation, due to grounds for termination, may not be available at all or only to a limited extent) might have already been “used up”, with the consequence that it will not be possible to take out a KfW promotional loan. In that case, the borrower could perhaps strive to come to an agreement under which the KfW promotional loan would profit from the security for the existing financing at an equal rank (pari passu). However, it appears doubtful whether the secured lender would consent to such an agreement. Nor is it clear whether this solution would be acceptable from KfW’s point of view.

Even if freely available assets were at hand which could be offered as security, it must still be considered that many existing financing instruments normally prohibit the creation of security with only a few exceptions (in particular a “negative pledge” clause in syndicated loan agreements). Several – somewhat more generous – financing documents can instead contain a “most favoured lender clause”. Such clauses are typical for promissory notes, for example. The borrower undertakes that if it incurs a new secured financial debt, it will create equivalent securities in favour of the lender under the existing financing. An exception from this obligation, which could allow a KfW promotional loan to be taken out without providing the existing lender with subsequent security, would require the consent of the existing lender and, in particular in the case of a promissory note with a large number of investors, could give rise to considerable practical difficulties.

5. No claim to a KfW loan

Of decisive importance is the fact that companies seeking state aid have no claim to obtain support from KfW; rather, KfW generally decides according to its due discretion whether and under what terms it will grant a promotional loan. Thus, KfW is generally free to impose certain conditions on the borrower. In the state aid practice of the Member States, for example, it is not unusual for the recipient of the state aid to be submitted to a prohibition of distribution, as a rule for the duration of the assistance measure. The reason for this is clear: the state should not be financing the rescue while the shareholders approve dividends (principle of own contribution and requirement of burden sharing). This was a standard stipulation for bank bailouts during the financial crisis. The practical implementation of such a prohibition of distribution could prove to be difficult in some cases and might lead to delays.

6. Guarantee programmes

As far as aid within the scope of the guarantee programmes of the Federal Government and the Federal States is concerned, it still remains to be seen to what extent they will provide adequate assistance in practice. On the one hand, there is currently not much experience with this instrument in a crisis situation, which could lead to a lack of clarity and delays in the implementation of the guarantees. On the other hand, the central question arises here of whether a subsequent collateralisation of existing financing by a state guarantee would be possible if these support measures could only be applied to new loans that are taken out.

It should also be considered that the guarantee programmes generally may not be combined with state aid through the KfW special programme. Companies therefore need to consider very carefully which kind of aid would suit them best. It should also be considered that the numerous guarantee programmes of the state development banks are only available to a certain extent in each case and thus are most likely not suitable for large companies with large financing needs.

V. Conclusion

The Federal Government has responded with rapid and far-reaching measures to counter the negative economic consequences of the spread of the novel COVID-19. For many companies, these measures will provide the desired assistance. Nonetheless, upon closer inspection, the aid package contains some roadblocks that will have a substantial impact on a large number of companies.

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