BANKING LAW SYMPOSIUM

The New EU Architecture to Avert a Sovereign Debt Crisis: EFSM, EFSF & ESM

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OECD, Paris

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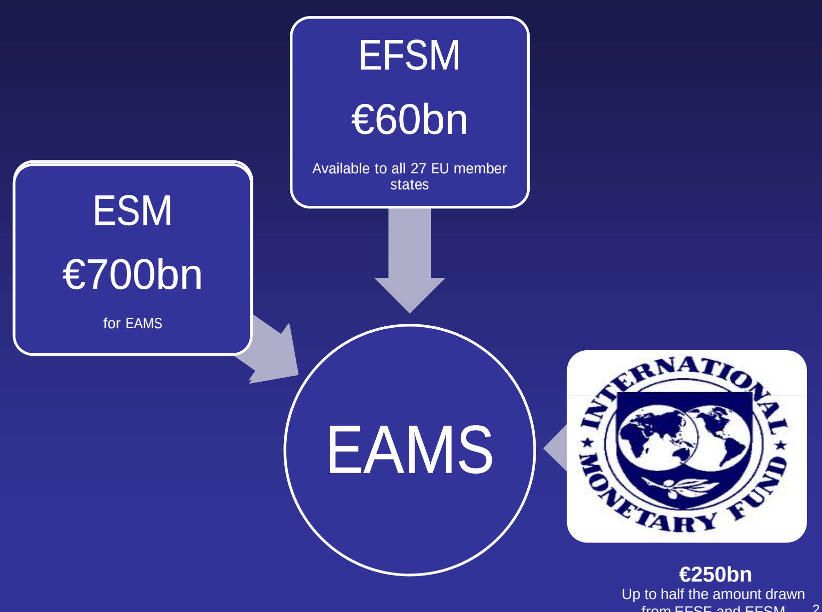

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Who?: The European Financial Stability Facility (EFSF) is a Luxembourgish company incorporated in 2010 by the 16 countries that share the euro.

What?: Provide temporary financial assistance (7½ years loan with an average debt maturity of 5 years) to EAMS in difficulty.

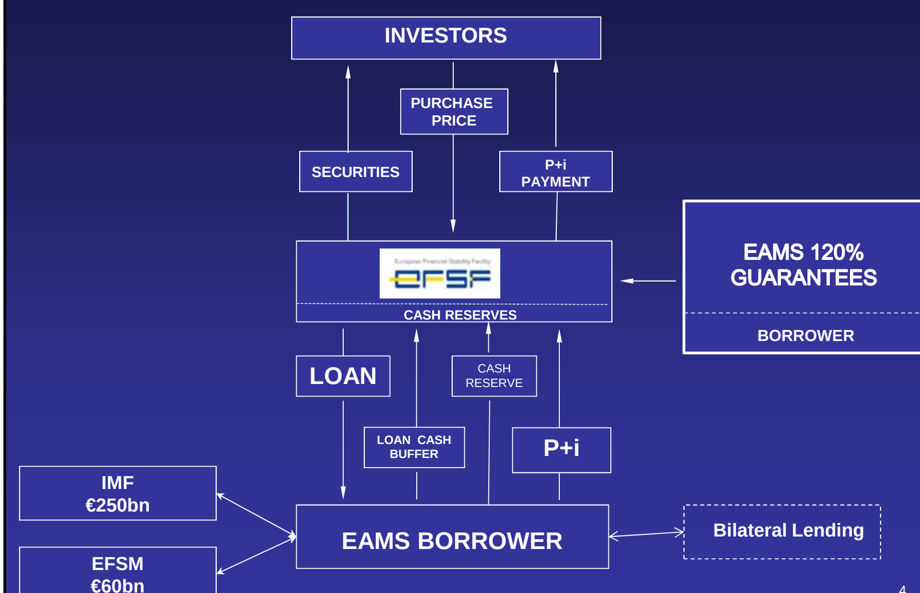
Where?: EMU

How?:

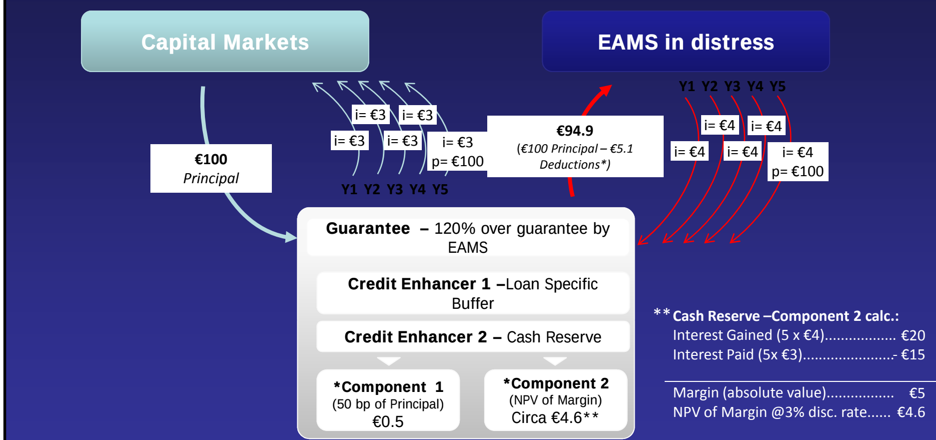
- issue AAA bonds (backed by 120% guarantees given by the 16 euro area Member States of up to € 440 billion on a pro rata basis) or other debt instruments on the market to raise the funds needed to provide loans.
- In exceptional circumstances intervene in the debt primary market in the context of a programme with strict conditionality.
- Not authorised to intervene in the secondary market.

When?: EAMS in financial difficulties.

Why?: To preserve financial stability of EMU.



SIMPLIFIED EFSF's GUARANTEE AND CREDIT ENHANCER STRUCTURE



Main assumptions:
- Market pays 3% interest rate over 5 years; principal bullet payment in year 5.
-EAMS in distress pays 4% interest rate over 5 years; principal bullet payment in year 5.
-All sums are expressed in million.

CREDIT ENHANCERS

➢Under the Framework Agreement (of constitution of the EFSF) there are several credit enhancers.

-Guarantees
-Grossing up of guarantees (120% over-collateralisation)
- Loan-specific cash buffer (50bp on the aggregate principal amount)
-Cash reserve (the net present value of the margin of the EFSF loan)
-Such other credit enhancement mechanism as may be approved (Article 5, EFSF Framework Agreement)

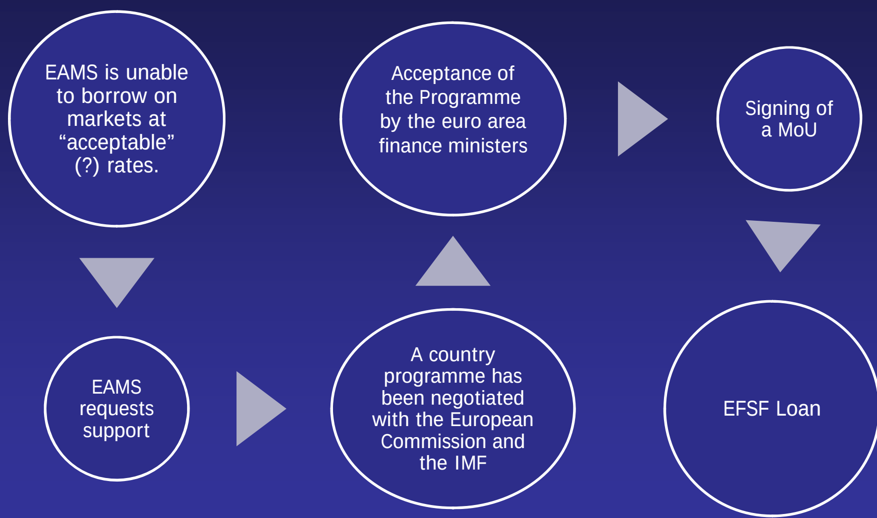
➢A downgrade of a member country would not necessarily lead to a downgrade of EFSF securities.

➢Guarantees are several, irrevocable, firm, unconditional and binding.

➢If a guarantor did not respect its obligations, guarantees from others could be called in to cover the shortfall.

➢The cash reserve and the loan-specific cash buffer are invested in very safe and liquid assets (asset-liability management conducted by the German Debt Management Office).

EFSF FLOW DIAGRAM



EFSF: MISCELLANEOUS

➢EFSF will only provide financial support if a EAMS loses access to markets (NO pre-funded or precautionary credit lines ⇨ LOLR under strict conditionality).

➢It could be agreed with a EAMS that funds are to be used to stabilise the banking sector (see Irish Programme—€35 billion out of the total €85 billion allocated to the banking sector).

➢The volume of the EFSF, together with the EFSM and the IMF, is large enough to provide temporary liquidity assistance to several Member States of the euro area.

➢EFSF does not have any currency limitation for its funding activities (majority of funds expected to be raised in €).

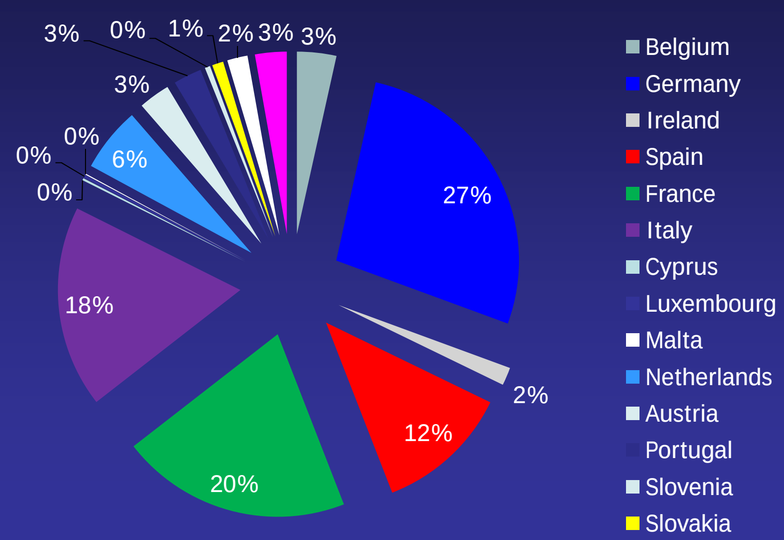
➢EFSF will not crowd other borrowers out of the market ⇨ EFSF will substitute refinancing needs of a country that is unable to borrow at reasonable rates.

➢Fail to meet conditions? ⇨ the loan disbursements and the country programme would be interrupted ⇨ review of the country programme + renegotiation of the MoU.

➢Member States that are not members of the euro area cannot access the EFSF (Balance of Payments facility under Council Regulation (EC) No. 332/2002 = €50bn)

➢Greece financial assistance was arranged prior to the EFSF’s existance

GUARANTEE PROVIDERS



SHAREHOLDER CONTRIBUTION

Member States	Credit rating (S&P/Moodys/Fitch)	ECB Capital Subscription Key	Contribution Key	Maximum Guarantee Commitments (€m)	Adjusted Contribution Key
Austria	(AAA/Aaa/AAA)	1.9%	2.8%	12,241	3.0%
Belgium	(AA+/Aa1/AA+)	2.4%	3.5%	15,292	3.7%
Cyprus	(A-/A2/AA-)	0.1%	0.2%	863	0.2%
Finland	(AAA/Aaa/AAA)	1.3%	1.8%	7,905	1.9%
France	(AAA/Aaa/AAA)	14.2%	20.4%	89,657	21.9%
Germany	(AAA/Aaa/AAA	18.9%	27.1%	119,390	29.1%
Greece	(B/B1/BB+)	2.0%	2.8%	12,388	0.0%
Ireland	(BBB+/Baa3/BBB+)	1.1%	1.6%	7,002	0.0%
Italy	(A+/Aa2/AA-)	12.5%	17.9%	78,785	19.2%
Luxembourg	(AAA/Aaa/AAA)	0.2%	0.3%	1,101	0.3%
Malta	(A/A1/A+)	0.1%	0.1%	398	0.1%
Netherlands	(AAA/Aaa/AAA)	4.0%	5.7%	25,144	6.1%
Portugal	(BBB-/Baa1/BBB-)	1.8%	2.5%	11,035	0.0%
Slovakia	(A+/A1/A+)	0.7%	1.0%	4,372	1.1%
Slovenia	(AA/Aa2/AA)	0.3%	0.5%	2,073	0.5%
Spain	(AA/Aa2/AA+)	8.3%	11.9%	52,353	12.8%
Total			100%	440,000	100%

Source: EFSF

European Financial Stability Facility

EFSF

RATINGS

Moody's Investors Service

"The Aaa rating is based on EFSF's contractual elements, including the irrevocable and unconditional guarantees by the participating states, EFSF's cash reserve and the loan-specific cash buffer as well as the creditworthiness of the participating Aaa Eurozone Member States and their firm commitment to EFSF."

FitchRatings

"The 'AAA' rating is based on the credit enhancement provided by the 'over-guarantee' mechanism and cash reserves. The cash reserves will be sized to ensure that any potential shortfall of 'AAA' guarantor coverage of EFSF debt payments due in the event of a borrower default will be sufficient to meet all payments."

STANDARD &POOR'S

"The rating on EFSF reflects our view that guarantees by 'AAA' rated sovereigns and freely available liquidity reserves invested in 'AAA' securities will, between them, cover all of EFSF's liabilities."

	EFSF I (old)	EFSF II (new)
Face Value	EUR 440	EUR 780
Effective Lending Capacity	EUR 255.5+/-	EUR 440
Over-guarantee	120%	165%
Purpose	(1) Provide temporary financial assistance by the issuance of debt instruments. (2) In exceptional circumstances intervene in the debt primary market. (3) Not authorised to intervene in the secondary market. (4) Not able to provide precautionary credit lines	Financial assistance by way of: (1) loan disbursements; (2) precautionary facilities; (3) facilities to finance the recapitalisation of financial institutions in a EAMS through loans including non-programme countries; (4) facilities for the purchase of bonds in the primary and secondary markets
In Force?	Yes	Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Portugal, Slovenia, Spain Austria, Cyprus, Malta, Netherlands, Slovakia

SOVEREIGN DEBT RESTRUCTURING

ESM

➢24-25/03/11: the European Council confirmed to establish a permanent crisis resolution mechanism – the European Stability Mechanism (ESM).

➢Operational as of mid-2013 ⇨ following an amendment to the European Treaty by 1 January 2013 (Art. 136)

➢The ESM will be established as an **intergovernmental organisation under public international law**.

➢The function of the ESM will be to mobilise funding and provide financial assistance (under strict conditionality) to EAMS.

➢ESM may also exceptionally intervene in the debt **primary** market under the same conditionality.

➢The ESM will have a capital structure similar to multilateral lending institutions of € 700 bn. (effective lending capacity will be €500 bn).
-Paid-in capital (€80 bn)
-Callable capital + Guarantees (€620 bn)

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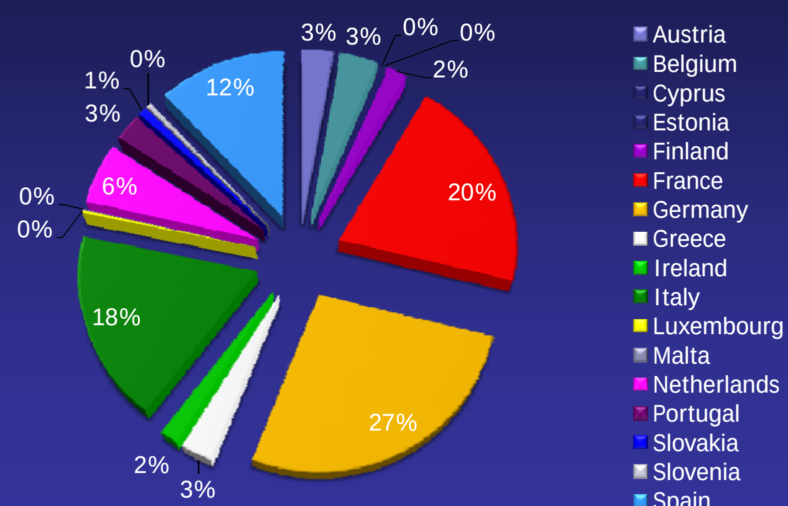
SOVEREIGN DEBT RESTRUCTURING

ESM SHAREHOLDER CONTRIBUTION KEY (BASED ON ECB CONTRIBUTION)



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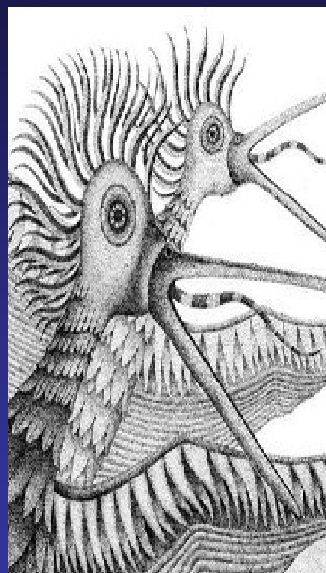
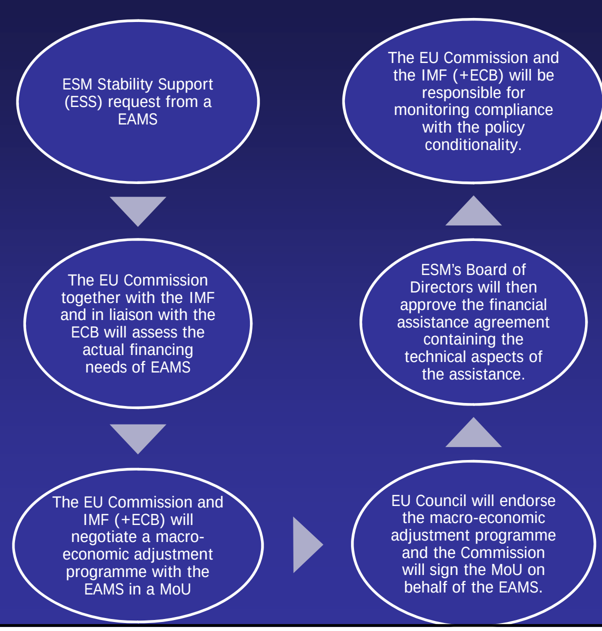
ESM: TECHNICAL ASPECTS



- ESM will work closely with the **IMF** in providing financial assistance + active participation of the **IMF** (in all circumstances) will be sought on a technical and financial level.
- The debt sustainability analysis will be jointly conducted by the Commission and the **IMF**, in liaison with the ECB.
- The policy conditions attached to a joint ESM/IMF assistance will be negotiated jointly by the Commission and the **IMF**, in liaison with the ECB.
- EAMS (+non EAMS) may participate on an ad hoc basis alongside the ESM in financial assistance operations for euro area Member States (*ad-hoc* bilateral loans).
- ESM would not require the credit enhancements of the EFSF to secure a AAA rating.

ESM FLOW DIAGRAM



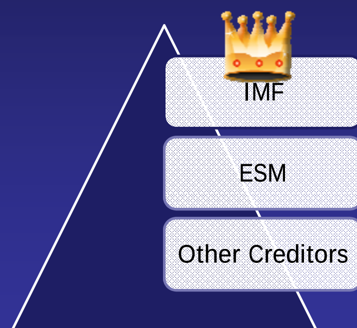
New Paragraph Art. 136 EU Treaty	"The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality".

or

… *rara avis* or another layer of bureaucracy?

➢The EFSF has the same standing as any other sovereign claim on the country (pari passu)

➢ESM will enjoy preferred creditor status in a similar fashion to the IMF, while accepting preferred creditor status of IMF over ESM.



ESM: THE BIG DILEMMA

***… rara avis,* another layer of bureaucracy?**

or

INTERNATIONAL MONETARY FUND

Statement by the Eurogroup (28 November 2010):

> *"In order to facilitate this process, standardized and identical collective action clauses (CACs) will be included, in such a way as to preserve market liquidity, in the terms and conditions of all new euro area government bonds starting in June 2013. Those CACs would be consistent with those common under UK and US law after the G10 report on CACs, including aggregation clauses allowing all debt securities issued by a Member State to be considered together in negotiations."*

Statement in 2003 by the Chairman of the EU Council of Economic and Finance Ministers (a former Minister of Economy and Finance of Greece)

> "*… EU Member States will no longer issue such bonds without any CACs*"

WILL THIS TIME BE DIFFERENT?
(the policy agenda)

- EFSF = Market approach with sovereign guarantees
- Buried the idea of a SDRM?
- Several commonalities with SIV (if involved in extensive bond purchasing)
- Several commonalities with CDOs (CRAs valuation methods)
- Weren't SIVs* and CDOs at the heart of the crisis in 2007-2008?

- Too much debt – crowding-out effect?
- Too much (ESM preferred) debt = less PSI
- PSI = market solution
- CACs = another market solution
- SDRM = 6 feet under !
- ESM = *rara avis,* another layer of bureaucracy or IMF?

EFSF/ESM if it is a short term market failure. Solving a long term structural problem ... NO !

*A SIV is a finance company that attempts to profit from credit spreads between long-term assets, such as asset-backed securities, and short-term liabilities, such as commercial paper.

Any Questions ?

谢谢. Cam rá. Efharisto. Obrigado.
Gracias. Grazie. Thank You.
Merci. Dankeshen. Etc.

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