

## THE EU ARCHITECTURE TO AVERT A SOVEREIGN DEBT CRISIS

by

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### Abstract

This paper analyzes what has been the EU institutional reaction to the Euro-area sovereign debt problems, focusing in particular on the new architecture designed to avert a financial crisis. It analyses (i) the European Financial Stabilization Mechanism (EFSM), an EU financial assistance feature available to all 27 member states, (ii) the European Financial Stabilization Facility (EFSF), a temporary credit-enhanced SPV with minimal capitalization created to raise funds from the capital markets (via an investment grade rating) and provide financial assistance to distressed EAMS at comparatively lower interest rates, and (iii) the European Stability Mechanism (ESM), an intergovernmental organization under public international law. Finally, some concluding remarks are provided.

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Key words: sovereign debt, structured finance, financial crisis, European Union, guarantees, bonds

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### OECD work on financial-sector guarantees

OECD work on financial-sector guarantees has intensified since the 2008 global financial crisis as most policy responses for achieving and maintaining financial stability have consisted of providing new or extended guarantees for the liabilities of financial institutions. But even before this, guarantees were becoming an instrument of first choice to address a number of financial policy objectives, such as protecting consumers and investors and achieving better credit allocations.

A number of reports have been prepared that analyse financial-sector guarantees in light of ongoing market developments, incoming data, and discussions within the OECD Committee on Financial Markets. The reports show how the perception of the costs and benefits of financial-sector guarantees has been evolving in reaction to financial market developments, including the outlook for financial stability. The reports are available at [www.oecd.org/daf/fin](http://www.oecd.org/daf/fin).

- Financial safety net interactions;
- Deposit insurance;
- Funding systemic crisis resolution;
- Government-guaranteed bank bonds;
- Guarantees to protect consumers and financial stability.

As part of that work, the Symposium on “Financial crisis management and the use of government guarantees”, held at the OECD in Paris on 3 and 4 October 2011, focused on bank failure resolution and crisis management -- in particular, the use of guarantees and the interconnections between banking and sovereign debt. Conclusions from the Symposium are included at the end of this paper. This paper is one of nine prepared for presentation at this Symposium, comprising:

- Managing crises without guarantees: How do we get there?
- Costs and benefits of bank bond guarantees;
- Sovereign and banking debt interconnections through guarantees;
- Impact of banking crises on public finances;
- Fault lines in cross-border banking: Lessons from Iceland;
- The macro-prudential authority: Powers, scope and accountability;
- Effective practises in crisis management;
- The Federal Agency for Financial Market Stabilisation in Germany;
- The new EU architecture to avert a sovereign debt crisis.

## 1. Introduction: The Global Financial Crisis and its Impact on Sovereign Debt

The unprecedented global financial crisis and economic downturn that hit the world in 2007-2008 has resulted in the deterioration of budget deficits and caused an overall increase of sovereign debt levels across the world. This deterioration is mainly due to falling revenues resulting from a decreased real and financial activity. In 2010, advanced countries averaged a budget deficit of 8.3%<sup>1</sup>. In the same year the public debt to gross domestic product ratio in those economies reached a level of 97%, increasing from below 75% in 2006. Research by Reinhart and Rogoff shows that a debt to GDP ratio beyond the 60% to 90% level for developed countries may become counterproductive for the economy and a debt spiral may be created in cases where GDP growth falls below the weighted average interest paid on the bonds<sup>2</sup>. At the epicentre of the recent sovereign debt crisis are the euro-area Member States (EAMS), particularly Greece, Ireland and Portugal who have had to procure financial assistance from the European Union (EU), other EAMS, the International Monetary Fund, the European Central Bank and other non-EAMS sovereigns in an attempt to regain sustainability by reducing their sovereign debt burden in an orderly manner.

This paper analyzes what has been the EU institutional reaction to the sovereign debt challenges, in particular focusing on the new architecture designed to avert a financial crisis. The first section provides an analysis of the impact that the global conditions had on Greece and the need for an *ad hoc* financial assistance. The case of Greece is analyzed due to its triggering effect and because of it the different mechanisms that were developed and implemented. Then, section two analyses the European Financial Stabilization Mechanism (EFSM), an EU financial assistance feature available to all 27 member states. Section three analyses the European Financial Stabilization Facility (EFSF), a temporary credit-enhanced SPV with minimal capitalization created to raise funds from the capital markets (via an investment grade rating) and provide financial assistance to distressed EAMS at comparatively lower interest rates. Section four focuses on the treaty that created the European Stability Mechanism (ESM) - an intergovernmental organization under public international law. Since the ESM treaty has a provision requesting private sector involvement in any financial assistance program to be granted, this section will be followed by the complementary analysis of the role played by the private sector in sovereign debt restructurings, i.e. the use of exchange offers, CACs and contractual enhancements. Finally, some concluding remarks and views regarding the way forward is provided.

## 2. The First Greek Bail-out

In April of 2009, the European Council adopted a decision according to Article 126 of the TFEU on the existence of an excessive deficit in Greece<sup>3</sup>. The Greek government deficit for 2009 was 12.7% and its debt to GDP ratio 113%, both well above the convergence criteria set by the Treaty on European Union (also known as the Maastricht Treaty)<sup>4</sup>. In December 2009, following article 126(8) of the TFEU, the European Council stated that Greece had failed to comply with its recommendation issued in April 2009 when an excessive deficit procedure was initiated<sup>5</sup>. On 16 February 2010, on the 2994<sup>th</sup> meeting of the Economic and Financial Affairs (Ecofin) Council it was decided to (1) give notice to Greece to remedy its excessive deficit by 2012 setting budgetary consolidation measures according to a specific timetable; and, (2) to bring its economic policies in line with the EU broad economic policy guidelines and

remove the risk of jeopardising the proper functioning of the economic and monetary union (EMU)<sup>6</sup>.

The Greek government efforts are detailed in a Stability and Growth Programme (SGP). The aim of the SGP is to bring the fiscal deficit of Greece to less than a 3% by 2012 and reduce the government consolidated debt as a percentage of GDP from 2012 onwards. In order to safeguard this deficit-reduction target, the Greek government adopted additional measures aiming at reducing costs and enhancing revenues. The Greek government's short and medium term fiscal and reform strategy measures include budget, tax, social security, and public administration reform, as well as institutional changes to enhance the credibility and sustainability of policies<sup>7</sup>.

Following a recent restatement of Greek data by Eurostat, Greece reached a budget deficit of (-13.6%) and a Debt/GDP ratio of 115% in 2009. The profile of deficit reduction is more modest in the revised SGP, reflecting the upward revision of estimated deficit and the downward revision to the growth projections. In the revised SGP, the Greek government is aiming for a budget deficit of (-4.9%) of GDP in 2013 with an outstanding debt/GDP ratio of 149%.

In February 2010, the Heads of State of the Government of the EU stated their support for the Greek government efforts and commitment and that they were determined to take coordinated action (if needed), to safeguard financial stability in the euro area as a whole<sup>8</sup>. In this context, a month later, euro area member states (EAMS) reaffirmed their willingness to take determined and coordinated action and made available a package involving coordinated bilateral loans and IMF financing<sup>9</sup>. This assistance has to be considered '*ultima ratio*' ( i.e. if market financing is not a viable option) and would be subject to strong conditionality based on an assessment by the European Commission (EC) and the European Central Bank (ECB)<sup>10</sup>.

In April 2010, EAMS announced that the EC in liaison with the ECB, will start working with the IMF and the Greek authorities on a joint programme (including amounts and conditionality, building on the recommendations adopted by the Ecofin Council in February<sup>11</sup>)<sup>12</sup>. Shortly after, and due to deteriorating conditions which made very costly for Greece to obtain financing from the capital markets, bilateral loans were formally requested to EAMS on 23 April 2010.

In early May, Greece and the EC (acting on behalf of the EAMS) entered into a Memorandum of Understanding (MoU) agreeing on a programme to correct fiscal and external imbalances and restore confidence<sup>13</sup>. The programme's financing requirements would be covered by the EAMS and the IMF while strengthening Greece's re-access to the private capital markets. The estimated "public financing gap" for the entire length of the programme was EUR110 billion<sup>14</sup>. It was agreed to be covered through: (1) an intergovernmental framework via pooled matching bilateral loans provided by EAMS in the amount of EUR80 billion; and, (2) an IMF Stand-by Arrangement in the amount of EUR30 billion<sup>15</sup>. Greece will draw on these resources in parallel throughout the program period on an eight to three ratio in each disbursement<sup>16</sup>. The coordination and management of the pooled bilateral loans is set out in an Intercreditor Agreement.

Following the execution of these agreements, an Ecofin Extraordinary Council meeting took place to address the delicate situation of Greece. In the meeting it was decided to adopt

a comprehensive package of measures to preserve financial stability in Europe<sup>17</sup>. These measures included the establishment of two additional sources of financial assistance to complement the *ad hoc* loan facility agreed with Greece. These two new sources of financial aid are:

(1) European Financial Stabilisation Mechanism (EFSM): is a mechanism based on article 122(2) of the TFEU that foresees financial support for member states in difficulties caused by exceptional circumstances beyond their control<sup>18</sup>. It is an intergovernmental agreement to provide financial assistance of up to EUR 60 billion subject to strong conditionality in the context of a joint EU and IMF support which will be on terms and conditions similar to those imposed by the IMF. This mechanism will operate irrespectively of the facility providing medium term financial assistance to non-euro EAMS balance of payments.

(2) European Financial Stabilisation Facility (EFSF): is a temporary credit-enhanced SPV with minimal capitalization created to raise funds from the capital markets on its investment grade rating and provide financial assistance to distressed EAMS at lower interest rates than those available to the latter. The financial support to EAMS through the EFSF shall be provided on comparable terms to the stability support loans advanced by EAMS to Greece.

The total volume of these two mechanisms is EUR 500 billion. While EFSM is available to EAMS and non-EAMS member states, the EFSF is only available to EAMS. This two mechanisms are analysed in more detail in the following sections.

### 3. The European Financial Stabilisation Mechanism (EFSM)

The EFSM was put into place to facilitate a coordinated and expedited assistance to preserve the financial stability in the EU<sup>19</sup>. It was established by the EU Council Regulation No. 407/2010. The implementing powers required for the establishment and use of this mechanism were vested in the EU Council. The EFSM will complement the existing facility providing medium-term financial assistance for non-EAMS established by Council Regulation (EC) No 332/2002<sup>20</sup>.

The activation of the EFSM will be in the context of a joint EU/IMF support programme and will impose strong economic policy conditions to serve a double purpose, i.e. to preserve the sustainability of the public finances of the distressed member state and restore its capacity to obtain financing from the markets.

The financial assistance provided by EFSM is either in the form of a loan or of a credit line granted to the member state in distress<sup>21</sup>. As a general rule, the loan should be in instalments<sup>22</sup>. The ECB acts as the fiscal agent regarding the administration of the loans between the EC and the central bank of the beneficiary<sup>23</sup>. The costs in implementing the financial assistance will be borne by the beneficiary<sup>24</sup>.

The capital required for the provision of financial assistance will be raised on behalf of the EU by the EC—in accordance with the EU Council—in the capital markets<sup>25</sup> or with financial institutions. Unless there is a default from the beneficiary, EFSM financing would not entail any budgetary expenditure due to its back-to-back nature. In the event of default, the EU Commission would draw on its cash balances and, in the event of it not being sufficient, it will draw additional cash resources from member states<sup>26</sup>.

In the event that funds are raised but not disbursed, these will be kept on a dedicated cash or securities account handled in accordance with rules applying to off-budget operations and cannot be used for any other purpose than to provide financial assistance to member states under the EFSM<sup>27</sup>. The outstanding amount of loans or credit lines to be granted to member states is limited to the margin available under the own resources ceiling for payment appropriations<sup>28</sup>. The limitation of not granting financial assistance beyond the margin available under its own resources ceiling for payment appropriations imposed on the loans/lines of credit under the EFSM to the EC, acts as a safeguard. It limits the EC from calling for own resources payments from the EU budget of member states equivalent to 1.23% of EU Gross National Income (GNI)<sup>29</sup>.

A member state seeking financial assistance under EFSM shall discuss its financial needs with the EC—in liaison with the ECB—and submit a draft economic and financial adjustment programme to the EC and the Economic and Financial Committee. The EU Commission will assess the submitted financial adjustment programme and make a proposal to the EU Council, who will make a decision by a qualified majority<sup>30</sup>.

Upon the approval by the EU Council, the EC and the beneficiary member state shall enter a MoU detailing the general economic policy conditions approved and agreed. The MoU will be communicated to the European Parliament and the EU Council<sup>31</sup>.

Thereafter, every six months and in consultation with the ECB, the EU Commission will re-examine the agreed general economic policy conditions and discuss with the beneficiary member state any changes that may be needed to its adjustment programme. If deemed necessary, the EC will make an adjustment proposal to the initial general economic policy conditions agreed and submit it to the consideration of the EU Council<sup>32</sup>. This is in line with the general rule that loans should be disbursed in instalments to allow periodical revisions (and eventually suspend the release of further instalments)<sup>33</sup>. Also, it is possible that upon request of the beneficiary member state and where circumstances permit, a revision of the applicable interest rate can be conducted aiming at improving the financial conditions and easing the burden. Therefore, the EC may refinance all or part of its initial borrowing or restructure the corresponding financial conditions<sup>34</sup>.

If the member state in distress resorts to external (non-EU) financial assistance subject to economic policy conditionality (e.g. IMF), the member state shall first consult the EC to assess: (1) additional financial assistance available under the EU arrangements; and, (2) the compatibility of the envisaged economic policy conditions with pre-existing commitments<sup>35</sup>.

The table below summarises the issuances made by the EC in order to raise the required capital for EFSM. These issuances include the assistance packages put in place for Ireland and Portugal (and Romania under the Balance of Payments Facility under Regulation (EC) No 332/2002).

Capital Raised by the EU Commission for the EFSM			
Date	Issuance	Purpose	Observations
5 Jan. 2011	2015 2.5% EUR 5bn bond	EUR 5bn to Ireland first tranche under EFSM	300%+ oversubscription  The resulting interest rate of the loan to Ireland was 5.51% (cost of borrowing for the EU at 2.59% plus a margin of 2.925% as decided by the Council on 7 Dec. 2010)
17 Mar. 2011	2018 3.25% EUR 4.6bn bond	EUR 3.4bn to Ireland under the EFSM.  EUR 1.2bn to Romania under the Balance of Payments facility (EUR 4.85bn already disbursed)	300%+ oversubscription
24 May 2011	2021 3.5% EUR 4.75bn	EUR 3bn to Ireland under the EFSM  EUR 1.75bn to Portugal under EFSM	300%+ oversubscription
25 May 2011	2016 EUR 2.75% 4.75bn	EUR 4.75bn to Portugal under EFSM	---

Source: Commission Press Release MEMO/11/4 of 5 January 2011, "EUR 5 billion bond issue for Ireland"; Commission Press Release MEMO/11/180 of 17 March 2011, "EUR 4.6 billion bond issued to assist Ireland and Romania"; Commission Press Release MEMO/11/336 of 24 May 2011, "EUR4.75 billion bond issued for EU's assistance packages to Ireland and Portugal"; and, Commission Press Release MEMO/11/344 25 May 2011, "Second EUR 4.75 billion bond issued this week to support EU's assistance packages".

#### 4. European Financial Stabilisation Facility (EFSF)<sup>36</sup>

The EFSF is the foundation of the current European sovereign crisis containment framework. It is a temporary credit-enhanced SPV with minimal capitalization created to raise funds from the capital markets on its investment grade rating and provide financial assistance to distressed EAMS at lower interest rates than those available to the latter.

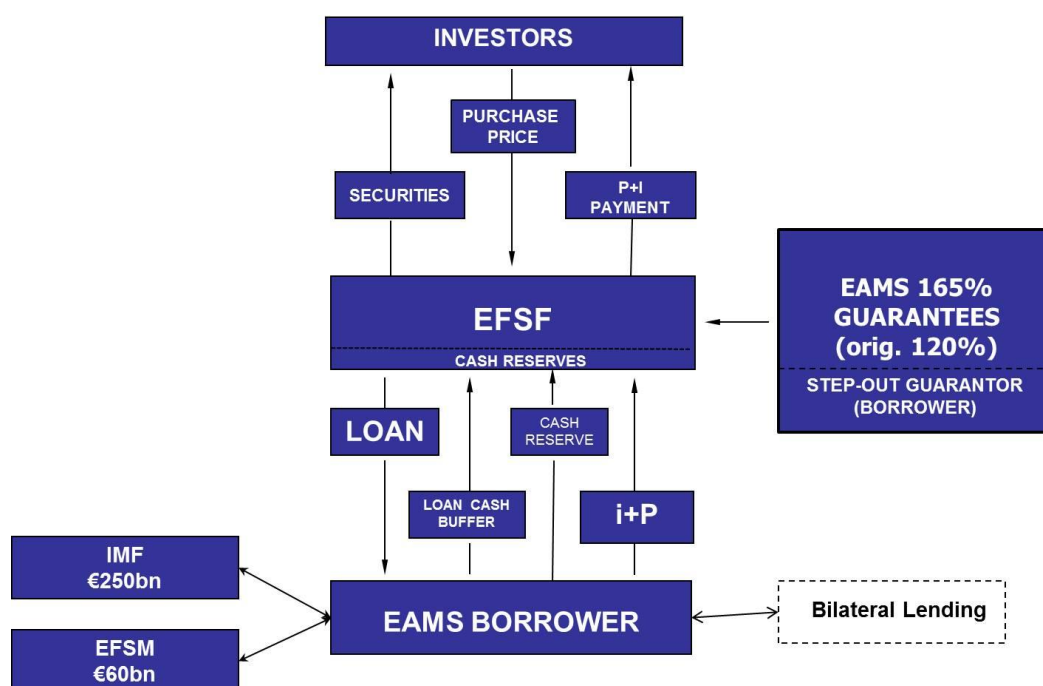
The EFSF is a Luxemburgish public limited liability company incorporated by the 16 countries sharing the euro in 2010<sup>37</sup>. The main purpose of the EFSF is to facilitate or provide financing to member states of the EU in the form of loan facility agreements or loans up to EUR 440 billion if: (1) their currency is the euro; (2) they are in financial difficulties; and, (3) have entered an MoU with the EC—acting on behalf of the EAMS—regarding budgetary discipline and policy conditionality. As part of assistance programmes to EAMS in financial difficulties, some of the funds received can be used to stabilise the banking sector (e.g. Ireland received a EUR 85 billion assistance programme, out of which EUR 35 billion were allocated to the immediate strengthening and comprehensive overhaul of the banking sector)<sup>38</sup>.

EFSF facilities are put in motion upon a stability support request made by an EAMS. The EC acting on behalf of the EAMS (and in liaison with the ECB and the IMF) will

negotiate and approve a MoU with the borrower (which shall be consistent with a decision that the EU Council may adopt under Article 136 of the TFEU)<sup>39</sup>. After the approval of the MoU, the EC (in liaison with the ECB), will make a proposal to the Eurogroup Working Group of the main terms of the Loan Facility Agreement to be proposed to the borrower. If the Eurogroup Working Group agrees on the main terms of the Loan Facility Agreement proposed by the EC, it will—jointly with the EFSF—negotiate the detailed and technical terms of the loan facility agreements. The terms need to be approved by the EAMS and be aligned with what has already been approved by the EC, the Eurogroup Working Group and the ECB. The EFSF guarantors delegate powers to the EFSF to sign the loan facility agreements on their behalf, provided that there is a unanimous approval by all of the participating EAMS. Any financial assistance provided to a EAMS borrower is linked to strict policy conditions which are set out in a MoU<sup>40</sup>. If the country fails to meet the policy conditions agreed, the loan disbursements and the programme are interrupted until a review of the country programme is conducted and the MoU is renegotiated (if applicable).

In order to raise the money required to facilitate or provide financial assistance, the EFSF will be entitled to issue financial instruments<sup>41</sup> or enter in financial arrangements with its shareholders, in respect of which its liabilities may be guaranteed by some or all of its shareholders or may be otherwise collateralized or benefit from credit support mechanisms<sup>42</sup>. The main method used so far is the issuance of bonds to raise the funds needed for the provision of loans to countries in financial difficulties. The bond issuances are backed by timely, unconditional, irrevocable and several guarantees given by the 16 EAMS on a pro rata basis, in accordance with their share in the paid-up capital of the ECB. These guarantees will cover up to 120% (now 165%) of the value of the bonds issued to raise the required capital to grant the facility.<sup>43</sup> The granted guarantees cannot be altered due to their irrevocable nature. This notwithstanding, debt issuances might not include the same guarantors since a guarantor might need to step-out from the pool of guarantors and require financial assistance (stepping-out guarantor).

The following diagram illustrates a simplified structure of the EFSF financing mechanism:





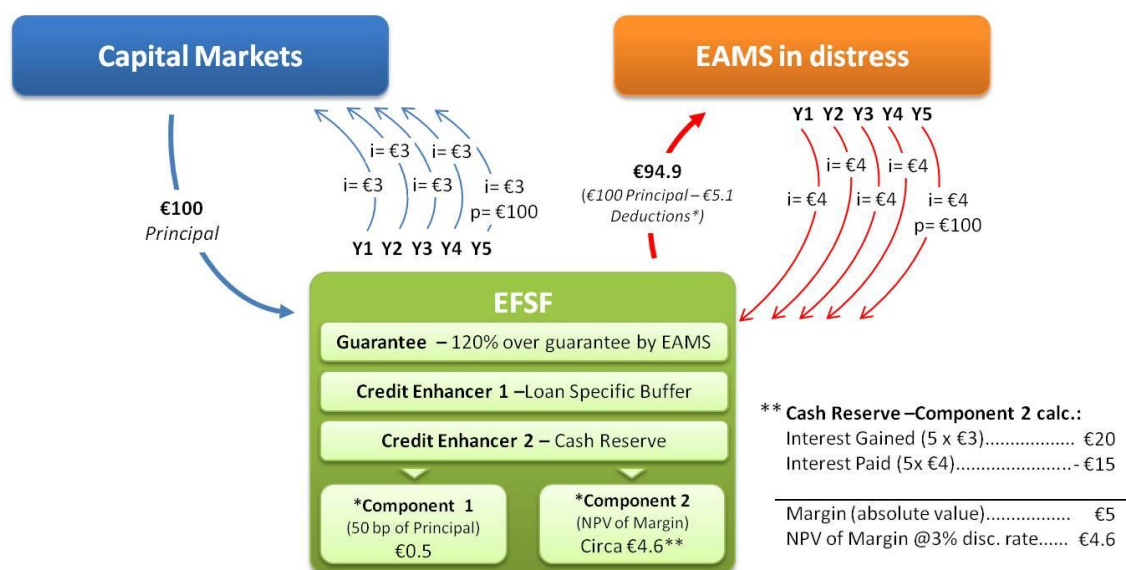
The EFSF maximum available assistance facility of EUR 440 billion is complemented by: (1) the ESFM financial assistance of up to EUR 60 billion; and, (2) allegedly IMF financial assistance of up to EUR 250 billion<sup>44</sup>, creating a safety net of a maximum of EUR 750 billion. However, it is worth stressing that there is no formal commitment between the IMF and the EU regarding the allegedly pledge of funds that can be drawn from the former to palliate the crisis. However, due to the current rating of the guarantors, not all guarantees are taken into account for purposes of the rating of the debt securities issued to secure a AAA/Aaa rating. Therefore, the effective lending capacity available under the EFSF is less than EUR 440 billion. In exceptional circumstances, the EFSF can intervene in the primary markets in the context of a programme with strict conditionality.

The debt instruments issued by EFSF to obtain financing are to be serviced by the loan repayments received from the EAMS borrower, which will match the scheduled payments under the loan granted. If a borrower fails to fulfil its obligations on time, funds shall be drawn from either the guarantees provided by the EAMS or the reserves set up to face any potential contingency. The mechanics available to face any delay or failure to pay the debt instrument holders, are sovereign guarantees and two credit enhancement mechanisms: the loan specific cash buffer and general cash reserves. The triggering of these mechanisms is:

1. Sovereign Guarantees: EFSF will first call on the non-borrowing EAMS' guarantees on a pro rata basis (i.e. their share in the paid-up capital of the ECB, adjusted for the share quota of those sovereigns that do not act as guarantors—the stepping-out guarantors).
2. Loan Specific Cash Buffer: The exact methodology to calculate this buffer has not been disclosed. It comprises a residual portion of the loan disbursement amount to ensure that all of EFSF's outstanding debt instruments are matched (factors taken into account include borrower's credit condition and EFSF's position and credit support available).
3. General Cash Reserve: This reserve comprises (a) a 50 basis-point service fee; and, (b) a percentage equal to the net present value (calculated on the internal rate of return (IRR) of the debt instruments to be issued to raise the capital for the loan) of the anticipated margin (interest plus fee) that would accrue on each loan at maturity.

The following diagram illustrates how do the guarantees and credit enhancements under the EFSF work:

### Simplified EFSF 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.

The loan specific cash buffer and the general cash reserve are deducted from the loan made to the borrowing country and will remain invested in liquid ‘AAA/Aaa’ rated securities.

EFSF issuances have received the highest possible credit rating by all major credit rating agencies<sup>45</sup>. The main rationale behind this rating is that the credit rating agencies understand that the debt instruments used under the medium-term notes (MTN) programme are considered worthy of the maximum investment grade rating because (1) the guarantees from ‘AAA/Aaa’ rated EFSF members (Austria, Finland, France, Germany, Luxembourg and the Netherlands); and, (2) the liquidity reserves invested in ‘AAA/Aaa’ rated securities should cover all of EFSF’s potential liabilities. In other words, all potential claims against the EFSF are covered by ‘AAA/Aaa’ guarantors and cash. However, the face value of the ‘AAA/Aaa’ guarantees provided by ‘AAA/Aaa’ rated EFSF members constitutes the actual effective limit to the total amount that the EFSF can lend to EAMS. Otherwise, an EFSF issuance beyond that limit will not achieve the maximum investment grade credit rating. The rating agency rationale can be explained as follows: if (1) the rating of one (or more) of the ‘AAA/Aaa’ guarantors is lowered AND, (2) consequently, the lower rating on the sovereign guarantor/s result in less than 100% of the ‘AAA/Aaa’ coverage on the debt instrument issued by EFSF; then, the credit rating agency would also lower the rating on the debt instrument issued by EFSF<sup>46</sup>. Therefore, the downgrade of a EAMS does not necessarily imply that the debt instruments issued by the EFSF will be downgraded.

The EFSF is considered as an “Agency—non credit institution” under the liquidity category II of the Eurosystem collateral framework classification. Therefore, the debt instruments issued by EFSF are considered eligible collateral for European Central Bank refinancing operations<sup>47</sup>. The EFSF operates with the support of the German Debt

Management Office (DMO) for the issuance of bonds or other debt instruments on the market.

EFSF does not operate as an intergovernmental financial institution. Therefore, it does not have any kind of priority claim against the borrower or enjoy a preferred creditor status. It stands on a *pari passu* basis vis-a-vis other creditors.

#### **4.1. Amendments to the EFSF**

An amendment was introduced to the original EFSF Framework Agreement to increase its lending capacity and widen its scope. These are discussed below. For practical purposes and when it is required to differentiate between the original EFSF and the “enhanced” EFSF resulting from these amendments they will be referred as EFSF I and EFSF II, respectively.

On 24 June 2011, the European Council agreed to increase the maximum guarantee commitments to EUR 780 billion to reach an effective lending capacity of EUR 440 billion. This requires an increase in the over-guarantee of up to 165%. Also, it was agreed to widen the scope of the EFSF to exceptionally intervene in the secondary markets (prior to the amendments, the EFSF was able to intervene in exceptional circumstances in the primary markets).

In a statement dated 21 July 2011 the Heads of State or Government of the EAMS and EU institutions stated their intention to enlarge the scope of the EFSF. The EFSF—subject to the national ratification—now can provide financial assistance by way of:

1. Loan disbursements: this is what EFSF I was performing so far. In this respect, there are no changes to the way in which these loans are granted. The same mechanisms should be observed.
2. Precautionary facilities: The precautionary facilities work as credit lines to a non-programme countries with the objective of overcoming external temporary shocks by securing financing to revert a temporary condition and prevent a crisis from occurring. The EFSF has developed, in line with the IMF crisis prevention facilities (i.e. Precautionary Credit Line and Flexible Credit Line)<sup>48</sup>, two types of credit lines:
  - a) Precautionary conditioned credit line (PCCL): the PCCL is limited to EAMS with robust policy frameworks and a fundamentally sound economic and financial situation. The following criteria should be met (and maintained throughout) to qualify for a PCCL<sup>49</sup>: (i) respect of SGP commitments (although countries under excessive deficit procedure could still access PCCL); (ii) sustainable public debt; (iii) a track record of access to international capital markets on reasonable terms; (iv) a sustainable external position; and, (v) the absence of bank solvency problems that can pose systemic threats to the euro. EAMSs under an excessive imbalance procedure could still access a PCCL subject to demonstrating a formal commitment to address the imbalances identified by the European Council. The average size of this credit line is 2-10% of the EAMS GDP and it would be granted for a year, renewable for two periods of six months. An availability fee will be charged to cover EFSF’s costs.
  - b) Enhanced conditions credit line (ECCL): the ECCL is a credit line to EAMS with a sound general economic and financial situation but which do not comply with the eligibility criteria required for accessing a PCCL. Since the ECCL will

be granted with conditions, the EAMS (after consultation of the EU Commission and the ECB) shall adopt the required corrective measures to revert the systemic weaknesses and maintain its sound general economic and financial situation. The average size of this credit line is 2-10% of the EAMS GDP and it would be granted for a year, renewable for two periods of six months. An availability fee will be charged to cover EFSF's costs.

3. Facilities to finance the recapitalisation of financial institutions in a EAMS through loans including non-programme countries: it is important to stress that any facility granted for purposes of recapitalising financial institutions will be granted to EAMS and not directly to a particular financial institution<sup>50</sup>. Therefore, it should be expected that it would be performed by means of a three-party approach whereby the private sector and the public sector contribute to the recapitalisation of the financial institutions. The three parties involved are: (a) the institution's shareholders; (b) the domestic public sector (EAMS); and, (c) the regional or European public sector (other EAMSs via the EFSF). The conditionality attached to these facilities could be the restructuring of the distressed or undercapitalized entity or the provision of the necessary capital for its resolution. According to the EFSF the conditionality would be "lighter" due to the sectorial nature of these facilities and the need for expediency<sup>51</sup>. Since these facilities will constitute state aid, the European rules on state aid shall be observed<sup>52</sup>.
4. Facilities for the purchase of bonds in the secondary markets (in cases where the ECB analysis recognizes the existence of exceptional financial market circumstances and risks to financial stability): secondary market intervention by EFSF aims at supporting the functioning of debt markets and the appropriate price formation in bonds of governments undergoing exceptional circumstances of limited liquidity. The financing of a security market programme will be conditioned. The conditions will vary depending on whether the EAMS is already under a support programme or not. For those already under a programme, the macro-economic policy conditions of such programme will apply. For those that are not already under a support programme, the fulfilment of the ex-ante eligibility criteria based on the European fiscal and macro-economic surveillance framework and the required necessary corrective actions will be imposed as conditions. Upon proper market conditions, the holdings of EFSF as result of a secondary market intervention could be of-loaded to private investors freeing EFSF's lending capacity. Other options include: holding until maturity, selling back to issuer or use as for repos with commercial banks. The amount of EFSF's purchases is limited to a 50% of the issued amount.
5. Primary market intervention: the participation in primary market purchases is a complementary approach to EFSF loans under a macroeconomic adjustment programme or a precautionary credit line and the conditions attached to the financing would be those under such programmes. According to EFSF, this "[t]his complementary financing tool would primarily be used towards the end of an adjustment programme to facilitate the return of the beneficiary country to the market or as an alternative to the draw-down of funds under a precautionary programme"<sup>53</sup>. The aim of the purchase of securities in the primary market is to allow EAMS to maintain or restore its relationship with the dealer/investment community. Upon proper market conditions, the holdings of EFSF as result of a primary market intervention could be of-loaded to private investors freeing EFSF's lending capacity. Other options include: holding until maturity, selling back to

issuer or use as for repos with commercial banks. The amount of EFSF's purchases is limited to a 50% of the issued amount.

The granting of the financial assistance will be subject to entering a MoU with strict conditionality with the EC (acting on behalf of the EAMS). The financial assistance required for the purchase of debt instruments in the primary or secondary market or the recapitalization of financial institutions and their terms thereof shall be in accordance with guidelines adopted by the board of directors of EFSF acting unanimously<sup>54</sup>.

Some of these amendments (e.g. over-guarantee increase, precautionary programmes, etc.) required an amendment to the EFSF Framework Agreement and their entry in force was subject to national ratification procedures. The procedure was completed on 18 October 2011 when these amendments entered into force.

## 5. European Stability Mechanism (ESM)

In October 2010 (after financial assistance was provided to Greece and while conditions continued deteriorating), with the aim of ensuring balanced and sustainable growth, the EU Council agreed on the need for member states to establish a permanent crisis mechanism to safeguard the financial stability of the euro area as a whole<sup>55</sup>. It was resolved that consultations should be undertaken towards a limited treaty change for said purpose but not modifying the so-called "no bail-out" clause included in article 125 of the TFEU<sup>56</sup>. Further, the EU Council agreed in December 2010 that there is a need for EAMS to establish a permanent stability mechanism, i.e. the ESM. This was shortly followed by the Conclusions of the European Council<sup>57</sup> and the EU Council decision 2011/199/EU amending Article 136 of the TFEU with regard to a stability mechanism for EAMS<sup>58</sup>, both were adopted on 25 March 2011.

This section analyses the features of the ESM and the text of the agreed treaty (Treaty). The Treaty is still subject to ratification, approval or acceptance by the signatories. The Treaty will enter into force on the first day of the second month following the date when instruments of ratification, approval or acceptance have been deposited by signatories representing no less than 95 % of the total subscriptions.

The ESM will be an international financial institution based in Luxembourg. It was created by EAMS to mobilise funding and provide financial assistance under strict economic policy conditionality to its members, when they are threatened or experiencing severe financing problems. The main rationale behind the ESM is safeguarding the financial stability of the euro area as a whole under a macro-economic adjustment programme, proportionate with the severity of the economic and financial imbalances of the EAMS.

The Treaty starts by restating the importance of the EU framework and its economic governance rules (e.g. Stability and Growth Pact and the macroeconomic imbalances framework), whereby the ESM should be seen as an extraordinary mechanism to safeguard the financial stability of the euro area as a whole.

Due to the extraordinary nature of the ESM, the access to financial assistance is conditioned to strict economic policy conditionality under a macro-economic adjustment programme and a rigorous analysis of public debt sustainability. In line with the EFSM and EFSF, the ESM will require active participation of the IMF on both, technical and financial aspects. It is important to stress that in one of the whereas of the Treaty it is stated that financial assistance to the Treaty contracting parties (ESM Members) is provided in cases

where “*regular access to market financing is impaired*”. This reflects the extraordinary nature of the lending under circumstances that no other party would be willing to lend, i.e. international lender of last resort (ILOLR). The role of the ILOLR is usually played by the IMF<sup>59</sup>, therefore the Treaty states that the ESM “*will enjoy preferred creditor status in a similar fashion to IMF, while accepting preferred creditor status of the IMF over the ESM*”. It is worth stressing that the IMF priority is not established anywhere and acts *de facto*, the Treaty is the first formal official document where it has been acknowledged. The Treaty has created another super-priority although subordinated to that of the IMF.

The required funding is obtained either by: (1) issuing financial instruments; (2) entering into financial or other agreements with third parties; and/or (3) arrangements with ESM Members. ESM shall use risk management tools to minimise potential risks.

The ESM has an authorised capital stock of EUR 700 billion divided into paid-in (EUR 80 billion) and callable shares (EUR 620 billion). If an ESM Member fails to meet the required payment under a capital call a capital call will be made to all other ESM Members to cover for the short-fall, ensuring that the ESM receives the total amount of paid-in capital needed.

The participation of each EAMS is based on the key for subscription, by the national central banks of ESM Members of the ECB's capital pursuant to Article 29 of Protocol (No 4) on the Statute of the European System of Central Banks and of the ECB<sup>60</sup>. The initial maximum lending volume is of EUR 500 billion and will assume the tasks that are currently performed by the EFSM and EFSF on July 2013<sup>61</sup>.

The governance structure of the ESM comprises a Board of Governors, a Board of Directors and a Managing Director. The Board of Governors are in charge of setting the guidelines and policies of the ESM, while the Board of Directors are entrusted with the running and day-to-day operations of the ESM in accordance with the Treaty and the by-laws<sup>62</sup>. Considering the way in which the duties have been split, to certain extent an analogy can be made between the governance structure of ESM and that of a company in regard to shareholding meetings and their role, as well as board of directors meetings and agenda. However, each member, irrespective of their percentage participation has one vote. The Board of Governors is comprised by one appointee by each EMS Member. Each Governor shall appoint a member to the Board of Directors, whose appointment is revocable at any time. Appointments to both boards also include the appointment of an alternate member in case of absence or impossibility to participate. Both, the Board of Governors and the Board of Directors require a double threshold quorum of two thirds of the members (number of ESM Members) with voting rights representing at least two thirds of the voting rights (number of votes). The decisions by the Board of Governors can be adopted either by mutual agreement (i.e. unanimity, although abstentions do not prevent a mutual agreement decision) or an 80% qualified majority. The decisions of the Board can be adopted by mutual agreement, qualified majority and/or simple majority. For a detailed description of the responsibilities of the Boards of Governors and Directors and the required majorities to adopt decisions see Appendix 1. Finally, the Managing Director is the legal representative of the ESM and will chair the meetings of the Board of Directors and shall participate in the meetings of the Board of Governors.

There will also be an Auditing Board comprised of three independent members not taking instructions from the ESM governing bodies, the ESM Members or any other public or private body and external auditors who will audit its accounts.

The financial assistance to be provided by ESM is short-term or medium-term stability support in the form of a loan. The pricing for the loan shall cover funding costs plus a

margin determined by the Board of Governors. In exceptional circumstances, the Board of Governors can decide to proceed with bond purchases in the primary market in order to maximise cost efficiency.

ESM Members undertook the irrevocable and unconditional obligation to provide their percentile contribution to the authorised capital stock, which is the limit of their liabilities. The Board of Governors has the mandate to establish a reserve fund and if required, other funds. In the event of losses arising in the ESM, these shall be supported against (in order of priority): (1) the reserve fund; (2) the paid-in capital; and, (3) the appropriate amount of the authorised unpaid capital, which shall be called in.

Any new member state adopting the euro will become an ESM member with full rights and obligations as from the entry into force of the decision of the EU Council taken in accordance with Article 140(2) TFEU. New ESM Members will be admitted on the same terms and conditions as existing ESM Members receiving shares in the ESM in exchange for its capital contribution.

The Treaty encourages member states (EAMS and non-EAMS) to provide financial assistance on an *ad-hoc* basis (e.g. Denmark, Sweden and the UK provided bilateral assistance to Ireland to complement the EFSM/EFSF/IMF programme). In those cases, the EAMS (i.e. ESM Members) will support equivalent creditor status to those involved in bilateral lending alongside the ESM.

Non-EAMS providing financial assistance on an *ad-hoc* basis will participate as observers in the ESM meetings when the financial assistance and its monitoring is discussed and will have access to any available information in this respect.

The 27 EU member states authorized the EAMS to request the EU Commission and the ECB to perform the tasks required by the Treaty. The EC and the EU Council are entrusted with post-programme surveillance duties within the framework established by Articles 121 and 136 of the TFEU.

Any disputes concerning the interpretation and application of the Treaty arising between the ESM Members or between them and the ESM should be submitted to the Board of Governors. If the decision of the Board of Governors is contested, the dispute shall be submitted to the jurisdiction of the EU Court of Justice, following the criteria set forth in Article 273 of the TFEU (EU Court of Justice Jurisdiction).

The procedure for the granting of the financial assistance is as follows:

1. A formal request for financial assistance to the Chairperson of the Board of Governors by an EMS Member.
2. Upon receipt of a request, the Chairperson of the Board of Governors will request the EC (in liaison with the ECB) to: (a) assess the existence of a risk to the financial stability of the euro area as a whole; (b) to undertake (jointly with the IMF) an analysis of the debt sustainability of the ESM Member in distress; and, (c) assess the financing needs of the ESM Member and the type of private sector involvement that is required (i.e. maintenance of exposure or a reprofiling/restructuring).
3. Based on the European Commission's assessment, the Board of Governors may decide to grant—in principle—financial assistance to the ESM Member.
4. If the decision of the Board of Governors is favourable, the EC (jointly with the IMF and in liaison with the ECB) will negotiate with the ESM Member an MoU

detailing the economic policy conditionality, contained in a macro-economic adjustment programme, to be attached to the financial assistance.

5. The draft MoU will be considered by the Board of Governors and subject to their approval, the EC will sign the MoU on behalf of the ESM.
6. The Board of Directors will approve the financial assistance agreement drafted by the Managing Director detailing the technical aspects of the financial assistance and the disbursement of the first tranche of the assistance.
7. A warning system will be put in place by the ESM to ensure that it receives the repayments due under financial assistance in a timely manner.
8. The EC (jointly with the IMF and in liaison with the ECB) will be entrusted with monitoring the compliance with the economic policy conditionality attached to the financial assistance (a mutual agreement decision by the Board of Directors, based on the monitoring performed by the European Commission, is required prior to any further disbursement of the tranches of the financial assistance).

The Treaty expressly indicates that jointly with the provision of financial assistance, some form of private sector involvement should be sought on a case-by-case basis. The nature and the extent of the private sector involvement will be limited to the envisaged outcome of the macro-prudential adjustment programme. In this regard, the Treaty observes two possible scenarios: (1) that the macro-economic adjustment programme can restore public debt to sustainable levels, the beneficiary shall take initiatives to encourage private investors to maintain their exposure; and, (2) that the macro-economic adjustment programme cannot (by itself) restore the public debt to sustainable levels, therefore, the beneficiary shall engage in good faith in active negotiations with private creditors to secure their involvement in restoring debt sustainability. In the second scenario, financial assistance and future disbursements is conditioned to a satisfactory assessment of the degree of involvement and its effectiveness aiming to safeguard ESM's resources.

An additional feature to be observed as a complementary measure to safeguard the stability of the euro, is the mandatory inclusion of standardised and identical Collective Action Clauses (CACs) in the terms and conditions of all new euro area government bonds as of July 2013. The irony is that a Treaty was required despite the fact that the EU member states agreed in April 2003 to lead by example<sup>63</sup>. In a statement in 2003 by the Chairman of the EU Council of Economic and Finance Ministers (a former Minister of Economy and Finance of Greece) stated that "... *EU Member States will no longer issue such bonds without any CACs*"<sup>64</sup>. Probably, the Treaty is not the best place to have included such provision since the Treaty creates a new international financial institution and therefore, micromanaging the legislation of EAMS on something that the EU as a whole has been working since 2003 should be adopted in a different forum. This notwithstanding, such initiative undoubtedly should be welcomed, although extended to non-EAMS.

## 6. Available Mechanisms<sup>65</sup>

Different mechanisms have been made available and/or developed at both, the EU and EAMS, levels to tackle the EU sovereign debt crisis. These include:

1. Balance of Payment loans to non-EAMS as per Council Regulation 332/2002;
2. Bilateral Loans;
3. Pooled ad-hoc bilateral loans;



4. EFSM assistance;
5. EFSF precautionary lines;
6. EFSF bank recapitalizations;
7. EFSF loans;
8. EFSF bond purchases (in the primary and secondary markets).

The mechanisms listed under five through eight above are only available to EAMSs and are going to be replaced by the ESM. However, based on the current wording of the ESM Treaty, it would not be able to intervene in the secondary markets, grant precautionary lines or intervene to recapitalise banks. However, due to the circumstances forced the need to widen the scope of the EFSM, it should be expected that the treaty of the ESM would be amended to reflect this changes since they took place after the ESM treaty was finalized.

This financial assistance is complemented by: (1) IMF stand-by arrangements and the mandatory inclusion of CACs on new debt instruments that would facilitate a restructuring of the outstanding private debt, if required.

## 7. Concluding Remarks

As it has already been established, the EFSF is a temporary credit-enhanced SPV with minimal capitalization created to raise funds from the capital markets (via an investment grade rating) and provide financial assistance to distressed EAMS at comparatively lower interest rates. The EFSF has already raised concern due to its similarity with other SPVs or structured vehicles that were at the epicentre of the US sub-prime mortgage crisis (e.g. Collateralized Debt Obligations or CDOs and structured investment vehicles or SIVs). Although the CEO of the EFSF has openly denied the similarities between the EFSF and a CDO, the fact that it has been needed to do so is already a bad indication<sup>66</sup>. Several academics and industry participants claim that there is no difference between the two<sup>67</sup> and credit rating agencies have used CDO rating methodology to rate the EFSF debt issuances<sup>68</sup>. Actually, an Investment Bank recently published a report titled “CDO + Monoline = SPIV” where several similarities with structured products financing and reminiscences from the practices that contributed to the sub-prime mortgage crisis are established<sup>69</sup>.

In addition, with an increasing participation in primary and secondary markets, the thin line that differentiates the EFSF from a traditional SIVs could easily erode. The use of the EFSF (despite its similarities with those structure products that were allegedly blamed for the subprime mortgage crisis) should be embraced if its aim is to correct a short term market failure. However, it should not be seen as a tool to solve long-term structural problem.

It should also be kept in mind that an extensive financial assistance from the EFSF (and eventually) the ESM could produce a crowding-out effect among private lenders. These creditors in a second stage can even be subordinated to the priority granted to the ESM acting as ‘lender of last resort’ (LOLR). As widely known, the LOLR role of the central bank remains the major rationale for most central banks around the world, both in developed and developing countries<sup>70</sup>. The LOLR role is to provide credit in emergency situations. This role of the LOLR has been adopted by the IMF in the international level (ILOLR), towards its member states during economic and/or financial crises. Since the IMF is not a commercial organisation seeking profitable lending opportunities and often lends at

a time when other creditors are reluctant to do so—and at interest rates that are below those that would be charged at that juncture by the private sector<sup>71</sup>—preferred creditor status is to be assigned to this lending. The IMF has clearly explained that the ILOLR role benefits not just Fund members but official and private creditors alike by allowing the Fund to assist member countries in regaining a sustainable financial path and helping to promote orderly resolutions to debt problems, when necessary<sup>72</sup>. As noted by Lastra, the IMF plays different roles by wearing different ‘hats’. Among these are: (1) that of an ‘honest broker’ or arbiter between creditors and debtors; (2) a primary lender by means of providing financial assistance to countries experiencing balance of payment needs; (3) a preferred creditor with an interest at stake; (4) an ILOLR; (5) a crisis manager; and, (6) a standard setter<sup>73</sup>. Therefore, putting the IMF claims together with commercial claims in a workout would fundamentally undermine the Fund’s capacity to play those vital roles in future<sup>74</sup>.

The reasons outlined in the previous paragraph, are the rationale for the de facto priority claimed by and implicitly assigned to the IMF, World Bank and regional developing banks<sup>75</sup>. But, most importantly, the preferred status is as result of the ILOLR role of the IMF that not only benefits its members but other creditors (bilateral and private) that see themselves in a better position by the assistance provided by the IMF to the sovereign to regain sustainability and therefore an orderly restructuring. The ILOLR is performed by the IMF when other credit providers are not willing to lend as result of the deteriorated situation of the country<sup>76</sup>.

The ESM will be providing ILOLR lending and therefore, should be granted priority. However, it will not be exempt from challenges in courts of law since its priority is not pre-established but one formally imposed by the ESM Treaty. On a more practical note, the preferred-creditor status assigned to the ESM (jointly—although inferior—to the IMF) will subordinate the sovereign debt market diminishing the payment prospects. This can be translated in an increased cost of financing and—as previously mentioned—a crowding-out of the market of the private sector.

## EPILOGUE

### (Post 26 October 2011 Eurogroup Summit)

On 26 October another meeting of the Heads of State or Government of the EAMS took place to address the deteriorating sovereign debt crisis in the euro-area. The main issues agreed were: (1) a greater private-sector involvement in the resolution of the Greek debt problem (with a nominal discount of 50% on notional Greek debt excluding ECB's holdings and a EUR 30 billion sweetener) and the agreement on a second financial assistance programme; (2) two leveraging options for the EFSF to enhance its resources (credit enhancement/insurance and the use of SPVs); (3) measures to restore confidence in the banking sector mainly focusing on their recapitalization and the need to provide lending to the real economy; (4) to further improve the economic governance of the euro-area; and, (5) reinforce—once more—the notion that EAMSs will do whatever it takes to safeguard financial stability<sup>77</sup>.

Of particular interest is what has been agreed regarding the EFSF. The two new leveraging options to enhance EFSF's available resources are:

1. Credit Enhancement/Insurance Option: to provide a partial credit enhancement in the form of risk insurance or credit default swap to investors acquiring EFSF debt instruments in the primary market. This would be an optional 'ad-on' available when buying the debt instruments and it is estimated that could cover up to a 20% of the value of the bonds. This credit enhancement certificate can be detached from the underlying instrument and traded separately. Of particular note is that instead of relying on the widely known and accepted common practice of a 'credit event' of the International Swaps and Derivatives Association (ISDA) as the triggering event of the right to collect on the credit enhancement mechanism, the EFSF will use a definition provided by the EAMS defaulting on the obligation<sup>78</sup>. The credit enhancement will be provided and backed by EFSF being the EFSF the holder of the counterparty risk.
2. Structuring SPVs Option: to set up special purpose vehicles to raise funds and provide financing to EAMS or acquire their bonds in the primary and/or secondary markets, pooling together the EFSF, private and public investors. The SPV can issue different instruments (senior, convertible, capital participation or subordinated instruments) with a different risk/return profile. The capital of the SPV would be structured in a way in which the EFSF's capital could be subordinated (absorb the first tranche of losses) to increase participation of investors.

These two options can be used simultaneously based on the needs and the market conditions. It has been estimated that under the proper market conditions the leverage could be of up to one trillion euro. The details of these two options will be finalised in a Eurogroup meeting to take place in November 2011 and based on the work by the European Working Group, the European Commission and the EFSF.

The market has reacted negatively to the new two-option scheme. A debt issuance scheduled for 2 November 2011 to raise the funds required for a disbursement to Ireland on its assistance programme had to be rescheduled due to the volatility of the markets. This bond auction took place on 7 November 2011 and the EFSF had to pay an interest rate close to 3.6% for EUR 3 billion (177 basis points higher than German 10-year bonds). This has raised several questions among investors regarding the credibility of the EFSF to raise funds<sup>79</sup> and whether it is the best vehicle for that purpose<sup>80</sup>.

The EFSF is mutating from a temporary credit-enhanced SPV with minimal capitalization created to raise funds from the capital markets to a multi-optional over complex structured entity. It is also important to stress that its core is its investment grade which could deteriorate due to the increasing volatility of the financial markets, particularly in the euro-area.

## Appendix I

### Governance Structure and Functioning of the Main Bodies of the ESM

Majority Required	Board of Governors	Board of Directors
100% abstentions do not prevent a mutual agreement decision	Issue new shares on terms other than at par (Art. 8(2))	Decide on the disbursement of the tranches of the financial assistance subsequent to the first tranche based on the report provided by the European Commission (jointly with the IMF and in liaison with the ECB) (Art.13(7)).
	Capital calls (Art. 9(1))	Any decision delegated by the Board of Governors that requires mutual agreement (Art. 6(5))
	Change the authorised capital stock and adapt the maximum lending volume (Art. 10(1))	
	Updates of the subscription key (Art. 11(3) and 11(6))	
	Grant of financial assistance + economic policy conditionality included in the MoU (Art. 13(3)) and set the financial terms and conditions, and the choice of instruments (Art. 12 to 15)	
	Give mandate to the EU Commission to negotiate (jointly with ECB) the economic policy conditionality attached to each financial assistance (Art. 13(3))	
	Change the pricing structure/ policy for financial assistance (Art. 14(4))	
	Change the list of financial assistance instruments that may be used (Art. 16)	

Majority Required	Board of Governors	Board of Directors
	Establish modalities of the transfer of EFSF support to the ESM (Art. 35)	
	Approval of new members and any required adaptation to the Treaty (Art. 39)	
	Delegations to the BoD (5(6))	
	Setting out the detailed technical terms of accession of a new member (Art. 39)	Any decision not listed above or below.
	Election of Chairperson and Vice-Chairperson (5(2))	
	Set the by-laws of the ESM and the rules of procedure applicable to the Board of Governors and Board of Directors (5(9))	
	Determine the list of Directors' incompatibilities (Art. 6(8))	
	Appointment and removal of the Managing Director (Art. 7)	
	Establishment of other funds (Art. 20)	
	Actions for debt recovery (Art. 21(2) and 21(3))	
	Approve annual accounts (Art. 23(1))	
	Appoint members of the Internal Auditing Board (Art. 24)	
	Approve external auditors (Art. 25)	
	Waive the immunity of the Chairperson of the Board of Governors, a Governor, alternate Governor, Director, alternate Director or the Managing Director (Art. 30(2))	
	Determine the taxation regime applicable to the ESM staff (Art. 31(5))	
	on a dispute between an ESM Member and the ESM, or between ESM Members, in connection with the interpretation and application of the Treaty (Art. 32(2))	
	Any other necessary decision not contemplated (Art 5(7))	
+50%	n.a.	Call in authorised unpaid capital to restore the level of paid-in capital if the amount that the latter is reduced by the absorption of losses below the level established in Article 8(2) (EUR 80bn), as may be amended by the Board of Governors following the procedure provided for in Article 10, and set an appropriate period of time for its payment by the ESM Members (Art. 9(2))
		Distribute a dividend to the ESM Members if the amount of paid-in capital and the reserve fund exceeds the level required to maintain the lending capacity of the ESM and proceeds from the investment are not required to avoid a payment shortfall to creditors (Art. 19(2))

## Notes

- 1 International Monetary Fund (IMF): “World Economic Outlook” (April 2010).
- 2 See Carmen M. Reinhart and Kenneth S. Rogoff: “This Time is Different: Eight Centuries of Financial Folly”, Princeton University Press (2009). Also see Carmen M. Reinhart, Kenneth S. Rogoff, and Miguel A. Savastano, ‘Debt Intolerance’, Brookings Papers on Economic Activity (2003).
- 3 See Article 1 of the Council Decision of 27 April 2009 on the existence of an excessive deficit in Greece (2009/415/EC).
- 4 According to article 104(c) of the Maastricht Treaty (1992 OJ (C 191) 1), the annual government deficit measured as government deficit to gross domestic product (GDP) must not exceed 3% at the end of the preceding fiscal year. The Treaty also indicates that the ratio of gross government debt to GDP must not exceed 60% at the end of the preceding fiscal year. The reference values for government deficit is set at 3% and for gross government debt to GDP at 60%. The criteria set forth in the Maastricht Treaty is no longer applicable for those countries that adopted the euro. The fiscal policy framework applicable to them is the Council Regulation (EC) No. 3605/93 of 22 November 1993 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community, which heavily relies on the convergence criteria and includes reporting procedures and sanctions.
- 5 See the 2981st Economic and Financial Affairs Council meeting held on 2 December 2009, Press Release No. 16838/09 (Presse 352).
- 6 See Council of the European Union, Press Release 6477/10 (Presse 28), 16 February 2010.
- 7 See Ministry of Finance of Greece,  
<http://www.minfin.gr/portal/en/resource/contentObject/contentTypes/genericContentResourceObject.fileResourceObject.arrayOfFileResourceTypeObject.topicNames/stabilityGrowthProgram/pageNumber/1/resourceRepresentationTemplate/contentObjectListAlternativeTemplate#fragment-6>.
- 8 Statement of the Heads of State or Government of the European Union, 11 February 2010, available at [http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ec/113563.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/113563.pdf)
- 9 Statement by the Heads of State and Government of the Euro Area, 25 March 2010, available at [http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ec/113563.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/113563.pdf)
- 10 See supra 9.
- 11 See supra 6.
- 12 See Statement on the support to Greece by Euro area Members States, 11 April 2010, available at [http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ec/113686.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/113686.pdf).
- 13 See Section 5 of the MoU between the European Commission, acting on behalf of the EAMS and the Hellenic Republic, dated 3 May 2010 (on file with the author).
- 14 See Section 23 of the MoU between the European Commission, acting on behalf of the EAMS and the Hellenic Republic, dated 3 May 2010 (on file with the author).

- 15 Greece requested a Stand-By Arrangement in an amount equivalent to SDR 26,432.9 million (EUR 30 billion) for a period from 9 May 2010 through 8 May 2013 which was approved on 9 May 2010.
- 16 See supra 14.
- 17 See Council of the European Union, Extraordinary Council Meeting, 9-10 May 2010, Press Release No. 9596/10 (Presse 108).
- 18 As noted in Council Regulation (EU) No. 407/2010, these difficulties may be caused by a serious deterioration in the international economic and financial environment. See Council Regulation (EU) No. 407/2010 (OJ L 118/1).
- 19 The EC should regularly review whether the exceptional circumstances threatening the financial stability of the EU as a whole exist.
- 20 Article 143(1) and 143(2) of the TFEU provide for the EU Council to grant assistance up to EUR 12 billion to non-EAMS when it is in difficulties or is seriously threatened with difficulties regarding its balance of payments. To this extent, if immediate action is required, a loan or a facility providing medium-term financial assistance would be extended and it would be linked to economic policy measures designed to re-establish or ensure a sustainable balance of payments. The purpose of this facility is to serve the needs of non-EAMS and those of new member states until they adopt the euro. The loans are financed by recourse to the capital markets and financial institutions. Article 352 of the TFEU grants the powers for these loans to be financed exclusively with funds raised in the capital markets in lieu of funds from other member states. EU Council Regulation No. 332/2002 (OJ L 53/1) repealed Regulation (EEC) No. 1969/1988 (OJ L 178). Currently, Romania, Latvia and Hungary have benefitted from this facility.
- 21 See Article 2 of EU Council Regulation No. 407/2010 (OJ L 118/1).
- 22 See Article 4 of EU Council Regulation No. 407/2010 (OJ L 118/1).
- 23 See the decision of the ECB of 14 October 2010 concerning the administration of the borrowing and lending operations concluded by the Union under the European financial stabilisation mechanism, ECB/2010/17 (OJ L 275/10).
- 24 See Article 7 of EU Council Regulation No. 407/2010 (OJ L 118/1).
- 25 The Offering Circular of the EU's Programme for Euro Medium Term Notes (EMTN) used to issue notes to raise capital to finance Euratom loans, balance of payment loans (Council Regulation 332/2002) and macro-financial assistance to third countries (Articles 212 and 213 of the TFEU) has been increased by EUR 60 billion to reflect EFSM's financing needs. See Communication from the Commission to the Council and the Economic and Financial Committee on the European Financial Stabilisation Mechanism, COM(2010)713.
- 26 The EU Commission can request additional resources based on Article 12 of Council Regulation No 1150/2000/EC, Euratom of 22 May 2000 implementing Decision 2007/436/EC, Euratom on the system of Communities own resources. Also see Communication from the Commission to the Council and the Economic and Financial Committee on the European Financial Stabilisation Mechanism, COM(2010)713.
- 27 See Article 6(3) of EU Council Regulation No. 407/2010 (OJ L 118/1).
- 28 The ceiling for payment appropriations relates to the amount of money expected to be paid out during the financial year. See Article 2(2) of EU Council Regulation No. 407/2010 (OJ L 118/1).



- 29 In the event of a default, the EC will be able to call additional own resources from member States from (1) the Multi-Annual Financial Framework (MFF) ceiling for payment appropriations (or the payment appropriations authorised in the annual budget, if already known); and, (2) the total amount of guaranteed reimbursements due (principal + interest). However, this must not exceed 1.23% of EU GNI in any given budget year. See 2007/436/EC, Euratom; and, see Communication from the Commission to the Council and the Economic and Financial Committee on the European Financial Stabilisation Mechanism, COM(2010)713.
- 30 A minimum of 255 votes out of 345 (73.9%) is required to reach a qualified majority.
- 31 See Article 3(5) of EU Council Regulation No. 407/2010 (OJ L 118/1).
- 32 See Article 3(7) of EU Council Regulation No. 407/2010 (OJ L 118/1).
- 33 See Article 4(2) and 4(3) of EU Council Regulation No. 407/2010 (OJ L 118/1).
- 34 See Article 6(5) of EU Council Regulation No. 407/2010 (OJ L 118/1).
- 35 See Article 3(8) of EU Council Regulation No. 407/2010 (OJ L 118/1).
- 36 At the moment that this article was drafted, the amendments to the EFSF Framework Agreement were still subject to national ratification processes. Therefore, the numbering of the Articles referenced in this section might change as result of the modifications being considered. Also, some new features will be included conditional to the ratification by each EAMS. This article includes a specific section addressing the most salient changes to the EFSF.
- 37 EFSF Articles of Incorporation, Section 3.
- 38 See MoU between Ireland and the EC dated 11 May 2010 available at [http://ec.europa.eu/economy\\_finance/eu\\_borrower/ireland/index\\_en.htm](http://ec.europa.eu/economy_finance/eu_borrower/ireland/index_en.htm).
- 39 If an MoU has already been entered under a EFSM arrangement, there is no need to negotiate a different one provided that it also covers EFSF stability support. See Article 2(1) of the EFSF Framework Agreement.
- 40 In the case of Ireland, the main agreed policy issues rested on three pillars: (1) strengthening and comprehensive overhaul of the banking system; (2) ambitious fiscal adjustment; and, (3) growth enhancing reforms, in particular on the labour market (see MoU between Ireland and the EC dated 11 May 2010 available at [http://ec.europa.eu/economy\\_finance/eu\\_borrower/ireland/index\\_en.htm](http://ec.europa.eu/economy_finance/eu_borrower/ireland/index_en.htm)). In the case of Portugal, the main agreed policy issues included a three year joint EU/IMF programme based on three pillars: (1) fiscal adjustment (including better control over Public-Private-Partnerships and State-Owned Enterprises; reforms of the health system and of public administration; ambitious privatisation programme); (2) growth and competitiveness enhancing reforms of the labour market, the judicial system, network industries and housing and services sectors; and, (3) measures to ensure a balanced and orderly deleveraging of the financial sector and to strengthen the capital of banks, including adequate support facilities (see MoU between Portugal and the EC dated 15 May 2011 available at [http://ec.europa.eu/economy\\_finance/eu\\_borrower/portugal/index\\_en.htm](http://ec.europa.eu/economy_finance/eu_borrower/portugal/index_en.htm)).
- 41 According to Section 9 of the EFSF Articles of Incorporation, it can issue bonds, notes or debt instruments under registered or bearer form. Those issued in registered form cannot be converted into bearer form.
- 42 See supra 37.

- 43 Each EAMS providing a guarantee has entered a Deed of Guarantee governed by English law to unconditionally and irrevocably guarantee the due and punctual payment of its guarantee contribution key percentage of all sums. See the EFSF Framework Agreement, particularly Article 2(3) and (6) and Articles 1(1) of each Deed of Guarantee agreement.
- 44 The IMF funds can be provided as stand-by arrangements as in the case of Greece (see supra note 15) or Extended Fund Facilities (EFF) as in the cases of Ireland and Portugal. Ireland's EFF arrangement was agreed on 16 December 2010 and it expires on 15 December 2013. The total approved amount of the Irish EFF is SDR 19,465.80 million (circa USD 30 billion), out of which SDR 6,422.43 million were drawn (circa USD 10 billion). Portugal's EFF arrangement was agreed on 20 May 2011 and it expires on 19 May 2014. The total approved amount of the Portuguese EFF is SDR 23,742.00 million (circa USD 37 billion), out of which SDR 5,611.43 million were drawn (circa USD 8.75 billion).
- 45 Standard and Poor's assigned a AAA rating (See Standard & Poor's 'European Financial Stability Facility's EUR 27 Billion Debt Issuance Program Rated 'AAA'', 19 January 2011); Moody's assigned a Aaa long-term rating (see Moody's 'Key Elements of the Aaa Rating of the First Drawdown under EFSF's First Issuance Programme', 1 February 2011) and Fitch has assigned a AAA rating (see 'Fitch Rates Europea Financial stability Facility's Guaranteed Debt Issuance Programme 'AAA'', 19 January 2011).
- 46 See Standard & Poor's, 'European Financial Stability Facility', 24 January 2011.
- 47 See <http://www.ecb.int/paym/coll/html/index.en.html>
- 48 See IMF, 'IMF Lending', IMF Factsheet, available at <http://www.imf.org/external/np/exr/facts/pdf/howlend.pdf>
- 49 See EFSF, Draft EFSF Guideline on Precautionary Programmes, dated 19 October 2011, unpublished draft on file with the author. Available at <http://publicintelligence.net/efsf-draft-guidelines/>.
- 50 See Article 2(1)(a) of the EFSF Framework Agreement.
- 51 See EFSF frequently asked questions dated 26 October 2011, available at [http://www.efsf.europa.eu/attachments/faq\\_en.pdf](http://www.efsf.europa.eu/attachments/faq_en.pdf)
- 52 For an enlargement on state aid in periods of crisis see I. Kokkoris and R. Olivares-Caminal, *Antitrust Law Amidst Financial Crisis*, Cambridge University Press, 2010. For a complete list of the European rules on State aid see [http://europa.eu/legislation\\_summaries/competition/state\\_aid/index\\_en.htm](http://europa.eu/legislation_summaries/competition/state_aid/index_en.htm).
- 53 See EFSF, Draft EFSF Guideline on Primary Market Purchases, dated 19 October 2011, unpublished draft on file with the author. Available at <http://publicintelligence.net/efsf-draft-guidelines/>
- 54 See Article 2(1)(b) and 2(1)(c) of the Amendment to the EFSF Framework Agreement.
- 55 EU Council, 30 November 2010, EUCO 25/1/10 (REV 1), CO EUR 18 (CONCL 4)
- 56 See supra 55.
- 57 EUCO 10/11 (D/11/3).
- 58 See 2011/199/EU (L 91/1). The following paragraph has been added to article 136 of the TFEU: "[t]he 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”.*

- 59 Regarding the ILOLR role of the IMF, see Jeffrey Sachs, ‘Do We Need an International Lender of Last Resort’, 1995, Frank D. Graham Lecture at Princeton University, 20 April 1995 (unpublished manuscript); Charles W. Calomiris, ‘The IMF’s Imprudent Role as Lender of Last Resort’, *The Cato Journal*, 1998, Vol. 17, No. 3, pp. 275–294; Stanley Fischer, ‘On the Need for an International Lender of Last Resort’, 1999, *Journal of Economic Perspectives* 13, pp. 85-104; Adam Lerrick and Allan H. Meltzer, ‘Blueprint For An International Lender Of Last Resort’, 2003, *Journal of Monetary Economics* 50, 289–303; Giancarlo Corsetti, Bernardo Guimarães and Nouriel Roubini, ‘The Tradeoff between an International Lender of Last Resort to Deal with Liquidity Crisis and Moral Hazard Distortions: A Model of the IMF’s Catalytic Finance Approach’, 2003, Mimeo, Yale University and New York University.
- 60 OJ C 115, 9/5/2008, page 230
- 61 There will be a transitional phase from the establishment of the ESM and until the complete run-down of the EFSF. During this period, the consolidated ESM and EFSF lending shall not exceed EUR 500 billion (See Article 34 of the ESM Treaty). Also, subject to the authorization of the Board of Governors in re acquiring the rights and assume the obligations of the EFSF (Article 35 of the ESM Treaty).
- 62 The ESM by-laws are going to be adopted by the Board of Governors.
- 63 See ECFIN/CEFCPE(2004)REP/50483, 12 November 2004.
- 64 Statement by Mr. Christodoulakis, Minister of Economy and Finance of Greece, in his capacity as Chairman of the EU Council of Economic and Finance Ministers, to the International Monetary and Financial Committee, 12 April 2003. It becomes even more amusing when, particularly analysing Greek sovereign bonds it can be concluded that not all issuances after 2003 include CACs.
- 65 Macro-financial assistance to non-EU countries is not included as part of the array of options since the focus of this paper is EU assistance tools. For an enlargement on macro-financial assistance to non-EU countries see COM(92)400 of 16 September 1992; COM(94)229 of 7 June 1994; COM(95)572 of 27 November 1995; COM(96)695 of 8 January 1997; COM(98)3 of 13 January 1998.
- 66 See Klaus Regling, No Grounds to compare EFSF to CDO, the Financial Times, 28 February 2011. This letter was a response to an article by Anousha Sakoui published in the Financial Times on 25 February 2011 titled ‘Sovereigns turn to pre-financial crisis wizardry’.
- 67 For example, Nouriel Roubini tweeted that the “EFSF [is] a CDO as you take a bunch of dodgy less than AAA sovereigns (& some semi-insolvent) and try to package an vehicle that gets AAA rating” (available at <http://twitter.com/#!/Nouriel/status/25242967098789889>). Others include: (1) Satyajit Das, ‘Debt suffling will be a self-defeating exercise’, the Financial Times, 12 July 2010; (2) Nomura, ‘The CDO at the Heart of the Eurozone’; European Rates Flash, 29 June 2011; (3) Nomura, ‘EFSF 2.0, 3.0 and Beyond’, European Rates, Insights, 29 September 2011; (4) Andrew Roberts, ‘Overview: CDO2 Again?!’, RBS European Rates Weekly, 30 September 2011; and, (5) Tracy Alloway, Debt Crisis Efforts Carry Crisis-Boom Echos’, the Financial Times, 29 September 2011.
- 68 See for example Moody’s, ‘Key Elements of EFSF’s (P)Aaa Rating’, Global Sovereign Special Comment, 20 September 2010.

- 69 See Citi, 'European Credit Weekly: CDO + Monoline = SPIV', 28 October 2011.
- 70 See Rosa M. Lastra, 'Legal Foundations of International Monetary Law', Oxford University Press, 2006, pages 491-498 (Legal Foundations) and 'Lender of Last Resort, an International Perspective', *The International and Comparative Law Quarterly*, Vol. 48, No. 2 (Apr., 1999), pages 340-361.
- 71 See International Monetary Fund, 'Proposals for a Sovereign Debt Restructuring Mechanism (SDRM)', A Factsheet - January 2003, available at <http://www.imf.org/external/np/exr/facts/sdrm.htm>.
- 72 See International Monetary Fund, *Financial Risk in the Fund and the Level of Precautionary Balances*, Prepared by the Finance Department (in consultation with other departments), approved by Eduard Brau, February 3, 2004, available at <http://www.imf.org/external/np/tre/risk/2004/020304.pdf>
- 73 See Lastra Legal Foundations supra 70, page 499.
- 74 See supra 71.
- 75 See Nouriel Roubini and Brad Setser, 'The Reform of the Sovereign Debt Restructuring Process: Problems, Proposed Solutions and the Argentine Episode' paper prepared for the conference on 'Improving the Sovereign Debt Restructuring Process' co-hosted by the Institute for International Economics and Institut Francais des Relations Internationales, Paris, 9 March 2003, page 4; Lastra Legal Foundations supra 70, page 486; Steven L. Schwarcz, 'Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach', *Cornell Law Review*, Vol. 85(956), 2000, pages 956-1034 and 'Idiot's Guide to Sovereign Debt Restructuring', *Emory Law Journal* 53, 2004 pages 1189-1218; IMF supra 71 and 72.
- 76 However, Bolton and Skeel Jr. contend that this de facto priority is partly an illusion because the IMF has generally agreed to roll over its loans when the sovereign is unable or unwilling to pay (See Patrick Bolton and David Skeel Jr., *Redesigning the International Lender of Last Resort*, U. 6 CHI. J. INT'L L. 177 (2005).
- 77 See Euro Summit Statement, 26 October 2011, available at [http://www.consilium.europa.eu/uedocs/cms\\_Data/docs/pressdata/en/ec/125644.pdf](http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/125644.pdf)
- 78 See EFSF frequently asked questions dated 26 October 2011, page 12, available at [http://www.efsf.europa.eu/attachments/faq\\_en.pdf](http://www.efsf.europa.eu/attachments/faq_en.pdf)
- 79 See David Oakley, 'Investors shun EFSF 10-year debt sale', *Financial Times*, 2 November 2011.
- 80 See Peter Spiegel, 'EFSF bond purchase beset by delays', *Financial Times*, 9 November 2011.

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## **Symposium on “Financial crisis management and the use of government guarantees” \***

(OECD, Paris, 3 and 4 October 2011)

### ***Background***

Almost three years after what many observers had considered the peak of this global financial crisis, we are still waiting for normalcy to prevail. Instead, tensions in funding markets have risen very significantly in recent weeks mainly as a consequence of the sovereign debt crisis in Europe. Currently, we find ourselves once again contemplating guarantees, with some observers calling for the creation of explicit government-supported arrangements for guaranteeing bank debt, such as those temporarily put in place by many governments in 2008/09. In this context, the Symposium on “Financial crisis management and the use of government guarantees” held on 3 and 4 October 2011 turned out to be very topical, certainly more topical than policy makers would have wished.

The Symposium was characterized by an open and frank dialogue between policy makers, policy consultants and other academics on the policy response to the financial crisis, the use of guarantees, failure resolution, banking and sovereign debt interconnections, as well as other financial safety net aspects. The mix of participants from academia and the public and private sector, and both from the economic and the legal profession helped participants appreciate some of the institutional details that get lost in much of the public debate on the topic. Numerous policy suggestions were made as to how to improve the use of government-supported guarantees and the design of the financial safety net, so as to improve existing mechanisms to avert future crises or check them at an early stage. One key message was that guarantees can be a powerful policy tool, but that they need to be employed with limits and priced appropriately.

### ***Costs and benefits of the use of guarantees***

The use of guarantees, where they worked well and where they precipitated other problems, were issues that came up throughout the Symposium. Together with measures to enhance liquidity and capital of financial institutions, sovereigns effectively provided the function of the guarantor of last resort for financial claims in response to the global banking crisis. Despite the rather ad hoc nature of some policy measures, the policy response helped avoid the worst outcome, which could have been a series of failures of systemically important financial institutions, with dire consequences for real activity. Despite their associated problems, guarantees have been an important element in preserving liquidity and restoring market functionality, and it would be difficult to manage financial crises without them. Moreover, other forms of intervention are likely to be more intrusive.

Nonetheless, guarantees were not without cost. Further to administrative costs, they created significant contingent potential liabilities for sovereigns, which was compounded by a failure to charge fees commensurate with the risk which created additional costs. The costs of such underpriced insurance included potential distortions to competition and incentives, which give rise to moral hazard and the potential for additional problems down the road.

### ***Pricing government guarantees***

In principle, pricing structures should be designed in such a way that the premiums paid by beneficiaries of guarantees reflect the costs that they would have incurred if markets had functioned properly. As it turns out, however, pricing was not always appropriate. For example, the case of Ireland has highlighted the risk of underestimating losses from already existing claims, but where the ultimate extent of losses arising from those claims is uncertain. Guarantees have also been introduced for new liabilities, such as bank bonds, in many OECD in an effort to help banks regain access to markets. This effort was generally considered a success. However, fees typically were set as a function of the characteristics of the issue or the issuer and, in practice, were on average broadly flat across countries. In Europe, an effort was undertaken to harmonise fee structures across borders, making them a close function of a measure of the history of credit default swap spreads for the issuer, with the explicit aim being to avoid competitive distortions between banks.

Unfortunately, the costs for banks of issuing such government-guaranteed bonds turned out to be significantly affected by the identity of the guarantor. This is not so surprising, as theory suggests that the market value of a sovereign guarantee is not only a positive function of the weakness of the borrower but also a positive function of the creditworthiness of the sovereign. Thus, to avoid competitive distortions, the strength of the sovereign should be taken into account in the pricing of government-provided guarantees.

### *Crisis management experiences and changes in the financial safety net*

The costs and benefits of guarantees have to be weighed against the alternatives. In Iceland, for example, an all-encompassing guarantee would not have been credible. The more limited guarantee announced together with the resolution approach adopted implied that shareholders were wiped out and that unsecured non-priority creditors bore losses. The link between bank and sovereign credit risk was severed. Whether that approach was available elsewhere is questionable. In fact, extensive guarantees were in many cases introduced precisely because alternative tools for resolving severe problems were either not available or not trusted to work smoothly enough to avoid a systemic fallout. In particular, effective failure resolution mechanisms for some types of troubled financial institutions tended to be absent.

In the meantime, special legislation for dealing with stressed financial institutions has been introduced in many countries, which has successfully addressed some issues. For example, new institutions and legal frameworks have been introduced that facilitate the restructuring of stressed banks and the rescue of systemically relevant parts of banks. Other issues prevail, however, including the issue of how to resolve stressed large financial institutions in a cross-border context. For example, further reforms are needed for cross-border banking activities in the European Single Market, where the issue is to match the European passport for banks with a pan-European safety net including deposit insurance and supervision.

While use of guarantees was a central theme, the Symposium also analyzed other aspects of the design of safety nets. There is a need for policymakers to elaborate on the specific roles of the various safety net participants and stakeholders so as to better understand how the financial safety net should work during times of crisis. Moreover, the traditional three-tier safety net, consisting of a lender of last resort, bank deposit insurance, and a (micro-prudential) regulator-supervisor was considered incomplete, which led to calls for the creation of additional players or functions, including:

- a macro-prudential authority, with the power to alter the composition of central bank assets, to adjust capital adequacy and liquidity ratios, and to propose fiscal and structural changes affecting financial intermediaries.
- an institutionalized tiered systemic crisis insurance function, inspired by mechanisms developed for funding resolution of natural or man-made catastrophes. To limit moral hazard, a layered approach with self-insurance as the first layer, private insurance and reinsurance as another layer and the government as a reinsurer of last resort was suggested.
- a bank failure resolution fund, which would be separate from the general government budget and funded through ex ante contributions of financial intermediaries according to their systemic importance, to finance resolution measures that require the rapid availability of funds in systemic crises.
- an institutionalized investor of last resort, which would establish ex ante conditions for providing support and establish credible bounds to the extent of support in systemic crises, thus helping to legitimize future support measures and limit associated moral hazard.

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 \* OECD Secretariat assessment, facilitated by the rapporteur James McCollum. The opinions expressed here do not necessarily reflect the official views of the Organisation or of the governments of its member countries. For further enquiries please contact Sebastian Schich at [Sebastian.Schich@oecd.org](mailto:Sebastian.Schich@oecd.org).