New facilities help safeguard financial stability in Europe

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The unsustainable level of government debt in Europe began to threaten financial stability in 2010. Highly indebted governments agreed to adjust their finances, but a solution to the sovereign debt problems also required enhanced coordination of economic policy between EU countries and instruments for financing the adjustment programmes of the financially distressed countries. The negotiations over the support package for Ireland marked the beginning of new financial stability arrangements. Debt issuance by the European Financial Stability Facility and the European Financial Stabilisation Mechanism has got off to a good start, and the first loans to Ireland have already been paid via these channels. Even so, the financial markets still expect yields on euro area peripheral government bonds to remain high until a permanent, comprehensive solution to the sovereign debt problems has been found.

Sovereign debt problems resolved with new facilities

In Europe, unsustainable sovereign debt burdens emerged in 2010 as the main current threat to the stability of the financial system and the economy. The most highly indebted euro area sovereigns found it increasingly difficult to access market funding, and the associated costs were rising right from the beginning of the year. For investors, government bonds are one of the least risky instruments, as the probability of governments defaulting is low. However, the markets began to reprice the sovereign credit risk, and the yields on Greek, Irish, Portuguese and Spanish government bonds, in particular, began to rise strongly. In addition, trading in some segments of the euro area government bond markets was either disrupted or almost entirely dried up. With the escalation of the sovereign debt crisis in May 2010, the Ecofin Council decided to establish a mechanism to stabilise the European economy and financial system. The mechanism was two-fold, comprising the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM).

The EFSF is a special purpose vehicle owned by governments in the euro area.[1] Its purpose is to help preserve the financial stability of the euro area by granting fixed-term loans to euro area governments that are experiencing exceptional problems with their finances. The EFSF itself issues debt on the markets to raise funds for these loans. It is a temporary mechanism that can grant loans until June 2013.

The EFSM provides a mechanism for granting loans to EU member states experiencing serious

[1] The European Financial Stability Facility was established in June 2010, and its activities as currently constituted will come to an end in June 2013.

economic or financial disruption due to exceptional events.[2] The European Commission raises the funds for the credit arrangements either from the capital markets or direct from financial institutions. The maximum amount that can be lent via the EFSM depends on the volume of the EU's own funds, which accumulate from sources such as customs duties and agricultural levies. The Commission has estimated that total lending via the EFSM will be at most EUR 60 billion under the current EU budget.

Loans granted under the financial stabilisation arrangements will have conditions attached.

Loans granted under both these stabilisation facilities will have conditions attached. The government receiving assistance must agree with the EU and the IMF on an economic and financial adjustment programme. Once this is agreed, the European Commission and the government concerned sign a memorandum of understanding listing, among other things, the economic and fiscal policy conditions attached to the assistance. Decisions on loans granted under the EFSF are taken on a unanimous basis by the euro area member states. Decisions on loans under the EFSM require a qualified majority in the Council of the European Union, which has representation from all EU member states. The European Commission, in liaison with the ECB, and the IMF monitor compliance with the terms of the loan arrangements.

[2] The European Financial Stabilisation Mechanism was established on 13 May 2010 under Council Regulation (EU) No 407/2010.

In May 2010, Greece became the first euro area member to agree a major economic adjustment programme. The EUR 110 billion support included therein comprises EUR 80 billion from the EU and EUR 30 billion from the IMF. Support by euro area countries was granted via bilateral loans. This meant the EFSF and EFSM were not yet activated at this point. The Commission does, however, administer the bilateral loans granted to Greece. Finland's share of the loan arrangement for Greece will amount to a maximum of EUR 1.6 billion.

The European financial stabilisation arrangements restored confidence to the financial markets only temporarily, and the sovereign debt crisis began to spread to other highly indebted countries in the euro area. Market sentiment weakened particularly in Ireland, where the banking sector was in difficulties, and in Portugal, due to its large public debt. Spain launched reforms to the savings bank sector, but there was seen to be a need for additional capitalisation. Italy's need for refinancing was also held to be considerable.

The situation in Ireland deteriorated when it was estimated that the banking rescue package announced by the government in September 2010 would take the general government deficit to over 30% of GDP. Although some of the additional expenditure was one-off in nature, market confidence in the

government's capacity to manage its debt and in the country's banking system deteriorated. At the end of November 2010, the EU and IMF agreed a financial support package for Ireland totalling EUR 85 billion.[3] The agreement included EUR 17.7 billion from the EFSF and a further EUR 22.5 billion from the EFSM. This marked the first time the financial stabilisation arrangements were activated.

Debt issued by the financial stabilisation arrangements is guaranteed by European governments

In the context of the new financial stabilisation arrangements, euro area countries do not lend directly to each other, but instead guarantee the loans either directly (EFSF) or indirectly (EFSM). For example, to fund loan disbursements to Ireland, the EFSF issues debt on the markets and euro area countries guarantee the debt issuance. The EFSF holds guarantees to a maximum of EUR 440 billion. Each euro area country's share of the guarantees is determined according to their share of the ECB's subscribed capital, whereby Finland's share is approximately 1.8%, or EUR 7.92 billion.[4] Greece and Ireland do not provide guarantees, as they have been granted financial assistance.

[3] The package includes support to be paid via Ireland's pension fund and bilateral loans to Ireland from the United Kingdom, Sweden and Denmark.

[4] Once it joins the euro area, Estonia is also due to participate in the EFSF.

For the EFSF to be effective, it is important that borrowers repay their loans. It is therefore vital that each government that borrows is committed to their country's economic and financial adjustment programme. As the economies of the assisted countries recover, their ability to service their loans will also improve. If, however, a borrowing government fails to repay or is late in repaying the principal or interest on its loan, and this results in a shortfall of funds to repay interest and/or principal on the EFSF bonds, the EFSF will request payment from euro area governments on a pro rata and pari passu basis. The EFSF's creditworthiness is particularly enhanced by the fact that the bonds it issues must have guarantees amounting to 120% of their nominal value.

In addition to the government guarantees, the EFSF's creditworthiness is also enhanced by the cash buffers to be attached to the loans. In the first place, borrowers will pay a service fee equal to 0.5 percentage points of the total loan capital when taking out a loan from the facility. Secondly, borrowers will pay the net present value of an interest margin cash flow calculated on the total capital of their loan. Thirdly, the amount paid to loan recipients will be reduced by a loan-specific cash buffer. These charges will not lower the amount of the total loan capital, thereby accruing cash buffers within the facility. The EFSF will then invest

The EFSF's creditworthiness is underwritten by government guarantees and cash buffers.

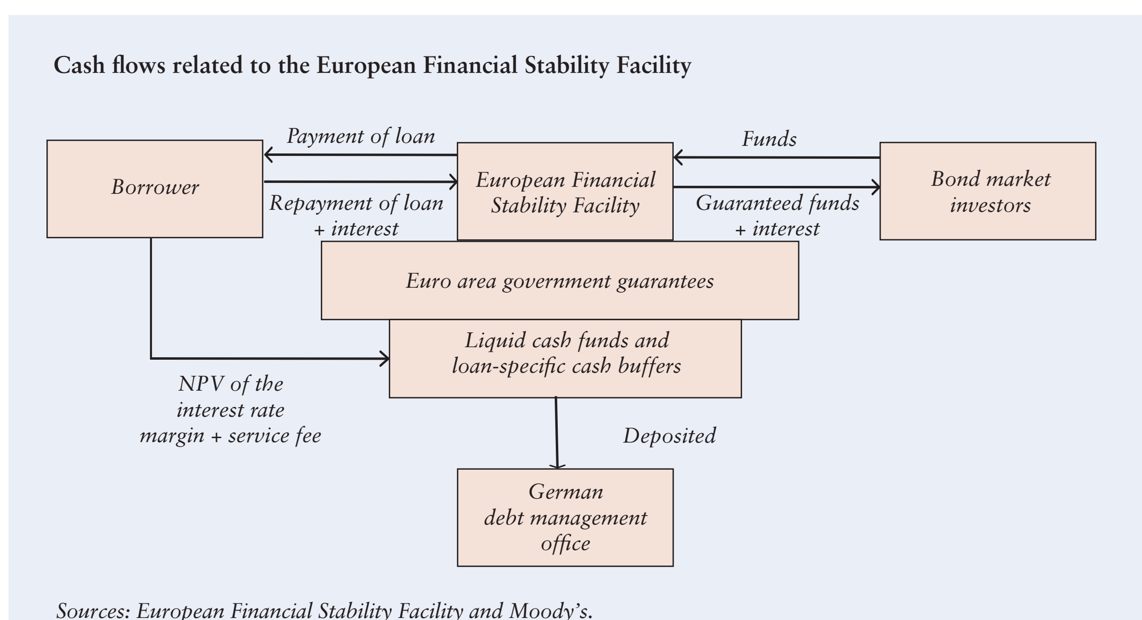
the cash in AAA-rated instruments. The facility will be able to use these cash buffers for repaying interest and principal only on bonds issued for funding the specific loan to which the buffers relate until the borrower has repaid the loan (Chart 1).

The EFSF will determine the size of the loan-specific cash buffers in such a way that the bonds it issues to fund a loan will always be covered by guarantees from AAA-rated governments and cash. Within the euro area, Germany, France, the Netherlands, Luxembourg, Finland and Austria all have the highest possible credit rating for their government bonds. Thanks to the government guarantees from euro area countries and the cash buffers on the loans granted by the EFSF, the major credit-rating agencies have assigned the EFSF bonds the best possible credit rating (eg Standard & Poor's AAA rating). This is based on the fact that the guarantees and the EFSF's liquid cash funds together exceed its debt. In terms of creditor rights the EFSF has the same standing as the private sector and does not have the same sort of preferred creditor status as the IMF.

Guaranteeing EFSF bonds for more than their nominal value allied to the accumulation of cash buffers will reduce the capacity of the loan arrangements. With the present level of guarantees, it has been estimated that the EFSF will be able to offer the financially distressed countries loans totalling approximately EUR 250 billion, less than 60% of the

Chart 1.

Cash flows related to the European Financial Stability Facility



Sources: European Financial Stability Facility and Moody's.

guaranteed sums. The maximum amount that can be lent will, however, depend on a number of factors, including the credit ratings of the guarantors, the level of interest rates, and the maturity and other terms and conditions of the loan. As an example, of EUR 5 billion issued on the markets, the EFSF was able to lend EUR 3.6 billion to Ireland in February 2011.

Lending by the EFSM is indirectly guaranteed by all EU member states via the EU budget. Although the EFSM itself is new, the work it does, as such, is not, as the European Commission has in the past already issued debt in the name of and on behalf of the EU. It has used the funds raised by this debt issuance to finance balance-of-payments support and macro-financial assistance granted by the EU. The Commission cannot, however, finance its own activities on its own behalf.

The EU can grant medium-term financial support to member states experiencing serious balance-of-payments problems; at present the maximum support it can offer is EUR 50 billion. Balance-of-payments support is, however, available only to non-euro area member states, whereas the EFSM can also provide financial support to euro area countries. During the financial crisis, support has been provided via the balance-of-payments facility to Hungary, Latvia and Romania. At the beginning of 2011, approximately EUR 12 billion was still outstanding on these loans. Macro-financial assistance, meanwhile, is granted by the EU to non-EU countries, of which EUR 600 million was still outstanding.

The credit rating of the EU's debt is not linked to the credit risk of countries in receipt of EU loans, as all the funding instruments are guaranteed by the EU budget. If the borrower is unable to repay the loan to the EU, the Commission will service its debt from the EU budget. Finland's share of the EU's own funds is under 2%. EU member states are under a statutory obligation to guarantee all the Union's debts, which is why EU issues have the best possible credit rating. In addition, loans granted by the EFSM incorporate – in the same manner as EFSF loans – a cash buffer, which is channelled back to the EU budget.

Debt issuance off to a good start

The EFSF issues bonds on the markets in order to raise funds for re-lending to euro area governments. Debt is issued only in response to requests for assistance by euro area governments approved by the Eurogroup, and the funds are earmarked in such a way that the EFSF issues bonds solely to fund the adjustment programme of a specific country. Moreover, as it is currently constituted, the EFSF raises funds solely for governments. In connection with the Irish financial support package, however, it was agreed that the Irish government could use

Demand for the first bond issued by the EFSF in January 2011 was high.

EUR 35 billion of the total EUR 85 billion package to support the country's banking sector.

The EFSF issued its first bond, with a maturity of five years, at the end of January 2011. Demand for the bond on the primary markets was almost nine times the EUR 5 billion offered. According to market participants, this level of demand was the highest ever seen for a syndicated issue of this size. The average yield on the primary markets was around 2.9%, which at the moment of issuance was approximately 0.6 percentage points more than the yield on German government bonds of equivalent maturity and 0.3 percentage points more than the yield on Finnish government bonds. Japanese investors subscribed to 20% of the bond issuance, while the largest investor group was public entities. The yield spread vis-à-vis Germany is partly explained by the fact that the liquidity of EFSF bonds on the secondary markets is weaker than that of German government bonds. In addition, the use of EFSF bonds as collateral in interbank loans or interest rate derivatives is not so well established.

The financial markets saw the EFSF bond as attractive because the AAA-rating means the bond's credit risk is low. Moreover, considering the low level of credit risk, the bond's yield is superior to eg German or French government bonds. Its yield on the secondary markets has so far held at slightly below 3%. Since it was issued, however, the yield spread to the corresponding German government bond has clearly narrowed, as yields on German bonds have increased and the EFSF bond's yield has remained relatively unchanged.

The EFSF has announced its debt issuance will total EUR 26.5 billion in 2011–2012. This is equivalent to the Finnish government's estimated gross funding needs for 2011. In addition to the issuance already concluded, the EFSF estimates it will in 2011 issue bonds to the value of a further EUR 11.5 billion, possibly in the form of two benchmark bonds. The facility will aim to achieve liquid markets for its bonds. The bond issuances are expected to be euro-denominated, but it could also issue bonds in other currencies. The German debt management office issues bonds on behalf of the EFSF and also invests the loan-specific cash buffers.

The Commission's debt issuance is also based on the terms of loans granted by the EU (back-to-back lending), which define eg the maturity of the bonds to be issued and their denomination, volume and value date. The EFSM, administered by the Commission, issued its first bond at the beginning of January 2011 to finance the loan arrangements for Ireland. Thus it was active in the markets before the EFSF. The maturity of this first bond was 5 years, and its average yield was priced at the

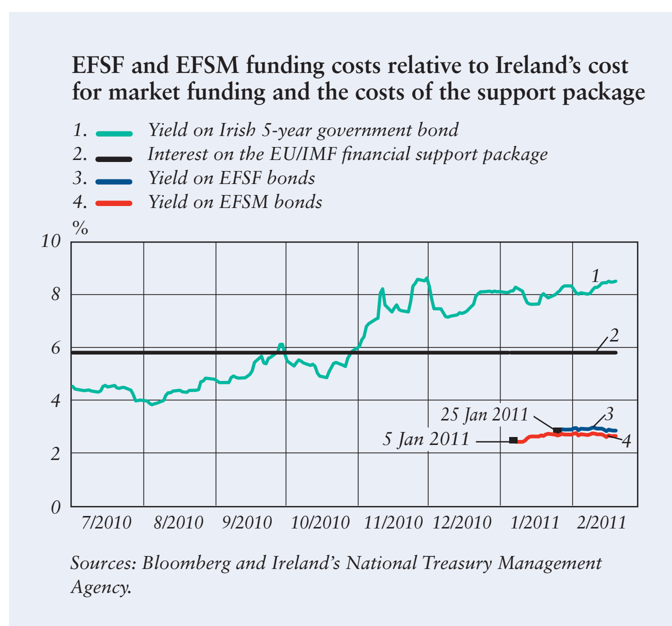
moment of issuance at around 2.5%, or 0.7 percentage points higher than the yield on 5-year German government bonds. Thus, the pricing of the EFSM bond corresponds to the bonds issued by the Commission in 2010, one of which was used partly to finance the balance-of-payments programme for Romania.

Demand for the EFSM bond was four times the amount issued (EUR 5 billion). Demand was worldwide, and 22% of the issue was auctioned to Asian investors. Almost half of all investors were banks or asset managers, 39% public entities and 12% insurance and pension funds.

The Commission is planning to issue in the name of the EU altogether almost EUR 20 billion euro-denominated 5–10-year bonds in 2011. Most of these, valued at EUR 17.6 billion, will be used to fund the EFSM loan to Ireland. The nominal value of the outstanding EU bonds at the end of 2010 was approximately EUR 12.5 billion, of which EUR 2 billion will mature in 2011. Thus the stock will more than double by the end of 2011.

The new financial stabilisation facilities will in practice almost entirely replace Irish sovereign debt issuance until 2013. Ireland aims, however, to preserve its access to market funding during the life of the support package. It is intending to issue bills and begin issuing bonds when market conditions permit. A comparison of Ireland's own funding costs and the costs of the financial stabilisation arrangements (Chart 2) reveals that Ireland will pay interest of approximately 6% on the loan it receives from the EFSF, comprising the EFSF's own funding costs (at present around 2.9%) and a margin of around 3 percentage points. For the loan via the Commission's EFSM, Ireland will pay slightly less, approximately 5.5%. This comprises the Commission's own funding costs (around 2.6%) and a margin of 2.9 percentage points. According to Ireland's National Treasury Management Agency, the total costs of the country's EUR 85 billion support package are approximately 5.8%, and the average duration of the loans 7½ years. The interest rate is lower than Ireland's corresponding rate for market funding, which was

Chart 2.



around 8% at the beginning of 2011. The final interest payable on the support package loans will depend on the prevailing market rates.

Permanent stabilisation mechanism in place after 2013

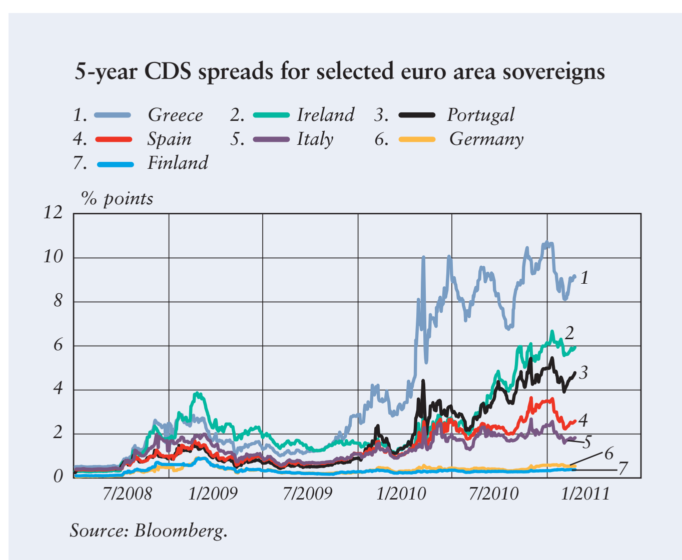
In December 2010, EU countries decided that the agreed interim financial stabilisation arrangements, such as the EFSF, would be replaced from the middle of 2013 by a permanent European Stability Mechanism (ESM). The decision was based on a previous Eurogroup position statement, which pointed up the need to clarify euro area countries' own responsibility in managing economic policy and the participation of private investors in credit arrangements.

In future, the ESM will assess on a case-by-case basis whether the debt position of a government seeking assistance is sustainable. Governments facing liquidity problems will be eligible for a loan in the same manner as with the EFSF at present. The granting of a loan will require the agreement of all euro area countries, and any loans granted will be conditional on the aims of the recipient government's adjustment programme.

The ESM will incorporate collective action clauses that will facilitate the possible negotiation process with creditors. It will have preferred creditor status relative to private creditors, although not relative to the IMF. This means the ESM will be able to assume a significant role in the management of debt restructuring. It will also be able to provide liquidity support during the restructuring process. Only new debt securities issued after 2013 by euro area governments will contain collective action clauses.

The establishment of a permanent financial stabilisation mechanism is part of the drive for reinforced economic surveillance in Europe. Within the EU, there are ongoing discussions over how economic policy coordination can be enhanced by improving administrative and monitoring systems for general government finances. Also still undecided are the details of the ESM. There have been discussions as to how the lending capacity of the present EFSF could be increased or its

Chart 3.



Source: Bloomberg.

mandate expanded, eg to enable it to purchase government bonds on the secondary markets.

In early 2011, expectations grew on the financial markets that Europe would find a comprehensive solution to the debt crisis. Confidence in the peripheral euro area was enhanced by the high demand for the EFSF and EFSM bond issues and the successful debt issues by individual governments, despite stubbornly high yields and credit default swap premia on the government bonds of the most heavily indebted countries (Chart 3). In order to sustain financial market confidence, it is essential to achieve a credible, comprehensive solution to the debt problems.

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