Improving and Expanding the European Financial Stability Facility

A Policy Maker Brief for European Finance Ministers

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Abstract

The current capital and operational structure of the EFSF is highly inefficient and has led to growing calls for an urgent expansion of its capacity. This Policy Maker brief offers four distinct standalone but complementary suggestions on how its capacity could be increased with three of the suggestions not needing any additional commitments from Member States.

These measures can be used on a standalone basis or in various combinations with each other. If used together, they have the capacity to increase the effective capacity of the EFSF **to more than €1,000 billion – a quadrupling of capacity**, without much additional commitments from Member States. If additional Member State commitments are ruled out, the other three measures can still increase the capacity of the EFSF to **as much as €750 billion**. The switch to providing partial guarantees by itself can instantaneously increase the capacity of the EFSF **to more than €500 billion**, a doubling of its current effective capacity of about €250 billion. (Note the preferred creditor option probably does not sit very well with the partial guarantee option.)We also strongly recommend that the EFSF should charge MS only on a cost recovery basis.

Background

The European Financial Stability Fund (EFSF) has a notional size of €440 billion as defined by Member State Commitments. It is structured as a "société anonyme" under Luxembourgish law and has been operational since August 2010 with the Euro area Member States as its shareholders.

The EFSF is backed by guarantees from member states in proportion to their ECB capital subscription with each member state being responsible for 120% of its share of EFSF commitments so the total size of the guarantee provided works out to be €440 billion.

In its effort to seek a AAA credit rating the ESFS employs three tools

1) An over guarantee from Member States that amounts to 120% of their EFSF commitments
2) A cash reserve set aside from borrowers plus a service fee
3) A loans specific cash buffer

The AAA rating comes from all borrowing being backed by either a guarantee from a AAA rated country (1 above) or by AAA assets held by the EFSF (2 and 3 above are invested in AAA bonds and notes).

Country	Fitch Rating	Share of EFSF	Size of Guarantee	GDP (2010)	Guarantee as % of GDP
Austria	AAA	2.90%	13	281	4.54%
Belgium	AA+	3.60%	16	352	4.50%
Cyprus	AA-	0.20%	1	17	5.18%
Finland	AAA	1.90%	8	178	4.70%
France	AAA	21.30%	94	1948	4.81%
Germany	AAA	28.40%	125	2498	5.00%
Greece			0	229	0.00%
Ireland			0	156	0.00%
Italy	AA-	18.70%	82	1548	5.32%
Luxembourg	AAA	0.30%	1	40	3.30%
Malta	A+	0.10%	0	6	7.33%
Netherlands	AAA	6%	26	585	4.51%
Portugal	A+	2.60%	11	171	6.69%
Slovakia	A+	1%	4	66	6.67%
Slovenia	AA	0.50%	2	36	6.11%
Spain	AA+	12.50%	55	1051	5.23%
Total		100%	440	9,162	4.80%

Figure: The size of the EFSF *Based on Data from Fitch Ratings, EFSF, ECB, Eurostat*

As can be seen from the table above, more than 60% of the backing is for the EFSF is from Member States with a AAA rating, more than 35% from Member States with a AA rating and less than 5% from Member States with a A rating.

The second point of note here is that the size of commitment as Member State GDP is small but significant lying in the range of roughly 3%-7% of MS GDP.

A third point that stands out is that the % of GDP commitment from larger Member States is on average lower than the commitment from smaller Member States.

The current lending capacity of the EFSF is perceived to be insufficient

Because the Member State Guarantees are supposed to be 120% of the EFSF commitments, it follows naturally that the maximum capacity of the EFSF to provide support is already diminished to €367 billion. Once further adjustments are made for all loans to be backed by AAA guarantees or AAA assets this further diminishes to around €250 billion-€270 billion, only about 60% of the headline number.

Another complication is that Member States which draw on the EFSF also withdraw the guarantees they have provided to the vehicle. This means that every time a new Member State accesses the facility, it not only diminishes the unused part of the facility but also reduces the overall size of the EFSF. Portugal and Spain, widely seen to be the next in line for EFSF support together account for 15% of the size of commitments a significant amount.

At a size of €250 billion the EFSF is rightly perceived by markets to probably be insufficiently large in order to fulfil the need to support any of the larger Member States should they need to draw on the

facility. That is why there is an earnest on-going discussion about the need to expand the size of the facility.

Many Member States are reluctant to provide additional support or guarantees for the EFSF so any tool that can help increase the effective size of the support the EFSF can provide without increasing the commitments from Member States would be very welcome.

The capacity to provide support can be increased by four distinct sets of measures

1) ***Increasing Member State Guarantees to 7.5% of 2010 GDP:***

As discussed above, under the ECB capital share criteria, the larger Member States have, on average, lower commitments compared to the smaller member states. If we take the 7% of GDP maximum level of commitment from smaller states as a new benchmark and change the EFSF's funding criteria so each Member State provides 7.5% of its GDP in guarantees the nominal size of the EFSF increases to about €660 billion, a 50% increase in size. It also increases the share of AAA commitments from 60.5% to 63% so will increase the real effective lending capacity of the EFSF to about €370-€390 billion a substantial increase under the current structure while retaining its AAA credit rating.

This would be a more equitable burden sharing across states and would provide for the needed boost to size without affecting the AAA rating that is so cherished by EU policy makers. However, there is a reluctance on behalf of Member States to provide additional commitments.

2) ***Letting go of the irrational attachment to AAA rating:***

Even at the time the structure of the EFSF was being discussed we questioned the need for a AAA rating on efficiency grounds. Subsequent events have only increased our doubts about the need for the EFSF to target a AAA rating.

Seeking AAA rating was justifiable on two grounds 1) reputational and 2) in order to lower the cost of funds. The thinking was that if the European Union, one of the most credit worthy regions in the world, could not design a multilateral vehicle that enjoyed the highest credit rating that might cause some reputational damage. This line of reasoning has some merit in it but a good case can be made that the incoherence of policy making and delayed responses to recurring crisis are far more significant. EU policy makers should be willing to consider jettisoning the AAA rating.

The second justification, of lower borrowing costs, is on even thinner ground. First, the borrowing costs increase only very slowly down the rating scale and the difference between AA and AAA is very small with the difference in borrowing costs between A and AAA larger but still close to the 1%-2% mark depending on market conditions. As the following graph shows, borrowing spreads increase rather slowly at first and then more rapidly down the rating scale. Most important, by setting the interest rate at which funds will be made available to Ireland at close to 5.8%,, the EFSF is not passing on the low cost of borrowing it is expected to enjoy because of the AAA rating to borrowers so the justification for the inefficient use of the capital structure to achieve this rating is not defensible.

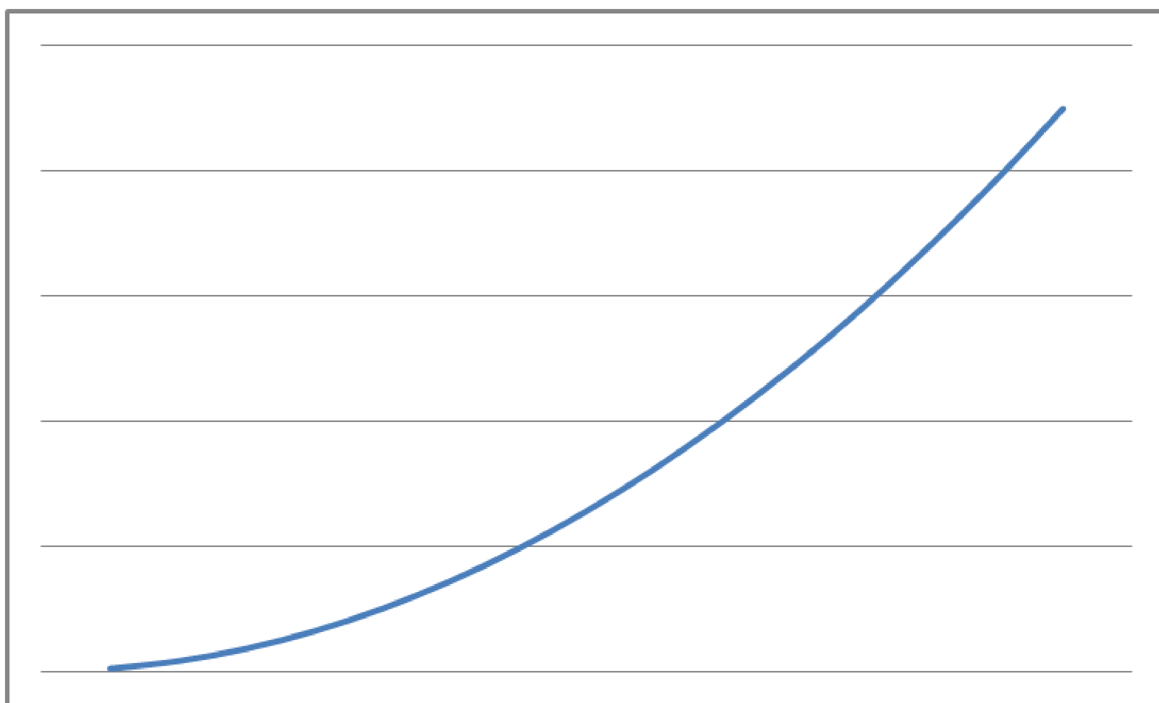

Figure: The graph shows how bond spreads typically evolve as one goes down the rating scale

If the EFSF were to agree to settle for a AA rating, its lending capacity can be instantly increased from about the current levels of €250 billion-€270 billion to more than €400 billion without any increase of commitments on behalf of Member States. This is a boost of more than 50%. We strongly believe that this is a step policy makers should instantly consider. In fact, in discussions at the next Euro group meeting the possibility of targeting not just a AA rating but an even lower rating of A should not be dismissed.

That having been said, we believe that the biggest efficiency gain for the EFSF will come from a move to a AA capital rating that would not only allow for a significant expansion of the lending capacity of the EFSF but will also allow it to borrow at spreads that are very close to the cost of funds under a AAA rating. Moreover, we firmly believe that the EFSF should on-lend to troubled Member States on a pass through basis after making deductions for operational and administrative expenses.

This would address the very pertinent objections raised by many commentators including ourselves of the logic of current high lending costs to troubled countries such as Ireland that only help exacerbate the problems being faced by these Member States.

3) Putting in place a preferred creditor status for the EFSF

We believe that the decision not to grant a preferred creditor status to the EFSF was flawed. As we have discussed elsewhere, creditworthiness for a facility such as the EFSF can come from one of two fronts 1)the strength of liabilities (capital or guarantees) or 2) the safety of its assets (ensuring that loans will always be repaid) or a combination of the two.

The EFSF mistakenly went for an extreme version of 1 by deciding not to ask for a preferred creditor status. However, for the same level of capital and guarantee commitments, an EFSF that has a

preferred creditor status would be seen to be much more creditworthy than an EFSF that does not enjoy such a status.

The corollary to this is that for a given level of capital and guarantee support (€440 billion), the EFSF can significantly increase its lending capacity while retaining its credit worthiness if a preferred creditor status is introduced. While a statutory provision is preferred as we have explained elsewhere, even a non-binding clause in the MoU between the borrowing Member States and the EFSF can significantly increase its immediately capacity to lend by tens of billions of Euros.

4) By switching to issuing partial guarantees for new Bond issuance by Member States

The current operation of the EFSF, whereby it first borrows in the financial markets and then lends funds to Member States in the form of loans is highly inefficient from the perspective of both transaction costs and the use of its balance sheet.

As we highlighted in a 2010 paper for the European Parliament (Building a Crisis Management Framework for the EU), a much more efficient use of the balance sheet of the EFSF would have been to guarantee new bond issues by troubled Member States. These bonds could be issued with maturities of anywhere between 1-5 years and enjoy any degree of guarantee between 100% on the one hand and much lower amounts on the other.

Given the expected losses the market seems to be factoring in on Greek and Irish Debt we recommend that the EFSF guarantee new Bond Issues from Troubled Member States against the first 40% of losses. This would have the instantaneous effect of 1) restoring capital market access for troubled Member States 2) significantly lowering the borrowing costs they face 3) more than doubling the effective size of the EFSF to more than €500 billion instantaneously.

Conclusion

We strongly recommend that the EFSF 1) shift to guaranteeing the 40% of losses on new bond issues by troubled Member States and 2) target a lower AA rating.

We recommend also that the EFSF seek a preferred creditor status in its MoUs with troubled Member States.

We suggest that if a decision is made to expand the size of commitments for the EFSF, then these be driven by a shift to a % of GDP formula which is more equitable across Member States and addresses some of the imbalance between smaller and larger Member States under the current quota system. Moreover, we recommend targeting a size of 7.5% of 2010 GDP.

We also strongly recommend that the EFSF lower the cost of provision of support to a purely cost recovery basis.