An Optimal Design for the European Stabilization Mechanism (ESM)

Re-Define Policy Maker Brief for Euro Group Finance Ministers

Sony Kapoor, Managing Director

Sony.Kapoor@re-define.org

Abstract

This Policy Maker Brief aggregates the advice Re-Define has provided to a number of European Finance Ministries, the European Parliament and the European Commission in a single place and in a format best suited for decisions by the Euro group of finance ministers and leaders on the design of the permanent European Stabilization Mechanism.

We address ESM design issues relating to its 1) legal structure and status 2) funding model 3) credit rating 4) size 5) preferred creditor status 6) governance and operational structure 7) decision making process 8) toolkit of instruments to aid Member States in trouble and 9) existence within a broader framework of EU crisis prevention and crisis resolution. We recommend that the ESM

1) be set up as a treaty based international financial institution aka the EBRD with Euro Member States as shareholders
2) has size at which it is able to meet around 1/3 of the Euro zone's annual sovereign debt issuance for a period of two years (Euro 600-750 billion)
3) is supported by Euro MS providing a small amount of paid in capital (1%-2% of planned size or Euro 7.5-15 billion) and substantial pro rata guarantees(Euro 400-500 billion) in proportion to their 2010 share of Euro area GDP
4) seek a AA not a AAA credit rating
5) has a statutory preferred creditor status backed by the letter of law
6) has Euro group finance ministers on its board of governors and senior finance ministry officials as executive directors and a lean secretariat that is able to draw on expertise from member Euro zone countries and EU institutions when needed. It should work closely with the IMF, the ESRB, the ECB, the EC and Debt Management Offices and Finance Ministries of the Euro MS
7) has a decision making flowchart conducive to quick decision making under pressure
8) uses the provision of partial (against first loss) and full guarantees for troubled MS bond issuance as the primary intervention tool with an additional flexible toolkit that includes the possibility of providing loans, lines of credit and bond purchase facilities
9) is the Crisis Mitigation part of an effective and comprehensive EU Crisis Management Regime with Crisis Prevention and Crisis Resolution as the other parts of the package

The Legal Basis and Form of the ESM

There are three main models for the legal form the ESM could take. 1) The first is that of a statutory EU institution either deeply embedded in the EU such as the European Investment Bank (EIB) or a more light touch creation such as the recently created European Banking Authority (EBA). 2) The second model is that of creating an international public law entity in the form of a treaty based international financial institution such as the European Bank for Reconstruction and Development (EBRD). 3) The third possibility is that of setting it up as a private entity with the European Financial Stability Facility (EFSF) that has the legal form of a 'society anonymous' under Luxembourg law as a model.

All of these structures come with their particular advantages and disadvantages. However, for the important Crisis Mitigation role that the ESM is expected to fulfil in the EU, we believe that a statutory form under Community law would be the most credible. It will also mean that the ESM will be accountable to the European Parliament, which will increase the transparency and ensure that its work will be well scrutinized. This structure might create some complications because only Euro Member States (MS) will have a real stake in its work but these can be resolved in a number of ways.

A second best, but perhaps more realistic solution given the politics involved, would be to set up a treaty based international financial institution aka the EBRD with Euro MS as shareholders. The EBRD itself was created on a fast track time table in less than 18 months between conception and launch so an even shorter timetable for the ESM is definitely possible. Care should be taken to have an easy scope for both 1) expansion to include new Euro members and 2) the possibility of an ad hoc non Euro MS participation on a case by case basis.

We do not recommend the use of an EFSF like legal structure because a non-statutory entity is less suitable for the size and importance that the ESM will have and there are few precedents for the use of a private entity for interstate action at this scale.

It is planned that the legal basis for the ESM will be provided by the insertion of the following clause into Article 136 of the TFEU.

"The member states whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality." This, as we will see in a subsequent section, imposes serious constraints on what the ESM may be able to do.

The Size

The ESM should have a substantial capacity for providing liquidity support to troubled member states so that it can carry out operations in multiple member states simultaneously. This would seem to indicate the need for a very large size. However, it is important to remember that the ESM (in contrast to the EFSF) is likely to operate purely as a short term liquidity support facility. This means that the time horizon of any lending operation will be short.

So the ESM should have a size that would allow it to provide liquidity support to multiple member states but only for short periods. 1-2 years is a reasonable time frame for debt restructuring that might be needed for some of the member states in crisis and a good estimate of the time needed to overcome a liquidity crisis. So a good base funding scenario would be the ability to support a third of the Euro zone borrowing needs for a period of 1-2 years.

Eurozone government borrowing will be in the range of Euro 7-9 trillion in the near future and currently has an expected average maturity of 5-7 years. This puts annual financing needs for the Eurozone at more than Euro 1 trillion so the targeted size of the ESM (1/3 of needs for 2 years) should be Euro 600-750 billion.

No matter what size policy makers choose at the launch of the ESM, it is important to provide an upward flexibility that can handle contingencies.

The Funding Model

We suggest that the ESM have a three tier funding structure 1) a small amount of paid in capital 2) substantial pro-rata guarantees or callable capital from Euro MS that provide the main source of strength for the operation of the ESM 3) an accumulation of own resources through any operational profits.

The ESM, if it is set up as an International Financial Institution as we recommend, should have some paid in capital that should be minimised given the toughness of the prevailing fiscal climate and for efficiency considerations. We believe that a paid in capital base of between 1% and 2% of intended size would be appropriate. In particular, because the ESM will operate only as an emergency facility and will not have any on-going operations that necessitate the use of capital, it makes sense to minimise the use of paid-in capital on efficiency grounds. It is useful to look at the European Investment Bank as a benchmark. It has a subscribed capital base of EUR232.4bn of which only 5% is paid in.

For the ESM, this can come in the form of 1) direct transfers by MS 2) left over profits (if any) from the operation of the EFSF when it is wound up 3) transfers of fines envisaged under the Excessive Debt and Excessive Imbalance procedures of the EU 4) levies on financial institutions or 5) financial transaction taxes. In general a diverse set of funding sources that can draw on both the private and the public sector makes sense.

The bulk of the firepower for the ESM will come in the form of callable capital (or MS guarantees) where Euro MS agree to provide irrevocable guarantees to meet any liability of the ESM in a timely manner. This model is the work horse for International Financial Institutions most of which derive their creditworthiness from the size of the total subscribed capital base (paid in plus callable) that can be attributed to highly rated (AAA or AA) sovereigns.

There have been suggestions (from Eurobond advocates, some academics and from Citicorp) that the guarantees provided by Euro MS to the ESM should be ‘joint and several’ where each MS is responsible for the whole amount of the guarantee rather than the amount pro-rated according to a quota system. This, it has been suggested, will improve the creditworthiness of the ESM.

We believe that such ‘joint and several guarantees’ which underpin the liabilities of the European Commission, are completely unnecessary for the ESM and are potentially dangerous for smaller MS. Given the high proportion (more than 90% under any feasible quota share arrangement) of MS commitments that will be AAA or AA rated, there is no need for the ESM to seek a ‘joint and several’ guarantee model. The ESM, as demonstrated by the very high ratings achieved by IFIs such as the EIB, EBRD, the World Bank (IBRD) etc. can be credit worthy under the same paid in/callable capital model.

Indeed joint and several liability for the ESM would potentially impose a liability on smaller MS that is a big multiple of their GDP. For example, under an extreme scenario, a small country such as Malta can be held liable for the whole of the ESM. So the ESM should follow a pro rata model for callable capital/guarantee from MS. What should this quota be based on?

Here there are two models 1) the ECB where MS quotas are based on an average of population weights and GDP weights and the 2) EIB where MS quotas were decided roughly on the basis of the size of their GDP at the time of accession. Of these, the ECB system that has also been used for the allocation of guarantees for the EFSF imposes significantly higher burdens on smaller and poorer MS (see “Improving and Expanding the EFSF, Re-Define 2011).

We believe that the ESM quotas should be based on ‘capacity to pay’ for which we recommend the use of MS GDP as a proxy. MS quotas should be allocated in proportion to their 2010 GDPs.

Credit Rating and Funding Needs

As we will see in a subsequent section, we recommend that the ESM work differently from both other IFIs and the current model for the EFSF. Unlike these institutions which borrow money in capital markets and then on-lend it to eligible borrowers, we believe that the ESM should work mostly through guaranteeing bond issues by MS in financial trouble. As we will see later, this has several advantages. This means that the ESM is not likely to need to borrow substantial sums in the bond markets though it should be flexible enough to do so if needed.

In any case, bond investors need to be assured that any funds provided to the ESM or underpinned by guarantees from the ESM will be repaid. This is the only instance under which they will be willing to provide funds at a cost low enough for the ESM to be able to fulfil its Crisis Mitigation mandate.

This assurance comes from two sources 1) ensuring the safety of repayments by troubled member states 2) ensuring the availability of adequate capital, and/or legally binding guarantees by Euro member states so that investors would get repaid even under a scenario of the troubled member state being unable or unwilling to repay the liquidity support it has received from the ESM. These two forms of assurance, on the asset and liability sides of the balance sheet of the ESM respectively, are mutually reinforcing and to some extent mutually substitutable.

This means that the ESM can achieve a desired high creditworthiness through one of three routes 1) a very strong repayment protection with relatively weak capital/guarantee support 2) a strong commitment to repay combined with strong capital/guarantee support and 3) a relatively weak repayment protection combined with a very strong capital/guarantee support.

Of these, option 1 is most efficient in the sense that it would require the lowest upfront commitment of capital and guarantee from member states. For IFIs such as the EIB, this is achieved at least partly through having a well-diversified and safe lending portfolio. This is obviously not an option for the ESM which by the nature of its mandate will have large concentrated and risky credit exposures. This can be achieved with a strongly enshrined preferred creditor status for the ESM so repayments of ESM funds even by troubled member states are assured. This is the approach we recommend and is discussed more completely in the subsequent section on preferred creditor status.

Option 2 may be achieved with a less strong (non-statutory) preferred creditor status that is taken to be customary but is not backed by the letter of law. This will require significantly stronger (read higher) capital and guarantee support from member states compared to option 1for any given size of the fund.

Option 3, where there is no preferred creditor status, may end up looking like the current form of the EFSF which needed a convoluted and inefficient structure of excess guarantees, locked in collateral and lower lending capacity in order to obtain an AAA credit rating.

We believe that option 1 would be most suitable for the mandate of the ESM.

The next major question to address is what, if any, credit rating the ESM should target. Unlike the EFSF which needs to borrow funds in the private markets the ESM is likely to concentrate on issuing guarantees. This means that obtaining a credit rating is less important for the ESM. However, the spread payable on MS bonds guaranteed by the ESM will be linked to its credit rating so the ESM will need to seek a rating. What should this targeted rating be?

As we have explained in detail in our policy maker brief "Improving and Expanding the EFSF, Re-Define 2011" we believe that policy maker obsession with a AAA credit rating is overdone but may be understandable in the context that an EU institution with a less than sterling credit rating may carry some reputation risk.

For example, the convoluted model followed by the EFSF (discussed in detail in that paper) in order to achieve an AAA credit rating is not very efficient. It seriously limits the effective size of lending and increases effective costs for borrowing member states.

That is why, we believe that the ESM should only seek an AA rating. A detailed discussion on this can be found in "Improving and Expanding the EFSF, Re-Define 2011".

Assuming a size of Euro 750 billion, we recommend that the ESM be launched with a paid in capital of Euro 7.5 billion – Euro 15 billion. The callable capital guarantees/ needed for a AA rating will then be in the range of Euro 400 – Euro 500 billion assuming that the majority of the ESM's operational support will be provided in the form of partial guarantees protecting investors against the first 40% - 50% loss for MS bonds guaranteed by the ESM (see section on instruments of support and the Policy Maker brief "Improving and Expanding the EFSF, Re-Define 2011" for more detail.

Thus the present Euro 440 billion level of MS guarantees provided for the EFSF seems like a reasonable starting point for the ESM.

Preferred Creditor Status

As discussed briefly in the preceding section on the funding model for the ESM, the place accorded to the ESM in the hierarchy of creditors is one of the most important parameters that will determine the credit worthiness of the ESM.

Internationally, multilateral institutions such as the World Bank, the IMF, the EBRD etc. are widely believed to enjoy a preferred creditor status that ranks them above all other creditors for sovereign borrowings in particular. This status, which is not backed anywhere by the letter of law is customary in nature and is driven by a number of factors such as 1) default on multilateral commitments can cut off all important access to further funding/support from these institutions which is a highly undesirable scenario 2) multilateral financial institutions such as the IMF often provide funds to countries that are in financial trouble so their financing can be seen to be a form of 'debtor in possession financing' that is made available to private companies under bankruptcy proceedings and does enjoy a statutory preferred creditor status and 3) the reputational risk of being considered to be a 'pariah state' is very real and can carry real political and even economic costs.

For these reasons, no country has, till date, defaulted on their commitments to institutions such as the IMF and the World Bank. (Another is that the multilateral organizations have used creative accounting techniques so as to avoid recognizing even much delayed payments as a default).

This status, as far as we know, has also not been tested in courts. In fact there has been some ambiguity about the existence of this preferred creditor status including doubts expressed by the auditor general of Canada. This preferred creditor status one of the drivers behind the relatively high credit worthiness enjoyed by many multilateral institutions than would be justifiable for an equivalent financial exposure by a private financial institution. In the words of the International Finance Corporation, part of the World Bank group, its "preferred creditor status is not a legal status, but it is embodied in practice and consistent universal recognition. It is granted by member governments of IFC and recognized by other creditors. It is also an important element in IFC's triple-A ratings."

The strongest form of a preferred creditor status is one that is statutory in nature being backed by the letter of law. This is the kind of status that is enjoyed by providers of 'debtors in possession financing' under the US Chapter 11 bankruptcy code.

Because of the uncertainty associated with the legal validity of a non-statutory preferred creditor status that the Member States seem to be aiming at, it is almost certain that the creditworthiness of the ESM will be lower and the borrowing costs for the ESM will be higher than these would be under a preferred creditor status that is backed up by the letter of law. Given the scarcity of Member State funding and the natural reluctance of Member States to provide more callable capital or guarantees than strictly necessary, it would be imprudent to not to fully exploit the credit enhancement that a statutory preferred creditor status can bring the ESM.

That is why we strongly recommend that the preferred creditor status of the ESM be firmly enshrined in Community law. The understandable desire of Member States, due to the customary subordination of regional multilateral creditor interests to international multilateral creditor interests, to rank the ESM behind the IMF can be easily tackled by providing for this in the same piece of legislation.

It has been suggested that the preferred creditor status enjoyed by the ESM may lead to a sharp withdrawal by private lenders who fear that their claims get subordinated as the size of support from the ESM increases. This may lead to private investors shunning any country that accesses the ESM.

This is a legitimate concern but is not much supported by historical evidence. It has been shown that the involvement of the IMF as a provider of liquidity support has increased the final payments that have accrued to private creditors of troubled emerging markets where the IMF provided substantial support. By ensuring the continuing availability of funds at a reasonable cost, a liquidity provider of last resort can help increase the overall size of funds available for repayment to private creditors compared to the alternative scenario of countries being unable to borrow at reasonable costs which can trigger large deadweight economic costs that reduce the likelihood of repayment.

Another important point is that the ESM under most scenarios is only likely to temporarily replace borrowing that under other scenarios would have happened in the markets at a higher cost. So the existence of the ESM as envisaged is unlikely to increase the overall debt to GDP ratio of a country but should reduce its overall cost of servicing debt compared to alternative scenarios.

The final point here is that the ESM can be designed in a way that concurrent lending by the private sector may be treated pari passu with the ESM because it can be seem to be conceptually similar to the 'debtor in possession financing' we have referred to in a previous section. This can ensure continuing market access for the Member State and can make exit from an ESM program easier.

Another even simpler way of achieving the same outcome can be by using the date of the first ESM access by a Member State as the cut-off date for any restructuring of debt that might be required if Crisis Mitigation measures prove insufficient.

Governance and Organization

The ESM, as currently envisaged, will support Euro area MS facing financial trouble and in turn will be backed by all Euro area MS. It is appropriate then that the ESM have a board of governors comprising Euro group ministers of finance. The board can then appoint (part time) Executive Directors who, as in the case of the IMF, are likely to be senior finance ministry officials from Euro MS.

The ESM is expected to have a highly variable work load with long periods of inactivity interrupted by occasional bursts of hyperactivity. Having a big staff would be extremely inefficient as they would have nothing to do most of the time. That is why the ESM should go for a model that has a small secretariat that is supported by a network of competent officials and experts from Euro area finance ministries, debt management offices, central banks and EU institutions as needed. The ESM should also have the flexibility to draw on expertise of the private sector if needed.

In addition, it is envisaged that the ESM will maintain close relationships with the European Systemic Risk Board (ESRB), the ECB, the European Commission, the IMF and Euro member Finance Ministries and Debt Management offices to help it with 1) Monitoring 2) Analysis and 3) Operations.

Decision Making Process

As currently envisaged, the ESM would work in the following way

1) A euro area Member State facing financing difficulties, would make a request for support to the Euro group and the IMF 2) The Euro group would then ask the Member State to discuss its possible financing needs, together with a draft macroeconomic adjustment program, with the Commission,

the ECB and the IMF 3) The Commission (together with the ECB and the IMF) would assess the program and forward its analysis and recommendation to the Euro group 4) The Euro group would assess whether the problems faced by the Member State is one of solvency or liquidity and would take a unanimous decision on the program which would then be forwarded to the European Council and a MoU would eventually be signed by the Commission on behalf of the Member States.5) The Euro group would then decide the main terms of the facility under which MS are supported 6) Compliance with the policy conditions will be monitored by the Commission in liaison with the ECB

This process 1) sounds convoluted 2)is likely to be time consuming 3)involves far too many actors 4) has too many stages and 5) needs to pass through the high threshold of unanimity in the Euro group. Another complication is plan to make an upfront decision on whether the Member State problem is one of liquidity or solvency, something that is very hard to make a judgement call on ex-ante.

This decision making process is not conducive to quick decision-making that would be crucial for effective crisis mitigation. The uncertainty about the final outcome and the substantial time the decision making process is likely to involve seem designed to cause market jitters and trigger contagion rather than calming markets and preventing contagion the stated purpose of setting up the ESM in the first place.

Ideally, there should be automaticity in the availability of limited amounts of liquidity support from the ESM. Each member state should have a right of automatic access up to a limit of say 5% of GDP for a limited period of time say 6 months. A more stringent approval process by the Euro group (together with advice from the ECB, the Commission and the IMF) should kick in when the request for support exceeds 1) this minimum size or 2) is for a longer duration with conditionality increasing from none (for minimum access) to more substantial as the size and/or duration of the ESM support is ratcheted up.

The right to automatic access and the size of automatic access can be made conditional on the degree of compliance with the new enhanced stability and growth pact and macroeconomic balance obligations so it can also provide a positive incentive for ‘good behaviour’.

The involvement of the IMF should be optional rather than mandatory. Given that Euro Member States are locked within the same monetary system there is a strong positive externality that derives from the provision of timely liquidity support to Member States facing financial stress. It can help minimise spill overs of financial stress and can effectively limit contagion. So there is a logical case for a graduated response that starts ex ante with the regional stabilization program but involves the international (IMF) stabilization program if the problems are serious and large enough to merit an international interest outside of the EU. The concurrent discussions on setting up global stabilization mechanisms and global safety nets are relevant in this regard.

So our suggestion is that 1) Member States have a right of automatic access to limited support from the ESM 2) that ESM support may go hand in hand with IMF involvement but that such involvement should not be mandatory 3) that the level of conditionality be proportionate to the size and duration of support sought by Member Sates 4) that the decision making process be simplified to fewer stages to allow for quick decisions 5) and that decisions for support be taken by the Euro group on the basis of a double supermajority (2/3 members and 2/3 quota of ESM support) to allow for more certainty in the decision making process.

However, this model for the ESM may not be fully compatible with the planned change to the treaty that specifies that "The member states whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality."

This seems to suggest that 1) automaticity is ruled out someone (the European Commission in consultation with the ECB and IMF) needs to make a judgement that the stability of the Euro area as a whole is under threat 2) strict conditionality is an integral part of the support.

If this specification of the treaty change is taken as a given, we need an alternative model for decision making.

Here we suggest that 1)the IMF should be treated as the liquidity provider of first resort with the ESM getting involved only if there is a solvency problem or if the magnitude of liquidity problems is large and affects multiple Euro MS 2) the ESRB should also be authorized to kick start a ESM process if it perceives a systemic threat to the Euro zone as it is likely that given the strong conditionality, MS will leave it far too long before they call on the ESM for help with a real possibility of negative spill-overs of their financial problems into other Euro MS as contagion takes hold. (See decision flow chart in the Annex to this paper)

As we will see in a subsequent section, the use of guarantees rather than loans will also substantially speed up the working of the ESM.

Toolkit of Instruments

For purposes of effective Crisis Mitigation, it is imperative that the ESM be provided with a diverse and broad set of instruments that it can use to support troubled MS. Scrambling around for new means of support (as is happening in the case of the EFSF now) in the middle of a crisis is a recipe for contagion.

As our analysis below will show, we strongly believe that the ESM should use the provision of guarantees as the instrument of choice for supporting MS in trouble. At a minimum, the ESM should be empowered with a toolkit that allows it to 1) prove partial or full guarantees for MS bond issuance 2) provide loans 3) provide lines of credit 4) buy MS bonds in the primary and secondary market and 5) finance buy back operations.

We strongly believe that there are several advantages to the EFSM/EFSF providing bond guarantees rather than loans. Some of these are 1) it eliminates (drastically reduces) the need for upfront capital 2) it reduces the pressure for a AAA credit rating 3) it can allow the ESM to leverage a given amount of MS guarantees to support a much larger program by using partial guarantees 4) it eliminates (reduces) transaction costs associated with the provision of loans 5) it significantly speeds up the process of providing support to MS as guarantees can be activated instantaneously 6) it allows for a smoother and more flexible and quick exit as guarantees are self-extinguishing 7) it allows MS in trouble to retain market access 8) the spread between non-guaranteed and guaranteed bonds can provide a useful market signal for the reform process in the MS 9) it reduces the scope for a double counting of outstanding Euro zone sovereign debt which can arise with the use of loans 10) guarantees are cheaper for the ESM to provide and for the troubled MS to use than loans would be.

There is a qualitative difference between the provision of guarantees which do not require the ESM to mobilize upfront funds and the use of all the other instruments mentioned above all of which will mean that the ESM will need to mobilize funds.

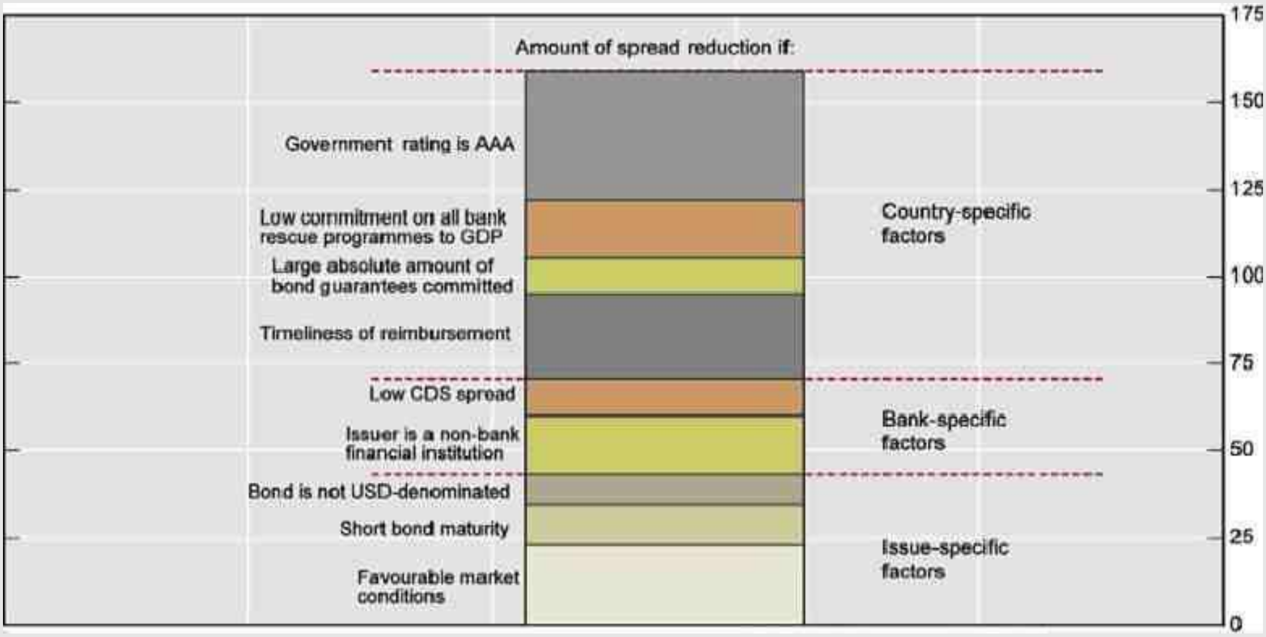
There are many successful examples of bond insurance and credit enhancement. AMBAC and MBIA, two of the leading municipal bond insurers in the United States worked for several decades using a thin sliver of capital to provide credit enhancement to municipal bonds throughout the Unites States. The organizations went under only after they had abandoned their traditional model and started providing bond insurance to structured products that resulted in large losses when the financial crisis hit. However, the basic model of AMBAC and MBIA provides a good lesson for the design of the ESM.

As the box below highlights, many EU member states ran very successful bond guarantee programs which can serve as a good basis for deigning the guarantee program for the ESM.

BOX: THE EU BOND GUARANTEE PROGRAM FOR BANKS

More than EUR 600 billion of bonds were successfully issued by EU banks under Member State guarantees, and these were very effective in stemming the crisis. This concept should be translated to sovereign bonds.

Factors influencing spreads of bank bonds issued under public guarantee in the EU



Source: "Government guarantees on bank funding: Should we extend them into 2010 despite improved bank profitability and the schemes' distortionary effects?" Vox EU column by Aviram Levy and Fabio Panetta, 2009

As the previous graph shows, the most important determinant of the cost of issuing guaranteed bonds is the strength of the guarantee (the country specific factors in the graph) with the nature of the issuing entity and liquidity of the bond issue being far less important.

EU banks have issued more than EUR 600 billion of government guaranteed bonds since the collapse of Lehman brothers and this has been a crucial crisis mitigation and liquidity provision instrument for banks which otherwise would have potentially collapsed after the crisis reduced possibilities for reasonably priced funding.

The cost of guarantees at 0.5% for bonds can be used as a benchmark for states. UK, German and French banks all issued more than EUR 100 billion of guaranteed bonds each. At one point, in the first quarter of 2009, as much as 30% of the funding needs of European banks were met through the issuance of guaranteed bonds.

Source: “Building a Crisis Management Framework for the EU”, European Parliament, Sony Kapoor 2010”

The Broader Crisis Management Framework

The ESM can only be successful within a comprehensive Crisis Management Framework for the EU. As we have seen in this crisis, the EU is suffering greatly from the absence of such a framework. Below we provide the justification and context for developing such a framework.

Crisis management is firstly and foremost about minimising the likelihood of occurrence by putting in place effective ex ante risk reducing policies – **Crisis prevention**. No matter how good such policies look on paper, economic externalities, and endogenous developments in financial markets or stochastic factors can dislocate even the best plans and trigger potentially destabilizing disturbances in the financial markets. These often take the form of liquidity black holes and/or asset prices collapses and/or a collapse in confidence. The challenge at this stage is to contain the crisis, limit damage, stop widespread contagion and restore confidence – **Crisis mitigation**. Even with the best of efforts to contain a crisis, sometimes it will deepen and spread. Under such a scenario, mitigation gives way to rescue and making a fresh start – **Crisis resolution**.

In fire-fighting terms, prevention comes from having a strong fire code, responsible behaviour and taking appropriate precautions. The distinction between crisis mitigation and resolution is somewhat arbitrary but nonetheless critical. Crisis mitigation is about putting out an incipient fire and stopping it from spreading. It will involve the use of smoke alarms, hand-held fire extinguishers, fire blankets and fire doors. Mitigating a crisis or a fire successfully often entails little cost or damage and going back to the ‘normal state of affairs’ is usually easy.

If the crisis or fire is too large or the mitigation tools are inadequate, the problems deepen and spread and cause widespread damage. This is where the big boys, the fire brigade or in the case of financial markets, recapitalizations or bankruptcy are needed to help limit damage and make a fresh start. The degree of collateral damage and the possibility of a healthy fresh start depend on the quality of crisis resolution and rescue measures, or in the case of fire, on the quality and response time of fire brigades and the existence of appropriate insurance policies.

Crisis Prevention depends on 1) responsible fiscal and monetary policies, 2) sound regulation, 3) a countercyclical approach to policy making, 4) moderate to low levels of public and private debt, 5) minimising imbalances and 6) having sufficient room for policy manoeuvre to lean against unfavourable developments. Better co-ordination and surveillance can help too, particularly in the context of the euro area. Prudence and policy space are critical here.

Crisis Mitigation has a lot to do with 1) moving quickly to restore confidence in the financial markets, 2) provision of temporary liquidity and balance of payment support and 3) ring fencing problems so as to minimise contagion. Speed of intervention, minimising conditionality and a credible scale of intervention are critical at this stage. Having a much clearer view of the endgame, in case mitigation fails, can also help calm nerves and restore some semblance of order in the market.

Crisis Resolution often entails substantial costs and involves structural changes, particularly for private sector entities. 1) ex-ante contingency plans, 2) formalized speedy resolution frameworks and 3) the possibility of orderly restructuring are all essential elements of an effective crisis resolution toolkit. A fair burden sharing procedure, predictability and the possibility of redemption are critical at this stage.

Thus, an effective crisis management framework for the EU will focus on putting crisis prevention, crisis mitigation and crisis resolution tools in place for both the financial sector and sovereigns.

A much more detailed discussion that includes specific policy recommendations particularly on Crisis Prevention can be found in our paper "Building a Crisis Management Framework for the EU", European Parliament, Sony Kapoor 2010".

A detailed discussion on Crisis Resolution can be found in our paper "How to Exit the Euro Crisis? Re-Define Policy Maker Brief, Sony Kapoor 2011"

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Annex: Decision Flowchart for the ESM