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Draft

EFSF Guideline on Primary Market Purchases

1. Introduction

The conclusions of the Heads of State or Government of the Euro area on 11 March 2011 in connection with the establishment of the ESM by 2013 state that financial assistance from both the EFSF/ESM will take the form of loans. It also states that in order to maximize the cost efficiency of their support, the ESM and the EFSF may also, on an exceptional basis, intervene in the primary markets in the context of a programme with strict conditionality. This guideline will explore some of the considerations of why, when and how an entity such as the EFSF could utilize this ability to intervene in the primary markets.

In addition, at the Euro Area Summit on 21 July 2011, the Heads of State or Government of the Euro Area and EU institutions agreed to increase the flexibility of the EFSF and ESM in order to address contagion by allowing them to (i) act on the basis of a precautionary programme; (ii) finance recapitalisation of financial institutions through loans to governments including in non-programme countries; (iii) intervene in the secondary markets on the basis of an ECB analysis that financial stability is at risk.

On 26 October, the Heads of State or Government of the Euro area countries agreed to enhance the capacity of the EFSF by allowing the EFSF to provide credit enhancement to primary bonds issued by a Member State and creating Co-investment funds (CIF). CIFs would allow the combination of public and private funding to enlarge the resources available for the EFSF.

A CIF would invest in primary or secondary sovereign bonds of a country that has entered into a Memorandum of Understanding with the European Commission specifying conditionality.

2. Objective

In respect to EFSF activities, the Member State will have access to funding primarily through the EFSF lending window, for which the rate will be established in line with the prevailing pricing policy. The EFSF, or equivalently a CIF created for the purpose of providing additional funding, may engage in primary market purchases ("PMP") as a complement to regular loans under a macroeconomic adjustment programme or to draw-downs of funds under a precautionary programme. The main objective of primary market purchases is to allow the Member State to maintain or restore its relationship with the dealer/investment community and thereby to increase the efficiency of EFSF lending.

In almost all cases within the euro area, Member States have typically enjoyed relatively straightforward access to the capital markets through syndicated transactions over the past years and continue to have varying degrees of diversification and depth. Furthermore,

Member States have installed formal bond auction processes enabling dealers to purchase securities including bills, notes, and bonds directly. Primary market purchases by the EFSF should be established in a manner that enables the Member State already under an EFSF program or using a precautionary credit line to take advantage of this historical access to the capital markets and therefore to the investment community.

An approach where EFSF, as a backstop and provider of liquidity, facilitates the access of a beneficiary Member State to its standard lending instruments on markets carries several benefits.

For the beneficiary Member State, EFSF's participation would reduce its risk of experiencing a failed auction or not raising the required fund amount. EFSF presence in the transaction also limits the risk that "out of the market" prices are posted by opportunistic primary dealers to test the needs from the country by ensuring that a minimum size will be secured. This reassurance should encourage the Member State to return to the financial markets earlier than otherwise. PMP from the EFSF may be especially warranted to prepare Member States re-entering the private market at the end of a financial assistance programme or to support Member States whose economic conditions are still sound to continue refinancing via the market under a precautionary programme.

For the EFSF, a PMP would create some leverage of its financing and increase its efficiency. By encouraging market access and complementing the funding of a beneficiary Member State in the market, it directly reduces the financing needs to be covered by the official sector, and thus preserves the lending capacity of the EFSF. Unlike with the provision of loans, the securities obtained by the EFSF via primary market purchases could in fact be resold to private investors, when market conditions have become accommodative. In doing so, the EFSF may help contribute to secondary market liquidity and free lending capacity.

From an investor or market perspective, the Member State's restored or continued presence in the markets would increase the supply and liquidity of outstanding and new bonds of the Member State in a market-transparent manner. On this account, PMP would address liquidity requirements from investors and reduce undesirable price effects. By encouraging Member States to maintain or restore their presence in the market, the EFSF addresses the needs of investors who have certain limitations on the percentage of outstanding amount of a country's debt they are allowed to hold. Such restrictions should avoid risks of not being able to get adequate prices when trading these bonds. Without new bond issues and the stock of tradable bonds shrinking due to redemptions and programme financing, this restriction may become binding in some cases and such investors will have to rebalance their portfolio. This may lead to forced selling of part of their bond portfolio of the Member State in order to maintain the prescribed limits. Such sales would lead to price pressures and higher market rates for Member States.

3. Timing of primary market purchases

In view of the objective and conditions for primary market purchases mentioned above, this 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. Careful market analysis is required to decide on the conduct of a PMP operation and ensure its success. First, the intervention may have a very different effect on the market than the announcement of a loan. Second, once the primary market purchase takes place, the market will know whether there has been a strong / low appetite for the bond from the private sector. This may affect future interventions and also have secondary market implications. Therefore, any such intervention

requires careful market screening. This would have to be provided by the issuing country and EFSF.

It should not be fully excluded that a PMP is used at an earlier stage or from time to time in longer intervals for specific maturities. Spreads have often increased further after countries actually entered a programme due to some concerns whether countries can re-enter markets as required and therefore obtain sufficient liquidity. Potentially, a PMP conducted at an earlier stage of a programme or done within clear limits in the course of the programme might help to prevent such developments.

A primary market purchase conducted by the CIF could also be used as a financing tool in substitution for a direct extension of loans and payments made under a precautionary programme to the Member State, thus enhancing the lending capacity of the EFSF.

4. Modalities of Primary Market Purchases

Primary market activities are among the important indicators of public demand for the specific credit at the specified maturity and pricing. Thus they are very important elements of transparent and efficiently functioning markets. In the case of EFSF's participation in the primary market this character should be preserved. At the same time, EFSF's participation has to be significant enough to reduce the execution and liquidity risks of the issuing Member state meaningfully. The modalities of the intervention need to strike a balance between assuming funding responsibility for the Member State and not undermining the market element relevant for the issuing Member State.

To achieve these targets a rules based mechanism seem recommendable to determine at which price EFSF purchases securities and at what amount. The details of this mechanism will depend to some degree on the specific issuing format.

As a common point, the primary market purchases of the EFSF would be conducted at market price. As already expressed, it seems more adequate to consider that participation in PMP would take place only if a reasonable participation of private investors at a rate not excessively above the EFSF funding rate as the Reference Funding Rate is possible. The analysis whether a rate is excessive should be based on an assessment of the financing needs and gap of a country in the context of the overall monitoring, as well as an assessment of current market conditions.

4.1. Participation in auctions

EFSF should participate at the weighted average price of the auction to minimize EFSF's impact on the auction result and to maintain the information character of the auction. A bilateral agreement between EFSF and the borrowing Member State will settle the cost compensation for the bonds bought by EFSF.

Generally, the amount EFSF purchases should be limited to no more than 50% of the final issued amount. That means that EFSF's share is no larger than the share bought by the market. Additionally it gives an incentive to the issuer to accept market bids, because for each million of accepted market bids the member state will receive an additional million from EFSF. An example of how the intervention can be conducted is illustrated in Annex 1 of this document. Only when a new bond is issued and in the unlikely case that prior market analysis failed to give the right signals, this approach need to be modified. There must be an extension

of this rule to avoid the issuance of a small illiquid bond into the market place if insufficient market bids are received at acceptable levels to sell 50% or more of the targeted issuance amount to the market and EFSF. In this scenario, the EFSF will buy the balance between the amount which can be sold to the market and 50% of the targeted issuing amount. That assures that the outstanding amount is at least half of the originally targeted amount. The participation restriction would not apply if loans or payments made under a precautionary programme are extended a by way of a primary market purchase of CIFs.

4.2. Participation in syndicated transactions

In situations where the EFSF purchases bonds in a syndicated transaction, the EFSF will purchase its securities at the re-offer price (means EFSF will pay no fees) as they do not represent any underwriting risk to the corresponding syndicate group.

The amount EFSF purchases will be limited to no more than 50% of the final issued amount, thus leaving at least half of the transaction to the market via the syndicate members. If the order book does not allow selling of at least 50% of the targeted issue amount at the estimated RFR or better, EFSF will purchase the balance between the amount which could be sold to Investors and 50% of the targeted amount. The remaining 50% must be taken up by the syndicate. The participation restriction would not apply if loans or payments made under a precautionary programme are extended by way of a primary market purchase of CIFs.

Whether the transaction will be conducted through an auction or syndicate has to be determined by technical experts on a case by case basis.

5. Procedures and activation

A Member State receives access to this form of EFSF financial assistance in the context of its support under a macro-economic adjustment programme or under a precautionary programme. The extension of financing based on primary market purchases is an approach complementing the standard financing through loans under a macro-economic adjustment programme or through draw-downs of funds under a precautionary programme. As such, it has to fall into the overall financing envelop for the programme and would substitute the disbursement of a loan or the draw-down of funds. If the PMP does not yield the necessary financing due to limited private investor participation, the financing gap would have to be closed through a standard EFSF loan.

For PMPs the standard respective procedures of requesting financial assistance, adoption and surveillance under a programme apply. It should be envisaged to generally approve the possibility to use this approach when the Eurogroup/Board of Governors grants a financial assistance programme or a precautionary programme for a country and include the respective provisions in the Financial Assistance Facility Agreement or modify existing Loan Facility Agreements accordingly.

In order to benefit from this financing approach, the EWG/Board of Directors should then decide by mutual agreement upon the proposal of EFSF to approve these operations for the disbursement of financial assistance or the draw-down of funds to a beneficiary Member State and its main terms. This decision should be taken after having received the report from the European Commission on the economic conditionality including the debt sustainability considerations in the context of the programme monitoring procedure. In the case of a

precautionary programme, the use of PMPs shall trigger a reassessment of the conditionality of the MoU including the assessment of additional reform measures and a re-evaluation of the adequacy of a precautionary programme. Involvement of the IMF in the monitoring procedure will be actively sought.

6. Management of the portfolio of bonds and pricing

If the EFSF has acquired bonds under its PMP facility, four strategies can be implemented:

- Sell the bonds back to the market when the demand is restored: this would necessitate an active risk management and would potentially disturb the issuance of the country on the primary market,
- Hold the bonds to maturity: This would limit the market risk and is consistent with the actual policy of the ECB.
- Keep the bonds as available for sale and sell the bonds back to the country.
- Use bonds for repos with commercial banks to support the liquidity management of the EFSF.

The Financial Assistance Facility Agreement will specify how any profits and losses will be settled.

All costs, including costs of carry and hedging, and expenses incurred by the EFSF in connection with this financial assistance support facility have to be paid by the euro area Member State benefiting from the PMP.

Annex 1: Example of a potential intervention in the Primary Market by EFSF

The following is an illustrative example of a potential intervention of the EFSF in an Auction of a Member State. The prices and volumes of the market bids are shown in columns A and B (sorted by Price). For this example, total Bids received amount to €770 mill. (of which €100 mill. at non-competitive rates). Then, an average price, weighted by the accumulated volume (C), is calculated in column D. This would be the price at which EFSF shall participate in the auction

According to the EFSF participation principle, the purchase of the bonds must be limited to the 50% of the final amount issued. This participation amount is shown in column E. Finally, the Funding Cost is shown in column G, calculated as an average (weighted by volume) between the Purchase Price of the auction and the RFR. This is the final price at which the Member State and the EFSF should align based on the bilateral agreement.

Expected Size (€mill)	1,000
max part EFSF	50%
RFR (ref.funding rate)	5.50%
Sec.Market Level	5.60%
= allocation A	
= allocation B	

Price	Bids per price (€ mill)	Total Bids (€ mill)	Weighted avege. Price	Max participation EFSF (€ mill)	Final Funding Vol. (€ mill)	Final avege. Funding Cost
A	B	C	D	E	F	G
non comp.bids	100	100				
5.10	10	110	5.10	110	220	5.30
5.20	10	120	5.15	120	240	5.33
5.30	10	130	5.20	130	260	5.35
5.40	70	200	5.34	200	400	5.42
5.50	50	250	5.39	250	500	5.45
5.60	30	280	5.43	280	560	5.46
5.70	80	360	5.51	360	720	5.51
5.80	180	540	5.63	460	1000	5.57
6.00	30	570	5.65	430	1000	5.59
6.50	110	680	5.81	320	1000	5.71
7.00	10	690	5.83	310	1000	5.73
8.00	50	740	6.00	260	1000	5.87
10.00	30	770	6.18	230	1000	6.03

The possible results of the auction are highlighted in green (allocation A) and blue (allocation B).

Allocation A: This would be the option of picking the first result with a Funding Cost below the RFR. The auction would not be fully subscribed under this option but the funding cost would be under both the RFR and the Secondary Level. The private sector is involved with 280m at a rate better than the RFR.

Allocation B: Option of picking the first result in which the total amount would be achieved. The auction would then be fully subscribed but the funding cost is above the RFR. Furthermore, two accepted bids from the private sector are above the Secondary Market level, at 5.70 and 5.80.

To summarize, this exercise reveals that the Member State, depending on the result of the auction, might be in a position to decide between a fully subscribed auction at a worst price or look at the economics and choose a not fully subscribed auction at a better price. This trade-off is made only under the responsibility of the Member State.

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EFSF Guideline on interventions in the secondary market

In their statement of 21 July, the Heads of State and Government of the euro area and EU institutions have decided to improve the effectiveness of the EFSF and of the ESM and to address contagion.

The Member States have agreed that the flexibility of the two institutions should be increased as they would now be allowed to a) act on the basis of a precautionary programme, b) finance recapitalisation of financial institutions; c) intervene in the secondary markets.

On 26 October Heads of State or Government of Euro area countries agreed to enhance the capacity of the EFSF by allowing the EFSF to provide credit enhancement to primary bonds issued by Member States and creating Co-investment funds (CIF). CIFs would allow the combination of public and private funding to enlarge the resources available for the EFSF. A CIF would invest in primary or secondary sovereign bonds of a country that has entered into a Memorandum of Understanding specifying conditionality.

This guideline outlines the main approach which could trigger the decision to intervene in the secondary bond market of a country. The main operational aspects of the organisation and of the funding strategy are also described.

1. Objectives and modalities for the intervention on the secondary market

Heads of State and Government considered secondary market intervention by EFSF as one further tool helping to support the financial stability of the euro area. So far this tool has been used on a more general level by the ECB in the context of the SMP. Interventions by the Eurosystem in public and private debt securities markets in the euro area, however, were done to ensure depth and liquidity in those market segments that are dysfunctional.

Secondary market intervention by EFSF has a twofold objective. First, it serves to support the functioning of debt markets and appropriate price formation in government bonds in exceptional circumstances where the limited liquidity of markets threaten financial stability and push sovereign interest rates towards unsustainable levels. In the course of the on-going sovereign debt crisis in several occasions and for different countries price dynamics have emerged which are difficult to explain by economic fundamentals. Correction of earlier unfounded expectations on the bailout of countries and speculation on the political coherence of the euro area played a role here. Price formation followed its own accelerating dynamics in pricing countries effectively out of the market. One objective of EFSF secondary market interventions is to pre-empt and counteract such pricing dynamics.

Second, against the background of heightened uncertainty, markets for some sovereigns have become very thin and induced refinancing problems for the banking system. EFSF intervention serves the purpose of a market making to ensure some liquidity in debt markets and giving incentives to investors to further participate in the financing of countries.

2. Conditionality

2.1. Financial Market Conditions for Activation

Conditionality for secondary market intervention relates to the issue of what are the financial market conditions under which the tool should be applied to ensure its effective use. The Heads of State and Government indicated that it should be done on the basis of ECB analysis and following a decision by mutual agreement from Member States.

The analysis will determine the potential existence of exceptional financial circumstances and risks to financial stability. Such environment should be characterised e.g. by unusually volatile markets, unidirectional movements and widening of the bid/offer range for prices as a result of poor liquidity. Further details should be given to the type and structure of analysis and how recommendations are derived.

The ECB will provide an expert analysis of financial market disruptions and contagion risk. In addition, it could give in an advisory capacity, recommendations regarding the volumes and types of assets to be purchased. The analysis on financial market disruptions and contagion risk will be provided as a confidential report to decision-makers. Further advice will take place in the context of the ECB's participation in a technical committee implementing the secondary market intervention.

2.2. Eligibility conditions and corrective action

Access to a SMP facility will imply appropriate policy reform efforts to be specified in a MoU. For programme countries compliance with the macro-economic policy conditions is clearly a requirement. Countries benefiting from such interventions outside a macro-economic adjustment programme would have to comply with ex-ante eligibility conditions as defined in the context of the European fiscal and macro-economic surveillance framework and take corrective action. The possible criteria which could be used to assess whether a country qualifies for a secondary market purchase facility:

- The respect of the SGP commitments. Countries under excessive deficit procedure could still have access to this facility provided they fully abide by the various Council decisions and recommendations aiming at ensuring a smooth and accelerated correction of their excessive deficit.
- A sustainable public debt.
- The respect of their EIP commitments. Countries under an excessive imbalance procedure could still access SMP, provided that they can demonstrate that they are committed to addressing the imbalances identified by the Council.
- A track record of access to international capital markets on reasonable terms.
- A sustainable external position.

- The absence of bank solvency problems that would pose systemic threats to the euro area banking system stability.

The country would have to agree to the continued compliance with these criteria as a condition for the access to this facility as well as continued compliance with appropriate policy reforms as specified in the MoU.

3. Procedure

3.1. Acceptance Procedure

The procedure is initiated by a request from a Member State to the President of the Eurogroup for access to the Secondary Market Purchase Programme. In case of exceptional financial market circumstances and risks to financial stability of the euro area as a whole, the ECB will issue an early warning to the EWG. In all cases, an ECB report identifying the existence of exceptional financial market circumstances and risks to financial stability of the euro area as a whole will assess the need for interventions.

The Commission, in liaison with the ECB, would prepare within 1-2 days a MoU specifying the availability period, the fiscal adjustment and structural reforms needed for support.

A MoU and Financial Assistance Facility Agreement will be adopted by the EWG and the Board of Directors and signed. The intervention envelope made available by the EFSF - fixed by an EWG/EFSS Board of Directors technical sub-committee, including the ECB - will be equal to the remaining lending capacity of the EFSF. The technical sub-committee will also set pro-tempore intervention caps for the EFSF. The guarantee amount needed to finance the EFSF envelope will be approved, where necessary, by restricted committees in National Parliaments under a fast track procedure.

The EWG/EFSS Board of Directors technical sub-committee, including the ECB, sets pro-tempore intervention caps, designs an intervention strategy and decides on the daily tactics for portfolio managers of EFSF interventions in a secret way. It will report on a weekly basis on the conduct and volume of the operations to the EWG/Eurogroup. Where necessary, restricted committees in National Parliaments will be appropriately involved.

3.2. Monitoring Procedure

The Commission, in liaison with the ECB, monitors the compliance of the beneficiary Member state with the conditionality specified in the MoU and reports regularly to the Eurogroup/EWG. Any deviation from the MoU objectives agreed by the Member State requires a reconsideration of the adequacy of the secondary market interventions. Such a situation could lead to a revision to the MoU, including conditionality, or the termination of the secondary market purchases. There will be a monthly reassessment of the program including a decision of the EWG/Eurogroup on the continuation of the programme.

3.3. Pricing, Costs and Expenses

The Financial Assistance Facility Agreement will specify how any profits and losses will be settled between the beneficiary Member State and the EFSF.

4. Operational aspects of the intervention

Secondary market purchases of euro denominated bonds of euro area Member States can be activated immediately subject to the EFSF or CIF capacity available, on the basis of ECB analysis recognizing exceptional market situation and contagion risk that could threaten financial stability of the euro area as whole and its Member States, and the compliance with the acceptance procedure. Interventions are implemented based on the decision of the EWG/Board of Directors technical sub-committee including the ECB

The SMP allows the ESCB to buy all marketable debt instruments if they are a) denominated in EUR, b) either (i) issued by central governments or public entities of the Member States whose currency is the Euro, or (ii) issued by other entities incorporated in the euro area and meeting the asset eligibility criteria of the ECB collateral rules for repo operations. The EFSF secondary market intervention will have a more limited scope being directed towards euro denominated securities issued by the public sector of a euro area Member State.

The operational setup of the EFSF or CIF secondary market purchases will ensure transparency (use of electronic platforms as well as voice to execute the transactions), equality of treatment and search for performance by putting intermediaries in competition with the objective to trade at the best price. Communication of the main elements of the programme will be made to the public.

5. Management of the portfolio of bonds

Once bonds have been bought and booked in the EFSF securities account, four strategies can be implemented:

- Sell the bonds back to the market when the demand is restored: this would necessitate an active risk management and would potentially disturb the issuance of the country on the Primary market,
- Hold the bonds to maturity: this will increase the total amount of guaranties used and reduce EFSF's lending capacity. This would limit the market risk and is consistent with the actual policy of the ECB.
- Keep the bonds as available for sale and sell the bonds back to the country, which could have a positive impact on its debt ratio if the transaction is done under par value.
- Use bonds for repos with commercial banks to support the liquidity management of the EFSF.

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EFSF Guideline on Precautionary Programmes

1. Introduction

At the Euro Area Summit on 21 July 2011, the Heads of State or Government of the Euro Area and EU institutions agreed to increase the flexibility of the EFSF in order to address contagion by allowing them to (i) act on the basis of a precautionary programme; (ii) finance recapitalisation of financial institutions through loans to governments including in non-programme countries; (iii) intervene in the secondary markets on the basis of an ECB analysis that financial stability is at risk.

On 26 October Heads of State or Government of Euro area countries agreed to enhance the capacity of the EFSF by allowing EFSF to provide credit enhancement to primary bonds issued by a MS and creating Co-investment funds (CIF). CIFs would allow the combination of public and private funding to enlarge the resources available for EFSF. Credit enhancement to primary bonds could inter alia be provided by means of partial protection certificate issued together with primary bonds of the MS.

2. Objective

The objective of a precautionary programme is to support sound policies and prevent crisis situations by encouraging countries to secure the possibility to access EFSF assistance before they face difficulties raising funds in the capital markets. In this way, precautionary programmes should help Member States whose economic conditions are still sound to continue refinancing via the market, while at the same time avoiding the possible negative connotations of being a 'programme country', i.e. actually in receipt of external financial assistance. Beyond helping to reinforce the credibility of the country's macroeconomic performance, an important contribution of a precautionary programme may be the positive signal that it sends to markets. This means a precautionary programme should be designed in a way that reduces the stigma effect of a regular programme, while ensuring an appropriate strict conditionality.

By its nature as a crisis prevention tool, the precautionary programme should have lighter procedures and be more swiftly implementable than the regular crisis resolution programmes supported by the EFSF. The less cumbersome procedures should allow countries to react in a timelier manner in order to prevent a crisis and reduce exposure to contagion, as well as to send a positive signal and comfort financial markets that this is only a short-term arrangement.

More flexibility means that a precautionary programme could be seen as a 'reserve type' instrument, i.e. a credit line to overcome external temporary shocks to prevent a crisis from occurring. As a corollary, it is important that the resources available are sizable enough to counter doubts that the country has sufficient funds to meet its financing needs and to give market confidence. However, the tool should not merely be seen as a liquidity facility but as an effective and comprehensive crisis prevention tool.

3. Type of credit lines

Types of credit line

	Precautionary conditioned credit line (PCCL)	Enhanced conditions credit line (ECCL)
Access	<ul style="list-style-type: none"> Countries with robust policy frameworks and very strong track records in economic performance 	<ul style="list-style-type: none"> Countries with sound policies and fundamentals, but with some vulnerabilities that preclude using the PCCL
Benchmark	<ul style="list-style-type: none"> IMF's FCL 	<ul style="list-style-type: none"> IMF's PCL
Ex-ante conditions	<ul style="list-style-type: none"> Yes 	<ul style="list-style-type: none"> Yes
Ex-post conditions	<ul style="list-style-type: none"> No 	<ul style="list-style-type: none"> Yes
Cap	<ul style="list-style-type: none"> No upfront cap 	<ul style="list-style-type: none"> No upfront cap
Typical size	<ul style="list-style-type: none"> 2-10% of GDP 	<ul style="list-style-type: none"> 2-10% of GDP
Information exchange	<ul style="list-style-type: none"> Yes 	<ul style="list-style-type: none"> Yes
Duration	<ul style="list-style-type: none"> 1 year, renewable for 6 months twice 	<ul style="list-style-type: none"> 1 year, renewable for 6 months twice

Three types of credit lines are foreseen: a precautionary conditioned credit line (PCCL) and an enhanced conditions credit line (ECCL), and an enhanced conditions credit line offering partial risk protection (ECCL+). There is no explicit upfront cap, but the size of the credit lines, unless provided as risk protection, is expected to vary between 2 and 10% GDP of the Member State concerned. The degree of risk protection is specified in the terms and conditions as adopted by the Eurogroup.

3.1 A precautionary conditioned credit line (PCCL)

Access to a PCCL, which can be drawn as a loan or primary market purchase, is based exclusively on pre-established conditions and is limited to euro area Member States where the economic and financial situation are still fundamentally sound and which remain evidently committed to maintaining sound and credible policies in the future.

A *global assessment* shall be made on whether a Member State qualifies for PCCL, using as a basis the following criteria:

- The respect of the SGP commitments. Countries under excessive deficit procedure could still access PCCL, provided they fully abide by the various Council decisions and recommendations aiming at ensuring a smooth and accelerated correction of their excessive deficit.
- A sustainable public debt.

- The respect of their EIP commitments. Countries under an excessive imbalance procedure could still access PCCL, provided that they can demonstrate that they are committed to addressing the imbalances identified by the Council.
- A track record of access to international capital markets on reasonable terms.
- A sustainable external position.
- The absence of bank solvency problems that would pose systemic threats to the euro area banking system stability.

The beneficiary Member State shall ensure a continuous respect of the eligibility criteria after the PCCL is granted, to be monitored by the Commission. The PCCL has an initial duration of one year and is renewable twice, for six months each time. The availability fees charged shall aim at covering fully the costs occurred by the EFSF.

3.2 An enhanced conditions credit line (ECCL)

Access to an ECCL, which can be drawn by way of a loan, primary market purchase is open to euro area Member States whose general economic and financial situation remains sound, but which do not comply with some of the eligibility criteria required for accessing a PCCL. Accordingly, the Member State concerned shall, after consultation of the Commission and of the ECB, adopt corrective measures aimed at addressing the above mentioned weaknesses and avoiding any future problems with access to market financing, while ensuring a continuous respect of the eligibility criteria which were considered met when the credit line was granted.

The ECCL has an initial duration of one year and is renewable twice, for six months each time. The availability fees charged shall aim at covering fully the costs occurred for the EFSF.

3.3 An enhanced conditions credit line with sovereign partial risk protection (ECCL+)

In addition, an ECCL can be provided in the form of sovereign partial risk protection to primary bonds. The Partial Protection Certificate gives the holder of the certificate a fixed amount of credit protection equal to a percentage of the principal amount of the sovereign bond. The sovereign bond and certificate are issued together to investors, but the bond and the certificate will be detachable and traded separately. In order for investor to claim the protection, the investor will be obliged to demonstrate that they hold outstanding sovereign bonds of that Member State of at least the same principal value as the original bond covered by the Certificate.

Access to the ECCL+ corresponds - as a basis - to the same criteria and conditionality as that of the ECCL, while reflecting the specific circumstances requiring the issuance of a PPC. The MoU will detail the corrective measures to be adopted during the availability period and the commitment to comply with the eligibility criteria for the duration of the PPCs. Non-compliance would lead to a revised or new MoU including new policy measures if needed.

The beneficiary Member State would be allowed to draw on this facility by making PPCs available together with its primary bonds issuance as long as it complies with the conditionality within the maximum availability period of one year, renewable twice for six months. Any payments under the certificate, which would only be due in case of a credit event, could occur beyond the availability period depending on the maturity of the certificate. The possible duration of the EFSF engagement will be set in the Financial Facility Assistance Agreement.

EFSF will charge an availability fee to cover all funding and operational costs. The beneficiary Member State will also have to cover any costs related to a protection payment.

4. Accompanying enhanced surveillance

A Member State receiving an ECCL, ECCL+ or drawing a PCCL is placed under enhanced surveillance by the Commission for its availability period. The content of the enhanced surveillance will vary according to the nature of the risks to financial stability or imbalances to address. Where the regular EU multilateral surveillance (EIP, SGP...) identifies possible risks with regards to the financial stability of the Member State concerned after the end of the availability period, the Commission is expected to make this Member State subject to enhanced surveillance.

On a request from the Commission, it shall notably:

- (a) Communicate any information needed for the monitoring of public expenditures and tax revenues;
- (b) Carry out an Audit of its public finances (covering both revenue and spending sources);
- (c) Carry out, under the supervision of Eurostat, an audit of the quality of the statistics used for establishing the public accounts;
- (d) Communicate to the Commission and the ECB on a weekly basis disaggregated information on developments in its financial system;
- (e) Carry out, under the supervision of the European Banking Authority, stress test exercises or sensitivity analysis necessary to assess the resilience of the banking sector to various macroeconomic and financial shocks, as indicated by the Commission and the ECB, and share the detailed results with them;
- (f) Provide the EFSF with all necessary information required for the execution of its lending activity and related risk management (such as monthly information regarding its financial condition, cash balance and other key information that would usually be provided for facilities of this type and any of the information mentioned above if deemed useful).

5. Procedure and activation

The involvement of the IMF in the design and implementation of precautionary programmes will be actively sought in all cases. To benefit from an EFSF credit line, the request by the Member States concerned shall follow the following steps:

- (a) A euro area Member State makes a request for a credit line to the members of the Eurogroup.
- (b) The members of the Eurogroup task the Commission, in liaison with the ECB, to assess the risk of future problems in maintaining access to market financing on reasonable terms, the respect of the eligibility conditions and the possible need for corrective measures of the Member State making the request.
- (c) On the basis of this analysis, the members of the Eurogroup decide by unanimity on a proposal from the EFSF whether to grant such a credit line, its type (PCCL, ECCL or ECCL+), amount, and duration. In order to allow for rapid activation if needed, there will be a MoU and a Financial Assistance Facility Agreement (FFA) specifying already the modalities

of possible financial assistance if the precautionary programme were to be activated. The FFA will be signed along with the MoU.

(d) The Commission, in liaison with the ECB, will carry out an enhanced surveillance of the Member State concerned (where a ECCL/ECCL+ is granted or a PCCL drawn) and report every three months to the members of the Eurogroup Working Group on the persistence of the risk of future problems in maintaining access to market financing on reasonable terms and on the continuous respect of the policy conditions (including the implementation of the corrective measures announced by the beneficiary Member State in case of ECCL/ECCL+).

(e) In case the Member State deviates from its policy conditions or if those commitments have become clearly inadequate to resolve the threat of financial disturbance, the members of the Eurogroup, after having received an analysis from the Commission prepared in liaison with the ECB, may decide on a proposal from the EFSF to close the credit line. The beneficiary Member State will then be expected to request a regular stability support, with a full macroeconomic adjustment programme, following the procedure applicable to it.

(f) The activation of the credit line is at the initiative of the beneficiary Member State. The Member State has the flexibility to request the draw-down of funds or a primary market intervention at any time during the availability period of the credit line according to the agreed terms. It shall inform the EFSF at least a week in advance of its intention to draw funds, depending on the intended size. The maximum size of a tranche or primary market purchase shall be set in the initial decision to grant a credit line. The lending conditions will be the same as for regular EFSF loans.

(g) The fulfilment of the conditionality of the MoU shall be reassessed and the adequacy of a precautionary programme re-evaluated by the members of the Eurogroup Working Group, on the basis of an EFSF proposal that incorporates the analysis from the Commission, in liaison with the ECB, when funds are drawn by the beneficiary Member State. A decision shall be taken on a case by case basis by the Eurogroup Working Group on whether the beneficiary Member State steps out from its guarantee to the EFSF.

Haushaltsausschuss

17. Wahlperiode

Ausschuss-
drucksache:

4230

Maximising the capacity of the EFSF

Draft Terms and Conditions – November 2011

On 26 October 2011, Heads of State or Government of euro area Member States agreed on maximizing the capacity of EFSF based on two approaches. They mandated the Eurogroup to finalise the terms and conditions for the implementation of these modalities in November, in the form of guidelines and in line with the draft terms and conditions prepared for the EFSF.

The two approaches achieve the objective of enlarging the capacity of the EFSF without increasing the euro area Member States' guarantee commitments underpinning the EFSF, respecting fully the rules of the Treaty. Within the terms and conditions of the ratified Framework Agreement, the options are designed to support the continued market access of euro area Member States under financial distress and safeguard financial stability of the euro area. The options could provide immediate and credible support, always linked to appropriate conditionality and seeking co-operation with the IMF, whilst preserving the credit standing of the EFSF and its objectives.

The rationales of the two approaches are:

- Option 1: Credit enhancement to primary sovereign bonds issued by Member States aimed at increasing demand for new issues of Member States' sovereign bond programmes and lowering the Member State's funding costs thereby supporting the sustainability of public finances.
- Option 2: The creation of one or more Co-Investment Funds (CIF) to allow the combination of public and private funding to enlarge the resources available to EFSF's financial assistance instruments. The CIF would aim to create additional liquidity and to enhance market capacity to fund loans. It would purchase bonds in the primary and/or secondary markets. Where the CIF would provide funding directly to Member States through the purchase of primary bonds, this funding could, inter alia, be used by Member States for bank recapitalisation.

Financing under options 1 and 2 will be linked to a Memorandum of Understanding entailing policy conditionality appropriate to the financial instrument chosen, and monitoring and surveillance procedures as specified in the EFSF Guidelines. Option 1 will be applied under the guidelines for precautionary programmes or under regular programmes. Option 2 will follow the guidelines on primary and secondary market purchases. These two financing approaches will strengthen the capacity to implement the tools available to EFSF – precautionary programmes, secondary market purchases, bank recapitalisation, as well as loans and primary market purchases, within the overall governance approach akin to EFSF financial support.

The following sections provide more detailed terms and conditions.

Option 1 – Sovereign partial risk participation

Product	<p>Member State bond issued in combination with a Partial Protection Certificate of the same maturity as the attached bond. The sovereign bond and the Certificate are initially offered together to investors. The bond and the certificate will be detachable after initial issue and can be traded separately.</p> <p>For any Member State to have the benefit of the certificate, it will be necessary for the Member State to enter into a Memorandum of Understanding specifying inter alia conditionality, and a Financial Assistance Facility Agreement (FFA) with EFSF</p> <p>The Partial Protection Certificate gives the holder of the certificate an amount of fixed credit protection equal to [20% – 30%] (to be determined in the light of market circumstances) of the principal amount of the sovereign bond to which it was initially attached.</p>
Purpose	<p>The main objective is to facilitate issuance by Member States at sustainable rates maximising EFSF capacity while providing a predefined degree of protection to investors.</p>
Issuer	<p>Sovereign bond is issued by Member States in line with their normal issuance process for a maturity decided by the Member State, in co-operation with the EFSF.</p> <p>The sovereign bond, identical in form to others issued by the relevant Member State, is issued at a lower yield than current market yields for the Member State, reflecting the partial protection provided by the certificate.</p> <p>The Partial Protection Certificate is issued by a special purpose vehicle (SPV) in Luxembourg for the same maturity as the bond to which it is initially attached.</p> <p>The SPV would not be legally connected to the EFSF or Member States.</p>
Partial Protection Certificate	<p>The certificate gives rise to a claim in the event of a Member State credit event under the full ISDA definition, which covers</p> <ul style="list-style-type: none">(a) failure by the Issuer to make full and timely payments of amounts scheduled to be due in respect of one or more bonds, subject to grace periods; or(b) repudiation or moratorium; or(c) restructuring <p>These losses will be determined based on the ISDA procedures.</p> <p>[In addition, in the case of Modified Sovereign Restructuring</p> <ul style="list-style-type: none">(i) Modified Sovereign Restructuring means a voluntary

restructuring, exchange or debt buy-back or other event affecting a sufficiently high percentage of the private holders of one or more obligations and resulting in one of the Reserved Matters listed in the Collective Action Clauses being adopted by the euro area Member States.

- (ii) In order for the Modified Sovereign Restructuring event to be triggered the aggregate amount of obligations affected must reach a threshold to be specified.

If a Modified Sovereign Restructuring event is triggered, the full [20%-30%] of protection will be paid out.]

The SPV shall finance the payments due by receipt of drawings made under a financial assistance facility agreement ("FFA"). The SPV will settle the claim by delivering cash or EFSF bonds. Under this route, the claim is unfunded until the time of a call. Upon investors' request it could be considered, that claims would be funded at the outset.

The investor will be required, at time of claim or settlement, to demonstrate that they hold outstanding sovereign bonds of that Member State of at least the same principal value as the original bond covered by the Certificate.

Regulatory considerations

The necessary regulatory approvals or exemptions will be sought

Option 2 – Co-investment Approach

Product	<p>Co-Investment Fund (CIF) established to invest in sovereign bonds of Member States, in primary and/or secondary markets.</p> <p>The CIF will have one or more compartment(s). Each compartment could either be dedicated to a single Member State or to more than one Member State.</p> <p>The CIF will have a predefined lifetime.</p>
Purpose	<p>The CIF will attract external capital sources to Member States' sovereign debt markets, maximising EFSF resources while providing a degree of protection to investors.</p> <p>The CIF will invest in sovereign bonds of a Member State which has entered into a Financial Facility Assistance Agreement (FFA) with EFSF. Where the CIF provides funding directly to Member States through the purchase of primary bonds, this funding could, inter alia, be used by Member States for bank recapitalisation.</p> <p>The CIF will as a rule hold the bonds to maturity, but could have some flexibility to sell them earlier in pre-defined circumstances under normal market conditions.</p>
Issuer	<p>The CIF will be a subsidiary of the EFSF, domiciled in Luxembourg. It will have a board of directors appointed by the EFSF.</p> <p>The investment policy of the CIF will be specified at the outset by the Board and will provide investors with clarity about how their interests will be protected through the CIF's decision-making and investment guidelines. The principles for buying bonds will be compatible with the approved guidelines for EFSF's purchases of primary and secondary bonds.</p> <p>The CIF will have three layers: First Loss Tranche, a Participating Tranche, freely tradable and potentially a third layer of a rated Senior Debt Tranche, freely traded. Selected CIF compartments may adopt a two tranche structure if needed to meet investor preferences.</p> <p>All tranches would have maturities equal to the life of the respective CIF compartment, although maturities in the potential third tranche of Senior Debt could be linked to the underlying sovereign bonds acquired by the CIF.</p>

Size of Issuer	<p>The size of each tranche will be determined in the light of take-up from investors in the Participating Tranche and bond investors' appetite for any Senior Debt Tranche.</p>
First Loss Tranche	<p>A first loss tranche will be financed by the EFSF.</p> <p>A coupon of the first loss tranche will be set to cover the all-in funding and related operational costs of the EFSF. The tranche is made available to the CIF after the EFSF enters into a FFA with the relevant Member State and the signing of a MoU specifying conditionality.</p> <p>At maturity of the CIF, or earlier in the case of any sale of underlying bonds, the First Loss tranche will be redeemed from disposal proceeds, after redemption of the capital of any Senior Tranche, the Participating Tranche, but ahead of any gains.</p> <p>The EFSF funding for the First Loss Tranche will be guaranteed by the Member States.</p>
Participating Tranche	<p>A tranche of participating units will be sold to investors; these units will be tradable.</p> <p>The tranche ranks ahead of the First Loss Tranche in any distributions of gains from the CIF, after repaying the capital contribution from both the First Loss Tranche and the capital of the Participating Tranche.</p> <p>The tranche would be funded in pre-agreed drawdowns and any undrawn commitments to be supported by acceptable commitments.</p> <p>It will receive a coupon from the cashflows being generated by the CIF. This may rank in priority to, or after, the coupon due on the the First Loss Tranche. The coupon due on any Senior Bond tranche will rank ahead of both these tranches.</p> <p>At maturity of the CIF, or earlier in the case of sales of the underlying bonds, the Participating tranche will be redeemed pro-rata from disposal proceeds, ahead of the First Loss Tranche but prior to distribution of any gains.</p> <p>The majority or all of the gains made on investments at termination of the CIF will be allocated to this tranche, after repayment of all Senior Tranche and EFSF First Loss capital.</p>
Senior Debt Tranche – optional	<p>The CIF can issue rated fixed-income senior bonds, ranking ahead of the Participating Tranche and the First Loss Tranche.</p> <p>The bonds will have a target rating of AA/A dependent on the underlying securities purchased.</p>
Regulatory considerations	<p>The CIF will obtain the necessary regulatory authorization/exemptions within the EU and other jurisdictions where it operates or adopt operational guidelines which ensure compliance with securities and other regulations.</p>

