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European Rates Strategy

No Free Lunch: Update of EFSF Leverage Proposals

Robert Crossley
+44-20-7986-9255
robert.crossley@citi.com

- The EFSF remains inadequate to the task before it, in our view.
- The latest proposals do not materially change the picture.
- All roads still lead to Frankfurt.
- The ECB is unlikely to act before governments.
- Bond markets are going to struggle to turn optimistic.
- The risk/reward for bond investors hasn't changed: still little reason to buy.

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

No Free Lunch

Update of EFSF leverage proposals: squaring the circle?

We examine the latest proposals to calm the bond markets and explain why we think the proposals to leverage the EFSF are fundamentally flawed. The EFSF remains inadequate to the task before it, in our view. All roads still lead to Frankfurt, but the ECB is unlikely to act before governments. Bond markets are going to struggle to turn optimistic. The risk/reward for bond investors hasn't changed: there is still little reason to buy

The latest proposals[1]

The proposal

Partial Risk Protection (PRP): issuing 20-30% protection certificates alongside new debt that would give rise "to a claim in the event of a Member State credit event".

What it overlooks

Leaving aside natural investor scepticism as to what would definitely trigger the guarantee given recent discussions surrounding Greece CDS, the fundamental point is that a guarantee is only as good as the guarantor's ability (and willingness) to honour it. The key question is who is ultimately providing this PRP. As we said before when this idea came up in the guise of first loss protection, though admittedly only 10-15% (instead of the current proposed 20-30% and which would be tradeable), that is still cold comfort in event of a default where loss rates are more typically north of 50%. An investor would be happy to have the protection for free but it is unlikely to make a material impact on the decision to buy or not to buy.

The proposal

The Co-investment Fund (CIF): creating EFSF subsidiaries "which would attract external funding" with capital layers providing different risk profiles.

The problem it overlooks

Once again this relies on investor appetite. Spreads on EFSF bonds do not point to pent up demand.

The bottom line

The statement optimistically states that "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."

Most would agree that the EFSF is too small, that nobody wants to increase their guarantees or put actual money in, and that Treaty change would be both tortuous and way too slow to arrest the crisis. However, PPP and CIF are essentially nothing new, and neither solve the problem nor address it in a meaningful way.

The ECB will not act before governments

The proposals for the ECB to give the IMF more firepower are unlikely to happen until the ECB are satisfied that governments are taking credible action on the necessary scale and in an appropriate timeframe. That hasn't happened yet.

The basic problem

Making the EFSF bigger: theory and practice

We have said from the outset that the EFSF is too small to do the job required. The conundrum is how to increase the EFSF's capacity without committing any more money. Unfortunately the laws of economics haven't been repealed, and there is no free lunch. That is the unpalatable truth facing policy-makers and politicians alike, but one they still seem yet to fully grasp.

Recognition of the inadequate size of the EFSF is behind the leverage debate and proposals. The headline idea may be right (make it bigger), but the devil is in the detail and there are significant problems with all the proposals. For this and other reasons, we argue that all roads in this crisis ultimately lead to Frankfurt.

[1] See 30 November, *Sovereign Debt Crisis Update*, Juergen Michels.

Options to increase the EFSF's firepower

The two main options to increase the EFSF's firepower that don't necessarily require another change in the EFSF framework agreement (and therefore an unlikely and drawn-out ratification process by all 17 member states) are:

Route 1: repo operations

1. Leveraging via repo operations with either the Eurosystem or market participants, using purchased sovereign bonds. This option drifts in and out of the news according to the political currents. Although not currently on the table, the reasons why it doesn't work cast light on the fundamental tensions at the heart of various proposed 'solutions'.

Route 2: guarantees

2. Provision by the EFSF of (first loss) guarantees to a third party up to the remainder of the EFSF's notional €440bn capacity not already spoken for. The third party, which could be either the ECB, or a joint SPV with a supranational, or private investors, would then purchase government bonds.

Problems with the repo route and the wider implications

The EFSF becoming a bank in order to do repos would probably require ratification

To obtain the status of an eligible counterparty in the Eurosystem that the EFSF would require to use ECB open market operations, the EFSF would need to become a bank. That would, in the view of our experts, probably require a change in the EFSF framework and hence ratification by all 17 member countries.

Ways to sidestep the ratification hurdle

One way to sidestep this would be for the EFSF to repo bonds to the private sector, but it is an open question how happy counterparties would be conducting large scale repo operations with an EFSF that might not be AAA-rated. Another way to sidestep the ratification difficulty would be to access the ECB window through an SPV created by an entity that is already an eligible counterparty with the ECB, e.g., the EIB. However, as our economists put it, "it is not obvious" that this would be consistent with the mandate of the EIB[2] . And to change that the 27 EU member countries that own the EIB would have to agree. No mean feat.

Mandates can't just be ignored

But it is not the EIB's mandate that is the main problem: it is the ECB's. As Bundesbank President Jens Weidmann – who is clear that ECB funding of the EFSF as "equivalent to the monetary financing of state budgets"[3] - puts it:

> *We have a mandate and we have to stick to our mandate. Fixing an interest rate for a country is certainly not compatible with our mandate. You would guarantee a certain refinancing cost for a government and you could not argue that this was not monetary financing[4]…*

Weidmann hits the nail on the head

> *The role of the central bank is clearly defined. It is to ensure price stability and to support the competent authorities in ensuring financial stability. With this formulation, it is clear that the responsibility for financial stability lies with governments. The EFSF [the European financial stability facility] or the ESM [its successor, the European stability mechanism] are ways to buy time and, in that sense, are sensible instruments…*

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[2] And in any case the EIB's balance sheet (€438bn and subscribed capital of €262bn) might not be large enough to support a €2tn SPV.

[3] Financial Times, 13 November.

[4] This issue of monetary financing is a key issue, not least because it pertains to credibility, which is the key to the whole crisis. Elsewhere in the 13 November FT interview Weidmann elaborates: "*I think the prohibition of monetary financing is very important in ensuring the credibility and independence of the central bank, which allow us to deliver on our primary objective of price stability. This is a very fundamental issue. If we now overstep that mandate, we call into question our own independence… Monetary financing set[s] the wrong incentives, neglect[s] the root causes of the problem, violate[s] the legal foundations on which we work, and destroy[s] the credibility and trust in institutions.*"

The other inconvenient feature of the landscape and possible options relates to legality, and its interpretation. Weidmann again:

What the ECB can and can't do

> *The crucial point is that the eurosystem is not permitted to lend to eurozone member states – no matter whether this is done directly or indirectly by using the IMF as an intermediary…*
>
> *The eurosystem is a lender of last resort – for solvent but illiquid banks. It must not be a lender of last resort for sovereigns because this would violate Article 123 of the EU treaty [prohibiting monetary financing – or central bank funding of governments]. I cannot see how you can ensure the stability of a monetary union by violating its legal provisions.*

So are guarantees any better?

At least the guarantee route is more obviously legal. Article 2(3) of the amended EFSF structure explicitly gives the right to provide guarantees. The idea is that the EFSF would provide (first loss) guarantees to a third party up to their €440bn capacity. The third party, which could be either the ECB, or joint SPV with a supranational, or private investors, would then purchase government bonds, up to the specified leverage limit.

Guarantees bring us straight back to the thorny issue of the ECB's mandate

But almost immediately we find ourselves back to the thorny issue of the ECB's mandate. For the ECB to take the role of the Fed in their TALF programme the ECB would have to change its stance considerably. Arguing that purchases are being done to improve the transmission mechanism of monetary policy is difficult if they are backed by guarantees from the EFSF[5].

The murkiness surrounding guarantees

But leaving this (very considerable) issue to one side, there are a number of problems surrounding guarantees. Even though ratings agencies have emphasized that there is little theoretical difference between the default probability of a AAA and AA, guarantees provided by a AA are less attractive. And it is still unclear what would actually trigger them. If a 'voluntary restructuring' of Greek debt doesn't trigger CDS, a rational investor might question the guarantee trigger[6].

No free lunch

Furthermore, any meaningful extension of the EFSF guarantees would probably lead to sovereign downgrades, and in particular of the AAAs. And ultimately "*what the 17 euro area member states gain as ultimate beneficial owners of the ECB* [whose lending to the EFSF is secured*] they lose as providers of the guarantee*"[7]. It all comes back to political will and credibility. And that is the problem.

Weidmann on what really matters

In his recent comments[8] Bundesbank President Jens Weidmann characterised the whole situation very succinctly:

> *I think the EFSF has the resources to deal with the problems in the eurozone. I don't want to say that leverage is not useful, but you just have to be aware that this is not a magic wand. Markets will look through financial engineering and it is clear that all the leverage will in the end increase the expected loss on the guarantees. What matters is whether there is political will in the countries standing behind the EFSF to honour the guarantees.*

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[5] The ECB could theoretically do large scale purchases in a non-inflationary way even without any EFSF guarantees, but its independence may be called into question if it was forced to.

[6] Also, in the same way that you don't have your disaster recovery site on another floor of your building, you wouldn't choose insurance whose ability or willingness to pay may be materially impacted by the very event you want them to insure you against.

[7] Logically, "The EA member states ought to be indifferent between the EFSF borrowing €2.2bn unsecured in the market or the EFSF borrowing €2.2bn from the ECB through repo".

[8] Financial Times, 13 November.

The repo route would probably lead to a downgrade too

Similarly, using repos to increase the effective EFSF capacity above €440bn[9] would, in the view of our economists, "*likely prompt the credit rating agencies to react immediately with a downgrade of the EFSF's AAA rating*" (28 September, *Still Too Early For A Grand Plan*). If the EFSF is downgraded to AA, not only does the theoretical pool of investors shrink[10], but also the appetite of those investors is likely to be dulled. That might not be a showstopper per se, but given the amount of issuance probably required to be digested it is a significant potential negative.

How much money is there to leverage?

And even if the (considerable) leverage hurdles can be overcome or sidestepped it is still debatable whether there is enough to leverage. €300bn is left from the effective capacity of the EFSF of €440bn after existing commitments. If €30-50bn is reserved for extension of existing/new bailout programmes, that would leave approximately €250bn for guarantees to a third party[11]. It may be uncertain how much leverage that might be allowed to support, but what is clear is that it would be a smaller amount for a AA than a AAA.

All roads lead to Frankfurt

All roads lead to Frankfurt

"*The only viable way of substantially levering up the EFSF would be an arrangement with the ECB…* [but] *this would require a turnaround in the ECB's crisis management policy. In our view, such a turnaround is only likely if the ECB sees actions (and not just pledges) from the euro area governments to implement austerity measures and structural reforms and to introduce a stricter version of the Stability and Growth Pact with automatic and biting penalties."* (Juergen Michels, et al. "*Still Too Early For A Grand Plan*", 28 September)

The bottom line

The practical importance of any credible solution is that it alters the risk/reward for investors

The problem is that we have reached a stage where even good news (or rather, the reduction of certain negative risks) doesn't lead to buying of bonds by investors or traders. There are still so many risks and negatives that there is no reason to buy, or at least not to wait. The practical importance of any credible solution is that it alters the risk/reward for investors.

Progress is being made, but policymakers, hamstrung by politics, are always behind the curve

Progress is being made, slowly[12]. But policymakers, hamstrung by politics, are always behind the curve. The circle that Europe has always had to square is that the political acceptability/workability of any 'solution' tends to be inversely proportional to the economic efficacy/impact. And as time ticks by the price for arresting the crisis rises.

Ultimately, at least one of two things has to happen

Ultimately, at least one of two things has to happen. Someone has to put their hand in their pocket (either rich countries or investors) and/or the ECB has to effectively assume risk on a massive scale at a non-market price, with all the moral hazard that goes with that.

[9] The amount backed 100% by the guarantees of the AAA-rated member states.

[10] It is easy to forget that the total EFSF issuance outstanding is currently only €16bn.

[11] Assuming loans to governments in order to recapitalize banks come from the EIB instead of the EFSF as was originally envisaged.

[12] However, it is also important to keep one's eye on some key facts: structural problems still need to be addressed, however the time is bought to allow this to happen. That time has to be used wisely and not squandered by political priorities. And growth is a necessary condition of any path out of the woods. It is symptomatic of just how desperate the crisis is that these fundamental points are relegated to a footnote and receive scant airtime.

Appendix A-1

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