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Europe

Euro SSA Strategy

The EFSF and ESM in 2013

Peter Goves
+44-20-7986-3215
peter.goves@citi.com

- **EFSF Supply:** The EFSF has announced a long-term funding range of €55bn-€60bn for 2013 and intends to issue across the whole curve up to 30-years.
- **ESM Supply:** The ESM has already provided €34.9bn of FRNs and bills to the FROB as part of the Spanish bank recapitalisation package. The prospect of tradable ESM securities in 2013 is already attracting investor interest.
- **New Investment Opportunities:** We detail the distinguishing characteristics of the ESM and update our peer analysis table for core SSA issuers. High quality supply from the EFSF will also enhance liquidity and should provide new investment opportunities within fixed income markets.
- **ESM as an Investor in SSAs:** As well as being a borrower and provider of stability support, the ESM will also be an *investor*, with ultimately €80bn of (loss-absorbing) paid-in capital to deploy according to ESM Investment Policy criteria. We see this as supportive for the broader SSA market going forward.

The EFSF and ESM in 2013

In the following three articles, we first detail supply in 2013 from both the EFSF (€55bn-€60bn indicated) and ESM. Secondly, we provide details on the ESM's operational structure and finally we analyse the market implications of the ESM's own Investment Fund Policy.

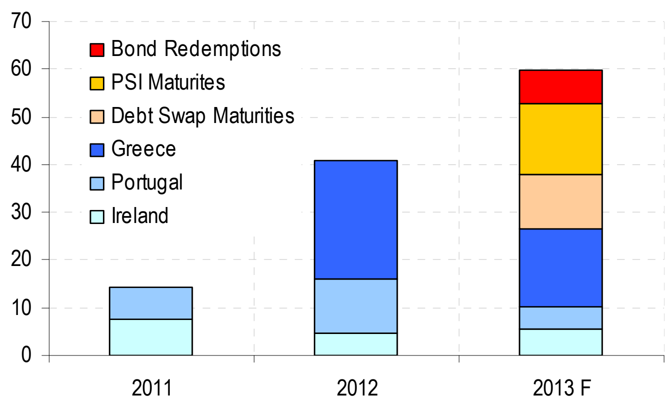
(1) EFSF and ESM issuance in 2013

Issuance was resilient in 2012 and we expect healthy demand in 2013

EFSF supply: The EFSF has announced a long-term funding target of €55bn-€60bn for 2013 and intends to issue across the whole curve up to 30yrs. This amount reflects commitments to Ireland (€5.6bn), Portugal (€4.5bn) and Greece (€16.5bn) as well as redemptions for PSI bonds (2nd Greek bailout, €14.85bn in 2013), the redemption of securities issued in the recent Greek debt swap (€11.3bn) and the redemption of the 0.125% Dec13s (€7bn). A full break down is shown in Figure 1. Figure 2 indicates the planned long-term programme on a quarterly basis.

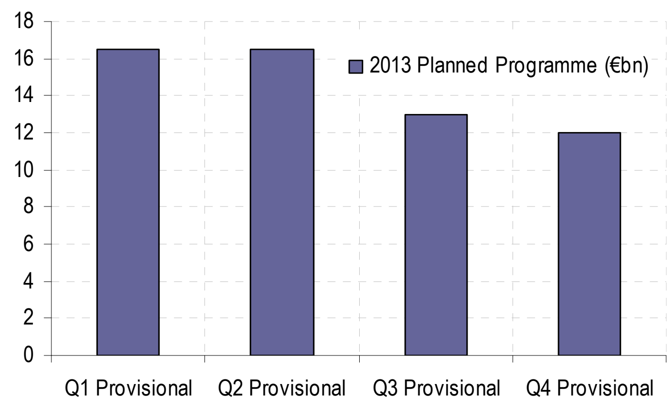
Market impact and investment opportunities: Such high quality supply is likely to improve market liquidity and provide further investment opportunities. in our view. Given the strong outright performance in 2012, relative value trading on core curves and seeking out new issue premia are recommended strategies for 2013.

Figure 1. EFSF Annual Funding Programme Breakdown (€bn)



Source: EFSF, Citi Research

Figure 2. EFSF Quarterly Funding Programme Planned for 2013 (€bn)



Source: EFSF, Citi Research

EFSF to continue servicing existing commitments: The EFSF will cease to enter new programmes after 30th June 2013. However, it will continue to service and roll over existing debt (as the loans it makes to sovereigns tend to have a higher maturity than EFSF bonds issued). It will also continue to meet existing Troika commitments in 2013 and 2014.

Figure 3. ESM Issuance on 5th Dec 2012 (€bn)

ESM Issue	Type	Amt (€bn)
ESM FRN Dec15s	FRN	12
ESM FRN Jun14s	FRN	6.5
ESM Dec14s	FRN	12
ESMTB zero Feb13s	Bill	2.5
ESMTB zero Oct13s	Bill	6.468
	Total	**39.47**

Source: ESM, Citi Research

ESM supply: On 3rd December last year, Spain requested €39.5bn for the recapitalisation of its banking sector as part of the pre-agreed package, which had earmarked up to €100bn of EFSF/ESM resources. Two days later, the ESM issued three FRNs and two bills for that purpose (Figure 3). The securities were subsequently transferred to the FROB, which will allocate resources in line with the Spanish bank recap package. As such, these bills and FRNs do not constitute tradable secondary market securities. Also note that this assistance was originally assumed by the EFSF and was later transferred to the ESM (without senior status).

ESM in 2013: The ESM indicated in its December newsletter that "*given its funding requirements, ESM is expected to launch its long-term funding programme in the second half of the year*". The ESM is also to take over the EFSF's regular bill programme. Given the prospect for ESM supply this year, we have updated our recent primer on the ESM to highlight its principal characteristics (including its Investment Policy for its own paid-in capital) and compare it with other core SSAs.

(2) The operational ESM: market implications

We see the establishment of the ESM as an important step in the development of the wider crisis management framework. The ESM's features of paid in capital, preferred creditor status and its shareholders' commitment are likely to ensure core market status within the European supranational universe. We update our primer on the ESM below, first published in the European Rates Weekly, 11th October 2012.

The ESM becomes operational: The European Stability Mechanism was officially inaugurated on 8th October 2012. As detailed above, the first issuance by the ESM occurred in early December 2012 whereby €39.4bn of securities where transferred to the FROB as part of the pre-agreed recapitalization package for Spanish banks.

Establishing the ESM is an important step in the development of the euro area's wider crisis management framework

Peer comparison: Many investors are focused on how this issuer might compare with other SSA credits – especially given the prospect that the ESM might soon issue its own tradable securities. In general, we see the establishment of the ESM as an important step forward in the development of the wider euro area architecture for combating market stresses and providing stability support (particularly in combination with the ECB's OMT programme). In general, the specific credit positives of paid-in capital, preferred creditor status and wide support from its shareholders are likely to mean the entity secures its place as a core issuer within the European SSA market. In this context, we have updated our peer analysis table for core SSA issuers as shown in Figure 4 below. Further details can be found in our note *Euro SSA Strategy - An Introduction to Core European SSA Issuers*.

Figure 4. Select Core European SSA Characteristics

	KfW	EFSM (EU)	EFSF	ESM
Founded	1948	May 2010 by EU Council Regulation #407/2010. EEC established in 1958 under the Treaty of Rome	7th June 2010	Inaugurated on 8th October 2012
Purpose / Mission Statement	"one of the world's leading and most exerienced promotional banks. We apply our expertise and strength to sustainably improve the economic, social and ecological conditions of peoples' lives" (KfW Mission Statement)	Article 122(2) of the EU Treaty stipulates "... the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned"	"EFSF has been incorporated on 7 June 2010 for the purpose of making stability support to euro-area Member States". EFSF Framework Agreement.	To provide stability support "to the benefit of ESM Members which are experiencing, or are threatened by, severe financing problems, if indispensable to safeguard the financial stability of the euro area as a whole and of its Member States". From Article 3 ESM Treaty
Guarantee Structure	Explicitly guaranteed by Germany in German law.	27 EU States guarantee the EU's budgetary commitments	17 euro area member states explicitly guarantee EFSF commitments	17 euro area member states explicitly guarantee ESM commitments
Moody's Rating	Aaa (Neg Outlook)	Aaa (Neg Outlook)	Aa1 (Neg Outlook)	Aa1(Negative Outlook)
S&P Rating	AAA (Stable)	AAA (Neg Outlook)	AA+ (Neg Outlook)	Unrated
Lending	2011 lending volume €436.7bn	Max EFSM lending is €60bn	€192bn in commitments out of €440bn in total lending capacity.	€500bn in maximum lending capacity; €100bn earmarked for the Spanish bank recaps
Capital Structure Characteristics	2011 balance sheet size of €494.8bn. Equity of €17.8bn of which €3.3bn is paid-in, nearly €6bn is in reserves and €6.1bn comes from retained earnings.	€60bn of the EU budget effectively guarantees EFSM lending. The budget is raised from 27 member states to promote EU objectives	Guarantee structure with €726bn in gross guarantees based on ECB capital proportions.	€80bn paid in capital, €620bn in callable capital. Total subscribed capital of €700bn based on ECB capital keys.
Issuance Characteristics	75%-80% of supply in EUR and USD. Euro benchmark programme in €3-5bn in size. Private placements and non-benchmarks also provided	EUR denominated only with maturities ranging 5yr-30yr with a focus on liquid benchmark issues	Euro denominated bonds issued but no formal currency restriction. Issues can be via syndications, auctions, taps and private placements	Euro main funding currency, bonds up to 30yr years. Syndications, auctions and private placements (similar to EFSF)
Bond Issuance	2012: €78.4bn 2013 expected: €70bn-€75bn	2012: €15.8bn 2013 expected: €4.7bn	2012: €44.8bn 2013 expected: €55bn-€60bn	2012: €0bn in bond issuance, €34.9bn in FRN and bills that were transferred to the FROB

Source: Annual Reports, European Commission, EFSF, ESM, Citi.

The European SSA secondary market – issuer characteristics matter

How the ESM fits into the broader SSA market

Key supras: Key European supranational issuers include the EU and the EFSF. As we have previously noted (*Euro SSA Strategy - An Introduction to Core European SSA Issuers*), the ESM has a capital structure similar to other multinational lending entities - albeit with a policy mandate to provide financial support to EMU sovereigns rather than broader pan-European economic objectives. Formally, the ESM is an intergovernmental organisation enshrined in international law (unlike the EFSF, which is a vehicle established under Luxembourgish law).

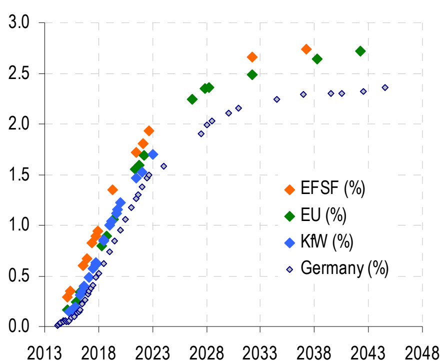
Core SSA issuers have benefited from their relatively high credit quality but the market still differentiates by issuer

Secondary market: Yield and ASW curves for key European SSA names are shown in Figure 5 and Figure 6 to indicate where such credits trade in the secondary market. Throughout much of the last year, core SSA names benefited from their high credit quality in a hunt for yield environment. That said, although there has been yield compression, there is still a degree of market differentiation among issuers. This has been a feature of the core SSA sector ever since Q3/Q4 2011 given rising EMU sovereign downgrade concerns (Figure 7). Drilling deeper into individual issuers, the market also focuses on differences in capital structure characteristics, asset quality and market traditions, and technical factors can also play their part.

Demand for core SSAs is likely to remain firm given broader euro area outlook

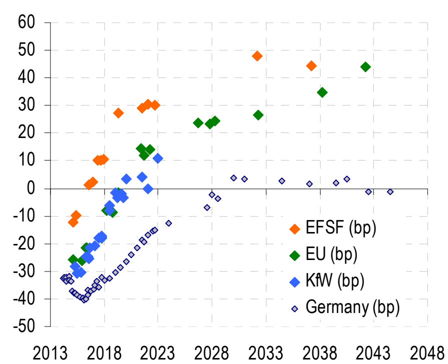
SSA outlook: As a market, we believe the SSA sector should continue to benefit from its high credit quality and relatively low volatility. Overall, given the various fundamental concerns in the euro area and likely volatility in EMU spreads, we expect demand for AAA/AA SSA paper to remain healthy in 2013. Further details can be found in our *2013 Outlook*.

Figure 5. Core European SSA and Germany Yield Curves (%)



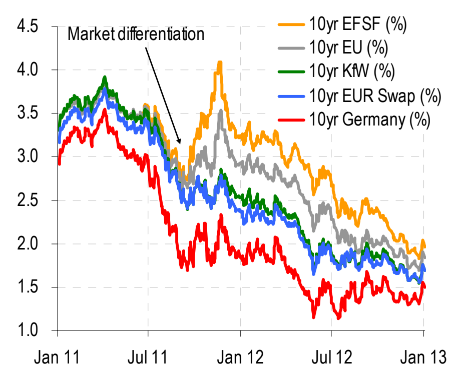
Source: Citi Research

Figure 6. Core European SSA and Germany ASW Curves (%)



Source: Citi Research

Figure 7. 10yr Yield History, Core European SSA Market, Germany and EUR swap rates (%)



Source: Citi Research

ESM characteristics and distinguishing features

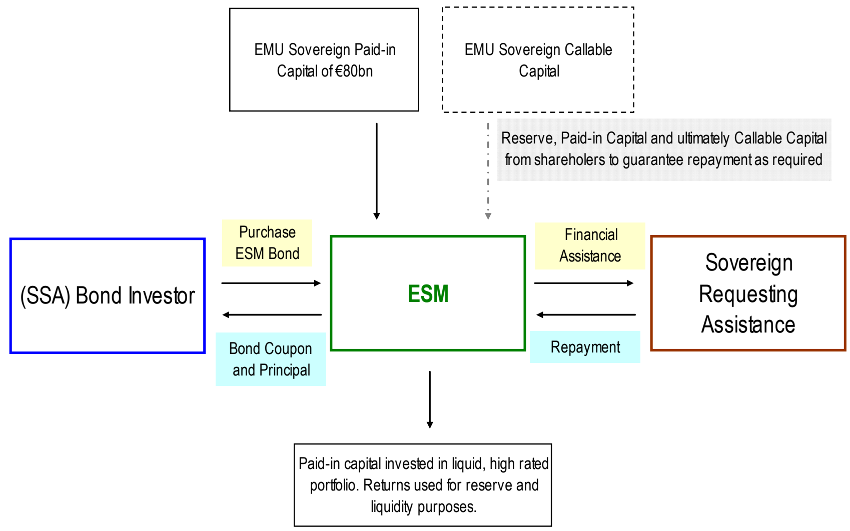
What is the ESM able to do?

ESM tools: The ESM has a capital structure similar to multinational lending institutions, although there are important differences. As an entity, it is an intergovernmental organisation established by Treaty with a Board of Governors and Board of Directors. Its purpose is to provide stability support to sovereigns who request (conditional) financial aid. It can provide loans, precautionary credit lines, purchase bonds (both in the primary and secondary market), and finance bank recapitalisations through loans to governments. Like the EFSF, the ESM can raise funds in the capital markets and then manage resources to provide financial aid.

Paid-in capital of €80bn ultimately, €32bn currently

ESM structure: Unlike the EFSF, the ESM will ultimately have paid-in capital totaling €80bn (€32bn provided in 2012, €32bn more due in 2013 and €16bn in 2014). This is to be invested in high quality assets (see page 7). Total subscribed capital is €700bn, of which €620bn is callable. The general structure of the ESM is highlighted schematically in Figure 8.

Figure 8. Likely ESM Structure, Schematic



Source: Citi Research, ESM, Moody's ESM Rating.

How does the ESM compare to the EFSF?

Key differences of the ESM vs EFSF

In some ways, the ESM is similar to the EFSF, in that its central policy mandate is to provide conditional financial aid to EMU sovereigns upon request. It also has similar tools, such as purchasing bonds and providing loans. In terms of distinguishing features and enhanced credit supports, we would highlight the following:

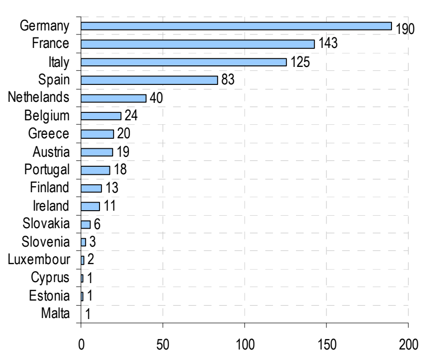
- Paid-in capital of €80bn
- Maximum lending capacity of €500bn
- Permanence
- Seniority
- Intergovernmental organization established under international law

Fundamental ratios and credit supports

Such features have already been incorporated into rating agency analyses. Fitch and Moody's recently attributed AAA and Aa1 ratings respectively. In terms of credit fundamentals, we highlight the following key ratios:

- Total lending (€500bn) to total subscribed capital (€700bn) is capped at 71%.
- The proportion of paid-in capital (€80bn) to total capital (€700bn) is 11.4%. Subscribed capital contributions are shown in Figure 9
- The ESM Treaty stipulates the maintenance of a minimum 15% ratio between paid-in capital (€80bn) and outstanding amount of ESM issuances (Article 41).

Figure 9. ESM Total Subscribed Capital Contributions (€bn)



Source: ESM, Citi.

Structural features

Capital calls: Article 9 of the ESM Treaty details how capital calls can be enforced to meet ESM obligations and maintain the integrity of the structure. The Board of Governors and the Board of Directors may call in authorised unpaid capital. In addition, Article 9(3) states that

"*The Managing Director shall call authorised unpaid capital in a timely manner if needed to avoid the ESM being in default of any scheduled or other payment obligation due to ESM creditors. The Managing Director shall inform the Board of Directors and the Board of Governors of any such call. When a potential shortfall in ESM funds is detected, the Managing Director shall make such capital call(s) as soon as possible with a view to ensuring that the ESM shall have sufficient funds to meet payments due to creditors in full on their due date".*

In addition, Article 13(6) sets out a "warning system" to ensure timely repayments to the ESM are ensured. The overall callable capital mechanism is described as "exceptional" by Fitch ("European Stability Mechanism", FitchRatings, 10th October).

ESM is rated Aa1 by Moody's and AAA by Fitch

Rating: Together with the preferred creditor status[1], the ESM has attracted a high credit quality status from the rating agencies. As with other core European supranationals (such the EU and EFSF) however, a broad credit challenge at the moment is the underlying creditworthiness of euro area sovereigns. This was recently seen when Moody's downgraded France from Aaa to Aa1 on 19th November and then subsequently moved the ESM to Aa1 according to their criteria. However, the market largely shrugged off this event in a fairly muted reaction (especially given that France was already rated AA+ by S&P since January 2012).

Bottom line: enhanced features likely to ensure core SSA status

All eyes remain on whether Spain will seek EFSF/ESM sovereign level support in 2013

ESM in 2013: More broadly, the environment for core SSA issuers remains relatively constructive in our view given the wider uncertainty in Europe. We largely focus on relative value trading strategies in 2013 and opportunities in new issues. Going forward, all eyes are on Spain and if/when the sovereign formally requests aid from the EFSF/ESM (*Global Economic Outlook and Strategy - Prospects for Economies and Financial Markets in 2013 and Beyond*). Depending on how any forthcoming financial assistance is organised, should bond purchases form part of any agreement, then we would expect the ECB do much of the heavy lifting (*Global Economics View - Three bits of good and one piece of bad news about Europe*). This could limit the extent to which we see significant ESM supply.

- The certainty in establishing the euro area's permanent stability mechanism is clearly a welcome step in the development of the wider crisis management framework.
- We believe that given the ESM's features of paid in capital (which is invested according to ESM criteria, see below), preferred creditor status and its shareholders' commitment will enable it become a core market issuer within the European supranational universe.

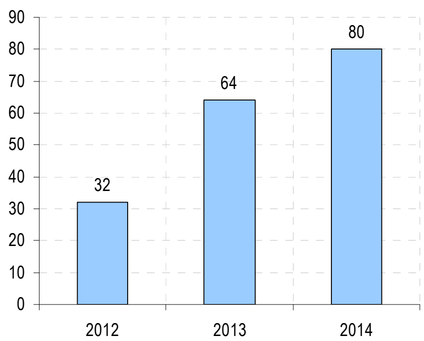
[1] Documented in the ESM Treaty. Note also that the ESM is junior to the IMF.

(3) The ESM as an Investor

As well as being a borrower and provider of stability support, the ESM will also be an *investor* itself with ultimately €80bn of (loss-absorbing) paid-in capital to deploy according to ESM Investment Policy criteria. Much of this capital is likely to find its way into highly liquid and highly rated government and SSA securities. In this updated article (first published European Rates Weekly 1st November), we focus on how this is likely to operate based on ESM guidelines. The emergence of such a buyer is likely to be supportive for the broader SSA market going forward.

An €80bn fund investing in government and SSA securities

Figure 10. ESM Cumulative Paid-in Capital Schedule (€bn)



Source: Citi Research, ESM

Paid-in capital: As stated, one of the distinguishing features of the ESM vs the EFSF, is that the ESM will ultimately have €80bn in paid-in loss absorbing capital. The full amount will be paid in gradually up until 2014 (Figure 10). The ESM had €32bn in such funds paid in over 2012.

Purpose: The ESM's Investment Policy makes clear that "*the main objective of Investment Portfolios is to ensure that the maximum lending volume is always readily available, and to absorb potential losses*". Crucially, such paid-in capital is therefore not available for ESM loans or direct stability support to sovereigns requesting financial assistance. The market value of the funds must exceed 15% of the maximum lending volume (ultimately €500bn). Such funds will be invested in securities in a "prudent" manner and allow for diversification by asset class and geography. As the ESM FAQ states: "*the paid-in capital will be invested in high quality liquid assets and in accordance with ESM investment guidelines*". Returns can be used to build reserves and/or cover operating or administration costs.

Portfolio structure and criteria

The portfolio is split into two tranches:

€5bn in short-term tranche

- **Short-term tranche:** This is to be at least €5bn in size with the purpose "*to allow the ESM to face any temporary disbursement to cover any shortfall due to a non-payment by a beneficiary country*". The investment strategy is capital preservation and will be invested in highly liquid assets at a 1-year horizon.

Remaining funds in medium/long-term tranche

- **Medium/Long-term tranche:** The remaining funds will help ensure "*the financial health of the ESM*" and will be managed to enhance returns subject to criteria. This tranche shall be invested with a capital preservation objective, at a 3-year horizon, and the market value should be such that it constitutes at least 15% of the targeted maximum lending volume.

Portfolio to comply with "General Eligible Asset Lists" and associated criteria

Figure 11. ESM General Eligible Asset List

Issuing Entities	Investment Instruments	Rating Criteria
Central Banks Sovereigns / DMOs Euro area government related agencies Supranationals	Debt Securities (including bonds, bills, covered bonds, CP, certificates of deposit) Deposits (secured and unsecured)	Minimum rating for all debt securities: equal or higher than at least AA

Source: ESM Investment Policy

According to ESM Investment Policy, assets for the short-term tranche shall be compliant with the “General Eligible Assets Lists” (detailed in Figure 11). Assets for the medium/long-term tranche will ensure that an amount equivalent to 15% of the maximum lending volume of the ESM at the time will also be invested in the “General Eligible Assets Lists”. Amounts exceeding this 15% threshold are eligible for the “Enlarged Eligible Assets Lists” which includes financial institutions.

Diversification: In both tranches, the Investment Policy is clear: “*For diversification purposes, at least 30% … shall be invested either in supranational institutions or outside the Euro area*” complying with the Eligible Assets Lists. Furthermore, “*no sovereign exposure shall represent more than its capital key as defined by the Treaty”*. Further details on the ESM contribution keys were detailed on page 5.

Bottom line: supportive for SSA spreads over time

ESM as an investor: In theory therefore, of the ultimate €75bn in the medium term tranche, at least 30% will be invested supranational institutions. Candidates meeting the AA rating and wider eligibility criteria mostly reside in the core SSA market, although it will clearly be at the discretion of the ESM managers as to how this operates in practice. Furthermore, liquid core and soft-core government bond markets such as Germany and France meet the criteria for the non-supranational portion of the fund.

Supportive for SSA spreads over time

- The ESM is the newest entrant into the wider SSA universe. The ultimate complexion of the ESM portfolios, as detailed in the Investment Policy, will likely ensure a diversified and liquid fund focused on high quality assets. In practice, this means that there is now a new marginal “buyer” of core European government and SSA paper.
- This should help support spreads over time in our view. Given the prudent and conservative manner of the fund’s characteristics, it is not necessarily the case that huge secondary market distortions should arise from this dynamic – especially not in the larger government bond markets. The head of the ESM has already indicated that in terms of moving the market, it is something “we don’t want to do”[2].
- As the capital is invested over time and the ESM further establishes itself, we expect this to be broadly supportive of spreads.

[2] Bloomberg, 30th October

Appendix A-1

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