



## How to increase the impact of the EFSF without more money?

### A Guide and State of Play (Oct 2011)

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#### Context

The EFSF is supported by the 17 Euro area Member States who have guaranteed to repay any of its liabilities up to a maximum of Euro 726 billion with each country offering a percentage of this. Germany's share of the guarantee is Euro 211 billion and France's is Euro 158 billion. Because a decision was taken that the EFSF would seek an AAA rating its capacity is limited by the amount of guarantees it has from AAA rated member states which is only Euro 440 billion.

This is enough to support Greece, Ireland and Portugal which are all small but not Spain and Italy which are also now facing unsustainably high borrowing costs. There is ZERO political will amongst member states to increase the size of their support for the EFSF so the challenge is to find a way of increasing its effective firepower without increasing MS support. The only way of doing this is **to increase the RISK** that the EFSF takes. One way of thinking about this is that now that MS have promised Euro 440 billion which they had intended to be used as **'debt'** which is relatively safe and turn this into **'equity'** which is far more risky. The size done not change, but the risk goes up.

#### History

First in [September 2010](#) and then again in [January 2011](#), Re-Define had proposed the idea that instead of borrowing from the market and then lending on to troubled countries as the EFSF currently does, the EFSF should instead encourage MS to continue to borrow from markets and offer a **'credit enhancement'** in the form of a full or partial EFSF guarantees or their new bonds. This would

- lower the interest costs as the new bonds with guarantees would be perceived to be safer
- cut down the transaction costs incurred by the EFSF having to first borrow and then lend
- make the process of supporting countries much quicker

Guaranteeing only part of the bonds, say just against the first 25% of losses, would mean that rather than every 100 Euro of EFSF capacity being only able to support 100 Euro of borrowing now that same Euro 100 could support Euro 400 of borrowing by troubled member states. That is why this idea, which had at first been rejected by the European Commission legal Service, is so attractive to the EU and has made a comeback. It is now clear that this concept, or some economically equivalent version of it, is likely to be adopted by the Euro area countries this week. We **recommend** that they limit the size to **Euro 1 trillion**.

**On the next two pages we address the Pros (page 3) and Cons (page 2) of leveraging the EFSF**

## A list of Concerns

At [Re-Define](#) we have serious reservations about some of the on-going discussions, which have bordered on the ill-informed and the irresponsible. Here are our thoughts which we have already conveyed to EU Finance Ministers for whom we had written the Original '[Leveraging Options for the EFSF](#)' paper.

**First**, we had put forward the idea at a time the crisis was contained in the periphery and now that we have a **systemic crisis**, the idea, which would have worked well then, **may not work**. With Spain and Italy in trouble, Euro area growth having come to a dead halt and the **French AAA rating fragile**, there is **only so much that the EFSF can do. The ECB will now have to increase its support, one way or another.**

**Second**, a [perverted version](#) of our idea now being promoted by Allianz and Deutsche Bank is being made to **look like a silver bullet** by them. What they are promoting looks more like [snake oil to me](#). Their optimism in terms of the degree of leverage they can apply is completely unjustified. It is very hard for us to see how the effective size of a leveraged EFSF **can be much more than Euro 1 trillion if it is to remain effective** in its primary purpose, which is to lower borrowing costs to sustainable levels.

**Third**, **any state of the world where a guarantee issued to say, Italy, would be called** because it cannot repay its debt would have to be so bad a state of the world that many other countries and banks are also likely to be in trouble in Europe at the same time. **Things will be so bad** that other Euro area countries supporting the EFSF may have trouble honouring their guarantees to the EFSF and the EFSF to the bondholders it guaranteed. **So EFSF guarantees cannot be relied on in a strictly financial sense.**

**Fourth**, a leveraged EFSF may simply not be able to fulfil its primary purpose. This purpose is to bring the borrowing costs for Italy and Spain down to sustainable levels. At present the EFSF borrows at roughly 3.5% and Italy at 6%. Italian borrowing costs need to be brought below 4.5% to be sustainable. **The more the EFSF is leveraged the higher its risk and hence the higher the price it will need to pay to borrow.** If the EFSF can only borrow at 4%, a full guarantee will bring Italian borrowing costs down to this level.

A 50% guarantee may (only roughly – as the real effect on cost reduction will be bigger) bring borrowing costs down to 5%. Of course the EFSF will not provide guarantees for free and there will be an explicit or implicit (if it offers [collateral instead of guarantees](#)) charge payable which will make Italian borrowing even more expensive. The point is that **there are serious limits to how much leverage can be applied as the higher the leverage the less effective the EFSF will be in bringing borrowing costs down.**

**Fifth**, leveraging the EFSF **may pose a direct threat to French AAA rating.** As we discussed on the previous page, EFSF leverage can only work by making the EFSF more risky. France is exposed to the EFSF to the tune of Euro 158 billion at most. If the EFSF is leveraged substantially and as guarantees start getting used increasing France's effective exposure, this may become the last straw that tips France's already fragile AAA over. However, this threat will only become real when the size of used guarantees grows large.

**Sixth**, there are other problems with the insurance proposal some of which are legal and the others market related. The split of the primary and secondary market that will occur if the EFSF guarantees new bond issuance can be problematic especially if it weighs down bank holdings of old sovereigns bonds. Also, the EFSF may have to use a collateral route because of legal problems with guarantees.

**The best solution is missing in action**

Undoubtedly **an ECB-led solution would work best to stem the panic** as we showed in this [Policy Maker Brief](#). An open-ended commitment from the ECB to buy the bonds of troubled illiquid but not insolvent MS such as Spain and Italy would be by far the best solution in an economic sense. The ECB has ruled this out vehemently. **A second possibility** is a solution that partners the ECB with the EFSF. This could either take the form of turning the EFSF into a bank which buys and then repos sovereign bonds with the ECB or the EFSF offering the ECB some form of credit protection such as guarantees on its holdings of sovereign bonds thus encouraging it to buy more bonds.

Neither of these solutions which are the first and second best options economically is politically acceptable at this point. This political infeasibility has been the main reasons that Re-Define and others have been led to explore options for expanding and leveraging the EFSF. **The choice now is between no additional help for Spain and Italy and the use of partial guarantees from the EFSF.** Eventually the ECB will have to blink.

**The hope that we and many others have is that the ECB will blink in this game of chicken** and change its mind. We know that the German government's opposition to ECB intervention is only skin deep although the Bundesbank will take the fight to the end. However Trichet remains dead opposed and Draghi will find it very hard politically to step up the ECB's commitment **to support Italian bonds simply because he himself is Italian.** So this fight continues.

The ECB, we know reliably, **will wait before things get 'much-much' worse** before it steps in. One way of achieving this outcome is to announce that there is no deal and a panic will no doubt ensue. Calling the ECB's bluff in this manner may, however, be very dangerous and cannot be controlled. A number of banks may fail.

**Is there a way that the partial insurance EFSF model may work?**

The EFSF insurance model **will certainly be better than no announcement.** In particular, the announcement itself will not trigger a downgrade of France as some have insinuated. **A non-announcement**, through a spike in Italian spreads – and their negative impact on French banks and hence the French sovereign **may do so.**

**The best way** to present the idea, which may then work, at least temporarily to restore some calm in the market would be as a **political signal** that this means that all 17 Euro member states believe that Spain and Italy are fundamentally solvent so feel comfortable putting themselves in harm's way between bondholders and any losses. As a pure financial tool, it is almost useless (see page 2).

**Another useful feature** of the guarantee structure becomes clear when you think of it as a group lending scheme, of the kind that has been very successful in **microfinance**. Default rates amongst some of the poorest and most risky borrowers have stayed very low because making a peer group jointly liable for the repayment of the loans of all its members significantly increased monitoring and peer pressure within the group for no one to free ride. **A similar logic will work here** where once France and Germany (and other Euro area countries) are liable for potential Italian losses they will do everything within their (substantial) power to stop Italy and Spain from even coming close to default let alone actually defaulting. This substantially reduces the risk for bondholders and the EFSF **could succeed in lowering the borrowing costs for Italy and Spain** if this is communicated well. In effect, the new bonds will be like **mini-Eurobonds**.

**A final point**, which is very important, is that using the EFSF in such a way would make it **politically easier for the ECB** to support Spain and Italy. We have suggested, for example, that the ECB could **selectively support the secondary market in these new bonds** through its SMP making the program more likely to succeed. And **if the EFSF dies trying**, the ECB has a perfect political cover to step up saying **there is no alternative.**