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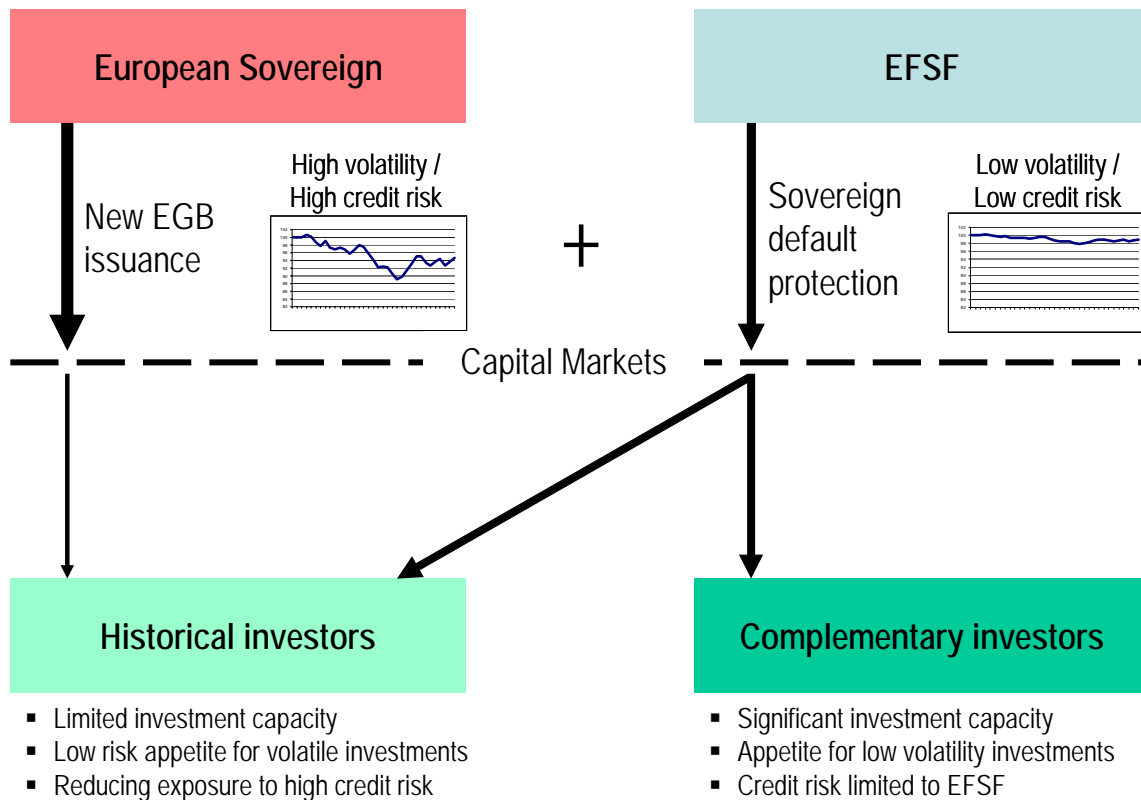
## **Proposal for the Creating Efficient Firewalls through EFSF**

### **I. Introduction**

- Stabilization of vulnerable European sovereign debt markets requires a Firewall Structure that directly dampens volatility and creates incentives for current investors to sustain their exposure and for new investors to step into the targeted market
- The structure proposed here does not purport to enhance the credit profile of targeted government bonds. Rather it acts through the technical drivers of market prices to reduce sources of speculative activity and risk premiums, thereby stabilizing conditions for current investors. By extension, the lowering of spreads will create arbitrage opportunities for new investors, increasing the provision of liquidity at government auctions and syndications
- Acting through well-established sovereign credit default protection instruments, the Firewall Structure presented here allows the EFSF to target its intervention and thereby incentivize the provision of liquidity in targeted government markets
- We focus on stabilizing conditions for the provision of liquidity through the primary market. Thus we believe that the volume of intervention required to transition to a normalized market (a process of, say, two years) will be considerably less than has been assumed to date. Recalling the modest level of activity in recent months required to dislocate the market, there will be significant efficiencies obtained (elasticity of impact on risk premiums) through intervention via the sovereign default protection market

### **II. Summary of the Structure**

- EFSF will provide sovereign default protection to investors in newly-issued European government bonds in exchange for a premium to be paid by the investor; this function could be performed through a sovereign default protection purchase window available at the time of a new government auction or syndicated issue
- An investor wishing to participate in the program will need to certify ownership of a new primary market EGB to the EFSF to be eligible for the purchase of sovereign default protection
- The sovereign default protection will provide the investor protection in the case of default or other credit event trigger (to be defined) associated with the issuer of the EGB
- The investor is essentially providing the liquidity to the issuer of the newly-issued EGB while the EFSF carries the credit risk in exchange for a fee



#### Impacts on EFSF

- EFSF will provide standard sovereign default protection to investors providing new liquidity to the European governments chosen by EFSF to participate in the program, therefore no change in the framework of the EFSF should be required
- EFSF will post/receive collateral (e.g. cash or newly-issued EFSF bonds) to reflect changes in value of the sovereign default protection contract it has provided
- EFSF will naturally build its "leverage" over time through the premiums received from providing the sovereign default protection. As noted above, we believe that it should be possible to calibrate the amount of per annum protection (assuming that existing investors will absorb a greatly diminished but still significant percentage of gross primary market issuance) broadly within the scope of existing EFSF balance sheet capacity

#### Impact on markets

- The program will have an immediate impact on the market by limiting investor interest in creating speculative positions by shorting the sovereign credit through CDS. The cost of carry of short positions will become increasingly high and the mark-to-market could move rapidly against the speculator if the EFSF lowers the cost of the sovereign default protection
- With the EFSF providing sovereign default protection at a given price for EGBs, the cash yield for the EGBs will necessarily fall as sovereign default protection levels decline. If the cash yield remains too high on the EGBs, there will be attractive negative basis opportunity for investors. This would motivate an investor to buy a newly-issued EGB in the market and to buy sovereign default protection from EFSF, leading to a high positive carry with credit



risk limited to EFSF. This creates liquidity for the EGB issuer while also leading to a tightening of the cash yield on the newly-issued EGB

- The ability for credit institutions to be used to generate the demand and liquidity needed to achieve maximum benefits of the sovereign protection program provided by EFSF will be fully scalable as credit institutions, even in times of stress, will be able to generate the liquidity needed to fund the newly-issued EGBs through ECB refinancing operations if no other source is available
- A new investor base will be created to increase the liquidity pool available to issuers of EGB eligible for this program. As with other forms of credit protection, this solution would provide additional funds currently being held in cash or other AAA fixed income investments to purchase the newly-issued EGBs benefiting from EFSF sovereign default protection. As the investor in the new instrument would be running EFSF credit risk, it would not need to be traditional buyer of EGBs of the sovereign in question
- The price stabilization and tightening bias provided by the intervention of the EFSF should also allow existing investors in EGBs to maintain their exposures and potentially even increase them to pre-crisis levels. This is essential to halt the outflow of international investors from certain EGBs

## **VI. Conclusion**

- This document proposes a Firewall Structure based on provision by the EFSF of sovereign default protection, made available to investors providing liquidity at auctions or syndications by sovereigns benefiting from this support. Efficient and targeted intervention by the EFSF will address promptly speculative behavior while taking advantage of investor responsiveness to stabilization of well-established sovereign default protection instruments