The Sovereign Firewall – Options Note

1. INTRODUCTION

On 9 December 2011, the euro-area Heads of State or Government (HoSoG) confirmed that the EFSF would remain active until mid-2013 and would ensure the financing of existing programmes, as needed, beyond that date. In addition, the HoSoG agreed that the Treaty establishing the ESM should enter into force on 1 July 2012 and that the adequacy of the lending ceiling of €500bn applied to the combined EFSF/ESM should be reassessed in March 2012.[1] On this basis, the Eurogroup has been tasked with reaching an agreement on the adequacy of the so-called sovereign firewall. Several options for reinforcing the firewall, with varying degrees of ambition, have already been discussed by the EWG. This note builds on these discussions and presents a new set of three possible options, while considering (in annex) the different implications of using the EFSF and the ESM for government deficits and debt in the Member States.

2. OPTIONS FOR STRENGTHENING THE SOVEREIGN FIREWALL

The three options, as presented in this note, explore possible avenues to increase the size of the sovereign firewall, taking into account considerations previously highlighted in discussions in the Eurogroup and the EWG, e.g. the credit quality and issuance capacity of the EFSF, the expectations of financial markets and international partners (such as the G20 and IMF), the impact of capital structure and credit ratings on the overall lending capacity of the EFSF/ESM. Each option is assessed in terms of pros and cons.

Option 1: Combining the full ESM capacity with the used EFSF capacity

This option would increase the EFSF/ESM's total lending volume beyond the current ceiling of €500bn to €700bn. However, the new available lending capacity would be €500bn (subtracting the roughly €200bn already committed under the EFSF).

- The EFSF would no longer be available for new lending after the entry into force of the ESM Treaty on 1 July 2012, but it would continue to service its existing commitments of about €200bn.
- The ESM would be available for all new lending with a capacity of €500bn depending on the pace of paid-in capital. Based on current agreements of paid-in capital, only €200bn of ESM lending capacity would be effectively available on 1 July 2012 although paid-in capital could be accelerated, if needed.

As the EFSF would continue to issue in the market beyond 1 July 2012 for a clearly defined amount to finance the outstanding commitments under the Greek, Irish and Portuguese programmes, detailed decisions would be needed on the respective roles and tasks of the EFSF and ESM with a view to organizing their smooth co-existence.

This option would comply with Recital 6 and Articles 10 and 39 of the ESM Treaty, the combination of which stipulates a combined lending ceiling of €500bn but allows for a reassessment of that ceiling. A change of the ESM Treaty would not be required; the increase in the

[1] ESM Treaty has been signed and the ratification procedures at national level are ongoing. The note assumes an end to the ratification process with entry into force of the ESM, as foreseen, in July 2012 and takes the cumulative EFSF/ESM lending volume as the base assumption.

lending ceiling to €700bn could be decided by the euro-area Member States during the March review and then endorsed by the ESM Board of Governors upon entry into force of the Treaty.

Pros:	- Immediate increase of total lending volume to €700bn. - Total new lending capacity effectively available would be €500bn, depending on the pace of paid-in capital (without impact on the liabilities of the Member States).
Cons:	- This option is not viable if it leads to competition between the EFSF and ESM as issuers in the market. The two entities would have to coordinate their funding activities to avoid competition. - The unused EFSF capacity would be lost immediately at the time when the ESM enters into force and takes over new lending operations. - The EFSF used capacity will progressively disappear as those amounts are reimbursed by beneficiary Member States without the possibility of being re-used. - The new lending capacity of €500bn would most likely be insufficient to unlock resources from other G20 partners. - The markets could consider the new lending capacity to be insufficient in the event that one or several large Member States would need to be taken out of the market. As a result, the brunt of the stabilisation effort would be likely to continue to fall on the ECB.

Option 2: Combining the full ESM and EFSF capacities

This option would increase the EFSF/ESM's total lending volume beyond the current ceiling of €500bn to €940bn. The new available lending capacity would be temporarily increased to €740bn until 30 June 2013.

- The EFSF would remain available for new lending after the entry into force of the ESM Treaty on 1 July 2012, servicing its existing commitments of about €200bn and providing new lending capacity of about €240bn until 30 June 2013. Thereafter, the new lending capacity would no longer be available.

- The ESM would be available for all new lending with a capacity of €500bn depending on the pace of paid-in capital. Based on current agreements of paid-in capital, only €200bn of ESM lending capacity would be effectively available on 1 July 2012 although paid-in capital could be accelerated, if needed.

As the EFSF would continue to issue in the market beyond 1 July 2012, detailed decisions would be needed on the respective roles and tasks of the EFSF and ESM with a view to organizing their smooth coexistence. Keeping the EFSF and ESM in the market based on some functional differentiation, where the EFSF would be restricted to engaging in non-cash transactions, funding activities concentrating on the long- or short-end of the yield curve, or funding leverage options would raise operational difficulties for the EFSF and does not seem sustainable over an extended period.

This option would comply with Recital 6 and Articles 10 and 39 of the ESM Treaty, the combination of which stipulates a combined lending ceiling of €500bn but allows for a reassessment of that ceiling. A change of the ESM Treaty would not be required; the increase in the lending ceiling to €940bn could be decided by the euro-area Member States during the March review and then endorsed by the ESM Board of Governors upon entry into force of the Treaty.

Pros:	- Immediate increase of total lending volume to €940bn. - Total new lending capacity effectively available would be €740bn, depending on the pace of paid-in capital to the ESM (of which up to €500bn without impact on the liabilities of the Member States); new lending capacity would fall back to €500bn from 1 July 2013 - The implied newlending capacity would be more likely to unlock resources from other G20 partners. - The markets would be more likely to consider the new lending capacity sufficient and the brunt of the stabilisation effort would no longer fall on the ECB
Cons:	- This option is not viable if it leads to competition between the EFSF and ESM as issuers in the market. The two entities would have to coordinate their funding activities to avoid detrimental competition. - The unused EFSF capacity would be lost when the facility is discontinued. - The EFSF used capacity will progressively disappear as those amounts are reimbursed by beneficiary Member States without the possibility of being re-used.

Option 3: Transforming the unused EFSF guarantees into ESM capital

This option would increase the EFSF/ESM's total lending capacity beyond the current ceiling of €500bn to €940bn. The new lending capacity of the ESM would be permanently increased to €740bn.

- The EFSF would no longer be available for new lending after the entry into force of the ESM Treaty on 1 July 2012, but it would continue to service its existing commitments of about €200bn.

- The unused EFSF guarantee commitments of about €240bn would be transformed into additional subscribed capital of the ESM implying a new ESM lending capacity of approximately €740bn. The ESM would be available for all new lending up to this capacity, depending on the pace of paid-in capital. Based on current agreements of paid-in capital, only €200bn of ESM lending capacity would, however, be effectively available on 1 July 2012 although paid-in capital could be accelerated, if needed.

Considering that the ESM has a permanent nature and a more flexible capital structure compared to the EFSF, this is the most far-reaching option. It would implement a permanent increase of the capacity of the sovereign firewall, as it would ensure that part (or the whole) of existing EFSF guarantee stock would be transferred to the ESM.

This option would comply with the ESM Treaty and, therefore, require no Treaty change However, parliamentary approval for a change in the ESM authorized capital stock would be required.

Pros:	- Immediate increase of total lending volume to €940bn - Total new lending capacity effectively available would be €740bn, as the unused capacity of the EFSF would become permanent under the more streamlined and effective structure of the ESM. - Because guarantees and callable capital imply the same exposure for national budget, transforming the sums earmarked as guarantees into callable capital would have no additional fiscal impact.

	- Working exclusively through the ESM would not affect national public debt beyond the amount of paid-in capital to be raised on the market (see Annex for further explanation). - There would be no competition between the two institutions for market funding (debt issuance). - The implied new lending capacity would be most likely to unlock resources from other G20 partners. - The markets would be most likely to consider the new lending capacity sufficient and the brunt of the stabilisation effort would no longer fall on the ECB.
Cons:	- Additional subscribed capital would require some additional paid-in capital in order to maintain a stable rating and the robustness of the mechanism. - Changing the capital stock requires parliamentary approval - Subscription key of EFSF guarantee is not exactly identical to that of ESM capital. - When the EFSF is discontinued, its used capacity will progressively disappear as those amounts are reimbursed by beneficiary Member States without the possibility of being re-used.

3. PRELIMINARY CONCLUSIONS

The three options for increasing the available capacity of the sovereign firewall are summarized in Table 1. Option 1 would allow for a more limited increase in the lending capacity and would imply a swift move towards using the ESM only for new lending. However, reaching the full ESM capacity of €500bn would require a substantial acceleration of paid-in capital. Given the marginal increase envisaged, this option could be viewed as maintaining the status quo, which both G20 partners and the markets consider as inadequate. In that context, this option is likely to fall short of providing the necessary credibility to unlock an increase in IMF resources.

Option 2 would provide a potentially more substantial increase in total lending capacity during the transition period (assuming the full availability of the remaining EFSF capacity) and could induce greater market confidence. However, it would imply a reduction in the lending capacity once the EFSF is no longer able to enter into new issuances and would require clear functional differentiation during the period of co-existence of the EFSF and ESM.

Option 3 is the only one of the three that would ensure a permanent increase in the overall capacity of the sovereign firewall under a structure that is more streamlined and robust. As the annex of this note indicates, it would also provide clear benefits when compared to continuing to provide financial assistance under the EFSF.

Whatever the option chosen, a further acceleration of payments of paid-in capital – with two tranches in 2013 – would help reinforce market confidence and add credibility to the ESM.

Table 1: Summary of the three options for strengthening the sovereign firewall

	July 2012	**End of transition period**

	New cumulative ceiling	**Combined new lending capacity**[2]	**New lending capacity**
Option 1 **Combining the full ESM capacity with the used EFSF capacity**	€700bn	€500bn	€500bn
Option 2 **Combining the full ESM and EFSF capacities**	€940bn	€740bn	€500bn
Option 3 **Transforming the unused EFSF guarantees into ESM capital**	€940bn	€740bn	€740bn

[2] Theoretical calculation: The effective lending capacity of the ESM varies according to the methodologies used by the various credit rating agencies. The figure assumes that, if need be, Member States would accelerate the payment of the paid-in to maintain the 15% ratio between paid-in and outstanding supports, as foreseen by the Treaty.

Annex. Impact on Member States' debt and deficit

The use of EFSF compared to ESM funding has a different impact on the debt and deficit profile of 'guarantor' Member States. This is one key element that could be considered in the decision-making process.

When the EFSF is used to provide financial assistance, the debt of guarantor Member States is immediately impacted by the same amount as the debt issued by the EFSF for the particular programme. In some cases, however, the guarantee amounts accounted for in national budgets could be even larger – as some Member States take into account not only the principle but also the interest born for the duration of the financial assistance. In the event of default (or loss for the EFSF), guarantor Member States will have to shoulder a deficit equal to the defaulting amount of the EFSF debt issued.

The situation is very different under the ESM. Participating Member States' debt would be directly impacted by their share of paid-in capital only to the extent that payment of the paid-in capital would create an additional financing need on the market, which is the base assumption in this note; this implies an overall impact of €80bn accumulated during the phase-in period.

In general, ESM Members' debt would only be increased by the amount of capital called in to cover additional lending (during the phasing-in period) or potential losses (after absorption, in order to reconstitute the paid-in capital) and to the extent that funding would need to be raised on the market. Hence, debt would not increase as long as the €533bn maximum capacity enabled under the ESM Treaty by the €80bn level of paid-in is not surpassed.[3] Hypothetically: if the lending volume were someday increased to €600bn (with the same proportion of paid-in capital), Member States' total cumulative debt would amount to only €90bn.

According to preliminary Eurostat consultations, capital payments for the purpose of loss absorption would constitute capital transfers and would, therefore, also impact ESM Members' deficits. As such, it is more difficult to determine the exact impact on deficit at any given point in time. It would depend on whether the paid-in capital is reconstituted or not. In either case, if the ESM's full capacity (assuming €500bn ceiling) were used, and the total paid-in of €80bn has been disbursed, the maximum impact on deficit that could be incurred should be € 420bn (500-80=420b)[4]

The table below illustrates the concepts discussed above. Note that the ESM debt impact upon entry into force is taken as €32bn (assuming the payment of two tranches of paid-in in 2012) and experiences only small incremental increases until the full paid-in capital amount is reached. In terms of an impact on both debt and deficit, however, it is clear that the ESM provides a more attractive structure for providing financial assistance.

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[3] This note assumes that, in keeping with the Treaty and previous methodology indicated by credit rating agencies (CRAs), paid-in capital represents 15% of the total possible lending capacity. As such, the 80bn paid-in capital of the ESM could be used under the Treaty to lend up to €533bn. Recent consultations with CRAs, however, indicate that substantive rating migration of euro area Member States and changes in the methodology used by CRAs have affected the credit quality of the callable capital structure since initial consultations held in March 2010. Furthermore, each of the primary rating agencies differs in its assessment of the underlying capital structure. These developments could, therefore, impact the ESM lending capacity.

[4] Under the assumption that once losses are in excess of €420bn, the €80bn existing paid-in capital would be sufficient to cover needs, and no additional calls would be necessary.

Table 2: Impact of EFSF and ESM on Member States' debt and deficits

Lending Activity	EFSF Debt / deficit	ESM (Debt)
0	0	32.0
50	50	32.0
80	80	32.0
100	100	32.0
150	150	32.0
213	**213**	**32.0**
250	250	37.5
300	300	45.0
350	350	52.5
400	400	60.0
450	450	67.5
500	**500**	**75.0**
550	550	82.5
600	600	90.0