RISK-SHARING WITHIN THE EMU: THE ESM EXPERIENCE

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Introduction

At the height of the Financial Crisis, the G-20 called for strengthening the Global Financial Safety Net

In the Euro-area, following the debt crisis, that crystallised in a process leading to the creation of a common backstop to facilitate crisis resolution and support policy reform by national authorities.

While all safety nets, regional (Chiang Mai, FLAR) and multilateral (IMF, WB), deliver risk sharing, the form on which this is achieved depends on the underlying problem and the tools deployed.

The aim of this presentation is to briefly explain how the ESM came to life, how it works and why its operations have far reaching implications for official sector risk-sharing.
The path to the creation of the ESM

**December 2009:** Greek recognition of data falsification...market panic

→ **First policy step:** fiscal adjustment

**March 2010:** Greece requests official support

→ **Second policy step:** bilateral loans by EA countries (Greek Loan Facility)

**May 2010:** Portugal and Ireland go red

→ **Third policy step:** Creation of the EFSM and EFSF

**July 2011:** Crisis des not abate. Eyes look towards Spain & Italy

→ **Final policy step:** Creation of European Stability Mechanism

Along this process:

Significant modifications of lending terms

Additions to the ESM toolkit
## EFSF & ESM: overview

<table>
<thead>
<tr>
<th><strong>Legal Structure</strong></th>
<th><strong>Private company under Luxembourg law</strong></th>
<th><strong>Inter-governemental institution under international law</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Duration</strong></td>
<td>June 2010-June 2013</td>
<td>Permanent institution</td>
</tr>
<tr>
<td></td>
<td>No new programmes from 1 July 2013</td>
<td></td>
</tr>
<tr>
<td><strong>Capital structure</strong></td>
<td>Backed by guarantees of euro area Member States</td>
<td>Subscribed capital of €704.8bn* €80.55bn in paid-in capital €624.3bn in committed callable capital</td>
</tr>
<tr>
<td><strong>Maximum Lending capacity</strong></td>
<td>€192bn committed for Ireland, Portugal &amp; Greece</td>
<td>€500bn</td>
</tr>
<tr>
<td><strong>Creditor status</strong></td>
<td>Pari passu</td>
<td>Preferred creditor status (after IMF)**</td>
</tr>
<tr>
<td><strong>Credit Rating</strong></td>
<td>AA (negative) / Aa1 (stable) / AA (stable)</td>
<td>- / Aa1 (stable) / AAA (stable)</td>
</tr>
<tr>
<td><strong>Risk Weighting / HQLA designation</strong></td>
<td>0% Risk Weighted / High Quality Liquid Asset for LCR***</td>
<td></td>
</tr>
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* The initial subscribed capital of €700 bn has increased since the accession of Latvia in March 2014 and Lithuania in February 2015
** For the financial assistance for recapitalisation of the Spanish banking sector, pari passu will apply
*** Regulation (EU) no. 575/2013 (Capital Requirements Regulation), Article 118. Following a decision published by the Basel Committee on Banking Supervision on 18 March 2014, EFSF & ESM securities will be included in the list of entities receiving a 0% risk weighting under Basel II, as well as received HQLA categorisation for Liquidity Coverage Ratio computation under Basel III
ESM: mission and scope of activity

**Mission**: to safeguard financial stability in Europe by providing financial assistance to euro area Member States

**Instruments**

- Loans
- Primary Market Purchases
- Secondary Market Purchases
- Precautionary Programme
- Bank recapitalisations through loans to governments
- Direct bank recapitalisation

All assistance is linked to appropriate conditionality

EFS/ESM finance their activity by issuing bonds or other debt instruments

EFS/ESM act as intermediaries for market financing, granting beneficiary countries access to AAA-financing
Financial Assistance Instruments

■ Loans
  – Objective: assist MS that have significant financing needs but have lost access to market financing
  – MoU (negotiated by EC, in liaison with ECB and where possible IMF) details conditionality

■ Primary market purchases
  – Objective: allow MS to maintain or restore market access
  – For use by MS under macro-economic adjustment programme or under precautionary programme
  – Limit: no more than 50% of final issued amount. ESM can hold / sell back to country / resell on market / use for repos

■ Secondary market purchases
  – Objective: support functioning of debt markets and appropriate price formation in government bonds
  – For use by programme and non-programme countries, with conditionality. Subject to ECB report identifying risk to euro area and assessing need for intervention

■ Precautionary programme
  – Objective: prevent crisis situations by assistance before MS face difficulties in raising funds and avoid negative connotation of being a programme country
  – Precautionary conditioned credit line (PCCL) and Enhanced conditions credit line (ECCL). Country placed under enhanced surveillance by EC during availability period

■ Bank recapitalisation through loans to governments
  – Limit contagion of financial stress by assisting a country to finance recapitalisation of bank(s) at sustainable borrowing costs
  – For countries not under a macro-economic adjustment programme. Eligible if 1) lack of alternatives via private sector 2) inability of country to recapitalise banks without experiencing adverse effects on its financial stability and 3) ability to reimburse the loan. Conditionality applies.
EFSF and ESM loans: long term commitment

**EFSF - €174.6 billion outstanding loans**

- **Ireland**
  - Date Agreed: November 2010
  - Concluded: December 2013
  - Amount disbursed: €17.7 bn
  - Weighted average maturity: 20.8 years
  - Final maturity: 2042

- **Portugal**
  - Date Agreed: May 2011
  - Concluded: May 2014
  - Amount committed by EFSF: €26 bn
  - Amount disbursed: €26 bn
  - Weighted average maturity: 20.8 years
  - Final maturity: 2040

- **Greece**
  - Date Agreed: March 2012
  - Expired: June 2015
  - Amount outstanding: €130.9 bn
  - Weighted average maturity: 31.14 years
  - Final maturity: 2054

**ESM - €500 billion**

- **Recapitalisation of Spanish banking sector**
  - Date Agreed: November 2012
  - Concluded: December 2013
  - Amount disbursed: €41.3 bn
  - Amount repaid: €5.6 bn
  - Weighted average maturity: 12.5 years
  - Final maturity: 2027

- **Cyprus**
  - Date Agreed: March 2013
  - Duration: Q2 2013-Q1 2016
  - Amount committed: approx €9 bn
  - Amount disbursed: €6.3 bn
  - Weighted average maturity: 14.92 years
  - Final maturity: 2031

- **Greece**
  - Date Agreed: August 2015
  - Duration: Until August 2018
  - Amount committed: up to €86 bn
  - Amount disbursed: €26bn*
  - Weighted average maturity: 32.3 years
  - Final maturity: 2059

*including €4.6 bn in ESM notes which were cancelled
The EFSF/ESM lending rates are attractive to countries...

Low funding costs via bills and bonds deliver low rates for EFSF and ESM loans

<table>
<thead>
<tr>
<th>ESM cost of funding*</th>
<th>0.955%</th>
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<tr>
<th>ESM lending rates</th>
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<tbody>
<tr>
<td>Cyprus</td>
<td>1.254%</td>
</tr>
<tr>
<td>Spain</td>
<td>0.943%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>EFSF cost of funding*</th>
<th>1.602%</th>
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<table>
<thead>
<tr>
<th>EFSF lending rates</th>
<th></th>
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<tbody>
<tr>
<td>Ireland</td>
<td>2.269%</td>
</tr>
<tr>
<td>Portugal</td>
<td>2.104%</td>
</tr>
<tr>
<td>Greece</td>
<td>1.371%</td>
</tr>
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</table>

* Refers to pool funded loans, data as of 30/04/2015
EFSF & ESM Funding Strategy

- EFSF and ESM have the same funding strategy and same funding team but act as different entities.
- Providing beneficiary countries with funding at best conditions with priority given to:
  - mitigating liquidity and interest rate risk
  - proposing the best balance between costs and maturities

**Funding strategy**

**Short term funding**
- Regular bill programme (ESM only)
- Unsecured money market

**Long term funding**
- Highly liquid benchmark bonds
  - Up to 45 year ESM, (< 2056 for EFSF)
  - Taps possible
  - Via syndications, auctions
  - Private placements
  - Non euro currencies envisaged
  - **N-Bonds**

**Fund pool**
- Funds are not attributed to one country but pooled
- Each entity has one unique rate for all countries

**Diversified Funding Strategy**

**Cashless transactions**
- Issue & Repurchase Process
## Divergence between IMF and ESM: Maturities and Lending rates

<table>
<thead>
<tr>
<th></th>
<th>EFSF/ESM</th>
<th>IMF</th>
<th>IMF</th>
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<th>IMF</th>
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<tbody>
<tr>
<td></td>
<td>Maturity</td>
<td>Interest rate</td>
<td>Maturity</td>
<td>Interest rate</td>
<td>Maturity</td>
</tr>
<tr>
<td>Greece</td>
<td>5 years</td>
<td>404 bps</td>
<td>5 years</td>
<td>323 bps</td>
<td>7.5 years</td>
</tr>
<tr>
<td></td>
<td>30 years</td>
<td>93 bps</td>
<td>8 years</td>
<td>307 bps</td>
<td>15 years</td>
</tr>
<tr>
<td></td>
<td>30 years</td>
<td>123 bps</td>
<td>8 years</td>
<td>410 bps</td>
<td>22 years</td>
</tr>
<tr>
<td></td>
<td>32 years</td>
<td>129 bps</td>
<td>8 years</td>
<td>405 bps</td>
<td>22 years</td>
</tr>
<tr>
<td>Ireland</td>
<td>7.5 years</td>
<td>15 years</td>
<td>7 years</td>
<td>309 bps</td>
<td>12.5 years</td>
</tr>
<tr>
<td>Portugal</td>
<td>15 years</td>
<td>255 bps</td>
<td>7 years</td>
<td>309 bps</td>
<td>15 years</td>
</tr>
<tr>
<td>Spain</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Cyprus</td>
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Sources: International Monetary Fund, European Commission, European Financial Stability Facility, European Stability Mechanism and Bloomberg.
As described before, overtime, the approach of IMF and ESM diverged significantly.

The risk-sharing features of the provision of support relate to:

- Underlying problem
- Available tools

IMF lending is geared towards the resolution of short-term BoP problems.

EFSF/ESM lending can be designed to address fiscal, banking or financial account crises.
Optimising official risk-sharing? Collaboration between RFAs and IMF

- Official institutions may need to coordinate to achieve the best outcome given their separate abilities to deliver risk-sharing

- Complementarity
  - RFAs’ comparative advantages
    » In-depth knowledge on regional economies ➔ strengthening ownership
    » More tailored instruments available: PMP, SMP, Bank Recap (Europe)
    » Legitimacy and democratic support, less stigma
    » Relatively ample resources and quicker reaction (in Europe)
  - IMF’s comparative advantages
    » IMF suitable for systemic crises
    » Broader representation
    » Established policy commitment tools and surveillance capacity

- Risks
  - Conditionality design and coordination
    » Avoid “programme shopping”
Thanks!
Annex
Funding statistics

### Outstanding debt
(including cashless transactions, € bn)

<table>
<thead>
<tr>
<th></th>
<th>Cash</th>
<th>in kind</th>
<th>Overall</th>
</tr>
</thead>
<tbody>
<tr>
<td>EFSF</td>
<td>151.4</td>
<td>48.2</td>
<td>199.6</td>
</tr>
<tr>
<td>ESM</td>
<td>39.7</td>
<td>13.9</td>
<td>53.5</td>
</tr>
<tr>
<td>Total</td>
<td>191.1</td>
<td>62.1</td>
<td>253.1</td>
</tr>
</tbody>
</table>

### Average remaining maturity (years)

<table>
<thead>
<tr>
<th></th>
<th>Bills</th>
<th>Bonds</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>EFSF</td>
<td>-</td>
<td>6.4</td>
<td>6.4</td>
</tr>
<tr>
<td>ESM</td>
<td>0.2</td>
<td>3.0</td>
<td>2.4</td>
</tr>
</tbody>
</table>

### Repayment of loan principal by beneficiary countries

- **Ireland**: 2029 - 2042
- **Portugal**: 2025 - 2040
- **Greece**: 2023 - 2054
- **Spain**: 2025 - 2027
- **Cyprus**: 2025 - 2030
The three financial assistance programmes for Greece

- The new ESM programme is the third package of financial assistance for Greece

1st programme (2010-2011)
- Greek Loan Facility (bilateral loans): €52.9 bn
- IMF: €20.1 bn
- Total: €73 bn

2nd programme (2012-2015)
- EFSF: €141.8 bn
- IMF: €11.7 bn
- Total: €153.5 bn

3rd programme (2015-2018)
- ESM: up to €86 bn (committed)
- IMF: TBD

- ESM is the largest creditor of Greece. Currently, 45% of all Greek public debt. If third programme is fully disbursed, ESM will hold 60% of all Greek public debt.

Note: For the first two programmes, amounts disbursed are shown. For IMF loans (disbursed as SDR), the corresponding figure in euros is based on exchange rate at time of disbursement.
Divergence between IMF and ESM: loan sizes

Source: Corsetti et al. (2016)
Divergence between IMF and ESM: lending rates

Source: Corsetti et al. (2016)
How to facilitate RFAs-IMF cooperation?

- Only concrete example: Troika model in Europe

- *G-20 Principles for cooperation between the IMF and RFAs (15/10/2011)*
  - Institution/region specific modality
  - Cooperating while respecting the independence and decision-making processes of each institution
  - Information sharing and joint missions
  - Consistency in lending conditions
  - IMF’s preferred creditor status