Intergovernmental Agreement and National Collateral Legislation

Centrum für Europäische Politik

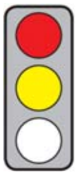
REFORM OF THE EUROPEAN FINANCIAL STABILITY FACILITY (EFSF)

Status: 4 October 2011

MAIN ISSUES

Objectives: The EFSF is to receive a larger financial volume and new legal instruments.

Parties affected: All citizens.



Pro: EFSF loans to finance the recapitalisation of banks increase the pressure for reforms, as they increase the likelihood of terminating financial assistance where reform requirements are not complied with.

Contra: (1) Without implementation of reform measures, or where these are not complied with, the EFSF serves to perpetuate the current crisis.

(2) The right of countries receiving EFSF assistance to decide whether or not other countries should receive further EFSF tranches reduces the willingness for reforms.

(3) The new provision that single euro states could make additional payments to the EFSF can lead to an uncontrollable burdening of budgets in such states.

(4) The purchase of state bonds has no impact on the basic data of a state; on the contrary, it weakens the pressure for reforms. Moreover, they are no longer needed for rescuing financial institutions.

(5) Financial assistance to rescue the euro infringes the bail-out prohibition.

CONTENT

Title

EFSF Framework Agreement as amended with effect from the Effective Date of the Amendments (26 August 2011)

Brief Summary

Note: Articles and Recitals quoted refer to the draft of the amended EFSF Framework Agreement, unless otherwise stated.

- **Background and objectives**
  - On 9. May 2010 the finance ministers of the euro zone decided to establish a limited support system for euro states suffering from financial problems, due to expire on 30 June 2013 (s. CEP Analysis).
  - To date, this system has included the following elements:
    - the European Financial Stability Facility (EFSF) with guarantees of up to 440 bn Euro provided by euro states;
    - the European Financial Stabilisation Mechanism (EFSM) [Regulation (EU) No. 407/2010] with financial aid from EU own capital of up to 68 bn Euro (see CEP Policy Brief on the multiannual Financial Framework); and
    - credits from the International Monetary Fund (IMF) of up to 250 bn Euro.
  - As a reaction to serious tension on the financial market, on 21 July 2011, the heads of states and governments of the euro zone decided to amend the existing EFSF. The objective of the amendments is to increase the operative financial volume of the EFSF and to provide it with new legal instruments.

- **Increase the operative financial volume of the EFSF**
  - The EFSF will be provided with guarantees to the amount of 780 bn Euro (to date: 440 bn Euro) (Annex 1). This is to allow for financial assistance in real terms of 440 bn Euro without losing the top-rating ("AAA").
  - The volume of national guarantees is calculated on the basis of the national share in the capital key of the European Central Bank (ECB). The German share will continue to be around 27%. This equals a volume of 211 bn Euro (to date: 123 bn Euro) (Annexes 1 and 2).
  - In order to maintain the solvency of the EFSF – for instance in the case of heavy reliance – all euro states may decide unanimously that individual EFSF euro states must provide additional liquidity, grant the EFSF subordinated loans or take over EFSF liabilities for a limited period. (Art. 5 (3))

- **EFSF instruments ("Financial Assistance Facility")**

  In future, the EFSF may as well as granting ordinary loans also (Art. 2 (1) lit. b):
  - grant loans for the purpose of recapitalizing financial institutions;
  - provide credit lines which if required may be used directly ("precautionary facilities");
  - purchase state bonds from euro states in the secondary market; and
  - purchase state bonds directly from emitting euro states in the primary market.

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- **Requirements**
  - A key requirement for loans for the recapitalisation of financial institutions, "precautionary facilities" and the purchase of bonds in the secondary market is that they are granted and used to "avoid contagion" (Art. 2 (1) lit. b and c).
  - The purchase of bonds in the secondary market must be based on the ECB's having determined the existence of "exceptional financial market circumstances and risks to financial stability" (Art. 2 (1) lit. b).
  - Euro states wishing to use EFSF Financial Assistance Facilities must conclude with the EU Commission a Memorandum of Understanding (MoU), including conditions on "budgetary discipline and economic policy guidelines" (Preamble No. 2).
    - The remaining euro states must approve such an MoU and stipulate the "main" terms of each facility, in particular on the maturity and the interest rate to be paid (Art. 2 (1)).
    - For loans to recapitalise banks, comprehensive adjustment programmes are not mandatorily required; they can be also granted to non-programme countries (Art. 2 (1) lit. c).
    - If further tranches from the approved financial assistance are requested, the Commission is to submit a report on the requesting country's compliance with the agreed terms. The remaining states decide whether or not the terms have been complied with. (Art. 3 (1)).

- **Interest rate**
  - For ordinary loans with a term of up to three years, the EFSF may request a margin of 2 percentage points in addition to their own funding costs. For loans with a longer term, the margin may amount to 3 percentage points as of the fourth year. (Preamble No. 2a)
  - The interest rate for loans to Greece, Ireland and Portugal, however, are to be cut to 3.5%. (Preamble No. 2a)

- **Decision rules within the EFSF**

  Those euro states acting as guarantors for financial assistance to a state (i.e. states which at the time of the granted assistance have not already been beneficiaries themselves) decide "on a unanimous basis" (Art. 10 (5)):
  - whether and under which political and financial terms (MoU) a euro state receives assistance;
  - whether the purchase of state bonds through the EFSF is to be a part of such assistance; and
  - whether a state has complied with the agreed payment terms.

Policy Context

On 30 June 2013 the EFSF will expire and be transferred to the bail-out package of the European Stability Mechanism (ESM). The ESM is to be legalised through a new Art. 136 (3) TFEU.

ASSESSMENT

Economic Impact Assessment

The larger **rescue package** containing more instruments can also only provide liquidity aid short term; it **cannot solve the problems which caused the euro crisis**. Any hopes that it might do so fail to recognize the fact that the real problem of the reeling euro states lies in the excessive, non-sustainably financed credit needs of not only the state but also the private sector, as has been proven by current account deficits and/or capital account surpluses of Southern European economies for years. While the rising prices of these credits indicate their weak sustainability and should therefore serve as a motivation to reduce credit needs, the EFSF focuses precisely on making such credits available at very cheap interest rates.

EFSF aid is acceptable only if accompanied by a downsizing of the macro-economic current account deficits funded through foreign credits. Therefore, a restructuring of state budgets is necessary. Equally important, however, are real economy reforms, cuts in over-regulation, bureaucracy and too high unit labour costs and the promotion of innovation. Only such reforms can increase the competitiveness of the countries concerned and can help downsizing current account deficits.

If EFSF aid does not provide for such **fundamental reform requirements and if non-compliance with requirements is not sanctioned by the termination of further payments,** then **the EFSF will perpetuate the current crisis** by further weakening the incentives to the affected Member States to carry out fiscal policy and real economy reforms. In fact, it is appropriate that the EFSF is subject to unanimous state decisions with regard to whether or not financial aid is granted. However, it is equally appropriate that those states which are beneficiaries must not participate in the first approval procedure regarding new financial assistance to other states. **States receiving financial assistance should**, unlike the provided provisions, **not be entitled to participate in decisions regarding the payment of further aid tranches to those countries which received financial assistance prior to them**. This increases the likelihood of the terms not being complied with.

The EFSF can refinance its credit volume of 440 bn Euro only at best conditions (AAA) if Germany, Finland, France, Luxemburg, the Netherlands and Austria keep their AAA rating. **Should**, for instance, **France lose its AAA-rating** – and this is a very real possibility – then the EFSF's capability to receive AAA-credits is reduced by 3.5% – from a full volume of 440 bn Euro down to 286 bn Euro. To upgrade the EFSF volume back to

AAA-conditions would require a massive increase of guarantees of the remaining AAA states – up to 317 bn Euro for Germany alone. In order to avoid such high risks for the German public budget, in this case **it is better to forego a renewed increase of guarantees and in turn the AAA-rating of the EFSF**. This would make the granting of loans more expensive and increase the impetus for reform. Under no circumstances should **further contributions of single euro states** to the EFSF be decided. That could lead to an uncontrollable burdening of their budgets and make the EFSF totally untrustworthy.

The future **power of the EFSF to grant loans** to states **for the purpose of recapitalisation of banks gives credibility to the threat to freeze assistance where reform efforts appear to be flagging**. For a prompt termination in the case of non-compliance would lead to payment default and consequently to a massive depreciation need among banks throughout the entire euro zone. The EFSF could help alleviate the fear of such a scenario. However, as these EFSF means to recapitalise banks are not mandatorily linked to reform requirements, it is questionable whether or not a repayment can be expected. As a result, it is likely that financially sound countries will finance the recapitalisation of banks in other euro states.

The purchase of state bonds through the EFSF does little to change the basic economic data of a state. In fact, extremely high-volume purchases would be needed in order to reduce the interest rate noticeably. Such a risk is not acceptable; **in fact, it undermines any reform pressure**. Secondary market purchases only relieve capital investors: they exempt them from their liability for the credit default risks entered into and enable financial institutions to clear their balance accounts of state bonds exposed to default risks at the expense of guaranteeing EFSF states. **In future, such purchases are no longer necessary, as "systemic" financial institutions will be rescued directly**. Primary market purchases have a similar impact as direct loans, but, more than direct loans, whose volume depends on the extent of the refinancing requirements, primary market purchases run the risk of an excess purchase volume.

Any proposals to establish the EFSF in the form of a bank should be strictly rejected. An EFSF bank would be able to refinance itself through the ECB by way of depositing previously acquired state bonds. This would render pointless the efforts to strengthen the strained independence of the ECB.

Legal Assessment

Legislative Competency

As a privately organised intergovernmental construction, the EFSF needs no EU competency.

Compatibility with EU Law

The financial assistance to "rescue the euro" continues to infringe the bail-out prohibition (Art. 125, 122 TFEU; for the status quo see CEP Analysis), as long as the opening clause is not in effect (Art. 136 (3) TFEU).

Conclusion

If EFSF assistance is provided without being linked to fundamental reform requirements, or if these are not complied with, the current crisis will be further perpetuated through the EFSF. Countries receiving EFSF assistance should not be entitled to decide on the payment of further tranches to other countries. Additional subsequent payments made by individual euro states to the EFSF could lead to uncontrollable burdens on public budgets in the affected states. EFSF loans to recapitalise banks increase the pressure for reforms. The purchase of state bonds has no impact on the basic data of a state; in fact, they weaken the pressure for reforms. They are not necessary in order to rescue financial institutions as they can be rescued directly in future. Financial assistance to rescue the euro infringes the bail-out prohibition.