# The European Stability Mechanism

It looks like a hedge fund

Lundgreen's Capital
professional financial advisory

# Contents

# About the author and background of this working paper

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Peter Lundgreen, founder of Lundgreen's Capital, has 25 years of experience in risk advisory in the financial market, servicing a wide range of international clients. Lundgreen's Capital publishes a range of magazines and newsletters for clients and the professional network; these publications are read in 10 countries. Peter Lundgreen is used by a range of media in Denmark as well as international media.

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Peter Lundgreen
CEO
Lundgreen's Capital
Amaliegade 36
DK – 1256 Copenhagen
Denmark

Phone +45 70 26 88 55

www.lundgreenscpaital.com

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# Executive summary

This working paper argues that the ESM is a financial vehicle where investors can't get the full picture of the risks incorporated in the fund. Further the ESM will only to a certain extend create stability, beyond this risk point the ESM will generate volatility and destabilise the financial market. This is instead of acting as a stabilising institution as the normal perception of the ESM is.

The ESM is a permanent crisis resolution mechanism for the countries of the euro area. The initial rescue facility of the euro area, the EFSF, will in principle only remain active in financing programmes that started prior to the ESM's establishment. The ESM's lending capacity is €500 billion, and the combined lending ceiling of the EFSF/ESM is set at €700 billion.

The paid-in capital acts as a buffer against losses that could occur from ESM lending activities or their bond purchase from troubled countries. The paid-in capital is therefore not a source for lending from the ESM to the member states but to ensure stability and security for the ESM.

The ESM can invest up to 70 pct. of the paid-in capital in member state bonds. Effectively some of the member states are just issuing debt to pay into the ESM rescue fund and afterwards the money is recirculated back to the member states because the ESM buys the newly issued member state bonds into the ESM investment portfolio.

What we find highly critical is the fact that the ESM by far is not safeguarding the paid-in capital in the most optimal way. The correct solution would be to invest in the highest rated sovereign bonds issued outside the euro area with the currency risk eliminated as it is today. In a situation where the ESM lending capacity is fully utilised, losses from the invested paid-in capital could be one of several fatal destabilising factors.

Bail-out lending or bond purchase potentially represents a very large part of the balance sheet; this is financed by issuing short-term and long-term debt. The financial health of the ESM (and the EFSF) will extremely depend on how the value of the bail-out lending and bond purchase behaves.

One of several financial risks we are observing is a significant refinancing risk. The ESM borrows with shorter maturities than the lending to the troubled countries represent. The safest solution would be to match the borrowing maturities with those in the lending book.

The refinancing problem could also occur when the member states are facing economic stress. The effect is that where the ESM should have been a stability mechanism, it in reality adds volatility to a financial crisis.

Not alone is the ESM funding itself shorter than it lends out, the ESM is also taking high risks by lending out to distressed economies (or by buying their bonds). When a financial vehicle with a high credit rating lends out to lower rated counterparties, we regard this as credit speculation from a financial perspective.

The rescue fund is ready to purchase government debts at higher prices than the market. In the revaluation of the portfolio this should lead to an immediate loss, which correctly should be reserved from the paid-in capital at the same time.

We argue that that in reality the remaining bail-out power is €300 billion with hardly is sufficient to cover the needs of a Spanish bail-out.

About the risks surrounding the ESM we notice leverage on the paid-in capital, a funding mismatch between liabilities and the bail-out assets, which we regard as speculation, and extreme credit leverage. The extreme credit leverage emerges from the purchase of distressed financial assets that nobody else wants to buy. The latter part is the nature of the fund; the two first risk components are not. Still, the ESM member states want investors to buy debt issued by this financial vehicle. If we were to describe the fund, then the risk picture would look like a hedge fund – the world's largest.

It is very valid to discuss a failure of the ESM – a financial meltdown of the fund. We have covered the arguments behind the risk of failure in this working paper. Our clear opinion is that instead of stabilising factors, several accelerating risks are embedded in the construction of the fund, and this could be fatal.

Based on the risk scenarios, conclusions in this working paper and especially the volatility generators embedded in the construction of the ESM (and the EFSF) we regard it too uncertain to invest in debt issued by the EFSF and the ESM with maturities reaching beyond 1 year maturity.

# Preconditions

The title refers to the current euro area bail-out fund, the European Stability Mechanism (ESM); though we allow ourselves to include the temporary rescue fund, the European Financial Stability Facility (EFSF), in some areas of this work. We are fully aware of the very different legal framework behind the two vehicles but from a financial risk perspective we expect some similarities to be replicated in the ESM.

The ESM has not been rated by the rating agency Standard & Poor's. In some of the internal policies of the ESM, the common rating scale from Standard & Poor's and Fitch is used. We therefore take the liberty of converting all ratings in this working paper into the Standard & Poor's scale. The current rating at Moody's is Aa1 which is the equivalent to AA+ at Standard & Poor's, the rating at Fitch is AAA. The EFSF is rated by all the three leading rating agencies with the rating equal to AA+ in Standard & Poor terms.

We are not concluding on the credit quality, like a rating agency would do. We have the focus on how risks could develop. In this context it should be mentioned that the ESM (predominately the EFSF) runs large risk positions in the 15 to 30 years segment. This means that we have a long-term view on how risks could develop. It is not just a discussion and assessment about the current economic environment.

This working paper has the focus on the financial risks surrounding the ESM. It includes which financial risk factors are embedded in the current construction of the ESM as a financial vehicle. It is important for us to highlight that this report has the focus on the ESM as a financial vehicle. We are not expressing any opinion about the management of the ESM, the operation as such and the daily work done within the organisation and we are certain that all guidelines, policies, agreements etc. are strictly followed at the ESM and both the organisation and each individual is working very professionally. This report solely focuses on the framework and policies, which are the foundation for the construction of the ESM.

About 3 weeks before this report was finalised, we had a telephone conversation with representatives of the ESM. It was agreed that we could forward our questions about the ESM via e-mail. Two days later we submitted 16 questions, and the e-mail was read on the same day. So far we haven't received any reply yet.

# About the European Stability Mechanism (ESM)

Following the ratification of the ESM Treaty by the member states of the euro area, the European Stability Mechanism was inaugurated on 8 October 2012 in Luxembourg during the first meeting of the ESM Board of Governors, comprising finance ministers of the euro area countries. The ESM Member States have transferred the first two instalments of paid-in capital (amounting to €32 billion), and the ESM is fully operational, i.e. ready to provide financial assistance if requested.

**The main objectives of the ESM:**

- Providing loans to countries experiencing or being threatened by severe financing problems
- Purchasing bonds of an ESM member state in primary and secondary debt markets
- Providing precautionary financial assistance in the form of a credit line
- Financing recapitalisations of financial institutions through loans to governments including non-programme countries

The ESM is a permanent crisis resolution mechanism for the countries of the euro area. Its purpose is to provide stability through a number of financial assistance instruments to ESM member states which are experiencing or being threatened by severe financing problems. For this purpose, the ESM is entitled to raise funds by issuing capital market instruments and engaging in money market transactions.

The initial rescue facility of the euro area, the EFSF, will in principle only remain active in financing programmes that started prior to the ESM's establishment. However, for a transitional period until June 2013 the EFSF may engage in new programmes to ensure that the ESM's full lending capacity of €500 billion can be attained. Afterwards the EFSF will continue functioning in an administrative capacity until all outstanding loans and bonds have been repaid.
The ESM's lending capacity is €500 billion and the combined lending ceiling of the EFSF/ESM is set at €700 billion.

The on-going lending programmes for Ireland, Portugal and Greece will remain with the EFSF. The financial assistance of up to €100 billion earmarked for the recapitalisation of the Spanish banking sector (granted by the Eurogroup on 20 July 2012) will be transferred to the ESM without gaining seniority status.

**The capital behind the ESM**

Subscription to the paid-in capital will be made in five instalments. The first two instalments amounting to €32 billion have already been paid by all ESM members.
• Authorised unpaid capital may be called in to restore the level of paid-in capital if the latter is reduced by the absorption of losses.
• A minimum of 15% ratio between paid-in capital and outstanding amount of ESM issuance will be maintained during the capital phase-in period; paid-in capital is not available for lending - it is invested in high quality liquid assets.

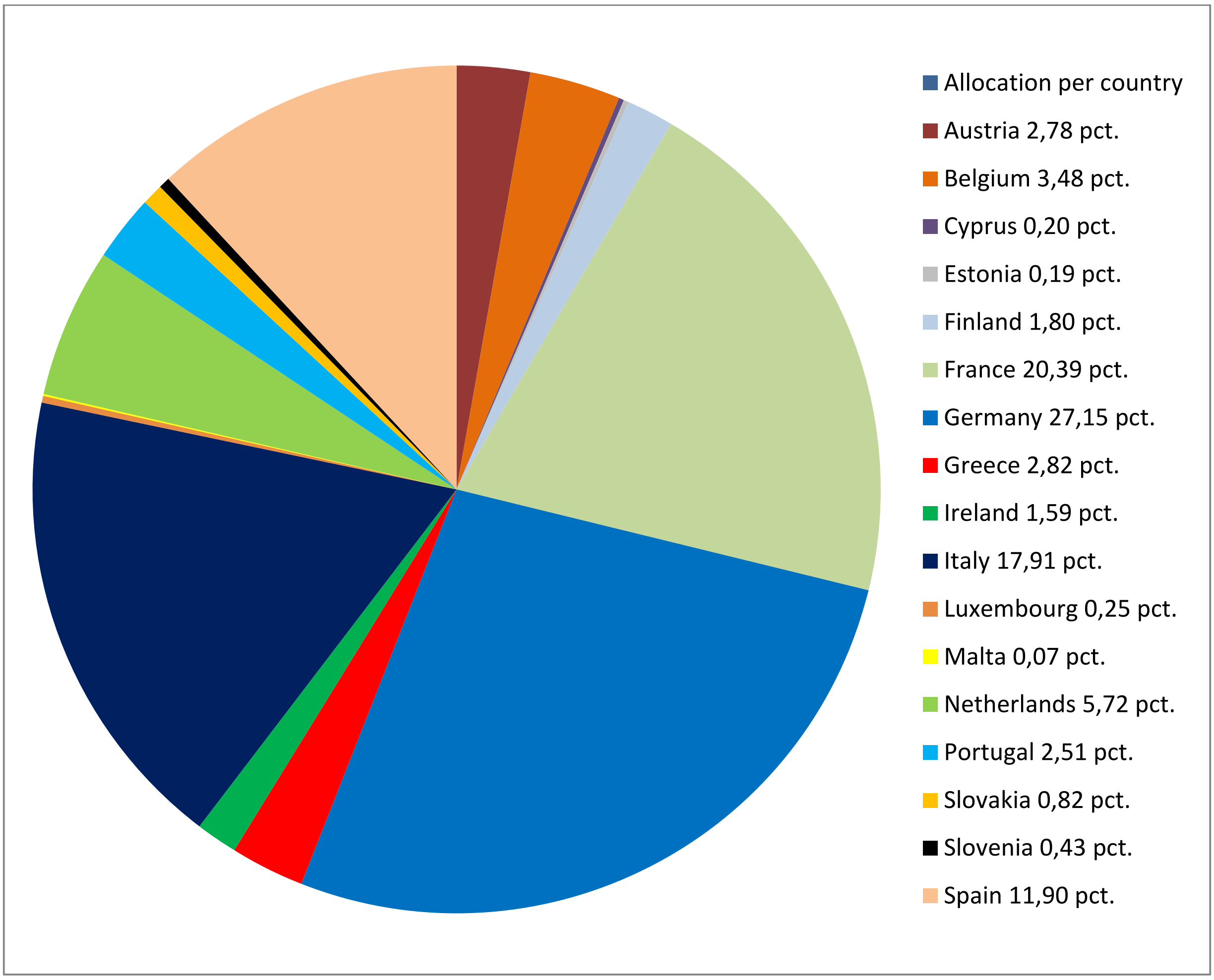
**Table 1**
**The distribution among the 17 euro member states (shown as table):**

| **Country** | **Allocation in pct.** | **Capital Subscription** | **Paid-in Capital** |
|---|---|---|---|
| Austria | 2,783 | 19,48 | 2,22 |
| Belgium | 3,477 | 24,34 | 2,77 |
| Cyprus | 0,196 | 1,37 | 0,16 |
| Estonia | 0,186 | 1,3 | 0,15 |
| Finland | 1,797 | 12,58 | 1,43 |
| France | 20,386 | 142,7 | 16,31 |
| Germany | 27,146 | 190,02 | 21,72 |
| Greece | 2,817 | 19,71 | 2,25 |
| Ireland | 1,592 | 11,14 | 1,27 |
| Italy | 17,914 | 125,39 | 14,33 |
| Luxembourg | 0,25 | 1,75 | 0,2 |
| Malta | 0,073 | 0,51 | 0,06 |
| Netherlands | 5,717 | 40,02 | 4,57 |
| Portugal | 2,509 | 17,56 | 2 |
| Slovakia | 0,824 | 5,77 | 0,66 |
| Slovenia | 0,428 | 2,99 | 0,34 |
| Spain | 11,904 | 83,32 | 9,52 |
| Total | 100 pct. | €700 bn | €80 bn |

Source: The ESM

**Figure 1**

**Distribution among the 17 euro member states (as shown in graphic):**




Source: The ESM

**Table 2**

The first bond and bill issues at the ESM:

| Maturity | Type | Amount | Beneficiary |
|---|---|---|---|
| 11/02/2013 | 2 month Bill | €2.5 billion | SAREB** |
| 11/10/2013 | 10 month Bill | €6.468 billion | Banks (via FROB*) |
| 11/06/2014 | 18 month FRN | €6.5 billion | Banks (via FROB) |
| 11/12/2014 | 2 year FRN | €12 billion | Banks (via FROB) |
| 11/12/2015 | 3 year FRN | €12 billion | Banks (via FROB) |

# The investment policy for paid-in capital

### The investment policy

The paid-in capital acts as a buffer against losses that could occur from ESM lending activities or their bond purchase from troubled countries. The paid-in capital is therefore not a source of lending from the ESM to the member states but to ensure stability and security for the ESM. The investment objectives are described in the Treaty and in the “Investment policy” of the ESM.

Here are two quotes from the “Investment policy”, article 1:

*“The Investment Portfolios shall be used in line with Article 25 of the Treaty to cover losses arising in ESM operations, and specifically any shortfall due to a non-payment by a beneficiary ESM Member.”*

And:

*”The Investment Policy of ESM must ensure that the Investment Portfolios’ market value exceeds a threshold of 15% in relation to the Page 2 of 7 targeted maximum lending volume of ESM for a high level of confidence,…”*

It is initially stated that the paid-in capital should be seen as a secure investment portfolio within the financial vehicle ESM. The lending or bond purchase that the ESM conducts is funded by bond issues. To assure a certain confidence in the ESM’s ability to repay its obligations timely, the rating agencies demanded that the ESM must always hold a 15 pct. buffer of the lending in liquid assets.

Apparently the investment portfolio should not only generate higher safety for the investors buying bonds issued by the ESM. The paid-in capital investment portfolio must also generate a return to cover the operational costs of the ESM. This is explained in the “Investment policy”, article 1, by this quote:

*“In line with Article 22 of the Treaty, the ESM shall be entitled to use part of the return on its Investment Portfolios to cover its operating and administrative costs. In line with Article 23 of the Treaty and the dividend policy, investment return can be retained as reserves or distributed as a dividend to the ESM Members.”*

At first glance this might sound reasonable, but in principle it conflicts with the interest of the ESM bondholders. We recognise that the costs for operating and administrating the ESM would just be a fragment of the return for a normal portfolio of €80 billion. But this is a rescue fund where everything is about security and confidence, which changes the expected return on investment significantly. The “Investment policy” even mentions to pay out returns to the member states; this is an indication for an active managed investment portfolio. It also indicates the founders’ expectation of a lowering of the safety surrounding of the paid-in capital to get some return. Given that the investors are interested in maximum stability for the paid-in capital, there is a conflict of interest with the owners of the ESM; we will be discussing this matter further in the next section.

**Too much risk**

Articles 2 and 4 of the “Investment policy” explain more about the risk taking for the paid-in capital.

Article 2 covers the foreign exchange risk arising from the investments. It says:

*“Any currency risk shall be hedged into Euro to ensure a limited remaining foreign exchange risk for the ESM”.*

We agree very much with this risk profile, as any capital requirement from the paid-in capital will always be in EUR.

Article 4 covers what the ESM describes as “portfolio structure”. The ESM operates with two sub-portfolios representing two different maturities, one called the “Short-term tranche” and the other one called the “Medium / Long-term tranche”. For both sub-portfolios the following rule applies:

*“… at least 30% of this amount shall be invested either in supranational institutions or outside the Euro Area … .”*

The consequence of this rule is that the ESM can invest up to 70 pct. of the paid-in capital in member state bonds (though the maximum country limit equals the “capital subscription”, i.e. it includes the guarantee). Effectively some of the member states are just issuing debt to pay into the ESM rescue fund and afterwards the money is recirculated back to the member states because the ESM buys the newly issued member state bonds into the ESM investment portfolio.

The ESM "Investment strategy" tries to counterweight the risks arising from this construction by demanding a minimum rating of AA for the securities the paid-in capital is invested in. From an isolated view one could argue that this secures some safety for the paid-in capital. The reason can be seen in table 3, where the member states are listed with their individual rating of the sovereign debt.

**Table 3**

| Rating | ESM member state |
|---|---|
| AAA | Finland, Germany, Luxemburg, the Netherlands |
| AA+ | **The ESM**, Austria, France |
| AA | Belgium, **minimum rating for investments** |
| AA- | Estonia |
| | **Theoretical calculated weighted ESM rating** |
| A+ | |
| A | Slovakia |
| A- | Slovenia |
| BBB+ | Ireland, Malta |
| BBB | Italy |
| BBB- | Spain |
| BB+ | |
| BB | Portugal |
| BB- | |
| B+ | |
| B | |
| B- | Greece |
| CCC+ | Cyprus |

Source: Standard & Poor's and Lundgreen's Capital

We have calculated the weighted rating of the ESM where we use the weights based on the "capital subscription" distribution. Compared to the calculated ESM rating, the rule about investing in minimum AA rated papers for the paid-in capital results in higher safety for the investors buying bonds issued by the ESM, one could argue. Basically some of the higher rated larger member states like Germany and France are issuing debt that is invested in lower rated papers with the help of the ESM with the possibility of a return. We regard this as speculation.

What we find highly critical is the fact that the ESM by far is not safeguarding the paid-in capital in the most optimal way. The correct solution would be to invest in the highest rated sovereign bonds issued outside the euro area with the currency risk eliminated as it is today. Then the paid-in capital would be protected in the best possible way and could act as a true buffer for holders of ESM debt in case the ESM explored a loss.

This correct solution will increase the robustness of the ESM and reduce the risk of unfavourable market movements for the European economies in case of further deterioration. As an example we expect that the ESM has invested a part of the paid-in capital in French sovereign bonds with the rating of AA+. France has just been downgraded from AAA and has so far not come up with any substantial economic reform package. At the same time Europe is feeling stronger economic headwind. In a risk assessment it would be advisable to include the possibility where France loses two rating nudges, falling down to AA-. This is not unlikely at all. In this case the ESM investment portfolio would be forced to sell out the full holding of French bonds. This would increase the market volatility for French sovereign bonds and the possible loss from the bond portfolio at the ESM. This example also shows the increasing uncertainty for investors, as the 15 pct. threshold might lose value. As long as the "Capital subscriptions" (the member state guarantees) haven't been fully drawn, the member states are covering the losses, if they can. But in the situation where the ESM lending capacity is fully utilised, losses, like in the example with the French bonds, could be one of the more fatal destabilising factors.

By using the correct solution, the safety for investors would increase. The consequence of placing the paid-in capital in the highest rated securities is a reduced return on the investment portfolio. Given the current extreme low interest rate environment (praised by the same politicians that constructed the ESM), the return could even be negative. An additional cost factor would be the operational and administrative costs from the operation of the ESM. Having the most secure buffer against potential losses might cost money. But it is to be seen as a life or fire insurance, and these cost money. With the right and correct solution, as suggested, the ESM member states would buy a certain degree of protection.

# A financial risk perspective on bail-out actions

### Riding the interest rate curve

The prior chapter covered the risk management of the paid-in capital. In this section we will comment on some risk issues surrounding the bail-out or bond purchase actions that the ESM/EFSF is or could be involved in. The bail-out potentially represents a very large part of the balance sheet and is financed by issuing short-term and long-term debt. The financial health of the ESM (and the EFSF) will depend extremely on how these assets behave. Just for purposes of clarification, by assets we mean the member state bonds purchased directly or in the secondary markets plus bilateral lending to the governments or to the banking sector in the member states, all in connection with rescue actions.

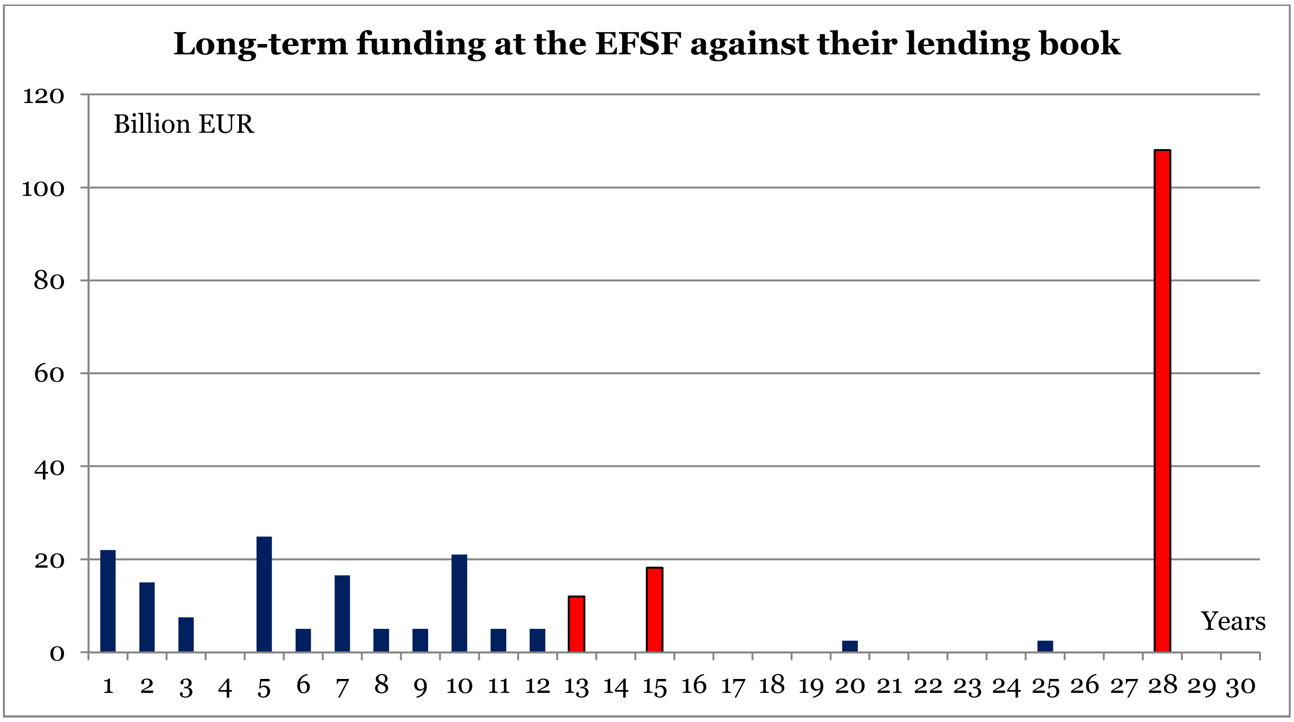
We haven't found any policy or guidance that describes how the ESM should manage the financial risks arising from the back-up or bail-out actions. This extremely important part of the balance sheet needs to be managed even more carefully than the paid-in capital. One of several financial risks we observe is a significant refinancing risk. In figure 2 on the next page we are using the long-term funding information from the EFSF. The reason is that the EFSF has been operative for a longer time than the ESM and therefore gives a better picture of how the funding operation works and which strategy is used.

The dark blue bars represent the long-term funding debt issues done by the EFSF and the red bars represent the lending obligations (in the notes below the chart some details on the lending are given). Regardless of whether some of the bail-out help includes a partly amortising repayment, it is then very visible that the ESM is funding itself with much shorter maturities than the maturities of the rescue obligations. The red bars represent the average maturities calculated by the ESM (EFSF). The loan documentation used by the bail-out actions refer to a maximum average maturity of 15 years, which corresponds well with the maturities for Ireland and Portugal. The average maturity for the bail-out facility for the Spanish banking sector is 12.5 years. So far the funding programme for the ESM has been focusing on short-term debt issue and "long-term" debt issue up to 3 years. A clear indication that the ESM follows the same funding pattern like how the EFSF funding operates.

This funding strategy represents a refinancing risk of extreme magnitude. If the economic conditions in Europe continue to worsen, then the absolute price for funding most likely will go up.

But the real risk is that investors might refrain from investing in Europe; this could result in a liquidity problem for the ESM. The liquidity crisis could emerge at the same time when other factors are pointing downwards as well. Again the ESM would accelerate the problems if Europe was hit by deeper economic stress. We haven't included the short-term funding at the ESM, as the long-term funding explains the risk well enough.

**Figure 2**




Source: The EFSF

Note: On 7 March 2012 the EFSF did a cashless issue of €35 billion with a maturity of 1 year. It was connected to Greece but the bonds have been cancelled later and are therefore not included in the graphic. The lending to Greece includes some amortising starting in 2023 and 2044.

It is always reasonable to get a feeling for how possible a risk is – how big is the risk for refinancing problems? It's a development that can happen faster than many believe and we should remember that the ESM bail-out rescues are long-term obligations. This means that the spectrum of possible risk developments widens further.

A concern that we have is that the people who created the financial vehicle called the ESM occasionally seem to have the view that the financial world is static or at least can be controlled. These people are the current European political leaders that have the aim to keep the euro area together as it is today. But the financial world is very dynamic, which could conflict with the purpose of the ESM – to keep the euro area in a static grip. To give an example of a likely scenario, we pick France again. Not only could the country's credit rating be lowered by two nudges down to AA-, but other country ratings also might go up. China is currently rated AA- by Standard & Poor's though China's economy and wealth has been growing substantially every year. It is imaginable that China's long-term credit rating goes up by two nudges to AA+ at the same time. This illustrates the double effect of this situation. Not only does France (and the ESM) get more difficulties finding funding due to its own economic condition, but China is also increasingly getting more and more attractive for investors. Many political leaders in Europe are focusing too much on finding a solution that is stable under the current economic conditions but not resistant to realistic future financial developments or stress.

This is why we regard the funding mismatch seriously dangerous within the construction of the ESM. We highly recommend that the funding has the same maturity as the lending to the rescued member states has, as a minimum. Under the current risk-management approach the ESM then might end up competing with the member states if the funding market gets difficult to access. This is another example where the ESM would accelerate volatility within the financial markets instead of adding stability. I this context it should be mentioned that the EU Commission fully covers the interest rate risk when they participate in a bailout and therefore has eliminated the refinancing risk to zero.

We couldn't find any policy for the management of the bail-out assets. We therefore have to work with the assumption that the ESM could chose to utilise the whole lending capacity to one country. This represents an enormous risk that increases the probability of the lending spinning into a situation out of control. Some would claim that this view is speculative, though several economists are pointing out that the rescue of Spain in the end could demand more than the full capacity of the ESM. A bail-out of Spain is in our view increasingly likely, though the amount needed is still too early to estimate.

When calculating the maximum bail-out capacity of the ESM, we recommend including only the countries that haven't applied for bail-out assistance yet (either at the EFSF or the ESM). Spain guarantees for 11.9 pct. of the capital subscription (i.e. the guarantees), and for the next years we cannot recommend regarding the guarantees from Cyprus, Greece, Ireland and Portugal as valid. This lowers the guaranteed capital by another 7.1 pct.

This reduces the ESM's bail-out power by 19 pct. or €134 billion, which results in a total size of €566 billion, of which €100 billion are committed to Spain already and around €175 billion for other EFSF bail-out programmes. These amounts seem very large, but in reality the remaining €300 billion of realistic bail-out power are hardly sufficient to cover the needs of Spain.

## Only distressed assets

Not alone is the ESM funding itself shorter than it is lending out, but the ESM is also taking high risks by lending out to distressed economies (or buying their bonds). When a financial vehicle with high credit rating lends out to lower rated counterparties, we regard this as credit speculation from a financial perspective. This is the way normal commercial banks or investors with high risk appetite behave.

The risk management of the bail-out assets is unclear to us. We have raised a range of questions to the ESM to understand the risk management better. Unfortunately, we have not received any reply from the ESM yet.

The rescue fund is ready to purchase government debts at higher prices than the market. In the revaluation of the portfolio this should lead to an immediate loss, which correctly should be reserved from the paid-in capital at the same time. We have also asked questions about the risk handling and valuation of the lending to governments and / or banking sectors that have run out of financing sources. This is of very high importance because the paid-in capital acts as a buffer against losses from the bail-out assets, though nobody has a feeling for the magnitude of these losses in case there will be any.

About the risks surrounding the ESM we notice leverage on the paid-in capital, a funding mismatch between liabilities and the bail-out assets, which we regard as speculation, and extreme credit leverage. The extreme credit leverage emerges from the purchase of distressed financial assets that nobody else wants to buy. The latter part is the nature of the fund; the two first risk components are not. Still, the ESM member states want investors to buy debt issued by this financial vehicle. If we were to describe the fund, then the risk picture would look like a hedge fund – in this case the world's largest. Some are referring to the guarantees; but the returns for investors are low and they must trust in guarantees that are partly issued by troubled member states. The ESM has parts in its construction that embed high leverage though the returns for investors are low. We therefore argue that the risk versus return does not correspond.

# The rescue of the ESM in case of failure

One could question if it's valid to cover the subject about a possible rescue of the ESM at all. Critics might claim that we are pointing at a hypothetical risk and it is nonsense to talk about a failure of the ESM. We argue differently; firstly, there are no hypothetical risks. If a risk is defined, then it exists and the evaluation is solely about the probability of the risk to develop towards the worst case scenario. One should keep in mind that the largest financial surprises or crises typically started out as very unlikely scenarios.

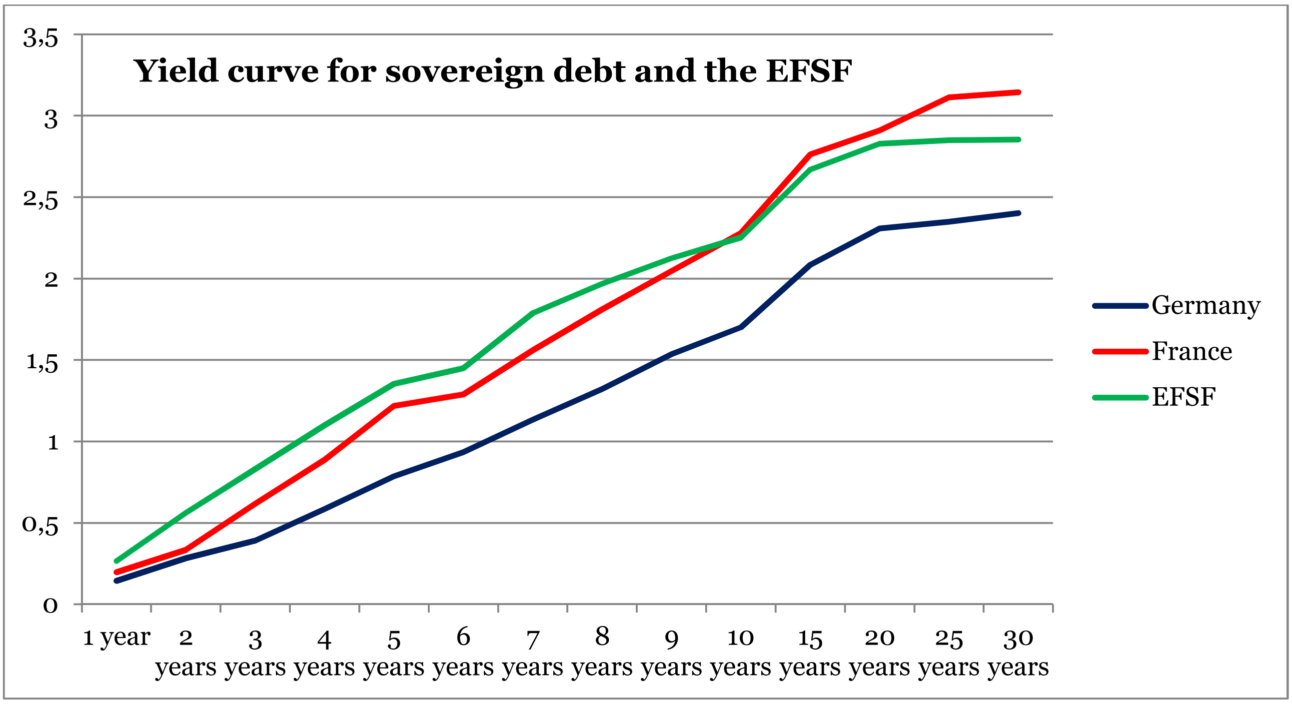
Regarding the ESM it is very valid to discuss a failure, a financial meltdown of the fund. We have covered the reasons in this working paper; the conclusion is that several accelerating risk factors instead of stabilising factors are embedded in the construction of the fund. One of several concerns we have is that the financial market and people in general de facto regard the ESM as backed by Germany because the country has a stake in the fund.

When pricing the debt issues from the ESM it is dangerous for investors to trust that Germany can or will back the rescue fund regardless of what happens. The decision of the German Federal Constitutional Court of 12 September 2012 stated that Germany cannot increase its guarantee obligations towards the ESM unless the German Parliament approves it. From today's perspective it could seem like just another guarantee that might be discussed but in the end approved as it always is. It's very unlikely that everything will work out so smoothly because if Germany was asked to increase its guarantee, this would mean that the ESM rescue fund is in trouble. Germany has already guaranteed for €190 billion, which is 7.25 pct. of its total GDP. A troubled ESM would indicate a deeper economic crisis in Europe, which in turn would put the political discussion about higher guarantees in a difficult context. We do not expect Germany to be able to bail-out the rescue fund on its own. As a consequence investors should not price too much safety into the ESM debt based on the German stake in the ESM. Some might remember the market movements when the euro was crated. The majority of the market considered all euro area sovereign debt to be of almost the same quality. Even the spread between Greek and German sovereign debt narrowed to the almost invisible – a serious mistake as the history proved.

The German Constitutional Court ruling clarified another issue, almost in a subordinate clause. However, it could be of significant importance. The court stated that money transfer links from the European Central Bank (ECB) was strictly prohibited. As a consequence the ECB is not able to back the ESM with liquidity in case of a refinancing crisis. One solution would be to grant a banking license to the ESM, though it would have to be politically approved. This solution could be blocked by some countries all of a sudden. The possibility of the ESM being taken over by the ECB is currently just a speculation though the only realistic solution which brings back the full risk to taxpayers within the euro area. The alternative would be to give the ESM access to funding directly at the ECB. In both cases huge write downs for the taxpayers within the euro area is very likely.

Figure 3 shows the yield curves for the German and French sovereign debt plus debt issued by the EFSF. It confirms that German debt still belongs to the most favoured among investors as one of the worlds "safe heavens". But there a couple of other indications that we advise investors to follow over time.

**Figure 3**




Source: Various

From 1 to 10 years maturity the interest rate on EFSF debt is higher than the sovereign debt issued by France. From 10 to 30 years France explores the highest yield on its debt. As shown earlier is the majority of debt issued by the EFSF of short to mid-term maturity. That the pricing of the long-term debt issued by the EFSF behaves differently can be a signal of less liquidity in the long-term issues. This makes the long-term debt issues from the rescue fund less attractive for investors. Alternatively are investors regarding long-term debt issued by the rescue fund more attractive than French debt. This would confirm the dangerous perception about Germany probably will back-up the rescue fund. Should France be downgraded by 2 nudges by the rating agencies then the yield on French debt naturally increases. Earlier we used the same example as an argument for how this event could de-stabilise the ESM. All though the EFSF and the ESM are working under different legal frameworks then we expect the consequences that could develop (described in “A financial perspective on bail-out actions”) after a French downgrading to AA- as serious for the ESM as well. We argue that the long-term debt issued by the rescue fund is priced too optimistic by the market.

The behaviour of the spread between the yield curves of German debt and the EFSF debt is unusual. For debt with 2 years maturity the EFSF debt is trading 0.28 percentage point higher than the German debt. This spread widens to around 0.65 percentage point in the 7 and 8 years maturity but narrows to 0.45 percentage point for the debt with 30 years maturity. It can be the same explanation with too low liquidity in the long-term EFSF debt. As the EFSF issues most debt with 5 to 10 years maturities the unusual behaviour of the spreads alternatively could be a stress signal that we recommend investors continuously to follow. Already now, before a potential very large rescue operation, the market might have an oversupply of debt issued by the rescue fund. This is another indication of a potential refinancing problem for the ESM.

# Conclusion

The current firepower and political backing of the EFSF / ESM rescue fund makes us less nervous for investors purchasing debt with short maturities with up to 1 year. This opinion can be withdrawn without any notification at any time.

Based on the risk scenarios, conclusions in this working paper and especially the volatility generators embedded in the construction of the ESM (and the EFSF) we regard it too uncertain to invest in debt issued by the EFSF and the ESM with maturities reaching beyond 1 year. Compared to a sovereign debt, or debt issued by a corporation, there are too many factors that remain unclear which fundamentally makes it difficult to evaluate the risk and to determine the right price of the securities issued by the rescue fund. If an investment is unclear or the risks might not be exact described then it's another argument for avoid investments in such financial vehicles like the ESM.

For the users, or clients, of the ESM this uncertainty should be a reason of deep concern. For a financial troubled counterparty, in this case a country or its banking sector, refinancing always is a welcome sweetener. Valuable experience has learned many that the financial partner must be strong. This is of particular importance for counterparties relying deeply on the financing source. We recommend the countries that are using, or intent to use, the EFSF / ESM as financing source to consider this sincerely. Some might claim that the troubled countries don't have other alternatives. We see this very differently, though it requires another working paper to cover that subject.

Regarding the taxpayers within the euro area then we are concerned about how the rescue fund has been explained to the public. The politicians behind the construction of the EFSF / ESM have explained that the rescue fund will create stability. To some extent they are right but beyond a certain risk point they are deeply wrong because the ESM will increase volatility in the financial markets and not create stability. How likely it is that the euro area reaches this risk point is not possible to say but it can be reached with nothing more than a further downwards economic development in Europe, in other words, this is likely or maybe even highly likely. Should this be the case then we haven't found any evidence that there is a political plan B about how to rescue the ESM. The reason we are raising this issue is not politically motivated. But should the ESM explore financial stress, the number of negative voices against the ESM could then grow if the financial vehicle had not been explained correctly at its introduction.