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EFSF AND ESM COMBINED TO CREATE EUROZONE FIREWALL

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THE EUROZONE COMBINES ITS STABILITY MECHANISMS TO EUR 800 BN

Introduction

Since the second Greek bail-out was agreed in February this year, the international community has been urging the Eurozone to take action to contain the sovereign debt crisis from spreading. Although the immediate threat posed by Greece has been contained, the Spanish and Italian economies are still considered weak. All eyes have now turned towards the Eurozone's financial stability mechanisms with the head of the OECD, Angelo Gurría, perhaps echoing the markets' sentiment best, stating in his calls to the Eurozone to bolster its stability funds:

*"The mother of all firewalls should be in place... It's something you're telling the markets: I've got the firepower and, if I need to, I'm going to use it"*¹.

The 'magic number' EUR 1tn appeared to be the general consensus, among the international community and a number of Eurozone members alike, as the minimum amount required to sufficiently stave off the risk of contagion. With the EFSF's lending capacity diminished by recent bail-outs, the pressure was on to fix the firewall.

Germany's chancellor, Angela Merkel, head of the Eurozone's largest and most influential economy, has, however, always been reluctant to change the plans regarding the Eurozone's stability mechanisms, let alone to increase their firepower. However, on 30 March 2012, the Eurozone finance ministers agreed to combine the European Financial Stability Facility and the European Stability Mechanism (the Eurozone's fledgling permanent financial stability fund) in the hope of creating a firewall strong enough to contain the sovereign debt crisis.

In this update, we take a look at the Eurozone's stability mechanisms, what they are and how they work and what the new combined funds will mean in terms of size and capacity to contain the sovereign debt risk.

Eurozone Stability Mechanisms

The European Financial Stability Facility

On 9 May 2010, the 27 Member States of the European Union agreed to create the European Financial Stability Facility² (EFSF). The EFSF was incorporated on 7 June 2010 as a private company under the laws of Luxembourg (a *Société Anonyme*). The EFSF was created to preserve the financial stability of Europe's monetary union by providing financial assistance to Eurozone Member States, if needed. Created as a temporary facility in lieu of a permanent stabilisation mechanism (in the form of the European Stability Mechanism – see below), it technically terminates automatically on 30 June 2013. However, since the EFSF was activated in 2011 in connection with a series of bail-outs (see below), it will now remain in existence until such loans have been fully repaid (or the Member States agree otherwise).

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Chambers European Excellence Awards, 2009; Shortlisted 2010, 2011/ Who's Who Legal Awards, 2006, 2008, 2009, 2010, 2011/The Lawyer European Awards-Short-listed, 2010, 2011

"Best Portuguese Law Firm for Client Service"
Clients Choice Award - International Law Office, 2008, 2010

"5th Most Innovative Law Firm in Continental Europe"
Financial Times - Innovative Lawyers Awards, 2011

"Corporate Law Firm of the Year - Southern Europe"
ACQ Finance Magazine, 2009

"Best Portuguese Tax Firm of the Year"
International Tax Review - Tax Awards 2006, 2008

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¹ Statements given on 27 March 2012

² For more detailed information on the EFSF please refer to its website: <http://www.efsf.europa.eu/about/index.htm>

European Financial Stability Facility



The EFSF's scope of activity includes the authority to³:

- issue bonds or other debt instruments on the market to raise the funds needed to provide loans to countries in financial difficulties;
- intervene in the debt primary and secondary markets;
- act on the basis of a precautionary programme; and
- finance recapitalisations of financial institutions through loans to governments including in non-programme countries.

Although the EFSF works closely together with the IMF and its financial assistance programmes mirror those of the IMF, unlike the IMF, the EFSF does not enjoy preferred creditor status. Private investors may be reluctant to provide loans if there were too many preferred creditors, defeating one of the objectives of the fund which is to assist Member States to return to the normal debt markets.

The EFSF is authorised to issue bonds for a maximum amount of EUR 780 bn, which corresponds to a EUR 440 bn lending capacity⁴.

The EFSF can only act⁵:

- after a support request is made by a Eurozone Member State;
- a country programme has been negotiated with the European Commission and the IMF in liaison with the ECB;
- that programme has been accepted by the Eurozone's finance ministers; and
- a memorandum of understanding has been signed.

Very simply summarised, the EFSF works by issuing bonds backed by guarantees from (usually AAA rated) Eurozone Member States with the EFSF lending that money to those Eurozone Member States ("Lender State"). They then, in turn, on-lend that money (so-called 'back-to-back' lending) to the relevant debt-stricken Eurozone Member States ("Borrower State"). It is important to note that, from an accounting perspective, this means that the amounts 'drawn' under the EFSF, therefore, ultimately both register on the Lender State's and the Borrower State's balance sheets, increasing both their debt levels.

The EUR 440 bn lending capacity is boosted by the European Financial Stabilisation Mechanism (EFSM) which can issue loans up to EUR 60 bn. These funds are obtained by the European Commission raising funds on the market using the EU budget as collateral. The combination of these two funds means that the initial temporary Eurozone 'firewall's' maximum lending capacity is EUR 500 bn.

The EFSF was activated for the first time in November 2011 in connection with the EUR 85 bn Irish Bail-Out. Since then both Portugal and Greece (for a second time⁶), have requested assistance, respectively amounts totalling EUR 78 bn and EUR 130 bn. As a result of the EFSF's participation in these bail-outs (totalling EUR 200 bn), the facility's capacity has diminished to EUR 240 bn; nearly half of its total capacity. This has been seen by many, including the main international and economical institutions such as the IMF and the OECD, as insufficient safeguard against contagion in the Eurozone.

The European Stability Mechanism ⁷

The European Stability Mechanism (ESM), as intended at its creation, is the permanent replacement of the EFSF. It was given a legislative base in December 2010 by way of a simple, two-line amendment⁸ to the Treaty of Lisbon⁹ which avoided the further need for Member State referendums. In addition to the amendment, a separate treaty establishing the ESM was signed on 2 February 2012¹⁰.

Follow the link to download a copy of the treaty:

³ http://www.efsf.europa.eu/attachments/faq_en.pdf

⁴ This is explained by the credit enhancement structure which includes an overguarantee of up to 165%.

⁵ See footnote 3

⁶ The first Greek bail-out took place prior to the EFSF being incorporated and therefore falls outside its scope.

⁷ The information in the following section is based upon legislation and information otherwise available in the public domain in force at the date of this update. It does not take into consideration any changes to relevant legislation that have not been made public at this time.

⁸ Amendment Art 136 Treaty of Lisbon: "The member states whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality".

⁹ The Treaty on the Functioning of the European Union

¹⁰ Technically two treaties have been agreed in this respect, with an initial treaty being agreed on 11 July 2011. However, only the later version is expected to be ratified and implemented.

<http://www.european-council.europa.eu/media/582311/05-tesm2.en12.pdf>

Under the current terms of the ESM treaty, unlike the EFSF, the ESM is not a private company. It will be an intergovernmental institution established under public law. It is expected to come into force in July 2012 or as early as sufficient Member States ratify the treaty. Initially, it was foreseen that the ESM would run parallel to the EFSF for one overlapping year and then replace the EFSF in 2013.

The ESM's scope of activity is the same as that of the EFSF (see above) and it too requires a support request and country programme agreed with the European Commission, IMF and ECB before it can act. Its overall lending capacity is capped at EUR 500 bn. Unlike the EFSF, it lends directly to Member States requiring support, avoiding the need for additional debt to be registered on the balance sheets of Lender States. Unlike the EFSF, loans issued by the ESM will enjoy preferred creditor status but will be subordinated to the IMF's claims.

As mentioned above, initially the ESM was to replace the EFSF in 2013. However, the need for the EFSF to be activated called into question (i) how the EFSF and the ESM would now work in practice and (ii) what the overall lending capacity of the funds should be given the current sovereign debt crisis.

The Firewall

Once the dust had settled on the second Greek bail-out, the attention turned to how to prevent any further contagion in the Eurozone (and potentially beyond its borders). Most experts agreed that a 'bazooka' or 'firewall' of financial stability support would be the best solution for the fragile Eurozone economy.

An internal discussion among Eurozone members ensued regarding the future of the funds. Germany did not see the need to increase the firepower of either fund as it would make no difference in their opinion. But many finance ministers wanted to see the EFSF merge with the ESM rather than it being replaced by it. This could potentially increase the ESM's firewall to EUR 740 bn of 'fresh lending' capacity. The international community also persistently urged Eurozone ministers to consider putting a mega-firewall in place to contain the risk of contagion.

Come March 2012, Eurozone finance ministers were ready to take a decision on the future of the financial stability funds and the need for a bigger firewall. However, ministers looked likely to clash over its size when they met in Copenhagen at the end of the month.

On 30 March 2012, an agreement was reached to combine the EFSF and the ESM as follows (summarised):

- The ESM's time-table will be brought forward, which effectively means that the paid-in capital will be made available more quickly with two instalments to be made in 2012, two in 2013 and a final instalment in 2014 .
- The ESM will be the main instrument to finance new programmes as from July 2012.
- The EFSF will only remain active in respect of financing programmes that have started before that date (i.e. the bail-outs to Ireland, Portugal and Greece totalling EUR 200 bn), although it can technically dip into the EUR 240 bn if it needs to until mid-2013.
- The combined overall ceiling for EFSF/ESM lending will be set at EUR 700 bn (EUR 200 bn already paid out by the EFSF + ESM EUR 500 bn).
- In addition EUR 49 bn out of the EFSM and EUR 53 bn out of the bilateral Greek loan facility have already been paid out to support current programme countries.

Follow the link to download the official statement of the Eurogroup dated 30 March 2012: http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/129381.pdf

The Eurogroup goes on to explain in the statement, that, when you add everything up:




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"All together the euro area is mobilising an overall firewall of approximately EUR 800 billion, more than USD 1 trillion".

Conclusion

Critics have been quick to point out that, in fact, nothing has really significantly changed other than that the ESM time-table has been brought forward; that this is, in fact, not the "mother of all firewalls" that Mr Gurria and the international community at large were hoping for.

However, Eurozone ministers are now hopeful that the significance of combining the two stability funds and showing that the numbers 'add up', will be sufficient incentive for the participants to double the IMF fire fighting reserves next month at the Spring Meetings of the IMF and the World Bank.

	EFSF	ESM
START DATE	7 June 2012	Sometime July 2012
TERMINATION DATE	30 June 2013 However, since it has been activated, it will run until all loans have been paid back.	Permanent fund
FORM	Private company under Luxembourg law (Société Anonyme)	International / Institution
LEGAL BASIS	No Council and EU Member States decision	■ Art 136 Treaty of Lisbon ■ ESM Treaty
OBJECTIVE	Preserve financial stability of Europe's monetary union by providing temporary financial assistance to Eurozone Member States if needed.	Same See Art. 3 ESM Treaty
SCOPE OF ACTIVITY	<ul style="list-style-type: none"> ■ issue bonds or other debt instruments on the market to raise the funds needed to provide loans to countries in financial difficulties; ■ intervene in the debt primary and secondary markets; ■ act on the basis of a precautionary programme; and ■ finance recapitalisations of financial institutions through loans to governments including in non-programme countries. 	Same
MAXIMUM LENDING CAPACITY	EFSF EUR 440 bn EFSM EUR 60 bn (in additional loans)	EUR 500 bn
LOANS OUTSTANDING	EUR 200 bn in bail-outs	None
CREDITOR RANKING	Not preferred creditor	Preferred creditor status Subordinated to IMF
LENDING STRUCTURE	On-lending 'Back-to-Back' with Lender State Eurozone Members	Direct lending to Borrower State Eurozone Member
MERGED FUNDS EFSF EUR 200 bn EFSM EUR 49 bn Bi-lateral loans EUR 53 bn ESM EUR 500 bn EUR 802 bn (of which EUR 500 bn is available)		

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