Market Insight

The ESM needs the G20 to help boost its firepower; debt-tranching can be the catalyst

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As more details on the EU banking supervision plans emerged at the EU leaders summit last week, it is becoming clearer that the EU is banking on the ESM to finance the transition out of the Eurocrisis. Is this realistic? We believe not. In this Market Insight we put forward the risks of the current ESM set up and our ideas as to how the ESM could increase its firepower without overburdening the EU countries' sovereign debt ratings. Structured Finance can help!

The European Union is failing to overcome its financial problems, despite it creating the European Stability Mechanism (ESM) and despite the European Central Bank (ECB) launching bond purchase programmes for troubled EU-countries. Although these initiatives provide breathing space, they will only work if accompanied by successful structural reforms. If, for whatever reason, those reforms do not materialise, the EU countries that are currently still strong will begin feel the negative impact on their credit status too, because the ESM draws heavily on the strength of the richer European countries. In part due to this connectivity, the rating agencies have placed many Euro-zone countries on their negative watch lists. This negatively impacts the creditworthiness and credibility of the ESM itself, because the ESM is likely to be downgraded as and when their largest contributors are downgraded. This negative feedback loop will become ever more vicious cycle in the scenario in which the problem countries underachieve their planned reforms. We question whether, at that point, the EU, with the ESM in place, would be strong enough to overcome its own financial problems?

We call for a more prudent approach to avoid such a scenario. This approach allows the EU to entice other countries, such as the G20 (in an IMF-context), to give their financial support in solving the crisis, rather than relying on the current set up in which the EU more or less forces its Euro-zone members to contribute to the ESM. In this Market Insight we propose a solution that relies on the existing ESM fund, but that channels worldwide available capital towards the European problem countries, under auspices of the IMF. The firepower and credibility of the fund will be enhanced by the participation of countries where, unlike the EU, there is far less need for de-gearing of governmental financial commitments, for example China. In the structure we put forward, the EU will continue to bear, via the ESM, the bulk of the credit risk of the problem countries – but no longer in a way that threatens to exceed the EU-members' capacity.

Shortfalls of the ESM

In its current guise, the ESM aims to gather capital, via European guarantees, to support European countries in financial distress. The fund is the successor to the European Financial Stability Facility (EFSF). The ESM relieves the ECB of its task as lender of last resort, so that the ECB can focus on monetary policy. However, in our opinion, the ESM suffers from a number of problems.

First, the fund has a size of € 700 billion of which it can lend up to € 440 billion. That is too small to contain debt problems of Italy and Spain, who together have government debts outstanding of about € 3,000 billion. The danger lies in a potential fire sale of sovereign bonds if and when the markets sense that the EU cannot muster up sufficient firepower to provide these countries with the debt they require to finance their deficits. If Italy or Spain request a bailout by the ESM, the ECB will undoubtedly help by purchasing Italian or Spanish bonds. However, the ECB will have to exercise restraint, especially if the financial reforms in those countries stall or inflation rises sharply as a result of its bond purchase programme. Spanish and Italian interest rates will once again spike and their default may become unavoidable, with painful long term consequences for those countries and the EU as a whole.

Second, the size of the ESM cannot readily be increased as the ESM treaty requires the largest risks to be borne by the richer EU countries, in proportion to their share in the equity of the ECB. Germany and France contribute respectively € 190 billion (27% of the total) and € 142 billion (20% of the total) towards the ESM. These are huge sums and there will come a point where they will be unwilling or unable to increase their risk without jeopardising the credit rating of their own sovereign debt. Downgrades of France or Germany will also negatively impact the credit rating of the ESM. This is a real problem that is being closely watched by the rating agencies and financial markets. The future prospects of Europe as a whole would suffer from an erosion of Germany's still formidable financial status. And as past experiences with sovereign crises show, it takes many years for countries to recover from major dents in the market's confidence in their debt service capability.

Third, the decision-making process within the EFSF – and its successor the ESM – regarding country bailouts is very complex. It is not tried and tested, and remains subject to European political interests. For example, in June 2012 the EFSF leadership, consisting of all 17 ministers of the Euro-zone countries, gave the go- ahead to provide a rescue package to Spanish banks directly rather than routing it via the Spanish government. This was approved despite there being no clear European supervision of the recipient financial sector in Spain. Such actions increase "moral hazard'. The direct support of the Spanish banks without proper arrangements with the national government and its financial sector carries the risk that funds will be wasted.

Fourth, especially in the EU countries with the highest credit status, public opinion is turning against further financing and paying off the debts of heavily indebted EU-partners. The EU leadership is receiving increasingly negative press for not being seen to be managing the process well. As a result, the EU is being split in two.

Fifth, the bailout mechanisms are complicated, as are the financing arrangements: there are ECB policies that are distinct from EFSF policies, and the latter will be replaced by another set of distinct ESM policies. That complexity makes it hard for the general public (voters) to fully understand and accept the commitments their countries are asked to make. There is a risk that where arrangements require a vote by European Finance Ministers, a sufficient majority will not be found because these ministers cannot afford the domestic political backlash of sanctioning further ESM loans.

In short, Europe needs a fund solution that meets the following criteria:

1) A fund big enough to guarantee the financial stability of the European problem countries, so that interest rates can be kept at a manageable level.
2) A fund whose capital doesn't have to rely EU-countries only, so that the individual member states are less exposed to the Euro crisis. That would improve their grip on their own credit rating and ultimately benefit the creditworthiness of the fund itself too.
3) A fund organised at arm's length from intra-European political motives, in order to prevent moral hazards.
4) A fund that is structured in such a way to entice G20 countries with a fiscal surplus to be motivated to contribute to the fund.

The fund structure

The casual reader may be surprised to hear that our proposed solution is yet another fund. However, please consider our reasoning. Our proposal avoids the complications associated with the establishment of yet another new, politically motivated, support fund: we advocate retaining the existing funds but overlaying a tranching structure thereby allowing cooperation between European Countries and G20 countries with a surplus to combat the Euro crisis whilst aligning the risks and returns taken by these two constituencies.

We propose that the IMF be tasked with implementing a structure in which the ESM and G20 intensify their cooperation. The ESM would continue to set conditions towards problem countries regarding structural reforms. It would also maintain its central bailout role towards such countries, but it wouldn't increase its capital base. Instead, the ESM would provide its bailout loans by means of a financing structure in which the G20 countries participate, to a combined total many times larger than the ESM itself. In order to shield the G20 from the credit risks of lending to the European problem countries, and to offer them an adequate risk-adjusted return on their investments, the structure provides loans to the problem countries on a "tranched" basis. The ESM loans will be subordinated to the G20's loans, i.e. they will have to absorb the first credit losses on the loans they provide to countries that receive ESM bailout packages. The G20 only incur default risk once the ESM's funds are inadvertently depleted by credit losses on the bailout packages they may provide to Italy, Spain or other EU countries. The ESM provides the G20 with a buffer worth € 700 billion, collectively supplied by the EU contributors. That way the total financing structure can easily cover the € 3,000 billion of sovereign debts of Italy and Spain, which means that market speculation against these countries can be quashed. It is important to implement the tranched structure before Spain and/or Italy call on the ESM; otherwise the buffer that the ESM can provide to the G20 would be undermined.

Interestingly, in February 2011 there was a public debate in the *Financial Times* on whether the EFSF was already *de facto* tranching its debt when it increased its size from its initial € 250 billion to € 440 billion. At the time, the EFSF's CEO Mr. Klaus Regling considered the accusation to be so important that it warranted him writing an open letter of refutation in which he emphasised the equal rights of investors in the EFSF. We now argue in favour of explicitly departing from this principle, by attracting rescue funds on a tranched basis, with each tranche carrying a return commensurate with its risk profile in order to attract G20 participation in potential European bailouts.

There's a global macro-economic logic to this idea: it allows sovereigns with excess investment capacity, like China, to participate in the financing of countries with large borrowing needs. That is not the case in the current ESM set up, because within the confines of the EU there are no surplus countries. Because of this logic, the proposed fund structure promotes global macro-economic stability and can attract large sums of capital. Finally, the firepower will be increased without further jeopardising the creditworthiness of the stronger EU countries such as Germany and France, because their contributions to the ESM do not have to go up, and that is good for global stability too.

If you agree with our views in this Market Insight, and even if you don't, we would be delighted to hear from you (info@bishopsfieldcapital.com).