19 October 2011

EFSF Guideline on Primary Market Purchases

1. Introduction

The conclusions of the Heads of State or Government of the Euro area on 11 March 2011 in connection with the establishment of the ESM by 2013 state that financial assistance from both the EFSF/ ESM will take the form of loans. It also states that in order to maximize the cost efficiency of their support, the ESM and the EFSF may also, on an exceptional basis, intervene in the primary markets in the context of a programme with strict conditionality. This guideline will explore some of the considerations of why, when and how an entity such as the EFSF could utilize this ability to intervene in the primary markets.

In addition, at the Euro Area Summit on 21 July 2011, the Heads of State or Government of the Euro Area and EU institutions agreed to increase the flexibility of the EFSF and ESM in order to address contagion by allowing them to (i) act on the basis of a precautionary programme; (ii) finance recapitalisation of financial institutions through loans to governments including in non-programme countries; (iii) intervene in the secondary markets on the basis of an ECB analysis that financial stability is at risk.

2. Objective

In respect to EFSF activities, the Member State will have access to funding primarily through the EFSF lending window, for which the rate will be established in line with the prevailing pricing policy. EFSF may engage in primary market purchases ("PMP") as a complement to regular loans under a macroeconomic adjustment programme or to draw-downs of funds under a precautionary programme. The main objective of primary market purchases is to allow the Member State to maintain or restore its relationship with the dealer/investment community and thereby to increase the efficiency of EFSF lending.

In almost all cases within the euro area, Member States have typically enjoyed relatively straightforward access to the capital markets through syndicated transactions over the past years and continue to have varying degrees of diversification and depth. Furthermore, Member States have installed formal bond auction processes enabling dealers to purchase securities including bills, notes, and bonds directly. Primary market purchases by EFSF should be established in a manner that enables the Member State already under an EFSF program or using a precautionary credit line to take advantage of this historical access to the capital markets and therefore to the investment community.

An approach where EFSF, as a backstop and provider of liquidity, facilitates the access of a beneficiary Member State to its standard lending instruments on markets carries several benefits.

For the beneficiary Member State, EFSF's participation would reduce its risk of experiencing a failed auction or not raising the required fund amount. EFSF presence in the transaction also limits the risk that "out of the market" prices are posted by opportunistic primary dealers to test the needs from the country by ensuring that a minimum size will be secured. This reassurance should encourage the Member State to return to the financial markets earlier than otherwise. PMP from the EFSF may be especially warranted to prepare Member States re-entering the private market at the end of a financial assistance programme or to support Member States whose economic conditions are still sound to continue refinancing via the market under a precautionary programme.

For EFSF, PMP would create some leverage of its financing and increase its efficiency. By encouraging market access and complementing the funding of a beneficiary Member State in the market, it directly reduces the financing needs to be covered by the official sector, and thus preserves the lending capacity of EFSF. Unlike with the provision of loans, the securities obtained by the EFSF via PMP could in fact be resold to private investors, when market conditions have become accommodative. EFSF may by doing so help contribute to secondary market liquidity and free lending capacity.

From an investor or market perspective, the Member State's restored or continued presence in the markets would increase the supply and liquidity of outstanding and new bonds of the Member State in a market transparent mannered. On this account, PMP would address liquidity requirements from investors and reduce undesirable price effects. By encouraging Member States to maintain or restore presence in the market, the EFSF addresses the needs of investors who have certain limitations on the percentage of outstanding amount of a country's debt they are allowed to hold. Such restrictions should avoid risks of not being able to get adequate prices when trading these bonds. Without new bond issues and the stock of tradable bonds shrinking due to redemptions and programme financing, this restriction may become binding in some cases and such investors will have to rebalance their portfolio. This may lead to forced selling of part of their bond portfolio of the Member State in order to maintain the prescribed limits. Such sales would lead to price pressures and higher market rates for Member States.

3. Timing of primary market purchases

In view of the objective and conditions for primary market purchases mentioned above, this complementary financing tool would primarily be used towards the end of an adjustment programme to facilitate the return of the beneficiary country to the market or as an alternative to the draw-down of funds under a precautionary programme. Careful market analysis is required to decide on the conduct of a PMP operation and ensure its success. First, the intervention may have a very different effect on the market than the announcement of a loan. Second, once the primary market purchase takes place, the market will know whether there has been a strong / low appetite for the bond from the private sector. This may affect future interventions and also have secondary market implications. Therefore any such intervention requires careful market screening. This would have to be provided by the issuing country and EFSF.

It should not be fully excluded that PMP is used at an earlier stage or from time to time in longer intervals for specific maturities. Spreads have often increased further after countries actually entered a programme due to some concerns whether countries can re-enter markets as required and therefore obtain sufficient liquidity. Potentially, PMP at an earlier stage of a programme or done within clear limits in the course of the programme might help to prevent such developments.

4. Modalities of Primary Market Purchases

Primary market activities are among the important indicators of public demand for the specific credit at the specified maturity and pricing. Thus they are very important elements of transparent and efficiently functioning markets. In the case of EFSF's participation in the primary market this character should be preserved. At the same time, EFSF's participation has to be significant enough to reduce the execution and liquidity risks of the issuing Member state meaningfully. The modalities of the intervention need to strike a balance between assuming funding responsibility for the Member State and not undermining the market element relevant for the issuing Member State.

To achieve these targets a rules based mechanism seem recommendable to determine at which price EFSF purchases securities and at what amount. The details of this mechanism will depend to some degree on the specific issuing format.

As a common point, the intervention of EFSF would be at market price. As already expressed, it seems more adequate to consider that participation in PMP would take place only if a reasonable participation of private investors at a rate not excessively above the EFSF funding rate as the Reference Funding Rate is possible. The analysis whether a rate is excessive should be based on an assessment of the financing needs and gap of a country in the context of the overall monitoring, as well as an assessment of current market conditions.

4.1. Participation in auctions

EFSF should participate at the weighted average price of the auction to minimize EFSF's impact on the auction result and to maintain the information character of the auction. A bilateral agreement between EFSF and the borrowing Member State will settle the cost compensation for the bonds bought by EFSF..

Generally, the amount EFSFM purchases should be limited to no more than 50% of the final issued amount. That means that EFSF's share is no larger than the share bought by the market. Additionally it gives an incentive to the issuer to accept market bids, because for each million of accepted market bids the member state will receive an additional million from EFSF. An example of how the intervention can be conducted is illustrated in Annex 1 of this document. Only when a new bond is issued and in the unlikely case that prior market analysis failed to give the right signals, this approach need to be modified. There must be an extension of this rule to avoid the issuance of a small illiquid bond into the market place if insufficient market bids are received at acceptable levels to sell 50% or more of the targeted issuance amount to the market and EFSF. In this scenario, the EFSF will buy the balance between the amount which can be sold to the market and 50% of the targeted issuing amount. That assures that the outstanding amount is at least half of the originally targeted amount.

4.2. Participation in syndicated transactions

In situations where EFSF participates in a syndicated transaction, EFSF will purchase its securities at the re-offer price (means EFSF will pay no fees) as they do not represent any underwriting risk to the corresponding syndicate group.

The amount EFSF purchases will be limited to no more than 50% of the final issued amount, thus leaving at least half of the transaction to the market via the syndicate members. If the order book does not allow selling of at least 50% of the targeted issue amount at the estimated RFR or better, EFSF will purchase the balance between the amount which could be sold to

Investors and 50% of the targeted amount. The remaining 50% must be taken up by the syndicate.

Whether the transaction will be conducted through an auction or syndicate has to be determined by technical experts on a case by case basis.

5. Procedures and activation

A Member State receives access to this form of EFSF financial assistance in the context of its support under a macro-economic adjustment programme or under a precautionary programme. The extension of financing based on primary market purchases is an approach complementing the standard financing through loans under a macro-economic adjustment programme or through draw-downs of funds under a precautionary programme. As such, it has to fall into the overall financing envelop for the programme and would substitute the disbursement of a loan or the draw-down of funds. If the PMP does not yield the necessary financing due to limited private investor participation, the financing gap would have to be closed through a standard EFSF loan.

For PMPs the standard respective procedures of requesting financial assistance, adoption and surveillance under a programme apply. It should be envisaged to generally approve the possibility to use this approach when the Eurogroup/Board of Governors grants a financial assistance programme or a precautionary programme for a country and include the respective provisions in the Financial Assistance Facility Agreement or modify existing Loan Facility Agreements accordingly.

In order to benefit from this financing approach, the EWG/Board of Directors should then decide by mutual agreement upon the proposal of EFSF to approve these operations for the disbursement of financial assistance or the draw-down of funds to a beneficiary Member State and its main terms. This decision should be taken after having received the report from the European Commission on the economic conditionality including the debt sustainability considerations in the context of the programme monitoring procedure. In the case of a precautionary programme, the use of PMPs shall trigger a reassessment of the conditionality of the MoU including the assessment of additional reform measures and a re-evaluation of the adequacy of a precautionary programme. Involvement of the IMF in the monitoring procedure will be actively sought.

6. Management of the portfolio of bonds and pricing

Once bonds have been bought and booked in EFSF securities account, four strategies can be implemented:

- Sell the bonds back to the market when the demand is restored: this would necessitate an active risk management and would potentially disturb the issuance of the country on the primary market,
- Hold the bonds to maturity: This would limit the market risk and is consistent with the actual policy of the ECB.
- Keep the bonds as available for sale and sell the bonds back to the country.

- Use bonds for repos with commercial banks to support the liquidity management of the EFSF.

The Financial Assistance Facility Agreement will specify how any profits and losses will be settled.

All costs, including costs of carry and hedging, and expenses incurred by the EFSF in connection with this financial assistance support facility have to be paid by the euro area Member State benefiting from the PMP.

<u>Annex 1</u>: Example of a potential intervention in the Primary Market

Following there is an illustrative example of a potential intervention of EFSF in an Auction of a Member State. The prices and volumes of the market bids are shown in columns A and B (sorted by Price). For this example, total Bids received amount to €770 mill. (of which €100 mill. at non-competitive rates). Then, an average price, weighted by the accumulated volume (C), is calculated in column D. This would be the price at which EFSF shall participate in the auction

According to the EFSF participation principle, the purchase of the bonds must be limited to the 50% of the final amount issued. This participation amount is shown in column E. Finally, the Funding Cost is shown in column G, calculated as an average (weighted by volume) between the Purchase Price of the auction and the RFR. This is the final price at which the Member State and the EFSF should align based on the bilateral agreement.

Expected Size (€ mill)	1,000
max part EFSF	50%
RFR (ref.funding rate)	5.50%
Sec.Market Level	5.60%
= allocation A	
= allocation B	

Price	Bids per price (€ mill)	Total Bids (€ mill)	Weighted avge. Price	Max participation EFSF (€ mill)	Final Funding Vol. (€ mill)	Final avge. Funding Cost
A	B	C	D	E	F	G
non comp.bids	100	100				
5.10	10	110	5.10	110	220	5.30
5.20	10	120	5.15	120	240	5.33
5.30	10	130	5.20	130	260	5.35
5.40	70	200	5.34	200	400	5.42
5.50	50	250	5.39	250	500	5.45
5.60	30	280	5.43	280	560	**5.46**
5.70	80	360	5.51	360	720	5.51
5.80	180	540	5.63	460	1000	**5.57**
6.00	30	570	5.65	430	1000	5.59
6.50	110	680	5.81	320	1000	5.71
7.00	10	690	5.83	310	1000	5.73
8.00	50	740	6.00	260	1000	5.87
10.00	30	770	6.18	230	1000	6.03

The possible results of the auction are highlighted in green (allocation A) and blue (allocation B).

<u>Allocation A</u>: This would be the option of picking the first result with a Funding Cost below the RFR. The auction would not be fully subscribed under this option but the funding cost would be under both the RFR and the Secondary Level. The private sector is involved with 280m at a rate better than the RFR.

<u>Allocation B</u>: Option of picking the first result in which the total amount would be achieved. The auction would then be fully subscribed but the funding cost is above the RFR. Furthermore, two accepted bids from the private sector are above the Secondary Market level, at 5.70 and 5.80.

To summarize, this exercise reveals that the Member State, depending on the result of the auction, might be in a position to decide between a fully subscribed auction at a worst price or look at the economics and choose a not fully subscribed auction at a better price. This trade-off is made only under the responsibility of the Member State.