European Financial Stability Facility
EFSF

7 November 2011

Terms of Reference for Consultation with Market Participants

Maximising the capacity of the EFSF

On 26 October 2011, Heads of State or Government of Euro-area countries agreed on maximizing the capacity of EFSF based on two approaches. They mandated the Eurogroup to finalise the terms and conditions for the implementation of these modalities in November, in the form of guidelines and in line with the draft terms and conditions prepared for the EFSF.

Further work has been undertaken to specify the terms and conditions of these two options, the partial risk protection and the co-investment approach. The note takes stock of this work and outlines in more detail the options before a process of consultation with market participants and related parties is launched to assess the financial, legal and statistical viability and efficiency of these approaches. After these consultations, the Eurogroup will decide on the final outcome.

1. Objective

Both options achieve the objective of enlarging the capacity of the EFSF without increasing the Euro-area Member States' guarantee commitments underpinning the EFSF, respecting fully the rules of the Treaty. Within the terms and conditions of the ratified Framework Agreement, the options are designed to support the continued market access of Euro-area Member States under financial distress and safeguard financial stability of the Euro-area. The options could provide immediate and credible support, always linked to appropriate conditionality and seeking co-operation with the IMF, whilst preserving the credit standing of the EFSF and its objectives.

The rationales of the two approaches are:

- Option 1: Credit enhancement to primary sovereign bonds issued by Member States would aim at removing concerns about the liquidity position of a Member State. The intention would be to increase demand for new issues of Member States' sovereign bond programmes and lower the Member State's funding costs thereby supporting the sustainability of public finances.

- Option 2: The creation of one or more Co-Investment Funds (CIF) would allow the combination of public and private funding to enlarge the resources available to EFSF's financial assistance instruments. The CIF would aim to create additional liquidity and to enhance market capacity to fund loans. It would purchase bonds in the primary and/or the secondary markets. Where the CIF would provide funding directly to Member States through the purchase of primary bonds, this funding could, inter alia, be used by Member States for bank recapitalisation.

Financing under options 1 and 2 will be linked to a Memorandum of Understanding entailing policy conditionality, and monitoring and surveillance procedures as specified in the EFSF Guidelines. In either option, all costs falling on the EFSF would be fully covered by the beneficiary Member State.

While in principle both options are not mutually exclusive, a decision on which of Options 1 and 2 represents the most efficient use of EFSF resource can only be assessed after further dialogue with potential investors and rating agencies - and the answer may vary according to the beneficiary Member State. For each particular financial assistance, it would be desirable to concentrate EFSF and private sector resources on the best suited option to maximize its firepower; however the possibility to deploy both approaches should not be excluded.

2. Mechanics

Option 1

A Member State (the bond issuer) issues a sovereign bond with credit enhancement through a partial protection certificate attached with the same maturity. The sovereign bond and certificate are sold to investors as a package – it is then for decision whether the certificate could be separable and freely traded after issuance[1]. The partial protection certificate gives the holder of the certificate an amount of fixed credit protection equal to a percentage of the principal amount of the sovereign bond to which it was initially attached. The degree of credit protection will be determined in the light of the circumstances of the Member State concerned; the public exposure would be clearly capped.

The sovereign bond in question is issued at a lower coupon than current market yields for the Member State, reflecting the partial protection provided by the certificate. The certificate is issued at nil cost.

The certificate is triggered by a missed payment of principal or interest due arising from a Member State credit event including: failure by the Issuer to make full and timely payments of amounts in respect of one or more bonds; repudiation or moratorium; or where there is a reduction or deferral of amounts due under the bond. The holder of the certificate would then be entitled to compensation in relation to the principal amount of bonds held, up to the maximum amount covered by the certificate. Work is continuing on finalising the details of the trigger events and terms of payment.

Payments under the protection can only be triggered where investors can demonstrate that they hold outstanding bonds of the same sovereign and at least same principal value as the original bond covered by the certificate for a claim on a certificate to be payable.

The arrangements behind this structure will ensure compliance with requirements under the Treaty and the EFSF Framework Agreement. Any support will be made available through financial assistance from EFSF to the Member State under a Memorandum of Understanding, specifying

[1] The principal purpose of allowing the certificate to be detached and separately tradable would be to reduce the potential for segmentation of sovereign bond markets. This option has advantages and disadvantages which are being explored further in discussion with stakeholders.

conditionality, and an FFA. Member States adopting this solution will need to ensure consistency with their outstanding bond and loan covenants.

Option 2

One or more Co-Investment Funds (CIFs) would be established, with dedicated CIFs (perhaps within a single Fund) having a mandate to facilitate funding of one or several Member States. They will invest in primary or secondary sovereign bonds of a country which has entered into a Memorandum of Understanding specifying conditionality. The vehicle is likely to hold the bonds to maturity, although there might be some flexibility for the life of the fund to be shortened in the event of a clear return to conditions of normality in sovereign bond markets.

These vehicles are designed to attract external capital sources, maximising EFSF resources and to provide a degree of credit protection to investors. The CIF's purpose of risk sharing will be reached through different capital layers with different loss absorption. The CIF will have a nominal equity capital, together with a first loss layer provided by the EFSF, above which would be a capital instrument which participates in the majority or all of the gains made by the CIF. There is also the potential for a third tranche of rated senior debt instruments. The latter tranches would be freely traded instruments and would mature in line with the life of the CIF. The size of each tranche will be determined in the light of take-up from investors in the Participating Tranche and bond investors' demand for any Senior Debt Tranche. If the CIF comprises a two tranche structure, the vehicle may be channelled through an IMF trust fund or administrative account.

The CIF would have a board of directors appointed by the EFSF. The investment policy of the CIF will be specified and will provide investors with clarity about how their interests will be protected through the CIF's decision-making. The principles for buying bonds will be compatible with the approved guidelines for EFSF's purchases of bonds primary and secondary markets.

3. Steps to launch the Options

In the coming weeks Member States, market participants, rating agencies and other stakeholders will be consulted to assist in addressing remaining technical issues relating to the proposed approaches.

Member States will be further consulted in finalising terms and reviewing the specific technical issues which may arise on an individual sovereign basis. Consultations are taking place with Eurostat which will decide on the treatment of both options for Member States' debt statistics.

In its next meeting, the Eurogroup will then decide on the terms and conditions of the two approaches. Subsequently the aim is to complete legal and operational work by the end of November, followed by implementation in December.

Annex A - Option 1

Instrument type	Member State bond issued with a Partial Protection Certificate of the same maturity attached to the bond. The sovereign bond and certificate are initially issued as a package to investors. One option would be for them to remain as a package for their life; another would be for the bond and the certificate to be detachable after initial issue and traded separately. For any Member State to have the benefit of the certificate, it will be necessary for the Member State to enter into a Memorandum of Understanding specifying inter alia conditionality, and a Financial Assistance Facility Agreement (FFA) with EFSF. The Partial Protection Certificate gives the holder of the certificate an amount of fixed credit protection equal to a percentage (to be determined in the light of circumstances of the relevant Member State) of the principal amount of the sovereign bond to which it was initially attached.
Instrument purpose	The main objective is to facilitate issuance by Member States at sustainable rates maximising EFSF capital while providing a predefined degree of protection to investors.
Issuer	Sovereign bond is issued by Member States in line with their normal issuance mechanics for a maturity decided by the Member State, in co-operation with the EFSF. The sovereign bond, identical in form to others issued by the relevant Member State, is issued at a lower coupon than current market yields for the Member State, reflecting the partial protection provided by the certificate. The certificate is issued at nil cost. The Partial Protection Certificate is issued by a special purpose vehicle (SPV) for the same maturity as the bond to which it is initially attached. The SPV would not be legally connected to the EFSF or Member States.
Protection Certificate	The certificate gives rise to a claim in the event of any missed payment, whether principal or interest due, arising from a Member State credit event including: (a) failure by the Issuer to make full and timely payments of amounts scheduled to be due in respect of one or more bonds, subject to grace periods; (b) repudiation or moratorium; or (c) material change in the terms of a bond issued by the Issuer; (d) In case of a dispute as to whether credit event has occurred, EFSF shall be entitled to refer the issue to a determinations committee (composition to be discussed).

The methodology for loss calculation is being finalised.

In the case of detachable certificates, losses would be determined by reference to a wider pool of bonds issued by the relevant Member State.

The SPV shall finance the payments due by receipt of drawings made under a financial assistance facility agreement ("FFA"). The SPV will settle the claim by delivering cash or EFSF bonds.

The investor will be obliged to demonstrate that they hold outstanding sovereign bonds of that Member State of at least the same principal value as the original bond covered by the Certificate. This mechanism and settlement mechanics are subject to further legal analysis and are being finalised.

Annex B - Option 2

Instrument type	Co-Investment Fund (CIF) established to invest in sovereign bonds of Member States, in primary and/or secondary markets. Individual CIFs, or legally separate compartments of a CIF, are expected to be dedicated to one or several Member States. The CIF will have an expected life of [•] years.
Instrument purpose	The CIF will attract external capital sources to Member States' sovereign debt markets, maximising EFSF resources while providing a degree of protection to investors. The CIF will invest in sovereign bonds of a Member State which has entered into a Financial Facility Assistance Agreement (FFA) with EFSF by way of investment in its sovereign bonds. Where the CIF provides funding directly to Member States through the purchase of primary bonds, this funding could, inter alia, be used by Member States for bank recapitalisation. The CIF may hold the bonds to maturity, but could have some flexibility to sell them earlier in defined circumstances.
Issuer	The CIF will be a subsidiary of the EFSF, domiciled in Luxembourg. It will have a board of directors appointed by the EFSF. The investment policy of the CIF will be specified at the outset by the Board and will need to provide investors with clarity about how their interests will be protected through the CIF's decision-making. The principles for buying bonds will be compatible with the approved guidelines for EFSF's purchases of primary and secondary bonds. The CIF will have two or three layers: EFSF First Loss Tranche, a Participating Tranche, freely tradable and potentially a third layer of a Senior Debt Tranche, freely traded. All tranches would have maturities equal to the life of the CIF, although maturities in the potential third tranche of Senior Debt could be linked to the underlying sovereign bonds acquired by the CIF.
Size of Issuer	The size of each tranche will be determined in the light of take-up from investors in the Participating Tranche and bond investors' appetite for any Senior Debt Tranche.

EFSF First Loss Tranche	A first loss tranche will be provided by the EFSF. EFSF will receive a coupon equal to its own cost of funding on its funded tranche. Tranche is made available to CIF after the EFSF enters into a FFA with the relevant Member State and the signing of a MoU specifying conditionality. At maturity of the CIF, or earlier in the case of any sale of underlying bonds, EFSF First Loss tranche will be redeemed pro-rata from disposal proceeds, after redemption of the capital of the Participating Tranche, but ahead of any gains.
Participating Tranche	A tranche of participating units will be sold to investors; these units are likely to be tradable. The tranche ranks ahead of the EFSF First Loss Tranche in any distributions of income from the CIF. The tranche would be funded in pre-agreed drawdowns and any undrawn commitments would need to be supported by acceptable commitments. It will receive a coupon from the cashflows being generated by the CIF, after payment of the coupon on the EFSF First Tranche and the coupon due on any Senior Bond tranche. At maturity of the CIF, or earlier in the case of any sale of the underlying bonds, the Participating tranche will be redeemed pro-rata from disposal proceeds, ahead of the EFSF First Loss Tranche but prior to distribution of any gains. The majority or all of the gains made on investments at termination of the CIF will be allocated to this tranche.
Senior Debt Tranche – optional	The CIF could also issue rated fixed-income senior bonds, ranking ahead of the Participating Tranche and the EFSF First Loss Tranche.
Regulatory considerations	The CIF will need to assess whether it needs any regulatory exemptions within the EU, and adopt operational guidelines which ensure compliance with securities and other regulations in other jurisdictions where it operates.