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**COMMUNICATION FROM THE COMMISSION TO THE COUNCIL AND THE
ECONOMIC AND FINANCIAL COMMITTEE**

on the European Financial Stabilisation Mechanism

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INTRODUCTION

In May 2010, the European Union and euro-area Member States set up the European Stabilisation Mechanism that consists of the European Financial Stabilisation Mechanism and the European Financial Stability Facility to safeguard EU financial stability amid severe tensions in euro-area sovereign debt markets. The European Financial Stabilisation Mechanism (hereafter referred to as the EFSM) was established by Council Regulation (EU) N°407/2010 of 11 May 2010¹ and constitutes an important pillar of the European framework for addressing the current exceptional circumstances.

According to article 9.(1) of the Regulation, the Commission shall forward to the Economic and Financial Committee and to the Council, within six months following the entry into force of the Regulation and where appropriate every six months thereafter, a report on the implementation of the Regulation and on the continuation of the exceptional circumstances that justified the adoption of the Regulation. To this end, the Commission adopts this Communication.

Article 9.(2) of the Regulation points out that the report, where appropriate, shall be accompanied by a proposal for amendments to the Regulation with a view to adapting the possibility of granting financial assistance without affecting the validity of decisions already adopted. However, the Commission is of the opinion that there is no need to amend the Regulation at the present juncture and in line with the most recent developments.

Box 1. Functioning of the EFSM

The EFSM essentially reproduces for the EU 27 the basic mechanics of the existing Balance of Payments Regulation² for non-euro area Member States. When the mechanism is activated, it allows the Commission to borrow in financial markets on behalf of the Union under an implicit EU budget guarantee. The Commission then on-lends the proceeds to the beneficiary Member State. This particular lending arrangement implies that there is no debt-servicing cost for the Union. All interest and loan principal is repaid by the beneficiary Member State via the Commission. The EU budget guarantees the repayment of the bonds through a p.m. line in case of default by the borrower.

The EFSM is a part of a wider safety net. Along side the EFSM, the European Financial

¹ Council Regulation (EU) No 407/2010 of 11 May 2010 establishing a European financial stabilisation mechanism (OJ L 118, 12.5.2010, p.1).

² Council Regulation (EC) No 332/2002 of 18 February 2002 establishing a facility providing a medium-term financial assistance for Member States' balances of payments (OJ L 53, 23.2.2002, p.1).

Stability Facility (EFSF), i.e. funds guaranteed by the euro area Member States, and funding from the International Monetary Fund are available for euro area Member States. Non-euro area Member States are also eligible for assistance under the Balance of Payments Regulation. The EFSM and the EFSF can only be activated after a request for financial assistance has been made by the concerned Member State and a macroeconomic adjustment programme, incorporating strict conditionality, has been agreed with the Commission, in liaison with the ECB.

1. IMPLEMENTATION OF THE REGULATION

Following adoption of Regulation 407/2010, the European Union took the necessary steps to enable a quick and smooth use of the EFSM. These actions have comprised: (i) the necessary budgetary adjustments and (ii) an upgrading of the Commission's capacity to raise funds on the financial markets.

Actions taken in relation to the EU budget

Actions taken in relation to the EU budget include: (i) the creation of a budget line for the guarantee provided by the EU on Union loans raised for financial assistance under the EFSM; and (ii) a revision of the estimate of the available margin under the own resources ceiling.

Creation of a budget line

An appropriate budget structure was created for hosting the coverage provided by the EU budget for possible financial assistance operations carried out under the EFSM.^{3 4}

In normal circumstances, financial assistance under the EFSM would not entail any budget expenditure (due to its "back to back" nature). This would only occur in the highly unlikely event that a beneficiary Member State defaults on its obligations. The structure includes a new budget line (01 04 01 03) for the guarantee provided by the EU on Union loans raised for financial assistance under the EFSM. The budget line carries a token entry (p.m.). The Commission will ensure that the legal obligations towards the bondholders are fulfilled in a timely manner and would propose, if necessary, to make available on this budget line the appropriations needed.⁵

³ Amending Budget No 5 for the year 2010 covering the creation of the budget structure for the European Financial Stabilisation Mechanism has been adopted by the Budgetary Authority on 22 September 2010. The Commission Draft Amending Letter No 2/2011 which also incorporates those changes into the 2011 draft budget has been submitted to the Budgetary Authority on 11 October 2010.

⁴ A similar structure already exists for the Balance of payments facility for non euro-area Member States.
⁵ In case of a default the Commission would first raise the necessary amount to service the debt by drawing on its cash balances and, if these are not sufficient, draw additional cash resources from Member States on the basis of Article 12 of Council Regulation No 1150/2000/EC, Euratom of 22 May 2000 implementing Decision 2007/436/EC, Euratom on the system of Communities own resources. In a second step, the Commission would propose to budget the cash advance.

A new, corresponding budget line 802 has also been created on the revenue side to account for any potential reimbursements after an initial default or for any other revenue arising in connection with the guarantee provided by the EU.

Revision of the estimate of the available margin

Regulation 407/2010 restricts the volume of outstanding loans or credit lines to the margin available under the own resources (OR) ceiling. Indeed, the own resources decision limits the possibilities for the EU budget to call for own resources payments from Member States equivalent to 1.23% of EU Gross National Income (GNI). To be absolutely certain that the Commission will be able to call additional OR from Member States in case of a default on a guaranteed payment, the combined total of (i) the Multi-Annual Financial Framework (MFF) ceiling for payment appropriations (or the payment appropriations authorised in the annual budget if already known) and (ii) the total amount of guaranteed reimbursements due (principal + interest) must not exceed 1.23% of EU GNI in any given budget year.

At the time of the adoption of the Regulation, it was estimated that, with careful management of the repayment schedules, a volume of up to EUR 60 billion for the EFSM could be accommodated below the OR ceiling in addition to the volume of EUR 35 billion which remains available under the Balance of Payments facility.⁶

The available margin under the OR ceiling has recently been re-evaluated based on the most recent macro-economic data. There is no reason to change the basic assessment which concludes that, with careful management of repayment schedules, both the EFSM and the Balance of Payments facility can still be fully accommodated below the OR ceiling.

Actions taken in relation to the Commission's capacity to raise funds

Actions taken in relation to the Commission's capacity to raise funds have included (i) a revision of the Euro Medium Term Note Programme (EMTN) and (ii) a confirmation of the Commission's highest possible investment rating.

EMTN programme revised

The European Union and Euratom have been issuing notes under the EMTN Programme in order to finance: (i) Balance of Payments loans; (ii) macro-financial assistance to third countries in accordance with Articles 212 and 213 of the Treaty on the Functioning of the EU; and (iii) Euratom loans for safety upgrades of nuclear power plants.

In anticipation of possible increases in the EU's borrowing activity due to the establishment of the EFSM, the Programme Offering Circular has been amended accordingly and the amount of the Programme has been increased by EUR 60 billion to a total of EUR 80 billion. If needed, the EMTN Programme can be further promptly increased to EUR 110 billion.

⁶ A further EUR 15 billion under the BoP regulation has already been allocated as external financial assistance to Latvia, Hungary and Romania.

AAA rating of the EU confirmed

Following the establishment of the EFSM, the major credit rating agencies confirmed their AAA rating on the EU and Euratom issuing notes and, at the same time, applied these ratings to the increased EMTN Programme⁷.

There are many important features that have enabled the confirmation of the EU's AAA rating. First, the EU is unconditionally committed to honouring its legal obligations towards its lenders. Second, the European Commission has the right to draw on Member States' resources to ensure that sufficient budget revenues are available at all times to cover all obligatory expenditures, including debt servicing. And lastly, Member States are legally obliged to balance the EU's budget, including debt-servicing.

The debt-management practices followed by the EU result in a debt-servicing profile (principal and interest payments) not exceeding the fiscal headroom provided by the difference between the OR ceiling and annual budgetary payments. The outlook on the EU is stable, reflecting expectations that there will be no substantive change in the key factors underpinning the ratings. In the opinion of the major credit rating agencies, solid support from Member States and the existing layers of debt-servicing protection are expected to continue to underpin — the EU's very high credit standing.

2. ASSESSMENT OF CIRCUMSTANCES JUSTIFYING CONTINUATION OF THE EFSM

The financial crisis has impacted heavily on the public finances of Member States via financial support measures for the financial sector, a discretionary fiscal policy response and the operation of the automatic stabilisers. The combined effect has been a sharp widening of government budget deficits and a corresponding increase in public debt to GDP ratios. While the Member States are now working diligently to consolidate their public finances in line with commitments under the Stability and Growth Pact, significant tensions have emerged in euro-area sovereign bond markets since mid-2009 as reflected in a substantial divergence in yields and CDS spreads, particularly for the peripheral Member States. Despite some improvement in the weeks following the announcement of the EFSM and EFSF, market conditions have deteriorated again since mid-August, with yield and CDS spreads for the peripheral Member States returning to levels recorded in May 2010. As issuing conditions for euro-area sovereigns remain stressed, it can be concluded that the market circumstances which justified the EFSM persist.

Member States face significant financing needs

Increased borrowing due to the financial crisis has been reflected in higher government financing needs, much of which have been met by short-term issuance. Looking forward, therefore, it is clear that EU governments will continue to face substantial financing challenges in the coming years.

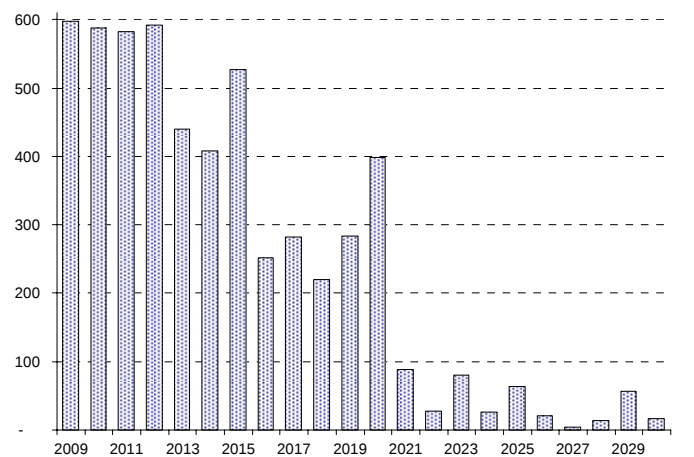
⁷ See, for example, Standard & Poor's communication of 30 June 2010.

On 21 November Ireland requested financial assistance from the European Union and euro-area Member States. In the context of a joint programme EU/IMF, the financial assistance package to Ireland will be financed from the EFSM and the EFSF, supplemented by bilateral loans to be negotiated by EU Member States.

In 2010, most euro area Member States have run high government deficits, which has led to a substantial increase in the total issuance of euro-denominated government bonds and a further accumulation of government debt. This overall increase in the supply of sovereign bonds has aggravated difficulties for some smaller issuers in accessing the market. This also implies a continued rollover risk for the future. The amounts that will need to be raised from the market in 2011 are broadly the same as in 2010, and they will remain at least that high for several years. Chart 1 presents the amounts of euro area government bonds outstanding at the end of September and maturing over the next 20 years.

In this situation, many Member States have adopted fiscal consolidation measures to be implemented in coming years in order to prevent or slow down a further increase of the government debt and its servicing cost. However, the refinancing needs of many Member States are likely to remain high as consolidation efforts only gradually feed through.

Chart 1. Euro area governments refinancing needs (EUR bn, as of September 2010)



Source: Bloomberg, EC calculations

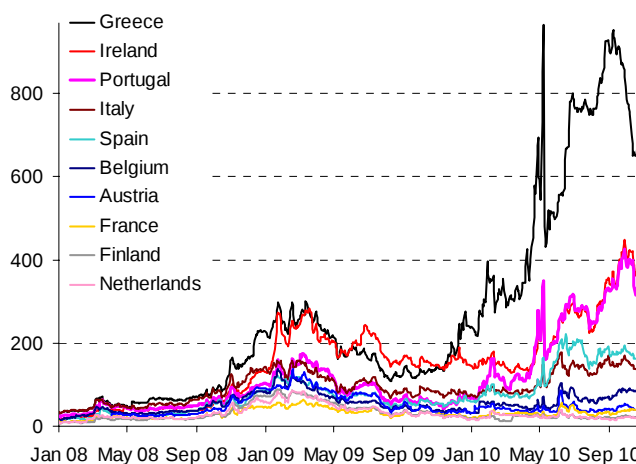
Issuing conditions have not yet normalised

Tensions in the euro-area sovereign bond market have driven government yield spreads to record levels for some Member States. In May 2010, the yield spreads ranged between 25 and 965 basis points to German Bund, a degree of divergence which is unprecedented since the creation of the euro. After the announcement of the EFSM and the EFSF, yield spreads declined temporarily but have since widened again (see Chart 2).

In addition to continuing the use of monetary policy operations such as the covered bonds purchase program (CBPP) and enhanced credit support measures, tensions in euro-area sovereign bond markets prompted the ECB to launch the Securities Markets Programme (SMP) in May 2010⁸ in order to "ensure depth and liquidity in those market segments which were dysfunctional", and restore an "appropriate monetary policy transmission mechanism". The ECB has since conducted interventions in the euro area public and private debt securities market by purchasing government bonds of specific Member States (see Chart 3). The monetary impact of these bond purchases is sterilised by conducting liquidity-absorbing operations so as to leave the monetary policy stance unaffected.

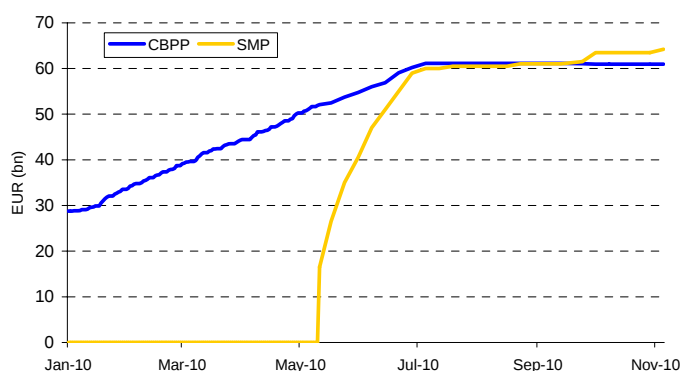
By 8 November 2010, the ECB had bought about EUR 64.2 billion of euro area government bonds via the SMP. (Disaggregation by type/country of the purchases is not made public.) The ECB has been reducing the scale of its interventions over time, with no or few purchases during July to September. In order to calm renewed volatility in bond markets, the ECB has recently temporarily stepped up its government bond purchases, buying bonds worth about EUR 2 billion in the week ending October 1st, and an additional EUR 711

Chart 2. Euro-area 10-year government yield spreads to German Bund



Source: Bloomberg, EC calculations

Chart 3. ECB's Covered Bond Purchase Programme (CBPP) vs. the Securities Market Programme (SMP) purchases in 2010 (in bn EUR)



Source: ECB, EC calculations

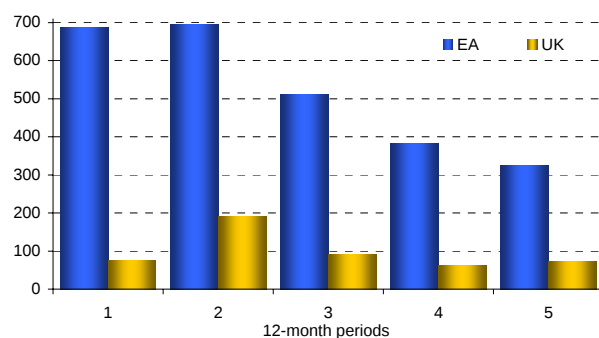
⁸ Decision of the European Central Bank of 14 May establishing a securities markets programme (ECB/2010/5) (2010/281/EU)

million in the week ending November 5th.

Competition for market-based financing likely to remain intense

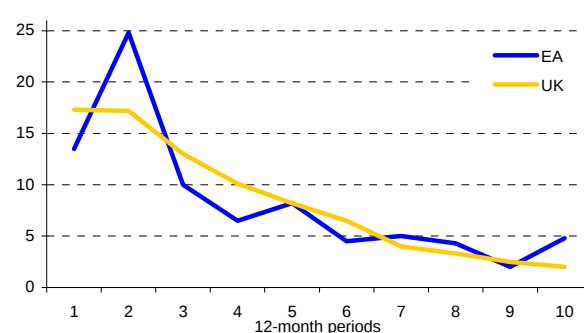
The increased refinancing needs of Member State governments in coming years will coincide with similar refinancing needs in the banking sector and is likely to ensure intense competition for market-based funding. Significant rollover pressure will be felt through year-end 2012, with around EUR 1.8 trillion of EU bank debt due to be financed in the next 24 months. This near-term pressure can partly be explained by favourable interest rate conditions on short-term debt and the significant roll-over of bank bonds, including those with government guarantees.⁹ (see Charts 4, 5, and 6) An additional factor could be the increase in financing needs due to ongoing recapitalisation efforts.

**Chart 4. EU bank bond maturity profiles
(EUR bn, in 12-month periods from 1 July 2010)**



Source: IMF; EC staff calculations

**Chart 5. EU bank debt maturing as %
of total outstanding (from 1 July 2010)**

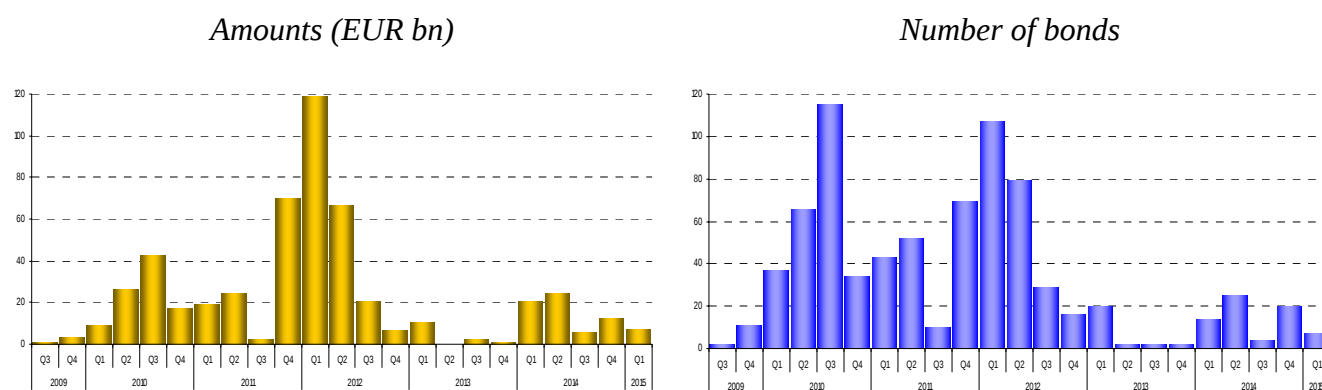


Source: IMF; EC staff calculations

Commission calculations show that peak amounts of state-guaranteed bank debt are expected to mature in the fourth quarter of 2011 through the second quarter of 2012. Comparing charts 5 and 6 illustrates the close correlation between the maturity profiles of both general and guaranteed bank debt and highlights the periods that will be most challenging in the coming months and years.

⁹ Heavy cumulative issuance by banks in the aftermath of the crisis means that approximately 50% of currently outstanding bonds will mature in the next three years.

Chart 6. Maturity profile of EU bank debt issuance with government guarantee



Note: All bonds are considered to expire at the end of the maturity. No intermediate amortisations are considered.

Source: Bloomberg; Commission staff calculations.

At the same time, sovereign risk concerns have induced a "flight to quality", prompting a potential decline in demand for bonds issued by economies with high-risk characteristics. This could create competition between high-risk sovereigns and AAA-rated, guaranteed bank debt as long as guarantees remain in place.¹⁰ Although guarantee schemes that are still in place are set to expire on 31 December 2010¹¹, the Commission could grant extensions up to end-June 2011 (some schemes have already been prolonged) and possibly further if deemed necessary. During this time, severe market competition not only in terms of quality, but also in respect to quantity, is likely to be sustained. Competition will be particularly challenging in the period through year-end 2012 and again in 2014, as debt issuances with 1 to 3-year (the bulk) and 5-year maturities come due on both fronts.

CONCLUSION

The market situation requires maintaining a safety net

This Communication describes some of the key challenges for Member State governments in financing their budget deficits as a result of the financial crisis and subsequent strains in the sovereign debt market. The European Financial Stabilisation Mechanism was created in response to the need for a policy instrument that would help safeguard financial stability in the EU and euro area by alleviating market concerns about the EU's capacity to respond to a severe sovereign debt crisis.

Ambitious fiscal reforms, supported by external financial assistance via a macro-economic adjustment programme in the case of Greece, have helped contain the worst of the market turmoil. Nonetheless, sovereign risks remain elevated, as markets continue to focus on the sustainability of public finances, with some governments having limited access to funding and rising costs.

¹⁰ Approximately 86% of the nearly EUR 600 billion in government guaranteed bank debt that was issued between October 2008 and December 2009 was rated AAA, comprising a significant portion of the totals that will come due through 2012.

¹¹ This would mean that when refinancing or in the event of a new issuance, such debt instruments would carry the rating of the banks themselves and no longer the rating of the sovereign guarantors.

In that context, a shift in investor perception seems to have taken place during recent months, with tensions in sovereign debt markets now expected to persist for a longer period. This revision in investor expectations reflects not only the scale of budgetary adjustment required in some Member States, but also the prospect of a relatively gradual economic recovery and a durably fragile banking sector.

National and supranational financial backstops – including the EFSM and EFSF – have been established to prevent contagion and provide a critical line of defence. But these measures are temporary and must be combined with further policy action in order to rebuild financial system resilience and resume normal market functioning. Current exceptional circumstances justify not only the creation of, but also maintaining such mechanisms in place for the time being, as illustrated by the recent Irish request for an EFSM support. Withdrawing these backstops too early or too abruptly could trigger strong market reactions and reignite a sovereign debt crisis.

Against this background, the Commission concludes that the exceptional events and circumstances that justified the adoption of Regulation n°407/2010 establishing a European financial stabilization mechanism still exist and that the Mechanism should, therefore, be maintained.