Doubts Grow on Euro Fund

OCTOBER 20, 2011

By STEPHEN FIDLER and CHARLES FORELLE

BRUSSELS—Doubts grew about the effectiveness of a key proposal for stemming Europe’s deepening debt crisis as it emerged that officials have ruled out a plan for the euro-zone’s bailout fund to directly guarantee bond issues.

Instead, European officials are discussing a scenario in which governments issuing bonds would borrow from the bailout fund to guarantee a portion of the bond issues—a move that would increase debts for already troubled economies.

Pressure is rising ahead of a weekend summit of European leaders billed as critical to stemming the region’s deepening debt crisis. French President Nicolas Sarkozy on Wednesday—after visiting his wife, Carla Bruni, in a Paris clinic shortly before the birth of their first child—made an unexpected trip to Frankfurt to meet with German Chancellor Angela Merkel and other top European officials gathered at a farewell celebration for European Central Bank President Jean-Claude Trichet.

Meanwhile, more than 100,000 Greek workers, students and business owners marched through the streets of Athens ahead of Thursday’s parliamentary vote for deeper spending cuts, in a protest marked by clashes with riot police.

Faced with Sunday’s summit deadline, European officials are looking for ways to bolster the euro-zone bailout fund’s firepower without increasing financial commitments from governments such as Germany that are backing it. As the French and German leaders met, it emerged that the talks are focusing on using the fund to provide collateral to back up bond issues by troubled countries. The idea would be to use the collateral to boost investor confidence by providing guarantees for an initial portion of losses in the event of default—known as first-loss insurance—and keep borrowing costs for countries like Spain and Italy from spiraling to unsustainable levels.

Lawyers for governments and European institutions have warned that using the bailout fund to provide direct guarantees would violate the European Union’s treaty restrictions preventing bailouts of struggling governments, according to people familiar with the matter.

This poured cold water on the widely circulated notion that the bailout fund, known as the European Financial Stability Facility or EFSF, on its own could simply stand as a guarantor for euro-zone bond issues.

Under the plan now being discussed, the fund would work like this: A government seeking to raise money at a bond auction would borrow additional amounts from the fund to provide guarantees that some portion, say 20%, of the bonds would be repaid. The guarantees, probably in the form of bonds issued directly to the government by the EFSF, would be held in trust in the event of a default.

The collateral plan would serve a similar purpose as the direct guarantee might have: giving investors an incentive to buy bonds from troubled countries that need financing. The difference is that it would increase the total debts of those countries.

An insurance plan of some kind would boost the effectiveness of the bailout fund. That’s because insuring a portion of a country’s bond issue consumes less of the EFSF’s resources than buying 100% of the issue.

Italy and Spain, the countries viewed as possible users of the program, need to borrow €900 billion ($1.24 trillion) by mid-2013—without the extra borrowing that might be required from the EFSF.

Officials say there are still major divergences on how far governments need to go this weekend in detailing their plans for boosting the fund.

The German government hasn’t yet shown its hand in the debate about specific options, but Finance Minister Wolfgang Schäuble is open in principle to some version of the first-loss insurance idea, according to German lawmakers briefed about the negotiations this week.

Publicly, Germany has said it is looking for the most “efficient” way to use the EFSF’s finite funds in the bond market while leaving Germany’s potential liabilities at their present level of €211 billion.

Governments are homing in on an insurance idea because it is the preferred alternative to boosting the fund—allowing it to become a bank and finance itself through the European Central Bank—has been rejected. France backs the proposal but the ECB and Germany are vehemently opposed, and officials also say European Union lawyers see it as violating the no-bailout clause. Many analysts argue the backing of the ECB is essential to any of these ideas being effective.

As financial analysts examine the insurance proposals, they doubt that they can come close to providing the €2 trillion widely viewed as necessary to quell the skittishness of bond investors. Jacques Cailloux, European economist at Royal Bank of Scotland, said Wednesday in a note that “the insurance policy is more likely to fail than to succeed in attracting private-sector interest.”

The first reason this is difficult is that a significant proportion of the fund is already earmarked. The lending capacity of the fund is €440 billion, roughly the sum of the guarantees it has available from the euro-zone’s six triple-A governments.

The fund has pledged €26 billion to Portugal’s bailout plan, €17.7 billion to Ireland, and will require about €70 billion for a new bailout for Greece. But it’s also expected to provide funding to boost the capital of euro-zone banks—and may be called on to back bank funding. Assuming a conservative €50 billion needs to be set aside to help banks, just €275 billion is left: enough to guarantee 20% losses on €1.4 trillion of bonds.

Sony Kapoor, managing director of the Re-Define financial think tank, says governments are being pulled in several directions. They want the fund’s firepower to be big, which implies a substantial leverage of the €440 billion. But the fund also needs to be effective. For investors, the more extreme the leverage, the more worried they will be about whether the EFSF guarantees are worth anything.

A third factor is, the more the EFSF leverages up, the more at risk are the guarantees provided to it by Germany and the stronger economies in the euro zone. For France, whose triple-A credit rating is the most vulnerable in Europe, a big expansion of the EFSF could be the final straw. If France loses its triple-A, then confidence in the EFSF guarantees unravels and the debt crisis begins to infect the core of the currency union.

Analysts also question whether investors will believe in the guarantees. If they don’t, borrowing costs won’t fall. The key is...
whether Germany and the other creditors to the EFSF insist on being repaid if the guarantees are called because of a default. If Italy has to find the resources to pay back Germany and others, then these resources aren’t going to repay bondholders.

Even if the EFSF declares it won’t insist on being a senior creditor in the event of default, the important thing is “not just what the nominal seniority of the creditors is, what the markets believe the seniority is,” says Justin Knight, bond strategist at UBS Investment Research.

—Matina Stevis, Marcus Walker and Margit Feher contributed to this article.

Write to Stephen Fidler at stephen.fidler@wsj.com and Charles Forelle at charles.forelle@wsj.com