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European Financial Stability Measures: Recent Developments and U.S. Exposure

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Introduction: U.S. Exposure to the European Sovereign Debt Crisis

As recently as July 2011, a number of financial measures have been implemented by institutions and member states of the European Union (the "EU") to address the current sovereign debt crisis and ensure financial stability in the EU. These measures include the extension of loans to the countries known collectively as the "European periphery" — Portugal, Ireland, Italy, Greece, and Spain — and the establishment of inter-governmental facilities to repurchase government bonds in the debt markets.

U.S. ownership of the European periphery's sovereign debt has been estimated at $18 billion, although the actual figure may actually be higher, since U.S. pension funds and other institutional investors are not required to disclose these holdings. Although this amount is relatively marginal compared with the holdings of European institutions, the indirect exposure of U.S. institutions to the EU sovereign debt crisis is significantly larger than it first appears.

According to recent reports, U.S. ownership of securities in the European periphery's private sector is approximately $70 billion. Ratings downgrades or insolvencies at any of these companies could result in financial losses for U.S. funds and investors. Most importantly, a default or deterioration of the conditions in the European periphery would likely spark a "systemic contagion," as the collapse of Lehman Brothers in September 2008 and the volatility of financial markets in recent days have clearly demonstrated.

Similarly, a vicious circle links sovereign risk, bank creditworthiness and the real economy. Banks in the European periphery (as well as banks in other EU countries with large positions in the European periphery's sovereign debt) have in recent weeks seen their funding costs and credit default swap premiums increase exponentially, while their issuance of short-term wholesale debt has fallen sharply.

This "collateral damage" is likely to spill over to U.S. institutions as adversity hits the European banks to which these U.S. institutions are creditors. For example, Moody's recently put Crédit Agricole, BNP Paribas and Société Générale on notice for a possible downgrade because of their potential exposure to a Greek default. According to JPMorgan estimates, U.S. money market funds have loans outstanding to French banks of approximately $200 billion (or near 12% of the assets under management). Furthermore, a recent report by Fitch Ratings revealed that the top ten U.S. prime money-market funds have about half of their assets invested in securities issued by European banks.

Another serious concern is the exposure that the U.S. might have to the European periphery through credit default swaps ("CDSs") issued by U.S. banks and insurance companies to provide insurance against default to the holders of government bonds. These are the same contracts that brought down insurance behemoth, AIG, in the wake of the 2008 credit crunch. According to the Bank for International Settlements, U.S. banks have approximately $150 billion in credit default swap exposure to the European periphery, which represents the largest portion of such exposure by any country alone. The terms of restructuring of the sovereign debt that are currently being negotiated may trigger a default event under the outstanding CDSs and obligate the U.S. banks to make the payments provided thereunder, with severe consequences for the U.S. financial industry and overall economy.

In addition, as U.S. companies are increasingly exposed to international markets, any conditions adversely affecting the European periphery could have negative effects on their business and financial results. Although the majority of U.S. publicly traded companies do not break down their EU revenues on a country-by-country basis in their securities disclosures, research reveals that several U.S. private and public companies have significant revenue exposure to the European periphery, especially in the energy, pharmaceutical and industrial sectors. In addition, the strains in bank funding markets described above could cause the London Interbank Offered Rate ("LIBOR") to spike, which would push up borrowing costs for many non-financial businesses.

As a result, U.S. companies and financial institutions need to pay great attention to the public and private finances in the European countries in which they operate, and review their portfolios and business plans to mitigate risks, as any worsening in sovereign debt risk in these countries could affect their European subsidiaries, with negative implications to the U.S. parent company.

As negotiations regarding a restructuring of the European periphery's debt enter into a decisive phase, what follows below is a high-level summary of the most recent financial measures and regulatory proposals designed to stabilize the EU financial markets.

Background

Seventeen of the twenty-seven EU member states, known as the "Eurozone," share an economic and monetary union and use the euro as their common currency. Since 1999, Eurozone member states have transferred monetary sovereignty to the European Central Bank (the "ECB") and other EU governmental entities with responsibility for monetary policy.

A body of regulatory requirements referred to as the "Stability and Growth Pact" was passed in 1997 to enforce fiscal responsibility and set certain national debt ceilings among Eurozone member states. In particular, the ratio of each member state's annual government deficit to GDP cannot exceed 3%, and gross government debt to GDP cannot exceed 60%. However, these regulations have suffered from the lack of a meaningful enforcement mechanism and have come under increasing scrutiny during the current financial crisis.

In October 2008, as the EU entered its first official recession, the heads of state of the Eurozone and the ECB, at an extraordinary summit in Paris, agreed to a 14-point program to stabilize the European economy. A critical point of this process was the establishment of the European Financial Stabilization Mechanism (the "EFSM") and the European Financial Stability Facility (the "EFSF").

The EFSM is a regulation that gives the EU Commission the authority to raise up to €60 billion in funds to provide loans or other funds to Eurozone member states facing a "severe financial disturbance," subject to the adoption of an "economic and financial adjustment program," including specific measures to restore financial stability. Once the mechanism is activated, the EU Commission is authorized to grant loans or lines of credit and to borrow in the financial markets on behalf of the EU to then lend the proceeds to the beneficiary member state. The EU budget guarantees the repayment of the bonds in case of default by the borrower.

The EFSF is a Luxembourg entity funded by the Eurozone member states and governed by an inter-government agreement. The mission of the EFSF is to provide financial assistance to financially distressed member states, by issuing bonds or other debt instruments backed by guarantees from the Eurozone countries. Issuances by the EFSF are executed by the German Debt Management Office ("DMO") on behalf of the EFSF. Although EFSF's total guarantee commitments are equal to €440 billion, the facility currently has an effective lending capacity of no more than €250 billion, because bailout measures must be guaranteed by AAA-rated member states. The guarantee commitments are made by member states on a pro rata basis, with Germany (27%) and France (20%) contributing the largest shares.

The EFSM and the EFSF can only be activated upon a member state's request for financial assistance and the adoption of a conditional macroeconomic adjustment program to be approved by the EU Commission and the ECB. In July 2011, the lending capabilities, scope of activities and maximum guaranty commitments of the EFSF were further expanded.

The recent financial bailout measures for Greece, Ireland and Portugal were the result of a concerted effort by EFSM, EFSF and the International Monetary Fund (the "IMF"). However, with the EFSF due to expire in 2013, the regulatory field is about to change again. On June 24, 2011, the EU Council established a new crisis resolution mechanism, the European Stability Mechanism ("ESM"), with the mission of replacing the EFSM and the EFSF as a permanent inter-government organization to provide financial aid to distressed Eurozone member states.

In addition, at the March 24, 2011 summit of the EU Council, a "Euro Plus Pact" was signed by each of the Eurozone countries, as well as by Bulgaria, Latvia, Lithuania, Poland and Romania, to adopt a comprehensive package of measures to "strengthen the economic governance and competitiveness of the euro area and of the European Union." The plan is a successor to the "Competitiveness Pact" that was advocated earlier in the year by the French and German governments and is designed to become a more stringent successor to the Stability and Growth Pact.

Recent Financial Stability Measures

Second Financial Assistance for Greece

A first €110 bailout package for Greece (subject to the adoption of certain austerity measures) was approved in May 2010, including a €80 billion contribution from all Eurozone members on a bilateral basis (subject to management authority of the EU Commission) and a €30 billion funding from the IMF. However, following a review of Greece's financial conditions in March of this year, it became clear that the rescue plan of Greece was not sufficient to enable the country to restore its debt limits and boost an economic recovery.

As a result, on July 21, 2011, a second three-year €109 billion bailout package for Greece was passed. The second Greek loan facility will be co-funded by the EFSF and the IMF, although an important contribution — in the amount of approximately €50 billion — will come from the private lending sector in the form of a credit enhancement through the voluntary exchange of certain bonds maturing between 2011 and 2020. The assistance package will be used to cover Greece's budgetary needs, a recapitalization of Greek banks and a contribution to a debt buyback program for Greece.

The EFSF loans will have lower interest rates and extended maturity dates (from the current 7.5 years to a minimum of 15 years and up to 30 years with a 10-year grace period) than the comparable 2010 Eurozone loans. It is anticipated that the revised EFSF lending rates and maturities will apply to all outstanding financial instruments issued to assist Greece, Portugal and Ireland.

Financial Assistance for Portugal and Ireland

Following a formal request for financial assistance made by the Portuguese authorities, on May 17, 2011, the EU announced the approval of a €78 billion financial assistance program, which will be shared equally (€26 billion each) by the EFSM, the EFSF and the IMF. The Portugal bailout package is contingent upon the adoption of certain tax austerity measures, a reform of the judicial, employment, and housing sectors and a restructuring of the debt ratio and capital requirements of banks. The first EFSF bonds issues in support of Portugal were placed on June 15 and 22, 2011.

On November 28, 2010, Ireland received a €85 billion financial assistance package, consisting of: (i) €4.8 billion in bilateral loans from the United Kingdom, Sweden and Denmark; (ii) €22.5 billion from the EFSM; (iii) €17.7 billion from the EFSF; (iv) €22.6 billion from the IMF; and (v) €17.5 billion from certain Irish government agencies. The Ireland bailout package is contingent upon a reorganization of the banking sector, a fiscal plan to reduce the national debt and certain growth-enhancing legislative reforms. A first €5 billion EFSF bond issue was placed on January 25, 2011 and was oversubscribed by investors. The EFSF anticipates issuing additional bonds in the amount of €10 billion by the end of 2011.

ECB Liquidity Measures and Bond-Buying Program

Since the inception of the Greek debt crisis, the ECB has adopted a number of measures in the name of European financial stability, including a May 6, 2010 decision to accept certain Greek sovereign debt as collateral, and the adoption on May 10, 2010 of certain "non-standard" measures primarily designed to provide liquidity to Eurozone banks at a fixed rate. These non-standard measures are still in effect and include: (i) the establishment of temporary liquidity swap lines with the Federal Reserve to provide short-term US dollar liquidity in exchange for collateral or under repurchase agreements; (ii) certain 3-month and 6-month longer-term refinancing operations ("LFTOs") at a fixed-rate tender or at a rate equal to the average minimum bid rate of the main refinancing operations ("MROs") during the term of the LFTOs; and (iii) a bond-buying program for the Eurozone's debt securities markets known as Securities Market Programme ("SMP").

The ECB has actively implemented its bond-buying program and, according to recent reports, it currently holds approximately €74 billion worth of the European periphery's debt, largely consisting of Greek, Irish and Portuguese government bonds. At an emergency conference held on August 7, 2011, the ECB indicated its intention to use its powers under the SMP to purchase outstanding government bonds of Italy and Spain. These measures appear pivotal to addressing the debt crisis at a time when the ESFS' increased lending capacity and bond-buying authority are not yet fully effective and operational.

Amendments to the European Financial Stability Facility (EFSF)

At present, the EFSF has an effective lending capacity of no more than €250 billion. It has been argued that at €250 billion — and already committed to bailouts of Greece, Ireland and Portugal — the facility is not large enough to handle a bailout of Spain, and that, even at €440 billion, the EFSF alone would not be enough for both Italy and Spain for any significant length of time. Indeed, the IMF has recently estimated that Italy's financing needs will run between €340 and €380 billion annually over the next 5 years.

For these reasons, on June 24, 2011, the EU Council approved an amendment to the EFSF's Framework Agreement. The purpose of the amendment was to (i) raise member states' guarantee commitments to €780 billion, including an "over-guarantee" by each member state of up to 165%, (ii) increase the EFSF's effective lending capacity to €440 billion, and (iii) expand the scope of the EFSF, by allowing the entity to purchase bonds on the primary debt markets under certain circumstances.

On July 21, 2011, to further improve the effectiveness of the EFSF, the Eurozone summit further expanded the EFSF's scope of activity allowing it to (i) act on the basis of a precautionary program, (ii) finance recapitalization of financial institutions through loans to governments including in countries not covered by existing programs, and (iii) intervene in the secondary markets on the basis of an ECB analysis recognizing the existence of exceptional financial market circumstances and risks to financial stability and on the basis of a decision by mutual agreement of the EFSF member states to avoid contagion.

The authority to act preemptively in countries that are not recipients of an existing bailout measure is designed to give the EFSF room to maneuver to prevent a crisis in Spain and Italy. Furthermore, the EFSF — unlike in the past — will have the power to buy government bonds and other bad assets ailing Eurozone countries from private investors. However, the amendments to the EFSF's Framework Agreement regarding guarantee commitments (which will have the effect of increasing EFSF's effective lending capacity up to €440 billion) and preemptive actions, including on the primary and secondary debt markets, will be required to be approved by the individual member states in accordance with their ratification procedures. It is expected that the amendments will not become effective until the third quarter of 2011.

It is also anticipated that the interpretation of the rules governing the expanded powers of the EFSF will be subject to intense legal analysis. The EFSF's mission and its inter-governmental programs have come under legal scrutiny since the entity's formation, as Article 125 of the EU Treaty (the "no bailout" clause) prohibits the EU and its member states from assuming or discharging any other member state's financial obligations (including through guarantees). On such grounds, three cases have been filed and are still pending in German Federal Constitutional Courts, claiming that Germany's financial assistance to Greece and the guarantees provided under the EFSF are in conflict with EU and German law. On July 5, 2011, a joint hearing on all three cases was held, but no final decision appears to be close. It is possible that the German courts will require a parliamentary vote on all future requests for bailout funds.

EFSF's newly-created power to purchase bonds on the primary and secondary markets may raise similar legal issues. The purchase by the EFSF of bonds issued by member states to discharge past obligations could be viewed as an "indirect" assumption of such member state's financial obligation. In addition, it remains to be seen how the requirements of EFSF's "precautionary program" will be interpreted and what conditions will be viewed as constituting "exceptional market circumstances" to enable the EFSF to purchase bonds on the secondary market. However, these amendments are clearly a far-reaching step towards the pooling of the debt of Eurozone member states, and have played an important role in accelerating the establishment of ESM, EFSF's successor entity.

The European Financial Mechanism (ESM)

As described above, on June 24, 2011, the EU Council decided to establish a permanent crisis resolution mechanism, the European Stability Mechanism ("ESM"). The ESM is expected to replace the EFSF at the end of its term in 2013 and will also result in the abolition of the EFSM. However, in recent days, as the debt woes of Spain and Italy have continued to escalate, some Eurozone governments have been discussing a new phase-out strategy, pursuant to which both ESM and EFSF would be kept in place and coexist. The two bailout funds together would total nearly €1 trillion, which would leave more than €700 billion to provide financial assistance for Italy and Spain.

The process of establishment of the ESM is moving rapidly, as the key EU member states in recent weeks signed a Treaty to set forth the governance structure, powers and other key aspects of the ESM. Like the EFSF and EFSM, the purpose of the ESM will be to provide financial assistance to Eurozone member states, under strict policy conditionality, when they are experiencing or are threatened by severe financial problems. The ESM Treaty authorizes financial assistance in the form of loans or, as an exceptional measure, through the purchase of bonds on the primary markets. It is contemplated that the ESM will offer loans at funding costs plus 200 basis points for loans up to three years and plus another 100 basis points for loans longer than three years, with no service charge. Currently, EFSF's margin for Ireland stands at 247 basis points, while the margin for Portugal is 208 basis points.

The aggregate capitalization of the facility will be equal to €700 billion, and its lending capacity will be set at €500 billion. Unlike the EFSF, ESM's capital structure will include not only individual guarantees but also €80 billion in fully paid-in capital and €620 billion in additional callable capital. Therefore, the ESM will not require the credit enhancements (including over-guarantee, cash buffer and cash reserve) that the EFSF needs to have to secure an AAA rating.

If the ESM is implemented, a legal issue that may arise is whether the direct purchase of bonds on primary markets is consistent with Article 125(1) of the EU Treaty. However, on March 25, 2011, the EU Council adopted a decision to amend Article 136 of the EU Treaty so that an EU legal basis can be created for the ESM. The amendment will become effective following ratification by all member states. It is anticipated that national approval procedures will be completed by the end of 2011.

The "Euro Plus Pact" and the EU Financial Regulatory Reform

As described above, the "Euro Plus Pact" is a recently adopted plan pursuant to which the member states of the Eurozone, Bulgaria, Latvia, Lithuania, Poland and Romania have made specific commitments to a list of political reforms that are designed to improve the fiscal strength and competitiveness of each country. The plan is revolutionary because it represents the first step towards establishing a common EU economic policy along with the EU monetary policy.

The Euro Plus Pact requires each participating member state to provide commitments on an annual basis with respect to four main goals: (i) fostering competitiveness (by reducing wage costs, especially in the public sector, and increasing productivity); (ii) improving employment (by increasing long-term and unemployment rates and lowering employment taxes); (iii) enhancing sustainability of public finances (among other things, by limiting early retirement and increasing the sustainability of pensions, health care and social benefits); and (iv) reinforcing financial stability.

An additional goal of the pact is tax policy coordination, as participating member states are committed to adopting national legislation to implement the EU fiscal rules set forth in the SPG. According to the draft conclusions from the summit, among other things, participating countries are expected to develop a common corporate tax base as a "revenue neutral way forward to ensure consistency among national tax systems." The commitments made by each member state are subject to monitoring by other Euro Plus Pact participants on the basis of a report generated by the EU Commission. However, as the pact is currently set out, there are no binding obligations and no enforcement measures are currently contemplated.

As of January 1, 2011, the EU has also implemented a new framework for financial supervision and the oversight of systemic risk, which represents the first step towards the establishment of a EU financial regulatory authority. The new financial supervisory framework consists of a European Systemic Risk Board ("ESRB"), which has the responsibility to detect and respond to systemic risks to the financial system and a European System of Financial Supervisors, which consists of three European Supervisory Authorities ("ESAs"), including the European Securities and Markets Authority, the European Banking Authority, and the European Insurance and Occupational Pensions Authority, with responsibility for the oversight of micro-prudential supervision of financial institutions within their respective sectors.

The ESRB has an advisory role but is entrusted with the power to issue recommendations which, if not complied with by the member states, may be referred to the EU Council. The goals of the ESAs include (i) monitoring the application of EU rules, (ii) mediating between national supervisors, and (iii) providing advice to the EU Commission in relation to the content of new legislation and licensing credit rating.

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We are continuing to monitor these developments in order to guide our clients through these regulatory reforms and measures, which affect the global markets, as well as the business of all U.S. and foreign global companies, banks and financial institutions.

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