Observation

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EUROPEAN SOVEREIGN DEBT: STILL WITHOUT SIGNS OF RESOLUTION

HIGHLIGHTS

- Last week's European Council meeting had generated expectations for a strong response from European governments to the debt crisis.
- Although progress was made on a number of areas such as the establishment of the European Stability Mechanism (ESM), key aspects for the short-term evolution of the crisis were unaddressed
- Particularly relevant is the lack of agreement on how the EFSF lending capacity will be boosted to €440 billion
- Political upheaval in Portugal and continued severe funding challenges for Irish banks will be the driving risk factors in the coming months, until details on the EFSF and ESM are finalized in June

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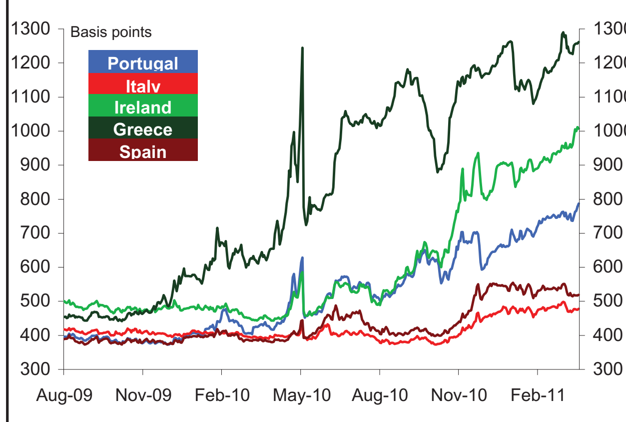
Over the last two weeks, there have been important developments in the European sovereign debt front. Last Friday, European governments meeting at the European Council set up the European Stability Mechanism (ESM), a permanent financial assistance instrument that will take over from the European Financial Stability Facility (EFSF) when the latter expires in 2013. However, European governments did not reach accord on how they will extend the lending capacity of the EFSF, which was one of the key elements on last week's agenda. Earlier, the European Banking Authority had unveiled the details and methodology for this year's banking stress tests. This exercise does not include a sovereign default scenario, but at least it will require banks to make detailed disclosures of their sovereign exposures. In this short note, we discuss these issues and their implications. Our impression is that only limited progress is being made to address the sovereign debt issues, with the implication that markets will continue to speculate about the possibility of future debt restructuring.

European Stability Mechanism

The ESM is a permanent facility that will take over after the EFSF expiration in 2013. The ESM will have a total subscribed capital of €700 billion. Of this amount, €80 billion will be in the form of paid-in capital provided by the euro zone countries being phased in from July 2013 in five equal annual installments. In addition, the ESM will dispose of a combination of committed callable capital and of guarantees from its members to a total amount of €620 billion.

10-YEAR SOVEREIGN BONDS YIELDS



Source: Bloomberg, TD Economics

The ESM will be allowed to purchase the bonds of a member state in the primary market, provided the country is already participating in a financial assistance program and subject to strong conditionality. However, ESM debt purchases in the secondary market have not been contemplated. This means the European Central Bank might remain the backstop for sovereign debt markets in periods of turmoil. The central bank had indicated that it would favor being relieved from that role.

Furthermore, the ESM will enjoy preferred creditor status in a similar fashion to the IMF, while accepting preferred creditor status of IMF over ESM. This means that, in the event of default, the ESM claims on the defaulting country will by paid before those of other creditors.

In the event of a request for financial assistance by a member country, the ESM will conduct debt sustainability analysis. If it is concluded that a macro-economic program cannot realistically restore the public debt to a sustainable path, the country will be required to secure its creditors' direct involvement in restoring debt sustainability. The granting of the financial assistance will be contingent on the borrower having a credible plan and demonstrating sufficient commitment to ensure adequate and proportionate private sector involvement.

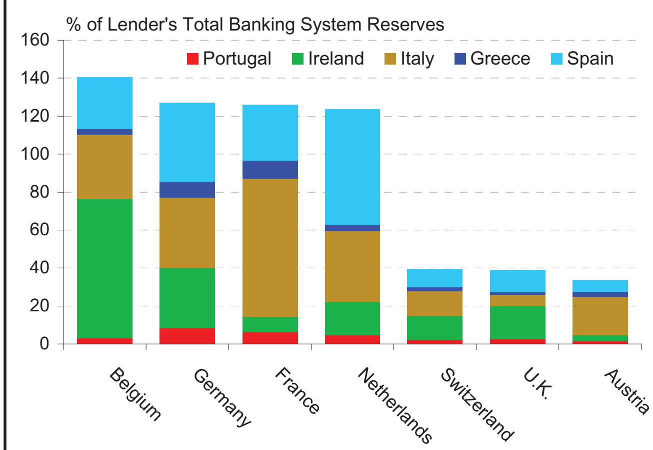
In combination with the ESM, euro zone members have agreed to include Collective Action Clauses (CACs) in all new euro zone government securities, with maturity above one year, from July 2013. The euro zone CACs will be consistent with the CACs that are common in New York and English law. The objective of such CACs will be to facilitate agreement between the sovereign and its private-sector creditors in the context of private sector involvement abovementioned. If a majority of bondholders agree to the terms of a renegotiation, these new terms become binding for all bondholders.

Collective Action Clauses and private sector involvement within a financial assistance program are two key elements that will greatly facilitate the restructuring of debt issued after 2013. If these elements were in place today, one could foresee the latter would already have been pursued as a component of the European response to the current sovereign debt crisis. But in the absence of these options, European authorities have been struggling to enhance the capabilities of the EFSF, to convince the markets that the facility will have enough firepower to deal with both a hypothetical Portuguese and Spanish bail-out. For more details on the main characteristics of the EFSF, please see our previous report: [European Sovereign Debt: The Time Has Come For The ECB To Guard The Euro].

Extension of EFSF lending capacity

At last week's summit, euro zone governments agreed to extend the lending capacity of the EFSF from its current €250 billion to €440 billion. However, they could not reach agreement on how this will be achieved, and a final decision has been delayed until the end of June. The countries with the highest credit ratings were expected to increase their guarantee contribution margins, whereas those with lower credit ratings would make cash capital contributions. This proposal found political resistance in some of the high-rating

EUROPEAN BANKING EXPOSURE TO PIIGS



Source: BIS, TD Economics, as of September 2010

countries, as we discuss later. But first, let's discuss the 2011 banking stress tests.

European Stress tests

On March 18th the European Banking Authority (EBA) unveiled the scenarios and methodology to be used by European banks when conducting the 2011 stress tests. The exercise began in early March and will be run until June, and it is being carried out on a broadly similar group of banks as the 2010 predecessor stress test, covering over 65% of the EU banking system total assets, and at least 50% of the national banking sectors in each EU Member State. The simulation period covers 2011 and 2012.

The test's adverse scenario assumes euro zone GDP contracts 0.5% and 0.2% in 2011 and 2012, respectively, which represents an accumulated 4-percentage-point decline relative to the baseline scenario. This is more severe than the 3-percentage-point decline assumed in last year's test. Moreover, declines in both commercial and residential real estate prices have also been made more dramatic in the adverse scenario of this year's test.

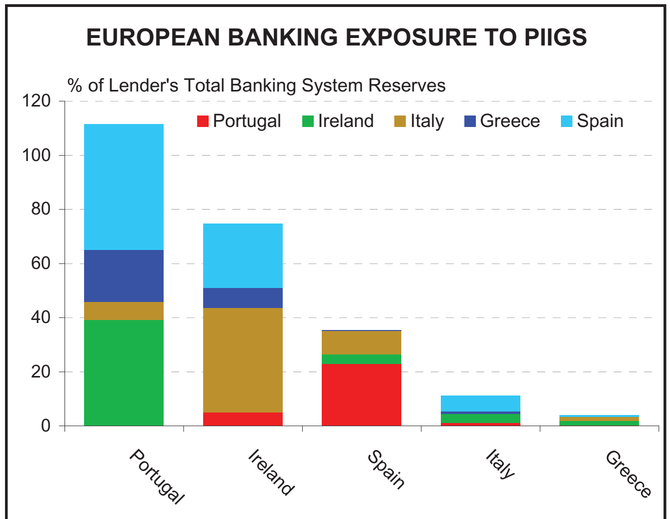
However, not all the assumptions are more stringent. The new stress test has a cumulative 15% decline in euro zone equity share prices, compared to the more severe 36% drop assumed in July's 2010 tests. Furthermore, similar to last year's test, there is no sovereign restructuring/default assumption. The sovereign shock is incorporated via country-specific interest rate spikes, which would affect the banks' trading book valuations. According to the EBA's methodological note: "In the baseline scenario… sovereign exposures in the trading book will be subject to a general "interest rate" stress, representing an upward movement in the swap curve. This general interest rate stress will affect non-sovereign exposures the same way as sovereign exposures. In addition, under the adverse scenario, direct European Economic Area sovereign exposures registered in a trading book will be subject to further valuation shock based on specific sovereign rate shocks". In other words, the impact to the banking book will not come from an explicit haircut being imposed onto held-to-maturity sovereign exposures, but rather indirectly through higher probability-of-default and loss-given-default arising from the interest rate shock.

To partially compensate for the absence of a sovereign default scenario, the EBA has stated that "banks will also be expected to disclose their exposures to sovereigns broken down by accounting portfolios (i.e., available-for-sale, held-to-maturity, and held-for-trading), maturities and countries". We see this as a "compromise" solution: it limits the size of potential recapitalization plans to be implemented by each sovereign – which makes the stress test exercise more palatable politically – but at the same time, it will kick start a market-induced correction. In other words, the banks perceived to be more at risk from a potential restructuring will likely be compelled by the markets to boost their capital levels above what the formal result of the tests might indicate. Rather than this ad-hoc approach, we have indicated earlier that we favored the inclusion of a sovereign default scenario, so recapitalization needs could be formally assessed through a uniform methodology and results could then be subject to peer review.

Irish stress test

As a prelude to the broader European stress test exercise, the Irish government will release on Thursday the stress test conducted on Irish banks, which were agreed upon with the IMF and the EU at the time of signing last year's financial assistance program. The initial estimates were for total recapitalization needs of around €35 billion, which means an additional €25 billion will have to be funded in excess of the €10 billion recapitalization funds already set aside. If the stress test results confirm this initial assessment, the impact on Irish fiscal accounts would drive the country's sovereign debt to 125% of GDP. This has been one of the arguments the new coalition government has been using to convince their European peers that Ireland needs a reduction in the interest rate on the loans of the bail-out program.

At the same time, the Irish government is seeking medium-term liquidity support from the ECB to replace the €70 billion of emergency liquidity assistance the Irish central



Source: BIS, TD Economics, as of September 2010

bank has provided to domestic institutions. In a previous report, we highlighted the potential liability this emergency liquidity represented for the Irish sovereign and the risks unstable Irish banks pose to overall European financial stability (see European Sovereign Debt: Stress Testing Banks for "Sovereign Default" Is Key Next Step). The ECB is in a very difficult spot. It would like to reduce its emergency liquidity assistance to Irish banks to force them to de-lever, but doing so could mean the banks take further loses due to the forced sale of sharply discounted assets. This could make the banks even more unstable and eventually exacerbate the delicate fiscal position of the Irish sovereign.

The Political Dimension

As the debt crisis deepens, political strains have escalated across the euro zone. In debt-beleaguered European nations, governments are facing fierce opposition to austerity measures, whereas voters in the fiscally sounder countries are growing increasingly discontent about the prospect of bailing out their profligate neighbors.

Portuguese Prime Minister José Sócrates resigned last week after his minority government failed to gain parliamentary support for a set of deficit-cutting measures. That fiscal package – the fourth in 12 months – sought to reassure Portugal's creditors the country will reach its 4.6% of GDP fiscal deficit target this year. Mr. Sócrates will stand as prime minister of a caretaker government until Portugal's president Aníbal Cavaco Silva calls new elections. Due to constitutional restrictions, this can not happen until late May. Of course, this political stalemate would delay a resolution to Portugal's fiscal woes at a critical juncture: the country has to make debt payments of €5 billion and €7 billion in April and June, respectively. Any negotiations by Portuguese authorities of a potential financial assistance program from the IMF and EU akin to those of Greece and Ireland will be more complex under the current domestic state of affairs. Moreover, after the Irish experience, both multilateral institutions (the IMF and EU) will be somewhat reluctant to negotiate a program that would impose strong conditionality with a government in transition. The new Irish coalition government has been adamantly asking for changes in the terms of loans negotiated by the previous government late last year.

Domestic politics also played a major role last week in altering Germany's stance at the European Council meeting regarding initial paid-in capital contributions to the ESM. On Monday 21st, euro zone finance ministers had agreed to put €40 billion immediately into the fund upon its creation in 2013, with the rest being paid in over three years. But, fearing a backslash at yesterday's elections in the state of Baden-Württemberg, Ms. Merkel's coalition partners resisted such a large up-front contribution, and the German chancellor finally managed to spread out the payments to €16 billion per year over five years.

As we mentioned earlier, national politics could also delay the actual implementation of the EFSF modifications agreed upon last week at the European Council, because those changes require national ratification. For instance, Finland has dissolved its parliament and will hold elections on April 17, which means a new Finnish government could be formed by May at the earliest, delaying the country's ratification of the EFSF new funding structure. Moreover, that government may include the True Finns party, which opposes an increase in Finland's EFSF guarantees, further complicating the outlook.

Final Remarks

In a previous report we had stressed how domestic politics would pose a significant risk to the effectiveness of the EFSF, given the fact that every disbursement under an EFSF financial assistance program has to be "unanimously" approved by the guarantor members. The upcoming revision to Irish progress toward its program targets by the European Commission, the ECB and the IMF will provide a clue on how smoothly this process will go. Any deviation from those targets will put European governments at a cross-road. They would have to approve the disbursement and face a potential political backslash at home for their laxity; or, they might delay the disbursement, which could exacerbate the borrower's liquidity difficulties and elicit a negative financial market reaction.

If we combine these considerations with the fact that weak economic growth will make the program targets difficult to achieve, regardless of excruciating fiscal consolidation efforts, then one could see why, despite the bail outs, financial markets are still pricing Greek and Irish debt at massive discounts. The price of their debt suggests markets are still assigning those debt instruments a high probability of default. Unfortunately, the expectations for a strong response to the debt crisis generated in advance to last week's European Council gathering have only been addressed through half-way measures, and this will continue to weigh on the markets. We will have to wait for the results of the banking stress tests and the final details on the structure of the ESM and the new EFSF guarantees to be certain that the resolution of the European debt crisis is headed in the right direction.