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EFSF Guideline on interventions in the secondary market

In their statement of 21 July, the Heads of State and Government of the euro area and EU institutions have decided to improve the effectiveness of the EFSF and of the ESM and to address contagion.

The Member States have agreed that the flexibility of the two institutions should be increased as they would now be allowed to a) act on the basis of a precautionary programme, b) finance recapitalisation of financial institutions; c) intervene in the secondary markets.

On 26 October Heads of State or Government of Euro area countries agreed to enhance the capacity of the EFSF by allowing the EFSF to provide credit enhancement to primary bonds issued by Member States and creating Co-investment funds (CIF). CIFs would allow the combination of public and private funding to enlarge the resources available for the EFSF. A CIF would invest in primary or secondary sovereign bonds of a country that has entered into a Memorandum of Understanding specifying conditionality.

This guideline outlines the main approach which could trigger the decision to intervene in the secondary bond market of a country. The main operational aspects of the organisation and of the funding strategy are also described.

1. Objectives and modalities for the intervention on the secondary market

Heads of State and Government considered secondary market intervention by EFSF as one further tool helping to support the financial stability of the euro area. So far this tool has been used by the ECB in the context of the SMP. Interventions by the Eurosystem in public and private debt securities markets in the euro area, however, were done to ensure depth and liquidity in those market segments that are dysfunctional.

Secondary market intervention by EFSF has a twofold objective. First, it serves to support the functioning of debt markets and appropriate price formation in government bonds in exceptional circumstances where the limited liquidity of markets threaten financial stability and push sovereign interest rates towards unsustainable levels. In the course of the on-going sovereign debt crisis in several occasions and for different countries price dynamics have emerged which are difficult to explain by economic fundamentals. Correction of earlier unfounded expectations on the bailout of countries and speculation on the political coherence of the euro area played a role here. Price formation followed its own accelerating dynamics in pricing countries effectively out of the market. One objective of EFSF secondary market interventions is to pre-empt and counteract such pricing dynamics.

Second, against the background of heightened uncertainty, markets for some sovereigns have become very thin and induced refinancing problems for the banking system. EFSF intervention serves the purpose of a market making to ensure some liquidity in debt markets and giving incentives to investors to further participate in the financing of countries.

2. Conditionality

2.1. Financial Market Conditions for Activation

Conditionality for secondary market intervention relates to the issue of what are the financial market conditions under which the tool should be applied to ensure its effective use. The Heads of State and Government indicated that it should be done on the basis of ECB analysis and following a decision by mutual agreement from Member States.

The analysis will determine the potential existence of exceptional financial circumstances and risks to financial stability. Such environment should be characterised e.g. by unusually volatile markets, unidirectional movements and widening of the bid/offer range for prices as a result of poor liquidity. Further details should be given to the type and structure or analysis and how recommendations are derived.

The ECB will provide an expert analysis of financial market disruptions and contagion risk. In addition, it could give in an advisory capacity, recommendations regarding the volumes and types of assets to be purchased. The analysis on financial market disruptions and contagion risk will be provided as a confidential report to decision-makers. Further advice will take place in the context of the ECB's participation in a technical committee implementing the secondary market intervention.

2.2. Eligibility conditions and corrective action

Access to a SMP facility will imply appropriate policy reform efforts to be specified in a MoU. For programme countries compliance with the macro-economic policy conditions is clearly a requirement. Countries benefiting from such interventions outside a macro-economic adjustment programme would have to comply with ex-ante eligibility conditions as defined in the context of the European fiscal and macro-economic surveillance framework and take corrective action. The possible criteria which could be used to assess whether a country qualifies for a secondary market purchase facility:

- The respect of the SGP commitments. Countries under excessive deficit procedure could still have access to this facility provided they fully abide by the various Council decisions and recommendations aiming at ensuring a smooth and accelerated correction of their excessive deficit.
- A sustainable public debt.
- The respect of their EIP commitments. Countries under an excessive imbalance procedure could still access SMP, provided that they can demonstrate that they are committed to addressing the imbalances identified by the Council.
- A track record of access to international capital markets on reasonable terms.
- A sustainable external position.
- The absence of bank solvency problems that would pose systemic threats to the euro area banking system stability.

The country would have to agree to the continued compliance with these criteria as a condition for the access to this facility as well as continued compliance with appropriate policy reforms as specified in the MoU.

3. Procedure

3.1. Acceptance Procedure

The procedure is initiated by a request from a Member State to the President of the Eurogroup for access to the Secondary Market Purchase Programme. In case of exceptional financial market circumstances and risks to financial stability of the euro area as a whole, the ECB will issue an early warning to the EWG. In all cases, an ECB report identifying the existence of exceptional financial market circumstances and risks to financial stability of the euro area as a whole will assess the need for interventions.

The Commission, in liaison with the ECB, would prepare within 1-2 days a MoU specifying the availability period, the fiscal adjustment and structural reforms needed for support.

A MoU and Financial Assistance Facility Agreement will be adopted by the EWG and the Board of Directors and signed. The intervention envelope made available by the EFSF - fixed by an EWG/EFSF Board of Directors technical sub-committee, including the ECB - will be equal to the remaining lending capacity of the EFSF. The technical sub-committee will also set pro-tempore intervention caps for the EFSF. The guarantee amount needed to finance the EFSF envelope will be approved, where necessary, by restricted committees in National Parliaments under a fast track procedure.

The EWG/EFSF Board of Directors technical sub-committee, including the ECB, sets pro-tempore intervention caps, designs an intervention strategy and decides on the daily tactics for portfolio managers of EFSF interventions in a secret way. It will report on a weekly basis on the conduct and volume of the operations to the EWG/Eurogroup. Where necessary, restricted committees in National Parliaments will be appropriately involved.

3.2. Monitoring Procedure

The Commission, in liaison with the ECB, monitors the compliance of the beneficiary Member state with the conditionality specified in the MoU and reports regularly to the Eurogroup/EWG. Any deviation from the MoU objectives agreed by the Member State requires a reconsideration of the adequacy of the secondary market interventions. Such a situation could lead to a revision to the MoU, including conditionality, or the termination of the secondary market purchases. There will be a monthly reassessment of the program including a decision of the EWG/Eurogroup on the continuation of the programme.

3.3. Pricing, Costs and Expenses

The Financial Assistance Facility Agreement will specify how any profits and losses will be settled between the beneficiary Member State and the EFSF.

4. Operational aspects of the intervention

Secondary market purchases of euro denominated bonds of euro area Member States can be activated immediately subject to the EFSF or CIF capacity available, on the basis of ECB analysis recognizing exceptional market situation and contagion risk that could threaten financial stability of the euro area as whole and its Member States, and the compliance with the acceptance procedure. Interventions are implemented based on the decision of the EWG/Board of Directors technical sub-committee including the ECB

The SMP allows the ESCB to buy all marketable debt instruments if they are a) denominated in EUR, b) either (i) issued by central governments or public entities of the Member States whose currency is the Euro, or (ii) issued by other entities incorporated in the euro area and meeting the asset eligibility criteria of the ECB collateral rules for repo operations. The EFSF secondary market intervention will have a more limited scope being directed towards euro denominated securities issued by the public sector of a euro area Member State.

The operational setup of the EFSF or CIF secondary market purchases will ensure transparency (use of electronic platforms as well as voice to execute the transactions), equality of treatment and search for performance by putting intermediaries in competition with the objective to trade at the best price. Communication of the main elements of the programme will be made to the public.

5. Management of the portfolio of bonds

Once bonds have been bought and booked in the EFSF securities account, four strategies can be implemented:

- Sell the bonds back to the market when the demand is restored: this would necessitate an active risk management and would potentially disturb the issuance of the country on the Primary market,
- Hold the bonds to maturity: this will increase the total amount of guaranties used and reduce EFSF’s lending capacity. This would limit the market risk and is consistent with the actual policy of the ECB.
- Keep the bonds as available for sale and sell the bonds back to the country, which could have a positive impact on its debt ratio if the transaction is done under par value.
- Use bonds for repos with commercial banks to support the liquidity management of the EFSF.