The European Financial Stabilisation Mechanism (EFSM)

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The European Financial Stabilisation Mechanism (EFSM) is a facility to provide loans to EU Member States in financial difficulty. It is financed by borrowing against the EU Budget (up to a total of €60bn); funds are then lent on to the countries concerned at an interest premium. The EFSM is not used independently, but forms part of a loans package, involving another EU facility (the European Financial Stabilisation Facility, or EFSF) and the IMF.

The UK is indirectly liable through its share in the EU Budget for loans made under the EFSM, and there has been some discussion about the process by which it became involved. The EFSM was originally agreed at an extraordinary meeting of the EU Economic and Financial Affairs Council on 9 May 2010, between the UK General Election and the formation of the Coalition Government. The then Chancellor consulted George Osborne and Vince Cable about the UK's involvement in the EFSM, although the content of these discussions is disputed. Agreement on the EFSM was made by qualified majority, and the UK could not have unilaterally opted-out of the mechanism.

Thus far, the EFSM has been used to secure €22.5bn of loans to Ireland and €26bn to Portugal (only €8.4bn of these funds have thus far been disbursed), representing a third of the international element of their loans packages in each case.

From 2013, it is expected that the EFSM and EFSF will be permanently replaced by a €500bn European Stability Mechanism. This will be financed by guarantees from eurozone countries only, so it will not involve any liability for the UK. Outstanding debt issued under the EFSF and EFSM will remain within these frameworks until it is paid.

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1.1 Background

On 9 May 2010 an extraordinary meeting of the Economic and Financial Affairs Council (ECOFIN) agreed to create a European Financial Stabilisation Mechanism (EFSM), as part of a comprehensive package of measures to help maintain financial stability in Europe. The meeting took place against the backdrop of considerable uncertainty about eurozone public finances, sparked by a sovereign debt crisis in Greece. In response to problems there, eurozone states had issued ad hoc bilateral loans to Greece to supplement assistance from the IMF. A key objective of the ECOFIN meeting was to calm market tensions by formalising arrangements for providing loans to beleaguered Member States. The outcome was the creation of two EU borrowing facilities, the €60bn EFSM and the €440bn European Financial Stabilisation Facility (EFSF).[1]

1.2 Legal basis

The stated legal basis for the provision of loans under the EFSM is Article 122(2) of the Treaty on the Functioning of the European Union (TFEU). This allows EU financial assistance to be granted to a Member State facing 'severe difficulties caused by natural disasters or exceptional occurrences beyond its control'. The 'exceptional occurrence' in this case is the international financial crisis, although doubts have been expressed about whether the debt crises of Member States have indeed been beyond their control. It has also been suggested that the EFSM conflicts with Article 125, which prohibits the EU and individual Member States from 'assum[ing] the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any

[1] Agreement on the European Central Bank's Securities Markets Programme was also reached at this meeting. The figures of €60bn and €440bn refer to the total initial stated lending capacity of the EFSM and EFSF respectively. In the case of the EFSF, the lending ceiling is likely to be somewhat lower than this.

Member State'.[2] Some commentators, however, have seen the complementarity between Articles 122 and 125 as justifying the sort of assistance provided by the EFSM:[3]

> Article 122(2) TFEU must be interpreted as a "counterweight" to the no bailout clause. The exclusion of co-responsibility does not automatically rule out assistance interventions in favour of Member States in difficulty. If that were the case, Article 122(2) would be meaningless.

1.3 Cross-party consensus?

The 9 May 2010 extraordinary meeting took place after the UK General Election, but before the formation of the Coalition Government. Thus, it was the then Chancellor of the Exchequer, Alistair Darling, who was in attendance when the EFSM was agreed.[4]

Before committing to participation in the EFSM, Alistair Darling consulted George Osborne and Vince Cable.[5] However, the content of these discussions is disputed. The Prime Minister has stated that Mr. Osborne objected to the decision:-[6]

> I believe that we should not have any liability for bailing out the eurozone, but given the current emergency arrangements, established under article 122, we do have such a liability.
>
> That decision was taken by the previous Government, and it is a decision to which my right hon. Friend the Chancellor specifically objected when it was taken by his predecessor after the election but before this Government took office.

Alistair Darling has disputed this interpretation:-[7]

> **Mr Alistair Darling (Edinburgh South West) (Lab):** Does the Prime Minister accept that when he referred to the discussions that took place last May on the eurozone fund he gave a somewhat incomplete account of my conversation with the now Chancellor? We did indeed agree that we should do everything we could to keep Britain out of the main part of the rescue fund, but in relation to the smaller element to which the Prime Minister refers, what we discussed was not voting against, but abstention, recognising that Britain could have been outvoted-that is exactly the same thing that the Chancellor of the Exchequer referred to when dealing with Ireland. So when the Prime Minister next refers to this issue, perhaps he would give the whole account, not a partial account, of what happened.
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> **The Prime Minister:** Fortunately, I have had a full discussion with the Chancellor about that issue and he was absolutely clear that it was something to which Britain should not agree; nor should we.

[2] See, for instance, the debate in European Committee B, 1 Feb 2011 (Financial Stabilisation Mechanism). There have also been legal challenges in the German Constitutional Court.

[3] Common Market Law Review 47(4), *Guest Editorial: the no-bailout clause and rescue packages, by Jean-Victor Louis*

[4] A full list of participants can be found in the Council Press Release on the meeting outcomes.

[5] See, for instance, FT *Cameron plays up need for Irish success*, 18 Nov 2010

[6] HC Deb 28 March 2011 c35

[7] HC Deb 28 March 2011 c39

An explanatory memorandum dated 15 July 2010 on the EFSM regulations, provided by the Treasury to the EU Scrutiny Committee and signed by Conservative Treasury Minister Justine Greening, suggests that cross-party consensus had indeed been gained:-[8]

> The Government regrets that the Scrutiny Committees did not have time to consider this document [the Council Regulation establishing a European Financial Stabilisation Mechanism] before it was agreed at Council. It should be noted that **whilst agreement on behalf of the UK was given by the previous administration, cross-party consensus had been gained**

2 The design of the EFSM

2.1 Financing

The EFSM provides a loans facility for any EU Member State[9] that is 'experiencing, or is seriously threatened with, a severe economic or financial disturbance caused by exceptional occurrences beyond its control'. The loans are financed by issuing bonds on the open market using the EU Budget as a guarantee (the European Commission is responsible for these operations); the maximum total borrowing under the EFSM is limited to €60bn.[10]

Any loans from the EFSM are envisaged in its regulations to 'be in the context of a joint EU/IMF (International Monetary Fund) support'; that is, the EFSM is not expected to be used independently, but will form part of a loans package, alongside the other EU facility (the EFSF) and the IMF. In Ireland's case, one-third of its loans package (€22.5bn) is being supplied via the EFSM, one-third from the IMF, a quarter from the EFSF and the remainder through bilateral loans.[11] In Portugal's case a third of the €78bn package (€26bn) will come from the EFSF, EFSM and IMF respectively.[12]

Thus far, the Commission has made two EFSM bond issues, of €5bn (5 Jan 2011) and €3.4bn (17 March 2011): both of these were to fund Ireland's loans package.[13] To support lending commitments to Portugal and Ireland in 2011, it is expected to make four further issues of €3-5bn each.

2.2 Conditions

To obtain assistance from the EFSM, Member States are required to submit a draft economic and financial programme to the Commission and ECOFIN. Decisions on assistance are then taken by the Council on the basis of a qualified majority vote, following a proposal from the Commission. The Council decision must contain:-[14]

- The procedures for assistance (amount, disbursement schedule etc.)

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8 HM Treasury Explanatory Memorandum to HC European Union Scrutiny Committee *Council Regulation Establishing an European Financial Stabilisation Mechanism*, 15 Jul 2010 (author's emboldening)

9 Including non-eurozone Members

10 Under separate arrangements, the EU is also authorised to borrow up to €50bn against the EU Budget to provide balance of payments assistance to Member States whose currency is not the euro. There is also a smaller (€600m) macro-financial assistance programme to provide financial assistance to non-Member States.

11 Ireland is also providing €17.5bn of funds from its own reserves (not included in these proportions).

12 Commission Memo 11/313

13 European Commission *European Financial Stabilisation Mechanism – Details on transactions*

14 A full description of the process involved can be found in the report of the EU Scrutiny Committee on the Council Regulation establishing the EFSM. The Regulation itself (9606/10) can be found here. OJ L 12 May 2010 p. 1-4

- The economic policy conditions attached to the loan
- An approval of the adjustment programme prepared to meet these conditions

The policy conditions are contained in a Memorandum of Understanding between the Member State and the Commission; it is the Commission's responsibility to determine compliance with these during the term of the loan. In practice, the contents of the Memorandum, together with the procedures for assistance would be the product of negotiation between the Commission, the IMF, the ECB and the Member State concerned.

2.3 Interest rate

The interest rate charged on EFSM borrowing is negotiated on a case-by-case basis, but will in general be equal to the cost the EFSM faces on the open market, plus a premium. In Ireland's case, the borrowing cost for the first tranche of EFSM support (€5bn) was 2.59% and the agreed premium was 2.925%, giving an interest rate of 5.51%. The interest premium goes back to the EU Budget and is distributed to the EU's 27 member states at the end of each financial year. The size of the premium has been criticised by Ireland's finance minister for jeopardising Ireland's recovery and hence the eurozone's future:-[15]

> There's one view that it is only about Portugal, Greece and Ireland, but it's really about the eurozone as a whole... you enhance the possibility of the success of a [bailout] programme if you reduce the price [of funds]. Europe needs a win as much as Ireland and Greece and Portugal need a win. . . The failure of any programme would be very bad for the eurozone, the eurozone is in crisis every three weeks.

3 Liability to the UK arising from the EFSM

The UK faces an indirect contingent liability through its participation in the EFSM, equivalent to its share in the EU Budget. In other words, the cost of default on EFSM loans will be borne by the EU Budget: if this creates a shortfall in revenue, it will be made up by further Budget contributions from Member States. Based on its 2011 Budget share, the UK would contribute 12.5% to these costs if they arose.

The maximum liability the UK can incur through the EFSM is thus equal to 12.5% of €60bn, or €7.5bn (£6.6bn).[16] For this to occur, the EFSM ceiling of €60bn would have to be reached, and all borrowing countries would have to default on 100% of their loans. The recent history of sovereign debt restructuring suggests the latter event is extremely unlikely.[17] Based on borrowing up to 19 May 2011, the UK's liability is €1.2bn (£1.1bn).

Unlike the IMF, loans under the EFSM (and the EFSF) rank *pari passu* with private creditors; that is, in the event of default, payment of EFSM loans does not take particular precedence over payment of other holders of sovereign debt. The rationale for this is that too many creditors with 'preferred' status (like the IMF) can crowd out private investors wishing to purchase sovereign debt.[18]

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[15] The Irish Independent *Noonan warns of risk to euro from harsh bailout rates*, 18 May 2011

[16] Exchange rates are April monthly average spot rate (Bank of England Series XUMAERS)

[17] See, for instance *Haircuts: Estimating investor losses in sovereign debt restructurings 1998-2005* (IMF Working Paper WP/05/137) and *Sovereign Defaults: the price of haircuts* (draft paper by Cruces and Trebesch)

[18] This is because the larger the proportion of debt held by preferred creditors, the greater is the burden of any default on the remaining 'ordinary' creditors.

4 The future of the EFSM

From 2013, it is expected that the two existing eurozone facilities (the EFSM and EFSF) will be replaced by a permanent mechanism with a lending capacity of €500bn, known as the European Stability Mechanism (ESM). Importantly, the ESM will not involve any financial contributions or guarantees from Member States whose currency is not the euro;[19] thus, the UK will not incur any liability from loans made under this mechanism.

Since there is no legal basis for a permanent fund of this sort, its creation will require an amendment of the Treaty on the Functioning of the European Union. It is expected that the national approval procedures necessary for this will be completed by the end of 2012, so that the ESM enters force on 1 January 2013 and replaces the EFSF and the EFSM from June 2013. For more details on this process, see Library Standard Note SN/IA/5812 *Amending the EU Treaty: the European Stability Mechanism*.

Only new loans from 2013 will take place under the ESM: any outstanding debt under the EFSF and EFSM will remain within these frameworks until it is paid.

[19] This was established at the Council meeting of 16-17 Dec 2010, following the draft decision to amend the TFEU (see Annex I to the conclusions)