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Could any country risk a eurozone bail-out?

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By Wolfgang Münchau

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I spent the best part of last week trying to figure out the mechanics of the **eurozone's €440bn bail-out fund**. The exercise reminded me of my research into the credit market, with its promises of credit enhancement and other logic-defying concepts. The European Financial Stability Facility is in many respects like a gigantic collateralised debt obligation and uses much of the machinery of modern finance.

But there is one important difference. In the days of the credit bubble, there was some ultra-cheap credit at the other end of a long CDO cash flow chain – subprime mortgages, for example. In the case of the EFSF, the situation could not be more different. **Greece** was very lucky to get into trouble before the EFSF was set up and was able to obtain its first €20bn loan tranche at an interest rate of about 5 per cent. This was calculated on the basis of a cheap money market rate, plus a small administration fee and a lending margin.

I cannot see how the EFSF can offer similarly attractive rates. We are not yet in a position where it would make sense for any country, not even Ireland or Portugal, to borrow from the EFSF.

When that changes, what happens then? My numbers are extremely rough, with lots of rounding errors – and probably other errors as well. But they give an approximate order of magnitude. The EFSF last week **obtained a triple A rating**, which will help it raise cash in the bond markets at good rates. To obtain the rating, the EFSF had to agree to an over-collateralisation. In this specific case it means that the EFSF needs to obtain government guarantees of €1.2bn for each €1bn in bonds it wants to issue.

EDITOR'S CHOICE

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Once it raises the funds, the EFSF will not be able to lend on all of the €1bn, but only the portion backed by the collateral of those countries that themselves have a triple A rating. That reduces the amount available to the borrower to €700m. What about the €300m gap? This is where it gets really complicated, and I am going to spare you the gory detail. A substantial part of this gap serves as a cash buffer, ready to be used if the borrower defaults.

So what is the interest rate? The borrower essentially pays the sum of the EFSF's funding costs, an administration margin and a lending margin. The triple A rating should ensure that the funding costs for the EFSF are not extremely high, but I doubt that the EFSF could obtain a funding rate as cheap as that available to the European Investment Bank. The EFSF is not a sovereign investment bank, but a rather complicated and not very transparent structure, right out of the textbook of modern finance. One of the reasons the EIB was not eager to run the bail-out fund itself was precisely because it did not want its own credit rating tainted. I would thus assume that the EFSF's funding costs exceed those of the EIB by a good margin.

Let us assume the EFSF raises the €1bn at an interest rate of 4 per cent. With administration charges and lending margins of 350 basis points, the effective interest rate to the borrower would be 7.5 per cent. What about the cash buffer? The EFSF must reinvest the buffer in the best triple A rated securities in the market. So if its own funding costs are 4 per cent, and if it invests the cash buffer into German bonds at a hypothetical yield of 2 per cent, there is a loss of 2 percentage points. This also has to be paid for by the borrower. This comes on top of the 7.5 per cent interest. It is not all that hard to conceive of a situation in which the borrower would end up paying a total interest rate of 8 per cent. Of course, the actual interest rates will depend on

several factors: the EFSF's own funding costs, the size of the lending margin, the gap between funding costs and reinvestment proceeds and probably several more factors. But no matter how you twist this, it is hard to construct a cheap loan out of this.

Three issues arise from this set-up. The first is that no country would ever want to borrow from the EFSF, unless it was absolutely unavoidable. The typical situation where an EFSF loan would be useful would be a case of egregious market failure. If the borrower is insolvent, the EFSF cannot help.

The second is that the overall amount for lending is significantly reduced. The headline figure of €440bn is misleading. First, one should deduct the shares of Greece, Ireland and Portugal, then the effect of the over-collateralisation and then the share of countries without a triple A rating. A more realistic ceiling is thus €250bn on my calculations, and that is still probably way too high. This may be enough to help a couple of small countries but would be inadequate if a large country should get into trouble.

And finally, the whole edifice would collapse if France was downgraded. This is a non-zero probability event, to put it mildly. Without France, Germany would be the sole pillar of the system, a role Germany would probably not accept.

Having looked at this in some detail, I find it hard to conceive of a situation where a country would both borrow from the EFSF and live happily ever after.

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Lady Economist | September 28 2:38am | Permalink Report

Wolfgang would it ever be possible to see the research and data you have done on the EFSF,great essay to.

The Slog | September 27 9:46pm | Permalink Report

The huge dollops of common sense served up by Herr Munchau offer a guiding light through a dark sea of EU obfuscation.
One is reminded of the Groucho Marx line about not wanting to be a member of any club that would have one as a member. But chiefly, the abiding lesson of this piece is that cheap loans are only available to those who can afford them. As the Japanese say, 'Bank give you umbrella when sun shining'.
Brilliant piece.
http://nbyslog.blo...you-zirped-by.html

dump | September 27 2:59pm | Permalink Report

You try to save the leg but time comes when you need to cut it to save your life.

Greece is the most obvious cheater and thief that needs to be thrown out of EUZONE, maybe leave them in EU, but without voting rights for 10 years.

Southern European | September 27 1:56pm | Permalink Report

The spread is 300 bps for 3y loan and 400 bps for longer maturities. 50bps is the flat upfront arrangement fee (one off). I doubt that the EFSF doesn't manage to finance itself at Mid Swaps + 10 or something like that (supra nationals AAAs do it every day), so a 5y loans would run at around 6%, slightly above what Ireland and Portugal are still paying. Yes, it is a last resource for sovereign issuers, not the first option.

Comment9 | September 27 12:37pm | Permalink Report

Interesting analysis. I;n not an expert in sovereign debt but 350bps margin seems high...especially if EFSF's mandate is likely non-profit.

Bengt Larsson | September 27 11:07am | Permalink Report

I don't know about the rest, but the 20% over-collateralization was there since the beginning. It was there to cover for the fact that a state that needed to draw on the facility couldn't contribute at the same time. So that part wasn't added to get a rating.

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a greek | September 27 8:06am | Permalink Report

To US pessimist:

As far as numbers are concerned I totally agree with you.

However, we should not forget that there always is a source of very cheap money, called .... Quantitative Easing, which could help the current arrangement go on for a long time, even scrape through, provided some tidying up is done in all parts of Europe and continues to be done for the foreseeable future.

Up to know Frankfurt has not resorted to that, mainly because of the ferocious German resistance to any inflationary policy which they tend to equate with the wild inflation at the time of Weimar Republic, something that seems to have scarred the Teutonic psyche much more than the loss of two world wars in a half century.

Printing money as a way out of an economic mess is something the UK has done, and might do again soon; even Mighty America has not shied from it. Under the circumstances, the Eurozone might decide to go this way too.

A couple of units of Inflation could ease the pain on the guilty without burdening too much the innocent. And of course it would certainly spread the unavoidable losses much wider and help avoid major upheavals and schisms.

Under normal circumstances, nobody in his right mind would be an advocate of inflationary politics. Now, it seems it is the lesser evil, the less chaotic way out.

But, of course, it will be a major political decision. Actually it will be THE political decision of the first half of the 21st Century of Europe. Either Capital will suffer some pain too, or all the cost of the mess wild spending politicians created, will strangle the South as its first victim, and then eventually the malaise will creep North with devastating unemployment, rampant resurrections of Nationalism and probable collapse of the Union of Europe.

In other words, no matter how irresponsible the politicians have proven so far, it is still up to them to decide whether they will opt for a mild retrench of everybody in Europe, or will insist on the annihilation of the more guilty in which case I agree with you that all hell will break loose.

US Pessimist | September 27 12:40am | Permalink Report

"This may be enough to help a couple of small countries but would be inadequate if a large country should get into trouble. "

True. If Spain or Italy starts going down, it all unravels.

Portugal cannot keep swapping low interest rates for high interest rates and not cut spending. What is it?? 6.24% for the 10 year? 4% more than the Germans. Is that sustainable? 9.4% to 7.3% is the goal for deficit reduction and that's a long shot! I don't have the exact figures at my fingertips so forgive me if I'm off a little, but they were going the wrong direction. I thought they were being forced to control spending? And another salient question: how much can the ECB shovel out and be solvent? They can maybe handle the PIGS, but add Italy and it becomes a rather dicey situation doesn't it?
And do you honestly think Greece can meet their goals and come out of this 150% debt to GDP and pay their bond holders? What a joke.

The eurozone arrangement will be shaken to its very core in the next year or so. Greece 2.0 is just starting to heat up. I am shorting the euro and shorting anythng relating to the collapse of the eurozone. I'm betting in a thousand different ways against the southern periphery. We'll see how I do.

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